Be Wary Of Fading Carry

A *RealMoney* reader wrote last week in response to a post on the strengthening dollar, “Strong US Dollar & strong commodity prices.....Very interesting commentary!! Does this same logic apply to Emerging market stocks & the previous leaders like agriculture, infrastructure?”

I had included a table at the end of a column on the euro of its impact on U.S. industry groups. As the euro has a strongly positive relative performance beta for groups such as fertilizers & agricultural chemicals, construction & engineering, agricultural products and construction & farm machinery, I would have to say the partial contribution of a stronger dollar vis-à-vis the euro on the U.S. stock market is negative. That is one of those “all else held equal” statements that people hate economists for; how can you possibly hold all else equal?

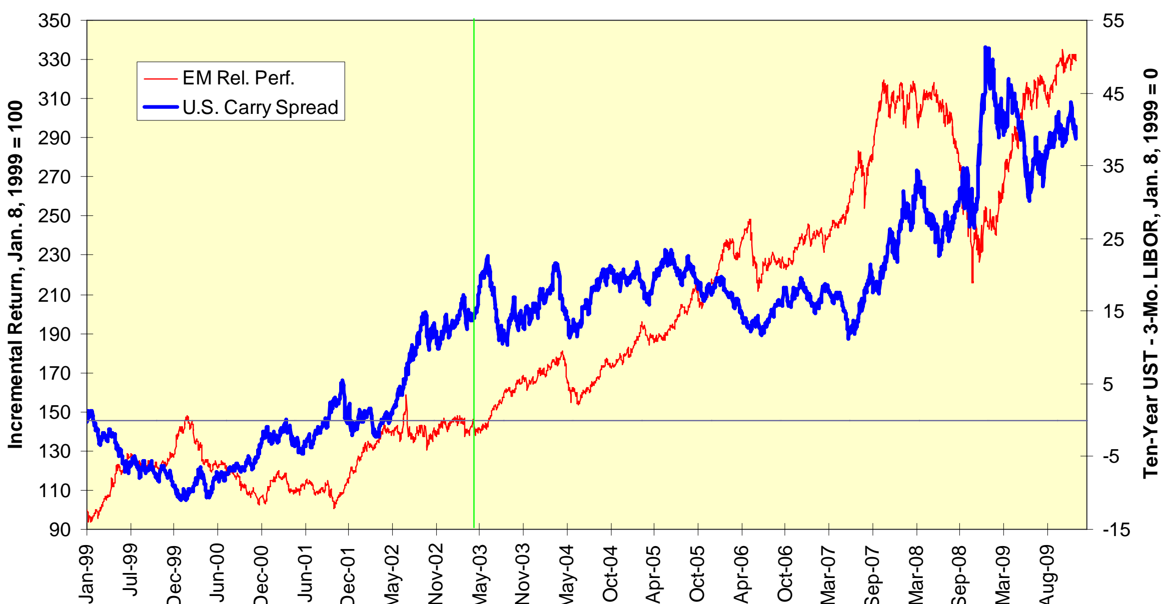
The more interesting turn of events is going to happen in the wonderful world of emerging markets. It has been an article of faith amongst many these markets have benefited enormously from global carry trades, but as is the habit in these parts, the data must be examined before an opinion is offered.

For each of the charts below, the dependent variable 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. The May 6, 2003 declaration of war on deflation is marked with a green vertical line; this was truly a watershed date in the history of emerging market investing.

The Carry Trades
There is no such thing as “the carry trade;” as all financial transactions involve sacrificing the yield on one asset to obtain the yield on another, the number of potential carry trades is extremely high. We can take a look at three different currency trades into the euro, with the euro being selected as the principal alternative to the dollar. These will be the return on borrowing dollars and lending in euros, borrowing yen and lending in euros and finally borrowing in a 50-50 blend of dollars and yen and lending into euros.

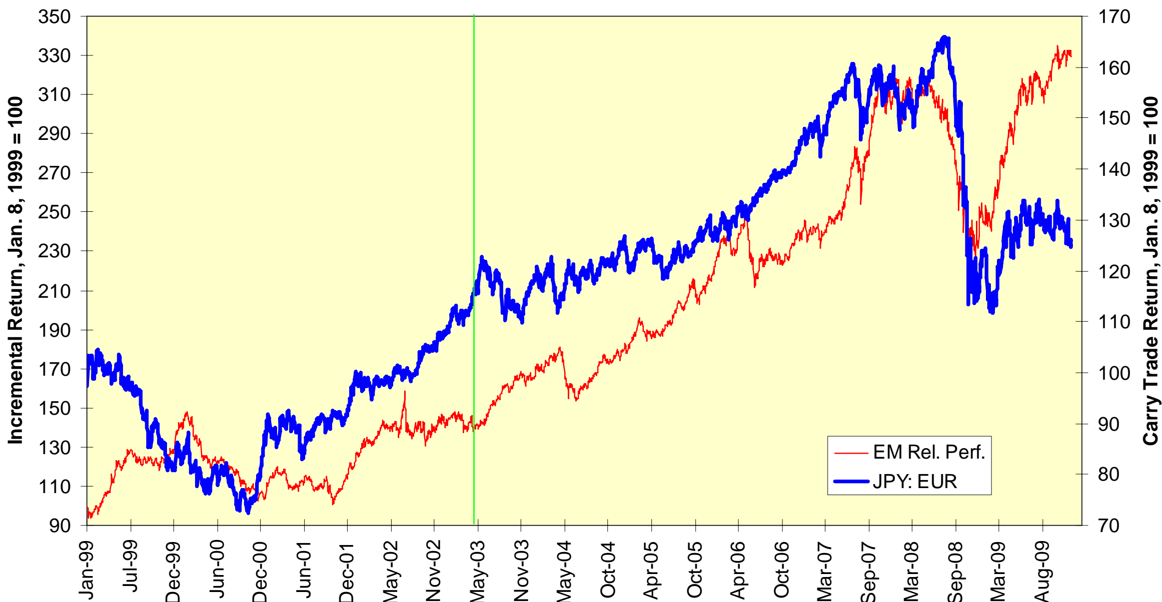
First, though, let’s take a look at the influence of the U.S. yield curve trade’s total return on the incremental performance of emerging markets. This is going to be defined as the total return of holding ten-year U.S. Treasuries less the total return on a constant-maturity three-month LIBOR position. 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

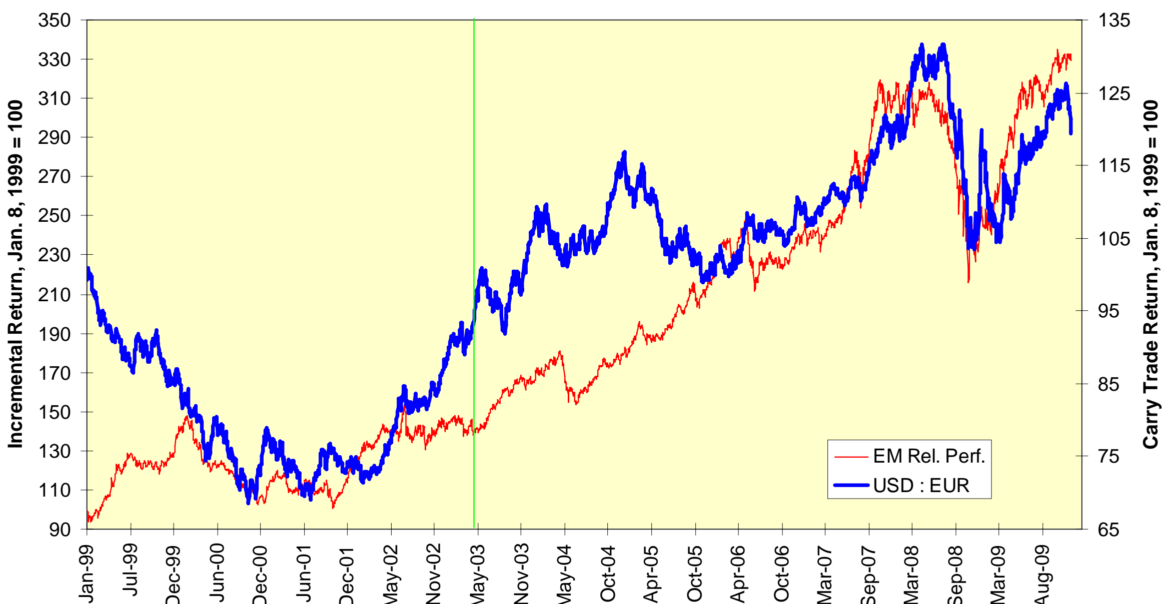


While there are periods such as August 2007-March 2008 and June 2009 to the present when both series are rising in parallel, there are enough exceptions here to dismiss the U.S. yield curve carry spread as a strong explanatory variable for emerging markets' incremental performance.

Now let's shift to the yen carry trade into the euro. Here the relationship is quite strong from the January 1999 advent of the euro all the way to the end of April 2009. If this column was being written eight months ago, I very well might have concluded this carry trade was the dominant variable for explaining emerging markets.

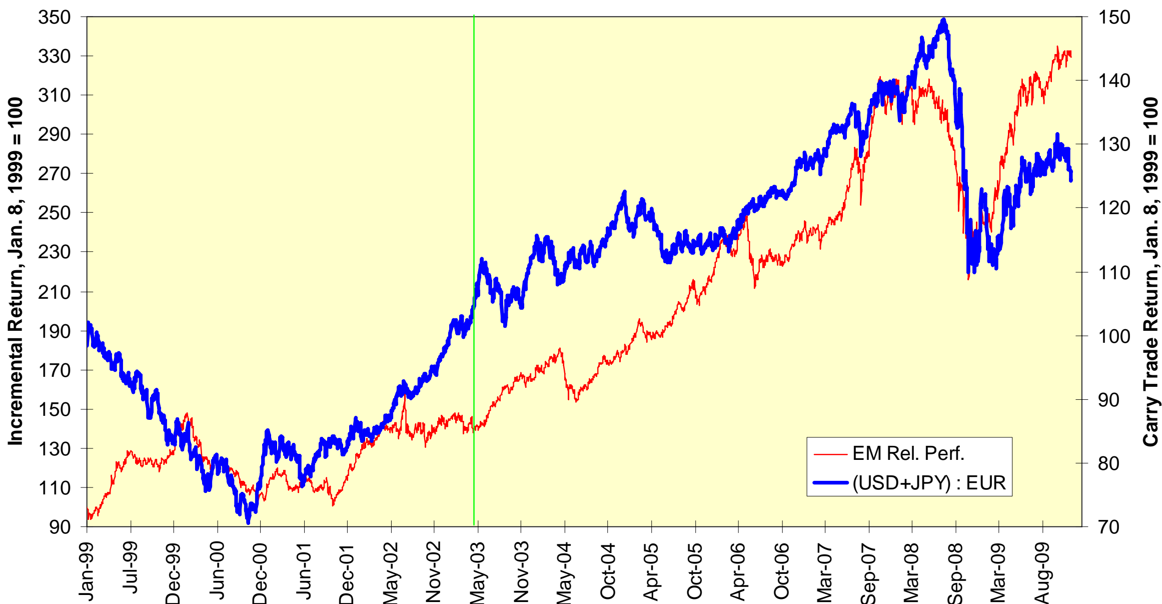


The most likely explanation for this change in the efficacy of the yen carry trade as an explanatory variable would be the shift to the dollar carry trade as U.S. short-term rates started to fall below Japanese rates. This made the dollar the preferred funding currency for global carry trades and did no small amount of damage to Japan. If this is the case, we should expect to see the dollar carry trade continue to match emerging market performance, and it did all the way until the Greek and Spanish credit downgrades at the start of December hit this particular carry trade.



Interestingly, had this column been written at the end of November 2005, the dollar carry trade would not have been considered a strong explanatory variable. Fashions come and go in markets, and the dollar carry trade came and stayed with a vengeance.

Finally, carry trades seem to be an either/or proposition. If we blend the dollar and yen as funding currencies, the net explanatory power seems to dissipate. You either fund with one or the other, but not with both.



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. If short-term interest rates rise in the U.S., which seems likely at some point in 2010, emerging markets can do fine so long as yen rates continue to hug the ground. If both rates stay near zero, emerging markets will continue to do fine. If neither, and we must emphasize the "neither" part, short-term interest rate stays low, look for an exodus from emerging markets in general and indeed from all risky assets.