

# Bill Miller Commentary

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Dear Shareholder,

I normally don't have a view about the near term direction of the stock market, having learned it appears to conform reasonably well to the academic's version of the random walk. One can sometimes get a good sense of major turning points such as July 02, or March 03, or even March 00, since they usually coincide with extremes of valuation or sentiment or volatility. Such extremes are not in evidence today. Stocks have meandered most of the year with a downward bias in the US, in contradistinction to the behavior of most of the world's markets, which have performed quite well, especially in local currency.

This is very curious. Every market in the world appears to have gone up this year, except China, which always goes down, and Slovenia, which must not have gotten the message this is an up year. Pakistan had an earthquake that killed 40,000 people and it is up 40%. Iceland, Romania, Ukraine, Malta, Morocco, Nigeria, Israel, Mauritius, and almost everywhere else is up, except the largest, most important, most liquid, most transparent, most prosperous, most productive, market in the world: the US.

It has not been fundamentals that have been holding our market down, and it has not been valuation either. The economy is strong, balance sheets are as liquid as they have ever been, profit margins and return on equity are hovering near all time highs, earnings are growing double digit, companies are buying back stock in record amounts, mergers and acquisitions are happening at nice premiums to prevailing prices. Private equity shops are flush with cash and are snapping like piranhas at every opportunity. Interest rates under 5%

hardly present an impediment to higher prices, and the S&P 500 at 15x next year's earnings is not straining to grow into investor's expectations.

In my view, two things have kept our market from participating in the global rally: oil prices and the Fed. The US is the world's largest energy consumer and has been used to low energy prices. The experience of dramatically higher gasoline prices and the prospect of paying much more for heating oil this winter have kept investors worrying about the impact on consumption spending, which accounts for a record 70% of GDP. The Fed has raised rates 11 times and appears intent on continuing to do so, judging by the hawkish comments coming from Fed governors.

I think things are about to change, and soon. Indeed, they have already begun to change, and I believe the US market will begin to take notice in fairly short order.

Oil prices appear to have peaked at \$70.85 the day after hurricane Katrina made landfall. When the damage from hurricane Rita could not move them to new highs, I think the market was saying that a premium of \$25 dollars or so above the marginal cost of oil production—estimated at about \$40—is sufficient to compensate for the complete litany of reasons given why oil deserves to sell where it does, including the prospect of Hubbert's peak, the lack of US refining capacity, the supposed insatiable demand from China and India, the apparent inelasticity of demand to price, and so on.

Oil prices have been drifting down since Katrina, despite the continuing supply disruptions and damage due to the hurricanes. The

behavioral response to high prices is underway, as SUV sales have plunged, demand is down year over year for gasoline, consumer confidence is falling, and far eastern nations are beginning to unwind energy subsidies due to the cost on their budgets. I think we have good evidence that \$70 oil or higher puts global growth in jeopardy, and hence serves as an effective governor on oil prices.

If oil prices have stopped going up, that removes one impediment to the US market going up. The other impediment is the Fed, which I also think is about to get out of the way.

The Fed has raised the funds rate 11 times and is poised to go to 12 on November 1. It has done so to remove the policy accommodation put in place to counter the bursting of the tech bubble and the ensuing economic weakness emanating from the aftermath of Sept 11, the junk bond collapse, and the corporate scandals. It has also explicitly expressed concern about “froth” in the residential real estate market, and one way to inhibit that is to raise the cost of financing. It has succeeded at the short end, but failed at the long end, resulting in Chairman Greenspan’s “conundrum” of why it is that intermediate and long rates have not risen as they “ought” when the Fed is moving short rates higher.

The minutes of the Federal Open Market Committee meeting held on September 20 revealed that “some sentiment was expressed to consider changes to forward-looking aspects of the statement at upcoming meetings...” If rates are increased at the next meeting, as is widely expected, it appears that some change in the forward looking statement may be forthcoming. There is a psychological difference between a funds rate of 3.75%, where we are now, and 4%, where we will be next. Each round number represents a different psychological level. Faced with poor consumer confidence, weakening numbers in some of the manufacturing time series, and the recent poor behavior of stocks even as oil prices have moved lower, the Fed may indicate they are getting close to the end of the tightening cycle.

I think any indication the so far inexorable series of

rate increases is not going to continue apace, coupled with oil prices that stay below \$70, will send the US stock market sharply higher, as these macro inhibitors to the market’s excellent fundamentals are removed.

A rising market will also likely solve Mr Greenspan’s conundrum. A pause, or even the signal of a future pause, in the rate increases will awaken the bond vigilantes from their Rip Van Winkle slumbers as they begin to fret about inflation. Falling bond prices will also shake loose those who think bonds have little risk, since they have done so well for so long, and that stocks are risky since they have done poorly. If stocks start to rise, their perceived riskiness will fall, and money will be attracted to equities and away from bonds. The resulting rise in intermediate and long rates will feed back into mortgage rates, slowing if not halting the speculative activity in real estate. That money will likewise move to stocks. Thus the solution to the conundrum is a paradox: to get rates to rise, stop raising rates.

Whether the rate increases stop at the next meeting, or not until January, the end is in sight, and the market should begin to discount it soon. That discounting will begin in earnest as soon as the forward looking language changes.

The old leadership in the market -- oils, utilities, REITs, commodity related names, and housing -- have all corrected more than the market in the most recent decline. This often suggests a change to new leadership. New leadership usually consists of those groups, sectors, or areas that are cheap, have performed poorly, and where expectations are low.

The leading candidate that meets those criteria is the mega cap S&P 500 names, the group that peaked in early 2000 and that has trailed the mid and small caps ever since. Within that group, financials and technology appear most attractive, with low valuations, excellent balance sheets, and lots of share repurchase activity. The end of Fed tightening would likely provide a big boost to tech

and financials. Among the old leaders, the home-builders stand out, trading at 5 or 6x earnings due the incessant drumbeat about a housing bubble. That industry would benefit greatly from better capital discipline via share repurchase, and some merger and acquisition activity.

I think the market is going up.

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