Daiwa Securities

# Daiwa's View

## Will the carry trade strengthen pressure to sell the yen?

- Rate hikes by ECB may raise the yen's position as funding currency
- But investor risk sentiment doesn't appear to be at the point of actively encouraging carry trades

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### Will the carry trade strengthen pressure to sell the yen?

**Rate hikes by ECB may raise the yen's position as a funding currency, but current risk sentiment does not suggest expansion of carry trade**

As I mentioned in a previous *Daiwa's View* report[1], the ECB is taking steps towards raising rates. At the beginning of this week, ECB President Christine Lagarde indicated an aggressive stance towards rate hikes, stating in a blog post, "I expect net purchases under the APP to end very early in the third quarter. This would allow us a rate lift-off at our meeting in July, in line with our forward guidance. Based on the current outlook, we are likely to be in a position to exit negative interest rates by the end of the third quarter."

In the midst of many central banks in developed nations moving towards normalization of monetary policies, based on pricing in the financial market, only Japan is expected to maintain a zero interest rate one year from now. One nation whose interest rate is expected to remain low, ranking next to Japan's, is Switzerland, whose interest rate one year from now is projected to be around 0.5%.

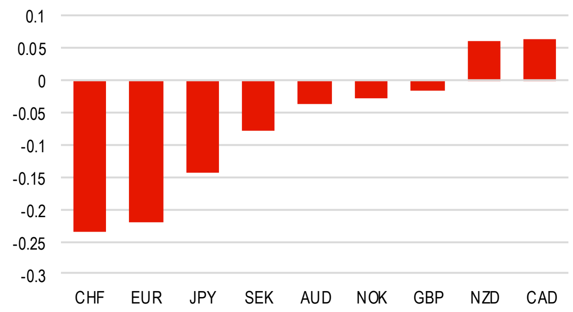
With it seeming that we are moving from a world in which many nations have zero or negative interest rate policies to one with positive interest rates, the topic of funding currencies is gaining increasing attention in the market. In the forex market, we often see carry trades in which funds are procured via low interest rate currencies and managed using high interest rate currencies. Recently, it has been said that the yen, the Swiss franc, and the euro are used as funding currencies in many cases.

The carry-to-risk ratio, which is calculated by dividing the interest rate differential by the expected currency fluctuation rate, is regarded as an important indicator with carry trades. As shown in Chart 1 on the next page, the Swiss franc now ranks the lowest in risk-adjusted returns, followed by the euro and the yen. Meanwhile, we see that returns from the Canada dollar and the NZ dollar are high. This indicator enables us to confirm that the yen, the Swiss franc, and the euro are options as funding currencies.

One issue with analyzing carry trades is limited data. With it being difficult to distinguish carry trades from other transactions, it is very difficult to carry out strict measurement. In many studies, currency futures positions in the CFTC Commitments of Traders report are adopted as a proxy variable for carry trades. For reference, Gabriele Galati et al. found that there was a significant correlation between the carry-to-risk ratio and CFTC currency futures positions[2].

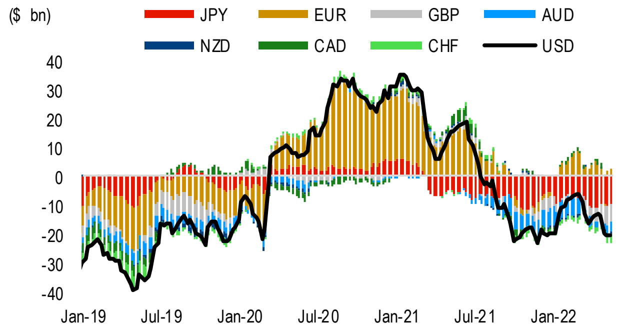
[1] For details, refer to Good opportunity to buy European bonds, euro? by Kenta Tadaide (*Daiwa's View* dated 19 May).
[2] Galati Gabriele, Alexandra Heath, and Patrick McGuire, "Evidence of carry trade activity," BIS Quarterly Review, September 2007.

**Chart 1: Carry-to-risk Ratio**




*Source: Bloomberg; compiled by Daiwa Securities.*
*Note: The 3-month interest rate difference between US and other nations is used as the interest rate difference. The 3-month implied volatility of each currency against USD is used as the expected currency fluctuation rate.*

**Chart 2: CFTC Currency Futures Positions**



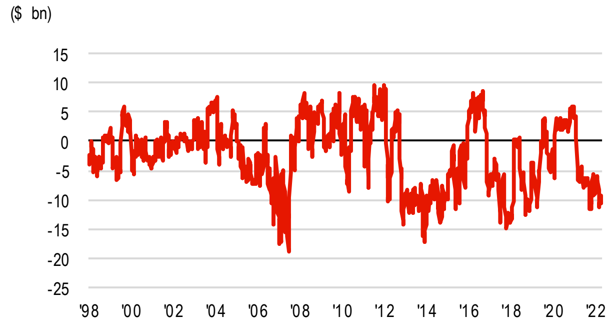

*Source: CFTC, Bloomberg; compiled by Daiwa Securities.*
*Note: Positive figures indicate buying of each currency/USD selling, while negative figures denote selling of each currency/USD buying. USD data shows total of net positions vs. respective currencies.*

Confirming CFTC currency futures positions since the outbreak of the COVID-19 pandemic, we find that, in 2020, the dollar saw short positions amid large-scale monetary easing in the US, while the euro saw long positions accumulate substantially alongside long positions on the yen (Chart 2). However, amid stronger expectations for a US economic recovery and monetary normalization, there has been a gradual shift with the dollar from short to long positions. During this time, the currencies that were sold included the yen, the Australian dollar, and the Swiss franc, among others. Long positions on the euro have declined to the point of being roughly square positions.

So far, the euro and the Swiss franc have been used as funding currencies. However, once their interest rates rise due to rate hikes by the ECB and the Swiss National Banks, some anticipate that (1) these currencies will become less attractive as funding currencies and (2) there will be an increasing shift to the yen due to a relative gain in the yen's position (as a funding currency). If so, the yen is likely to face depreciation pressure in terms of supply/demand conditions.

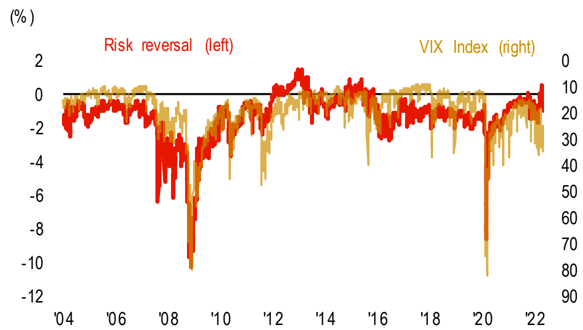
Chart 3 shows yen futures positions over the long term. Yen short positions currently amount to $9.9bn, but the greatest extent reached by yen short positions during the pandemic was $11.8bn. During the 2010s, yen short positions reached $17.3bn in 2013. Yen short positions reached their greatest extent, amounting to $19.0bn, in 2007, when the yen carry trade was widely used before the Global Financial Crisis. From a historical perspective, it wouldn't surprise me if short positions expanded in scale by 1.5 to 2.0 times.

**Chart 3: Yen Positions in CFTC Currency Futures Trading**




*Source: CFTC, Bloomberg; compiled by Daiwa Securities.*
*Note: Positive figures indicate buying of each currency/USD selling, while negative figures denote selling of each currency/USD buying.*

**Chart 4: USD/JPY Risk Reversal**




*Source: Bloomberg; compiled by Daiwa Securities.*

Investors accumulate carry trade positions when excess returns are expanding due to substantial widening of the interest rate spread between the investment currency and procurement currency, amid increasing risk-on sentiment in the market. Investors' currency fluctuation risk sentiment can be observed via risk reversal (the difference in implied volatility between the yen call and put options), which is one type of currency option transaction. In addition, risk reversal is highly correlated with the VIX index, which is a leading index for monitoring investors' risk sentiment (Chart 4).

In the carry trade, there are cycles in which the generation of excess returns attracts further investment, causing a self-fulfilling expansion of trade earnings. At the same time, the more earnings expand, the greater the accumulating risk of a plunge in the invested currencies (a risk of a surge in the yen). Accordingly, the insurance premiums to avoid such losses are said to be reflected in risk reversal.

As shown in the recent plunge in stock prices and widening of credit spreads, the main topic in the market is shifting from interest rate risk to recession concerns. From the standpoint of interest rate differentials, steady hikes in interest rates around the world from now on are likely to induce carry trades more than before. However, investor risk sentiment doesn't appear to be at the point of actively encouraging carry trades.

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