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CAPITAL MANAGEMENT

Month-End Commentary

May 2008

Market Commentary

The S&P 500 Index made reasonably healthy upward progress in May, returning +1.3% (+16.8% annualized). The high-water mark for the month occurred on May 19, when the S&P traded briefly intraday above its 200-day moving average for the first time since December 27, 2007, but closed about a point below it, thus disheartening market technicians and touching off a market consolidation phase in the latter half of the month.

TOTAL RETURNS

	May	QTD	YTD
S&P 500 Index	+1.30%	+6.23%	-3.80%
Dow Industrials	-1.10%	+3.55%	-3.71%
Nasdaq Composite Index	+4.69%	+10.87%	-4.52%
S&P MidCap 400 Index	+5.29%	+13.41%	+3.37%
Russell 2000 Index	+4.59%	+8.97%	-1.81%
Dow Jones Wilshire 5000 Index	+2.09%	+7.17%	-3.04%
S&P 100 Index	-0.02%	+4.57%	-5.83%
Russell 1000 Growth Index	+3.67%	+9.11%	-2.00%
Russell 1000 Value Index	-0.16%	+4.71%	-4.42%

Sources: Bloomberg, Wilshire, Russell

Small- and mid-cap stocks were notably strong during the month, and are now the two best-performing major market indices year-to-date. The Nasdaq Composite was also strong, driven by a surge in technology stocks (+5.6%), the best-performing S&P 500 sector for the month.

The Dow Industrials and mega-cap-dominated S&P 100 Index were both down for the month, as was the Russell 1000 Value Index. These performances are all largely explained by the weak performance of financials in May. The S&P 500 financials sector was down -6.1% for the month, the only S&P sector to post a decline, and trailing the next-worst-performing sector (consumer discretionary stocks) by 6.7%. A number of mega-cap financials were especially weak, including American International Group (-22.1%), Bank of America (-9.4%), Citigroup (-12.3%) and JPMorgan Chase (-9.8%), thus dooming the Dow and S&P 100 to sub-par results. Given the strength in tech and weakness in financials, it should be no surprise that the Russell 1000 Growth Index outperformed its value counterpart handily.

Despite the moderate gain in the month, May was a challenging month for investors as soaring oil prices simultaneously fueled both inflation and recession fears, leading to a sell-off in bonds and financial stocks and a re-widening of credit spreads. Efforts to explain the breathtaking rise in oil prices to a recent high of $135 on the July WTI futures contract have touched off a flood of commentary and written work from Wall Street analysts, oil industry executives, politicians, economists, academics, traders, market pundits, television commentators and the major news and print media. Having read and tried to absorb much—but certainly not all—that has been written about oil in the last several weeks, we'd like to share our views on the subject because we think it's important that clients understand how we're thinking about what we regard as the most important issue facing investors at the present time. In our view, the direction of oil prices over the balance of this year and into 2009 will be a—and perhaps *the*—key influence in how the U.S. equity markets and the U.S. economy perform over that period.

As we see it, the recent spike in oil prices is unusual by historical standards because it is the first not caused primarily by a disruption in supply. Unlike the Arab Oil Embargo of 1973-1974, the Iranian Revolution of 1979 and the Gulf War of 1990-1991, the rise in oil prices from 2002 to the present primarily has been driven—at least in its initial stages—by the inexorable growth in world demand, turbocharged by demand growth in emerging market nations, especially China and India.

You won't get a lot of argument from most people that the relatively tight supply and demand balance for crude oil that has developed in recent years has been an important contributor to the rise in oil prices. Where the legitimate argument begins, in our view, is: (1) how much of the price rise does this factor alone explain, and (2) are there other factors at work that have taken oil prices beyond the point that pure supply and demand factors would dictate?

Before answering these questions, we thought it might be useful to delve a little deeper into both the supply and demand side of the oil pricing equation. First, with respect to supply, it's important to understand that—with limited excess production capacity available worldwide—the supply of oil in the short term is relatively inelastic. Still, given that the real price of oil has increased about five-fold since 2002, one would have expected a larger supply response than has been forthcoming. In fact, it appears that conventional world oil production has been relatively flat since 2005 at about 85 million barrels per day. We see several reasons why this could be so.

First, six years is not a long time in the context of the time it takes to develop an oil field, so the supply response may be on the way, but it's just not here yet. The last doubling of oil prices has occurred in the last year or so. No supply response over that time frame could have been reasonably expected.

In our opinion, the second major reason that new supply has not grown as one might have expected is depletion. Oil is a non-renewable resource. The world's existing oil fields are obviously in varying stages of their production life-cycle but are, on average, experiencing production declines (i.e., depletion) of about 4% per year. If conventional oil production is roughly 85 million barrels per day, then the first 3.4 million barrels of new daily production every year only serves to offset declines in existing fields. That's 12.4 billion barrels per

year of new production to offset depletion. In the 1960s it was not uncommon to find 40 to 50 billion barrels per year of new oil reserves. Nowadays, 10 to 15 billion barrels is considered a more typical exploration year. Lower annual oil discovery rates, and the possibility that depletion rates might accelerate in the future as some of the world's largest oil fields (such as Ghawar in Saudi Arabia and Burgan in Kuwait) go into decline, have led some to conclude that world oil production is peaking, or will peak within the next decade. Those holding that view might well be willing to pay a "scarcity rent" over and above the going price in order to secure future oil supplies.

The final reason supply has not responded to rising prices is that production increases nearly always seem to take longer and be smaller than forecast. For example, in a recent paper entitled "Understanding Crude Oil Prices," James D. Hamilton notes that actual production gains in 11 oil-producing countries fell short of gains predicted for 2004 to 2006 by Cambridge Energy Research Associates (CERA) by a total of about two million barrels per day. Without more information, we can't know for sure what caused these shortfalls from expectations, but one possible explanation is that oil-producing countries do not necessarily have the incentive to increase production as rapidly as oil-consuming nations may want. They may believe that they will maximize the long-term value of their oil reserves by developing them more slowly. Then again, adherents to the "peak oil" theory might argue that oil-producing countries are trying to increase production, but they just can't do it.

On the demand side of the equation, world oil demand has continued to grow in the face of a several-fold increase in prices. A big reason for this is emerging markets demand growth, especially growth in China. In the last five years, yearly oil consumption in China has grown from 1.88 billion barrels to 2.80 billion, an increase of 919 million barrels a year, or about 37% of the total increase in world consumption over that time frame. With real GDP growth in recent years running in the low double-digits, China is obviously at a stage of its economic development where its thirst for oil is growing rapidly. The Chinese government also has been subsidizing oil prices, thus muting the effect of higher prices on Chinese consumers. Fuel subsidies, in fact, are widespread in emerging market nations. Morgan Stanley estimates that half the world's population enjoys fuel subsidies, as almost a quarter of the world's gasoline (petrol, to the Brits) is sold at less than market prices. The cheapest gasoline is in Venezuela, at five cents per liter. Chinese motorists pay $0.79 per liter, expensive compared to Venezuela, but a relative bargain compared with $1.04 in the U.S. and $2.35 in Germany.

The latest jump in oil prices is making subsidies much more costly, and strains on governmental budgets are forcing some nations to lift subsidies. On May 24, Indonesia raised fuel prices by +30%, followed shortly by Taiwan (+13%) and Sri Lanka (+24%). China has yet to lift subsidies that currently amount to about 1% of GDP, but even it may do so after the Olympics.

Putting the supply and demand side of the equation together, what emerges is a situation where current world oil demand has grown to the point where it is taxing the world's immediately available production resources. In this environment, because of the comparatively high price inelasticity of both oil supply and demand, relatively small disruptions in supply or increments in demand can have outsized effects on price.

We believe the incremental "investment demand" from institutional investors allocating a portion of their assets to commodities primarily through the futures market has created just such an outsized effect on oil prices. This view is controversial, with many arguing that so-called "index speculators" have had little effect on commodity prices. We are persuaded otherwise. According to a May 19, 2008 report titled "Blame It on Your Pension Fund" from Probability Analytics Research in Chicago, open interest in the West Texas Intermediate (WTI) crude oil contract traded on the NYMEX has soared over the last five years to a recent high of over 1.5 million contracts from an average of less than 500,000 contracts prior to 2004. Together with the 300,000 increase in open interest in the comparable Brent Crude contract, the combined 1.3 million increase in open interest (at 1000 barrels per contract) represents incremental demand of 1.3 billion barrels of oil, or about 53% of the increase in world oil consumption over that period. Index speculators would not necessarily have accounted for all of that increase in open interest, but Michael Masters (of Masters Capital Management in Atlanta) estimates that they accounted for about two-thirds of it. Specifically, in testimony before a Senate subcommittee on May 20, 2008, Masters estimated that over the last five years, index speculators through the futures market increased their net exposure to petroleum products by the equivalent of 848 million barrels of oil, an impact roughly equivalent to the 919 million barrel increase in demand from China over that period.

In a tight market for physical oil, how large a price impact could the incremental investment demand from commodity indexers have had? Probability Analytics Research estimated the equilibrium level of oil prices ex-investment demand to be between $60 and $75 per barrel, with investment demand adding roughly $60 to the price of oil justified purely by physical demand factors. Is this realistic? We're obviously not sure, but interestingly, Probability Analytics' price range is very similar to the $60 to $70 range often quoted by Saudi Arabian oil minister Ali Al-Naimi as being an economic floor for oil based on the marginal cost of production for alternative energy sources.

Whether or not justified by underlying fundamentals, the fact remains that oil is hitting an all-time high as this is written, nearing $140 intraday. Some analysts are predicting oil prices of $150 to $200 later this year. Could it happen? It's certainly possible, but our sense is that prices at current levels are starting to bite. Anecdotal evidence is that the long-awaited demand response may have begun. Airlines—choking on $4 per gallon jet fuel prices—are slashing capacity. Sales of gas-guzzling SUVs and light trucks are collapsing in the U.S., while small cars and hybrids are flying off the lot. Public transportation ridership is increasing.

Not just in the U.S. but throughout the OECD, oil demand is starting to drop off. Demand responses take time, but we think we may have reached a tipping point. Gary Becker, an economist at the University of Chicago, has calculated that in the past, over periods of less than five years, oil consumption in the OECD dropped by only 2% to 9% when oil prices doubled. But over

longer periods, consumption dropped by 60%. The precise numbers will likely differ this time around, but the pattern should be the same.

Outlook

We have come to the view that the outlook for the U.S. economy and U.S. equity market is heavily dependent on the direction of oil prices. In our opinion, the higher oil prices go, the more challenging the outlook for the equity market and the economy will become. Higher oil prices pose risks to both the outlook for inflation as well as the economy's ability to recover from its below-trend growth rate.

The market faces other challenges as well. Housing remains moribund, and after a brief period of outperformance, both housing and financial stocks have begun to lag the market again. Credit spreads have also re-widened, indicating that investors are having second thoughts about whether the worst is really behind us in the credit markets.

On a valuation basis, the S&P 500 does not look expensive to us at 14.5x and 12.7x bottom-up, cap-weighted consensus estimates for 2008 and 2009. Even with the back-up in the 10-year Treasury yield to about 4.0% and using our new equity risk premium of 4.5% (up from 4.0% to compensate for a more uncertain environment), we still estimate the fair value multiple of the S&P 500 to be about 17 times earnings.

One very encouraging development since our last letter is that, as we had hoped, it appears Chairman Bernanke has shifted the Fed's focus from rate cuts to fighting inflation and defending the dollar. The Fed fund futures market now sees it as a virtual certainty that the Fed will hold rates steady in June. In fact, the futures market sees rates staying flat through October, with the possibility of a 25-basis-point increase in December.

Dr. Bernanke gave the clearest indication that we can remember from a Fed Chairman that he is focusing on the value of the dollar in remarks to the International Monetary Conference in Barcelona on June 3, 2008. On the subject of the dollar, he said: "In collaboration with our colleagues at the Treasury, we continue to carefully monitor developments in foreign exchange markets. The challenges that our economy has faced over the past year or so have generated some downward pressures on the foreign exchange value of the dollar, which have contributed to the unwelcome rise in import prices and consumer price inflation. We are attentive to the implications of changes in the value of the dollar for inflation and inflation expectations and will continue to formulate policy to guard against risks to both parts of our dual mandate, including the risk of an erosion in longer-term inflation expectations. Over time, the Federal Reserve's commitment to both price stability and maximum sustainable employment and the underlying strengths of the U.S. economy—including flexible markets and robust innovation and productivity—will be key factors ensuring that the dollar remains a strong and stable currency."

Before closing, we'd like to highlight a couple of other encouraging developments. First, despite the ongoing credit crisis, continued weakness in housing and the recent spike in oil prices, the U.S. economy appears to have narrowly avoided recession, to this point at least. First-quarter real GDP growth was modestly positive, and it appears that the second quarter could be as well. The economy's ability to absorb bad news without buckling has been quite impressive.

Lastly, we would note that on May 20, 2008, Steve Leuthold's Major Trend Index improved to positive. Leuthold's equity market indicator was right on the money when it turned downward in June 2007. We should have paid more attention then, and we certainly hope the indicator keeps up its good batting average now.

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

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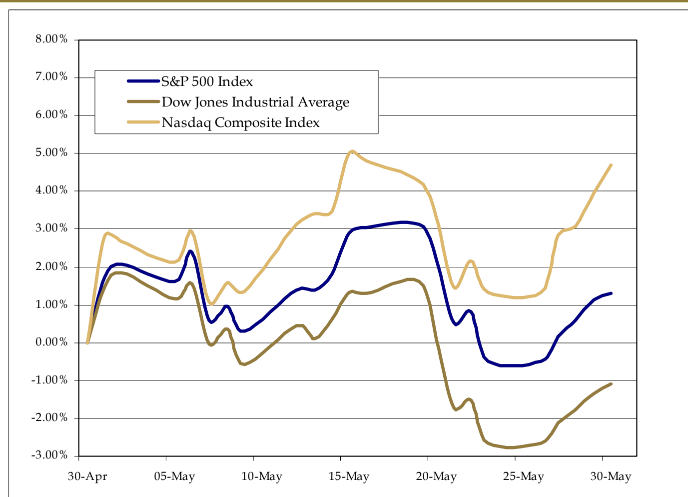
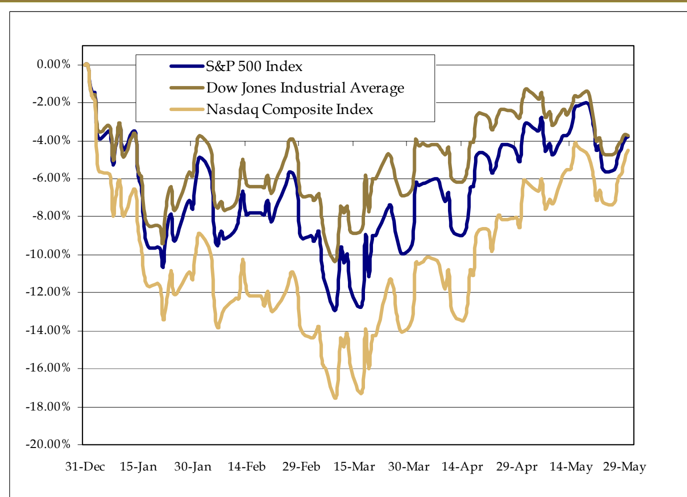
Chairman, Investment Policy Committee
Legg Mason Capital Management

Major Indices May Performance



Sources: Bloomberg and FactSet

Major Indices YTD Performance



Sources: Bloomberg and FactSet

Monthly U.S. Market Update (Total Returns)

Index Name	May	QTD	YTD
Broad Market Indices			
S&P 500	1.30	6.23	(3.80)
Dow Jones	(1.10)	3.55	(3.71)
Russell 1000	1.83	7.00	(3.15)
NASDAQ	4.69	10.87	(4.52)
Dow Jones Wilshire 5000	2.09	7.17	(3.04)
Russell 2000	4.59	8.97	(1.81)
Russell 1000 Growth	3.67	9.11	(2.00)
Russell 1000 Value	(0.16)	4.71	(4.42)
S&P 500 Sector Indices			
S&P 500 Consumer Discretionary	0.61	4.90	(1.27)
S&P 500 Consumer Staples	1.40	1.18	(1.06)
S&P 500 Energy	3.45	14.70	6.45
S&P 500 Financials	(6.09)	0.05	(13.92)
S&P 500 Health Care	2.02	3.58	(8.35)
S&P 500 Industrials	1.03	2.43	(1.61)
S&P 500 Information Technology	5.62	12.93	(4.23)
S&P 500 Materials	4.80	10.52	7.18
S&P 500 Telecomm Services	3.37	8.35	(6.54)
S&P 500 Utilities	3.36	8.81	(2.00)

Sources: Bloomberg, FactSet, Russell, Wilshire

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