Market Dynamics

Volume 8, Issue I42

November 6, 2009

Performance Management System

The Dollar Carry Trade

Portfolios heavy with under-performing stocks almost never outperform the market.

Ignat's Law

Roubini Says Carry Trades Fueling "Huge" Asset Bubble.

Bloomberg Headline on October 27, 2009

A collection of recent newsletters is available on the web site.

Please visit the web site at http://www.clayallen.com/

Market Dynamics
7325 S. Jackson St.
Centennial, Colorado

Phone: 303-804-0507

clayallen@msn.com

A recent news item on Bloomberg covered a presentation by NYU professor Roubini that referred to a worldwide dollar carry trade that has resulted in "huge bubbles" in stocks and commodities. The professor concluded that this dollar carry trade could spark another financial crisis.

The dollar carry trade involves borrowing in dollars at very low rates and investing in assets in other countries that promise higher returns. This must be occurring largely outside the US and may be a reason for the strength in emerging market equities and commodities. This seems to be an inherently speculative strategy and it does pose new risks.

It seems that the positions that are created as a result of the carry trade are build up over time. These positions can be built up with an huge amount of leverage. In essence it is borrowing short and lending or investing in long lived assets. The trade is influenced by the expected returns on the assets purchased but it can also be affected by exchange rate fluctuations and borrowing costs associated with the carry trade.

The positions associated with the carry trade are difficult to identify and it is up to each lender to evaluate the credit worthiness of each borrower. Many times these borrowings are not reported and are kept secret.

Interest rates will not remain at the very low levels currently being received in the US. At some point interest rates must return to more normal levels and this may cause the carry trade to start to fail.

Professor Roubini said "Everybody's playing the same game and this game is becoming dangerous." It is worth considering what happens when the carry trade starts to fail. The leveraged positions are built up over time but when the trade starts to fail "there may be a rush to the exit." This rush to the exits can be extremely brutal if the carry trade has resulted in excessive leverage. This can result in the forced liquidation of the assets within a short period of time. This is the origin of financial market panics and a collapse of asset prices.

It should be understood that the carry trade must be reversed at some point. A long-term investor who buys fully paid positions cannot be forced by market conditions to liquidate. To many conventional, long-term investors the carry trade is somewhat mysterious but financial history is replete with examples of liquidity panics. The excessive application of leverage to hold risky assets seems to be the root cause of these panics.

We don't know if professor Roubini will be correct in his appraisal of the dollar carry trade but it is certainly a warning to all market participants. The movements of interest rates in the US and the behavior of markets around the world need to be watched carefully just in case his forecast proves to be correct. In his presentation he allowed that the carry trade might last for another year or two due to the flood of liquidity that has been created by central banks.

It seems hard to imagine that another market crisis could be created so soon but it is almost certainly true that extremely low interest rates have, once again, stimulated the excessive use leverage.

W. Clay Allen CFA