

AUD – Downside Risks Loom

- The AUD remains in a fragile position, which has been highlighted by the Aussie dollar's price action in recent days.
- Downside risk remains and a break under USD0.9000 continues to be a near-term threat.



The AUD/USD has depreciated considerably in recent months. It has fallen from an exchange rate near 1.0600 in mid April to be as low as 0.9036 in early July. It also seems like only a matter of time before the AUD breaks under the critical support level near and around USD0.9000. The price action in recent days suggests that the AUD is in a fragile position.

In particular, the AUD's vulnerability was highlighted yesterday; the AUD's reaction to the minutes from the US Federal Reserve meeting and the ensuing remarks by Fed Chairman Bernanke were poor. These events should have produced a sustained appreciation in the Aussie dollar. But it did not. The AUD's bounce amounted to nothing more than a dead-cat bounce.

The AUD was sitting near USD0.9090 ahead of the Fed minutes and before the Sydney open of trade yesterday. It then rose to as high as USD0.9305 during the Asian trading session yesterday in the wake of the minutes and Bernanke's comments. But the AUD completely gave up those gains within 24 hours, suggesting there is underlying weakness for the Aussie dollar at these

levels.

While there was not a fundamental shift in the minutes, the remarks from Bernanke did appear more on the dovish side. Taken together, the minutes and remarks suggest that the timing of a reduction in the Fed's bond-buying program (or quantitative easing) might be pushed out. Market expectations that the program might start to taper off as soon as September may therefore be off the mark.

The Fed's bond-buying program has pressured the USD in recent years because it equates to printing money and erodes the value of the currency. It was introduced by the US Federal Reserve as a means to stimulate the US economy.

The impact of effectively 'printing money' was to keep bond yields low and force capital to seek more productive uses. So any prospective changes to this bond-buying program will influence demand for the USD and the value of the AUD against the greenback.

Indeed, the effective debasement of the US currency via quantitative easing had been one of the key factors that helped elevate the AUD to parity and above. Now the expected reversal will likely be one of the key reasons for keeping it under parity.

Other factors representing downside risk for the AUD are concerns about the outlook for economic growth in Australia and expectations for further reductions in Australia's cash rate. Moreover, there has been a rise in the uncertainty surrounding the Chinese economic outlook.

So the pressure for the AUD will be downwards. But within this trend, volatility will continue. The uncertainty around when the reduction in the US quantitative easing program will begin should continue to encourage volatility in the AUD.

Please also refer to our AUD Outlook published in our July Quarterly Economic Outlook.

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