Market Commentary

The S&P 500 Index posted its sixth consecutive monthly gain in August, up +3.61%, capping its best six-month gain since 1933. It was an odd sort of month, in that only two S&P sectors, Financials (+12.99%) and Industrials (+4.53%), posted better results than the index itself, while eight sectors lagged. Apart from financials, which rocketed ahead, the other nine S&P sectors were up only +1.7%, on average.

Trading volume became highly concentrated in financials late in the month in what looked to us like an unhealthy outbreak of speculative activity. Former pariahs, AIG (up +245% for the month), Freddie Mac (+269%), and Fannie Mae (+233%) took center stage in the run-up. According to data from *The Wall Street Journal's* Market Data Group, five stocks, the aforementioned trio plus Citigroup and Bank of America, accounted for 35% of NYSE Composite volume on Thursday, August 27. Those same five stocks also accounted for an average of more than 30% of daily volume from August 5 through month end.

TOTAL RETURNS

	August	QTD	YTD
S&P 500 Index	+3.61%	+11.45%	+14.97%
Dow Industrials	+3.97%	+13.07%	+10.79%
Nasdaq Composite Index	+1.67%	+9.67%	+28.29%
S&P MidCap 400 Index	+4.37%	+13.49%	+23.10%
Russell 2000 Index	+2.87%	+12.77%	+15.75%
Dow Jones US Total Market Index	+3.61%	+11.70%	+16.69%
S&P 100 Index	+3.42%	+10.98%	+12.12%
Russell 1000 Growth Index	+2.07%	+9.32%	+21.93%
Russell 1000 Value Index	+5.23%	+13.84%	+10.58%

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

Just as the final decimation of financials marked the bottom of the market in March, the late-August speculative frenzy in financials may have marked a short-term top in the market. Obviously no one knows for sure, but we believe September could prove to be a trying month for the bulls. Historically, September has been the weakest month of the year for both the Dow Industrials and S&P 500 Index. Since 1950, the S&P 500 has been down an average of -0.6% in September, declining 57% of the time. Over the same timeframe, the Dow has been down an average of -1.0% in September, dropping 63% of the time. If the first couple of trading sessions of the month are any indication, September 2009 won't be much fun either.

The big news in overseas markets in August was the sharp sell-off in the Shanghai Composite, down -21.8% for the month. By one accepted definition, this decline of greater than -20% qualifies as a bear market. Whatever one chooses to call it, the decline has toppled the Shanghai Composite from its perch as the best performing major equity market year to date. The new leaders in that category through August are Russia's MICEX Index (+65.6% YTD) and India's BSE Sensex 30 Index (+63.3%). We wouldn't necessarily count the Shanghai Composite out of the race for all of 2009. The Chinese market bottomed earlier than most other world bourses in November 2008 and exhibited strong upside leadership through July 2009. Its August correction may presage the onset of corrections or consolidations in other world markets, including the U.S.

TOTAL RETURNS IN U.S. DOLLARS

	August	YTD
FTSE 100 Index (UK)	+4.66%	+28.46%
DAX Index (Germany)	+3.20%	+15.44%
CAC 40 Index (France)	+7.58%	+21.16%
MICEX Index (Russia)	+2.48%	+65.61%
NIKKEI 225 (Japan)	+3.33%	+16.45%
Hang Seng Index (HK)	-3.95%	+40.19%
Kospi Index (So. Korea)	+0.06%	+46.84%
Shanghai SE Comp. (China)	-21.78%	+48.27%
BSE Sensex 30 Index (India)	-1.54%	+63.26%

Source: Bloomberg

In addition to the speculative activity in financials, noted above, and the August correction/bear market in the bellwether Shanghai Composite, we see a number of other signs that suggest to us that the much-anticipated market correction may be upon us. Heading the list is the heavy recent selling activity by corporate insiders. Insider sales typically exceed buying activity by a wide margin. The long-term average of insider sales-to-buys is about 7 to 1, according to TrimTabs. In the dark days of March 2009, at the bottom of the market, that ratio dropped to just 2 to 1. In August, insiders sold 31 times as much stock as they bought, a record, according to TrimTabs. After a better than +50% gain in the market, this is perhaps understandable, but worrisome nonetheless.

At the same time that insiders have greatly stepped up their selling, short-sellers, bloodied by the market's relentless advance, have been closing out their positions, having lost their taste for the short side. According to research firm Bespoke Investment Group, the average short interest in major equity indices has fallen to its lowest levels since the top of the market in October 2007.

Another moderately worrying sign, at least in the short term, is the surge in initial public offerings (IPOs). The 11 new IPO filings in August were the largest number since December 2007.

Further adding to our short-term concern about the market is the fact that investor sentiment, deeply pessimistic in March, has recently turned decidedly more upbeat. Ned Davis Research's Crowd Sentiment Poll, which bottomed in March 2009 at a multi-decade low of 30.9, rebounded to over 63 by late August. Davis classifies any reading above 61.5 as reflective of extreme investor optimism, but does not expect the market to become seriously vulnerable until the reading tops 68. Nevertheless, the fact that this indicator has moved into bearish territory cannot be especially comforting to the bulls.

Another sentiment turnaround has been observed by Jake Bernstein, an independent market analyst, who maintains a Daily Sentiment Index that measures the mood of small traders. Just before the market turned in March, only 2% of investors were optimistic, according to Mr. Bernstein's work. Now, the index shows that 89% are feeling bullish, the same percentage who were bullish in October 2007 when the Dow hit its record high.

If the foregoing is not enough evidence to suggest that—at a minimum—the market is due for a breather, the August 2009 *BusinessWeek* special issue cover story trumpeting "The Case for Optimism" should give investors pause. Cover stories in the mainstream business press have a proud tradition of serving as fairly reliable contrary indicators.

Outlook

We continue to believe that stocks began a cyclical bull market in March 2009 that could ultimately carry the S&P 500 to 1250 to 1350 by the end of 2010. We call this a cyclical, rather than secular, bull market because we think it is unlikely, as we see things now, that the popular averages will reach new all-time highs before the next bear market sets in. That could be wrong, of course, and we hope it is, but that is our current thinking. We further believe, for the reasons discussed earlier, that the market is vulnerable to a -10% to -15% correction in the near term, a correction that may well be in its early stages as this is written. A -15% decline from its recent intraday high of 1039 on August 28 would push the S&P 500 down to about 883, or roughly its 200-day moving average. We regard that as a reasonable estimate of the near-term risk in the market.

At the March 2009 lows, investors' expectations were so low and their collective outlook so pessimistic that all that needed to happen for stocks to be a good buy was that the world not come to an end. Following the strongest six-month rally in over 75 years, the outlook for stocks from here forward is much more heavily dependent, in our view, upon the strength of the recovery in economic activity and corporate profits. We see a reasonable case for optimism on both scores, at least relative to consensus expectations, which strike us as muted.

In terms of economic activity, we think there is a strong case to be made that the recession is over and that the economy has begun to recover. The latest piece of evidence in support of that view is the Institute of Supply Management's (ISM) manufacturing index, which rose to 52.9 in August from 48.9 in July. A reading above 50 indicates that the manufacturing sector is expanding. Former Fed Governor Lyle Gramley, Chief Economic Strategist at Soleil Securities, shares our view that the economy has entered recovery mode. He recently (8/26/09) published an informative piece entitled "The First Year of Recovery" which looks at nine post-World War II recoveries to see what light they may shed on what our expectations should be for the coming year.

FIRST YEAR OF RECOVERY

Year Ending:	Percent Increase in Real GDP	Percent Decline in Real GDP, Preceding Recession	Percent of Previous Peak GDP after 4 Quarters of Recovery
Q2, 1955	7.9%	-2.5%	105.2%
Q2, 1959	9.5%	-3.1%	106.1%
Q1, 1962	7.5%	-1.6%	106.4%
Q4, 1971	4.5%	-0.1%	103.8%
Q1, 1976	6.2%	-3.2%	102.8%
Q3, 1981	4.4%	-2.2%	102.1%
Q4, 1983	7.7%	-2.6%	104.9%
Q1, 1992	2.6%	-1.4%	101.2%
Q4, 2002	1.9%	-0.3%	102.3%
Average	**5.8%**	**-1.9%**	**103.9%**

Source: Haver Analytics, Soleil SecuritiesCo.

The table above, courtesy of Soleil Securities, shows that, in nine post-WWII recoveries, real GDP grew an average of

+5.8% in the first year. The data above reveal that severe recessions have tended to be followed by sharp recoveries, whereas milder recessions have been followed by below average advances. This pattern would argue for an above average recovery, but Gramley believes that the pattern will not hold this time around due to his expectation that the recovery in consumer spending will be muted. Gramley believes sluggish wage growth and limitations on the availability of credit will restrict the rebound in consumer outlays. Without offering a specific forecast, Gramley summaries his view as follows: "In short, the odds weigh heavily in the direction of a relatively modest recovery over the next year, implying a growth rate of real GDP well below the 5.8% average of the last nine recoveries."

While sounding a bit pessimistic, Gramley's view on the economy is not really at odds with another of our favorite economists, Ed Hyman, Chairman of ISI Group, who argues for real GDP growth in the range of +4% over the next year. We believe real GDP growth of this magnitude, while below average by post-WWII standards, would be a pleasant surprise to most market participants. Hyman's recipe for +4% real GDP growth over the next year is (1) a swing in inventories from -$141 billion to +$50 billion, which would lift GDP by +1.5%; (2) housing starts reaching a million annual rate by mid-2010, which would add another +1.5%; and (3) auto sales at a 12 million annual rate, which would add +0.5% to GDP. Hyman expects a +0.5% boost from trade over the next year to bring total real GDP growth to +4.0%. He assumes all other components of GDP growth—consumer spending (ex-autos), total business capital spending and total government spending—to have a net zero impact.

Most of Hyman's assumptions look reasonable to us. The swing in inventories certainly looks achievable. Auto sales at a 12 million annual rate are not a stretch in our view, given that they ran at more than a 14 million annual rate in August, albeit with a strong "cash for clunkers" tailwind which will not be repeated. If we were to quarrel with any of his assumptions, we might argue that an annualized rate of one million housing starts by mid-2010 might be a little optimistic. Offsetting this, however, we think a net zero contribution from all other components of GDP is probably too conservative. On balance, we think Hyman's +4.0% real GDP forecast looks about right.

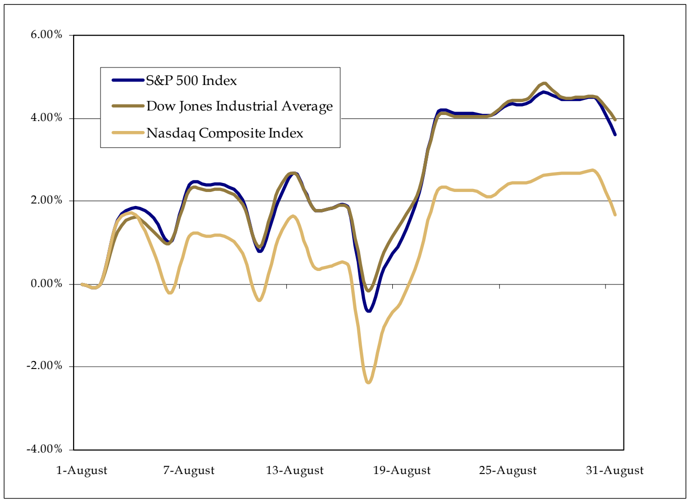
Regarding the outlook for corporate profits, we argued last month that the corporate sector is poised for a sharp snapback. Corporate balance sheets are in generally good shape and free cash flow margins for the sector as a whole have held up surprisingly well due to aggressive cost-cutting in the face of declining revenues. In our opinion, even modest revenue growth in a recovery would have a leveraged effect on the bottom line. ISI Group's Nancy Lazar is forecasting just such an increase. Based on her model of the historical relationship of profits to GDP in the first year of recoveries, if nominal GDP rises +5.0% in the next four quarters (ISI's forecast), corporate profits should increase +18.5%. Together with the +11.3% rise already recorded in the first half of 2009, this prospective gain would put profits up +31.9% from their trough by mid-2010, according to Lazar. Her forecast is not far off the +34.5% profit gain implied by the change in bottom-up consensus earnings per share for the S&P 500, from $54.28 in 2009 to $72.99 in 2010, as reported on Standard & Poor's website.

We have long employed a discounted-cash-flow methodology for evaluating the attractiveness of individual securities and for the market as a whole. For the S&P 500 Index, we have previously assumed a long-term return on equity of 16%, a long-term earnings growth rate of 6%, a weighted-average cost of capital (WACC) estimated by adding an equity risk premium (ERP) to the yield on the 10-year Treasury, and a competitive advantage period (defined as the time over which returns will exceed the WACC) of 20 years. Using a WACC of 7.81% (4.50% ERP + 3.31% 10-year Treasury Yield), those assumptions yield a current fair value multiple of 19.3 for the S&P 500 Index, compared to an August month-end valuation of 18.8 times Standard & Poor's 2009 consensus estimate of $54.28, and 14.0 times their 2010 estimate of $72.99. Applying our fair value multiple of 19.3 to the consensus 2010 estimate of $72.99, implies that the S&P 500 could, in theory, trade over 1400 by year-end 2010. Given the uncertainty of the environment, this strikes us as a bit optimistic. If we tone down our expectations a little, and assume a long-term ROE of 15% to 16%, a long-term earnings growth of between 5% and 6%, and a WACC of 8%, the fair-value multiple for the S&P 500 centers on a range of 17.5 to 18.0 times earnings, implying a fair-value range of about 1275 to 1315 by year-end 2010. That strikes us as more realistic.

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

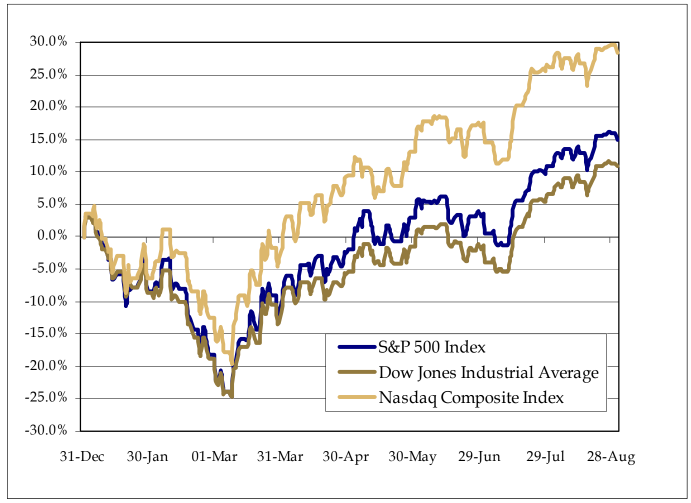
David E. Nelson, CFA
Chairman, Investment Policy Committee
Legg Mason Capital Management

Major Indices August 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	August	QTD	YTD
Broad Market Indices			
S&P 500	3.61	11.45	14.97
Dow Jones	3.97	13.07	10.79
Russell 1000	3.63	11.54	16.36
NASDAQ	1.67	9.67	28.29
Dow Jones US Total Market Index	3.61	11.70	16.69
Russell 2000	2.87	12.77	15.75
Russell 1000 Growth	2.07	9.32	21.93
Russell 1000 Value	5.23	13.84	10.58
S&P 500 Sector Indices			
S&P 500 Consumer Discretionary	3.48	13.28	23.00
S&P 500 Consumer Staples	0.96	7.39	5.50
S&P 500 Energy	0.79	5.22	3.00
S&P 500 Financials	12.99	23.00	18.82
S&P 500 Health Care	2.36	8.40	8.59
S&P 500 Industrials	4.53	14.26	7.48
S&P 500 Information Technology	2.55	11.96	39.80
S&P 500 Materials	2.15	15.77	31.84
S&P 500 Telecomm Services	(2.38)	2.55	(1.52)
S&P 500 Utilities	0.79	4.70	2.91

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