

# Durable or Cyclical?

Navigating the Global Equity Rotation

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After more than a decade of US equity dominance, the investment landscape shifted markedly in 2025. International equities delivered their strongest relative performance in nearly two decades, while the concentrated mega-cap technology leadership that defined prior years began to fracture. At the same time, the AI narrative evolved from a broad market tailwind into a more selective and demanding inquiry into monetization, capital discipline, and competitive durability. For institutions already holding diversified equity portfolios, the relevant question is not whether to diversify — it is whether the structure of that diversification still fits the market environment ahead. Against this backdrop, this paper examines the structural forces driving global equity rotation and what they may mean for institutional investors in 2026 and beyond.

The paper addresses four themes: the drivers and potential durability of international equity leadership; the broadening of US market breadth beyond mega-cap technology; the evolution of the AI investment narrative from broad tailwind to selective opportunity; and the structural distinctions between the current market environment and the late-1990s technology bubble. It also considers recent developments in the Middle East. It concludes by examining what this might mean for equity portfolio construction going forward and discusses the potential need for rebalancing in the short-term.

## Key Takeaways

- › **International equities outperformed for the first time in over a decade:** International equities beat US equities by the widest margin in nearly two decades in 2025 with the MSCI ACWI ex-US returning 32.4% in USD terms versus 17.9% for the S&P 500. This was driven by a weaker dollar, historically cheap valuations, a favorable sector mix, and looser fiscal policies abroad. For institutions with global equity exposure, this outperformance has likely shifted geographic weights above policy targets in ways that warrant rebalancing review.
- › **Market breadth improved, but not all the broadening represents durable quality.** After years of mega-cap technology dominance, investors rotated toward cyclical, value, and small-cap companies as the Fed cut rates, the economy remained resilient, and valuations normalized. Equal-weighted indices started to outperform cap-weighted peers. Notably though, ~40% of Russell 2000 constituents remain unprofitable and many of these lower-quality names outperformed in the short term, creating challenges for managers who avoided them.
- › **The macro backdrop has been broadly constructive, but questions remain about the return on massive AI capital expenditures.** The US economy entered 2026 with real GDP growth estimated for the year to be in the 2.0%–2.5% range with moderating inflation, supporting expectations for continued central-bank easing. Also here in the United States, the “One Big Beautiful Bill Act” (OBBBA) should provide a modest fiscal impulse via infrastructure and tax incentives, while corporate earnings and consumer spending have remained robust! Key risks to this constructive backdrop include the war in the Middle East and whether massive AI capital outlays will generate returns sufficient to justify their scale. On the latter point it is worth noting that today’s AI leaders are funding spending primarily through free cash flow rather than the speculative equity issuance that characterized the dot-com era.
- › **Geopolitical risk re-emerges as a macro variable:** US-Israeli strikes on Iran have brought the flow of oil through the Strait of Hormuz effectively to a halt, pushing Brent crude to over \$110/barrel. Given that 20% of global oil and LNG transits through the strait a prolonged conflict could reignite inflation. This would complicate central bank policy, and weigh heavily on energy-importing economies in Europe and Asia. While the base case is a relatively short-lived disruption (OPEC spare capacity can offset Iranian supply losses), the risk of escalation is non-trivial and represents a meaningful tail risk to the constructive macro backdrop outlined above.

## International Leadership – Why It’s Happening and What Could Change

After more than a decade of US dominance, international equities delivered their strongest relative performance in nearly two decades in 2025. The MSCI EAFE returned 31.2% in USD terms versus 20.6% in local currency terms – a 10.6% gap that illustrates just how much of the gain was dollar-driven. MSCI Emerging Markets gained 33.6%. Both indices outperformed the S&P 500’s 17.9% by the widest margin since the early 1990s, and international stocks have continued to outpace US equities into 2026. The key question is whether this marks a durable reversal of US structural dominance or a cyclical correction.

**Figure 1**  
Global Equity Market Performance

Index <sup>2</sup>	2025 Return (%)	2026 YTD Return as of 3/26/2026 (%)
S&P 500	12.8	0.7
MSCI EAFE	17.9	-5.1
MSCI EAFE (Local)	20.6	0.4
MSCI Emerging Markets	33.6	3.5
MSCI Emerging Markets (Local)	31.3	5.2

The shift began early in 2025 as international equities (MSCI ACWI ex US) outperformed US stocks by 14% in the first four months of the year. This was driven by a historic valuation gap (MSCI ACWI ex-US at 13x forward earnings versus 21x for the S&P 500, an 8th-percentile reading since 2003), tariff uncertainty, accommodative central banks, fiscal policy shifts, and a weakening US dollar.<sup>3</sup> Sector composition also played a key role as international indices carry significantly lower technology weightings and greater exposure to financials, industrials, materials, and defensives, areas that benefited from rising defense budgets, large-scale infrastructure initiatives, and a more favorable interest rate environment.

Fiscal and monetary policy pivots also played an important role. In Europe, the combination of European Central Bank rate cuts (their policy rate was reduced by 100 basis points through 2025) and significant new defense and infrastructure spending, which is estimated to unlock hundreds of billions of euros, supported growth

in traditionally value-oriented sectors. Additionally, Asia benefited from semiconductor demand and corporate reforms in select markets, while commodity tailwinds aided resource-rich emerging economies.

A weaker dollar amplified US investor returns, with a meaningful portion of gains reflecting currency translation. Multiple expansion was also a driver of results rather than earnings growth. For example, Eurozone corporate earnings only modestly increased despite strong equity performance, indicating that much of the rally was valuation and sentiment driven rather than one led by earnings. A key risk to sustained outperformance is a potential US dollar rebound, driven by divergent monetary policy, renewed US growth outperformance, or increased geopolitical tensions, which may erode both currency tailwinds and the relative valuation advantage.

The escalating conflict in the Middle East beginning in early March adds a new and meaningful risk variable to the international outperformance thesis. The disruption to Strait of Hormuz shipping flows, through which approximately 20% of global oil and LNG transits, disproportionately affects energy-importing economies in Europe and Asia. European gas storage levels entering 2026 were already historically low (estimated at roughly 30% capacity following a harsh winter), leaving the continent particularly exposed to a sustained LNG supply disruption.

Equity markets in energy-importing Asian economies, which had been among the strongest performers in early 2026, came under acute pressure following the initial outbreak of the conflict, with South Korea, for example, recording a double-digit correction. For commodity-exporting emerging markets, higher energy prices represent a potential tailwind to export revenues and fiscal positions, though this benefit must be weighed against the broader risk-off environment and tightening global financial conditions. On net, the Middle East conflict introduces a meaningful bifurcation within the international equity opportunity set, requiring investors to differentiate between energy importers and exporters, and between economies with direct supply-chain exposure to the Gulf and those more insulated from the conflict.

# US Equity Market Breadth: Broadening Beyond Mega-Cap Technology

**Figure 2**  
US Equity Market Performance

Index <sup>2</sup>	2025 Return (%)	2026 YTD Return as of 3/26/2026 (%)
Russell 2000	12.8	0.7
S&P 500	17.9	-5.1
S&P 500 Equal Weighted	11.4	0.2
Magnificent 7 <sup>4</sup>	24.9	-12.5

US equity markets entered 2025 with the top five S&P 500 companies accounting for more than 27% of market capitalization – surpassing even the peak of the 2000 tech-bubble. That concentration proved fragile: The announcement of tariffs on so called “Liberation Day” triggered a sharp Q1 sell-off last year with the “Magnificent 7” significantly underperforming as investors rotated out of prior winners. Yet the full year told a more constructive story, as market leadership broadened meaningfully beyond the top names.

The Russell 2000 (small cap) rose ~14% in the second half of 2025, closing the year at an all-time high, up 12.8% for the year driven by three factors: 1) Fed rate cuts disproportionately benefitted small caps given their higher share of floating rate debt, 2) continued US GDP growth of ~2.5% supported these smaller domestically focused businesses, and 3) extreme valuation discounts compared to larger companies invited mean reversion. Quality dispersion, however, remains a concern with nearly 40% of Russell 2000 constituents reporting negative trailing 12-month earnings. Many of these weaker names outperformed during the initial rally. Historically, small-cap outperformance during rate cutting cycles has depended on credit availability and balance sheet strength; companies with solid fundamentals are best positioned as conditions normalize, while overleveraged names remain vulnerable if risk appetite fades.

Other key themes/changes from late last year into 2026 in US equity markets include cyclical sectors like energy and materials leading the way, the equal weighted version of the

S&P 500 beating the standard market cap weighted version given the decline in the “Magnificent 7”, and value stocks outperforming growth.

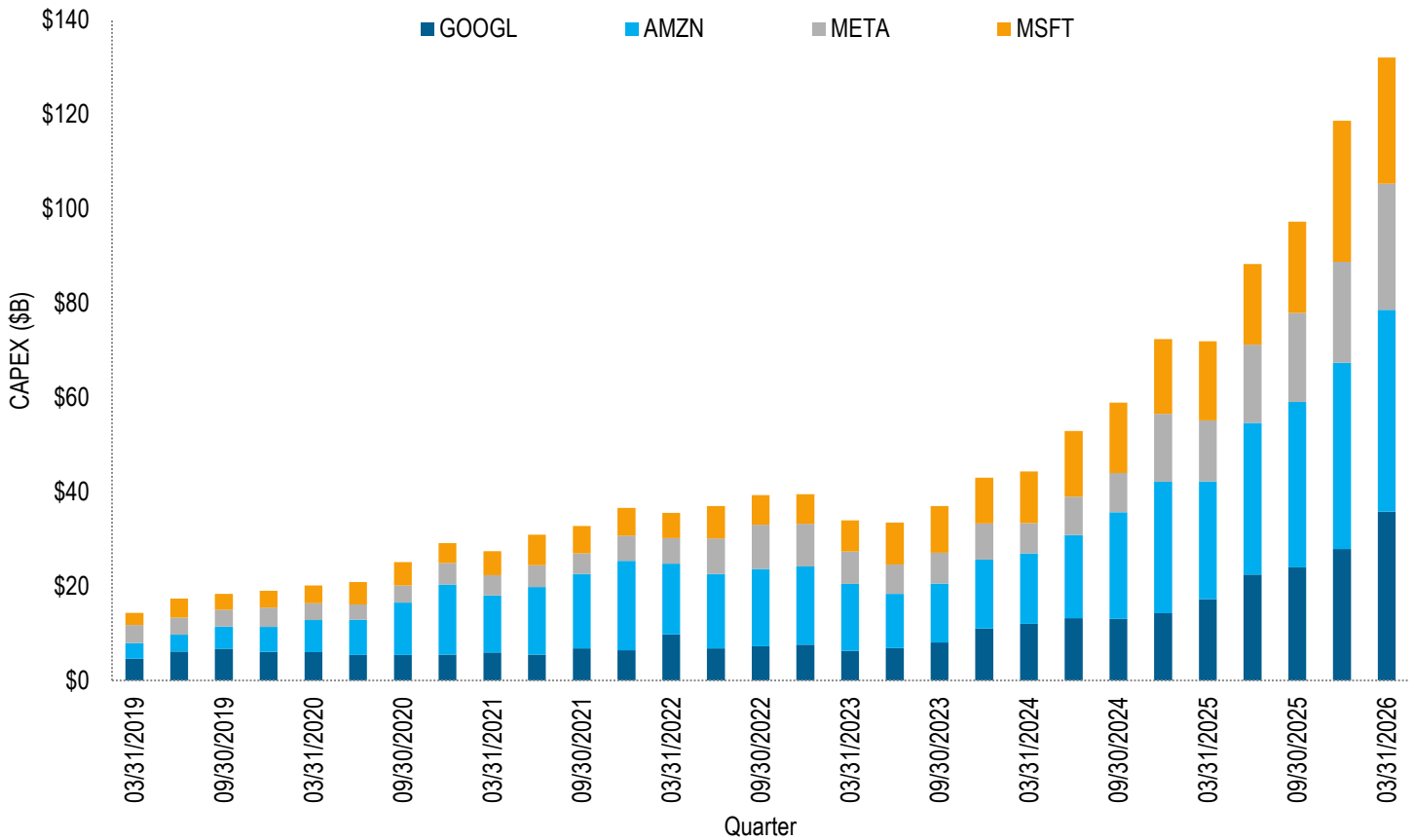
Index concentration, while not a reliable timing signal on its own, does create vulnerability when paired with stretched valuations and narrow earnings breadth – as was the case last year. The broadening seen in late 2025 and early 2026 has reduced some of these vulnerabilities, but concentration remains elevated by historical standards.

## AI Narrative Shift: From Tailwind to Test

The AI narrative underwent a fundamental shift in 2025. Through mid-year, any association with AI spending drove multiple expansion as investors assumed broad productivity gains and profit growth. That consensus fractured in the second half of the year, giving way to a more demanding question: which companies will generate returns on their AI investment? What had been a blanket tailwind became a headwind for industries facing disruption, and capital began rotating away from indiscriminate AI exposure toward selective positions.

Hyperscaler capital expenditure on AI infrastructure exceeded \$500 billion in 2025 with forecasts for over \$600 billion this year, initially supporting optimism across semiconductors and the broader technology ecosystem. That optimism was tested as competitive dynamics evolved faster than markets had priced. Alphabet’s Gemini demonstrated capabilities rivaling the leading models while running on proprietary semiconductors – calling into question whether early infrastructure leads would translate into durable moats. At the same time, several hyperscalers began internalizing AI workloads, potentially limiting third-party demand growth sooner than expected.

**Figure 3**  
Hyperscaler Quarterly CAPEX (\$B)<sup>5,6</sup>



The AI narrative has evolved from efficiency gains to potential disruption. AI threatens to render certain enterprise software categories obsolete and will likely automate portions of logistics, transportation, and financial services over time. This reassessment contributed to early 2026 volatility and produced greater performance dispersion both within the largest technology names and across the broader market.

Rotation along the AI value chain, from infrastructure and semiconductors toward application-layer companies and non-technology sectors demonstrating real integration (healthcare diagnostics, industrial optimization, energy exploration), may continue. Markets have increasingly demanded proof of monetization, not just adoption. This shift is already visible within the largest technology cohort: companies that were collectively viewed as monolithic AI beneficiaries are no longer behaving as a cohesive group, with meaningful performance dispersion across names. This divergence may widen as investors seek to distinguish long-term winners from those at risk of displacement.

## Valuations are High But Not Another Dot.Com Bubble

Comparisons to the late-1990s dot-com bubble are understandable – a transformative technology, surging capital investment, and elevated valuations are common to both eras. The underlying fundamentals are markedly different though. Today’s leading AI companies generate substantial earnings and free cash flow. The four major hyperscalers (Alphabet, Amazon, Meta, and Microsoft) produced ~\$200 billion in free cash flow in 2025 even as they ramped up spending. They are projecting ~\$650 billion in AI capex for 2026 funded by operating cash flows, balance sheet cash, and selective debt issuance – a fundamentally different profile from the venture-dependent, cash-burning internet companies of the dot-com era.

In the late 1990s, capital markets rewarded speculative narratives over sustainable business models. The Nasdaq rose ~600% from 1995 to 2000 before falling 77% as IPO funding collapsed. Investors leaned on unconventional proxies like website hits, daily active users (DAUs), and total addressable market (TAM) to justify valuations untethered from earnings. When external financing dried up, the fragility of those models was exposed. Today's technology companies serve billions of users with proven monetization — a fundamental distinction from that era.

While certain AI-centric names exhibit bubble-like characteristics, the risk of a systemic dot-com-style unwind appears substantially lower. The Nasdaq 100's forward P/E of ~27x at the end of 2025 compares favorably to ~60x at the dot-com peak; 99 of 100 constituents were profitable in 2025 with average net margins of ~42%, versus margins of ~23% and more than 20% loss-making companies in 1999. More broadly the banking system is better capitalized, policymakers are more attuned to emerging risks, and investors are increasingly distinguishing between cash-generative innovators and companies lacking tangible business substance. This selectivity meaningfully reduces the risk of another unchecked speculative frenzy.

## Near-Term Considerations

The investment landscape in 2026 is defined by transition and complexity. The defining themes of the prior decade — US equity concentration and mega-cap technology leadership, most recently amplified by AI as a blanket valuation tailwind — have given way to a more discriminating environment where geography, sector, quality, and fundamentals all matter. International equities remain a compelling part of long-term institutional equity portfolios though in the near-term investors should recognize that much of 2025's outperformance was currency- and sentiment-driven rather than earnings-led. Within equities broadly, selectivity is paramount: the AI narrative now demands evidence of real monetization, and nearly 40% of Russell 2000 constituents remain unprofitable despite the small-cap rally.

The most consequential near-term risk is the escalating Middle East conflict, which has disrupted Strait of Hormuz shipping flows and introduced the possibility of a second major energy shock — one that could reignite inflation, complicate central bank easing, and weigh disproportionately on energy-importing economies in Europe and Asia.

For most institutional investors, the most important near-term practical question is one of rebalancing. International equity's strong outperformance in 2025 and into 2026 has likely pushed geographic weights above policy targets for many institutions. The fact that much of the recent gains have been driven by currency and sentiment rather than earnings-led may make the outperformance more reversible than the headline returns suggest. This argues for thoughtful, deliberate rebalancing back toward policy targets rather than allowing drift to persist as a passive outcome.

The rebalancing question does not stop at geography. Within US equities, the rotation away from mega-cap technology concentration and the growing dispersion within the AI trade have created their own drift away from the narrow leadership that defined prior years and toward a broader, more quality-driven opportunity set. For long-horizon institutional investors, the shifts of the last two years are a reminder that equity allocations built for one market regime do not automatically fit the next and that the most durable portfolios are those where geographic weights, sector exposures, and style biases reflect deliberate conviction rather than the accumulated impacts of market moves over the last decade.

## End Notes

<sup>1</sup> Source: Federal Reserve Summary of Economic Projections – December 2025 and IMF World Economic Outlook Update – January 2026

<sup>2</sup> Source: FactSet.

<sup>3</sup> Source: Bloomberg.

<sup>4</sup> Source: Dodge and Cox - The Case for International Equities

<sup>5</sup> 03/31/2026 values reflect estimates.

<sup>6</sup> Source: Bloomberg.

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