

Market Commentary

As we suspected it might, the U.S. equity market ran into a bit of a headwind in June, with all major market indices posting declines for the month, save for the Nasdaq Composite, which was up a scant 1 basis point. Investors' primary concerns during the month, in our judgment, were rising interest rates and widening credit spreads, which served to throw cold water on the S&P 500's new all-time high celebration early in the month. The rise in 10-year U.S. Treasury note yields to a high of 5.30% in mid-June put pressure on stocks, which the rally in bond prices through the end of the month only partially alleviated.

TOTAL RETURNS

	June	Q2	YTD
S&P 500 Index	-1.66%	+6.28%	+6.96%
Dow Industrials	-1.49%	+9.11%	+8.75%
Nasdaq Composite Index	+0.01%	+7.70%	+8.17%
S&P Mid-Cap 400 Index	-2.18%	+5.84%	+11.98%
Russell 2000 Index	-1.46%	+4.42%	+6.45%
Dow Jones Wilshire 5000 Index	-1.61%	+6.07%	+7.56%
S&P 100 Index	-1.25%	+7.16%	+6.03%
Russell 1000 Growth Index	-1.49%	+6.86%	+8.13%
Russell 1000 Value Index	-2.34%	+4.93%	+6.23%

Sources: Bloomberg, Wilshire, Russell

We think it is notable that in the midst of the general market decline the Nasdaq Composite managed to post a fractional gain for the month. In our opinion, this is due to the strong performance of tech stocks during the month and for the quarter, and also reflects the emergence of growth stocks as market leaders over the course of the last few months. Information technology and energy were the only S&P 500 sectors to post price gains in the month of June, and also were the two best-performing sectors for the quarter as a whole. As might be guessed with interest rates rising and credit worries starting to surface, rate-sensitive sectors such as financials and utilities lagged badly in June and were also at the bottom of the performance chart for the quarter.

In a nice turnaround from the first quarter, performance trends for the month of June and the second quarter were satisfyingly consistent with the Old Game/New Game paradigm we first postulated in the second half of last year. Mega- and large-cap stocks outpaced mid- and small-caps. Growth handily outperformed value and the Nasdaq Composite was strong. We could not have written a better script.

Thus far, the market has played out this year largely as we expected going into 2007. First-half gains are largely consistent with the "bullish" scenario we laid out in December 2006. They are admittedly a bit shy of our "very bullish" scenario, but you can't have everything. As we stand at the half-year mark, we continue to see reasonably good prospects for the balance of 2007 and into next year. Interest rates pose a challenge—especially if they rise from here. Credit spreads—which are still relatively tight but have begun to widen—also bear watching. We'll have more to say about our expectations for the balance of 2007 in the Outlook section, but first we thought it might be interesting to spend some time handicapping the 2008 presidential election. Coincidentally, but conveniently, the latest issues of both *Barron's* and *Fortune* have cover articles on that subject.

While in some respects the 2008 elections still seem miles away, they really are not. The 2008 state primaries are more front-end loaded than they have ever been. As shown in the early primary calendar below, by February 5, 2008, primaries and/or caucuses for 30 states (representing 347 of 538 electoral votes) will have been held. We suspect that the 2008 elections will soon enter investors' purviews, if they haven't already.

Early 2008 Primary Calendar

Jan 8	DC (3)
Jan 14	IA (7)
Jan 19	NV (5)
Jan 22	NH (4), WY (3)
Jan 29	FL (27), SC (Dem Primary - 8)
Feb 2	SC (GOP Primary - 8)
Feb 5	AL (9), AK (3), AZ (10), AR (6), CA (55), CO (9), CT (7), DE (3), GA (15), IL (21), MI (17), MO (11), NJ (15), NM (5), NY (31), NC (15), ND (3), OK (7), OR (7), PA (21), RI (4), TN (11), UT (5)

Sources: ISI Group & National Association of Secretaries of State

At this point, both the Republican and Democratic fields are unusually crowded, with 17 Republicans and 9 Democrats having garnered betting interest on the prediction market Intrade.com (an affiliated website of Tradesports.com). We believe the crowded field—especially on the Republican side—is a reflection of the fact that for the first time since 1952 neither a sitting president nor vice president is a candidate.

INTRADE.COM FRONT-RUNNERS									
2008 Presidential Election - Party Nominees									
REPUBLICAN	7/3/07	6/29/07	6/25/07	6/21/07	DEMOCRAT	7/3/07	6/29/07	6/25/07	6/21/07
Giuliani	34.0%	32.4%	30.6%	29.2%	Clinton	44.3%	47.7%	49.4%	48.6%
Thompson	33.9%	33.8%	28.2%	30.3%	Obama	34.6%	31.0%	30.7%	30.0%
Romney	20.1%	20.2%	22.0%	21.3%	Gore	9.1%	9.5%	9.3%	9.7%
McCain	<u>4.4%</u>	<u>5.0%</u>	<u>8.7%</u>	<u>9.2%</u>	Edwards	<u>5.3%</u>	<u>5.0%</u>	<u>5.3%</u>	<u>5.5%</u>
	92.4%	91.4%	89.5%	90.0%		93.3%	93.2%	94.7%	93.8%
Field	9.0%	8.0%	8.9%	8.7%	Field	3.7%	3.3%	4.1%	3.8%
	101.4%	99.4%	98.4%	98.7%		97.0%	96.5%	98.8%	97.6%

Source: Intrade.com

As regular readers know, we are big fans of prediction markets, having found them to be much more accurate than polling data in handicapping elections. As a measure of their collective wisdom, we remind readers that bettors on Intrade.com accurately predicted the outcome of all 50 state races in the 2004 presidential elections.

As of early July, Intrade.com bettors have tagged four GOP and four Democratic candidates as the early favorites to win their party's nomination. The table above shows Intrade.com bettors' assessment of the odds each candidate had of winning on four dates in the recent past. Odds are for the bid side of the market and do not always sum to 100%.

Interestingly, each party has one undeclared candidate—Al Gore on the Democratic side and Fred Thompson on the GOP side—as one of its front-runners. Thompson, in fact, is vying with Rudy Giuliani for the top spot among Republican candidates. Some of the trends evident in the table are also interesting. Senator Hillary Clinton is the clear favorite on the Democratic side, but has been losing ground to Senator Barack Obama in recent weeks. John Edwards, after peaking at about 19% in early 2007 (not shown in the table), has been holding steady at a little over 5%, while non-candidate Gore has been tracking in the 9% range. On the Republican side, Giuliani and Thompson have been trading the lead back and forth over the last few weeks, which must be a bit disconcerting to Giuliani since Thompson has yet to officially declare. Both Giuliani and Thompson have been gaining ground recently, primarily at the expense of Senator John McCain, but also in a smaller way from Mitt Romney and the rest of the GOP field. McCain is the real train wreck over the last six to nine months. He peaked at over 50% in late 2006 and has been in steady decline ever since. With only a reported \$2 million left in his war chest, McCain has recently scaled back his campaign operations, and frankly, looks like toast to us.

In addition to betting on party nominations, Intrade.com also offers the opportunity to wager on which political party and which individual candidate will win the presidency in 2008. The left-hand side of the table on the next page presents the odds of the four leading Republican and Democratic candidates (plus New York Mayor Michael Bloomberg) winning the presidency in 2008. The right-hand side of the table shows the implied odds of winning, assuming the individual gets his or her party's nomination. We computed the implied odds by dividing the odds of winning by the odds of getting the nomination. For example, on 7/3/07, Intrade.com showed Clinton having a 27.9% chance of winning the presidency in 2008. Dividing that probability by her 44.3% odds of winning the Democratic nomination gives her a 63% probability of winning the presidency if she, in fact, gets the nomination.

Once again, we think this table is pretty interesting. It says that Intrade.com bettors continue to see Clinton as the leading candidate for the presidency, but her lead is fading a bit. She was nearly a 2-1 favorite over Obama a couple of weeks ago, but is only about a 3-to-2 favorite in our latest look at the data. Clinton also shows up as a formidable opponent for the Republicans assuming she gets the nomination. She ranks best in this regard save for non-candidate Gore, who is a 3-to-1 favorite to win the presidency if he chooses to run and gets the nomination.

On a political party basis, Intrade.com bettors rate the Democrats as 55% favorites to win the presidency, while the Republicans have a 41% chance and the field (essentially Bloomberg) has a 4.2% chance. In our view, the Intrade.com data, coupled with the general mood of discontent with the Bush administration and the consequent desire on the part of the electorate for change, suggest that it is increasingly likely that the Democrats will win the White House in 2008. If so, how investor-friendly is a Democratic administration likely to be?

INTRADE.COM FRONT-RUNNERS								
2008 Presidential Election - Winner								
CANDIDATE	Odds of Winning				Implied Winning Odds, If Nominated			
	7/3/07	6/29/07	6/25/07	6/21/07	7/3/07	6/29/07	6/25/07	6/21/07
Clinton (D)	27.9%	29.5%	33.1%	33.2%	63.0%	61.8%	67.0%	68.3%
Obama (D)	19.0%	17.4%	17.2%	17.3%	54.9%	56.1%	56.0%	57.7%
Thompson (R)	18.1%	16.0%	16.0%	16.0%	53.4%	47.3%	56.7%	52.8%
Giuliani (R)	18.0%	17.5%	14.1%	13.2%	52.9%	54.0%	46.1%	45.2%
Romney (R)	8.7%	9.4%	9.7%	9.7%	43.3%	46.5%	44.1%	45.5%
Gore (D)	6.8%	6.8%	7.0%	7.0%	74.7%	71.6%	75.3%	72.2%
Bloomberg	3.5%	5.4%	4.1%	-	-	-	-	-
Edwards (D)	2.6%	2.5%	3.0%	3.1%	49.1%	50.0%	56.6%	56.4%
McCain (R)	2.0%	3.6%	4.8%	4.7%	45.5%	72.0%	55.2%	51.1%

Source: Intrade.com, LMCM Estimates

In its July 2, 2007 issue, *Barron's* published the results of a survey they did of nine announced candidates—Romney, Giuliani and McCain for the GOP, and Richardson, Obama, Clinton, Dodd, Biden and Edwards for the Democrats—designed to measure the investor-friendliness of each candidate, and by extension, the two major political parties. *Barron's* reporter Jim McTague asked each candidate to answer questions on a number of key economic issues and then graded their responses on an A to F scale, awarding a numerical value of 4 for every A, 3 for every B, and so forth, down to zero for every F. Three questions dealt specifically with taxes: estate taxes, dividends/capital gains and income-tax reform in general. One question dealt with health care, another with energy policy and the final one rated how investor-friendly the candidate was likely to be based upon his or her past record.

Not surprisingly, at least to us, the Republicans scored as decidedly more investor-friendly. Romney was at the top of the class with 5 A's and 1 B for a numerical score of 3.83. Giuliani ranked second with one fewer A's and one more B, and an average score of 3.67. McCain ranked third with 3 A's and 3 B's and an average score of 3.5. The average of the three Republicans was 3.67, or a letter-grade of A-.

On the Democratic side, only New Mexico Governor Bill Richardson was even close to any Republican with an average score of 3.0, a solid B. Sadly, from an investor's perspective, Richardson has a decidedly slim chance (1.8% according to Intrade.com) of getting his party's nomination. Among the other Democrats, Obama scored best but could only muster an average grade of 2.0 (a solid C). Clinton averaged 1.8 and Edwards 1.5. (We're guessing this is the lowest grade Hillary ever got on any test in her whole life.) The three leading Democratic candidates in the survey averaged 1.77, roughly a C- in letter-grade terms.

We are well aware that history says investors shouldn't necessarily fear a Democratic administration. In fact, according to Ned Davis Research, since the beginning of the twentieth century, the Dow Industrials have climbed an average of 7.19% a year when the Democrats held the White House, versus 4% under Republican presidents. That said, the current crop of Democratic candidates seems patently less investor-friendly than their Republican counterparts. If, as seems increasingly likely, the Democrats take over the White House in January 2009, the sledding may get rougher for market participants.

## Outlook

We spent longer on the political discussion than we originally intended, but the Outlook section should be shorter than usual because we really don't have that much new to say. We continue to believe that low-teens returns for the S&P 500 Index for the year are a reasonable expectation, assuming 10-year U.S. Treasury yields stay at 5% or lower. If long rates rise from here, double-digit returns for the S&P 500 this year will be more of a challenge.

As far as Fed policy is concerned, not much has changed there in the last 30 days either. As expected, the FOMC maintained the Fed funds rate at 5.25% in a unanimous vote that marked the one-year anniversary of the committee's decision to raise rates to that level in June 2006. Fed Chairman Ben Bernanke and other Fed governors continue to talk tough on inflation—as they must to maintain their inflation-fighting credentials—but, given the recent moderation in core inflation, we believe it is quite unlikely that they will feel the need to raise rates. Fed fund futures market participants now expect the Fed to be on hold well into 2008, which seems like a reasonable bet to us.

With the 10-year Treasury at 5%, based on what we regard as reasonable assumptions for long-term growth (6% to 7%) and returns on equity (16% to 17%), we believe the market is worth between 15.5 and 16.5 times earnings. The S&P 500 trades near the mid-point of that range based on 2007 cap-weighted consensus estimates and one or two multiple points cheaper (depending on which end of the valuation range you use) based on consensus expectations for 2008. Those numbers suggest modest upside to the market through the balance of 2007 and some further potential for gain in 2008.

Others are more optimistic about the market over the next 12 to 18 months. For example, FTN Midwest Research strategist Tony Dwyer, whose work we admire, thinks the S&P 500 will trade at 18 times his 2008 earnings estimate of \$100 before the end of 2008, suggesting nearly 20% upside in the market over that time frame. He notes that the S&P 500 Index traded at a multiple of 18 or higher in the last two bull markets, in an environment of long rates that were higher than those that prevail currently. To be fair, Dwyer's is one of the most bullish views on the Street. That is probably why we like him so much.

The market sell-off in June has relieved some of the pressure that we noted in last month's commentary. As of month-end June, the S&P 500 Index was only 5.2% above its 200-day moving average, versus 9.3% above in early June. A few cautionary indicators remain, however, suggesting that investors should continue to be on guard in the near term.

For one, Stanford Group strategist John Mendelson's "last hour indicator" is flashing signs of "distribution," meaning in the jargon of technical analysts that money is moving from strong to weak hands. For years, Mendelson has watched the market in the last hour of trading (believing that activity during this period is dominated by professional traders and institutions) and compared it to market activity during the rest of the trading day, looking for divergences in market behavior. In a June 21, 2007 missive, Mendelson noted that the last hour indicator peaked on February 27 and has remained flat as the S&P 500 and several other major market indices made new all-time highs in May and June. This pattern concerns him and bears watching in his view.

Another long-time market observer, Steve Leuthold of the eponymous Leuthold Group, waved a yellow caution flag in his June monthly, noting that his Major Market Index had fallen to the neutral zone after several years on a buy signal. Leuthold has published his Major Market Index since 1975, and it has proven to be an indicator worth watching. Leuthold makes clear that he is not ready to throw in the towel on this bull market just yet, noting that of the 35 times since 1975 that his MMI has dropped from positive to

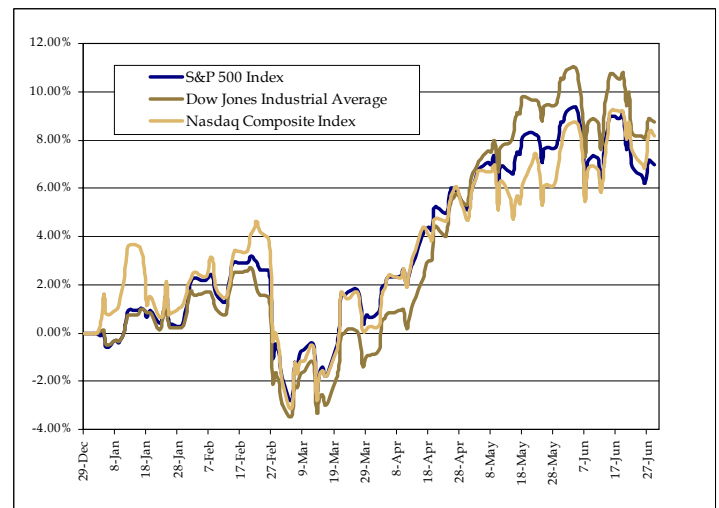
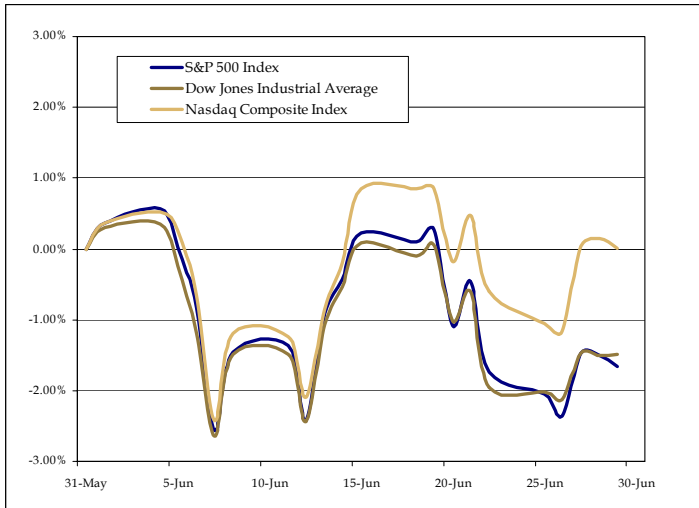
neutral, 19 times it has reversed back to positive, while in the 16 other cases it has dropped from neutral to negative. The drop to neutral was enough to persuade him to reduce his equity exposure from maximum to mid-range levels, however. We thought this was worth noting.

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 June Performance

Major Indices YTD Performance



Sources: Bloomberg and FactSet

Sources: Bloomberg and FactSet

Monthly U.S. Market Update (Total Returns)

Index Name	June	Q2	YTD
<i>Broad Market Indices</i>			
S&P 500	(1.66)	6.28	6.96
Dow Jones	(1.49)	9.11	8.75
Russell 1000	(1.91)	5.90	7.18
NASDAQ	0.01	7.70	8.17
Dow Jones Wilshire 5000	(1.61)	6.07	7.56
Russell 2000	(1.46)	4.42	6.45
Russell 1000 Growth	(1.49)	6.86	8.13
Russell 1000 Value	(2.34)	4.93	6.23
<i>S&amp;P 500 Sector Indices</i>			
S&P 500 Consumer Discretionary	(1.71)	3.66	2.89
S&P 500 Consumer Staples	(1.89)	2.69	4.92
S&P 500 Energy	1.77	14.76	17.22
S&P 500 Financials	(4.15)	2.12	(0.79)
S&P 500 Health Care	(3.53)	4.99	6.07
S&P 500 Industrials	0.11	9.76	10.96
S&P 500 Information Technology	0.66	10.36	9.33
S&P 500 Materials	(0.60)	7.12	16.72
S&P 500 Telecomm Services	(2.60)	7.63	15.47
S&P 500 Utilities	(5.07)	(0.38)	8.87

Sources: Bloomberg, FactSet, Russell, Wilshire

The information contained herein has been prepared from sources believed reliable but is not guaranteed by us as to its timeliness or accuracy, and is not a complete summary or statement of all available data. This data is intended solely for our clients, is for informational purposes only, and may not be publicly disclosed or distributed without our prior written consent.

The views expressed in this commentary reflect those of Legg Mason Capital Management ("LMCM") as of the date of this commentary. These views are subject to change at any time based on market or other conditions, and LMCM disclaims any responsibility to update such views. These views may not be relied upon as investment advice and, because investment decisions for clients of LMCM are based on numerous factors, may not be relied upon as an indication of trading intent on behalf of the firm. The information provided in this commentary should not be considered a recommendation by LMCM or any of its affiliates to purchase or sell any security.