CARRY TRADE

What is the Carry Trade?

Leveraged Carry Trade Example:

Let's say you borrow $1,000,000 at an interest rate of 1%. The bank won't just lend a million bucks to anybody though. It requires cash collateral from you: $10,000. You'll get it back once you pay back the money. Then you turn around, walk across the street to another bank and deposit the $1,000,000 in a savings account that pays 5% a year. A year passes. What's your profit?

You *earned* $50,000 in interest from the bond ($1,000,000 * .05). You *paid* $10,000 in interest ($1,000,000 * .01). So your net profit is $40,000. With a measly $10,000, you earned $40,000! That's a 400% return!

What is a Currency Carry Trade?

Carry trading is one of the simplest strategies for currency trading that exists. A carry trade is when you buy a high-interest currency against a low-interest currency. For each day that you hold that trade, your broker will pay you the interest difference between the two currencies, as long as you are trading in the interest-positive direction.

For example, if the Pound (GBP) has a 5 percent interest rate and the US Dollar (USD) has a 2 percent interest rate, and you buy or go long on the GBP/USD, you are making a carry trade. For every day that you have that trade on the market, the broker is going to pay you the difference between the interest rates of those two currencies, which would be 3 percent. Such an interest rate difference can add up over time.

Know When Carry Trades Work and When They Don't

Carry trades work best when investors *feel* risky and optimistic enough to buy high-yielding currencies and sell lower-yielding currencies. Economic conditions may not be good, but the outlook of the buying currency does need to be positive.

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If the outlook of a country's economy looks good, then chances are that the country's central bank will have to raise interest rates in order to control inflation. This is good for the carry trade because a higher interest rate means a bigger interest rate differential.

On the other hand, if a country's economic prospects aren't looking too good, then nobody will be prepared to take on the currency. Especially if the market thinks the central bank will have to lower interest rates to help their economy.

To put it simply, carry trades work best when investors have *low risk aversion*. Carry trades do not work well when risk aversion is HIGH (i.e. selling higher-yielding currencies and buying back lower-yielding currencies). When risk aversion is high, investors are less likely to take risky ventures. When economic conditions are uncertain, investors tend to put their investments in safe haven currencies that offer low interest rates like the U.S. dollar and the Japanese yen.

Carry Trade Criteria

It's pretty simple to find a suitable pair to do a carry trade. Look for two things:

- Find a high interest differential.
- Find a pair that has been stable or in an uptrend. This gives you the ability to stay in the trade AS LONG AS POSSIBLE and profit off the interest rate differential.

For example between January 2000 and May 2007, the Australian dollar/Japanese yen currency pair (AUD/JPY) offered an average annual interest of 5.14%. For most people, this return is a pittance, but in a market where leverage is as high as 200:1, even the use of five- to 10-times leverage can make that return extremely extravagant. Investors earn this return even if the currency pair fails to move one penny. However, with so many people addicted to the carry trades, the currency almost never stays stationary. For example, between February and April of 2010, the AUD/USD exchange rate gained nearly 10%. Between January 2001 and December 2007, the value of the AUD/USD increased approximately 70%.

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Carry Trade Risk

While carry trades might seem an attractive way of profiting from your forex trading activities and wide interest rate differentials between currencies, be aware that these trades also have a substantial potential for loss, as well as profit. The following list includes some of the primary risks commonly associated with carry trades:

Currency Risk: Since carry trades will generally be held unhedged, this means that any return from the interest rate differential needs to be in excess of any adverse exchange rate movements in the carry trade currency pair. As a result, a currency pair will usually be chosen for the carry trade for which the trader forecasts the higher interest rate currency will appreciate over the chosen time frame relative to the lower interest rate currency.

The carry trader might make this forecast based on a suitable combination of technical and fundamental analysis, since it will usually be for a fairly long time frame.

Leverage Risk: An important risk factor for retail forex traders to consider with the carry trade is that if substantial leverage is used to implement it, then sharp unfavorable market movements

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could result in losses that may prompt margin calls or the position being automatically stopped out by your forex broker.

Interest Rate Shift Risk: When carry traders seek to compound their interest on a monthly or even daily basis to increase their overall returns, they can then be subject to returns that can vary depending on movements in the interest rate differential. For example, if the interest rate differential widens, this will generally be a move in the carry trader's favor, which they can take advantage of in the next compounding period. On the other hand, when interest rate differentials narrow, the carry trader will then receive a lower return than anticipated in their next interest compounding period.

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