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Appreciation ESG 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.
- ▶ 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.
- ▶ Eliminating waste and pollution, circulating products and materials and regenerating nature are three basic principles at the heart of the circular economy that align with ClearBridge's fundamental ESG framework.

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.

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We also follow measures of liquidity to assess the environment for risky assets. Although we have been concerned that sustained high 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 would likely use a growth scare as opportunity to methodically add incremental risk to the 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 ESG modestly underperformed the benchmark S&P 500 Index in the second quarter. On an absolute basis, the Strategy had positive contributions from six 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 staples, consumer discretionary, IT 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 and financials sectors.

On an individual stock basis, the biggest contributors to absolute performance during the quarter were Nvidia, Apple, Costco, Microsoft and Alphabet. 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 Exxon Mobil in the energy sector, whose shares we did not retain.

ESG Highlights: Dispatches from the Circular Economy

The Ellen MacArthur Foundation lists three basic principles of the circular economy: eliminating waste and pollution, circulating products and materials, and regenerating nature. These principles align with some key parts of ClearBridge's fundamental ESG framework, notably factors such as resource efficiency, recycling, product life cycle management, renewable generation and land usage, which we engage on as part of ongoing company research. By reducing energy use, stress on the environment and pollution, the circular economy is also linked to mitigating climate change and conserving biodiversity.

Many ClearBridge holdings thus contribute to the circular economy as they either execute on best practices or make improvements in these areas. We have often highlighted Trex as exemplary of the circular economy. Trex is the market share leader of wood-alternative composite decking. Trex's low-maintenance and high-quality decking products are composed of 95% recycled wood fibers and plastic, making use of waste that would otherwise end up in landfills. Trex has continued to innovate and advance plastic recycling processes. Recently, as the demand for "clean streams" of plastic waste has increased in different parts of the economy, Trex has upgraded technology to be able to accept "dirtier" streams of plastic waste into the manufacturing process. This allowed Trex to begin using additional quantities of waste plastic that would otherwise never be recycled, without compromising product quality standards. Trex products are more durable and have a longer life than traditional wood decking, therefore reducing overall raw material usage and end-product manufacturing. Finally, the quality and durability of the product saves consumers money through less frequent replacements and lower maintenance and upkeep costs.

Molecular Recycling Takes a Step Forward








While companies like Trex are making clear gains on plastic recycling, a circular economy that solves for plastics use remains a challenge. Regulatory bodies are stepping up requirements, such as the EU's new rules to reduce, reuse and recycle packaging, provisionally agreed upon in March 2024. Under the new rules, plastic packaging must also include minimum recycled content. Helping companies meet these new rules will be ClearBridge holding Eastman Chemical, which makes a range of advanced materials, chemicals and fibers for everyday purposes, among them plastics for food packaging.

In a recent engagement with Eastman Chemical we discussed two different chemical recycling technologies it has developed: polyester renewal technology (PRT) and carbon renewal technology (CRT). PRT recycles polyester-based materials such as soda bottles, carpet fibers and even clothing, breaking down their basic molecules until they are indistinguishable from materials made from virgin or nonrecycled content. CRT operates in a similar way but can take a broader range

of plastic types and replaces the use of coal as a feedstock to make fibers. Combining these two technologies gives Eastman a competitive advantage in molecular recycling, as it can take most types of waste plastics (Exhibit 2). Ironically, securing feedstock (i.e., waste plastic) has been a bottleneck to scaling molecular recycling as competitor technologies not using Eastman's dual technologies often require the waste plastic to be separated purely according to grade, which waste and recycling companies do not readily offer. Eastman's dual technology approach allows it to accept most plastic grades, making it less reliant on waste companies' sorting.

Eastman's first recycling plant is now operational in Tennessee, which will supply its internal Advanced Materials lines while also proving out the technology. The company is already working toward a second plant in Texas that will have Pepsi as its anchor customer. In the second plant, not only will Eastman help Pepsi meet its recycled content goals, but it is also expected to receive long-term, take-or-pay volume commitments, for doing so. This should greatly improve earnings visibility, and in turn, potentially valuation.

Exhibit 2: Eastman Chemical's Molecular Recycling Methods

Plastic Type	Common Uses	Eastman Molecular Recycling	
		PRT	CRT
 PETE	Bottles, Textiles, Carpet, Films, Forms	Yes	Yes
 HDPE	Thicker Bottles, Containers	No	Yes
 PVC	Pipes, Wiring, Sheeting	No	Not Yet (2 nd Generation)
 LDPE	Film, Bags	No	Yes
 PP	Medical	No	Yes
 PS	Food Containers, Utensils	No	Yes
 OTHER	Baby Bottles, Water Jugs	No	Yes

Source: Eastman Chemical.

Sustainable Food Needs Sustainable Plastic

As the case of Eastman Chemical suggests, plastic is central to sustainable food. Accordingly, companies in the food industry can advance the circular economy through practices such as recycling,

reducing or improving the sustainability of packaging and reducing landfill waste. Canadian grocer Loblaw can make an impact with all three of these practices.

In a recent engagement with Loblaw, we discussed its goal of making 100% of its control brand and in-store plastic packaging recyclable or reusable by 2025. This would put it in compliance with the Golden Design Rules (GDR), a set of rules established by the Consumer Goods Forum, made up of leading international retail and consumer goods companies, to benchmark packaging design, emphasizing the reduction of materials and the removal of problematic elements.

Noteworthy steps along the way have involved changes to Loblaw's protein packaging, which used to come in polystyrene foam trays; the vast majority now are packaged in clear recycled PET trays, which are accepted in all the municipalities in which the store operates and allow for greater detectability in the recycling stream. The shift to PET trays for mushrooms led to 39.9 million trays entering the recycling stream in 2023. Removing the plastic window from 10 kg potato bags allowed 23 million bags to be more easily recycled in 2023. In addition, extending expiry dates for its PC Money Account and PC Mastercard physical cards should prevent more than 10,000 kgs of plastic waste in the next 12 years.

Loblaw's advances in these areas also speak to its power to use its size to change the industry, as it communicated its GDR standards to hundreds of control brands and national brand vendors, effectively dictating a new national industry standard for plastic packaging. While navigating recycling standards and practices that vary from municipality to municipality, to improve recycling rates overall Loblaw supports extending producer responsibility, a system that give brand owners responsibility of both the cost and performance of recycling systems, incentivizing them to increase the recyclability of their packaging while empowering them with control over the recycling systems themselves.

Food waste is an avoidable crisis that has both environmental and societal costs, and linking food as an organic resource in a circular economy can reduce land use and better support growing populations. Loblaw has set a goal to send zero food to landfill by 2030, a goal supportive of Sustainable Development Goal 12: Responsible Consumption and Production, in particular target 12.3, to halve global food waste by 2030. The company is currently ramping up data collection on food waste but achieved over 78,000 metric tons of diverted food waste in 2023, with most going to composting, animal feed and redistribution of food surplus to food charities.

Supplying the Auto Aftermarket

LKQ is also focused on recycling heavy materials. LKQ is the largest wholesale distributor of alternative parts for the auto aftermarket in North America and Europe. It provides "like kind and quality" (LKQ)

auto parts as lower-cost alternatives to those provided by auto OEMs. It is the largest wholesale distributor of collision parts (used to repair vehicle exteriors) in the U.S. and Canada and the largest distributor of mechanical parts (used to repair internal components) in Europe. LKQ also runs its own salvage and recycling operations. As the world's largest recycler of cars at end-of-life, recovering 90%+ of the materials from scrap cars for reuse or recycling, LKQ supports resource efficiency and responsible consumption as an investable theme.

In a recent engagement with LKQ we had an extensive discussion about how it has become increasingly efficient over time at inventorying and selling more parts from its salvage vehicles, which reduces the amount of parts going for scrap and increases LKQ's margins, as it earns higher revenues from same fixed cost of goods.

Circular Economies Span All Sectors

One powerful aspect of the circular economy is how, although with differing dynamics and levels of challenges, every sector may contribute. ClearBridge will continue to share key company advances and engagements on the topic as our holdings innovate to operate more efficiently and enable a more resilient economic system, with fewer emissions and less waste.

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