A weaker dollar as the Fed moves toward neutral: 3 calls for FX

We are mildly bearish on the dollar into 2026 as the Fed brings the policy rate down to neutral. We see risks skewed to the dollar's downside should a more politically minded Fed take US real rates a lot lower or even be dragged into a scheme to target longer-dated Treasury yields

Fed Chair Jay Powell. We expect the Fed to cut rates back to neutral near 3 to 3.25%

ING's base call: Less restrictive Fed policy delivers softer dollar

Our baseline call sees the Fed cutting rates back to neutral somewhere near the 3.00/3.25% area. With the ECB not touching its policy rate during 2026, FX hedging costs for eurozone holders of US assets should fall further. Three-month hedging costs have already fallen to 1.85% per annum from 2.45% as recently as July and are expected to fall further. Increased hedging activity should weigh on the dollar as it did in April this year.

For reference, the recent ECB Financial Stability report highlighted that eurozone investors, as of the second quarter 2025, held $3.8tr of US equities, $800bn of US sovereign debt and $1.5tr of other US debt securities. With debt investors typically dealing with lower

prospective returns, it will largely be this community which we expect to raise dollar hedge ratios next year.

Our risky call: Risk of negative real rates hurting the dollar

If political pressure mounts on the Fed to cut rates, we will all definitely be talking more about real interest rates in the US turning negative again. Two-year real swap rates have dropped to just 0.75% now from a peak of 2.5% in 2023. Any suggestion that the Fed is taking rates to inappropriately low levels could see real US rates turn negative again and weigh on the dollar.

For reference, when the Fed attempted to reflate the economy after the pandemic, real rates were taken down to the -3% area, and the dollar was under broad-based pressure. Were US real rates to make it back to the -1% area in 2026, we could see the dollar some 5-7% lower from current levels.

Our bold call: QE would be a game-changer for the dollar

Were the nexus of the US Treasury and the Fed to somehow agree that yield curve control was a good idea, the resurgence of quantitative easing would weigh heavily on the dollar. Printing money to keep the long end of the Treasury market in check, while good for growth, would further damage the credibility of the dollar and lead to a much clearer return of the 'risk on, dollar off' trading environment seen in the decade immediately after the Global Financial Crisis.

In the absence of a crisis, we presume the ECB and the Bank of Japan would be operating with much more stable balance sheets than the Fed and that the euro and the yen would witness some meaningful outperformance against the dollar. Under this policy, the US administration could achieve two of its goals at the same time: stable funding levels for the US government and a weaker dollar.

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