

Global Macro Insights

Summary

May overview: Tariffs continued to dominate the May news cycle, as financial markets tried to come to grips with outcomes and some tariff-related effects surfaced in economic data. Actual inflation outcomes are still benign so far, but concerns remain about the impact of tariffs. Developed market central banks continued the cautious easing cycle in May, with some staying on hold and others reducing rates at a moderate pace. Policymakers continue to voice concern about the effects of tariffs on growth and inflation. The US dollar (USD) weakened modestly against most currencies over the course of the month. US bond yields rose on a credit rating downgrade and fiscal concerns. Sovereign bond yields were also higher across most other developed markets but mixed among emerging markets.

Outlook: Tariffs pose downside risk to growth and upside risk to inflation. We continue to monitor policy developments under the new US presidential administration for their possible effects on the economy and financial markets, and to identify which countries are likely to be positively or negatively affected by the new tariff environment. Other risks to the growth and inflation outlook include geopolitical developments, such as ongoing conflicts. Global monetary policy is broadly expected to remain in a moderate downward cycle (with the principal exception of Japan), but tariffs pose a threat here too. We believe the USD remains broadly overvalued even after its depreciation this year, and our portfolios focus on specific currencies and bonds where we see value across both developed and emerging markets.

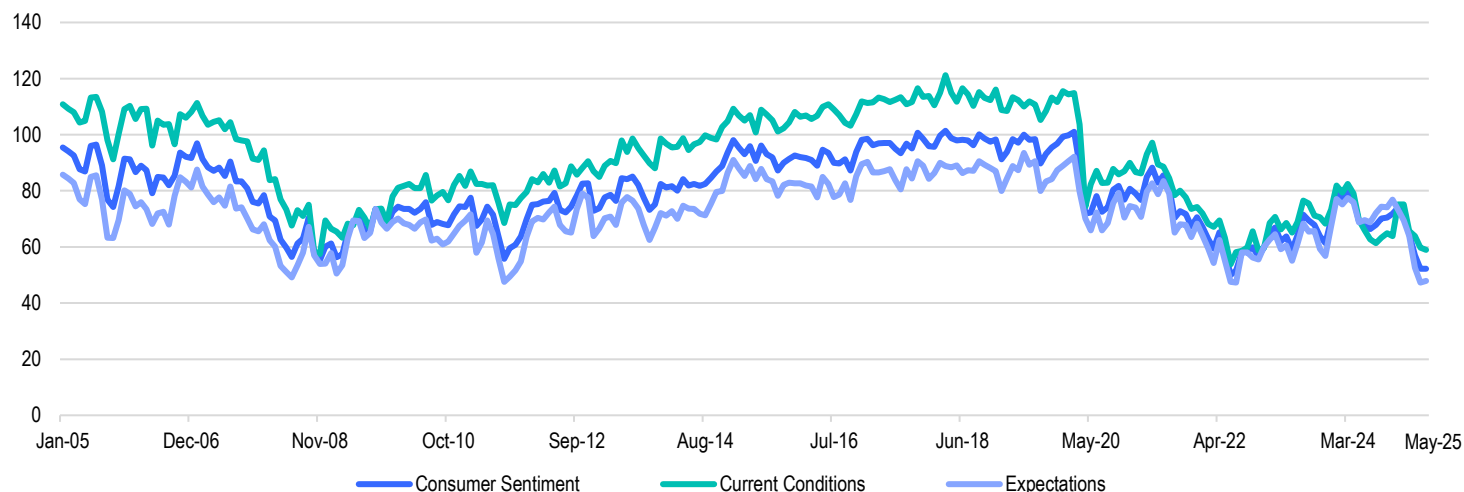
General market and economic overview

As the back-and-forth on tariff negotiations continued over much of May, financial markets tried to align with outcomes.

Sentiment surveys in both the United States and elsewhere mostly continued to show the negative effects of both uncertainty and tariff expectations on consumer and business confidence, though some were better than prior readings. The latest University of Michigan consumer confidence survey again recorded sentiment falling while inflation expectations leapt. Manufacturing purchasing manager indexes are soft while services are more resilient, but still close to break-even. The labor market remains resilient, with the unemployment rate at 4.2%. Tariffs are likely the reason that US imports jumped (due to front-loading ahead of tariff increases), with the corollary that exports increased in a number of Asian countries (including China and South Korea) as well as Canada. As geopolitical shifts continue around US tariff imposition, China and the European Union (EU) are taking steps to warm relations while the United States and United Kingdom announced a trade deal. Political developments included German Chancellor Merz being elected by Parliament, a short-lived conflict between India and Pakistan, and elections in Australia and (just after month-end) presidential elections in Poland.

US Consumer Sentiment Remains Weak Amid Tariff Uncertainty

Exhibit 1: University of Michigan Consumer Sentiment Survey (Index, 1966 = 100)



Sources: University of Michigan. There is no assurance that any estimate, forecast or projection will be realized.

After strengthening earlier in the month, the USD fell back thereafter to end the month little changed. The US Dollar Index (DXY) edged down by 0.1% over May, bringing its year-to-date loss to 8.1%.¹ On a broader basis, most currencies were largely flat or modestly higher against the USD over the month, though a few currencies depreciated.

Recent inflation progress has been uneven across countries. US headline Consumer Price Index (CPI) inflation edged down by 0.1% to 2.3% year-over-year (y/y) in April, while core CPI was unchanged at 2.8% y/y, still its lowest level since early 2021. Preliminary euro area (EA) inflation data fell to 1.9% in May (from 2.2% in April). Inflation in Japan was unchanged and still robust at 3.6% y/y in April, with its current headline inflation rate remaining the highest among the G10. Tariffs have introduced upside risk to the inflation outlook in a number of countries.

Developed markets mostly remain in moderate monetary easing cycles, with an already-cautious approach toward the pace of rate cuts underlined with uncertainty over the effects of tariffs. The US Federal Reserve (Fed) kept rates on hold in May, while Australia and the United Kingdom cut rates on contained inflation outlooks. Though the Bank of Japan (BoJ) remains an exception to other developed markets as it is in a tightening cycle, it also left rates unchanged in May; the last rate increase was in January 2025.

By contrast, a number of emerging markets are much further into their easing cycles, with some now slowing or pausing their rate cuts while a couple of countries are already raising rates again. In Latin America, Brazil raised rates again in May. Across other emerging markets with May policy meetings, central banks either remained on hold or eased moderately. China eased a variety of monetary measures in May to cushion the economy, likely in anticipation of negative effects from tariffs.

Developed market sovereign bonds mostly drifted higher in May. Moody's downgraded the US credit rating to Aa1 from Aaa, becoming the last of the three major ratings agencies to strip the United States of the highest credit rating. This added to tariff uncertainty and the expansionary fiscal proposals under consideration in the United States to undermine bonds there. The yield on the 10-year US Treasury note rose 24 basis points (bps) over the month to 4.40%, while in the EA, the benchmark German Bund yield rose 6 bps to 2.50%. Japan's 10-year government bond yield rose by 18 bps to 1.49% in May, off its most recent peak but still close to its highest levels since 2009, partly due to reduced government purchases and weak investor demand.

Emerging market local-currency bond yields were mixed over the month. Yields generally fell in Asia and in South Africa, while rising in emerging Europe and showing mixed performance in Latin America. Overall, local-currency emerging market indexes rose in May. Emerging market sovereign debt also generally gained in May. The JP Morgan Emerging Markets Bond Index Global (EMBIG Global) rose by 0.9% in the month.²

Outlook and positioning

Tariffs have jeopardized the view that US and global growth will have a soft landing. Regardless of where tariffs actually settle, the prevailing uncertainty is likely to be detrimental to investment as well as some types of consumer spending. Globally, growth is likely to be weaker as the effects of tariff impositions play out. That said, we do not expect an outcome of deep recession. In the United States, consumers remain relatively healthy, and the Fed has several tools at its disposal to help cushion growth. In Europe, external headwinds include tariffs, though sentiment about domestic growth prospects improved following the announcement of the ReArm Europe Plan in March. Japan's structural shift toward reflation continues, though tariff uncertainties could weigh on growth in the near term. The International Monetary Fund's latest World Economic Outlook forecasts global growth at 2.8% in 2025 and 3.0% in 2026. Emerging markets are expected to grow by 3.7% in 2025 and 3.9% in 2026, while advanced economies are projected to grow 1.4% this year and 1.5% next year. Within emerging markets, Asia (forecast at 4.5% growth in 2025 and 4.6% in 2026) remains the strongest region.³

Risks have also risen around the inflation outlook. Although the global inflation cycle is currently in a downtrend, shorter-term setbacks in some countries may become more permanent if tariff-related increases result in second-round effects to become embedded in inflation. A rise in inflation expectations (in some instances to multiyear highs) across a range of consumer surveys raises concern in this regard, and a range of central banks—including the Fed—have highlighted the potential risks to inflation. In addition, the final outcome of the US budget bill may complicate the inflation outlook. We will monitor developments on these fronts.

Global monetary policy trends became asynchronous during the easing cycle, and the current heightened uncertainty adds to forecast risk. Cycles have become desynchronized, with various countries at different stages of their easing cycles; Brazil is already beyond the end of its easing cycle and raising rates again. Japan remains a notable exception to the global-inflation and interest-rate downtrend, as the BoJ continues to normalize policy in response to reflationary conditions. Global risks around tariffs are significant here too, and a number of central banks have highlighted tariff uncertainty as clouding the interest-rate outlook.

The tariff and policy outlook emanating from the United States cast some clouds over a generally positive emerging markets environment. Sounder policies and reforms in a number of emerging markets have led to improved economic fundamentals, while we also expect various emerging markets to benefit from reshoring initiatives. Wherever tariffs finally settle, different countries will likely benefit or suffer from the trade realignments that will follow. In general, we think the imposition of tariffs will likely also underpin the current global trend of regionalization and reshoring. Possible lower global capital flows in the current environment may also pose a risk to some countries. Moreover, some countries generally remain more vulnerable to weaker fundamentals, and some will be hurt more than others by tariffs and changing US foreign policy. We therefore closely monitor idiosyncratic factors in different countries to identify relative valuation opportunities among countries.

In our view, the USD remains broadly overvalued. While some currencies may stay soft or weaken against the USD, we expect a number to gain against the greenback. This view factors in cyclical factors (interest rates and slowing growth) and structural ones (particularly the United States' twin current account and budget deficits), as well as a pivot in financial asset flows away from the United States from investors (and sometimes officials) reacting to the new US administration's policies. With this as a base view, we see opportunity in non-dollar assets in select countries within both developed and emerging markets.

On a regional basis, we find select countries in the Asia-Pacific region attractive. We focus on countries with positive fundamentals and undervalued currencies, as well as those we expect to be more insulated from tariff effects. We expect the Japanese yen to benefit from Japan's structural reflationary shift and monetary policy normalization, as well as reshoring. Australia has solid macroeconomic fundamentals, which should provide upside potential while limiting downside risk. In India, continued progress with structural reforms and benefits from reshoring underpin a positive view. Malaysia is well entrenched in the global supply chain and is also likely to benefit from reshoring. We also believe all these countries are relatively more protected against tariffs. We expect the Chinese authorities to continue a trend of supporting domestic growth when needed, which should help underpin its Asian neighbors and trading partners.

In Latin America, we favor countries with prudent macroeconomic policies, relatively high yields and what we regard as undervalued currencies. The independence of central banks in certain countries and resultant proactive monetary policy is a key strength, in our view. Additionally, Mexico's geographic proximity to the United States has made it an attractive destination for nearshoring. We can expect to see some political campaigning ahead of midterm elections in Argentina later this year and general elections in Brazil and Colombia in 2026, and we will monitor potential implications for policy.

Beyond these two broad regions, which remain our largest regional exposures, we also see opportunity in certain emerging and frontier markets in both local-currency and hard-currency assets. In our assessment, certain African countries have seen fundamentals improve noticeably and offer attractive opportunities for potential yield pickup, and we have increased exposure in some portfolios in select African countries, as well as certain countries in frontier Asia.

In local-currency positions, we favor select countries in both developed and emerging markets where we see value in their currencies, bonds or both. We remain highly selective at the sovereign level, given significant variations in economic fundamentals and policy responses. Our portfolios are constructed to capture potential upside in currencies we consider to be undervalued against the USD, while we also hold net-negative positions in others where we have identified specific weaknesses. Our long currency exposures focus on countries with strong trade dynamics, sustainable current account positions, better fiscal management and stronger growth potential. In bonds, we hold positions in select countries where we identified opportunities from various factors, including inflation and interest-rate outlooks, fiscal progress and other economic reforms and/or reshoring. We aim at 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 resilient fundamentals and attractive risk-adjusted yields.

Given the current stage of the global rate cycle, as well as improving fundamentals and policy responses in some emerging and frontier markets, we have expanded our holdings in **select hard-currency-denominated sovereign credit.**

Geopolitics have impacted markets significantly at times over the past few years, and we continue to closely monitor developments.

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Endnotes

1. Source: Bloomberg. The DXY measures the value of the US dollar relative to a basket of foreign currencies, often referred to as a basket of US trade partners' currencies. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future performance.** See www.franklintempletondatasources.com for additional data provider information.
2. Source: Bloomberg. The JP Morgan EMBI Global tracks total returns for traded external debt instruments in the emerging markets. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future performance.** See www.franklintempletondatasources.com for additional data provider information.
3. There is no assurance that any estimate, forecast or projection will be realized.

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

Concentrations of certain securities, regions or industries is subject to increased volatility. Investment strategies incorporating the identification of **thematic investment opportunities**, and their performance, may be negatively impacted if the investment manager does not correctly identify such opportunities or if the theme develops in an unexpected manner.

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