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Stay wary of a resurgence in tariff tensions

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The delay in tariffs on Canada and Mexico last week had seen markets unwind some of the risk aversion that had been priced in, including a reversal of USD strength. This proved shortlived though with the announcement of tariffs on steel and aluminum over the weekend. Ultimately, the Trump administration's trade agenda is still some distance from complete, and tensions will continue to ebb and flow. Investors should continue to position for a resumption of tariff action, along with a re-intensification of geopolitical risks. Aside from selling the risk of appreciation in tariff-target currencies, oil and gold remain viable portfolio buffers even in the face of a robust USD in the near term.

Following the delay in tariffs on Canada and Mexico, financial markets seemed to have breathed a sigh of relief. Also, the 10 percentage-point tariff rate hike on imports from China is lower than earlier threatened; and China's retaliation seemed aimed at avoiding an escalation. The VIX equity volatility index fell from 18.6 to a low of 15.5 before settling around 16.5; and the DXY USD index (a key beneficiary of tariffs) ended the week down around 0.8%, and down 1.7% since its mid-January peak. Should investors assume the tariff threat has peaked and hop on the risk-on bandwagon?

Notwithstanding the tepid start to the trade war, it is much too early to preclude a reescalation of trade tensions and more trade restrictions. Tariffs were touted as key pillar of President Trump's electoral platform, and he has not declared an end to the negotiations with Canada, Mexico, or China. Also, tariffs on EU exports to the US remain on the cards. Furthermore, there appears to be little reason to see the US Federal Reserve cutting rates in the near term, as the US labor market data for January has turned out to be overall better than expected, even if the nonfarm payrolls number was slightly disappointing.

We expect the US macroeconomic backdrop to be supportive of the USD remaining well-bid in the near term, before declining gradually through the year. Investors should continue to position for this, along with a potential spike in geopolitical risks. Aside from selling the risk of appreciation in tariff-target currencies, oil and gold remain viable portfolio buffers even in the face of a robust USD in the near term. These are among some key areas we think investors should focus on.

Sell appreciation risks in vulnerable currencies. With the tariff threat being concentrated on a small group of economies for the time being, it would make sense to sell the appreciation risks in those currencies to add to portfolio income. For now, Canada, China, and the EU seem to be the most likely targets. We believe the USDCAD and USDCNY might go as high as 1.46 and 7.50 over the next few months, with the EURUSD potentially going as low as 1.00 over the same period. We would therefore look at selling the downside risks in the USDCAD and USDCNY, and the upside risks in the EURUSD.

Oil price likely to remain supported. Within the energy sector, crude oil has the most negative linkage with the USD, albeit at a relatively weak -0.2 over the past 30 years. However, spikes into positive correlation territory were seen during large production disruptions in Iraq and Libya in September 2013 and the start of the war in Ukraine in 2022, on anticipation of large Russian crude supply disruptions. We continue to believe that supply and demand factors will likely be the stronger driver for the price of oil. Energy demand should remain resilient even as supply could be curtailed by the Trump administration's efforts to reduce access to Russian and Iranian supply. Despite the potential for USD strength in the near term, we expect the price of Brent crude to drift toward USD 80/bbl and we favor selling the risks of crude oil prices falling to generate income.

Hold on to gold. Gold is another asset that can be hurt by USD strength, which would make it more expensive when measured in other currencies. But its appeal as a perceived safe-haven asset has helped it start 2025 strongly. Central banks' net buying exceeded 1,000 metric tons for the third consecutive year in 2024, and investment demand hit a four-year high as inflows to ETFs returned in 2H2024. We expect central banks to remain active buyers in the year ahead (for diversification purposes), and trade-related tensions should keep investment demand strong. We thus lift our forecasts to USD 3,000/oz over the next 12 months, and believe holding around 5% within a USD balanced portfolio for diversification is optimal over the long term.

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