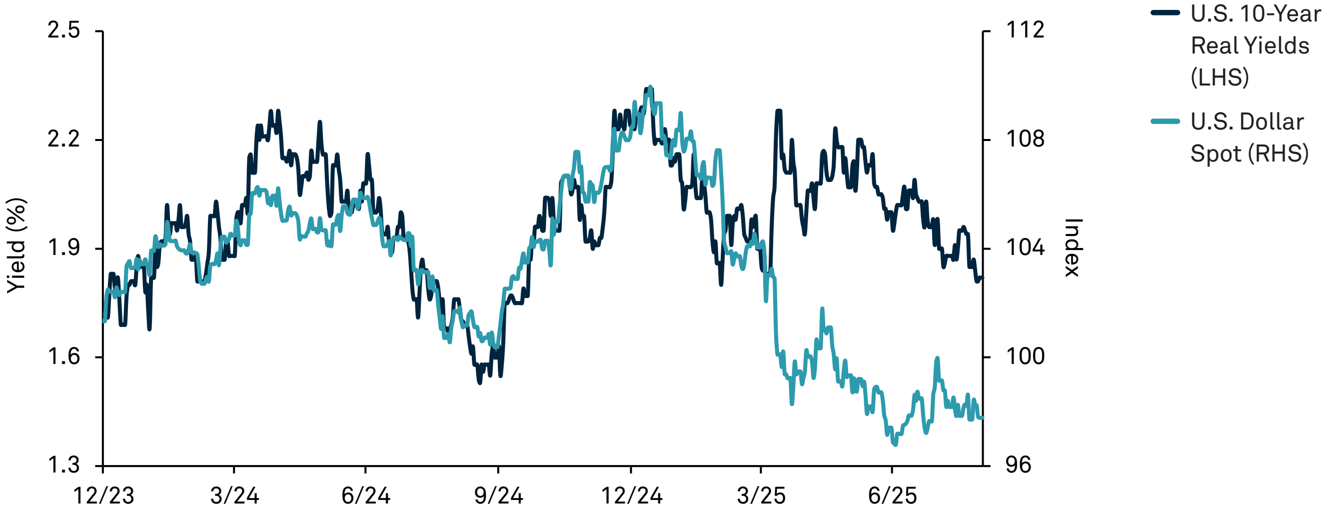
THE U.S. DOLLAR: FROM PRIVILEGE TO PRESSURE

Today's global economy is defined by a significant imbalance — the U.S.' large, persistent trade deficit. Expectations for continued U.S. economic strength, which keeps domestic consumption elevated and attracts foreign capital, is the primary reason for the imbalance. This dynamic has supported stronger import demand relative to the rest of the world and widened the U.S. trade deficit. If expectations of U.S. economic performance remain intact, global investors are likely to maintain their appetite for U.S. assets.

Through a shift in trade and industrial policy, the U.S. government aims to reduce import dependence and revive domestic production, particularly in manufacturing, as part of a broader effort to reshore the economy and critical supply chain infrastructure.

10-Year U.S. Real Yields vs. U.S. Dollar Index



Sources: BNY Investments, Bloomberg. Data as of October 31, 2025.

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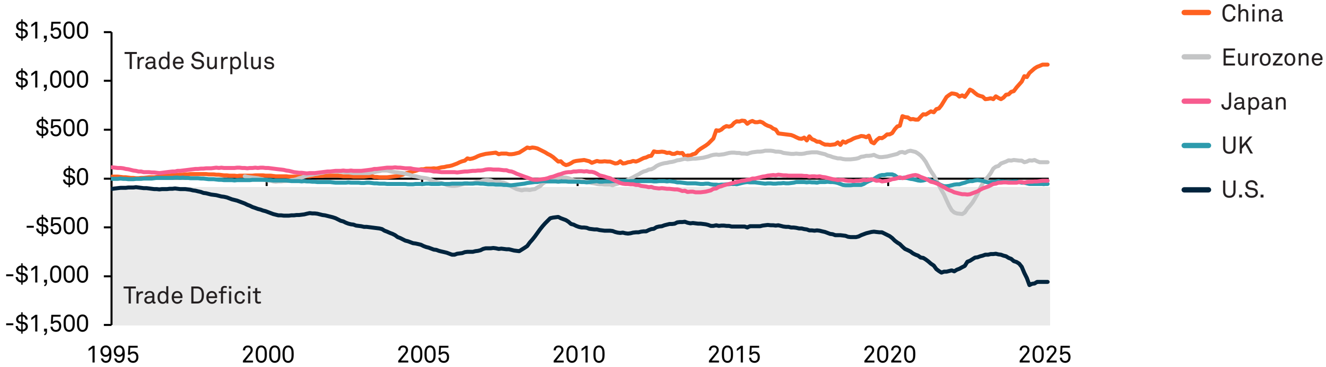
Rebalancing Trade

Broadly, there are two primary paths to narrowing the U.S. trade deficit. The first is for U.S. growth to slow, either through tighter policy or by imposing restrictions on free trade to curb domestic demand for imports. The second is for the rest of the world to grow faster than the U.S., likely through stronger fiscal policy stimulus, thereby lifting demand for U.S. exports. The first path rebalances trade by reducing global demand, while the latter is more constructive for global growth.

Global Trade Imbalances

Trade Balance (Billions USD)



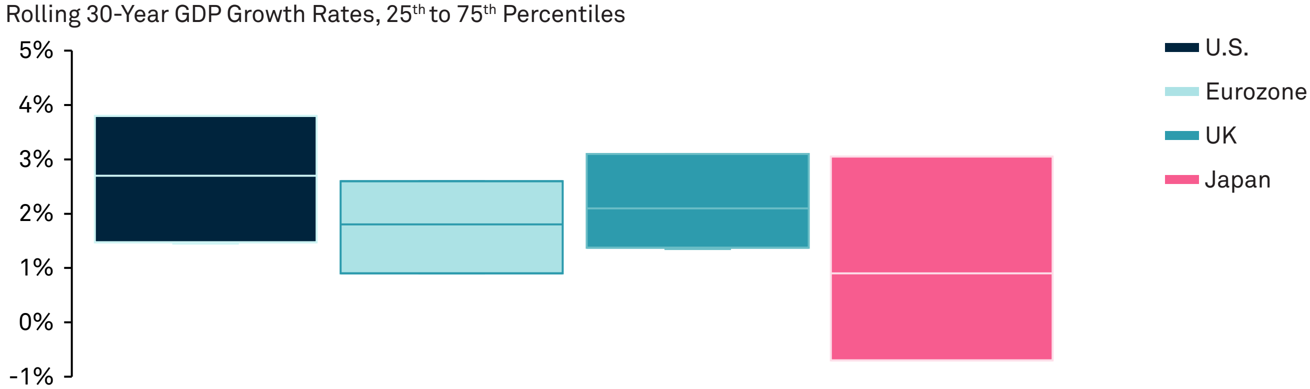
Sources: BNY Investments, Bloomberg. Data as of October 31, 2025.

Recent policy shifts around the world suggest that both sets of dynamics are at play. In the U.S., higher tariffs are functioning as a tax on domestic consumption, tempering demand. Meanwhile, increased fiscal stimulus in economies such as Germany and China supports foreign demand. Together, these measures contribute to a gradual redistribution of global growth, narrowing the gap between the U.S. and the rest of the world.

As global growth rates converge, growth differentials between the U.S. and other economies will narrow. The resulting convergence puts downward pressure on U.S. assets and the dollar as investors diversify their investment portfolios.

Developed Market Real GDP Growth Rates

Rolling 30-Year GDP Growth Rates, 25th to 75th Percentiles



Sources: BNY Investments, Bloomberg. Data as of October 31, 2025.

Strong Valuations

Another driver of U.S. dollar weakness is valuation. Despite this year's correction, the U.S. dollar remains above its 10-year moving average. One way to assess the currency's valuation is through purchasing power parity (PPP), which estimates the exchange rate at which a basket of goods and services would cost the same in the U.S. as abroad. The PPP rate, along with the real effective exchange rate (REER), serves as a benchmark for long-term fair value. When the market exchange rate is notably stronger than these measures, it suggests the U.S. dollar is rich by historical standards and may face further downside as valuation pressures persist.

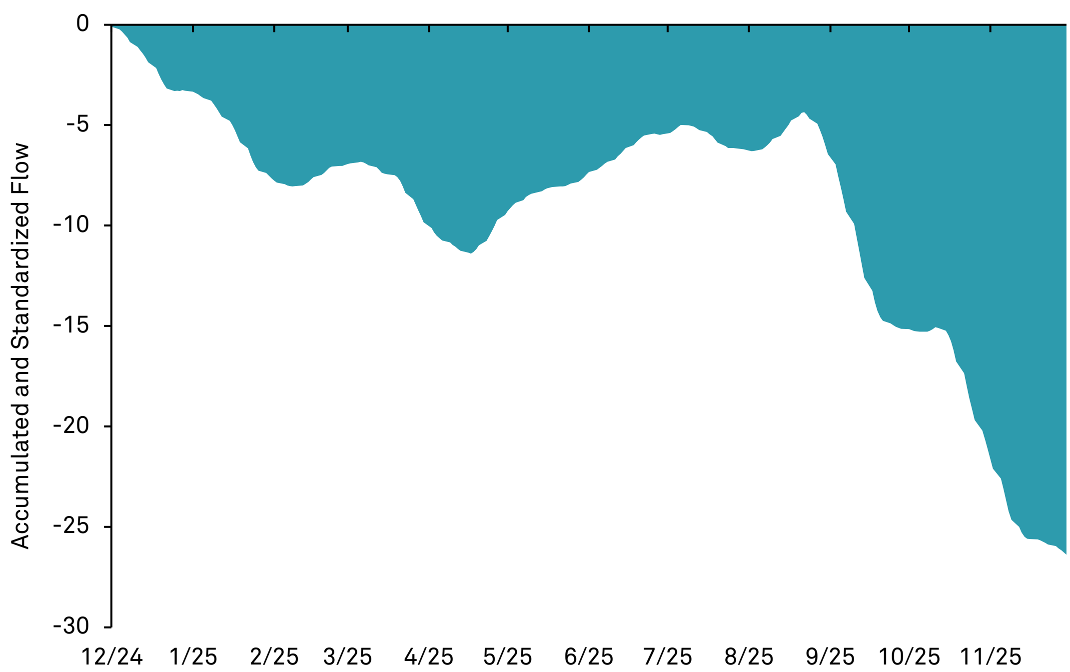
Increased Hedging

Against this backdrop of trade rebalancing, growth convergence and elevated U.S. valuations, global investors have structurally increased FX hedge ratios on U.S. dollar-denominated assets. For example, during April's cross-asset selloff, U.S. Treasuries didn't provide their typical stabilizing ballast and correlations broke down, prompting global allocators to raise currency hedges on U.S. exposures.

U.S. Treasury Flows

Cross-Border U.S. Treasury Demand

Flows are weaker since the beginning of the year.

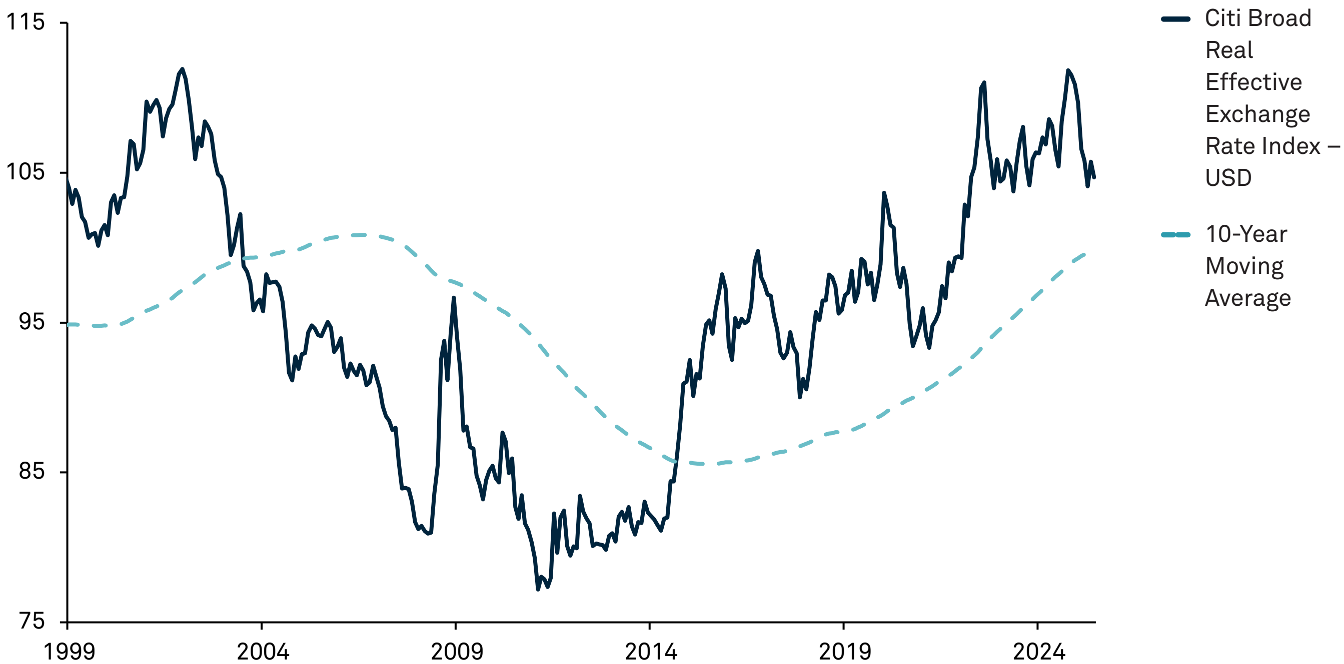


Sources: BNY iFlow, Bloomberg. Rebased to 0 as of December 2024. Data as of October 31, 2025. A standardized flow is an exponential moving average asset flow, divided by trailing asset flow standard deviation, where asset flow is daily net aggregate trading.

Other incentives to hedge U.S. asset exposure have also grown increasingly compelling. We believe rising term premia could steepen the U.S. yield curve; a steeper curve boosts the pickup that foreign investors earn when hedging U.S. dollar bond exposure and lifts the optimal hedge ratio. As a result, even where capital continues to flow into U.S. assets, a growing share is likely to arrive hedged, dampening the traditional currency support that historically accompanied inflows.

Over time, we expect the U.S. dollar's REER to revert toward its 10-year moving average, as depicted below. Three persistent forces anchor this outlook: the ongoing convergence of global growth rates and rebalancing of trade, the structural rise in FX hedging by international investors, and the dollar's continued overvaluation relative to long-term benchmarks like PPP and productivity-adjusted measures. Even after this year's correction, the U.S. dollar remains elevated versus fundamentals. With policy shifts reducing the degree of U.S. outperformance, and capital flows becoming more diversified, these pressures reinforce a gradual, structurally weaker dollar over the long term.

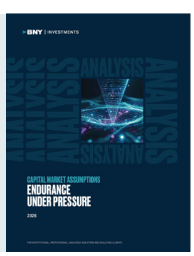
U.S. Dollar Real Effective Exchange Rate Index vs. 10-Year Moving Average



Sources: BNY Investments, Bloomberg. Data as of October 31, 2025.

This is an excerpt from our 2026 report, Capital Market Assumptions: Endurance Under Pressure

For further discussion and in-depth analysis, read the **full report**.



Disclosure

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The capital market assumptions are BNY Advisors' estimates based upon historical market performance and the current market environment. References to future expected returns are not promises of actual returns that may be realized and should not be relied upon. Actual returns may vary significantly. In addition, the historical returns used as a basis for this analysis are based on information gathered by BNY or from third-party sources and have not been independently verified.

The forecasts contained herein are for illustrative purposes only and are not guarantees of performance. The forecasts have inherent limitations because they are not based on actual transactions. The forecasts are based upon historical returns of the selected investments and subjective estimates and assumptions about circumstances and events that may not have taken place and may never do so.

Some of the factors that could impact these forecasts include, but are not limited to:

- General economic conditions
- Financial market performance
- Interest rate levels
- Changes to current laws or regulations, and
- Future geopolitical conditions

Asset class returns are not reflective of anticipated returns for associated indexes.

The results do not represent, and are not necessarily indicative of, the results that may be achieved in the future.

Robust Strategic Asset Allocation (RSAA) is a framework for classifying the market environment with a combination of macroeconomic and market indicators with judgment. BNY Advisors has defined historical regimes for the period starting in May 1973.

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