

PM Perspectives

Have we seen the local USD peak?

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The backdrop

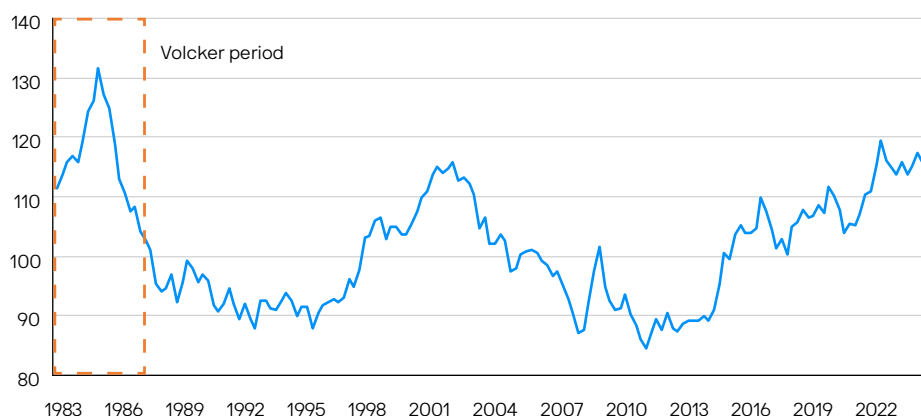
When it comes to the US dollar, we have been expecting weakness, as expressed in our recent Bond Bulletin (see [“The Euro Breaks Free as Risk Premiums Unwind”](#), 20 February 2025). We believe the US dollar peaked in mid-January, and remain positioned for dollar weakness in our active currency portfolios and overlays, such as in our Global Aggregate strategy. We also caution against using the dollar to hedge broader risk-on portfolios given the scale of the shift in global capital towards US risk assets.

Degrees of exceptionalism.

The US is an exceptional economy, and punches well beyond its weight. A common refrain at this year's World Economic Forum meeting in Davos was that the US is 4% of the population, 25% of global GDP and 60% of global market capitalisation. Location matters, however, and the dollar now sits at its highest level since the Volcker period of the early 1980s ([Exhibit 1](#)).

Exhibit 1: Fed trade-weighted real dollar index since 1983

Fed trade-weighted real dollar index



Source: Federal Reserve Economic Data, J.P. Morgan Asset Management. Data as of December 2024.

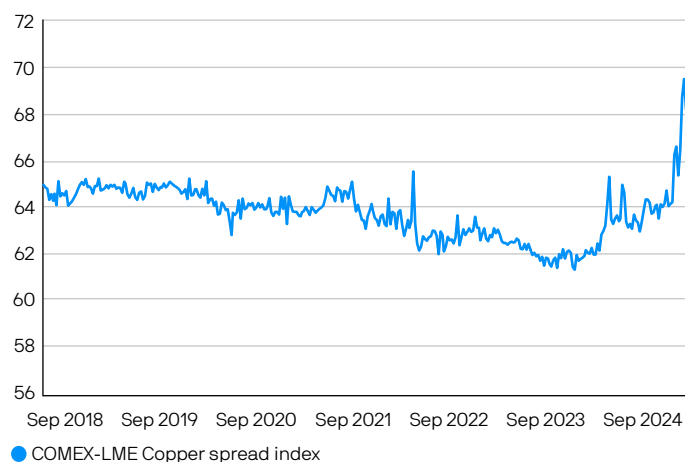
To maintain this valuation, or move higher, the US must continue to outperform the rest of the global economy, which is a tough ask given the current starting point. Any signs of a reversal trend is likely to spark dollar selling. But where could these signs emerge from? We're keeping a close eye on tariffs and trade, capital flows, and interest rate differentials and hedging costs.

Tariffs and trade

The dollar has strengthened, in part, due to President Trump's implementation of tariffs on Chinese imports, and the threat of higher and broader tariffs to come. Currencies have adjusted to account for the potential terms-of-trade shock. This policy is not costless to the US economy, however, and past experience shows that poorly designed tariffs can hurt the industries they were intended to protect—for example, in the recent move to place tariffs on steel and aluminum imports.

Tariffs may be justified on national security grounds but there is an economic cost even before they come into effect, with US manufacturers rushing to get commodities into US warehouses and driving up costs relative to prices paid elsewhere in the world. A clear example of this is seen in the COMEX-LME spread for copper (**Exhibit 2**).

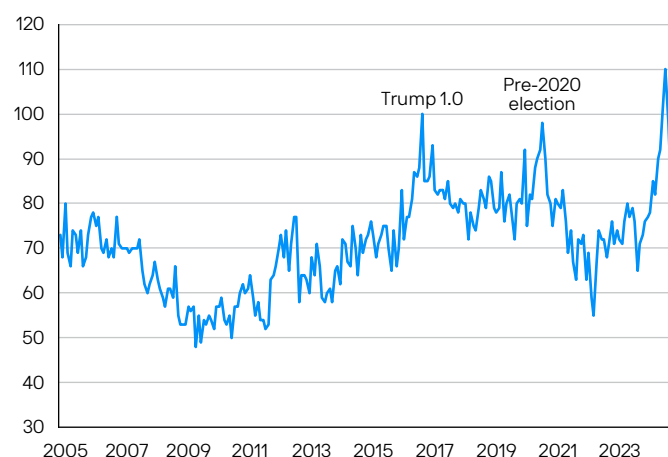
Exhibit 2: comex-lme copper spread index



Source: Bloomberg, J.P. Morgan Asset Management. Data as of 21 February 2025.

Uncertainty over tariffs will likely dampen sentiment at US manufacturers, who were upbeat on the prospect for deregulation. We would expect the ISM manufacturing index to start falling the longer the uncertainty persists, especially if the rise in core input costs keeps the Federal Reserve (the Fed) from cutting interest rates—as happened in 2018 during the first trade war. The NFIB Index, which measures sentiment across 800 small US companies, already suggests that some of the euphoria around President Trump's election win will be difficult to maintain—the headline index has dropped, while the measure of uncertainty is at a level not seen outside of election months (**Exhibit 3**).

Exhibit 3: NFIB small business uncertainty index



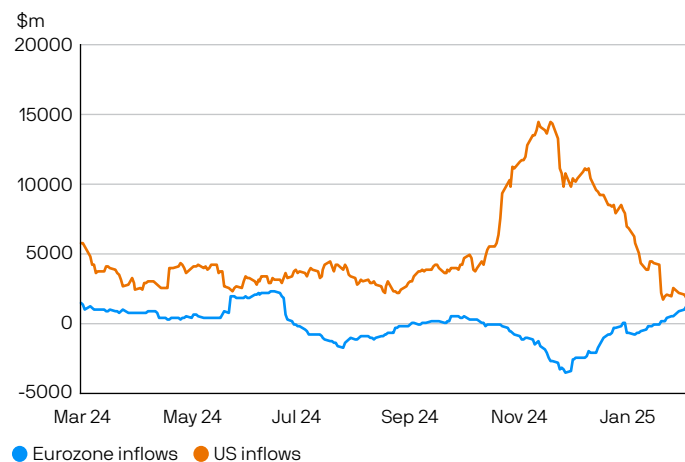
Source: Bloomberg, J.P. Morgan Asset Management. Data as of 31 December 2024.

Capital flows

Capital flows have also boosted the US dollar. We track over 17,000 mutual funds and ETFs to build a map of global capital flows. Our data reveals that the election of President Trump sparked huge inflows into US risk assets and a liquidation elsewhere, continuing a theme that began with ChatGPT's emergence into the broader public domain. Most risk assets are likely to be unhedged, so these inflows into the US will have had a direct currency impact.

Given US valuations, we see these inflows as a misallocation. In a benign scenario, the performance of European defence stocks and Chinese technology stocks have reminded investors that good stories are not exclusively found in the US—and that things only need to get less bad to trigger big price moves. In a more malign scenario, US earnings may fail to justify current valuations, and a correction in US assets would see capital repatriated. As the latest ETF flows data shows, we have tentatively started to see a reversal of the post-election flows into the US, supporting currencies away from the dollar (**Exhibit 4**).

Exhibit 4: ETF monthly cross-border flows across regions



Source: Bloomberg, J.P. Morgan Asset Management. Data as of 19 February 2025.

For this reason, we are cautious about using the US dollar as a hedge for broader risk in our fixed income portfolios. While a drop in risk assets would initially see the dollar appreciate in reaction to increased volatility, we believe the eventual outcome would be a weaker dollar, as risk positions get decompressed. The Fed also has the most room to respond to an adverse shock by cutting rates.

Interest rate differentials and hedging costs

The inflows into US capital markets from abroad are less likely to be hedged than in previous periods. The reason is partly because foreign investors have been buying more equities vs. bonds, and also because the cost of hedging is now more expensive. The risk to the dollar here is two-fold.

First, the dollar's multi-year appreciation and high carry has seen hedge ratios drop to very low levels. Investors are running huge amounts of currency risk where their liabilities and reporting currencies are not US dollar-denominated.

Second, should there be any weakness in global growth, the US has more room to cut rates and, arguably, has the most dovish central bank relative to its growth and inflation outlook. Just ask yourself, where would eurozone rates be today if Fed chair Powell was in the shoes of European Central Bank president Lagarde? We suspect that they'd be lower. This interest rate dynamic reduces the US dollar's utility in a risk off environment, and suggests that funding currencies, such as the Japanese yen or Swiss franc, could stand to benefit more.

Conclusion

With the Trump administration moving fast with tariffs, the first response from many investors has been to buy US dollars. In our view, however, the outlook for the US dollar is poor. The currency appears to be over-valued and over-owned, and looks to be highly susceptible to a change in market narrative—be it a China growth surprise, a European equity renaissance, a US manufacturing wobble, or any other shift in sentiment away from the US. While it's difficult to predict these moves in advance, we do see a clear asymmetry for the US dollar from here.

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