



LET'S TALK ABOUT...

FINANCIAL LEXICON EDITED BY THE SWISS ASSOCIATION OF ASSET MANAGERS

Carry Trade

(Part one) We go back to a topic we already reviewed some time ago, because something new has emerged about it. Firstly may we remind what the term means: fundamentally it refers to borrowing in a “low cost” currency (that is with low interest rates and not so likely appreciation potential) in order to invest in assets with higher expected returns. It is a diffused investment practice, but its features have changed in years. The traditional borrowing currencies in carry trades have long been the Swiss Franc and the Japanese Yen, whose yields and interest rates have historically been lower than averages. Such moneys were borrowed so to invest in equity or high-yield bonds, or just in strongly appreciating currencies, through monetary instruments or plain cash. Common target currencies, thanks to their high yields and appreciation expectations, have been, in different periods, the British Pound or the South African Rand, the Norwegian Crown or the Australian and New Zealand Dollars, the Icelandic Crown and so on. However in many cases the high yields paid could not balance the currencies' sudden and huge falls, as a result of different causes. Moreover a double loss may take place, in that the depreciation of the target currency combine with an unexpected upturn of the debt money. That has indeed been the case for the Swiss Franc as a consequence of the several market storms and its role of safe haven for many investors, and such has been the prevailing trend for the Yen too, all the more in the past months due to the repatriation of large amounts of foreign investments after the earthquake, the tsunami and the related nuclear troubles in Japan.

So, in line with the new currency scenario, the US Dollar has gradually come to replace the Swiss Franc and the Yen as a debt currency. However the greenback's role is definitely more complex and differentiated, as it will be analyzed in the next article. *(to be continued) - GLT*

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(Part two) The ideal carry trade lies in selling (or borrowing) a low-cost (low interest) currency with poor appreciation potential, and to invest in another currency (or in instruments denominated in it) with high yields, stable value and, all the better, some appreciation perspective.

Obviously the carry trade is all the more interesting, in terms of return, the wider the spread is between the two currencies' rates, as well as their exchange relation, as this type of financial transactions tend to go on pretty long periods of time and often use high leverage ratios.

Equally obviously the financial history indicates that such ideal conditions, although taking place for some time, may often "break up" suddenly and unexpectedly, for many reasons. Forex exchange rates are more vulnerable, while interest rates tend to move in more gradual and predictable ways, so to allow "dismounting" carry trades in time for avoiding losses.

We have noted that classical borrowing currencies have been the Swiss Franc and the Japanese Yen, thanks to their historically low interest rates. But, at certain times, their external values suddenly increased, so to make them less interesting for borrowing and going short of them. Since some time their debt position has been taken by the US Dollar, which is marked by extremely low interest rates and a long-time weakening trend, also due to the Federal Reserve's ultra-expansive monetary policies, with repeated quantitative easing and other unconventional practices. So many investors borrow (or short) the USD and invest in high-yielding currencies, commodities and related instruments. But the USD as a debt currency may take some additional risks: if it shows a clear "secular" downtrend (as the USD index vs. a basket of foreign moneys clearly indicates), sudden unexpected upturns are all the same frequent, not to say of inverse movements in high-yielding and "trendy" target currencies.
(to be continued) - GLT

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(Part three) We have just discussed a new trend in carry trades, that is borrowing in a currently low cost money – the US Dollar – in order to invest in secondary high yielding currencies, e.g. the “Austral” or Latin-American ones, as well in financial instruments which are denominated in them. We have also reminded that the wider the spread between the two involved currencies’ yields, the more the operation may turn potentially rewarding. However the borrowing rate and the expected return are just one side of the picture: we have also to consider the possible appreciation of the borrowing currency and the related depreciation on the one in which we invest. Such moves have often been a source of risk and losses in the past, when investors have borrowed, as a matter of instance, in Swiss Francs or Japanese Yens, and have invested in suddenly downturned South African Rands, Norway Crown and Iceland Crown, the latter having been a real “star” for some time, before it was rocked by the country’s dramatic financial crisis.

A good indicator for carry traders may be the stability of yields and relative exchange rates between the two selected moneys, however considering that moves may be sudden and ample.

The history of currency market is proof of that, also because it particularly attracts huge amounts of investors’ “hot money”, which is extremely mobile and unstable. And a major general rule is always valid, according to which high yields are the mirror of higher risks, for currencies too, because of higher inflations, potential devaluations, financial and economic unbalances and troubles. In this perspective the position of the US Dollar as a borrowing currency is now pretty complex: rates, and then borrowing cost, are actually extremely low, the long-term trend looks bound for decline, heavy public accounts and trade unbalances support such stance but, by the moment, the greenback still stands as the global reference currency and shows its role of a safe haven (together with the Swiss Franc) whenever major crisis and strong turbulences disrupt the markets. And such is the case in a scenario where its direct competitors – namely the Euro – are confronted with very serious problems too. Thus a USD-borrowing carry trade may imply some additional risk compared to the ones it normally involves. *(the end) - GLT*

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