FX Daily: Tariffs - ready, fire, aim

The Trump administration has surprised FX markets by imposing large tariffs earlier than expected. The dollar has strengthened sharply on the back of lower global growth expectations and potentially less room for the Fed to cut rates. Expect heightened volatility and more headline-driven moves as investors await the next update from Washington

Unless Trump surprises with a very last minute de-escalation in tariffs, expect DXY to stay bid near this year's high

USD: Trump delivers

Saturday's announcement that Washington would go into full tariff mode against Mexico and Canada starting tomorrow has come as a surprise to FX markets. As recently as Friday afternoon, reports were circulating that tariffs would come into effect on 1 March – seemingly providing a month for Canada and Mexico to negotiate away the tariff threat. Instead, it looks like the 'maximum pressure' negotiating position of this new Trump administration is to tariff first, perhaps in an effort to get the best deal as quickly as possible. The trouble for investors, however, is that the off-ramp to these tariffs remains unclear. There have been remarks from President Donald Trump to the effect that there's 'nothing they can do' to avoid these tariffs. This points to a more substantial, permanent shift to a high tariff-low tax US economy and perhaps is consistent with the major report being asked of the US Commerce Department as to why the US runs large, perennial trade deficits. This report is due in April and could lead to universal tariffs.

The FX market reaction has unsurprisingly been a defensive rally in the dollar. The DXY gapped higher by a percent. The currencies most heavily hit were understandably the commodity currencies - those currencies that benefit from global growth. In fact, the New Zealand and Australian dollars have been hit harder than the Canadian dollar. Outperforming are the defensive Japanese yen and Swiss franc. This is also driven by the 2% fall in S&P futures - under pressure on the prospect that US supply chains will break and corporate profitability will be hit. Notably as well, we have seen a flattening in the US yield curve. Investors have taken 8bp out of this year's Federal Reserve easing cycle on the view that tariffs are inflationary. And 10-year yields are lower on the increased risks of recession. Again, this flatter US yield curve is dollar positive and negative for growth-sensitive currencies. For reference, this Bank of Canada analysis is well worth a read for what 25% tariffs mean for Canada's growth and inflation profile.

Where to from here? Investors will be on tenterhooks to see whether any phone conversation today between President Trump and his counterparts in Canada and Mexico can yield any results in 24 hours. Probably not is most people's guess. The FX market will then be looking at the fallout on equity markets. For example, do US equities fall enough to re-price a more dovish Fed easing cycle? If that is the case, then the Japanese yen does not only outperform on the crosses, but against the dollar too. But this is a negative environment for all the growth-sensitive and commodity-backed currencies and we would not stand in the way of a further fall here. When it comes to equity markets, there is going to be a lot of attention on the US automakers today.

Macro may take a back seat this week. However, there is the January ISM manufacturing confidence today and the highlight will be Friday's January jobs data. This jobs data will be complicated by the annual benchmark revisions, which could knock a third off of prior job creation figures and prove a downside risk to the dollar.

Unless Donald Trump surprises with a very last-minute de-escalation in tariffs (unlikely) expect DXY to stay bid near this year's high. Friday's benchmark revisions will probably be the best chance of DXY filling the overnight gap left down to 108.56.

Chris Turner

EUR: A clean negative

The growing prospect of a global trade war and tariffs heading towards the EU is a clean euro negative. Those important two-year EUR:USD rate differentials have widened around 20bp over the last couple of sessions as investors price less easing from the Fed and more easing from the European Central Bank. This plus the increased risk premium for a global trade war saw EUR/USD touch a new cycle low of 1.0140 in early Asia. There is now an upside gap to 1.0350, but that only gets filled if there is some rapprochement in North America today or equities fall hard enough to prompt some wide-scale deleveraging of positions to a market very long the dollar already.

Presumably tough talk from Europe that it will not be pushed around will be seen as a euro negative. And as above, the threat of a major report in April to justify US universal tariffs will see investors retain a sell-rally mindset in EUR/USD.

Chris Turner

GBP: Briefly out of the line of fire

Sterling has been one of the least badly hit G10 currencies, arguably because the UK runs a trade deficit with the US and goods exports to GDP are relatively small. That is why EUR/GBP is under pressure today. However, we see Thursday's Bank of England rate meeting as a possible negative event risk for sterling. Given the broadly positive dollar environment, however, this looks more like a story for GBP/USD than EUR/GBP. A bias towards 1.2200 and possibly 1.2100 for GBP/USD looks likely this week, depending on the US trade story.

Chris Turner

CEE: Same region different monetary policy

This week, the focus shifts again to the local story in the region and central banks. This morning we saw January inflation in Turkey, which fell from 44.4% to 42.1% year-on-year. Thanks to the January repricing, the month-on-month rate jumped from 1.0% to 4.3% under pressure from new-year wage adjustments and seasonality linked to high renewal rates of rental contracts. Later today we will also see PMI data across the region, which could show some small improvement in sentiment for January. Retail sales in the Czech Republic will be released on Wednesday and the National Bank of Poland is very likely to leave rates unchanged at 5.75% the same day. The main focus as always will be the governor's press conference on Thursday, which should again show a hawkish tone.

However, the Czech Republic will get more attention on Thursday. Industrial and January inflation numbers will be released in the morning. For the first time, we will see a flash estimate, which is new in the Czech Republic this year. We estimate a drop from 3.0% to 2.5%, one-tenth below market expectations. Later in the day the Czech National Bank will decide on rates, for the first time this year, and present a new forecast. We expect a resumption of the cutting cycle after the December pause, with a 25bp cut to 3.75%. The forecast in general should show a dovish picture with weaker inflation, GDP and stronger FX compared to November. Given that the rate cut was well-telegraphed, the main question is what the central bank's next steps will be this year.

CEE FX on Friday saw its first sell-off after several strong days. However, the market corrected quickly showing CEE resistance to the global environment. Still, it tells us something about the next move. As we discussed here earlier, PLN and CZK in particular are showing stronger readings than indicated by rates and Friday's move confirms this. Therefore, we continue to retain this negative bias. We will be watching mainly the CZK this week which should come under pressure after the CNB rate cut on Thursday and market expectations of further monetary easing. We therefore see 25.350-400 EUR/CZK at the end of the week or higher should the market overreact to the CNB rate cut.

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