FRANKLIN TEMPLETON

Hedge Fund Strategy Outlook

Q3 2026

Summary

As we enter the second half of 2026, the investment landscape remains constructive but increasingly dependent on continued economic resilience and supportive policy expectations. Risk assets have benefited from improving liquidity, resilient corporate earnings and ongoing investment tied to artificial intelligence (AI) and productivity-enhancing technologies. However, elevated valuations, concentrated market leadership and heightened sensitivity to macroeconomic and geopolitical developments have left markets vulnerable to bouts of volatility and rapid repricing.

While financial conditions remain generally supportive, recent inflation surprises, evolving central-bank expectations and persistent geopolitical tensions have narrowed the margin for policy flexibility. As a result, investors face a backdrop in which optimism remains prevalent, but the tolerance for disappointment appears increasingly limited. We believe this environment is likely to produce greater differentiation across regions, sectors, industries and individual securities.

In this setting, we also believe hedge funds remain well positioned to provide diversification, active risk management, and alpha generation. Rising dispersion, uneven fundamental performance and periodic market dislocations are creating attractive opportunities for managers with flexible mandates and disciplined risk frameworks. We continue to favor strategies that emphasize security selection over broad market exposure, capitalize on episodic volatility, and can adapt quickly as market leadership, policy expectations and macroeconomic narratives evolve.

Strategy Insights

Long/short equity (technology) | **Page 5**
Improving market breadth, robust earnings growth, increased stock dispersion and secular disruption make the strategy compelling for active managers.

Systematic macro | **Page 6**
The recent resurgence in performance highlights the value of diversification and the importance of remaining patient when maintaining long-term conviction in a strategy.

Event-driven | **Page 7**
AI-motivated capital spend is contributing to record-setting levels of corporate activity across mergers and acquisitions (M&A), debt and equity issuance, and initial public offerings (IPOs).

Strategy Outlooks

Long/short equity	Constructive on long/short equity as corporate fundamentals, resilient earnings growth, increasing market dispersion and global breadth afford an attractive environment for stock selection. The specter of macro and valuation concerns still linger, and therefore we continue to favor less beta-driven fund structures.
Relative value	Neutral outlook, with benefits of certain strategies—such as strong new convertible bond issuance and potential for higher equity volatility—being offset by higher risks due to geopolitical fragility, rich valuations and elevated strategy leverage.
Event-driven	Neutral though slightly improving outlook. Tailwinds of record levels of corporate activity across M&A, activist campaigns, leveraged buyouts (LBOs) and IPO issuance, offset by concerns about elevated valuations, tight spreads and geopolitical risks, resulting in a moderated outlook for the strategy.
Credit	We remain underweight amid historically tight spreads and an oversupply of capital, favoring nimble, idiosyncratic and long/short credit opportunities that are better positioned to take advantage of volatility and dispersion.
Global macro	The outlook remains positive, with active central-bank policy shifts and elevated market volatility providing a robust opportunity set for macro-focused managers. We continue to expect performance dispersion as tail risks remain in place.
Commodities	The outlook remains compelling, but complex. Market volatility, geopolitical fragmentation and structural shifts in global trade and industrial policy are helping create a more dynamic environment for directional and relative value approaches.
Insurance-linked securities (ILS)	The Atlantic hurricane season started with a near-average season prediction from forecasters, though *El Niño* conditions may still lead to surprising idiosyncratic events. ILS markets continue to grow with a broader issuer and buyer base, expanding opportunities. Spreads have moderated but remain attractive given the uncorrelated nature of the asset class.

Macro Themes We Are Discussing

1. Markets remain resilient, but the margin for error is narrowing

Economic growth and corporate earnings have remained more resilient than expected, while AI-related capital spending continues to support investment and sentiment. However, market valuations remain elevated; positioning is increasingly concentrated, and investor expectations leave little room for disappointment. Markets appear increasingly sensitive to incremental changes in growth, inflation and policy expectations.

Hedge fund implication: Strong stock and sector dispersion should continue to reward managers focused on security selection and relative-value opportunities rather than relying on broad market beta.

2. Policy uncertainty has replaced policy support as the key macro variable

While monetary easing provided a tailwind in 2025, the discussion has shifted toward the sustainability of growth, the path of inflation and the degree of flexibility available to policymakers. Recent inflation surprises and geopolitical developments have reduced confidence around the path of future policy, increasing the potential for market volatility around economic releases and central-bank communication.

Hedge fund implication: Macro, relative value and opportunistic trading strategies may benefit from recurring repricing events across rates, currencies, and risk assets.

3. Dispersion is broadening across regions, sectors and individual securities

Headline volatility remains relatively contained, but underlying dispersion continues to increase. Regional growth trajectories, differing policy responses, balance-sheet quality and varying exposure to secular themes such as AI are creating meaningful divergence beneath the index level. The result is a market environment where winners and losers are becoming more differentiated.

Hedge fund implication: Elevated dispersion creates a favorable backdrop for long/short equity, credit selection and multi-strategy approaches that can exploit relative mispricings.

4. Geopolitical risks are becoming a more persistent market factor

Geopolitical developments continue to influence commodity markets, inflation expectations, supply chains, defense spending and investor sentiment. Rather than producing one-off shocks, geopolitical developments are increasingly acting as a recurring source of uncertainty that can alter market leadership and create episodic dislocations.

Hedge fund implication: Flexible managers with the ability to dynamically adjust risk exposures are likely to be advantaged relative to more static investment approaches.

5. Crowding and concentration remain important sources of risk

Although equity leadership has broadened somewhat, a relatively narrow group of companies and themes are still heavily influencing major indexes. Elevated investor consensus around a small number of secular growth narratives increases the likelihood of sharp rotations should expectations shift.

Hedge fund implication: The opportunity set increasingly favors managers capable of identifying both underappreciated beneficiaries of structural trends and crowded areas where expectations have become overly optimistic.

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Q3 2026 Outlook: Strategy Insights

Highlighting areas where evolving market dynamics are shaping the opportunity set across hedge fund strategies

Long/short equity (technology)

Throughout the year, we have seen the investment narrative shift from the Magnificent Seven to a broader universe of technology enablers and adopters, improving market breadth across market caps and geographic regions. By way of example, one can look to the performance of the Technology Select Sector Index, a market-cap weighted index heavily skewed toward the Magnificent Seven, versus an equal-weighted counterpart for evidence of broader participation from technology companies. The equal-weighted index has closely tracked its cap-weighted counterpart since the start of 2025 and even recently started outperforming, as compared to significantly underperforming in prior years (see Exhibit 1). At the same time, rising dispersion within tech and AI—between winners and laggards in semiconductors, software, infrastructure and applications—can create a rich landscape for stock-picking, rewarding investors who can distinguish durable earnings power from hype. Additionally, thematic opportunities exist beyond AI infrastructure and data center capital expenditure, including robotics, automation, cybersecurity and defense tech, which are still relatively nascent and stand to benefit from greater AI integration. Importantly, the opportunity is increasingly global: Japanese, Taiwanese and South Korean hard-tech companies, European industrial and automation firms, and select emerging market platforms are all positioned to benefit from the AI investment cycle, offering diversification beyond traditional US mega-cap growth.

Exhibit 1A: S&P Technology

Market-Cap vs. Equal-Weighted (Cumulative Returns)

January 1, 2020–December 31, 2024

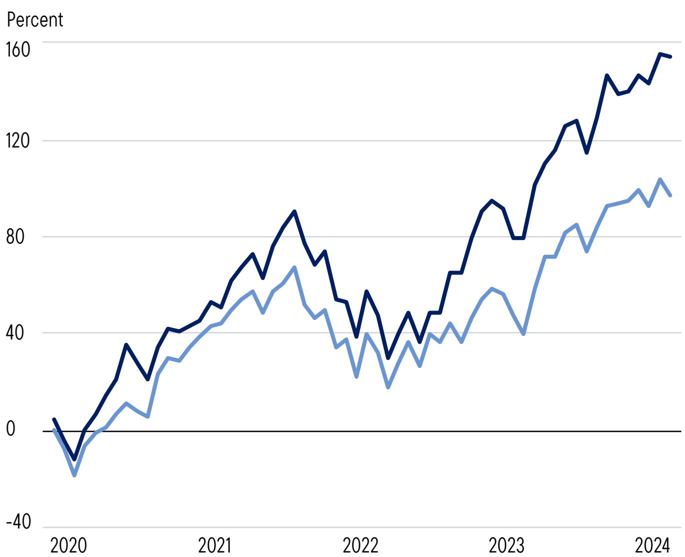
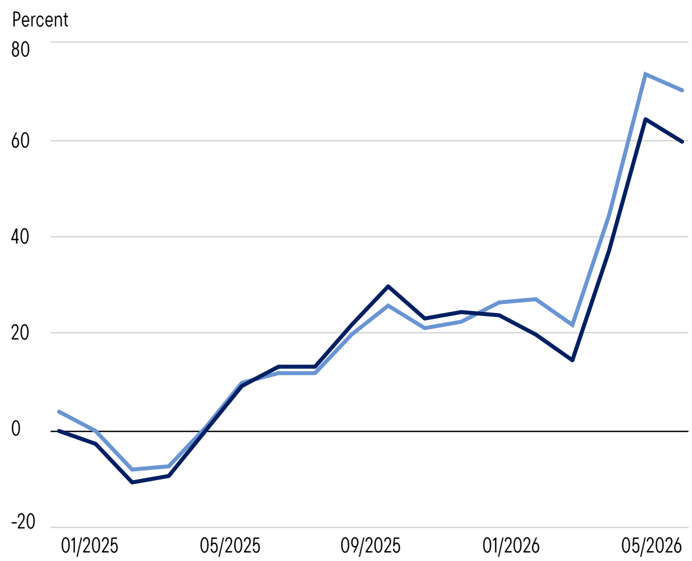


Exhibit 1B: S&P Technology

Market-Cap vs. Equal-Weighted (Cumulative Returns)

January 1, 2025 –June 30, 2026



Technology Select Sector Index — S&P 500 Equal Weight Information Technology (Sector) Index (USD)

Source: Bloomberg. Important data provider notices and terms available at www.franklintempletondatasources.com.

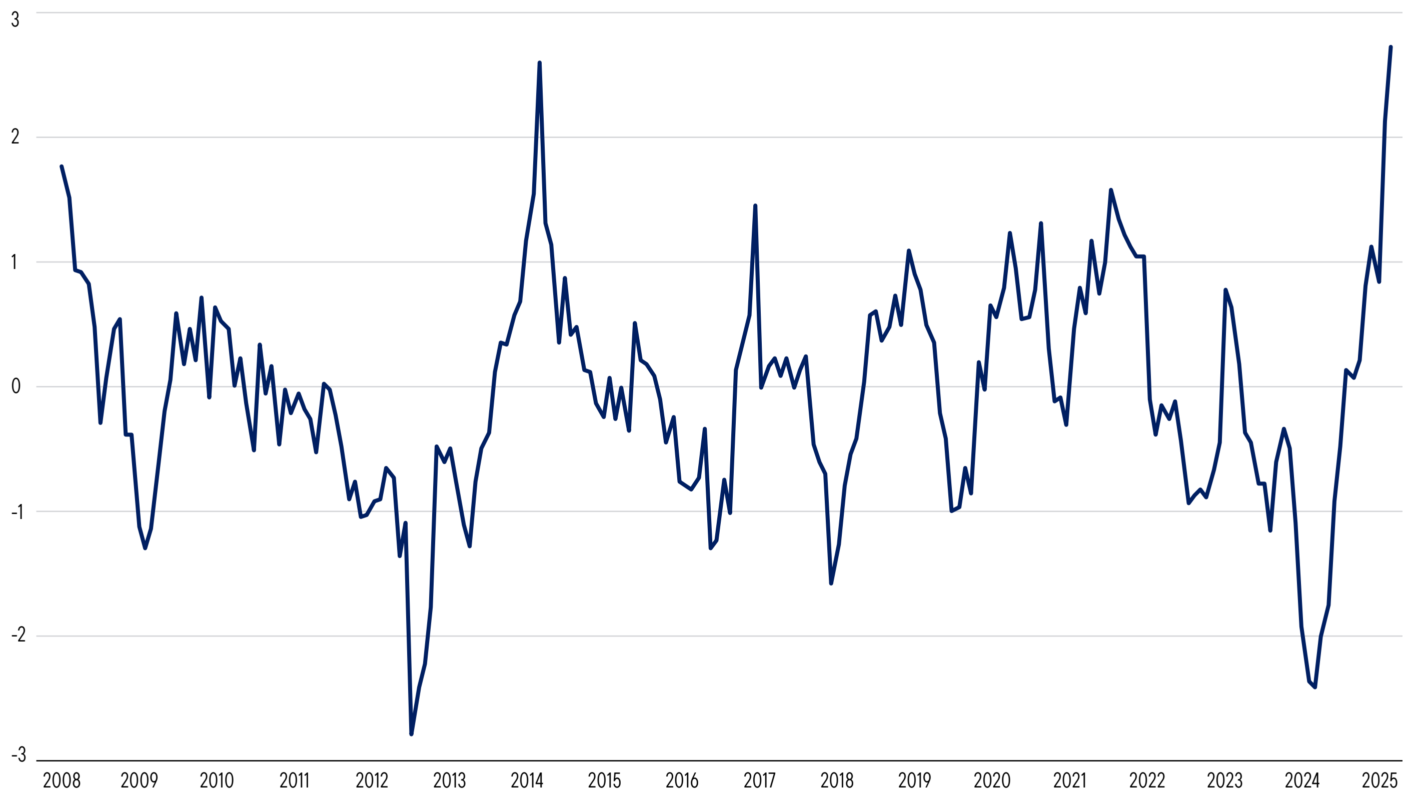
Systematic macro

After a period of disappointing performance post-2022, risk-adjusted returns have rebounded sharply for systematic macro strategies over the past 12 months, underscoring the importance of patience with long-term conviction strategies. Macro dispersion and persistent trends across timeframes, especially within commodities and equities, have supported performance. Episodes of strong performance, particularly during periods of broader market volatility and mixed results for other strategies, serve as a reminder that diversifying strategies can play an important role in improving portfolio resilience. Systematic macro can offer a differentiated return stream that is less dependent on traditional equity and credit beta, while providing the flexibility to take long and short exposures across global markets. This adaptability can help portfolios navigate changing inflation, growth and policy regimes, particularly when conventional asset-class relationships become unstable. That said, after a strong recent run, investors should be mindful that performance may moderate, especially if recent trends reverse. The case for systematic macro remains compelling, but we believe it should be grounded in the strategy's long-term role as a diversifier and potential source of crisis period resilience.

Exhibit 2: Trailing 12-Month Sharpe Ratio

HFRX Macro: Systematic Diversified CTA Index

January 2008–May 2026



Sources: HFR Database, Bloomberg. Important data provider notices and terms available at www.franklintempletondatasources.com.

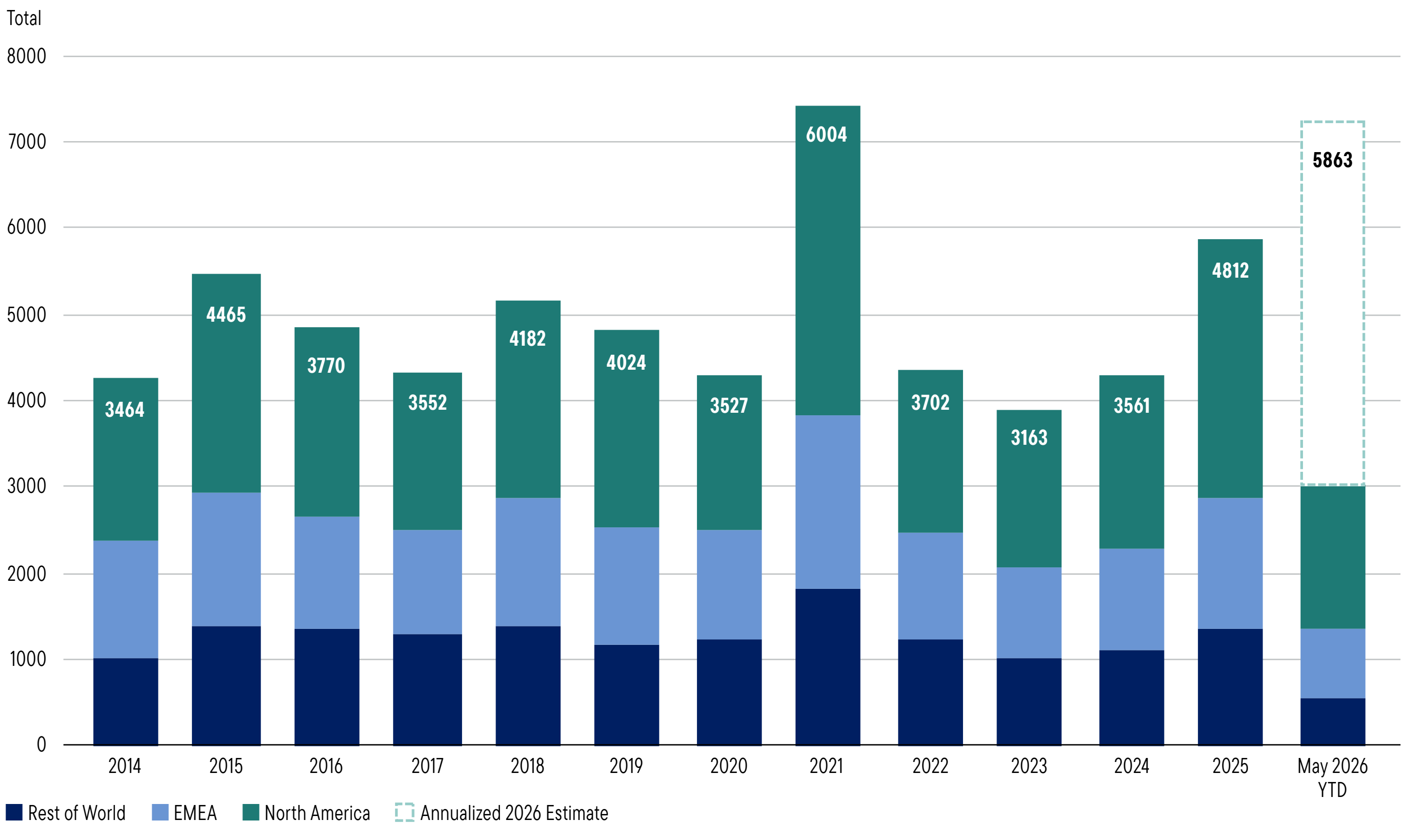
Event-driven

Despite elevated market volatility in Q1, global corporate event activity came back strong in the second quarter, with year-to-date totals approaching US$3 trillion and setting up a potentially record-breaking year of M&A activity. A number of factors are driving the pent-up demand for corporate mergers, not the least of which is the AI arms race. This is leading to aggressive bidding for unique intellectual property, and/or access to hardware, power or compute resources. The massive funding demands associated with onshoring and building out AI infrastructure are leading to many other types of corporate activity, including new issuance of debt and equity, IPOs and sales of non-core businesses. This environment is presenting a robust opportunity for event-driven investors, and we believe this trend will continue. Importantly, this strategy does not need to serve as a directional play on being long the AI theme—but rather, a play on the disruption (whether positive or negative) that AI is likely to continue to have on a range of markets, sectors, and asset classes.

Exhibit 3: Global Announced M&A Volume

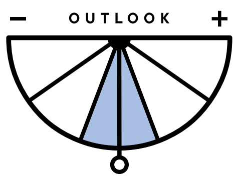
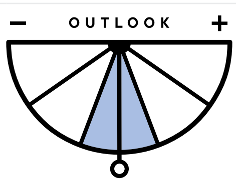
Near-Record Levels of M&A Activity So Far in 2026 (US$ Billions)

January 1, 2014–May 31, 2026

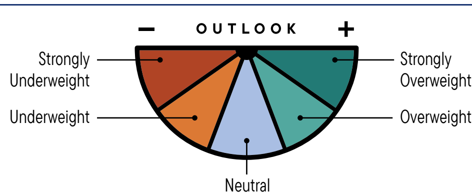


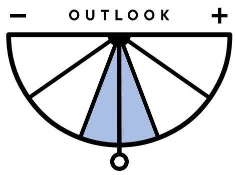
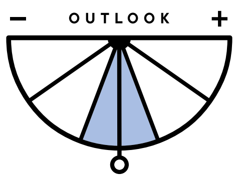
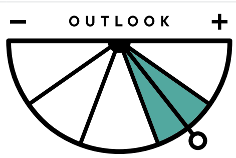
Source: Citi M&A Executive Summary, May 2026. 2026 estimate calculated by annualizing first five months of volume. Values shown above each bar represent annual totals (excluding double-counting). Annual totals don't match the sum of regional totals due to double-counting of cross-border situations. Important data provider notices and terms available at www.franklintempletondatasources.com.

Q3 2026 Outlook by Strategy

Strategy	Outlook	Our viewpoint
Long/short equity		The outlook for long/short equity has grown constructive on the back of solid fundamentals, strong earnings reactions, reduced intra-stock correlation and elevated dispersion across single-stocks, market caps, sectors and geographies. The set of investment opportunities has broadened beyond the mega-cap hyperscalers that have largely driven markets in recent years. Additionally, as the impacts of AI and related technologies permeate throughout the economy, they are likely to create additional cohorts of winners and losers across sectors, thereby deepening the opportunity set on both the long and short sides. From a technical perspective, these elements bode well for dynamic stock selection.
Relative value		Our relative value strategy outlook has remained neutral, albeit with modest downgrades at the sub-strategy level. Convertible arbitrage has been benefiting from record new issuance, used to refinance 2020-2021 bonds and to fund the massive infrastructure needs of the AI-boom buildout. However, the bonds coming to markets are generally priced rich due to high demand, and the strategy remains competitive and prone to elevated concentration risk given the dominance of levered arbitrage investors. Within volatility, the relentless volatility selling has been depressing levels and limiting breakouts during brief market corrections in most asset classes. Finally, aggressive central bank issuance and refinancing activity, along with strong demand from speculative investors, has buoyed fixed income relative value strategies. However, the relative current calm in the markets is underscored by potential risk due to elevated risks of a policy error disrupting an over-levered and fragile equilibrium. In aggregate, relative value strategies have benefited from favorable market conditions but are facing some obvious and non-obvious market risks, leading us to be balanced in our outlook for the strategy.
Event-driven		The outlook for event-driven remains neutral, though marginally improved from the prior quarter due in part to improvements at the sub-strategy level. The Q1 equity market volatility has more or less resolved, leading to the release of pent-up demand for corporate activity. We are setting new records in M&A and LBO activity, activist campaigns, and IPO issuance; with all these categories expected to continue delivering for the rest of the year, there are plentiful opportunities for managers to pursue. Tapering out excitement somewhat is the combination of tight event spreads, elevated equity valuations and potential fragility in the credit markets. Reversal of any of these trends could have a dramatic negative impact on confidence and valuations, quickly drying up the spigot of corporate activity, or at least exposing the strategy to a fair amount of volatility. Considering these cross-currents, our outlook for the strategy remains neutral for now.

Understanding the pendulum graphic



Strategy	Outlook	Our viewpoint
Credit		We remain underweight credit. While all-in yields remain appealing, the opportunity set is increasingly defined by carry rather than valuation, as spreads have remained resilient and continue to price relatively constructive outcomes. Credit markets are trading with a high tolerance for macro uncertainty, supported by strong technicals, but leaving limited margin for error should growth, policy expectations or underlying fundamentals shift. This creates an asymmetric risk profile, where upside is largely driven by carry while downside risks are not fully reflected in valuations. While this dynamic is evident at the index level, dispersion remains elevated at the issuer level. We therefore favor active, trading-oriented, and long/short strategies capable of dynamically managing exposure and exploiting dispersion and episodic volatility, alongside managers focused on idiosyncratic, event-driven and structurally complex opportunities where pricing may be more attractive.
Global macro		The opportunity set remains robust, particularly for tactical approaches that can react to shifts in geopolitics, policy, and economic trends. Managers continue to face an environment with multiple at-bats, albeit with the potential for sharp reversals as markets react to macro-heavy newsflow. Developed market central banks remain an important area of focus as policymakers respond to shifting growth and inflation data, and as the Federal Reserve has transitioned to new leadership. For emerging market specialists, leadership changes and idiosyncratic developments can compound the opportunity set while broader global macro developments continue to present a balance of risk and opportunity. We maintain our long-term conviction in systematic strategies, acknowledging that a persistence of recent macro trends and asset class dispersion could remain tailwinds.
Commodities		There is a striking balance between opportunities and risks for commodity specialists in today's market. Both directional and relative value approaches remain exposed to geopolitical headlines, which can create bouts of volatility as well as attractive entry points for fundamentally sound trade structures. We continue to value diversification and strong risk management in this environment and look forward to a potentially rich opportunity set if uncertainty around exogenous factors recedes.
Insurance-linked securities (ILS)		The 2026 Atlantic hurricane season began June 1, with most major forecasters expecting near-average activity as *El Niño* conditions may develop during peak months. Seasonal forecasts are useful but are only one input; catastrophe bond outcomes depend more on storm track, landfall, insured exposure and loss characteristics, as a single major hurricane can materially affect the market. Catastrophe bonds have continued to grow in 2026, supported by strong issuance, transaction upsizings and first-time sponsors, while manageable first-half losses have helped sustain favorable conditions. Spreads have moderated from post-2022–2023 dislocation levels but rebounded from late-2025 lows. We continue to view catastrophe bonds as attractive, offering compelling risk-adjusted return potential and diversification benefits given their low correlation with traditional assets.

Outlook Trend for Strategies and Sub-Strategies

Strategies	Q2 2026	Q3 2026	Changes
Long/short equity			↑
Long/short equity			
Equity market neutral			
Europe			↓
Technology			↑
Health care			
Relative value			
Convertible arbitrage			
Volatility arbitrage			
Fixed income			↓
Event-driven			
Activist			
Merger arbitrage			
Special situations			
Credit			
Direct lending			
Distressed			
Long/short credit			
Structured credit			↓
Global macro			
Discretionary			↓
Systematic			↓
Emerging markets			↓
Commodities			
Directional			
Relative value			
Insurance-linked securities			
Catastrophe bonds			↑
Other ILS			

Sub-strategies ranked by Z-score*

Rankings	Z-Score	Our Conviction
Health care	2.0	
Technology	1.6	
Cat bonds	1.1	
Event-driven–special situations	0.6	
Long/short credit	0.5	
Equity market neutral	0.4	
Other ILS	0.4	
Discretionary	0.3	
Fixed income	0.2	
Commodities–relative value	0.1	
Long/short equity	0.1	
Activist	0.1	
Event-driven–merger arbitrage	0.0	
Volatility arbitrage	0.0	
Convertible arbitrage	-0.1	
Commodities–directional	-0.2	
Structured credit	-0.6	
Emerging markets	-0.7	
Europe	-0.8	
Systematic	-0.9	
Distressed	-1.6	
Direct lending	-2.7	

Z-Score	Pendulum	Conviction
> +1		Strongly overweight
+0.5 to +1		Overweight
-0.5 to +0.5		Neutral
-1 to -0.5		Underweight
< -1		Strongly underweight

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Glossary

Alpha
A mathematical value indicating an investment's excess return relative to a benchmark. Measures a manager's value added relative to a passive strategy, independent of the market movement.

Convertible arbitrage
A hedge fund investment strategy that seeks to profit from pricing differences between a company's convertible securities (usually convertible bonds) and its common stock.

Correlation
The degree of interaction between an investment's return and that of the comparison Index. The correlation coefficient, expressed as a value between +1 and –1, indicates the strength and direction of the linear relationship between the investment's returns and the returns of the index.

Directional
An investment strategy where a trader or fund takes positions based on a view that the price will move up or down.

Discretionary
Refers to an investment approach where portfolio managers make investment decisions based on their own analysis, judgment, and interpretation of economic, political, and market developments.

Leveraged buyout (LBO)
An LBO is the acquisition of a company using a significant amount of borrowed money, typically with the acquired company's cash flows and assets used to support repayment of the debt.

Magnificent seven
Refers to a group of large-cap U.S. technology-oriented companies comprising Apple, Microsoft, Amazon, Alphabet, Meta Platforms, Nvidia, and Tesla.

Merger arbitrage
An investment strategy that seeks to profit from the price difference between a target company's current stock price and the price offered in a proposed merger or acquisition.

Relative value
Relative value is a method of determining an asset's value that takes into account the value of other assets. In contrast, absolute value looks only at an asset's intrinsic value and does not compare it to other assets.

Sharpe ratio
A risk-adjusted measure of investment return. The higher the Sharpe ratio, the better the fund's historical risk-adjusted performance.

Special situations
An investment strategy that seeks to profit from corporate events or extraordinary circumstances that can affect a company's value.

Systematic
An investment approach that uses quantitative models, algorithms, and predefined rules to identify and execute trading opportunities across global markets.

Volatility arbitrage
A trading strategy that aims to profit from differences between the implied volatility of an asset (as reflected in option prices) and the trader's estimate of its actual or future realized volatility.

Z-score
A Z-score is a numerical measurement used in statistics of a value's relationship to the mean (average) of a group of values, measured in terms of standard deviations from the mean. If a Z-score is 0, it indicates that the data point's score is identical to the mean score.

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