The Dollar Carry Trade Could Unwind

Those who count on professional money managers to be an arrogant greed-driven herd comprised of individuals who believe they can be the first one out the door are in for a surprise: This is always the case. For all of the dense mathematical tomes written on risk management, one of the most common and persistent errors in the world of trading is the presumption of infinite liquidity at a single price during a time of crisis. That this is the case is quite appalling given the large data sample saying it is not so.

Liquidity is the one asset whose supply disappears as its price rises. This is why we get volatility spikes during stock market selloffs and large gaps on the charts when the unexpected happens. If the present unpleasantness in global markets continues, look out for an unwinding of dollar carry trades and some real potential for an execution vacuum or two.

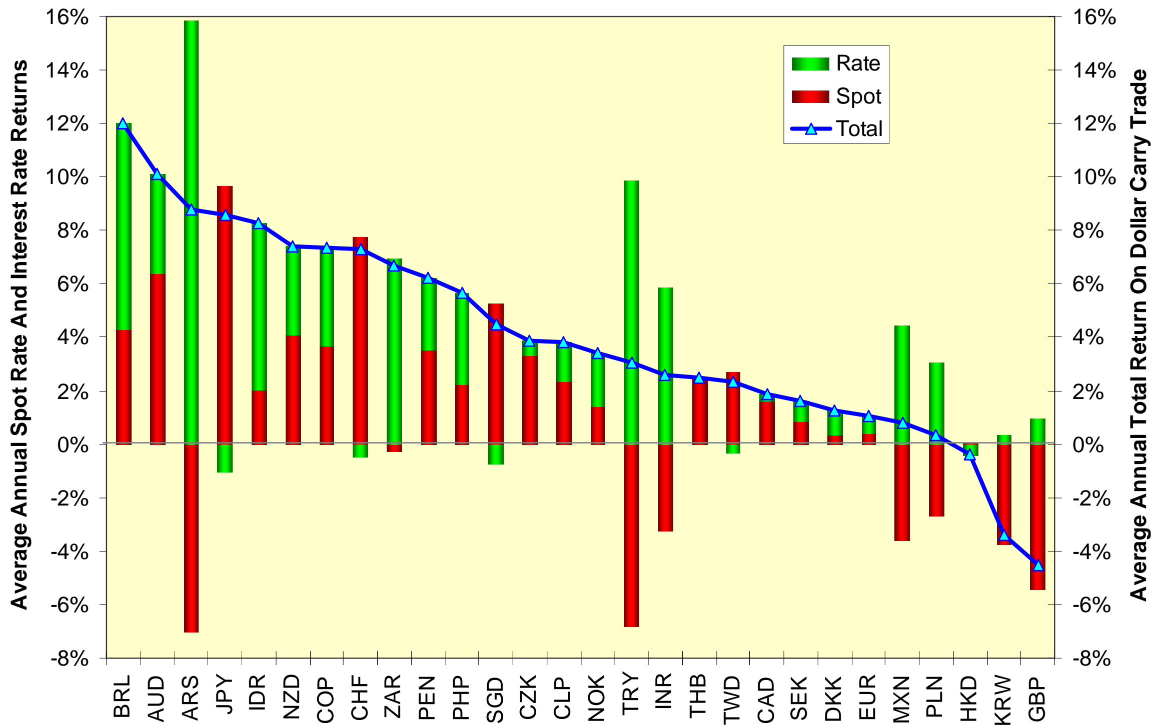
Very Wary Of Carry
The dollar carry trade really moved to the global fore ahead of the yen carry trade once the Federal Reserve began its rate-cutting and money-pumping panics in August 2007. A carry trade is simplicity itself: You borrow dollars, sell them, buy whatever currency your little heart desires therewith and then lend them in that currency. Your risks are whatever you invest in could go down and that the dollar will become more expensive when it comes time to repay your loan.

The big advantage the dollar carry trade had over the yen carry trade is the yen had a disconcerting habit of getting stronger every now and then. The dollar, under the fine stewardship of Messrs. Geithner and Bernanke ("A strong dollar is in the best interests of the United States, blah, blah, blah") did not seem to have that risk. More important, the dollar was and is the world's reserve currency, something the world should be embarrassed about, and that means whatever we printed we could shove down someone else's throat.

International finance has more in common with a monster truck rally than most people realize.

What happens when the assets financed with cheap dollars go down in price and investors sell them? The answer is a sudden demand for dollars is created. The *Bloomberg* correlation-weighted dollar index has jumped more than 9% since the end of July. That in turn creates a buying panic; the volatility for three-month dollar forwards for euro-denominated investors has jumped from 11.9% to more than 17.5% over the same period. This has the makings of a vicious cycle.

The most motivated sellers are those who are trying to protect profits; there is no worse feeling than having a gain turned into a loss. If we map the average annual carry trade returns for the dollar into a range of currencies since August 2007, we see only a few are at a net loss. These include the Hong Kong dollar, the Korean won and the British pound. Some currencies, such as the Brazilian real and Australian dollars, still have a high open profit.



Many of these carry returns were much higher at the end of 2010 as the Jackson Hole sugar buzz was still coursing through the markets' veins. Keep an eye out for dollar strength: It could turn into a rout of selling in foreign bourses (I love the word "bourses") and make you wish you had kept your hard-earned and easily printed dollars here at home.