FX: Why we remain bullish on the dollar

The dollar has come under some pressure on the back of the rerating of the US growth outlook and expectations that the Russia-Ukraine conflict is nearing an end. However, we expect US tariffs to regain centrality and drive the dollar sustainably higher

Large post-US election dollar long positions were trimmed in February as markets reassessed some of the key drivers of the USD bullish trend. In this note, we discuss those drivers and why we remain bullish on the dollar.

Firstly, US tariffs. Markets have adapted to President Trump's unpredictable communication style and are treating tariff threats with a greater dose of scepticism. However, our baseline view remains that the US will go ahead with tariffs on the European Union and Asia. That could be part of a Treasury-led, longer-lasting policy measure – as opposed to the erratic, border-focus approach seen in the US-Mexico-Canada trade incident. We expect a peak protectionism risk premium in FX in the second quarter, which implies a stronger dollar and a weakening of developed European and emerging Asia currencies.

The second factor that contributed to recent dollar weakness has been souring sentiment on US activity. The consumer story has softened, but we doubt there will be enough deterioration in hard data to bring the Federal Reserve closer to a rate cut, which we currently expect only in September. As long as markets are comfortable with no more than two cuts (our call) in 2025, the pass-through to a weaker dollar will be limited, and a gradual worsening of US activity and employment should not really hinder a tariff-led dollar rally.

Finally, geopolitics. The FX market is broadly pricing in a Russia-Ukraine peace deal in the near term, and the residual downside risk for the dollar from that should not be big. Ultimately, a clear shift towards a more confrontational US-EU relationship could be the longer-term takeaway, and EU defence spending shouldn't be enough to revive the bloc's stagnant economy.

We continue to expect downside potential extending to parity for EUR/USD. Our year-end target is 1.02, but we acknowledge there are some upside risks should the tariff story or US exceptionalism deflate sooner. The European Central Bank will likely continue to cut rates to at least 2.0%, and remain a net negative for the euro.

In the rest of G10, sterling is facing substantial downside risks from fiscal turbulence and potentially larger Bank of England cuts, and we see GBP/USD heading towards the low 1.20s. Commodity currencies should suffer from revamped tariff risk, while the yen can resist a dollar reappreciation better than others.

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