

## ClearBridge Advisors Market Commentary



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Since the financial and housing collapses of 2007-2008, we repeatedly have discussed the headwinds facing the economy. In contrast to our view on the economy, we have felt that the stock market was made quite attractive by the declines suffered by so many good companies during the prior decade.

The disconnect between an undervalued stock market and an economy stuck in neutral has been difficult for many observers to reconcile. There has been no shortage of things to worry about. Unemployment is stubborn and painful for too many people. Europe is mired in recession, as accumulated sovereign debt has collided with questionable fiscal "remedies" that make any recovery problematic. The Chinese economy, long an engine of growth for the rest of the world, has slowed markedly, adding to the woes of the countries whose exports have been impacted.

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Making it all more difficult is the issue we have flagged since August of 2011: the stultifying partisan enmity in our government. The inability to avoid a downgrade in the credit rating of the U.S. was merely a preview of what has occurred and what probably lies ahead. It has been given a name by Federal Reserve Chairman Ben Bernanke: the fiscal cliff.

If no budget agreements are reached by year-end, simultaneous tax increases and spending cuts will automatically occur. We have not been optimistic about the prospects for an agreement by an intransigent congress. Worse still, we are not sure that whatever agreement might be reached will be positive for the economy on a short-term basis.

For all the political posturing about whose fault the dismal economy is, the sad fact is that a weak recovery was in the cards all along. What we went through in 2007-2008 was not a classic post-World War II recession. It was an asset collapse in which housing, banks, stocks, and credit all got decimated. An asset collapse is deflationary. Assets get re-priced at substantially lower levels, and losses are severe. The unwinding of the debt buildup of the prior 20 years continues to be a huge headwind. Vibrant end demand is missing, as consumers have neither the wherewithal nor the will to spend as they did in prior periods.

The Federal Reserve, led by Bernanke, who is a scholar and expert on the Great Depression, helped stop the worst of the declines in 2009 by putting massive amounts of money into the system. A policy of quantitative easing<sup>1</sup> (called QE1 and QE2) was designed to lower interest rates, thus providing banks with liquidity and helping stressed homeowners to refinance at much lower mortgage rates.

A byproduct of the Fed's stimulus was a diminution of rates of return on very safe investments available to savers and retirees. In effect, the attempts by the Fed to save or invigorate banks and housing have forced people into riskier assets. We have been strong advocates of dividends, particularly because for the first time in over 50 years, stocks began to yield more than bonds. In addition, corporate balance sheets are generally flush with cash and dividends have room to grow, as indeed they have over the past three years.

The Fed's latest move (QE3) leaves no doubt in our minds that it is trying to create some asset reflation. Flooding the system with credit and asset purchases has arrested the deflation, particularly in housing, which has shown signs of strengthening. Reflation, or the attempt to raise asset prices, has indeed helped the stock market. Ultra-low interest rates, coupled with absolute stock valuations that are reasonable, have made equities a vehicle of choice for many investors.

The excellent returns of the past three years have been accompanied by widespread skepticism, which has kept markets from overheating. Given the uncertainty over how the fiscal cliff will be resolved, we continue to believe that high quality companies will remain the best place to be for the next several years, but we are not averse to keeping some cash reserves on the sidelines to take advantage of any negative fallout from potential government mistakes. If the Fed is successful at reviving the economy, or if general price inflation returns, we believe stocks should be a good hedge. If not, the dividend growth should be of comfort.

<sup>1</sup> **Quantitative** easing refers to a monetary policy implemented by a central bank in which it increases the excess reserves of the banking system through the direct purchase of debt securities.

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