Does the Buck Stop Here?

What to Make of Recent U.S. Dollar Weakness

Key Takeaways

- U.S. dollar weakness in the first half of 2025 has led investors to question if the strong dollar regime of the past 15 years has come to an end. A stabilizing currency more recently, however, suggests cyclical factors could be at play.
- Factors that have contributed to dollar weakness this year include hedging of U.S. assets, the structural challenges of growing federal deficits and the Trump administration's trade and tariff policies.
- Given the strong linkage between the dollar and relative equity performance over the past 50 years, the path of the greenback will have important ramifications for geographic equity leadership. We believe it prudent for investors to review their global allocations given a strong likelihood the next decade will look quite different from the past one.

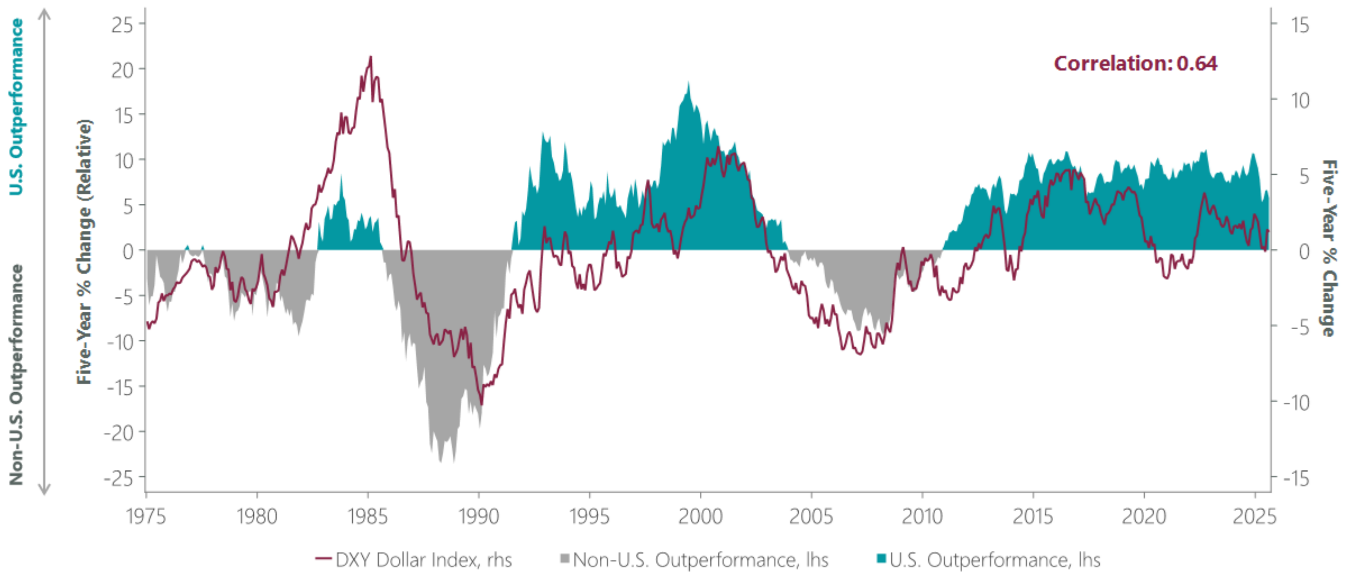
U.S. Exceptionalism Has Been a Dollar Tailwind

The U.S. has been a global leader from an economic and financial market perspective over the past 15 years, with the U.S. economy more than doubling in size (+111%) since the end of the Global Financial Crisis (GFC) in mid-2009 while European (eurozone) GDP is just 29% larger. At the same time, U.S. assets have offered superior returns with the S&P 500 Index outpacing the MSCI All Country World Index (ACWI) ex-U.S. 871% to 235%. Given that capital tends to flow to where the highest returns are available, it is perhaps predictable that this era has been marked by a strong U.S. dollar with the DXY Dollar Index rising 60% from its 2008 lows to a 2022 peak.

The simultaneous strength in the greenback and U.S. equities is unsurprising given the strong linkages between geographic equity market leadership and currency regimes going back to the mid 1970s. In fact, the correlation between the DXY and regional equity market leadership (S&P 500 versus MSCI ACWI ex-U.S.) is 0.64 over the past 50 years, indicative of a robust relationship (Exhibit 1).

The U.S. dollar was firmly entrenched as the world's reserve currency prior to the GFC, and the era of U.S. exceptionalism that followed further solidified this status. Such status has been questioned at times, however, as ongoing quantitative easing (QE) from the Federal Reserve coming out of the GFC, the rise of cryptocurrencies, the growing U.S. federal debt

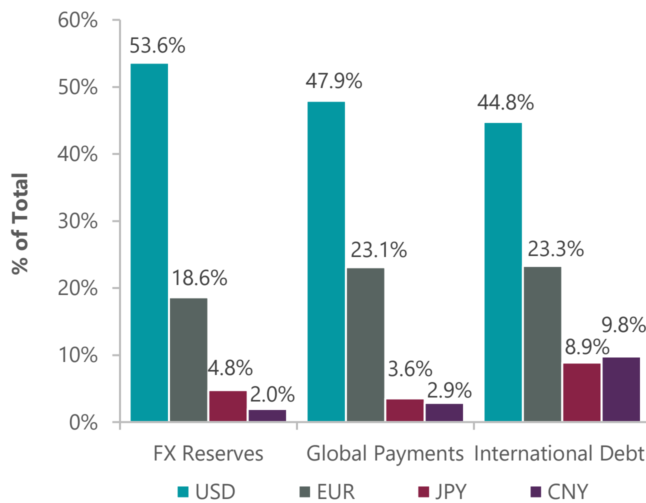
Exhibit 1: Regional Equity Leadership Tethered to the Dollar



Note: Price return. Data shows rolling five-year annualized performance differential between S&P 500 and MSCI ACWI ex-U.S. indices vs. U.S. Dollar Index. Data as of Sept. 15, 2025. Sources: S&P, MSCI, Intercontinental Exchange (ICE), Macrobond.Past performance is not a guarantee of future results. Investors cannot invest directly in an index, and unmanaged index returns do not reflect any fees, expenses or sales charges.

burden and incremental de-dollarization steps from some (primarily emerging market) central banks have led to fears that the dollar may be losing its place in the global order. Despite these fears, the greenback remains the go-to currency for central bank foreign exchange (FX) reserves around the world, along with global payments and international borrowing.

Exhibit 2: U.S. Dollar (Still) Dominates

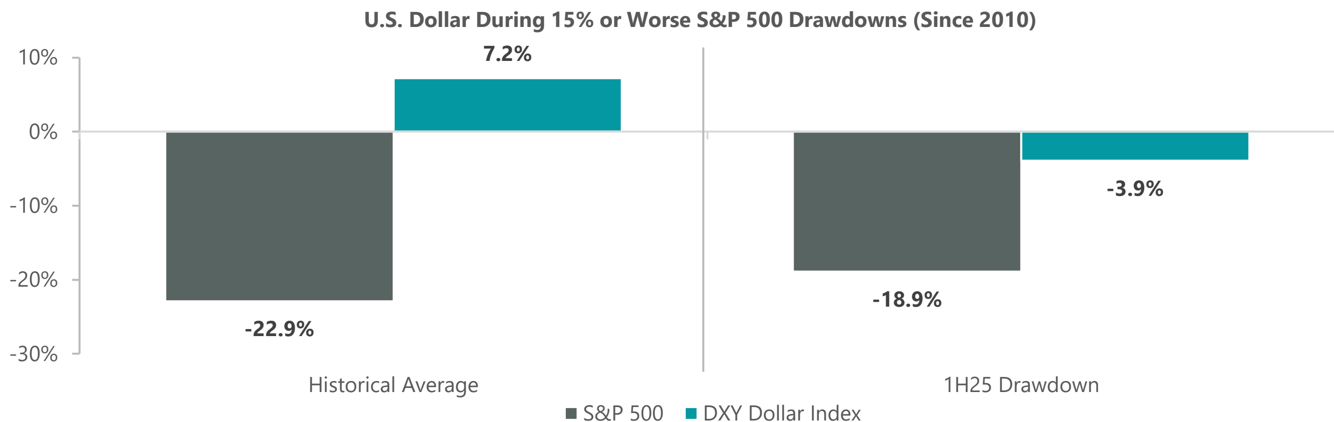


Data as of Sept. 9, 2025. International Debt represented by the Bloomberg Global Aggregate benchmark. Sources: Bloomberg, SWIFT, International Monetary Fund (IMF), Macrobond.

While the dollar is still safely embedded as the world's reserve currency, recent dollar weakness has caused investors to question if the secular dollar bull market that began in 2008 has come to an end. The DXY fell 10.7% in the first half of 2025, its worst six-month stretch since the GFC; among six-month stretches dating back to 1967 this is in the bottom decile. Although the dollar has stabilized in the months since, investors are continuing to question whether a regime shift is underway that would lead to a systematically weaker U.S. dollar.

Regime shifts are difficult to definitively identify while they are underway, although one marker is a disconnect between price action in the market and investor expectations given an event occurring. Since 2010, the U.S. dollar has acted as a safe haven currency, appreciating by an average of +7.2% during the five previous selloffs of 15% or worse in the S&P 500. However, the greenback fell by 3.9% during the S&P 500's 18.9% selloff earlier this year, the first time that the dollar has depreciated during a material risk-off period over the time frame.

Exhibit 3: Dollar Dissonance



Historical average reflects average of trade-weighted dollar performance from S&P 500 selloffs of more than 15% from 2010 to 2022. 1H25 drawdown reflects drawdown period from Feb. 19 – April 8, 2025. Data as of June 30, 2025. Sources: FactSet, ICE, S&P.

Signs of a U.S. Dollar Regime Shift

A single period of simultaneous equity and dollar weakness does not necessarily mean a regime shift is underway. That said, investor expectations coming into the year were for a stronger dollar, particularly in light of the administration's global trade agenda and the pattern of dollar strength following the implementation of tariffs in 2018 during the first Trump trade war. This weakness is not only a sign of a potential regime shift, but it has also taken FX experts by surprise as currency models that focus on interest rate differentials have broken down recently.

This approach to forecasting FX moves focuses on the relative monetary policy stance between central banks, with currencies typically appreciating in favor of countries with higher short-term interest rates. These models tend to work well over the intermediate term, but the USD/EUR currency pair has seen the dollar significantly undershoot the level the model suggests given the differences between Fed and European Central Bank policy so far this year (Exhibit 4).

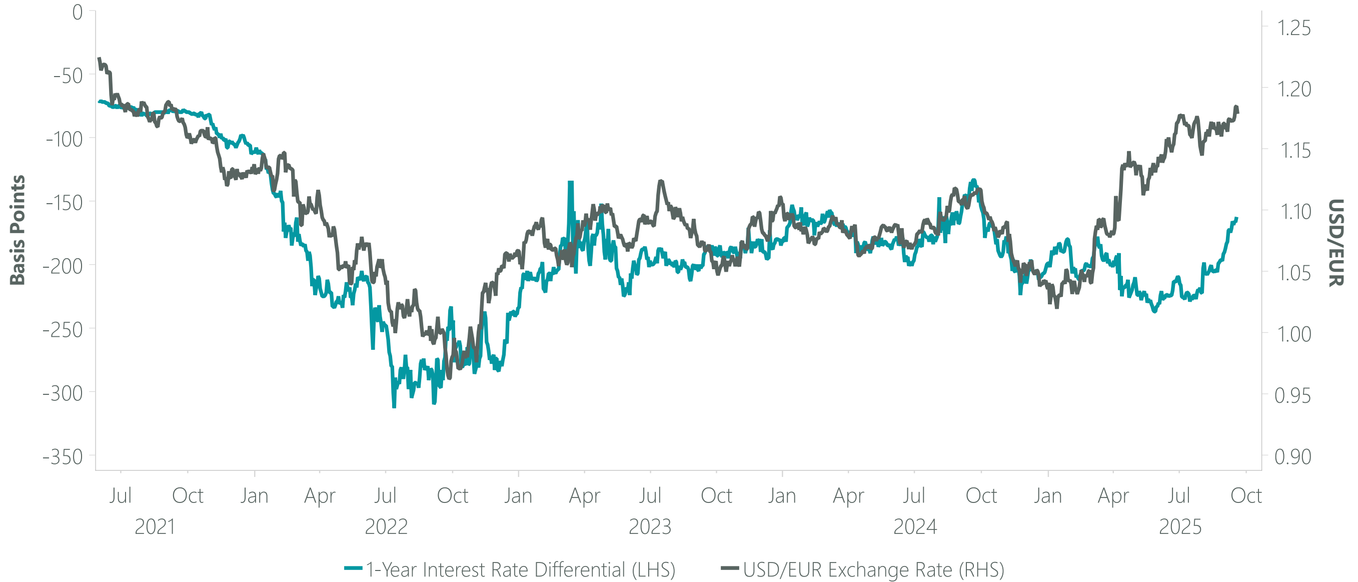
A Potential Shift in Currency Hedging

In our view, other factors are playing a large role in 2025's U.S. dollar weakness. One of these factors is an increase in hedging activity, as the strength of U.S. equity, fixed income, and credit markets in the first half of the year suggests investors are not selling U.S. assets *en masse*. The Treasury Department's Treasury International Capital (TIC) data, as one example, showed that foreign investors purchased $147 billion of U.S. Treasurys in May — the most since August 2022 and the second-largest month on record dating back to 1977 — indicating a healthy appetite remained for U.S. government debt in the month following the Liberation Day tariff announcements. Moreover, after seeing modest outflows in April, U.S. equities have seen a strong rebound in flows from overseas investors alongside the market rally in May and June, according to the same TIC dataset. In the absence of large outflows that would indicate broad-based reallocation away from U.S. investments, hedging — for example taking offsetting positions in other currencies to reduce risk of holding U.S. dollars — appears to have been a primary driver of dollar weakness so far in 2025.

In recent years, hedging USD exposure was a secondary consideration for many investors given the dollar's strong run. Currency was a tailwind for many non-U.S. investors deploying capital into the U.S. Furthermore, the dollar tended to be negatively correlated to U.S. equity holdings, particularly during periods of market strain as described earlier. Investors could take additional risk in U.S. equities knowing that currency appreciation would help offset some of their losses when the market turned lower. With that relationship under threat, investors are understandably recalibrating and recent data from Deutsche Bank suggests that 80% of inflows from foreign investors into U.S. equity ETFs have been currency hedged over the past three months, up from 20% at the start of the year.

Should correlations between currencies, U.S. investments, and non-U.S. investments shift in a lasting way, investors will continue to re-evaluate their thinking around hedging USD exposure. If this dynamic becomes the "new normal," updated risk parameters will drive an increased emphasis on hedging on the part of non-U.S. investors, which would ultimately be a headwind for the greenback.

Exhibit 4: Interest Rate Differential Currency Models Breaking Down



Data as of Sept. 15, 2025. Sources: U.S. Department of Treasury, Macrobond.

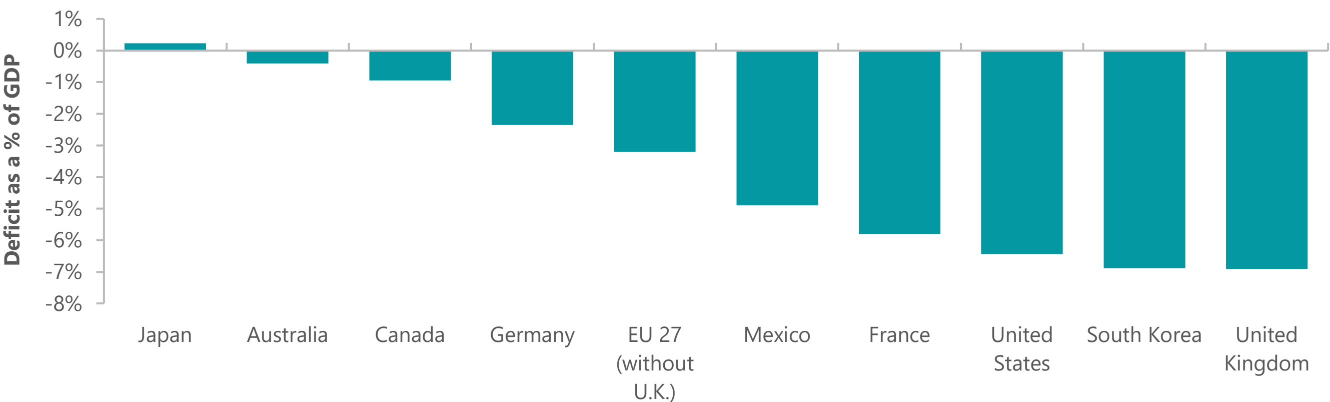
Deficit Side Effects

Another potential driver of dollar weakness is the structural challenge from funding the so-called "twin deficits": the federal budget and current account. The twin deficits have grown by $11 trillion cumulatively since mid-2009 and public sector dissaving (spending more than is available) has become a key driver of superior U.S. economic growth since the GFC, with GDP having increased by $15 trillion.

Although increased tariff revenues should help improve the twin deficits, the passage of the One Big Beautiful Bill (OBBB) puts the budget deficit on a path to remain at 6%–7% of GDP for the foreseeable future, meaning the twin deficits aren't likely to improve over the next few years. The key consideration for both the dollar and economic growth is the *relative* change in the budget deficits compared with other key economies. Outside of the U.K. and Japan, most other major nations have considerably more scope to increase their budget deficits than the U.S. does (Exhibit 5).

It isn't difficult to visualize a future in which the rest of the world meaningfully increases its fiscal spending (and thus deficits) while the U.S. largely stands still

Exhibit 5: Budget Deficits Around the World

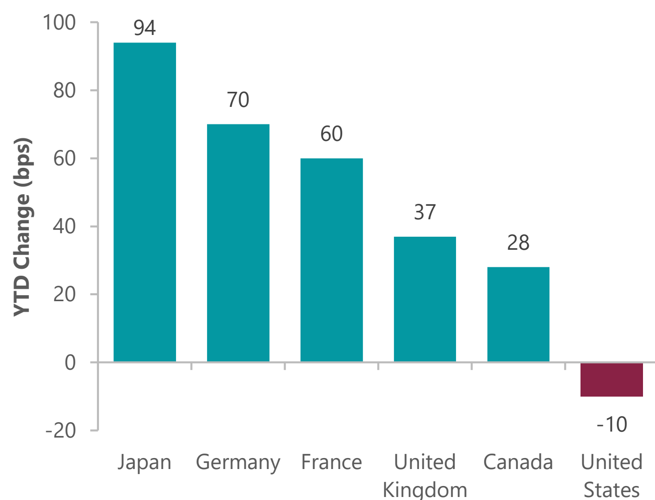


Data as of Sept. 16, 2025. Sources: International Monetary Fund (IMF), Eurostat, French National Institute of Statistics & Economic Studies (INSEE), Mexican Ministry of Finance & Public Credit (SHCP), Statistics Canada, U.K. Office for National Statistics (ONS), U.S. Bureau of Economic Analysis (BEA), German Federal Statistical Office (Statistisches Bundesamt), China Ministry of Finance, Australian Bureau of Statistics, Bank of Japan (BOJ), Korea Ministry of Economy & Finance, Macrobond.

or even reins in government spending over the next few years. China and Japan are both deploying fiscal stimulus measures at present given sluggish domestic economic growth, while earlier this year, to support an increase in military spending, the eurozone loosened the 3% of GDP deficit limit set by the Maastricht Treaty. The German government has taken this even further, proposing spending up to 20% of GDP over the next 10 years to beef up military spending and infrastructure. The bottom line is that most major economic blocs around the world are warming to the idea of a more supportive fiscal stance, while the U.S. is more hamstrung.

Global fixed income markets may already be sniffing out the potential for additional fiscal support with long rates moving higher globally and yield curves steepening. While the U.S. 30-year Treasury bond yield has *decreased* by 10 bps this year through September 12, the 30-year JGB (Japan) is up 94 bps, the German 30-year Bund yield has risen by 70 bps, the 30-year OAT (France) is up 60 bps, 30-year U.K. gilt yields are 37 bps higher, and Canadian 30-year government bonds are up 28 bps. These moves are in part reflecting an improvement in economic growth expectations resulting from increased fiscal support coupled with the boost from central bank cutting and increased visibility on trade policy.

Exhibit 6: Global 30-Year Sovereign Bond Yields



Data as of Sept. 12, 2025. Sources: U.S. Department of Treasury, Japanese Ministry of Finance, Macrobond.

A Cyclically, not Structurally, Weaker Dollar?

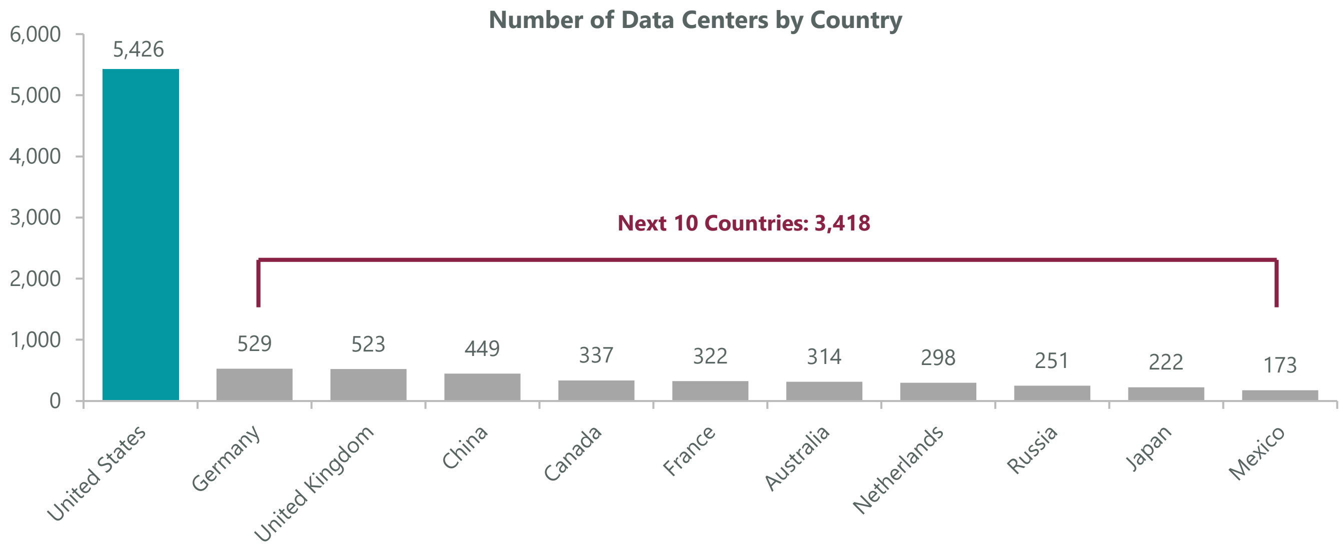
The other possibility is that the recent dollar decline is not a sign that a new weaker dollar regime is beginning, but rather the result of cyclical trends that will reverse over the next few years. These dynamics include the Trump administration's global trade policies and interactions with allies. Higher tariffs tend to lower economic growth along with corporate profit margins and profits overall, which could have been the main driver of dollar weakness. If this is a one-off adjustment, dollar weakness would not be expected to persist once the global economy has adapted to the new trade regime.

At the same time, the administration's communication style has rattled some non-U.S. investors, incrementally deteriorating confidence in U.S. assets. As trade deals have materialized over the summer, tensions have eased and the general narrative of capital flight from the U.S. has died down with the DXY stabilizing. As trade policy becomes more settled, tensions are less likely to flare up, making this source of dollar weakness unlikely to play as large a role in the coming years.

In the intermediate term, the potential for superior U.S. economic growth to re-emerge may also curb downside for the dollar. America remains the global leader in AI with ~2,000 more data centers than the next 10 largest countries combined. As the infrastructure buildout to support AI continues, the U.S. economy should see a disproportionate benefit in the form of improved productivity, a backdrop supportive for the greenback (Exhibit 7).

Additionally, material U.S dollar weakness relative to key Asian currencies is improbable in the near term. Chinese policymakers appear unlikely to allow substantial yuan appreciation given the ongoing deflationary struggles China is experiencing, while the Japanese yen remains deeply undervalued. Although these more near-term tactical dynamics may not have much bearing on a potential regime shift, they are important considerations for investors.

Exhibit 7: The AI Investment Boom



Data as of March 31, 2025. Source: Statista.

Potential U.S. Dollar Regime Shift Remains a Key Debate

The path forward for the U.S. dollar is one of the key debates in financial markets, with compelling arguments on both sides. Dollar bears believe the buck won't act as a safe haven currency going forward, driving foreign investors to hedge their FX exposure to a greater degree. At the same time, shifts in the relative amount of fiscal support appear likely to drive a narrower relative economic growth differential between the U.S. and major non-U.S. economies, and by extension currencies and equities.

Dollar bulls argue that a regime shift is not underway. Instead, they tend to believe that recent FX moves can largely be traced back to the Trump administration's global trade actions and communication style. While this took investors by surprise in the days following the Liberation Day tariff announcements, the emergence of greater clarity in the months since has led to financial market normalization and currency stability. Additionally, the U.S. has been a relative economic and equity market outperformer over the past 15 years, and recent policy changes have not yet altered that trajectory.

Whether or not a new regime is already underway will only be clear with the benefit of hindsight; however, we believe a durable inflection lower in the dollar is nearing if it hasn't already arrived. In fact, before the weakness broke out in the first half of 2025, the DXY Dollar Index had not recovered to its September 2022 highs. Given the strong correlation between the dollar and relative geographic leadership, we believe it is prudent for investors to revisit their allocation to non-U.S. equities and consider increasing their international exposure as the next decade may look quite different from the last one.

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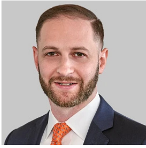

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