

Market Commentary

The last thing most investors would have expected following February's late-month swoon is that the U.S. equity market would be making new yearly highs fewer than sixty days later. But that is exactly what has happened.

TOTAL RETURNS

	Apr	YTD	Memo Item 5/5/06 - 4/30/07
S&P 500 Index	+4.43%	+5.10%	+13.89%
Dow Industrials	+5.86%	+5.52%	+15.42%
Nasdaq Composite Index	+4.30%	+4.76%	+8.53%
S&P Mid-Cap 400 Index	+3.04%	+9.02%	+8.28%
Russell 2000 Index	+1.80%	+3.78%	+5.43%
Dow Jones Wilshire 5000 Index	+4.01%	+5.46%	+13.02%
S&P 100 Index	+4.85%	+3.74%	+15.31%
Russell 1000 Growth Index	+4.71%	+5.95%	+11.07%
Russell 1000 Value Index	+3.70%	+4.98%	+16.64%

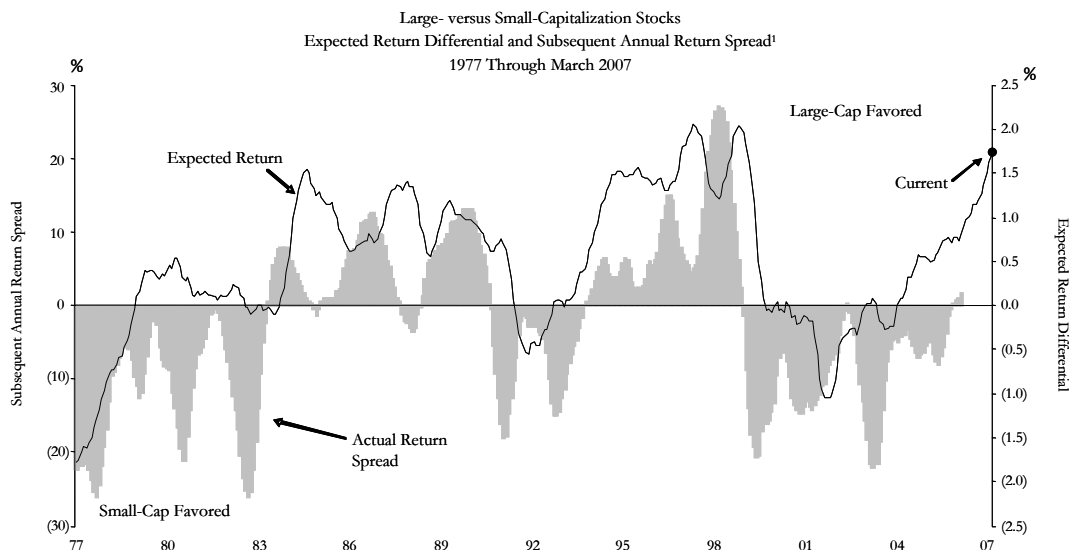
Sources: Bloomberg, Wilshire, Russell

April's returns were strong across the board, but were especially robust in the large- and mega-cap-dominated indices (the S&P 500, the S&P 100 and the Dow Industrials). Mega caps reasserted themselves in April after a period of sub-par performance early in the year. The S&P 100 Index (our mega-cap proxy) is still the worst performing major market index year-to-date, but is beginning to close the performance gap.

Lengthening the performance horizon a bit, the recent dominance of mega caps becomes clear. (Please see memo item in table.) Since the market's interim peak in early May 2006, the Dow Industrials and S&P 100 Index have outperformed the S&P Mid-Cap 400 Index by a factor of almost two, and bettered the Russell 2000 Index's return by a factor of nearly three.

It makes sense to us that the superior performance of large and mega stocks over small and mid caps would continue. The chart below, provided to us courtesy of Empirical Research Partners, shows that large-cap stocks now enjoy a statistically significant 175 basis point expected return advantage over small-cap stocks, just shy of a 30-year high. The last time expected returns were this heavily tilted in favor of large-cap stocks was the mid-1990s, from whence large caps went on a half-decade run of significant outperformance. Could we be setting up for the same kind of large-cap outperformance over the next five years? We can't know for sure, but we think the relative valuation data now strongly supports that view.

Within the large-cap universe, we believe mega caps could be an especially good place to look for ideas. Not only does the average mega stock have superior financial strength, return on equity and dividend yield compared to the average large-, mid- and small-cap stock, but the sector's relative earnings growth is improving as well, as the economy slows. According to Empirical Research Partners, whereas the largest 100 stocks had earnings growth rates that trailed other large caps from 2002 to 2006, in the first quarter of 2007, the mega-cap group's average earnings growth rate was faster. Importantly, the fact that the mega-cap sector has begun to outperform suggests to us that investors are beginning to appreciate the sector's virtues.



¹ Large-capitalization stocks are the largest 750 stocks by market capitalization and small-capitalization stocks are the next 2,000. Data are capitalization-weighted and smoothed on a trailing six-month basis.

Source: Michael L. Goldstein, Empirical Research Partners, May 2007

The U.S. economy continued to slow in the early months of 2007. Reported first quarter real GDP growth of 1.3% was lower than most expected and probably overstates the weakness in the economy. Final domestic demand grew at 2.0%, the upper end of the 1.6% to 2.0% range that it has tracked over the last four quarters. Residential investment fell for the sixth consecutive quarter, down at a 17% annual rate in the first three months of 2007, knocking a full percentage point off GDP growth. Auto sales were also a drag on growth, as were inventory de-stocking and trade. Exports fell 1.2%, while imports advanced 2.3%, reducing GDP by 0.5 points.

We obviously cannot know for sure, but the first quarter of 2007 could mark the low point for GDP growth in what we continue to believe is a mid-cycle slowdown. Inventory de-stocking appears to be near an end and should no longer be a drag on GDP as the year progresses. The worst of the housing slowdown may also have passed as well. This sector may continue to be a drag on GDP growth for a few more quarters, but its negative impact will likely diminish, in our view. Another support for U.S. GDP growth will likely be more rapid growth overseas. This likelihood combined with year-to-date weakness in the dollar should boost U.S. exports and discourage imports, perhaps enough to switch trade from a detractor to a contributor to GDP growth.

As long as consumer incomes and employment levels remain healthy, as we expect they will, consumer spending should continue to chug along, albeit at a moderately slower pace due to the reduced stimulus from mortgage equity withdrawals. Overall, we think it is reasonable to expect GDP growth in the range of 2% in the second quarter of 2007, accelerating to 2.5% to 3.0% in the back half of the year.

Corporate profit growth in the first quarter is coming in surprisingly strong considering the slowdown in GDP growth. At the start of 2007, analysts were expecting first-quarter earnings growth for the S&P 500 Index of 8.7%, according to Thomson Financial. By early April, expectations had dropped to only 3.3% growth. The diminution in analyst expectations was probably caused by a disappointing February 2007 pre-announcement season, during which an unusually large number of companies signaled they would report below-consensus results. In aggregate, analysts' worries are not being realized. Through Monday, April 30, 328 of the S&P 500 companies (65.6%) had reported aggregate earnings growth of 8.2%, with 67.4% exceeding expectations, and only 21.3% missing estimates.

If, as seems likely to us, economic growth bottoms out in the first or second quarter of 2007 and begins to re-accelerate in the second half of the year, investors may begin to wonder what the Federal Reserve's response to such a scenario might be. Would the Fed feel compelled to begin raising rates again, or would it stand pat? The answer to this question, as always, is: It depends. If the Fed believes that inflation is under control, we see no reason why they would want to impede a re-acceleration in GDP growth. If not, then we would need to worry about further Fed tightening.

But what constitutes inflation being under control as far as the Fed is concerned? At first, the answer seems obvious. The Fed's stated "comfort zone" for their favorite inflation measure—the chain-weighted rate of increase in personal consumption expenditures, excluding food and energy—is 1% to 2%. They've said this many times, but is it really true? The Fed certainly wants the market to believe it's true, but what do FOMC members themselves believe? Former Fed governor Lyle Gramley suggested in a piece several months ago that the Fed's "real" comfort zone is not actually 1% to 2%, but probably more like 1.5% to 2.5%. His reasoning—which we find persuasive—is that the last time the inflation rate got to the low end of the Fed's supposed comfort zone in 2001, the FOMC seemed anything but "comfortable." In fact, both their actions and words suggested that Fed officials were petrified by the specter of low inflation morphing into a 1930s style deflation. To stave off this possibility, the Fed aggressively lowered the funds rate to 1% and left it there for a year. Ben Bernanke himself said that if necessary, the Fed could drop money from helicopters to restore liquidity to the system.

When you think about it, why shouldn't the Fed's inflation comfort zone be 1.5% to 2.5% (or even 2% to 3%) rather than 1% to 2%? Inflation has averaged just over 3% for the last 80 years in the U.S. and the economy and the equity market have done fine. Moreover, the inflation rate implied by the pricing of 5-year and 10-year TIPS (Treasury inflation protection securities) is about 2.5%, and market participants do not seem overly concerned about the prospect of inflation at that level.

As the foregoing should make clear, the fact that core inflation is currently running slightly above the Fed's supposed 1% to 2% comfort zone does not bother us all that much. Importantly, we think it doesn't bother the Fed much either. They just have to keep saying that it does to maintain their inflation-fighting credentials. If the Fed can succeed in subtly moving the target inflation rate range from 1%-2% to 1.5%-2.5% without spooking the market, inflation could become a non-issue for investors. Even if the Fed can't move the bull's-eye, the latest figures on wage inflation suggest that core inflation may drop back into the Fed's existing comfort zone in the next few months anyway.

Outlook

Surprise! Surprise! We remain bullish on the U.S. equity market. Up to now, that has been the correct stance to have taken. We think it remains so. Hopefully we will be smart enough or alert enough to figure out when it is no longer correct to be bullish.

Actually, it is almost scary how good the market looks to us. If everyone were as optimistic as we are, we'd be worried, but as far as we can tell, they're not. In fact, we see a lot of evidence that investors in general are still skeptical.

Mutual fund investors certainly don't seem to be optimistic, at least not about the U.S. equity market. According to data from the Investment Company Institute, domestic mutual funds experienced net outflows in seven of the last eight months of 2006—flows were marginally positive in October—recording total net outflows of \$28.8 billion. Over the same period, mutual fund investors

pumped \$69.4 billion into international funds. Mutual fund buyers showed a bit more enthusiasm for domestic equities in early 2007, investing a net total \$17.8 billion through February. Net flows fell off significantly in March following the market's late February downdraft, suggesting that investors are continuing to "head for the hills" at the first sign of market weakness.

Further evidence that investors remain skeptical of the market's advance is the exceptionally high level of short-selling taking place. Steve Leuthold reports in his April 2007 "Perception for the Professional" that the short-interest ratio on the NYSE is 2.76 standard deviations above its long-term norm. In the past, readings above two standard deviations have been an indication that investors are too pessimistic and, therefore, have been a reliable buy signal.

It is most unusual to see short interest rising in a rising market. Normally, investors get more optimistic as the market rises. At the top, there is no one left to buy, because everyone is already fully invested. That certainly doesn't seem to be the case in this bull market. Investors have been dragged along kicking and screaming this time around. In contrast to prior bull markets since 1960, the bull market that began in October 2002 has been driven entirely by earnings growth.

According to data compiled by Omega Advisors, Inc., the ten S&P 500 bull markets since October 1960 (excluding the current one) have lasted an average of 37.5 months and generated average appreciation of 102%—31% of the advance attributable to earnings growth and 69% attributable to P/E multiple expansion. The bull born in October 2002 is now 54 months old and is up 90.8% from its trough through April 30, 2007—with 104% of the advance attributable to earnings growth and -4% attributable to P/E expansion. In other words, the market's P/E has actually contracted since 2002.

We think 2007 could be the year that investors begin to see some P/E multiple expansion. The only question in our minds is how much. At a minimum, we see earnings growth for the S&P 500 Index in the range of 6% to 7% and dividends of about 2% being augmented by P/E expansion of 4% to 7%, implying a 0.5 to 1.0 point increase in the market's P/E from 15.9 (based in 2007 estimates) to 16.5 to 17.0 times. That scenario would produce total returns for the S&P 500 Index of 12% to 16%, which we think is a realistic expectation for the full year.

Our bullish case for the U.S. equity market continues to be the same as it has been, and can be summarized as follows: (1) The economy is undergoing a mid-cycle slowdown (similar to those of 1985 and 1995) that will not morph into recession. (2) Inflation—a lagging indicator—will moderate as the year progresses. (3) Monetary policy will continue to be neutral to accommodative. (4) Corporate profit growth will moderate with the slowing economy, but remain healthy. (5) Corporations are continuing to generate huge amounts of free cash flow and using it in largely shareholder-friendly ways—raising dividends faster than earnings, buying back stock in record amounts and making (in general) sensible judgments with respect to acquisitions and capital spending. (6) Valuations are reasonable both in absolute terms and especially in relationship to bonds, where a significant disconnect between the cost of debt and

returns available in the equity market is spurring a huge—and sensible—wave of merger and acquisition and private equity transactions. (7) Despite the favorable outlook, the public does not seem particularly interested in the domestic equity market, suggesting to us that opportunities for gain have not been fully recognized or exploited.

In terms of developments that could derail our optimistic view, any number of things could go wrong. We won't note all of them here because you can read about them in lots of other places. We would mention three issues—one of which could impact the U.S. market this year, the second of which is probably more of a 2008 worry, and the last of which is a longer-term concern.

The first area of concern is the possibility that a bubble is developing in the Shanghai market for Chinese stocks. The Shanghai market is up between 3.5 and 4 times since 2004. It was up 130% in 2006 and is up a further 44% this year. When the Shanghai market dropped 9% on February 27, other stock markets around the world—including the U.S. market—dropped sharply in sympathy. A further rise and subsequent collapse of the Shanghai market could again trigger declines in other world markets, particularly if it were to be accompanied by a material slowing of the Chinese economy.

Massive participation by Chinese retail investors who have relatively limited investment alternatives has driven the Shanghai market to near-bubble valuation levels of 42 times 2006 profits and 30 times estimates for 2007. In addition, because the market is closed to foreigners, the Shanghai shares of many Chinese companies trade at substantial premiums—in a number of cases as much as 100%—to the same companies' Hong Kong traded shares. This situation bears watching, in our view.

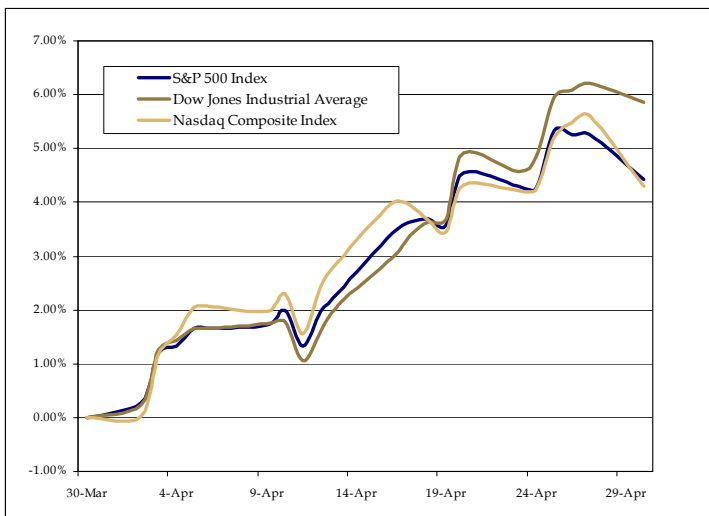
Another question that the equity market will face later this year that will loom much larger next year is: What will the priorities be of the next presidential administration—one which is increasingly likely to be Democratic? It is at least conceivable that an anti-Bush backlash could put a Democrat in the White House and sizable Democratic majorities in both the House and Senate that could set the stage for higher taxes on dividends and capital gains in 2010, or possibly sooner. It also may raise the odds of protectionist legislation being enacted. The market would react negatively to either of these developments, in our view.

The big long-term problem facing the economy and the stock market is the approaching retirement of the baby-boom generation with its attendant massive increases in spending for social security, Medicare and Medicaid. When the market will begin to discount the scope of this problem is difficult to say, but probably not any time soon. For now, and for the immediate future, we believe the important thing to do is to stay sensibly and vigilantly bullish.

As always, we thank you for your support and welcome your comments.

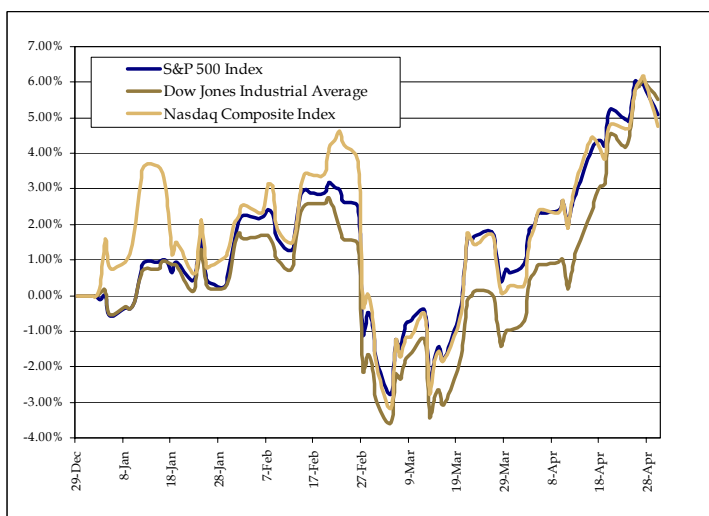
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Major Indices April Performance



Sources: Bloomberg and FactSet

Major Indices YTD Performance



Sources: Bloomberg and FactSet

Monthly U.S. Market Update (Total Returns)

Sector Index Name	April	YTD
<i>Broad Market Indices</i>		
S&P 500	4.43	5.10
Dow Jones	5.86	5.52
Russell 1000	4.20	5.47
NASDAQ	4.30	4.76
Dow Jones Wilshire 5000	4.01	5.46
Russell 2000	1.80	3.78
Russell 1000 Growth	4.71	5.95
Russell 1000 Value	3.70	4.98
<i>S&P 500 Sector Indices</i>		
S&P 500 Consumer Discretionary	2.52	1.76
S&P 500 Consumer Staples	3.34	5.58
S&P 500 Energy	5.22	7.47
S&P 500 Financials	4.14	1.17
S&P 500 Health Care	7.18	8.29
S&P 500 Industrials	4.74	5.89
S&P 500 Information Technology	5.41	4.42
S&P 500 Materials	1.98	11.11
S&P 500 Telecomm Services	0.79	8.13
S&P 500 Utilities	4.21	13.89

Sources: Bloomberg, FactSet, Russell, Wilshire

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