FRANKLIN TEMPLETON

May 2026

Franklin Templeton Investment Solutions

Allocation Views

Looking through the energy cost shock—stronger earnings, lower tail risks



Not FDIC Insured | No Bank Guarantee | May Lose Value

Summary

We take a more optimistic view of equities in May against a background of waning hostilities in the Middle East and strong corporate earnings.

Open conflict with Iran has given way to tense diplomacy as both sides attempt to find a resolution that meets their objectives. Shipping through the Strait of Hormuz is likely to remain restricted for some time, but de-escalation has stabilized markets, which continue to look past the energy cost shock.

We expect pockets of volatility amid the ebb and flow of conflict resolution, but tail risks have reduced materially in recent weeks, meaning isolated setbacks should have minimal impact as markets trend higher.

Global macro conditions present a mixed picture but remain broadly supportive for risk assets, while earnings growth estimates have strengthened across the world, shrugging off geopolitical tensions and looking through macro uncertainty.

Against this background, we adopt a "risk-on" stance within our cross-asset positioning and improve our view of US core equities and emerging market (EM) equities. Within fixed income, our preference is to diversify international bond exposure while trimming US duration.

Macro themes

Steady growth

- Earnings breadth has moderated, but robust earnings expectations fuel an optimistic post-conflict outlook.
- The US economy has proven resilient, while labor market data is disparate but remains stable.
- Leading economic indicators remain mixed as business activity is crimped by higher input costs and waning confidence.

Moderating inflation

- We expect limited second order effects from the energy impulse as conflict in Iran moves closer to a resolution.
- US inflation dynamics remain challenging. Core inflation is elevated, but some measures show pressures moderating.
- Core goods inflation remains above trend. Tariff pressures may have peaked but are currently offset by global supply chain tightness.

Policy bifurcation

- There is an increasing bifurcation between supportive fiscal policy and restrictive monetary policy as markets assess the energy price shock.
- The Middle East conflict has catalyzed a recalibration of policy expectations, with multiple hikes now priced in for most regions other than the United States.
- Fiscal policy in major economies is generally supportive of growth. US tax refunds will likely offset tariff headwinds, while energy support packages could also prove influential.

Portfolio positioning themes

Upgrading equities

- Conflict in the Middle East is moving toward resolution, and we would expect markets to look through any temporary setbacks.
- Corporate fundamentals remain strong amid double-digit earnings growth expectations for the next 12 months.
- Sentiment and positioning are not yet overextended, despite the recent strong market rally, supporting risk assets.

Rotating toward US core

- We improve our view of core US large-cap equities, given the conditions for market breadth have weakened in line with slower economic growth.
- Sustained optimism toward EM equities, amid healthy corporate fundamentals and positive exposure to artificial intelligence (AI) capital investment (capex) themes.
- We increase underweight exposure to European and UK equities, influenced by weaker macro backdrops in those regions.

International duration

- We expect demand destruction to have a greater impact on monetary policy decisions than market pricing suggests, decreasing the chance that central banks meet market hiking expectations.
- Resilient US growth and challenging inflation dynamics make Federal Reserve (Fed) easing less likely, in our view. We stay underweight US duration with a preference for international bonds.
- Excess returns for equities appear more attractive than credit, amid strong earnings and tight spreads.

We take a more optimistic view of equities in early May, against a background of waning hostilities in the Middle East and strong corporate earnings.

Open conflict with Iran has given way to tense diplomacy, as both sides attempt to find a resolution that meets their objectives. Shipping through the Strait of Hormuz is likely to remain restricted for some time, but de-escalation has stabilized markets, which continue to look past the energy cost shock.

We expect pockets of volatility amid the ebb and flow of conflict resolution, but tail risks have reduced materially in recent weeks, meaning isolated setbacks should have minimal impact as markets trend higher.

A mixed macro picture

Global macro conditions present a mixed picture but remain broadly supportive for risk assets. Leading indicators of economic activity have weakened somewhat in the past month, but current activity indicators show some improvement, suggesting a response to positive progress in the Middle East.

In the United States, economic growth has weakened but remains positive. The Atlanta Fed GDPNow forecasting model[1] shows growth of 1.2% year-on-year (y/y), while a measure from the Federal Reserve Bank of New York is higher, at 2.81%.

Purchasing Managers' Index (PMI) data[2] also improved in April, with business activity growth rebounding, led by the manufacturing sector, which saw output rise at the sharpest rate for four years. This was partially driven by stock-building amid fears of price hikes linked to the rising cost of energy.

The price of energy clearly looms large in the minds of consumers and businesses, even if it is not yet reflected in macro data. However, we expect to see limited second order effects from the energy impulse, meaning that temporarily higher oil and gas prices are unlikely to materially impact the cost of goods and services.

However, the rising cost of living is a serious point of concern, highlighted by the shrinking contribution that personal consumption is making to US growth, as fragile consumer confidence influences spending. This is supported by the University of Michigan Consumer Sentiment Index,[3] which has fallen to record lows.

We are, therefore, concerned with measures of inflation that accurately reflect changes to the cost of living, namely personal consumption and expenditure (PCE) inflation.

Fed Chair nominee Kevin Warsh has highlighted recently that he prefers looking at "trimmed averages" to uncover underlying inflation. It is important to note here that the methodology for calculating trimmed mean inflation has been criticized as not truly indicative of underlying inflation trajectories.[4]

Critics believe it may present an artificially rosy picture of inflation, erroneously supporting the case for policy stimulus. Currently there is a clear discrepancy between trimmed mean PCE inflation (2.36%) and core PCE inflation (3.20%).[5]

Additionally, the US labor market remains resilient, in our view, with unemployment levels close to NAIRU,[6] and does not provide clear validation for policy stimulus from the Fed.

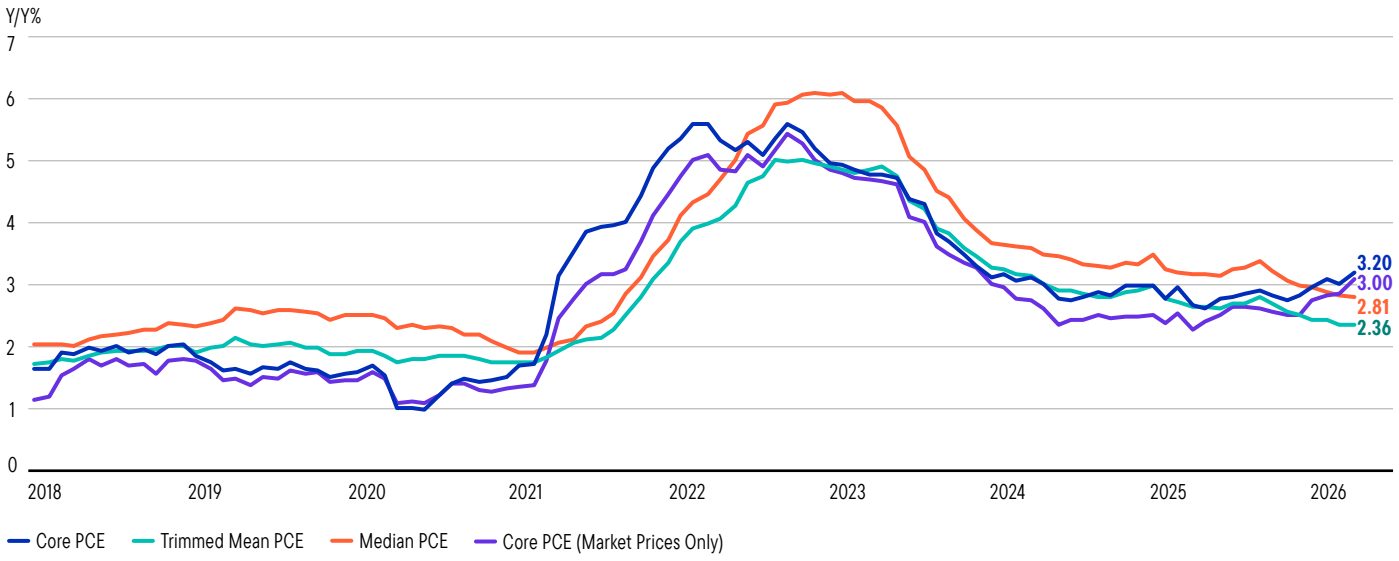
Rather, we would expect the Fed to remain on hold until the future path for growth and inflation becomes clearer. As a result, our decision to move "risk-on" is mainly predicated on strong corporate fundamentals rather than policy support.

1. Source: GDPNow. Federal Reserve Bank of Atlanta. April 21, 2026.
2. Source: S&P Global US Flash PMI. S&P Global. April 23, 2026.
3. Source: Survey of Consumers. University of Michigan. April 2026.
4. Source: "So you want to talk about trimmed mean inflation?" Employ America. April 28, 2026.
5. Source: BEA – May 4, 2026.
6. Non-Accelerating Inflation Rate of Unemployment.

Divergent Data

The True Impact of Inflation Remains Unclear

Exhibit 1: Various Measures of Annual US PCE Inflation, Including Trimmed Mean

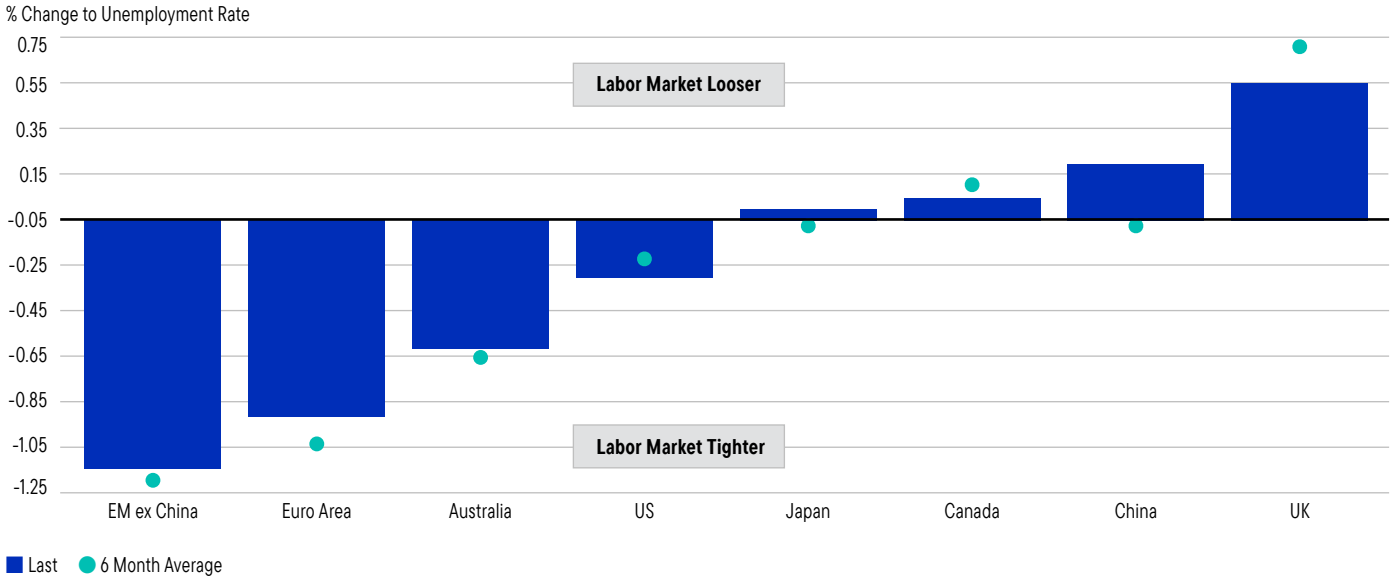


Sources: BEA, Atlanta Fed, Macrobond, BLS. As of May 4, 2026.

Labor Market Resilience

The US Labor Market Has Tightened Recently

Exhibit 2: Changes to Global Unemployment Rates During the Last Six Months (Versus 10-Year Moving Average)



Sources: Macrobond, BLS. As of May 4, 2026.

Robust earnings expectations

Earnings growth estimates have strengthened across the world, shrugging off geopolitical tensions and looking through macro uncertainty. The clear outlier is EMs, where year-on-year growth of 34% is expected across the next 12 months, supported by massive flows of capital expenditure from AI hyperscaler businesses into Asia's semiconductor industry.

Double-digit earnings growth is also expected in developed markets, led by the United States, as revisions to earnings expectations have improved sharply during the last three months. This is notable, given it is set against the background of a recent pullback that has weakened market momentum and seen a smaller percentage of listed firms trading above their 200-day moving averages.[7]

First quarter results in the United States have been strong, with a high percentage of companies delivering earnings surprises and beating estimates. The story is not totally upbeat, though, as we have observed some recent weakness in earnings breadth across styles, suggesting that a smaller group of sectors or names are driving the broader positive earnings story.

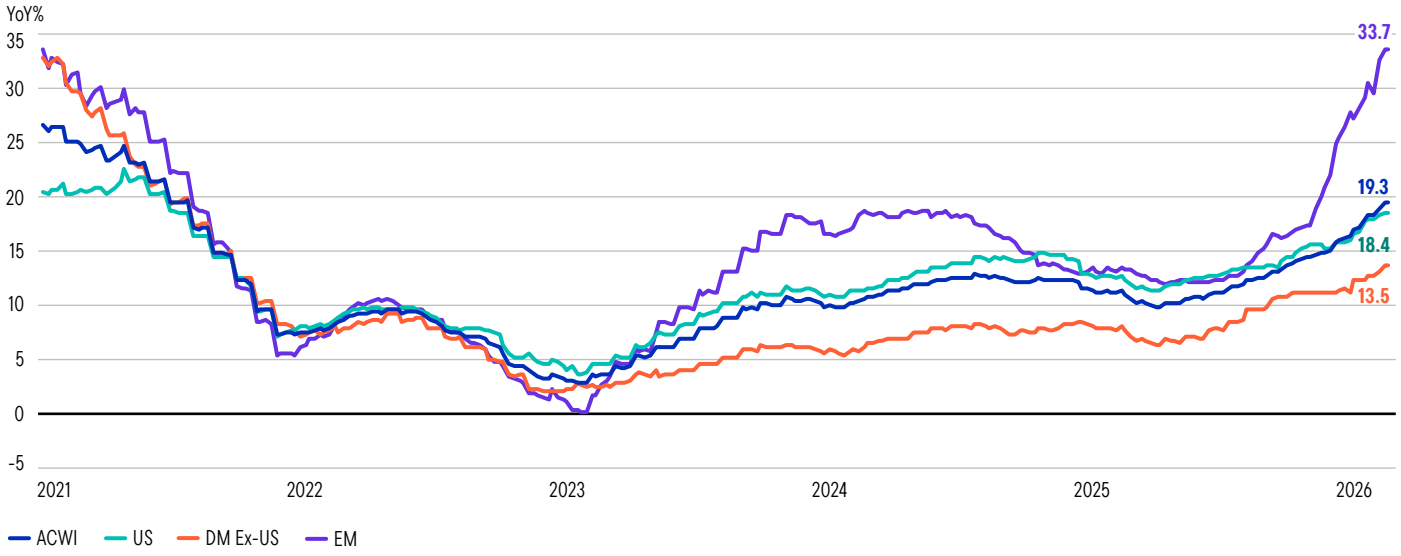
Market estimates[8] for US earnings growth over the next 12 months are 18%, reflecting 23.6% for US growth stocks and 15.3% for value stocks, as the technology sector continues to drive earnings.

Financials and materials names are also expected to post strong earnings growth in the first quarter, helped by elevated interest rates and rising precious metals prices, but the energy sector is yet to see the benefit of higher prices in earnings.

Double-Digit Delivery

Earnings Growth Expectations Appear Robust

Exhibit 3: Earnings-Per-Share (EPS) Growth Expectations Across the Next 12 Months for Global Corporates (% Y/Y)



Sources: IBES, Macrobond. As of April 27, 2026. ACWI= MSCI All-Country World Index, US= MSCI USA Index. DM Ex-US=MSCI World ex USA Index. EM= MSCI Emerging Markets Index. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses and sales charges. **Past performance is not an indicator or guarantee of future results.**

7. Source: Macrobond as of April 28, 2026.
8. Source: Institutional Brokers' Estimate System (IBES) as of April 28, 2026.

Sentiment and valuations

Measures of sentiment and positioning have rebounded alongside the recent market rally, as investors adopt a more "risk-on" stance in line with a deescalation of conflict in the Middle East. While overall levels of sentiment have now normalized, they are not yet stretched and still offer support to equities.

Our fair value model indicates that strong corporate earnings growth supports current equity market pricing, implying that any overvaluation is marginal.

In fact, excess returns over risk-free assets (cash) appear attractive, powered by double-digit earnings growth expectations, thus offering further support for the tilt toward equities within our cross-asset positioning.

Taking all the above arguments into consideration, we have improved our view of US core equities, as large-cap financials and technology names continue to beat earnings expectations, and oil majors are set to benefit from energy price increases. Elsewhere, we add to EM equities, which have been fueled by the ongoing strength of the AI hardware sector.

Internationalizing duration

While we hold a preference for equities over bonds from a cross-asset perspective, we retain some duration exposure within our fixed income portfolio.

We have adopted a dichotomous view of government bonds, in which our preference is to diversify international bond exposure while trimming US duration.

Markets expect most central banks (other than the Fed) to raise interest rates over the next six months, in response to rising inflation pressures. However, we believe demand destruction will have a greater impact on monetary policy decisions than market pricing suggests, decreasing the chances of interest-rate rises.

In addition, market estimates for terminal interest rates implemented by major central banks are higher than the assumptions FTIS has modeled.[9] In short, the market expects international interest rates to rise further and faster than our forecasts, in an environment where hiking rates against an uncertain macro background may materially impact growth.

This offers some relative value versus expectations for the terminal fed funds rate, which appears more realistic to us at 3.5%, indicating that markets believe US rates are already at the top of their range.

The current yield available on international duration also appears relatively attractive, given higher term premia and steeper yield curves in comparison to US Treasuries. This is related to the market's focus on inflationary pressures that we view as excessive, suggesting there is some additional value in international government bonds. It could now be a good time to lock in attractive yields.

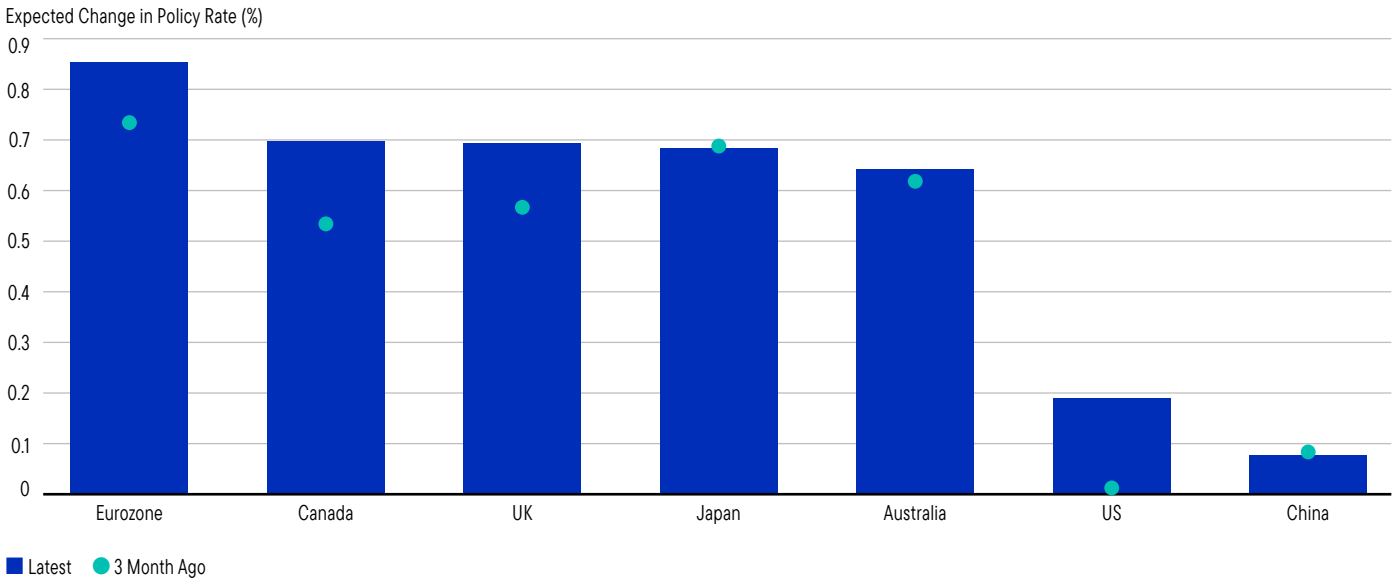
This thinking is predicated on the assumption that conflict in the Middle East does not worsen. The vulnerability of international markets in Europe and Asia to energy supply shocks is a concern and could derail our thesis, if war reignites and bolsters the existing hawkish momentum behind global monetary policy.

9. Source: Macrobond, with reference to market-implied terminal rate three years in the future (2029).

Hawkish Policy Pivot

Major Central Banks Have Become More Hawkish Over the Past Quarter

Exhibit 4: Anticipated Change in Policy Rate over the Next Year for Major Central Banks (%)



Sources: Bloomberg, Macrobond. As of May 2026. There is no assurance that any estimate, forecast or projection will be realized.

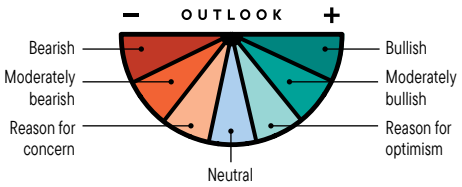
Allocation settings views—May 2026

Pendulum settings reflect cross-asset-class views

High level allocation tier

Asset class	Conviction	Our viewpoint
Equities		• Our approach to risk became somewhat more constructive heading into May, as tensions in the Middle East show tentative signs of easing. • Tensions are likely to remain for some time, while energy supplies may also be restricted, but we would expect markets to look through any temporary setbacks. • Sentiment and positioning are not yet overextended, despite the recent strong market rally, supporting risk assets.
Bonds		• The Middle East conflict has catalyzed a recalibration of policy expectations, with multiple hikes now priced in for most regions other than the United States. • Inflation is proving to be sticky, which is likely to keep global real yields somewhat elevated. However, we expect demand destruction to play a greater role in monetary policy decisions than market pricing suggests. • Resilient US growth and challenging inflation dynamics make Fed easing less likely, in our view, supporting our preference for international bonds.
Alternatives		• Higher energy prices mean the risks attached to Operation Epic Fury appear adequately priced into markets. • Beyond conflict in the Middle East, increased demand from AI offers long-term support to energy and industrial metals. • Elsewhere, we see structural attractions in naturally diversifying alternatives such as private assets.
Cash		• We believe elevated short-term yields offer attractive risk-free returns. • However, the requirement to lower our portfolios' interest-rate sensitivity has moderated as yields have risen. • With lower geopolitical left-tail risk and a desire to add to risk appetite, we have reduced our cash holdings this month and added to global equities.

Understanding the pendulum graphic



Arrows represent any change since the last month end.

Allocation tier

Asset class	Conviction	Our viewpoint

Equity regions: Pendulum settings relative to equity asset class broadly

Growth

United States



- High-quality stocks tend to outperform in an environment of macro risks, and markets historically reward growth names when the economic outlook falters.
- Rotation momentum has been reduced by slowing economic growth, which typically impacts the real economy, narrowing market breadth and hurting consumption and manufacturing.
- We remain concerned about the sustainability of AI capex, but more immediate macro concerns mean we favor core US equities as a defensive measure.

Value

United States



- Corporate fundamentals remain strong, but economic developments have changed the calculus elsewhere and pushed us to neutralize our style factor preferences.
- Growth is slowing and labor data has softened somewhat, while core inflation has begun to rise, complicating any response from the US Fed.
- Slowing growth typically weakens cyclical earnings momentum, working against the broadening-out trade.

Small-Cap Stocks

United States



- Earnings strength and attractive valuations support small-cap leadership, in our view, while the small-cap domestic US market is still broadly insulated from Middle East tensions.
- Fiscal stimulus has provided a floor for labor markets and consumption, despite waning consumer sentiment.
- However, the “K-shaped” economy favors high-income consumers and large businesses.

International

Canada



- Canadian earnings growth forecasts improved in April and large energy majors should see further improvement as higher energy prices expand margins.
- Canadian macro indicators were mixed in March, as manufacturing and services PMI weakened amid higher costs and softer demand.
- The Bank of Canada held rates steady in March, as it chose to prioritize inflation, which remains somewhat elevated in certain areas.

Europe ex United Kingdom



- Economic growth indicators remain weak, impacted by rising input costs as well as structural weaknesses in Germany—including high energy costs, labor shortages and regulatory burdens.
- A subdued macro backdrop, higher energy prices and weak domestic demand could begin to weigh on eurozone equities. We have seen this reflected in thinner profit margins, and a narrowing breadth of positive earnings revisions.
- Against this background, we increase our underweight to eurozone stocks as these markets have greater exposure to Middle East energy than their North American counterparts.

Allocation tier

Asset class	Conviction	Our viewpoint
United Kingdom		• UK consumers are saving more, while disposable income growth has fallen sharply into negative territory amid a weakening labor market. • The United Kingdom is facing significant macro headwinds, including slowing economic growth and negative employment growth. Higher energy prices are beginning to exacerbate these factors. • While UK earnings revisions are seeing a boost due to energy names, revisions breadth remains weak. Together with an ugly macro backdrop, we prefer Canada as a portfolio hedge should energy prices remain at stretched levels.
Japan		• The new Japanese government coalition is pushing ahead with targeted fiscal policy stimulus, while earnings growth remains strong. • Corporate reform measures have the capacity to improve efficiency, return on equity and profit margins, lifting valuations. • Japan is particularly vulnerable to an energy price shock, but the country holds healthy energy reserves and should have no supply concerns for the next few months.
Australia		• Financials and materials stocks make up more than 65% of broad Australian equity indexes, helping the market to outperform throughout the recent conflict. • More restrictive monetary policy may be required to rein in well-above trend inflation that now faces energy price shocks, dampening growth expectations. • An ensuing slowdown in credit growth from higher rates and lower growth is expected to weigh on banks' earnings going forward.
Emerging ex China		• The likelihood of an extreme energy price shock linked to the closure of the Strait of Hormuz has begun to diminish. • Earnings expectations continue to rise rapidly across EMs ex-China. This is being driven by significant AI capital spending by hyperscalers on hardware components made in Asia. • Earnings revisions appear positive, but revisions breadth has narrowed amid the success of the semiconductor industry in Asia. Key quarterly earnings reports from index heavyweights such as Samsung, TSMC and SK Hynix have been strong.
China		• China's economy remains K-shaped, with weak domestic demand offset by strong exports, reducing the urgency for stimulus. • For equities, the outlook hinges on the domestic backdrop, with property weakness and persistent deflation continuing to weigh on sentiment. • While new e-commerce regulations may help stabilize valuations at the margin, the broader backdrop of limited stimulus and uneven growth keeps us neutral.

Allocation tier

Asset class	Conviction	Our viewpoint
Fixed income sectors: Pendulum settings relative to fixed income asset class broadly		
US Treasuries		• Markets are no longer pricing in multiple interest-rate cuts from the Fed, as labor markets have stabilized and growth is near trend. • Sticky core inflation will make it difficult for the Fed to ease policy. • Rising fiscal deficits and uncertainty around a new Fed regime can add to upward pressure on yields, keeping us underweight US duration.
Eurozone Government Bonds		• In Europe, we expect demand destruction to play a greater role in monetary policy decisions than market pricing suggests, reducing the chances of interest-rate rises. • Higher energy prices have the potential to add further pressure to an economy already weakened by regulatory burdens, labor shortages and competition from China. • However, despite resilient risk asset markets, energy prices remain near cyclical highs and may continue to add upward pressure to eurozone yields.
UK Government Bonds		• We expect demand destruction to play a greater role in monetary policy decisions than market pricing suggests. Thus, we believe the market is currently overpricing the number of expected Bank of England rate hikes this year. • Slowing wage growth, weak labor market momentum and fiscal tightening are likely to increase the attractiveness of UK Gilts. • The UK government has raised taxes to narrow its fiscal deficit. As back-loaded taxes feed through, it is likely to slow economic growth, lower inflation and compound labor-market weakness.
Canada Government Bonds		• We think markets are pricing too little easing from the Bank of Canada (BoC) given the softer growth outlook. As growth slows, Canadian government bond yields should have room to fall. • There are growing risks to the Canadian economy, given its dependence on cyclical sectors and high exposure to US trade, which should weigh on activity and support demand for duration. • Labor markets are loosening, which should ease pressure on wages and inflation over time and give the BoC room to cut interest rates.
Japan Government Bonds		• Our valuation framework suggests 10-year JGB yields are above long-run equilibrium, supporting a tactical rally case from current levels. • Real incomes remain vulnerable to higher energy prices, while consumer confidence has weakened sharply, pointing to softer underlying demand and a more fragile growth backdrop. • We think markets have overreacted to the oil shock and are pricing a more aggressive Bank of Japan hiking path than is likely, especially if subsidies limit pass-through and growth concerns persist.

Allocation tier

Asset class	Conviction	Our viewpoint
Australian Government Bonds		• The RBA's recent tightening has reinforced its inflation credibility, but we think markets may be overestimating how far policy needs to move from here. • Relatively weak leading economic indicators suggest tighter financial conditions should increasingly weigh on domestic activity, even if inflation remains sticky in the near term. • This leaves Australian government bonds looking more attractive on a relative basis, especially versus markets where fiscal and term-premium pressures are a larger headwind to duration.
Investment Grade		• The investment-grade sector has benefited from resilient corporate fundamentals and improved guidance. • Tight spreads make the risk/reward profile less attractive. • In addition, increased bond issuance by hyperscalers to fund AI capex has increased the supply of investment-grade credit in the market, driving down prices.
High Yield and Loans		• Excess returns on equities appear more attractive than credit, amid strong earnings and tight spreads. • Moreover, investors are not benefiting from the usual cushion of falling interest rates in this scenario. • We believe the balance of risk and rewards favors neutrality.
Emerging Market (EM) Debt		• We remain neutral on EM local-currency debt amid a strengthening US dollar and ongoing risks to macro stability in Asia. • EM local-currency debt still offers a compelling long-term opportunity, as fiscal and monetary policy stability, in tandem with corporate governance improvements, should help to boost inflows of foreign capital. • We see more current upside in equities, given strong earnings expectations in emerging markets.

Allocation Views

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The hallmark of our approach is a central forum—the Investment Strategy and Research Committee (ISRC)—which generates a top-down view across asset classes and regions. Furthermore, it connects and synthesizes the bottom-up sector and regional insights of the global investment teams at Franklin Templeton. The ISRC also calibrates firmwide views with original analysis from our dedicated teams, which include both fundamental and quantitative research professionals.

FTIS actively engages with clients in an ongoing, collaborative partnership, to understand each client's particular needs and then to draw from our extensive global resources and capabilities to meet those goals. These portfolios are built, managed and monitored in the framework established by the ISRC, and undergo rigorous tests under multiple scenarios and market regimes.

Contributors



Max Gokhman, CFA
Deputy Chief Investment Officer



Thomas Nelson, CFA, CAIA
Head of Market Strategy



Miles Sampson, CFA
Head of Asset Allocation Research

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