Reading the Markets USD

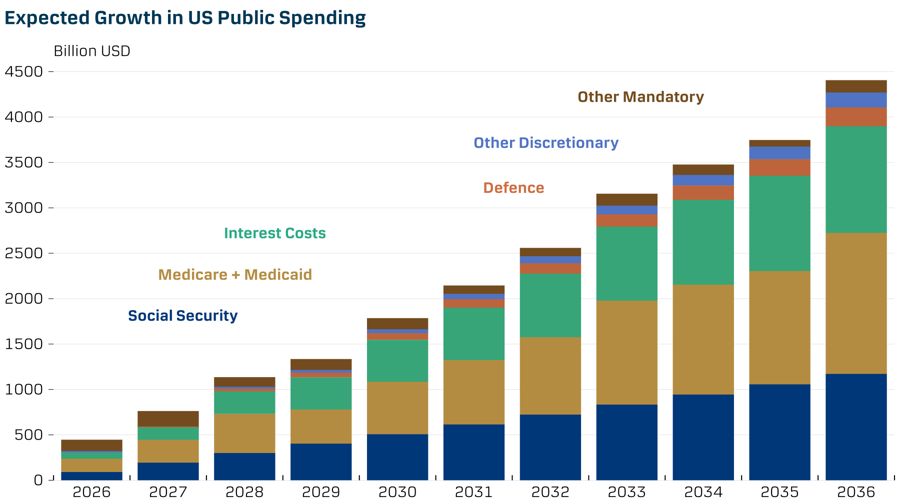
Little action, a lot of uncertainty

Amidst the varying interpretations of the US Treasury's buyback announcement last week, the most important takeaway might just be the return of an uncomfortable sense of economic policy uncertainty. And yes, calling it a 'return' might be a stretch given that we are talking about the administration whose warfare on Iran has been the most important market theme of the past six months. But during the same period, fiscal and tariff policies have seen only relatively modest changes compared to 2025 – is that about to change now?

At face value, we do not want to overinterpret the significance of the buybacks alone. *The Treasury recommended increasing the buyback volumes for 10-30y Treasuries already more than a year ago* in its Q3 25 QRA report after studying the relative liquidity conditions between off-the-run and on-the-run securities. As such, the decision did not come completely out of the blue. The same report underscores that issuance strategy should remain the main tool for adjusting the weighted average maturity (WAM) of outstanding debt. The buybacks shorten the WAM temporarily (when financed with T-bill issuance), but typically within its usual annual variance.

That said, the surprise timing of the announcement (in between regular QRAs) and Bessent's following remarks about yields 'not reflecting fundamentals' make the operation look a lot more like a direct intervention than just relative liquidity support. While we may be stating the obvious here, such intervention does nothing to influence the root cause of the rising yields (e.g. the deficits).

Chart 1. Growth in US public spending largely explained by structural factors



Source: Macrobond, US Congressional Budget Office, Danske Bank

Key views

- **Macro.** Cyclical outlook remains healthy, even if stagnant labour supply growth weighs on real growth. GDP +2.0% in 2026, close to consensus of +2.2%.
- **The Fed.** 25bp hikes in December and March. Rates held at 4.00-4.25% for the rest of 2027 (above market pricing).
- **EUR/USD.** Relative macro and monetary policy outlook push EUR/USD lower towards 1.12 on a 12M horizon. Below consensus (1.18) and forward (1.18).
- **10Y UST.** 5.00% in 12M (above forward at 4.89%).

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US public spending is rising primarily because of the aging demography. Over the coming decade, CBO predicts that 90% of the expected increase in spending is related to social security and health care costs as well as consequently rising interest payments (chart 1). The future of these programmes is not in the hands of Bessent, but the Congress, where Republicans are widely expected to lose control of at least the House in the upcoming mid-terms (chart 2). **Reducing structural deficits is a politically difficult task even with a unified congress – and it will be near impossible with a divided one.**

So 'peak deficit' is not here yet – but what's next for UST yields?

In the medium-term (6-12M), increased intervention risk could force markets to price in a higher term premium for Treasuries to compensate for the political uncertainty. In other words, the interventions could even end up being counterproductive and deliver the exact opposite of what Kevin Warsh has aimed to achieve with his 'no forward guidance' policy. We continue to forecast 10y UST yield rising to 5.00% over the next 12M in our latest *Yield Outlook*, 18 August.

This would be the case even if the Treasury funds the buybacks from its cash balance at the Fed, as *reported yesterday*. TGA-funded buybacks would simply delay the required T-bill financing further into the future, while providing a temporary boost to USD liquidity in the process. The US Treasury currently holds approx. USD950bn in its cash balance, which is in line with its own earlier guidance for end-September target.

The short-term (3M) outlook might be less one-sided depending on whether the Treasury follows the buybacks up by also changing its issuance strategy in the next QRA in early November. For what it's worth, the recent widening of long-end swap spreads suggest that Treasury bonds have enjoyed some increased demand relative to swaps, even if the intervention effect on outright yields was quickly reversed (chart 4).

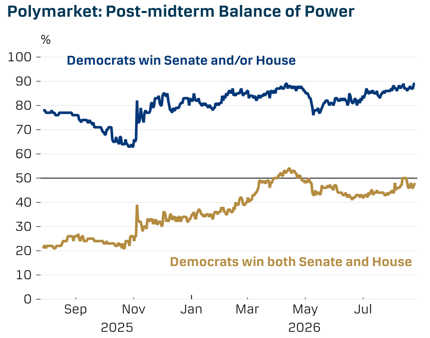
The Fed, liquidity and the USD

Lower long-end UST yields would be politically convenient ahead of the mid-terms, as they would drive down fixed mortgage rates. Shorter WAM of all debt outstanding would also tie the government's financing costs more closely to the Fed's monetary policy. And perhaps the renewed independence concerns were the reason why a seemingly technical buyback announcement also lifted precious metal prices – and weighed on broad USD last week.

Note that the Fed will not make additional reserve management purchases of T-bills this month, which steepens the Treasury's uphill battle on high yields (see *NY Fed's guidance*). For now, the Fed has managed to stabilise USD liquidity conditions, as repo rates remain in the middle-to-low end of the target range for the Federal Funds rate. In that sense, the decision to end net purchases should be uncontroversial. Also note that most US GSIBs reduced their supplementary leverage ratio further in Q2, which should be supportive of the USD money market conditions.

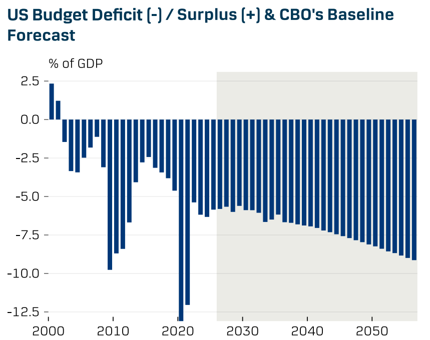
We think that the latest USD FX weakness has been amplified by a shift in positioning. Just a month ago, *IMM positioning data* showed that non-commercial investors were caught stretched long USD going into late summer. And judging by risk reversal skews, this has quickly been reversed over the past week and a half. In front-end contracts, market now demands a premium for EUR/USD calls over similar-delta puts for the first time since the war in Iran erupted (chart 6).

Chart 2. Republicans stand to lose House majority at the mid-terms



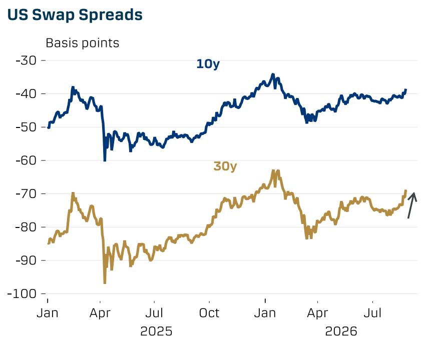
Source: Bloomberg, Polymarket, Danske Bank

Chart 3. Current budget deficit far away from the expected peak (if there is even one in sight)



Source: Macrobond, CBO, Danske Bank

Chart 4. Long-end swap spreads widened after the buyback announcement



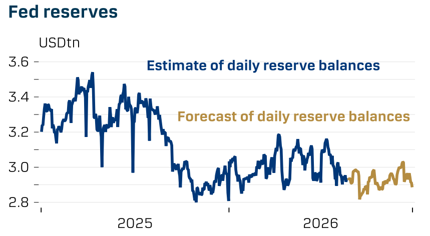
Note: Past performance is not a reliable indicator of current or future results
Source: Bloomberg, Danske Bank

But looking further ahead, we think that the relative macro-outlook still favours lower EUR/USD towards 2027. The US business cycle shows few signs of cooling momentum with the composite PMI rising to 56.0 in August – the highest since March 2022. We maintained our 12M forecast at 1.12 in last week's *FX Forecast Update*, 21 August.

Renewed tariff uncertainty remains an upside risk to EUR/USD in the near-term. The latest 50% tariffs announced on Canada apply to just USD20bn worth of Canadian imports, or 5% of the total, which means the overall US weighted-average tariff rate rises by just 0.3%. This means the move itself should have little impact on broader markets, but the choice of legal authority – Section 338 of the 1930 Tariff act – warrants a closer look. The law in question allows the president to impose tariffs of up to 50% without congressional approval or separate investigations, but it has never been used before. Whether courts allow this could set an important precedent for the final two years of Trump's tariff policies.

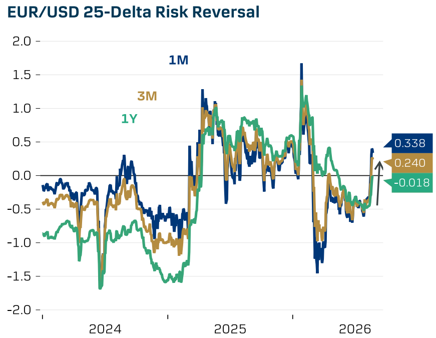
Scott Bessent did not announce new secondary tariffs yesterday despite calling for an 'economic D-Day' over Iran. He threatened secondary sanctions for entities that continue to deal with Iran, but did not specify how the administration plans to monitor compliance with its demands, when could the pressure be applied and how broadly? Needless to say, China is an obvious target for any measures aimed at isolating Iran. *Bloomberg* reported yesterday that the administration is close to applying a new 7.5% tariff on Chinese goods due to excess manufacturing capacity but note that this would be the result of the Section 301 investigations started last spring – rather than a direct response to China supporting Iran. We wrote about the outlook for Section 301 tariffs in *RtM USD - Tariff deadline looms, but macro impact eases*, 14 July.

Chart 5. Ample reserves for the rest of the year



Source: Macrobond, Danske Bank

Chart 6: Sharp shift in EUR/USD positioning



Note: Past performance is not a reliable indicator of current or future results
Source: Bloomberg, Danske Bank

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