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Market Memo

Research and Insights

The Carry Trade

During the first week of August, the S&P 500 fell nearly 3% the day after the US employment numbers were released. The markets expected the US to have created 175k jobs. When the jobs data were released, the US added only 114k jobs. The market sell-off was short-lived and soon began rising again. If a recession were imminent, I could see the markets reacting with a large sell-off. However, the jobs data pointed to a slowing of the labor market, which is what the Fed had been waiting for to begin lowering the Fed Funds rate. I was struck that the media and market action on the day of the data release were more muted, with the S&P down a little over 1%.

Remember that this week, the Central Bank of Japan also surprised the markets with an interest rate increase. They raised the Japanese overnight interest rate from 0-0.1% to 0.25%. US rates on the one-year bond were 4.75ish % during this time. Japan raised its interest rate on July 31st. The S&P 500 fell 3% the following Monday, which, to me, is the likely reason the media chose the narrative of a slowing economy.

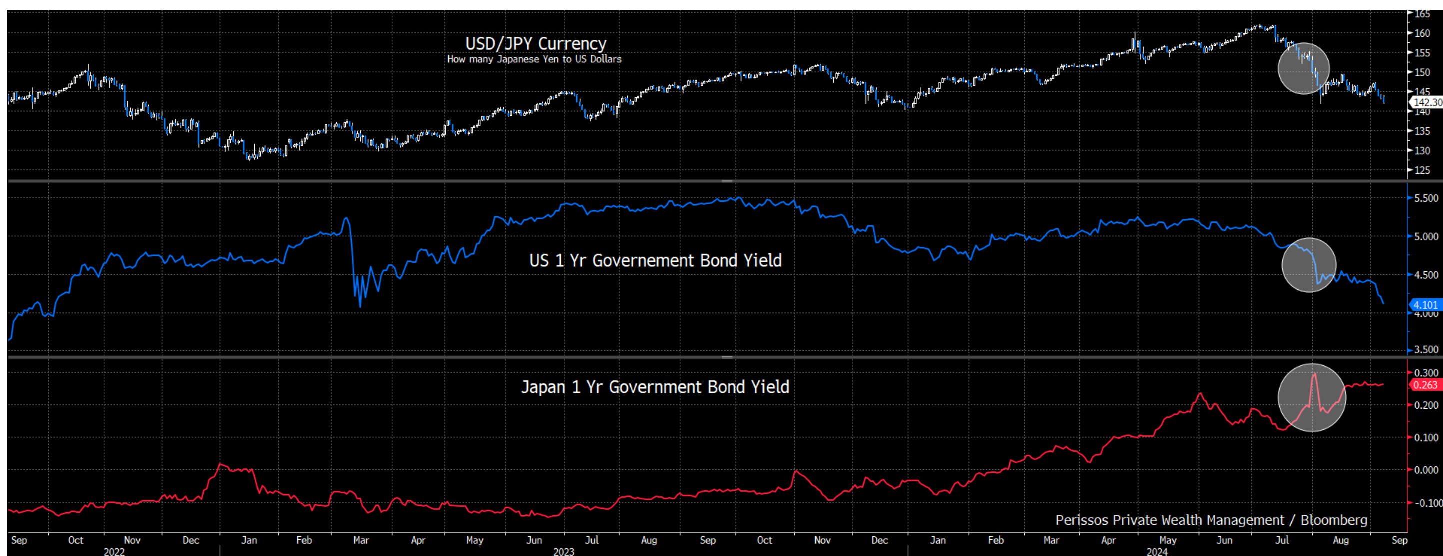
During my morning routine of analyzing market data, I noticed something interesting. The US dollar had weakened significantly over the previous couple of weeks leading up to the Japanese interest rate increase. To me, this was the classic example of a carry trade reversing. For those unfamiliar with how a carry trade works, let me give you a basic explanation.

Let’s say you have access to two different banks in different countries, and each one offers different interest rates. One bank is in Japan, and it gives loans at a really low interest rate, maybe 0.5%. The other bank is in the US, and it offers savings accounts that pay a higher interest rate, like 5%. You think, "If I can borrow money cheaply from the Japanese bank and then invest it in the US, where I earn more, I can make a profit!"

This is basically how the carry trade works. You’re borrowing money from a country with low interest rates (Japan, in this case) and investing it in a country with higher interest rates (like the US) to earn more. The difference between the low interest you pay to borrow and the high interest you earn from investing is your profit.

However, the carry trade depends on things staying stable. For example, if the value of the US dollar drops compared to the Japanese yen, or if interest rates suddenly change, you could lose money. If the US currency weakens, it means the money you invested could be worth less than what you borrowed in yen, making it harder to pay back the loan. This is the risk of the carry trade: if the market moves against you, what seemed like an easy profit can quickly turn into a big loss.

So, while the carry trade can be profitable for a while, it's risky because currencies and interest rates can fluctuate unpredictably. Below is a chart showing the dynamics of a carry trade.



The shaded circles show that the carry trade would have begun to unwind (become unprofitable) during the first week of August. A carry trade doesn't mean you have to invest the borrowed money in safe assets like US bonds; you can also invest it in stocks. When interest rates in Japan begin to rise and the US dollar begins to weaken, you have to pay back the Japanese bank with more dollars, meaning the trade is less profitable, and if the markets continue to move against your carry trade, you could lose substantial amounts of money.

As the chart shows, the dollar began to weaken against the Yen in mid-July. At the same time, US interest rates began to fall, and Japanese interest rates began to rise. This is not a good combination if you borrow in Yen and purchase in US dollars.

I bring this up because I believe yesterday's sell-off was caused by the unwinding of a Japan/US carry trade once again. The media is claiming that the markets sold off due to a weakening labor market, which translates into a weakening economy. I just can't buy into that narrative. Over 140k jobs were created last month, and the unemployment rate went DOWN, not up. Yes, the labor market is weakening, which is exactly what we want to bring inflation back to 2%.

The chart shows that this past week, US interest rates fell, the dollar fell, and Japanese interest rates held steady. This led up to the release of US employment data yesterday, which caused a big drop in both the US dollar and US interest rates. Again, this is not good for carry trades.

It looks to me like investors have been borrowing in Japanese yen and buying US tech stocks. When the trade unwinds, we see a big sell-off in tech stocks, which is exactly what we saw last month and yesterday.

I would be much more worried about the US economy if the unemployment rate resumes increasing. For now, the data suggest the economy is slowing but not falling off a cliff, and as long as it remains gradual, we should see inflation continue to move lower slowly. Of course, only if we don't see any unforeseen economic shocks.

All my best,

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