LEGG MASON CAPITAL MANAGEMENT

Month-End Commentary

June 2005

Market Commentary

The major U.S. equity market indices produced mixed results in June, following uniformly strong showings in May, which followed generally weak results in April.

TOTAL RETURNS[1]

	April	May	June	Q2	YTD
S&P 500 Index	-1.90%	+3.18%	+0.14%	+1.37%	-0.81%
Dow Industrials	-2.81%	+2.97%	-1.70%	-1.63%	-3.65%
Nasdaq Composite Index	-3.86%	+7.73%	-0.48%	+3.07%	-5.12%

[1] Source: Bloomberg

For the month of June, the S&P 500 Index was up marginally, while the Dow Industrials and Nasdaq Composite were down. All three indices remain in negative territory through mid-year. For the quarter, the S&P 500 and Nasdaq Composite posted gains while the Dow Industrials lagged noticeably, due to weakness in two stocks with high dollar share prices, IBM and MMM, which were down 18.8% and 15.6%, respectively, for the quarter. Because of the quirky way in which the Dow is calculated, high-priced stocks have an outsized impact. The $17.18 drop in IBM and $13.39 decline in MMM during the second quarter translated—via the magic of the Dow divisor of 0.13033708—into a decline of 234.55 Dow points, which more than accounted for the entire 228.79 point drop in the Industrial Average for the three-month period.

The anomalous performance of the Dow Industrials in the second quarter relative to the S&P 500 Index illustrates rather dramatically that even widely followed indices can give a distorted picture of what is going on in the market as a whole. For a more accurate picture, we turn to yet another indicator—the Dow Jones Wilshire 5000 Total Market Index, which represents the combined market capitalization of nearly 5,000 companies listed on the three major U.S. exchanges, and is the broadest measure of performance available for the U.S. stock market. The Wilshire 5000 was down 2.22% (excluding dividends) in the first quarter, up 2.32% in the second, and up 0.05% for the six months through June. Call it a draw between the bears and the bulls for the first half of 2005. Who will hold sway in the second half of 2005? We're still siding with the bulls for reasons we summarize in the Outlook section of this letter.

Wouldn't it be ironic if it took a terrorist attack on London's mass transit system to get the U.S. equity market moving on the upside? As crazy as that sounds at first blush, so far—in the first two days after the attack—that is what happened. After plummeting as much as 4% in the immediate aftermath of the bombings, the London FTSE, Paris CAC and Frankfurt DAX all righted themselves and closed on Thursday (7/7/05) down in the range of 1.4% to 1.8%. On Friday, all three major European bourses rallied sharply, closing the week at or slightly above pre-attack levels. The U.S. equity market's response to the attack was equally startling. After opening down about 1%, the major U.S. indices rallied throughout the day Thursday, and finished in positive territory. The rally continued on Friday (7/8/05) as the Dow Industrials (+1.43%), S&P 500 (+1.17%) and Nasdaq Composite (+1.79%) all registered impressive gains for the day.

How can it be that the market would rally in the face of this craven act of terrorism? After all, worries about the timing and location of the "next" terrorist attack have been among the market's worst fears. Well, firstly, despite the tragic loss of life, the markets may have been relieved that the damage was not worse, and the death toll was not even higher. In addition, the markets may have sensed that the attack will galvanize support for a more global anti-terrorist campaign, so that it will no longer be just Bush and Blair against terrorism, but perhaps the entire civilized world. Finally, as selling dried up in the wake of the tragedy, market participants may have come to the collective realization that if GM's downgrade to junk, $62 oil and a terrorist attack could not put the market down, maybe the market does not want to go down. Maybe the market wants to go up.

As expected the FOMC raised the Fed Funds rate 25 basis points to 3.25% at its June 30 meeting, the ninth straight such increase since June 2004. Another 25 basis point hike in August to 3.50% now looks highly likely, as the June bounce back in the ISM's purchasing manager's index to 53.8 from 51.4 in May makes it much less likely that the index will fall below 50 in July—an event that has prompted the Fed to stop tightening in the past. A pause in September—which was priced into the Fed Funds futures market a month ago—also seems less likely. The futures market is now predicting a Fed Funds rate of 3.7% by September 30 and something over 3.8% by year-end 2005. Those forecasts are higher than they were a month ago, but lower than three months ago, as futures market participants struggle to decipher whether the economy is continuing to weaken or the so-called "soft-patch" is over. Nancy Lazar and Ed Hyman of ISI Group remain in the "slowdown" camp, but even they have been impressed with the U.S. economy's strength in June, and have recently raised their real GDP estimate for the second quarter to 3%.

In truth, over the last several weeks, U.S. economic data has been coming in surprisingly strong. In addition to the previously mentioned snap back in the June ISM, first quarter GDP was revised up (again) to 3.8% from 3.7%, the June Michigan consumer confidence index rose to 96.0 (versus an expectation of 94.6), May factory orders gained +2.9%, the June non-manufacturing ISM index rose to 62.2 from 58.5 in May, and June retail sales were the best in thirteen months. On the housing front, U.S. mortgage applications rose 9.6% in June, even as mortgage rates rose slightly for the month. Job growth in June was 146,000, lower than some forecasts, but still healthy. Month-to-month fluctuations aside, the U.S. economy has created over 500,000 jobs in each of the last three quarters, and the unemployment rate dropped to a new cyclical low of 5% in June, about half the level that prevails in many countries in continental Europe.

Outlook

We remain optimistic about the outlook for equities for the rest of 2005. As always, there are clouds on the horizon, but on balance, we believe the positives far outweigh the negatives. Having stated the bullish case for equities in some detail in previous letters, we simply recapitulate the key points here, elaborating where appropriate.

(1) Stocks rise with earnings. Though corporate profit growth has slowed from its exceptionally rapid pace last year, per share S&P 500 earnings should still grow more than 10% this year. Stock prices are highly positively correlated (over 0.90) with the direction of profits, not their rate of growth.

(2) Dividends are rising faster than earnings. Dividends are back in style and we think that is good news for investors. In the first quarter of 2005, corporate earnings grew by about 14% while dividends increased by almost 16%. In the second quarter, dividends jumped by 13%, almost double the rate of profit growth. Since dividend payout ratios are near historic lows, this appears to be a trend that could continue for several years to come. Since the end of 2002, thirty-three companies in the S&P 500 have initiated dividends, bringing the total to 384. Market participants are applauding the trend. So far this year, dividend payers in the S&P 500 have handily outperformed non-dividend payers, rising 2.9%, on average, versus an average decline of 1.5% among non-dividend payers.

(3) Valuations are attractive. At less than 16 times consensus 2005 earnings and boasting an earnings yield of 6.3%, we think stocks—as measured by the S&P 500—are attractive in both absolute terms and relative to competing alternatives.

(4) Fed Policy is evidence-based, not formulaic. In our view, the Fed is pursuing a very pragmatic, evidence-based, approach to monetary policy. They continue to believe their stance is accommodative, and that accommodation can be removed gradually. If the economy slows—and particularly if the ISM drops below 50—we believe the Fed will back off. If the economy reaccelerates, the Fed will probably continue to tighten. The important point, in our view, is that a Fed Funds rate of 3.25% and 10-year Treasury bond yield of 4% are not impediments to a rising stock market. The same goes for a 4% Fed Funds rate and 4.5% to 5% 10-year, provided the economy continues to chug along.

(5) Corporations are beginning to open their purse strings in ways that are beneficial to shareholders. As we have noted previously, corporations are in their best shape in decades, with record cash as a percentage of assets, and huge free cash flows. After an extended period of caution, corporations are starting to spend. Dividends are growing faster than earnings, share buybacks are at record levels, M&A activity is accelerating and capital spending appears to be in the early to mid-stages of a meaningful recovery. We regard this as very good news.

Areas of concern remain pretty much the same: housing, oil, protectionism and the trend of earnings. The amount of ink devoted to the coming bursting of the "housing bubble" is truly remarkable. If, and when, it finally arrives, no one will be able to say they weren't warned. Our view is that downturns in housing have normally been the result of downturns in the economy, rather than the cause of them. As long as employment and consumer incomes continue to grow at a healthy clip, and mortgage rates stay at, or near, current levels, we think the likelihood of a meaningful decline in housing is relatively small. We believe the "canaries in the coal mine" are California and Florida, and are monitoring development there for signs of weakening price trends.

We have been surprised by the persistent strength in oil prices and are coming around to the view that it may well be "different this time," in the sense that high prices are being driven by the inexorable growth of demand rather than disruptions in supply, as in the past. That said, in the short-term we continue to believe that prices are due for a pull back, and are, therefore, not inclined to initiate new positions at this time. Longer-term, as Bill Miller has said in a number of recent forums, we continue to study and monitor the energy area carefully.

Protectionism remains a key threat to the equity market in our opinion, and we are monitoring developments in the U.S. Congress, hoping that recent protectionist rhetoric does not become policy reality.

Finally, we continue to watch the trend of corporate earnings for signs of a downturn. Up to this point in the recovery, earnings have beaten expectations fairly consistently. We think the consensus is still a bit pessimistic, but only time will tell. The strength in the dollar—if it persists—may create a bit of a headwind for profits in the latter part of this year and into 2006.

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

David E. Nelson, CFA
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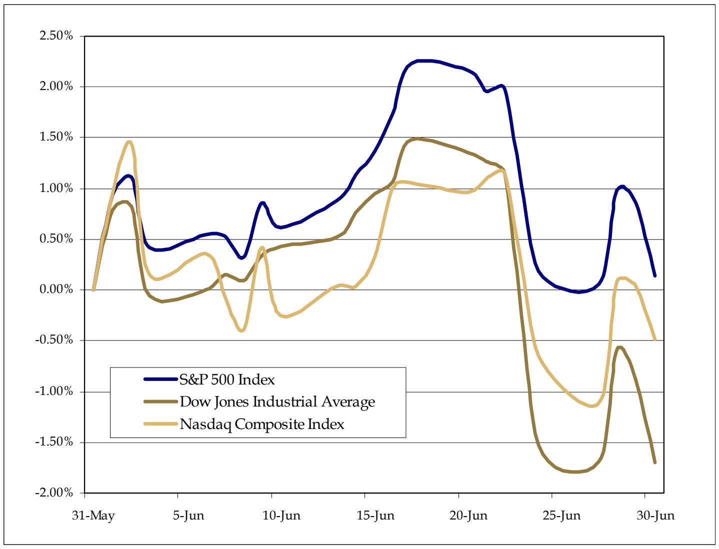
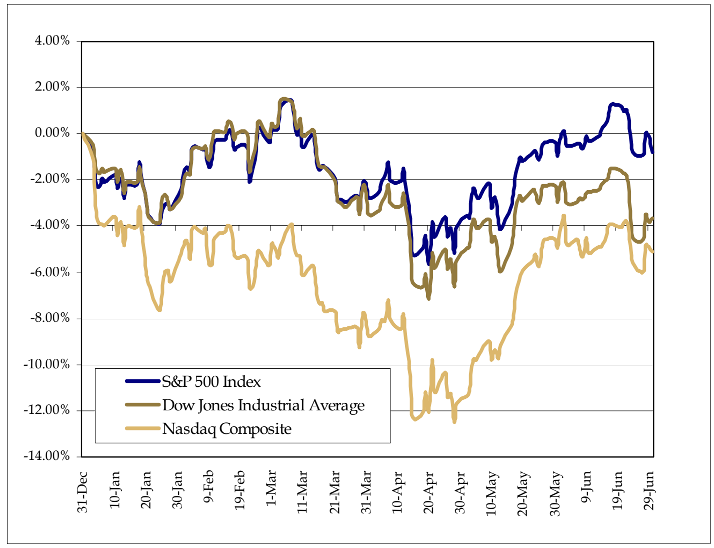
Major Indices June Performance



Source: Bloomberg and FactSet

Major Indices YTD Performance



Source: Bloomberg and FactSet

Monthly U.S. Market Update (Total Returns)

	June	Q2	YTD
Broad Market Indices			
S&P 500	0.14	1.37	(0.81)
Dow Jones	(1.70)	(1.63)	(3.65)
Russell 1000	0.41	2.05	0.11
NASDAQ	(0.48)	3.07	(5.12)
Wilshire 5000	0.90	2.47	0.02
Russell 2000	3.86	4.32	(1.25)
Russell 1000 Growth	(0.37)	2.46	(1.72)
Russell 1000 Value	1.09	1.67	1.76
S&P 500 Sector Indices			
S&P 500 Consumer Discretionary	(0.05)	(0.99)	(6.63)
S&P 500 Consumer Staples	(1.82)	(0.63)	0.04
S&P 500 Energy	5.83	1.99	19.92
S&P 500 Financials	1.43	4.32	(2.33)
S&P 500 Health Care	(0.32)	4.13	3.51
S&P 500 Industrials	(2.66)	(3.32)	(4.86)
S&P 500 Information Technology	(1.73)	1.77	(5.70)
S&P 500 Materials	(1.82)	(9.47)	(7.83)
S&P 500 Telecomm Services	1.41	3.57	(4.49)
S&P 500 Utilities	5.83	9.31	15.24