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US dollar weakness expected to return while gold stays supported

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The US dollar index has climbed roughly 1% from its recent sell-off lows, while gold has shed USD 100/oz from record highs. While the greenback is likely to be supported in the near term, we expect dollar weakness to resume later this year. Gold, meanwhile, should continue to attract investor demand.

The US dollar's sell-off has stabilized in recent days, with the DXY Index of the US currency against major peers close to 1% above its recent lows at the time of going to print. At the same time, gold has retreated after US President Donald Trump stepped back from comments about removing Federal Reserve Chair Jerome Powell from office and showed greater willingness to strike a trade deal with China to reduce tariffs. Gold now stands at around USD 3,300/oz, around 6% below the psychological USD 3,500/oz barrier broken in the midst of tariff turbulence.

We think the USD is short-term oversold, and expect a period of consolidation in the near term. Chair Powell is unlikely to be forced out, and the Federal Reserve has sounded caution on rate cuts while other central banks are easing. While March US jobs data from the JOLTS survey showed the smallest number of monthly openings since January 2021, declining layoffs in the same release suggest that the total labor market picture, including April's nonfarm payrolls data due Friday, will show a generally resilient jobs market whose weakening is gradual at most. This should contain risk-off sentiment and help support the US dollar.

Over the medium term, however, we believe the trend of dollar weakness is likely to resume. Bullion, meanwhile, should stay well supported by "safe-haven" demand and structural buying.

The US economy is likely to slow more than elsewhere, and elevated fiscal deficits will come into greater focus.

While activity data have yet to show the impact of Trump's tariff decisions, sentiment indicators are starting to reflect a deterioration in future output, suggesting that negative sentiment is building in the economy. In our base case, we now expect US economic growth of 1.5% in 2025 versus the expectation of more than 2% growth we held earlier this year. We see growth of 0.7% for the Eurozone this year, (around 0.2 percentage points weaker than when we entered 2025) and below 4% for China (roughly 0.5 percentage points weaker). Separately, with the US debt-to-GDP ratio at 123% as of December last year, elevated US interest costs may be a headwind for the USD over the medium to long term.

The Fed should resume interest rate cuts later this year. To balance growth concerns against the risk of a resurgence in inflation, the US central bank's policy flexibility appears to be more limited in the near term. Powell has stressed that he is keen to ensure that one-off price increases arising from higher tariffs do not drive second-round effects that could lead to more sustained inflation. However, we believe the Fed will be able to resume policy easing in the second half of this year, reducing rates by 75-100 basis points to support growth as price pressures ease and the labor market weakens. Lower rates will support gold prices as the opportunity cost of holding bullion is reduced.

Demand for gold is rising structurally. Improving headlines on potential trade deals are likely to cap gold's potential gains after an impressive run on safe-haven demand, but we have also seen signs of a more structural shift in gold allocations. For example, Beijing has allowed insurance funds to invest in gold, while global central banks are systematically raising gold's share of total reserves. We forecast central banks will buy around 1,000 metric tons in 2025 after purchases of around this level over the last three consecutive years, and raised our expectation for exchange-traded fund (ETF) net buying in 2025 to 450 metric tons, from 300 metric tons. With ongoing tariff and geopolitical uncertainties, we believe gold should stay well supported toward our base case target of USD 3,500/oz.

So, we prefer using any periods of near-term USD strength to reduce dollar allocations in favor of currencies such as the Japanese yen, euro, British pound, and Australian dollar. We also like selling the risk of a rising USD for yield pickup. Gold, however, remains an effective portfolio diversifier and hedge, and we recommend around a 5% allocation to the precious metal as part of a balanced and well-diversified portfolio.

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