

FX Viewpoint

Currencies
Global

USD strength on improving fundamentals

- ◆ The USD outlook has improved on stronger US data and reduced Fed uncertainty
- ◆ A less aggressive Fed may limit gains but could still leave the USD strong against the EUR, GBP and JPY
- ◆ Policy uncertainty and fiscal risks may cause volatility, but we still expect the USD to strengthen gradually

The **USD is in a markedly better position** than it was only a month or so ago, when weaker US economic data, a negative focus on rising Treasury yields and uncertainty over Federal Reserve (Fed) policy had undermined confidence.

We assess the USD through cyclical, structural, and policy uncertainty factors, **all of which are now more supportive**. US economic data have surprised to the upside again, concerns over the Fed's communication have eased after its latest policy meeting, and fiscal concerns have moderated relative to challenges elsewhere.

The main question is how far the Fed will raise interest rates. The two-year Treasury yield, which reflects policy expectations, has risen steadily since February, supporting the USD. Markets now price in around 85bp of hikes by October 2027, while HSBC Economics expects only one further 25bp increase. If the Fed tightens less than expected, USD gains could be more limited, but **may still outperform the EUR, GBP and JPY** if their central banks also deliver less than anticipated.

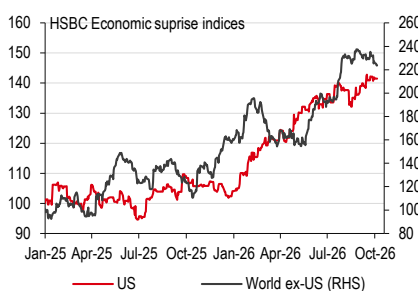
A slower US tightening cycle could also provide some relief to more cyclical currencies, **such as the AUD, and to emerging-market currencies** as a whole.

USD outlook has improved over the last month

Slower-than-expected Fed hikes could limit the USD's rise...

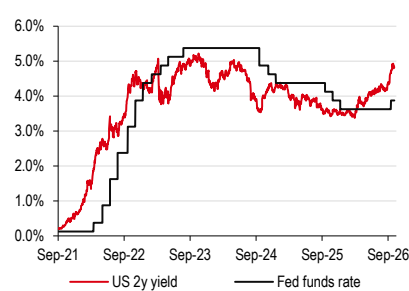
...and provide relief for the AUD and emerging market FX

1. Upside US data surprises have been recovering versus other countries



Source: Bloomberg, HSBC

2. Rising US 2-year Treasury yields signal hawkish shift and USD support



Source: Bloomberg, HSBC

Fiscal credibility concerns are also affecting other major economies. French and Italian government bond spreads versus Germany have widened, while UK markets remain sensitive ahead of the 28 October Budget. **These challenges may help keep the USD supported** against the likes of the EUR and GBP.

Fiscal concerns abroad may support the USD vs EUR, GBP

The US midterm elections could introduce additional volatility. The USD weakened after the 2022 elections alongside falling US Treasury yields, but history may not repeat itself. The relationship between the USD and different components of Treasury yields has changed, **making the election impact difficult to predict**.

We expect the USD to continue its gradual move higher

We expect the **USD to continue grinding higher**, although the pace may be modest and sensitive to Fed policy, Treasury yields and political developments.



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