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Appreciation Strategy

Key Takeaways

- ▶ New market leadership emerged in the first quarter, with long-lagging sectors outperforming and reversing the AI-driven momentum that dominated the prior three years.
- ▶ In our view, the “buy the dip” mindset that was so successful over the past decade looks less reliable in an environment where inflation risk, policy uncertainty and labor market softening are all rising simultaneously.
- ▶ If geopolitical conditions stabilize and input cost pressures begin to moderate, the economy may still have enough underlying momentum to move through this period without lasting damage. That possibility argues for selectivity rather than indiscriminate defensiveness.

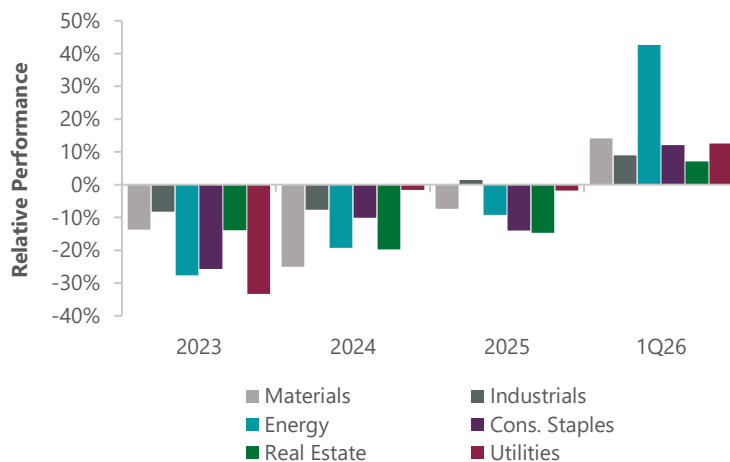
Market Overview

The first quarter of 2026 was defined by a sharp shift in market leadership and a material deterioration in investor sentiment by quarter end. January and February were relatively calm at the S&P 500 Index level, but important changes were already taking place beneath the surface. That calm gave way to volatility in March, when U.S. and Israeli strikes on Iran triggered a broad selloff with the index declining 5.0% during the month. By quarter end, the S&P 500 was down 4.3%, though still up a healthy 17.8% over the trailing 12 months.

One of the quarter’s defining features was the emergence of new market leadership. Long-lagging sectors outperformed, reversing the AI-driven momentum that dominated the prior three years (Exhibit 1). Materials, industrials, energy, utilities, real estate and consumer staples all outperformed in the quarter despite having lagged the index in calendar years 2023, 2024 and 2025 (save for industrials’ in-line performance in 2025 largely due to AI-levered shares).

Energy was the clear standout, rising 38.2% as the U.S.-Iran conflict pushed crude oil prices above \$100 per barrel. Materials also performed well, led by chemicals and mining companies that benefited from concerns around geopolitical supply disruption. Industrials’ outperformance was driven primarily by defense companies and entities tied to AI and energy infrastructure. Finally, consumer staples, real estate and utilities found footing as relative safe havens after a protracted period of underperformance (staples shares have lagged the index by nearly 50% over the past three years).

Exhibit 1: Long-Lagging Sectors Outperformed



As of March 31, 2026. Source: ClearBridge Investments, Bloomberg Finance.

The techno-optimist vision of an “age of abundance,” in which AI, robotics and automation drive sharply lower costs, is being challenged by scarcity across critical inputs.

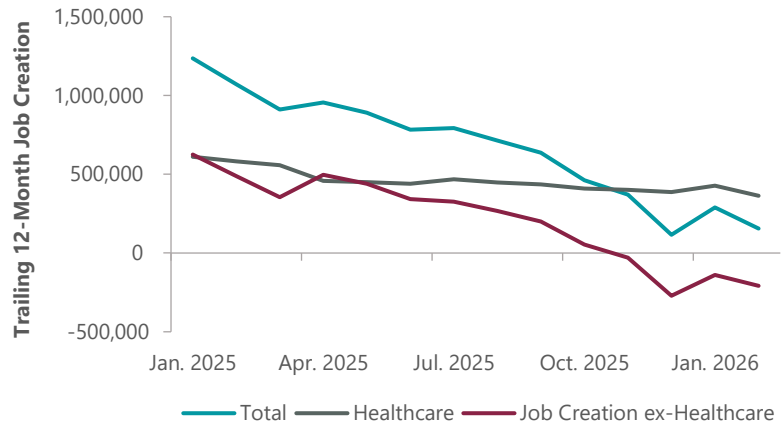
By contrast, information technology (IT) and communication services, which led the market in each year from 2023 to 2025, underperformed sharply in the first quarter, falling 9.1% and 6.9%, respectively. Weakness began in January during earnings season as investors increasingly questioned the return on the substantial capital expenditures being undertaken by major technology companies such as Microsoft, Alphabet, Amazon and Meta. Those concerns broadened over the course of the quarter, moving from hyperscalers to hardware companies (the AI “picks and shovels”) and eventually hit one of the market’s hottest corners: memory. Financials and consumer discretionary also lagged as investors reassessed expectations for capital markets activity, credit quality, travel demand and housing in the face of persistent inflation pressures, particularly higher fuel costs.

Outlook

The near-term backdrop for equities has become less favorable over the past 90 days, and it should remain so even if the U.S. ultimately steps back from its campaign in Iran. The market is now contending with a more complicated mix of slowing labor demand, moderating wages and signs of inflation pressure.

The labor market appears increasingly choppy. While March was a little better, during the previous four months overall payroll growth decelerated. Net job creation was negative excluding health care jobs, a lone bright spot for labor demand (Exhibit 2). Meanwhile, wage growth has steadily declined from its 2023 peak, straining the purchasing power of U.S. consumers, who are already outspending their income, on average. With corporations under pressure to demonstrate efficiency gains from investment in AI and automation, we do not expect labor conditions to reaccelerate meaningfully in the near term.

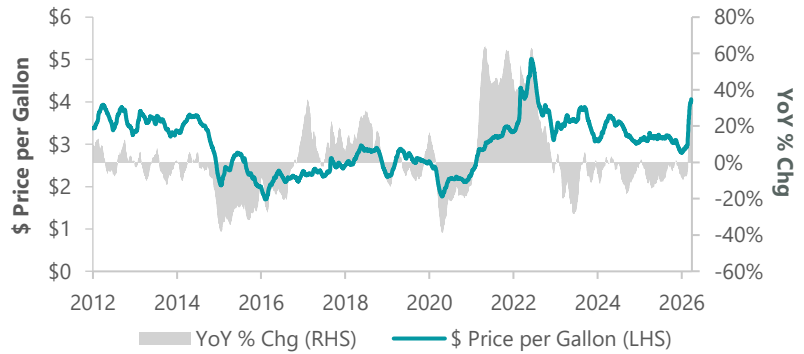
Exhibit 2: Job Creation Negative Except for Health Care



As of March 31, 2026. Source: ClearBridge Investments, Bureau of Labor Statistics.

Meanwhile, inflation headwinds are tangible. The politicization and weaponization of energy infrastructure is likely to leave a long tail of higher energy prices. Yes, we are less dependent on oil than in previous energy shocks, but \$4/gallon gasoline (up 28% year over year) will divert discretionary spending and mute the impact of higher tax refunds (Exhibit 3). The technology supply chain is also experiencing price pressure. With semiconductor foundries already struggling to meet surging demand, a potential helium shortage (an indispensable gas used in semiconductor manufacturing) due to natural gas infrastructure damage in the Middle East will raise the cost of incremental chip production. In addition, memory shortages driven by insatiable AI demand have pushed spot prices for this commodity materially higher, placing upward pressure on a broad range of products including phones, PCs and gaming consoles. In that context, the techno-optimist vision of an “age of abundance,” in which AI, robotics and automation drive sharply lower costs, is being challenged by scarcity across critical inputs.

Exhibit 3: Daily National Average Gas Prices



As of March 31, 2026.

Source: ClearBridge Investments, Bloomberg Finance, American Automobile Association.

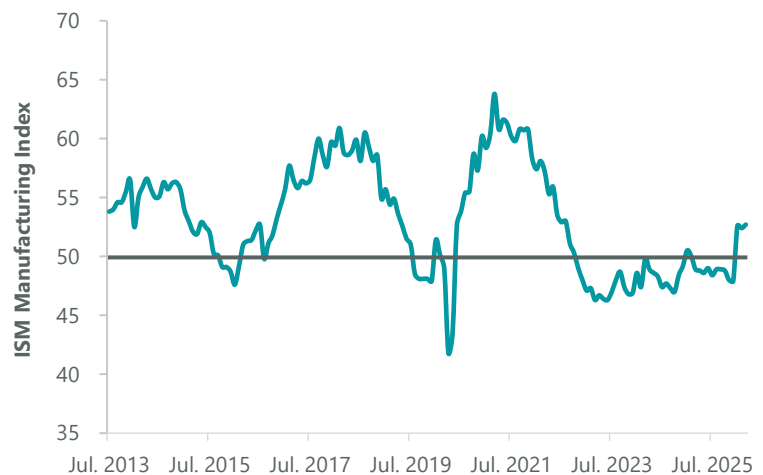
This, in turn, creates a difficult backdrop for the Federal Reserve. The Fed’s ability to ease financial conditions to support the labor market appears constrained given price pressure. Cutting rates risks

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reigniting runaway inflation. Meanwhile, raising rates to tame inflation risks further weakening of an already decelerating labor market. For risk assets such as equities, the concept of a Fed put supporting stocks is harder to bet on today, in our view.

Even so, the outlook is not uniformly negative. The year began with signs of economic acceleration: the ISM Manufacturing Index has posted three consecutive months of expansion (a first since 2022; Exhibit 4), and corporate earnings continue to exceed expectations. The Supreme Court decision has (at least temporarily) rolled back tariffs, and tax refunds may offer a modest near-term cushion for consumers. Finally, equity markets have remained resilient, leaving the wealth effect tailwind in place for America’s highest earners. In sum, if geopolitical conditions stabilize and input cost pressures begin to moderate, the economy may still have enough underlying momentum to move through this period without lasting damage. That possibility argues for selectivity rather than indiscriminate defensiveness.

Exhibit 4: A Return to Expansionary Territory



As of March 31, 2026. Note: A reading >50 denotes expansion, while <50 denotes contraction. Source: ClearBridge Investments, Bloomberg Finance, Federal Reserve.

Conclusion

Current conditions argue for a more cautious stance. The continued strength in high-beta AI and quantum computer stocks during the March market decline indicates that animal spirits remain high. In our view, the “buy the dip” mindset that was so successful over the past decade looks less reliable in an environment where inflation risk, policy uncertainty and labor market softening are all rising simultaneously.

The combination of a softer consumer backdrop and renewed cost pressure meeting a long period of uninterrupted credit expansion (with significant expansion in the unregulated corner of private credit) suggests that the early stages of a credit cycle may be

forming. If that proves correct, investors may need to revisit playbooks that have not been relevant in over a decade. Future market corrections, in that scenario, may carry greater risk and last longer than many have come to expect.

As always, we remain focused on through-the-cycle outperformance with an emphasis on downside protection. We are closely evaluating balance sheet strength and cash flow durability across our AI-exposed holdings to ensure our exposure remains concentrated in companies with the financial resilience to withstand a cooling in today's exceptionally strong environment.

Portfolio Highlights

The ClearBridge Appreciation Strategy outperformed the benchmark S&P 500 Index in the first quarter of 2026. On an absolute basis, the Strategy had positive contributions from five of 11 sectors. The energy sector was the main positive contributor, while IT, communication services and financials were the main detractors.

In relative terms, overall allocation helped while stock selection detracted. Stock selection in financials proved beneficial, while stock selection in the consumer staples and materials sectors detracted from relative results. Overweights to materials and industrials and underweights to IT and consumer discretionary also helped.

On an individual stock basis, the biggest relative contributors during the quarter were ASML, Entergy, Eaton, Johnson & Johnson and Linde. The biggest detractors were Microsoft, McCormick, Bank of America, Thermo Fisher Scientific and not owning Applied Materials.

During the quarter, we initiated a new position in Roblox in communication services. We exited Amphenol in IT and McCormick in consumer staples.

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