Making FX carry trades work

Choose a carry currency not just for yield but for its attractive long-term value

By Heng Koon How

AN FX (foreign exchange) carry trade used to be a fairly straightforward propositon. All one needs to do is simply to identify the appropriate currencies on both sides of the carry trade. To choose a funding currency to go short, the main criterion is to select a currency that has low or zero yield. Ideally, it would be even better if the respective central bank of the chosen funding currency is dovish.

To pick a carry currency to go long, one could simply select from a whole list of currencies with high yield. Typically, currencies with high yield tend to suffer from relatively weak economic fundamentals. The trick would be to select a carry currency that has the "least negative" economic fundamental.

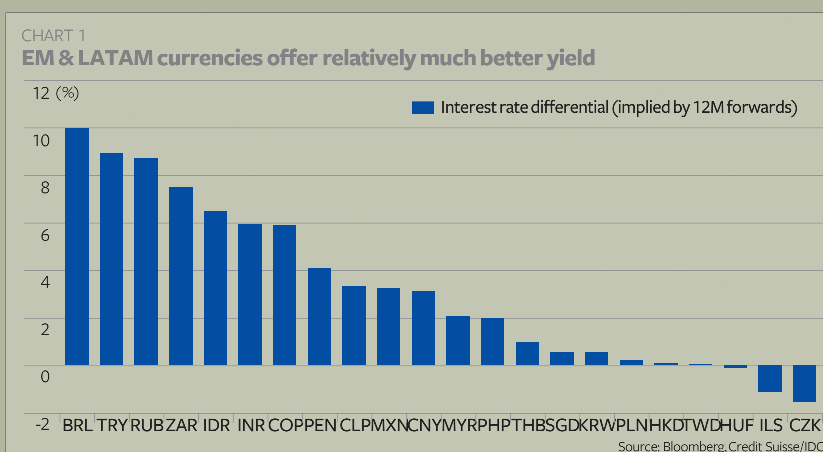
Popular carry trades include going long the AUD (Australian dollar) against the JPY (Japanese yen), or going long the CNH (offshore yuan) against the EUR (euro). However, despite all the best efforts, recent carry trades tend to fall apart and end badly.

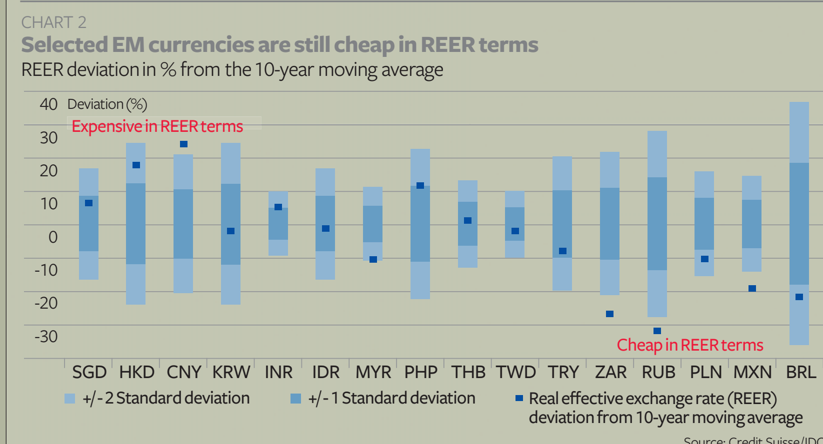
Funding currencies

In mid-2014, the European Central Bank (ECB) started lowering its benchmark deposit rate into negative territory. Since then, a growing handful of developed market central banks had also lowered their benchmark deposit and lending rates to negative – for example, the Swiss National Bank (SNB), Sweden's Riksbank and most recently (and controversially) the Bank of Japan (BOJ). On the surface, it would seem that there should be no lack of currencies to choose from when selecting a funding currency. After all, the list is growing for funding currencies that have zero or sub-zero rates.

However, since the start of 2016, the EUR, CHF (Swiss franc) and JPY have all rallied strongly instead. There were investors who used the JPY as a funding currency, only to see all their portfolio gains wiped out by the 10 per cent rally in the JPY across Q1 from 120 to 108 against the USD (US dollar). The BOJ had implemented negative deposit rates on top of quantitative easing, but contrary to expectations of weakening, the JPY strengthened.

Similarly, despite the best efforts in verbal intervention by ECB president Mario Draghi and the commitment by the ECB to implement quantitative easing indefinitely, the EUR also rallied about 6 per cent across Q1, from 1.08 to 1.15 against the USD. It would appear that shorting the wrong funding currency could be financially fatal.





Carry currencies

Similarly, carry currencies also refused to rally as expected and fell hard instead. At the beginning of 2015, there were investors who were tempted by the very attractive 8 per cent yield in the TRY (Turkish lira) and reasoned that such a high yield would be more than adequate to compensate for the elevated economic and political risk in Turkey. However, the high yield offered little comfort in terms of carry as the TRY collapsed nearly one-third across 2015, from 2.3 to 3.0 against the USD.

A less dramatic example of a popular carry currency is the AUD. It has a less impressive yield of 2 per cent, but fell by a very significant 12 per cent against the USD across 2015, from 0.80 in January to 0.70 by the end of 2015.

In Asia, the CNH used to be a favourite carry currency that could do no wrong. The CNH used to pay around 3 per cent in the money markets and since its launch in 2010, had appreciated non-stop on an annual basis. However, that one-sided bet soon fell apart from mid-2014 as China embarked on painful FX regime reforms to internationalise the CNH. Since then, the CNH had been on a consistent weakening trend.

Risk adjusted and attractively valued FX carry trades

One possible solution is to choose carry currencies not solely based on attractiveness of yield, but also based on attractiveness of long-term value. There are selected Emerging Market currencies that are relatively cheap on a long-term Real Effective Exchange Rate (REER) basis. In addition, one could also "risk adjust" the yield of the carry currency.

Once the yield of the carry currency is divided by the underlying implied volatility, high yielding currencies that are inherently volatile will no longer look attractive as they will end up with a much lower risk adjusted carry ratio. In other words, the higher volatility erodes the underlying carry.

Under this approach, the BRL (Brazilian real) may be a suitable carry currency as it currently has implied 12M forward carry of about 10 per cent and has fallen so much over the past two years that it is now significantly undervalued on a REER basis. And after the blowout last year, the BRL's implied volatility has also fallen, contributing to lesser risk adjusted slippage.

However, choosing a funding currency remains very tricky. This may boil down to the confidence one has in the effectiveness of a central bank's monetary policy to prevent excessive strength of their currency. On this note, clearly confidence is currently very low in the BOJ after their botched introduction of negative rates in January. The JPY is likely to stay volatile and will not be a suitable funding currency. In contrast, the EUR would seem a more suitable candidate for funding currency.

In conclusion, a possible risk adjusted and attractively valued FX carry trade would be to go long the BRL and against the EUR. W

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