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WEEKLY RESEARCH NOTES

Crunch time for carry

Leonardo da Vinci said that 'simplicity is the ultimate sophistication'. That is a phrase many participants in financial markets would do well to heed. The simplest investment and trading strategies often work remarkably well for long periods of time. However, another characteristic of markets is that 95 percent of profits (and losses) are made in 5 percent of time-periods. Following a single investment strategy blindly is likely to be very costly in periods when investor behavior changes.

One trading strategy has had more column inches devoted to it than any other in recent years: the carry trade. In a recent note* Axa Investment Managers shows that following a simple carry strategy with a long/ short portfolio of 16 currencies (long the eight highest yield currencies and short the eight lowest) would have generated 574 basis points annualized return since December 1998; proof that simple ideas can work. However, year-to-date, despite all the hype surrounding carry, Axa's theoretical long/ short strategy would have lost 277 basis points.

State Street Global Markets' proprietary measures of investor behavior can help identify when strategies are in and out of favor and when these transitions are likely to occur. In August, the currency recommendations of the global macro strategy team had a bias toward carry. In that month the Kiwi dollar appreciated 7 percent against the yen; happy days for the carry trade. However, a fortnight ago the team reoriented their recommended portfolio of trades away from carry. This was prompted by their price-based measure of risk appetite dipping into neutral territory and a decline in cross-border equity flows.

Cross-border flows have slightly improved over the last week (see chart). However, investors are highly selective. Their preference is for old Europe – particularly Italy, Germany and Switzerland – and developed Asia, though the momentum of flows into Japan is cooling. What is particularly marked is a sharp decline of flows into heavily energy or commodity-oriented economies such as Norway and Canada and to a lesser extent Australia, one of the favored carry currencies.

The evil twin of high yield is a large current account deficit. Even New Zealand's finance minister Michael Cullen felt compelled to remind speculators earlier this month that his country was running a deficit equal to 9 percent of GDP. However, it is the path of the yen, not high-yielding currencies, which will ultimately decide the fate of carry.

Short yen, in part to fund carry strategies, has been the consensus trade of the summer. By the beginning of September speculative investors tracked by the CFTC in the US had built a record \$9.46 billion short. Perhaps concerned by position risk in advance of the G7 meeting, \$2 billion was bought back in the following week. However, this position is still in the bottom percentile (in other words speculative investors have been more negatively positioned on less than 1 percent of past occasions).

Long-term institutional investors tracked by State Street Global Markets' Foreign Exchange Flow Indicator are also short the yen. 120-day flows, our proxy for positioning, are in the 21st percentile. The surprisingly low inflation number for July (0.2 percent versus market expectations of 0.5 percent) made selling yen seem like a one-way trade. However, it is far too early to say that Japanese deflation has been derailed.

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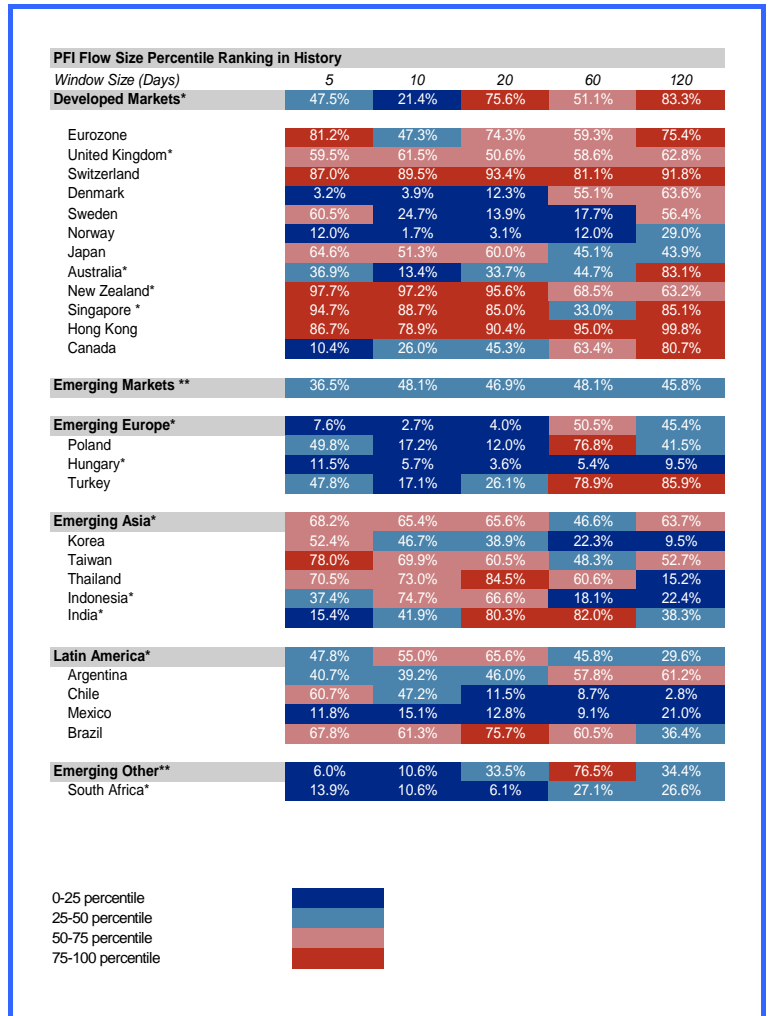


The Ministry of Finance's quarterly survey of the corporate sector released in the first week of September showed wage costs accelerating from 2 percent to 3.5 percent year-on-year. Sales growth was 8.6 percent. The debt/cash flow ratio which has been at historically low level picked up, suggesting corporations are tapping into abundant liquidity in the banking sector to gear up their balance sheets. The MoF will keep a weather eye on this. Investors betting that interest rates will not have to rise from 0.25 percent this year are probably on a good wicket, but it is by no means the sure thing extreme positioning suggests.

The elephant in the room is global imbalances. In an echo of history, the real effective exchange rate of the yen is now at its lowest since 1985. In September that year the G5 agreed the Plaza Accord, which dramatically weakened the dollar and strengthened the yen. Twenty-one years on, global imbalances are back on the agenda of the now G7. Though no one is expecting a dramatic Plaza-like announcement to emanate from Singapore, even a nod to the issue could be enough to spark a rally in the yen and other Asian currencies. State Street Global Markets' macro strategy team retains a long yen position.

Carry strategies have flourished as US yields have fallen. The 10-year treasury yield fell from 5.15 percent to 4.72 percent during July and August, but has since backed up to 4.79 percent. The Fed pause and the low inflation number in Japan encouraged a revival in risk appetite during the summer. But as summer turns to autumn it could be the wrong time to get too carried away with carry.

* Comparing simple currency strategies (available at www.axa-im.com)



Most country flow has a 5-business day lag

* Denotes lag of 2 more business days.

** Denotes lag of 4 more business days

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