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Carry 'sequence' cart and horse common sense 7 Aug 2007 03:22 PM
by Alan Rohrbach

To quote an eminently citable American President, "Well, there you go again." Early year FT "carry 'tirade' Cassandra" warnings yielded to LEX column common sense as the equities made new highs into April. Recently the FT outsourced the role of carry trade Chicken Little to various Insight column contributors.

Yet, the temptation from watching the recent rise of the yen must have been too much, as last Thursday's Short View resuscitated carry trade concerns. The adept John Authers offered a balanced view, including reasons why the yen might also remain weak. That said, the rationale for an independent rise in the yen that might cause asset market problems beyond those engendered by other factors still smacked of a 'crisis' warning.

Both back in March and previous there were good reasons this would not likely be the case, and those abide at present on both fundamental and technical perspectives. It seems long past time for a cart and horse review of the primary dynamic fomenting yen strength in addition to extended reasons a carry trade crisis remains unlikely.

The one factor which FT consistently fails to review in spite of its obvious implications for this situation is the 'sequence' of carry trade liquidation. In spite of the extent of the yen recovery during the sharp February-March equity market selloff, it was consistently the weak asset prices which fomented yen strength, and not vice versa. The lack of a crisis in current and previous activity is consistent with the common sense explanation of why the yen is strengthening. Assets are purchased with cheap yen borrowings. When they are sold the portfolio manager is left with an unwanted debt in a net foreign exchange position. The repayment of those carry trade borrowings brings yen purchases. In practice, asset sales foment technical yen strength as part of orderly and rational position liquidation.

Other factors mitigating a full blown yen explosion have been reviewed so extensively and remain so prominent as to not require additional review here. The latest extension of that is the initial progress Mr. Sarkozy has made in French labor market liberalization that might further strengthen Europe just as Japan's Mr. Abe faces political gridlock. Suffice to say that economic conditions which might require an equalization of Japanese yields with the balance of the world remain highly problematic at best.

The only chance that will occur is the sharp reduction of yields elsewhere in response to a global asset price crash. While I am skeptical of the global economy and equity markets at present, I do not have any sense further weakness will take the form of a crash. In taking a much broader technical view of trends and cycles than many analysts (although certainly not all), I saw that the carry trade gyration into March as just an intermediate-term yen correction into resistance in spite of its sharp near term rise. At present only an unlikely forceful yen move above levels (USD 113.50, GBP 230.00 and EUR 150.00) well above current prices will signal possible self-sustained secular yen strength.

The present telling indication is that even the US equities slide into new recent lows at the end of last week did not occur in conjunction with the yen moving to a new current rally high. This is clear empirical evidence that yen strength is (at least so far) only a by-product of asset price devaluation, as opposed to a driving force behind it. While the Cassandra's refuse to acknowledge it, the 'sequence' of carry trade liquidation is cart and horse common sense that belies any actual or potential crisis.

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