Simple Foreign Currency Carry Trades

Foreign currency trades can become part of a decent recurrent diversified money market income strategy. Although either a hedged or unhedged carry trade can provide recurring income, they are subject to currency movements.

The basic carry trade strategies are:

Buy and hold – The US dollar investor buys an amount L in USD of a long yielding currency X and sells a low yielding one Y, at a cross currency exchange rate S_1 (ie. X/Y). The investor will invest the proceeds in the X currency at benchmark rate Rx for a given maturity. At the same time the investor will borrow the same amount in currency Y, paying Y's benchmark rate Ry for the same maturity. The maturity of this trade is usually for more than a month. At maturity, the proceeds of the long position are sold for currency Y, paying the total amount owed in Y for profit. For this trade to be profitable, $L^* S_2^*(1+ Rx) > L^*(1/ S_2)^*(1+ Ry)$, where S_2 is the cross currency exchange rate at maturity.

Tactical – Same carry trade but, the positions are placed and unwound on a short term basis (eg. on a daily), capturing daily positive carry income differentials.

Hedged – Same carry trade, but the exchange rate risk is reduced or eliminated altogether by hedging the cross currency exchange rate S at trade inception.

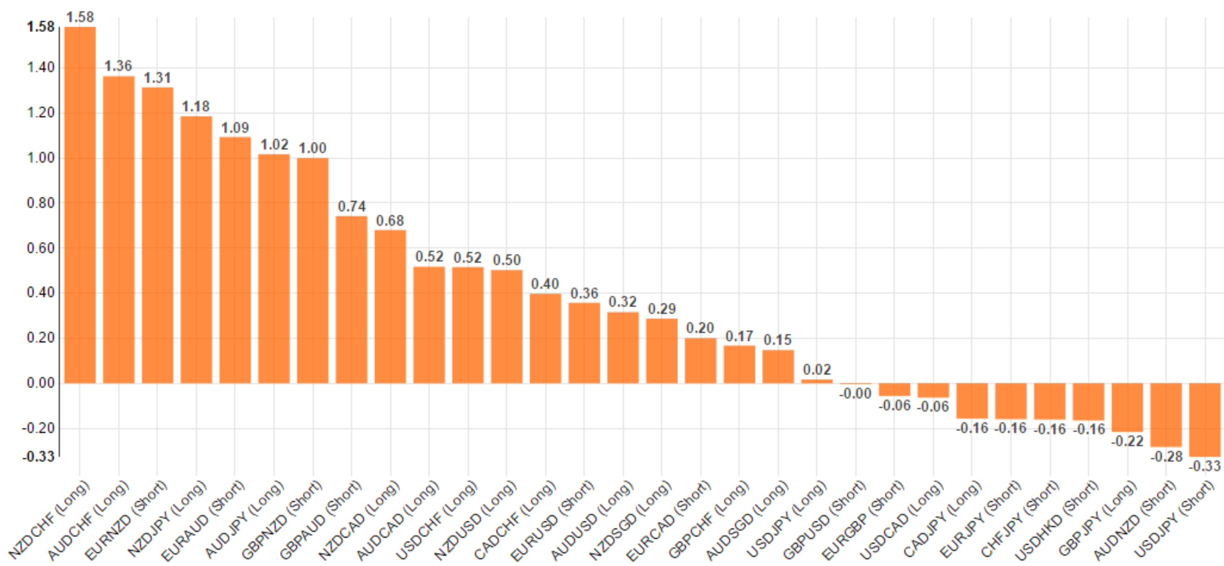
Just like when you lend or borrow from a high street bank, there's a fee to pay. This is called the interest rate margin or spread. The dealing bank(s) plus the broker all add their fees into the mix.
Most brokers do publicize their interest rate spreads on their websites. These are usually listed under rollover/swap charges.

The dealing bank will typically use an overnight rate such as Libor plus a spread to fix the interest amounts that are due. Bigger and more creditworthy brokers can demand a better rate. The arranging broker and intermediaries may then add their own mark-up as well. The difference between the long/short swap values is the rollover– or swap spread. This is your carry trading cost. This spread are related to a cross currency basis swap spread used by intermediary swap dealers in pricing longer term swap spread rates, in that in this case, these spreads are applied on a daily rollover swaps basis.

Looking at the following tables we could see that investor are better off taking daily exchange rate risk and "rolling spot" the long position in the highest yield currency by shorting the lowest yielding one. In this case buying $100k in NZD, investing the NZD in the daily benchmark rate and borrowing CHF paying the daily benchmark, plus/minus a spread.

When setting up a carry trade, interest yield differential is not the only factor to consider, especially if investors are planning on using a buy and hold strategy, as radical shifts in the pair exchange rate trends can significantly impact the profitability of this trade.

Currency Pairs Average Net Interest Yields
Yields ordered by currency pair and trade.



The table below shows the top carry trade opportunities at the present time (see full table).

Carry Trade		Broker Average		Highest Yield		Daily Income
NZDCHF	Long	1.58%	1.60%	Alpari	3.21%	$6.03
AUDCHF	Long	1.36%	1.54%	ETORO	2.53%	$5.20
EURNZD	Short	1.31%	1.19%	HOTFOREX	2.83%	$8.44
NZDJPY	Long	1.18%	1.10%	EASYFOREX	2.47%	$4.64
EURAUD	Short	1.09%	1.15%	NORDFX	2.26%	$6.74
AUDJPY	Long	1.02%	1.26%	NORDFX	2.62%	$5.37
GBPNZD	Short	1.00%	0.93%	HOTFOREX	2.81%	$9.95
As of: May 2017						

Source: Foxpro
The table above shows the net interest rate yields on the most liquid currency pairs. The “broker average” column shows the average yield and swap spreads across multiple brokers. The “highest yield” column lists the broker with the most attractive current yield/spread combination. The final columns, “daily income”, shows the potential daily income on 1 standard lot carry trade ($100k) using the best broker rate.

IB Forex CFDs*

		Balance Cutoffs (in Quote Currency)			Contract Interest Charged/Paid on Open CFD Positions		
Currency Pair	Position	Tier I	Tier II	Pair BM	Forex CFDs Below Tier I	Forex CFDs Between Tier I & II	Forex CFDs Above Tier II
AUD.CAD	Long/Short[1]	1300000	13000000	1.000%	0.000% / 2.000% (BM -/+ 1%)	0.250% / 1.750% (BM -/+ 0.75%)	0.500% / 1.500% (BM -/+ 0.5%)
AUD.CHF	Long/Short[1]	1000000	10000000	2.294%	1.294% / 3.294% (BM -/+ 1%)	1.544% / 3.044% (BM -/+ 0.75%)	1.794% / 2.794% (BM -/+ 0.5%)
AUD.CNH	Long/Short[1]	6500000	65000000	-0.120%	-1.620% / 1.380% (BM -/+ 1.5%)	-1.370% / 1.130% (BM -/+ 1.25%)	-1.120% / 0.880% (BM -/+ 1%)
AUD.HKD	Long/Short[1]	8000000	80000000	1.434%	-0.066% / 2.934% (BM -/+ 1.5%)	0.184% / 2.684% (BM -/+ 1.25%)	0.434% / 2.434% (BM -/+ 1%)
AUD.JPY	Long/Short[1]	110000000	1100000000	1.507%	0.507% / 2.507% (BM -/+ 1%)	0.757% / 2.257% (BM -/+ 0.75%)	1.007% / 2.007% (BM -/+ 0.5%)
AUD.NZD	Long/Short[1]	1300000	13000000	-0.250%	-1.250% / 0.750% (BM -/+ 1%)	-1.000% / 0.500% (BM -/+ 0.75%)	-0.750% / 0.250% (BM -/+ 0.5%)
AUD.SGD	Long/Short[1]	1300000	13000000	1.165%	0.165% / 2.165% (BM -/+ 1%)	0.415% / 1.915% (BM -/+ 0.75%)	0.665% / 1.665% (BM -/+ 0.5%)
AUD.USD	Long/Short[1]	1000000	10000000	0.813%	-0.187% / 1.813% (BM -/+ 1%)	0.063% / 1.563% (BM -/+ 0.75%)	0.313% / 1.313% (BM -/+ 0.5%)
AUD.ZAR	Long/Short[1]	14000000	140000000	-5.472%	-6.972% / -3.972% (BM -/+ 1.5%)	-6.722% / -4.222% (BM -/+ 1.25%)	-6.472% / -4.472% (BM -/+ 1%)
CAD.CHF	Long/Short[1]	1000000	10000000	1.294%	0.294% / 2.294% (BM -/+ 1%)	0.544% / 2.044% (BM -/+ 0.75%)	0.794% / 1.794% (BM -/+ 0.5%)
CAD.CNH	Long/Short[1]	6500000	65000000	-1.120%	-2.620% / 0.380% (BM -/+ 1.5%)	-2.370% / 0.130% (BM -/+ 1.25%)	-2.120% / -0.120% (BM -/+ 1%)
CAD.HKD	Long/Short[1]	8000000	80000000	0.434%	-1.066% / 1.934% (BM -/+ 1.5%)	-0.816% / 1.684% (BM -/+ 1.25%)	-0.566% / 1.434% (BM -/+ 1%)
CAD.JPY	Long/Short[1]	110000000	1100000000	0.507%	-0.493% / 1.507% (BM -/+ 1%)	-0.243% / 1.257% (BM -/+ 0.75%)	0.007% / 1.007% (BM -/+ 0.5%)
CHF.CNH	Long/Short[1]	6500000	65000000	-2.414%	-3.914% / -0.914% (BM -/+ 1.5%)	-3.664% / -1.164% (BM -/+ 1.25%)	-3.414% / -1.414% (BM -/+ 1%)

Source: Interactive Brokers

Hedged Carry Trades

Argentina's synthetic carry trade is a perfect example of market opportunities. 3mo. USDARG future is trading at around 18.6% premium to spot before fees and taxes. With a 90 days Lebac, trading around 22.50%, that means you're gaining a 3.9% and assuming a 1% commission, investors are left out with around a 3%pa trade on a 90 days hedged trade. Furthermore, if investors were to borrow 500K usd at 90 days, for example, at around 2%pa (depending on their brokers' spread commissions)*, they'd be netting around 1%pa in a 90 day carry trade arbitrage, which is a decent return, and since the Lebacs are issued in pesos by the argentine central bank, this investment assumes little sovereign and convertibility risk and comfortably be compared with a money market alternatives for those investors willing to maintain part of their short term portfolio locked up in offshore accounts.**

*based on Interactive Brokers spreads for 500k

**investors wishing to get exposure to this synthetic carry trade need to open a foreign account at an argentine registered brokerage or bank.

Dual Currency Deposit

These simple vanilla products have been around for at least two decades catering primarily to high net worth individuals and other more sophisticated institutional investors such as small hedge funds. However with proper risk management and monitoring can be positioned as part of a wider short term, money market portfolio.

Let's say for example, an investor is looking for a money market alternative to his/her 90day CD offer rate of 0.6% in USD for $100k. This investor can buy a 45day USD DCD linked to the Australian aussie (AUD) by depositing, for example US$ 100,000 and getting his/her USD 100,000 back at maturity plus US$125 (1%pa) interest return if the AUDUSD does not trade below a strike level of 0.7100. In case the AUDUSD at maturity is below at or below that level, the deposit amount will be converted at in AUD at the strike rate of 0.7100 with the interest credited in USD. So in this case, the investor would be buying AUD at 0.7100 at maturity regardless of where AUDUSD is trading below. Therefore, if at maturity the AUDUSD is trading at 0.7000 for example, the investor essentially lost US$1,400. Given the today's AUDUSD rate of 0.7459, if investors set the strike level conservatively, they will be reducing the chances of conversion and generate a significant pickup in yield on their money market funds.
In this popular product, investors are therefore selling the option from an out of the money level (ie. selling an OTM call in the principal currency (base) of the deposit by selling an OTM put in the exposure currency). Mostly the risk of the product is disregarded when depositors are focused on the total interest rate. (ie. deposit rate in base currency + option premium) On the other hand DCD products do not include any leverage so, in theory, the maximum investors can lose is the principal amount invested.

Currency Rate Exposure	: USD/AUD
Principal Amount	: USD 100,000
Tenor	: 1.5 Month
Deposit Rate	: 0.1%
Spot Rate	: 0.7463
DCD Level	: 0.7100
DCD Rate	: 1.01%
DCD Net Interest Amount	: US$ 125
Tax for deposit	: 25%

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