Chaos carries a risk for emerging markets

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Chaos theory holds that a butterfly flapping its wings in Tokyo could cause a tornado in Texas. The analogy is relevant for investors. There is chaos in the markets, with financial hurricanes blowing at full force worldwide.

Yesterday's savage selling forced Korea's stock market to close early and led to the biggest daily fall for the pound against the dollar. It follows events, many in Tokyo, that seem as inconsequential as the flapping of a butterfly wing.

People have talked about the "yen carry trade" for years. Those of a bearish persuasion had warned it was one of the greatest bubbles left to burst. Many others, judging by my e-mail inbox, found their warnings farfetched. But events last week suggest the bears were right, Their theory deserves re-examination.

Since the 1990s, Japanese interest rates have been minuscule as Japan fights deflation. That opens the chance to borrow in yen, or sell the yen short, and park in other currencies that pay a higher yield, or use the cheap funds to make risky investments elsewhere. Traders doing this pocket the difference, or "carry".

It is easy money- unless the yen rises sharply, thus raising the cost of the debt.

So, when uncertainty increases, the yen tends to strengthen as investors take their profits in the carry trade and sell stocks.

Since 2004, the correlation between the US stock market and the euro-yen exchange rate, as the chart shows, has been total.

There is argument about who was making the trade. Some said Japanese retail investors (known as Mrs Watanabe) who recognised that, with a weak yen, the best returns came from investing overseas, selling the yen in the process. Others reckoned it was one of many ways in which hedge fund managers found cheap leverage.

Both now seem to be correct. The carry trade was also broader than many appeared to realise. More or less all currencies that paid a high yield (virtually all currencies in the emerging markets, and even the euro and the British pound) were overvalued. There was a general undervaluation of low-yielding currencies such as the Swiss franc and, recently, the dollar.

Several bubbles have already burst. US housing was followed by credit, commodities and then stocks. These were interconnected. Deprived of cheap credit and facing losses, investors (led by hedge funds) were forced to sell whatever investments were still showing a profit. For many investors, that involves buying dollars as non-American investments are sold. Japanese retail investors brought their money home. Hedge funds repaid debts in yen.

As a result, the carry trade bubble has burst. That removes the last source of cheap money and forces yet more selling of other assets.

It is a self-reinforcing process. George Soros, the billionaire hedge fund manager, labels the problem "reflexivity"; market moves affect external reality.

Thus the currency crash sharply raises the risk that emerging market nations could default. It inflicts losses on multinationals in the emerging markets and makes planning for all multinationals virtually impossible. So the crash is reflexive and causes more problems in the real world.

But it is not wholly self-reinforcing. It has had reinforcement from outside. This week brought news that the UK is in recession and that China, the motor of the world's growth, is slowing down. Earnings figures emerging from corporate US suggest the recession is biting, but brokers' forecasts have not caught up with reality, still projecting double-digit percentage gains in profits for next year.

Can a carry trade truly form a "bubble"? The forex market is a set of zero-sum games. When one currency moves against another, one side benefits directly at the cost of another. An underlying store of wealth cannot increase, as it can in stocks or commodities.

But in the past week, high-yielding currencies are behaving exactly like an asset class in a bubble. Such sharp devaluations in the past were because government attempts to peg prices broke down. There is no precedent for currency moves on the scale of the past week's in a free-floating environment.

Further, this sell-off was indiscriminate; every high-yielding currency fell catastrophically.

Now we know the world is on a yen standard, history looks different. In yen terms, the FTSE-100 is its lowest in 13 years, and the S&P 500 is at a 12-year low. The S&P is down 57 per cent from its peak, on the yen standard. The FTSE is down by two-thirds.

Viewing the world in yen terms should have made obvious that equities were in an unsustainable bubble. From a low in 1994, the S&P quadrupled in yen terms before peaking. In the past three years, Brazil, the most popular emerging market recently, gained 267 per cent and then lost every yen of it.

With no precedents, it is hard to see where a general currency sell-off could end. But forex is behaving like a crashing stock market, and stock markets tend only to find a level once they have overshot and become too cheap. For many in the emerging markets, that could be ruinous.

Fonte: Financial Times, London, October 25 e 26 2008, Primeiro Caderno, p. 16.