RBC Gestion mondiale d'actifs

Global currency outlook

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The U.S. dollar's decline: a new chapter in global currency markets

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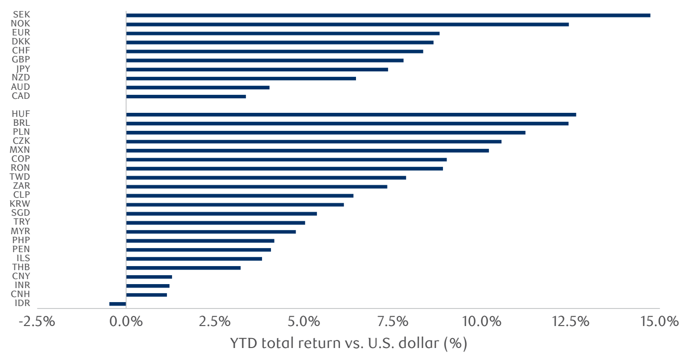
"Gradually, and then suddenly" is a quote from Ernest Hemingway's 1926 novel *The Sun Also Rises*. Hemingway might as well be describing the attitudes of investors: the U.S. dollar has in just a few months flipped from the much-loved developed-market currency to most-hated and has become one of the worst performing currencies since Donald Trump's inauguration in late January. We had been awaiting the U.S. dollar's turn for some time but were nonetheless amazed by how quickly things changed. Trump's second term, we think, will come to be known as marking the beginning of a multi-year dollar decline and a momentous shift for foreign-exchange markets that will impact the broader investment landscape. Our forecasts imply further gains for the euro, pound, yen and Canadian dollar over the year ahead, and we believe that emerging-market currencies will record similar gains.

At the beginning of the year, the U.S. dollar looked invincible because it offered the most attractive interest rates, while also benefiting from superior U.S. equity returns and the U.S. economy's status as the strongest among developed-market nations. At the time, few investors were willing to bet against the greenback because Trump, as president-elect, appeared set to unveil policies that would propel the greenback even higher. It was commonly supposed that his tariffs on other nations would be dollar-positive, largely because U.S. trade partners would weaken their currencies to regain competitiveness. What's more, the U.S. Federal Reserve (Fed) would have to keep interest rates relatively high to combat higher inflation, providing further support for the greenback.

Things have played out quite differently. In fact, the prior assumptions about tariffs and the dollar couldn't have been more wrong. The U.S. dollar has turned out to be one of the worst performing currencies this year and has weakened since January by about 10% against a basket of other currencies (Exhibits 1 and 2). The dollar's sudden turn reflects several things:

- **The realization that the U.S. economy is likely to slow in response to tariffs**. There's even an argument that Trump's trade measures could hit U.S. economic activity harder than that of trade partners, at least initially. This is because other countries only experience disruption in trade with a single trade partner, whereas the entirety of U.S. trade is affected by tariffs. Sectors acutely affected include auto manufacturing, where the imposition of 25% tariffs threatened to impede the movement of parts across the Mexican and Canadian borders. Moreover, there is a risk that shipments of some consumer goods will run dry if Trump decides to reimpose tariffs anywhere near the 145% rate that was originally imposed on Chinese imports but later withdrawn. Businesses and consumers lack the confidence to spend (Exhibit 3) given the unpredictability of current U.S. policy.
- **Anxiety about large government debt loads**. It is no longer just the UK and Brazil that are being challenged by investors over fiscal spending and large deficits. Greater attention is also being focused on whether the U.S. and Japan will be able to continue issuing debt without having to pay much higher compensation. The fact that yields on the 30-year U.S. Treasury bond breached 5% in May indicates that investors are demanding greater returns on loans extended to the government. There's no doubt that this nervousness would be even greater if the U.S. dollar didn't serve as the world's reserve currency. Even before the pandemic, the U.S. stood out as one of the largest fiscal offenders, with budget deficits averaging close to 5% of GDP during 2015-2019. In the five years following the pandemic, the budget deficit has ballooned to more than 7%. Each year of this fiscal excess adds to the debt stock, with total debt to GDP rising toward 100% of GDP in 2023 from 31% in 2001 (Exhibit 4). The first budget of President Trump's second term threatens to expand the debt level to 129% of GDP by 2035.

Exhibit 1: U.S. dollar weaker against most currencies

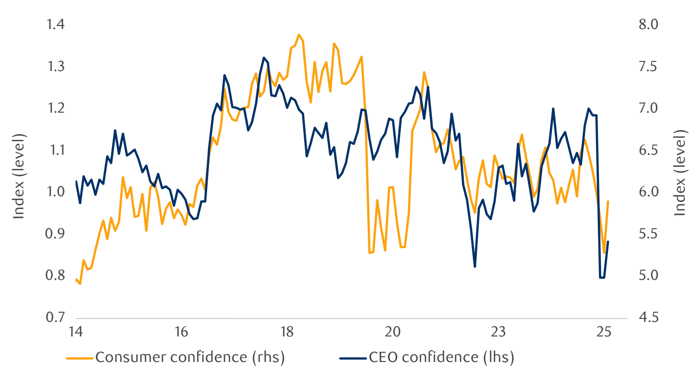


Note: As at May 29, 2025. Source: Bloomberg, RBC GAM

Exhibit 2: Pronounced U.S.-dollar weakness

Note: As at May 30, 2025. Source: Bloomberg, RBC GAM

Exhibit 3: Business and consumer confidence waning

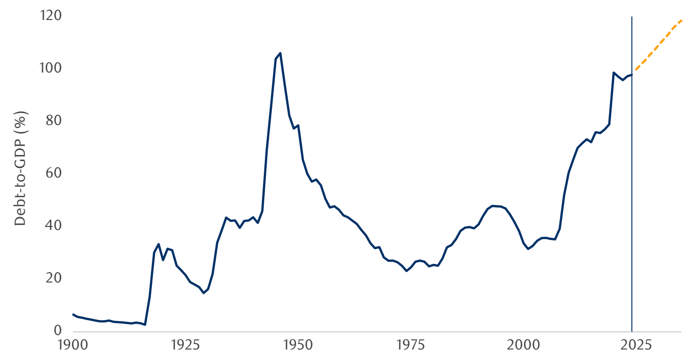


Note: As at May 30, 2025. Source: Conference Board, Chief Executive Group, Macrobond, RBC GAM

- **Erosion of central-bank independence**. Trump's warning that he would consider firing Fed chairman Jerome Powell was not taken lightly by investors, and his persistent social-media criticism of Powell fly in the face of the Fed's mandated independence. Bondholders are especially sensitive to such meddling because it's seen as a way of artificially suppressing borrowing costs and because it could result in excessive inflation that eats into investor returns.
- **Deglobalization**. Trump's apparent plan to reshore production in the U.S. and abandon trade relationships underpins a global trend toward deglobalization. A U.S. economy that buys less goods from the rest of the world translates into fewer U.S. dollars being exchanged in the conduct of global trade. Moreover, the trend of regionalization (increased trade within Asia rather than bilaterally with the U.S.) encourages more trade and investment to occur in the renminbi and in other currencies, meaning less overall demand for the greenback. We have already seen a small increase in energy trade occurring in other currencies, a trend that was boosted when Iran was banned from using U.S.-based payments systems. The seizure of Russian state assets has also prompted reserve managers to diversify their foreign-exchange holdings. Gold's substantial rally over the past few years is evidence of this reallocation.
- **Waning U.S. influence**. America's international withdrawal from world affairs is occurring not just in trade but in the geopolitical sphere as well, with less support for the World Health Organization (WHO), World Trade Organization (WTO), Paris Climate Accord and North Atlantic Treaty Organization (NATO). History suggests that the country that secures global trade and shipping lanes gets to enjoy the "exorbitant" privilege associated with having the primary reserve currency. The U.S. has enjoyed this status since the end of World War II, and it is estimated that the ability to borrow more cheaply lowers funding costs between 0.25% and 1.00% and saves Americans at least $100 billion in yearly interest expense. An open question, then, is whether the U.S. is slowly ceding this privilege at a time when it is most needed given the rapidly expanding debt load.

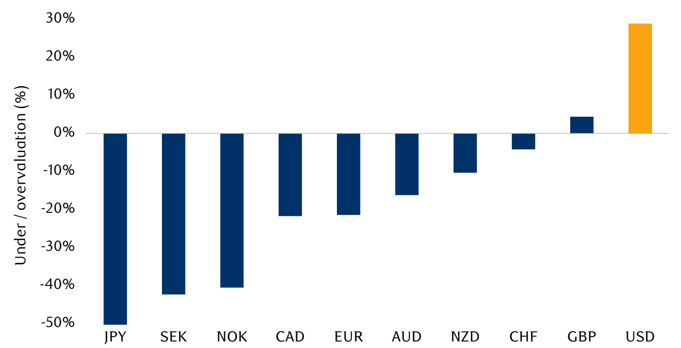
The backdrop for the greenback was not especially positive prior to Trump's return to the White House, since the currency was already substantially overvalued relative to peers (Exhibits 5 and 6). A myriad of other long-term structural

Exhibit 4: U.S. debt-to-GDP expected to rise above 100%



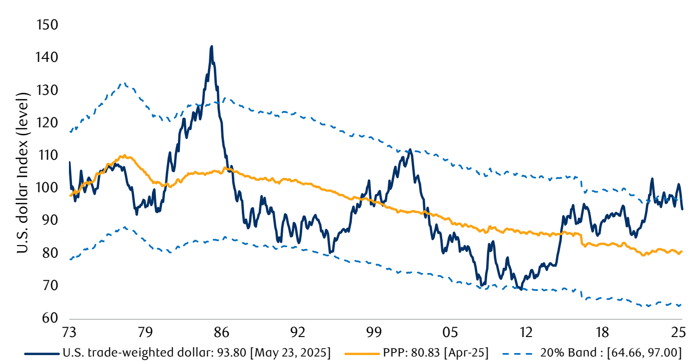
Note: As at December 31, 2024. Source: U.S. CBO, RBC GAM

Exhibit 5: U.S. dollar remains overvalued



Note: As at: January 20, 2025. Source: Bloomberg, RBC GAM

Exhibit 6: U.S. dollar overvalued based on purchasing power parity model

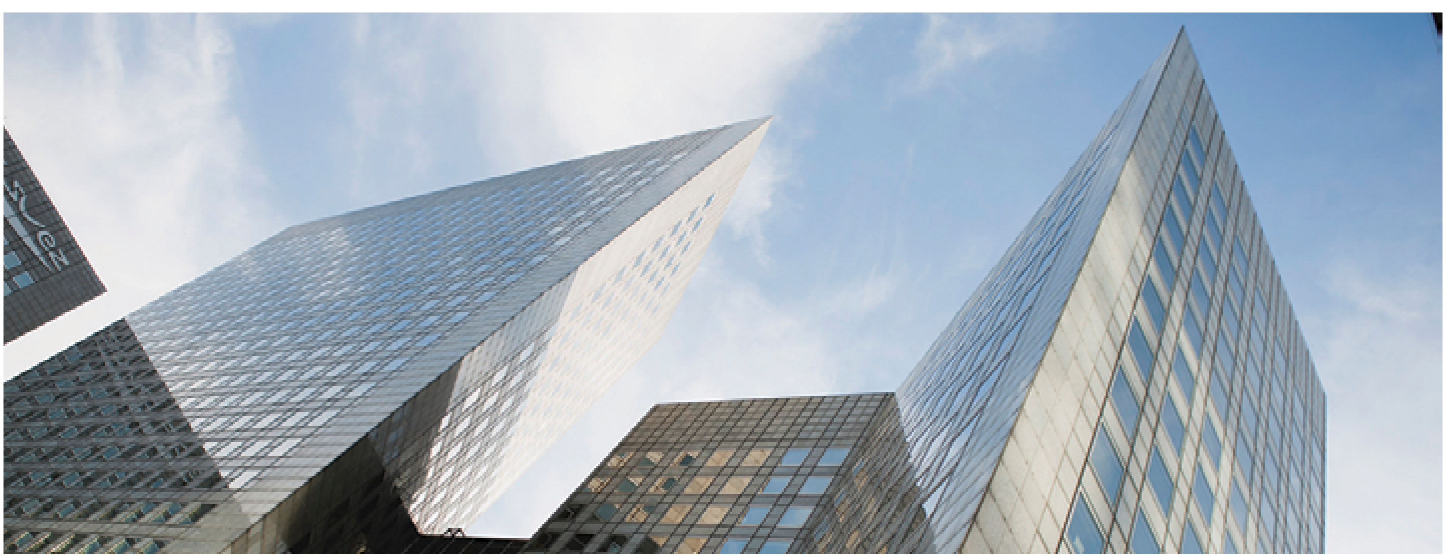


Note: As at May 23, 2025. Source: Bloomberg, U.S. Federal Reserve, RBC GAM negatives were overlooked until this year by investors who had focused on shorter-term cyclical positives. Indeed, these short-term positives – largely prompted by significant fiscal stimulus that boosted growth – is what supported the greenback in the years following the pandemic. The fact that new structural negatives are now emerging at the same time as the shorter-term cyclical tailwinds are fading (Exhibit 7) leaves investors to ponder whether their investments should be allocated somewhere other than the U.S.

Exhibit 7: Structural factors aligning against the U.S. dollar

	Previously	Additions since inauguration
Structural	× Overvaluation × Persistent current account and budget deficits × Rising debt and servicing costs × Higher inflation than peers ✓ Primary reserve currency ✓ Tech/AI leadership ✓ Innovation culture ✓ Energy independence ✓ Deep and liquid capital markets ✓ Military dominance	× Policy unpredictability × Social repression (ESG, DEI, education, science) × Threat to central bank independence × Loss of geopolitical influence × Deglobalization reduces dollar demand × Possible taxes on foreign investment × Safety of capital questioned (Mar-a-Lago Accord, lock-up in century bonds) × DeepSeek puts AI leadership in doubt
Cyclical	✓ Pro-cyclical fiscal spending ✓ Yield advantage ✓ Stronger economic activity ✓ Equity outperformance ✓ Capital inflows drive U.S. dollar demand	× 50 basis points more Fed easing priced in × Collapse in confidence (businesses/consumers/investors) × Tariff impact bigger for U.S. than for other countries × Rising inflation × Large cuts to federal employment × Immigration overhaul × European fiscal spending reduces U.S. exceptionalism

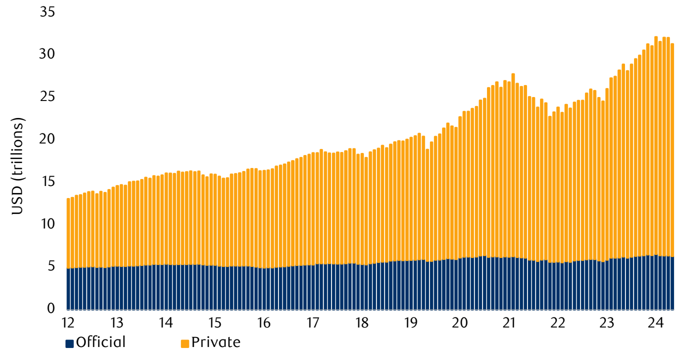
Note: As at May 30, 2025. Sources: RBC GAM



It is worth noting that foreigners have massive holdings of U.S. assets. Since much of the press is focused on reserve managers that are invested in Treasuries, it is perhaps surprising to see that the bigger U.S. exposure held by foreigners is in fact private-sector holdings of U.S. equities (Exhibits 8 and 9). These have grown by a whopping US$10 trillion over the past half-decade as investors benefited hugely from both U.S.-dollar strength and technology-sector outperformance. Goldman Sachs notes that this has been an easy position to keep on the books, owing to the fact that it had delivered three important qualities: (i) better returns than other equity regions, (ii) low levels of volatility and (iii) the natural hedge of the U.S. dollar's negative correlation to the stock market. So far this year, those three elements have all been put in question in the aftermath of Trump's early-April "Liberation Day" tariffs. Particularly important is the changing relationship between stocks and the U.S. dollar. In past years, the U.S. dollar reliably rallied during market downturns, helping to offset investment drawdowns for foreign investors. This relationship seems to have changed in 2025, where foreigners are experiencing a double hit from falling stocks and a falling dollar (Exhibit 10).

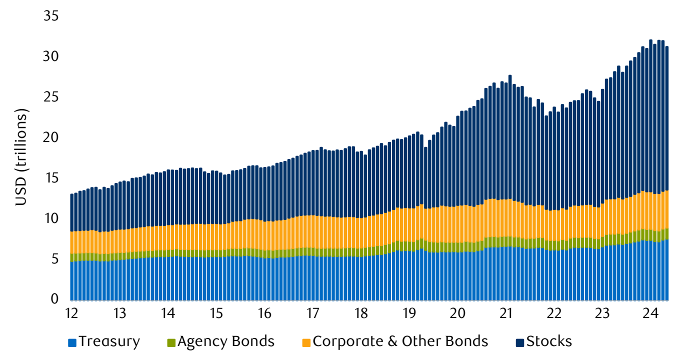
Will foreigners repatriate any part of that US$10 trillion increase in holdings? Early signs of this shift can be seen in mutual-fund and ETF flows and its continuation would surely have an impact on currency markets even if a small percentage of that capital is repatriated. Importantly, foreigners need not actually liquidate their holdings for a currency impact to be felt. It is also possible that foreigners keep their U.S. asset holdings but simply hedge currency exposure. Custodial data from State Street (Exhibit 11) confirms that there is lots of room for such hedge ratios to rise, and the decision to reduce currency risk is an easier one to make than a broader regional reallocation. We are doubtful that mutual funds, pensions and insurers have begun to place significant hedges on their U.S. holdings, but we believe that such actions are coming and that they will have a significant impact on currency markets. One example of this impact, though perhaps a special case, can be seen in the sudden appreciation of the Taiwanese dollar in early May. Taiwanese life insurers hold sizable U.S. assets and hedge only a small portion of the currency risk. Similarly, the country's exporters typically keep large U.S.-dollar cash balances because that cash earns higher rates of interest in

Exhibit 8: Foreign holdings of U.S. assets are mostly in private hands



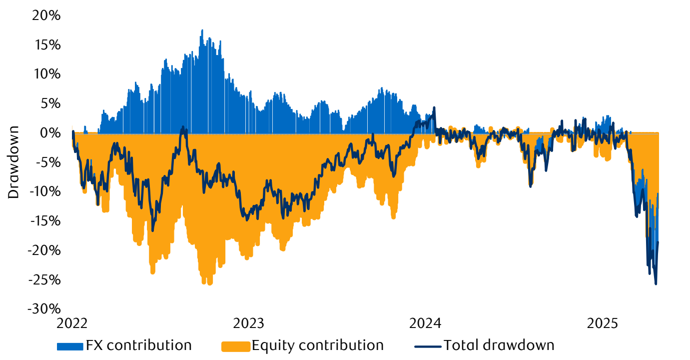
Note: As at March 31, 2025. Source: U.S. Department of Treasury, RBC GAM

Exhibit 9: Largest share of foreign holdings is U.S. equities



Note: As at March 31, 2025. Source: U.S. Department of Treasury, RBC GAM

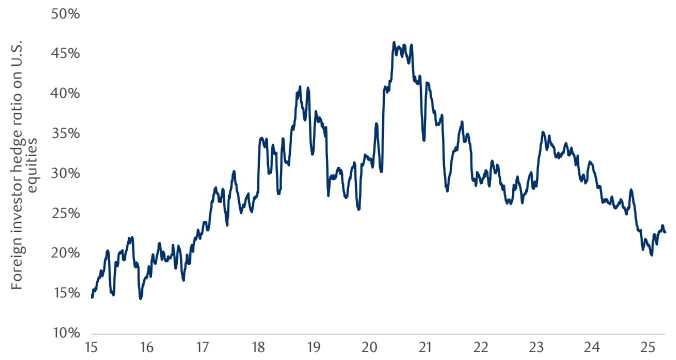
Exhibit 10: S&P 500 return to European investors after currency impact



Note: As at May 30, 2025. Source: Bloomberg, Deutsche Bank, RBC GAM the U.S. than it would if kept onshore. For a long time, earning higher yields abroad made sense, since the central bank controlled the currency and protected insurers from sudden currency fluctuations. In early May, however, the central bank stepped back from its currency interventions, causing a rush for domestic investors to liquidate their U.S. dollars. The result was a sudden 11% appreciation in the Taiwanese dollar over the course of two days (Exhibit 12).

The changing relationship between fixed income and currency markets is also worth mentioning. For many years, the difference between interest rates among regions has been an important driver of exchange rates because investors tend to buy currencies of countries and regions where they can earn the highest returns. This link has broken down for the first time in many years, indicating a new set of priorities for traders, or at least the existence of a new source of capital movement that outweighs the influence of yields. For example, the gap between U.S. and German 2-year yields still lies in favour of the greenback and suggests that the euro should have remained where it started the year at US$1.04. Instead, the single currency has surged to US$1.14 (Exhibit 13). A similar dynamic exists for the Canadian dollar (Exhibit 14) and for other currencies, where the U.S. dollar is trading weaker than interest rates alone can explain. We also note the increased frequency with which U.S. stocks, bonds and

Exhibit 11: Hedge ratios have room to rise

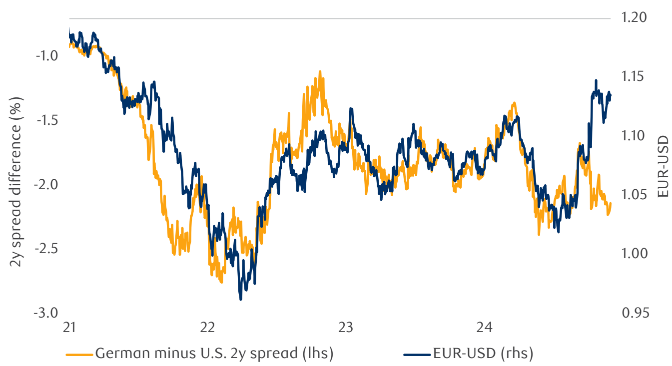


Note: As at May 27, 2025. Source: State Street, RBC GAM

Exhibit 12: Sudden Taiwan dollar appreciation in May

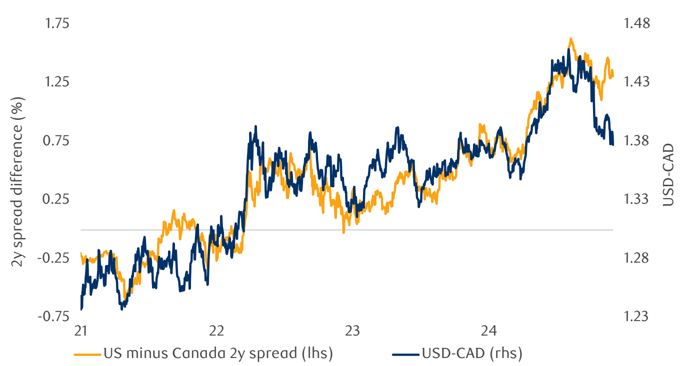
Note: As at June 2, 2025. Source: Bloomberg, RBC GAM

Exhibit 13: Euro trading stronger than interest rate differentials suggest



Note: As at May 30, 2025. Source: Bloomberg, Macrobond, RBC GAM

Exhibit 14: U.S. dollar trading weaker against the loonie than interest rate differentials suggest



Note: As at May 30, 2025. Source: Bloomberg, Macrobond, RBC GAM the dollar fall in tandem. This behaviour tends to be common for emerging-market currencies, but is generally rare for the U.S. We think it mirrors the "sell America" trade as investors shy away from investing in the country.

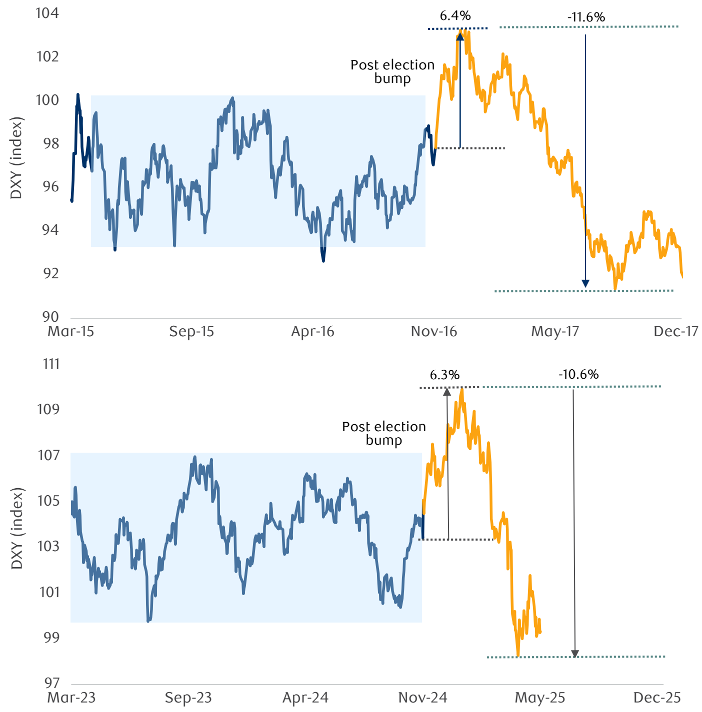
Clearly, much has changed over the past quarter and the outlook for the U.S. dollar has deteriorated substantially. The dollar's 8.4% trade-weighted decline since Trump's inauguration partially reflects these new negatives, though to be fair, the currency's path has not differed much from the last time he was elected (Exhibit 15). We believe much more dollar weakness lies in store, both this year and over the next several years. The currency in our view will continue depreciating for several years until it finally reaches a point where overvaluation is corrected. Both developed and emerging-market currencies should rise against the greenback, and we therefore forecast above-consensus returns for euro, yen, pound and Canadian dollar for the 12 months ahead.

If our outlook materializes, the greenback's decline will likely have far-reaching impacts. A few changes to the global investment landscape could include:

- A positive impact on U.S. earnings as foreign income is translated into more U.S. dollars. On the other hand, a weaker dollar means lower net income for foreign firms that repatriate profits earned in the U.S.
- A lower debt burden for emerging-market companies and countries that have borrowed in U.S. dollars.
- Emerging-market equities could benefit as they tend to outperform when the U.S. dollar falls.
- Precious metals are likely to rise, as are share prices of the resource companies that mine them.
- A disinflationary impact for countries outside of the U.S. and higher associated odds of monetary easing from central banks aside from the Fed.

There will be, no doubt, many other effects of a significant and sustained depreciation of the U.S. dollar. We suspect that, if not immediately obvious, they will be flushed out relatively quickly as the dollar continues to decline.

Exhibit 15: U.S. dollar performance mirrors 2016



Note: As at March 5, 2025. Source: Bloomberg, RBC GAM

Euro

As the second-most traded currency, the euro essentially acts as the "anti-dollar," and the currency's appreciation this year partly reflects the extent to which the greenback has fallen. Having said that, there have been a number of positive developments in Europe this quarter that could strengthen the currency in coming months.

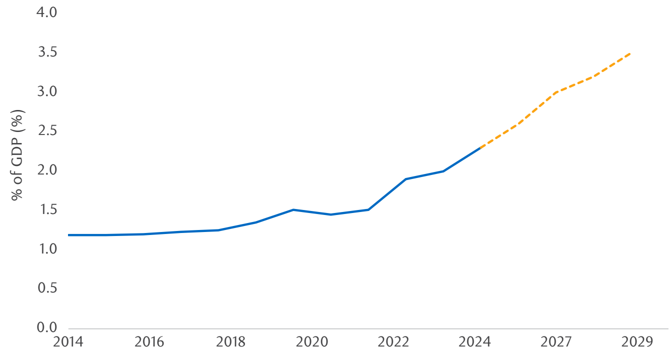
For one, there's a greater sense of solidarity within Europe these days following Trump's trade war. This shift is not simply about deepening trade ties within Europe but also strengthening efforts toward a capital-markets union and boosting EU competitiveness in line with recommendations made by Mario Draghi, who served as Italian prime minister and ECB president.

Rebuilding the defense industry has also become a priority (Exhibit 16) following Trump's cancellation of the implicit NATO security guarantee to Europe, and the region's commitment to rearmament will underwrite new jobs and investment. Germany's Rheinmetall, one of the few arms producers in Europe, is reported to be doubling its workforce after the country exempted defense spending above 1% of GDP in the calculation of government borrowing limits. The European Commission has also made commitments to invest in military capabilities, as did member states including Poland and Finland.

A greater amount of fiscal spending in general also aids economic growth. Germany leads this effort with a new fiscal plan, and the stronger political mandate given to its new coalition government helped facilitate the creation of a 500 billion-euro infrastructure fund used to finance investments in energy as well as areas that will help boost innovation such as research, education and science.

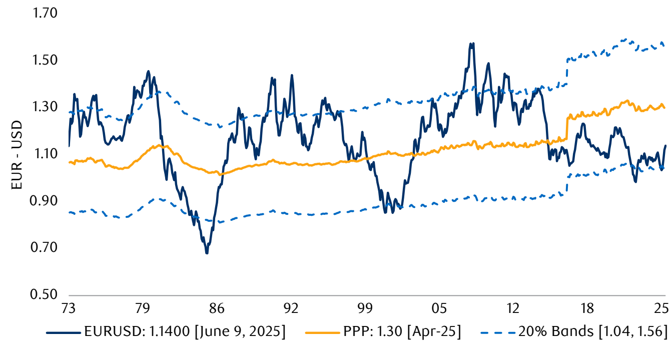
Even after this year's appreciation, the euro remains cheap based on purchasing power (Exhibit 17) and stands to gain from the repatriation or hedging of U.S. assets, much of which is owned by Europeans (Exhibit 18). We expect the single currency to reach US$1.22 within a year and to strengthen beyond that level in 2026.

Exhibit 16: German defense spending set to reach 3.5%



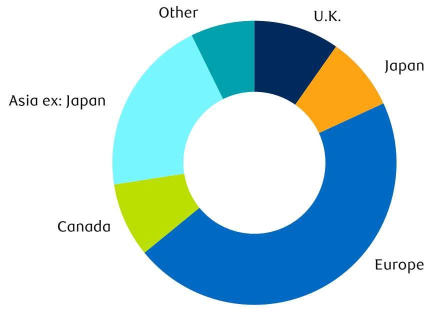
Note: As at December 31, 2024. Source: NATO, RBC GAM

Exhibit 17: Euro undervalued based on purchasing power parity model



Note: As at June 9, 2025. Source: Bloomberg, RBC GAM

Exhibit 18: Europeans represent a large share of foreign holdings of U.S. assets



Note: As at March 31, 2025. Source: U.S. Department of Treasury, RBC GAM

Japanese yen

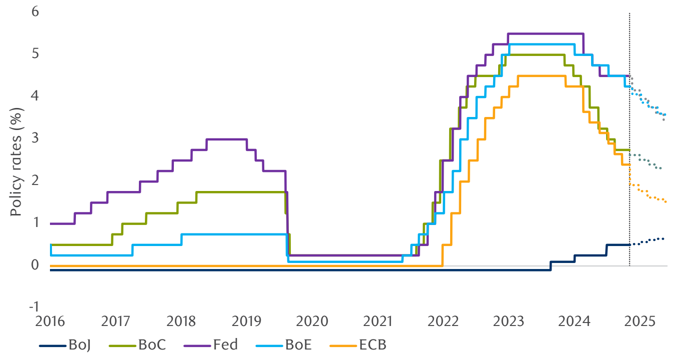
The yen has been one of our favoured currencies for several quarters owing to its extreme undervaluation, rising Japanese inflation and expectations that the Bank of Japan will raise interest rates faster than other developed-market central banks. The fact that monetary authorities in the G10 are in the midst of cutting rates has helped narrow Japan's yield disadvantage even further (Exhibit 19).

Japan also stands out because it has a government that is actively seeking a stronger currency. While there was initial speculation that yen strength could form part of a U.S.-Japan trade deal, Japan's finance minister publicly stated that authorities would not interfere with the market-determined exchange rate. Even still, the idea of currency intervention can't be ruled out entirely given the unpredictability of Trump's negotiating tactics and the fact that his tariffs now face legal challenges. If the goal is to reduce large U.S. trade deficits, a weaker dollar and stronger yen would help restore U.S. competitiveness.

Capital flows also support a stronger yen thanks to increased Japanese investor demand for Japanese government bonds and foreign demand for Japanese stocks (Exhibit 20). Capital inflows have been supplemented by the fact that the yen is seen as the only reliable safe-haven currency now that the U.S. dollar appears to have lost that status (Exhibit 21).

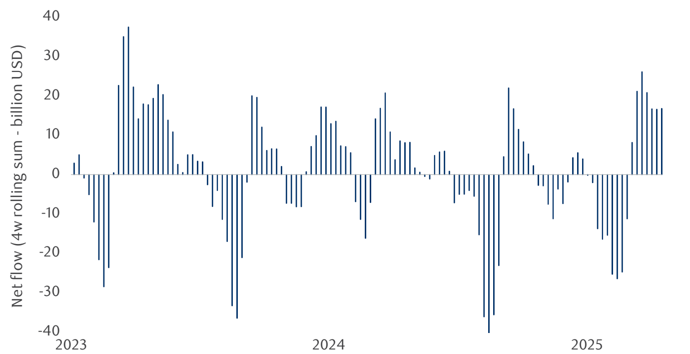
Our prior forecast of 142 was reached in April, so we extend our forecast again to reflect a continuation of U.S.-dollar weakness and the yen's still-positive fundamental backdrop. We expect the Japanese currency to reach 133 per dollar within the next 12 months.

Exhibit 19: Yen supported by falling rates outside Japan



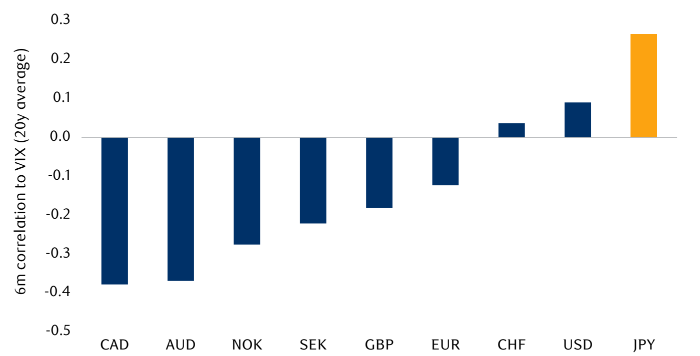
Note: As at June 3, 2025. Source: Bank of Canada, Bank of Japan, Federal Reserve, Bank of England, European Central Bank, RBC GAM

Exhibit 20: Foreign demand for Japanese equities supports the yen



Note: As at May 30, 2025. Source: Japanese MOF, Gavekal, RBC GAM

Exhibit 21: The yen is the only true safe-haven currency



Note: As at June 2, 2025. Source: Bloomberg, RBC GAM

British pound

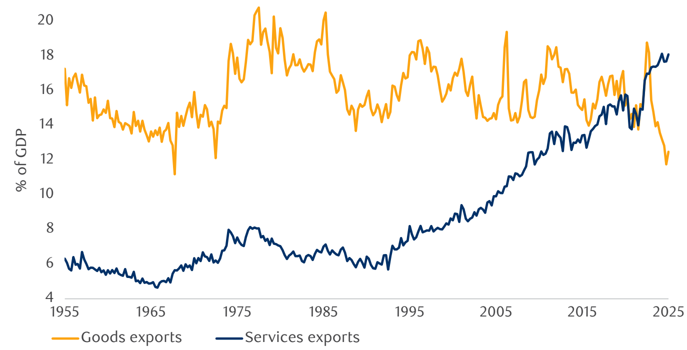
We remain less optimistic on the pound than the euro or yen, conscious of the fact that the UK has weaker economic prospects and a more fragile fiscal situation. To counter Britain's economic challenges, the Bank of England is expected to reduce interest rates and hold down the value of the pound. Also, while it is fairly valued versus the dollar, the pound is actually expensive when compared to the currency of the UK's largest trading partner, the eurozone.

This said, the pound has also achieved our prior forecast and we are inclined to think it can still rally against the greenback. The increase in forecast is partly owing to our expectation for a broader decline in the dollar but is also a nod to the country's trade orientation. For one thing, the UK conducts less trade with the U.S. than do most developed-market peers, and the fact that it runs a trade deficit with the U.S. makes the country less of a target for Trump's trade policy. A trade agreement between the two countries has already been struck in principle, but there are many details that have yet to be solidified, so we won't be surprised if renewed trade tensions return to haunt the pound. A second reason that the UK is more immunized from tariffs is that the UK's exports are more oriented toward services (Exhibit 22), where tariffs haven't been imposed.

A fairly speedy improvement in net portfolio flows is also notable (Exhibit 23). This is especially important given that investors are generally becoming more discerning in how they fund countries with fiscal and current-account deficits. Similar to the U.S., the UK has run twin deficits for many years, but the uptick in investment flows suggest that investors are not shunning the UK as a destination for capital.

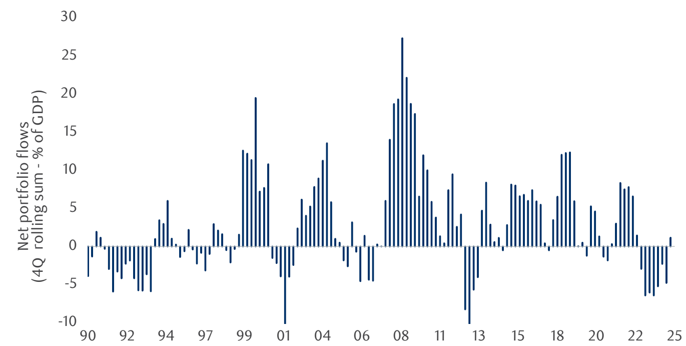
Our new forecast for the pound is US$1.38, five cents higher than last quarter.

Exhibit 22: Composition of UK exports



Note: As at March 31, 2025. Source: UK ONS, RBC GAM

Exhibit 23: Portfolio flows start to support the pound



Note: As at December 30, 2024. Source: UK ONS, RBC GAM

Canadian dollar

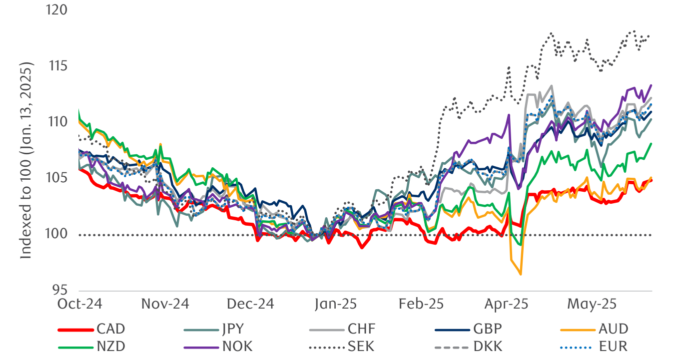
The Canadian dollar has rallied by 5% this year but has generally lagged other G10 currencies that benefited even more from the U.S. dollar's decline (Exhibit 24). The underperformance rests upon a more dovish central bank, some political uncertainty in the lead-up to the late-April federal election and, in particular, a high vulnerability to tariffs. Canada's tight trade and economic ties with the U.S. make it especially sensitive to Trump's whimsical tariff declarations, with risks of much larger economic implications than for Europe, Japan or the UK. While the economy fared better than expected in the first quarter, it only strengthened because companies were bolstering inventories and front-loading exports ahead of the imposition of tariffs.

Clear signs of softness have emerged in the labour market, and the high level of uncertainty is likely to curb large consumer- and business-spending decisions. Economists have already slashed Canadian GDP forecasts in response to the more challenging environment (Exhibit 25), and our own economic outlook implies that Canada will underperform its potential by more than peers amid slowing of economic momentum and uncertainty around trade.

At the same time, the loonie is supported by a number of important positives, including a relatively sound fiscal position (Exhibit 26), strong banking system and cheaper electricity costs. Fiscal stimulus may temporarily buffer the economic impact of tariffs, as the new government appears committed to a continuation of budget deficits. More important for the long-run outlook, however, are the new prime minister's plans to invest in infrastructure and to focus on productivity-enhancing reforms. The elimination of inter-provincial trade barriers and the establishment of west-to-east oil and gas pipelines would be of largest consequence.

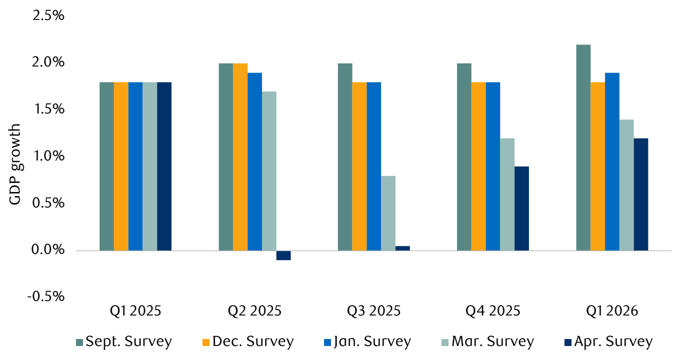
We recognize that the outlook for the Canadian dollar at this stage pivots more on the broader fluctuations of the U.S. dollar than on any Canadian-specific factors. The decline in the greenback is simply too big of an influence for currency investors to ignore and there's little that domestic developments can do to outweigh that overarching theme. As a result, we expect that the loonie will continue to benefit from U.S.-dollar weakness, and its underperformance relative to the euro, yen and pound will soon reach its limits. We forecast that the loonie will appreciate to C$1.32 per U.S. dollar over the next year, which is slightly less than the gains we expect from the euro and yen.

Exhibit 24: Canadian dollar lagging other G10 currencies



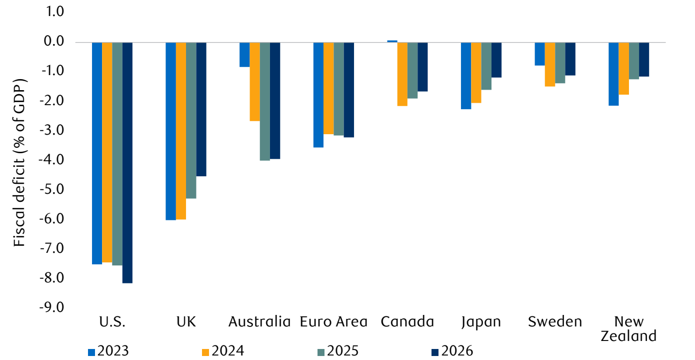
Note: As at June 2, 2025. Source: Bloomberg, RBC GAM

Exhibit 25: Economists have lowered Canadian GDP forecasts



Note: As at April 23, 2025. Source: Bloomberg, RBC GAM

Exhibit 26: Canada runs a conservative fiscal deficit relative to peers



Note: As at December 31, 2024. Source: OECD, RBC GAM

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