

Market Commentary

April's market returns offered a glimmer of hope to long-suffering large cap devotees, as the granddaddy of all market indices, the Dow Jones Industrial Average, was the star performer for the month, up 2.48%, while the small cap Russell 2000 Index was actually down a couple of basis points. For the year-to-date, small and mid-cap stocks still lead the parade, but the Dow Industrials have begun to close the gap.

TOTAL RETURNS		
	April	YTD
S&P 500 Index	+1.34%	+5.61%
Dow Industrials	+2.48%	+6.83%
Nasdaq Composite	-0.71%	+5.62%
S&P Mid-Cap	+1.41%	+9.14%
Russell 2000 Index	-0.02%	+13.92%
Wilshire 5000	+1.06%	+6.65%

Sources: Bloomberg, Wilshire, Russell

Waiting for the turn in large cap relative performance is starting to feel like *Waiting for Godot*, but we hope not, since, in the Beckett play, Godot never shows up. A more apt analogy might be the boy who cried "Wolf!" By the time the turn in large caps actually comes, no one will believe it.

In addition to the decided preference investors have shown for small and mid-cap stocks over large caps for the last several years, they have also taken a liking to lower quality assets. GaveKal Research's Anatole Kaletsky calls it a 3-year "Dash for Trash," during which the lowest quality, most cyclical assets have been so much better performers than high quality assets, that "unpredictable earnings now command an absolute premium to steady growth. In the U.S. market, for example, stocks rated 'C,' the most speculative class in the S&P classification system, have appreciated by 17% this year, while the 'A' stocks have gone up only 1%. The 'A' stocks now

trade on an average P/E of 15 to last year's earnings, while 'C' stocks trade at a 17 P/E. High quality stocks are at a 16% discount to normal valuations, while low quality trades at a 36% premium."

What has precipitated this "Dash for Trash," and, more importantly, what might cause it to end? GaveKal Research's answer, which we find persuasive, is Japanese monetary policy. Unlike the U.S. monetary base, which has grown fairly steadily and in line with U.S. GDP growth over the years, the Japanese monetary base has been allowed to (caused to?) double in fewer than three years on three separate occasions in the last 35 years. Following the most recent doubling from 2001 to 2004, the Japanese monetary base is now actually larger than that of the U.S., quite remarkable for an economy less than half the size of our own. Each prior surge in Japan's monetary base (1971-1973, 1985-1987 and 2001-2004) has led to massive bull markets in real estate, share prices, commodities and gold, followed—after the expansion ended—by a serious market downturn. What makes this issue so important now is the fact that the Bank of Japan's (BoJ) three-pronged expansionary policy of quantitative easing (QE), zero interest rate policy (ZIRP) and exchange rate stabilization—in place for the last several years—may be beginning to change.

Japan's current monetary policy was born from a desire to stave off the deflationary bust that followed the bursting of its stock market and real estate bubbles in the late 1980's. In an effort to offset a collapse in monetary velocity (V) brought on by Japanese banks' near insolvency and consequent unwillingness to lend, the BoJ engineered a massive increase in the quantity of money (Q), and thus, the policy of QE was born. In conjunction with QE, the BoJ also implemented ZIRP and an exchange stabilization plan designed to hold the yen in a band of 105 to 120 to the U.S. dollar.

While entirely appropriate responses to the domestic circumstances they were designed to alleviate, these

policies have had two major—and in all likelihood, unintended—consequences for the world economy. First, they have encouraged the development of a massive, worldwide carry trade, whereby investors and speculators borrow in yen at near-zero rates, with minimal currency risk, to buy all manner of assets elsewhere in the world. Second, these policies' expansionary effects have served to at least partially undermine the tightening regimes undertaken by the U.S. Federal Reserve, the Bank of England and the European Central Bank over the last two years.

In the brave new world of global finance in which we live, GaveKal Research posits the existence of a "new yield curve," which looks not at the difference between U.S. long rates and U.S. short rates, but, rather, at the spread between U.S. long rates and Japanese short rates. Over the last ten years, fluctuations in the spreads of this "new" yield curve correlate highly with changes in the OECD's composite of leading indicators. The "new" yield curve also suggests that U.S. monetary policy is not currently as restrictive as it would appear to be when comparing only domestic long and short rates.

## Outlook

As we noted in our March Commentary, we continue to be constructive on the outlook for the U.S. equity market, but our optimism has been tempered somewhat by the rise in 10-year U.S. Treasury yields from about 4.35% at the beginning of the year to about 5.10% currently. This rise increases the cost of capital in our market valuation model from 8% to 9%, which, in turn, lowers the fair value P/E multiple of the market. Our latest work shows the S&P 500 Index to be roughly fairly valued based on this year's consensus earnings. We continue to expect earnings growth of about 10% in 2007 vs. 2006, and our best estimate is that the market will make upward progress of about that magnitude over the next twelve months. The range of outcomes around this central tendency is unusually wide at present, in our opinion, because the available evidence about the probable course of economic growth continues to be mixed and confusing.

In the current uncertain environment, the market has become especially sensitive to news items that suggest that the Fed either may, or may not, be done tightening. The release of the March Federal Open Market Committee (FOMC) minutes on April 18, 2006 caused the S&P 500 to surge 1.7%, as investors focused on the dovish sentence: "Most [FOMC] members thought that the end of the tightening process was likely to be near, and some expressed concerns about the dangers of tightening too much, given the lags in the effects of policy." Nine days later during Congressional testimony, Chairman Bernanke's comment that the committee may take no action at one or more upcoming meetings fueled a stock market rally on Thursday (4/27), and a subsequent decline occurred on Monday (5/1) when CNBC reporter, Maria Bartiromo, revealed that Chairman Bernanke had told her at a correspondent's dinner over the weekend that his comments had been "misinterpreted." Is this apparent waffling on Bernanke's part just a "rookie mistake" by an incoming Fed Chairman who needs to learn that people hang on his every word, or do they reflect genuine confusion on his part about what the Fed should do next? We think it is probably a little of both.

Based on Chairman Bernanke's April 27 Congressional testimony and the statement accompanying the May 10 FOMC meeting, the Fed continues to expect economic growth to moderate "toward a more sustainable pace" as the year progresses. Apart from a slowdown in housing, thus far the evidence to support that view is spotty. The Fed seems to be relying on the cumulative lagged effects of its 16 previous 25 basis-point rate hikes since June 2004, together with the dampening effects of \$70 oil prices and a continued cooling in the housing market to do the job.

Despite the fact that surging gold and commodity prices might argue against it, we think the Fed's slowdown scenario is still the most probable one for a number of reasons. First, the housing market does indeed seem to be slowing. Housing starts dropped 7.8% in March to 1.96 million units, while new home sales are off 21% in the five-month period through February. Mortgage rates above 6.5% appear to be beginning to bite. Second, \$70 oil prices are draining

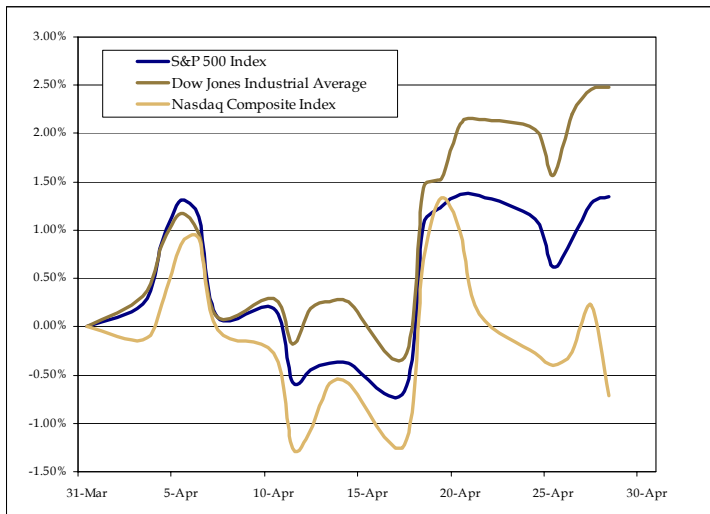
record amounts of liquidity from the coffers of developed nations and their citizenry. Third, employment growth appears to be moderating with April's job growth of 138,000 having come in below even the most pessimistic forecast among 74 economists surveyed. Fourth, and most importantly in our view, Japanese monetary policy has become more restrictive.

We noted in the Commentary section that Japan's expansionary monetary policy has been working at cross purposes to U.S. monetary authorities' efforts to tighten policy over the last two years. Apparently satisfied that the Japanese economy is on a sustainable growth path, the Bank of Japan (BoJ) has recently abandoned its policy of quantitative easing (QE). In fact, for the first time since 2001, the Japanese monetary base is now actually declining, as, incidentally, is the U.S. monetary base. In addition, the yen has begun to appreciate relative to the U.S. dollar, or the dollar has weakened vs. the yen, depending on how one looks at it. Thus, two of the three pillars of Japan's expansionary monetary policy have now been removed. One pillar remains, the zero interest rate policy (ZIRP). Its continuation may perpetuate the "carry trade" environment that has served as a key underpinning to the bull markets in commodities, gold, energy, emerging markets, junk bonds and small and mid-cap stocks. Should it too be removed or should speculators begin to shy away from borrowing in an appreciating currency, the stage would be set for a market environment that is much friendlier to high quality, U.S. large and mega cap stocks, and much less friendly to the lower quality, more cyclical and less liquid asset classes that have been the principal beneficiaries of the recent liquidity driven bull market.

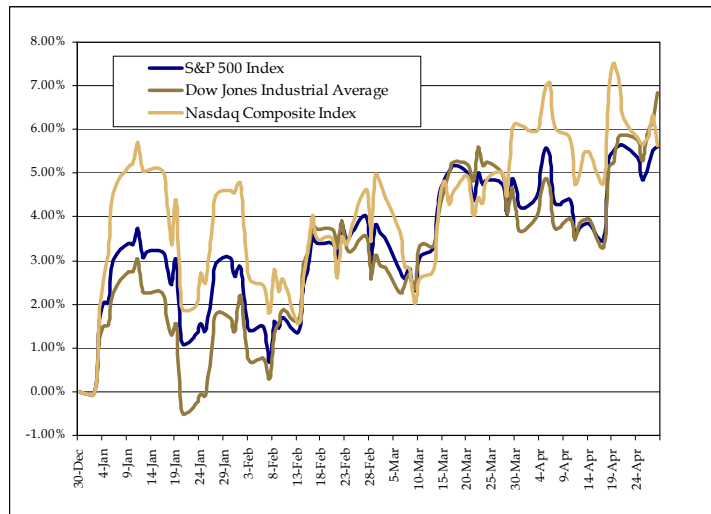
As always, we appreciate your support and welcome your comments.

**David E. Nelson, CFA**  
**Chairman, Investment Policy Committee**  
**Legg Mason Capital Management**

Major Indices April Performance



Major Indices 2006 Performance



Source: Bloomberg and FactSet

Source: Bloomberg and FactSet

Monthly U.S. Market Update (Total Returns)

Sector Index Name	April	YTD
<i>Broad Market Indices</i>		
S&P 500	1.34	5.61
Dow Jones	2.48	6.83
Russell 1000	1.20	5.75
NASDAQ	(0.71)	5.62
Dow Jones Wilshire 5000	1.06	6.65
Russell 2000	(0.02)	13.92
Russell 1000 Growth	(0.14)	2.95
Russell 1000 Value	2.54	8.63
<i>S&amp;P 500 Sector Indices</i>		
S&P 500 Consumer Discretionary	1.31	4.31
S&P 500 Consumer Staples	0.78	2.35
S&P 500 Energy	5.13	14.64
S&P 500 Financials	4.33	7.71
S&P 500 Health Care	(3.14)	(1.92)
S&P 500 Industrials	2.03	9.22
S&P 500 Information Technology	(1.15)	2.98
S&P 500 Materials	3.57	11.27
S&P 500 Telecomm Services	(2.16)	11.98
S&P 500 Utilities	1.59	0.41

Sources: Bloomberg, FactSet, Russell

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