

Market Commentary

The U.S. equity market rallied in May from depressed levels in April and is now up for the quarter, but still down year-to-date.

TOTAL RETURNS

	May	QTD	YTD
Dow Industrials	+2.97%	+0.07%	-1.99%
S&P 500 Index	+3.18%	+1.22%	-0.95%
Nasdaq Composite Index	+7.73%	+3.57%	-4.66%

The tech-heavy Nasdaq Composite led the rally in May, up 7.7% for the month. Higher beta stocks in the S&P 500 were also stand-out performers for the month as illustrated below:

S&P 500

	Average Beta	5/31/05 Mkt Val (\$Bln)	4/29/05 Mkt Val (\$Bln)	% Change MV
High Beta Quintile	1.88	2,064.6	1,942.7	+6.3%
Low Beta Quintile	0.45	2,185.0	2,157.5	+1.3%
S&P 500 Index	1.02	10,879.5	10,559.9	+3.0%

Source: S&P Compustat, FactSet Data Systems, LCMC

Two-thirds of the S&P 500's high-beta quintile by market value was technology stocks, the best performing sector for the month, up 7.7%, excluding dividends. The next best performing sector, and the only other one to outperform the S&P 500, was consumer discretionary stocks, up 5.8%. For reasons discussed more fully in last month's client letter, we have been expecting a rebound in the "growthier" areas of the market. We got that in spades in May. Whether that trend will persist is another question. We think the answer is yes, but it remains to be seen. A key clue will be the tech sector's relative performance in any market pullback. If the sector maintains some or all of its recent relative gains during a correction, that may signal that a new trend away from more defensive stocks—which, based on our work, look expensive—toward more growth-oriented ones—which, as a group,

look attractive to us—may have begun.

The extreme levels of investor pessimism that we noted in April have abated somewhat as the market has rallied. Some short-term market indicators such as the put-call ratio—now 0.55, down from over 1.00 in April—and the volatility index (VIX)—now 12, down from 17 in April—are even suggesting that a market pullback is forthcoming. Should that happen, it would not trouble us, as we continue to believe that fundamentals argue for higher stock prices in the second half of the year.

We have noted previously that the nearly two-month period between the May 3 and June 30 Open Market Committee meetings gives the Fed a good deal of time to observe the behavior of the economy before having to act again. The way we read the situation, most of the evidence since the May meeting points to the conclusion that the Fed should be one (or possibly two) 25-basis point rate hike from completion of tightening. Employment growth, while still healthy, appears to be slowing (+78,000 jobs in May). GDP growth also appears to be slowing. Core inflation seems to be under control (+1.6% year-over-year in April according to the core PCE deflator, +2.2% year-over-year according to the core CPI). Gold and commodity prices—with the notable exception of oil—are flat to down. Year-over-year money supply growth is flat. U.S. Treasury bond prices have rallied sharply. The 10-year yield is below 4%, and the 30-year is about 4.3%. Tax receipts are running "unexpectedly" strong, suggesting that the budget deficit—originally forecast to be \$427 billion this fiscal year—may come in closer to \$350 billion. In addition, U.S. short rates are now higher than those in Europe and the dollar has rallied sharply versus the euro since the beginning of 2005. All of this data suggests to us that the Fed has little need to continue tightening much, if any, beyond June.

Perhaps the strongest argument for the Fed to stop raising rates is the Institute of Supply Management's purchasing manager's index (PMI), which dropped to 51.4 in May from 53.3 in April. The past behavior of the PMI suggests that it is almost certain to drop below 50. According to data from Tony Dwyer, market strategist for FTN Midwest Research, since 1948, whenever the PMI has declined from over 55, where it was earlier this year, to under 55 where it is now, it has dropped below 50

about three-quarters of the time. Since 1982, a breach of 55 has led to a break of 50 every time. **Importantly, in the Greenspan era, whenever the PMI has broken 50 on the downside, the Fed has stopped raising interest rates.**

Outlook

So, if the PMI drops below 50—as we expect—doesn't that mean we're heading for a recession, and wouldn't that be bad for stocks? The answer is: maybe so, but probably not. As the U.S. economy has become more service, and less manufacturing, oriented, a PMI below 50 has become a less reliable indicator of the onset of recession. Again, according to data from Tony Dwyer, from 1948 to 1982, a drop in the PMI from above 55 to below 50 led to recession two-thirds of the time (8 of 12 instances). Since 1982, a similar drop below 50 has led to recession only 22% of the time (2 of 9 instances). One-third of the time since 1982 (3 of 9 instances), a drop in the PMI below 50 has signaled—not recession—but a mid-cycle slowdown which led to a sharp rally in equities in all three cases—August 1984, March 1995 and December 1997.

We think it is particularly instructive to compare the situation that existed in March 1995 with our present circumstances, as we see many parallels. In addition to the PMI dropping below 50, March 1995 saw: (1) a bottoming in the U.S. dollar after a period of weakness; (2) the yield curve flattening dramatically from 3 months to 10 years, as it is doing now; (3) industrial commodities stabilizing after a run-up; (4) a slowdown in real GDP growth to +0.7% in Q2 1995 from +4.8% in Q4 1994; (5) fears of a collapse in consumer spending caused by excessive debt levels and weak income growth; and (6) a divergence of opinion between top-down strategists and bottom-up analysts on the outlook for corporate profit growth. Then, as now, strategists' estimates were much lower than the bottom-up composite. In March 1995, the bottom-up consensus proved to be far more accurate and the S&P 500 was up 34% for the year, as profits surged in the latter half of the year. Even the reasons for NOT buying stocks in 1995 sound familiar now: (1) a probable recession and drop in corporate earnings; (2) still high valuations by historical standards (P/E's bottomed at 15X); (3) weakening foreign economies; (4) soaring U.S. budget and trade deficits; and (5) a debt-ridden consumer.

Today, as in 1995, people seem to be able to find a lot more reasons to avoid stocks than to buy them. Today,

too, there is a fairly wide divergence between the bottom-up consensus EPS forecast for the S&P 500 Index of \$74.61 in 2005 and \$83 in 2006, and the top-down consensus of \$71.50 and \$77.50 for 2005 and 2006, respectively. Even assuming that the bottom-up consensus is too optimistic, as it often is, if we split the difference between these two groups of forecasters, we get what we regard as reasonable estimates for the S&P 500 of \$73 and \$80 per share for this year and next. Applying the 18 multiple of earnings that we believe is currently appropriate for the S&P 500—based on its composite characteristics of 16% return on equity, 8% cost of capital and 6% long-term earnings growth rate—we derive point estimates of 1314 and 1440 for the S&P 500 for year end 2005 and 2006, respectively. Since forecasting is not an exact science, we feel more comfortable thinking in terms of valuation ranges for the S&P of 1300 to 1325 by year end 2005 and 1425 to 1450 by year end 2006.

What could go wrong to upend this scenario? Plenty of things, obviously, and we will discuss a few concerns in a moment, but first we'd like clients to consider what could go right! Having spent the better part of the past week in New York City at a conference, we had the opportunity to talk to a wide variety of investment professionals about their outlook for the market. The results of our highly informal survey are that the thing that would surprise the greatest number of people is a very strong market, say, up 20% or more through the balance of this year. Since the market often does what is least expected, we think this is a scenario worth factoring into one's investment thinking. How would it happen? Try this: the Fed stops tightening, the mid-cycle slowdown ends, bottom-up earnings estimates prove accurate, and the market takes off on the upside.

What, on the other hand, could go wrong? Barring some one-off event that no one can predict, in our opinion, the most likely problem scenario that could develop is that the current economic slowdown morphs into a recession with a concomitant drop in corporate profits. That would not be good, but as we see it based on history, there's only about a 20% chance that will happen.

Another potential negative development would be a "bursting" of the "housing bubble." A full explication of this topic would require more space than we have available this month. Google "housing bubble" and you get about 205,000 hits, so there are obviously plenty of people who have an opinion on this subject. Suffice it to say here that it is not completely clear that there is a "housing bubble," and that if there is, that it is about to "burst." But, if there

is, and if it does, that would definitely be bad because the average American family has a lot more of its net worth tied to real estate than to stocks or bonds.

The final issue that merits some attention in thinking about what could go wrong is the threats posed by globalization. Don't get us wrong, we think globalization is mostly a good thing, but that's not the point. Whether we like it or not, globalization is a fact of life. It's here, it's increasing and it ultimately can't be stopped. But that doesn't mean that the groups that are dislocated by it won't try to fight it, or stop it if they can. Many of the issues making the front pages of the newspapers these days are ultimately about globalization. GM's downgrade to junk is about globalization. The French "non" vote and the Dutch "nee" vote in the recent EU constitutional referendums are about globalization. The U.S. Congress' protectionist rhetoric and clamoring for the Chinese to revalue its currency are also about globalization. All of these groups long for things to be the way they used to be before, not how they are now and are likely to be in the future. GM workers want to keep their jobs. The French and the Dutch want to keep their 35-hour workweek, six weeks of vacation, and generous retirement and health care benefits. But GM workers can't compete with Asian laborers who are happy to work for a small fraction of U.S. wages, in the same way that French and Dutch workers can't compete with the proverbial "Polish plumber."

As we see it, the biggest threat to continued globalization is the rise of protectionism. Alan Greenspan recently called the threat of protectionism "truly worrisome." As noted, the U.S. Congress is pressing the Bush Administration to pressure China into allowing the yuan to appreciate versus the dollar. Over time, we believe this will happen, but we don't expect much change in the near term and we hope that Congress doesn't do anything silly like imposing trade sanctions on China, if the Chinese don't act as quickly as Congress deems necessary. The evidence is pretty conclusive that trade barriers hurt everyone because they lead to "beggar thy neighbor" retaliation that leaves both parties worse off. Most economists now acknowledge that the Smoot-Hawley Tariffs of 1930 contributed greatly to the length and depth of the Great Depression.

We think the reason that the Chinese are reluctant to allow any substantial revaluation of the yuan is because they are fearful of what it would do to their economy, employment levels and corporate profits. We think there is some merit to their concerns. China is already

burdened with massive excess capacity in many industries. An economic slowdown—a likely result of any material upward revaluation in their currency—would only exacerbate that situation. Also, despite the booming Chinese economy, many Chinese companies are not making much money as it is. The Shanghai composite index recently fell to an 8-year low, in part on fears that the government would greatly expand its program of privatizing formerly state-owned-enterprises, but also because of margin pressure from rising costs. As a result, we expect only cosmetic moves by the Chinese on the currency front for the time being.

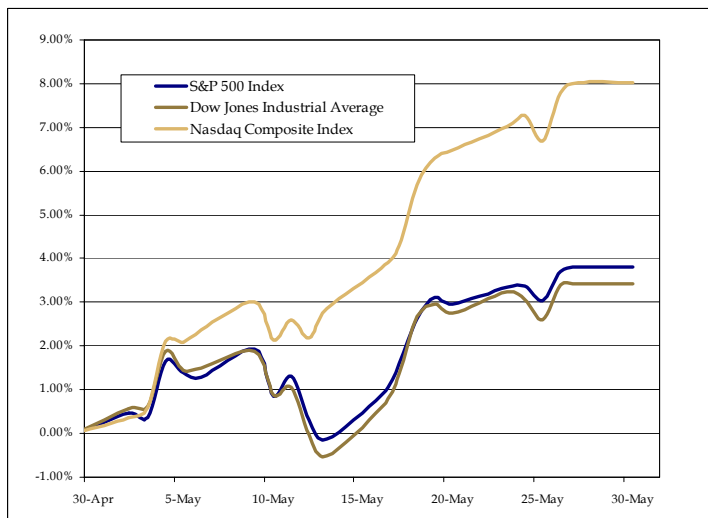
As always, we appreciate your support and welcome your comments.

David E. Nelson, CFA

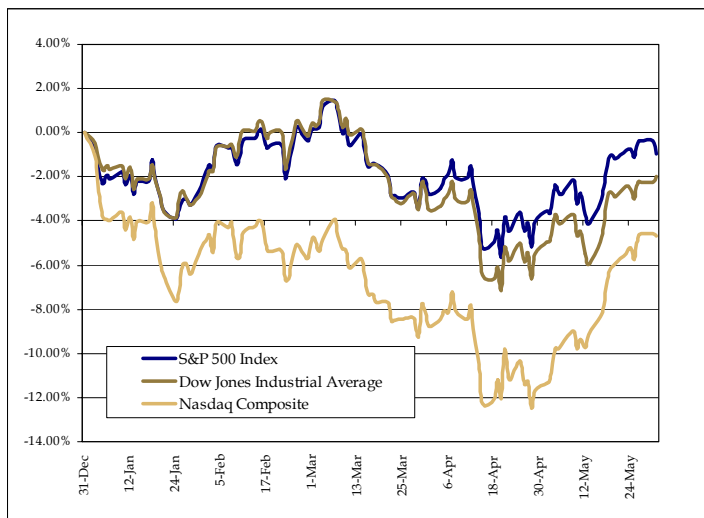
Director of Market Analysis

Legg Mason Capital Management

Major Indices May Performance



Major Indices YTD Performance



Source: Bloomberg and FactSet

Source: Bloomberg and FactSet

Monthly U.S. Market Update

	May	QTD	YTD
Broad Market Indices			
Total Return S&P 500	3.18	1.22	(0.95)
Total Return Dow Jones	2.97	0.07	(1.99)
Russell 1000	3.54	1.64	(0.30)
Total Return NASDAQ	7.73	3.57	(4.66)
Wilshire 5000	3.90	1.56	(0.87)
Russell 2000	6.55	0.44	(4.92)
Russell 1000 Growth	4.84	2.84	(1.36)
Russell 1000 Value	2.41	0.57	0.66
S&P 500 Sector Indices			
Total Return S&P 500 Consumer Discretionary	5.90	(0.94)	(6.58)
Total Return S&P 500 Consumer Staples	2.16	1.21	1.90
Total Return S&P 500 Energy	1.76	(3.63)	13.31
Total Return S&P 500 Financials	2.74	2.85	(3.71)
Total Return S&P 500 Health Care	1.04	4.47	3.84
Total Return S&P 500 Industrials	2.42	(0.68)	(2.26)
Total Return S&P 500 Information Technology	7.81	3.56	(4.04)
Total Return S&P 500 Materials	(0.84)	(7.79)	(6.13)
Total Return S&P 500 Telecomm Services	1.19	2.13	(5.82)
Total Return S&P 500 Utilities	0.16	3.30	8.90

Source: Bloomberg and FactSet

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