Morgan Stanley

INVESTMENT MANAGEMENT

BIG PICTURE

The International Rebalance

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For the past 15 years, U.S. equity markets have dominated global investing, significantly outperformed the rest of the world and attracted record capital inflows. The next era of economic growth and equity market performance is unlikely to be confined to U.S. borders. It will not be about abandoning U.S. exposure, but restoring balance and positioning portfolios for the next decade.

The remarkable run of the U.S. has reinforced a deeply entrenched home-country bias among American investors, often leading to an overexposure to domestic markets and an under-allocation internationally. Studies point to a mix of institutional and behavioral factors responsible for this home bias. The institutional factors often stated include restrictions on capital flows, transaction costs and information bias. Behavioral factors include optimism about local markets, mistrust of foreign information and historical familiarity.

International investors also have a large exposure to U.S. equities and the U.S. dollar (USD). As of 2024, foreign investors held 18% of U.S. equities, a record high, equaling $16.5 trillion in U.S. corporate stocks. This global participation underscores the confidence in the U.S., further reinforced by the strength of the dollar over the last 15 years. However, a large portion of this exposure is unhedged, leaving portfolios vulnerable to currency swings.

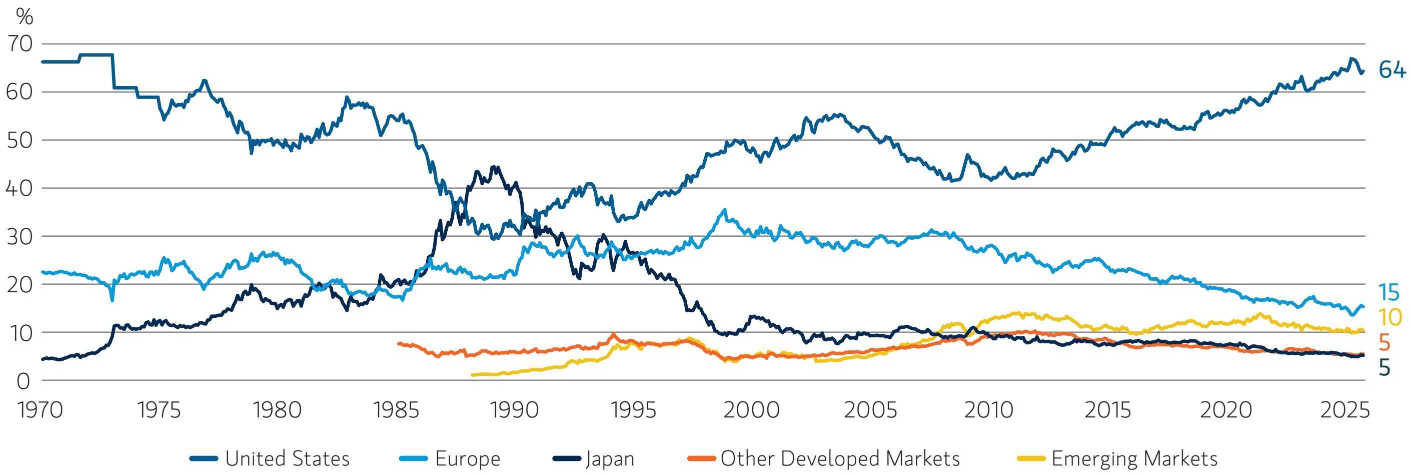
Over the past decade and half, the U.S. has achieved exceptional economic growth and market performance. U.S. equities have outpaced global markets by a wide margin, delivering a compounded annual growth rate (CAGR) of nearly 13.5% since 2010, more than double the 6.1% CAGR of the world markets excluding the U.S. Today, asset allocators need to address three key questions:

- **Will the U.S. leadership rotate?**
- **What strategic framework is best suited for international allocation?**
- **What should one own in international markets?**

DISPLAY 1

U.S. Share in Global Markets at 1970s Peak

Market Cap Share in Global Equities (MSCI World Index)



Source: MSIM, Bloomberg, FactSet, Haver. As of April 30, 2025. It is not possible to invest directly in an index. **Past performance is not indicative of future results.**

Historical Playbook: Global Leadership Rotates

History tells us that market leadership rotates. In the eight decades following World War II, international stocks have outperformed the U.S. markets in four separate decades—in the 1950s, 1970s, 1980s and 2000s. During these outperformance cycles, international equities beat U.S. returns by a median of 4.9% CAGR.

Today, U.S. market dominance is near historical extremes. U.S. equities account for 64% of global market capitalization, approaching levels last seen in the 1970s *(Display 1)*. Other regions have experienced dramatic declines. Europe's market weight has plummeted to 15%, less than half of its high mark of 35% reached in the late 1990s. Japan now represents just 5% of global markets, about one-tenth of its late 1980s prominence.

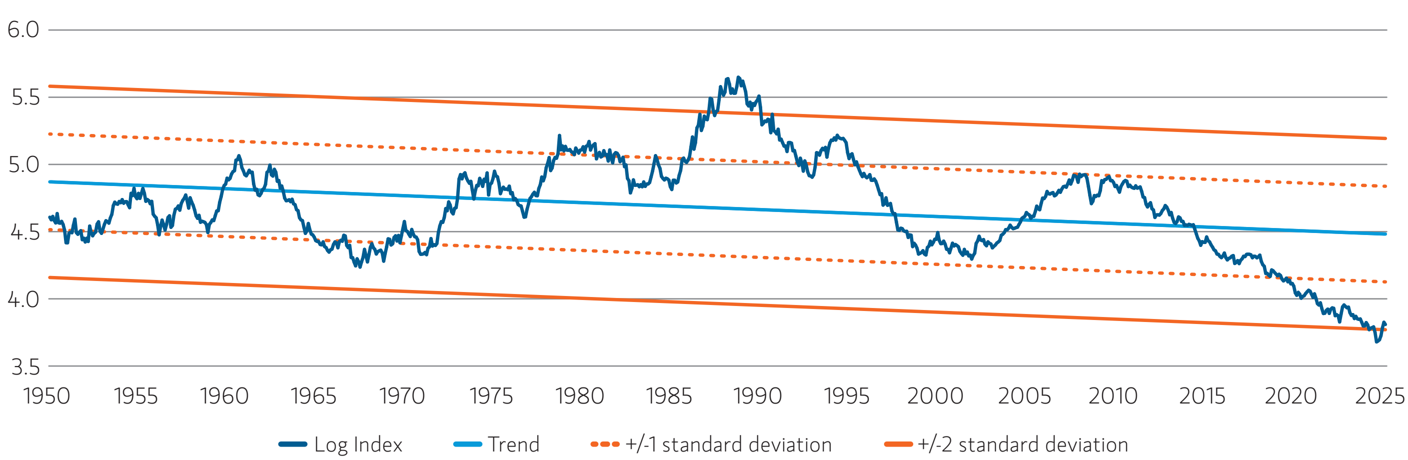
Post-WW II returns and valuations of international equities relative to the U.S. market are currently at multi-decadal lows *(Display 2)*.

DISPLAY 2

International Equities Relative Performance at Post-War Lows

International x U.S. / United States: Long-Term Relative Performance – Index (log scale)

Past performance is not indicative of future results.

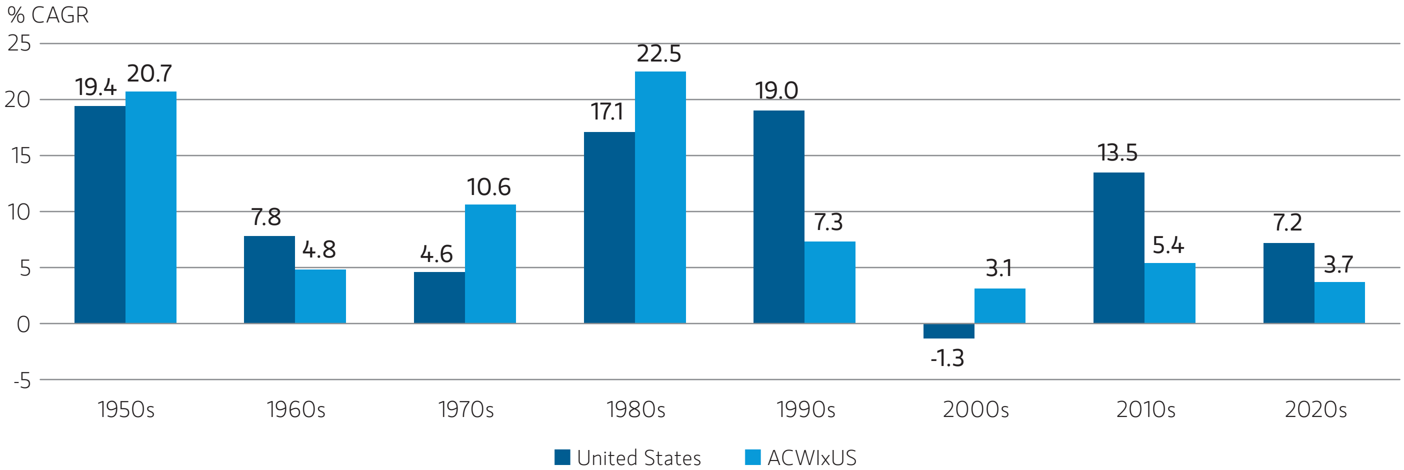


Source: MSIM, Bloomberg, FactSet, Haver. As of May 31, 2025. It is not possible to invest directly in an index.

DISPLAY 3

Historically, 50% Probability of Outperformance in International Equities

Past performance is not indicative of future results.



Source: MSIM, Bloomberg, FactSet, Haver. Based on total equity return 10-yr CAGR (compound annual growth rates) in USD. Based on the S&P 500 and MSCI All Country World ex U.S. Indexes. As of May 31, 2025. It is not possible to invest directly in an index.

There were decades when international equities dominated. The 1970s were marked by two oil shocks followed by stagflation which severely hobbled the U.S. market. In the following decade, Japan's economic miracle of the 1980s delivered extraordinary returns, while the U.S. endured a double recession. In the 2000s, the investment landscape once again tilted toward international stocks with China's emergence on the global stage. Its entry into the World Trade Organization, combined with a booming commodity supercycle, sparked a strong rally in international equities, lifting both emerging and developed markets relative to the U.S. These shifts demonstrate a critical lesson: market dominance is rarely permanent *(Display 3)*.

Since 2009, U.S. companies have consistently outperformed their European and Asian peers. They have leveraged superior technology, optimized global supply chains and enjoyed unmatched access to capital. U.S. firms also benefited from outsourcing production to lower-cost countries. Post COVID, aggressive fiscal measures further bolstered U.S. performance compared to the rest of the world. But many of these tailwinds are now fading.

Additionally, a large part of U.S. outperformance was supported by the rise of the dollar over the last 15 years. The U.S. currency typically moves in cycles: on average, the dollar has moved up in 10-year cycles and down in 6.5-year cycles. This time the U.S. dollar is up over a rare 14.5-year cycle and looks stretched based on long-term metrics, like real effective exchange rates and purchasing power parity.

Today, fiscal and monetary policies are increasingly more favorable outside the U.S. In particular, international equities, especially those in Western and Eastern Europe, several emerging markets and pockets of Japan, now present compelling opportunities. These regions offer attractive valuations, improving growth fundamentals and inexpensive currency valuations.

Our Framework for International Allocation

We deploy a disciplined, two-pronged framework for our international ex U.S. portfolio and aim to derive 50% of our alpha from **top-down** decisions and the other 50% from **bottom-up** selections, blending macro and micro insights to identify the right countries, sectors and securities.

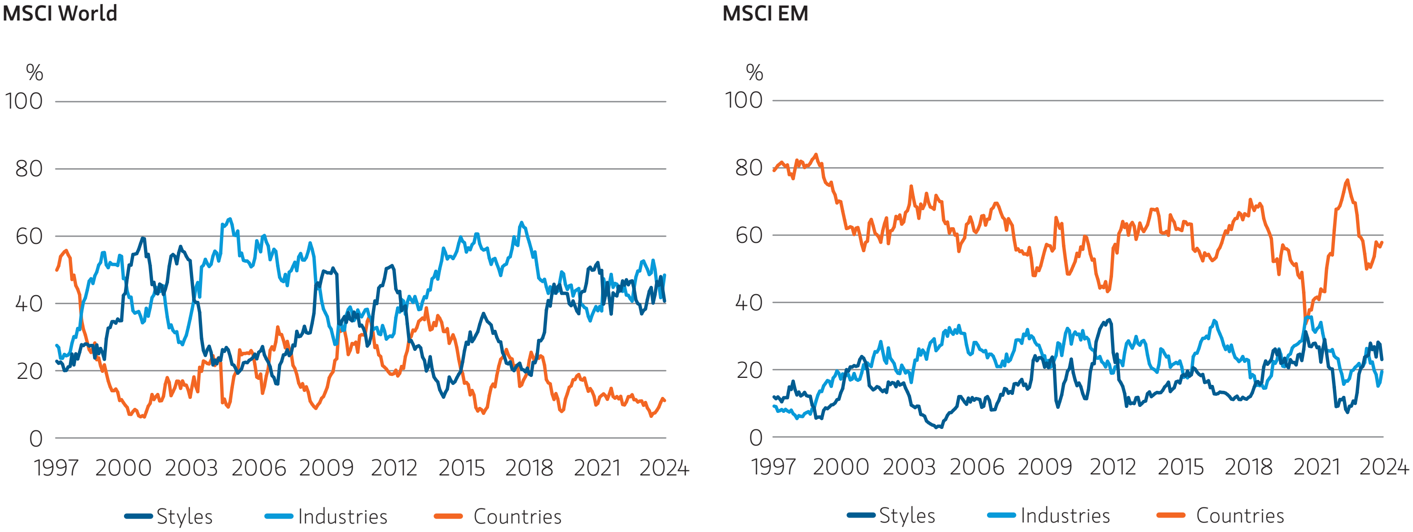
- **TOP-DOWN** includes macroeconomic country and thematic sector analysis.
- **BOTTOM-UP** includes security analysis independent of any style bias.

Importantly, currency is a not a byproduct of our investment decisions. Rather, it's an integral part of the process and can, on average, contribute roughly one-third of total returns. Currency considerations are central to both top-down and bottom-up decisions.

DISPLAY 4

What Matters in Developed and Emerging Markets Investing

Contribution of Systemic Risk Factors by Index



Source: Contribution of Risk Factors to Explained Cross-Sectional Volatility (MSCI, BARRA, GEM3). MSCI World and Emerging Markets Index data as of July 31, 2024. Risk factors shown are systematic factors and not including specific or currency risk. For illustrative purposes only and not meant to depict the performance of a specific investment. It is not possible to invest directly in an index. **Past performance is not indicative of future results.**

1. **TOP-DOWN:**
   COUNTRIES AND INDUSTRIES MATTER.
   MSCI Barra's analysis highlights how risk and return dynamics vary between developed markets (DM) and emerging markets (EM). In EMs, choosing the right countries is critical, while in DMs, selecting the right industries is key *(Display 4)*.

Our **country framework** includes analyzing politics and policy, liquidity and balance sheets of public and private sectors, growth and earnings of the country indices and currency implications.

Our **industry framework** involves thematic analysis in sectors that are globally interconnected, where performance is shaped not just by local fundamentals but global supply chains, regulatory shifts, innovation trends and geopolitical dynamics.

- **COMMODITIES:** Global demand and supply dynamics are vital for understanding this sector to determine resource location, cost curves and currency dynamics.
- **ENERGY:** The global push for energy security is redrawing the map for investment. Global demand and supply for fossil fuels, increasing share of renewables, cost curves and geopolitical developments are important considerations for positioning.
- **TECHNOLOGY:** Understanding where competitive advantage lies in the global technology supply chain, from hardware to software, is critical.
- **HEALTHCARE:** Demographic shifts, pharmaceutical pipelines and biopharma innovation are important considerations.

2. **BOTTOM-UP:**
   STOCK SELECTION WITHOUT A STYLE BIAS.
   As core investors, we avoid style biases. We are not restricted to classifications like "growth" or "value." Instead, our philosophy emphasizes investing in companies with strong fundamentals and growth potential. Valuations matter, but we focus on value stocks when there are catalysts to unlock that value, whether through margin expansion, operational leverage or structural tailwinds.

What to own in international markets

Several countries and themes have tailwinds that make a compelling case for international rebalancing.

COUNTRY TAILWINDS

We believe now is the time to shift focus to countries with large domestic economies, robust liquidity cycles, and supportive monetary and fiscal policies—conditions that are now more favorable outside the U.S.

India leads as a structural story with structural reforms implemented over the last decade, a domestic, demand-driven economy with low GDP per capita, and significant catch-up potential with increasing consumption and investment. The country has the ability to withstand external shocks thanks to its strong service orientation in exports, sound external position and adequate reserves.

Europe, long held back by austerity in core economies, and deleveraging on the periphery, is now pivoting to growth. Both of those trends are reversing. Core countries are now resorting to stimulus measures while the peripheral countries, including Greece, Italy, Ireland and Spain, are pushing ahead with structural reforms, deleveraging and expanding tourism while attracting capital through EU support.

The EU Recovery and Resilience Facility (RRF) fund at 2-3% of GDP through 2027, should reignite consumer demand, which has been subdued, and support a domestic recovery. We see opportunities in Core Europe, the Periphery and Eastern Europe.

Reforms are also underway in key emerging markets like Brazil and Indonesia while a move to implement more orthodox policies in frontier markets like Egypt and Kenya, along with currency devaluations make for attractive investments.

INDUSTRY TAILWINDS

- **AI ADOPTION:** We like artificial intelligence (AI) adopters rather than just enablers, and digital platforms across several industry verticals in international markets.
- **INDUSTRIAL RENEWAL:** Compelling industrial opportunities in defense, electrification and automation align well with the current stage of the industrial cycle globally.
- **FINANCIALS:** Regional tailwinds support financials which stand to benefit from fiscal stimulus in Core Europe, deleveraging in Peripheral Europe and domestic recovery in Eastern Europe.
- **SILVER ECONOMY:** Aging populations in Europe and North Asia (Japan, Korea, China and Taiwan) will create demand for healthcare, financial security and automation. On the other hand, the rising share of millennials and Gen Z will benefit value-driven consumption and digital platforms.

The Bottom Line:

For asset allocators, this is not about abandoning U.S. exposure, it's about restoring balance and positioning portfolios for the next leg of the economic and stock market cycle. International equities are the underpriced call option on domestic demand recovery, policy divergence, industrial investments and currency rotation.

After a decade and a half of U.S. dominance, the balance of risk and reward has shifted. We believe now is the time to diversify globally: investors who fail to look beyond U.S. borders may risk missing the next market cycle.

Risk Considerations

Diversification does not eliminate the risk of loss. There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by a portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in a portfolio. Please be aware that a portfolio may be subject to certain additional risks. In general, **equities securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, market and liquidity risks. The risks of investing in **emerging market countries** are greater than the risks generally associated with investments in foreign developed countries.

INDEX DEFINITIONS

Standard & Poor's 500 Index is an unmanaged index of large-cap stocks commonly used as a measure of U.S. stock market performance.

The **MSCI World Index** is a free float adjusted market capitalization weighted index that is designed to measure the global equity market performance of developed markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.

The **MSCI Emerging Markets Index** is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance of emerging markets.

The **MSCI All Country World Ex U.S. Index** is a free float-adjusted market capitalization weighted index designed to measure the equity market performance of developed and emerging markets, excluding the U.S. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.

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