GLOBAL PERSPECTIVES

JUNE 2025

BY WILLIAM P. STERLING, PH.D.

Global Strategist

THE GREAT ROTATION: WHY INTERNATIONAL DIVERSIFICATION MAY FINALLY PAY OFF

HIGHLIGHTS

- The US dollar's extreme overvaluation has created conditions for sustained weakness that could benefit international stocks.
- Historical patterns show international equities outperform US markets during dollar decline cycles, with currency translation effects amplifying returns for American investors.
- Trade tensions, pressure on emerging markets to strengthen their currencies, and easier Fed policy suggest the dollar's 13-year upswing may be ending.

A FUNDAMENTAL SHIFT TO DOLLAR WEAKNESS

After more than a decade of US stock market dominance, a fundamental shift may be underway. International equities are showing signs of life, emerging markets are stirring, and the catalyst driving this potential "great rotation" sits right at the heart of global finance: the US dollar's long-overdue decline.

The numbers tell a compelling story. While US stocks have delivered spectacular returns since 2011, international markets have until recently lagged dramatically — not because of inferior business fundamentals, but largely due to currency headwinds. As those headwinds finally reverse into tailwinds, investors may be witnessing the early stages of a multi-year shift that could reshape portfolio strategies worldwide.

UNDERSTANDING THE CURRENCY CONNECTION

To grasp why the dollar matters so much for investment returns, consider what happens when currencies move. A "strong" dollar means it takes more foreign currency to buy one dollar — making US exports expensive overseas while keeping imports cheap for Americans. A "weak" dollar flips this equation: US goods become bargains abroad, but foreign products cost more at home.

For investors, these currency shifts create powerful translation effects. When US investors buy foreign stocks and the dollar subsequently weakens, their returns get amplified. A 10% gain in European stocks becomes 15% when the euro strengthens 5% against the dollar. Conversely, during the dollar's long rise from 2011 to early 2025, international investments faced a persistent currency headwind that masked otherwise solid underlying performance.

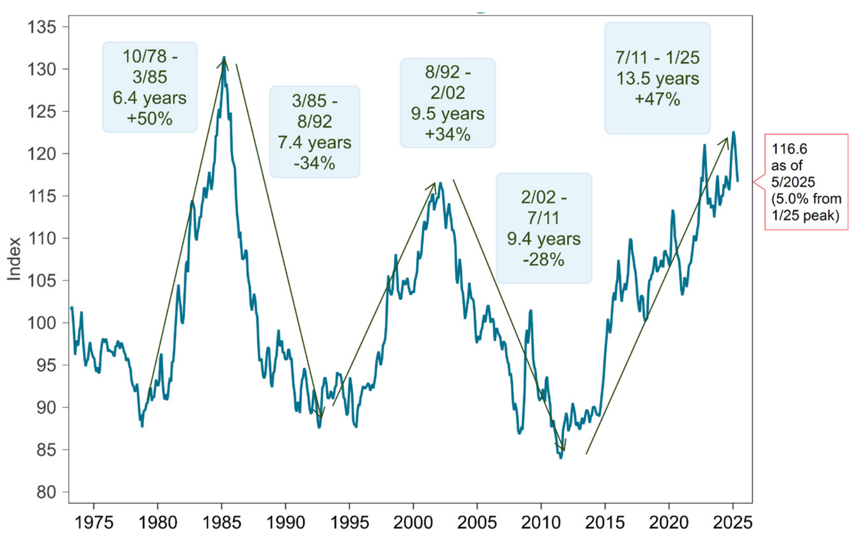
The impact on multinational corporations works similarly. When Apple or Microsoft report quarterly earnings, their overseas revenues get translated back into dollars. A weaker dollar means those foreign sales are worth more in dollar terms — providing an earnings boost even if local market performance remains unchanged.

THE FOUNDATION: HISTORIC DOLLAR OVERVALUATION

The stage for this potential rotation was set by one of the most extreme currency overvaluations in modern history. After a 13-year climb that boosted the dollar's real trade-weighted value by 47%, the greenback reached a level that historically has proven to be unsustainable **(Figure 1)**.

FIGURE 1

The Dollar Has Ample Room to Decline Further: The US Real Trade-Weighted Dollar Index



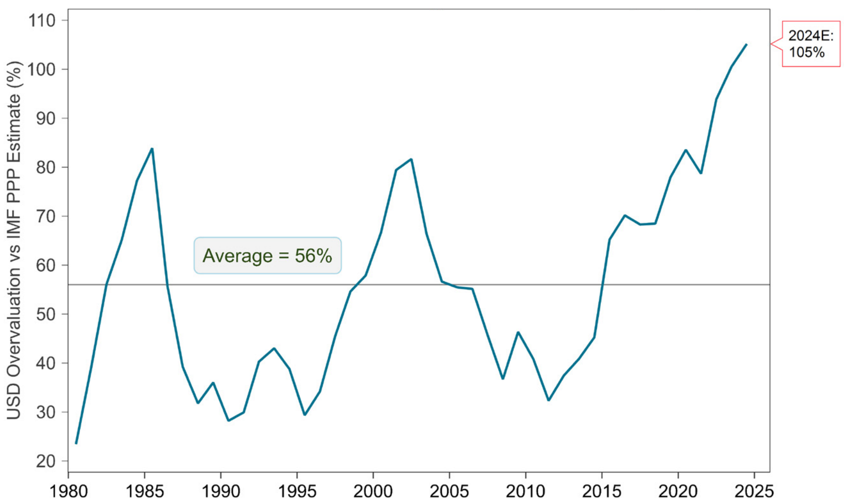
Sources: GW&K Investment Management, Bloomberg, Federal Reservce, and Macrobond.

The Fed's real trade-weighted dollar index is off its January 2025 peak but remains about 16% higher than its long-term average rate. Historically the dollar has tended to move in multi-year cycles.

As of May 2025, the Federal Reserve's broad dollar index sat 16% above its long-term average — a level reached only 6% of the time since 1973. More striking still, International Monetary Fund (IMF) data showed the dollar was 105% overvalued on a purchasing-power basis in 2024, eclipsing previous peaks from 1985 and 2002 **(Figure 2)**.

FIGURE 2

US Dollar Overvaluation vs Foreign Currencies Based on Purchasing Power Parity (%)



Sources: GW&K Investment Management, IMF April 2025 World Economic Outlook, and Macrobond.
Note: Based on the ratio of IMF estimates of world ex US GDP in PPP-based vs nominal terms.

Based on the IMF's PPP estimates, the US dollar posted a record overvaluation in 2024 of 105% against non-US currencies, eclipsing previous peaks reached in 1985 and 2002.

This overvaluation shows up in everyday terms through metrics like *The Economist*'s Big Mac Index. A burger costing $5.79 in America sold in January this year for the equivalent of just $3.11 in Japan, suggesting the yen was undervalued by 46% against the dollar **(Figures 3 and 4)**.

Using a broader measure of purchasing power parity (PPP) maintained by the IMF, similar patterns exist across major currencies. For example, for developed market (DM) currencies captured by the MSCI World Index, the median overvaluation of the dollar in 2024 was estimated to be 23% **(Figure 5)**. For emerging market (EM) currencies captured by the MSCI Emerging Markets Index, the median overvaluation of the dollar in 2024 was estimated to be a whopping 114% **(Figure 6)**.

Such extreme imbalances cannot persist indefinitely. Currency markets, like stretched rubber bands, eventually snap back toward equilibrium. The question isn't whether the dollar will weaken, but how much and how quickly.

FIGURE 3

US Dollar and Foreign Currency Over/Undervaluation Based on *The Economist*'s "Big Mac Index"

Foreign Currency	Under/Overvaluation of National Currency from a US Tourist Point of View (%)	Under/Overvaluation of US Dollar from a Foreign Tourist's Point of View (%)	Big Mac Price, USD
Swiss Franc	38.0	-27.5	7.99
Argentine Peso	20.0	-16.7	6.95
Norwegian Krone	15.2	-13.2	6.67
Euro	2.8	-2.7	5.95
British Pound	-1.0	1.0	5.73
Swedish Krona	-2.1	2.1	5.67
Danish Krone	-5.2	5.5	5.49
Canadian Dollar	-6.2	6.6	5.43
Turkish Lira	-8.1	8.8	5.32
Polish Zloty	-10.0	11.1	5.21
Colombian Peso	-10.7	12.0	5.17
Singapore Dollar	-10.7	12.0	5.17
Australian Dollar	-15.9	18.9	4.87
New Zealand Dollar	-17.6	21.4	4.77
Mexican Peso	-20.6	25.9	4.60
Czech Koruna	-21.2	27.0	4.56
Chilean Peso	-21.4	27.3	4.55
Brazilian Real	-30.4	43.7	4.03
Thai Baht	-30.7	44.4	4.01
South Korean Won	-33.7	50.8	3.84
Hungarian Forint	-37.1	59.1	3.64
Chinese Renminbi	-39.2	64.5	3.52
Japanese Yen	-46.3	86.2	3.11
Hong Kong Dollar	-46.8	88.0	3.08
Malaysian Ringgit	-48.2	93.0	3.00
Philippine Peso	-50.1	100.3	2.89
South African Rand	-52.0	108.3	2.78
Indonesian Rupiah	-56.1	128.0	2.54
Taiwan Dollar	-58.9	143.3	2.38
United States	NA	NA	5.79
Median	**-19.1**	**23.6**	**4.69**

Sources: GW&K Investment Management, Bloomberg, and *The Economist* (January 2025).

FIGURE 4

Applying Burgernomics to the Japanese Yen

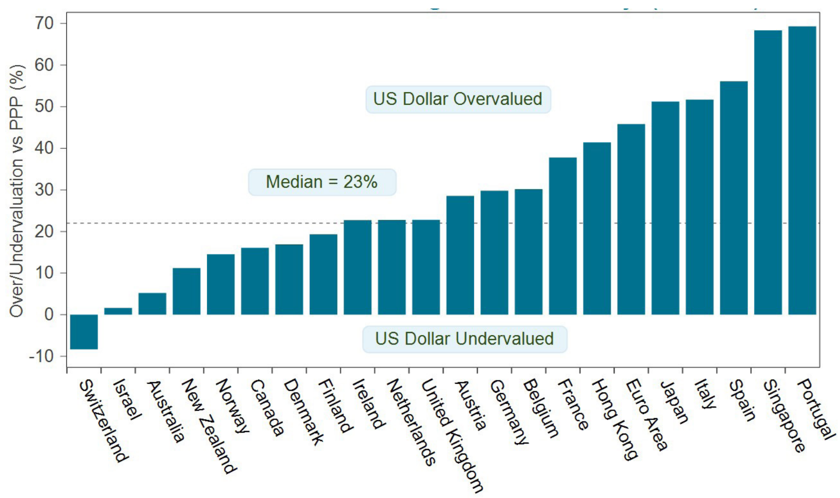
In Japan, a Big Mac is priced at ¥480, whereas in the United States it costs $5.79. This price differential implies a PPP exchange rate of 82.9 yen to the dollar, based on the equalized purchasing power of the two currencies. However, the market exchange rate in January 2025 stood at approximately 154.3 yen to the dollar, signaling a notable deviation from the theoretical law of one price.

From the point of US tourists in Japan, the yen is undervalued by about 46%, reflecting the degree to which Big Macs in Japan are a bargain to US tourists. That's because at the market exchange rate of 154.3 yen to the dollar, a Big Mac in Japan costs only $3.11 to the US tourist compared to $5.79 back in the US.

Conversely, from the point of view of Japanese tourists to the US, the dollar is 86% overvalued relative to the yen. That's because at the current exchange rate, Japanese tourists are used to paying the equivalent of $3.11 for a Big Mac back in Japan. But the $5.79 price for Big Mac in the US is 86% higher. Put differently, for the law of one price to hold, the yen would have to appreciate by 86% against the dollar.

FIGURE 5

Over/Undervaluation of USD vs MSCI World Currencies Based on IMF Purchasing Power Parity (2024E)

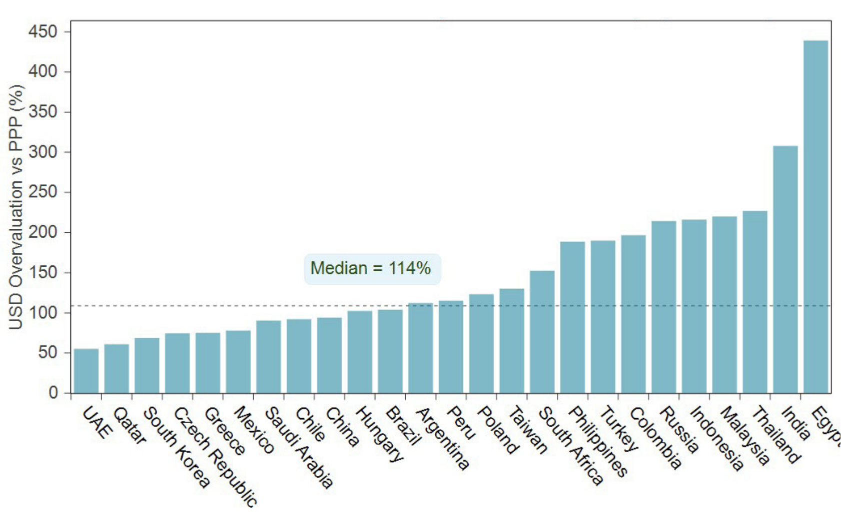


Sources: GW&K Investment Management, International Monetary Fund, and Macrobond.
Note: Based on ratio of IMF April 2025 estimates of each nation's GDP in PPP versus current dollars.

The median degree of US dollar overvaluation in 2024 against a group of key DM nations was 23%, but it was notably overvalued against important currencies like the euro (46%) and the yen (51%).

FIGURE 6

Overvaluation of USD vs MSCI EM Currencies Based on IMF Purchasing Power Parity (2024E)



Sources: GW&K Investment Management, International Monetary Fund, and Macrobond.
Note: Based on ratio of IMF April 2025 estimates of each nation's GDP in PPP versus current dollars.

The median degree of dollar overvaluation against a group of key EM nations was 114%, reflecting those nations' structural need to spur trade surpluses and build dollar reserves.

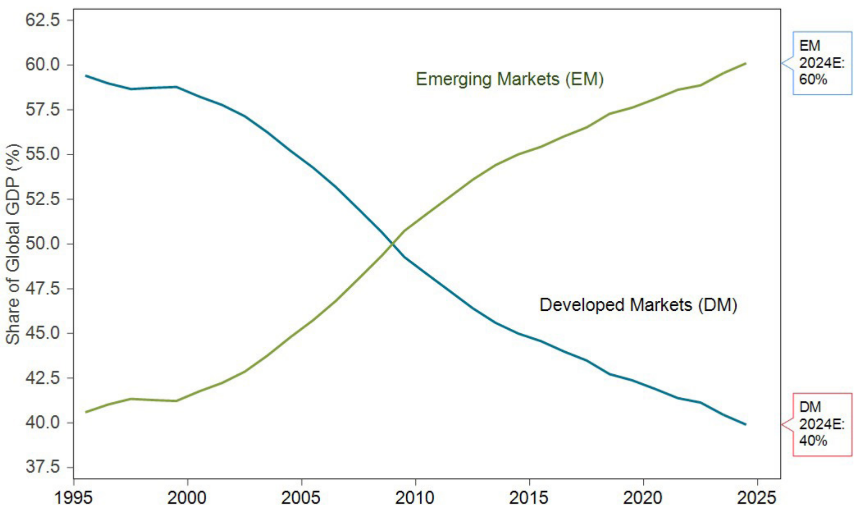
WHY THIS TIME MAY BE DIFFERENT

Several structural changes suggest the dollar's decline could be more sustained than previous corrections. The most significant involves the shifting weight of emerging markets in the global economy.

Since 1995, emerging markets' share of global GDP on a purchasing-power basis has surged from 40% to 60% **(Figure 7)**. This massive economic bloc has systematically undervalued their currencies to maintain export competitiveness and build dollar reserves. As their collective economic influence grows, the structural demand for an overvalued dollar that financed America's twin deficits becomes harder to sustain. Political pressure on emerging market nations to strengthen their currencies seems likely to intensify.

FIGURE 7

Shifting Center of Gravity: Regional Share of Global GDP, 1995–2024E



Sources: GW&K Investment Management, International Monetary Fund, and Macrobond.
Note: The lines show each region's combined share of global GDP on a purchasing power parity basis.

The rapidly growing weight of EM nations in global GDP has meant that their policies of trade promotion and currency undervaluation helped push the US dollar's overvaluation to a record level in 2024.

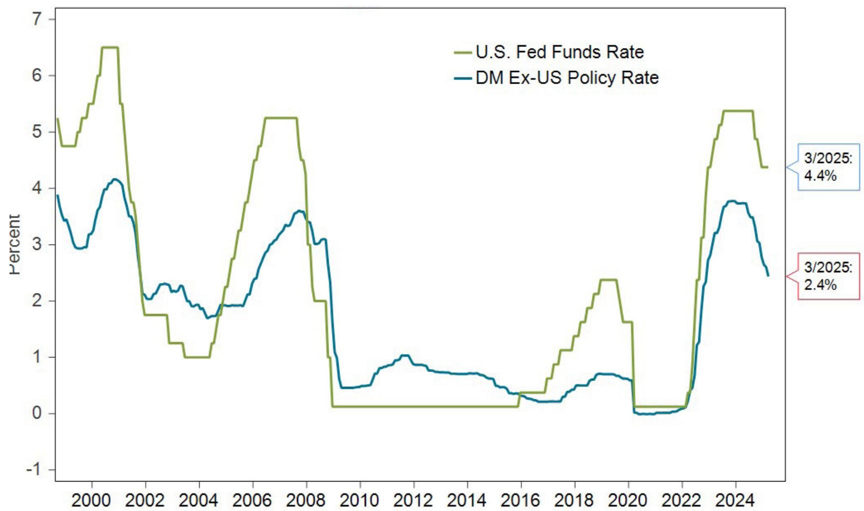
Meanwhile, the Federal Reserve's policy stance has begun to normalize after several years of aggressive tightening **(Figure 8)**. Interest rate differentials that previously attracted global capital to dollar assets have narrowed since the Fed pivoted toward easing in September 2024. This removes a key pillar supporting the dollar's recent strength.

Perhaps most importantly, America's trade policies are accelerating these trends. Tariffs and trade tensions, rather than strengthening the dollar as traditional theory might suggest, have instead undermined confidence in US economic leadership. Policy uncertainty has prompted investors to diversify away from dollar assets, while the growth-dampening effects of protectionism reduce America's economic attractiveness relative to other regions.

The dollar's traditional role as a "safe haven" during global stress is also showing cracks. Recent market turbulence saw the dollar fall alongside stocks — a rare occurrence that suggests investors are questioning America's automatic appeal during crises.

FIGURE 8

The Fed Went Bigger, Faster with Rate Hikes: But Has Been Less Aggressive So Far with Rate Cuts



Sources: Federal Reserve Bank of Dallas and Macrobond.
Note: Non-US policy rates based on 18 DM nations, aggregated at US trade weights.

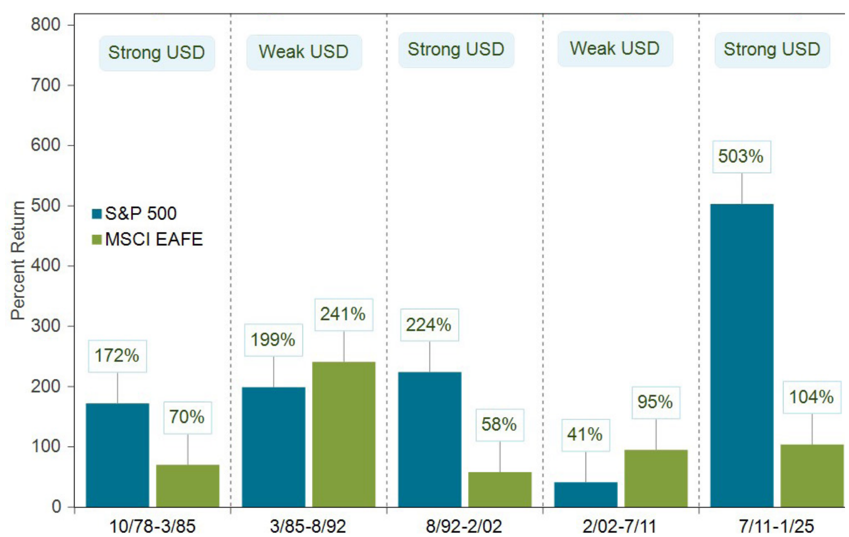
Until very recently, the dollar's strength can be largely attributed to the Fed's aggressive rate hikes and higher-for-longer stance relative to foreign central banks. But we could easily see a weaker dollar if the Fed is more aggressive with rate cuts in response to economic weakness generated by the trade war.

THE INVESTMENT PLAYBOOK

History provides a roadmap for what happens when the dollar enters sustained declines. During previous periods of significant dollar weakness — such as the 2002 – 2011 cycle when the dollar fell roughly 30% — international stocks notably outperformed their US counterparts **(Figure 9)**.

FIGURE 9

S&P 500 vs International Equity Returns During Strong vs Weak USD Cycles (1978–2025)



Sources: GW&K Investment Management, Bloomberg, MSCI, S&P Global, and Macrobond.

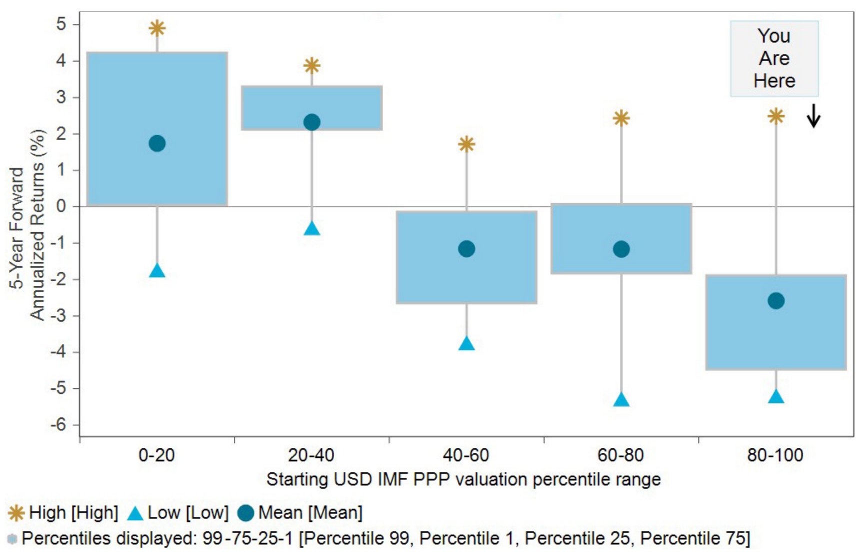
Although the S&P 500 has outperformed international equities over the past few decades, it has typically underperformed the MSCI EAFE Index during multi-year periods of US dollar weakness.

The pattern makes fundamental sense. Dollar weakness typically accompanies improving global growth and easier global financial conditions. International markets, with their heavier weightings in cyclical sectors like banks, materials, and energy, tend to benefit more than the growth-heavy US market during such periods.

When the dollar has been extremely overvalued historically, as it is now, the Fed's Trade-Weighted Index has tended to decline over the subsequent five years at an average pace of 2.6% annually **(Figure 10)**. If that pattern holds, international investors could enjoy years of currency tailwinds on top of any underlying market gains.

FIGURE 10

US Real Trade-Weighted Dollar 5-Year Future Returns From Different Starting PPP Levels (1985–2024 data)



Sources: GW&K Investment Management, IMF, Bloomberg, and Macrobond.

When the dollar has been extremely overvalued, as it is now, the Fed's Trade-Weighted Index has tended to decline over the next five years at an average pace of 2.6% per year.

Within the US market itself, dollar weakness creates clear winners and losers. Large multinational corporations — particularly in technology, industrials, and consumer goods — benefit as their overseas earnings translate into more dollars. Companies generating 50% or more of revenues abroad often see significant earnings boosts when the dollar declines.

Conversely, purely domestic companies miss out on these translation gains while potentially facing higher input costs from more expensive imports. This dynamic has already begun playing out, with internationally diversified large-cap stocks outperforming smaller, domestically focused companies as the dollar's decline accelerated through 2025.

Emerging markets represent perhaps the biggest opportunity. Many emerging economies carry substantial dollar-denominated debt, making them highly sensitive to currency movements. A weaker dollar reduces their debt service costs while making their exports more competitive globally. Combined with their already attractive valuations relative to developed markets, emerging market stocks could see sustained outperformance if dollar weakness persists.

The commodity complex also benefits from dollar decline, as most raw materials are priced in dollars globally. A weaker greenback typically translates into higher commodity prices, benefiting resource-rich countries, and materials sectors worldwide.

RISK FACTORS AND TIMELINE

Not all dollar weakness scenarios are created equal. A gradual, orderly decline driven by natural economic rebalancing represents the best-case scenario for international diversification. However, if dollar weakness stems from a sharp loss of confidence in US economic management, the resulting financial instability could overwhelm any currency benefits.

Trade policy remains a wildcard. While recent tariffs have accelerated dollar weakness by undermining confidence, a dramatic escalation could trigger broader global recession fears that might temporarily restore the dollar's safe-haven appeal. Conversely, an unexpected de-escalation could improve US growth prospects and slow the dollar's decline.

The Federal Reserve's policy path will be crucial. If inflation proves stickier than expected, forcing the Fed to maintain higher rates longer than other central banks, dollar weakness could stall. However, if global growth accelerates while US growth lags, the dollar's decline could accelerate beyond comfortable levels.

Based on historical precedents, investors should think in terms of multi-year cycles rather than quick reversals. Previous dollar peaks have led to sustained weakness lasting seven to nine years, suggesting patience will be required for international diversification strategies to fully pay off.

CONCLUSION

After more than a decade of US market dominance, the conditions are aligning for a potential changing of the guard. Extreme dollar overvaluation, shifting global economic weights, and changing policy dynamics all point toward sustained dollar weakness ahead.

For investors, this suggests the era of overwhelming US outperformance may be ending. International diversification — long dismissed as a drag on returns — could finally deliver the benefits portfolio theory promised. The great rotation may not happen overnight, but the foundations are firmly in place. Smart investors would be wise to position accordingly, before everyone else notices the tide has turned.

William P. Sterling

William P. Sterling, Ph.D.
Global Strategist

DISCLOSURES:

This represents the views and opinions of GW&K Investment Management. It does not constitute investment advice or an offer or solicitation to purchase or sell any security and is subject to change at any time due to changes in market or economic conditions. The comments should not be construed as a recommendation of individual holdings or market sectors, but as an illustration of broader themes. Data is from what we believe to be reliable sources, but it cannot be guaranteed. GW&K assumes no responsibility for the accuracy of the data provided by outside sources.

GW&K ESTABLISHED 1974 | 50 YEARS

Boston Headquarters
222 Berkeley Street
Boston, Massachusetts 02116
617.236.8900

Other Location
Winter Park, Florida

www.gwkinvest.com