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*Point of View*

# "The Ghost of 2008 Shakes Investor Confidence"

**June 2010 Market Commentary**

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The stock market suffered its worst May in 48 years, adding an exclamation point to the old adage "Sell in May and go away." On second thought, better advice this year would have been "Sell in April to avoid the May rush!" The only good news in May was that those calling for a nasty correction—to wring the excessive optimism out of the market that had built up in April —got their wish. The S&P 500 has now officially undergone its first correction of more than -10% since March 2009, having declined -12.27% from its April 23 closing high of 1217.28 to a May 26 closing low of 1067.95. The index rallied late in the month to close May down -8.20% and down -7.98% on a total-return basis. Monthly declines in the other major market indices we track were surprisingly uniform, ranging from -7.20% for the S&P Mid-Cap 400 Index to -8.51% for the S&P 100 Index.

**Total Returns**

| | May | QTD | YTD |
|---|---|---|---|
| S&P 500 Index | -7.98% | -6.53% | -1.50% |
| Dow Industrials | -7.56% | -6.15% | -1.63% |
| Nasdaq Composite Index | -8.17% | -5.70% | -0.13% |
| S&P Mid-Cap 400 Index | -7.20% | -3.24% | +5.56% |
| Russell 2000 Index | -7.59% | -2.35% | +6.29% |
| Dow Jones US Total Returns Index | -7.89% | -5.92% | -0.11% |
| S&P 100 Index | -8.51% | -7.47% | -3.20% |
| Russell 1000 Growth Index | -7.64% | -6.60% | -2.26% |
| Russell 1000 Value Index | -8.22% | -5.85% | +0.54% |

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

In retrospect, the market became vulnerable to a correction in mid-April as investor sentiment indicators revealed levels of optimism normally associated with intermediate tops in the market, and the market itself became quite extended on the upside relative to its own 200-day moving average, leaving little room for disappointment. To his credit, veteran market technician John Mendelson called attention to the market's vulnerability in a Special Report dated April 19. Over the course of the next week, Mendelson—prompted by weakness in the Chinese market, a negative reading from his proprietary "Last Hour" indicator, and the indictment of Goldman Sachs on fraud charges—changed his interim market outlook from bullish to bearish, saying that he expected a correction of more than -10%. His instincts were exactly right.

A lot of damage was done in May, both to the technical condition of the market and to investors' psyches. Both will take time to repair. Market volatility returned with a vengeance, evoking nightmares of 2008 and sending individual investors—who had just recently started tiptoeing back into the market—scurrying again for the perceived safety of cash and U.S. Treasuries. We regard this as very unfortunate, but completely understandable. The five weeks ended 5/28/10 witnessed volatility that could undermine the equanimity of the most grizzled market veteran much less the average guy (or gal) on the street. During that 25-day period, the

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Dow Industrials posted triple-digit point gains or losses seventeen times, and managed to advance two days in a row only once, on April 28 & 29. As reported by Robert Farrell, another veteran market technician in a 5/30/10 piece entitled "Not a Good Month" that same 5-week period produced an unusual number of other market extremes including six 90% down days, two 90% up days, two selling climaxes, the largest rise in the VIX (to 48.20 on 5/21/10) since 2008, a 15% decline in the S&P 500 (on an intra-day basis), and the deepest oversold condition since late 2008.

We think the selling climax that occurred on May 6, the so-called "Flash Crash," may have been particularly unsettling to the average investor. We certainly found it to be so. May 6 started out as a garden variety down day, as sovereign debt concerns in the euro zone sent U.S. stock prices down in the morning hours. By 2PM, the Dow was down about -1.5% to roughly 10,700, while the S&P 500 was down -2.9% to 1145. According to the "Preliminary Findings Regarding the Market Events of May 6, 2010" (published jointly on May 18 by the U.S. Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commissions ("SEC")), at about 2:40PM, stock prices began to decline with "extraordinary velocity" and within five minutes, the Dow and S&P 500 both fell an additional -5% on enormously high volume, most of which appeared to have been generated by the high-frequency trading entities ("HFTs") which have come to dominate trading activity in recent years. In a matter of minutes, the stocks of a number of very substantial companies were driven down to literally pennies per share, as millions of computer-generated sell orders searched relentlessly for buyers, eventually completing their transactions at nonsensical prices. The most egregious of these trades were subsequently cancelled, but we fear many investors—especially those entering market orders—were likely shocked at what passed for "market" prices on the afternoon of May 6.

We find the events surrounding the May 6 "Flash Crash" to be troubling, as we believe it is the kind of occurrence—especially if repeated—that could further undermine the public's already fragile confidence in the stock market. According to the joint report of the CFTC and SEC referenced above, a total of 19.4 billion shares were traded on May 6, approximately 2.2 times the average daily trading volume in the fourth quarter of 2009. These volumes dwarf the 2.12 billion shares reportedly traded on the NYSE on May 6, and the two-year average trading volume of 1.15 billion shares. Obviously, HFTs must have accounted for a significant percentage of this incremental trading volume, but how much? And who is doing what? And what strategies are they employing? Nobody really seems to know for sure. Or those who do know aren't talking. Is HFT a positive or negative? That depends on whom you ask. Tradeworx, Inc., a high-frequency trading firm, in an April 21, 2010 presentation to the SEC, said that HFTs play a valuable role by increasing market liquidity. They argued that HFTs don't cause market volatility, though they do acknowledge benefiting from it. We're skeptical. We don't really understand why it's necessary to be able to generate a half a million or a million orders in a microsecond, or why locating your computers a few feet closer to the exchanges' order systems, so your orders arrive a few nanoseconds faster, is a good thing, unless your game is front-running someone else's order. A couple of things do seem clear. First, any system in which a stock can trade from $30 to $0.01 and back to $30 in a matter of minutes is not functioning properly. Second, any trading landscape which gives even the appearance that it is rigged in favor of insiders will likely turn off the investing public.

**Returns in U.S. Dollars**

| | May | QTD | YTD |
|---|---|---|---|
| FTSE 100 Index (UK) | -10.92% | -12.18% | -12.35% |
| DAX Index (Germany) | -9.95% | -11.94% | -14.16% |
| CAC 40 Index (France) | -12.76% | -17.79% | -21.61% |
| MICEX Index (Russia) | -11.38% | -11.59% | -4.45% |
| NIKKEI 225 (Japan) | -8.83% | -9.68% | -5.46% |
| Hang Seng Index (HK) | -5.49% | -5.82% | -8.46% |
| Kospi Index (So. Korea) | -13.09% | -9.00% | -5.71% |
| Shanghai SE Comp. (China) | -9.39% | -16.29% | -20.57% |
| BSE Sensex 30 Index (India) | -7.52% | -6.07% | -2.32% |

*Source: Bloomberg*

Market unpleasantness in May was not relegated only to the U.S. In fact, as shown nearby, the U.S. has been one of the best performing equity markets this year. In May, only the markets in India and Hong Kong did better, and, on a year-to-date basis, the U.S. has bested all of the foreign markets we track.

## Outlook

The market downdraft which began in April and turned nasty in May has shaken investors' confidence. It has also rekindled fears that the insanely volatile market of late 2008 and early 2009, which investors had hoped was a thing of the past, may have returned, and with it, the prospect of further declines, possibly to new lows, in the equity market. Obviously, we cannot know for certain what the future holds, but we strongly believe that further material weakness in the equity markets is unlikely, and that the market is, in fact, in the process of stabilizing at current levels, and will resume its advance in the next few weeks. We believe gains from the present level could come more haltingly, with volatility likely remaining elevated, though probably not as high as in recent weeks. We continue to see worthwhile gains ahead for the remainder of 2010 and into 2011, with our long-stated year-end 2010 target range of 1250 to 1350 on the S&P 500 still seeming to us like a reasonable objective. The low end of that range, which seems like the more prudent end to focus on currently, implies upside in the mid-teens for the S&P 500 by year end. On the downside, we believe the S&P 500 could find support in the 1040 area, which it broached in early February and again in late May, implying about -5% risk from current levels.

Despite the recent unwelcome spike in volatility, one thing which gives us considerable confidence that we are not seeing a replay of 2008 in 2010 is the behavior of credit spreads. Credit markets led equity markets lower in 2008. Whenever it looked like the equity market might be trying to stabilize, the clear message from the continued widening of credit spreads was that there was more pain to come. In contrast to 2008, U.S. credit markets this year have reacted relatively calmly to the euro zone sovereign debt crisis thus far. Credit spreads have widened a bit, but nothing like they did in 2008. For example, junk bond spreads have widened by 125 basis points or so, to a little over 900 basis points, versus their late 2008 peak levels of about 2200 basis points. Similarly, the U.S. Libor-OIS spread has widened by only about 20 basis points from the mid-teens to the mid-thirties over the last month, a far cry from its peak spread of roughly 450 basis points in late 2008. As long as credit spreads remain comparatively well-behaved, we think there's a very good chance that further damage to the equity markets will be relatively minor.

We also find it encouraging that the recent market correction has quickly cooled investors' budding ardor for stocks. As noted above, investor sentiment readings reached excessive levels of optimism in April, which—not coincidently—was the first month to see meaningfully positive net flows into U.S. domestic equity mutual funds since the bull market began in March 2009. The downdraft quickly squelched that optimism, as both the NDR Crowd Sentiment Poll and the Hulbert Newsletter Stock Sentiment Index have recently plunged back into "Extreme Pessimism" territory. Since 1997, the Hulbert Sentiment Index has recorded readings this negative only about 15% of the time, a bullish indicator as the market has averaged a +33.7% annualized gain in past periods when investors were this pessimistic. Sure enough, investors have again been voting with their feet as Lipper FMI (previously AMG Data Services) reported the largest weekly net outflow from equity funds and equity ETFs ever recorded in its 20-year history—$16.7 billion for the week ending May 26.

As our readers are all too aware, the U.S. equity market faces an unusually large number of uncertainties at present, including: (1) a sovereign debt crisis in Europe which threatens to push the euro zone back into recession; (2) a policy-induced slowdown in China which threatens to spread to the rest of Asia; (3) a BP well gushing oil into the Gulf of Mexico creating the worst oil-industry disaster in U.S. history and threatening to wreak untold havoc on Florida, the east coast of the U.S., and even possibly Europe (via the Gulf Stream) if it is not capped soon; and (4) an activist Congress with what it perceives to be a Populist mandate to tax the rich to pay for an ever-increasing array of entitlement programs.

In the face of all this uncertainty, can the equity market actually go up? We think the answer is yes, but the progress from here could be grudging. We expect the market to be bludgeoned higher by a recovering economy and sharply rising corporate earnings. The macro concerns listed above could limit the multiple at which investors are willing to capitalize those earnings.

Consensus earnings estimates are notoriously unreliable. Most often they prove to be too optimistic, but after deep recessions, they can be too pessimistic for a time. Recently, analysts have collectively been erring on the side of pessimism, but after being wrong in that direction for several quarters in a row, they may now have become too optimistic. We just don't know, but let's assume they have. So, instead of the current 2011 consensus estimate of $96.61 for the S&P 500 Index, let's use $90.00. At its May month end close of 1089.41, the S&P 500 was trading at 12.1 times that estimate, for an earnings yield of 8.26%, nearly 500 basis points higher than the 10-year Treasury yield. That strikes us as quite attractive in the context of a 3.27% 10-year Treasury and money funds that yield next to nothing. If, heaven forbid, the current 2011 consensus estimate of $96.11 proves to be accurate, then the S&P 500 is currently trading at only about 11.3 times earnings.

A problem all investors face is that there is so much data available to analyze, and so many disparate opinions as to how that data should be interpreted, that it is easy to get caught up in the minutia and become a victim of "analysis paralysis." In order to avoid this fate, we have found it useful to try to simplify our investment case as much as possible. In this context, we think Tony Dwyer, an equity strategist whose work we admire and who now hangs his hat at Collins Stewart LLC, makes as straightforward a bullish case for equities now as any we have seen. Dwyer's case rests on five postulates:

1) The equity market is driven by the direction of earnings (not the rate of change).
2) The direction of earnings is driven by economic growth.
3) Economic growth is driven by the steepness of the yield curve, income growth and credit availability (as measured through various credit spreads)
4) Credit is driven by Fed policy.
5) Fed policy is driven by core inflation.

All five of these factors are currently supportive of higher equity prices. Earnings are rising and the economy is recovering, supported by an accommodative Fed which is not worried about inflation in the near and intermediate term. Based on this relatively straightforward line of reasoning, we think the equity market is headed higher.

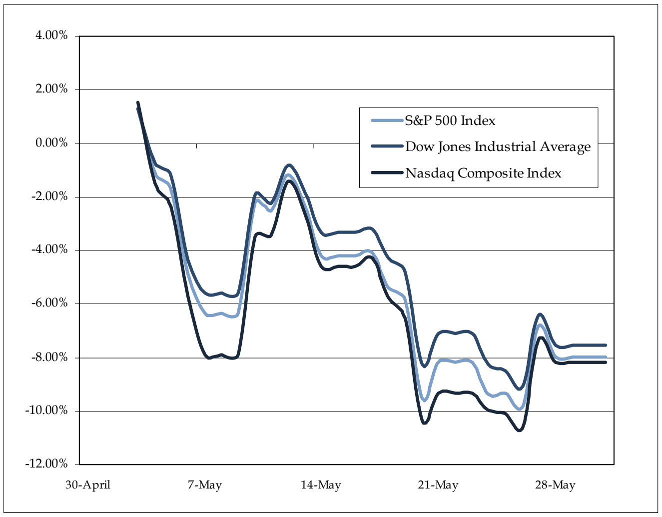
As always, we thank you for your support and welcome your comments.

**David E. Nelson, CFA**
June 7, 2010

## About the Author

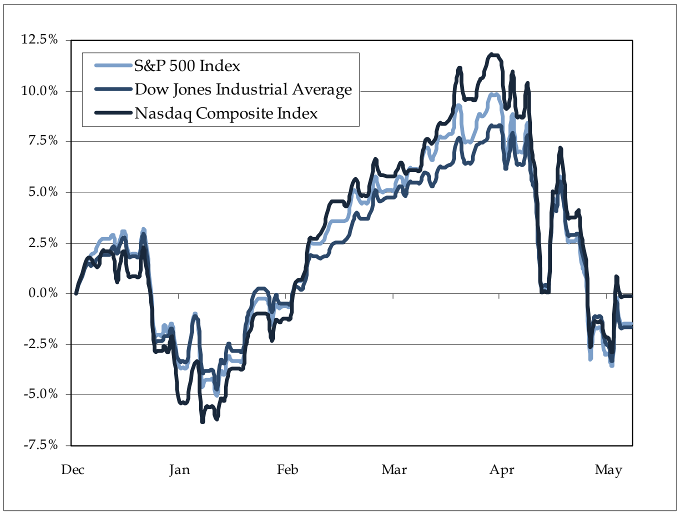
David Nelson currently serves as Portfolio Manager of the Legg Mason Capital Management American Leading Companies Trust mutual fund and as Chairman of LMCM's Investment Policy Committee. He holds the designation of Chartered Financial Analyst, is a past President of the Baltimore Security Analysts Society,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

## Major Indices: May 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 | May | QTD | YTD |
|---|---|---|---|
| *Broad Market Indices* | | | |
| S&P 500 | (7.98) | (6.53) | (1.50) |
| Dow Jones | (7.56) | (6.15) | (1.63) |
| Russell 1000 | (7.93) | (6.22) | (0.88) |
| NASDAQ | (8.17) | (5.70) | (0.13) |
| Dow Jones US Total Market Index | (7.89) | (5.92) | (0.11) |
| Russell 2000 | (7.59) | (2.35) | 6.29 |
| Russell 1000 Growth | (7.64) | (6.60) | (2.26) |
| Russell 1000 Value | (8.22) | (5.85) | 0.54 |
| *S&P 500 Sector Indices* | | | |
| S&P 500 Consumer Discretionary | (7.00) | (1.33) | 9.00 |
| S&P 500 Consumer Staples | (4.60) | (5.91) | (0.44) |
| S&P 500 Energy | (11.38) | (7.44) | (6.87) |
| S&P 500 Financials | (9.16) | (7.94) | 2.33 |
| S&P 500 Health Care | (6.72) | (10.30) | (7.24) |
| S&P 500 Industrials | (9.53) | (5.77) | 6.54 |
| S&P 500 Information Technology | (8.10) | (6.46) | (4.68) |
| S&P 500 Materials | (9.46) | (9.04) | (6.42) |
| S&P 500 Telecomm Services | (3.90) | (4.00) | (8.15) |
| S&P 500 Utilities | (5.61) | (3.12) | (6.55) |

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