FRANKLIN TEMPLETON

October 2025

Franklin Templeton Investment Solutions

Allocation Views

Responsibly bullish



Not FDIC Insured | No Bank Guarantee | May Lose Value

Summary

We adopt a positive view of risk assets ahead of the final quarter of 2025, as we weigh extended equity valuations against a generally positive macro environment, strong corporate fundamentals and monetary policy easing.

The strength of the current global equity rally has surprised many market participants, given stocks have brushed off tariff uncertainty, inflation concerns and labor market weakness to post stellar gains.

Such a powerful advance naturally brings warnings about irrational exuberance, especially where retail investors are concerned. However, we prefer to take a more measured approach, examining the underlying macro and corporate environment for signs of weakness.

Our analysis finds a broadly positive setup for risk assets, where improving business activity and solid economic growth has provided the platform for a strong second-quarter earnings season. Policy easing amid steady growth has further bolstered equity market momentum.

From a cross-asset perspective, we balance this stance by strengthening our pessimism toward fixed income.

Macro themes driving our views

A resilient growth story

- Leading economic indicators remain resilient, driven by strong services growth.
- Forward-looking surveys have reversed recent pessimism, and earnings revisions have improved.
- Greater clarity around US trade policy has supported sentiment, but we are monitoring labor market dynamics for further signs of weakness.

Balanced inflation outlook

- Inflation remains above central bank targets in most developed economies. We expect inflation to remain sticky through the end of this year, influenced by tariffs.
- US companies are currently absorbing tariff-induced inflation pressures by tightening margins. An additional material impact on core goods inflation is likely.
- However, services inflation has moderated, helped by lower housing costs, and should offset pressures elsewhere.

Policy leans supportive

- We expect the Federal Reserve (Fed) to adopt a more dovish interest-rate strategy, but we think expectations are lofty relative to a balanced inflation outlook.
- Despite the impact of perceived political influence, we believe the Federal Open Market Committee's (FOMC) will maintain an objective approach to monetary policy.
- Fiscal policy in major economies such as the United States and Germany has become an influential driver of asset prices, notably the US tax bill.

Portfolio positioning themes

Responsibly bullish

- Several major central banks are currently easing into strengthening economies, offering a tailwind to risk assets.
- Positive earnings revisions and guidance reflect robust corporate fundamentals, supporting equity market momentum.
- Despite the recent rally in equities, sentiment appears surprisingly neutral. Positioning also remains restrained, leaving room to add risk.

Diversified equity risk

- We retain our optimistic view of US large-cap stocks relative to small-cap names. Robust earnings and renewed enthusiasm for artificial intelligence (AI) guide our thinking.
- We upgrade Chinese equities, as a technology rally and positive AI trends fuel markets. Sustained retail activity is also a factor.
- We retain an optimistic view on Canadian equities, helped by an improved commodities outlook. Elsewhere we retain pessimism toward Japanese stocks.

Underweight government bonds

- We believe market expectations for Fed policy easing are somewhat optimistic. This maintains upward pressure on longer-term yields, curtailing our preference for US duration.
- Concerns around fiscal sustainability have driven higher term premia in US Treasuries (USTs), increasing the possibility of a supply-demand imbalance.
- Within fixed income, we prefer UK Gilts and Canadian government bonds amid weak labor markets.

We adopt a positive view of risk assets ahead of the final quarter of 2025, as we weigh extended equity valuations against a generally positive macro environment, strong corporate fundamentals and monetary policy easing.

The strength of the current global equity rally has surprised many market participants, considering stocks have brushed off tariff uncertainty, inflation concerns and labor market weakness to post gains close to 30%[1] since a post-Liberation Day nadir in early April. US technology stocks have done even better, with the Nasdaq Composite Index rising almost 50%[2] in the same period.

Such a powerful advance naturally brings warnings about irrational exuberance, especially where retail investors are concerned. However, we prefer to take a more measured approach, examining the underlying macro and corporate environment for signs of weakness.

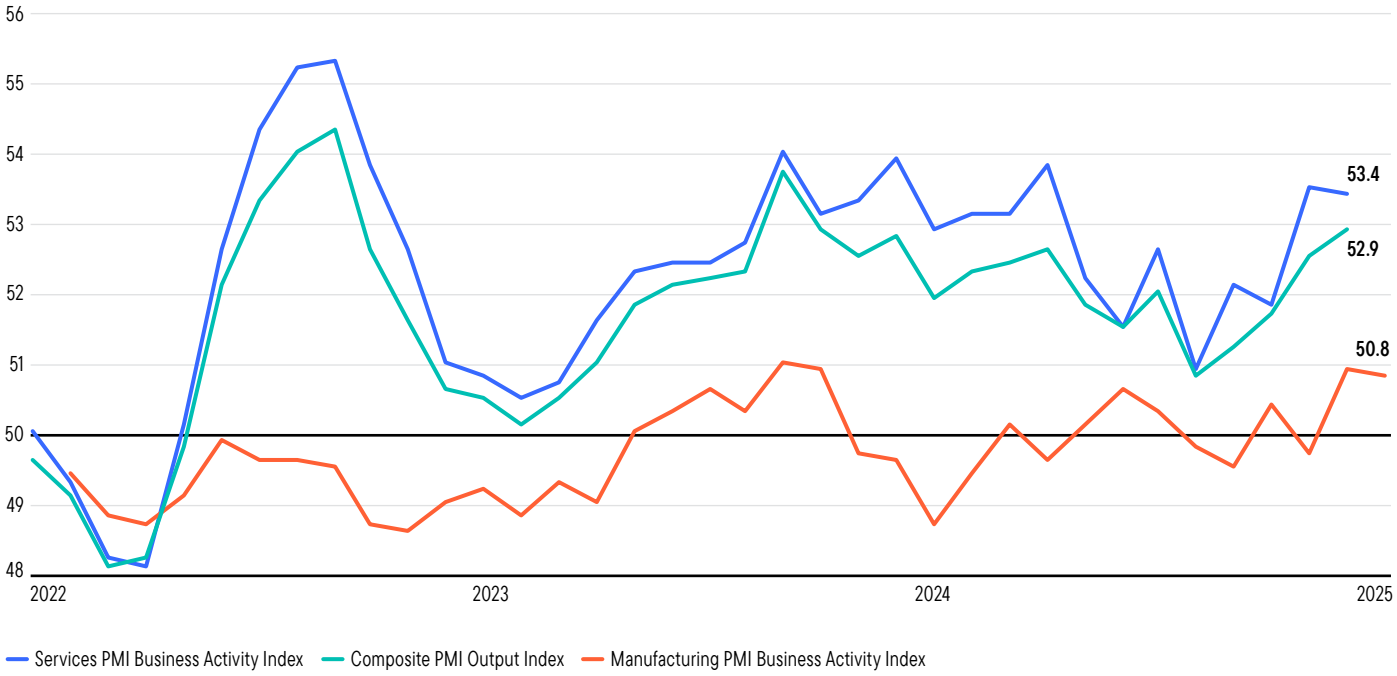
Our analysis finds a broadly positive setup for risk assets, where improving business activity and solid economic growth has provided the platform for a strong second-quarter earnings season. The US economy grew at an annual rate of 3.8% in the second quarter of 2025,[3] a healthy clip that has not slowed into the third quarter, according to estimates from the Atlanta Fed GDPNow model.[4]

Against this background, forward earnings-per-share (EPS) growth forecasts for global stocks have risen into double digits, led by US companies, while there is also a clear improvement in the magnitude and breadth of earnings revisions.

Resilient Global Economy

Business Activity is Improving Across Manufacturing and Services Sectors

Exhibit 1: Purchasing Managers' Index (PMI) Data for Global Services and Manufacturing Activity (Three-year Period)



Sources: S&P Global, Macrobond. As of September 2025.

From a policy standpoint, signs of US labor market weakness provided the US Fed with a reason to cut interest rates in September, even as core inflation remained above target.[5] Policy easing amid steady growth has bolstered equity market momentum, despite investors already anticipating the move.

Fair value analysis does suggest to us that equities are expensive, with most good news priced in, but we place greater emphasis on fundamentals. In addition, measures of sentiment remain surprisingly neutral, while positioning also looks restrained—notably among discretionary investors—suggesting the rally has room to run.

We still believe that growth will slow, and goods inflation will rise, against the backdrop of tariff uncertainty, but those forecasts have not yet manifested in weaker corporate guidance. This strengthens our conviction in a responsibly bullish approach to risk as we move into the final quarter of 2025.

From a cross-asset perspective, we have balanced this stance by strengthening our pessimism toward fixed income. We believe market expectations for Fed easing are lofty given resilient growth and persistent inflation pressures, while fiscal instability should put further upward pressure on long-term yields. As a result, we prefer the lower interest-rate sensitivity of cash. We also improve our view on commodities, noting that gold may act as a useful inflation hedge.

A different perspective on US small caps

The prevailing view among market commentators is that US small-caps are set to outperform, as policy easing fuels "risk-on" sentiment. This view relies on the added benefits that smaller companies derive from lower interest rates, given higher debt loads. Analysts in favor of this thesis point to small-cap forward earnings expectations, which have risen above 40%[6] and comfortably exceed their large-cap counterparts.

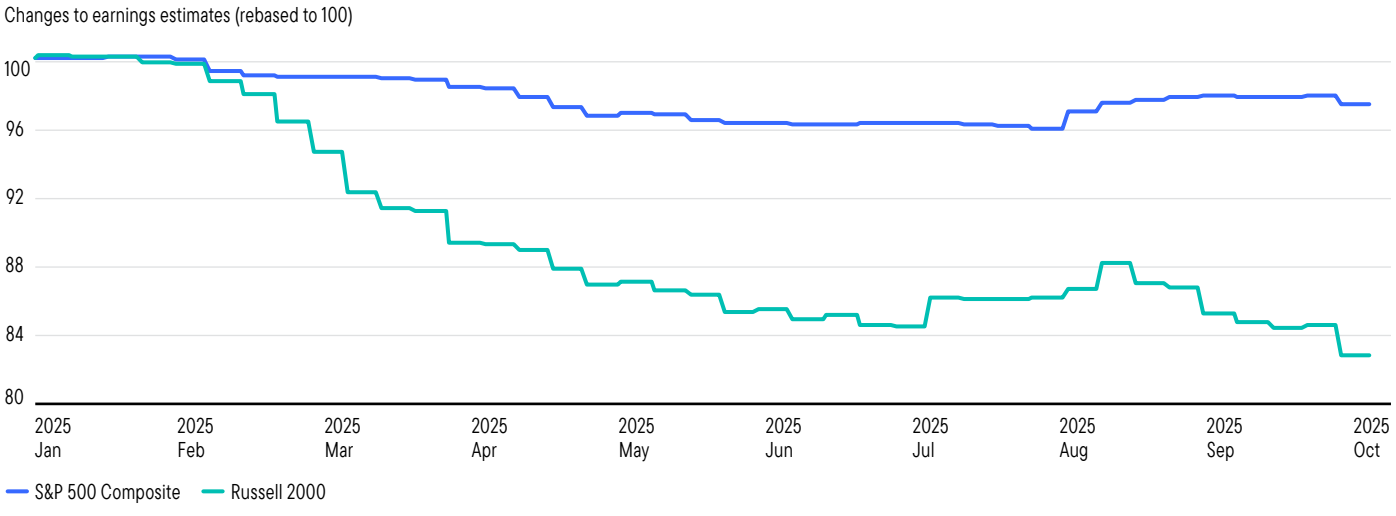
We take a different view, based on our belief that market expectations for Fed easing are too lofty. Broadly speaking, large companies have been more resilient, with stronger balance sheets able to withstand slowing growth and higher debt servicing costs. They also have more flexibility to narrow margins and absorb tariff shocks.

We believe the recent rally in small-cap indexes is a knee-jerk reaction to lower interest rates and masks the underlying fundamentals of the constituent companies. Earnings expectations for the 2025 calendar year have fallen recently, suggesting to us that lofty targets, circa 40%, are unrealistic. Interest expenses as a percentage of total debt for Russell 2000 companies are almost double that of S&P 500 companies, at an average of 7.2%, while 40%[7] of Russell 2000 Index participants are unprofitable.

Big is Beautiful

Forward Earnings Estimates for Large Cap US Companies Are More Resilient Than Their Small-cap Counterparts

Exhibit 2: A Comparison of Changes to Calendar Year 2025 EPS Growth Forecasts for the S&P 500 Index and Russell 2000 Index



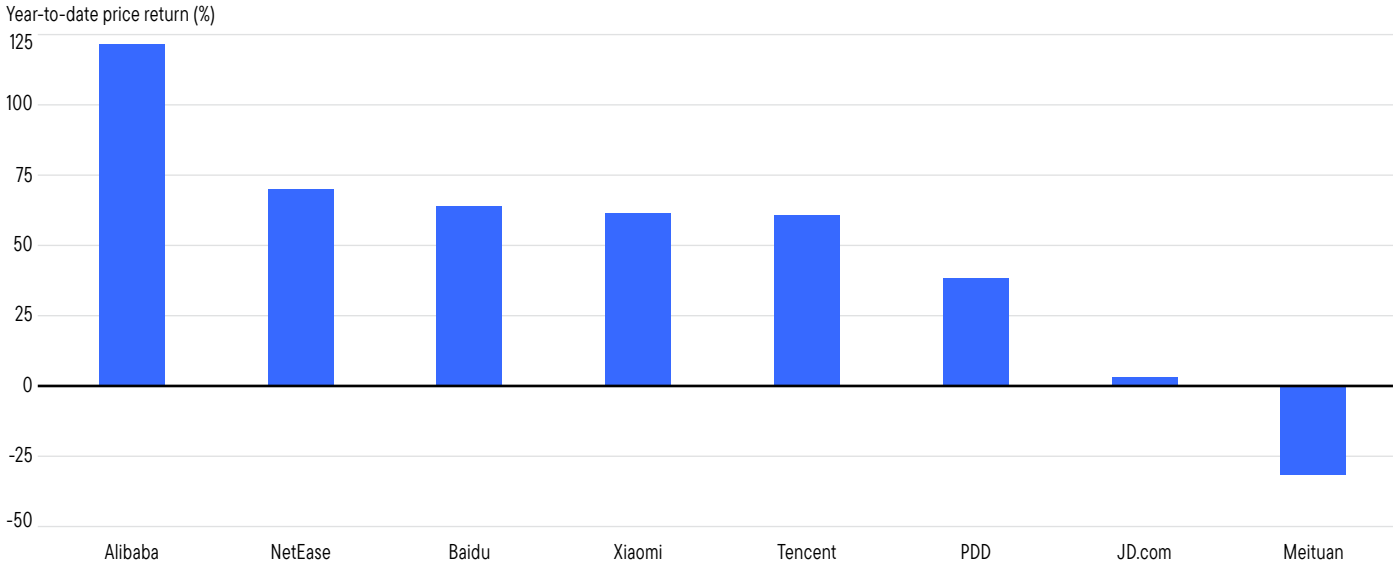
Source: Macrobond.

Upgrading Chinese equities

Moving into October, we have neutralized our view on Chinese equities, despite a persistently weak domestic macro environment. The rationale behind this move is linked almost exclusively to AI, as mega-cap Chinese technology names such as Tencent, Alibaba and Xiaomi work in concert with the government to secure China's position in the global AI revolution. These companies have been able to shrug off economic weakness and drive earnings via lucrative public contracts and expanding client bases.

Chinese Tech Titans
China's Equity Rally is Being Driven by the Global AI Revolution

Exhibit 3: A Comparison of Year-to-date Equity Returns for Some of China's Largest Companies



Sources: Bloomberg, Macrobond. As of October 2, 2025. Specific securities mentioned are for illustrative purposes and not investment recommendations or discussions about any current FT holdings.

In addition, the prospect of fiscal and monetary stimulus to support an ailing domestic economy (no matter how ineffectual) has prompted Chinese retail investors to pour their savings into stocks, largely AI names.

Conversely, companies tied more closely to the real economy have weaker earnings expectations. The constituents of the MSCI China Index derive 85%[8] of their revenues from a fragile domestic economy, which has been severely weakened by overcapacity. Profits are down, wage growth is decelerating, and consumer confidence is falling as deflation pressures margins.

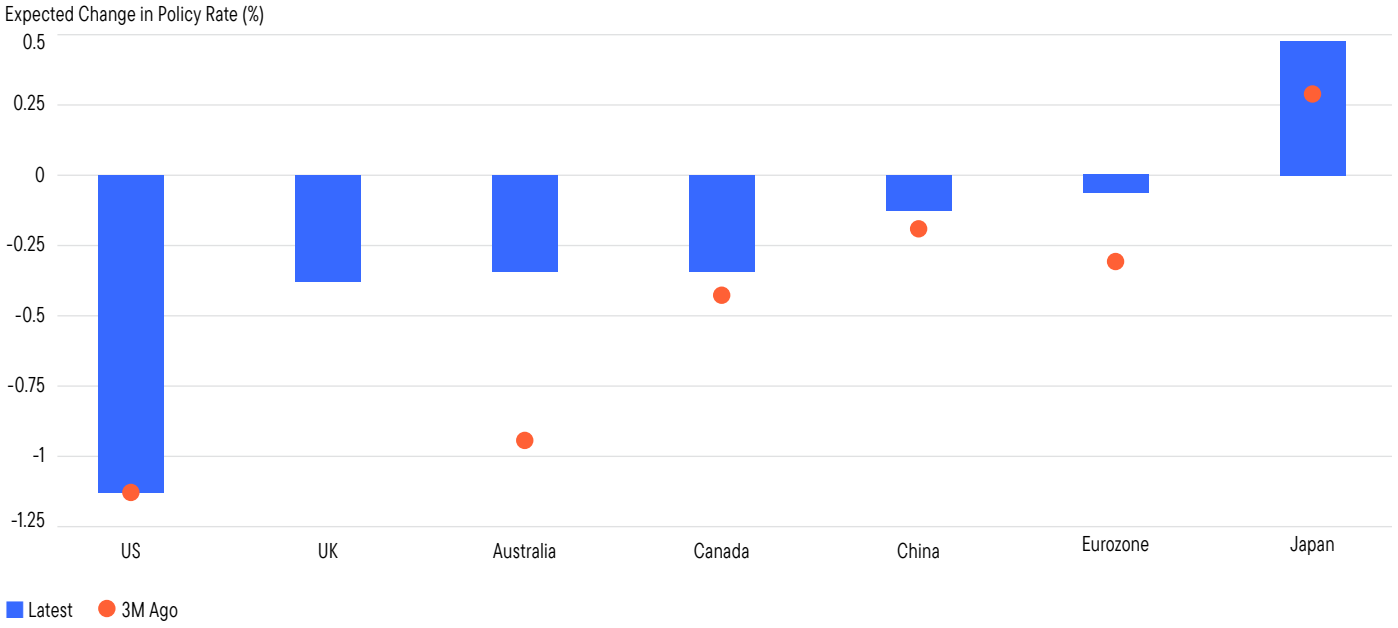
Lofty easing expectations

Our underweight position in USTs is predicated on the thesis that market expectations for Fed easing are somewhat optimistic. Markets are currently expecting at least three more cuts between now and June 2026—a move that would, at a minimum, bring the federal funds rate down from 4%-4.25% to 3.25%-3.5%. This feels like an ambitious target to us, with core inflation above 3% and the prospect of further upside pressure from tariffs on the horizon.

A Supportive Fed

The Fed is Expected to Ease Policy to a Greater Extent Than Other Major Central Banks

Exhibit 4: A Comparison of Expected Changes to Central Bank Policy Rates Over the Next 12 Months (October vs 3-months Ago)



Sources: Bloomberg, Macrobond. As of October 2025

If easing was curtailed, it would push longer-term UST yields higher and valuations lower. A world where rates are pressured higher by strong growth and accompanying inflation pressures is unappealing for fixed income investors. However, it is not as damaging as the alternative, where fiscal sustainability concerns increase term premia.

In this scenario, longer-term yields could become more volatile, depending on the reaction of the bond markets. Tax cuts under President Trump's "One Big Beautiful Bill" legislation are projected to widen the fiscal deficit, while a judicial challenge to the legality of tariffs could remove vital revenue from the government's coffers.

The specter of fiscal dominance is another risk factor for duration investors. The newest member of the Federal Open FOMC, Governor Stephen Miran, has already made a considered case for interest rates to move lower. He argues that the neutral rate[9] is below current Fed assessments, given the US economy must absorb the impact of seismic changes to tariffs, immigration and tax policy. In our view, materially lower interest rates would fuel inflation and put further upward pressure on long-term yields.

With these arguments at the forefront of our thinking, we take an underweight position in government bonds, preferring a shorter duration profile within our fixed income portfolio.

Emerging debt opportunities

Elsewhere within our fixed income portfolio, we have upgraded our view on emerging market (EM) local-currency debt. Resilient global growth is providing a supportive backdrop for EM assets, particularly given fiscal concerns that are changing the risk-return calculus of investing in developed-market government bonds. In addition, Fed easing should weaken the US dollar, offering a potential currency tailwind to the performance of local EM debt.

Considering commodities

We have upgraded our view on commodities, offering our portfolio managers an opportunity to diversify into an alternative asset class less correlated with traditional investments.

We take a positive view of commodities overall, influenced by a resilient macro backdrop. A growing global economy, combined with tighter Russian sanctions, should provide a favorable supply-and-demand equation for energy, while US tariffs could apply upward pressure to industrial metals prices.

Elevated gold prices are a risk, but the value of precious metals as a hedge to inflation, a weaker US dollar or geopolitics, should not be underestimated, as evidenced by the upturn in interest from major central banks and global institutions.

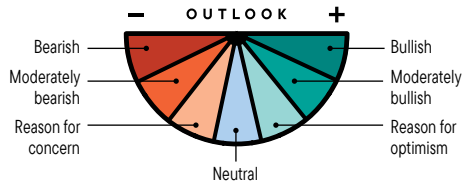
Allocation settings views—October 2025

Pendulum settings reflect cross-asset-class views

High level allocation tier

Asset class	Conviction	Our viewpoint
Equities		• Resilient economic growth is offering a tailwind to risk assets, supplemented by easier monetary policy from some major central banks, notably the Fed. • Positive earnings revisions and guidance reflect robust corporate fundamentals, supporting equity market momentum. • Despite the recent rally in equities, sentiment appears surprisingly neutral. Positioning also remains restrained, leaving room to add risk.
Bonds		• We believe market expectations for Fed policy easing are too optimistic. This maintains upward pressure on longer-term yields, in our view, curtailing our preference for US duration. • Inflation remains above central-bank targets in most developed economies. We expect goods inflation to remain sticky through the end of this year, influenced by tariffs. • Despite perceived political influence, we believe the FOMC will maintain an objective approach to monetary policy amid an uncertain inflation outlook.
Alternatives		• Our view on commodities has improved, as a weakening US dollar and persistent inflation increases gold's attraction as a diversifier. • A resilient growth backdrop and increased demand from AI offer support to energy and industrial metals. Supply constraints linked to geopolitical risks are also a factor. • Elsewhere, we see structural attractions in naturally diversifying alternatives such as private assets.
Cash		• The current macro backdrop complements the defensive features of cash. • Cash or short-term UST bills offer an opportunity to lower our portfolio's interest-rate sensitivity during a period of fiscal policy uncertainty. • We believe elevated short-term yields offer attractive risk-free returns.

Understanding the pendulum graphic



There is no assurance that any estimate, forecast or outlook will be realized.

Allocation tier

Asset class	Conviction	Our viewpoint

Equity regions: Pendulum settings relative to equity asset class broadly

Growth

United States



- We have seen US economic growth hold up well despite some weakness in the labor market, while enthusiasm for AI is supporting some large-cap growth names.
- Second-quarter earnings results came in substantially better than expected, while corporate guidance for the third quarter has improved.
- Trade policy remains a key risk, as rising input prices are increasingly likely to be passed onto consumers amid tight corporate margins and rising earnings expectations.

Value

United States



- US equities have historically proven defensive during periods of macro uncertainty. In addition, we have seen a broadening out of earnings growth relative to expectations across styles and sectors.
- Positioning and sentiment indicators suggest that discretionary buyers still under-own US value stocks.
- Equity momentum appears strong, while market breadth has been expanding and forward earnings estimates are holding up well. Fed easing should further support equities, in our view.

Small Cap

United States



- Earnings revisions are starting to moderate, relative to large caps, while forward earnings growth expectations are significantly higher, and appear optimistic.
- Small-cap companies face quality concerns and tariff-related challenges compared to large caps. Overall, there are fewer positive earners, they are less profitable and have higher debt.
- As a result, small caps generally have high interest-rate sensitivity and minimal margin capacity to absorb higher input costs. They also have higher exposure to imported intermediate goods.

Canada



- Strong momentum and breadth signals continue to support Canadian equities. Earnings growth expectations remain stable and healthy.
- An improved outlook for commodities should further fuel Canadian stocks, given the influence of energy and mining companies on indexes.
- Ongoing monetary and fiscal policy stimulus should support further growth, as should US tariff exemptions.

Euro Area ex United Kingdom



- Tariff risks remain elevated, despite the recent trade deal, with a 15% tariff on most goods and higher sectoral aluminum and steel tariffs. Manufacturing activity may decline amid fading demand and lower business confidence.
- A weaker domestic macro backdrop could weigh on eurozone equities. We are already seeing this reflected in trailing earnings growth and forward earnings growth revisions for the next 12 months.
- Europe's strong links to China leave it vulnerable to slowing Chinese demand, while a strong euro has compounded the earnings drag for exporters.

Allocation tier

Asset class	Conviction	Our viewpoint
United Kingdom		• The United Kingdom has limited sensitivity to US tariffs, following the recent trade deal agreed between the two countries. • However, as economic growth flatlines there is limited policy support given fiscal deficit and inflation concerns. • Earnings growth for UK companies is expected to be comparatively weak in 2025 but is forecast to improve somewhat next year.
Japan		• Leading indicators of economic growth are weakening, influenced by the crystallization of a 15% tariff rate on Japanese exports to the United States. This is expected to erode corporate earnings and slow economic growth. • Forward earnings growth expectations look weak compared to other regions, notably the United States. The Bank of Japan's (BoJ's) plan to unwind equity holdings added further downward pressure to stocks. • Inflation is a pressing concern in Japan, making monetary policy stimulus less likely.
Australia		• The Australian economy stands out as one of the least-sensitive regions to US tariff policy. However, the country's position as a tariff insulator is now less meaningful following the completion of several major US trade deals. • The Reserve Bank of Australia (RBA) has downgraded growth expectations amid sluggish productivity. This is influenced by a persistently weak macro environment in China. • The country has strong policy flexibility, but sustained wage growth could add to inflation pressures, restricting the RBA's ability to ease monetary policy.
Emerging ex China		• EM Asian exporters are seeing declining momentum across technology and industrials goods as global demand softens. • Disproportionately high US tariffs on countries in the region further impacts demand, particularly sectoral tariffs on important industries such as semiconductors. • However, market breadth and momentum have improved recently amid supportive monetary and fiscal policy.
China		• Retail investors armed with significant household savings have sparked a liquidity-driven rally in Chinese equity markets. • Macro and corporate fundamentals in China remain weak, but markets are looking past this as China's leading tech companies continue to surprise to the upside amid AI developments. • Fiscal and monetary stimulus measures have had little impact, and domestic demand continues to stagnate due to a deteriorating property sector, a weak labor market and low consumer confidence.

Allocation tier

Asset class	Conviction	Our viewpoint
Fixed income sectors: Pendulum settings relative to fixed income asset class broadly		
US Treasuries		• The yield curve could steepen again during the next few months, as tax reductions and tariff uncertainty fuel inflation expectations. Fiscal deficits may increase if tariff receipts are curtailed, reducing foreign ownership of USTs and increasing dependence on price-sensitive purchasers. • The Fed cut interest rates in September, emphasizing labor market weakness. However, we expect higher effective tariff rates to feed into core goods inflation, meaning market expectations for future Fed interest-rate cuts may be too optimistic. • Ultimately, we currently prefer the less interest-rate-sensitive portion of the US Treasury curve.
Eurozone Government Bonds		• Ongoing disinflation and the potential for tariffs to weigh on growth could prompt the ECB to ease further. • However, a relatively resilient economy and German fiscal expansion could present barriers to monetary policy stimulus. • Reallocation from USTs could also drive demand for eurozone duration, but momentum has stalled given the potential for increased issuance to add upward pressure on longer-term yields.
UK Government Bonds		• Slowing wage growth, weak labor market momentum and looming fiscal tightening increase the attractiveness of UK Gilts. • The UK government may need to raise taxes to narrow its fiscal deficit. This is likely to slow economic growth and compound labor market weakness. • Given the weak macro environment, we believe market expectations for interest-rate cuts are too conservative, although sticky inflation may make the Bank of England cautious.
Canada Government Bonds		• Slowing growth and a slack labor market support our constructive outlook for Canadian government bonds. • Headline inflation appears to be relatively subdued, which should allow the Bank of Canada to continue with its rate-cutting cycle, if required. However, fiscal stimulus could delay those cuts. • Tariff-related front-loading from US customers has reduced demand for Canadian imports, weighing on overall economic activity.
Japan Government Bonds		• Long-end yields remain elevated, but we think the risk-reward set up remains unfavorable given persistent inflation pressures. • The BoJ continues to normalize monetary policy to contain elevated inflation, weakening yield momentum. Structural wage pressures could further fuel inflation and bolster the BoJ's rate-hiking cycle. • Weak growth could counter the BoJ's policy tightening objectives, but the recent election outcome improves the chances of fresh fiscal support for the economy.

Allocation tier

Asset class	Conviction	Our viewpoint
Australian Government Bonds		• The RBA left interest rates unchanged at its September meeting, despite annual consumer price index inflation remaining below 3%. • The RBA remains data-dependent and has deemed a robust labor market and a relatively healthy macro environment as reason to pause further stimulus. • However, weakening economic activity may change that calculus.
Investment Grade		• The investment-grade sector has benefited from resilient corporate fundamentals, and improved guidance, but weaker macro forecasts are a concern. • Credit spreads remain narrow, making the risk/return profile less attractive to us despite loose financial conditions. • Against this background, we hold a neutral position on higher-quality credit, preferring the defensive features of government bonds.
High Yield and Loans		• Technical indicators such as spread momentum and equity market breadth support high-yield bonds. However, cooling employment and persistent inflation present headwinds. • Cracks could emerge if profitability weakens while rates stay high, leading to greater credit spread dispersion. • Stretched valuations and growth risks further limit the risk-adjusted returns available from these assets.
Emerging Market (EM) Debt		• EM local-currency debt offers a compelling opportunity, as resilient global growth, Fed easing and expectations for a weaker US dollar could create powerful tailwinds for assets denominated in EM currencies. • The fiscal weakness in developed market economies strengthens the case for EM exposure, improving risk-adjusted returns. • Fed easing should provide further support for EM bonds, in our view.

1. Sources: MSCI ACWI Index, Bloomberg. The MSCI ACWI captures large- and mid-cap representation across developed and emerging markets countries. The index covers approximately 85% of the global investable equity opportunity set. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or guarantee of future results.**
2. Source: Bloomberg. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. Past performance is not an indicator or guarantee of future results.
3. Source: US Bureau of Economic Analysis. September 25, 2025.
4. Source: Atlanta Fed GDPNow Q3 2025 Estimate. September 26, 2025.
5. Core CPI inflation (3.1%). Source: US Bureau of Labor Statistics. August 2025.
6. Source: ISRC, as of September 29, 2025.
7. Source: LSEG Datastream.
8. Sources: FactSet, Morgan Stanley. As of May 16, 2025.
9. Neutral rate - a real interest rate (nominal rate minus the 2% inflation target) that supports the economy at full employment while stabilizing prices.

Allocation Views

At **Franklin Templeton Investment Solutions (FTIS)**, we translate a wide variety of investor goals into portfolios powered by Franklin Templeton's best thinking around the globe. We serve a variety of institutional clients, ranging from sovereign wealth funds to public and private pension plans in addition to retail multi-asset clients around the world.

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

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal.

Equity securities are subject to price fluctuation and possible loss of principal. **Large-capitalization companies** may fall out of favor with investors based on market and economic conditions. **Small- and mid-cap stocks** involve greater risks and volatility than large-cap stocks.

Fixed income securities involve interest rate, credit, inflation and reinvestment risks, and possible loss of principal. As interest rates rise, the value of fixed income securities falls. Changes in the credit rating of a bond, or in the credit rating or financial strength of a bond's issuer, insurer or guarantor, may affect the bond's value. **Low-rated, high-yield bonds** are subject to greater price volatility, illiquidity and possibility of default.

The allocation of assets among different strategies, asset classes and investments may not prove beneficial or produce the desired results. To the extent a strategy invests in companies in **a specific country or region**, it may experience greater volatility than a strategy that is more broadly diversified geographically.

Commodity-related investments are subject to additional risks such as commodity index volatility, investor speculation, interest rates, weather, tax and regulatory developments.

International investments are subject to special risks, including currency fluctuations and social, economic and political uncertainties, which could increase volatility. These risks are magnified in **emerging markets.** The government's participation in the economy is still high and, therefore, **investments in China** will be subject to larger regulatory risk levels compared to many other countries.

Investing in privately held companies presents certain challenges and involves incremental risks as opposed to investments in public companies, such as dealing with the lack of available information about these companies as well as their general lack of liquidity.

Active management does not ensure gains or protect against market declines. Diversification does not guarantee a profit or protect against a loss.

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