ClearBridge Investments

Appreciation Strategy

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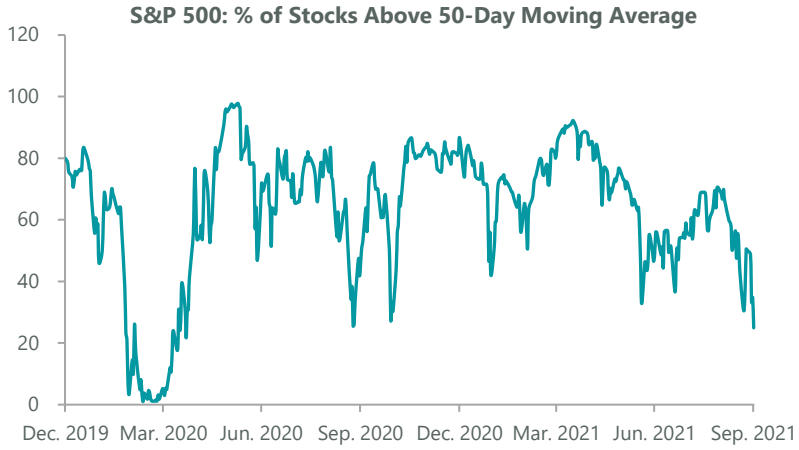
Key Takeaways

- For the first time since the 1970s, cost-push inflation seems widespread and persistent enough to materially lift inflation expectations; COVID-19 disrupted the system of tight, just-in-time inventories.
- Deteriorating breadth throughout the third quarter has provided a handful of idiosyncratic opportunities to initiate and build positions with attractive long-term prospects.
- Although risks have heightened, we remain 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.

Market Overview

The market hit a new high and rose 0.58% during the third quarter of 2021, marking the sixth consecutive quarterly increase and the index's longest quarterly winning streak since 2017. However, the market swooned -4.65% in September due to the apparent bankruptcy of China's largest property company, Evergrande, and fears of rising inflation. Market breadth, as measured by the number of stocks above their 50-day moving average, has deteriorated since April, suggesting risk of further market declines (Exhibit 1).

Exhibit 1: Market Breadth Has Deteriorated Since April



As of Sept. 30, 2021. Source: Bloomberg Finance L.P., ClearBridge Investments.

Financials — led by banks — was the S&P 500's best-performing sector in the third quarter as investors began to embrace the possibility of higher interest rates driven by expectations the Fed will taper extraordinary monetary policy accommodation. Financials haven't led the S&P 500 in a quarter since the second quarter of 2019 (when the federal-funds rate was 2.50%). Industrials were the worst-performing sector in the quarter as freight/logistics stocks and railroads were hit especially hard by input costs and volume bottlenecks. Materials were also a notable laggard as steel and copper miners pared back after a strong run. Several specialty chemicals companies warned of earnings pressure from higher raw materials. Of note, energy had a wild intra-quarter swing. At the end of August energy sector underperformance versus the index was over 15 percentage points, but a powerful run in September left the sector only two percentage points behind the index for the quarter. No doubt, energy's performance was driven by the roller coaster ride in the oil market. The price of a barrel of oil went from $75 down to $62 and back to $75 within the 90 days.

As we enter the final quarter of 2021, our wall of worry has grown as second-derivative headwinds abound. Expectations for U.S. GDP growth are being revised downward as supply bottlenecks crimp output across the economy; rising costs on everything from gasoline to groceries are hitting disposable incomes; rising wages and input costs are paring corporate profit margins; extraordinary monetary policy is likely to taper soon; and corporate taxes seem poised to rise.

For the first time since the 1970s, cost-push inflation seems widespread and persistent enough to materially lift inflation expectations. COVID-19 disrupted the system of tight, just-in-time inventories. A dearth of shipping containers in China and surpluses in the West, caused by the U.S.'s tariff battle with China, compounded the problem. China's desire to reduce heavy industry pollution reduced exports of steel and aluminum and drove steel to record prices and aluminum to 14-year highs. The world underinvested in traditional energy starting in 2017, but new renewables sources have not come online fast enough to fill the supply gap. The U.S. has ample jobs available, but workers lack the necessary skills and live in the wrong places. Wages are up from $8/hour to just under $15/hour at major retailers in the last five years. There is a lot of discussion of stagflation in the market, but this seems wrong to us. Demand is strong — too strong — while supply is held back by temporary issues that will ease as we emerge from COVID-19. The Federal Reserve is looking for 2% inflation. We think it will exceed that, probably for several years.

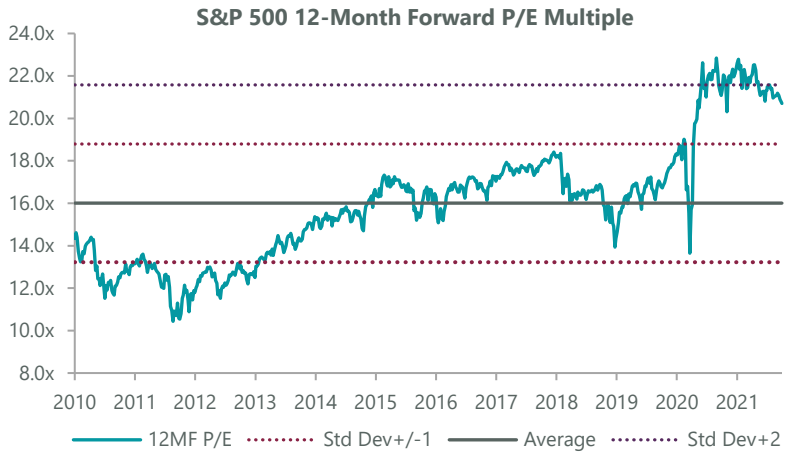
Meanwhile, the outlook in China — and its impact on global growth — is a mystery. President Xi's "common prosperity"

platform threatens to disrupt its technology industry. Chinese debt as a percentage of GDP exploded from 80% in 2008 to 400% now. Evergrande, the largest Chinese property company, is functionally bankrupt. Another Chinese real estate company, Fantasia, is in default and three other large companies saw their bond prices collapse. A quarter of the Chinese economy is real estate. Individuals have much of their wealth invested in it. Chinese bankruptcy laws are different than the West's and they will intervene in markets in a way that Western governments will not. But the hangover from the orgy of debt creation is likely to be significantly lower growth during the next several years.

We would view a return to historically average EPS revision patterns as a market headwind given currently stretched valuations.

Given the concerns detailed above, it might come as a surprise that the S&P 500's valuation remains nearly two standard deviations above historical average (Exhibit 2). As discussed in our second-quarter letter, we believe the broad market is being supported by unprecedented positive EPS revisions. To wit, the S&P 500's 2021 consensus EPS forecast is +23% since July 2020 versus the average historical estimate revision of -4.7% (consensus tends to overestimate future earnings and revise downward as a year progresses). However, September represented the first negative revision to 2021 and 2022 EPS expectations since the year began, which makes third-quarter earnings and 2022 outlooks of critical importance. We would view a return to historically average EPS revision patterns as a market headwind given currently stretched valuations.

Exhibit 2: S&P 500 Valuation Multiples Are Stretched



As of Sept. 30, 2021. Source: Bloomberg Finance L.P., ClearBridge Investments.

A market with valuations near all-time highs makes it challenging for us to find stocks to buy. However, deteriorating breadth throughout the third quarter has provided a handful of idiosyncratic opportunities to initiate and build positions with attractive risk/reward prospects. Banks are likely to benefit from a strong economy, low default rates and higher interest rates. We believe there are pockets within the technology sector at

reasonable valuations that will benefit from a return to the office. However, we would be wary of semiconductors, given glimmers of supply shortages easing. We are also optimistic the third quarter's soft patch in volumes for railroad companies is an opportunity for the patient investor as bottlenecks ease. We believe commodity cost concerns at specific coatings and specialty chemical companies will be offset by price increases in the first half of 2022, providing an opportunity for margin-driven outperformance. Finally, we view housing and housing-exposed enterprises as having a longer tail than investors appreciate as we work off a decade of below-trend household formation and folks incrementally migrate away from cities.

Outlook

Our outlook is essentially unchanged from last quarter. We remain at a crossroad uncertain whether low rates and peaking growth will drive a narrow market led by secular, growth-oriented stocks; whether economic momentum and reduced Fed accommodation will drive outperformance from cyclical and interest-rate-sensitive stocks; or whether Fed policy will truncate the expansion and usher in a bear market. We believe the latter two scenarios are more likely from here and believe the Appreciation Strategy is well-positioned should our forecast materialize. The former environment — a narrow, tech-driven market — would continue to be more challenging for our Strategy.

Although risks have heightened, we remain 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. We remain focused on high-quality earnings compounders with quality balance sheets and durable competitive advantages that we believe will protect investor downside.

Portfolio Highlights

The ClearBridge Appreciation Strategy underperformed the benchmark in the third quarter. On an absolute basis, the Strategy had gains in four of 11 sectors. The main contributors to performance were the information technology (IT), health care and financials sectors. The materials, industrials and communication services sectors were the main absolute detractors from performance.

In relative terms, stock selection and sector allocation were detractors. In particular, stock selection in the communication

services and consumer discretionary sectors weighed on relative returns, while stock selection in the IT sector contributed positively. An overweight to the materials sector also detracted.

On an individual stock basis, the biggest contributors to absolute performance during the quarter were Microsoft, Alphabet, Thermo Fisher Scientific, JPMorgan Chase and Apple. The biggest detractors were PPG Industries, Pinterest, United Parcel Service, Amazon.com and Air Products and Chemicals.

During the quarter we initiated positions in Cisco Systems in the IT sector and Activision Blizzard in the communication services sector. We closed positions in Amgen in the health care sector and International Business Machines in the IT sector.