FX Daily: Day one volatility

The dollar suffered a positioning squeeze yesterday as Trump fell short of announcing universal tariffs on day one. However, CAD and MXN are facing more downside risks as the new president said he expects to raise 25% tariffs on both countries by 1 February. Expect a lot of headline-related noise this week, with action in the crosses based on tariff threat perception

US President Donald Trump has stated his intent to raise tariffs on Canada and Mexico by 1 February

USD: Volatility here to stay

The first day of Donald Trump's presidency was a volatile one for FX markets. The dollar tumbled before the inauguration as markets got tipped off by media reports that Trump would not impose tariffs on day one. The large dollar long positioning into the event and potentially some thinner liquidity due to US holiday may have exacerbated the move.

In the slew of day-one executive orders, Trump confirmed the establishment of the External Revenue Service tasked with collecting tariff and duties. Other executive orders declared a national emergency at the border and on energy, and unwinding some of former president Joe Biden's green energy measures.

However, later in the day, Trump said he would likely impose 25% tariffs on Canada and Mexico by 1 February. That generated a rebound in the dollar – with CAD and MXN erasing daily gains. Still, DXY is trading around 0.7% off Friday's close, as markets are at least cautiously optimistic that indiscriminate universal tariffs won't be delivered all in one go. Understandably, European currencies and those exposed to China are receiving the most support.

At this point, there is more downside room for CAD and MXN to fall should Trump follow through with the tariff threat. Canada is currently led by outgoing prime minister Justin Trudeau, about to face a Liberal Party leadership contest for his replacement, and likely to face early elections. It was reported that Canadian officials had already laid out plans to retaliate against US tariffs targeting products that would asymmetrically damage US producers compared to the domestic impact on consumers.

We estimate USD/CAD is embedding just above 2% in risk premium (i.e., overvaluation). That is less than in previous weeks, signalling markets may still not fully price in the 25% tariff risk and opening up more upside potential for the pair. Canada will also release CPI data today, but that will likely have limited impact on the currency. We expect a USD/CAD rally north of the 1.45 area for now.

Despite yesterday's positioning readjustments, dollar net longs likely remain stretched. For reference, we calculate that CFTC net dollar positioning versus reported G10 currencies (i.e., G9 excluding SEK and NOK) was at +24% a week ago, the highest since June 2019 (when Trump was in office). With that in mind, European currencies and China proxies (AUD and NZD) can hang on to gains for a little longer.

Data will play a secondary role this week as all the attention will be on Trump's first executive orders. Incidentally, the Federal Reserve is in the quiet period ahead of next Wednesday's meeting. Expect a lot of "headline trading" and short-term noise, with risks still skewed for a stronger dollar.

Francesco Pesole

EUR: Short-term upside room in the crosses

EUR/USD remains cheap and oversold despite yesterday's rebound. We estimate that the pair is still trading around 1.5% below its short-term fair value, signalling some tariff related risk remains in the price.

The euro could fare well in the crosses if more days pass without Europe being explicitly mentioned in Trump's tariff comments. That support may, however, prove rather short-lived as things can – as we learned yesterday with Canada and Mexico – change abruptly on protectionism, and the euro remains generally unappealing from a number of macro fundamentals. This means any rebound may well fall short of 1.050 in EUR/USD.

On the data side, today's ZEW surveys out of Germany will tell us whether there is any glimmer of hope in the otherwise gloomy activity picture. Expectations are for broadly unchanged reads since December, which would confirm the recessionary mood.

Francesco Pesole

GBP: Uneventful jobs data release

EUR/GBP was unfazed this morning by the release of UK labour figures. Wage growth excluding bonuses was slightly higher than expected. However, the month-on-month increase in private sector pay, which the Bank of England (BoE) closely monitors, was more subdued.

This figure has been fluctuating and follows a stronger reading previously. Unemployment figures have been rather unreliable, but there are still broad indications that the jobs market is cooling enough to reduce wage growth over the year ahead. The BoE's recent CFO survey shows expected wage growth dropping below 4% in recent months. This doesn't significantly alter the BoE's outlook, with a February rate cut still our base case.

EUR/GBP is looking at some upside risks in the short term as markets can still price in more Bank of England easing and continue to embed idiosyncratic GBP risks related to higher borrowing rates. At the same time, as discussed above, the euro could see some tentative relief on Trump not targeting the EU with tariffs for now.

Francesco Pesole

CEE: Outperforming EM space

Similarly to yesterday, the calendar in the CEE region is empty today and we will see more in the second half of the week. Only political speakers are scheduled in Hungary today, which usually triggers market headlines. CEE currencies rallied yesterday, similarly to the EM space, following the US tariff headlines. While some gains were erased, CEE currencies outperformed the EM space by the end of the day.

As we discussed yesterday, EUR/PLN moved down the trading range to 4.250-270 and it looks like we will test the lower bound in the coming days thanks to the hawkish National Bank of Poland support. EUR/HUF also briefly touched 410, this year's lows, allowing HUF assets to show some rally as well.

In the medium-term we expect EUR/HUF to head towards 420, but in the short-term we believe the pair can stabilise around 412. EUR/CZK also briefly headed lower but saw the biggest pull back within CEE yesterday, and we believe it will stay closer to 25.300 until the Czech National Bank shows more dovish headlines ahead of its February meeting, which could be as early as the end of this week.

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