QNB Economics
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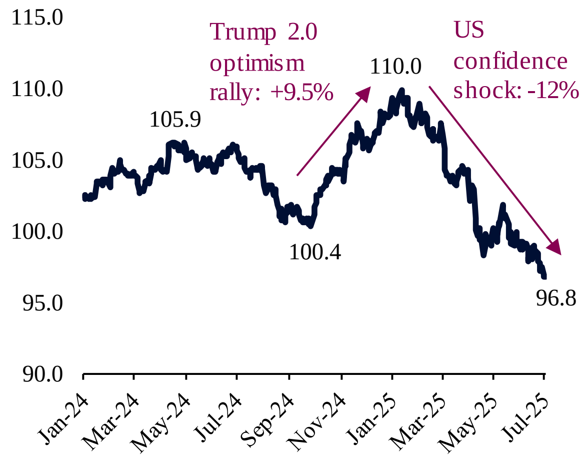
What is next after significant USD depreciation?

There is no market like the foreign exchange (FX) market. With over USD 7.5 trillion in daily turnover, FX is by far the largest and most liquid financial asset class in the world. Unlike equities or bonds, FX operates 24 hours a day, five days a week, with major currency pairs being traded across every continent. Moreover, FX markets act as real-time barometers of global macroeconomic dynamics, instantly reflecting shifts in capital flows, risk sentiment, interest rate expectations, and geopolitical developments.

Movements in major currency pairs offer a uniquely fast and comprehensive signal of how investors are repositioning in response to both cyclical and structural global trends. In this context, recent USD weakness has taken many market participants by surprise, contradicting the previous consensus of a "strong USD" associated with a long-standing US economic exceptionalism and Trump 2.0-related policy tailwinds. In fact, after peaking in early January 2025 on the back of a rally driven by expectations for a market friendly new US administration under Trump, the USD index (DXY) collapsed by 12%.

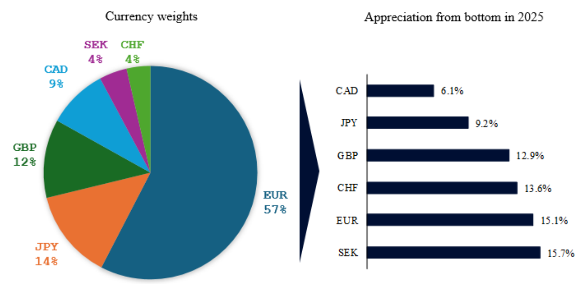
USD index (DXY)
(DXY index points, 2024-2025)



Sources: Bloomberg, QNB analysis

Importantly, the sharp DXY depreciation amounted to the worst start of the year for the US currency since 1973, when then President Richard Nixon engineered the USD de-pegging from gold and a significant currency devaluation. The recent DXY depreciation was also broad based, including all major currencies within the DXY basket, i.e., the Euro (EUR), the Japanese Yen (JPY), the Pound Sterling (GBP), the Canadian Dollar (CAD), the Swedish Krona (SEK), and the Swiss Franc (CHF).

Breakdown of DXY
(Currency weights and appreciation from bottom in 2025)



Sources: Bloomberg, QNB analysis

This major movement was driven by a significant spike in economic policy uncertainty coming from the US. This has been caused by convoluted fiscal and trade policy making, which damped investor sentiment and led to a significant slowdown of US growth expectations, as well as longer-term questions about governance, rule of law and the future of the US role as a safe haven for foreign capital.

After such a significant move, however, it is natural to consider what is next for the USD. Has the depreciation gone too far? What to expect for the medium- and long-term?

In our view, while the sharp move and extended positioning of traders may grant a pullback of the USD over the short-term, conditions are likely set for further USD depreciation over the medium- and long-term. Three main arguments sustain our position.

First, the big gap in growth between the US and other major advanced economies are set to narrow significantly over the coming years, effectively moderating the so-called US exceptionalism. Strong net migration and a looser US fiscal stance have been strong forces behind the US outperformance. However, new migration policies and limited fiscal space all point to a further US slowdown. In contrast, leading economies from the Euro area, such as

Germany, are expected to perform a much more accommodative fiscal policy, increasing investments in defence and infrastructure. As a result, the US-Euro area GDP growth differential, which favoured the US by an annual average of 220 basis points (bps) over the last few years, is set to narrow to 70 bps over 2025-2027. This should strengthen the EUR against the USD, driving the DXY further down – the EUR counts for 57.6% of the DXY basket.

Second, an assessment of the USD suggests that the currency is overvalued and in need for an adjustment. A common way to look at currency "valuations" is to analyse trade-weighted, inflation-adjusted exchange rates, i.e., the real effective exchange rates (REER), and compare it to their own long-term averages or historical norms. This REER metric is more robust than traditional FX rates as it captures changes in trade patterns between countries as well as economic imbalances in the form of inflation and inflation differentials. The REER picture for May 2025 suggests that the USD is indeed the most overvalued currency in the advanced world, by more than 17% of its notional "fair value." Hence, it would be expected for the currency to adjust towards fair prices over the medium-term.

Third, cross-border financial asset positions suggest that a structural re-balancing of global capital allocations may trigger a significant wave of capital outflows from the US. The US is currently a large net debtor to the rest of the world, with a net international investment position (NIIP) that is negative by USD 24.6 trillion. The picture has also been deteriorating sharply, as the NIIP of the US progressed from a marginal negative figure of around 9% of GDP at the start of the GFC to 88% of GDP by the end of last year. This suggests that the US is by far the country where most global economic imbalances tend to concentrate. This level of cross-exposure seems to be starting to become uncomfortable to both creditors and debtors, requiring significant adjustments. This would demand further capital outflows from the US in a multi-year process, causing additional USD selling pressure.

All in all, this year has brought so far the sharpest depreciation of the USD of the last half a century. However, over the medium- to long-term, there is still scope for further USD depreciation, due to the narrowing of the US economic outperformance, the overvaluation of the USD, and the massive accumulation of non-resident assets in the US. A more orderly process of currency adjustments would probably require significant global macro cooperation.

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