

Market Commentary

For only the second time since 1998, the S&P 500 Index posted positive returns in the third quarter. Returns across major market indices were fairly tightly bunched between about 3.5% and 5% for the quarter. Small and mid-cap indices continued to outperform, but not dramatically so.

TOTAL RETURNS¹

	September	Q3	YTD
S&P 500 Index	+0.81%	+3.60%	+2.77%
Dow Industrials	+0.94%	+3.44%	-0.34%
Nasdaq Composite Index	+0.04%	+4.78%	-0.59%
S&P Mid-Cap 400 Index	+0.77%	+4.88%	+8.92%
Russell 2000 Index	+0.31%	+4.69%	+3.38%
Dow Jones Wilshire 5000 Index	+0.70%	+3.88%	+3.91%

¹ Sources: Bloomberg, Wilshire, Russell

The market's performance in the quarter was impressive, coming as it did in the face of Hurricanes Katrina and Rita, soaring fuel prices and a Fed seemingly more worried about accelerating inflation than a slowing economy. The market has taken a tumble in the early days of the fourth quarter as signs of economic weakness proliferate. The apparent disconnect between what the market seems to fear—an economic slowdown—and what the Fed seems to fear—accelerating inflation—is worrisome. In fact, we would argue that it is the key risk to the market. In our opinion, if the Fed remains too focused on fighting inflation, it risks over-tightening and precipitating a major economic slowdown and possibly even a recession.

We acknowledge that core inflation is now running above the upper end of the Fed's "comfort zone" of 1% to 2%. Chairman Greenspan is mindful that past surges in oil and gas prices have sent inflationary ripples through the economy. He also seems to be worried about "froth" in the housing market, if his recent comments and the release of a Fed study on the ef-

fects of refi activity on consumer spending are any indication. The "hawkish" tone of the FOMC's statement accompanying its latest 25 basis point tightening in September seemed designed to convince the market of the Fed's determination to nip inflation in the bud. If there was any remaining confusion about the Fed's position, it should have been dispelled by Dallas Federal Reserve President Richard Fisher's comment on October 4 that inflation was at the upper end of the Fed's tolerance zone, and "shows little inclination to go in the other direction." The Fed's tough stance on inflation and determination to continue tightening may also be motivated in part by its dismay over the fiscal profligacy of Congress and the Bush Administration, who are falling all over each other to see who can spend the most money on rebuilding the Gulf Coast in the wake of Hurricanes Katrina and Rita. Then too, Chairman Greenspan probably does not want to leave his successor with an "inflation problem," and he appears willing to risk erring on the side of too much tightening rather than not enough.

From where we sit, this is not a risk worth taking. As we read the situation, the U.S. economy is slowing of its own accord and does not need a helping hand from the Fed. Even before the recent storms, we think consumers—particularly low-end consumers—were already being squeezed by higher fuel prices. The recent post-hurricane surge likely tipped them over the edge, in our opinion. If the September plunge in SUV sales at both Ford and General Motors is any indication, the "demand response" to soaring fuel prices that some have been predicting may be underway. The early October plunge in the non-manufacturing ISM from 65 in August to 53.3 in September suggests that the service-sector—where most of the jobs have been created in recent years—is cooling off. Even the red-hot housing market seems to be coming off the boil. According to a recent New York Times article entitled "Slowing Is Seen in Housing Prices in Hot Markets," more sellers are putting their homes on the market, houses are sitting longer and prices are no longer

increasing rapidly. In Manhattan, the average sale price fell almost 13% in the third quarter from the second, but was still 10% higher than a year ago. In Fairfax County, Virginia (a suburb of D.C.), the number of homes for sale in August rose 50% from a year ago. For-sale listings have also swelled throughout California, according to the California Association of Realtors.

According to a new Fed study with the catchy title “Estimates of Home Mortgage Originations, Repayments and Debt on One-to-Four Family Residences,” personally supervised by Chairman Greenspan, consumers monetized a stunning \$600 billion of their home values in 2004 via cash-out mortgage refinancing and home equity loans. That infusion of cash into consumers’ pocketbooks—equivalent to 7% of disposable personal income—was double the value of President Bush’s tax cuts, and helps explain why consumer spending has held up well so far this year in the face of surging energy prices. From this point forward, refi activity is unlikely to provide incremental stimulus, in our opinion. For it to continue to do so, either housing prices must continue to rise, and/or mortgage rates must continue to fall. Neither seems all that likely, in our view.

With their “refi ATM” suddenly out of cash, we think middle and lower income consumers will be increasingly squeezed by \$3 per gallon gas prices and soaring home heating bills this winter and are likely to pull in their horns. Since consumer spending accounts for about 70% of U.S. GDP, it seems all but inevitable that GDP growth will slow.

The good news here is that if GDP growth slows, energy prices should begin to moderate (as they already appear to be doing) and house prices should also level off. Greenspan’s “inflation problem” would then become self-correcting. We hope the Fed comes around to this view too. If not, the market could be in for some tough sledding.

Outlook

Despite the challenging current environment, we continue to be constructive on the equity market

on both a relative and absolute basis. Whether it will actually trade higher by the end of the year is an open question. We think so, and hope so, but we recognize that—as of October 5—the S&P 500 is back to “Go” again, and there are less than three months left in the year.

Our favorable disposition toward the market is primarily based on valuation. The S&P 500 Index is up over 50% since October 2002, but so are its earnings, so the market’s P/E multiple remains very modest at 14.1x 2006 cap-weighted, bottom-up consensus earnings. We regard the market’s resultant earnings yield (E/P) of nearly 7% as being quite compelling versus cash yields of about 4% and yields on the 10-year Treasury bond of about 4.4%.

Two recent studies reach substantially the same conclusion as we do. The first study, entitled “Valuing Equities and Bonds in a Risky World” (September 12, 2005), is by David Miles, a strategist with Morgan Stanley. Miles begins his piece by noting that “it is difficult to find a set of plausible assumptions about risk, and investors’ attitudes to it, in the world today that can explain both equity and bond valuations. There appears to be a disconnect between what is priced into equity and bond markets.” Using a model recently developed by Robert Barro, an emeritus economics professor at Harvard often mentioned as a likely future Nobel Prize winner, Miles concludes that under his “base case” scenario, equities are priced to return 7.6% real in the future, while the “safest” bonds are priced to return under 2% in real terms. One of these almost has to be wrong. Miles’ view is that equities are reasonably priced, while investors are substantially overvaluing the safety offered by top quality bonds. In an email exchange in late September, I asked Miles if one made the alternative assumption that bonds were correctly valued, wouldn’t it be the case that stocks were significantly undervalued? He allowed that this conclusion was a legitimate inference from his work.

The second study by Citigroup’s Equity Strategist, Tobias Lefkovich, called “Profound Statistical

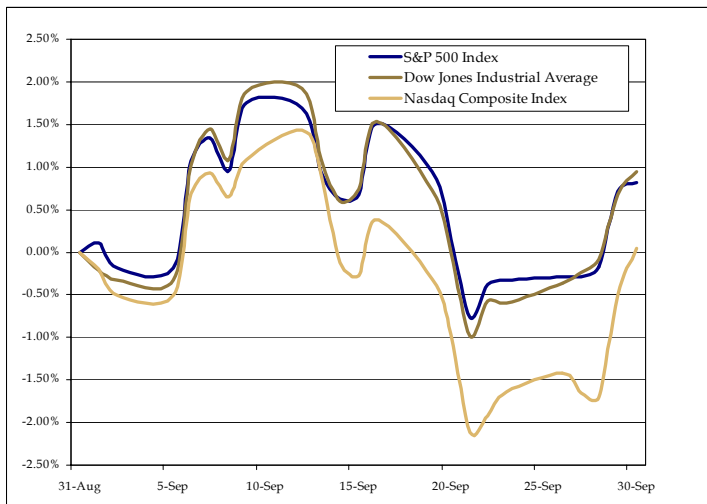
Bullishness” (September 30, 2005) evaluated the relationship between the trailing P/E of the S&P 500 Index and the combination of the yield on the 10-year Treasury bond and the equity risk premium. Lefkovich postulated that the relationship should be negative, meaning, for example, that a rise in either interest rates or the equity risk premium should lead to a decline in the S&P’s P/E ratio. Using monthly data from 1961 to the present, Lefkovich found the expected relationship with an impressively high correlation of 0.75. Lefkovich then analyzed only those monthly observations that were one standard deviation higher or lower than their predicted level based on the model’s best-fit regression line. The market’s performance in the ensuing 12 months under these circumstances was quite illuminating. Specifically, Lefkovich found that since 1961, when the actual trailing P/E was more than one standard deviation below the trend line P/E, the S&P 500 was up both six months and one year later *in every instance*. The average six-month gain was 13.1%, while the average 12-month appreciation was 25.3%. Since 13 out of the last 14 readings (including the latest for August 2005) have been more than one standard deviation below the mean regression line, the model is currently predicting sizeable gains for the S&P 500 Index over the next year.

In summary, investors are currently faced with the situation that stocks are statistically quite attractive, but their upward progress is being impeded by a laundry list of concerns. Our experience is that it is ever thus. Stocks do not get undervalued unless somebody is worried about something. The question is not whether there are problems. There are always problems. The question is whether those problems are already fully discounted or not. Obviously, we cannot be sure, but if the choice is between a rosy outlook and so-so valuation levels and a problematic outlook and attractive valuation levels, we’ll take the latter.

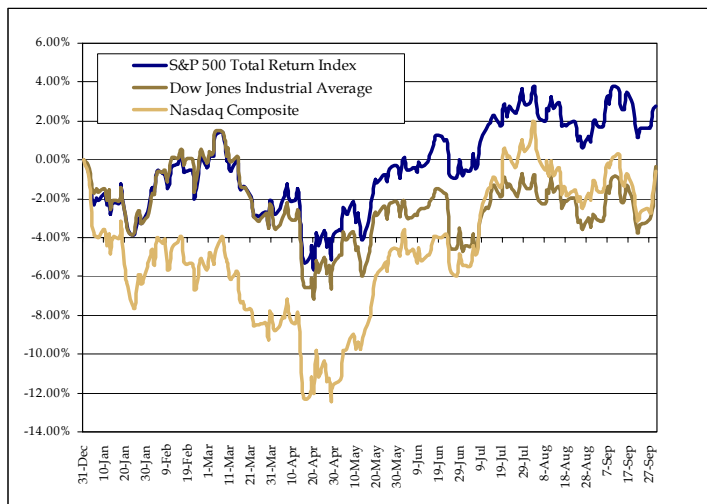
As always, we appreciate your support and welcome your comments.

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Major Indices September Performance



Major Indices YTD Performance



Source: Bloomberg and FactSet

Source: Bloomberg and FactSet

Monthly U.S. Market Update (Total Returns)

	September	Q3	YTD
<i>Broad Market Indices</i>			
S&P 500	0.81	3.60	2.77
Dow Jones	0.94	3.44	(0.34)
Russell 1000	0.93	3.95	4.06
NASDAQ	0.04	4.78	(0.59)
Wilshire 5000	0.70	3.88	3.91
Russell 2000	0.31	4.69	3.38
Russell 1000 Growth	0.46	4.01	2.22
Russell 1000 Value	1.40	3.88	5.72
<i>S&P 500 Sector Indices</i>			
S&P 500 Consumer Discretionary	(2.86)	(0.88)	(7.45)
S&P 500 Consumer Staples	1.44	3.08	3.12
S&P 500 Energy	6.03	18.25	41.80
S&P 500 Financials	0.92	0.67	(1.68)
S&P 500 Health Care	(0.61)	1.40	4.96
S&P 500 Industrials	1.37	2.41	(2.56)
S&P 500 Information Technology	0.29	5.96	(0.07)
S&P 500 Materials	0.78	1.91	(6.07)
S&P 500 Telecomm Services	(1.42)	(1.05)	(5.49)
S&P 500 Utilities	3.99	7.27	23.61

Sources: Bloomberg, FactSet, Russell

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