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FX: The dollar story improves

We see limited scope for a near-term EUR/USD rebound. Key factors for EUR/USD now are a hawkish Fed and a re-pricing of the ECB cycle on French fiscal concerns, which have sent rate differentials to their widest levels since 2022. Neither of those factors appears set for an imminent reversal, leaving EUR/USD to languish in a new 1.10-1.15 range



EUR/USD looks set to stay pressured on wide rate differentials

Dollar enjoys some cyclical strength

We see EUR/USD remaining in a 1.10-1.15 range over the next three to six months, as persistent US rate support and concerns over French debt keep real rate differentials tilted against the euro.

It is hard to believe that EUR/USD traded above 1.20 in January. Those fears of the dollar losing its safe-haven status as European investors reacted to egregious US foreign policy have dissipated this year as US cyclical strength has become more evident. There are no signs of international investors leaving US markets, and by our calculations, foreigners have kept their share of US bond and equity markets steady at around 20%.

As we argued at the time, 'sell America' moments have occurred in the past and tend to be short-lived. Correlations now suggest the dollar is playing its safe haven role again.

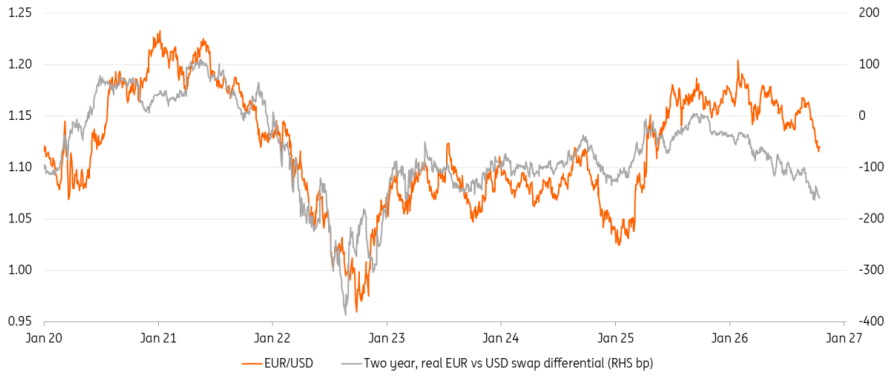
That dollar vulnerability at the start of the year was backed by a weak US employment story and the prospect of further easing. Today, the Federal Reserve is faced with a solid labour market, above-target inflation and the prospect of taking policy into mildly restrictive territory. While we are not looking for the central bank to deliver on all three hikes priced in over the next 12 months, we doubt that the current hawkish Fed pricing will leave the market until next spring. At that point, base effects look likely to bring inflation much closer to the Fed's 2% target.

In contrast, the near 75bp of European Central Bank hikes priced into the market looks more precarious. Heavy losses in French debt dragged euro short-dated swap rates lower in early October, and investors are rightfully questioning how the European Central Bank plans to take policy into restrictive territory at the time of a looming debt crisis.

That growing concern over French debt, which will probably be with us right through to presidential elections next April, should keep real rate differentials wide and keep EUR/USD under pressure. Higher oil and gas prices aren't helping the euro either.

In all, we now see EUR/USD staying offered in a 1.10-1.15 range over the next three to six months, with downside risks should a sharp deterioration in the French debt story demand a greater risk premium for the euro.

Real rate differentials move to 2022 wides



Source: Refinitiv, ING

What could hurt the dollar?

A key risk to our constructive dollar view is a renewed rise in FX hedge ratios among foreign investors. While confidence in the dollar has pushed hedge ratios back to very low levels, any renewed White House intervention in financial, trade or foreign policy could prompt investors to increase hedging and weigh on the dollar.

A big topic for FX strategists over the last 18 months has been foreign investor FX hedge ratios on US assets. Data suggests these have returned to very low levels again as confidence has

returned to the dollar story. As we witnessed briefly in August, when the US Treasury extended the duration of its Treasury buy-back operations, the dollar was hit by White House intervention in financial markets. Any fresh White House intervention in financial, trade or foreign policy, perhaps after the November midterms, could see the dollar come under pressure as investors raise hedge ratios again.

On the subject of the midterms, the base case of the Democrats winning the House looks unlikely to move FX markets much. But a Democratic clean sweep of Congress, and what it means for a potential government shutdown, regulation, and constraints on the AI build-out, could prove a cyclical negative for the dollar.

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