

Franklin Templeton Investment Solutions

Allocation Views

The deficit dilemma



Summary

Despite the positive newsflow as of late, much economic uncertainty remains across a medium-term horizon. Leading indicators of US growth have moved into regimes synonymous with negative equity returns, while consumer sentiment and CEO confidence remain weak and inflation expectations have risen.

A new dimension adding further uncertainty to the investment equation is the wide-ranging tax cuts that President Trump hopes will offset any drag on growth from tariffs. This may reduce the US Federal Reserve's ability to cut interest rates in support of the US economy and expand the fiscal deficit, adding further upward pressure on long-term US Treasury yields.

Against this background, we remain neutral on equities, as we assess the impact of ongoing tariff policy. Elsewhere, we favor cash over fixed income, as deficit concerns add uncertainty and erode the attractiveness of US duration.

Macro themes

Softening growth

- Leading economic indicators suggest growth is slowing.
- Forward-looking survey data indicate growth is likely to decelerate further. However, labor market data remains resilient.
- Volatile US tariff policy continues to fuel uncertainty, discouraging investment and depleting “animal spirits” over time.

Uncertain inflation outlook

- Significant progress has been made, although it has been bumpy, and inflation is still above targeted levels.
- Consumer survey data suggest a marked rise in inflation expectations, influenced by aggressive US trade policy.
- Markets are expecting transitory inflation, but we believe the macro backdrop is quite complex, adding to our uncertain outlook.

Divergent policy outcomes

- Fiscal policy in major economies such as the United States, Germany and China has become an influential driver of asset prices, notably US tax cuts.
- We expect a divergence of policy outcomes among Western central banks, as the Federal Reserve (Fed) adopts a “wait-and-see” approach to interest-rate strategy, against a changing US economic backdrop.
- Compared to developed economies, emerging market (EM) central banks have more room to implement policy easing, dependent on trade negotiations.

Portfolio positioning themes

Staying neutral, for now

- Positive news on tariffs has strengthened equity momentum, creating a more constructive setup in the near term.
- However, inconsistent US policy threatens to amplify uncertainty over the medium-term, dampening growth and fueling inflation.
- Against this background, we are recalibrating expectations for equity returns against ongoing market volatility.

US (un)exceptionalism

- We retain our pessimistic view of the United States, particularly small-cap stocks, amid heightened uncertainty and lower earnings guidance.
- The appeal of some international markets has improved, notably Australia and Canada, as both appear likely to benefit from low tariff sensitivity.
- We are optimistic on EM ex China, recognizing relatively healthy earnings growth and a more constructive macro backdrop.

Selective on duration

- US duration may not act as a defensive hedge amid inflation uncertainty, fiscal sustainability concerns and higher-term premiums.
- Markets have scaled back expectations around the depth and duration of interest-rate cuts, curtailing support for bonds.
- Within global fixed income, we prefer eurozone duration while we monitor the impact of tariffs on inflation and growth.

A continuous flow of positive tariff news has helped global equity markets erase most of the losses incurred since the beginning of April. However, as the consequences of US trade policy remain unclear, investors should decide how best to interpret this short-term optimism.

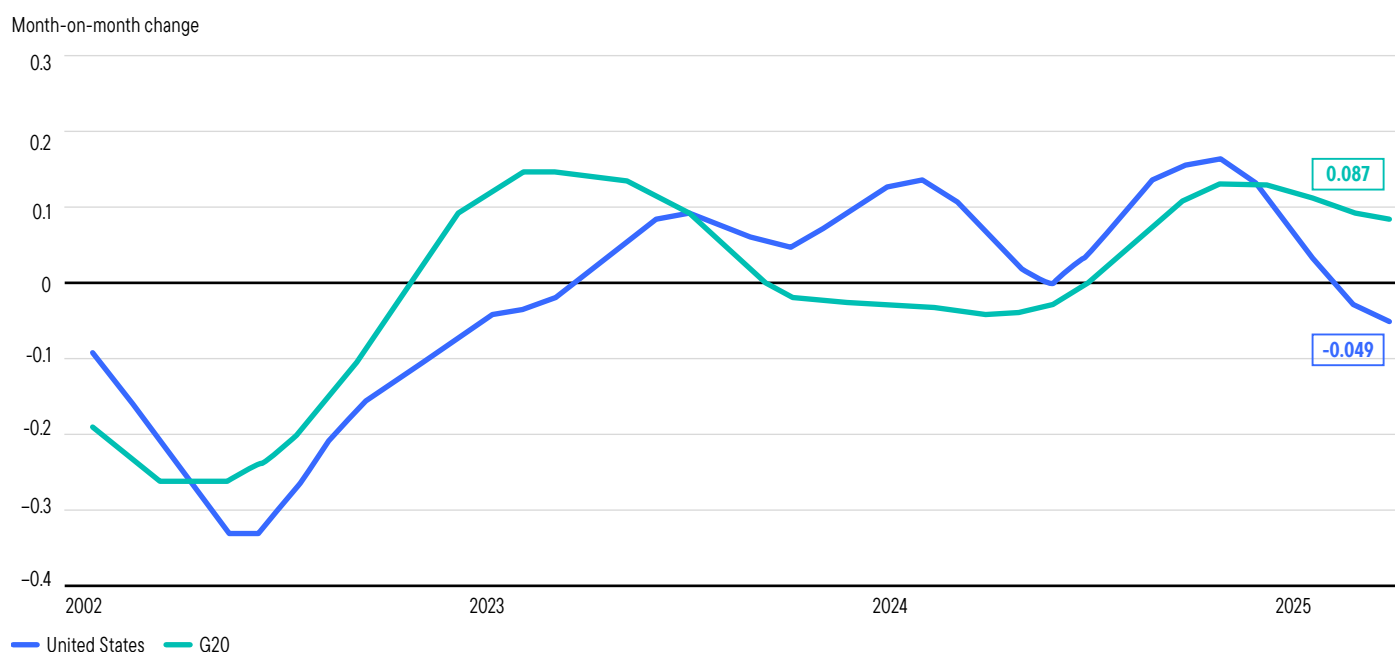
In last month's Allocation Views, we advocated selling into strength, as we highlighted an elevated medium-term risk of recession in the United States linked to slowing growth and persistent inflation. However, there are a few positive near-term tailwinds that we want to assess before "selling the rips," namely positive momentum due to stock prices trending above moving averages, constructive newsflow from trade deal announcements, and US judicial rulings that may alter the

Trump administration's approach to tariff policy. While we have made progress on these items, we still view it as too early to change positioning.

Despite the positive newsflow as of late, much economic uncertainty remains across a medium-term horizon. Hard US economic data for employment, growth and inflation looks resilient, but forward-looking indicators are weaker, suggesting that tariffs are yet to fully manifest in the real economy. Leading indicators of US growth have moved into regimes synonymous with negative equity returns, while consumer sentiment and CEO confidence remain weak and inflation expectations have risen.

Leading Indicators of Growth Have Weakened in the United States but Are More Resilient Globally

Exhibit 1: A Comparison of Growth Trends in the United States and G20 Countries Using the OECD Leading Economic Index



Sources: OECD, Macrobond. As of April 2025. See www.franklindatasources.com for additional data provider information.

One likely explanation for this disconnected data is that importers were successfully front-running tariffs by stockpiling inventory before tariffs were implemented. Forward-looking negativity also reflects the reality that, despite broad positivity since "Liberation Day,"¹ the volatility of trade policy and uncertainty has not waned. Similarly, despite some progress, the effective tariff rate applied to imports into the United States has still increased substantially.

Trailing earnings growth for US companies looks healthy, against first-quarter activity unhindered by tariffs. However, strong earnings results have had little impact on stock prices, while poor results have resulted in price declines. Forward earnings revisions have been downgraded, and guidance is cautious, suggesting a fragile trading environment across a range of industries, amid a tariff-induced slowdown.

According to FactSet, 68 out of 107 S&P 500 companies issued negative earnings guidance in the first quarter of 2025. This represents a figure of 64%, which is above the five- and 10-year average. In addition, 27% of companies have lowered their 2025 expectations, while only 9% have raised them, highlighting pessimism among executives. The industrials, consumer discretionary and information technology sectors are the worst affected, reflecting issues such as the higher cost of imported parts, global supply chain uncertainties and changing consumer behavior.

A new dimension adding further uncertainty to the investment equation is the wide-ranging tax cuts that President Trump hopes will offset any drag on growth from tariffs. This level of stimulus is likely to be inflationary, especially in the first few years, as much of the projected tax revenue from the "One Big Beautiful Bill Act" is expected to be raised in the latter part of its 10-year reconciliation window.

This may reduce the US Fed's ability to cut interest rates in support of the US economy. The tax cuts are also unlikely to be fully funded by tariffs, in our view, expanding the fiscal deficit and adding further upward pressure on long-term US Treasury yields.

Against this background, we remain neutral on equities, as we assess the impact of ongoing tariff policy. Elsewhere, we favor cash over fixed income, as deficit concerns add uncertainty and erode the attractiveness of US duration.

From a regional perspective, we retain our underweight allocation to US equities amid concerns about weak macro conditions, negative earnings revisions and poor technical momentum, amid expensive valuations. Leading growth indicators are weaker in the United States than in other regions and we believe they are set to weaken further as management teams curtail capital investment against an uncertain outlook. Price momentum and market breadth are also weak, with many investors viewing the geographically diversified revenue streams of “Magnificent Seven” firms² as a defensive play, despite outsized exposure to reciprocal tariffs.

Within US equities, we remain more pessimistic toward small-cap stocks. Lower valuations reflect weak trailing earnings momentum and earnings revisions, rather than mispricing, as the proportion of small firms with negative earnings rises. Small-cap companies are also more vulnerable to US stagflation, in our view, due to their domestic revenue focus and relatively higher debt levels compared to their size.

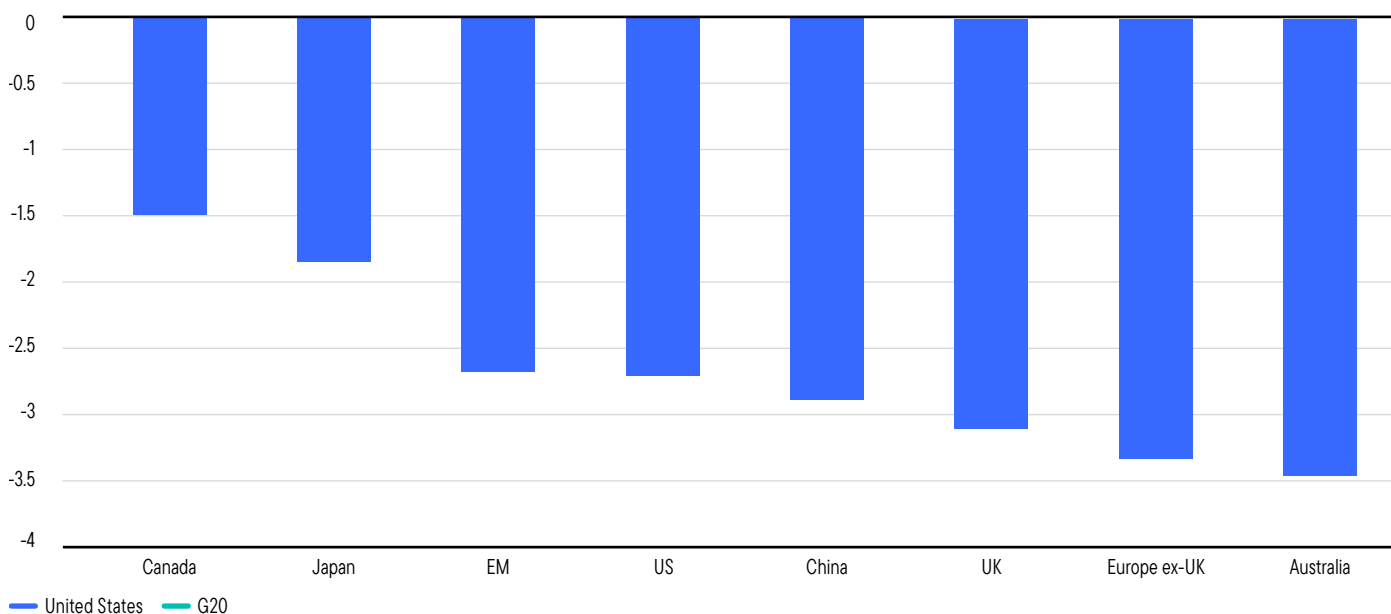
Conversely, we hold a more optimistic view of international markets that are less sensitive to tariff policy, notably Australia and Canada, which we believe are well-placed to outperform other markets, amid ongoing trade uncertainty. Australia currently has a trade surplus with the United States, while its export revenues are also well-diversified, due to close ties with other Asia-Pacific economies. In addition, the country has strong policy flexibility to offset any impact on growth or inflation caused by tariffs. We also believe Canadian equities will likely perform well, benefiting from a range of tariff exemptions that mean 80% of its current trade with the United States is unaffected. Canada also runs a trade surplus with the United States, if a heavy reliance on Canadian oil is discounted, meaning it should secure favorable terms in any future trade negotiations.

Taking a different perspective, we have become more optimistic on EM ex-China equities, largely because they have the potential to benefit from any further easing of US trade policy. The shift away from US exceptionalism appears to have already boosted EM ex-China stocks, which have outperformed US equities in the year-to-date period until the end of April. They are also exhibiting stronger trailing and forward earnings growth than their developed market counterparts. The recent sharp reduction of tariffs on China will likely benefit some EM ex-China economies indirectly, particularly those that export into China, such as Taiwan and South Korea. Equities in this region are undervalued, in our opinion, given that recent inflows have not fully replaced a significant flight of capital away from the region during the last few years.

Earnings Expectations for Canadian Companies Are Healthier Than in Other Regions, Helped by Lower Exposure to US Tariffs

Exhibit 2: Revisions to Forward Earnings Expectations for the Next 12 Months

Three-month percentage change



Sources: IBESW, Macrobond. As of April 29, 2025. See www.franklindatasources.com for additional data provider information. There is no assurance that any estimate, forecast or projection will be realized.

Turning to fixed income, our view on US duration has been adversely impacted by President Trump's tax bill, which will increase the US fiscal deficit. The Joint Committee of Taxation estimates that the bill as written would increase deficits by US\$3.8 trillion through 2034, or 1.1% of US gross domestic product (GDP). If the policies are extended permanently, we estimate it would add US\$5.3 trillion to deficits, or 1.5% of GDP.³ In our assessment, income from tariffs would not entirely balance the increased deficit, and the impact of tariffs on growth would likely offset any fiscal stimulus from the cuts.

This aggressive fiscal policy has raised inflation expectations and shaken faith in the US government as a risk-free borrower, leading term premiums to rise. Foreign investors, notably sovereigns, have responded by reevaluating their exposure to

the United States and redistributing risk elsewhere. This move is being exacerbated by shrinking trade deficits, which means foreign entities have less money to invest in US assets.

The depth and liquidity of the US Treasury market is impossible to replicate, but greater sovereign bond issuance in Europe, in line with fiscal stimulus measures, could absorb some demand. We believe this dynamic could, in time, erode the importance of US Treasuries to global fixed income investors. Even a relatively small reduction in holdings by foreign sovereigns could see more price-sensitive buyers demanding higher yields to absorb additional US Treasury supply. As a result, we are taking an underweight position in US duration, on the expectation that the yield curve will likely steepen further.

Inconsistent US Tariff Policy Is Fueling Economic Uncertainty

Exhibit 3: Changes to the Effective Tariff Rate on US Imports (January 2025–June 2025)

Date	Event / Tariff Change	Approximate Effective Tariff Rate (%)	Change
January 20, 2025	Trump inauguration; baseline tariffs	~3%	
February 4, 2025	10% tariff on China imports	~3.5%	▲
March 4, 2025	Tariffs: 10% China, 10-25% Canada, 25% Mexico	~12%	▲
March 7, 2025	USMCA exemption	~8.5%	▼
March 12, 2025	25% tariffs on steel & aluminum	~14% (weighted)	▲
April 2, 2025	10% across-the-board tariffs imposed ("Liberation Day")	~22.5%	▲
April 3, 2025	25% tariffs on autos	~23%	▲
April 5, 2025	10% tariffs on most countries	~20%	▼
April 9, 2025	China retaliation tariffs	Peak ~27%	▲
April 11, 2025	Exclusions on smartphones, computers, chips	17.4%	▼
May 3, 2025	25% tariffs on auto parts	~22%	▲
May 8, 2025	US-UK trade deal relief	17.8%	▼
May 14, 2025	US-China truce	15.10%	▼
June 4, 2025	Steel and aluminum tariffs doubled to 50%	~17%	▲
June 5, 2025	Federal court blocks most IEEPA tariffs	6.90%	▼
June 8, 2025	Appellate court temporarily reinstates tariffs	Raises rate back up to ~14.5%	▲

Sources: Yale Budget Lab / Wolfe Research/ Visual Capitalist.

In contrast, we are positive on European government bonds, as the eurozone has yet to put in place a memorandum of understanding (MoU) with the United States. The region could still be subject to punitive tariffs that would materially damage growth and increase the odds of recession. In addition, subdued inflation gives room for the European Central Bank (ECB) to cut interest rates further, while fiscal stimulus measures would need time to take effect.

Elsewhere, credit conditions have deteriorated somewhat in the face of heightened uncertainty and slowing growth. High-yield bonds have been resilient compared to equities, but we have found that the correlation to stock performance generally

risers alongside the odds of a recession. Spreads have narrowed in May, retracing much of the widening seen in April, but credit stress remains a factor, impacting financial conditions. Richer valuations alongside the possibility of further downside risks sees us remain neutral as we await further developments.

We also remain neutral on EM debt, despite EM central banks showing a willingness to ease policy to counter slowing growth. A weaker US dollar should provide further support to local-currency issues, but tight spreads appear to be underpricing recession risks against a background of ongoing tariff uncertainty.

Allocation settings views—June 2025

Pendulum settings reflect cross-asset-class views

High level allocation tier

Equities



- We retain a neutral stance toward risk assets amid US policy uncertainty. Our conviction toward global equities remains challenged by the magnitude and inconsistency of recent policy changes.
- However, positive news flow and expectations around trade negotiations support equity market momentum, stopping us from moving underweight.
- We hold a preference for EMs and international markets with lower sensitivity to US tariffs.

Bonds



- US duration may be a less defensive hedge amid elevated inflation and concerns about the perceived “safe haven” status of US Treasuries.
- Revenue from US tariffs is unlikely to fully offset the additional cost of tax cuts that were recently announced by President Trump.
- As a result, we have moved to an underweight position in bonds, notably US duration, as increased fiscal policy uncertainty is putting upward pressure on longer-term yields.

Alternatives



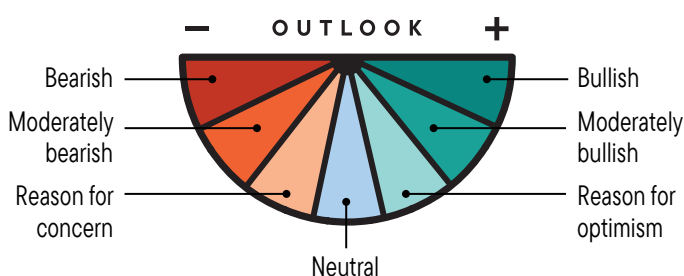
- We see structural attractions in naturally diversifying alternatives such as private assets.
- Continuing changes to usage and demand present headwinds to real estate.
- We have maintained a neutral view overall, consistent with our longer-term structural allocation.

Cash



- The current macro backdrop complements the defensive features of cash.
- Cash or short-term US Treasury bills offer an opportunity to lower our portfolio’s interest-rate sensitivity during a period of fiscal policy uncertainty.
- Elevated short-term yields offer attractive risk-free returns.

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 a deterioration in US fundamentals, increasing the chances of a recession. Growth stocks have historically shown high sensitivity to weak growth regimes.
- Market breadth and price momentum are relatively weak in the United States, in comparison to other equity markets.
- The broad information technology sector, including three members of the Magnificent Seven, generated more than half of its revenue abroad in 2024. Retaliatory tariffs are a critical pain point.

Value

United States



- Leading growth indicators are relatively weaker for the United States than other regions, while estimates for US earnings per share (EPS) growth appear too optimistic.
- Forward earnings growth expectations estimate a convergence between value and growth over the next 12 months.
- Trade deals are also important to the United States, given tariffs could meaningfully impact production costs across many US industries.

Small Cap

United States



- Small-cap earnings are more sensitive to cyclical macro factors than large-cap stocks.
- Small-cap valuation compression reflects relative earnings underperformance, rather than pure sentiment or mispricing.
- As a result, revisions to small-cap earnings are more negative, leading us to a bearish view.

Canada



- Current exemptions mean that Canada has the lowest effective tariff rate among our investable regions.
- Canada has a trade surplus with the United States (excluding oil), making a concrete trade deal more likely.
- Canada has had a relatively small downgrade to EPS expectations over the last three months. Ongoing monetary and fiscal policy stimulus should support further growth.

Europe ex United Kingdom



- Easier ECB monetary policy and increased fiscal stimulus may support the European economy against a background of falling inflation and stabilizing growth.
- European markets exhibit attractive valuations, improved breadth and positive earnings expectations relative to US stocks.
- However, geopolitical uncertainty and tariff threats remain a headwind, as do weak consumption and low consumer confidence.

United Kingdom



- The United Kingdom has limited sensitivity to US tariffs, given its trade surplus with the United States and a differentiated services-led export base.
- However, there is limited fiscal policy flexibility to support growth, while a recent uptick in inflation may make it harder for the Bank of England to stimulate the economy.
- In this context, we retain a neutral view of UK stocks, supported by their defensive characteristics during periods of volatility.

Allocation tier

Asset class

Conviction

Our viewpoint

Japan



- Japan is dealing with inflationary pressures that have resulted in tighter monetary policy, but equity markets appear to have broadly discounted this development.
- Market breadth has improved, and trailing earnings growth looks favorable, but heavy exposure to US automotive parts tariffs is a cause for concern.
- Against this background, we retain a neutral view on Japanese equities, amid fragile demand conditions.

Australia



- The Australian economy stands out as one of the least-sensitive regions to US tariff policy.
- Australia's exports to the United States are the lowest share of total exports among our investable regions.
- The country has strong policy flexibility to navigate additional tariff pressures. However, potential future deals that would negate the effects of tariffs on other regions could hurt this optimistic view.

Emerging ex China



- Forward earnings growth expectations are stronger for EMs than their developed market (DM) counterparts. Earnings revisions are also relatively healthy.
- The rollback of reciprocal US tariffs benefits EM assets directly and indirectly, given many EM firms have significant trade links with China.
- EM central banks have room to stimulate their economies if necessary.

China



- China has demonstrated a strong ability to reroute US bound exports through other countries, while the effective tariff rate the United States has imposed on China has fallen in recent weeks, boosting trade further.
- However, most Chinese corporate revenues are derived domestically, at a time when the country still faces significant macro and structural headwinds.
- The Politburo could implement more fiscal stimulus in July, but consumer confidence remains low, partially due to headwinds in the property sector.

Fixed income sectors: Pendulum settings relative to fixed income asset class broadly

US Treasuries










- The yield curve could steepen further during the next few months, as tax reductions lead to larger fiscal deficits. Widening deficits may reduce foreign ownership of US Treasuries and increase dependence on price-sensitive purchasers.
- However, tariffs introduce opposing forces on yields, as lower productivity lowers the natural rate of interest, while fiscal uncertainty pushes term premiums higher.
- Ultimately, we prefer the less interest-rate sensitive portion of the US Treasury curve.

Eurozone Government Bonds



- The ECB remains relatively dovish in its approach, as euro-area inflation falls toward target and growth remains relatively weak. Falling wage pressures should help to ease inflation further.
- US tariffs are likely to slow eurozone growth further, increasing the odds of recession.
- Against this background, we retain our constructive stance toward these assets.

Allocation tier

Asset class	Conviction	Our viewpoint
UK Government Bonds		<ul style="list-style-type: none"> The UK economy is slowly recovering and should be boosted by a trade deal with the United States, but inflation remains persistent. The Bank of England must balance these competing forces but is likely to view weak growth as a greater priority than sticky inflation, in our view, particularly given a lack of fiscal support. We hold a neutral view of UK Gilts, preferring the upside potential of eurozone bonds.
Canada Government Bonds		<ul style="list-style-type: none"> Tariff exemptions should support the economy, while leading indicators remain healthy. However, falling commodity prices linked to slowing global growth could negatively impact the Canadian economy. Inflation appears to be relatively subdued, allowing the Bank of Canada to continue with its rate-cutting cycle if required. Against this background, we hold a neutral view of Canadian bonds.
Japan Government Bonds		<ul style="list-style-type: none"> The Bank of Japan has moved away from negative interest rates and is beginning to tighten monetary policy. Japanese bond yields fell sharply following US tariff announcements in early April but have since rebounded in response to higher policy interest rates. We remain neutral on Japanese bonds, given persistent inflation pressures could mean the policy rate rises further.
Australian Government Bonds		<ul style="list-style-type: none"> The Reserve Bank of Australia (RBA) cut interest rates at its May meeting as annual trimmed mean inflation fell below 3% for the first time since 2021. Global economic developments are likely to overwhelm local monetary policy, but positive trade negotiations could favor Australian risk assets. However, uncertainty about the final scope of tariffs and policy responses in other countries has contributed to a weaker outlook for growth and employment in Australia.
Investment Grade		<ul style="list-style-type: none"> The investment-grade sector has benefited from resilient corporate fundamentals. Spreads have narrowed somewhat in May, retracing widening in April, and making the risk/return profile less attractive. Against this background, we hold a neutral position in higher-quality credit, preferring the defensive features of government bonds.
High Yield and Loans		<ul style="list-style-type: none"> High-yield credit has been resilient compared to equities, but the beta of high-yield credit to equities rises alongside the odds of a recession. We believe these odds are not fully priced in. Leading indicators of growth have deteriorated, while greater credit stress, higher interest rates and leverage are also a headwind. Spreads appear tight, having retraced most of the widening we saw in April, but all-in yields remain relatively attractive.
Emerging Market (EM) Debt		<ul style="list-style-type: none"> EM debt should benefit from easier monetary policy from EM central banks, in the event that US tariffs act as a drag on growth. However, hard currency EM debt spreads are tight and appear to be underpricing recession risks and trade-induced volatility. As a result, we hold a neutral outlook on EM debt while we await greater clarity in the coming months.

Allocation Views

At **Franklin Templeton Investment Solutions (FTIS)**, we translate a wide variety of investor goals into portfolios powered by Franklin Templeton's best thinking around the globe. We serve a variety of institutional clients, ranging from sovereign wealth funds to public and private pension plans in addition to retail multi-asset clients around the world.

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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Endnotes

1. The Trump administration named April 2, 2025, "Liberation Day" following the imposition of what was dubbed "reciprocal tariffs" on US trading partners.
2. The "Magnificent Seven" are Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla.
3. There is no assurance that any estimate, forecast or projection will be realized.

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.

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. Changes in the credit rating of a bond, or in the credit rating or financial strength of a bond's issuer, insurer or guarantor, may affect the bond's value. **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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