

2026 Global Equity Outlook: International Equities Remain the Asymmetric Opportunity

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Many themes that were top of mind in 2025 remain highly relevant in 2026, including the somewhat surprising resilience in the U.S. and most economies worldwide.

As was the case a year ago, we enter 2026 with limited clarity on the trajectory for the global economy or equity markets. The capital intensity of developing artificial intelligence continues to increase. There has been a divergence in the breadth of market returns around the world, suggesting more opportunities to find relative value outside the U.S.

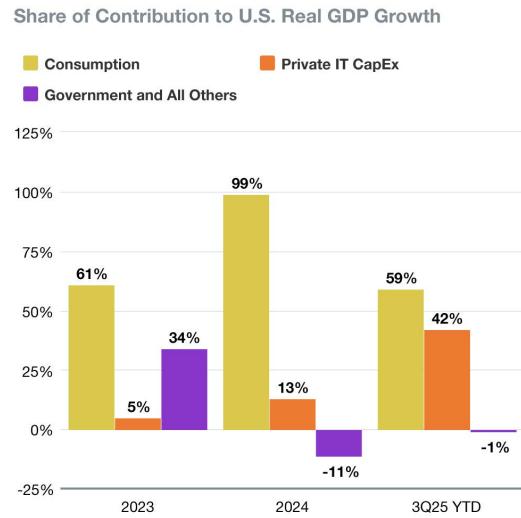
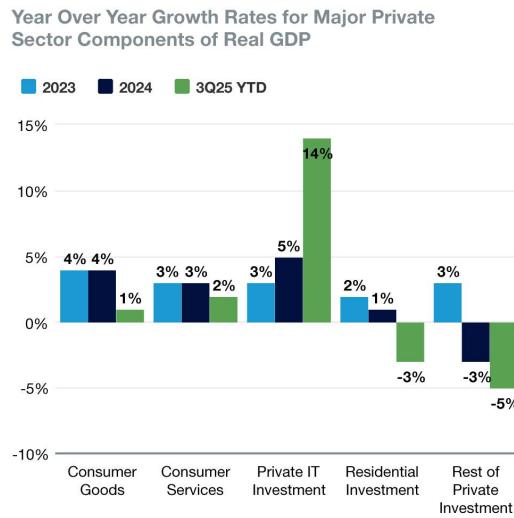
While it's not likely that there's kindling for a major crisis in the near term, most financial assets are currently priced with little compensation for risk, making it essential for investors to remain focused on individual security analysis and downside protection while pursuing differentiated returns.

A Two-Speed U.S. Economy: IT Investment Driving Growth Amid Broader Softening

Although only three-quarters of the 2025 GDP data have been released, there seems to be only a handful of pockets of real strength in the U.S. economy. Consumption has decelerated broadly, while capital expenditures for residential and non-IT investment are down year-on-year. The clear bright spot has been private IT capital expenditures, which encompass all data center and software investments related to the race for leadership in artificial intelligence.

IT investment is growing at over 14% year-over-year, which is almost five times faster than other major parts of the U.S. economy (see the left-hand chart below). However, with total IT investment now annualizing at about \$1.5 trillion, it's a much smaller component of the total economy than personal consumption (\$21 trillion) or federal, state, and local government spending (\$5 trillion-plus). Yet even though IT investment totals just about 5% of 2025 GDP, it looks set to contribute over 40% of 2025's GDP growth (see the right-hand chart below).

IT Investment Driving U.S. GDP Despite Broader Slowdown



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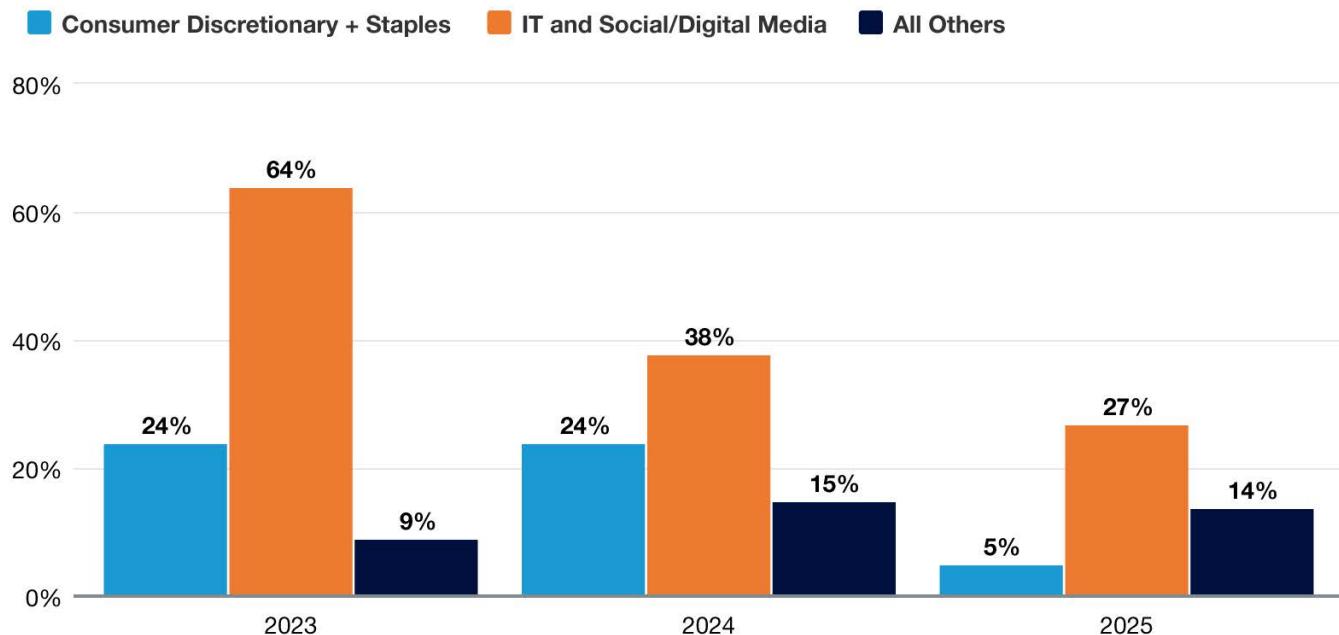


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In 2025, the U.S. equity market reflected the divergent growth rates of the overall economy, with consumer stocks delivering the lowest returns, as earnings were less compelling due to the deceleration in consumption. IT companies and social/digital media performed best, given their alignment with the AI theme. The returns of other sectors were in between, often reflecting relief rallies as new government policies were less impactful than initially feared.

While returns in the tech space were strong, there have been incrementally lower stock price returns each of the last two years, coinciding with rising valuations and the dramatic increase in the capital intensity of the AI race. Expectations are for the rate of growth in IT capex to decelerate in 2026 (given the high base), but the absolute level of IT spending should still be dramatic and notably higher than prior years. This is positive for the optics of measuring GDP, but investors are becoming more discerning about whether the companies are generating sufficiently attractive returns on the enormous amounts of newly deployed capital.

Sector Performance Divergence: Tech Leads, Consumers Lag in 2025



Source: FactSet, as of 31 December 2025.
Past performance does not guarantee future results.

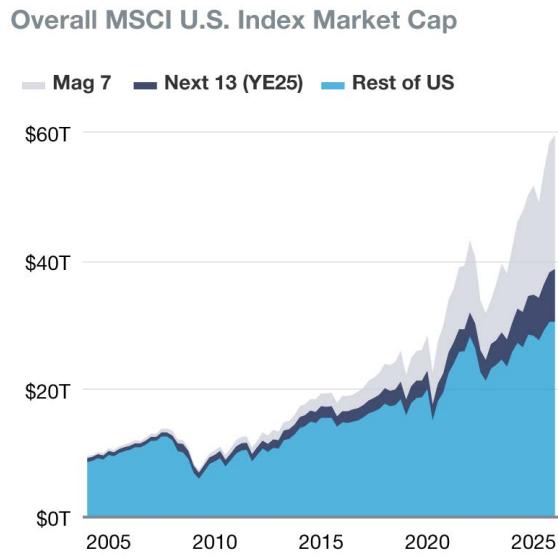
Given the pauses for various negotiations, the full weight of the new tariff regime will only be felt during the first half of 2026. The all-in effective blended tariff rate on U.S. imports was less than 4% in March 2025, about 10% by August, and it is currently expected to reach 15-17% in 2026. U.S. inflation in 2026 may remain stickier than wished as the higher tariffs and immigration policies are fully digested by the U.S. economy, flowing through consumer goods and the industrial supply chain.

With non-IT private capital expenditures shrinking in 2025, there has not yet been an employment tailwind or domestic production offset to rising tariffs. Hence, there is caution about predicting a major near-term recovery in consumer spending, and the low visibility into a rebound in non-IT private capital expenditures, despite the administration's goals. However, an unexpected tariff relief or new consumer stimulus could support stocks in the consumer sector (even if it challenges the fiscal deficit).

Diversification: Opportunities Beyond U.S. Mega-Caps

Exiting 2003 (when markets had rebased following the Tech Bubble and 9/11), the market capitalization of the ACWI ex US Index was approximately \$10 trillion, and the MSCI USA Index was almost identical in size. At the end of 2025, the U.S. index is nearly \$20 trillion larger than the international index. However, when excluding the "Magnificent 7" companies, the market cap of the remaining companies in both indices is actually still roughly equal. Big tech is unique to the U.S., but value creation has still continued around the world.

The Mag 7's Market Cap is Equal to the Entire MSCI U.S. Index's Market Cap in Early 2017



Source: Bloomberg, as of 31 December 2025.

As the “Magnificent 7” and similar names have become larger, there has been a historically unique degree of narrowness in U.S. stock market returns. Not only are the largest 25 weights in the U.S. Index now more than 50% of the total market cap, but they have contributed nearly 70% of the U.S. market’s return in each of the last three years.

The dominance of a few companies in the U.S. stands in stark contrast to international equities, where the larger weights are a far smaller component of the total index, and these largest companies have also had a much less significant impact on overall market returns.

U.S. Index Concentration vs. International Breadth



Source: FactSet, as of 31 December 2025.

Past performance does not guarantee future results.

The U.S. might be over-simplified as an *allocator's market*, where a key decision for relative performance is simply about whether to be overweight or underweight the biggest names in the index. However, the rest of the world appears to be a “stock picker's market,” where the breadth of solid ideas and opportunities for making relative value decisions can enable genuine alpha generation.

After a strong 2025, many investors are asking, "Is it time to fade the international rally?" or "Is it too late to allocate into international?" Investors shouldn't discount the chance that there could be occasional market dips or that a U.S.-related scare could weigh on all stocks globally. However, even after 2025, there aren't notable indications that international equities are over-extended.

In particular, there is a solid argument around the outlook for earnings growth. Simply put, U.S. stocks can keep trading at 20x or higher, and international companies can continue trading at 15x or lower, but if they're growing at similar rates, price appreciation can be similar. Add in optionality for an improvement in valuations along with dividends' contribution to total return, and the risk-return looks favorable outside the U.S.

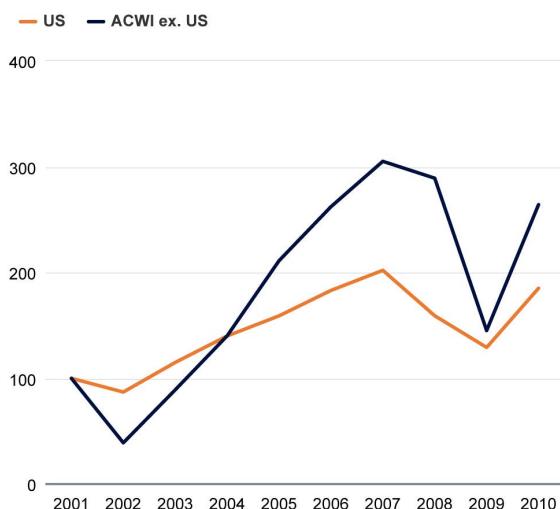
For investors patient enough to look past short-term market volatility, the academic argument is that over the medium- to longer-term, share prices have always moved in line with expectations about the trajectory of future earnings. In the 2000s, as the dollar weakened and U.S. companies recovered from the tech bubble excesses, earnings growth was more robust outside the U.S. In the 2010s, more stimulative policies following the Global Financial Crisis supported dollar strength and led to materially faster earnings growth. In the early years of this decade, the policy response to COVID-19, combined with certain dislocations from Russia's invasion of Ukraine, also led to faster U.S. earnings growth.

Today, AI-related tech companies are showing robust growth. There are various debates about the durability of the outlook for the current hot spots in the space, and investors have multiple ways to choose from when investing in high-growth tech. But excluding AI-related tech, the outlook for earnings growth is more similar around the world.

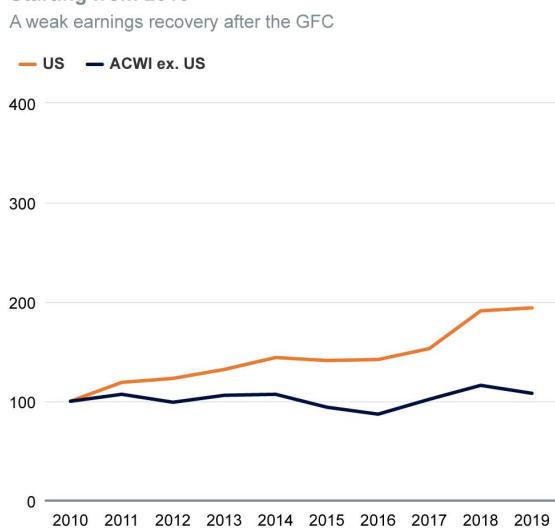
As the right side of the chart below illustrates, companies outside the U.S. have successfully adapted after COVID, and to the impacts from Russia's attack, and in the last few years, they have returned to a more visibly stable growth profile – making global diversification more attractive to investors who had previously viewed the U.S. as *the only game in town*.

Global Earnings Trends: International Expectations Keeping Pace with the U.S.

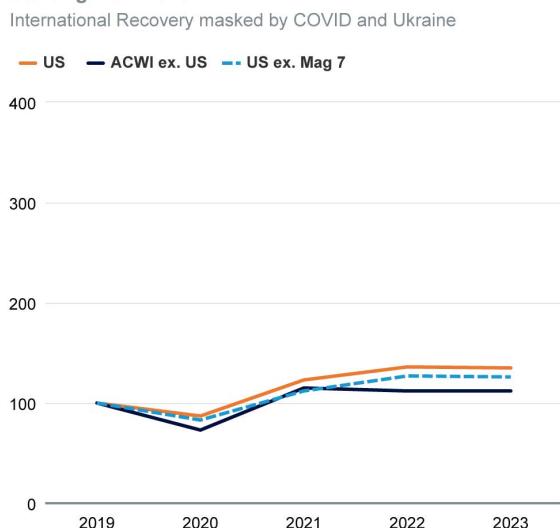
Starting from 2001



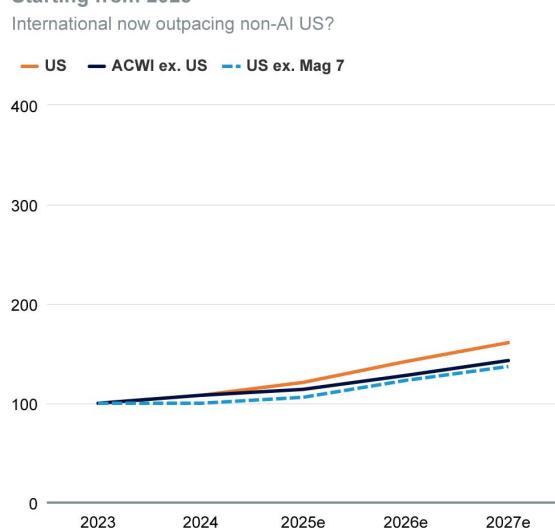
Starting from 2010



Starting from 2019



Starting from 2023



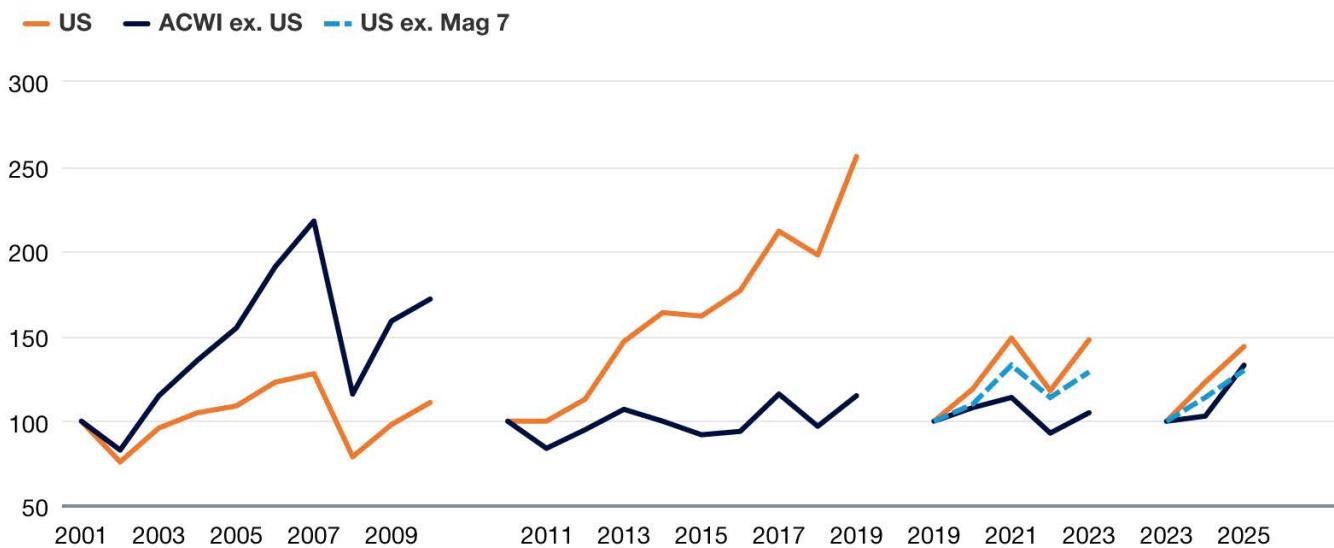
Source: Bloomberg, as of 31 December 2025.
Past performance does not guarantee future results.

And it's not just an academic idea that stocks follow earnings. Over the last 25 years, stocks have generally followed their earnings trends. Yes, opportunities to invest in high-growth companies wrapped up in the AI theme are largely found in the U.S. But as investors look toward a global environment where international companies are again growing earnings in a consistent fashion, there may be the potential for international equity returns to compete well with U.S. corporates across sectors in client portfolios.

Price Returns Track Earnings Over Time

Indices Total Cumulative Price Return Indexed to 100

Starting from year 2001, 2010, 2019 and 2023



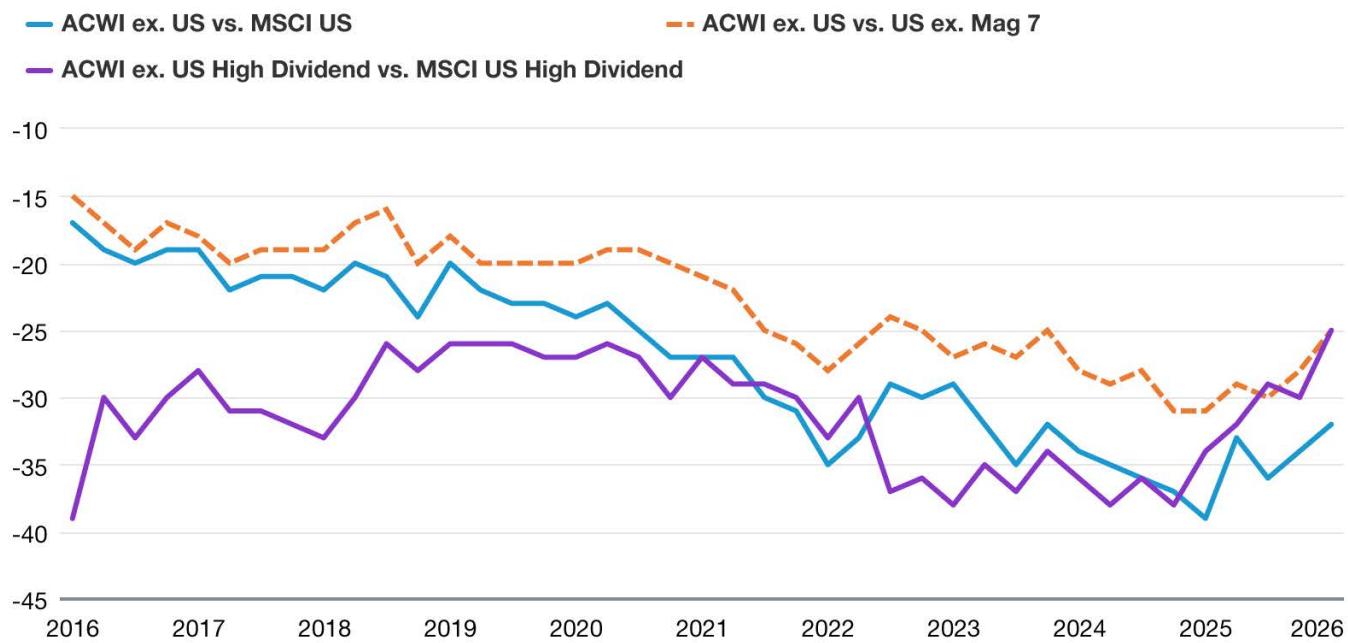
Source: Bloomberg, as of 31 December 2025.
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Relative Value and Downside Protection

For many years, one of the only arguments for investing outside the U.S. was "International is cheap." But when general visibility into earnings growth was lackluster, many international equities were "cheap for a reason."

Now, even after a strong 2025, investors may have more prospects for relative value outside the U.S. based on prices, fundamentals, and visibility. Amazingly, despite improved earnings fundamentals over the last few years, stocks outside the U.S. are still trading at a larger valuation discount than when earnings were stagnant in the latter part of the 2010s. This is true for the general index and when looking at narrower indices like high dividend-paying stocks.

Valuation Discounts Persist Despite Improved Fundamentals



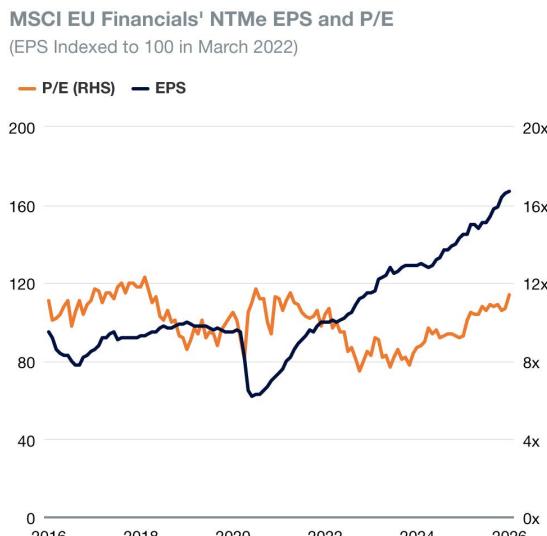
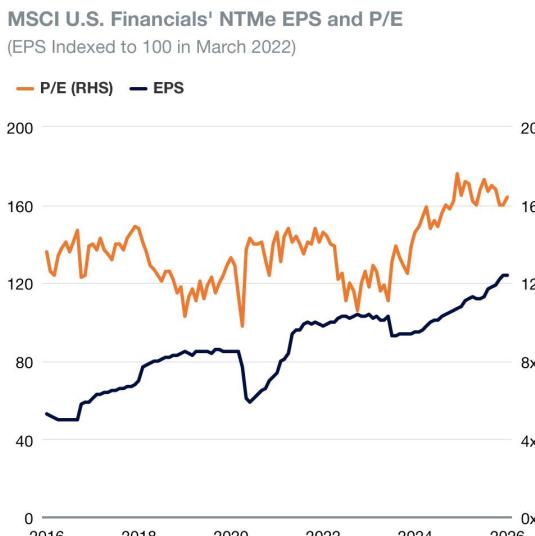
Source: Bloomberg, as of 31 December 2025.

The discounts shown in the broad indices extend across sectors and countries. The financials sector is just one area where there are individual securities with a differentiated return potential, but it exemplifies the relative value asymmetry when comparing a variety of non-U.S. companies with their American peers. For brevity, we'll just consider the specific case of European vs. U.S. financials.

Banks and insurance companies are beneficiaries of higher interest rates; therefore, the zero- or negative-interest-rate environment following the financial crisis and again during the COVID-19 pandemic was particularly challenging for the earnings of all financial institutions. The U.S. first began raising rates at the end of 2016, but Europe didn't see rates move off the zero bound until 2022. In both regions, financials worked hard to upgrade technology and operate more efficiently, so U.S. financials saw an inflection in earnings growth around 2017 while European financials began to see profits grow in 2023.

However, even with a notable improvement in earnings growth and the quality of earnings, along with strong balance sheets and excess capital, European financials haven't seen a valuation re-rate like their U.S. peers. U.S. financials are trading at their highest P/E multiples in over 20 years, while the P/Es and dividend yields in Europe remain largely unchanged from a decade ago, when uncertainty and fundamental risks were significantly higher, according to the next 12 months estimates (NTMe).

Financial Valuation Gap: Higher European Earnings Growth, Lower Valuations



Source: Bloomberg, as of 31 December 2025.

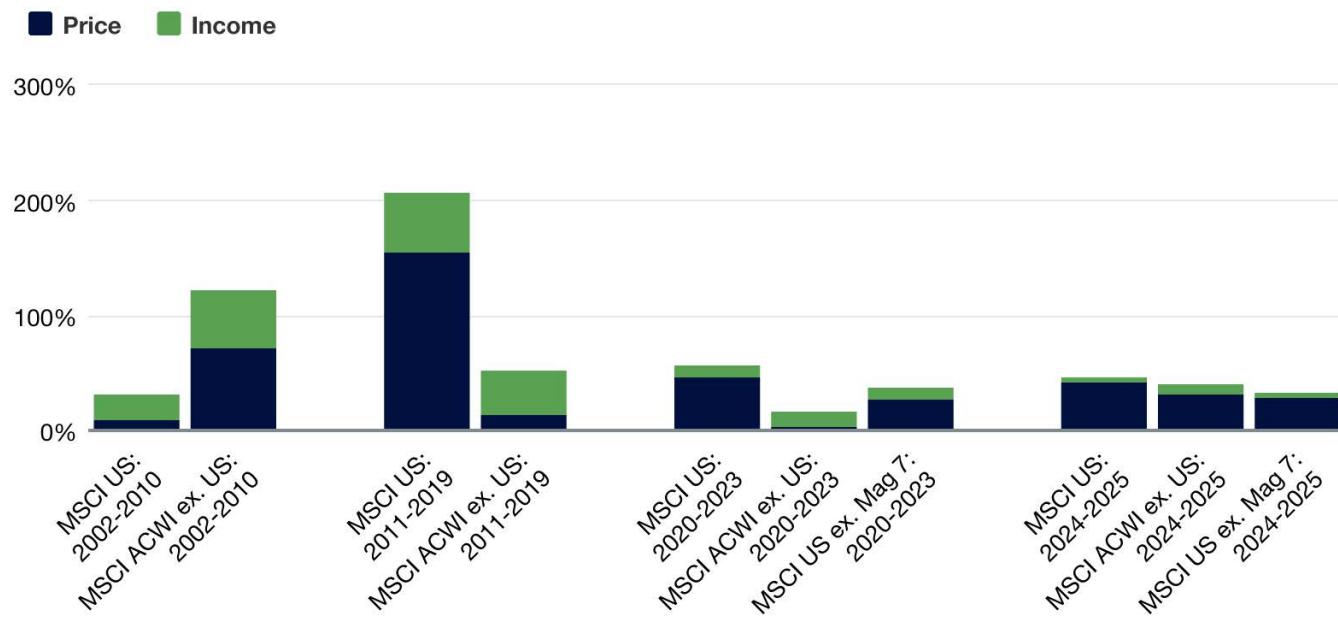
There have been similar trends across many sectors and countries. Yes, there was a prolonged period when fundamentals were challenged, but international fundamentals have recovered, while international valuations don't indicate much bullishness. 2025 didn't create a lot of froth in the market.

Still-low valuations, especially in the context of a healthier earnings picture following a strong 2025 performance, contribute to one component of downside protection for international equities. Valuation compression could be particularly painful for certain parts of the U.S. market, given the current state of U.S. valuations. An additional cushion is also available, as expectations for international earnings growth appear to be less aggressive compared to forecasts for the U.S.

While dividends are generally discussed in the context of total return, it's often forgotten how dividends cushion the impact and "investor ride" of share price declines. Being "paid to wait" by dividends allows investors to be more patient during market volatility or to maintain conviction when a single bad quarter causes a sell-off.

In the previous charts, we showed how index price returns have closely tracked index earnings growth. However, the chart on the right only shows the price return and omits the contribution of dividends to the total return. The following chart illustrates how material dividends can help mitigate a tough environment. ACWI ex U.S. earnings grew hardly at all from 2010 to 2019, and the cumulative share price return was only 15% over the nine years. However, dividend income contributed an additional 39% to the total return. Cumulative price appreciation was 5% while dividend income added 14% to total return during the challenging 2020-2023 period.

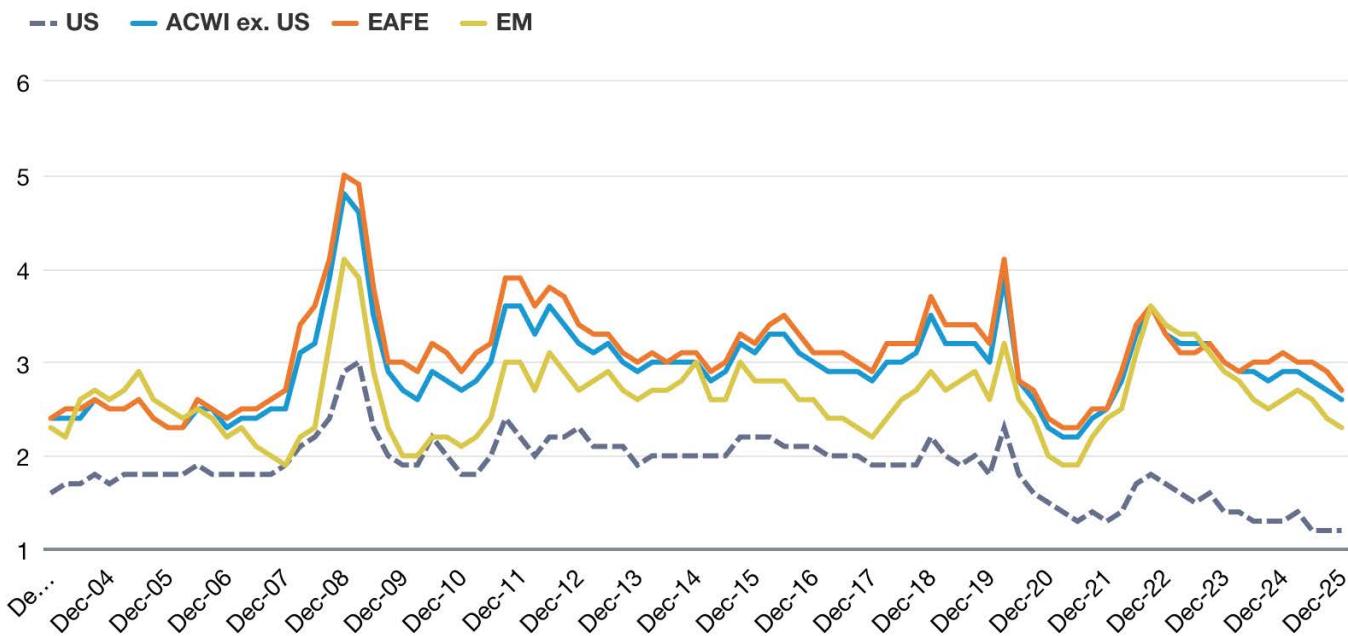
Dividends as a Cushion: Enhancing Total Return Stability



Source: Bloomberg, as of 31 December 2025.
Past performance does not guarantee future results.

If the stability of the economic or market environment is in question, or non-US earnings growth is weaker across the world, dividends will cushion the blow. However, across sectors, there is typically in excess of 200 basis points less cushion for downside protection from stocks outside the U.S.

Dividend Yields Are Notably Higher Outside of the U.S.



Source: Bloomberg, as of 31 December 2025.
Past performance does not guarantee future results.

Currency Optionality: A Hidden Lever for Global Returns

One additional component of the return stream is the optionality surrounding currency movements in 2026 and beyond. An allocation to non-U.S. equities can provide sector and country diversification, valuation diversification, business quality and fundamentals diversification, dividend income diversification, and currency diversification.

History shows that the changing dynamics around foreign exchange rates can be material to global investors' total shareholder returns. Using the U.S. Federal Reserve's Trade Weighted Nominal Broad Dollar Index for perspective:

- From 2001-2010, as the U.S. recovered from the tech bubble and the rest of the world accelerated from the 1990s geopolitical resets, the dollar weakened by an average of about 2% per year.
- From 2011-2020, when the U.S. economy was particularly strong compared to much of the world, the dollar strengthened by an average of about 2% per year.
- From 2021-2024, as the world struggled to recover from COVID and feared Russia-Ukraine dislocations, the dollar strengthened by almost 4% per year.
- In 2025, as the role of the U.S. within the global system was debated and the economic vitality of the rest of the world became clearer, the dollar weakened by about 7%, reversing nearly half its move since 2020.

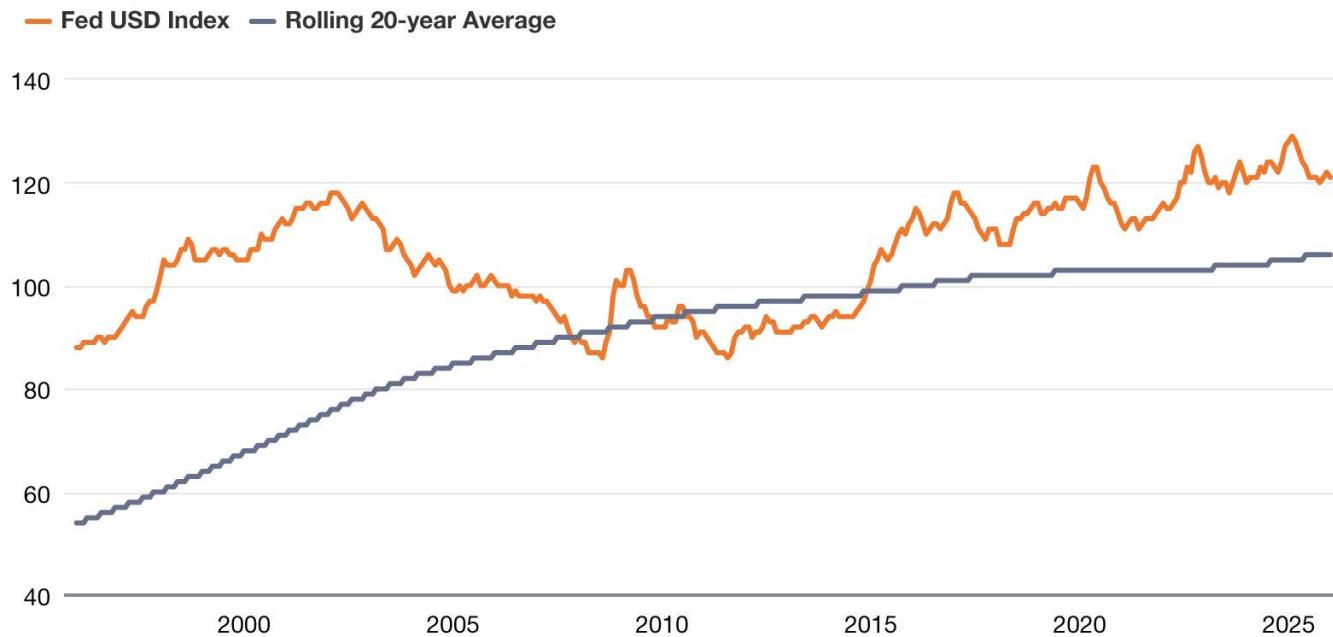
The most notable 2025 movement was in the Euro, along with other European and Latin American currencies, while Asian currencies was generally more muted. In 2025, the MSCI U.S. index's total return was +17.75%, while the MSCI EU index returned +20.20% in euro terms and +36.30% in dollar terms. In other words, local returns still outpaced those of the U.S., but the currency impact was significant. This situation was similar around the world, with exchange rates having differing effects by country (currency was almost immaterial for the MSCI Japan, where the yen-denominated return was +24.70% while the dollar return was +25.13%).

The prospect of a stable or weakening dollar could be another tailwind for stocks outside the U.S. in 2026 and beyond. Over the last 10-15 years, the total return for international equities has faced a persistent headwind from local currency weakening. Therefore, simply being in a stable exchange rate regime can allow earnings power to shine.

International stocks aren't dependent on this, but it isn't outlandish to think that the dollar could weaken by 1-2% per year going forward, reversing much of the strength it gained over the last decade. The following chart shows the Fed's Trade Weighted Nominal Broad Dollar Index over the last 30 years, along with the trailing 20-year average.

The index peaked at 130 on January 13, 2025, along with the U.S. exceptionalism narrative. After Liberation Day, in conjunction with other policies and geopolitical developments, the dollar began to weaken more consistently. The index is still almost 14% above its 20-year average and more than 40% above its 50-year average. As the reversion during the 2001-2010 period showed, dollar weakening can persist beyond 2025, and it is possible to see substantially more dollar weakness.

Dollar Trends: Potential Tailwinds for International Equities



Source: Bloomberg, as of 31 December 2025.
Past performance does not guarantee future results.

Final Thoughts

There is more unpredictability around the moving pieces in the U.S. environment, relative to the rest of the world, than we have seen in quite some time. This makes it easier for equity investors, based anywhere in the world, to consider reducing their U.S. allocations to diversify into other geographies. Yet great companies are also adapting to succeed in this changing landscape. While investors should remain “macro and policy aware”, active investors generally are most focused on the resilience and unique characteristics of each investment. The most valuable service active investors can provide isn’t predicting the macro but rather assessing whether these businesses can thrive (not simply survive) during these uncertain times.

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