June 2009

Market Commentary

The S&P 500 Index eked out a small gain in June, again frustrating those calling for a correction. As in May, the S&P underwent a mild intra-month correction, pulling back about -7% from its intraday monthly high of 956.23 on June 11, to an intraday low of 888.86 on June 23, but finished the month almost exactly where it began at about 919. Thus far, the market has really only undergone a sideways correction, closing June about where it traded in the first week of May. Encima Global chief, David Malpass, has noted an interesting tendency for the market to make interim lows in March, July and November in recent years. If that pattern holds, we could be in for a bit more of a pullback in July than we've seen so far.

Monthly returns for the major U.S. market indices were generally moderate, with the exception of the Nasdaq Composite Index, which gained a healthy +3.47% on the strength of the tech sector. The Dow Industrials fell in June and was the worst performer for the quarter, though still up a tidy +11.96%. The Nasdaq Composite and the Russell 2000 led the pack for the quarter, suggesting that the risk trade is alive and well. The S&P 500 Index's quarterly return of +15.93% was its best three-month showing since the fourth quarter of 1998.

TOTAL RETURNS

	June	QTD	YTD
S&P 500 Index	+0.20%	+15.93%	+3.16%
Dow Industrials	-0.41%	+11.96%	-2.01%
Nasdaq Composite Index	+3.47%	+20.34%	+16.98%
S&P MidCap 400 Index	+0.62%	+18.75%	+8.47%
Russell 2000 Index	+1.48%	+20.69%	+2.64%
Dow Jones US Total Market Index	+0.37%	+16.97%	+4.45%
S&P 100 Index	+0.64%	+14.59%	+1.02%
Russell 1000 Growth Index	+1.12%	+16.32%	+11.53%
Russell 1000 Value Index	-0.74%	+16.69%	-2.87%

Sources: Dow Jones, Russell®, NASDAQ® (via Bloomberg), S&P (via Bloomberg)

While June returns overseas were mixed with China showing notable strength and Russia notable weakness, on a quarterly basis, foreign market returns trounced domestic indices, with *every* foreign market listed above besting *all* domestic indices in dollar terms.

TOTAL RETURNS IN U.S. DOLLARS

	June	QTD	YTD
FTSE 100 Index (UK)	-1.52%	+26.48%	+11.46%
DAX Index (Germany)	-3.15%	+25.03%	-0.49%
CAC 40 Index (France)	-4.26%	+22.96%	+1.76%
MICEX Index (Russia)	-14.36%	+39.24%	+50.35%
NIKKEI 225 (Japan)	+3.83%	+26.71%	+6.46%
Hang Seng Index (HK)	+1.62%	+37.68%	+30.39%
Kospi Index (So. Korea)	-1.81%	+23.85%	+25.89%
Shanghai SE Comp. (China)	+13.45%	+26.11%	+64.18%
BSE Sensex 30 Index (India)	-2.20%	+58.65%	+53.33%

Source: Bloomberg

Two related market controversies continued to rage in June. First, is the market's advance since early March the beginning of a new bull market or merely a bear market rally? And second, if it is a new bull market, is it a cyclical or secular bull? We believe the weight of the evidence suggests that a new bull market began in March 2009. Last month, we cited the May month end bullish reading from Leuthold Group's Very Long-Term (VLT) indicator, originally developed by Edwin "Sedge" Coppock in the 1960s, as supportive of that view.

More bullish technical data emerged in June as the S&P 500's 50-day moving average crossed its 200-day moving average from below on June 23. This technical pattern—known as a "Golden Cross"—has historically heralded higher prices ahead over the next year for the stock or index in question. The pattern has proven to be most bullish when the 200-day moving average is declining, as it is now for the S&P 500. Since 1947, the S&P 500 has experienced 32 Golden Crosses, 20 when its 200-day moving was rising and 12 when it was declining. In the 12 cases where the 50-day moving average crossed above a declining 200-day moving average, the S&P 500 Index was up an average of +10% in the next six months and +18.7% over the next year, rising in the subsequent six- and twelve-month periods 11 of 12 instances, or 92% of the time, according to data from Birinyi Associates.

It may, at first, seem odd that the Golden Cross would be a more reliable predictor of higher prices ahead when an index's 200-day moving is declining than when it is rising. Upon reflection, though, it makes some sense as this pattern most commonly occurs during the latter stages of a recession after a steep market decline from which stocks have begun to recover. We take some encouragement from the fact that the Golden Cross pattern is not just evident in the S&P 500 Index, but in a wide variety of other market indices. In the last month or so, the 50-day moving average has crossed the 200-day from below in the Nasdaq Composite Index, the MSCI Emerging Market Index, the CRB Commodity Futures Index, the Silver Futures Index and the West Texas Intermediate Crude Index. In our view, this bullish pattern is evidence of an increasing appetite for risk across a broad range of asset classes.

Our bullishness over the next year or two is based principally upon our belief that the market will return to more normal valuation levels as the economy and corporate profitability recover from the severe economic downturn that we believe is bottoming, or will soon bottom out. Despite our optimism with respect to the next year or two, on a longer term basis, we believe the challenges of funding the health care and retirement needs of the baby boom generation within the context of a generally deleveraging economy may create strong enough secular headwinds that the major market indices do not reach new all-time highs before the next bear market sets in. If true, the current bull will have proven to be cyclical, rather than secular, in nature.

Probably the most significant, and least avoidable, headwind we see is the "global aging" wave that will transform the demographic structure of the developed world's population over the next several decades as a result of falling fertility rates and rising longevity worldwide. Throughout most of history, the elderly (aged 65 and over) comprised a relatively small percentage of the population—never more than 3 or 4 percent in any country until very recently. In the developed world today, they comprise 16 percent of the population, according to data from a recently (2008) published book entitled *The Graying of the Great Powers* by Richard Jackson and Neil Howe. By 2030, according to Jackson and Howe, the elderly will comprise 23 percent of the developed world's population, rising to 26 percent by 2050.

The age wave will hit all developed economies hard, but some harder than others. Because of its higher expected fertility rate (2.0%) and more liberal immigration policies, the U.S.'s total population is expected to continue to grow +40% by 2050, while the population of Western Europe is expected to stagnate at current levels, and the population of Japan is expected to fall by more the -20%. Jackson and Howe project that the U.S.'s relatively better population growth outlook will lead to faster real GDP growth rates than Europe or Japan, as well. They forecast baseline real GDP growth of a little over +2% between now and 2050 in the U.S., while they expect the growth rates in Western Europe and Japan over the same time period to average about +1.1% and +0.7%, respectively. As good as it is expected to be in a relative sense, the forecasted real GDP growth rate of +2% is still more than a full percentage point lower than the U.S.'s post-WWII average growth rate of more than +3%.

In addition to its implications for likely future GDP growth rates, the age wave has major implications for the projected costs of two of the "Big Three" entitlement programs—Social Security and Medicare. Jackson and Howe project that the cost of government old-age Medicare and Social Security benefits (what they call the "current deal") will rise from 9.3% of GDP in 2005 to 17.9% in 2030 and 21.4% in 2050. These increases will obviously put considerable strain on U.S. government finances and make running anything even close to a balanced Federal Budget a real challenge.

Outlook

We continue to be quite optimistic about the outlook for the U.S. equity market over the next year or two. We believe a cyclical bull market began in March 2009 that could carry the S&P 500 to between 1250 and 1350 by the end of 2010 or the first half of 2011. We think the impetus for rising stock prices will be a recovery in corporate profits as the U.S. economy emerges from its sharpest downturn in several decades. Unlike many other observers, who appear to expect a sluggish recovery, we think the severity of the previous downturn argues for a fairly sharp snapback in GDP initially, with growth leveling out at a moderate, but still attractive, rate after that. As the economy begins to improve, we believe the massive amounts of cash on the sidelines (variously estimated at between $4 and $8 trillion), earning next to nothing, could power a surprisingly strong advance in the market. To be sure, corrections will occur. Many observers believe one is overdue. In our view, the combination of improving fundamentals and the afore-mentioned boatload of cash on the sidelines, should limit corrections to -10% to -15%, and thus we would be surprised to see the S&P 500 break 800 on the downside.

In our opinion, the market was discounting a fairly high likelihood that we were entering another depression in early March. As that scenario came off the table, and the outlook improved from "dreadful" to merely "less worse," the market rallied sharply. We believe the "less worse" phase of the market's advance has about run its course and further sustained upside progress from here will have to be based upon actual improvement in the economy. Happily, we believe that is exactly what will happen in the second half of 2009. Our confidence is based on the fact that a wide variety of leading indicators of economic recovery are now flashing green.

Joe Kalish of Ned Davis Research Inc. (NDR) has identified 12 such leading indicators, all 12 of which are now pointing to an imminent improvement in economic activity. The leading indicators identified by NDR fall into seven categories: financial, employment/compensation, sentiment, housing, spending, manufacturing/inventories and composites. In the financial category, the S&P 500 Index turned positive in March 2009, while the yield spread between Moody's Baa bonds and long-term Treasuries turned bullish (ie., began to narrow) in December 2008. The two employment-related leading indicators—the one-month change in non-farm payrolls and the one-month change in the state diffusion index—turned positive in January and February 2009, respectively. The University of Michigan Consumer Sentiment Index bottomed out in November 2008. New home sales bottomed in January 2009. On the consumer spending front, the year-to-year change in personal consumption expenditures (PCE) on durable goods bottomed in October 2008. Both the manufacturing Purchasing Manager's Index (PMI) and inventory-to-sales ratio turned positive in December 2008. In terms of composite indices, NDR's own Economic Timing Model turned up in November 2008. The Economic Cycle Research Institute's (ECRI) Weekly Leading Index turned positive in March 2009. The final holdout had been the OECD U.S. Composite Leading Indicator (CLI). Based on data released on June 8, that indicator rose to 90.9 in April from March's 90.7 reading. Kalish noted in a June 12 NDR report detailing the April reading: "While the uptick is small in absolute terms (about half of its historical average), it is nonetheless significant, as the CLI has not retested its troughs in any of the recessions since 1955."

One thing we would find troubling, and which could derail our generally optimistic assessment of the next year or two, is if Fed Chairman Bernanke is not reappointed when his term expires in January 2010. By all accounts, President Obama is a big Bernanke fan, but we still worry a bit about the possibility that he will find it politically expedient to appoint a Democrat—Larry Summers, most likely—to replace him. We think this would be a huge mistake, to which the market could potentially react quite negatively, in our view. In our opinion, Chairman Bernanke has done a masterful—not perfect, but masterful—job of dealing with the current crisis. As a keen student of the Depression of the 1930s, we believe that Bernanke correctly understands that the "clear and present danger" for now and the immediate future is not inflation, but deflation. In view of the collapse in the velocity of money, triggered by the virtual shutdown of the shadow banking system and dramatic tightening of bank lending standards, we think Bernanke's trillion dollar-plus expansion of the Fed's balance sheet was exactly the right medicine, and likely prevented a depression from occurring.

Some commentators have criticized the Fed's aggressive expansion of its balance sheet, arguing that it will trigger a surge in inflation. We believe those criticisms are misplaced, for the time being, at least. Until the velocity of money starts to rise and loan growth picks up meaningfully, the chance that aggressive reserve expansion will trigger inflation is relatively minor, in our view. Former Fed Governor Alan Blinder expressed a similar view in a recent (6/21/09) Sunday *New York Times* editorial entitled, "Why Inflation Isn't the Danger." Blinder opined that the Fed is well aware of its responsibility to withdraw its extraordinary monetary stimulus when the time is appropriate and, in his view, has the competence to accomplish its goal of keeping inflation under 2%. Blinder notes that market implied inflation rates over the next 5 to 10 years as measured by TIPS/Treasury spreads are now comfortably below 2%. Blinder concludes his editorial with a series of rhetorical questions, which he answers persuasively, in our opinion:

> But if the inflation outlook is so benign, why have Treasury borrowing rates skyrocketed in the last few months? Is it because markets fear that the Fed will lose control of inflation? I think not. Rising Treasury rates are mainly a return to normalcy. In January, the markets were expecting about zero inflation over the coming five years, and only about 0.6 percent average inflation over the next decade. The difference between then and now is that markets were in a panicky state in January, braced for financial Armageddon; they have since calmed down. My conclusion? The markets' extraordinarily low expected inflation in January was both aberrant and worrisome—not today's. As long as expected inflation doesn't rise much further, you should find something else to worry about. Unfortunately, choices abound.

As always, we thank you for your support and welcome your comments.

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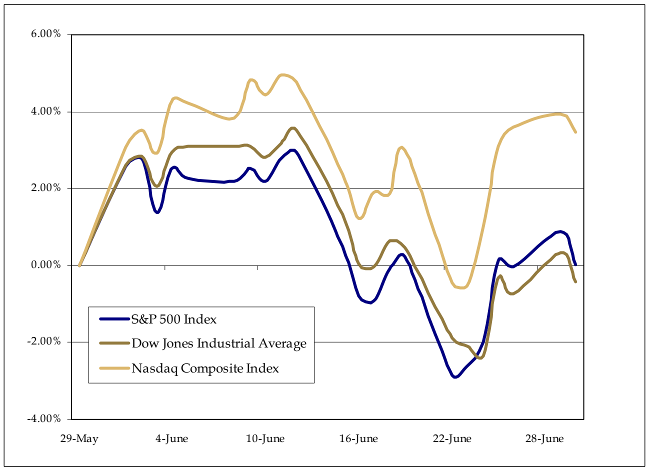
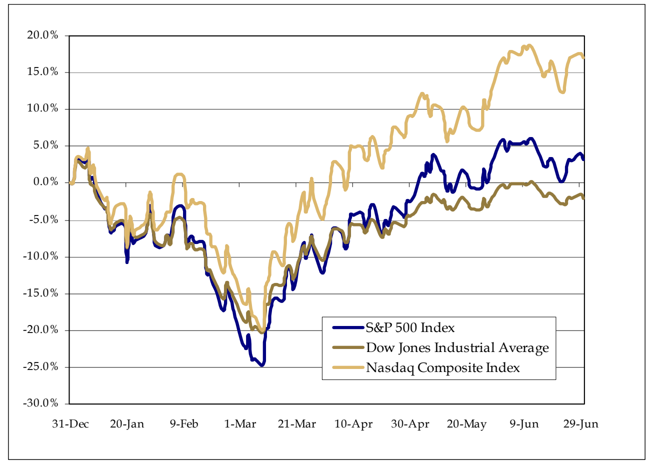
Chairman, Investment Policy Committee
Legg Mason Capital Management

Major Indices June Performance



Sources: Dow Jones, NASDAQ® (via Bloomberg), S&P (via Bloomberg)

Major Indices 2009 Performance



Sources: Dow Jones, NASDAQ® (via Bloomberg), S&P (via Bloomberg)

Monthly U.S. Market Update (Total Returns)

Index Name	June	Q2	YTD
Broad Market Indices			
S&P 500	0.20	15.93	3.16
Dow Jones	(0.41)	11.96	(2.01)
Russell 1000	0.24	16.50	4.32
NASDAQ	3.47	20.34	16.98
Dow Jones US Total Market Index	0.38	16.81	4.47
Russell 2000	1.47	20.69	2.64
Russell 1000 Growth	1.12	16.32	11.53
Russell 1000 Value	(0.74)	16.70	(2.87)
S&P 500 Sector Indices			
S&P 500 Consumer Discretionary	0.54	18.14	8.58
S&P 500 Consumer Staples	0.64	9.81	(1.76)
S&P 500 Energy	(4.60)	10.70	(2.11)
S&P 500 Financials	(2.10)	35.68	(3.40)
S&P 500 Health Care	2.65	8.88	0.17
S&P 500 Industrials	(2.13)	18.89	(5.93)
S&P 500 Information Technology	4.06	19.71	24.87
S&P 500 Materials	(4.62)	16.27	13.89
S&P 500 Telecomm Services	1.14	3.40	(3.97)
S&P 500 Utilities	5.55	10.17	(1.71)

Sources: Dow Jones, Russell®, NASDAQ® (via Bloomberg), S&P (via Bloomberg)