Bucking the trend

The end of the carry trade brings a new era of complexity to currency markets.

Illustration by S. Kambayashi

From 2002 to 2007, foreign-exchange trading was pretty simple. Buy the currencies with the highest yields and sell those with the lowest. This “carry trade” created high returns with low volatility.

In theory the trade made little sense. High-yielding currencies should be compensating investors for the risk of depreciation, and low yields have been a characteristic of strong currencies like the Swiss franc. But who cared about the theory when, for a long time, the carry trade produced bumper returns?

Then came the credit crunch and some carry trades broke down spectacularly. The high yields on offer from Iceland did not compensate investors for the collapse of the krona. East European debtors are still coming to terms with the downside of one carry trade, borrowing in low-yielding currencies like the euro or Swiss franc. It saved them interest costs in the short term but it also created a nasty mismatch: their wages and revenues were in one currency and their liabilities were in another.

Now markets have reached a stage, in the biggest economies at least, where the carry trade looks hard to pull off. Thanks to the desperate efforts of central banks to revive their economies, most currencies yield virtually nothing. There is not enough of a spread between the dollar, euro and yen to reward speculators.

Although that is true in nominal terms, David Woo of Barclays Capital argues that there is still a difference in real yields. America is now officially in deflation so real yields on Treasury bonds are around 3%. That compares well with real yields in Japan, Canada and Britain and it may be attracting capital flows into the dollar.

But another possibility is that the focus has moved away from yields to other factors. This would not be the first time. In the late 1990s America’s superior growth prospects were perceived to be good for the dollar, as the country attracted portfolio flows into technology stocks. At other times, trade patterns have dominated, with deficit countries perceived to be vulnerable to currency declines.

What could be the basis for the new regime? Adam Cole of the Royal Bank of Canada reckons the answer is the credibility of economic policy. In America the authorities have shown themselves willing to try everything to boost the economy, including lower interest rates, bank rescues, fiscal stimulus and quantitative easing (expanding the money supply). In contrast, the European authorities have been more cautious. That is why the dollar has been strong against the euro recently.

This is odd. Running budget deficits and printing money tend to weaken a currency. David Bloom of HSBC argues that the currencies of those countries that have adopted quantitative easing will underperform those that have not.

But it may be a sign of the severity of the crisis that currency traders are willing to ignore their misgivings about such unorthodox tactics. As Ajay Kapur of Mirae Asset Management puts it: "In a debt deflation, the currency of the least responsible country benefits."

Another possibility is that currencies are being driven by risk appetite. That seems to be true in developing countries: emerging-market currencies have rallied alongside equity markets in recent weeks. And it makes a certain amount of sense. If rising stockmarkets are a sign that the world economy is stabilising, then export-driven emerging markets should be the first to benefit.

When investors turn risk-averse, they seem to favour the dollar, as was illustrated yet again on April 27th when the outbreak of swine flu caused the greenback to gain ground. A further reason why the dollar may be benefiting during stockmarket sell-offs is because American investors, who piled money into foreign shares in recent years, are bringing their money back home.

And the dollar may also be gaining a following from those who focus on trade deficits as an important agent in foreign-exchange markets. For years, the size of the American current-account deficit was seen as bearish for the buck. But the global slowdown, and in particular the falling oil price, have caused the deficit to shrink dramatically.

The new world of foreign exchange may thus be much more complicated than the old. But for the moment most factors seem to be favouring the dollar. Ironically, the greatest danger for the greenback might result from the success of the efforts of the Treasury and the Federal Reserve to revive the global economy. Not only might investors start to chase high yields again, but they might also start to worry about how the bill for all those unorthodox policies is going to be paid.

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