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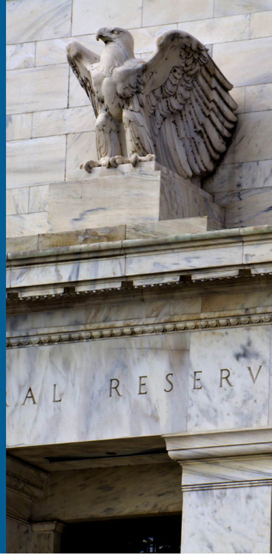

Are the U.S. and Emerging Markets Converging?

TALES FROM THE EMERGING WORLD | EMERGING MARKETS EQUITY TEAM | October 2025

U.S. stocks have dominated global financial markets for the last decade and a half, driven by robust earnings, a market rerating and the gravitational pull of a strong U.S. dollar (USD). Emerging markets (EM), by contrast, struggled under the weight of repeated crises—from the Asian financial crisis of the late 1990s, to the Global Financial Crisis and the COVID-19 pandemic. These shocks left EM equities and currencies at near-record discounts relative to the U.S., leading many investors to dismiss the asset class.

Having learned the hard way, EMs have rebuilt credibility through structural reforms, including balanced budgets and tightened monetary policy. Ironically, while many EMs have moved towards orthodoxy, the U.S. appears to be moving in the other direction, with growing policy volatility and government intervention. The fundamental differences that were instrumental to divergent equity market performance—politics, monetary and fiscal policies, earnings growth and external balances—are narrowing.

This convergence is most evident in currencies. In particular, the U.S. "strong dollar" policy is waning, and USD weakness has ensued. This is likely to compress U.S. premiums compared to the rest of the world, significantly improving the outlook for returns outside the USD. We believe that once the AI (Artificial Intelligence)-led rally in the U.S. runs out of steam, EMs have the potential to outperform, a trend that maybe already underway.

Here are the four reasons why we believe the U.S. and EM equities are converging:

Political Spillover

Traditionally, U.S. markets largely disregarded developments in Washington. What happened in the nation's capital did not significantly impact markets, and who resided in the White House did not affect equity markets.

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That is no longer the case. Political developments such as tariff disputes and budget negotiations have led to heightened policy volatility, influencing markets in ways once associated only with emerging economies. Events such as "Liberation Day" earlier this year led to a sharp drop in the S&P 500, while the subsequent "90-day pause" on tariffs sparked a reversal. This is not unlike recent policy shocks in Brazil under the Lula administration or the impeachment of South Korea's president at the end of 2024 that led to heightened market volatility. Today it seems that politics plague both developed and emerging markets alike.

Fiscal Trajectory

One of the clearest warning signs of a troubled economy is the steady erosion of fiscal discipline. U.S. President Trump's One Big Beautiful Bill Act (OBBBA), enacted in July, is projected to increase the existing budget deficit by 5% next year. According to the Congressional Budget Office (CBO), the U.S. budget deficit amounted to 6.4% of GDP last year. The tax and health care legislation is expected to add an additional $3.4 trillion to the deficit over the next decade, increasing public debt to at least 125% of GDP by 2034. While deficits are expected during economic downturns, this trajectory suggests the U.S. will continue to run persistent, and larger, deficits.

Conversely, EMs, once synonymous with fiscal excess that forced painful adjustments, have in many cases imposed greater discipline. Budget deficits are now broadly under control, with the average EM deficit lower than that of the U.S.

Even Argentina, long considered a symbol of fiscal mismanagement and central bank interference, has taken a decisive turn toward orthodoxy. President Javier Milei has slashed spending, rebuilt reserves and adopted a managed float for the peso.

Central Bank Credibility

An independent central bank is the cornerstone of a credible monetary policy. Yet today, the independence of the U.S. central bank is increasingly under pressure. President Trump has fired off a barrage of criticism against the Federal Reserve, demanded lower rates and even called for Chairman Jerome Powell's resignation. More recently, the president dismissed the Commissioner of the Bureau of Labor Statistics following the release of unfavorable employment data, further unsettling investors. These actions highlight a clear effort to politicize the Fed, whose independence is widely viewed as a pillar of U.S. economic and market stability.

This behavior is reminiscent of past episodes in EMs. In 2019, Turkish President Recep Tayyip Erdogan fired his central bank governor for failing to cut interest rates quickly enough. The dismissal led to a sharp deterioration of the Turkish lira. Brazil has also at times pressured its central bank to cut interest rates prematurely.

Yet, in recent years, EM central banks have earned credibility by acting decisively and independently to contain inflation. Most EM central banks are independent, and many are implementing tight monetary policy with real interest rates (i.e., the nominal rate less inflation) not only positive, but in some cases firmly in the high single digits.

Current Account Deficit: A Growing Challenge

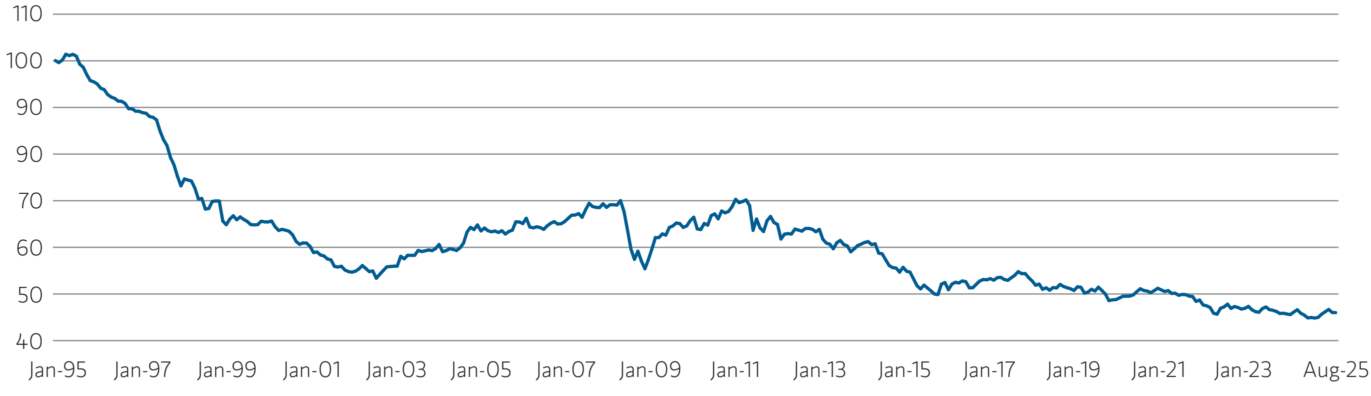
The U.S. continues to face a persistent current account deficit. In the past, the U.S. economy relied heavily on the willingness of foreigners to buy USD assets to finance its trade deficits. Foreign investors, who currently own about $8.5 trillion of U.S. treasuries, were willing to buy U.S. assets, in part, to keep their own currencies weak against the dollar.

This "strong dollar" policy, which has been in place since the 1990s, is now unraveling *(Display 1)*. The current administration's criticism of "currency manipulation" is a direct

DISPLAY 1

The End of the Strong Dollar Policy

MSCI EM Currency Index vs. USD Index



Source: Bloomberg. As of August 31, 2025. It is not possible to invest directly in an index. **Past performance is not indicative of future results.**

attack on countries that keep their currencies artificially weak versus the USD. In classic balance-of-payments economics, a country with a current account deficit (all else being equal) should see its currency weaken. For years, that logic did not apply to the USD—until today. Historically, EM economies struggled to fund their large current account deficits, often leading to balance-of-payment crises, particularly under fixed-exchange-rate regimes. This continues today, and it appears that the U.S. is now joining the camp of typical global economies, where large external imbalances lead to currency weakness.

EM current accounts today are much more balanced, with their average deficit close to zero. So, while the U.S. has an intractable current account deficit problem, EMs are in a relatively strong balance-of-payments position.

The Bottom Line

The U.S. is moving toward a more protectionist economy behind a high tariff wall. The administration has imposed 50% tariffs on Brazil and India, 35% on goods from Canada, and 30% on China, with many other countries facing rates of around 15%. The government is now also a direct shareholder in several companies, including Intel, and has a "golden share" agreement with U.S. Steel.

The U.S. still benefits from high per-capita GDP, strong institutions and the reserve currency, so it cannot be classified as an EM. Nonetheless, these advantages are being eroded by policies that undermine the country's traditional strengths.

The irony is that the country that once lectured EMs about discipline, is now drifting toward protectionism and greater state involvement. By contrast, EMs have spent the past two decades rebuilding credibility and implementing sensible economic reforms. As a result, the gap between the U.S. and EMs has narrowed significantly in both directions.

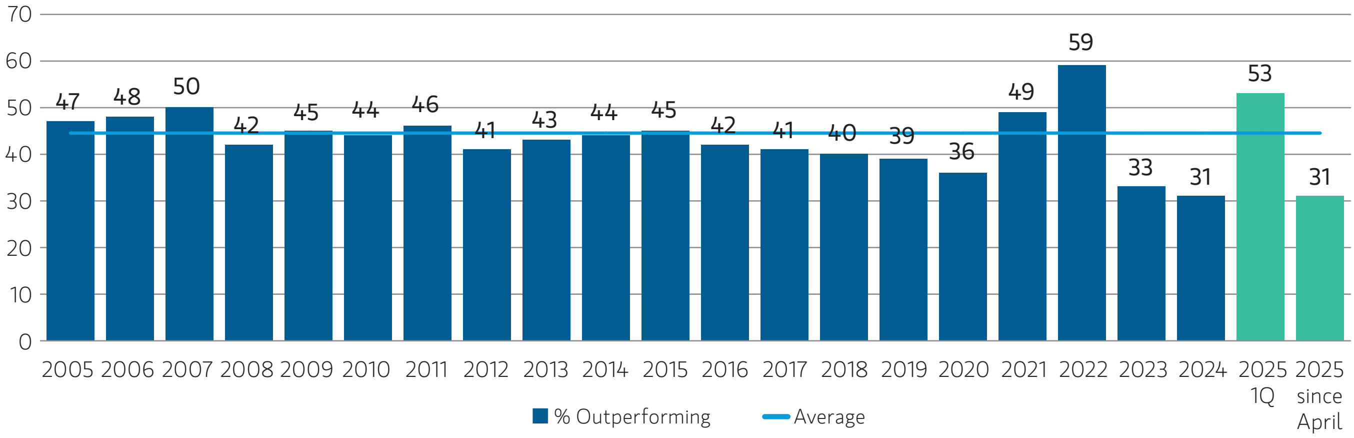
The recent rally in U.S. equity markets has been impressive, but is increasingly narrow, led by the AI theme. Since the April lows, only 31% of U.S. stocks have outperformed the S&P 500 Index *(Display 2)*. While EMs performed roughly in line with the U.S. over the past year, if you were to exclude the "Magnificent 7" stocks[1] that are driving the current rally, EMs are outperforming. Given the extent of progress, EMs look far more attractive than in the past, and they are delivering results. While calling a top is difficult, once the AI theme in the U.S. cools, EMs have the fundamentals in place and the potential to shine.

DISPLAY 2

Is U.S. Outperformance Running out of Steam?

The percentage of U.S. stocks beating the S&P 500 is at its lowest point in 20 years

Past performance is not indicative of future results.



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

[1] The "Magnificent 7" stocks are Amazon, Apple, Google, Microsoft, Meta, Nvidia and Tesla.

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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

The **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 EM Currency Index** measures the total return of 25 emerging market currencies relative to the US Dollar where the weight of each currency is equal to its country weight in the MSCI Emerging Markets Index.

The **USD Index** is an index of the value of the United States dollar relative to a basket of foreign currencies, often referred to as a basket of US trade partners' currencies.

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