Goldman Sachs The Markets

"The most attractive hedge"

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Date of recording: April 24, 2025

Chris Hussey: The US dollar has been sinking. Why? And what does it mean for markets around the world? This is The Markets. I'm Chris Hussey. Today is Thursday, April 24th, and my guest is Brian Dunne, head of Americas Foreign Exchange Options Trading in Goldman Sachs's Global Banking and Markets. Brian, welcome to the show.

Brian Dunne: Thank you very much.

Chris Hussey: All right, let's cut to the chase. What happened to the dollar?

Brian Dunne: Yeah, it's no secret that financial markets have seen a lot of volatility in the last couple months, and FX has certainly not been immune to that. We've come off from levels pre-inauguration of something like 10% now, which relative to the history of the dollar is a pretty volatile move in such a short period of time.

I think there are sort of two things, maybe three, that I would use as a summary of what is many different cross-currents that are going through. But one, we actually, outside of the US, we had a very large upgrade to fiscal out of Germany. And that was a huge surprise that was not priced in the market.

The second is the markets' consensus on tariff policy has shifted pretty dramatically towards the US having less pricing power in negotiations that are coming out of the White House. And as a result, we've taken a pretty big markdown in forecasts for things like corporate profits or real incomes in the US this year. And so where those two things lead me is we've seen a pretty dramatic change in the relative growth forecast for the US relative to the world. As an example, we've only downgraded our European GDP forecast from the beginning of this year by a tenth. We've downgraded the US from 2.5% of real GDP to 1.3. So pretty meaningful change, if I take those numbers and I look at it for all of global growth, that number is 2.5 to 2.1. So a pretty meaningful downgrade in our forecast of US growth relative to the world.

And then the second thing that I would say is, for a very long period of time, the international community has invested in US assets, and this concept of US exceptionalism is one that has really persisted since the GFC. We estimate that the number of unhedged dollar assets that are out there is on the order of two to three trillion dollars equivalent. And if those dollars are either needed to be repatriated completely -- in other words, selling of US assets -- or just need to be FX hedged, that is the potential for a very substantial amount of dollar selling in the coming months or maybe years.

Chris Hussey: So a lot of moving parts there. We've had a 10% devaluation. Where to from here?

Brian Dunne: Yeah. So we think it can persist. I think the second part of what I said is the big key. Do the FX hedgers that have been unhedged for the last decade-plus actually come to market? The anecdotal evidence that we have in our conversations with clients, with our flow metrics over the last month, indicate that the answer is "yes." But as you can imagine, it's going to take some amount of time.

These aren't flows that are seen in our short-term positioning metrics or that happen on a whim. These are C-level decisions from corporates and other investment firms that are being made. I think we can probably use fair value models that indicate that the dollar is still overvalued by between 10 and 15%. I think from a timing perspective, that's a bigger and harder question to answer, but if I just look at where the DXY has been since COVID, the late 2020 to early 2021, we were somewhere in the vicinity of, like, 85 to 90. And we're still at about 100 in terms of level today. So we have relatively recent precedent for it to be quite a bit lower, and that is not even factoring in the potential for these flows to come to market.

Chris Hussey: Yeah, DXY is a trade-weighted index. So what is the smart money saying? The guys you talk to all day long? Do they want to carry on with this devaluation trade, do you think? Or do you think they want to see if this hedging issue really does surface?

Brian Dunne: I think that there is pretty widespread consensus that the dollar should continue to depreciate on a trade-weighted basis. I think the big question that people are asking is timing. And I think that, unfortunately, is a very hard question to answer. And I think it will ultimately be driven a lot by two things.

One, the consistent changes or maybe some level of consistency that comes out of policy from the administration in the US. And two, I think ultimately it will become about data. So far, we've seen sentiment data roll over pretty significantly in the US and abroad, but mostly in the US. But we haven't really started to see it, the hard data, roll over. I think if that starts to happen then I think that probably increases the chances that you see the Fed deliver cuts, and ultimately what we see in FX is you really need carry to start working against you to get those hedging flows to come to market.

So if I had to take a guess, I think that this is a story for now, but it also has some acceleration where the convexity term is US data over the next two or three months.

Chris Hussey: All right. Is that your favorite trade? Give us your favorite trade.

Brian Dunne: Yeah, I think so. Look, I think the dollar should continue to depreciate. I think that we will see repatriation flows. I think that particularly for those that are hedgers of traditional risk assets, looking at dollar-yen downside is probably the most attractive hedge, if not just trade, of the next handful of months.

I think that the level that you're getting short dollar-yen from about call it 142 to 143 looks relatively attractive on short-term metrics. On a much longer term metric, it looks even more attractive. And I think outside of Europe, which we did mention earlier, but I think Japan probably is the other one where the repatriation flows or the hedging programs have the potential to get upped substantially, where you have a real flow dynamic that's also working in your favor.

The correlation of dollar-yen on the exchange rate versus things like equities or credit, either globally or against the US, is materially positive. And so if you see a further drawdown of stocks or something like that or we're moving into a recession, you would expect for dollar-yen to work pretty well in that scenario.

Chris Hussey: When you mentioned dollar-yen, I do think about the difference in the central banks, the BOJ versus the Fed. Is that involved in here? The Fed, could they change this trade?

Brian Dunne: I think Fed reaction function is a risk to the short dollar view for sure. I mean, this is very small, but I thought Powell's comments -- I think it was late last week -- it was very interesting to me that he was incrementally more hawkish than I think the market expected. And actually yet the dollar still sold off after that. So I think that it's a trade where the market will focus on growth in the US more so than actual Fed policy.

But it is a risk. And I think, historically speaking, you would say, yes, that should be dollar positive. I thought the price action last week was actually very telling.

Chris Hussey: All right. Last question, what's next? What are you watching for in the week ahead?

Brian Dunne: Well, it's going to be the news flow out of the White House. We don't really have much in the way of US data, and even the next set of data doesn't really fully capture tariff impact. So I think on the data front, I'm still on the sidelines in terms of a directionality to markets until the following month.

Chris Hussey: Brian, thanks so much for joining us.

Brian Dunne: Thanks, Chris.

Chris Hussey: That does it for this week's episode of The Markets. I'm Chris Hussey, and thanks for listening.

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