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The Case for Reducing US Equity Overweight: Concentration, Valuation, and the Coming Regime Shift*

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1. Introduction

The most consensus trade in the world is not a trade, it is the default. Global portfolios are more concentrated in US equities than at almost any point in history. For most institutional investors, this overweight is not the product of a deliberate decision but the accumulated result of passive flows, benchmark discipline, and a prolonged period of US outperformance that has rendered the position invisible. This position is part of the furniture rather than a bet to be examined. And that invisibility is the problem. Positions become dangerous not when they are contested but when they are unexamined.

2. The Scale of the Concentration

The US now accounts for approximately 65 percent of the MSCI All Country World Index, as shown in Figure 1. This share has roughly doubled since the early 1990s and is close to its highest level on record. This is not simply a reflection of American economic dynamism. It is a structural artefact of passive investing and dollar denominated capital flows, which together create a self-reinforcing feedback loop in which rising prices inflate index weights, which attract further passive inflows, which push prices higher still. Strikingly, the US equity weight is more than four times its share of global GDP measured at purchasing power parity, a gap that implies the premium reflects valuation inflation rather than economic footprint.

The concentration does not stop at the country level. Within the US market, the top ten stocks account for a share of total capitalisation that rivals the dot-com peak. Owning a "diversified" global equity portfolio today means, in large part, owning a view on the continued dominance of a small number of American technology companies.

Wurgler (2011) showed that index inclusion causes stocks to move more with the index and less with their own fundamentals. This price distortion accumulates as passive vehicles grow. The Koijen and Yogo (2019) demand systems approach to asset pricing demonstrates how inelastic institutional demand can sustain large and persistent deviations of price from fundamental value. Passive investing does not merely reflect US dominance, rather it amplifies and entrenches it in ways that create genuine fragility. When the flows reverse, the adjustment could be sharp.

One feature of market-capitalisation weighting deserving of explicit attention is the inflow amplification effect. In a closed system with no external flows, a large-cap stock that underperforms a smaller peer will see its index weight decline mechanically. Passive weighting is, in this sense, self-correcting. But this logic breaks down when the index itself is

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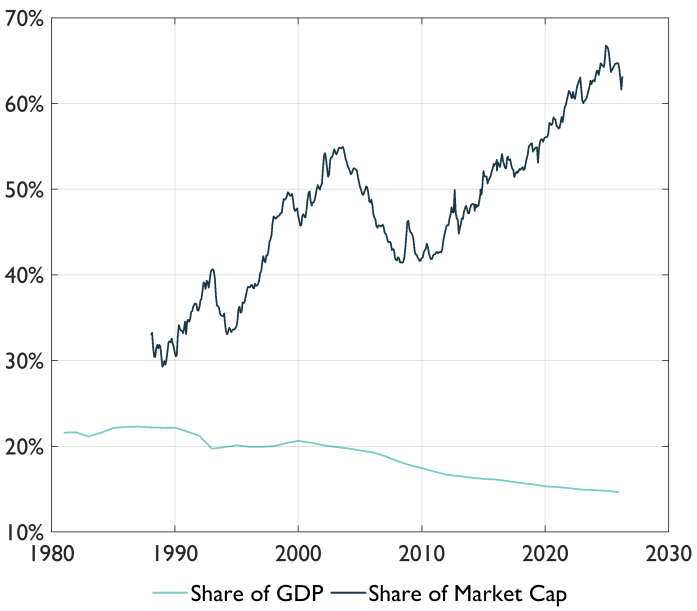
Figure 1: United States Share of the MSCI ACWI and Global GDP



Sources and Notes: Fulcrum Asset Management LLP, IMF, World Bank, Haver Analytics and MSCI. Figure compares the US weight in the MSCI ACWI with its share of global GDP measured at Purchasing Power Parity (PPP). April 23, 2026.

attracting continuous net inflows, as passive vehicles have done throughout the past decade. Each new dollar invested in a market-cap weighted index is allocated in proportion to current weights. This means that large-cap stocks receive disproportionately large absolute dollar flows even if their returns are no better than average. The result is a persistent price support mechanism that is independent of fundamentals. New inflows sustain the weight, the maintained weight attracts further inflows, and the cycle repeats. Inelastic institutional demand of precisely this kind can sustain valuations far above what a fundamentals-based model would predict (Koijen and Yogo, 2019). This mechanism does not require any individual investor to be irrational, rather it is merely an aggregate consequence of individually rational passive behaviour.

For the investor based outside the United States, this amounts to a precise inversion of the home bias puzzle identified by French and Poterba (1991). They documented that investors systematically hold far more domestic equity than international diversification would prescribe. The contemporary irony runs the other way, as a global investor holding a standard benchmark is not diversified at all. The bias has simply been outsourced to an index.

There are also principled theoretical reasons, beyond valuation and momentum, why this concentration is suboptimal even under rational expectations. The market capitalisation benchmark is welfare optimal only under the restrictive conditions of frictionless trade, complete markets, and stable preferences. As we show formally in Appendix A, once trade costs and risk aversion are introduced into a standard international general equilibrium framework, the optimal US equity share falls substantially below 70 percent. The sharp rise in trade barriers since early 2025 makes this theoretical case considerably more urgent.

3. Valuations: Necessary But Not Sufficient

The valuation case is stark. US equities trade at a substantial premium to the rest of the world on every conventional metric (forward price-to-earnings,

price-to-book, cyclically adjusted earnings) and that premium is elevated relative to US equities' own history, as shown in Figure 2. The rest of the world offers the converse. European, emerging market, and UK equities trade at discounts rarely seen outside of genuine crises.

The standard rebuttal is not unreasonable. The Fama and French (1992, 1993) factor framework supports higher valuations where underlying returns on equity are persistently superior. The US technology sector has delivered earnings that have repeatedly confounded sceptics. The US genuinely has structural advantages through deeper capital markets, stronger property rights, more dynamic labour markets, and a technology ecosystem without global peer. This argument deserves to be taken seriously.

But the argument about whether the US deserves **some** premium is categorically different from whether it deserves **this** premium. What the evidence shows is not that US equities are mispriced in absolute terms, but that the current spread between US and non-US valuations implies an earnings growth differential over the coming decade with no reliable historical precedent.

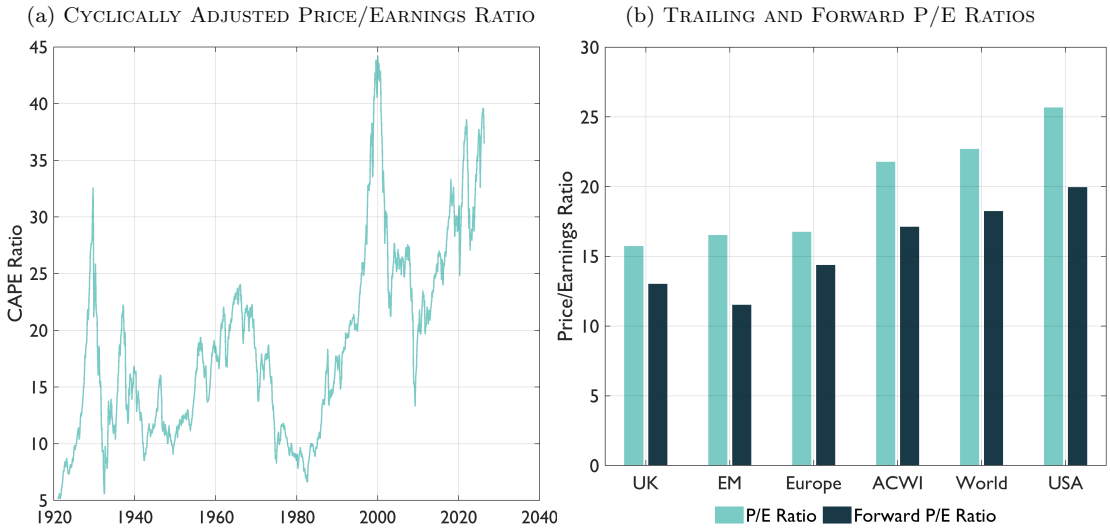
This matters because of a robust empirical regularity that starting valuations predict long-run returns. Campbell and Shiller (1988, 1998) demonstrated that the cyclically adjusted price-earnings ratio accounts for a substantial share of variance in 10-year equity returns. Cochrane (2011) reframed this not as a market inefficiency but as evidence of time-varying risk premia. For instance, when prices are high relative to fundamentals, expected future returns are low, reflecting compressed risk compensation. One need not believe in simple mean reversion to accept the conclusion that buying at today's US multiples means accepting lower forward returns, and the question is whether investors are being adequately compensated for doing so.

A subtle objection which also deserves attention is reconstitution risk. Even granting that current mega-cap valuations are stretched, the US might reconstitute its index dominance through the next layer of technology leadership. This may arise through the AI infrastructure build-out, defence technology, quantum computing, or the next generation of platform businesses. In that world the index weight is maintained but the underlying constituents rotate. This scenario is plausible, but it does not vindicate passive market-cap exposure to the current index for two reasons. First, it is to a considerable degree already embedded in current valuations as the market is pricing continuity of US technology dominance, not a discount for reconstitution risk. Second, if the next wave of value creation occurs in early-stage or mid-cap technology, it is more likely to be captured by a US or global small-cap mandate than by an index overwhelmingly dominated by its largest existing constituents. The passive investor holding the MSCI ACWI today is not buying exposure to the next generation of US technology. Instead they are buying it at the prices implied by the last one.

The UK case is particularly compelling from this vantage point, and we make no apology for dwelling on it. FTSE valuations relative to global peers stand near multi decade lows. Sterling remains materially undervalued on a purchasing power parity basis, an instance of the persistent real exchange rate deviations documented by Rogoff (1996), which tend to be slow to correct but ultimately self-reversing over medium-run horizons. The structural headwinds that drove the de-rating[1] are well understood and, critically, already priced. An investor buying UK equities today acquires depressed assets in a depressed currency. This represents a double margin of safety that is unusual in developed markets.

[1] Including Brexit related institutional outflows, an index composition weighted toward commodities and financials, a period of acute domestic political instability.

Figure 2: Equity Market Valuation Ratios



Sources and Notes: Fulcrum Asset Management LLP, Shiller MSCI, and Haver Analytics. Panel (a) shows the historical evolution of the Cyclically Adjusted Price to Earnings (CAPE) Ratio in the US, from Shiller. Panel (b) shows the latest Price to Earnings (P/E) and Forward Price to Earnings Ratios for several MSCI funds. April 23, 2026.

4. A Mechanism Sustaining the Mispricing

If the concentration and valuation case is this apparent, why does the overweight persist? Part of the answer lies in the incentive architecture of delegated asset management, which is more structural than behavioural.

Scharfstein and Stein (1990) formalised herding as a rational response to reputational risk. When managers are evaluated relative to peers and benchmarks, deviating from consensus is costly even when correct. Lakonishok et al. (1994) documented this empirically, showing that professional investors systematically favour stocks with recent strong performance, not out of naivety, but because the career consequences of being wrong while different are far more severe than being wrong while conventional. The asymmetry is central as consensus errors are shared and therefore survivable; idiosyncratic errors are not.

Applied to the US overweight, the implication is precise. A fund manager who reduces US equity exposure and underperforms a benchmark with 65 percent US weight faces a clear and immediate career risk, even if the decision is correct in expectation over a five year horizon. The result is a stable equilibrium of shared overexposure, as no single manager has a unilateral incentive to rebalance, so the aggregate position persists well beyond what valuation or diversification logic would support. This is not irrationality, rather it is a collectively suboptimal outcome arising from individually rational behaviour. That distinction matters since the mispricing will not correct gradually as information accumulates. It will correct when the trigger for coordinated repositioning arrives.

The AI narrative has entrenched this further. The thesis that American technology is at the vanguard of the most consequential technological shift since the internet is not obviously wrong. But narratives and returns are different objects. What matters is the price paid for the narrative and US technology valuations currently embed an assumption of near flawless earnings execution that leaves little margin for the disappointments or multiple compression

that have historically followed periods of concentrated market leadership. Crowded trades do not unwind because the thesis is wrong. They unwind when the marginal buyer disappears.

5. Geopolitical Risk: The Inversion

One of the more significant analytical shifts required by the current environment is a reassessment of where geopolitical risk originates. The conventional framework, embedded in decades of portfolio construction, treated the US as the safe core of global portfolios and the rest of the world as the source of disruption. For instance, the European debt crises, emerging market currency collapses, commodity shocks, political instability at the periphery. On this view, a heavy US weight was not just a return bet but a risk management decision.

That framework is increasingly difficult to sustain. Policy volatility, trade fragmentation, and institutional strain are now domestic American phenomena. The strategic calculus that drove reserve managers to hold dollar assets, through a combination of deep liquidity, rule of law, and geopolitical reliability, has become more complicated. Concentrating a portfolio in US equities is no longer straightforwardly a hedge against geopolitical risk, instead in important respects, it **is** the geopolitical risk. The diversification logic, properly applied, now points in the opposite direction from where it has historically pointed.

6. Structural Shifts: Slow, Then Sudden

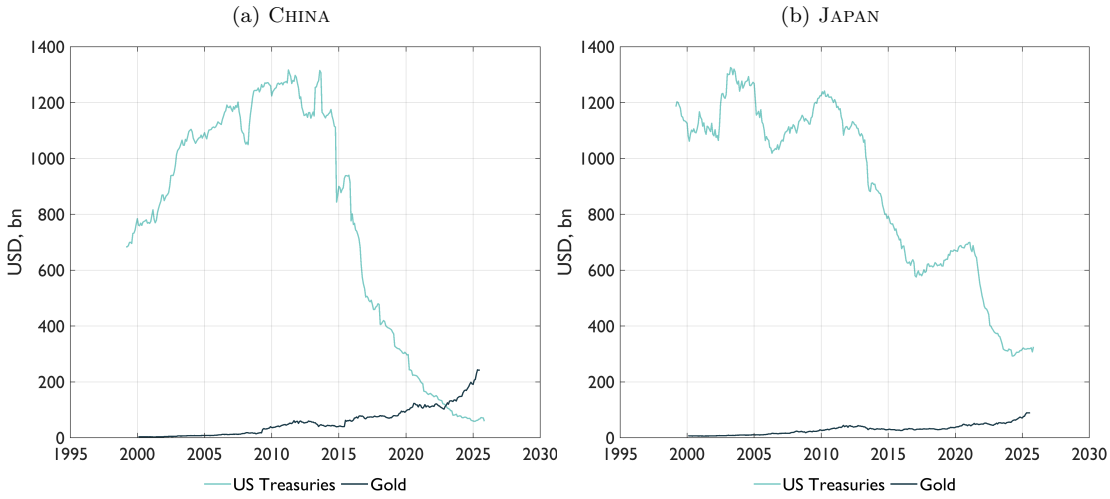
The rotation is already visible at the margins. Over the past year, the FTSE 100 has materially outperformed the S&P 500 on a total return basis. This divergence reflects both valuation support and the more defensive sector composition of the UK index. Value and commodity linked equities have reasserted themselves. US market leadership has narrowed rather than broadened, which is historically a late cycle configuration.

It is worth pausing on this divergence, because it has received remarkably little attention relative to its magnitude. This near silence is itself informative. A passive investor benchmarked to the MSCI ACWI has no incentive to monitor cross-market performance as the index rebalances mechanically, and relative returns between constituents are invisible to them. The same career-risk calculus that sustains the US overweight also suppresses attention to evidence that would challenge it. The UK's outperformance is not a secret but it is simply unobserved by the investors most likely to act on it.

More consequential are the structural flows operating in the background. China and Japan have both consistently reduced their holdings of US Treasury securities while increasing allocations to gold and real assets, as shown in Figure 3. This shift accelerated materially following the freezing of Russian reserves in 2022. The financial consequence, irrespective of the geopolitical motivation, is a reduction in structural demand for dollar assets from the world's largest reserve managers.

This connects to a broader dynamic. Eichengreen (2011) identifies the "exorbitant privilege" of reserve currency status. This is the mechanism by which dollar dominance compresses US borrowing costs and generates a persistent structural bid for dollar denominated assets, inflating valuations across the entire US asset complex. The corollary is symmetric as any erosion of that status unwinds both effects simultaneously. The IMF's COFER data show the dollar's share of global foreign exchange reserves declining slowly but persistently since the early 2000s. The process is gradual, and wholesale displacement of the dollar remains a tail scenario. But the direction of travel is established, and for asset pricing, direction matters as much as speed.

Figure 3: US Treasury and Gold Holdings



Sources and Notes: Fulcrum Asset Management LLP, U.S. Treasury, IMF, and Haver Analytics. Panel (a) shows China and panel (b) shows Japan. Official gold holdings are reported by central banks and compiled by the IMF, and are valued at market prices. US Treasury holdings are sourced from the TIC database and represent total country level holdings of US securities, including both official and private sector investors. April 23, 2026.

7. The Hegemon Analogy

History offers a useful, if sobering, parallel and the relevant evidence is closer to home than is sometimes appreciated.

A century ago, British equities occupied in global portfolios a position analogous to that held by US equities today. Sterling was the world's reserve currency. British capital financed global trade and London sat at the centre of international finance. The transition to American financial hegemony was gradual, and stretched across many decades and two World Wars, but its financial market consequences, when they arrived, were swift. Dimson et al. (2002)'s century long dataset of global equity returns documents the scale of this. UK equities were dominant in global portfolios at the start of the twentieth century, but delivered substantially lower real returns than their American counterparts over the following decades. The British share of global market capitalisation declined in a pattern that would look familiar to any analyst watching non-US equity weights today. Eichengreen and Flandreau (2009), examining the currency dimension of the same transition, show that sterling's displacement as the leading international currency happened faster than commonly assumed once the underlying conditions were in place. This serves as a reminder that gradual processes can have sudden tipping points.

The lesson is not American decline. It is that market leadership persists far longer than fundamentals justify, and then corrects faster than investors expect. The dot-com experience offers a more recent illustration. In this episode, US equity outperformance peaked in early 2000, and the subsequent decade of non-US outperformance was one of the most sustained in the post-war period. However, capital did not meaningfully rotate into international equities until well into that repricing. Waiting for confirmation of a regime shift means paying full price for the adjustment.

8. Portfolio Implications

The prescription is not dramatic rotation. Binary positioning, through abandoning US equities for the rest of the world, confuses a rebalancing thesis with

a directional macro call, and introduces precisely the kind of idiosyncratic tracking error against which the Scharfstein and Stein (1990) analysis cautions.

The appropriate response is more measured. Portfolios running US equity weights at or above benchmark should consider gradual reduction, accepting modest near term tracking error in exchange for improved long run diversification. The rebalancing should target markets where the valuation case is clearest. We believe this is in the UK and selectively continental Europe in developed markets and in EM where improving external dynamics and attractive starting valuations offer a genuine risk premium. But investors also need to diversify both equity and currency exposure away from the concentrated single country risk that currently dominates global portfolios.

The currency dimension warrants explicit attention. A portfolio overweight in US equities is, implicitly, a portfolio substantially long the dollar. As the structural dollar bid moderates, through reserve diversification, multipolar trade settlement, and gradual erosion of the exorbitant privilege, that currency exposure could become a meaningful headwind to returns even if US corporate earnings prove resilient.[2]

The objection of "but the US is still the strongest" is both true and beside the point. The argument is not that US equities will deliver negative absolute returns. It is that the risk-adjusted case for a 65 percent weight is weaker than at any point in recent decades, and that the expected cost of acting now is low relative to the expected cost of acting late.

9. Conclusion

US equity dominance is historically extreme, valuation rich, and structurally challenged. The forces sustaining it (passive flows; dollar hegemony; the AI earnings narrative; and the career risk equilibrium of shared overexposure) remain intact but are more fragile than they appear. The forces eroding it (reserve diversification; currency realignment; geopolitical risk repricing; and rising trade frictions) move slowly, and then all at once.

The evidence assembled here, from the predictability literature, the theory of delegated investment, the history of hegemonic transitions, and the formal welfare analysis in the Appendix, converges on the same conclusion through independent routes and different methodologies. That convergence is precisely what makes it compelling. The cost of being early is modest tracking error. The cost of being late is losing the adjustment.

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[2] A further tail scenario, beyond the scope of this note, is the gradual internationalisation of equity exchange provision itself, whether through cross-listings, the growth of non-US technology exchanges, or structural shifts in where companies choose to list. This would affect both the composition of global indices and the relationship between domicile and economic exposure.

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A. Appendix: Frictions, Fear, and the Fallacy of the Market Portfolio

A.1. The Benchmark and Its Hidden Assumptions

The market capitalisation benchmark, the implicit foundation of any passive global equity allocation assigning roughly 65 percent to US equities, is welfare optimal only under a restrictive set of conditions. These include frictionless goods trade, complete financial markets, and a representative agent with stable preferences. Under these assumptions, holding equities in proportion to global market weights allows investors to replicate the world endowment and smooth consumption perfectly across countries (Coeurdacier and Gourinchas, 2016; Lucas, 1982; Sharpe, 1964).

These conditions are implausible in practice, and they are becoming less plausible as the global trade environment deteriorates. The theoretical case for a 65 percent US allocation is, in this precise sense, built on foundations that the current environment is actively undermining. Market capitalisation weights are a useful descriptive benchmark but they are not a normative one once trade frictions and incomplete risk sharing are taken seriously.

A.2. Framework of Obstfeld and Rogoff (2001)

We use the two country general equilibrium framework of Obstfeld and Rogoff (2001) to study how a representative investor in a small open economy, calibrated to resemble the UK, should optimally allocate equity holdings between domestic and US assets in the presence of iceberg trade costs and constant relative risk aversion preferences.

The central mechanism is the insurance role of foreign equity. In a frictionless world, holding foreign assets allows an investor to smooth consumption against domestic shocks. A bad domestic harvest can be offset by income from abroad, imported at no cost. Trade frictions disrupt this logic. Iceberg trade costs drive a wedge between domestic and foreign prices, so that foreign equity returns no longer translate reliably into domestic consumption. The insurance value of foreign holdings falls, and falls further the higher the trade costs.

Intuitively put, owning a foreign farm sounds attractive. But if getting the harvest home is costly and uncertain, the effective value of that ownership is substantially lower than it appears. If you are also particularly averse to going hungry, that is, if your effective risk aversion is high, then impaired transmission combined with high downside sensitivity makes the foreign farm far less attractive than naive diversification logic suggests. This intuition generalises. Within the Obstfeld and Rogoff (2001) framework, a global equity allocation that mechanically assigns nearly 65 percent to US equities is difficult to justify. US assets expose the investor not only to global risk factors but also to US specific consumption, policy, and valuation risks, which become less desirable precisely when trade frictions rise or when global risk aversion increases.

A.3. A Changing Global Environment

Since the start of 2025, the global trade environment has deteriorated sharply. The new US administration has implemented a sequence of tariff increases and trade policy measures that have raised effective trade costs and heightened policy uncertainty (Benigno et al., 2025; Davies and Wales, 2025). Average US tariff rates rose from roughly 2.5 percent at the start of the administration to close to 12 percent in the most recent data, reversing several decades of gradual liberalisation Wales (2025). These developments matter not only for goods markets but also for international portfolio allocation. Higher trade costs weaken the ability

of financial markets to insure consumption risk across borders, thereby altering the optimal composition of global equity portfolios. The sharp concurrent rise in economic policy uncertainty reinforces this effect through the risk aversion channel described below.

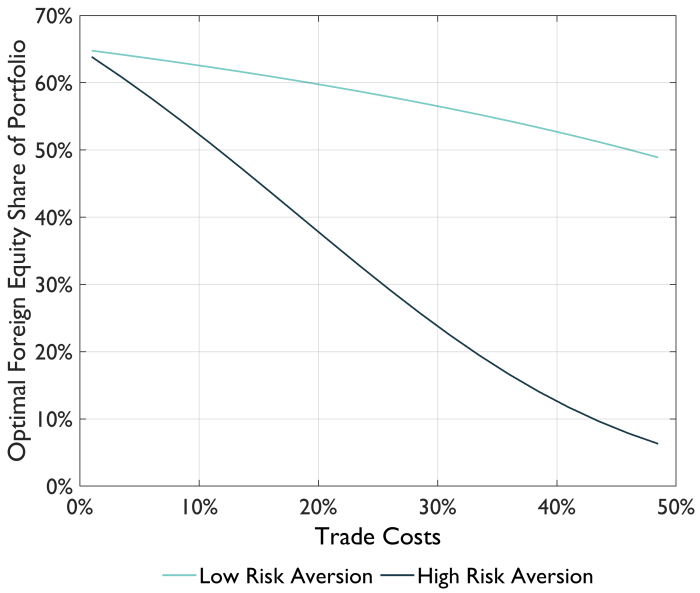
A.4. Results: Trade Costs, Risk Aversion, and Optimal Weights

The model's key comparative statics are unambiguous and robust across plausible parameter ranges.

Trade costs alone. Starting from the current market-capitalisation benchmark of approximately 65 percent US equities, an increase in trade costs of the magnitude already observed since early 2025 reduces the optimal US portfolio share to around 60 percent, even holding investor risk preferences constant. This is a welfare theoretic result, not a valuation or momentum signal. It reflects the reduced insurance value of US asset holdings when goods-market transmission is impaired.

Trade costs combined with elevated risk aversion. When heightened policy uncertainty and geopolitical risk raise investors' effective risk aversion, a reasonable characterisation of the current environment, the optimal US equity share falls substantially further, approaching 40 percent in our baseline calibration. The interaction between trade frictions and risk aversion is non-linear, as once frictions are high enough that foreign assets no longer hedge domestic risk effectively, even moderate increases in risk aversion trigger sharp portfolio retrenchment. This echoes the earlier result of Cole and Obstfeld (1991), who showed that when the gains from international risk sharing are sufficiently small, trade frictions alone can largely offset the theoretical benefits of diversification, causing portfolios to tilt sharply toward domestic assets.

Figure 4: Welfare Optimal US Portfolio Share



Sources and Notes: Fulcrum Asset Management LLP. Figure shows optimal US portfolio shares in a calibrated version of the two country model from Obstfeld and Rogoff (2001) under alternative trade cost and risk aversion scenarios. Specifically, it plots equation (16) using the parameterisation $\theta = 2$ (low risk aversion) and $\theta = 6$ (high risk aversion), across a range of trade costs. April 23, 2026.

These results should be interpreted as steady state, welfare optimal deviations from market capitalisation benchmarks and not as short horizon return forecasts or valuation based timing signals. The argument is

that investors mechanically holding 65 percent in US equities are accepting a suboptimal consumption risk profile given the current trade environment, independent of any view on near term US equity performance.

A.5. Why Frictions Matter

In a frictionless world with complete financial markets, investors can insure cheaply against country specific shocks through both goods trade and asset trade, giving rise to a diversified portfolio reminiscent of the Markowitz (1952) market portfolio. More recent work has formalised this mechanism in asset-pricing settings, showing that goods-market frictions systematically distort optimal international asset holdings even in the absence of explicit financial constraints (Coeurdacier and Gourinchas, 2016).

Once trade costs are introduced, this logic breaks down. Trade frictions make foreign goods more expensive and less responsive to shocks, reducing the extent to which consumption can be smoothed across countries. This weakens the link between financial diversification and consumption insurance as holding foreign assets no longer delivers the same welfare gains as in a frictionless environment. From an investment perspective, this reduces the attractiveness of foreign equities in precisely the states of the world where insurance is most valuable. This effect is distinct from, and cumulative with, the valuation and herding arguments made in the main text.

A.6. Why Risk Aversion Amplifies

Risk aversion plays a critical amplifying role. In low friction environments, financial markets can largely offset consumption risk, making investors comfortable holding substantial foreign exposures. When trade costs rise, investors are forced to bear more residual risk, and foreign assets become less effective hedges against adverse domestic outcomes. Higher risk aversion magnifies this effect when risk averse investors place greater weight on downside outcomes and rationally reduce foreign equity holdings relative to market capitalisation benchmarks, prioritising robustness over maximal diversification.

This interaction between trade frictions and risk preferences is central to the current argument. It provides a coherent explanation for why portfolios should shift structurally away from US equities in periods of rising trade barriers and heightened uncertainty, precisely the conditions prevailing in the current global environment, without appealing to irrationality, market inefficiency, or behavioural bias.

A.7. Relationship to the Home Bias Literature

These results recover and reframe the classic home bias puzzle of French and Poterba (1991) and Tesar and Werner (1995) in a contemporary context. The original puzzle was that investors hold too much domestic equity relative to the frictionless theory. The contemporary counterpart is that global investors hold too much US equity relative to what a properly specified model, i.e. one that takes trade frictions and incomplete risk sharing seriously, would prescribe. The mechanism is the same but the direction is inverted.

Baxter and Jermann (1997) showed that the international diversification puzzle is worse than it appears. Once human capital, which is predominantly domestic, is accounted for investors should hold even less foreign equity than naive portfolio theory suggests, because their non-financial wealth is already concentrated domestically. The analogous point applies for non-US investors today as their labour income and consumption baskets are predominantly non-US, which further weakens the case for a 65 percent US financial portfolio weight. Lewis (1999) and Coeurdacier and Rey (2013) provide comprehensive surveys of how goods market frictions,

non-tradable sectors, and currency risk jointly generate equilibrium deviations from market-capitalisation portfolios, as deviations that the current tariff shock will only widen.

A.8. What the Framework Does and Does Not Say

Two caveats are important. First, the results concern steady state welfare optimal allocations, not the path of US equity returns. The framework says nothing directly about timing, about the next quarter's performance, or about when market prices will reflect these welfare optimal weights. Instead, the claim is structural, as investors passively holding 65 percent in US equities are accepting a suboptimal risk profile given the current trade environment, regardless of what US equities do in the near term.

Second, the framework abstracts from features that support some premium for US assets, including dollar liquidity, the depth of US capital markets, and the global revenue exposure of US technology firms. These partially insulate US domiciled corporate earnings from domestic trade frictions. These are real advantages. The point is not that they are absent, but that they do not, on their own, justify the specific 65 percent allocation implied by a passive benchmark, particularly when the theoretical foundations of that benchmark are being actively eroded. The convergence of the valuation evidence, the herding literature, the geopolitical risk reassessment, and the formal welfare theoretic analysis here points consistently in the same direction. This convergence, arrived at by independent methods and resting on different assumptions, is the strongest argument of all.

B. Obstfeld and Rogoff (2001) Derivation

The equations below provide a simplified mapping of the Obstfeld and Rogoff (2001) framework used above.

$$EU = \mathbb{E}\left[\frac{C^{1-p}}{1-p}\right], \tag{1}$$

$$C = \left[C_H^{\frac{\theta-1}{\theta}} + C_F^{\frac{\theta-1}{\theta}}\right]^{\frac{\theta}{\theta-1}}, \tag{2}$$

$$P_F = \frac{P_F^*}{1-\tau}, \qquad P_H^* = \frac{P_H}{1-\tau}. \tag{3}$$

$$\frac{1}{P_H}\frac{\partial U}{\partial C_H} = \frac{1}{P_H}\frac{\partial U^*}{\partial C_H^*}. \tag{4}$$

$$\frac{1}{P_F}\frac{\partial U}{\partial C_F} = \frac{1}{P_F}\frac{\partial U^*}{\partial C_F^*}. \tag{5}$$

$$\frac{\partial U}{\partial C_H} = C^{-p}C_H^{-\frac{1}{\theta}}, \qquad \frac{\partial U}{\partial C_F} = C^{-p}C_F^{-\frac{1}{\theta}}. \tag{6}$$

$$C_H^{-\frac{1}{\theta}}C^{-p} = (1-\tau)\,(C_H^*)^{-\frac{1}{\theta}}(C^*)^{-p}. \tag{7}$$

$$(1-\tau)\,C_F^{-\frac{1}{\theta}}C^{-p} = (C_F^*)^{-\frac{1}{\theta}}(C^*)^{-p}. \tag{8}$$

$$\frac{C_H}{C_F} = \left(\frac{1}{1-\tau}\right)^{\theta} \frac{C_H^*}{C_F^*}. \tag{9}$$

$$C_H + (1-\tau)C_H^* = Y_H, \tag{10}$$
$$C_F^* + (1-\tau)C_F = Y_F. \tag{11}$$

Special case with $p = 1/\theta$

$$\frac{C_H}{C} = (1-\tau)\frac{C_H^*}{C^*}, \qquad (1-\tau)\frac{C_F}{C} = \frac{C_F^*}{C^*}. \tag{12}$$

Equity shares

$$C_H = X_H Y_H, \tag{13}$$
$$C_F = (1-\tau)X_F Y_F. \tag{14}$$

$$X_H = \frac{1}{1+(1-\tau)^{\theta-1}}, \tag{15}$$

$$X_F = \frac{(1-\tau)^{\theta-1}}{1+(1-\tau)^{\theta-1}}. \tag{16}$$

$$X_H^* = X_F, \qquad X_F^* = X_H. \tag{17}$$

Calibrating $\tau = 0.10$ to approximate the observed rise in effective US tariff rates and setting $\theta = 2$, equation (16) yields an optimal foreign equity share of approximately 65 percent under trade costs alone, falling toward 50 percent as risk aversion rises.

C. Full Obstfeld and Rogoff (2001) Intuition

The key insight is as follows. In the Obstfeld and Rogoff (2001) model, the benchmark that rationalises a market capitalisation portfolio, such as a 65% weight on US equities, relies on international risk sharing. When trade costs are negligible, state contingent claims and the international goods trade jointly allow agents to smooth consumption across countries. Adverse domestic shocks can be offset by importing goods and by income from the holding of foreign assets. In this environment, equity claims primarily serve as insurance devices, and optimal portfolios replicate the world endowment, yielding allocations close to global market weights. Introducing trade costs breaks this mechanism. Iceberg trade costs drive a wedge between domestic and foreign prices, so that the international goods market adjustment no longer transmits shocks efficiently across countries. As a result, consumption becomes more tightly linked to domestic output, and foreign equity returns provide weaker insurance against domestic risk, ex ante. In equilibrium, risk averse agents respond by reducing their holdings of foreign assets, since these assets no longer hedge consumption effectively. The fall in the optimal foreign equity share is therefore not a reaction to expected returns, but a direct consequence of impaired consumption risk sharing caused by trade frictions. When risk aversion rises, this effect is amplified,

because trade costs prevent full consumption smoothing, the welfare cost of holding foreign claims increases sharply, leading to a further decline in optimal foreign portfolio shares.

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