# Kiss The Dollar Carry Trade Good-Bye

Much of the focus on global carry trades has been, understandably, on the Japanese yen and the Swiss franc, and with good reason. As discussed here in a series of columns beginning in April 2006 and ending in September 2007, the yen carry trade and its spasmodic threats at unwinding propelled much of the gain in the credit boom and some of the loss in the subsequent crunch. Even today, as underscored in a recent Columnist Conversation, traders have learned to focus on one aspect of the yen carry trade, the euro/yen cross-rate, discussed here in December 2008, as a barometer for global risk appetites.

The dollar carry trade has received much less attention, but it has been operative for years, beginning with Alan Greenspan's ill-fated decision to end the consequences of one burst bubble with another bubble. It did not take the world's credit junkies, a category possibly inclusive of all of us, long to figure out that if the policy of the U.S. government was to keep short-term interest rates low and the dollar weak, then they could borrow cheap dollars, lend them elsewhere and not be faced with the risk of stronger dollars when the trade was unwound.

Viewed through this prism, we can attribute the massive rallies of emerging markets and commodities between mid-2003 and mid-2008 as the logical outcome of a dollar carry trade. Let's make the argument chronological. Japan's stock and real estate bubbles peaked in December 1989. Japan did not start cutting its rates aggressively until the mid-1990s and did not reach its zero interest-rate policy until February 1999 and quantitative easing until March 2001. Our stock market hit its first peak in March 2000, our residential real estate market in July 2006, and our stock market hit its second peak in October 2007. We more or less reached both zero interest rates and quantitative easing by December 2008.

Hold your applause, please. The dollar carry trade is disappearing. While Japan's liquidity flood did nothing to arrest Japan's 19 year-old Lost Decade, at least their cheap yen financed global growth elsewhere as Japan was alone in recession. As recently as November 2007, I incorrectly thought the dollar carry trade might support prosperity outside of the U.S., but that hope collapsed under the weight of a global recession. I also said in that column:

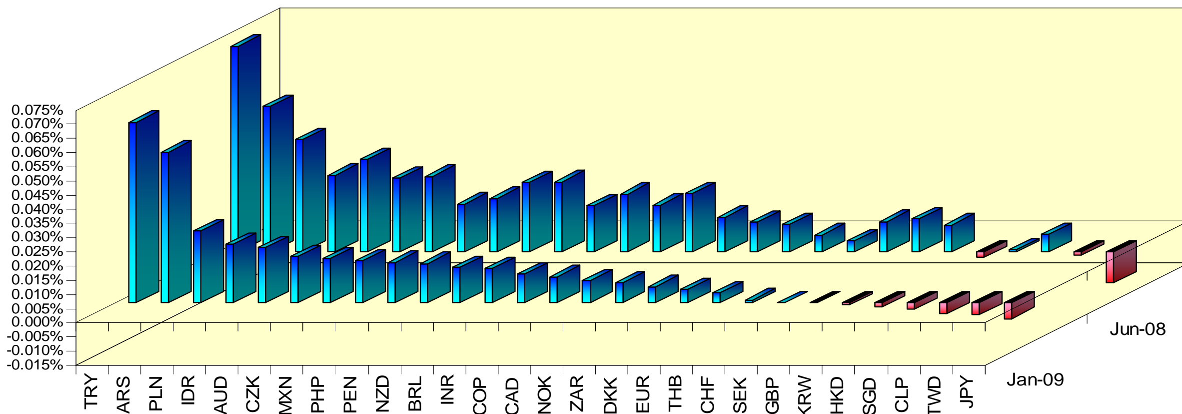
> *The Federal Reserve has been trying to reflate the economy with lower interest rates, just as it did in 2001-2003 and later in 2004-2005, by keeping rates too low for too long. Comments last Friday by Federal Reserve Governor Randall Kroszner indicate this ploy may be ending, but we shall see how central banks react to the next financial crisis.*

So, how did the central banks react to the next financial crisis? Like ticked-off chimpanzees at zoo feeding time.

**No Need To Borrow Cheap Dollars**

A carry trade can be decomposed into an interest rate spread and spot currency rate components. If I borrow U.S. dollars at a low rate and lend in New Zealand dollars at a high rate, I am earning the interest rate spread. Of course, none of this means a thing if the New Zealand dollar collapses; that is the spot currency rate risk. Investors in global stocks, bonds and in particular short-term interest rate instruments learn this the hard way. Icelandic bank accounts, anyone?

Let's map the average daily total carry return for the dollar against 28 different currencies from the January 1999 inception of the euro to June 2008, the last month before Hank Paulson began his excellent adventure, and to the present.

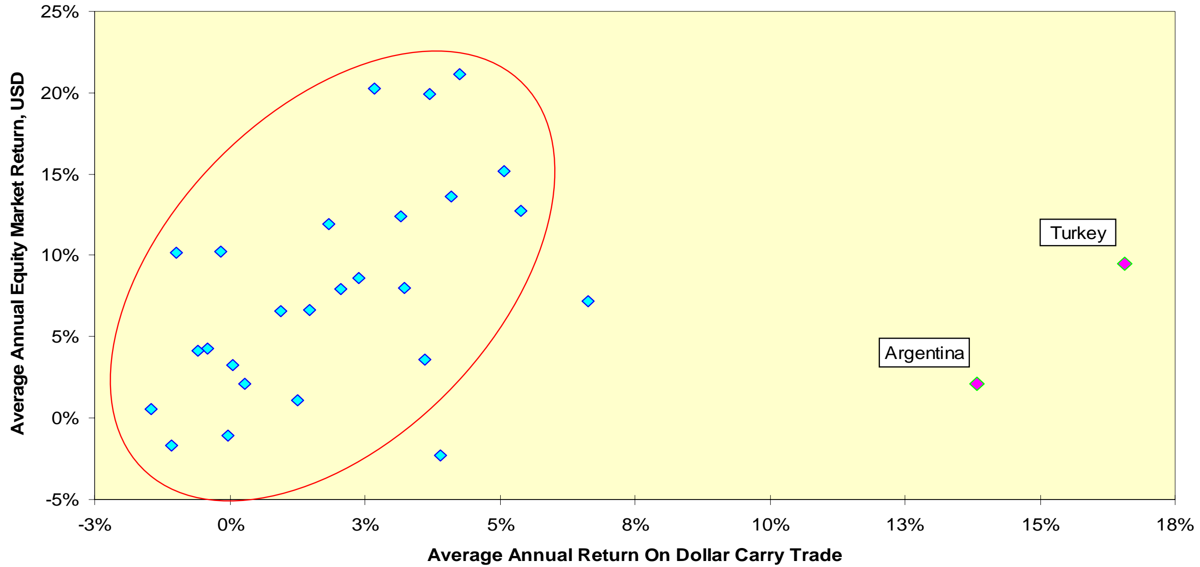



In the period ending in June 2008, the dollar carry trade was negative against only three currencies; all marked in red, the Japanese yen and the Taiwan and Singapore dollars. That number has expanded now to seven, the British pound, Korean won, the yen, the Chilean peso and the Singapore, Taiwan and Hong Kong dollars. The carry to the yen shifted to a positive number. Only three currencies, the Argentine peso, the yen and the Hong Kong dollar, saw an increase in their average daily carry to the U.S. dollar.

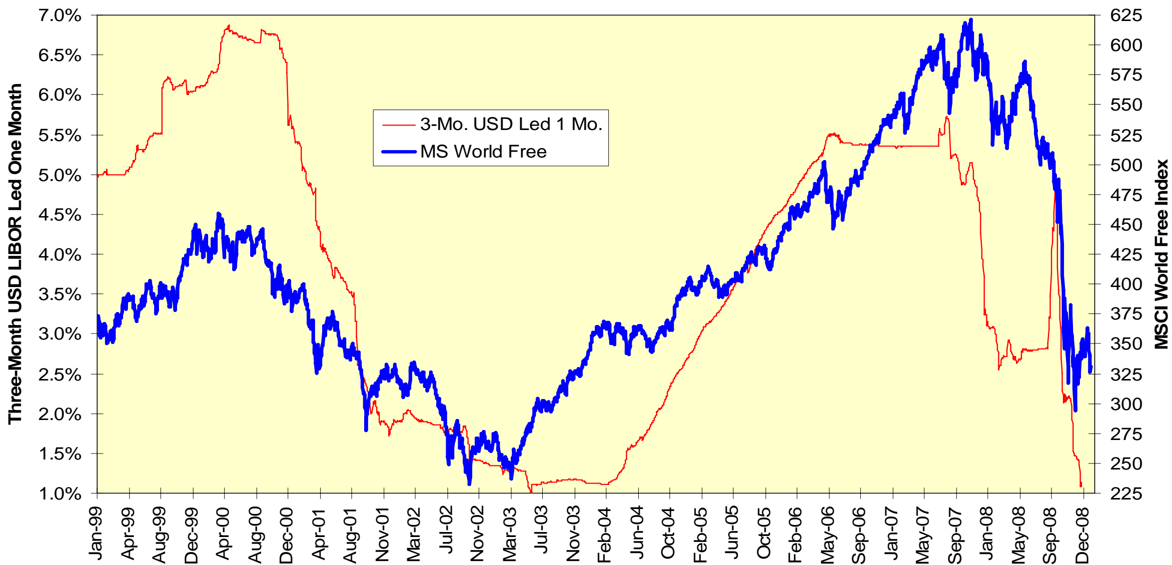
The reason behind this change is too obvious: The world's central banks are presently engaged in a race to zero. In a global recession with declining demand for investment capital, why bother borrowing someone else's currency and incur the currency risk when your own currency is becoming free itself?

**Not Without Loss**

In a statement with reversed causation, the world will miss the dollar carry trade. The higher returns American investors enjoyed from the international portion of their portfolios were correlated directly to the dollar carry trade. If we exempt perpetual outliers Turkey and Argentina from the analysis, the average annual total return in U.S. dollar terms for national stock markets had a 1.22 beta to the average annual return on the dollar carry trade. As was the case with the yen carry trade, the prospect of high returns elsewhere and low returns at home encouraged dollar holders to lend the currency abroad.




If we really wanted to be direct about the matter, all we would need to do is map the return of the MSCI World Free index against three-month dollar LIBOR led one month. The world's central banks, whose job it is to provide price stability and preserve the value of their respective currencies – yes, I do know the Federal Reserve has a dual mandate to promote full employment by means no one can demonstrate works – have done nothing but chase stock prices lower.




**The Sad Results**

The net of the dollar carry trade's death is a decline in global investment demand for the dollar, lower returns for U.S. investors overseas, zero interest rates on the horizon everywhere. What a success story. We will add trillions of dollars of public debt to this for all manner of misdirected spending and squander governments' credit ratings around the world. And yet we hear from various quarters the problem is we have not done enough of this foolishness; just a little more will help. Yes, like it helped in Japan during and after the yen carry trade ran its course.