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The dilution of the dollar's dominance

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Despite the USD bottoming in April, we believe that the US dollar's decline has not yet run its course. While diversification away from the USD is likely to continue, investors navigating this sea change will need to tailor their response to their needs. For starters, investors should make sure to match the FX exposure of their assets and liabilities. Beyond that, investors will need to balance the trade-offs between yield, volatility, and liquidity when managing excess USD cash.

Since troughing on 21 April, the USD seems to have found its footing, with the USD index (DXY) up 1% since then, after having risen as much as 3.6% in mid-May. This comes on the back of a sharp 10.6% decline in the DXY from mid-January to 21 April, leaving the DXY still down 9.2% year-to-date. Investors might be justified in asking if the worst has indeed passed for the USD or if this is merely a brief interlude before the depreciation resumes.

Unfortunately for the USD, the erosion of confidence in US policymaking looks set to be somewhat indelible, which exacerbates the impact of shifting growth differentials, changing policy expectations, and evolving global capital flows. We expect diversification out of the USD to continue. How should investors respond and adapt to this potential sea change?

Matching FX exposure of assets with liabilities. Investors should start by taking note of any larger or recurring expenses, like tuition, property, or business expenses. A fall in the value of the USD would increase the size of non-USD liabilities in USD terms. This speaks to the benefit of aligning the currency mix of assets with future liabilities, which can help investors manage potential currency risk, especially amid the shifting FX landscape.

One variant of this is for non-USD-based investors to rebalance their portfolios and increase the allocation to their home currency, which tends to be where many investors' long-term liabilities will be. This is probably a good time for this as

higher US returns, lower perceived policy uncertainty, and reduced geopolitical risk over the last few years have led many investors to raise their USD holdings beyond their long-term strategic targets, especially in excess cash. Indeed, repatriation into various G10 currencies like the EUR and CHF has already been observed.

Yield, volatility, and liquidity. After having adjusted for expected liabilities and reference currencies, investors should consider the risk-reward trade-off of their currency choices. When considering diversifying out of an excess of USD holdings, it is likely that liquidity will be a key consideration. On liquidity, the EUR is the best alternative to the USD, which remains the most liquid as the dominant reserve currency. Other highly liquid currencies include the JPY, GBP, AUD, CHF, and CAD. Emerging market currencies tend to offer higher yields, but also come with significant volatility, lower liquidity, and sometimes capital controls.

Among these, the JPY and CHF are the most defensive. These currencies tend to hold up well in times of market stress and are often preferred for capital preservation and stability, although large swings are still possible. The AUD, GBP, and CAD meanwhile tend to perform well in strong global equity markets but also tend to underperform in downturns. They mostly offer higher yields, but with more risk and less liquidity/market depth than the USD or EUR. While attractive for their higher yields, these three currencies also come with greater volatility.

APAC investors might also consider the CNY and SGD. For investors in the Asia Pacific region, the JPY and AUD probably offer greater familiarity from within the G10 space, while also offering good alternatives depending on the individual investor's risk outlook. There are two further options worth considering for Asian investors: the SGD and the CNY. Within Asia, the SGD is a liquid option that inversely tracks broad USD moves.

The CNY though has come to the fore with the recent de-escalation in tariff tensions with the US. While a US-China trade agreement within the 90-day window is by no means guaranteed, a positive outcome would lessen the pressure on the Chinese economy and provide a further tailwind for the CNY. On the flipside, China's policymakers are likely to carefully manage the pace of appreciation given ongoing deflationary pressures and lingering uncertainties. We see further upside as these headwinds ease and exporters convert more foreign revenues back into CNY. As sentiment shifts from caution to cautious optimism, the CNY could gradually strengthen toward 7.0 against the USD in the coming months. Moreover, there could be a benefit from potential currency gains by reducing the FX hedging on CNY positions.

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