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Policy turmoil undermining faith in USD

05 May 2025, 07:14 am MYT, written by UBS Editorial Team

A raft of unorthodox policies and subsequent reversals have raised questions about US policymaking and by extension, the USD. The Trump administration's partial retreats from some of its more punitive positions might provide some reprieve and engender episodic relief rallies in the USD. We would use any near-term dollar strength to reduce USD allocations in favor of currencies such as the EUR, JPY, GBP, and the AUD. We also like selling the USD's upside potential for a yield pickup.

After a 10.4% fall from its mid-January peak, the USD index (DXY) seems to have found its footing. The fall had been due to a combination of tariff concerns (including the 2 April shock), worries about the erosion of US Federal Reserve independence, and talk of financial repression via the so-called "Mar-a-Lago Accord." More recently, President Trump has disavowed replacing Fed Chair Jerome Powell, and the Trump administration has paused the implementation of "reciprocal" tariffs and moderated its tone on China. The "Mar-a-Lago Accord" has also receded from the headlines.

But before breathing a sigh of relief, it is worth stepping back and noting that the DXY is still down 9.8% from the January peak and down 4.5% from 2 April. Investors should be careful that the policy uncertainty might well have undermined confidence on an enduring basis, which is likely to manifest in medium-term downside in the USD. Investors should look to take advantage of any rallies in the USD to position for a medium-term USD decline.

Possible near-term USD bounce if policy uncertainty ebbs. President Trump has recently said he has no intention to replace Fed Chair Powell before his term (as Chair) ends in May 2026, so as to install someone more sympathetic to Trump's dovish inclinations. But markets might take some time to be fully convinced given President Trump's vacillations on policy decisions. We do however believe that President Trump will ultimately exercise restraint for two key reasons: 1) Fed independence is seen as key to good policymaking and economic management, so any genuine threat to that could undermine financial stability; and 2) weakening US economic data in the coming months should give the Fed license to cut rates in line with its dual mandate. If the Trump administration manages to refrain from pressuring the Fed, the USD might stage a bit of a relief rally.

USD weakness beyond the near term. After April's policy turmoil, we believe that institutional investors (especially European ones) are over the coming months likely to increase their FX hedges on the US assets that they have accumulated over the last few years of underperformance in European risk assets. Additionally, yield differentials are likely to turn against the USD in the coming months. The acute spike in policy uncertainty is likely to leave its mark on private investment and the overall US economy. We anticipate US growth decelerating to as low as 1.5% this year, with negative quarter-over-quarter data readings later in the year. We think this leaves room for more Fed rate cuts than are currently priced in by markets. Also, this Fed easing is likely to resume just as the ECB and other central banks are about to end or be done with their own easing cycles. We also expect investor focus to shift to the US's large twin (i.e., fiscal and current account) deficits. With the US policy risk premium still likely to remain a drag on the USD, the USD should trend lower.

Use USD rallies to lighten exposure. We have lowered our USD forecasts across the board. Our EURUSD forecasts have been lifted to 1.14 in June, 1.16 in September, 1.16 in December, and 1.18 in March 2026. We now see GBPUSD at 1.38 by September 2025 and 1.39 by March 2026. Our USDJPY forecasts have been cut to 144, 142, 140, and 138. As for AUDUSD, our new June, September, December, and March 2026 forecasts stand at 0.64, 0.66, 0.68, and 0.70. In the context of these new forecasts, we would use any near-term dollar strength to reduce USD allocations in favor of currencies such as the EUR, JPY, GBP, and the AUD. For the EURUSD in particular, moves below 1.12 would constitute attractive opportunities to lighten or hedge USD exposures. We also like selling the USD's upside potential for a yield pickup.

In the near term, we expect USDCNY to stay range-bound around 7.30 amid unresolved trade tensions and domestic growth uncertainties. With the USD now weakening broadly, we think the upside potential for USDCNY has significantly diminished. Investors may consider gradually reducing hedges on CNY positions, as the environment should turn more constructive for the CNY. We have adjusted our USDCNY forecasts to 7.20, and 7.15 for December 2025 and March 2026, respectively – down from 7.30 for both.

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