The Dollar Carry Trade And Global Equities

The reasons why the dollar carry trade could unwind were discussed here last week; now let's take a look at the importance of the carry trade into two widely recognized global equity indices, the MSCI-Barra Emerging Market (EM) and Europe/Australasia/Far East (EAFE) indices. These support ETFs such as the iShares MSCI Emerging Markets and iShares MSCI EAFE, respectively.

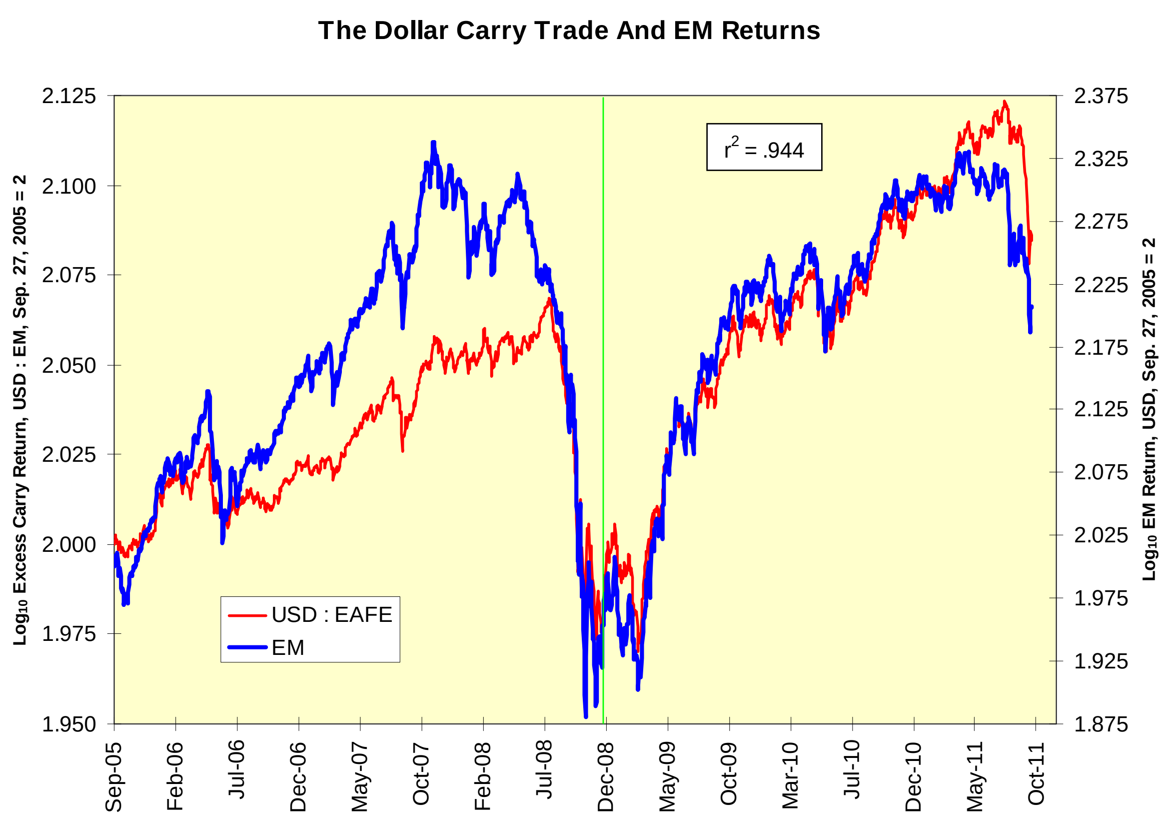
This latter point cannot be over-emphasized; not everything can support an ETF.

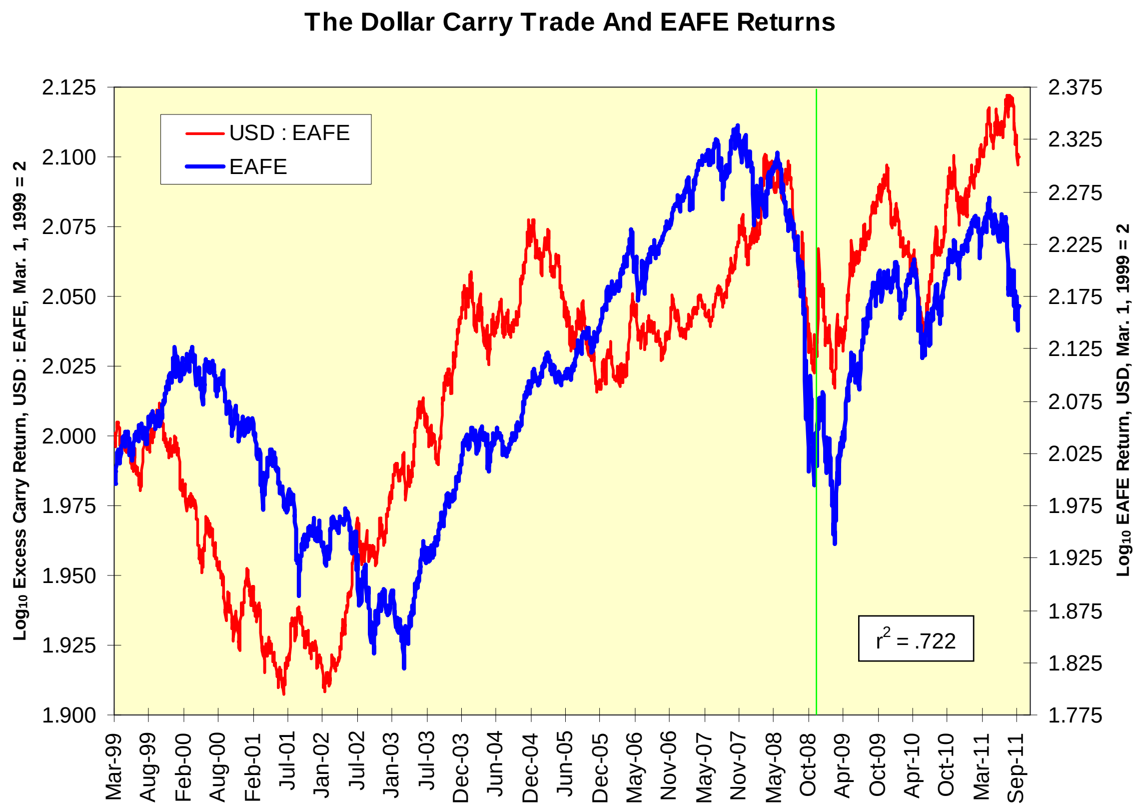
Rinse And Repeat

While carry trades are made to sound exotic by the financial priesthood, fear not for they are actually quite simple. The dollar carry trade consists of borrowing the greenback at the going rate, selling it for another currency and then using that other currency to engage in the financial razzle-dazzle for which you are justifiably famous. Such as buying index ETFs.

That part of the trade can make geniuses out of simpletons. The hard part comes when it is time to unwind if the genius-purchased assets (Yes, of course we bought it! That is what everyone else was doing!) are going down in price and the dollar is strengthening.

We can construct indices of excess carry returns for currency baskets designed to mimic the country composition of these two stock indices and map them against the indices' total returns in USD terms. I chart these indices on a common logarithmic scale so that equal vertical distances correspond to equal percentage changes.





The case for a close carry trade dependence after the U.S. adoption of zero interest rate policies in December 2008, marked with a green line, is stronger for the EM index; the r-squared or percentage of variance explained is a very strong 0.944. The EAFE r-squared to its carry trade index is a less robust but still-strong 0.722. In both cases, the stock returns lead the excess currency carry returns, which confirms the principle currency exchange rates are now as much a function of prospective asset returns as expected interest rate differentials.

In any event, we are at the juncture where weak or negative stock market returns outside of the U.S. will be associated with a rising dollar and vice-versa. More troubling is the self-reinforcing nature of this relationship: Weak stock returns outside of the U.S. create dollar strength and dollar strength erodes the carry trade into non-U.S. assets. This risk is going to be with us for a while considering how dollar carry trades have accumulated since late 2008.