Scotiabank
Global FX Strategy

FX SNAPSHOT
Wednesday, November 4,
2026

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USD After the Midterms

Despite the seismic shift in domestic US politics delivered by the midterm elections, markets remain relatively calm. That is not all that unusual. Studies show that equity market volatility is typically a little elevated, relative to average levels, into and just after US mid-term elections, but uncertainty quickly normalizes, usually within a matter of days. That may well be the case again, but the swerve left may still have some impact on markets and the USD in the coming months.

There is little mystery behind the basic motivation for change. Voter fatigue, affordability concerns and worries about the evolution of the tech/AI sector were all certainly factors in taming Republican enthusiasm and bolstering Democratic and independent voters' desire for a different direction. Voter turnout was very high, resulting in a Democratic sweep that may assure the party of congressional control through 2032, at least.

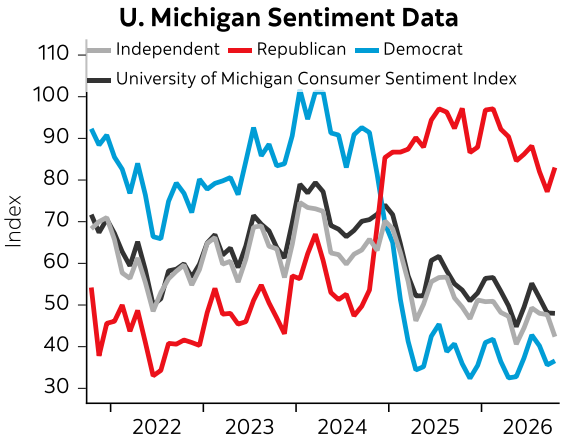
FX reaction has been calm, and that is reasonable. The result was not too surprising, given polling and probability-market pricing, and is highly unlikely to change any of the key FX drivers for the moment. Democratic control of Congress will likely constrain US fiscal policy, via typical "gridlock," but will not affect tax policies and spending plans already in place. The USD impact will be limited from that angle.

Concern that the Democratic win will put the brakes on the tech sector is perhaps overstated, but lawmakers will note that voter motivation for change was certainly linked to worries about AI and data-centre development. The presidential veto will almost certainly block major legislative moves, but more stringent local and federal oversight could still result. This may be a headwind for the sector rather than a significant obstacle, and perhaps a minor negative for the USD in the months ahead. Note that this does not preclude a correction in the tech sector for another, non-political reasons.

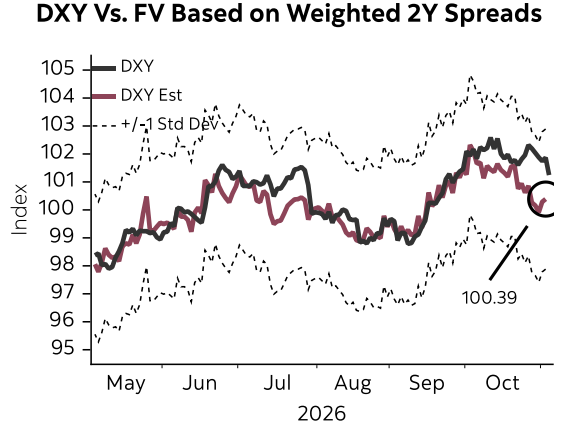
Elsewhere, the election result may not affect trade policy, which is largely executive-led, or foreign policy, which remains primarily the president's prerogative. But it may prompt a greater desire to find an off-ramp from tensions on the trade front, a modest CAD positive perhaps, and in the Gulf, a negative for crude.

Democratic control of Congress should reduce President Trump's ability to reshape the FOMC by blocking loyalist nominees. It may also severely curtail the investigation of Governor Cook, a newly minted hawk. That could be a plus for the USD and would certainly be a boost for the concept of central bank independence.

Overall, the political shock looks bigger than the likely FX shock. Fundamentals and monetary policy should quickly reassert themselves as the primary market drivers. The USD still looks a little rich relative to a basic assessment of fair value, driven by front-end spreads, and we note that year-end seasonality can be volatile, with the USD typically weakening in December. We favour looking to fade short-term USD gains overall.



Source: Macrobond, Scotiabank FICC Strategy



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