LEGG MASON CAPITAL MANAGEMENT Month-End Commentary

May 2006

Market Commentary

May 2006 was a tough month for stocks in virtually every major equity market around the world. We probably should have been on our guard when *Barron's* ran a "Dow 12,000" cover story in its May 1, 2006 issue, a celebratory piece that proved to be premature. By the end of the month, investors' moods had soured considerably, and a bear appeared on the cover of the May 27, 2006 issue of *The Economist*.

TOTAL RETURNS

	May	QTD	YTD
S&P 500 Index	-2.88%	-1.57%	+2.57%
Dow Industrials	-1.46%	+0.99%	+5.27%
Nasdaq Composite	-6.10%	-6.77%	-0.82%
S&P Mid-Cap	-4.51%	-3.17%	+4.22%
Russell 2000 Index	-5.62%	-5.63%	+7.52%
Wilshire 5000	-3.12%	-2.09%	+3.32%

Sources: Bloomberg, Wilshire, Russell

As in April, the blue-chip oriented Dow Jones Industrial Average was the best performing major market index, and the only one that is up quarter-to-date. For those who have been anticipating a recovery in the relative performance of large cap stocks, the performance symmetry in May was perfect. The mega cap S&P 100 Index (-2.20%) outperformed the large-cap S&P 500 Index (-2.88%), which, in turn, outperformed the S&P Mid-Cap Index (-4.51%), which bested the small-cap Russell 2000 Index (-5.62%).

The pain was, by no means, reserved exclusively for US investors. International markets took a pasting as well. For the month, the FTSE (Britain), CAC (France) and DAX (Germany) were all down between 3% and 6%; the Nikkei (Japan), Hang Seng (Hong Kong) and Kospi (South Korea) indices were down between 3% and 8%; while Jakarta (Indonesia) was down almost 7%, and the Karachi (Pakistan) bourse lost over 10%.

In our opinion, the proximate cause of this global shellacking was the drying up of global liquidity that we noted in last month's commentary. For the first time in 15 years, the three largest central banks in the world—the US Federal Reserve (Fed), the European Central Bank (ECB) and the Bank of Japan (BoJ)—are all tightening monetary policy at the same time. This is not the sort of environment that is normally conducive to rising equity markets. Oil prices over $70 per barrel are also draining billions of dollars per day from the collective coffers of the developed world, putting a liquidity squeeze on nearly everyone, especially middle and lower income consumers.

As if liquidity worries were not enough, the market also seems to be especially jittery lately about the likely course of Fed policy and, in particular, whether the Fed can achieve its goal of engineering a slowdown in the economy without overdoing it and tipping the economy into recession. Until May, the "Goldilocks" scenario—that the economy would be neither "too hot" nor "too cold" but "just right"—seemed to hold sway among investors. At that time, many observers seemed convinced that the Fed might pause at 5.00% to assess the situation. But following an April inflation report that came in above expectations and some hawkish statements from Fed Chairman Ben Bernanke, the Fed funds futures market now rates the odds at a little better than 3-in-4 that the Fed will bump the funds rate by 25 basis points (the seventeenth such increase since June 2004 for those keeping score) to 5.25% at its next meeting in late June. Putting aside the question of whether the Fed should raise rates again in June, we are inclined to agree with the consensus that they probably will. Chairman Bernanke finds himself in a difficult position at present. After the airing of an off-the-cuff comment to CNBC reporter Maria Bartiromo that the market had misunderstood his earlier Congressional testimony, market participants seem concerned—wrongly, in our view—that Bernanke might not be taking the inflation threat seriously enough. In order to correct this perception and atone for what Bernanke himself terms a "lapse in judgment on my part," we think the Fed Chairman may now feel the need to layer on one or two more rate increases than would otherwise have been necessary to reestablish his inflation-fighting credentials and, thus, tamp down longer term inflationary expectations.

In our view, this situation raises the risk that the Fed will overdo its tightening and precipitate a downturn in the economy, rather than just a slowdown. As former Fed Governor Lyle Gramley notes in a recent strategy piece, entitled "Will the Fed Achieve a Soft Landing?", "the Fed does not have a particularly commendable record in this regard. On the contrary, during the 1950s, 60s, 70s, and 80s, efforts by the Fed to tighten monetary policy in order to contain inflation led to recurrent recessions." Gramley goes on to say that the Fed's recent track record in managing the economy has been more encouraging, as it successfully engineered a mid-cycle slowdown in 1994-1995, and acted aggressively to counter the effects of the bursting of the dot.com bubble in 2000.

Gramley, a close and knowledgeable observer of monetary policy, is optimistic that the Fed will succeed in pulling off a "soft landing" this time. He cites several factors in support of this view. First, "the firming of monetary policy since the middle of 2004 has been very gradual, permitting ample time for markets to adjust to it." Second, the inflation problem the Fed faces now is much less severe than in past expansions, reducing the need for harsh measures. Third, the Fed's success in maintaining price stability in the past decade has tended to anchor long-term inflation expectations, making it easier for them to deal with bouts of cyclical inflation.

Recent evidence suggests that the economy is, indeed, slowing. In addition to the housing market, which is clearly slowing, consumer spending appears to be moderating, probably reflecting the combined impact of high energy prices and the slowdown in home price appreciation. Employment data for May also confirm a slowing of economic growth in the second quarter. Payroll employment rose considerably less than expected, and there were downward revisions for the prior two months.

Factors suggesting that any slowdown in the economy will be contained include the facts that fiscal policy remains stimulative and the corporate sector continues to be very healthy. Capital spending remains strong, profits and cash flows robust, and inventory-to-sales ratios low.

In our view, the overall picture is consistent with a slowing, but still healthy, economy. In short, just what the Fed wants.

Outlook

The recent sell-off in the market and historical precedent suggest that the market could be in for some tough sledding between now and the fall. The market has an uncanny habit of making an important low every four years, often in October. According to veteran market strategist and technician Bob Farrell, seven of eleven four-year cycle lows since 1960 have come in October. The worst six months of the investment year have historically been May through October. Since 1950, the average price gain in the Dow Industrials over that six-month period has been 0.7%. In contrast, the Dow's average gain from the beginning of November until the end of the following April has been 7.9%, or more than ten times better. Also since 1950, of the 20 worst percentage decline months, eleven were in August, September, and October. Twelve of the 20 worst weeks over that same period were also in August, September, and October, with 7 of the 20 in October alone. The preceding data provide fairly strong evidentiary support for the old market maxim: "Sell in May and go away."

The damage done to the market in May, coupled with inflation worries, political uncertainties surrounding the mid-term elections, the continuing morass in Iraq, and fears that—in his efforts to reestablish his inflation-fighting credentials—Fed Chairman Bernanke may tighten "too much," has convinced some market commentators that a bear market has begun. Charlie Blood, chief market strategist at Brown Brothers Harriman, typifies this group. He is calling for a peak-to-trough decline in the market of about 15%. From the S&P 500's recent peak of 1325.76 (5/5/06), that implies a decline to about 1127, from which point Blood projects a solid up year in 2007. Perhaps it's just semantics, but we would call that scenario, should it occur, a severe correction, not a bear market. The classic definition of a bear market is a 20% or greater decline from a prior market peak. Anything less than 10% is normally classified as a correction. The 10% to 20% decline area is no-man's land, between correction and bear. Regardless what you call it, should it occur, it obviously wouldn't be much fun for equity owners.

While acknowledging that our previous expectations of low double-digit market gains for 2006 are now probably too optimistic, we remain constructive on the equity market and would view any weakness that might occur between now and the fall as a buying opportunity. Where the market actually ends the year will be dependent on how long and deep any correction might be, and how quickly the market recovers thereafter. Our main message is that we believe investors should be mindful of Warren Buffett's admonition to be "greedy when others are fearful, and fearful when others are greedy."

Our constructive attitude is based on the twin pillars of reasonable valuation levels and a still healthy outlook for corporate profit growth. Based on long-term assumptions we have detailed in prior commentaries, we estimate the S&P 500 Index to be worth about 15.4 times earnings. Interestingly (to us at least), that is exactly where the S&P 500 traded in relation to this year's consensus earnings at its recent high of 1325.76 (5/5/06). At its May month-end closing price of 1270.09, the S&P 500 was valued at 14.8 times 2006 cap-weighted, bottom-up consensus estimates for the S&P 500 companies, and 13.4 times expectations for 2007, implying a 10.7% year-to-year growth in earnings. From that 1270 level of the S&P 500, we see the market as about 4% undervalued on this year's earnings, and about 15% undervalued based on 2007.

To give a sense of what the market might look like after a 10% correction or (God forbid) a 20% bear market, we present the table below which shows where the market would trade on a P/E multiple basis if it underwent a 10% or 20% drop from its May 5 high based on current consensus estimates for 2006 ($85.70) and 2007 ($94.85).

% Decline From High	Implied S&P 500	Implied '06 P/E	Implied '07 P/E
10%	1193	13.9x	12.6x
20%	1061	12.4x	11.2x

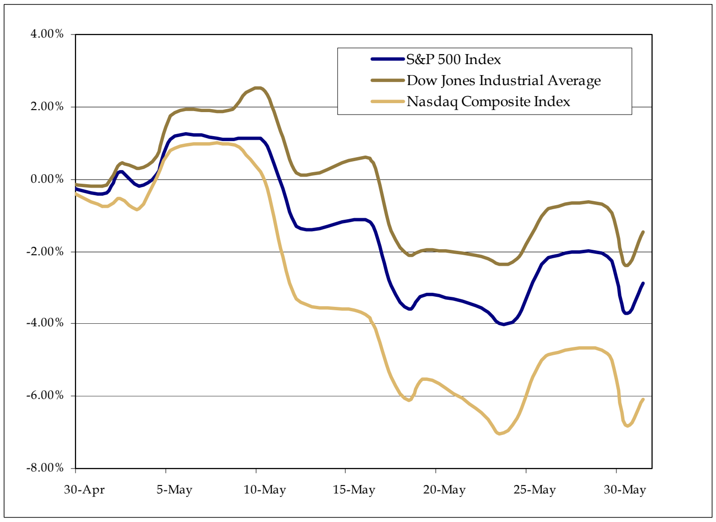
Following a 10% drop in the S&P, its earnings yield (E/P) would be nearly 7.2%, or more than 200 basis points higher than the current yield on the 10-year Treasury note. It has been our experience that earnings yield differentials of this magnitude or greater are very favorable for stocks. Assuming no change in earnings estimates, at 1193, the S&P 500 would have upside to our estimate of fair value of about 11% on 2006 estimates and 22% on 2007's expectations. At 1061, following a 20% drop, the S&P would be table-poundingly attractive, with upside to fair value of 24% on this year's estimates, and nearly 38% on 2007's.

Obviously, if long rates rise significantly or the earnings outlook deteriorates materially, then we'd have to take another look at the numbers. Whatever the course of the market for the remainder of this year, we believe that, in general, large cap and especially mega cap stocks offer the most attractive risk-reward profiles in the marketplace. Given the fact inflation is running only a bit above the Fed's comfort zone currently, and could well ease as the economy slows, we think the proper mindset for investors in the coming months is to be looking for buying opportunities while being respectful of the risks on the downside.

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

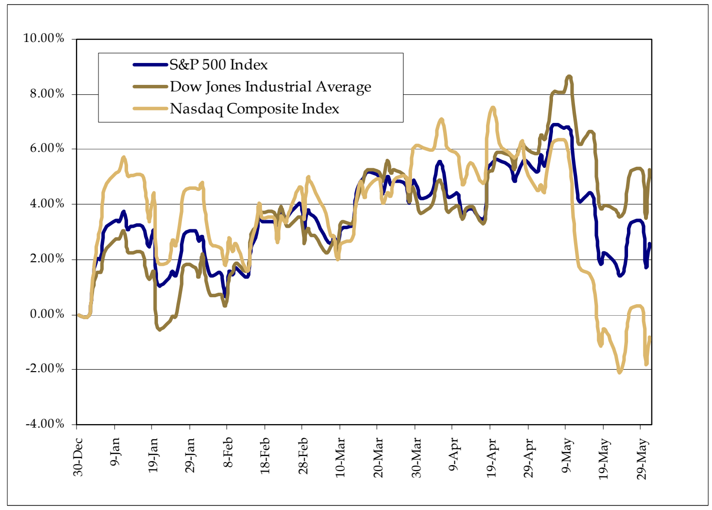
David E. Nelson, CFA
Chairman, Investment Policy Committee
Legg Mason Capital Management

Major Indices May Performance



Source: Bloomberg and FactSet

Major Indices 2006 Performance



Source: Bloomberg and FactSet

Monthly U.S. Market Update (Total Returns)

Sector Index Name	May	QTD	YTD
Broad Market Indices			
S&P 500	(2.88)	(1.57)	2.57
Dow Jones	(1.46)	0.99	5.27
Russell 1000	(2.95)	(1.79)	2.62
NASDAQ	(6.10)	(6.77)	(0.82)
Dow Jones Wilshire 5000	(3.12)	(2.09)	3.32
Russell 2000	(5.62)	(5.63)	7.52
Russell 1000 Growth	(3.39)	(3.52)	(0.54)
Russell 1000 Value	(2.53)	(0.05)	5.88
S&P 500 Sector Indices			
S&P 500 Consumer Discretionary	(1.51)	(0.22)	2.74
S&P 500 Consumer Staples	0.60	1.38	2.96
S&P 500 Energy	(2.84)	2.14	11.38
S&P 500 Financials	(3.68)	0.49	3.75
S&P 500 Health Care	(1.94)	(5.02)	(3.83)
S&P 500 Industrials	(1.58)	0.42	7.49
S&P 500 Information Technology	(7.05)	(8.11)	(4.28)
S&P 500 Materials	(4.03)	(0.61)	6.78
S&P 500 Telecomm Services	(2.99)	(5.08)	8.63
S&P 500 Utilities	1.59	3.20	2.01

Sources: Bloomberg, FactSet, Russell