

Market Commentary

After more than seven years, the S&P 500 Index finally closed at a new all-time high on the last day of the month, thus providing further confirmation in the minds of many market technicians that the bull market that began in October 2002 is alive and well. New all-time highs are not merely a U.S. phenomenon. Most major market indices around the world have been making new highs regularly over the last several months. Domestically, the only major index not to make a new all-time high this year is the tech-heavy Nasdaq Composite, which was still over 48% below its 2000 peak of 5048.62 through month end. In our view, it will be a good while before we see new highs in the Nasdaq Composite, no knock on the companies comprising that index, but rather a recognition of the truly otherworldly nature of its valuation level in 2000.

TOTAL RETURNS

	<u>May</u>	<u>QTD</u>	<u>YTD</u>
S&P 500 Index	+3.49%	+8.07%	+8.77%
Dow Industrials	+4.62%	+10.76%	+10.40%
Nasdaq Composite Index	+3.25%	+7.70%	+8.17%
S&P Mid-Cap 400 Index	+5.01%	+8.20%	+14.48%
Russell 2000 Index	+4.10%	+5.97%	+8.03%
Dow Jones Wilshire 5000 Index	+3.66%	+7.81%	+9.32%
S&P 100 Index	+3.50%	+8.52%	+7.37%
Russell 1000 Growth Index	+3.60%	+8.47%	+9.76%
Russell 1000 Value Index	+3.61%	+7.44%	+8.77%

Sources: Bloomberg, Wilshire, Russell

As noted in *USA Today* (6/1/07), it took the S&P 500 Index 57 months to reach a new all-time high, three times longer than the average of the previous ten bull markets dating back to 1942. In our view, the market's average performance following those prior ten new all-time highs may provide a useful road map for what to expect from the market over the balance of the year. Since 1942, after recording a new all-time high, the S&P 500 was, on average, 0.7% lower in one month, 2.1% higher in three months, and 5.6% higher in six months. A further gain of 5% to 6% in the back half of 2007 would—with dividends—put the S&P 500 up about 15% or 16% for the full year—in line with our prior expectations. We think that's reasonable but, of course, not guaranteed.

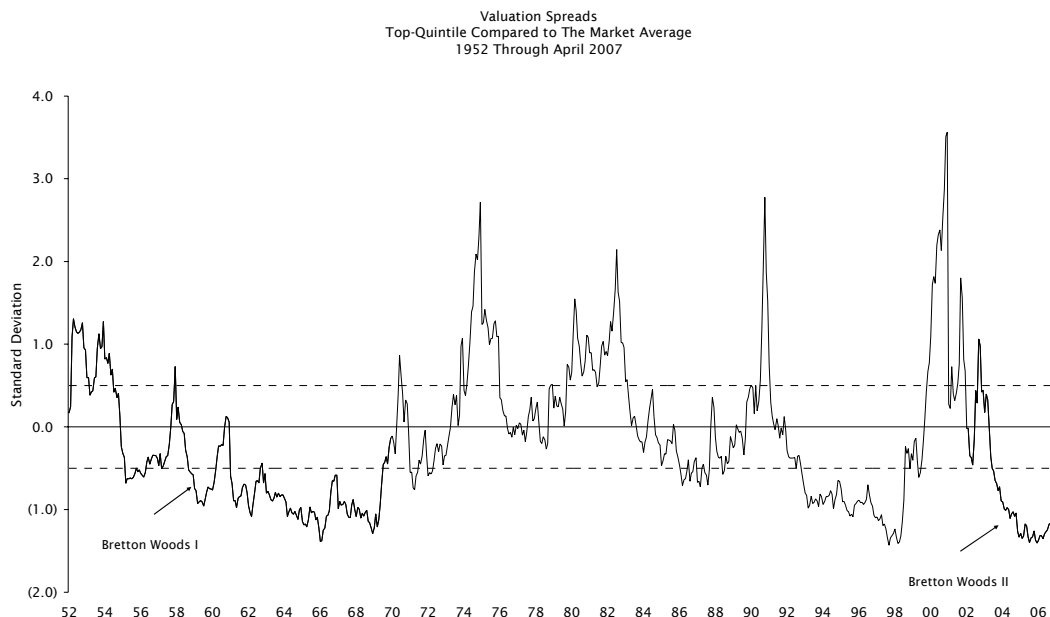
It would surprise us greatly if the market got through the balance of 2007 without a meaningful correction, however.

In fact, we think the market is vulnerable in the short term to a pullback on the order of 5% for a number of reasons that we'll discuss more fully in the Outlook section. Suffice it to say here that, in our view, the next 5% advance in the S&P 500 could as easily come via a -5%/+10% pattern, as from a straight shot to +5%.

Twenty years ago when I was on the brokerage side of Legg Mason and shared monthly client letter writing responsibilities with Ernie Kiehne and Bill Miller, I wrote a celebratory piece on the 20<sup>th</sup> anniversary of the Summer of Love (1967). My graying hair and the approach of my 60<sup>th</sup> birthday attest to the fact that June 2007 marks the 40<sup>th</sup> anniversary of Summer 1967, when those going to San Francisco were advised by Scott McKenzie to "wear some flowers in your hair." As an aside, Bill Miller has noted elsewhere, and I firmly agree, that while he and I are getting—and looking—older, Ernie looks exactly the same as he did 20 years ago. He was 69 then and 89 now and still going strong.

Early June 2007 marks the 40<sup>th</sup> anniversary of two other significant events—the release on June 1, 1967 (in the UK) and June 3 (in the US) of the Beatles' *Sgt. Pepper's Lonely Hearts Club Band*, and—on a more sober note—the Six-Days' Arab-Israeli War, which began on June 5, 1967. *SPLHCB*, the Beatles' eighth album, is often cited, according to Wikipedia, as "the most influential album of all time by prominent critics and publications, ranking number 1 on *Rolling Stone's The 500 Greatest Albums of All Time* in 2003." The territory Israel acquired as a result of the Six-Days' War—the Golan Heights, eastern Jerusalem, the Gaza Strip, the Sinai Peninsula and the West Bank—remains a bone of contention in the Middle East region to this day.

Another thing that has had me thinking about the late 1960s recently is the chart on the next page showing the valuation spreads of the top-quintile of stocks (the cheapest 20%) compared to the market average from 1952 through April 2007. As is true of many of the best charts we see depicting the character of the market, it comes from Michael Goldstein of Empirical Research Partners.



Source: Michael Goldstein, Empirical Research Partners, May 2007

As is visually apparent from the chart, valuation spreads are about as compressed now as they have been at any time since 1952. Spreads were similarly—but not as consistently—compressed for much of the 1960s and in the mid-to-late 1990s. Goldstein’s chart raises a couple of interesting questions, in our view. First, what is the investment significance of spread compression? And second, can we learn anything about the current market environment from analyzing past periods of valuation spread compression? I believe the answer to the second question is yes, but before we get to that, we need to answer the first.

Based on visual inspection of the chart and my own market experience, valuation spreads tend to be widest at, or near, major market bottoms—1974, 1982, 1991 and 2002. These are normally periods of high stress in the market, where most stocks are going down, but some sectors are getting absolutely killed. As this happens, the spread between the very cheapest stocks in the market and the average stock tends to widen out. In these environments, the best investment strategy—though often the most painful if you’re early—is to load up on the very cheapest stocks (which are usually concentrated in a few sectors) and wait. If you don’t get fired by your clients for owning really scary stocks first, you normally make a lot of money as the market turns and valuation spreads begin to narrow.

In contrast, market environments where valuation spreads are compressed tend to occur after the market has been doing well for a period of time. As the market

advances, pockets of severe undervaluation get identified and exploited. Ultimately, this process of identification and exploitation leads to a market, such as we have today, where everything is priced the same. Obviously, that last statement is a bit of an exaggeration, but the spirit of the comment is true, in my judgment. In many industries and sectors today, we see little valuation discrimination between the very best companies and the merely average. An important reason for this, in our opinion, is that private equity buyers tend to target the improvable companies in an industry, not the best run, and the market has figured this out. But the inter-sector valuation spreads are also quite compressed, suggesting that the market is not discriminating as much as it normally does between good and bad businesses (as measured by their respective returns on invested capital). In market environments where valuation spreads are compressed, it would seem to make sense to focus on high-quality, high-return businesses that can grow, because you don’t have to pay a premium—or much of one—for them. In short, it seems to us that it should pay to focus on growth stocks. That proved to be true in the mid-to-late 1990s, as well as the 1960s.

Turning to our second question, we think we may be able to gain insights into the current market by comparing it to the market of the late 1960s. Interestingly, market valuations, long-term interest rates and inflation levels were quite similar in both periods. According to data from ISI Group, 10-year U.S. Treasuries yielded an average of 4.67% in the decade of the 1960s, nearly the same as the 4.72% they have averaged so far in the 2000s. We do not have good valuation data on the S&P 500 Index back into

the 1960s, but Value Line data shows that the Dow Industrials traded at 16.3 times earnings on average in 1967, while the CPI averaged 2.8% that year. Again, these figures are strikingly similar to today's valuation and inflation levels. As of May 31, 2007, the S&P 500 traded at 16.4 times 2007 consensus estimates (bottom-up, cap-weighted) and inflation has been running in the mid-to-high 2% range, depending on the measure.

Geopolitically, the late 1960s and today have many similarities. For one, the Middle East region is still in turmoil. Also, today, as then, the U.S. is embroiled in an unpopular war—Vietnam (then) and Iraq (now)—both of which were entered in a similarly dissembling and naïve fashion, without full appreciation for their ultimate duration or ramifications. In the 1960s, then President Johnson's insistence upon prosecuting the war in Asia while funding the Great Society at home (Guns & Butter) led ultimately to an upsurge in inflation and the 1971 abandonment (by President Nixon) of the U.S. dollar's convertibility into gold, the linchpin of the Bretton Woods Agreement that had provided the framework for international monetary relations since July 1944.

A number of market observers, including Empirical's Michael Goldstein, have referred to the symbiotic relationship between the U.S. and China in recent years as Bretton Woods II, in recognition of the stabilizing and salutary effect the relationship has had on worldwide economic growth and world trade. The U.S. consumer's virtually insatiable appetite for low-cost consumer goods has powered China's export-driven economy to low-double-digit growth rates in GDP and rapid employment gains. In exchange, the Chinese have underwritten the U.S. consumer's shopping spree with low-cost vendor financing by recycling their U.S. dollar trade surplus into U.S. Treasury securities, helping to hold down long-term interest rates and, thus, indirectly stimulating the U.S. economy. With China's largely U.S. dollar-denominated currency reserves having grown to over \$1 trillion, the worry in some circles is that their willingness to continue recycling their dollar reserves into U.S. Treasuries may wane, with potentially negative consequences for U.S. interest rates.

At this point, it is not clear to us how long the so-called Bretton Woods II regime will last, and what—if anything—might undermine it. With the benefit of history, we know that the bull market of the 1960s was followed by the bear market of 1973-1974. We also know that periods of valuation compression don't last forever, but they can—as the 1960s prove—last for the better part of a decade. What we don't know is how long the current period of

relative market stability and spread compression will last, or how it will end. We raise the issue here because we believe the possibility that this era of stability could end badly is the chief risk facing the market over the next several years. In our opinion, failure of the U.S. political process to properly prioritize funding for our external and internal security needs, the maintenance requirements of our aging infrastructure and the galloping cost of the "Big Three" social programs—Social Security, Medicare and Medicaid—could have serious negative consequences for the U.S. economy and equity market sometime in the next five to ten years.

This is not a today problem, but it is a problem we need to start thinking about—today.

## Outlook

We continue to be constructive on the outlook for the U.S. equity market for the balance of 2007. In our view, prospects remain good for S&P 500 total returns in the low- to mid-teens for the full year. However, we do not expect it to be all smooth sailing in the back half of the year. In fact, we believe the market is vulnerable to a short-term correction on the order of 5% or so. The correction might even have already begun.

Our reasons for near-term caution relate both to the technical condition of the market as well as its valuation in relation to interest rates. On the technical side, for our money, there is no better market technician than Stanford Group's John Mendelson. In our experience, he has been right about individual stocks, groups and the market as a whole far more often than he has been wrong. In this context, we want to highlight a recent piece (6/5/07) in which Mendelson notes that the S&P 500 Index is now more extended on the upside than at any time since this bull market began in October 2002. As regular readers of our Commentary are aware, Mendelson measures the market's extendedness by comparing its current level with its 200-day moving average. According to his "Rubber Band Theory," when the market gets too stretched on the upside or downside, it tends to "snap back" in the other direction to restore its balance.

As of early June 2007, the S&P 500 Index (SPX) was 9.3% above its 200-day moving average. By comparison, at its prior bull market high on March 24, 2000, the SPX was 12.8% above its 200-day. Even more extremely, at

its top on August 25, 1987, almost two months before the Crash of '87, the SPX was 17.8% above its 200-day.

To be clear, Mendelson believes—and we agree—that the bull market that began in October 2002 remains intact and that the market is nowhere near as vulnerable as it proved to be in 1987 and 2000. He does believe, however, that the market may well be making an intermediate-term top (à la May 5, 2006) and be vulnerable to a 5% to 7% correction.

From a valuation standpoint, the rise in the S&P 500 year-to-date combined with the recent back up in 10-year U.S. Treasury rates to over 5% suggests to us that the market at a forward P/E of about 16.4 is currently about fairly valued based on 2007 estimates. It's possible that consensus estimates are too low. That has been the case fairly consistently over the last several years. With the economy looking like it may have bottomed in the first quarter of 2007, that may well continue to be true. Then, too, there's no law that says the market can't get overvalued. It has been so before and will be again. We can only report that, based on our work, the market no longer looks undervalued on current earnings. Thus, in our view, absent a decline in long-term interest rates, market returns going forward will be driven more by earnings and dividends than by P/E multiple expansion. As a final point on the subject of valuation, we would note that the last time the market got to what looked to us like fair value was April 2006, just prior to the May/June 2006 correction.

In terms of the economy, it looks increasingly probable that the first quarter of 2007 will mark the low point in this mid-cycle slowdown. First-quarter real GDP growth was recently revised downward from 1.3% to 0.6%, principally because trade and inventory de-stocking were even worse than originally estimated. The expected bounce back in both these areas will thus be from lower than previously anticipated levels and should, therefore, add incrementally to second-quarter GDP growth.

Apart from the expected rebound in trade and inventories, a number of other signs point to stronger growth in the second quarter. Robust labor demand is one of them. Payroll employment rose 157,000 in May, and the unemployment rate remained unchanged at 4.5%. In addition, the service sector purchasing managers index (PMI) rose from 56.0% in April to 59.7% in May, much better than expected, and the highest reading in twelve months. Our expectation is that business capital spending will continue to perk along, as well. Housing is likely to stay weak for longer than was expected a month or so ago, but, even so,

the drag on GDP should diminish from the 1% level of recent quarters to perhaps half that figure.

All things considered, it now appears that second-quarter real GDP growth will top 2.5% and could even reach 3%. The futures markets have taken note of the signs of incremental economic strength and now assign a near-zero probability to a Fed rate cut before year-end 2007.

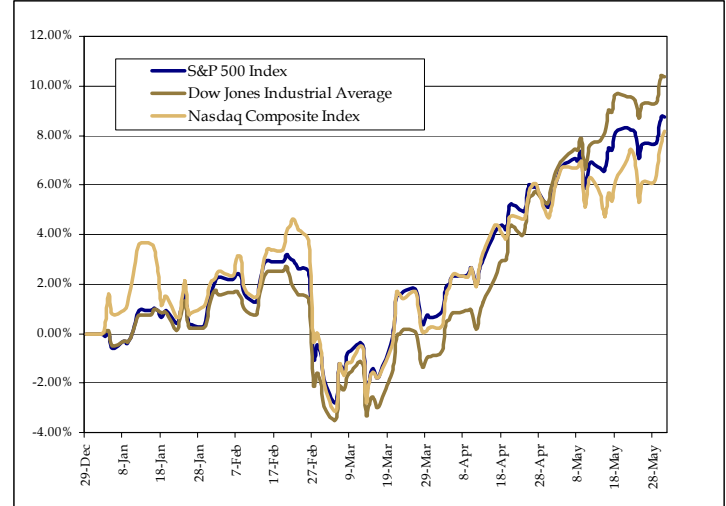
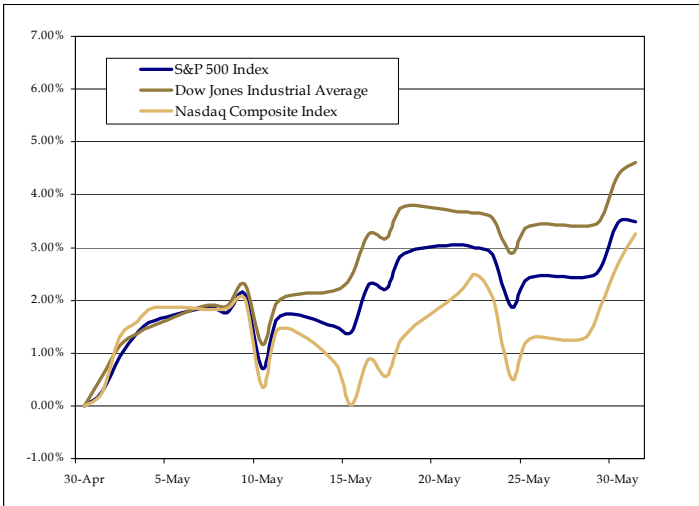
In our mind, the Fed now seems more likely to be on hold into 2008, which has both positive and negative implications for the equity market. On the positive side, the strengthening economy should bolster corporate earnings prospects, increasing the likelihood that they will continue to exceed analysts' expectations. The bar is already set pretty low for the second quarter, where earnings are expected to be up just 3.2% over last year's second quarter. On the negative side, P/E multiple expansion might be tougher to justify with the Fed on hold and 10-year U.S. Treasury rates over 5%.

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

**David E. Nelson, CFA**  
**Chairman, Investment Policy Committee**  
**Legg Mason Capital Management**

Major Indices May Performance

Major Indices YTD Performance



Sources: Bloomberg and FactSet

Sources: Bloomberg and FactSet

Monthly U.S. Market Update (Total Returns)

Index Name	May	QTD	YTD
<i>Broad Market Indices</i>			
S&P 500	3.49	8.07	8.77
Dow Jones	4.62	10.76	10.40
Russell 1000	3.60	7.96	9.27
NASDAQ	3.25	7.70	8.17
Dow Jones Wilshire 5000	3.66	7.81	9.32
Russell 2000	4.10	5.97	8.03
Russell 1000 Growth	3.60	8.47	9.76
Russell 1000 Value	3.61	7.44	8.77
<i>S&amp;P 500 Sector Indices</i>			
S&P 500 Consumer Discretionary	2.87	5.46	4.68
S&P 500 Consumer Staples	1.29	4.67	6.94
S&P 500 Energy	7.18	12.77	15.18
S&P 500 Financials	2.30	6.53	3.50
S&P 500 Health Care	1.54	8.83	9.96
S&P 500 Industrials	4.67	9.64	10.83
S&P 500 Information Technology	4.01	9.65	8.62
S&P 500 Materials	5.68	7.77	17.42
S&P 500 Telecomm Services	9.65	10.51	18.56
S&P 500 Utilities	0.70	4.93	14.68

Sources: Bloomberg, FactSet, Russell, Wilshire

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