The Yuan Carry Trade Is Here

The problem with things such as syllogisms, the Pythagorean Theorem, Avogadro's number and the transitive property of equality is they are presented to us at a time in our lives when various hormones are competing, often rather successfully, for our attention.

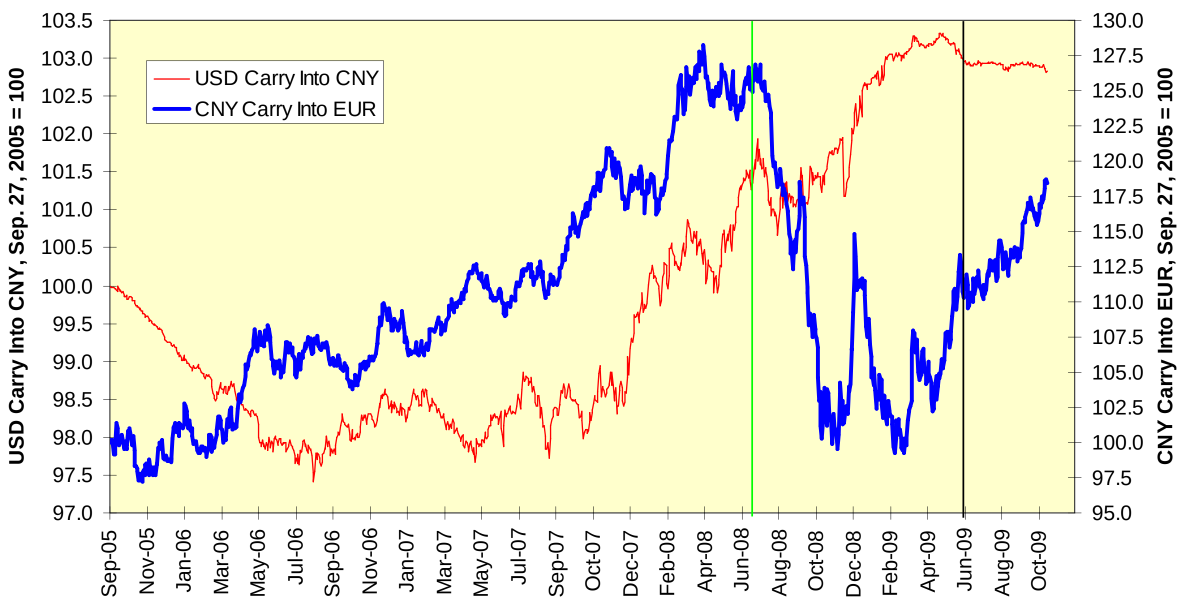
Now that we are older we can focus undistracted on the transitive property as it applies to global carry trades: If there is a dollar carry trade into just about all other currencies and if the Chinese yuan has been re-pegged to the dollar in a death grip that would have done the late Bruce Lee proud, then there must be a yuan carry trade into other currencies as well.

QED.

Getting Carried Away
As we have discussed previously with regards to the mechanics of carry trades, the return can be split into two components, the spot rate change and the interest rate spread. The spot rate change is familiar to anyone who looks at the screen and sees a cash market quote for a euro, a yen, etc. The interest rate spread component, which is familiar to all traders in currency futures and forwards, stays behind the scenes. Yet over time, as all investors in high-yielding currencies can attest, it is the interest rate spread that drives overall carry returns. Emerging market bonds have benefited from and have been hurt by the behavior of yield-chasing investors over the years.

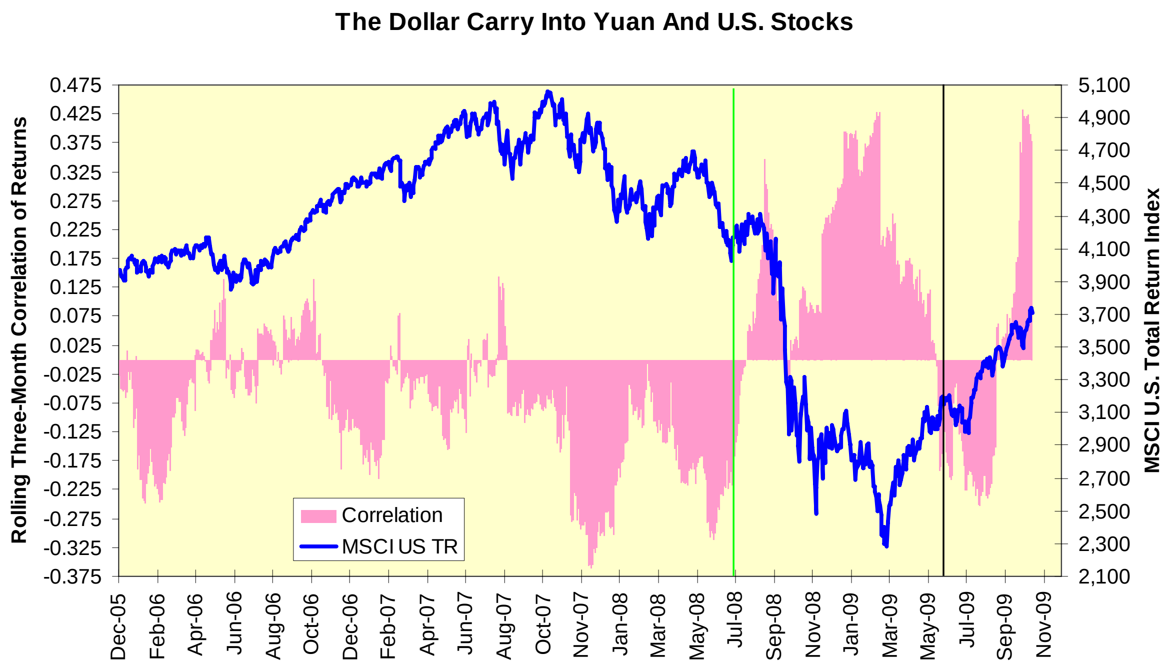
Let's map the total return of two carry trades over the past five years, that of the dollar into the yuan and that of the yuan into the euro. Two key dates are marked on the chart, the July 2008 re-pegging of the yuan to the dollar after a brief, three-year experiment by China in letting the yuan revalue, and a more indeterminate point during June 2009 when U.S. and Chinese short-term interest rates converged. We can infer this latter point by seeing when the dollar carry into the yuan starts to flatten; as the spot rate has been pegged, this must mean the net interest rate carry became zero. That transitive property rocks, no?

A Tale Of Two Carries

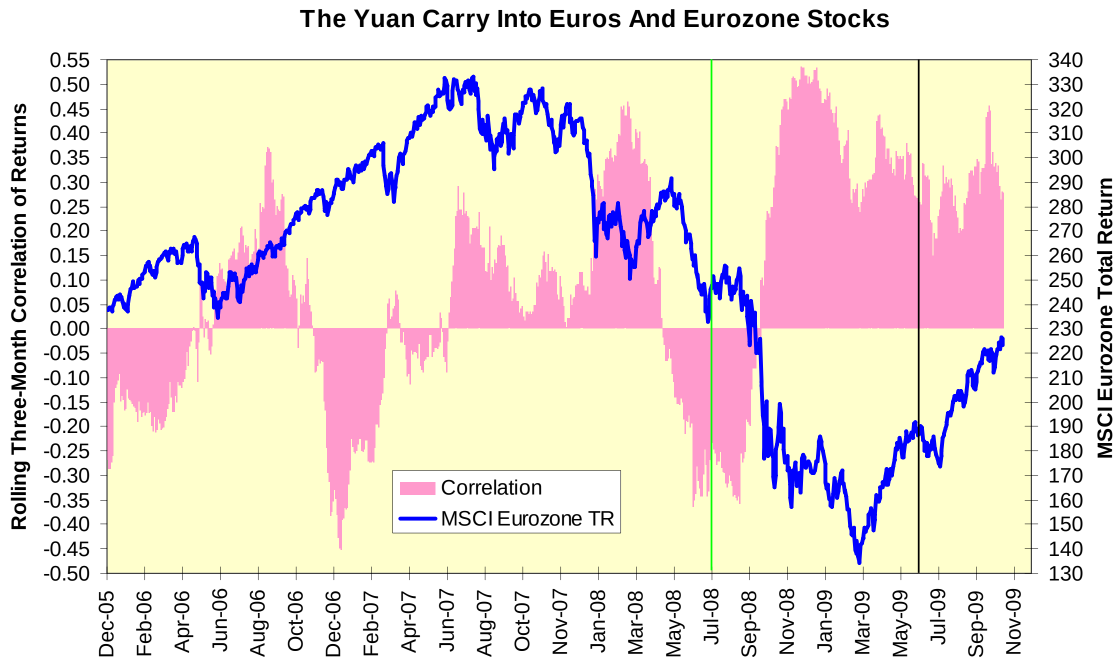


Please note how the yuan carry into the euro kept on growing after June 2009. Not only has the euro's spot rate against the dollar and yuan moved in the common currency's favor, the interest rate spread has remained in the euro's favor as well. Anyone with the facilities to do so can borrow the dollars the Federal Reserve is printing to monetize the Treasury's debt or $2.273 trillion in foreign reserves on China's books and lend or invest in the Eurozone. Moreover, the carry trade open into the Eurozone is open to all other currencies whose interest rates are higher and whose monetary policies are more sober than ours at the moment, a category most likely inclusive of various cannibalistic tribes living in the New Guinea highlands and blubber-munching Inuit living along the Arctic coast of Nunavut.

Stock Market Impact
Free money tends to turn ordinary mortals into living, breathing bull market geniuses, and 2009 has not been an exception to this rule. If we map the rolling three-month correlation of returns of the MSCI U.S. total return index against those of the dollar carry into the yuan, we see two breaks in behavior after the re-pegging in July 2008 and after the interest rate convergence in June 2009. As both underlying series turned down during the second half of 2008, the correlation of returns was positive, and as the dollar carry trade into the yuan started to disappear in 2009 as stocks were rallying, the correlation was negative. However, once the dollar started yielding less than the Japanese yen in late August, all bets were on: The correlation turned sharply positive and the market scarcely has had a pullback worthy of the name.



We should expect different behavior for the correlation of returns between the MSCI Eurozone index and the yuan carry into the euro, and we in fact see them. Here the correlation shifted into strongly positive territory as the financial crisis of 2008 deepened and both underlying series were negative. However, unlike the dollar case, the yuan carry trade into the euro remained open and positive for all of 2009. This is powerful fuel indeed for Eurozone stocks and goes a long way to explaining their 95.7% gain in dollar terms (as opposed to 62.5% for the U.S.) since the March low.



Bond Market Impact
The same exercise can be repeated for a comparison between American and European bond market returns for both sovereign and corporate bonds. The various charts and data analyses will not be presented at this time in the interests of space.

The bond case has an interesting twist: While the returns on U.S. government bonds did not change significantly from previous periods once U.S. and Chinese interest rates converged, the returns on corporate bonds did increase significantly as the yuan carry trade opened. If the opening of the yuan carry trade was significant, we should expect the Eurozone bond response to have been stronger for the sovereign bonds as well as being significantly different for the corporate bonds, and that has been the case.

Double Your Fun
All of us learn an eternal truth about leverage early in our careers: It is a lot of fun on the way up and hell on wheels on the way down. If the global bull market is being fueled by excess liquidity, a proposition whose truth I hold to be self-evident, and if the world's largest holder of currency reserves has added its weight to the world's largest creator of liquidity, then we have levered up on the liquidity trade by creating a dual dollar/yuan carry trade.

At some point the game will be over with the money pump; it always is. This will mean the unwinding of the dual carry trade will carry greater force than it would if it were a dollar carry trade alone. This is related to that commutative property of equality: If the yuan equals the dollar, then the dollar equals the yuan. Whatever label you wish to attach, the next carry trade unwinding is going to be a mess of the first order.