

The Importance Of Being Carried

We do not do science anymore; we do politics. We never did do non-political economics; the field originally was called “political economy,” and still is at the author’s alma mater, Johns Hopkins. Even with this imperfect experience in mind, it was still quite strange indeed to hear the debate during the post-March 2009 rally whether carry trades had anything to do with the whole affair.

The issue was about assigning future blame. If the March 2009 – April 2010 rally could be attributed to quantitative easing and near-zero interest rates, then the central banks would have been guilty once again for contributing to an asset bubble and to future inflation. They had to deny any connection between their actions and those within a wide variety of stock, non-sovereign bond and commodity markets. This put them in the rather absurd position of arguing financial carry, a subject that should be no more controversial than stating water runs downhill, did not matter. To hear arguments that the record-steep yield curve through August 2010 or \$1,250 per ounce gold or a dollar so weak by October 2009 a number of countries were wondering out loud whether it needed to be replaced as a global reserve currency, an idea that died with the euro’s near-death experience in May 2010, was rather mind-blowing for those who prefer their arguments to be based on fact and logic.

As Humpty Dumpty said to Alice, “When I use a word, it means just what I choose it to mean – neither more nor less.”

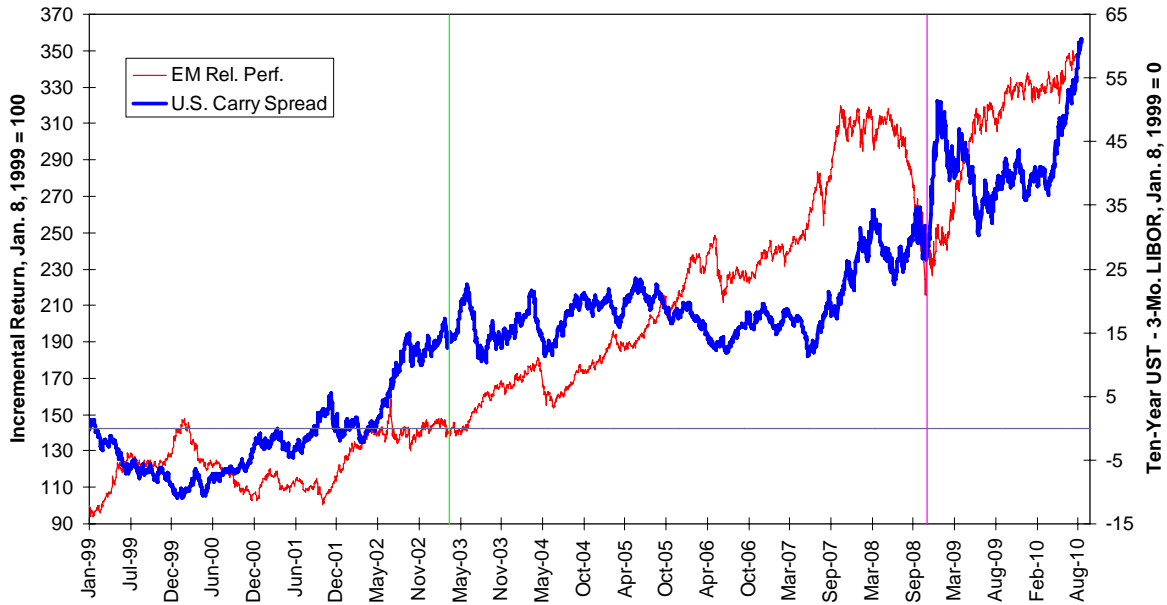
The Emerging Market Linkage

First, let’s stipulate there is no such thing as “the carry trade;” anytime anyone borrows in a lower-rate instrument or lends/invests in a higher-rate instrument, a carry trade has been consummated. Let’s examine the role of several different carry trades. Each chart below is marked with two vertical lines. The green one depicts the May 6, 2003 declaration of war on deflation by the Federal Reserve; this was truly a watershed date in what turned out to be the creation of the second financial bubble to burst in the last decade. The magenta one depicts the November 20, 2008 bailout of Citigroup and the appointment of then-Federal Reserve Bank of New York President Timothy Geithner to be Secretary of the Treasury in the incoming Obama administration. This finalized the politicization of the Federal Reserve and paved the way for the move to near-zero interest rates on December 16, 2008 and to quantitative easing on March 18, 2009.

The dependent variable for all but the last chart will be the incremental total return of the MSCI Emerging Market Free index to the MSCI World Free index. This measures investor preference for shifting allocations away from so-called senior and developed markets and into the supposedly higher-risk emerging markets. We will conclude with comparing the total returns of two different commodity indices to a single carry trade, a blend of the Japanese yen and U.S. dollar carried into the euro. These carry trades combine the net interest spread between deposits in the two countries involved plus any changes in the currency spot rate.

Now let’s start by looking at the influence of the U.S. yield curve trade’s total return on the incremental performance of emerging markets. This is going to be defined as the total return of holding ten-year U.S. Treasuries less the total return on a constant-maturity three-month LIBOR position. LIBOR is used for two reasons. First, you and I cannot borrow at the Treasury rate; second, the three-month swap rate is the basis for much short-term financing.

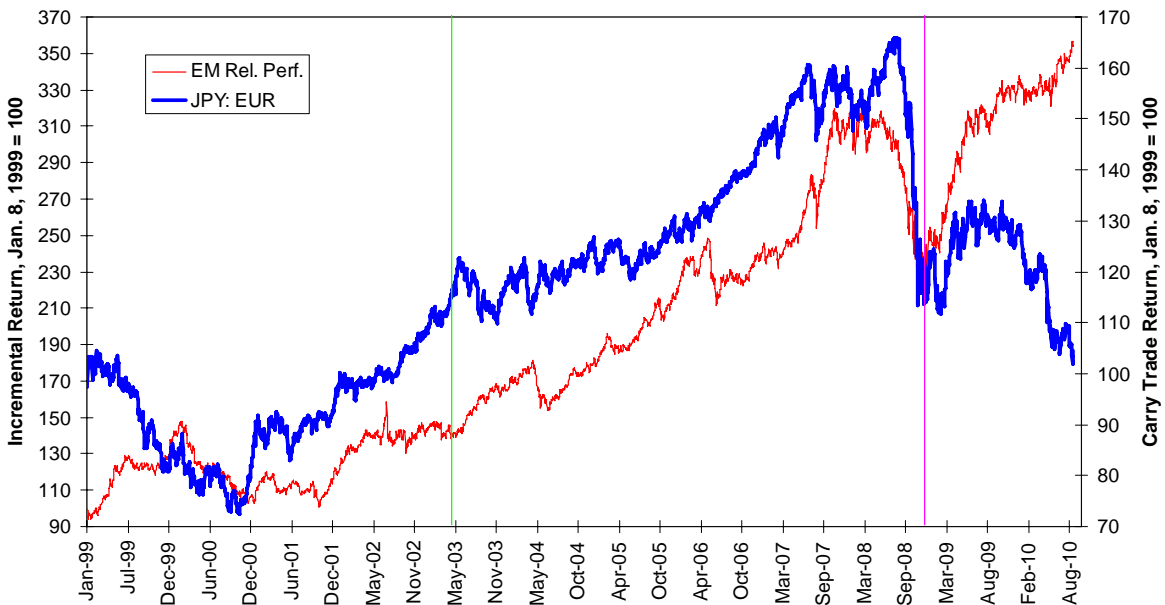
Emerging Markets' Incremental Return And The U.S. Yield Curve Carry



On balance, the U.S. yield curve does not appear to be a significant explanatory variable for the incremental performance of emerging markets. The intriguing periods include August 2007-March 2008 and June – December 2009; this is when both series are rising in parallel. However, no relationship with more exceptions to than confirmations of a hypothesis can be taken very seriously.

Let's shift then to the yen carry trade into the euro; this is the generic "yen carry trade." Here the relationship is quite strong from the January 1999 advent of the euro all the way to the end of April 2009. If the data history stopped at that point, we very well might have concluded this carry trade alone was the dominant variable for explaining emerging markets.

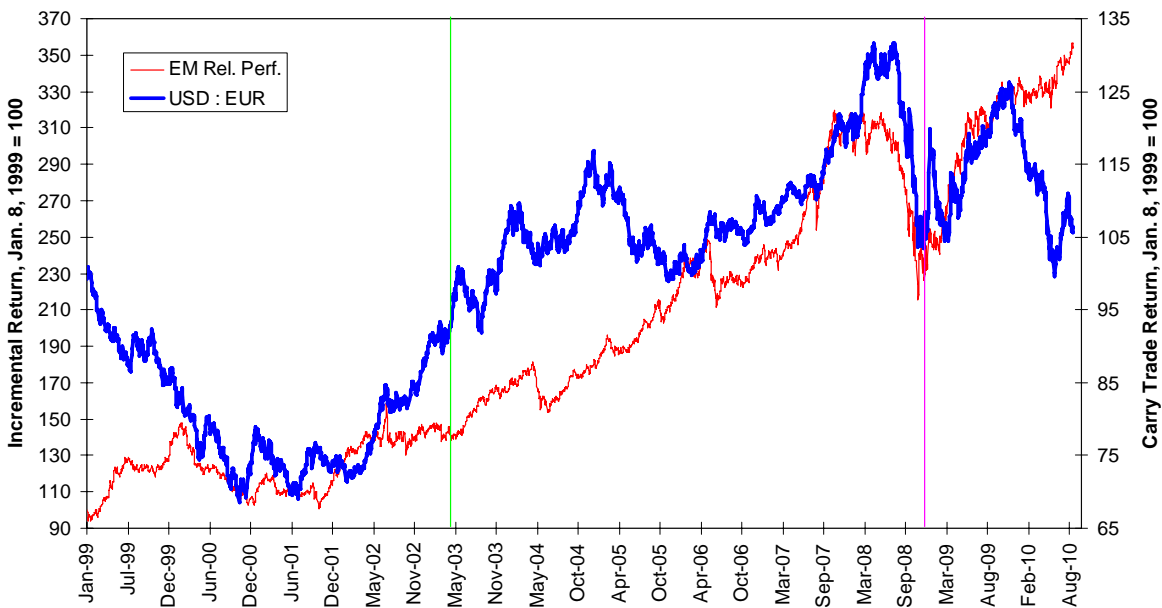
Emerging Markets' Incremental Return And The Yen:Euro Carry



How can we explain the decrease in the yen carry trade's efficacy after April 2009? The most likely explanation is the shift to the dollar carry trade as U.S. short-term rates started to fall below Japanese rates (see "How Japan Lost More Than A Decade," September 2010) after the March 2009 quantitative easing. This made the dollar the preferred funding currency for global carry trades and did no small amount of damage to Japan as yen carry trades

were unwound and the yen strengthened in response. This mechanism remained in place even after the yen once again became cheaper to borrow than the dollar in March 2010. Was there a strong increase in the correlation between the dollar carry trade and the incremental performance of emerging markets after April 2009?

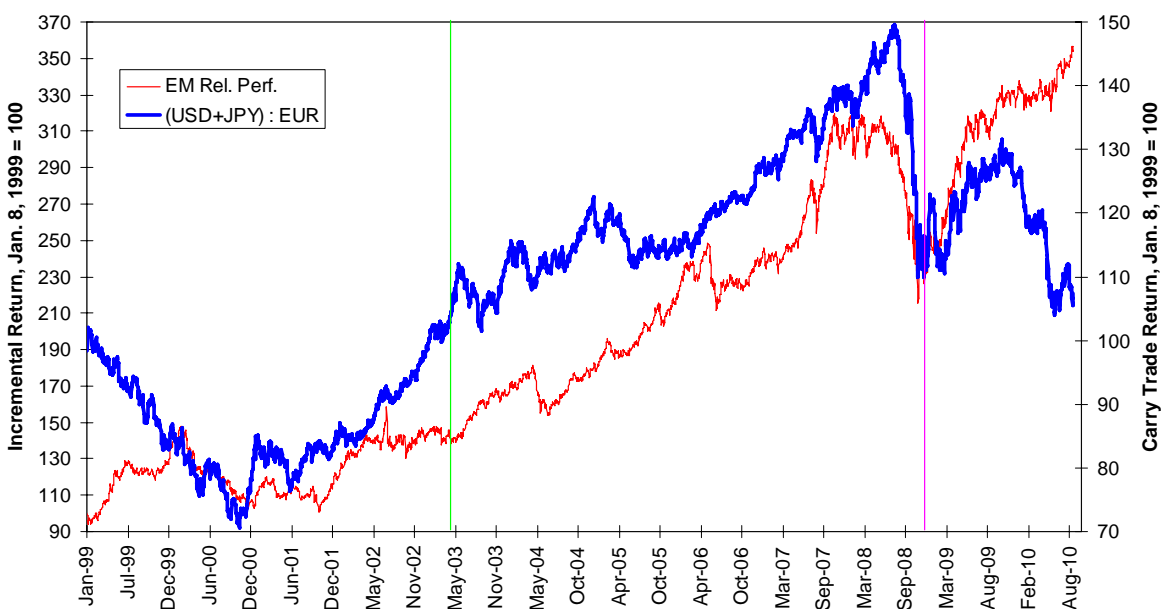
Emerging Markets' Incremental Return And The Dollar:Euro Carry



The answer was a strong “yes” until the credit downgrades of Greece, Spain and other Eurozone currencies beginning in December 2009 pushed the euro lower against the dollar and reduced the carry trade’s return.

If this question had been posed five years ago, the dollar carry trade would not have been considered a strong explanatory variable for emerging market performance. Fashions come and go in markets, and the dollar carry trade came and stayed with a vengeance. Finally, the economics of any carry trade is a rather binary affair; either traders are doing it en masse or they are not doing it at all. If we blend the dollar and yen carry trades in hope of stitching an explanatory variable together for financial assets, we fail. The task at hand always is to find the carry trade du jour.

Emerging Markets' Incremental Return And The Combined Carry

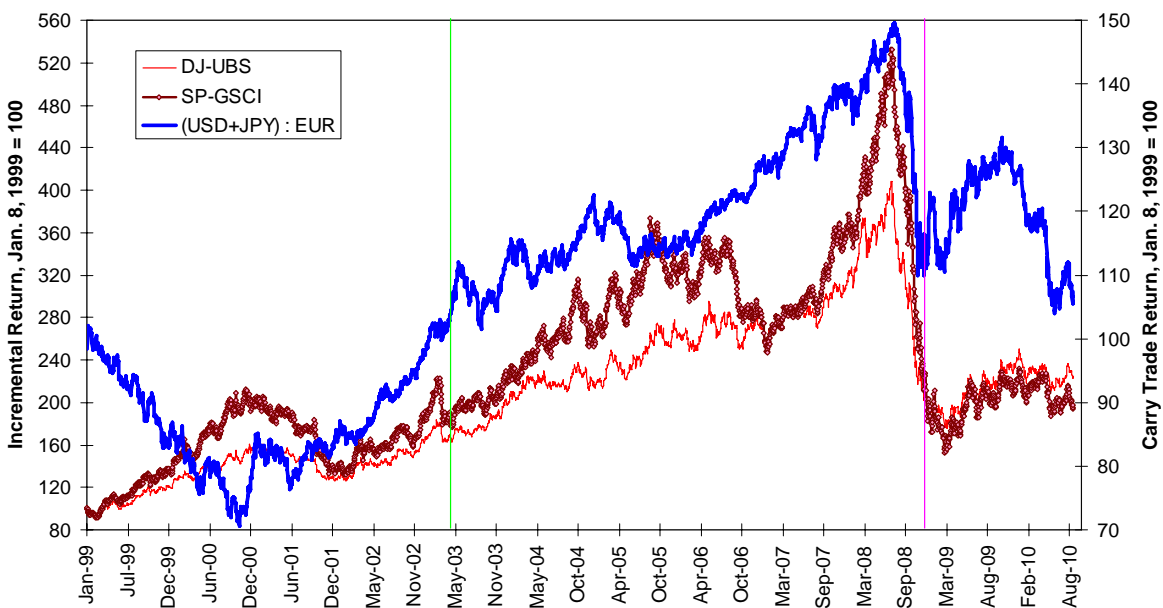


Commodity Carry

The conclusion reached immediately above seems to change, however, when we shift the dependent variable from the incremental performance of emerging markets to the total returns for the Dow Jones-UBS and S&P-GSCI commodity indices. This is due perhaps to the more highly correlated nature in recent years between the members of the physical commodity indices as opposed to the components of the emerging market indices. Commodities with large weights in the indices, such as crude oil, trade in a global market with a large number of competing buyers and sellers; the incremental performance of an index of emerging markets to a global equity index is subject to much lower correlation between index components.

Restated, global commodity markets can rise and fall with greater unison and for reasons unrelated to the economics of carry trades such as supply shocks or increased industrial demand.

Commodity Indices' Total Return And The Combined Carry



Bubble On

Global markets have rolled from one carry trade to another ever since Japan moved to solve its problems by monetary creation in 1995. That has produced a succession of bubbles and crises, starting with the 1990s technology bubbles and the Asian financial crisis. Wherever and whenever a bubble is found and a subsequent bust is produced, you will find a carry trade standing nearby. The central bankers may deny they had any role in creating what they regard as non-bubbles, but what good does assuaging their egos and malfeasance do for anyone else?

Regardless of which carry trade fuels which bubble, the one message that should not and cannot be ignored is the link between emerging markets and *some* carry trade. It is simplistic and needlessly diminishing to consider emerging markets and not senior markets to be fueled by carry – both are – but the greater the perceived risk of any asset, the more it benefits from lower financing costs. The cycle of bubble-and-bust will end only when central banks and the politicians who love them stop trying to create financial bubbles to clean up the damage from the last financial bubble's bursting. That will end the wide differentials in interest rates that create the financial flows from the funding sources into the risky assets or flows between risky and theoretically non-risky assets such as government bonds in what has been dubbed the "risk-on / risk-off" trade.. That is economics for a political world.