The US dollar surged again on Wednesday against a basket of emerging market (EM) currencies, adding urgency to the question of which EM countries are most vulnerable to a receding “carry trade”, the multitrillion dollar flow that has swollen domestic debt markets since 2009.

A soaring dollar piles pressure onto EM carry trade investors, who typically borrow dollars at low interest rates in order to buy high yielding EM domestic debt. When the dollar surges, they suffer currency losses that offset their interest rate gains, prompting them to sell.

If the current unwinding develops into a stampede, it could deprive some countries of the infusions of international capital required to keep debt-fuelled growth models afloat. The US dollar rose to a new 11 year high against all EM currencies on Wednesday, according to the JPMorgan EMCI index, bringing its index gains to 3.5 per cent in the past month.

**Some EM countries are much more exposed**

One measure of vulnerability looks at the ratio of EM local government bonds owned by non-residents (see chart). Over 45 per cent of Malaysia’s ringgit-denominated government bonds are held by foreigners, while international investors own around 35 per cent or more of local bonds in Poland, Hungary, Mexico, Indonesia and Hungary.
While these ratios help provide a sense of the reliance on foreign flows by country, they do not include inflows into short term money market instruments – a vehicle favoured by carry traders.

Stephen Bailey-Smith, head strategist, Africa forex and fixed income at Standard Bank, estimated that in the case of carry investing in large African economies, around two thirds of the inflows go into money markets, while the remaining third enters local government bond markets.

Money market reporting by countries is patchy, with the Bank of International Settlements (BIS) showing blank entries for most EM countries. However, a BIS paper by Ma Guonan and Augustin Villar, estimates that total foreign portfolio flows into EM financial assets (including foreign and local currency bonds, money market instruments and equities) burgeoned from just over $4tn in 2008 to over $8tn at the end of 2012 (see chart).

The chart shows that over 18 per cent of total portfolio investments in EM countries at the end of 2012 were by non-residents – revealing a sharp increase in dependency on international capital since 2008.

In absolute terms, the comparisons are more stark: just over $8tn is roughly equivalent to the size of the combined GDP of Brazil, Russia, India, Mexico, Indonesia and Turkey.

Thus even a mild sell-off of EM assets by foreigners could have a significant impact on EM countries that have become engorged with international capital. A panic could pose systemic challenges.

**Getting caught by the EM whiplash**

The other salient feature of EM investing as the US Federal Reserve turns more hawkish is that shifts in US yields exert a magnified impact on their EM counterparts.

Ma and Villar show that between the end of April 2013 and January 2014, the US long-term yield rose 97 basis points, sending EM local bond yields up by 268 basis points and EM foreign currency bond yields up by 172 basis points.

Such a whiplash effect may be repeated as the US Fed ends its programme of quantitative easing this month, underpinning US dollar strength. Obviously, a key variable for the carry trade will be the speed and longevity of the dollar’s bull run.

David Bloom, global head of FX strategy at HSBC, sees a long appreciation:
We are only at the early stages of a USD bull run. We believe this will ensure it is not only the strongest currency in 2014, but also in 2015. Even though we have long been advocates of a strong USD, we have substantially revised many of our forecasts to reflect this expected USD supremacy. The USD rally so far has only been roughly 5 per cent yet history shows a 20 per cent rise would not be implausible.

Watch for where the carry wears thin
With such a weight of money invested in EM securities – either through the carry trade or through longer term investment strategies – it is understandable that funds scrutinise market dynamics for early signs of capital flight.

Investment bankers estimate potential carry trade returns based on a prediction of how an EM currency is likely to perform and the prevailing differential between US dollar yields and local bond/money market instrument yields.

According to Luis Costa, strategist at Citi, the prospective carry return on the Israeli shekel and Czech Koruna have already turned negative, while returns on the Thai baht, Malaysian ringgit, Korean won, Mexican peso, Romanian leu, Polish zloty and Hungarian forint are all below 3 per cent – suggesting a scant incentive to engage in the carry trade in these currencies.

However, such projections offer only one perspective on how carry flows may run. Other sources of vulnerability are high inflation, hefty current account deficits relative to GDP (see chart), slowing GDP growth and a reputation for unorthodox monetary policies. All of these factors can undermine the outlook for a country's currency, thereby reducing the attraction of the carry trade in that currency.

Exotic trades are getting hit first
As James Mackintosh writes, junk bonds are already feeling the heat. The premium that these “high yield” bonds offer over government paper reached a post-2008 low of 3.2 percentage points, but an accelerating sell-off has pushed this spread up to 4.4 points.

In some African markets, the stakes are getting higher. “The strong dollar environment makes it very difficult for those investing in currencies and interest rates,” said Bailey-Smith of Standard Bank. “Africa exists at the riskiest end of the spectrum on this trade.”

The high interest rate differential between the US and African countries such as Ghana, Zambia, Nigeria, Egypt and Uganda – all of which have one-year money market rates in double digits – is providing a measure of protection against the unwinding of the carry.
However, the popular Nigerian naira carry is showing signs of fatigue, Bailey-Smith said. “We think there has started to be an unwinding of the naira carry trade, adding some pressure to the naira,” he said. “If anything we are seeing slight outflows from the Nigerian local debt markets.”

However, while the use of the US dollar as a source currency for the carry is coming under pressure, the euro and yen are offering attractive alternatives. Bailey-Smith said that increasingly investors are borrowing in euro or yen, exchanging them for US dollars and then changing their US dollars into the target African carry currency. Such moves could help stabilise the carry unwinding, analysts said.

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