It's time for investors to rethink geographic diversification

A multipolar world implies a review of asset allocation

A multipolar world

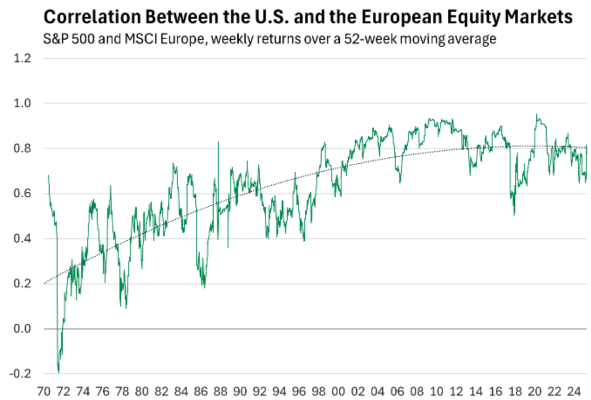
At the end of the Cold War, the world saw the emergence of what was essentially a unipolar system dominated by the United States – politically, militarily, economically and technologically. Even so, the establishment of the European Union in the 1990s and the rise of China in the 2000s gradually reshaped this balance, while emerging regional powers, such as India, Brazil and Saudi Arabia, also increased their influence. Even though multipolarity had been in the making for some time, the Trump administration's isolationism and trade war have hastened its arrival, at least from the economic standpoint.

This regime shift is clearly not without consequences. A multipolar world is more fragmented and less predictable. It also involves new geopolitical dynamics as some major powers compete for influence while others establish closer relations and step up their trade. A multipolar world can reorganize itself according to changing political and economic interests, contrary to the views apparently held by the Trump administration's strategic advisers, who act as if American exceptionalism were an immutable truth. Although geographic diversification hasn't been a key criterion for investors in a unipolar context, the prospect of this new regime makes overexposure to U.S. assets increasingly difficult to justify.

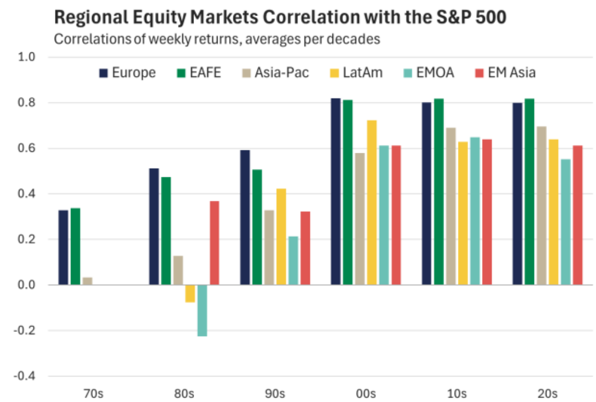
Changes in historical correlations

Since China joined the World Trade Organization in 2001, globalization has intensified, leading to a sharp rise in the correlation of stock market returns between countries. In this context, geographical diversification has proved less useful. The prolonged outperformance of the U.S. stock market since 2010 has also contributed to investors' lack of interest in international equities. Moreover, institutional investors have favoured a factor-based approach (styles, sectors, themes, etc.) rather than seeking exposure to a particular country or region. Finally, the growing weight of multinationals, which are, by definition, exposed to the entire world, has also reduced the need for geographical asset allocation.

The correlation of returns between stock markets has increased since the 2000s



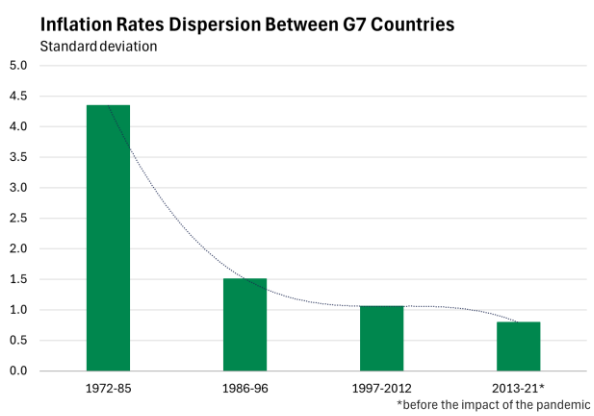
Sources: DGAM, LSEG, April 2025



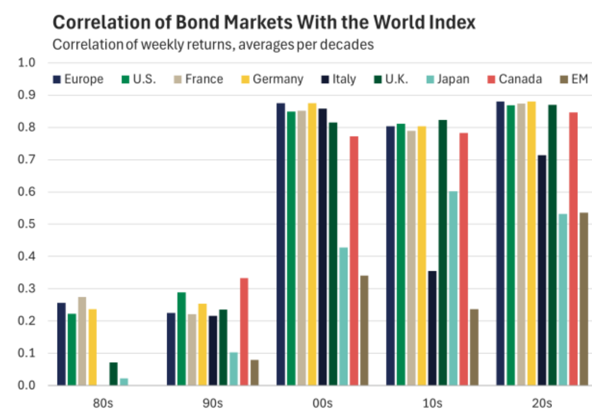
Sources: DGAM, LSEG, MSCI, April 2025

A similar rise in the correlation between bond markets has also occurred since the 2000s. Globalization and the increase in trade flows have significantly reduced the inflation differential between countries. This convergence has helped reduce the dispersion of returns on government-debt markets. A multipolar world could lead to higher inflation differentials – even in the short term – as U.S. tariffs and the resulting retaliatory measures unevenly impact supply chains and production costs in different markets.

Lower inflation differentials across countries have increased bond market correlation



Sources: DGAM, LSEG, May 2025



Sources: DGAM, LSEG, Bloomberg, May 2025

The new trade regime disrupts the supply chain

Optimization of the global supply chain is based on the comparative advantages of countries, such as the quality of their infrastructure, and the strategic decisions that companies make to take advantage of them. It leads to higher profit margins for businesses and lower prices for consumers. International competition thus helps contain inflation, promoting low interest rates and economic growth. In the 1980s, Republican President Ronald Reagan defended such competition, deeming it a driver of innovation, in contrast to protectionism.

Under the Trump administration's tariff regime, the supply chain of U.S. companies is no longer optimized on the basis of production costs but according to the origin of components. Companies

Sources: DGAM analysis, LSEG, as of April 30, 2025

must absorb the inherent cost increase within their profit margins or try to pass some of the increase on to consumers in the form of inflation. Large importers, such as retailers and the automotive industry, are among the most affected. In international markets, U.S. multinationals are also being hit with tariffs in response to their government's actions.

In contrast, European and Asian multinationals are benefitting not only from a less disrupted supply chain but also from U.S. companies' loss of competitiveness on international markets and sometimes even from boycotts of their products, Boeing and Tesla being prime examples. That being said, they have to offset their loss of market share in the United States by developing new outlets. New trade agreements between countries deemed to be reliable partners will be the order of the day, at the expense of U.S. firms struggling with their government's isolationism. The recent free-trade agreement between India and the United Kingdom, as well as the acceleration of trade talks between China, Japan and South Korea, is evidence of the ongoing reorganization.

Obviously, Asian and European firms are not exempt from difficulties under this regime. Those that choose to play the Trump administration's game in order to maintain market share in the United States have to invest in marginally profitable, or even unprofitable, operations on U.S. soil and absorb part of the tariffs within their profit margins. Even if growth is elsewhere, the United States is still a key market, especially for car manufacturers.

The share of revenues from the United States is low for Chinese companies but much larger for European and Japanese companies

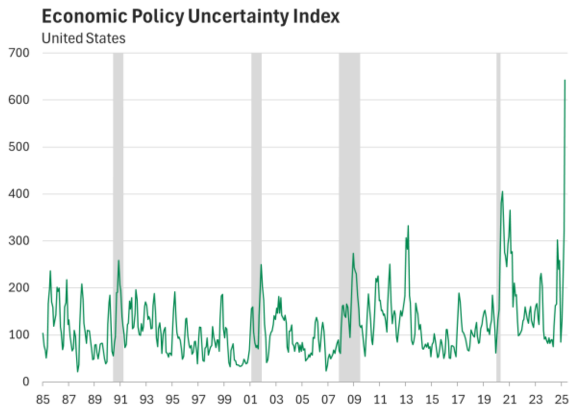
Source: Morgan Stanley Research, 2024

Uncertainty: another burden for U.S. companies

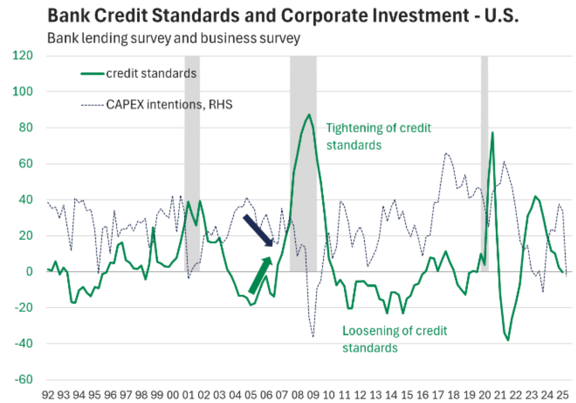
Even though comparative advantages determine a country's place on the global economic stage, ideological decisions by heads of state can undermine it by holding back a nation's investment, research and development, and progress. The unpredictability of the economic policies we're seeing this year is inimical to business investment. In such an environment, long-term investment decisions that require significant capital are likely to be postponed or cancelled. If a company thinks the current administration – or the next one – will reduce or cancel the tariffs, it will shelve its plans to expand, under duress, in the United States.

The propensity of banks to lend could also be an issue. If they tighten their credit standards owing to uncertainty, investment will be even more limited. The drastic drop in U.S. business investment intentions this year illustrates the negative impact of uncertainty on capital spending.

An unpredictable environment is unfavourable to investment



Sources: DGAM, Economic Policy Uncertainty, May 2025



Sources: DGAM, LSEG, Federal Reserve, Philadelphia Fed, May 2025

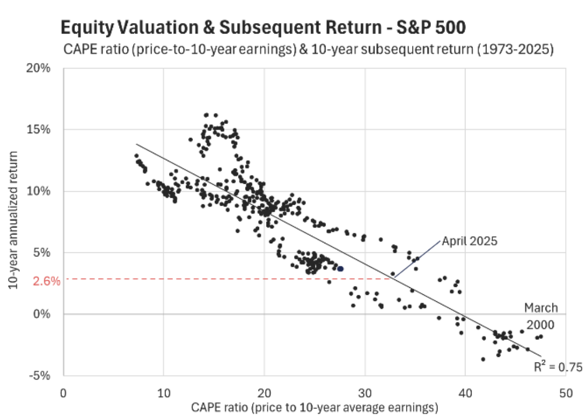
In contrast, China, Japan, South Korea and the Southeast Asian (ASEAN) countries have recently pledged to collaborate more, increase trade and provide a more predictable environment for business.

The relative valuation of the stock markets offers a useful starting point for diversification

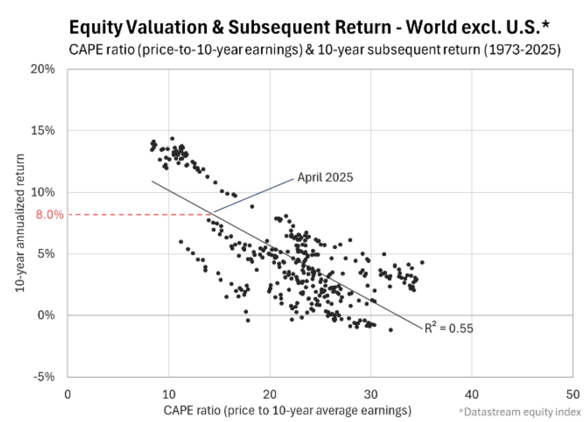
For the long-term investor, it seems like a good time to diversify, from the standpoints of relative valuation and market sentiment (investor appetite) alike.

The U.S. stock market is extremely expensive relative to its own history and to other stock markets. Until recently, this American exceptionalism was justified by the greater profitability and the technological advancement of U.S. companies. That being said, new import taxes and less competitive production costs in the United States will undermine profitability. As for the United States' technological lead, it is rapidly diminishing as China advances.

The high valuation of U.S. equities implies their future returns will be less attractive than those of international equities, which are much less expensive



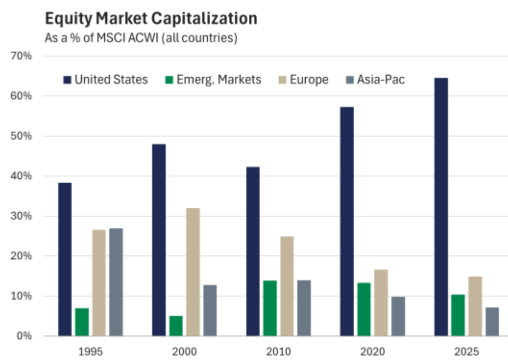
Sources: DGAM, LSEG, May 2025



Sources: DGAM, LSEG, May 2025

Investors' appetite for U.S. financial assets has been undeniable in recent years, as evidenced by their extremely high allocation to this market, as well as the record concentration of the MSCI ACWI in U.S. equities (more than 64% in 2025 versus 50% in 2014). So there's a long way to go in terms of rebalancing and diversification. The unpredictability of the Trump administration, or just its shocking rhetoric, is likely to continue driving capital away. The devaluation of the greenback illustrates the decline in interest in U.S. financial assets since the start of the year. The outperformance of international equities this year could well mark the beginning of a long rebalancing.

The weight of U.S. equities in the MSCI ACWI has increased significantly over the years



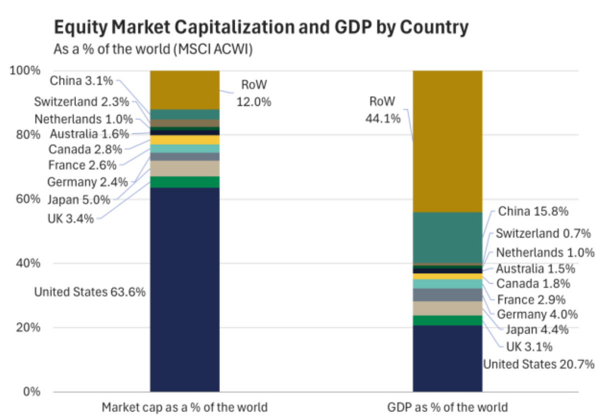
Sources: DGAM, LSEG, MSCI, April 2025

Conclusion

U.S. isolationism is a regime shift that has quickly led to a series of fundamental adjustments around the world, ranging from Germany's program to modernize its defence and infrastructure to the trade agreements signed in Asia and Europe. All these countries want to quickly reduce their dependence on the United States and diversify their sources of revenue.

The United States' share of the world economy, at about 20%, remains large but is falling. In contrast, the weight of U.S. equities in global market capitalization, at more than 63%, has risen sharply over the years, well beyond what is justified by their fundamentals and growth prospects.

The imbalances between countries' global market capitalization and true economic weight are significant



Sources: DGAM, LSEG, MSCI, Visual Capitalist, May 2025

Sources: DGAM analysis, LSEG, as of April 30, 2025

We think a rebalancing is quite likely. The relatively attractive valuation of equity markets outside the U.S. and investors' limited positioning in them also support rebalancing. Remember that nearly 80% of the world's economic activity takes place outside the United States. The markets with the fastest-growing middle class, the greatest infrastructure needs and the most abundant labour force are in Asia. The fact that Europe, whose economic weight is equal to that of the United States, is rolling up its sleeves and uniting in response to the many challenges awaiting it could very well contribute to a structural shift that holds promise over the medium and long terms.

In a world that is once again multipolar, we're in favour of rethinking entrenched ideas about sources of diversification and of reviewing investment policies in terms of geographical positioning, the limits of which are often dictated by benchmark stock and bond indexes. To thrive in a changing world, we will have to look boldly beyond the strictures imposed by such benchmarks.

To take full advantage of the benefits offered by geographical diversification, don't hesitate to contact us directly. We offer top-down global equity strategies, with geographical distribution playing a key role in the decision-making process.

Jean-Pierre Couture

Economist and Senior Portfolio Manager
Desjardins Global Asset Management

Sources: DGAM analysis, LSEG, as of April 30, 2025

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