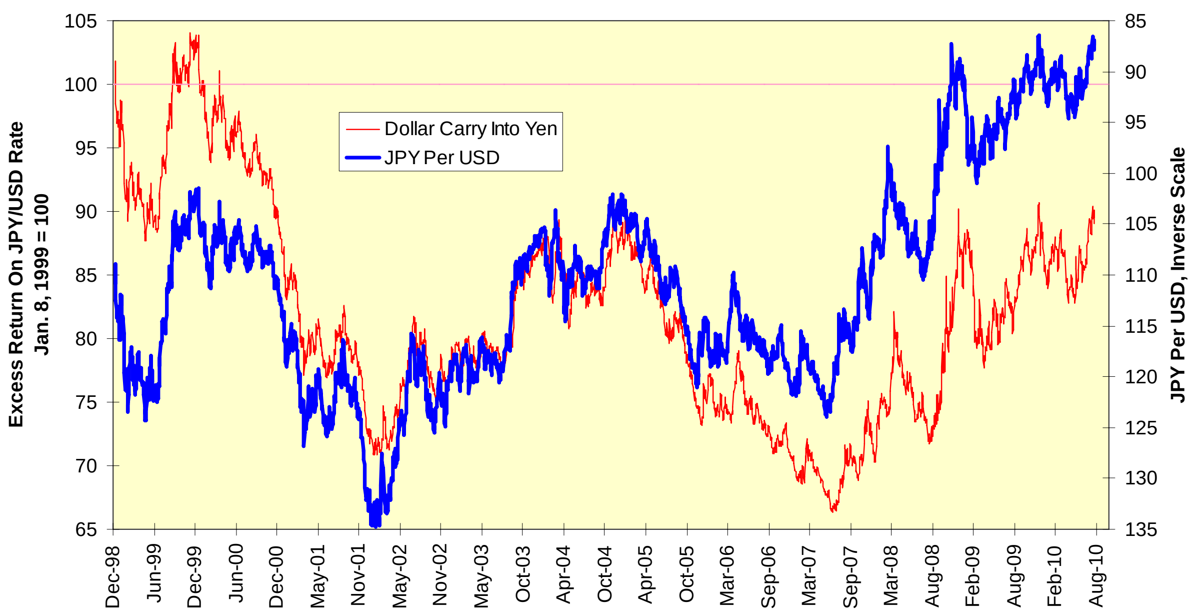
Cheap Yen Not Igniting Carry Trades

Somewhere in our lives we all learn to classify goods as superior or not. We might want to buy the cheapest gasoline or bag of potato chips, but we instinctively pull back from buying the cheapest wine, perfume or even menu item at a decent restaurant. This instinct seldom applies to borrowing, though; we presume money is money and a cheaper rate is a better rate.

If you are a player in the global carry trade market, you generally search for the cheapest funding source. Between August 24, 2009 and March 5, 2010, that was the U.S. dollar; Benjamin S. Bernanke, proprietor. We won the race to the bottom with Japan. That was tugging on Godzilla's, um, whatever; I have no idea what on Godzilla can or should be tugged upon, and while I have yet to see the Scourge of Tokyo decked out in a cape, I am content to drop the inquiry right here and now. Three-month Japanese interest rates of 24 basis points are now 24 basis points below their American counterparts, and that is a pretty significant difference at those levels.

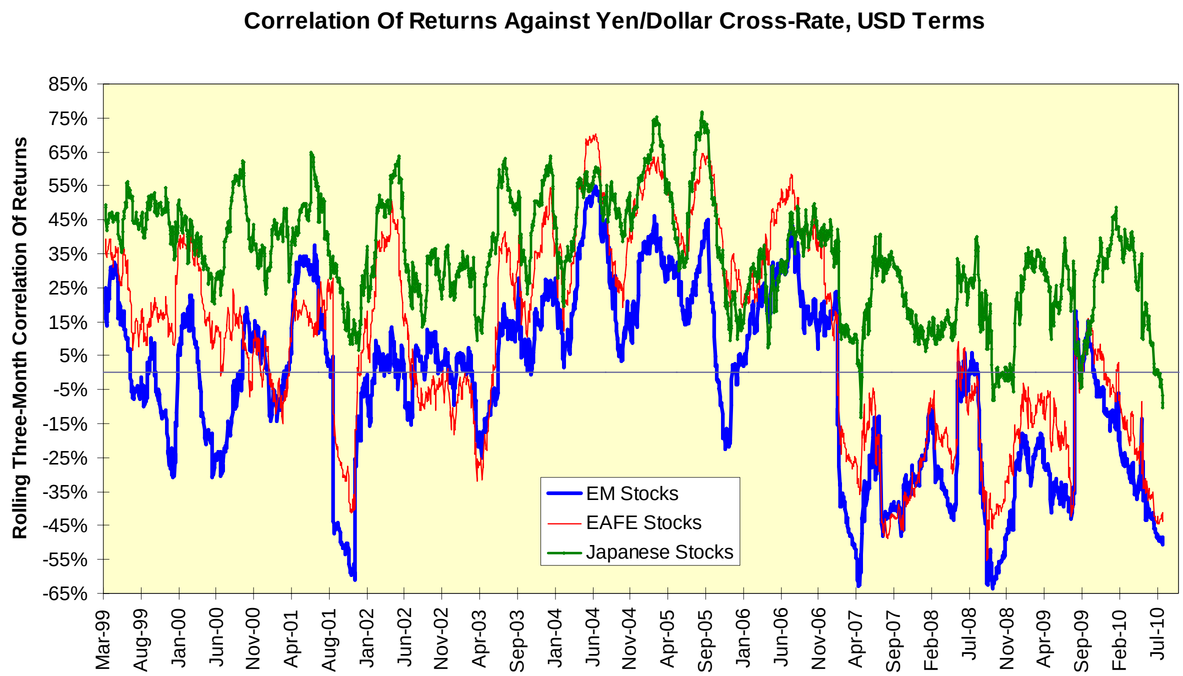
But if the goal of the Bank of Japan is to cheapen their currency in the always-vain hope it will maintain their export competitiveness with China and other lower-cost Asian exporters, it is not working. Not only is the yen continuing to rise, but the return on borrowing dollars and lending into the yen has stayed firm during the recent interest rate switch. The trade earns nothing on interest, but gains as the yen rises.

The Yen-Dollar Carry Index And Cross-Rate



Japan is discovering what currency analysts have known for years, and that is while currencies such as the Canadian dollar can follow interest rate differentials somewhat reliably, the yen does not. Its long use in carry trades meant every global financial hiccup – and we've had enough of those, haven't we? – produces a bout of carry trade unwinds. Those who borrowed the yen have to pay back the loan in a panicky market rise. You get tired of that after a while. Moreover, Japan's perpetual trade surplus means there are a large number of importers of Japanese goods who have to go into the yen market and buy it to pay their suppliers, and that forces the yen higher as well.

The net result of all this is the lower borrowing cost has failed to drive the yen lower vis-à-vis the dollar; fewer carry traders borrowing the yen means less downward pressure on the currency. We can demonstrate the carry trades' failure to launch by mapping the three-month correlation of returns between the dollar carry into the yen and three stock indices in USD terms, the MSCI Emerging Markets and EAFE (Europe, Australasia and Far East) indices and Japan itself. These correlations are collapsing toward their all-time negative levels.



This problem will only get worse for Japan should short-term interest rates in the U.S. be driven lower once again. You would think the Bank of Japan would have learned by now cheap money creates as many problems as it solves. Actually, you might think the Federal Reserve would be learning this lesson, too.