Whatever Happened To The Euro/Yen Cross-Rate?

The urge to find reliable trading indicators is surpassed only by various biological instincts in normal people and remains unsurpassed in hard-core trading addicts. These indicators originate somewhere in the heavens, flash meteorically across the sky and end up creating big smoking craters on the ground.

Sometimes this is due to a rather normal propensity to confuse correlation with causality. Behavioralists long have recognized the human mind not only rejects randomness but actively seeks patterns. This probably contributed to our survival on more than one occasion. If we combine correlation with a solid fundamental explanation, including my analysis from last December, everyone joins the party and starts relying on the pattern.

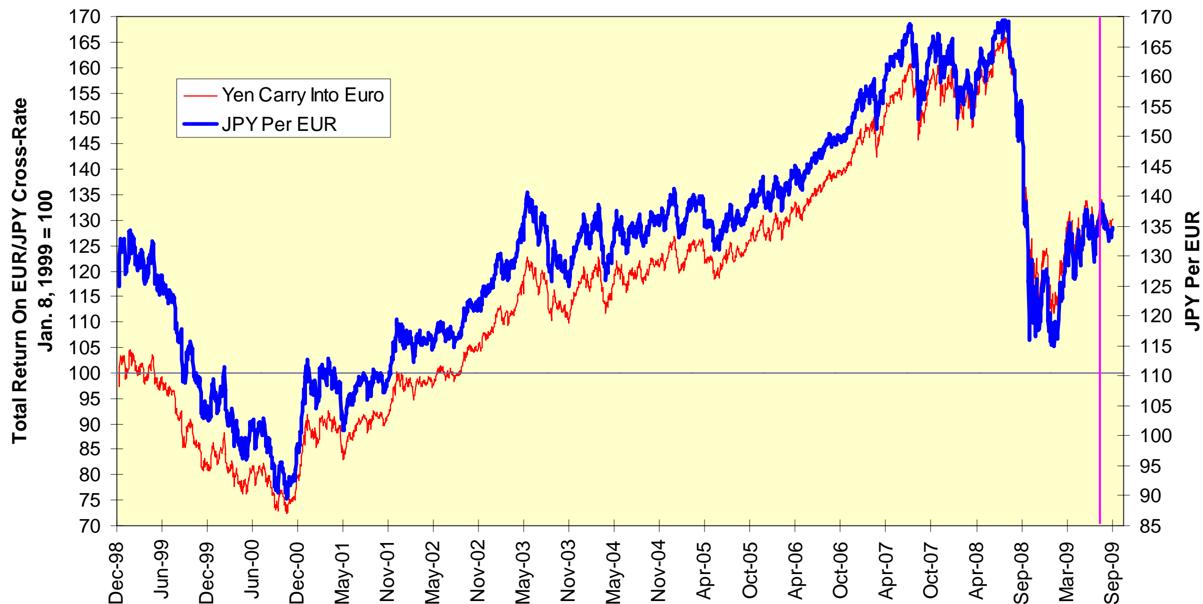
The explanation I offered, that increased global risk perception prompted yen carry traders who had borrowed the swapped it into another currency and invested in markets outside of Japan, to unwind their trades. This raised the value of the yen against the euro, and as the process also worked in reverse when risk acceptance rose, we had a bona fide working barometer of risk.

The Link Breaks…Or Has It?

Several observers have suggested the euro/yen cross-rate is now a broken indicator as it has been oscillating around 135 JPY per EUR since April during a time when risk appetite has surged globally. This is too harsh of a judgment. For example, gravity wants to pull you to the center of the earth right now, but you are defying it rather easily wherever you are. Step out of an open window, and you will find gravity is operating still. This is what is happening with the euro/yen cross-rate; it is our task to find what is defying it.

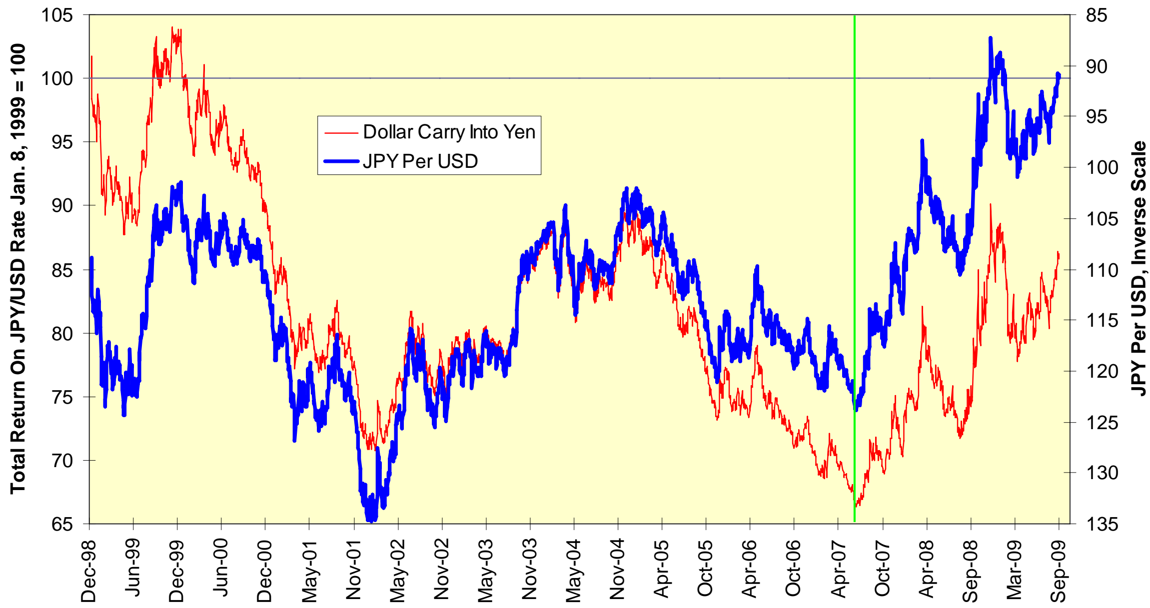
First, let's take a look at the cross-rate from two perspectives, the spot rate and the total return earned by borrowing three-month yen and lending in three-month euros since the January 1999 advent of the common currency. As yen rates were consistently lower than euro rates by a considerable margin until about a year ago, the total return on the carry trade outpaced the change in the spot rate. Once euro rates started to fall and the interest rate differential narrowed, the two measures converged. The total return on the carry trade hit a local maximum on August 7, 2009, marked with a magenta vertical line; it has retreated just under 3% from that point.

The Euro-Yen Carry Index And Cross-Rate



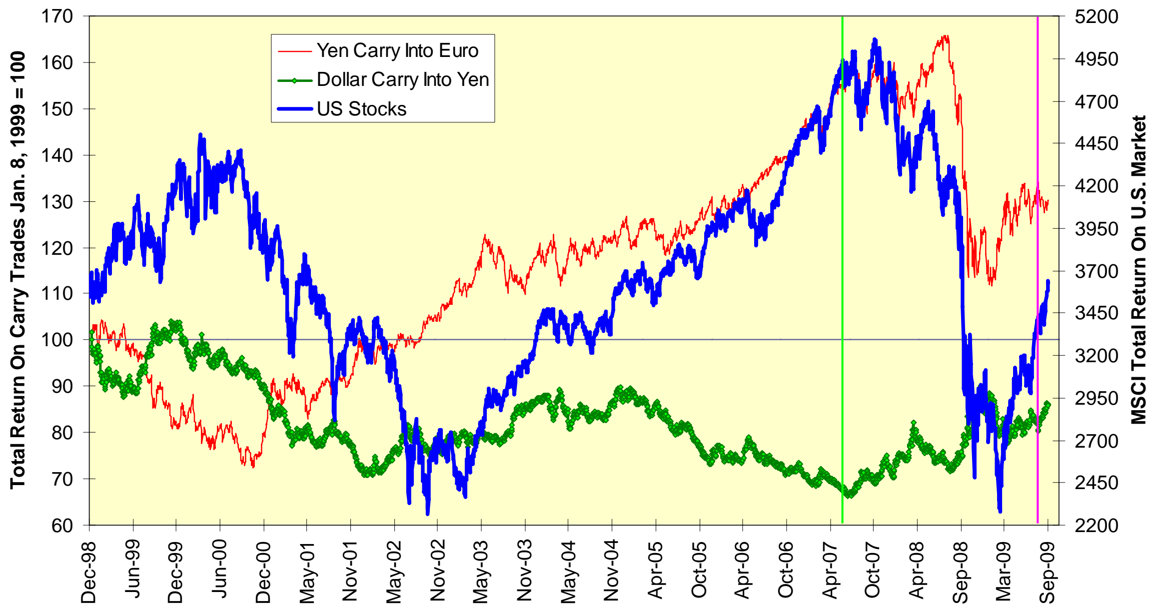
Now let's add a different carry trade, that of borrowing in the dollar and lending in the yen. Except for a brief period in 1999 during a yen rally, this trade was a complete money-loser from the start and kept on losing money until June 22, 2007, marked with a green vertical line. A combination of ever-lower dollar rates and a yen rallying under the weight of carry trade unwinds has made the dollar carry trade into the yen highly profitable; its annualized excess return since that date has been 12.15%.

The Yen-Dollar Carry Index And Cross-Rate



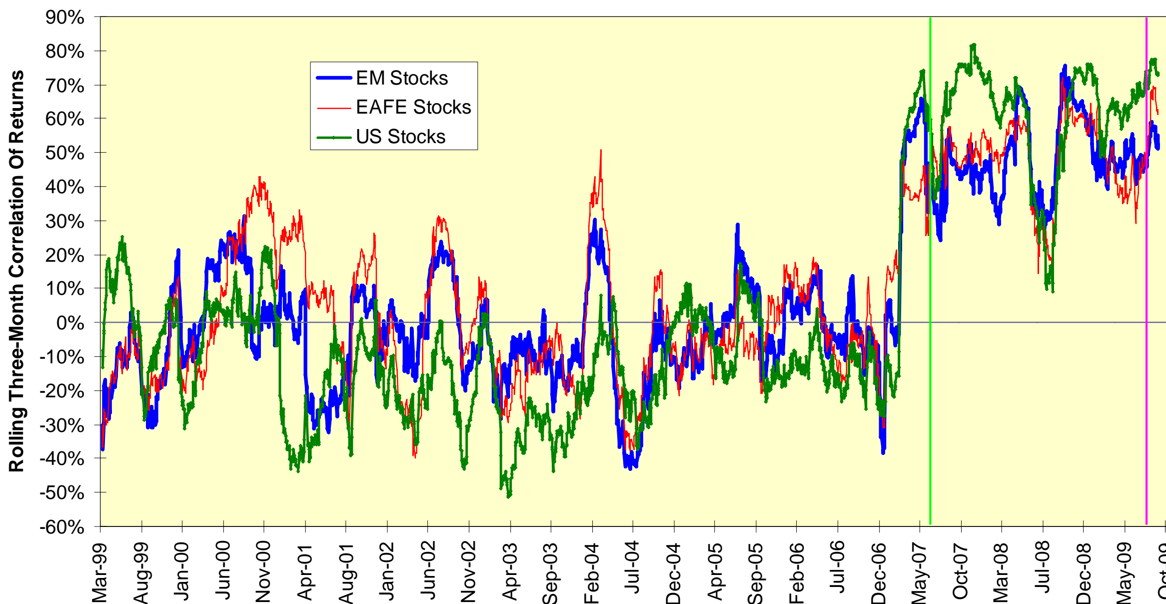
Now let's combine the two carry trades and compare it to the total return on the U.S. stock market as measured by MSCI. The long-term correlation between the euro/yen carry' return index and U.S. stocks between mid-2005 and the recent breakdown is apparent (this will be displayed in correlation of returns in the next chart to satisfy quantitative purists such as myself). Also apparent is the sudden upturn in the total return on the dollar/yen carry trade. It has been 6.86% since the August 7, 2009 local maximum for the euro/yen carry trade; this contrasts favorably to the 6.01% return on the MSCI U.S. index over the same period.

U.S. Stocks And Carry Trades



Savor that one for a second. Japan has been the poster child for low interest rates for more than 15 years, and yet you could have made more by borrowing the dollar and lending the yen than you could have made in U.S. stocks during what has seemed like a relentless rally. If that does not support the thesis offered here last week the U.S. stock market rally is liquidity-propelled, nothing does.

Finally, the dollar carry trade has been lurking beneath the waves for a much longer time than most of us have been aware. If we map the rolling three-month correlation of daily returns of the MSCI U.S. index, the Emerging Market Free index and the EAFE index against those of the euro/yen cross-rate, we find the long-term strong correlation between the euro/yen cross-rate and these equity indices really did not begin until the return on the dollar carry trade into the yen bottomed. Restated, the dollar carry trade's rebirth made the euro/yen cross-rate a viable market indicator. Rising global risk led to the Federal Reserve' decision to solve every problem known to humanity with lower interest rates; this opened the dollar's carry into a yen strengthening as its carry trades were being unwound. That is a large number of moving parts, is it not?



The euro/yen cross-rate did not leave you. You left it for someone younger and hotter, the dollar carry trade. That fling will last for as long as the Federal Reserve says it will last.