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KEMPEN

INVESTMENT MANAGEMENT

Global Currency Stability

Is the US dollar's role challenged?

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For Professional Investors only

A strategic inflection point

The US economy has outperformed almost every other over the past century delivering the dollar the unchallenged status as the global reserve currency. Along with this, the US benefits from significant economic flexibility but this story of US exceptionalism is well documented. However, with the return of President Trump and a shifting geopolitical landscape, investors must now consider whether recent changes are cyclical or structural, and what that means for long-term portfolio positioning.

This evolving environment poses a critical question for pension funds and trustees: was the dollar's sharp decline in early 2025 a temporary correction, or does it mark the beginning of a more structural, long-term transformation? And how should trustees prepare for a potential new currency regime? Those who act early will be better placed to turn uncertainty into strategic advantage.

Why the dollar still matters

The US dollar has been the dominant global reserve currency since the end of Second World War. It has long been trusted by central banks and viewed as a safe haven during periods of market stress. Today, it still accounts for around 58% of global foreign exchange reserves¹, although this has declined by 13% over the past two decades. Gold and the euro remain distant challengers.

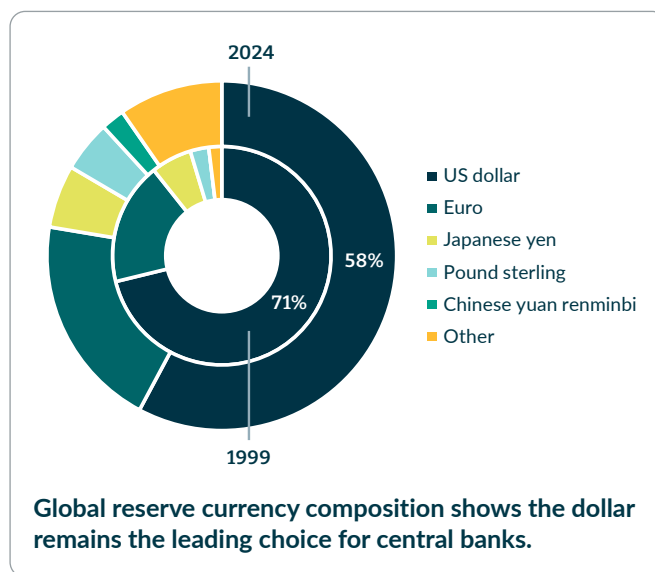
Its influence extends beyond reserves. The dollar plays a central role in global trade, particularly in commodities such as oil, and remains dominant in international payments. As of March 2025, it represented nearly half of SWIFT transactions and more than 80%² of trade finance. This widespread use supports the dollar's strength and allows the US to run large trade deficits while maintaining geopolitical influence.

Much of this resilience has been attributed to US exceptionalism. Real GDP in 2024 stood nearly 4% above its pre-pandemic trajectory, while most other major economies remain below trend. This outperformance, which mirrors patterns seen after both the global financial crisis and the Covid-19

pandemic, has been driven by robust consumer spending, elevated productivity, a dominant tech sector and a resilient labour market.

Early and aggressive action by the Federal Reserve also helped boost yields and attracted global capital. Together these factors have continued to reinforce the dollar's global dominance. But that status is now being tested. A new set of pressures is emerging, each with implications for trustees and long-term portfolio strategy.

Figure 1: Despite headwinds, the dollar still dominates reserves



Source: International Monetary Fund – Currency Composition of Official Foreign Exchange Reserves

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¹ Source: International Monetary Fund – Currency Composition of Official Foreign Exchange Reserves

² Source: MacroMicro & The Society for Worldwide Interbank Financial Telecommunication (SWIFT)

Five forces reshaping the US dollar's global role

Behind the dollar's recent volatility lie deeper structural shifts. From geopolitics to fiscal policy, five forces are reshaping how the world sees and uses the US dollar.

1. Weaponisation of the dollar through sanctions

The US has increasingly used its financial infrastructure to enforce sanctions, most notably against Russia and Iran. In response several countries have stepped up efforts to reduce their reliance on US-denominated assets, a trend known as 'de-dollarisation'.

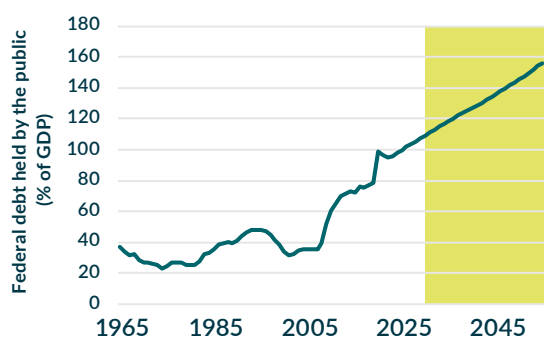
While gradual, it is placing sustained pressure on the dollar's dominance. Gold has emerged as a preferred alternative, with central banks increasing purchases to record levels, signalling a desire to diversify away from the US dollar.

2. Rising US debt and long-term fiscal concerns

US public debt is projected to reach historic highs, raising concerns over long-term sustainability. Credit rating agency Moody's recently downgraded the US from its top-tier rating to 'Aa1', reflecting these pressures. This could lead to higher borrowing costs, undermining confidence in the dollar.

The fiscal deficit, already exceeds 7% of GDP and is expected to widen further under Trump's proposed tax policies. For a currency that underpins the global financial system, this, casts doubts on the dollar's future credibility as a reserve currency.

Figure 2: US debt trajectory raises long-term concerns



Public debt as a percentage of GDP is forecasted to grow significantly, challenging fiscal sustainability.

Source: Congressional Budget Office

3. Trade policy and its impact on dollar strength and global growth

The Mar-a-Lago Accord, signed in early 2025, marked a strategic shift in US trade policy. Higher tariffs and a weaker dollar are now central to efforts to correct trade imbalances and revitalise domestic industry. Echoing the 1985 Plaza Accord, the Trump administration aims to rebalance global trade by weakening the dollar, restructuring sovereign debt and using tariffs as both economic levers and geopolitical tools.

However, the US faces a strategic dilemma: it aims to curb capital inflows that strengthen the dollar, while still relying on foreign investment to finance its deficits, a balancing act that, if mismanaged, may erode confidence in the dollar's global role.

4. Signs of fading American exceptionalism

After years of strong performance, the US economy is showing signs of cooling. Growth is forecast to slow to 2.4% in 2025, with unemployment expected to peak at 4.2% mid-year. A contraction in the first quarter, downgraded IMF forecasts, and narrowing yield premiums all point to slowing momentum, as inflation, rising borrowing costs and trade frictions weigh on activity.

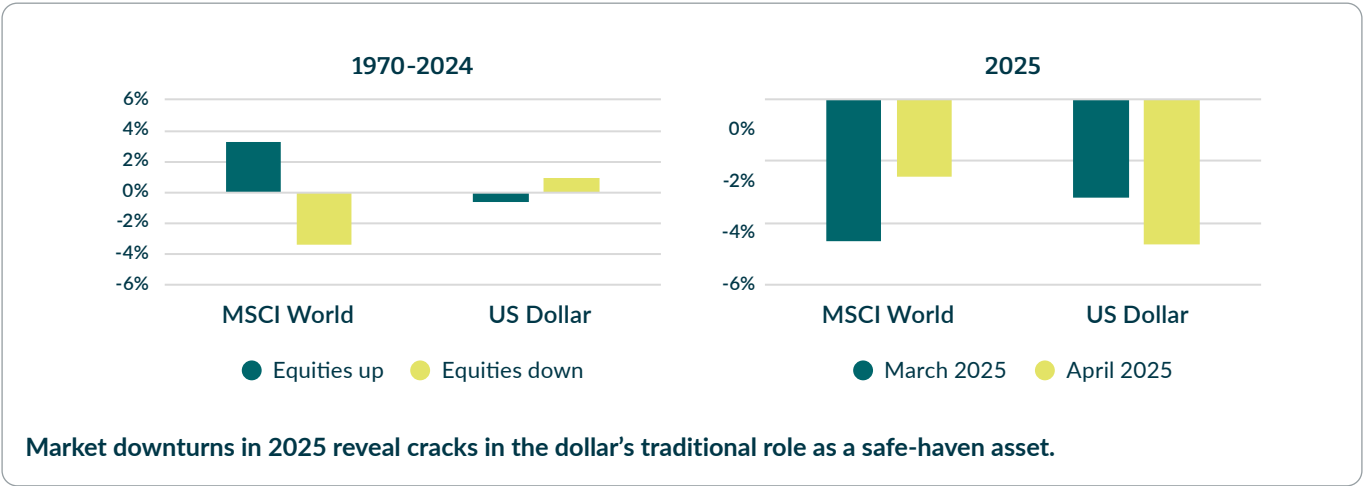
Recent capital outflows suggest investors are reassessing their exposure. While this may be cyclical it highlights the need for broader portfolio diversification.

5. Pressure on the dollar's safe haven status

Safe-haven assets typically attract demand during periods of economic stress or geopolitical instability, with the US dollar historically benefiting from this dynamic. In past downturns, the dollar has offered a partial hedge when equities fell.

But in 2025, sentiment-driven selling has weighed on the dollar, even in risk-off environments. That said, during global panic, investors tend to liquidate assets to raise cash, typically in US dollars. This such actions typically lead to dollar appreciation, particularly as demand for US Treasuries rises.

Figure 3: Dollar's safe-haven status tested in 2025



Sources: J.P. Morgan Wealth Management, Bloomberg Finance L.P. ata as of April 24, 2025.

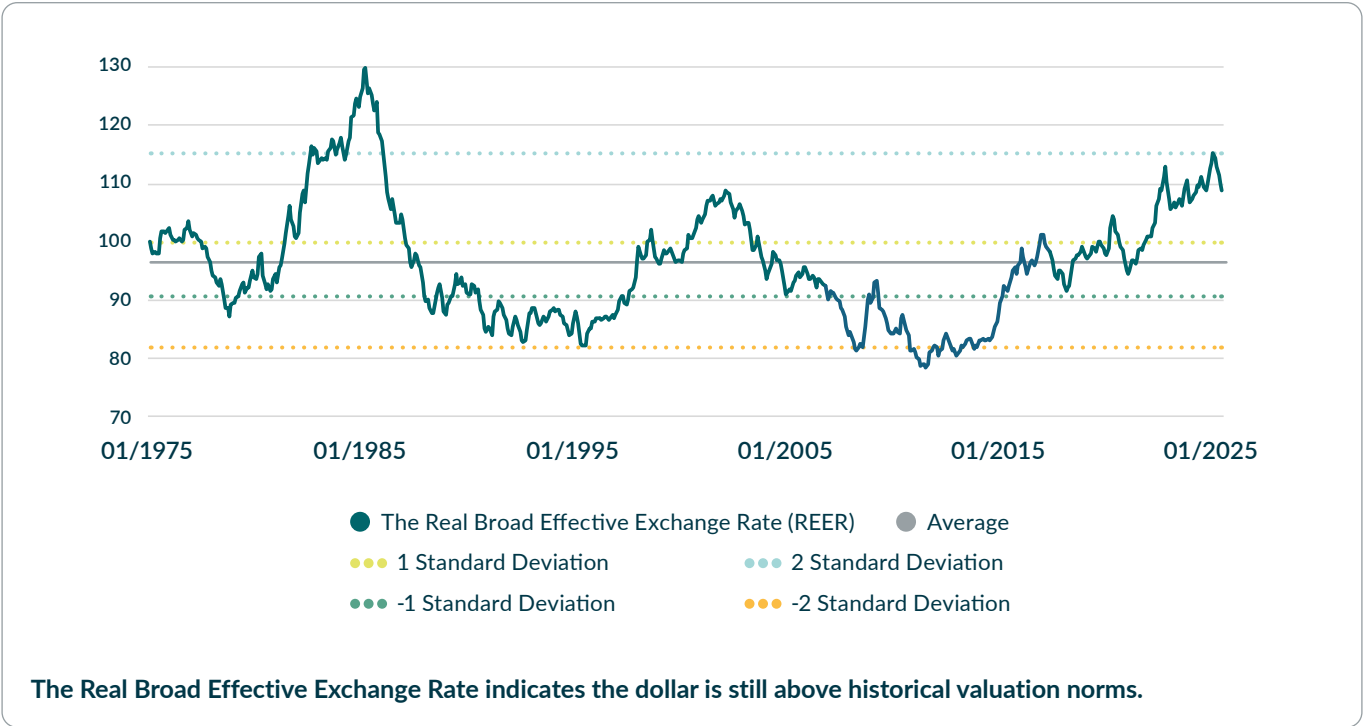
Is the US dollar still overvalued?

Currency markets are notoriously challenging, especially when geopolitical dynamics are involved. In recent years, the narrative around an overvalued US dollar has gained traction, with President Trump among those advocating for a weaker currency.

The US dollar fell by approximately 11% in the first half of 2025, its steepest decline in over five decades, marking the end of a 15-year bull cycle. Although it recovered by 3.2% in July, the risk of further depreciation remains elevated, sparking debate over whether this marks a structural shift or a temporary correction.

From a valuation standpoint, the dollar still appears stretched. Using the US Real Broad Effective Exchange Rate (REER), it has only recently dipped below the threshold of two standard deviations above its 50-year average, a level that historically signals potential for further downside.

Figure 4: Valuation metrics suggest dollar remains stretched



Source: Bank for International Settlements via FRED. The Real Broad Effective Exchange Rate (REER) is an index that measures the value of a country's currency relative to a basket of other major currencies, adjusted for inflation differentials. Data before 31/1/1994 is backfilled using the Real Narrow Effective Exchange Rate.

Key considerations for pension funds: What should trustees be asking?

How resilient is the portfolio to rising geopolitical and macroeconomic volatility?

Greater unpredictability is likely, driven by shifting geopolitical dynamics, evolving trade relationships, and rising fiscal pressures. While the dollar remains central, its role as the global reserve currency is facing gradual challenges, including concerns around debt levels, trade policy, and its use in sanctions. This trend introduces greater currency volatility and geopolitical risk.

Should the allocation to US assets be reconsidered?

The US remains a key driver of global growth, led by its tech sector and deep capital markets. However, rising concentration risk, especially in large-cap tech, warrants attention, with the MAG 7 now larger than the market cap of the next seven largest MSCI ACWI countries combined.

While these companies continue to benefit from strong earnings and durable competitive advantages, overexposure to a single market or sector increases vulnerability. Rather than reducing exposure outright, investors may consider diversifying, rebalancing, and reviewing currency strategies to manage risk while retaining US exposure.

Are there other tail risk hedges worth considering?

The US dollar's 2025 performance has been largely sentiment-driven, with global funds reducing exposure and triggering sustained selling, even in risk-off environments. Still, the dollar remains a core safe-haven asset, especially amid rising geopolitical and fiscal uncertainty. In this context, investors may benefit from broadening tail-risk hedging strategies through greater diversification, looking beyond the dollar to assets with different defensive characteristics.

Central banks are increasingly turning to gold, while currencies like the yen and Swiss franc, valued for their neutrality and liquidity, also tend to perform well during periods of market stress. Their appeal, however, can shift with changes in monetary policy and broader market dynamics.

One challenge is that investors could retain a US dollar tail-risk exposure without adjusting their asset allocation, simply by not hedging US dollar denominated assets, which are often plentiful in institutional portfolios. Building meaningful exposure to alternatives such as the franc or gold in enough scale to create a tail risk hedge would require adjusting allocations for many investors.

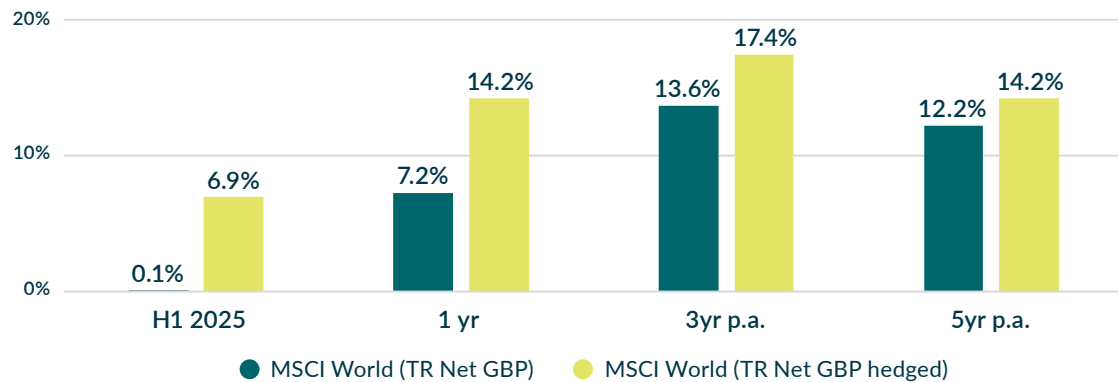


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Is it time to reconsider currency hedging ratios?

With US policy increasingly influencing the direction of the dollar, now may be a prudent time for pension funds and trustees to reassess currency hedging strategies. The dollar's recent weakness has reversed the tailwinds unhedged investors enjoyed in prior years, introducing greater short-term volatility. As shown in Figure 5, FX effects created a swing of nearly 7% in equity returns over the first half of 2025 underscoring the impact of currency exposure on performance.

Figure 5: Currency hedging impacts equity performance



FX effects created a ~7% swing in equity returns over H1 2025, highlighting the importance of hedging strategy.

Sources: Van Lanschot Kempen, Refinitiv

While currency markets tend to balance out over the long term, short-term volatility can be significant. This is particularly true for de-risked pension schemes who may hold substantial non-GBP fixed income holdings, where unhedged FX exposure can materially affect returns, unlike in equities, where currency impact is typically less pronounced. What is key is to decide if strategically (long-term) there is a case for a certain hedge ratio and if a tactical or dynamic short-term overlay is suitable – the latter being notoriously hard to predict.

Focus for pension trustees

External factors: Monitor macro shifts

1. 'Weaponisation' of the dollar
2. US borrowing and sustainability
3. US trade policy and tariffs creating a global slowdown
4. Could US exceptionalism be waning?
5. Is the US dollar's 'safe haven' status under threat?

Internal factors: Monitor your portfolio

2. How resilient is the portfolio to rising geopolitical and macroeconomic volatility?
3. Should the allocation to US assets be reconsidered?
4. Are there other tail-risk hedges worth considering?
5. Is there a need to reconsider currency hedging ratios?



Preparing for a shifting currency regime

The dollar may still be dominant, but dominance does not mean it will be forever, or that FX rates will remain static forever.

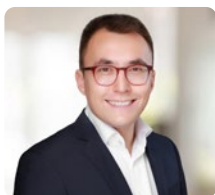
It is premature to call time on the dollar's reserve currency status, but cyclical shifts and deeper structural forces are reshaping its global role. Trustees should weigh up the implications of a currency that is increasingly politicised and with tail risks if the status quo of US exceptionalism declines.

The key question is not if the dollar will face pressure, it would be possible to consider pressure on all currencies which are notoriously difficult to "call".

The key question is are trustees positioned to ensure they manage currency risk appropriately. Strategic positioning, through thoughtful portfolio construction, tailored asset allocation, and proactive risk management will be essential to navigate this new landscape.

Now is the time to turn to building a currency strategy fit for a more resilient future.

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