

CHAPTER 7 – International Arbitrage and Interest Rate Parity

Weak dollar reprises its role as 'carry' trade funder

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MUMBAI, June 2 (Reuters) - The U.S. dollar's weakness since the start of Donald Trump's presidency has made it the preferred funding currency for popular "carry" trades, fuelling heavy flows into higher-yielding emerging market currencies.

Dollar-funded carry trades in the Indonesian rupiah, Indian rupee, Brazilian real, Turkish lira among other currencies, are back in vogue, fund managers said.

In a typical currency carry trade, investors use cheap-to-borrow currencies to fund investments in those with better yields. Returns are boosted if the borrowed currency weakens.

The dollar, traditionally less favoured than the Japanese yen or Swiss franc for such trades, has become the funding currency of choice as Trump's trade war stokes recession worries and an investor retreat from U.S. Treasuries.

Carl Vermassen, a portfolio manager at Zurich-based asset manager Vontobel, has added to carry trades on the rupee and rupiah.

"Emerging market local currency was basically shunned for the simple reason: to avoid local currency risk at a time of an almighty dollar," he said. "But, given most investors deem U.S. exceptionalism to have ended, things are changing."

Claudia Calich, head of emerging market debt at M&G Investments, also expects dollar weakness to persist and support carry trades.

The London-headquartered fund oversees more than 312 billion pounds (\$423.5 billion) and favours the rupee and Philippine peso for carry positions within Asia and the Brazilian real and Mexican peso in Latin America.

The more investors rush back into dollar carry trades, the deeper the dollar's losses are likely to be, analysts said. The dollar index has fallen 8.5% so far this year, dropping below

the critical 100 mark in mid-April for the first time in nearly two years. It was last seen at 99.30.

That means investors are finding good carry not just in the likes of the rupee and rupiah, whose yields are above the 4.5% yield in the United States, but even those with low interest rates such as the South Korean won, where the Bank of Korea recently lowered its rates to 2.5%. The won has led gains in Asian currencies this year with a 6.7% rally against the dollar.

The yield advantage over dollars, or the "carry", measured by the three-month tenure is 2% on the Indian rupee and 1.2% for Indonesia's rupiah.

Brazil's real gives a much higher carry at 9% but is far more volatile, meaning the trade could go horribly wrong if the currency depreciates, instead of appreciating.

The future expected 3-month volatility, also called implied volatility, for the real is 8.1% compared with 4.7% for the rupee.

Goldman Sachs said carry trades were "a big theme" in recent meetings with its New York clients, with interest growing in Latin American and European markets.

"If volatility settles some more, we will start to hear more about dollar-funded carry trades," ING Bank said. "This could be a story for this summer."

HUGE INFLOWS

Since "FX carry trades" typically involve investments in bond or money markets in these destinations, analysts expect to see heavy flows into emerging markets.

Data for April shows investors bought bonds worth \$8.92 billion, the highest for any month since last August, in South Korea, India, Indonesia, Thailand and Malaysia.

While some of those flows could have been straight real-money investments into these markets, analysts say carry trades also boomed. In South Korea, foreign investors bought \$7.91 billion in bonds, the most since May 2023.

Tom Nakamura, vice-president and head of fixed income & currencies at Canadian fund AGF Investments, finds carry trades in Turkey attractive since the central bank's adoption of more orthodox monetary policy. Turkey's benchmark rates are at 46%

Questions

1. Describe a carry trade for a U.S. firm doing business with India. Calculate the potential profits for the U.S. investor.
2. Are “carry” trades arbitrage trades? Explain. Describe a scenario, involving the Brazilian real, where a carry trade does not work.
3. Refer back to your answer to question 1. Could an Indian firm benefit from arbitrage in the same manner as U.S. firms? Explain.
4. The Turkish lira (TRY) is trading at 39.33 TRY/USD. Calculate the 3-month Forward rate for the TRY/USD exchange rate. Is arbitrage possible?
5. Last week, the European Central Bank reduced interest rates by .25%, leaving the benchmark rate at 2%.. Explain the effect of this interest rate cut on the USD/EUR forward premium.