Single-Currency Carry Trades And Global Equity Returns

The late columnist Mike Royko, a heavy smoker, used to describe his regular morning exercise as, “A hacking cough.” As I never acquired that bad habit, I have to replace it by looking at various charts and going, ‘Yuck!” in rapid order. A distressingly large number of global markets have been producing that reaction since the yen carry trade went missing in action earlier this year, soon to be followed by a diminution of the dollar carry trade into markets such as Mexico.

In both cases yen- and dollar-domiciled investors, respectively, decided to cash in the bubbly gains in global stock indices such as the EAFE and MSCI Emerging Market (EFA and EEM are the two most popular ETFs here) and in emerging market bonds, accessible through ETFs such as the iShares J.P. Morgan Emerging Markets Bond ETF (EMB). Emerging market currencies have taken it on the chin and in more colorful places; since the yen’s bottom on May 22, 2013, the excess carry return into a basket of emerging market currencies has been -8.82%.

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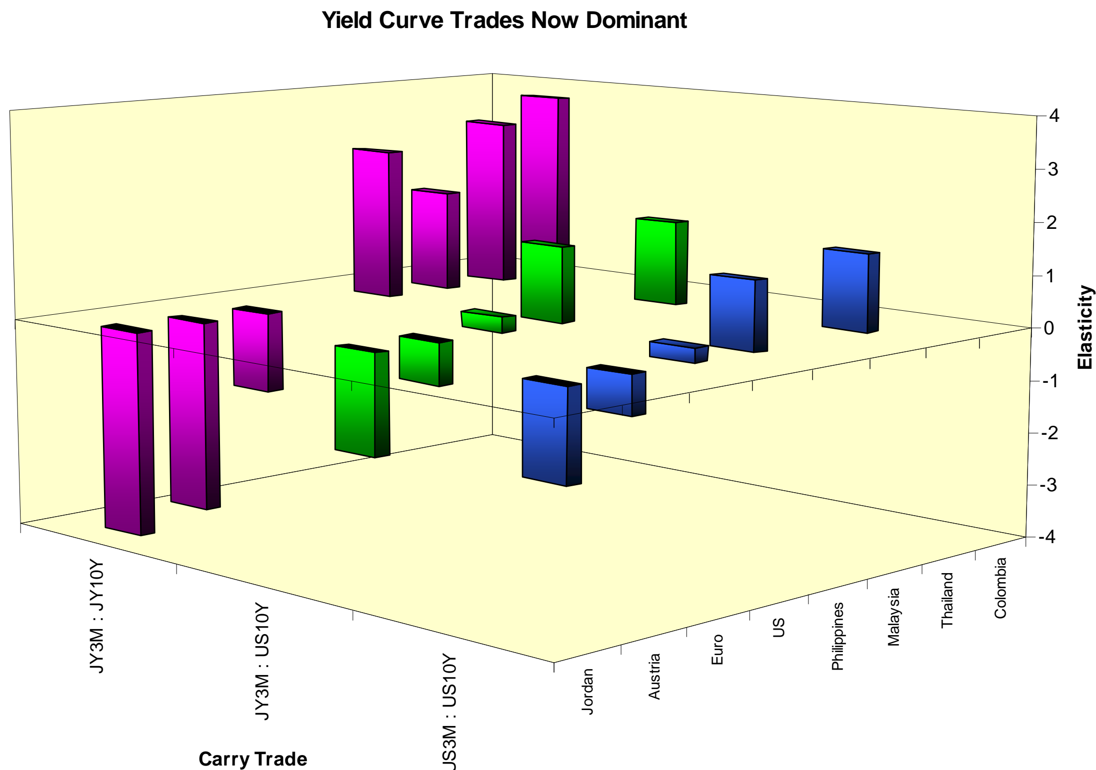
The hot phase of the financial crisis started six years ago last week with the backstopping of BNP-Paribas (BNPQY) by the European Central Bank, to be followed a little more than a week later by the first in a series of rate cuts, to what now seems like an alpine 4.75%, by the Federal Reserve. Let’s use August 2007 as a starting point and calculate the performance of forty different markets relative to the MSCI World Free index in U.S. dollar terms. We then can calculate the elasticities of those relative performances against a series of carry trades.

I first ran this exercise in August 2010, just prior to the famous Jackson Hole hint of QE2. As many of 16 of these markets had statistically significant betas to the carry trade between the yen and the euro. That number is down to zero. The euro/yen cross-rate once was considered the barometer of global risk-aversion and acceptance; it is now demonstrably unimportant.

The chart below depicts what is left of important carry trades. The most important one is the yield curve trade in Japan itself between three months and ten years, followed by the carry from three-month yen into ten-year dollars and then the dollar’s yield curve trade.



What this chart signifies is how important steep yield curves have become in national bond markets have become. They have driven the cross-currency trades into unimportance; if I can borrow my own currency near 0%, why should I take the risk of borrowing your currency? I then can invest the borrowings in longer-term bonds or in riskier assets such as stocks and real estate in my own currency. Those inflated prices make other markets attractive in comparison and effectively transmit loose money here into higher asset prices there.

We have been trained ever since Japan's failed attempt to end the yen carry trade in 2006 to watch out for cross-currency carry trades unwinding, and this is good advice still. What is increasingly important is the global risks carried in separate national yield curves flattening. A flatter yield curve here will flatten your investments there, and vice-versa, even in the absence of cross-currency carry trades unwinding.