6 October 2026

Reading the Markets USD

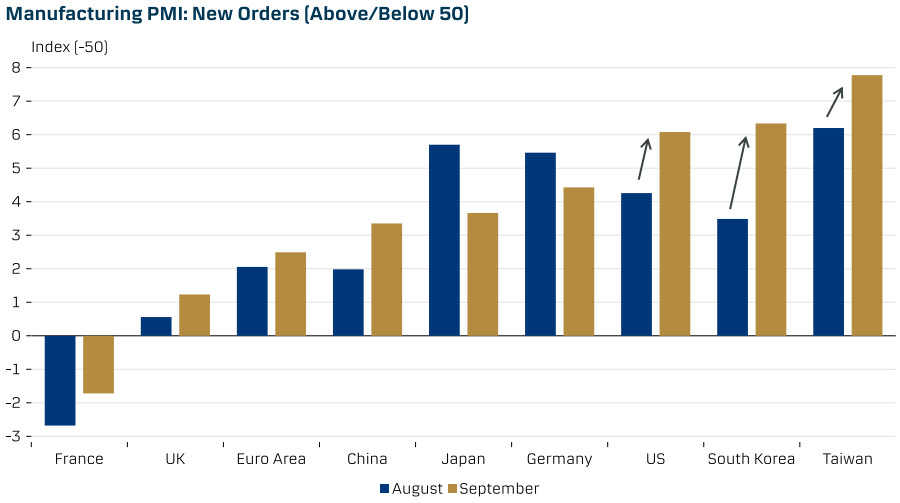
French debt concerns keep EUR/USD under pressure

After the Fed delivered a rate hike at the September meeting, expectations of another hike as early as October quickly emerged but have since faded. We continue to expect the Fed to hike rates again in December and March. **We think monetary policy tightening will proceed gradually, as the FOMC takes time to evaluate the data before deciding to hike rates again.**

In the latest meeting, most FOMC members saw only one further rate hike in 2026. The Fed's Williams and Jefferson both said last week that the Fed could take time to review additional data before deciding whether another hike is necessary. Jefferson and Williams, together with Chair Warsh, form part of the informal FOMC leadership known as the troika, so their views carry more weight than those of individual FOMC members. The combination of recent tightening in financial conditions and last week's data releases supports their case for less urgency. PCE inflation was revised down more than expected, wage growth was low, employment growth declined and the unemployment rate ticked slightly higher. **Unless we see a big upside surprise in September inflation, we think the FOMC will stay on hold in October.**

Despite the soft jobs report and downward inflation revisions, the US growth outlook still looks strong. **We think this will lead to further inflationary pressures that the Fed will eventually be forced to address.** Businesses report input costs near their highest levels since 2022 (Chart 2). Demand for products related to AI capex shows no signs of slowing. The US is heavily dependent on imports from South Korea and Taiwan for the AI buildout, and businesses there and in the US report increased order flow (Chart 1).

Chart 1. No signs of cooling in the AI boom

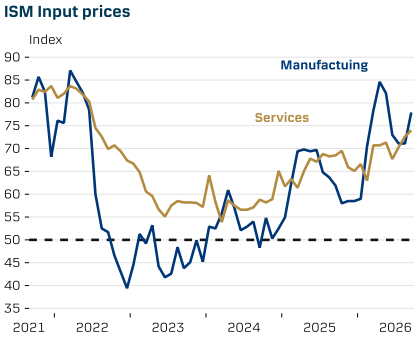


Source: Macrobond, S&P Global, Danske Bank

Key views

- **Macro:** Cyclical outlook remains healthy, even if stagnant labour supply growth weighs on real growth. GDP +2.1% in 2026, in line with consensus.
- **The Fed:** 25bp hikes in December and March. Rates held at 4.25-4.50% for the rest of 2027 (below 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 (1.14).
- **10Y UST:** 5.20% in 12M (below forward at 5.50%).

Chart 2: Businesses report high input prices



Source: Macrobond, US BEA, Danske Bank

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High demand for AI inputs is not just a growth driver, but also an inflation driver. US import price inflation stood at 7.0% y/y in August, the highest level since 2022. Import prices for computers, peripherals and semiconductors rose to 19.1% y/y in August, the highest level on record.

Furthermore, the consumption outlook now looks better after the savings rate was revised up to 4.1% from 3.0% (see Chart 3). Consumers have more room in their budgets for further consumption growth before they eventually need to cut back. **Given the strong growth outlook, we think further tightening of monetary policy will be necessary down the road.**

EUR/USD at 1.12 – what now?

EUR/USD hit our 12M target of 1.12 ahead of schedule, but we think the downward trend will persist towards 2027.

The past week's drop in EUR/USD has been fundamentally different from what we saw through most of September. The UST curve steepened as markets pulled back their most aggressive rate hike plays and long-end term premium turned higher (Chart 4). At the same time, euro area terms-of-trade improved modestly. Crude oil prices have traded relatively steady, but diesel crack spreads and natural gas prices have come off recent highs. On the macro front, the latest US Jobs Report was clearly weaker than we (or markets) expected, and EA flash HICP data was broadly hotter than expected. Under normal market conditions, this would have been a EUR/USD-positive cocktail.

But last week was far from normal. The widening of the OAT-Bund spread drove EUR weakening not only against USD but also against all other G10 currencies. EUR/USD risk reversals continued declining as demand for hedging downside risks grew. The 3M RR is trading down at the most negative level since summer 2024 – long before the US elections and Liberation Day.

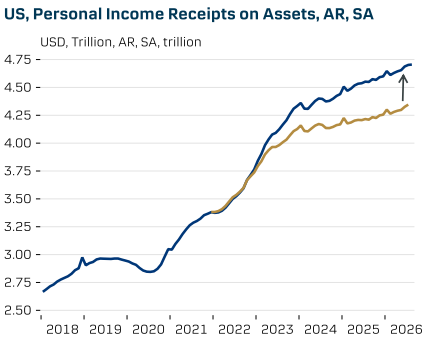
The EURUSD XCCY basis widened on Friday as the cost of USD funding rose in the FX swap market (Chart 5). Basis could well widen further if risk sentiment continues to deteriorate (as it did back in March) and the 3M tenor looks particularly exposed if the cost of hedging over year-end starts to rise. The FX forward curve also steepened last week as USD rates rose.

Hence, from a risk-management perspective, EUR-denominated investors hedging USD FX exposure may consider extending hedges over year-end to hedge the risk of further widening of the basis. But at the same time, the steeper curve and higher outright level make it less attractive to term out hedges, in our view. Option hedges appear increasingly attractive relative to forwards, as the more negative skew can help offset the rising hedging cost due to a widening interest rate differential.

Ultimately, we are not very optimistic that the French will be able to solve their budget issues soon, but even a temporary relief in concerns could lead to a rebound in EUR/USD, given that positioning appears to have swung very short EUR. Naturally, if the OAT-Bund spread widens further and markets begin to speculate with ECB intervention, the decline could easily extend as well.

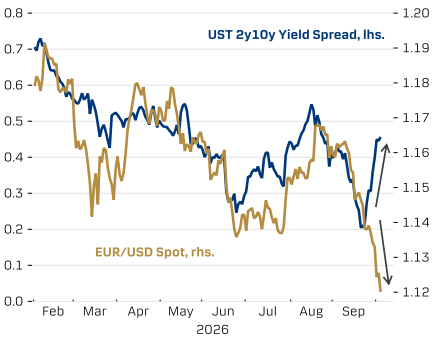
Looking further ahead, the relative macro picture is still unchanged. PMIs and Asian export data show no signs of AI capex boom cooling, but rather the opposite. We believe the Fed will likely pause in October, but the case for hiking later remains intact. Europe continues to struggle with high energy prices, and the ECB finds itself in a difficult situation balancing fiscal stability with inflation risks. We have long argued that the ECB is more likely to underdeliver on markets' rate hike expectations, and in the big picture, the current debt concerns reflect the weak macro fundamentals. **In the 3-12M horizon, we think the declining trend in EUR/USD is likely to persist.**

Chart 3: Household savings rate was revised up, driven by stronger capital gains



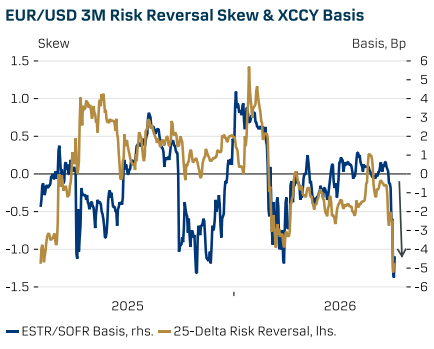
Source: Macrobond, U. S. BEA, Danske Bank

Chart 4: EUR/USD falls even when the UST curve steepens



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

Chart 5: Premiums for USD liquidity and downside EUR/USD protection grow



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Sources: Macrobond, Bloomberg, Danske Bank

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