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MARKET COMMENTARY

1Q 2013

"Healing is a matter of time, but it is sometimes also a matter of opportunity."

- Hippocrates

Randy Befumo, CFA
Director of Research

Market Review

For the first time in four years, Santa failed to bring investors a rally for Christmas. Instead, partisan bickering over the so-called "fiscal cliff" put a lid on fourth-quarter gains. The broad S&P 500 Index declined 0.4% for the quarter, putting a damper on holiday cheer. This disappointing performance was in stark contrast to the gains St. Nicholas delivered in Q4 '09, Q4 '10 and Q4 '11. While "basically flat" was not exactly a Christmas to remember, investors did have some small consolation -- it could have been far worse. It was only four years earlier in 2008 that investors got a visit from the goat-headed Bavarian Christmas monster Krampus and were given a -23.0% lump of coal.

Apart from a disappointing Q4, investors had plenty to celebrate at the end of 2012, as the US economy continued to slowly heal. 2012 saw a +16.0% total return, the fourth consecutive positive annual result and the third double-digit gain in four years. An investor who bought the S&P 500 on December 31, 2008 is now 72.4% richer through the end of 2012, a tidy +14.6% annualized result. While hardly the *fin de siècle* +26.3% annualized returns seen from 1996 to 1999, this four-year return ranks well above the +10.1% annualized returns from 1900 through 2000. Apparently someone forgot to tell the US equity market it was supposed to post only so-so returns during the New Normal.

Exhibit 1. Annual Total Returns for S&P 500[1]

Year	Return
1996	23%
1997	33%
1998	29%
1999	21%
2000	-9%
2001	-12%

Year	Return
2002	-22%
2003	29%
2004	11%
2005	5%
2006	16%
2007	5%

Year	Return
2008	-37%
2009	26%
2010	15%
2011	2%
2012	16%

Reviewing the sector results, the long-awaited housing recovery drove this exceptional year. Financials rallied 6.0% in the fourth quarter, finishing 2012 in pole position with a 28.9% gain. Large-cap banks awoke from their post-2009 slumber, with previous goats Bank of America and Citigroup leading the charge. All banks benefited from a resurgence in home-price appreciation, *the* critical variable in the mortgage equation. According to the popular Case-Shiller index, home prices rose 4.3% in the twelve months ended October 2012, levels briefly glimpsed in early 2010 and otherwise not seen since the housing bubble. Shrinking mortgage losses and ongoing balance-sheet restructuring were the winds that filled the sails of Bank of America and Citigroup, driving 109.8% and 50.6% gains, respectively. Fellow mortgage giants JPMorgan and Wells Fargo also handily beat the market.

Consumer Discretionary rallied alongside Financials, posting a 2.3% gain in the fourth quarter that completed a 24.1% return for the full year. Not only does home-price appreciation shrink mortgage losses, it also leads to additional construction and perks up consumer spending through the magic of the wealth effect. House-related industries like home builders, appliance manufacturers, building products makers and home-improvement retailers all contributed mightily to the sector's advance. Not wanting to be left out, secularly advantaged Internet retailers like eBay and Amazon, traditional retailers like the Gap and Target, and online travel agent Expedia all posted strong performances for the year, cementing the sector's number-two spot for the year.

On the other side of the sector ledger, 2012 was a bad year for "Safety First" bond proxy investing (Exhibit 2). Among the worst three performers were ports in the storm Utilities and Consumer Staples, as well as former secular darling Energy. The modest 12 basis point decline in the US government ten-year note yield was not enough to buoy Utilities for a second year in a row, and the sector only managed a +1.3% total return for the full year. For Energy, the middling gain of 3.8% for Brent Sea crude in 2012 led to a tepid 4.6% gain for the oil-heavy index, despite US natural gas' 15.0% rally. Consumer Staples fared better than both with an 11.1% gain, although it still lagged the broader market, as weak pricing and volumes in the developed world more than offset quiescent commodities, putting a cap on appreciation.

Exhibit 2. S&P 500 Sector Indices[1]

Indexes (% change)	December	4Q12	2012
S&P 500 Consumer Discretionary	0.61	2.27	24.14
S&P 500 Consumer Staples	-1.88	-1.47	11.08
S&P 500 Energy	0.59	-2.71	4.64
S&P 500 Financials	4.80	6.01	28.92
S&P 500 Health Care	-0.20	0.07	17.89
S&P 500 Industrials	2.56	3.76	15.42
S&P 500 Information Technology	-0.02	-5.72	14.82
S&P 500 Materials	3.16	2.93	15.24
S&P 500 Telecomm Services	-0.91	-6.02	18.31
S&P 500 Utilities	0.05	-2.84	1.31

[1] *Source: Bloomberg (through December 31, 2012)*

Compared to sector results, returns by size and style were far less remarkable (Exhibit 3). For the full year, returns for all size categories were in a relatively narrow 200-basis-point band, with Mid-Cap's entire margin of victory for the year coming in December. Style told a similar story, with the Russell 1000 Growth and Value entering the fourth quarter in a dead heat and Value only pulling away by ~200 basis points in December. Similar performance from various size and style cohorts suggests a broad dispersion of value as all components benefit from the achingly slow, broad-based US recovery.

Exhibit 3. Broad US Market Indices[2]

Indexes (% change)	December	4Q12	2012
S&P 500 Index	0.91	-0.38	16.00
Dow Industrials	0.79	-1.74	10.24
Nasdaq Composite Index	0.63	-2.47	17.75
S&P Mid-Cap 400 Index	2.19	3.61	17.88
Russell 2000 Index	3.56	1.85	16.35
S&P 100 Index	0.30	-1.90	16.10
Russell 1000 Growth Index	-0.03	-1.32	15.26
Russell 1000 Value Index	2.07	1.52	17.51
Russell 1000 Index	1.04	0.13	16.46
Russell MidCap Index	2.25	2.94	17.66

While the US produced strong results in 2012, several international markets generated even stronger gains. Japan's inclusion in the 20%-plus club surprised many. Japan's new Prime Minister Shinzo Abe's economic program of nominal-GDP targeting coupled with powerful stimulus represents a departure from Japan's traditionally staid approach. With a 17.3% surge in the fourth quarter and a 10.2% gain in December alone, markets appear to like "Abe-nomics." Combined with ECB President Mario Draghi's quantitative easing, China's decision to increase their fiscal deficit to fund urbanization, and the modest deficit reduction that came from resolution of the US fiscal cliff, monetary and fiscal policy appears to be turning from austerity to stimulus in an attempt to accelerate the tepid pace of recovery.

Exhibit 4. Broad Foreign Market Indices[2]

Indexes (% change)	December	4Q12	2012
Local Currency			
FTSE 100 Index (UK)	0.62	3.53	10.61
DAX Index (Germany)	2.79	5.49	29.06
CAC 40 Index (France)	2.58	8.91	20.38
MICEX Index (Russia)	4.89	1.56	8.81
NIKKEI 225 (Japan)	10.18	17.33	25.47
Hang Seng Index (Hong Kong)	2.86	8.99	27.44
Kospi Index (South Korea)	3.33	0.05	9.40
Shanghai SE Composite (China)	14.60	8.79	5.83
BSE Sensex 30 Index (India)	0.51	3.77	27.99
Brazil Bovespa Index	6.05	3.00	7.40

[2] *Source: Bloomberg (through December 31, 2012)*

Comment

Reviewing the US record of economic growth since the financial crisis, it is hard to come away with any other conclusion than that the economy is slowly healing (Exhibit 5). In the three years through September 2012, the average growth in real GDP has been 2.3%. This is little more than half the 4.3% average growth seen from 1995 to 2000 and also below the 2.7% average increase experienced from 2003 to 2007. Perhaps most surprising, the average growth over the past three years is only ~50 to ~120 basis points better than the post-bubble *recession* levels of 2001 and 2002. Three years after the financial crisis, what we perceive as average would probably have felt like a mild recession if it had occurred in the 1990s.

Exhibit 5. Real GDP[3]

Year	Real GDP ($B)	Growth
1996	9,425.8	3.7%
1997	9,845.9	4.5%
1998	10,274.7	4.4%
1999	10,770.7	4.8%
2000	11,216.4	4.1%
2001	11,337.5	1.1%
2002	11,543.1	1.8%
2003	11,836.4	2.5%
2004	12,246.9	3.5%

Year	Real GDP ($B)	Growth
2005	12,623.0	3.1%
2006	12,958.5	2.7%
2007	13,206.4	1.9%
2008	13,161.9	-0.3%
2009	12,757.9	-3.1%
2010	13,063.0	2.4%
2011	13,299.1	1.8%
2012 (Sep)	13,652.5	2.7%

Recent medical research into “slow healing” wounds suggests that, at least for human injuries, more than 75% of the time there is an underlying pathology. Slow healing is not normal. Prior to 2009, when it came to recoveries after downturns, “worse was subsequently better.” The magnitude of the decline was directly proportional to the size of the recovery. MKM Partners’ Michael Darda conclusively showed that there were no exceptions to this pattern --- not even the Great Depression. Instead, in this recovery the normal economic healing process has been interrupted by some factor or combination of factors that we have not experienced in the modern era. While many are quick to diagnose indebtedness as the underlying cause, the failures of fiscal austerity in Europe and to a lesser degree the US do not seem to support this view.

Outlook

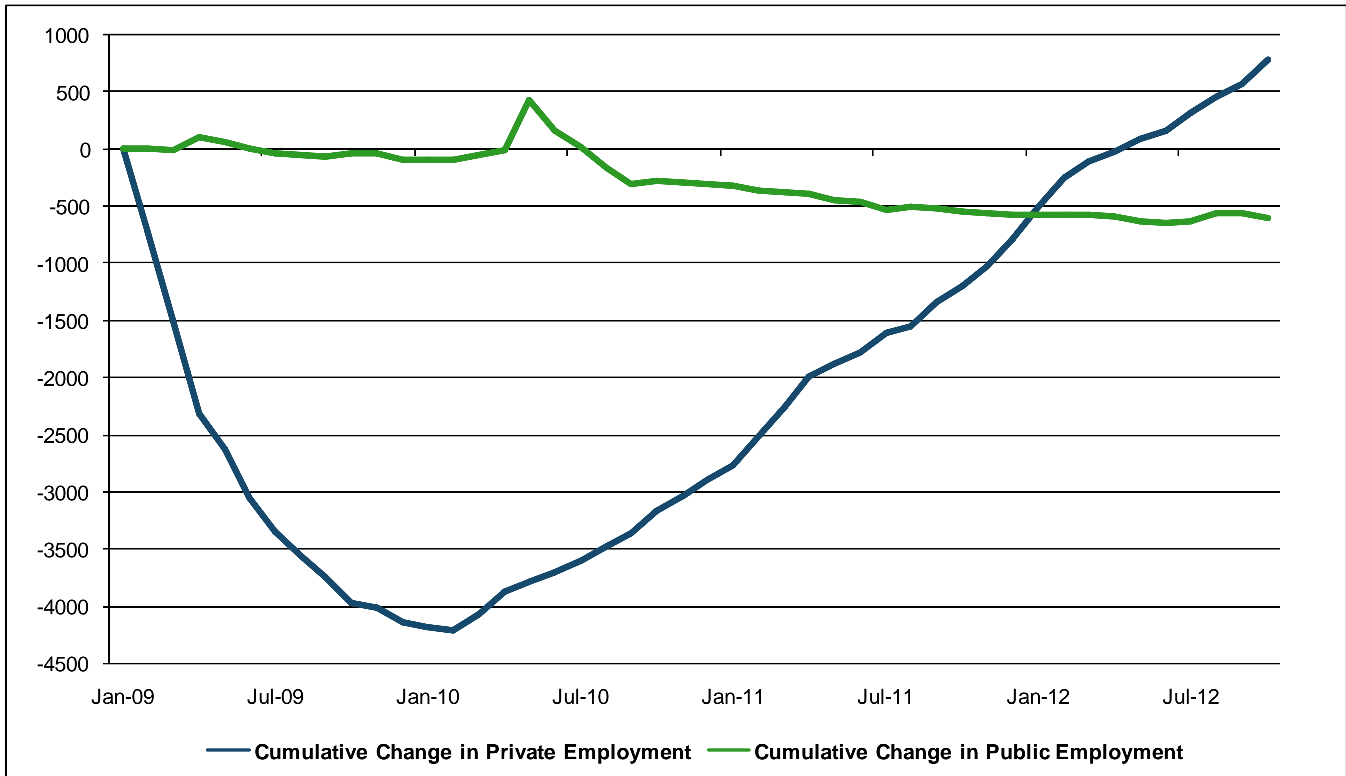
While it is hard to pinpoint the underlying disorder slowing the recovery, there is mounting evidence that it is abating, setting up the potential for stronger US economic growth. While initially dismissed by some as a weather anomaly, incremental evidence is signaling that the US housing sector continues to strengthen. Housing contributes directly to GDP in two ways: building houses and spending related to houses. The first two accounted for 17% to 19% of GDP from 1975 to 2005, but have more recently fallen to only 15%. A return to normal levels would boost GDP by ~290 basis points, pushing growth to levels last seen in the late ‘90s. It is inescapable that normalization in housing would be a big deal.

Beyond its direct impact on GDP, housing influences growth through the wealth effect – the increase in spending that accompanies an increase in perceived wealth. While a lack of quality data has impeded economists’ efforts to pinpoint the size of the wealth effect, there is general agreement that it is sizeable. Until this year, except for a brief respite in early 2010, the US economy has faced a negative wealth effect, dampening consumer spending and investment.

[3] *Source: Bloomberg (through September 30, 2012)*

While overall job creation has been mixed, a clear pattern has emerged with growing private payrolls offset by shrinking government payrolls over the last four years (Exhibit 6). Private payrolls have recovered decisively and are more than a million jobs ahead of January 2009 levels. At the same time, state and local governments under budget constraints have cut more than a half a million positions, triggering the greatest drawdown in government payrolls since the post-World War II decline. All these signs point to at least a continuation of the slow healing, absent policy mishaps or geopolitical disasters.

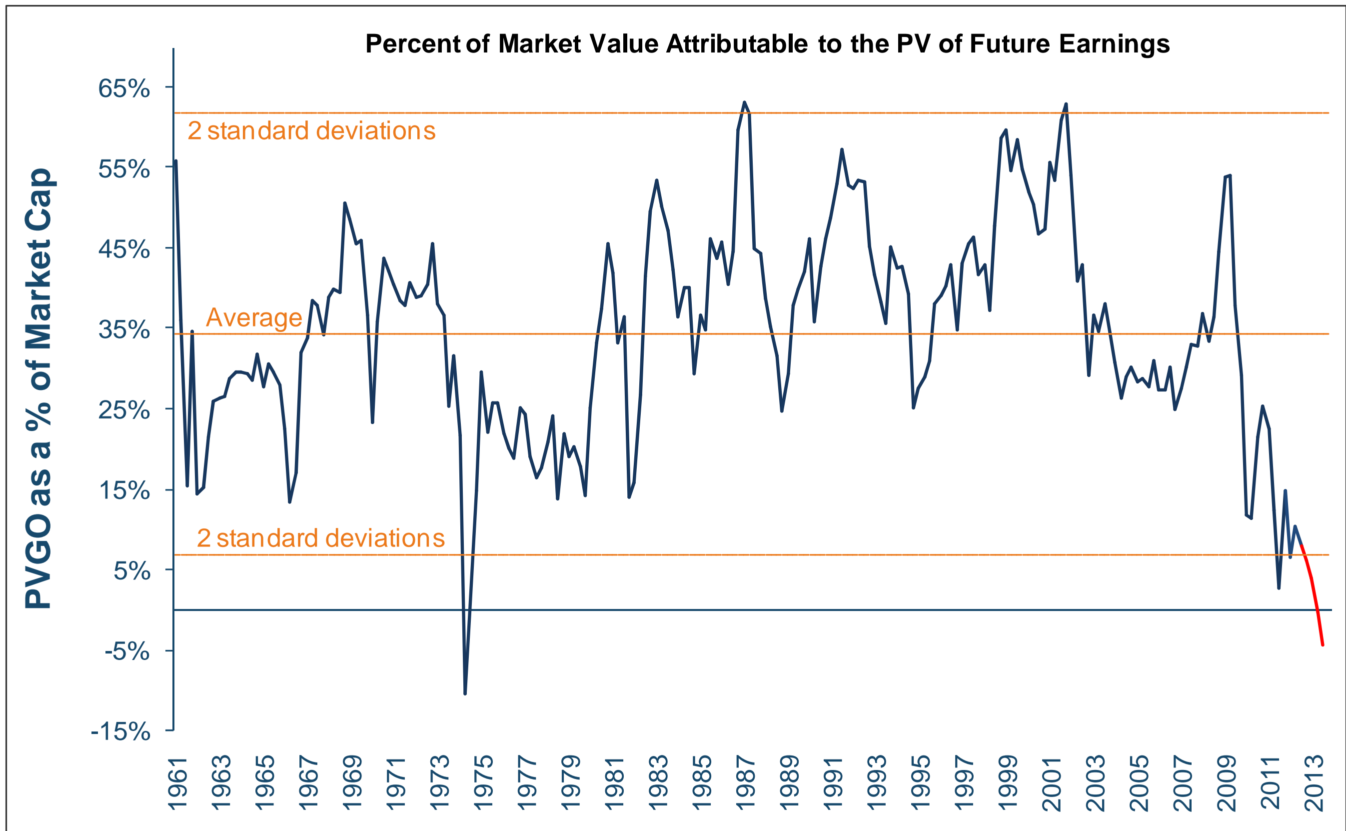
Exhibit 6. Private Employment Improvement versus Public Slump Since 2008[4]



While markets and GDP rarely sync, it would be foolish to rule out the possibility for 2013, given the low growth expectations embedded in stock prices currently (Exhibit 7). Investors do not appear to be paying much for growth outside of a few select sub-industries. With the S&P at only 12.7x bottom-up forecasts, there is room for margins to slip from all-time highs and still not have overpaid for equities. That doesn't mean 2013 won't have its challenges. US fiscal jitters, rising tensions over Iran's nuclear program, Europe's continued struggles with its sovereign debt, and the ever present risk of exogenous events like 2011's tsunami all have the potential to spark double-digit corrections. However, low embedded growth expectations, high returns on capital, and solid return of capital all support current valuations that are not demanding. Investors who ignored these factors and abandoned equities in 2009 have missed some of the strongest years since the '90s. Therefore, despite the risks, we believe the odds favor stocks generating reasonable returns over the next three to five years. Further, we think that US equities should continue to perform well relative to other global stock markets and to fixed income over that period.

[4] *Source: Bloomberg, Bureau of Labor Statistics (through November 30, 2012)*

Exhibit 7. The S&P 500 Is Currently Discounting Negative Future Earnings Growth[5]



Randy Befumo, CFA
Director of Research
Legg Mason Capital Management
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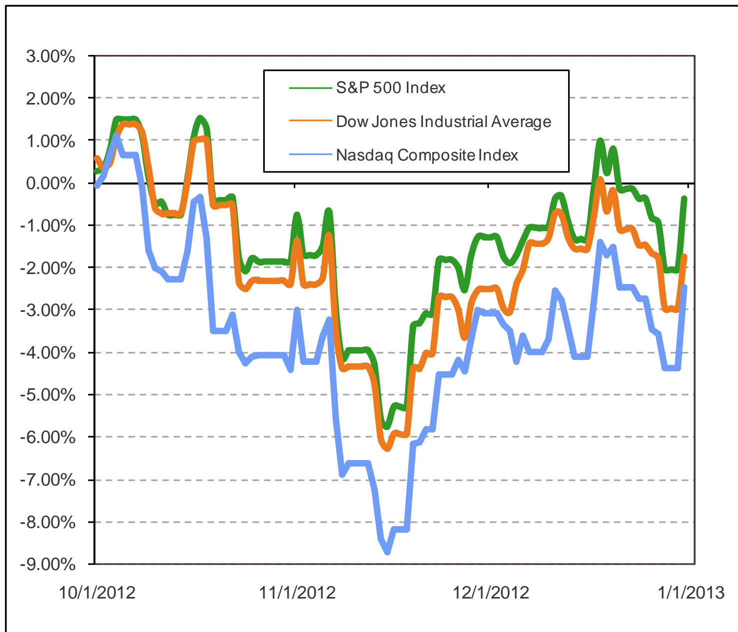
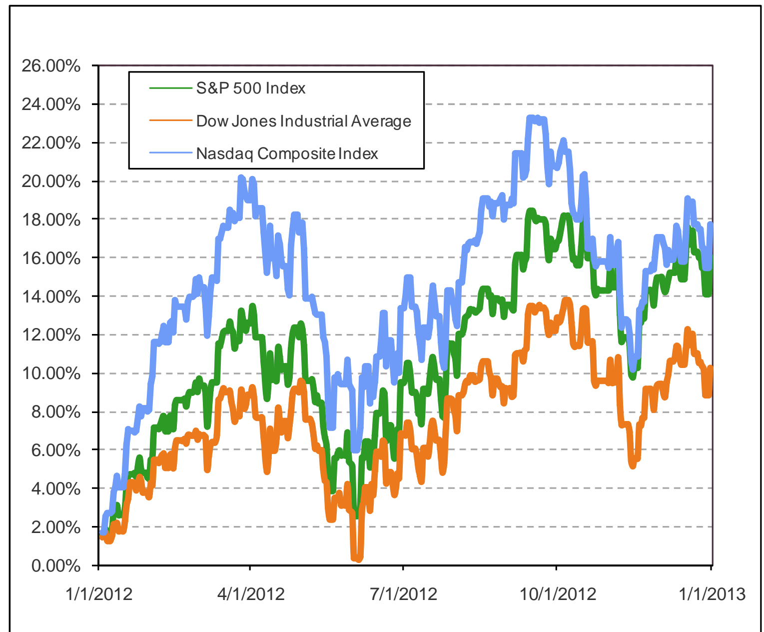
[5] *Source: Standard & Poor's, Aswath Damodaran, LMCM estimates (through December 31, 2012). May not be copied or redistributed without the express written consent of Legg Mason Capital Management.*

Major Indices: 4Q 2012 Performance[6]



Major Indices: 2012 Performance[6]



Broad US Market Indices[6]

Index Name	4Q12	2012
S&P 500 Index	-0.4%	16.0%
Dow Industrials	-1.7%	10.2%
Nasdaq Composite Index	-2.5%	17.7%
S&P 100 Index	-1.9%	16.1%
Russell 1000 Index	0.1%	16.5%
S&P Mid-Cap 400 Index	3.6%	17.9%
Russell 2000 Index	1.9%	16.3%
Russell 1000 Growth Index	-1.3%	15.3%
Russell 1000 Value Index	1.5%	17.5%

S&P 500 Sector Indices[6]

Sector	4Q12	2012
S&P 500 Consumer Discretionary	2.3%	24.1%
S&P 500 Consumer Staples	-1.5%	11.1%
S&P 500 Energy	-2.7%	4.6%
S&P 500 Financials	6.0%	28.9%
S&P 500 Health Care	0.1%	17.9%
S&P 500 Industrials	3.8%	15.4%
S&P 500 Information Technology	-5.7%	14.8%
S&P 500 Materials	2.9%	15.2%
S&P 500 Telecomm Services	-6.0%	18.3%
S&P 500 Utilities	-2.8%	1.3%

Broad Foreign Market Indices[6]
(Returns in US Dollars)

Index Name	4Q12	2012
FTSE 100 Index (UK)	4.1%	15.8%
DAX Index (Germany)	8.3%	31.7%
CAC 40 Index (France)	11.6%	22.6%
MICEX Index (Russia)	4.3%	15.1%
NIKKEI 225 (Japan)	6.2%	12.2%
Hang Seng Index (Hong Kong)	9.0%	27.7%
Kospi Index (South Korea)	4.3%	18.5%
Shanghai SE Composite (China)	9.7%	6.9%
BSE Sensex 30 Index (India)	0.1%	24.1%
Brazil Bovespa Index	2.1%	-2.0%

[6]*Source: Bloomberg (through December 31, 2012)*

About the Author

Randy Befumo joined Legg Mason in 1998 as a Research Analyst and was named Director of Research in May 2007. Randy is currently responsible for managing the analyst team. Previously, Randy was responsible for research in the telecommunications, media, technology and power industries. Randy also led the team that developed LMCM's Market Intelligence products. He spent three years as a Senior Analyst for an online investment service, developing news and research offerings and managing a staff of six. He was also an NCO in an Army Reserve medical unit for six years. Randy earned a B.A. in Interdisciplinary Studies from the College of William and Mary. He received his CFA designation in 2002. Randy is an adjunct faculty member at the Johns Hopkins Carey Business School teaching advanced securities analysis and currently serves on the boards of the Maryland SPCA and the Southwest Baltimore Charter School.

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