

Market Commentary

After rallying over 24% off its November 20 bottom through the first three trading days of the New Year, the market turned ugly again for the rest of month, with the S&P 500 Index closing down -8.43%, its worst January showing on record. The S&P 500 was still up over 10% from its November low through month end, but it doesn't feel that way, following the drubbing that the market—and especially the financials—took in January. This is definitely not the start to the year we had hoped for when we penned our December commentary, encouraged by the early year strength that the market might set a friendlier tone this January than last. The ink was hardly dry on that missive, when the market turned down again.

TOTAL RETURNS

	January
S&P 500 Index	-8.43%
Dow Industrials	-8.65%
Nasdaq Composite Index	-6.35%
S&P MidCap 400 Index	-7.25%
Russell 2000 Index	-11.12%
Dow Jones Wilshire 5000 Index	-8.17%
S&P 100 Index	-9.16%
Russell 1000 Growth Index	-4.81%
Russell 1000 Value Index	-11.50%

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

Had the market been up in January, the historical odds according to the “January Barometer” would have overwhelmingly favored an up year in 2009. Now that January has finished down, the historical odds say that there's nearly a 60% chance the year will finish down, as the 22 down January's since 1950 have been followed by down years 13 times. We recognize that correlation is not the same as causation, and would point out that there are notable exceptions to this pattern. The S&P 500 was down -1.8% in January 1982 and finished up +14.8% (price only) for the year. The S&P was also down -2.7% in January 2003 and closed the year up +26.4% (price only). Both 1982 and 2003 were transition years from bear market to bull market. We think there is a reasonable chance that 2009 could also turn out to be a transition year from bear to bull, with the key questions being: (1) how much more pain do we have to endure on the downside? And (2) can we turn the corner in a meaningful way by year end?

John Mendelson, a veteran market observer with Stanford Group Company whose work we admire, also believes the market is in a bottoming process. He marks the likely low for this cycle as being October 10, 2008 when 2901 NYSE stocks made new 12-month lows. He calls the November 20, 2008 low, when the

Dow Industrials and S&P 500 bottomed, the “CNBC low,” noting that despite new lows on the leading market indices, the number of individual stocks making new lows on that date was only 1894, or 1007 fewer than on October 10. He finds this pattern to be similar to the 2002-2003 market bottoming process, when the number of daily new lows on the NYSE peaked in July 2002, but the major market indices did not bottom until October 2002. Mendelson sees the current market weakness as a testing process of last year's lows and finds it encouraging that the number of NYSE daily new lows is greatly diminished, totaling only 132 recently (2/2/09). Despite the record January decline, Mendelson also takes solace in the fact that the “S&P 500 Index (SPX) rose in the 11 months following each of the five worst Januarys on record—1970: -7.6%, 1960: -7.1%, 1990: -6.9%, 1939: -6.4% and 1978: -6.2%.” Suffice it to say that even if the market is, as Mendelson and we believe, in a bottoming process, that process is likely to last for several more months, with numerous fits and starts and plenty of volatility, second-guessing and nail-biting accompanying it.

As the dollar-based returns below illustrate, January's downdraft was not relegated solely to the U.S., with eight of the nine major foreign indices listed down for the month, and continental Europe and Russia especially hard hit. The one bright spot for the month was the Shanghai SE Composite which gained nearly 9% in January. It would be heartening if this strength is a precursor to a coming improvement in China's growth prospects.

TOTAL RETURNS IN U.S. DOLLARS

	January
FTSE 100 Index (UK)	-7.07%
DAX Index (Germany)	-18.04%
CAC 40 Index (France)	-15.03%
MICEX Index (Russia)	-17.12%
NIKKEI 225 (Japan)	-9.36%
Hang Seng Index (HK)	-7.77%
Kospi Index (So. Korea)	-4.00%
Shanghai SE Comp. (China)	+8.99%
BSE Sensex 30 Index (India)	-2.84%

Source: Bloomberg

As it has for the better part of a year and a half, the financial sector of the S&P 500 led the market down in January, with a -26.3% decline. The money center banks were especially hard hit, led by Bank of America (-53.3%) and Citigroup (-47.0%), but joined, discouragingly, by banks such as U.S. Bancorp (-40.7%), Wells Fargo (-35.9%) and J.P. Morgan Chase (-18.1%), which had previously been deemed to be relatively well-positioned to weather the financial storm. The chief investor concerns that surfaced during the month were, it seems to us: (1) whether or not the banking system has sufficient capital to absorb the level of asset write-downs and credit losses that are likely before the

cycle turns, and (2) if it does not, how that capital short-fall should be funded, and on what terms.

Financial Stability Plan

The Obama administration has been working on a comprehensive plan to stabilize the banking system and, in doing so, to unplug the still largely frozen credit markets so that they are in a position to support and finance an economic recovery. Treasury Secretary Geithner unveiled this much anticipated Financial Stability Plan on Tuesday, February 10. The equity market's reaction was immediate and quite negative, with the S&P 500 nose-diving over -3% almost immediately, and closing the day down -4.9%. The market had been expecting better, having rallied over +5% the previous week as various likely provisions of the plan were test-marketed via a series of trial balloons. The Plan as presented Tuesday seemed more punitive than market participants had been led to believe, with fewer specifics than hoped for as well.

While certainly not perfect, on closer examination, we think the Financial Stability Plan (FSP) is a good deal more constructive than the equity market's initial reaction to it would suggest. As GaveKal's Anatole Kaletsky put it in an insightful 2/11/09 piece ("Punish or Restructure?"), "closer inspection of the Treasury documents, plus conversations with some well-informed people in Washington, suggests there was more to it than meets the eye." A major reason for the lack of specificity in Tuesday's announcement was, according to Kaletsky, a row within the Obama Administration between those—such as Geithner and Larry Summers—who wanted to focus on the economics of how best to remove "toxic" assets from bank balance sheets and unfreeze the credit markets, and those—such as Rahm Emanuel, David Axelrod and many Congressional leaders—who felt it was politically important to vilify Wall Street "fat cats" and have any measures to support banks be, or at least appear to be, punitive to existing bank shareholders.

The most clearly constructive element to the FSP seems to us to be the expansion of the existing Treasury Asset-Based Securities Loan Facility (TALF) from \$200 billion to \$1 trillion, via a commitment of \$100 billion of TARP funds to the program which will be leveraged 10-to-1 by the Federal Reserve. We think the five-fold expansion of this program is a belated, but welcome, recognition on the part of the Administration of the importance of the securitization market, an important element of the so-called "shadow banking system" that was largely ignored in TARP I, and as a consequence, has shrunk severely. Geithner acknowledged as much on Tuesday: "Addressing our credit crisis on all fronts means going beyond simply dealing with banks. While the intricacies of secondary markets and securitization—the bundling together and selling of loans—may be complex, they account for almost half of the credit going to Main Street as well as Wall Street. When banks making loans for small businesses, commercial real estate or autos are able to bundle and sell those loans into a vibrant and liquid secondary market, it instantly recycles money back to financial institutions to make additional loans to other worthy borrowers. When those markets freeze up, the impact on lending for consumers and businesses—small and large—can be

devastating. Unable to sell loans into secondary markets, lenders freeze up, leading those seeking credit like car loans to face exorbitant rates. Between 2006 and 2008, there was a net \$1.2 trillion decline in securitized lending (outside of the GSEs) in these markets." Purchases under this expanded program are expected to begin relatively quickly, perhaps within a week or two.

It is harder for us to analyze the other two main elements of the FSP, the Public-Private Partnership (PPP) designed to remove "legacy" or "toxic" assets from bank balance sheets, and the Financial Stability Trust (FST) intended to inject convertible "contingent equity" into banks once they have cleansed their balance sheets by selling "legacy" assets to the PPP. Both of these programs seem likely to help stabilize the financial system and, by implication, help set the stage for eventual economic recovery. Whether the programs are friendly or unfriendly to existing shareholders is less certain, and will be determined by the specific terms upon which assets are purchased and capital injected, and, perhaps more importantly, by the capital strength of each individual financial entity.

Clearly, there will be the normal conflict of interest between buyers and sellers in transactions executed under the PPP. Private capital will not participate unless it sees an opportunity to make money. Banks want to receive the highest prices possible for assets they sell. The government will have the ability to influence the terms of trade by offering non-recourse financing at attractive rates to prospective buyers. The government also would seem to have an incentive to see transactions occur at "fair" prices, because if prices are too low, bank sellers will take bigger hits to their capital—hits that will ultimately be funded by the taxpayer—than would otherwise have been the case, while hedge fund-type buyers may be seen to be ripping off the system. On the other hand, prices that are too high will not attract the requisite buying interest.

As part of the Financial Stability Trust element of the FSP, banks over \$100 billion in assets and any other bank seeking additional TARP II capital will be required to undergo a comprehensive stress test, which Treasury Secretary Geithner described as a "forward looking assessment of what banks need to keep lending even through a severe economic downturn." It is not yet clear exactly what standard will be used to assess banks' capital strength. Tier 1 capital has been the traditional standard, but sentiment seems to be growing in Washington to use tangible common equity (TCE). We shall see.

Whatever standard is chosen, exactly how that standard is applied will also be important. On this subject, Geithner said: "The Treasury Department will work with bank supervisors and the Securities and Exchange Commission and accounting standard setters in their efforts to improve public disclosure by banks. This effort will include measures to improve the disclosure of the exposures on bank balance sheets. ***In conducting these exercises, supervisors recognize the need not to adopt an overly conservative posture or take steps that could inappropriately constrain lending*** (Our emphasis)." In our view, this last sentence leaves ajar the door to a possible relaxation of strict mark-to-market accounting standards, which we believe are highly pro-cyclical and have been unnecessarily destructive of

bank capital in the last year or so. We were encouraged to hear Rep. Barney Frank, House Financial Services Committee Chairman, also say on CNBC today (2/11/09) that some forbearance on mark-to-market accounting might be appropriate during this crisis.

We will save discussion on the stimulus bill for the February monthly.

Outlook

The market continues to be quite volatile and has not gotten off to the start we had expected. As we noted earlier, it appears that the market-bottoming process that we think began in October 2008 may have several more months to run. Whether the market has meaningful downside from here depends on what one's standard for undervaluation is, in our view.

Our traditional frame of reference has been the post-WWII era; first, because it represents a period of over six decades; second, because the body of economic and market data for that period is quite robust; and third, because the U.S. economy has been more service-based in the post-WWII era than previously and, thus, valuation comparisons between the pre- and post-WWII eras seemed less relevant to present circumstances. By post-WWII standards of valuation, we think today's market is significantly undervalued. In fact, by one measure that we'll discuss shortly, the market appears more undervalued than at any time since 1958.

However, if we can believe Treasury Secretary Geithner, that "Today, our nation faces the most severe financial crisis since the Great Depression," we may need to expand our frame of reference to include pre-WWII valuation possibilities. By these standards, according to an analysis from Steve Leuthold's February issue of "Perceptions for the Professional," the market has downside risk to about 600 on the S&P 500 Index. Let us elaborate.

As we have noted before in these commentaries, we are a great admirer of Steve Leuthold's analytical work and look forward to receiving his monthly "Green Book." The February issue contains a fascinating analysis of the long-term (1876 – Present) valuation of the S&P 500 Index using Benjamin Graham's Intrinsic Value Model, which he first developed in the 1930s and refined in 1962. Graham believed that the intrinsic value of a company or the market as a whole could be estimated by multiplying a company's normalized earnings by an appropriate multiple based on the company's growth rate and then adjusting that figure for changes in the level of interest rates. Graham believed that a company that wasn't growing was worth 8.5 times earnings. Sustainable growth raised the value of the company by a factor of $(8.5 + 2G)$, where G was the growth rate. Graham further adjusted the appropriate earnings multiplier for changes in the level of rates. His adjustment factor was $(4.4\% \text{ divided by the AAA bond yield})$, reflecting the fact that AAA bond yields were 4.4% in 1962 when he refined his earlier valuation model.

Applying Graham's valuation model to the S&P 500 Index, using a current normalized earnings estimate of \$66.35, long-term growth

rate of 6% and AAA bond yield of 5.32%, the S&P is worth 1125, versus a closing price on 2/11/09 of 833.74, a 26% discount. This is the largest discount to intrinsic value since 1958, using this methodology.

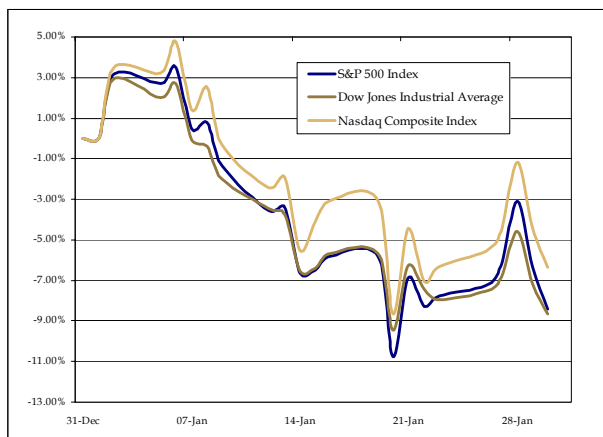
It turns out that 1958 is an important line of demarcation for a couple of reasons. That was the year that the dividend yield on the S&P 500 Index dropped below the 10-year Treasury yield on a sustained basis, remaining below it for over 50 years, until late last year. The year 1958 was also when the S&P 500 began to trade consistently above intrinsic value using Graham's model. Prior to 1958, with a few brief exceptions in the early 1880s, the late 1890s, and the late 1920s, the S&P 500 had traded consistently below intrinsic value. Leuthold calls the pre-1958 era a period of "high risk aversion" and the post-1958 period one of "low risk aversion."

The important point of this analysis is that bear markets bottomed at dramatically different levels in the two eras. In the pre-1958 "high risk aversion," era the 14 bear markets from 1877 to 1958 bottomed at a median -46% discount to intrinsic value. In the post-1958 era, 10 bear markets bottomed at a median +22.6% premium to intrinsic value. The bottom line is: if we're still in the post-1958 valuation environment, then we've very likely seen the worst. If we've morphed into a pre-1958 "high risk aversion" era, then we could be in for more pain. A -46% discount to intrinsic value would suggest downside in the S&P 500 to about 607. If we are agnostic about what era we are in and look at the entire period 1877 to the present, the median bear market low was a -28.5% discount to intrinsic value, suggesting a downside objective of 804 on the S&P 500.

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 January Performance



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

Monthly U.S. Market Update (Total Returns)

Index Name	January
<i>Broad Market Indices</i>	
S&P 500	(8.43)
Dow Jones	(8.65)
Russell 1000	(8.16)
NASDAQ	(6.35)
Dow Jones Wilshire 5000	(8.17)
Russell 2000	(11.12)
Russell 1000 Growth	(4.81)
Russell 1000 Value	(11.50)
<i>S&P 500 Sector Indices</i>	
S&P 500 Consumer Discretionary	(10.56)
S&P 500 Consumer Staples	(7.49)
S&P 500 Energy	(3.15)
S&P 500 Financials	(26.31)
S&P 500 Health Care	(1.24)
S&P 500 Industrials	(12.60)
S&P 500 Information Technology	(3.05)
S&P 500 Materials	(7.17)
S&P 500 Telecomm Services	(9.91)
S&P 500 Utilities	(0.65)

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

The information contained herein has been prepared from sources believed reliable but is not guaranteed by us as to its timeliness or accuracy, and is not a complete summary or statement of all available data. This data is intended solely for our clients, is for informational purposes only, and may not be publicly disclosed or distributed without our prior written consent.

The views expressed in this commentary reflect those of Legg Mason Capital Management ("LMCM") as of the date of this commentary. These views are subject to change at any time based on market or other conditions, and LMCM disclaims any responsibility to update such views. These views may not be relied upon as investment advice and, because investment decisions for clients of LMCM are based on numerous factors, may not be relied upon as an indication of trading intent on behalf of the firm. The information provided in this commentary should not be considered a recommendation by LMCM or any of its affiliates to purchase or sell any security.

The Dow Jones IndexesSM are proprietary to and distributed by Dow Jones & Company, Inc. and have been licensed for use. All content of the Dow Jones IndexesSM ©2009 is proprietary to Dow Jones & Company, Inc. The Dow Jones Wilshire IndexesSM are jointly produced by Dow Jones & Company, Inc. and Wilshire Associates, Inc. and have been licensed for use. All content of the Dow Jones Wilshire IndexesSM ©2009 is proprietary to Dow Jones & Company, Inc. & Wilshire Associates Incorporated.

Russell®, Russell 2000® Index, Russell 1000 Growth® Index, and Russell 1000 Value® Index are trademark/service marks of the Frank Russell Company.

Neither LMCM nor its information providers are responsible for any damages or losses arising from any use of this information.