Emerging Markets' Reliance On Cheap Dollars Grows

The dollar carry trade has taken over the role once occupied by the yen carry trade.

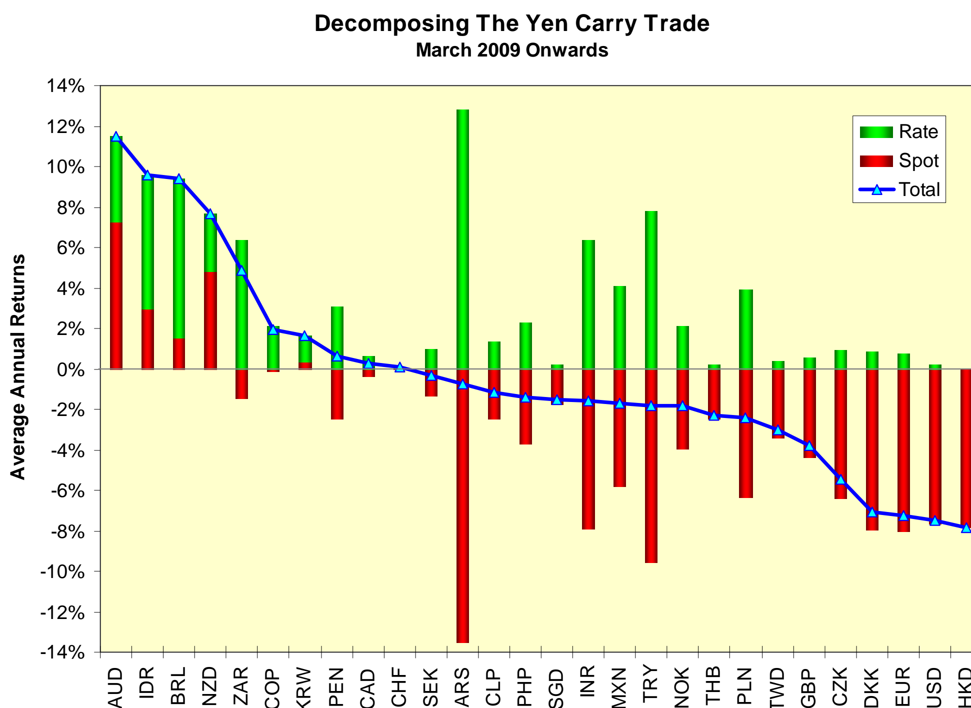
If you live long enough, something I aspire to do, you will see everything come back into style: Wide ties, wide lapels, those inexplicable shoulder pads women wore in the 1980s, buy-and-hold investing, money-market funds yielding more than 0% to the first eleven decimal places, etc.

If you are reading this in Japanese, you must wonder when the yen carry trade will come back into style. It really took off in 1995 when the Bank of Japan tried to weaken a yen surging after funds were repatriated following the Kobe earthquake. The flood of yen available to borrow at low interest rates helped fuel the late 1990s stock market bubble, the one that convinced so many people they were long-term investors at heart and could ride out all sorts of downturns because, you know, the market's long-term direction is always higher.

As that trade involved borrowing the yen and selling it to finance someone else, it put downward pressure on the yen and convinced Japan's mercantilists they could export their way back to prosperity. The yen did go into a twelve-year trading range, yes, but China displaced Japan as the great Asian exporter. You might have thought some of this lesson would have been learned in Washington, but that is asking too much.

Enter The Dollar Carry Trade

If Prince Charles is the Prince of Wales, is Ben Bernanke the Whale of Prints? Discuss. Regardless, once the helicopter's blades started whirring in full force with quantitative easing in March 2009, the yen carry trade started to disappear from the scene. The average annual returns on the trade of borrowing the yen and lending it into 28 different currencies over the post-QE1 period are displayed below. The total returns are composed of the spot rate component and the interest rate spread component.

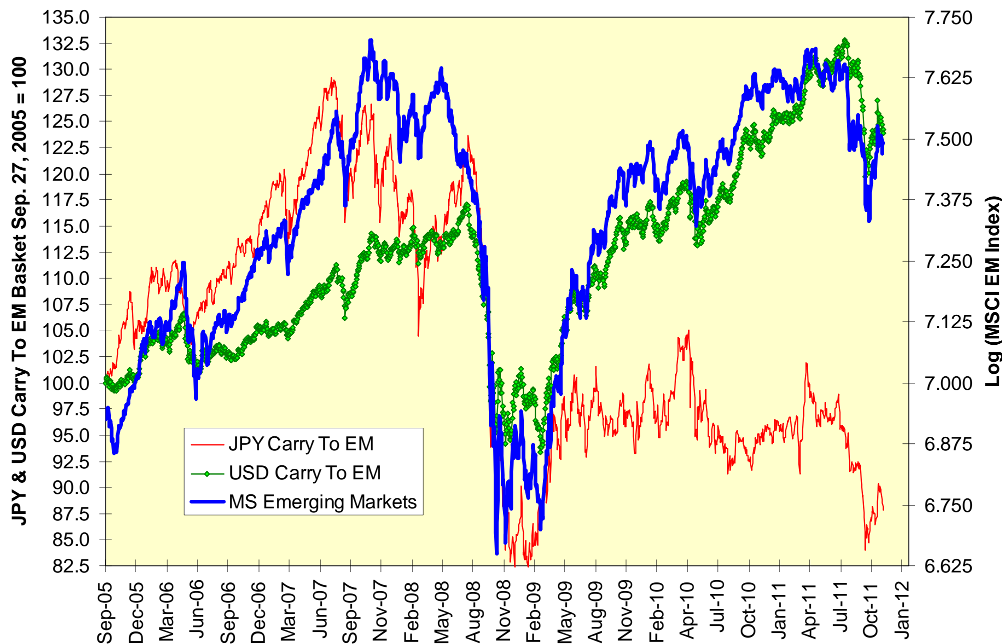


All of those total returns used to be positive; eighteen of them are negative now as the surging yen has turned most spot rate returns negative. This turns into something of a vicious cycle as fewer yen are borrowed and sold. Japan is faced with a rising yen and all of its interventions against it have been fruitless.

Emerging Market Impact

If we construct a basket of emerging market currencies in the weights approximating the stock weights of the MSCI-Barra Emerging Market index, which in turn underlies the iShares MSCI Emerging Markets index ETF, we can map the carry returns from borrowing both the dollar and the yen and lending into this basket. Prior to the first rate cuts by the Federal Reserve in 2007, the EM index was linked closely to the yen carry trade. That relationship started to

shift to the dollar carry trade in 2008; by the advent of QE1 in March 2009, the yen carry trade became an irrelevance and the EM index tracked the dollar carry trade.



However, just as everything comes back into style, nothing lasts forever. As I noted in September's Why the Dollar Carry Trade Could Unwind, a financial crisis could leave to sudden and fairly massive revaluation of the beleaguered greenback and trigger a wave of liquidation in non-USD assets. Please note in the chart above how a slowdown in the dollar carry trade's gains this past April led to a self-reinforcing cycle of emerging market losses and lower carry trade returns.

Investors in emerging markets thus are dependent on the U.S. remaining monetarily incontinent. The Bernanke Federal Reserve has yet to disappoint on this count, but even responsible behavior returns if you wait long enough.