Expanding Global Opportunities

A strategic framework for international and emerging markets allocation

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Stephen Dover, CFA
Chief Market Strategist, Head of Franklin Templeton Institute

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The contributors featured in this paper reflect the breadth of expertise across the Franklin Templeton investment organization. Together, they offer insights informed by different disciplines, regional perspectives and sector specializations, providing a broader lens through which to examine today's investment landscape.

By bringing together a range of viewpoints, this paper reflects the value of diverse perspectives in exploring complex investment themes and fostering a more comprehensive understanding of the opportunities and risks shaping global markets.

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Executive summary

This paper presents the case for emerging market (EM) allocations within the broader context of global investment strategy. In a period of heightened geopolitical complexity—spanning the 2026 US-Iran conflict, challenges to globalization, political transformation and ongoing great power competition—we believe the case for engaged emerging markets exposure has never been stronger.

The global investment landscape has fundamentally shifted. The unipolar order that defined the post-Cold-War era has given way to a multipolar environment characterized by regional conflict, divergent policy objectives and fragmented global trade. For institutional investors, complexity creates challenge and opportunity. As we outline below, emerging markets offer avenues to enhance returns, diversify portfolios and help institutional investors meet their objectives.

Three converging and reinforcing forces are propelling a fresh approach to emerging markets:

- **Structural transformation:** Many emerging markets have adopted sound institutional reforms, creating more viable and resilient monetary and fiscal policy frameworks.
- **Economic dynamism:** Many emerging markets have diversified their economies and have demonstrated an ability to adapt to rapidly changing geopolitical dynamics, including to tariffs and other impediments to globalization. Emerging markets have come a long way from their more crisis-prone and globalization dependent origins of the 1980s and 1990s.
- **Changing US dollar outlook:** For a variety of reasons, an era of unassailable US dollar strength is transitioning to one of a stable-to-weaker dollar. Narrowing interest differentials and a broadening of investment opportunities worldwide are part of that dynamic, as are signs that a more multi-polar currency system for payments, reserves and finance is arriving. Emerging markets—debt and equity—generally perform well during periods of dollar stability or even weakness.

For investors, other considerations are also important, including:

- **Earnings and valuation support:** Corporate profits growth in emerging equity markets is expected to improve significantly over the next two years, which should help to "unlock" lower valuations and therefore improve returns in both emerging equity and corporate credit markets.
- **Income opportunities:** In developed markets (DMs), nominal and real yields remain relatively low, yield curves are historically flat (reducing the attractiveness of duration) and credit spreads are tight. In contrast, parts of the emerging market complex (such as large parts of Latin America and Brazil in particular), offer higher real interest rates and, overall, local currency debt is supported by dollar weakness.
- **Enhanced portfolio diversification:** Driven by improved returns, as well as contributions from correlation and volatility, emerging debt and equity markets can provide diversification opportunities in global portfolios.

Capturing opportunities in emerging markets requires strategies that maintain flexibility across implementation approaches, including active security selection and discretionary tactical allocation. Investors must be able to identify and realize opportunities at the security level, but they must also be equipped to respond to and manage rapid shifts in risk, including geopolitical risk, via tactical reallocation across regions, sectors and asset classes.

This paper establishes the strategic rationale for emerging markets. We examine structural transformations across three pillars—re-globalization, technological disruption and institutional resilience—and then detail investment opportunities by region and asset class. We also consider how emerging markets are likely to impact portfolio returns and risk.

The renewed case for global investing

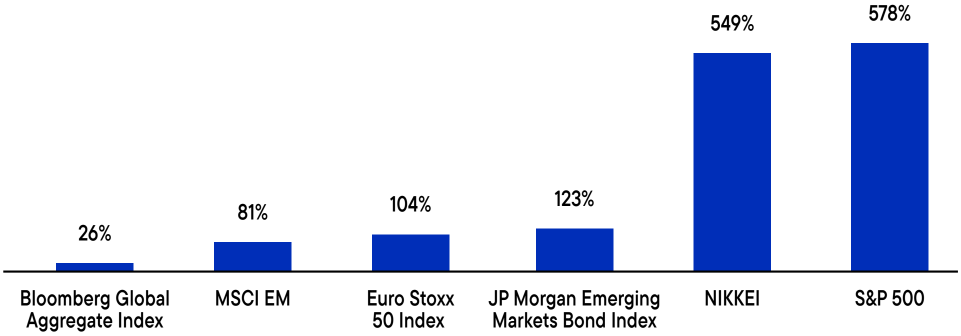
Any consideration of emerging markets must begin with the case for global investment strategy. The decision to allocate capital internationally is not just about geographic diversification. Rather, it is increasingly driven by fundamental shifts in absolute and relative returns that drive global capital flows, by the discovery of new investment opportunities, and by the need to identify and manage concentration risk.

This section establishes the reasons why active international allocation strengthens institutional portfolios that also reinforces the rationale for emerging market allocations.

In an extended period of "US exceptionalism"—roughly spanning the 15 years from the global financial crisis to the middle of the current decade—investors increasingly gravitated to US equity and credit markets. That was understandable, given the superior returns—in absolute and risk-adjusted terms—delivered by US financial assets. Importantly, superior returns on US assets were driven by superior fundamentals, including growth, institutional solidity, vast market liquidity, innovation and historic levels of profitability.

US Outperformance Since 2010

From January 1, 2010 to June 3, 2026



Sources: Bloomberg, Franklin Templeton Institute.

Thought leadership contributor

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At the same time, however, US-based equity returns became more concentrated, as mega-capitalization stocks accounted for a growing share of widely followed market-capitalization indexes.

Partly driven by concerns about concentration risk and partly because of improving returns in other markets, investors have more recently begun to look for opportunities in other markets. Over the past year, European, Japanese and emerging equities, and particularly emerging debt, have episodically produced superior returns to those found in US equity and fixed income markets. Those outcomes have begun to raise awareness of global opportunities, among them in emerging markets.

Renewed interest in global investing stems from other factors as well. Economic and monetary policy divergence is becoming more significant. Prior to the US-Iran War, the Federal Reserve (Fed) was biased to cut rates, the European Central Bank (ECB) had paused its easing cycle, the Bank of Japan (BoJ) had already cautiously begun to hike rates, and various emerging central banks were prepared to cut rates amid falling inflation. Those divergences in policies had contributed to a weakening of the US dollar since early 2025, which in turn boosted investor interest in non-US markets, including in emerging markets.

With the outbreak of the war and the impairment of shipping via the Strait of Hormuz, policy perceptions have again shifted. The Fed and emerging central banks are now (mostly) on hold, the ECB and the BoJ are inclined to tighten their monetary policies. Unsurprisingly, volatility, correlation and returns have shifted markedly. But the underlying point remains: Divergence in the conduct of monetary policy creates opportunity for tactical re-allocation.

And it isn't just about monetary policy. In many respects, fiscal policy divergence is even more notable.

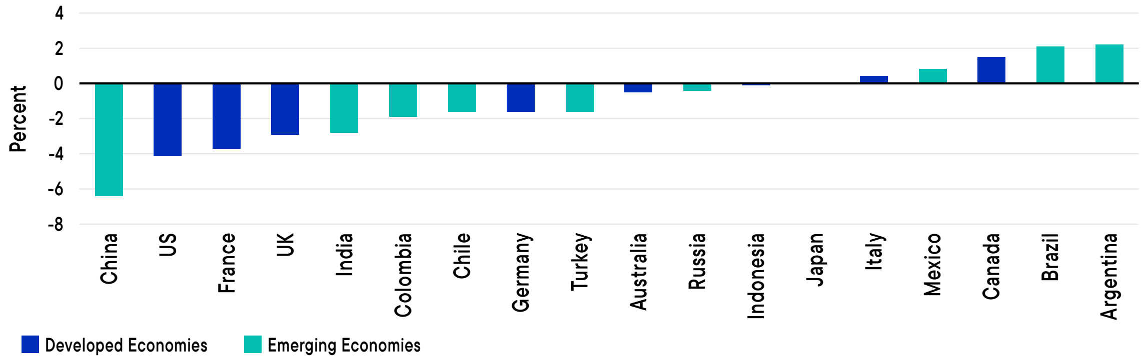
In the United States, large structural budget deficits are forecasted over the next decade. Meanwhile, Japan's new government is promising more fiscal stimulus as well. So, too, are Germany and the European Union.

In contrast, over the past decade many emerging countries have been pursuing more disciplined, orthodox fiscal policies, with the upshot that their sovereign credit fundamentals are improving in absolute and relative terms. That trend lends support to secular declines in risk premia and should manifest in even lower nominal and real interest rates, as well as stronger emerging currencies. Directly, that boosts emerging debt returns, but it also lends greater resilience to many parts of the emerging complex.

EM and DM Fiscal Balances

Central government primary balance as % of gross domestic product (GDP)

April 2026



Source: IMF World Economic Outlook (WEO) Database.

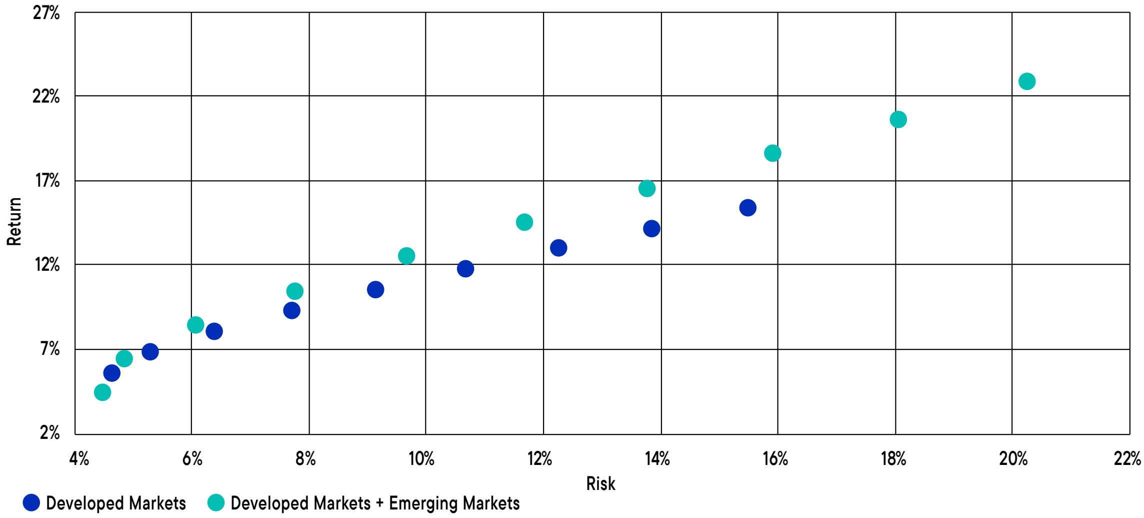
As noted, global markets—including emerging markets—have recently exhibited episodes of outperformance relative to US equity and fixed income returns. That is important, because for most of the past 15 years US exceptionalism has been dominant. So much so, indeed, that if one compares the efficient frontiers of investing with and without emerging markets since 2010, it is clear emerging market allocations had almost no positive impact on portfolio returns, adjusted for risk, over the past 15 years.

But we believe those historic results are not likely to persist. Owing to improving emerging market fundamentals, which we describe in detail in the next section of this paper, absolute and relative expected returns are shifting in their favor. Using our estimated year-ahead returns across all markets—developed and emerging, public equity and debt—a clear upward and leftward shift in the efficient frontier is apparent when comparing a developed market only to a blended emerging and developed portfolio. We believe emerging markets (alongside other non-US developed markets) are therefore poised to contribute to improved portfolio performance in the year ahead—and most probably for longer.

Efficient Frontiers for DM and EM Equity and Bond Portfolios

Based on FTI one-year expectations

As of March 2026



Source: Bloomberg, Franklin Templeton Institute estimates.

Emerging economies: fundamental improvement

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EMs are undergoing a profound transformation, one that is not cyclical in nature but structural, durable and increasingly self-reinforcing. The traditional narrative of emerging markets as externally dependent, volatility-prone economies is being reshaped by a new set of underlying forces that are redefining their role in the global economy.

EMs have generally shown significant resilience this decade, facing down a series of shocks arising from the COVID-19 pandemic, the inflationary outcome of the Russia-Ukraine war and the US Fed's sharp interest-rate hikes during 2022-2023, and last year's substantial tariff volatility. Not only did EMs survive this period, but many have thrived.

As world trade reconfigures and global actors realign geopolitically, EMs have found themselves generally well-placed to benefit from these global shifts—including some that are likely to benefit under the new tariff regime. This compares to earlier years when EMs would often face crises (whether debt, balance of payments and/or in banking systems) from global shocks. The fact that EMs are in a favorable position now is largely a result of policy choices that have situated them handsomely to face a rapidly changing world economy.

In this regard, we note three significant global regime changes that we believe EMs are now well-placed to benefit from: structural improvements in EMs, global trade reconfiguration, and a shift in the US dollar's ability to attract global capital inflows.

Regime change 1: EMs are structurally sounder

Policy responses with respect to both monetary and fiscal policy have improved significantly across EMs over the past couple of decades. Adoption of sound, credible policies and nurturing of institutions (such as inflation targets, fiscal rules and independent central banks) have helped policy formulation and improved the market's perception of the credibility of EM policymakers.

These policy adoptions have put many EMs in a more favorable position globally. Being in a position of relative strength in the contexts of trade, investment and global supply chains when the globe has experienced a series of shocks is, perhaps, surprising given the traditionally volatile history of these countries. Broadly, EMs have reached this point through a series of macro-policy reforms arising from the need to draw lessons from past crises. This is crucial, because economies that are more structurally sound (rather than simply reaping cyclical benefits when they come around) are more likely to stay strong and even improve from here. We discuss here how EMs have generally changed their policy approach over the years to reach this stage of resilience, including monetary and fiscal policy, how EMs have evolved in managing their balance of payments, and the effect this has had on financing flows and structural macroeconomic reforms.

The reforms and better policy approaches that EMs have undertaken in recent decades arose from learning the lessons of both the EM crisis periods of the 1980s and 1990s as well as those of global crises, including the global financial crisis (GFC) of 2007-2009. Prior to the late 1990s, most EMs had yet to adopt inflation targeting or fiscal rules. On the external front, they generally lacked substantial foreign exchange reserves, and many still had some form of fixed exchange rate. As a result of these structural vulnerabilities, exchange-rate shocks and fiscal shocks tended to lead to episodes of domestic disruption and crisis. Addressing these vulnerabilities through various reforms—including inflation targeting frameworks with independent central banks, fiscal rules and fiscal councils for fiscal policy, as well as significantly higher foreign exchange reserves and floating exchange rates to reduce external vulnerability—substantially improved EMs' resilience.

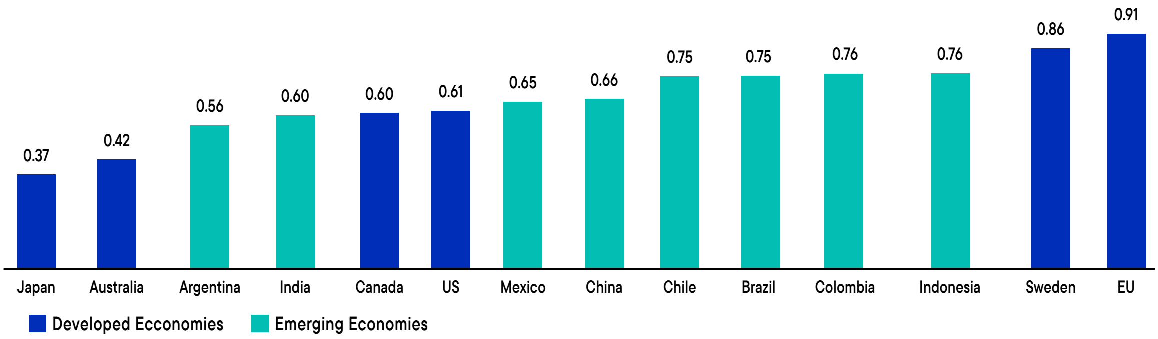
Monetary policy

Historically, EMs were marked by high and even hyper-inflation, as central bank interest rate policy was often subordinated to political aims. Central bank financing of government deficits—also a politically-motivated outcome—further contributed to inflation pressures. Reforms to monetary policy in a number of EMs have resulted in lower and more stable inflation.

- Central bank independence—meaning that the central bank is not subject to political influence over monetary policy decisions—is generally seen as critical for being able to implement appropriate monetary policy. Independence in this context has been steadily increasing in EMs for some time, since starting to pick up noticeably in the 1990s and early 2000s.
- Inflation targeting was initially adopted by smaller open advanced economies, first by New Zealand in 1990 then by some other developed markets. Some EMs across various regions—including Central and Eastern European countries then in transition to market economies, various Latin American countries and South Africa—had adopted inflation targets in the late 1990s and early 2000s. The number of inflation-targeting countries, including EMs, has continued to increase since then. Inflation targeting can lend credibility to policymakers. It is often seen as a complement to central bank independence as it presents an objective measure by which to assess whether the central bank is implementing appropriate monetary policy.
- In tandem with the trend toward independent, inflation-targeting central banks, monetary policy transparency in EMs has improved as well. This is an important factor as it reduces uncertainty among market participants and, often, will increase confidence in the central bank and its decision-making.

Cross-Country Measures of Central Bank Independence

As of 2022



Source: Romelli, D., 2022. The political economy of reforms in central bank design: evidence from a new dataset. Economic Policy, 37(112), pp. 641-688.

The fruits of these improvements are seen in more recent laudable monetary policy implementation in EMs, with a recent example being proactive monetary policy as inflation threats arose in 2021 after the COVID-19 pandemic.

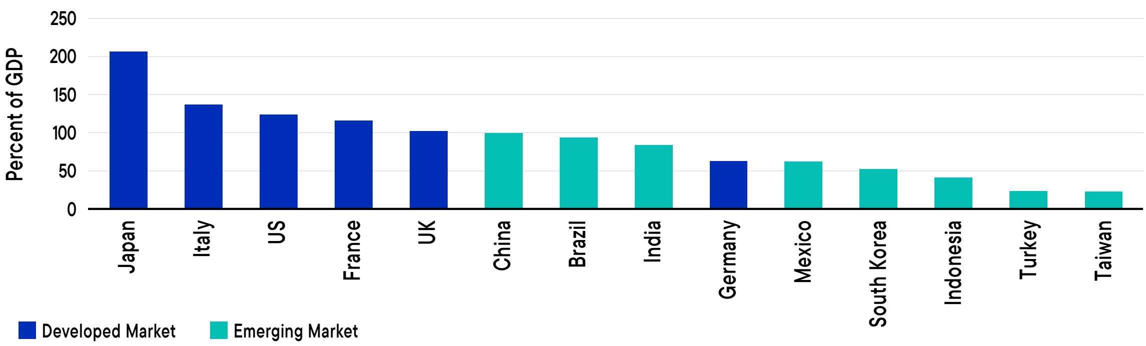
Fiscal policy
Historically, EMs faced various problems in managing their fiscal accounts, including excessive spending leading to large budget deficits and high debt levels, and the inflationary implications of central bank financing. As with monetary policy, fiscal policy management has generally improved over the years to a point where the fiscal situation is seldom a trigger for economic instability as it might have been in the past.

- Fiscal rules are a key tool for prudent fiscal management. A fiscal rule is a durable constraint on fiscal policy through numerical limits on budgetary aggregates, typically aimed at correcting distorted incentives and containing pressures to overspend, particularly in buoyant economic times. Fiscal rules are designed to ensure fiscal responsibility and debt sustainability. They may dictate one or more aspects of the overall budget balance, government expenditure, government revenue, and government debt. EMs started adopting fiscal rules from 1997; by now, EMs across different regions have adopted fiscal rules. Simply having a fiscal rule does not guarantee it will be adhered to, so other criteria need to be assessed as well.
- Fiscal councils are another approach to signal sound fiscal policy management, as fiscal councils usually provide analyses about the fiscal situation and can warn if it is deteriorating. As with other reforms, the number of emerging countries with fiscal councils has been increasing. As with fiscal rules, we caveat that the mere existence of a fiscal council does not guarantee that politicians will heed their advice or analysis.
- The use of single Treasury accounts has become more prevalent across EMs. allowing for greater oversight of overall government spending. Notably, many EMs are now able to provide counter-cyclical policy measures when external financing conditions worsen—a key demonstration of the successful development of public finance policies in these countries.

Fiscal situations in many countries across the globe worsened following the COVID-19 pandemic, but notably this was more pronounced in advanced economies than in EMs—in other words, in terms of fiscal health, EMs have generally outperformed advanced economies in recent years. Moreover, EMs have since been more proactive in repairing their fiscal situation than advanced economies.

General Government Fiscal Debt

2025



Sources: International Monetary Fund - World Economic Outlook (April 2026), Bloomberg. As of June 3, 2026.

Structural reforms to foster growth and/or attract foreign investment have further entrenched progress and boosted trend growth rates, building on the stronger macro foundation that the fundamental monetary and fiscal reforms described above provide. Such structural reforms are often related to specific idiosyncratic factors and specifically targeted at trade and/or attracting foreign direct investment (FDI). In most cases, a "package" of reforms rather than any single one has supported growth.

For example, in India policy has focused on strengthening macroeconomic fundamentals and continued structural reforms; these have combined to make India stand out globally in terms of growth outcomes. Real Indian GDP growth has averaged over 6% since 2000. Fiscal reforms, banking sector reforms, liberalization of foreign direct investment, and initiatives such as "Make in India" have been pivotal in driving sustainably high trend growth in India this century. Additionally, emphasis on digitalization and innovation led to a rise in startups and expanded the digital economy.

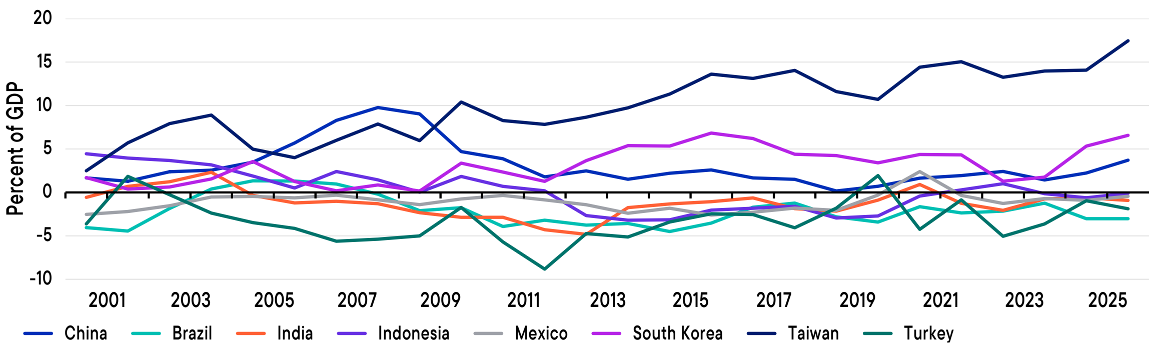
Malaysia has also undergone a profound economic transformation from a predominantly agricultural- and commodity-based economy to one with robust manufacturing and services sectors. This evolution has positioned Malaysia as a leading exporter of electrical appliances, parts and components, driving remarkable growth that elevated the nation from low-income to upper-middle-income status within a single generation. This achievement can be attributed to strategic development policies focusing on outward-oriented, labor-intensive growth, investment in human capital, and credible economic governance to ensure macroeconomic stability. In addition, Malaysia has signed and implemented various bilateral and regional free trade agreements (FTAs) as well as wider trade partnerships. These initiatives have driven Malaysia's stronger integration into the global trade network. Malaysia has also fostered a vibrant and competitive business environment that contributes to industry diversification and helps shield the nation from dependence on external factors and shifting geopolitical pressures.

Financing flows into EMs have improved markedly compared to previous years, with much of the flow now being longer-term (such as for fixed investment) rather than "hot money" (short-term, easily reversible flows such as portfolio flows) that previously characterized inflows. This improvement in the funding mix is partly an outcome of the reforms mentioned above that make countries more attractive to longer-term foreign capital but have also been fostered by **better balance-of-payments-related policies.** In addition, as local financial markets have deepened, EMs have been able to source a greater portion of their funding domestically, leaving them less vulnerable to a balance of payments shock.

External Balances or Financing Terms

Current account balance

2000 to 2025

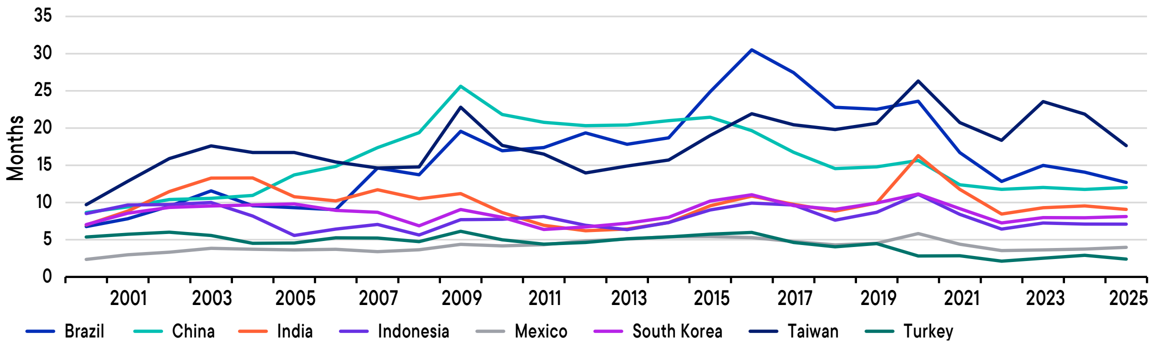


Sources: International Monetary Fund - World Economic Outlook (April 2026), Bloomberg. As of June 3, 2026.

Balance of payments crises used to be a common feature among emerging markets. These included rapid declines in capital inflows ("sudden stops") due to external shocks. These jolting reversals in capital flows were generally associated with a sharp decline in output. Currency pegs were also once common, as was government usage of capital markets to gain access to foreign currency to defend those pegs, making fixed exchange-rate systems vulnerable if a government lost access to capital markets. After many EMs liberalized their financing systems following the 1980s crises, "sudden stops" also coincided with periodic banking crises. This mostly happened because regulators were slow to prevent growing mismatches in banks' domestic/foreign currency exposures, creating vulnerabilities to sudden moves in exchange rate.

Foreign Exchange Reserves Expressed as Months Import Cover

2000 to 2025



Sources: FactSet, Oxford Economics. As of June 9, 2026.

Today, we see fewer crises associated with capital flow reversals. Other than the COVID-19 shock, where growth contractions were global, emerging markets have traversed recent geopolitical and inflation shocks without "sudden stops." Moreover, no major EM experienced a banking crisis either during the pandemic or after. These outcomes illustrate that EMs now show greater resilience to external shocks than in the past. Reasons for this include:

- EMs have adopted somewhat more flexible currency regimes. Consequently, reserves do not drop sharply as they used to when authorities were spending reserves defending currency pegs. Also, improved macroeconomic policy management has meant that many EM currencies are less subject to large and persistent losses of value.
- EMs have built up foreign reserves to manage external shocks and smooth out large externally induced shocks. Indeed, since the 1980s, EMs accumulated reserves at a rapid pace. Reserves adequacy ratios—such as reserves coverage of merchandise imports or short-term debt—have improved significantly as well.
- The pace of sovereign defaults has slowed over time as reserve adequacy has strengthened.
- EMs have also improved banking supervision to reduce banks' asset-liability duration and foreign exchange mismatches, factors which had been leading causes of the interplay between banking and balance of payments crisis. As a result, EM banks' resilience to foreign exchange shocks has improved significantly.
- Government asset-liability matching in currency exposure terms has also improved, which means that the public debt stock is also better insulated from foreign exchange shocks.

- While most EMs experienced persistent current account deficits prior to the 1990s, current accounts subsequently moved closer to balance. Significantly, EMs are not only borrowing less from the rest of the world, but the composition of financing is also changing. Current account financing generally now relies more on durable sources of capital inflows (e.g., foreign direct investment flows [FDI]).

Local financial markets development in EMs has added another layer of protection against externally induced crises. Governments have become less reliant on foreign currency financing as local financial markets have deepened, enabling governments to increase the share of local currency financing. This means that if the exchange rate depreciates sharply, debt burdens do not surge due to the foreign exchange revaluation effects as they did in the past. Furthermore, if external financing dries up, emerging governments can turn to domestic sources of funding. For most large EMs, local currency issuance has been rising over time and is now more than 50% of total debt outstanding. In addition, the domestic institutional investor base in EM has increased.

Along with macro policy and structural reforms, other factors have helped drive domestic demand and have been contributing to EM resilience in the face of external shocks. These vary by country but include factors such as favorable demographics, productivity-enhancing innovation, financial inclusion and urbanization. These factors can accelerate trend growth and boost domestic consumption, helping to insulate economies from external shocks.

Regime change 2: Global trade reconfiguration

Trade diversification has made EMs less reliant on individual trading partners. While the United States and China remain the two largest global trading hubs, most EMs have not singularly aligned with one of these, thus enabling them to trade in whichever way is most advantageous. In addition, trade between EMs has generally increased. EMs have therefore become less vulnerable to shocks emanating from a single trading partner—an important development as the United States has introduced high tariffs.

Increased connectedness among trading partners stemming from improved logistics infrastructure and the emergence of low-cost exporting hubs has resulted in more flexible global trading networks than those that existed in the postwar US hegemonic structure. For instance, China has joined the United States at the center of the global trade network. Despite the political tension between the two hubs, most peripheral countries are agnostic about trading partners—they simply want to trade with the country that maximizes their payoffs. This approach has opened opportunities for EMs within the global trade context.

Reshoring has also boosted prospects in EMs, supporting their balance of payments both through inward investment flows into production facilities and via their exports. While EMs have been increasingly integrating into global trade systems for some time, we are also seeing a deepening trend of integration into global supply chains. There has been a shift from earlier globalization (where companies chased the lowest production costs). Genuine “de-globalization” is not occurring. Rather, re-shoring and diversification of supply chains, including toward “nearshoring,” are the hallmarks of global trade in the 2020s. Many emerging countries stand to benefit, as FDI flows in to establish new production facilities expand.

Regional trade agreements have seen a renewed impetus in the wake of the Trump administration’s tariff push, which in many cases have benefited EMs. A striking example, but far from the only one, is the recently concluded free trade agreement between the EU and the South American Mercosur trading bloc after years of previously stalled negotiations. As well as providing direct access to more markets than before, these agreements have also meant that EM trade can shift to insulate countries from the effects of US tariffs.

Regime change 3: US dollar (USD) vulnerability

The net international investment position (NIIP) in the United States, which reflects the cumulative amount of investment by foreigners on a net basis relative to GDP, is currently around 90% of GDP. This reflects the fact that the United States has absorbed a large amount of foreign capital. Accordingly, the NIIP has roughly doubled over the past decade. Those strong inflows kept the USD strong over the past two decades even in the face of the large US current account and fiscal deficits (the “twin deficits”). But a growing NIIP also presents a potential vulnerability. If for any reasons inflows slow, the dollar would depreciate. In this regard, a factor to watch is any pivot in financial asset flows away from the United States, which could arise from concerns about US politics, geopolitics or slowing US growth. Similarly, efforts by investors to diversify holdings away from the United States would undermine the value of the dollar.

Risks

Historically, emerging markets have not had the institutional stability of developed markets and have therefore tended to be riskier destinations for investment flows. While EMs have worked hard over the past decade or so to place themselves in a more sound position, they remain subject to various additional risks, some of which they have agency over but some of which are out of their control. These include:

- An escalation in trade wars would likely lead to a global slowdown. And while EM exports are less dependent on any one country than in the past, trade still represents a larger fraction of GDP in emerging markets, so any deceleration in global growth would harm them.
- Oil price shocks remain a significant risk for EMs, particularly those that are net energy importers. Higher energy prices could also “un-anchor” inflation expectations, particularly if surging energy prices lift food prices.
- Although macro policy management has improved, debt ratios are generally higher than before the pandemic, so there is less fiscal room today to deal with adverse events. Similarly, many countries have seen foreign exchange reserves levels fall since the pandemic, creating more external vulnerability. Also, countries that relied on domestic funding sources have used up some of these savings (such as the usage of pension fund withdrawals in Chile and Peru).

Part One

The case for international markets

Beyond home bias

For institutional investors, the decision to allocate capital internationally is no longer simply about geographic diversification. It is a strategic imperative driven by fundamental shifts in global capital flows, policy divergence and managing concentration risk.

US equity markets, while demonstrating strong performance in recent decades, exhibit growing concentration risk. The "Magnificent Seven" technology stocks comprise approximately 30% of S&P 500 market capitalization. US-dollar-denominated assets dominate many institutional portfolios, creating currency concentration.

This section establishes five reasons why active international allocation strengthens institutional portfolios that reinforce the portfolio rationale for considering emerging market allocations.

Thought leadership contributor

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Five key reasons for international markets for institutional investors

Active management and portfolio construction

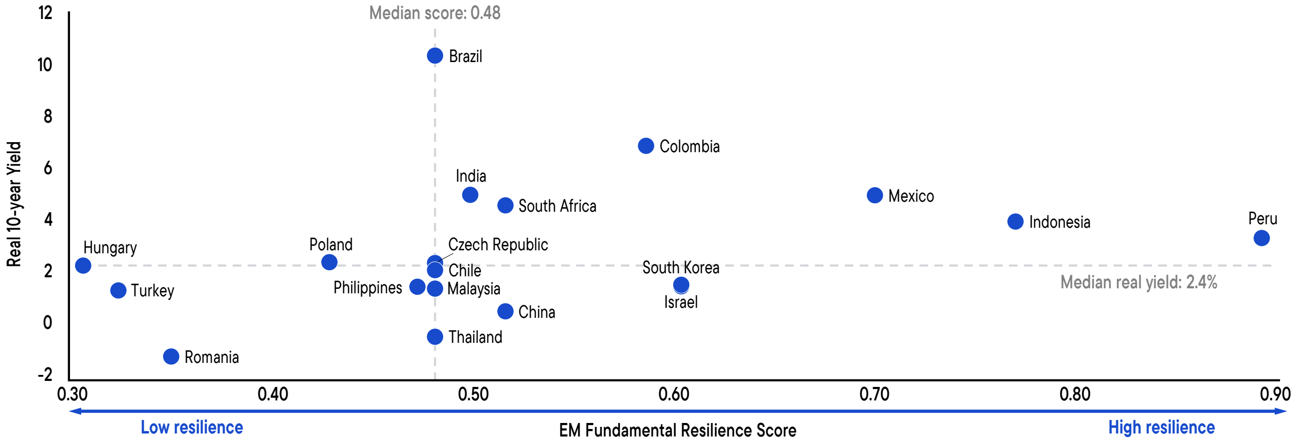
1 | Global capital rotation trends demand more dynamic allocations

Capital rotation today is increasingly driven by relative opportunity across regions, asset classes, and currencies rather than broad risk-on/risk-off shifts

Where Does Yield Meet Resilience?

EM real 10-year yields vs. fundamental resilience

As of June 10, 2025



Sources: Bloomberg, Macrobond. Analysis by Franklin Templeton Institute. The EM Fundamental Resilience Score is a composite indicator based on three pillars: external liquidity (short-term external debt and current account balance as a percentage of foreign exchange reserves), energy import dependence, and fiscal sustainability (debt levels and expected budget balances). The score is intended for illustrative comparison of macroeconomic fundamentals and does not constitute an investment recommendation. Proxy real yield is calculated as the nominal 10-year government bond yield minus Bloomberg's expected inflation rate for 2026.

Active managers identifying these dispersions, whether in undervalued European cyclicals, Asian consumption themes, or emerging market supply chain beneficiaries, generate returns uncorrelated to US market beta. Global diversification has evolved from risk mitigation into an active return source, particularly as passive cap-weighted approaches mechanically concentrate exposure in the largest and most expensive markets.

The macroeconomic backdrop has never been more compelling for active international management. Global growth, inflation and policy trajectories are diverging sharply—the Fed, ECB, and Asian central banks face distinct challenges cascading into currency movements, rate differentials and equity valuations demanding tactical positioning. Valuation dispersion has widened dramatically, with US equity multiples trading at 30% premiums to international peers despite comparable growth prospects. This structural mispricing creates clear advantages for active approaches rotating capital toward relative value.

Practical implementation increasingly relies on sophisticated asset allocation overlays expressing macro and relative value views. Strategic portfolios have become dynamic frameworks where regional exposures, sector tilts, and currency positions adjust in response to evolving fundamentals—capitalizing on Mexican reshoring, Japanese exporter competitiveness, or Indian infrastructure development ahead of consensus.

Why active matters

Active management enables dynamic asset allocation overlays, adjusting regional, sector and currency exposures in response to evolving macro conditions. Passive global indexes rebalance on fixed schedules based on market capitalization, systematically missing inflection points in relative value and macro shifts.

2 Fragmented liquidity and policy divergence favor active flexibility

Liquidity now varies widely across markets because countries are moving through different monetary cycles and have different levels of fiscal tightening.

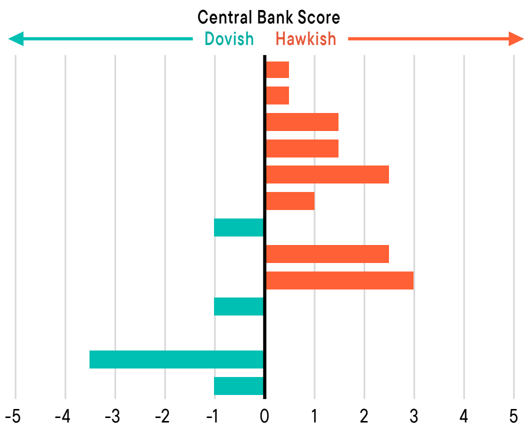
De-Synchronized Central Banks Make Exposure Selection More Critical

Central bank dovish-hawkish rating

March 31, 2026

Central Bank	Inflation Outlook Perception	QE/Liquidity Mgmt Programs	Interest-Rate Forward Guidance
Federal Reserve (Fed)	1.0	-0.5	0.0
Bank of Canada (BoC)	0.5	0.0	0.0
European Central Bank (ECB)	1.0	0.5	0.0
Bank of England (BoE)	1.0	0.5	0.0
Norges Bank (NB)	1.0	0.5	1.0
Sveriges Riksbank	0.5	0.5	0.0
Swiss National Bank (SNB)	-1.0	0.0	0.0
Bank of Japan (BoJ)	1.0	0.0	1.5
Reserve Bank of Australia (RBA)	1.0	1.0	1.0
Reserve Bank of New Zealand (RBNZ)	-0.5	1.0	-1.5
Bank of Korea (BoK)	0.0	0.0	0.0
People's Bank of China (PBoC)	-0.5	-2.0	-1.0
Reserve Bank of India (RBI)	0.0	-1.0	0.0

Dovish Neutral Hawkish



Source: Franklin Templeton Fixed Income Research.

Fragmented liquidity and policy divergence across global markets create distinct opportunity sets that passive strategies cannot capture. Liquidity now varies widely as countries move through different monetary cycles—some markets are entering easing cycles while others remain restrictive battling inflation. This asynchronous environment means capital flows, funding costs and market depth differ dramatically by geography, rewarding managers who navigate these divergences with tactical precision.

Local liquidity dynamics increasingly influence asset pricing independently of global risk sentiment, creating exploitable mispricings. When European markets experience ECB liquidity support while Japanese markets face tightening, relative valuations shift independently of fundamentals. Currency funding markets, banking system strength and bond market depth create region-specific liquidity premiums manifesting in equity valuations and credit spreads. Active managers can position portfolios to benefit from liquidity-driven dislocations—rotating toward markets where improving liquidity supports expansion or avoiding regions where withdrawal poses downside risks.

During market stress, passive exposure amplifies volatility asymmetrically. Index strategies mechanically maintain allocations as market depth evaporates, forcing unfavorable execution. Active managers can preemptively reduce exposure to liquidity-constrained markets and exploit dislocations created by forced selling. As policy normalization proceeds at different speeds globally, international diversification requires active management to navigate this fragmented landscape—static passive allocations may concentrate liquidity risk undermining portfolio resilience.

Why active matters

Active managers can tilt allocations toward markets and improving liquidity, manage exposure to less liquid segments, and adjust positioning as policy paths diverge, enhancing capital efficiency at total portfolio level.

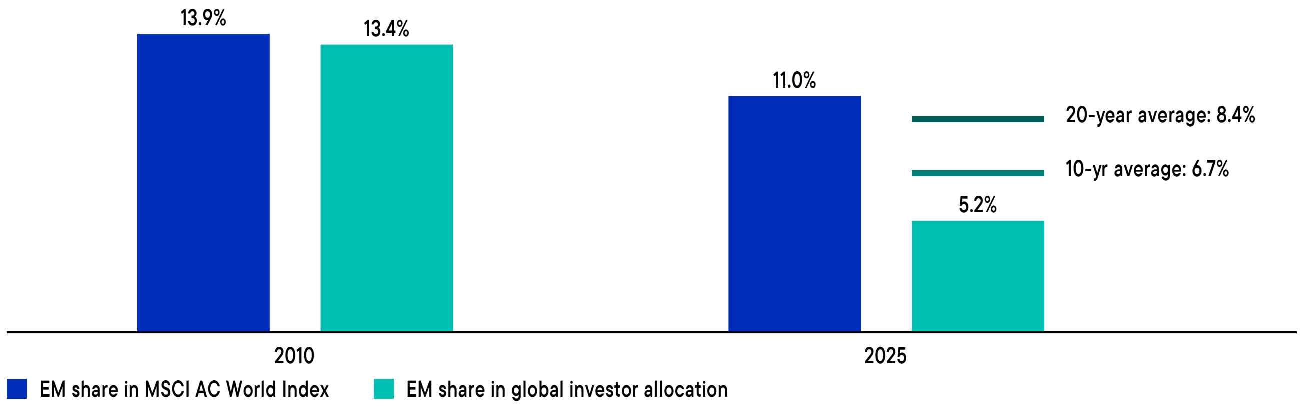
3 Persistent under-allocation has increased US concentration risk

Many institutional portfolios remain structurally under-allocated to international markets, particularly relative to long-term strategic targets—creating both concentration risk and opportunity.

Many Institutions Are Significantly Underweight Non-US Assets

EM equity share of market and investor allocations

As of December 31, 2025



Sources: MSCI; JP Morgan. Allocation data is based on EM ex onshore funds % of global assets under management (AUM) which is a total of all mandates including Global, North America, Western Europe, Japan, Pacific ex. Japan, and EM (ex. onshore).

Calculation for global AUM is based on funds domiciled internationally, including those in the US and Europe. Reason for excluding onshore funds is to look at foreign flows/positioning from an EM perspective.

Home bias has increased reliance on US assets to alarming levels. For example, in 2010, emerging markets comprised 13.9% of the MSCI AC World Index with average investor allocations at 13.4%. Today, EM's index share is 11.0%, but average allocations have collapsed to just 5.2%.

Furthermore, when US equities represent 60% of institutional allocations despite comprising roughly 60% of global market cap and less than 25% of global GDP, portfolios make an implicit bet on perpetual American exceptionalism. This concentration extends beyond equities; dollar-denominated bonds, dollar-based commodities, and US multinationals compound currency exposure, creating vulnerability to US-specific shocks.

The danger lies in how benchmark concentration masks underlying risk. During favorable periods, home-biased portfolios appear prudent, reinforcing behavioral bias against international allocation. Yet beneath apparent stability, a single sector, handful of mega-caps, and one currency dominate outcomes.

This systematic under-ownership creates exploitable inefficiencies. When capital disproportionately favors US markets regardless of valuations, international equities trade at persistent discounts, offering alpha opportunities. For institutional investors, active international allocation serves dual purposes: reducing dangerous US concentration while capturing returns from under-owned global segments.

Why active matters

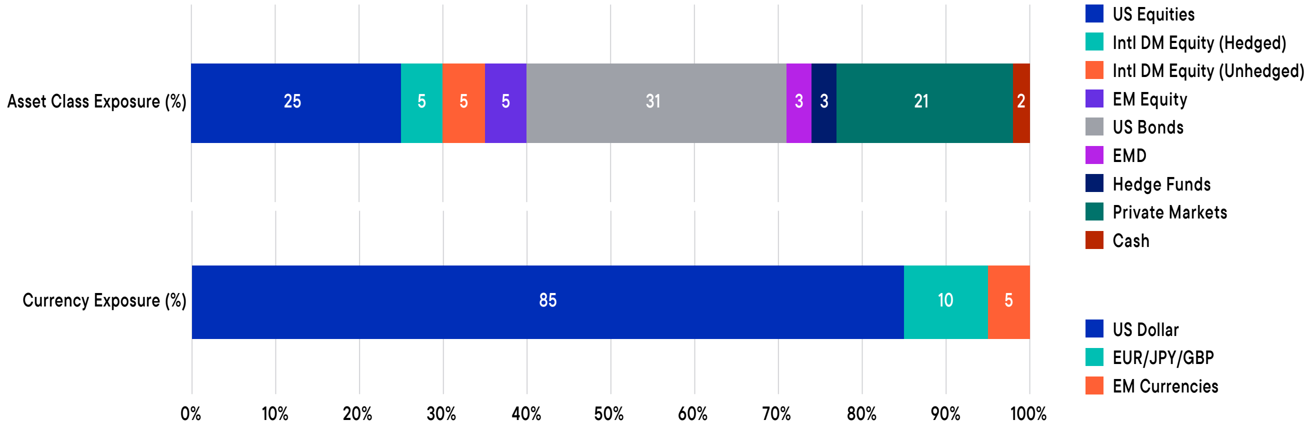
Active strategies allow investors to re-introduce balance into portfolio construction, selectively reallocating capital toward under-owned regions while maintaining quality, liquidity and risk controls.

4 US dollar dependence may be the largest unintended risk in your portfolio

Extended US asset outperformance has created increasing implicit dollar exposure that magnifies portfolio vulnerability.

US Dollar Strength Has Masked Concentrated Currency Risk in Allocations

Average portfolio composition by asset class and currency exposure



Source: Preqin, Institutional Allocation Study 2025. Survey Conducted in Q1 2025. Survey population included 1,633 institutional investors including public pensions, private pensions, endowments foundations, and insurance companies. The survey provided broad categories including equity, fixed income, private markets, hedge funds and cash allocations. Underlying breakdown between US and international equity/fixed income and currency exposure is an approximation made by Franklin Templeton. For illustrative purposes only.

The typical institutional portfolio, while diversified across asset classes (global equity, fixed income, and alternatives), remains highly concentrated from a currency perspective with approximately 80% USD exposure—an unintended dollar bet that permeates the entire allocation.

Furthermore, when US equities dominate allocations and consistently outperform, dollar exposure grows mechanically through appreciation, creating a feedback loop that intensifies currency concentration without deliberate decision. This matters because currency exposure has become increasingly correlated with equity and credit risk rather than providing diversification. During market stress, dollar strength often coincides with risk asset selloffs, meaning hedged international portfolios simultaneously face equity drawdowns and adverse currency moves.

The shifting global monetary landscape makes dollar diversification particularly urgent. Diverging policy paths create differentiated currency outcomes impacting returns independent of underlying asset performance. Active international allocation allows positioning for these divergences, capturing direct currency returns and portfolio diversification benefits.

Beyond risk mitigation, other currencies offer return potential and diversification through multiple channels: the Brazilian real provides ~8% real carry, commodity-linked currencies like the Indonesian rupiah, Chilean peso, and South African rand offer alternative exposures, while the Indian rupee and Mexican peso deliver growth betas uncorrelated to US cycles.

Why active matters

Active management enables international currency positioning, including selective hedging, unhedged exposure or tactical currency tilts, allowing investors to diversify return drivers without introducing unintended USD concentration bets.

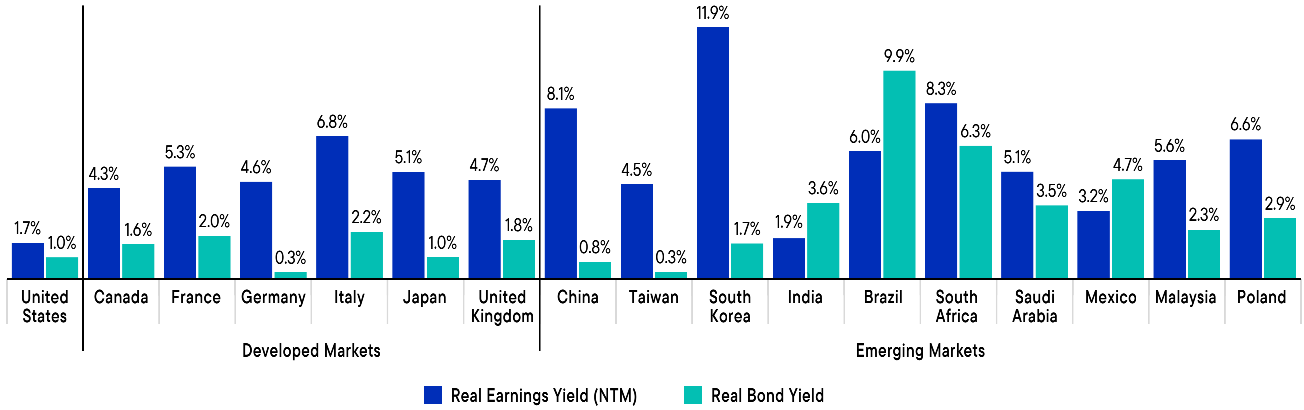
5 | Active international exposure can strengthen portfolio resilience

International markets offer diversification across economic cycles, policy regimes and currencies, yet outcomes depend fundamentally on implementation.

Broadening Portfolio Scope Opens up More Favorably Long-Term Return Opportunities

US vs. international real earnings yield and bond yields

As of March 31, 2026



Sources: FactSet, Bloomberg, MSCI Indexes, Tullett Prebon Information, National Sources. Analysis by Franklin Templeton Institute and Global Research Library. Country real earnings yield is based on the specific MSCI Index and is measured as the next 12 months.
Note: February inflation data has been considered for Canada, Japan, UK, South Africa and Saudi Arabia.

Passive exposure can reinforce concentration and volatility rather than mitigate it. Market-cap weighted international indexes mechanically overweight the largest positions regardless of valuation or quality, creating concentration risks that mirror problems investors seek to escape. When mega-cap stocks dominate benchmarks or momentum-driven flows amplify volatility, passive exposure provides geographic labels without genuine diversification.

Index composition prioritizes size over quality, creating portfolios laden with state-owned enterprises, highly leveraged conglomerates, or companies facing governance challenges. Active management allows quality screening, targeting well-governed companies with sustainable business models and reasonable leverage. This qualitative overlay proves particularly valuable where disclosure standards vary and governance practices span a wide spectrum.

Risk management is critical in today's fragmented environment. As monetary policies diverge and geopolitical tensions fragment supply chains, active managers can reduce exposure to markets facing capital controls, rotate away from regions experiencing credit stress, or increase allocations to recovering economies—flexibilities absent from passive approaches.

Why active matters

Active international strategies integrate security selection, asset allocation overlays and currency management, allowing institutions to enhance resilience while maintaining flexibility in changing market conditions. Index-based exposure to EMs provides diversification in name only—active management provides genuine resilience.

Part Two

The emerging markets opportunity

Why emerging markets within international allocation

Having established the strategic case for international allocation, we now examine why emerging markets specifically represent the most compelling component of that opportunity set. The same factors that argue for international diversification—capital rotation, policy divergence, concentration risk, currency considerations, and resilience—are amplified in emerging markets, while additional structural catalysts unique to these economies create enhanced return potential.

Key differentiators

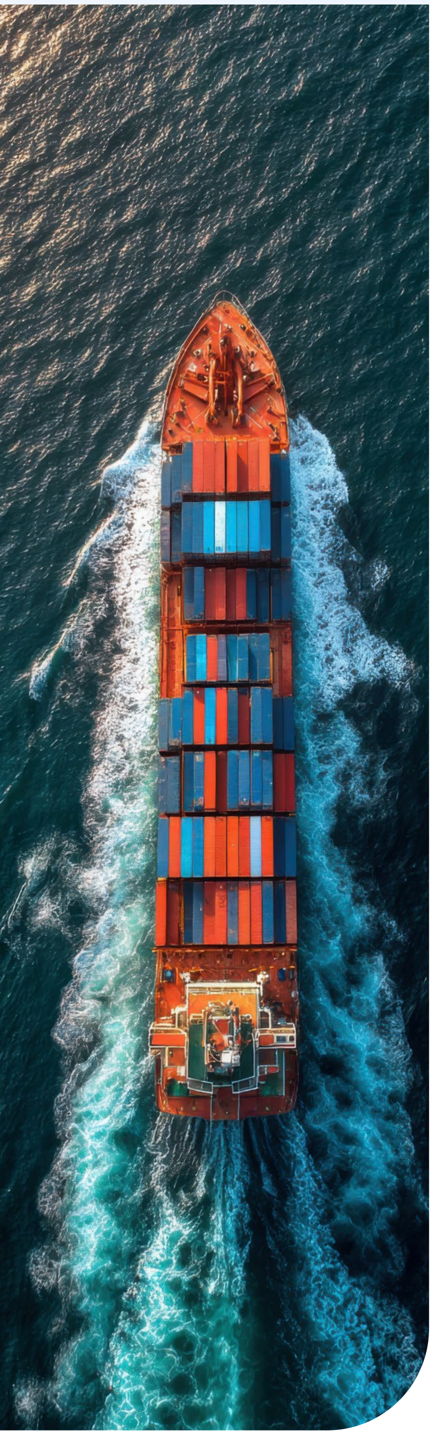
- Historically higher GDP growth, though not a reliable indicator of investment returns.
- Emerging markets have generally grown faster than developed economies at the macro level, but this growth has often failed to translate into strong or consistent equity returns—China over the past two decades being a prominent example. As a result, GDP growth should be viewed as contextual background rather than a primary investment thesis.
- Selective fiscal discipline rather than broad structural superiority.
- While global competition and disinflationary pressures have limited the scope for transformative reform everywhere, several (though not all) emerging markets have demonstrated relatively strong fiscal discipline and debt management compared with high-income economies, which may provide pockets of resilience rather than a uniform structural advantage.
- Policy flexibility in some EMs, alongside significant reform fatigue elsewhere.
- Although advanced economies are actively pursuing industrial policy and regulatory reform—often aggressively—the results remain uncertain. In contrast, some emerging markets retain a degree of policy flexibility and pragmatism that can allow for quicker adjustment, though this is uneven and far from universal.
- Potential for differentiated risk-adjusted returns, not inherently higher returns.
- Emerging markets may offer opportunities for improved risk-adjusted returns through diversification, valuation dispersion and idiosyncratic country or sector exposures, rather than through a blanket expectation of superior absolute performance.
- Targeted exposure to future growth themes rather than broad "next generation" leadership.
- While frontier technologies such as artificial intelligence (AI), robotics, and advanced energy systems are largely concentrated in developed markets (with China as a key exception), emerging markets may benefit indirectly through supply chains, resource provision, digital adoption and demographic-driven demand growth rather than primary technological leadership.

"The opportunity in emerging markets lies in their inefficiency: diverse economies, uneven capital access, and misunderstood fundamentals create fertile ground for disciplined, active investment."

Nicholas Hardingham, CFA
Director of Emerging Market Debt
Franklin Templeton Fixed Income

Thought leadership contributor

Robert Abad
Senior Client Portfolio Manager
Western Asset



The structural transformation: Three pillars

Emerging markets are undergoing a profound transformation, one that is not cyclical in nature but structural, durable and increasingly self-reinforcing. The traditional narrative of emerging markets as externally dependent, volatility-prone economies is being reshaped by a new set of underlying forces that are redefining their role in the global economy.

Three structural pillars, re-globalization, the disruption dividend and an architecture of self-reliance, are collectively driving this shift. Together, they are repositioning emerging markets from the periphery of global growth to increasingly central participants in trade, capital flows and innovation.

1. Re-globalization (Not de-globalization)

Global trade is being reconfigured into a more regional, multipolar system, with emerging markets playing an increasingly central role in supply chains and capital flows.

Key points

- Globalization is being reconfigured, not reversed, as trade flows shift toward a more regional multipolar structure
- Supply-chain diversification is positioning EMs as critical nodes in global production networks
- Nearshoring and friend-shoring are accelerating investment into manufacturing hubs and logistics corridors
- EMs are increasingly shaping global trade and capital flows

Investment Implications

- **Industrialization:** Advanced manufacturing and industrial upgrading driven by sustained capex cycles
- **Infrastructure:** Expansion of ports, transportation networks and digital logistics platforms
- **Ecosystems:** Development of supply-chain clusters and localized production networks
- **Trade corridors:** Country-specific opportunities aligned with proximity to end markets
- **Active allocation:** Greater dispersion reinforcing the need for active management

Bottom line: Re-globalization reflects a broadening of global economic participation, positioning emerging markets at the core of trade and production.

2. The disruption dividend (demographic and digitalization)

Favorable demographics and rapid digital adoption are accelerating productivity, financial inclusion and domestic demand.

Key points

- Younger populations and expanding labor forces
- Digital leapfrogging via fintech and platform ecosystems
- Increased financial inclusion and productivity gains
- Growth of domestic consumption bases

Investment implications

- **Digital platforms:** Scalable fintech, payments and e-commerce ecosystems
- **Financial inclusion:** Expansion of banking, lending and insurance platforms
- **Consumption:** Rising middle class driving demand for goods and services
- **Urbanization:** Growth in housing, transportation and services
- **Innovation:** Local tech ecosystems with global scalability
- **Productivity:** AI and digital adoption driving efficiency gains

Bottom line: Demographics and digitalization are enabling transition to consumption-led and innovation-driven growth.

3. An architecture of self-reliance

Strengthening policy frameworks and local markets are reducing external dependence and enhancing resilience.

Key points

- Improved monetary and fiscal frameworks
- Central bank independence and regulatory quality
- Development of local capital markets
- Stronger reserves and policy buffers

Investment Implications

- **Local debt:** Attractive real yields in local currency markets
- **Credit markets:** Expansion of corporate credit and private markets
- **Financial systems:** Deepening of banks, pensions, and asset management
- **Equities:** Broader and more mature equity markets
- **Resilience:** Reduced exposure to external shocks
- **Policy differentiation:** Country-level credibility driving returns

Bottom line: Institutional strengthening supports more resilient and self-directed economies.

Why emerging markets now

The convergence of these three pillars marks a structural inflection point. Emerging markets are becoming more integrated, resilient and internally-driven.

These forces are mutually reinforcing, expanding opportunities across industrialization, digital ecosystems and local capital markets while improving risk-return characteristics.

Bottom line: Emerging markets are structural drivers of global growth, diversification and long-term capital appreciation.

Fixed income overview

Thought leadership contributor

Nicholas Hardingham, CFA
Director of Emerging Market Debt
Franklin Templeton Fixed Income

A significant structural improvement in EM fundamentals argues for the asset class to become a core part of an international investment portfolio, in our view. Cyclically, solid global growth and supportive financial conditions continue to support EM debt, though we acknowledge that current heightened geopolitical uncertainty may affect shorter-term performance. AI-related capex and robust consumption are driving forces in a resilient US economy, which is a further tailwind to EM support from the global cycle and investor risk appetite. Reduced trade pressures also offer some relief. Robust growth despite global uncertainty has been a feature of EM economies for the past few years, and according to the IMF's latest forecasts, EM growth is still expected to continue to meaningfully outpace that of developed markets in 2026.

As noted earlier, a range of EM countries have achieved substantial progress on economic policy reform. The combination of accommodative global financial conditions and the recent challenge of the 2020–2022 crisis period have yielded both a political will and a sense of urgency for many governments to push through tougher measures, supporting fiscal consolidation and monetary policy orthodoxy. Higher nominal EM growth rates and current account improvements should help to mitigate general fiscal risks, while external debt relative to total debt remains steady. As many EM countries are continuing efforts to consolidate public finances, this trend of bolstering fiscal prudence stands in contrast to developed market fiscal expansion. Several countries are now leading on reform, enacting changes that should durably improve credit quality, potentially supporting ratings upgrades and anchoring spreads. These improvements have been especially robust within EM high yield (HY); many of the most vulnerable credits recorded the strongest gains in 2025. We have observed a broad-based upgrade cycle in EMs over the past two years and continue to expect the trend of positive rating outlooks outnumbering negative outlooks, although disproportionately biased toward HY.

We expect the trend of diversification away from US dollar-based assets to continue, which may support EM currencies as the USD trend shifts from being a headwind to a tailwind.

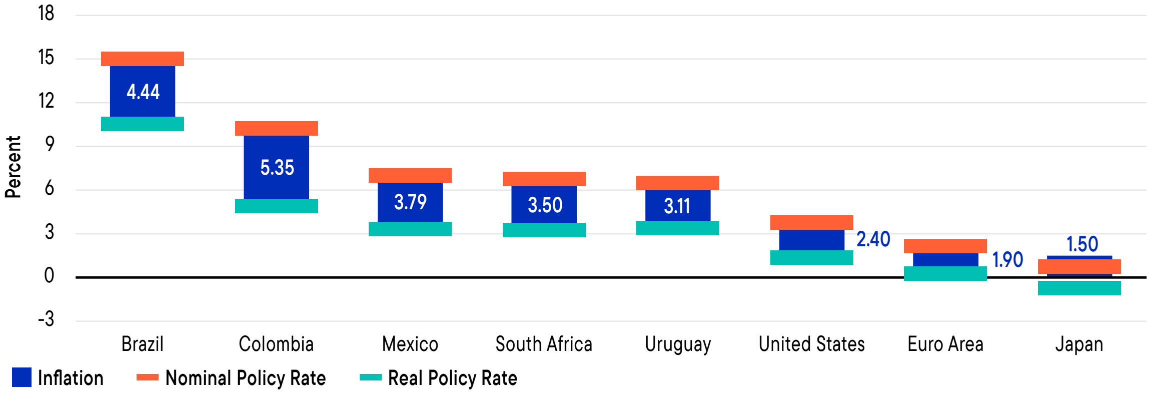
The shock from the Iran war has interrupted prior monetary policy trends, notably in Latin America where conditions had supported likely easing in various countries in the region. Although a number of other EM central banks are likely near the end of their monetary easing cycles, EM real yields (i.e., yields adjusted for inflation) remain high by historical standards, which should help to anchor inflation expectations and attract and retain flows into EM local-currency bond markets. This should provide some buffer against any unforeseen deterioration in the global macro environment. If the current Middle East conflict is resolved in such a way that the energy shock recedes, we could expect some resumption of easing or removal of tightening measures that were enacted in response to higher oil price-induced inflation.

Once more, we highlight that while fundamentals have generally improved significantly across EMs, the asset class shows significant variation across countries—whether due to differing vulnerabilities to cyclical or energy shocks, different fundamental economic policy paths, or both. As such, vigilance and active management remain key to selecting investment opportunities among sovereigns. EM corporate spreads have generally tightened in line with sovereigns. Higher levels of issuer-specific volatility among Latin American issuers don't appear to us to be indicative of broader systemic credit pressures. Leverage and margins remain stable across the asset class, while our qualitative-led research process continues to identify diverse risk/reward opportunities.

Select Emerging Markets, Particularly in Latin America (e.g., Brazil) Offer High Real and Nominal Yields and Have the Potential to Deliver Compelling Returns for Investors

Real policy rates (%): Select EMs vs. US, euro area and Japan

As of February 28, 2026



Source: Bloomberg, data as of February 28, 2026. The real policy rate is the difference between the nominal policy rate and inflation rate.

Emerging Market Currencies More Resilient

Weighted-average basket of EM currency exchange rates

2000–2026

Source: Bloomberg.
Deutsche Bank EM FX Equally weighted spot index of 21 EM (9 Asia, 7 CEEMEA, 5 Lat Am) currencies using geometric mean formula with base March 1, 2000. Indexes updated daily as of NY close. Regulatory disclaimer: www.dbresearch.com/em_fx_indice

> **"We view emerging market debt as a fundamentally-driven opportunity set where disciplined country selection and a long-term horizon can uncover value that markets often misprice."**

Michael Hasenstab, Ph.D.
Portfolio Manager, Chief Investment Officer
Templeton Global Macro

Emerging markets equity outlook

Thought leadership contributors

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Putnam Investments

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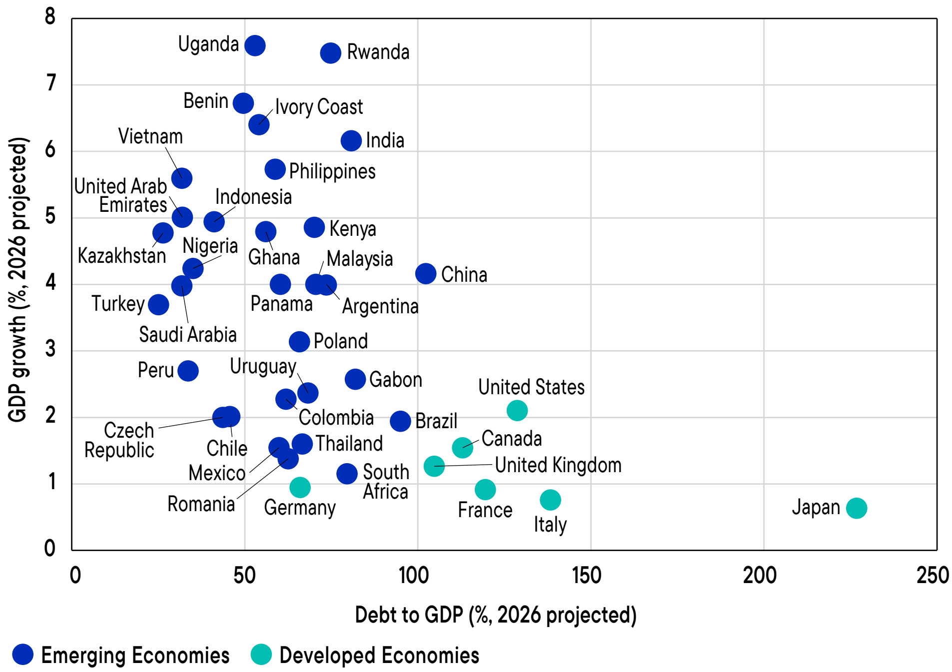
A turning point after a lost decade

After more than a decade of relative underperformance versus US equities, emerging markets are entering a new phase. The environment today reflects a combination of improving earnings quality, discounted valuations, declining volatility and years of under-allocation by investors. Taken together, these conditions are consistent with the early stages of a new cycle.

Emerging markets have typically led in durable, multi-year phases instead of short-lived bursts. Past episodes of meaningful EM outperformance, including 1987–1994 and 1999–2010, developed over extended periods rather than over the span of a few quarters. During the 1999–2007 period, for example, MSCI EM Index delivered approximately 410% in cumulative total return compared with roughly 39% for the S&P 500 Index.

Emerging Markets Generally Have Stronger Growth and Sounder Public Finance than Developed Markets

Projected growth rates and debt-to-GDP ratios: select EM countries vs. G7
October 2025



Source: IMF World Economic Outlook, October 2025. Latest data available.

While history never repeats itself precisely, the current backdrop shares several characteristics that have previously accompanied meaningful shifts in relative performance.

The previous decade was defined by persistent headwinds for emerging markets, including a strong US dollar, slower growth across parts of EMs, and margin pressure. Many of these headwinds have begun to stabilize or reverse. As a result, EM equities appear well-positioned to benefit from improving fundamentals while valuations still reflect investor skepticism.

Earnings and fundamentals are showing signs of improvement

A key driver of future EM equity returns is the inflection in earnings trends. The previous decade was disappointing for emerging market equities because EPS was largely stagnant. EPS for the MSCI EM Index was about US$80 in 2014 and US$80 in 2024. In contrast the S&P 500 Index grew EPS during the period from US$110 to US$240. Why? The answer resides in a perfect storm of a strong dollar, slowing Chinese growth, rising corporate equity issuance, and contracting margins. But the future looks different. Over the next two years EM EPS is forecast to grow 89% while US earnings are forecast to grow 46%. Importantly, these developments are occurring while EM profits expectations remain subdued, opening scope for positive surprises.

Valuations and positioning tell a different story

Despite signs of improving fundamentals, EMs continue to trade at meaningful discounts relative to US equities. These valuation gaps remain wide even as profitability metrics have stabilized, suggesting that market pricing still reflects legacy concerns rather than current conditions.

Currently there is a historically wide gap in fundamentals between US and EM equities; the S&P 500 trades at approximately 22 forward earnings with a ~1% dividend yield, while the MSCI Emerging Markets Index trades at roughly 13x forward earnings with a ~3% dividend yield. Assuming valuation multiples remain unchanged, the combination of earnings growth and dividends implies a materially higher expected return profile for EMs over the next two years, with additional upside potential should valuations re rate—an outcome supported by the index's improving return on equity.

At the same time, investor exposure to EMs remains low across many US-centric portfolios. A prolonged period of underperformance has driven persistent underweights, creating an environment in which even incremental shifts in capital allocation could have an outsized impact on relative performance. In this context, EMs do not require a decisive change in investor optimism to perform well; a modest easing of entrenched pessimism may be sufficient. Persistent under allocation amplifies the impact of improving fundamentals when cycles turn.

Rethinking risk in emerging markets

A longstanding concern among investors has been higher volatility in emerging equity markets. Over time, however, the volatility gap between EM and US equities has narrowed meaningfully. In several recent periods, realized volatility across emerging markets has been comparable to that of developed equity markets.

> **"Stock prices follow earnings, and earnings are growing faster in emerging markets. If faster GDP growth translates into faster EPS growth, we will have another multi-year period of EM outperformance."**
>
> **Brian Freiwald**
> Portfolio Manager
> Putnam Emerging Markets Equity

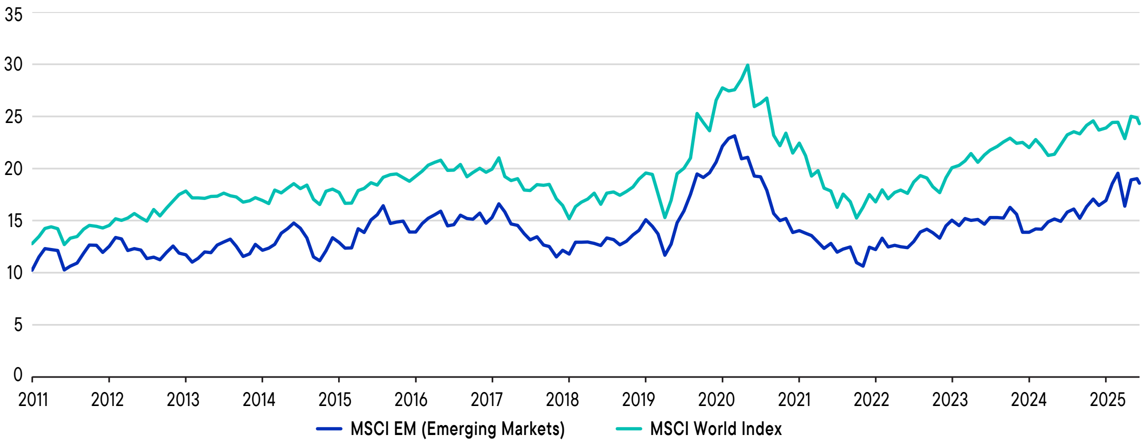
Despite this convergence, valuation and positioning continue to imply elevated risk premia. This disconnect suggests that market perceptions have been slow to adjust to structural improvements in EM balance sheets, market depth and policy frameworks. Narrowing volatility supports a reassessment of EM risk assumptions rather than a continuation of prior ones.

The observed reduction in volatility challenges the notion that EM inherently warrants a persistent valuation discount.

Persistent Valuation Discounts in EMs Support a Compelling Case for Strategic Allocation

P/E ratios consistently lower

2011 to 2026



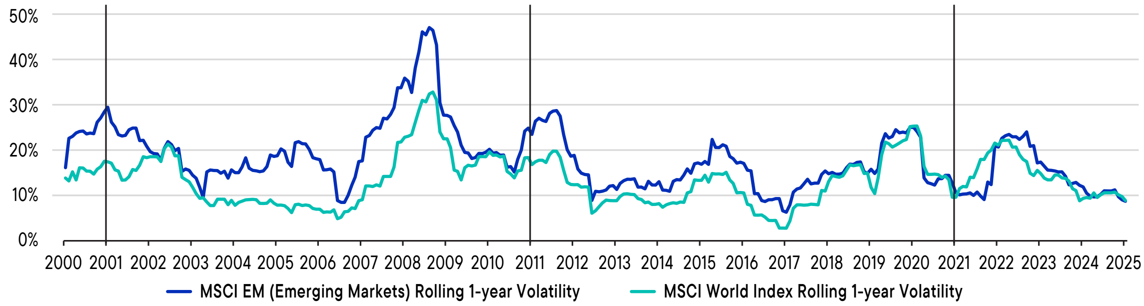
Source: Bloomberg.

Risk (Volatility) Has Receded in Emerging Equity Markets

Annualized one-year rolling volatility: EMs vs. DMs

December 2000-December 2025

	2001-2010	2011-2020	2021-2025
EM Average	22%	16%	15%
DM Average	14%	12%	15%
Difference	8%	4%	0%

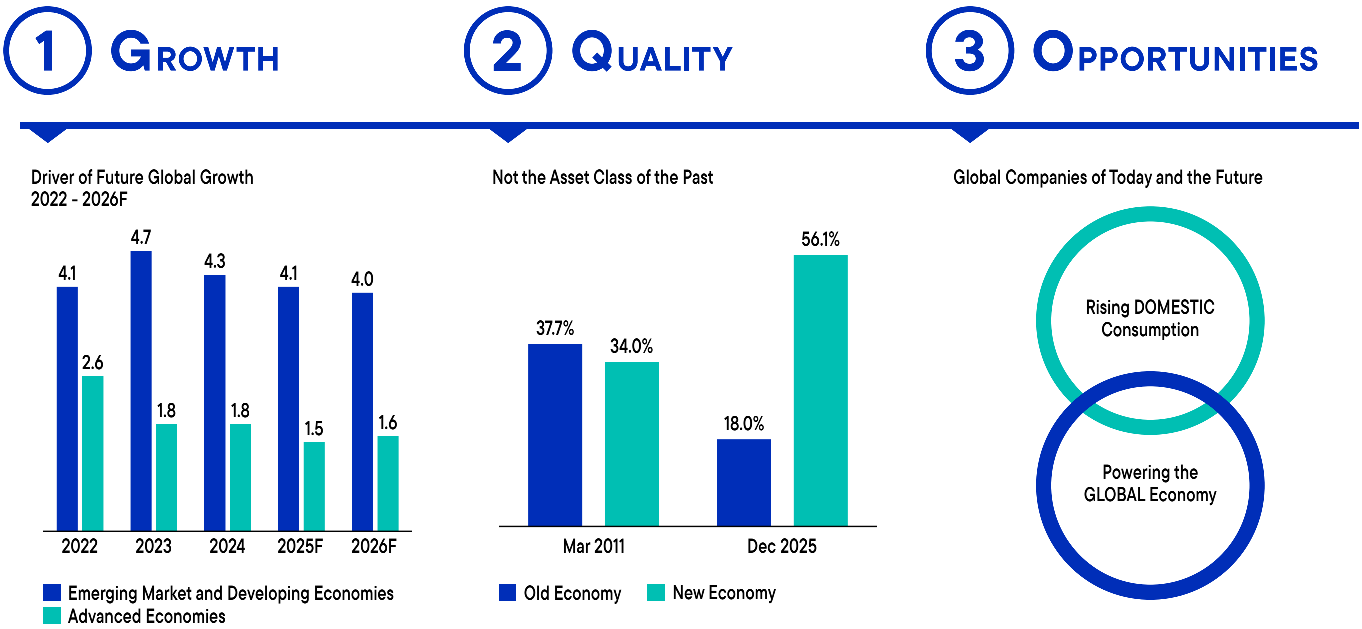


Sources: Franklin Templeton Capital Market Insights Group, MSCI, Factset Rolling one-year volatility based on rolling (monthly) annual standard deviation of the respective indices. **Past performance is not an indicator or a guarantee of future performance.** Indexes are unmanaged and one cannot invest directly in an index.

As Growth and Market Quality Improve, EMs Are Increasingly Positioned as a Meaningful Component in Diversified Portfolios

GEM - Growth, quality and opportunities

As of December 2025



Sources: Left chart - International Monetary Fund, World Economic Outlook Database, December 2025; Centre-MSCI; FactSet, Based on weightings in MSCI EM Index. New Economy as defined by Consumer Discretionary, Consumer Staples, Health Care, Information Technology & Communication Services. Old Economy as defined by Energy, Materials & Industrials.

Conclusion: strategic opportunity

Emerging market equities today reflect a rare combination of improving fundamentals, discounted valuations relative to US equities, reduced realized risk and persistent under-ownership. Historically, similar environments have marked turning points and the start of a new cycle. For investors it may be time to rethink old assumptions about EMs and reassess long-term positioning. EM equities offer exposure to global growth, innovation and domestic consumption at valuations that continue to reflect caution rather than conviction. The balance of evidence increasingly supports viewing EMs not as a tactical allocation, but as a strategic component of diversified equity portfolios as the cycle evolves.

Part Three

The institutional imperative: Strategic portfolio positioning

The changed landscape

The era of synchronized global cycles has given way to a world of more uneven but broader opportunity. Diversification now extends beyond geography to include sectors, industries and technologies that move at different speeds. Success in this environment requires separating short-term noise from longer-term structural forces.

Thought leadership contributor

Timothy Quagliarello
Head of US Institutional Sales,
Franklin Templeton

Key realization:

For too long, many portfolios have been underweight the very regions poised to drive the next wave of global prosperity.

The evolution of risk and opportunity

Compelling growth opportunities and perhaps more importantly, a significantly enhanced capacity for self-reliance and risk management, characterize this new era of emerging markets. The days of EMs being solely at the mercy of external shocks are fading, replaced by economies with stronger institutional frameworks, diversified growth engines and robust domestic buffers.

Portfolio construction principles

- Identify EM-specific catalysts: Focus on structural transformations unique to emerging economies
- Apply active management: Leverage policy divergence, market inefficiencies and regional opportunities
- Manage concentration risk: Rebalance away from over-allocations to single markets or currencies
- Integrate multiple return drivers: Combine security selection, regional allocation and currency management
- Navigate geopolitical complexity: Dynamically adjust positioning in response to evolving risks

Implementation considerations for institutions

Active vs. passive in emerging markets

- Market efficiency arguments favor active management in less mature markets
- Policy divergence and liquidity fragmentation create alpha opportunities
- Need for on-the-ground research and local expertise
- Risk management requires active oversight and dynamic positioning
- Geopolitical developments demand flexible, responsive allocation frameworks

Asset allocation framework

Equity exposure:

- Regional allocation based on growth, valuation, structural tailwinds and risk assessment
- Sector positioning to capture thematic opportunities
- Stock selection focused on quality, governance and competitive positioning

Fixed income exposure:

- Duration management across yield curves
- Credit selection spanning sovereign to corporate bonds
- Local currency vs. hard currency positioning
- Yield optimization with risk controls

Currency positioning:

- Tactical overlay based on carry, valuation and macro outlook
- Selective hedging vs. unhedged exposure
- Regional currency baskets for diversification

> **“Maintaining current allocations is an active decision. In a world of narrower market leadership and greater global divergence, emerging markets merit a more deliberate role in the institutional allocation conversation.”**

Timothy Quagliarello
Head of US Institutional Sales
Franklin Templeton

Deeper dive

Investors today face a richer and more complex set of choices than at any point in modern market history. The expanding range of viable markets and asset classes marks a shift away from the scarcity mindset that once defined global investing, when emerging markets were viewed primarily as risky outliers in a system anchored by a small group of major developed economies.

Today, emerging markets are contributing significantly to the next phase of global expansion. They offer not only compelling growth opportunities but also a greater capacity for self-reliance and risk management than in previous decades. Stronger institutions, deeper financial systems and more diversified economic structures are reducing vulnerability to external shocks. Many emerging economies now operate under more flexible exchange-rate regimes and inflation-targeting frameworks, allowing policymakers to absorb external disruptions more effectively than in the past. While volatility has not disappeared, the macroeconomic foundations of many emerging economies are stronger than longstanding perceptions often imply.

Recent market performance reinforces this shift in perception. Emerging market equities and local currency bonds delivered strong returns in 2025, renewing investor interest after several years of developed market dominance. Even after this improvement, valuations across many emerging markets remain attractive relative to developed economies, with equity markets in several regions trading at meaningful discounts to US stocks while offering higher dividend yields. Earnings growth in many emerging markets is increasingly driven by domestic consumption, infrastructure investment and technology adoption rather than solely by external demand. As capital flows gradually rebalance and global investors reassess geographic diversification, these valuation gaps are becoming harder to ignore.

From a portfolio construction perspective, it is also important to recognize that the growing concentration of a small number of technology companies in major US equity indexes has led many institutional investors to reassess the degree of concentration within developed market allocations. While these firms have delivered strong growth, their weight within global benchmarks has raised questions about diversification and valuation risk. Emerging markets provide exposure to different economic cycles, policy frameworks and sector compositions, offering a potential counterbalance to concentrated developed market exposures. Many emerging market indexes are more heavily weighted toward financials, commodities, manufacturing and domestic consumption sectors than the technology-dominated indexes of developed markets. This difference in sector composition means emerging market assets can behave differently across economic cycles, offering investors a broader set of return drivers within a global portfolio.

Fixed income markets provide another important dimension of the investment opportunity. In the local markets space, many emerging economies continue to offer nominal and real yields that exceed those available in developed markets, reflecting earlier monetary tightening cycles and, in several cases, stronger fiscal discipline. In parts of Latin America and Eastern Europe, policy rates remain well above those in the United States and Europe, leaving investors with meaningful carry opportunities even after adjusting for inflation. These yield differentials have renewed interest in local currency debt markets, particularly as several emerging central banks are now positioned to ease policy following their earlier tightening cycles.

Currency dynamics remain an important consideration. The recent upheaval in the Middle East has increased volatility in the US dollar and other reserve currencies, reinforcing the importance of careful country selection and risk management. While currency fluctuations can amplify short-term volatility, they also create opportunities for investors able to distinguish between economies with credible policy frameworks and those with more fragile fundamentals. For diversified portfolios, local emerging market debt can offer both income and return drivers that are less tightly linked to the economic cycles of developed markets.

Another dimension of this transformation is the growing role of private capital in emerging markets. Sovereign wealth funds, pension funds and global infrastructure investors are increasingly allocating capital to transportation networks, energy systems, logistics platforms and digital connectivity across emerging regions.

For institutional investors, we believe the question is no longer whether emerging markets deserve a place in global portfolios, but how to incorporate them more effectively across equities, fixed income and private markets. Investors who look beyond headlines and focus on credible institutions, technological innovation and policy adaptability will be best positioned to capture the opportunities created by this evolving global economy.

Bottom Line

Success requires embracing judgment, curiosity and openness to lessons from diverse markets. The evolution of emerging markets—strengthened by institutional reforms, dynamic flexibility, and global supply chain realignment—reframes where opportunity and risk reside and broadens how investors see the world.

The investment thesis in sum

- International allocations are strategically aligned with the performance objectives for most institutional portfolios that now face concentrated exposures. They provide access to complementary growth drivers as well as diversification and risk-mitigation benefits that today's US-centric allocations can no longer deliver.
- Emerging markets represent a dynamic component of international opportunity, driven by structural transformations including nearshoring, innovation and institutional strengthening that are creating differentiated outcomes across regions and unlocking new growth pathways.
- Geopolitical complexity underscores the value of strategies that maintain optionality, allowing differentiation between directly affected markets and those positioned for long-term outperformance, through active security selection combined with complementary implementation approaches.
- Structural transformation is enhancing emerging economy, debt and equity market resilience while enhancing long-term growth and return potential. Flexible exchange-rate regimes, inflation-targeting frameworks, deeper domestic financial systems, and diversified economic structures are reducing vulnerability to external shocks and creating more durable growth models.

- Active management enables differentiation between markets directly affected by geopolitical tensions and positioning in markets poised for long-term outperformance. It also enables diversification by exposures to markets benefiting from capital rotation.
- Current under-allocations in global portfolios to emerging markets represent opportunity, whereas concentration in developed markets leaves portfolios vulnerable dislocations. Attractive EM debt and equity valuations create compelling entry points for long-term capital.

The call to action

Institutions seeking genuine diversification and superior returns are shifting their attention to international opportunities, above all in emerging markets. Performance is improved, driven by economic resilience, rapid adaptation, orthodox policy, rising earnings, compelling valuations, and attractive yields.

The geopolitical backdrop is characterized by regional conflicts, great power competition and policy divergence. It demands dynamic portfolio management. Markets will reward investors who distinguish between transitory disruptions, cyclical movements and structural transformation and are able to implement those views across regions and sectors based on fundamental analysis. Opportunity is emerging, and is there for the taking.

“Relying on global portfolios can mean narrow emerging market exposure, concentrated in megacaps. A dedicated EM allocation opens the door to broader growth opportunities.”

Andrew Ness
Portfolio Manager
Templeton Global Emerging Markets

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. **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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FTINS-EGOPP-0726