Emerging Markets' Carry Harvest

There's nothing like free money. Period. In addition, there's nothing like free money to convince the most pedestrian bankers they are mean, lean bonus machines. While we are at it, free money has a way of insinuating itself into all manner of market nooks and crannies via global carry trades, the not-so-fine art of borrowing cheap and lending somewhat dearer.

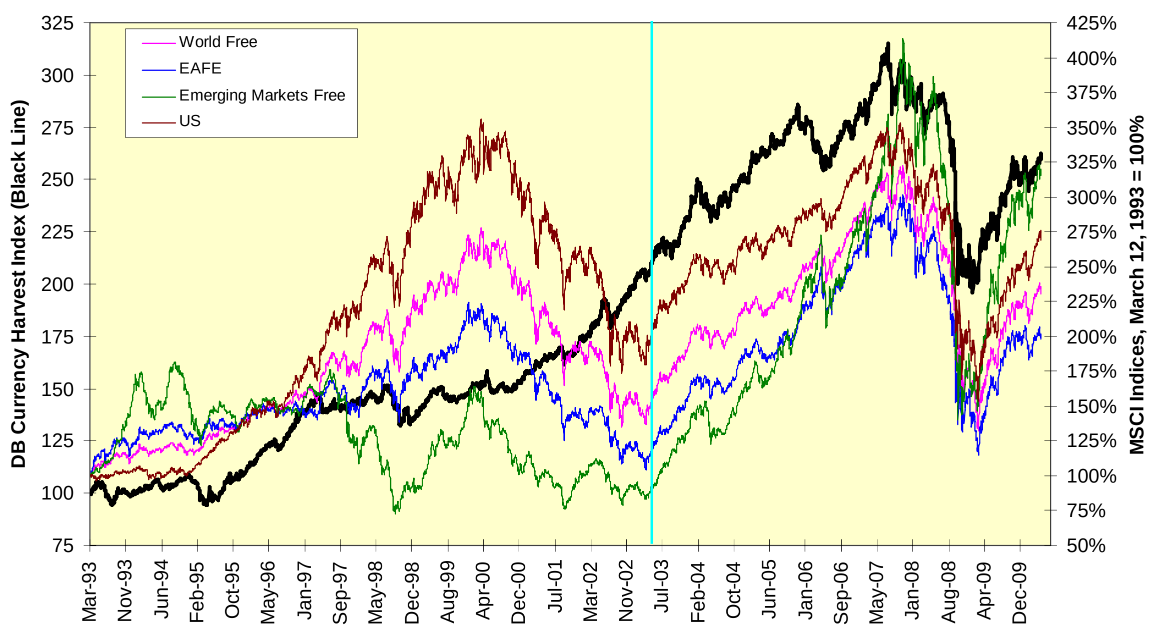
We can and will illustrate this several ways and across a number of markets as one size does not quite fit all in the application of this concept. For now, let's focus on a currency futures-based index, the Deutsche Bank G-10 Currency Futures Harvest index, which follows the strategy of going long in the futures of currencies with relatively high yields and going short in futures of currencies with relatively low yields. For forward curve aficionados and those who have to live with one, the former set of currencies has an inverted forward curve, while the latter are in carry structures. You can ride up one and slide down the other while you are harvesting your gains (gosh, I should do marketing literature for synthetic CDOs).

Remembrance Of Things Future

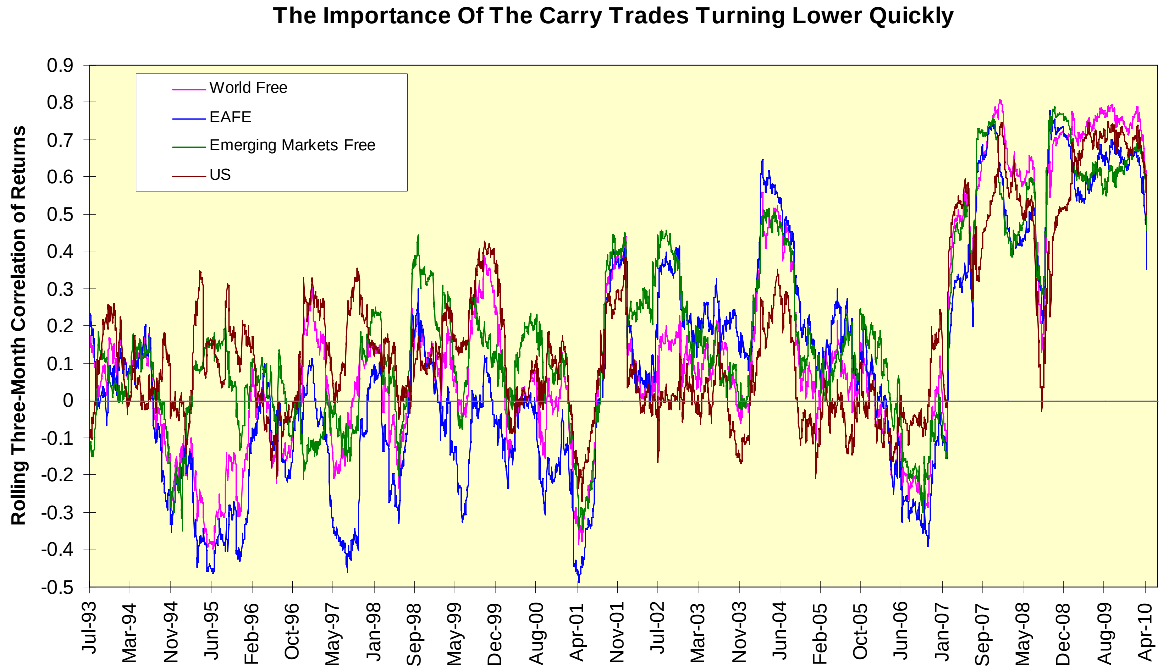
If we map the Harvest index against the MSCI World, Emerging Markets, U.S. and EAFE (Europe, Australasia & Far East) indices all re-indexed to March 1993, we find little in the way of direct correlation until the Federal Reserve's first war on deflation in May 2003, marked with a turquoise vertical line. After that, global equity returns increasingly became a function of carry returns. By the time we entered the rollercoaster down and then back up in 2007-2009, the two paths were virtually one and the same.

This is a very simple and straightforward relationship: A steep yield curve both encourages borrowing at the cheap rates in a funding currency such as the dollar or the yen and it encourages borrowing to invest in riskier assets such as stocks. Once the carry is threatened, everything unwinds simultaneously and you get a 2007-2009 debacle.

The Carry Trades And Global Stock Indices



Now let's rearrange the data above into a map of the rolling three-month correlation of returns between the Harvest index and the four stock indices. Please note how the recent readings in the 80%+ range have been the highest on record. In addition, please note how the ugliness of 2008 began with turn lower in these correlations during January; they eventually bottomed out near zero by the end of the year.



The present decline in correlations has been underway since January. Part of this has been an upending of expected currency relationships; the ultra-cheap dollar has been rallying in response to the euro's travails, and this means a carry trade from the dollar into the euro has lost you money as the spot rate decline has offset the interest rate gain. The cheap yen has advanced for much the same reason.

Think back to last year how a large number of traders associated the stock and euro rallies together despite warnings some quarters – well, me mostly – this was but a temporary linkage. The same lesson applies for today: A strong dollar at ultra-low rates is really a flight from the euro and euro-linked currencies. What will remain true, however, is any whiff of higher short-term rates in the U.S. will clobber both stocks and the currency carry trade simultaneously. As a result, the Federal Reserve will avoid raising rates for as long as possible.