

Market Commentary

The S&P 500 Index posted its best monthly showing since 2003 in April, recovering roughly half the ground it lost in the first quarter. May has gotten off to a promising start with solid gains in the first two trading days. From its March 17 low, the S&P 500 was up +8.7% through April month-end. Through Tuesday, May 6, the S&P 500 is +11.3% off its bottom.

TOTAL RETURNS

	Apr	YTD
S&P 500 Index	+4.87%	-5.03%
Dow Industrials	+4.70%	-2.63%
Nasdaq Composite Index	+5.90%	-8.80%
S&P MidCap 400 Index	+7.71%	-1.83%
Russell 2000 Index	+4.19%	-6.12%
Dow Jones Wilshire 5000 Index	+4.97%	-5.02%
S&P 100 Index	+4.59%	-5.81%
Russell 1000 Growth Index	+5.25%	-5.46%
Russell 1000 Value Index	+4.87%	-4.27%

Sources: Bloomberg, Wilshire, Russell

The major U.S. equity market indices showed strength across the board in April. The broadest of these—the Dow Jones Wilshire 5000 Index—was up just under +5%. Indices performing better than this were the S&P MidCap 400 Index (the champ for the month and leader in the clubhouse year-to-date), the Nasdaq Composite and the Russell 1000 Growth Index. The monthly leaders gave evidence of an increased appetite for risk on the part of investors. No index did badly during the month, but one had to finish last, and it turned out to be the Russell 2000.

On a sector basis, returns were more disparate. Consumer staples stocks (-0.22%)—the best-performing S&P 500 sector in the first quarter—were left at the starting gate in April, as investors focused on a more venturesome lineup that included energy (+10.88%), technology (+6.92%), financials (+6.54%) and materials (+5.46%). Energy and financial stocks have been highly anti-correlated in the recent past, so we found it a bit surprising that they were strong together in April.

Our thesis that the Fed-brokered rescue of Bear Stearns by JPMorgan Chase might mark the point of maximum pessimism, and therefore, quite possibly, the bottom of the current financial crisis appears to be playing out. As noted above, the market has rallied sharply since March 17, led by the financials, which are up +18.0% since then through May 6. With the market up and the clouds appearing to lift a bit, it's easy to forget how black the mood was just seven weeks ago.

We were reminded of the litany of concerns circulating in the media at that time as we read Richard Russell's latest *Dow Theory Letter* a few days ago. For those not familiar with Russell, his *Dow Theory Letter* is celebrating its 50th anniversary this year. Coincidentally, the latest issue of *Barron's* (5/5/08) has a piece by Russell arguing that the bull market is intact and new highs are likely ahead. Anyone who has managed to maintain his sanity—and his client base—through 50 years of stock market gyrations must be doing something right and has our sincere admiration. We monitor his thinking periodically as a subscriber to his letter. In his April 30 letter, Russell ticks off what he describes as “a few” of the bearish worries plaguing investors recently. He credits a similar list penned by John Bollinger in his *Capital Growth Letter* as the inspiration for his list. Both Russell and Bollinger believe that investors are currently overly pessimistic and that the market's recent rise is a classic example of “climbing a wall of worry.” Below are a few of the worries Messrs. Russell and Bollinger see weighing on the market recently:

- (1) The dollar is going to zero.
- (2) The U.S. is headed for a depression.
- (3) The U.S. financial system is melting down and will drag the international financial system with it.
- (4) The U.S. is in secular decline.
- (5) A derivatives explosion will bankrupt the financial system.
- (6) U.S. consumers have too much debt.
- (7) The U.S. is the world's biggest debtor and headed for banana republic status.
- (8) We spend too much and save nothing.
- (9) Our public education system is a disaster.
- (10) The U.S. is becoming

a nation of obese and out-of-shape diabetics. (11) We don't make anything anymore. (12) China will bury us. (13) European dependence on Russian oil and gas will make it a de facto satellite of Russia. (14) The wars in Iraq and Afghanistan are bankrupting us. (15) The Fed is pushing on a string. (16) Bernanke doesn't know what he is doing. (17) Baby boomers are becoming net sellers of financial assets to fund their retirement and will be a drag on the market for years to come. (18) Foreigners are buying up America. (19) We are too dependent on foreign oil. (20) Gas is headed to \$5/gallon. (21) The western U.S. is running out of water. (22) Social Security will implode. (23) Medicare and Medicaid are out of control and will bankrupt us. (24) There is not enough food to go around. (25) Global warming is a looming disaster. (26) No matter which party wins the White House in November, tax rates on income, dividends and capital gains are going up. (27) If inflation doesn't kill us, hyper-inflation, stagflation, deflation or depression will.

With the above list of concerns weighing on investors' psyches, it is no wonder that consumer confidence has recently dropped to a multi-decade low. The surprise, if any, is that in the face of all this negativity, the market has managed to rally. Given that there is at least an element of truth to most of the concerns listed above, what is the market seeing that perhaps others are not that would explain its strength? In the Outlook section, as an antidote to what we also see as excessive media focus on what could go wrong, we offer a list of things that might go right and could, should they occur, support a continued advance—perhaps a sizeable one—in the market.

Outlook

With the equity market having rallied strongly off its March 17 low, a market correction somewhere along the way would not especially surprise or trouble us. That said, we think the path of least resistance for the market is up through the balance of the year. In our opinion, with credit market conditions now on an improving trend and the worst of the financial crisis likely behind us, the stock market's appeal versus cash and bonds will begin to assert itself. Our valuation work indicates that the S&P 500 Index is currently worth about 17.5 times

earnings versus a current P/E on 2008 consensus estimates of about 14.5 times, suggesting upside to fair value in the range of 20%.

One reason for our optimism on stocks is that we believe the Fed's latest rate cut may be its last for this cycle. If we're right that the Fed is done, history argues for above-average returns over the next 12 months. According to Ned Davis Research, following the end of the 13 Fed easing cycles since 1954, the Dow Jones Industrial Average was up +3.9%, +8.2% and +17.6% in the ensuing three, six and twelve months, respectively, more than twice its long-run average.

So is the Fed done? Well, it's not a lock by any means, but it's far more likely than not, in our view. The futures market now sees the most likely course for the Fed funds rate as no change at the June and August meetings followed by a 25-basis-point increase at the September meeting. That outcome would be fine with us. In our opinion, further rate cuts could prove to be counterproductive. We believe that the availability of credit is far more important than the price from here on. In that light, we applaud the Fed's latest actions to provide additional liquidity to the market through an expansion in its Term Auction Facility (TAF) to \$150 billion, an increase in its reciprocal currency arrangements with the European Central Bank (ECB) and the Swiss National Bank (SNB), and its expansion of acceptable collateral for its Schedule 2 Term Securities Lending Facility (TSLF) auctions to include AAA/Aaa-rated asset-backed securities.

With these liquidity-enhancing mechanisms in place, we believe the Fed and the Treasury would be well advised to turn their collective focus toward stabilizing the U.S. dollar. Since the Fed began easing in September 2007, the trade-weighted dollar is down -5.9% and oil prices are up nearly +50%. In our view, a sincere commitment on the part of the Fed and Treasury to defend the dollar could act to temper inflation worries, triggering a welcome decline in oil and other commodity prices, and giving a nice boost to the stock market. In our view, a clear negative feedback loop has developed in recent months where dollar weakness has contributed to rising commodity prices, which have heightened inflation fears that have, in turn, engendered further dollar weakness. We believe turning that vicious cycle into a virtuous one would be hugely beneficial to the equity market.

Another thing that could give the market a shot in the arm is if Senator McCain managed to win the presidency in November. This is still not the percentage bet, but may be a higher probability than the roughly 40% odds currently quoted on Intrade.com. Let's be clear, we think President Bush's approval ratings are so low and the antipathy toward him so widespread that the market could trade higher upon his departure from office, no matter who his successor is. Our presumption, however, is that the market may prefer a McCain victory over either potential Democratic nominee because his overall platform is more business and investor friendly, especially with respect to taxes on dividends and capital gains.

The bruising and increasingly acrimonious battle between Senator Clinton and Senator Obama for the Democratic nomination is benefitting Senator McCain, in our opinion. The contentious primary races point to a cultural divide between Democrats that could threaten the party's post-primary ability to unify behind its nominee. Senator Clinton's support is coming increasingly from white voters who did not go to college, the traditional heart and soul of the old Democratic party. In addition to the African-American community where he is the clear favorite, Senator Obama's support has tended to come more from the younger, better-educated and wealthier segments of the party. Party leaders are increasingly fearful that Democratic voters will either stay home or vote for Senator McCain rather than support a Democratic nominee they did not favor. A recent *Wall Street Journal*/NBC News poll highlights this risk. In the poll, 30% of Clinton voters said they would not vote for Senator Obama, and 22% of his supporters said they won't vote for Senator Clinton. Who knows what those voters will actually do come crunch time, but such sentiments must be music to Senator McCain's ears.

Two recent polls illustrate just how tight the presidential race is becoming. A *Wall Street Journal*/NBC News poll conducted from April 25-28 shows Obama besting McCain 46% to 43% in a head-to-head matchup, with Clinton edging McCain 45% to 44% among registered voters interviewed. Both those spreads are within the margin of error of +/- 3.1%. An *Economist*/YouGov poll conducted at about the same time shows McCain ahead of both Democratic candidates, Clinton by 44% to 43%, and Obama by 45% to 42%. Again, these results are within the margin of error, thus indicating a statistical dead heat.

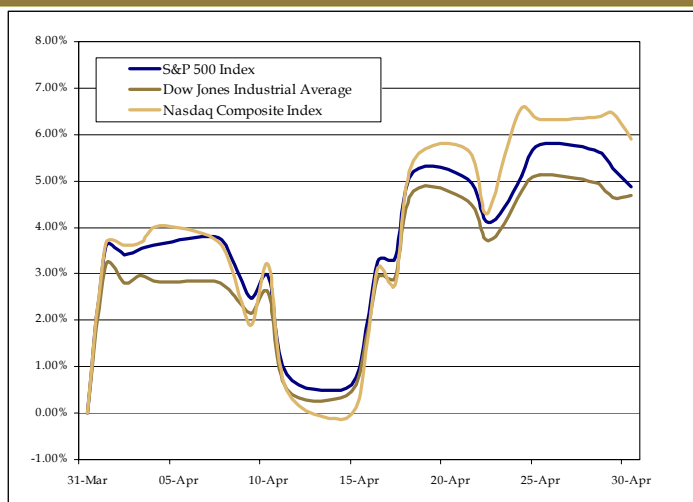
The final thing that would, in our judgment, give a nice boost to the market, were it to occur, is if the Bush administration announced that instead of continuing to add oil to the Strategic Petroleum Reserve (SPR), it would start releasing reserves instead. In our view, this is the single most productive thing the administration could do to ease inflationary pressures on the economy. Many observers argue that there is a speculative premium of \$30 or more built in to the current oil price over and above what pure supply-and-demand fundamentals would dictate. Releasing reserves from the SPR could shrink that premium sharply, in our view. In addition, from the Bush administration's perspective, such a move would have the added benefits of: (1) providing an effective tax cut to consumers in the form of lower gasoline prices; (2) enhancing Senator McCain's election prospects; (3) lifting President Bush's approval rating out of the cellar; and (4) lessening fears among conspiracy theorists that a key reason why the U.S. is building the SPR is that it plans to attack Iran. We also believe the market would respond favorably to the move since there have been many more victims of rising oil prices than beneficiaries. In our opinion, the logic of such a move is quite compelling. Unfortunately, the odds of the Bush administration actually doing it are probably no more than 25%, in our opinion.

As we said earlier, we don't think any of these scenarios are required for the market to make upward progress through the balance of the year. Assuming, as we do, that the worst of the financial crisis has passed, we think the market's attractive valuation relative to competing alternatives alone argues for higher prices. Enhancing prospects further, in our opinion, is the reasonable likelihood that the Fed may have finished its easing cycle with historically favorable implications for market returns. A McCain victory in November is still only about a 40% probability, but would be a plus for the market on balance if it happens. Finally, a decision by the administration to release reserves from the SPR could be hugely beneficial to the equity market, in our opinion, but is, admittedly, a bit of a long shot. But we can dream!

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

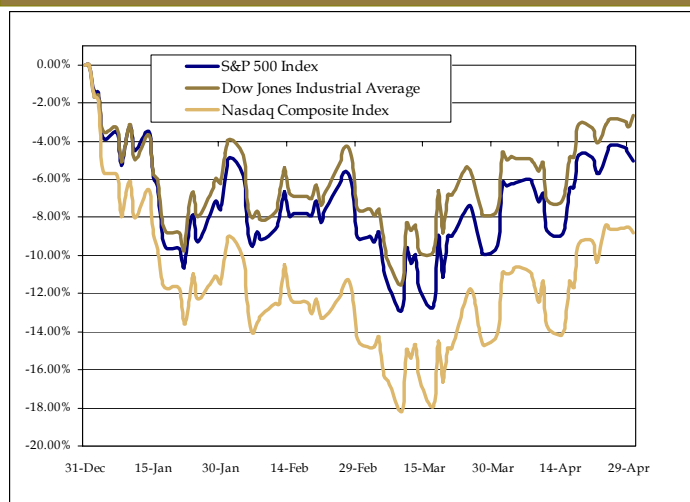
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Major Indices April Performance



Sources: Bloomberg and FactSet

Major Indices YTD Performance



Sources: Bloomberg and FactSet

Monthly U.S. Market Update (Total Returns)

Index Name	April	YTD
<i>Broad Market Indices</i>		
S&P 500	4.87	(5.03)
Dow Jones	4.70	(2.63)
Russell 1000	5.07	(4.89)
NASDAQ	5.90	(8.80)
Dow Jones Wilshire 5000	4.97	(5.02)
Russell 2000	4.19	(6.12)
Russell 1000 Growth	5.25	(5.46)
Russell 1000 Value	4.87	(4.27)
<i>S&P 500 Sector Indices</i>		
S&P 500 Consumer Discretionary	4.27	(1.87)
S&P 500 Consumer Staples	(0.22)	(2.42)
S&P 500 Energy	10.87	2.90
S&P 500 Financials	6.54	(8.34)
S&P 500 Health Care	1.53	(10.17)
S&P 500 Industrials	1.39	(2.61)
S&P 500 Information Technology	6.92	(9.32)
S&P 500 Materials	5.46	2.27
S&P 500 Telecomm Services	4.81	(9.59)
S&P 500 Utilities	5.28	(5.18)

Sources: Bloomberg, FactSet, Russell, Wilshire

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