FX Comment

Treasury issuance, foreign demand, and the US dollar

- Bearish dollar outlook at consensus levels...
- ...where record-high debt issuance will test the outlook
- Foreign demand and moderation will be key for the dollar

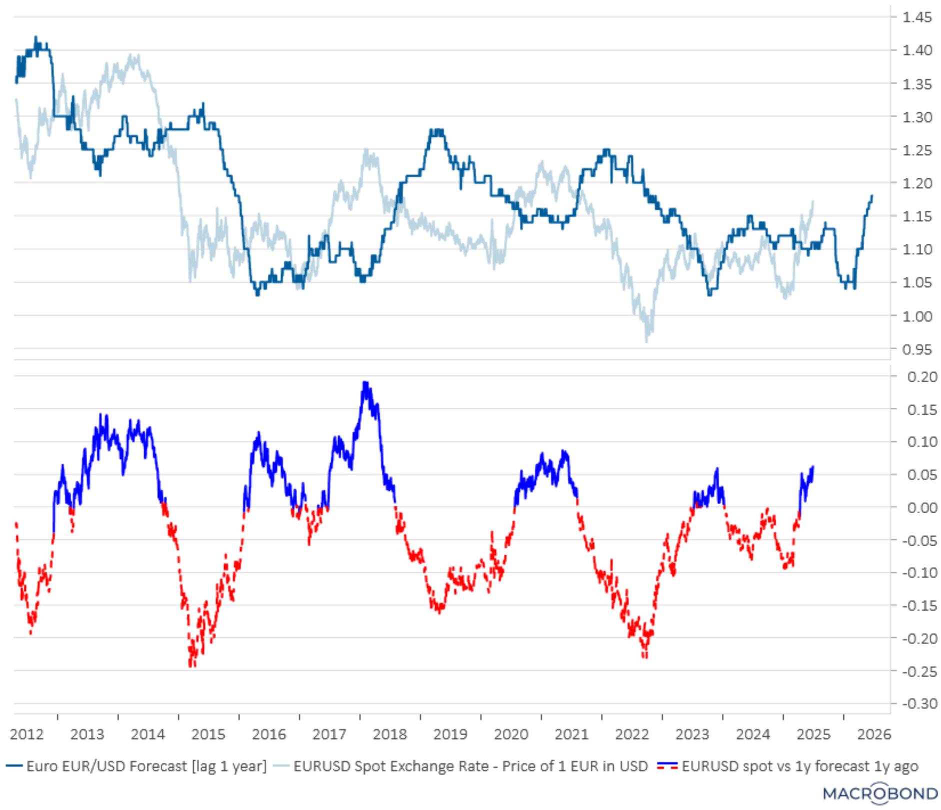
Michel Gubel, michel.gubel@handelsbanken.se

The dollar consensus view

With the political turmoil and the ongoing tug-of-war in other markets, many have been surprised by the stock market's resilience. Valuations on the S&P 500, currently at 23.5x earnings, have doubled since the financial crisis and are approaching levels last seen in the year 2000. While earnings metrics in isolation should not be overemphasised, the gap between the equity and bond markets has widened, fuelled by ongoing political uncertainty since Trump's inauguration with the turmoil centred mostly around the bond market.

For most of this year, the dollar has been trading on the back foot (see FX commentary), pressured by sector rotation, inflation/tariff concerns, and geopolitical volatility. The US dollar index has declined by 12% since January, with little support from the current administration. The consensus narrative has centred on a steady dollar decline, yet many of those forecasts have now hit previous one-year targets, offering little additional guidance unless the forecasts are revised further. Going forward, there may be good reason to reconsider the balance between less volatility and high carry costs. For example, the one-year forward rate for EUR/USD has reached 1.20 at current spot levels – after an already substantial dollar sell-off. The spot rate has drifted far beyond last year's forecasts and now trades nearly 500 pips past the one-year projections (see graph). In this context, a short dollar position has become more costly, while hedge levels become less attractive.

EURUSD 1Y forecast vs. Spot



EURUSD, 5 figures above last year's consensus

Sources: Bloomberg and Handelsbanken

So what could alter the current trend and result in an alternative scenario with a stronger dollar than most forecast? A widening interest rate differential – especially via a moderate rise in short-end US yields, could play a more significant role going forward. The US has not issued any new Treasury debt since January due to the ongoing political gridlock and the absence of a new budget. The Treasury General Account (TGA) Washington's checking account – is running low and will need to be replenished soon. Some estimates suggest that US Treasury issuance could reach USD 1.7 trillion between August and year-end. As a result, a sharp increase in T-bill and short-term note supply could drive front-end yields higher, particularly for short-dated US debt. This could mark a pivotal shift in dollar dynamics – and potentially challenge the prevailing bearish consensus and our forecast of a further weakening of the dollar.

Moderation is key for the dollar

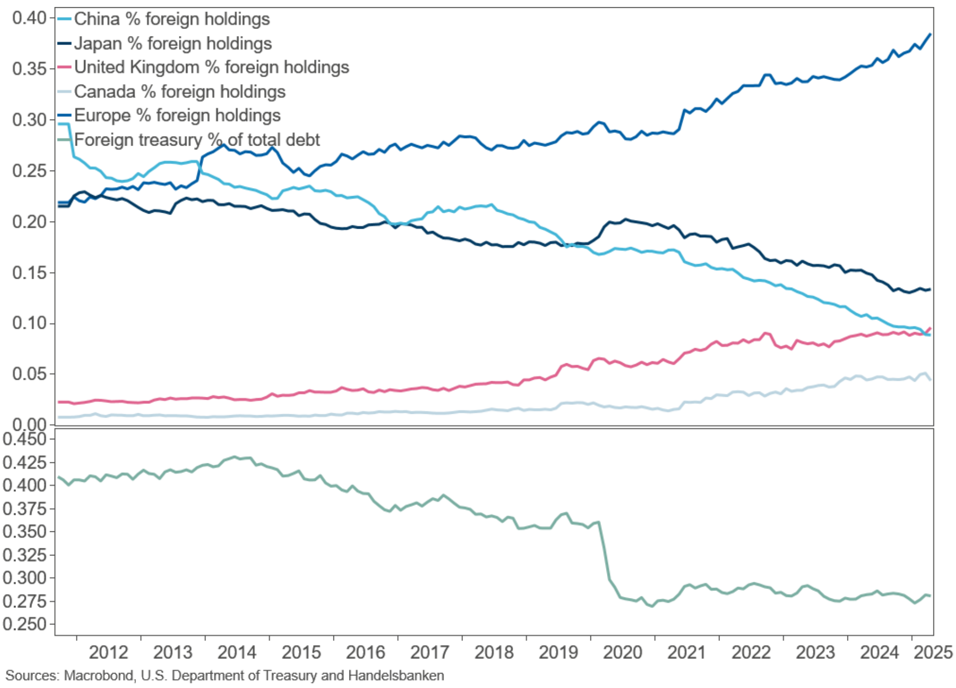
With the likely outcome of higher Treasury issuance, buyers will demand compensation in the form of higher yields. Historically, rising yields have attracted global capital – especially when other economies, like Sweden or Japan, continue to maintain low interest rates. While a dysfunctional bond market with sharply rising yields would likely continue to stress US assets, a moderate rise in yields could unfold quite differently from the current bearish outlook.

A gradual increase in interest rate differentials between US Treasuries and the rest of the world could begin to attract capital back into the dollar. From a historical perspective, sustained periods of interest rate decoupling tend to be short-lived – unless the current administration actively pushes capital away from the US. One example of that threat, Section 899 – widely referred to as the "revenge tax" – was dropped from the recent budget (the "One Big Beautiful Bill") at the request of Treasury Secretary Scott Bessent. Originally designed to penalise foreign governments and investors from countries imposing “unfair” extraterritorial taxes, its removal likely reduces near-term downside risks for the dollar. While it is too early to assess the full outcome of future policy moves, this development helps mitigate some worst-case scenarios.

Looking ahead to increased Treasury issuance in the coming months, a mix of relatively stable auction results and continued foreign interest would support the dollar – either through wider interest rate differentials or increased hedging costs for dollar-denominated assets, where hedging (selling of USD) becomes a less attractive option. While many argue that the risk will remain elevated going forward, the inflows back towards the US equity market might offer some guidance for the worst fears out there. The issuance schedule will be announced shortly following the X-date on 24 July according to comments by US secretary Scott Bessent, with most supply expected in T-bills and 2–7 year notes.

Rather than take an aggressive stance on the outcome of upcoming auctions, we emphasise tracking foreign demand. The optimistic view suggests that foreign interest will hold up, especially since foreign holdings as a percentage of total US debt are near historical lows. Countries like China and Japan have already reduced their holdings over the past decade and will likely not have the same impact going forward.

Foreign holding of Treasuries



Foreign interest of total debt at 28%

Sources: Bloomberg and Handelsbanken

In short, the upcoming period of elevated issuance will test investor confidence in the dollar's reserve currency role. In this environment, moderation – both in issuance and in policy – will be key to stabilising sentiment around the dollar. Other US assets have been showing more reliance than expected, section 899 has been scrapped, and hedging costs have risen in the current environment.

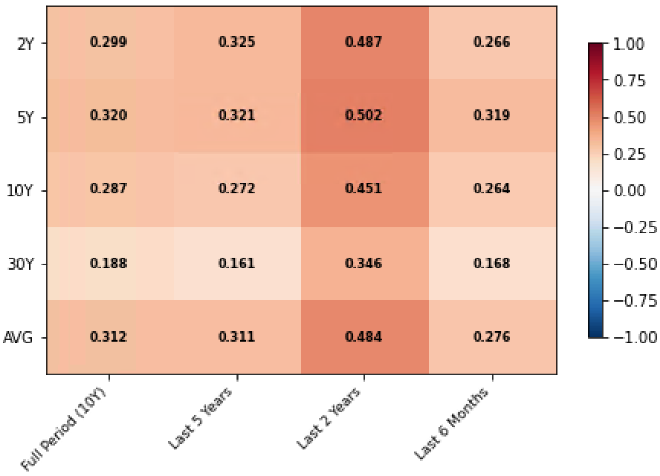
Interest differential tends to matter

Without going into growth, inflation risks and political aspects of the current EURUSD move, the graph looks into the nominal interest differentials and how it has played out historically. The current disconnect between interest differentials (swap rates) and spot suggest that this behaviour has shifted in 2025. This does, however, not change the fact that the dollar is cheaper, and interest rate differentials have widened, hence a hedged dollar position has become less evident.

What has become more evident in the most recent turmoil is a clear breakdown (potentially temporary) in correlation, which is illustrated in the heatmap below. The average swap spread has explained only 7% of the moves in EURUSD spot over the last six months (correlation: +0.266), which lost significant explanatory power compared to the 2-year period before (23% explanatory power, correlation: +0.483). Going forward, a moderate rise in swap spreads (higher 2Y) will balance some of the fears while hedging costs become even higher.

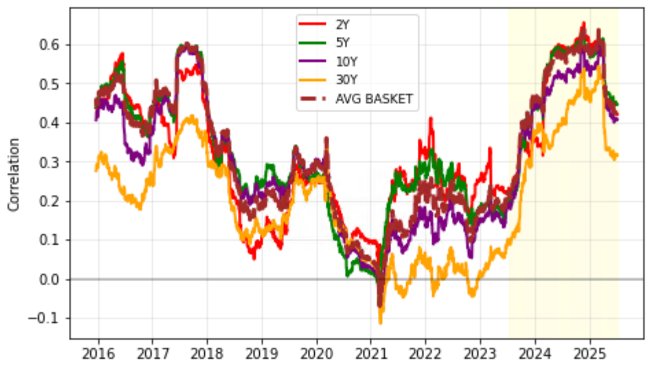
From a trading and pricing perspective, a return towards a stronger dollar is not discounted by market metrics: where the one year forward for EURUSD is close to 1.20 while the risk reversal offers a discount on EURUSD puts (+0.6).

Correlation heatmap



Sources: Macrobond and Handelsbanken

Rolling 1-year correlation



Sources: Macrobond and Handelsbanken

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