LEGG MASON CAPITAL MANAGEMENT Month-End Commentary

May 2009

Market Commentary

The S&P 500 Index cheered the bulls but frustrated those investors looking for a market correction, posting its third straight monthly gain in May, up +5.59%. The biggest correction the bears could muster during the month was a -5.51% pullback from the S&P 500's intra-day high of 930.17 on 5/8 to an intra-day low of 878.94 five trading days later. Following that modest setback, the S&P 500 rallied into month end and, on June 1, surged +2.59% to a new 2009 closing high of 942.87, closing above its 200-day moving average for the first time since December 2007, and prompting veteran market technician Ned Davis (who is a cyclical bull, but secular bear) to recommend that clients move to their maximum allowed exposure to equities

Impressively, the S&P's surge to a new year-to-date high occurred on the same day that General Motors filed for Chapter 11 bankruptcy, an event which would normally be expected to derail the market. The fact that it did not speaks volumes about how far in prominence General Motors has fallen since its heyday in the 1950s when then-GM President Charles "Engine Charlie" Wilson is widely reported to have said: "What's good for General Motors is good for the country." The fact that he did not actually say exactly that does not diminish the fact that the outlook for the U.S. economy is no longer inexorably bound up with the fate of General Motors, as it once was thought to be.

TOTAL RETURNS

	May	QTD	YTD
S&P 500 Index	+5.59%	+15.70%	+2.96%
Dow Industrials	+4.52%	+12.42%	-1.61%
Nasdaq Composite Index	+3.47%	+16.30%	+13.06%
S&P MidCap 400 Index	+2.74%	+18.01%	+7.80%
Russell 2000 Index	+3.01%	+18.93%	+1.14%
Dow Jones US Total Market Index	+5.29%	+16.37%	+4.08%
S&P 100 Index	+5.62%	+13.86%	+0.38%
Russell 1000 Growth Index	+4.96%	+15.03%	+10.29%
Russell 1000 Value Index	+6.18%	+17.57%	-2.15%

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

Our sense is that many investors have been rooting for a correction so that they can get more fully invested, but so far, the market has not accommodated them. Veteran market technician John Mendelson, now with Potomac Research Group, echoed the same sentiment in a recent piece. Fresh off a four-city round of client meetings, Mendelson wrote that he continues to see an "overall cautious mood among investors," with a common remark from clients being something to the effect that: "I have too much cash. What are the chances of a significant pullback in the market over the near term so I can get more cash into the market?" Mendelson's anecdotal sense that many investors are sitting on a lot of cash is supported by a *Wall Street Journal* report last week that the value of money-market funds exceeded stock funds in May for the first time in 16 years. In contrast, the value of stock funds was more than three times greater than money-market funds in the summer of 2007, according to Mendelson.

Kevin Pleines and Jeffrey Rubin of Birinyi Associates put out a one-page piece on 6/1/09 suggesting that those looking for a meaningful market correction may continue to be frustrated. They note that the current rally is only the fourth time in 82 years that the S&P 500 has gained at least +37% in 58 trading days. In the prior three instances (8/10/32, 5/11/33 and 11/3/82), the S&P 500 rallied over +20% further before succumbing to a correction larger than -10%. Of course, nothing says this time has to follow the same script, but nothing says it doesn't either. A further +20% rally from the S&P 500's June 1 close of 942.87 would put that index at about 1131. We can only imagine the agony investors still sitting on the sidelines at that point would be feeling, having missed a nearly +70% rally off the bottom.

TOTAL RETURNS IN U.S. DOLLARS

	May	YTD
FTSE 100 Index (UK)	+14.54%	+13.19%
DAX Index (Germany)	+10.73%	+2.75%
CAC 40 Index (France)	+13.48%	-6.29%
MICEX Index (Russia)	+33.06%	+75.56%
NIKKEI 225 (Japan)	+11.60%	+2.54%
Hang Seng Index (HK)	+18.31%	+28.31%
Kospi Index (So. Korea)	+4.28%	+28.21%
Shanghai SE Comp. (China)	+6.28%	+44.71%
BSE Sensex 30 Index (India)	+36.53%	+56.78%

Source: Bloomberg

Similar to March and April, as strong as May's market rally was in the U.S., it paled in comparison to the performance of most major foreign markets. For the nine foreign markets listed above, the S&P 500 Index is ahead of only Germany's DAX Index (+2.75%) and Japan's NIKKEI 225 (+2.54%) on a year-to-date basis. For the month, India's BSE Sensex 30 Index was up a stunning +35.63%, followed closely by Russia's MICEX Index (+33.06%). Russia and India are now ahead of prior leader China on a year-to-date basis, though the Shanghai SE Composite is still up a none-too-shabby +44.71% so far in 2009. In our view, the strong year-to-date performance of emerging market indexes, together with the sharp upturn noted by ISI Group in their purchasing managers' indexes (PMIs), is persuasive evidence that their economies have begun to recover. The growing likelihood of sharp recovery in emerging market economies may well be the main reason behind the recent strength in oil prices and other commodities.

Outlook

We are growing increasingly confident that the market made its low for this cycle in early March and that the move off that low is the beginning of a new bull market, rather than a bear market rally. Whether this bull is a cyclical bull within a continuing secular bear market, as Ned Davis and others believe, or the beginning of a new secular bull market is unclear at this point, but for a while, at least, we think it won't matter. Our main message to clients is that we believe the market has made an important bottom and is going higher over the next year or so, and that investors should be positioned accordingly.

Our optimism is based on a number of factors including the action of the market itself, the improvement in credit markets and narrowing of credit spreads, the ongoing recapitalization of the U.S. banking system, the dramatic recovery in emerging market equities, and, finally, the upturn, both here and abroad, in a wide variety of leading indicators which normally presage an upturn in economic activity.

In our opinion, the impressive rebound in stocks since early March is significant because the market itself is one of the most reliable leading indicators of economic activity that we have. Through June 2, the S&P 500 Index is up over 42% from its March low on an intra-day basis. Strength of this magnitude has normally been seen only in the initial stages of a new bull market, rather than in a bear market rally. As we noted earlier in the commentary section, the current rally is only the fourth time in 82 years that the market has been up +37% or more in 58 trading days, according to data from Birinyi Associates. All three prior instances confirmed the validity of bull-market moves, and all three advanced an additional +20% before suffering a correction of greater than -10%.

Stocks have rallied sharply since March, not just in the U.S., but worldwide. The MSCI World Index was up almost +9% in May, its best monthly performance in more than 30 years. Emerging markets, which are highly sensitive to incremental economic growth, have been notably strong year-to-date (total returns in local currencies): China (+44%), Korea (+24%), Hong Kong (+28%), India (+51%), Russia (+84%), Brazil (+41%), Venezuela (+30%), Chile (+30%), Argentina (+47%) and Mexico (+9.5%). We seriously doubt that world equity returns would be this strong, or this broad-based, if an upturn in the global economy were not in the offing.

Credit market conditions have improved considerably in recent months and credit spreads have narrowed dramatically. The LIBOR-OIS spread, which blew out in the fall of 2008, peaking at 364 basis points last October, has narrowed to 44 basis points recently. Investment-grade corporate spreads have narrowed to under 300 basis points from nearly 600 basis points last fall, while high-yield spreads are down 1000 basis points from their 2008 highs of 2000 basis points over the same period. Both investment-grade and high-yield issuance have rebounded significantly in the first five months of 2009. In all, credit markets, including the commercial paper and interbank lending markets, appear to be on the mend.

The ongoing recapitalization of the U.S. banking system is also quite encouraging in our view. According to a *Wall Street Journal* article, through Tuesday (6/2/09), the 19 financial institutions required to be stress-tested have raised a total of $65 billion in new common equity since May 7. Nonguaranteed debt sales and the conversion of preferred shares to common stock have generated about another $20 billion, for a total of $85 billion, comfortably more, in most cases, than the amounts required by the government stress tests. A number of institutions—including J.P. Morgan Chase, Goldman Sachs and Morgan Stanley—will likely use their "excess" capital to pay back TARP funds as soon as they are permitted to do so. In a welcome turn of events from earlier this year, one banking executive is quoted by the *WSJ* as saying, "It's easy to raise capital now," investors are "happy to gobble it up."

On the economic front, we also see a number of encouraging signs. Purchasing managers' indexes (PMIs) for both production and new orders have turned up in many developed and emerging market countries in the last couple of months. China's PMIs have actually risen above 50, indicating that their manufacturing sector is actually growing again, and suggesting that China may prove to be an important engine of global recovery. In the U.S., new manufacturing orders rose in April for the first time since the recession began, suggesting that the U.S. economy may begin to recover in the second half of 2009. Other recent signs of improvement in the U.S. economy include a seventh consecutive weekly gain in ISI Group's trucking survey and a U.S. Commerce Department report that shows construction spending rose unexpectedly in April, led by gains in residential and commercial building. Inventory liquidation, which was a huge negative contributor to U.S. GDP in the fourth quarter of 2008 and first quarter of 2009, also appears to be nearing an end, as the Institute for Supply Management announced on Tuesday (6/2/09) that for the second straight month, more purchasing managers said customers' inventories were too low than said they were too high.

To be sure, the economic environment remains challenging in many respects. Job losses remain uncomfortably high, though the rate of loss seems to be diminishing. Recent changes in credit card laws, while ostensibly intended to protect consumers, will likely have the effect of reducing the availability of credit to subprime and other low-FICO-score borrowers, who will be forced to pursue less attractive sources of funding, such as payday loans, to satisfy their credit needs.

Perhaps the biggest challenge facing corporate America in general will be the fact that *nominal* GDP growth, even as the economy begins to recover, is likely to be as low, or lower, than at any time since WWII. In this environment, attractive sales growth rates will be difficult to achieve.

Longer term, of course, investors face the issue of how the U.S. government will finance its ever-increasing Social Security, Medicare and Medicaid obligations while still maintaining its credit rating and the integrity of the U.S. dollar. Constructive resolution of these issues would brighten the long-term outlook for equities considerably. Failure to properly address the issues could well lead to the decidedly less favorable outcome that secular bears envision.

Longer-term concerns notwithstanding, we think that over the next year or so, the market has a good chance of trading higher, perhaps substantially higher, as the U.S. and world economy begin to recover and credit market conditions continue to normalize. In sizing the upside opportunity, as well as the downside risk, that investors face over the next 12 to 18 months, we found Leuthold Group's June monthly "Green Book" discussion of their Very Long Term (VLT) Momentum indicator—which recorded a "buy" signal at the end of May—to be especially germane.

The VLT indicator was originally developed by market technician Edwin "Sedge" Coppock who wrote an article in *Barron's* about it in 1962. The indicator—a smoothed rate of change in stock prices—is not designed to identify market bottoms, but rather to confirm that a new uptrend in stock prices is "for real" and likely to persist. The VLT indicator—which has given 24 "buy" signals since 1931—is normally late to turn positive, missing the first +20.7% (on average) and +17.2% (based on the median) of the bull market's move. The latest signal, if valid, missed the first +35.9% off the bottom this time around. Still, based on history, the signal portends worthwhile gains ahead for the market. In the 24 prior instances since 1931, the S&P 500 has advanced a further +56.2% (on average) from the time of the buy signal until the end of the bull market. The median gain has been +42.1%. On the downside, investors have suffered average drawdowns from the point of the buy signal to the low point in the bull move of -8.7%. The median drawdown has been only -1.2%.

In the interest of full disclosure, these relatively modest drawdown figures consist of a lot of very good results mixed in with a few spectacular failures of the model. These include a -68.3% drawdown from the August 31, 1931 buy signal, and, more recently, a -32.3% drawdown from the December 31, 2001 buy signal. So, in effect, the indicator has a great batting average on both the upside and downside, but when it fails, it fails miserably.

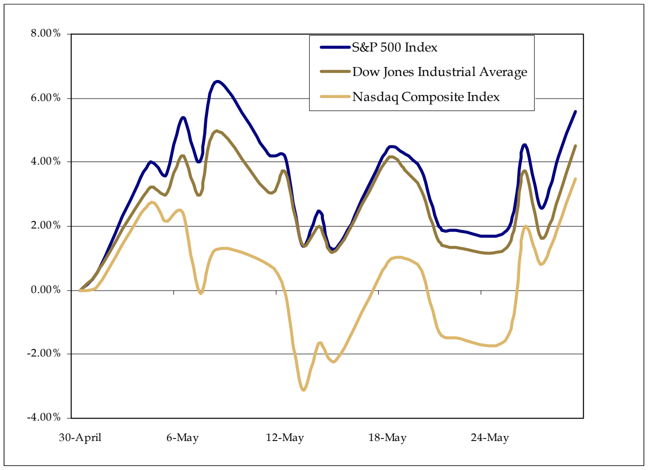
Looking at the raw historical data from Leuthold Group on the indicator, it appears that if the indicator is going to fail, it does so fairly quickly. A good rule of thumb appears to be that if the market drops more than -14% from the point of the buy signal, then the buy signal is invalidated and should be ignored. That level would be about 790 on the S&P 500 Index, so that figure seems like a reasonable maximum downside target, assuming the VLT indicator is working.

On the upside, if the S&P 500 trades up between +42.1% (the median gain historically following a VLT buy signal) and +56.2% (the average gain), that would take the index to between 1306 and 1436 before this bull move is over. The mid-point of that range is 1371, so based on this line of analysis, the S&P 500 has about 452 points of upside from its 919.14 close on May 29, 2009, and downside risk of about 129 points to 790, providing investors with about a 3.5 to 1 (452/129) reward-to-risk ratio. We like those odds.

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

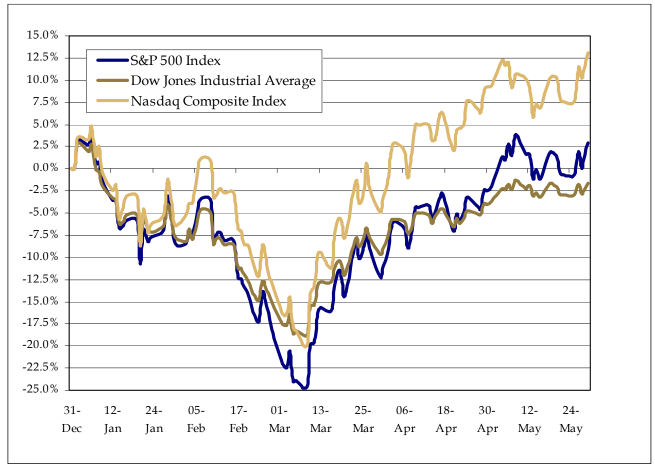
David E. Nelson, CFA
Chairman, Investment Policy Committee
Legg Mason Capital Management

Major Indices May Performance



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

Major Indices 2009 Performance



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

Monthly U.S. Market Update (Total Returns)

Index Name	May	QTD	YTD
Broad Market Indices			
S&P 500	5.59	15.70	2.96
Dow Jones	4.52	12.42	(1.61)
Russell 1000	5.53	16.22	4.07
NASDAQ	3.47	16.30	13.06
Dow Jones US Total Market Index	5.29	16.37	4.08
Russell 2000	3.01	18.93	1.14
Russell 1000 Growth	4.96	15.03	10.29
Russell 1000 Value	6.18	17.57	(2.15)
S&P 500 Sector Indices			
S&P 500 Consumer Discretionary	(0.96)	17.50	7.99
S&P 500 Consumer Staples	5.65	9.11	(2.39)
S&P 500 Energy	10.68	16.04	2.61
S&P 500 Financials	13.25	38.58	(1.33)
S&P 500 Health Care	6.86	6.08	(2.41)
S&P 500 Industrials	3.08	21.48	(3.88)
S&P 500 Information Technology	2.64	15.04	19.99
S&P 500 Materials	5.82	21.90	19.40
S&P 500 Telecomm Services	(1.28)	2.24	(5.05)
S&P 500 Utilities	3.72	4.38	(6.88)

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