ClearBridge Investments

Appreciation Strategy

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Key Takeaways

- Powerful U.S. economic performance and a 95% decline in U.S. COVID-19 cases drove strong market gains, while under the surface the market is wrestling with post-pandemic uncertainties.
- With the 10-year Treasury yield stalled out, either the economic strength is real, and yields should rise, or market valuations are at risk.
- We are constructive on the outlook for economic growth and believe businesses levered to improved economic activity have on average a better risk/reward than the mega cap secular growth companies. This is especially true if inflationary pressures linger longer than investors expect.

Market Overview

Powerful U.S. economic performance and a 95% decline in U.S. COVID-19 cases drove an 8.6% gain in the S&P 500 Index during the second quarter of 2021. The U.S. market increased in each of the last five quarters for a cumulative increase of 69.7%, the strongest gain in 75 years. Underneath the surface however, the second quarter's market performance was a tale of two halves illustrative of a market wrestling with an uncertain post-COVID-19 economic landscape.

Economic recovery plays such as financials and energy led during the first half of the quarter, continuing the trend that began in late 2020 when the COVID-19 vaccine rollout became tangible to U.S. investors. Secular growers, especially the big technology stocks, took over at mid quarter. Tech's leadership accelerated post the mid-June FOMC meeting where the Federal Reserve discussed tapering monetary policy accommodation. The yield curve, which flattened steadily during the quarter (a common warning sign for equity investors), accelerated its compression after the meeting, reflecting fears Fed actions to quell inflation could derail the nascent U.S. economic recovery (Exhibit 1).

Exhibit 1: 10-Year Treasury Minus 2-Year Treasury Yields

As of June 29, 2021. Source: ClearBridge, Bloomberg Finance.

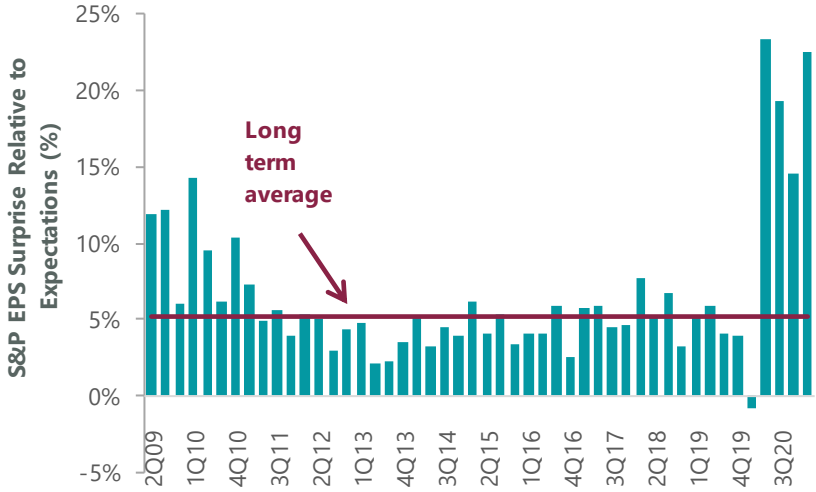
The strongest sectors during the quarter were technology, real estate, energy and communication services, while the weakest were utilities and consumer staples. This mixture reflects the change in leadership during the quarter in a heady market that favored high-beta stocks.

As investors we are wrestling with several issues. First, how can a stock market that is nearly two standard deviations above its historical average price/earnings ratio and 20% above its previous peak valuation on the Buffett ratio continue to rise? Second, given the enormous strength in the U.S. economy and commodity price pressures, why has the 10-year Treasury yield stalled out and even fallen below 1.5% — a real interest rate of -0.75% — when the historical average real interest rate is +0.25%? Either the economic strength is real, and yields should rise, or market valuations are at risk.

Positive earnings revisions explain the market surge. The S&P 500's 2021 consensus EPS forecast rose +16.9% since July 2020 versus the average historical estimate revision of -3.9%, and 2022 EPS estimates are +13.2% over this same timeframe. Normally consensus tends to overestimate future earnings requiring negative revision as time passes, but since mid-2020 earnings estimates have been dramatically underestimated. Importantly, the largest percent changes to EPS expectations have come in the energy, materials, and financials sectors, supporting a hand-off of leadership — from secular growth to cyclical recovery — and buoying a market regularly notching all-time highs. The breadth (percentage of companies reporting an EPS beat) and depth (percentage of difference versus consensus expectations) of earnings surprises are at the highest levels since before the Global Financial Crisis (GFC).

Earnings topped consensus expectations by a whopping +21.4% in the first quarter of 2021 (Exhibit 2), the second-largest upside surprise in any earnings season since the GFC (the second quarter of 2020 EPS beat expectations by +23.2%). Earnings surpassed consensus expectations by more than 15% in each of the last four quarters, compared to the average surprise of +5.7%. Finally, 87% of companies in the S&P 500 exceeded consensus expectations in the first quarter, the best performance since the GFC and well above the 68% long-term average. In sum, corporate execution versus market expectations over the past year was nearly as unprecedented as the environment corporations operated in.

Exhibit 2: Historic Earnings Surprises



As of June 30, 2021. Source: ClearBridge, FactSet.

If fundamentals are so powerful, why has the U.S. 10-year Treasury yield fallen below 1.5%? The past month the BAA spread, the difference between junk bond yields and investment grade, has been the lowest this century, suggesting that the bond market is indeed comfortable with the U.S. economic outlook. Clearly, the Fed's commentary from the June FOMC meeting created fear that the Fed could act precipitously, hurting growth next year. Coming into the FOMC meeting there was a strong consensus that interest rates would rise. Some investors might have been too aggressively positioned and were forced to cover by the Fed comments. It is likely that international money flows, a flight to safety, are a partial cause for the Treasury yield declines. While U.S. COVID-19 cases have plummeted and growth has soared, total cases in the world are near peak and global economic recovery is trailing that of the U.S. China's crackdown on its business's autonomy and on cryptocurrencies is driving money flows into U.S. Treasurys.

Our economic view remains largely unchanged from our first-quarter outlook except for a slight wrinkle. We continue to believe the economic rebound is on solid footing as evidenced by

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plentiful job openings, robust corporate capital spending plans, and a still-liquid consumer. The one wrinkle is — although we still believe inflation pressures will prove transitory — we expect inflationary forces to linger well into 2022, longer than our prior expectation. This is because despite robust job openings, positions remain hard to fill, likely requiring higher wages (despite the economy having 6.7 million fewer jobs than before COVID-19); supply chain disruptions are mending slower than expected; and demand appears to be absorbing incremental manufacturing capacity.

A market and valuations at all-time highs make it challenging for us to find stocks to buy. We continue to believe housing is at the start of a powerful cycle ignited by migration from the cities to the suburbs plus pent-up demand from over a decade of below-trend household formation. Several large cap pharmaceutical companies and biotechs offer visible growth and good dividend yields and sell at modest valuations. We remain positive on railroads as volumes will benefit from a robust U.S. economy. The industry has done a remarkable job the past two decades reducing its capital intensity and increasing its operating margins — but we see room for even more improvement.

Outlook

Investors are at a crossroads, uncertain whether low rates and peaking growth will drive a narrow market led by secular growth-oriented stocks; whether economic momentum will drive further outperformance from cyclical and interest-rate-sensitive stocks; or whether Fed policy will truncate the expansion, ushering in a bear market. As risk-averse, valuation-conscious investors who believe a diversified portfolio will outperform through the cycle, we are well-positioned in the latter two scenarios. The former environment — a narrow, tech-driven market — would be more challenging for our Strategy.

We are constructive on the outlook for economic growth and believe businesses levered to improved economic activity have on average a better risk/reward than the mega cap secular growth companies. This is especially true if inflationary pressures linger longer than investors expect. Although the growth selloff in April and May did present us with opportunities in technology, our portfolio remains methodically and prudently tilted slightly more toward investments that reflect our view. This is done within the context of our rigorous focus on high-quality stocks that protect investor downside. We believe the ClearBridge Appreciation Strategy's conservative approach to investing in a portfolio of high-quality earnings compounders with quality balance sheets and durable competitive advantages is well-positioned for a powerful economic recovery and an expensive stock market.

Portfolio Highlights

The ClearBridge Appreciation Strategy underperformed the benchmark in the second quarter. On an absolute basis, the Strategy had gains in 10 of 11 sectors. The main contributors to performance were the information technology (IT), communication services, health care and industrials sectors. The utilities sector was the only absolute detractor from performance.

In relative terms, stock selection and sector allocation were modest detractors. In particular, stock selection in the financials sector weighed on relative returns, while stock selection in the industrials and IT sectors contributed positively.

On an individual stock basis, the biggest contributors to absolute performance during the quarter were Microsoft, Apple, Facebook, Adobe and Amazon.com. The biggest detractors were Walt Disney, Cognizant, Ecolab, Verizon and Ball.

During the quarter we initiated positions in Hartford Financial Services in the financials sector and Enphase Energy in the IT sector. We closed positions in Chubb in the financials sector and Cognizant Technology Solutions in the IT sector.