



A large part of recent USD strength can be attributed to better US macro data, which suggests that if new tariffs are introduced, the US dollar could appreciate further. (UBS)

2025 could be a story of two halves for the US dollar

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The USD has strengthened further in 2025, with the DXY index reaching the highest level since November 2022.

Better-than-expected US data (most recently nonfarm payrolls and the services sector purchasing managers' index) have resulted in lower expectations for the number of Federal Reserve rate cuts this year. In turn, US yields have moved higher, providing broad USD support.

With US activity likely to stay robust amid ongoing tariff worries for the rest of the world, we now expect the US dollar to stay stronger for longer and have revised our G10 FX forecasts.

US exceptionalism supports a strong dollar. US economic data are likely to stay strong in the near term, in our view. Elsewhere, economic news has been mixed, with growth prospects for Europe remaining subdued. Growth is expected to accelerate in China, with consensus forecasts of 5%/y for 4Q, but the risk of US tariffs remains a potential headwind. Where domestic uncertainty has surfaced in recent weeks, including in South Korea (political), the European Union (growth and political), and the UK (fiscal), this has been accompanied by currency weakness.

Potential monetary policy divergence could push the dollar higher in the near term. We still expect the Fed to cut rates twice this year, for a total of 50bps of easing, but don't expect these reductions until 2Q and 3Q. In contrast, we expect the European Central Bank to cut rates by 100bps in the first half of the year. Policy divergence is a powerful driver of currencies, which leads to trending FX markets and the potential for overshooting exchange rates.

Tariff risks do not appear to be fully priced in. A large part of recent USD strength can be attributed to better US macro data, which suggests that if new tariffs are introduced, the US dollar could appreciate further. The Fed's own analysis from 2018 during Trump's first term determined that it was better to look through the one-off inflationary impacts from tariffs. But given recent experience with inflation at four-decade highs, concerns over the inflationary impact of tariffs are dominating market narratives in the near term. If tariffs were to materialize, the DXY could trade in a 110-115 range, EURUSD could drop below parity, GBPUSD could slide below 1.20, and USDCHF could move toward 0.94, in our view.

But we still believe that 2025 will be a story of two halves—USD strength in 1H, and a partial or full reversal in 2H. The USD currently trading close to multi-decade highs in strongly overvalued territory and elevated investor positioning (with the CFTC futures showing the highest level of dollar net length since 2015) underpin this narrative. Our new EURUSD forecasts reflect this trajectory: We expect the currency pair to trade at 1.00 in March 2025, 1.02 in June, and 1.06 in December. In China, effective tariff rates could rise dramatically, but the CNY has only partially priced in this risk. We therefore see potential for further downside and reiterate our forecast for USDCNY to reach 7.50 by June, versus 7.33 at the time of writing.

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