

The Dynamics of Geographic versus Sectoral Diversification: Is There a Link to the Real Economy?

ABSTRACT

We study the dynamics of gains from sectoral versus geographic diversification and relate economic sources to changes in those gains. We estimate conditional correlations between returns on the U.S. equity market and 16 equity markets and 10 local industries from other OECD countries and find that the average correlation across countries has increased in relation to that across industries. We also show that this process is accompanied by increased alignment in the industrial structures across countries and an increase in the average conditional correlation of aggregate production growth across countries relative to that of disaggregated production growth, especially among developed economies. Thus, the increased benefits of industry-level investing across developed markets are reflected in the real side of the global economy. However, country-level investing should remain the predominant asset allocation approach in emerging markets.

JEL classification: G12; G15

Keywords: Diversification gains; Asset allocation; International equity markets; Industrial structure; Industrial production