FX: Reading Draghi’s dovish bluff

ECB attempts to talk down the euro this week may prove ineffective

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USD: Political woes working against the dollar have become too difficult to fight

The US government shutdown will dominate the domestic narrative this week, with the question now turning to how long the impasse between the President and the Democrats will continue. A swift resolution is proving somewhat difficult given the current ‘blame game’ taking place on Capitol Hill; the looming November mid-term elections means that both sides of Congress may be first looking to save face with a deeply polarised US electorate. A Senate vote is scheduled for 1200 ET today – though it is largely expected to fail. The political woes working against the US dollar have become too difficult to fight – and with the more economically damaging debt ceiling issue still to come in late Feb/early Mar – the dollar may be waiting a while for any political reprieve. DXY test of 90 possible.

EUR: Draghi’s dovish bluff suggests euro doesn’t need to sell-off this week

The name of the game for markets will be reading President Mario Draghi's dovish bluff at this week's ECB meeting (Thursday). Our economists see it as too early to commit to an explicit end to QE purchases, though we don't feel the EUR needs to necessarily sell-off on this; it would presume that investors have been positioning for an ECB policy shift as early as this week – and we don't feel that this has been the case. Moreover, while the central bank is likely to toe the party line of a strong EUR being a ‘source of uncertainty’, Draghi may struggle to find evidence that the recent move higher in the EUR has been anything but justified by fundamentals (albeit weaker fundamentals elsewhere as well). Indeed, a range of models that we monitor tend to support this stance: (1) EUR/USD close to 1.23 still remains undervalued based on our short-term financial model; (2) EUR/USD below 1.25 means that the ECB's macro 'pain threshold' has not been breached – and the central bank will find it difficult to credibly cite recent currency strength as a drag on the real economy (just yet); and (3) the OECD PPP estimate – a medium-term anchor point for EUR/USD – is around 1.32-1.33 (still some 8-9% away from current levels). As such, attempts by Draghi to talk down the EUR this week may prove ineffective – with markets in recent years getting better at spotting dovish central bank bluffs. We remain inclined to fade any post-ECB meeting move lower in EUR/USD, with the 1.2140/50 area providing resistance. The ECB cannot change the positive fundamental EUR backdrop.

JPY: Skilful display of dovish showboating by Kuroda might just cap yen gains

The Bank of Japan meeting this week (Tuesday) may command more attention than usual – not least because of recent speculation that the central bank may be looking to signal a hawkish policy shift. We think that it is way too soon for any explicit change to the current policy regime, although one could easily interpret the central bank's more upbeat outlook on the economy as a small step towards the unconventional monetary policy exit door. Given that the macro story no longer makes the JPY a go-to short, it's all about managing expectations for Governor Haruhiko Kuroda this week. We wouldn't be surprised to see a skilful display of dovish showboating in the post-meeting presser – including some pre-emptive concerns over 'disorderly' FX moves. This suggests USD/JPY may be supported above 110 for now – but real money buyers of yen may be looking to swoop in.