Nordea

02 October 2026

Macro & Markets: Europe's energy bill meets Europe's debt bill

Marketing communication

Samir Barki

The euro is struggling as the rate differential stops working in its favour and elevated energy prices erode Europe's terms of trade. A crowded political calendar and rising borrowing costs are exposing weak fiscal discipline in key member states.

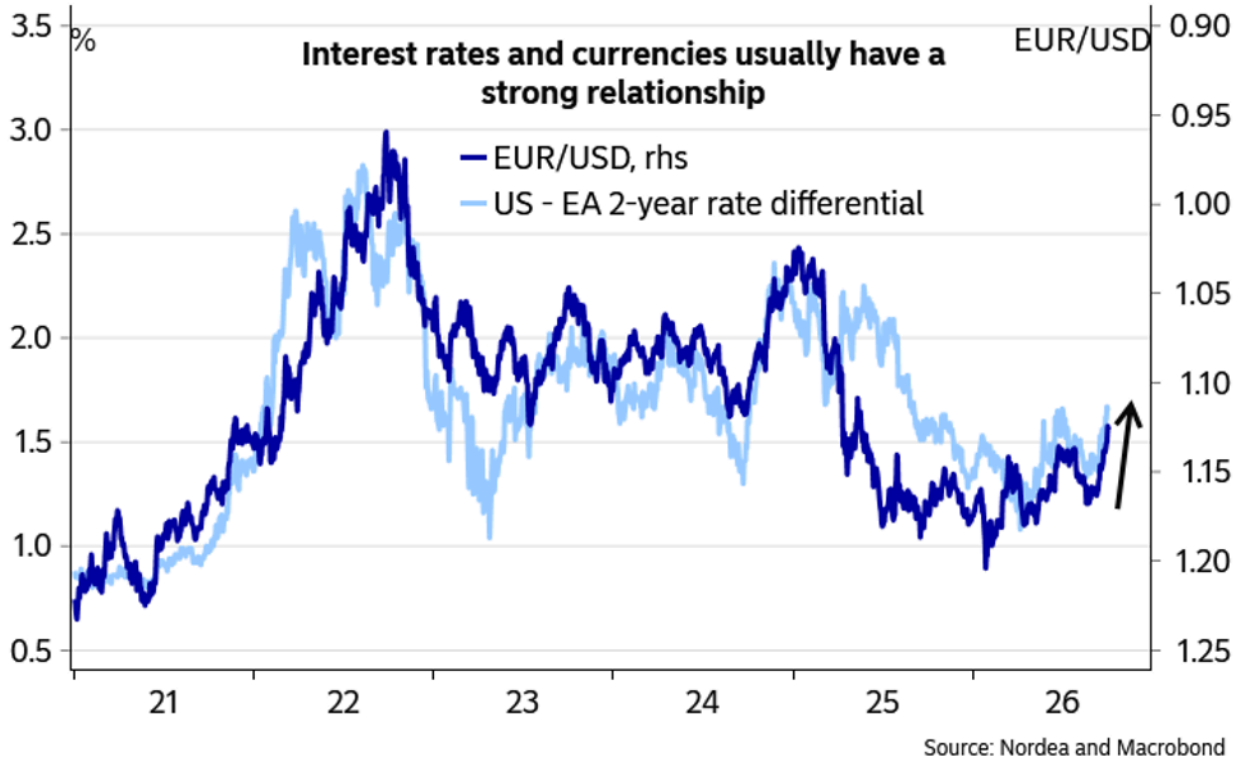
"I don't want to comment on the situation of any individual euro area country specifically. Political uncertainty and budget deficits weigh on investment and activity. We expect growth to be 0.9% in the euro area this year, compared with 0.5% in France. The gap is clear. In addition, when your debt is close to 120% of GDP and not on course to be brought under control, it's a serious matter." Christine Lagarde, President of the ECB, on 28 September

The euro is under pressure on two fronts. The energy shock triggered by the Middle East conflict transfers income from the euro area, a net energy importer, to exporters and weakens its terms of trade. At the same time, France's fiscal problem is testing a currency union with no collective mechanism to absorb it. The ECB can lean against either shock, but not both without cost.

We keep our EUR/USD forecasts unchanged. **Our constructive USD view rests on three pillars:** a rate differential that stays supportive as the Fed tightens while ECB pricing has little room to rise further in light of our baseline; continued capital inflows into US equities and credit on the back of the AI investment boom; and political and debt risks in Europe, which are more likely to hold the market's attention in the short term than US debt concerns while the US economy is booming. Risk aversion adds a fourth: the USD smile strengthened the dollar when the conflict began, and would do so again if tensions escalate. That mix is consistent with 1.14 at year-end and a test of 1.12 in H1 2027, when French election risk peaks and the rate differential is still working in the USD's favour. A recovery to 1.17 in H2 2027 should follow as rate differentials become less supportive for the USD, French political risk fades from the market's focus and US debt concerns move to the fore. **With spot already trading close to our year-end and H1 2027 levels, the risks around these**

forecasts are tilted towards further dollar strength rather than the opposite, and the drivers behind our H1 2027 downside view are already pushing EUR/USD lower. EUR/USD has tracked the US-EA two-year rate differential closely since 2021 and favors the USD (Chart 1).

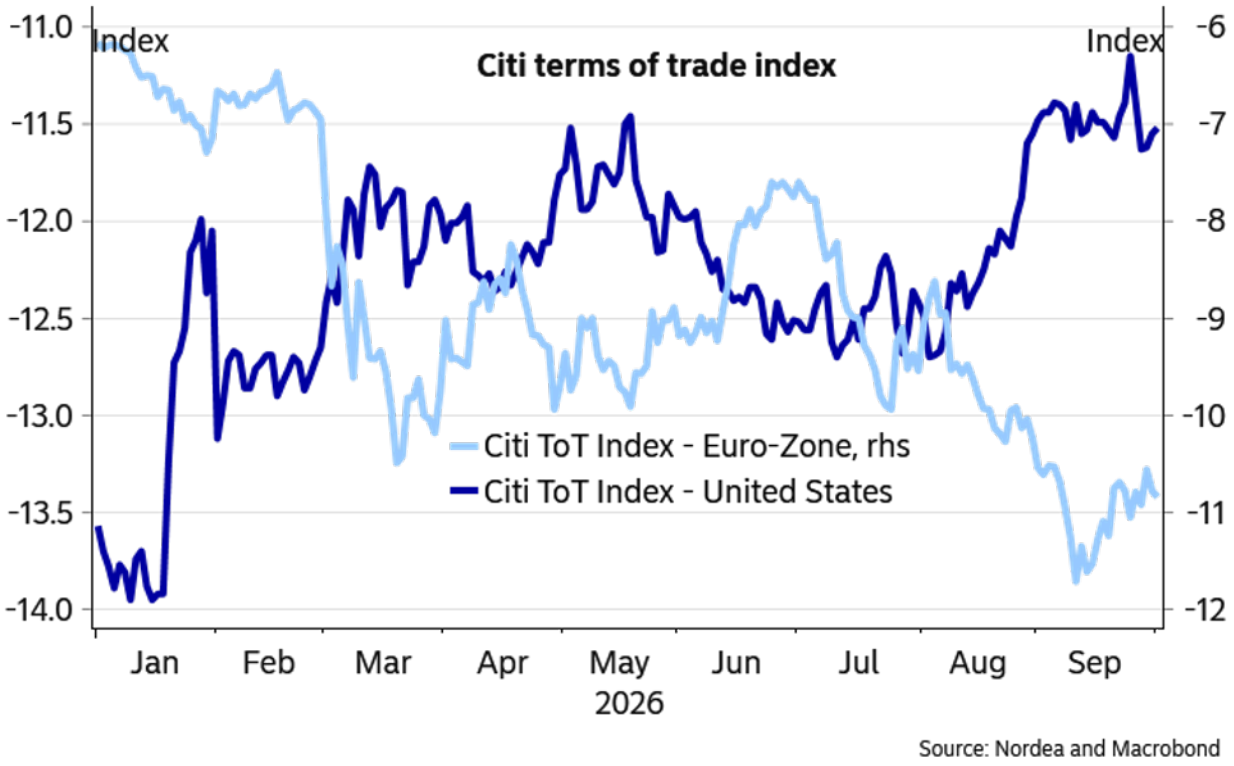
Chart 1: Rate differential still favors the USD



The energy shock hits Europe, not the US

Energy prices remain elevated, and the shock is asymmetric. The US is a net energy exporter, while the euro area is a net importer. Europe buys LNG at global prices, whereas US gas trades at a fraction of the European benchmark. This erodes Europe's competitiveness in chemicals, metals and fertilisers and feeds through to electricity, food and freight costs. **The income transfer to energy exporters is stagflationary for Europe and far less damaging for the US.** The Citi terms-of-trade indices show the divergence clearly: the euro area's index has fallen since January while the US index has improved (Chart 2).

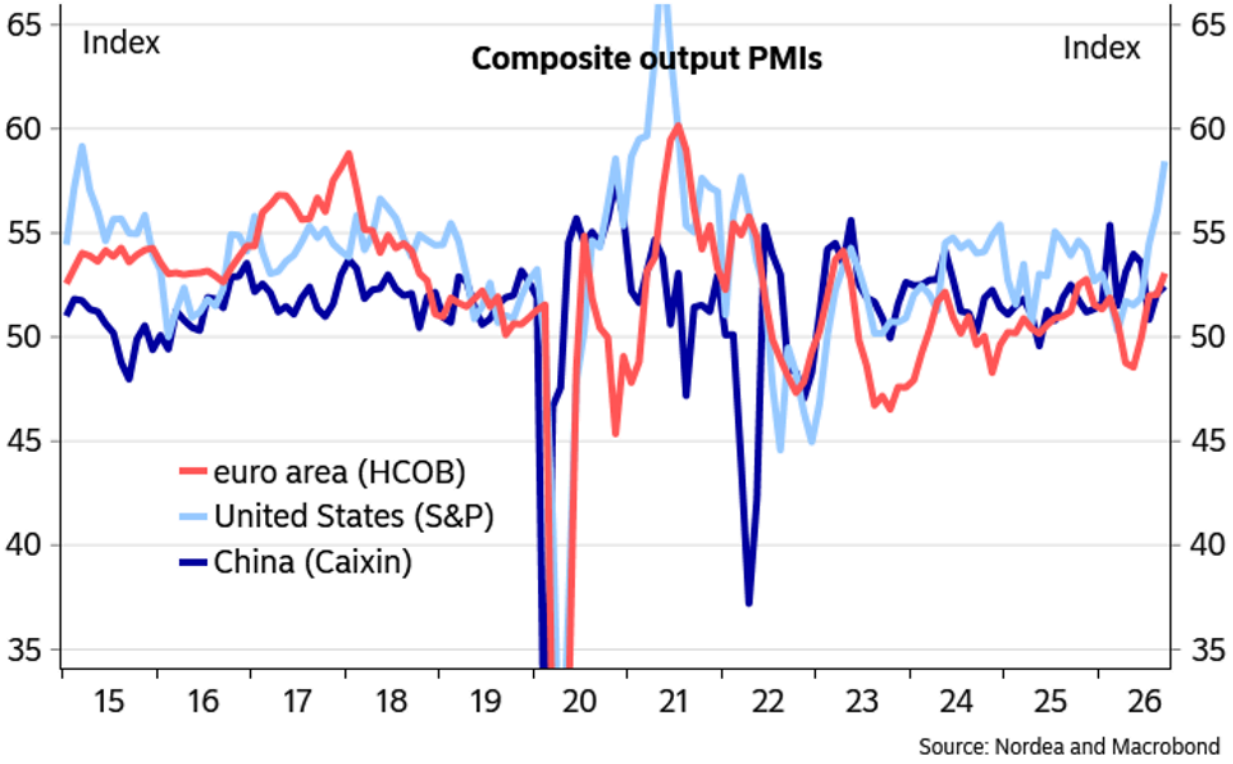
Chart 2: The energy price shock is a terms-of-trade loss for Europe, not the US



Euro-area activity has held up so far. The composite PMI fell into contraction in April for the first time in 16 months, as the war in the Middle East pushed input and output prices up at their fastest pace in more than three years. It has since recovered from 49.1 in the second quarter to an average of 52.0 in the third quarter (Chart 3). **The longer energy prices stay high, the harder that resilience will be to sustain:** oil is still around USD 100 per barrel, and gas prices remain elevated with European storage below its seasonal norm heading into winter. Headline inflation is rising, but second-round effects have yet to show up in the data. Historically, they take time to emerge.

Chart 3: Euro-area activity has recovered, but the US still leads

Nordea



Two central banks, two different problems

For the ECB, the energy shock has two phases. In the first, higher energy prices lift headline inflation and short-end rate expectations, which supports the EUR, provided the shock does not hit risk sentiment hard enough to trigger the dollar's safe-haven appeal. That was the dominant phase after the initial risk-off move at the start of the conflict had faded, at a time when markets were still not fully convinced the Fed would hike before the midterms.

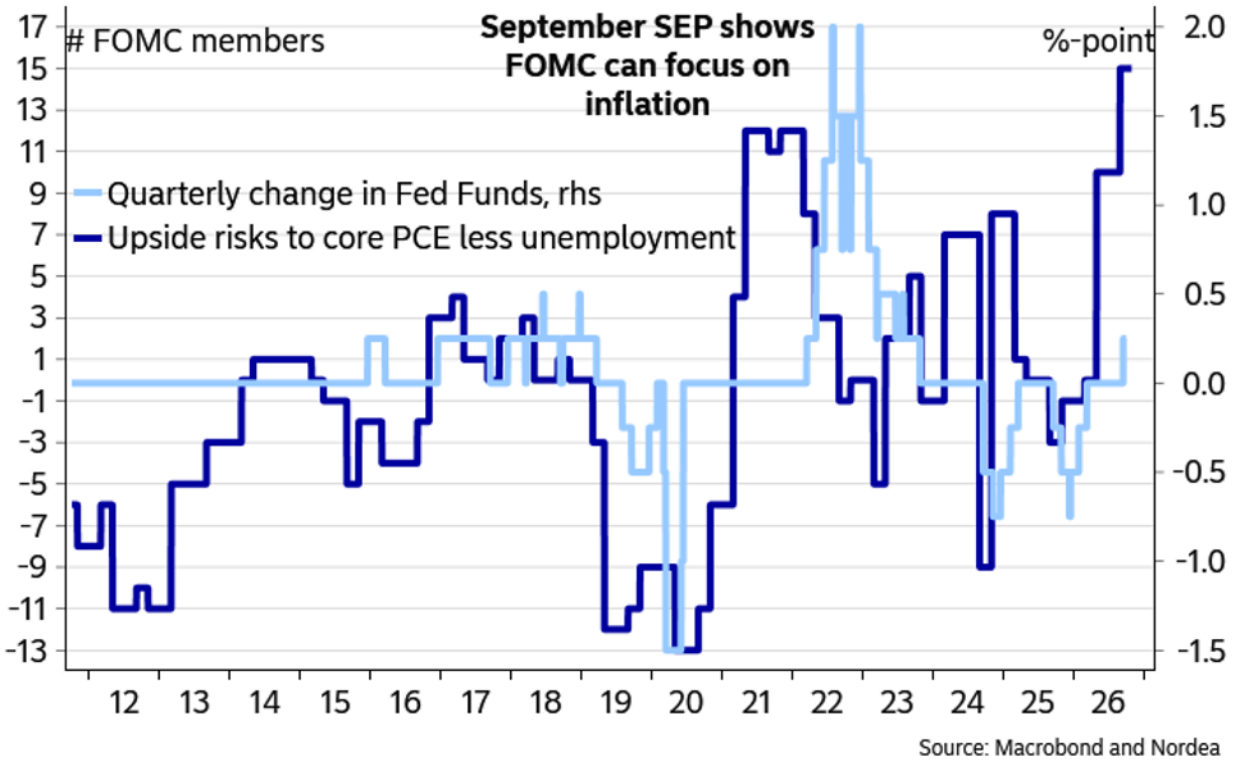
The second phase would be less friendly to the euro. **Our baseline does not assume a significant hit to euro-area growth, but the risk rises the longer energy prices stay elevated:** persistently high prices erode real incomes and demand, and would eventually ease medium-term inflation pressure. The ECB's single mandate may make it slow to acknowledge such a shift, but markets would likely move first. Markets price three further ECB hikes by September 2027; we expect two, the same as for the Fed, and see the risks tilted to the downside relative to market pricing. With that much already priced, there is little left in ECB expectations to support the currency. If the market scales back its ECB pricing towards our call, or below it, while the Fed delivers, the rate differential moves in the USD's favour. This is the logic behind our H1 2027 low.

The Fed faces a clearer choice. Core PCE inflation is 3.0%, still too high, and unemployment of 4.1% is close to full employment. The August core PCE print surprised to the downside, but methodological changes appear to have biased it lower, which limited the market response. Overall, US activity remains resilient and inflation well above target. **Further tightening is needed to stop a tight labour market from feeding stronger wage growth and more persistent services inflation.** The Fed would normally look through a supply

shock, and the White House is urging it to do so. But with demand firm and services inflation sticky, the risk of cost pressures becoming embedded is too high to ignore.

The committee has stayed united, and the lack of a clear trade-off between its inflation and employment objectives gives it room to tighten further (Chart 4). We expect it to follow through with two more rate hikes, with risks tilted towards additional tightening.

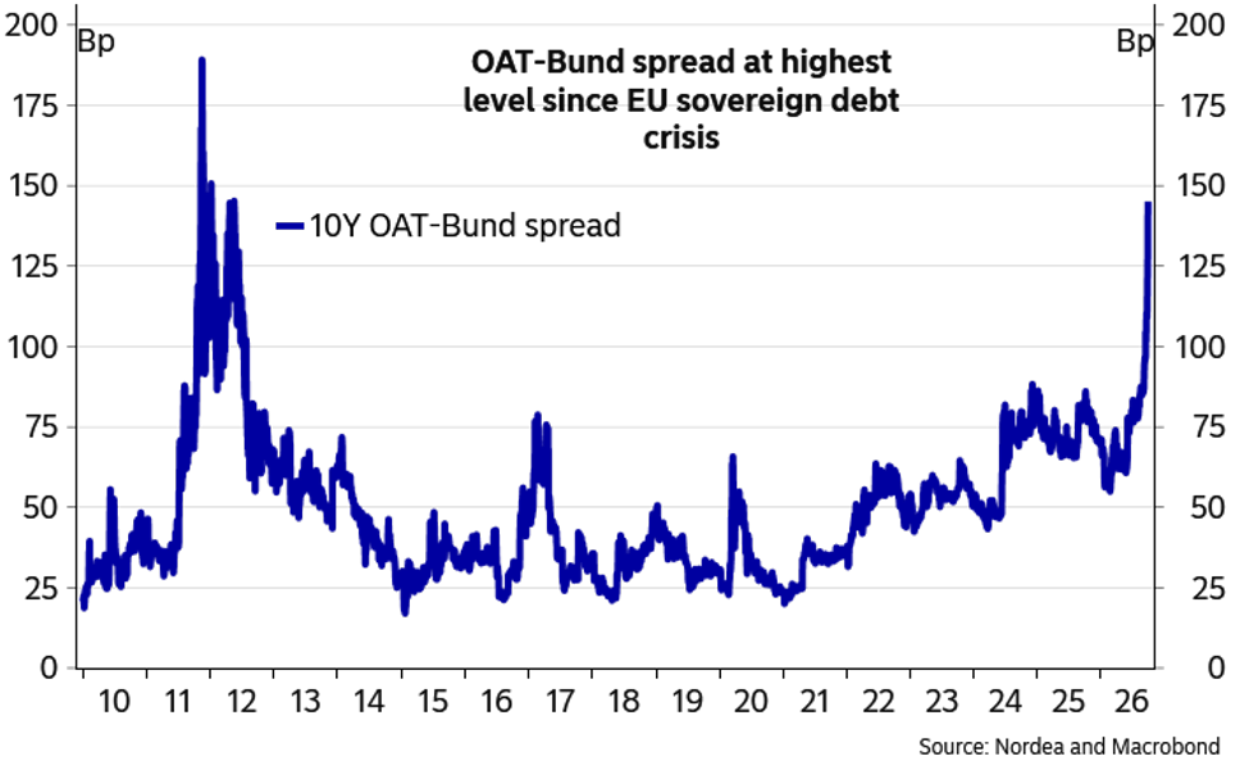
Chart 4: The SEP gives the Fed room to keep hiking



France: the fiscal risk markets cannot ignore

France's presidential election in April and May 2027 is the most market-relevant political event on the horizon, and the campaign is effectively under way. Budget talks in the National Assembly begin in October and November, with tensions likely to peak in early December, as in 2024 and 2025. **No candidate has a credible plan to stabilise public debt, because none is willing to commit to pension reform or tax increases, and that is the key market risk.** Whoever wins will inherit a large deficit without a mandate to close it, leaving spreads vulnerable regardless of the name on the ballot. Markets have begun to price this: the 10-year OAT-Bund spread reached 145bp this week, its widest since 2012, against an average of around 75bp over the past year (Chart 5). We expect further widening: higher yields lift the interest burden, which deepens concerns about debt sustainability and feeds back into spreads. France should remain in focus after the government unveiled its draft 2027 budget yesterday. Although the proposal included EUR43bn in savings, the country's fiscal watchdog said it relied on "optimistic" assumptions.

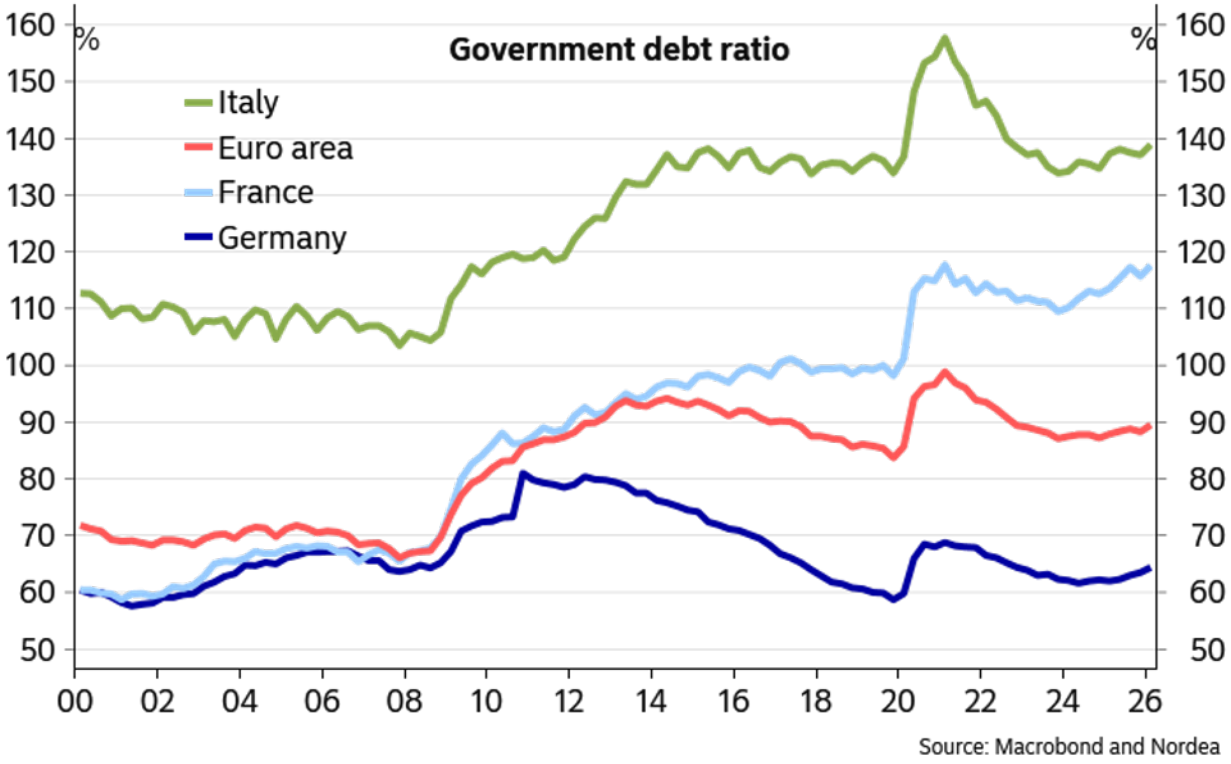
Chart 5: OAT-Bund spread at its widest since the euro crisis



France's debt ratio already sits well above both the euro-area average and Germany's (Chart 6), which leaves little room for a market-driven rise in funding costs. The ECB could also become a factor. If it judged the widening in spreads to be disorderly, it could activate the Transmission Protection Instrument (TPI). **That could contain OAT spreads, but it would also expose the euro area's structural vulnerability by turning a French fiscal problem into a wider concern for the currency union.** It would also create an awkward policy mix: easing financial conditions in one member state while tightening across the euro area would raise questions about the ECB's objectives and independence.

Chart 6: France debt ratio has decoupled form the euro area's

Nordea



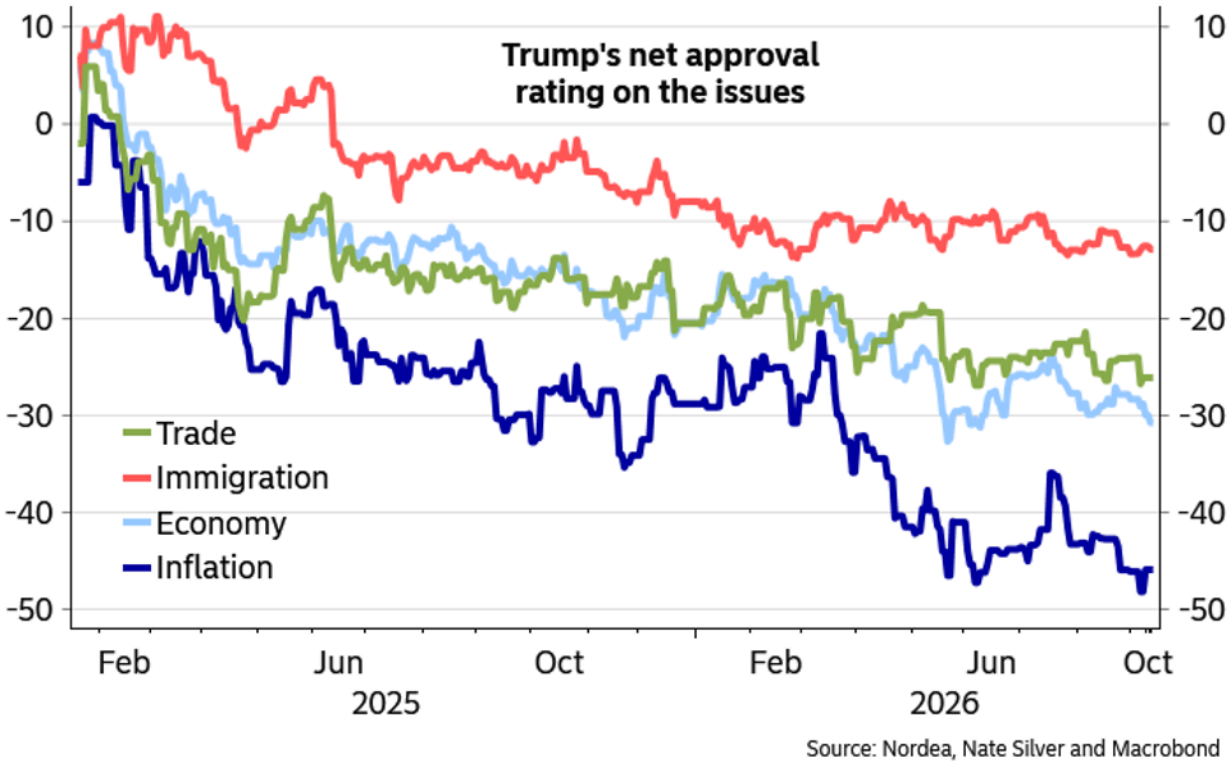
Germany and the US midterms: noise for now

Neither event is likely to move the currency in the near term, but both shape the longer-term backdrop: **Germany for the cohesion of the currency union, the US for the fiscal path behind the dollar.**

In Germany, September's state elections confirmed the Alternative für Deutschland's (AfD) momentum. It won 43.8% in Saxony-Anhalt on 6 September, up 23 points, while the CDU's share halved to 17.2%. Two weeks later, the AfD doubled its vote to 38% in Mecklenburg-Vorpommern and became the largest party, although the firewall keeps it out of government. Its more openly critical stance towards the euro makes its rise a structural negative for the currency union over time. For now, however, it is not tradeable: the federal firewall remains intact, and the next federal election is not due until 2029.

In the US, the midterms are five weeks away, and Trump's net approval rating continues to deteriorate on inflation, the economy, trade and immigration (Chart 7). Democrats lead in House polling, while the Senate race is tighter. For markets, the implications run mainly through fiscal policy. A Democratic sweep would raise government shutdown risk and possibly also a standoff in raising the debt ceiling, a Republican sweep would remove some checks on deficit-financed spending, and a divided Congress would mean gridlock, probably the bond market's preferred outcome. None of these scenarios points to near-term fiscal consolidation, so the election does not change our view.

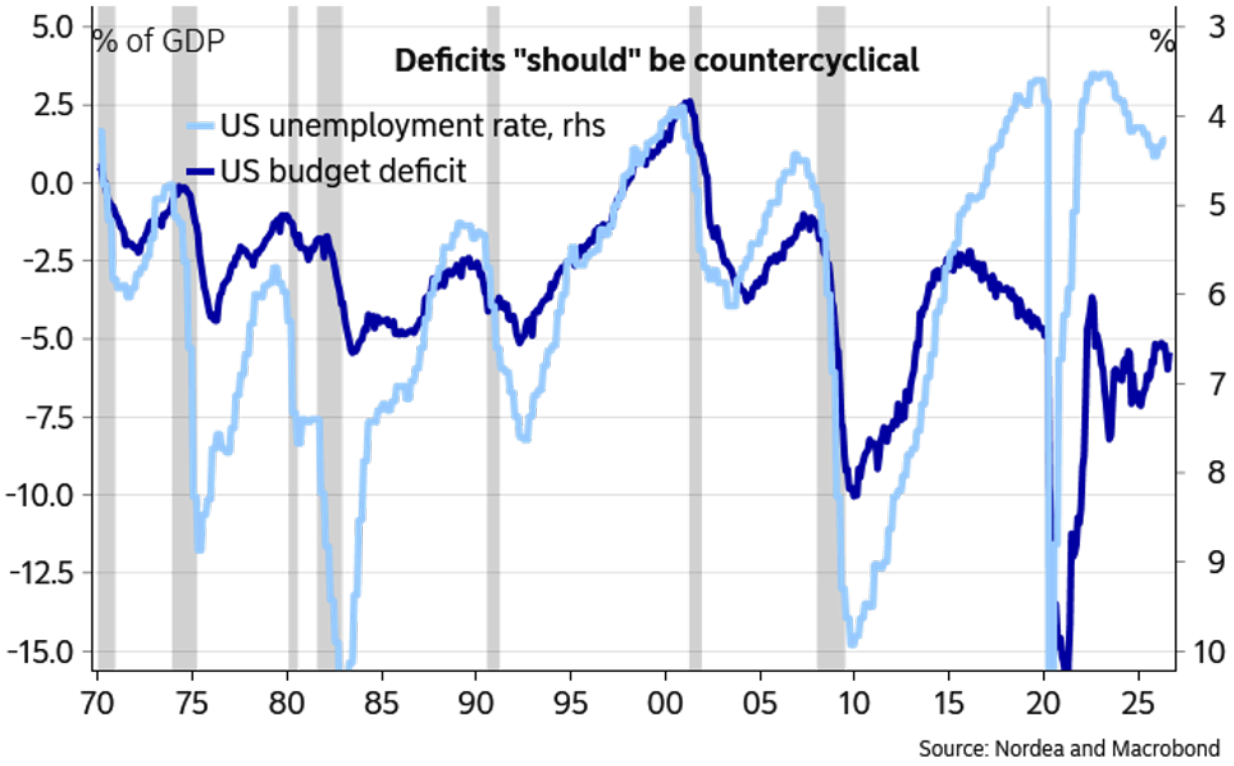
Chart 7: Inflation is costing Trump approval ahead of the midterms



Why the US deficit is not weakening the USD yet

Fiscal policy is unusually loose for this stage of the cycle, with a deficit of 5.4% of GDP despite unemployment of just 4.1% (Chart 8). **Yet nominal growth of 6.3% still comfortably exceeds the average interest rate on outstanding federal debt, which contains the immediate pressure on debt dynamics.** The debt ratio is therefore not on an explosive path for now. The interest bill rises as maturing low-coupon debt is refinanced at higher yields, and if investors demand more compensation for holding long-dated Treasuries, or if slower growth erodes the gap between growth and interest rates, concerns about debt sustainability would weigh on the USD. We expect that to become more material in H2 2027 rather than now: with US growth this solid, debt sustainability is unlikely to be top of mind for markets in the near term.

Chart 8: Fiscal policy is loose when it should be tight



For FX, relative vulnerability matters more than the absolute size of the deficit. The US has one Treasury and one central bank behind one currency. The euro area has a common currency but no fiscal union, and therefore no collective mechanism to absorb debt stress in an individual member state. **In the near term, markets are consequently more likely to punish European fiscal weakness than US debt concerns,** and more so if the ECB were forced to step in, which is not our base case.

What would change our mind

Four developments could challenge our view. First, a sharp fall in energy prices combined with a US government shutdown would ease the euro area's terms-of-trade drag and shift the fiscal focus to Washington. Second, Fed easing under political pressure while the ECB kept hiking would reverse the rate differential and, more importantly, undermine the Fed's independence and credibility, which would weigh on the USD well beyond the rates channel. Third, a correction in AI valuations and deteriorating confidence darkening the economic outlook and prompting Fed easing. Lastly,, a credible French budget package addressing pensions or taxes would reduce the tail risk in OATs, but not the election risk. None is our base case.

Samir Barki
FX Strategist
samir.barki@nordea.com

DISCLAIMER

Nordea Markets is the commercial name for Nordea's international capital markets operation.

The information provided herein is intended for background information only and for the sole use of the intended recipient. The views and other information provided herein are the current views of Nordea Markets as of the date of this document and are subject to change without notice. This notice is not an exhaustive description of the described product or the risks related to it, and it should not be relied on as such, nor is it a substitute for the judgement of the recipient.

The information provided herein is not intended to constitute and does not constitute investment advice nor is the information intended as an offer or solicitation for the purchase or sale of any financial instrument. The information contained herein has no regard to the specific investment objectives, the financial situation or particular needs of any particular recipient. Relevant and specific professional advice should always be obtained before making any investment or credit decision. It is important to note that past performance is not indicative of future results.

Nordea Markets is not and does not purport to be an adviser as to legal, taxation, accounting or regulatory matters in any jurisdiction.

This document may not be reproduced, distributed or published for any purpose without the prior written consent from Nordea Markets.

In the United States, to the extent that this publication or report includes an analysis of the price or market for any derivative and is not otherwise exempt from the applicable U.S. Commodity Futures Trading Commission (CFTC) regulations, it is approved for distribution in the United States to US persons that are eligible contract participants from a CFTC perspective. Nordea Bank Abp is a provisionally registered swap dealer with the CFTC. Any derivatives transactions with US persons must be effected in accordance with the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Nordea Bank Abp, Satamaradankatu 5, FI-00020 NORDEA, Finland, domicile Helsinki, Business ID 2858394-9

Further information on Nordea available on www.nordea.com