# Schadenfreude Is Not An Asian Shtick

Of all the sentiments the human race embodies, *schadenfreude*, or a smug satisfaction at the misfortunes of others is amongst the most lamentable. Yet it is so embedded in our expectations it seems natural the dollar's travails, once joined by the euro's travails, had to redound to the benefit of someone else. A quick spin of the globe might suggest Australia or Canada as beneficiaries, but those two economies combined simply are not large enough to offset the losses elsewhere. The same holds for smaller European countries, Switzerland in particular; the country has enough trouble absorbing flight capital out of the Eurozone let alone the United States in combination.

This leaves Asia by default. Bloomberg and J.P. Morgan have created an index of Asian currencies outside of Australia and Japan, composition and weights given below; while its history goes back to September 1994, we will confine the analysis to the post-September 27, 2005 period when the Chinese yuan started to trade more freely in the interbank market.

As an aside, the rise of Asia in general and China in particular might have been unthinkable in the previous culture; you are invited to watch the movie version of Pearl Buck's *The Good Earth* to see how China was regarded during the 1930s.

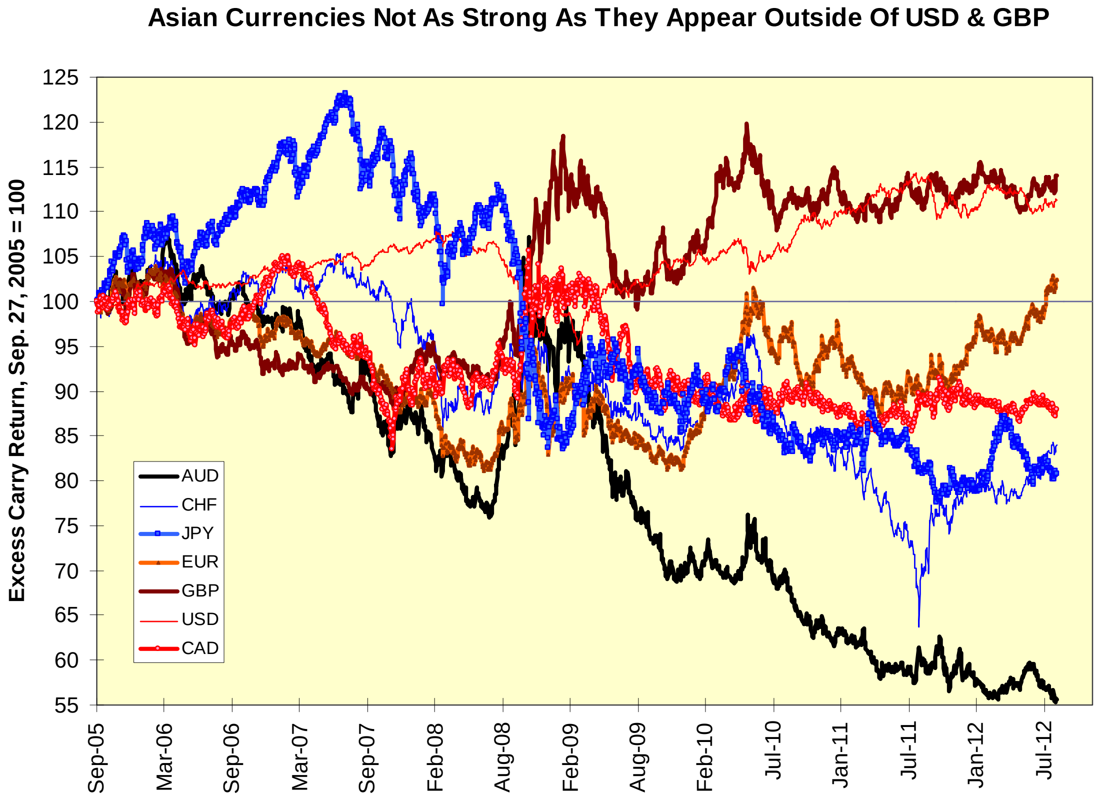
**Bloomberg-J.P. Morgan Asian Currency Index**

| | | |
|---|---|---|
| China | CNY | 36.05% |
| Korea | KRW | 15.48% |
| Singapore | SGD | 9.64% |
| Hong Kong | HKD | 8.76% |
| India | INR | 7.81% |
| Taiwan | TWD | 6.67% |
| Malaysia | MYR | 5.16% |
| Thailand | THB | 4.91% |
| Indonesia | IDR | 3.19% |
| Philippines | PHP | 2.33% |

**Carry Into The Asian Index**

While the Asian index hit its highest level against the USD since the Asian Crisis of 1997-1998 in mid-2011, this is not an universal experience against other major currencies. If we map the excess carry return into the index from a group of major currencies, an unmistakable conclusion emerges: Only the USD and GBP have been weakening consistently against the Asian index. The AUD, CHF and JPY have strengthened rather substantially since the global market low in March 2009; all for different reasons. The AUD's strength has been a function of its strong commodity-led export growth and campaign to fight imported inflation via higher short-term interest rates. The CHF has strengthened mostly as a sanctuary from the EUR, and the JPY has strengthened under a combination of persistent disinflationary pressures and the country's current account surplus.

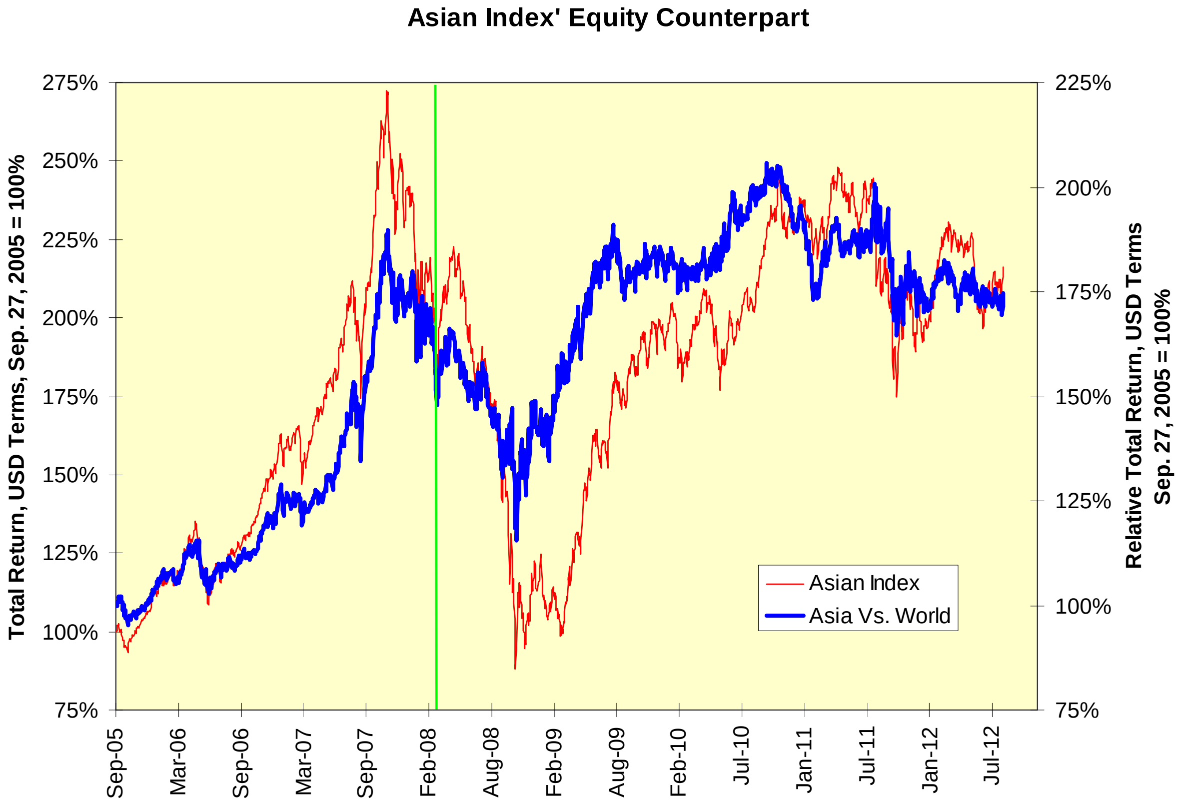
We can restate the chart below simply as "The Asian index is not stronger; the USD is absolutely weaker."




**The Carry Trades**

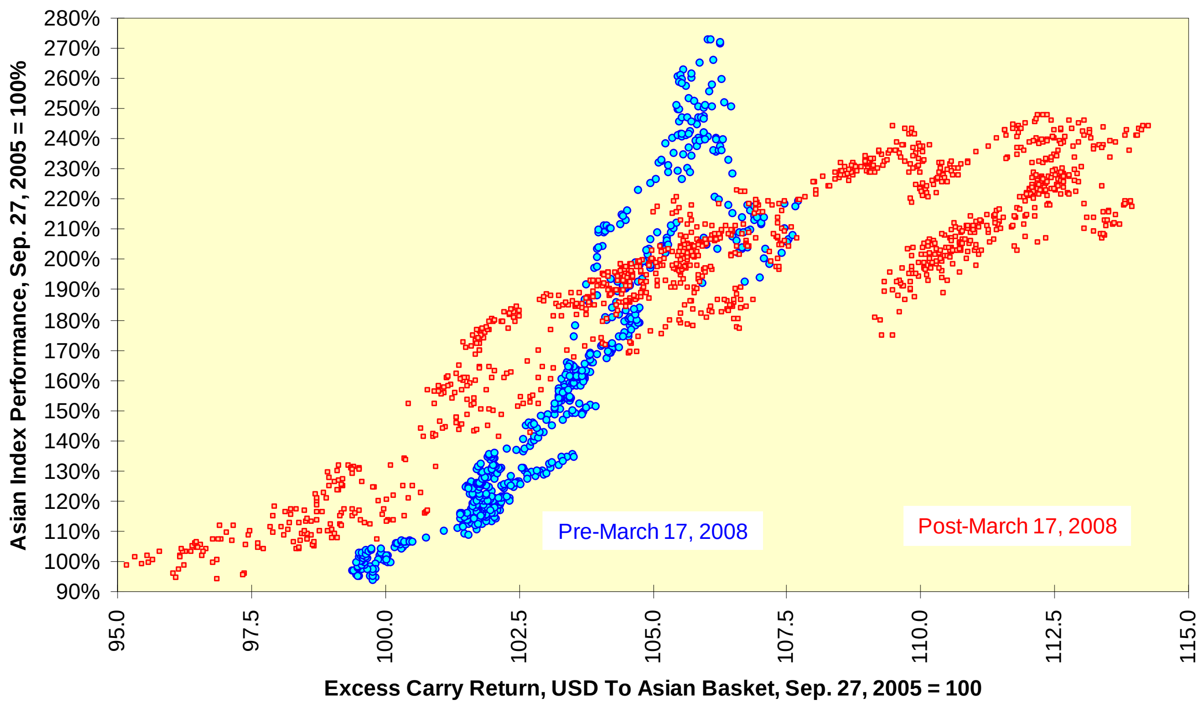
Both the USD and JPY have been funding vehicles for carry trades into equity markets for years (see "The Long, Awful Life Of The Dollar Carry Trade," and "Requiem For A Carry Trade," January and February 2012, respectively). If we construct an equity index in the composition and weights of the Asian currency index, how does it relate to the carry trades from the USD and JPY into the currency basket?

That reconstructed equity index is presented below both in USD terms on both an absolute total return basis and on a relative to the MSCI World index basis. A breakpoint is superimposed on the March 14-17, 2008 weekend where Bear Stearns went under and was rescued by the very same J.P. Morgan; while this may not seem like the logical breakpoint in the data series given all of the other candidates available, the relationship between the USD excess carry return and the absolute Asian equity index' return seemed to change significantly at that point, as seen in the second chart below.



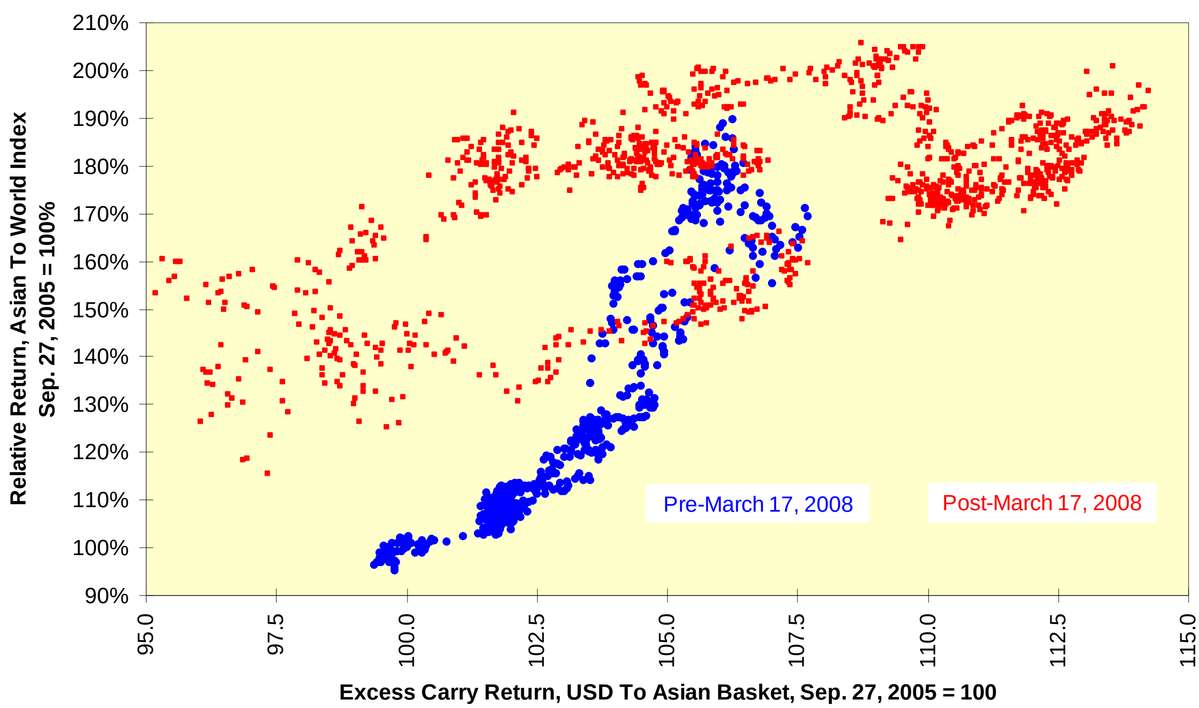

Prior to March 2008, the absolute USD total return of the Asian equity index was a quadratic function of the excess carry return from the USD into the Asian currency index. A little bit of money went a long way in encouraging risk. After March 2008, the relationship switched to a more linear one; gains and losses on Asian equities rose and fell with gains and losses on the currency carry, but not at a turbocharged rate.

**Asian Equities As Function Of USD Carry Trade**
**Absolute Return**



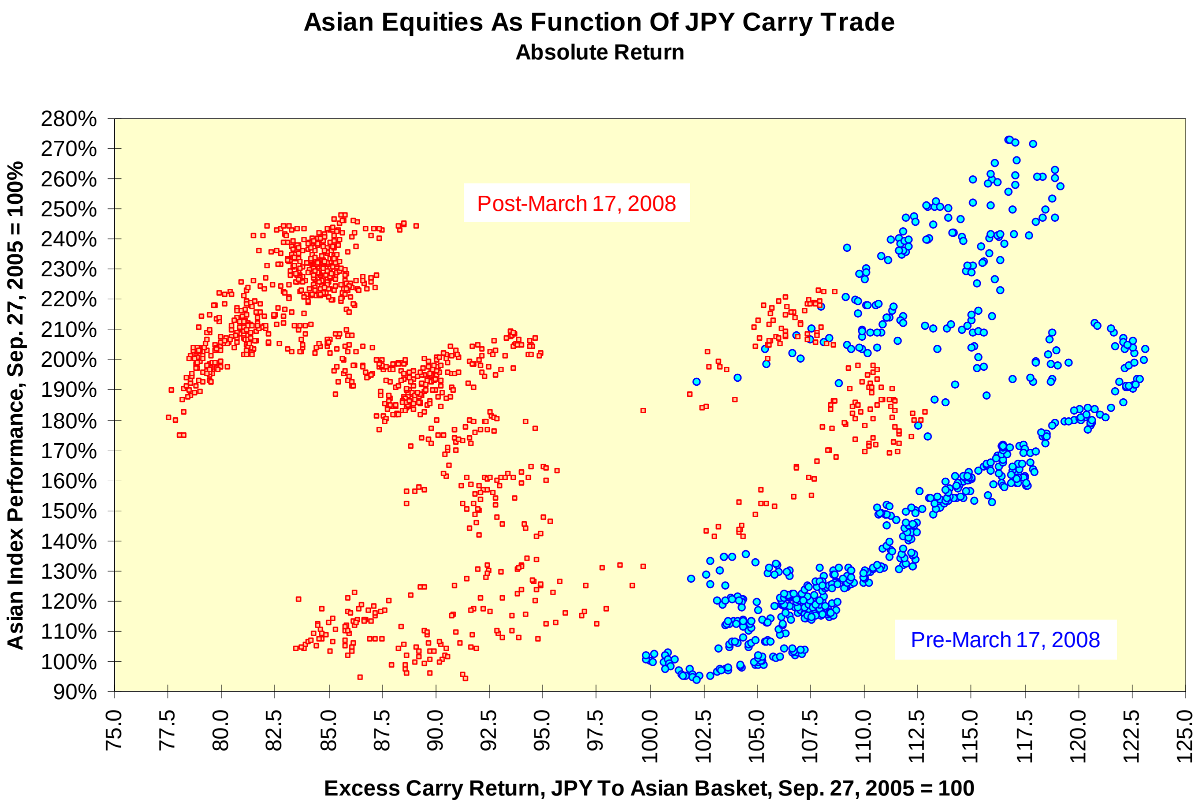

The same analysis holds in general, but with less statistical robustness for the post-March 2008 observations, when we switch the dependent variable to the Asian equity index' relative total return. This is attributable to the large increase in volatility, both lower and then higher, over the two years following March 2008.

**Asian Equities As Function Of USD Carry Trade**
**Relative Return**



Now comes the surprising part, and that is the relative unimportance of the yen carry trade to the Asian equity index. Had this analysis been extended back to 1994, something the author would have liked to have done had the data been available; the yen carry trade would have been the dominant factor, especially in the late 1990s. *C'est la vie*. However, Japan's aborted attempt to end the carry trade by raising short-term interest rates and withdrawing excess reserves in May 2006 lowered its role in financing global financial fun-and-games. This role was assumed in 2008 by the dollar.

The result is an odd combination of a weak negative relationship between the absolute performance of the Asian equity index and the excess carry return of the yen into the Asian currency index prior to March 2008 and an erratically positive relationship thereafter.




In addition, if we transform the dependent variable from absolute to relative performance, the relationship tightens up; it is almost as if causality shifts to the point where we have to wonder whether the absolute performance of Asian equities affects the yen carry trade more than vice-versa. This is a highly plausible argument: A downturn in stock market performance could and probably did lead Japanese investors to cash in their shareholdings and repatriate the yen.

**Going Forward**

Should we expect the problems of the Eurozone and U.S. to make the Asian basket, more than one-third of which is the CNY, a leading alternative in global finance and trade? Probably not; until and unless China allows full convertibility of the CNY and ceases its on-again / off-again revaluation policies, the CNY will not become a reserve currency or a vehicle for pricing global trade. The other nine currencies in the basket are too small and unrelated to constitute a currency bloc. Finally, after the experience of the euro, it may be a long time, if ever, before anyone carries the day with a, "Let's create a common currency" argument.