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FX: Cyclical dollar bullishness takes over

After much discussion about a structural decline in the dollar last year, investor sentiment is now swinging towards a cyclical dollar rally. Bearish flattening of the US yield curve is once again the dominant theme, but this is not 2022, and the dollar does not have to rally that far

Investor sentiment is shifting back towards a cyclical dollar rally as markets price a more prolonged period of tighter US monetary conditions

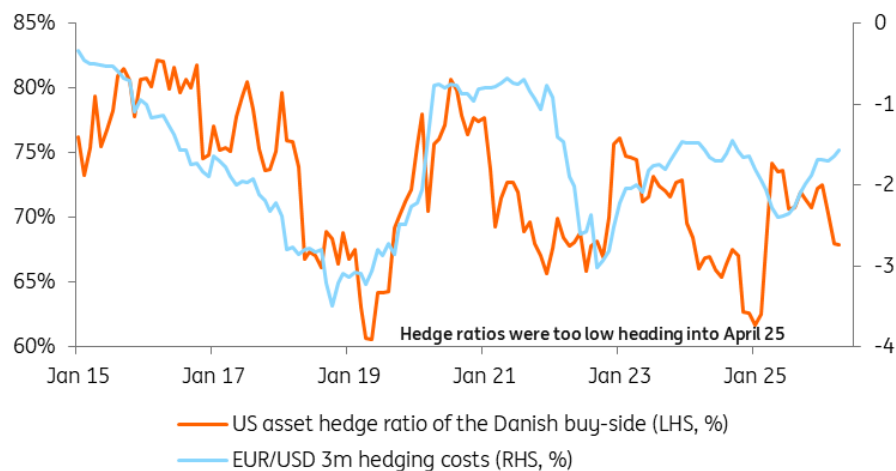
Structural factors postponed

A year ago, shortly after the 'Liberation Day' tariffs in April, the dollar was licking its wounds after a 12% year-to-date decline. At that time, evidence pointed to the European buy-side having been very under FX-hedged on their US investments and being forced to raise their hedge ratios in a hurry. There was also much discussion about a structural loss of confidence in the dollar and the loss of its safe-haven status.

On the subject of hedge ratios, the latest data from the Danish pension fund industry once again points to a European buy-side running dollar hedge ratios below levels which could normally be expected with respect to hedging costs. During March and April this year, dollar hedge ratios were pared back to the 68% area – well below the 73% level which would normally be expected given the cost of hedging US risk back into euros.

This suggests that the buy-side is once again happy to run dollar FX risk. Far from structural factors triggering an over-hedged position, the European buy-side is again drifting back towards under-hedged positions in the dollar.

European buy-side happy to run low dollar hedge ratios again



Source: Danish Central Bank, LSEG

Cyclical factors in play

We had taken a position over the last year questioning the calls for a structural decline in the dollar. None of the data really supported that contention, whether it be the currency share in FX reserve portfolios, transaction preferences, FX preferences for debt issuance or indeed, foreign holdings of US assets.

Instead, we felt the cyclical story would again dominate – and that cyclical story has undergone a substantial reversal over the last six to eight weeks. Far from the benign environment of bullish yield curve steepening in the US as the Federal Reserve prepared to cut rates back to neutral at 3.25%, markets have witnessed bearish flattening on the assumption that the Fed will need to apply the monetary policy brakes after all.

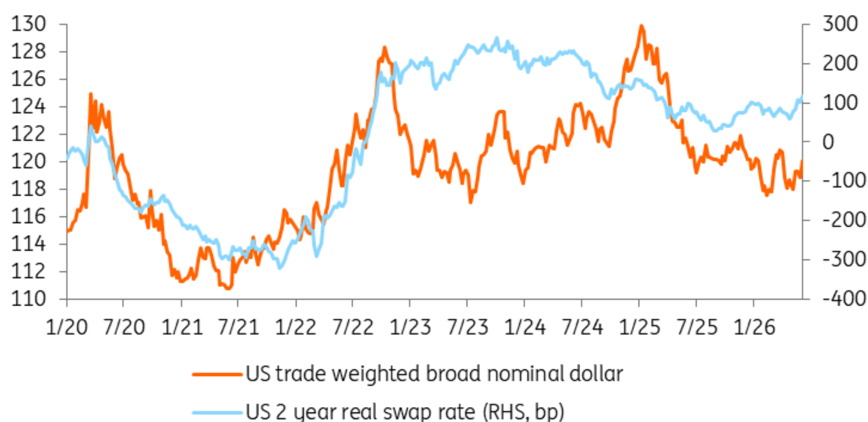
That cyclically bullish dollar story looks set to dominate over the coming months as the Fed rides out the inflation spike at a time of stable employment. The fact that we are pushing our call for a Fed rate cut back from this December and deep into 2027 is clearly going to create some headwinds to EUR/USD. Additionally, higher energy prices through the rest of 2026 – especially our call for a belated pick-up in natural gas prices – mean that we have to cut our EUR/USD forecast profile.

That means EUR/USD could be pressured into the 1.13/14 region over the coming months, and that any pick-up into year-end could lack momentum. And any bullish momentum for EUR/USD could in fact be postponed until next spring/summer if the Fed really is able to bring

rates lower at that time. Instead of a year-end 2026 forecast of 1.20, EUR/USD could be struggling to make it much above the 1.16/17 area.

But we certainly are not looking for the kind of Fed tightening cycle seen in 2022 nor the magnitude of the spike in natural gas prices seen in that year either. That means EUR/USD does not need to trade aggressively lower. Some defensive European Central Bank tightening is also providing some defence to the euro.

US real rates moving higher - but this is not 2022



Source: LSEG, ING

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