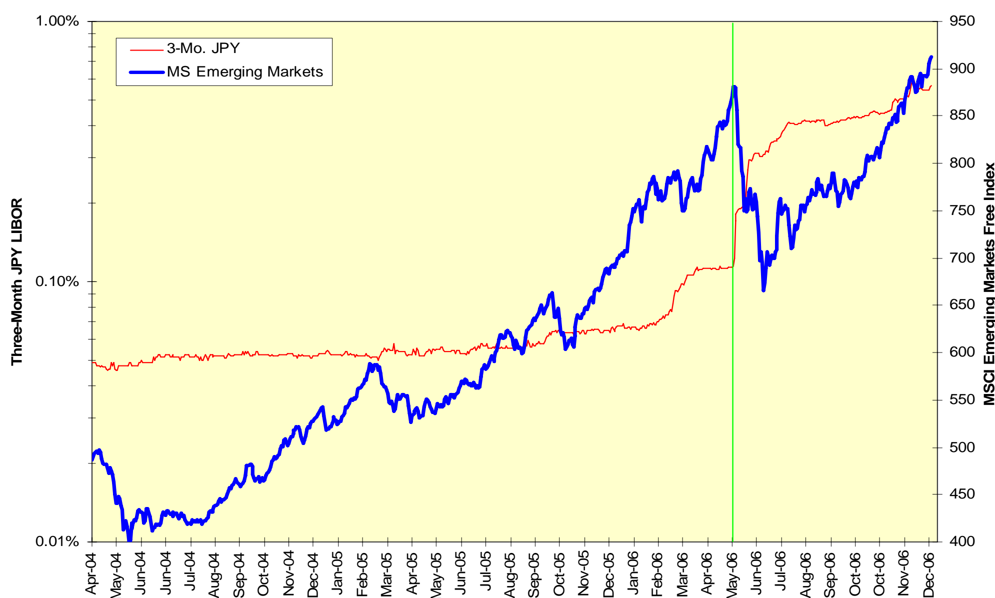
The Yen Carry Still Matters

A calendar year can be both a long and a short time. Our collective memory of 2006, compressed already to bumper-sticker size, was it was a very good year for the markets. The aggregate numbers say so, and who am I to dispute?

But how many of us recall the trapdoor opening under global markets in mid-May and staying open until mid-June? It seemed as if 2006 was going to be a long year at that point. The villain, for those who wish to impute causation, was the Bank of Japan and its decision, chronicled here in July 2005, to withdraw ¥21.56 trillion yen from its banking system in between February and June 2006; that would be equivalent to the Federal Reserve draining $188 billion from our banking system over a similar period.

Short-term rates in Japan shot higher and emerging market equities plunged. While three-month yen LIBOR continued to move higher all the way into the end of the year – all the way to 0.5675%, that is – emerging markets stabilized and managed to close the year at a new high.

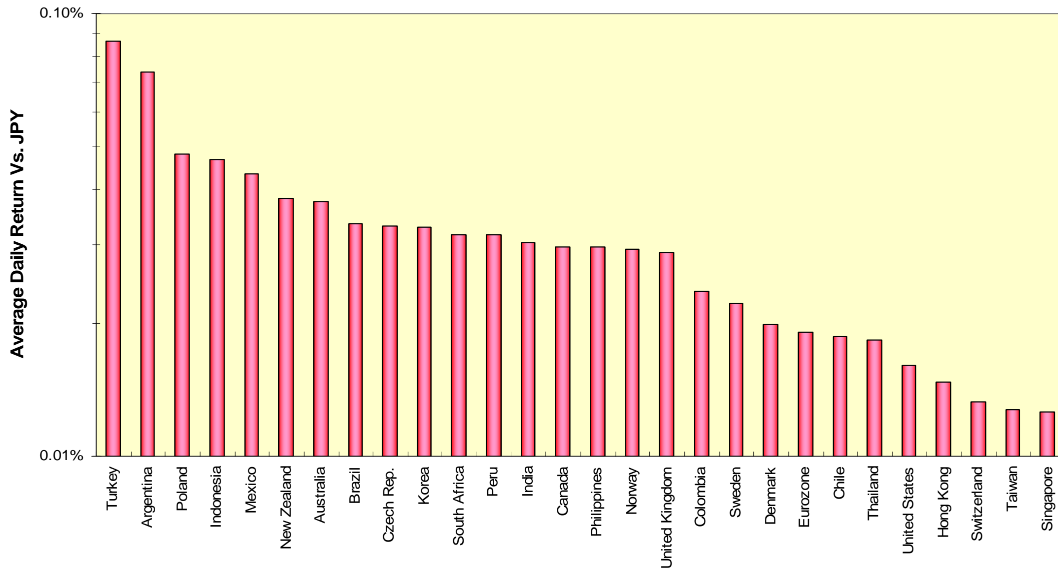
Short-Term Yen Rates And Emerging Markets



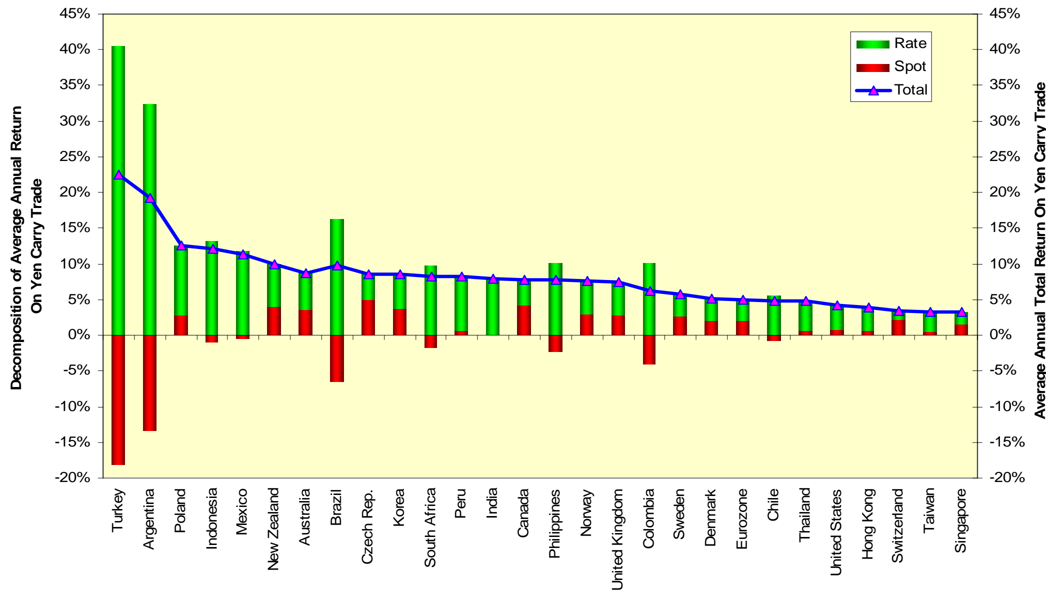
The Yen Carry

The reason for emerging markets' resilience, as we shall see below, is the continued persistence of a positive yen carry. You can still borrow in Japan, swap this currency for a higher-yielding one and pocket the interest rate spread subject to the risk of the higher-yielding currency depreciating too much.

While much of the focus on the yen carry trade has been on the U.S. market as Japan is one of our largest creditors, the average daily return on the yen carry since the January 1999 advent of the euro has been greatest for emerging market currencies such as the Turkish lira and Argentine peso. Other currencies with major interest rate spreads relative to the yen include the Polish zloty, Indonesian rupiah and Mexican peso. The average daily yen carry returns for 28 different currencies are depicted in the chart below.

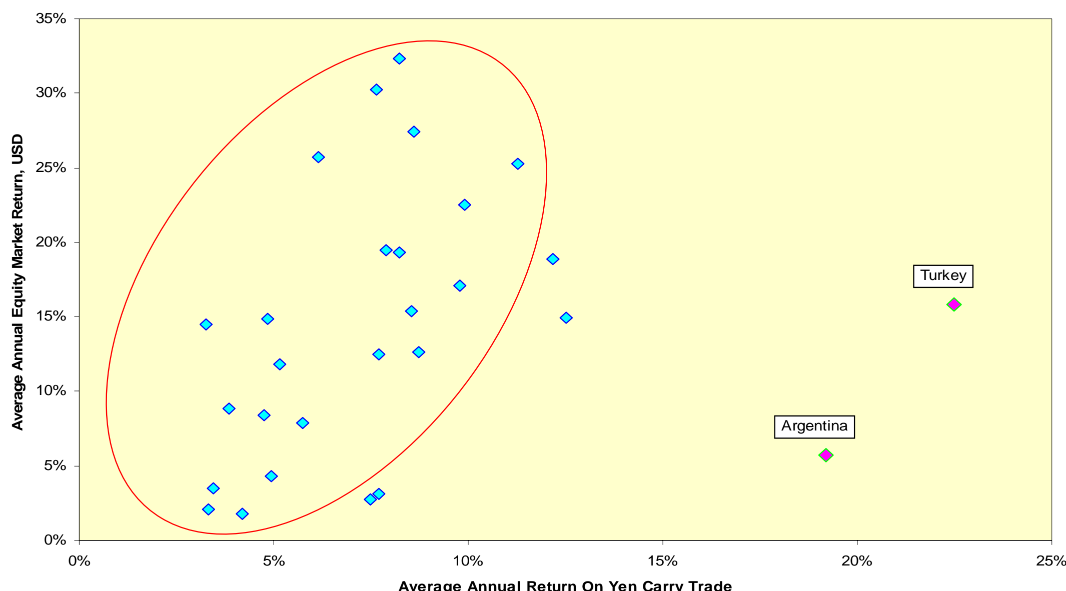


As high interest rates constitute an artificial prop to any currency, the U.S. dollar included, we should ask whether the large interest rate spreads for the Turkish lira, Argentine peso, etc., have been offset by declines the their spot rate. The answer is yes, but not enough to derail the trades materially. If we add the spot rate gains and losses to the interest rate spread gains, we find that even the biggest spot rate losses are but a fraction of the interest rate spread gains.



Stock Market Vulnerability

Stock market investors who spend an excess of their waking moments worrying about the Federal Reserve's next move in the mistaken assumption that rate cuts mean good and rate hikes mean bad should be asking themselves whether their domestic misunderstanding has a valid passport. It does. We can map the average annual returns of the countries in our data sample against the average annual total return for the yen carry, spot rate return plus interest rate spread return. Even if we isolate the obvious outliers of Turkey and Argentina, the positive relationship between stock market returns in dollar terms and total return on the yen carry trade is both visually apparent and statistically demonstrable; the regression beta is 1.776.



The comparable regression betas for the two components, the interest rate spread and the spot rate, are quite different. In the spot rate case, we have a non-deterministic relationship with a beta of -0.03, excluding Turkey and Argentina. This should lead us to suspect it is the interest rate spread component which drives the relationship between stock market returns and the yen carry trade. Here the regression beta is 1.03, once again exclusive of Turkey and Argentina.

Rates And Capital Flows

The connection is clear: The high rates of emerging markets attract capital from low-rate countries such as Japan. These capital inflows not only support the various currencies, but they support the various equity markets as well. The world got a taste of what a rate and liquidity shock from Japan could look like last May-June, and in a grander scale it got a similar shock ten years ago this coming July with the Thai baht devaluation and the onset of the Asian crisis.

Short-term rates will have to rise further and faster in Japan someday, a statement that has been as routinely unsuccessful for the past decade as a forecast of the sun rising in the west. When those rates rise, countries whose currencies and markets have depended on cheap and readily available capital will have to adjust. This adjustment need not be a disaster; after all, China alone has $1 trillion in foreign exchange reserves which can be lent to whomever, and it is in no one’s interest to see a repeat of the Asian crisis on any scale.

The key will be how well the Bank of Japan communicates its intentions to the market and whether they can be more adroit this time than they were in the spring of 2006. This is a tall order and will go a long way toward determining how fast 2007 goes by in our minds.