Market Commentary
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Insigneo Weekly Dispatch

The Aftermath of the yen Carry Trade

Exploring the roots of the yen carry trade and the effects of its collapse.

Guidance on investments and the major structural factors behind your clients' portfolios.

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The Aftermath of the yen Carry Trade

Last week will probably go down as one that market participants will remember for a long time. Amid heightened volatility and sharp price swings, traders saw events occurring right before their eyes that they initially did not believe could be possible: the Japanese Central Bank, or BoJ, meaningfully increasing its policy rate, a strong Japanese yen (JPY) appreciation, and the increasing fears that the US may not survive recession rumors completely unscathed. Even if most of the volatility has already dissipated and markets are now experiencing a period of "tense calmness," we deemed it fit to review the events of last week, the effects those events had on the markets, and what we believe could the best ways to position affected investments for the future.

Even if some market participants believe that the events of last week occurred unexpectedly, the buildup for some of these dynamics started earlier in the Summer. In early July, the yen began appreciating sharply as investors positioned their portfolios in anticipation of a potential rate hike by the BoJ. This occurred amid initially positive earnings surprises that stemmed from the second quarter 2024 earnings season. However, some of these earnings reports eventually raised red flags regarding the AI equity rally, signaling that it could potentially be running too far too fast, after disappointing results from a number of companies in the technology sector. Adding fuel to the fire was weak employment data in the United States, spooking the markets into considering the effects of the labor market on the economy and the increased possibility of recession in this country.

The BoJ tightened its monetary policy at practically the same time that the Fed signaled rate cuts could be on the cards for its September meeting. This potential tightening in a rate differential that had been at all-time high levels for more than two decades, together with the negative surprise coming from July's labor market release, were the necessary ingredients to trigger a sell-off in riskier assets. The instability in the market was rampant, to the point that some investors speculated that the Fed could host an emergency meeting to cut its policy rate before the September meeting.

The chaos in the global markets stemmed from the selloff in Japanese markets over the weekend, when the largest equity indices collapsed. That collapse led to a spike in the CBOE Volatility Index – VIX – which we discussed in our previous commentary, which in turn, led to a spillover effect across different markets. Emerging Markets' assets proved to be the most affected. Nonetheless, this volatility episode proved to be short-lived, especially after BoJ Deputy Governor Shinichi Uchida stepped up to ease investor fears by downplaying the chance of more rate hikes in the near future, which in turn led to a yen devaluation. These comments stood in contrast with more hawkish comments previously from Governor Kazuo Ueda.

Another point that should be highlighted is that Japan's economy returned to growth in the second quarter of 2024 after growing 0.8% QoQ, which suggests that monetary policy normalization by the BoJ may not have been as premature as some had believed. The resiliency of Japanese inflation figures, which ultimately forced Prime Minister Fumio Kishida's resignation, must be closely monitored.

The situation in Japan was one that stemmed both from political and economic variables, where the weakness of its currency set the stage for investors to take advantage of what has been labeled as the "carry trade." Let us explore what it exactly constitutes and how it came to be in this specific case.

In essence, a carry trade is an investment transaction involving two steps. First, investors borrow assets in a relatively less expensive market or currency. Second, investors then use these low-cost funds to invest in assets in other markets with higher returns. In essence, a carry trade is a form of margin trading strategy, where investors borrow low-cost assets to fund the purchase of investments with higher yields.

Now, let us delve into what happened in this specific case. In an effort to stimulate the economy, the BoJ had held interest rates in artificially negative territory for the past seventeen years, which also weakened the yen. This led investors, both domestic and foreign, to borrow yen-denominated funds in this country for many years. Goldman Sachs estimates that this borrowing could have reached levels between USD 50 billion and USD 200 billion. On the other side of the world, the Federal Reserve was increasing interest rates in the

United States, maintaining them at high levels for several years. The same dynamic was evident in many other countries, including several in Latin America. As a result, the same investors that borrowed "cheaply" in Japan, used these assets to purchase higher yielding assets in countries like the United States, Mexico, and Brazil. Most of the funds were likely deployed in assets with relatively low levels of risk, such as US Treasuries. However, some were also used to purchase higher risk assets around the world. Leverage was high.

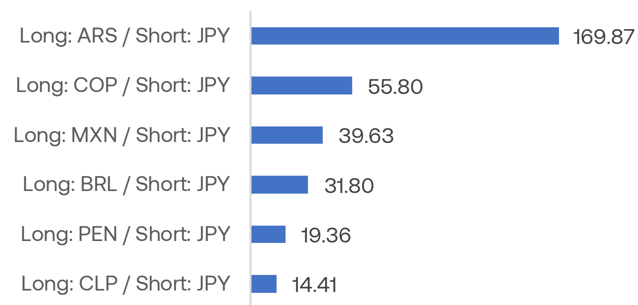
Then, earlier this month, to reign-in the yen, the BoJ raised interest rates from close to 0% to 0.25%. On the surface, this does not seem like a significant move. However, it signaled the beginning of a meaningful change in monetary policy in Japan, as well as the beginning of the end of the yen carry trade. Investors with exposure to this trade began selling their positions in other assets to pay back the funds they had borrowed "cheaply" before their costs crept higher and eroded their profits. Thus began the unwinding of the yen carry trade. Goldman Sachs estimates that as much as 90% of this unwinding could be behind us. However, Goldman also points out that this number could be underestimating the full extent of the unwinding, as there could be more to come.

A logical question stemming from this unwind would be: "What happens to the yen and Japan's equity markets?" From the perspective of the yen, although it is likely to remain volatile, we would not be surprised if it continues to trend higher over time. We think it is very possible that the BoJ will intervene to control the high volatility of this currency, given the prospects of a changing monetary policy, as well as fiscal and political uncertainty in the country. However, there is also a high likelihood that, over the long term, the BoJ will hike rates further to stabilize the economy, leading to a continued rise in the yen.

The yen's volatility is also weighing on the Japanese stock market. On the one hand, a higher yen increases costs for the Japanese consumer, as well as for the country's domestic companies. On the other hand, a higher yen could prompt Japanese investors to repatriate money that had been invested outside the country. Many of these funds will likely be invested in Japanese equities, which could lead to a rise in the country's stock markets. Additionally, an improving economic background will likely strengthen local equity markets. We think that, over the long term, Japan's stock markets could move higher, representing an investment opportunity with meaningful potential. However, it is very likely that they will remain highly volatile in the short to medium term, which makes this investment more suitable for investors with a long-term horizon and a high tolerance for risk.

Japanese markets were not the only ones affected by the unwinding of the yen carry trade; currencies around the world also felt its effects. Zooming in on Latin American currencies and how the region digested the effects of the carry trade unwind, there are several things that need to be taken into consideration. Firstly, Latam was a very attractive market between 2022-2023, when the region offered higher rates than developed economies. When coupled with dollar weakness, it enticed investors to execute the carry trade we mentioned before in Latin America. In fact, the carry returns for Latin America for 2023 were all above the 14% handle:

Latin American Currencies Outperformed the JPY - Carry returns (%)



Source: Bloomberg. 12/30/2022 to 12/29/2023

Even if the carry returns for the region on a year-to-date basis are still largely positive, Latam was not unscathed from the aftermath of the yen carry trade unwind. The Bloomberg Latam Equally Weighted Spot FX Index, an index that represents the equally weighted performance of the spot exchange rates of the LATAM currencies relative to the USD, is slightly negative month-to-date (-1.94%), with the sharpest drop coinciding with the unwinding trade. Of course, the USD's strength this year has posed a challenge to the attractiveness of the region, only worsened by a weaker macroeconomic environment. However, there is a silver lining to this situation: once the volatility of the yen carry trade faded, Latin American currencies rebounded and have rebounded with markets. Even when we consider that the emerging markets may not be the best positioned to weather volatile times, maintaining a balanced, diversified exposure to different currencies may prove beneficial in times like these.

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