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FX Daily: Tariffs bring back full defensive mode

In response to criticism of tariff 'confusion', President Trump stepped in emphatically yesterday to announce that tariffs would be going ahead on Canada, Mexico and China next Tuesday. That's the day when he delivers a speech to a joint session of Congress. There is still time for deals to be struck, but FX markets have fully switched to defensive mode

President Trump and UK Prime Minister Keir Starmer met in the Oval Office on Thursday

USD: Dominant tariff factor buoys the dollar

Just as we were discussing the diminishing impact of tariff rhetoric on FX markets, President Trump yesterday emphatically delivered 4 March as the date on which tariffs would go into effect. Financial markets have responded. The dollar is firmer against most currencies, equity markets are down - and down quite sharply at 3% in Japan and Korea - and bond markets have seen a little bull flattening consistent on the back of lower growth expectations.

Of course we have been here before and there are still four days for deals to be cut. Turning first to Canada and Mexico, it seems Mexico is most likely to cut a deal given that it's probably got the most to lose. The Mexican peso is actually holding in quite well - presumably on the view that a deal would be cut. The chances of a deal with Canada might be lower in that the beleaguered Liberal party is performing well as it stands up to the US. And Canada might be more resistant to being bounced out of other trade agreements, such as the CPTPP. This is an agreement with several partners in Asia, including Vietnam and may well be seen by the US as a back-door route for Chinese products to enter the US. We continue to see downside risks to the Canadian dollar (see below), with USD/CAD potentially trading at 1.48 should tariffs be implemented.

Turning to China, the extra 10% tariff next Tuesday is an aggressive surprise and follows a 10% across-the-board increase in tariffs on 4 February. If it goes through, the new tariff regime could potentially be worse than anything seen under Trump 1.0. There is clearly a powerplay at work here, where President Trump speaks to a joint session of Congress on Tuesday, the day before Chinese Premier Li delivers the Government Work Report at the Two Sessions gathering. These tariffs look more ideological than transactional and could potentially trigger a sharper response from Beijing. It is not our baseline view, but speculation may resurface that China will allow a weaker currency after all. Expect more attention on USD/CNH now and we have seen the three-month risk reversal - the price of a USD/CNH call option over an equivalent USD/CNH put option - rise back towards early February highs. The threat of a weaker renminbi can keep the majority of the EMFX complex on the backfoot.

And away from trade, we are keeping one eye on the sharp fall in crypto this week. The MVDA index, a basket of the 100 largest digital assets, has fallen 20% this week. Given the prevalence of crypto across US households, any further sharp fall and the threat of broader asset market deleveraging strongly favours defensive positioning in FX. Therefore it is no surprise to see the Japanese yen and Swiss franc performing strongly on the crosses. A cross rate like CAD/JPY could trade to 100 should tariffs go through against Canada this week.

Today's US data may take a back seat to the tariff story. A soft January real spending figure and a downside surprise to the core PCE deflator (expected at 0.3% month-on-month could prove a mild dollar negative - within the over-riding bullish dollar narrative of trade wars. And we also see the January advanced trade release today. Another monthly deficit around $110-120bn should be a reminder that Trump means business as he seeks to correct the goods deficit which last year stood at a staggering $1.2tr.

Given DXY is heavily weighted towards European currencies, look for a move up to 108 today. However, the yen should outperform on the crosses.

Chris Turner

EUR: Tariff threat dominates

The emphatic nature of the tariff threat has proved a wake-up call for EUR/USD and traded volatility prices have jumped. We were never in the camp arguing that a global trade war had been fully factored into global FX markets and retain a view that EUR/USD can move to the 1.00/1.02 area in the second quarter as tariffs come in more broadly and the ECB cuts the deposit rate to 1.75%.

We have been here before though. And any news of Canada and Mexico cutting a deal with Washington could see yesterday's EUR/USD losses turning around. But for the time being, the threat of tariffs and their impact on global growth is euro negative. And we expect investors to be adopting more defensive positions into next Tuesday's event risk.

Back to today and the eurozone calendar focus is on German CPI, some final GDP readings and an ECB survey of inflation expectations. We see a short term window for EUR/USD to move lower and think that 1.0400/0420 intra-day resistance can hold and a move below 1.0370 opens up 1.0330 and potentially even 1.0280 ahead of next Tuesday.

Chris Turner

GBP: PM Starmer performs well in Washington

The continued measure of UK PM Keir Starmer's relatively warm relationship with Donald Trump can be marked by the fact that when tariff noise picks up, EUR/GBP trades lower. Whether the UK and the US can secure a new trade deal remains to be seen, but certainly the UK is less exposed to tariffs than its European counterparts. It is hard to argue against EUR/GBP testing major lows at 0.8225 next week.

We are bearish on GBP/USD, however. And later in March, the refocus on the domestic UK story - and probable government spending cuts - could send GBP/USD all the way back to 1.22/23.

Chris Turner

CAD: Starting to take the tariff threat more seriously

USD/CAD rallied yesterday as Trump outlined a tariff schedule that explicitly includes duties on Canada and Mexico from 4 March. The pair is currently embedding around 2% of risk premium, according to our short-term fair value model. That is above the 1.5 standard deviation, but still well below the nearly 4% peak risk premium that was embedded in USD/CAD on 3 February.

Back then, we published this note to discuss our view on CAD under the assumption that 25% tariffs would go ahead. Most of those considerations stand, and depending on how long tariffs remain in place, a move to 1.50 is a definite possibility. The difference this time is that markets are treating Trump's tariff threat with more scepticism, refusing to price in the full tariff effect and partly betting on another last minute deal.

We still see upside risks to USD/CAD today unless there are any reports of a de-escalation. We see 1.45 as the level that would mark a shift to markets pricing in the tariff risk as a base case. If duties are levied on Tuesday, then we'll look at 1.480 as the key resistance to be tested.

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