



Bakumatsu

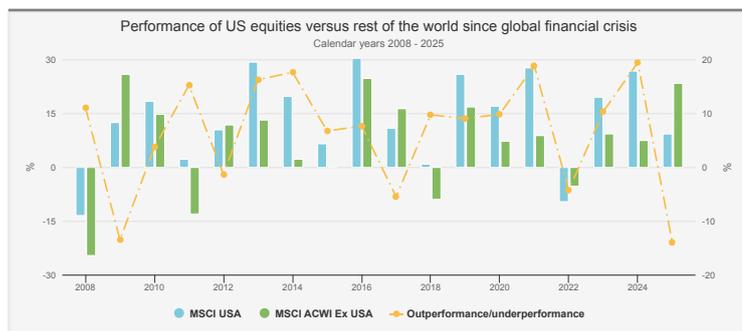
We make the case for investing less in the USA.

Update
16 March 2026

The term ‘Bakumatsu’ refers to the final years of the Edo period in Japanese history, during which the Shogunate — the hereditary military government — came to an end. For nearly 700 years, the military ruler, known as the Shogun, held actual political power in Japan, while the emperor was largely a symbolic head of state. However, a combination of geopolitical and societal changes gradually undermined the Shogunate’s authority. These pressures ultimately culminated in the Boshin War, a civil conflict that pitted the Shogunate, which sought to preserve the existing order, against the imperial court, which aimed to restore governing authority to the emperor. The defeat of the Shogunate in this conflict brought an end to a system that may once have seemed immutable.

Arguably, the Shogunate’s seven-century-long rule over Japan may be reminiscent of the dominance of US equities over the rest of the world, particularly since the global financial crisis (GFC). Since 15/09/2008 — when Lehman Brothers filed for bankruptcy — the MSCI USA Index has returned 815.5%, more than three times the 260% return of the MSCI ACWI ex USA Index. In addition, between 2008 and 2025, US equities outperformed the rest of the world in c. 72% of calendar years, as the chart below shows. In our view, the reasons for this strong outperformance include the dominance of technology-related stocks — which are strongly represented in US equity indices — supportive monetary and fiscal policies, cheap energy from shale, and the strength of the US dollar.

Fig.1: Calendar-Year Returns



Source: Morningstar

Past performance is not a reliable indicator of future results.

However, we believe there are signs that US hegemony in global equity markets may be coming to an end. Investors have shown greater interest in equity markets outside the US since last year, driven by concerns over the health of the US economy, the erratic behaviour of the Trump administration, and more attractive valuations in other regions. As the chart below shows, US equities

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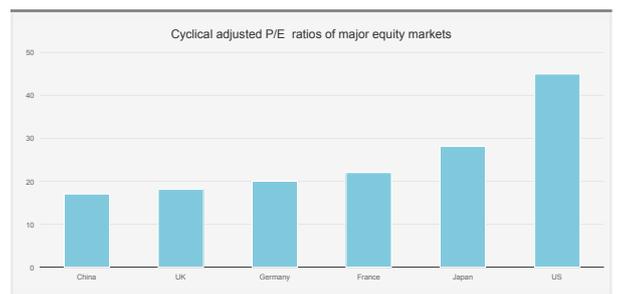


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stand out as particularly expensive compared to other major equity markets when measured by the cyclically adjusted price-to-earnings (P/E) ratio. As a result, investors may opt to rotate out of US equities on valuation grounds.

Fig.2: Cyclical Adjusted P/E Ratio



Source: Ruffer, GFD CAPE data, adjusted for subsequent daily price changes data to January 2026

Meanwhile, AI spending has become an important contributor to the US economy, with hyperscalers such as Microsoft, Amazon, and Oracle having collectively invested several hundred billion US dollars in AI infrastructure. In fact, AI-related capital expenditures accounted for 1.1% of US GDP growth in H1 2025. As such, a slowdown in AI spending could materially impact US economic growth and have ripple effects, notably on the job market,



with fewer hires in IT services, hardware manufacturing, and construction roles, among others. This would also likely weigh on consumer sentiment, which is already low relative to historical standards. It is also worth noting that, while these investments could eventually boost profits, they may also reduce companies' free cash flow (FCF) generation. In the short term, slower FCF growth could trigger negative market reactions, and the consequences could be more severe if these CAPEX investments fail to meet long-term expectations. Finally, the US dollar is facing structural challenges, including de-dollarisation trends, while a high public deficit could erode confidence in the currency.

As a result, we believe investors should consider adding some geographical diversification in their portfolio, as US equities may be experiencing their own 'Bakumatsu' period. In fact, US equities significantly underperformed the rest of the world in 2025 (in GBP terms) and are also lagging year-to-date (as of 10/03/2026). In this article, we explore investment opportunities in major equity regions outside of the US.

Europe

Investors have been allocating more capital to European equities since the beginning of the year. We believe this may reflect a shift in sentiment towards the region following its strong performance in 2025. In fact, Europe ex-UK was the best-performing major equity region last year (in GBP terms), as the chart below shows. Moreover, while European equities are now expensive relative to historical levels, they are still trading at a discount to their US counterparts. This may be prompting investors wary of lofty valuations to favour Europe over the US on a relative basis. There have also been improvements in the macroeconomic outlook for the Eurozone, such as falling inflation and interest rates lower than those in the US and UK, which may have caught investors' attention. Finally, we believe there are some clear investment themes that could sustain market returns in the region, notably Germany's stimulus package, which particularly targets infrastructure and defence.

Fig.3: Returns In 2025



Source: Morningstar

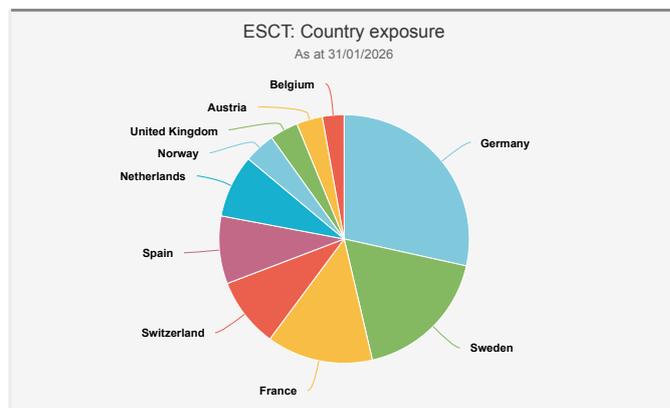
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In our view, Germany's €500bn stimulus package represents a paradigm shift and may have the potential to be a game changer for Europe. Historically, Germany — Europe's largest economy — prioritised balanced budgets and low public debt. In fact, the country has had a 'debt brake' enshrined in its constitution since 2009, which limits the federal government's ability to borrow, although it was loosened in March 2025. However, this approach has resulted in underinvestment, leading to crumbling infrastructure and a decline in industrial competitiveness. The stimulus package seeks to address these issues, which we believe could prove supportive for industrials and infrastructure-related companies.

The package also focusses on defence, a matter that has become crucial for Europe since the outbreak of the war in Ukraine in 2022, and has been compounded by questions around American commitments to European defence. EU member states have been ramping up defence spending in recent years, which is estimated to have reached €381 million in 2025 — a c. 63% increase compared with 2020. As Germany aspires to build Europe's largest army, we believe this theme may have further scope to run.

We think **European Smaller Companies Trust (ESCT)** could be well positioned to benefit from Germany's stimulus package. German stocks account for approximately a quarter of the portfolio, as the pie chart below shows, with manager Ollie Beckett having identified opportunities linked to infrastructure and defence spending.

Fig.4: Country Exposure



Source: Janus Henderson

UK

UK equities delivered their best annual gains since 2009 last year. In spite of this, they remain out of favour with investors, with outflows from UK equity funds having continued in 2025. Moreover, while the FTSE 100 Index has rerated to its long-term valuation averages as a result, UK equities continue to trade at a discount to other developed markets, including the US, Europe, and Japan.



However, we believe the outlook for UK equities may be stronger than fund flows and valuations suggest. For instance, UK household balance sheets are in good shape, with low debt levels that could support a recovery in consumption. The balance sheets of UK corporates are also healthy, providing scope for credit expansion to fuel growth. In addition, the sectoral composition of the FTSE 100 Index, which is rich in energy-related businesses, could prove attractive going forward. Rising power demand from data centres could be a key driver, while higher geopolitical tensions may also be supportive, as countries seek to strengthen energy security. Finally, it is worth remembering that three-quarters of UK large-cap companies, as well as nearly half of mid-cap businesses, generate their revenues overseas, meaning they are not overly reliant on the domestic economy.

That said, we believe the best opportunities in the UK equity market are to be found in the small- and mid-cap (SMID) space. Unlike their large-cap peers, SMIDs are still trading at a discount to their historical averages, offering potential for rerating. In fact, the FTSE 250 ex Investment Trusts and the Deutsche Numis Smaller Companies ex Investment Trusts indices are both trading on a lower P/E ratio than the FTSE 100, which we view as an anomaly, since SMID indices typically command higher valuation multiples than their large-cap counterparts, reflecting their greater growth potential. Moreover, SMIDs are benefiting more from M&A activity, with both private equity firms and corporate buyers taking advantage of low valuations in this part of the UK equity market. In addition, interest rates in the UK have progressively fallen since 2024, reducing borrowing costs and making refinancing existing debt more affordable. Lower yields from risk-free assets may also increase the appeal of UK SMIDs.

As a result, we believe that investment trusts taking an all-cap approach could prove attractive at this juncture, allowing investors to gain exposure to a potential rerating of UK SMIDs while maintaining allocation to the remaining opportunities within the large-cap space. We would particularly highlight **Fidelity Special Values (FSV)**, with managers Alex Wright and Jonathan Winton applying a contrarian approach, investing in overlooked and undervalued companies. Following the strong performance

Fig.5: Market Cap Exposure



Source: Fidelity International

of the FTSE 100 Index in 2025, they have increased their bias towards SMIDs.

Emerging markets

For the first time since 2020, emerging markets outperformed their developed market peers last year. We believe this outperformance could be sustained in the near term, as emerging markets may benefit from tailwinds such as lower US interest rates, a weaker US dollar, and attractive valuations relative to developed markets. In fact, as the table below shows, emerging market equities are currently trading on lower forward P/E ratios than their US and other developed market peers, while offering stronger earnings growth expectations over the next 12 and 24 months.

Valuations & Earnings Growth Expectations

INDEX	MSCI EM	MSCI WORLD EX USA	MSCI USA
P/E (forward to the end of 2027) (x)	10.6	14.6	18.9
P/E (forward to the end of 2028) (x)	9.3	13.6	16.8
Earnings growth (1-yr forward) (%)	21.4	10.4	15
Earnings growth (2- yrs forward) (%)	28.1	7.5	11.4

Source: Bloomberg, as at 10/03/2026

Over the long term, we believe emerging markets could benefit from powerful structural growth themes, including rising living standards, the reshaping of global supply chains, and rapid technology adoption, among others. On the technology front, it is worth highlighting that many companies in emerging markets, particularly those listed in Taiwan and South Korea, are deeply embedded in the AI supply chain, while China is viewed as the closest competitor to the United States in terms of AI developments. Interestingly, the team at Ruffer Investment Company (RICA) prefers to gain exposure to the AI theme through Chinese companies, which trade on lower valuations than their US peers. We published a **new note** on RICA last week.

Moreover, companies across emerging markets have made efforts in recent years to improve shareholder returns, notably through increased share buybacks and higher dividends. This includes South Korea, which launched its 'value-up' programme in 2024, emulating Japan's corporate governance reforms. Meanwhile, many Chinese companies, including those traditionally focussed on capital appreciation such as Alibaba, have distributed more of their FCF to shareholders via dividends and share repurchases (see our **recent strategy article**). These



changes in attitude towards shareholders may enhance the appeal of emerging market equities and make them more accessible to dividend-seeking investors, allowing them to benefit from their growth potential without compromising income objectives.

We view **Schroder Oriental Income (SOI)** and **JPMorgan Emerging Markets Dividend Income (JEMI)**, both of which pay a 'natural' income, as attractive vehicles to capture the growth potential of emerging markets while benefiting from improvements in dividend culture across these regions. SOI boasts a 19-year track record of dividend increases and currently offers a historic yield of c. 3.2%. In contrast, JEMI offers a historic yield of c. 3.5% and currently trades at a slightly wider discount — c. 6.8% versus c. 4% for SOI — offering somewhat more rerating potential.

Fig.6: DPS & EPS



Source: Schroders

Japan

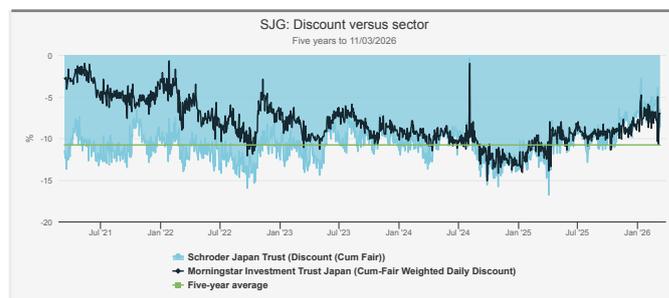
Similar to other regions, Japanese equities outperformed their US peers last year. We believe ongoing corporate governance reforms will be a key driver for this outperformance to continue. While large-caps have largely rerated since 2023, as discussed in a **previous article** — with the TOPIX now commanding a higher multiple than most major developed markets outside the US — we think this theme may continue to unfold in the smaller end of the market-capitalisation spectrum. Many smaller Japanese firms are lagging in their plans to improve shareholder value and still hold substantial cash on their balance sheets. It is in this segment of the market that **AVI Japan Opportunity (AJOT)** seeks opportunities. The team applies an activist, engagement-led approach, focussing on balance sheet inefficiencies and governance improvements to unlock shareholder value.

However, we think Japanese equities could also benefit from further tailwinds beyond corporate governance reforms. This includes the revamping of the NISA — Japan's equivalent of the UK ISA — which, combined with the return of inflation, could incentivise retail investors to move out of cash and deploy capital into equities. In addition, Japan is one of the largest providers of foreign direct investment worldwide, meaning that some capital could potentially be repatriated and reallocated into

domestic assets. This could result from improvements in the investment environment in Japan, for example. In addition, the landslide election victory of Sanae Takaichi in February 2026 should enable the Japanese prime minister to implement expansionary fiscal policies without facing parliamentary friction, which could provide an economic boost. However, such policies may push JGB yields higher, particularly given Japan's already elevated debt-to-GDP ratio (above 200%).

Given this backdrop, we believe **Schroder Japan (SJG)** could be attractive at this juncture. The portfolio is exposed to companies that may benefit from a steeper yield curve, such as insurers, as well as industrially linked businesses that could gain from government stimulus designed to spur the economy. In addition, SJG is overweight SMID companies, which are more exposed to the domestic economy and would be well positioned to benefit if expansionary fiscal policies result in stronger economic growth. The trust is also trading at a c. 9% discount, offering rerating potential. Interestingly, discounts remain wide in the AIC Japan sector compared with most other regional equity sectors. To us, this suggests a disconnect between investor sentiment and fundamentals, given the strong returns generated by Japanese equities and several sector constituents, including SJG, over the past five years.

Fig.7: Discount



Source: Morningstar

Conclusion

The victory of the imperial forces over the Shogunate in the Boshin War led to the Meiji era, during which Japan embarked on a transformative period of reform and modernisation, adopting technologies, sciences, and other concepts from Western countries. This enabled the insular nation to develop rapidly and become a powerful modern state.

Just as the Japanese embraced change during the Meiji era, we believe investors should embrace change in their portfolios by introducing greater global diversification. We think 2025 demonstrated the merits of geographical diversification and reminded investors that compelling opportunities exist outside the US. While we do not suggest cutting exposure to the US to zero, as it remains the deepest and most liquid equity market in the world, we



view the weight of the US in standard global equity indices — typically over 60% (c. 62% in the MSCI ACWI) — as too high, given the potential challenges the US is facing.

Of all the major equity regions we have reviewed, the emerging markets are, in our view, the most compelling, thanks to a combination of attractive valuations relative to developed markets, higher earnings growth expectations, and strong structural growth themes. We also see a strong case for UK SMIDs, which trade at a discount to both their large-cap peers and their long-term averages. To us, this suggests an anomaly that could correct over time, with supporting dynamics already in place, such as M&A activity and interest rates having come down since 2024.



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