MARKET VIEW

International Exchange Rates: More Dollar Declines Ahead?

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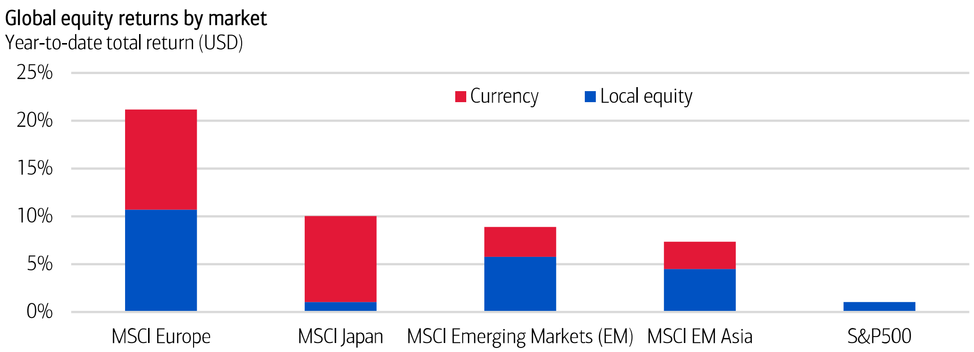
Exchange rates have accounted for a significant portion of the leadership in international equity markets this year, with the U.S. dollar (USD) falling by 5% to 10% against most major global currencies. As of the end of last month, currency appreciation had accounted for around 50% of the USD-denominated total return in Europe, close to 35% of the USD-denominated total return in emerging markets and almost the entire USD-denominated total return in Japan so far in 2025 (Exhibit 2). And given the likelihood of further shifts in global trade, fiscal and monetary policy over the months ahead, we would expect exchange rate movements to remain a key driver of investor returns.

Exhibit 2: Exchange Rates Have Driven A Large Portion Of International Equity Market Returns In 2025.



Source: Bloomberg. Data as of May 30, 2025. Indexes are unmanaged and do not take into account fees or expenses. It is not possible to invest directly in an index. **Past performance is no guarantee of future results.**

Tariffs and relative growth expectations have been central to the direction of international currencies relative to the U.S. dollar over the course of the year. Even after the May reduction in tariff levels on China and the U.K., the average effective rate on U.S. goods imports across countries and specific sectors remains at its highest level since 1937 at 16.4% according to the Yale Budget Lab. And though imports are only a relatively small (14%) share of U.S. GDP, the negative impact on U.S. growth of close to a full percentage point on most estimates is still expected to exceed that (just a few tenths of a point) on the rest of the world—the levies apply to virtually all goods imports coming into the U.S. but only to a fraction of the goods exports leaving from other countries. This divergence in the growth outlook has been a source of support for international exchange rates, alongside a narrowing of the 10-year yield differential between the U.S. and other major markets such as Europe and Japan since the start of the year.

On top of stretched multiples in the underlying U.S. equity market, we also still view the U.S. dollar as overvalued on a trade-weighted basis at current levels of close to 1.5 standard deviations above its 20-year average. On the flip side, emerging Asian currencies in particular appear among the most undervalued globally. Exchange rate undervaluation in Asia is largely structural, with central banks across the region persistently intervening to limit currency appreciation and stay export competitive. This has been reflected in significant reserve accumulation over the 25 years-plus since the Asian financial crisis of the late 1990s, since which foreign exchange reserve levels have increased roughly tenfold on average for the regional constituents within the emerging market index. It has also of course been reflected in large regional trade surpluses across the major Asian economies.

The tariff war is, however, likely to force at least a partial reversal of this process given the U.S. focus on reducing its bilateral deficits with markets in Asia and elsewhere—perhaps even by calling on them to revalue their currencies in exchange for lower tariffs. Indeed investor speculation that this might be an explicit condition of the current trade talks contributed to the April–May surge in the Taiwan dollar and other Asian currencies. For the

Portfolio Considerations

On top of stretched multiples in the underlying U.S. equity market, we still view the U.S. dollar as overvalued on a trade-weighted basis at current levels despite the price depreciation so far in 2025. With the likelihood of a bigger relative U.S. growth slowdown ahead, further rebalancing away from highly valued U.S. assets, and a consolidation of the U.S. balance of payments position, we would not be surprised to see further gains for international currencies from current levels.

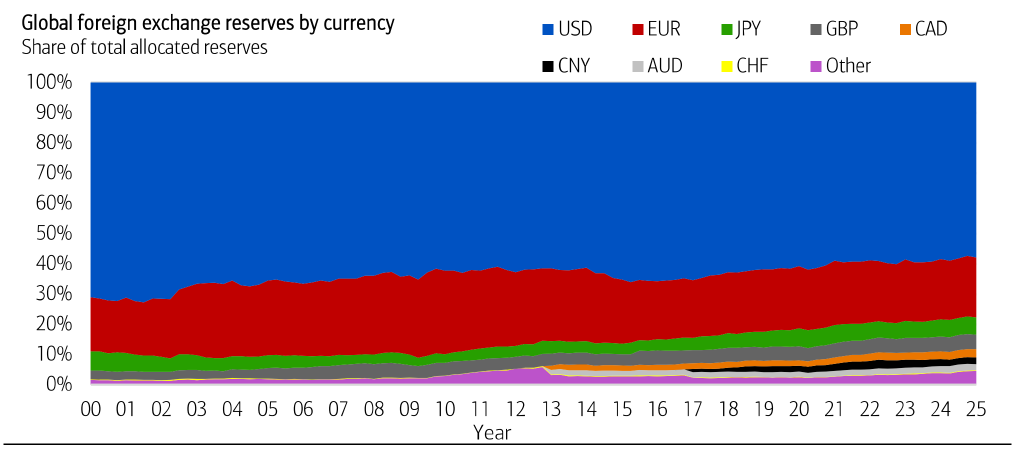
U.S., a smaller trade and current account deficit would also imply fewer dollars in the hands of foreign investors for asset purchases (i.e. a smaller capital account surplus) and therefore less support for the U.S. dollar. We would therefore expect to see a degree of mean reversion to the upside in Asian currencies as the dollar weakens.

And with China and other countries in emerging Asia looking to rebalance their economies toward more domestic consumption (and become less reliant on external demand), a greater degree of currency appreciation is likely to be tolerated. This would boost dollar-based returns for U.S. investors in emerging markets. And in this regard, it will also be important to watch for any new exchange rate policy as part of the prospective trade deals to be announced over the coming weeks ahead of the expiration of the 90-day negotiation periods with China and the rest of the world. With the likelihood of a bigger relative U.S. growth slowdown ahead, further rebalancing away from highly valued U.S. assets, and a consolidation of the U.S. balance of payments position, we would therefore not be surprised to see further gains for international currencies from current levels.

Looking over the longer term, investors have also voiced more structural concerns on the outlook for the U.S. dollar in light of the higher deficits projected to fund the budget bill currently making its way through Congress. We nonetheless see a low likelihood of a more disorderly decline for the dollar or any material change in its reserve status given its fundamental advantages over other major currencies.

In contrast with China, the U.S. provides strong institutional protections for investors such as rule of law, independence of judiciary and capital market openness. In contrast with individual eurozone member countries, the U.S. controls its own monetary policy, making it less prone to the type of credit crisis experienced by the eurozone in the 2010s. In contrast with both China and the eurozone, the U.S. offers capital market depth and liquidity, comprising the majority (around 65%) of listed global equities and a plurality (around 40%) of outstanding global government bonds, which should be in greater demand as ageing populations create a structural need for pension fund fixed income assets. The U.S. dollar also continues to dominate global trade and foreign exchange reserve holdings, with over 80% of global trade finance and close to 60% of global central bank reserves still denominated in dollars (well ahead of the second-placed euro on 20%) and declining only gradually (Exhibit 3).

Exhibit 3: USD Remains The Dominant Currency In Global Foreign Exchange Reserves.



Source: IMF. Data as of 2024.

These fundamental strengths may not necessarily immunize the U.S. dollar from further weakness in the current cycle, but they should make any additional price declines more orderly and limit the extent to which it could be displaced as a reserve currency. And though we do not expect any large-scale shift in manufacturing operations from multinational companies into the U.S. in response to tariffs (particularly given the uncertainty over how long they might remain in place), any eventual reshoring wave could also be outright dollar positive. In the nearer term however, we see a continuing environment of international exchange rate strength and further dollar depreciation back toward more normal levels as the most likely market outcome.