Monthly Analysis – May

Gábor Orbán: Weakening dollar, strengthening forint: a return to carry trade?

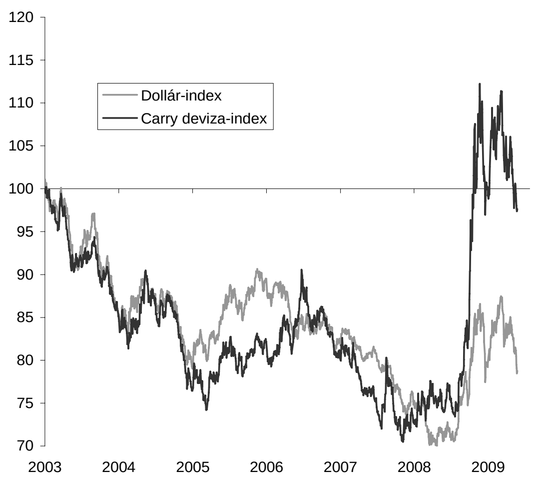
Carry trade, one of the popular investment strategies of the past decade, suddenly lost its significance in the financial crisis that began to unfold in mid-2007. The weakening of the dollar seen over the past month and the simultaneous strengthening of the emerging markets raises the question: could carry trade be on its way back?

Carry trade is nothing other than a short position in the financing currency (dollar, yen, or Swiss franc, though more recently the Czech koruna has also been classified as such), and a long position in a high-interest-rate emerging market currency such as the forint. Three factors must be in place for this to work: 1) a low-yield environment on the developed markets which encourages investors to take risks in regions outside the developed markets, while providing a cheap source of funds for investment; 2) a positive interest margin, which makes it worth buying and holding the emerging market currency even if it is not appreciating against the financing currency such as the dollar (this is what the term "carry" refers to); and 3) the volatility of the carry currency needs to be low, so that the exchange rate risk will be offset by the interest differential. As the trend of a weakening dollar clearly increases the attraction of a carry position, we can also assume there is a partial causal relationship between the two phenomena.

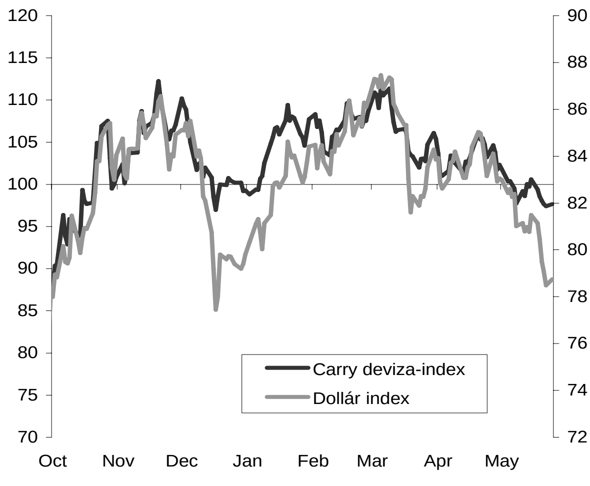
The dollar has undergone a major weakening over the past month, which appears to have taken place against a background of increasing risk appetite. Meanwhile, emerging market currencies, including the high-interest-rate "carry" currencies such as the forint have, albeit by a lesser extent, all appreciated in recent weeks. The correlation between a weaker dollar and stronger emerging market currencies is not a new, post-subprime crisis phenomenon; in fact, it has been one of the most dominant features in the market landscape for some time now. Between 2003 and 2007, as can be seen on the diagram on the left, there was a notably close interrelationship between the weakening of the dollar and the strengthening of the carry currencies. From mid-2007 to the end of 2008, this correlation ceased to exist due to increased volatility and the global shortage of funds, and amid the general process of de-leveraging, the importance of the "carry" as a factor influencing investors fell close to zero. Then with the Lehman collapse, any remaining carry positions were liquidated: the massive reduction in risk appetite resulted in a "flight to quality", which strengthened demand for dollar instruments deemed to be safer as against anything else, including carry currencies. Furthermore, foreign currency liquidity dried up in the peripheral countries, leading to a considerable rise in the cost of (interest on) foreign currency funds, and as a result, the carry often evaporated, despite the relatively high forint etc. interest-rate levels.

Relationship between the dollar index and the carry currencies in the recent period and over the longer term

January 2003 – May 2009



October 2008 – May 2009



Source: Bloomberg.
The dollar index shows the weighted average of the futures rate of the dollar against the euro, the yen, the pound sterling, the Canadian dollar, the Swedish krona and the Swiss franc. The carry currency index is calculated as the non-weighted average of the forint, the Romanian leu, the Icelandic krona, the Australian and New Zealand dollar, and the South African rand against the dollar. Lower figures represent a weakening of the dollar against major currencies and a strengthening of the carry currencies.

A significant number of financial investors are now concerned by the question of whether the old correlations between the dollar and carry currencies or risky instruments in general may return, or whether the absence of the carry factor seen in the recent period is here to stay.

In order to weigh-in on the debate, we need to go back to the preconditions for the carry-game. As regards the yield environment, the interest-rate level on developed markets is very low, and the financing terms have substantially improved, although funds have not become as cheap as they were before 2007. The picture is similarly mixed in terms of the interest differential: although the interest margin on emerging markets has clearly increased in recent months, it is very attractive in the case of dollar/euro instruments as well, and therefore the existence of a “carry” does not in itself necessarily result in the appreciation of the emerging market currency. Thirdly, the volatility of emerging market currencies, although it has fallen significantly, is only just moving into harmony with the interest margin.

The situation is of course complicated by the fact that the weakening of the dollar may also be partly due to a fall in confidence in the US government’s pursuit of an aggressive policy of economic stimulation. The dollar is also under pressure from the enormous US budget deficit (13% this year), particularly since a downgrading of the US economy has become a distinct possibility. This, on the government securities market, translates into rising yields and a selling pressure on longer maturities. How does the picture change if the weakening of the dollar takes a disorderly, chaotic form? From that point on, the whole concept of a “risky asset” needs to be re-evaluated. For emerging market instruments, this would bring about an unfavourable change due to the general rise in volatility. Of course, it is also possible that the rise in the yields on US government bonds is only a correction of the flight following the earlier Lehman bankruptcy, or an expression of the expectation of higher real yields due to better growth prospects – and emerging market instruments, including the forint, could respond by strengthening. However, until this question is settled, it is too early to talk of a return of the carry-trade to the world of investments.

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