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In an Unsteady World, Time to (Finally) Tilt Away from U.S. Equities?

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- For many years after the Global Financial Crisis (GFC), U.S. equity markets enjoyed tailwinds that led asset owners to wave the white flag on global diversification. But these tailwinds have abated.
- High U.S. macroeconomic and policy uncertainty alone can justify a benchmark-relative tilt towards non-U.S. equities.
- Moreover, despite slowing relative earnings growth, the valuation gap between U.S. and non-U.S. equities has widened, leaving it vulnerable to sharp repricing from downside shocks in the U.S. or upside surprises abroad.

In 2025, non-U.S. stocks posted their best start to the year (versus the U.S.) in decades. Their relative strength served as a potent reminder of the benefits of global diversification. While historically, investors embraced non-U.S. equity allocations to diversify portfolio risk, exploit regional relative value opportunities, and expand the opportunity set for stock selection, the dominance of U.S. equities and the dollar for more than a decade after the Global Financial Crisis led many to question balanced positioning.

In this note, we reaffirm the rationale for non-U.S. equity allocations in the current environment. Benefits of geographic diversification have increased as the influence of global drivers has weakened, while that of regional drivers has grown. Moreover, leaning towards non-U.S. equities looks compelling in a world marked by heightened macroeconomic and policy uncertainty.

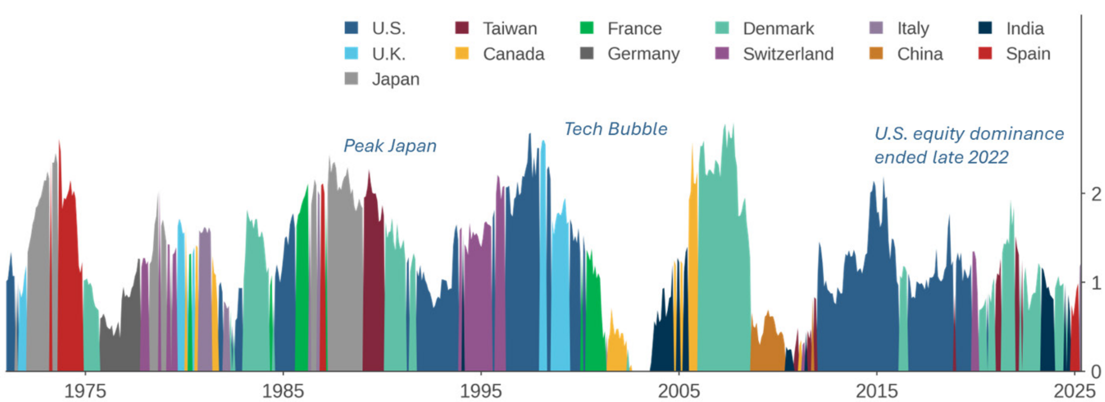
Diversification: Tides Have Turned

Over the past decade, many asset owners started to question the value of global diversification. But several factors that fueled those doubts have subsided.

First, a prolonged era of U.S. stock dominance ended, reducing pressure on allocators to align with it. Since late 2022, several global equity markets have outperformed the U.S. *Figure 1* illustrates this shift with a snapshot of the best-performing country equity market on a rolling three-year basis since 1975. While the U.S. (dark blue) stood out for a decade through 2022, the mix of colors in recent years shows renewed heterogeneity in leadership. As of May 31, 2025, the U.S. only ranked 11th. The chart also highlights that the prior run of U.S. market dominance is the historical exception rather than the rule and that regional leadership can shift quickly.

Figure 1: Best Performing Equity Market across DM and EM

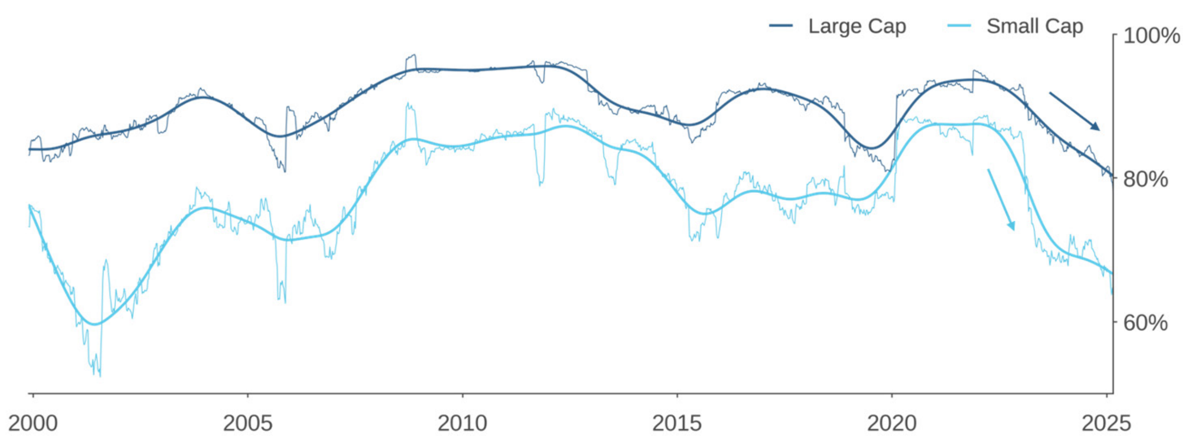
Highest rolling 36-month Sharpe Ratio (USD) by country



Sources: Acadian calculations based on Bloomberg and MSCI Indexes. MSCI data copyright MSCI 2025. All Rights Reserved. Unpublished. PROPRIETARY TO MSCI. For illustrative purposes only. Returns do not reflect actual trading or actual accounts, and they do not include transaction costs. Every investment program has the opportunity for losses as well as profits. Past performance is no guarantee of future results.

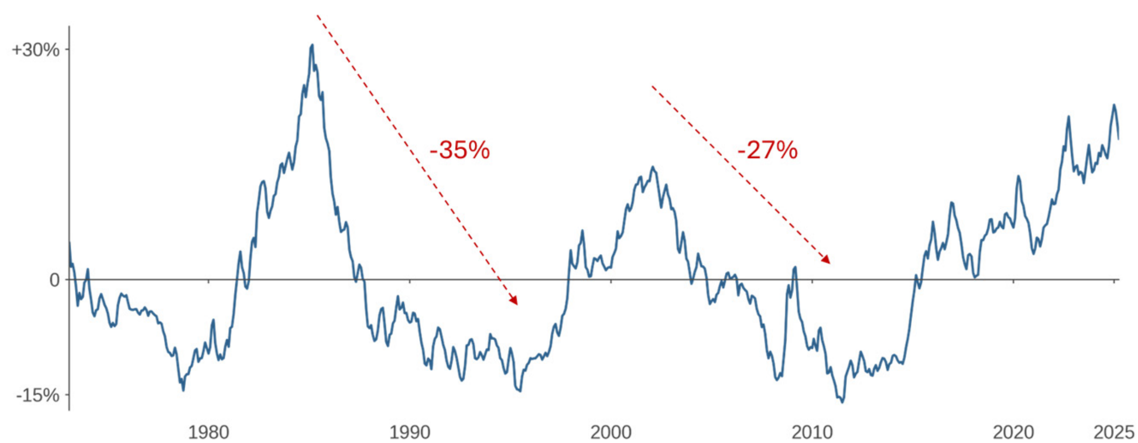
Figure 2: Diminished Influence of Global Drivers

Fraction of returns variation in DM ex-U.S. portfolios explained by select global risk factors



Adjusted R-squareds from 36-month rolling regressions of major market returns on market-based and industry risk factor returns for stocks in the largest and smallest quintiles by market capitalization. Risk factor returns based on a commercially available risk model. The solid lines represent the application of a Hodrick-Prescott filter to the raw data. Sources: Acadian, MSCI Copyright MSCI 2025, All Rights Reserved. Unpublished. PROPRIETARY TO MSCI. For illustrative purposes only.

Figure 3: Real U.S. Dollar Index



Time series splices U.S. Federal Reserve Trade Weighted Real Broad Dollar Index (2006-present) and Real Broad Dollar Index-Goods Only (1973-2005). Source: Acadian based on data from the Federal Reserve. For illustrative purposes only. It is not possible to invest directly in an index.

Second, there are signs that financial market integration has weakened, reversing a decades-long trend. *Figure 2* shows that the fraction of developed markets (DM) ex-U.S. equity returns explained by global systemic drivers has tailed off in recent years, approaching 30-year lows.[1] The decline has been especially pronounced among small-cap stocks (light blue), which tend to be more domestically focused. Decreased influence of global factors on returns leaves greater room for risk reduction from geographic diversification.

Third, years of sustained U.S. dollar strength eroded returns to unhedged non-U.S. assets and reinforced home-country bias among U.S. investors. Against that backdrop, dollar weakness in 2025 took many investors by surprise. Yet *Figure 3* shows that the depreciation has not (yet) been severe in historical terms: the real U.S. dollar index remains not far from its 50-year highs. Given the macro-political environment, these still-elevated levels argue for caution against equity positioning that implicitly assumes further dollar strength. A decline from here could provide a meaningful tailwind for non-U.S. assets: *Figure 3* shows two historical episodes, following the Plaza Accord and the internet bubble, that were both characterized by depreciation of 3–4% p.a. (peak-to-trough losses of 35% and 27%, respectively).

[1] See Bekaert, Geert and Urias, Manuel, "Diversification, Integration and Emerging Market Closed-End Funds," Journal of Finance, American Finance Association, 51 no.3 (1996): 835-869, and Solnik, Bruno and Roulet, Jean-Charles, "Dispersion as Cross-Sectional Correlation," Financial Analysts Journal, 56 no.1 (2000): 54-61, for evidence on persistent diversification benefits linked to structural economic trends rather than cyclical, short-term drivers.

Figure 4: Price-To-Forward Earnings Valuation Ratios

Based on MSCI USA and World ex-USA indexes

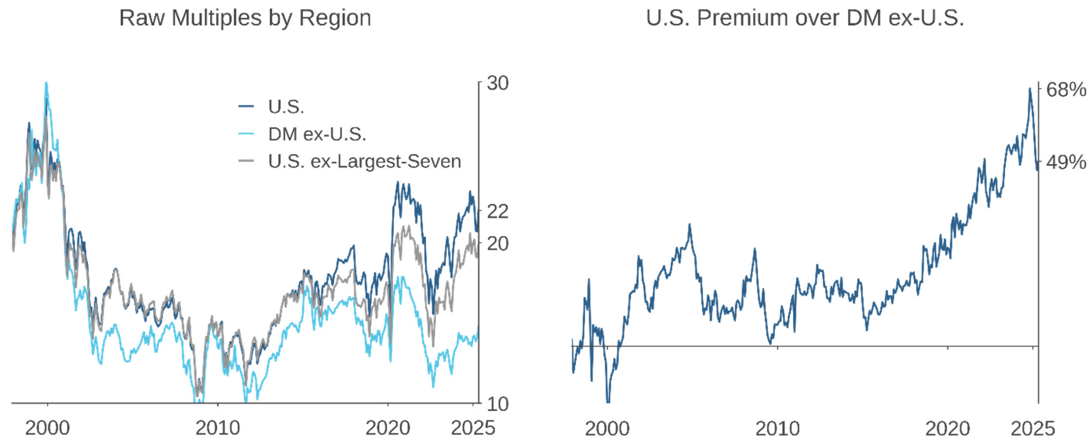


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Table 1: Returns Decomposition – Large-Cap Stocks by Region

Multiple expansion versus fundamentals

	Multiple Change			Cash Earnings Growth		
	U.S.	**U.S. ex-Mag Seven**	**DM ex-U.S.**	**U.S.**	**U.S. ex-Mag Seven**	**DM ex-U.S.**
2023-24	18%	12%	4%	5%	1.6%	4%
2017-21	7%	5%	1%	9%	8%	6%
2000-16	-3%	-4%	-6%	6%	5%	5%

Decomposition of annual total returns of stocks in the top 90th percentile as ranked by USD market cap. Portfolios are market capitalization-weighted and rebalanced annually. Source: Acadian based on data from Worldscope. For illustrative purposes only. The chart represents an educational exhibit and does not represent investment returns generated by actual trading or actual portfolios. The results do not reflect trading costs, borrow costs, and other implementation frictions and do not reflect advisory fees or their potential impact. For these and other reasons, they do not represent the returns of an investible strategy. Hypothetical results are not indicative of actual future results. Every investment program has the opportunity for loss as well as profit.

The "Market Favors the U.S." Outlook: Is that Warranted?

Fueling a case for international equities, current valuations still reflect stretched expectations for companies in the U.S. in contrast to a subdued outlook elsewhere. *Figure 4* provides evidence: Relative to other DM equities, U.S. stocks are trading at a historically high forward-earnings premium, close to +50%.

Yet while the U.S. valuation premium remains high, earnings growth has slowed. Table 1 shows that over the past two years, U.S. equity multiples expanded at a blistering pace, +18% p.a., while earnings growth slowed to 5% versus an average of 9% during the frothy 2017–2021 period. In fact, U.S. multiples have, over the past two years, grown twice as fast as they did from 2017–2021 even though earnings growth has halved.

Some defenders of still-lofty U.S. valuations have justified them based on the potential for further increases in AI-driven capital expenditures and productivity gains. But assumptions underpinning such forecasts should not be taken for granted. For example, functional breakthroughs that led to high-performance yet lower-cost LLMs have raised questions around whether early movers in that space will enjoy returns to their capital investments.[2] Also calling this AI-based defense of valuations into question, while U.S. earnings growth outside of the Magnificent Seven has been anemic, just 1.6%, multiples for these stocks expanded at a pace more than twice the 2017–21 average.

[2] "Chinese AI start-up DeepSeek pushes US rivals with R1 model upgrade," *Bloomberg*, May 29, 2025.

In summary: the regional divergence in valuations has created a fragile condition in which a painful relative repricing could be triggered either by downside shocks to growth in the U.S. or upside surprises elsewhere. The 2022 and 2025 selloffs provide recent examples of the former, as U.S. stocks were relatively hard hit by global economic concerns. Potentially a harbinger of the latter, non-U.S. companies have recently enjoyed better-than-expected growth that hasn't yet been capitalized; valuations in DM ex-U.S. remain about 10% below their long-term median.

A Call to Action

How should allocators respond to heightened uncertainty associated with abrupt shifts in U.S. economic policy and geopolitical posture? Using an illustrative framework in which investors allocate across cap-weighted U.S., DM ex-U.S., and EM portfolios, we would estimate that the cap-weighted benchmark implicitly assumes further U.S. outperformance on the order of 4% per annum.[3] In contrast, an investor who believes that the U.S. market will perform in-line with the other two regions would allocate only 40% to the U.S., a large underweight.[4] In fact, in this framework, an investor would underweight the U.S. market by 8% or more if they foresaw U.S. outperformance of anything less than 2% per year. The underweight becomes more pronounced if we assume that market integration deteriorates and regional correlations drop to levels that prevailed more than 25 years ago.

Conclusion

Given the high U.S. weighting in the global equity index, it does not take an extremely pessimistic view about U.S. stocks' relative prospects to justify a benchmark-relative tilt towards other markets.

Still-stretched U.S. valuations, signs of diminished U.S. earnings growth, and questions about underlying technology-based narratives that have been used to justify the U.S. valuation premium provide sufficient grounds to warrant such consideration. Moreover, an ebbing of global equity market integration suggests greater risk-reduction benefits from diversification.

Given the combination of these trends, investors should not reflexively accept U.S.-heavy benchmark allocations as their default positioning. Instead, allocators should consider more balanced exposure to markets around the globe.

[3] Hypothetical exercise based on a stylized 3-asset portfolio representing U.S., DM ex-U.S., and EM equities. Relative expected return for U.S. equities is varied from -4% to +4% in increments of 1%. Exercise uses trailing 120-month average risk and correlation as of May 2025. Assumptions derived from the MSCI USA, MSCI World ex-USA, and MSCI EM indexes. Please contact us for other details.

[4] As of May 2025, U.S. equities accounted for about 64% in the MSCI ACWI Index.

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