Surging US dollar threatens emerging markets’ carry trades

By James Kynge in London

The term “carry trade” sounds innocuous, even benign. But as the US dollar continues to surge, the multitrillion dollar flow that has engorged emerging markets (EMs) risks reversing, threatening growth in much of the developing world, analysts warn.

Investors engaging in the carry trade borrow in a low-interest currency, such as the US dollar, to invest in the higher yielding domestic debt of emerging markets. But stress on the carry trade mechanism is growing, with a gauge of EM currencies, the JPMorgan EMCI index, falling to its lowest point against the US dollar in 11 years.

Investors are increasingly deciding that their losses in the foreign exchange market eclipse their gains from the interest rate differential, prompting them to cut and run. Were market participants to unwind their carry trades in unison, selling EM assets to buy dollars, the process would exacerbate the market conditions that they were fleeing.

Several analysts sense danger. “The carry trade strategies are finally cracking,” said Luis Costa, currency strategist at Citi bank. “The market has been so flooded with liquidity and interest rates have been so low for so long but this is turning now.”

David Hauner, strategist at Bank of America Merrill Lynch, predicts a lengthy market correction. “It is very clear that this isn’t the end of the carry trade for ever but it is a correction,” he said.

The headwinds eviscerating the carry trade are reinforced by a robust outlook for the US dollar that derives from three enduring trends: the US economy is recovering strength, boosting the greenback’s attractiveness; the US Federal Reserve is poised to end its programme of quantitative easing in October, tightening dollar liquidity; finally, the European Central Bank has begun a dovish phase of monetary policy, enhancing the dollar’s outlook relative to the euro.

The impact of a shift in sentiment away from EM local currency bond markets is already visible. The JPMorgan GBI EM local currency...
Issuance of local currency debt has also slowed, with just $22bn in bonds launched in August, compared with a monthly average of $62bn over the past year, according to estimates by the Institute of International Finance (IIF).

Such figures expose the vulnerability of several EM economies that rely on carry trade inflows not only to keep domestic interest rates low but also to finance current account deficits, fund infrastructure projects and keep corporations flush with cash.

A sudden withdrawal of the carry trade risks having a profound impact on their economies. Though the magnitude of the EM carry trade is unknown, estimates suggest that about $2tn in overseas capital is invested in local EM debt. This is slightly bigger than the Indonesian and Mexican economies combined. Total foreign ownership in local EM bond markets rose from 8 per cent to 17 per cent between 2007 and 2012, according to the Bank of International Settlements.

Some countries are particularly exposed to the carry trade’s fickle fortunes. In Malaysia, the proportion of government bonds under foreign ownership has risen to more than 45 per cent. It is above 35 per cent in the cases of Poland, Hungary, Mexico and Indonesia.

The key measure of a country’s vulnerability to the withdrawal of carry trade flows resides in the differential between local and US dollar interest rates when judged against currency futures prices. According to this measure as calculated by Citi, carry trade investors in Israeli shekel and Czech koruna debt would currently face losses.

Despite the growing concerns, some investors remain sanguine. “The tightening in EM financial conditions will test the resilience of local bonds as an asset class,” said Gerardo Rodriguez, portfolio manager at BlackRock, the investment management company. “But we are not seeing a disorderly unwinding of the carry trade.”

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