

WINNING TRADES  
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**It's a New Year:** CHINA SURPRISE IN 2011: THE STEADY INTERNATIONALIZATION OF THE CHINESE YUAN, **HARMONIC ELLIOTT WAVE**, POUND TO FEEL MORE PAIN, THE "CARRY TRADE" EXPLAINED, **AND MOVING AVERAGES 101...**



## *The “Carry Trade” Explained...*

**The carry trade strategy is an institutional currency trading strategy that is one of the most used strategies in the world. It is fairly straight forward and easily understood. Ron Schelling opens a discussion on how to use the carry trade strategy to profit in the currency markets.**

**T**he trading term “carry trade” refers to a currency trade where investors borrow a low-yielding currency and lend (invest in) a higher-yielding currency. This type of trading is thought to correlate with global financial and exchange rate stability and retract in use during global liquidity shortages, but the carry trade is often blamed for rapid currency value collapse and appreciation.

The risk in carry trading is that foreign exchange rates will change to the effect that the investor has to pay back a more expensive currency with a less valuable currency. In theory,

according to uncovered interest rate parity, carry trades should not yield a predictable profit because the difference in interest rates between two countries should equal the rate at which investors expect the low-interest-rate currency to rise against the high-interest-rate one. However, carry trades weaken the currency that is borrowed since investors sell the borrowed money by converting it to other currencies.

It is estimated that over USD 1 trillion may have been staked on the Japanese yen carry trade. Since the mid-1990s, the Bank of Japan has kept Japanese interest rates at very low levels making it profitable to borrow the Japanese yen to fund activities in other currencies. These activities included subprime lending in the United States and the funding of emerging markets, especially BRIC countries and resource rich countries. The trade largely col-

lapsed in 2008 particularly with regards to the Japanese yen.

Understanding exactly how the carry trade works is quite simple and carry trading is the most used strategy in the world. The carry trade strategy is an institutional strategy and we will look for good risk/reward currency pairs. To create a good carry trade, we buy one currency and sell a second with an interest rate differential. For example, we are long a currency with a high interest rate (since we are buying a currency with a high interest rate, we receive interest payments) and we are short a currency with a low interest rate (since we are borrowing a currency with a low interest rate, we borrow at low cost and pay low interest payments) and cash in the difference between the two interest rates.

#### EXAMPLE OF A CARRY TRADE

Here is an example – long one currency with a high interest rate – the Australian dollar, which has a rate today (as of this writing) of 4.75% and short another currency with a low interest rate (that has been nearly zero for a long time) – the Japanese yen at 0.05%. With a simple calculation, you can see that if I put my money at 4.75% and I pay 0.05% in borrowing cost, I will pocket the difference.

The idea of a carry trade is to buy a currency with a high interest rate, sell a currency with a low interest rate and cash the difference between the two rates. This strategy will help us take the difference between the cost of borrowing and interest earned – which is far from speculative short-term strategies. This is one of the reasons why institutional traders use such a strategy.

#### RESEARCH FOR A CARRY TRADE

To understand and achieve the best possible carry trade, some research needs to be done. We look for currencies with high interest rates to invest in and currencies with low interest rates to borrow. Then, we have to face a couple of different choices – trade the most liquid currency or currencies that are a little more exotic. On several Forex websites, you can find tables that show the most liquid currencies – U.S. dollar, British pound, Japanese yen, euro, Canadian dollar, Swiss franc, New Zealand dollar and Australian dollar - with their respective interest rates.

FOREX RATES		INTEREST RATES	
	AUD		4.75%
	NZD		3.00%
	CAD		1.00%
	EUR		1.00%
	GBP		0.50%
	USD		0.25%
	CHF		0.25%
	JPY		0.05%

the same strategy on the Turkish lira or the Hungarian forint or the South African rand.

And as we can see it clearly: interest rates are even higher. The

main issue with trading exotic currency pairs is that generally you have to pay a large spread to do the trade. For a long-term trader using the carry trade strategy, the spread is not that important because it does not affect the position in a year lifetime.

#### RETURN ON INVESTMENT

How can we calculate the yield relative to the position we have using the carry trade strategy?

Interest will be credited as follows – the interest rate of the currency that is purchased minus the interest rate of the currency that is sold. So by taking a simple example on liquid currencies (we discussed previously the case), we can be long the Australian dollar and short the Japanese yen. We will borrow at 0.05% and we will collect 4.75%. So in my example, I bought one lot of the Australian dollar/Japanese yen pair and calculate the difference between the two interest rates, 4.75% minus 0.05%.

Divide by the number of days in the year and multiply by the position taken on a lot (for example 100,000) and the outcome is \$10 interest per day that I cash in. A broker can ask me for only \$250 margin on this type of transaction, which is to say that I have leverage of 1 to 400 at this time then I can automatically make a lot of money if everything goes my way. To summarize this example: interest payments will be credited for the long position on the Australian dollar/Japanese yen pair and will be charged for the short positions on the same pair.

The Australian dollar against the Japanese yen is attractive to an investor looking for a carry trade. (There was a lot of speculation in relation to gold because the Australian dollar is correlated to gold). It is true that gold has recently climbed rapidly and steadily and many investors took advantage of rising interest rates on the Australian dollar.

However, if you look at the evolution of this pair (I remind you that automatically when you have a pair that offers an attractive yield of 7% to 8%, it is interesting to trade this particular currency – the currency which offers 8% when the euro offers 1% or the dollar which offers 0.5%. This phenomenon will likely attract more participants to trade those pairs and perhaps help the pair move upward. Since you can borrow Japanese yen for next to nothing, most people working in institutions or banks borrow the Japanese yen and mechanically take the opportunity to collect interest on a little more exotic currency or just a few safer pairs and earn the interest rate differential.

#### EXPLANATION OF A CARRY TRADE

Let's say I have an account with \$10,000. I will use a leverage of 10 for a long transaction on the Australian dollar / Japanese yen pair. At the time, the value of the position I take will be \$100,000 and the cost of borrowing will be 0.1% per year on the Japanese yen. The profit I make is the interest rate that I will cash in – 3.75% per year. So the interest rate differential will be 3.65%. The profit in one year will be \$100,000 multiplied by 3.65% which will be \$3,650, the percentage gain is 36.5% (remember my account of \$10,000). If I earn \$3,650, I won 36.5% of its

\$10,000, I have a leverage that is 10. After a year I have market three possibilities – The Australian dollar / Japanese yen pair went down:

Gains from the interest rate differential are \$3,650. The issue is on the loss side: my position lost value. Of course, I earned interest but I lost on the falling currency pair. If the loss on this position is less than \$3,650, the result: as I won \$3,650 of interest, I have a profit.

If the loss of my position is \$3,650: my position lost value of \$3,650, I earn the interest of \$3,650, the loss on my position of \$3,650 minus the amount earned from interest of \$3,650 gives a result equal to zero.

And if I have a loss on the market position that is bigger than \$3,650, I lose money on the overall position. I still earn the interest rate differential, however if the currency falls over 3.65%, I

will start to lose money on the overall position (interest plus profit or loss on the position).

**The Australian dollar / Japanese yen pair is flat:**

A year later, the interest earned is \$3,650 and then no gain or loss on the currency pair: 36.5% return on investment.

**The Australian dollar / Japanese yen pair went up:**

If the pair goes up, interest earned is \$3,650. Suppose my currency pair moved up 20%, I gain an extra 20% so any gain on the currency pair is addition to the interest rate differential.

**KNOWN RISKS**

The 2008 – 2009 Icelandic financial crises have among its origins the undisciplined use of the carry trade. Particular attention has been focused on the use of euro denominated loans to purchase homes and other assets in Iceland. Most of these loans defaulted when the relative value of the euro appreciated dramatically causing loan payments to become unaffordable.

The U.S. dollar and the yen have been the currencies most heavily used in carry trade transactions since the 1990s. There is substantial mathematical evidence in macroeconomics that larger economies have more immunity to the disruptive aspects of the carry trade mainly due to the sheer quantity of their existing currency compared to the limited amounts used in Forex carry trades. However, the collapse of the carry trade in 2008 has been blamed in Japan for a rapid appreciation of the yen.

As a currency appreciates, there is pressure to cover debts in that currency by converting foreign assets into that currency, so this can be an accelerating effect in currency valuation changes. When a large swing occurs, this can cause a carry reversal. The timing of the carry reversal in 2008 contributed substantially to the credit crunch that caused the 2008 global financial crisis. Though, relative size of impact of the carry trade with other factors is debatable. A similar rapid appreciation of the U.S. dollar occurred at the same time, and the carry trade is rarely discussed as a factor for this appreciation. **TFJ**

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