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Treat the return of risk appetite with caution

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The USD's broad fall in recent weeks suggests a gradual return of risk appetite in financial markets. We worry that the market's optimism is premature and that it is being complacent about tariff risks. We believe investors should remain vigilant and continue to protect portfolios against spikes in risk aversion from multiple sources. This can be done via going long AUDSGD and silver, while selling both upside risk in EURUSD and downside risk in USDCAD.

The decline in the USD index (DXY) resumed late this week and has exceeded 3% in total since the mid-January peak. This coincides with the trajectory of the VIX equity volatility index, which peaked at 19.5 in mid-January and gradually declined to a recent low of 15.5, as the initial fear about tariff disruptions subsided. The DXY peaked just under 110 and has now declined to under 106.50, as market optimism over an end to the war in Ukraine gained traction and boosted the EUR, which accounts for over half of the DXY. How much can, or should, investors back this growing risk appetite in financial markets?

We would caution investors against letting their guard down. The spike in the VIX on Friday (21 February) to an 18.2 close on disappointing US economic data revealed some fragility in market sentiment. Financial markets might be prematurely sanguine about the potential negative impact of tariffs, as well as the likelihood of an early end to the conflict in Ukraine. Because both of these issues directly affect global flows of trade and investments, the FX space is likely to be highly sensitive to changes in sentiment and narrative. We would continue to position for spikes in uncertainty and volatility, especially in the following ways.

Go long AUDSGD and sell AUDUSD downside risks. Following the "hawkish" cut from the RBA, we expect just one more 25bps cut this year. This is more hawkish than market consensus of closer to two cuts (44 bps priced in). Aside from this, we see greater potential for upside surprises to Australia's and China's (major destination for Australian exports) GDP growth compared to market consensus. On the US side, our expectation of 50bps of cuts this year is slightly more dovish than the market consensus. We believe this confluence of factors should push the AUDUSD higher to 0.66 by year-end. Admittedly, US tariffs remain a key risk, which could temporarily push the pair under 0.60. However, we suspect that a repricing of RBA expectations should prompt some profit-taking on extended short-AUD positioning and bring AUDSGD toward our target of 0.88. We also like selling downside price risks in the AUDUSD, AUDEUR, and AUDCAD.

Sell risk of EURUSD upside and USDCAD downside. These positions would help to cushion portfolios against the risks of undue optimism over both a resolution in Ukraine and the shelving of tariffs on Canada. We worry that it might be too early to price in a turnaround in Europe, with many risks still on the horizon, notably tariffs. We thus like selling the upside in EURUSD (to 1.0595) for yield pickup over one month. In the wake of the pause in tariffs on Canada, the USDCAD has declined 2.5%, and we believe this may reflect complacence about tariff risks. Rate differentials suggest the USDCAD should be trading around 1.44 versus 1.42 currently. We therefore see value in selling USDCAD downside risk below 1.4030 over the coming month, before the looming April tariff deadline.

Sell downside risks in silver and/or go long silver medium term. Notwithstanding the recent rise in the price of silver, we remain positive on it. We previously noted that silver had lagged gold's sharp rise, and has room to catch up. We believed the gold-silver ratio above 90 was unsustainable, and it has recently been dipping to levels below 88.5; we expect the ratio could fall below 80 by the end of the year. Silver is likely to continue to enjoy robust industrial and investment demand over the rest of the year, and we see the price of silver climbing to USD 38/oz by end-2025. In the meantime, this offers room to sell the price downside risk (USD 30/oz) for yield pickup.