Economic Research Unit

Economics Weekly

Dollar to remain under pressure as Fed cuts towards neutral

Last week we published our 'Global Watch', setting out our projections for exchange rates and interest rates in 2026. The key call was that we expected the Federal Reserve to cut its policy rate to 3.25%-3.5% by mid-2026, continuing to put downward pressure on the dollar so that the €/$ exchange rate will push into a $1.20-$1.25 trading range early next year. So far, our view looks on track. The 'dot-plot' accompanying yesterday's Fed policy decision indicated the majority of FOMC members see interest rates being cut by a further 50bps to 3.5%-3.75% by December, such has been slowdown in US job creation. The €/$ exchange rate briefly rose above $1.19 following the news.

Last week's ECB forecasts showed higher spending on infrastructure and defence is expected to prop-up Euro Area GDP growth by 0.25pp in 2026, offsetting any negative impact of uncertainty from US tariffs. In this context, it isn't surprising ECB policymakers have given a consistent message that the easing cycle is over for now. So we see ECB rates on hold until mid-2026. In contrast, November's Budget will be a key date for the sterling and UK rate outlook. Should the fiscal consolidation of tax hikes and spending cuts exceed £20bn (0.7% of GDP) it may persuade investors the Bank of England has more scope to cut rates and put sterling under pressure. Nonetheless, on balance, we still see sterling trading in a 84-89p range against the euro into 2026.

Our key projections for exchange rates and central bank policy rates: Last week we published our 'Global Watch' setting out our key forecasts for 2026. A key call is that the €/$ exchange rate will push through into a $1.20-$1.25 range in H1 2026. The dollar is likely to remain under pressure as the Federal Reserve cuts it's policy rate towards 3%. Concerns on the US fiscal position and volatile policymaking from the Trump administration will also weigh on the dollar. In contrast, the ECB looks set to remain on hold until at least mid-2026. We expect the Bank of England will have room to cut interest rates by 50bps to 3.5%. We expect sterling will continue to trade in it's current range of 84-89p against the euro, although the November 26th budget will be a key event.

Fed's September rate of 25bps cut to 4-4.25% just the beginning: The 'dot-plot' and economic projections accompanying the Fed's September 17th decision indicated the majority of FOMC members expect two further 25bps cuts to 3.5%-3.75% by end-2025 and to 3.4% by end-2026. In his press conference Fed chair Jay Powell described September's decision as an '*insurance cut*' reflecting the recent softening of the labour market. Nonetheless, the FOMC's forecast is still for robust GDP growth of 1.8% and 1.9% through 2026 and 2027, with the unemployment rate staying low at 4.4% next year and core PCE inflation above target at 2.6%. The overall impression is that the Fed is still unsure what message to take from the recent flattening-off in employment growth. However, clearly most policymakers still intend to cut rates, taking a benign view that any upward pressure on consumer prices from US tariffs will have a once-off impact on prices.

ECB forecasts show surprisingly resilient Euro Area economy: Last week the ECB revised up it's projection for Euro Area GDP growth to 1.2% in 2025. This reflected resilient GDP data for H1, with consumer spending and investment making solid contributions. However, recent PMI surveys have also shown signs that conditions in the manufacturing sector are gradually improving. Crucially, the ECB also expects higher infrastructure and defence spending, particularly in Germany, to add 0.25pp to Euro Area GDP growth in 2026. Although the forecast for HICP inflation is 1.7% in 2026, core (excluding energy and food) inflation is expected to be 1.9% only marginally below the 2% target. So in this context, it isn't surprising that ECB policymakers have given a consistent message that the easing cycle is over for now.

November 26th Budget key event for UK rate outlook and sterling: To no great surprise the Bank of England kept rates on hold at it's September 18th policy meeting. Given still elevated UK CPI (3.8%) and wage (4.7%) inflation, markets see limited scope for the Bank of England to loosen policy. Options are pricing in just one 25bps cut to 3.75% by April 2026. However, this view could change. There is now a consensus the November 26th Budget will see tax rises and spending cuts of at least £20bn (0.7% of GDP). However, this would still leave Chancellor of the Exchequer Rachel Reeves with limited headroom vis-a-vis her fiscal rule to achieve a current budget balance by 2029/30. Should the Labour government choose to implement a sharper fiscal adjustment, still early-on in the life of the parliament, it may well persuade investors the Bank of England will have greater scope to cut rates and put sterling under pressure.

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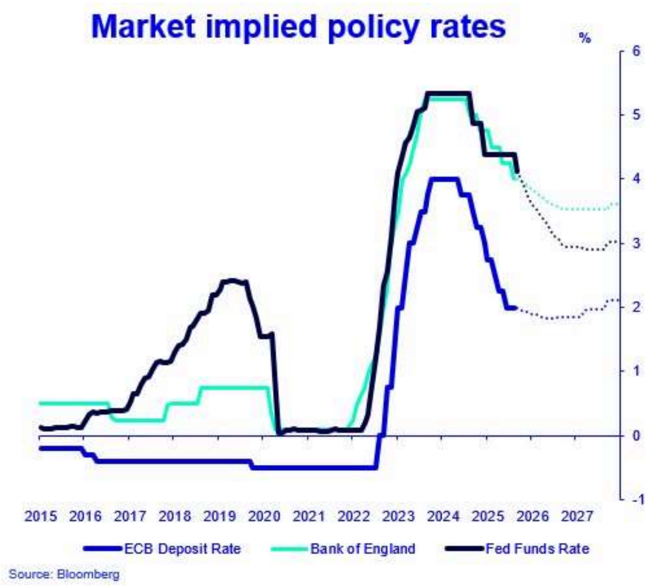

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