

Market Commentary

June was a painful month for equity investors. In fact, you have to go all the way back to the Depression year of 1930 to find a worse June for the Dow Industrials than the one they just posted. At month-end, the Dow closed -19.87% below its October 2007 high, coming within a whisker of slipping into “official” bear market territory. Both the Dow and S&P 500 succumbed to the bear in July’s early going, down -21.30% and -20.48%, respectively, from their October highs through July 9.

TOTAL RETURNS

	June	Q2	YTD
S&P 500 Index	-8.43%	-2.73%	-11.91%
Dow Industrials	-10.04%	-6.85%	-13.38%
Nasdaq Composite Index	-9.07%	+0.82%	-13.18%
S&P MidCap 400 Index	-7.03%	+5.43%	-3.90%
Russell 2000 Index	-7.70%	+0.58%	-9.37%
Dow Jones Wilshire 5000 Index	-8.14%	-1.55%	-10.92%
S&P 100 Index	-8.90%	-4.73%	-14.20%
Russell 1000 Growth Index	-7.20%	+1.25%	-9.06%
Russell 1000 Value Index	-9.57%	-5.31%	-13.57%

Sources: Bloomberg, Wilshire, Russell

The financials continued to lead the market lower in June, declining -18.37% for the month. Consumer discretionary stocks (-12.11%), industrials (-12.23%) and telecom stocks (-11.51%) also posted double-digit declines for the month. Only the energy sector (+2.28%) of the S&P 500 Index was able to post a gain, on the strength of a +9.93% rise in crude oil prices for the month.

Foreign markets provided no safe haven, as few were up and many were down as much or more than the U.S. market. Emerging markets were especially hard hit, particularly India and China, which were down -19.49% and -18.71%, respectively, in dollar terms for the month.

For those of us who thought that the Fed-brokered rescue of Bear Stearns would likely mark the bottom for financial stocks, June was a deep disappointment, as most major bank and financial indices dropped to new lows. Initially, the financial stocks followed the recovery script we had expected, rising +2.5% and +5.2% in the four- and eight-week periods, respectively, following the Bear Stearns rescue, as they had in seven prior financial crises dating back to 1933, according to data from ISI Group. In May

and June, however, the recovery pattern broke down. Whereas past financial crises had seen the financials +13.9% higher, on average, 13 weeks after the crisis event, at the 13-week mark this time around the financials tracked by ISI Group were -13.5% lower, on average. As of the end of June, they had declined an average of -23% since March 17. Definitely not what the doctor ordered for those long the group.

Why have the financials so far been unable to find a bottom? In our view, the most likely answer is \$140 a barrel oil. The surge in oil prices in the midst of an ongoing credit crisis has increased the odds of recession, in our view, and thrown the whole equity market, and especially the financials, for a loop. Credit spreads have re-widened, not to their worst levels, but enough to raise the likelihood of further mark-to-market write-downs in the second quarter. Those write-downs, coupled with the increased loss provisioning and charge-offs associated with a downturn in the credit cycle, make estimating ultimate losses for this cycle a continuing challenge. On a more positive note, the problematic outlook for financials seems to be nearly fully reflected in current prices, as the sector now trades at a lower relative price-to-book value than it did at the bottom of the last cycle in 1990.

While it is disappointing to us that financial stocks have meaningfully breached their March lows, we are encouraged that credit spreads, while having re-widened somewhat, are holding below their worst levels. This suggests to us that the U.S. financial system is, indeed, on the mend, but the trend toward improvement is being masked by the destabilizing effects of \$140 oil. In our view, a meaningful pullback in the price of oil would be hugely beneficial to the U.S. economy and the U.S. equity market. We think just such a pullback could be in evidence before year-end, triggered by demand destruction.

In a real sense, the spike in oil prices is planting the seeds of its own destruction, in our view, because the pain of \$140 oil and \$4 gasoline is so great that it forces radical changes in behavior. We’re seeing it in the automobile market, where hybrids are sold out, while SUV and light truck sales are down about -30% and their residual values have dropped about -20% year over year. As one senior Ford Motor Company official said recently, in the last two months, “We have seen more of a shift in the market than in 20 years of CAFE [Corporate Average Fuel Efficiency standards]. People are buying what they need.”

We are also seeing a meaningful drop in the demand for gasoline in the U.S., especially in the formerly hottest real estate markets (California, Florida, Arizona and Nevada). In these markets, where house prices are off by more than the national average and unemployment rates have risen by almost twice as much as those in the rest of the country, gasoline demand has fallen by -5% this year, compared to about -2% in the rest of the U.S. Overall, vehicle miles traveled in the U.S. are down over -2% on a year-over-year basis, nearly matching their worst previous showing (1974) in the last 37 years.

Up till now, we have not seen meaningful demand destruction in emerging markets, the source of 80% of demand growth in this cycle. But even here, some slowing of demand for oil seems inevitable. Until recently, oil prices in emerging markets had enjoyed heavy government subsidies. In the last month or so, many countries—including Taiwan, Indonesia and Sri Lanka—have begun to reduce those subsidies. Even China—thought to be loath to hit consumers beleaguered by soaring food prices with increasing oil prices—has reduced subsidies.

We believe the partial lifting of oil price subsidies in China is the latest in a growing list of reasons why the Chinese economy is in the early stages of a material slowdown. If true, we believe the slowdown could trigger a meaningful change in the investment landscape in the U.S. For several years, the global growth trade has worked in spades, and it has paid handsomely to be long energy and commodities and short financials. The linchpin of that trade has been double-digit real growth in China. So why do we think China will slow?

The case for a China slowdown begins with the unprecedented degree of monetary policy tightening implemented by the People's Bank of China (PBoC) in the last two years. Since June 2006, the PBoC has raised the reserve requirement ratio (RRR) that banks must meet 19 times from 7.5% to 17.5%. Over the same period, the PBoC has raised China's base lending rate seven times from 5.85% to 7.47%. Since monetary policy normally acts with an 18- to 24-month lag, one would expect the effect of tightening to be showing up about now. That seems to be happening. Year-over-year growth in Chinese exports to the G3 (U.S., European Union and Japan) has dropped steadily from a high of nearly +30% in 2004 to about +20% in 2005, +15% in 2006, +12% in 2007 and roughly +2% in the first quarter of 2008. At the same time, year-over-year growth in wages has climbed steadily in the last several years, and in the first quarter of 2008 exceeded the growth rate of imports by more than seven times. In short, a classic corporate profit squeeze is developing in China, which could further slow growth. These factors, combined with the natural tendency of host countries' economies to slow in the year following the Olympic Games, suggest to us that a slowdown in China

is on the way, one that could have a material impact on the demand for oil and other commodities.

Outlook

As we noted last month, we believe that oil prices above \$135 per barrel pose a significant threat to the U.S. equity market and the U.S. economy. Oil prices at these levels or higher increase the odds that the U.S. economy will fall into recession, a view shared by a number of other market observers we respect, including Michael Goldstein of Empirical Research Partners and former Fed Governor Lyle Gramley. Mr. Gramley notes in a recent piece that the increase in oil prices in the second quarter alone has drained an incremental \$200 billion from the pockets of U.S. consumers, an amount greater than the tax rebates that were intended to act as a stimulus to the economy. The combined effects of sky-high oil prices, rising unemployment and the negative wealth effects of both declining stock and house prices have led Mr. Gramley to conclude that U.S. real GDP growth is likely to be negative in the fourth quarter of 2008. Whether this period is ultimately classified as a recession may be a matter of semantics.

Another worry for investors is now that the market correction has morphed into a bear market, how much more weakness in stocks can investors expect? According to data from Birinyi Associates, there have been 13 bear markets in the post-WWII era, averaging declines of -28% and durations of 380 days. So, if this turns out to be an average bear market, history says it should be over by the end of 2008, with investors facing an additional -8% to -10% of downside risk.

Some might argue that because of the severe dislocations in the financial sector, this bear market might prove to be worse than average. We believe the arguments are at least as good that it may be less than average, and in fact, may be close to ending, both in terms of time and degree of downside risk. In support of the latter view, we note that outside the financial sector, many other sectors of the economy are reasonably healthy. In addition, interest rates are quite low in both relative and absolute terms compared to other bear market periods. Inflation, while troublesome recently, is not disastrously high, as it was in the late '70s and early '80s, for example. Finally, stock valuations going into this downturn last October were not at nosebleed levels and appear quite attractive currently, even if, as seems likely, consensus estimates for this year and next are a bit optimistic.

After the punch in the stomach the market delivered to investors in June, it is tough to be bullish on the outlook. Ironically, that very fact is the chief reason for optimism, in our view. The best buying opportunities in the market most often occur during periods of discouragement and pessimism.

Signs of investor pessimism are widespread, and it's hard to blame people. The Dow Industrials' first-half price decline of -14.4% was its worst since 1970. Foreign markets were no better, as the MSCI World Index declined -13% in the first half of 2008, its worst showing in 38 years. More than half the stocks in the S&P 500 Index were down more than -10% in the month of June alone. According to veteran market observer Bob Farrell, the five-week percentage of advancing issues recently hit 39.4%, the first reading below 40% since 2002.

On the economic front, unemployment is up and house prices are continuing to fall. As a consequence, consumer confidence is at a 28-year low and investors are heading for the hills in droves. According to *Barron's*, net redemptions from domestic equity mutual funds totaled \$80.4 billion over the last 12 months. S&P 500 short interest on the New York Stock Exchange is at a record high 10.4 billion shares. Shares short now total 3.57% of all shares listed on the NYSE, a percentage that is over +50% higher than the previous record set in 2002. These investor actions are fully reflected in the venerable Lowry indices of buying power and selling pressure (followed by Bob Farrell for over 50 years), which recently reached one of their widest spreads ever, as selling pressure hit a new all-time peak.

Poll after poll shows that investors are deeply pessimistic about the outlook for the market. Market newsletter writers are as bearish as they've been in quite some time. Further, the latest American Association of Individual Investors poll shows that bears outnumber bulls by 2-to-1, similar to the reading in March 2008.

Legendary investor John Templeton, who died this week at 95, was famous for urging that investors "buy at the point of maximum pessimism." This is great advice, but advice, unfortunately, that most investors regularly choose to ignore. Their response when faced with the recommendation to buy when the outlook seems bleak is, "How do you know this is the point of maximum pessimism? How do you know things won't get much worse?" The truthful answer is that often you don't. Our job as investors is to assess the situation on a probabilistic basis, looking for opportunities that offer the greatest reward for the risks assumed. In this effort, we find it very valuable to pay particular attention to long-time market observers who have the ability to put the current market environment in historical perspective. One of our favorites is John Mendelson. We value his work not only because he has a good long-term record, but because it is based on what people do, not what they say.

We call attention to John Mendelson because one of his most reliable indicators, his colorfully named "Diaper Indicator," flashed a buy signal on July 7. In a July 8, 2008 note, Mr. Mendelson had this to say:

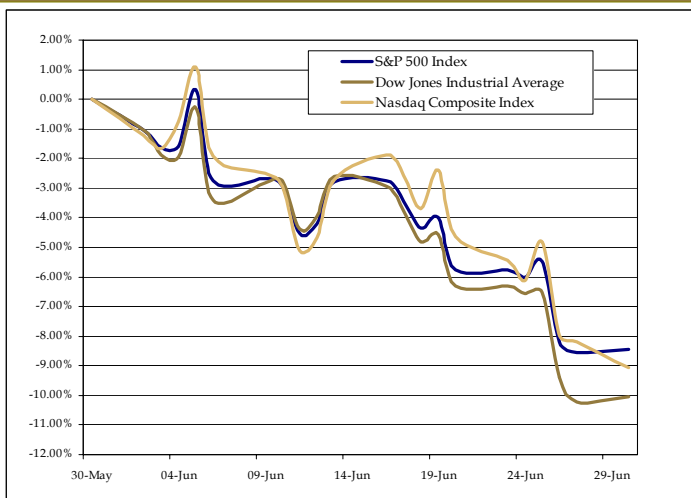
"My proprietary 'Diaper Indicator' measures the difference between advancing and declining volume and its rate of change looking for 'a highly emotional moment.' It is a calculation that translates into numbers my long standing phrase. . . *There has never been an intellectual low.* I like this indicator, which I designed decades ago to highlight **significant bottoms**, as it has an accurate record and produces few signals. It **is not** a trading tool and does not work on the sell side. The last buy signal was at the close on March 17, 2008, the day of the inter-day low on the S&P 500 Index (SPX). As noted in my Weekly Report of March 18, the prior buy signal was **five years before** on March 11, 2003, the date of the S&P 500 low that was followed by a huge rally over the next 12 months. The **only time** in the decades since it was developed when there have been two buy signals within a relatively brief period of time were the buy signals of late July 2002 when the New Low List reached its peak and most stocks bottomed and early October 2002 when the popular indices made their final lows . . . a period of about two and one-half months. The second shortest period between buy signals prior to this were two of the dates mentioned above . . . early October 2002 and mid-March 2003 or five months. Obviously, the recent period from March 17 is about three and one-half months. The 'Diaper Indicator' gave another buy signal at the close last night [July 7, 2008] suggesting an extremely emotional tone in the current equity market, one historically seen at significant bottoms."

In closing, we note that valuation spreads widened by a near-record amount in June and now stand nearly three standard deviations above their long-term mean (almost as high as they have ever been). Twelve months ago, when valuation spreads were near record lows, we did not pay sufficient attention to the difficulties a period of widening spreads might present to our style of investing. That said, from here, our approach should begin to produce much improved results, even if valuation spreads widen somewhat further. When they begin to narrow, we should shoot the lights out.

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

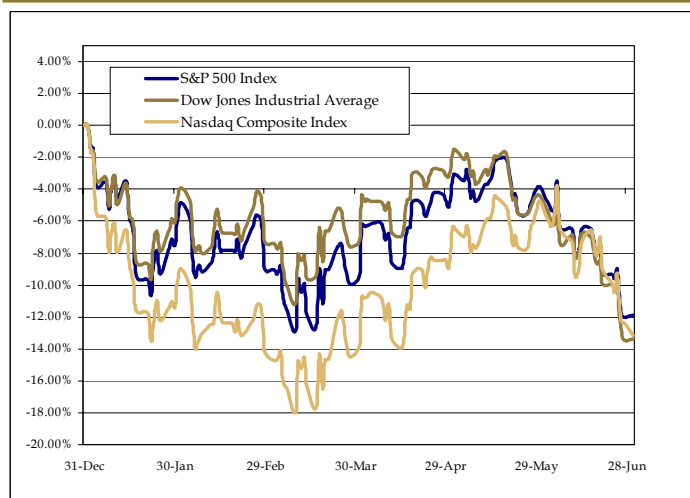
David E. Nelson, CFA
Chairman, Investment Policy Committee
Legg Mason Capital Management

Major Indices June Performance



Sources: Bloomberg and FactSet

Major Indices YTD Performance



Sources: Bloomberg and FactSet

Monthly U.S. Market Update (Total Returns)

Index Name	June	Q2	YTD
<i>Broad Market Indices</i>			
S&P 500	(8.43)	(2.73)	(11.91)
Dow Jones	(10.04)	(6.85)	(13.38)
Russell 1000	(8.31)	(1.89)	(11.20)
NASDAQ	(9.07)	0.82	(13.18)
Dow Jones Wilshire 5000	(8.14)	(1.55)	(10.92)
Russell 2000	(7.70)	0.58	(9.37)
Russell 1000 Growth	(7.20)	1.25	(9.06)
Russell 1000 Value	(9.57)	(5.31)	(13.57)
<i>S&P 500 Sector Indices</i>			
S&P 500 Consumer Discretionary	(12.11)	(7.80)	(13.22)
S&P 500 Consumer Staples	(6.45)	(5.35)	(7.44)
S&P 500 Energy	2.28	17.31	8.88
S&P 500 Financials	(18.37)	(18.32)	(29.73)
S&P 500 Health Care	(4.65)	(1.24)	(12.61)
S&P 500 Industrials	(12.23)	(10.11)	(13.65)
S&P 500 Information Technology	(9.24)	2.50	(13.08)
S&P 500 Materials	(5.52)	4.42	1.26
S&P 500 Telecomm Services	(11.51)	(4.13)	(17.30)
S&P 500 Utilities	(0.77)	7.97	(2.76)

Sources: Bloomberg, FactSet, Russell, Wilshire

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