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Appreciation Strategy

Key Takeaways

- ▶ Four of 11 sectors in the S&P 500 outperformed the overall index in the quarter — though only two produced meaningful outperformance — as the market was driven by a return to AI leadership.
- ▶ While the market seems to believe sweeping reciprocal tariffs are a negotiating tool, not a base case outcome, we believe they are the key risk to corporate profits in the second half of 2025; we are less concerned about geopolitical events or the outlook for fiscal and monetary policy.
- ▶ Although we believe the market is fully valued, policy remains favorable to economic growth in the near-term while capital markets conditions suggest stocks can continue to perform well, with positive catalysts supporting the outlook for 2026.

Market Overview

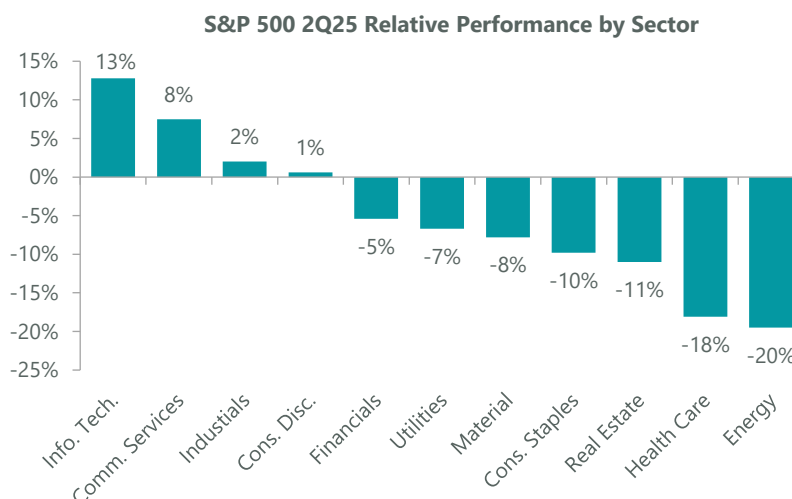
The second quarter of 2025 took investors on quite a roller coaster ride. The quarter began with a post-Liberation Day dive that saw the S&P 500 Index decline 11% over the quarter's first six trading days. Clearly, equity investors feared the economic impact from the largest potential tariff increase since the Smoot-Hawley Act of 1930. However, a decisive policy shift on April 9 — pausing tariffs for 90 days — quickly initiated a steep climb. The S&P 500 rose 24.5% in 56 trading days from the April 8 low into June 30 to finish the quarter with a 10% advance to a new all-time high. At this point it seems clear investors believe sweeping reciprocal tariffs are a negotiating tool, not a base case outcome.

Four of 11 sectors outperformed the index in the quarter — though only information technology (IT) and communication services produced meaningful outperformance — as the S&P 500 was driven by a return to AI leadership. IT stocks dominated the index, rising 23.7% and led by semiconductor and software stocks, which returned 43% and 29%, respectively (yes, in the second quarter alone). Thirteen of the 25 top-performing stocks in the S&P 500 were IT stocks, while five more were levered to powering the artificial intelligence boom. Communication services was the next best-performing sector, driven by rebounds in Netflix and Meta Platforms following the tariff pause. Finally, industrials and consumer discretionary sectors narrowly beat the market. Industrials stock performance was led by businesses levered to data center demand growth, while travel stocks — cruise lines specifically — led the advance for consumer discretionary.

All seven underperforming sectors lagged the index by over 5% (Exhibit 1), marking the first time seven sectors lagged the index by such margins in a quarter since the fourth quarter of 1999. Energy and health care stocks bore the brunt of underperformance, declining 8.6% and 7.2%, respectively. Energy sector performance was hindered by a 9% decline in the price of oil as traders bet the current Middle East conflict would spare energy assets and be short lived.

Health care malaise was broad-based as health care service providers, life sciences and tools, biotechnology and pharmaceuticals were four of the seven worst-performing industries in the quarter, declining in absolute terms and materially underperforming the index. Health care service providers were hit by continued turmoil at industry bellwether UnitedHealth Group in addition to industrywide concerns over the rising cost of care. Biotechnology and pharmaceutical stocks were hit as the Trump administration intensified U.S. drug pricing pressure and threatened potential pharmaceutical tariffs. The One Big Beautiful Bill signed on July 4 cut Medicaid funding. Reducing medical spending has been a political third rail and it has now for the first time been touched.

Exhibit 1: S&P 500 Driven by AI-Heavy IT Sector



As of June 30, 2025. Source: ClearBridge Investments, Bloomberg.

Outlook

After two outsize positive performance years in 2023 and 2024 (+26% and +25%, respectively), U.S. equity markets are digesting a mixed bag of risks and opportunities in 2025. While the second quarter saw increased volatility from concerns over the impact of tariffs on economic growth and inflation, markets quickly dismissed those concerns, rallying back to all-time highs. In our view, the U.S. stock market currently stands near fair value, lacking material upside in the short-run and vulnerable to potential downside surprises in the second half of the year. We are more focused on the outlook in 2026

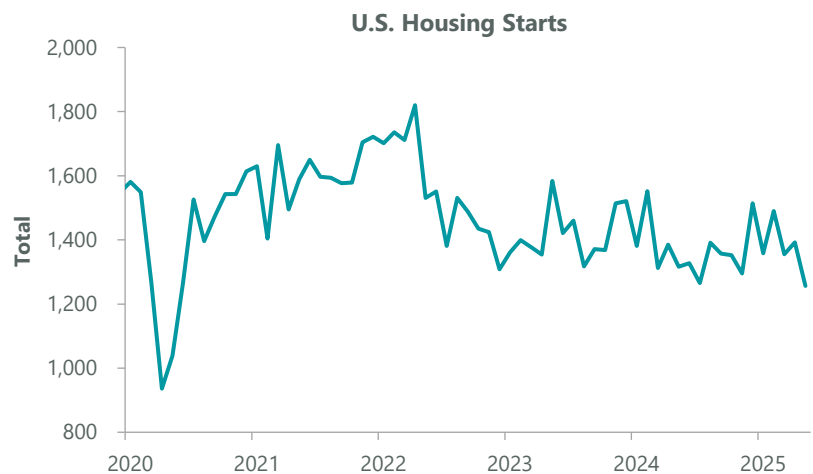
Despite our relatively cautious stance, the backdrop for risk assets remains decidedly positive.

when multiple catalysts could drive an acceleration in corporate profits and many of the current risks are likely to dissipate.

We believe that tariffs are the key risk to corporate profits in the second half of 2025 and are less concerned about geopolitical events or the outlook for fiscal and monetary policy. While it seems likely the tariff deal deadline extended beyond July 8, there has been slow progress beyond a few broad deal “frameworks.” Tariffs on our biggest trading partners in the EU and China are likely to stay high and take longer to resolve, while tariffs on secondary trading partners will remain in place for an extended period. To date, the impact to both growth and inflation has been muted by existing inventory and a fear of backlash for raising prices; however, our conversations with corporate management teams suggest that, while they are willing to absorb some cost, prices are likely to rise this fall as pre-tariff inventory is absorbed. We estimate that the average effective tariff rate will ultimately settle in the 14%–15% range from approximately 2.5% in the prior year. Given imports at 14% of U.S. GDP, that would increase inflation by 2% minus whatever portion of the cost is borne by foreign exporters.

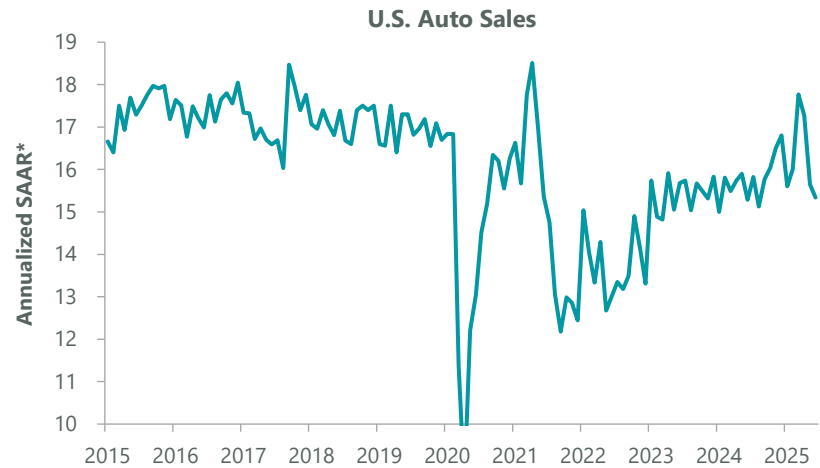
While the overall economy can absorb that impact without a recession, we believe that current profit estimates are too high and are likely to weaken. Housing, autos (Exhibits 2 and 3) and investment spending excluding AI are all starting to weaken and should become more pronounced in the months ahead. Fortunately, inflation expectations continue to be well anchored, and although higher tariffs are likely to lead to higher goods inflation, lower oil prices and a slowing housing market should help to offset those pressures. We expect long-dated rates to remain higher for longer as deficit concerns are real and worrisome.

Exhibit 2: Housing Growth Weakening



As of May 31, 2025, latest available as of June 30, 2025. Source: ClearBridge Investments, U.S. Census Bureau.

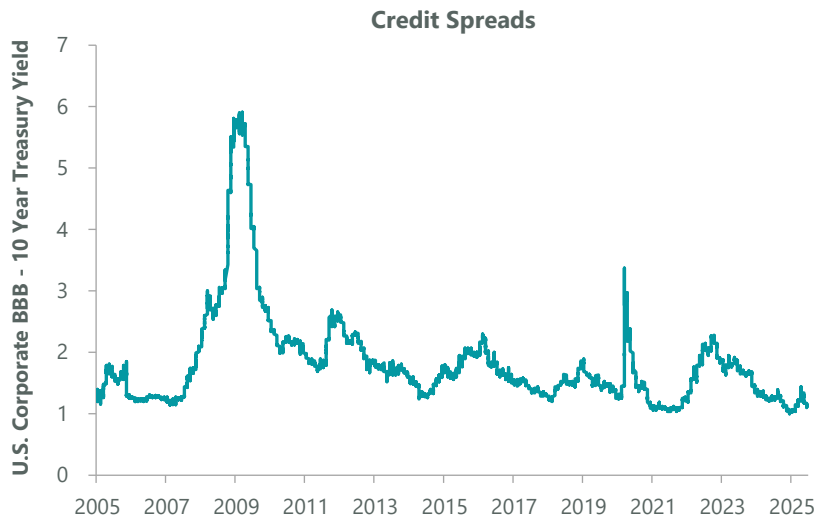
Exhibit 3: Auto Sales Also Under Pressure



*Seasonally adjusted annual rate. As of June 30, 2025. Source: ClearBridge Investments, Ward's Automotive Group, Bloomberg.

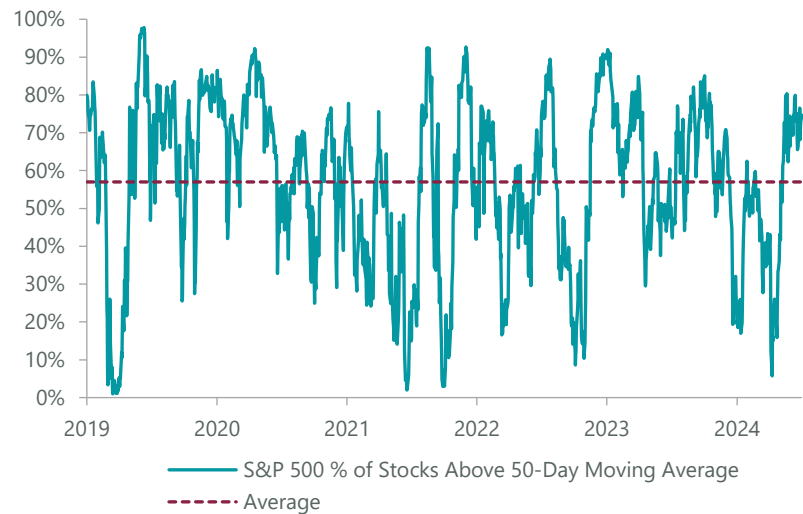
Despite our relatively cautious stance, the backdrop for risk assets remains decidedly positive, suggesting that pullbacks remain buyable. Credit spreads have again tightened to all-time lows (Exhibit 4), market breadth remains positive with nearly 75% of S&P 500 stocks above their 50-day moving average (Exhibit 5), the yield curve remains positively sloped with well-anchored short rates, and capital markets activity appears to be accelerating.

Exhibit 4: Low Credit Spreads Suggest Investor Confidence



As of June 30, 2025. Source: ClearBridge Investments, Bloomberg.

Exhibit 5: Market Breadth Has Improved



As of June 30, 2025. Source: ClearBridge Investments, Bloomberg.

Conclusion

Our economic and market outlook has improved since the administration softened its stance on Liberation Day tariffs. Although we believe the market is fully valued, policy remains favorable to economic growth in the near term while capital markets conditions suggest risky assets — such as stocks — can continue to perform well. As such, we have leaned incrementally into more cyclical areas of the market while lightening our exposure to traditionally defensive sectors. That said, we are long-term investors focused on outperforming through a market cycle via downside protection. We remain focused on looking out two to three years to make investment decisions based upon our assessment of a company's longer-term sustainable earnings growth rate versus what is implied in today's share price while being mindful of how near-term earnings trends or government policy outcomes could impact the road ahead.

Portfolio Highlights

The ClearBridge Appreciation Strategy underperformed the benchmark S&P 500 Index in the second quarter. On an absolute basis, the Strategy had gains in seven of 11 sectors. The IT, communication services and industrials sectors were the main positive contributors to performance, while the health care sector was the main detractor.

In relative terms, overall stock selection contributed positively but was offset by negative sector allocation. Stock selection in the IT, communication services, materials and energy sectors and a health care underweight added the most, while stock selection in the health care, industrials and financials sectors, an IT underweight and a materials overweight detracted.

On an individual stock basis, the biggest contributors to relative performance during the quarter were Apple, Microsoft, Netflix, Eaton and Broadcom. The biggest detractors were Berkshire Hathaway, Nvidia, UnitedHealth Group, Thermo Fisher Scientific and Travelers Companies.

During the quarter, we initiated new positions in Texas Instruments and Palo Alto Networks in the IT sector and Old Dominion Freight Line and Boeing in the industrials sector. We exited positions in NextEra Energy in the utilities sector, ConocoPhillips in the energy sector, Workday and Arista Networks in the IT sector, U.S. Bancorp in the financials sector, Merck and UnitedHealth Group in the health care sector and PepsiCo in the consumer staples sector.

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