

Market Commentary

The U.S. equity market suffered another dreary month in April as the major indices continued to slide.

	TOTAL RETURNS		
	April	YTD	4/12 - 4/15/05
S&P 500 Index	-1.90%	-4.00%	-3.79%
Dow Industrials	-2.81%	-4.81%	-4.00%
Nasdaq Composite Index	-3.86%	-11.50%	-4.84%

As the far right column above illustrates, the three days ending Friday, April 15th accounted for all of the market's weakness during the month, and a sizeable portion of the damage done year-to-date. This brief period seems to represent a microcosm of what is bugging investors lately, as the news flow during those three days was filled with headlines and stories about the threat posed by rising interest rates and inflation, and the negative effects of higher-priced oil, and its main derivative product, gasoline, on global growth.

On the subject of gasoline prices, please permit me to rant a bit as we attempt to dispense once and for all with the idea that gasoline is expensive. It is not—at least not in the U.S. Europe is a different story, but that's because of taxes. Gasoline in the U.S. is cheap—not as ridiculously cheap as it was a few years back—but cheap nonetheless. Consider this. A gallon of unleaded gasoline costs about \$2.35. A gallon of milk costs \$3.45 and a gallon of water costs \$7.36—if you buy it in 20 ounce bottles for \$1.15 a pop. If you want expensive, let's talk about a Starbucks Grande Latte—16 ounces for about \$3.25. That's \$26.00 a gallon. Now, that's expensive! Even at today's prices, gasoline is a relative bargain. A recent American Petroleum Institute study found that between 1982-84 and 2005, the

price of gasoline increased 25% less than the 92% increase in the "All Items" category of the CPI, rising only 66.8%, or about 2.5% compounded. In fact, if some scientist figured out how to make internal combustion engines run on water instead of gasoline—which on the surface sounds like a great idea—it would cost us more than double what it does now to fill up our tanks. If I see one more local news program bemoaning the "high cost" of gasoline, I think I'll scream.

Abraham Lincoln once observed that "People are about as happy as they make up their minds to be." Lately investors have made up their collective mind to be unhappy. Everything that happens is interpreted as bad news. Evidence of strength in the economy raises fears of accelerating inflation and rising interest rates. Evidence of weakness triggers concerns about falling profits. A vocal minority—led by economist Paul Krugman, who hasn't smiled since the Clinton Administration—is worried about stagflation, the double-whammy of slower growth and rising inflation.

As we discussed in detail last month, we believe that the primary reason investors are so gloomy lately is that they are still traumatized by the bear market of 2000-2002 and discouraged because the trailing 5-year return of the market (specifically the S&P 500 Index) has been negative for 10 of the last 11 quarters. Investor sentiment has continued to worsen in the last month and is now at remarkably low levels. Bob Brogan, who writes the Signal Report, puts it this way: "The NYSE Public and Specialist Short Sale ratios are reflecting the highest levels of investor pessimism in the history of the Exchange. For the week ending April 15th (there's always a 2-week lag in the data), Specialist Short Sales amounted to only 15% of all Short sales (below 20% is a Bullish Bell ringer) and Public Shorts were 3.7 times the Specialists. **These are incredible numbers!** Public short sellers are almost as bad as the odd-lot short sellers, as they are rarely correct on their directional market

bets, and the Specialists—who control the book on their assigned companies and as such are in control similar to the house dealers in Las Vegas—are seldom wrong. Whenever these ratios reach an extreme high or low (they are presently at an historic low), it pays to bet with confidence with the Pros (the Specialists). The last time we saw these ratios come in at such distressed (low & bullish) levels was September 18, 2002 and August 13, 2004—need we say more!”

In a piece subtitled “The Triumph of the Pessimists?” Michael Goldstein, head of Empirical Research Partners, cites a recent survey sponsored by The Vanguard Group as evidence that investors in general are dramatically overestimating the risk of stocks currently. Vanguard asked a group of defined-contribution plan participants a series of questions about their expectations for equities in the coming years. Respondents’ answers in aggregate were uniformly pessimistic. For example, they rated the likelihood that bonds would outperform stocks over the next 10 years as being about 40%, whereas the actual percentage has been about 15% since 1926. Respondents rated the odds that stocks will remain flat for ten years also as about 40%, while in actuality they have been flat for any given 10-year period since 1926 less than 5% of the time. Most remarkably in our view, respondents rated the odds that the stock market would drop 33% in any given year as about 50%/50%. This has only happened once in the last 133 years, yet investors’ current collective mindset is such that they believe it is an even-money bet going forward.

If we haven’t yet convinced you that sentiment is terrible (and therefore bullish), perhaps two studies by Mark Hulbert, publisher of the Hulbert Stock Newsletter Sentiment Index (HSNSI), will do the trick. (We are grateful to Kiril Sokoloff of 13D Research for calling this to our attention.) In a recent article entitled “Wall of Worry is Getting Steeper,” Hulbert noted that his tracking of recommended stock market exposure by short-term market-timing newsletters stood in late April at a negative 24.4%, meaning that the average short-term timing service was short the stock market. Hulbert wrote that

there was only one other period since March 2000 when his HSNSI was lower—in mid-April of this year, when it fell to negative 30.6%.

Kiril Sokoloff’s 13D-Research Inc. recounts another Hulbert study that evaluated sentiment readings from the American Association of Individual Investors (AAII). For the week ending March 31, 2005, 51% of investors surveyed were bearish. Of the 926 weekly readings compiled since mid-1987, only 20 (or 2.2%) have shown higher levels of bearishness than this. Fifteen of the 20 higher readings occurred in late 1990 and early 1991, following the first Gulf War, and during a period of crisis in the commercial real estate market and U.S. banking system. Quoting 13D, “Two more extreme bearish readings occurred immediately before the bull market began in March 2003. Another occurred at the market low in July 2002, and the other at the October 2002 low.” Convinced?

Outlook

Our continuing positive assessment of the outlook for U.S. equities rests on three factors: sentiment, fundamentals and valuation. Sentiment we have already covered. Sentiment is bad, and that’s good.

On the subject of fundamentals, we like what we see. The outlook is not perfect, but then it almost never is. And when it is, look out! Real GDP growth appears to have slowed in the first quarter to about 3.1%. We say “appears” because—as market strategist Ed Kerschner has often noted—reported GDP numbers are a moving target, subject to numerous revisions before the “final” numbers are reported. The evidence is still mixed—unemployment claims suggest slower growth ahead, while employment growth suggests things are fine—but we think first quarter real GDP growth has almost as good a chance of being revised upward as downward as time passes.

But let’s say that the economy is slowing a bit. Is that such a bad thing? We think not. Corporate profits appear to be holding up quite well. According to Business Week (5/9/05), first quarter First Call consensus estimates for the companies in the S&P 500

Index were for 7.6% profit growth as we entered the year, whereas it now appears likely the S&P 500 companies will post composite growth of 13.2% in net income from continuing operations in the quarter. The cap-weighted bottom-up First Call consensus earnings growth forecast for the S&P 500 for all of 2005 now stands at +12.6%, up from +10.6% at the beginning of the year. Even assuming the current forecast is a shade high, as the bottom-up consensus often is—earnings growth of 10% or more for the full year looks like a better and better bet.

Ed Hyman and Nancy Lazar of ISI Group think the economy is entering a “mid-cycle” slowdown that may continue into early 2006 and see real GDP growth slowing to 2% for a quarter or two. This scenario, if true, would take the pressure off the Fed to continue raising rates by 25 basis points per meeting, as many now expect. Ed and Nancy think it may be “one and done”, i.e., the Fed will raise rates by 25 basis points at the June 30 meeting and then sit tight. Under this scenario, ISI Group expects bonds to improve first (which they have been doing), with stocks to follow as reduced worries about inflation and interest rates more than offset the negative effects of any slowdown in profit growth.

We do not think one needs to be quite as optimistic on interest rates as ISI Group in order to be constructive on the stock market. The way we see it, the Fed has no interest in “croaking” the economy. Their desire is to do what is necessary to promote long-term economic growth and price stability. The Open Market Committee now has nearly two full months (between the May 3rd and June 30th meetings) to see how the economy behaves before having to act again. They should have a much better feel for what is really happening with the economy by then.

Valuation is the final reason we continue to be constructive on the market. We believe the S&P 500 is moderately undervalued based upon trailing earnings, and—at 15.7 times First Call consensus estimates—is about 13% undervalued based on 2005 numbers. The S&P 500's 2005 earnings yield of

6.37% is more than 200 basis points higher than the current 10-year Treasury bond yield of around 4.20%—more than adequate compensation in our opinion for the greater volatility of stocks over bonds. With a composite free cash flow yield of roughly 5%, growing at 6% long-term, we think stocks represent a very attractive alternative to Treasuries, which offer cash flow yields of between 4% and 5% (depending on maturity) and don't grow at all.

While investors generally seem unmoved by the compelling economics offered by stocks currently, private equity firms and corporate buyers are increasingly recognizing the opportunity. That is why we're seeing an increasing number of deals announced. If investors as a whole continue to mope, we might see the current stream of deals turn into a flood. Unlike previous LBO booms, which were based on taking over bad companies and fixing them, this boom will likely be driven by buyers taking over good companies (with cash-rich balance sheets), selling too cheaply, and leveraging up their balance sheets to earn outsized returns. If this trend continues, it might prove to be the “catalyst” needed to get investors out of their current funk.

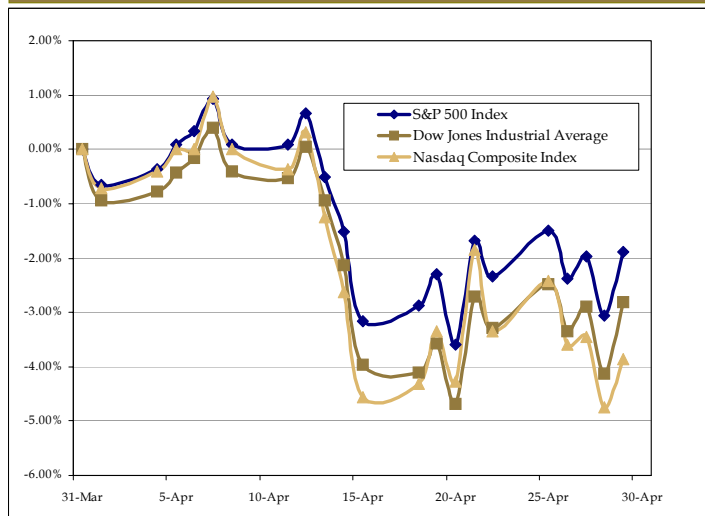
As always, we appreciate your support and welcome your comments.

David E. Nelson, CFA

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Legg Mason Capital Management

Major Indices April Performance



Source: Bloomberg and FactSet

S&P 500 Index Sector Performance

	April	YTD
Consumer Discretionary	(6.46%)	(11.79%)
Consumer Staples	(0.92%)	(0.25%)
Energy	(5.30%)	11.35%
Financials	0.11%	(6.28%)
Health Care	3.40%	2.77%
Industrials	(3.03%)	(4.57%)
Information Technology	(3.94%)	(10.99%)
Materials	(7.01%)	(5.33%)
Telecommunication Services	0.93%	(6.93%)
Utilities	3.13%	8.72%

Source: Bloomberg and FactSet

Major Indices Performance

	April	YTD
S&P 500 Index	(1.90%)	(4.00%)
Dow Jones Industrial Average	(2.81%)	(4.81%)
Russell 1000	(1.84%)	(3.71%)
Nasdaq Composite Index	(3.86%)	(11.50%)
Dow Jones Wilshire 5000	(2.26%)	(4.59%)
Russell 2000	(5.73%)	(10.76%)
Russell 1000 Growth	(1.90%)	(5.91%)
Russell 1000 Value	(1.79%)	(1.70%)

Source: Bloomberg and FactSet

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