Key Takeaways

- Stocks feel and look expensive, yet, with low interest rates continuing to defy conventional wisdom and with enormous liquidity, it is equally difficult to envision a bear market.
- We remain encouraged by the prospects of continued dividend increases for the foreseeable future.
- The divisiveness between the president and Congress, and huge philosophical differences between Congress and economists over policy actions will make tax reform difficult to achieve.

Market Overview and Outlook

If current headlines determined stock prices, markets would be reeling. There are two key things keeping stocks high. The first, as we have discussed often over the past several years, is low interest rates. They provide little or no competition for investment dollars. The second is the hope for tax reform – specifically, tax cuts. Every time the stock market teeters, someone in the administration talks up tax cuts. We have no complaints about the stock market's performance. From the depths of 2009, through what we dubbed the “Golden Age of Dividends,” through the most recent two years of additional strong gains, our portfolios have benefited handsomely.

It remains to be seen whether a dysfunctional Washington can get any much-needed reforms in the tax code, let alone any cuts. The divisiveness between the president and Congress, together with huge philosophical differences between Congress and economists over “cuts” versus “revenue neutral actions,” will make changes difficult to achieve. The squabbling over the health care program has created ill will and roadblocks to other measures. While we would love to see tax policies that would get the economy on a faster track, we remain skeptical about them happening. We hope to be proven wrong.

In managing assets for people, we are regularly assessing an array of risk factors. We try to determine whether stocks are expensive or cheap; whether interest rates are likely to rise and by how much; if there is a consistent message from Washington, and is it helpful; and whether geopolitical risks are high enough to impact markets. There are several signs that risks are higher than what is being priced in by the stock market. Our preference always has been to be more aggressive in our purchases when stocks are depressed and more cautious when assets are expensive. As this market has gone from extreme undervaluation in 2009 to new heights in 2017, we have been looking for signs of price exhaustion and excessive risk taking by participants. On an absolute basis, by measures that we have found reliable over decades, stocks feel and look expensive. It is very hard to find compelling values, so some cash reserves seem
reasonable. Yet, with interest rates continuing to defy conventional wisdom by staying very low and with enormous liquidity provided by central banks around the world, it is equally difficult to envision a bear market. The market, we concluded earlier this year, is priced properly, with modest upside potential.

Our Federal Reserve seems intent on raising rates in a slow, steady manner. What we do not understand is the seeming obsession about getting inflation up to 2%. When did very low inflation become a problem or a bad thing? We suppose the Fed is looking at the effects of technology, automation, globalization and the lingering hangover from the 2008 crisis, and worries about slipping into a deflationary environment. In some ways, we already have that. Wages might be picking up a bit, but GDP growth remains subpar and consumers are still subdued. The big issue of income inequality is not going away. Too many wage earners are still struggling to make ends meet. It is hard to make the case for higher interest rates.

One feature of the long-running bull market that began in 2009 is the rotation that continues to bring certain groups of stocks in or out of favor. For example, utilities were being dismissed a few years ago as too expensive. Yet they have made new highs this year, while continuing to raise dividends. Consumer staples have been under pressure recently, but they have been among the best dividend growers over the years. We maintain a diversified portfolio, including industrial, financial and technology stocks that have enabled us to withstand the vagaries of the popularity of different groups at different times. While we cannot control the price of stocks, we can continue to focus on income and income growth from our collection of outstanding businesses. To this effect, we have not been disappointed, and we remain encouraged by the prospects of continued dividend increases for the foreseeable future.

**Portfolio Highlights**

The ClearBridge Dividend Strategy performed in line with its S&P 500 Index benchmark during the third quarter. On an absolute basis, the Strategy had gains in all 11 of the sectors in which it was invested for the third quarter. The main contributors to the Strategy’s performance were the information technology (IT), industrials and financials sectors.

In relative terms, the Strategy generated returns on par with its benchmark driven primarily by stock selection decisions, whereas sector allocation detracted from overall performance during the quarter. Strong stock selection and an underweight allocation in consumer discretionary most helped relative performance during the period. Stock selection in both the industrials and utilities sectors also helped relative performance. Conversely, stock selection in the energy sector hurt relative performance the most. Stock selection in the materials sector and an underweight allocation in the IT sector also detracted from relative results. In addition, the Strategy’s cash position hurt relative returns.

On an individual stock basis, Texas Instruments, Berkshire Hathaway, Raytheon Company, Apple and Microsoft were the largest contributors to absolute performance during the third quarter. The biggest detractors from absolute returns included positions in Kimberly-Clark, Nestle S.A, Kinder Morgan, Travelers Companies and Mondelez International.

During the third quarter, we established positions in McCormick in the consumer staples sector, Kinder Morgan in the energy sector and U.S. Bancorp in the financials sector and closed a position in Automatic Data Processing in the IT sector. The Strategy also received shares of DowDuPont in the materials sector following the merger of existing holding DuPont with Dow Chemical; and shares of Brighthouse Financial following its spinoff from existing holding MetLife.