RBC Global Asset Management

The US dollar: from dominance to decline

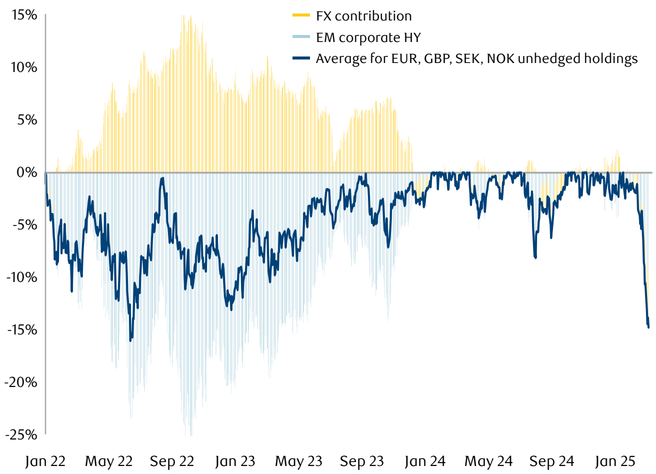
EM local markets are benefitting from a long-term structural shift

July 2025

With the EM local sovereign index up 12.5% year-to date, we explain why local markets are uniquely poised to benefit from broad dollar weakness and how clients can reap the benefits of this performance via a blended approach across EM Debt.

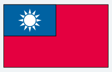
- Since the GFC, there has been one key macro trade amongst investors – buying long US dollar assets unhedged. Capital inflows resulted in foreign investors owning a huge volume of US assets (USD30 trillion), with these assets comprising 30% of global portfolios, the highest level in 25 years[1].
- Hedging ratios are low, and while many jurisdictions don't report these and data is scarce, we estimate that foreign investors hold approximately USD14 trillion unhedged in US equities and fixed income[2].
- This has led to a worrying US net international investment position. Its negative external asset position is already among the largest globally. Further, the previously negative correlation between the dollar and risks assets (which contributed to low hedge ratios and dollar overvaluation reaching near 4-decade highs) has turned positive. Chart 1 shows how the US hedge is no longer working.
- The large volume of foreign ownerships means that even small shifts in allocation or hedging ratios will impact flows and FX significantly. This creates a backdrop whereby the dollar is likely to decline over the coming years. The process of re-allocation is a medium- and long-term theme, and it is a shift that is unlikely to be reversed.

Chart 1: Peak-to-trough S&P 500 drawdown for unhedged European investors



Source: Deutsche Bank Research, as at March 2025.

Taiwan: a useful test case on the impact that local hedging dynamics can have on the currency market.



- Taiwanese lifers hold sizeable US assets, a byproduct of the country's large historical current account surplus. Moreover, they are holding these assets with a historically low hedge ratio at 55% (historical average is circa 70%).
- As a result of the market turmoil in April – and shifting correlations between the dollar and US assets – these lifers began to increase their hedge ratios. This created an imbalance in the FX market, leading to currency appreciation of 10% over just two days, the largest 2-day move in recent history.
- Meanwhile the central bank was more circumspect about currency intervention, given the US administration's focus on currency manipulation.

Source: Deutsche Bank, Bloomberg Finance LP.
Excludes FX denominated policies and based on top 4 lifers' data.

1 UBS, TIC, Haver, Goldman Sachs, as at March 2025.
2 UBS, TIC, Haver, Bloomberg, as at March 2025.
We assume 20% FX hedge ratio for equities and 50% for fixed income.

Broad dollar weakness is poised to benefit EM local markets

There are tentative signs of inflows into EM equities, which should support EM currencies, as investors diversify away from tech-heavy US indices (Charts 2 and 3). Normally, global market shocks would mean an EM currency sell-off (due to the broader USD rally), however this time a weakened dollar means EM central banks are focusing on growth.

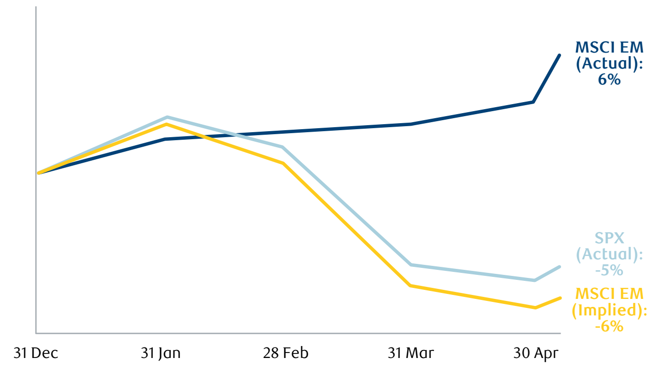
Inflation is well anchored (and could moderate further due to weak commodity prices and re-routing of China goods into EMs), real rates are elevated, and central banks are in a strong position, with plenty of room to ease policy. As a result, EM local rates markets are uniquely positioned to benefit from the current environment.

For example, Brazil offers near double-digit real rates, with the central bank poised to begin a rate cutting cycle. Further, the currency is poised to benefit from increased agricultural exports to China, as the country diversifies away from the US. As such, Brazil local markets are primed to benefit in the coming months.

Additionally, 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.

Chart 4 shows how positive performance for the local markets asset class has already started. Divergence is underway and we believe there is much further to go. In an environment of ongoing volatility, we believe some of the most compelling and undervalued investment opportunities reside within EM, offering the potential for diversification and uncorrelated returns.

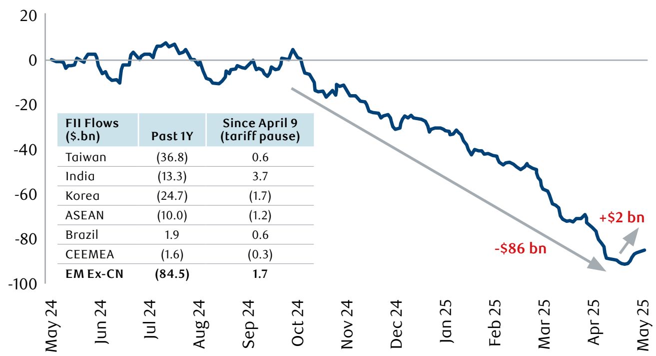
Chart 2: Strong MSCI EM Index performance year-to-date (USD)



Source: Goldman Sachs, as at April 2025.

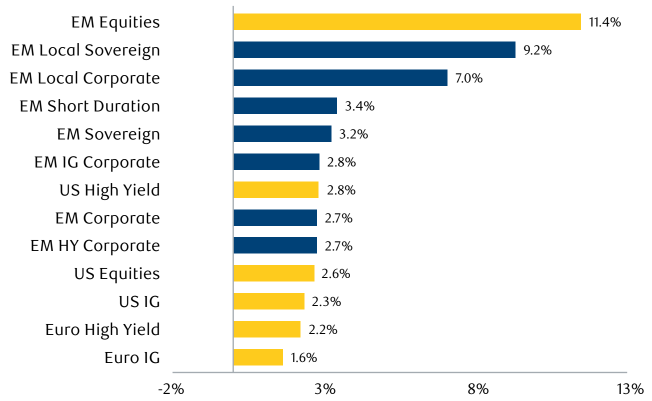
Chart 3: Strong flows into EM Equities should support local currencies

FII flows (USDbn) – EM ex-China



Source: Goldman Sachs, as at April 2025.

Chart 4: Major asset class returns YTD



Source: JPMorgan, MSCI, BofA, S&P and Bloomberg, as at 30 May 2025. EM Corporate: JPM CEMBI Diversified; EM IG Corporate: JPM CEMBI Diversified IG; EM HY Corporate: JPM CEMBI Diversified HY; EM Sovereign: JPM EMBI Global Diversified; EM Local Sovereign: JPM GBI-EM Global Diversified; US IG: JULI ex EM (US HG); Euro IG: MAGGIE (Euro HG); US High Yield: JPM HY (US HY); Euro High Yield: JPM Euro HY (Euro HY); US Equities: S&P 500; EM Equities: MSCI Emerging Markets Index.

Ways to gain exposure without being fully invested in EM local markets:

Many clients would like to be positioned for the USD decline but are cautious about investing purely in local markets. Below we show two ways to access these markets via a blended approach that targets a wider opportunity set. These strategies capture the diversification of the EMD asset class and have strong track records over multiple time horizons.

A dynamic approach to EM hard and local currency sovereign debt

Local Currency Sovereign Debt

- At close to US$12 trillion, this is the largest EMD sub sector.
- Currency and rates risk present.
- Concentrated index – 20 countries represented.
- Growing asset class.
- Virtually no default risk.
- Good liquidity.

Hard Currency Sovereign Debt

- Longest serving sub asset class in EMD.
- Significant diversification with 70+ countries.
- Total debt stock at circa US$1.5 trillion.
- Reasonably liquid bonds universe.
- No currency risk.
- Possible default risk or restructuring risk.
- High default risk – index duration circa 6.76yrs.
- Index includes quasi sovereign issuers.
- Increasing issuance of sustainability linked bonds.

Significant diverification
~75 countries
~20 currencies

Vast opportunity set
~USD28 trillion

Source: RBC GAM, as at March 2025.

For clients looking to gain exposure to a total return strategy, an unconstrained approach allocates across four sub-asset classes – hard and local currency corporates and sovereigns – depending on where attractive value can be found. This provides the investor the widest opportunity to find compelling opportunities.

Please contact your Distribution representatives for further information on these strategies.

Our investment experts are also happy to discuss the case for EM local markets further.

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