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Recalibrating Dollar Dominance in a Shifting Global Order

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In Focus

We believe the reshaping of American trade policy and the overturning of post-war geopolitical norms by an unconventional US administration have been the primary drivers of the US dollar's significant year-to-date depreciation. Rising concerns over the cost of servicing the growing federal debt, amplified by the "One Big Beautiful Bill", along with high-profile challenges to US institutions including the Federal Reserve (the Fed), have also contributed to investor unease.

> This dollar weakness has served as a reminder to international investors, many of whom have benefited from holding dollars in the long bull market in US financial assets, that currency exposure counts.

> However, a broader perspective is needed. We consider concerns the dollar could lose its status as the world's reserve currency to be overblown. Longstanding and deeply embedded structural reasons support the dollar's continued prominence, while fiat and digital currency alternatives are not viable leaders of the global currency order at this stage.

> We see signs that investors outside the US are recalibrating their considerable dollar exposures after a lengthy period of ascendancy for the currency and US financial assets. We believe this will contribute to a further, albeit modest, softening in the dollar, supported by the Fed resuming its easing cycle, diverging from the monetary policy trajectories of the eurozone and Japan. A weaker dollar should continue to underpin non-US assets, particularly emerging markets, helping them build on their strong showing thus far in 2025.

The dollar, that iconic symbol of American economic strength, has faced mounting pressures this year. By 30 June, the ICE US Dollar Index (DXY), which values the greenback against a basket of major currencies, had fallen 11%. This represented the dollar's worst first-half performance since 1973, when it officially moved to a floating exchange rate following the collapse of the post-war Bretton Woods system (Exhibit 1).

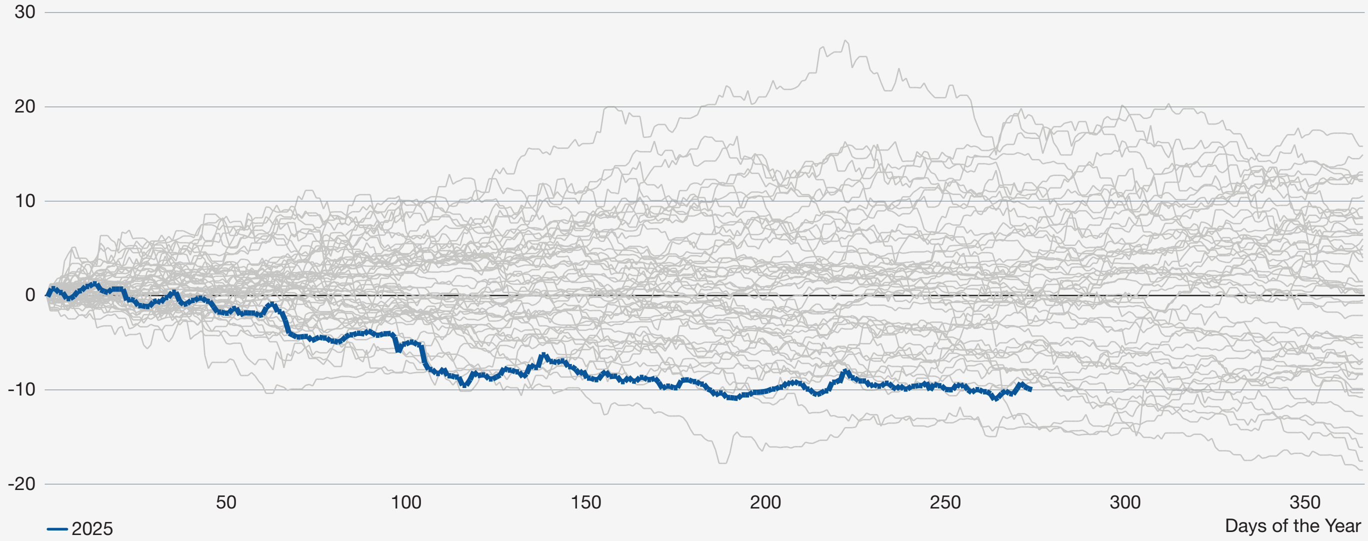
The scale of the move in the dollar can also be viewed in a longer-term valuation and competitiveness context. The Real Effective Exchange Rate (REER) measures currency strength against trading partners, weighted by trade volume and adjusted for inflation. Over this period, the magnitude of changes in REER has been striking, with the euro and dollar effectively switching places (Exhibit 2). The euro appreciation represented a dramatic move, from 0.4 to 2.2 standard deviations above its historical average, while the dollar underwent substantial normalization, from 2.2 to 1.2 standard deviations above its historical average. Valuation alone is generally not a specific catalyst, but it supports a more balanced perspective on the current value of the dollar.

While the dollar has remained somewhat stable over the last couple of months, it remains almost 10% weaker year to date. This significant depreciation has led to concerns about the greenback's resilience and prompted speculation that its status as the world's reserve currency is in doubt.

Exhibit 1

A Tough Year to Date for the US Dollar

US Dollar Yearly Cumulative Returns: 1973–2025 (%)

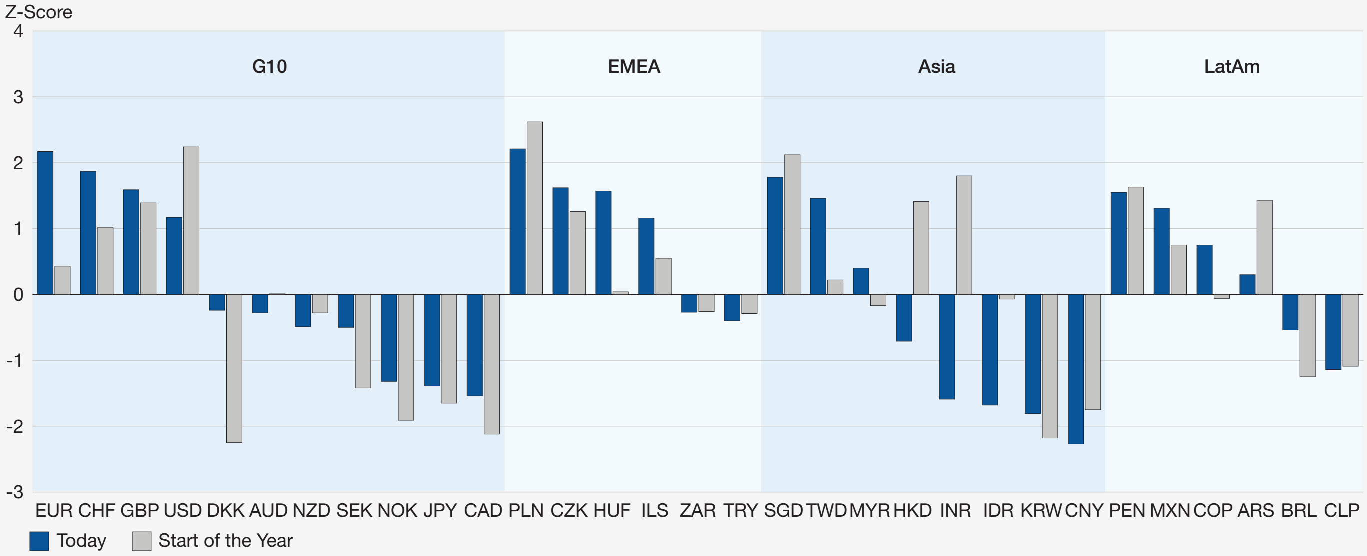


As of 30 September 2025. Source: Lazard, Bloomberg

Exhibit 2

Global Real Effective Exchange Rate (REER)

Z-Score



As of 30 September 2025. Source: Bank of International Settlements, Bloomberg

Bucking Expectations

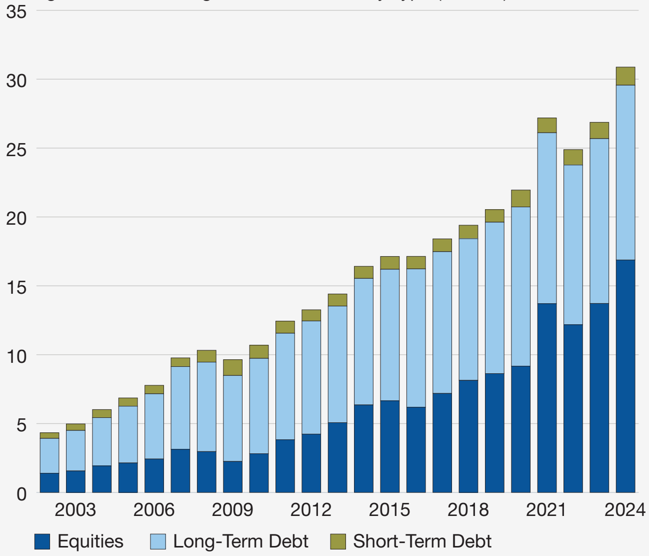
The dollar's sharp fall in the first half of the year confounded broad market expectations. Having entered 2025 trading at its highest level versus other major currencies since 2002, the market narrative was for continued dollar strength supported by investor positioning and historically low hedge ratios. US exceptionalism, a Big Tech-led AI frenzy absorbing global capital, above-target inflation keeping US interest rates higher, and the incoming administration's anticipated trade and business-friendly deregulation policies together lent further support for the greenback. But financial markets have a long history of defying received wisdom. Furthermore, in our view, many international investors had grown complacent about their dollar exposure after being rewarded in recent years for assuming currency risk amid insatiable appetite for American stocks and bonds (Exhibit 3).

Comprehensive hedge ratio data is not widely available and varies across asset type, investment strategy, and client domicile. However, based on data samples published by some central banks, it appears investors may have pursued lower hedge ratios for the US dollar in recent years. We believe a significant number of non-US domiciled investors had come to regard the dollar as a one-way bet—if they considered their dollar exposure at all in their clamor for US assets. Consequently, many were markedly overweight the dollar coming into 2025.

Exhibit 3

US Financial Assets in Demand with Non-US Investors

Foreign Portfolio Holdings of US Securities by Type (US$ tn.)



As of 30 June 2024. Source: US Treasury

A Shaken Political Kaleidoscope

What has changed to upset the mighty buck? In our opinion, the overturning of long-established US policy norms, along with escalating worries over the country's fiscal position, has introduced an increased risk premium for the dollar and sovereign US assets. We believe the US administration's break with the post-war Western geopolitical consensus on global trade and defense has been the main driver behind the dollar's year-to-date weakness (Exhibit 4).

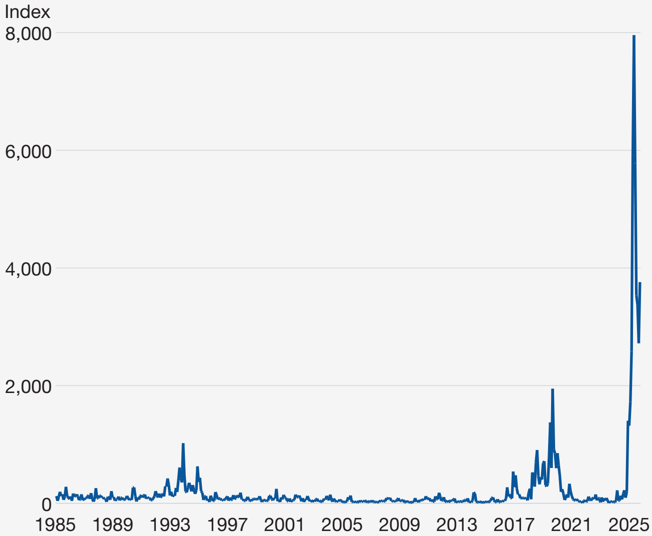
Investor wariness over major policy shifts, coupled with international concerns over the reliability of the US as a trading and political partner, has been amplified by the government's atypical approach to policymaking and communication.

Unease has been further heightened by the administration's high-profile confrontations with established US institutions, most notably the Fed.

A political sea change implemented by an unconventional leadership has seemingly catalyzed the long-term structural reasons for a weaker dollar we identified in our October 2023 paper, "Currency's Comeback."[1]

Exhibit 4

Global Trade Policy Uncertainty Has Spiked



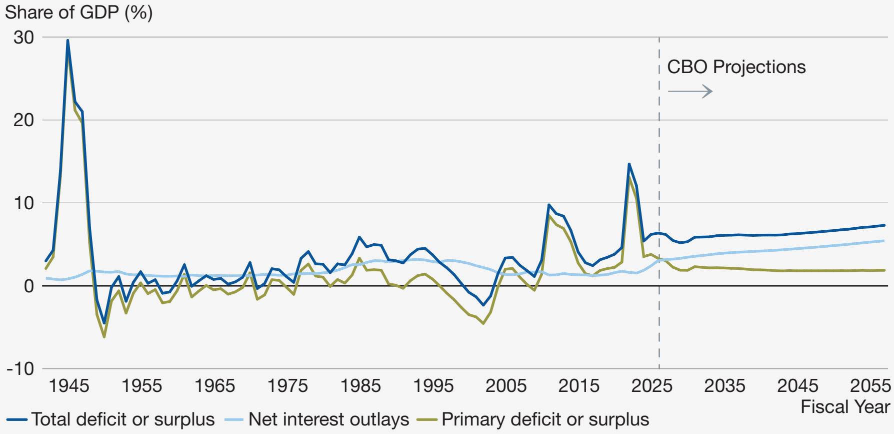
As of 30 September 2025. Source: Baker, Bloom & Davis

Fiscal Strains

Further contributing to the pressure on the dollar is the prospect of additional strain on US public finances, with the mounting burden of federal government interest payments being most noteworthy. Interest payments already represent 17% of total federal spending, while a fiscal Rubicon was crossed last year after these costs exceeded defense spending for the first time in US history. Continued US fiscal expansion via the One Big Beautiful Bill Act has impacted economists' expectations for interest expenses, which are expected to reach historically unprecedented levels by 2026 (Exhibit 5).[1]

Exhibit 5

Rising Actual and Projected US Interest Costs

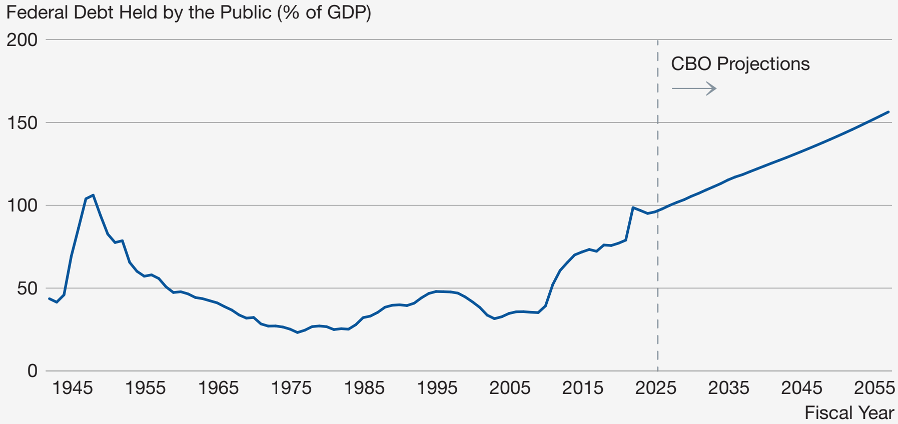


As of 27 March 2025. Source: Congressional Budget Office (CBO)

Meanwhile, with the annual budget deficit hitting 6.4% of GDP in 2024, the debt pile continues to grow. Debt-to-GDP currently stands at 125% and is projected to rise steadily over the next three decades (Exhibit 6).

Exhibit 6

Growing US Public Indebtedness



As of 27 March 2025. Source: Congressional Budget Office

Elevated interest costs and rising debt levels could increasingly strain the federal budget, potentially hindering current and future US administrations' ability to execute policy programs. They also create the conditions where an incumbent administration might be tempted to push for lower interest rates to trim an onerous interest bill. This is a potential path to the erosion of the Fed's independence and the credibility of its monetary policy, which would have materially negative long-term implications for the dollar.

Warnings from the Bond Market

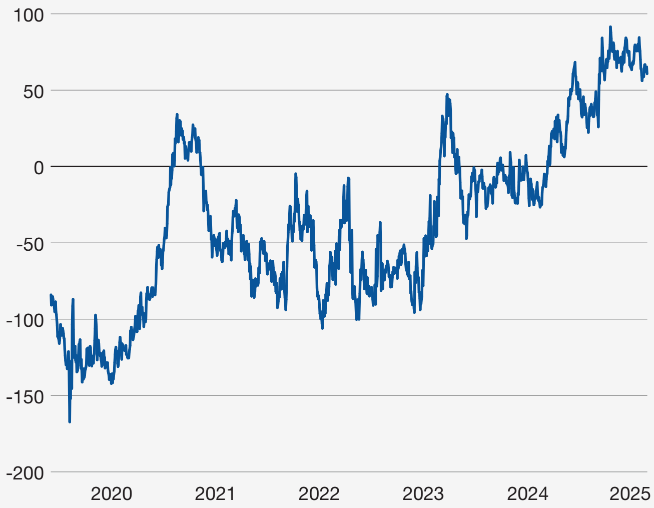
The forecast rise in US government interest costs has heightened investor concerns about the country's long-term economic health. This concern has emerged despite continued short-term cyclical strength, with GDP growth remaining robust and corporate America still looking healthy, even if the labor market has recently cooled. The disconnect between current economic performance and increasing investor unease reflects growing recognition that today's fiscal trajectory poses significant long-term challenges, regardless of the economy's present resilience.

Further contributing to the pressure on the dollar is the prospect of additional strain on US public finances. The 10-Year Treasury term premium is a catch-all measure that effectively captures the extra yield required by investors to compensate for uncertainty related to owning long-duration versus short-duration bonds. It is not directly observable, but models of this premium, including the widely followed ACM model, have drifted steadily upwards since late 2024 (Exhibit 7). This implies investors are becoming less inclined to own long-duration US debt.

This increase in term premium and related rise in the US 10-year Treasury yield since April has created a breakdown in the traditional relationship between rates and the currency. Higher rates in the context of a credible central bank would typically have been accompanied by an increase in the dollar. In fact, the reverse has happened (Exhibit 8).

Exhibit 7

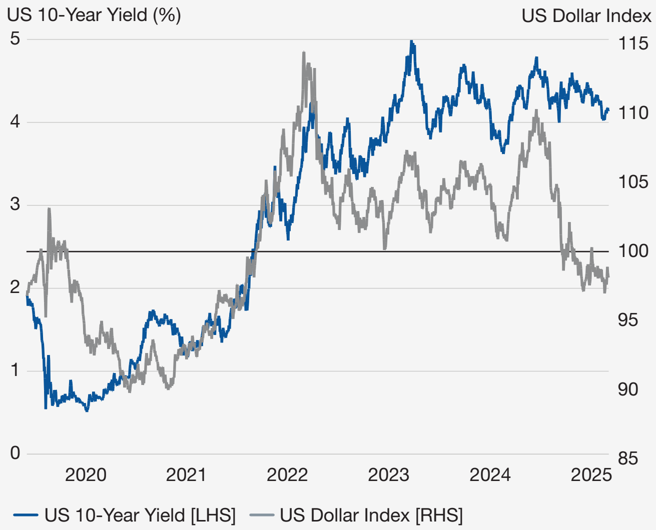
The Climbing US 10-Year Treasury Premium



As of 30 September 2025. Source: Bloomberg, Federal Reserve Bank of New York

Exhibit 8

The Decoupling of the US 10-Year Treasury Yield and US Dollar



As of 30 September 2025. Source: Bloomberg, Federal Reserve Bank of New York

A Waning Dollar Smile

A shift in long-held investor views may also be detected in signs of a breakdown of the so-called dollar smile. This established theory posits that the US currency tends to strengthen in periods of economic extremes—either periods of outsized US economic growth (e.g., the 1998–2000 TMT boom), or global instability when investors seek safety (e.g., the global financial crisis)—and weakens during periods of relative underperformance or more modest growth by the US economy.

In the wake of US military strikes on Iran in late June, a widely unexpected move that led to heightened, albeit short-lived, geopolitical tensions, the dollar rallied only slightly; traditionally, it would have been expected to surge. In addition, despite an early April spike in the VIX index (a measure of stock market volatility) following the initial announcement of US tariffs, the greenback continued to weaken.

The dollar has reacted counter to or less sensitively than historical experience in these market scenarios. In a global political environment transformed by the US administration, it seems investors are rethinking the interplay between politics, economic policy, and currency movements.

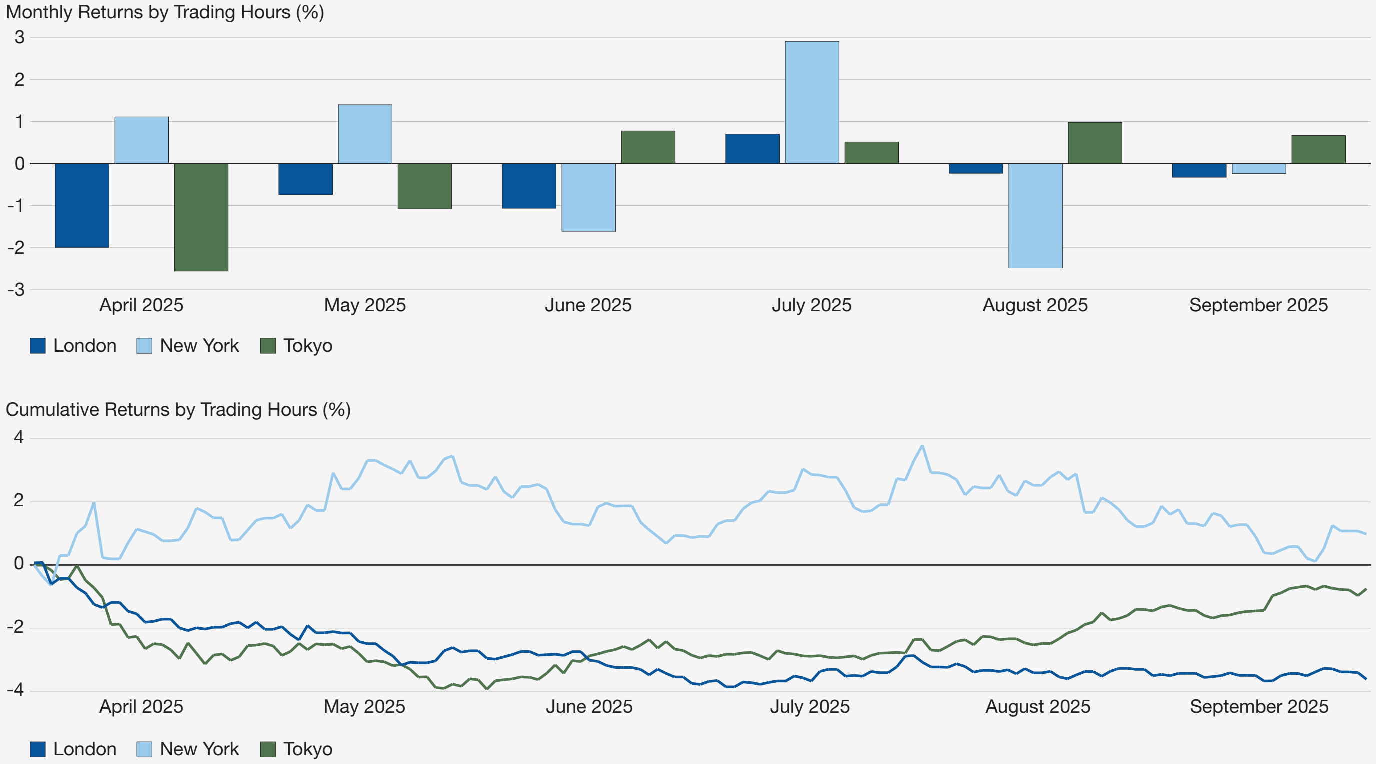
Global Ripples

These developments have not been self-contained. Dollar weakness in 2025 has created cascading effects around the world, even in the case of pegged currencies. The Hong Kong Monetary Authority injected over $16 billion in early May to defend its peg when the Hong Kong dollar strengthened to the limit of its trading band against the US dollar, causing local interest rates to decline from 4.06% to 0.57% and creating the widest Fed Funds–HIBOR spread since 1988.

Similar dynamics have played out across Asia. The Taiwan dollar surged over 7% in May—its largest move since 1989—driven by trade agreement speculation and subsequent corporate selling of the US dollar. This triggered a broader regional shift away from their US currency exposure, with parallel strengthening in the currencies of Singapore, South Korea, Malaysia, and China and with most of the US dollar underperformance occurring outside of New York trading hours (Exhibit 9). The underlying drivers may reflect a fundamental reassessment of dollar dominance: market skepticism about US economic policy, concerns over tariff impacts, and growing recognition of China's expanding global influence.

Exhibit 9

Dollar Weakness in April Mainly Occurred outside New York Trading Hours



As of 30 September 2025. Source: Lazard, Bloomberg

Recalibration, but Dollar Primacy Remains

The US currency's year-to-date weakness and its decoupling from traditional market dynamics underline investors' shifting perception of the dollar in a fast-evolving global geopolitical landscape. But we do not believe this is the beginning of the end for the greenback as the world's reserve currency.

First, the dollar still serves as the world's primary medium of exchange. It facilitates 88% of foreign exchange transactions and handles 47% of SWIFT payments, significantly outpacing the euro (Exhibit 10).[2] It also denominates 60% of foreign currency debt issuance and serves as the anchor for over 65 countries' currency pegs.[3] This dominance creates powerful network effects that resist rapid displacement.

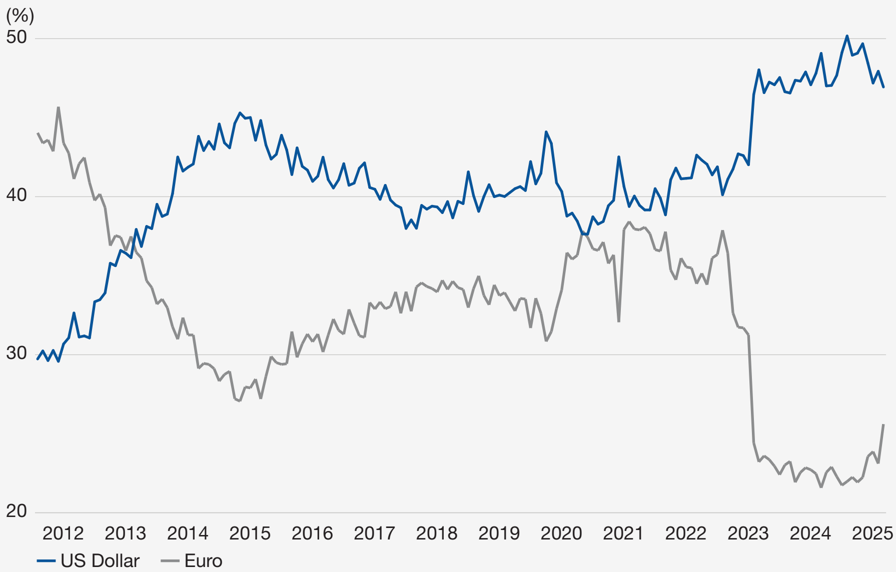
Second, the dollar and the US economy retain the requisites for a global reserve currency: liquid and open markets, a functioning rule of law widely used in international trade, confidence in the currency as a store of value, and an independent central bank—admittedly, the latter has been challenged in recent months.

Third, there is currently no viable alternative to the dollar as a global reserve currency. The two fiat currency alternatives most often proposed, the euro and the yuan, present limitations. The euro, often cited as the most likely challenger, faces significant obstacles. The eurozone government bond market is much smaller than the $29 trillion US Treasury market, while increasing political fragmentation within the euro bloc undermines the possibility of coordinated action. Furthermore, the region's underwhelming economic performance over the past two decades and muted growth prospects weigh on its viability as an alternative reserve currency.

The yuan is also highly unlikely to usurp the dollar as the world's primary reserve currency any time soon. The Chinese government maintains strict controls on capital flows, and China's financial markets lack the depth, liquidity, and transparency of their US counterparts. In addition, China's political and legal systems are less predictable and less open than their Western equivalents, making the yuan a less attractive option for global reserve holders.

Exhibit 10

Dollar and Euro Shares of Global SWIFT Payments



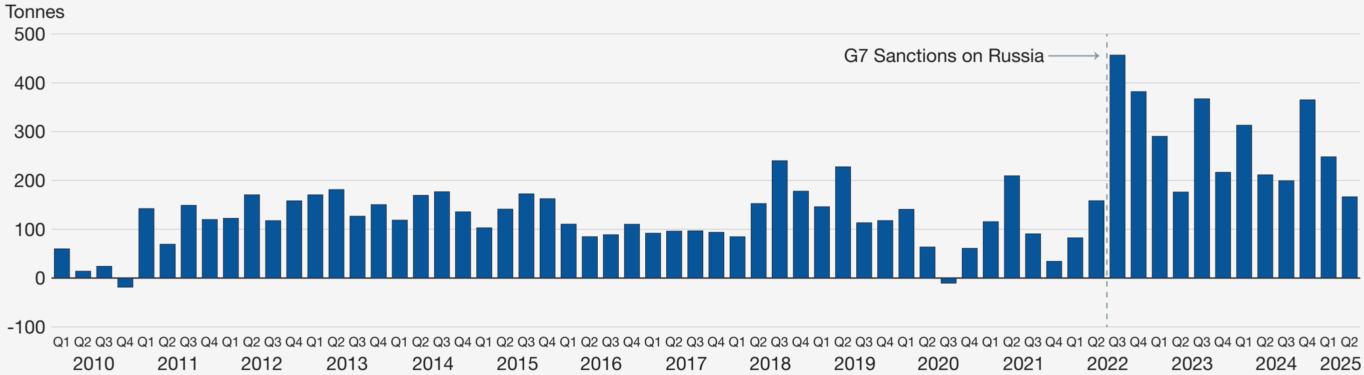
As of 31 August 2025. Source: Bloomberg, Swift

Reserve Alternatives

Could other types of assets such as gold and cryptocurrency replace the dollar as a reserve asset? Gold was the world's primary reserve asset until 1971, when President Nixon suspended the dollar's convertibility to gold, marking the beginning of the end of the Bretton Woods system. Following Russia's 2022 invasion of Ukraine and subsequent G7 sanctions, central banks accelerated gold purchases, driving prices up over 110%. The European Central Bank (ECB) estimates central banks now account for 20% of global gold demand, pushing reserves to levels not seen since Bretton Woods (Exhibit 11). However, gold has significant limitations as a reserve alternative. It does not generate income and poses practical challenges for transactions and storage, limiting its viability as a full substitute for fiat currencies.

Exhibit 11

Changes in Central Bank Holdings of Gold



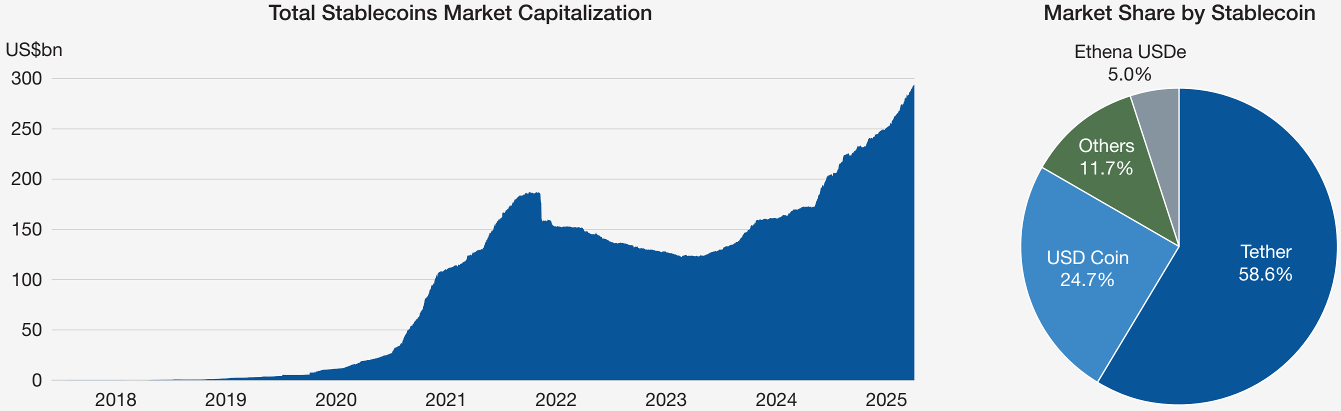
As of 30 June 2025. Source: ICE Benchmark Administration, Metals Focus, Refinitiv GFMS, World Gold Council

Digital currencies are also suggested as alternative reserve currency. But they present a paradox for dollar dominance. While often positioned as challengers, in some cases they are reinforcing the US currency's global reach.

With 99% of stablecoins pegged to the US dollar and their market capitalization surging from $130 billion to $277 billion since early 2024, they effectively expand dollar access globally. Over 80% of stablecoin transactions occur outside the US, creating new pathways for dollarization in emerging markets.[4] Despite rapid growth, stablecoins still represent fewer than 1% of global payment flows at $30 billion (Exhibit 12).[5]

Exhibit 12

Stablecoin's Growing Market Capitalization



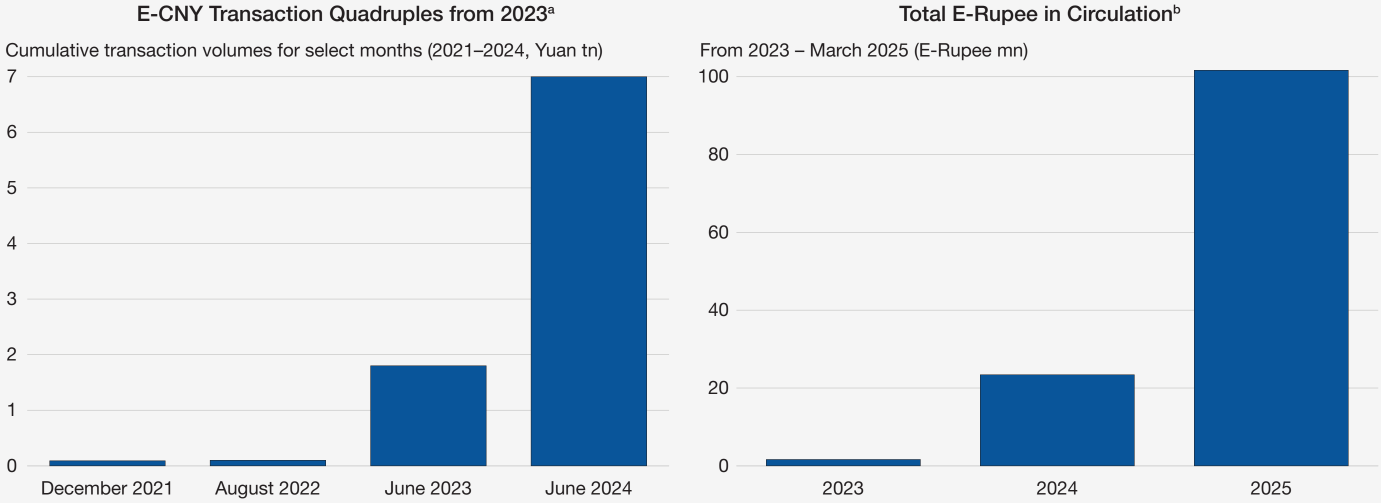
As of 30 September 2025. Source: DefiLlama

However, the longer-term challenge comes from a different category of digital currencies: Central Bank Digital Currencies (CBDCs). The issue lies not in any individual CBDC replacing the dollar—China's digital yuan and India's e-rupee face the same capital control limitations and structural constraints as their physical counterparts that prevent them from becoming global reserves. Instead, the risk is systemic fragmentation. With 137 countries now exploring CBDCs, representing 98% of global GDP, these currencies collectively enable a proliferation of parallel settlement networks. While no single CBDC can challenge the dollar, their combined emergence allows countries to establish bilateral settlement arrangements that bypass dollar conversion entirely. Cross-border wholesale CBDC initiatives have more than doubled since Russia's invasion of Ukraine, signaling accelerating momentum toward alternative settlement infrastructure (Exhibit 13).

This distinction is crucial: stablecoins extend the dollar's reach today, while CBDCs threaten to fragment the global payment system of tomorrow, not through creating a superior replacement, but through the steady erosion of the dollar's necessity in international transactions.

Exhibit 13

China and India's Lead on Central Bank Digital Currencies



a. As of 30 June 2024. Source: Atlantic Council, People's Bank of China (PBoC did not release official data in 2022)
b. As of 31 March 2025. Source: Atlantic Council, Reserve Bank of India

Future Path: Further Weakness but No Collapse

We believe the path of least resistance for the dollar from here is likely to be ongoing but modest weakness, not collapse. This dynamic should be further supported by the resumption of the Fed's rate-cutting cycle, especially with the ECB now seemingly finished lowering rates and the Bank of Japan expected to resume rate hikes, albeit at its traditionally slow pace.

While its recent performance has stoked concerns that its global dominance is fading, the dollar remains entrenched as the primary global reserve currency due to the sheer scale and liquidity of US capital markets. In contrast, as noted above, alternative currencies, such as the euro or yuan, still face significant structural barriers. While many economists and investors are sympathetic to the potential for continued dollar weakness, we believe the broader market has yet to fully grasp the complex dynamics between politics, economic policy, and hedging incentives.

Looking further ahead, we believe the long-term trend is likely to be towards a multipolar currency order. Over the last few decades, non-traditional reserve currencies have grown from negligible levels to approximately 10% of total reserves, driven by active diversification by central banks across 46 countries.[6] This trend toward smaller currencies, such as the Australian dollar, Canadian dollar, and other non-traditional reserve currencies, provides evidence of this emerging new order. But while the US dollar's share of global reserves appears to have peaked, we expect it to remain the largest single currency component of reserves for the foreseeable future. We believe its role as the cornerstone of international trade and finance will persist.

Pivoting toward Diversification

For investors, the implications of this dollar recalibration are significant. It may be appropriate to consider pivoting toward broader diversification after a long period when US financial assets have dominated portfolios.

This could involve greater exposure to international markets and emerging economies, which may be poised for higher future growth relative to US assets. European equities, underpinned by favorable valuations and expected to benefit from massive fiscal stimulus via German defense and infrastructure spending, potentially represent one promising avenue. Meanwhile, emerging markets, buoyed by expanding middle classes, superior demographics, and, in some cases, healthier public finances than many developed economies, offer attractive long-term prospects for diversification, albeit with the risks typically associated with emerging markets such as political uncertainty, currency restrictions, and liquidity challenges.

Active currency hedging may also play a vital role in mitigating risks associated with currency volatility. Investors who depend on dollar-denominated returns may benefit from hedging strategies that offset potential losses caused by dollar depreciation.

In summary, we believe it is important not to overstate the significance of the dollar's material weakness this year. While we do not envisage an end to the greenback's status as the global financial medium of choice, we do anticipate a modest softening in the US currency in the near term. We expect global investors will rationally view the dollar with an incrementally higher risk assumption and manage their exposure and hedge ratios accordingly.

Important Information

Notes

1. Source: US Treasury. Data as of 30 June 2025.
2. Source: Bank of International Settlements
3. Source: Federal Reserve
4. Source: Atlantic Council
5. Source: McKinsey
6. Source: International Monetary Fund

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