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FX

Yield curve dynamics drive the dollar

It looks like the US yield curve is becoming increasingly important for dollar pricing. In simple terms, it seems a flatter curve is dollar-positive and a steeper curve is dollar-negative. In light of a more hawkish Fed outlook, we now expect the dollar to stay stronger for longer

Fed hawkishness and a flatter yield curve should help the dollar

Fed hawkishness versus the debasement trade

EUR/USD continues to bounce around in a broad 1.13-1.18 range – largely determined by US policy settings. In effect, the dollar has done a round trip on the hawkish-dovish-hawkish communication this summer by new Fed Chair Kevin Warsh.

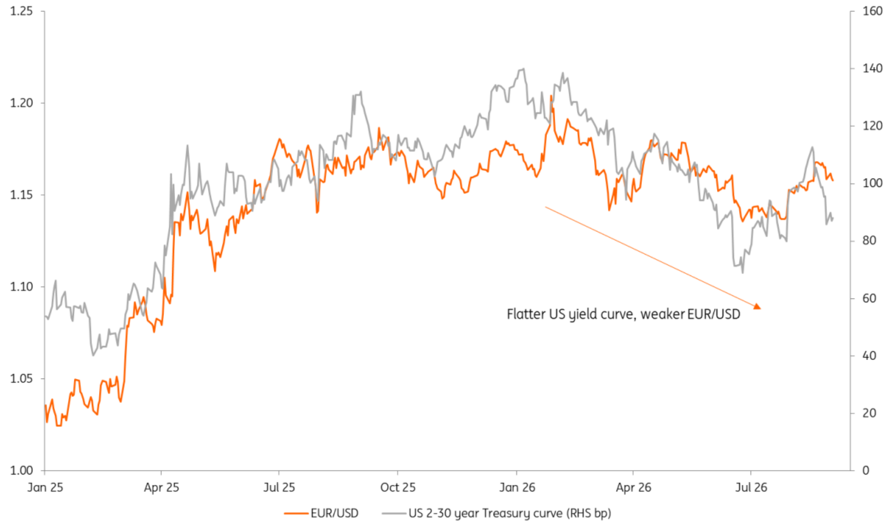
In light of ING's house view switching to a rate hike in September, short-dated US yields well over 4.00% look like they can keep the dollar broadly supported into year-end. That is why we are dropping our year-end 2026 EUR/USD forecast to 1.16 from 1.18 and raising the USD/JPY profile to 160 from 158.

A Fed hike and presumably a hawkish Fed stance into year-end will go some way towards dissuading investors from the debasement trade, which since 2025 has favoured the likes of the Swiss franc, gold and bitcoin at the expense of the dollar.

On the subject of the debasement trade, the recently announced US Treasury liquidity measures at the long end of the curve have unnerved investors and weighed on the dollar. Our forecasts of a stable/stronger dollar into year-end assume that the sell-off at the long end is relatively contained – tighter Fed policy should help. If we're wrong and 30-year Treasury yields surge through 5.50%, steepening the yield curve, then the dollar probably comes lower. Such a move would likely see a generalised rise in volatility and unnerve carry trade positions in high-yield FX.

As to the timing of the next leg lower in the dollar? On a cyclical view, we are now delaying our forecast dollar decline to the second quarter next year. That is when US inflation should have dropped back to 2% and Fed policy expectations can swing back from tightening to easing.

EUR/USD versus the US 2-30 year Treasury curve



Source: Refinitiv, ING

Intervention just got more difficult

Japanese authorities have little to show for the close to $100bn spent in USD/JPY selling intervention in late July/early August. The success of intervention in 2024 was primarily a function of timing Fed policy settings superbly well ahead of a Fed easing cycle which started in September that year.

Fast-forward to today and what should be imminent Fed tightening will work against recent FX intervention and place the burden squarely on the BoJ to surprise hawkishly. A 50bp hike in September seems unlikely, as do back-to-back hikes. Instead, and if the government does place a high priority on a stronger yen, we will need to see some fresh policy initiatives to encourage more investment in domestic assets. A redirection of GPIF investments domestically would be a surprise but would be consistent with the government's local investment drive. Unless something like this is seen, it looks like the Bank of Japan and probably the US Treasury too will be called upon again to sell USD/JPY in the 163/165 region.

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