



Scott Glasser
Chief Investment Officer,
Portfolio Manager



Michael Kagan
Managing Director,
Portfolio Manager



Stephen Rigo CFA
Managing Director,
Portfolio Manager

Appreciation Strategy

Key Takeaways

- ▶ The soft landing rally that gained traction in November 2023 continued through 2024's second quarter, driven by virtually ideal disinflation data and continued fervor around AI.
- ▶ Wage growth will be the key moving forward to determine whether the Fed can cut rates before the economy loses too much momentum.
- ▶ We do not expect the top-heavy market of the second quarter to continue and believe a diversified portfolio with investments focused on durable growth at attractive valuations is best positioned in this transitioning interest rate regime.

Market Overview

The soft landing rally that gained traction in November 2023 continued through 2024's second quarter, driven by virtually ideal disinflation data and continued fervor around AI. The S&P 500 Index has now advanced in six of the past seven quarters (including seven of the past eight months). The second quarter's 4.3% advance left the S&P 500 up 15.3% year to date and an eye-popping 34% off the November 2023 low.

Market performance narrowed from the broad base of the early stages of the current rally. Information technology (IT) and communication services shares rose 13.8% and 9.4%, contributing 115%, or more than all, of the S&P 500's return. Apple and Nvidia alone accounted for 76% of the benchmark's return in the quarter. Narrow markets, especially after a large rise, have historically been risky markets. This has us on alert for a correction should the AI frenzy cool.

On the flip side, six of the 11 GICS sectors declined in absolute terms in the quarter, including the shares of materials, industrials, energy and financials stocks, which are key barometers of economic activity. Materials, the worst-performing sector, declined 4.5%, underperforming the benchmark by 878 bps, the sector's worst relative performance quarter in nearly nine years. Industrials, the second-worst-performing sector, underperformed the S&P 500 by 717 bps, its worst showing since the first quarter of 2020. Financial, energy, health care and real estate shares underperformed the benchmark by more than 500 bps.

We also follow measures of liquidity to assess the environment for risky assets. Although we have been concerned that sustained high

Narrow markets, especially after a large rise, have historically been risky markets.

interest rates and the withdrawal of liquidity from a shrinking Fed balance sheet would tighten financial conditions, the impact of this dynamic has yet to impact key measures of liquidity: corporate credit spreads still look benign; bank deposits are expanding for the first time since 2022; and capital markets activity showed robust debt issuance. Clearly, we underestimated the degree to which enormous fiscal spend would help offset tightening monetary conditions. Although we are concerned a quantitative tightening liquidity drain is a matter of when and not if, we expect the Fed to ensure ample liquidity exists through the presidential election.

Outlook

We are at a key inflection point for the economy and investors, in our view. After hovering near expansion territory, the ISM Manufacturing Index has slipped back into contractionary territory. Leading indicators of consumer expectations have deteriorated. More specifically, transport volumes are anemic with railroad car loads flattish and trucking and logistics mired in contraction. Higher delinquency rates on credit cards and mortgages indicate that consumer credit has started to deteriorate. Housing starts and new home sales, which had held up surprisingly well given sticky mortgage rates, are finally showing signs of fatigue. Finally, the employment picture bears watching as late spring job openings declined while the unemployment and underemployment rates ticked higher. Although we believe investors underestimate the risk of a U.S. recession, we do not foresee a severe or protracted downturn. We would likely use a growth scare as opportunity to methodically add incremental risk to the portfolio.

This is not all bad for investors. An economic slowdown combined with continued disinflationary data would compel the Fed to begin an interest rate cutting campaign, bolstering the chances of a Fed engineered soft landing. We are at the last mile to determine whether disinflation will reach the Fed's 2% target, which we view largely as a wage question, since services inflation remains sticky. Today, wage growth at 4.7% remains too high to reach the last mile target, but the trend is favorable, having declined consistently over the past year. Most economists circle 3.5% wage growth as the level that would support a 2% core PCE (3.5% wage growth + 1.5% productivity = 2% core inflation). To us, wage growth will be the key moving forward to determine whether the Fed can cut rates before the economy loses too much momentum to accomplish a soft landing (Exhibit 1). We remain in wait-and-see mode on this topic. History has shown tackling the last mile has proved challenging, with elevated risk that easing too soon could spur a renewed bout of inflationary pressures.

Exhibit 1: Wage Growth Pointing in Right Direction to Reduce Core Inflation



As of March 31, 2024. Source: ClearBridge Investments, Atlanta Fed, Bloomberg Finance.

In sum, near-immaculate inflation data has further cemented the soft landing narrative as consensus, while animal spirits are betting that AI will revolutionize the global economy. We believe this dynamic has heightened the risk to the investment landscape should there be any stall in the disinflationary trend or disappointment in AI-driven capex. Our focus is, first, can corporate America monetize its investment in AI enough to justify capital spending levels that support the valuations of AI-related stocks? And second, will a weaker jobs market and the deflationary force of technological advancement deliver disinflation supportive of Fed rate cuts this fall?

Longer term, we worry about the sustainability of government debt and the increasing burden of higher interest rates on the budget deficit. At some point the U.S. will need to increase taxes or cut spending to prevent debt costs from spiraling out of control. Neither will happen in an election year, but the next Congress faces stark choices. By no means is the U.S. dollar's status as reserve currency our birthright.

While we are optimistic about the long-term benefits generative AI will have on workplace productivity, aggressive assumptions need to be made to justify current valuations for the direct hardware vendors. Software stocks have lagged this year, creating opportunities in companies that can successfully monetize generative AI. We admire the business models of the largest technology companies, but we are mindful of their regulatory risks and also the concentration risk they create for our portfolio. We are positive on much of the health care sector as market expectations for medical device and life science/tool companies have come in markedly, while we find the non-cyclical nature and modest valuation of pharmaceutical companies appealing. We are positive on select cyclicals such as rails where expectations are low and sustained economic growth would create

We admire the business models of the largest technology companies, but we are mindful of their regulatory risks and the concentration risk they create for our portfolio.

upside. We believe stable financial conditions and the potential for rate cuts and a steeper yield curve will benefit select financial companies such as banks. We do not expect the top-heavy market of the second quarter to continue and believe a diversified portfolio with investments focused on durable growth at attractive valuations is best positioned in this transitioning interest rate regime.

Conclusion

Although we remain constructive on the medium-term outlook, we believe narrow market performance and the upcoming presidential election pose risks to today's placid environment. We believe investors should anchor return expectations closer to longer-term trends (high-single digits annually) versus the current ebullient backdrop. There is value in many non-AI corners of the market, especially should the Fed ease financial conditions.

We are long-term investors focused on the risk-adjusted returns a diversified portfolio can deliver through a market cycle. Rather than trying to bet on near-term earnings trends, we believe it is better to look out two to three years and make investment decisions based upon our assessment of a company's longer-term, sustainable growth rate relative to what is implied in today's share price.

Portfolio Highlights

The ClearBridge Appreciation Strategy underperformed the benchmark S&P 500 Index in the second quarter. On an absolute basis, the Strategy had positive contributions from seven of 11 sectors. The IT sector was the main positive contributor to performance, while the financials sector was the main detractor.

In relative terms, stock selection contributed positively while sector allocation detracted. Specifically, stock selection in the consumer discretionary and energy sectors contributed the most, while stock selection in the communication services, financials and materials sectors detracted, along with an IT underweight and overweights to the materials, financials and industrials sectors.

On an individual stock basis, the biggest contributors to absolute performance during the quarter were Nvidia, Apple, Microsoft, Alphabet and Eli Lilly. The biggest detractors were Walt Disney, Travelers, U.S. Bancorp, Visa and PPG Industries.

During the quarter, we initiated a new position in ConocoPhillips in the energy sector and closed positions in Intel in the IT sector and Hartford Financial Services in the financials sector. Portfolio holding Pioneer Natural Resources was acquired by holding Exxon Mobil in the energy sector whose shares we retained.

Past performance is no guarantee of future results. Copyright © 2024 ClearBridge Investments.

All opinions and data included in this commentary are as of the publication date and are subject to change. The opinions and views expressed herein are of the portfolio management team named above and may differ from other managers, or the firm as a whole, and are not intended to be a forecast of future events, a guarantee of future results or investment advice. This information should not be used as the sole basis to make any investment decision. The statistics have been obtained from sources believed to be reliable, but the accuracy and completeness of this information cannot be guaranteed. Neither ClearBridge Investments, LLC nor its information providers are responsible for any damages or losses arising from any use of this information.

Performance source: Internal. Benchmark source: Standard & Poor's.