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The Long View: Bubble or Boom?

"As firms or households see others making profits from speculative purchases and resales, they tend to follow. When the number of firms and households indulging in these practices grows larger, and the belief spreads that the object of speculation can only go up, speculation for profit leads away from normal, rational behavior to what have been described as 'manias' or 'bubbles'."

- Charles Kindleberger; *Manias, Panics, and Crashes*

Key Takeaways

- ▶ Whether or not a stock market bubble is forming has become a key debate for investors. We believe a boom may be on the horizon, driven by a favourable policy mix and a healthy consumer that should support earnings growth.
- ▶ Despite recent U.S. labor market weakness, the economy remains on solid footing with the ClearBridge Recession Risk Dashboard still flashing a green signal, with a positive signal change in ISM New Orders offsetting a deterioration in Housing Permits this month.
- ▶ While equity valuations are elevated, they are backed by healthy earnings and strong cash flows. Historically, global equities have fared well once the Fed embarks on a cutting cycle that coincides with a soft landing, which we believe will play out once again in the coming year.

The velocity of the S&P 500 Index's 35% rally from the April lows has taken many investors by surprise, including us. Nearly all traditional valuation metrics suggest the market is expensive: the forward (next-12-month) P/E now stands at 22.8x, a level previously only witnessed during the tech bubble of the late 1990s. While some signs of froth are certainly evident, other factors suggest the market's recent advance is grounded in a favourable policy mix that supports improving fundamentals, or perhaps even a boom, into 2026. As a result, whether a bubble is forming has become a key debate for equity investors.

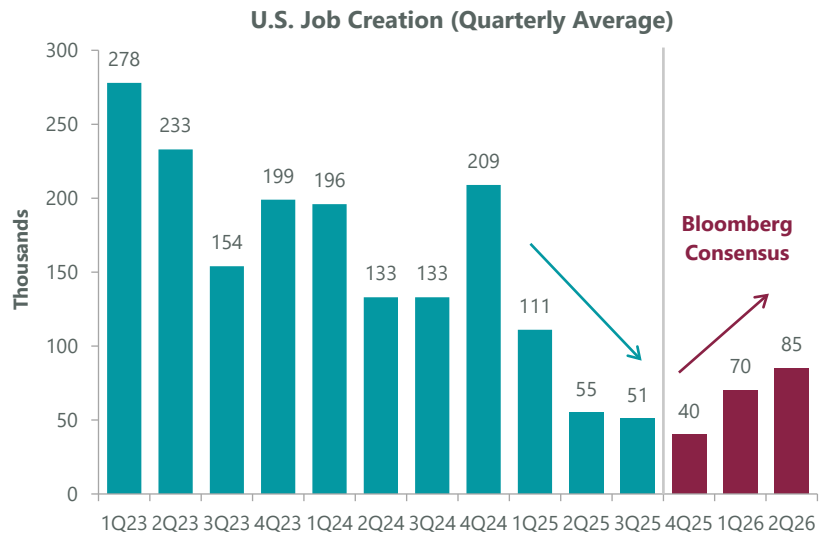
Is a Bubble Forming?

One example of a decoupling between stock prices and underlying fundamentals that bears watching is recent [U.S. labor market weakness](#), the argument being that slowing job creation is a sign that the economy is on shaky footing. By extension, equities should be

lower as reduced labor income weighs on overall consumer spending.

However, job creation remains in positive territory and is expected to rebound into 2026 as fiscal stimulus from the One Big Beautiful Bill (OB BB) comes online and trade/immigration policy headwinds abate. Importantly, the index of Aggregate Weekly Payrolls — a good proxy for overall U.S. labor income — continues to show solid gains and has expanded at a 4.2% annualised pace through the first eight months of the year, which should power future consumption. Furthermore, with uncertainty waning and hiring expected to rebound, it would not be a surprise to see this metric accelerate toward 2024’s 4.6% pace in the coming months.

Exhibit 1: U.S. Labor Market Slowdown



Note: Quarterly average change in nonfarm payrolls. The term “consensus” within the capital markets industry refers to the average of earnings estimates made by professionals. As of 30 September 2025. Sources: Bloomberg, U.S. Bureau of Labor Statistics (BLS), Macrobond.

A key reason we remain less concerned about the recent labor malaise is the strong overall green expansionary signal emanating from the ClearBridge Recession Risk Dashboard. The dashboard saw two signal changes in September, with ISM New Orders improving from red to yellow as the metric remained above 48 in September following the August spike, while Housing Permits deteriorated from green to yellow. With these mixed signal changes, the overall reading remains firmly in green territory.

Exhibit 2: U.S. Recession Risk Indicators

	September 30, 2025	June 30, 2025	March 31, 2025	
Consumer	Housing Permits	●	↑	↑
	Job Sentiment	×	×	×
	Jobless Claims	↑	↑	↑
	Retail Sales	↑	↑	↑
	Wage Growth	↑	↑	↑
Business Activity	Commodities	↑	↑	↑
	ISM New Orders	●	×	×
	Profit Margins	●	●	↑
	Truck Shipments	↑	↑	●
Financial	Credit Spreads	↑	↑	↑
	Money Supply	↑	↑	↑
	Yield Curve	●	●	×
Overall Signal	↑	↑	↑	

↑ Expansion ● Caution × Recession

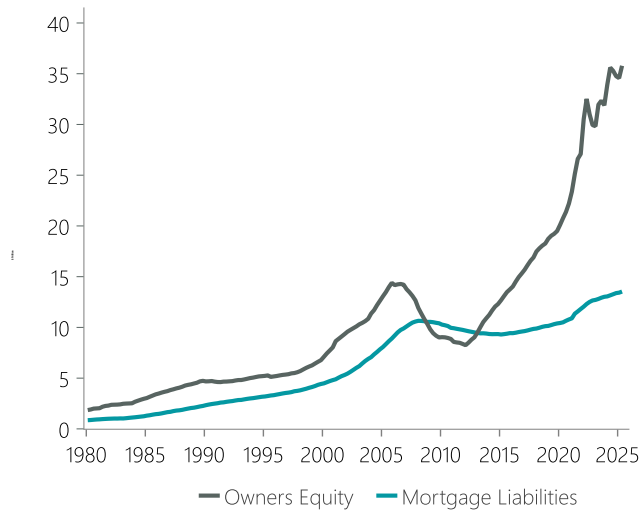
Data as of 30 September 2025. Sources: BLS, Federal Reserve, Census Bureau, ISM, BEA, American Chemistry Council, American Trucking Association, Conference Board, Bloomberg, CME, FactSet and Macrobond. The ClearBridge Recession Risk Dashboard was created in January 2016. References to the signals it would have sent in the years prior to January 2016 are based on how the underlying data was reflected in the component indicators at the time.

Housing permits have been sluggish for much of the past two and a half years but have declined in each of the past five. The dashboard focuses on housing permits because they tend to move ahead of actual “shovels in the ground” metrics such as housing starts. While housing starts remain within the range experienced since late 2022, housing permits have been steadily slipping over the past three months and are now nearing a 1.3 million annual pace, a drop of 12% from the recent peak in late 2024.

High home prices and interest rates have strained affordability and housing market activity metrics have plunged in response. The good news is that it does not appear that homeowners are overextended as lenders have maintained stringent underwriting terms over the past 15 years. In fact, consumers appear to have the ability to add leverage if desired given strong balance sheets, providing a buffer and source of funds if needed.

Aggregate homeowners’ equity has skyrocketed to \$35.8 trillion according to Federal Reserve data. With mortgage liabilities of just \$13.5 trillion, consumers appear to have ample room to tap home equity lines of credit (HELOCs). Total HELOC borrowing outstanding peaked in 2009 according to FDIC data and troughed 61% lower in 2022, with a modest 8% rise occurring over the past three years. This lack of consumer leverage suggests that to the extent a real estate bubble may be forming, it bears little resemblance to the last one.

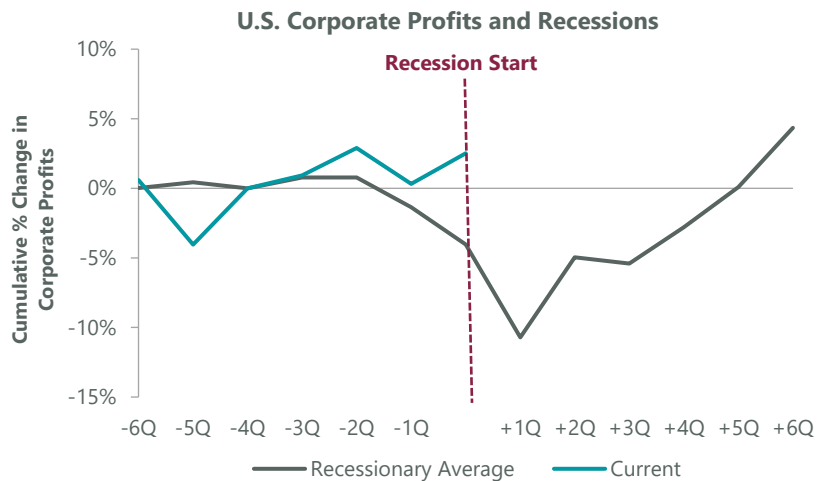
Exhibit 3: Home Equity Boom



Data as of 11 September 2025, latest available as of 30 September 2025. Sources: Federal Reserve, Macrobond.

Another area where fundamentals are not suggestive of bubble territory is corporate profits. Earnings picked up in the second quarter, and forward guidance from companies suggests that they are finding ways to offset the costs from higher tariffs with margins and profits expected to continue to rise in the third quarter and into 2026. Accelerating earnings are a harbinger of a healthy labor market, whereas they tend to plateau and then decline beginning two quarters on average ahead of historical recessions dating back to 1965. With the consensus expecting continued profit growth in the year to come, the recent trajectory also bears little resemblance to these past periods. Put differently, corporate profits are arguing against a decoupling between equity prices and underlying fundamentals.

Exhibit 4: Profits Don't Look Recessionary



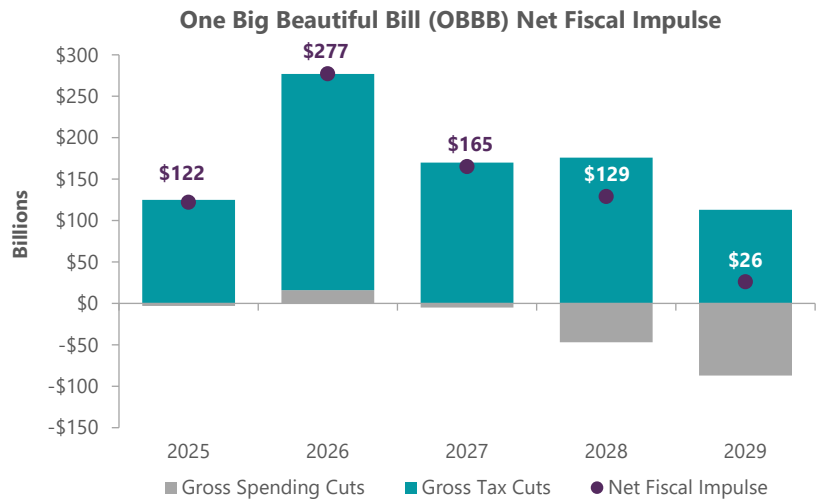
Note: Nonfinancial Corporate Profits w/IVA and CC Adj (Gross Value Add), 1965-Present. Data as of 30 June 2025, latest available as of 30 September 2025. Source: BEA, Bloomberg, NBER.

Is a Boom Forming?

Many of the disconnects between rising equities and underlying fundamentals that the bubble camp highlights are more nuanced than they initially appear. This begs the question if, instead of a bubble, is a boom on the horizon? The fiscal and monetary policy backdrops are more suggestive of a boom, with the potent policy mix of a Fed cutting cycle and a fiscal stimulus package. This combination is typically only seen in the wake of economic downturns in an effort to lift the economy out of the doldrums.

Although the Fed may ultimately under-deliver on the expectations of an additional four-plus cuts priced into futures markets by the end of 2026, we believe that multiple cuts will occur. If the Fed ultimately ends up cutting less than the market expects, we believe this would be treated as a positive by investors given it would likely come amid a healthier economic backdrop. With the passage of the OBBB, the boost from fiscal policy is more certain than the Fed's path in 2026. Fiscal stimulus in the form of consumer and corporate tax cuts will arrive in 2026, with the Congressional Budget Office (CBO) estimating the impact at nearly 1% of GDP.

Exhibit 5: Tax Tailwind



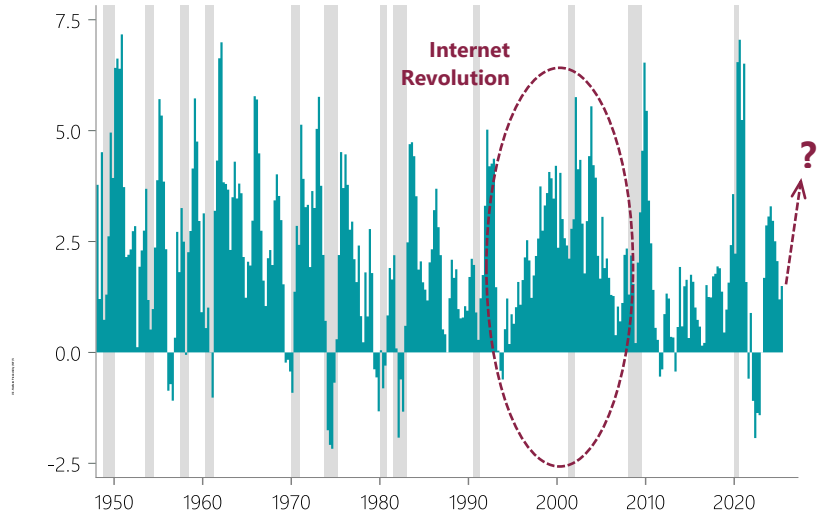
Data as of 30 September 2025. Based on final CBO Scoring of the One Big Beautiful Bill Act. Source: Wolfe Research. There is no assurance that any estimate, forecast or projection will be realised.

The improved outlook for 2026 is not just a function of government policy, however. Economists expect consumer spending to remain robust while business investment accelerates on the back of continued strength in artificial intelligence (AI) infrastructure. Already, some investors point to hundreds of billions of dollars in infrastructure capex (chips, power, data centers) and sky-high pay packages for leading AI researchers as signs of irrational exuberance reminiscent of the late 1990s tech bubble.

However, it is important to note that while equities did form a bubble during this period, the underlying economy also saw benefits. With the benefit of hindsight, this is clear in productivity data from the

Internet revolution. The key question at present is whether strong productivity gains can be sustained and move higher from here in a similar fashion. Put differently, will AI ultimately live up to the hype — and, even if not fully, will enough benefits materialise that can drive upside to economic growth and a boom?

Exhibit 6: The Productivity Pickup



Note: Gray shading marks recessionary periods. Data as of 4 September 2025, latest available as of 30 September 2025. Sources: U.S. Bureau of Labor Statistics (BLS), NBER and Macrobond.

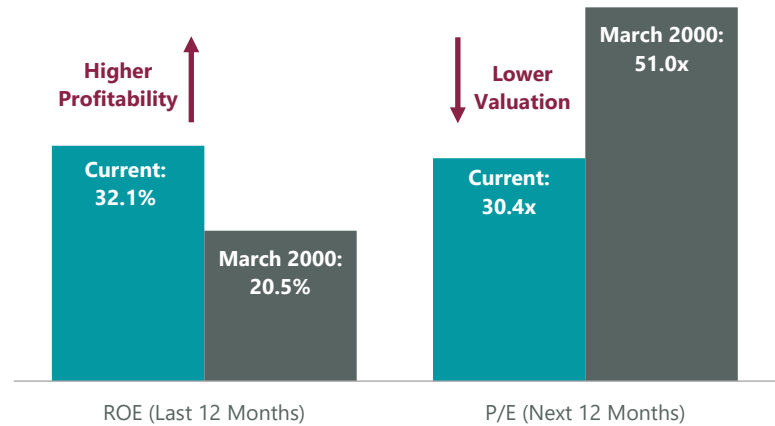
Stocks vs. The Economy

A common adage is that “the stock market is not the economy.” The two are closely related but can disconnect at times and in certain areas. As of late this rings most true with regard to AI, with signs of froth evident in some areas of the equity market. One example is the 52% advance in the Goldman Sachs “Non-Profitable Tech” index year to date, where investors are placing significant emphasis on potential earnings of these companies.

However, many of the current tech leaders that have powered the index higher in recent years are delivering strong profits and free cash flow. This is a stark difference from the tech sector lead by the Four Horsemen — Intel, Cisco, Microsoft and Dell — of the late 1990s. While investors are assigning lofty multiples to the potential leaders of tomorrow, the sector still trades materially below the multiples seen during the peak of the tech bubble while delivering superior (50% better) returns on equity.

Exhibit 7: Not the Dot Com

S&P 500 Technology Sector Profitability and Valuation



Data as of 30 September 2025. Sources: FactSet, S&P.

There is no guarantee that the current tech-driven bull market will reach the size of previous bubbles before encountering problems or collapsing. However, this reminds us of another time-tested market adage, “Bull markets don’t die of old age, they’re killed by the Federal Reserve.” With that in mind, if a bubble is indeed forming, we could be witnessing its early days because the Fed is working to support the economy and financial markets, not slow their ascent.

The Fed began to cut rates last month. Historically, equities have fared well in the year after the Fed began a soft landing rate cut cycle, rising 18.3% on average over the next year and 48.6% over the next two. If sell-side consensus expectations of 12.9% EPS growth over the next 12 months are realised, it would be consistent with a soft landing as one-year forward earnings historically decline double digits on average in recessionary outcomes.

Exhibit 8: Not All Cuts Are Equal

S&P 500 Price Changes						
Initial Rate Cut	Economic Outcome	-1Y EPS Growth	+1Y EPS Growth	6-Month	12-Month	24-Month
Apr. 1980	Recession	12.2%	-3.0%	22.8%	33.1%	9.6%
June 1981	Recession	0.5%	-5.6%	-4.6%	-15.5%	22.6%
Oct. 1984	Soft Landing	22.5%	-9.4%	10.4%	11.3%	41.4%
June 1989	Recession	16.4%	-15.7%	7.4%	12.2%	21.1%
July 1995	Soft Landing	33.8%	20.3%	11.2%	21.1%	59.8%
Sept. 1998	Soft Landing	3.6%	5.5%	18.0%	25.9%	44.7%
Jan. 2001	Recession	11.0%	-16.8%	-9.1%	-14.8%	-34.7%
Sept. 2007	Recession	10.6%	-8.9%	-12.4%	-15.6%	-32.8%
July 2019	Recession	9.5%	-12.1%	8.2%	9.8%	47.5%
Sept. 2024	Soft Landing	6.9%	10.8%	6.0%	15.0%	???
Recessionary Average		10.0%	-10.3%	2.0%	1.5%	5.5%
Soft Landing Average		16.7%	6.8%	11.4%	18.3%	48.6%
Sept. 2025	???	10.8%	12.9%*	???	???	???

*Sell-side consensus expected next-12-month EPS growth. Rate-cut cycles of at least 75 bps. The term “consensus” within the capital markets industry refers to the average of earnings estimates made by professionals. Sources: FactSet, Shiller, S&P.

It is not just U.S. equities that have done well following the commencement of a soft landing rate cut cycle. Both developed and emerging market equities have also delivered strong returns historically during these periods, with average returns of 24.3% and 27.6% respectively in the year following the first soft landing cut.

Exhibit 9: International Equity Leadership Following the Cut

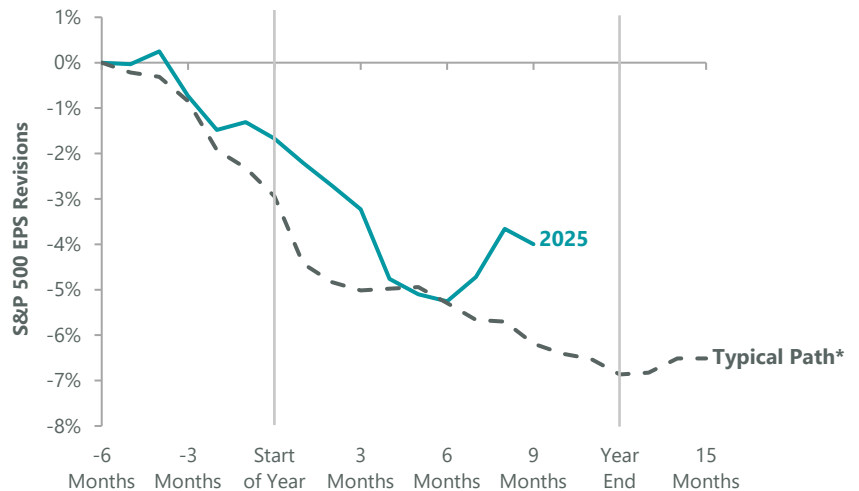
Subsequent 12-Month Price Return					
Initial Rate Cut	Economic Outcome	MSCI EAFE	MSCI EAFE Growth	MSCI EAFE Value	MSCI Emerging Markets
Apr. 1980	Recession	32.5%	32.4%	32.5%	--
June 1981	Recession	-7.0%	-11.0%	-4.2%	--
Oct. 1984	Soft Landing	40.7%	41.5%	40.6%	--
June 1989	Recession	2.4%	-0.3%	5.5%	22.3%
July 1995	Soft Landing	13.3%	11.6%	15.4%	5.4%
Sept. 1998	Soft Landing	25.7%	20.3%	30.7%	51.4%
Jan. 2001	Recession	-21.2%	-24.2%	-18.4%	-1.2%
Sept. 2007	Recession	-24.0%	-20.3%	-27.6%	-28.4%
July 2019	Recession	-0.4%	10.5%	-11.1%	6.2%
Sept. 2024	Soft Landing	17.6%	10.7%	24.7%	26.2%
Average		8.0%	7.1%	8.8%	11.7%
Recessionary Average		-2.9%	-2.2%	-3.9%	-0.3%
Soft Landing Average		24.3%	21.0%	27.9%	27.6%

Note: Rate cut cycles of at least 75 bps. Sources: FactSet, MSCI, NBER.

Although strong gains on the back of rate cuts would seem to play into the bubble narrative, one key bubble ingredient that we believe remains missing is speculative excess. Although signs of froth exist, classic bubbles typically see rapid price acceleration driven by investor euphoria, indiscriminate buying and a detachment from financial realities.

At present, investor sentiment remains cautious with the number of bullish and bearish respondents to the AAI Sentiment Survey being nearly balanced (+3.7 bullish, a mid-pack reading). Widespread indiscriminate buying does not appear to be playing out and the rally in equities has coincided with an improving fundamental outlook, which suggests a lack of detachment from financial reality. To that end, economist expectations for 2026 GDP have risen by 40 bps from the mid-May lows, while sell-side EPS expectations for the S&P 500 took an unusual turn higher during the third quarter following passage of the OBBB and as trade policy visibility improved.

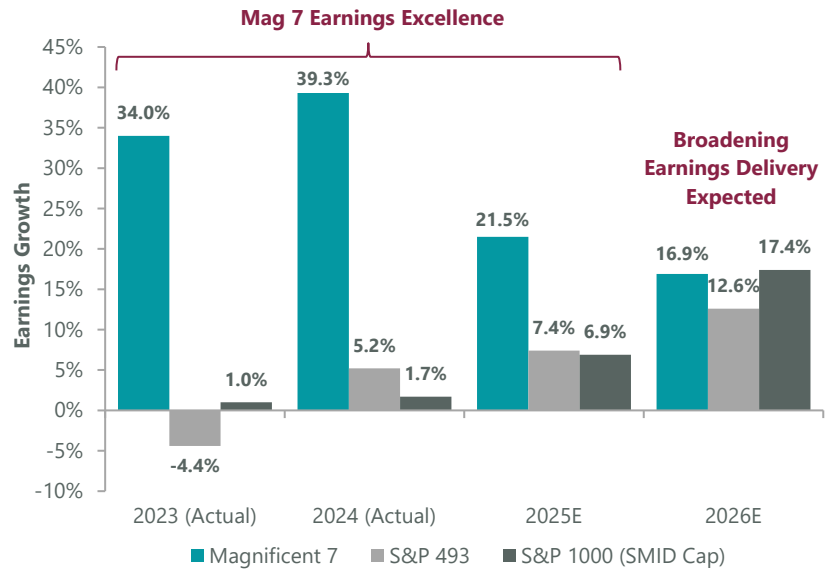
Exhibit 10: EPS Revisions Resilient



*Typical Path is 2012-2017, 2019, and 2022-2024; 2018 is excluded due to TCJA (Tax Cuts and Jobs Act) distortion; 2020-2021 is excluded due to COVID-19 pandemic distortion; Percent change in \$ EPS expectations. Data as of 30 September 2025. Sources: FactSet, S&P.

Because the improved fundamental outlook is not simply the result of AI, a broader group of companies are expected to benefit in 2026. Sell-side EPS expectations show a broadening, with the S&P 493 and small and mid cap companies in the S&P 1000 Index poised to close the gap to the Magnificent Seven in terms of earnings delivery in 2026. With the Magnificent Seven's EPS growth advantage dissipating, market leadership could rotate with less expensively priced laggards of this cycle such as SMID cap and value catching up on a relative basis.

Exhibit 11: Closing the Gap



The term “consensus” within the capital markets industry refers to the average of earnings estimates made by professionals. Magnificent 7 data refers to the following set of stocks: Microsoft (MSFT), Amazon (AMZN), Meta (META), Apple (AAPL), Google parent Alphabet (GOOGL), Nvidia (NVDA), and Tesla (TSLA). Data as of 30 September 2025. Sources: FactSet, S&P.

Bubble or Boom?

Historically, bubbles have formed when overly ample liquidity has encouraged excessive risk-taking behavior. While liquidity is certainly ample at present, excessive risk-taking behavior does not appear to be playing out in our view, given the improving fundamental outlook that has coincided with recent equity market strength. This is not to say that signs of excess do not exist nor that pockets of weakness aren’t apparent. However, these remain somewhat isolated or are explainable, such as reduced immigration being a primary contributor to slower job creation.

Looking ahead, we believe that the usual linkage between output and employment is likely to be weaker than is generally believed. The Atlanta Fed’s GDPNow tool currently projects third-quarter GDP to be 3.8%, while net job creation has been below 25K in three of the past four months. While some of the factors driving this decoupling are policy-driven, such as immigration, this dynamic could persist if AI begins to more meaningfully boost productivity.

Fewer workers doing slightly more (with improved tools) can deliver economic and corporate profit upside, allowing continued economic and EPS gains even in a sluggish hiring environment. This scenario would likely see equity markets surge to even higher levels in the coming year, as companies would get the benefits from higher sales while keeping costs in check, further expanding margins and lifting profits.

Over the long run, changes in earnings expectations explain the vast majority — about two-thirds over one-year periods and three-

quarters over two-year periods — of stock price movement. Only time will tell if equities are currently discounting an overly optimistic “bubbly” future or an underappreciated “boom” in earnings, but the broadly improving outlook leads us to believe that the boom scenario is more likely. Should a pullback emerge in the coming quarter, we believe investors will move to quickly buy the dip given ample liquidity and the powerful fiscal and monetary policy tailwinds in place.

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