LMCM
Point of View

Greece, Goldman & Gulf of Mexico Oil Spill Gum Up the Gears

May 2010 Market Commentary

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The S&P 500 Index rose +1.58% in April, but it didn't feel that good, as the market ran into heavy going in the back half of the month, including three daily declines of more than -1.6% (April 16, 27 and 30), and a weekly decline of -2.5%, the worst since January, to close out the month. The declines on April 16 (-1.61%) and April 27 (-2.34%) both saw over 90% of NYSE issues close lower on the day. Veteran market technician Bob Farrell considers such lop-sided market action to be a warning signal of a possible change in market direction. The proximate cause of both declines was Goldman Sachs. The company was indicted for fraud by the SEC on April 16 and members of its management team were subjected to a day-long grilling by a Senate panel investigating the charges on April 27.

Total Returns

	April	YTD
S&P 500 Index	+1.58%	+7.05%
Dow Industrials	+1.53%	+6.42%
Nasdaq Composite Index	+2.68%	+8.75%
S&P Mid-Cap 400 Index	+4.26%	+13.74%
Russell 2000 Index	+5.66%	+15.01%
Dow Jones US Total Returns Index	+2.15%	+8.44%
S&P 100 Index	+1.14%	+5.79%
Russell 1000 Growth Index	+1.12%	+5.81%
Russell 1000 Value Index	+2.59%	+9.55%

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

Another veteran technician whose teeth were set on edge by the Goldman indictment was John Mendelson, who has been steadfastly bullish since March 2009. Mendelson, whose cautionary antenna had been raised by recent weakness in his proprietary "Last Hour Indicator" and some evidence of investor complacency in the CBOE put/call statistics he monitors, was unnerved by the Goldman indictment, as he believes it may be symptomatic of "an assault on Wall Street by the Obama Administration" that could damage investor psychology sufficiently to trigger the first correction of more than -10% since the bull market began. Only time will tell whether or not this turns out to be true, but, since the volatility index (VIX) has spiked up again and the market seems to be reacting more negatively to bad news and less positively to good news, including continued strong corporate earnings reports, we believe it is a possibility investors must seriously consider.

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Returns in U.S. Dollars

	April	YTD
FTSE 100 Index (UK)	-1.41%	-1.61%
DAX Index (Germany)	-2.21%	-4.67%
CAC 40 Index (France)	-5.75%	-10.13%
MICEX Index (Russia)	-0.23%	+7.83%
NIKKEI 225 (Japan)	-0.93%	+3.70%
Hang Seng Index (HK)	-0.35%	-3.14%
Kospi Index (So. Korea)	+4.71%	+8.49%
Shanghai SE Comp. (China)	-7.61%	-12.33%
BSE Sensex 30 Index (India)	+1.57%	+5.62%

Source: Bloomberg

In general, foreign markets continued to do less well than the U.S. market in April, with most registering declines. Weakness was especially pronounced in the euro zone, as concerns over the widening sovereign debt crisis in several southern European countries soured equity investors across the continent. Matters came to a head on Tuesday, April 27, after the sovereign debt ratings of Greece and Portugal were cut by Standard & Poor's. European stocks fell by the largest one-day amount in five months after S&P cut Greece's long-term credit rating to "junk" status and slashed Portugal's rating two notches to A-. S&P has negative outlooks on both countries' debt. Yields on Greek two-year notes hit 17%, up roughly +400 basis points (bps) for the day, while credit-default swaps on Greek debt rose +104 bps to a record 814 bps. As noted earlier, the April 27 selloff in Europe triggered weakness in the U.S. market, which was exacerbated by the Goldman Senate grilling. Even the $147 billion Greek bailout package brokered by the International Monetary Fund (IMF) over the May 1-2 weekend has, thus far, done little to quiet concerns that Greece may ultimately need to restructure its debt, and may also be only the first, and likely least costly, in a series of required rescue operations.

Meanwhile, in Asia, China's Shanghai SE Composite was the weakest foreign market we track for the month of April (-7.61%) as well as year-to-date (-12.33%), as concerns appear to be growing among investors that the People's Bank of China's monetary tightening regime may overshoot, precipitating a greater-than-intended slowdown in the Chinese economy. Those concerns have been exacerbated in early May, as weaker-than-expected manufacturing data in China have weighed heavily on its equity market. In truth, the Shanghai Composite has been a notable laggard for nearly nine months now, having peaked in August 2009, and made a series of lower highs since then. It recently broke below an uptrend line dating back to October 2008—not an encouraging sign from a technical viewpoint—suggesting that the market believes the slowdown concerns are credible.

As if the uncertainties surrounding Goldman, Greece and China were not enough to shake investors' equanimity, the April 20 explosion on Transocean's Deepwater Horizon drilling rig and subsequent fire and oil leak has given investors yet another thing about which to worry. Apart from the tragic loss of life involved and probable monumentally expensive clean-up effort required, the oil spill throws a monkey wrench into the Obama Administration's recently announced plans to expand offshore drilling in U.S. waters.

As with the oil spill, the other situations mentioned above—Goldman, Greece and China—have broader implications for investors as well. In the case of the Goldman indictment, the question is not so much whether or not Goldman committed fraud, but rather whether the anti-Wall Street sentiment engendered by the incident increases the likelihood that the financial reform bill working its way through Congress ends up containing heavy-handed, ill-advised or capricious provisions that have the unintended consequence of making future financial crises more, rather than less, likely. In the case of Greece, it seems to us less consequential whether or not the country defaults or restructures its debt (which seems like a reasonably good bet to us), than whether a Greek default will precipitate a contagion that triggers similar actions by Spain and Portugal, an outcome that could threaten the long-term viability of the euro itself, in our view. Finally, the weakness in China's equity market raises broader questions about whether the global growth story led by China and other emerging markets is still intact.

Outlook

It is entirely possible that the uncertainties surrounding Greece, Goldman and the Gulf of Mexico oil spill could, in combination, be sufficient to precipitate the first -10% correction in the U.S. equity market since March 2009. Should it occur, such a correction would take the S&P 500 Index down to about 1100, at which point we believe the market would begin to find its sea legs, if it had not already done so at higher prices. From a purely technical point of view, the S&P 500's 200-day moving average, a level that often attracts buying support, is just under 1100. More importantly, at 1100, the S&P 500 would offer compelling value, in our opinion, based on consensus earnings per share expectations of $80 for 2010, and $95 for 2011, according to Standard & Poor's. At 11.6x 2011 earnings, the S&P 500 would offer a forward earnings yield of 8.6%, more than 500 basis points higher than the current 10-year Treasury yield of 3.41%. From 1100, assuming that the economy and earnings continue to recover as we expect, we believe the S&P 500 could work its way back to the 1250 to 1350 range that we have believed for some time is a reasonable year-end 2010 target. If consensus estimates for 2011 are on the mark, we believe the S&P 500 has attractive upside potential next year as well.

In thinking about how best to convey our thoughts on the outlook for the U.S. equity market at this juncture, we find a framing that PIMCO co-CEO Mohammed El-Erian has used in a couple of recent press interviews to be a useful mental model. In a May 3 *Barron's* interview and an earlier April 26 Q&A with *Financial Times* reporter Henny Sender, El-Erian offered the view that the current economic environment is being driven by strong cyclical tailwinds, but faces looming structural headwinds. El-Erian's opinion is that the market is placing too much emphasis on the cyclical tailwinds and not enough on the structural headwinds. In his May 3 *Barron's* interview with Leslie Norton, El-Erian said:

> There are very strong cyclical tailwinds that will hit structural headwinds in the second half. The cyclical tailwinds driven by the stimulus and the inventory cycle will get weaker. The structural headwinds of consistently high unemployment, difficult credit conditions and a very large fiscal deficit become more of a reality. Cyclical tailwinds speak directly to the market's playbook. Structural headwinds do not. Then, the market has a problem aggregating all these together into a new picture. Human beings are anchored by certain things. The minute something takes us out of our comfort zone, out of what is familiar, we need overwhelming evidence that it's happening. That leads to a recognition lag. Market participants are challenged because you can be too early or too late.

We believe El-Erian's comments are very insightful and focus the discussion about the outlook for the economy and the market exactly where it needs to be. Where we disagree with PIMCO, at present, is the degree of weight to accord each of these two opposing forces in positioning portfolios. PIMCO's belief that the U.S. economy is headed for a "new normal" characterized by secularly slower growth is driven, in our view, by its conviction that structural headwinds will dominate the economic landscape. In contrast, our portfolio positioning has, for the last year or so, been driven by the belief that because of the trauma of the prior deep recession and brutal bear market, most investors have been consistently underestimating the powerful cyclical recovery potential of the economy and its leveraged effect on the recovery in corporate earnings. To this point, that portfolio positioning has been correct. The key question now, in our opinion, is when, and how quickly, to transition from a pro-cyclical portfolio positioning to one that is appropriate for a more normalized economic environment. We believe 2010 is the year in which this transition needs to be made.

Investor skepticism concerning the economy's recovery potential has gone through a number of stages. In the teeth of the recession, many observers claimed that the economy would not recover at all, and we were, in fact, headed for another depression. Once the economy showed signs of life, skeptics said that any recovery would be anemic, taking the shape of a "U" or "L" or "W" (the double-dip school of thought), but certainly not the "V" shape that has characterized past recoveries from severe recessions. Now that the recovery has displayed more V-shaped characteristics than most observers believed possible, the debate has begun as to whether the recovery is as strong as it should be, and whether or not it can stand on its own two feet as monetary and fiscal stimulus is withdrawn over the next year or so.

These last two questions—the ultimate strength and sustainability of the recovery—are key considerations and we will continue to evaluate the evidence as it unfolds. For now, we think the available evidence supports the view that the economic recovery will be stronger than most observers expect, but likely not as strong as history would suggest coming out of a deep recession. (The structural headwinds are real, not imagined.) We also continue to believe that investors generally fail to fully appreciate the power of the recovery underway in corporate earnings. Though consensus earnings estimates are clearly pointing in the direction, we don't think most investors have much faith in the numbers.

Finally, we continue to believe that investors—traumatized by their disastrous experience with stocks in the bear market on 2007-2009—are turning a blind eye to the current attractiveness of equities relative to cash and bonds. We think the continued recovery in earnings in the U.S. and relative stability of the U.S. dollar, together with legitimate investor concerns about the outlook for equities in the euro zone and China, could transform U.S. equities into a favored asset class, rather than one to be underweighted or avoided.

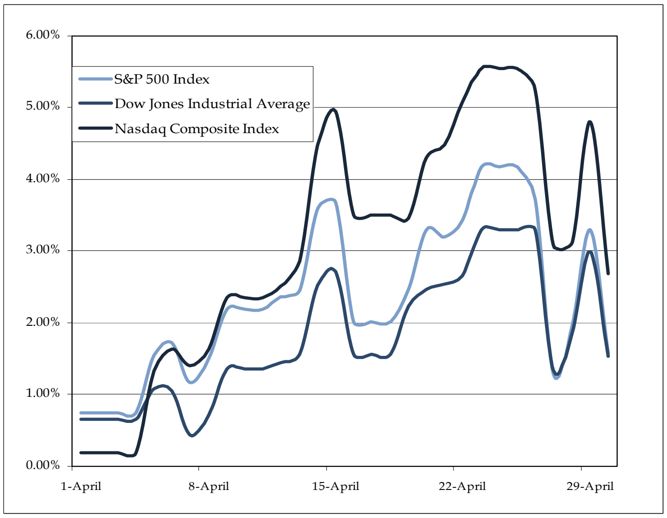
As always, we thank you for your support and welcome your comments.

David E. Nelson, CFA
May 7, 2010

About the Author

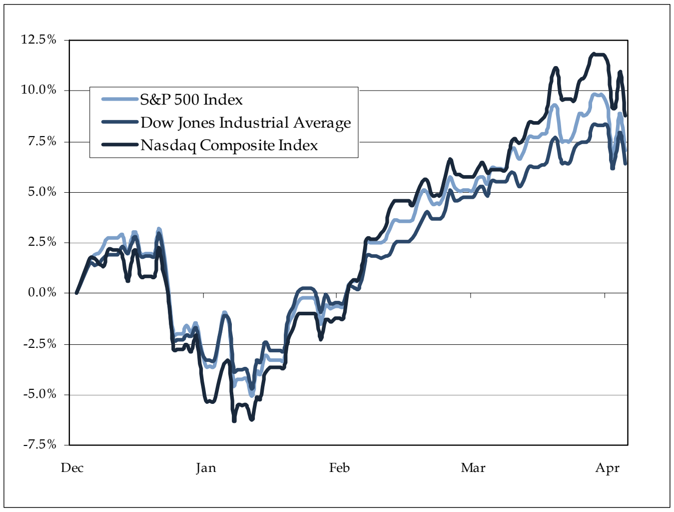
David Nelson currently serves as Portfolio Manager of the Legg Mason Capital Management American Leading Companies Trust mutual fund and as Chairman of LMCM's Investment Policy Committee. He holds the designation of Chartered Financial Analyst, is a past President of the Baltimore Security Analysts Society,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

Major Indices: April 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	April	YTD
Broad Market Indices		
S&P 500	1.58	7.05
Dow Jones	1.53	6.42
Russell 1000	1.85	7.65
NASDAQ	2.68	8.75
Dow Jones US Total Market Index	2.15	8.44
Russell 2000	5.66	15.01
Russell 1000 Growth	1.12	5.81
Russell 1000 Value	2.59	9.55
S&P 500 Sector Indices		
S&P 500 Consumer Discretionary	6.10	17.21
S&P 500 Consumer Staples	(1.38)	4.36
S&P 500 Energy	4.45	5.10
S&P 500 Financials	1.35	12.66
S&P 500 Health Care	(3.83)	(0.56)
S&P 500 Industrials	4.15	17.75
S&P 500 Information Technology	1.79	3.73
S&P 500 Materials	0.47	3.36
S&P 500 Telecomm Services	(0.11)	(4.43)
S&P 500 Utilities	2.63	(1.00)

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