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The Dollar May Be the Pressure Valve

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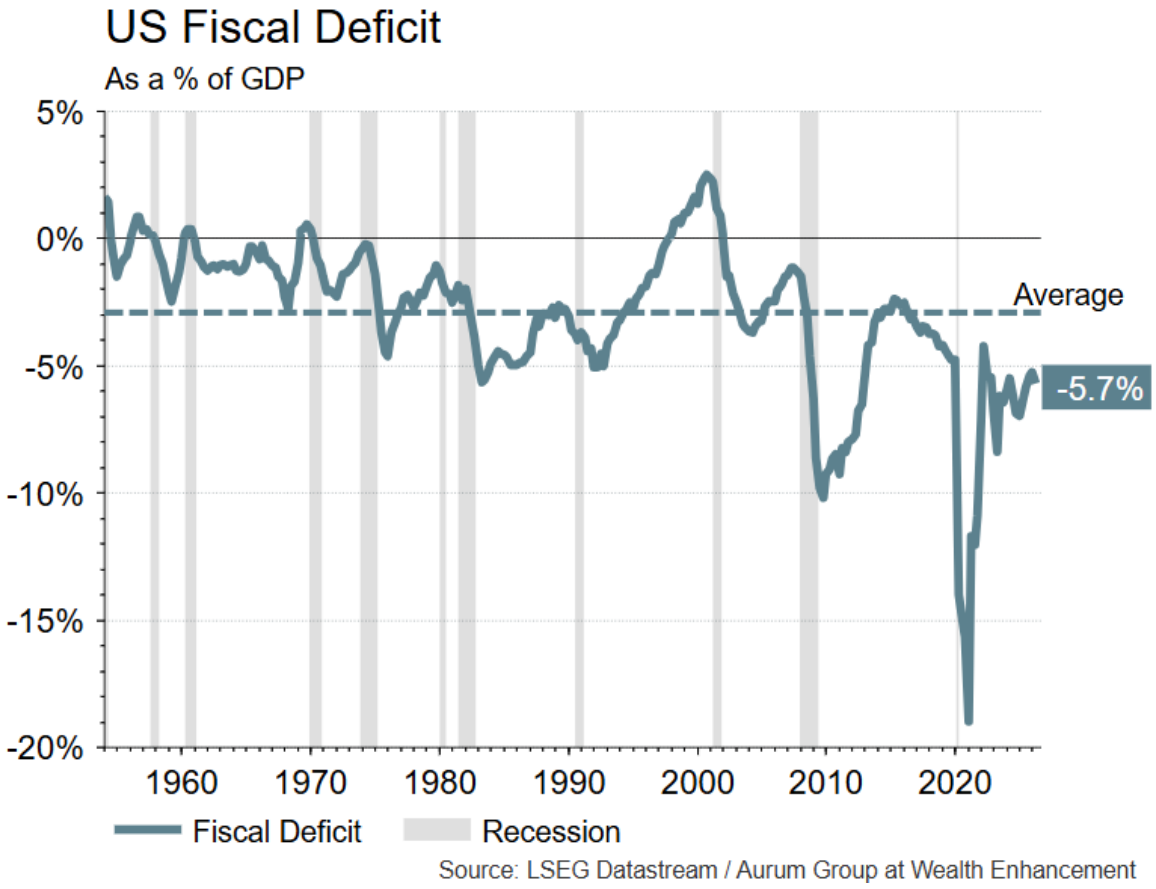
Treasury Secretary Scott Bessent made headlines last week when the Treasury announced plans to increase its purchases of longer-term government bonds. The goal is to improve trading in the bond market and ease some of the pressure pushing long-term interest rates higher. Bessent also said the Treasury has a “big toolkit” and could expand its purchases beyond the amount first announced.

The first market reaction was positive, but it did not last long. Treasury yields soon moved higher again. Investors remain concerned about large federal deficits, rising interest costs, inflation, and the growing supply of bonds needed to fund government spending. The federal budget deficit is on track to exceed $2 trillion this fiscal year, while total government debt recently passed $40 trillion.

Inflation’s Higher Resting Heart Rate

Large deficits are not new, but they have helped give inflation a higher “resting heart rate” over the past five years, as coined by a strategist from KKR. Even when inflation slows, it may settle above the very low levels investors enjoyed before the pandemic.

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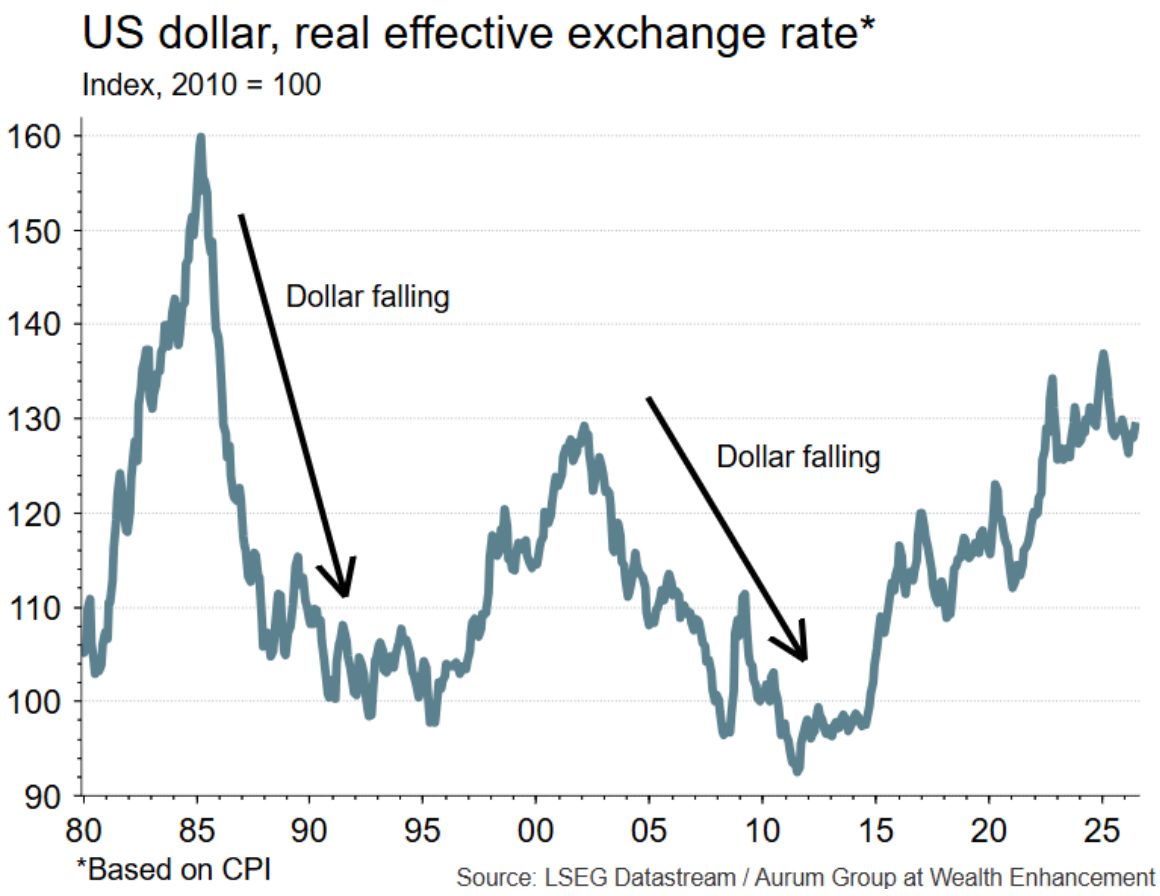


Many investors assume this must lead to much higher interest rates. That is possible, but it is not the only outcome. The Treasury can change the mix of short-term and long-term debt it issues. It can also buy back older bonds. The Federal Reserve has its own tools that can influence interest rates and financial conditions.

These actions cannot erase the cost of heavy government borrowing. They may simply move the pressure somewhere else.

One possible release valve is the U.S. dollar. If policymakers limit the rise in long-term interest rates, U.S. bonds may become less attractive to global investors. That could reduce demand for dollars and lead to a gradual decline in the dollar's value. Recent market reports suggest this concern helped lift gold and other assets following the Treasury's announcement.

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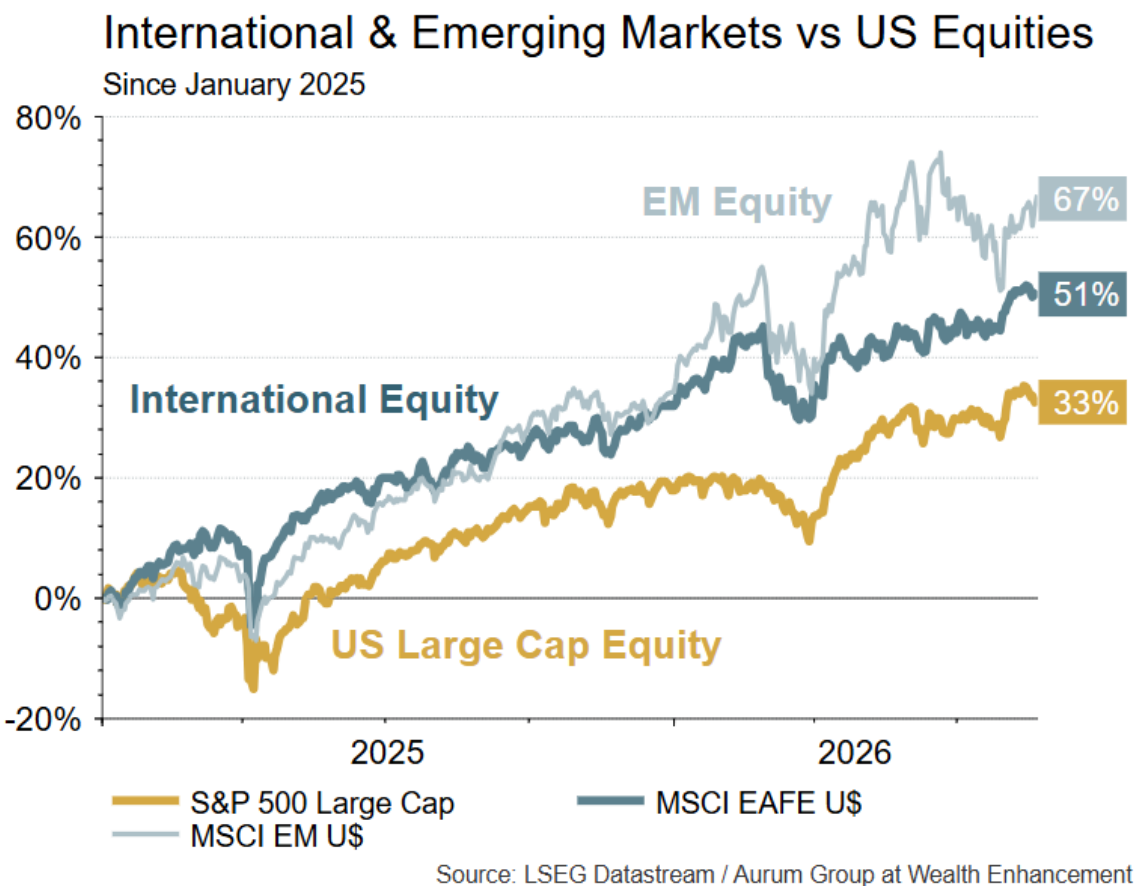
This does not mean the dollar is about to collapse. A slow decline is a more reasonable risk to consider. It could also provide some economic benefits. A cheaper dollar makes U.S. goods less expensive for overseas buyers, which may help American exporters.

What Should Investors Do?

The answer is not to make a large bet against the dollar. It is to build a portfolio that does not depend on the dollar always being strong.

International stocks are one way to do this. When a U.S. investor owns an overseas company, the investment often includes exposure to that country's currency. If the dollar falls, the value of those foreign earnings can rise when translated back into dollars. International stocks also provide access to different economies, industries, and market cycles.

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Global bonds can add another layer of diversification. However, government finances vary widely from one country to another. Some nations may have improved inflation, responsible budgets, or falling interest rates. Others may face rising debt, weak currencies, or political stress.

For that reason, we prefer flexible global bond strategies. These managers can invest more in countries with improving conditions while reducing or hedging exposure to countries facing greater risks. They can also manage currency exposure instead of simply owning every market in an index.

The goal is not to predict the dollar's next move. It is to prepare for more than one outcome. In a world of large deficits and active policy support, broad global diversification may be more valuable going forward for portfolios.

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