Monthly Observation

AUGUST 2025

WHEN THE GREENBACK BENDS

PART 1: THE DOLLAR CYCLE & FISCAL DOMINANCE

EXECUTIVE SUMMARY

The US Dollar (USD) remains the dominant force in the global financial system. It is the world's primary reserve currency, the main unit for trade invoicing, and the most commonly used funding currency in capital markets, serving as the backbone for global debt issuance, commodity pricing, and cross-border settlements. That position is unlikely to change anytime soon. The dollar's structural advantages—market depth, liquidity, legal protections, and the fact that everyone already uses it—are unmatched. However, slight shifts are occurring, driven by geopolitics, domestic fiscal realities, and a willingness among both allies and adversaries to diversify. While the dollar will continue to be the key reserve currency, cyclical forces threaten to bend the greenback, a position it has not experienced sustainably for much of the past decade.

THE DOLLAR'S DOMINANCE

> "The reports of my death are greatly exaggerated" -Mark Twain

The USD's dominance is being challenged, but its leadership in global finance remains secure for the foreseeable future. For example, as shown in Chart 1, the US Dollar accounts for nearly 60% of the composition of official foreign exchange reserves (COFER), with the euro (EUR) at around 20%, and nothing else comes close. Despite the hype about challenging the dollar, the Chinese RMB makes up only 2% of COFER. Additionally, Chart 2 shows that the USD holds the largest share in areas like trade invoicing, foreign exchange turnover, and SWIFT payments.

CHART 1 Currency Composition of Official Foreign Exchange Reserve (COFER)

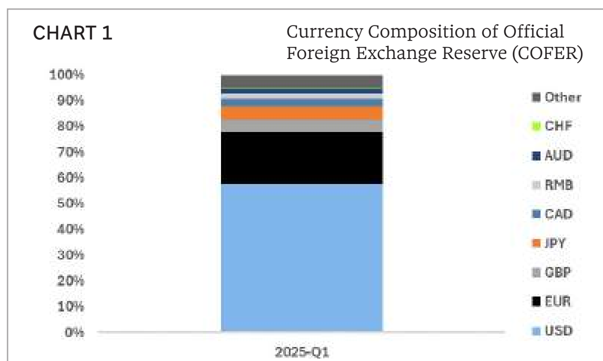
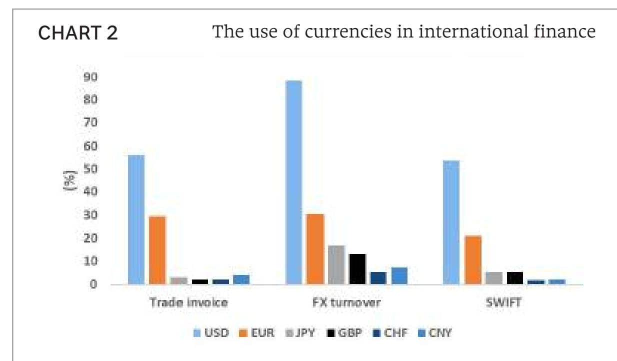


CHART 2 The use of currencies in international finance



Source: (Left) International Monetary Fund (IMF) and (Right) BIS Quarterly Review June 2024

While some believe the dollar's reign as "King" is ending, the data demonstrates it's no easy feat. Three key factors that underpin its hold on international finance are:

SCALE AND LIQUIDITY

The dollar dominates international finance because of its depth, liquidity, transparency, and the ability of capital to flow freely in and out of the dollar-based system. Additionally, the US Treasury market is the deepest and most liquid pool of "risk-free" capital in the world. The dominance of one strengthens the other and further reinforces the dollar-based system.

INSTITUTIONAL TRUST

Trust relies on the rule of law, transparency, and a credible central bank to uphold the dollar-based system. Admittedly, the Federal Reserve (the Fed) might face greater challenges as it will need to work more closely with the U.S. Treasury due to fiscal constraints. Nonetheless, its capacity to support the global financial system during times of stress, as it has in the past, will stay intact, preserving its essential role.

NETWORK EFFECTS

The widespread acceptance of the currency increases its usage and makes it difficult to replace.

THE DOLLAR CYCLE

"All is flux, nothing stays still." -Heraclitus

While we don't doubt the dollar's dominance in international finance, like any other asset, it is not immune to macroeconomic shifts, cyclical forces, and broader structural trends. The past decade has seen a period of sustained USD strength, so we need to look further back to find times when that wasn't the case. Chart 3 shows a long-term history of the US Dollar Index (DXY) starting in the early 1970s. A few points worth highlighting:

- The long-term trendline for the US Dollar over the past five decades has been downward.
- Amid this long-term trend, the dollar has experienced three significant uptrends: 1980-1985, 1995-2002, and 2014 to the present.
- Downward cycles can be protracted, sometimes lasting around ten years.

While the dollar might be vulnerable to a pullback, as will be discussed, the main point is not to mistake a cyclical downturn in the US dollar for a false sign that its status as the world's reserve currency is being challenged. Ironically, even though the USD holds the largest share of central bank reserves, as mentioned earlier, its share has been decreasing for nearly a decade, from about 66% of COFER in 2016 to 58%. Despite this, the dollar has maintained its position as the reserve currency and was generally in an uptrend during this period.

(L) YCharts, as of July 2025, (R) IMF, as of Q1 2025

So, even though we do not believe the dollar is at risk of being dethroned, it is not immune to regime shifts, which, when they happen, can have wide-ranging effects on the global economy, financial markets, and asset allocation. Therefore, despite the advantages that the dollar has, we believe several forces will prevent the dollar from remaining in an uptrend:

VALUATIONS

It’s no surprise that the bull run has led to the dollar being overvalued against many of its key counterparts, as illustrated in Chart 5. For instance, based on purchasing power parity (PPP) implied fair value, it is 17% overvalued relative to the Canadian dollar (CAD) and 36% against the Japanese Yen (JPY). PPP is a poor timing tool; however, it serves as a useful benchmark for estimating potential downside if the trend reverses. Still, as the long-term history chart shows, the unwinding happens over several years.

GEOPOLITICS

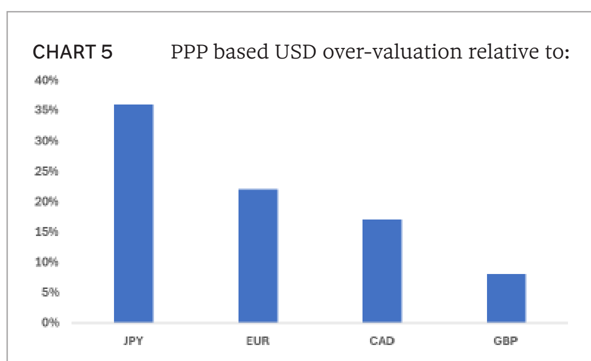
A growing aspect of US foreign policy is the “weaponization” of the dollar through sanctions. It’s no coincidence that as sanctions use has increased over the past decade, the USD’s COFER share has decreased as targeted nations diversify their foreign currency reserves. While not threatening the global dollar-based system, continued “de-dollarization” of FX reserves presents an additional headwind as the cycle shifts.

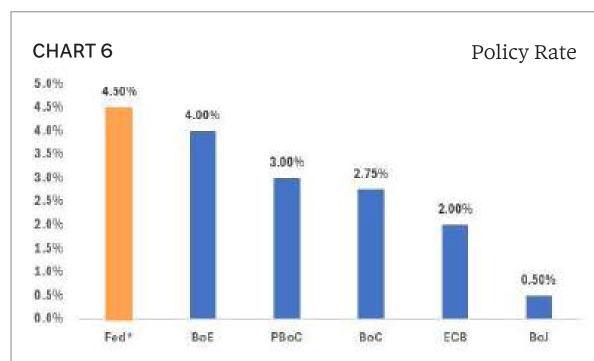
TRADE POLICY

President Trump’s use of tariffs as a negotiating tool has disrupted long-standing trade relationships, frustrating trade partners and allies. The U.S. has a negative net international investment position (NIIP) of about -$25 trillion. This means foreigners own $25 trillion more in U.S. assets than the U.S. owns in foreign assets. While we don’t subscribe to the “sell America” trade narrative that is talked about in the media, the more important point is that even small shifts in global portfolio rebalancing away from U.S. assets can affect the USD and U.S. financial assets more broadly.

MONETARY POLICY

The Fed’s policy rate is higher than many of its key counterparts, as shown in Chart 6, but that is expected to change as the Fed nears restarting its rate-cutting cycle. Looser monetary policy will likely shift short-term rate differentials against the USD.





Source: (L) UBC, Sauder School of Business. PPP stands for purchasing power parity and can serve as a proxy for relative currency valuations. (R) YCharts.

FISCAL DOMINANCE

> "The dollar is our currency, but your problem."
> -John Connally, Treasury Secretary, 1971-1972

America's "exorbitant privilege," the idea that issuing the world's reserve currency allows it to borrow cheaply and without significant consequences, is fully reflected in the quote above. Treasury Secretary Connally made the now-famous statement in response to trade partners who were worried about the currency volatility that followed President Nixon's decision to suspend dollar convertibility into gold in 1971, effectively ending the Bretton Woods system, as the dollar fell by roughly 30% from 1971 to 1980, as shown in Chart 3. For different reasons, the dollar in 1971—just as today—was too strong for policy goals. This also points to more fundamental reasons why the dollar cycle might be changing, namely, fiscal concerns and policy aims.

Reserve currency status has given the US a level of budgetary flexibility that other countries lack. However, debt levels are now among the highest in the G7, behind only Japan and Italy, as shown in Chart 7, and the budget deficit, which exceeds 6%, as shown in Chart 8, isn't expected to close anytime soon. In other words, debt levels have grown so large that monetary policy, as the main factor influencing the business cycle, needs to be reconsidered.

CHART 7 General Government Debt (Percent of GDP)

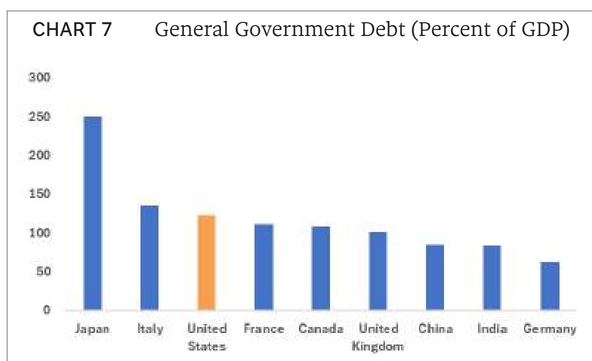


CHART 8 US Government Surplus or Deficit 1929-2024

Source: (L) IMF, based on data as of 2023. (R) YCharts

That shift in thinking isn't easy to achieve. The belief that monetary policy is the primary driver of the U.S. economy has been widely accepted since the era of Fed Chair Alan Greenspan, and for good reason. The saying that 'economic cycles don't die of old age, the Fed kills it' highlights the role monetary policy plays in shaping the business cycle. While monetary policy will stay vital, the fiscal background is now transforming the landscape.

We are moving from the old world of "monetary dominance," where monetary policy was the primary force behind the business cycle, to "fiscal dominance," where the federal government's spending policies will take the lead and influence central bank decisions. This change occurs because, as the government's borrowing and debt levels grow large, the central bank's interest rate decisions have an outsized effect on the budget, more specifically, on interest expenses, and, in turn, debt sustainability. In essence, although the Fed has a dual mandate, there is a creeping implicit third mandate—to keep government debt manageable.

Taken to an extreme, the likelihood of more frequent bouts of inflation than during the post-GFC to pre-COVID era, along with a weaker dollar, increases. The latter outcome, however, could be seen as a feature rather than a flaw. One key goal of the current administration is reindustrialization and reviving domestic manufacturing. A weaker dollar would support this by making US exports more competitive. So, while we don't believe the current administration has a "weak" dollar policy, we also don't think it aims for a "strong" one. In fact, Stephen Miran, the recently appointed, though yet to be confirmed, Fed governor and current Chair of the Council of Economic Advisors, has publicly stated that the dollar is overvalued, which undermines US manufacturing and contributes to trade deficits.

In essence, we believe the USD is at a crossroads for various reasons. It will continue to play a vital role in international finance, as no other currency can match the reach and influence of U.S. capital markets to replace the dollar-based system. However, cyclical and structural factors will influence dollar trends in the coming years.

CYCLICAL
The dollar's overvaluation, along with geopolitical tensions and a dovish shift in monetary policy, make it vulnerable to a downturn.

STRUCTURAL
The U.S. fiscal path, along with the administration's goal of reindustrialization, will require more creativity from policymakers and closer policy coordination between the U.S. Treasury and the Fed. These efforts are likely to be dollar-negative, but during the interim, they would still align with policy goals.

While we have extensively discussed why we believe the greenback is about to bend, we haven't yet covered what this means for asset allocators. That will be the focus of next month's Observation.

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