Fx Strategy
A REPUBLICAN SWEEP COULD OVERTURN USD WEAKENING IN 2025

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On the FX space, we think the major impact on the USD of a Trump presidency could derive primarily from the US-China trade war channel and, on a lesser extent, from the US-EU one. Given that FX plays as the intermediary between countries in international trade, in a world of largely free-floating exchange rates, any actual material government-imposed restrictions should result in a consequent reassessments of exchange rate levels.

We see the terms of trade (ToT) channel as the most important driver of FX valuation following the imposition of tariffs. A tariff acts as a fee paid on imports, which is either absorbed by corporations or passed through to consumers.

Evidence shows that since 2018, foreign currencies have broadly weakened against the USD (Figure 1), largely benefiting foreign exporters. Under an upcoming second wave of trade wars, we therefore expect that these corporates, which benefited from local currencies devaluation, would be more willing to drop prices to maintain volumes, as they did during the increase in tariff levels in 2018. As a result, our baseline assumption is that US imposed tariffs by an incoming Trump administration would likely act as a positive terms of trade shock in favor of the USD.

FIGURE 1.

Impact of Trump's trade war on bilateral terms of trade

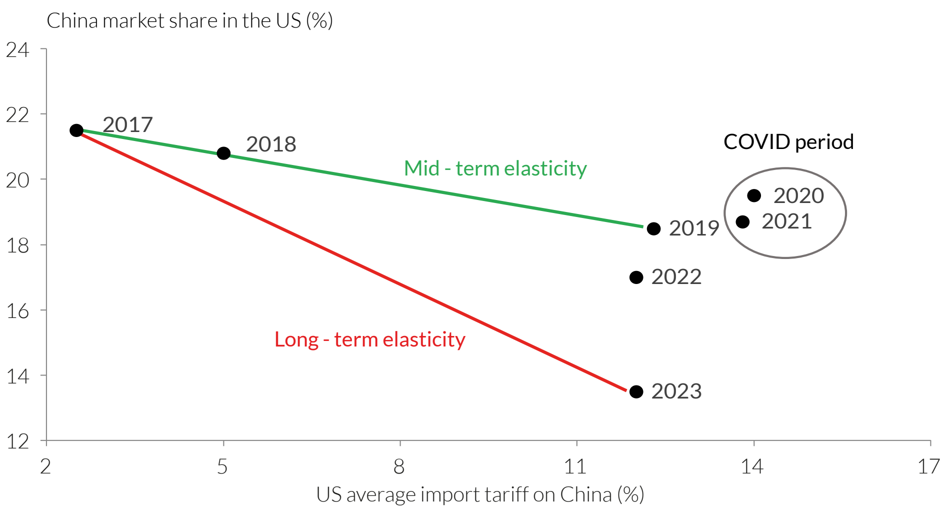
Source: US customs, Haver Analytics, Anima Research

Evaluating tariffs through the lens of the ToT also intrinsically captures the relative elasticities of goods[1] . Countries that export more elastic goods would be more vulnerable to tariffs, as price changes would have a larger impact on demand. Hence, as a general rule, we expect exchange rates to be more sensitive to ToT for those countries which export more elastic goods rather than less elastic ones.

To empirically measure elasticities of goods, we considered what happened during the previous trade war under the Trump presidency. Therefore, first of all we estimated elasticity of China's share in US total imports (**Figures 2**, **3**).

FIGURE 2.

Elasticity analysis of China's share in total US imports



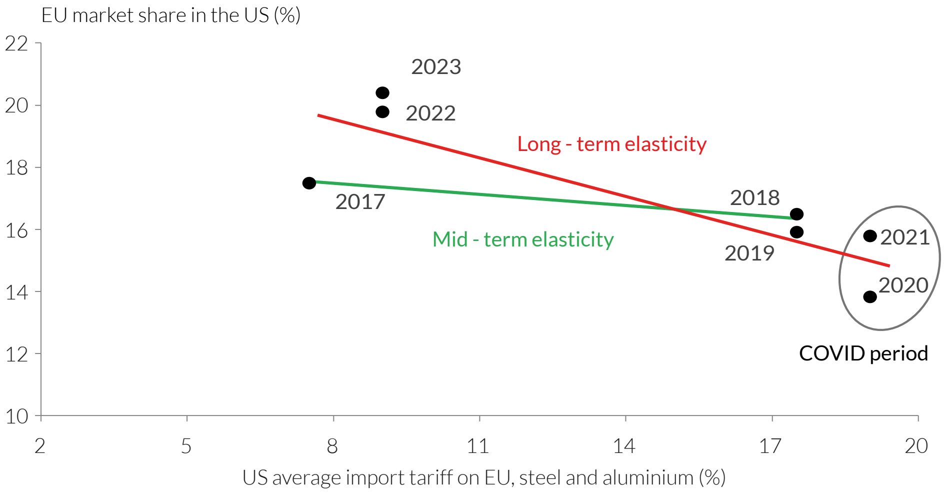
Source: US customs, Haver Analytics, Anima Research

1 - See: [https://documents1.worldbank.org/curated/en/099524306202324085/pdf/IDU01ba09ebe0931f-04f070a11c0471fc38ea0e2.pdf](https://documents1.worldbank.org/curated/en/099524306202324085/pdf/IDU01ba09ebe0931f04f070a11c0471fc38ea0e2.pdf)

The Eurozone was not immune to the global trade dispute unleashed by the US administration in 2018 too. Some industrial sectors (such as steel and aluminum) were heavily impacted, while the overall direct FX impact for the regional economy was contained, as only around EUR6.4bn (less than 1% of EU's GDP) in EU exports were affected. Furthermore, in 2021 the Biden administration replaced Trump's tariffs on steel and aluminum with a tariff-based quota system, where the below-quota EU export has been exempted from US tariffs.

FIGURE 3.

Elasticity analysis of Eurozone's share in total US imports, based on tariff on steel and aluminum



Source: US customs, Haver Analytics, Anima Research

Below, by using the elasticities we empirically derived, we estimate the impact on USD/CNY and EUR/USD of a Trump presidency under two different scenarios: 1) Split Congress and 2) Republican sweep.

1. **Under a split Congress scenario, we expect Trump to rely on executive orders, which should end up imposing trade tariffs only on a bilateral base (mainly targeting China). We expect USD/CNY to appreciate by 9% in 2025 (EOY target at 7.9). We expect no major impact on EUR/USD in 2025.**

Consistent with our analysis, we estimate that direct and indirect impacts of tariff hikes by 1pp increase in the US's average tariff on Chinese goods lowered China's US import market share by 0.3% over the first two years (Figure 2: mid-term elasticity: 2017-2019, green line) and by 0.4pp per annum over 2017-23 period (long-term elasticity, Figure 2, red line). Thus, each 1pp rise in US import tariffs reduced China's US import market by 0.15pp in the first year and cumulatively by 0.4pp annually in the longer run.

Therefore, assuming goods elasticity to have remained broadly unchanged, we expect imposing a 60% tariff on China (likely in three rounds of 20% each, from 2025 to 2027) will reverberate on the USD/CNY cross by depreciating the Chinese currency by around 9% in the mid-term. At the same time, we assume Chinese authorities may be open to allow the CNY to weaken broadly in line with the change in fair value to support a stumbling economy and to promote trade with other countries (i.e. we do not expect PBoC to hike rates to lift the CNY).

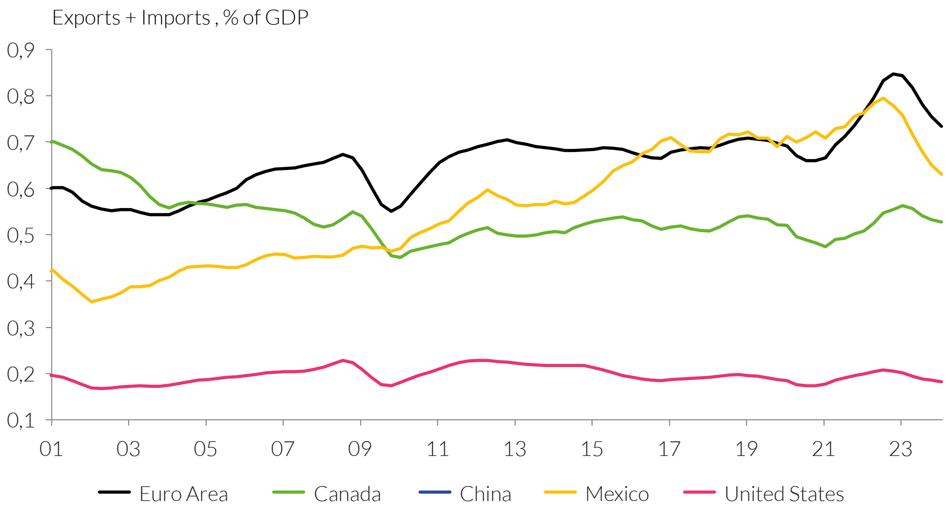
2. **Under a Republican sweep scenario, Trump could end up imposing across-the-board tariffs of up to 10% globally (impacting the Eurozone), plus the 60% tariff hike on Chinese exports. As a result (and all else being equal), we expect EUR/USD to depreciate by 5% in 2025 (EOY target at 1.09). We expect USD/CNY to appreciate by 9%, as per Scenario 1.**

In the scenario – for the sake of clarity we use a 10% tariff imposed by the US on the rest of the world – we expect the depreciation of the EUR to be relevant for two primary reasons: 1) given the EU's high degree of trade openness (**Figure 4**), the EUR shows to be quite sensitive to the ToT (**Figure 3**: long-term elasticity at 0.5%, red line) and (ii) we expect tariffs to affect a larger basket of goods than just steel and aluminum this time. Thus, all else being equal (i.e. the Fed's and the ECB's monetary policies) we expect both factors to leave the EUR particularly vulnerable to shifts in global trade dynamics next year.

Anyway, we caution these results should be taken with a pinch of salt at this stage, as: 1) it is still uncertain to what extent a Trump administration would follow through with its threat and 2) even then, models cannot fully capture the complex economic and political dynamics involved.

FIGURE 4.

Trade openness



Source: US customs, Haver Analytics, Anima Research