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# The US Dollar Free Lunch Is Over. What Now?

## EUR Investors — Dutch Perspective

- We expect a multiyear US dollar bear market, rather than a straight-line plunge, 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 euro-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 euro is poised to underperform several currencies outside the US dollar.

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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.

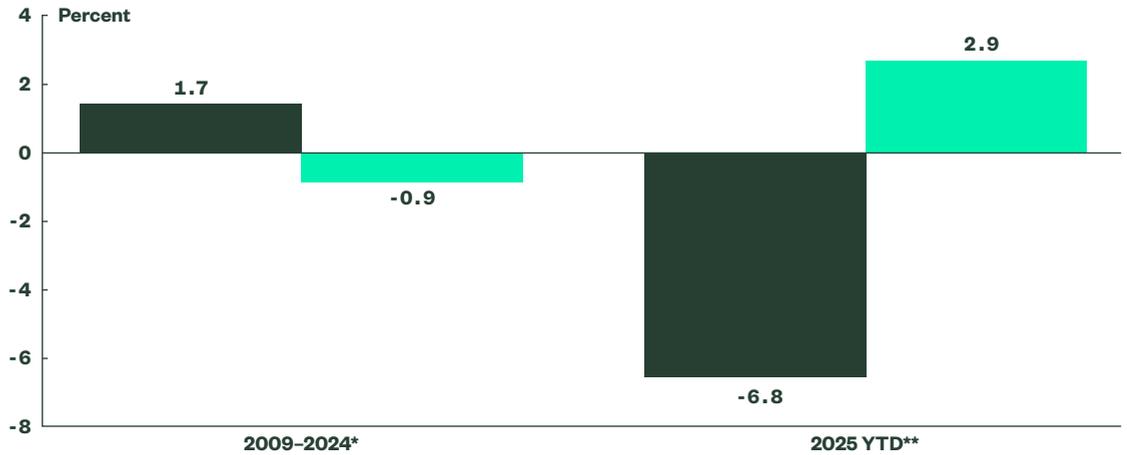
However, it is exceptionally difficult for us to see how the performance of the last 15 years can persist for the next 10 to 15 years — or even the next three to five. We believe this US dollar free lunch era is over.

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.<sup>1</sup>

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

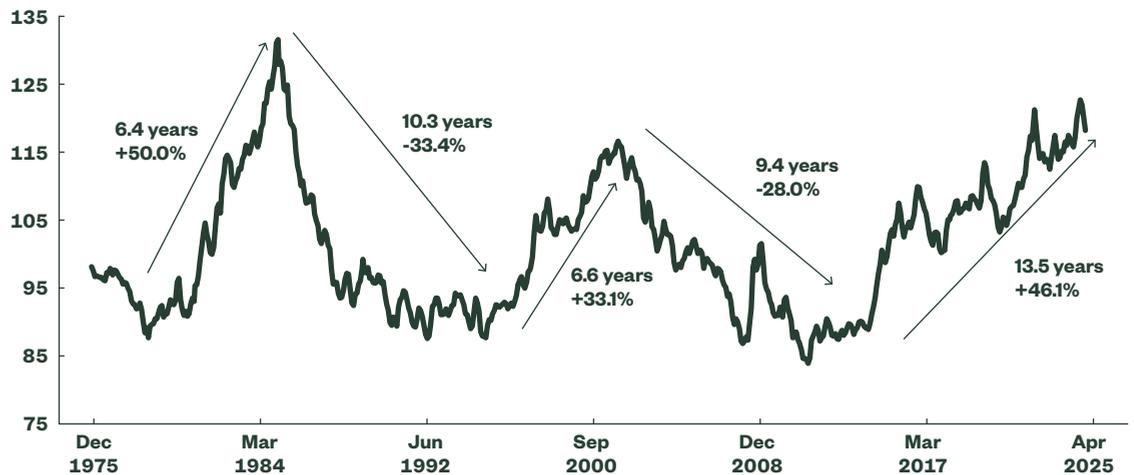
Return Impact  
 Volatility Impact



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. Euro 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.

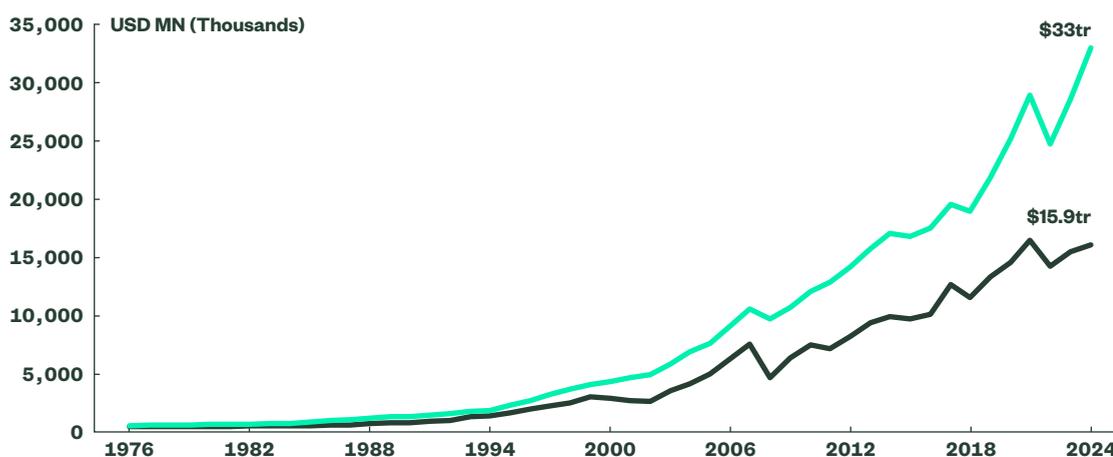
## The Case and Catalysts for a US Dollar Bear Market

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 expenses — even if the Federal Reserve cuts rates aggressively in the near term.

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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.

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## **Taking the Long View on the US Dollar's Prospects**

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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.

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## **The Euro Economic and Currency Outlook**

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Over the next three to five years, we expect the euro to strengthen to at least the 1.30–1.35 range versus the US dollar, up from the current level around 1.17. This view largely relies on the deterioration of the US outlook described above. However, just as we believe US dollar and equity valuations imply an overly optimistic view on US exceptionalism, we believe investors have been overly pessimistic on the euro and European assets.

Before digging into the rationale for a stronger euro, it may be helpful to provide a little context. A move towards 1.35, a level not seen since 2014, seems very high. In past US dollar bear markets, the euro (and the deutsche mark before it) moved from a low of 25%–30% below our estimates of long-run fair value to a high of 25%–30% above fair value. If the pattern were to repeat, we would expect the euro to reach 1.45–1.50. From that perspective, our base case prediction of 1.30–1.35 suggests a historically subdued valuation cycle, just 9%–13% above fair value or less than half the move seen in the last two US dollar bear markets.

The Economic and Monetary Union has been stuck in an ultra-low productivity growth regime alongside weak labor force growth — a double negative for potential growth. Investors have largely priced in a continuation of that sclerotic growth for as far as the eye can see. While we don't see an EU productivity renaissance, on the margin we see improvement over the next five to 10 years for several reasons:

- Higher fiscal spending
- Improved interest rate differentials
- More favorable capital flows
- Strong household balance sheets
- Euro safe haven appeal

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This is a multiyear view. The remainder of 2025 is likely to be more challenging for the euro after its dramatic appreciation from an intraday low of 1.014 on 3 February 2025, to 1.17 at the time of writing, a period of just under five months. A sustained move above 1.20 in 2025 is quite possible given longer-term bearish US dollar sentiment, but it is difficult to justify based on current fundamentals.

US interest rates currently remain high, meaning the cost of carry for hedging the US dollar is also high. We expect that dynamic to steadily but gradually decline in the rest of 2025 and 2026. The positive fiscal impulse led by German spending is impressive, but delays in actual spending may limit the benefits in 2025 and early 2026. US tariff uncertainty also looms large. President Trump has taken a tough line with the EU, and whatever the final tariff rates, they are likely to weigh on EU growth over the next 12 months.

Offsetting these near-term headwinds, we see slower-than-expected US labor markets, a solid chance for three Federal Reserve rate cuts, and softer growth weighing on the US dollar during the second half of 2025. On balance we expect the euro to hold its gains but struggle to move materially higher this year, though we concede that risks around this baseline are skewed to the upside.

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## How Euro Investors Can Approach Currency Hedging

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Euro 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 euro as much more fully valued, and in many cases expensive, relative to many currencies. As a result, we suggest low 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.

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## Special Considerations for Dutch Investors: Managing Currency Risk in the New Pension System

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### Current FX Hedging Policy

The new pension law was accepted on 1 July 2023. By 1 January 2028, all pension funds will have to have transitioned to the new framework, in which the many existing defined benefit schemes will be converted to defined contribution schemes.

As a result, managing currency risk within the pension system will become more market driven and less regulatory driven. Here is how we expect foreign exchange (FX) hedging to evolve in the years ahead.

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Within the current regulatory system, pension plans are required to hold a certain reserve reflecting the risk that they are exposed to. This reserve, known as the buffer requirement, includes currency risk. A pension fund that fully hedges its currency exposure can then apply the freed-up risk budget elsewhere.

Within the return portfolio, some pension funds would fully hedge their exposure to the major developed currencies — US dollar, Japanese yen, British pound, and Swiss franc — while leaving emerging market currencies unhedged as a result of the cost. With this strategy, pension funds can easily achieve a currency hedge of 80%.

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### FX Hedging Under the New Pension System

Within the new framework, such a buffer will no longer be required and there will no longer be a regulatory incentive to hedge currency risk. (A solidarity reserve will still be required.) In addition, investment risk will be transitioned to the pension plan member. As a result, currency hedging policy will essentially be driven by market investment beliefs only.

Pension funds will have to make decisions in a few areas:

**Currency hedging policy along the DC glidepath** The glidepath typically starts with large exposure to the return-seeking portfolio for the youngest members and converts mostly to the euro-denominated liability-driven investing (LDI) portfolio for the older members. Exposure to foreign currency thus goes down automatically as well.

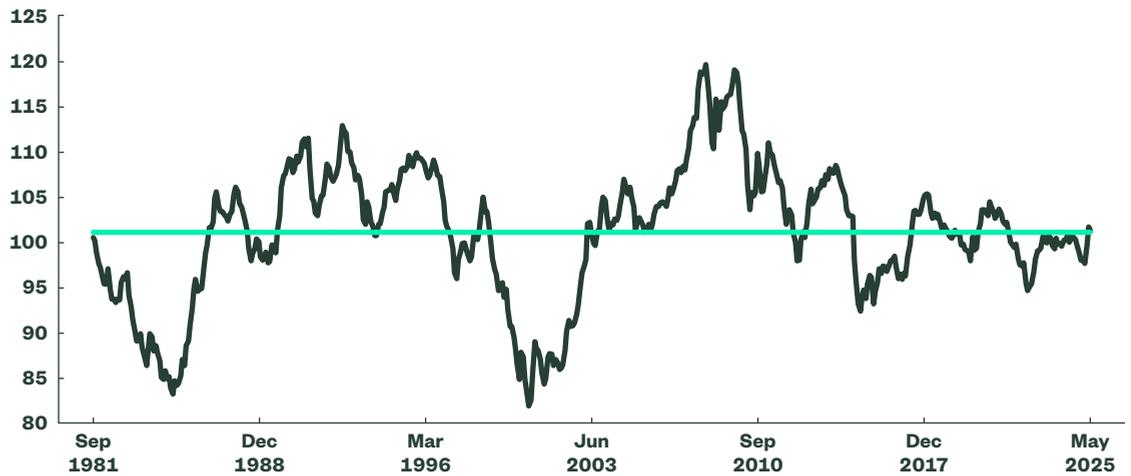
As a result, there is no need to develop a currency hedge policy tied to the member cohort. One unique currency hedging policy for the return-seeking portfolio suffices.

**Defining a strategic currency hedge ratio policy per currency pair** For equities, the 50% hedge ratio is the “least regret” ratio, with the lowest long-term risk. In global high yield, the lowest long-run risk is found at a 60% hedge ratio (see Figure 5). We recommend hedging global treasuries and investment-grade debt at or near 100%.

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Figure 4  
**Emerging Markets**  
**Effective Exchange**  
**Rate: 12 PARTNERS -**  
**NOMINAL NADJ**  
**Difficult to see a cycle...**

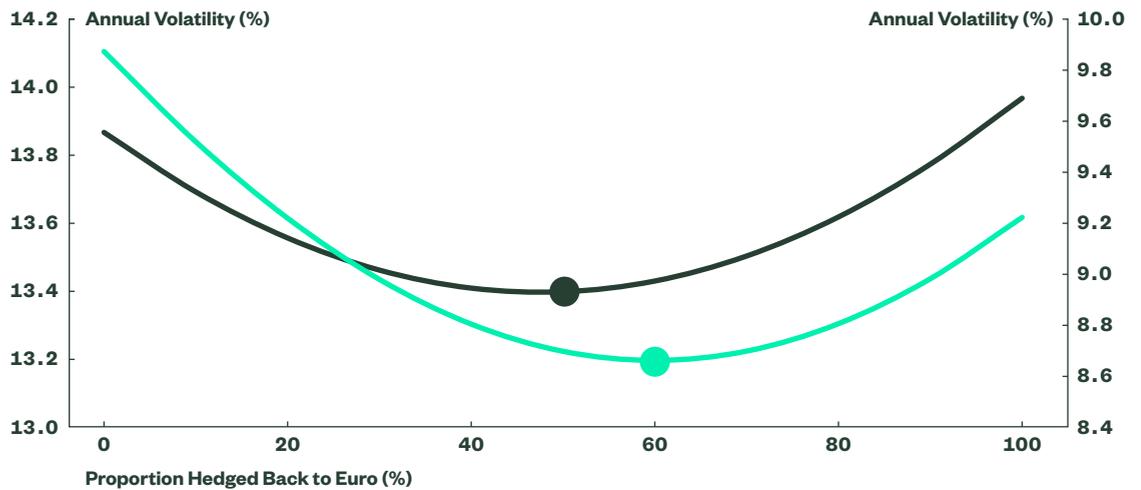
■ Effective Exchange Rate: 12 Partners — NOMINAL NADJ  
 ■ Average Over the Full Period



Source: London Stock Exchange Group/State Street Global Advisors; as of 30 May 2025.

Figure 5  
**Hedge Ratio, 25-Year**  
**Horizon 1999–2025 for**  
**MSCI World in Euro**  
 Volatility Impact of  
 Currency Hedging  
 January 1997–May 2025

■ Equity: MSCI World xEMU Index (LHS)  
 ■ Fixed Income: Bloomberg Global Corporate High Yield Index (RHS)

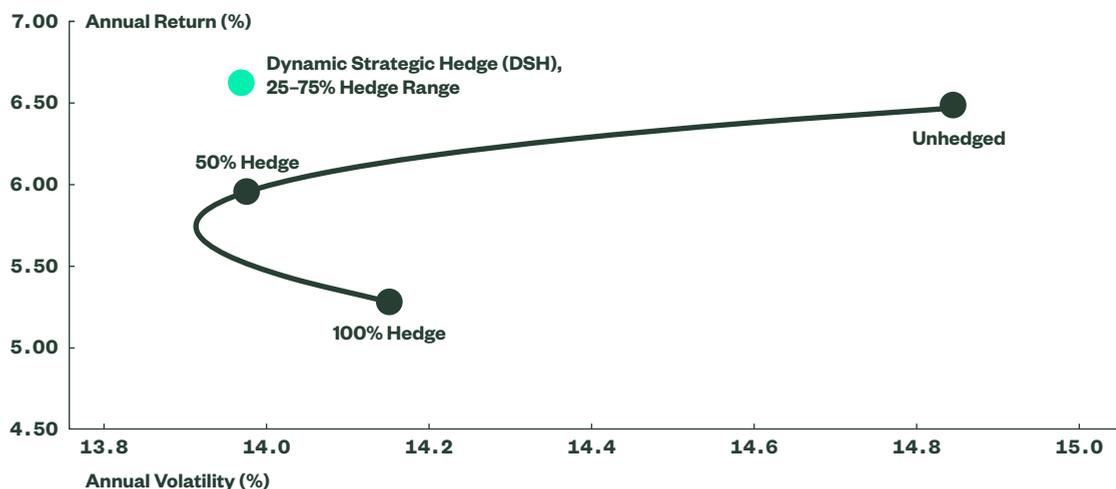


Source: Bloomberg/State Street Global Advisors.

**Dynamic strategic considerations** A 20-year wait seems very long. It's not a luxury to instead review the currency hedge ratio over the medium-term horizon with Dynamic Strategic Hedging (DSH). As there is no buffer requirement attached to the hedge ratio within the new pension system, pension funds can easily implement a variable hedge ratio (see Figure 6).

Within DSH, a minimum and maximum hedge ratio per currency can be identified — for example, 25%–75%. We expect the US dollar to experience a downturn in the coming few years, so its hedge ratio might be 75% (see Figure 7).

Figure 6  
**Backtest of Different Hedging Policies MSCI World xEU, Jan 1997–May 2025**



Source: Bloomberg/State Street Global Advisors.

Figure 7  
**Strategic and DSH for the USD/EUR Currency Pair**

	Strategic long-term hedge ratio for EUR/USD (%)	Dynamic Strategic Hedge ratio for EUR/USD as of 30 June 2025 (%)
Government Bonds	100	100
Corporate Bonds	100	100
High-Yield Bonds	60	Increased: 75–100
Global Equity	50	Increased: 75–100

Source: State Street Global Advisors.

## Endnote

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

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\* This figure is presented as of June 30, 2025 and includes ETF AUM of \$1,689.83 billion USD of which approximately \$116.05 billion USD in gold assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Investment Management are affiliated. Please note all AUM is unaudited.

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