

Market Commentary

What started out to be the worst January on record turned out to be only the fifth worst since 1950, as the Fed rode to the stock market's rescue with two rate cuts totaling 125 basis points in the space of nine days. Prior to the Fed's 75-basis-point intra-meeting rate cut on January 22, the market had gotten pretty ugly, with the S&P 500 down nearly 10% for the month and over 15% from its October 2007 closing high of 1565.15. From its closing low of 1310.50 on January 22, the S&P 500 rallied over 5% through month-end to cut its January loss to 6%, heartened by the Fed's newly found focus on the downside risks, confirmed by its follow-on 50-basis-point cut at its regular month-end meeting.

TOTAL RETURNS	
	Jan
S&P 500 Index	-6.00%
Dow Industrials	-4.48%
Nasdaq Composite Index	-9.86%
S&P Mid-Cap 400 Index	-6.16%
Russell 2000 Index	-6.82%
Dow Jones Wilshire 5000 Index	-6.05%
S&P 100 Index	-6.07%
Russell 1000 Growth Index	-7.80%
Russell 1000 Value Index	-4.01%

Sources: Bloomberg, Wilshire, Russell

Early in the month, the market decline was fairly ecumenical with nearly everything getting hit with relatively equal force. As the month progressed and especially after the Fed stepped in, the rules of the road changed dramatically as last year's winners got slammed and last year's losers moved to the forefront. For the month as a whole, the flip-flop could hardly have been more complete. Financial stocks (-0.3%), the pariahs of 2007, went from worst to first in the performance derby, followed closely by the consumer discretionary stocks (-1.3%), the other ugly-duckling group of 2007. Last year's leading group, energy (-10.9%), took it on the chin, as did the tech stocks (-12.5%), led lower by one of last year's market darlings, Apple, off 32% for the month. Foreign markets also provided no shelter from the storm, as they generally fared worse than the U.S. market. The Morgan Stanley Capital International EAFE Index sank 9.3% in dollar terms and 11% in local currencies, while the MSCI Emerging Markets Index tumbled 13% in both dollars and local currencies.

In another major flip-flop from 2007, the momentum-based investment strategies that were so wildly successful last year got their comeuppance in January, as stocks with the best prior price momentum underperformed those with the worst momentum by over 1000 basis points in 2008's opening month, according to

Empirical Research Partners. Empirical's data also revealed that the cheapest stocks in their valuation-based model, which failed so miserably in 2007, outperformed the most expensive stocks by more than 1000 basis points in January. Given this data, it should surprise no one that the Russell 1000 Value Index outperformed its growth counterpart by nearly 400 basis points for the month. Has momentum investing's magic spell been broken and will investors' return to a valuation-based focus be sustained? We think the answer is yes, but only time will tell.

Does the weak start to the year portend a down year for the market in 2008? The so-called "January Barometer," which posits that as January goes, so goes the year, would suggest that it does. First recognized by Yale Hirsch in 1972, the January Barometer appears to be an especially good predictor when the market is up in January. In the 58 years since 1950, the S&P 500 has been up in January 37 times. Of those years, the S&P has been up for the year 34 times, or more than 90% of the time. On the downside, the correlation is not as strong, but the market direction in January is still predictive of the direction of full-year results more often than not. In the 21 years since 1950 that the S&P 500 has been down in January, it has finished the full year down 12 times, or a little more than half the time. When the market is very weak in January, as it was this year, the odds rise that the year itself will also be down. Following the 10 worst Januarys since 1950, the S&P 500 was down for the year 7 times. Those are higher odds of a down year than we like to see. On the other hand, in those same 10 worst Januarys, the S&P 500 was down an average of 5.5% for the month, but only down an average of 5.8% for the full year. So, most of the damage for the year was done in the first month, and from there, the market was about flat for the rest of the year.

As if the tough start to the year were not enough to worry about, investors continue to face great uncertainty concerning the likelihood of recession this year. On this issue, the recent data is mixed. The Fed's aggressive action on rates in the latter half of January served to alleviate one of our chief concerns, namely that the Fed did not fully appreciate the downside risks to the economy posed by the turmoil and mistrust in the credit markets. Following the Fed's intra-meeting rate cut, the odds of recession on Intrade.com dropped back into the high 60s from a high of 75% in mid-January, only to bounce back over 70% following today's (2/5/08) release of an unexpectedly weak January ISM non-manufacturing index reading, which dropped to a near-recessionary level of 41.9.

At this point, we are maintaining our internal odds of recession at about 55% to 60%. The weak ISM report was an unpleasant surprise, to say the least. On the other hand, other precursors of recession are not in place at present. This is particularly true with respect to inventory levels. Normally, the inventory-to-sales ratio rises sharply ahead of recession, but recently it has remained low and falling. Real rates, at less

than 2%, are far below the 4% level that has typically accompanied—and arguably engendered—past recessions. We are by no means out of the woods, but we think there is a reasonable chance that we’ll avoid recession in 2008. Since the stock market has gone a long way toward discounting a recession already, should one not occur, we believe the market’s snapback potential is quite considerable.

In the wake of the market’s January downdraft, we are heartened by the sour mood of the investing public. We noted last month that data from the American Association of Individual Investors (AAII) was about as pessimistic as it ever gets. This mood is confirmed by Ned Davis Research’s Crowd Sentiment Poll, which, as of January 29, was registering solidly in the “extreme pessimism” zone that, in the past, has been associated with spirited market rallies. Finally, we were impressed with Mark Hulbert’s “Strategies” column in a recent Sunday edition of *The New York Times* (January 27, 2008). In his *Times* piece, Hulbert contrasted the investment sentiment of two very different groups: investment newsletter editors and corporate insiders. He noted that investment newsletter writers—who as a group are usually wrong about the direction of the market—are currently very bearish. In contrast, corporate insiders—who usually get it right—are bullish.

Describing their track record of success as “inglorious,” Hulbert reports that the subset of investment newsletter editors that focus on timing the market’s short-term gyrations are currently recommending an average exposure to equities of minus 1%, down from a suggested net exposure of 46.7% in October 2007. In other words, they currently want their subscribers to be net short the market, after a 15% drop. Hulbert finds the speed with which newsletter writers have turned bearish to be a bullish indicator itself, since it contrasts sharply with their normal behavior of remaining stubbornly bullish as the market declines. For example, three and a half months after the market’s peak in March 2000, the recommended exposure among short-term market-timing newsletters was actually higher than it was at the top of the market.

In contrast to investment newsletter editors, corporate insiders are now behaving more bullishly than at any time since November 2002, based on transactions reported to Argus Research. According to Argus, the normal insider sell-to-buy ratio is about 2.5 to 1. For the week ending January 18, it was 0.89 to 1. Since week-to-week ratios can be volatile, Argus calculates an eight-week moving average, whose most recent reading was 1.44 to 1. This is the lowest reading since the eight weeks ended November 15, 2002, when it was 1.33 to 1. While we can offer no assurances about the near-term direction of the market, based on the track record of corporate insiders versus the track record of investment newsletter editors, we think it makes a lot more sense to be bullish from here than it does to be bearish.

Outlook

The historical odds favor 2008 being a down year in the market. As we noted in the Commentary section, in the 10 worst Januarys since 1950, which on average are about as bad as this January, the market was down for the year 7 times. We see those odds, we understand those odds, and we respect those odds. But in our heart of hearts,

we still think 2008 will be an up year in the market—maybe not a big up year, but an up year nonetheless. Why are we willing to bet against the historical odds? Two reasons. First, investor sentiment is extremely pessimistic, which is bullish because it means that a lot of bad news is already priced into the market. Second, the current valuation level of the market looks a lot more like a bottom to us than a top.

Take a good, hard look at the table below. It presents key valuation metrics for stocks, bonds and cash at the top of the market in 2000, the bottom of the market in 2002 and as of the end of January. The last time we used it was at the end of November 2007. At that time, we argued that stocks were reasonably attractive versus bonds. Since then, bonds are up and the S&P 500 is down about 100 points, or roughly 7%. So, as a short-term timing tool, the chart is arguably not too helpful. But as an indicator of long-term value, we have found it to be very useful. Looking at the spread between the earnings yield on stocks and the 10-year Treasury note yield has been a simple, but effective, way of measuring the relative attractiveness of stocks versus bonds. The negative 258-basis-point spread in March 2000 was a powerful buy signal for bonds and sell signal for stocks. The whopping 385-basis-point positive spread in October 2002 was an equally strong signal that stocks were very attractive. We find it fascinating that the spread in favor of stocks today is nearly as wide as it was in October 2002. It was even wider at the market’s recent low (1/22/08).

	March 24, 2000	October 9, 2002	January 31, 2008
10-Year T-Notes	6.20%	3.56%	3.56%
10-Year TIPS	4.09%	2.21%	1.21%
6-Month Bills	6.16%	1.51%	2.06%
S&P 500 Price	1,527.46	776.46	1,378.55
Dividend Yield	1.06%	2.04%	2.09%
Earnings Yield	3.62%	7.41%	7.32%
P/E Ratios:			
10-Year T-Notes	16.1x	28.1x	28.1x
S&P 500	27.6x	13.5x	13.7x
6-Month T-Bills	16.2x	66.2x	48.5x

Sources: Bloomberg, Factset Data Systems, LMCM Estimates

As we have noted in past discussions of this chart, the obvious risks to this type of relative valuation, or spread, analysis is either that the yield on the 10-year Treasury will rise substantially, or that the 2008 estimate of S&P 500 earnings (\$100.92/share) implied by a 7.32% earnings yield is way too high. With that in mind, we thought it might be useful to test the sensitivity of our spread model to short-falls in earnings to see how low S&P 500 earnings would have to fall to make stocks unattractive relative to bonds based on this framework.

S&P 500 EPS 2008E	Implied P/E 2008E	Implied Earnings Yield 2008E
\$100.92	13.7x	7.32%
95.00	14.5x	6.89%
85.00	16.2x	6.17%
75.00	18.4x	5.44%

Our experience has been that stocks are attractive relative to bonds when the earnings yield on stocks exceeds the yield on the 10-year Treasury by 200 basis points or more. Using this rule of thumb, based on the January month-end 10-year Treasury yield of 3.56%, S&P 500 earnings in 2008 would have to fall below \$77 per share in order for stocks to have an earnings yield less than 200 basis points higher than Treasuries. Alternatively, if 10-year Treasury yields backed up to 4%, S&P 500 earnings in 2008 could fall to about \$82.70, and stocks would still sport a 2% yield advantage over bonds.

As of now, we do not see earnings shortfalls in 2008 of anything like this magnitude as very likely. In fact, outside of the now well-publicized problems in the financial sector, earnings have been holding up reasonably well. With about half of constituent companies having reported, S&P 500 earnings ex-financials are up about 12% year-over-year in the fourth quarter of 2007, and while year-over-year growth is expected to slow to a 2.2% and 1.9% rate in the first and second quarters of 2008, respectively, comparable growth rates ex-financials are expected to be 12.3% and 11.3%, respectively.

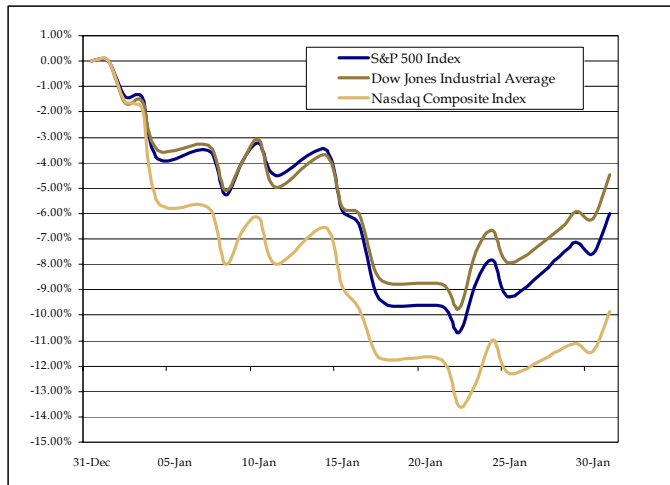
With the U.S. economy set to slow meaningfully in 2008, a shortfall from expectations in corporate earnings is a clear risk to our constructive outlook on the U.S. equity market from here. Even if we avoid outright recession in 2008, a 1% to 2% real GDP environment with core inflation something over 2% implies nominal GDP growth of 3% to 4%. That's going to "feel" like a recession to a lot of companies. In this environment, we think risks are highest where expectations are still elevated.

As we suspected it might be, 2008 is turning out to be a very different kind of year than 2007. We do not believe this will be a "buy the new high list" kind of a year. We think it could be a challenging year—to be sure—but also one in which valuation matters a lot more than it did in 2007. In short, it should be much more our kind of year.

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

David E. Nelson, CFA
Chairman, Investment Policy Committee
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Major Indices January Performance



Sources: Bloomberg and FactSet

Monthly U.S. Market Update (Total Returns)

Index Name	January
<i>Broad Market Indices</i>	
S&P 500	(6.00)
Dow Jones	(4.48)
Russell 1000	(6.00)
NASDAQ	(9.86)
Dow Jones Wilshire 5000	(6.05)
Russell 2000	(6.82)
Russell 1000 Growth	(7.80)
Russell 1000 Value	(4.01)
<i>S&P 500 Sector Indices</i>	
S&P 500 Consumer Discretionary	(1.27)
S&P 500 Consumer Staples	(5.20)
S&P 500 Energy	(10.92)
S&P 500 Financials	(0.34)
S&P 500 Health Care	(4.81)
S&P 500 Industrials	(4.41)
S&P 500 Information Technology	(12.49)
S&P 500 Materials	(3.93)
S&P 500 Telecomm Services	(9.10)
S&P 500 Utilities	(6.84)

Sources: Bloomberg, FactSet, Russell

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