# FX Daily: Dollar trapped between tariffs and first quarter slowdown

Today marks a further large step into Donald Trump's America First Agenda. Substantial tariffs are being imposed on Canada and Mexico. Additional tariffs have gone in on China. Canada and China have announced retaliatory tariffs. Surprisingly, the FX market reaction has been subdued, largely because soft US economic activity is undermining the dollar

Donald Trump has confirmed tariffs on Mexico and Canada

## USD: Tariffs are dollar positive, an equity correction is not

During President Trump's first term in office, we felt the sequencing of tax cuts (late 2017) and then tariffs (March 2018-August 2019) were key reasons for a strengthening dollar. In other words, the US economy had some fiscal support before tariff wars were waged.  What seems to be the case today is that Washington is engaging in protectionism very early in its new administration without the domestic back-up. This means that while the US is now broadening its tariff regime to Canada and Mexico, weak domestic US activity has seen the market reprice to 75bp rather than 50bp of Fed easing this year.  This is preventing the dollar from strengthening on the tariff news.

Where the dollar trades near term may be a function of what happens to US equity markets. 25%

tariffs on major trading partners may come as something of a shock and historically trade wars have been bad news for equities. It would be no surprise now for investors to adopt more defensive positioning, which would see the Japanese yen and Swiss franc continue to outperform on the crosses. Should US equities take a turn for the worse, we could then also see USD/JPY and USD/CHF turning lower in outright terms too.

The implementation of tariffs today also serves as a reminder that Washington requires tariff revenue for its fiscal agenda. That may suggest today's tariffs are slow to reverse and may well be broadened into universal tariffs in April. Expect President Trump to outline such an agenda today when he delivers a speech to a joint session of Congress at 21ET. With tariffs so central to his agenda of bringing higher-paid manufacturing jobs back to the US, this will remain a very difficult environment for currencies backed by commodity exports or with very open economies.

Ultimately, we still think the dollar will broadly strengthen in the first half of the year, but it's going to be a bumpy ride.

DXY is heavily weighted to European FX, which is being buffeted by both tariff news and plans for aggressive defence spending in Europe. It's a tough call, but the tariff story could well keep DXY support at 106.15/35 intact - unless US equities tank.

Chris Turner

## EUR: European defence spending narrative looks overblown

EUR/USD had a decent rally yesterday as investors focused on the explosive rally in European defence stocks. That Europe needs to spend a lot more on defence now is not in doubt. The question is what does it mean for FX? Can European defence spending move the needle on European growth and curtail some of the ECB easing cycle?

Our eurozone economic team doubts defence spending will have a significant impact on European growth prospects. After all, Germany has only spent around a quarter of its EUR100bn Special Defence Fund established in 2022 after the Russian invasion of Ukraine. We certainly don't want to stand in the way of the rally of European defence stocks nor the steepening in European government bond curves, but we do have our doubts about the merits of buying the euro on this narrative.

Instead, it has largely been the softening of US data and the repricing of Fed expectations that have driven EUR/USD higher. Here the Atlantic two-year spread has narrowed a staggering 35bps in less than a month, entirely driven by the re-pricing of the Fed. Whether this narrows any further may be a function of how US equities react to the tariff news.

EUR/USD is a tough call at the moment, but looming tariffs are a real threat to an open economy such as the eurozone. And if EUR/USD were to spike through resistance at 1.0535/50 for some reason, we doubt such a rally would be sustainable.

Chris Turner

## JPY: One of the few beneficiaries

The shift to defensive FX positioning is helping the Japanese yen. Equally, the threat of a global trade war and what it means for growth prospects can see global interest rates edge closer towards the low rates in Japan - also a yen positive. Looking for the yen to outperform on the crosses now will be a popular view. Pairs like EUR/JPY, AUD/JPY and CAD/JPY will be expected to trade lower as activity currencies are priced lower.

USD/JPY is a little more difficult. A decisive break under 148.50/65 may require an equity sell-off or a big downside miss to Friday's US job reports - which would see President Trump likely take more interest in a lower Fed policy rate.

Chris Turner

## SEK: The preferred channel of better European sentiment

The Swedish krona continues to markedly outperform its G10 peers, as SEK appears the preferred way to play market optimism on a Ukraine-Russia peace deal and the boost in EU spending. Crucially, SEK is a high-beta currency for eurozone sentiment, and the rally in European equities is adding fuel to the krona's rally this week.

EUR/SEK is now trading close to the key 11.00 support. In the near term, a break lower is more likely than not, especially as we expect the ECB reiterate a dovish stance on Thursday and Sweden's inflation data (also released on Thursday) are expected to show a pickup in CPIF inflation that should keep Riksbank easing expectations in check.

Beyond the short term, we are not convinced of lasting SEK strength. We expect US tariffs in April to weigh on European sentiment, and a correction in equities should hit SEK more than the euro. Incidentally, markets may be close to peak optimism on Russia-Ukraine, and a suboptimal truce for Ukraine and the EU would weigh on SEK. We continue to favour EUR/SEK staying above 11.00 this summer.

Francesco Pesole

### Author

**Chris Turner**
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

**Francesco Pesole**
FX Strategist
francesco.pesole@ing.com

**Frantisek Taborsky**
EMEA FX & FI Strategist
frantisek.taborsky@ing.com