

THE CALM AFTER THE STORM

The first half of 2025 delivered all the thrills and scares of a turbocharged roller coaster. The twists and turns were sudden and startling; the ups and downs were vicious and violent. The ride left investors shaken from a potentially calamitous experience where mistakes would have been easy to make and expensive to stomach.

Three factors converged to spark the second quarter storm of volatility.

1. Trade and Tariffs
2. Israel and Iran
3. Deficits, Dollar and Treasuries

The first two factors appear to have petered out in terms of significance at this time in early July. The jury is still out on elevated fiscal risk from the high deficit and its impact on the U.S. dollar and Treasuries. We briefly summarize the first two topics and devote most of our attention in this article to the third theme above.

Trade and Tariffs

The initial trigger for the second quarter turmoil was the unexpectedly large “reciprocal” tariffs announced by President Trump on April 2. The administration had long signaled its desire to reshape the order of global trade and restore balance between tariffs on U.S. exports and imports. Even though higher baseline tariffs of 10% had already been priced in by then, the large additional reciprocal tariffs stunned markets and set off historic selloffs in the stock, bond and currency markets in early April.

Our last Market Insights publication in mid-April had forecasted the likely impact of tariffs on the economy and markets. We believed then that the threat of tariffs was more likely to be used as a negotiating tactic than implemented ideologically regardless of economic and market disruptions.

Even as we indulgently observed the sharp market declines in early April, we had high conviction that the trajectory of tariffs would **NOT** lead to a recession, a bear market or even a prolonged correction. Markets reversed from the April 8 lows as tariff deadlines were extended and the worst fears on trade wars did not materialize.

Trade, tariffs and geopolitical tensions no longer present material risk to the economy and the markets.

We believe that U.S. exceptionalism will continue for a long time.

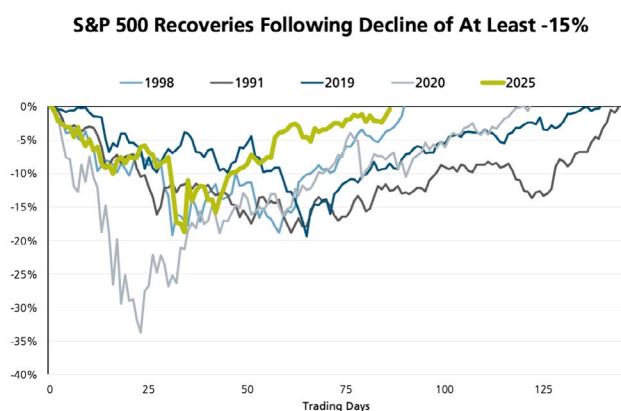
The dollar’s status as the world’s reserve currency will also persist well into the future.

We anticipate more stable markets and lower volatility in the second half of 2025.

Rapid inflections in the trade narrative created a historic gut-wrenching rollercoaster ride in the stock market. We share some remarkable data points to highlight the extreme volatility.

The S&P 500 index fell by -10.5% over two trading days on April 3 and 4. It was the third worst 2-day decline in this century and only the sixth time in the last 75 years that the index lost more than -10% in 2 days. The S&P 500 index fell by about -19% from its previous high on February 19 to its low on April 8. In an unprecedented turnaround, it regained all of those losses to make a new all-time high on June 27. Figure 1 shows the 5 fastest recoveries on record after stock market declines in excess of -15%.

Figure 1: 2025 is the Quickest Recovery Ever after a Decline of -15%



Source: FactSet

At 87 trading days, 2025 marks the quickest recovery back to a new all-time high in the history of the U.S. stock market.

While very few trade deals have actually been signed and trade uncertainty continues to linger, we still maintain that trade and tariffs have largely become non-events for financial markets. We are also pleased that the second quarter rebound in the stock market validated our original thesis on the topic.

Israel and Iran

Geopolitical tensions also flared up in the Middle East during the second quarter. Iran's rapidly advancing nuclear program, which Israel views as a threat to its existence, was the main catalyst for

the escalation. Iran is deemed to have long been in breach of its 2015 nuclear agreement that limits its enrichment of uranium in exchange for relief on economic sanctions.

Israel's long-standing conflict with Iran and its proxies escalated in June when it launched attacks on Iranian nuclear facilities and military targets. Iran retaliated with missile and drone strikes against Israeli military sites and cities. The U.S. supported Israel in its defense against the Iranian attacks and eventually brokered a cease-fire between the two countries that has since held. In between, the U.S. separately initiated offensive strikes on Iranian nuclear sites to establish credible military deterrents.

Such a brief summary hardly captures the troubled history and future instability of this conflict. However, we believe that the worst of this crisis is behind us at this point. Even as it unfolded in June, we stood by our long-standing belief that geopolitical crises rarely have a lasting impact on markets. Almost on cue, oil prices have receded as geopolitical risks in the Middle East have dissipated.

Deficits, Dollar and Treasuries

The large U.S. debt burden has worried investors for quite some time. At the surface, many of these concerns appear to be well-founded. High and rising debt can lead to higher inflation, higher interest rates, slower growth and a weaker currency. Investors have harbored a chronic fear that U.S. interest rates may spike above 5% and that the U.S. dollar may eventually lose its status as the world's reserve currency.

The topic of deficits and the outlook for Treasuries and the U.S. dollar remained in focus throughout the second quarter. The market turmoil from tariffs saw a historic breakdown of correlations between U.S. stocks, bonds and the dollar. When investors sell U.S. stocks during periods of stress, they normally seek out the safe havens of Treasury bonds and the U.S. dollar. When stocks go down, bonds typically go up and so does the dollar.

In early April, we saw exactly the opposite outcome.

The 10-year Treasury bond and the U.S. dollar both fell even as stocks sold off. The pursuit of isolationist trade policies and a willingness to disrupt global alliances cast doubts on the continued demand for Treasuries and the U.S. dollar. The 10-year Treasury bond yield rose from 4.0% to 4.5% as bonds sold off during the week of April 7. Investors worried that foreign holders of U.S. Treasuries would cut back their holdings as a result of dwindling trade surpluses or in retaliation for the trade war.

The fiscal deficit also came back to the fore when Republicans pushed through their signature tax legislation by the narrowest of margins. With the passage of the tax bill, the fiscal deficit is projected to rise by an additional \$3.5 to \$4 trillion. Investors now worry that a big problem just became a whole lot bigger.

While the bond market has since stabilized, the U.S. dollar has continued its remarkable downward slide. And even as stocks trade at new highs, there are still unanswered questions about the yet-to-be-seen inflationary impact of recent new tariffs, the festering risk of higher interest rates and the possible end of dollar hegemony.

We narrow our focus from here on to briefly answer the following questions.

- How has the trade war changed the short-term and long-term outlook for the U.S. dollar?
- What are the likely effects of the dollar weakness in 2025?
- Is there any relief for short-term policy rates or long-term interest rates in the next 12 months?

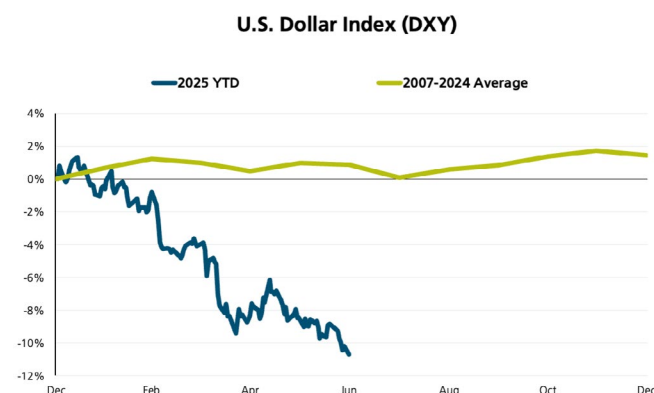
SECULAR OUTLOOK FOR THE DOLLAR

Recent Concerns

2025 has seen a reversal in the performance of U.S. assets across the global landscape. U.S. stocks and the U.S. dollar have significantly underperformed their international counterparts. By the end of June, the dollar had declined by more than -10%. The last time the dollar fell so much at the start of the year

was 1973, soon after its decoupling from the price of gold. We show this year's historic dollar weakness in Figure 2.

Figure 2: Dollar Has Worst Start to a Year in Recent History



Source: FactSet, as of June 30, 2025

Both stocks and the dollar had soared after the Republican clean sweep in the 2024 elections. The early optimism was based on the pro-business campaign promises of fiscal stimulus and deregulation. This enthusiasm soon reversed as more restrictive policy initiatives such as government spending cuts and tariffs leapfrogged the administration's pro-growth plans.

The unexpectedly chaotic launch of government cuts and tariffs soured global sentiment and perceptions to such an extent that investors were forced to ask themselves an existential question. Is this the end of U.S. exceptionalism? And more specifically, is this also the end for the dollar as the world's reserve currency? We answer these questions in the next section.

U.S. Exceptionalism and Exorbitant Privilege

U.S. exceptionalism was founded on the basic principles of democracy, freedom and justice, and then carefully built over many decades through enterprise, innovation and capitalism. We understand the recent concerns about U.S. exceptionalism but have high conviction in defending its survival and longevity. We reiterate our key foundational

arguments to support continued U.S. exceptionalism well into the future.

- Technological innovation that contributes to both productivity growth and disinflation
- Institutional support and personal initiatives to pursue risk-taking
- Strong economic growth and incomes driven by sound macroeconomic policies
- Low inflation from credible monetary policy
- Well-regulated capital markets
- Government and institutional adherence to the rule of law
- Strong and credible military presence

As a result, the U.S. dollar also enjoys unparalleled dominance in currency markets and global trade. The U.S. dollar currently accounts for more than 80% of foreign exchange transactions, almost 58% of global central bank reserves and over 50% of global trade invoicing.

The U.S. enjoys an “exorbitant privilege” from the dollar’s status as the world’s reserve currency. The term, first coined by the then French Finance Minister, Valéry d’Estaing, in the 1960s, refers to the unique benefits the U.S. enjoys as a result of dollar hegemony. The world’s demand for dollars and U.S. debt securities reduces government borrowing costs and increases consumer purchasing power. It also insulates the U.S. from a balance of payment crisis because it can purchase imports in its own currency.

We observe that U.S. dollar dominance is being gradually whittled away in both central bank reserves and global trade. The dollar’s share of global currency reserves has fallen from above 70% in 1999 to below 58% now. A mere two years ago, it was above 60%. The euro’s share is now above 20% and gold continues to become an increasingly larger reserve asset for central banks. We expect the gradual attrition in the dollar’s share to continue but still expect it to be around 50% several years from now.

The U.S. dollar’s enduring safety, stability, convertibility and liquidity will serve it well for a long time. Despite the 2025 blip, we believe that secular U.S. exceptionalism and dollar hegemony are still intact.

We address the recent weakness in the U.S. dollar next, both in terms of causes and effects.

DOLLAR WEAKNESS IN 2025

Cause, Effect or Coincidence?

We begin our review of recent dollar weakness by posing a couple of additional questions. Did the trade war affect the dollar in 2025? And what are the implications of today’s weak dollar on growth and interest rates?

The answers to these questions are neither simple nor verifiable by hard evidence. We use a mosaic approach of inferences and interpretation to offer insights that may spark interest and reflection.

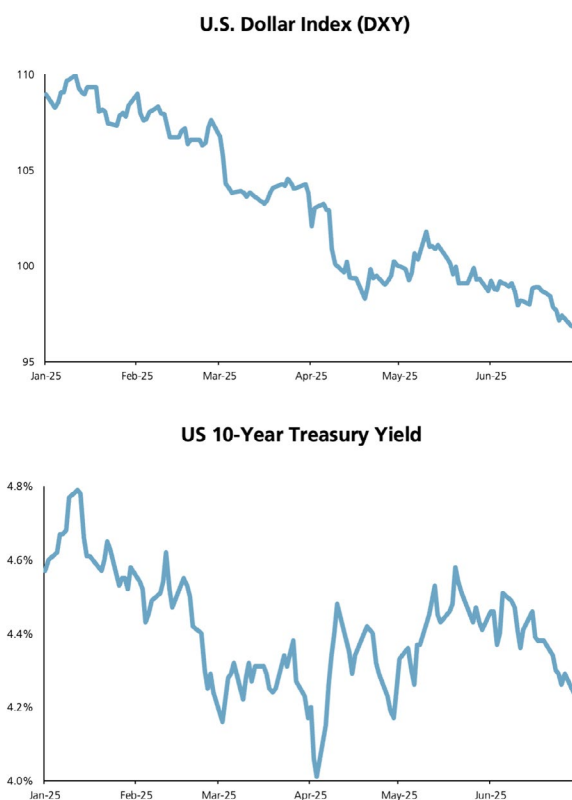
We believe the administration’s main goals for global trade are to: 1) increase demand for U.S. goods overseas through more balanced trade agreements and 2) reduce the U.S. deficit with higher tariff revenue. The administration clearly wants to address asymmetrical tariffs on U.S. exports and imports; we pay higher tariffs on our exports to other countries than they pay on our imports from them. It also wants to target other unfair trade practices such as currency manipulation that hurt our global competitiveness.

Let’s introduce a new concept which is the polar opposite of “exorbitant privilege.” We might call it an “exorbitant burden” or “handicap” or even “freight.” The burden or handicap of a perennially strong currency is that it also makes U.S. goods perennially more expensive and less competitive. Both Treasury Secretary Scott Bessent and Head of White House Council of Economic Advisers Stephen Miran have made several references to this dichotomy in 2025.

Clearly, a weaker dollar and lower interest rates help achieve the policy goals mentioned above. The weak dollar increases international demand for U.S. goods

and any decline in interest rates slows down the growth of the federal deficit. Figure 3 shows how these outcomes have been meaningfully achieved as of June 2025.

Figure 3: Weaker Dollar and Lower Treasury Yields in 2025



Source: FactSet, as of June 30, 2025

While this convenient alignment of desired 2025 outcomes and stated policy goals may be just a coincidence, we do not rule out a more causal dynamic at play here. We find other similar, but more nuanced, effects in our later discussion of U.S. inflation and interest rates.

Global Growth Dynamics

The implications of a weak dollar for global growth are quite intuitive to understand.

One of the more immediate effects of a weak dollar is an increase in commodity prices. Commodities are a critical source of exports and revenues for many

emerging economies such as Mexico, South Africa, Brazil and Chile. Higher commodity prices improve balance sheets for many emerging market commodity exporters. Emerging countries also get a reprieve from lower debt repayment costs since most of their external debt is U.S. dollar-denominated.

Foreign currency gains also increase purchasing power in developed international economies. In fact, this rise in foreign demand comes at the same time that U.S. goods become more competitive because of the weak dollar. Higher U.S. exports help U.S. GDP growth at the margin. And more importantly, foreign profits of U.S. multi-national companies get restated in U.S. dollars at a more favorable exchange rate. These foreign currency translation effects become a tailwind for S&P 500 earnings growth in the near term.

U.S. Inflation and Interest Rates

We first address concerns about the yet-to-be-seen inflationary impact of recent new tariffs. There are many points in the supply chain where the impact of tariffs can be absorbed (e.g. foreign manufacturer, foreign exporter, domestic importer or the U.S. consumer). Supply chains can also be realigned with more favorable foreign domiciles. And finally, consumers can adjust their own preferences to buy cheaper substitutes. We believe that recent new tariffs will not materially affect U.S. inflation or growth. And to the extent that they do, the July legislation on tax cuts will more than offset the negative impact of tariffs.

We close out our discussion with some of the less intuitive effects of a weak dollar on U.S. interest rates. We offer our more esoteric insights here more as food for thought instead of a definitive theory or a high-conviction view on transmission mechanisms.

The role of a weak dollar in potentially reducing interest rate appears counter-intuitive at first glance. We lay out the framework and outline the process step by step.

We begin with short-term interest rates.

Let's start with the implication of a weak dollar for U.S. import inflation. Just as a weak dollar makes U.S. exports cheaper, it makes U.S. imports more expensive. Import inflation ticks higher as the dollar declines. A straightforward extension of this theme is a marginal decrease in consumer spending because of higher import prices. One more relevant detail on import inflation. Higher import inflation increases headline inflation more, and sooner, than it does core inflation. Policymakers also deem many volatile headline components to be transitory and, therefore, less relevant for core inflation.

We take these building blocks to make a plausible argument for how a weak dollar may induce the Fed to lower policy rates more quickly. Assume that the economy weakens a tad because of higher import inflation. Evidence of the slowing economy will be easily visible in a weaker job market and lower consumer spending. While this is going on, the real Fed funds rate (nominal rate minus core inflation) remains essentially unchanged. Why? Core inflation does not change as import inflation rises because of muted and lengthy lag effects.

Imagine the Fed's position in this setting. With its real policy rate essentially unchanged in the midst of slowing growth, the only way to ease monetary policy is through rate cuts. Needless to say, lower short-term rates are a desired outcome for the administration.

The scenario outlined above is also conducive to a decline in long-term interest rates. Investors quickly price slower growth prospects into lower long-term interest rates.

We can also think of another, even more nuanced, mechanism through which long rates may come down. As foreign economies grow faster in the near term, foreign central banks are more likely to raise their policy rates. As our Fed funds rate remains fixed and then drifts lower, the differentials between foreign and U.S. short-term rates will decrease.

The next link in this chain of logic is that this smaller interest rate differential reduces currency hedging costs for foreign investors. And finally, armed with

lower hedging costs, more foreign investors may find hedged U.S. Treasuries to be an attractive investment. This incremental demand for long-duration Treasuries can also bring long-term interest rates down at the margin.

We swiftly switch gears from the theoretical back to the practical in conclusion.

SUMMARY

We offer a number of practical takeaways in our summary.

- Trade, tariffs and geopolitical tensions no longer present material risk to the economy and the markets.
- We believe that the underperformance of U.S. stocks and the dollar is more cyclical in nature than secular.
- We believe that U.S. exceptionalism will continue for a long time.
- The exorbitant privilege that the U.S. enjoys from the dollar's status as the world's reserve currency will persist well into the future.
- The recent dollar weakness may achieve several desired outcomes for the administration.
 - Increased international demand for U.S. goods
 - Imminent rate cuts by the Fed
 - Lower long-term rates at the margin

In the calm after the storm, we anticipate more stable market conditions and significantly lower volatility in the second half of 2025. Even as chaos transitions to calm, we remain vigilant and prudent in managing client portfolios.

Contact us to learn more about our services.
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