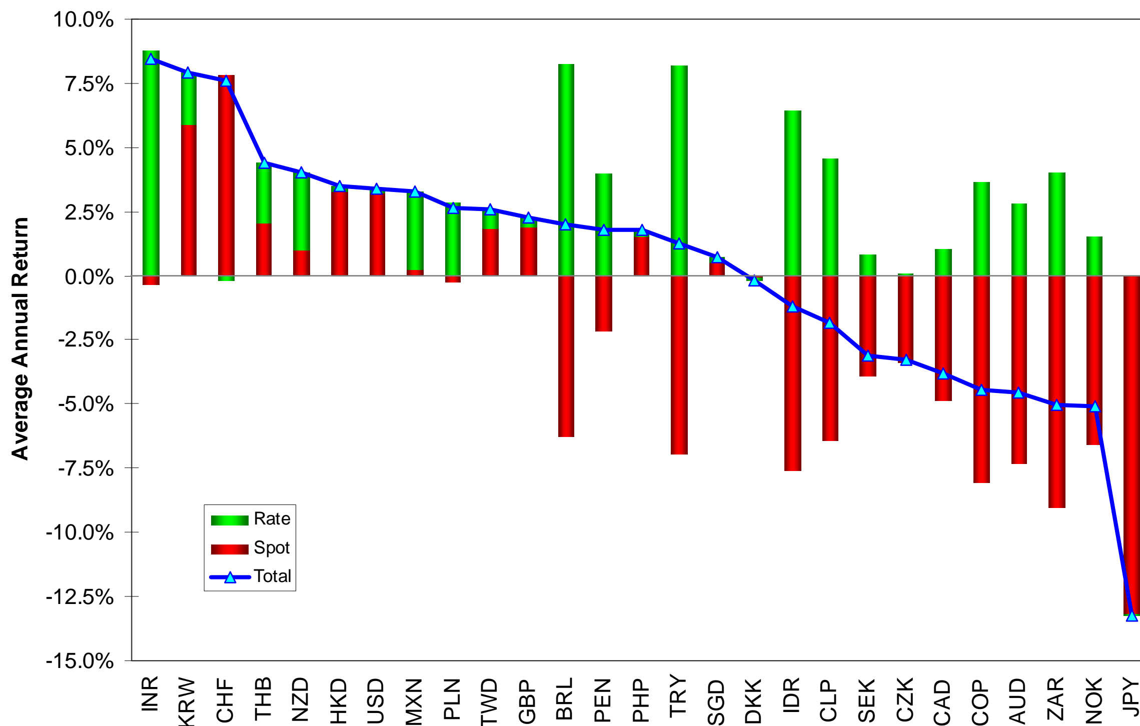
Getting Ready For The Euro Carry Trade

I recall a comment made about a certain 2008 Vice-Presidential candidate regarding the subject of newspapers, "She should have said, 'I read *The Economist*. Everyone lies about that!'" What I recall about *The Economist* from that era is every time the dollar was taking it on the chops, they would run some silly cover depicting a mouth-agape George Washington from the dollar bill sliding off into oblivion. May our words be tender and gracious for one day we may have to eat them.

While the yen carry trade dominated international finance between May 2003 and July 2007, the time when early inklings of the financial crisis led to an unwinding of positions, and the dollar carry trade dominated international finance between the start of QE in March 2009 and the yen's renewed downturn starting in November 2012, the potential euro carry trade was nowhere to be found. If you were going to borrow anything in Europe, it would be the Swiss franc. What could go wrong there?

But just as every bad hair and clothing style comes into and out of fashion at least once, the euro carry trade will see its day and soon now that Mario Draghi has fired up *le helicopter* to drop euros into every stadt and ville on the continent. Knowing the Eurozone's bureaucracy, it will not take long for 30,000-word regulations to appear on how this money must land on the beaches of Normandy and other places where European history has hit a few speed bumps.

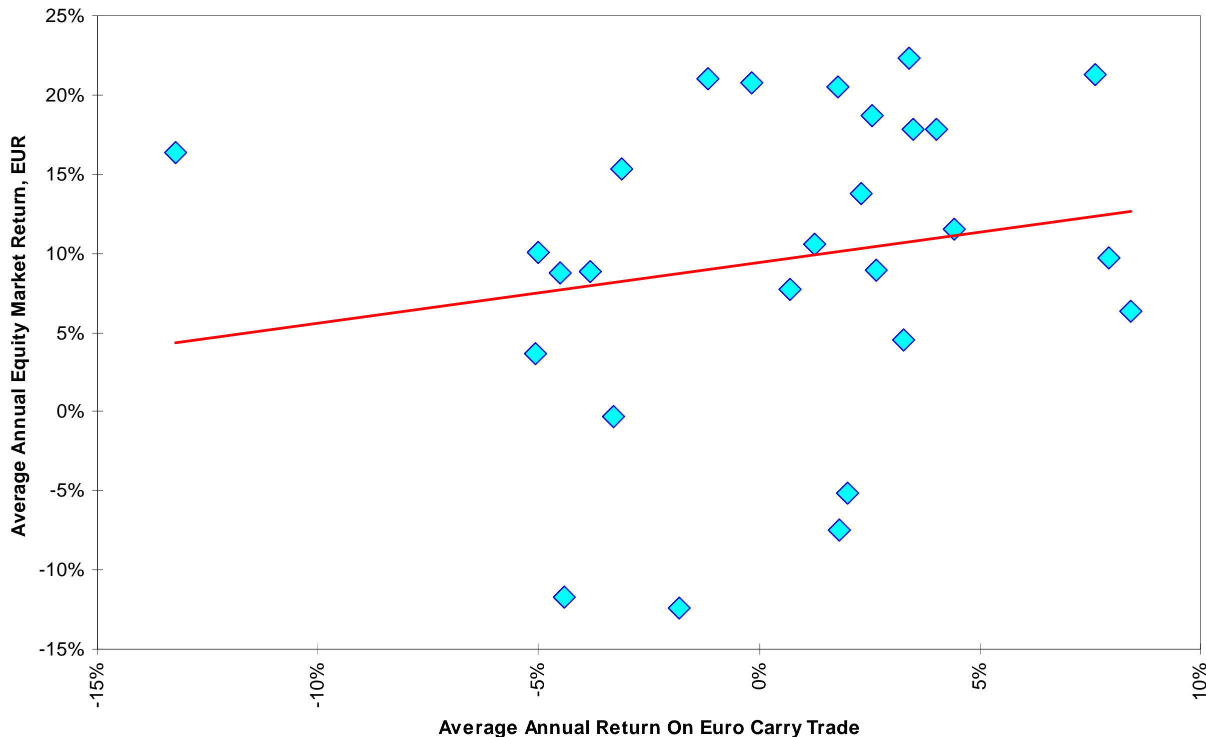
Let's set a baseline for this trade using the data between the July 2012 "whatever it takes" statement on saving the euro and last week's announcement there will be more of them to save each and every month. Any carry trade can be decomposed into its interest rate and spot rate components. The chart below depicts these two components on an average annual return basis, sorted by total carry return, for a group of 27 countries.



We can see, for example, how the euro's carry into the Indian rupee (INR) has been an interest rate affair while its carry into the Swiss franc (CHF) has been a spot rate affair. On the other end of the spectrum, borrowing euros to lend into Japanese yen (JPY) has been a complete loser.

As carry returns and equity returns were linked for both the dollar and yen carry trades, we should expect something similar to occur for the euro carry trade. It will, but it is still a work in progress. If we map the average annual

equity returns in euro terms for the same 27 countries, we see a beta of 0.384. This should increase between now and the end of 2016.



All of those newly created euros are going to need a home. Right now, risk-averse investors and commercial banks seem to be willing to accept negative bond yields, but that is going to get old soon. Look for those euros to prop up all manner of higher-yielding emerging markets such as India, Thailand, Mexico, Poland, Brazil, Peru and the Philippines along with Korea, New Zealand, the U.K. and the U.S.