The U.S. Dollar: An Untapped Portfolio Diversifier

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Key Takeaways

- **The U.S. Dollar as a Diversifier:** The dollar has exhibited a strong negative correlation to equities (-0.56 vs. the S&P 500 over 3 years), making it a powerful portfolio hedge.
- **Safe-Haven Demand:** During periods of market stress, investors frequently flock to the dollar, reinforcing its role as a stabilizing force.
- **Cost-Effective Hedging:** Contrary to common misconceptions, currency hedging may be profitable due to the carry trade advantage, given higher U.S. interest rates.
- **Implementation Strategies:** Investors may gain long dollar exposure through currency-hedged equities, direct dollar ETFs (e.g., USDU) or trend-following strategies such as managed futures.
- **Near-Term Constructive View:** Technical indicators support a case for continued dollar strength, making now an opportune time to consider long dollar exposure.

Investors are facing a volatile and uncertain landscape so far in 2025. A new administration is moving swiftly to implement its key policy priorities, reshaping trade, regulation and economic strategy, all while markets contend with uncertainty around the future of the AI trade, geopolitical tensions and the potential for escalating tariffs.

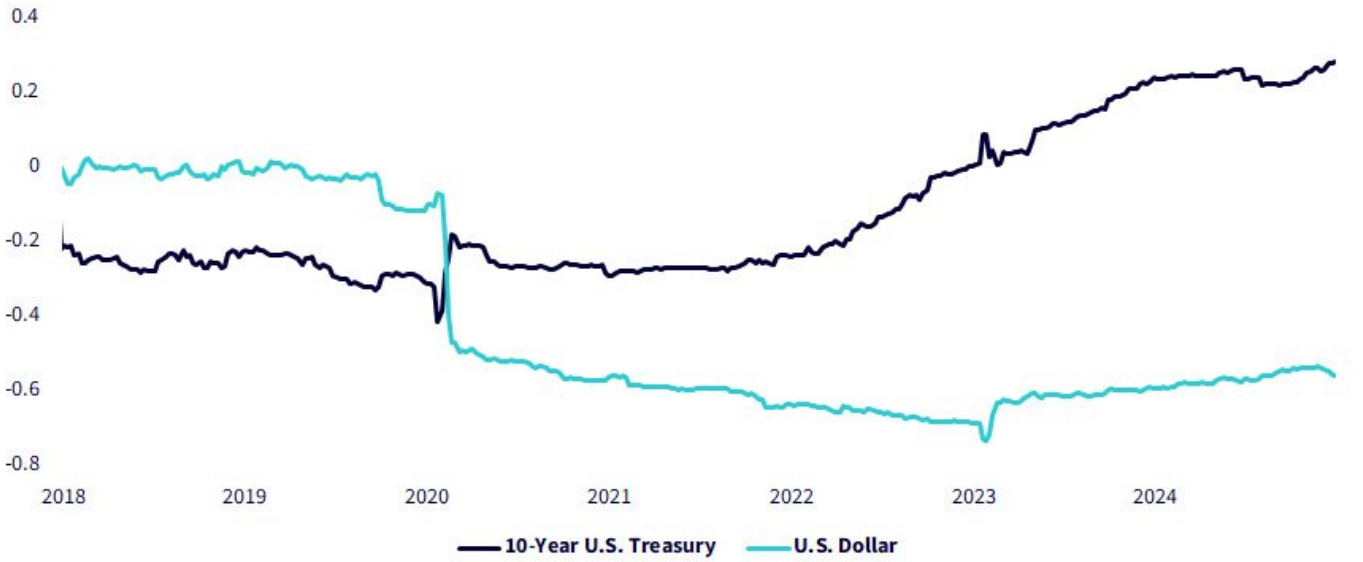
In this environment, portfolio diversification is more critical than ever. Some traditional hedges, like bonds, have been less reliable in recent years. But one asset has stepped up as a powerful diversifier: the U.S. dollar.

An Increasingly Useful Diversification Tool

The U.S. dollar has proven to be one of the most effective portfolio diversifiers in recent years. Figure 1 demonstrates that over the past three years, its correlation to the S&P 500 Index has been -0.56, offering

better diversification than traditional hedge assets such as gold (0.18), core fixed income (0.40) and even Treasuries (0.28).

Figure 1: Rolling 3-Year Correlations of 10-Year Treasury, U.S. Dollar vs. S&P 500 Index



Sources: WisdomTree, FactSet, as of 1/31/25. Calculated as trailing three years of weekly correlations of the S&P 500 Index relative to the Bloomberg US Treasury Bellwether 10Y Index and the Bloomberg Dollar Total Return Index. **Past performance is not indicative of future results. You cannot invest directly in an index.**

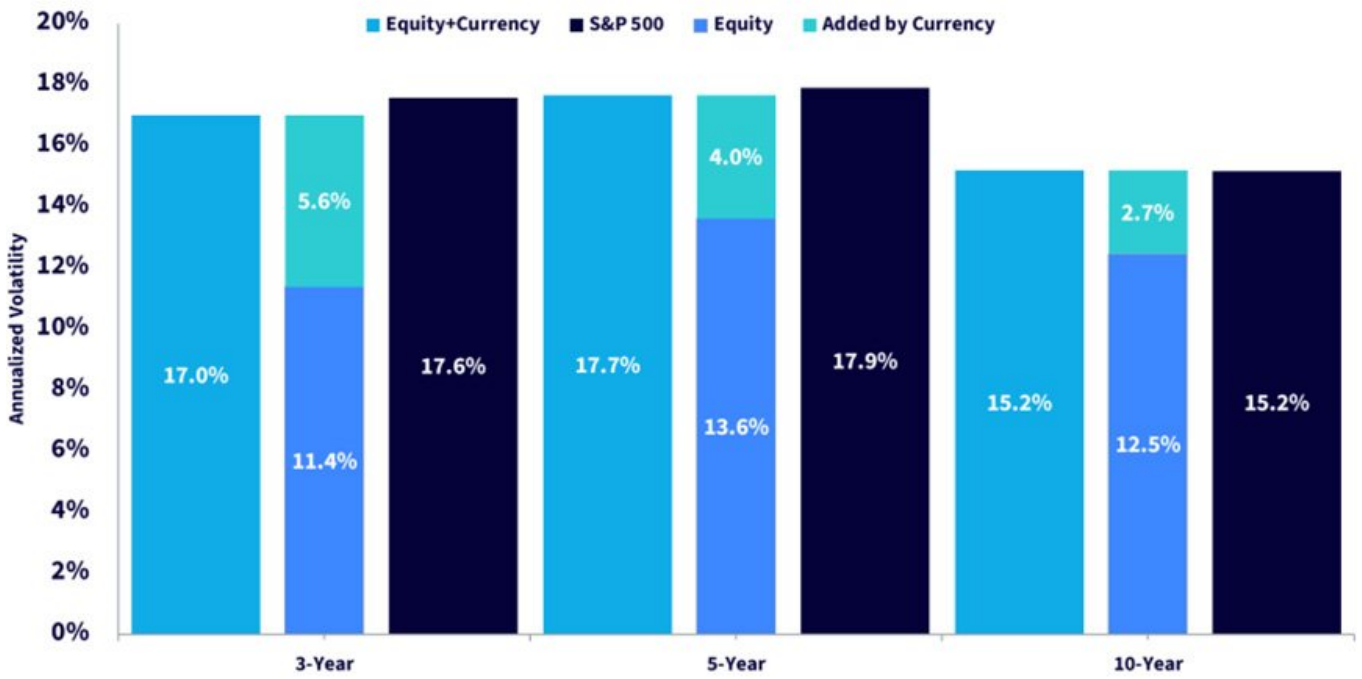
During periods of market turmoil, investors frequently turn to the dollar as a safe-haven asset, further enhancing its role in reducing portfolio risk.

How to implement long U.S. dollar exposure

One of the most capital-efficient ways to gain long dollar exposure is through currency-hedged international equity strategies. These strategies not only help reduce portfolio volatility by eliminating unhedged currency risk but also introduce a long-dollar tilt, providing an effective tool for diversifying equity beta.

Unhedged currency exposure on top of equity exposure has historically introduced significant volatility while providing minimal—if any—contribution to excess returns. Moreover, volatility in local international stock markets has consistently been lower than that of the S&P 500 Index, as seen in figure 2.

Figure 2: Contribution of Unhedged Currency Risk to Historical International Equity Volatility



Sources: WisdomTree, MSCI, S&P, as of 9/30/24. Equity + Currency represented by the net returns of the MSCI EAFE (USD) Index. Equity represented by the net returns of the MSCI EAFE (Local) Index. Currency represented by the difference between the net returns of the MSCI EAFE (USD) and MSCI EAFE (Local) indexes. **Past performance is not indicative of future results. You cannot invest directly in an index.**

Yet, unhedged equity investments inherently assume that the dollar will weaken against international currencies—a view that many investors do not actively hold. This leads to a key question: if one does not have high conviction about currency movements, why invest in an asset that carries an uncertain return but a certain risk? In the WisdomTree Core Equity Model Portfolio, we mitigate this by hedging a significant portion of the currency risk within the international developed market equity allocation.

Additionally, a common misconception is that currency hedging is expensive. However, in the current environment, long U.S. dollar exposure may actually offer a return advantage through positive carry, which is a function of the interest rate differentials between the U.S. and developed international markets.

Outside of currency hedged equities, another way to express a long dollar view is through outright exposure to the dollar itself. For example, we incorporate the WisdomTree Bloomberg U.S. Dollar Bullish Fund (USDU) in the WisdomTree Liquid Alternatives Model Portfolio, which provides direct exposure to the dollar versus a basket of foreign currencies in an ETF structure.

Additionally, trend-following strategies such as managed futures may capitalize on prevailing price trends across currencies, offering a more dynamic approach to currency risk management.

Tactical Views: Constructive on the Dollar

Beyond the strategic rationale, we also see a compelling near-term case for dollar strength. Recent price action has been supportive, with the dollar having broken out to more than two-year highs to start 2025. Several short-term technical indicators such as the Moving Average Convergence Divergence (MACD) and stochastic oscillators also suggest a potential buying opportunity for more tactical investors.

Final Thoughts

In our view, the dollar has emerged as a resilient hedge against equity risk, providing stability when markets need it most. With traditional hedges like bonds proving less reliable in recent years, incorporating long dollar exposure may provide an effective tool for risk management.

Whether through currency-hedged international equities, direct dollar exposure or alternative strategies such as managed futures, investors have multiple avenues to capitalize on the dollar's defensive qualities and potential return benefits.

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