India

Economy

Trust Deficit: Fall of the dollar (DXY) index

- The DXY index fell sharply by 9.7% in 2025 with a rise in downside volatility, potentially signaling a structural shift in global trust in the US dollar.
- This decline is driven by policy unpredictability, threats to the Federal Reserve's independence, and rising institutional mistrust.
- While full-scale de-dollarization remains unlikely, nations are increasingly turning to gold and local currency swaps to hedge against dollar risk.

DXY index witnesses a sharp 9.7% decline

The sharp 9.7% drop in the DXY index (a measure of the value of the US dollar relative to a basket of foreign currencies) in 2025 may reflect more than just rate differentials. It appears symptomatic of a deeper global realignment — one where confidence in the US dollar as the sole anchor of the financial system is eroding. From a de-dollarization trend and shifting reserve preferences to growing geopolitical fragmentation, 2025 may be remembered as a watershed year where the world stopped taking for granted its overdependence on the US dollar – the bedrock of the global financial system for nearly eight decades.

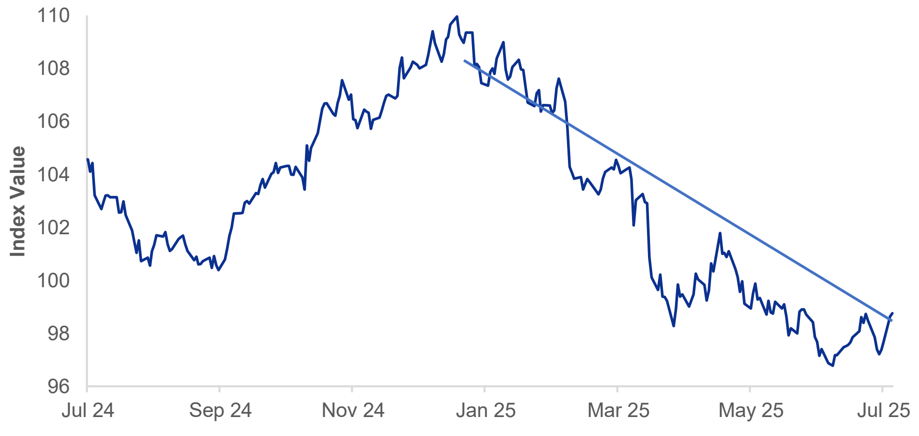
The decline is driven by lack of confidence in the greenback

The decline potentially points to larger systemic issues in the global economy, particularly overdependence on the US dollar and a structural loss of confidence in its status as the globally dominant currency. Things that have been taken for granted for decades – looking to the US during times of uncertainty, free capital flows, institutional independence and trust, and consequently, the dollar's safety, have fundamentally been challenged in 2025.

Countries are looking to increase their gold holdings

Nations are increasingly reducing their reliance on the US dollar through local currency trade, gold purchases, and digital currency experiments. While full de-dollarization remains unlikely due to the lack of alternatives and US dominance, a gradual shift—especially via gold and currency swaps—is already underway.

Figure 1: One-year closing level of DXY index



SOURCE: INCRED RESEARCH

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Five-year index movement

Over the last five years, the DXY index displayed sharp swings that reflected both cyclical macroeconomic shifts and potential structural turning points. The highest annual return occurred in 2022, with the index rising by 7.6%, coinciding with the Federal Reserve's most aggressive rate hike cycle in decades, heightened geopolitical tensions, and a global flight to safety — all of which reinforced the dollar's dominance. Meanwhile, 2021 and 2024 offered positive returns of around 6%, reflecting intermittent rebounds in the dollar, likely driven by relative US economic strength or periodic bouts of global uncertainty.

Figure 2: Five-year closing level of DXY index

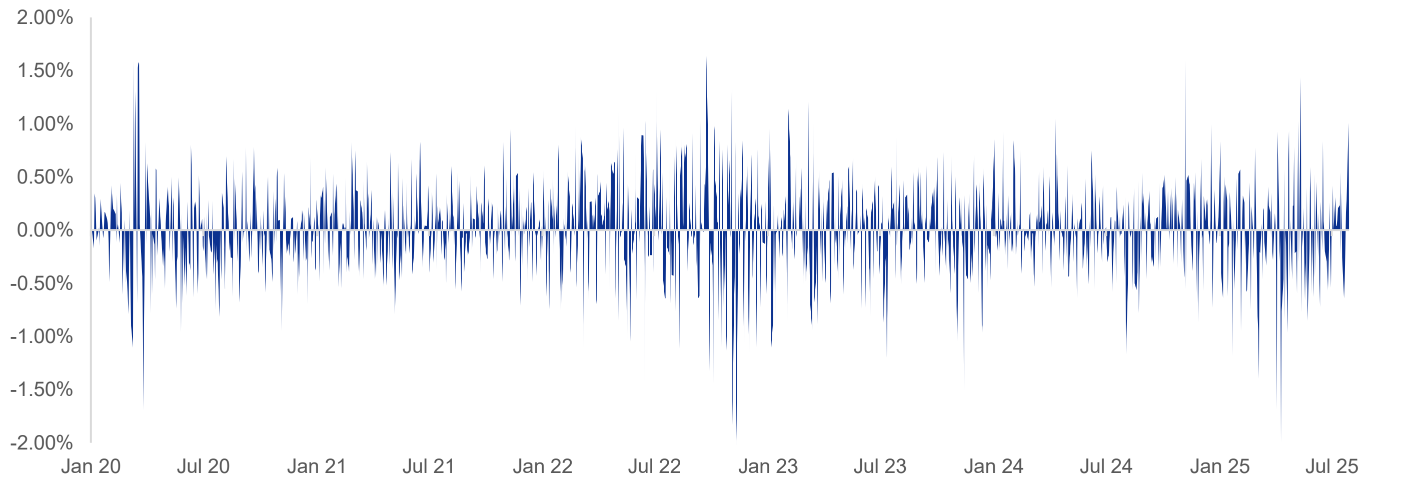
SOURCE: INCRED RESEARCH

In stark contrast, the lowest return came in 2025, with the index plunging 9.7%, marking not just one of the steepest declines in the five-year span but potentially the beginning of a secular downtrend in the dollar. This drop far exceeded previous drawdowns and came alongside a noticeable pick-up in volatility, suggesting more than just routine mean reversion. Together, these highs and lows form a pattern consistent with a currency navigating the end of a dominant cycle — from the COVID-19 pandemic era liquidity to rate-driven strength to what may now be a more fundamental reassessment of the dollar's role in the global system.

Decoding return volatility: Cyclical noise or structural changes?

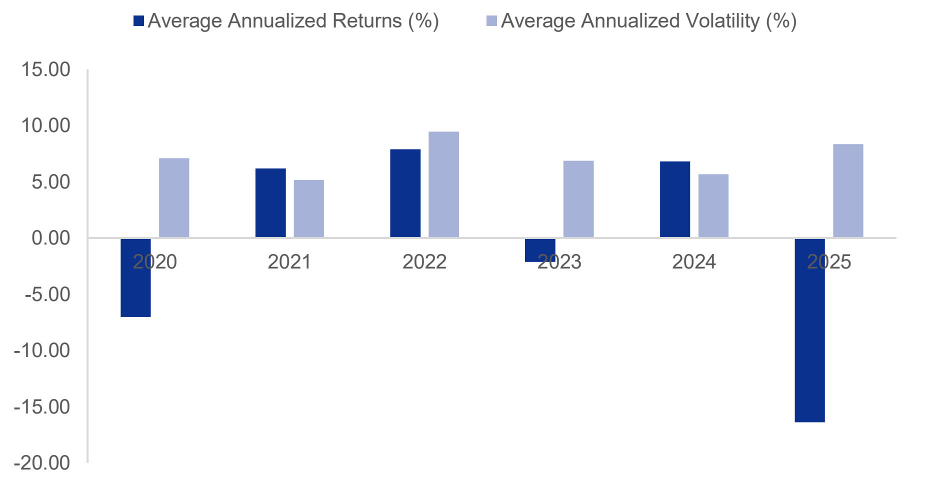
It is evident from the DXY return data that there are signs of volatility clustering. The volatility is clustered around certain time periods (2020, 2022, 2025) demonstrating a pattern of periods of high volatility followed by low volatility. The most prominent spikes occurred in 2022 and again in 2025, both years marked by not only elevated annualized volatility (9.3% and 5.9%, respectively) but also large directional moves in the DXY.

Figure 3: DXY index returns 2020-present



SOURCE: INCRED RESEARCH

Figure 4: Five-year DXY index return behaviour (%)



SOURCE: INCRED RESEARCH

The average annualized return and volatility for 2025 are based on daily return data from 1 Jan 2025 to present. The return data has been annualized from a partial-year dataset; hence, these numbers assume that the current return behaviour (daily average and standard deviation) from the first half of the year would continue for the rest of 2025. Thus, the annualized return for 2025 might be higher (or even lower) than the figure in the graph, depending on whether the index appreciates (or depreciates) in the rest of 2025.

While the volatility spike in 2022 coincided with a sharp appreciation in the DXY index—reflecting upside volatility driven by aggressive Fed tightening and global risk aversion—the situation in 2025 is different. In 2025, elevated volatility was associated with a sharp decline in the DXY index, indicating downside volatility. While volatility itself implies risk regardless of direction, a downside risk in the dollar carries deeper implications, especially given its status as the world's primary reserve and settlement currency. A disorderly or prolonged fall in the dollar not only affects global capital flows and inflation dynamics but may also signal waning confidence in the USD-centric financial system. This shift towards downside volatility should therefore be viewed not just as a market correction, but as a potential early warning of more structural dislocation in the dollar's global role.

In any case, it is reasonable to assert that the movement in the DXY index is not merely the result of random fluctuations, but rather a reflection of broader macroeconomic shifts and evolving policy dynamics. This makes it all the more critical to contextualize the index's sharp decline in the first half of 2025 within the larger global narrative.

Explaining the DXY decline

Uncertainty, uncertainty, and uncertainty

From wars spanning across continents, to tariff threats, unsustainable US debt, institutional mistrust, issues of sovereignty, and the Donald Trump administration's idiosyncrasies, there is no doubt that 2025 has been a year marred by uncertainty. It is almost as if every new policy or event throws the world into a tailspin before the markets and its participants can fully price-in the existing information.

The Trump administration's erratic policy shifts—particularly its tendency to reverse tariff decisions and use them as last-minute bargaining tools—have eroded US policy credibility. This unpredictability not only undermines trust in the administration's commitments but also casts doubt on the stability of the broader US economic framework. As a result, global investors and governments are increasingly questioning the reliability of the US as an economic anchor, leading to diminished confidence in the dollar. The politicization of key decisions, coupled with the perception of short-termism in trade and monetary matters, has weakened the dollar's long-standing status as a dependable reserve currency.

Close Call: Section 899 of the 'Big Beautiful Bill'

The US dollar's safe-haven status rests on the unrestricted flow of capital—the fundamental assumption that investors can freely move their money in and out of US markets without fear of capital controls, asset freeze, or policy unpredictability. This openness has long underpinned confidence in US financial assets and the dollar itself.

Section 899 of the 'Big Beautiful Bill,' seeks to penalize "discriminatory foreign countries" by imposing higher US taxes on certain cross-border income earned by foreign entities and individuals. This could significantly impact asset managers, including hedge funds, private equity, real estate investment trusts or REITs, and sovereign wealth funds.

By taxing capital income from certain foreign investors, Section 899 raises the cost of capital and could potentially deter foreign investment. Although Section 899 was ultimately shelved, its proposal alone has introduced significant uncertainty for global investors. The threat of punitive tax measures on foreign capital shook confidence in the US as a reliable and open investment destination, reinforcing concerns about rising policy unpredictability and weakening the perception of the dollar as a safe-haven asset.

Modest gains amidst steep losses

It has not been all losses for the dollar in 2025. During the brief Iran war, the dollar regained some of its lost value in the early days of the "12-day war." This is primarily because US debt is still considered as a safe asset, especially during times of political turmoil – a view that is increasingly contested. Further, the US is somewhat insulated to crisis in the Middle East. While most of the nations in the world, including those in Europe and Asia, would be devastated by a prolonged rise in crude oil prices, it would not be unequivocally bad news for the US – the world's largest oil producer, thanks to a rise in shale oil production.

However, even though there is considerable doubt regarding the dollar and its overdependence, there is no clear successor. This classic case of rising discontent with the regime but an absence of a strong and reliable opposition seems to be a sign of our times.

The dollar's guardian under fire

The independence of a central bank is a foundational pillar of modern economies, premised on the belief that monetary policy should be insulated from political pressures to ensure long-term economic stability and efficient capital markets. For decades, the Federal Reserve or Fed's autonomy has underpinned global trust in US financial markets and the dollar itself. However, this independence is now under severe strain, thanks to the Trump administration's intimidation and interference.

Trump has openly exerted pressure on the Fed to cut interest rates to stimulate the economy, given that inflation is now mostly under control at 2.4% in May 2025 — below forecasts and close to the Fed's 2% target. Fed Chairman Jerome Powell has resisted such moves, citing lingering uncertainty, especially the inflationary risks of Trump's tariff policies. In response, Trump has reportedly threatened to fire Powell, a move that would deeply undermine the Fed's credibility. The situation escalated when two of the seven Fed governors — who typically avoid public commentary — voiced support for rate cuts, raising the likelihood of politically-influenced monetary easing. Although Powell and another governor swiftly pushed back, the damage was done: markets are now questioning the Fed's institutional integrity.

If the world begins to see the Fed as politically compromised, the core rationale for the dollar's reserve currency status — trust in the Fed to maintain the dollar's value — is at risk. With Fed policy increasingly seen as subject to political interference, the appeal of saving in dollars diminishes, potentially accelerating capital outflows and further undermining global trust in the dollar.

Make America Great Again (MAGA)

Now that the days of steady globalization are behind us, one can safely say that countries are increasingly looking inwards. The Trump administration has been quite vocal about reindustrializing the US economy and making its manufacturing competitive at the global scale. Ironically, Trump's Council of Economic Advisers have argued that the dollar's status as the reserve currency is more a burden than a benefit. The reserve currency status increases global demand for the dollar, making US exports relatively more expensive, leading to persistent trade deficits and loss of jobs as manufacturers move production overseas.

This logic is flawed on at least three accounts. Firstly, it blatantly ignores the myriad benefits the US has experienced, thanks to the dollar being a reserve currency. It has given the US liquidity, ability to carelessly print money and raise debt, and geopolitical influence. Secondly, trade deficit is not only a function of currency power but also depends on other macroeconomic variables such as the savings/consumption rate, and inflation. Lastly, it completely disregards deliberate policy choices to make US a service-oriented economy over the last few decades.

While Trump's economic advisors have misunderstood the complex notion of causality, and overattributed the dollar's impact on trade deficits, a weakening dollar does play into Trump's fantasy of reindustrializing America – a key component of Make America Great Again (MAGA). However, there is still a catch. How do we reconcile this view with the fact that Trump is unwilling to let go of the dollar's global dominance? Trump has consistently been threatening nations, especially BRICS, with additional tariffs in case they move away from the dollar. While he wants the dollar to weaken, he still wants it to maintain its status as the globally dominant currency – an inherent contradiction.

Figure 5: Average yearly annualized returns

	Daily	Annualized	Annualized %
2020	-0.000268	-0.07	-7.01
2021	0.000239	0.06	6.18
2022	0.000305	0.08	7.89
2023	-0.000083	-0.02	-2.14
2024	0.000262	0.07	6.82
2025	-0.000631	-0.16	-16.39

SOURCE: INCRED RESEARCH

Figure 6: Annualized yearly volatility

	Daily	Annualized	Annualized %
2020	0.004382	0.07	7.09
2021	0.003200	0.05	5.15
2022	0.005881	0.09	9.47
2023	0.004265	0.07	6.85
2024	0.003521	0.06	5.68
2025	0.005169	0.08	8.33

SOURCE: INCRED RESEARCH

Figure 7: Returns during 2020-2025

	Daily	Annualized	Annualized %
Average	0.0000164	0.004	0.43
Std. Deviation	0.0044406	0.072	7.16

SOURCE: INCRED RESEARCH

Figure 8: Index value in 2020-2025

Average	**100.23**
Std. Deviation	5.66

Figure 9: Yearly index value

	Average	Volatility
2020	95.82	3.18
2021	92.50	1.93
2022	104.00	5.22
2023	103.44	1.61
2024	104.20	1.76
2025	102.41	4.12

SOURCE: INCRED RESEARCH

Figure 10: DXY index composition

DXY Movers	Name	Weight (%)
EUR	Euro	57.6
JPY	Japanese Yen	13.6
GBP	British Pound	11.9
CAD	Canadian Dollar	9.1
SEK	Swedish Krona	4.2
CHF	Swiss Franc	3.6

SOURCE: INCRED RESEARCH

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Hold	The stock's total return is expected to be between 0% and positive 10% over the next 12 months.
Reduce	The stock's total return is expected to fall below 0% or more over the next 12 months.

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Neutral	A Neutral rating means stocks in the sector have, on a market cap-weighted basis, a neutral absolute recommendation.
Underweight	An Underweight rating means stocks in the sector have, on a market cap-weighted basis, a negative absolute recommendation.

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