Focus

27/05/2025

Within **Focus** we comment on extraordinary market events and analyse capital market related special topics.

The role of the US dollar in global portfolios is undergoing structural change

For decades, European and Asian investors benefited from holding assets denominated in US dollars. They not only offered excellent liquidity and high returns, but also provided a natural hedge against global risk-off events. This relationship is aptly described by the so-called ‘US dollar smile’ – a phenomenon that describes how the dollar traditionally tends to appreciate both during periods of US economic strength and during times of global crisis, while depreciating when the US economy is comparatively weak. The resulting high demand for US dollars and US assets also strengthened the position of the US dollar as the world's dominant reserve currency. However, this traditional behaviour is being challenged by recent macroeconomic, geopolitical and structural developments.

In the recent phase of market turbulence, the US dollar was not the classic ‘safe haven’

In the most recent phase of market turmoil, the dollar has not behaved like a typical safe haven, losing value as risk aversion has increased. In this article, we explain why we believe that the recent weakness of the US dollar is not only tactical and cyclical in nature, but also strategic and structural. The role of the US dollar in portfolios is undergoing a transformation driven by changes in global capital flows, investor sentiment and political dynamics. This has profound implications for global asset allocation, which investors should be aware of.

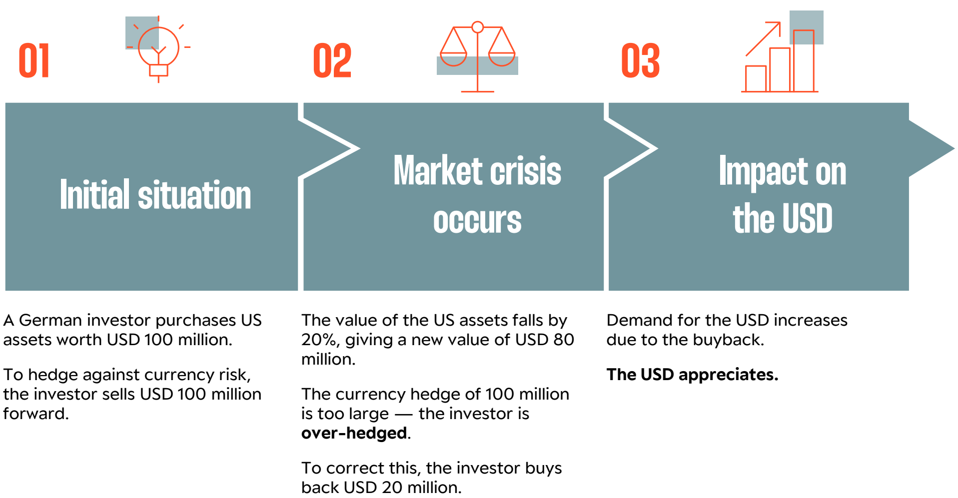
The traditional smile of the US dollar

Historically, the US dollar has performed well during times of crisis and when the US economy is strong

The so-called USD smile theory states that the US dollar tends to perform well in two different scenarios. On the one hand, the US dollar appreciates during periods of global financial stress or risk aversion, as it is considered a safe, liquid haven and demand for US government bonds (‘flight to safety’) increases. This has been true historically, even when the turmoil originated in the US. Another reason for the frequent appreciation of the US dollar in times of crisis is that international investors tend to hedge the currency, especially when it comes to their bond exposure. A European pension fund that buys corporate bonds or equities in the US, for example, often hedges at least part of its US dollar exposure. If the value of these US assets then falls in times of crisis, the investor is overhedged the greenback, i.e. too heavily ‘short’ the US dollar, and must buy back the US dollar to return to her target currency hedging ratio.

Fig 1: If currency-hedged underlyings fall, the FX hedge must be adjusted

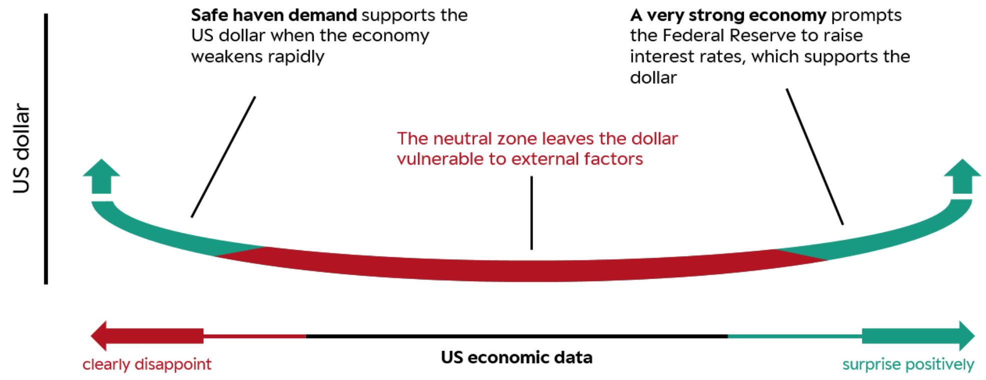
Example illustration



Source: own illustration

Fig 2: The US dollar typically exhibits a 'smile'

Schematic illustration of the traditional relationship



Source: own illustration

On the other hand, the US dollar also tends to appreciate in times of strong US growth and high or increasing interest rate differentials. Only in the middle, with high global risk appetite and rather synchronised economic growth, does the US dollar tend to weaken.

The dollar tends to weaken only during phases of broad economic recovery and when risk appetite is high

This relationship has been present in recent years, supporting unhedged USD exposures in many European and Asian portfolios. The currency component served as a hedge against sell-offs, while structural inflows into US assets – particularly government bonds and equities – provided tailwinds for returns.

The drivers of change

Recently, however, the behaviour of the US dollar changed. Although the difference between US yields and yields outside the US widened and global risk aversion increased, the US dollar depreciated (see Fig. 5).

Five reasons why the dollar has not shown its traditional behaviour recently

In our view, this regime change is mainly driven by **five** factors:

1) Confidence in US institutions is eroding

Under the Trump administration, the traditional pillars of the US – institutional independence (e.g. of the Federal Reserve, the courts and the universities), stable trade relations and geopolitical leadership – are increasingly being called into question. An unpredictable tariff policy, vocal attacks on the independence of the US Federal Reserve, a lax approach to facts and truth, and an 'America First' attitude have contributed to growing uncertainty and dwindling confidence in the reliability and stability of the US.

The traditional pillars of the US are being called into question

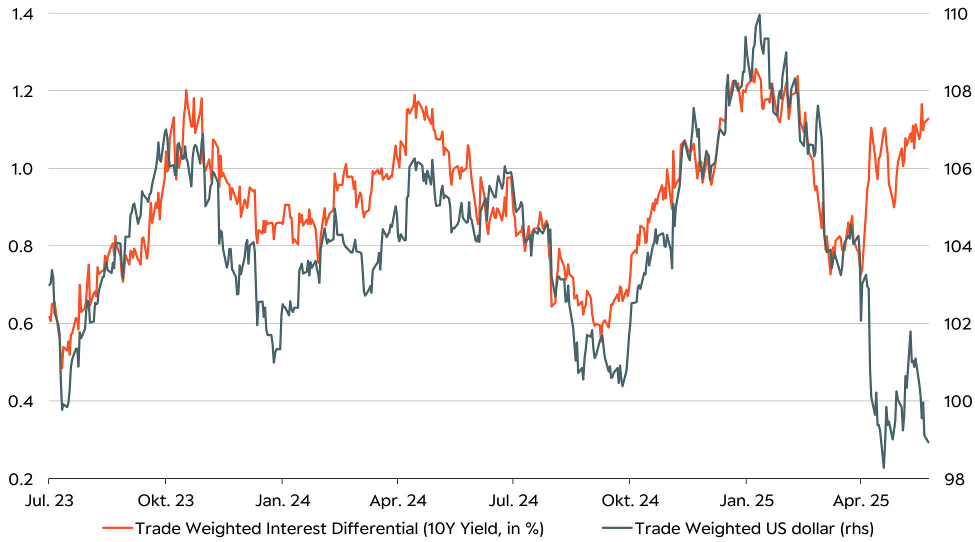
2) Exploding (foreign) debt is calling into question the country's status as a safe haven

Investors are wondering whether US assets – in particular government bonds – still offer relative safety in an environment characterised by fiscal expansion, political polarisation, rising government debt and potentially lower trend growth in the US. This is particularly relevant given that, unlike in Japan, for example, US public debt is not held domestically but largely by foreign investors. The ratio of US net foreign debt to gross domestic product, at 90%, is similar to the government debt ratio.

Fears over rising US debt are growing

Fig 3: Correlation between interest rate differentials and the US dollar has recently broken

Trade weighted interest rate differential (10-year yield) vs. trade weighted US dollar



Time period: 01/07/2023 – 26/05/2025

Bloomberg, own calculations

3) Less need to recycle US dollar reserves

In the past, countries with trade and current account surpluses vis-à-vis the US have allowed at least some of their foreign exchange reserves to flow back into US financial markets. This resulted in consistently high demand for US assets from abroad. However, Trump's explicit goal of reducing trade deficits weakens this mechanism. As trade balances shift, demand for US assets will also be affected.

Trump's aim to reduce the trade deficit will reduce demand for US assets

4) Emergence of alternative investment targets and opportunities

At the same time, structural, fiscal and monetary framework conditions outside the US are changing. For example, China has become a serious competitor to the US in the race for artificial intelligence supremacy, posing a threat to the US tech sector. Additionally, Germany and the EU have begun to relax their fiscal policy. This creates new opportunities for domestic investment and reduces the need for capital allocation abroad. At the same time, the rising volume of German government bond issuance is likely to increase their liquidity and make them more attractive to international investors. A structural rebalancing appears to have begun, which is likely to be driven further by large institutional investors such as pension funds.

Market size and liquidity of alternatives, such as Bunds, are increasing

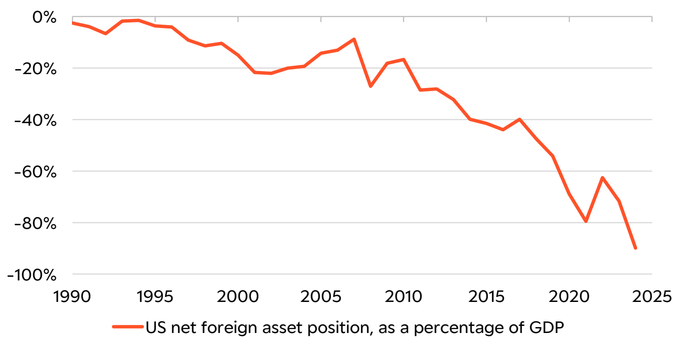
5) The de-dollarisation of central bank reserves

Since Russia's war against Ukraine and Russia's loss of access to its USD reserves due to sanctions, the central banks of emerging markets, in particular the Chinese central bank (PBoC), have been reducing the share of US dollar assets in their central reserves. Instead, they are increasingly buying gold and other currencies. In the medium term, declining global demand combined with strong supply of US government bonds is likely to lead to a weaker US dollar and higher US Treasury yields. This seems to be the only realistic scenario that would ensure sufficient demand for US government bonds. Although the total value of foreign exchange reserves held in US assets has remained constant over the past ten years, the share of USD foreign exchange reserves is already declining significantly (see Fig. 5).

Central banks are increasingly diversifying their reserves by investing in gold and other currencies

Fig 4: US net foreign debt at record levels!

US net foreign asset position, as a percentage of GDP

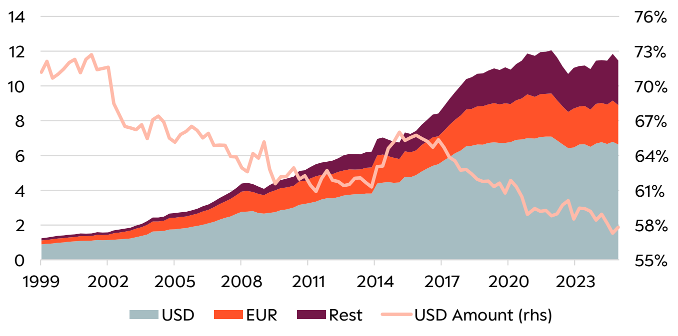


Time period: 01/01/1990–30/12/2024, annual data

Source: BEA, Bloomberg, own calculations

Fig 5: The share of the dollar in foreign exchange reserves is declining

Foreign exchange reserves in trillions of US dollars and dollar share of central banks



Time period: 01/01/1990–30/12/2024, annual data

Source: IWF, own calculations

Strategic asset allocation in transition

Shifts in asset allocation typically occur in two stages: first tactically, then strategically

Strategic shifts in asset allocation are multi-stage, gradual in nature and do not follow a straight line. However, they usually evolve in two waves:

Wave 1: Tactical and speculative reallocation

First, tactical and speculative market participants such as asset managers and currency traders begin to hedge or reduce their USD exposure based on expected changes. These flows are often sentiment-driven and fuelled by short-term dynamics.

Wave 2: Structural allocations by asset owners

The second, more significant wave is triggered by large institutional investors such as pension funds, insurance companies and sovereign wealth funds. Due to their long-term investment strategy and governance processes, these organisations move slowly, but when they act, the flows are large and sustained.

Wave 2 is yet to come and could result in sustained, multi-year weakness of the US dollar

In our view, we are currently in wave 1, in which speculative and hedging flows are beginning to put pressure on the US dollar. If the picture of a changing role for the US dollar solidifies, the much larger flows from wave 2 are yet to come. These are likely to lead to sustained US dollar weakness over several years. Paradoxically, the fact that the structural shift has not even begun to take effect is the most pessimistic part of the narrative of a structurally weaker US dollar.

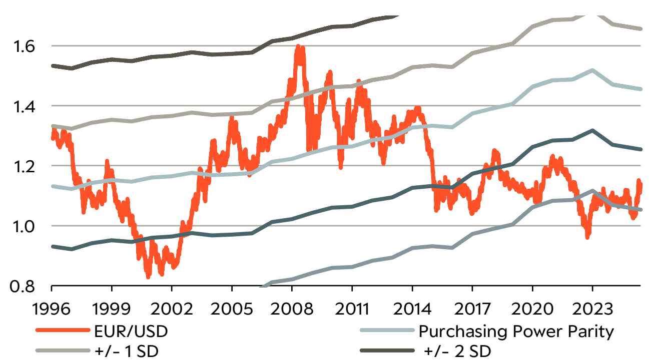
Implications for investors

The valuation of the US dollar and US assets is likely to normalise in the coming years

The recent weakening of the US dollar should not be interpreted as a tactical correction or temporary deviation. Rather, it is likely to be a strategic shift in global capital flows – incrementally away from the US and towards other regions. After years of US exceptionalism, investors are once again recognising the benefits of more global diversification, especially as the correlation of equity regions has already declined since the global financial crisis due to less globalisation. This structural trend is supported by more than a decade of strong inflows into the US and US dollar assets, which have led to a significant overvaluation of the US dollar against most other currencies and relatively high valuations of US dollar assets. We consider a normalisation of both the valuation of the US dollar and US dollar assets over the next three to five years, comparable to the period from 2002 to 2008, to be realistic. This suggests that investments outside the US in a

Fig 6: Despite its recent weakness, the US dollar remains overvalued compared to other currencies

EURUSD compared to EURUSD purchasing power parity according to the OECD

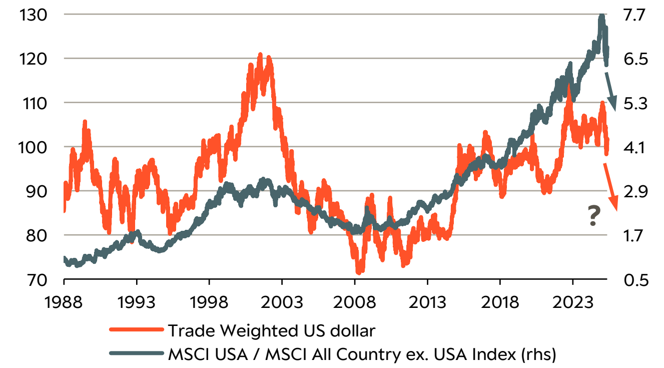


Time period: 01/01/1996–26/05/2025

Source: OECD, Bloomberg, own calculations

Fig 7: Over the past 15 years, US equities have outperformed in conjunction with the appreciation of the US dollar. A depreciation of the US dollar would favour international equities over US equities

Trade weighted US dollar vs MSCI USA/MSCI World ex. USA



Time period: 01/01/1998–13/05/2025

Source: Bloomberg, own calculations

single currency will perform better in relative terms in the medium term than they have over the past 15 years.

Key findings for European investors

FX hedging strategies need to be re-evaluated. Given the risk of a weaker US dollar in the medium term, investors should consider hedging the currency risk on their US dollar assets more heavily or even reducing their positions. This would further weaken the dollar, with the exception of the reduction in already currency-hedged US assets. However, paradoxically, a higher currency hedging ratio for US assets could lead to the dollar appreciating more strongly in times of crisis and depreciating more strongly in times of recovery, due to the adjustment of currency hedges.

Investors are likely to hedge against currency risk more strongly or reduce their exposure to USD assets — paradoxically, however, this could lead to a stronger US dollar during periods of market stress —...

Fig 8: Implications if more and more international investors expect a weaker US dollar in the medium term and adjust their portfolios

	More USD-Hedging	Divestment of US-Assets...	
		...without USD-Hedging	...with USD-Hedging
Effect on USD	negative	negative	neutral
Medium-term effect on USD at risk-off	positive	neutral	negative
Medium-term effect on USD at risk-on	negative	neutral	positive

Source: own illustration

Geographical diversification should be strengthened. Given fiscal expansion in Europe and waning support from the US dollar, a shift towards assets from the rest of the world could be justified. This applies in particular to investors who have been heavily exposed to US assets in recent years.

......diversify more geographically, ...

Institutional flows should be monitored. Statements by CIOs of large institutional investors, capital flow data and fund positioning could be signs of an incipient wave 2.

...observe the behaviour of institutional investors, ...

Currency allocation should be viewed as a strategic tool. Currencies are no longer just passive by-products of global exposure but should be viewed as an active component of portfolio structure and managed accordingly.

...and actively manage currency risks

Conclusion

The US dollar is likely to lose some of its global supremacy

The US dollar is likely to lose some of its global dominance – possibly even to the extent that it is no longer the reliable anchor in global portfolios that it once was. A combination of political uncertainty, structural trade adjustments and shifting capital flows is likely to lead institutional investors to strategically reduce their exposure to the dollar. This shift is still in its infancy, and the full impact on capital markets – from foreign exchange to government bonds, equities, gold and cryptocurrencies – is likely to become apparent only in the coming quarters and years. The supply of 'safe havens' will increase in the coming years, not only because of rising US debt, but also because of the higher debt supply of other governments. In the past, large investors had to invest in US government bonds because there was no viable alternative with a high credit rating for sovereign wealth funds. This could now change, at least slightly, as a result of Germany's infrastructure plans.

In our view, a strategic shift in the asset allocation is imminent globally. To navigate the new global financial landscape, it will be crucial for investors to understand the drivers of this shift and adjust their portfolios accordingly if necessary.

The devaluation of the USD is unlikely to be straightforward and will instead take place in stages

However, the dollar's status as the world's reserve currency is not yet under threat in the medium term due to a lack of viable alternatives

However, investors should be aware that the potential structural shifts we have identified will be slow and uneven, rather than linear. The pronounced weakness of the US dollar since the beginning of the year has significantly altered the positioning of tactical, speculative and systematic investors. In the short term, there may be significant countermovements. There are a number of possible drivers for this: a de-escalation in the trade war, a shift in market focus from tariffs to tax cuts and deregulation by the Trump administration, a return of confidence in US equities (even if reservations about US government bonds or the US dollar remain) or the fact that tariffs are inflationary in the US and deflationary in other countries, which could lead to a more pronounced widening of interest rate differentials. And even if the US dollar continues to lose ground as investors seek alternatives and diversify their portfolios, its status as a global reserve currency does not appear to be at risk in the coming years due to a lack of alternatives.

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