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Why the US dollar is still overvalued

- **The US dollar is substantially overvalued according to different metrics including our own fundamental model estimates**
- **The Japanese yen and the euro are the most undervalued versus dollar**
- **Cyclical drivers and FX hedging have mainly contributed to dollar weakness in 2025**
- **In our forecast horizon we expect the dollar to weaken further due to negative cyclical developments and more concerns on the structural factors**

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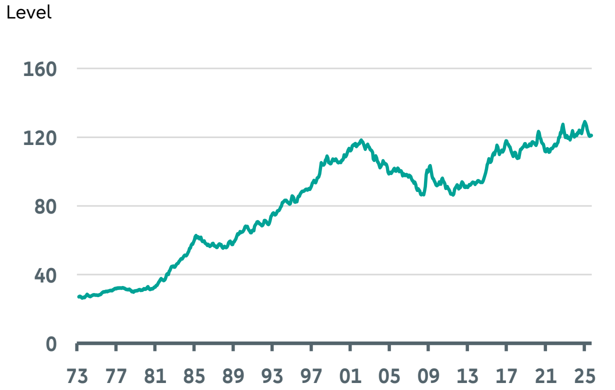
Introduction

Since the start of the year, the dollar has declined by 13% in value relative to the euro, 4% versus the yen, and even 17% versus the Swedish krona. On a trade-weighted basis, the US dollar has declined by 6% in nominal terms and around 4% in real terms. The dollar's decline raises questions on the current valuation of the dollar. Is it now undervalued, still overvalued, or is it trading close to where its fundamentals suggest it should be. In this publication we set out a number of arguments making the case that the dollar remains overvalued. We also discuss recent dynamics and what triggers could result a more sustained decline than the one we have already experienced this year.

Nominal broad trade-weighted dollar index



Source: Bloomberg, Fed, ABN AMRO Group Economics

Real broad trade-weighted dollar index

Source: Bloomberg, Fed, ABN AMRO Group Economics

Strong dollar in the past

The Fed's trade-weighted index (the dollar against a basket of other currencies weighted by their importance in US foreign trade) shows how strong the dollar is compared to other currencies. In nominal terms, the index indicates that the dollar is near its highest level since this series started in 1973. Looking at the index in real terms, which accounts for inflation in the US relative to that in other countries, the dollar is also very high compared to historical levels. It currently exceeds the previous peak of 2001 but hasn't quite reached 1985 levels yet.

In 2001, the dollar had risen to its peak on the back of a safe haven effect due to a number of crises in the preceding period, including the Peso crisis (1994), the Asian currency crisis (1997-1999), the Russia crisis (1998), the Long-Term Capital Markets crisis (1998), the Latin America crisis (1998-1999), the Argentina economic crisis (2001-2002), and the bursting of the Dot.com bubble (March 2000). At the time, the US economy was growing modestly, but years of careful government spending resulted in a large budget surplus. The Federal Reserve was increasing interest rates, and real interest rates were rising. At the same time, the US was importing more than it was exporting, leading to a growing trade deficit. The dollar reached its peak in July 2001, but then it began to decline for several reasons. Real interest rates dropped significantly and eventually turned negative due to the Fed's monetary policy shifts. Additionally, the budget surplus turned into a large deficit of over 3%, and the trade deficit continued to worsen. These issues persisted until the subprime mortgage crisis hit the US in 2006. However, during the peak of the Global Financial Crisis, investors still turned to the dollar as a safe currency to hold, and it temporarily bounced back.

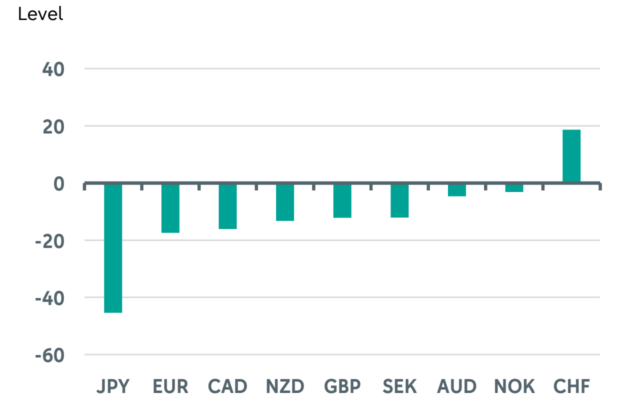
Back in 1985, the US economy was growing rapidly with a good balance between growth and inflation, and real interest rates were high but starting to decline. However, the US was facing issues with its current account balance and fiscal balance, meaning it was importing more than it was exporting and spending more than it was earning. This period was when Fed Chair Volcker successfully reduced inflation. Because the dollar was so strong, the US, Germany, Japan, France, and the UK agreed to lower the dollar's value on September 22, 1985, in what is known as the Plaza Accord. This decision happened when the dollar had already reached its peak strength. At the start of this year, there was similar talk of a 'Mar-a-Lago' accord (see more here). This was based on the idea outlined in a paper by Stephen Miran. The accord was part of a grand plan to devalue the dollar, similar to the above mentioned 1985 'Plaza Accord'. This intention may have been partly responsible for some of the depreciation we've seen, even without an actual accord.

Now, the US has substantial and persistent fiscal deficits that are expected to rise, as well as the largest trade deficit on record, although it is difficult to assess where things will settle with the tariffs. At the same time, real rates have increased substantially over the past years, particularly on the back of waning inflation, but are now expected to decrease as the Fed has resumed its easing cycle. At the current juncture, the economy looks more like that of 1985 than that of 2001, although there are worries of asset price bubbles in the AI realm now as well, more on that later. Then, the Plaza accord did some of the work in reducing the value of the dollar, but the macro played a substantial role as well. What can we expect now?

Valuation of the US dollar

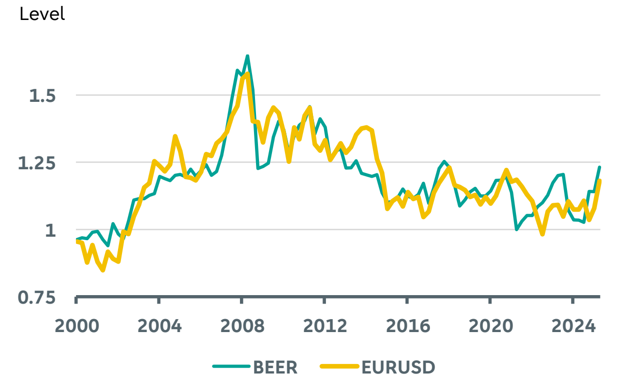
To understand if the dollar is overvalued, we can use Purchasing Power Parity (PPP). PPP helps compare what money can buy in different countries, giving us a better idea of currency value. The OECD provides PPP data for many countries, including those with major currencies (the G10 countries). The most recent data is from 2024. For the euro, PPP estimates are available for most countries in the euro area, and a GDP-weighted average PPP level is calculated for these countries. The graph below on the left shows the results.

Valuation versus US dollar



Source: OECD PPP 2024, Bloomberg spot, ABN AMRO Group Economics

Our BEER model points to 1.23 as of Q2



Source: LSEG, Bloomberg, ABN AMRO Group Economics

According to PPP, the dollar is most overvalued compared to the Japanese yen, with a PPP-based overvaluation of about 40%. This measures also implies a 17% overvaluation relative to the euro. The only exception is the CHF, to which the dollar is 19% percent undervalued on a PPP-basis. Using GDP-weights, the PPP analysis suggests a EURUSD valuation of 1.42.

Another estimate of the valuation of the dollar compared to the euro comes from our internal BEER (Behavioural Equilibrium Exchange Rate)-type model, which uses quarterly data to estimate a 'fundamental value' of the exchange rate based on macroeconomic fundamentals, including terms of trade, relative yields and relative price levels. The latest available data points to a 'fundamental' value of the EURUSD at 1.23 – the highest since 2017 – and up substantially since its low in 2024Q3.

What happened in 2025?

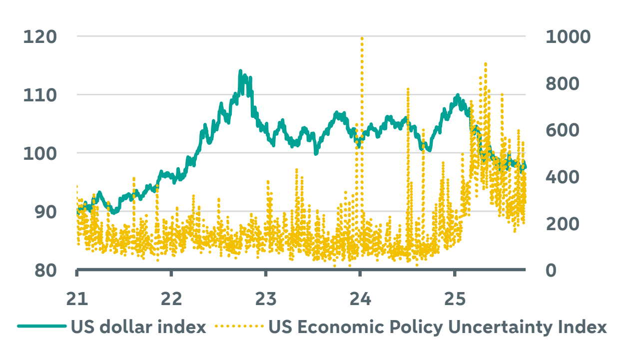
As indicated above the US dollar has weakened substantially this year. Since mid-September the dollar has stabilised. Despite its weakness the dollar is still overvalued. Several reasons have been mentioned in the market why the dollar has weakened this year. These include Trump's attacks on stable US institutions including the Fed and the loss of the dollar safe haven status. While these factors have played a role, we think that there have mainly been two important drivers for dollar's weakness this year, namely cyclical drivers and FX hedging. We focus on these drivers in the section below. We do think that the other structural drivers may play out in risk scenarios, which are highlighted later in the report.

Cyclical drivers

The US administration's policies have impacted growth prospects, inflation dynamics and expectations about monetary policy. Expectations of more monetary policy easing by the Fed, weaker than expected growth and unfavourable inflation dynamics have weighed on the US dollar. In addition, it is likely that economic policy uncertainty caused by the Trump Administration has resulted in a lower dollar. The graph below on the left shows US Economic Policy Uncertainty and the US dollar. The dollar has the tendency to weaken if US Economic Policy Uncertainty increases. This year this index has been historically elevated.

US policy uncertainty and the dollar

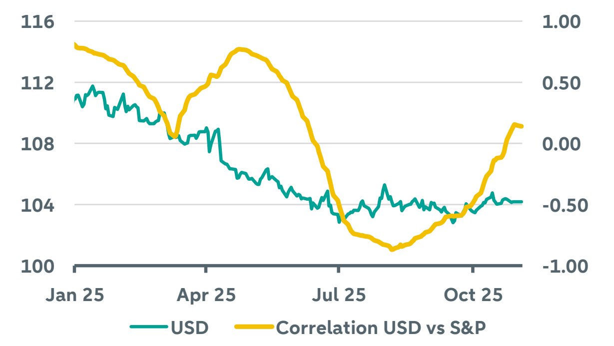
US dollar index US Economic Policy uncertainty index



Source: Bloomberg, ABN AMRO Group Economics

Correlation between the dollar and S&P

90-days rolling correlation



Source: Bloomberg, ABN AMRO Group Economics

More dollar hedging

The hedging of overseas investors of their US assets is an important dynamic in FX markets. For example, when Japanese investors buy US assets (like bonds or stocks), they might want to hedge against currency risk (to protect themselves from losses in case the dollar weakens relative to the yen). The cost of hedging depends on several factors, including:

- The difference between US and Japanese interest rates
- The current exchange rate between the US dollar and the Japanese yen
- If there is high demand for hedging in one currency (e.g., the US dollar), it can drive up the cost of these hedges
- If there's stress in the market (e.g., a shortage of dollars), the cost of hedging can increase

If the cost to hedge becomes too high compared to its historical average, these investors might decide to hedge less of their US investments or keep the position completely unhedged (meaning they take on the currency risk directly). The hedging strategy affects currency markets. If for example Japanese investors buy US assets without hedging, the entire effect of the transaction is felt in the FX market because they are buying dollars to pay for the US assets. This increases demand for dollars, which can strengthen the dollar. If the Japanese investor hedges the dollar position, they also make a second, opposite transaction in the FX market to hedge the currency risk. This reduces the overall impact of the original transaction on the FX market since the buying and selling of dollars partly cancel each other out. The cost of hedging plays a big role in these decisions. If hedging is expensive, investors may avoid doing it upfront, but they might hedge later if they start losing a lot of money. This delayed hedging can cause larger swings in currency markets.

In a recent report, the BIS (Bank for International Settlements) explains that the US dollar weakened in April 2025 partly because of how overseas investors managed their currency hedging. When the dollar lost value, investors who owned dollar-denominated assets (like US stocks or bonds) experienced losses on the portion of their investments that wasn't protected (unhedged) from currency risk. To minimize these losses, some investors decided to increase their protection (hedge ratio) after the dollar started falling. This means they started selling more dollars in the FX market, which put even more downward pressure on the dollar, amplifying its weakness (see more here).

The relationship between the value of the dollar and US stock markets is constantly changing. If the value of the dollar is expected to rise, there is less inclination to hedge positions. However, when the dollar began to fall significantly, investors became nervous and decided to hedge more. The chart at the top right shows that the correlation between the dollar and the S&P changed from positive to negative during the dollar sell-off.

Outlook for the dollar

Above we explained that cyclical drivers and FX hedging have been the main contributors to dollar weakness this year and that the dollar is still overvalued. We remain negative on the dollar during our forecast horizon due to cyclical factors and structural factors.

Cyclical drivers negative for the dollar

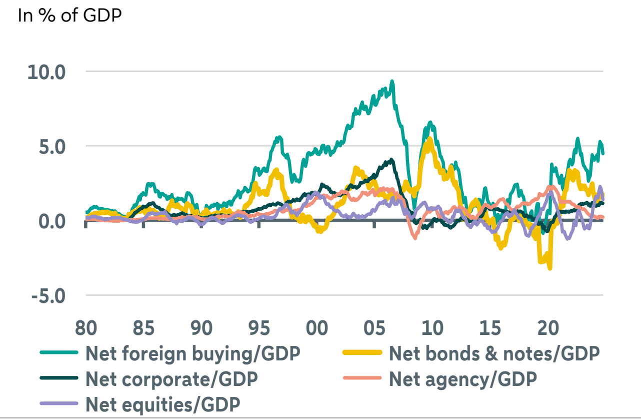
In our forecast horizon we continue to expect the cyclical drivers to weigh on the dollar. We expect the Fed to become more dovish. This may already be reflected in the price but the risk of an even more dovish tilt on the back of more pressure of President Trump is not. Moreover, a more dovish Fed is not ideal for the inflation outlook (see more here). As a result, real interest rates will likely decline, and this is a negative for a currency.

Structural factors to gain more attention

Next to the cyclical factors we expect the structural factors to gain more attention such as fiscal deficit en current account deficit.

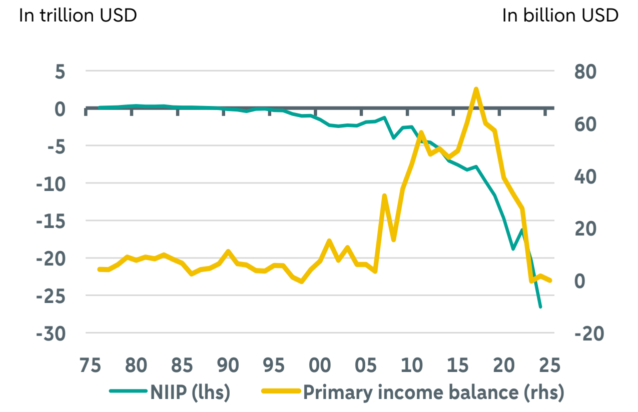
We start with the US fiscal deficit. The US fiscal deficit is on an unsustainable trajectory (see our note here). In July One Big Beautifull Bill Act (OBBBA) was passed and adds to soaring debt. The extension of tax cuts in that bill is largely unfunded and present a risk of increasing the annual fiscal deficit from the current 5-6% to 7-8% over the coming years. As of now, part of those costs appears to be offset by tariff revenue. Tariff revenue is likely to decrease over the coming years, while government spending may increase further. Overall, the fiscal position will deteriorate. Concerns about the unsustainable fiscal deficit and government shut down have contributed to dollar weakness via the increase in risk premia meaning that investors wanted a higher compensation for the risk they take. The graph below on the left shows that net portfolio flows into bonds, notes and agency have declined but foreigners have **not** been net-sellers of US bonds. It is likely that they have increased FX hedging (see above).

Treasury international capital flows US



Source: Bloomberg, ABN AMRO Group Economics

Net international investment position



Source: Bloomberg, ABN AMRO Group Economics

The US not only runs a large fiscal deficit (and even increasing) but also a large current account deficit. Foreigners were willing to finance this deficit because of the special status of US assets and the US dollar. The graph above on the right shows the US net international investment position. What is extremely worrying for the US is that foreigners own more US assets than the US holds foreign assets. And the gap between the two has never been this large (green line in the graph). For years the net primary income balance was very positive. This means that the US residents were able to earn more on their foreign assets than foreigners earned on US assets. This dampened the negative current account balance. Recently this positive primary income balance has evaporated (yellow line). For now, foreign investors seem to hold on to their US assets, but they have started to hedge their exposure or have increased their hedges (see above). If they were to decide to adjust their US asset holdings this could have a significant impact on US asset prices and the US dollar (more on this in the risk scenario).

Downside risks to our outlook

We forecast further weakness of the dollar with a forecast of 1.25 for EUR/USD at the end of 2026. But movements in financial markets are rarely managed and we are aware of this. What developments could cause a more severe sell-off of the dollar? In this section we focus on this.

Foreign investors start selling US assets and the dollar

As mentioned above foreign investors have continued to buy US assets but they have increased their hedges to dampen the impact of a prolonged dollar decline. At some point in time, they could decide to stop buying US assets because buy and hedge don't have an attractive risk reward anymore and/or an unhedged position is not desirable. They could even decide to close some of these positions. In such a situation they would sell US assets. It is difficult to pinpoint what the trigger is of change in behaviour would be apart from the hedging cost. One possible trigger could be that investors could worry that the boom in US equities fuelled by the ideas of US dominance in AI and digital assets is about to slow down or even burst.

Fears of the Fed losing its independence

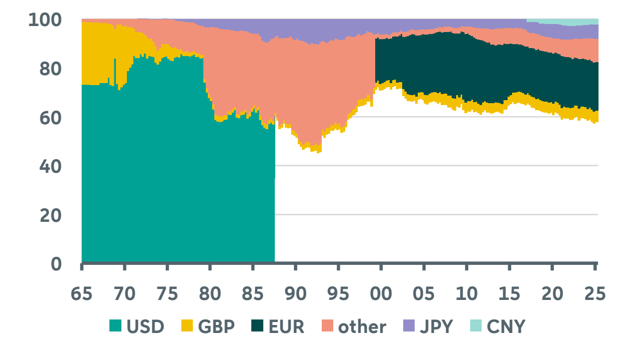
On top of this President Trump's direct challenges on stable US institutions and skirmishes with the rule of law and constitution are not good news for the dollar. His attacks of the Fed have resulted in fears that the Fed may lose its independence. Indeed, the attacks on the Fed have intensified, and the important date is in February, when regional Fed presidents have to be reappointed by the Federal Reserve board (see more here). The dismissal of Fed Governor Lisa Cook, which is currently being fought in court, is critical. If the Supreme Court rules in the administration's favour before February, Trump would likely be able to exert substantial influence over the future composition of the FOMC. We think that if the Fed were to lose its independence, inflation expectations will rise, real yields will decline further, and the dollar will decline.

Fears of losing its superior status in financial markets

Another risk of a more severe dollar sell-off are fears that the dollar's role in the financial system may soften and/or that the dollar may lose its safe haven status. Some investors have already expressed these fears in 2025. The hegemony of the dollar is based on several dynamics including share of GDP, share of invoicing, share in cross border lending, share in international reserves, share in FX turnover, share in payments, deep financial markets and military power. If the dollar is able to continue this dominant role depends on if there will be a serious competitor for these sub-roles. We think that it is unlikely that the dollar will lose its dominant role in the financial system and/or its safe haven status in the coming years. This is because there is no viable alternative in terms of liquidity to the dollar, not in fiat currencies (euro, yen, Chinese yuan), not in commodity (gold) and not in the digital world (bitcoin, ether, stablecoins). We will dive more into this topic in a forthcoming publication.

Composition currency reserves

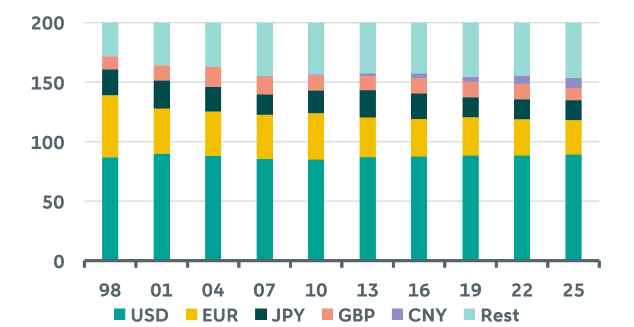
In %



Source: IMF Currency Composition of Official Foreign Exchange Reserves (COFER)

Foreign exchange turnover by currency

In %



Source: BIS, as two currencies are involved in each transaction, the sum of shares in individual currencies will total 200%. Adjusted for local and cross border inter-dealer double-counting, i.e., "net-net" basis; daily averages in April.

What we want to share already is the dollar's role in the world of fiat currencies. The graphs above show how strong the position of the dollar currently is. The chart on the left shows the reserve composition of central banks. Countries hold reserves for a number of reasons including to weather economic shocks, pay for imports, service debts, and moderate the value of their own currencies. Many countries cannot borrow money or pay for foreign goods in their own currencies—since much of international trade is still done in dollars—and therefore they need to hold reserves to ensure a steady supply of imports during a crisis and assure creditors that debt payments denominated in foreign currency can be made. Most countries want to hold their reserves in a currency with deep and liquid financial markets since they want to be sure that they can access their reserves in a moment of need (see more here). Central banks hold a large amount of dollars. The dollar's share has fluctuated between 45% and 85% and the average since 1965 is 65%. In recent years the dollar's share has declined somewhat. It is currently below the long-term average, but it is still substantially above the low set in the 1990s and far above the shares of other currencies. So, there is room for dollar's share to decline further without challenging the dollar's dominant reserve currency status.

The chart on the right shows the role of the dollar in foreign exchange markets. The latest triennial central bank survey of the BIS shows that the US dollar was on one side of the transaction of 89.2% of all trades up from 88.4% in 2022 (of the 200%). The share of the euro fell to 28.9% (from 30.6%) and that of the Japanese yen was virtually unchanged at 16.8%. The share of sterling declined to 10.2% (from 12.9%). The shares of the Chinese renminbi and the Swiss franc rose to 8.5% and 6.4%, respectively (see more here). If we look at central bank reserve composition and foreign exchange turnover there is no real competitor to the dollar. As indicated above. We focus on the dollar's central role in the financial system in another publication.

Upside risks to our outlook

One of the reasons why the dollar's decline has stabilized in recent months is that investors view that the US will play a dominant role in AI and in digital assets. The US Administration seems to have as a strategy to dominate fiat currencies and digital currencies alike. The spillover from digital assets to regular financial markets (demand for stable US assets as reserves for stablecoins for example) is not that large yet but as developments could go in overdrive, so do the spillover effects. As a result, the dollar will cement its central role in the financial system and not many currencies (fiat or digital) will be able to compete with the dollar. More demand for dollar in the digital world will also result in higher demand for US assets. It is likely that this will support the dollar.

Conclusion

The US dollar is substantially overvalued according to different metrics including our own. The Japanese yen and the euro are the most undervalued versus dollar. Cyclical drivers and FX hedging have mainly contributed to dollar weakness in 2025. In our forecast horizon we expect the dollar to weaken further due to negative cyclical developments and more concerns on the structural factors.

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