CARRY TRADE

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Rising interest rates come as bad news for those who wish to take a home loan or a car loan. However, rising interest rates bring several opportunities with them as well…

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And one opportunity in this regard is that of ‘Carry Trade’, which essentially means borrowing in one market where interest rates are lower and investing in another market where interest rates are high and thereby making a gain.

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But it is not that simple because it involves two different currencies. One currency is of the country where interest rates are low while the other currency is of the country where interest rates are high.

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And for ‘Carry Trade’ to be profitable, it is crucial that the exchange rates between the countries remain stable. Otherwise instead of a gain one could land up making a serious loss. Thus ‘Carry Trade’ is not devoid of risk.

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Now, as we always do, let's try and get a better understanding of the concept with the help of an example.

Lets assume that the interest rate in US is 2% whereas is in India it is 7% And let's say someone borrows $100 in USA to invest in India at 7%.

It is evident that the differential of 5% (7% - 2%) is the opportunity to make a profit for taking an exchange rate risk.

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Let’s assume the exchange rate is Rs 50 = $1.

Now if someone in the US wants to invest in India, he has to invest Indian Rupees for which he has to purchase Indian Rupees.

So if the amount in question is $100, then as per assumed exchange rate of Rs 50, it would amount to Rs 5000.

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So when Rs 5000 is invested for one year in India at 7%, it would earn an interest of Rs 7% x 5000 = Rs 350.

Thus at the end of the period the total amount would be Rs 5350.

On conversion assuming no change in exchange rate, it would be $ 5350/50 = $107 or a net earning of $7.

Now had the investment been made in the USA itself at 2%, it would have earned net $2 only.

Hence by participating in carry trade an additional $5 profit opportunity emerged because of differential interest rates between two countries.

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But here we have made a huge assumption that the exchange rate remained stable across the investment time period.

This however may not be the case most of the time & in the event of exchange rate variation, the consequence can be painful for the investor.

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Let's see this by looking at the same example.

We had assumed the exchange rate as Rs 50 = $1

However, if in the interim period the Rupee grew stronger to Rs 40, let's see what happens to the investment…

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At 7% we saw that the investor in our example made Rs 350 and the final amount that he received was 5350. At the exchange rate of Rs 50 = $1 he received $ 107.

However it the rupee grew weaker in the interim period to Rs 60 = $ 1, he would now receive only $ 5350/60 = $ 89.16.

Thus he would actually make a loss of nearly $11 instead of a gain of $2 he would have made had he invested in USA itself.

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This is the currency risk that one has to take in carry trade. If the currency of investment becomes weaker the consequences for the investor are painful and if the currency on the other hand were to get stronger his gains to would get stronger.

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Conversely, if the exchange rate had become Rs. 40 = $1,he would actually have made USD 5350*/40$ =$133.75 which would have given him a significant gain of $33.75 vs. $2 ifhe had invested in USA itself.

Please refer earlier slides o find out how the amount 5350 was worked out.

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Since 'Carry Trade' involves borrowing in one market to fund investments in another market, both 'gains' and 'losses' can get magnified due to the currency fluctuations.

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However, in real life, the moment the traders get a feel that exchange rates are changing unfavorably, they rapidly unwind their positions by withdrawing their investments, and converting them into dollars.

This is famously known as ‘Carry Trade Unwinding’.

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While we have explained 'Carry Trade' in fixed income investment in our example, one must understand that 'Carry Trade' also refers to investments in any other asset class like shares, commodity, real estate, etc in one country by taking leverage from another country.

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Hope you have understood the concept of 'Carry Trade'.

Thinking of Investment

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