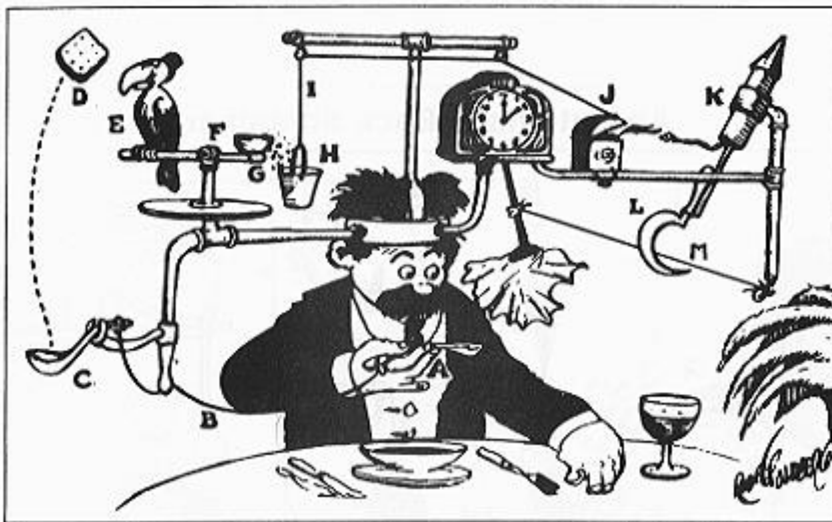
Self-Operating Napkin



CARRY TRADE

Carry trades involve borrowing at low cost in one currency to achieve higher returns from investments in another currency

5 components

1. More than one currency
2. Highly leveraged investing
    a. Usually in fixed income
3. Colleterial is another, other securities
4. Due to the high leverage the risk potential is greater than the reward
    a. Think of the casino. In roulette their risk is a 36 to one payout, there reward is the 1 (the amount bet).. for the casino there are 38 choices and they pay 36;1. So their win % is 105.55%
5. Too many institutions in the same trade, on the same side

Many moving pieces.

1. Currencies fluctuation
2. Interest rates in both countries
    a. Relative movement between those rates
3. Value of collateral
4. Margin %
5. Margin rates
6. Computer recalculating potential risk vs potential reward
7. Portfolio risk
8. Liquidity (rare)
9. Momentum, fear vs greed

Risk / return

Example. Assume yen=dollar

Borrowing cost in Japan = ZERO

Borrowing cost in USA = 6%

US treasuries yield 4%

So you borrow borrow $$ against your US stock portfolio,

Move $$ to Japan and convert to YEN, and then borrow to buy USA Treasuries using Yen that you borrowed at zero.

When the BOJ raises rates to ¼ of 1 percent, two things happened.

1. Cost of borrowing went up , which reduces potential and real returns
2. Relationship of Yen to US dollar changes against you.
    a. Yen drops to a level that it takes 101 yen to equal 1 US dollar
    b. So your profit potential has dropped from 400 BP to 275 BP
    c. Rasing Japnaese rate causes Japanese money to flow back home, dropping price of other governments securities, so your Treasuries drop in price a bit, possibly causing a margin call, or in anticipation of a call you choose to sell other liquid assets to shore up this investment= risk rebalancing

Us treas initial margin

- 1 year to less than 3 years: 2% of market value
- 3 years to less than 5 years: 3% of market value
- 5 years to less than 10 years: 4% of market value
- 10 years to less than 20 years: 5% of market value

FROM KEITH FITZ-GERALD

Carry trades, refer to a practice in which sophisticated investors borrow in a currency with low rates (aka "cheaper money") like the Yen than invest that in higher yielding assets (with bigger profit potential) elsewhere like the USD.

Here's the thing. The narrative didn't fit the.

Japanese financials had a disorderly unwind which is why most of the selling was concentrated in Japan, Asia, and US futures particularly during the overnight markets before bleeding into the early August rout (that I told you would likely be a speed bump).

Calling it a "carry trade unwind" makes for an easy explanation, but that's about it.

If the carry trade phenomenon were true, the correlation between the MSCI Kokusai (which measures all global stocks outside Japan) would be substantial – probably at or close to "1."   It's not.

FactSet data as of 8/12/24 show the correlations between net JPY short positions and weekly S&P 500 price returns in USD and between weekly changes in net JPY short positions and weekly MSCI Kokusai price returns in local currencies are **just 0.02 and 0.03 respectively from 6/16/2006 to 8/9/24**.

You'll have better luck finding the Loch Ness Monster than you will an *actual* carry trade unwind.