

Diversified asset allocation and US fiscal dominance (Abridged)

After the most significant sell-off in the Greenback since 1973 during H1 2025, investors are recognising the need for more diversified portfolios. The challenge lies in the fact that many asset allocations are anchored to free-float market cap-weighted indices with a survivorship bias. These naturally overweight the US, given higher average free floats than is typical in the Rest of World (RoW), and lofty valuations.

This piece explores different approaches to geographical asset allocation, offering a practical framework for investors seeking to reduce concentration risk and build more resilient portfolios in a shifting global macro landscape. We think the rising risk of fiscal dominance in the US – where monetary policy becomes constrained due to very high government debt and interest costs – will lead investors to consider diversifying into regions where this dynamic is less prevalent.

Rethinking asset allocation: How much can investors diversify away from US equities?

Most asset-allocators' global equity portfolios are benchmarked against the MSCI ACWI. Its country weightings are calculated by each country's free float market cap, meaning the ACWI is 65% US stocks. However, the US makes up only 35% of earnings from the ACWI. In our view, to develop a truly diversified portfolio, investors should consider the *total* size of each market, i.e., not just the free float, as well as its daily traded volumes. Fig 1 calculates the total market cap and daily turnover per region, demonstrating a large discrepancy to the MSCI ACWI weightings. This shows that essentially, MSCI ACWI investors hold a large, if unintended, active overweight in US stocks.

Fig 1: Equity market exposure

MSCI ACWI		Allocation by		Unintended Active	
Region	%	Mkt Cap	Turnover	Mkt Cap	Turnover
US	64.4%	48.4%	39.8%	16.0%	8.6%
DM ex-US	25.2%	24.0%	19.7%	1.3%	4.3%
CN	3.0%	8.3%	31.5%	-5.3%	-23.2%
EM ex-China	7.5%	18.5%	8.8%	-11.1%	9.7%
Frontier	0.0%	0.9%	0.3%	-0.9%	0.6%

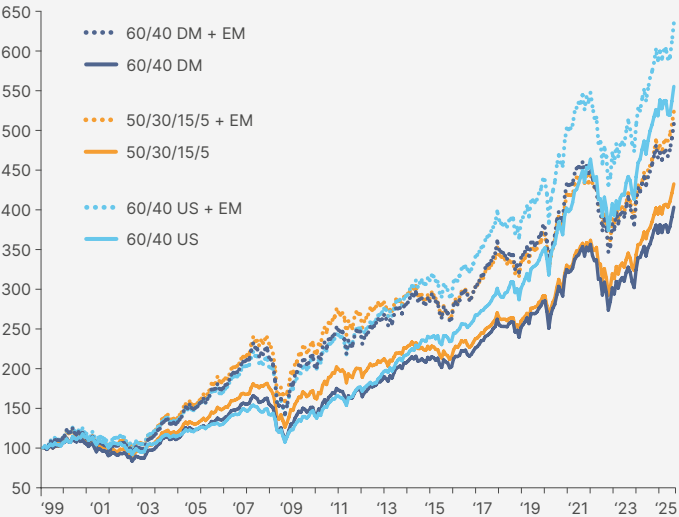
Source: Bloomberg, CEIC, Ashmore. Data as at June 2025.

Adding EM assets boosts total returns and risk-adjusted returns

Fig 2 shows the performance of three theoretical passive portfolios since 31 December 1998 and compares it with the performance of the same allocations with an additional exposure to EM. In summary, adding EM exposure to almost any portfolio (dotted lines of Fig 2) improved total returns, without increasing volatility significantly.

Theoretical Portfolio	Composition
60/40 DM	MSCI World / JP Morgan GBI DM bonds
60/40 DM + EM	40% MSCI World; 20% EM eq.; 25% DM govt; 15% EM debt
50/30/15/5	50% DM equities, 30% DM bonds; 15% commodities ² ; 5% DM cash
50/30/15/5 + EM	Adds 1/3 of EM across equities, bonds, cash ³
60/40 US	60% S&P 500; 40% US Treasuries
60/40 + EM	Adds 1/3 EM across equities, bonds ⁴

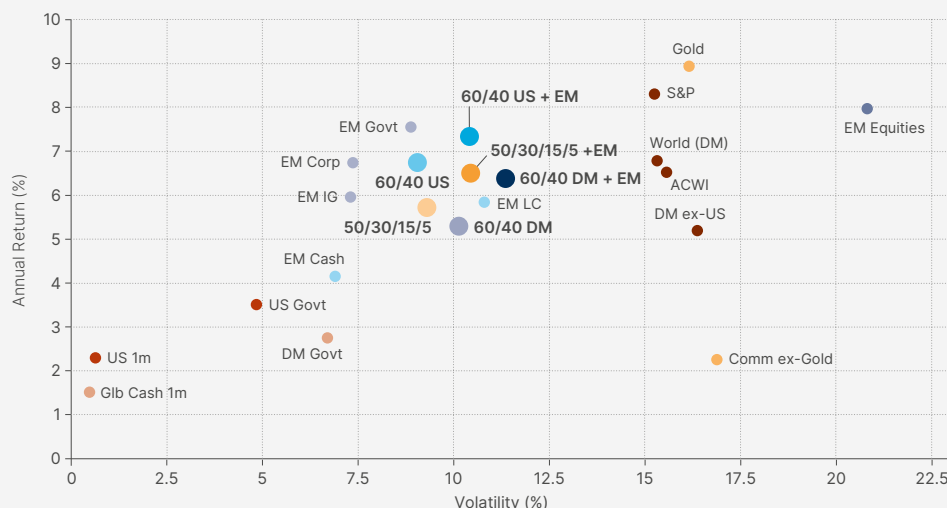
Fig 2: Total returns with and without EM allocation



Source: Bloomberg, CEIC, Ashmore. Data as at 30 June 2025.

Fig 3. shows that adding emerging market (EM) exposure moves portfolios up the efficient frontier by improving risk-adjusted returns.

Fig 3: **Efficient frontier across asset allocation strategies and building blocks**



Source: Bloomberg, Ashmore. Data as at 30 June 2025.

Correlations and portfolio construction considerations

Optimal portfolio diversification should always be at the forefront of investors' minds. However, asset allocators now need to pay extra close attention to a macro landscape which is shifting fast and changing cross-asset correlations with it.

- The US bonds vs. stocks correlation**
 Has remained positive since April 2021. This means that, for US investors in particular, bonds do not diversify equity portfolios as effectively as they did during most of the prior 20 years.
- The US equities/USD correlation**
 Flipped to positive in 2025, particularly during market sell offs. This matters for overseas investors, who had a natural hedge to their US exposure during most of the last 20 years when the correlation was mostly negative.
- EM USD Sovereign debt vs. US 60/40 portfolios**
 EM Sovereign debt has had a very low relationship with US 60/40 portfolios, even lower than global 60/40 allocations.
- EM Local Currency (LC) Sovereign debt vs US 60/40**
 Correlation has been declining as USD has sold off. Broad diversification away from USD and high nominal and real interest rates suggest increasing demand for EM LC debt going forward.

The positive correlation between US stocks, bonds and currently the dollar means higher volatility for a classic US or indeed global 60/40 portfolio. This suggests it is now paramount to consider the addition of less correlated assets, such as EM stocks and bonds, to portfolios to restore diversification.

The inconvenient truth

As we continue to highlight, diversifying away from US assets, particularly equities, is key now that the pro-cyclical fiscal expansion that fuelled US exceptionalism is set to reverse, in our view. Tariffs will be the primary driver of this reversal, representing a large tax hike spread across both corporates and consumers. At the same time, other major global economies, namely the EU and China, look set to move into significant fiscal expansion over the next few years. This fiscal policy divergence leads us to believe asset allocators should be looking to.

- Pay long-end EUR rates vs. receive front-end to intermediate US rates.
- Buy RoW currencies (EUR, JPY, RMB, EM), sell USD.
- Buy RoW equities vs. US equities.

The spectre of fiscal dominance

'Fiscal dominance' arises when monetary policymakers lose the freedom/ability to control inflation through rate cuts. This can happen either due to direct government interference, or due to government debt so large that raising rates becomes counterproductive, potentially leading to capital flight and currency depreciation, which is inflationary. When monetary policy remains loose in an inflationary environment, currencies weaken, yields curve steepen and scarce asset prices rise as currency debasement sets in.

Threading the needle: Lower rates, but no inflationary pressures:

While the US is not yet in full-scale fiscal dominance, it is flirting with it. Trump wants low rates and will probably soon appoint a Federal Reserve chair who he sees eye-to-eye with. Fiscal dominance can be avoided, however, if fiscal consolidation fosters a macro environment where rates can be kept low without causing inflation. The US administration seem cognisant of this, but executing this plan will not be straightforward. While tariffs can be a powerful revenue raising tool, there are of course many risks, principally a recession, which would likely derail any consolidation efforts. Kevin Warsh, the current favourite to be next Fed Chair, has also talked about shrinking the Fed's balance sheet, a kind of quantitative tightening, while lowering rates to neutralise the loosening of financial conditions.

Conclusion

In a quickly shifting macro landscape, where traditional cross-asset correlations are breaking down, we strongly believe investors will be compelled to increase diversification. Raising exposure to EM equity and EM debt can enhance diversification in global multi-asset portfolios and tends to boost total returns in the long-run.

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The Emerging View

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By Gustavo Medeiros and Ben Underhill

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Head office

Ashmore Investment Management Limited, 61 Aldwych, London, WC2B 4AE T: +44 (0)20 3077 6000

Local offices

Bogota T: +57 1 316 2070	Jakarta T: +6221 2953 9000	Riyadh T: +966 11 483 9100	Lima T: +511 391 0396	Fund prices www.ashmoregroup.com Bloomberg FT.com Reuters S&P Lipper
Dubai T: +971 440 195 86	Mumbai T: +9122 6269 0000	Singapore T: +65 6580 8288		
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