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FX: Dollar dances in the dark

The dollar has been enjoying the hawkish reassessment of Fed policy over the last couple of months. In practice, however, there hasn't been much communication from the Fed at all now that Kevin Warsh is stepping back from forward guidance. If we're right with our Fed call of unchanged policy, the dollar can hand back recent gains over the coming months

We're mildly dollar negative into year-end and into 2027

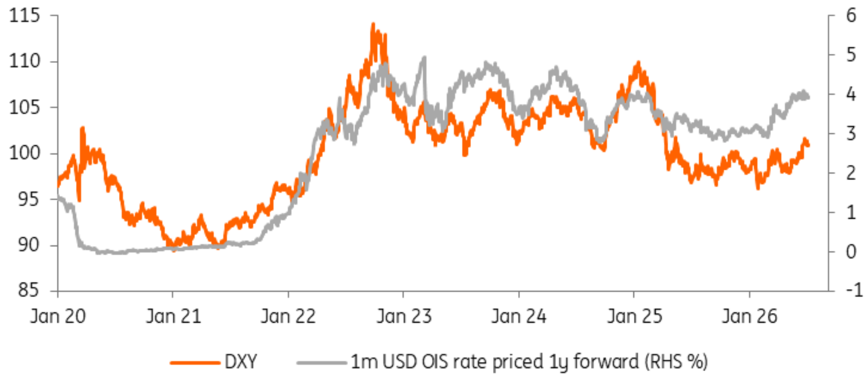
Fed story returns as dominant theme in FX

A stronger dollar was the obvious trade on the back of the attack on Iran. US energy independence and the terms-of-trade shock to Europe and Asia made the dollar the go-to currency in March.

Yet the resilience of risk assets and the stop-go nature of the conflict saw geopolitics take a lesser role in FX pricing over subsequent months. Now the path of Fed policy is firmly back in the driving seat. Here, better US data and a hawkish FOMC last month have the market pricing over 30bp of Fed hikes this year.

However, our house call is that the Fed will ride out the summer without touching rates and if that is the case, the dollar will need to come lower.

DXY dollar index versus short-dated US rate expectations



Source: Refinitiv, ING

3 interacting themes for the second half

1. Lower US rates and lower dollar hedging costs

As above, the house call of an unchanged Fed policy rate into next year is at odds with market pricing of hikes. If the Fed does indeed continue to look through temporarily higher inflation without hiking, short-dated US interest rates will be falling come September. That will bring dollar hedging costs lower and encourage foreign investors to raise FX hedge ratios on US assets. The cost for eurozone investors to hedge US assets, using three-month forwards, has already dropped to 1.5% p.a. from 2.5% over the last year. Those costs could well be narrowing further to 1.00% into next year based on our Fed profile.

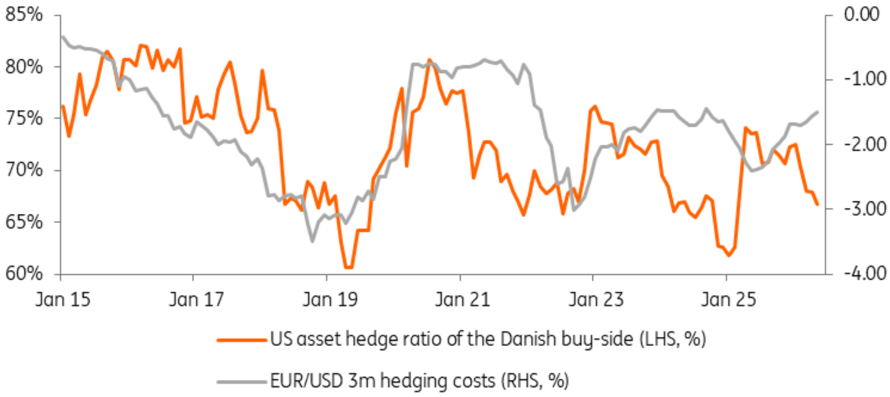
2. Dollar hedge ratios are relatively low

The hot topic in FX markets last year was foreign investors running low FX hedge ratios on their US assets at the start of the year and then aggressively raising them, selling dollars, after Liberation Day. One might say that lightning doesn't strike twice, but once again it looks like investors are running low hedge ratios again. Indications from the Danish buy-side suggest Europeans might be running dollar hedge ratios down at 67% on the view that the dollar is a good store of wealth given relatively high rates and its performance as a safe haven again during this year's Middle East crisis. That 67% hedge ratio is much lower than current hedging costs would normally suggest – which would be more like 73%. Thus, any loss of confidence in the dollar could see a similar adjustment in hedge ratios to that seen last April.

3. Mid-Term US election risk

If hedging costs are to come lower at a time when foreign investors are running low US hedge ratios again, what could be the trigger for an adjustment? Last year it was the erratic policy around tariffs on Liberation Day. This year we have US midterm elections in early November. The Republicans are widely expected to lose the House and withdraw President Trump's options to stimulate the economy with tax and spend policies. This could see a swing back to foreign policy and trade at the White House, which, given current long dollar positioning, could prove a threat to the dollar.

European FX hedge ratios on US assets are dropping



Source: Danish Central Bank, Refinitiv

> Altogether, but largely driven by the Fed view, we're mildly dollar negative into year-end and into 2027. EUR/USD and USD/JPY can end this year near 1.18 and 158, respectively. Clearly, a Fed hike is not in our calculations, and if seen would merit firmer dollar forecasts across the board.

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