Forex Focus: Aussie's Rally Coming To An End

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A DOW JONES NEWSWIRES COLUMN

LONDON (Dow Jones)--It's like watching a bird having its wings clipped.

Up until last week, the strength of the Australian economy, the country's close association with China as well as the prospects for the global economic recovery all appeared to be working in the Australian dollar's favor.

Within a few days, however, the currency's future has become much less certain.

See how the Aussie's rally has stalled:
http://www.dowjoneswebservices.com/chart/view/4184

Australia has lost its prime minister, China has unpegged its currency and confidence in the U.S. economy isn't what it was.

In other words, there is a lot less reason for investors to buy the Aussie now than there was even a week ago.

In itself, the resignation of Kevin Rudd as prime minister may not have been a bad thing. He was forced to resign largely because of his plans to introduce a super tax on the profits of mining companies.

However, the planned policy didn't go with Rudd. His deputy who stepped into his shoes, Julia Gillard, is as committed as Rudd to achieving a budget surplus and this means the tax could well stay, still posing a risk to the country's growth prospects.

On top of that, Australia now faces a general election that could be called before the end of the summer

Domestic issues aside, China's surprise decision the weekend before last to finally abandon its yuan peg to the U.S. dollar was not good news for the Aussie.

The Australian dollar has long benefited from its close trading links with one of the world's largest and strongest economies.

Although Beijing has so far kept a lid on an serious rally in the Chinese currency--the yuan being fixed early Monday hardly changed from its fix on Friday--this still represents a de facto tightening in Chinese monetary policy that will slow the country's economic expansion as well as its demand for Australian commodities.

As a currency strategist at Morgan Stanley said: "Though it has been difficult, we remain short of the Australian dollar."

"As China has begun to allow the yuan to revalue, we believe that the Australian dollar will lose support as it has long acted as a proxy trade for China."

To make matters worse for the Aussie, there was distinct reduction in investor appetite for risk last week as the U.S. Federal Reserve made it clear that the U.S. recovery remains fragile and that U.S. interest rates are unlikely to go up early next year as most financial markets have been expecting.

On Friday, the official U.S. first quarter gross domestic product estimate was revised down to 2.7% form 3.0%.

Concern over Europe's sovereign debt crisis also reared its head again as the cost of insuring against a default in Greek debt rose to a new record high.

Apart from raising the price that other peripheral euro-zone debtors have to pay for their funds, this also puts the health of European lending banks back under scrutiny.

This means that international investors will once again become nervous, preferring to put their funds in safe havens rather than take the risk with higher-yielding currencies such as the Aussie.

Early Monday in Europe, the Aussie was flat. It traded at $0.8740 at 0645 GMT, unchanged from late Friday in New York, according to EBS.

Overall, market sentiment remained negative with investors worried about the impact the agreement by the Group of 20 industrial and developing nations on halving deficits by 2013 will have on growth prospects.

The euro slipped to $1.2364 from $1.2388 but was hardly changed at Y110.52, compared with Y110.56.

The dollar did manage to rise to Y89.40 from Y89.26.

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Reuters   USD/DJ

Thomson   P/1066 or P/1074

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