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U.S. DOLLAR: LOSING ITS LUSTER?

Executive Summary

- What allows the dollar to function effectively as the global reserve currency is its large, deep, and liquid capital markets.
- In this note, we explain what has been behind the weak U.S. dollar performance year-to-date. Both the direction and magnitude of this move surprised many market participants, as the prevailing consensus at the beginning of the year foresaw a stronger dollar in 2025.
- Structural advantages and emerging risks define the long-term role of the U.S. dollar as global reserve currency. But globally diversified investors are equally impacted by price fluctuations in the dollar, and our view is that risks remain tilted towards a continuation of the recent depreciation from historically overvalued levels.
- Our view is that a viable alternative to replace the U.S. dollar as the global reserve currency doesn't currently exist. However, this view should not lead to complacency, as a lack of alternatives does not mean that there is no attempt to diversify away from the dollar.
- The current environment for the U.S. dollar further enhances the value proposition of a diversified asset allocation, with a mix of U.S. and non-U.S. equity and fixed income holdings.



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In this piece, we address several of the most common questions that our clients have asked regarding the outlook for the U.S. dollar (USD). We discuss the history and the key drivers that have made the U.S. dollar the global reserve currency for decades, examine the structural advantages that support its role as well as the emerging risks that challenge it, explain the drivers of currency valuations, and present our medium-term outlook for the greenback.

What gives the U.S. dollar status as the global reserve currency?

The U.S. dollar's status as the global reserve currency can be traced back to the 1944 Bretton Woods Conference, during which the International Monetary Fund (IMF) and the World Bank were founded by forty-four member countries. As part of the accords reached at the Conference, each country agreed to peg the value of its currency to the USD, which in turn would be convertible to gold at the rate of \$35/ounce. As a result, the dollar became a source of stability intended to prevent currency wars in which frequent devaluations could be executed to gain a competitive trade advantage.

The U.S. dollar's convertibility to gold was suspended in 1971 by President Richard Nixon as gold reserves held by the U.S. were not enough to cover the stock of dollars in circulation outside of the U.S. A system of floating exchange rates replaced the Bretton Woods system, which was instrumental in cementing the global dominance of the USD. Many countries continue to tie their currencies to the dollar or allow them to fluctuate only within a tight range relative to the greenback. The U.S. dollar remains deeply embedded in the global financial system: major commodity markets are priced in USD (including the global oil trade); around half of global payment transactions executed on the SWIFT (Society for Worldwide Interbank Financial Telecommunication) network are denominated in dollars; around 70% of foreign currency debt is issued in dollars;

and global monetary authorities have allocated around \$6.7 trillion in foreign exchange (FX) reserves to dollar claims.

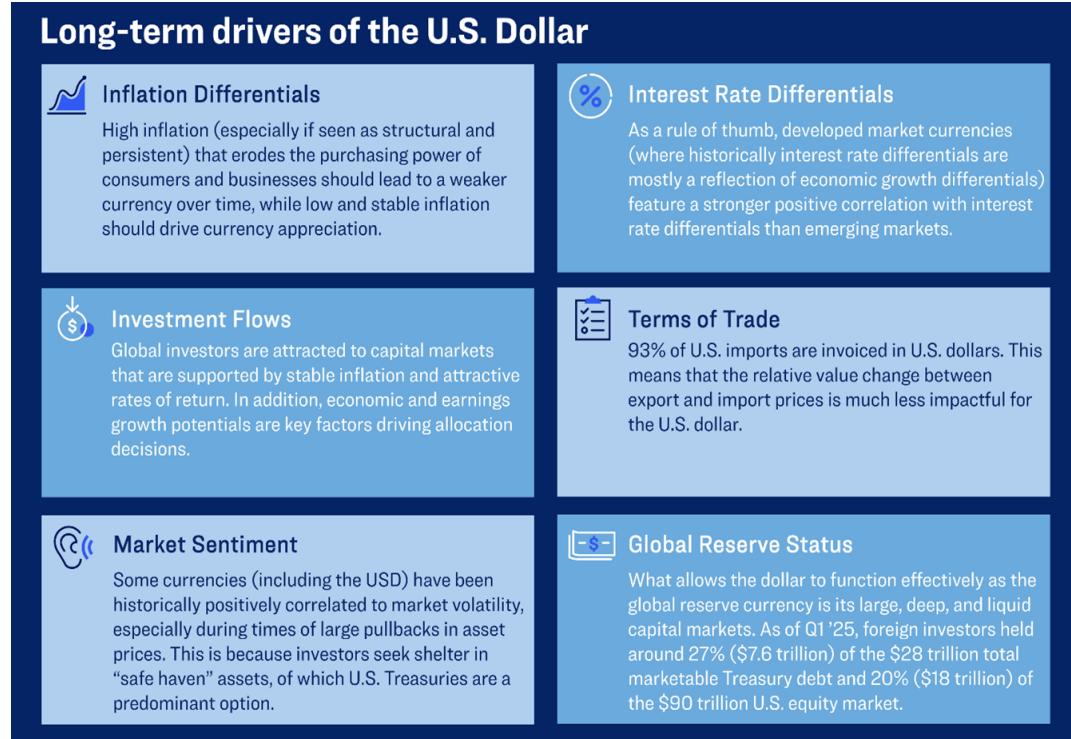
Ultimately, what allows the dollar to function effectively as the global reserve currency is its large, deep, and liquid capital markets. As of Q1 2025, foreign investors held around 27% (\$7.6 trillion) of the \$28 trillion total marketable Treasury debt and 20% (\$18 trillion) of the \$90 trillion U.S. equity market. By offering the ability to invest reliably and profitably across a massive and best-performing opportunity set, the U.S. dollar holds an advantage that is still unrivaled. The primary benefit of a dominant USD on the international stage is that it creates structural demand for dollar-denominated assets. This allows the U.S. government to fund its growing external debt liabilities at relatively low and stable interest rates, although there could be limits to this privilege.

What drives cyclical fluctuations in the value of the dollar?

As noted above, the U.S. dollar's global reserve status represents a powerful source of structural demand. However, there are other factors that determine the fair value of a currency relative to other currencies (Figure 1):

FIGURE 1

Structural drivers of long-term U.S. dollar performance.



Source: TIAA Wealth Chief Investment Office.

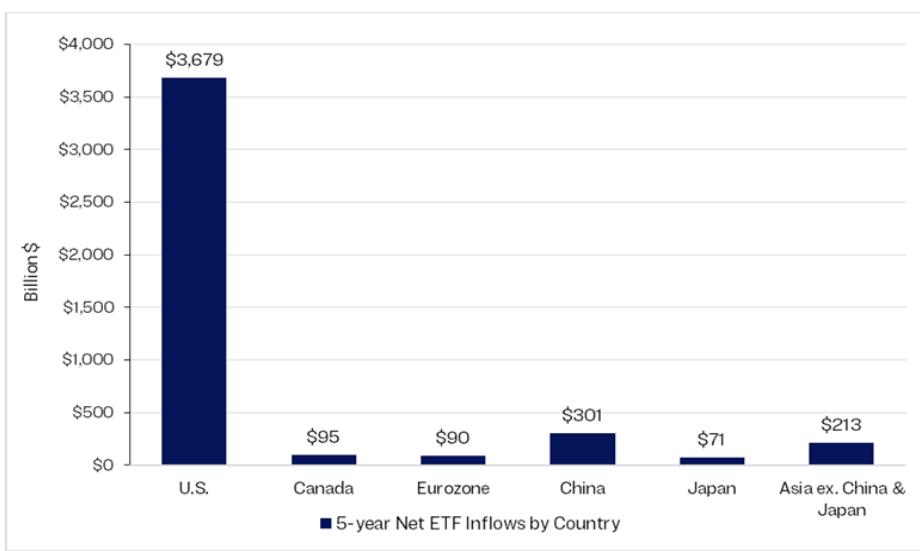
- **Inflation differentials.** Over time, the relative value of two currencies should theoretically adjust in order to preserve a "purchasing power parity." In other words, a basket of goods in different countries should cost the same when converted to a common currency. As a result, high inflation (especially if seen as structural and persistent) that erodes the purchasing power of consumers and businesses should lead to a weaker currency over time, while low and stable inflation should drive currency appreciation.
- **Interest rate differentials.** This is typically a primary driver of short-term currency performance. When rising interest rates are an expression of stronger return potentials and improving economic growth, currencies supported by rising interest rates usually outperform currencies with declining interest rates. That said, this dynamic is weakened when an

increase in interest rates is primarily driven by a spike in price inflation, so that inflation-adjusted return potentials look less, not more attractive; or by fiscal sustainability concerns that cause foreign investors to sell local bond holdings. As a rule of thumb, developed market currencies (where historically interest rate differentials are mostly a reflection of economic growth differentials) feature a stronger positive correlation with interest rate differentials than emerging markets (where inflation is less stable and fiscal positions are shakier).

- **Investment flows.** This is, at least in part, a direct consequence of inflation and interest rate differentials. Global investors are attracted to capital markets that are supported by stable inflation and attractive rates of return. In addition, economic and earnings growth potential are key factors driving allocation decisions. The superior growth rates offered by the U.S. economy and equity market, supportive fiscal policy that allowed U.S. consumers to better withstand the loss of purchasing power, increasingly attractive bond yields following the Federal Reserve's (Fed) tightening cycle in 2022 and 2023, and the emergence of the artificial intelligence (AI) theme all played a part in drawing large inflows into U.S. assets over the past five years (Figure 2).

FIGURE 2

U.S. markets have been in high demand.



Source: Bloomberg, TIAA Wealth Chief Investment Office.

- **Terms of trade.¹** Typically, when a country's value of exports grows faster than its value of imports (leading to a higher terms of trade), foreign demand for its currency rises relative to local demand for foreign currencies. As a result, a higher "terms of trade" should result in a stronger currency—assuming all other factors are equal. The USD is not completely immune to this dynamic. However, 93% of U.S. imports are invoiced in U.S. dollars.² This means that the relative value change between export and import prices is much less impactful for the U.S. dollar.
- **Market sentiment.** Some currencies (including the USD) have been historically positively correlated to market volatility, especially during times of large pullbacks in asset prices. This is because investors tend to seek shelter in "safe haven" assets. Of these, U.S. Treasuries have historically been the predominant option given their high liquidity and ease of access. Over the past 30 years, when the VIX index³ rose by more than 10 points from its lows during any given month, the U.S. dollar index posted a median performance of 1.1% over the same period.

¹ The ratio of the value of exports relative to the value of imports.

² Based on Bureau of Labor Statistics' data.

³ A popular gauge of short-term market volatility.

Why has the dollar depreciated year-to-date?

The trade-weighted U.S. dollar index has depreciated by 6% year-to-date (YTD)⁴, and was ~8% lower by the beginning of July, before recouping some of the losses. Both the direction and magnitude of this move surprised many market participants, as the prevailing consensus at the beginning of the year foresaw a stronger dollar in 2025. There are a few reasons why such a sharp decline might seem counterintuitive:

- The imposition of elevated tariff rates on all major U.S. trading partners reduces the competitiveness of global exporters selling goods into the U.S. In theory, a stronger USD was expected to act as a balancing mechanism that would offset the inflationary impact of tariffs on U.S. consumers⁵ on one hand, and the loss of competitiveness suffered by global economies⁶ on the other hand. Instead, the rollout of President Trump's trade agenda accelerated the decline in the greenback.
- The VIX index spiked from a low of 17 to a high of 60 following April 2, when President Trump announced reciprocal tariff rates. Despite this surge in market volatility, the trade-weighted U.S. dollar index fell by more than 3% in April.
- The U.S. dollar index depreciated by much more than what would have been implied by interest rate differentials, which remained wide in favor of U.S. yields.

However, the apparent departure of the U.S. dollar from historically reliable fundamental drivers can be explained by a range of factors:

- U.S. economic exceptionalism is threatened by three trends: 1) the sharp rise in the U.S. effective tariff rate, with material risks faced by U.S. consumers and businesses; 2) rising concerns about the sustainability of large fiscal deficits, and how they might be financed in an increasingly fragmented global order; 3) the ongoing crackdown on immigration flows, which could reduce the growth potential for the U.S. economy (as the labor force grows at a much more muted pace).
- Tariffs are working as a wake-up call for global governments that became too complacent about the need to boost domestic consumption and investments, and too reliant on the U.S. growth engine. This has been a key motivation behind the unprecedented fiscal package passed by the German parliament in February, the more decisive (by Chinese standards) fiscal easing in China, and the decision by non-U.S. NATO members to boost defense spending over the next several years. A transition from an export-oriented (and therefore U.S.-reliant) economic growth model, to a domestic-oriented (and therefore geared towards stronger consumption and private investments) model in many developed and emerging countries would boost the attractiveness of these markets over the long term.
- Tariffs could also reduce global demand for U.S. assets over the long term, a dynamic that investors could be preparing for by changing their allocation decisions. If tariffs are successful at shrinking the value of goods imported into the U.S., it could lead to less dollar liquidity available globally

⁴ As of August 1, 2025.

⁵ A stronger currency is disinflationary because it allows domestic buyers to purchase foreign goods with fewer dollars.

⁶ A weaker currency makes exports cheaper for foreign buyers.

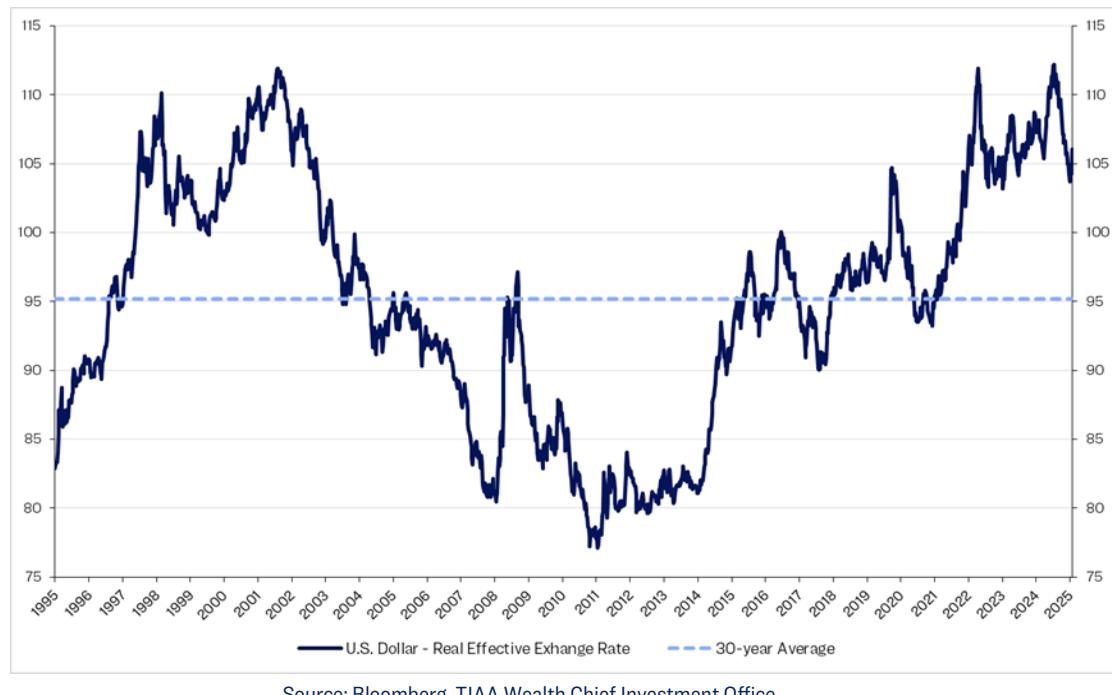
to be reinvested in U.S. assets. This would come at a perilous time, as the issuance of U.S. Treasury debt is set to continue to swell, and therefore requires more, not less, participation of foreign investors in U.S. markets.

These factors have combined to reduce the attractiveness of U.S. assets relative to non-U.S. assets, which in turn has led to U.S. dollar weakness in the first half of the year. However, the extent of the USD depreciation YTD has been exacerbated by three, more technical elements:

- Over the past decade, global asset allocators, on average, have built an overweight exposure to U.S. assets, balanced by an underweight exposure to non-U.S. assets, therefore adding to the urgency to rebalance portfolios at a time of potentially significant macroeconomic shifts.
- A National Bureau of Economic Research (NBER) working paper estimated that non-U.S. insurance companies, pension funds and mutual funds only hedged the USD exposure on 44%, 35% and 21%, respectively, of their U.S.-based asset allocation.⁷ These relatively low hedging ratios were justified by the relentless rise in the value of the U.S. dollar relative to global peers; however, growing concerns about a weakening USD are likely to cause a rise in these hedging ratios,⁸ which should translate into a crucial headwind for the greenback.
- Finally, and importantly, the U.S. dollar appears significantly overvalued across a range of fair-value measures. From a “real effective” standpoint,⁹ the USD was trading almost 18% above its long-term average at the end of 2024 (Figure 3).

FIGURE 3

The U.S. dollar appears historically overvalued.



Source: Bloomberg, TIAA Wealth Chief Investment Office.

⁷ When left unhedged, the currency exposure associated with a foreign investment can add (if the currency appreciates) or detract (if the currency depreciates) from the overall performance of said investment, sometimes significantly.

⁸ Hedging the currency exposure requires selling the currency in which non-domestic assets are denominated.

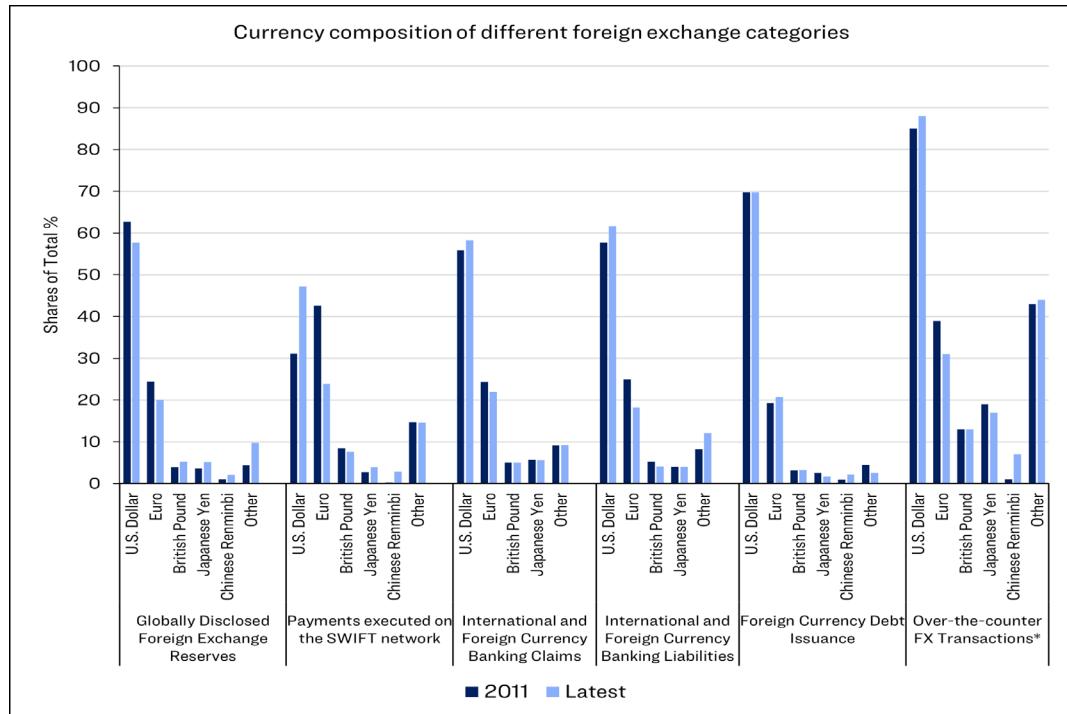
⁹ The real effective exchange rate measures the inflation-adjusted value of a currency against a basket of other currencies.

Is the U.S. dollar at risk of losing its global reserve status?

The IMF releases data on the currency composition of official foreign exchange reserves, also known as COFER, on a quarterly basis. This report shows that the USD share of global FX reserves has declined from 66% in 2015 to 58% in Q1 2025, fueling concerns that a broader departure from the dollar as the global reserve currency is underway. However, COFER is only a partial representation of the aggregate usage of the greenback. A more complete view suggests that the dollar is at least as widely used as it was in 2014, from payment transactions to banking claims and foreign currency debt issuance (Figure 4). We expect the dollar to preserve its global role going forward, for the reasons outlined below. However, challenges to the USD's global role have increased over the past few years, and they have arguably intensified in 2025.

FIGURE 4

The U.S. dollar is still as widely used as it was in 2014.



Source: IMF, SWIFT, BIS, TIAA Wealth Chief Investment Office.

*OTC FX transactions involve two currencies at any time. As a result, the sum of all shares is 200%

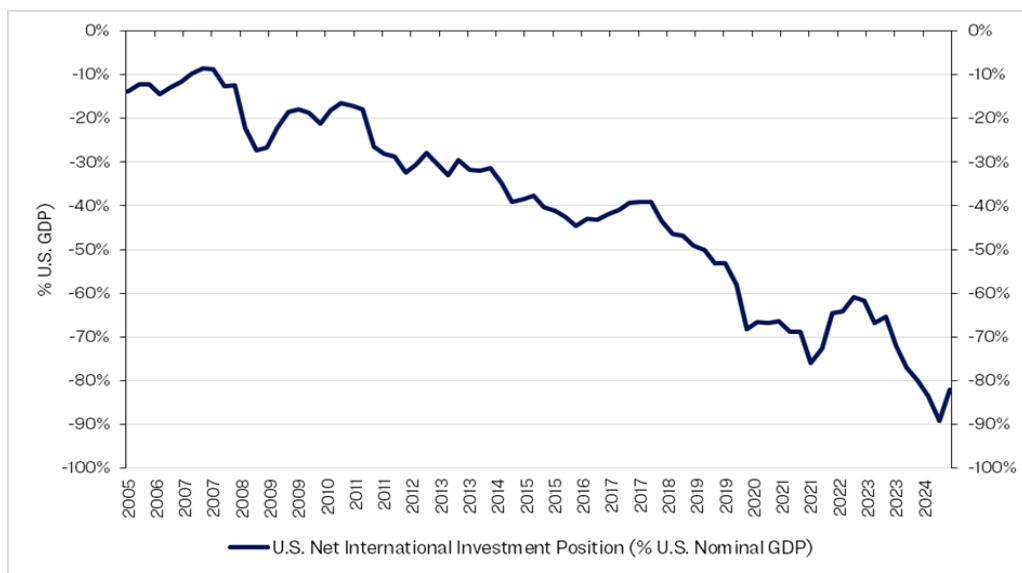
- Strong innovation and a more dynamic U.S. labor market have contributed to best-in-class productivity growth, which in turn raises the growth potential of the U.S. economy. Since Q1 2004, labor productivity is up 40% in the U.S., compared to 17% in the European Union.
- Alongside productivity, the other key ingredient of long-term growth is demographics— specifically labor force growth. The U.S. working-age population (aged 15-64) is projected to increase by a little more than 1% over the next 10 years, according to World Bank data. Not exciting, but significantly more encouraging than population projections in other major economies like the Eurozone and China, where the working-age population is projected to decline by 8% and 6%, respectively, over the next decade.
- Strong and independent political and policymaking institutions, robust property right protections, and a long history of honoring debt payments also contribute to shoring up confidence in the U.S. economy. That said, we see two key risks: 1) the threats to Fed independence, which could undermine the central bank's credibility; and 2) the politicization of bipartisan

government agencies, which could threaten the integrity of economic data.

- More than 30% of international bank loans and 40% of international debt securities where both borrower and creditor are non-U.S. residents is denominated in USD. This creates a structural shortage of dollar liquidity that supports global demand for the greenback. Moving away from this regime would require a complete overhaul of the global financial system, which would take several decades to accomplish. That said, the U.S. economy is one of the largest net debtors globally, with a large negative net international investment position (the difference between foreign assets owned by U.S. investors and U.S. assets owned by foreign investors) equal to -82% of nominal Gross Domestic Product (GDP) (Figure 5). This creates vulnerabilities for the U.S. dollar, should the combination of tariffs and fiscal sustainability concerns, as discussed above, lead to a lower participation of foreign investors in U.S. capital markets.
- Finally, our view is that a viable alternative to replace the U.S. dollar as the global reserve currency doesn't currently exist. However, this view should not lead to complacency, as a lack of alternatives does not mean that there is no attempt to diversify away from the dollar. The strong performance of gold (+63% since the end of 2023) and Bitcoin (+165% since the end of 2023) is symptomatic of shifting attitudes towards the USD, and partly reflects the risks described above, from global fragmentation to debt-related concerns. The creation of money transfer networks alternative to SWIFT by China (CIPS – Cross-Border Interbank Payment System) and Russia (SPFS – System for Transfer of Financial Messages) are also evidence that the creation of regional blocs designed to rival the global hegemony of the U.S. and of U.S. capital markets poses long-term challenges for the greenback.

FIGURE 5

The U.S. economy is one of the largest net debtors globally.



Source: IMF, Bureau of Economic Analysis, TIAA Wealth Chief Investment Office.

What is our medium-term view on the value of the U.S. dollar?

Structural advantages and emerging risks define the long-term role of the U.S. dollar as global reserve currency. But globally diversified investors are equally impacted by price fluctuations in the dollar, and our view is that risks remain tilted towards a continuation of the recent depreciation from historically overvalued levels.

- Tariffs present a range of risks for the U.S. dollar. We believe they might continue to gradually reduce foreign demand for U.S. assets relative to demand for non-U.S. assets. They are likely to raise the price of imports relative to the price of exports, therefore negatively impacting the USD through the terms of trade channel, as discussed above. They could also weaken economic growth momentum in the U.S.
- While the Fed continues to adopt a wait-and-see approach in light of tariff-induced inflation pressures, we expect interest rate cuts to resume towards the end of 2025 and potentially accelerate in 2026, as economic growth remains sluggish. This should also represent a headwind for the dollar via the interest rate differential channel.
- Concerns about the sustainability of the large U.S. budget deficit could also weigh on dollar valuations, and there are signs that foreign investors have begun demanding higher compensation for financing the ballooning Treasury debt issuance in the form of higher yields and a weaker dollar.
- The more isolationist economic stance promoted by the Trump administration is finally pushing global governments to implement more decisive policies aimed at improving domestic consumption and investments, and lessening the reliance on the U.S. economy. Our view is that this could continue to boost the attractiveness of non-U.S. assets relative to U.S. assets, which in turn should support a continued rebalancing of investment flows in favor of more diversified global allocations.
- Finally, a less bullish outlook for the U.S. dollar should also result in foreign investors opting to hedge larger portions of their U.S. allocation exposure, a dynamic that could add to selling flows impacting the U.S. dollar.

In our view, the current environment for the U.S. dollar further enhances the value proposition of a diversified asset allocation, with a mix of U.S. and non-U.S. equity and fixed income holdings.



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