



Decoding the Yen Carry Trade conundrum



Just as the domestic equity markets had experienced a robust comeback, following the volatility during the week of the full Union Budget for FY 2024-25, another major event, this one of global proportions, barraged the benchmark indexes. On the 5th of August, many investors found themselves grappling with a term that had not made its presence felt so widely since the global financial crisis of 2007-08. For new players in the market, the Yen carry trade was a largely unknown phenomenon but given the hawkish stance that is now being displayed by the Bank of Japan, it is time to revisit this concept and decode its impact on global markets.

What is a carry trade?

It entails borrowing money at a low interest rate and then deploying the borrowed money in an asset that can potentially yield higher returns.

Assessing the Yen carry trade

For years, investors have leveraged Japan's persistently low interest rates through a strategy known as the "**Yen carry trade**" – an approach which involves borrowing Yen at minimal rates and investing the funds in higher-yielding assets abroad, such as stocks or bonds.

The 6 steps in the Yen carry trade



Borrow Yen:

Investors borrow Yen at low interest rate in Japan



Convert the currency:

The borrowed Yen is then converted into a currency that offers high-yielding options. The most popular one has been the USD



Invest in high-yielding assets:

The converted funds are invested in higher-yielding assets like stocks, bonds, real estate, usually in another country



Investors can also choose to not convert the borrowed Yen and instead deploy the borrowing in global Yen denominated equity funds that invest in global equities



Profit from difference:

Consequently, investors set up a nice arbitrage that allows them to capture the difference between the high return asset and the lower cost of borrowing the Yen

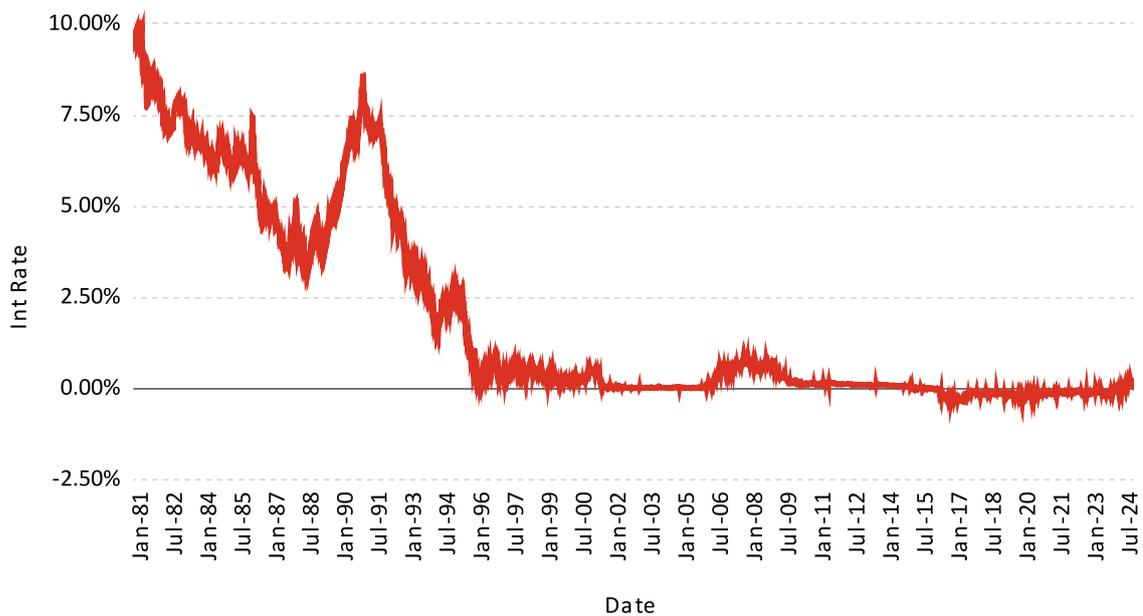


Convert the USD denominated assets back in to Yen to pay back the borrowings

Further, for this trade to be profitable, the currency must remain stagnant or depreciate against the Dollar

Historically, this strategy capitalised on Japan's ultra-low interest rates, which were maintained following the 1990s asset bubble burst and subsequent deflation. The Bank of Japan's policy of keeping rates near zero continued even as other major economies began raising their rates. This divergence led to the Yen weakening, which fuelled the Yen carry trade as investors anticipated continued depreciation of the Yen. However, the Japanese central bank's recent unexpected decision to increase its main interest rate to **0.25%** has disrupted this strategy. The yen's abrupt appreciation against the dollar has caused significant losses for those who bet on its decline, resulting in heightened market volatility and diminished profitability for Yen carry trades.

Exhibit 1: Japan interest rate trajectory



Looking back in time

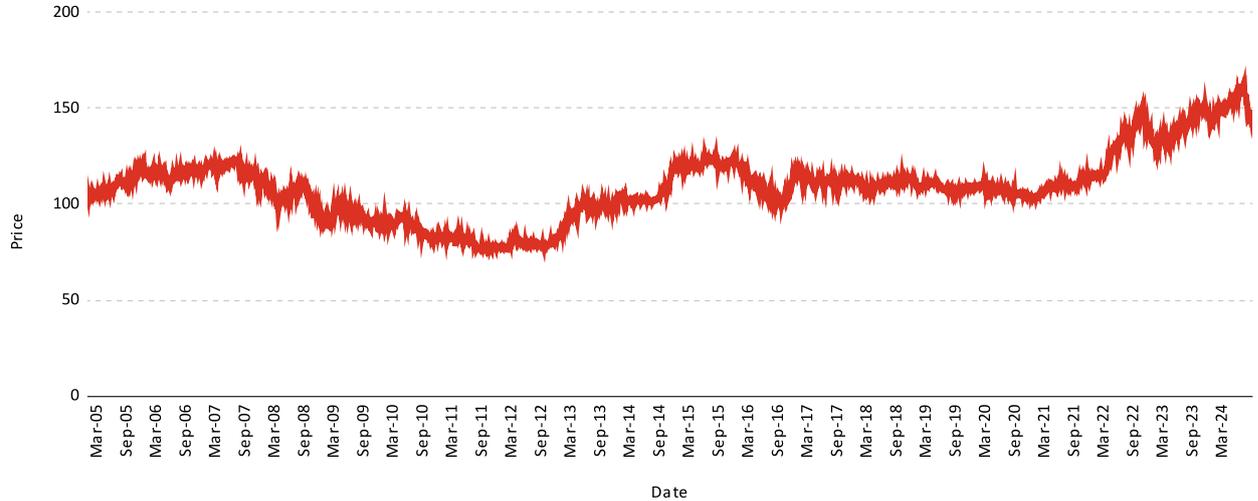
The Yen carry trade has been a significant player in global financial crises since the 1990s. Originating from Japan's decision to keep interest rates low following the burst of its asset bubble in the late 1980s, the carry trade allowed investors to borrow Yen at minimal costs and invest in higher-yielding assets abroad. **This strategy gained prominence during various crises, including the Asian financial crisis of 1997-98, the dot-com bubble of 2000, and the Chinese stock market crash of 2015.** The practice reached notable heights leading up to the 2008 global financial crisis¹, with estimates suggesting the involvement hundreds of billions of dollars. As the crisis unfolded, risk aversion soared, prompting a flight to safety that drove up the Yen's value significantly – this sudden appreciation rendered many carry trades unprofitable, exacerbating market turmoil and contributing to global economic instability. And with the ongoing unwinding of the trade, it is safe to assume that this is not the last we hear of this phenomenon.

Impact on the market

The unwinding of Yen carry trades poses a significant threat to global markets, with particular implications for countries experiencing substantial Yen-denominated investments.

1. <https://economictimes.indiatimes.com/markets/stocks/news/the-yen-carry-trade-understand-it-because-last-monday-was-not-the-first-nor-the-last-time-it-hit-your-stock-portfolio-/articleshow/112444342.cms?from=mdr>

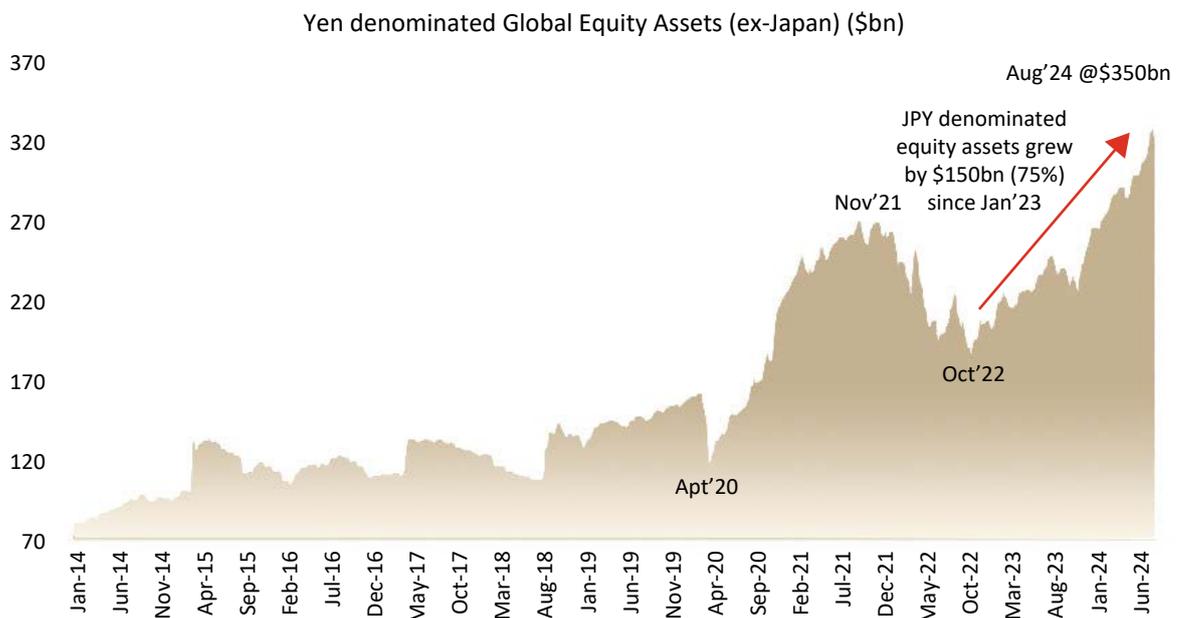
Exhibit 2: USD/JPY trend



Since January 2023, Yen-driven investments have witnessed a significant surge across the globe, driven by a sharp depreciation of the Yen against the Dollar – the exchange rate witnessed a significant **decline of 27%**, dropping from **127 to 162²**. According to reports, Yen-denominated assets in global equity funds (ex-Japan) have increased from **USD 200 Bn to USD 350 Bn**, over the last 18-months.



Exhibit 3: Yen denominated global equity assets (ex-Japan) (USD Bn)



2. <https://www.wrightresearch.in/blog/what-is-the-japanese-yen-carry-trade-impact-on-india-and-global-markets/>

What should investors do?

Past instances of Yen carry trade unwinding, notably during the 2008 global financial crisis, provide a relevant context – the sudden appreciation of the Yen during that period resulted in a broad sell-off of Yen-denominated assets, exacerbating market instability and leading to significant contractions in various asset classes. In this scenario, it is advisable that investors adopt a strategic approach.



Focusing on high-quality stocks with robust fundamentals and sustainable growth prospects is highly recommended – large-cap stocks generally offer more stability during periods of market volatility.



Mid-cap and small-cap investments should be selected with care, emphasising companies with strong growth potential and sound management.

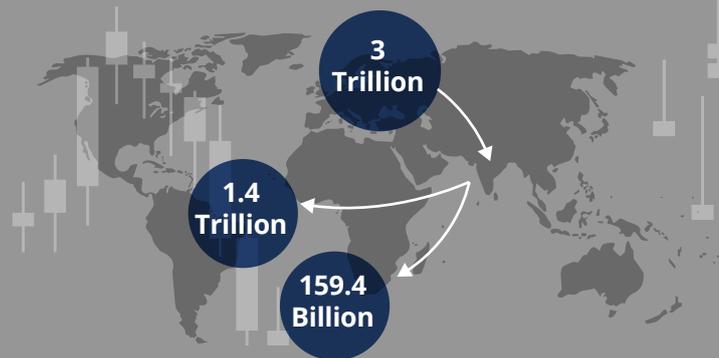


Monitoring global events and rebalancing portfolios in response to market shifts remains essential even as maintaining a portion of the portfolio in cash can provide flexibility to capitalise on market dips.

Adopting a long-term investment perspective, with a focus on quality and resilience, will go a long way towards navigating short-term volatility and positioning for potential recoveries, thus ensuring a balanced and strategic approach to market fluctuations.

While the Yen carry trade caused a bloodbath across markets, the impact of the unwinding will remain transitory at best, given the strong outpouring of support from domestic institutional investors. Since the beginning of 2024, DIIs, including mutual funds, insurance companies and pension funds, have bolstered the market even as foreign institutional investors took a step back –

From January 1 to August 21, these investors have pumped in **over ₹3 trillion** into the domestic stock market, even as FIIs have reduced their investments to **₹159.4 billion**, from **₹1.40 trillion** a year ago³.



Further, India's fundamentals remain strong, despite the unwinding of the carry trade, making this an optimal time to recalibrate portfolios and reposition for robust returns across asset classes.

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