WESTERN ASSET INTERMEDIATE MUNI FUND INC.
Form N-CSR
March 05, 2009

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

# FORM N-CSR

## CERTIFIED SHAREHOLDER REPORT OF REGISTERED MANAGEMENT INVESTMENT COMPANIES

Investment Company Act file number 811-6506

Western Asset Intermediate Muni Fund Inc.
(Exact name of registrant as specified in charter)

| | |
|---|---|
| 55 Water Street, New York, NY | 10041 |
| (Address of principal executive offices) | (Zip code) |

Robert I. Frenkel, Esq.
Legg Mason & Co., LLC
100 First Stamford Place
Stamford, CT 06902
(Name and address of agent for service)

Registrant s telephone number, including area code: (800) 451-2010

Date of fiscal year end: December 31

Date of reporting period: December 31, 2008

ITEM 1. REPORT TO STOCKHOLDERS.

The **Annual** Report to Stockholders is filed herewith.

**ANNUAL REPORT** / DECEMBER 31, 2008

**Western Asset**
**Intermediate Muni**
**Fund Inc.**

**(SBI)**

Managed by **WESTERN ASSET**

INVESTMENT PRODUCTS: NOT FDIC INSURED • NO BANK GUARANTEE • MAY LOSE VALUE

**Fund objective**

The Fund s investment objective is to provide common shareholders a high level of current income exempt from regular federal income taxes* consistent with prudent investing.

* Certain investors may be subject to the federal alternative minimum tax ( AMT ), and state and local taxes will apply. Capital gains, if any, are fully taxable. Please consult your personal tax or legal adviser.

**What s inside**



**Legg Mason Partners Fund Advisor, LLC ( LMPFA ) is the Fund s investment manager and Western Asset Management Company ( Western Asset ) is the Fund s subadviser. LMPFA and Western Asset are wholly-owned subsidiaries of Legg Mason, Inc.**

**Letter from the chairman**

Dear Shareholder,

The U.S. economy weakened significantly during the 12-month reporting period ended December 31, 2008. Looking back, U.S. gross domestic product ( GDP )i contracted 0.2% in the fourth quarter of 2007. This was due to continued weakness in the housing market, an ongoing credit crunch and soaring oil and food prices. The economy then expanded 0.9% and 2.8% during the first and second quarters of 2008, respectively. Contributing to this rebound were rising exports that were buoyed by a weakening U.S. dollar. In addition, consumer spending accelerated, aided by the government s tax rebate program. However, the dollar s rally and the end of the rebate program, combined with other strains on the economy, caused GDP to take a step backward during the second half of 2008. According to the U.S. Department of Commerce, third quarter 2008 GDP declined 0.5% and its advance estimate for fourth quarter GDP decline was 3.8%, the latter being the worst quarterly reading since 1982.

While there were increasing signs that the U.S. was headed for a recession, the speculation ended in December 2008. At that time, the National Bureau of Economic Research ( NBER ) which has the final say on when one begins and ends announced that a recession had begun in December 2007. The NBER determined that a recession had already started using its definition, which is based on a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in production, employment, real income and other indicators.

Regardless of how one defines a recession, it felt like we were in the midst of an economic contraction for much of 2008. Consumer spending, which represents approximately two-thirds of GDP, has been disappointing. According to the International Council of Shopping Centers, retail sales rose a tepid 1% in 2008, the weakest level in at least 38 years. In terms of the job market, the U.S. Department of Labor reported that payroll employment declined in each of the 12 months of 2008. During 2008 as a whole, 2.6 million jobs were lost, the largest annual decline since World War II ended in 1945. In addition, at the end of 2008, the unemployment rate had risen to 7.2%, its highest level since January 1993.

**Letter from the chairman *continued***

Ongoing issues related to the housing and subprime mortgage markets and seizing credit markets prompted the Federal Reserve Board ( Fed )ii to take aggressive and, in some cases, unprecedented actions. When 2008 began, the federal funds rateiii was 4.25%. This was quickly brought down to 3.00% by the end of January 2008, on the back of two Fed rate cuts. The Fed continued to lower the federal funds rate to 2.00% by the end of April 2008, but then left rates on hold for several months. This was due to growing inflationary pressures as a result of soaring oil and commodity prices, coupled with the sagging U.S. dollar. However, as inflation receded along with oil prices and the global financial crisis escalated, the Fed cut rates twice in October to 1.00%. Then, in mid-December 2008, it reduced the federal funds rate to a range of zero to 0.25%, an historic low. In conjunction with its December meeting, the Fed stated that it will employ all available tools to promote the resumption of sustainable economic growth and to preserve price stability. In particular, the Committee anticipates that weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time.

In addition to the interest rate cuts, the Fed took several actions to improve liquidity in the credit markets. In March 2008, it established a new lending program allowing certain brokerage firms, known as primary dealers, to also borrow from its discount window. Also in March, the Fed played a major role in facilitating the purchase of Bear Stearns by JPMorgan Chase. In mid-September 2008, it announced an $85 billion rescue plan for ailing AIG and pumped $70 billion into the financial system as Lehman Brothers bankruptcy and mounting troubles at other financial firms roiled the markets.

The U.S. Department of the Treasury has also taken an active role in attempting to stabilize the financial system, as it orchestrated the government s takeover of mortgage giants Fannie Mae and Freddie Mac in September 2008. In addition, on October 3, 2008, the Treasury s $700 billion Troubled Asset Relief Program ( TARP ) was approved by Congress and signed into law by President Bush. As part of TARP, the Treasury had planned to purchase bad loans and other troubled financial assets. However, in November 2008, Treasury Secretary Paulson said, Our assessment at this time is that this is not the most effective way to use TARP funds, but we will continue to examine whether targeted forms of asset purchase can play a useful role, relative to other potential uses of TARP resources, in helping to strengthen our financial system and support lending.

During the 12-month reporting period ended December 31, 2008, both short- and long-term Treasury yields experienced periods of extreme volatility. Investors were initially focused on the subprime segment of the mortgage-backed market. These concerns broadened, however, to include a wide range of financial institutions and markets. As a result, other fixed-income instruments also experienced increased price volatility. This unrest triggered several flights to quality, causing Treasury yields to move lower (and their prices higher), while riskier segments of the market saw their yields move higher (and their prices lower). This was particularly true toward the end of the reporting period, as the turmoil in the financial markets and sharply falling stock prices caused investors to flee securities that were perceived to be risky, even high-quality corporate bonds and high-grade municipal bonds. On several occasions, the yield available from short-term Treasuries fell to nearly zero, as investors were essentially willing to forgo any return potential in order to access the relative safety of government-backed securities. During the 12 months ended December 31, 2008, two-year Treasury yields fell from 3.05% to 0.76%. Over the same time frame, 10-year Treasury yields moved from 4.04% to 2.25%.

The municipal bond market underperformed its taxable bond counterpart over the 12 months ended December 31, 2008. Over that period, the Barclays Capital Municipal Bond Index[iv] and the Barclays Capital U.S. Aggregate Index[v] returned -2.47% and 5.24%, respectively. Even though municipal securities typically hold up fairly well during periods of market volatility, the aforementioned flight to quality into Treasuries negatively impacted the tax-free bond market.

**A special note regarding increased market volatility**

In recent months, we have experienced a series of events that have impacted the financial markets and created concerns among both novice and seasoned investors alike. In particular, we have witnessed the failure and consolidation of several storied financial institutions, periods of heightened market volatility, and aggressive actions by the U.S. federal government to steady the financial markets and restore investor confidence. While we hope that the worst is over in terms of the issues surrounding the credit and housing crises, it is likely that the fallout will continue to impact the financial markets and the U.S. economy well into 2009.

Like all asset management firms, Legg Mason has not been immune to these difficult and, in some ways, unprecedented times. However, today s challenges have only strengthened our resolve to do everything we can to help you reach your financial goals. Now, as always, we remain committed to providing you with excellent service and a full spectrum of investment choices. And rest assured, we will continue to work hard to ensure that our investment managers make every effort to deliver strong long-term results.

We also remain committed to supplementing the support you receive from your financial advisor. One way we accomplish this is through our enhanced

**Letter from the chairman *continued***

website, www.leggmason.com/cef. Here you can gain immediate access to many special features to help guide you through difficult times, including:

- Fund prices and performance,
- Market insights and commentaries from our portfolio managers, and
- A host of educational resources.

During periods of market unrest, it is especially important to work closely with your financial advisor and remember that reaching one s investment goals unfolds over time and through multiple market cycles. Time and again, history has shown that, over the long run, the markets have eventually recovered and grown.

**Information about your fund**

Please read on for a more detailed look at prevailing economic and market conditions during the Fund s reporting period and to learn how those conditions have affected Fund performance.

Important information with regard to recent regulatory developments that may affect the Fund is contained in the Notes to Financial Statements included in this report.

As always, thank you for your confidence in our stewardship of your assets. We look forward to helping you meet your financial goals.

Sincerely,

**R. Jay Gerken, CFA**

Chairman, President and Chief Executive Officer

January 30, 2009

All index performance reflects no deduction for fees, expenses or taxes. Please note that an investor cannot invest directly in an index.

i Gross domestic product ( GDP ) is the market value of all final goods and services produced within a country in a given period of time.

ii The Federal Reserve Board ( Fed ) is responsible for the formulation of policies designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.

iii The federal funds rate is the rate charged by one depository institution on an overnight sale of immediately available funds (balances at the Federal Reserve) to another depository institution; the rate may vary from depository institution to depository institution and from day to day.

iv The Barclays Capital (formerly Lehman Brothers) Municipal Bond Index is a market value weighted index of investment grade municipal bonds with maturities of one year or more.

v The Barclays Capital (formerly Lehman Brothers) U.S. Aggregate Index is a broad-based bond index comprised of government, corporate, mortgage- and asset-backed issues, rated investment grade or higher, and having at least one year to maturity.

**Fund overview**

### Q. What is the Fund s investment strategy?

**A.** The Fund s investment objective is to provide common shareholders a high level of current income exempt from regular federal income taxes consistent with prudent investing. Under normal market conditions, the Fund invests at least 80% of its total assets in municipal obligations. The Fund also maintains a dollar-weighted average effective maturity of between three and 10 years. Under normal market conditions, the Fund will invest at least 80% of its total assets in debt securities that are, at the time of investment, rated investment grade by a nationally recognized statistical rating organization ( NRSRO ) or, if unrated, of equivalent quality as determined by the investment manager. In addition, up to 20% of the Fund s total assets may be invested in debt securities that are, at the time of investment, rated below investment grade by an NRSRO or, if unrated, of equivalent quality as determined by the investment manager.

At Western Asset Management Company ( Western Asset ), the Fund s subadviser, we utilize a fixed-income team approach, with decisions derived from interaction among various investment management sector specialists. The sector teams are comprised of Western Asset s senior portfolio managers, research analysts and an in-house economist. Under this team approach, management of client fixed-income portfolios will reflect a consensus of interdisciplinary views within the Western Asset organization.

### Q. What were the overall market conditions during the Fund s reporting period?

**A.** During the fiscal year, the U.S. bond market experienced periods of increased volatility. Changing perceptions regarding the economy, inflation and future Federal Reserve Board ( Fed )i monetary policy caused bond prices to fluctuate. Two- and 10-year Treasury yields began the reporting period at 3.05% and 4.04%, respectively. Treasury yields moved lower and their prices moved higher during the first quarter of 2008, as concerns regarding the subprime mortgage market and a severe credit crunch caused a flight to quality. During this period, investors were drawn to the relative safety of Treasuries, while increased risk aversion caused other segments of the bond market to falter.

Treasury yields then moved higher in April, May and early June 2008, as the economy performed better than expected and inflation moved higher. Over this period, riskier fixed-income asset classes, such as high-yield bonds and emerging market debt, rallied. However, the credit crunch resumed in mid-June, resulting in another flight to quality. Investors risk aversion then intensified from September through November given the severe disruptions

**Fund overview** ***continued***

in the global financial markets. During this time, virtually every asset class, with the exception of short-term Treasuries, performed poorly. At the end of the fiscal year, two- and 10-year Treasury yields were 0.76% and 2.25%, respectively.

Tax-free bonds were not immune to the volatility in the financial markets during the reporting period. In addition to increased risk aversion, the municipal market was pressured by issues related to monoline bond insurers and a lack of liquidity. In addition, there were fears that an economic recession would negatively impact municipalities, as they would generate less tax revenues.

**Q. How did we respond to these changing market conditions?**

**A.** During the reporting period, two major themes played out. The municipal yield curve[ii] steepened dramatically from a very flat to a more normal or, at various times, steep slope. Additionally, credit quality spreads widened substantially as deleveraging and forced selling in the municipal market created a scenario where higher quality was much more in demand. As a result of these developments, we extended the Fund s duration[iii] and added some attractively valued lower-quality securities to the portfolio.

**Performance review**

For the 12 months ended December 31, 2008, Western Asset Intermediate Muni Fund Inc. returned -7.56% based on its net asset value ( NAV )[iv] and -8.44% based on its New York Stock Exchange ( NYSE ) market price per share. The Fund s unmanaged benchmark, the Barclays Capital 1-15 Year Municipal Bond Index[v], returned 2.48% for the same period. The Lipper Intermediate Municipal Debt Closed-End Funds Category Average[vi] returned -10.85% over the same time frame. Please note that Lipper performance returns are based on each fund s NAV.

During the 12-month period, the Fund made distributions to shareholders totaling $0.41 per share. The performance table on the next page shows the Fund s 12-month total return based on its NAV and market price as of December 31, 2008. **Past performance is no guarantee of future results.**

Certain investors may be subject to the federal alternative minimum tax, and state and local taxes will apply. Capital gains, if any, are fully taxable. Please consult your personal tax or legal adviser.

**PERFORMANCE SNAPSHOT** as of December 31, 2008 (unaudited)

| PRICE PER SHARE | 12-MONTH TOTAL RETURN* |
|---|---|
| $8.52 (NAV) | -7.56% |
| $7.55 (Market Price) | -8.44% |

**All figures represent past performance and are not a guarantee of future results.**

***Total returns are based on changes in NAV or market price, respectively. Total returns assume the reinvestment of all distributions in additional shares in accordance with the Fund s Dividend Reinvestment Plan.**

**Q. What were the leading contributors to performance?**

**A.** The Fund s allocation to the Local General Obligation sector contributed to performance for the period. General Obligation municipal bonds are supported by the full faith and credit of the issuing jurisdiction and are senior to all other obligations of the municipality. In an environment where concerns were mounting about creditworthiness, the municipal market could no longer rely on municipal bond insurance, which was previously attached to 60% of new issues, causing them to be AAA-rated. Investors sought out General Obligation securities in the wake of the unprecedented volatility witnessed in the municipal market during 2008. These securities also tend to be more liquid and actively traded, making them appealing in an uncertain market environment.

Our weighting to the Pre-refunded[vii] sector was also beneficial as a flight to quality to U.S. Treasuries caused this area to be the best performer within the municipal market. A lack of exposure to the Tobacco and Airline sectors contributed to the Fund s relative performance, as well, as did maintaining an underweight to the Housing sector. Finally, having a portfolio with higher credit quality positions than that of its peers contributed to performance as spreads widened significantly during the 12-month reporting period.

**Q. What were the leading detractors from performance?**

**A.** From a sector perspective, allocations to Health Care,[1] Industrial Development and Pollution Control and Electric revenue bonds detracted from results. As opposed to General Obligation municipal bonds that are supported by the full faith and credit of the issuing jurisdiction, securities in these sectors are supported by a defined stream of revenue. In times of market stress, investors tend to move out of these sectors as they seek the refuge of State and Local General Obligation securities, which they perceive to be more secure. In addition, there were concerns regarding the Health Care sector due to pressure on funding, as municipalities struggled to

1 Health Care consists of the following industries: Hospitals/Nursing Facilities, Pharmacy Services, Medical Wholesale Drug Distributors, Drug Delivery Systems, Medical Products/Instruments, Medical & Laboratory Testing, Healthcare Cost Containment and Scientific Instruments.

**Fund overview *continued***

balance their budgets. Industrial Development and Pollution Control issues are supported by corporate credit. During the reporting period, corporate credit spreads widened significantly due to increased investor risk aversion.

The Fund s yield curve positioning also detracted from performance for the period.

A short position in U.S. Treasury futures was a drag on the Fund s performance. We use U.S. Treasury futures, both long and short positions, to manage opportunistically the Fund s interest rate exposure (i.e., duration). We would sell these futures short if we wanted to shorten the duration of the portfolio. Conversely, we would be long the futures contracts if we wanted to quickly extend the portfolio s duration. This strategy generally produces reliable results. However, this was not the case during the reporting period as the massive flight to quality toward the end of the fiscal year drove U.S. Treasury yields down to historically low levels while, at the same time, municipal yields rose dramatically. Therefore, while the short position did help reduce the Fund s average duration, the defensive aspect of the strategy was overwhelmed by the extreme widening between U.S. Treasury and municipal yields.

Finally, the Fund s use of leverage, via municipal Auction Rate Cumulative Preferred Stock ( ARCPS ), detracted from performance relative to the unleveraged benchmark. While leverage offers the potential to generate additional income and increased total returns for common shareholders, the benefits provided by leveraging are influenced by the price movements of the bonds added to the portfolio as a result of the leverage. As mentioned above, tax-free bonds came under pressure due to risk aversion, concerns about monolines and lack of liquidity. Overall declining valuations had a negative effect on performance that was magnified by the use of leverage. The ARCPS dividend rates ranged from 1.142% to 11.347% during the fiscal year. The weighted average dividend rate for the year ended December 31, 2008 was 3.499%. Although the Fund s borrowing costs were relatively high for periods during the fiscal year, overall, the use of leverage increased the Fund s net investment income available to common shareholders.

**Looking for additional information?**

The Fund is traded under the symbol SBI and its closing market price is available in most newspapers under the NYSE listings. The daily NAV is available on-line under the symbol XSBIX on most financial websites. *Barron s* and The *Wall Street Journal s* Monday edition both carry closed-end fund tables that provide additional information. In addition, the Fund issues a quarterly press release that can be found on most major financial websites, as well as www.leggmason.com/cef.

In a continuing effort to provide information concerning the Fund, shareholders may call 1-888-777-0102 (toll free), Monday through Friday from 8:00 a.m. to 6:00 p.m. Eastern Time, for the Fund s current NAV, market price and other information.

Thank you for your investment in Western Asset Intermediate Muni Fund Inc. As always, we appreciate that you have chosen us to manage your assets and we remain focused on achieving the Fund s investment goals.

Sincerely,

**Western Asset Management Company**

January 20, 2009

The information provided is not intended to be a forecast of future events, a guarantee of future results or investment advice. Views expressed may differ from those of the firm as a whole.

RISKS: Keep in mind, the Fund s investments are subject to interest rate and credit risks. As interest rates rise, bond prices fall, reducing the value of the fixed-income securities held by the Fund. Lower-rated, higher-yielding bonds, known as junk bonds , are subject to greater credit risk, including the risk of default, than higher-rated obligations. The Fund may use derivatives, such as options and futures, which can be illiquid, may disproportionately increase losses, and have a potentially large impact on Fund performance. Certain investors may be subject to the federal alternative minimum tax, and state and local taxes will apply. Capital gains, if any, are fully taxable.

All index performance reflects no deduction for fees, expenses or taxes. Please note that an investor cannot invest directly in an index.

i The Federal Reserve Board ( Fed ) is responsible for the formulation of policies designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.

ii The yield curve is the graphical depiction of the relationship between the yield on bonds of the same credit quality but different maturities.

iii Duration is the measure of the price sensitivity of a fixed-income security to an interest rate change of 100 basis points. Calculation is based on the weighted average of the present values for all cash flows.

iv Net asset value ( NAV ) is calculated by subtracting total liabilities and outstanding preferred stock (if any) from the closing value of all securities held by the Fund (plus all other assets) and dividing the result (total net assets) by the total number of the common shares outstanding. The NAV fluctuates with changes in the market prices of securities in which the Fund has invested. However, the price at which an investor may buy or sell shares of the Fund is the Fund s market price as determined by supply of and demand for the Fund s shares.

v The Barclays Capital (formerly Lehman Brothers) 1-15 Year Municipal Bond Index is a market value weighted index of investment grade (Baa3/BBB- or higher) fixed-rate municipal bonds with maturities of 1-15 years.

vi Lipper, Inc., a wholly-owned subsidiary of Reuters, provides independent insight on global collective investments. Returns are based on the 12-month period ended December 31, 2008, including the reinvestment of all distributions, including returns of capital, if any, calculated among the 7 funds in the Fund s Lipper category.

vii A pre-refunded bond is a bond in which the original security has been replaced by an escrow, usually consisting of treasuries or agencies, which has been structured to pay principal and interest and any call premium, either to a call date (in the case of a pre-refunded bond), or to maturity (in the case of an escrowed to maturity bond).

**Fund at a glance (unaudited)**

**INVESTMENT BREAKDOWN** (%) As a percent of total investments December 31, 2008

**Schedule of investments**

**December 31, 2008**

**WESTERN ASSET INTERMEDIATE MUNI FUND INC.**

| FACE AMOUNT | SECURITY | VALUE |
|---|---|---|
| MUNICIPAL BONDS 99.3% | | |
| | **Alabama 3.2%** | |
| $ 3,000,000 | Alabama State Public School & College Authority, FSA, 5.125% due 11/1/15 | $ 3,051,630 |
| 1,225,000 | Baldwin County, AL, Board of Education, Capital Outlay School Warrants, AMBAC, 5.000% due 6/1/20 | 1,251,680 |
| 1,000,000 | Saraland, AL, GO, MBIA, 5.250% due 1/1/15 | 1,052,690 |
| | *Total Alabama* | *5,356,000* |
| | **Alaska 1.7%** | |
| 1,000,000 | Alaska Industrial Development & Export Authority Revenue, Williams Lynxs Alaska Cargo Port LLC, 8.000% due 5/1/23(a) | 817,300 |
| 500,000 | Anchorage, AK, GO, Refunding, FGIC, 6.000% due 10/1/14 | 582,775 |
| 1,250,000 | North Slope Boro, AK, Refunding, MBIA, 5.000% due 6/30/15 | 1,342,163 |
| | *Total Alaska* | *2,742,238* |
| | **Arizona 0.1%** | |
| 158,000 | Maricopa County, AZ, Hospital Revenue, St. Lukes Medical Center, 8.750% due 2/1/10(b) | *164,036* |
| | **Arkansas 1.5%** | |
| 1,500,000 | Arkansas State Development Finance Authority Hospital Revenue, Washington Regional Medical Center, 7.000% due 2/1/15(c) | 1,567,995 |
| 1,000,000 | Warren County, AR, Solid Waste Disposal Revenue, Potlatch Corp. Project, 7.000% due 4/1/12(a) | 942,330 |