Trying To Relaunch The Euro Carry Trade

If and when the world's grand experiment with accommodative monetary policies ends, someone will ask the question whether carry trades were the goal of such policies or simply their consequence. I will opt for the latter. Even though central banks and finance ministries have engaged in competitive devaluations or at least have exercised forbearance in raising short-term interest rates for fear of a stronger currency, these goals seem to be secondary to countering deflationary pressures, lowering government borrowing costs and shifting investors into riskier assets.

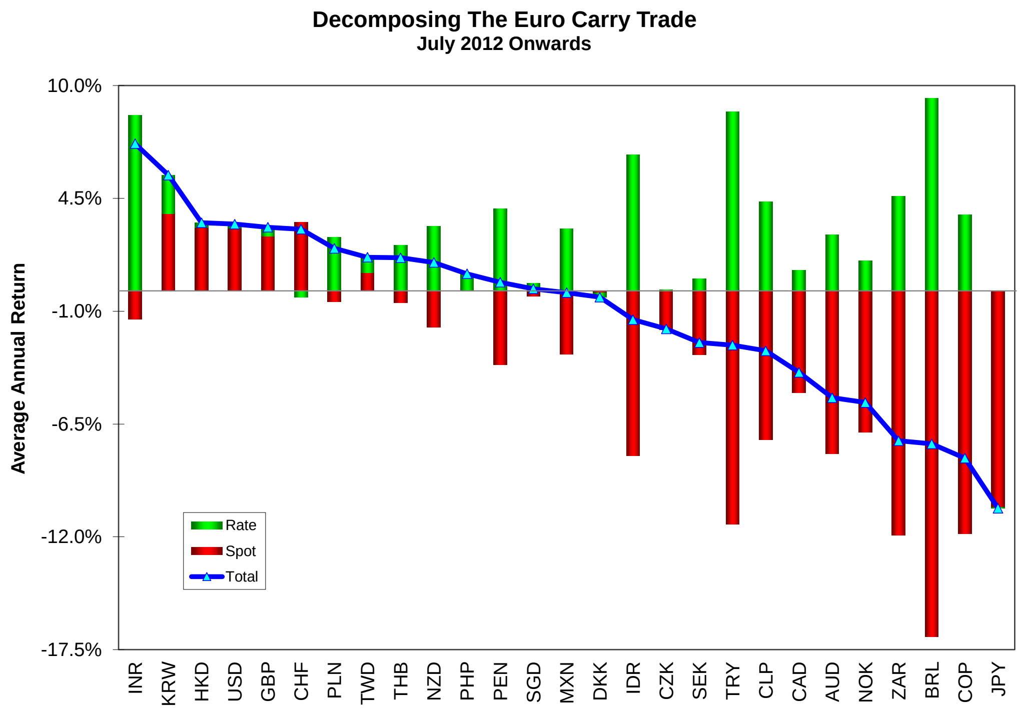
I wrote about the impending euro carry trade just after the formal launch of Eurozone QE in January and concluded:

> 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.

Investors tired of negative Eurozone bond yields by the end of April and any emergent euro carry trade into emerging markets started to deteriorate in mid-May as the much larger dollar carry trade started to unwind. Still, Mario Draghi thought Mario Draghi was doing the right thing, and hinted last week the European Central Bank would expand or extend its QE operations.

Updating The Carry Trade

Let's update the euro carry trade using the data between the July 2012 "whatever it takes" statement on saving the euro and last week's announcement ECB press conference. 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.

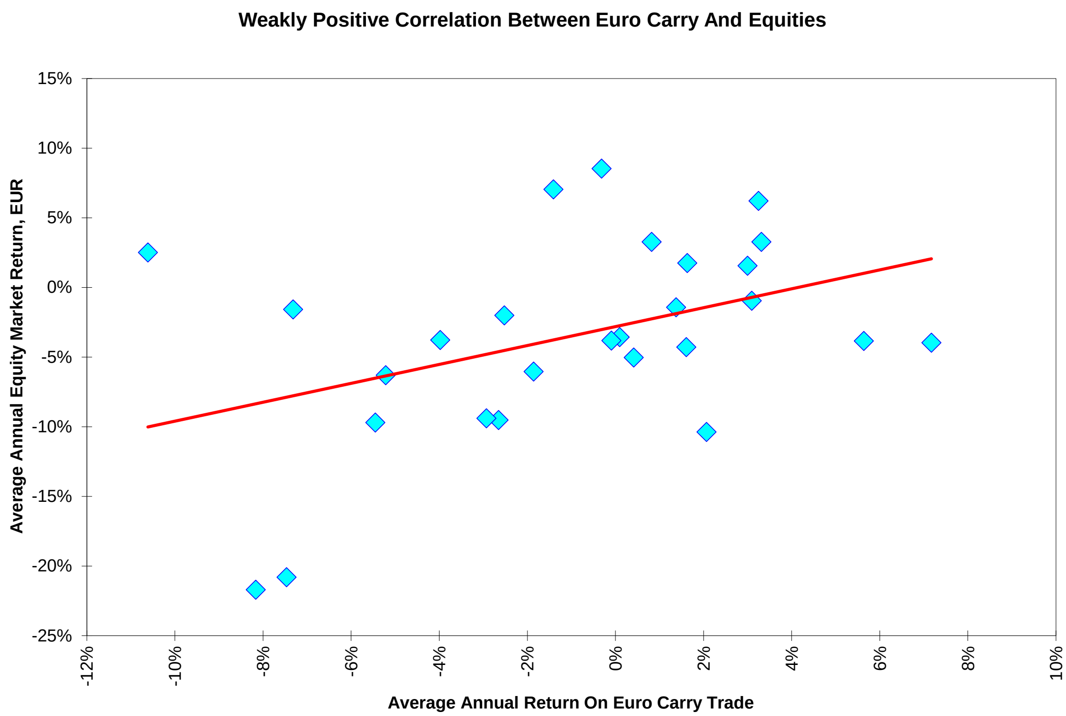


Of the thirteen currencies with negative average annual carry returns, only three currencies, the CHF, JPY and the pegged DKK have had negative interest rate carries.

Seven currencies with positive average annual carry returns, the INR, PLN, THB, NZD, PEN, SGD and MXN, have had negative spot rate returns. The CHF is the only currency with a positive average annual carry return and a negative interest rate return over this period; this is a direct result of the history of franc ceiling imposition.

The Euro Carry And Equities

Now let's map the average annual equity returns associated with each currency against the euro carry trade into that currency. The beta, or slope of the trendline, has increased sharply since May 2015, from 0.337 to 0.679. This suggests an expansion of the euro carry trade would have a positive effect on global equity returns.



This is not a free one-way trade, though. Not only will the euro have to depreciate against other currencies that may be driven lower in response, but investors may balk at fleeing into equities just because the returns on cash are hovering on either side of zero and sovereign bonds are overpriced.