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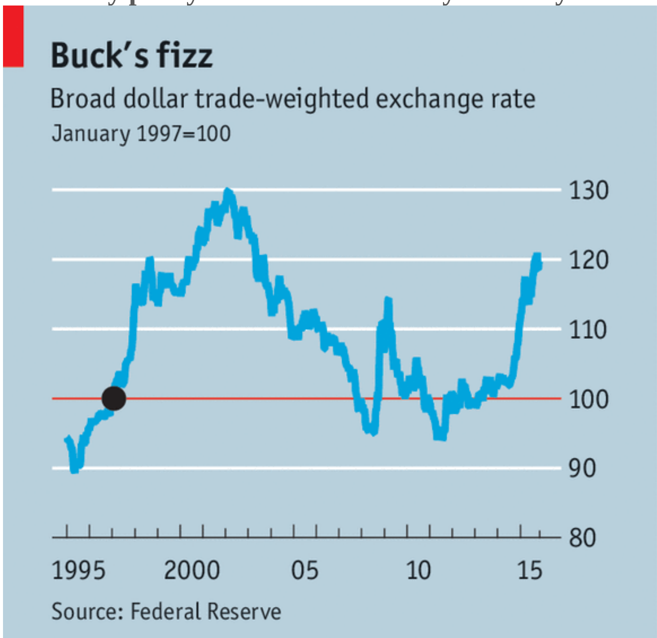
What a carry on

Monetary policy could drive currency volatility



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NEXT month will probably see the first great divergence in monetary policy since the financial crisis of 2008. The Federal Reserve is widely expected to push through a rate increase—its first since 2006. But the European Central Bank is expected to cut its deposit rate, already in negative territory, or to expand its programme of asset purchases. The Bank of Japan is also expected to maintain or amplify its expansionary monetary policy.

For the currency markets, the shift will herald a new era. Before 2008 one of the most popular strategies was the "carry trade"—borrowing in a low-yielding currency and investing in a higher-yielding one. But with interest rates in most of the rich world at or close to zero since 2008, there has been little carry to trade.

After December traders can probably look forward to a prolonged divergence between interest rates in America and the euro zone. Back in 2010 the markets thought the first interest-rate increase by the Fed and the ECB would occur at roughly the same time. (In fact, the ECB fleetingly began raising rates in 2011, before cutting them again.) But now there is an expected hiatus of nearly three years between the Fed's first increase and the ECB's first move, according to David Riley of BlueBay Asset Management.

The gap between American and German bond yields also reflects this divergence in expectations. On November 18th five-year Treasury bonds yielded 1.68%; German bonds with the same maturity had a negative yield of 0.14%. That is the biggest gap since the creation of the euro. It may well encourage income-seeking investors to pile into the dollar.

A further surge in the dollar could have big consequences. Emerging-market countries that tie their currencies to the dollar, formally or informally, will see their exchange rates rise, and their exports become less competitive. This could cause some to consider a devaluation. But there could also be difficulties for developing countries without dollar pegs. If their currencies fall sharply, that will put a strain on companies that have borrowed in dollars. Capital flight could also complicate refinancing for local-currency borrowers. Corporate debt in emerging markets has risen from 50% of GDP in 2008 to almost 75%.

In short, currency risk could become a big source of turbulence in financial markets, as it was in the late 1990s (the Asian crisis) or the early 1990s (when the European Union's Exchange Rate Mechanism broke apart). The volatility of the dollar versus the euro and yen, as measured by contracts traded on the Chicago Board Options Exchange, stayed below 10% for much of 2013 and 2014; this year it has risen to 10-15%.

Such volatility is a big concern for international investors. They might successfully pick an outperforming stock in another country, only to see all their gains evaporate as a consequence of exchange-rate movements. "Foreign-currency exposure is no longer a simple numéraire that can be hedged away or ignored," wrote Geraldine Sundstrom of PIMCO, a fund manager. "Foreign-exchange considerations will weigh disproportionately on the investment climate and opportunities."

Further dollar strength is not inevitable: rate expectations could already be reflected in prices. On a trade-weighted basis, the dollar has already had an energetic bull run (see chart). The pace of its rise over the past 12 months has been the fastest since the early 1980s. Fund managers polled by Bank of America-Merrill Lynch think that bullishness about the dollar is the most crowded trade in the markets at the moment.

If it were to happen, a further rapid rise in the dollar would affect the American economy, reducing import prices (and thus inflationary pressures) and cutting export growth (affecting GDP). A stronger currency equates to monetary tightening; this might reduce the extent to which the Fed needs to push up rates.

Indeed, central banks such as the ECB that have tightened since the credit crisis have been forced to reverse course. Torsten Slok of Deutsche Bank says that the median interval between the first such rate increase and the first cut was only 16 months. That suggests that a December rate increase could be followed by a cut in early 2017.

Since 2008 it has seemed as if all central banks have been happy to let their currencies decline, as a way of easing pressure on their domestic economies. Implicitly or explicitly, the Fed will be breaking with that approach if it pushes up rates in December. Billions of dollars will be at stake as investors try to cope with the fallout.