CARRY TRADE AND CAPITAL DESTRUCTION

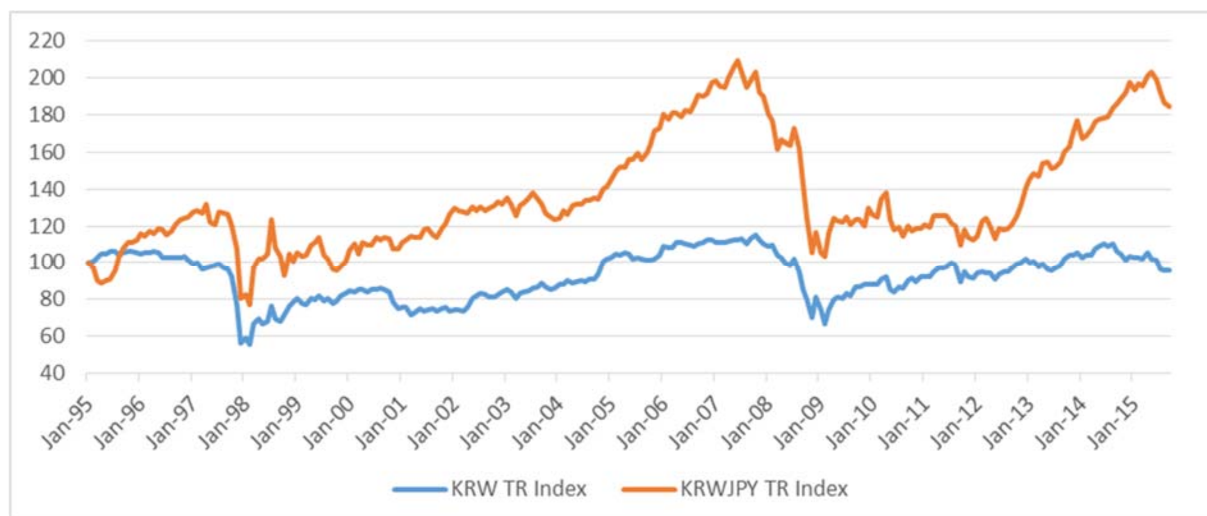
John-Paul Burke's Market Views

"Initially the 'carry' from a relative interest rate advantage generates a positive return, but ultimately depreciation should destroy the accumulated income. By observing where we are in this characteristic total return pattern, we can glean what the potential downside might be as the currency progresses through the remainder of the cycle."

Structurally high inflation economies experience a loss of currency value over the long term. To offset this, high interest rates are necessary to compensate for the loss. These two opposing forces determine the total return (TR) of a currency by pulling in opposite directions. Initially the 'carry' from this relative interest rate advantage generates a positive return, but ultimately depreciation should destroy the accumulated income. By observing where we are in this characteristic total return pattern, we can glean what the potential downside might be as the currency progresses through the remainder of the cycle.

A currency pair which demonstrates this characteristic over the course of three cycles since the 1990's is that of KRWJPY (long Korean won, short Japanese yen). Japanese investors faced with low domestic interest rates have long sought to increase their incomes. By borrowing low yielding JPY at 3 month deposit rates and investing in high yielding KRW deposit rates, they have produced healthy interest rate returns (carry).

A total return (TR) index showing the returns of this strategy over time displays these gains until periodically the KRW has devalued in JPY terms and eliminated all of the accrued carry and capital gains up until that point. The index typically falls back towards 100 as depreciation equals the accumulated interest rate returns. This pattern can be observed in two complete cycles up until 2009. A third appears to have started in August 2012. Weakness from mid-2015 could be the start of a reversion pattern as Korea seeks to once again gain competitive adjustment through its currency.

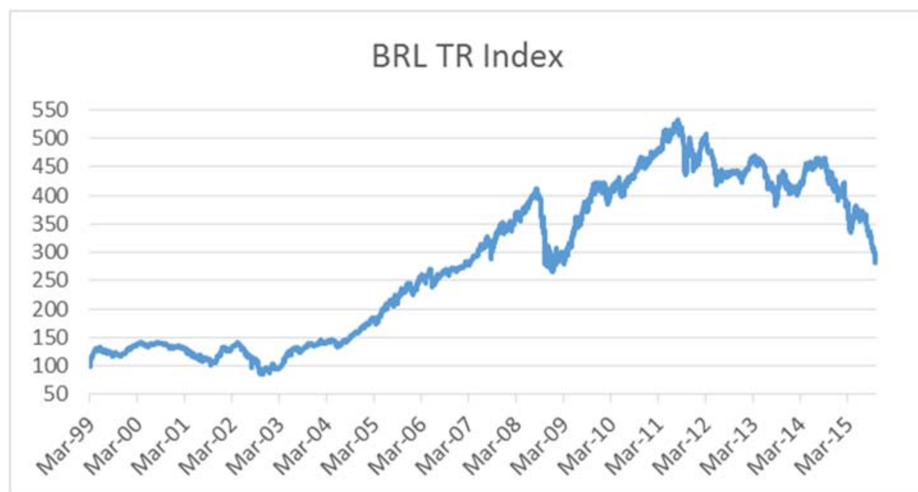


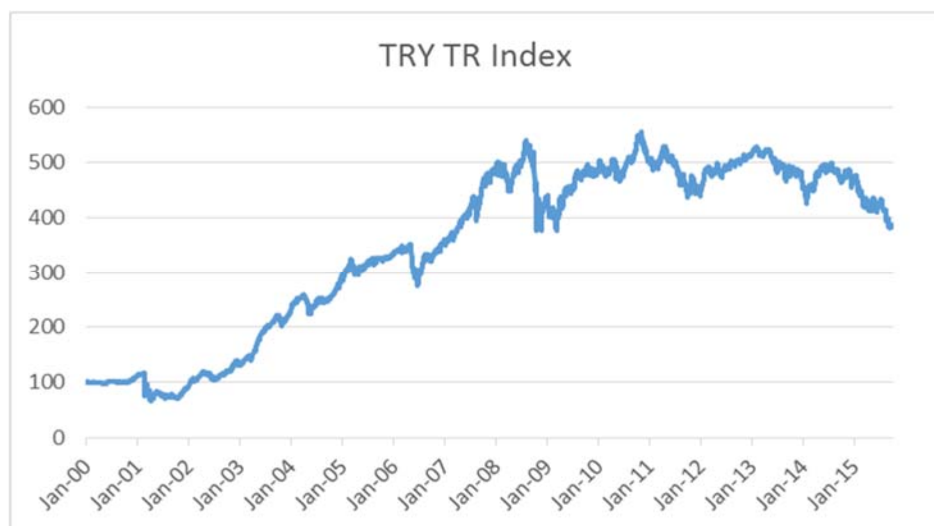
Similarly, the long KRWUSD (long Korean won, short US dollars) equivalent of the strategy, shown in blue in the chart above, displays much the same pattern but with a more narrow range. It is interesting to note how the interest rate carry is insufficient to even compensate USD holders for their risk of KRW devaluations over time.

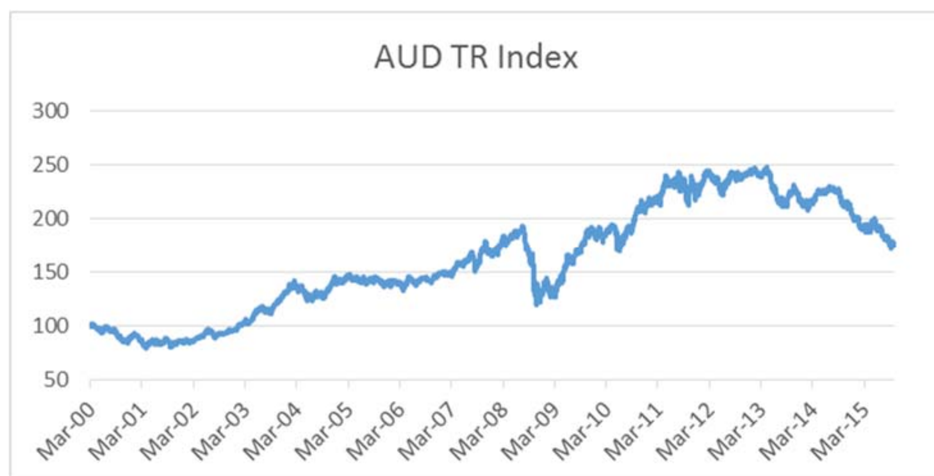
It looks probable that the current emerging market cycle started in the early 2000's with the combination of rapid growth inducing Chinese industrialisation, a commodity super-cycle and declining global interest rates. An environment was created in which investors subsequently priced various emerging market currencies well beyond their historic total return ranges in the belief that fundamentals had been permanently divorced from prior cycles. Multiple quantitative easing policies initiated by the US Federal Reserve following the financial crisis have resulted in speculators chasing carry even as interest rate returns have fallen below levels warranted by deteriorating fundamentals.

As the conditions sour, a reversion to the long term average looks probable in my view as the emerging market cycle passes out of its favourable patch. When the interest rate differential fails to adequately compensate for growing risks, a sudden rebalancing can occur, which has historically taken the total return back to the level it was when the cycle began.

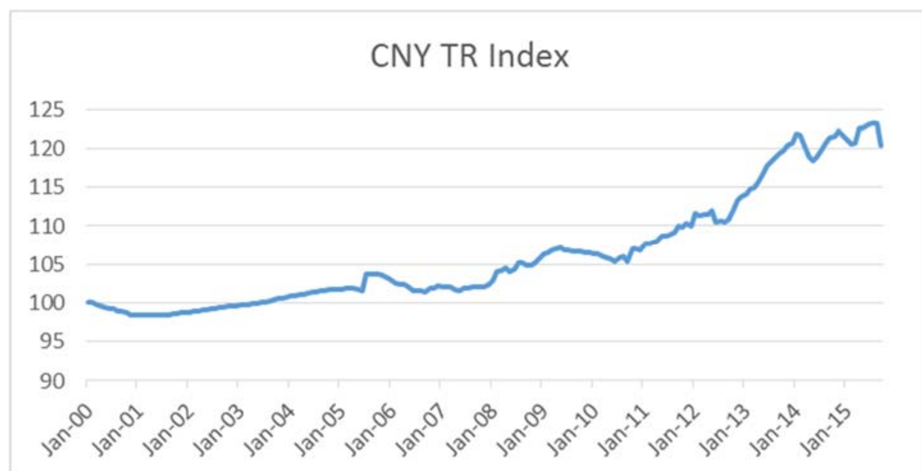
When viewing emerging market currencies versus the US Dollar through this lens, many appear to have further to fall despite their recent declines.







Perhaps unsurprisingly, high yielding, commodity related currencies have been the recipients of large amounts of capital as each country's fundamentals improved with the maturing commodity super-cycle. Now as that cycle ends and fundamentals deteriorate with slowing growth, the currencies have begun to destroy the returns accumulated during the period. However, I would suggest there is further to go.



Interestingly, China, the country at the heart of the emerging market cycle since the early 2000's has been a profitable place to accrue currency returns. As growth stalls under the weight of excess industrial capacity and debt, a sizeable currency devaluation strikes me as warranted. A total return reversion here, would of course have serious ramifications for the Asian region and far beyond as competitive retaliation would very likely ensue, nonetheless the policy looks very sensible and increasingly likely to me.

INFORMATION

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