ClearBridge
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Consequences of Capital Flows Can't Be Ignored

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Key Takeaways

- Capital flows are the market's true energy source, amplifying every dollar into outsize price swings.
- The Fed and passive investors have become powerful, price-insensitive forces distorting market signals.
- Currently, the market's kinetic energy, represented by price momentum, is extremely high as massive amounts of capital flow into concentrated U.S. indexes. Meanwhile, the market's stored energy, represented by valuation, remains underappreciated.

The Physics Behind Market Fear and Greed

One of the core concepts in thermodynamics is that energy flow drives most systems. This principle also helps explain the behavior of economies, life and — importantly — financial markets, where capital flows act as the system's energy source, with potentially massive impacts. For instance, the Inelastic Market Hypothesis (IMH) suggests that for every $1 of capital flows, the market's aggregate value changes by roughly $5, which goes a long way in describing why stock prices are so much more volatile than underlying changes in fundamentals and intrinsic value would suggest, as well as why the market often seems to ignore obvious risks as it cycles across the long arc between fear and greed. We believe the IMH is a critical short- to intermediate-term driver, setting up the long-term valuation-driven returns that we try to capture through our investment process.

Market data supports the IMH by showing that the price elasticity of demand of the aggregate stock market is relatively small — a fancy way of saying that higher stock prices don't dampen buying demand much at all, while low prices don't increase demand. In fact, if anything, elasticity drops as you get into extremes as the emotions of greed and fear take over in the tails.

In contrast, our valuation-disciplined process is highly price elastic. We think long-term potential returns rise and fall as prices dislocate to extremes around our assessed intrinsic value. As a result, we become aggressive buyers when markets experience fear-driven collapses, and actively shed risk when greed takes over. The elasticity gap between our process and the market has only widened due to ongoing structural market changes, which have mostly arisen from two effectively valuation-blind buyers of assets, who are price inelastic by design.

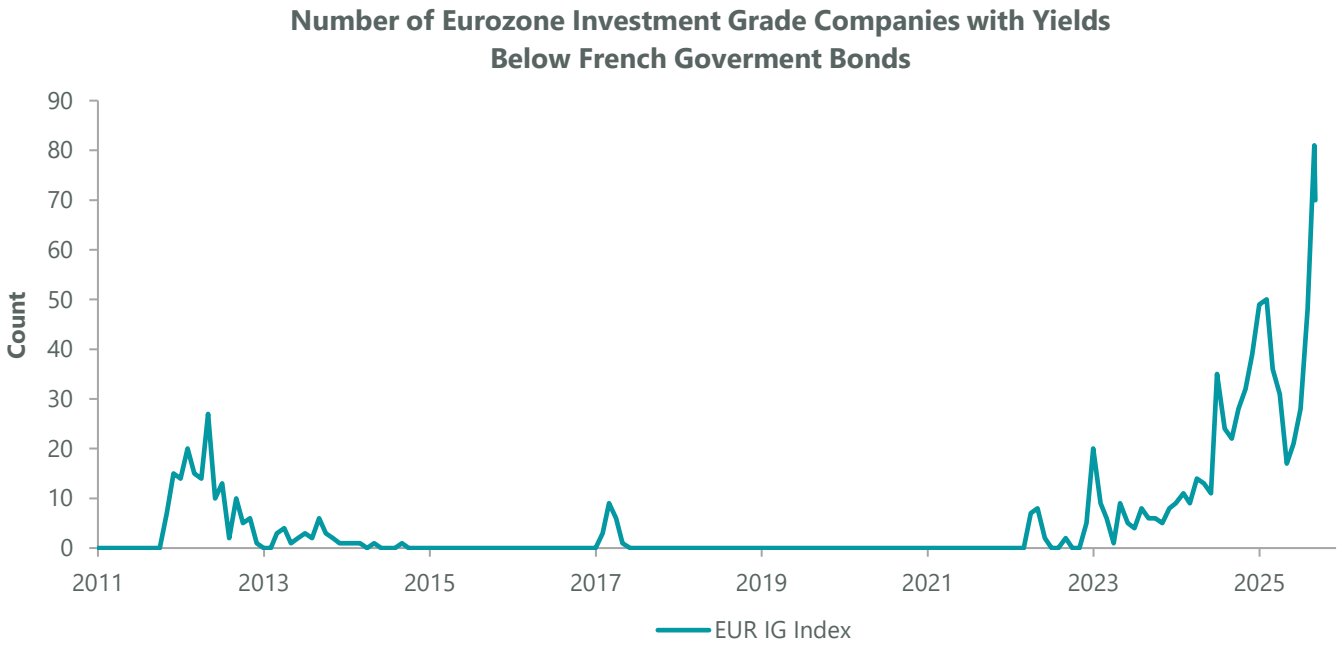
Inelastic Buyers: The Fed and Passive Investors

The first inelastic asset buyer was the Federal Reserve, which launched its quantitative easing (QE) program coming out of the Global Financial Crisis. QE's explicit goal was to manipulate market pricing signals in fixed income markets, resulting in an extended period of negative real, and in many cases negative nominal, interest rates. Many investors argued there were simply not enough risk-free assets to go around, and in December 2020 negative-yielding government debt peaked at over $18 trillion globally. This bubble in risk-free assets spilled over to equity

markets, driving up the prices of low-volatility "bond-proxy" stocks to historically high levels thanks to inelastic buying. In response to this market regime, often described as an inverted bubble, we did the opposite of the crowd and bought higher-volatility stocks where we were getting paid extremely well by the market to take risks. This contrarian approach set up the attractive nominal and relative returns we have realized since the 2020 peak of investors paying governments to take their money.

However, the problem with distorting fundamental price signals with price inelastic buying is that you end up with lingering issues from misallocated capital and distorted policy. In the case of the inverted bubble, the supply of government debt exploded. This solved the shortage of "risk-free" assets but has left us on an unsustainable fiscal path where the sovereign debt of many developed countries is now compounding well above underlying economic growth. An increasing number of corporate borrowers have debt yielding below that of their respective sovereign debt yields. This inverted risk premium is theoretically not supposed to happen, but begs the question: what happens to global markets if we lose the anchoring bedrock of a credible true risk-free rate? Arguably the probability of a sovereign debt crisis is rising, which is fueling a powerful causal narrative in support of the ongoing bull market in gold and bitcoin.

Exhibit 1: European Corporate Yields Spike Over Sovereign Concerns



As of September 3, 2025. Source: iBoxx, Goldman Sach Investment Research.

The second inelastic asset buyer is the passive investor, whose dominance has been growing. According to the IMH and observed data, for every $1 of passive inflows the market's aggregate value increased by approximately $3 to $8. This would make passive inflows the dominant driver of equity prices and explains why markets have been so incredibly resilient to outside risk factors. When factoring in the recent decline in new equity supply from historically low issuance and a current record level of U.S. stock buyback activity, the path of least resistance for equities has been up. This process also creates a powerful feedback loop as higher prices bring in more flows, driving higher prices, similar to a perpetual motion machine.

This passive feedback loop has generated the exact opposite effect of the fear cycle and perceived shortage of risk-free assets seen during the QE era. As animal spirits have shifted from fear to greed in recent years, the market is acting like we are running out of volatility and risk assets. Just as casinos and online betting firms manufacture risk for gamblers, the market is increasingly acting like the world's largest casino in manufacturing volatility and risk for

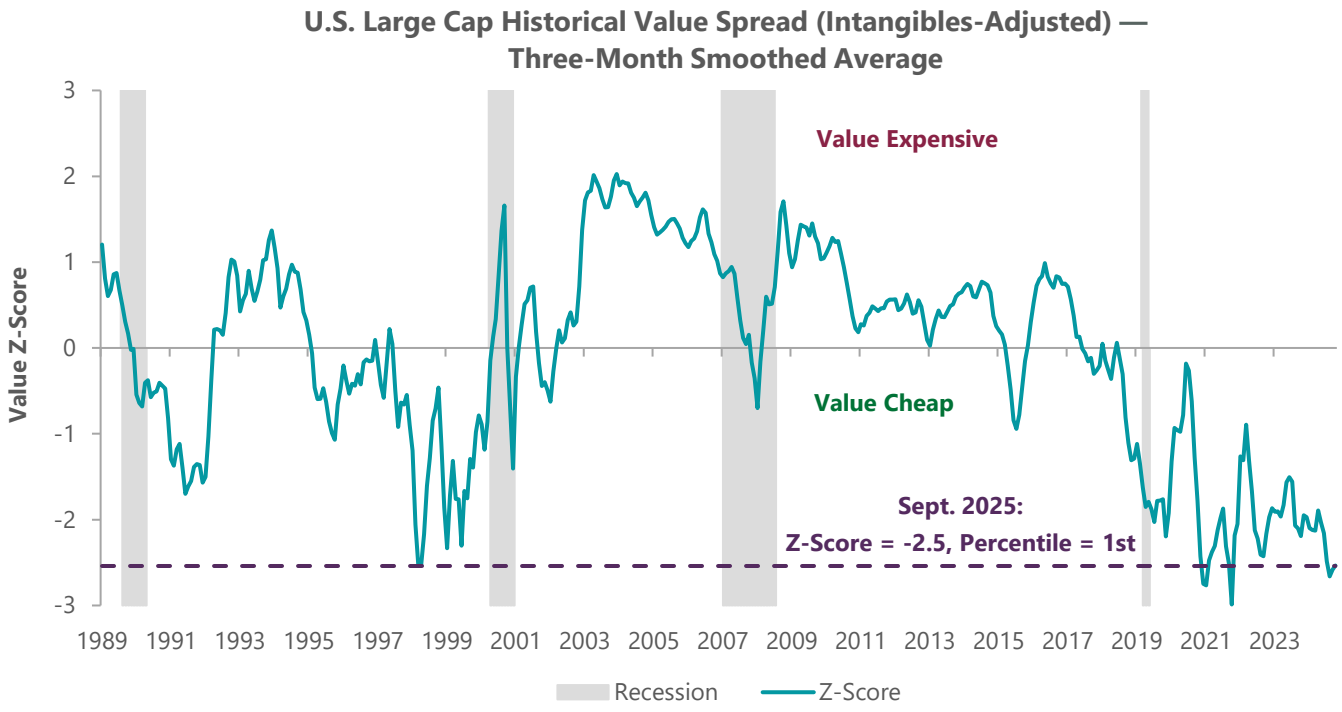
investors. We are seeing this in the proliferation of double- and triple-leveraged ETFs and the explosion in options volume. Current estimates are that the notional daily value of options trading ranges from 150% to 250% of the cash market volume, adding tremendous rocket fuel to the IMH framework.

The paradox of this aggressive chasing of risk is that the measures of current risk have effectively been put to sleep, although this is not an unexpected outcome in systems like markets, where positive feedback is present. However, the level of risk premiums — along with volatility, correlations and credit spreads — across markets is at historically extreme and unsustainably low levels. If financial markets are good at anything, it is supplying what investors are demanding; just as risk-free assets have caught up with demand, the risk that markets are currently craving is being manufactured at an accelerating rate. Ultimately, when the risk catches up and inevitably overshoots demand, risk measures typically all move higher together as correlations spike. The only real protection, therefore, will be to avoid these crowded areas of awakening risk through resilient diversification.

Balancing Potential and Kinetic Energy

Another way to view the current market environment is by explaining the difference between another thermodynamic concept: kinetic and potential energy. Kinetic energy is being used when something is in motion, while potential energy is stored. In markets, price momentum is kinetic energy, while valuation is potential energy.

Exhibit 2: Spread Between Value and Growth Near All-Time Highs



As of Sept. 30, 2025. Source: ClearBridge Investments.

Currently, the market's kinetic energy is extremely high as massive amounts of capital flow into concentrated U.S. indexes. However, this creates the risk that momentum can reverse suddenly, where even small reversals in capital flows can lead to violent market corrections and crashes at an accelerated rate. Hence the old trader adage that "the market takes the escalator up but the elevator down." Right now, the gap between the kinetic energy of growth and the potential energy of value are near record levels as capital chases the market's crowded, kinetic energy (Exhibit 2). Managing this risk requires recognizing that this potential and kinetic energy are diversifiers to one another — and most of the time a mix of both is ideal.

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