

The Rewards of Rebalancing

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INVESTORS CAN GAIN FROM EMBRACING MORE OF OUR WORLD

Global investors were poised for a long-overdue great rebalancing even before the turbulent start to 2025. But things are now speeding up as geopolitics reshapes the global economy and capital markets.

The catalyst was the concentrated risk associated with rising political and policy uncertainty in the United States. But the deeper drivers are older, structural, and more consequential.

These include fading tailwinds behind US asset outperformance, growing misalignment between where capital is concentrated and where global growth is happening, stronger policies in several emerging market and developing economies, and converging risk profiles for advanced and emerging market economies.

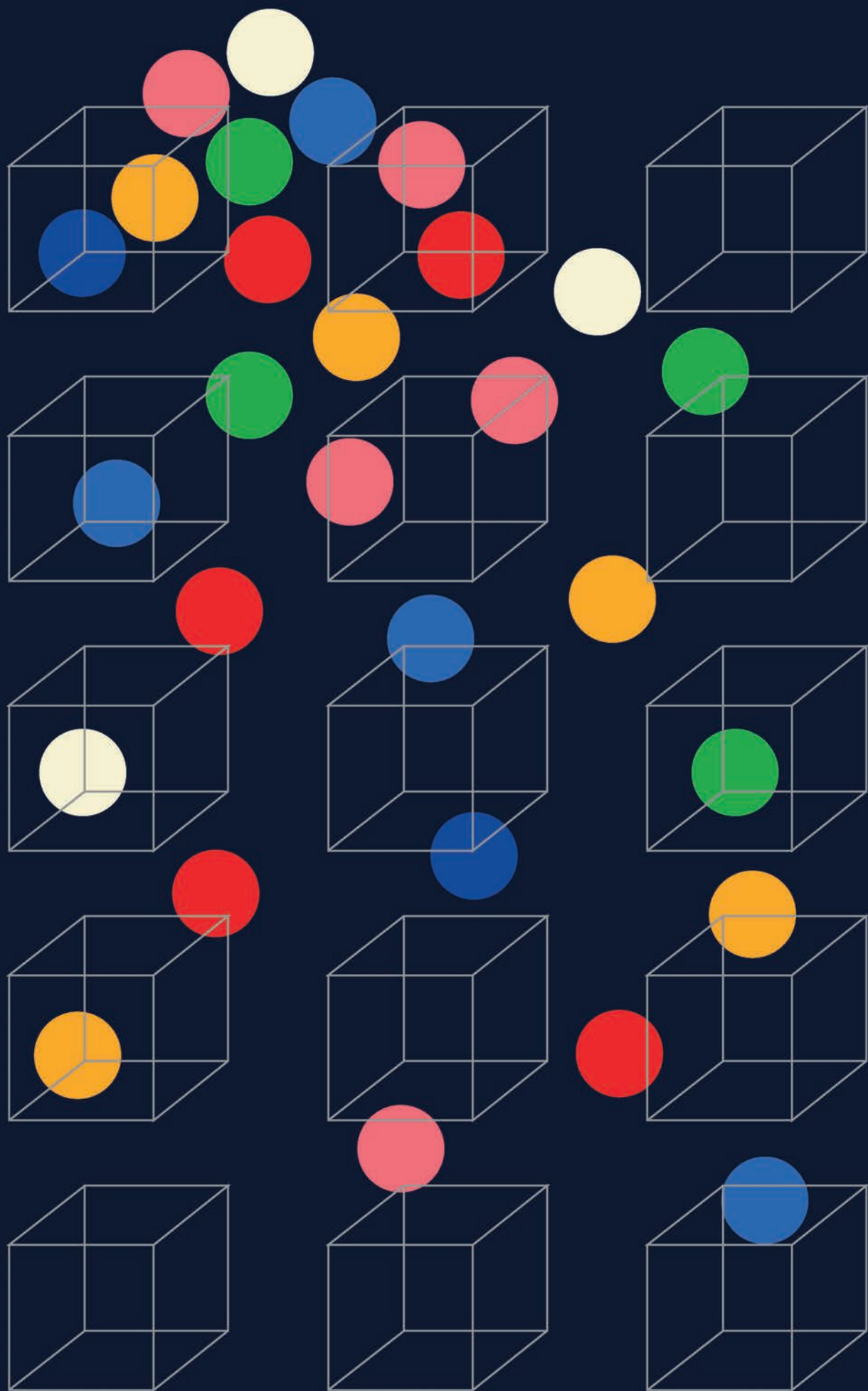
Distorted capital map

With just 4 percent of the world's population, the US accounts for about two-thirds of global stock market capitalization and nearly 40 percent of

bond markets. It may be the world's largest economy, but it accounts for only 9 percent of global growth, 13 percent of trade, and 15 percent of global economic output on a purchasing-power-parity basis. Such concentration is financially risky, economically inefficient, and ultimately unsustainable.

Theory dictates that capital should flow to places where risk-adjusted returns are greatest and investment opportunities strongest. But, as the Nobel Prize-winning economist Robert Lucas Jr. observed in a 1990 paper, global savings have instead flowed from younger, faster-growing economies to slowing, aging ones—a phenomenon known as the “Lucas paradox.”

This movement has inflated US asset prices, increased correlations across global portfolios, and kept capital scarce in places where it would do the most to diversify risk and raise productivity. But with the world's deepest capital markets, a formidable innovation ecosystem, powerful companies, and the dominant currency, the US exerts a mighty pull.



Diminishing tailwinds

The forces that have amplified US asset returns for decades are now fading. American financial dominance benefited from a rare combination: declining interest rates, lower corporate taxes, quantitative easing, a strong dollar, fiscal indulgence, and a growing share of income flowing to capital over labor.

These attributes boosted foreign demand for US financial assets. Outsize stock market returns drove foreign investors to triple their exposure to US equities to more than \$20 trillion over the past decade. That further raised valuations and strengthened the dollar—which in turn further compounded gains, particularly for international investors.

Such tailwinds, already largely diminished, are now more likely to reverse.

Evidence increasingly points to a turn in the strong dollar cycle—an important tailwind for the past decade and a half. Expectations of further weakening have driven up the demand for, and the price of, hedging dollar exposures, making the tailwind a headwind. A weaker dollar also increases the relative attractiveness of emerging market and developing economies and has been a strong driver of their significant outperformance since early last year.

Room for further cuts to US taxes and interest rates—major tailwinds for profitability and valuation—is limited. In fact, both are as likely to go up as down given the ballooning deficit and persistent inflation. Even if tax and interest rate cuts do materialize, they will not match the halving of tax rates and several percentage point decline in real interest rates that boosted US equities in the past. And the Federal Reserve is well on its way toward quantitative tightening—a far cry from the days of \$9 trillion in peak asset purchases that turbocharged gains. The record share of GDP corporate profits now command is also likely to reverse.

Lower interest expenses and lower corporate taxes alone explain more than 40 percent of the real growth in US corporate profits between 1989 and 2019, and lower risk-free rates explain the expansion in price-earnings multiples over that period. A large chunk of the golden age of US asset returns was one-off repricing.

As these tailwinds fade, profit growth and equity returns are likely to be materially lower than in the recent past.

At the same time, concentration risk has surged. In the past three years, just seven companies accounted for 55 percent of total S&P 500 returns, mostly on the back of the AI boom. The top 10 companies now make up 40 percent of the index. This is not broad-based growth, but a narrow and increasingly fragile bet on a single sector in a single economy. In fixed income, there has been gradual erosion

of the traditional safe haven status of US Treasuries, the largest component of the US bond market.

This does not mean a sudden rush for the exit or even a “sell America” trade. The sensible question is not whether investors should own US assets, but how much they should own. When expected returns fall and risks rise, the logic of reallocation becomes inevitable for institutional investors bound by a fiduciary duty to invest money wisely—aiming for the highest possible return without taking unnecessary risk.

Capital shifts

Rebalancing starts at the margin, shifting investment away from the United States, but its gradual pace does not diminish its macroeconomic impact.

Allocation to the US is so large now that even modest changes matter. Norway’s \$2.2 trillion oil fund, for example, allocates 53 percent of holdings to US assets. Trimming that share to 40 percent—still a sizably overweight position given the country’s shrinking economic footprint—would free up about \$250 billion for investment elsewhere.

The same reasoning applies for pension funds, insurers, and other sovereign wealth funds, with trillions of dollars likely to seek other opportunities in coming years. Some of that capital will be redeployed in developed economies, especially in the United Kingdom, the euro area, and Japan, where valuation multiples remain more modest and index concentration is far less pronounced.

But emerging market and developing economies offer the most opportunity by far. They have driven three-quarters of global growth in recent decades, and the latest IMF data show that China and India alone accounted for nearly half of global growth last year, three times the combined contribution of the US and the European Union.

Even as advanced economies face a steep demographic decline, further depressing their growth prospects, India and sub-Saharan Africa will each gain more than 12 million workers every year. Labor productivity growth in emerging market and developing economies, at about 3 percent, is more than three times the average for advanced economies. And on other measures of economic contribution and potential, such as trade and innovation, emerging economies’ share continues to rise. The world’s center of gravity has shifted: Emerging economies are now the key drivers of global growth.

The risk-return case

Financial markets have been much slower to reflect this shift. Emerging market and developing economies accounted for only about 11 percent of global equity market capitalization and 26 percent of bond

markets at the end of 2025, a fraction of their much larger share of global GDP.

That gap captures the heart of the misallocation and should be closed. It also explains why even modest reweighting by the largest asset owners will be macroeconomically significant: It would both plug the annual financing gap of more than \$4 trillion and lower financing costs for these economies. The high cost of capital particularly hinders climate mitigation and adaptation investments, since the high up-front costs of these make project viability hypersensitive to financing costs.

Investors traditionally demand much higher returns in emerging market and developing economies because of a long-standing assumption that advanced economies are inherently safe and emerging markets inherently risky. This no longer holds, at least in the aggregate. Some emerging economies may still be more risky than individual advanced economies, but at the portfolio level the gap in currency, political, fiscal, and policy risks between advanced and emerging economies has narrowed, even disappeared.

The burden of public debt, for example, is now far heavier across advanced economies than in emerging market and developing economies, at 108 percent of GDP compared with 75 percent, according to the IMF. The gap in currency volatility has also converged, as have sovereign default rates. In fact, several emerging economies now have lower public debt ratios, more orthodox monetary policy, stronger reserve buffers, and greater policy predictability than many developed economies, including the US.

Political risk appears to be converging too. It's harder to argue that rising polarization and growing instability in the politics of many advanced economies pose less policy risk than in several emerging economies. Further evidence of this convergence lies in the sound economic performance of many emerging economies faced with new global shocks, which in the past would have triggered a crisis. This means investors no longer need significantly higher returns from their emerging economy portfolios.

As outsize returns in the US moderate, even as risk and concentration rise, the robust returns, limited riskiness, and large diversification potential of emerging economy investments offer the perfect opportunity for rebalancing.

Portfolio optimization

Emerging market and developing economies offer more than higher growth and profit potential. They generate structurally different returns since their demographics, currencies, politics, policy regimes, and sectoral composition differ from

DATA

67%

The US accounts for about two-thirds of global stock market capitalization.

those of the US and of one another. In general, correlations between markets are lower than between developed markets, for example in the euro area—smaller, less integrated emerging economies offer additional diversification benefits. This enhances emerging economies' value both for returns and for portfolio resilience.

Modern portfolio theory posits that assets should be judged not only by expected return but by their contribution to whole-portfolio risk and return. Yet many "global" portfolios are simply concentrated bets on US equities, Treasuries, the dollar, and a small group of tech companies. This matters because lower interest expenses and corporate taxes and large fiscal deficits have enhanced US corporate profits and equity valuations in a manner that cannot be sustained. Meanwhile, elevated valuations, market concentration, and rising correlations make these portfolios vulnerable.

The case for rebalancing follows directly from institutional investors' fiduciary obligations to maximize long-term risk-adjusted returns. As this rebalancing moves emerging market and developing economy allocations closer to their weight in the world economy, it will lower financing costs, in turn boosting investment, jobs, and growth and supporting a more resilient, low-carbon economy.

Rebalancing is inevitable, but the timeline is uncertain. Weak project pipelines, misaligned incentives, perverse regulations, and investors' general unfamiliarity with these markets could all slow the pace. Removing these barriers should be a top policy priority. Doing so will unlock stronger, more balanced growth for the global economy and reward investors with higher risk-adjusted returns. With some luck, it may even spell the beginning of the end of the Lucas paradox. **F&D**

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