No Deliverance From Dueling Carries

Future economic historians will marvel at both U.S. quantitative easing and at Japan's very mixed successes in breaking its two decades-plus of deflationary pressures by printing enough yen to destroy its value. For now, traders will have to contend with both U.S. tapering of QE and at Japan's ultimate decision whether it wants to keep playing this game.

The yen started to move lower in September 2012. It then broke out to the downside on November 14, 2012 and then renewed its plunge on April 4, 2013 with a promise to print ¥7 trillion per month. This quantity approached the American QE3/4 level of $85 billion per month prevailing at the time; the U.S. economy was about two and one-half times as great as Japan's at the time. This is the sort of desperation you could see from space.

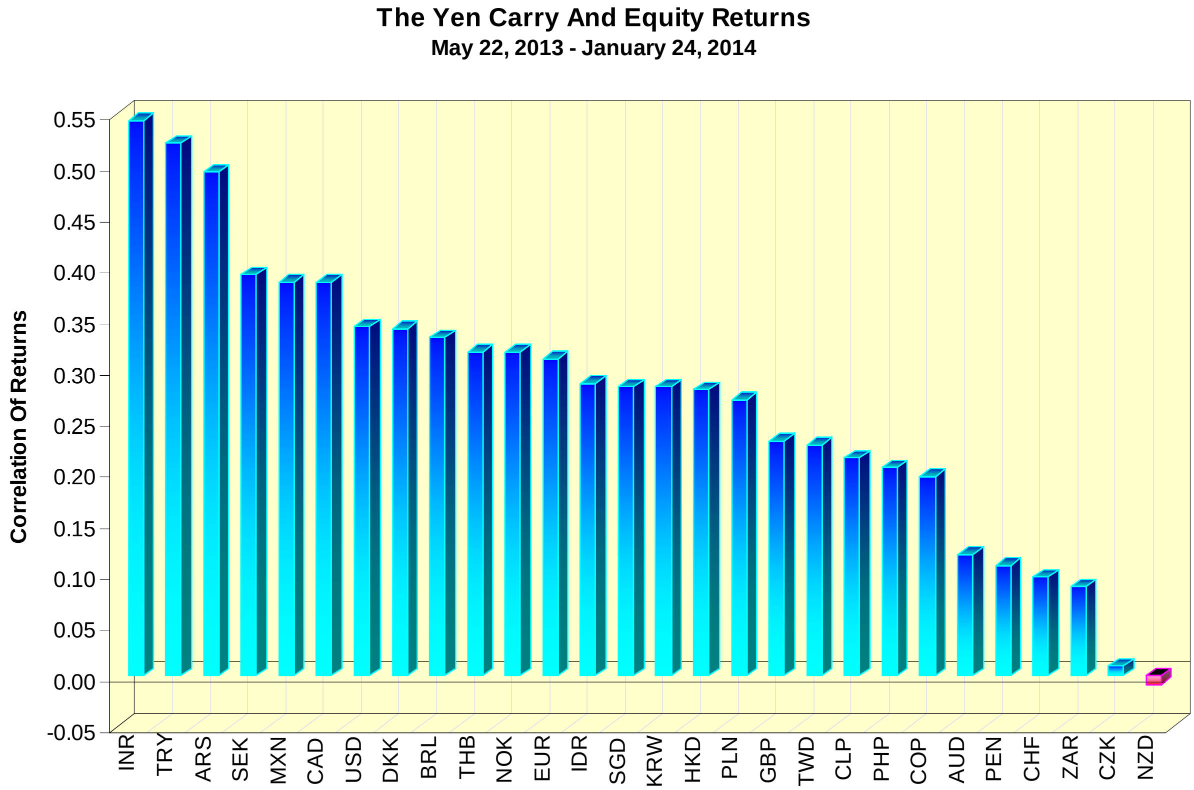
Dueling Carry Trades

These two piles of printed money had to go somewhere, and the initial response was what the initial response to such efforts always is, a flow into financial assets. If the global economy has slack capacity and if investments in real plant and equipment have to be made with long lead-times for long-running productive lives and in response not to current but rather to expected conditions, it would be irrational for the money to flow anywhere else. Financial assets have a second advantage relative to real assets, one many homeowners discovered the hard way during the residential real estate bust: They are liquid. You may not like the price being bid, but you can sell most simple financial assets quickly; complex derivatives are another matter altogether.

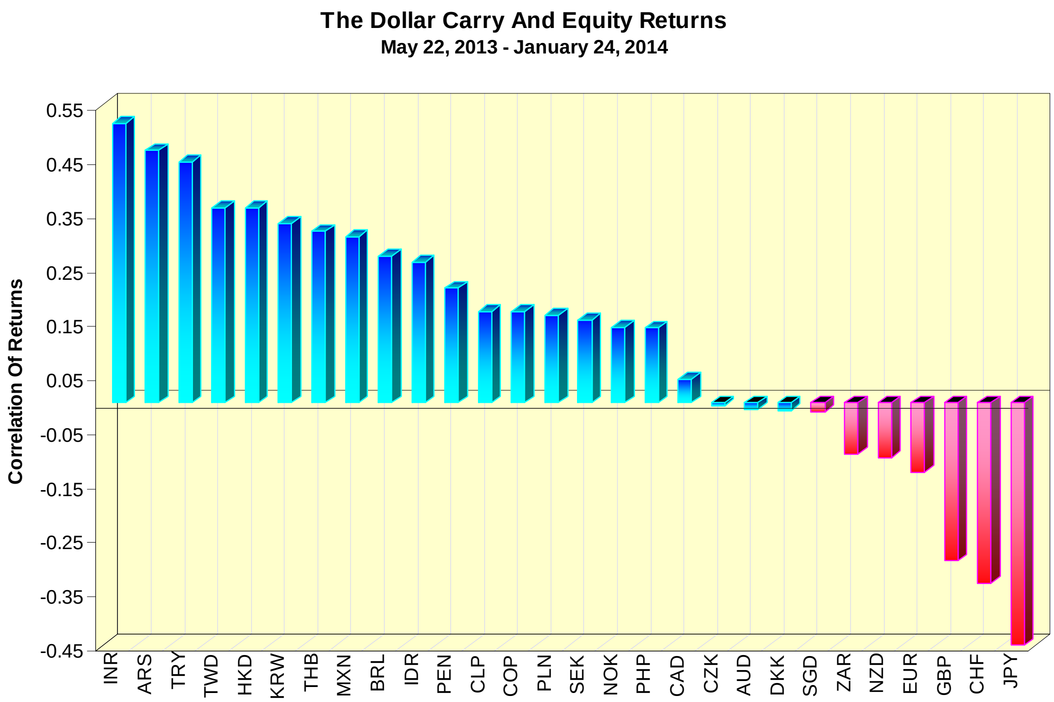
If Japan's efforts to demolish its own currency's purchasing power and the value of its citizens' accumulated savings were to succeed, dubious goals both, a reignition of the yen carry trade would have to be involved. This trade started to disappear in the summer of 2007 with persistent deflation in Japan and with the rise of the dollar carry trade in 2008 (see "Requiem For a Carry Trade," February 2012). The Japanese yen had to displace the dollar, the Swiss franc and other low-yielding currencies, and this was no small task in a world flooded with paper. It would not be a case of if you print it, they will come.

Let's compare the correlations of returns between the yen and dollar carry trades into individual currencies and their associated equity markets measured in local currency terms between the first signal of American tapering of QE on May 22, 2013 and January 24, 2014. The yen carry trade's correlation of returns against national equity markets has been surprisingly straightforward, unidirectional and strong; the only negative correlation of returns has been against New Zealand.

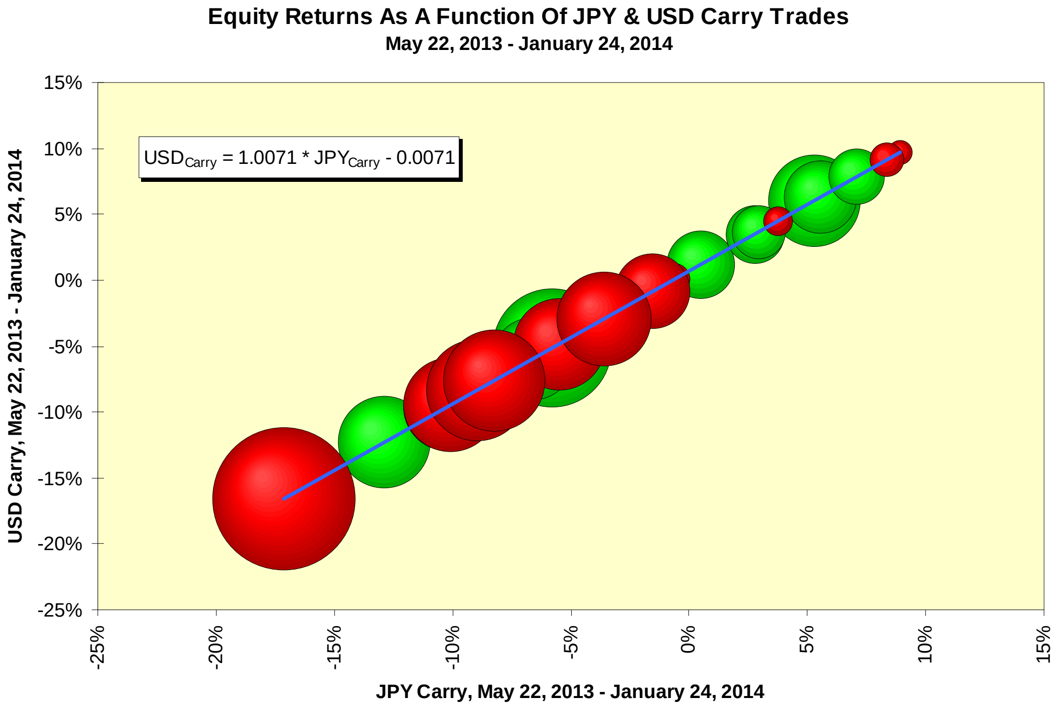
Positive correlation of returns can be deceptive in its interpretation. If both the carry return and the equity return are negative, the correlation is just as positive as if the opposite were true. This certainly was the case for the yen carry into markets such as India, Turkey and Argentina hit hard by the combination of simultaneously weak equity and currency markets.



If we duplicate the exercise for the dollar carry trade over the same period, we see a much more differentiated picture. The same weak-to-weak combinations for the INR, ARS and TRY, inter alia, are visible. However, as several major currencies both yielded less on average than did the USD and gained against the USD on a total carry return basis as well. These included major currencies such as the JPY itself and the CHF, GBP and EUR. These produced a negative correlation of returns between the dollar carry trade and those national equity markets.



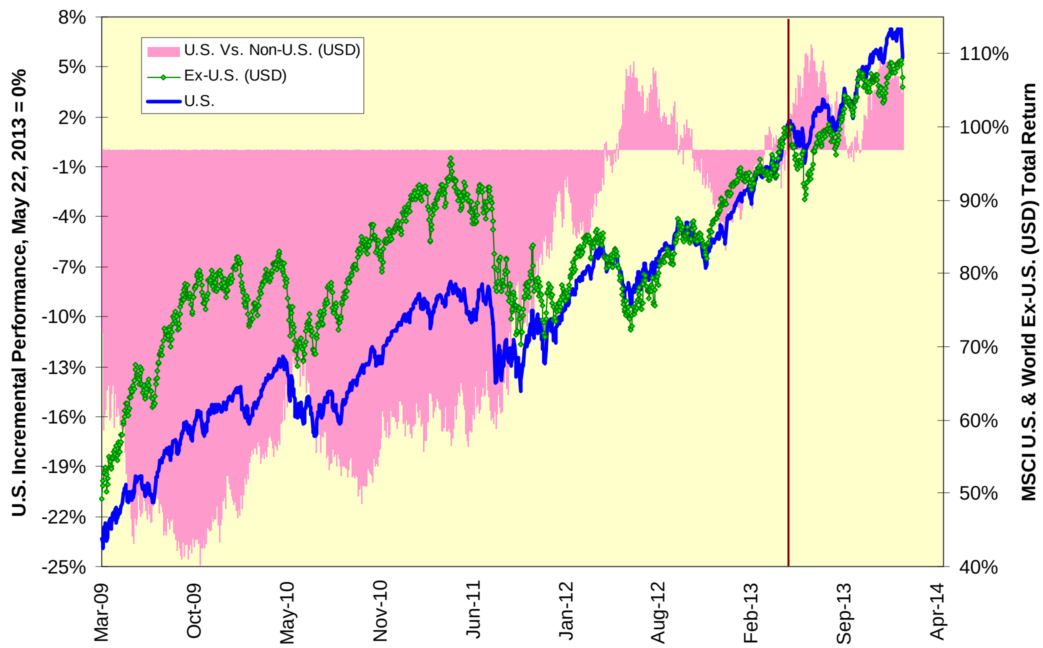
The yen carry trade was able to acquire market share in the global lending business at the expense of the dollar carry trade, especially after the April 2013 expansion of Japanese money-printing. If we map equity returns as a function of the two carries between May 2013 and January 2014, we see a regression beta of 1.007. This near 1:1 relative importance represented a massive increase from what had been a 1:3 relative importance in February 2013. More important, positive national equity returns, marked with green bubbles, are clustered in the northeast corner of the chart where both carry returns are positive; the opposite tendency is true for negative equity returns marked in red bubbles.



Direct U.S. Impact

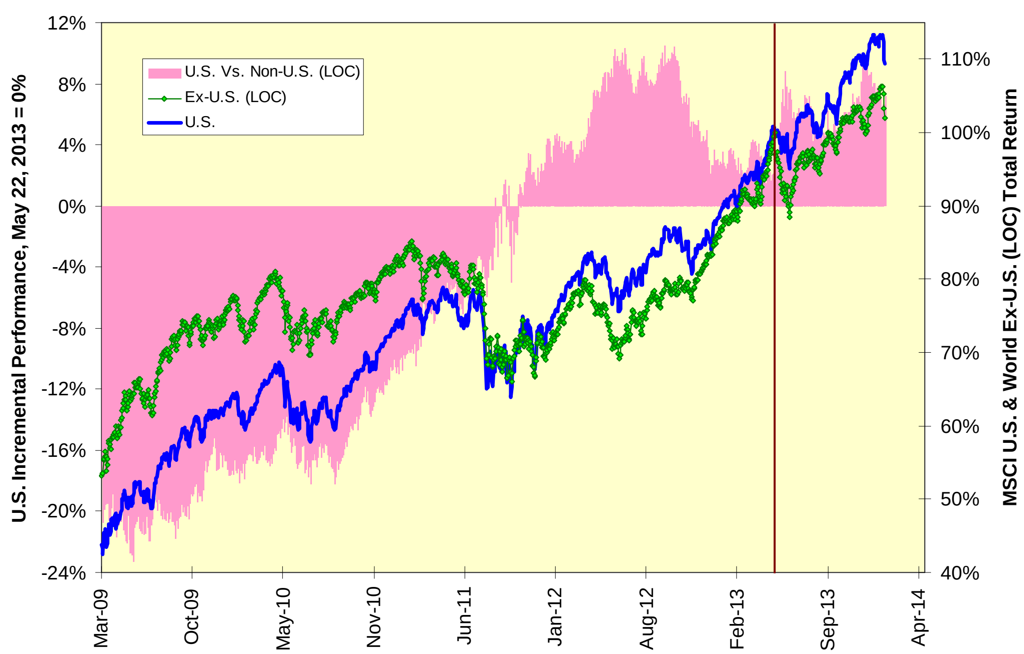
The U.S. has been both an absolute and a relative direct beneficiary of both carry trades. If we compare its total return in USD terms to that of the MSCI World Ex-U.S. index, we see the U.S. outperformed the rest of the world by 3.8% since taper-talk began in May 2013. This stands in great contrast to strong U.S. underperformance relative to the rest of the world between the initiation of QE1 in March 2009 and the end of 2011. Restated, the U.S. had financed the rest of the world's outperformance via QE1 and QE2, but the imminent slowing of the money spigot pulled the proverbial rug out from the rest of the world's feet.

The U.S. Has Outperformed Rest Of World In Taper Talk Era
In USD Terms



If we were to repeat this exercise in local currency terms, we would see the U.S. outperformed the rest of the world by an even heftier 7.2%. While the dollar may have softened somewhat against several of the major currencies, it gained strongly against emerging markets and other key currencies such as the AUD and CAD.

The U.S. Has Outperformed Rest Of World In Taper-Talk Era
In Local Currency Terms



Regardless of which carry trade or measure of global equity returns we use, there is no denying the role of both the dollar and yen carry trades supporting equity returns separately and in conjunction with each other. This might be all well and good if we lived in a make-believe world even more than we do, one in which QE could go on forever without any negative externalities. Such is not the case. The dual role of the carry trades suggests their removal, separate or together, will be a headwind for financial markets unless offset by rising earnings.