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FX Focus: AUDUSD – China Premium Embedded into AUD

FIGURE 1: FX Forecasts

Forecast (Jan 2025)	Spot	0-3m	6-12m	Long-term
AUDUSD	**0.6345**	**0.6200**	**0.6500**	**0.6800**

Source: Citi Wealth Investments as of February 2025.

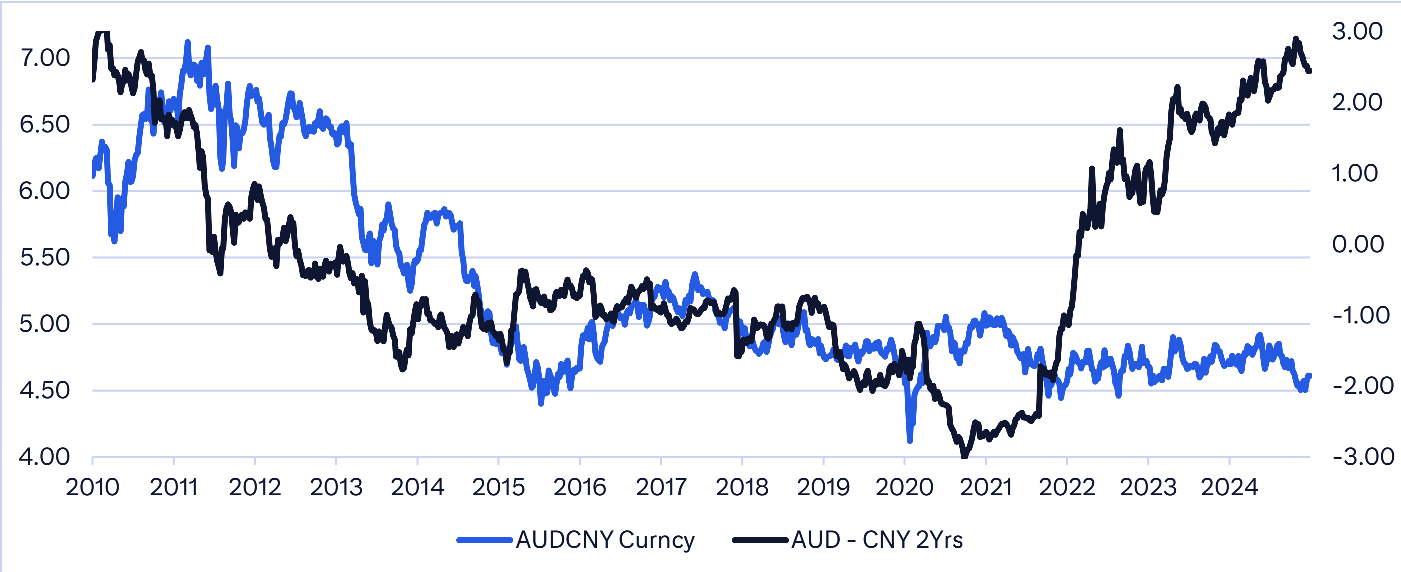
Expectations about China's recovery and US tariffs are undoubtedly important in driving AUD sentiment. While Australia may escape any direct tariff threat (Trump has indicated as much), due to its Free Trade Agreement and trade deficit with the US, AUD would be unable to fully escape the indirect impact of a hike in US tariffs on Chinese imports which may hit Australia's commodities exports to China and more directly pose a headwind for AUD via a further weakening of RMB. Nor would AUD be able to escape risk aversion sentiment likely to arise from a potential global trade war if US went ahead to levy higher tariffs on goods from the rest of the world.

However, the sharp decline in AUD since the end of September has not been as much from a build-up in the China premium, but more from the turn in AUD – USD short rate differentials as markets repriced towards a more hawkish Fed while bringing RBA rate cuts forward to February. This completely turned AUD – USD rate differentials pricing on its head from prior to September – end when markets had been projecting RBA rates to rise above Fed Funds by Q2'2025. But following the December FOMC meeting in which the Fed pared back its "dot plot" to just 2 rate cuts for 2025, US rates rose sharply relative to AUD rates which changed market projections to RBA rates expected to remain well below Fed rates for the entirety of 2025. This caused the rapid fall in AUDUSD from ~0.6945 at the end of September to a low of ~0.6088 in early February.

As for the China premium, AUD has been pricing that in well over the course of 2023-24 and especially in the period leading up to President Trump's inauguration in Q4'2024. The China premium into AUD can best be estimated by the misalignment between where the AUDCNY cross is currently trading versus where it should be trading as implied by AUD less CNY short interest rate differentials. AUD is highly correlated to movements in RMB, but AUD is currently trading well below what is implied by AUD – CNY rate differentials and the difference represents the China premium embedded into AUD. For now, there may be enough of a China premium embedded into AUD given that the PBoC seems unwilling to weaken RMB much further.

With an adequate China premium and a hawkish Fed/ dovish RBA now priced into AUD, downside risks in AUDUSD look limited and a drop to sub 0.60 looks unsustainable. However, any significant rebound in AUD will likely have to come from a U-turn in AUD – USD short rate differentials. This would require the Fed to turn dovish once again or for the RBA to forgo any further rate cuts after having cut 25bp in February. It is notable that Governor Bullock indicated at the February meeting that she is not confident the RBA can deliver the quantum of rate cuts markets are discounting (almost a further 2 25bp cuts this year). But this looks to be a H2'2025 story. For now, the first 100 days of Trump's administration is likely to see market volatility related to US tariff threats on China and the global economy more generally dominate sentiment, potentially leading to more safe haven bids into USD which may end up seeing AUDUSD trading in a 0.60 – 0.64 range.

FIGURE 1: AUDCNY spot has been trading well below what is implied by 2Yr AUD – CNY yield differentials since early 2022



Source: Bloomberg, February 18, 2025.

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