

Market Commentary

The ghosts of the Crash of 1987 spooked investors only briefly in October, as the market continued to recover from its mid-August low. On October 19, the twentieth anniversary of the '87 Crash, the S&P 500 closed down 39.45 points (2.56%), a far cry from the 57.86 point (20.47%) drop it suffered on the corresponding day in 1987. By month-end, the S&P 500 had recovered its October 19 loss and more, closing at 1549.38, up 1.6% for the month on the strength of a 1.2% Halloween rally celebrating the FOMC's decision to cut the Fed funds rate by another 25 basis points (to 4.50%) on October 31. The celebration was short-lived, however, as investors took a negative view of the Fed's decision to return to a neutral policy stance and sent the S&P 500 lower by 2.6% on November 1.

TOTAL RETURNS

	Oct	YTD
S&P 500 Index	+1.59%	+10.87%
Dow Industrials	+0.38%	+13.74%
Nasdaq Composite Index	+5.89%	+19.10%
S&P Mid-Cap 400 Index	+2.63%	+13.93%
Russell 2000 Index	+2.87%	+6.12%
Dow Jones Wilshire 5000 Index	+1.91%	+11.21%
S&P 100 Index	+1.51%	+11.61%
Russell 1000 Growth Index	+3.40%	+16.51%
Russell 1000 Value Index	+0.01%	+5.98%

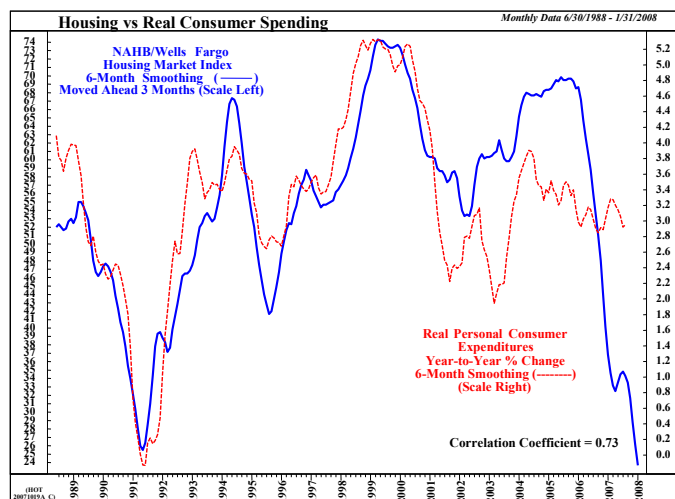
Sources: Bloomberg, Wilshire, Russell

The star of the show for October was the Nasdaq Composite Index, up 5.9% on the strength of a nearly 25% rally in Microsoft—its largest component—and continued strength in other of its leading components, including Google (+24.6%), Apple (+23.8%) and Research in Motion (+26.3%). As might be expected given the strength of the Nasdaq, growth handily outperformed value in the month and now leads by over 1000 basis points on a year-to-date basis (using the Russell 1000 Growth and Value Indices as proxies).

We admit to being more than a little puzzled about the outlook for the economy and the equity market at present. The surprisingly strong third-quarter real GDP growth rate of +3.9% and October's payroll employment advance of 166,000 suggest that the U.S. economy is fine and, therefore, the Fed is right to return to a neutral policy stance. The dreadful market action of the financial stocks (which are often a harbinger of the future direction of the stock market), the collapse of the housing market and the continued turmoil in the fixed income markets suggest that all is not well.

Up to now, the subprime-induced damage to the financial, housing and credit sectors seems to have been relatively well contained. We're not sure how much longer that can remain true. In and of itself, the housing sector represents only a small fraction of GDP.

But trends in the housing market have tended to lead trends in real consumer spending by about three months over the last twenty years, as illustrated in the chart below from Ned Davis Research. The chart shows a 0.73 correlation between the National Association of Homebuilders (NAHB)/Wells Fargo Housing Market Index (shifted forward by three months) and the year-over-year change in Real Personal Consumer Expenditures. If this correlation continues to hold true, the fact that the housing index has fallen off a cliff recently does not bode well for consumer spending.



Source: Ned Davis Research

As bad as the housing market has been, it is the weakness in financial stocks that really concerns us. This is not just any sector. It is the largest one in the S&P 500, with a weighting of 19.25% as of the end of October (down from over 20% for the last several years due to its poor recent relative performance). More importantly, well-functioning financial markets are a key component of a healthy economy. They are the grease in the axle, the oil in the engine, the blood in the economy's circulatory system. If the financial sector is not healthy, the economy cannot remain healthy for long, in our view. In that context, the financial sector's recent underperformance is worrisome. The financial sector of the S&P 500 was down 1.81% in October and is down 6.73% year-to-date through October, trailing the S&P 500 Index by about 350 and 1800 basis points, respectively, over those two time frames. On November 1, the Keefe Bruyette & Woods Bank Index (BKX) was down 5.4%, its largest single-day decline since October 9, 2002 (the bear market low). Encouragingly, the average one-month return of the BKX (since inception) following a -4% or greater loss day has been +7.2%, with 80% of instances being positive, according to market strategist Tony Dwyer, whose ultimate source was www.sentimentrader.com.

Financials are not behaving as they normally do at this point in the cycle. According to data from Ned Davis Research, in the six months prior to the second rate cut in the eight Fed easing

cycles since 1975, financials have typically been the second-best performing sector in the S&P 500, up about 10% on average. Tech stocks have normally been the worst performers, down 7% on average. This time around is the exact opposite. As of 10/30/07, the information technology sector of the S&P 500 was up 15.6% for the last six months, while the financial sector was down 10.4%. So tech stocks have done over 2000 basis points better than they usually do prior to a second Fed rate cut, and financials have done about 2000 basis points worse.

So, why are financials acting so poorly? As is often the case, Empirical Research Partners has some useful insights into this question. Empirical notes in a piece entitled "Timing the Financials" (11/02/07) that the aggregate balance sheet of the publicly held financial stocks is now nearly twice the size of the aggregate balance sheet of the non-financial sectors of the market, whereas in 1990, it was roughly the same size (see Exhibit 1). "Moreover," Empirical's work continues, "there's been a nearly continuous acceleration in the growth rate of assets per share throughout this decade, while at the same time, the relative returns on assets have been falling." (See Exhibits 2 & 3.)

Empirical's analysis raises the interesting, and important, question of whether or not the financial sector has—in some sense—gotten "too big" and/or "too leveraged" relative to the size of the rest of the economy. We're not sure, but the market seems to be saying that it has. This doesn't mean that it's wrong to own any financials, but it does mean that if a financial de-leveraging process has begun, it may take longer than normal for it to run its course. This may be the main message that the poor recent market performance of the financials is trying to deliver, and it behooves us as investors to carefully consider the full implications of the message. At a minimum, we should recognize that it will take time and be difficult to determine when all the bad news is fully discounted in the stocks.

Outlook

While we continue to be generally constructive on the market over the next twelve months, the outlook, in our view, is importantly dependent on whether or not the U.S. economy can avoid recession. We think the odds of recession in 2008 have risen lately. They are not yet 50/50 in our view, but they are getting closer to that. Bettors on Intrade.com have recently put the odds of recession in 2008 at between 40% and 45%. That seems about right to us. Thus, the percentage bet remains no recession, but the odds are thinning.

We believe the two things most likely to tip us into recession are: (1) a housing-induced material slowdown in consumer spending, and (2) continued turmoil in the financial sector of the economy and stock market. We discussed these two issues earlier, and our increasing concern about them is the principal reason that we have bumped up our odds of recession in the last few weeks.

The arguments against recession continue to be moderately more persuasive to us than the arguments in favor of it. A principal argument against recession is that, despite the recent plunge in housing activity, real GDP growth has been running at an annual rate of

Exhibit 1

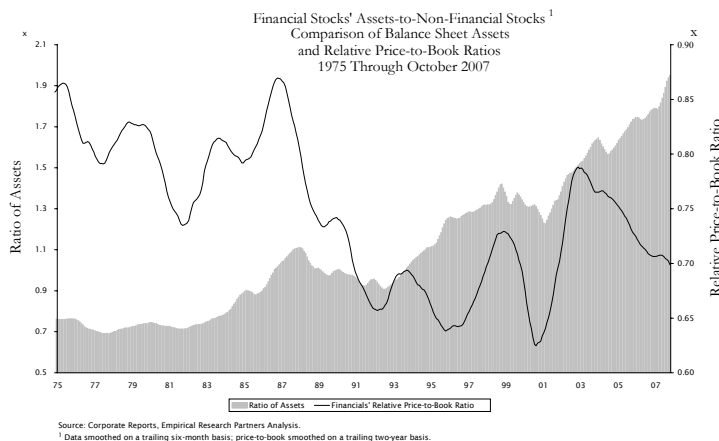


Exhibit 2

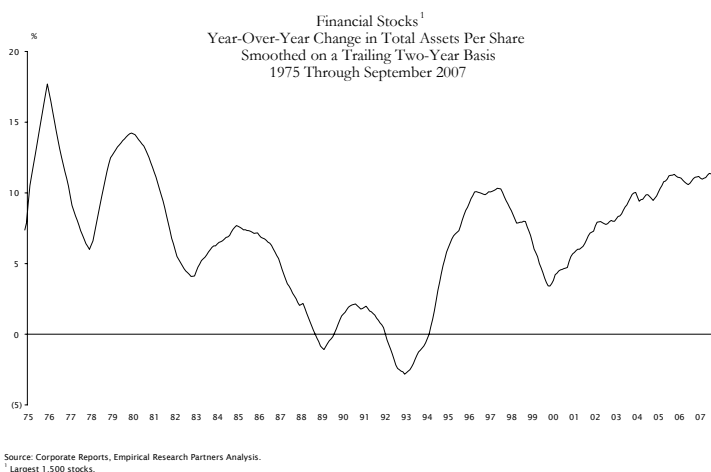
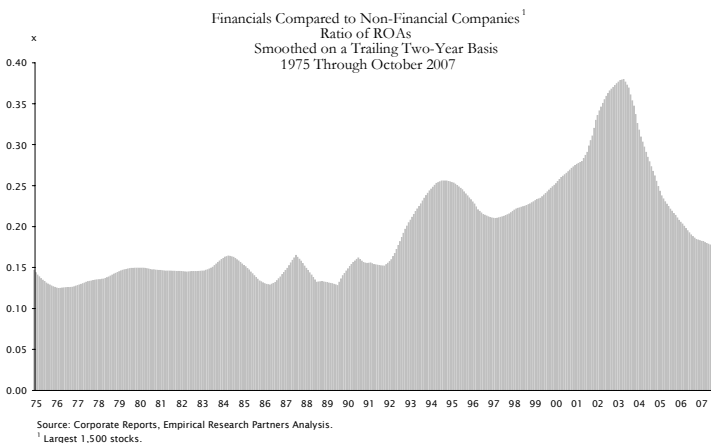


Exhibit 3



nearly 4% for the last two quarters. A key reason for this is the strength of net exports, which have risen at an annual rate of 8-1/4% in real terms for the last six quarters, compared with a growth rate of about 2-1/4% for real imports. According to former Fed Governor Lyle Gramley, the increase in net exports has offset roughly two-thirds of the decline in residential investment since the first quarter of 2006.

Another factor that has helped stave off recession so far this year is the stock market gains that have boosted consumer net worth by several trillion dollars since the end of 2005, helping to offset the negative effects of a decline in mortgage equity withdrawals (MEW) and the year-over-year drop in house prices. This may be one reason why consumers have continued to spend at a faster clip than many expected. Healthy wage gains and reasonably robust job growth have also been important in sustaining consumer spending.

A question increasingly on our minds is whether the Fed is “behind the curve” in responding to the evolving economic situation. We were encouraged that the Fed acted preemptively in August and September to cushion the expected negative impact of the credit crunch on overall economic growth. While the Fed’s 25 basis point rate cut in October was also welcome news, the accompanying statement signaling that the FOMC had shifted back to a neutral policy stance from a bias toward easing was not well received by the market. In our opinion, it was this statement that triggered the violent sell-off in the stock market—and particularly in financial stocks—on November 1. The market’s concern seems to be that if the Fed has, indeed, gone into reactive rather than proactive mode, by the time more evidence of economic weakness emerges, it may be too late to avoid recession. In our view, the Fed should take its cue from the financial sector. If financial stocks stabilize, we think the Fed can afford to sit tight and wait for more data. If financials continue to be noticeably weak, we think the Fed needs to return to a more proactive stance.

Assuming, as our base case does, that we can sidestep recession in 2008, the market should be able to post returns in line with, or slightly better than, its long-term averages next year. On a valuation basis, with the 10-year U.S. Treasury Note yielding 4.33%, we believe the S&P 500 is fairly valued at about 17.4 times earnings, versus current price-to-earnings multiples of 16.4 times 2007 consensus estimates and 14.6 times 2008 estimates. If 2008 estimates are right, the market has implied upside approaching 20% through the end of next year. Even allowing for some slippage in earnings estimates due to a slowing economy, if long rates behave, market returns in the high single-digits to low double-digits seem like reasonable expectations to us. Presidential election years have historically shown the second-best returns in the four-year election cycles, averaging 9% (before dividends) since 1928, with 15 of 20 instances showing positive returns.

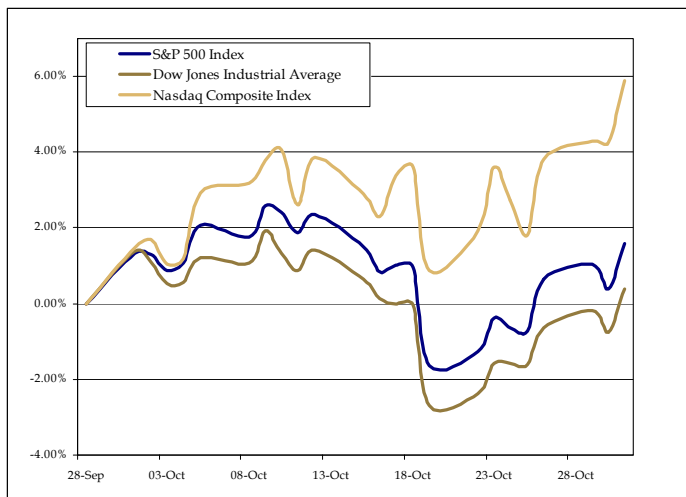
Even if the economy suffers a recession in 2008, we believe the market could show positive returns in 2008, though it would almost certainly go down first. In our view, a recessionary market decline would likely do the most damage to the sectors where

optimism is currently greatest—such as global cyclicals—while doing the least incremental damage to sectors—such as the financials—where pessimism is already quite pervasive.

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

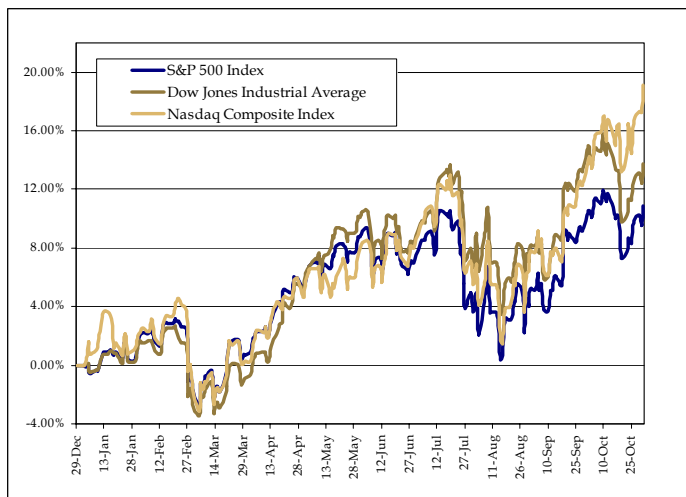
David E. Nelson, CFA
Chairman, Investment Policy Committee
Legg Mason Capital Management

Major Indices October Performance



Sources: Bloomberg and FactSet

Major Indices YTD Performance



Sources: Bloomberg and FactSet

Monthly U.S. Market Update (Total Returns)

Sector Index Name	October	YTD
<i>Broad Market Indices</i>		
S&P 500	1.59	10.87
Dow Jones	0.38	13.74
Russell 1000	1.74	11.21
NASDAQ	5.89	19.10
Dow Jones Wilshire 5000	1.91	11.21
Russell 2000	2.87	6.12
Russell 1000 Growth	3.40	16.51
Russell 1000 Value	0.01	5.98
<i>S&P 500 Sector Indices</i>		
S&P 500 Consumer Discretionary	0.06	(3.52)
S&P 500 Consumer Staples	1.81	11.95
S&P 500 Energy	1.08	30.10
S&P 500 Financials	(1.81)	(6.73)
S&P 500 Health Care	1.95	9.27
S&P 500 Industrials	(0.54)	16.82
S&P 500 Information Technology	7.15	24.51
S&P 500 Materials	4.10	27.46
S&P 500 Telecomm Services	(0.80)	16.99
S&P 500 Utilities	6.68	18.41

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.