Global Macro Insights

Summary

March overview: The Middle East conflict began in late February when the United States and Israel struck Iran, and it has dominated much of the news flow and financial market sentiment throughout March. The market reaction has evolved. Initially there was a traditional risk-off move which then turned into a selloff in core developed bond markets as oil prices surged, triggering fears of stagflation—a scenario characterized by inflation combined with stagnant or slow growth and rising unemployment. The US dollar (USD) strengthened over the course of the month, largely attributed to safe-haven flows in the wake of the conflict. The sharp rise in oil prices (between 50% to more than 60% higher over the month depending on benchmark used) led to concerns about both inflation and growth. This in turn resulted in renewed uncertainty over the path of monetary policy, and a number of central banks that held policy meetings during March highlighted the potential impacts on policy. Actual policy moves were divergent, with benchmark rates flat among most developed markets but with differing undertones, while emerging market (EM) central banks were a mix of unchanged, easing and hiking. Inflation continues to diverge somewhat among economies, but the focus has shifted to potential upward pressure from higher oil prices. The latest data on economic activity showed prior growth in the United States, the euro area revised lower, but Japan revised sharply higher. The USD strengthened in March, lifted by a safe-haven bid against the background of the conflict. Sovereign bond yields were mostly higher globally, as the rise in oil prices ignited inflation fears.

Outlook: Uncertainty remains a pervasive issue globally. For much of last year, political developments in particular countries, including elections and changing US tariff and trade policy, dominated headlines and led to uncertainty. But the most recent global events have turned geopolitics into the main source of potential instability. The latest events have raised stagflationary risks, and we acknowledge that some countries are more vulnerable to higher oil prices than others, but for now our views on developed markets remain largely unchanged. Risks have risen among EMs, but our longer-term constructive view arising from the strides forward in better policy, economic management and fundamentals over past years remains intact. The latest developments seem to confirm that the global monetary policy easing cycle is likely close to an end, and interest rate have already risen in countries like Australia and Colombia where inflation is of concern. We highlight that our thesis of “global rewiring” remains intact, and despite the geopolitical uncertainty, different economic agreements continue to proceed; latest examples include the free trade agreement (FTA) between Mercosur and the European Union (EU), which will begin on May 1, and a FTA between Australia and the EU signed in March.

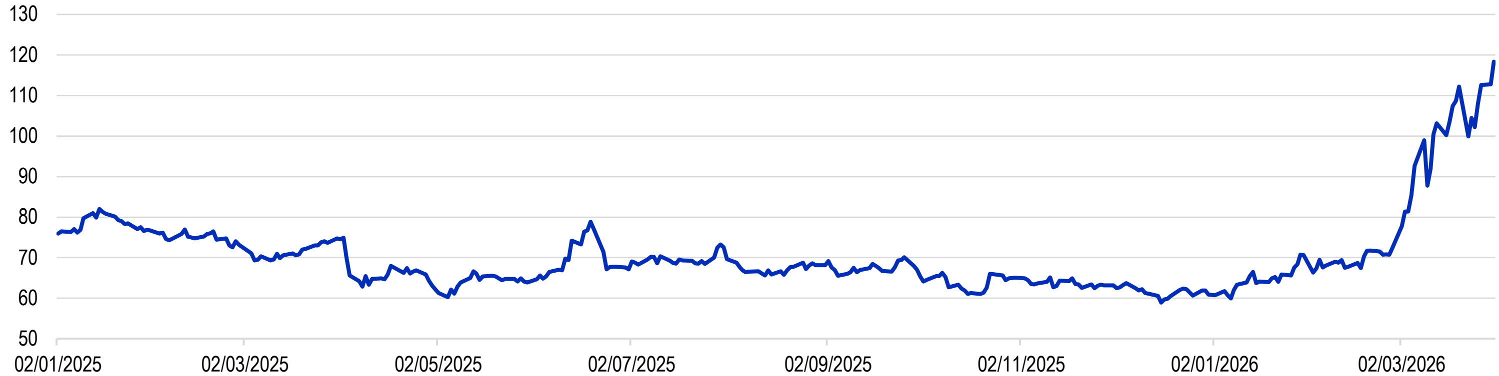
General market and economic overview

Geopolitical news dominated in March as the conflict between the United States, Israel and Iran continued, with strikes from Iran into other regional countries adding to the uncertainty. Officials have made conflicting statements about negotiations, and it remains unclear how long the conflict might last. Oil prices have risen sharply (Exhibit 1), but other shipping costs such as freight and insurance have also moved higher since the conflict began. The situation will look more severe the longer the conflict continues, particularly if any oil infrastructure is damaged in addition to the Strait of Hormuz closure. The risks to global growth will intensify the longer the conflict goes on, but we also point out that both developed markets and emerging markets proved resilient through the last few global stress points, including the COVID-19 pandemic and the Russia-Ukraine war, although it is also true that some buffers in both groupings (including fiscal space and balance of payments reserves) have been drawn down to varying extents. We continue to closely monitor developments in the Middle East in respect of any potential impact on our current views.

Oil Prices Surged in the Wake of the Middle East Conflict

Exhibit 1: Brent Crude Oil Futures, US$/Barrel

January 1, 2025 to March 31, 2026



Sources: Bloomberg. As of March 31, 2026

In the **United States**, fourth quarter (Q4) 2025 gross domestic product (GDP) growth was revised to 0.7% quarter-over-quarter (q/q) seasonally adjusted and annualized (saar) from 1.4% in the advance estimate, a sharp fall from 4.4% the prior quarter. February nonfarm payrolls were significantly worse than expected, falling by 92,000, and the unemployment rate ticked up from 4.3% to 4.4%. Various employment cost indicators were somewhat higher.

Euro area (EA) indicators showed some weakness, particularly in the surveys undertaken after the Middle East conflict began, including forward-looking confidence indicators. EA Q4 2025 GDP trended lower to 0.2% q/q and 1.2% year-over-year (y/y), as a revision to Irish GDP dragged the figure down due to the volatile information technology and pharmaceutical sectors. For the year as a whole, EA real GDP was up 1.4% y/y, which reflects a good overall recovery driven by internal and external demand.

In **Japan**, the Ministry of Finance's Q4 survey showed capital expenditure (which includes software) rising again and above expectations, driven by the non-manufacturing sector. Q4 2025 GDP expectations increased to 1.3% (q/q saar), compared to a preliminary 0.2% increase and consensus of a 1.0% increase. Similarly, expectations increased for both private capital expenditure and private consumption. In news on wages, the Japanese Trade Union Confederation's member unions are demanding an average wage increase of 5.94% this year, compared to the 6.09% request made a year ago. Unions representing smaller firms are seeking a 6.64% raise, the largest since at least 1994, compared to last year's request of 6.57%.

Developed market global inflation outcomes are still diverging somewhat. The US Consumer Price Index (CPI) was unchanged in February at 2.4% y/y, while the core CPI (excluding the more volatile food and energy components) was likewise flat at 2.5% y/y. In the EA, preliminary headline inflation rose to 2.5% in March from 1.9% y/y in February, though core inflation dipped to 2.3% y/y from 2.4% y/y the previous month. Inflation in Japan slowed to 1.3% y/y in February from 1.5% y/y in January, reflecting subsidies introduced under Prime Minister Sanae Takaichi's inflation-relief measures. Inflation in most developed markets currently remains above central bank inflation targets. By contrast, inflation readings in **a significant number of EMs are within their target ranges**, with a few exceptions (mainly in Latin America). However, recent energy price moves pose clear risks to the inflation outlook.

Central-bank meetings during March invariably indicated that the effects of the conflict and the resulting surge in oil prices on overall inflation and growth could affect the path of monetary policy. Meanwhile, actual policy paths diverged among banks globally. The US Federal Reserve (Fed) left rates unchanged in March, with the federal funds rate target range at 3.50%–3.75%. The meeting statement and press conference emphasized uncertainty related to the Iran war, indicating that the Fed would look through any initial oil supply shock effect on inflation to focus on core developments, while also noting a likely dragging effect on the economy; ultimately the Federal Open Market Committee retained an easing bias. The European Central Bank (ECB) and Bank of Japan (BoJ) likewise left policy rates unchanged at their March meetings. The ECB reiterated its data-dependent approach, outlining potential stagflationary outcomes and asserting that the central bank is well-positioned to respond as necessary. ECB President Christine Lagarde also noted in a speech that the ECB will act "decisively and swiftly" if the current surge in energy costs risks a broader bout of inflation. The BoJ retained a similar hawkish undertone. Australia's central bank raised rates another 25-basis points (bps) in a split vote, though policymakers indicated the split related more to timing than about the need for a hike. Norway's Norges Bank left rates unchanged but tilted toward an explicit hawkish bias, indicating rate increases would be forthcoming. As an oil exporter, Norway's growth should be less affected than some other economies, leaving the central bank to focus on inflation. Among EMs, Brazil, Mexico and Poland all implemented 25-bps cuts in March, while Colombia delivered a largely expected 100-bps interest-rate increase. South Africa, Peru, Chile, Malaysia and China were among the EMs leaving rates unchanged in March.

The USD gained in March as risk aversion around the Middle East conflict supported the greenback, with the US Dollar Index (DXY) gaining 2.4%.[1] The USD appreciated against almost all developed and emerging market currencies in March, with notable exceptions including the Colombian peso and Kazakhstani tenge. Both are net oil exporters, though we note a number of other oil-exporting currencies weakened against the USD during the month.

Sovereign bond yields were mostly higher in March, as markets priced in expected increases in inflation in the wake of the rise in oil prices. In developed markets' 10-year bonds, the US Treasury note yield was 38-bps higher at 4.32%, while the benchmark EA yield rose 36-bps to 3.00% and the Japanese government bond yield increased by 24-bps to 2.35%. Most other developed and emerging market bond yields also rose, with Colombia and Kazakhstan again being among the exceptions where bonds were stronger over the course of the month**. EM sovereign credit overall fell in March on a combination of the inflation outlook and weaker risk sentiment**, with the J.P. Morgan EMBI Global Index (JPM EMBIG) falling 3.1%.[2]

Outlook and positioning

Uncertainty about growth and inflation outcomes has increased markedly since the start of the conflict. We are analyzing individual countries in terms of potential impacts on both growth and inflation. A number of factors are at play, including whether countries are net oil importers or exporters, oil dependency of economic activity, whether they have subsidy mechanisms to protect consumers from higher energy prices, and the extent to which monetary and fiscal policy might be expected to offset the effects on inflation, growth or both. For example, in the United States, energy goods now account for only about 2% of total personal consumption (near historical lows), implying that the drag on spending from higher oil prices should be smaller than in past episodes. A number of EMs have fuel price subsidies that should cushion the impact of an oil price shock on inflation and consumption, but these come at varying fiscal costs.

Despite the conflict, recent developments around trade and other economic relationships continue to support our thesis that global rewiring is underway. The FTA between Mercosur and the EU will begin on May 1, following Uruguay, Brazil, Paraguay and Argentina now having ratified the deal in their parliaments. An FTA between Australia and the EU was signed in March. Additionally, Iceland announced it will hold a referendum in August to determine whether membership talks with the EU should be reopened.

Local politics also remains a factor to watch amid a number of elections this year. Hungary holds parliamentary elections on April 12. Colombia held congressional elections in March and will conduct presidential elections in May (with a possible second round in June). Brazil holds general elections in October.

We still remain constructive on select EMs over the medium to longer term, despite near-term risks from the current conflict. Sounder policies and reforms across a range of countries have strengthened their fundamentals, in our view. The resilience of EMs is evident not only in how they weathered the stresses of the past few years, but in external validation of the positive impact of sounder policies, such as a number of International Monetary Fund agreements recognizing countries' progress on reform, a swath of credit rating upgrades in a broad range of countries across regions and income levels over the past year or so, and generally good demand for sovereign bond issuance. In the shorter term, EM currencies and bonds could potentially come under some pressure from risk aversion arising out of the latest Middle East developments. We would generally expect oil exporters to outperform oil importers. Overall, we would expect EMs that have made significant strides in improving their macroeconomic frameworks and reducing balance of payments vulnerabilities should be better insulated against the current crisis. Longer-term, we expect fundamentals to reassert themselves.

Central bank actions are diverging as the global monetary policy easing cycle nears its end, with potential spillover effects from the Middle East conflict into inflation and growth adding uncertainty to the outlook. Inflation outcomes complicate the outlook for meaningful further easing in developed markets. We still expect some further policy rate reduction from the Fed this year. The recent ECB meeting suggests the central bank will act decisively to adjust interest rates in the face of inflation pressure if necessary. Australia has already raised rates this year, though this may not necessarily herald a complete upward cycle in rates. We continue to expect the BoJ to continue gradually normalize rates. A significant number of EMs appear to be near or at the end of their rate reductions, with the main exception of Brazil where potential rate cuts come in context of a period of interest-rate increases last year counter to the general trend.

We maintain the view that the USD is broadly overvalued, and we expect further depreciation over the medium term. That said, we concede that there may be some shorter-term safe-haven flows into the USD given the current Middle East conflict.

Against a background where we think the Fed is likely to cut rates somewhat further while most other developed market central banks pause —or even raise rates, in the case of Japan and Australia and possibly the ECB —we think the underlying trend will still be dollar weakening. We believe the ongoing asset allocation shift into non-USD assets is likely a sustainable trend. We also look to carry as a source of return, which underpins our view of select opportunities in non-dollar assets in EMs in particular. Beyond carry, we also think the shift into EM assets is also a recognition both of their structural improvements and greater role in the world economy. We are also constructive on select developed market currencies.

The global fiscal outlook remains a structural concern, particularly among core developed markets. As noted, the costs of the Middle East conflict are likely to further increase pressure on the fiscal position in the United States as well. Even before the war, the Congressional Budget Office projected that large and growing deficits would cause government debt to increase from 101% of GDP this year and to 120% in 2036, surpassing the previous high of 106% in 1946. Consequently, we remain wary of longer-term bonds which we would expect to bear the brunt of the implications of fiscal loosening.

At present, our core regional views remain unchanged, though we are monitoring effects of the Middle East conflict and individual country sensitivities.

- **Our two main focus areas currently remain the Asia-Pacific region and Latin America**. In Asia, we generally focus on countries with positive fundamentals and undervalued currencies, as well as those we expect to be more insulated from tariff effects. In Japan, we continue to see evidence of a structural reflationary shift. In Latin America, we favor countries with prudent macroeconomic policies (including those where central banks have proved to be independent and proactive), relatively high yields and undervalued currencies.
- **We also see opportunities in certain emerging and frontier markets in both local currency and hard-currency assets. In particular, we have exposure in some portfolios in select African countries** where we believe reform efforts have resulted in notable improvements in fundamentals and the economic outlook. Elsewhere in Africa, reforms are reaping rewards, with improving economic conditions and growth prospects in a number of countries. South Africa and some other African countries benefited from credit ratings upgrades last year. We also have some holdings in select frontier Asian markets. These all also offer attractive opportunities for potential yield pickup, in our analysis.

In local-currency positions, we hold select countries in both developed markets and EMs. Our currency positions focus on potential upside based on our assessment of long-term undervaluation against the USD. These countries historically have had robust balances of payments and growth fundamentals. In bonds, we hold positions in countries where we identify supportive fundamentals. These might cover a range of factors, such as inflation and interest-rate outlooks, fiscal progress and other economic reforms, and/or anticipated economic benefits from reshoring or other deeper integration into the global economy. We aim for a relatively high overall portfolio yield by holding higher-yielding, local-currency positions in specific emerging and (where relevant) frontier markets that we view as having attractive risk-adjusted yields.

In hard-currency-denominated sovereign credit positions, we favor emerging (and, where relevant) frontier markets with improving fundamentals and policy responses.

In all positions, we closely monitor idiosyncratic factors in different countries to identify relative valuation opportunities. We remain highly selective at the sovereign level, given significant variations in economic fundamentals and policy responses.

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ENDNOTES

1. Source: Bloomberg. As of March 31, 2026. The DXY is a measure of the value of the dollar against six foreign currencies: the euro, Swiss franc, Japanese yen, Canadian dollar, British pound and Swedish krona. **Past performance is not an indicator or a guarantee of future performance.** Indexes are unmanaged and one cannot invest directly in an index. Important data provider notices and terms available at www.franklintempletondatasources.com.
2. Source: Bloomberg. As of March 31, 2026. The JPM EMBIG tracks total returns for US dollar-denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities. **Past performance is not an indicator or a guarantee of future performance.** Indexes are unmanaged and one cannot invest directly in an index. Important data provider notices and terms available at www.franklintempletondatasources.com.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. There is no assurance that any estimate, forecast, or projection will be realized.

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.

Currency management strategies could result in losses if currencies do not perform as expected.

Active management does not ensure gains or protect against market declines.

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

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**. Investments in companies in a specific country or region may experience greater volatility than those that are more broadly diversified geographically. 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.

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