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FX Focus: DXY – USD Moves Have Not Played Out As One Would Expect

FIGURE 1: FX Forecasts

Forecast (Mar 2025)	Spot	0-3m	6-12m	Long-term
DXY Index	103.15	106.57	102.07	99.16

Source: Citi Wealth Investments as of March 2025.

Global risk assets have been shaken by the larger-than-expected US reciprocal tariffs that are inflationary for the US and disinflationary for the rest of the world (RoW). Yet, the dollar has not strengthened to rebalance inflation risks (US vs RoW) nor has it found a safe haven bid on global risk aversion flows – that mantle has gone to CHF and JPY.

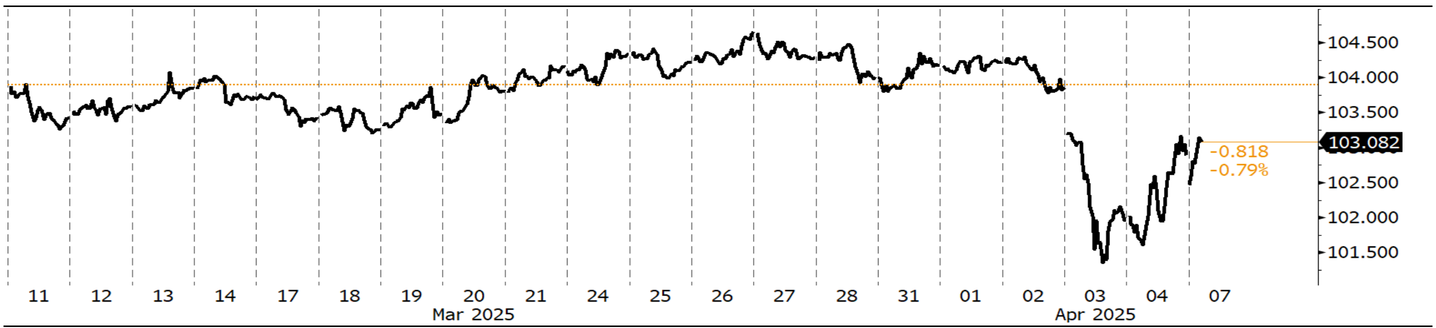
Instead, the asset rotation theme particularly out of US into European stocks that began in early March has replayed post the tariff announcement and pushed the DXY Index down to as low as 101.27 on expectations that US economic growth will be zero in 2025 and the US would likely take a bigger hit than the RoW amid a fiscal tightening from higher tariffs (2.5% of GDP). US rates markets have also turned more dovish on the Fed by pricing 4 25bp cuts this year (2 more than the Fed "dot" plot) which means markets are now pricing a more activist Fed to stimulate growth.

But unless the US economy collapses, the Fed is unlikely to deliver that kind of easing. Tactically, dollar positioning has also turned flat after having been overly long earlier this year so investors have a renewed capacity to buy USD once again and the dollar still offers the most attractive real yields within G10 FX. And let's not forget that the reciprocal tariffs not only represent a near-term growth/ inflation shock to the US, but a growth/ disinflationary shock to the rest of world. Odds of a US recession have risen sharply and admittedly, this is yet to translate to higher odds of a global recession. But once markets see the US reciprocal tariffs as a threat to the global economy, that is likely to eventually support a safe haven bid into USD.

Indeed, after Mexico, Canada and China, Europe (the euro area, UK and Switzerland) is the most exposed to a growth hit from US tariffs. Citi Economics estimate European goods imports to the US amount to 3.57% of euro area GDP and a 20% tariff levied EU goods (excluding pharmaceuticals) and 25% on autos is likely to see close to a 1pp hit in GDP this year with Ireland, Germany and Italy likely the most negatively exposed. Trade diversion risks are also larger now which raises the risk of further disinflationary pressure from a potential redirection of global goods oversupply into the European market from China. The only inflationary offset should come from a EUR depreciation, which typically occurs alongside tariff increases, but this does not seem to be playing out for now and the negative shocks could bring the euro zone economy back on the verge of recession in 2H25.

As far as China is concerned, the disinflationary impulse from China's weak domestic demand, potential trade wars and China's retaliation still rank among the greatest risks to RMB in 2025 but China's strategy of depreciating its currency vs the trade basket instead of USD is consistent with its diversification of trade flows away from the US to Asia (East and South-East Asia now rank as China's top trading partner).

FIGURE 1: DXY has sold off sharply following the US “Liberation” Day reciprocal tariff announcement



Source: Bloomberg, April 7, 2025.

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