THE FADING SMILE

August 2025

ARC RESEARCH

THE PURSUIT OF BETTER INVESTMENT PERFORMANCE

“Change is the law of life. And those who look only to the past or the present are certain to miss the future.”

John F. Kennedy, 1917 - 1963
35th president of the United States

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For the past 17 years the US dollar has been riding the wave of a secular bull market. During this period, discretionary fund managers (DFMs) managing non-US dollar denominated portfolios have come to rely on unhedged US dollar exposure to enhance returns and reduce realised volatility.

The US dollar has been strong during periods of US-led global economic growth but has also met demand as a safe haven during periods of financial market volatility.

The tendency to perform well in both risk-on and risk-off market conditions has become known as the "dollar smile".

But the smile might just be fading into a frown.

Dollar Smile Theory: The US dollar strengthens during crises and periods of strong US growth, but weakens in stable global conditions.

The table below shows the seven occasions since 2003 that the ARC US Dollar Steady Growth Private Client Index has experienced drawdowns greater than **10%**.

Alongside each drawdown is the performance of the trade-weighted US Dollar Index (DXY) during that drawdown period.

Period	ARC USD Steady Growth PCI drawdown (%)	Trade-weighted US Dollar Index (%)
31/10/2007 - 09/03/2009 Global Financial Crisis	-35	+16
02/05/2011 - 04/10/2011 European debt crisis	-16	+9
21/05/2015 - 11/02/2016 China wobbles	-14	+0
26/01/2018 - 24/12/2018 Trade war concerns	-13	+8
12/02/2020 - 23/03/2020 Pandemic crash	-23	+3
04/01/2022 - 12/10/2022 Inflation surge	-23	+18
19/02/2025 - 08/04/2025 Projected economic downturn	-10	-4

Source: ARC Research, Bloomberg

The US dollar has rallied, or at least held its ground, during all but the most recent financial market drawdown period.

The DXY had been trading in a reasonably tight range since 2023 but broke out to the downside this year.

This sharp sell-off, combined with the failure of the US dollar to rally on the back of the "*Liberation Day*" equity market correction, has led many commentators to start questioning whether the bull market that started in March 2008 is over and that the secular trend for the greenback is now down.

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Concern over the future strength of the US dollar is shared by private client discretionary fund managers (DFMs).

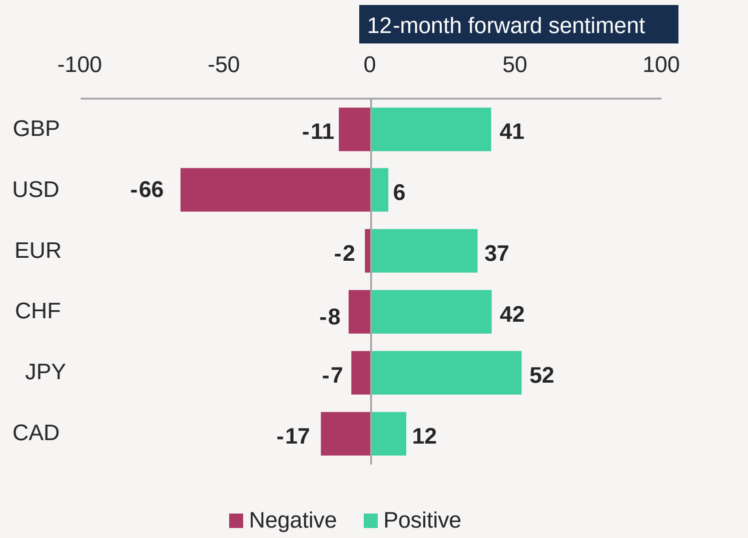
In the most recent ARC Market Sentiment Survey the US dollar was the most negatively rated asset, suffering a **78-percentage point** swing in net sentiment compared with a year ago.

US dollar 12-month forward net sentiment

78

June 2024	June 2025
+18	-60
net positive	net negative

Source: ARC Research Limited



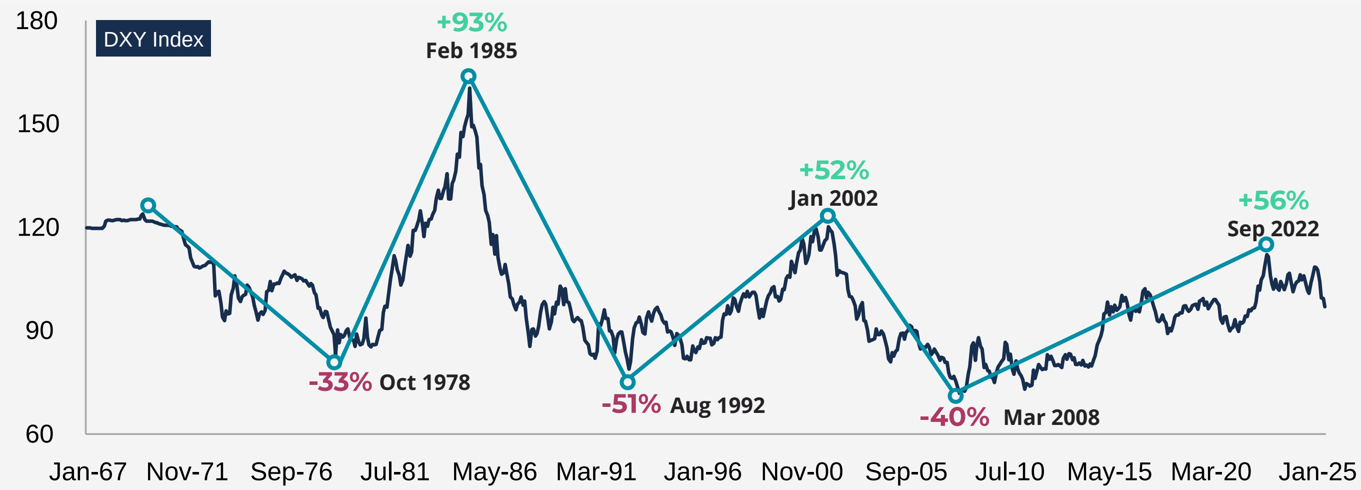
Source: ARC Research Limited

Two thirds of those surveyed expect the US dollar to decline over the next 12 months, with just **6%** expecting US dollar strength.

The ARC Market Sentiment Survey is a quarterly survey of our investment management community examining the 12-month outlook for the major asset classes and sectors.

While the US dollar has been strong for the best part of two decades, it has not always been thus.

As the following chart shows, since the introduction of the DXY in 1973 the US dollar has broadly traded sideways against the currencies of its major trading partners, albeit with 6 distinct bull & bear cycles over that period. The average life of these cycles has been around 9 years.



Source: ARC Research, Bloomberg

What has triggered the negative swing in sentiment away from the US dollar?

There are several factors that may have influenced investors to take a more cautious view on prospects for the US dollar.

The stubbornly high US budget deficit and rapidly increasing level of US government debt as a percentage of GDP was highlighted by Moody's recent downgrade of U.S. government debt from Aaa to Aa1.

Probably of greater importance, however, is US government policy. President Trump's strategy since he took office for the second time is clearly aimed at reducing the US trade deficit through a combination of tariffs, a renegotiation of international economic relationships and, most importantly, addressing a perceived overvaluation of the dollar.

President Trump has not wasted any time in using tariffs as a foreign policy tool and "renegotiating" with trading partners. The approach has been adversarial resulting in a spike in economic policy uncertainty of a magnitude only exceeded in recent years during the COVID-19 pandemic. This uncertainty has done little to encourage new investment into the US and probably goes a long way towards explaining recent weakness in the US dollar.

Seeking simultaneously to devalue the US dollar; reduce the trade deficit; and maintain the US dollar's status as reserve currency of the world will be a tricky balancing act.

Whether President Trump's trade policies will prove successful remains to be seen, but increased volatility in FX markets, and the US dollar in particular, seems inevitable either way and will have a material impact on the investment outcomes experienced by investors.

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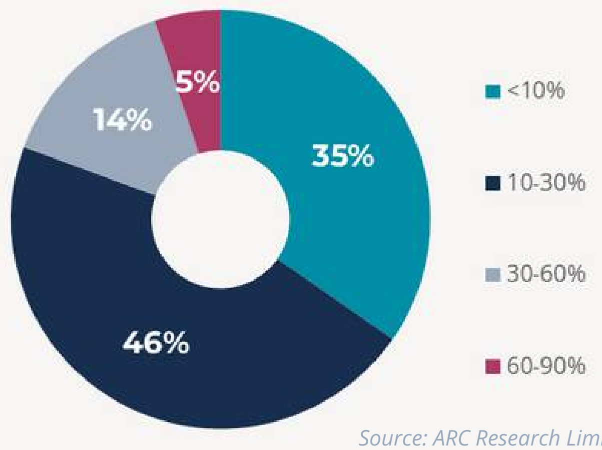
US Dollar exposure within discretionary portfolios

DFM responses to a recent ARC Market Sentiment Survey revealed that exposure to US assets, particularly equities, has become a significant part of the typical private client discretionary portfolio.

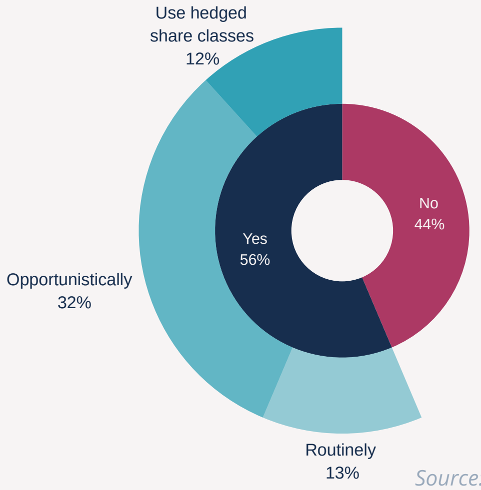
Of the DFMs that responded, **35%** now run their equity exposure on a global basis – i.e. aiming for **70%+** of a client's equity exposure invested in US stocks.

DOMESTIC EQUITY EXPOSURE FOR A TYPICAL STEADY GROWTH STRATEGY



Source: ARC Research Limited

EQUITY HEDGING POLICY



Source: ARC Research Limited

Previous surveys suggested that only **25%** of DFMs routinely hedge currency exposure emanating from these equity positions; almost half never hedge; and the remainder hedge on a tactical basis.

Of course having a material un-hedged exposure to the US equity market has served international investors well for many years. US equity markets have outperformed, while the US dollar has been stable during periods of global equity market strength. The fact that the US dollar has also generated positive returns during periods of equity market turbulence has reduced drawdowns for non-US dollar denominated investors.

Sterling investors in particular have benefitted from a strengthening US dollar during periods of equity market volatility, thereby reducing the extent of that drawdown when measured in Sterling terms.

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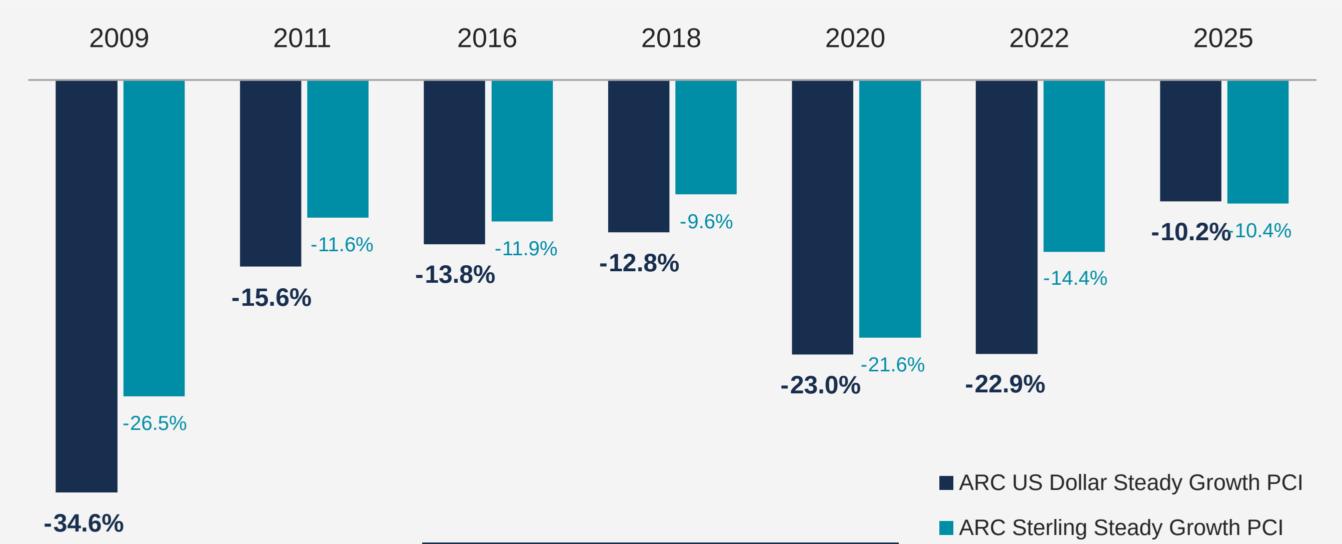
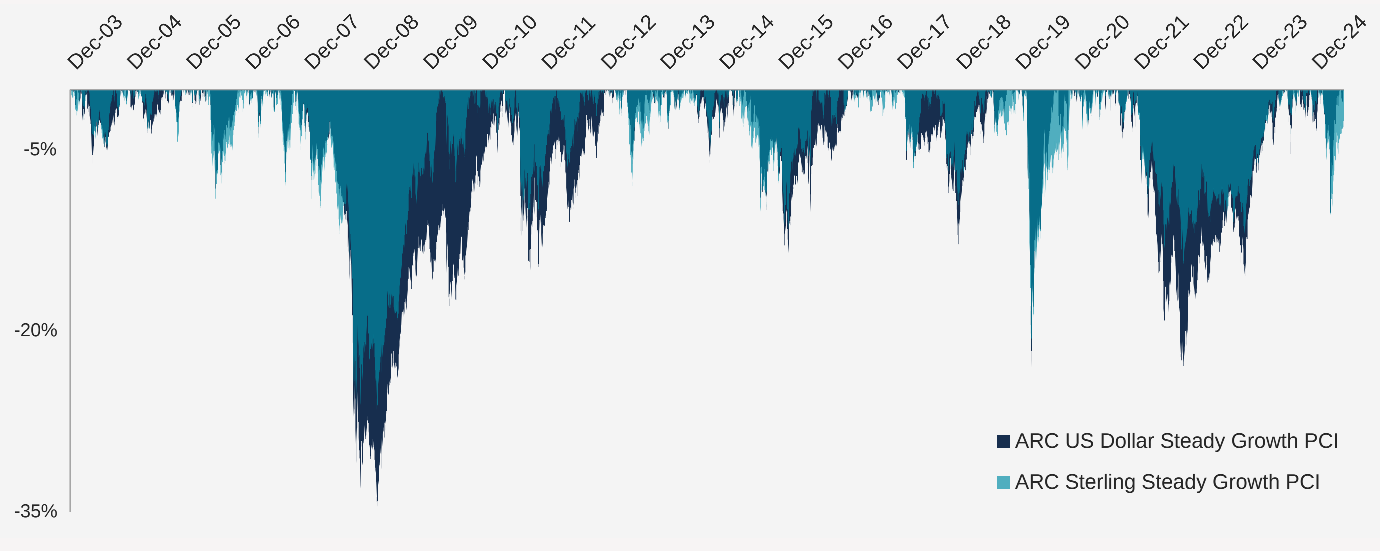
The contrasting fortunes of US and Sterling reference currency investors is illustrated by comparing the drawdown profile of the ARC US Dollar Steady Growth PCI to the Sterling equivalent.

Without the currency tailwind, drawdowns for US dollar reference currency investors have been materially deeper.



DRAWDOWN PROFILES



Source: ARC Research Limited

Should the US dollar smile morph into a smirk or a frown this relationship could reverse. If that were the case, then Sterling investors would need to brace themselves for higher levels of portfolio volatility and deeper drawdowns.

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How might DFMs protect portfolios during periods of equity market volatility?

In the following table we examine the performance of Sterling against the US dollar, UK government bonds and gold during the six drawdowns greater than **10%** experienced by the ARC Sterling Steady Growth PCI since 2003. Along with currency, fixed income and gold would be considered traditional portfolio diversifying assets.

We also show the performance of the "VIX". VIX is the ticker symbol and popular name for the Chicago Board Options Exchange's CBOE Volatility Index, a measure of the stock market's expectation of volatility based on S&P 500 index options.

COMPARATIVE PERFORMANCE DURING PERIODS OF DRAWDOWN IN THE ARC STERLING STEADY GROWTH PCI

Period	All figures are in %					
	Drawdown	USD vs GBP	Bonds*	Gold (GBP)	Gold (USD)	VIX
29/10/2007 - 03/03/2009 Global Financial Crisis	-26.5	47	17	70	16	156
07/07/2011 - 04/10/2011 European debt crisis	-11.7	3	4	10	6	156
10/04/2015 - 11/02/2016 China wobbles	-11.9	1	3	5	3	124
12/02/2020 - 23/03/2020 Pandemic crash	-21.6	12	2	11	-1	348
08/12/2021 - 14/10/2022 Inflation surge	-14.4	18	-14	9	-8	61
06/02/2025 - 07/04/2025 Projected economic downturn	-10.4	-2	1	2	4	203

*Domestic 3-7 Years Government Bonds

Source: ARC Research Limited

As with the US dollar, high quality government bonds had historically insulated portfolios well during equity market corrections. This relationship broke down dramatically in 2022 when it was the spike in bond yields that triggered the equity market sell-off. In the current inflationary environment, any assumption that government bonds will display negative correlation during periods of equity market weakness is open to debate.

Gold has protected Sterling denominated portfolios well during periods of market volatility. But much of this protection has come from the weakness of the pound against the US dollar as opposed to any real safe-haven demand for gold.

Perhaps the most certain way to hedge against equity market volatility is to gain asymmetric exposure to volatility itself – so called "tail-risk" protection. This is evident from the performance of the VIX in the table above and can be achieved in several ways through the use of equity, credit and volatility linked instruments. But tail-risk protection generally involves the use of derivatives and currently many DFMs are reluctant to deploy such strategies into private client portfolios.

CONCLUSION

The US dollar's smile may be fading, and the relationships between asset classes that held true in the past are starting to be questioned.

And here lies the challenge for DFMs. If the future is likely to look different to the past, and the US dollar can no longer be trusted to perform during periods of market stress, how might portfolios be positioned to protect investors from unacceptable levels of volatility and drawdown?

For investors this is a crucial question as volatility and drawdown are two of the key factors to be considered when thinking about suitability and selecting an appropriate risk profile. Higher than anticipated drawdowns are likely to test the resolve of investors, and might cause them to liquidate their portfolios at exactly the wrong time.

As JFK observed more than 60 years ago, those who look only to the past or the present are certain to miss the future. The role of the DFM is to meet their clients' investment objectives and to do so while taking a suitable level of risk. Perhaps a new approach is needed if in the future traditional diversifying assets no longer perform as needed?

The irony is that in order to provide protection against equity market drawdowns it might be necessary for DFMs to add complexity, and perceived risk, to their clients' portfolios. Yet sometimes a synthetic smile is better than a real frown!

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