Key Questions

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Will the US Debt Ceiling Debate Cause the US Dollar to Be Dethroned?

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No. But the dollar's dominance may diminish, and thus international markets may merit renewed consideration.

In the first four months of this year, financial markets, in general, have fared well: The S&P 500 Index has advanced over 9%; the tech-heavy NASDAQ 100 Index has spiked over 20%; of the 24 largest equity industry groups we track, only five are in negative territory; and following one of their worst years in history, bond prices are also decidedly higher for the year.

Yet, the decline of one major benchmark caught our attention. Not because of the magnitude of its decline. But because its decline runs counter to its performance during other periods defined by economic and geopolitical uncertainty. The benchmark I am referencing is the US Dollar Index and in my view, its modest pullback deserves discussing.

In episodes of financial strain, the US dollar has commonly displayed signs of strength. During the Great Financial Crisis in 2008-09, for instance, the dollar surged 25%. Similarly, in the two-month period following the outbreak of COVID-19, the greenback appreciated 10%. Looking further back reveals similar patterns: the US dollar is traditionally viewed as a safe haven amid stormy financial conditions.

It is curious, therefore, to observe the dollar's recent decline against a mild (thus far) "risk-off" environment brought about by concerns involving the US banking system.

The dollar's decline (down 2% year-to-date, and down 7% from its high last October) coincides with several significant geopolitical developments including Saudi Arabia's Crown Prince proclaiming he is "no longer interested in pleasing the United States"; Malaysia's Prime Minister declaring there is "no reason" for his country to rely on the US dollar; and, perhaps most notably, China signing bilateral currency arrangements with several countries, thus deepening their economic ties with China.

Such events – some of which are symbolic, but some are indeed substantive – are furthermore occurring at a time when skepticism over America's political system is on the rise due, in large part, to concerns over the debt ceiling and whether or not Congress will increase it. Concerns over our political dysfunction are prompting some to posit that the US dollar's status as the world's reserve currency might be severely damaged, and "King Dollar" would be dethroned.

We have discussed the debt ceiling in detail in previous writings, so we won't elaborate on the mechanics again here. But we should acknowledge that concerns over the debt ceiling are surfacing now for it appears as if the so-called "X-Date" (the date on which the US may technically be no longer able to meet its obligations with 100%

certainty) may appear sooner and faster than previously anticipated (now possibly May/June versus July to September).

Despite this potentially unwelcome event, we continue to believe that the US will not default on its debt and, like they have done nearly 100 times before, Congress will extend the debt ceiling, but most likely not until the last possible moment (or possibly slightly later). This could spark some noticeable gyrations in the financial markets. Yet we continue to think such volatility will be short-lived (weeks, maybe a few months). Why? The stakes of default are just too high and the consequences just too unknowable.

In a similar manner, we do not believe the US dollar will lose its status as the world's dominant reserve currency. The US, we staunchly believe, possesses a considerable number of unrivaled assets including a deep-seated spirit of innovation, a flexible labor market, large and liquid capital markets, and less direct conflict as a result of a considerable geographic advantage.

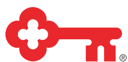
That said, at the margin, the dollar's dominance will diminish and, over time, could be dis-intermediated by newer forms of exchange, including central bank digital currencies (CBDCs). Currently, the dollar accounts for 58% of the global currency reserves which firmly places the dollar in a dominant position versus the Euro (~20%), the British Pound (~5%) and Chinese Renminbi (<3%). Yet, this share is down from 72% in 2000, and from 66% in 2014.

Looking forward, we can envision further US dollar weakness (again, at the margin). Such would be precipitated by the Federal Reserve cutting interest rates later this year, or next. As such, the combination of these forces suggests investors may be wise to revisit their allocations to non-US markets and possibly increase exposure there.

More specifically, on a strategic basis, we advise investors split their allocations to global equities as follows: two-thirds toward US equities, and one-third directed toward international equities. Over the past several quarters, we suggested that on a tactical basis, higher allocations toward US assets was preferred on the belief that the protracted war in Ukraine would pose significant economic challenges to Europe. Due to a much milder winter, however, those challenges were mercifully avoided.

Thus, as these strains appear to have subsided, and as the US dollar's dominance diminishes – but does not disappear – international markets merit renewed consideration.

For more information, please contact your advisor.



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