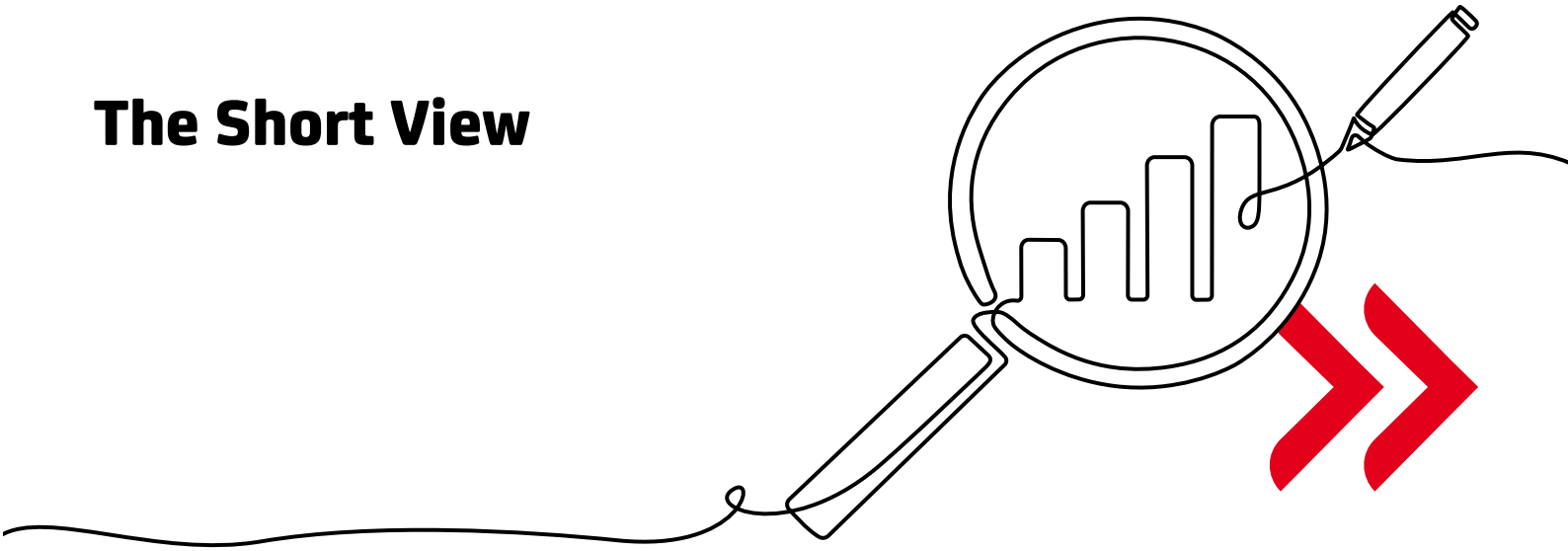
The Short View



The Short View offers insights on key macro and market stories and is designed to promote discussion and debate.

The USD: between soaring UST yields and buying opportunities

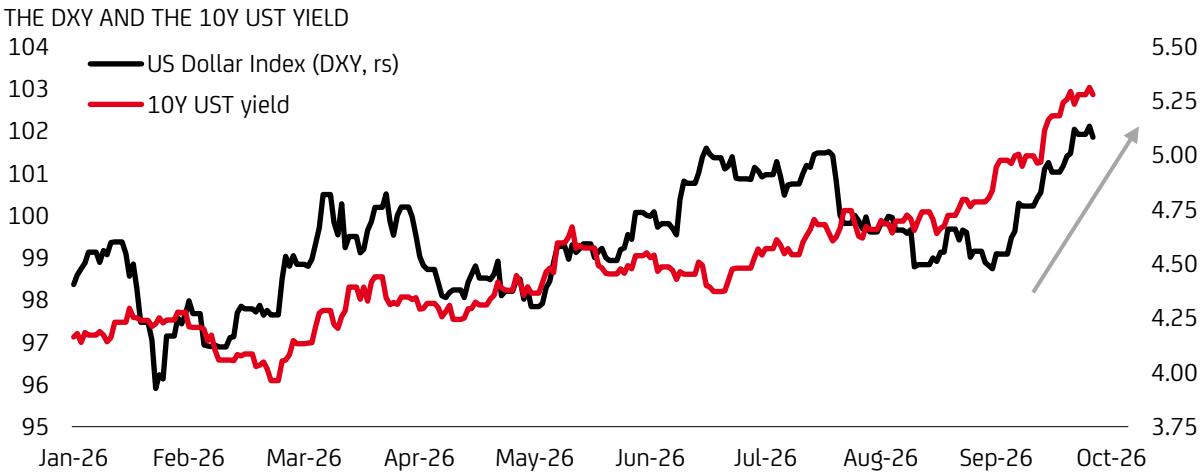
7 October 2026

The recent USD rally has largely been driven by the sharp rise in UST yields amid expectations of aggressive Fed tightening. Three weeks ahead of the next FOMC meeting, however, investors may view current US yield levels as a buying opportunity, potentially taking some of the steam out of the USD rally. However, political climate across the eurozone may still act as a brake against a full-fledged EUR-USD recovery.

1. **The event:** the EUR-USD rebound above 1.12 (up to 1.1276) is proving to be short-lived again, as the 10Y UST yield is back to 5.30%, and thus close to the recent peak of 5.34% after a drop to 5.25% yesterday.
2. **The key question:** Three weeks ahead of the next FOMC meeting (28 October) investors face a choice: will the current bond sell-off continue, or have yields reached levels that represent an irresistible buying opportunity? If the latter view gains traction, the USD would be forced to take some shine off.
3. **Our view:** A decline in US yields could reduce safe-haven demand. However, growing political tensions across the eurozone could hamper a full rebound in EUR-USD.

Price action since early September has again confirmed how interest rates, interest rate expectations and long-term yields across maturities are the primary drivers of the USD, even before considering yield spreads. All things being equal, yield spreads determine the pace of USD moves, while their direction is primarily determined by US interest rates. This relationship is illustrated in Chart 1, which plots the US dollar index (DXY), a measure of the greenback against six major currencies (EUR, JPY, GBP, CHF, CAD and SEK) against the 10Y UST yield. The relationship is broadly unchanged when the DXY is plotted against 2Y and 30Y UST yields.

CHART 1: THE US DOLLAR INDEX AND US YIELDS: A CLOSE RELATIONSHIP



Source: LSEG, the Investment Institute by UniCredit

The USD and soaring bond yields: the story so far

The 10Y UST yield fell to a low of 3.93% on 2 March, just after the outbreak of the US-Iran conflict, and reached 5.34%, its highest level in roughly 20 years, on 5 October.

In our view, the reason behind this sharp rise is more a market overreaction to the signals coming from the Fed on the monetary policy front than something related to long-term fundamentals, such as a structural increase in US growth potential or an abrupt rise in inflation fears.

Central banks are still suffering from having reacted too late to the sharp increase in inflation that followed the outbreak of the Russia-Ukraine conflict in 2022. This delay in hiking rates has made them even more sensitive to sharp increases in price pressure. In addition, the bond sell-off started when the debate over AI shifted from its potential to boost US growth structurally to the dangers associated with it.

Hence, the sharp rise in bond yields, starting in the US and then spreading worldwide, seems more like an overshoot, with the Fed's new communication regime probably playing an important role.

While in theory the Fed intends to provide market participants with less information, in practice it has steadily moved one step ahead of market expectations. In June, markets expected only the removal of the easing bias, but Kevin Warsh, the new Fed chair, revealed the board's intention to hike rates. At Jackson Hole in late August, when markets expected a simple reiteration of the original message on rates, he downplayed a series of US economic data releases that had been less buoyant than expected throughout the month.

Consequently, over roughly three weeks (the FOMC meeting was on 16 September), investors priced back in the prospect of an imminent rate hike after such expectations had been almost wiped out by the US data. The net result was that in practice markets "forced" the Fed to deliver a rate hike in September rather than in December, as it might have originally intended, to avoid a credibility problem.

But on 16 September, Warsh added that the Fed had "more work to do", prompting markets to price in very aggressive tightening ahead. The US forward curve immediately priced in a significant probability of another 25bp rate hike at the October FOMC meeting, an expectation that was almost fully wiped out following the far-from-buoyant US jobs report for September. Forwards ended up pricing in up to 100bp of rate hikes over the following year, implying that the fed funds target range could reach 4.75-5.00%. Moreover, after the FOMC meeting, many Fed officials, including both voting and non-voting members, continued to stress the need for further rate hikes, given that US growth remained solid and inflation was high.

However, as we analyse in our recent Coffee Break (EUR-USD and the Fed's potentially dangerous game, 5 October 2026), US economic data would need to continue to come in very strong and price data would need to confirm that inflation pressures are rising sharply to validate such aggressive rate-hike pricing. Otherwise, investors may start fearing the risk of overtightening, i.e. that the Fed might hike rates too aggressively, leading the US economy into a recession. If so, markets should progressively reprice a less aggressive Fed tightening path, UST yields should retreat from peaks, and the USD should ultimately lose some of its current shine.

At the same time, however, if central banks, and the Fed in particular, do little to calm markets, investors will ultimately be convinced that the sharp rise in yields is justified because it essentially reflects central banks' monetary policy intentions. In 2012, ECB President Mario Draghi solved the European government bond crisis with just three words ("whatever it takes"). Today Kevin Warsh could go one better with only two: "too much".

The USD and soaring bond yields: should I stay or should I go?

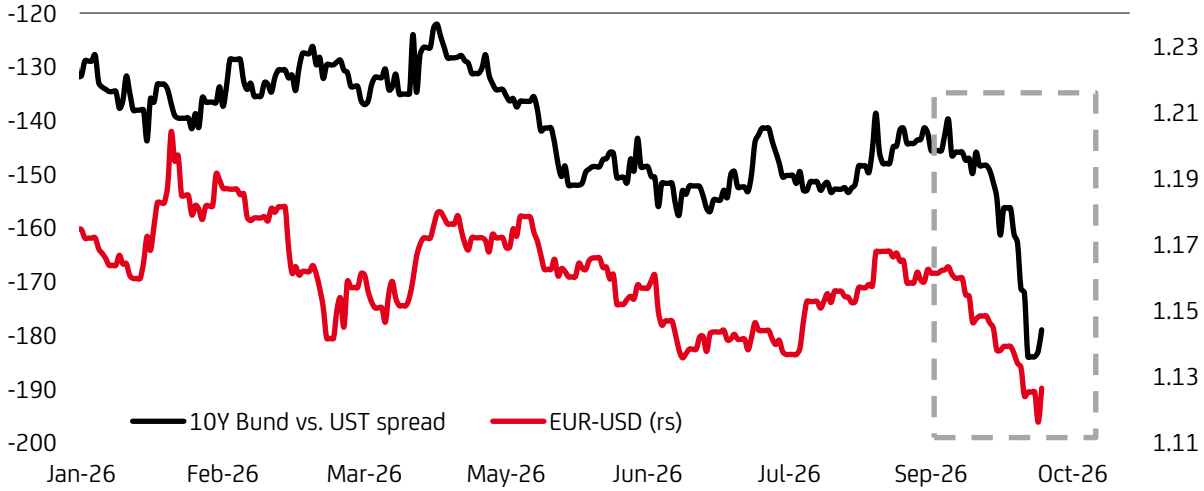
But here is the key point: the next FOMC meeting is three weeks from today, an enormous amount of time, considering the speed at which markets move. In the meantime, investors must solve a clear dilemma and must answer The Clash's famous question: "should I stay or should I go?"

In this case, it means: should I continue to ride the ongoing bond market sell-off as it drives yields worldwide to even higher levels, or should I consider current levels an irresistible buying opportunity, even in the absence of any signal from central banks? Indeed, with UST yields already having peaked at 5.34% and the US forward curve already pricing in a Fed funds target range of 4.75%-5.00% next year, expecting an even higher fed funds target range, and thus higher bond yields, requires a real act of courage. It would mean assuming a trajectory for US economic growth and inflation that is very difficult to envisage.

Early attempts to reverse this course emerged yesterday, with the 10Y UST yield easing to 5.25% and EUR-USD immediately rebounding to 1.1276. However, they proved short-lived and the road is likely to be bumpy, because: **1.** as shown in Chart 2, part of the decline in UST yields is being matched by a corresponding decline in Bund yields, meaning that spreads are not narrowing enough in the EUR's favour to provide the common currency with a significant boost; and **2.** creeping political risk in the eurozone could limit the room for a strong recovery of the common currency, as we analyse below.

CHART 2: SIGNS OF EUR-USD BOTTOMING OUT ARE STILL PREMATURE

EUR-USD AND THE 10Y UST-BUND YIELD SPREAD

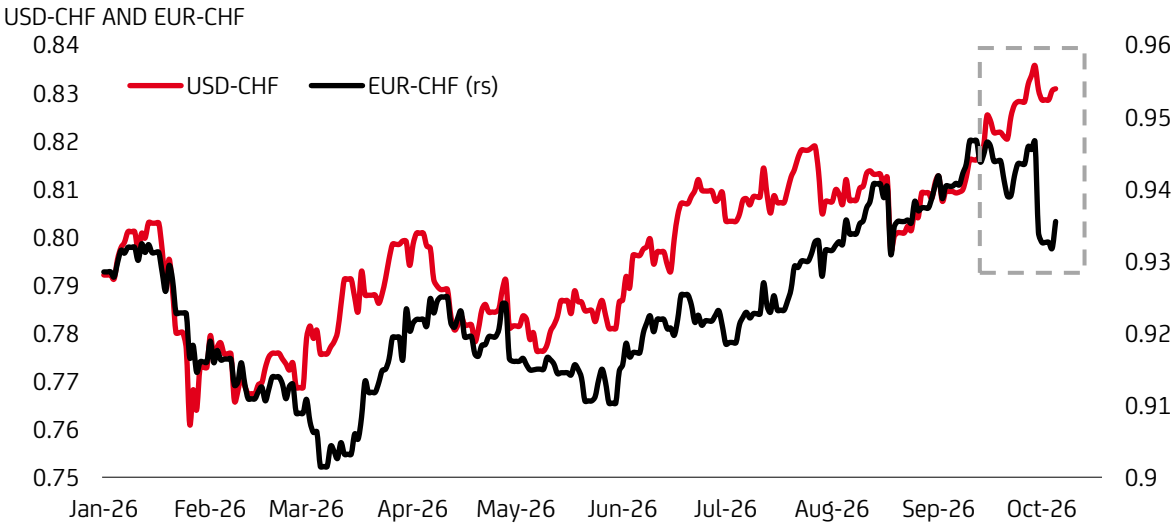


Source: LSEG, the Investment Institute by UniCredit

Can eurozone political tensions hamper a EUR-USD rebound?

If the ongoing market crisis originated in the US and to some extent was driven by the Fed, its resolution will also have to come from the US and the Fed. It is important to stress how the flight to quality spread across asset classes: in bond markets with spreads versus Bunds widening, and in FX, with strong purchases of the USD and CHF. The CHF's role in the current crisis is even more significant given the diverging policy outlooks in Switzerland and Japan. While the BoJ may accelerate its monetary policy normalisation, the SNB is keeping its policy rate at zero, increasing the potential for the Swiss franc to replace the JPY as a funding currency for carry trades.

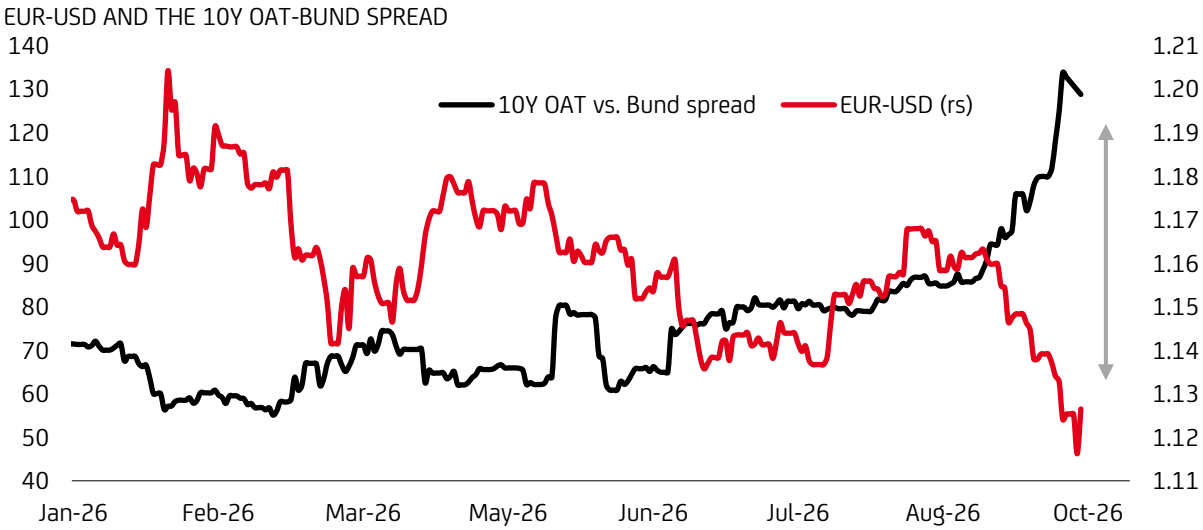
CHART 3: THE CHF APPRECIATED MORE AGAINST THE EUR THAN THE USD



Source: LSEG, the Investment Institute by UniCredit

Still, even if UST yields return to pre-sell-off levels, with the 10Y UST yield slipping back to 4.80%, it's level at the start of September, it does not necessarily follow that EUR-USD would also return to around 1.16, where it stood at the same time. This is because lingering political tensions, initially surrounding regional elections in Germany and subsequently emerging in France and Spain, may represent idiosyncratic risk factors that could hinder a fully-fledged recovery in EUR-USD. This is visible in Chart 4, in which EUR-USD is plotted against the 10Y OAT-Bund spread.

CHART 4: EUROZONE POLITICAL TENSIONS ARE A RISK FACTOR FOR THE EUR



Source: LSEG, the Investment Institute by UniCredit

Of course, we are far from the debt concerns that triggered the European sovereign debt crisis in 2012. But if the political climate across the eurozone heats up further next year, this could create a political risk premium that the euro, too, would have to bear.

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