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Global Macro Insights

Rethinking equity diversification in an era of geoeconomic fragmentation risks

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> In our view, heavy US concentration and geoeconomic fragmentation risks could justify more geographically diversified equity positioning
>
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Executive Summary

In 2022, we identified three secular forces with potential to drive profound transformations within the macroeconomic and investment backdrops: debt accumulation, decarbonisation, and deglobalisation.

Since President Trump's re-election, and particularly following his self-declared 'Liberation Day' tariff announcements on 2 April 2025, the tangible consequences of deglobalisation have become more evident. For example, Section 899 of the Trump administration's recent "big, beautiful tax bill" imposes retaliatory measures against countries which are deemed to have enacted unfair foreign taxes against US businesses.

We have therefore established a framework to assess potential medium-term scenario outcomes associated with this shift and their implications (Figure 1). In our view, we are witnessing fragmentation of the global economic, technological and security orders, and expect this to impact international capital flows. This could justify more geographically diversified equity positioning.

This paper explores the rationale for rebalancing investors' portfolios away from a US-centric capitalisation-weighted approach. It underscores the fact that this could enhance portfolio resilience within regimes characterised by elevated geopolitical and geoeconomic uncertainty. However, it also affirms that there are trade-offs to consider when reducing US exposure.

Figure 1: Mapping trade war scenarios:

Changing the rules of the game carries risks and opportunities for the US

We started with "blanket tariffs" but are now moving towards "strategic fragmentation"

	China isolation	Blanket tariffs	US isolation	Fragmentation
Description	End point is to disconnect China from the world economy. US coerces 'allies' and even some non-aligned countries (e.g. India) into imposing tariffs/trade barriers on China in exchange for US market access.	US fails to achieve global re-ordering, and reverts to high 'reciprocal' tariffs on most countries, effectively reverting to isolationism. Potential variant could be 'Fortress North America' in which CA & MX mimic US tariffs.	World sees US actions as neo-imperialism, pushing EU into China's arms. EU & China decide to integrate further to cushion their economies from US tariffs. US blanket tariffs remain, isolating.	Regional blocks are created with US, Europe and China being the main sphere of influence (CPTPP*, RCEP*, Euro bloc, USMCA*). Bilateral trade increases within blocks but overall global trade volume reduces.
Biggest loser and macro implications	China: severe negative growth shock through its high exports dependence and inability to re-route to the US.	US & World: For US - durably raise inflation & hit total factor productivity (TFP) growth. For World – remove major market and supply chain link, without alternatives created. Also, some China re-routing to US still possible.	US & Eurasian periphery: For US - strategic failure AND a stagflation hit. For periphery –deflationary; lose access to multiple markets simultaneously, with China able to compete locally.	World: the entire world loses out especially the more open and export dependent economies.
Relative winners/losers	Winners: countries experiencing increased China competition, e.g. Japan, S. Korea, Taiwan, Germany, India. Losers: those integrated into China's supply chains, e.g. Vietnam, Cambodia, Myanmar.	Winners: 'Allies' able to do deals with the US e.g. CA, MX, UK, JP Losers: All non-allies with US. China and other Asia EMs most impacted (EMAX exports 56% of GDP and 45% directed to US and China).	Winners: China, China integrated (e.g. Cambodia & MY) & EU Losers: US, peripheral DMs (e.g. UK, JP, SK).	Winners: Countries with large domestic markets/more closed economies Losers: open economies on the periphery of the blocks.
Final US effective tariff rates	15-20% range: China (+60%), 25% sector tariffs and 10% on ROW with some exemptions.	>40%: China +145% with no exemptions and reverting to reciprocal tariff on April 2nd.	(>40%) Same as Blanket tariffs scenario.	Effective tariff rates are significantly lower (0-10%) within US blocs/allies and >40% for outside the blocks.

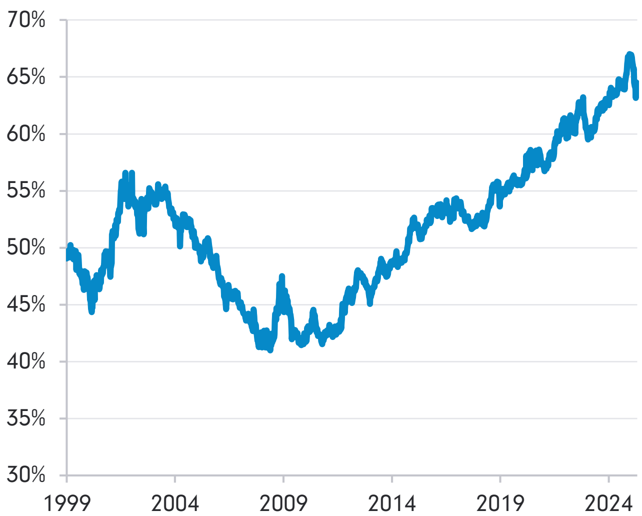
Source: Fidelity International, May 2025.

*Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), RCEP (Comparison of the Regional Comprehensive Economic Partnership), United States-Mexico-Canada Agreement (USMCA)

US market dominance and concentration

Over the past two decades, the US's share of global equity market capitalisation has risen sharply (Figure 2). This has been driven by strong corporate earnings (EPS) growth and significant price-to-earnings (P/E) multiple expansion (Figure 3). In fact, US equities' valuation expansion has been underpinned by exceptionally robust earnings growth (Figure 4). Investor flows have followed these fundamentals, compressing US equity risk premia and strengthening the US dollar, which further boosted the US's weighting in global equity indices.

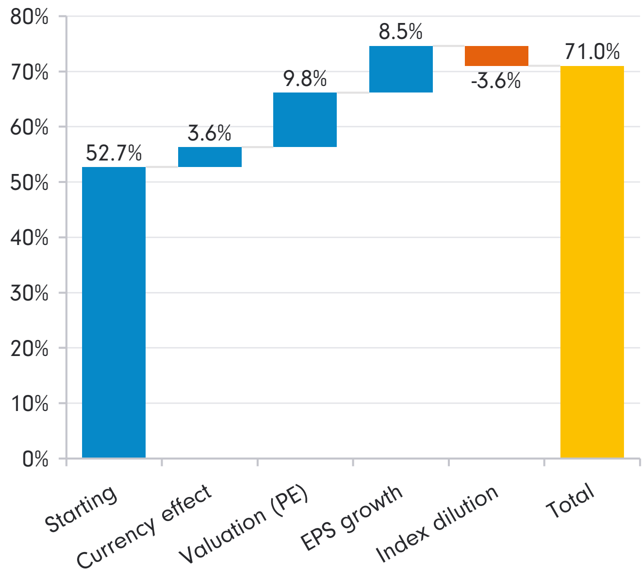
Figure 2: US weight in MSCI AC World Index



For illustrative purposes only. Past performance is not a reliable indicator of future results.

Source: Fidelity International, Bloomberg, April 2025.

Figure 3: US weight in MSCI World Index Change since December 2004

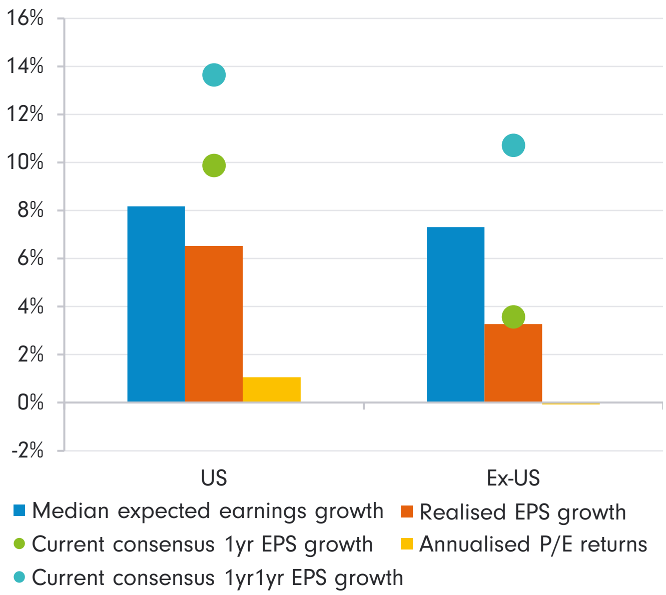


For illustrative purposes only. Past performance is not a reliable indicator of future results.

Note: Starting with 1/1/2005 market capitalisation of MSCI USA and MSCI World ex-USA indices, in USD. We apply to this the earnings growth seen in local currency, and resume weights to 1 to calculate change in weights due to local earnings growth. P/E effect considers the change in weights due to relative P/Es between US and non-US indices. Currency effect reflects the weighted average change in FX rates vs USD implied by MSCI World ex-USA returns data. Index dilution is a residual term reflecting the difference between index price returns and change in index market capitalisation.

Source: Fidelity International, Bloomberg, LSEG DataStream, April 2025.

Figure 4: EPS growth and market valuations



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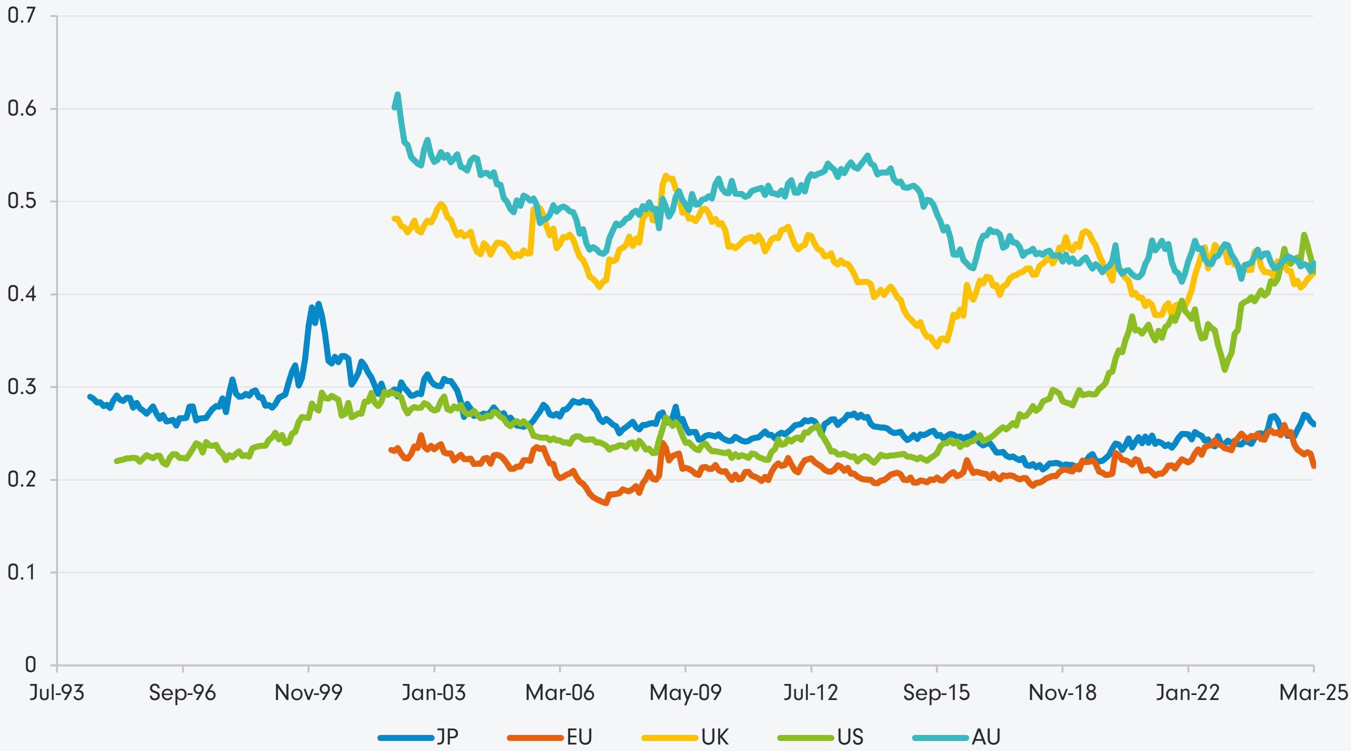
Note: Chart demonstrates that US companies have historically been closer to achieving lofty EPS growth expectations (orange bar closer to blue), and hence US saw capital inflows and a rise in valuations (Yellow bar). US EPS growth expectations for the next two years also remain higher (blue, green dots).

Source: Fidelity International, Bloomberg, LSEG DataStream, Jan 2005 - Apr 2025.

In addition, **company-level concentration** within the US market has climbed to historical highs. A handful of mega-cap technology and AI-focused companies now account for an outsized portion of the US equity market, potentially adding significant idiosyncratic and thematic risk to investor portfolios. This heightened concentration means investors in broad US and global indices are increasingly exposed to a narrow set of drivers. The combination of US market dominance globally and high internal concentration raises concerns that many portfolios are **less diversified than they appear,** and overly dependent on the continued outperformance of US mega-cap tech stocks.

Figure 5: Share of top 10 stocks in the top 200 stocks market capitalisation



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Note: Indices used: Japan: TPX Index, Europe: SXXP Index, UK: NMX Index, US: RIY Index, AU: AS30 Index. Source: Fidelity International, March 2025.

Diversification case study: Euro-based portfolio

We conducted a case study for EUR-based investors on the impact of reducing US equity portfolio weightings by 12% from current levels, bringing them closer to the 25-year historical average. This enhances diversification and delivers potential for more resilient returns across different macroeconomic regimes. However, it also introduces a modest total tracking error of roughly 1.7% versus a capitalisation-based global equity index (Figure 6). Although this is non-trivial, it is moderate in an absolute sense for a strategic allocation change.

- **Equity exposure rebalancing:** Approximately +1.5% contribution to tracking error, stemming from different country, sector, and style exposures after reducing US weight.
- **FX exposure differences:** Approximately +0.8% contribution, reflecting the currency impact of being effectively short USD and long non-US currencies relative to the original portfolio.
- **Diversification offset:** About –0.7% contribution, reducing net tracking error. The equity and currency exposures are not perfectly correlated, so some of the volatility introduced by shifting equity weights is dampened by opposing movements in exchange rates.

Figure 6: Tracking error decomposition of a 12% underweight US equity portfolio

Figure 6a: Tracking error components

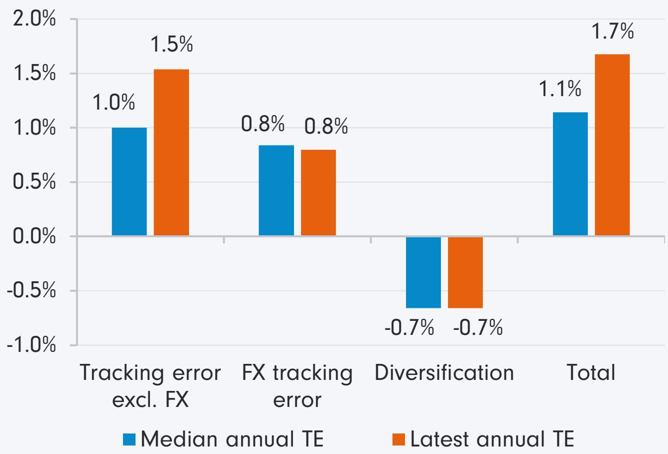


Figure 6b: Relative sector exposures

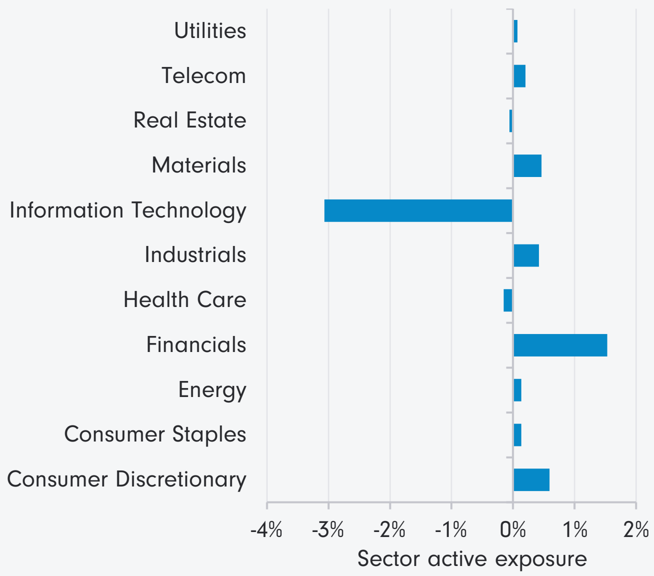
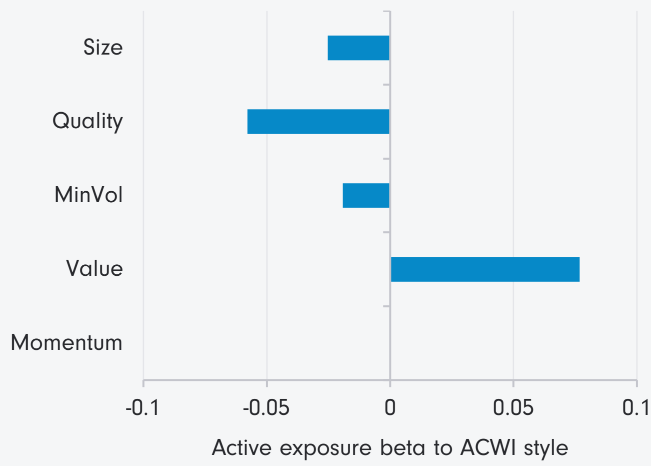


Figure 6c: Relative factor exposures



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Note 6a: Two portfolios considered: 1) 64%:36% MSCI USA:ACWI ex USA, 2) 52%:48%, both in EUR. 1) uses the current weights of USA in MSCI ACWI, 2) uses 25-year average. TE ex-FX considers the difference between the two portfolios in local currency. FX TE incorporates a 12% offsetting FX position. Total includes a diversification factor as a balancing item.

Note 6b: Sector Active Exposures derived from BarraOne.

Note 6c: Based on an OLS over the past ten years. Independent variables: excess returns of MSCI ACWI styles over EUR cash. ACWI styles indices: 'Momentum':'M1WD000$ Index', 'Value':'M1WDOV Index', 'MinVol':'M00IWD$O Index', 'Quality':'M1WDQU Index', 'Size':'M1WDSC Index'. Tracking error the dependent variable.

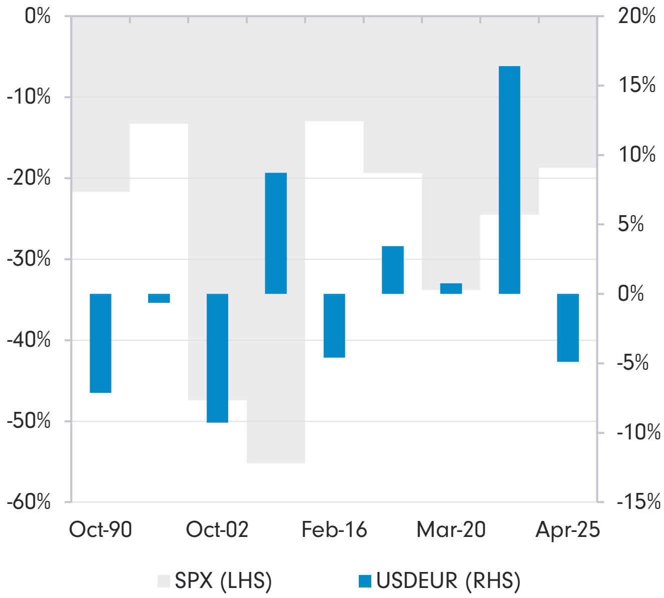
Source: Fidelity International, BarraOne, April 2025.

Currency management considerations

The question of currency hedging becomes crucial when tilting a portfolio away from the US, given that the dollar has appreciated substantially over the past decade. We note that a EUR/USD currency hedge costs roughly 1.75% per annum at present, implying a breakeven exchange rate of about 1.19 in three years.

The US dollar has historically offered defensive qualities during global shocks. However, Figure 7 shows that this has not always held during US-centric drawdowns. In a more fragmented economic environment, cross-regional hedges like the dollar may become less effective.

Figure 7: USDEUR returns during S&P 500 Index drawdowns



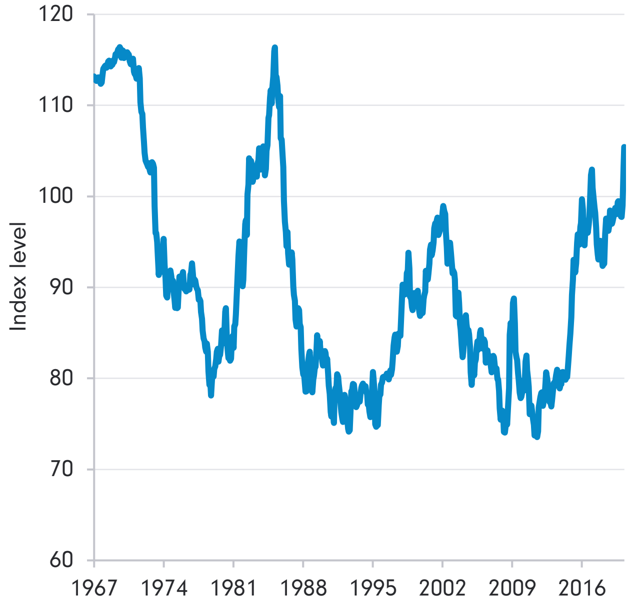
For illustrative purposes only. Past performance is not a reliable indicator of future results.

Source: Fidelity International, Bloomberg, April 2025.

Several indicators point towards a weakening of the dollar over the medium term. Firstly, the current US administration has signalled a desire to moderate the dollar's strength, which immediately strengthens the case for reassessing currency exposures, particularly for Euro-based investors. Valuation metrics also suggest that the dollar is overvalued (Figure 8), with extreme highs having typically been followed by roughly 20% five-year declines historically (Figure 9, left panel).

Despite this, interest rate differentials still favour the dollar at present, implying a near-term EUR/USD fair value closer to 1.05 (Figure 9, right panel).

Figure 8: USD real effective exchange rate valuations are reaching extreme levels



For illustrative purposes only. Past performance is not a reliable indicator of future results.

Source: Fidelity International, Bloomberg, LSEG DataStream, April 2025.

These opposing factors create a strategic tension for investors around currency hedge implementation. On one hand, the dollar appears fundamentally stretched and poised to weaken; on the other, positive carry and yield spreads argue for patience in hedging. Investors must weigh the potential benefits of hedging against opportunity cost if the dollar were to remain strong longer than fundamentals would suggest.

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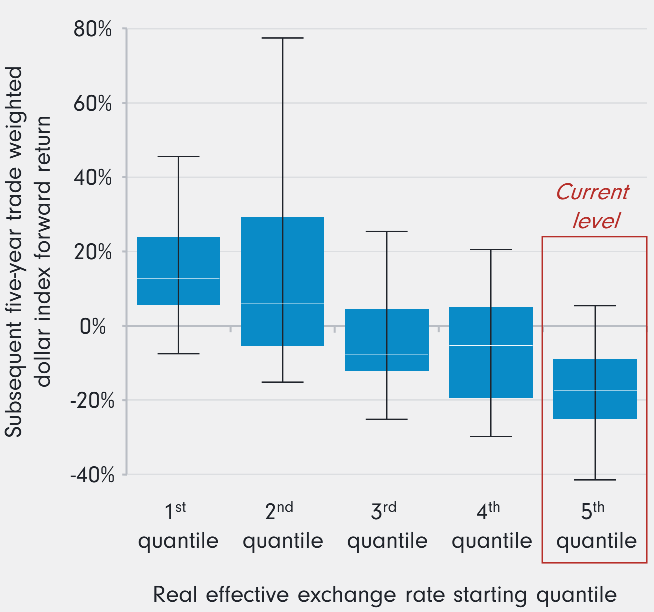
>
> — **Max Stainton**
> Global Macro Strategist

Figure 9: Valuations and interest rate differentials - opposing forces for USD

Figure 9a: The USD has struggled historically when valuations were at current levels

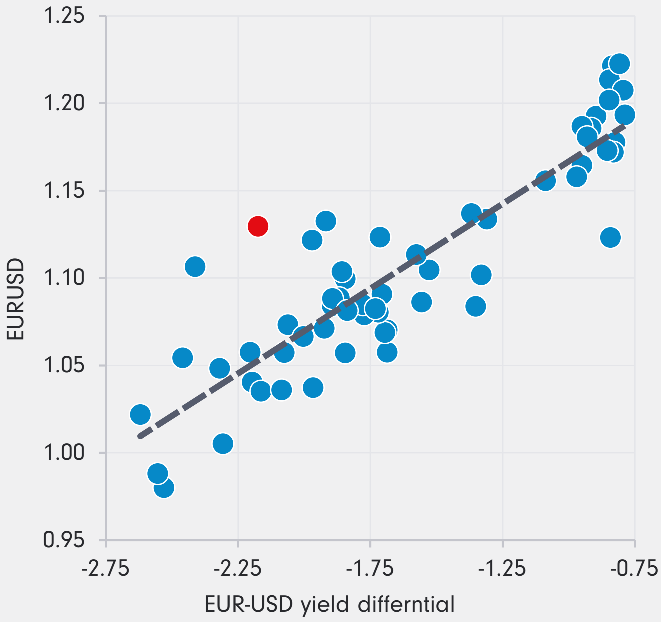


For illustrative purposes only. Past performance is not a reliable indicator of future results.

Note: Chart shows the historical distribution of returns given relative dollar real effective exchange starting level. Solid blue bars represents 25th-75th percentile returns, with white centre lines the medians. Whiskers (outer lines) represent 5th and 95th percentile returns. At the current level, returns have been negative historically: almost the entire distribution is below 0, with a median five-year return of -20%. The gap from 5th to 25th percentile is also larger than 75th to 95th, demonstrating a negative skew in historical returns from current levels. Real effective exchange rate series used is BIS Narrow REER (BISNUSR Index).

Source: Fidelity International, Bloomberg, May 2025.

Figure 9b: On the other hand, interest rate differentials vs EUR are supportive, implying a 1.05 level



For illustrative purposes only. Past performance is not a reliable indicator of future results.

Note: Simple OLS regression yields the line of best fit shown, and the implied value of 1.05 based on current 2-year yield differentials (red dot to best fit line).

Source: Fidelity International, Bloomberg, May 2025.

Conclusion

US equities' outsized role in global portfolios has been driven by valuation expansion, dollar strength, and earnings outperformance in recent years, factors which may prove less persistent in the future. Evolving currency dynamics associated with the shift towards increased international economic fragmentation could also pose further challenges to US equity returns, relative to those of their international counterparts.

Investors may therefore consider moving away from global equity portfolios to those composed of regional building blocks, which would provide more flexibility to express granular country-specific views. As part of this, they might contemplate the use of equity factor strategies to enhance diversification within regions, given high levels of concentration within standard capitalisation-weighted US indices.

It will also be important to review underlying currency exposures, to assess the ongoing suitability of any existing currency hedging policies in the context of their associated costs.

Those considering portfolio rebalancings should weigh the benefits against the potential for increased tracking error. They should also consider the efficiency of portfolio implementation, seeking to capture any opportunities to reduce unnecessary transaction costs. For example, reallocating a portion of a portfolio's US equity exposure to other regional equity and US equity factor strategies might allow the concentration, currency and diversification risks highlighted within this document to be addressed in an efficient manner.

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