July 2005

Market Commentary

The major U.S. equity market indices produced sizzling returns in July, matching the weather on much of the East Coast and other parts of the country. We've added a few more indices to our usual three—the S&P 500, Dow Industrials and Nasdaq Composite—both for greater completeness and because we want to make a few comments about the relative performance of various market sectors.

TOTAL RETURNS[1]

	July	YTD
S&P 500 Index	+3.72%	+2.88%
Dow Industrials	+3.72%	-0.07%
Nasdaq Composite Index	+6.24%	+0.80%
S&P Mid-Cap 400 Index	+5.25%	+9.30%
Russell 2000 Index	+6.34%	+5.00%
Dow Jones Wilshire 5000 Index	+4.19%	+4.21%

[1] Source: Bloomberg

Within the S&P 500 Index, returns for the month of July were positive in all ten sectors, but only four sectors—consumer discretionary, energy, information technology, and materials—outperformed the index. Financials were the weakest sector, up only 1.3% on a price-only basis for the month.

Returns for the S&P 500 and Dow Industrials—though strong—still trailed the other indices listed by roughly 50 to 260 basis points for the month, depending on the index. This wasn't supposed to happen. Entering 2005, many investors—ourselves included—expected large cap stocks to outperform their small and mid-cap counterparts this year. That may yet happen, but so far it hasn't.

For an explanation of why large cap stocks have underperformed smaller capitalization sectors so far this year, one need look no further than the top decile of the S&P 500. Through July, the largest 50 companies in the S&P 500 by beginning year market value were down 1.7%, while the other 450 stocks in the index were up 5.6% on a cap-weighted basis. The ten largest market cap companies as the year opened—General Electric, Exxon Mobil, Microsoft, Citigroup, Wal-Mart, Pfizer, Bank of America, Johnson & Johnson, American International Group and IBM—were down 3.3%, on average. Of these ten, only Exxon/Mobil and Johnson & Johnson were up through July.

This performance is quite a comedown from the late 1990's when mega cap stocks ruled the roost. As of the end of 1999, these same ten companies, six of which—GE, Exxon Mobil, Microsoft, Wal-Mart, Pfizer and IBM—were then in the top 10, traded at 38.4 times trailing earnings, a premium to the S&P 500's capitalization-weighted trailing P/E of 30.4X. The same ten stocks appreciated by 36.6% on a cap-weighted basis in 1999, more than 1700 basis points better than the S&P 500's price gain of 19.5% that year.

In 2000, the mega cap stocks in the S&P 500 began a period of sustained underperformance, which has continued through mid-2005. As of the end of July, the ten largest market cap companies as 2005 began trade at an 11% discount to the S&P 500 (14.5X to 16.3X) rather than the 26% premium they carried versus the market back in early 2000.

Why have these stocks underperformed for the last five years or so? Well, our take is that they got too expensive and have now underperformed for so long that investors have given up on them. Are they cheap enough to buy? With P/Es lower than the market, and dividend yields and returns on equity higher, they certainly seem to be worth a look.

There is a great scene in the 1980's classic "Footloose," starring Kevin Bacon, in which the Bacon character, Ren McCormack, goes up against the local alpha male, Chuck Cranston, in a game of "chicken." With a group of local teens watching, Ren and Chuck bear down on each other riding tractors on a gravel road between a hill and an irrigation ditch. The one who turns off the road first gets wet and is "chicken." Ren "blinks first" and starts to bail, but his shoelace gets caught in the accelerator and he can't jump off, so he hangs in there, forcing Chuck to swerve, sending him and his tractor into the drainage ditch.

What brought this scene to mind is that a similar game of chicken is now in progress between the Greenspan Fed and the long end of the bond market. So far, neither side has blinked. For its part, the Fed has shown its resolve by raising the Fed Funds rate 25 basis points at all ten FOMC meetings since June 2004, from 1% to 3.5%, and seems set to continue. The Fed Fund futures market is now pricing in two or three more 25 basis point rate hikes by December, to bring the Funds rate to between 4% and 4.25% by year end. A couple of months ago, during the economic "soft patch," we had thought that the Fed might get to 3.25% or 3.50% and then take a breather. The recent spate of strong economic numbers—especially the ISM Manufacturing Index's pop to 56.6 in July from 53.8 in June and 51.4 in May—now suggests to us that the futures market has it right, and that the Fed Funds rate will be 4% or higher by year end.

The 10-year Treasury bond has—uncharacteristically—maintained its steely resolve in its game of chicken with the Fed until very recently, when it may have "blinked" by rising in yield to over 4.4% from a recent low of about 3.9%. Even after the latest backup in yield, the 10-year Treasury still yields less than the 4.69% it did on June 29, 2004, when this tightening cycle began. The failure of long rates to rise as expected in the face of Fed tightening has been a puzzlement to many—including Chairman Greenspan, who has called it a "conundrum." In a recent speech reported by *The Wall Street Journal*, Federal Reserve Bank of San Francisco President Janet Yellen said the debate over the odd behavior of long rates "boils down to whether the [drop] is due to various 'special factors' operating independently of the current business cycle, or instead augurs bad economic news on the horizon." If "special factors," such as increased investor confidence that inflation will remain low, or purchases of bonds by foreign central banks, are the reason for low bond yields, "the federal funds rate probably needs to be somewhat higher than would otherwise be appropriate," Ms. Yellen said. But if the market is anticipating hard economic times, "a somewhat easier policy may be appropriate."

We think Ms. Yellen's comments neatly frame Chairman Greenspan's dilemma: namely, that depending on the reasons *why* long rates are so low, the Fed should either be tightening further or backing off. As we analyze it, Greenspan would prefer to see the 10-year Treasury yield back up a bit more—to between 4.5 and 5 percent—so that he can continue to raise the Fed Funds rate into the low 4's without inverting the yield curve. If 10-year yields do not rise, Chairman Greenspan will be faced with a decision as to what to do. Let's hope his shoelace doesn't get caught in the accelerator when it comes time for him to make it.

Outlook

More and more, the outlook for the equity market for the balance of 2005 is becoming a tug-of-war between long rates—which have recently begun to rise—and earnings—which have continued to exceed expectations. Our bet is still that stronger earnings will win out and drive stocks higher by year end. Our best guess remains a gain in the range of 10% for the S&P 500. In our judgment, the current 10-year Treasury yield of 4.4% is not a significant impediment to stocks' upward progress. Should the 10-year yield drift past 5%, it would begin to represent a headwind for stocks, in our opinion.

Without question, corporate earnings have continued to be a bright spot for the market. At the beginning of 2005, the bottom-up cap-weighted First Call consensus called for a 10.5% gain in S&P 500 earnings to about $73.80 for a year. Many market commentators viewed those numbers as too optimistic, and most top-down strategists were forecasting earnings gains in the mid single-digits for the year. Rather than being too optimistic, those bottom-up estimates now look too conservative. With the second quarter earnings reporting season almost complete, the new bottom-up consensus for 2005 is $75.60, up 13.3%. The preliminary outlook for 2006 calls for a further gain of 10.7%, to about $83.71. With nearly all of its constituent companies having reported, the second quarter of 2005 will mark the 13th consecutive quarter that the S&P 500 has recorded double digit year-over-year earnings growth. Once again, earnings for the vast majority of individual companies and for the index as a whole have exceeded expectations.

Skeptics will note that the second quarter also marked the sixth consecutive quarter in which year-over-year earnings growth slowed from the preceding quarter. Decelerating profit growth has been a major complaint of many who are negative on the market. Confounding the skeptics, however, the S&P 500 has returned 10% over those same six quarters, not an overwhelming gain to be sure, but proof enough that the market can rise in the face of decelerating profit growth.

The third quarter of 2005 will provide a bit of a challenge for the market as year-over-year consensus profit growth expectations—at +15.9%—seem a tad optimistic. The real challenge for the market through the balance of the year will be the behavior of long rates. The table below shows a rough estimate of how we think the rest of this year and the next could play out.

		Implied S&P 500 Prices Based Upon	
10-Year Treasury Rates	Implied P/E Multiple	2005 FC Consensus EPS(E) $75.60	2006 FC Consensus EPS(E) $83.71
4.0%	18.6X	1406	1557
4.5%	16.9X	1278	1415
5.0%	15.4X	1164	1289

Source: First Call (FC) for EPS estimates; LMCM Model

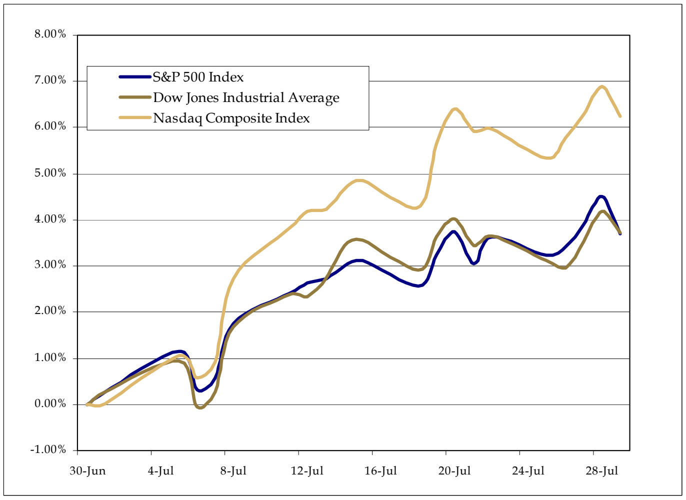
Using our base case long-term S&P 500 forecast, which calls for 6% earnings growth, a 20-year growth period, 16% return on equity and a 4% equity risk premium, the table above shows the implied price range for the S&P 500 based on First Call consensus estimates for 2005 and 2006 and the 10-year Treasury rate varying from 4% to 5%. For example, all other things being equal, a rise in the 10-year yield from 4% to 4.5%, reduces the warranted P/E of the S&P 500 from about 18.6X to 16.9X.

As we see it, these numbers suggest that from July month end levels, the S&P 500 has about 14% upside through the end of 2005, to 1406, and downside risk of about 5.7%, to 1164. Based upon our expectations of continued increases in earnings in 2006, we believe the market has upside in the range of 4% to 26% through the end of 2006.

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

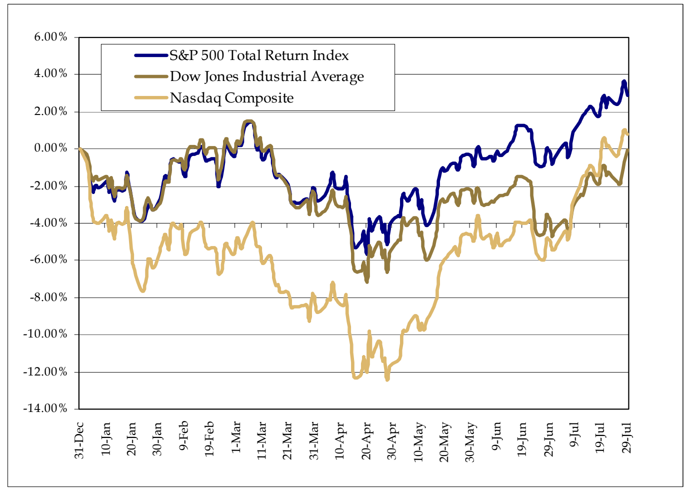
David E. Nelson, CFA
Director of Market Analysis
Legg Mason Capital Management

Major Indices July Performance



Source: Bloomberg and FactSet

Major Indices YTD Performance



Source: Bloomberg and FactSet

Monthly U.S. Market Update (Total Returns)

	July	YTD
Broad Market Indices		
S&P 500	3.72	2.88
Dow Jones	3.72	(0.07)
Russell 1000	3.89	4.00
NASDAQ	6.24	0.80
Wilshire 5000	4.19	4.21
Russell 2000	6.34	5.00
Russell 1000 Growth	4.89	3.08
Russell 1000 Value	2.89	4.71
S&P 500 Sector Indices		
S&P 500 Consumer Discretionary	5.61	(1.39)
S&P 500 Consumer Staples	3.09	3.13
S&P 500 Energy	5.78	26.85
S&P 500 Financials	1.52	(0.84)
S&P 500 Health Care	2.31	5.90
S&P 500 Industrials	3.33	(1.69)
S&P 500 Information Technology	5.86	(0.17)
S&P 500 Materials	5.36	(2.89)
S&P 500 Telecomm Services	3.99	(0.68)
S&P 500 Utilities	2.24	17.82

Source: Bloomberg and FactSet