

Market Commentary

Investors on the lookout for a market correction must be starting to feel like Vladimir and Estragon in Samuel Beckett's play *Waiting for Godot*, wondering whether the event they await will ever occur. It looked as though a meaningful correction was developing in early July, as the S&P 500 dropped below its 200-day moving average, hitting an intraday low of 869.32 on Wednesday, July 8 and a closing low of 879.13 a couple of days later. Then, just as the bears were licking their chops in anticipation of more downside carnage, the market turned sharply higher, ruining the head-and-shoulders top pattern that bearish technicians had divined, and instead, adding further pictorial credibility to the market bottoming process that the bulls argue began last October. In the last three weeks of July, the S&P 500 surged +12.3% to a new year-to-date closing high of 987.48. Market strength has continued in the early days of August as the S&P 500 has traded comfortably above the 1,000-point level for the first time since last November. If the early July bottom was, in fact, the much-anticipated correction, it was relatively mild by historic standards, measuring -9.1% for the S&P 500 from its June high on an intraday basis, and only -7.1% on a closing basis.

On a sector-return basis, the S&P 500 continued to exhibit a pro-cyclical tilt in July, as materials (+13.33%), consumer discretionary (+9.47%), industrial (+9.31%), technology (+9.17%) and financial stocks (+8.86%) led, while consumer staples (+6.37%), healthcare (+5.90%), telecom services (+5.04%), energy (+4.40%) and utilities (+3.88%) lagged. Year-to-date, tech stocks (+36.32%) are the standout performers, joined by the materials group (+29.06%) and consumer discretionary stocks (+18.86%). Telecom services (+0.88%), utilities (+2.10%), and energy (+2.20%) are notable laggards.

TOTAL RETURNS

	July	YTD
S&P 500 Index	+7.56%	+10.97%
Dow Industrials	+8.75%	+6.56%
Nasdaq Composite Index	+7.86%	+26.18%
S&P MidCap 400 Index	+8.74%	+17.95%
Russell 2000 Index	+9.63%	+12.53%
Dow Jones US Total Market Index	+7.82%	+12.63%
S&P 100 Index	+7.32%	+8.41%
Russell 1000 Growth Index	+7.10%	+19.45%
Russell 1000 Value Index	+8.18%	+5.08%

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

As has been true for much of 2009, strong gains in the U.S. equity market were eclipsed by even stronger gains overseas in July. For the month, of the foreign markets listed below, the S&P 500's +7.56% return bettered the returns of only Russia (+7.49%) and Japan (+5.86%) in dollar terms. On a year-to-date basis, the S&P 500 Index trails all foreign markets below.

TOTAL RETURNS IN U.S. DOLLARS

	July	YTD
FTSE 100 Index (UK)	+10.12%	+22.75%
DAX Index (Germany)	+12.41%	+11.86%
CAC 40 Index (France)	+10.67%	+12.63%
MICEX Index (Russia)	+7.49%	+61.61%
NIKKEI 225 (Japan)	+5.86%	+12.70%
Hang Seng Index (HK)	+11.94%	+45.96%
Kospi Index (So. Korea)	+16.58%	+46.76%
Shanghai SE Comp. (China)	+15.46%	+89.55%
BSE Sensex 30 Index (India)	+8.14%	+65.82%

Source: Bloomberg

Obviously, the stock market has recently been much stronger than many investors dared dream possible. Why has the market been so strong? In our view, the most obvious answer is that the economy is bottoming out and the Great Recession of 2009 may be over. The official beginning and end of recessions are determined by the National Bureau of Economic Research, usually well after the fact. For example, it was not until mid-2008 that the NBER determined that the current recession began in December 2007. While the official end of this recession may not be identified for many months, when it is, we think a likely end point could be June 2009. Joe Kalish of Ned Davis Research (NDR) expressed this view in a July 20 piece entitled, "Recession Ended in June – What It Means for the Market," noting that June saw the third straight monthly rise in the index of Leading Economic Indicators, an event normally signalling the onset of an economic expansion. He further noted that the ratio of coincident-to-lagging indicators, which normally troughs around the end of recessions, bottomed in March 2009.

Former Fed Governor Alan Blinder expressed a similar view in a July 24 *Wall Street Journal* op-ed, "The Economy Has Hit Bottom." In his piece, Blinder opined that the steep decline in housing, auto production, business investment and inventories has ended, and that as these

sectors stabilize and begin to grow again, the “arithmetic of bottoming out takes hold” and sets the stage for “a reasonable chance that the second half of 2009 will surprise us on the upside.” The initial boost to GDP will come merely from a cessation of the steep declines, a process PIMCO’s Paul McCulley calls “addition by the elimination of subtraction.”

When growth begins, the boost to GDP from current depressed levels could be quite startling. Take housing starts, for example. From current levels, housing starts would need to rise +84% just to get back to their average *trough* level in the past seven recessions, according to data from Leuthold Group. Even with housing accounting for a very depressed 2.6% of GDP currently, a rise in starts of this magnitude would add over two percentage points to GDP growth over whatever timeframe it took to accomplish. As auto production rises from depression-like levels to merely recessionary levels, GDP will get a similarly large bump. The same can be said for inventories, as they begin to rebuild. By such a process, third quarter 2009 real GDP will rise by a minimum of 3% to 4%, in our opinion, and possibly faster.

Despite the growing body of evidence that the economy is bottoming out and beginning to improve, many investors remain skeptical of prospects for recovery in both the economy and the stock market. NDR reported that their Crowd Sentiment Poll reached a short-term peak on June 5, but retreated quickly as the market sold off into early July. Though the sell-off was relatively mild, NDR noted that their “sentiment poll acted like we were seeing a major decline, falling again to just 46.8% bulls on July 13, a sign of extreme pessimism, particularly in light of market action, which remained good, specifically market breadth, which showed very few stocks making new lows.”

A common complaint among those skeptical of the market’s strength is that we are seeing a “low quality” rally on light volume which has come “too far, too fast.” Let’s look more closely at that complaint. While it’s true that so-called “low quality” stocks have led this advance so far, that is nearly always the case, and thus says nothing meaningful about the durability or authenticity of the rally. Junk stocks, the so-called “dogs,” led the advance off the 2002 bear market bottom as well. The advance subsequently broadened out and led to a doubling of the market in five years. The reason low quality stocks often lead off the bottom is that they are the very stocks that get obliterated in the previous market decline. Since many of these stocks are priced as though they are going out of business at the bottom of the market, when they don’t go bust, their percentage gains off the bottom can be eye-popping.

True to form, stocks rated “C” by Standard & Poor rose +30% in the first four months of this year, while A-rated stocks lost -5.7%, according to figures compiled by Howard Silverblatt of S&P. More recently, performance differentials have narrowed. From the end of May through late July, Standard & Poor calculates that C-grade stocks returned about +9%, while their A-rated counterparts returned nearly +7%. There is reason to believe that quality stocks will ultimately have their day in the sun, as they now sport much more attractive valuations than their lower quality counterparts. According to S&P’s data, A-grade stocks have an average price-to-earnings ratio of 16.0, while C-grade stocks trade at an average P/E of 50.6.

As to the complaint that light trading volume makes the rally since March suspect, we are skeptical of this criticism for a couple of reasons. First, with the proliferation of electronic communications networks (ECNs), alternative trading systems (ATs) and other off-exchange trading pools, we believe that the NYSE volume figures normally monitored by market technicians are failing to capture much of the actual trading volume taking place. Second, despite the conventional wisdom that new bull markets need to be accompanied by an explosion in volume to be authentic, the data back to 1932 is mixed on this market “truism,” according to Leuthold Group. They note that low volume can be bullish under certain circumstances. Their August monthly cites the following example: “Last month Steve Leuthold noted that—while technicians were focused on a small, ‘head and shoulders’ (H&S) topping pattern in the S&P—a much bigger, ‘inverted’ (and bullish) H&S pattern was nearing completion. **Light volume** as this pattern nears completion is critical to the validity of the pattern, according to the ‘bible’ of chart formations—Edwards & Magee’s *Technical Analysis of Stock Trends*—which states, ‘The real tip-off appears when activity fails to pick up appreciably on the right shoulder.’ Light volume suggests investors doubt the bullish reversal is for real—exactly the sense we have today.”

## Outlook

We continue to believe that the market advance since March 2009 is the opening, and likely the most powerful, leg of a new cyclical bull market, rather than a bear market rally. Investors sitting on the sidelines have already missed out on almost a +50% gain. That’s roughly four to five years worth of returns at stocks’ historic appreciation rate. As signs that the worst has passed proliferate, many investors are realizing that they should have been more constructive on equities in March. They have too much cash and, so far, the market corrections have been mild, denying them an attractive re-entry point. We can certainly sympathize. The news flow

and market action earlier this year were pretty scary. But, in retrospect, it is those truly terrifying times that present the best buying opportunities.

While the rate of gain will almost certainly moderate, we think worthwhile gains lie ahead before this bull market breathes its last. As of now, we believe the S&P 500 Index has the potential to reach 1,250 to 1,350 by the end of 2010. Depending on how strong the recovery in the economy and corporate profits turns out to be, we could adjust that target range either upward or downward. As we see things today, we think the surprises are more likely to be on the upside than downside.

As we noted earlier in this commentary, and in previous months, housing starts and auto production have fallen to such depression-like levels that a rebound to merely recessionary levels will give a sharp boost to GDP. Once the economy begins to recover, we think strength will feed on itself, as businessmen and women regain their courage and sense of optimism about the future. This self-reinforcing phenomenon certainly occurred on the downside. As financial markets collapsed last fall, dire economic forecasts gained credibility, causing corporate managements to respond in unprecedented ways. They cut inventories, payrolls and capital spending dramatically in expectation of a coming global depression. In its present streamlined condition, the corporate sector has what Wells Capital Management's Jim Paulsen calls "spectacular profit leverage" to any improvement in the economy. Empirical Research's Michael Goldstein discusses the same phenomenon in his latest strategy piece, noting that corporate free cash flow margins this quarter "will be in the +8% to +9% range, matching what was seen at the business cycle peak a year-and-a-half ago, remarkable considering sales are down by -10%." Adding further credence to the health of the corporate sector, 75% of the companies in the S&P 500 Index are beating earnings expectations so far in the second-quarter reporting season, according to Strategas Research Partners. Some observers carp that fewer companies are beating revenue expectations, and thus beating earnings estimates only through cost-cutting. While conceding that fact, we would argue that companies are controlling what they can control in a difficult environment, and deserve credit, not criticism, for that.

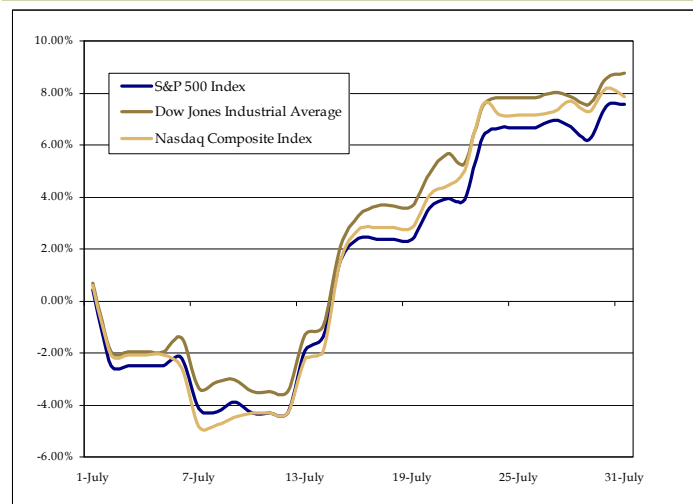
In closing, we would note the old admonition that "In a bull market, be bullish." We think we're in a bull market and, therefore, we remain bullish. We think the recession is over, that the economy will grow in the second half of 2009, that stocks are attractively valued (especially relative to cash and Treasuries), that the recovery in corporate earnings could surprise investors on the upside, and that, given all of the foregoing, investors are generally far too negative about the outlook for the stock market. We further believe that the

mountain of cash on the sidelines earning next to nothing makes it likely that market corrections will be contained to the -10% to -15% range. We consider the S&P 500's 200-day moving average of 872 to be a reasonable estimate of the downside risk in the market at present. Given the fact that, as of late July, the S&P's 200-day moving average has bottomed and is now rising, we believe that the downside risk in the market will diminish over time. We would also highlight two final points for the technically minded. First, the S&P 500 is now fully "in gear" from a technical standpoint, which is to say that its 10-day moving average is above its 50-day, which is, in turn, above its 200-day, and all moving averages are rising. There isn't a market technician in the world that could call that anything but bullish. Finally, with the S&P 500 having recently broken above 1000, Steve Leuthold notes that there is no overhead "chart resistance" until the 1200-1260 level.

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

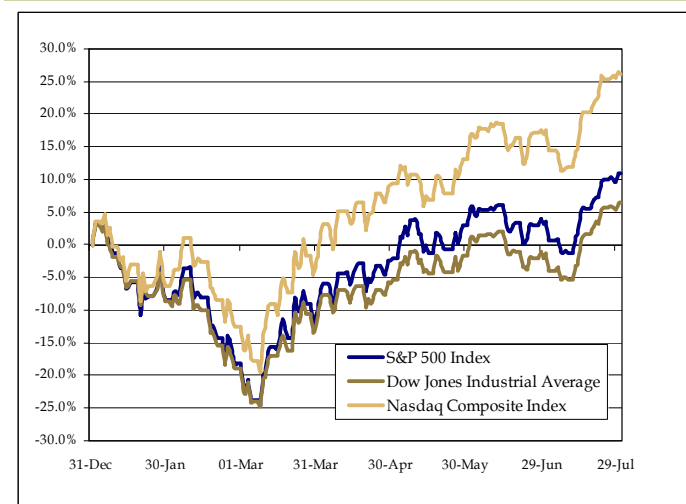
**David E. Nelson, CFA**  
**Chairman, Investment Policy Committee**  
**Legg Mason Capital Management**

### Major Indices July 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	July	YTD
<i>Broad Market Indices</i>		
S&P 500	7.56	10.97
Dow Jones	8.75	6.56
Russell 1000	7.63	12.28
NASDAQ	7.86	26.18
Dow Jones US Total Market Index	7.82	12.63
Russell 2000	9.63	12.53
Russell 1000 Growth	7.10	19.45
Russell 1000 Value	8.19	5.08
<i>S&amp;P 500 Sector Indices</i>		
S&P 500 Consumer Discretionary	9.47	18.86
S&P 500 Consumer Staples	6.37	4.50
S&P 500 Energy	4.40	2.20
S&P 500 Financials	8.86	5.17
S&P 500 Health Care	5.90	6.09
S&P 500 Industrials	9.31	2.83
S&P 500 Information Technology	9.17	36.32
S&P 500 Materials	13.33	29.06
S&P 500 Telecomm Services	5.04	0.88
S&P 500 Utilities	3.88	2.10

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

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