

Market Commentary

The equity market languished in August, as oil again took center stage, followed late in the month by the devastating arrival of Hurricane Katrina.

TOTAL RETURNS¹

	August	QTD	YTD
S&P 500 Index	-0.91%	+2.77%	+1.94%
Dow Industrials	-1.20%	+2.48%	-1.26%
Nasdaq Composite Index	-1.41%	+4.74%	-0.63%
S&P Mid-Cap 400 Index	-1.11%	+4.08%	+8.09%
Russell 2000 Index	-1.85%	+4.36%	+3.06%
Dow Jones Wilshire 5000 Index	-0.98%	+3.16%	+3.19%

¹ Source: Bloomberg, Wilshire, Russell

The month began routinely enough with another Fed rate hike—the 10th since June 2004—bringing the Fed Funds rate to 3.50%. The FOMC’s accompanying statement that it still considered monetary policy to be “accommodative” seemed to convince the futures market that the Fed would take the Funds rate to between 4% and 4.25% by year-end. The hike precipitated a sell-off in the stock market and a rally in the bond market, as fears (if you owned stocks) or hopes (if you owned bonds) of a slowing economy resurfaced. The 10-year Treasury bond—which had yielded less than 4% in June—closed at a yield of 4.42% on August 8 (the day prior to the Fed’s August meeting). Following the meeting, the 10-year began a steady rally. By the time Katrina hit the Louisiana coast on August 29, 10-year Treasury yields had already dropped back into the low 4%’s.

Recent evidence of economic slowing in the U.S. includes weak chain-store sales in August, declining consumer confidence, an apparent cooling in the housing market, and a drop in money supply growth (M2M) to just 1.3% year-over-year. The recent slowdown in money growth is not just confined to the U.S., but is, in fact, a worldwide phenomenon. According to

GaveKal Research, such a downturn in global liquidity normally presages a slowdown in GDP growth.

The economic slowdown that appears to have been in progress prior to Hurricane Katrina will likely be exacerbated by the storm. Katrina’s devastating effects were pervasive: (1) 80% of the city of New Orleans under water; (2) 25% of U.S. oil production and 16% of U.S. natural gas production shut-in; (3) nine refineries processing a combined 2 million barrels per day of crude oil, out of commission; (4) soaring gasoline prices, now over \$3 per gallon in many parts of the country; (5) possible mudslide-induced damage to the latticework of undersea pipelines that brings oil and gas to shore from production platforms in the Gulf of Mexico; (6) disruption of grain exports from the Midwest; (7) sections of the Interstate 10 causeway across Lake Pontchartrain in pieces and impassable; (8) millions without power; (9) hundreds of thousands of people homeless and jobless, facing a rebuilding process that will take months, or even years; and, last but surely not least, (10) a death toll numbering in the hundreds.

Amid the mind-numbing barrage of gloomy statistics, rays of hope are beginning to emerge. After a troublingly slow and disorganized start, the process of recovery has begun. The city of New Orleans has been almost completely evacuated, two of three breaches in the city’s levee system have been closed, and some pumping stations have reopened. The grim chore of finding and identifying the dead has begun. The LOOP (Louisiana Offshore Oil Port)—which processes a million barrels a day of foreign oil (7% of U.S. imports)—appears to have been largely spared, has power and is operating at about 75% of capacity.

On a personal note, all 265 Legg Mason employees who live and work in the affected areas have been accounted for. Some have lost their homes and nearly everything else they own, but they are all alive and safe, and for that we are very grateful.

Notwithstanding the devastation that has occurred and the myriad of uncertainties that remain, thus far the U.S. equity market has reacted to the hurricane and its aftermath with a high degree of equanimity. The S&P 500 Index was up on Monday, August 29, the day Katrina made landfall on the Gulf Coast, and rose in three of the next five days, gaining over 2%. Like the market's rise in the wake of the London subway bombings, its advance in the aftermath of Hurricane Katrina may strike many as counterintuitive.

Upon reflection, we can think of two reasonable explanations for the market's behavior. First, the market appears to believe that the uncertainty created by Katrina, combined with the likelihood of its exacerbating any slowdown which might have already been in progress, will cause the Fed to back off and stop raising rates. On Friday, September 2, the Fed Funds futures market put the odds at 70% that the Fed would raise its overnight rate a quarter point to 3.75% in September. A week earlier, such an increase was seen as a virtual certainty. In addition, whereas the futures market had earlier expected three rate hikes between now and year-end, by September 2 it expected only one.

Paul McCulley, chief economist at fixed-income giant PIMCO, is even more optimistic. He believes the Fed will forego even the September increase. Which view is correct remains to be seen, but our opinion is that the market is correct in assuming that the Fed is no more than one hike from done.

The second possible explanation for the market's rise in the days following Katrina is the behavior of oil prices themselves. Not only have oil prices not risen as one might have expected, they have actually fallen. To be sure, product prices—gasoline and heating oil—have spiked up, but crude prices themselves are down several dollars per barrel since Katrina hit. President Bush's quick decision to make crude oil available from the strategic petroleum reserve, on loan, to Gulf Coast refineries was a psychological positive in this regard. Beyond that, the market may be sensing that the spike in product prices will induce the much-needed reduction in demand that is required to bring oil prices down on more than a temporary basis.

Outlook

The economic reverberations of Katrina make the near-term outlook more uncertain than usual. Questions abound. How long will it take before New Orleans is habitable again? How many people will return when it is? Will we, or even should we, rebuild in the lowest lying areas of the city? The answers to these and a myriad of other questions will not be known for months, if then.

In the midst of the uncertainty, we are inclined to take our cue on the outlook from the equity markets themselves, which seem to be saying that the disruptive effects of the storm are manageable and have increased the odds that the Fed is done, or nearly done, raising rates. If true, without the headwind of rising interest rates, investors might take more kindly to the prospects of an equity market that is priced very attractively—in our judgment—both on an absolute basis, and relative to competing alternatives.

On consensus forecasts, the S&P 500 is now trading at about 16.5 times 2005 estimated earnings and only 15.5 times preliminary 2006 numbers. Based upon our current fair-value P/E for the S&P 500 of 18, we judge the market to be about 9% undervalued based on 2005 estimates, and 16% undervalued based on next year's estimated earnings. The corresponding earnings yields of 6.1% (2005) and 6.4% (2006) suggest that the market is also attractive relative to 10-year Treasury yields in the low 4%'s.

The obvious risk to this scenario is that earnings turn out to be much weaker than consensus estimates. This possibility cannot be dismissed out-of-hand, since some economic slowing in the immediate aftermath of Katrina seems almost inevitable. Any such slowing only increases the likelihood, in our opinion, that the Fed will postpone further rate increases, and may even begin to cut rates if the slowdown persists. Then too, the rebuilding process following the clean-up phase of the recovery is likely to stimulate GDP growth.

Taking our cue from the equity market may seem a bit naïve. After all, the market is not always right in

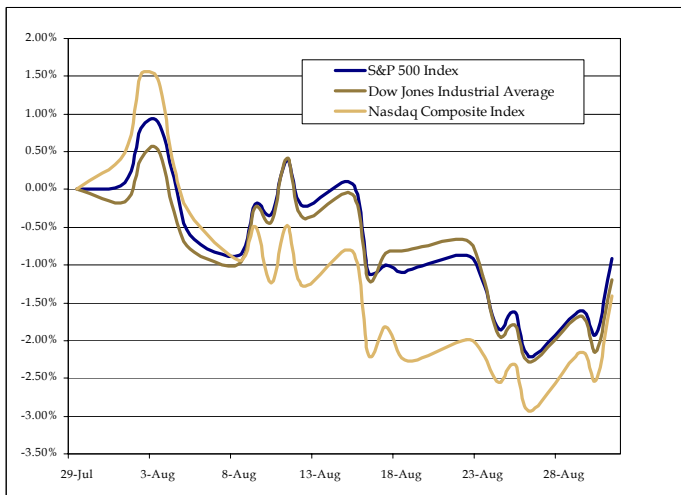
its assessment of events, and sometimes goes to ridiculous extremes. In our opinion, now is not one of those times. The U.S. economy and the U.S. equity market are the ultimate complex systems. They are ever-evolving, adapting and changing. When an event occurs that seems so obviously negative, and the market does not react negatively to it, we need to pay heed and ask ourselves why. Trying to fathom the twists and turns of the market is like playing chess against a grandmaster. We may be looking a move or two ahead, but we have to be mindful that the grandmaster is probably looking several moves beyond that.

For now, or until the facts dictate otherwise, we remain constructive on the outlook and believe the market will trade higher by year-end. With only four months left in the year and the market up only marginally to date, a full year gain of 10% looks like a bit of a stretch. But the market was up even less at this time last year, and finished 2004 with a total return of nearly 11%. We'll keep our neck out a while longer.

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

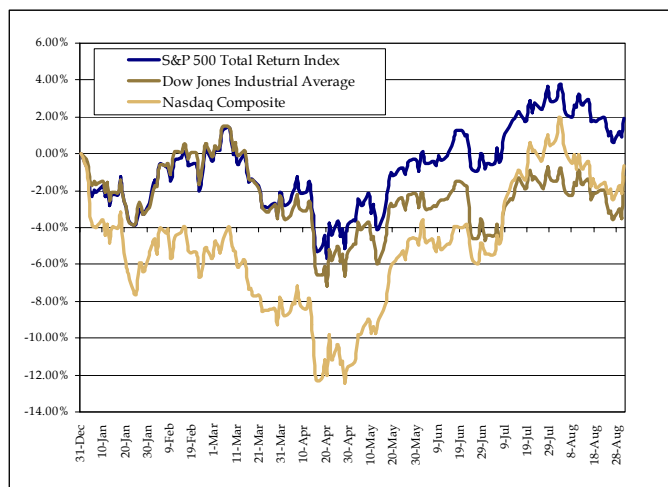
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Major Indices August Performance



Source: Bloomberg and FactSet

Major Indices YTD Performance



Source: Bloomberg and FactSet

Monthly U.S. Market Update (Total Returns)

	August	QTD	YTD
<i>Broad Market Indices</i>			
S&P 500	(0.91)	2.77	1.94
Dow Jones	(1.20)	2.48	(1.26)
Russell 1000	(0.87)	2.99	3.10
NASDAQ	(1.41)	4.74	(0.63)
Wilshire 5000	(0.98)	3.16	3.19
Russell 2000	(1.85)	4.36	3.06
Russell 1000 Growth	(1.29)	3.54	1.75
Russell 1000 Value	(0.43)	2.45	4.25
<i>S&P 500 Sector Indices</i>			
S&P 500 Consumer Discretionary	(3.38)	2.04	(4.72)
S&P 500 Consumer Staples	(1.44)	1.61	1.65
S&P 500 Energy	5.42	11.52	33.73
S&P 500 Financials	(1.75)	(0.25)	(2.58)
S&P 500 Health Care	(0.28)	2.03	5.60
S&P 500 Industrials	(2.23)	1.02	(3.88)
S&P 500 Information Technology	(0.19)	5.66	(0.36)
S&P 500 Materials	(4.02)	1.12	(6.80)
S&P 500 Telecomm Services	(3.47)	0.38	(4.13)
S&P 500 Utilities	0.89	3.15	18.87

Source: Bloomberg and FactSet

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