

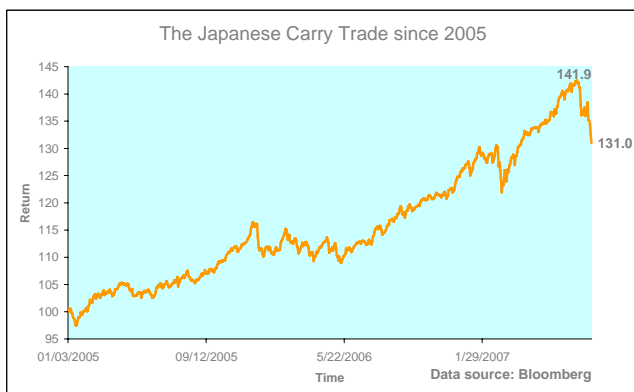
“What a carry on!”

By Stewart Cowley

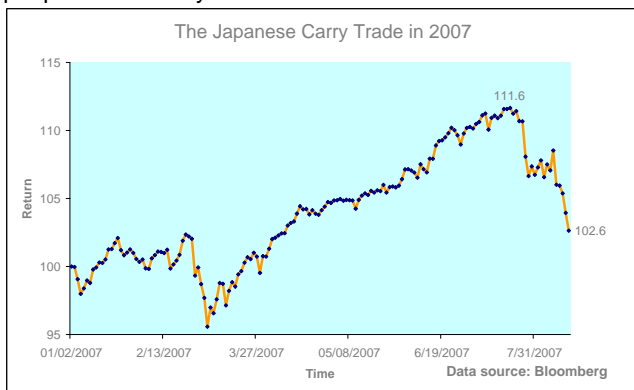
Newton Global Fixed Income Strategy

Managing our yen currency option position

If you have it in your heart, spare a thought for the poor old Japanese carry trader; that nervous and exotic creature who for a long time has been borrowing Japanese yen, investing it in any old thing, and then making lots of money out of it. You can get a feel for their experience by constructing an equally weighted basket of currencies including the euro, US dollar, UK sterling, the New Zealand and the Australian dollars, and watching the return profile (see first chart). Over the past couple of years you can see that this simple strategy has returned over 42% when both currency movements and the interest differential between Japan and other nations are taken into account.



Of course, this masks a lot because (see the right of the chart) things haven't been that great more recently. In a world that needs and demands constant and instantaneous gratification from investments, this is bound to make certain people a bit twitchy.



If you just look at this calendar year for instance, what was about a 12% return from the carry trade is now barely 2% (although in March the trade reached -5%, so things have been considerably worse).

The point of going through this calculation is precisely that – it is only a calculation and there is no mention of sub-prime, economics or storms, although they are tangentially related.

If you are a carry trader using the yen as a base, then the temptation must be to cut your losses, protect what you have and bring the money home. This is precisely what is happening at this time; a self-feeding process of risk reduction which is reversing all the previously successful strategies that have propped up returns for several years. You understand now why the yen is appreciating in a bewildering fashion whilst currencies like the New Zealand and Australian dollars seem to be in a race to see who can fall the most each day.

Clearly, this is a process that can go on for some time and will only stop when the last investor has sold their last risk asset and bought their last bit of Japanese yen back. Nobody can tell the exact moment when that will occur, but you have to start thinking about where you want to be in your portfolio when it's over, rather than being mesmerised by the present.

If you look at the fundamentals in the world, nothing has changed very much. For sure, there are some serious and real dramas occurring in the money markets as borrowers have been sequentially turned away by the market and then, finally, by the banks. This process will weed out the weak and unsound and so we should continue to see losses popping up all over the world linked to investments made in US asset-backed securities. However, the point is that they are popping up all over the world rather than being concentrated in the hands of the many in a single place. In that sense, this isn't a classical 'credit crunch' which leads to a systemic problems. It's serious but not life threatening. Moreover, it is an episode to get through. Making heroic predictions in these circumstances may get you a lot of attention but your chances of being right are no better than tossing a coin.

When the dust settles it will be easy to understand that whatever the mathematics of the carry trade were, they still work. At present those things that were once perceived to be 'good' are being sold to cover the losses of those things that are 'bad', and for which there is no bid in the market. In that case don't look for the rational in these markets because it isn't there. More to the point, we are currently being thrown around by a set of agendas that we have no access to because they are essentially private and may never become public. All we see are prices moving on a screen.

We've made some money out of owning about 24% (after adjustment for the delta of our currency option) in the yen during the reversal of the carry trade, and it's not something we will be letting go of in the near future. However, we will be banking some of the profits by managing the position and rolling out into new strike prices as this process progresses and comes to an end point. It is then that the reversal and re-risking begins again in earnest.

FOR PROFESSIONAL INVESTORS ONLY

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