

Perspective from
Franklin Equity
Group

The Goldilocks risk: What if things go right in 2026?

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Key takeaways:

- **The US economy could be approaching a Goldilocks equilibrium in 2026:** growth that's neither too hot or too cold, with inflation anchored and fiscal and monetary policy that is broadly supportive.
- **Productivity gains should underpin growth and drive returns:** Artificial Intelligence (AI) adopters are positioned to lead the next leg of the market cycle, leveraging automation, advanced analytics and operational efficiency to unlock margin expansion and stronger profitability.
- **Valuation dispersion creates opportunity:** The valuation gap between the top decile of the S&P 500 and the broader market remains near multidecade highs. This reflects recent market narrowness but also creates a compelling opportunity for active investors as leadership broadens.

The Goldilocks risk

The US economy could be approaching a Goldilocks equilibrium in 2026: growth that's neither too hot nor too cold, with inflation anchored and a broadly supportive fiscal and monetary policy. Paired with AI-driven innovation fueling productivity across industries, our outlook for 2026 has a positive bias, as we see the upside scenario increasingly likely.

Despite our optimism, this outcome is far from certain. Elevated valuations in key growth segments leave little room for error, market leadership remains narrow, with recent market volatility reflecting uncertainty around AI adoption, earnings durability and policy timing. AI's promise is undeniable, but its near-term impact on profitability and labor remains in flux. For growth investors, we see 2026 as a year where quality is poised to shine even in a volatile market.



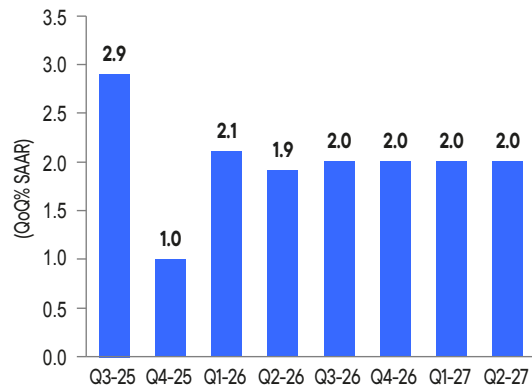
Macroeconomic backdrop: growth is resilient, but narrow

The US economy continues to outperform most developed markets with Gross Domestic Product (GDP) growth running near 2%¹—a pace strong enough to sustain employment but not hot enough to push inflation higher. This balance gives the Federal Reserve flexibility to guide rates back toward neutral, creating conditions that may be “just right” for an extended economic expansion.

Exhibit 1: US Real GDP and Inflation Forecast

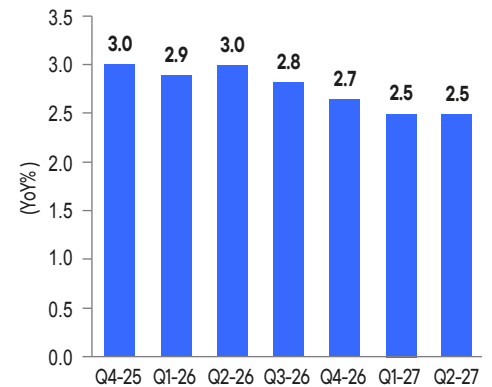
Real GDP Growth Forecast

Q3-25 to Q1-27



Inflation Forecast

Q4-25 to Q2-27



Source: Bloomberg Consensus. October 31, 2025. There is no assurance that any estimate, forecast or projection will be realized.

Inflation and policy: Inflation is decelerating toward the Fed's 2% target, supported by supply-chain normalization and productivity gains. We see inflation headwinds continuing to normalize as tariff impacts moderate.

Consumer dynamics: Household strength remains bifurcated. High-income consumers continue to spend, supported by real wage gains, rising asset values and healthy balance sheets. Lower-income households remain more selective, with spending patterns reflecting tighter budgets.

The productivity pivot: margin leverage and capex discipline

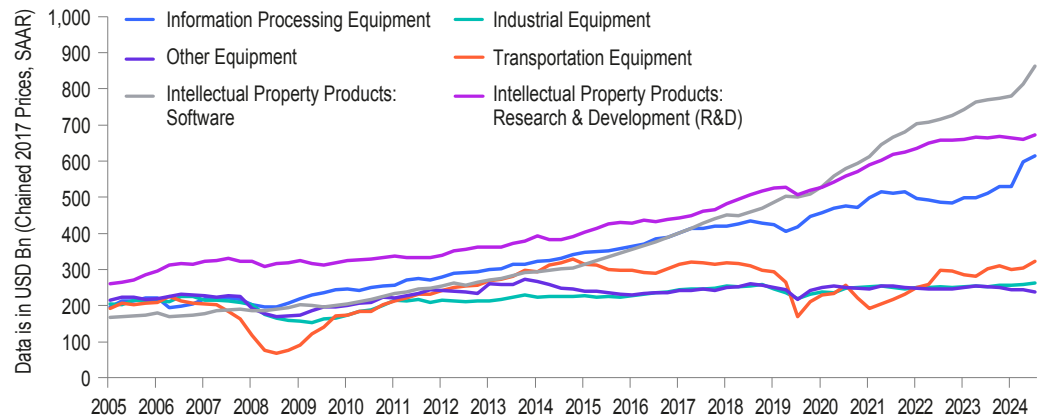
In 2026, we expect the market narrative around AI to shift from infrastructure build-out toward tangible, real-world applications. As this application era takes hold, leadership should transition to companies that convert AI spending into measurable productivity gains—streamlining workflows, improving decision quality and reshaping cost structures. These AI adopters are positioned to lead the next leg of the market cycle, leveraging automation, advanced analytics and operational efficiency to unlock margin expansion and stronger profitability.

Exhibit 2: US Capex Moves Toward Software and R&D

“Higher refunds and broader tax cuts should reinforce disposable income and near-term consumption trends supporting the US consumer.”

US Capital Expenditures

December 30, 2005–June 30, 2025



Sources: FactSet, US Bureau of Economic Analysis. June 30, 2025.

Impact of tax refunds and stimulus

Much has been written about the K-shaped economy and the divide between low- and high-end consumers in the United States. Asset prices and the wealth effect have benefited the top half of the economy, but looking ahead, we see potential stimulus and tax changes that could provide a meaningful tailwind to consumer spending more broadly. Higher refunds and broader tax cuts should reinforce disposable income and near-term consumption trends supporting the US consumer.

“Looking toward 2026, conditions may favor a broadening of market leadership, with opportunities emerging across sectors beyond technology and companies below the mega-cap threshold.”

Market breadth: leadership beyond mega-caps

In recent years, a small group of mega-cap innovators—dominated by the “Magnificent Seven”²—has driven the majority of index returns, benefiting from scale and AI leadership. Looking toward 2026, we believe conditions should favor a broadening of market leadership, with opportunities emerging across sectors beyond technology and companies below the mega-cap threshold.

Several dynamics support this potential shift:

• Macro conditions favor broader participation

Stable growth, moderating inflation and a more predictable monetary policy environment create a supportive backdrop for a wider set of business models. Small- and mid-cap companies stand to benefit from improved financing conditions, normalized cost structures and greater investor interest in cyclical and innovation-driven growth.

• Earnings contributions are normalizing

The earnings gap between mega-caps and the broader market peaked in 2023–2024. In 2026, sectors such as health care, industrials, consumer discretionary and select financials are well-positioned to take on leadership, supported by stabilizing costs and productivity gains.

• AI’s impact is expanding beyond top platforms

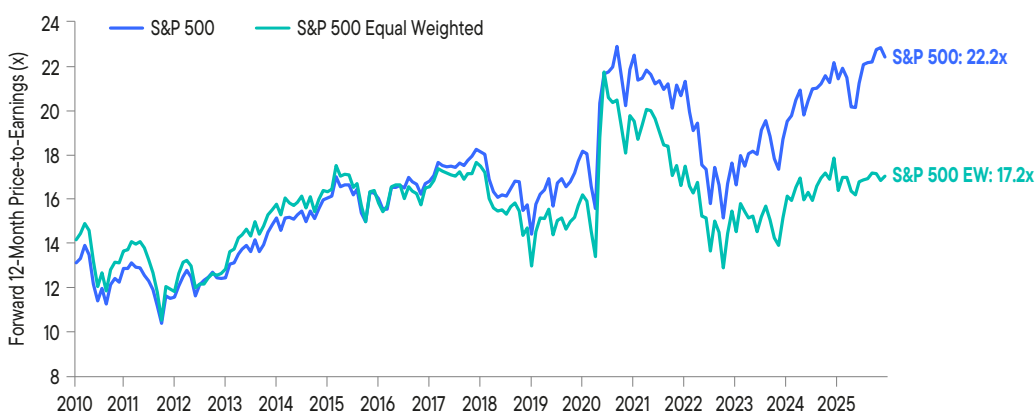
The next phase of AI adoption should increasingly benefit companies across the value chain. Traditional industries including industrial automation, health care tools, logistics and business services are beginning to realize tangible efficiency gains from AI integration.

• Valuation dispersion creates opportunity

The valuation gap between the top decile of the S&P 500 and the rest of the market remains near multidecade highs. While reflecting recent market narrowness, we believe this gap presents a compelling opportunity for active investors as leadership is likely to broaden.

Exhibit 3: S&P 500 versus S&P 500 Equal Weight Index: Next 12 Months (NTM) Price/Earnings Ratio (PE)

S&P 500 vs. S&P 500 Equal Weighted NTM PE
15-year period ended August 31, 2025



Source: FactSet, as of August 31, 2025. S&P Dow Jones Indices. 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 a guarantee of future performance.** Important data provider notices and terms available at www.franklintempletondatasources.com.

The opportunity: quality growth and secular tailwinds

Our view on US equities remains positive but selective. In an environment where growth is available but not abundant, we focus on owning high-quality franchises with durable competitive advantages, often supported by secular tailwinds. We are focused on several themes in the strategy:



1. Health care innovation

AI-driven diagnostics, advanced med-tech robotics and efficiency solutions that improve outcomes and address systemic costs.



2. Industrial technology and power systems

US re-industrialization and reshoring is driving demand for automation, electrification and infrastructure investments.



3. Fintech consumer and payments platforms

Scale, proprietary data and consumer trust is likely to drive resilient earnings and recurring revenue models.



4. AI beneficiaries and compute infrastructure

AI adoption is accelerating and can drive substantial benefits across the economy. We view compute infrastructure as the foundational commodity of the modern economy.

Across these themes, the common link is a focus on businesses with clear competitive advantages and strong fundamentals. Companies that innovate, maintain healthy profit margins and invest strategically are likely well positioned to deliver consistent, high-quality growth in a market where true quality remains scarce.

“For growth investors, this is the moment to lean into selectivity, focusing on franchises positioned at the intersection of secular tailwinds and operational discipline.”

Risks we're monitoring closely

Key risks include stubborn services inflation, which could introduce bouts of volatility. AI adoption is another swing factor, with implementation likely to be uneven as firms manage governance and integration. Valuations also warrant attention: Many leaders trade at premiums to history, supported by strong growth but leaving limited room for missteps. Against this backdrop, maintaining valuation awareness and a balanced, long-term portfolio remains essential.

Conclusion: Why quality growth matters now

If the past few years were defined by navigating volatility, 2026 will be defined by a focus on quality and fundamentals. The fiscal and economic conditions appear to be aligning to support growth. We expect continued innovation-led expansion underpinned by quality fundamentals, an environment where we think disciplined, active management has the advantage.

For growth investors, this is the moment to lean into selectivity, focusing on franchises positioned at the intersection of secular tailwinds and operational discipline. Depth over breadth, fundamentals over narrative—this is how long-term compounders are built.

Endnotes

1 Source: Bloomberg Consensus, October 31, 2025.

2 Magnificent Seven, the stocks of Alphabet, Amazon, Apple, Meta, Microsoft, NVIDIA and Tesla.

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All investments involve risks, including possible loss of principal.

Equity securities are subject to price fluctuation and possible loss of principal.

Small- and mid-cap stocks involve greater risks and volatility than large-cap stocks.

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