AllianceBernstein®

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The Dollar: Half Awake in a Fake Empire?

The dollar is now less of a safe haven and investors should respond accordingly. Having said that, the lack of any viable alternative means that a shift away from the dollar is likely to be slow rather than sudden. Indeed, despite all the angst and column inches, there is zero evidence of significant outflows from US assets so far.

There are distinct reasons for the dollar being more risky: fiscal sustainability questions, geopolitics and capricious policy making. Given this range of forces that all point in the same direction, we think that the dollar's reserve status will indeed be eroded and that the process of de-dollarization is set to last, albeit at a slow pace. The lack of a liquid alternative is the dollar's strongest support.

The fiscal concerns are, to some extent, shared with G7 economies, and the interplay of sovereign risk and demand for liquid assets is complex and highly uncertain. After all, there is no level of debt/gross domestic product (GDP) that constitutes a hard limit.

The geopolitical aspect of the dollar is an inescapable part of forming a view. This process also encompasses central bank digital currencies (CBDCs) and the evolution in the nature of money. To that end, this note also includes a book-review section covering recent important publications in this field (these works might also be of use for those seeking topical beach reading this summer).

We analyse strategic currency hedging in multi-asset portfolios and show how the benefits vary for investors in different regions. We suggest how this should adapt given the changing risks of dollar exposure.

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Sometimes questions from investors coalesce around a topic in such a dominant way that it is very easy to determine what our next note should be about. At the moment that issue is the US dollar, its role and the prognosis for its future. A lot of the focus in financial commentary is on whether the dollar's recent deprecation will continue (the consensus seems to suggest that it will). We agree with that view, but we also want to link this to the riskiness of the dollar, as opposed to just its direction. A discussion of the dollar also requires addressing bigger topics such as geopolitics, the new cold war and the meaning of reserve-currency status.

We have addressed related issues in recent notes to tackle the topic of US assets and bigger shifts in the nature of money:

Our recent note on US exceptionalism robustly defends the case for a strategic overweight of US equities.

We also recently addressed the question of trust in US assets and the extent to which this may have seen a permanent impairment as a result of capricious policymaking and suggestions of forcible conversion of foreign holdings of US bonds.

We have also recently discussed the role of tokenization and the social role of money and the future of work.

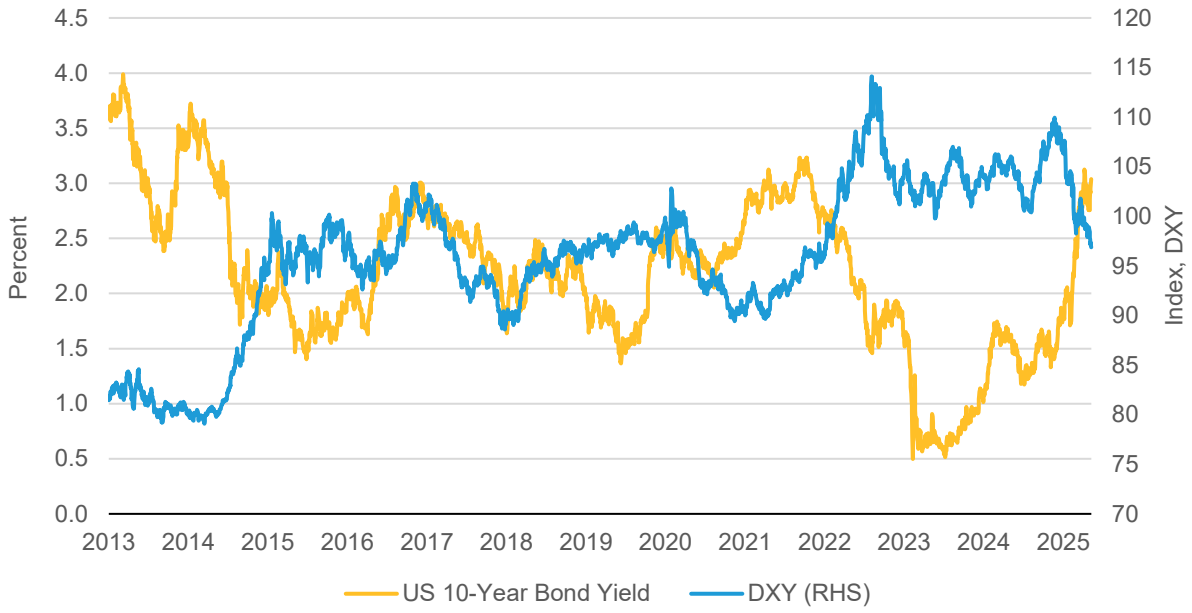
This note focuses on the dollar specifically. We start outlining recent changes in dollar behavior and whether there is a sign of a real movement out of dollar assets. We review threats to reserve currency status, which necessarily touches on deeper questions such as: What is money? We review several recent significant books that address these big picture questions of currency. We conclude with the implications for portfolios and what it means for the need to hedge dollar exposure.

The conclusion we reach is that there are three distinct threats to the dollar's status: worries about fiscal sustainability, geopolitics and domestic policy choices. Some of these concerns, e.g. fiscal worries, apply to other economies too; for others, such as geopolitics, timing is very hard to determine and is bound up in the changing global role of the US. Set against this is the lack of desirable alternatives, which tempers the likelihood of abrupt changes. Nevertheless, with such different forces in place, investors who continue to use the same rules of thumb about the dollar are at risk of being only half awake to multiple changes taking place in different spheres that point in the same direction. Hence, our use of the lyrics from The National in our title. Non-US investors should change their approach to currency hedging—we explore what this means for different types of investors.

We are obliged to think the dollar is less safe

We start this note with the clear evidence that the dollar's behavior has changed. Since so-called "Liberation Day" with its steep tariffs, the correlation between the trade-weighted dollar value and US bond yields has shifted (*Display 1*). Days when the dollar weakens now coincide with an increase in US bond yields. To be fair, while the chart looks dramatic, the apparent strong positive relationship between the trade-weighted dollar and bond yields didn't hold in the same way pre-pandemic. Nevertheless, the breakdown in this relationship now is a sign of disbelief in the US dollar as a safe-haven asset.

DISPLAY 1: THE DOLLAR - BOND YIELD RELATIONSHIP SUGGESTS A CHANGE OF RISK PERCEPTION



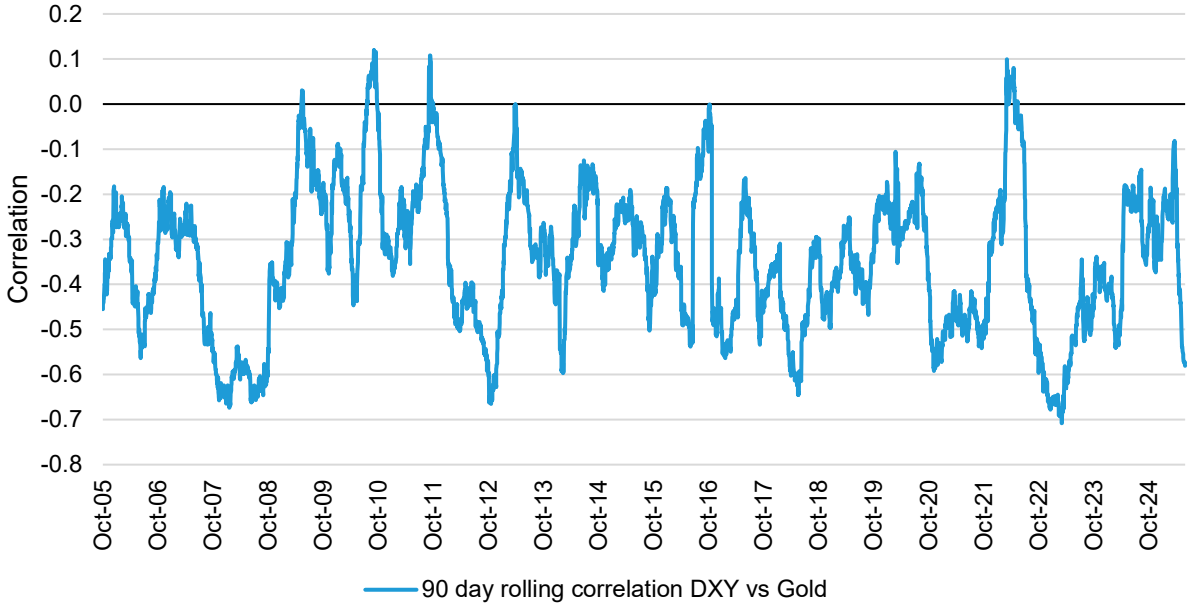
Past performance and current analysis do not guarantee future results.

As of June 30, 2025

Source: LSEG Data & Analytics and AllianceBernstein (AB)

We also note a significant decrease in the correlation of dollar and gold (itself priced in dollars). The 90-day rolling correlation of DXY and gold is –0.6; that is not outside the bounds of history, but is back at levels last seen in the global financial crisis and post-COVID inflation shock (*Display 2*).

DISPLAY 2: DIFFERENT VIEWS ON SAFE HAVENS: GOLD AND US DOLLAR CORRELATION HAS FALLEN



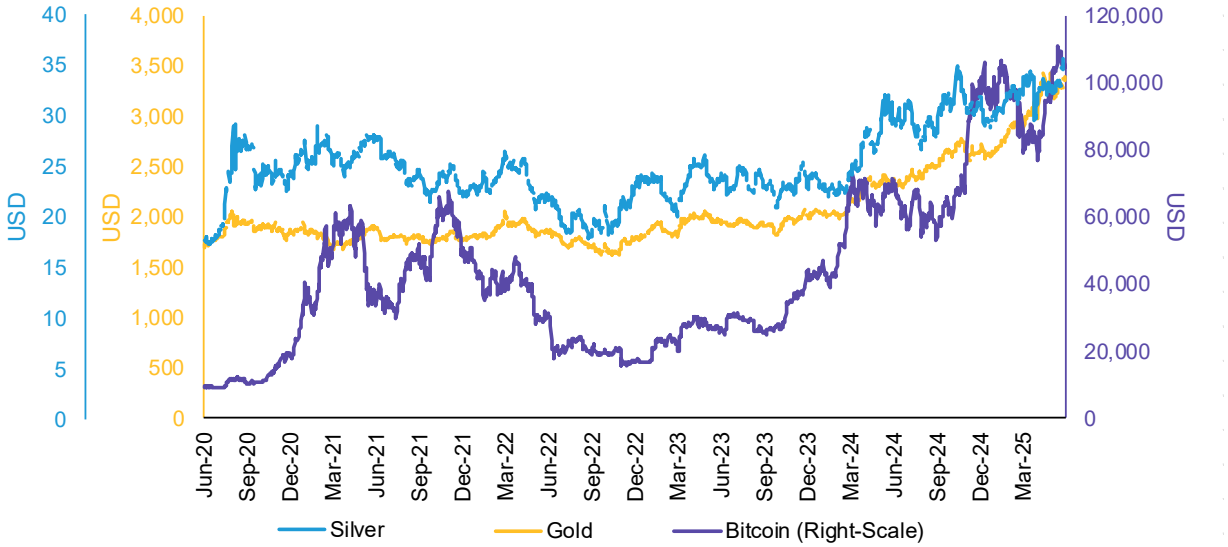
Current analysis does not guarantee future results.

As of June 2, 2025

Source: LSEG Data & Analytics and AB

We have also seen similar moves from three of the key non-fiat "currencies"—gold, silver and bitcoin (*Display 3*)—implying that despite significant differences among them, that their common properties as potential non-fiat assets are coming to the fore. This behavior has now belatedly spilled over into platinum, which is up 40% since the beginning of May. It is remarkable that this recent rally in assets like silver and platinum has occurred with no rise in inflation expectations. Instead, it has happened at the same time that the debate about the dollar's reserve-currency status has intensified to the point where it dominates other economic issues. Platinum and silver had, until recently, not taken part in this shift; they are not traditionally central bank assets. But as more investors wake up to the risk to the dollar, and given the extraordinary rally in gold in recent years, it seems likely that more investors are likely to allocate to silver and platinum, as they view them as the next assets to participate.

DISPLAY 3: GOLD-BITCOIN-SILVER CORRELATION IS UP



Current analysis does not guarantee future results.

As of June 4, 2025

Source: Bloomberg and AB

The basis for the fears around the dollar

There are several distinct aspects of dollar risks that need to be separated because they have different implications.

The proximate worry is the question of fiscal sustainability. This is not a new concern: questions have been prevalent in our meetings with clients for a number of years. Nevertheless, the fiscal trajectory of the US gives this issue renewed concern. At the time of writing, US President Donald Trump's One Big Beautiful Bill possibly increases the US net debt by $3.3 trillion over the next 10 years, according to Congressional Budget Office projections.

This is not just a problem for the US. Yes, the fiscal trajectory is worse there, but for the G7 overall the ratio of net debt to GDP is at the same level as it was at the end of WWII. Japan sailed through the current US debt-to-GDP level long ago. We recently noted that it is far from obvious that aggregate net debt/GDP constitutes a hard limit. Of more concern is that the US annual cost of debt service now exceeds the defense budget, a point we touch on below.

The second concern is possible policies that change the terms for non-US holders of US assets. This topic first flared up with the putative Mar a Lago accord idea presented by Steve Miran, the Chair of the Council of Economic Advisers. This proposal would convert US debt securities held by non-US entities into much longer-term debt, or apply some kind of service fee to coupons, i.e. a soft default. The administration appears to have backed away from the proposal. In a similar vein, the early drafts of the OBBB included a proposal (section 899) to tax foreign capital at a range of 5–20%.

Whether or not these individual measures pass is not the core point. The genie is out of the bottle, not least of which via the sheer capriciousness of US policymaking this year. The treatment of foreign capital invested in US assets might not be the same in the future as it has long assumed to be. This fundamentally challenges the idea of open capital markets, and the risk of a change in terms for foreign investors is non-zero, thus creating a significant disincentive to hold US assets.

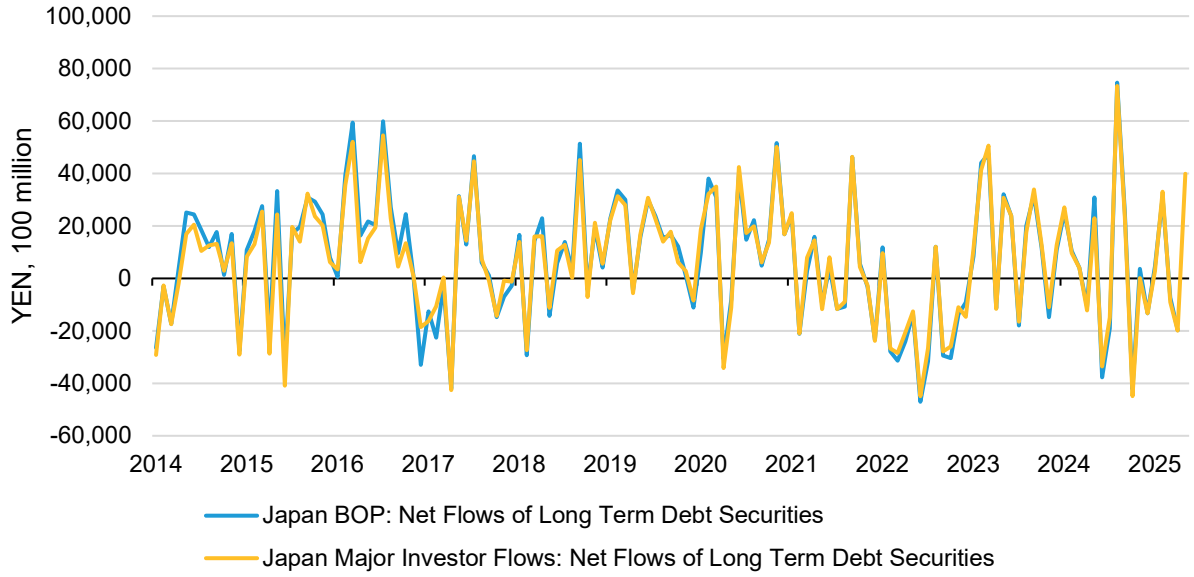
The third leg to this argument is the geopolitical imperative of US rivals to de-dollarize. The weaponization of US dollar access in the wake of the Russian invasion of Ukraine has accelerated efforts, particularly by China and Russia, to find payment systems beyond the reach of the US. Framing the current geopolitical context as a new cold war between the US and China implies there will be a broader demand for nations to find non-dollar alternatives.

All talk and no flow?

The talk of the last few months has been around the idea of a mass reallocation out of US assets. We have certainly witnessed this conversation in our recent interactions with investors. Getting comprehensive data on cross-border flows in real time can be hard, but there are various windows through which this can be viewed.

When your author was marketing in Tokyo in April when fears of a Mar a Lago accord were at their peak, the "vibe" was of investors looking to sell US bonds. Indeed, this did happen. According to data from Japan's Ministry of Finance, that country's pension funds sold more than Y 3 trillion of long-dated bonds in the first two weeks of April. Given their asset allocation, this was presumably dominated by selling US government bonds. The problem with this narrative is that since that time, Japanese pension funds have not only net repurchased what they sold but have gone on to buy more (*Display 4*). Weeks with outflows from US bonds have led to articles in prominent publications about the risk of US capital flight, but so far, at least, such dips have been followed by even larger inflows.

DISPLAY 4: JAPAN'S PENSION FUNDS BUYING/SELLING OF LONG-DATED US BONDS



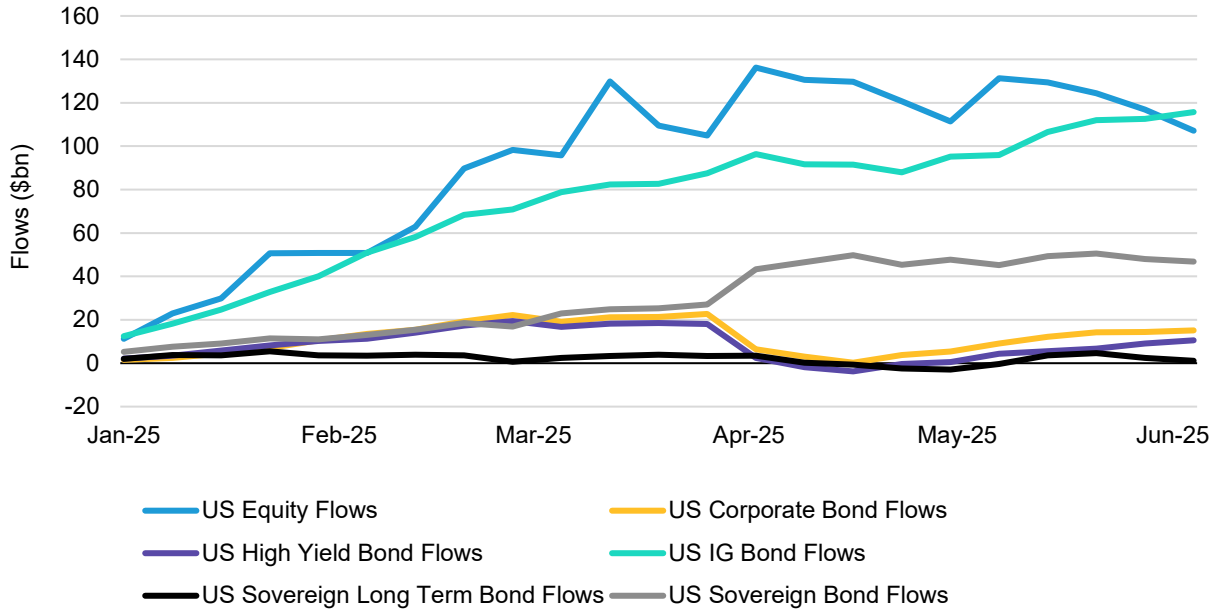
Current analysis does not guarantee future results.

As of May 30, 2025

Source: Japan Ministry of Finance and AB

It is too early to have comprehensive post-"Liberation Day" data from central banks on cross-border flows, but as far as flows into investment funds go, there is no sign of a selling of US assets—equities or bonds. Indeed, in the turmoil of early April, US high-yield and investment-grade credit saw outflows while US sovereign bonds saw inflows. Investors seem to have followed the playbook of what to do in a traditional business-cycle slowdown, not displaying an existential worry about government securities. We think it is right for investors to recognize that continued US growth exceptionalism underpins the case for US equities. However, the case for US bonds is less clear.

DISPLAY 5: FLOWS INTO US ASSETS



Current analysis does not guarantee future results.

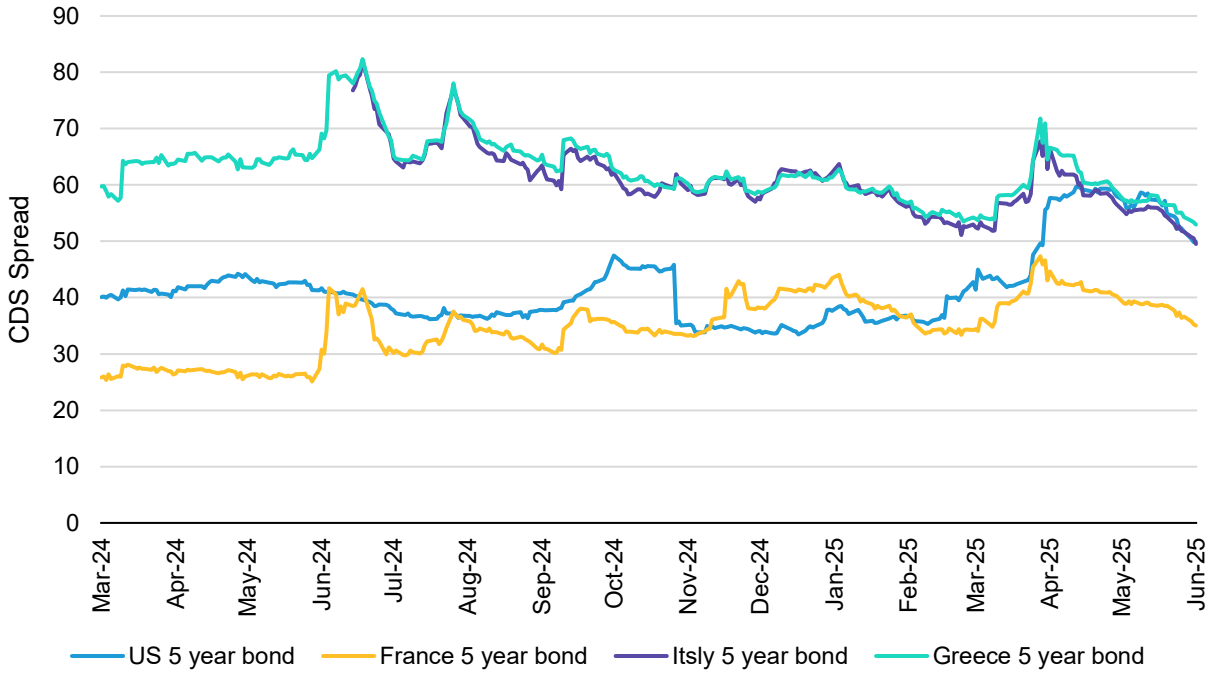
As of June 11, 2025

Source: EPFR and AB

The conclusion from this? Despite all the brouhaha, there have been no net flows out of US assets this year. So far, at least, this is all talk and no action. It may, of course, be too soon for any moves to show up in data. Also, the real issue here is strategic rather than tactical, and changes in strategic allocation are rightly taken slowly and humbly. Maybe we must simply wait to see this in the data.

However, this apparent lack of real rebalancing means that investors could be badly burned tactically if they position for a rapid shift out of US assets. The risk of US assets "should" be priced and hence the yield curve "should" be steeper. One observation that was much commented on is that US credit default swaps now trade in line with those of Italy and Greece, and on par with countries rated BBB (*Display 6*). However, demand for liquid assets has swamped fears over sovereign risk so far, and it seems very hard to point to a proximate force that could change this.

DISPLAY 6: US CDS SPREAD NOW AT SIMILAR LEVELS TO ITALY AND GREECE



Past performance and current analysis do not guarantee future results.

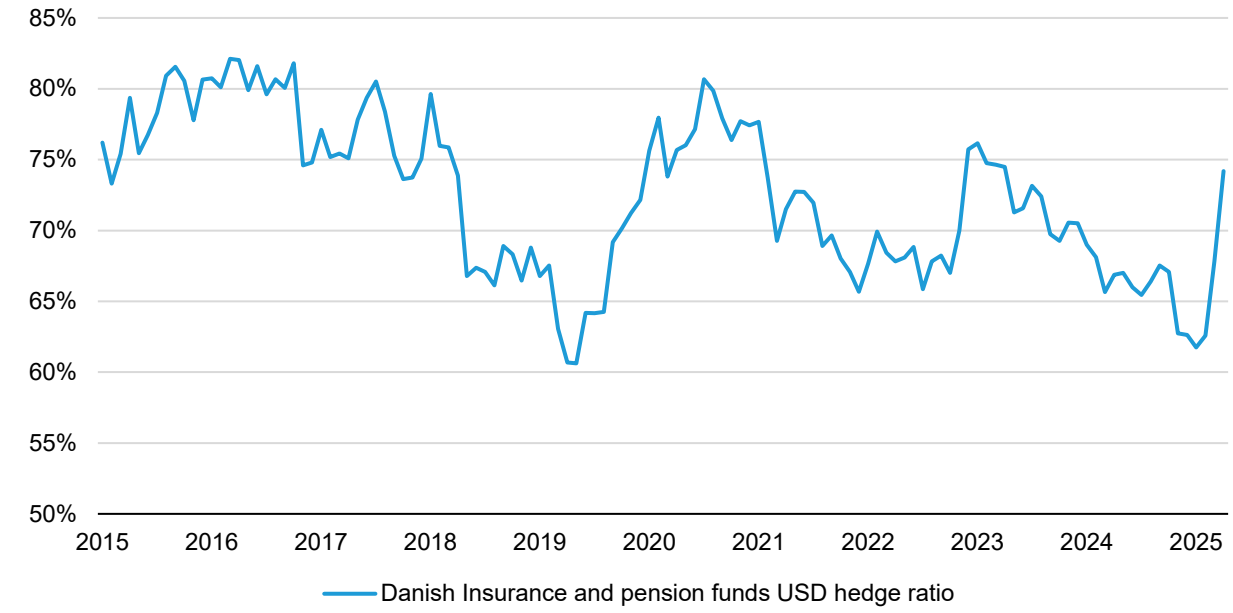
As of June 10, 2025

Source: Bloomberg and AB

Ultimately, we think a flow out of US bonds will occur. However, there are significant impediments. So far, the need for liquidity has swamped all other concerns. There have been flows into other asset areas since April's tariff rollout, e.g. into German equities and emerging market (EM) debt and notably into gold. But all these are moves have been into less liquid assets. To meaningfully effect a strategic change in allocation away from US bonds, investors will have to change their governance structures to accept lower liquidity. That might be hard.

Although there is no evidence of net selling of US assets, there is some emerging evidence of non-US investors increasing their hedging of US assets. As we discuss later in this note, we think that this move makes sense. One example of this shift comes from Danish pension plans, which happen to have timely data on hedging activity. For those institutions, there has been a sharp increase in the amount of hedging of US assets.

DISPLAY 7: DANISH INSURANCE AND PENSION FUND USD HEDGE RATIO IS UP SHARPLY



Current analysis does not guarantee future results.

As of April 30, 2025

Source: Danmarks Nationalbank and AB

Concerns about fiscal sustainability could, in theory, have been used to justify a negative view on duration and the dollar for a long time, but so far demand for liquid assets has swamped all else. Carlyle criticized economics as being dismal explicitly because it sought to reduce all human interaction to supply and demand. But here is an example where supply and demand might not be the only considerations. In the context of a new cold war and shift in economic regime, there are questions of political economy, with a focus on the political. We consider this topic in the next section.

Reserve currency and transubstantiation

Discussions on the role of the dollar ultimately have to be linked to its status as a reserve currency. Tactically, this might not be the paramount concern for investors more focused on the immediate question of whether to shift allocations, but strategically, we think this matters a great deal, as it is set to drive significant capital reallocation.

The bottom line for us is that there is no alternative to the US dollar for now. Having said that, the pressure to de-dollarize, both for geopolitical and economic reasons, is growing. Hence, the most likely path is a slow but consistent flow out of the dollar and into a range of other assets. Developments could accelerate this, but it is hard to imagine a set of circumstances that *increases* the dollar's role from today's level. Therefore, there is the idea that we have reached peak dollar, not necessarily in terms of trade-weighted value (Short-term changes in the business cycle or investor panic could always move exchange rates), but in terms of its role in reserves and share of international transactions. It is really the lack of any viable alternative, and to some extent the unwillingness of investors to accept that the rule of thumb of many decades might have changed, that is likely to make the de-dollarization process slow. For now, at least.

It is unclear what the Trump administration thinks of the balance of costs and benefits of the dollar having its current status. The administration has railed against the alleged overvaluation of the dollar that results from the international demand for dollar assets. At the same time, there have been threats to punish states that move away from dollar payment systems.

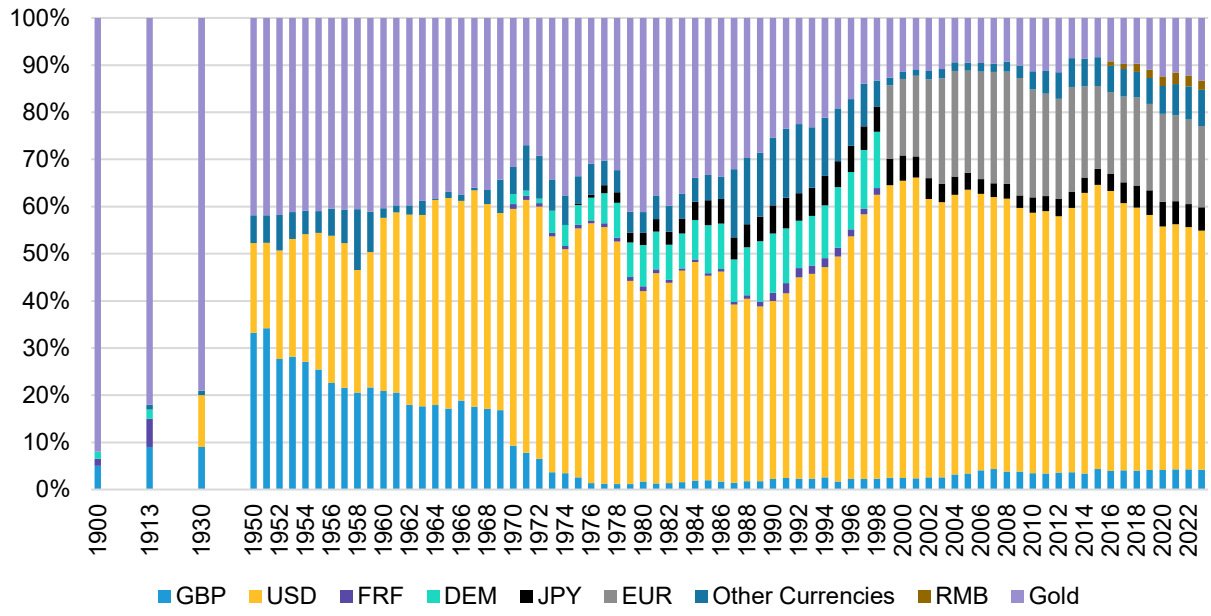
One possible interpretation of the last few months is that an explicit objective of US policy announcements that might be detrimental to foreign capital is actually to lower the value of the dollar. If that is the case, perhaps the 7% fall in the dollar since the start of April has been a policy success. However, this aim seems unlikely to us, as there would have been less-destructive ways to achieve such an outcome. Indeed, any future attempt to negotiate a possible Plaza-type accord will be complicated by the significant loss of trust in the US amongst erstwhile allies. At the same time, incentives for the world to find dollar alternatives has accelerated even more after the last few months.

The US administration railed against the supposed cost of maintaining the reserve currency, partly because of the idea that some of the cost results from the need to preserve military hard power. This seems to work both ways, though. Yes, it is true that through history countries that controlled the reserve currency, or equivalent, of the time also had dominant militaries. At the same time, the possession of reserve-currency status allows the country in question to borrow more cheaply. What is critical is that there is an ability to raise funds in a crisis without creating a run on the reserve currency. This is currently a significant advantage for the US, so we are not sure that this interaction between reserve-currency status and hard power should really be regarded as a cost.

It is informative to consider the last time there was a change in reserve currency. It took the 20 years of the inter-war period for reserve-currency status to shift from sterling to the dollar. There is ample evidence that the two currencies shared reserve status between the wars. This shift took two decades despite the contender for reserve status being quite clear. True, it was not clear in the 1920s and 1930s how totally dominant the dollar would become by virtue of the international system that emerged at the end of WWII, but the transition still took a long time. This time, it is very unclear indeed what might constitute a dollar rival, hence we are not holding our breath to see such a transition.

If one takes central bank reserves as a measure for currency dominance, then the role of the dollar is unrivaled (*Display 8*). There has been a decline in the dollar's share of reserve assets over the last five years, but this is mainly in favor of gold rather than other fiat currencies. Indeed, considering gold's remarkable appreciation in recent years and the rapid pace of gold purchasing by central banks, gold is now in line with the euro as the second-largest reserve asset for global central banks. Similarly, when International Monetary Fund's drawing rights were last rebalanced in 2022, the weight of the dollar actually increased, with the extra weight of the renminbi coming at the expense of sterling, yen and euro.

DISPLAY 8: CENTRAL BANK INTERNATIONAL RESERVES OVER TIME



Current analysis does not guarantee future results.

As of May 30, 2025

Source: Barry Eichengreen, IMF, LSEG Data & Analytics and AB

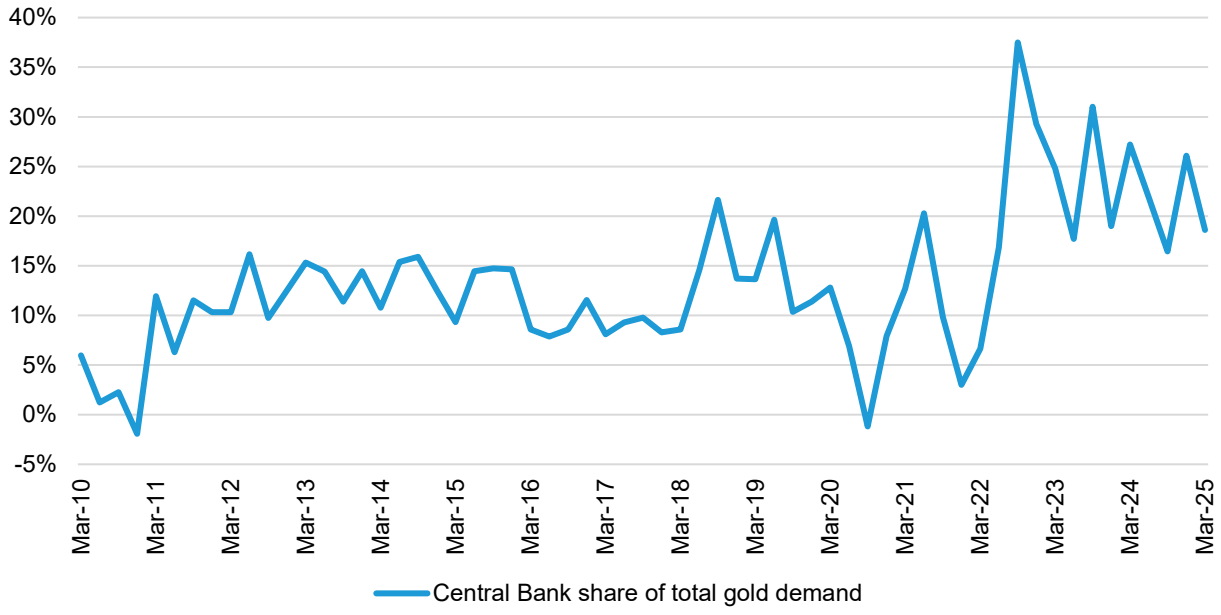
We pointed out earlier that there are three strands to the debate around the status of the dollar: fiscal-sustainability questions, geopolitics and concerns about the evolution of US policy. These can be thought of as internal threats to the dollar (fiscal sustainability and policy changes) and external threats (the geopolitical push to de-dollarize).

The conclusion we draw: these are strong forces with different underpinnings and playing out over different time scales, but all pointing in a similar direction. However, there is simply not going to be an abrupt shift, as no other currency or asset has equivalent status. China is highly unlikely to make its currency convertible, as it would likely spur huge capital flight, and if international investors are worried about the ability of the US government to weaponize dollar access, they are hardly like to be more positive about the role of the Chinese government.

Fiscal sustainability is not only a US concern. The G7 overall has the same level of debt/GDP as at the end of WWII. Japan surpassed the current level of US debt a long time ago. The specific issue is that the rate of deterioration of the fiscal position in the US is worse than in other large economies, but this is an almost impossible balance to call. There is (plainly) no absolute level of debt/GDP that constitutes a limit. If anything, we would give more credence to the Ferguson limit, discussed in the book review section below, that compares the interest cost of debt with the defense budget. Debt levels have been rising for decades; it is only with the interest-rate cycle turning that this constitutes a problem. We saw fears about sovereign debt suddenly flare up in the "Liz Truss moment" for the UK and in the run up to the last French election. So far, the demand for liquid assets has swamped fears about sovereign risk. That is not to dismiss such fears. The ability to service debt does matter and, as we saw earlier in this note, affects the riskiness of the dollar. The conclusion is that this condition is likely to be a long-running problem rather than constitute an acute break by itself.

The geopolitical aspect of the change in the status of the dollar comes down to the strategic imperative of rivals to the US to de-dollarize. This urge is seen in the jump in central banks' share of gold buying after the Russian invasion of Ukraine (*Display 9*). That the share of central bank buying has decreased recently partly reflects the surge in investor buying after two years of gold outperforming equities.

DISPLAY 9: CENTRAL BANK SHARE OF GOLD DEMAND SURGED AFTER RUSSIA INVADED UKRAINE



Current analysis does not guarantee future results.

As of March 31, 2025

Source: World Gold Council and AB

Gold, however, is not really a dollar alternative at scale. Yes, it has been acquired to give a backup basis for non-dollar systems, but as with previous attempts at gold standards, the supply cannot keep track with modern expectations of growth rates. What would challenge the dollar would be a broader shift to an alternative asset used for international trade and for pricing commodities. With the US already energy self-sufficient, the petrodollar system does not have the same level of strategic importance, creating more opportunities for alternative base currencies for commodities.

A real threat would come from a balkanization of payment systems. Here, the role of central bank digital currencies (CBDCs) and other private forms of digital money could really make a difference, hence we include a discussion of this in the book review section of this note. We argue that it is not the technology itself that is the key determinant of adoption here. Instead, what is significant is that the technology has been developed at the same time as there are other economic and geopolitical pressures for change. If it were just the presence of new technology itself as a determinant, that would likely not be sufficient to drive significant change in the dollar's role.

In this way, we see the growth of CBDCs and stable coins as a parallel to the growth of tokenization in asset management. It is not the technology alone that is the key determinant—it is the need for increased exposure to real assets and the need for liquidity that drives the adoption of the technology and why we think tokenization will become increasingly important for investors. See our recent note on tokenization that also discusses the changing social basis of money.

There are significant hurdles in implementing CBDCs, not least of which is the apparently widely held view that the need for them is not obvious, at least from a US perspective. More than that, two specific hurdles suggest there will be significant pushback on their development, at least in the West. First is the question of personal liberty. As we discuss in the book review section that follows, while in theory anonymity could be built into such systems, there is a significant risk that CBDCs do not have anything like the degree of anonymity that cash has. This risk leads to deep debates about the rights of the individual versus the right of the state, the advantages of reducing criminal activity versus the imposition of morality set by one group on another, and other aspects. It is far beyond the remit of central banks to determine answers to these questions, so this debate seems set to run indefinitely.

The second problem is a somewhat more prosaic one, or at least it falls within the realm of economics as opposed to political philosophy. If individuals have access to a retail CBDC, then it is possible that they might prefer that choice over holding deposits at commercial banks. This could threaten the whole fractional reserve banking system, which has underpinned credit creation over centuries. Indeed, credit creation by commercial banks, partially backed by deposits, has been the main source of money creation in the modern economy. Thus, the rise of CBDCs raises questions about where money comes from and how it is created. Developments on this front in the presence of geopolitical and economic pressure on the dollar could speed a fragmentation of payment systems to the detriment of the dollar's role.

Neither of these impediments is as significant in China however, especially not the former, so it seems more likely at this stage that the development of CBDCs will continue to advance faster in China and in BRICS+ countries more generally. It is unclear what form this development will take, i.e. "bridges" between individual country CBDCs or a more China-centric system. Meanwhile, digital-currency innovation in the West, at the moment at least, appears to be more dominated by the private sector in the form of stable coins.[1]

Both these internal and external threats to the dollar bring one back to more fundamental questions, such as what gives money its value and what might undermine that value? One can't help but think there are similarities between the process by which some form of accepted money (be it paper or digital) acquires value and the process of transubstantiation in the Catholic mass. One often, after all, hears the word "faith" associated with the value of a currency. But how does this process come about? How does paper or digital money attain value, and is this process changing given the combination of new technologies with a shift in the geopolitical and economic order?

There is the view that money derives its value from social convention; if this was the case, then alternative units or crypto assets could take the role of fiat currency in theory. However, the alternative view is that in modern societies government gives money its value. What this comes down to is the idea that modern money derives its value from the requirement to pay taxes in it, combined with governments having a monopoly on "hard power." Prasad, in "The future of money" (which we review below),

[1] FT on why card fees are high in US and hence more immediate stable coin role. https://ww CBDC/ Crypto..]w.ft.com/content/28cfb319-4dea-4129-bb6d-ad91fe5010f0

suggests that the various forms money takes—store of value, unit of account and medium of exchange (to which Rosa and Larsen would add "information")—are separating, and that maybe we should not expect to find all these uses in the same entity. This sounds very similar to Esther Perel's view that expecting one single partner to fulfill all the different relationship needs implied in modern society is unrealistic and bound to lead to disappointment.

What does this mean for the dollar? The bottom line is the implication that an increasing share of international transactions and reserve-currency holdings will flow to non-dollar entities. However, the fact that gold has now caught up to become equal in size to the euro as the second largest holding in central bank reserves shows that other established alternatives are not without problems. Indeed, it is the problems that exist with all alternatives that will likely keep this change slow. So yes, we do expect the dollar to depreciate, but it is really dollar risk rather than dollar returns that is the real shift. Hence, the conclusion from this note is really about hedging dollar assets rather than a directional forecast.

Review of recent books on money and the dollar

There have been a number of recent books on the dollar and broader issues around the status of money and how it is changing. As they touch on the bigger questions raised in this note, we review aspects of them here for those who are interested in delving deeper into these topics. As ever, when we discuss books in our research, these should not be taken as traditional book reviews. Instead, we discuss the key points in these books that we think are germane to shifts that investors must grapple with in the way they think about strategic asset allocation, given the macro challenges today.

Any discussion of the role of the dollar quickly spills over from economics into geopolitics. Indeed, despite three of the works we discuss here coming from very different angles, Rogoff, Rosa, and Larsen and Ferguson all implicitly or explicitly acknowledge the interplay of reserve-currency status and hard power. Thus, the geopolitics of the dollar is an inescapable part of forming a view on its future return and risk level.

Probably the most relevant of these books to the immediate issue of the dollar's role is Rogoff's recent book.

Rogoff: Our dollar your problem: This is a very prescient book, given that it was written in 2024, just before the deluge of concern about the role of the dollar.

There is an interesting history of other recent contenders to dollar hegemony, and the author suggests that at least part of the total dominance of the dollar is luck (the Japanese agreeing to devalue the yen in the 1980s and the admission of Greece into the euro holding back possible dollar rivals). The key part for discussions about the structural role of the dollar looking forward are the limits to the dollar's role: Rogoff concludes that the period of pax dollar has peaked. Having said that, a decline could take a long time given the lack of obvious alternatives. However, this has critical implications for funding the US government, as the global demand for dollars has given the US a huge advantage that might be at risk.

Rogoff identifies the geopolitical threats to the dollar from the wish of rivals to the US, particularly China, to find an alternative. However, he asserts that the real threats to the dollar come from within, not externally. This is the view that the level of debt matters and the mistaken view that low rates can persist indefinitely. Linked to this, he thinks that people are too complacent about inflation, assuming that the problem has been solved by central banks. Rogoff thinks that the post-pandemic world that sees deglobalization and concerns about high debt levels will lead to structurally higher levels of inflation.

As an aside, one view that flows from this position is that it is a mistake to view US government debt as safe. An outright default is unlikely (though the author asserts that the 1930s did see what constitutes a default,) but what is more likely is an erosion of the value of US bonds by inflation.

The advantage of the US dollar being a reserve currency is mainly a lower cost of funding for the US government, but also the ability to weaponize access to dollars to contain rivals. There has been a lively debate about what the costs of the reserve currency are for the US. The main one that Rogoff cites is the idea that to have the global reserve currency likely also requires one to have hegemonic military power. The link is debated; there are clear historical parallels to the previous role of sterling, and to other currencies that attained reserve status before that. The linkage possibly flows both ways. Having unrivaled hard power enables the US to enforce rules, but also having the reserve currency brings the critical benefit of allowing the US to quickly raise funding in an emergency.

There is a discussion of crypto. Rogoff confidently asserts that there is zero chance of crypto replacing the dollar (we agree). This necessarily leads to a discussion of "what is money." He rejects the Harari view that money is purely a social convention in the sense that what constitutes money is mutual agreement between people. Rogoff is very much of the opinion that the role of government is critical and that governments will always have the last say as to what counts as money.

At the same time, he strongly disagrees with the idea that crypto is worthless. Interestingly, Rogoff's view is that the backstop for crypto is its critical role in the underground economy, which he estimates as constituting between 20% and 30% of the economies of many large nations. We are not so sure that we agree with this, in the sense that the broader hunt for non-dollar, non-fiat assets also seems to constitute a demand for crypto. Rogoff also makes the point that crypto is helpful for evading capital controls and critical for those who do not have banking access, a point that we agree on.

There is a brief discussion of CBDCs. Rogoff says there are really two reasons for them: 1) to improve efficiency of payments and 2) to try and deflate or limit the role of the dollar. He thinks that CBDC development should be left for smaller nations, as the US has the most to lose. Ultimately, he is skeptical that it can compete with the dollar.

Rosa and Larsen: Smart Money

The authors take a very different view on CBDCs from Rogoff's. In their eyes, there is a case for developing CBDCs that is geopolitical in nature; from this point of view, they are a key part of the new cold war between the US and China. Interestingly, the book ultimately makes a *moral* argument for the West to develop CBDCs. The argument is that if the West doesn't act, then the 1.4 billion people who are unbanked will likely move to a payment system dominated by China. The other part of their argument is that the West has an opportunity to show that digital money is compatible with liberal democracy, as the other emerging model is autocratic.

The book describes how the argument for and against the development of CBDCs is about the future of money. It forces us to reconsider fundamental questions about what money is. Here, the view is closer to the idea of money as an information system rather than merely a store of value.

The focus of the book is really the symbiosis of geopolitics and money. The weaponization of the US dollar in the wake of the Russian invasion of Ukraine has been a critical stimulus for China's development of the e-Yuan. The authors then link this to the development of the Belt and Road initiative. The claim is that this project is not only a force to develop infrastructure but also to encourage a broad use of Yuan financing. The authors claim that China is seeking to position the e-Yuan as a "reserve currency" for countries that are in the Belt and Road group. There are potentially broader implications for BRICS+ nations and the currency used to price commodities, which the authors see as critical given the likelihood of a massive increase in energy demand from advanced economies.

Rosa and Larsen are critical of the approach taken in the West. This approach has evolved from the view that CBDCs are a "solution in search of a problem" (as concluded by a House of Lords report on the topic) to outright skepticism with a view that CBDCs are a tool for authoritarian control of individuals' finances. Instead, the preferred blockchain digital money emerging in the West is stable coins. The authors think the future of money is "too important to be left to the private sector," yet that seems to be exactly the path being followed. (Indeed, Rogoff takes the view that this allows for private sector innovation).

In our view, we liked the attention that this book brought to the geopolitical aspect of CBDCs. However, in our mind there was not enough coverage of the dangers to established models of credit creation in capitalist economies posed by the potential for CBDCs to disintermediate commercial banks.

Prasad: The Future of Money

The book covers a number of important issues around the topic of digital money, but the core theme germane to our topic here is that it makes the case for CBDCs. The conclusion includes the phrase "The rise of CBDCs is a foregone conclusion." However, the book is not only a discussion of the economic case for CBDCs. It also includes an intriguing exploration of the idea that the advent of digital money implies a separation of the various forms of money, and moreover that conversations about the social

implications of digital money in the form of inequality and questions of liberty are never far from the discussion (rightly so in our view).

Prasad suggests that the advent of digital money leads to a struggle between centralized official money and private forms of money. This is not a new state of affairs, though. We have seen this before, just prior to the era of central banks becoming so powerful, e.g. in the 19th century.

For Prasad, the positive case for CBDCs rests on the following points:

- The shift away from cash diminishes the role of the central bank. If one takes the view that the control of money is too big an issue to be left to the private sector, then CBDCs can restore the role of central banks (people will have different instinctive responses to this, of course).

- Financial inclusion, i.e. the ability of the unbanked to have easier access to money, though we think this might be double edged: What if people are unbanked explicitly because of choices made by the state?

- Monetary sovereignty, in the sense of defending the ability to implement monetary policy (which, for example, would be a problem if prices started to be set in, say, crypto). It also brings the ability to innovate on monetary policy, e.g. through the ability to implement negative rates and helicopter money.

- Reduce corruption/shadow economy (though this is also double edged in our view)

There is also a discussion of the case *against* CBDCs.

There is a legitimate fear of banking disintermediation—if retail CBDC is available, then this might cause capital flight from deposit-taking banks. Prasad particularly focuses on this in the context of the possibility for a bank run in a time of panic. That is a real concern, though our more strategic worry is the impact this could have on credit creation in the long term and hence on aggregate growth.

The other big case against CBDCs is privacy. The author takes the view that "the displacement of cash by digital payment systems will eliminate any vestige of privacy in commercial transactions." This is a sobering statement, and one that those of a libertarian bent have already campaigned against. Prasad recognizes that the anonymity of cash has allowed society to evolve at certain times to make certain laws unviable when social mores have moved on. He cites the ending of prohibition in the US as an example; one can think of any number of similar cases today.

The book takes the view that the emergence of new payment systems raises questions about what constitutes a reserve currency and what is a safe haven, which of course is exactly what we are seeing today. On this point, though, Prasad writes that while use of digital renminbi will grow, it will be no threat to the dollar "for a decade." However, this book was written before the Russian invasion of Ukraine, so it came before the intensification of the geopolitical imperative for de-dollarization.

While the book sees the rise of CBDCs as inevitable, the questions it raises also suggest that the future path of monetary evolution will be a social, political and possibly even a moral choice rather than a path determined by technology alone. After all, how much privacy or anonymity should there be in society?

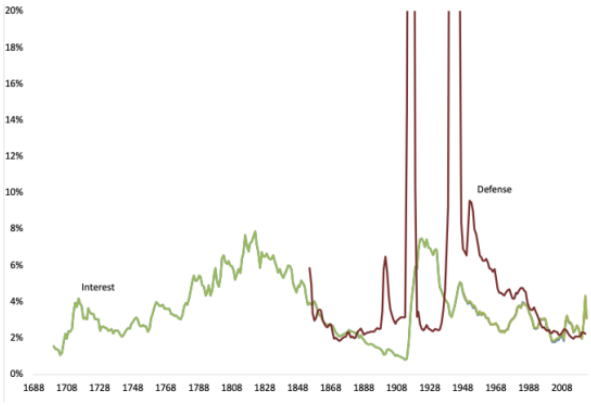
Ferguson's Law: Debt Service, Military Spending, and the Fiscal Limits of Power

This publication is not strictly about money and neither is it a book but an extended paper. Nevertheless, we include it here as it is highly relevant to the current debate. Niall Ferguson recently proposed Ferguson's limit (named, it seems, after Adam Ferguson, the eighteenth-century Scottish philosopher of the Enlightenment rather than Niall himself). The law states that a great power that spends more on debt servicing than on defense will not remain a great power for long. This point is relevant because in 2024, US debt-service cost exceeded its defense budget ($882 billion versus $874 billion) for the first time. Ferguson cites Habsburg Spain, Bourbon France, the Ottoman Empire and Austria-Hungary as a list of unhappy examples where the cost of debt service exceeded defense spending—with deleterious consequences for these states to retain the ability to project power. This shortcoming was especially dangerous in times of more rapid technological change, when the need to service debt meant it was not possible to catch up with rivals.

The country that was most like the US in this regard was the UK, especially in the wake of WWI. UK defense spending was greater than the interest-service cost of debt in the late 19th century. In 1913, on the eve of WWI, interest payments were at an all-time low of 0.8% of GDP; defense spending accounted for 3.2%. As the war concluded, defense spending fell but interest-servicing costs soared to 7% of GDP in the early 1920s (*Display 10*). This curtailed the ability of the UK to project hard power. It was also the period when sterling began to lose its global reserve-currency status, at first shared with the US dollar and then lost altogether after WWII.

An interesting aspect of the UK case is that it managed to cross back over the Ferguson limit. For the whole of the Cold War, the UK spent more on defense than on interest-servicing charge. In 1982, the time of the Falklands War, the UK was still spending 4.4% of GDP on defense, a level above the share that the US spends on defense today. However, this crossing back over the Ferguson limit required a policy of allowing the debt to be inflated away and, with that, a very significant devaluation of sterling (from $5 per pound on the eve of WWII to $2 by the early 1980s). This is an uncomfortable parallel to the US.

DISPLAY 10: UK INTEREST AND DEFENSE EXPENDITURE (1688–2023)



Historical analysis does not guarantee future results.

As of February 21, 2025

Source: Niall Ferguson (2025), Ferguson's Law: Debt Service, Military Spending, and the Fiscal Limits of Power, Hoover Institution History Working Paper 202502)

DISPLAY 11: US INTEREST AND DEFENSE EXPENDITURE (1947–2023)

Historical analysis does not guarantee future results.

As of February 21, 2025

Source: Niall Ferguson (2025), Ferguson's Law: Debt Service, Military Spending, and the Fiscal Limits of Power, Hoover Institution History Working Paper 202502

McWilliams: Money – A Story of Humanity

Unlike most of the other material discussed in this section, this book is mainly a work of economic history covering the evolution of money from the very earliest times. There is a fascinating discussion of the first issuance of coins and events such as the Roman credit crisis of 33 AD.

The book's coverage of more contemporary issues probably has most relevance for the investment implications of changes in the nature of money, in particular what McWilliams sees as a coming struggle between private and public money—a point of discussion in the other books discussed here. McWilliams is very dismissive of crypto and stablecoins, taking the view that the state will not give up power over money and worrying that these currency alternatives create the risk of regressive wealth transfer. He concludes that bitcoin is to money what Esperanto is to language: a source of obsession for supporters but of little practical use in reality.

Currency hedging in multi-asset portfolios

For non-US investors, the approach taken for managing currency exposures is a first-order strategic and tactical decision. With the USD dominating the available market cap of equities available to buy, the key question for any investor—be they based in sterling, euro, yen, Swiss franc or Aussie dollar, is the amount, if any, of this USD exposure to hedge.

To hedge or not to hedge – simplistic argument

To hedge: Currency risk is unrewarded and uncorrelated with markets, and hence should be eliminated from portfolios in the absence of any strong view on the direction of any particular currency.

Not to hedge: Hedging comes with a small but inevitable frictional cost on returns; even absent any view on the direction of currency exchange rates, this will impact long-term returns.

Building a strategic approach

It is important, whenever referring to a strategic approach, to understand the time horizon we are concerned with. It would be naive to think that "strategic" is forever in all but the simplest of asset-allocation decisions—perhaps limited to equities versus bonds.

Our preferred approach is that strategic decisions are ones that you expect to play out sometime within the next five to 10 years, but that does not preclude them from happening quicker than this, and creates the need to react quickly (in strategic terms) to capture the gains when they occur. For example, we may think an asset class is fundamentally mispriced but that market dynamics need to shift considerably for this to be realized. We believe that currency falls well within this camp, with mispricing able to last far beyond the tactical horizon of many investors but with an inescapable force of gravity in terms of purchasing power parity, current-account deficits and interest rate/inflation differentials.

Common strategic approaches

Three approaches are common within the market:

1) **No hedge:** This approach is also common in two use cases: retail investors unaware of the risks they are running and investors with a very strong home bias (typically US investors) where the incidence of currency risk is minimal.

2) **100% hedge:** All assets are 100% hedged back to the investors' currency. This approach is common in two use cases: first, mutual funds built from a single-currency perspective with the objective of making them easy to move based on simple NAV hedge to any other currency, and second by absolute return long/short investors running to very tight short-term risk budgets and unwilling to let currency dominate the investor return experience.

3) **Partial hedge:** Where two not entirely unrelated approaches dominate:

   Low risk asset hedge only: Hedging applies to lower-risk assets, such as bonds and absolute return strategies. This approach tends to dominate among lower-sophistication asset allocators, such as smaller wealth advisers and institutional investors, often constrained by their access to suitable vehicles.

   Integrated hedge: A hedge ratio on assets is often set with allowance for the underlying volatility of the assets held. This tends to be the preferred approach of the most sophisticated institutional investors and wealth managers. Most common is a full hedge on low-risk assets, such as bonds and absolute return strategies, combined with a fixed-rate hedge, typically 50%, of foreign-currency risk on risk assets, predominantly equities and often constrained to developed market currencies.

Our preferred approach to currency hedging

Unsurprisingly, we favor the last of these approaches, but with a slight nuance that the hedge ratio should vary by the currency of the underlying investors and based on their strategic outlook for currency markets, predominantly the US dollar, given US stocks' significant proportion of global equity markets.

Intuitively, the application of this approach in practice is:

1. Hedge ratios should vary based on investors home currency market:

    a) Safe haven currencies, such as the US dollar, yen, euro and Swiss franc, should tend to a higher strategic hedge ratio, benefitting less from the safe-haven nature of the USD.

    b) Procyclical currencies, such as the Australian dollar, sterling and EM currencies, should tend to a lower strategic hedge ratio, benefiting more from the safe-haven nature of the US dollar and to a lesser extent the euro.

2. Our conclusions in this paper suggest that all investors would benefit from reduced exposure to the US dollar, including the following views:

    a) The US dollar will weaken.

    b) A negative correlation of the US dollar with equity markets is less likely.

The strategic hedging range: today and tomorrow

Display 12 illustrates our case for hedging foreign-currency exposure based on an investor's base currency, from the perspective of an investor in global developed-market equities. This is a simplistic strategic asset allocation framework that helps to set the guardrails (a 25% range) within which an asset allocator should consider both setting their long-term strategic hedge and perhaps tactically adjusting their hedge.

DISPLAY 12: STRATEGIC HEDGING EXAMPLES

Investor Currency	Portfolio Foreign Currency Exposure	Volatility Reduction Provided by Foreign Currency	Drawdown Protection Provided by Foreign Currency	Long-Term SAA Hedging Range*	Current Position
USD	Low	Minimal	Negative	75-100%	Reduce
EUR	Average	Positive	Balanced	50-75%	Increase
GBP	High	Positive	Positive	25-50%	Increase
CHF	High	Negative	Negative	75-100%	Increase
JPY	High	Negative	Balanced	50-75%	Increase
AUD	High	Positive	Balanced	50-75%	Increase

Current analysis does not guarantee future results.

* As a percentage of a market cap weighted developed market portfolios overseas currency exposures should be hedged

As of June 30, 2025

Source: Bloomberg, MSCI and AB

To capture a few highlights from the table:

For US dollar and Swiss franc investors, the home currency's highly defensive nature makes foreign currency exposure beyond tactical positioning undesirable from the perspective of both diversification and drawdown protection. However, it should be noted in the case of US dollar investors the relatively low foreign currency exposure within portfolios and the ability to build a well-diversified portfolio without owning overseas stocks means that a broader range of hedging strategies would often be applied in practice.

Both euro and yen investors benefit to some extent from having some currency exposure and should probably hedge at least 50%. In the case of euro investors, the breadth of the home market does allow for a lower hedge ratio, to the extent that a home biased portfolio is used. For yen investors a backward-looking approach would suggest a hedge ratio strategically towards a

higher level would make sense but it should be noted that this currency shows signs of being in transition from a defensive currency more like the Swiss franc to one which has more similarities with the euro.

For sterling investors, the significant benefits of holding USD exposure from both a volatility management and drawdown protection perspective result in a lower strategic hedge range.

Returns: currency can damage/enhance investors' wealth

Return differentials on an annualized basis over three years between hedged and unhedged global equities can be significant for all investors, with Japanese and Australian investors the most exposed (*Display 13*).

DISPLAY 13: RETURN DIFFERENTIALS OF HEDGED VS. UNHEDGED

	Max Return Differential Annualized over 3 Years	Average 3-Year Annualized Return Differential
US Dollar	5.8%	0.4%
Euro	9.8%	-1.3%
Sterling	9.9%	-1.4%
Swiss Franc	9.6%	0.3%
Yen	16.3%	-7.1%
Australian Dollar	21.3%	-0.3%

Past performance and current analysis do not guarantee future results.

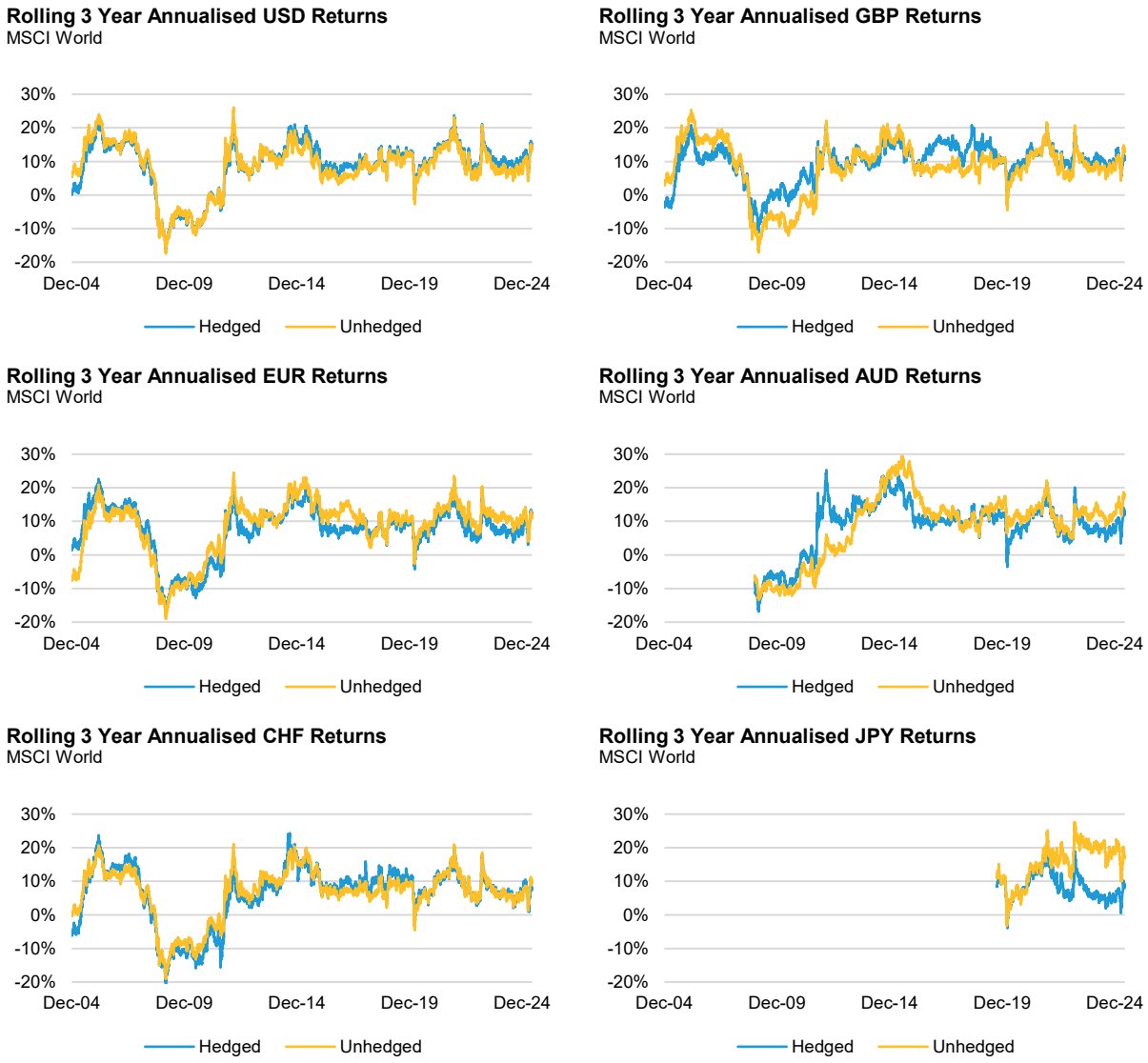
[* As a percentage of a market cap weighted developed market portfolios overseas currency exposures should be hedged

Index used is the MSCI World Index Unhedged and Hedged to the relevant currency with net dividends reinvested.

As of June 30, 2025

Source: Bloomberg, MSCI and AB

DISPLAY 14: ROLLING THREE-YEAR ANNUALIZED RETURNS – HEDGED AND UNHEDGED



Past performance and current analysis do not guarantee future results.

Index used is the MSCI World Index Unhedged and Hedged to the relevant currency with net dividends reinvested.

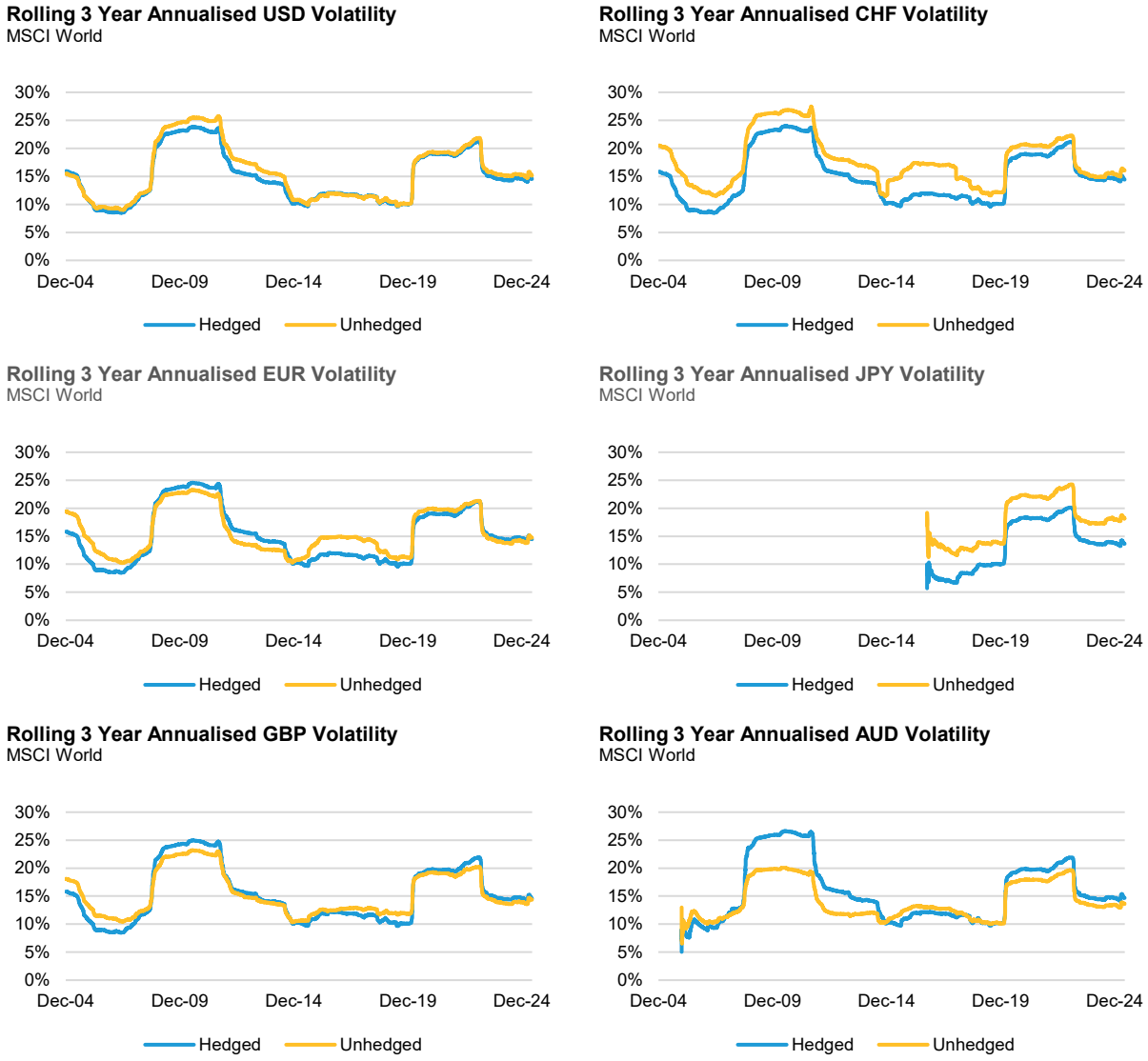
As of June 30, 2025

Source: Bloomberg, MSCI and AB

Volatility management: hedging does not always reduce volatility

For US dollar, Swiss franc and yen investors, hedging historically has reduced portfolio volatility in nearly all markets (*Display 15*). However, for the euro, sterling and Australian dollar, the case is more balanced, with hedging unattractively increasing volatility in volatile markets and reducing it in low volatility markets.

DISPLAY 15: ROLLING THREE-YEAR ANNUALIZED VOLATILITY = HEDGED AND UNHEDGED



Current analysis does not guarantee future results.

Index used is the MSCI World Index Unhedged and Hedged to the relevant currency with net dividends reinvested.

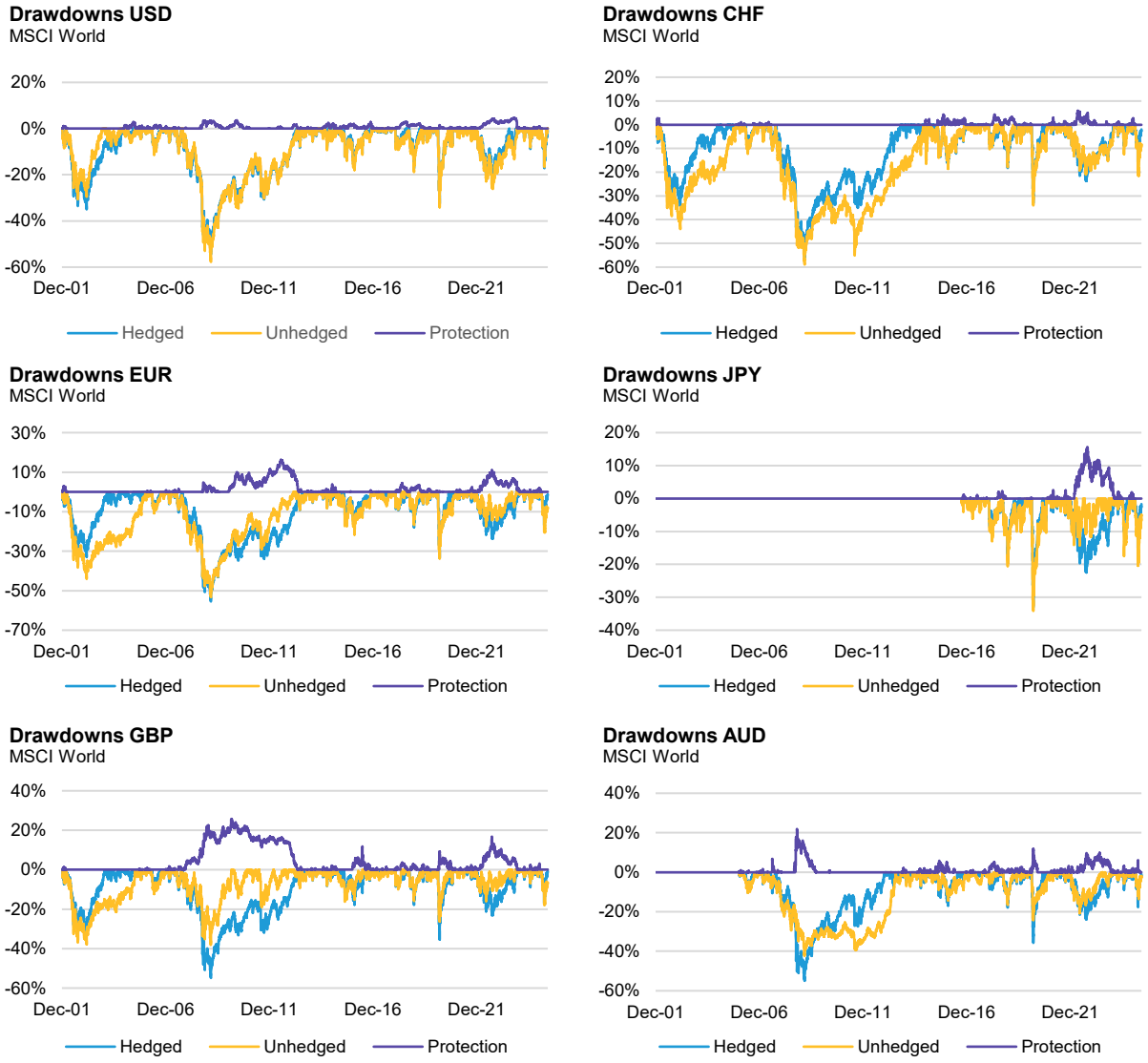
As of June 30, 2025

Source: Bloomberg, MSCI and AB

Drawdown protection

Sterling investors see strong drawdown protection from holding unhedged equities (*Display 16*). For US dollar, Swiss franc and Australian dollar investors, that protection appears to be minimal, whereas protection is more nuanced for yen and euro investors, often protecting initially but also delaying any market recovery.

DISPLAY 16: DRAWDOWNS – HEDGED AND UNHEDGED



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Index used is the MSCI World Index Unhedged and Hedged to the relevant currency with net dividends reinvested.

As of June 30, 2025

Source: Bloomberg, MSCI and AB

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