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As the dollar weakens, the carry trade returns to vogue

◆ Investing in emerging market currencies using the dollar as the borrowing currency has started to have large positive returns again, according to Bloomberg.

◆ Currency trades that were unprofitable for a year have started to make money again as the dollar falls.

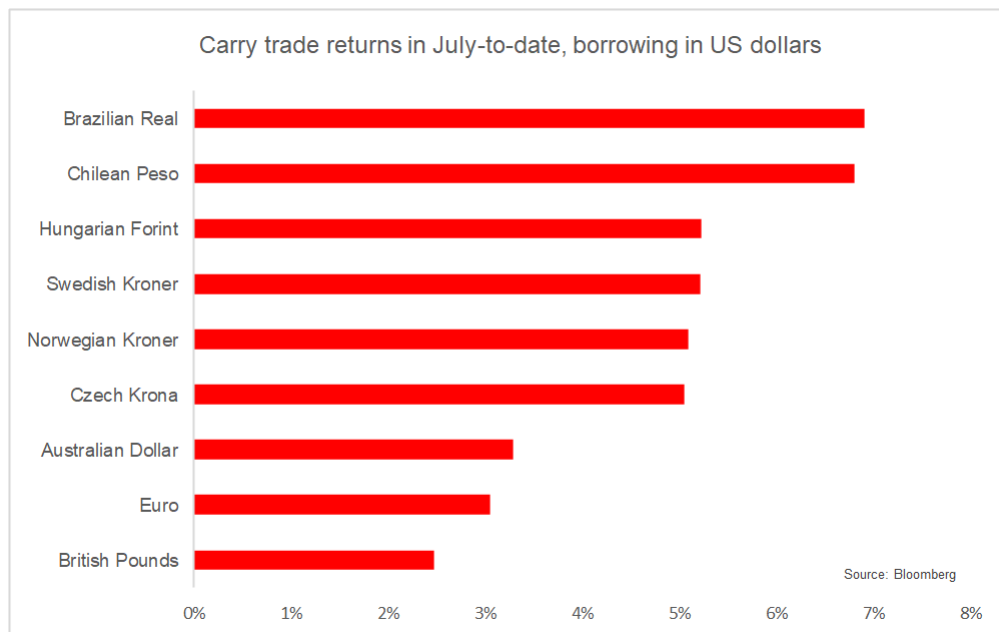
◆ The dollar index continued its correction, holding below the key 95.00 level for a second day.

◆ The move could support gains in broad emerging markets and help replenish the coffers of some countries with significant deficits.

◆ The FAB AAC remains overweight in investment grade corporate bonds and emerging market dollar debt.

The US dollar drop was extending today and it is starting to give strength to carry trades, many of which had been unprofitable for the better part of the past year. Using US dollars to buy Brazilian reals, for instance, would have produced losses of 26.8% in the year ended 30 April, according to Bloomberg calculations. Since the end of April, however, that same trade would have made a gain of 7.6%. Much of that return has been logged since the start of July, with a carry trade in the Brazilian currency offering 6.92% returns so far, according to Bloomberg.

That move could accelerate as the Federal Reserve continues to offer what seems like an unlimited supply of dollars and promises to keep interest rates low for the foreseeable future. The result could be a boon for some emerging markets, which were suffering from dwindling reserves.



Countries which had plugged their current account deficits with investor inflows, especially on their higher-yielding government bonds, such as Egypt, Brazil, South Africa and Indonesia, have already started to see flows return. That has a power of being self-fulfilling too. As more investors seek yields and do these carry trades, the currencies appreciate and provide even larger gains.

Naturally, it can all go the other way as well. But as long as the US dollar continues to depreciate, and with interest rates so low in the developed countries, there is a strong incentive for large investors to pursue this sort of trade and keep pushing other currencies higher.

That has a very positive implication for stock and bond markets of some of the biggest emerging markets. Dollar investments in shares of companies in these markets will now have a higher return than before.

Selling dollars and buying Brazilian reals was a losing trade until the start of May

On the bond side, the reappreciation of their home currencies makes it easier for these companies to translate local revenues into hard currency. This reduces the likelihood of defaults of such debt.

The tricky part for investors is the fact that the dollar remains a haven currency. Whenever there is volatility investors flock back to the greenback. The low interest rate environment is slowly bringing volatility down. This is likely to continue, given the history of what happened in the past 10 years. However, while volatility on average is lower when interest rates are low, there also are more instances when there are large volatility spikes. So even profitable carry trades can get wiped out pretty quickly.

Investment Strategy Update

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