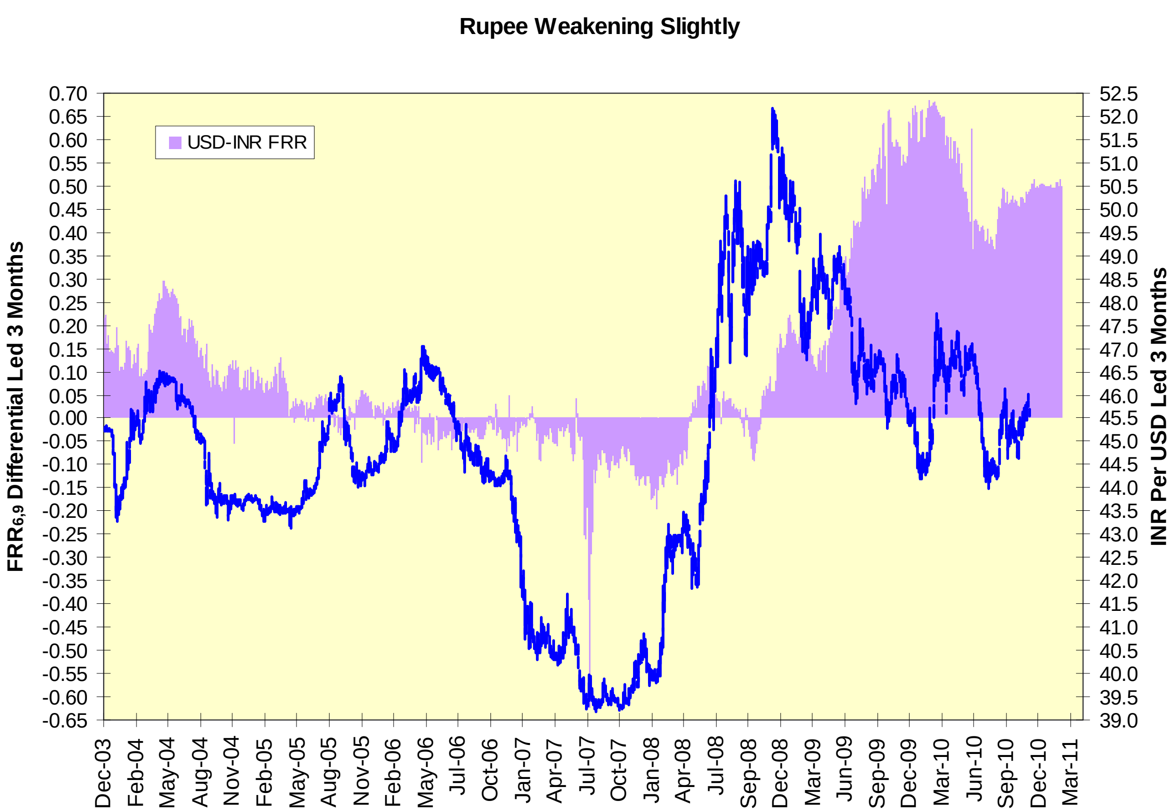
India And The Limits To Carry

One of the slammier (not a real word, but I just added it to my dictionary to get rid of that annoying red underline) dunks in recent years was the dollar carry trade. The U.S. printed dollars, they were borrowed to be invested elsewhere and life was good, at least for a while. Then the Federal Reserve turned the dial up to 11 and the rest of the world caught on to the idea that while a cold beer on a hot day might be refreshing, a quart of Ben's Best Busthead (not in dictionary either) might be a little excessive.

The rest of the world, as I noted in the case of Brazil, responded with capital controls, taxes on investments and pleas falling upon deaf ears for the U.S. to cease and desist. Dr. Frankenstein could fill them in on the rest of the story regarding the relative ease between creating a monster and controlling it. Let's see how this story is playing out in another member of the BRIC quartet, India, using the same format from last March.

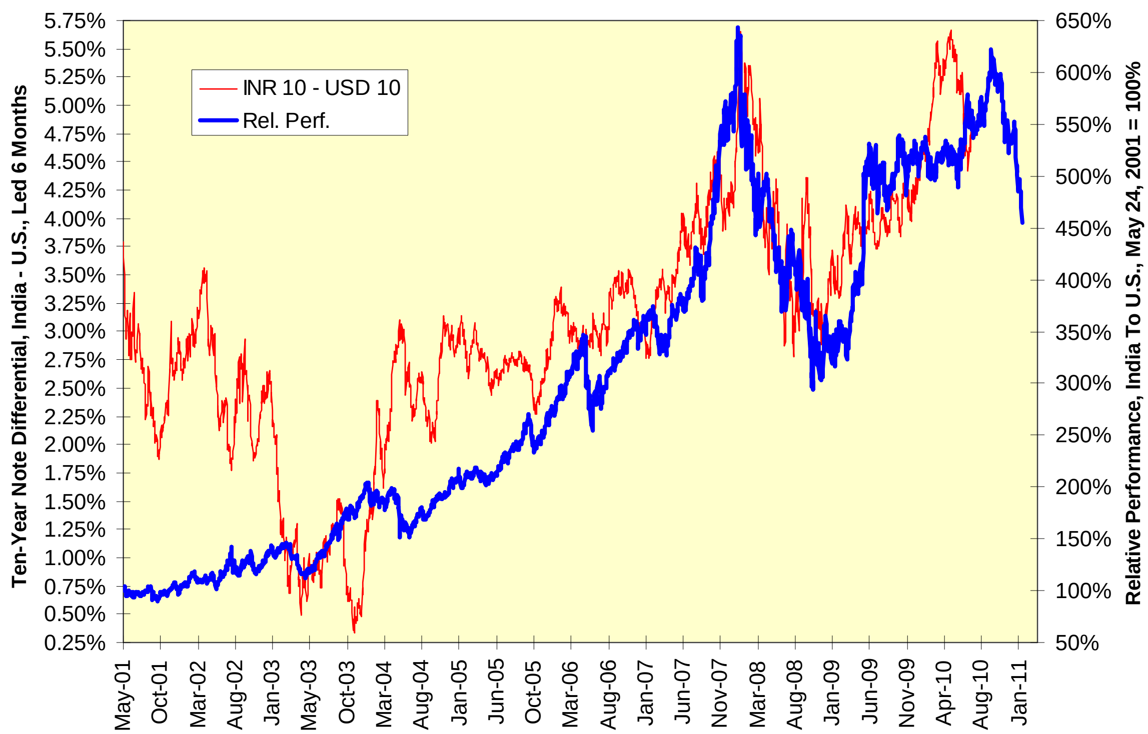
Hang On, Rupee

The Indian rupee (INR) had been rallying since the U.S. went to its zero interest rate policy in December 2008. The currency, plotted inversely, rose as the U.S. money-market yield curve rose relative to its Indian counterpart. These expected interest rate differentials are measured by the forward rate ratios between six and nine months ($FRR_{6,9}$). These are the rates at which we can lock in borrowing for three months starting six months from now, divided by the nine-month rate. A steeper yield curve normally was associated with expectations for higher interest rates and therefore was considered bullish for a currency, but that changed as the world shifted to "perma-expectations" for higher U.S. interest rates.



The INR is weakening now as India is forced to keep raising interest rates to combat inflation of 9.64% for urban non-manual workers. Those higher interest rates should increase the carry rate return for borrowing USD and lending INR, but a funny thing has happened since early October: The excess carry return has turned negative and Indian stocks have started underperforming U.S. stocks. Indeed, since October 4, 2010, American stocks have outperformed Indian stocks by 26.8% in USD terms. You deserve a BRIC today.

Long-Term Interest Rates And Relative Stock Performance



The only good news from an Indian financial market perspective is this relative stock market underperformance should lead to lower long-term rates in India relative to the U.S. through the first half of 2011. Higher short-term interest rates often slow an economy and move a yield curve toward inversion; the U.S. yield curve remains extremely positively sloped.

The Federal Reserve has insisted it has done something without precedent in human history; print a reserve currency without inflationary consequence. India would beg to differ, and all those who chased over to the BRIC markets in search of return will discover the carry trade has its limits. Mae West once proclaimed in another context, “Too much of a good thing can be wonderful.” Not if it is money printed without regard to the consequences.