FX: The reality checks for the euro

The German election provides a reality check on eurozone political risks

EUR: A bigger than anticipated fallout

The EUR fallout from the German elections has been more significant than most may have anticipated, though understandable when considering the underlying implications. Not only does it risk slowing down any Merkel-Macron attempts for a deeper eurozone integration, we suspect the rise of the populist AFD party is likely to provide a reality check on the way investors view EZ political risks. Indeed, since the French elections, we've noted that the EUR may have been playing the role of a 'political haven' – especially when taking stock of the political risks plaguing the likes of other G4 currencies (namely USD and GBP).

However, the return of the 'populist voter' in a European election is a reminder that political risks haven't completely abated for the euro especially with the spectre of the possibly more contentious Italian elections looming in early 2018. This could well be a concern for medium-term real money investors (eg, reserve managers), while any waning EZ recovery sentiment could see a pause in the cyclical EUR upswing. While we see little fundamental reasons for EUR/USD moving lower, we note the pair risks breaking out of a head-and-shoulders pattern (support 1.1835/40) that might see a broader correction towards 1.16. A dovish Yellen may help to avoid this scenario.

Chasing dollar strength?

The Fed Chair, Janet Yellen, will be speaking later this Tuesday (1550 GMT) and we note the title of her speech contains the word 'uncertainty', which is the equivalent of Kryptonite for currencies. While global markets witnessed a brief bout of flight-to-safety after North Korea's foreign minister stated that US actions were a declaration of war on his country, the risk-off fallout was contained in Asian markets overnight.

Uncertainty in Japan

The Japanese Prime Minister, Shinzo Abe announced yesterday he would dissolve the diet later this month and call a snap election – most likely on October 22. The tactical move is aimed at shoring up the current coalition's two-thirds majority in the lower house, while also securing a mandate to press ahead with Abenomics and reflationary policies; the PM announced plans for a 2 trillion yen economic stimulus package, which would be used mainly for increased spending on child care and education. Investors may be wary of the positive implications of any modest stimulus, while the prospect of higher budget deficits – and a break from fiscal discipline – would warrant a larger fiscal premium in JPY assets. Flaring US-North Korea tensions may well support safe-haven JPY flows in the near-term, though the election is a new source of uncertainty for the yen. For short-term investors, this could make the Swiss franc the preferred risk-off vehicle. Note USD/JPY 1M vols now trading above 10.

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