Global Markets Daily: Tariffs and the Dollar: Why We Flipped Our View

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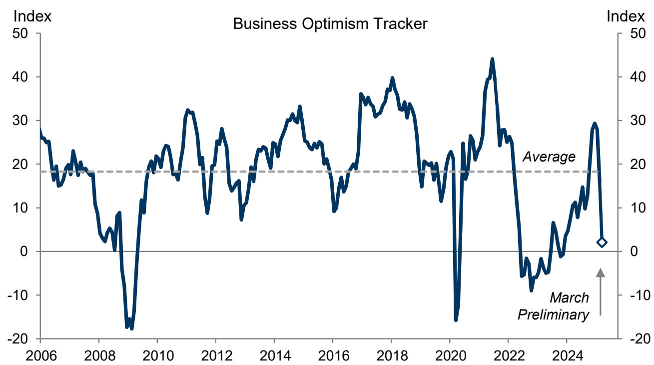
- We have made a major shift in our Dollar view after seeing the developments of the last few weeks and rethinking the likely implications of these policy changes. We now expect recent Dollar weakness to persist, particularly in DXY terms.
- First, the combination of an unnecessary trade war and other uncertainty-raising policies is severely eroding consumer and business confidence. Second, negative trends in US governance and institutions are eroding the appeal of US assets for foreign investors. Third, rudimentary calculations and a constant back-and-forth makes it difficult for investors to price outcomes other than high uncertainty.
- It is also likely that the changing nature of the tariffs changes the paradigm for determining the shape of the tariff impact. Tariffs on less-substitutable goods gives foreign exporters greater pricing power. It is possible that across-the-board tariffs could have a similar effect–US businesses and consumers become the price-takers, and it is the Dollar that needs to weaken to adjust if supply chains and/or consumers are relatively inelastic in the short term.
- We have previously argued that US exceptional return prospects are responsible for the Dollar's strong valuation. But, if tariffs weigh on US firms' profit margins and US consumers' real incomes, they can erode that exceptionalism and, in turn, crack the central pillar of the strong Dollar.

Tariffs and the Dollar: Why We Flipped Our View

We have made a major shift in our Dollar view after seeing the developments of the last few weeks and rethinking the likely implications of these policy changes. We now expect recent Dollar weakness to persist, particularly in DXY terms. This change reflects a number of related factors, but the common thread is that the exceptional positioning that has supported the strong Dollar over the last decade is likely to reverse. We do not think tariffs will be a source of support for the Dollar. Instead, in the current form and together with other policy changes that have been enacted, they are likely to serve as an additional drag.

The combination of an unnecessary trade war and other uncertainty-raising policies is severely eroding consumer and business confidence. We had previously expected that trade-related uncertainty would weigh more on foreign countries than the US, but so far soft data in the US has shown more worrying signs while European sentiment has been surprisingly resilient. As we recently discussed, much of this decline looks consistent with other policy issues—DOGE-related policy shifts and a potential embrace of greater fiscal restraint, for instance—as respondents have reported consumption cutbacks amid fears of a loosening labor market, and a sharper fall in service sector surveys than in manufacturing (Exhibit 1). But, tariff policy is undoubtedly a part of the uncertain policy mix contributing to the shakier US economic outlook. Following last week's tariff announcement, rate differentials moved sharply against the Dollar as markets priced more domestic damage (Exhibit 2), which was consistent with a shifting market response to tariffs.

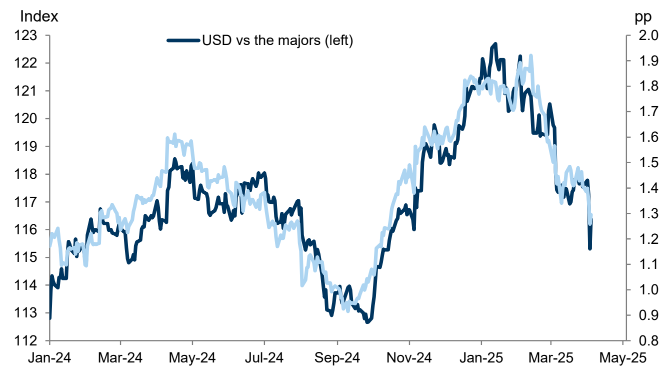
Exhibit 1: Soft data in the US has shown increasingly worrying signs



Composite of the 6-months ahead business conditions components of the Dallas, Kansas City, New York, Richmond, and Philadelphia Fed business surveys, the 12-months outlook for the US economy component of the Chicago Fed Survey of Economic Conditions, the "optimism about the economy" and "optimism about own company" components of the Duke University, Richmond Fed, and Atlanta Fed CFO Survey, the Conference Board measure of CEO confidence, the Business Insider CEO Economic Outlook Survey diffusion index, and the NFIB "expect the economy to improve" diffusion index. Our preliminary estimate for March is based on surveys released thus far.

Source: Goldman Sachs Global Investment Research

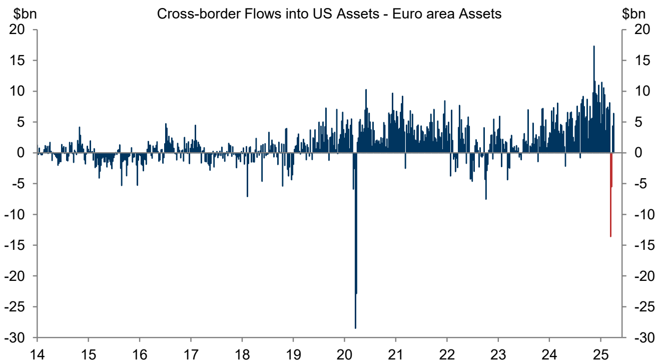
Exhibit 2: Rate differentials moved sharply against the Dollar last week



Source: Bloomberg, Goldman Sachs Global Investment Research

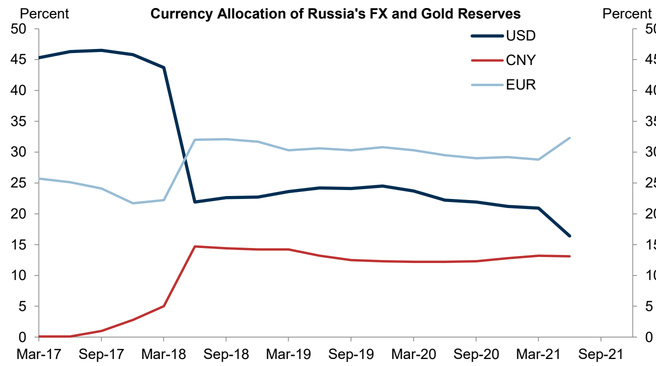
Negative trends in US governance and institutions are eroding the appeal of US assets for foreign investors. US tariff announcements and a more aggressive stance toward historical allies have hurt global opinions about the US and US assets. The combination of much stronger-than-expected foreign spending plans and weaker US asset performance has already led to some brief but active rotation out of US assets (Exhibit 3) and increased interest in hedging US assets. To some extent, this is not necessarily new. We have written a number of times that maverick policy choices could erode the Dollar's appeal, as exemplified by Russia's decision to diversify away from the Dollar in 2018 and documented elsewhere (Exhibit 4); it is now clear that foreign officials have taken a number of actions to attempt to reduce their reliance on the Dollar. This is one of several reasons that the Dollar share of FX reserves has steadily declined over the last decade and now sits close to its lowest level since the advent of the Euro. However, up to now, private sector investors have more than compensated for reduced official sector demand, likely lured by superior asset returns. It is possible that the broader policy disruptions and eroded exceptionalism will see private sector investors follow a similar pattern now.

Exhibit 3: Weaker US asset performance led to some brief but active rotation out of US assets



Source: EPFR, Goldman Sachs Global Investment Research

Exhibit 4: There is isolated evidence that policy choices have diminished the Dollar's appeal for some official-sector investors

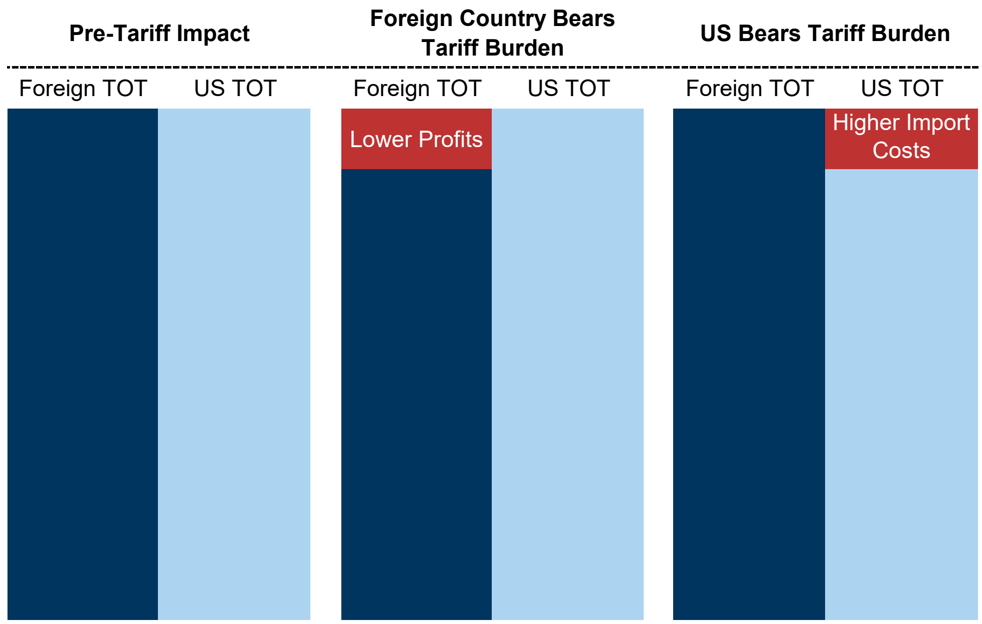


Source: Central Bank of Russia, Goldman Sachs Global Investment Research

Rudimentary calculations and a constant back-and-forth makes it difficult for investors to price outcomes other than high uncertainty. We had previously expected that investors and businesses would be able to examine the initial tariff proposals and price the likely implications for asset prices. Some had even described the reciprocal tariff deadline as a "market clearing" event. Instead, the nature and frequency of these announcements has provided little clarity—the only certainty seems to be yet more uncertainty.

It is also likely that the changing nature of the tariffs changes the paradigm for determining the shape of the tariff impact. Tariffs can be paid through some combination of lower foreign firm margins, lower domestic margins, or higher domestic consumer prices (Exhibit 5). Typically, academic literature finds some mix between these three channels, with the Dollar on average appreciating to offset about 50% of the tariff rate increase. But, if domestic firms have less negotiating power, then the pass-through will be smaller. And the error bands around those estimates are wide, in part because every tariff implementation is a little different. In fact, in the first trade war, we and other researchers found that China was able to fully pass on the cost of the tariffs to US businesses and consumers; the impact on the Dollar came mainly around narrow windows and a variety of other channels like risk aversion. We have previously discussed this dynamic in a slightly different context. In the case of tariffs on so-called critical imports, which are hard to substitute, increased foreign pricing power means that US terms of trade could need to adjust via higher import costs. That means the Dollar should depreciate, rather than the foreign currency.

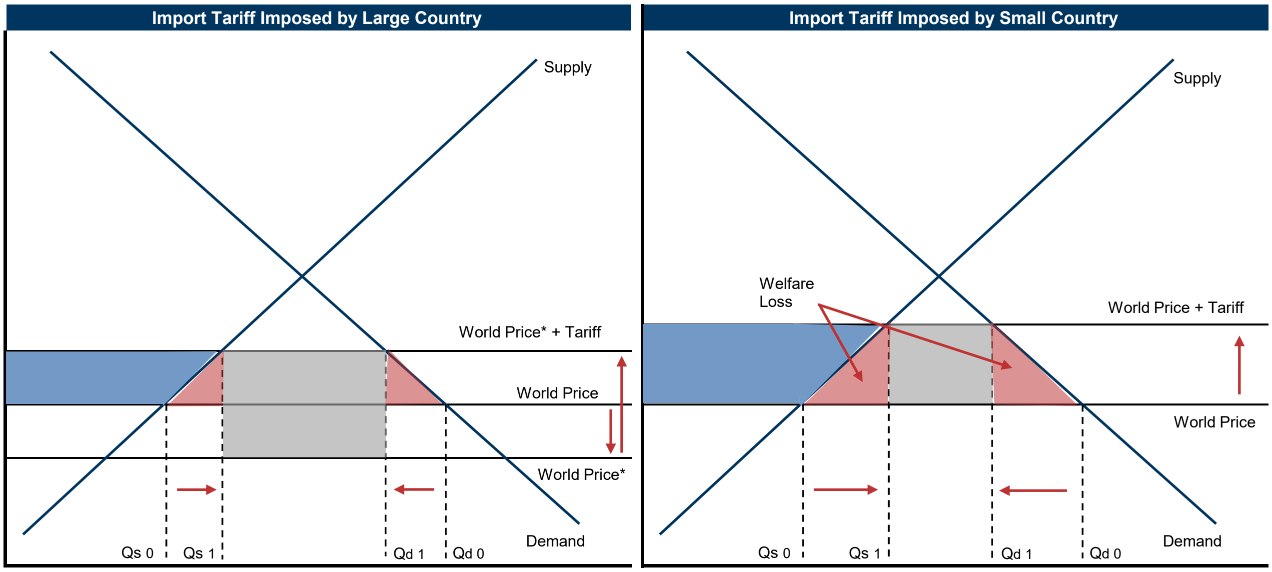
Exhibit 5: Tariffs can be paid through some combination of lower foreign firm margins, lower domestic margins, or higher domestic consumer prices



Source: Goldman Sachs Global Investment Research

With broad and unilateral tariffs now on the table, there is less incentive for foreign producers to provide any accommodation–US businesses and consumers become the price-takers, and it is the Dollar that needs to weaken to adjust if supply chains and/or consumers are relatively inelastic in the short term. Essentially, the US raising tariffs across the board changes the dynamic for FX considerations. Up to now, we have been thinking of the US as the dominant country in the standard tariff welfare diagram (Exhibit 6). The pricing power of the large country leads to the dynamic we described above—the world price (ex-tariffs) falls somewhat to accommodate the tariff increase as foreign firms "pay" some portion of the tariff. But, with the cost of foreign production rising everywhere, it is possible that the *US* becomes the *small* country in this model, and will have to bear the full cost of the tariffs. In this outcome, US terms of trade would deteriorate and the Dollar would depreciate.

Exhibit 6: With foreign costs rising everywhere, it is possible that the US becomes the small country in the standard tariff welfare diagram



Source: Goldman Sachs Global Investment Research

This is far from guaranteed, but it is newly possible with a 10% across-the-board tariff affecting every country outside the US. The US administration has maintained that it can still negotiate as the large country in each bilateral discussion, and that foreign supply will be more inelastic than US demand. But, the current dynamic at least opens a new possibility set relative to the first trade war, when there was potentially room for US companies to source goods from outside China and avoid the tariffs. We have documented that China's indirect exports to the US rose substantially following the initial tariff increases in 2018-19. If the US is now unwilling to negotiate on the 10% baseline increase, and US companies cannot readily move manufacturing to domestic options, we think it is likely that US firms will find themselves as the price-takers in ongoing negotiations.

For this reason, we now think it is more apt to draw comparisons to Brexit rather than the first trade war. Rather than raising the cost of doing business with a single country, or a subset of countries, this policy looks likely to raise trade barriers all around. Like with Brexit, it is conceivable that these changes will force the US to sustain a smaller current account, with the currency providing part of the adjustment mechanism. Even without shifting the current account norm, our GSFEER model estimates that the Dollar is around 20% overvalued. We expect these recent policy changes will ultimately see markets compress that overvaluation.

These channels are all interconnected. Most importantly, we have previously argued that US exceptional return prospects are responsible for the Dollar's strong valuation. But, if tariffs weigh on US firms' profit margins and US consumers' real incomes, they can erode that exceptionalism and, in turn, crack the central pillar of the strong Dollar.

There are still a number of uncertainties, and reasons why the Dollar could still appreciate. First, US policy priorities could shift again. A narrower version of tariff increases and reduced uncertainty would likely help partially restore the dynamics that previously took the Dollar close to all-time highs, and again make the first trade war a more apt comparison. Second, it is still far from clear that the market's early treatment of this as a mostly US-concentrated shock will endure. A sharper decline in global growth expectations would eventually amplify the Dollar's safe haven properties. Third, some of the Dollar's recent response to tariff announcements can be attributed to tight CNY currency management. But, since the reciprocal tariffs were announced on April 2, CNY has depreciated against the Dollar. In the first trade war, CNY movements had some knock-on effects that reverberated across FX markets.

TRADE IDEAS

Best Trade Ideas Across Assets

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1. KRW 2/10Y IRS steepener, opened September 4, 2024, at -12bps, with a target of 30bps, and a stop of -30bps, currently trading at 10bps.
2. Stay long Indonesia 1Y SRBIs fully FX hedged, opened on October 3, 2024, at 6.82%, with a target of 5.70%, and a revised stop of 6.70%, currently trading at 6.37%, as of March 28.
3. Close long the sovereign USD bonds of Chile, Costa Rica, Jamaica, Jordan, Oman and the UAE as an equally weighted basket, opened on December 13, 2024, at 0%, with a total return target of 3%, and a revised stop of 0.3%, for a potential total return of +0.4%.
4. Close long FX hedged 10Y SAGBs (2035s), opened January 08, 2025, at 10.43%, at a target of 9.90% and a revised stop of 11.00%, for a potential loss of 57 bps (-2.0% total: -3.2% duration, +2.1% carry, -0.9% FX-hedging cost).
5. Stay short THB/KRW, opened January 10, 2025, at 42.30, with a target of 39.0, and a stop of 44.0, currently trading at 42.46.
6. Receive INR 2Y NDOIS, opened January 28, 2025, at 6.08%, with a revised target of 5.50% and a revised stop of 5.85%, currently trading at 5.69%.
7. NSE India Consumption vs. NSE Infra outperformance pair trade, opened February 03, 2025, at 1.41, with a target of 1.70, and a stop of 1.25, currently trading at 1.31.
8. Close long an equally weighted basket of Frontier currencies including EGP, KES, NGN and TRY, opened on February 12, 2025, at 0%, with a total return target of 6%, and a stop of -3%, for a potential total return of +0.5%.
9. Receive 5y AUD IRS vs. Pay 5y NZD, opened February 21, 2025, at 0.26, with a target of -0.10, and a stop of 0.45, currently trading at 0.23.
10. Buy SFRZ5 96.25 put vs sell 0QZ5 96.25 put (in net premium), opened March 7, 2025, at -0.03, with a target of 0.12, and a revised stop of -0.03, currently trading at 0.02.
11. Stay short AUD/JPY, opened March 17, 2025, at 94, with a revised target of 85.0, and a revised stop of 91.5, currently trading at 88.78.

12. Sell 1x2 A/A+17 3m 2s10s curve cap spread, opened March 21, 2025, at 0.00, with a target of 0.10, and a stop of -0.05, currently trading at 0.02.
13. Pay 2y2y CORRA vs receive 2y2y SOFR, opened April 4, 2025, at -0.98, with a target of -0.65, and a stop of -1.15.
14. Go long 2Y CGBs, opened April 6, 2025, at 1.47%, with a target of 1.05%, and a stop of 1.70%.

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