FX in Focus

Loss of US Exceptionalism Strengthens Case for FX-Hedging US Equities (Fishman/Kanter)

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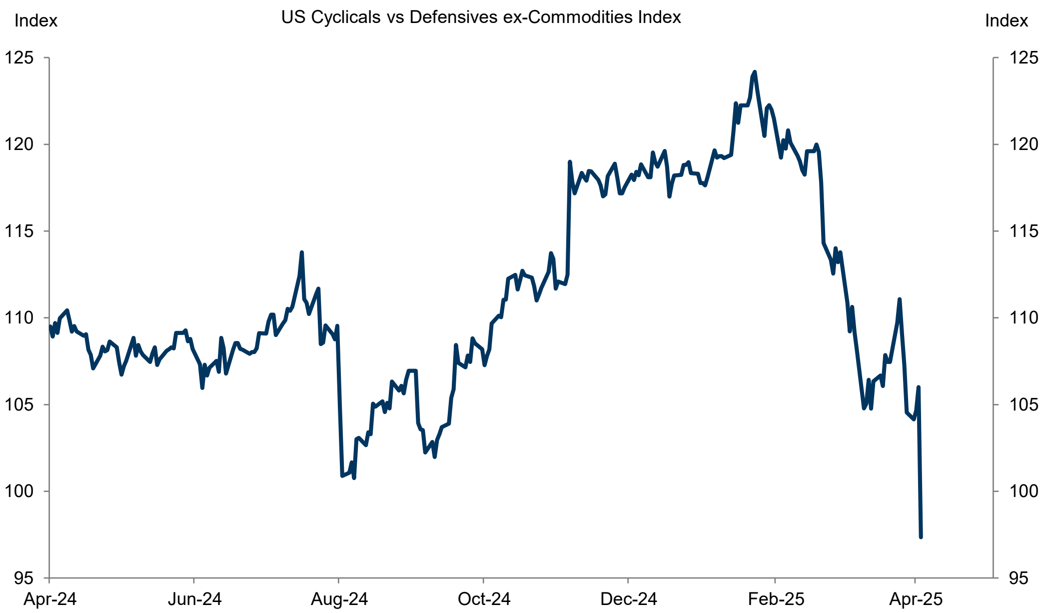
- The loss of US exceptionalism and higher recession risk argue for a shift in hedging strategy. The macro backdrop in recent years has leaned *against* FX-hedging US equities from a foreign investor perspective and *in favor* of FX-hedging non-US equities (particularly in Japan) from a US investor perspective. In a few short months, those conclusions have flipped.
- The case for foreign investors to *raise* hedge ratios looks particularly clear—especially in Japan and Europe. Meanwhile, we think US investors should consider *reducing* hedge ratios or simply buying non-US equities unhedged. Higher odds of a US downturn would normally argue for US investors to *increase* FX-hedging of non-US equities, as reducing foreign currency exposure has historically raised returns during equity bear markets. But we see reason for more caution in the current backdrop.
- First and foremost, a world of more balanced global growth and better return prospects abroad allows for more frequent (and longer-lasting) periods when the Dollar and equities sell off together. Foreign investors' shift towards unhedged US equity exposure in recent years also leaves scope for bigger episodes if strategies adjust. Price action on April 3 clearly reflected this dynamic; the S&P 500 and EUR/USD saw the largest 1-day combined move since 2000 (mainly driven by equities). With higher tariffs and an economy closer to recession, markets may also become more worried about US stagflation if the Fed appears hesitant to cut as growth momentum slows. That scenario should weigh more heavily on the Dollar, particularly against the Yen.
- The risk remains that tariffs ultimately depress economic growth in the rest of the world more than in the US, boosting the Dollar from subsequent shifts in relative rates. But a broader set of tariffs (vs mainly China in 2018-2019) generally weakens the incentive for foreign producers to lower prices, leaving the US more likely to adjust. Moreover, elevated policy uncertainty and FX volatility look likely to remain features of the year ahead. And, outside the US, there may not be a sufficient growth hit from tariffs to outweigh the recent optimism on return prospects abroad. As a result, we think US investors should be better off adding JPY, CHF, and even EUR exposure as protection rather than raising hedge ratios on non-US equities. This is one reason why we now expect to see further Dollar depreciation over the coming year.

Loss of US Exceptionalism Strengthens Case for FX-Hedging US Equities

The loss of US exceptionalism and higher recession risk argue for a shift in hedging strategy. A common proxy for US growth pricing—US cyclicals versus defensives stocks—dropped 8% on April 3, furthering the equity market correction already under way (Exhibit 1). The backdrop of US exceptionalism in recent years has leaned *against* FX-hedging US equities from a foreign investor perspective and *in favor* of FX-hedging foreign equities (particularly in Japan) from a US investor perspective. In a few short months, those conclusions have flipped.

Exhibit 1: A common proxy for US growth pricing dropped 8% on April 3



Source: Bloomberg, Goldman Sachs Global Investment Research

Our hedging framework outlines four main considerations that should be on an investor's "checklist" before deciding to reduce foreign currency exposure or not, with some factors receiving greater weight than others depending on the type of investor.

1. **Portfolio composition:** there exists a clear case for nearly always fully hedging foreign bond investments, while the decision (and the share) to hedge foreign equity investments depends on a broader set of factors.
2. **Cross-asset correlations:** specifically, whether the destination market's currency is "riskier," or more highly correlated with its domestic equity market, than an investor's home currency.
3. **Carry:** or the relative interest rate differential between the foreign economy and an investor's home economy.
4. **The economic outlook:** particularly, the odds of a US (or global) recession over the investment horizon. For corporates hedging exposures in international operations, the most relevant factors are carry and the likely state of the global economic cycle over the hedging horizon, in addition to some consideration of FX valuation.

Going through each in turn suggests that foreign investors should *raise* their FX-hedge ratios of US equity investments, while US investors should consider *reducing* FX-hedge ratios or just buying foreign equities unhedged, particularly in more "defensive" currency denominations—i.e., JPY, CHF, and EUR. We can see that clearly when we calculate average monthly annualized equity returns by base currency and destination market, on both a hedged and unhedged basis, over recent years and just the past three months (Exhibit 2).[1] Our results highlight that, since the start of the year, owning FX-hedged US equities would have generally raised returns (and reduced volatility) for foreign investors on average.[2] At the same time, owning FX-hedged non-US equities—here we show European equities—would have broadly reduced returns (and raised volatility) for US investors on average.[3] Both outcomes are in sharp contrast to recent years. There are limited publicly available data on hedging activities. But several Swedish pension funds as well as Japanese life insurance companies have reportedly lowered their hedge ratios on US equities in recent years, leaving room for a new shift in strategy. The conclusions are similar from the corporate perspective: the case for non-US corporates to hedge USD exposure has strengthened, while the case for US corporates to FX hedge has weakened.

1 We follow the same methodology as in *Global Markets Analyst: FX Hedging—An Investor's Framework*, October 12, 2023. We focus on six major developed markets and calculate monthly annualized equity returns using the MSCI Local Index for each economy. Unhedged equity returns are calculated as effectively the sum of the equity index return (in local currency) plus the spot FX return (foreign currency vs base currency). Hedged returns are calculated as effectively the sum of the equity index return (in local currency) plus the carry return from being short the foreign currency and long the base currency, derived from the Bloomberg Carry Return Index for each cross.

2 One exception is CAD-based investors. Hedging would have reduced returns as CAD depreciated on average over the first three months of 2025. Meanwhile, FX hedging would have raised returns on average for JPY-based and AUD-based investors, but average volatility would have been slightly higher but close to zero.

3 The exception was Canada equities; returns were still higher and volatility was lower when FX-hedged since CAD depreciated on average over the first three months of 2025. But the differential was smaller than over prior periods, and USD/CAD has recently started to participate in broader Dollar depreciation.

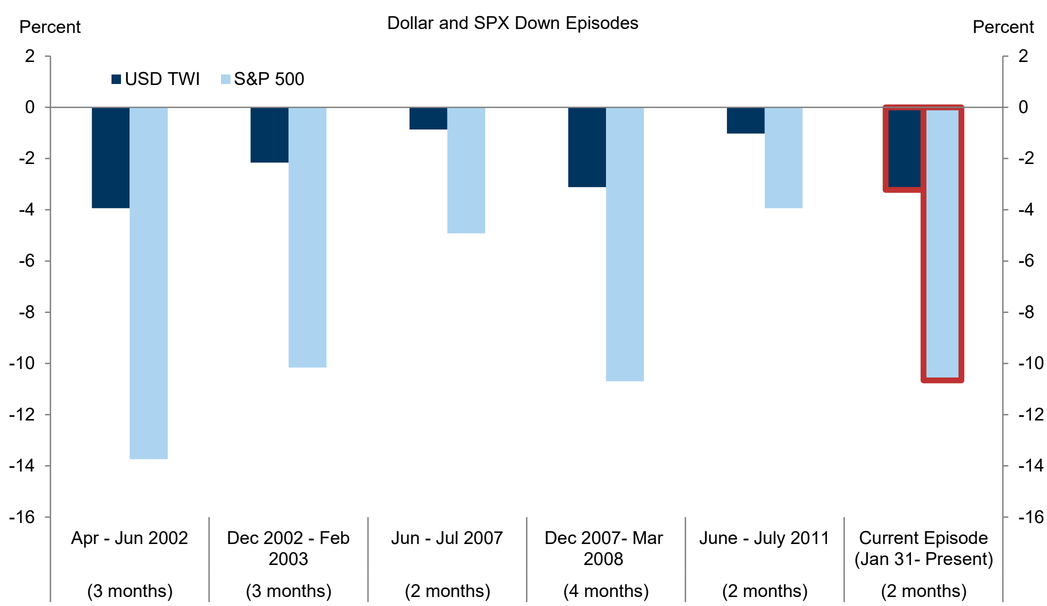
Exhibit 2: Since the start of the year, owning FX-hedged US equities would have generally raised returns (and reduced volatility) for foreign investors

Hedged vs Unhedged Equity Portfolio, Average Monthly Annualized Statistics						
	JPY-Based Investor in US Equities					
	Unhedged (%)		Hedged (%)		Difference (pp)	
Since:	Return	Volatility	Return	Volatility	Return	Volatility
Jan-15	12.9	17.6	8.0	15.5	-4.9	-2.1
Jan-18	15.5	18.2	8.0	17.3	-7.5	-0.9
Jan-22	14.3	17.0	0.9	17.0	-13.4	0.0
Jan-25	-27.2	12.6	-15.5	12.7	11.6	0.0
	EUR-Based Investor in US Equities					
	Unhedged (%)		Hedged (%)		Difference (pp)	
Since:	Return	Volatility	Return	Volatility	Return	Volatility
Jan-15	11.7	15.3	8.7	15.5	-2.9	0.2
Jan-18	12.7	16.3	9.1	17.3	-3.6	1.0
Jan-22	7.0	16.0	3.5	17.2	-3.5	1.2
Jan-25	-26.2	19.3	-13.7	12.8	12.5	-6.5
	GBP-Based Investor in US Equities					
	Unhedged (%)		Hedged (%)		Difference (pp)	
Since:	Return	Volatility	Return	Volatility	Return	Volatility
Jan-15	12.5	13.1	9.9	15.5	-2.6	2.4
Jan-18	11.7	14.3	10.4	17.3	-1.3	2.9
Jan-22	6.8	13.7	5.2	17.2	-1.7	3.5
Jan-25	-22.5	19.0	-12.0	12.8	10.6	-6.2
	AUD-Based Investor in US Equities					
	Unhedged (%)		Hedged (%)		Difference (pp)	
Since:	Return	Volatility	Return	Volatility	Return	Volatility
Jan-15	13.4	12.4	10.5	15.5	-2.9	3.1
Jan-18	14.5	12.8	10.4	17.3	-4.1	4.5
Jan-22	10.3	13.3	4.5	17.2	-5.8	3.9
Jan-25	-15.3	12.8	-12.2	12.8	3.1	0.0
	CAD-Based Investor in US Equities					
	Unhedged (%)		Hedged (%)		Difference (pp)	
Since:	Return	Volatility	Return	Volatility	Return	Volatility
Jan-15	12.8	13.1	10.2	15.5	-2.6	2.4
Jan-18	13.1	13.6	10.7	17.3	-2.5	3.7
Jan-22	9.6	13.7	4.9	17.2	-4.8	3.5
Jan-25	-12.0	15.9	-13.4	12.8	-1.4	-3.1
	USD-Based Investor in European Equities					
	Unhedged (%)		Hedged (%)		Difference (pp)	
Since:	Return	Volatility	Return	Volatility	Return	Volatility
Jan-15	4.0	18.3	6.8	16.0	2.8	-2.2
Jan-18	3.1	19.9	6.5	16.7	3.4	-3.2
Jan-22	2.4	20.0	5.8	15.5	3.4	-4.5
Jan-25	57.5	11.1	34.7	18.2	-22.9	7.1

Source: Bloomberg, Goldman Sachs Global Investment Research

Higher odds of a US recession and falling equity prices normally argues in favor of FX-hedging non-US equities, as reducing foreign currency exposure has historically raised returns on average for US investors during equity bear markets. But we think the current backdrop warrants more caution. Our recent work on periods when the Dollar and US equities have sold off together shows that the dynamic infrequently lasts for two consecutive months, likely due to the Dollar's safe-haven properties. But the current episode has already been that long, and we see further room to run (Exhibit 3). While we think the Dollar should still strengthen in a period of severe market stress due to its global role in financial markets, we see a clearer case for structural underperformance as the more balanced global economic growth backdrop—and an end to US exceptionalism—increasingly resembles the "trough" of the "Dollar smile." That said, the risk remains that a US recession spills over in greater form to the rest of the world, triggering renewed Dollar strength. But a broader set of tariffs (vs mainly China in 2018-2019) generally weakens the incentive for foreign producers to lower prices, leaving the US more likely to adjust. And the historically outsized ownership share of US assets and elevated policy uncertainty—particularly alongside growth optimism in Europe and China—leaves the left tail for the Dollar further away.

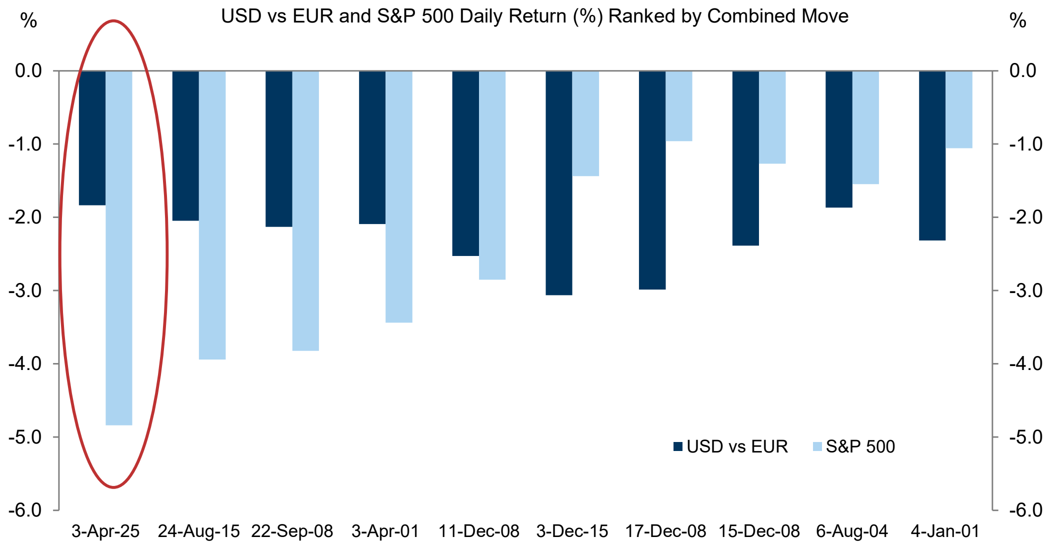
Exhibit 3: Of longer-lasting USD and SPX down episodes, the current one already represents one of the largest



Source: Bloomberg, Goldman Sachs Global Investment Research

Indeed, a world of more balanced global growth, better return prospects abroad, and overweight USD positioning allows for more frequent (and longer-lasting) periods when the Dollar and equities sell off together. Price action on April 3 clearly reflected this; the S&P 500 and EUR/USD saw the largest 1-day combined move since 2000 (Exhibit 4). The next biggest episodes were the "flash crash" of August 24, 2015, partially driven by China growth concerns and September 22, 2008, in the days following news of the US bank bailout plan. With tariffs on top of an economy closer to recession, markets may also become more worried about US stagflation whenever growth momentum slows, weighing more heavily on the Dollar particularly against the Yen.

Exhibit 4: On April 3, the S&P 500 and EUR/USD saw the largest 1-day combined move since 2000



To rank by the combined move, we take the sum of the absolute value of the change in EUR/USD and SPX.

Source: Bloomberg, Goldman Sachs Global Investment Research

Elevated policy uncertainty and FX volatility look likely to remain features of the year ahead. As a result, we think US investors should be better off adding JPY, CHF, and even EUR exposure as protection rather than raising hedge ratios on non-US equities. Meanwhile, the case for foreign investors to *raise* hedge ratios looks clearer—especially in Japan and Europe. This is one reason why we now expect to see further Dollar depreciation over the coming year.

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