



Broadening momentum: From US technology leadership to US small caps and emerging markets

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Overview

- Despite the solid gains in global equity indexes in 2025, we still believe conditions remain favorable for the rotational bull market to continue.
- We expect real US gross domestic product (GDP) to grow at 2.5% with moderating inflation, ongoing Federal Reserve (Fed) interest-rate cuts, a robust fiscal impulse and a broad-based earnings recovery to drive further equity gains over our tactical horizon. With the Fed likely to ease, monetary easing may continue in many emerging markets as well.
- We think market leadership will continue to broaden and that two often-overlooked equity market segments are poised to outperform: US small caps and emerging markets (EMs).

This paper serves as a sequel to three research papers we published beginning in January 2025 and offers a potential road map for investors seeking opportunities in 2026. We will discuss the following:

- Market broadening—revisiting our January 2025 theme
- What's ahead—potential for an earnings-driven bull market
- Why small caps may shine
- International opportunities are still compelling, with EMs poised to lead

Market broadening—revisiting our January 2025 theme

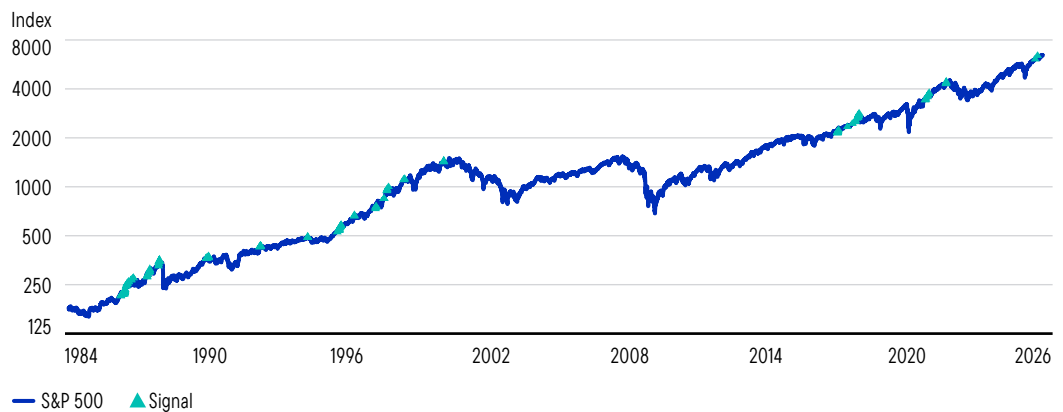
In January 2025, we published “[Get Ready for a Broader US Equity Market](#),” in which we demonstrated that lower interest rates, solid economic growth and ample liquidity have historically supported broader US equity market leadership.

Market performance has largely shown that our call was accurate. Throughout 2025, central banks globally continued to ease policy, US GDP growth remained robust despite ongoing trade tensions, and fiscal stimulus in both the United States and the eurozone sustained strong liquidity conditions. The result was a bull market, with all major US equity indexes reaching record-high levels last year. As the exhibit below shows, a combination like this is rather rare.

Exhibit 1: US Large and Small Caps Are Near All-Time Highs

S&P 500 Index and New Highs of Multiple Indexes

As of January 19, 2026



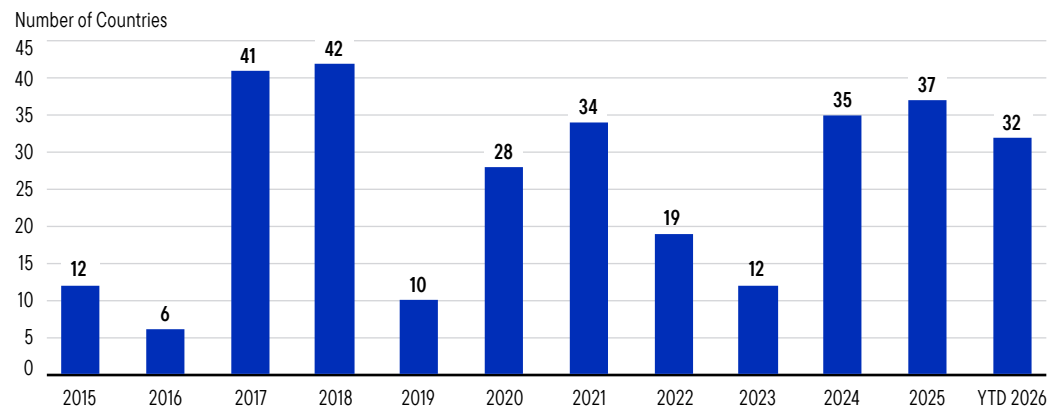
Sources: S&P Global, Nasdaq, Russell Investment Group, Bloomberg, Macrobond. Analysis by Franklin Templeton Institute. Data as of January 19, 2026. The green signal plot points indicate when all major indexes (S&P 500, Nasdaq Composite, Russell 2000, Russell 1000 and Dow Jones Industrial Average) reached new high levels, which the authors consider bullish for the broad market. Indexes are unmanaged and one cannot invest directly in an index. Indexes do not include fees, expenses or sales charges. **Past performance is not an indicator or guarantee of future results.** Important data provider notices and terms available at www.franklintempletondatasources.com.

However, this bullish price action was not limited to just the United States. In 2025 alone, 37 countries represented in the MSCI All Country World Index posted new one-year highs, the best result since 2018. This means that roughly 79% of countries globally have enjoyed bullish price action.

Exhibit 2: Around the World, Dozens of Markets Have Reached One-Year Highs

Number of Markets in MSCI All Country World Index at One-Year Highs Each Year

2015 to January 16, 2026



Sources: FactSet, MSCI. Analysis by Franklin Templeton Institute and Franklin Templeton Global Research Library. Data as of January 16, 2026. Indexes are unmanaged and one cannot invest directly in an index. Indexes do not include fees, expenses or sales charges. **Past performance is not an indicator or guarantee of future results.** Important data provider notices and terms available at www.franklintempletondatasources.com.

What's ahead? Potential for earnings-driven bull market

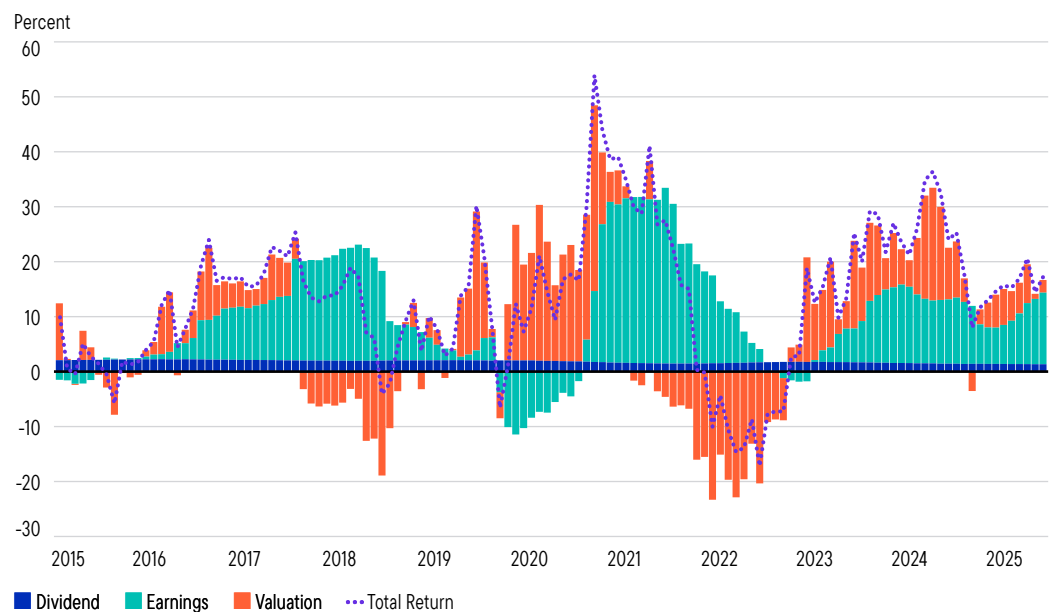
Despite the solid gains in global equity indexes last year, we still believe conditions remain favorable for further broadening of market leadership. The US economy remains resilient, underpinned by robust consumer spending, with the latest real GDP estimate at 4.2%¹—one of the strongest readings in recent years.

As widely expected, the Fed lowered the fed funds rate 75 bps from September to December of 2025. Since the start of the current easing cycle one year earlier in September 2024, the rate has declined 175 bps to 3.50%-3.75%.

Historically, a combination of solid economic growth and easier monetary policy has provided an ideal backdrop for corporate earnings expansion. We are already seeing this dynamic unfold, as the one-year S&P 500 total return for the past 12 months (through January 8, 2026) was 17.9%, and 13.6% of it came from earnings. *That's more than 75%.*²

Exhibit 3: Earnings Have Driven Most of the S&P 500 Index Return

Decomposition of S&P 500 Total Return



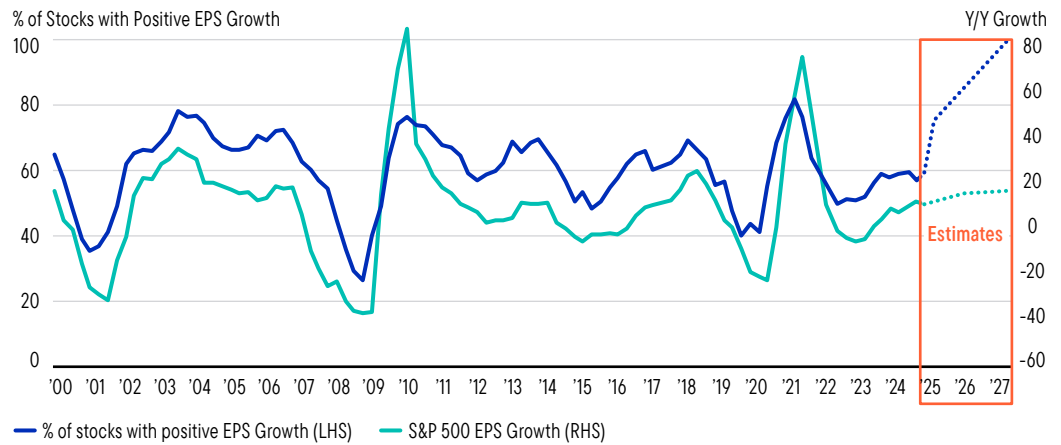
Sources: Bloomberg, Macrobond. Analysis by Franklin Templeton Institute. Data as of January 19, 2026. Indexes are unmanaged and one cannot invest directly in an index. Indexes do not include fees, expenses or sales charges. **Past performance is not an indicator or guarantee of future results.** Important data provider notices and terms available at www.franklintempletondata-sources.com.

What's also important is that forward-earnings expectations for S&P 500 companies are rising sharply, reinforcing the case for an earnings-driven bull market.

1. Source: GDPNow estimate. Atlanta Federal Reserve Bank. As of January 29, 2026. The GDPNow forecasting model provides a "nowcast" of the official estimate prior to its release by estimating GDP growth using a methodology similar to the one used by the US Bureau of Economic Analysis. GDPNow is not an official forecast of the Atlanta Fed. Rather, it is best viewed as a running estimate of real GDP growth based on available economic data for the current measured quarter. There is no assurance that any estimate, forecast or projection will be realized.
2. Source: Bloomberg. Analysis by Franklin Templeton Institute.

Exhibit 4: Outlook for S&P 500 Earnings to Rise

S&P 500 Earnings Per Share (EPS) Growth, 2000-2027



Sources: FactSet, S&P Dow Indices, FactSet Market Aggregates. Analysis by Franklin Templeton Institute and Franklin Templeton Global Research Library. Data as of January 19, 2026. Estimates for fourth quarter 2025, 2026 and 2027 are from FactSet. There is no assurance that any prediction, projection or forecast on the economy, stock market, bond market or the economic trends of the markets will be realized. Indexes are unmanaged and one cannot directly invest in an index. **Past performance is not an indicator or guarantee of future results.** Important data provider notices and terms available at www.franklintempletondatasources.com.

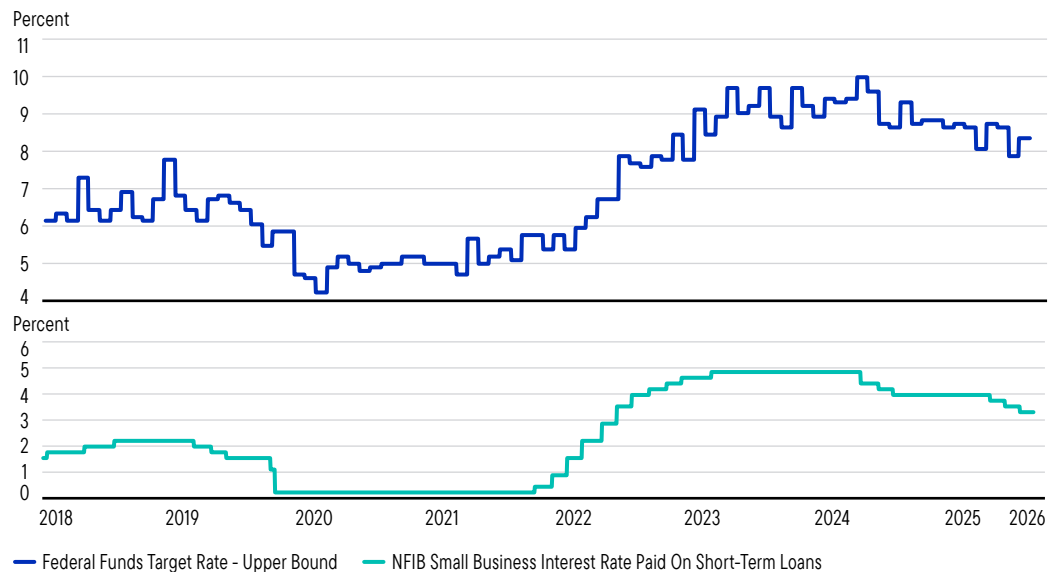
Why US small-cap stocks may shine

Currently, few areas of the market are as out of favor as small caps. Over the last one, three, five, 10 and 20 years the S&P 500 Index has outperformed the Russell 2000 Index, which shows that, in recent years, small caps have struggled to live up to their historical performance pattern because of the effects of sharply rising interest rates, to which they have been particularly vulnerable.

Since 2021, as the Fed tightened financial conditions, interest rates on short-term loans to small businesses rose from around 5% to nearly 10%, putting significant pressure on small-cap profitability.

Exhibit 5: Small Businesses Have Paid High Interest on Short-Term Loans

Federal Funds Rate and Interest Paid by Small Businesses

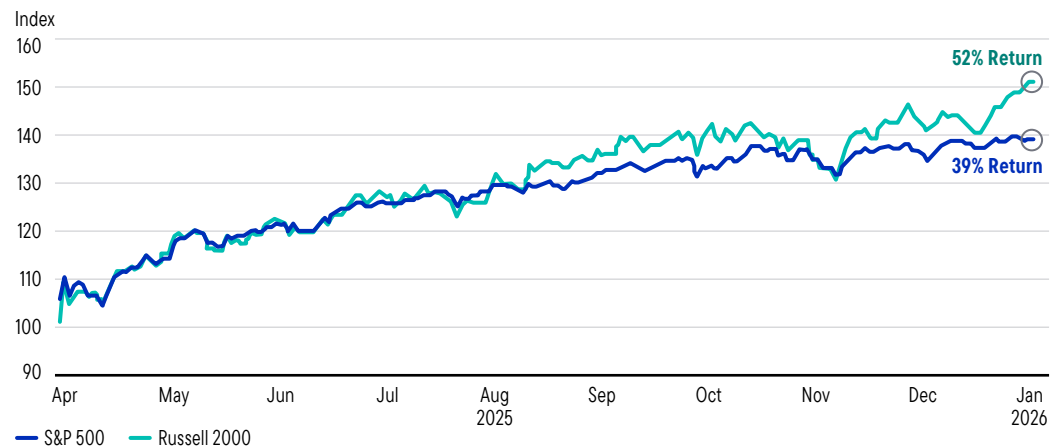


Sources: NFIB (National Federation of Independent Business), Bloomberg, Macrobond. Analysis by Franklin Templeton Institute. Data as of January 19, 2026. Important data provider notices and terms available at www.franklintempletondatasources.com.

Investors have had sound fundamental reasons to avoid small caps in recent years. Small-cap companies carried roughly three times more debt than large caps over the past 10 years, which has translated into over five times less capacity to service their short-term obligations (in the 10 years through 2025, the S&P 500 rose 298%, while the Russell 2000 Index rose only 150%).³

Today, however, we believe the worst may be behind small caps. With the Fed now embarked on a monetary easing cycle, lower interest rates could provide a much-needed boost to this rate-sensitive asset class. The Fed cut interest rates several times in 2024 and 2025. As the stock market remains the world's most efficient discounting mechanism, lower rates may help explain the recent small-cap outperformance following the “Liberation Day” (April 2, 2025) selloff—small caps have outperformed large caps by roughly 13% since the April market bottom.

**Exhibit 6: Small Caps
Have Outperformed
since “Liberation Day”
Market Bottom**
**S&P 500 and Russell 2000
Performance since April
2025**



Sources: S&P Global, Russell Investment Group, Bloomberg, Macrobond. Analysis by Franklin Templeton Institute. Data as of January 19, 2026. Indexes are unmanaged and one cannot invest directly in an index. Indexes do not include fees, expenses or sales charges. **Past performance is not an indicator or guarantee of future results.** Important data provider notices and terms available at www.franklintempletondatasources.com.

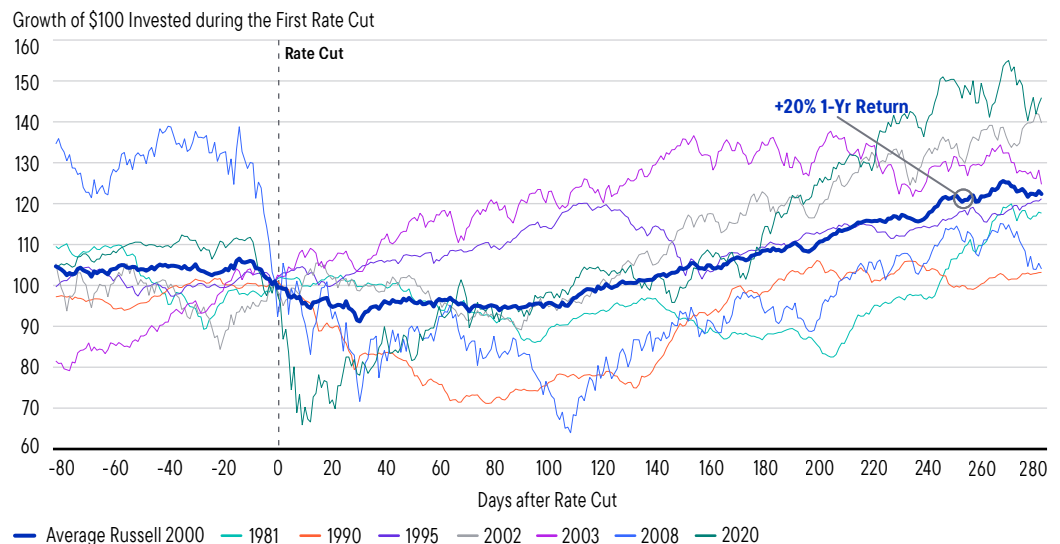
We have focused recent research on how financial markets and the broader macroeconomic backdrop have typically evolved in past market cycles when the Fed resumed cutting interest rates after a pause. In September 2025, we published [“How US Equities and US Fixed Income Performed with a Resumption of Fed Easing,”](#) and in this analysis we found that small caps have historically been one of the strongest-performing equity styles in such environments, advancing by an average of 20% within one year of the first interest-rate cut.

In sum, our research indicates a decline in rates should help reduce interest expense, support profitability and provide a much-needed tailwind for smaller businesses.

3. Source: FactSet. Analysis by Franklin Templeton Institute.

Exhibit 7: Russell 2000 Index Performance after Resumption of Interest Rate Cuts

Performance during Rate-Cutting Cycles since 1981



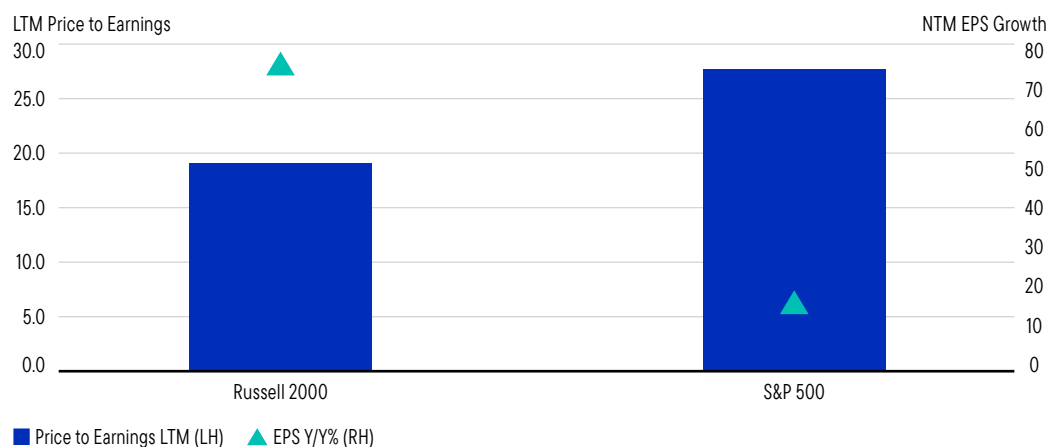
Sources: Russell Investment Group, Macrobond. Analysis by Franklin Templeton Institute. Data as of August 2025. Data available since December 1978. Dates of pauses in Fed's interest-rate cutting cycles: November 2, 1981; July 13, 1990; December 19, 1995; November 6, 2002; June 25, 2003; October 8, 2008; March 4, 2020. Indexes are unmanaged and one cannot invest directly in an index. Indexes do not include fees, expenses or sales charges. **Past performance is not an indicator or guarantee of future results.** Important data provider notices and terms available at www.franklintempletondatasources.com.

Attractive small-cap valuations

Despite the remarkable rally to new all-time highs in 2025—the first since 2021—small-cap valuations remain attractive relative to history. We believe small caps also continue to offer superior earnings potential, creating a compelling opportunity for investors seeking to diversify away from concentrated large-cap exposures. As Exhibit 8 illustrates, small caps are trading at a roughly 35% discount relative to large caps, while offering nearly three times stronger earnings growth prospects.

Exhibit 8: Small Caps Offer Attractive Valuations and Stronger Earnings Growth than Large Caps

S&P 500 Versus Russell 2000



Source: FactSet. Analysis by Franklin Templeton Institute. Data as of January 19, 2026. LTM means last 12 months; NTM means next 12 months. Indexes are unmanaged and one cannot invest directly in an index. Indexes do not include fees, expenses or sales charges. Important data provider notices and terms available at www.franklintempletondatasources.com.

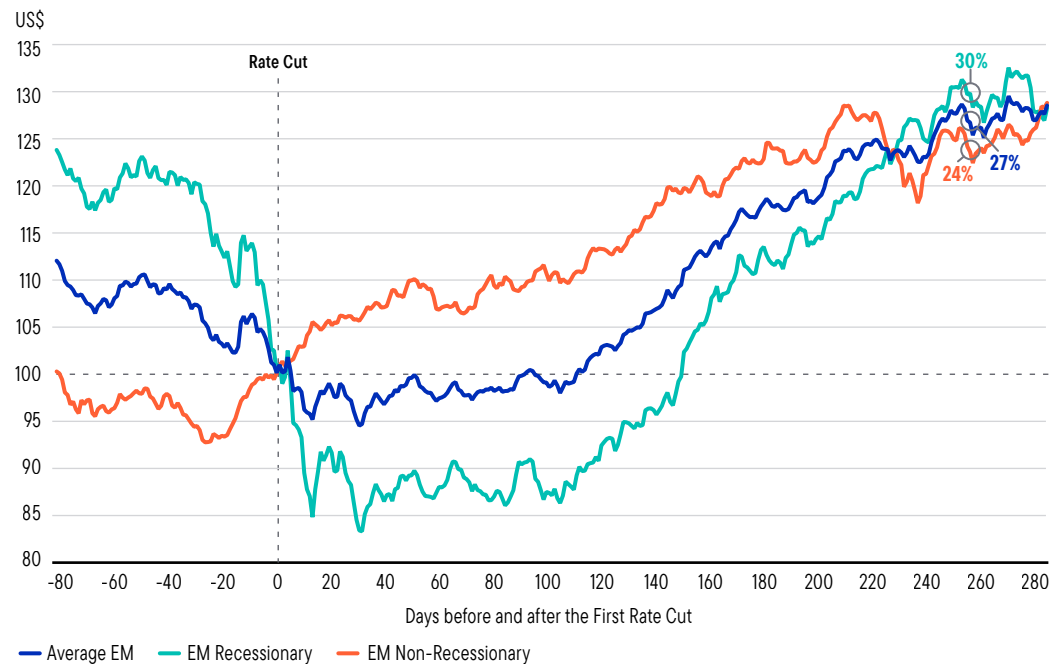
International opportunities are still compelling, with EM equities poised to lead

Looking beyond the United States, EMs are increasingly compelling as global monetary conditions pivot. With interest rates in major developed economies expected to ease, the EMs stand to benefit from both cheaper local funding and improved currency dynamics.

In our recent paper, [“How Global Equities and Fixed Income Performed with a Resumption of Fed Easing,”](#) we examined how global asset classes have historically performed following a Fed interest-rate cut after a pause. The results were striking: The MSCI Emerging Markets Index emerged as the best-performing equity benchmark in past market cycles, advancing by approximately 27% on average within one year after such a policy shift.

Exhibit 9: MSCI Emerging Markets Index Performance When the Fed Resumed Cutting Interest Rates after a Pause

Performance during Rate-Cutting Cycles since 1990

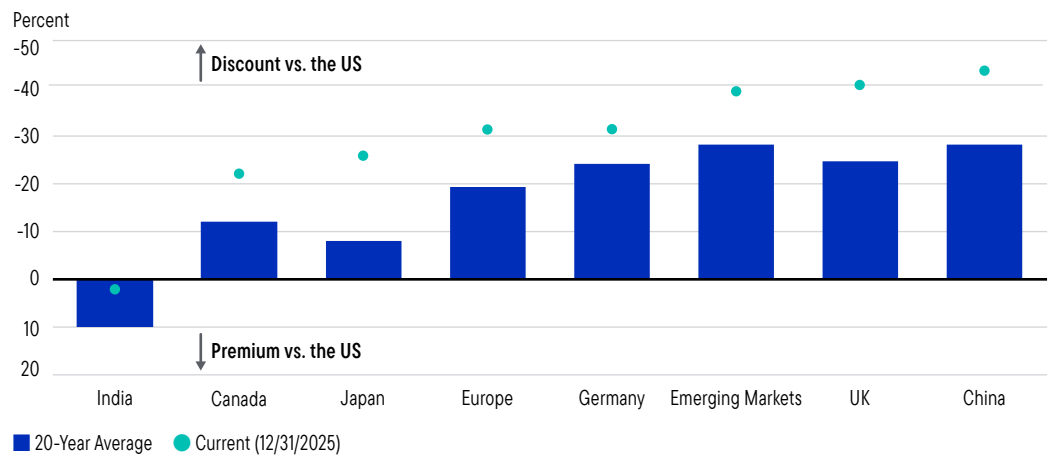


Sources: MSCI, Macrobond. Analysis by Franklin Templeton Institute. Average EM represents average index performance during interest-rate cutting cycles in the years 1990, 1995, 2002, 2003, 2008 and 2020. EM Recessionary represents average performance during rate-cutting cycles that began July 13, 1990, October 8, 2008, and March 4, 2020. EM Non-Recessionary represents average performance during rate-cutting cycles that began December 19, 1995, November 6, 2002 and June 25, 2003. Data as of September 2025. Indexes do not include fees, expenses or sales charges. **Past performance is not an indicator or guarantee of future results.** Important data provider notices and terms available at www.franklintempletondatasources.com.

Valuations, in our view, also strengthen the case for increasing exposure to EMs. As the exhibit below illustrates, the valuation discount of EM equities relative to developed markets is well above its 20-year average, placing the asset class among its most attractively priced levels in decades. This deep discount not only reflects years of investor under-allocation and lingering macro concerns, but we also see it as providing meaningful upside potential as global financial conditions ease and growth prospects stabilize.

Exhibit 10: Global Valuations Relative to US Stocks

NTM Price-to-Earnings Premium/Discount of Key Markets Versus United States



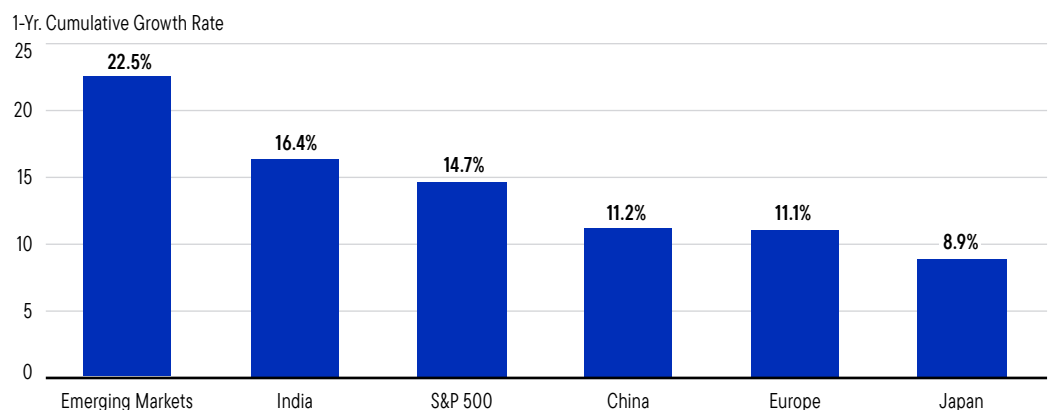
Sources: FactSet, MSCI, S&P Dow Jones Indices, FactSet Market Aggregates. Analysis by Franklin Templeton Institute and Franklin Templeton Global Research Library. Data as of December 31, 2025. NTM means next 12 months The price-earnings (P/E) measurement of the S&P 500 Index is used to represent the US market. For non-US countries and regions, the relevant MSCI Index is used: MSCI India Index, MSCI Canada Index, MSCI Japan Index, MSCI Europe Index, MSCI Germany Index, MSCI Emerging Markets Index, MSCI UK Index and MSCI China Index. Discount means that the country or region P/E is lower than the US P/E; premium means that the country P/E is higher than the United States. Indexes are unmanaged and one cannot invest directly in an index. Indexes do not include fees, expenses or sales charges. Important data provider notices and terms available at www.franklintempletondatasources.com.

Looking at one-year forward earnings expectations, companies in EMs are projected to deliver stronger earnings growth than the United States, Europe or Japan. This reflects both improving macroeconomic momentum and a broader recovery in corporate profitability across key EM economies.

We believe this combination of easier financial conditions, compelling valuations and solid earnings growth potential creates an attractive entry point for investors seeking to diversify portfolios and capture exposure to renewed global growth. As monetary policy loosens and global liquidity improves, we believe the fundamental and relative appeal of EMs could strengthen further, potentially setting the stage for a sustained period of outperformance.

Exhibit 11: EMs Offer Stronger Earnings Growth Potential than the US and Other Developed Markets

Expected One-Year Earnings Growth for 2026



Sources: FactSet, MSCI, S&P Dow Jones Indices, FactSet Market Aggregates. Analysis by Franklin Templeton Institute and Franklin Templeton Global Research Library. Data as of January 19, 2026. Estimates for 2026 earnings growth rates are from FactSet. The S&P 500 Index represents US stocks and for other countries and regions, the relevant MSCI Index is used: MSCI India Index, MSCI Japan Index, MSCI Europe Index, MSCI Emerging Markets Index and MSCI China Index. There is no assurance that any prediction, projection or forecast on the economy, stock market, bond market or the economic trends of the markets will be realized. Indexes are unmanaged and one cannot invest directly in an index. Indexes do not include fees, expenses or sales charges. Important data provider notices and terms available at www.franklintempletondatasources.com.

Conclusion

With the US economy showing strong growth and the Fed resuming its interest rate-cutting cycle in 2025, the environment looks increasingly favorable for corporate earnings to expand. It may be an opportune time to consider increasing allocations to equities, as our research indicates they are poised for potential further gains.

Our research themes in 2025 emphasized the likelihood for equity market performance to broaden beyond the Magnificent Seven.⁴ As we have entered 2026, our analysis of the capital markets continues to favor the likelihood of broadening performance. Here, we highlight two areas of equity markets that may be especially attractive—US small caps and emerging markets. Investors often avoid these areas of the market, but we believe they should instead take a closer look.

The recent struggles of small-cap companies can be attributed primarily to their vulnerability to rising interest rates, which significantly increased borrowing costs and pressured their profitability. However, with interest rates now at lower levels and perhaps more rate cuts ahead, the outlook for small caps is becoming increasingly favorable. As a result, this rate-sensitive asset class may experience a notable resurgence in performance. Our research finds valuations attractive on an historical basis, adding a potential tailwind to performance.

EMs are also becoming more attractive. Easing global monetary conditions should make local funding cheaper for EM companies, while also improving currency dynamics. Our research shows EM equities are currently undervalued relative to developed markets, offering what we consider significant upside potential as global financial conditions stabilize and growth prospects improve. We believe companies in EMs that are projected to deliver stronger earnings growth than their counterparts in the United States, Europe and Japan, now may be an opportune time to consider increasing exposure to this asset class.

Contributors

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4. The Magnificent Seven refers to Apple, Microsoft, Amazon, Alphabet (Google), Tesla, Nvidia and Meta.

Index definitions

Past performance is not an indicator or a guarantee of future performance. Indexes are unmanaged and one cannot invest directly in an index. They do not include fees, expenses or sales charges. Important data provider notices and terms available at www.franklintempletondatasources.com.

MSCI All-Country World Index (ACWI) captures large- and mid-cap representation across 23 developed markets and 24 emerging markets countries. With 2,517 constituents, the index covers approximately 85% of the global investable equity opportunity set.

MSCI Canada Index tracks the performance of large- and mid-cap companies in Canada, providing a comprehensive representation of the Canadian equity market.

MSCI China Index captures large- and mid-cap representation across China A shares, H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs).

MSCI Emerging Markets Index is a free float-adjusted, market capitalization-weighted index designed to measure the equity market performance of global emerging markets.

MSCI Europe Index is a market capitalization-weighted index designed to measure the equity market performance of developed markets in Europe.

MSCI Germany Index is designed to measure the performance of the large and mid cap segments of the German equity market. With 54 constituents, the index covers approximately 85% of the equity universe in Germany.

MSCI Japan Index is designed to measure the performance of the large and mid cap segments of the Japanese market. With 180 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in Japan.

MSCI India Index is designed to measure the performance of the large and mid cap segments of the Indian market. The index covers approximately 85% of the Indian equity universe.

MSCI United Kingdom Index is designed to measure the performance of the large and mid cap segments of the UK market, covering approximately 85% of its free float-adjusted market capitalization.

Nasdaq Composite Index is a market capitalization-weighted index of more than 2,500 stocks listed on the Nasdaq stock exchange.

Russell 2000® Index is a market capitalization-weighted index that measures the performance of the 2,000 smallest companies in the Russell 3000 Index.

S&P 500 Index is a market capitalization-weighted index of 500 stocks, a measure of broad US equity market performance.

1. The Magnificent Seven refers to Apple, Microsoft, Amazon, Alphabet (Google), Tesla, Nvidia and Meta.

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Diversification does not guarantee a profit or protect against a loss.

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

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.

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.

Large-capitalization stocks 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.

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