

The US Dollar Free Lunch Is Over. What Now?

GBP Investors

- We expect a multiyear US dollar bear market to develop, in which we expect the currency to drop at least 15% in the face of waning US economic exceptionalism and political reliability.
- Given this view, we recommend that UK-based investors aggressively hedge the US dollar.
- We suggest a dynamic, differentiated currency hedging framework that customizes hedge ratios by currency, as we believe the British pound is poised to underperform several currencies outside the US dollar due to UK fiscal, inflation, and productivity headwinds.

Investors who are unhedged to the US dollar have enjoyed a long period of higher returns and lower risk, but the dynamics have changed in 2025 and we believe the “new normal” will persist.

Over a decade-long bull market, the US dollar’s real value increased against a broad range of currencies. Solid relative GDP growth and exceptional corporate earnings growth supported strong capital inflows, high US interest rates relative to other major countries, and the widespread view of the US dollar as a safe haven. The US Federal Reserve’s broad trade-weighted US dollar index rose 46.1% from its trough in 2011 to its peak in January 2025. For much of this period, the dollar also enjoyed historically negative correlations to risky assets.

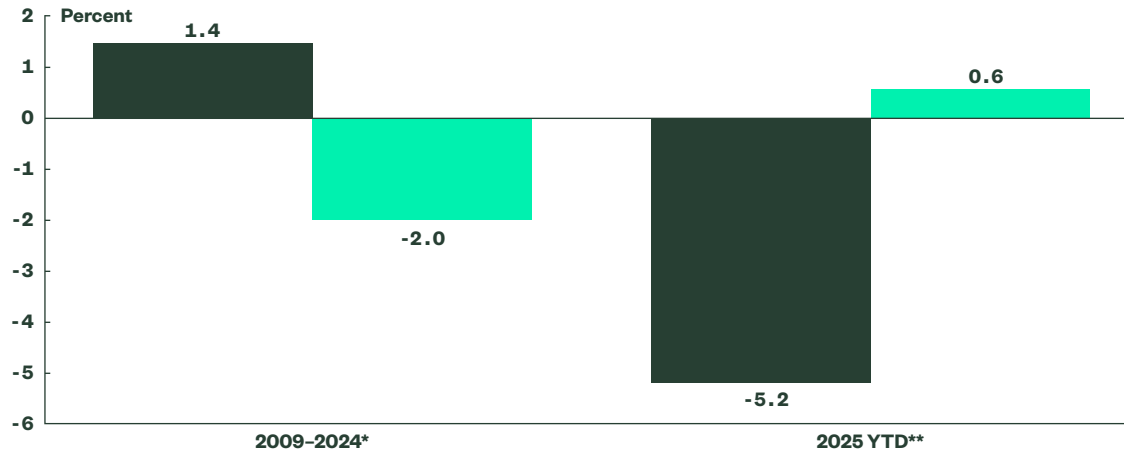
However, it is exceptionally difficult for us to see how the performance of the last 15 years can persist for the next 10 to 15 years — or even the next three to five. We believe this US dollar free lunch era is over.

In fact, we believe the US dollar is headed toward a multiyear bear market that will see it underperform most global currencies. In addition, we expect the US dollar’s negative correlation with equity markets to diminish, as investors’ perception of the dollar as a safe haven weakens.

This scenario would mark a seismic change for non-US investors. Over the last 15 years, unhedged US dollar positions offered strong gains, as well as diversification benefits when the US dollar rose as equities fell. The result was an appealing combination of higher returns and lower risk (Figure 1). This impact was amplified by the increasingly large role US assets play in most global portfolios — US assets make up more than 70% of the MSCI World Index, to take just one example.¹

Figure 1
Currency Impact on US S&P 500 Portfolio: GBP Investors

Return Impact
 Volatility Impact



Source: State Street Global Advisors/Bloomberg.
 *Annualized.
 **YTD through June 24, 2025.

While the US dollar has been weak in 2025, on a trade-weighted basis it remains extremely overvalued. A typical bear market could see the dollar fall 25%–35% over the next decade (Figure 2). In an environment in which the US dollar is a less reliable source of diversification and a potential source of outright losses, investors should consider hedging more of their global portfolios, including both equity and fixed income. UK investors in particular should hedge the US dollar aggressively based on our outlook.

Figure 2
Real Trade-Weighted US Dollar Index
 The US Dollar is Expensive!



Source: US Federal Reserve/State Street Global Advisors.

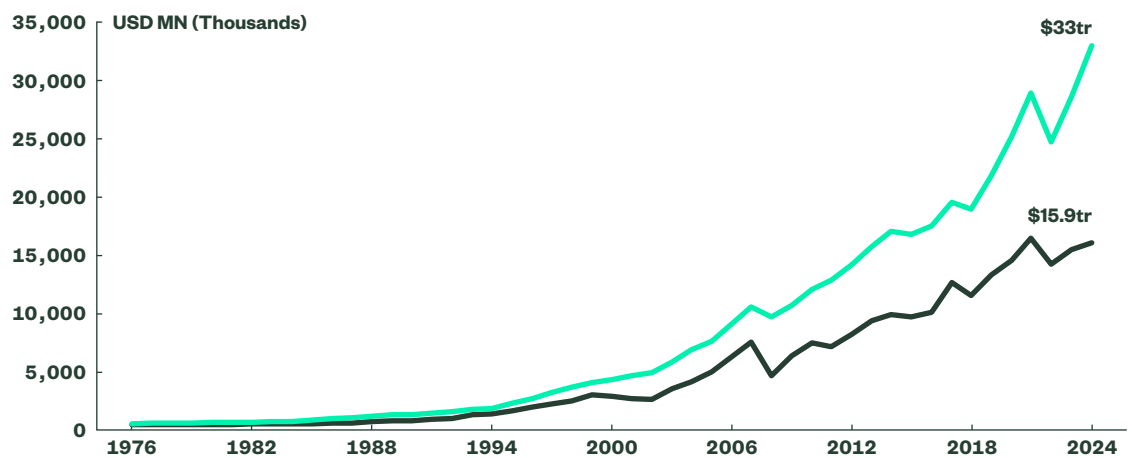
The Case and Catalysts for a US Dollar Bear Market

Most of the world has a concentrated exposure to US assets, a considerable portion of which is not currency hedged. As a result, the US dollar is the largest single exposure in many investors' portfolios. At the same time, we see the US dollar as extremely expensive by historical standards and believe the fundamental economic and political foundations of US exceptionalism are weakening. Yet the US dollar and US equity markets are priced at a premium, as though US exceptionalism will remain as robust for the next 10 to 15 years as it has been for the last decade-plus. By contrast, investors have for years fully priced in the chronic productivity problems and headwinds to growth in regions including Canada, the UK, and the EU.

Currency-unhedged investments have vast potential to unwind over the next several years. According to the US Bureau of Economic Analysis, non-US investors hold nearly \$63 trillion in US assets, about \$33 trillion of which is in portfolio investments (see Figure 3). A mere 10% increase in the average dollar hedge ratio would require \$3.3 trillion in US dollar sales, more than enough to support a prolonged US dollar bear market. If US investors rotate into more balanced global portfolios on these signals, or if the combined rotation and US dollar hedge increase by non-US investors exceeds 10%, the impact could be much larger.

Figure 3
Non-US Investors' Holdings in US Assets

■ US Portfolio Assets
■ US Portfolio Liabilities



Source: US Bureau of Economic Analysis (BEA).

Some may decide to continue to hold concentrated positions in US assets. Still, the high debt, policy uncertainty, and institutional uncertainty warrant an increase in US dollar currency hedge ratios in our eyes.

Why? The US faces projected fiscal deficits exceeding 70% of GDP for the ten years ended 2027, pushing the debt-to-GDP ratio above 100%. During the pandemic, US households and corporations secured a huge amount of financing at near-zero rates, shielding them from recent monetary tightening unlike global counterparts dependent on variable-rate debt. This unique combination of fiscal expansion and lower net interest expense drove exceptional US economic and corporate earnings outperformance that is unlikely to continue.

In the decade ahead, we expect to see a return to reality in which the US may still lead the world but by a substantially smaller margin. During this period, the US government will likely implement significant fiscal consolidation measures in response to the deficits. At the same time, US households and corporations face rising net interest expense — even if the Federal Reserve cuts rates aggressively in the near term.

And then there is the impact of the Trump administration's protectionist trade policies, reduced international cooperation, and overuse of sanctions, which make the US a distinctly less attractive trade, financial, and political partner in the eyes of the rest of the world. At the same time, they encourage greater cooperation among countries outside the US on trade, supply-side investments, and deregulation. A global turn away from the US is likely to further raise the cost of capital, slow potential growth, and hasten and deepen the fall of the US dollar.

Taking the Long View on the US Dollar's Prospects

While we have strong conviction in a US dollar bear market over the next several years, we are not calling for the demise of the dollar as the global reserve currency. The dollar has been the world's reserve currency for decades. It maintained that status during the 1985–1995 dollar bear market, which saw its trade-weighted value drop 33%, and the 2002–2011 dollar bear market, during which its value dropped 28%.

Replacing the US dollar as the reserve currency would require an entirely new ecosystem of deep, liquid markets for assets and liabilities, as well as payment networks outside the US banking system. Tail risks to the dollar's role have increased, but there is unlikely to be a suitable alternative over the next decade or two. Instead, we expect the US dollar to gradually become a weaker, less dependable reserve currency.

We also see this US dollar bear market as a multiyear process, rather than a straight-line plunge, because the forces likely to drive it will take time to play out.

The UK Economic and Currency Outlook

Over the next three to five years, we expect the British pound (GBP) to strengthen to the 1.45–1.50 range versus the US dollar, up from the current level around 1.37. This view relies more on the deterioration of US fundamentals described above than improving UK fundamentals.

Ultimately, GBP is caught between opposing forces that limit the scope for improvement in its fundamentals. On the positive side, UK rates are among the highest in the G10 and likely to remain so. This improves the attractiveness of the pound as a source of yield, while the near-zero cost of carry on US dollar currency hedges makes it more attractive for UK investors to reduce their US exposure, at least by currency hedging. Steady, positive real wage growth and household savings rates above 10% should also help support economic activity and, by extension, GBP. The UK has also avoided the worst of the Trump tariffs. What's more, a path towards a gradual improvement in UK-EU trade relations may provide support to the economy and currency.

However, a number of headwinds offset much of the positives. Neither fiscal nor current account deficits bode well for the UK and its currency. Fiscal policy is likely to be heavily constrained, limiting the government's ability to manage macroeconomic uncertainty and engage in productivity-enhancing investments. While high interest rates are positive for GBP, they also serve as a symptom of GBP negative factors. Sticky inflation above 3% limits the flexibility of monetary policy to manage US policy uncertainty and other global political or economic shocks. In short, if recent economic slowing accelerates, it's not clear the Bank of England will be able to respond as rapidly as other countries with better inflation and debt profiles.

Overall, we expect this mix of factors to limit GBP gains against the US dollar relative to cheaper G10 alternatives that have stronger long-term fundamental outlooks and greater scope for rotation out of the US dollar.

It's also important to emphasize that ours is a multiyear view. The remainder of 2025 is likely to be more challenging for GBP after its dramatic appreciation from an intraday low of 1.21 on 3 February 2025, to 1.37 at the time of writing — a 13.3% move in just under five months. Further material upside in 2025 is quite possible given longer-term bearish US dollar sentiment, but it is difficult to justify based on current fundamentals. We expect the pound to mostly hold its gains but struggle to move materially higher this year.

How UK Investors Can Approach Currency Hedging

UK investors have enjoyed very strong gains from holding US assets on an unhedged basis over the past 15 years. In addition, the US dollar has tended to rise whenever equity and credit markets correct lower, providing risk-reducing diversification benefits.

As we've discussed, we see glaring problems that suggest the next 10 to 15 years will be very different. As a result, we recommend aggressively hedging the US dollar. Yet one hedge strategy will not fit all: It will be increasingly important to differentiate hedging policies across currencies, each of which has a different risk/reward profile.

An active strategy that differentiates hedge ratios across currencies can help investors minimize risk in this uncertain environment. In particular, our longer-term, value-based Dynamic Strategic Hedging (DSH) strategy can help calibrate differing hedge ratios across currencies with a three- to five-year horizon. We see the British pound as much more fully valued, and in many cases expensive, relative to many currencies. As a result, we suggest lower than average or even 0% hedge ratios on several currencies, including the Japanese yen, Australian dollar, and Swedish krona.

Many investors have experienced short-lived but severe currency fluctuations that make further volatility particularly concerning. The current uncertain environment, combined with disruptive US policy decisions, complicates hedging decisions.

Investors whose concerns include shorter-horizon volatility may want to consider our Enhanced DSH strategy. This multi-strategy, multi-horizon approach is anchored by long-term value while also calibrating hedge ratios with an eye to broad risk regimes, relative economic performance, and cross-market technical factors in equity and commodity markets. This approach seeks to set hedge ratios with some attention to forces that drive currencies over a one- to 12-month horizon.

Endnote

1 <https://msci.com/indexes/index/990100>.

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