

Divergent Capital Asset Management “In the News”

Understanding the Yen Carry Trade and Its Current Market Impact

The yen carry trade is a strategy where investors borrow and sell Japanese government bonds they don't own, leveraging the low yields to exchange the yen for higher-yielding currencies like the U.S. Dollar or the euro. They then invest the exchanged currency in higher-yielding assets such as stocks or bonds in those markets. This strategy is highly profitable when interest rates are stable. However, recent market events have shifted this dynamic:

- **Bank of Japan Rate Hike:** Last week, the Bank of Japan raised interest rates into positive territory for the first time in 17 years.
- **Federal Reserve's Dovish Stance:** At the end of July, the U.S. Federal Reserve adopted a dovish stance and indicated potential rate cuts starting at the September meeting.
- **U.S. Employment Data:** Last Friday's report showed U.S. unemployment at 4.3%, the highest since October 2021, with only 114,000 jobs added, falling short of the expected 175,000. This was further compounded by downward revisions for May and June's employment gains.

These factors have created increased demand for yen and downward pressure on the U.S. dollar, causing the USD/JPY pair to drop by over 10%, rendering the yen carry trade unprofitable. As investors unwind their positions, selling off assets purchased with borrowed yen, there is speculation that this is driving the recent selloff in U.S.-based mega technology stocks.

The yen has been a popular carry trade currency due to Japan's zero-interest policy and persistent deflation. Recently, U.S. equities have been favored by carry traders due to the strong dollar. While it is unclear which specific assets investors purchase after selling Japanese government bonds, or the total size of these trades, it is evident that this is a significant global trade. The concern is the potential vicious cycle: value reductions lead to margin calls, forcing sales, which result in further losses and additional margin calls.

Dutch bank ING reports that cross-border yen borrowing has increased by \$742 billion since the end of 2021, according to data from the Bank for International Settlements. While this is not the total figure, it represents a substantial amount of unhedged cross-border yen loans outstanding.

Given these dynamics, we recommend keeping the yen on the top of your market screen to stay informed of ongoing market shifts.

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