LEGG MASON CAPITAL MANAGEMENT Month-End Commentary

October 2009

Market Commentary

The S&P 500 Index declined -1.86% in October, ending a string of seven consecutive monthly gains beginning in March 2009. During the month, established patterns were upended, as mega-cap stocks showed initial signs of asserting themselves, while prior leaders, the small- and mid-cap indices, took it on the chin, as did the Nasdaq Composite, which declined -3.61% in October, but remains the leading U.S.-based market index year-to-date. The venerable Dow Industrials, a proxy for mega cap quality stocks, in our view, posted the only positive return for the month, followed by the S&P 100 Index, another mega-cap proxy, which also gave a good account of itself.

TOTAL RETURNS

	October	YTD
S&P 500 Index	-1.86%	+17.05%
Dow Industrials	+0.14%	+13.65%
Nasdaq Composite Index	-3.61%	+30.70%
S&P MidCap 400 Index	-4.54%	+24.23%
Russell 2000 Index	-6.79%	+14.12%
Dow Jones US Total Market Index	-2.58%	+18.38%
S&P 100 Index	-1.08%	+14.25%
Russell 1000 Growth Index	-1.35%	+25.39%
Russell 1000 Value Index	-3.06%	+11.33%

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

The changing pattern of market returns was also evident in the S&P 500's monthly sector returns, as four of the five return leaders through September—financials (-5.98% in October), materials (-5.29%), industrials (-4.60%) and consumer discretionary (-2.41%)—all lagged in October. Only technology stocks (-0.36%), the leading S&P sector through September, managed to outperform in the down market of October as well, and thus retain its number one ranking year-to-date. Prior wallflowers, energy stocks (+3.25%) and consumer staples (+1.25%) posted gains in October, suggesting to us that investors are, at least to some extent, unwinding the so-called "risk trade," selling high-beta winners and rotating the proceeds into more defensive names. The fact that consumer staples and tech stocks—traditional hunting grounds for growth-oriented portfolio managers—were among the best performing groups for the month, while traditional value-manager stomping grounds such as financials, materials and consumer discretionary stocks were among the worst, probably goes a long way to explaining why the Russell 1000 Growth Index so handily beat its value counterpart in October.

There were few discernible patterns to returns in major foreign markets in October. In developed markets, the UK's FTSE 100 Index (+0.95%) eked out a small gain, while indices in Japan (-1.32%), Germany (-3.98%) and France (-4.34%) all posted losses in dollar terms. Emerging market returns were even more bifurcated, with China (+7.78%), Russia (+6.45%) and Hong Kong (+3.85%) posting healthy gains, while Korea (-6.55%) and India (-4.81%) booked sizeable losses. Year-to-date, foreign market dollar-denominated returns still largely overshadow returns here in the U.S., with only Japan's Nikkei 225 posting lower returns than the S&P 500 Index.

TOTAL RETURNS IN U.S. DOLLARS

	October	YTD
FTSE 100 Index (UK)	+0.95%	+33.56%
DAX Index (Germany)	-3.98%	+17.53%
CAC 40 Index (France)	-4.34%	+22.93%
MICEX Index (Russia)	+6.45%	+104.72%
NIKKEI 225 (Japan)	-1.32%	+15.45%
Hang Seng Index (HK)	+3.85%	+55.42%
Kospi Index (So. Korea)	-6.55%	+53.25%
Shanghai SE Comp. (China)	+7.78%	+66.89%
BSE Sensex 30 Index (India)	-4.81%	+72.72%

Source: Bloomberg

The question on a lot of investors' minds lately is whether the current market pullback, which began on October 19 and had taken the S&P 500 down about -5.62% on a closing basis through month end, is just the latest in a series of relatively mild corrections that end fairly quickly and are followed by new recovery highs, or one likely to last longer and do more damage. We're inclined to believe it's the former, but must acknowledge the possibility that it could be the latter.

Since the market bottomed in March, depending exactly how you count, there have been 8 or 10 mini-corrections, none of which took the S&P 500 down more than ten percent from a prior high. The most severe to date was a correction lasting 18 trading days that bottomed on July 8, during which the S&P 500 fell -9.09% on an intraday basis. The table below shows some statistics on the July correction and the four that followed it.

Low Date	S&P 500 Price	% Decline	Length (Trading Days)	VIX (Daily High)
7/8/09	869.32	-9.09%	18	33.05
8/17/09	978.51	-3.41%	2	28.39
9/2/09	991.97	-4.57%	4	29.57
10/2/09	1019.95	-5.57%	7	29.56
11/2/09	1029.38	-6.54%	8	31.84

Source: Bloomberg

In our view, the corrections since July have been remarkably orderly. Each has exhibited essentially the same characteristics, a relatively small drop of fairly short duration that was accompanied by a spiking of the Chicago Board Options Exchange (CBOE) S&P 500 Volatility Index (VIX) and the CBOE Put/Call Ratio. While the four most recent corrections have grown progressively more severe by about a percentage point each time, none has exceeded the depth of the July correction and none has been even half as long in duration. In addition, each successive low has been higher than the previous low, and each subsequent advance has led to a new recovery high in the S&P 500.

The latest market correction has followed much the same pattern as the three that preceded it, complete with a spike in the VIX and CBOE Put/Call Ratio. In fact, according to statistics from Potomac Research's John Mendelson, on November 2, the five-day average put-to-call ratio reached 104.1, higher than comparable figures at the S&P's lows in March, July, August, September and October. Thus, by this measure, investors early this month were more bearish and seeking higher levels of downside protection than at any time since the March lows. This behavior suggests to us that investors, as a group, have very little confidence in the market's upside potential and seem more than willing to nail down gains and put on hedges at the first hint of trouble. We're not sure exactly what you'd call this behavior, but it certainly isn't excessive optimism.

In the interest of full disclosure, while the current correction looks similar to its three predecessors, a few things "feel" different this time around. First, prior leadership groups, such as financials, industrials, materials and consumer discretionary stocks, have gotten hit harder than in past corrections, while prior laggards are coming to the fore. This may be only a healthy catch up move for lagging groups, but it could also presage a change in leadership, which is normally accompanied by a period of market turmoil. In addition, stocks are not responding as well to good news this earnings season as in the second quarter. We have seen a good number of stocks' declines, or failures to rise, in the face of an earnings "beat" be explained by the fact that "the company beat expectations, but not by as much as expected."

Since reaching an intraday low of 1,029.38 on November 2, the S&P 500 has rallied back toward its 50-day moving average (1,053.35), which it breached on October 28 for the first time since July. A recovery above its 50-day moving average would provide comfort to technically-minded investors—of whom there seems to be a growing number—that the correction is over. A failure to do so could bring prior interim S&P 500 lows at 1029, 1020, 992, and 979 into play as possible downside targets.

Outlook

We continue to hold the view that we are in a cyclical bull market that has upside potential to 1,250 to 1,350 for the S&P 500 by the end of 2010. We believe near-term downside risk should be limited to the range of 950 to 1,000 on the S&P 500. Taking the midpoint of our upside and downside target ranges, from its current level of about 1,050, we believe the S&P offers investors a better than 3-to-1 (250/75) reward-to-risk ratio through the end of 2010. In the next year or so, we believe the outlook for the equity market will be determined primarily by the strength of the economic recovery and the recovery in corporate profits, and secondarily by the outlook for interest rates, inflation and the U.S. dollar.

Beyond 2010, the Administration's fiscal policies will loom larger in the market's valuation equation, in our judgment. These include its tax policies, spending priorities, and ability—or lack thereof—to deal credibly with huge budget deficits caused by skyrocketing funding requirements for Medicare, Medicaid and Social Security, while at the same time maintaining the credibility and integrity of the dollar. The challenges are great and it is far from clear, at this point, how things will shake out. Historically, politicians do not deal with difficult problems until some sort of crisis forces them to act. This brings to mind a quotation widely attributed to Winston Churchill that "Americans will always do the right thing, when they have exhausted every other alternative." We like to think of ourselves as optimists in Churchill's mold, but the uncertainty surrounding how these issues are resolved and the likelihood that the government's fiscal challenges may come to a head in the medium term, is what leads us to believe that the U.S. equity market may not reach a new all-time high before the next bear market sets in. As we've said before, we'd be thrilled to be wrong about that.

Our longer term concerns notwithstanding, we think there is a fairly strong case for optimism with respect to the outlook for corporate profits next year. Quoting from Empirical Research Partner's November 2009 Portfolio Strategy report:

> For the third quarter, now over half reported, the S&P 500 is producing earnings at a $64 to $65 or so annual rate, with the financial sector contributing $4.50 of the sum. By comparison in the prior four quarters, the run rate was about $45, with the financials subtracting $(15) a share. To put those numbers in context, the peak earnings run rate of the last business cycle was $91.50, with financials contributing $25.60 or 28% of the total.

According to Bloomberg, the current 2010 consensus EPS forecast for the S&P 500 is $77.36, which is consistent with Empirical Research's estimate that the S&P 500 could earn $75 to $80 next year, assuming that the housing recovery proves sustainable. Empirical further believes that mid-cycle earning power for the S&P 500 is in the range of $85 to $90 per share. In their November 2009 strategy piece, they do not say, specifically, when they believe the S&P could achieve these earnings, but the implication is that it could be 2011 or 2012.

Considering 2010 earnings from a top-down perspective, ISI Group's Nancy Lazar is even more optimistic than the bottom-up analysts' consensus. Her profit model uses four factors—the shape of the yield curve, the year-over-year (YoY) change in junk bond yields, the YoY change in the OECD Broad Leading Indicators and the YoY change in unit labor costs—to forecast the YoY change in U.S. Corporate Profits Before Taxes, adjusted for inventory valuation allowances (IVA) and capital consumption allowances (CCA). Based on the sharply upward sloping yield curve, the nearly 1,000 basis point drop in YoY junk bond yields, the YoY surge in the OECD Broad Leading Indicators and the -2.2% drop in YoY unit labor costs, Lazar's model forecasts that corporate profits will be up +39.6% YoY by the second quarter of 2010, rising to $1,705.5 billion, a new all-time high. That forecast seems astonishingly high to us, but we are impressed that her model has an r-squared of 0.75 over the period 1992 to 2009.

Assuming that bottom-up consensus earnings for 2010 are reasonably accurate, the S&P 500's forward P/E is about 13.5x, which equates to an earnings yield of about 7.4%. That compares quite favorably to the 10-year Treasury yield of 3.5%, in our view. If the S&P 500 were to trade at the mid-point (1,300) of our target range for year end 2010, its trailing P/E would then be 16.8x, or an earnings yield of 6%. There's obviously no guarantee that the S&P will get to that level, but it doesn't strike us as an outlandish expectation.

With respect to monetary policy, it seems clear from the Fed's statement following its most recent Federal Open Market Committee (FOMC) meeting on November 4 that the Fed remains committed to maintaining a near-zero short-term interest rate policy for some time to come, at least through mid-2010, in our view, and perhaps longer. We think the two main objectives of this policy have been to help the banking system rebuild its capital base through earnings and to encourage investors to move out along the risk curve. These both seem like worthy goals to us, but the key risk to the strategy, in our opinion, is that it has encouraged the development of a carry trade whereby investors borrow dollars (effectively going short) to buy risk assets. If some of the assets acquired—such as oil, gold or other commodities—are perceived as inflation hedges, or inflation beneficiaries, their rising prices could trigger a weakening of the dollar, which, in turn, makes the carry trade all that much more profitable. What could be more fun than owning an appreciating asset while having a negative cost of carry?

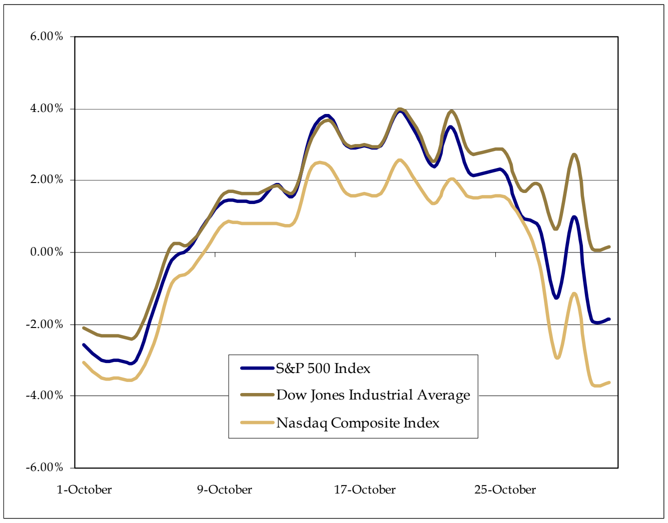
In truth, irrespective of what they say, we do not believe the Administration, the Fed or the Treasury want a strong dollar. Their dream scenario, in our view, is for the dollar to decline about -2% a year forever. That is pretty much what has happened for the last 100 years or so, during which time the dollar has lost about 95% of its purchasing power. That abysmal performance has not stopped the U.S. from prospering over that time period or the equity markets from having gone up many-fold. As bad as it has been in absolute terms, the dollar's relative performance against other major currencies has actually been quite good. According to data from *Triumph of the Optimists* (by Elroy Dimson, Paul Marsh and Mike Stanton), from 1900 to 2001, of 15 major currencies tracked, only the Swiss franc retained value better than the dollar, with the Dutch currency doing about the same.

What the U.S. can absolutely not afford to see is a collapsing dollar. An orderly decline is fine with them, in our opinion. Complete loss of confidence in the dollar would be a disaster. We think the risk of this happening in the short-term is not especially high. Remember, it was only last fall that investors worldwide were scrambling for dollars in a "flight to quality." Longer term, especially if we let our trade and budget deficits get out of hand, a more precipitous decline in the dollar becomes a real risk.

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

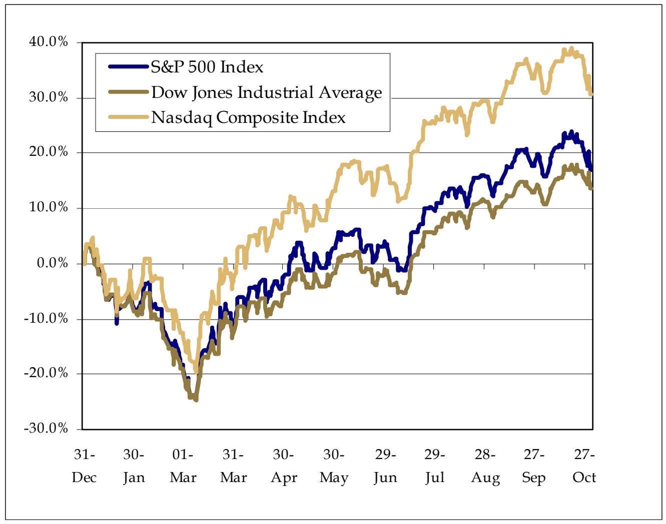
David E. Nelson, CFA
Chairman, Investment Policy Committee
Legg Mason Capital Management

Major Indices October 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	October	YTD
Broad Market Indices		
S&P 500	(1.86)	17.05
Dow Jones	0.14	13.65
Russell 1000	(2.21)	18.41
NASDAQ	(3.61)	30.70
Dow Jones US Total Market Index	(2.58)	18.38
Russell 2000	(6.79)	14.12
Russell 1000 Growth	(1.35)	25.39
Russell 1000 Value	(3.06)	11.33
S&P 500 Sector Indices		
S&P 500 Consumer Discretionary	(2.41)	26.41
S&P 500 Consumer Staples	1.25	10.77
S&P 500 Energy	3.25	11.30
S&P 500 Financials	(5.98)	14.00
S&P 500 Health Care	(2.23)	7.28
S&P 500 Industrials	(4.60)	9.47
S&P 500 Information Technology	(0.36)	45.57
S&P 500 Materials	(5.29)	31.06
S&P 500 Telecomm Services	(3.60)	(2.26)
S&P 500 Utilities	(3.03)	1.17

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