

FOREIGN EXCHANGE

UNWINDING OF THE YEN CARRY TRADE

“Japan had been growing for five years, yet its currency was at 18-year lows in real terms.”

Your opinion on: The Impact of additional rate hikes by the Japanese Government

Japanese officials have been put under pressure by the international community since Japan has been the main source of liquidity for global financial markets. These manoeuvres have, thus far, not yielded significant concessions from Japanese officials as Japan's economy still shows signs of relatively benign growth. So aggressive interest rate hikes are not needed. However, I do expect small and gradual interest rate increases to bring Japanese interest rates in line with the global tightening schedule. Clearly, Japanese officials are walking a tight rope between hiking rates, helping balance global imbalances and steering Japanese economic policy outlook, which has improved but is far from overheating.

Currencies are a “square game” ... how much longer can the Japanese Yen (JPY) carry trade exist?

The fundamentals of the carry trade are to borrow in a low yielding currency and to lend in a higher yielding currency. I don't expect Japanese interest rates to be raised by 150-200 basis points any time soon. If we believe the low interest rate environment in Japan will persist, then, the merits of investing in a “commodity cycle” and in high yielding currencies could, likewise stay intact. However with Japanese rates on the way up, albeit gradually, the yield advantage is getting narrower but will not disappear. It is not just the JPY which is used in this game, but the JPY is by far the largest carry currency.

Professionals have been shorting the Taiwanese Dollar (TWD) as a proxy against high yielding Asian Currencies. In the case of Central European (CE-4) currencies - the market has been borrowing in the Czech Koruna (CZK) and investing in the Hungarian Forint (HUF), Polish Zloty (PLN) etc. And then there is still the Swiss Franc (CHF) which offers comparatively lower interest rates against investing in the Brazilian Real (BRL) or in the Turkish New Lira (TRY).

What according to you are the reasons for an unwinding of the carry trade? Is it retail Japanese selling their currency or investors unwinding the carry trade? Or a combination of both?

We have not seen a mass exodus from Japanese retail accounts yet. Ripple effects from the ongoing unwinding of fixed income collateralised obligations and sub-prime loans are underway and will take time to be completed.

How should one invest in currencies to exploit this facet and optimise currency returns?

High yielding currencies like the Australian and New Zealand Dollar (AUD) and (NZD), emerging market currencies like the BRL, TRY etc. are all part of an on-going

diversification trade. With portfolio investment theories being more widely embraced, diversification trends into currency as asset class, as well as some carry trades with-in, will not disappear.

We may have times of re-adjustment and liquidity withdrawals, but the investment theme is expected to stay for the foreseeable future; barring a massive liquidity implosion, which would see global yields spiking considerably higher, and a global equity market meltdown.

Do you expect a persistence of volatility in Asian currencies, other specific currency pairs/crosses?

Implied volatilities in the case of Asian currencies have been artificially depressed in pursuit of higher returns, with option seller using any spike higher, than in the past. We have seen a small adjustment in implied volatility to higher, more normal levels, and we expect this to continue going forward.

Drawing on your extensive foreign exchange (FX) experience, have there been comparable currency analogies in the past?

Stretching back two decades... carry trades have always been a strategy currency hedge funds pursued. However, they were never as popular then, as they are now. When FX-volatility started its decline around three years ago (reaching historical lows this year) - carry trade emerged as one of the most rewarding strategies. The other performing style within FX proved to be the short selling of options. In contrast, during previous market crisis such as LTCM or in the case of the emerging markets - it was more a case of “flight to quality” - with save heaven currencies such as the CHF or the USD benefiting.

Your views on currency cycles and where we are presently... and your near term outlook on investing in currencies.

We are in a period of re-adjustment, where risk will be re-allocated to safer investment strategies. The quest for higher returns, by the swelling-in-number-participants, is what has driven markets. We have experienced a steady decline of volatility in all the major currency pairs over the last two years. This cycle is close to its end. I expect to see sharper moves and pronounced trends overall. This is what will eventually force central banks, to intervene yet again, in the open market. The market often underestimates the magnitude and duration of a trend in the currency world.

Of course, it is difficult to assume what would trigger such a move... but from my perspective and based upon the price action and charts observed, I believe we are pretty close to breaking out of the relatively tight ranges in which FX markets have been trading. Also, it is about time the real fundamentals (beyond interest rate differentials) be considered when it comes to determining the fair value of exchange rates.



Martin Wiedmann

Contact Information:
 Quaesta Capital AG,
 CEO, Martin Wiedmann

Telephone:
 +41 55 417 00 50

Email:
mw@quaestacapital.ch

Website:
<http://www.quaestacapital.ch>