Reduce excess dollar exposure

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- **Why?** (1) The USD's traditional role as a perceived "safe haven" during periods of market uncertainty is under question. (2) Tariffs will likely lead to slowing US growth and pave the way for the Federal Reserve to cut rates later this year as some other major central banks conclude their cutting cycles. (3) We believe that investors should review their currency allocations and align them with those required to meet liabilities or spending plans.
- **Why now?** (1) The protracted tariff negotiation process might trigger a redoubling of efforts to reassess excess exposure to USD assets amid unpredictable US policymaking. (2) We expect Fed rate cuts in the coming months could spark a resumption in the weakening of the US dollar. (3) If US economic data starts to weaken materially, USD depreciation could accelerate.

Amid questions about the "safe haven" status of the US dollar, investors should consider diversifying excess US dollar holdings.

The Dollar Index (DXY), which tracks the US currency against a basket of six major peers, has fallen by around 10% this year. Over the next 12 months, we expect the US dollar to depreciate further as US growth slows, the Federal Reserve likely cuts interest rates, and concerns about rising US debt levels and Fed independence linger. We target EURUSD at 1.23 and USDCHF at 0.76 by June 2026.

Investors can consider various ways to reduce, diversify, or hedge excess dollar exposure:

Increase allocations to EUR and AUD

EUR: As the most liquid alternative to the US dollar, the euro is likely to be a key beneficiary as investors seek to diversify away from the USD. With the Fed potentially resuming rate cuts just as the European Central Bank ends its easing, and Middle East tensions receding somewhat—which would benefit Europe as an energy importer—the euro could find additional support. One key factor to monitor is the US economy: If data is stronger than expected, EURUSD could consolidate; if the US weakens, the pair may move more quickly toward our June 2026 forecast of 1.23.

AUD: We think that Australia's rising real household incomes and higher house prices—potential precursors for a modest domestic recovery—alongside easing US-China frictions should lift AUDUSD. Notwithstanding some near-term softness in labor data, the Reserve Bank of Australia still looks on track to cut rates by 75 basis points through the first quarter of 2026 (versus 100bps for the Fed). Continued government stimulus may result in stronger-than-expected economic data. With US-China trade tensions easing, we expect AUDUSD to rise toward 0.70 in the first half of 2026.

Review currency allocations

While we expect the US dollar's decline to continue over the coming year, the significant interest rate differential between the USD and the euro and Swiss franc in particular means that hedging or underweighting the US dollar is expensive. We believe this is an important time for investors to ensure their strategic currency allocations are appropriate for their personal situations and recently published a guide on how to do this (see "A practical guide to currency allocation" for more).

Switch USD bond holdings to EUR IG

Another avenue to reduce the USD exposure of portfolios is to switch USD bond holdings to those denominated in EUR. We hold an Attractive view on investment grade (IG) bonds, including EUR IG. We find the outright level of yields (over 3%) appealing as they are still elevated versus historical levels. Fundamentals generally remain solid, and we expect limited credit quality deterioration in the medium term.

Appendix

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