



Appreciation Strategy



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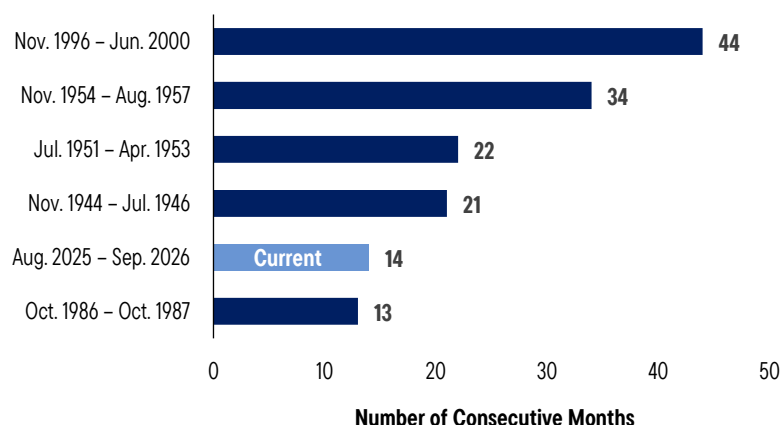
Key Takeaways

- ▶ Strong earnings growth continued to support equities, but sticky inflation, rising interest rates and deteriorating market breadth made the rally increasingly vulnerable.
- ▶ Tightening financial conditions are beginning to weigh on risk appetite and market liquidity, a notable change from recent quarters when capital markets were wide open.
- ▶ We remain cautious but do not see meaningful recession risk; a market correction could curb speculative excess and create opportunities to add selectively to high-conviction, long-term holdings.

Market Overview

Following the second quarter's historic run, the S&P 500 Index ground higher again in the third quarter, returning 2.3%; the index is up 12.7% year to date. September marked the 14th consecutive month in which the S&P 500's trailing three-year annualized total return exceeded 18% — the fifth-longest such streak of the past century, exceeded only by the late-1990s melt-up and three post-war episodes (Exhibit 1). An extraordinary run by any measure.

Exhibit 1: An Historic Run of Returns



As of September 30, 2026. Source: ClearBridge Investments, Atlanta Fed, Bloomberg Finance.

The market's advance has been underpinned by a remarkable surge in corporate earnings. Historically, analysts have entered each year too optimistic, revising EPS forecasts steadily lower as the year progresses. Through the current AI-fueled upcycle, the opposite has held: since

We view a narrowing market financed by leverage as another cautionary signal.

July 2025, consensus 2026 and 2027 EPS estimates for the S&P 500 have climbed 20% and 26%, respectively, driven primarily by rising expectations for information technology (IT) and energy. The rate of growth is equally striking. Consensus now calls for year-over-year EPS growth above 10% in 2027 — a fourth consecutive year of double-digit expansion — compounding off an exceptionally difficult 2026 comparison in which earnings are expected to grow roughly 30%. The last time the S&P 500 delivered double-digit earnings growth in four straight years was the 2002–2006 expansion.

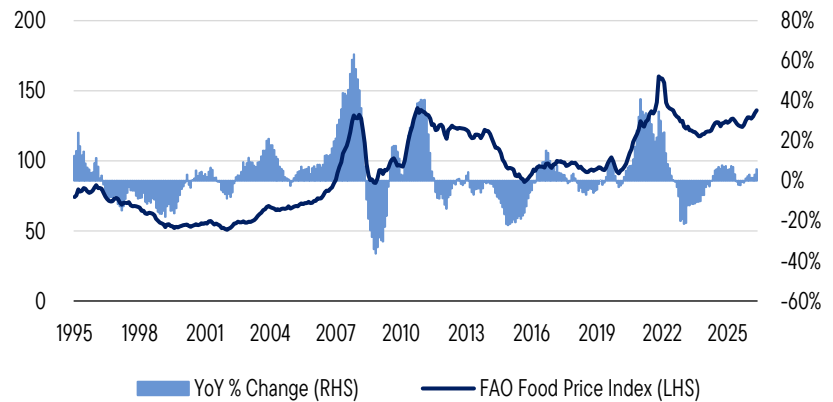
Energy led the benchmark in quarter, completing a round trip from best-performing sector in the first quarter to worst in second and back to best in third. Crude rose sharply over the quarter — Brent up 41% and WTI up 29% as the U.S.-Iran ceasefire announced in April fizzled by July, carrying the oil-levered sector with it. Health care was supported by a surge in life science and tools names as R&D spending appears to be recovering from its post-COVID hangover and as concerns eased over how AI might reshape drug discovery. Finally, IT shares extended their outperformance, though at a less spectacular pace than in the second quarter.

Utilities were the benchmark's weakest sector, pressured both by the sharp rise in long-term interest rates and by an unwind of the AI-power trade that had carried the group through the first half of the year. Industrials were dragged lower by transports and capital goods. Airlines struggled against rapidly rising fuel costs, while capital goods — defense in particular — contended with mounting concern that mid-term election gridlock will delay the budget clarity those businesses need to underwrite future Department of War demand. Consumer discretionary also lagged, with leisure-exposed names such as hotels and restaurants weighed down by the prospect that higher energy expenses will absorb incremental consumer spending.

Our [second-quarter commentary](#) described a nuanced backdrop: fundamentals broadly supportive of risk assets, but with several risks percolating beneath the surface. That characterization still holds, though in our view the risks to the rally have become materially more pronounced.

First, inflation remains sticky and shows signs of worsening. After bottoming at 2.3% in April 2025, the Consumer Price Index pushed solidly above 3% in the third quarter. Higher energy costs are plainly a contributor, with gasoline up 40% year over year to well above \$4.00 per gallon. Even if diplomatic efforts produce a renewed U.S.-Iran ceasefire, however, we do not expect crude to retreat to pre-war levels: global reserves need replenishing and we expect a lasting energy risk premium to remain embedded in the price since the weaponization of energy infrastructure appears to be the new normal. We are watching as well for a renewed bout of food inflation, as the Russia/Ukraine war disrupts key grains and elevated energy costs drive fertilizer prices higher (Exhibit 2).

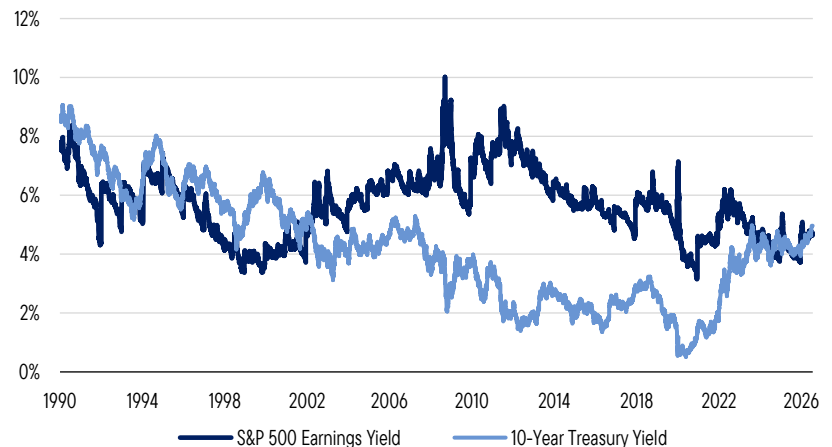
Exhibit 2: Monitoring for Food Inflation



As of September 30, 2026. Source: ClearBridge Investments, United Nations, Bloomberg Finance.

Second, interest rates have become unanchored, with Treasury yields surging to levels last seen nearly two decades ago, before the Global Financial Crisis. We view the absolute level of risk-free rates — the 10-year at roughly 5.25% — together with the velocity of the move as likely to further tighten financial conditions. Moreover, whether rates rising reflects the inflation dynamic described above, a repricing of global risk-free rates against mounting sovereign debt loads, or an expectation of meaningful GDP acceleration, we see little reason for yields to revert to a more “normal” level any time soon. This is a direct headwind to equity multiples, in our view. The 10-year Treasury yield has now converged with the S&P 500’s forward earnings yield of 5.25%, leaving equity investors effectively uncompensated for bearing equity risk — a condition with few precedents outside the late 1990s and the pre-crisis mid-2000s (Exhibit 3).

Exhibit 3: Equity Earnings and Treasury Yields Converge



As of September 30, 2026. Source: ClearBridge Investments.

Tightening financial conditions are beginning to weigh on risk appetite and market liquidity, a notable change from recent quarters when capital markets were wide open. According to Renaissance Capital, seven companies postponed or withdrew proposed IPOs in the third quarter, including the bellwether AI lab Anthropic. High-yield issuance

likewise slowed materially from the torrid pace of the first half, while the all-in yield required to fund a high-yield deal climbed to 8.3%, its highest since April 2025. Part of that increase simply reflects higher risk-free rates, but investors also demanded more for credit risk itself: the high-yield option-adjusted spread widened 39 basis points over the quarter to 309 basis points, its widest level since March when the U.S.-Iran war began. Even so, this spread still sits in only the 18th percentile of its history since 1994 — so although investors require greater compensation for risk today, the absolute incremental yield to investors remains benign.

Finally, we watch market breadth as a barometer of the health of the underlying trend. Breadth — measured as the share of S&P 500 constituents trading above their 50-day moving average — has deteriorated steadily to roughly 21%, back to levels last seen during the war-driven malaise of late March. To us, this signals stalling momentum beneath the index's surface and a warning that the market is less healthy than implied by the index price alone. Notably, that loss of breadth has not been accompanied by any reduction in risk-taking: FINRA margin debt continues to hover near the highs set in June, at the height of AI euphoria (Exhibit 4). We view a narrowing market financed by leverage as another cautionary signal.

Exhibit 4: Margin Debt Balance Near Recent Highs



As of September 30, 2026. Source: ClearBridge Investments, FINRA.

Portfolio Positioning

During the third quarter, the ClearBridge Appreciation Strategy increased its exposure to the energy sector, adding to our position in Diamondback Energy and initiating a position in Cheniere Energy. We believe energy — specifically domestic production of both oil and LNG — grows more valuable in a world where infrastructure is increasingly weaponized for geopolitical ends and where governments are prioritizing security of supply. We view this exposure as an important ballast for downside capture, one that preserves our capacity to invest selectively in more pro-growth, AI-levered opportunities should a market selloff create them.

Outlook

As through-the-cycle investors with an emphasis on downside protection, we believe current conditions argue for a more cautious stance. Although absolute levels are still relatively benign, financial conditions have begun to tighten, underlying momentum is waning and investor leverage to equities remains elevated.

As in the second quarter, the argument for continued robust benchmark returns remains nuanced given ongoing economic momentum and sustained technology-related capital expenditure against the risk factors discussed above. We do not see meaningful recession risk. Rather, we read the second quarter's herd mentality and the third quarter's breadth decay as evidence of a market vulnerable to a speculative washout — a correction that would force investors to retrench around their highest-conviction, long-term ideas rather than continue to chase momentum.

We would view such a correction, even a reasonably sharp one, as healthy for the long-term durability of the bull market.

Portfolio Highlights

The ClearBridge Appreciation Strategy outperformed its S&P 500 benchmark during the third quarter. On an absolute basis, the Strategy had positive contributions from five of the 11 sectors in which it was invested. The leading contributors were the IT and financials sectors, while the industrials and materials sectors detracted the most.

On a relative basis, stock selection in IT, financials, industrials and consumer discretionary contributed to performance. An overweight to energy also contributed. Conversely, stock selection in communication services, energy and materials detracted. An underweight to IT also weighed on results.

On an individual stock basis, the largest contributors to relative returns were Thermo Fisher Scientific and not owning Applied Materials, KLA, Lam Research and Caterpillar. The largest detractors were ASML, TJX, underweights to Microsoft and Meta Platforms and not owning Palantir Technologies.

During the quarter, besides activity discussed above, we initiated positions in Colgate-Palmolive in consumer staples, Mastercard in financials, ServiceNow in IT, United Rentals, XPO and Howmet Aerospace in industrials and Novartis and CVS Health in health care. We exited positions in Cisco Systems in IT, Stryker in health care, Ferguson, Honeywell International and Honeywell Aerospace in industrials, Space Exploration Technologies, Walt Disney and T-Mobile in communication services and International Paper in materials.

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