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Point of View

The Bull Market Celebrates a Birthday

April 2010 Market Commentary

David E. Nelson, CFA
Senior Vice President,
Portfolio Manager

The current bull market celebrated its first birthday on March 9 but with little fanfare. The *Wall Street Journal* wrote a subdued front page story on the event, but the *New York Times* and *Financial Times* barely made note of it. This strikes us as odd, and probably quite bullish, since the twelve-month return of the S&P 500 Index from March 9, 2009 (+72.29%) was the best in over 70 years. Instead of sporting party hats, many observers seem more inclined to fret about when the next correction might begin. Michael Santoli's March 15, 2010 Streetwise column in *Barron's* entitled "Is Another Market Pullback Near?" exemplified the cautious mood, failing to even mention the fact that the bull's first birthday had occurred in the previous week.

Total Returns

	March	YTD	One-Year
S&P 500 Index	+6.03%	+5.39%	+49.77%
Dow Industrials	+5.31%	+4.82%	+46.93%
Nasdaq Composite Index	+7.19%	+5.91%	+58.63%
S&P Mid-Cap Index	+7.13%	+9.09%	+64.07%
Russell 2000 Index	+8.14%	+8.85%	+62.77%
Dow Jones US Total Returns Index	+6.23%	+6.16%	+52.62%
S&P 100 Index	+5.84%	+4.61%	+45.09%
Russell 1000 Growth Index	+5.78%	+4.64%	+49.75%
Russell 1000 Value Index	+6.51%	+6.78%	+53.55%

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

Trailing twelve-month returns for the major U.S. and overseas equity market indices have been truly eye-popping (as shown above and below). The worst market over the last year (China) returned +33% in U.S. dollars, while the best (Russia) gained +120%. Most major indices here and abroad were up more than +50%.

In terms of S&P 500 sector returns, the much reviled financial stocks led the market higher with a +83.03% return, followed by industrials (+72.80%), consumer discretionary (+69.87%), technology (+58.00%) and materials (+56.04%). Less economically sensitive sectors of the market—telecom services (+12.22%), utilities (+21.01%), health care (+34.53%) and consumer staples (+35.91%)—trailed the index, as did energy (+29.56%).

LEGG MASON
CAPITAL MANAGEMENT
100 International Drive
Baltimore, MD 21202
866.410.5500
www.lmcm.com

Returns in U.S. Dollars

	March	YTD	One-Year
FTSE 100 Index (UK)	+6.23%	-0.20%	+60.47%
DAX Index (Germany)	+9.36%	-2.51%	+54.11%
CAC 40 Index (France)	+6.61%	-4.65%	+51.15%
MICEX Index (Russia)	+10.80%	+8.07%	+120.15%
NIKKEI 225 (Japan)	+4.78%	+4.67%	+47.46%
Hang Seng Index (HK)	+3.26%	-2.79%	+60.69%
Kospi Index (So. Korea)	+8.45%	+3.61%	+69.78%
Shanghai SE Comp. (China)	+1.87%	-5.11%	+33.07%
BSE Sensex 30 Index (India)	+9.48%	+3.98%	+106.26%

Source: Bloomberg

One would think that following such a bountiful year in the equity market, investors would be positively giddy with excitement. Nothing could be further from the truth. Anecdotal evidence from discussions with a number of friends who are financial advisors reveals that most investors remain very nervous and highly skeptical of the market's recovery. Flow of funds data supports the same conclusion, as flows into U.S. equity funds have only recently turned modestly positive, after being hugely negative all last year, while flows into bond funds have been massive.

In our view, investors' love affair with bonds is understandable, but wrong-headed. We believe they are yet again falling into the behavioral trap of buying today what they should have bought five years ago. In so doing, they are setting themselves up for another major disappointment, as we believe bond holders face the prospect of a secular rise in interest rates. No less an authority on bonds than PIMCO's Bill Gross, perhaps the best known bond manager of our era, is of the same opinion. In a March 25 Bloomberg Radio interview, Gross said that the almost three-decade bond market rally—which saw 10-year Treasury yields drop from a high of 15.8% in September 1981 to a record low of 2.03% in December 2008—may be drawing to a close. "Bonds have seen their best days," Gross said. "Real interest rates are moving higher. That's the main bear element in the bond market." If individual investors realized they were piling into bonds at the same time that Bill Gross was eyeing the exits, it might give them pause.

Investors' reluctance to embrace the current bull market in stocks is showing up clearly in trading volume figures. Normally, one year into a new cyclical bull market, NYSE trading volume (on a ten-week average basis) has been about 70% to 80% above the level seen at the prior bear market low, according to volume figures compiled by Leuthold Group on the 15 bull markets from 1932 to 2007. According to Leuthold: "Recent NYSE volumes, however, have been running about 25% below the levels seen at the March 2009 bear market low. In other words, volumes now amount to less than half what they have normally been at this stage of a new bull market." Will investors ultimately embrace the bull? We think the answer is yes. We just hope they don't wait too much longer.

Outlook

In early 2009, in many respects, it required a considerable leap of faith to be bullish on equities. Among other things, one had to believe that frozen credit markets would thaw, that gapping credit spreads would normalize, that the banking system would survive and that the sickening year-long decline in global equity markets would one day end. Many investors were unwilling or unable to make that leap of faith and, as a consequence, have missed one of the most powerful upswings in stock market history.

In our judgment, no such leap of faith is required today to be bullish on equities. An objective evaluation of the available evidence should be sufficient to do so, in our opinion. Credit markets have healed, credit spreads have narrowed and the banking system has been recapitalized. Most economic indicators point to recovery and corporate profits have snapped back strongly. So far, for many investors the evidence has not been sufficient to persuade them to be bullish. This merely tells us that the reptilian portion of the brain, the most primitive element that controls fight-or-flight responses, is a more powerful motivator of human behavior than the more-recently evolved neo-cortex, which houses our higher brain functions, including our ability to reason.

While appeals to reason may continue to be unpersuasive to some, we continue to believe it is worthwhile to make the bull case for equities. As with a simple tripod, the case rests solidly on three legs: (1) the technical condition of the market itself, (2) the nascent economic recovery, and (3) the outlook for corporate earnings and resultant valuation of the market.

From a purely technical point of view, the market is about as healthy as it ever gets. Most major indices are "in gear" on the upside, meaning that the index is trading above its own 10-day moving average, which is above the 50-day moving average, which is, in turn, above the 200-day moving average, and all of those moving averages are rising. In addition, nearly every major market index—with the lone exception of the Dow Jones Utilities Index—has recently made a new recovery high. Moreover, the NYSE Advance/Decline Line and the NYSE Daily Net New High index have also both posted new recovery highs in the last few days. Historically, at major market turning points, divergences develop between the popular averages (such as the Dow Industrials and S&P) and measures of market breadth (such as the advance/decline line). In other words, trouble develops when the generals lead and the troops stop following. No such divergences exist today.

In fact, the Leuthold Group notes in its April monthly commentary that:

> Market strength is so pervasive that NYSE Net New Highs (on a six-week moving average basis) moved to yet another new bull market high for the week ended April 1st. Historically, a new high in this indicator has served to "reset the clock" on the cyclical bull market. Following a bull market peak in Net New Highs since 1940, the median bull market has lasted another two years and delivered an additional S&P gain of 32%. (After the **worst** signal from the indicator, the cyclical bull market still lasted another 30 weeks and produced an additional 7% gain.)

As far as the economic backdrop is concerned, we believe that the economy bottomed in June or July of last year and that the recovery is beginning to gain traction. The Institute for Supply Management (ISM) data has been signaling expansion for a number of months. That trend continues as the ISM announced Monday (4/5/10) that its composite index rose to 55.4 in March, up from 53.0 in February, and better than consensus expectations of 54.0. Earlier (4/1/10) the ISM had reported that its factory index rose to 59.6 in March, its highest level since July 2004. The latest release indicates that the recovery may be broadening out beyond manufacturing into service segments. Service industries expanded in March at the fastest pace since May 2006. The ISM's gauge of new orders grew to 62.3 in March, the highest mark since August 2005 and a significant jump from February's 55.0 reading. Finally, export orders improved last month as well, rising to 57.5 from 47.0 in February.

An important element of the recovery picture fell into place last Friday (4/2), when the Bureau of Labor Statistics (BLS) reported that non-farm payrolls increased +162K in March, the best showing in three years. Total job growth came in somewhat below expectations of +184K, because Census hiring was below expectations. Private sector job gains, on the other hand, were better than expected at +123K. The BLS's household survey (which includes small businesses) showed a gain of +264K. We think the resumption of job growth should provide an important psychological boost to both businesses and consumers, as job losses during the recession generated an enormous amount of media attention. As encouraging as the data is, with the unemployment rate remaining at +9.7% and the underemployment rate (U-6) still higher at +16.9%, we believe the Fed will feel little pressure to boost the Fed funds rate any time soon, even if job growth accelerates in coming months, as we expect.

The outlook for corporate earnings continues to be quite robust as well. Fourth quarter 2009 results are in and 72% of companies beat consensus expectations, according to *Wall Street Journal* reporter Kelly Evans. The outlook for the first quarter of 2010 is for more of the same. The ratio of negative to positive earnings preannouncements, which typically averages about 2-to-1, is only running 1.3-to-1 for the first quarter. Firms in the S&P 500 are expected to report year-over-year earnings growth of about +37%, according to Thomson Reuters. They are also expected to see revenue growth averaging about +10%, the second quarterly gain in a row after four consecutive declines. The resumption of revenue growth could turbo charge earnings growth rates for many companies whose strong earnings performance up to this point has been driven largely by cost cutting.

Bottom-up consensus 2010 EPS estimates for the S&P 500 Index are approaching $80 per share, according to Thomson Reuters, while expectations for 2011 are about $96.50. It is uncertain at this point, whether these expectations will be realized or not, but if they are anywhere close, then the S&P 500 at about 15x 2010 estimates and 12.5x expectations for 2011 is very reasonably priced.

In summary, we believe most investors remain far too pessimistic about the outlook for equities. The economy is clearly in recovery, corporate earnings are booming and stocks are not expensive. With the Fed likely to be on hold until late this year due to moderating rates of core inflation, slack in the economy and continuing high rates of unemployment, we think we are in the sweet spot of the equity investment cycle. Stocks are clearly not as cheap as they were a year ago, but they are still attractive, in our view, especially relative to cash—which yields next to nothing—and bonds, which face the headwind of rising long-term interest rates. Rising long rates will ultimately pose a headwind for equities, but in the near term powerful earnings growth will mitigate the damage in our view.

To be sure, corrections will occur, but their timing is uncertain. When will the next one come along? Sadly, the answer is probably not until the public gets a lot more excited about equities than they are right now. For the time being, we think the risk of being underinvested or out of the market is at least as great as being in it.

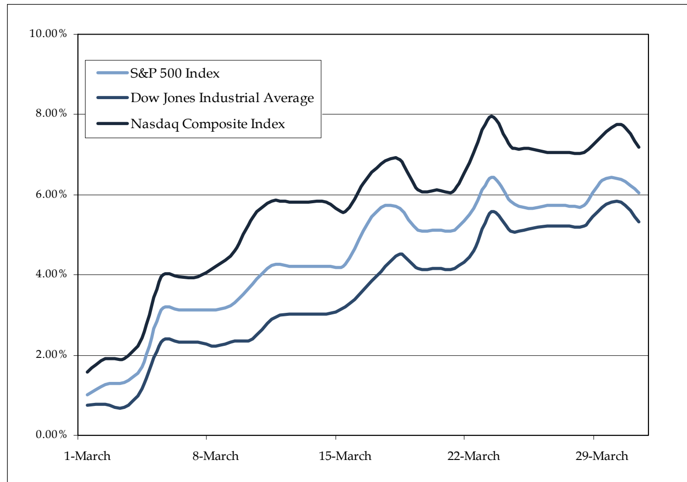
As always, we thank you for your support and welcome your comments.

David E. Nelson, CFA
April 7, 2010

About the Author

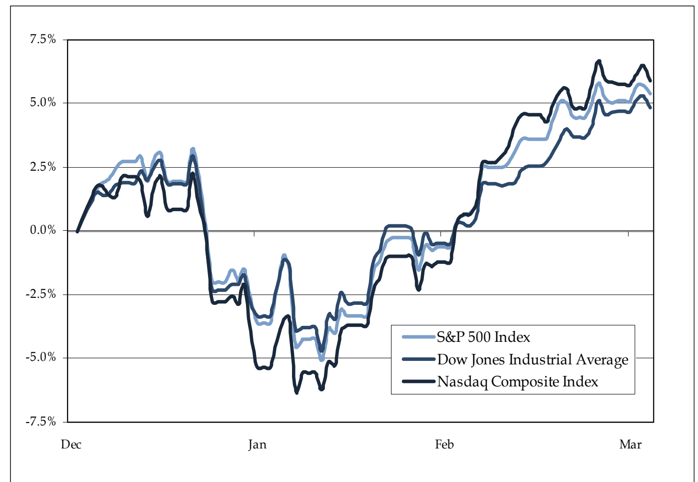
David Nelson currently serves as Portfolio Manager of the Legg Mason Capital Management American Leading Companies Trust mutual fund and as Chairman of LMCM's Investment Policy Committee. He holds the designation of Chartered Financial Analyst, is a past President of the Baltimore Security Analysts Society,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

Major Indices: March 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	March	YTD
Broad Market Indices		
S&P 500	6.03	5.39
Dow Jones	5.31	4.82
Russell 1000	6.14	5.70
NASDAQ	7.19	5.91
Dow Jones US Total Market Index	6.23	6.16
Russell 2000	8.14	8.85
Russell 1000 Growth	5.78	4.64
Russell 1000 Value	6.51	6.78
S&P 500 Sector Indices		
S&P 500 Consumer Discretionary	7.85	10.47
S&P 500 Consumer Staples	4.07	5.82
S&P 500 Energy	2.94	0.62
S&P 500 Financials	8.89	11.16
S&P 500 Health Care	2.61	3.40
S&P 500 Industrials	8.90	13.06
S&P 500 Information Technology	6.79	1.91
S&P 500 Materials	7.80	2.88
S&P 500 Telecomm Services	5.55	(4.32)
S&P 500 Utilities	2.75	(3.54)

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

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