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After a rocky January, the U.S. equity market seemed to find its sea legs in February as the S&P 500 Index rose +3.1% and most other major U.S. market indices posted similar or better gains. In the process, the equity market shook off a fair amount of bad news, including a spate of disappointing economic reports, a Fed hike in the discount rate and growing fears about Greece's and other so-called "PIGS's" (Portugal, Italy, Greece and Spain) ability to roll over their sovereign debt. All in all, it was a pretty impressive performance, suggesting to us that the S&P 500's recent -8.1% correction from January 19 to February 8 may have provided a sufficient respite to allow the market to begin working its way higher again. As this is written (3/4/10), the S&P 500 has recovered about 68% of the ground lost from its January 19 recovery high, is now up for the year, and has once again poked its head convincingly above its own 200-day moving average.

Total Returns

	February	YTD
S&P 500 Index	+3.10%	-0.61%
Dow Industrials	+2.95%	-0.47%
Nasdaq Composite Index	+4.37%	-1.20%
S&P Mid-Cap Index	+5.21%	+1.83%
Russell 2000 Index	+4.50%	+0.66%
Dow Jones US Total Returns Index	+3.42%	-0.06%
S&P 100 Index	+2.48%	-1.17%
Russell 1000 Growth Index	+3.44%	-1.08%
Russell 1000 Value Index	+3.16%	+0.26%

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

The market's recovery in February was led by the more economically sensitive sectors of the S&P 500, as consumer discretionary (+5.47%), industrials (+5.04%), materials (+4.42%), technology (+4.22%) and financial (+3.52%) stocks outperformed the index, while the traditionally more defensive sectors, telecom services (-1.25%), utilities (-1.25%), health care (+0.28%), energy (+2.35%) and consumer staples (+2.78%) lagged the benchmark. This market action is supportive, in our view, of the notion that an economic recovery is unfolding.

Returns in U.S. Dollars		
	<u>February</u>	<u>YTD</u>
FTSE 100 Index (UK)	-1.22%	-6.05%
DAX Index (Germany)	-2.25%	-10.86%
CAC 40 Index (France)	-2.85%	-10.56%
MICEX Index (Russia)	-4.87%	-2.46%
NIKKEI 225 (Japan)	+1.18%	-0.10%
Hang Seng Index (HK)	+2.47%	-5.86%
Kospi Index (So. Korea)	-0.11%	-4.46%
Shanghai SE Comp. (China)	+2.11%	-6.86%
BSE Sensex 30 Index (India)	+0.64%	-5.02%

Source: Bloomberg

In February, the U.S. equity market outperformed every major foreign market we track, in dollar terms, and, with the exception of the Japanese market, has fared much better than major foreign markets year-to-date. The U.S. dollar's performance has been mixed year-to-date versus other major currencies, strengthening a little over +4% versus the euro, weakening a bit less than -4% versus the yen, and trading relatively flat versus the major Asian currencies.

Many investors and a number of media outlets appeared to have been surprised by the Fed's February 18 decision to hike the discount rate by 25 basis points. We find this somewhat puzzling since, in our view, the Fed's intentions could hardly have been better telegraphed. On February 10, in a statement prepared for the House Financial Services Committee, Chairman Bernanke said:

Also, before long, we expect to consider a modest increase in the spread between the discount rate and the target federal funds rate. These changes, like the closure of a number of lending facilities earlier in this month, should be viewed as further normalization of the Federal Reserve's lending facilities... and should not be interpreted as signaling any change in the outlook for monetary policy, which remains about as it was at the time of the January meeting of the FOMC.

Bernanke's definition of "before long" turned out to be eight days. After an overnight swoon in the futures, the market recovered its equanimity and actually closed higher on February 19, the day following the rate hike. Bernanke further reassured the markets of the Fed's intention to keep rates "unusually low for an extended period" in his semi-annual monetary report to Congress on February 25. Taking the Fed Chairman at his word, we do not expect an increase in the fed funds rate until late this year or early next and do not view the Fed's ongoing normalization of monetary policy as a significant threat to the U.S. equity market.

Outlook

We continue to be constructive on the outlook for U.S. equities for the balance of this year. For a number of reasons, we believe the recent market correction may have run its course and that the market has resumed an upward trajectory.

In contrast to last year's advance, which was steep and fairly unrelenting, we see potential gains this year as likely to be more modest, though still worthwhile, and upward progress as likely to be a bit choppier.

One of the factors that leads us to believe that the latest correction is not the first sign of an impending top in the market is the action of the market itself. In his February 2010 edition of "View from the North Country," veteran market observer Steve Leuthold noted that his proprietary Major Trend Index, which turned bearish in mid-2007 and bullish again in late 2008, remains solidly in bullish territory. In fact, it gained strength in February during the market correction. Leuthold's Major Trend Index is constructed on a weight-of-the-evidence basis from about 190 separate indicators, some of which are "anticipatory" in nature while others are purely "reactionary" (trend-following). He reported that "almost every cyclical bull market top is preceded by serious warning flags emerging from a large number of these anticipatory indicators," and few, if any, such warning flags have shown up in this bull market to date. Based on his work, Leuthold continues to expect the S&P 500 to trade in the range of 1300 to 1350 later in 2010.

Veteran market technician John Mendelson has been calling attention to another encouraging aspect of the market's behavior in a number of his recent market analyses. One of Mendelson's key maxims, laid out recently in his March 2, 2010 report, is that the broad market leads the popular averages, such as the Dow Industrials and S&P 500. Mendelson's proxies for the broad market are the Bloomberg Advance/Decline Line for NYSE Stocks Only (TRADCNYC), which eliminates all preferred, closed-end, and bond funds from the NYSE listings, and the Value Line Index (KVY), an equal-weighted index of 1650 stocks. Mendelson's experience has been that important market declines are preceded by a marked divergence between his broad market proxies and the principal popular averages. No such divergences exist today. In fact, following a correction which began on January 11 and bottomed on February 8, coincident with the bottom in the popular averages, the Bloomberg Advance/Decline Line (TRADCNYC) broke out to a new recovery high on March 1. Based on this favorable action of the broad market, Mendelson believes it is only a question of time before the popular averages themselves break out to new recovery highs.

A common complaint among those who are less optimistic about the outlook for the market than we is that the market has come "too far, too fast" and, therefore, has already discounted the recovery we expect. A February 11, 2010 strategy piece by Thomas J. Lee, chief U.S. equity strategist for JPMorgan, suggests otherwise. According to Lee's work, the S&P 500's advance since March 2009 is sitting right on the trend line of the 19 bull markets since 1900 that lasted longer than 11 months. In fact, says Lee, this bull market "is tracking similarly to the more robust bull markets that have followed bear market declines of at least -40%. Lee's work further indicates that of the 19 relevant precedent markets, 18 showed positive returns from months 11 to 22 (corresponding to calendar 2010 in the current bull market), with an average gain for all 19 of +16%.

Another encouraging sign for the technical health of the market is the rapidity with which the extreme bullish sentiment we noted in January dissipated during the latest market pullback. The February 11 issue of 13-D Research's What I Learned This Week (WILTW) provides some interesting examples of how quickly bullish sentiment has faded recently. They note that the Hulbert Index of recommended portfolio investments by short-term, stock market-trading newsletters fell from 65.2% on January 5 to a recent low of 13.8%. The same index for the Nasdaq dropped from 71.4% on December 22 to a recent low of -16.1%. *Investors Intelligence* reported on February 10 that bulls had collapsed from 53.4% on January 8 to 34.1% currently. Bears in the same survey rose to 26.1%, and the number of advisors looking for a correction rose to 39.8%, the highest since 1983. The *American Association of Individual Investors (AII) Survey* confirms the drop in sentiment, as bulls fell from 49.18% on December 31 to a recent low of 29.23% on February 4. Likewise, *AII* bears rose from a low of 22.95% on December 31 to a high of 43.08% on February 4. Finally, Jason Goepfert's *Sentimentrader* reports that his bearish indicators have dropped to well under 5% and his bullish indicators are above 25%, the widest spread since March 2009.

In addition to muted investor sentiment and the behavior of the market itself, we also see the economic backdrop and the favorable outlook for corporate earnings as supportive of higher stock prices over the balance of the year. With a

few notable exceptions, the economic data continues to be encouraging. The latest housing numbers were pretty punk, but we believe some of that weakness could be weather-related. The real test for housing will be the spring selling season. If housing is still weak then, we may have a problem. Apart from housing, the drop in consumer sentiment is a bit worrisome, though perhaps understandable given the weakness in housing, the recent pullback in the equity market, and the dreary winter. Consumer confidence needs to revive in order to support an increase in consumer spending.

Thus far, the economic recovery has been led by the manufacturing sector. The latest figures suggest that continues to be the case. The upward revision in 4Q 2009 real GDP from 5.7% to 5.9% was principally due to greater business investment and increasing contributions from inventory rebuilding. In the same vein, the Chicago Purchasing Managers Index came in above expectations in February, showing a reading of 62.6, up from 61.5 in January, the highest level since 2005. Further confirming the strength in manufacturing, the Institute for Supply Management (ISM) reported on March 1 that its factory index exceeded 50, signaling expansion, for the seventh straight month in February. While down from January's five-year high reading of 58.4, February's 56.5 reading was still robust, and was accompanied by an ISM jobs gauge reading that was the highest since January 2005.

The economic recovery and especially the revival of the manufacturing sector have created a fertile environment for a rebound in corporate profits. According to Empirical Research Partners, in the latest quarter, corporate earnings grew by close to +30% and free-cash flow by +40%, on a revenue gain of only about +3.5%. Pre-tax incremental margins were nearly 75%, an astonishing level, as profitability benefited dramatically from prior deep cost cuts. Analysts are having trouble keeping up with the improvement, and, consequently, earnings estimates have been rising at about +1% a month recently, one of the fastest rates on record, according to Empirical. Bottom-up consensus estimates are approaching \$80 for 2010 for the S&P 500 Index, with a preliminary consensus for 2011 converging around \$95, according to Thomson Financial. We do not believe the market yet fully appreciates the strength of the recovery in earnings that is likely over the next 18 months.

Putting our thoughts about the market outlook in the simplest terms, the price (P) of the market is equal to earnings (E) times the appropriate capitalization rate (P/E). Thus, $P = E \times P/E$. Since we expect earnings (E) to surprise on the upside, the question of what the market is worth (P) depends on the appropriate capitalization rate (P/E). In our opinion, the rate at which investors are, or should be, willing to capitalize earnings has two broad components, one psychological and the other mathematical. The psychological component is based on investor confidence. The more confident investors are, the more they're willing to pay for stocks. The mathematical component is based on the level of interest rates. All else equal, the higher the prevailing level of interest rates, the less stocks are worth.

That does not mean that stocks cannot rise in the face of rising interest rates. It happens all the time, most recently from December 2008 to the present, during which the S&P 500 rose more than 27% at the same time that 10-year Treasury yields were rising from just over 2% to about 3.64%. But we think it's important to note that stocks did not rise since December 2008, or any other time, because interest rates were rising, but in spite of the fact that interest rates were rising, as the positive effects of improvements in investor confidence and expectations for earnings more than offset the negative effects of rising rates on market valuations. We believe the balance of 2010 could be just such a period, where rising earnings expectations and improving investor confidence trump the effect of rising rates as the economy recovers.

At some point, however, rising interest rates will begin to bite. It's impossible to know with certainty where that point is, but our current thinking is that 10-year Treasury rates below 4.5% will not represent a significant headwind to stocks, but rates above 5% probably would.

We think it is quite likely that 10-year Treasury yields are headed higher. The only questions in our mind are how far and how fast. If the U.S. doesn't get its fiscal house in order, we think the ultimate damage that rising rates could do to the outlook for U.S. equities is quite substantial. Tim Bond of Barclay's Capital, in a fascinating February 5, 2010

piece entitled “Global Speculations: Dancing by the Volcano,” estimates that holders of 10-year U.S. Treasuries face between 224 and 336 basis points of upward risk over the next five years, based on current government debt/GDP projections. We’re not sure exactly where the S&P 500 would trade five years from now if 10-year Treasury rates stood at 7%, but we do know that it would lower the fair value multiple of the market on our valuation work from about 20 to about 11 times earnings. So it’s hugely important to the appropriate valuation of the market that we get our country’s long-term finances in order.

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

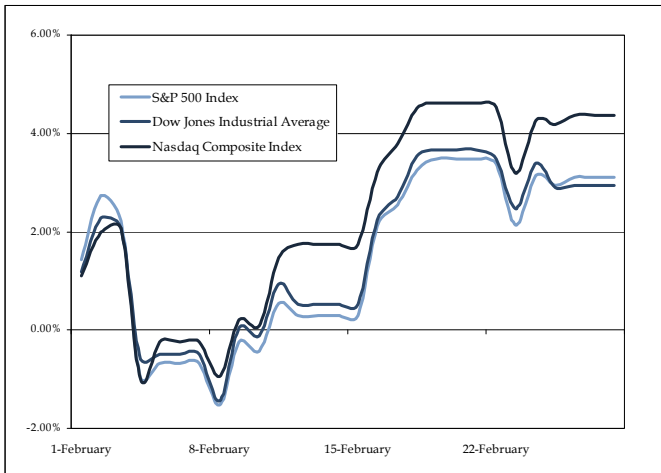
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March 4, 2010

About the Author

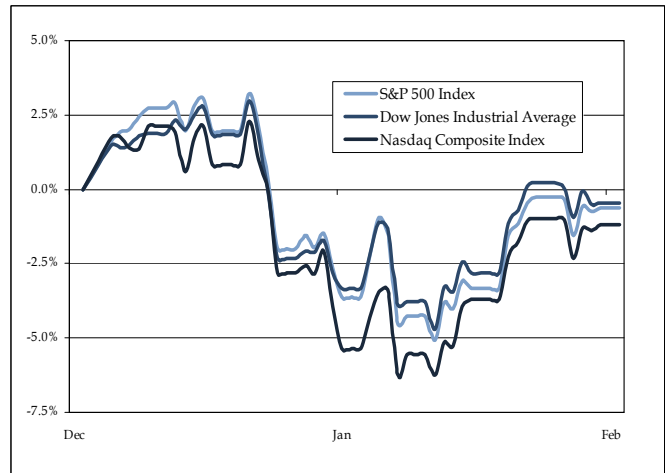
David Nelson currently serves as Portfolio Manager of the Legg Mason Capital Management American Leading Companies Trust mutual fund and as Chairman of LMCM’s Investment Policy Committee. He is a Chartered Financial Analyst, past President of the Baltimore Security Analysts Society, and has more than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

Major Indices: February Performance



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

Major Indices: Year-to-Date Performance



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

Monthly U.S. Market Update (Total Returns)

Index Name	February	YTD
<i>Broad Market Indices</i>		
S&P 500	3.10	(0.61)
Dow Jones	2.95	(0.47)
Russell 1000	3.30	(0.42)
NASDAQ	4.37	(1.20)
Dow Jones US Total Market Index	3.42	(0.06)
Russell 2000	4.50	0.66
Russell 1000 Growth	3.44	(1.08)
Russell 1000 Value	3.16	0.26
<i>S&P 500 Sector Indices</i>		
S&P 500 Consumer Discretionary	5.47	2.42
S&P 500 Consumer Staples	2.78	1.68
S&P 500 Energy	2.35	(2.25)
S&P 500 Financials	3.52	2.08
S&P 500 Health Care	0.28	0.77
S&P 500 Industrials	5.04	3.82
S&P 500 Information Technology	4.22	(4.57)
S&P 500 Materials	4.42	(4.57)
S&P 500 Telecomm Services	(1.25)	(9.35)
S&P 500 Utilities	(1.25)	(6.12)

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

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