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Jaideep Tiwari
Head, Global Foreign Exchange Investment Strategy

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FX Focus: USD - Gathering Multiple Headwinds

FIGURE 1: FX Forecasts

Forecast (May 2025)	Spot	0-3m	6-12m	Long-term
DXY	98.75	99.12	94.91	99.16

Source: Citi Wealth Investments as of May 2025.

USD has been consolidating during the whiplash from President Trump's back-and-forth on tariffs that has been overtaken by involvement of the US judiciary. The US Court of International Trade has decided to block reciprocal tariffs applied under the International Emergency Economic Powers Act (IEEPA) but the decision has been temporarily suspended by the Federal Appeals Court pending a final decision.

If the ruling by the US Court of International Trade' is overturned, the White House will move to quickly re-impose the earlier announced reciprocal tariffs on April 2nd. But if the ruling is allowed to stand, the Trump administration's focus will shift towards expanding Section 232 sectoral tariffs (as it already has with respect to the hiking in steel and aluminum tariffs to 50%) and Section 301 tariffs imposed on China during President Trump's first term and expanded under the Biden administration.

President Trump may yet get his way on tariffs, but the legal process could potentially extend the timeline on delivery well beyond the end of the current tariff pause (July 8th) resulting in greater uncertainty on US trade policy (including possible agreements to weaken USD via a currency accord) and creating more doubts about the ability of tariff revenues to fund the US budget gap (exacerbating fiscal concerns).

The USD's decline this year started with the downgrade of US exceptionalism when President Trump announced tariffs on China in February. The downgrading of US exceptionalism versus Europe accelerated in early March when Europe announced a massive fiscal stimulus plan related to defense and infrastructure build. Markets saw the fiscal loosening in Europe compared to the fiscal tightening in US from tariffs as a signal to shift capital out of US into Europe.

Then came Liberation Day on April 2nd when President Trump announced reciprocal tariffs on the rest of the world. Markets took that as a signal of the US wanting to reduce trade flows to rebalance its trade deficit. Markets judged this would require less recycling of trade surpluses by Europe, Japan and China via capital flows to fund the US current account deficit which accelerated the dollar's decline. Finally, by mid-May, fiscal concerns emanating from the US budget bill added to anxiety about US's twin deficits with markets concerned about whether there will be enough tariff revenue to cover the fiscal expansion over the next 10 years. This is because very few trade deals have been concluded with the US so far, making it difficult for markets to estimate just how much revenue from tariffs is likely to come over the next 10 years. With legal proceedings now dominating trade talks, the Trump administration's ability to re-work its tariff policy is likely to be delayed even further thereby extending the uncertainty on the timing of trade deals and the funding the US budget deficit gap over the next 10 years with tariff revenues.

Over the past month, the DXY's decline has also been strongly linked with market concerns about a possible blowout in the US budget deficit due to President Trump's fiscal spending initiatives in the US Budget Bill and with the reciprocal tariffs blocked, such fiscal concerns are set to escalate, raising a major medium-term headwind for USD.

Markets initially responded to the news of the US Court's decision as a risk-positive – with US equities extending gains and the USD bid returning. But that has quickly changed as the medium-term headwinds for the dollar continue to multiply which now include - the downgrading of US exceptionalism, reduced capital inflows into US, speculation of a currency accord to weaken USD, rising fiscal concerns on doubts about tariff revenue and now the US courts involvement in the tariff dispute potentially extending the timeline on any trade deals.

For now, with current market positioning already significantly short USD, having partly discounted some of the headwinds already, it is still possible for DXY to tactically rebound to the 102.00 – 103.00 area if some of the headwinds recede if only temporarily. However, the medium-term sentiment in USD has turned increasingly bearish and sellers likely await on any tactical rebound.

FIGURE 2: DXY unlikely to return to the pre- Trump reciprocal tariff levels of 103 and above on the US Trade Court's decision to block the tariffs

Source: Bloomberg, May 29, 2025.

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