

Market Commentary

U.S. stocks declined modestly in December, wrapping up a disappointing quarter in which the S&P 500 declined 3.33%. This was the worst fourth-quarter performance for the index since 2000's 7.82% decline, and represented only the fourth time in the last 25 years that the S&P 500 has posted a negative return in the final three months of the year. For the year as a whole, the S&P 500 posted a moderate total return of 5.49%. The Dow Industrial Average's return was slightly better at 8.88%, and the Nasdaq Composite's better still, at 10.66%. Previously noted style tilts toward large-cap and growth were very much in evidence in the full-year numbers, as the large-cap indices outperformed the Russell 2000 Index by 700 to 800 basis points, depending on the index, and the Russell 1000 Growth Index outperformed its value counterpart by nearly 1200 basis points.

TOTAL RETURNS

	Dec	Q4	Year
S&P 500 Index	-0.69%	-3.33%	+5.49%
Dow Industrials	-0.66%	-3.91%	+8.88%
Nasdaq Composite Index	-0.27%	-1.62%	+10.66%
S&P Mid-Cap 400 Index	-0.19%	-2.73%	+7.98%
Russell 2000 Index	-0.06%	-4.58%	-1.57%
Dow Jones Wilshire 5000 Index	-0.61%	-3.22%	+5.62%
S&P 100 Index	-0.74%	-3.48%	+6.12%
Russell 1000 Growth Index	-0.36%	-0.77%	+11.81%
Russell 1000 Value Index	-0.97%	-5.80%	-0.17%

Sources: Bloomberg, Wilshire, Russell

Hopes that the New Year might see a reversal of the fourth quarter's decline were quickly dashed, as the S&P 500 was down more in the first three trading days of 2008 (-3.84%) than it had been in the last three months of 2007. The Dow Industrial Average was down over 464 points (-3.47%) over the same three days, a start that Bloomberg News reported as the worst since 1904. We don't have good pricing data back that far, so we'll take Bloomberg at their word. The only years we could find to rival 2008's dismal start were 2000 and 1932. The first three trading days of 2000 were worse than this year for the S&P 500 (-4.56%), but not quite as bad for the Dow Industrials (-3.25%). The opening trading sessions of 1932 were a real rollercoaster ride. The Dow and S&P 500 were down 8.55% and 7.02%, respectively, in the first two trading days of 1932, but rallied sharply from there to finish the first week of trading (through Friday, January 8, 1932) up 5.01% and 5.54%, respectively, from their year-end closes. It's

probably too much to hope for that kind of rally in the coming days, but it's nice to dream!

In our opinion, the proximate cause of the market's weakness in the fourth quarter of 2007 and the early days of 2008 is that it has begun discounting a recession in the U.S. In fact, the market is behaving as though a U.S. recession is a virtual certainty. While we disagree that a recession is a foregone conclusion, recent developments have led us to believe that the odds that we are already in, or on the cusp of, a recession are now greater than 50/50. We put the current odds at about 55% to 60%. Our thinking has been influenced by a number of factors, including: (1) continuing unsettled conditions in the credit markets; (2) the action of the stock market itself, most notably, the continued weakness in consumer discretionary and financial stocks; (3) the weak December jobs report and the spike in the unemployment rate to 5%; (4) the decline in the Institute for Supply Management (ISM) manufacturing index to 47.7 in December, from 50.8 in November; and (5) the "wisdom of crowds" as reflected in the prediction market Intrade.com, which now puts the odds of recession in 2008 at about 60%.

If one could know with any degree of certainty that the economy was, in fact, slipping into recession, this information would be highly valuable, since stocks typically weaken in anticipation of recession, bottom out about halfway through it, and have already recovered much or all of their prior losses by the time it ends. Thus, it seems imminently logical that when a recession is on the way, one would sell stocks, waiting on the sidelines until the recession was about half over, and then buy back into the market. The problem with this approach is that recessions are notoriously difficult to predict, and most are not identified until well after they have begun, or, in the case of the two most recent recessions, until after they have ended. Faced with this difficulty, at any hint of recession, market participants have historically tended to sell first and ask questions later. This tendency is likely the reason that Nobel prize-winning economist Paul A. Samuelson is famously reported to have quipped: "The stock market has forecasted nine of the last five recessions."

Though we have recently come to believe that a recession in 2008 is more likely than not, a number of economists and strategists we admire are still betting the other way. ISI Group's models are still predicting a mid-cycle slowdown, but no recession. Their models are forecasting real GDP growth for the next couple of quarters to be in the range of 1%. Anatole Kaletsky and Charles Gave of

GaveKal Research also believe that the U.S. will avoid recession in 2008, but just barely. They note that the U.S. has never experienced a recession without real rates on long bonds moving above 3%, and often above 4%. Current real rates on 10-year and 30-year Treasuries of about 1.6% and 1.9%, respectively, are nowhere near those levels. GaveKal further notes that despite falling below 50, the current 47.7 reading on the ISM manufacturing index is consistent with real GDP of 1.5% to 2.0%. According to their work, the “recession trigger” on the ISM manufacturing index is 41.9.

The rising odds of recession have increased the likelihood of further Fed easing, in our opinion, a view that is shared by Fed funds futures market participants. As of January 8, futures prices indicated that it is a near certainty (98.5%) that the Fed will cut rates at the end of January, with a 38.6% chance of a 25-basis-point cut, a 50.3% chance of a 50-basis-point cut, and a 9.6% chance that the cut will be 75 basis points.

Declining stock prices, \$100 oil, weak jobs and manufacturing reports, and the spike in unemployment have soured investors’ appetite for stocks considerably in the last few weeks. In fact, one measure of investor sentiment—the American Association of Individual Investors (AAII) survey—has reached such depths of pessimism that it may be signaling that a meaningful rally in stocks is in the offing. A report from JPMorgan strategist Thomas J. Lee released on January 7, 2008 noted that the percentage of bearish investors in AAII’s latest weekly survey (1/04/08) exceeded the percentage of bulls by 29.5%. Only 15 times in the last 1,100 weeks, or 1.4% of the time, have the percentage of bears exceeded the percentage of bulls by 26% or more. In every prior instance when the reading was this negative, the S&P 500 was higher in 12 months by an average of over 20%. We, of course, can offer no assurance that the market will rally this time, but this contrary indicator’s past record of success is impressive and should offer investors some encouragement.

Outlook

In our view, the range of possible outcomes for the market in 2008 is wider than usual. Our best guess is that the U.S. equity market will post mid- to high-single-digit returns for the year, but we recognize there are plausible scenarios for returns that are both much better and much worse than that. In addition, returns could well be back-end loaded, with the first quarter and possibly first half tending to be weak, and with strength emerging in the second half of the year.

From a historical perspective, presidential election years have typically been good ones for the stock market. In the 20 presidential election years since 1928, the S&P 500 has

been up an average of 9% (excluding dividends), showing gains 15 times and losses 5 times. The skew of returns has also been favorable, as the market has been up 10% or more twice as often as it has been down.

While election year returns have been above average overall, they tend to be heavily dependent upon whether the incumbent party wins or not. Based on data from Ned Davis Research, since 1888, presidential election year returns have averaged 8.4% (ex-dividends). When the incumbent party wins, the returns have averaged 13.9%, while when it loses, the returns have averaged only 1.6%. Since the Democrats are currently given better than a 60% chance of retaking the White House from the Republicans by bettors on Intrade.com, we need to be realistic about our expectations for an election year tailwind.

From a pure valuation standpoint, the market appears to be trading at a significant discount to fair value based not only on our own work, but also on that of other strategists whose work we admire. One of those is Tobias Levkovich, Chief U.S. Equity Strategist for Citigroup Global Markets. Levkovich’s market valuation model compares the trailing P/E of the S&P 500 to the yield on the 10-year Treasury note plus an equity risk premium, and finds a statistically significant inverse correlation of 0.73 between the two. Since 1961, when the actual trailing P/E of the S&P 500 has been more than one standard deviation below its fair value trend line P/E (as it is currently), the S&P 500 has always been up over the next 12 months, with an average gain of 23%.

Our own valuation work estimates the current fair value multiple of the S&P 500 to be about 18.5 times earnings, based on the following set of assumptions: (1) long-term earnings per share growth of 6%, (2) return on equity of 16%, (3) weighted-average cost of capital equal to the 10-year Treasury note yield plus an equity risk premium of 4%, and (4) a 20-year competitive advantage period (CAP), which is our estimate of the length of time that the S&P 500 as a whole will earn returns in excess of its cost of capital.

Our fair value estimate of 18.5 times earnings for the S&P 500 compares to year-end P/Es for that index of 16.7 and 14.7 for 2007 and 2008, respectively, based on bottom-up, cap-weighted consensus earnings estimates, implying market undervaluation of better than 10% on 2007 estimates and more than 20% based on 2008 figures. The composite earnings per share estimates for the S&P 500 for 2007 and 2008 derived from aggregating bottom-up numbers are \$88.19 and \$99.75, respectively. The 2007 composite earnings estimate has come down from \$93 or so in the last few months and is probably fairly close to right, in our opinion, but the accuracy of the 2008 estimate is an open question.

Based on the slowing economy, the trend of earnings revisions and the increasing odds of recession, the 2008 S&P 500

composite estimate looks high to us by \$5 per share or so. Using a composite estimate of \$95 per share would mean that the S&P 500 began the year trading at about 15.5 times earnings and has dropped under 15 times following its early year weakness. Even if earnings are flat in 2008, the S&P 500's multiple would still be under 17 times earnings. Only a drop in composite earnings to less than \$80 would make the market look overvalued, based on our work. This is a scenario about which investors appear to be increasingly worried.

Apart from material earnings weakness, we think the other key risk to the market as a whole is the increasing likelihood that tax rates on dividends and capital gains will rise after 2010 if, as now seems probable, a Democrat wins the presidency in 2008. Jason Trennert of Strategas Research Partners estimates that if capital gains tax rates were to rise to 28% and tax rates on dividends were to rise to 39.5%, it would shave two multiple points off the market's fair value. In our opinion, the key takeaway from our and others' valuation work is that the market does appear to be undervalued, but probably not as much so as the consensus numbers suggest.

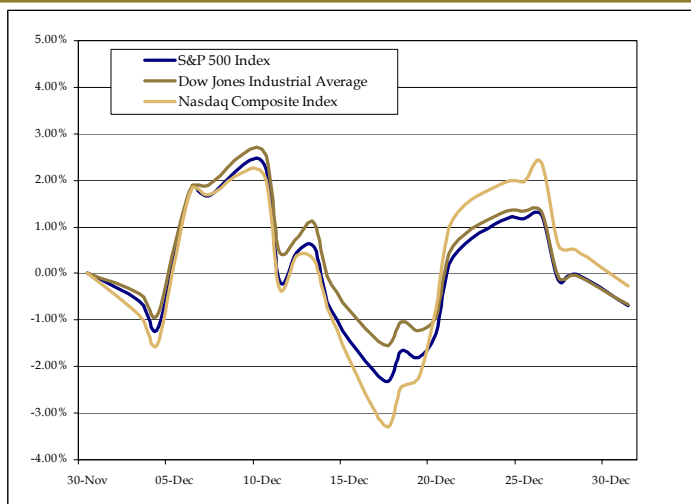
Speaking of valuation, in order for it to matter, investors have to care about it, which they clearly did not in 2007. As we have reported in our last few commentaries, according to data from Empirical Research Partners, the cheapest stocks in the market based on a composite of valuation factors underperformed the most expensive stocks on those metrics by nearly 2500 basis points in 2007. At the same time, those stocks with the best prior price momentum outperformed their weaker counterparts by more than 3300 basis points, a truly astounding premium. We would be very surprised if these trends persist throughout 2008. We believe that valuation will ultimately matter, as it always does eventually, and when the turn comes it will be a powerful one.

In summary, we believe 2008 could well turn out to be a volatile and difficult year. It certainly has been to this point. The market is currently weak and could remain so through the first quarter. On the other hand, investor sentiment as measured by AAII survey data is about as pessimistic as it ever gets, suggesting that a powerful rally may be in the offing. On balance, market valuation is quite supportive of higher prices, in our view. A near-term key to the direction of the market is satisfactory resolution of turmoil in the mortgage market. Easing of tensions there could trigger a powerful rally in stocks, but continued turmoil could drag the economy into recession and precipitate a bear market in equities.

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

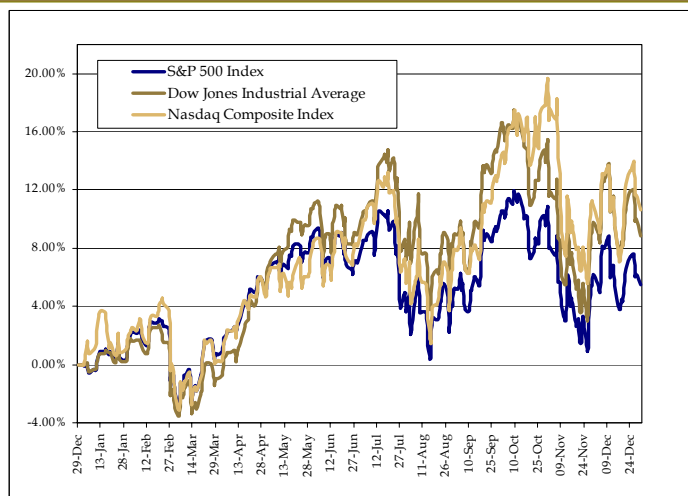
David E. Nelson, CFA
Chairman, Investment Policy Committee
Legg Mason Capital Management

Major Indices December Performance



Sources: Bloomberg and FactSet

Major Indices YTD Performance



Sources: Bloomberg and FactSet

Monthly U.S. Market Update (Total Returns)

Sector Index Name	December	Q4	2007
<i>Broad Market Indices</i>			
S&P 500	(0.69)	(3.33)	5.49
Dow Jones	(0.66)	(3.91)	8.88
Russell 1000	(0.65)	(3.23)	5.77
NASDAQ	(0.27)	(1.62)	10.66
Dow Jones Wilshire 5000	(0.61)	(3.22)	5.62
Russell 2000	(0.06)	(4.58)	(1.57)
Russell 1000 Growth	(0.36)	(0.77)	11.81
Russell 1000 Value	(0.97)	(5.80)	(0.17)
<i>S&P 500 Sector Indices</i>			
S&P 500 Consumer Discretionary	(4.79)	(10.00)	(13.21)
S&P 500 Consumer Staples	(0.96)	3.84	14.18
S&P 500 Energy	7.33	4.42	34.40
S&P 500 Financials	(5.44)	(14.33)	(18.63)
S&P 500 Health Care	(3.03)	(0.03)	7.15
S&P 500 Industrials	(0.59)	(4.62)	12.03
S&P 500 Information Technology	1.52	0.08	16.30
S&P 500 Materials	1.09	0.08	22.53
S&P 500 Telecomm Services	3.16	(5.08)	11.94
S&P 500 Utilities	0.26	7.55	19.38

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.