The Yen Carry Trade May Return

The theme of rising from the grave is a staple in bad teenage horror flicks and in financial Websites; how else can I explain the following follow-up to last November's "Yen Carry Trade, R.I.P?" My thesis was simple: Japan had lost the race to the bottom against the U.S. Ben, Ben, he's our man / if he can't print 'em / no one can.

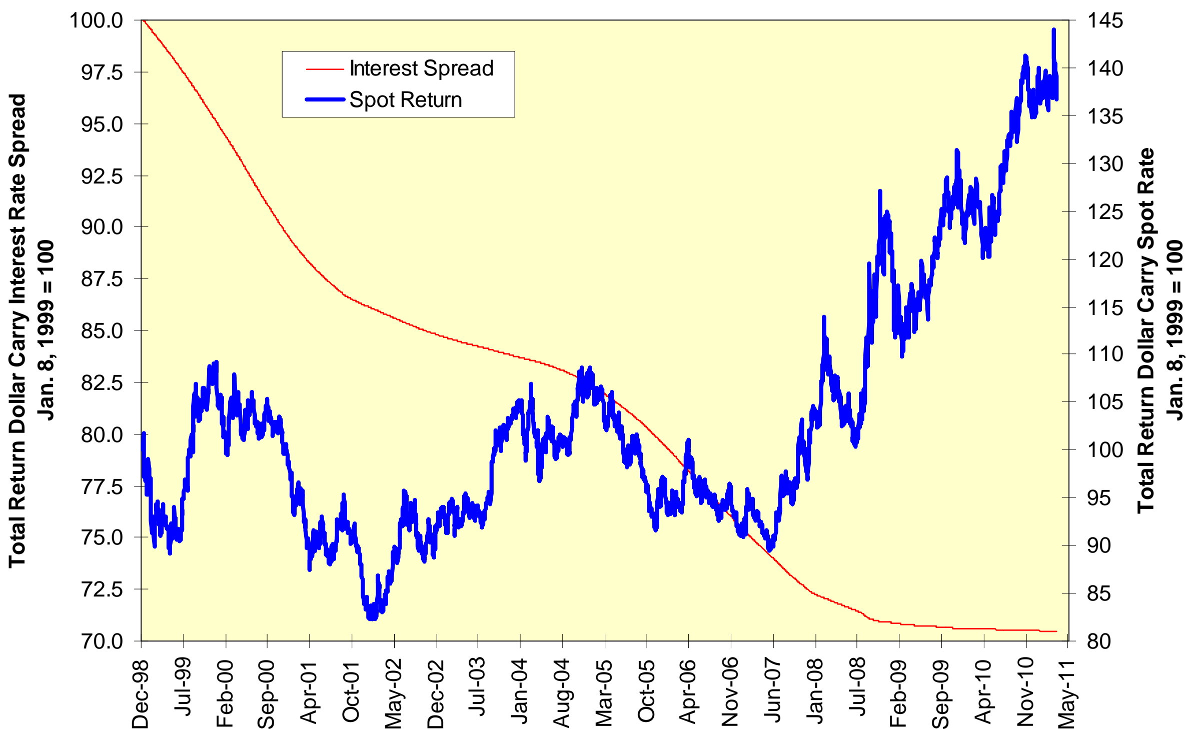
As the risk of yen revaluation in deflationary Japan exceeded the risk of dollar inflation in the U.S., where the Federal Reserve declared its intentions to have inflation rise and then abjured responsibility for inflation when it did rise and as Japan's customers were forced into "must-do" trades for buying the yen to pay their Japanese suppliers, why would anyone take the risk of borrowing the yen when they could borrow the dollar instead?

Now we are faced with the situation noted here yesterday, where the G-7 central banks have arrested the upward spike in the yen threatened after the country's disasters and affirmed the old highs just under 80 as resistance. The net result of this move is a global borrower can now borrow the yen without fear of further revaluation.

The Dollar Carry Into The Yen

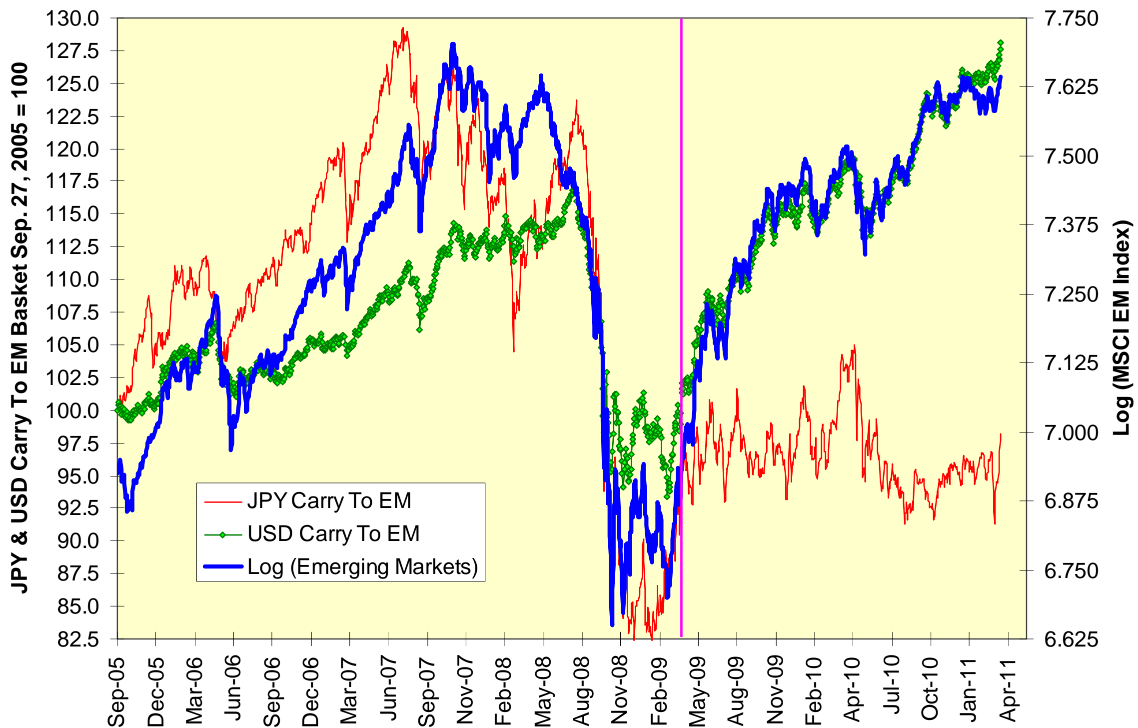
If we turn the trade around and look at the two components of the dollar carry into the yen, the interest rate spread and the spot rate return, we can see just how meaningless the interest rate component has been since the U.S. went to a zero interest rate policy in December 2008. The spot rate return on borrowing the dollar and lending the yen has moved higher as Japan has been unable to break away from its deflationary miasma while the Federal Reserve has convinced investors the U.S. will, one day, defeat the deflation that never existed.

The Yen-Dollar Carry Index Components



Reviving The Yen Carry Trade

If the U.S. does adopt an exit strategy from QE2 and the dollar becomes more expensive to borrow while the yen is not at risk of running away to the upside, the wider interest rate gap between the U.S. and Japan will make Japan the preferred funding source once again. As noted last November, this has not been the case since the financial crisis; we can match the carry return of the dollar into a basket of emerging market currencies quite closely, but the yen carry trade has been irrelevant.



Where does this lead? If the dollar carry seized the baton from the yen carry trade and allowed all manner of emerging market assets to shoot higher in 2009 and most of 2010, then the yen carry trade can return the favor and finance the U.S. should the Federal Reserve adopt an exit strategy. We would tighten; they would un-tighten for us.

That would be quite bullish for U.S. financial assets should events unfold this way.