

FX: Dollar bears retreat further

It was barely six weeks ago that EUR/USD briefly traded over 1.19. However, seemingly strong activity data from the US, combined with a Federal Reserve less committed to easing, has seen it correct to 1.15. Bears have virtually given up. Low volatility appears to be the most likely path ahead, although we remain slightly negative on the dollar



A more balanced market

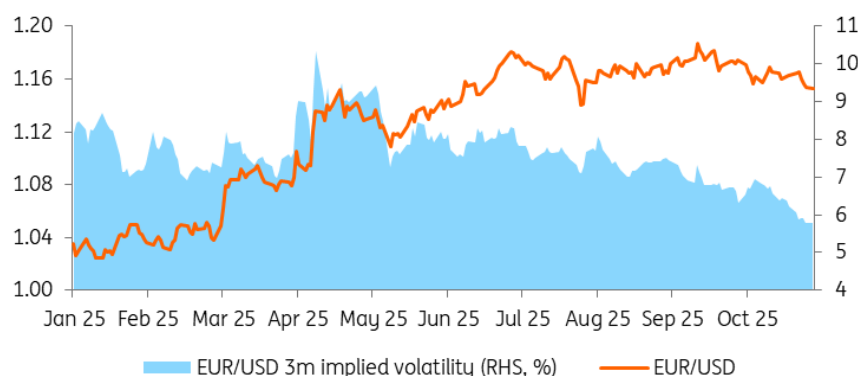
The late October Federal Reserve meeting was the latest event to give the dollar a lift. Whether the Fed truly wants to introduce 'optionality' into the debate over future rate cuts, or genuinely does not know its next step, remains to be seen. Either way, the cornerstone of the bearish dollar consensus – lower Fed policy rates – just became more complicated.

We recently argued that lower short-dated US rates would weaken the dollar, as the buy-side increased FX hedge ratios on US assets again. However, if the policy rate is going to stick around 3.75% for a while, there will be no rush to increase hedge ratios.

The FX option market suggests that investors are more likely to exit dollar shorts in a passive move, rather than actively taking long dollar positions. Well, at least in the case of EUR/USD. Here, three-month traded volatility has sunk below 6.0% and appears poised to drop to the summer 2024 lows of 5.4%. This suggests investors are losing interest in the EUR/USD trend and probably

favour a more listless, range-bound market into year-end.

Investors lose interest in the EUR/USD rally



Source: Refinitiv, ING

Dollar negatives are still present

We think it's too early to call time on the dollar bear trend and the EUR/USD rally. The house call is for three more Fed rate cuts, and there is much uncertainty over both the shape of the US labour market and whether political pressure will bear down on the Fed next year. At the same time, lower energy prices in 2026 should remove one of the dollar's competitive advantages and be welcome news to fossil fuel importers, such as the eurozone.

Although it may not seem relevant at the moment, the euro is expected to receive a boost from eurozone growth in 2026. Our macro team expects growth to accelerate in 2026 as German fiscal stimulus is implemented.

Our 1.20 forecast for EUR/USD for the end of this year is now a bit of a stretch. But year-end seasonality and the true state of the US jobs market should be supportive. And some modest gains next year are still the preferred call.

Sterling in focus

Softer inflation data and expectations of a fiscally tight budget from Chancellor Rachel Reeves later this month led to a drop in UK short-dated yields and sterling in October. Pricing for the 2026 Bank of England (BoE) easing cycle appears to be about right, with the terminal rate currently priced near 3.25%. As such, we don't think sterling needs to fall much further on the BoE story.

The budget is a major sterling event risk. Our base case sees sterling staying supported as Reeves does enough to support the gilt market without prompting a major reassessment of UK growth prospects and the BoE easing cycle. Reeves has to walk a fine line, however. Any further aggressive or less aggressive fiscal tightening is likely to be negative for the pound, with the latter scenario being more perilous.

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