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The Dollar Paradox Explained

There is an obvious riddle in today's markets: Why is the U.S. dollar down sharply while U.S. stocks are up?

The S&P 500, despite many ups and downs on tariff headlines, has climbed nearly 10% so far in 2025. Yet the ICE U.S. dollar index, which measures the currency's value against a basket of trading partners, is down the same amount.

One explanation appears to be that big foreign investors are spooked by trade-war tensions, threats against the independence of the Federal Reserve and so on. In response, they are reducing their U.S. dollar exposure.

But they still feel the need to be invested in the U.S. because they want, say, exposure to the artificial- intelligence growth story, or because they rely on the depth and liquidity of American bond markets. So rather than sell outright, they are choosing to offset some of that risk by placing bets against the dollar.

"At this stage it's not about selling the existing stock of U.S. assets," says Lombard Street Chief Economist Freya Beamish. But for slow-moving institutions like pension funds, "you just don't want to leave yourself more exposed to that than you have to."

A June paper by economists at the Bank for International Settlements bears this out. They found that foreign institutional investors in April and May retained their U.S. holdings but increased their positions in foreign-currency swaps and other instruments to make bets against the dollar.

In those months, the largest declines in the dollar occurred during Asian trading hours, the BIS paper says. That was despite the fact that U.S. Treasury bonds gained during those hours. This again suggests that Asian investors responded to trade-war risks by hedging dollars rather than selling U.S. bonds.

U.S. investors haven't had much reason to worry about the dollar in recent decades. But now, ignoring currency risks can mean leaving money on the table.

In particular, many investors hold too few foreign stocks and bonds in their portfolios. At times when the dollar is falling, returns on foreign holdings will be better in dollar terms. This in turn can help American investors improve returns while hedging against inflation, political chaos and other risks.

International stocks have underperformed for years, but that is now changing. Take for instance the iShares MSCI EAFE exchange-traded fund, which tracks developed-market equities outside the U.S. and Canada such as Europe and Japan. It is up 21.9% so far this year versus a 9.7% gain for the S&P 500.

You don't need fancy hedges to protect against a weaker dollar. Simple diversification can go a long way.

Aaron Back