

Ready to short EURUSD (and tighten EURJPY) as Germany faces political crisis (11-21-17)

The gist: The political crisis unfolding in Germany could spell the end of the euro's bull run, and the US dollar was showing signs of resurgence anyway – thus our interest in shorting EURUSD and tightening EURJPY.

Actions: Will short EURUSD in a moderate sized position on a ½ ATR break of the Nov 14th lows, with risk ½ ATR above the Nov 14th highs. Also tightening long EURJPY risk point to ½ ATR below Nov 20th lows.

The US dollar showed extraordinary weakness in 2017, for various reasons we've written extensively about. This weakness helped to reinforce the epic liquidity run by allowing the dollar to act as a funding currency and boosting the earnings of US multinationals.

A big part of the dollar's weakness was the switch-up of the long-running storyline as to stable versus unstable. In 2017 it was Europe that had become stable, and the United States that became unstable.

On the US side it was the Trump administration that provided instability. On Europe's side, the Merkel-Macron axis (Angela Merkel in Germany and Emmanuel Macron in France) brought political stability to the continent. This helped the euro to rise against the US dollar, along with strong European growth.

Now, though, Germany faces a new political crisis as Angela Merkel is unable to form a government. Merkel looks vulnerable, and could face a snap election in which she loses.

This turbulence has shaken the Merkel-Macron axis – and could possibly destroy it. That would damage the euro's attractiveness right at a point when the US dollar was strengthening anyway.

Various forecasters are seeing a strong US economy and three or four Fed rate hikes in 2018. At the same time, growing weakness in high yield debt markets could spur a flight to safety back into US treasuries (which would automatically favor the USD). And mean reversion favors the US dollar too, as part of the dollar's weakness in 2017 was due to aggressive risk-taking flowing out abroad via emerging market equities and debt. (When those flows reverse, capital comes back to US shores and gets converted back into US dollars, pushing the value of the USD higher.)

All of this means we are turning back round again to potential "USD short squeeze" conditions, and the euro is looking vulnerable against that backdrop with political crisis striking in Germany. The euro is also possibly topping out against the USD, as the first and second charts show.

As such we want to short EURUSD on a break below the Nov 14th lows in anticipation of a possible large downtrend. As prospects for the euro fade, we also want to tighten the risk point on the remaining portion of our EURJPY long, to just below the Nov 20th lows (fairly close here).

