11 April 2025

What Happens When the Reserve Currency Loses its Status?

Dear Investors

We'll keep this note brief – there's a lot happening in the world right now. But given the magnitude of current events, we felt it was important to share an update without delay. We are living through a period that can only be described as historically significant. In times like these, having the right macro positioning in a portfolio is more critical than ever. This is one of those rare moments when macro forces will likely drive the majority of investment returns. So, what are we seeing?

We're increasingly concerned that the US dollar – the world's reserve currency – may be at risk of losing that status. As you'd expect, such shifts are extremely rare. The last major transition like this occurred between the First and Second World Wars, when the British pound lost its reserve currency role. These changes don't happen overnight, but the pound gradually lost significant value over time.

Why could this happen? We're beginning to see price action in the markets that suggest to us that foreign investors are dumping US assets. A combination of the rise in the price of gold, higher long-end bond yields and a weaker dollar suggest that global investors may no longer see US assets as a safe or reliable store of value.

It may not take much – foreign investors merely slowing their pace of investment into the US could trigger a significant funding shortfall. Even if they just maintain their current holdings without adding more, the gap could become substantial. This type of dynamic is typically seen in emerging markets, where sudden stops in capital flows – often due to economic mismanagement – lead to sharp declines in bonds, equities, and currency values. These episodes are frequently accompanied by currency instability and surging inflation.

Why might foreign investors lose confidence in US assets? In short: Trump's policies. Tariffs are a form of economic aggression – designed not just to protect US industries, but to directly undermine the business models of major exporters like China. It's the economic equivalent of a competitor setting fire to your factory. On top of that, repeated threats of sanctions against various countries have created an atmosphere of unpredictability that rattles confidence in US markets. Recently, Trump even floated the idea of imposing tariffs and sanctions on Mexico, citing a decades-old water treaty from 1944. There are also reports that he's considering de-listing Chinese companies from US exchanges. If a country doesn't comply with US demands, it raises the question: how far might Trump go to enforce his will?

There are already plenty of incentives for foreign investors to sell their holdings of US Treasury bonds. Reportedly, According to reports, Treasury Secretary Bessent persuaded Trump to implement a 90-day pause on the reciprocal portion of his tariffs due to growing instability in the bond market. If countries like Japan, China, or others want to gain leverage over Trump during trade negotiations, selling US Treasuries could be an effective way to apply pressure through market channels.

This combination of market forces could well lead to an economic recession. If international investors begin to lose faith in the US dollar, then US asset valuations will come under pressure. A weakening currency combined with rising recession risks may make it increasingly compelling for foreign holders to offload their US assets.

Although Trump has paused his tariffs for now, we still see a two-thirds chance of a US recession this year. With uncertainty dominating the outlook, businesses are unlikely to commit to major capital expenditures. Even with the pause, the current level of tariffs remains higher than it was on Liberation Day.

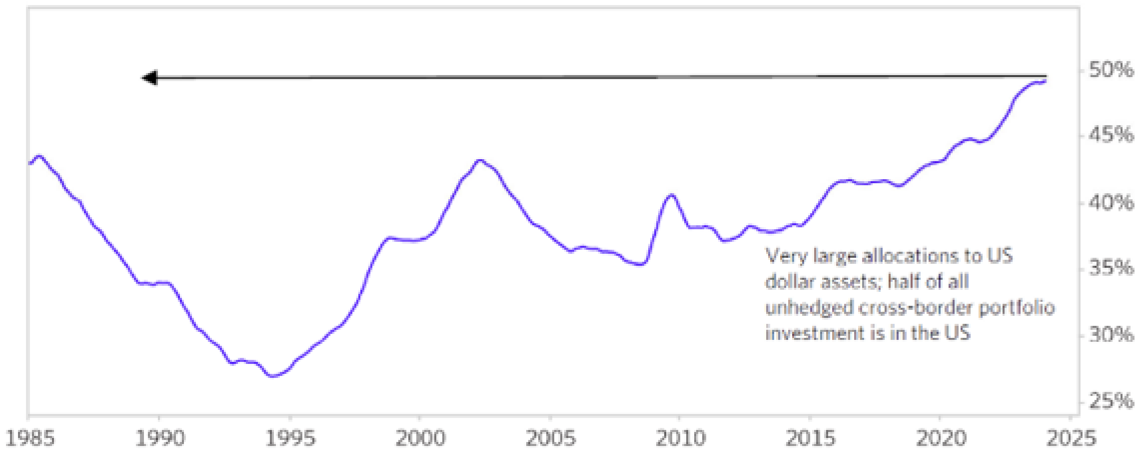
	Amount	Liberation Day	Now
EU	770	20%	10%
China	450	54%	125%
Japan	150	25%	10%
Vietnam	135	45%	10%
South Korea	130	25%	10%
Other	465	30%	10%
Canada	400	25%	25%
Mexico	500	25%	25%
Weighted Avg	3000	29.7%	31.8%

Source: US Census

It stands to reason that if one believed the tariffs imposed on Liberation Day would lead to a recession, a temporary pause shouldn't meaningfully change that view.

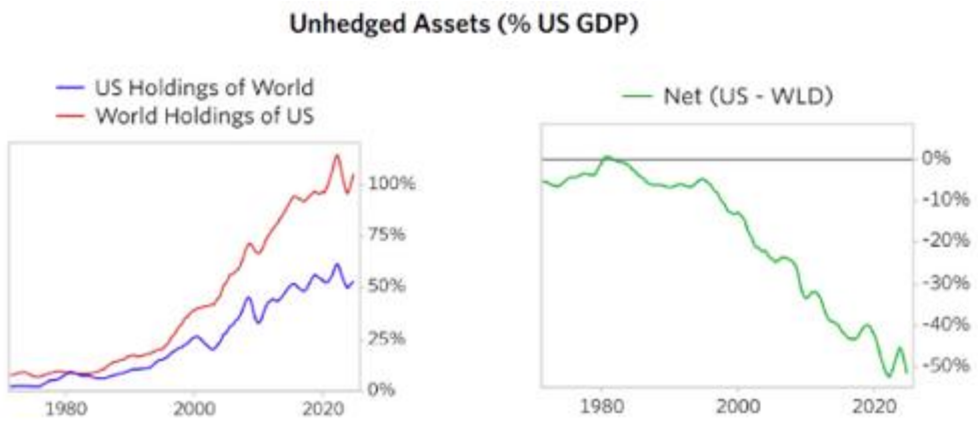
On top of this, the Republicans have recently passed a reconciliation bill in both houses. To secure support from fiscal hawks in the House, Speaker Johnson provided a written commitment to identify $2 trillion in spending cuts over the next decade. On top of what Musk is doing with DOGE, we'd estimate that around $350 billion in annual spending is being cut from the budget. The tariffs, in their current form, represent the largest federal tax increase since World War II, potentially generating around $500 billion per year. In total then, US spending power might be hit by around 3% of GDP. That would be massive.

This all comes at a time when foreigners are highly concentrated in US assets. For instance, the world currently holds approximately 50% of its cross border unhedged savings in US dollar assets, higher than at any point over the last four decades.



Source: Bridgewater

Alongside this, global investors hold significantly more US assets than the US holds abroad:



Source: Bridgewater

The US requires roughly $900 billion annually to finance its current account deficit. If that funding falls short, it will need to be rationed across asset classes. The most immediate pressure would fall on government bonds, where yields would likely rise. As those yields increase, investors may rotate out of equities and into bonds, putting further pressure on stock markets.

While Trump could likely prevail in a trade war if it were limited to trade alone, we're now facing a broader capital war. The administration's key vulnerability in this conflict is that the consumption-driven economy it has fostered is heavily financed by foreign capital. Given these dynamics, there's a real possibility that Trump will be forced to confront this reality.

We believe a short position on the US dollar is well justified in the current environment. We have no intention of stepping back until there is a clear reversal in Trump's policy direction. With inflation risks looming, we also don't expect the Federal Reserve to step in to stabilise markets any time soon.

The Trump administration's policies fundamentally favour a weak dollar. By aiming to boost US exports while curbing consumption – and encouraging the opposite in foreign economies – it seeks to reshape the current global dynamic. Currently, the US economy sucks in the capital of the world in exchange for a return. This allows the US to borrow heavily at low interest rates. In a rebalanced system, this steady recycling of foreign capital into US assets is likely to diminish.

If détente can be achieved between the US and China, then we'd be willing to reverse course. The two great powers now race to form the new trading rules and relationships that will govern the world. Xi, Trump and Putin are all impatient men. Xi has recently been negotiating with the EU on a new trading relationship, with a top-level meeting scheduled for June. These top level meetings usually occur only once a trade deal has largely been completed and only a small number of major issues remain. Meanwhile, Treasury Secretary Bessent said that he hopes to strike deals with major trading partners before confronting China. If meaningful progress toward global détente is made – or if Trump substantially rolls back his tariff policies – we would reassess our stance.

We believe that market and political pressures will eventually force the key players to act—but this process could take considerable time. Trade negotiations are complex and lengthy. For example, it took 15 months to renegotiate the USMCA, another 15 months for the US-Australia Free Trade Agreement, and more than two years to finalise the Brexit deal. At present, Xi appears to be digging in. His advantage lies in the Chinese government's complete control over the economy. The People's Bank of China can manage capital flows, set interest rates, print money, and influence asset prices. Meanwhile, the central government can deliver targeted fiscal stimulus to affected sectors. While both sides will face economic pain, China's leadership is insulated from the constraints of democratic accountability.

The US will have an advantage in this fight if it can rally support from other nations. It also benefits from being the primary consumer in global trade. However, its key weakness lies in the blunt nature of tariffs, which tend to harm domestic consumers as much as foreign exporters. Pain will be felt on both sides. Given that exports to the US represent a relatively modest share of China's overall economy, we sense that Chinese leaders believe they can endure more economic pressure than the US. While China's political system isn't immune to public discontent – as seen in the reversal of its COVID lockdown policy – it notably refrained from deploying fiscal stimulus during that time. On balance, we believe China may be better positioned to absorb economic strain. As such, a resolution between the US and China could take time. In the meantime, we intend to maintain our current positioning and continue to monitor developments closely.

Kind Regards,
Fawkes Capital Management

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