

First Half Ends on a Sour Note, but Second Half Should be Better

**July 2010
Market
Commentary**



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

After a mid-month rally which propelled the S&P 500 Index briefly back above its 200-day moving average, the market correction that began in late April resumed in the last half of the month, as political uncertainties and growing fears of a double-dip recession continued to overshadow what we regard as increasingly compelling stock valuation levels. Performance numbers for the month, quarter and year-to-date shown below illustrate the pervasive nature of the recent damage done to the major indices we track.

Total Returns			
	<u>June</u>	<u>QTD</u>	<u>YTD</u>
S&P 500 Index	-5.23%	-11.43%	-6.65%
Dow Industrials	-3.43%	-9.36%	-5.00%
Nasdaq Composite Index	-6.49%	-11.83%	-6.62%
S&P Mid-Cap 400 Index	-6.55%	-9.59%	-1.36%
Russell 2000 Index	-7.75%	-9.92%	-1.94%
Dow Jones US Total Returns Index	-5.52%	-11.12%	-5.64%
S&P 100 Index	-5.01%	-12.10%	-8.05%
Russell 1000 Growth Index	-5.51%	-11.74%	-7.65%
Russell 1000 Value Index	-5.63%	-11.15%	-5.12%

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

Selling pressure was particularly acute late in the month with several 90% down days on the New York Stock Exchange in the last week, as institutional investors seemed determined to raise cash to pretty-up their quarter-end balance sheets. The selling appears to have reached washout proportions on June 29, as the Arms Index (TRIN) soared to an intra-day high reading of 16.47. Veteran market technician, John Mendelson, calls the TRIN a “pressure monitor” measuring the percentage of volume flowing into rising and falling stocks, where 1.00 is equal pressure, a ratio below 1.00 indicates buying pressure, and a ratio over 1.00 indicates selling pressure. Many investors regard a TRIN of 2.00 as indicative of high selling pressure, while Mendelson himself uses 4.00. In a June 30, 2010 morning note, Mendelson called the 16.47 TRIN recorded on June 29 the highest he had ever seen, noting that it greatly exceeded the TRIN’s September 2008 high of 11.63 and its March 2009 high of 8.77.

It is not just the Arms Index that indicates that investors are, in some respects, more bearish now than they were in either late 2008 or early 2009, but also the CBOE Put/Call data, which shows that the volume of put buying has once again soared to levels higher than those recorded at the market low in March 2009. We find this degree of investor bearishness to be, at once, quite remarkable and, at the same time, very understandable. It is remarkable in the sense that—looking at things logically and

objectively—the economy is now clearly in recovery, earnings are in a steep uptrend, cash yields next to nothing, stocks are attractively valued and bonds look expensive. It is understandable in the sense that none of that seems to matter much right now. Investors are not currently thinking objectively, in our view. Their principal motivation at present is the avoidance of pain. They remember vividly the pain of the bear markets of 2000-2002 and 2007-2009. They have seen their stock portfolios melt in half or worse twice in the last decade and many, if not most, have completely lost faith in the long-term value of stocks as a wealth builder. Even the sharp recovery in stocks from March 2009 to April 2010 was met by the investing public with an enormous degree of skepticism and mistrust. Now that a market correction of, an as-yet undetermined magnitude is upon us, investors are heading for cover, their tolerance for pain and volatility having been exhausted. We can hardly blame them.

The investment environment has recently been as frustrating and enervating as any time we can remember. As we noted last month, the market has become increasingly dominated by high frequency traders (HFTs), many of whose strategies appear to be momentum-based and designed to profit from short-term movements in the market. According to a recent study by Abel-Noser, HFT is becoming increasingly concentrated in the most liquid names, with the 20 most active stocks accounting for nearly 29% of all domestic trading volume in June, and the top 99 stocks accounting for just over half of total volume last month. Three of the top five most active trading vehicles in June were ETF (exchange-traded fund) versions of leading market indices, including the SPDR S&P 500 ETF Trust (SPY), the iShares Russell 2000 Index (IWM) and the PowerShares Nasdaq 100 Index (QQQQ). These three indices alone accounted for over 14% of domestic trading volume in June, according to Abel-Noser.

The fact that index ETFs have become such a significant portion of total trading activity suggests to us that most HFT strategies are either short-term directional bets on the overall market or inter-sector arbitrage bets, as opposed to efforts to discern the relative merits of one individual security versus another. This trend is consistent with our view that stocks are becoming increasingly commoditized and helps explain why the movements of individual stocks are near all-time high correlation levels of almost 80%. We find this environment a challenging one as we try to make fundamental judgments about the relative attractiveness of individual securities.

We also see the political environment as a negative. There is an anti-business rhetoric emanating from the Obama Administration that we find counterproductive. The Administration claims to want to promote job growth, but most of its actions are acting at cross purposes to this goal, in our opinion, as it has created a great deal of uncertainty in the business community concerning future health care costs, regulatory burden and tax regime. Until business leaders get some clarity on these issues, we think they will be inclined to sit on their hands (and their cash hoards), rather than hiring new workers or committing capital to new projects.

Further heightening investors' near-term concerns, the economy has hit a soft patch, with most recent economic data—including private sector job growth, ISM manufacturing and new order data, auto sales and housing starts—coming in weaker than expected. On top of that, the war in Afghanistan does not appear to be going well, the Macondo oil well continues to foul the Gulf of Mexico and concerns persist about growth prospects in Europe and China. The spate of weak numbers, coupled with the stock market downturn and a growing sense of ennui, has triggered a sharp drop in consumer confidence, engendering fears that a “double-dip” back into recession may be in the offing.

With the plethora of concerns facing investors, they seem to have adopted an “anything but stocks” investment approach. After a brief foray into the stock market in April, investors resumed dumping their U.S. equity mutual funds in May and June, while increasing their commitment to both gold and U.S. Treasuries. Gold and Treasuries might seem at first like strange bedfellows, but their concurrent popularity could be the result of investors trying to hedge against the opposing risks of inflation (gold) and deflation (Treasuries). There might be an even simpler explanation. Investors are attracted to investments that have been treating them well recently and gold and Treasuries have been going up for the last 10 years, while stocks have been going down.

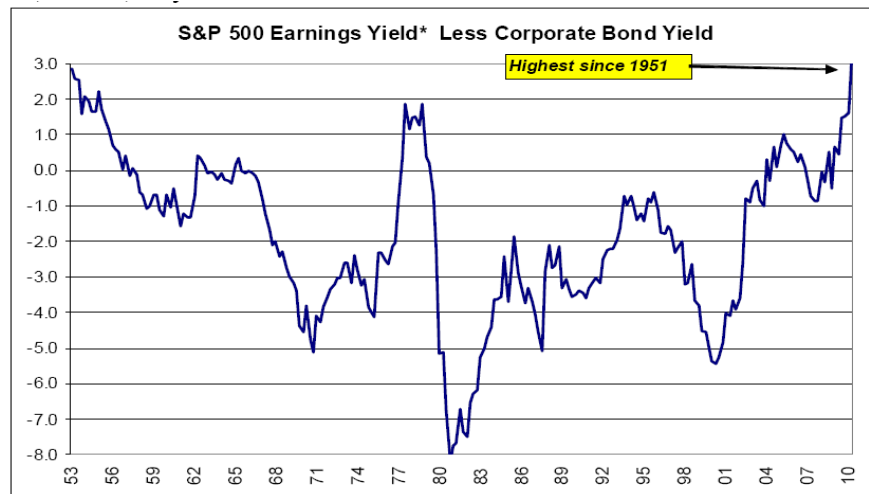
Outlook

As frustrating as the current environment is, we believe that the market merits a much higher valuation level than it is currently being accorded. Unless the economy slips back into recession—a scenario we view as quite unlikely—and corporate earnings turn down, we would expect the market to be meaningfully higher than it is now in the next six months to one year.

Former Fed governor Lyle Gramley, an economist whose work we greatly admire, puts the odds of a double-dip recession at about 10% to 20%. Work by two researchers at the Cleveland Fed, Joseph Haubrich and Kent Cherny, put the odds of a double-dip at about 12%, the low end of Gramley's range. In a paper published on July 1, Haubrich and Cherny note that the 2.34 percentage point gap between yields on two-year and 10-year Treasuries is more than twice the 20-year average and about the same as in 2003, just before real GDP rose 3.6%. The yield curve normally inverts prior to recession, the exact opposite of its shape now.

If the economy avoids recession and continues to recover, even if haltingly, earnings should continue to rise as well. Consensus estimates for the S&P 500 Index for this year and next are currently \$81.73 and \$94.84, according to Standard & Poor's, putting the S&P at about 12.6x 2010 estimates and 10.9x 2011 consensus based on month-end prices. The equivalent earnings yields are 7.9% and 9.2%, respectively, highly attractive relative to a 3% 10-year Treasury, in our view, implying equity risk premiums over the "riskless" asset of 4.9% and 6.2%, respectively. These figures compare to an average equity risk premium of 4.1% since 1926.

Since many investors are rightly wary of placing too much faith in analysts' estimates, we found it interesting that the market also looks quite attractive based on corporate profits as reported to the IRS and recorded in the Bureau of Economic Analysis' National Income and Product Account ("NIPA") tables. The chart below (courtesy of Michael T. Darda, Chief Economist at MKM Partners) compares the earnings yield of stocks using NIPA-based profits to corporate bond yields. The chart shows that the earnings yield on the S&P 500 Index is at its highest level versus corporate bond yields since 1951.



Source: Bloomberg; MKM Partners
 *Earnings yield based on NIPA-equivalent S&P operating earnings with 1988 as a base year

If stocks are so attractive, why then are they not generating more enthusiasm among investors? We think the answer is simply that investors' experience with equities over the last 10 years has been so painful that they have lost faith in stocks as long-term wealth builders. They have recently been putting their trust in asset classes which have treated them better, notably cash, Treasury securities and, to a lesser extent, gold.

Taking a much longer term view, the appeal of stocks as superior wealth builders should become more apparent. We first encountered the table below in Jeremy Siegel's book, The Future for Investors. The table in the book appears on page 171 and shows total real returns for five assets—stocks, bonds, Treasury bills, gold and the U.S. dollar—from 1802 to 2003. We have updated the figures in the table below through 2009 from data on the author's website, JeremySiegel.com. The table shows the inflation-adjusted value of one dollar invested in each asset in 1802 with income reinvested.

Total Real Return Indexes	
<u>1802-2009</u>	
Dollar	\$0.06
Gold	\$3.17
Treasury Bills	\$301.00
Treasury Bonds	\$1,423.00
Stocks	\$607,279.00

Source: JeremySiegel.com

We find the numbers in the table to be quite startling. Over the course of the 207-year period covered, the U.S. dollar has lost 94% of its value, proving that the risk of currency debasement is not a new problem. Gold has proven to be an effective hedge against currency depreciation, as its advocates argue, but has provided virtually no real return. Treasury bills have done considerably better than gold, and Treasury bonds better still, but the clear winner, by a factor of 426 times over its nearest rival, is stocks. In the very long run, it has been absolutely no contest.

Why do stocks so significantly outperform other financial assets over long periods of time? We actually think the answer is fairly simple. Stocks represent ownership interests in businesses. Over time, businesses have the ability to adapt and adjust to changing economic circumstances. Some succeed grandly; others fail miserably. But as a group, they have the ability to evolve, thus giving them the capacity to deliver returns that other financial instruments—whose terms are largely fixed—cannot match. To secure that advantage, equity owners must bear greater risk of short-term loss and higher volatility. Given the magnitude of the difference in returns over time, that strikes us as a risk worth taking.

The dismal performance of equities over the last 10 years has caused investors to lose sight of the long-term appeal of equities. We believe stocks are now priced to begin delivering much better returns. One need not stray far from the beaten path to find good quality stocks at very attractive prices. Andrew Bary, in an article in the latest issue of *Barron's* (July 5, 2010) entitled "Tempting 10s," found that 13 of the top 25 companies in the S&P 500 index trade at or below 10 times estimated 2011 earnings. The average P/E of the group is 8.5 times, with an average dividend yield of 2.6%, a yield, we might add, that is likely to grow in the mid- to high-single digit range in the future, in contrast to the 10-year Treasury yield which will remain fixed.

In similar fashion, Jim Grant, in his June 11, 2010 issue of Grant's Interest Rate Observer, ran a screen using Bloomberg to identify U.S. headquartered stocks with market capitalizations of more than \$5 billion, a return on equity greater than 15% (for the latest fiscal or calendar year), a dividend yield greater than 2%, a debt-to-assets ratio of less than 35% and a price-to-earnings ratio of less than 15. He found 32 qualifiers, all names the average investor would recognize. The average return on equity of the group was 34%, the average yield 3.6%, the average debt-to-assets ratio 21.3% and the average P/E ratio 11.6 times.

If you gave me the choice of owning that group of stocks (or any number of other stock portfolios with similar composite characteristics) for the next ten years or owning a portfolio composed of equal parts 10-year Treasuries and gold over the same period, I'd take the stocks in a heartbeat.

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

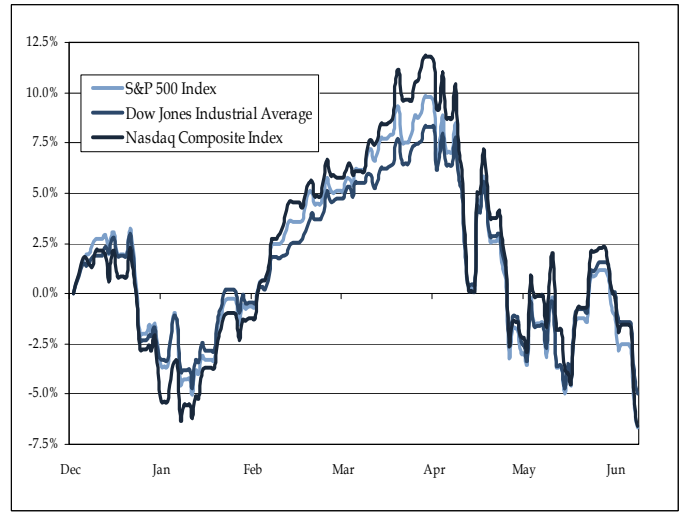
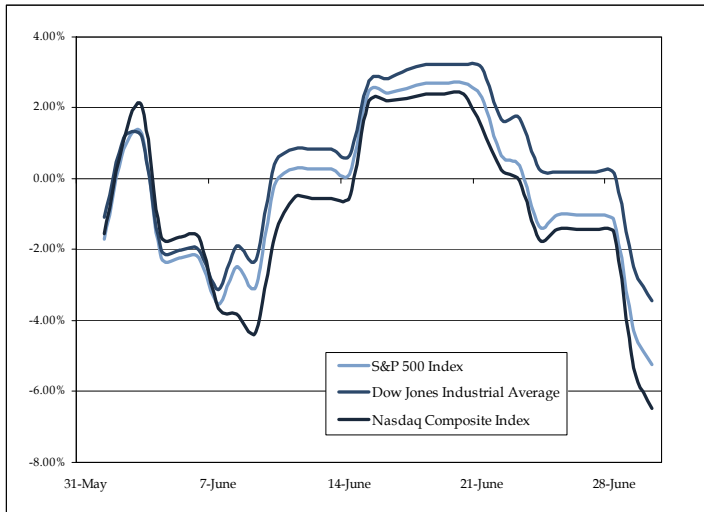
David E. Nelson, CFA
Chairman, Investment Policy Committee
Legg Mason Capital Management
July 8, 2010

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 LCMC'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: June Performance

Major Indices: Year-to-Date Performance



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

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

Monthly U.S. Market Update (Total Returns)

Index Name	June	QTD	YTD
<i>Broad Market US Indices</i>			
S&P 500	(5.23)	(11.43)	(6.65)
Dow Jones	(3.43)	(9.36)	(5.00)
Russell 1000	(5.57)	(11.44)	(6.40)
NASDAQ	(6.49)	(11.83)	(6.62)
Dow Jones US Total Market Index	(5.52)	(11.12)	(5.64)
Russell 2000	(7.75)	(9.92)	(1.95)
Russell 1000 Growth	(5.51)	(11.74)	(7.65)
Russell 1000 Value	(5.63)	(11.15)	(5.12)
<i>S&P 500 Sector Indices</i>			
S&P 500 Consumer Discretionary	(9.69)	(10.89)	(1.56)
S&P 500 Consumer Staples	(2.36)	(8.14)	(2.79)
S&P 500 Energy	(5.73)	(12.75)	(12.20)
S&P 500 Financials	(5.86)	(13.34)	(3.67)
S&P 500 Health Care	(1.67)	(11.79)	(8.79)
S&P 500 Industrials	(6.94)	(12.31)	(0.86)
S&P 500 Information Technology	(6.19)	(12.25)	(10.57)
S&P 500 Materials	(6.90)	(15.32)	(12.88)
S&P 500 Telecomm Services	(0.24)	(4.24)	(8.37)
S&P 500 Utilities	(0.64)	(3.74)	(7.14)
<i>Non-US Indices in US Dollars</i>			
FTSE 100 Index (Great Britain)	(1.75)	(13.84)	(14.01)
DAX Index (Germany)	(0.29)	(12.20)	(14.40)
CAC 40 Index (France)	(1.77)	(19.24)	(22.99)
MICEX Index (Russia)	(2.74)	(14.01)	(7.07)
NIKKEI 225 (Japan)	(1.14)	(10.71)	(6.53)
Hang Seng Index (Hong Kong)	2.20	(3.76)	(6.45)
Kospi Index (South Korea)	2.05	(7.13)	(3.77)
Shanghai SE Composite (China)	(6.20)	(21.48)	(25.49)

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

The views expressed in this commentary reflect those of Legg Mason Capital Management ("LMCM") as of the date of this commentary. These views are subject to change at any time based on market or other conditions, and LMCM disclaims any responsibility to update such views. These views may not be relied upon as investment advice and, because investment decisions for clients of LMCM are based on numerous factors, may not be relied upon as an indication of trading intent on behalf of the firm. The information provided in this commentary should not be considered a recommendation by LMCM or any of its affiliates to purchase or sell any security. The information contained herein has been prepared from sources believed reliable but is not guaranteed by us as to its timeliness or accuracy, and is not a complete summary or statement of all available data. This data is intended solely for our clients, is for informational purposes only, and may not be publicly disclosed or distributed without our prior written consent.

"Standard & Poor's®", "S & P®", "Standard and Poor's 500®" and "500®", "S & P 500®" are trademarks of The McGraw-Hill Companies, Inc.

The Global Industry Classification Standard ("GICS") was developed by and is the exclusive property and a service mark of Morgan Stanley Capital International, Inc ("MSCI") and Standard & Poor's, a division of The McGraw-Hill Companies, Inc. ("S&P") and is licensed for use by LMCM. Unauthorized use, disclosure, copying, dissemination or redistribution is strictly prohibited.

The Dow Jones Wilshire IndexesSM are calculated, distributed and marketed by Dow Jones & Company, Inc. pursuant to an agreement between Dow Jones and Wilshire and have been licensed for use. All content of the Dow Jones Wilshire IndexesSM ©2010 Dow Jones & Company, Inc. & Wilshire Associates Incorporated.

All Russell® Indexes are trademark/ service marks of the Frank Russell Company. Frank Russell Company ("FRC") is the source and owner of the Russell Index data contained or reflected in this material and all trademarks and copyrights related thereto. The presentation may contain confidential information and unauthorized use, disclosure, copying, dissemination or redistribution is strictly prohibited. This is a LMCM presentation of the Russell Index data. Frank Russell Company is not responsible for the formatting or configuration of this material or for any inaccuracy in LMCM's presentation thereof.

MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. This document is not approved, reviewed or produced by MSCI. No further distribution or dissemination of the MSCI data is permitted without MSCI's express written consent.

Neither LMCM nor its information providers are responsible for any damages or losses arising from any use of this information.