# UNDERSTANDING THE YEN CARRY TRADE AND HOW IT CAUSED SUCH A MARKET FUSS

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In finance, complex events often get simplified into catchy explanations. Recently, the 'unwinding of the yen carry trade' was widely cited as a key catalyst for the turmoil that shook global stock and bond markets in early August. What is the yen carry trade, why was it unwinding, and how did that cause an impact on global markets?

Simply put, a 'carry trade' is when investors borrow money in a country with low interest rates, like Japan, and invest this money in currencies with a higher interest rate, such as the US dollar, to profit from the difference. The trade remains profitable so long as the interest rate differential persists, and the currency being borrowed doesn't strengthen relative to the currency being invested in, such that the interest rate gains are wiped out.

The original yen carry trade first emerged around 1999 when Japan slashed its policy rates to zero after its asset price bubble burst. Japanese investors began pouring trillions of dollars into global markets to earn anything better than the zero yields on offer at home. In 2013, the carry trade as we know it today — yen borrowing by largely international investors including currency traders and hedge funds — started to gain momentum when Prime Minister Shinzo Abe's aggressive quantitative and qualitative policies kept rates in Japan ultra-low, coinciding with rising US rates, and a depreciating yen. More recently, proceeds from yen-based loans were used by global investors to ramp up exposure to risky assets, such as US technology shares, which have risen sharply in value. This amplified the allure of the yen carry trade, as investors could pocket the difference between the low yen interest rates and the rising value of US stocks. Over the years, the trade has grown in popularity amongst professional investors, with UBS estimating that since 2011 there has been a cumulative $500 billion placed in dollar-yen carry trades alone.

The problems with this trade emerged shortly after 31 July, when the Bank of Japan announced its biggest increase in interest rates in over 17 years, and signaled further rate hikes were on the cards. Expectations of higher rates in Japan, combined with anticipated rate cuts in the US, sent the yen soaring, causing the yen carry trade to unravel rapidly and investors scrambling to unwind their positions. A stronger yen means more dollars are needed to pay back yen-denominated loans, and with the yen having strengthened by 12% at one point, a year's worth of yen carry trade interest payments are easily wiped out, so it's no wonder investors were racing to exit positions. The sell-off in the US stocks bought with borrowed yen caused prices to fall, and with investors already skittish about the outlook for the US economy and the sustainability of high stock prices, a dramatic few days of market volatility ensued, with knock-on effects for global bond and stock markets.

Although animal spirits have since calmed down, the recent market volatility is a stark reminder that we're still working through the unintended consequences of more than a decade of easy money. For many years, interest rates were kept artificially low by many central banks around the world, leading to the establishment of highly levered positions in multiple areas of the market. To date, diligent and careful fundamental analysis has not been sufficiently rewarded, while excessive risk-taking and leverage has. But Mr Market has quite generously given investors fair warning: the system remains fragile, and areas of vulnerability are likely to continue to be exposed — particularly where valuations are stretched. Buyer beware.

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