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US dollar: Stronger for now, but still scope to fall

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The second term of President Trump, along with the Republican Party's control of Congress, has led to a significant strengthening of the US dollar. The dollar index has climbed around 6% since the start of October, marking its seventh straight weekly gain.

US dollar strength has arisen on investor expectations of dollar-positive policies such as domestic tax cuts and widespread imposition of tariffs with the aim of restoring US manufacturing competitiveness.

While we recently revised our currency forecasts to reflect more near-term USD strength, we still see scope for the US dollar to lose ground over the medium term, especially against European peers:

Dollar moves look out of sync with prior rates relationships. Notably, the close historical relationship between the broad dollar index and 10-year nominal US government bond yields suggests the US dollar index should be trading at closer to a 105 level, rather than the 106.6 level at present. Markets' expectations for a shallower path of Federal Reserve rate cuts also look overdone to us—we forecast 125 basis points of additional US rate cuts by the end of next year, as opposed to the 72bps priced as of today. So, we think the US dollar has scope to correct this overshoot by declining.

Markets may be erring by comparing the president-elect's prior policies to today. Unlike 2017, the current US economic environment features the Fed cutting rates and a higher US debt burden, which has implications for long-term funding costs and the market's appetite for US Treasuries. President Trump's proposed second-term policies may widen the twin deficits, undermining the dollar's long-term fundamentals and reversing some of the recent gains.

Trading partners have learnt from history. We believe the global economy is better positioned to handle US trade isolationism than it was under President Trump's first term, with businesses having diversified supply chains and even invested in reshoring to reduce tariff impacts. This may accelerate the shift in investors' focus from politics to economic fundamentals.

Better fundamentals elsewhere point to USD declines. We think investors will increasingly appreciate the contrast between slowing US activity and potential positive Eurozone growth surprises (from a low base) as 2025 unfolds. This realization could lead to lower US-Eurozone yield differentials (across the 2-, 5-, and 10-year points of the curve) and a rebound in the EURUSD exchange rate.

So, we retain a bias for investors to consider using periods of dollar strength to reduce exposure. Strategies include hedging dollar assets, switching cash and fixed income exposure to other currencies, and selling the risk of further USD strength through options as a means of generating yield.

We now expect EURUSD to trade in a 1.05-1.12 range through the early part of 2025, although brief dips beneath the bottom of this range can't be excluded. However, given our view that the dollar is overshooting relative to underlying fundamentals, we forecast EURUSD to trade at 1.12 by December 2025.

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