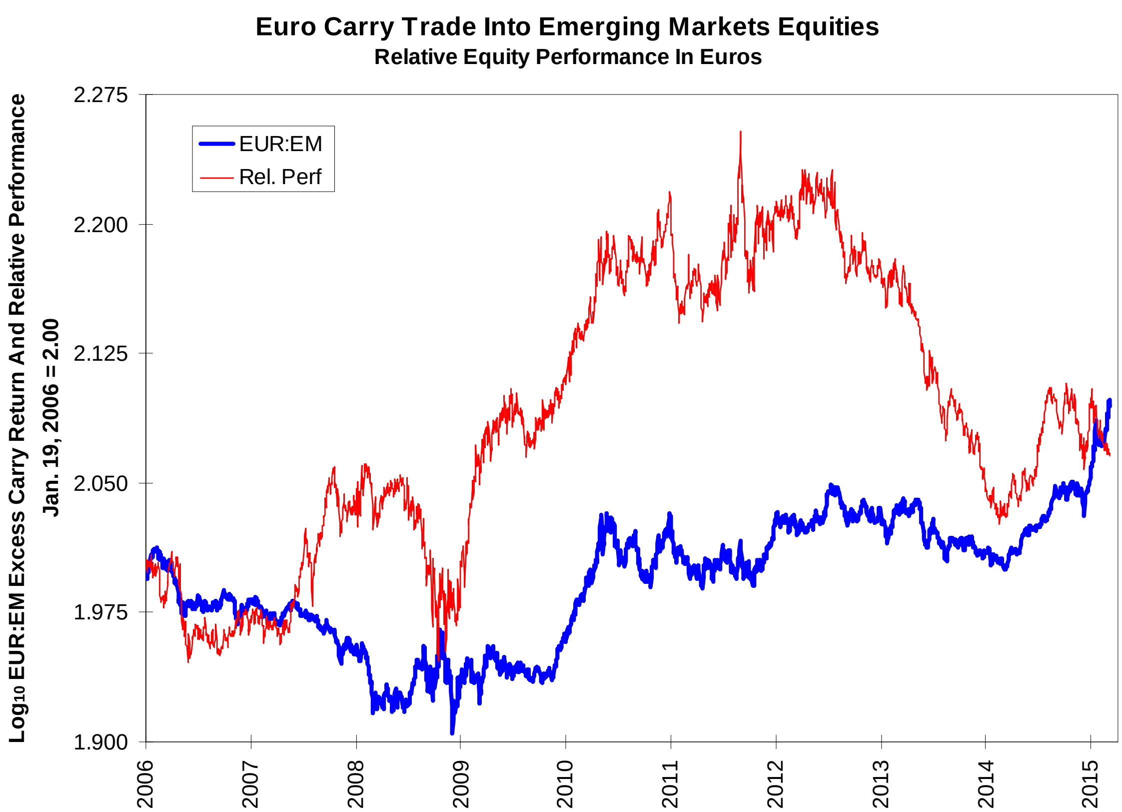
The Euro Carry Trade Is A Bond Affair

Will Rogers once observed, "There's no trick to being a humorist when you have the whole government working for you." So it is with being a market pundit blessed with central banks. They have provided me with the yen carry trade, the dollar carry trade, the Swiss franc carry trade of blessed memory and now the euro carry trade. Let's not even start with them admonishing their associated governments to put their fiscal houses in order as they engineer negative interest rates for those same governments and how they hold up 2% per annum destruction in purchasing power, AKA inflation, as some sort of laudable goal that should have come down from Mt. Sinai and yet was overlooked somehow with all that thunder and lightning, not to mention a golden calf or two.

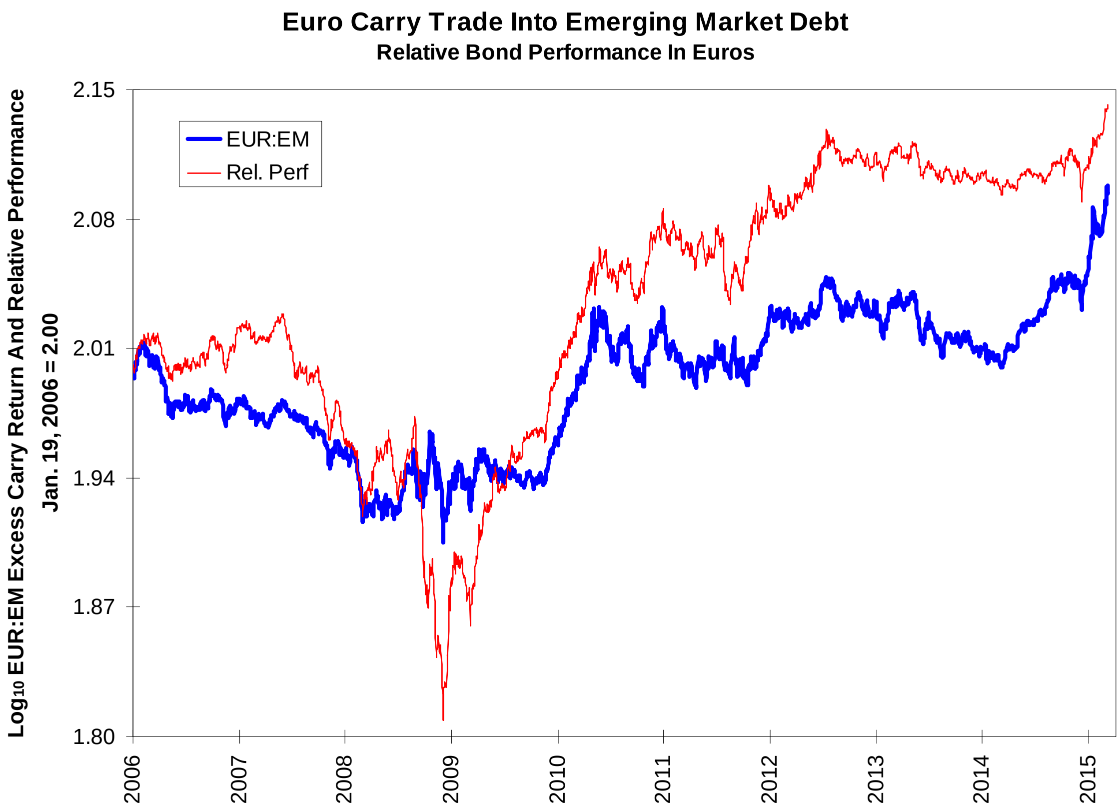
Speaking of the business end of a bovine, let's turn to the euro carry trade into emerging markets as measured by the MSCI Emerging Markets index. The excess carry return for borrowing the euro and lending into a basket of currencies weighted as this index has been 8.68% since the euro's current downturn began in May 2014. This is even more impressive when you consider, as I am sure you have, the MSCI EM currency index has declined 9.07% against the dollar over this same period. In currency trading, we give out style points for relative failure.

Relative Performance

The euro carry trade has done little for the relative performance of the EM basket vis-à-vis the MSCI Euro index. That has gained 2.44% over the same period, but much of that gain occurred prior to the August 22, 2014 hint by the ECB direct QE might be forthcoming. The relative gain for EM equities has been -3.84% since then.



The relative performance of emerging market bonds to Eurozone government bonds in euro terms as a function of the excess carry return of the euro into the EM basket is telling a different story. Here the relative gain has been 4.50% since May 8, 2014 and 3.69% since August 22, 2014. Euro-domiciled investors fleeing negative yields in the Eurozone are assuming the currency and credit risks of emerging market debt but have been unwilling to assume the earnings risk of emerging market equities.



One of the consequences, and I hesitate to say "unintended" consequences, of our own experience with quantitative easing is it forced people who really wanted to be savers into being investors. We really have no idea how many people who have loaded up on stocks, high-yield bonds, REITs, etc, over the past six years would have been just as happy to have stayed in a money-market fund had short-term interest rates not been forced to zero.

The behavior of the Eurozone investor fleeing the ECB's deliberate destruction of the euro's purchasing power suggests they are risk-averse at heart, although I do wonder whether emerging market debt actually is less risky than stocks from good companies headquartered in an EM country. If so, the dangers to all higher-risk investments when short-term interest rates are allowed to renormalize – a statement and not a forecast – are obvious.