

Market Commentary

The U.S. equity market correction that began in June resumed in earnest in late July. After rallying to a new all-time closing high of 1553.08 on July 19, the S&P 500 Index sold off sharply, finishing the month at 1455.27, down 3.1% in July, and 6.3% off its high reached only 12 days earlier. In our view, market action in the last week of July and the early sessions of August showed signs of downside capitulation that could indicate that the worst of the correction is over. Obviously, only time will tell, but we'll give evidence further on that leads us to believe that a worthwhile buying opportunity may be at hand. First, though, we'd like to offer a review of July's market action.

TOTAL RETURNS		
	July	YTD
S&P 500 Index	-3.10%	+3.64%
Dow Industrials	-1.35%	+7.29%
Nasdaq Composite Index	-2.13%	+5.87%
S&P Mid-Cap 400 Index	-4.31%	+7.16%
Russell 2000 Index	-6.84%	-0.83%
Dow Jones Wilshire 5000 Index	-3.40%	+3.90%
S&P 100 Index	-2.34%	+3.55%
Russell 1000 Growth Index	-1.55%	+6.45%
Russell 1000 Value Index	-4.62%	+1.32%

Sources: Bloomberg, Wilshire, Russell

July offered further confirmation of our "New Game" thesis. Mega-cap proxies, the Dow Industrials and S&P 100 Index, turned in strong relative performances. In fact, the Dow Jones Industrial Average has replaced the S&P Mid-Cap as the best-performing major market index year-to-date. In addition, large caps outperformed small caps for the month, growth handily outperformed value and the Nasdaq Composite held up well, offering further evidence that growth stocks have emerged as the new market leaders.

Sector returns were about as one would expect given the fact that oil prices were strong and the epicenter of worry continued to be subprime mortgage woes and their fallout effects on other areas of the credit market. For the month, only energy and industrial stocks posted positive returns. Financials, consumer discretionary, health care, and utilities stocks were notably weak.

On one level, the current market correction is not a surprise to us. We cautioned clients in our June market commentary that the S&P 500 Index was more extended on the upside than it had been in several years, and, therefore, was vulnerable to a pullback. On another level, it is always surprising how fast the mood of the market can change. Reflecting the fickle psyche of the investing public, morning anchors on CNBC went from celebrating Dow 14,000 to worrying about whether a new bear market had begun, all inside the space of two weeks.

At this point, we see this correction as normal and healthy. Since 2004, there have been five similar corrections—August 2004, April 2005, October 2005, June 2006 and March 2007—that have taken the S&P 500 down between 6% and 9%. The current correction is the sixth, and so far the damage has been contained to the same range. In truth, the S&P 500 has gone an unusually long period without a 10% correction from prior highs, and this could be the time we get it. On the other hand, we have seen a number of signs lately that suggest that the correction may have nearly run its course.

First, the S&P 500's 200-day moving average has proven to be a good support level in the prior five market corrections since 2004. Though the S&P 500 has traded below its 200-day moving average on several of these occasions, the extent and duration of the weakness has been moderate once the S&P hits this level. As of June 4, 2007, the S&P 500 was 130 points (or 9.2%) above its 200-day, but it closed the month of July only about 6 points (or 0.4%) above. Thus, much of the short-term vulnerability we saw in early June 2007 has been eliminated.

Another indication that the correction may be nearing an end is the 10-day cumulative advance/decline line. On Friday, July 27, 2007 (the end of an ugly week in the market), the 10-day cumulative advance/decline line total for the NYSE was -11,025, its third worst reading *ever*, according to data from Jeffrey Rubin of Birinyi Associates, Inc. The table below (also from Birinyi Associates) shows the performance of the Dow Jones Industrial Average five days and one month after the ten worst 10-day NYSE advance/decline readings.

Ten Worst 10-Day NYSE A/D Lines

Date	NYSE 10-Day	--- DJIA Change --- 5 Days	1 Month
8/4/98	-9,848	-0.29%	-8.31%
8/31/98	-9,892	+6.39%	+4.03%
9/20/01	-9,921	+3.64%	+9.88%
7/22/02	-10,022	+11.91%	+13.97%
5/10/04	-10,206	-0.83%	+3.79%
9/1/98	-10,257	+0.48%	-2.49%
9/24/01	-10,416	+2.71%	+8.56%
7/27/07	-11,025	?	?
7/23/02	-11,451	+12.69%	+16.29%
9/21/01	-11,862	+7.43%	+13.86%
	Average	+4.90%	+6.62%

Sources: Birinyi Associates, Inc., July 30, 2007

Apart from the latest reading and one instance in 2004, the remaining readings in this table all surround three events—the collapse of Long-Term Capital Management in 1998, the terrorist attacks of September 11 and the initial stages of the bear market bottom in 2002. Each of these events created a good buying opportunity in the market. In only two of nine cases prior to the latest instance was the market lower in the subsequent week or month. On average, the Dow was 4.9% and 6.6% higher in five days and one month, respectively.

Another sign that the market correction may be nearing an end is the recent spike in the Volatility Index (VIX). The VIX has doubled over the last three months, from 11.98 on April 16 to 24.17 on July 27. In our June 2006 market commentary, we presented data from Birinyi Associates which showed that following a rapid doubling in the VIX, the market historically had an excellent chance of being higher in the next one, three and six months. We have reproduced that data below, updated to include our calculation of 2006 results, which—consistent with past patterns—shows the market to have done well in the months following the doubling of the VIX from May 5 to June 13, 2006.

Date	VIX 50-Day ROC (%)	S&P 500 Performance (%)			
		Prior 50 Days	Next Month	Next 3 Months	Next 6 Months
8/6/1990	107.3	-5.7	-3.4	-5.9	4.2
4/4/1994	115.2	-7.5	3.2	1.7	5.2
8/31/1998	101.8	-13.2	9.5	21.6	29.1
9/17/2001	122.6	-16.0	4.9	9.2	12.2
7/23/2002	116.8	-25.8	17.5	11.6	11.3
6/13/2006	105.8	-5.7	1.7	8.2	16.6
	Average	-13.6	5.6	7.7	13.1

Sources: Birinyi Associates, Inc., LMCM Estimates

Following the latest doubling in the VIX, only time will tell whether the market is once again in an attractive buying range, but, in our opinion, several indicators that have been reliable in the past support that view.

Outlook

The recent market correction has more than halved the market's year-to-date gains from peak levels, such that the S&P 500 Index has returned just +3.64% through month-end July. Can we still achieve double-digit returns for the year?

In our May market commentary, with the S&P 500 up +8.77%, we wrote: "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%."

The S&P 500 is down almost exactly 5% since May month-end, so at least we got the -5% right. Now what about the next 10% on the upside? Can we get there by the end of 2007? We think we've got a decent shot at it, but it is by no means assured. We'll weigh the evidence as we see it in the balance of this letter and give you our best thinking, which is all we really ever do, or can do.

Apart from investor sentiment, which we've already discussed at some length, we think several other topics merit discussion in considering what to expect for the balance of the year: the earnings outlook, the macro backdrop, the outlook for interest rates and credit spreads, and market valuation.

In terms of earnings, we think the outlook remains largely constructive. Earnings growth is definitely slowing, but remains healthy, and most companies continue to beat expectations. One thing to watch is the financial sector, which accounts for about 21% of the market value of the S&P 500, but roughly 27% of the total earnings of the index. If reserves or write-downs from subprime loans—or collateral damage in such areas as CDOs and bridge loans—increase dramatically, financial sector earnings could fall short of expectations. This could be troublesome for the market, in our view.

As far as the macroeconomic backdrop is concerned, we see three key issues: the GDP outlook, the likely course of Fed policy, and the outlook for inflation. As with earnings growth, we think GDP growth is slowing but should

remain sufficiently healthy to support moderate corporate earnings growth. Second-quarter real GDP growth of +3.4% was artificially inflated by inventory restocking and a snap back in trade from depressed first-quarter levels. A more reasonable expectation for second-half real GDP growth is 2% to 2.5%, in our view. We think it's important to be especially humble about making GDP forecasts at this point in the economic cycle because the situation is so fluid. With bonds' recent strength and stocks' recent weakness, the financial markets have been "acting like" we may be going into a recession. This possibility cannot be totally discounted. The history of recessions is that many more are forecasted than actually occur, and the ones that do occur aren't recognized until after they've started or—in a few cases—until they're nearly over. That said, our most likely scenario continues to be that we are in a mid-cycle slowdown that will not morph into recession.

As regards the Fed, we believe—at worst—the FOMC will be on hold for the next six to twelve months. Further, we believe that the widening subprime contagion and continued weakness in the housing market has put the possibility of rate cuts back on the table. The Fed fund futures markets think so as well.

On the outlook for inflation, the news continues to be encouraging. Core PCE—the Fed's favorite measure of inflation—fell to 1.9% year-over-year in June, the lowest level since March 2004, and below the high end of the Fed's supposed comfort zone of 1% to 2%.

Long-term interest rates are also behaving well. Ten-year U.S. Treasury note yields—which peaked in June at 5.30%—were back to the 4.80% area by July month-end. This move seems to reflect a flight to quality by market participants, but also suggests that bond investors are not especially worried about inflation, in our judgment.

The real problem in the last month or so has been credit spreads, which have widened materially. Author and *Wall Street Journal* columnist James B. Stewart describes it as a "subprime crisis, which morphed into a mortgage-backed-securities crisis into a collateralized-debt-obligation crisis into a junk-bond collapse and now a credit freeze." That may be overstating it a bit, in our view, but we understand the sentiment. The problems created by increasing subprime defaults and widening credit spreads across a number of fixed-income asset categories have been greatly exacerbated by excessive leverage and reaching for yield. Our old friend and long-time market observer Ray DeVoe always said that more money has been lost reaching for yield than at the point of a gun. Was he ever right!

In terms of valuation, our work indicates that with long rates where they are and based on an assumption of 6% long-term earnings per share growth and return on equity of 16%, the S&P 500 Index is worth about 16 times earnings. Based on cap-weighted, bottom-up consensus estimates, the S&P 500 currently trades for about 15.8 times 2007 estimates and 14.2 times next year's numbers. This suggests to us that the market is modestly undervalued on this year's estimates, and about 13% undervalued using 2008 figures. Since the market generally looks ahead, we think 2008 estimates will be the more relevant figures to consider later this year.

Chief among the things that would cause one to be cautious on the market outlook is the mini credit crunch going on in the fixed-income markets. While base rates as measured by 10-year U.S. Treasury note yields have actually come down in the last month, effective financing rates have risen considerably due to the widening of credit spreads. The rise in effective rates may put a bit of a crimp in the private-equity business, thus removing one underpinning of support for the market. Ironically, it may increase demand for well-financed, globally dominant mega-cap stocks, which have been wallflowers for much of this bull market, but recently appear to be coming into their own.

Two long-time market observers that we admire and have talked about before, John Mendelson and Steve Leuthold, remain cautious on the near-term outlook for equities. Veteran technician John Mendelson, who now hangs his hat at Stanford Group Company, is troubled by a number of things, including the weakness in financial stocks, "the very large downside volume of the past few weeks and the breakdown of many prominent stocks below important support levels." This leads him to expect further weakness in the S&P 500 before it finds its sea legs.

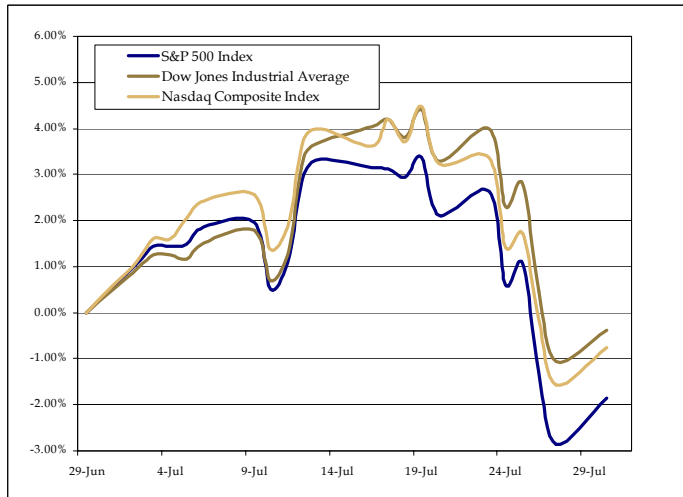
For his part, Steve Leuthold is heeding the message of his Major Market Index, which moved from positive to neutral in June, and neutral to negative in July, primarily as a result of weakening market breadth and momentum. Until June, his index had been consistently bullish since early 2003 when it turned positive. Following the dictates of his model, Leuthold now recommends that investors adopt a defensive posture.

As for us, we continue to whistle past the graveyard, believing that, despite the recent market trauma, the weight of the evidence still suggests that a constructive attitude toward the market is warranted.

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

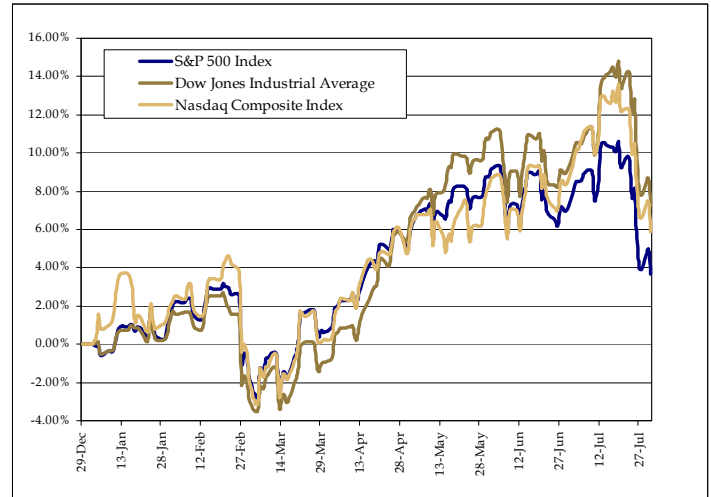
**David E. Nelson, CFA**  
**Chairman, Investment Policy Committee**  
**Legg Mason Capital Management**

Major Indices July Performance



Sources: Bloomberg and FactSet

Major Indices YTD Performance



Sources: Bloomberg and FactSet

Monthly U.S. Market Update (Total Returns)

Sector Index Name	July	YTD
<i>Broad Market Indices</i>		
S&P 500	(3.10)	3.64
Dow Jones	(1.35)	7.29
Russell 1000	(3.09)	3.87
NASDAQ	(2.13)	5.87
Dow Jones Wilshire 5000	(3.40)	3.90
Russell 2000	(6.84)	(0.83)
Russell 1000 Growth	(1.55)	6.45
Russell 1000 Value	(4.62)	1.32
<i>S&amp;P 500 Sector Indices</i>		
S&P 500 Consumer Discretionary	(5.80)	(3.08)
S&P 500 Consumer Staples	(2.23)	2.58
S&P 500 Energy	0.76	18.10
S&P 500 Financials	(7.80)	(8.52)
S&P 500 Health Care	(4.33)	1.47
S&P 500 Industrials	1.02	12.09
S&P 500 Information Technology	(0.44)	8.84
S&P 500 Materials	(2.24)	14.10
S&P 500 Telecomm Services	(2.23)	12.89
S&P 500 Utilities	(3.75)	4.79

Sources: Bloomberg, FactSet, Russell, Wilshire

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