January 2026

Franklin Templeton Investment Solutions

Allocation Views

AI, earnings and the case for staying risk-on

Summary

We retain measured conviction toward equities into 2026, as influential pillars of support for risk assets—such as inflation, policy and corporate fundamentals—remain healthy. These dynamics are fueling our belief that equities will likely continue to deliver positive returns for investors, despite stretched valuations.

Leading indicators of global growth remain healthy, while a combination of lower inflation pressures and softening employment data provides a good background for stimulative US Federal Reserve (Fed) policy.

Equally importantly, corporate fundamentals show little sign of weakening, as trailing earnings growth remains strong. Global forward earnings expectations and earnings guidance breadth have also moved higher.

Taking these arguments into account, we maintain an overweight allocation to equities within our policy portfolio, offset by an underweight allocation to fixed income. We retain our underweight duration positioning amid ongoing fiscal deficit uncertainties, while also holding exposure to commodities for hedging and diversification reasons.

Macro themes

A resilient growth story

- Certain leading economic indicators have weakened, but they remain broadly resilient, fueled by artificial intelligence (AI) capital expenditure (capex) and high-end consumers.
- Diminished tail-risk from tariffs has supported corporate sentiment and earnings, as evidenced by positive third-quarter reporting and guidance.
- The US economy has proven robust, but we continue to monitor labor market data, which has softened from a strong position but has not collapsed.

Moderating inflation trends

- Inflation sits above central bank targets in most developed economies, although inflation trends are broadly disinflationary.
- Tariffs have been absorbed by both consumer prices and business margins. Core goods inflation could persist, but pressures have likely peaked.
- Services inflation has eased due to lower housing costs and wages, helping counteract higher goods inflation.

Policy leans supportive

- Uncertain data may prevent the Fed from cutting rates again in the near term, but we expect moderate easing over the next year.
- Having said that, we think the magnitude of easing that markets are pricing in is too optimistic, given a robust economy and complicated inflation dynamics.
- Fiscal policy in major economies is an increasingly influential driver of asset prices. US tax refunds will likely offset tariff headwinds, while stimulus measures in Japan and Germany could also prove supportive.

Portfolio positioning themes

Responsibly bullish

- Positive earnings revisions and guidance support equity market momentum, outweighing valuation concerns, in our view.
- Leading and current indicators of economic strength remain broadly positive and support risk assets.
- Sentiment and positioning have become more optimistic. We believe this is a slight headwind for risk assets and feeds into the ongoing valuations debate.

Emerging equity opportunities

- We retain our optimistic view of US large-capitalization stocks relative to small caps and regional equities. Robust earnings and a supportive macro backdrop guide our thinking.
- Earnings expectations are rising rapidly across emerging markets (EMs) ex-China, influencing our more constructive view on the region. Macro conditions are also supportive.
- We remain broadly pessimistic on international developed-market equities and downgrade Canadian stocks, amid weaker earnings growth forecasts and an uncertain macro backdrop.

Underweight government bonds

- We believe longer-term market expectations for Fed policy easing are too optimistic. Elsewhere, central bank rhetoric has become more hawkish recently.
- Fiscal deficits are widening in major economies, as governments increase spending or cut taxes to stimulate growth. Consequent yield effects make us selective on duration.
- Tight spreads diminish the risk-adjusted returns available from credit. Earnings growth leads us to favor equities.

We retain measured conviction toward equities into 2026, as influential pillars of support for risk assets—such as inflation, policy and corporate fundamentals—remain healthy. These dynamics are fueling our belief that equities will likely continue to deliver positive returns for investors, despite stretched valuations.

Current activity indicators show growth above six-month averages in the United States, EMs, and Europe. In addition, continued disinflation trends have provided some room for central banks to bolster accommodative fiscal policy by cutting interest rates. Discounting some noise in the data, we are encouraged by US annual Consumer Price Index (CPI) inflation, which fell to 2.7% in November, while annual core inflation (less food and energy) also moved closer to target, at 2.6%. A combination of lower inflation pressures and softening employment data provides a good background for stimulative Fed policy, although we only expect to see one more rate cut in the first half of 2026.

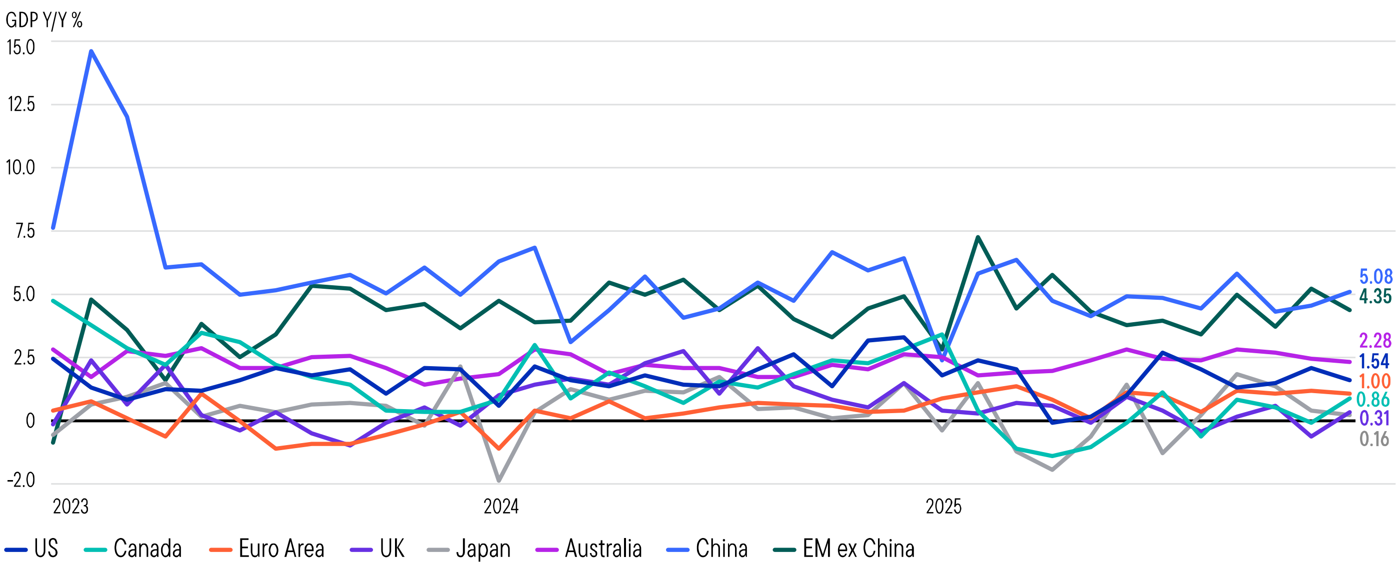
Equally importantly, corporate fundamentals show little sign of weakening, as trailing earnings growth remains strong. In addition, global forward earnings expectations are being revised higher, alongside earnings guidance breadth. Our fair value model forecasts forward earnings growth for US companies of 7.5% over the next 12 months.[1]

Having said that, recent developments around sentiment, positioning and momentum are valid arguments for a note of caution, as is a marginally less supportive macro backdrop. More optimistic sentiment among investors is a headwind for future equity returns, as is weaker price momentum resulting from an uptick in market volatility during October and November. A survey from AAII suggests allocation to stocks is currently in the 99th percentile on a 10-year lookback basis.[2] Elsewhere, some leading indicators of global growth have weakened at the margins over the last month, notably in North America and Europe.

Taking these arguments into account, we maintain an overweight allocation to equities within our policy portfolio, offset by an underweight allocation to fixed income. We retain our underweight duration positioning amid ongoing fiscal deficit uncertainties, while also holding an overweight position to commodities for hedging and diversification reasons.

Global Economic Activity Has Shown Impressive Resilience

Exhibit 1: Regional Current Activity Indicators (CAI)



Sources: Macrobond, Bloomberg, Goldman Sachs. As of December 1, 2025.

1. Source: Analysis by Franklin Templeton Investment Solutions. As of December 16, 2025. There is no assurance that any estimate, forecast or projection will be realized.
2. American Association of Individual Investors (AAII) – 16 December 2025.

Notes on inflation and labor market weakness

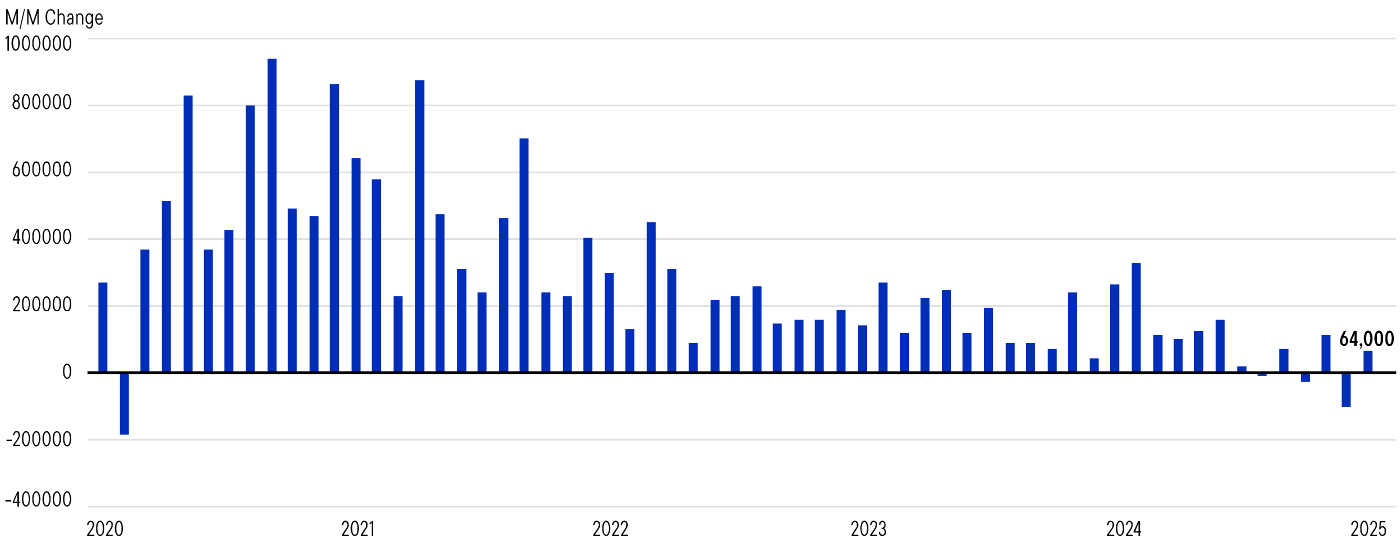
Headline US unemployment rose to 4.6% in November, as a softening labor market continued to give policymakers cause for concern. However, close interrogation of the data supports the thesis that core employment patterns remain relatively healthy. November's figure largely resulted from temporary layoffs and a reduction in government jobs associated with the end of the DOGE[3] buyout program. Permanent layoffs declined and private job growth stabilized, while hours worked and participation rates edged higher. In addition, nonfarm payrolls gained 64,000 in the month,[4] as employment rose in health care and construction.

In our view, this analysis helps bolster the case to remain positive on risk assets, particularly given the headline unemployment rate remains within Fed expectations. Elsewhere, cooling wage growth should reinforce confidence in ongoing disinflation, as should the sharp fall in US CPI inflation we mentioned earlier.

A stronger-than-expected jobs market, alongside falling inflation, strengthens the "goldilocks" environment for US stocks. This is a persuasive argument for a "risk-on" approach, when combined with our conclusion that tariff-induced inflation pressures are now past their peak.

Nonfarm Payroll Growth Rebounded in November

Exhibit 2: Monthly US Labor Market Survey Data



Sources: Macrobond, BLS. As of November 2025.

3. DOGE is the US Department of Government Efficiency
4. Source: "Employment Situation." US Bureau of Labor Statistics. November 2025.

Extended thoughts on an AI bubble

The levels of capital deployed this year in pursuit of AI development have begun to worry some investors, who have questioned the valuations of technology firms.

AI hyperscalers invested almost US$400 billion of capital in 2025, an increase of 68% on 2024. This seems like a very large number, but it only constituted 1.3% of nominal US gross domestic product (GDP). In comparison, capex during the dot-com boom in 2000 reached 4.25% of GDP. Our analysis suggests that capex could increase next year to US$700 billion and still be only 1.5% of US GDP.[5]

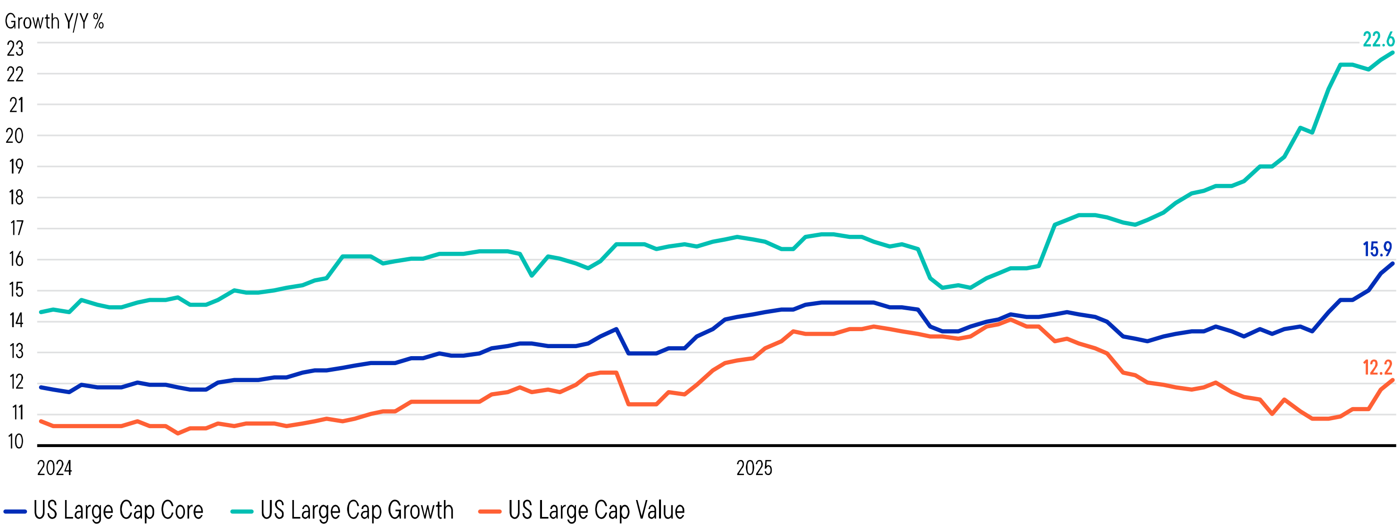
Importantly, debt would not be funding most of this investment because capex to free-cashflow ratios for hyperscalers are low. If debt were required, estimates suggest that an additional US$700 billion of net debt could be added to balance sheets without net leverage exceeding one-times earnings.[6]

There are some longer-term threats to AI investment that might result in a bubble forming and bursting. However, in our view, this is some way off and would probably result in an inflection point leading to a split between winners and losers. We believe the current profitability and balance sheet health of AI leaders fully support valuations and capex trends.

Against this background, forward earnings expectations for growth equities remain strong and support our overweight allocation to core US equities.

Earnings Expectations for US Growth Stocks Have Risen More Sharply Than Their Value Peers

Exhibit 3: US Large Cap CY26 Earnings per Share (EPS) Expectations, by Style Factor



Sources: Macrobond, Refinitiv Workspace, I/B/E/S. As of December 29, 2025. There is no assurance that any estimate, forecast or projection will be realized.

5. Source: Analysis by Franklin Templeton Investment Solutions.
6. FTIS Forecasts. EBITDA is an acronym for earnings before interest, tax, depreciation and amortization and is used as a measure of business performance. FTIS calculations; source Bloomberg.

EM opportunities

We retain our bullish view on EMs into 2026, as global trends including AI supply chain diffusion into Asia and US de-dollarization combine favorably with benign inflation and easier financial conditions.

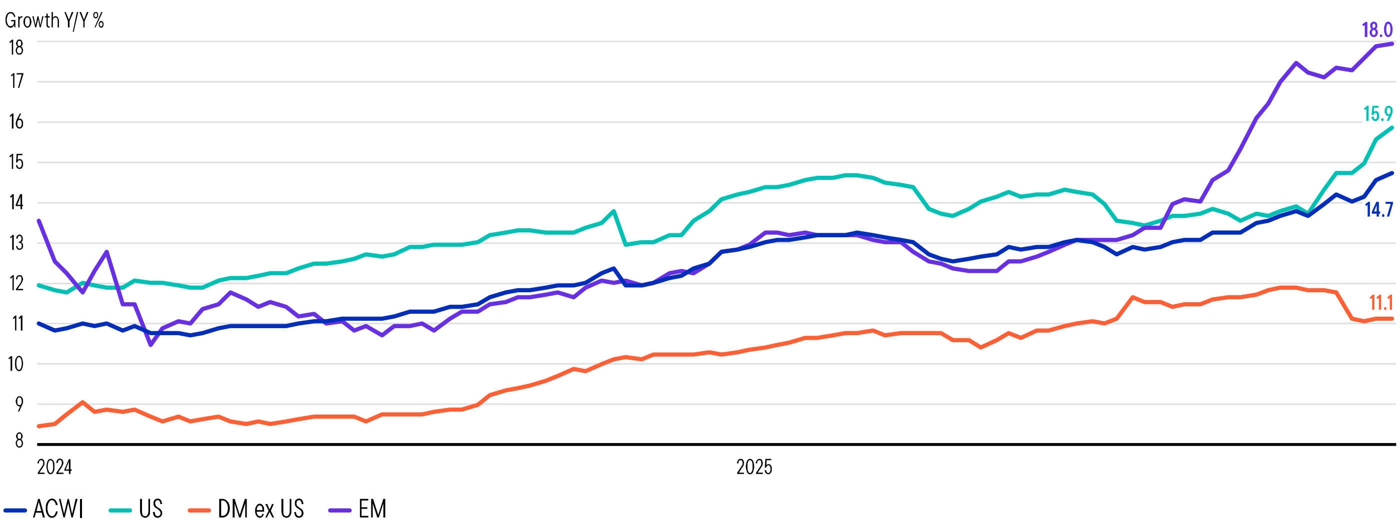
Against this background, EM indicators of economic growth, including purchasing managers' index (PMI) data and current activity indicators, look healthy. As a result, EM forward earnings revisions are the strongest across our investable regions.

The trend for de-dollarization is benefiting both EM equities and debt, as it lowers debt servicing costs and creates a more accommodative environment for EM earnings growth. In addition, greater fiscal and monetary stability increases the attractiveness of EM debt yields from a risk/reward perspective. This is particularly true at a time when fiscal deficits in developed markets are expanding.

In our analysis, EM equity valuations also appear inexpensive relative to their developed market counterparts, and this advantage is attracting international flows. On a 12-month forward basis, the FTSE Emerging Index trades at 15.7 times earnings, a 31% discount to developed markets.[7]

Forward Earnings Expectations for EM Stocks Are Meaningfully Higher Than Their Global Peers

Exhibit 4: Regional CY26 EPS Expectations



Sources: I/B/E/S, Macrobond and Refinitiv Workspace as of November 2025. There is no assurance that any estimate, forecast or projection will be realized.

7. FTIS calculations; source Bloomberg. The FTSE Emerging Index provides investors with a comprehensive means of measuring the performance of the most liquid large and mid-cap companies in the EM.

Canadian weakness

Our view on Canada has deteriorated in the last month, as a weakening macro backdrop combines with persistent inflation and hawkish central bank rhetoric.

Outperformance of Canadian stocks relies heavily on commodity exposure via the cyclical energy, materials and industrials sectors, which make up more than 40% of broad equity indexes in the country. As oil demand softens, we have seen leading indicators of economic activity and PMI data weaken. Labor market data appear robust, but our analysis suggests job gains have been concentrated in part-time work, while hiring remains weak in trade-sensitive sectors.

In addition, the Bank of Canada (BoC) appears to be more concerned with persistent inflation than slowing growth, to the extent that markets have begun to price in interest-rate hikes rather than stimulus. Annual Canadian CPI inflation was 2.2% in November, amid higher food prices.[8]

We feel the market's assessment of the Canadian economy is too optimistic, given that the underlying data does not provide enough support for current equity valuations. As a result, we have neutralized our equity overweight, while upgrading Canadian bonds to overweight.

Selective on duration

We remain broadly underweight duration, primarily due to upward pressure on longer-term US Treasury and European government bond yields, amid fiscal sustainability concerns.

In contrast, we have taken selective duration exposure in countries that we believe have weaker macro backdrops. This includes Canada, as we discussed earlier, but also the United Kingdom, where fiscal tightening in the form of tax increases is likely to suppress growth and inflation, making interest-rate cuts more likely.

We have also upgraded Japanese government bonds (JGBs) to neutral, as recent rate hikes have moved the yield on 10-year bonds close to equilibrium, meaning there is less risk of them moving substantially higher. In addition, yields on JGBs now appear attractive to us relative to other developed-market government bonds, which may fuel the repatriation of money from domestic investors, thus pushing yields down.

8. Source: Statistics Canada. December 15, 2025.

Allocation settings views—January 2026

Pendulum settings reflect cross-asset-class views

High level allocation tier

Asset class | **Conviction** | **Our viewpoint**

Equities

- Strong corporate fundamentals, as evidenced by positive forward earnings revisions and guidance, support equity market momentum. This outweighs valuation concerns, in our view.
- Certain leading economic indicators have weakened, but on a broad basis they remain resilient due to AI capex and high-end consumers.
- More optimistic sentiment and positioning offer a slight headwind for risk assets.

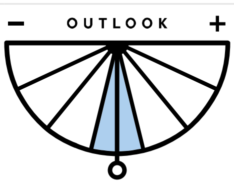
Bonds

- We believe market expectations for Fed policy easing across the next 12 months are too optimistic. This maintains upward pressure on longer-term yields, in our view, curtailing our preference for US duration.
- Inflation remains above central-bank targets in most developed economies. Services inflation has moderated, but goods inflation could remain sticky through the end of this year, despite evidence that pressures have peaked.
- Weaker fiscal discipline linked to tax rebates, tariff adjustments and defense spending may widen deficits in the United States and Europe, putting further upward pressure on yields.

Alternatives

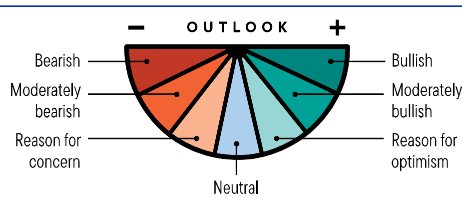
- Our view on commodities has moderated slightly, despite strong demand for precious metals, as oil demand softens and global inventories rise.
- However, a resilient global growth backdrop and increased demand from AI offer long-term support to energy and industrial metals. Supply constraints linked to geopolitical risks are also a factor.
- Elsewhere, we see structural attractions in naturally diversifying alternatives such as private assets.

Cash



- We believe elevated short-term yields offer attractive risk-free returns.
- However, the requirement to lower our portfolios' interest-rate sensitivity has moderated as yields have risen month-on-month.
- Additionally, a neutral cash allocation reflects our more positive view of equities and commodities.

Understanding the pendulum graphic



Arrows represent any change since the last month end.

Allocation tier

Asset class	Conviction	Our viewpoint

Equity regions: Pendulum settings relative to equity asset class broadly

Growth

United States

- We have seen US economic growth hold up well despite some weakness in the labor market, while relatively strong profitability and healthy cashflows have been supporting large-cap AI names.
- Third-quarter US earnings results look strong, while corporate guidance has improved.
- US financial conditions are currently easing. Fed cuts should support US equities, alongside robust growth and downside services inflation risks.

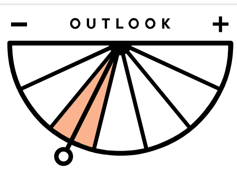
Value

United States

- US equities have historically proven defensive during periods of macro uncertainty. In addition, positioning and sentiment indicators suggest that discretionary buyers still under-own US value stocks.
- Trailing earnings-per-share growth for US value stocks is starting to accelerate, indicating an improvement in earnings breadth.
- Forward earnings estimates are holding up well and Fed easing should give them further support, in our view.

Small Cap Stocks

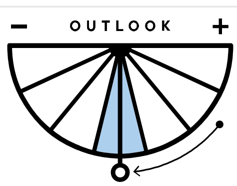
United States



- Earnings revisions are starting to moderate relative to large caps, while ambitious forward earnings growth expectations appear optimistic.
- Small-cap companies face quality concerns and tariff-related challenges compared to large caps. Overall, there are fewer positive earners, and they are less profitable and have higher debt.
- As a result, small caps generally have high interest-rate sensitivity and minimal margin capacity to absorb higher input costs. Recent credit sector concerns have focused on small-cap names.

International

Canada

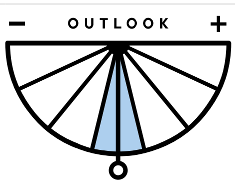


- Canada's over-reliance on commodities is a weakness, given softening global demand for oil and rising inventories.
- PMI data in both services and manufacturing has weakened, as have indicators of current economic activity.
- The BoC has chosen to prioritize sticky inflation and is likely to keep interest rates on hold rather than stimulate the economy.

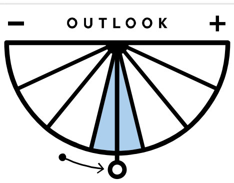
Europe ex United Kingdom

- Manufacturing activity has been contracting, due to structural weaknesses in Germany—including high energy costs, labor shortages and regulatory burdens. Political instability in France is also a headwind.
- A weaker domestic macro backdrop could weigh on eurozone equities. We are already seeing this reflected in trailing earnings growth and forward earnings growth revisions for the next 12 months.
- Europe's strong links to China leave it vulnerable to slowing Chinese demand, while a strong euro has compounded the earnings drag for exporters.

Allocation tier

Asset class	Conviction	Our viewpoint
United Kingdom		• The United Kingdom is our most defensive equity region. We are not in a defensive environment for risk assets, particularly among global equities. • The United Kingdom is facing significant macro headwinds, including slowing growth and labor market weakness. Fiscal tightening in the November budget is likely to exacerbate these factors. • Earnings revisions have fallen substantially for companies with both domestic and international exposure.
Japan		• The new Japanese government coalition is pushing ahead with fiscal policy stimulus despite elevated inflation. Corporate reform should also provide support to equities. • The Bank of Japan is still normalizing monetary policy. If this strengthens the Japanese yen, it will negatively impact exporters but benefit importers. • Forward earnings estimates have dropped, as tariffs eat into earnings and growth.
Australia		• The Australian economy stands out as one of the least-sensitive regions to US tariff policy. However, the country's position as a tariff insulator is now less meaningful following the completion of several major US trade deals. • Hotter-than-expected inflation has eliminated hopes for further interest-rate cuts from the Reserve Bank of Australia (RBA). Manufacturing PMIs continue to fall into contractionary territory, and industrial production growth has been negative throughout 2025. • Corporate earnings revisions have been improving, but trailing earnings have been weak, while equity market breadth has fallen amid persistently weak productivity.
Emerging ex China		• Earnings expectations are rising rapidly across EM ex-China, largely due to influential Asian economies. • Surges in both equity market momentum and breadth have accompanied positive earnings revisions, particularly in South Korea and Taiwan. • The risk of near-term tariff escalation from the Trump administration has also lessened for EM ex-China, while EM central banks still have room to ease in support of their economies, helped by lower inflation.
China		• Retail investors armed with significant household savings continue to support Chinese equity markets, although strong flows have been fueling volatility. • The recent pullback in equity markets does not materially diminish the attractiveness of China's leading tech companies amid positive AI developments, in our view. • Macro and corporate fundamentals in China remain weak and fiscal and monetary stimulus measures have had little impact. Domestic demand continues to stagnate due to a deteriorating property sector, a weak labor market and low consumer confidence.

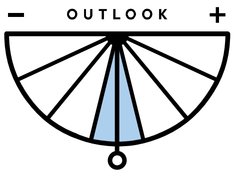
Allocation tier

Asset class	Conviction	Our viewpoint
Fixed income sectors: Pendulum settings relative to fixed income asset class broadly		
US Treasuries		• The Fed cut interest rates in December, emphasizing labor-market weakness. However, we believe market expectations for future Fed interest-rate cuts may be too optimistic amid a relatively robust macro backdrop. • We think market expectations of the Fed's neutral rate (r*) are too low. • Fiscal deficits may increase if tariff receipts are curtailed or judged illegal. Additionally, reduced foreign ownership of US Treasuries, as part of a de-dollarization trend, increases dependence on price-sensitive purchasers.
Eurozone Government Bonds		• Disinflation has slowed in the eurozone, while leading indicators of growth remain broadly supportive, making it difficult for the European Central Bank to ease further. • German fiscal expansion could add further upward pressure to eurozone yields and present a barrier to monetary policy stimulus. • Reallocation from US Treasuries could drive demand for eurozone duration, but momentum has stalled given the potential for increased issuance to fund investment.
UK Government Bonds		• Slowing wage growth, weak labor market momentum and looming fiscal tightening increase the attractiveness of UK Gilts. • The UK government has raised taxes to narrow its fiscal deficit. This is likely to slow economic growth, lower inflation and compound labor-market weakness. • Given the weak macro environment, we believe market expectations for inter-est-rate cuts are too conservative.
Canada Government Bonds		• The Canadian economy has been weakening amid waning energy demand and a dependence on cyclical sectors. • Labor market data looks robust but is skewed by part-time workers, in our analysis. • Markets have priced in rate increases from the BoC, but we think this is optimistic and would expect yields to fall from here.
Japan Government Bonds		• We believe recent interest-rate increases have moved JGB yields closer to equilibrium. • More attractive yields improve returns relative to other government bonds, encouraging inflows from repatriated domestic money. • Expectations of looser fiscal policy could stimulate the economy and fuel inflation, leading to higher yields, but CPI inflation is currently falling, which is bullish for JGBs.

Allocation tier

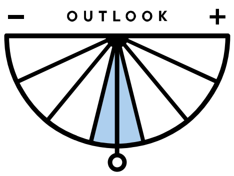
Asset class | **Conviction** | **Our viewpoint**

Australian Government Bonds



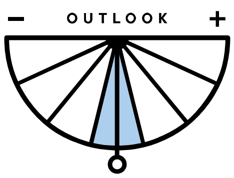
- The RBA left interest rates unchanged at its December meeting amid firming inflation.
- The RBA remains data-dependent and has deemed a tight labor market, sticky inflation and a relatively healthy macro environment as reasons to pause further stimulus.
- However, weakening economic activity and slowing employment growth may change that calculus.

Investment Grade



- The investment-grade sector has benefited from resilient corporate fundamentals and improved guidance, but uncertain macro forecasts are a concern.
- Credit spreads remain narrow, making the risk/return profile less attractive to us despite loose financial conditions.
- Against this background, we hold a neutral position on higher-quality credit, preferring the potential defensive features of government bonds.

High Yield and Loans



- Technical indicators such as spread momentum and equity market breadth have weakened recently, while cooling employment and persistent inflation present headwinds.
- Cracks could emerge if profitability weakens while rates stay high, leading to greater credit-spread dispersion. Investor outflows during recent credit uncertainty highlight a quality bifurcation among issuers and encourage selectivity.
- Stretched valuations limit the cushion from carry. A stable macro backdrop should keep spreads tight, but the balance of risk and rewards favors neutrality.

Emerging Market (EM) Debt

- EM local-currency debt offers a compelling opportunity as instability within developed markets, Fed easing and expectations for a weaker US dollar could create powerful tailwinds for assets denominated in EM currencies.
- The fiscal weakness in developed market economies strengthens the case for EM exposure, in our view, potentially improving risk-adjusted returns.
- We believe corporate governance improvements justify tighter EM risk premiums and should help to boost inflows of foreign capital.

Allocation Views

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The hallmark of our approach is a central forum—the Investment Strategy and Research Committee (ISRC)—which generates a top-down view across asset classes and regions. Furthermore, it connects and synthesizes the bottom-up sector and regional insights of the global investment teams at Franklin Templeton. The ISRC also calibrates firmwide views with original analysis from our dedicated teams, which include both fundamental and quantitative research professionals.

FTIS actively engages with clients in an ongoing, collaborative partnership, to understand each client's particular needs and then to draw from our extensive global resources and capabilities to meet those goals. These portfolios are built, managed and monitored in the framework established by the ISRC, and undergo rigorous tests under multiple scenarios and market regimes.

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