USD: party like it's 1999 or sell off like it's 2002 – the US midterms may hold the key



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- **The AI boom has delivered a positive demand shock to the US economy so far in 2026, boosting both growth and inflation. The Fed hiked rates in September as a result and seems poised to hike again in December and beyond. This has encouraged FX investors to draw parallels between 2026 and 1999 – when the dot-com boom supported the US economy and inflation and forced the Fed to embark on a tightening cycle that only peaked in late 2000. The USD BIS NEER rallied on the back of a growing rate advantage, huge foreign capital inflows into the US and FDI.**
- **The recent underperformance of technology stocks is a timely reminder of the risks for the USD associated with a potential reversal of the stock market rally. The USD gains so far in 2026 have been driven by unhedged foreign inflows into AI-linked US stocks and credit while demand for USTs remained languished due to the very weak US fiscal position and the weaponisation of the USD by the US.**
- **This leaves the USD vulnerable to a potential stop of foreign inflows into risk-correlated US assets during periods of risk-off, especially if demand for USTs stays weak. While we doubt that we are on the verge of a stock market rout reminiscent of 2002 – when the dot-com boom turned into a bust and weighed on the USD – an AI boom-bust cycle has now become the biggest USD-downside risk in 2027, in our view.**
- **The upcoming US midterms could act as a catalyst for further correction in the US tech stocks in the coming months. Before the vote, the market betting odds point at a decisive victory for the Democrats who have called for slowing down of the data centre expansion and imposing stricter government regulations of technological advances at the heart of the AI-investment boom. A slowing AI boom could add to the growth and inflation headwinds in the US and allow the Fed to cut rates in H227.**
- **In our recent FX focus piece, we used the 'USD smile' as a template for our FX outlook but assume that it would start resembling a 'smirk' – to reflect the reduced appeal of the USD during risk-aversion spikes due to growing reliance on risk-correlated foreign capital inflows into the US. We expect the USD to slide towards the bottom of the eponymous smile/smirk, dragged down by a loss of rate advantage and portfolio diversification flows in 2027.**

USD: party like it's 1999…

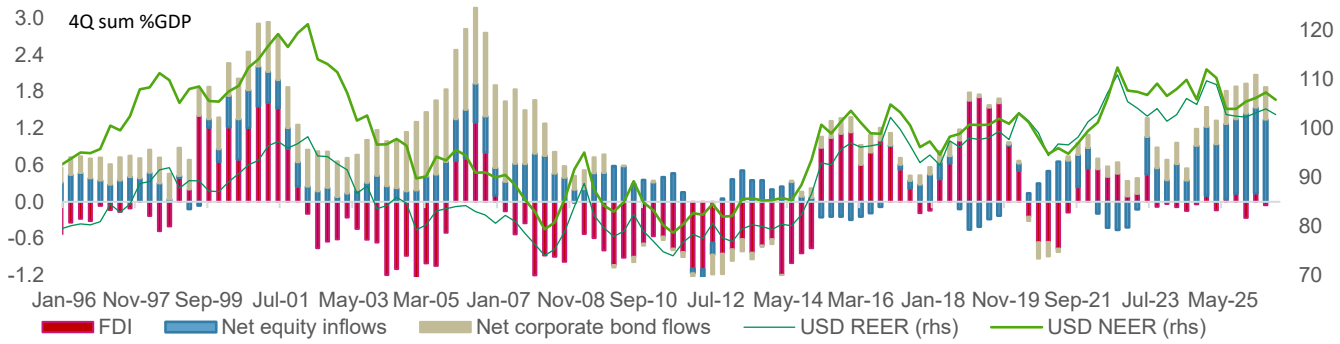
The AI boom has delivered a positive demand shock to the US economy so far in 2026, boosting both growth and inflation. The Fed hiked rates in September as a result and seems poised to hike again in December and beyond. This has encouraged FX investors to draw parallels between 2026 and 1999 – when the dot-com boom supported the US economy and inflation and forced the Fed to embark on a tightening cycle that only peaked in late 2000.

The USD BIS NEER rallied on the back of a growing rate advantage as well as huge foreign capital inflows into the US and FDI between 1997 and 2002 (Figures 1 and 2). In Figure 1, we plot the USD NEER and REER vs the net foreign buying of US stocks and corporate bonds as well as net FDI – shown as a share of GDP. A look at the overall size of the net capital inflows would suggest that the AI-related inflows lag the investment that fuelled the dot-com rally in 1999-2000.

As also shown in Figure 1, the foreign capital inflows into the US reversed sharply in the quarters following the Worldcom accounting scandal in 2002. The Fed further cut its rates aggressively in response to the 2001 US recession and this eroded

the USD relative rate appeal across the board (Figure 2). All this ushered in a period of pronounced USD weakness that lasted at least until 2005.

Fig 1. Net equity and credit portfolio flows as well as FDI vs USD NEER and REER



Source: Crédit Agricole CIB, Bloomberg, TIC

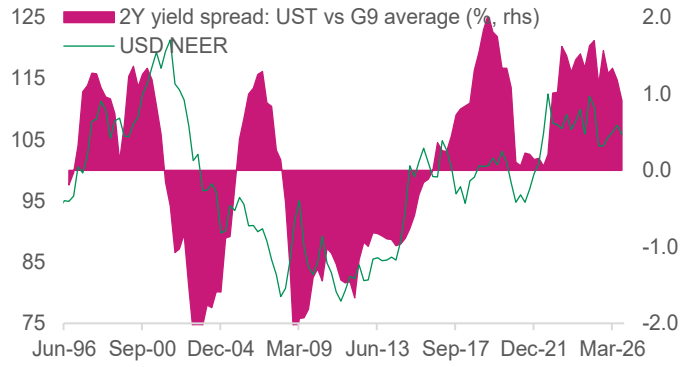
…or sell off like it's 2002?

Recent underperformance of technology stocks was a timely reminder of the risks for the USD associated with a potential reversal of the stock market rally. As highlighted by recent US TIC flow data, the USD gains so far in 2026 have been driven by (unhedged) foreign portfolio inflows into AI-linked US stocks and credit while demand for USTs has languished (Figure 3). Foreign demand for UST could remain weak from here due to:

1. The very weak US fiscal position; and
2. The weaponisation of the USD by the US.

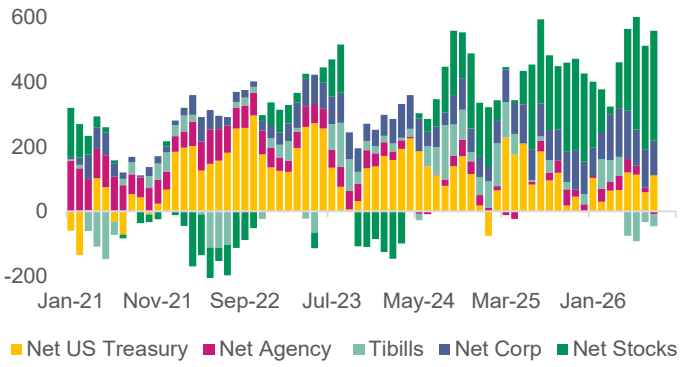
All this leaves the USD very vulnerable to a potential stop of foreign inflows into risk-correlated US assets during periods of risk-off, especially if demand for USTs stays structurally weak. While we doubt that we are on the verge of a stock market rout reminiscent of 2002 (see also Figure 1), an AI boom-bust cycle has now become the biggest USD-downside risk in 2027, in our view.

Fig 2. USD NEER vs spread: 2Y US rate vs G9 average



Source: Crédit Agricole CIB, Bloomberg

Fig 3. Demand for US stocks has dwarfed UST buying



Source: Crédit Agricole CIB, Bloomberg, TIC

Midterms hold the key?

Recent client meetings have suggested that many investors worry that the US midterms could act as a catalyst for a more notable correction in the US tech stocks in the coming months. Ahead of the vote, the market betting odds point at a decisive victory for the Democrats that could allow them to gain control over both the US House and Senate (Figure 4). On the campaign trail, the Democrats have repeatedly called for slowing down data centre expansion and further imposing stricter government regulations of technological advances at the heart of the AI-investment boom.

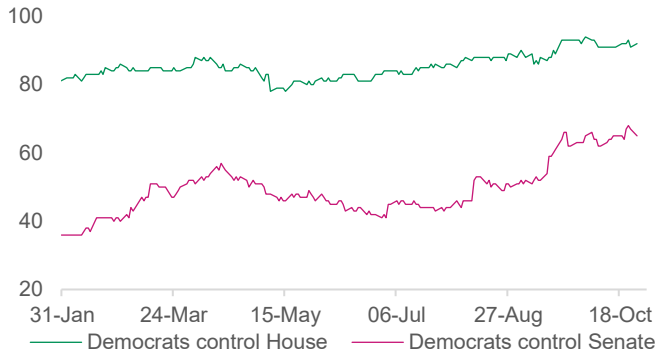
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Investors have already started questioning the longevity of the tech-stock market rally and the ability of the technology companies to continue to spend and invest at the current breakneck pace. Growing borrowing and energy costs have already eroded the profitability of many AI-related investments. Any legislative constraints to data centre expansion and/or an increase of regulatory oversight could add to the costs and reduce profitability.

Furthermore, the impact of the AI-investment cycle has recently transcended the US technology sector and its economic footprint covers several other sectors in the US economy such as manufacturing, construction and services. If we were to experience an AI-investment slowdown in the wake of the midterms, this could add to the growth and inflation headwinds in the broader US economy and even force the Fed to cut rates in H227.

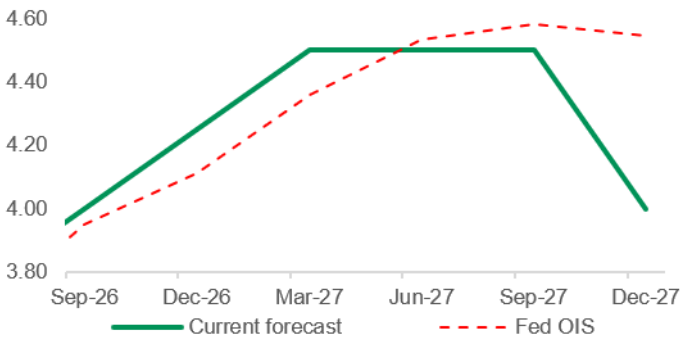
Our US economist expects US growth to cool down and inflation to slow down notably in 2027. The softening economic outlook is partly due to a loss of momentum of the AI-investment boom and further reflects the expectation of renewed slackening of the labour market that could result in the softening of US domestic demand. Because of that, we expect the Fed to reverse some of its earlier tightening and to cut rates twice before the end of next year. This is a more dovish outlook than is currently priced in by the rates markets (Figure 5).

Fig 4. Market betting odds ahead of the midterms: growing expectation of Democrat sweep of US Congress



Source: Crédit Agricole CIB, Bloomberg

Fig 5. Crédit Agricole CIB Fed rate hike expectations vs US OIS implied rate



Source: Crédit Agricole CIB, Bloomberg

USD outlook

From USD smile to USD smirk

Turning to the USD outlook, for our analysis we use the USD smile – the framework that links the currency performance to the prospects for higher US rates and/or risk-aversion spikes. In Figure 6, we show two paths for the USD smile using a green and a green dashed line respectively. Our goal is to illustrate the impact from the increase of risk-correlated capital inflows into the US that we observed in the last three years.

We have discussed that topic on several occasions and most recently as part of our FX market outlook. Our conclusion is that the growing importance of foreign buying of US risk-correlated assets has rendered the USD a less-attractive safe-haven during bouts of escalating risk aversion. This is why the 'new USD-smile' is starting to resemble a 'smirk' that points at less pronounced USD gains in response to risk aversion spikes (eg, the dashed green line in Figure 6).

USD outlook: two scenarios

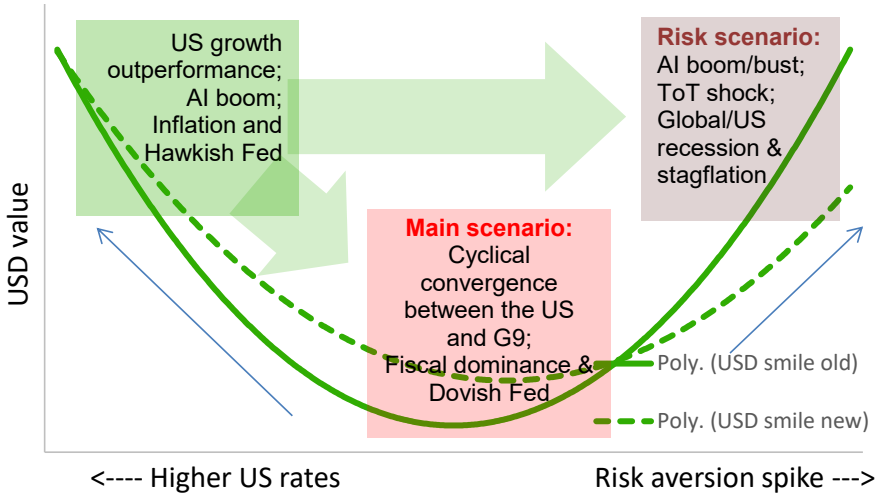
Also shown in Figure 6 are the two main scenarios that we consider for the next 6-12 months.

1. **Main scenario:** under our central scenario, we expect a slowing growth and inflation outlook to reduce the relative rate appeal of the USD and thus push it towards the bottom of the USD smile/smirk (Figure 6). Another important assumption we make is that the slowing AI-investment boom and its negative impact on US domestic demand would erode the international appeal of USD-

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denominated assets. Concerns about fiscal dominance over the Fed and thus lower US rates and yields could abound while de-dollarisation flows could intensify. In all, we expect portfolio diversification out of the USD to go up a notch next year.

Fig 6. The USD smile/smirk and our USD outlook



Source: Crédit Agricole CIB

2. **Risk scenario:** under our risk scenario, we assume that the AI boom turns into a bust and triggers a negative demand shock to the US economy. Another risk we consider is persistently high energy prices that fuel US (and global) stagflationary headwinds. We see market risk aversion surging and thus giving the USD a boost, under the risk scenario. As highlighted above, the USD may struggle to benefit fully due to its growing exposure to risk-correlated foreign capital inflows (eg, the dashed green line in Figure 6).

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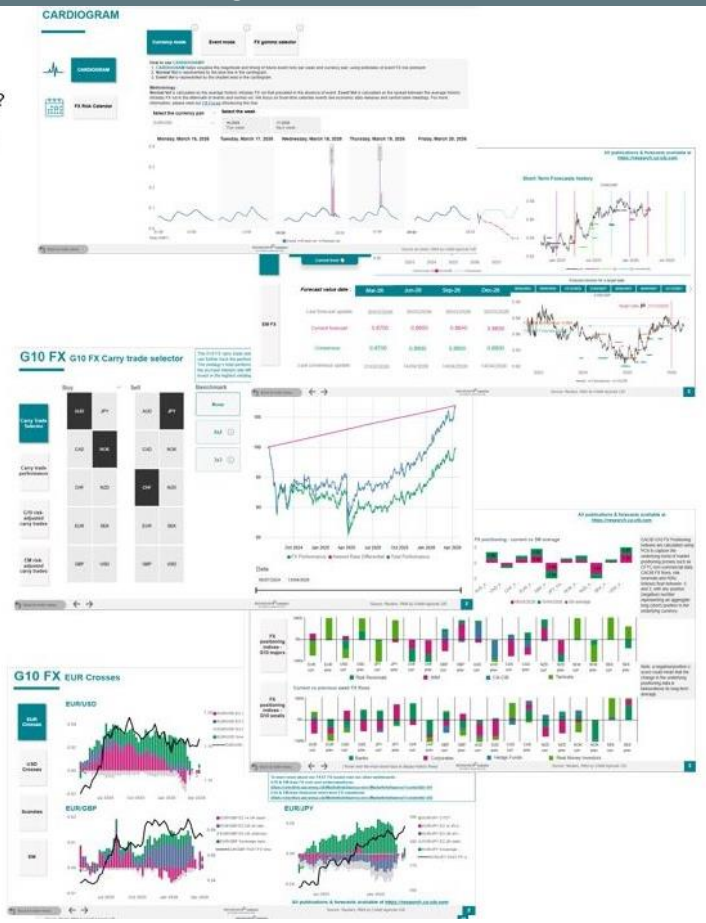
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