FX: Learning to live with volatility

It has been a rollercoaster start to the year in FX markets as investors have struggled to build baseline views for Trump's tariff plans. Currently, the dollar is under a little pressure on the view that tariffs could be more transactional than ideological and that some of the worst-case outcomes may not materialise after all

Trump's tariff threats are the big story for FX markets this year

Tariffs are the big story for FX markets this year. They can demand a risk premium of 4-5% in currencies on the receiving end of those tariff threats – an amount that can dwarf the impact of adjustments in interest rate differentials. This latter theme had dominated FX markets up until October last year.

As above, the return of the tariff threat into the second quarter should give the dollar another boost across the board. Having previously assumed in our EUR/USD profile that maximum tariff pressure would be something for the end of 2025, bringing that peak pressure forward a couple of quarters means we now see EUR/USD trading down to parity earlier.

We see no reason for a quick bounceback in EUR/USD over the summer. But EUR/USD is already around 5% undervalued on some of our medium-term models and any dip below parity is unlikely to be sustained this year.

We are also seeing a clear rise in realised volatility and that may well be the trend for the first half of this year. Trump has a strategy of keeping his opponents guessing, and given FX is one of the most efficient markets in the world, frequent changes in tariff assumptions are leading to unsettled conditions.

However, the Trump 1.0 tariff experience from March 2018 to August 2019 showed that FX markets did learn to live with this new environment. Realised volatility fell through 2019 even as tariffs continued to be raised. This could potentially mean more settled conditions later this year – barring any geopolitical shock.

The Fed's real, broad trade-weighted dollar

Source: US Federal Reserve

The one slight concern we have to an otherwise conviction call that the dollar stays strong is that US corporate earnings start to suffer on FX headwinds and Washington tries to take action.

Yet wanting a weaker dollar is inconsistent with the administration's trade, immigration and tax policies. And occasional social media complaints over a strong dollar – or more likely complaints against undervalued currencies of trading partners – only look likely to add to volatility rather than turning the strong dollar trend.

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