

Market Commentary

Stocks sold off again in October, which is nothing new, as they have been buffeted about all year long. This time, though, the decline was led by prior market darlings, the energy and utility stocks, which were down 9.3% and 6.3%, respectively, for the month.

TOTAL RETURNS¹

	October	YTD
S&P 500 Index	-1.67%	+1.05%
Dow Industrials	-1.09%	-1.42%
Nasdaq Composite Index	-1.38%	-1.96%
S&P Mid-Cap 400 Index	-2.15%	+6.57%
Russell 2000 Index	-3.10%	+0.17%
Dow Jones Wilshire 5000 Index	-1.74%	+2.11%

¹ Sources: Bloomberg, Wilshire, Russell

Mid and small cap stocks also underperformed the major large-cap indices, another interesting and potentially significant change. Lastly, market wallflowers—the financials—were the strongest sector in the market, up 3.2% for the month. Is this market action reflective of a normal correction in strong groups and a “dead-cat” bounce in weak ones, or does it presage a meaningful change in market leadership? Time will tell, but we’re inclined to believe the latter.

The market remained keenly interested in the Fed and the likely course of Fed policy in October. President Bush’s nomination of the Council of Economic Advisors Chairman, Ben S. Bernanke, to succeed Alan Greenspan as Fed Chairman in February 2006 was widely expected and met with nearly universal acclaim. Bernanke is well-qualified, in our judgment, and is expected to be confirmed easily by the Senate.

Also as expected, the Fed raised interest rates for the 12th time since June 2004 to 4% at their November 1 meeting. The Fed Fund futures market is now discounting two more 25 basis point hikes before

Greenspan’s term ends on January 31, 2006. Many observers expect Bernanke to establish his inflation-fighting credentials by hiking rates an additional 25 basis points to 4.75% at his first meeting as Chairman in March 2006. A minority view—held by such notable investment gurus as Pimco’s Paul McCulley and our own Bill Miller—is that the Fed will stop short of that level. In fact, following a recent television appearance on Wealth Track with Consuelo Mack, Paul and Bill authored a joint piece (available on Pimco’s website www.pimco.com) offering a paradoxical solution to the conundrum of why rising short rates have not led to higher yields at the long end. Their recommendation: in order to raise (long) rates, the Fed must stop raising (short) rates.

This writer comes down with his feet squarely on both sides of the issue. On the one hand, the Fed has made it abundantly clear that it is genuinely worried about inflation and seems willing to risk too much tightening rather than not enough. On the other hand, one cannot easily dismiss the views of two of the smartest observers on the investment scene today. In my opinion, what the Fed actually does with rates from here will depend on what the economy does in the three months between the November 1, 2005 and January 31, 2006 FOMC meetings. Lower oil prices and unambiguous signs of a slowdown in GDP growth should cause the Fed to back off. If the signals on economic growth and inflation continue to be mixed, I believe the Fed will keep tightening the screws to 4.75% or possibly even 5%.

As of now, the signals on growth remain mixed, but tending (in our opinion) toward the weak side. That said, those arguing that the economy remains robust have a good case. Real GDP growth in the 3rd quarter was an impressive 3.8%, marking the tenth straight quarter of growth above 3%. Personal consumption also grew 3.9%, versus an expectation of 3.3%. In addition, retail comp-store-sales rose 4.4% in September, again, better than was expected. On the industrial side of the economy, the ISM index

rose to 60 in October from 53.3 in September, the largest monthly increase since February 2002. Other signs of strength include productivity growth of 4.1% in the 3rd quarter, a 78% rebound in Baltic freight rates from their August lows, and copper prices near recovery highs.

The case for an economic slowdown, especially on the consumer side, is equally, if not more, compelling in our view. We made the case last month that the consumer—particularly the bottom 80% of the income distribution—was being squeezed fairly hard by high oil prices. The facts continue to bear that out. Consumer prices rose at their fastest pace in 25 years in October, and consumer spending on just four categories—medical, food, energy and interest payments—rose to a record 47.8% of disposable personal income (DPI). Debt service costs alone reached a record 13.6% of DPI. Job growth in October was a weaker than expected +56,000 (vs. +100,000 expected). According to data from ISI Group, U.S. home equity loan growth has weakened considerably due to the rise in the prime rate (off which most home equity loans are priced) from 4% to 7%. ISI's U.S. furniture buying index is also weak, as are car sales. GM, in particular, continues to struggle as its market share dropped to a record low in October on a continued slide in SUV sales. To top it off, a recent article in BusinessWeek (11/14/05) entitled, "Thirty and Broke," noted that the 30-something generation "could be the most indebted generation in modern history." Small wonder, then, that the University of Michigan's consumer confidence index in October fell to a 13-year low of 74.2.

Outlook

Turning to our outlook, we remind investors that things are not always as they appear, as residents of Turin, Italy will learn when McDonald's Corporation—responding to pressure from consumer groups—begins posting nutritional data on some product packages next February. (Turin, Italy? Well, I guess it's a start!) Anyway, after February, Turinites will probably not be shocked to learn that the infamous "Big Mac" contains 560 calories and 30 grams of fat. They may be surprised to

learn that a 1.5 oz. container of Creamy Ranch Sauce adds 200 calories and 21 grams of fat to their otherwise "sensible salad choice", thus rendering it almost as caloric and worse in terms of fat content than the artery-clogging Big Mac. So, what at first seems obvious turns out not to be so obvious after all.

We think something similar is happening in the U.S. stock market. It seems obvious to many that investors shouldn't own U.S. equities. A recent poll of 311 institutions by TimesOnLine (the Internet version of the U.K. Times) found that, "Institutional investors are more skeptical about the prospects for American equities now than during the depths of the Enron and WorldCom scandals." The study, which was commissioned by Merrill Lynch, concluded, "American equities are the most unpopular investment class in the world today." Echoing those sentiments, an October 17, 2005 USA Today headline blared, "Market Bears: Lack of Karma Spells Crash." These anecdotal readings are backed up by sentiment data tracked by veteran market technicians, Bob Farrell and John Mendelson. By Farrell's measures, "mid-October saw the most extreme selling... since 2003." Mendelson's put/call ratio (on a 5-day average basis) reached 118.8 on October 14—a higher (i.e., most bullish since it is a contrary indicator) level than those seen at the market's two most recent bottoms, April 2005 and August 2004. All of this data points to the conclusion that investors are feeling bearish, and—more importantly—acting bearish.

So, is it right to be bearish? We think not. Despite weakness in October, we continue to expect the market to give a good account of itself in the fourth quarter, and show respectable gains for the full year. We are encouraged by the fact that energy and utility stocks have taken a breather and have been replaced on the list of advancers by higher beta groups such as financials, technology and e-commerce stocks, which may be emerging as new market leaders.

We also continue to think the market looks attrac-

tive on a valuation basis, both absolutely and relative to competing alternatives. On a bottom-up, cap-weighted, First Call consensus basis, the S&P 500 Index trades at about 15.8X 2005 earnings estimates and 14.2X estimates for 2006. Assuming that the 10-year Treasury trades to yield between 4.5% and 5.0% in 2006, we think a fair value P/E range for the S&P 500 next year would be 15.5X to 17.0X. We thus believe the S&P has upside of between 10% and 20% over the next twelve to fifteen months.

We find ourselves especially drawn lately to mega cap stocks, which were hugely overpriced in 2000, but now trade at a discount to the overall market. The ten largest companies in the S&P 500 (by market capitalization) now trade at 14.0X 2005 earnings versus 15.8X for the S&P 500 as a whole, despite having better returns on equity and higher yields, on average.

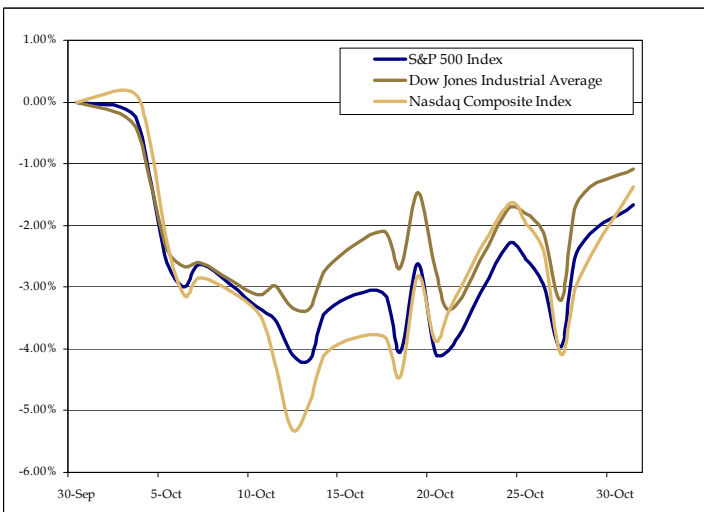
They say no one rings a bell at the top or bottom of the market, so nobody knows when the mega caps might wake up and start doing better. Come to think of it, though, the bell might have started ringing last week when Fidelity replaced Bob Stansky (a large cap guy) with Harry Lange (a small and mid-cap guy) at the helm of the \$52 billion Magellan Fund.

Speaking of bells, another might have been rung last week when several top oil executives—Lee Raymond (Exxon/Mobil), James Mulva (Conoco Phillips), John Hofmeister (Shell USA) and others—were summoned to our nation's capitol to answer charges from lawmakers that the energy industry is enjoying record profits at the expense of American consumers. If that's not a sign that energy prices have peaked at least for the time being, we'll be very surprised.

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

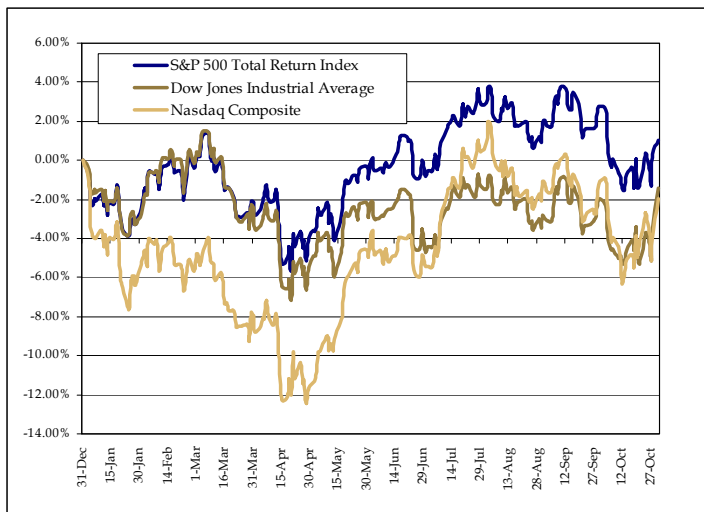
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Major Indices October Performance



Source: Bloomberg and FactSet

Major Indices YTD Performance



Source: Bloomberg and FactSet

Monthly U.S. Market Update (Total Returns)

	October	YTD
<i>Broad Market Indices</i>		
S&P 500	(1.67)	1.05
Dow Jones	(1.09)	(1.42)
Russell 1000	(1.75)	2.23
NASDAQ	(1.38)	(1.96)
Wilshire 5000	(1.74)	2.11
Russell 2000	(3.10)	0.17
Russell 1000 Growth	(0.97)	1.23
Russell 1000 Value	(2.54)	3.03
<i>S&P 500 Sector Indices</i>		
S&P 500 Consumer Discretionary	(1.97)	(9.27)
S&P 500 Consumer Staples	(0.27)	2.84
S&P 500 Energy	(9.34)	28.55
S&P 500 Financials	3.16	1.43
S&P 500 Health Care	(2.94)	1.87
S&P 500 Industrials	(1.12)	(3.65)
S&P 500 Information Technology	(2.19)	(2.27)
S&P 500 Materials	0.52	(5.59)
S&P 500 Telecomm Services	(1.22)	(6.65)
S&P 500 Utilities	(6.33)	15.79

Sources: Bloomberg, FactSet, Russell

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