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Negotiating the FX fallout from US tariffs

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The USD's appreciation in the wake of the US presidential election suggests that financial markets remain highly optimistic about US GDP growth versus the rest of the world. We think Trump's policies and the attendant risks are underpriced in the USD, and its strength might be short-lived. We expect certain G10 currencies to gain against the USD while emerging market currencies in Asia are likely to weaken, albeit unevenly, with the CNY the main loser.

Since the US presidential election, financial markets have been sanguine about the policy platform of the incoming Trump administration. The S&P 500 and the USD (DXY index) are up 6.6% and 2.5%, respectively. Markets still seem to be assuming only mild economic disruption from US trade tariffs, and thus remain focused on the expectations of robust economic growth. The USD's strength in particular seems to be dependent on this optimism about US exceptionalism.

In our view, markets may be underestimating the tariff impact and we would encourage investors to avail themselves of near-term USD strength to position for a medium-term softening of the currency. Our main concern is that financial markets are too complacent about the negative impact of impending policy changes on trade and immigration on US economic growth. The IMF estimates that US trade tariffs could well shave half a percentage point off US GDP growth by 2026. Additionally, we believe that an adverse impact on the labor market from immigration restrictions would be a net negative for US economic growth as well.

Investors though need to be mindful that as the application of trade tariffs is likely not going to be homogeneous, the impact on different bilateral currency pairs could differ in both magnitude and direction. We outline below how we think the USD might move against various major and Asian currencies, and how investors might best position their portfolios.

EUR, GBP, AUD likely to benefit from DXY softness. We believe an erosion in the USD's interest rate premium will be the primary driver of USD weakness against these three DXY constituents, in addition to the CHF—for the more risk averse. A benign inflation environment in the US, alongside easing labor market conditions, should allow the Federal Reserve to cut rates by 25bps this month, followed by another 100bps in 2025. This would exceed what's currently priced in, and we recommend selling USD upside for yield pickup over the course of the next few quarters.

Gradual USDJPY downside negated by carry costs. We expect a narrowing USD interest rate premium to help the USDJPY slide to around 145 by end-2025. Fed rate cuts will likely be the main source of this narrowing, with the Bank of Japan (BoJ) chipping in with 75bps of hikes by end-2025. However, the roughly 4% per annum carry cost of shorting the USDJPY is prohibitive to selling the pair, in our view. Thus, only USDJPY upticks to 155 can be used to hedge long-USD positions. JPY-based investors though might do well to go long on the AUD or the GBP—or sell JPY-upside potential against these—to harvest yield-positive total returns over the next 12 months.

Uneven pain for Asia FX. USD-based investors with exposure to Asia ex-Japan currencies should hedge this exposure, especially because most of them have a low carry and are thus inexpensive to hedge. We see clear downside risk for the CNY as China is the main target of US trade tariffs. Export-oriented-economy currencies (KRW, TWD, SGD, THB, MYR) are expected to also come under pressure, given the uncertainty over broader trade tariffs, plus the spillover from the likely hit to China's GDP growth. For CNY-based investors, we recommend they hold unhedged USD exposure while hedging CNY long positions as we expect the USDCNY to rise steadily toward 7.5 over the next 6-12 months.

The currencies of more domestic-oriented economies (INR, IDR, PHP) should be relatively resilient amid global trade tensions. However, these economies are running current account deficits and depend on countervailing portfolio inflows to support their currencies. A hit to global risk appetite would hurt these flows and potentially lead to temporary weakness in these three currencies.

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