



Appreciation Strategy



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Key Takeaways

- ▶ The technology-driven rally in the second quarter was truly unprecedented and marked a sharp reversal from the geopolitical malaise that plagued the first quarter: internal dynamics bore several similarities to the historic run of 1999's fourth quarter.
- ▶ Animal spirits remain elevated, with momentum stocks increasingly held by a more levered investor base at valuations leaving little margin for error; we believe current conditions argue for a more cautious stance.
- ▶ We would view a correction, even a reasonably sharp one, as healthy for the long-term durability of the bull market.

Market Overview

The technology-driven rally in the second quarter was truly unprecedented and marked a sharp reversal from the geopolitical malaise that plagued the first quarter. Although the S&P 500 Index's 15.2% return was "only" the 12th best quarter for the index since 1950, it was the first time since the creation of the Global Industry Classification Standards (GICS) in 1999 that only one sector outperformed the benchmark: information technology.

The second quarter's internal dynamics bore several similarities to the historic run of 1999's fourth quarter. First, it was the only quarter besides 4Q99 that nine of 11 GICS sectors underperformed the index by more than five percentage points. Second, 13 S&P 500 stocks appreciated by more than 100% during the quarter, the most on record. All but one of these companies (Humana) were technology stocks. This exceeded the prior record of 11 such stocks in 4Q99. AI bubble or not, the historic nature of the second quarter's performance is difficult to ignore.

After pausing during the first quarter, technology shares reasserted market leadership. Technology returned a remarkable 31.8%, more than double the return of the index. Following this blowout quarter, the sector appears poised to outperform the S&P 500 for a fourth consecutive year in 2026.

Industrials was the only other sector to even come close to the S&P 500's return, rising 14.9%, or 0.3 percentage points below the benchmark. Within the sector, businesses linked to construction and energy infrastructure are broadly benefiting from data center and semiconductor foundry capital expenditures.

Every other sector lagged meaningfully. Energy shares were the largest detractor, declining 13.5%, or -28.7 percentage points below the S&P

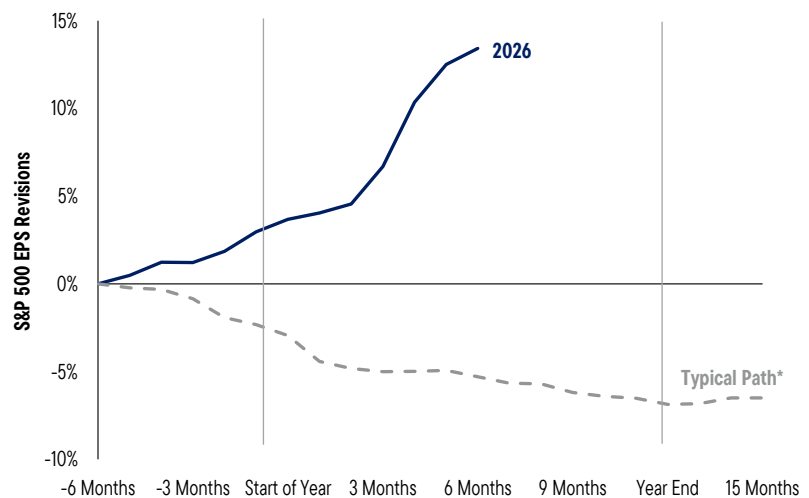
500, as oil prices fell 30% to below \$70 per barrel following the ceasefire agreement between the U.S. and Iran. Traditional defensive areas such as utilities and consumer staples were essentially flat, underperforming the index by roughly 15 percentage points, as investors used these sectors as sources of capital to re-risk portfolios back into the AI thematic.

Outlook

We believe the backdrop is nuanced. Fundamentals remain broadly supportive of risk assets, while several risks percolate beneath the surface.

Technology-driven capital expenditures are fueling a cyclical expansion in the industrial economy, which appears likely to serve as a tailwind to growth for the remainder of 2026. Indeed, the ISM Manufacturing Index has now spent six consecutive months in expansion, the first such stretch since the 29-month expansion between January 2020 and October 2022. At the same time, corporate profits have exceeded analyst expectations at a rate rarely seen outside of a post-recession economy (Exhibit 1).

Exhibit 1: Corporate Profit Expectations Unusually High

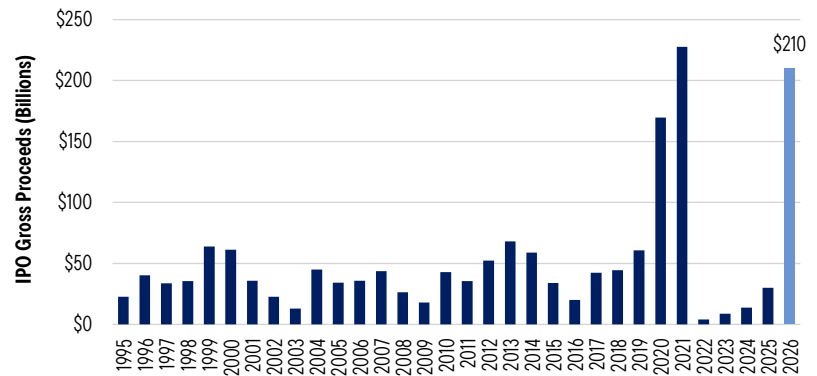


As of June 30, 2026. Source: ClearBridge Investments, S&P, FactSet.

Capital markets also remain wide open, supported by ample liquidity. Year to date, investment grade and leveraged loan issuance has already surpassed any full calendar year on record, while the high-yield issuance appears likely to exceed prior peaks. Buoyed by the successful SpaceX IPO, gross IPO proceeds are also likely to surpass any previous calendar year total (Exhibit 2). Finally, credit spreads are back to generational lows following a brief increase during the U.S.-Iran conflict.

Among the many risks facing markets today, euphoria and valuation are logical starting points. At 230%, the current ratio of equity market cap to GDP is now more than three standard deviations above its long-term average and well above any prior level in modern history. Yes, fundamentals are strong and profit margins are at record highs, but valuations suggest that expectations for future growth are also extremely elevated.

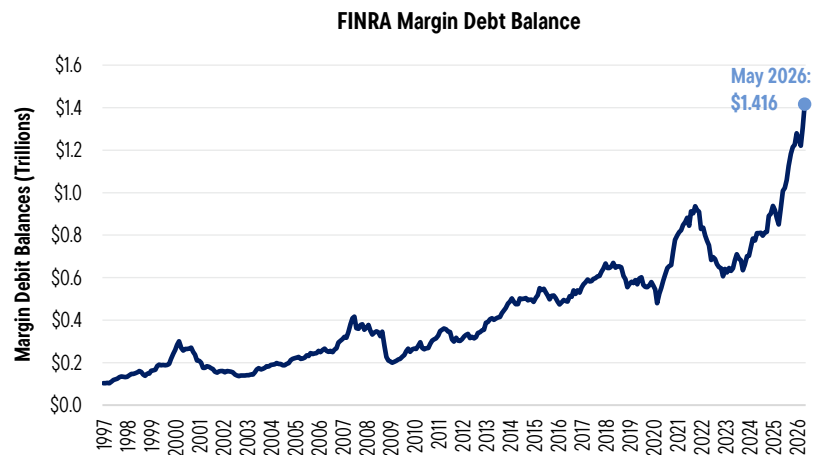
Exhibit 2: A Bumper Year for IPO Gross Proceeds



As of June 30, 2026. Source: ClearBridge Investments, FactSet. NYSE and Nasdaq listed companies; 2026 YTD is annualized.

Leverage is proliferating across the stock market. According to FINRA, margin debt balances rose 50% year over year and now stand at all-time highs (Exhibit 3). Zero-day-to-expiration (ODTE) options now account for 28% of all U.S. options volume, up from 18% three years ago, representing a five-fold increase since the 2022 launch of daily expirations. Today, zero-day options exceed \$1 trillion of daily notional trading. Meanwhile, leveraged ETFs have become increasingly popular, providing investors with targeted, levered exposure to the market's hottest trades. Leveraged ETFs now generate 13% of all ETF trading volume despite being only 2% of total ETF assets, underscoring robust demand from both traders and retail investors.

Exhibit 3: Margin Debt Balances at All-Time Highs



As of May 2026. Source: FINRA Margin Statistics; values shown are USD.

Other tangible risks bear watching. Inflation remains stubbornly elevated, as technology component shortages are challenging the decades-long assumption that technology advancement is inherently deflationary. The U.S.-Iran ceasefire remains tenuous, leaving energy markets subject to renewed volatility. The Federal Reserve appears to be in a position where raising rates remains the path of least resistance, with the yield curve flattening as short rates rise in anticipation of such a move. Finally, the midterm elections are likely to be contentious and could pull AI further into the political debate.

We view today's herd mentality as evidence of a market that is overdue for a speculative washout.

Conclusion

As through-the-cycle investors with an emphasis on downside protection, we believe current conditions argue for a more cautious stance. Animal spirits remain elevated, with momentum stocks increasingly held by a more levered investor base at valuations leaving little margin for error.

That said, given ongoing economic momentum and sustained technology-related capital expenditures, we don't see meaningful risk of a recession. Rather, we view today's herd mentality as evidence of a market that is overdue for a speculative washout. Such a correction would force investors to retrench and focus on their highest-conviction, long-term ideas rather than continuing to blindly chase momentum.

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

Portfolio Highlights

The ClearBridge Appreciation Strategy underperformed the benchmark S&P 500 Index in the second quarter of 2026. On an absolute basis, the Strategy had positive contributions from eight of 11 sectors. The IT sector was the main positive contributor, while energy was the main detractor.

In relative terms, stock selection and sector allocation detracted. Stock selection in IT, industrials, communication services, financials and consumer discretionary, overweights to materials and energy and an IT underweight detracted the most. Conversely, stock selection in materials and a consumer discretionary underweight were beneficial.

On an individual stock basis, the biggest relative contributors during the quarter were ASML, Palo Alto Networks, ASM International, an underweight to Microsoft and not owning Palantir. The biggest detractors were Netflix, underweights to Micron Technology and Advanced Micro Devices, and not owning Intel and Applied Materials.

During the quarter, we initiated new positions in SpaceX in communication services, Micron Technology, Cisco Systems, Advanced Micro Devices and Texas Instruments in IT and Diamondback Energy in energy. We exited Roblox in communication services, Boston Scientific and AbbVie in health care and Solstice Advanced Materials in materials. We also received shares of Honeywell Aerospace in the industrials sector following its spinoff from holding Honeywell International.

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