**The Investment Institute**
by UniCredit

# Coffee Break

*Coffee Break* is our daily publication, offering topical insights as an intellectual ingot to start the day.

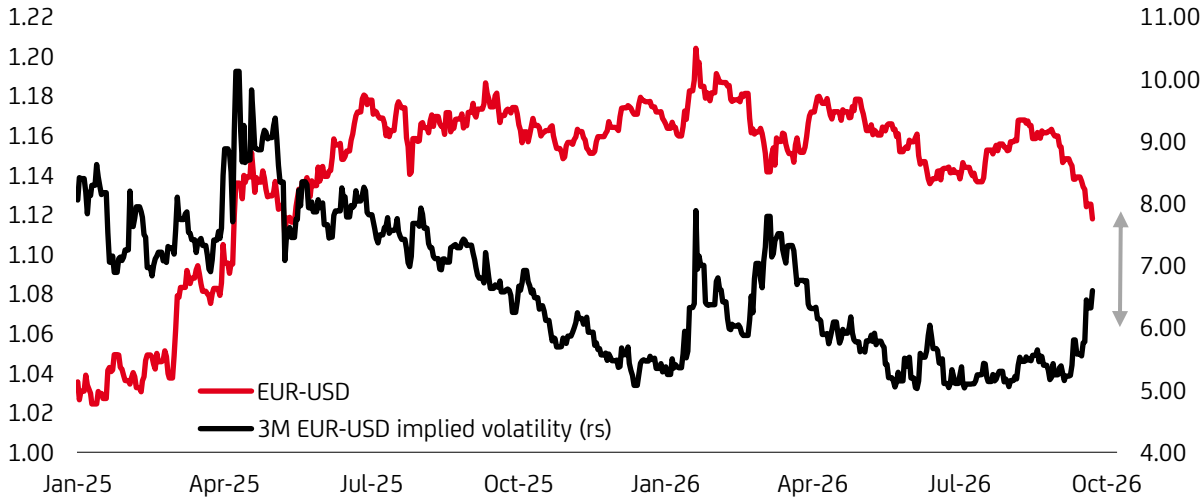
## EUR-USD and the Fed's potentially dangerous game

**5 October 2026**

The USD remains strong, reflecting expectations of heavy Fed tightening and skyrocketing US yields. EUR-USD volatility spiked to around 6.60%, as the pair tumbled below 1.12. The risk of a repricing of Fed rate hike expectations remains and may force the USD to give back part of its strength should the next US data releases show a weaker economy and slower inflation than the Fed anticipates. In the meantime, political tensions and contagion fears across Europe and the European bond market may keep the euro on offer.

**EUR-USD IMPLIED VOLATILITY HAS ULTIMATELY SPIKED AS THE PAIR'S FALL BELOW 1.13 ACCELERATED**

EUR-USD AND 3M IMPLIED VOLATILITY




Source: LSEG, The Investment Institute by UniCredit

**THE CONTEXT**

After reaching a high of 1.1711 in early August, EUR-USD started on a bearish trend, even tumbling below 1.12 this morning. The decline intensified following Fed Chair Kevin Warsh's speech at Jackson Hole, in which he downplayed the series of sluggish economic data released in the US in August, reiterating that the Fed would start hiking rates sooner rather than later. Forward rates were forced to reprice more intense Fed tightening after expectations eased on the back of the disappointing series of US data releases.

The Fed increased interest rates on 16 September by 25bp to 3.75-4.0%, with Warsh stressing that the Fed "still has work to do". His remarks increased expectations of further tightening in the US over the coming quarters. According to LSEG calculations, roughly a further 25bp of tightening is already priced in by December and a total of 80bp by October 2027. This means that the fed funds target range would peak at close to 4.75-5.00%. Rates are also expected to rise outside the US, with forward rates reflecting similar tightening by the ECB (22bp by December 2026 and 72bp by October 2027). The lack of substantial divergence between the two monetary-policy paths suggests that further tightening by the two central banks is unlikely to represent a key driver for EUR-USD. Still, interest rates and long-term yields in the US alone seem to be the major engine behind the overall USD strength. This means that as the ongoing crisis began in the United States, it is from the United States that it must end.

We think that technical analysis, which represents an important trading tool in FX, has also played a strong role in the EUR-USD dive: the fall below the 1.15 level represented the break of the neckline of a bearish head & shoulders pattern visible on daily charts, with the 1.1289 area as a final target. Usually, when a target on charts is reached, profit taking follows. Hence, the genuine drop below 1.1289 (current EUR-USD YTD low is 1.1162 reached this morning) suggests that investors still do not rule out riding a further decline of the euro, making a retest of 1.10 possible in the near term. This is also because growing political tensions across the eurozone (primarily in France and Spain) and fears of contagion across the European sovereign debt market are putting pressure on the euro.



## THE DATA

Our chart shows EUR-USD against 3M implied volatility. Typically, an abrupt fall in an exchange rate is associated with a sharp increase in implied volatility, mainly for hedging reasons. This ultimately occurred early this morning, pushing volatility to 6.60% after the pair dropped below 1.12. Despite its spike, volatility remains below the level close to 8% reached when the Middle East conflict started in February and above the 10% reached following the introduction of the "Liberation Day" tariffs in April 2025. Risk-reversal rates moved further in favour of EUR put/USD call options.



## OUR VIEW

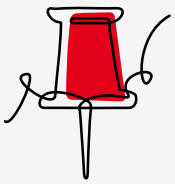
Since EUR-USD broke below 1.13, its outlook has become more fragile, at least in the near term. In addition, central banks have so far done little to calm the ongoing worldwide bond market turmoil, convincing investors that the rise in yields is justified.

However, while a retest of 1.10 for EUR-USD is likely in the near term, we remain cautious about a structural drop below 1.10. This is because, although tensions in Europe are increasing, clear catalysts for a further strong rise in the greenback remain elusive at this point. They include: **1.** a renewed and sharp escalation in the Middle East crisis and **2.** forward curves pricing in even greater tightening in the US, i.e. an upper limit of the fed funds target range above 5.00%.

Indeed, the Fed is playing a potentially dangerous game. By stressing that further monetary tightening depends on evidence that the US economy is healthy and inflation is set to remain high, the next US data releases need to be consistently strong to validate this assessment. In this regard, the US jobs report for September does point in that direction. Otherwise, investors would be tempted to evaluate the risk of Fed overtightening, with a consequent reduction in rate-hike expectations. Likewise, heavier Fed tightening compared to what forward rates are currently pricing in looks quite challenging, as it would require an even stronger US economy or an even-higher inflationary picture. In both cases, the USD may give back part of its current strength, offering EUR-USD a cushion to the downside or even a recovery, albeit a mild one.

Other factors that could take some of the shine off the USD include: **1.** further tensions between the US Treasury and the Fed regarding interest-rate management; **2.** concerns over the trajectory of the US twin deficits and the US debt burden; and **3.** the fact that the US administration may not dislike a less-buoyant greenback ahead of the midterm elections. In our view, when considering all these factors, a definitive EUR-USD stabilisation below 1.10 remains unlikely, especially in 2027. At the same time, however, a return much above 1.15 looks more ambitious than we originally anticipated.

One final remark: in July 2012, ECB President Mario Draghi managed to stem the eurozone sovereign debt crisis with just three words: "Whatever it takes". This time, Kevin Warsh could do the same with only two, while taking some shine off the USD: "too much".



## OTHER THINGS TO NOTE

**Italy approves new fiscal targets, limiting the impact of higher defence spending**

On Friday evening, the Italian government approved its Public Finance Planning Document, formally launching the preparation of the 2027 budget. The 2026 budget deficit target was confirmed at 2.9% of GDP amid exceptionally high uncertainty despite resilient economic growth, which is forecast at 1.0% this year. The government decided to make partial use of the fiscal flexibility clauses for energy-related and defence spending, which will amount to around 0.6% of GDP in both 2027 and 2028. This represents a scaling back of the plans outlined two months ago, when the government signalled its intention to make greater use of the fiscal flexibility available for defence spending. Including the impact of the National Escape Clause, the budget-deficit target for 2027 has been set at 3.4% of GDP, compared with 2.9% under a no-policy-change scenario, while the 2028 target has been set at 3.2% of GDP versus 2.7%. The deficit is then projected to decline to 2.3% of GDP by 2029, with a primary surplus of 2.4% of GDP. The debt-to-GDP ratio is expected to rise to 138.5% in 2027 from 138.1% this year, also reflecting an upward revision to the stock-flow adjustment. It is then projected to embark on a downward trajectory from 2028 onwards. (L. Federico)

**Bolsonaro takes lead in the first round of presidential election**

Flávio Bolsonaro secured 47% of the vote in Sunday's first round of presidential election in Brazil, finishing ahead of incumbent President Luiz Inácio Lula da Silva, who received 45%. The two candidates will contest the runoff on 25 October.

## TODAY'S DATA RELEASES

| Time (CET) | Country | Data | Period | UniCredit | Consensus | Previous |
|---|---|---|---|---|---|---|
| 09:45 | IT | Services PMI (index) | Sep | 53.8 | - | 55.2 |
| 11:00 | EZ | Producer price index, PPI (% yoy) | Aug | - | 7.6 | 5.8 |
| 16:00 | US | Services ISM (index) | Sep | - | 55.0 | 55.4 |

Source: Bloomberg, The Investment Institute by UniCredit

**Author**
Roberto Mialich, FX Strategist Global (UniCredit, Milan), roberto.mialich@unicredit.eu

**Editors**
Edoardo Campanella, Director and Editor-in-Chief of The Investment Institute (UniCredit, Milan)
edoardo.campanella@unicredit.eu
Francesco Maria Di Bella, FI Strategist (UniCredit, Milan), francescomaria.dibella@unicredit.eu

**UniCredit S.p.A**
The Investment Institute by UniCredit, Piazza Gae Aulenti, 4, I-20154 Milan

www.the-investment-institute.unicredit.eu

# Legal Notices

## Glossary

Terms used in the report are available on our website: Our glossary

## Marketing Communication

This publication/video constitutes a marketing communication of UniCredit S.p.A., UniCredit Bank Austria AG, Schoellerbank AG and UniCredit Bank GmbH (hereinafter jointly referred to as the "UniCredit Group") is addressed to the general public and is provided free of charge for information only. It does not constitute investment recommendation or consultancy activity by the UniCredit Group or, even less, an offer to the public of any kind nor an invitation to buy or sell securities. The information contained herein does not constitute an investment research or financial analysis since, in addition to the lack of content, it has not been prepared in accordance with legal requirements designed to promote the independence of investment research, and it is not subject to any prohibition on dealing ahead of the dissemination of investment research.

UniCredit Group, including all its group companies may have a specific interest in relation to the issuers, financial instruments or transactions detailed herein. Relevant disclosures of interests and positions held by UniCredit Group are available at: Conflicts of interest Any estimates and/or assessments contained in this publication represent the independent opinion of the UniCredit Group and, like all the information contained therein, are given in good faith on the basis of the data available at the date of publication, taken from reliable sources, but having a purely indicative value and subject to change at any time after publication, on the completeness, correctness and truthfulness of which the UniCredit Group makes no guarantees and assumes no responsibility. Interested parties must therefore carry out their own investment assessments in a completely autonomous and independent manner, relying exclusively on their own considerations of the market conditions and the information available overall, also in line with their risk profile and economic situation. Investment involves risk. Before any transaction in financial instruments please refer to the relevant offering documents. It should also be noted that:

1. Information relating to the past performance of a financial instrument, index or investment service is not indicative of future results.
2. If the investment is denominated in a currency other than the investor's currency, the value of the investment can fluctuate strongly according to changes in exchange rates and have an undesirable effect on the profitability of the investment.
3. Investments that offer high returns can undergo significant price fluctuations following any downgrading of creditworthiness. In the event of bankruptcy of the issuer, the investor may lose the entire capital.
4. High volatility investments can be subject to sudden and significant decreases in value, being able to generate significant losses at the time of sale up to the entire capital invested.
5. In the presence of extraordinary events, it may be difficult for the investor to sell or liquidate certain investments or obtain reliable information on their value.
6. If the information refers to a specific tax treatment, it should be noted that the tax treatment depends on the individual situation of the customer and may be subject to change in the future.
7. If the information refers to future results, it should be noted that they do not constitute a reliable indicator of these results.
8. Diversification does not guarantee a profit or protect against a loss.

The UniCredit Group cannot in any way be held responsible for facts and/or damages that may arise to anyone from the use of this document, including, but not limited to, damages due to losses, lost earnings or unrealised savings. The contents of the publication – including data, news, information, images, graphics, drawings, brands, and domain names – are owned by the UniCredit Group unless otherwise indicated, covered by copyright and by the industrial property law. No license or right of use is granted and therefore it is not allowed to reproduce its contents, in whole or in part, on any medium, copy them, publish them and use them for commercial purposes without prior written authorisation from UniCredit Group unless if purposes of personal use only. E 25/1