

# The August Outlook

## Market Stance

### CURRENT MARKET THEMES

**The continuing rally in risk assets since the spring largely reflects higher valuations, but corporate fundamentals also improved in the first half**

#### Commentary

- There was no sharp deterioration in global economic activity in the first half, but growth remains subdued
- Corporate profits growth has been firm
- Short-term investors have shown increased appetite for risk, as reflected in recent positioning shifts

#### Upshot

- The recent rally in risk assets has been material, but partially reflects a recovery from the April sell-off. Year-to-date returns are generally more muted

### MARKET PRICING: LOW RISK PREMIA

**Global equity valuations have once again become extended, and credit spreads are tight**

#### Commentary

- Low risk premia suggest a reduced buffer against market shocks, and in some respects positioning has become speculative – there is a high level of ‘crowding’ in strongly-performing high-volatility stocks
- Evidence is emerging of a weaker US economy, with higher inflation
- Policy risk associated with the US Administration remains elevated

#### Upshot

- We continue to implement a cautious investment strategy in multi-asset portfolios, with a lower equity weight than would be implemented in a less uncertain environment

### DOLLAR WEAKNESS

**The dollar peaked against a basket of other major currencies almost three years ago, and its decline has become more evident this year**

#### Commentary

- Potential causes of further dollar weakness include a wide range of political, economic and fiscal concerns
- The dollar’s role as a reserve currency could be further diluted
- In fundamental terms, the US currency is still at a high level, potentially increasing downside risks further

#### Upshot

- The main article explores these risks further, and potential hedging strategies for non-dollar-based investors.

### ALTERNATIVE OUTCOMES

**There are three risks which we continue to monitor closely which could deliver stronger equity market outcomes compared to our central case**

#### Commentary

- Aggressive Fed easing, interpreted by the market as a sensible response to a weaker economy, not acquiescence to political pressure
- Evidence that fast AI adoption rates are benefiting corporate performance and underlying productivity growth
- AI adoption leads to continuing outsized gains to US megacap stocks

#### Upshot

- These are not our central cases, but identifying risk before the event facilitates adjustment in portfolios should circumstance change

## The Long Read

# Hedging currency in a challenged US dollar dominated environment

### SNAPSHOT

The US dollar has resumed its weakening trend, marking a break from the multi-year bull cycle that previously supported returns for non-dollar investors. While recent equity market strength has reasserted US dominance, the dollar's depreciation is now a more persistent feature, with structural risks beginning to emerge. These include policy divergence within the US administration, fiscal imbalances, and a gradual erosion of the dollar's reserve currency status.

For investors, this shift has material implications. Currency hedging is increasingly important, particularly in fixed income and hedge fund portfolios, where even modest FX moves can distort returns. In equities, partial hedging - especially in large, liquid markets - can help manage volatility without incurring excessive costs. Saranac portfolios now reflect a more deliberate approach to currency exposure, with a 50% hedge on US and Eurozone equities for sterling-based clients. As currency dynamics become more influential, defining a clear hedging strategy is essential to protect portfolio outcomes.

### 1. Dollar bull market no longer evident

Following the market tensions evident in April, more recent market movements mirror trends seen in prior years, with equities rebounding and US megacaps outperforming. In this respect, US dominance in terms of equity market influence and performance has at least for now reasserted itself, making 2025 a more 'normal' period in the context of recent market history. Some of the policy-related stresses associated with the US Administration's economic policies are perceived to have abated, in particular the likelihood of exceptionally high tariffs.

### CHART 1

**US Dollar Peaked Against Other Developed Market Currencies in 2022**



<sup>1</sup>Source: Bloomberg/Saranac

However, in one important respect, the pattern of financial market returns has changed this year – the dollar has continued to weaken, the recent short-term bounce notwithstanding. There has, of course, been no sharp collapse, and the fall in the US currency has not been disorderly. However, a weaker trend has clearly been evident.

## The Long Read

Indeed, in a broader context, the dollar's peak against a basket of developed market currencies was in fact in the autumn of 2022, nearly three years ago, interrupted only temporarily by the strengthening in the aftermath of Trump's election. The dollar has fallen by some 15% in the past three years or so (chart 1)<sup>1</sup>. It has also weakened against emerging market currencies. It is therefore sensible to view the recent weakness as more than market 'noise'.

In the context of the past couple of decades, the extent of this adjustment is unusual. A big picture view is that the dollar had been in an extended bull cycle for around a decade, albeit an erratic one in which there were extended plateaus, and some non-negligible corrections. This structural appreciation has allowed investors in US assets from other currency bases to benefit from two asset class trends – outperforming equities in local currency terms, and a strong dollar. This is why recent history marks a potentially important break, with the US currency no longer being supportive of returns in dollar-denominated assets for investors with different currency bases.

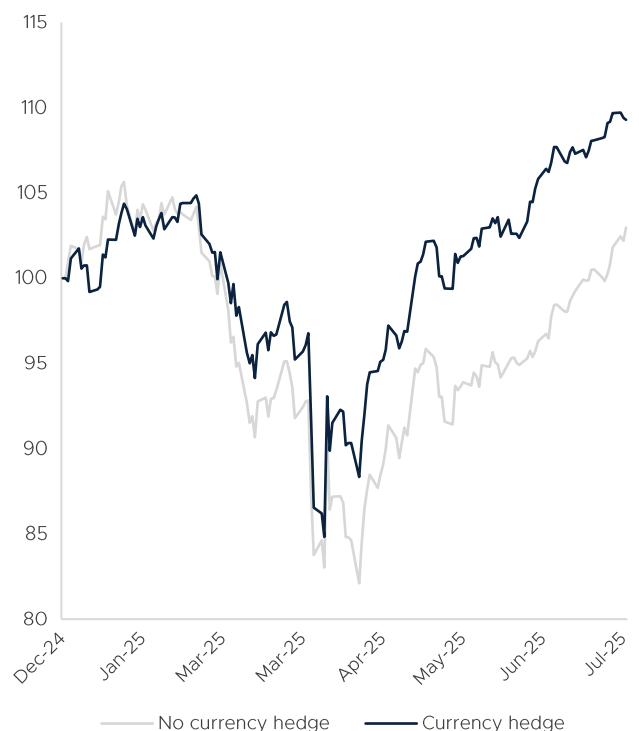
For example, sterling-based investors with a currency-hedged US equity exposure have achieved a return of almost 10% so far this year, whereas an unhedged investor has only just moved into positive territory (chart 2)<sup>2</sup>. At the same time, dollar weakness has been supportive of overseas asset-class returns for dollar-based investors, following an extended period when the dollar's strength worked against diversification into other equity markets.

### 2. Structural influences on the US dollar

In a perfect world, currency forecasting would be easy, and portfolios could easily be adjusted to account for prospective shifts in foreign-exchange markets, enhancing returns in the process. Sadly, this is not the world which anyone inhabits. While successful currency calls can periodically be made, such decisions tend to be more trading-oriented, and not associated with a longer-term currency strategy with active positions always in place.

CHART 2

### US Equity Returns from a Sterling Base



<sup>2</sup>Source: Bloomberg/Saranac

However, while precise longer-term currency projections are unreliable, it is necessary at least to be aware of high-level risks which might at some stage come into play, and in this respect some structural challenges to the dollar are beginning to emerge. Importantly, the Administration is not presenting a united front with respect to currency policy. Treasury Secretary Bessent has affirmed a strong dollar approach, but the White House has been more circumspect, with Trump favouring a 'weaker but not weak' currency to support the competitive position of US manufacturing firms.

In addition, some of the policies mooted, but not as yet implemented, by the Administration are dollar-unfriendly. These include the potential to constrain the independence of the Fed or to appoint a 'tamer'

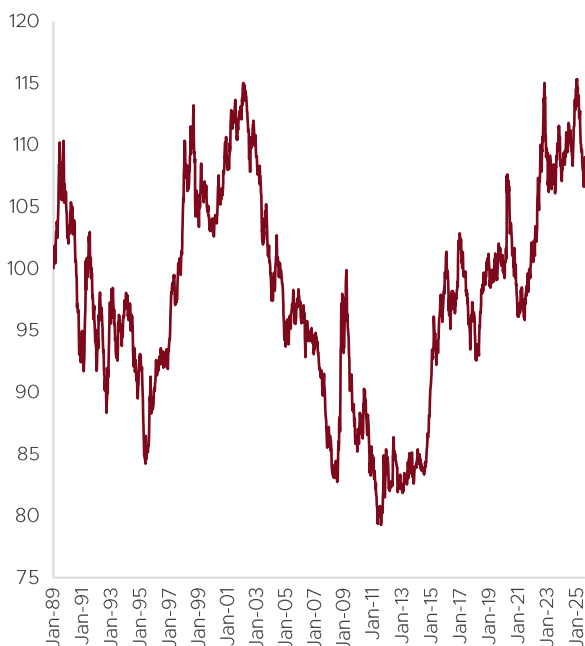
## The Long Read

Chair to replace Powell, taxes on capital inflows, and a forced restructuring of overseas holdings of US Treasuries. At the same time, some of the fundamentals for the US currency are moving in the wrong direction: the US budget deficit (~6% of GDP) and the sharp expected rise in the US debt to GDP ratio are challenges in this context, even though the US is not the only fiscally-challenged developed economy.

The US dollar's role as a reserve currency is frequently cited as a potential source of support, but care needs to be taken in this context. It has been a reserve currency for a long time, and this has not prevented multi-year periods of significant depreciation. On the contrary, if there were to be some slippage in this status, it could be a source of vulnerability for the US currency. Two influences in particular may be influential:

CHART 3

**US Dollar Level is Still Extended, Despite Recent Correction (Against basket of currencies, inflation-adjusted)**



<sup>3</sup>Source: Citibank/Bloomberg/Saranac

First, it is clear that there has been a long-term decline in the proportion of global foreign-exchange reserves held as dollars, from over 70% at the turn of the century to less than 60% now. This has not been associated with a long-term dollar bear market, but the trend seems likely to continue in a world of more elevated geopolitical tensions. Countries with challenged political relations with the US have been increasing gold reserves significantly, and even 'friendly' countries have been diversifying away from the dollar. Second, in a world of increasing financial sophistication, alternatives to dollar-based payments mechanisms are emerging, and these could over time depress demand for the US currency.

Given the size and liquidity of US financial markets, the US dollar is likely to remain the dominant global currency, but the extent of this 'exorbitant privilege' can diminish, which in turn could be associated with diminished fundamental support.

The starting point for the US currency is also potentially relevant. Against a basket of currencies, and after allowing for inflation differentials, the US currency is still at a very high level in a historic context. This is no good indicator of the likely short-term trend in the US currency, but it does highlight the potential for significant adjustment in the dollar over time (chart 3)<sup>3</sup>.

We cite these influences as long-term risks to the US currency, which investors in US assets should at least be cognisant of. Their influence over recent months may not have been dominant in explaining dollar weakness. Indeed, an interesting feature of this period has been an erosion of the yield premium of US bond yields over yields in other developed countries (chart 4)<sup>4</sup>. This 'cyclical' component is helpful in explaining short-term currency trends, and is consistent with the dollar's weakness year-to-date. There is, however, the potential for the structural factors outlined previously to come more into play at some stage.

## The Long Read

### 3. Integrating currency strategies into investment portfolios

#### a. Fixed income and hedge funds: currency hedges are required to protect returns

What is the best way to protect portfolios against volatility in the US currency? Saranac has a strong view that in fixed income portfolios, holdings in a different currency from the portfolio's base currency should always be hedged through forward contracts (with the exception of investments in emerging market local currency debt, which are typically only small holdings in a portfolio). The rationale is that even modest currency moves can dominate low-volatility bond portfolios, delivering returns which in the short-term can be significantly different from the steadily-compounding performance expected for many fixed income portfolios. In some circumstances, a carefully constructed low-risk bond portfolio can become, after the event, an unintended currency punt. A similar rationale is also relevant for hedge fund portfolios, where full hedging is the most appropriate strategy.

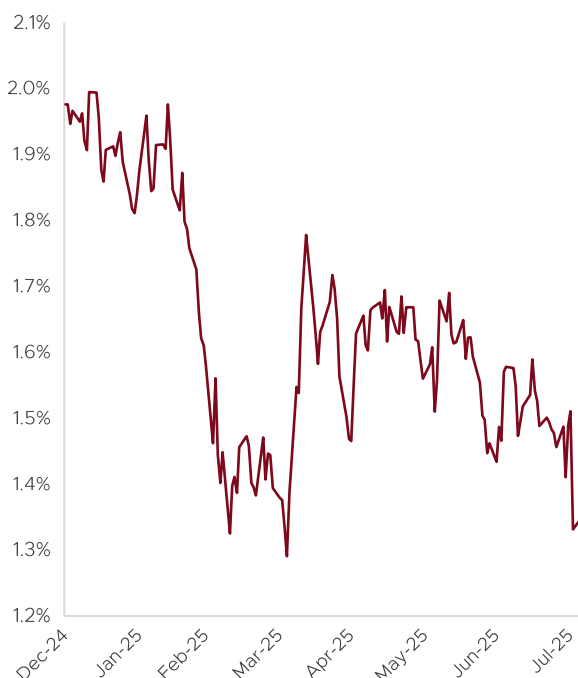
#### b. Equities: partial hedges can play an important role

We observe greater variation in practice as regards the currency hedging of equities in multi-asset portfolios, with some investors electing to currency hedge all non-base currency exposures, and other none. It is highly unusual, however, given the challenges of successful foreign-exchange forecasting, for the currency exposure to be managed successfully as an active portfolio overlay independent of the equity exposure.

Some investors choose to currency hedge all non-base currency equity exposures, with the rationale being that if currency is an unrewarded investment risk, why have any exposure to a risk with no expected return? One challenge to this position is that hedging currency exposures in small and illiquid markets (e.g. most countries in the emerging markets index) leads to unwarranted costs and complexity, so many investors pragmatically restrict currency hedging just to equity exposures with large, liquid and cheap forward markets (typically dollars, sterling, yen and Euros).

CHART 4

Premium of US 5-year yields over £/Euro/Yen equivalents



<sup>4</sup>Source: Bloomberg/Saranac

At the other end of the spectrum, some investors choose not to hedge any of their non-base currency equity exposures. Sometimes this choice is forced on them, as not all asset managers' back-office systems allow for this activity, particularly for private client portfolios. A more fundamental rationale is that equity holdings typically have a long time horizon, and over time the currency effect 'washes itself out'.

This argument allows for some interaction between equity and currency returns. For example, the Japanese equity market appears particularly sensitive to currency moves: a weaker yen supports the local market return and vice-versa. In this case, what overseas investors lose on a weaker yen, they get back (albeit probably only partially) from a higher local market return. In this case, there is a 'natural' hedge, rendering the formal hedge less necessary.

 **The Long Read**

These interaction effects between equities and currencies are not stable in the short term, but over time they do mitigate the need to hedge all overseas equity holdings. For example, what a UK investor has 'lost' this year through exposure to the US equity market unhedged against currency moves, is likely to have been offset to some extent by the S&P500's return being supported by the weaker dollar.

Saranac's policy toward equity hedging in multi-asset portfolios for sterling clients (for example) is to hedge 50% of the equities held in the US and the Euro area. We regard some hedging as helpful in controlling portfolio volatility over time, but this volatility reduction does not require a full hedge. This also insulates portfolios from being dominated by periodic very large moves in currencies, which can for a while swamp equity returns, and it also limits the cost of implementing currency hedges. Given the smaller exposure to overseas equities for US-dollar based portfolios, reflecting the high weight of US equities in a global portfolio, we do not hedge these residual currency positions. Again, the rationale is that some unhedged currency exposure can contribute to lower volatility over time.

Our conclusion is that given the higher possibility of currency volatility remaining a more relevant influence on portfolio returns going forward, it is more relevant than usual for investors to define what their hedging strategy should be.

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#### Saranac Partners Limited

+44 (0)20 7509 5700

16 St James's Street London SW1A 1ER

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