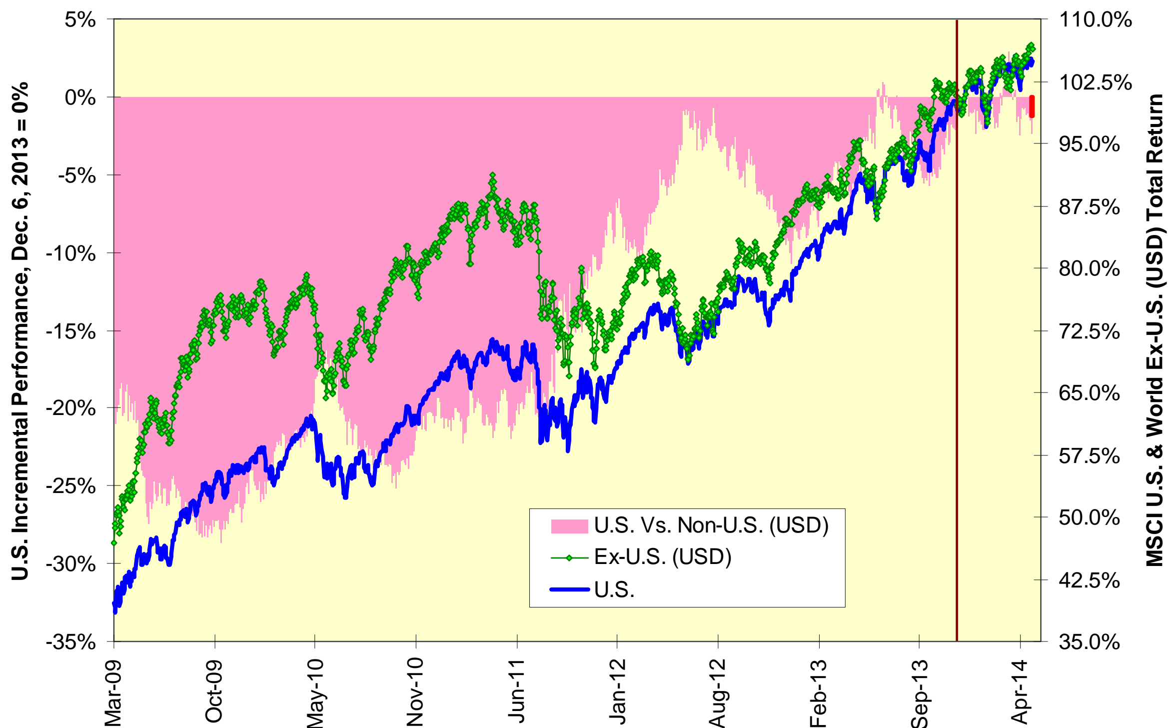
Getting Ready For A Euro Carry Trade

Mario Draghi is determined to weaken the euro and if we have learned anything about the European Central Bank chairman it is, like Lola, what Mario wants Mario gets and with an economy of effort. His "whatever it takes" statement in July 2012 marked the start of stability in the euro and a major compression in sovereign credit spreads of countries such as Spain and Italy, but unlike the Federal Reserve or the Bank of Japan, he has yet to conjure up trillions of euros to effect his actions.

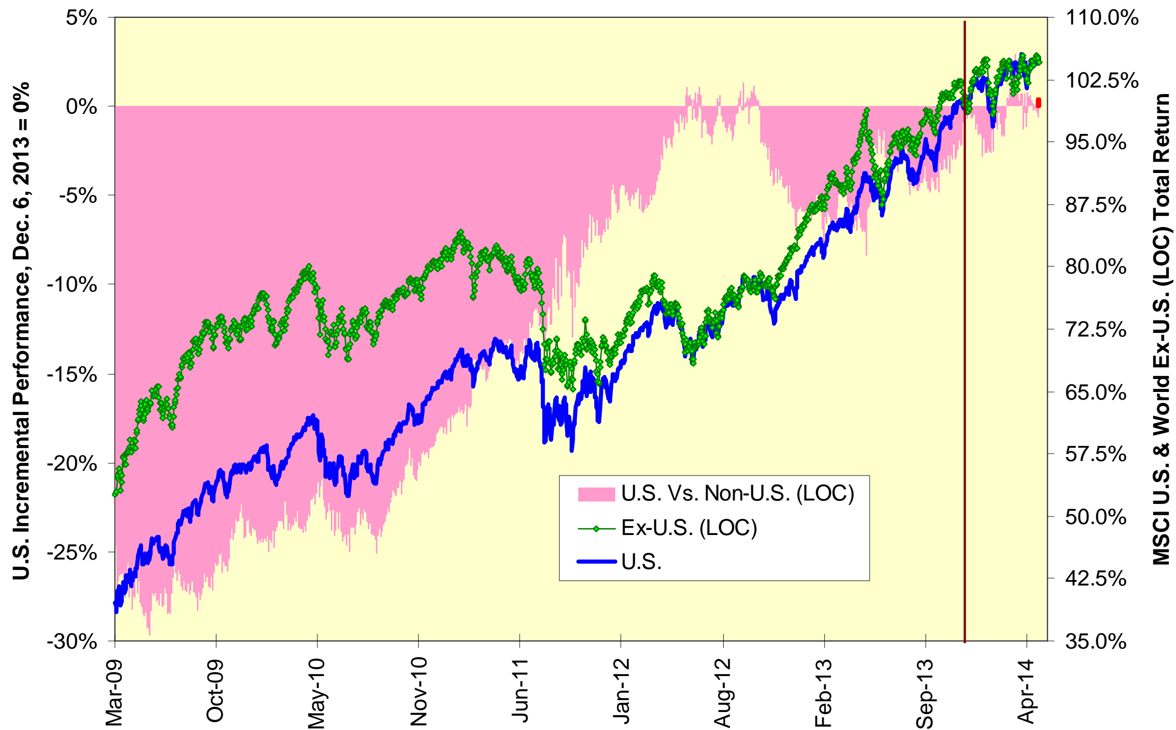
The Euro Rate Gap

It might come as a surprise to Americans who have come to take a perverse pride of sorts in having some of the cheapest money on the planet, but the three-month interest rate spread between the USD and EUR started to reverse on December 6, 2013. However, if you borrowed the euro to lend into the dollar, you would have lost 1.09% thanks to the euro's spot rate gain.

Let's ask ourselves what a world with a functioning euro carry trade would look like for dollar-domiciled equity investors, a category likely to include you. If we map the total returns in USD terms for the MSCI Barra U.S. index relative to their World Ex-U.S. index over the post-March 2009 QE era and re-index everything to December 6, 2013, we see the U.S. spent the entire October 2009 – May 2013 period outperforming the rest of the world in USD terms. That period corresponded to the onset of the Eurozone sovereign debt crisis at the start and the beginning of taper-talk in the U.S. at the end.



The past year has been a bit of a relative performance rollercoaster; the U.S. underperformed going into October 2013, outperformed going into December and has underperformed the rest of the world afterwards. We get pretty much the same narration if we express all of this in local currency terms.



Where Will The Money Go?
The key question, as the paragraph header states very clearly, is "Where will the money go?" The glory days of the yen carry trade, 2004-2007, saw cheap yen going to finance equity booms elsewhere in the world, emerging markets especially. The dollar carry trade between March 2009 and October 2010 also propelled emerging markets higher. If you are starting to sense a pattern here, you are correct: A euro carry trade will involve those cheap euros flooding into higher interest rate markets around the world. This is what cheap money does.

The chief beneficiaries of any emerging euro carry trade will not be the Eurozone or Japan or the U.S. but rather higher interest rate developed markets such as Canada, Australia and New Zealand and emerging markets such as Turkey, India and Brazil. Will this cause inflationary pressures in the emerging markets? Yes, of course; that is what cheap money does. Will Mario care? No, that is what central bankers do not do.