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Principal Asset Management℠

Don't overlook the world:
The case for going global in equity investing

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Investors today face no shortage of choices, but fewer sources of return. In the U.S. equity market, earnings-driven outperformance has been overwhelmingly concentrated in the Mag Seven, pushing indices higher while quietly increasing portfolio concentration. While the strength has been impressive, it has also sharpened a familiar challenge: how to pursue alpha while meaningfully diversifying risk.

One approach to diversification has been to look beyond the Mag Seven and toward the broader U.S. market, including the S&P 493. Yet true diversification may require a wider lens. International equities, long dismissed after a decade of relative underperformance, are re-emerging as a potential solution to rising concentration risk. A historically wide valuation gap between U.S. and non-U.S. markets, combined with signs of converging earnings growth, creates a compelling backdrop for re-evaluating global equity allocations as a source of strategic balance in portfolio construction.

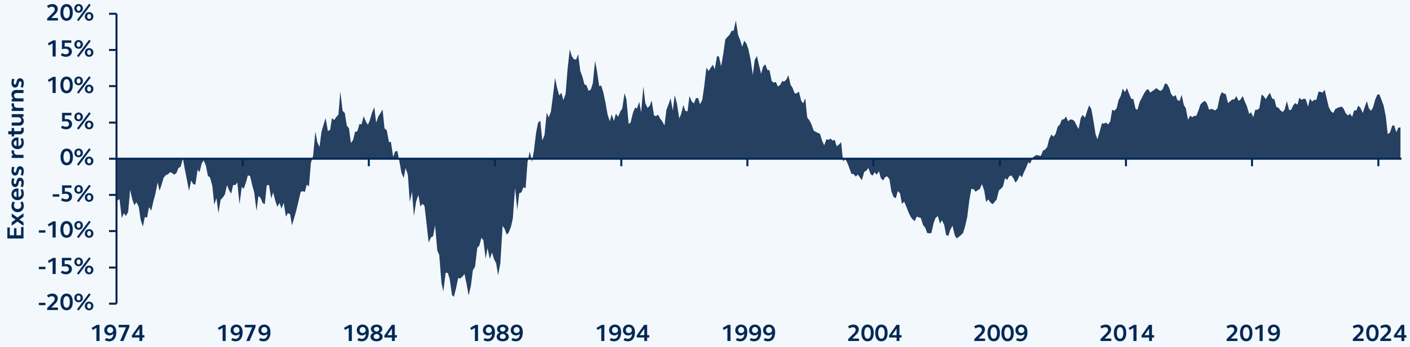
Earnings disparity and market concentration

U.S. equities have been the clear outperformers in recent years, supported by earnings growth that has meaningfully outpaced that of international markets. This leadership has naturally driven a pronounced investor bias toward U.S. allocations. Beneath the headline performance, however, returns have been increasingly concentrated within a small group of dominant technology firms, commonly referred to as the "Mag Seven"—Microsoft, Apple, Google, Amazon, Meta, Nvidia, and Tesla. In fact, technology accounts for more than 35% of the MSCI USA Index, but only 15% of the MSCI ex-USA Index. While these seven companies have indeed generated stellar earnings growth, the resulting concentration poses inherent risks that may leave investors vulnerable to sector-specific downturns.

It's been 14 years... is the cycle turning?

The U.S. market exhibits a relatively modest earnings yield, bolstered by a strong historical growth rate that has inflated valuations. Should U.S. growth expectations moderate as Mag Seven's growth reversion unfolds, American equities' returns would likely weaken. By contrast, the earnings yield for non-U.S. equities is more attractive, but its historical growth rate is significantly weaker. This divergence not only signals a compelling investment opportunity but also suggests the potential for significant upside if international equities and U.S. growth converge.

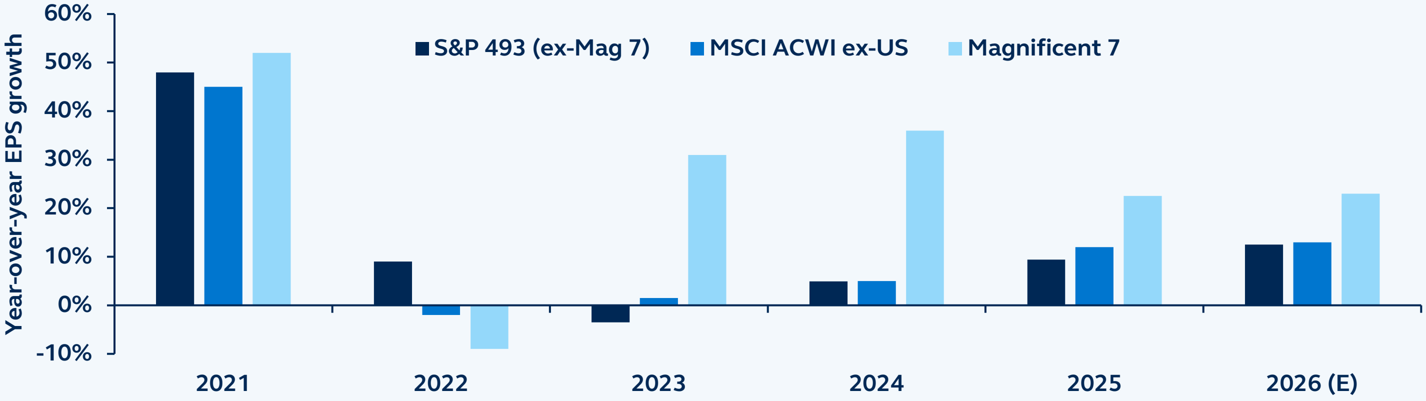
U.S. equity vs. international equity 5-year monthly rolling returns
MSCI U.S. vs. MSCI World Ex-U.S., 1975–2025



Source: Bloomberg. Data as of December 31, 2025.

Global earnings growth comparison: U.S. vs. International

Earnings growth of the ACWI ex-U.S. vs the S&P 493 (ex-Mag Seven) and Magnificent Seven, 2026 data is estimated



Source: MSCI, FactSet, Deutsche Bank, Principal Asset Management. Data as of December 31, 2025.

Shifting expectations: Earnings growth convergence on the horizon

The equity landscape is poised for a notable shift in the coming years. Analysts have begun forecasting a slowdown in the Mag Seven's growth as the law of large numbers takes hold. If growth expectations for these tech giants begin to taper, it will likely trigger a reevaluation of the premium currently afforded to high-multiple U.S. equities. Analysts predict that the Mag Seven's growth could converge with the rest of the U.S. equity market and, importantly, with international markets as well.

This impending slowdown in U.S. growth presents an opportunity for institutional investors. By diversifying into international equities, portfolios may capitalize on higher earnings yields and potentially stronger returns as the global economic cycle evolves. Historical performance data reinforces this outlook—U.S. and international equities tend to alternate periods of outperformance, demonstrating the cyclical nature of market dynamics.

Enhanced valuation metrics: Examining the relative appeal

The current valuation metrics strongly underscore an attractive entry point for international equities. When examining the cyclically adjusted price-to-earnings (CAPE) ratio, it's evident that U.S. equities are currently trading at levels suggesting overvaluation. For example, CAPE ratios in the U.S. hover around 39, significantly higher than their historical average of about 18. In contrast, European (approximately 21) and other international markets (ranging from about 15 in China to approximately 25 in Japan) offer more favorable valuations, making them increasingly appealing to investors seeking value.

International earnings growth has shown a clear inflection point, rising to 7.8% in the third quarter of 2025, the fastest pace in three years. This acceleration contrasts with increasingly mature growth dynamics in the U.S. and points to a gradual rebalancing of earnings leadership. As earnings improve outside the U.S., international equities appear better positioned to contribute both diversification benefits and incremental return potential to portfolios.

The long-term value proposition

Market cycles are inherently uneven, and periods of sustained leadership are often followed by inflection. A long-term horizon does not eliminate volatility, but it does allow portfolios to benefit from shifts in relative fundamentals as they emerge. Historical evidence suggests that selective exposure to international equities has improved risk-adjusted outcomes over full market cycles, particularly during periods when U.S. equity leadership narrows and concentration risk rises.

Today's environment reflects many of those conditions. As earnings momentum outside the U.S. improves and valuation differentials remain elevated, international markets are beginning to reassert their role in diversified portfolios. With U.S. equity performance still heavily anchored to the MAG Seven, broadening global exposure offers a more balanced source of return drivers across geographies, sectors, and economic cycles.

Taken together, these dynamics argue for a reassessment of global equity allocations. Looking ahead in 2026, incorporating international equities is not simply an exercise in diversification, but a means of aligning portfolios with evolving earnings trends, valuation regimes, and sources of long-term return.

Risk considerations

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