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Record Insights:
Taking stock of USD pessimism

Andrew Bloomfield, CFA
Head of Macro Research

Patrick Barley
Senior Analyst, Macro Research

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The US dollar stands at a potentially pivotal juncture. The real trade-weighted exchange rate has surpassed its peak at the time of the 1985 Plaza Accord (Figure 1), while the US now accounts for roughly two-thirds of global current account deficits (Figure 2). These mounting imbalances have drawn the ire of Republican trade hawks, and historical parallels with the Plaza Accord are fueling speculation about a possible shift toward a weaker dollar policy.

In this research note, we examine the **structural drivers behind dollar strength**, review the **factors behind its recent decline**, and evaluate whether **investor expectations of further weakness** are justified. We underscore the challenges of achieving a Plaza Accord-style agreement in today's environment and highlight the risks posed by Republican trade and fiscal strategies. Finally, we look beyond prevailing pessimism to assess the **potential case for renewed dollar strength**.

Figure 1 – US dollar real effective (trade-weighted) exchange rate

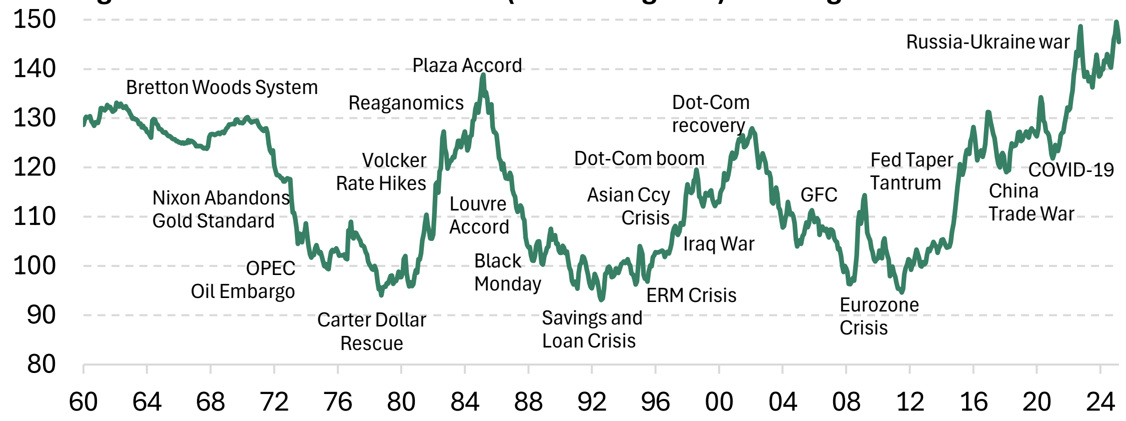
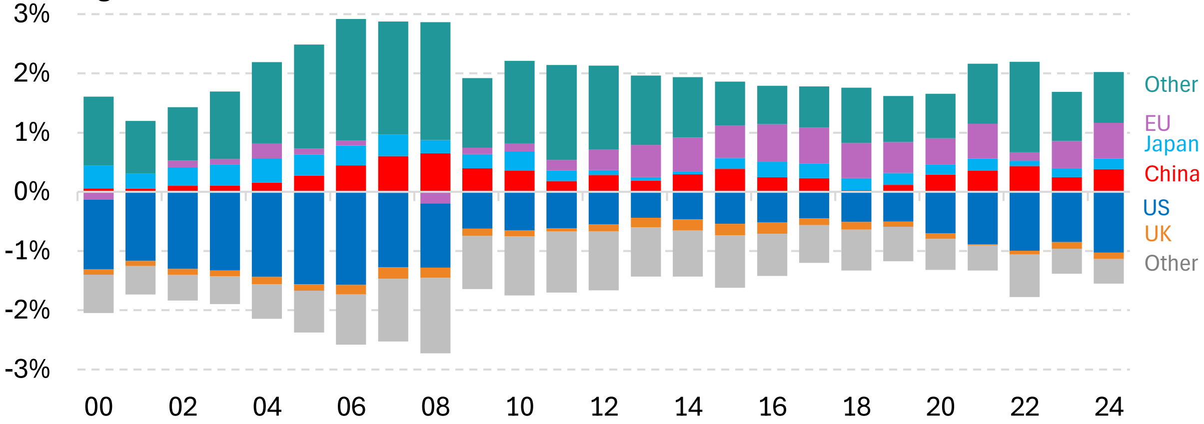


Figure 2 - Global current account balances as % of World GDP



Source: Record, IMF, Bruegal, Data as at 27 May 2025.

US Exceptionalism – too much of a good thing?

Persistent and widening twin fiscal and trade deficits have been a hallmark of the US economy for some time. To understand the outlook for the US dollar within this context, it is essential to first identify the drivers of its continued strength. In our view, dollar "exceptionalism" has been underpinned by a confluence of factors:

1) A productivity and technological growth advantage driving value misalignment
2) Insulation to the external environment amid geopolitical crises and risk-off inflows

Strong demand for US assets has supported the dollar throughout the current cycle (Appendix Figure A). However, this also introduces some vulnerabilities: if the public sector (via potential growth) or the private sector (via earnings growth) cannot meet investor expectations embedded in US external liabilities, outflows can follow. Furthermore, expansionary fiscal policy that draws in capital during periods of optimism directly grows the current account deficit when not offset by private savings (Figure 3).

In this context, the trade war has introduced a supply shock to the economy and weighed on earnings growth in the private sector – while other regions, notably Europe, are beginning to offer increasingly credible investment alternatives. The Trump administration's ambition to rebalance trade is, in principle, both sensible and warranted. However, its approach is undermining US economic and financial credibility due to:

1) *A misunderstanding of investment-saving gaps* as a driver of external imbalances

2) *The erratic use of tariffs* and near-embargo measures, which distort both trade flows and foreign capital demand.

Early signs of stress were first ignored in equity markets but could not be ignored in the bond market, as a sharp rise in term premia has alerted policymakers to mounting constraints. The rare and concurrent decline in US equity, bond, and currency markets has since cast doubt over the dollar's safe-haven status (Figure 4). With trade negotiations underway, market participants are questioning whether the Trump administration will embrace US dollar weakness as a tool for rebalancing the deficit.

Figure 3 – US savings and investment gap by sector (as % of GDP)

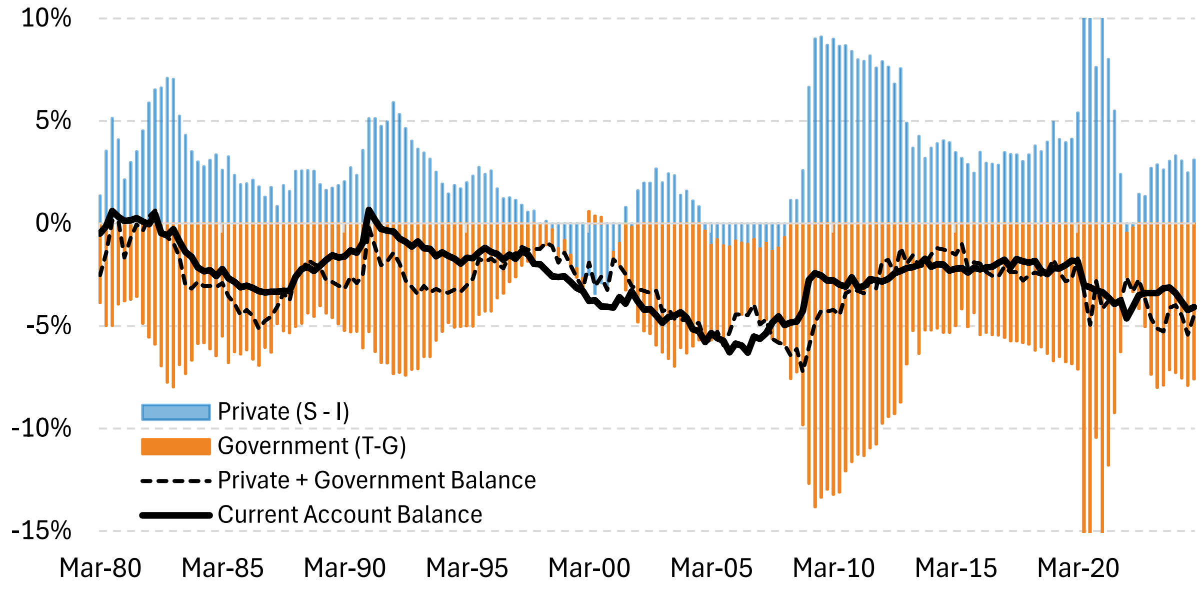
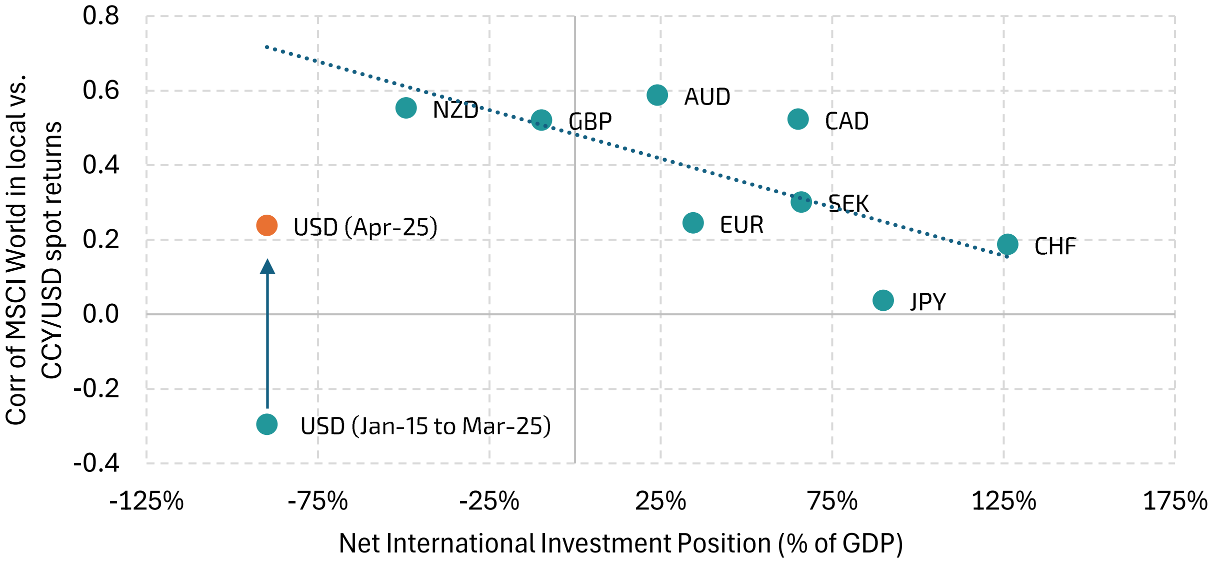


Figure 4 – International Investment position vs. currency and equity correlations



Source: Record, Macrobond US Bureau of Economic Analysis, National statistics offices, MSCI. Data as at 27 May 2025.

A Plaza Accord 2.0 seems unlikely

The Trump administration's economic policy has, in part, echoed ideas proposed in a blueprint paper1 by Stephen Miran, chair of the Council of Economic Advisors. In this framework, tariffs would pressure foreign countries into either appreciating their currencies or shifting industrial investment to the US. An extension of debt maturities would lock in financing as foreign investors are disincentivized from holding US debt.

Yet bond investors, alarmed by the size of tariffs and prospect of larger fiscal deficits, preempted the Treasury's plan to extend maturities ahead of any policies that would disincentivize holding dollars. Furthermore, the forced walk-back of tariffs with minor concessions, and much-reduced official foreign participation in US debt markets undermines the credibility of tariff threats (Figure 5, Appendix Figure B).

As a result, export-orientated reserve-holding countries – including China and Europe – with high trade exposure to the US are less likely to support a coordinated dollar devaluation. With that said, East Asian countries appear more receptive to bilateral currency talks. Japan, for instance, has considered its Treasury holdings as a bargaining tool, while South Korea is discussing currency policy with the US as part of trade talks.

Given the size of the FX market, any currency management policy also needs to be consistent with economic fundamentals to be durable. The rise in the real value of the US dollar has coincided with extraordinary productivity growth, which can impede mean reversion in real exchange rates (Figure 6). This makes the case for coordinated depreciation more complex and begs the question whether such an agreement is necessary under a moderating US growth path.

Any move toward a weaker dollar policy must be managed carefully. A gradual depreciation could enhance US competitiveness and improve the external balance by a revaluation of foreign assets relative to local-currency liabilities. However, a loss of confidence through unconventional policy risks eroding the safe-haven status of the US dollar.

Figure 5 – US import duties collected as % of GDP vs. Tariff rate

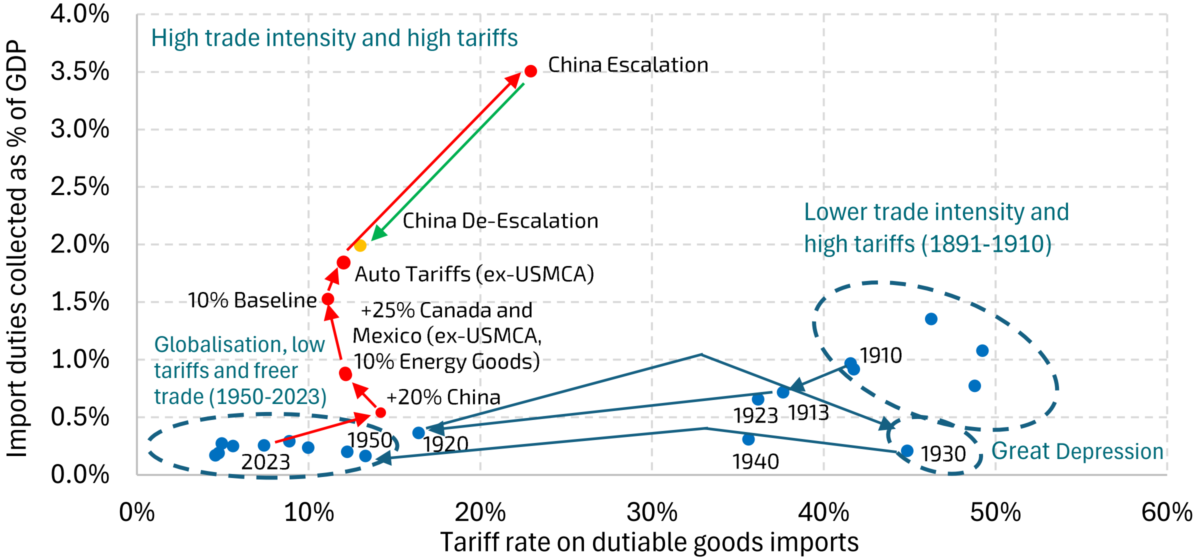
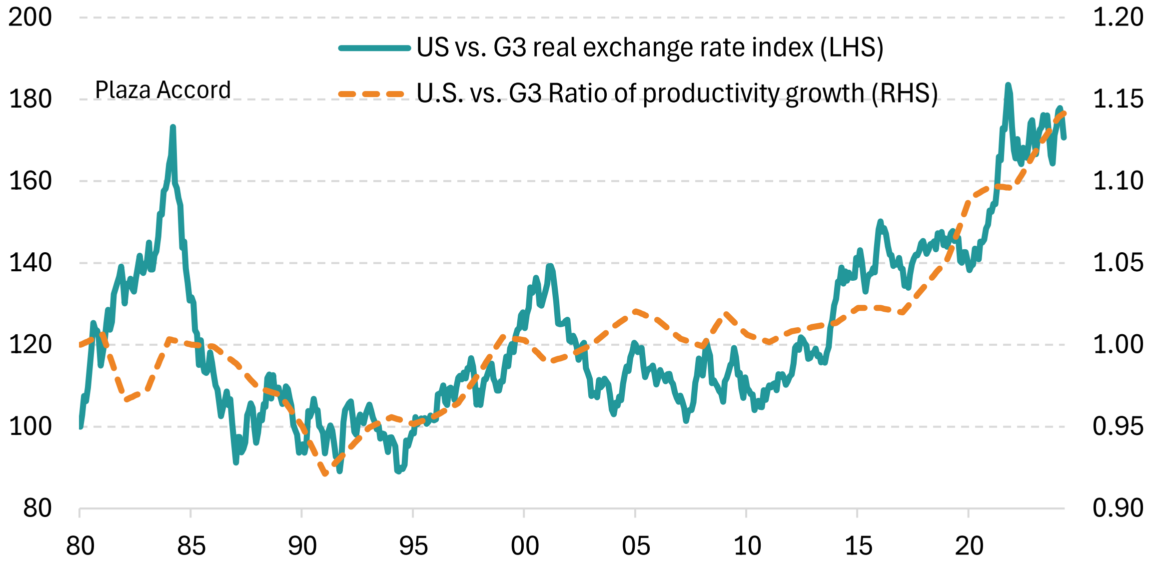


Figure 6 – US real exchange rate vs. index of relative GDP per capita



Source: Record, Macrobond, IMF, . 1 A User's Guide to Restructuring the Global Trading System (November 2024). Data as at 27 May 2025.

Policy credibility a greater risk to safe-haven status

While trade negotiations may yield some movement on currency policy, we think policy credibility is the larger risk to the US dollar. Ultimately, the US dollar's reserve currency status depends on more than just liquidity and scale; it requires the sustained confidence of foreign creditors, anchored in credible and consistent policymaking, with a demonstrated **willingness** and **ability** to issue external liabilities at scale.

The rollback of trade tensions suggests some willingness to preserve the US dollar's reserve currency status, and some normalcy has returned to equity-rate correlations. However, a wedge remains between the US dollar and its typical drivers (Figure 7), underscoring the critical role of credible policymaking. The US must maintain several key pillars of stability that support its position as the world's reserve currency:

1) *Fiscal policy*: The Trump administration has yet to acknowledge the link between trade imbalances and public spending. As a result, continued fiscal stimulus (e.g. extending tax cuts) risks affecting confidence if growth fails to offset rising term premia and/or forces the Federal Reserve's hand into controlling yields (Figure 8).

2) *Monetary policy*: While it is unlikely Trump removes Powell "for cause," given potential market fallout, some within his inner circle have proposed a "shadow Fed Chair" to guide policy. Undermining the Fed's independence would erode a key pillar of market confidence.

3) *Institutional policy*: Ignoring constitutional checks and balances can have unintended consequences. Policies seen as unconstitutional or politically motivated may spill over into fiscal decisions aimed at shoring up voter support, weakening investor confidence in the rule of law.

As these pillars are interconnected, weakness in one area increase the load on others, raising the risk that recent shifts in market correlations become structural. In such scenarios, the dollar would come under further pressure as institutional investors reduce exposure to US assets and mechanically increase hedge ratios on dollar holdings to maintain optimality of equity and fixed income portfolios.

Figure 7 – Market pricing of Fed terminal rate and DXY index

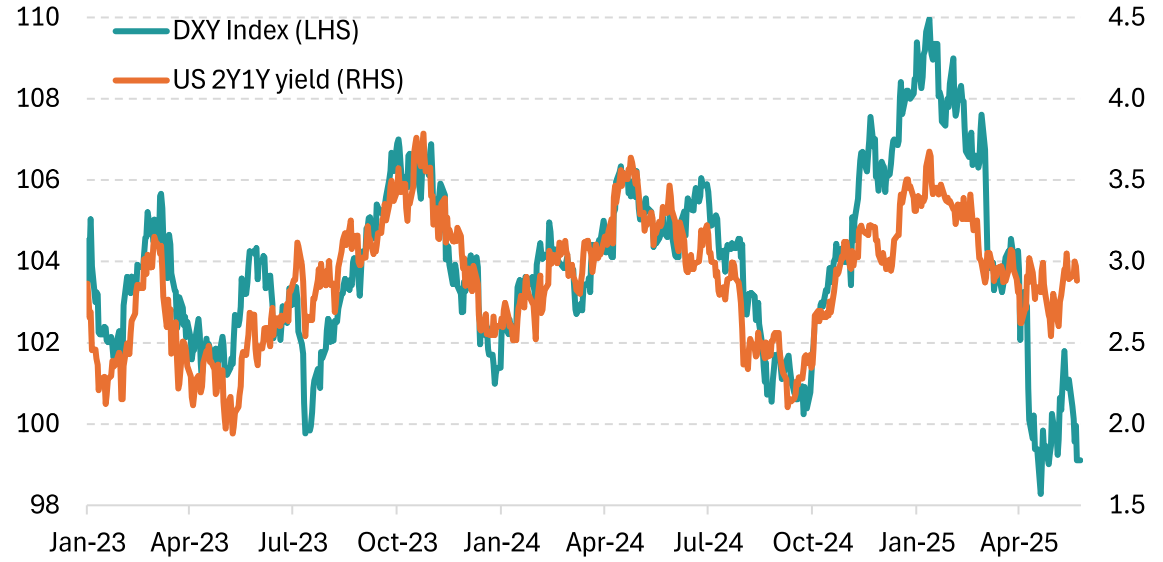
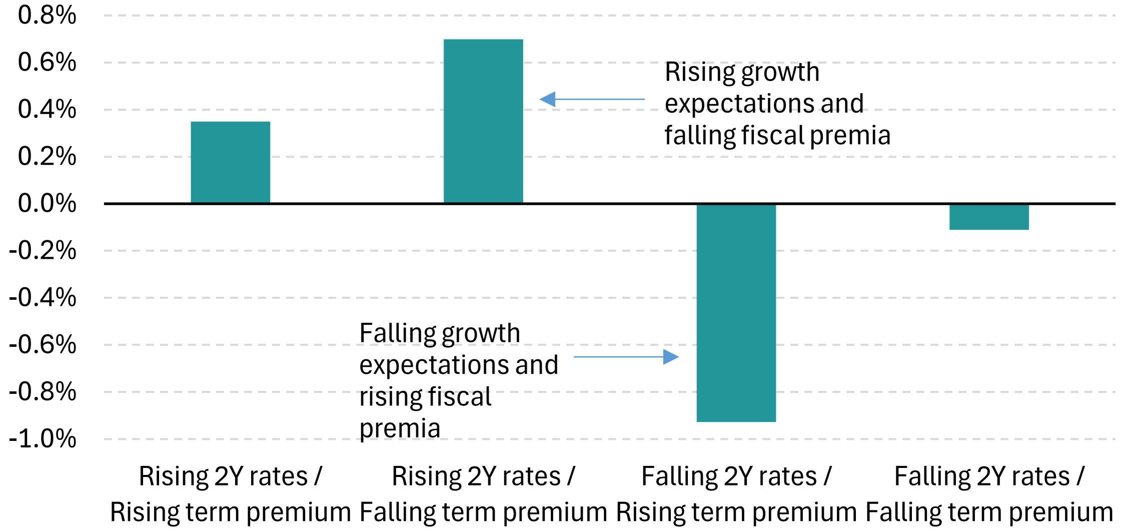


Figure 8 – Average monthly DXY performance under different growth and fiscal regimes



Source: Record, Macrobond, JP Morgan. Data as at 27 May 2025.

Looking through the USD pessimism

In view of the Trump administration's trade and fiscal policies, the market has adopted a predominantly negative view of the US dollar. This can be observed in the swift increase in the cost of protecting against US dollar weakness in the options market (Figure 9). Implied volatility on 25D EURUSD Calls are now 1% p.a. higher than EURUSD Puts, from being c. 1.5% lower just three months earlier and is approaching the extremes last seen during the COVID-19 pandemic. From the peak in January, the US dollar has already fallen by over 5% on a trade-weighted basis.

Heavy positioning for US dollar weakness, combined with a dislocation with financial market fundamentals creates the risk of rapid US dollar appreciation if there is a return to more market-friendly policies. The "liberation day" experience suggests that the Trump administration's negotiating approach is to push boundaries before moderating. The same could be true of the Republican spending bill if external market pressure forces politicians to adopt more sustainable fiscal policies.

As discussed elsewhere, the cyclical outlook for currencies is often well informed by relative productivity growth. Therefore, a comparison needs to be made with other regions; if longer-term growth merely catches down to other developed markets, this can limit the scope of dollar downside. Furthermore, investors may eventually need to refocus on issues outside of the US. For example, how does one reconcile Europe's military-led fiscal stimulus with much improved pricing of geopolitical risk in the region.

Ultimately, the US remains the world's largest economy and primary consumer. Therefore, a prolonged slowdown of US growth can be expected to spill over to the rest of the world, albeit with a lag (Figure 10). Additionally, the US dollar remains the world's primary global funding currency, and until that changes any major financial crisis that extends beyond US borders could reasonably be expected to drive risk-off demand if there are dollar shortages.

Figure 9 – 1-year 25D risk reversal implied volatility

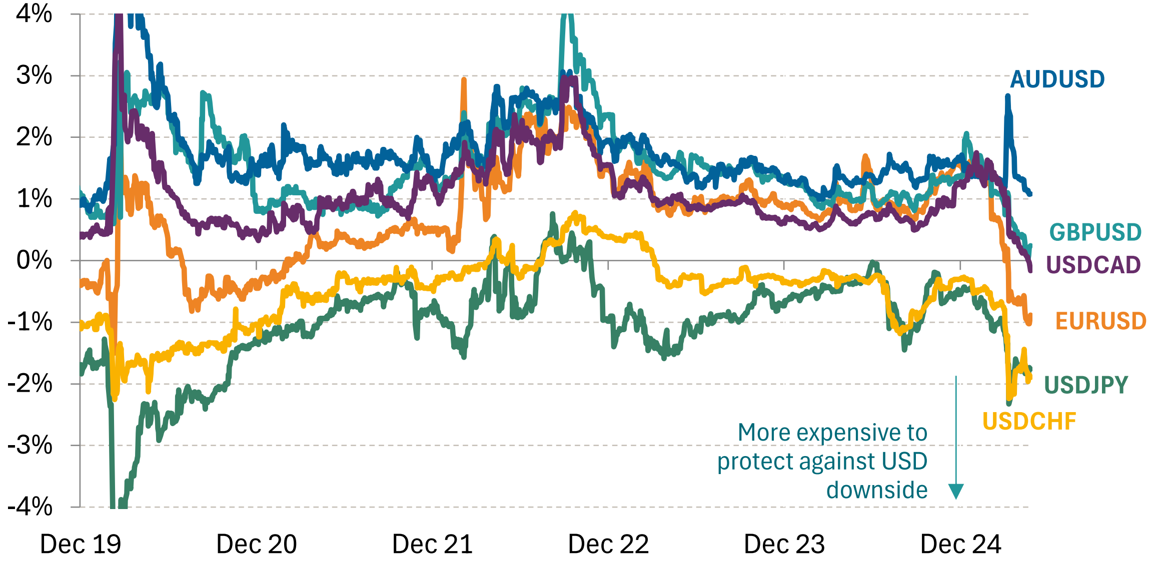
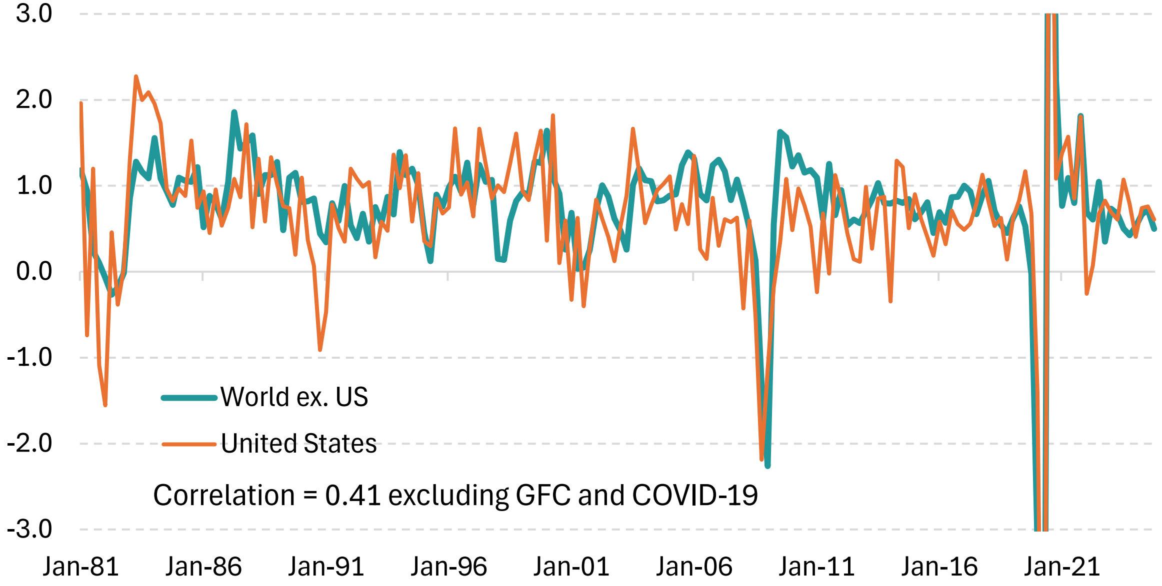


Figure 10 – US and World ex. US quarterly real GDP growth (%q/q)



Source: Record, W/M Reuters, Federal Reserve Bank of Dallas. Data as at 27 May 2025.

Conclusion

US exceptionalism and strong demand for US assets have supported the US dollar throughout this cycle, but the recent episode of weakness has exposed the dollar's **vulnerability to erratic governance and subsequent erosion in policy confidence**. Management of the US twin deficit lies at the core of the dollar question. Principally, the desire to rebalance trade is sensible and warranted, but we view the mercurial approach to tariffs as a self-defeating measure to manage the US current account deficit. Similarly, the fiscal rhetoric from Republican lawmakers and policy actions reveal a degree of dissonance that **is undermining US fiscal sustainability**.

That being said, the dollar's fate is far from written. Talks of a multilateral currency deal appear overdone given limited leverage. **The dollar's strength has also been underpinned by strong productivity growth** which complicates prospects of a coordinated depreciation given the size of the FX market. Some countries with cheap currencies and appropriate fundamentals in East Asia show more willingness to negotiate bilaterally; an orderly dollar depreciation could enhance US competitiveness and improve external sustainability through a revaluation of foreign assets relative to local-currency liabilities.

Ultimately, it is international confidence in US policy and institutions that underpins the US dollar's reserve status. We highlighted vulnerabilities across **3 pillars of US policy credibility: Fiscal, Monetary and Institutional policy**, and emphasized weakness in any one pillar places pressure on the others. Confidence in US policy has been undeniably shaken, however the "liberation day" experience suggests that under market pressure, the Trump administration can moderate policy. **As such, a restoration of policy confidence would likely lead to a rapid rebound in the dollar**.

Fundamentally, currency strength requires a relative comparison between economies. The US remains the world's largest consumer, and therefore any **sustained slowdown threatens to spill over to the rest of the world**. Concurrently, the rest of the world is not without its own economic and geopolitical risks given fracturing relations and shifting trade patterns. The US dollar also remains the world's primary global funding currency, and until that changes **financial shocks that extend beyond US borders could reasonably be expected to drive a flight to dollar safety**.

"You can always count on Americans to do the right thing — after they've tried everything else."
– Winston Churchill

Chart Appendix

Figure A – US cumulative current account and financial account flows ($bn)

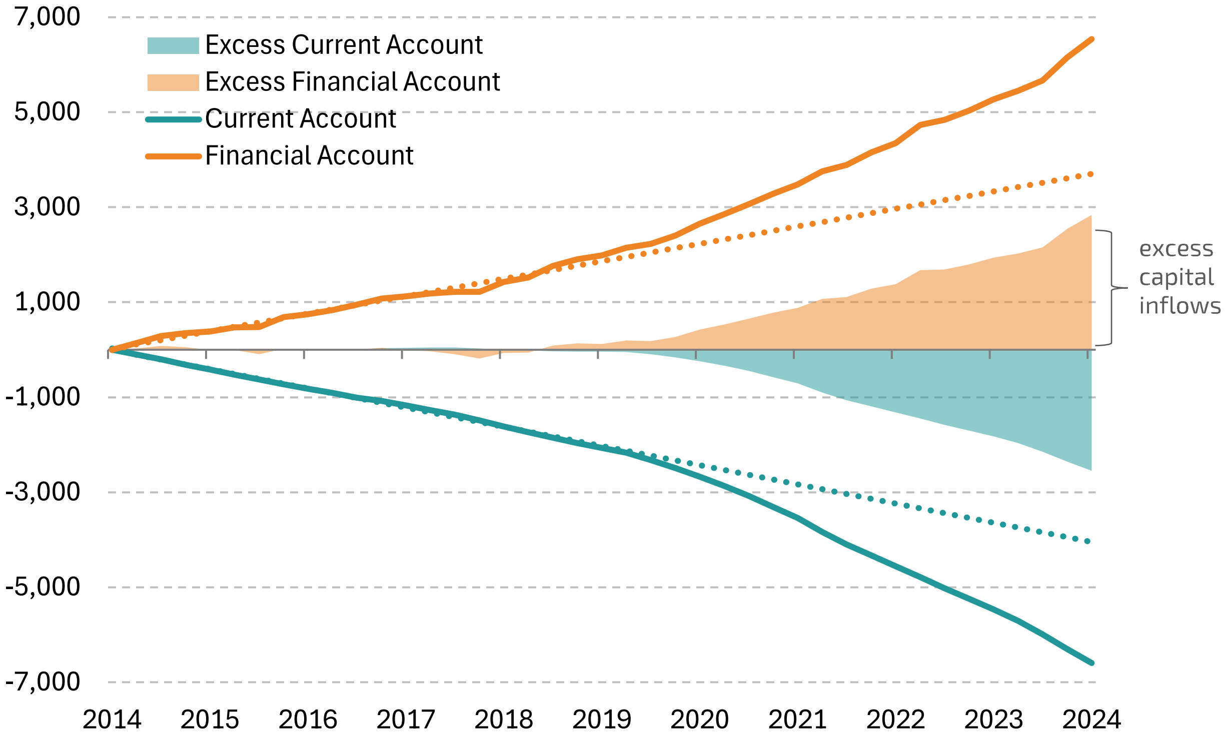
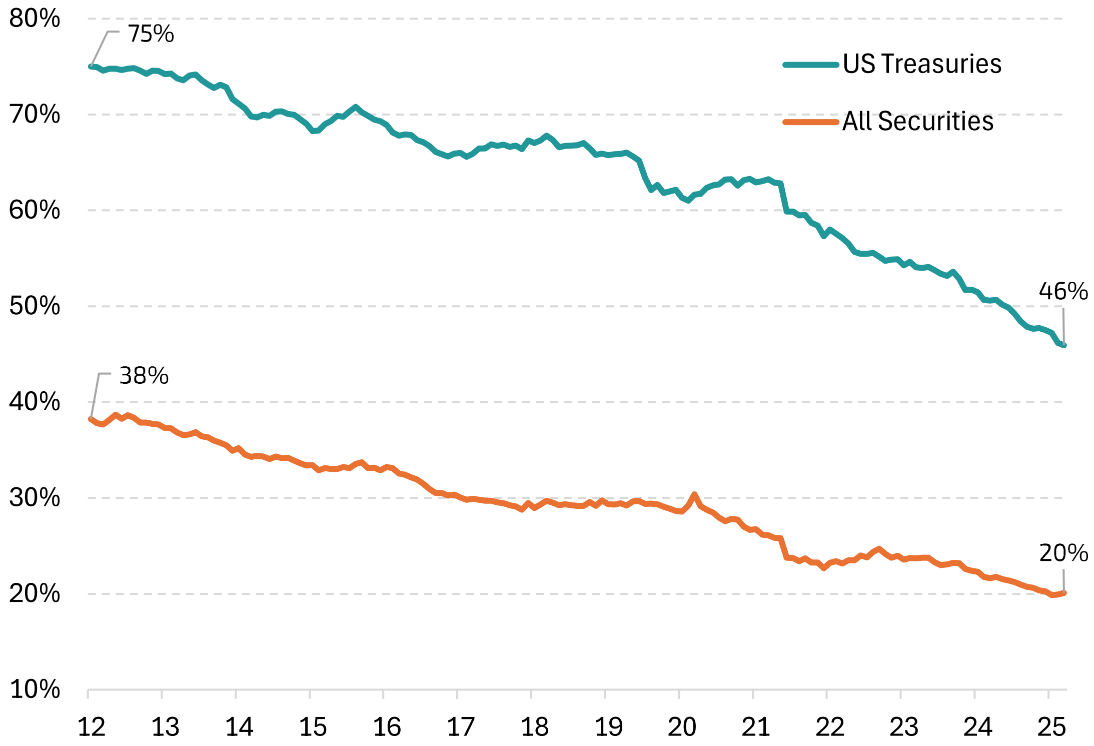


Figure B – Foreign official share of foreign holdings of US assets



Source: Record, IMF, OECD. Data as at 27 May 2025.

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