Economic Research | World in Focus

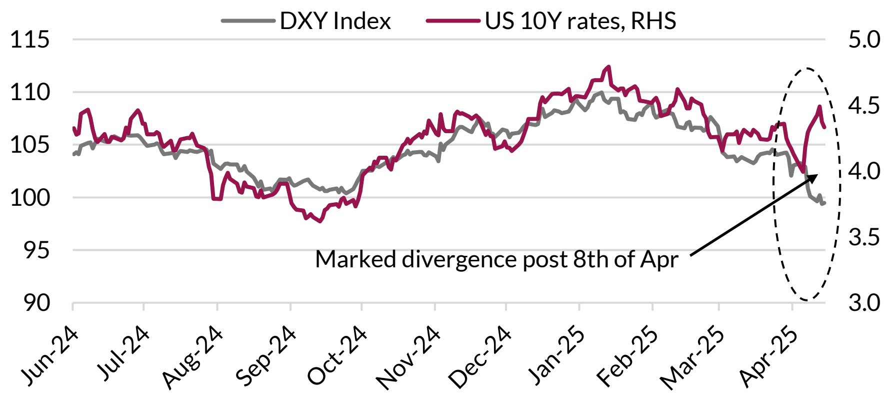
# The simple truths behind USD weakening in a risk-off

**April 17, 2025**

Capital Flows, Safe Haven, Hedging


Foreigners held US$62tn of USD assets in Dec-2024, +53% over 5Y. Now 60% of this is in US equities, which were 78% of incremental growth over 5Y. Thus, in a risk-off, as investors cut risk, they sell US assets (equities), when earlier they may have bought them (USTs). In our view initial USD weakness likely raised hedging demand, driving pro-cyclical weakness. With US at the epicenter of the global shock, P/E premium on US equities still elevated, and fiscal stress hurting USTs, foreigner selling may continue. This may reverse if the promised tax cuts and deregulation reverse US growth prospects. Thus, USD moves reflect portfolio rebalancing, in our view, not any deep rethink of the USD as a global reserve currency.


**Exhibit 1 - Divergence of USD vs. UST yields: not a loss of safe-haven status**




*Source: IMF, Axis Bank Research*

In prior episodes of global uncertainty, the USD tended to strengthen. However, since 8th Apr it has weakened against most currencies (CNY/IDR notable exceptions, Fig 2). Many have begun to attribute this to falling trust in the USD, but we believe it is too soon for large institutional money to make decisions of such import; the reasons are much more prosaic.

## There are more USD assets with foreigners, they are higher beta and unhedged

Not only are foreign holdings of US assets now much larger than in prior risk episodes, but they are also higher risk. These totaled US$62tn in Dec-2024 (213% of US GDP), up 53% in five years, with 78% incrementally in equities. Equity share is now ~60% vs. 49% in 2019. Thus, when global investors de-risk due to uncertainty, they sell more USD assets than they did earlier, when they may in fact have bought USTs. EU and Japanese investors had raised the share of US in equity allocations (Fig 3), further raising the need to trim US exposure.

## Higher DM yields (esp. adjusted for hedging costs) make USTs less attractive

During risk-off episodes, investors tend to gravitate towards US Treasuries. However, for two of the major buyers of US assets, i.e. the EU and Japan, rising domestic yields and growing currency volatility have made local bonds more attractive once adjusted for hedging costs (Fig 4). There is also some pro-cyclicality here: initial USD weakening triggers new demand for hedging when earlier exposures may have been mostly left unhedged.

## Fundamental pressures on US equities and debt is unlikely to ease soon

Given that US P/E premium to the world and DMs is still elevated (Fig 6), and profit share of GDP is at record highs (Fig 7). Similarly, elevated debt-to-GDP, exacerbated by elevated UST yields raises questions on debt-sustainability. These factors raise the risk of continued foreigner selling which could keep the USD weak. Some of these trends though have been exacerbated by the epicenter of the economic shock being the US. This could change if the tax cuts and deregulation measures get announced as promised later this year.


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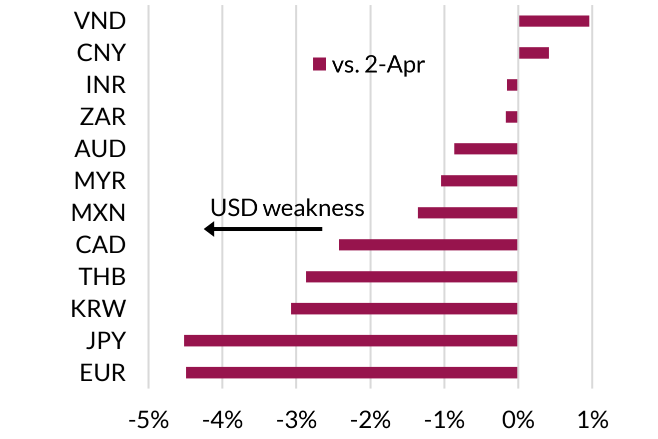
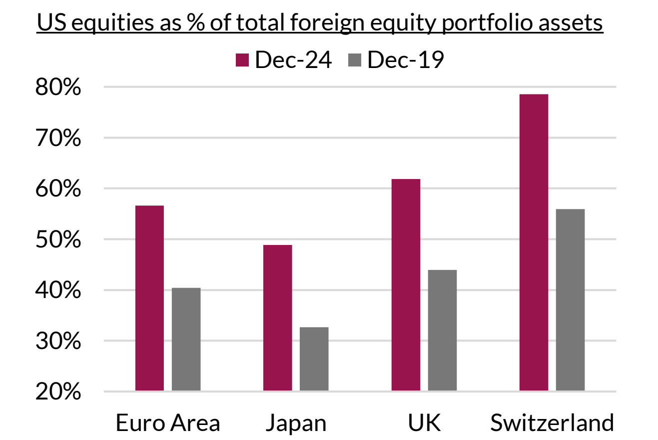
**Exhibit 2 - Dollar weakened vs. most currencies since Apr 2**



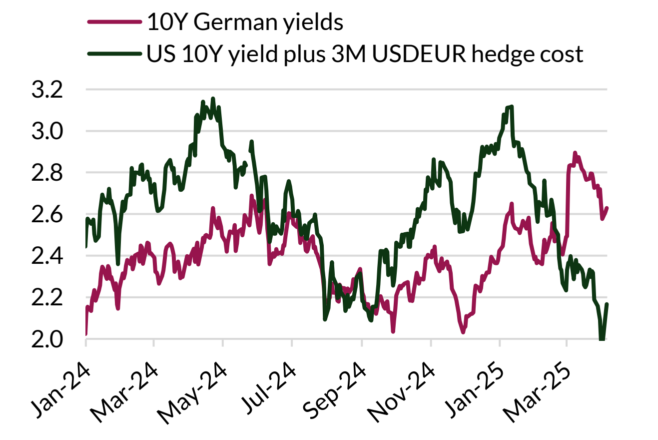

*Source: Bloomberg, Axis Bank Research*

**Exhibit 3 - Share of US in foreign equity allocations has risen**



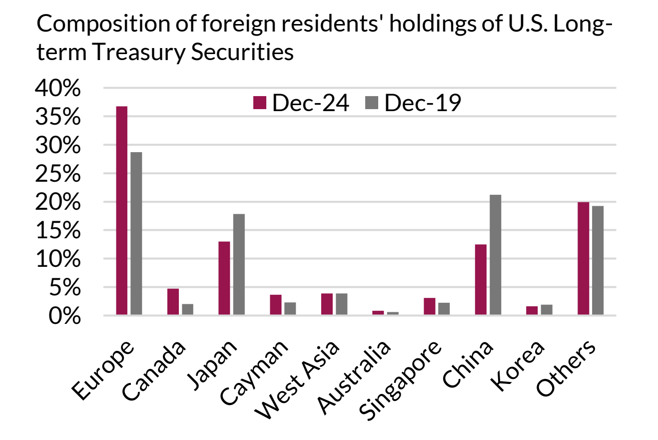

*Source: Bloomberg, Axis Bank Research*

**Exhibit 4 - Hedged bunds better for EU investors than USTs**



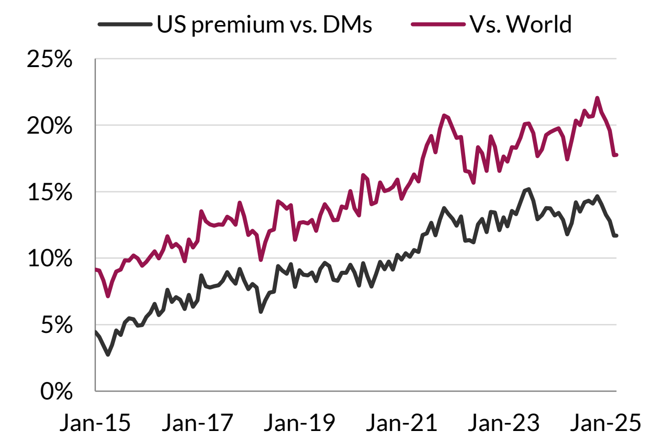

*Source: Bloomberg, Axis Bank Research*

**Exhibit 5 - Europe holds higher proportion of USTs**



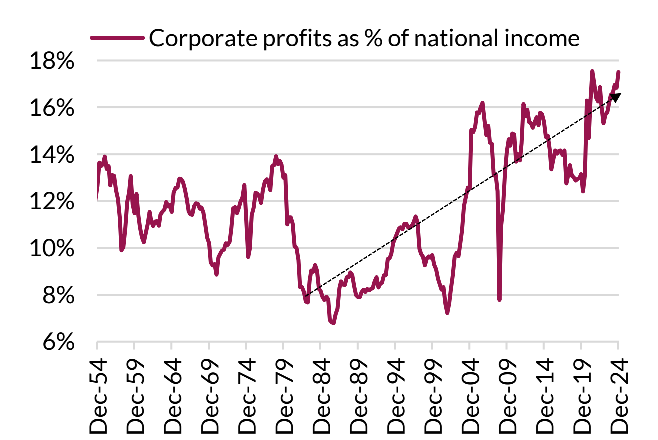

*Source: Bloomberg, Axis Bank Research*

**Exhibit 6 - US equities are still at a premium to world**




*Source: Bloomberg, Axis Bank Research*

**Exhibit 7 - US profit to GDP near/at all-time highs**




*Source: Bloomberg, Axis Bank Research*