RBC Global Asset Management

The death of the dollar... and the rise of EM local

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> "EM local stands out as the single most attractive asset class in global fixed income markets, where investors can benefit from the structural decline of the dollar."

A summary

- The recent tariff announcements by the US administration have jolted markets. Regardless of the outcome of ongoing trade negotiations, possible new policy measures, and eventual economic outcomes, the implication is clear: this spells the death of the 15-year dollar bull market.
- For the best part of the last two decades, investment portfolios globally have accumulated exceptional levels of US assets, but given we are at the tipping point of a structural shift in the outlook for the US dollar, markets should be prepared for a meaningful reduction in these holdings. Some asset repatriation has already taken place following the initial tariff announcements, with dollar weakness largely focused in safe havens like EUR, JPY, and CHF. However, we believe that we are only at the start of a broader dollar downtrend from extremely overvalued levels.
- Investors will now turn their focus to alternatives for allocating capital, not just to shield portfolios from the fallout, but with the potential to deliver a positive return. We argue that local rates in emerging markets (EM) provide the opportunity to earn attractive returns through yield compression in countries where policy rates are already elevated with inflation anchored, thus allowing central banks scope to cut rates as the negative growth impact of tariffs kicks in. Likewise, EM currencies, which have historically been vulnerable to global risk-off scenarios, will be poised to benefit as dollar weakness broadens out after the initial growth shock.
- **We would go as far as saying that by offering significant diversification as well as compelling potential returns, EM local stands out as the single most attractive asset class in global fixed income markets, where investors can benefit from the structural decline of the dollar.**

The long USD trade has paid off handsomely over the last 15 years

Since the GFC, there has been one 'big' trade amongst investors – being long US assets unhedged. Factoring in dividends, a European asset manager would have generated +859% by being long SPX unhedged since 2009; in other words, SPX in euros delivered a whopping +16.3% annually over 15 years, with only four material drawdowns (which were quickly reversed).

Capital inflows accelerated further post COVID:

This process of the US sucking in capital only accelerated in the last two years, helped by fiscal largesse (Chart 1). As a result, foreigners now own a whopping USD26 trillion of US assets, with USD18 trillion in US equities alone. The percentage this exposure represents in global portfolios is approaching 30%, the highest level in 25 years (Chart 2).

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While data on FX hedge ratios of these assets is scarce, most estimates put this at around 30% for equities, at the low end of historical ranges, once again highlighting the vulnerability to moves in the dollar.

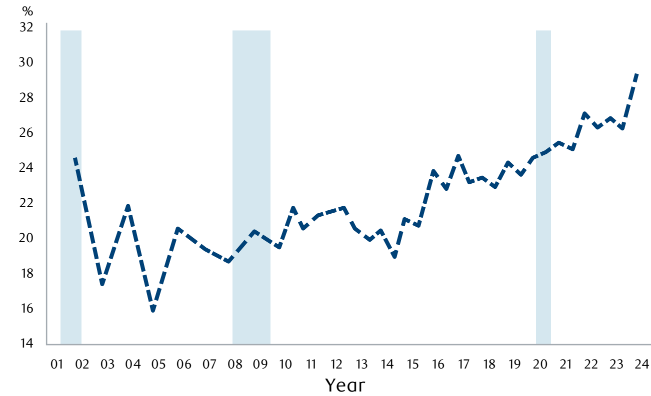
Why have foreign investors maintained such a low hedge ratio? The answer lies in the negative correlation over most of the post-2008 period between the dollar and risk assets, whereby holding long dollar exposure has served as an 'automatic stabiliser' for global portfolios. That is, the dollar has traditionally rallied during major risk-off episodes, thanks to its safe haven properties and funding stress creating a dash for dollars. This relationship has contributed to the dollar overvaluation reaching near four-decade highs (Chart 3).

We expect the trend going forward to be weaker USD

Recent developments surrounding the trade war under Trump 2.0 have given momentum to the view that the above-mentioned 'long USA' trade has come to an end. Foreign investors are questioning the need to be max long US assets given the policy uncertainty emanating from the new US administration. There are concerns that the growth impact could be largest for the US, leading to underperformance of US equities. Many are also challenging the merits of the US duration trade in a world where already-wide fiscal deficits are being adversely impacted by weak growth. Hedge ratios are likely to be increased, particularly as the dollar has weakened, along with US assets, in the most recent bout of risk-off, exacerbating rather than dampening losses.

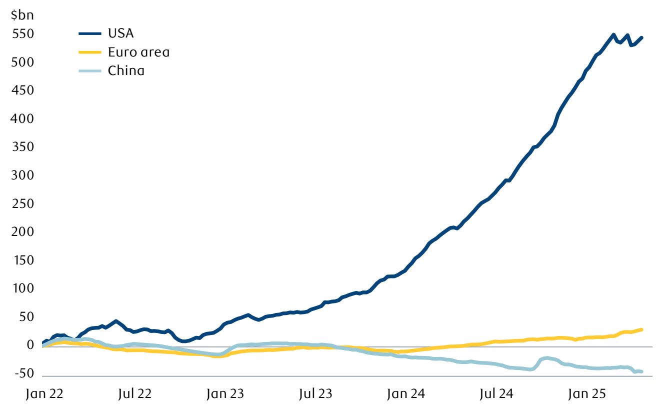
Whether it is fears around growth, loss of confidence in the US policy framework, or simply the realisation that the paradigm has shifted, investors are actively challenging their appropriateness of their US dollar positioning.

Chart 2: US assets as share of global portfolio investment assets



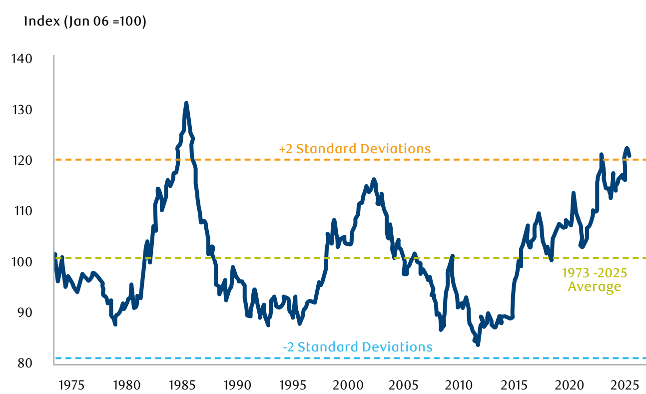
Source: Goldman Sachs, as at April 2025. Blue shading shows US recessions.

Chart 1: Cumulative cross-border fund flows



Source: Goldman Sachs, as at April 2025.

Chart 3: Real broad trade-weighted dollar index



Source: Goldman Sachs, as at April 2025.

The large stock of US asset ownership by foreigners means that even small shifts in allocation or hedge ratios would have a meaningful impact on flows and exchange rates.

This creates a backdrop in which the dollar is likely to decline over the coming years – the process of re-allocation is a medium-term one, and one that is now unlikely to be reversed. The toothpaste is now out of the tube, the cat's out of the bag, the die is cast – even if the Trump team backtracks on some of the most hawkish elements of trade policy, enough uncertainty has been created to question such a large ownership of US assets.

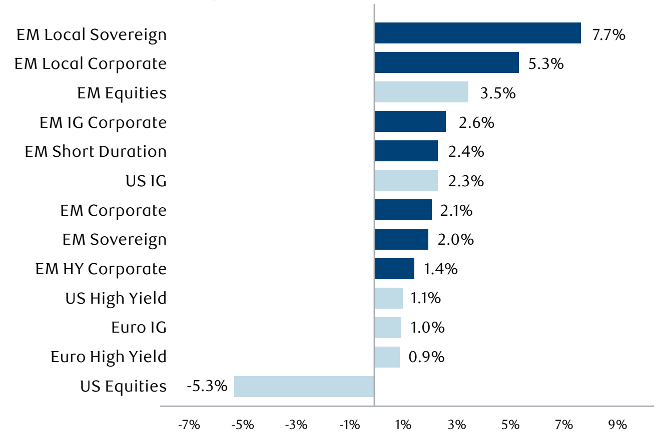
The rise of emerging local markets

Over the last month, the safe haven currencies with a capital repatriation angle (EUR, JPY, and CHF) performed strongly as they benefitted from both the growth shock and the increased repatriation/hedging. However, as the initial growth shock starts to fade over the coming months, we expect the dollar weakness to broaden out to include EM currencies as well. In addition to the weaker dollar 'lifting all boats', many EMs are poised to benefit directly from the new trade paradigm. India and Brazil, for example, stand out as relatively closed economies that would benefit from re-shoring away from China and strong Chinese demand for agricultural products, respectively. Other parts of Latin America, such as Mexico, should benefit from greater integration with the US in a multi-polar world. Central European countries – particularly Poland and Czechia – are in pole position to gain from growth spillovers driven by new German fiscal spending. Meanwhile, a number of low-yielding Asian currencies (such as the Malaysian ringgit) should benefit from capital repatriation and increasing hedge ratios, given large dollar hoarding by locals. Equity inflows are another source of currency strength, as investors diversify away from tech-heavy US indices.

As such, the next phase of dollar weakness will likely be accompanied by EM FX strength – we view this as a medium-term structural thematic and would consider potential volatility in the coming months as opportunities to build conviction.

One potential period of comparison is the dollar bear market of 2002-2008, which also came on the back of the bursting of a tech bubble, and a gradual reduction of US exposure by foreign investors. Over this period, EM currencies rallied by 35%[1]. Admittedly, we are unlikely to witness a similar global growth boom as we had then, but on the flipside the positioning in US assets is significantly larger (creating more space for repatriation and hedging-related dollar weakness).

Chart 4: Major asset class returns (YTD to end of April 2025)



Source: RBC GAM, as at April 2025

Normally, when we experience a major global growth shock, EM currencies tend to first sell off significantly due to the broader dollar rally that accompanies such risk-off episodes. As a result, we see inaction or even rate hikes from central banks, who are caught between the growth shock and the FX shock. This time around, EM currencies are not undergoing that sharp weakness because risk-off is being accompanied by a move lower in the dollar, allowing central banks to focus on the growth angle. Inflation is well anchored and could actually moderate further due to weak commodity prices and re-routing of China goods into EMs, real rates are elevated, and central banks are in a strong position, with plenty of room to ease policy. As a result, EM local rates markets are uniquely positioned to benefit from the current environment. The outperformance of EM local is already beginning to play out, as illustrated in Chart 4. While it is a volatile asset class, we believe there is strong potential for positive returns at the current juncture.

In sum, the start of the dollar bear market creates a positive environment for both EM currencies and local rates; we believe there is a reasonable probability of achieving double digit annual returns in the EM local asset class for the coming 3-5 years.

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