QNB

# Economic Commentary

QNB Economics
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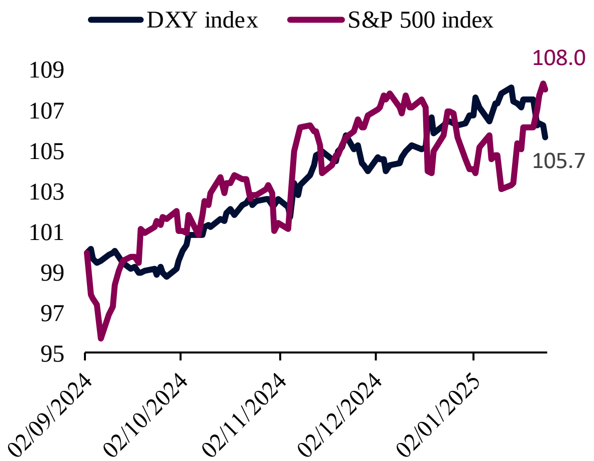
# What is the direction of the USD under Trump?

Few indicators convey as much information about global macro trends as the direction of currency fluctuations. This is particularly valid when it comes to deep, liquid foreign exchange (FX) markets of major currencies from advanced economies, such as the US Dollar (USD), the Euro (EUR), the Japanese Yen (JPY), the Swiss Franc (CHF) and the Pound Sterling (GBP). FX is driven by capital flows, which corresponds to real time reactions as well as expectations about risk appetite, relative economic performance and interest rate differentials.

In recent months, major FX markets have presented significant volatility. In fact, the USD Index (DXY), a traditional benchmark that measures the value of the USD against a weighted basket of six major currencies, has experience a marked appreciation on the back of Donald Trump's victory in the US general election in November 2024. The DXY appreciated by almost 6% since September 2024, an unusual fast move for the asset class, closely tracking periodic returns of the more risky and volatile US equities.

**DXY and the S&P 500 evolution**
(index points normalized, September 2nd = 100)

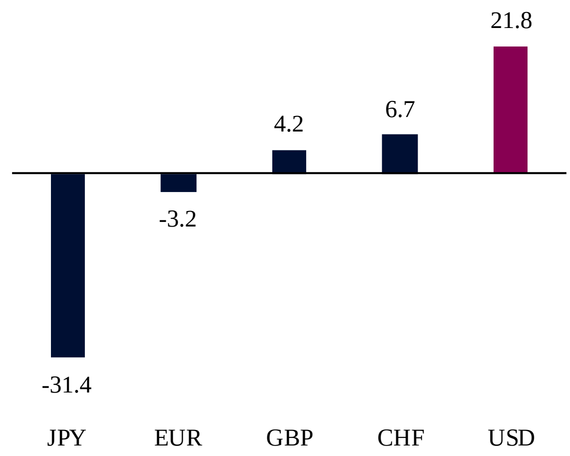



Sources: Bloomberg, QNB analysis

As the DXY surpassed the critical levels seen in September 2023, amid "peak" Fed hawkishness, analysts and investors debate the direction of the USD. Many believe that the USD should be well supported by Trump-driven US tariffs against major trade partners, a robust US economy and a Fed that could be forced to act more "cautiously" than its peers, due to higher US inflation.

However, an assessment of the USD suggests that the currency is overvalued and in need for an adjustment. A common way to look at currency "valuations" is to analyse trade-weighted, inflation-adjusted exchange rates, i.e., the real effective exchange rates (REER), and compare it to their own long-term averages or historical norms. This REER metric is more robust than traditional FX rates as it captures changes in trade patterns between countries as well as economic imbalances in the form of inflation and inflation differentials. The REER picture for December 2024 suggests that the USD is indeed the most overvalued currency in the advanced world, by more than 21.8% of its notional "fair value." As already discussed in one of our previous publications in mid-2024, before the Trump election, when the DXY index was hovering the 105-106 levels, just below current levels, "there is little room for further USD appreciation much beyond the existing levels."

**Currency deviation from REER 20-year average**
(in % as of December 2024)




Sources: Haver, BIS, QNB analysis

In our view, there is scope for a different scenario beyond the idea of a "strong USD" for the long-term. Two factors support our view of potential headwinds for the USD over the medium-term.

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First, shifts in the fiscal stance of major advanced economies could narrow their growth and interest rate differentials with the US. In recent years, the US has been more aggressive than its peers in applying expansionary fiscal policies, pushing its deficit to around 7% of GDP and bolstering economic performance. Now, as the new US economic team prepares a significant fiscal consolidation to bring the deficit closer to 3%, while other advanced economies lean toward more expansionary measures, the US growth advantage could diminish. A narrower growth differential ultimately favour other currencies over the USD.

Second, despite the existing uncertainty about the path of US policy rates and the popularity of the view that the monetary easing is "over" in the US, we believe that at least two more rate cuts are going to be enacted by the Fed in 2025. While still solid growth and a Trump-driven "inflation scare" are affecting expectations about the next Fed policy moves, a more comprehensive look at leading inflation indicators suggest that there is no room for panic or a sudden end to the monetary easing. A meaningful downtrend in non-cyclical inflation, coupled with a significant slowdown in economic activity and a looser labour market, favour further rate cuts to neutral levels, i.e., around 4%. This should then affect the interest rate differential between the US and other economies, easing global financial conditions and pushing more capital to non-USD assets.

All in all, we see limited scope for further USD appreciation much beyond current levels. The currency is likely to move toward more "fair" levels, supported by fiscal consolidation, additional monetary easing, and an administration focused on addressing imbalances.

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