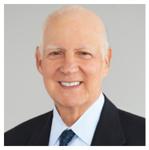
ClearBridge Investments

The ClearBridge View



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A Quarter Full of Sound and Fury, Signifying Nothing?

Paraphrasing Shakespeare's *Macbeth*, one has to wonder about the meaning of the first quarter of 2016. The actions in the securities markets were indeed furious, but did they signify anything significant? A brutal and swift 10% decline leading off the year was followed by a vigorous rally that brought the popular averages back to where they began the year, essentially unchanged.

As we had hoped in our year-end commentary, dividends, particularly rising ones, regained popularity in the very low interest rate environment. It was a good quarter for most of our sectors.

> We continue to believe that stocks are currently the asset category of choice, but require managed expectations.

In late December, we wrote with a high degree of conviction that we expected difficult and erratic markets would continue until oil prices stabilized. We interpreted the collapse of oil and other commodity prices as not just a matter of oversupply, but as a reflection of a marked slowdown in global economies and therefore, lack of adequate demand. We also felt that the minor rise in interest rates by the Fed, along with their misplaced confidence in the strength of the economic recovery in the U.S., was scaring the markets.

By mid-February, things had changed. Oil prices began to stabilize and then rally. Remarks from Fed officials became much more benign. As oil rose in price, so did hope that the recession in manufacturing was bottoming. Fears about banks and their energy industry loans subsided. Many stocks recovered from their lows.

Unfortunately, the sluggish economy we experienced in the years after the "Great Recession" of 2007-2009 has led to voter unease and an election year that is hard to watch. Candidates have taken discourse to the lowest possible levels. Being offered – besides name calling, smearing and juvenile comments – are simplistic solutions to very complex issues. Instead of ideas for growth, we get a blame game. The point is, we are uncertain about how financial markets will react as the election approaches, but we lean toward continued caution.

Regarding oil, it seems intuitive that lower energy prices would stimulate consumer spending and benefit companies that use a lot of petrochemicals and oil. However, as we discussed in our last commentary, the drastic decline in oil prices has hurt manufacturers and producers more than it has helped other parts of the economy. Consumers continue to behave cautiously, as modest personal income growth appears to be going to pay down debt incurred during the worst of the recession, or to increase savings. At some point, one would hope that the effects of low oil prices would reverse. That would be a huge boost to the economy.

One of the headwinds for our multinational companies has been the persistently strong U.S. dollar, which makes their goods more expensive in other countries. This has been compounded by the bizarre onset of negative interest rates elsewhere. Money typically flows to safe havens where rates are much higher – in this case, to the U.S. Recently, the dollar declined as the Fed softened its rhetoric about rate increases, lending some hope to our exporters, but there is not enough evidence that the dollar will remain low enough to aid earnings.

In the past, we have referred to our three determinants of stock market direction: earnings, interest rates and psychology. The best or worst markets occur when the three are in sync, either positively or negatively.

Earnings are under pressure now because of the sluggish economy, both here and around the world. Revenue growth is difficult to achieve, thus much of what we see in earnings improvement is a result of either cost cutting or large stock buybacks that increased earnings per share of the remaining shares. So we have to put earnings in the neutral-to-negative column.

Interest rates, on the other hand, have been and continue to be a huge plus for stocks. The price that people will pay for a dollar of corporate earnings is largely determined by competing investments. The 10-year Treasury note at 2% is not competition for stocks that are still selling at reasonable valuations.

Finally, psychology is an inexact but useful contrary indicator. Heavily bullish sentiment, such as we saw in 1999 and 2006, implies that investors already have put their money to work. Perversely, bearish sentiment, with investors expressing caution, holding heavy reserves, or shorting stocks, means lots of buying power can be applied if any spark sets off a rally. We saw that in February. We put psychology in the favorable camp now, as there is lots of skepticism about stocks, if not outright pessimism.

In sum, two of our three pillars are positive, one neutral-to-negative. That is not the stuff of either strong bull or bear markets. We continue to believe that stocks are currently the asset category of choice, but require managed expectations. The evidence tilts to a market that can produce modest but real returns. In such an environment, we again expect dividends to produce much of the upside and expect continued solid increases in payouts.

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