

Market Commentary

Thank goodness leap year only comes every four years, because February 29 was an ugly end to a tough month, with the S&P 500's 2.71% drop on that date accounting for over 80% of its February decline. While not as severe as January's decline, February's drop was, in many ways, more disheartening, because the month began so promisingly and ended so badly. February's news flow offered up an ample list of concerns. Gold and commodity prices surged, while the dollar made a new low against the euro. More perniciously, credit spreads—which had seemed to be on a narrowing trend in late January—widened significantly in February on a broad range of fixed-income instruments, heightening concerns among market participants and blunting, to some degree at least, the salutary effects of Fed rate cuts.

TOTAL RETURNS

	Feb	YTD
S&P 500 Index	-3.25%	-9.05%
Dow Industrials	-2.75%	-7.11%
Nasdaq Composite Index	-4.85%	-14.23%
S&P Mid-Cap 400 Index	-1.86%	-7.91%
Russell 2000 Index	-3.71%	-10.27%
Dow Jones Wilshire 5000 Index	-3.02%	-8.89%
S&P 100 Index	-4.30%	-10.10%
Russell 1000 Growth Index	-1.99%	-9.63%
Russell 1000 Value Index	-4.19%	-8.03%

Sources: Bloomberg, Wilshire, Russell

The performance flip-flop we wrote about in January flip-flopped back again in February, with investors ending their brief infatuation with consumer discretionary stocks and financials and renewing their long-standing love affair with energy and commodity stocks. For the month, only the energy (+7.0%) and materials (+2.1%) sectors of the S&P 500 posted positive returns. Other sectors that outperformed the S&P for the month were consumer staples, health care and industrials. Underperforming sectors included financials, telecom services, utilities, technology and consumer discretionary stocks. Financials (-11.2%), the most direct victims of renewed turmoil in the credit markets, and telecom services (-9.6%) were notably weaker than the overall market.

It is not a happy time for investors—such as ourselves—who have been constructive on the U.S. equity market. The February jobs report showing a decline in employment of 63,000 together with revisions to December's and January's

reports totaling 46,000 jobs increase the odds that first-quarter real GDP growth will be negative. Following the jobs report, the odds of recession on Intrade.com spiked to 69% from 59.5%. Lyle Gramley—who previously thought we would skirt recession—now believes the odds are about 3-to-1 that we're already in the early stages of recession. The wizard of Omaha, Berkshire Hathaway Chairman Warren Buffett, told CNBC anchor Becky Quick in a live TV interview on March 3, "By any commonsense definition, we are in a recession." We have come around to that view ourselves, believing that the odds that we are in a recession now exceed 75%.

Absent the current turmoil in the credit markets, we would have expected any recession to be relatively shallow and short-lived, with the overall health of the corporate sector and strong export growth tending to mitigate the expected slowdown in consumer spending. But, unfortunately, the turmoil in the credit markets cannot be ignored. In fact, it is the key risk to the overall economic outlook, as well as the outlook for the stock market, in our view.

Credit markets have deteriorated breathtakingly in the last month or so. Credit spreads over Treasuries have blown out for a variety of fixed-income instruments and the mortgage market has gone into virtual meltdown. Even loans guaranteed by the government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, are being viewed by the marketplace with deep suspicion. On Thursday, March 6, the index of yields on Fannie Mae guaranteed loans rose 13 basis points to 5.96% at the same time that the yield on 10-year Treasury bonds fell 9 basis points to 3.58%. The resulting spread of 238 basis points was the largest since 1986—wider even than spreads during the Crash of 1987—and up nearly 100 basis points since the beginning of 2008.

In our view, fixed-income investors should be licking their chops at the opportunities now available in the mortgage market. Instead, most seem to be avoiding even agency and AAA mortgages like the plague, as quality paper is dumped on the market via either forced or panic selling. This seems to us like a classic behavioral overreaction. Early last year, when perceived risks in the mortgage market were minimal, investors were willing to take on what proved to be enormous actual risk for little incremental compensation. Today, when perceived risk is enormous, actual risk is much diminished, in our judgment, and investors are being paid handsomely to assume it.

We believe disruption in the credit markets—and especially the mortgage market—is the most important problem facing investors today. It ranks number one, two and three on our list. Until it is solved, it will be nearly impossible for the equity market to make upward progress, in our opinion. We believe the Fed has it within its power to fix the problem, but rate cuts alone will not do the trick. Don't get us wrong, we believe that further rate cuts are necessary and important. They are, in our view, a necessary, but not sufficient, condition for economic and stock market recovery.

We think the Fed's expanded Term Auction Facility (TAF) is a step in the right direction. We especially applaud its expanded \$100 billion bank auction plan as well as its decision to make an additional \$200 billion available to primary dealers through a series of 28-day term repurchase agreements, allowing these institutions to exchange both agency and highly rated non-agency mortgage-related securities for Treasuries. As encouraging as these steps are, we would like to see the Fed address this crisis of confidence even more directly. We strongly believe that the Fed should use its formidable balance sheet to purchase mortgages in the open market. They could fund their purchases by selling Treasury securities for which there now seems to be exceptionally strong demand. This would not, in our view, constitute a bail out of the mortgage market. It would be purely an investment operation, in which the Fed sold securities that are in great demand—and arguably overpriced—to buy agency-backed mortgages that offer much higher yields and are arguably underpriced, but for which market participants currently have little appetite. We believe the Fed is highly likely to make money on this trade. The only thing that might prevent it from doing so is that merely announcing its intention to do so may eliminate the opportunity.

Outlook

We are pretty obviously in a difficult market environment. The S&P 500 broke through its January 22 closing low on Friday, March 7, finishing the session at 1293.37, down 17.4% from its October 9, 2007 closing high of 1565.15. It looks increasingly as though we are in a recession, and the market could definitely work its way lower, especially if the credit markets do not improve. As we noted earlier, we believe the stock market and the economy are hostage to the current crisis of confidence in the fixed-income markets. The ongoing deleveraging of the financial sector increases the near-term risk of more financial accidents and lends an air of legitimacy to recurrent rumors that this or that financial institution is about to go under.

At times such as these, the drumbeat of negative news always makes it difficult to keep one's composure and to recognize that times of crisis also offer great opportunities for those able to lengthen their time horizons from hours, days and

weeks to months, quarters and years. Amidst the current gloom, the seeds of the next market advance are being sown. The signs are there, if only we can recognize them.

On the sentiment front, investor bearishness is reaching extremes. Net flows into domestic equity mutual funds are hugely negative at present, as they were in late 2002 and early 2003, and as they have been at most attractive market entry points in times past. The 10-day put-call ratio matched its record January 2008 low reading of 0.85 last week, suggesting strongly that most investors expect further market weakness and are taking steps to protect themselves against it. Risk aversion has increased to such high levels that investors are now willing to accept negative yields to maturity on one-year, two-year, three-year and four-year TIPS (Treasury Inflation-Protected Securities). The yield to maturity on five-year TIPS is positive by only a few basis points. In our view, these negative real returns on shorter maturity TIPS are fairly dramatic evidence of the extent to which investors are willing to go to avoid their current twin nemeses—inflation and credit risk.

At the same time that investor sentiment is deeply pessimistic, market valuation levels are increasingly compelling as prices decline, in our judgment. The bottom-up, cap-weighted 2008 consensus earnings estimate for the S&P 500 has declined about 3% in the last month from \$100.92 at the end of January to \$97.98 as Friday, March 7. Using Friday's close of 1293.37, the S&P 500 has a current P/E of 13.2 times, for an earnings yield of 7.58%, a full 413 basis points higher than the current 3.45% yield to maturity on the 10-year Treasury. That is higher by nearly 30 basis points than the yield spread that prevailed at the stock market bottom in October 2002.

As we pointed out last month, there are a few key risks to this kind of spread-based analysis. First, rather than indicating how cheap stocks are, it might be showing how expensive Treasuries are. We think both things are true currently. Second, valuation-based tools are not always good timing tools. So, even if the market is, in fact, cheap, that doesn't necessarily mean that it will go up anytime soon. We acknowledge that fact. We do believe, however, that if the market is, in fact, as cheap as it looks on this measure, it will go up *eventually*.

The final risk with our relative-valuation-based approach is that the current consensus earnings estimate for the S&P 500 may be too high. It looks somewhat high to us, but the question is: By how much? In other words, the key issue—as it usually is—is not so much what will happen to earnings, as what will happen to earnings *relative to what the market has already discounted*? As we indicated last month, in our view, earnings would have to decline by a fairly considerable degree to make stocks unattractive relative to bonds. Specifically,

with the 10-year Treasury at 3.45%, the 2008 consensus estimate could fall to as low as \$70.50, and stocks would still have an earnings yield 200 basis points higher than the 10-year, a level that has favored stocks over bonds in the past.

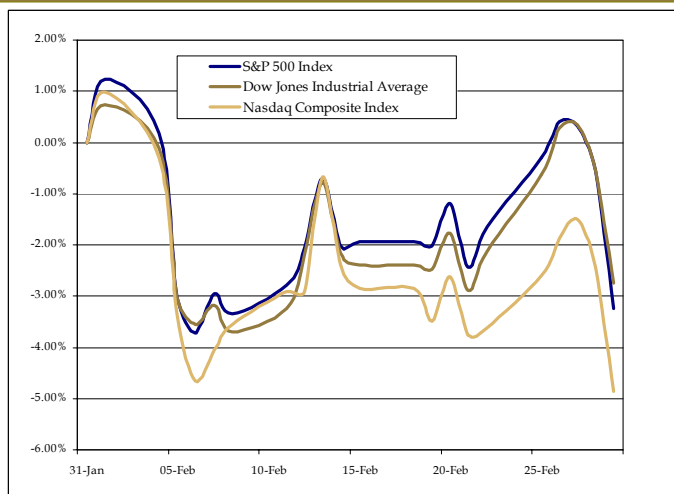
In summary, we find ourselves as investors in the situation where things are *in all probability* not as bad as they currently appear—but they *could be* as bad as they appear if confidence in the credit markets is not restored. We believe that continued aggressive Fed easing is a necessary, but not sufficient, condition for the healing process to begin. The Fed funds futures markets are pricing in a 100% probability that the Fed will cut rates on March 18—anywhere from 25 to as much as 125 basis points. Our bet is that they will do at least 75 basis points. But that is only step one, in our view. We think the Fed must act to restore confidence in high-quality mortgage assets by going directly into the marketplace and buying them. We think this would do wonders for investor confidence and would likely bring a flood of follow-on buying into the highest quality areas of the fixed-income market. With some sense of confidence restored, we believe the sorting out of lesser quality fixed-income assets could then proceed.

Is this a pipe dream on our part? Well, maybe, but we don't think so. Stranger things have happened. Remember that the presumptive Republican nominee for the presidency, John McCain, was thought to be a dead duck last July, when he was running out of money, his campaign operations were in disarray and he was given only a 4.4% chance of getting his party's nomination on Intrade.com. If that tell us anything, it tells us: (1) never give up and (2) things can change a lot in a few months.

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

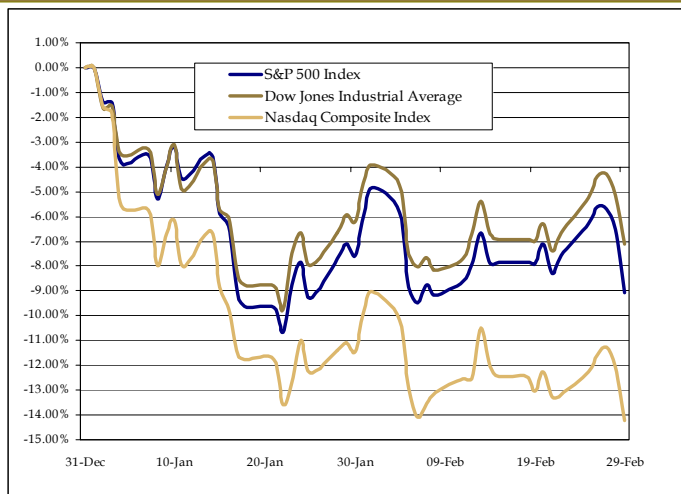
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Major Indices February Performance



Sources: Bloomberg and FactSet

Major Indices YTD Performance



Sources: Bloomberg and FactSet

Monthly U.S. Market Update (Total Returns)

Index Name	February	YTD
<i>Broad Market Indices</i>		
S&P 500	(3.25)	(9.05)
Dow Jones	(2.75)	(7.11)
Russell 1000	(3.06)	(8.87)
NASDAQ	(4.85)	(14.23)
Dow Jones Wilshire 5000	(3.02)	(8.89)
Russell 2000	(3.71)	(10.27)
Russell 1000 Growth	(1.99)	(9.63)
Russell 1000 Value	(4.19)	(8.03)
<i>S&P 500 Sector Indices</i>		
S&P 500 Consumer Discretionary	(3.91)	(5.14)
S&P 500 Consumer Staples	(0.19)	(5.38)
S&P 500 Energy	7.00	(4.68)
S&P 500 Financials	(11.24)	(11.55)
S&P 500 Health Care	(2.26)	(6.96)
S&P 500 Industrials	(2.66)	(6.95)
S&P 500 Information Technology	(4.00)	(15.99)
S&P 500 Materials	2.09	(1.93)
S&P 500 Telecomm Services	(9.60)	(17.83)
S&P 500 Utilities	(4.91)	(11.41)

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