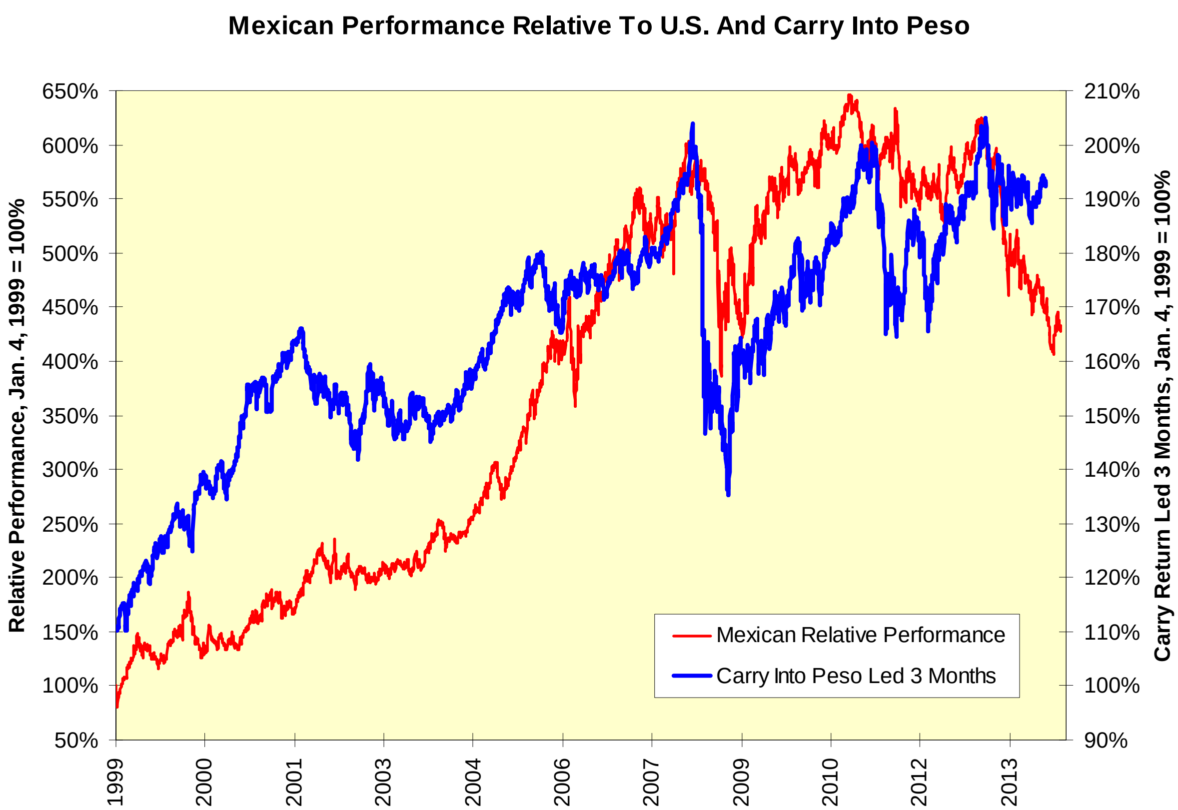
Will Cinco de Mayo Sink-o da Peso?

I hate to bring it up on a national holiday that either celebrates an 1862 defeat of a French force or the invention of the frozen margarita, but Mexico has been underperforming the U.S. by 33.33% in dollar terms since the end of November 2010. As I noted in [November 2013](), there is more to emerging markets than free money flowing from a funding-currency country; you need attractive interest rates in the receiving market to keep the carry trade open. Part of the reason for the rebound in the Latin American markets discussed [last month]() has been higher interest rates in Brazil.

But to complicate matters, as if I ever would do such a dastardly deed, poor relative stock market returns can outweigh simple carry trade inducements and lead to a weaker currency. The ideal combination for an emerging market these days is short-term interest rates high enough to maintain an open carry trade but not high enough to choke off the local bourse.

Peso And Performance
Let's revisit a [July 2013]() analysis of the link between the dollar carry trade into the peso and the relative performance of Mexican equities.



Prior to 2006 and the combined effects of much higher oil export earnings and worker remittances, the carry return into the peso reflected the effects of Mexico's much higher short-term interest rates. Yield hogs could send their funds south of the border, park them in short-term deposits and pray the peso would not devalue by more than the cumulative interest rate spread gain.

After 2006 and especially after the financial crisis led to a global downward compression of interest rates, the carry return increasingly reflected relative stock market performance; indeed, relative performance started to lead the carry return by three months on average. If Mexican equities performed strongly, yield hogs' performance-chasing cousins (let's call them performance pigs out of lack of better) started buying Mexican assets through funds such as the iShares MSCI Mexico Capped ETF (EWW) or ProShares Ultra MSCI Mexico *dos-por-uno* ETF (UMX).

This leading relationship is making the carry trade into the peso vulnerable. It has been able to levitate over the past year on the basis of its historically narrow but relatively attractive short-term interest rate gap, but all it will take for the peso to tumble is an interest rate scare here in the U.S. or one of those periodic emerging market panics we see every now and then. The current level of relative stock market performance implies the carry return is overvalued on the order of 14.25%.