

Market Commentary

The U.S. equity market has gotten off to one of its best starts in several years in the first two months of 2006. In terms of the S&P 500 Index, 1998 witnessed the best two-month start in the last ten years, up 8.40%, while 2004 also nosed out this year's first two months, up 3.25%. For those keeping score, the S&P 500 finished 1998 up 28.58%, while its full-year return in 2004 was 10.88%. We believe something in between those two figures, tending more toward the lower end, is a reasonable expectation for 2006. Of course, that remains to be seen.

**TOTAL RETURNS**

	February	YTD
S&P 500 Index	+0.27%	+2.93%
Dow Industrials	+1.48%	+3.00%
Nasdaq Composite Index	-0.97%	+3.66%
S&P 400 Mid-Cap	-0.84%	+5.01%
Russell 2000 Index	-0.28%	+8.67%
Wilshire 5000	-0.05%	+3.52%

Sources: Bloomberg, Wilshire, Russell

As this is written, the yield curve remains remarkably flat, but has shifted higher by about a quarter of one percent, such that 2-year, 10-year and 30-year Treasury yields are now all within a few basis points of 4.75%. The Fed Funds futures markets now imply that it is a virtual certainty that the FOMC will bump the Funds rate another quarter point to 4.75% in March, and put the odds that the committee will go to 5% in May at about 3-to-1 in favor of an increase.

The market's increasing conviction that the Fed will raise the Fed Funds rate to 5% or higher is based principally, in our view, on the prospect of a snapback in first quarter real GDP growth to a range of 4.5% to 5%, with attendant concerns about rising resource utilization rates, accelerating cost trends—especially in unit labor costs—and rising long-term interest rates.

The recent backup in rates has raised concerns about the housing market, one of the most interest rate sensitive sectors of the overall economy. With those concerns in mind, we'd like to focus some attention this month on

the homebuilders—a sector we have recently added to a number of client portfolios where appropriate given the individual mandates. We do so for two reasons. First, because the homebuilders are a controversial group, we thought clients might be interested in our investment rationale. Second, and perhaps even more important, we think developments in the housing market may bear meaningfully on a number of important issues, including the likely course of Fed policy, the overall strength of consumer spending, and the resultant outlook for the economy and the equity market as a whole.

In terms of the group itself, the homebuilding sector has become a key battleground between the bears and the bulls. The bears say that housing is a “bubble” in the process of bursting. They argue that the era of multi-decade low interest rates and double-digit home price increases is over and that a major drop in housing activity and an outright fall in housing prices is now in prospect. The bulls—while acknowledging that a housing slowdown does, indeed, appear to be underway—focus, instead, on the numerous competitive advantages of, and still-robust opportunities for market share gains enjoyed by, the large publicly traded builders. The bulls also point to the favorable long-term trends in household formation and immigration that should mitigate the severity of any cyclical downturn in housing activity. Finally, the bulls note that the widespread expectation of a housing slowdown appears to be more than adequately reflected in the stock prices of the homebuilding group, which now trades at a 63% (no misprint) discount to the S&P 500 Index on a forward P/E basis.

Because we have chosen to invest a portion of clients' assets, where appropriate, in the homebuilding sector, we have obviously sided with the bulls. We believe the large publicly traded builders are secularly advantaged in a variety of important ways versus the smaller “mom-and-pop” builders who still predominate in the industry. In terms of how our investments in these companies may play out over the next several years, we think the performance of the U.K. homebuilders over the last couple of years offers a useful analog. The U.K. housing market peaked in 2004, about a year ahead of the U.S. market. At that time, a number of U.K. housing stocks traded in the range of 5 to 6 times earnings, reflecting considerable market skepticism about their prospects. Since 2004, the U.K. homebuilders have dramatically outperformed the overall U.K. market

and seen their P/E multiples expand to about 9 to 10 times earnings, despite the fact that earnings estimates have been revised downward moderately over the intervening period. If we're right in our assessment of the group, the same could happen to the U.S. homebuilders over the next year or two.

In a broader sense, we believe the importance of the housing sector to the overall economy is difficult to overstate. Housing activity has been a linchpin of strength for the U.S. economy over the last several years. In our view, one important reason that the 2001 recession was relatively short and shallow was because home price appreciation made consumers "feel richer," thus buoying consumer spending and largely offsetting the negative effects of the equity bear market of 2000-2002 on household balance sheets and net worth.

We see evidence of this on both the macro and micro levels. On the macro level, the Federal Reserve estimates that consumers extracted "net equity" of \$600 billion, or 6.92% of disposable income, from their homes in 2004 alone. On the micro level, data from the Federal Reserve's recently released triennial Survey of Consumer Finances is equally illuminating as to the central role that house price appreciation has played in maintaining the health of consumer balance sheets in recent years.

**Table 1**  
**Homeowner Profile**  
**(Median Values)**

	2004	2001	% Change
Income	\$55,200	\$55,500	(0.5%)
Holdings of Stock*	\$34,400	\$53,300	(35.5%)
Primary Residence:			
Market Value	\$160,000	\$131,000	+22.1%
Less: Mort. Debt	<u>\$95,000</u>	<u>\$74,600</u>	<u>+27.3%</u>
Net Equity	\$65,000	\$56,400	+15.2%
Net Worth	\$184,400	\$182,900	+0.8%

\*Includes direct ownership and stocks held in retirement and other managed accounts  
Source: Federal Reserve Board, Survey of Consumer Finances (2004)

The survey data in Table 1 show that median family income for homeowners actually declined modestly from 2001 to 2004, suggesting that consumer spending could easily have been much more muted during the period than

it actually was. The hit to stocks from the bear market of 2000-2002 is also evident in the data, as median holdings of stock (both direct and indirect) fell \$18,900 (35.5%), from \$53,300 in 2001 to \$34,400 in 2004. One cannot say with certainty what portion of the decline in the value of stock holdings was due to sales versus a decline in market value, but, since the percentage of homeowners that held stocks declined from 62% to 59.1% during the 3-year period, one can presume that both factors were at work.

What the data in Table 1 illustrate reasonably conclusively, in our view, is that, had housing prices not appreciated sharply between 2001 and 2004, median homeowner net worth would almost surely have declined. In addition, while the median value of stock holdings held in 2001 was roughly equal to median net home equity in that year, by 2004, net home equity was nearly twice as large as the value of stock holdings. Finally, since the value of the median homeowner's primary residence in 2004 was \$160,000 (4.65 times the value of stock holdings), a 5% gain (or loss) in the value of that home has roughly the same impact on household net worth as a 23% gain (or loss) in the stock market. In short, the 70% of U.S. families that comprise the homeowner group is more dependent upon and leveraged to the trend in home prices than in stock prices.

At this point, we are anticipating a decrease in the rate of growth in housing prices, or a possible flattening of prices for several years. Selected markets could see price declines, but there has never been a generalized decline in home prices on a national basis, and we do not expect one this time around either. If we are wrong about this and home prices do decline on a nationwide basis, our investment case for the builders would be weakened. We think such an eventuality would spell trouble for the overall economy and market as well.

## Outlook

We remain constructive on the outlook for the U.S. economy and the U.S. equity market. We have learned nothing in the first two months of the year to suggest that 2006 cannot produce low double-digit total returns for investors in U.S. stocks.

We expect reported real GDP growth to rebound sharply in the first quarter of 2006, to a range of 4.5% to 5%. We believe the reported number will overstate the underlying strength of the economy for at least three reasons: (1) the same quirks in the way quarter-to-quarter GDP growth is calculated that made the fourth quarter of 2005 look weaker than it actually was, will make the first quarter look stronger than it actually is; (2) a record warm month of January will

wreak havoc on seasonal adjustment factors for such industries as homebuilding; and (3) one-time post-Katrina reconstruction and recovery activity in the Gulf Coast region will temporarily inflate GDP figures.

Following the first quarter, we expect GDP growth to slow to the 3% range as the year progresses. We still believe that the Fed will raise the Funds rate one more time in March to 4.75%, then sit tight for a while. This view is now at odds with the Fed Funds futures market, which puts the likelihood of an increase to 5% in May at about 75%. While acknowledging that this could be right, we would note that in 1995 when the Fed stopped raising rates, the futures market was still pricing in additional rate hikes. So, while the futures market has been behind the curve in failing to anticipate the full extent of Fed tightening over the last year or two, at some point the futures market will anticipate rate hikes that don't actually happen. We think such a time could be approaching.

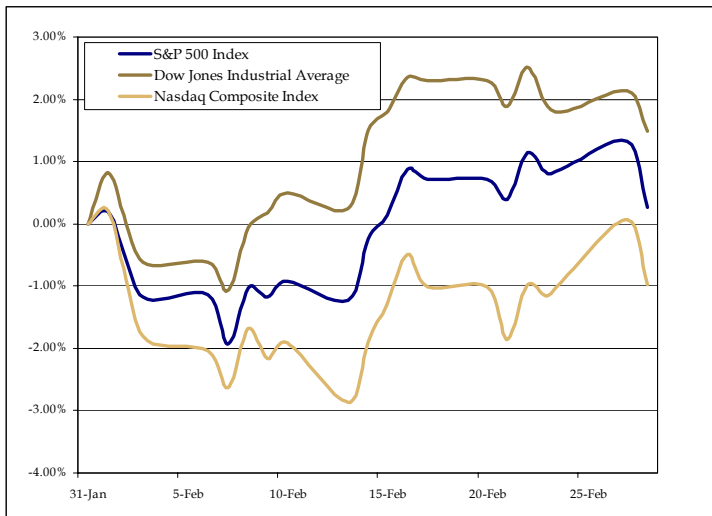
If we are correct that the Fed is near the end of its tightening regime, we think that would be very good news for the homebuilders and other interest-rate-sensitive groups, as well as for the market as a whole. If the Fed becomes too focused on fighting wage or commodity inflation and overdoes it on rate hikes, then the housing sector could be a principal victim. Because of the prominent role that housing values play in the health of household balance sheets and net worth, we don't think it would be the only victim.

Threading this needle will be Chairman Bernanke's first major challenge. He needs to slow the economy and the housing market without croaking either. We think he is up to the task, and we certainly wish him the best.

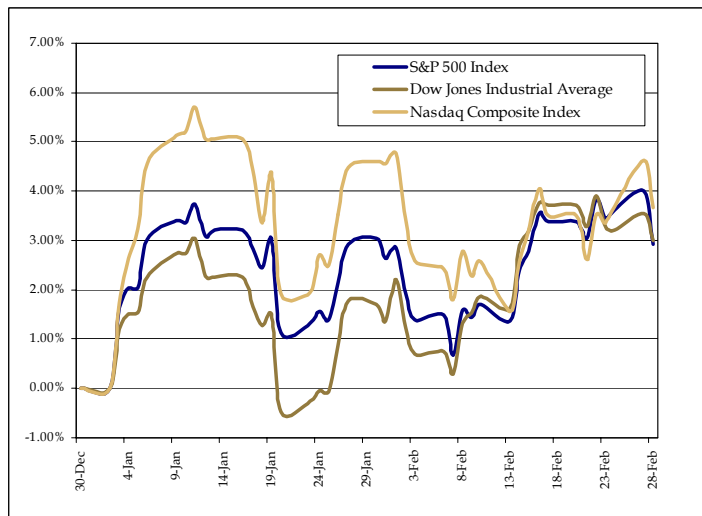
As always, we appreciate your support and welcome your comments.

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Major Indices February Performance



Major Indices 2006 Performance



Source: Bloomberg and FactSet

Source: Bloomberg and FactSet

Monthly U.S. Market Update (Total Returns)

Sector Index Name	February	YTD
<i>Broad Market Indices</i>		
S&P 500	0.27	2.93
Dow Jones	1.48	3.00
Russell 1000	0.22	3.03
NASDAQ	(0.97)	3.66
Dow Jones Wilshire 5000	(0.05)	3.52
Russell 2000	(0.28)	8.67
Russell 1000 Growth	(0.16)	1.59
Russell 1000 Value	0.61	4.52
<i>S&amp;P 500 Sector Indices</i>		
S&P 500 Consumer Discretionary	0.72	2.48
S&P 500 Consumer Staples	1.04	1.02
S&P 500 Energy	(7.81)	4.97
S&P 500 Financials	2.02	2.94
S&P 500 Health Care	1.02	2.52
S&P 500 Industrials	2.79	2.35
S&P 500 Information Technology	(0.88)	2.29
S&P 500 Materials	(1.84)	2.78
S&P 500 Telecomm Services	6.59	11.00
S&P 500 Utilities	1.11	3.60

Sources: Bloomberg, FactSet, Russell

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