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The market threw investors a curve ball in January, closing the month in the red, and quickly refuting the consensus view that stocks would likely be strong early in the year, but might run into heavier weather later on. Instead, after a decent start to the month which saw the S&P 500 Index cruise to a new recovery high (1150.23) on January 19, the S&P tanked in the last two weeks, dropping nearly -7% from that peak to close the month down -3.6%. Other major U.S. market indices followed suit, with the damage especially noticeable in the tech-heavy Nasdaq Composite (-5.34%) and Russell 1000 Growth Index (-4.36%). Once the market turned grumpy, nothing seemed able to cheer it up: not corporate earnings, which continue to exceed expectations; not Fed Chairman Ben Bernanke's confirmation for a second term, which had been in some doubt; and not even fourth quarter real GDP growth of +5.7%, which trounced consensus estimates.

| Total Returns                    |         |
|----------------------------------|---------|
|                                  | January |
| S&P 500 Index                    | -3.60%  |
| Dow Industrials                  | -3.32%  |
| Nasdaq Composite Index           | -5.34%  |
| S&P Mid-Cap Index                | -3.21%  |
| Russell 2000 Index               | -3.68%  |
| Dow Jones US Total Returns Index | -3.37%  |
| S&P 100 Index                    | -3.57%  |
| Russell 1000 Growth Index        | -4.36%  |
| Russell 1000 Value Index         | -2.81%  |

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

The market has righted itself in the early trading sessions of the new month, suggesting that January's swoon may be nothing more than the latest in the series of brief -6% to -7% pullbacks that have characterized the market's advance since March 2009. Or it could be the beginning of a more extended correction. Only time will tell. Arguments supporting the "more of the same" view are the facts that this correction, like those that preceded it, featured quick spikes in the volatility index (VIX) and CBOE Put/Call ratio, and a sharp drop in investor sentiment, which had reached "extreme optimism" levels in mid-January, according to Ned Davis Research. One possible sign that this correction could be more drawn out, and potentially more severe, than its predecessors is the fact that the S&P 500's 50-day moving average turned down in late January for the first time since April 22, 2009.

January's market decline is a bit of a bummer for followers of the January Barometer, an indicator popularized by Yale Hirsch that suggests that as goes January so goes the year. Before readers head for the window ledges, we think it's worthwhile to point out that this indicator is far more predictive of market behavior on the upside than the downside. Specifically, since 1950, the market has been up 37 times in January. In 34 of those instances, or 92% of the time, the market has been up for the year, a most impressive batting average. On the downside, the indicator has not worked nearly as well. Since 1950, 23 down Januarys have been followed by down years 13 times (56.5%) and up years the other 10 times (43.5%). So, it is far from definitive what the market will do this year based on this indicator. In fact, one need go back no further than last year, when the S&P 500 was down -8.6% in January and up +23.4% for the year, to find an instance when the January Barometer was spectacularly wrong. Suffice it to say, since we believe the weight of the evidence continues to support a constructive view on equities for the year, we don't think investors should be overly troubled by a down month in January.

| <b>Returns in U.S. Dollars</b> |                |
|--------------------------------|----------------|
|                                | <u>January</u> |
| FTSE 100 Index (UK)            | -4.89%         |
| DAX Index (Germany)            | -8.81%         |
| CAC 40 Index (France)          | -7.93%         |
| MICEX Index (Russia)           | +2.53%         |
| NIKKEI 225 (Japan)             | -1.27%         |
| Hang Seng Index (HK)           | -8.14%         |
| Kospi Index (So. Korea)        | -4.35%         |
| Shanghai SE Comp. (China)      | -8.78%         |
| BSE Sensex 30 Index (India)    | -5.62%         |

*Source: Bloomberg*

On a sector basis, health care (+0.49%) was the only one of ten S&P 500 sectors to post positive returns for the month. Consumer staples (-1.08%), traditionally a safe haven during periods of market turbulence, joined by industrials (-1.16%) and financials (-1.40%), also meaningfully outperformed the S&P in January, while materials (-8.61%), technology (-8.43%) and telecom services (-8.21%) stocks all lagged badly. Telecom carriers seemed to be gripped by fears of a price war, while materials and technology stocks appeared to be principal victims of a feared growth slowdown in China.

Poor returns were not limited only to U.S. stocks during the month but were widespread abroad as well. Of the major foreign markets we track, only Russia's MICEX Index posted positive returns in January, in both dollar and local currency terms. China's Shanghai SE Composite posted -8.78% returns in January, the worst among markets we track, as the specter of Chinese central bank tightening cast a pall over that market. Weak local currency returns in European markets were exacerbated by dollar strength versus the euro and British pound.

All in all, it was a month best forgotten. About the best that can be said of January 2010 is that, at least with respect to the U.S. and Europe, returns were not as bad as those posted in January 2009.

## Outlook

Calendar anomalies such as the January Barometer provide interesting tidbits for cocktail party banter, but when it comes to weighing the outlook for equities for the balance of the year, we think attention should more properly be focused on such factors as the outlook for corporate earnings, the likely course of economic recovery and appropriate levels of market valuation. On these scores, we see considerable reason for optimism.

Corporate America has continued to post surprisingly good earnings, beating analysts' expectations even in the teeth of the recession, as illustrated below in a table courtesy of Strategas Research Partners. That trend has persisted in the latest quarter, as—roughly half way through earnings season—78% of S&P 500 companies have beaten bottom-line expectations. More importantly, a growing number are also beating revenue expectations. In contrast to 4Q 2008 and 1Q 2009, when cost cutting was the order of the day and only about half as many companies beat revenue expectations as beat EPS expectations, so far in 4Q 2009, over two-thirds of companies are beating top-line expectations as well. We find this trend quite encouraging as we believe the benefits of corporate cost cutting have largely run their course, and the path to a sustainable recovery in earnings from here will be driven by revenue growth.

**Percentage of S&P 500 Companies Beating Consensus Revenue & EPS Estimates**

|                                      | <u>4Q</u><br><u>2008</u> | <u>1Q</u><br><u>2009</u> | <u>2Q</u><br><u>2009</u> | <u>3Q</u><br><u>2009</u> | <u>4Q</u><br><u>2009</u> |
|--------------------------------------|--------------------------|--------------------------|--------------------------|--------------------------|--------------------------|
| <b>% Beating on Revenues</b>         | 33.8%                    | 36.4%                    | 50.1%                    | 59.0%                    | 68.0%                    |
| <b>% Beating on EPS</b>              | 60.1%                    | 67.5%                    | 72.3%                    | 79.0%                    | 78.0%                    |
| <b>Revenue to EPS Surprise Ratio</b> | 0.56                     | 0.54                     | 0.69                     | 0.76                     | 0.87                     |

*Source: Strategas Research Partners, LLC*

In its February monthly, the Leuthold Group offers further encouraging news on corporate earnings, noting that for the first time since October 2008, the number of companies reporting year-to-year increases in earnings in January 2010 exceeded the number reporting earnings decreases by 480 to 387. In the past, when up earnings announcements begin to exceed down ones, it has been a fairly reliable signal that the economy is improving significantly. Leuthold further notes that the best average year-over-year revenue growth in 4Q 2009 is being registered by mega-cap stocks (the largest 50 U.S. companies by market value), at +5.8%, while large caps (the top 300) are growing at +2.4%, and mid-, small- and micro-cap stocks are still experiencing revenue declines.

The data concerning the outlook for the overall economy also continues to be encouraging. Fourth quarter 2009 real GDP growth came in well ahead of expectations at +5.7%. Even this strong performance was met with a good deal of skepticism, as noted bears, such as Nouriel Roubini and others, carped that GDP strength was mostly due to inventory “restocking.” Our reading of the numbers indicates that “restocking” had nothing to do with it. The +3.4% contribution that the inventory component to GDP made in the quarter arose from a dramatic reduction in the rate at which inventories are being *liquidated*. In 3Q 2009, business inventories declined by -\$139.2 billion, whereas in 4Q 2009, they declined “only” -\$33.5 billion. Inventory “restocking” is still ahead of us and should continue to provide a meaningful boost to GDP for at least the next few quarters.

The manufacturing sector of the U.S. economy also appears to be picking up steam. On Monday (2/1/10), the Institute for Supply Management (ISM) announced that its purchasing managers' index (PMI) rose to 58.4 in January from 54.9 in December, the largest month-to-month increase in six months. ISI Group's Stan Shipley calls the latest PMI orders and production figures “near boom like readings.” With manufacturing activity at its highest point since August 2004 and 13 of 18 industries surveyed showing growth, there seems to be little doubt that the recovery in the industrial sector of the economy is broadening and deepening.

Following a recent study of past manufacturing cycles, Strategas Research has concluded that we are currently in the “sweet spot” of the manufacturing cycle for both stock market returns and earnings growth. Strategas studied 13 past PMI cycles from 1953 to the present, dividing each into four stages. Stage One is the time period from the PMI’s trough value to when it reaches 50, the line of demarcation between economic contraction and expansion. Stage Two marks the PMI’s move from 50 to its cyclical peak; Stage Three, the period from the PMI’s peak back to 50; and Stage Four, the period from 50 to the PMI’s next cyclical trough. We are now in Stage Two, during which the S&P 500 Index has historically experienced its best gains (+20.1%) and best earnings growth (+27.6%), according to Strategas.

Notwithstanding the decidedly favorable outlook we see for economic recovery and corporate earnings, we are troubled by a number of issues which could pose threats to the market’s advance as the year progresses. Two stand out in our mind. First is the anti-business, populist rhetoric recently emanating from both Congress and the White House. We are apparently not alone in our concern as a recent quarterly survey of Bloomberg subscribers found that 77% of U.S. respondents regard President Obama as too anti-business. And don’t get us started on Congress. If we want to get depressed, all we have to do is spend a few minutes thinking about how it operates. In our view, the exigencies of the virtually continuous election cycle encourage modes of thinking that favor politics over economics, appearance over reality, form over substance and short-term expediencies over long-term solutions. These are not the approaches necessary to deal with our second major concern, namely the yawning federal budget deficit.

The fiscal 2011 federal budget released by the Obama Administration Monday (2/1) is breathtakingly large, calling for overall federal outlays to rise from \$3.72 trillion in fiscal 2010 (ending 9/30/10) to \$3.82 trillion in fiscal 2011. The resulting federal deficit is forecast to reach -\$1.6 trillion (nearly 11% of GDP) in 2010 before falling moderately to -\$1.3 trillion in 2011. As a share of GDP, outlays will reach a post-World War II record of 25.4% this year, up from 21% as recently as fiscal 2008, and far above the 40-year average of 20.7%. To close the yawning deficit over time, the Administration’s budget calls for tax increases on families with incomes greater than \$250,000 of nearly \$1 trillion over the next 10 years. The Obama Administration further proposes to raise taxes on banks and multinational corporations, while also reducing tax breaks for a number of industries, including oil and gas producers.

The Administration and Congress face a daunting task to close the budget gap. With mandated increases in social security, Medicare and Medicaid considered virtually untouchable, and interest payments on existing debt likely to increase by \$400 billion annually over the next decade, from about \$383 billion in 2009 to an estimated \$775 billion in 2020, the so-called “discretionary” portion of the budget will necessarily come under severe pressure. The process will require brutally difficult choices and compromise on both sides of the legislative aisle. So far, there isn’t even a hint this is happening. As very interested observers, we can only hold out the hope that Winston Churchill was right when he reputedly said, “Americans will always do the right thing, when they have exhausted all other possibilities.”

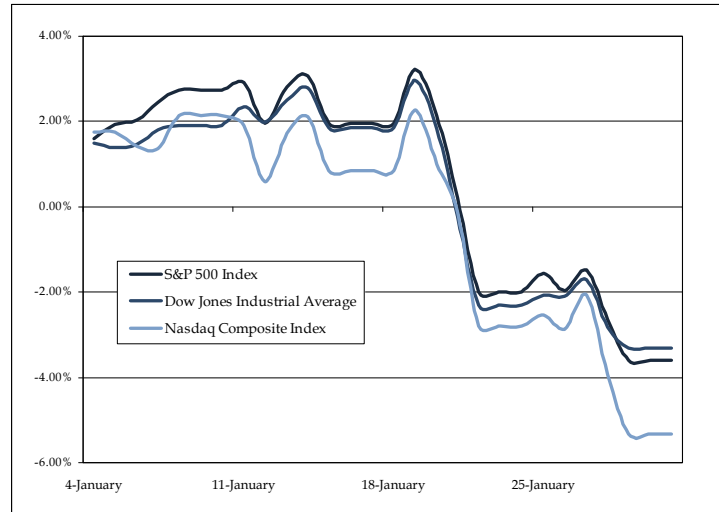
As always, we thank you for your support and welcome your comments.

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#### About the Author

David Nelson currently serves as Portfolio Manager of the Legg Mason Capital Management American Leading Companies Trust mutual fund and as Chairman of LMCM’s Investment Policy Committee. He is a Chartered Financial Analyst, past President of the Baltimore Security Analysts Society, and has more than 34 years of investment experience.

Major Indices: January Performance



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

Monthly U.S. Market Update (Total Returns)

| Index Name                        | January |
|-----------------------------------|---------|
| <b>Broad Market Indices</b>       |         |
| S&P 500                           | (3.60)  |
| Dow Jones                         | (3.32)  |
| Russell 1000                      | (3.60)  |
| NASDAQ                            | (5.34)  |
| Dow Jones US Total Market Index   | (3.37)  |
| Russell 2000                      | (3.68)  |
| Russell 1000 Growth               | (4.36)  |
| Russell 1000 Value                | (2.81)  |
| <b>S&amp;P 500 Sector Indices</b> |         |
| S&P 500 Consumer Discretionary    | (2.88)  |
| S&P 500 Consumer Staples          | (1.08)  |
| S&P 500 Energy                    | (4.50)  |
| S&P 500 Financials                | (1.40)  |
| S&P 500 Health Care               | 0.49    |
| S&P 500 Industrials               | (1.16)  |
| S&P 500 Information Technology    | (8.43)  |
| S&P 500 Materials                 | (8.61)  |
| S&P 500 Telecomm Services         | (8.21)  |
| S&P 500 Utilities                 | (4.93)  |

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

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