FX Daily: Lessons from a very short trade war

Markets are readjusting after Trump's last-minute deals with Mexico and Canada which delayed tariffs by a month. From now on, markets may well handle tariff threats even more cautiously, but a new layer of unpredictability argues against big dollar depreciation for now. Meanwhile, sterling is enjoying a rare haven status

USD: Rethinking FX reaction functions after the trade drama

To sum up yesterday's events, the US struck a deal with Mexico first and Canada and all parties agreed to delay tariffs by at least a month. Trump managed to obtain greater commitment to border security from both countries, although there seemed to be limited discussion on trade.

In a matter of hours, markets shifted from scrambling to assess the consequences of Trump's huge protectionist move to aggressively buying the dips in previously affected currencies. USD/CAD and USD/MXN are both trading below their Friday's close. Last week, as the US ramped up its tariff threat, we argued that Trump's handling of this tranche of protectionism would set a precedent that markets will use as a benchmark moving forward. If markets were reluctant to fully price in the impact of tariffs until the very last minute, yesterday's turnaround by Trump may well warrant even greater caution when it comes to future protectionism threats.

One of the basic assumptions behind the reluctance to fully price in tariffs was that there would need to be a clear economic advantage to ultimately justify such measures. In the case of Canada and Mexico, where mostly border security was mentioned as a motive for protectionism, that motive seemed to be lacking – hence the surprise at Trump's tariff announcement over the weekend. The question of whether Trump had planned an eleventh-hour deal with the two countries or was perhaps encouraged by some domestic backlash remains an open question. Either way, markets need to follow a rationale, and we think the conclusion is that Trump is ready to bluff his way into transactional victories, whether on border security or trade.

For FX, this means the dollar may not experience big rallies against directly and indirectly impacted currencies simply on the back of a tariff announcement, but only after duties effectively come to place and there are indications that they will stay. Let's look at AUD, NZD and the China tariffs for instance. US tariffs on China are due to come into effect today, and Beijing has already announced a retaliatory 10-15% duties on US energy exports and farm equipment, coming into effect on 10 February. A cross like AUD/CAD should trade sharply lower in this situation given Canada has dodged tariffs and China has not, but it is only 0.5% lower on the day. That signals markets are pricing in a good chance that the US and China will also strike a deal and delay tariffs.

The final point to make is that markets are not fully pricing out the tariff threat just yet. That's because tariffs have been only delayed by a month, and secondly because the rollercoaster of trade news in the past few days does leave markets with a higher degree of uncertainty and unpredictability that harms high-beta currencies both due to direct protectionism exposures and due to risk sentiment implications.

We can reasonably expect another correction in the dollar across the board if the US and China move towards a de-escalation in the coming days. But now that Trump has more concretely introduced the tariff threat into daily market news, the case for a structural flow against the dollar appears weak, and we would still expect support to DXY around 108.0. Today, the highlight in the US calendar will be December JOLTS jobs figures, although readjustments after the tariff scare should still dominate.

Francesco Pesole

EUR: Don't get too excited

Amid the US-Canada-Mexico tariff saga – which was the main driver of EUR/USD yesterday – eurozone flash CPI estimates for January came in slightly hotter than expected. The core measure was unchanged at 2.7% (expected 2.6%) for a fifth consecutive month and the headline inched higher for the fourth month in a row, again challenging the ECB's rather optimistic stance on disinflation.

As our economics team discusses here, this means that upside risks remain significant to inflation, but we are still confident that the trajectory remains deflationary for the remainder of the year. We still expect rates to be cut at least to 2.0% in the eurozone.

Looking at the implications of Trump's handling of the Mexico and Canada tariff threat, sentiment in the eurozone has improved on the back of expectations that a deal can be struck and protectionism averted. Still, extra caution is warranted in this sense. If part of Trump's motive to delay tariffs on US neighbours was domestic backlash for potential immediate economic pain for US consumers, that is not necessarily true for EU tariffs. On those, Trump can afford to play the longer game, and perhaps keep them in place for a prolonged period, making the EU feel some “pain” before striking a deal. Crucially, the motives for tariffs on the EU would not be border-related, where a deal is arguably quicker to achieve as we saw yesterday, but on trade imbalances, which often require longer negotiations.

With all this in mind, we are somewhat sceptical that the euro is bound for a major rally. Trump has already hinted the EU is next on the tariff list, and markets may probably find better value in buying the dips in currencies that have passed the protectionism peak against the euro, which is still to face the worst of it. We would expect a US-China trade deal to take EUR/USD close to 1.040, but the rally may lose steam around those levels.

Francesco Pesole

GBP: The big winner in the tariff saga

The pound emerged as a safe haven among pro-cyclical currencies yesterday, and seems to be retaining some solid footing after an American trade war was averted. The reason is simple: the UK does not have much to lose from US tariffs. UK exports to the US are less than 2% of GDP and those to China less than 1%. Incidentally, Trump seems in no rush to hit the UK with tariffs, also considering its goods trade balance with the US is arguably negligible. Trump also seemed to be on rather amicable terms with UK Prime Minister Keir Starmer after a recent call.

Another factor contributing to sterling strength was Starmer’s trip to Brussels. That was officially aimed at strengthening an EU-UK defence path, but on which markets may be double reading an intent by Starmer to gradually reconnect with the EU politically. That is inarguably positive for sterling, which remains highly sensitive to any development that can improve a worsening growth outlook.

There are however some downside risks for the pound this week, as we expect headlines today confirming the fiscal headroom for the UK Chancellor has evaporated due to higher borrowing costs, and on Thursday the Bank of England may deliver a dovish rate cut. Still, EUR/GBP may not return to the 0.8450 January peak soon.

Francesco Pesole

CEE: Safe haven within the EM market

Today's calendar is empty in the region however the global story provides plenty of impetus. After yesterday's inflation in Turkey, which surprised to the upside, and mixed PMI numbers the next events are the NBP and CNB meetings on Wednesday and Thursday. In the markets, yesterday's US tariffs triggered a sell-off in CEE currencies as in the rest of the EM space but CEE is showing some resilience to this type of headlines. At the same time, we saw a big pullback after the headlines from Mexico and especially the rates erased all losses and were actually stronger at the end of the day.

However, we see the CZK and HUF being exposed to this environment and a stronger US dollar will keep this part of the region under pressure. The CNB rate cut on Thursday and higher inflation in Hungary next week are FX negative on the local side in our view, which will make these currencies vulnerable. On the other hand, a hawkish NBP should keep PLN supported. The rate differential saw the biggest spike yesterday in Poland among CEE peers and Thursday's press conference is just another reason why the fade of yesterday's PLN weakness makes sense for us despite the current strong PLN levels.

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