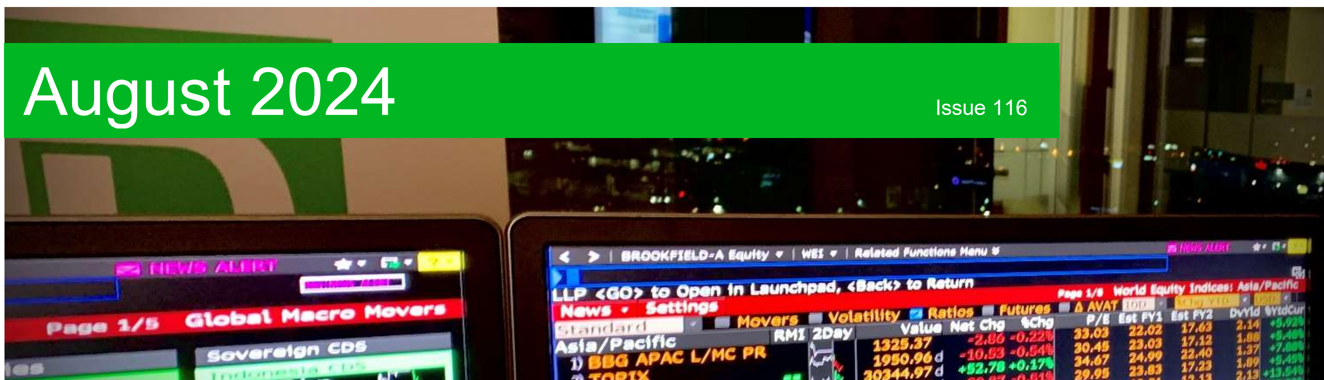
The Charter Group Monthly Letter



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Economic & Market Update

Crash & Carry

Imagine an investment opportunity where one could borrow at a very low rate of interest and invest that money at significantly higher rates of returns in securities, some of which are even backed by the U.S. government. In fact, this is not imaginary. It is an actual strategy that has been used by financial institutions and funds for years. And, they have mostly been earning juicy returns for decades.

The "Carry Trade" is all fine and dandy …

… until it isn't.

This is a type of strategy referred to as a "carry trade."

Given how lucrative this strategy can be, you might be wondering why I am not engaging in carry trades on behalf of clients! Good question.

During periods of stability, it is often profitable for institutional investment managers to borrow in a low-interest currency and then to invest in a currency with higher-yielding bonds or better returning equities.

The seductive appeal of carry trades lies in the fact that conditions that contribute to their profitability can remain in force for long periods of time. Eventually, they can begin to feel normal, at which point investors may start to underestimate the risks involved.

Those risks became evident this summer and contributed to some of the wild volatility we

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saw at the beginning of August.

Specifically, the main culprit behind the volatility was the "*yen* carry trade." For decades (right back to the beginning of my career in 1990), the yield on the U.S. 10-year Treasury bond (UST) has *always* been higher than the yield on the 2-year Japanese Government Bond (JGB) (**Chart 1**). In fact, the 10-year JGB yield has also remained below the 10-year UST for the entire period. And, there has been more stabilty across maturities in Japan relative to the U.S. as the 2 & 10-year bond yields have never inverted. In the U.S., the 2 & 10-year USTs have inverted nine times since 1990.

For decades, institutional investors have been able to borrow in Japan at very low rates that were reliably beneath the investment returns that they could earn elsewhere.

Chart 1:

Historical Bond Yields

Source: Bloomberg Finance L.P. as of August 19, 2024

The takeaway from this is that the Japanese credit market has been very stable and reliable with respect to a low cost of borrowing and keeping the cost of that borrowing well below potential investment returns.

Borrowing in Japan and investing in USTs is probably the most conservative of carry trades. If investors are feeling more assured and want to be more aggressive, they might invest that borrowed capital into something like Mexican government bonds which have yielded about 4.5% more than USTs over the last dozen years.[1] Because of the tantalizing yield pickup, this has become one of the more popular yen carry trades over the last decade.

Things can get even riskier if the borrowed capital is invested into equities, which clearly have no government-backing. In fact, many Japanese financial institutions have been active in this type of trade, with a focus on buying U.S. stocks. The AI-induced market

[1] Source: Bloomberg L.P. as of August 19, 2024.

gains in the U.S. have made this especially profitable.

Now for the bad news.

Because one is borrowing in yen and investing in securities denominated in U.S. dollars (or Mexican pesos), this is a possibility that the cross rate between the two currencies involved can threaten the positive yield spread between borrowing and investing. Where the foreign exchange cross rate is at any time is not the main issue. Instead, it is the relative movement between the two currencies beginning from when the carry trade is established that can cause havoc.

However, if the yen strengthens suddenly, heavy losses on the carry trade strategy might be incurred.

For example, from July 10th to August 6th, the Mexican peso fell 18.7% against the yen (**Chart 2**).[2] So, let's say on July 10th a hedge fund manager borrowed at 1.5% (a reasonable rate charged to prime customers at the time) in Japan to buy 10-year Mexican Government Bonds which were yielding 9.9% on that day.[3] Cumulative net interest yield earned over slightly less than a month would be about 0.63%. With the loss attributed to the decline in the peso, overall net loss at that point would be a little over 16.0%, even after the capital gains in the Mexican bonds are accounted for.[4] In addition to the sting of the loss, the hedge fund manager might have received a margin call from the institution in Japan that lent the funds, requiring the hedge fund to post more cash. The odds of the hedge fund having lots of cash isn't that great if borrowing was part of their initial strategy. This might then force the selling of other securities to generate that cash. And, if this is happening everywhere at once, lots of securities are going to be sold quickly which could have an adverse impact on the market like what we saw between August 2nd and 5th.

I used the yen carry trade which invested in Mexican Government Bonds to highlight some of especially harsh pain points in the market over that time. But even with USTs, the math is still dismal. The 10.8% drop in the U.S. dollar versus the Japanese yen from July 10th to August 5th (**Chart 2)** would still swamp a yen carry trade borrowing at 1.5% to invested in 10-year USTs yielding 4.3% on July 10th even when considering a 4.0% capital gain in the 10-year UST over that period.[5]

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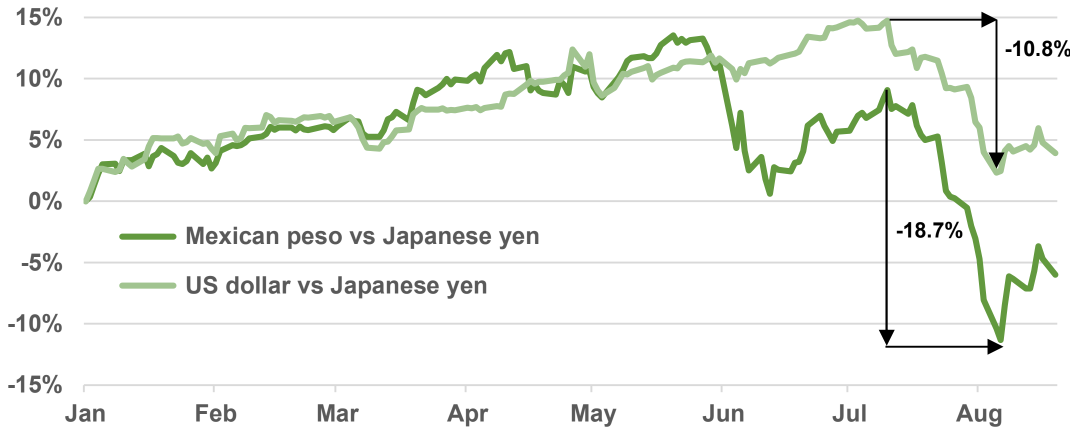
[2] Source: Bloomberg Finance L.P. as of August 19, 2024.
[3] Ibid.
[4] Ibid.
[5] Ibid.

Chart 2:

Relative Movements of Japanese yen Cross Rates

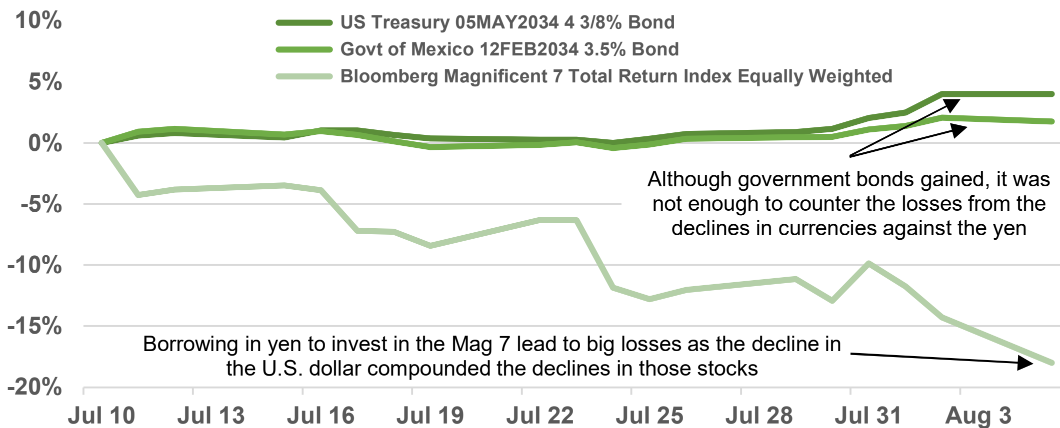


Source: Bloomberg Finance L.P. as of August 19, 2024

Finally, for fun, lets assume the hedge fund manager borrowed in Japan on July 10th and invested evenly in the Magnificent 7 stocks that have been catapulted by the AI enthusiasm over the last 21 months. In addition to the 10.8% drop of the U.S. dollar versus the yen, the total return of the Magnificent 7 portfolio from July 10th to August 5th was a decline of 18.0%.[6] Potentially lots of margin calls, and lots of selling to generate the cash needed to meet those calls.

Chart 3:

Relative Performance of Investments Since July 10



Source: Bloomberg Finance L.P. as of August 19, 2024

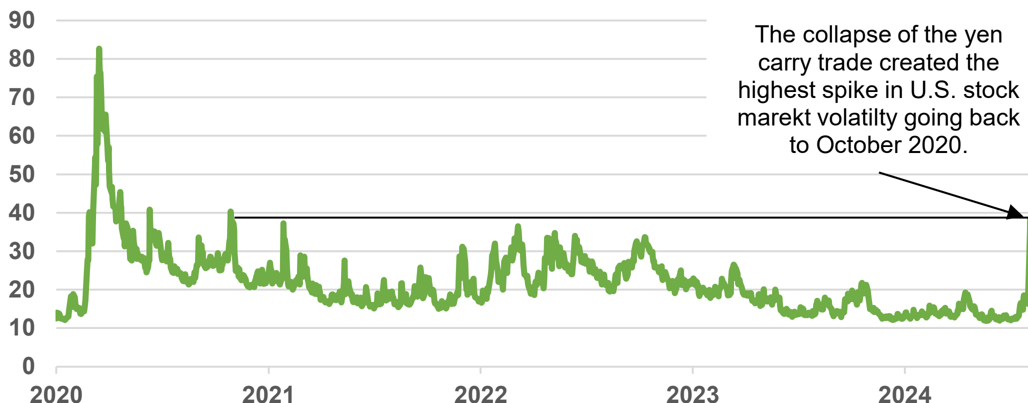
Very sudden spikes in the yen are not that common.

Could they become more common?

Thankfully, there has been a decent retracement in the prices of bonds and stocks since August 5th. However, we need to ask the question: Has something changed compared to the long stretches of time when the yen carry trade generally worked?

[6] Source: Bloomberg Finance L.P. as of August 19, 2024.

Chart 4:
Volatilty (VIX) Index



Source: Bloomberg Finance L.P. as of August 19, 2024

Well, it appears that something might be changing. Japan is beginning to feel inflationary pressures from increased manufacturing costs (higher prices for material inputs and for labour). For years, the Bank of Japan has fought against deflationary forces. Now, for the first time in decades, things have turned. In fact, Japanese consumers are getting so agitated by the presence of inflation that Prime Minister Fumio Kishida has decided to resign (Japan clearly has a low threshold for resignation compared to other countries!).

Surprise spikes in the yen could become more common if the Bank of Japan determines that higher interest rates are needed to combat imported inflation.

Inflation was the primary reason why the Bank of Japan felt that it had to increase interest rates in March by 0.25% for the first time since 2007. It then raised rates again by 0.25% on July 31st.[7]

And, bouts of imported inflation could become more common than in the last few decades as developed countries deal with deficit spending, higher wages and higher material prices compared to the pre-Covid era.

It should also be noted that Japanese inflation is being imported from the rest of developed world which has been tangling with above-target inflation for almost 3 ½ years now.[8] Inflation in Japan is not the result of excess domestic demand as Japanese consumers are grumbling about higher prices and have reigned in spending as a result.

In previous issues of the *Monthly Letter*, I have listed numerous factors that contribute to inflation which are likely to remain on the economic landscape for some time. As a result, there is still the potential for Japan to import more inflation. And, if that happens, what we saw at the beginning of August might be repeated.

[7] The Bank of Japan's base policy rate is called the Unsecured Overnight Call Rate and had been *negative* from January 2016 up to the 0.25% in March of this year!
[8] Generally, central banks in developed countries have set an inflation target of 2%.

Model Portfolio Update[9]

The Charter Group Balanced Portfolio
(A Pension-Style Portfolio)

	Target Allocation %	Change
Equities:		
Canadian Equities	12.0	None
U.S. Equities	38.0	None
International Equities	8.0	None
Fixed Income:		
Canadian Bonds	22.0	None
U.S. Bonds	6.0	None
Alternative Investments:		
Gold	8.0	None
Silver	1.0	None
Commodities & Agriculture	3.0	None
Cash	2.0	None

No changes to the securities or the asset allocations in the model portfolios since the beginning of July.

Despite the selloff at the beginning of August, all the asset classes used in the model portfolios are higher since the beginning of the summer.

The asset allocations and the securities in the model portfolios remained unchanged in July and through to mid-August.

At the end of July, most of the asset classes used in the construction of the model portfolios were positive for the month. All the asset classes declined over the first three days of August but have since recovered a significant portion of those declines. Extending back to the beginning of July, all of the asset classes have made gains and, accordingly, all those positive contributions have helped the model portfolios.

At the bottom of the selloff, the model portfolios had only given back about three weeks' worth of gains. We simply did not have much exposure to the areas that were the most vulnerable during the collapse of the yen carry trade discussed in the first section of this *Monthly Letter*.

[9] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of August 19, 2024. The asset allocations of individual clients invested in this Portfolio may differ because of the relative performance of the asset classes since the last rebalancing and because of differences in the timing of deposits and withdrawals. The Balanced Model Portfolio is part of a sequence of five portfolios ranging from conservative to aggressive: Conservative, Balanced Income, Balanced, Balanced Growth, and Growth.

The standout asset during July and the first few weeks of August was gold bullion. Prospects of U.S. interest rate cuts could potentially hurt the U.S. dollar and, since gold is denominated in U.S. dollars, this would result in a higher price (requiring more "devalued" dollars to buy an ounce of gold). The year-to-date increase in the gold price also likely reflects some inflation hedging demand in case the Consumer Price Index stays elevated. Even though interest rate cuts will help the price of gold, the market has been expecting them for about a year now. It doesn't make much sense for rate cuts to have more impact because they have been delayed. Personal and central bank hedging purchases of bullion likely explain the net gains in gold since last year.

Gold bullion continues to be the star performer.

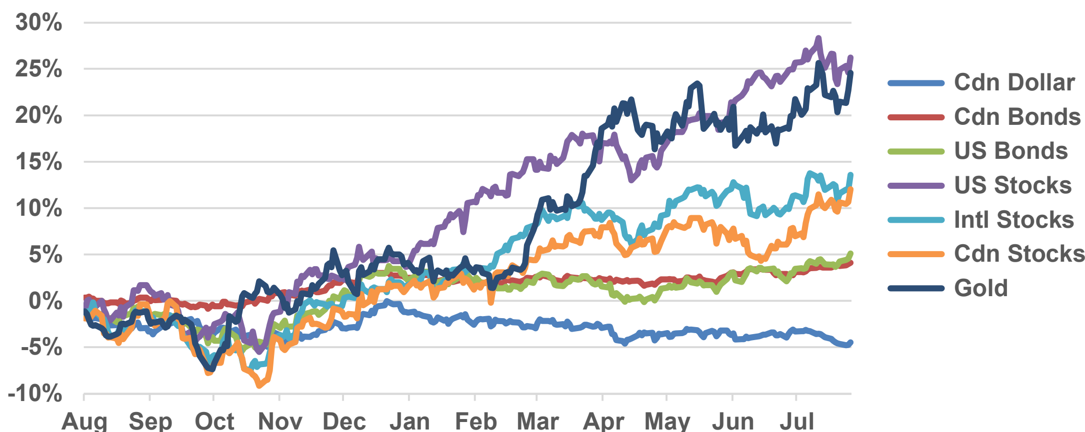
Looking forward, the U.S. presidential election is clearly on the horizon. Despite some market commentators recommending certain trading strategies for both potential outcomes, the fiscal and monetary conditions in the U.S. aren't likely to differ much regardless of who wins. Voters aren't demanding balanced budgets. My sense is that our model portfolio investment strategy that helped us navigate the last four years will be similar to the strategy that carries us forward irrespective of the election outcome. Companies that can manage costs well, have pricing power, and are not slaved to using debt will likely continue to be prominent in the portfolios. Companies that promise growth (ie: artificial intelligence) could get challenged during periods of deficit spending-induced volatility.

U.S. elections are unlikely to alter the trajectory of the U.S. economy or the rate of government spending. Thus, the portfolios won't likely see significant changes any time soon.

Below is the 12-month performance of the asset classes that we have used in the construction of The Charter Group's model portfolios. (**Chart 3**).[10]

Chart 5:

12-Month Performance of the Asset Classes (in Canadian dollars)



Source: Bloomberg Finance L.P. for the interval from August 1, 2023 to July 31, 2024

[10] Source: Bloomberg Finance L.P. – The Canadian dollar rate is the CAD/USD cross rate which is the amount of Canadian dollars per one U.S. dollar; Canadian bonds are represented by the current 3-year Government of Canada Bond; US bonds are represented by Barclays US Aggregate Bond Index; U.S. stocks are represented

Top Investment Issues[11]

Issue	Importance	Potential Impact
1. Global Geopolitics	Significant	Negative
2. Canadian Federal Industrial Policy	Moderate	Negative
5. Inflation (Portfolio Impact)	Moderate	Positive
3. China's Economic Growth	Moderate	Negative
4. Canadian Dollar Decline	Moderate	Positive
7. Short-term U.S. Interest Rates	Medium	Negative
6. U.S. Fiscal Spending Stimulus	Medium	Positive
8. Long-term U.S. Interest Rates	Medium	Negative
9. Global Trade Wars	Medium	Negative
10. Canada's Economic Growth	Light	Positive

by the S&P 500 Index; International stocks are represented by the MSCI EAFE Index; Canadian stocks are represented by the S&P/TSX 60 Composite Index; Gold is represented by the Gold to US Dollar spot price.

[11] This is a list of the issues that we currently deem to be the ten most important with respect to the potential impact on our model portfolios over the next 12 months. This is only a ranking of importance and potential impact and *not* an explicit forecast. The list is to illustrate where our attention is focused at the present time. If you would like an in-depth discussion as to the potential magnitude and direction of the issues potentially affecting the model portfolios, I encourage you to email me at mark.jasayko@td.com or call me directly on my mobile at 778-995-8872.

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The Charter Group is a wealth management team that specializes in discretionary investment management. For an annual fee, we manage model portfolios for private clients and institutions. All investment and asset allocation decisions for our model portfolios are made in our Langley, B.C. office. We do not outsource any of the decision-making for our model portfolios – there are no outside actively-managed products or funds. We strive to bring the best practices and the calibre of investment management normally seen in global financial centres directly to the Fraser Valley and are accountable for the results.

Accountability is further enhanced by the fact that we commit our own investable wealth to the same model portfolios in which our clients are invested.

The information contained herein is current as of August 19, 2024.

The information contained herein has been provided by Mark Jasayko, Senior Portfolio Manager and Senior Investment Advisor, TD Wealth Private Investment Advice, and is for information purposes only. The information has been drawn from sources believed to be reliable. Graphs and charts are used for illustrative purposes only and do not reflect future values or future performance of any investment. The information does not provide financial, legal, tax or investment advice. Particular investment, tax, or trading strategies should be evaluated relative to each individual's objectives and risk tolerance.

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Thank you to our clients and community for voting The Charter Group, your favorite for Investment Management and Financial Planning in Langley for the fourth year in a row.

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