

March 2009

Market Commentary

After declining sharply in the first week of the month to an intraday low of 666.79 on March 6, the S&P 500 rallied nearly +20% through month end to close March up +8.76%. At its March 6 intraday low, the S&P was nearly 900 points (-57.4%) below its October 9, 2007 closing high of 1565.15. Even following the spirited rally, the S&P closed the month at barely more than half its October 9, 2007 value.

The battered financials led the rally, as they had the decline, up +17.94% for the month, but still down -28.80% year-to-date. Three other S&P sectors—materials (+15.26%), consumer discretionary (+12.28%) and information technology (+12.14%)—also posted better than double-digit returns for the month, while utilities (+2.52%), energy (+3.79%) and consumer staples (+4.14%) were notable laggards. Tech stocks were the clear leaders for the quarter, up +4.31%, and the only S&P sector to post positive returns for the first three months of the year.

TOTAL RETURNS

	March	Q1
S&P 500 Index	+8.76%	-11.01%
Dow Industrials	+7.93%	-12.48%
Nasdaq Composite Index	+11.02%	-2.79%
S&P MidCap 400 Index	+9.05%	-8.66%
Russell 2000 Index	+8.93%	-14.95%
Dow Jones Wilshire 5000 Index	+8.71%	-10.56%
S&P 100 Index	+8.56%	-11.84%
Russell 1000 Growth Index	+8.92%	-4.12%
Russell 1000 Value Index	+8.55%	-16.77%

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

The major foreign markets listed below all posted gains in March, with South Korea, Russia and China showing notable strength. The Shanghai SE Composite is the standout performer for the year-to-date, up more than 30%. It appears that the combination of China's aggressive stimulus package (at about 3.2% of GDP) and prospects for 6.5% to 7% real GDP growth in 2009 is proving to be a powerful elixir for Chinese investors.

TOTAL RETURNS IN U.S. DOLLARS

	March	Q1
FTSE 100 Index (UK)	+2.69%	-11.87%
DAX Index (Germany)	+10.56%	-20.41%
CAC 40 Index (France)	+8.07%	-17.24%
MICEX Index (Russia)	+22.44%	+7.98%
NIKKEI 225 (Japan)	+6.56%	-15.98%
Hang Seng Index (HK)	+6.42%	-5.29%
Kospi Index (So. Korea)	+27.28%	+1.65%
Shanghai SE Comp. (China)	+14.04%	+30.19%
BSE Sensex 30 Index (India)	+10.08%	-3.35%

Source: Bloomberg

As we and a number of other market commentators have noted, the recent behavior of the economy and stock market is, in many respects, without precedent in the post-WWII era. Not since the Great Depression era of the 1930s have we witnessed some of the things we are seeing today. Until very recently, the parallels have all been about how bad things are now, with this or that market or economic condition being the worst “since the Great Depression.” We should all probably agree to use the acronym STGD as short-hand for “since the Great Depression” to save time and ink. In this vein, *Barron's* writer Michael Santoli recently noted in an article entitled “Listening to the Echoes of 1938” that, at their early March low, the broad indexes were as far below their 200-day moving averages as they had been at any time since 1938. He further observed that large companies (including GE) were on track to cut their dividends by a larger percentage than any year since 1938. We ourselves have reported that the trailing 10-year return on the S&P 500 has recently reached an all-time record low, worse even than the decade from 1929 to 1939, the previous record holder.

We think it is quite likely that all the recent references by news commentators, market pundits and political leaders—including our new president—to this being the worst economy STGD have served to exacerbate the downturn, as both businesses and consumers have been frozen into inaction fearing that we might be facing another depression. We have no hard evidence of this assertion, but anecdotally it seems valid. On a personal basis, it certainly rings true to me. My parents—who were born in 1910 and 1912—were in their 20s during the depression of the 1930s, and the economic devastation of that period was burned into their psyches such that they were both highly risk-averse until the day they died.

More happily, the market's recent strength is without precedent since the 1930s as well. According to Robert Farrell, the S&P 500's 10-day gain of +21.64% through Monday, March 23, was its best since the 10 days ending April 29, 1933. Farrell also noted that the 10-day breadth thrust through March 23 was also an impressive 2.26 times advances over declines. In the post-WWII period, 10-day breadth thrusts over 1.97 times have all heralded the beginning of a new bull market. Frustratingly for the bulls, this pattern did not hold in the 1930s, when breadth thrusts over 1.97 times sometimes heralded new bull markets and sometimes only bear rallies, according to Farrell.

So far, it is unclear whether the market's recent strength—which has continued in the early sessions of the new quarter and taken the S&P 500 up +26.8% from its March 6 intraday low of 666.79 to a recent intraday high on April 2 of 845.61—is “only” a bear market rally or the start of a new bull market cycle. We've wrongly called “the turn” a couple of times in the last year, so we want to be somewhat cautious in calling it now, but we believe that a plausible case can be made for the March 6 intraday low being “the low” for this market cycle. Our colleague, Bill Miller, is more definitive and has averred on a couple of occasions in the last week that the March 6 low is not only the low for this cycle but may, in fact, be “the low for the remainder of his lifetime.” A bearish friend of Bill's joked that he might be right about that, provided he doesn't live much longer. We, of course, hope he's right and lives to be 100.

Outlook

There have been a number of encouraging developments in the last month on the economic, policy and regulatory fronts that, in combination, give us growing confidence that we may be near an important inflection point, both in terms of the economy and the stock market. We believe these developments, together with the brutal market decline through early March that we believe discounted an enormous amount of bad news, have set the stage for the best rally in the market in over two years, one which could take the S&P 500 to the 1050 to 1100 level by year end 2009. As we'll argue further on, we think that we may be in the early stages of a new bull market, rather than just enjoying yet another bear market rally.

On the economic front, we think the economy may have bottomed in the first quarter of 2009. We believe the U.S. economy contracted at about the same rate in the first three months of 2009 as it did in the fourth quarter of 2008 (-6.3%). Things have been so bad for the last 180 days that mathematically, they almost have to get better. We're seeing that in car sales, which despite falling -34% year-over-year in March, were at an annualized pace of 9.86 million vehicles, up

over +8% from February's 9.12 million annualized rate. We're also seeing it in the manufacturing sector generally, where the Institute of Supply Manufacturers (ISM) Composite Index was up in March for the third month in a row. Recent data on housing activity is also coming in better than expected, and even mall traffic and restaurant sales seem to be perking up.

On the policy front, we believe the Treasury's recently announced Public-Private Investment Program (dubbed “P-PIP” in Washington), designed to assist banks in removing legacy assets from their balance sheets, has a reasonably good chance of working. The devil is always in the details, but we think the size of the program is meaningful, and we like the shared risk/shared profits aspect of the program. With the non-recourse leverage the government is providing buyers, the returns from the program should be reasonably attractive, even if asset pricing is not as distressed as it might have been without the refinements in mark-to-market accounting regulations that were approved by the Financial Accounting Standards Board (FASB) this past week.

It is these regulatory changes with respect to mark-to-market accounting that we find most encouraging. We know this is a controversial topic, with passionate views on both sides. In our opinion, the key issue is determining what best constitutes “fair value” for an asset. The “mark-to-model” regime that existed prior to the implementation of FASB 157 in November 2007 led to substantial abuses. FASB 157 was an honest effort to curb those abuses by requiring that “observable market inputs” be the primary determinant of “fair value” in pricing securities. When credit markets became dysfunctional, however, we believe “market” prices began giving overly pessimistic signals as to what many assets were worth. In our view, forcing banks and other financial institutions to mark assets to these increasingly distressed and illiquid “market” prices greatly exacerbated the banking crisis and subsequent economic downturn. In our opinion, the latest modification of “fair value” guidelines (FASB 157-e) allowing greater use of cash flow-based valuation methodologies takes a more balanced and sensible approach to how securities should be valued when markets are under great stress, as they have been for the last year or so. We disagree with those who view this as a cave-in or cop-out.

Interestingly, a similar move away from strict adherence to mark-to-market accounting for regulatory capital purposes is thought to have been an important step to ending the Great Depression, according to a March 20, 2009 article by Peter Niculescu in *American Banker* entitled: “Lesson Learned in '30s: End Marking to Market.” Mr. Niculescu writes that the Office of the Comptroller of the Currency (OCC) ended mark-to-market securities evaluations for banks in 1938, saying: “Bank investments should be considered in the light

of inherent soundness rather than on a basis of day-to-day market fluctuations” (*Federal Reserve Bulletin*, July 1938). He goes on to quote the OCC as saying in 1938: “By severing appraisal of bank investments from current market quotations, it is believed that the banks will be encouraged to purchase securities of sound business and industrial concerns, whether large or small, for their true worth and not speculative gains.” And “as the banks avail themselves of the opportunity, the necessity will be diminished for the creation of government agencies to furnish credit facilities which the banks should provide.” This sounds eminently sensible to us. The Obama Administration wants the banks to start lending again. By relieving or greatly diminishing the banks’ need to raise capital to fill balance sheet holes caused by accounting convention, the modified mark-to-market accounting rules increase the likelihood of that happening, in our opinion.

Now that a more balanced interpretation of the mark-to-market accounting rules have been put in place, we have two items left on our wish list: (1) reinstating the “uptick” rule and (2) reining in abusive practices in the credit default swap (CDS) market. In our opinion, these changes would re-level the financial playing field, which we believe has been tilted in favor of the bears since 2007.

The “uptick” rule was instituted in 1938 by then SEC Commissioner Joseph Kennedy, who, as a veteran short-seller himself, knew what a powerful weapon it was to be able to short stocks into weakness in distressed markets and wanted to remove that arrow from the short’s quiver. The “uptick” rule remained in place for 69 years, until July 2007, when intense lobbying by a number of hedge funds convinced the SEC to rescind the rule. Since the elimination of the uptick rule, the downside volatility of stocks, especially financial stocks, has been enormous. Shorts have used the absence of the uptick rule in conjunction with purchases of credit default swaps to initiate “bear raids” on financial institutions regularly since mid-2007. The shorts playbook has been very effective, in our judgment: blow out the CDS spreads while simultaneously shorting the stock, then lobby the rating agencies to downgrade the company because of the poor market action of its CDS, bonds and stock price.

As George Soros argued persuasively in a must-read op-ed piece entitled “One Way to Stop Bear Raids” (*The Wall Street Journal*, Tuesday, March 24, 2009), the shorts’ playbook was particularly effective against financial companies because their business is so dependent upon trust and confidence, and once confidence is shaken, bear raids can be self-validating. Soros opines that “AIG, Bear Stearns, Lehman Brothers and others were destroyed by bear raids in which the shorting of stocks and buying CDS mutually amplified and reinforced each other. The unlimited shorting of stocks was made possible by the abolition of the uptick rule, which would have hindered bear raids by allowing short selling only when prices

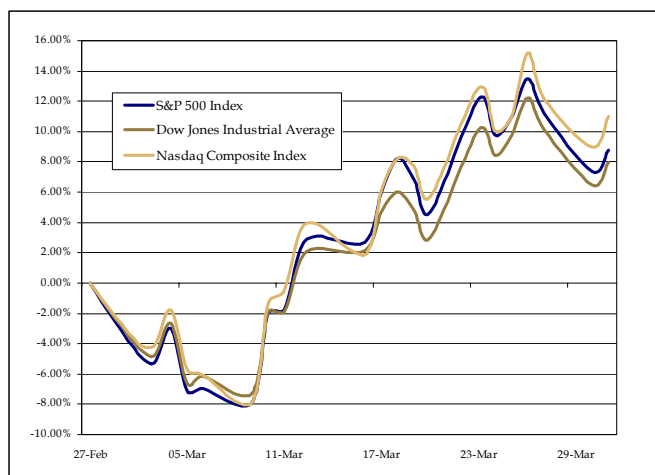
were rising. The unlimited shorting of bonds was facilitated by the CDS market. The two made a lethal combination.”

Soros’s prescription for leveling the playing field is to reinstate the uptick rule and to require that only those who own the underlying bonds ought to be allowed to buy CDS on those bonds. We think both of those ideas have merit. Our preference would be to have the “uptick” rule reinstated in its original form, but, as a compromise, we would also be supportive of the “modified uptick rule” proposed by the four major US stock exchanges that would be triggered after the price of a stock fell by a certain percentage (suggested at -10%). With respect to the CDS market, we could see expanding the list of eligible CDS buyers to include entities, such as suppliers, creditors or customers, who had some economic relationship with the company in question.

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

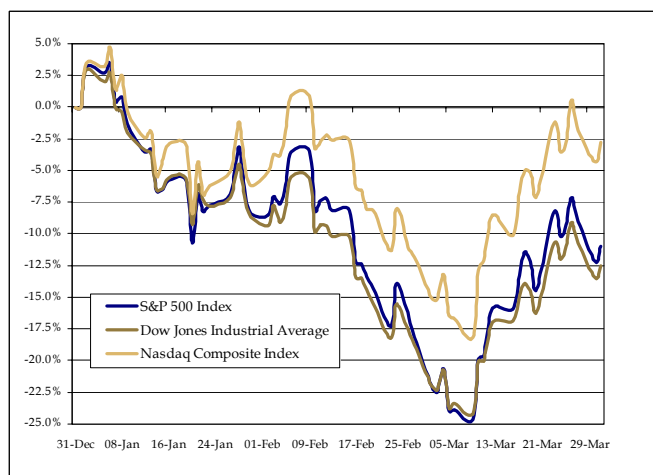
David E. Nelson, CFA
Chairman, Investment Policy Committee
Legg Mason Capital Management

Major Indices March Performance



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

Major Indices 2009 Performance



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

Monthly U.S. Market Update (Total Returns)

Index Name	March	Q1
<i>Broad Market Indices</i>		
S&P 500	8.76	(11.01)
Dow Jones	7.93	(12.48)
Russell 1000	8.75	(10.45)
NASDAQ	11.02	(2.79)
Dow Jones Wilshire 5000	8.71	(10.56)
Russell 2000	8.93	(14.95)
Russell 1000 Growth	8.92	(4.12)
Russell 1000 Value	8.55	(16.77)
<i>S&P 500 Sector Indices</i>		
S&P 500 Consumer Discretionary	12.28	(8.09)
S&P 500 Consumer Staples	4.14	(10.54)
S&P 500 Energy	3.79	(11.57)
S&P 500 Financials	17.94	(28.80)
S&P 500 Health Care	6.46	(8.00)
S&P 500 Industrials	9.31	(20.88)
S&P 500 Information Technology	12.14	4.31
S&P 500 Materials	15.26	(2.05)
S&P 500 Telecomm Services	6.06	(7.13)
S&P 500 Utilities	2.52	(10.79)

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

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.