MORNINGSTAR Wealth

From the Desk of the CIO

Philip Straehl Shares What's Top of Mind: October 2025

Morningstar Investment Management LLC
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The headline rarely tells the whole story—often, the subplot reveals the bigger picture.

This has certainly been true in 2025, as the resurgence of international equities has emerged as one of the year's defining themes. Both developed international and emerging markets have outperformed US stocks by double-digits in US dollar terms. But the drivers of this revival go far deeper than the simplistic narrative of "foreign investors selling US stocks," which has dominated discourse amid ongoing geopolitical tensions.

In this CIO letter, I examine the underlying forces that have propelled these gains. Beneath the surface, less visible forces have played an outsized role in shaping the strength of both developed and emerging markets. Two subplots stand out:

- The rally in developed international markets is, fundamentally, a dollar story.
- The resurgence in emerging markets is, in part, an AI story.

Understanding these dynamics is important—not only for interpreting this year's performance, but for assessing whether we are witnessing the early stages of a more durable regime shift in global equity leadership.

Developed International Stocks: Dollar vs. Domestic Story

Developed international equities took an early lead in 2025, outperforming their US counterparts by over 10% in the first quarter. This outperformance was catalyzed by a shift in Europe's fiscal posture, notably increased commitments to defense spending in response to the ongoing Russia-Ukraine conflict. The momentum was further accelerated by political change in Germany, where a new coalition pledged greater fiscal expansion.

The result was a broad-based rally across key sectors:

- European financials, particularly banks in the Eurozone, were major beneficiaries, with the European financials index rising more than 20%.

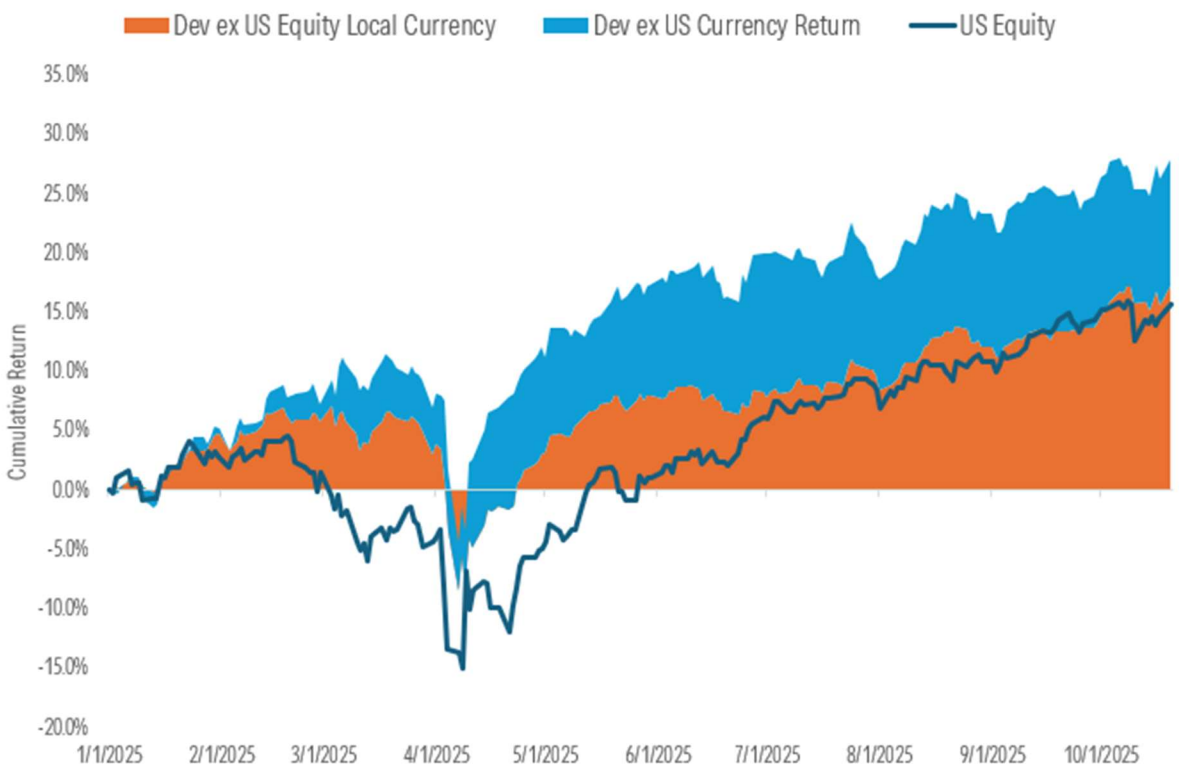
- Defense stocks surged, while other industries such as energy and telecommunications posted double-digit gains.
- Currency appreciation—notably in the euro and the pound—added roughly 4% to international outperformance relative to US equities.

However, the narrative shifted as the year progressed. While early gains were driven by the prospect of improving local fundamentals and fiscal optimism, US markets rebounded sharply in the second quarter, led by AI-fueled enthusiasm in its dominant technology sector. This narrowed the performance gap in local currency terms.

The evolving influence of currency is illustrated in Exhibit 1. As the dollar continued to weaken against developed market currencies following April's tariff shock, its impact became increasingly dominant:

- US equities, propelled by tech, caught up with developed international stocks in local currency terms.
- Currency effects accounted for nearly 90% of the outperformance of developed international equities year-to-date.

Exhibit 1: Dollar Weakness Drives Developed International Outperformance



Source: Morningstar Direct, MSCI, S&P. Data as of October 20, 2025. Past performance no guarantee of future results.

This raises two critical questions: Is the dollar's weakness a temporary tailwind—or a structural shift? And are the conditions in place for US equities to reassert leadership?

Our research suggests the dollar has further room to depreciate. This view is supported by our long-term valuation framework, the persistence of the US current account deficit, and rising hedge ratios among foreign investors—all pointing to sustained downward pressure on the currency.

At the same time, we continue to see upside in developed international equities. Valuations remain compelling, with many markets trading below our estimates of intrinsic value. This is particularly true in Europe, where improving fiscal dynamics and structural reform momentum are creating broad-based opportunities across sectors.

Emerging Markets: An Underappreciated AI Story

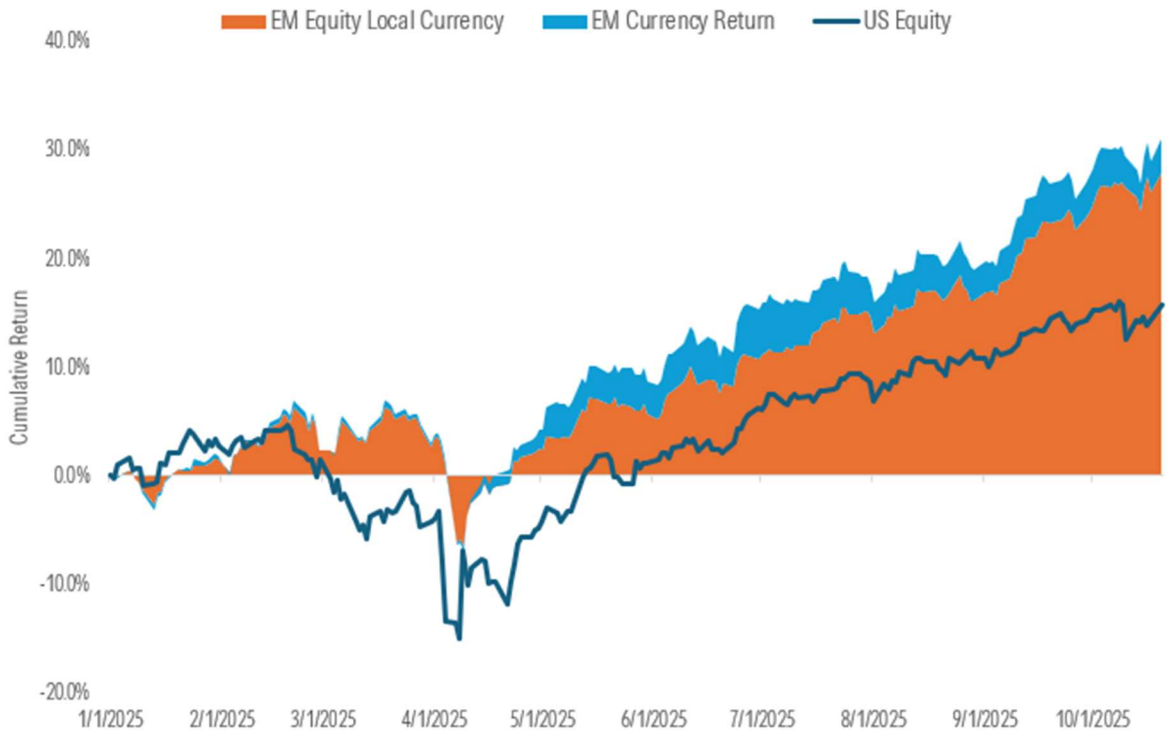
The story of emerging market outperformance in 2025 is distinct—both in timing and in its underlying drivers.

In the first quarter, emerging markets delivered mid-single-digit returns, largely fueled by strength in Chinese technology stocks. The breakout performance of Chinese AI upstart Deep Seek catalyzed a rally in China's tech sector, briefly weighing on US tech shares and giving emerging markets an early lead heading into the April tariff shock.

As the year progressed, emerging markets extended their gains, ultimately outperforming US equities by more than 15%, as shown in Exhibit 2. Several factors stand out:

- Local equity returns were the primary driver, with currency appreciation playing a more modest role.
- Regional concentration mattered: the bulk (~80%) of the gains came from Asian emerging markets—particularly China, Taiwan, and South Korea.
- Two sectors dominated, with nearly half of the gains concentrated in technology and communication services.
- Stock-level concentration was even more striking: just five companies—Taiwan Semiconductor, Alibaba, Tencent, Samsung Electronics, and SK Hynix—accounted for 43% of total gains. Each plays a critical role in the global AI value chain, from chip manufacturing to AI applications.

Exhibit 2: Emerging Market Stocks in Local Currency Drive Outperformance



Source: Morningstar Direct and MSCI. Data as of October 20, 2025. Past performance no guarantee of future results.

As we look forward, it's worth asking what these trends imply for the future prospects of emerging markets.

- AI exists outside US borders: The US is not the only place to invest in the AI theme. Emerging markets offer compelling, more attractively valued access through companies like Tencent, Alibaba, and Taiwan Semiconductor—each trading at a discount to our estimates of fair value and playing a critical role in the global AI ecosystem.
- Opportunities beyond tech: We continue to see value in emerging markets outside the AI narrative. Latin America, for example, remains attractively priced despite strong year-to-date performance. We believe this is supported by structural tailwinds, including improved fiscal discipline, favorable demographic trends, and a weakening dollar—all contributing to a positive investment backdrop.

Future Will Continue to be Nuanced

The outperformance of international equities in 2025 is far more nuanced than the narrative of global investors abandoning US assets suggests. The strength of international stocks in US dollar terms has been driven by a combination of dollar weakness, early optimism around European fiscal expansion, and AI enthusiasm that extends into emerging markets.

Looking ahead, it's reasonable to expect that relative returns between international and US equities will be shaped by a diverse set of factors. Just as no single variable explains the dominance of US equities in the post-Global Financial Crisis era, future leadership will likely be determined by a mosaic of influences.

Our research points to several factors supporting continued international strength. More attractive valuations and stronger foreign currencies are poised to extend beyond 2025 as key contributors in the evolving landscape that will determine the relative performance of global equity markets.

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