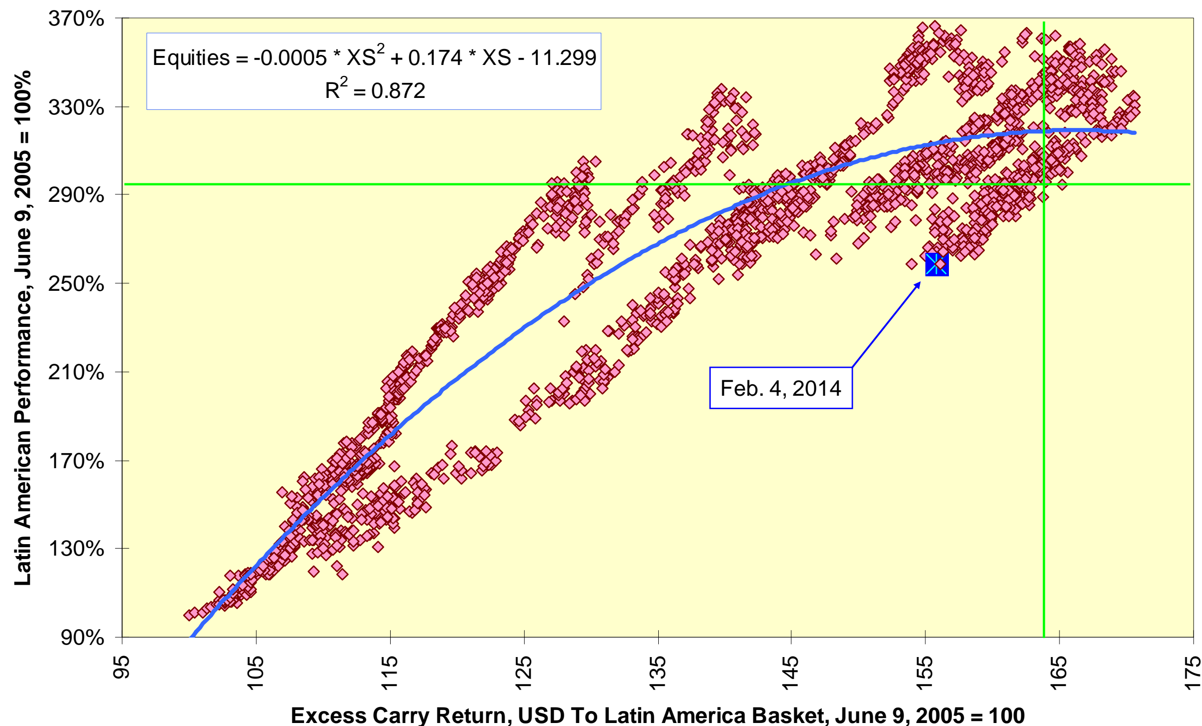
Carry Trades Can Propel Latin American Markets

Carry trades can taketh away, but they can giveth as well. If you are in investment management or in trading, you know one of the fastest ways to find yourself being dangled out of an open window is to tell clients, “It is better to give than receive.”

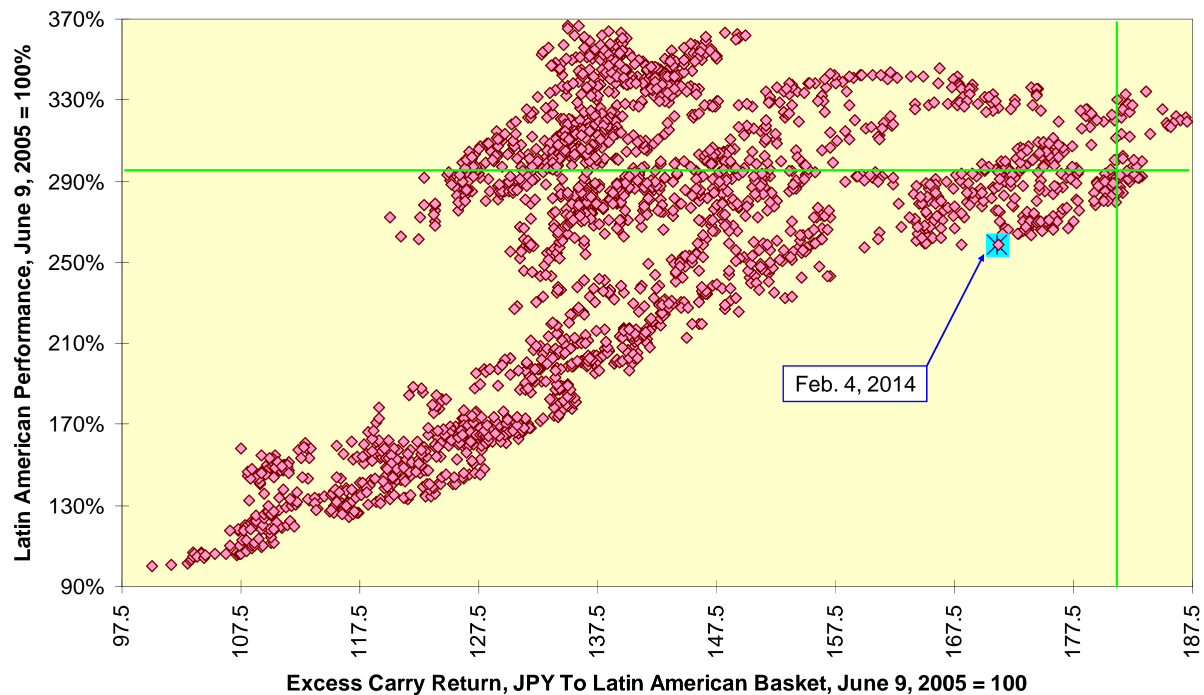
Latin American markets took a drubbing between May 2013 and February 2014. The MSCI-Barra Latin American Free index declined 24.2% in U.S. dollar terms over this period. Investors feared the consequences of changes in U.S. monetary policy and the unwinding of global carry trades. This same index has advanced more than 14.2% since early February.

What changed? A combination of some higher short-term interest rates in key Latin American markets and a realization the Federal Reserve was not really on the warpath pulled the Bloomberg-J.P. Morgan index of Latin American currencies, a counterpart to the Asian currency index first discussed in July 2011 and again in September 2013 higher by 3.73%. This index is 33% each the Brazilian real and Mexican peso, 12%, 10% and 7% the Chilean, Argentine and Colombian pesos, respectively, and 5% the Peruvian sol.

An equity index constructed in these weights has proven to be remarkably responsive to the excess carry return of both the dollar and the Japanese yen into the Latin American currency index. The relationship between the equity index and the dollar carry trade has shifted from a more linear relationship to a quadratic one (remember that quadratic equation from high school algebra? I bet you do). The significance of this is a diminishing return to a stronger dollar carry trade. Nevertheless, the r-squared or percentage of variance explained has been a very high 0.872. I marked the February low on the chart in addition to a bombsight marking the present environment. Please note how linear the path has been over the last two months.



I repeated the exercise for the yen carry trade. The statistical relationship has been so distorted by Japan’s various U-turns and policy changes that any modeling effort has to be more complex. However, we see the same linear relationship between Latin American equities and the yen carry trade since February.



As long as U.S. monetary policy remains accommodative and is joined by other major countries' policies as well, the Latin countries can assure themselves of retaining capital inflows simply by maintaining a sufficient short-term interest rate differential. It would be nice for the region if countries such as Argentina and Venezuela stopped acting like they are running a Marxist revival act, but I do not think that is likely to happen anytime soon. That would be like asking leopards to change their spots, and leopards just do not do that.

You can access the region simply via exchange-traded funds such as the SPDR Emerging Latin America fund (GML) or the iShares MSCI Emerging Markets Latin America ETF (EEML).