

Key Takeaways:

- While USD depreciation is a consensus macro view, positioning and valuation data suggest it is not yet fully priced, offering room for strategic allocation.
- A weaker USD is supported by both cyclical factors (e.g. rate differentials, relative growth revisions) and structural shifts (e.g. fiscal deterioration, declining reserve dominance).
- Tactical risks remain: short-term oversold signals and global macro shocks may support temporary USD strength.
- The potential for US exceptionalism via AI leadership and policy-driven growth exists, but markets already reflect high premiums, limiting near-term upside.
- Investors should consider equity proxies that historically benefit from dollar weakness - including EM and other ex-US equities, such as small-caps and commodity-linked exposures - to diversify and hedge against sustained USD depreciation.

USD Weakness - “Consensus”?

Anyone who has recently engaged in an FX discussion or read the latest Bank of America Fund Manager Survey might conclude that a weaker dollar view is ‘consensus’. The dreaded word in the active management community that typically ends further discussion on the topic. According to the latest Bank of America survey (July 2025), the most crowded trade is now “Short US dollar”.¹ One may strongly agree with this ‘crowded’ trade, having done extensive research already, and be content following the trend. If so, skip to page 4 to find five equity ideas that historically benefit from a weaker dollar trend. If not, this note will lay out the main arguments for the USD downside view and the common counterpoints. **Main takeaway - while dollar downside is a consensus theme, positioning and valuation data do not indicate a high degree of conviction. Therefore, investors can strategically position for USD depreciation, which we believe is supported by fundamental drivers.**

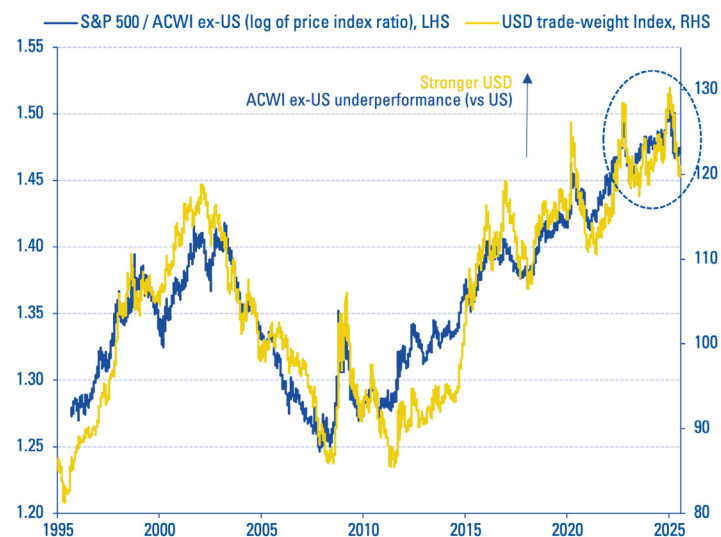
Positioning

Chart 1 provides a snapshot of current USD positioning in equity markets. It highlights the relative performance of US equities versus non-US equities over time and the close correlation to the nominal US trade-weighted dollar index (USD TWI). The year-to-date depreciation of the dollar (-7% based on the Fed nominal trade-weight index) coincides with non-US equity out-performance. The USD TWI is now closer to the bottom of its three-year range, making dollar shorts arguably unattractive for tactical investors. Longer term, if ‘consensus’ views are correctly identifying the downside risk for the world reserve currency, the USD TWI (gold line) is about 15% above its 30-year average and

40% above its 2011 low. Since 2011, US equities have outperformed ACWI ex-US over 400% points in USD total return terms.

Chart 2 illustrates another perspective: US equities continue to represent an outsized share of global portfolios. While this may reflect valid arguments around ‘US exceptionalism’ - such as stronger earnings growth, robust corporate governance, energy independence, and AI leadership - the dominance of US stocks does not imply broad consensus on dollar weakness. Or global investors believe “this time is different” and US stocks relative performance (to non-US stocks) can decouple from its historical correlation to the greenback.

Chart 1: US Equities (vs RoW) and the US Dollar



Source: Bloomberg

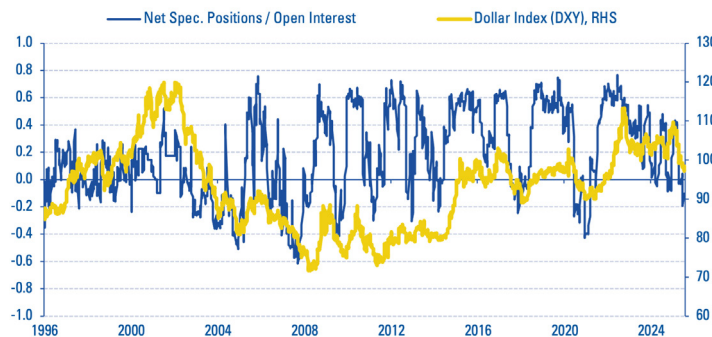
Chart 2: US market cap as a % of global equities



Source: Bloomberg and MSCI

CFTC data captures FX positioning in futures and options. Non-commercial traders - typically hedge funds and asset managers - serve as proxies for speculative activity in the broader FX market. Chart 3 shows recent net speculative data for the dollar index. The latest value is about 1.5 standard deviations below its 10-year historical average. In other words, the current short positions are below the historical norm, but not extreme (e.g. >2 standard deviations). One may backtest CFTC in different ways for tactical contrarian or momentum signals. Chart 3 shows that the USD trend can reverse sharply (e.g. 2021) when specs are short, or the trend can persist for years (e.g. early 2000s).

Chart 3: CFTC net speculative dollar positioning and DXY Index



Source: Bloomberg and CFTC

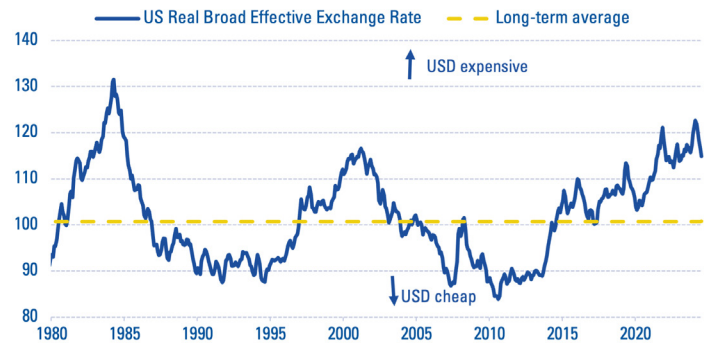
The Case for USD Weakness

As this paper highlights in the introduction, the case for dollar weakness is a consensus theme. Therefore, this section should serve as a summary of the key arguments rather than a comprehensive study on a ‘supposedly’ widely held view. If the reader is fully committed to the bearish case already, skip to the “Counterpoints” section on page 3. Otherwise, we provide a brief overview of the main drivers.

Valuation models suggest the dollar’s strength may be unsustainable. Estimates such as Purchasing Power Parity (PPP) and econometric models indicate that the greenback remains overvalued

relative to historical norms. The US Real Broad Effective Exchange (REER) provides a rough metric for how expensive the dollar has become (chart 4). The REER is 14% above its long-term average. Since 2011, the REER has appreciated 37% and has depreciated by 5% year-to-date. The historical series has been mean reverting over time, but trends can persist for years. The previous dollar peaks had notable catalysts including the Plaza Accord (1985) and the US recession/tech-bubble deflating around (2001-02). We believe there are cyclical and structural catalysts weighing on the dollar now.

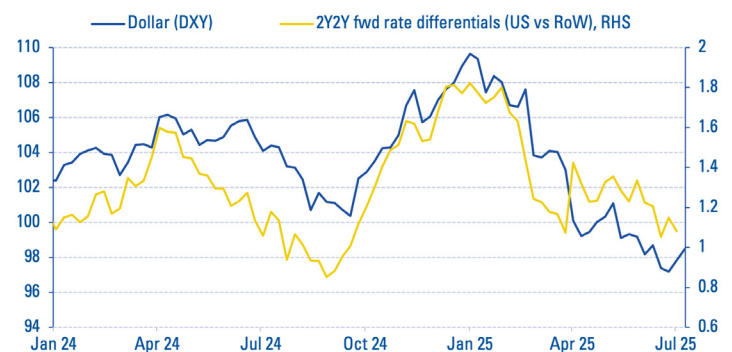
Chart 4: US Real Broad Effective Exchange (REER)



Source: Bloomberg

Cyclical drivers continue to support USD depreciation. Rate differentials (chart 5) align with recent trends, although the influence of interest rates on the dollar appears diminished relative to historical norms. Still, the chart shows there is some relationship over the past year. Relative growth differentials are also consistent with recent trends. Bloomberg year-ahead consensus US GDP forecasts have been downgraded 0.6 % points over the past six months. For comparison, Eurozone GDP forecasts have been upgraded marginally, and China GDP forecasts have fallen 0.1% points over the corresponding period. US growth expectations have been less exceptional.

Chart 5: US rate differentials and the DXY Index

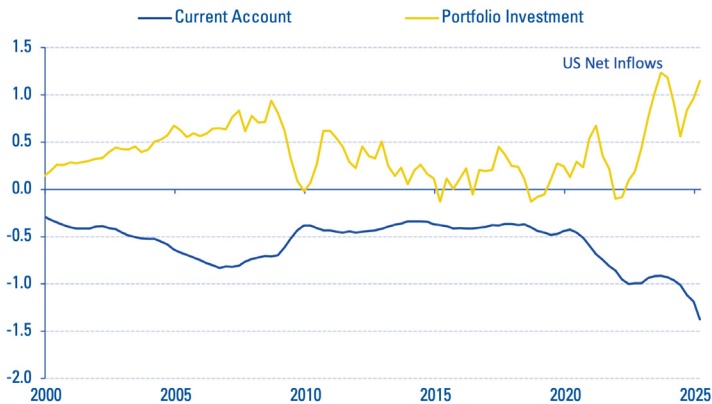


Source: Bloomberg

Structural drivers are outlined in Kenneth Rogoff's recent book *Our Dollar, Your Problem*. The book provides a comprehensive account of the post-WWII rise of the US dollar, past competitors, and the evolving risks to its dominance. The main take away is the dollar remains the world reserve currency and a sudden collapse is unlikely. However, we may be entering a 'post-peak dollar' phase as some of its strengths are eroding. External rivals (e.g. the EUR or RMB) are currently less obvious, but internal challenges (e.g. soaring debt, weakened institutions, and policy missteps) reduce its dominance and could usher in a more fragmented monetary system. We generally agree that the dollar is and will remain the world reserve currency over the foreseeable future. Nevertheless, that status does not exclude the possibility of material dollar depreciation (e.g. the USD TWI fell 28% between 2001 and 2008). Additionally, a less dominant US dollar implies a weaker trend given valuations remain rich on most measures.

Several policies from the current administration - including efforts to narrow the trade deficit - may encourage diversification away from US assets and the repatriation of capital from countries with net international investment surpluses. Portfolio inflows have been an important tailwind for the world reserve currency (chart 6), and this will likely become less supportive if the Trump administration is successful in reducing the US current account deficit.

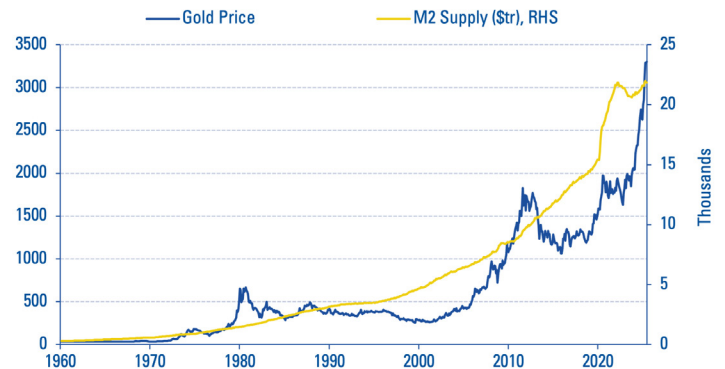
Chart 6: US current account and portfolio flows (USD trn)



Source: Bloomberg and BEA

In addition to the current account deficit, the US fiscal deficit is gaining more attention following the passage of the One Big Beautiful Bill (OB BB). The Penn Wharton Budget Model projects the US deficit to increase over 2025 to 2034, pushing US debt levels higher. Currency debasement – defined as a loss of value via inflation and financial repression – is a growing risk and already underway based on the historical appreciation of gold (chart 7) and arguably also Bitcoin. Central bank reserve diversification into gold is also contributing to this trend, and gold has appreciated relative to all major currencies over the long-run.

Chart 7: Gold price (/oz) and M2 supply (USD trn)



Source: Bloomberg

The Counterpoints

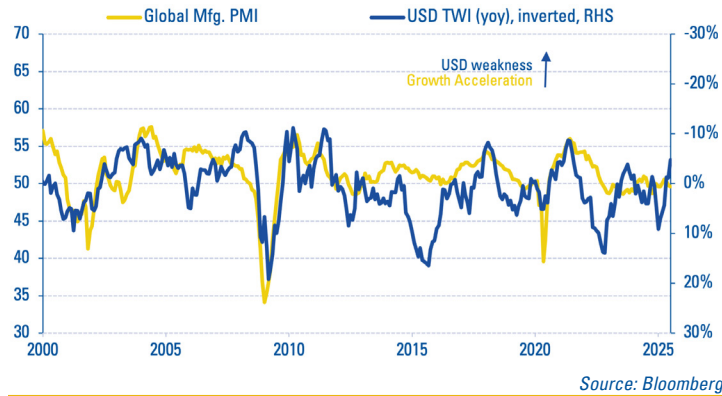
The previous section highlights some arguments for dollar downside, which have often been cited in various investment reports. We expect the dollar will depreciate over the coming years due to the factors outlined. This section outlines key risks and opposing arguments to our USD depreciation thesis.

The **first** counterpoint is tactical. The dollar has depreciated rapidly and now appears oversold based on several indicators. As highlighted earlier, CFTC positioning shows a build-up of USD short positions that will eventually need to be closed. From a short-term perspective, foreign exchange markets rarely move linearly and the DXY may be higher rather than lower over the next one to three months.

The **second** counterpoint is rate differentials may not continue moving against the USD. Roughly four Fed rate cuts are already priced over the next year, implying rate cuts are also a consensus view. If the Trump administration successfully boosts the US economy following the OB BB, rates and growth expectations may need to reprice higher – i.e. a return to US exceptionalism. However, economic growth projections are still subdued given the potential negative impacts from tariffs and immigration restrictions. Also, President Trump has explicitly posted that the “Fed should cut Rates by 3[%] points”. Even assuming the Fed acts independent when Powell's term ends in May 2026, political pressure will remain on the FOMC board for lower rates, and the new Fed chair will likely be adding a more dovish voice to the 12-member FOMC committee.

The **third** counter relates to the greenback's historical countercyclical relationship to growth (chart 8). If global growth weakens materially into a recession scenario, the dollar historically appreciates as a safe haven. A severe disruption to global trade, potentially triggered by a global trade war, could cause a sharp growth downturn and a flight to safety. Historically, owning more dollars is the safe-haven trade. However, the 2001 US recession was followed by a period of dollar weakness. The counter-cyclical correlation does not always apply. In addition, the dollar failed to rally in April 2025, following the Liberation Day shock, indicating some deterioration in its safe-haven status.

Chart 8: Global manufacturing PMI and the USD



The **fourth** argument to highlight also relates to tariffs. Recall the original consensus expectation was the dollar would rally in response to tariffs, as exporters to the US (e.g. China) could weaken their currencies to offset the cost of tariffs and maintain export competitiveness. From anecdotal evidence, these expectations are less prevalent but may still play some role in FX trends. The evidence so far reveals the US effective tariff rate has risen and the US dollar has depreciated.

Finally, Artificial Intelligence (AI) represents one of the most important long-term macroeconomic themes. The US currently leads in AI development and could see disproportionate gains, potentially supporting USD strength through capital inflows. However, similar to the rise in the personal computer and the internet, large productivity gains may not be evident within our one-to-three-year forecast horizon. Also, developments by China's Deepseek in January 2025 highlighted the challenges in monopolising generative AI technology. Overall, it may be premature to position for the next wave of US exceptionalism, particularly in US markets that already reflect a large premium.

Conclusion

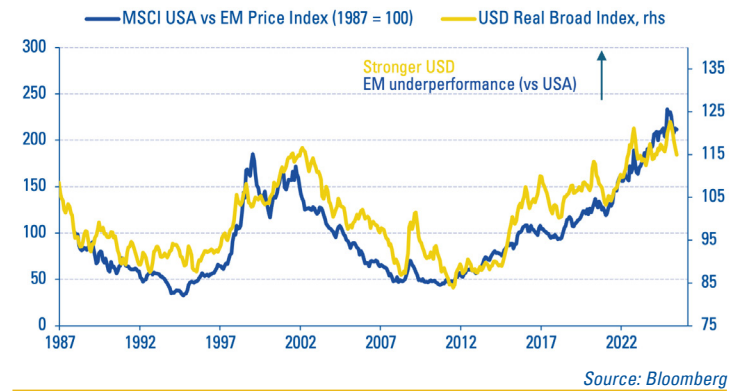
Our base case anticipates a 10–20% depreciation in the US dollar over the next three years, driven by rich valuations and weakening structural supports. Although downside is a consensus view, positioning and valuations suggest it is only partially priced in. A strategic portfolio should include exposures that benefit from sustained USD weakness. We provide five equity proxies that should benefit from dollar depreciation.

Equity Proxy #1 – ACWI ex-US outperformance

The latest Bank of America Fund Manager Survey also reflects a growing consensus that international equities will outperform. As illustrated in Chart 1, non-US stocks have only partially reversed their underperformance since 2011, suggesting a favourable entry point for increasing exposure to ex-US indices. This note has focussed mostly on US-specific drivers for brevity. However, various policies in non-US majors should support growth in their respective markets. Some examples are increased German fiscal spending, corporate governance reforms in Japan and South Korea, and greater demand for commodities linked to decarbonisa-

tion and AI. The relatively smaller size of ACWI ex-US (compared to US) means that even a modest inflow could have a disproportionately positive impact.

Chart 9: US Equities relative to EM and the US REER



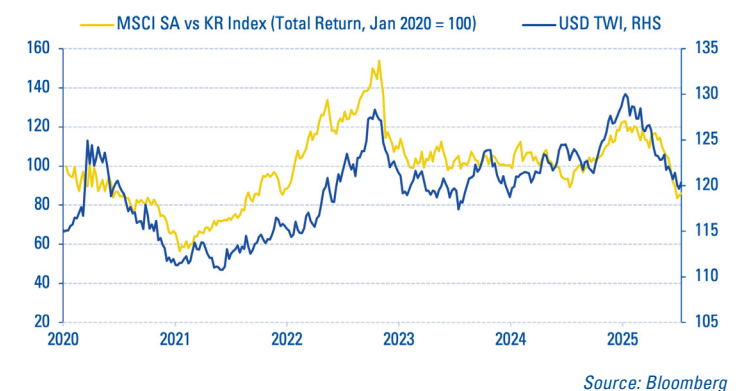
Equity Proxy #2 – Overweight EM versus US

Within the ACWI ex-US universe, our *Developed Markets Quarterly* has consistently maintained a constructive outlook on Emerging Markets (EM). Historically, EM assets have outperformed during periods of USD depreciation (see chart 9), and they also offer meaningful exposure to AI through local tech sectors.

Equity Proxy #3 – South Korea outperformance versus Saudi Arabia

Within EM, the relative performance of South Korea to Saudi Arabia has historically tracked the USD trend (chart 10). We continue to favour South Korea, supported by South Korea's improving corporate governance, while Saudi Arabia continues to maintain a dollar peg. These themes are discussed in more detail in our *Emerging Markets Quarterly*.

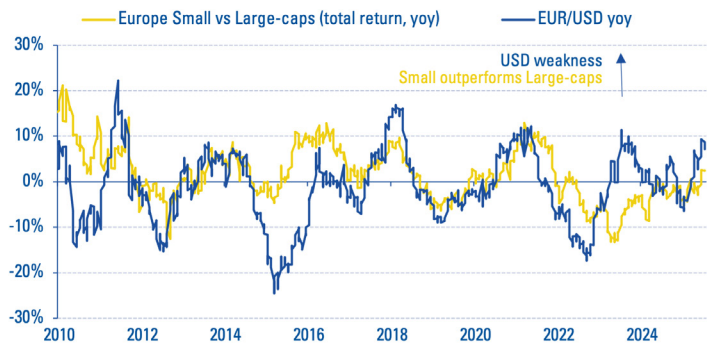
Chart 10: MSCI Saudi Arabia relative MSCI South Korea and the US dollar



Equity Proxy #4 – Favour DM ex-US small-caps versus large-caps

We have a positive bias toward small-cap equities within developed markets ex-US, as they can outperform large-caps during USD bear cycles. In Europe, for example, small-caps are more domestically focused and benefit directly from EUR strength, whereas large-caps are often exporters or multinationals, which may be negatively impacted by currency appreciation (see chart 11).

Chart 11: Europe small-caps vs. large-caps and EUR/USD

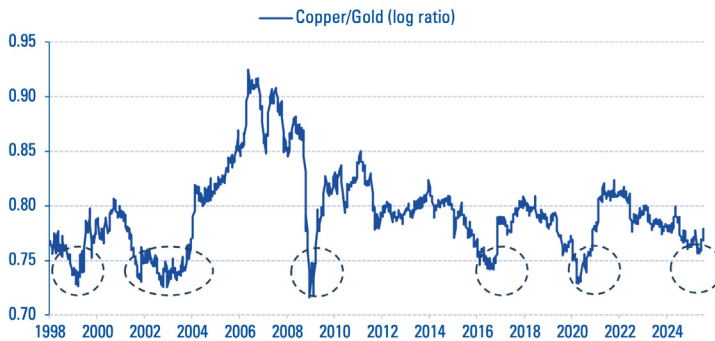


Source: Bloomberg

Equity Proxy #5 – Overweight Gold and Copper

Our *Cross-Asset Quarterly* maintains an overweight allocation to precious metals, with gold miners serving as a suitable equity proxy. Gold remains supported by central bank purchases and reserve diversification trends, while concerns around USD debasement provide additional tailwinds. However, long gold is becoming a more crowded trade on some measures. Copper has lagged gold in recent years (chart 12), in part due to weaker demand from the largest consumer China. Still, long-term demand projections remain favourable as major economies adopt more electric vehicles and improve energy infrastructure. Physical copper, miners, and countries exposed to copper (e.g. Chile) should benefit from a weaker USD trend.

Chart 12: Copper/Gold Ratio



Source: Bloomberg

Justin Kariya

July 23, 2025

ⁱ Note that “Long Magnificent 7” is currently ranked the second most crowded trade. The Bloomberg Magnificent 7 Total Return index is trading around all-time highs at the time of writing.



CITY OF LONDON
Investment Management Company Limited

Contacts

Macroeconomic Analysis

London Office

77 Gracechurch Street
London EC3V 0AS
United Kingdom

Phone: 011 44 20 7711 0771

Fax: 011 44 20 7711 0774

E-Mail: info@citlon.co.uk

Philadelphia Office

17 East Market Street
West Chester, PA 19382
United States

Phone: 610 380 2110

Fax: 610 380 2116

E-Mail: info@citlon.com

City of London Investment Management (Singapore) Pte. Ltd. Office

20 Collyer Quay

10-04

Singapore 049319

Phone: 011 65 6236 9136

Fax: 011 65 6532 3997

Website

www.citlon.com

www.citlon.co.uk

Disclosures

City of London Investment Management Company Limited (CLIM) is authorised and regulated by the Financial Conduct Authority (FCA) and registered as an Investment Advisor with the Securities and Exchange Commission (SEC). CLIM (registered in England and Wales No. 2851236) is a wholly owned subsidiary of City of London Investment Group plc. (CLIG) (registered in England and Wales No. 2685257). Both CLIM and CLIG have their registered office at 77 Gracechurch Street, London, EC3V 0AS, United Kingdom. City of London Investment Management (Singapore) Pte. Ltd. is a wholly owned subsidiary of CLIM.

While CLIM has used reasonable care to obtain information from reliable sources, no representations or warranties are made as to the accuracy, reliability or completeness of third party information presented herein. No responsibility can be accepted under any circumstances for errors of fact or omission. Some of the information in this document may contain projections or other forward looking statements regarding future events or future financial performance of countries, markets or companies. These statements are only predictions as of the date of this document which could change without notice and actual events or results may differ.

This document does not constitute an offer to sell or the solicitation of an offer to buy any securities. Nothing herein should be construed as investment advice to buy or sell any securities. Past performance is not a guide to future results. The value of an investment and any income from it can go down as well as up and investors may not get back the original amount invested.

The MSCI ACWI Index is designed to represent performance of the full opportunity set of large- and mid-cap stocks across 23 developed and 24 emerging markets.

The Bloomberg Terminal service and data products are owned and distributed by Bloomberg Finance L.P. (“BFLP”). BFLP believes the information herein came from reliable sources, but does not guarantee its accuracy. No information or opinions herein constitutes a solicitation of the purchase or sale of securities or commodities.