

## **CHAPTER 7 – International Arbitrage and Interest Rate Parity**

### **China's Yuan Shock Gives Carry-Trade Crowd Worst Year Since '08**

By Ye Xie Liz and McCormick  
Published: Aug 26, 2015.

China just gave investors one more reason to shun the most popular trading strategy in the USD 5.3 trillion-a-day currency market.

Carry trades, or borrowing one currency cheaply to invest in a higher-yielding asset elsewhere, were already suffering the biggest losses since 2008 as the rout in emerging markets sent potential purchases tumbling. By cutting interest rates two weeks after its shock devaluation from 4.85% to 4.6%, China effectively crossed the yuan off investors' shopping lists, too.

Add to this a surge in volatility -- which is kryptonite for these transactions because it can wipe out the profit from the interest-rate differential -- and carry traders are finding fewer and fewer ways to make money. JPMorgan Private Bank and the asset-management unit of Bank of China both say the strategy's best days are behind it.

"It's a terrible time to be long carry," said Joseph Capurso, a Sydney-based currency strategist at Commonwealth Bank of Australia. "Increased volatility -- which I think we'll stay with -- will continue to be terrible for carry. The period is over for carry trades."

A Deutsche Bank AG index tracking carry trade returns has plunged 13% this year, on track for its worst annual decline since the 2008 financial crisis.

#### **Bear Markets**

The losses accelerated in the past week as bear markets in equities around the world, combined with a plunge in oil and metals prices, sent currencies from South Africa's rand to Mexico's peso tumbling to records. They're the sort of currencies investors tend to buy in carry trades because of their relatively high interest rates.

A JPMorgan Chase & Co. measure of currency volatility meanwhile approached its highest level this year, further sapping carry returns.

"Across the board, carry has been under pressure," said Kristjan Kasikov, a London-based quantitative analyst at Citigroup Inc., the world's biggest currency dealer. "Weakness in commodity prices has hit some of the high-yielding currencies quite hard."

One of the most popular carry trades in recent months was borrowing yen to buy Australian dollars, according to CBA's Capurso. Investors would pocket the difference between Japan's near-zero borrowing costs and Australia's main rate, which at the start of the year was 2.5%.

The deals started to lose money, he said, as weaker growth in China and falling raw-materials prices sent the Aussie tumbling toward this week's six-year low versus the dollar at 0.7107 USD/AUD. Investors in the carry trades would have lost 6% in August, wiping out a 4% profit in the second quarter.

#### **China Trade**

Buying the yuan with funds borrowed more cheaply elsewhere was one of the most reliable ways to make money earlier in the year as China held its currency at about 6.2 CNY/USD.

As recently as mid-June, BlackRock Inc., which oversees USD 4.7 trillion, was piling into the trade and predicting it would remain a good bet for the next year and a half. The deal had been popular for some time, with Deutsche Bank estimating that almost USD 800 billion had poured into yuan carry trades since 2010.

The transaction turned sour on Aug. 11, when China unexpectedly devalued its currency to boost exports. Tuesday's interest-rate cut, its fifth since November, further undermined the yuan, which was at 6.4 CNY/USD Wednesday in New York.

As a result, buying the yuan with borrowed euros would have lost about 7% since the devaluation and 3% using dollars, after gaining an average 4 percent annually over the previous four years, data compiled by Bloomberg show.

### **Swiss Shock**

The People's Bank of China isn't the first central bank whose policy decisions upset the carry trade this year. Investors who took advantage of Switzerland's negative interest rates were left nursing losses when officials abandoned their exchange-rate cap back in January, sending the Swiss franc soaring to a record and upending deals funded in the currency.

Yet China's twin policy shocks have had the biggest impact, investors say, if only because of the sheer amount of money poured into yuan carry trades.

BOCHK Asset Management Ltd., a unit of Bank of China that overseas about USD 7.7 billion, says investors in the deals will probably take profits.

The yuan was "the best carry-trade currency for years because of its low volatility," said Ben Sy, head of fixed-income, currencies and commodities for Asia at JPMorgan Private Bank in Hong Kong. "Now, volatility has almost doubled. Definitely, people will unwind."

### **Questions**

1. Describe a carry trade for a U.S. firm doing business with China. Calculate the potential quarterly profits for the U.S. investor before the devaluation of the CNY.
2. Are "carry" trades arbitrage trades? Explain. Calculate the quarterly profits for the U.S. investor after the devaluation of the CNY.
3. Why is the volatility of an exchange rate relevant to carry trades?
4. On August 25, 2015, the PBOC cut interest rates by .25 points. Explain the effect of this interest rate cut on the CNY/USD forward premium.
5. Calculate the one-month Forward rate for the AUD/USD exchange rate. Is covered arbitrage possible?