December 2008

Market Commentary

The S&P 500 Index rallied a little over +1% in December, thus allowing 2008 to go into the record books as the worst year since 1937, rather than the worst year since 1931. A small victory, one might argue, but it was a welcome relief to see some "green on the screen" for a change. In truth, the S&P 500 has quietly rallied quite nicely off its November 20 bottom, up +20.47% on a total return basis through year end. Encouragingly, the rally has continued in early 2009 with the S&P 500 managing to post a modest gain in the first 5 trading days of January, which historically has augured well for a positive January, which in turn has augured well for a positive year in the market. We have discussed the so-called "January Barometer," first identified by Yale Hirsch, in previous years. Some commentators have written it off as an irrelevant calendar anomaly. We're not so sure. In our view, anything that happens 94.6% of the time—which is the percentage of times since 1950 that the market is up for the year after being up in January—is worth some attention. Far more often than not, in our experience, trading patterns in January have tended to set the tone for the year.

TOTAL RETURNS

	December	Q4	2008
S&P 500 Index	+1.06%	-21.94%	-37.00%
Dow Industrials	-0.39%	-18.38%	-31.93%
Nasdaq Composite Index	+2.79%	-24.37%	-39.98%
S&P MidCap 400 Index	+4.85%	-25.55%	-36.23%
Russell 2000 Index	+5.80%	-26.12%	-33.79%
Dow Jones Wilshire 5000 Index	+1.74%	-22.85%	-37.23%
S&P 100 Index	-0.02%	-20.10%	-35.31%
Russell 1000 Growth Index	+1.81%	-22.79%	-38.44%
Russell 1000 Value Index	+1.39%	-22.18%	-36.85%

Sources: Wilshire, Russell®, NASDAQ® (via Bloomberg), S&P (via Bloomberg)

The pattern of returns in December provides some evidence of an increasing appetite for risk among investors, with the Russell 2000 Index, S&P MidCap 400, Nasdaq Composite, and the Russell 1000 Growth Index showing the best returns among major market indices, while the Dow Industrials and S&P 100 Index—the two strongest major market indices going into the month—lagged. The message—if there is one—from S&P 500 sector returns is less clear. The relative strength in consumer discretionary and technology stocks and weakness in consumer staples and utilities is supportive of the view that investors became a bit more venturesome in December. On the other hand, health care—a traditional safe haven—was the best performing S&P 500 sector for the month, and financials—the year-long wallflower group—remained weak.

Despite being down -37% in 2008, the S&P 500 Index fared reasonably well compared to most foreign markets. Of the nine foreign markets listed below, only the Japanese market performed better in U.S. dollar terms. Yen-based returns for the NIKKEI 225 were -41.14%, but yen appreciation versus the dollar in 2008 cut dollar-based losses in Japan to -26.51%. The abysmal performance of the Russian market (-73.64% in dollars) was exceeded only by the total collapse of the Iceland stock market (not shown below), down over 94% in 2008.

	Returns in U.S. Dollars (%)	
	December	2008
FTSE 100 Index (U.K.)	-1.89%	-47.06%
DAX Index (Germany)	+14.44%	-42.80%
CAC 40 Index (France)	+8.45%	-42.90%
MICEX Index (Russia)	-7.32%	-73.64%
NIKKEI 225 (Japan)	+10.21%	-26.51%
Hang Seng Index (HK)	+3.63%	-46.05%
Kospi Index (So. Korea)	+13.53%	-58.98%
Shanghai SE Comp.(China)	-2.42%	-62.43%
BSE Sensex 30 Index (India)	+9.33%	-60.97%

Source: Bloomberg

A number of words come to mind to describe 2008, most of them not printable in a business-oriented publication. Perhaps the word that captures the zeitgeist of the year best is "extreme." Merriam-Webster defines "extreme" as "exceeding the ordinary, usual, or expected," and "going to great or exaggerated lengths." That sounds like 2008 in spades to us, when extremes ran in both directions. On the downside, we saw extreme declines in stock prices, car sales, housing starts, consumer confidence, Treasury rates and bullish sentiment. On the upside, we saw extreme increases in stock price volatility, housing delinquencies and foreclosures, valuation spreads, credit spreads of all descriptions, cash in money funds and bearish sentiment. We even saw some extremes in both directions for the same item. Oil hit a high of $147 in July supposedly on its way to $200, then collapsed to $32 in December, with many calling for a further drop of $20 to $25. If that's not extreme, we don't know what is.

The extremes we have all endured in 2008 have created an enormous degree of stress among investors. Under stress, human-beings react fairly predictably. Their time horizon shortens dramatically and their decision-making processes tend to be driven by their limbic system (or lower-brain function) which reacts instinctively and emotionally. Longer-term plans and rational thought go out the window and avoidance of pain becomes the dominant objective. Investment decisions made in this state are often emotionally satisfying in the short-term, but often financially injurious in the long-run.

Because the news flow over the next couple of quarters is likely to be pretty grim, it will not be easy for investors to fight the all-too-human tendency to seek the safety and security of cash, the financial equivalent of hiding under the bed. We urge investors to fight this tendency. In our view, investment opportunities abound in the current environment in nearly every asset class but cash. Waiting for the economic all-clear signal could therefore prove quite expensive, in our judgment, in terms of lost opportunity. In other words, the opportunity cost of holding cash is currently "extremely" high in our view, while the financial rewards for holding it are fast approaching zero.

Outlook

We believe it is increasingly likely that November 20, 2008 marked the bottom of this bear market cycle for the major indices such as the S&P 500 Index and Dow Industrials. Whether or not, and how closely, we revisit those lows as the market goes through its bottoming process is an open question. Our current thinking is that while corrections are inevitable as the bottoming process unfolds, we do not believe we will see 750 on the S&P 500 or 7449 on the Dow Industrials again. We most sincerely hope that we do not. We expect 2009 to be a tug-of-war between the near-term outlook—which will continue to be very challenging—and the long-term investment opportunity offered by common stocks at present—which we believe is quite substantial. Ultimately, we expect this tug-of-war to be resolved on the upside and believe the Dow and S&P 500 could both be up 25% to 30% for the year. That might seem "extreme," but such gains would do nothing more than return those indices to the ranges in which they traded as recently as September 2008.

Figuring out what the economy and the market will do next is not easy, some would say impossible, but in my role as Chairman of the Investment Policy Committee and author of these monthly market commentaries, it is my job to give it my best shot. Our approach at LMCM has been to analyze what we know, make what we regard as reasonable assumptions about what we don't know, and then try to figure what portion of the knowns, and what likelihoods about the unknowns, the market has already discounted.

What we know about the current economic outlook is that it is bad. We know recent job losses have been severe and the unemployment rate is on the rise. We don't know how high it will go, but a good guess seems to us to be 8% or a bit higher by late 2009 or early 2010. We know domestic manufacturing is weak, the December report from the Institute of Supply Managers (ISM) that their factory index dropped to 32.4, the lowest reading since June 1980, tells us that. We don't know how much further manufacturing will fall, but we may be seeing the worst of it right now. Based on data from Case-Shiller, we know that house prices have fallen 18% for the 12 months ended October 2008, but, again, we don't know how much further they will fall. Our working assumption is that house prices will stabilize by mid-2009, down another 10% to 15% from here. We know that GDP will be very weak in the fourth quarter, the only question is how weak and for how long. We are expecting GDP growth of -6% or so in the fourth quarter, with a similar decline in the first quarter of 2009 and some modest improvement in the second quarter but still negative growth on the order of -4%. As of now, we're expecting modest positive GDP growth in the latter half of 2009. We know that earnings estimates for many companies and the S&P 500 as a whole are declining, the question, again, is by how much. The top-down 2009 estimate for the S&P 500 is now $42.24 (from S&P) and $65.36 (from Reuters). The corresponding bottom-up estimates are $81.80 and $76.43. Using the wisdom of crowds and averaging all those estimates together, we get about $66.46. That seems like a reasonable place to set initial expectations for S&P 500 earnings for 2009.

As is obvious from the statistics above, most of what we know about the economy is not terribly encouraging. The question, though, is whether the market has discounted this news already or not. Our inclination is that it has. It's important to remember that the market is a discounting mechanism. The S&P 500 declined 52% from its peak on October 9, 2007 to the current trough of November 20, 2008, its worst such decline since the 1930s. Why? We think it's because it foresaw better than most observers (including us, by the way) the bad news that we're all reading about in the papers and hearing about on CNBC now. In similar fashion, the market will begin to rally before the news improves. In fact, it may have already begun to do so. Through today (1/8/09), the S&P 500 has returned 21.44% since November 20, 2008. Is the market saying the worst is over, or even if it's not, that the worst has been discounted? We don't know for sure, but a number of things suggest to us that this might be the case.

What is the market seeing that it finds encouraging? What are we seeing? For one thing, credit markets have begun to free up and credit spreads have started to narrow. Junk bonds have enjoyed a spirited rally since mid-December. Corporate bonds have also begun to act better. This is a necessary precondition to a sustained improvement in the stock market and economy, in our judgment. The TED spread is down from 450 basis points to 150 basis points, its lowest level since the collapse of Lehman Brothers. Credit Default Swap spreads have also narrowed materially. Finally, the Volatility Index (VIX), often referred to as the "Fear Index," has come down from the stratosphere. All of these developments are good news for the economy and the stock market.

Another thing we find very encouraging is that valuation spreads, which had blown out to an all-time record of over four standard deviations above their mean value since 1952, have begun to narrow, and valuation-based strategies have begun to perform exceptionally well. In our view, this is evidence that a measure of rationality is beginning to be restored to the pricing of stocks.

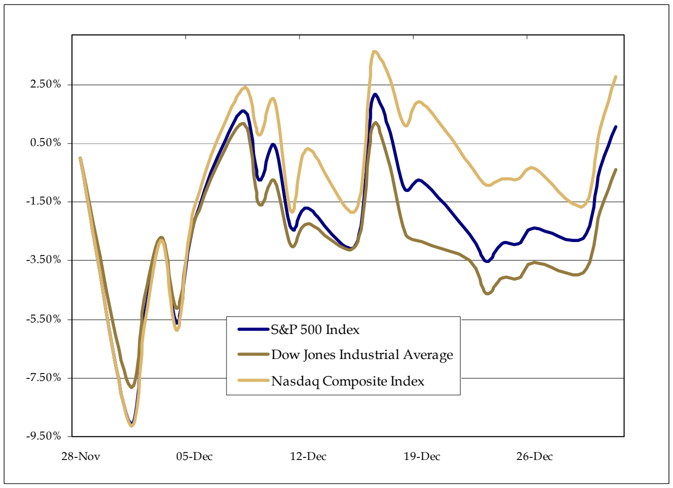
Investor behavior is also worthy to note and consistent with their behavior at prior important lows. Investors as a group are, unfortunately, their own worst enemies when it comes to making money in the market. They can be reliably predicted to throw money at the market after it has gone up, as they did by pouring $260 billion into U.S. focused Equity Mutual Funds in 2000. Equally predictably, they were massive net sellers of domestic equity funds in 2008, withdrawing $168 billion, most of it in the fourth quarter after nearly all the damage had been done to stock prices for the year. What investors want most dearly now is cash, and they have piled up $3.8 trillion of it in money market funds. This cash hoard is now equal to a record 37.7% of the total market value of U.S. common stocks. Investors seem content to hold cash for now, but as the yield on money funds drops meaningfully below 1%, and especially if stocks and bonds continue to rally, investors' views on the desirability of holding cash will likely change.

A final thing we find encouraging about the current market environment is that the long-term returns on stocks have historically been powerfully mean-reverting. Periods of above average returns are followed by periods of below average returns which, in turn, give way to renewed periods of above average returns. The mid-teens returns of the 1980s and 1990s have been followed in the new millennium by a period of distinctly sub-par returns. Since the beginning of 2000, the nine-year return of the S&P 500 Index has been -28.13% (or -3.60% compounded). As we noted in our November monthly, measured to the November 20, 2008 low, the 10-year annualized total return of the S&P 500 is -2.66%, a cumulative loss of -23.59% over that period, according to calculations from Steve Leuthold. The total return loss for that 10 year period matches the worst 10-year performance in U.S. stock market history, 1929 to 1939. That's bad news looking backwards, but quite likely to be good news looking forward, because, according to Leuthold, since 1926, when trailing 10-year compound annual returns have been 1% or less, subsequent 10-year compounded annual returns have averaged 10.7%, in a range of 7.2% to 15.6%.

On that cheerful note, we wish you and yours a happy and prosperous New Year, and as always, thank you for your support and welcome your comments.

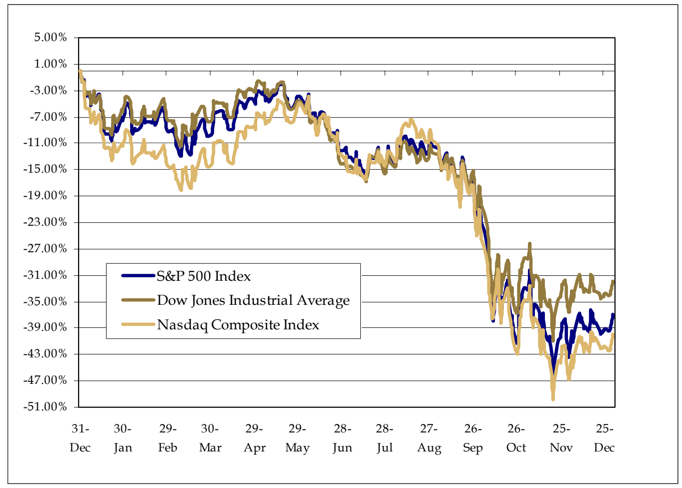
David E. Nelson, CFA
Chairman, Investment Policy Committee
Legg Mason Capital Management

Major Indices December Performance



Sources: Wilshire, NASDAQ® (via Bloomberg), S&P (via FactSet)

Major Indices 2008 Performance



Sources: Wilshire, NASDAQ® (via Bloomberg), S&P (via FactSet)

Monthly U.S. Market Update (Total Returns)

Index Name	December	Q4	2008
Broad Market Indices			
S&P 500	1.06	(21.94)	(37.00)
Dow Jones	(0.39)	(18.38)	(31.93)
Russell 1000	1.60	(22.48)	(37.60)
NASDAQ	2.79	(24.37)	(39.98)
Dow Jones Wilshire 5000	1.74	(22.85)	(37.23)
Russell 2000	5.80	(26.12)	(33.79)
Russell 1000 Growth	1.81	(22.79)	(38.44)
Russell 1000 Value	1.39	(22.18)	(36.85)
S&P 500 Sector Indices			
S&P 500 Consumer Discretionary	5.54	(22.85)	(33.49)
S&P 500 Consumer Staples	(0.33)	(12.83)	(15.44)
S&P 500 Energy	(3.99)	(20.61)	(34.86)
S&P 500 Financials	(0.25)	(36.89)	(55.27)
S&P 500 Health Care	6.81	(12.10)	(22.81)
S&P 500 Industrials	1.07	(23.92)	(39.92)
S&P 500 Information Technology	1.76	(25.73)	(43.14)
S&P 500 Materials	(0.37)	(30.78)	(45.66)
S&P 500 Telecomm Services	0.98	(1.38)	(30.48)
S&P 500 Utilities	(2.11)	(10.93)	(28.98)

Sources: Wilshire, Russell®, NASDAQ® (via Bloomberg), S&P (via FactSet)