



Axel Botte
Head of Market Strategy
axel.botte@ostrum.com



Zouhoure Bousbih
Emerging countries strategist
zouhoure.bousbih@ostrum.com



Aline Goupil-Raguénès
Developed countries strategist
aline.goupil-raguenes@ostrum.com

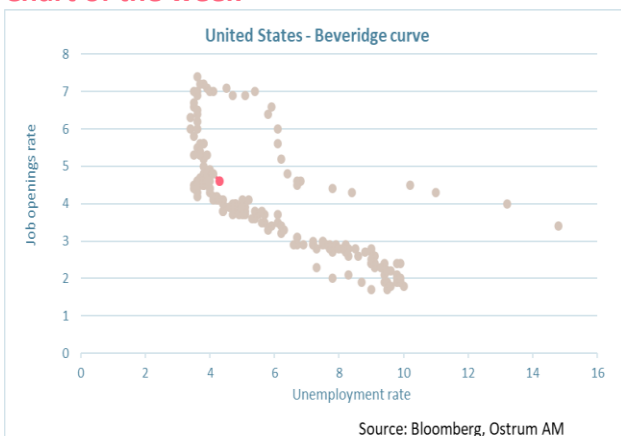
● **Topic of the week: August 5: Blame it on the carry trade?**
by **Zouhoure Bousbih**

- The volatility shock on August 5th was surprising in its speed and intensity;
- The peak of volatility at unusually high levels led to the unwinding of carry trade strategies, resulting in the appreciation of the yen;
- High-yield currencies, particularly the Mexican peso, were penalized;
- The foreign exchange swaps market facilitated carry trade strategies on the yen;
- These foreign exchange transactions are accounted for off-balance sheet, making it difficult to quantify the carry trade on the yen, estimated at 40 trillion yen by the BIS;
- The severity of the "sell-off" in global stock markets indicates that other factors also exacerbated the volatility, such as risk management through "Value at Risk" models and the increase in margin calls.

● **Market review: US job market to dictate market direction**
by **Axel Botte**

- US job growth at 142k in August, with unemployment ticking down to 4.2%;
- Fed policymakers seem to favor a 25 bp reduction in September;
- French OAT spreads below 70 bps after the nomination of Mr. Barnier as PM;
- Equities fell last week amid higher high yield spreads.

● **Chart of the week**



The US labor market is at the forefront of investors' concerns. The excess demand for labor following the COVID pandemic had made the relationship between the unemployment rate and job vacancies steep. The long-term relationship between the two variables is rather a decreasing one. The steepness the Beveridge curve is symptomatic of a labor market matching problem, linked to the mismatch between workers' hiring desires and the positions offered. The latest data for July seems to validate the idea of a normalization in which a reduction in labor demand would result in a simultaneous increase in unemployment.

● **Figure of the week**

16%

This is the decline in German industrial production since its peak in 2017. The contraction is most pronounced in the automotive and chemical sectors, penalized by the energy crisis. Germany heavily relied on Russian gas. Source: Destatis.

- **Topic of the week**

August 5th : Blame it on the carry trade?

The unwinding of the yen carry trade on August 5th took everyone by surprise due to its speed and intensity. This quickly raised questions about the scale of these strategies and their interactions with the global financial system.

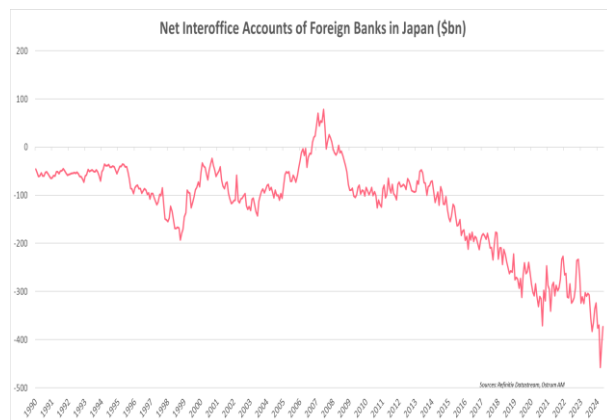
What is the carry trade?

The carry trade is a financial transaction in which one borrows in a low-interest currency to invest in higher-yielding financial assets. The most classic carry trade strategy involves borrowing in a low-interest currency to invest in another currency with a higher interest rate. The historically low interest rates in Japan have favored carry trades on the yen, which were extremely profitable under the Bank of Japan's (BoJ) "zero" interest rate monetary policy.

The actual scale of these carry trade strategies is difficult to estimate because unlike stock transactions, currency transactions are not centrally tracked. However, the Bank for International Settlements (BIS) estimates that the amount of cross-border loans in yen has increased significantly in recent years, reaching 40 trillion yen. These loans were made through the "inter-agency" accounts of foreign banks operating in Japan which played a significant role in the 2007 Subprime crisis.

Back to the future: The role of foreign banks during the 2007 subprime crisis

A significant portion of the carry trade was attributed to foreign banks operating in Japan, maintaining inter-agency relationships with their branches and subsidiaries in other countries. The graph below illustrates these inter-agency relationships by representing the "inter-agency" accounts.



These transactions could create negative or positive balances between different entities, reflecting financing needs and cash flows between banks. In the years leading up to the Subprime crisis, the net "inter-agency" accounts were typically negative, implying that foreign banks held a net long position on Japanese assets. This was linked to the attractiveness of Japanese financial assets, also known as the "Japanese premium," between 1997 and 1998, compared to other countries.

However, by 2005, the yen liabilities of foreign banks had significantly increased, leading

The BIS estimates the total amount of carry trade strategies involving the yen at 40 trillion yen.

The yen carry trade by foreign banks contributed to and exacerbated the 2007 Subprime crisis.

to unprecedented positive "inter-agency" accounts, nearly \$100 billion, as shown in the graph above. This means that foreign banks held a net short position on Japanese assets. These positions were heavily unwound in August 2007, coinciding with the early stages of the US credit crisis, and were further reduced as the credit crisis evolved in the second half of 2007 and in 2008 (according to "Yen Carry Trade and the Subprime Crisis," IMF, June 03, 2009, written by Masazumi Hattori and Hyun S Shin). In the recent period, the net "inter-agency" accounts are highly negative, not explaining the intense unwinding of the recent yen carry trade.

The importance of "Off-balance sheet": the crucial role of currency swaps

The BIS estimates that only 14 trillion yen (out of the estimated 40 trillion for the size of the yen carry trade) represents the amount of yen borrowing from "inter-agency" accounts. The rest is recorded in the "off-balance sheet." The foreign exchange swaps market has facilitated carry trade strategies.

The Crucial Role of the Foreign Exchange Swaps Market

A foreign exchange swap is an agreement between two parties to exchange equivalent amounts in two different currencies on an agreed date, and to exchange these amounts back on a later agreed date. Foreign exchange swaps are used to hedge currency risk or to speculate on exchange rate movements.

The foreign exchange swaps market also allows a company or a financial institution to borrow in a foreign currency without recording its transaction in traditional accounting standards but off-balance sheet. Most of the time, financial institutions borrow in dollars to invest in dollar-denominated assets. This is why during periods of high volatility, the foreign exchange swap basis widens.

The unusual movement of the FX swap basis during the recent volatility spike

The FX swap basis is an important indicator of dollar financing as it measures the cost for non-residents to borrow dollars offshore in exchange for their own currency. When the FX swap basis is negative, it means that the cost of financing in dollars is higher than the cost of financing in another currency.

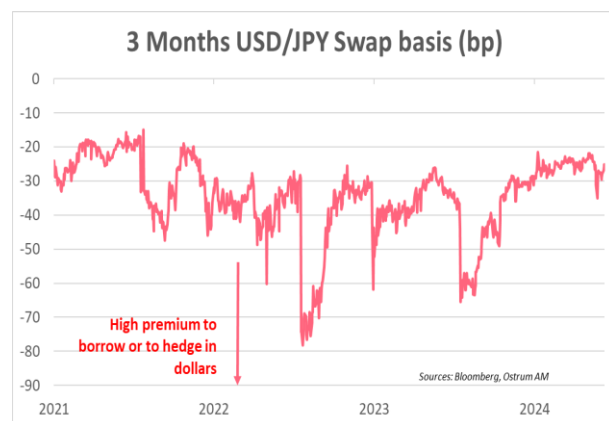
This can indicate a stronger demand for dollars and therefore a tightening of dollar financing conditions. The opposite graph shows the basis swap for the dollar-yen at 3 months.

The recent episode of volatility in the USD/JPY basis swap was brief and retraced over half of

the peak, moving from -35 bps to -25 bps. Operators in the offshore dollar funding market did not have difficulty finding dollars, in contrast to the previous liquidity episode in September 2023, where the 3-month USD/JPY basis swap reached nearly -70 bps. This is quite an atypical reaction in a financial stress context. Periods of high macroeconomic

The foreign exchange swaps market has facilitated carry trade on the yen.

The atypical movement of the FX swap basis during the recent financial stress does not indicate dysfunction in financial markets.



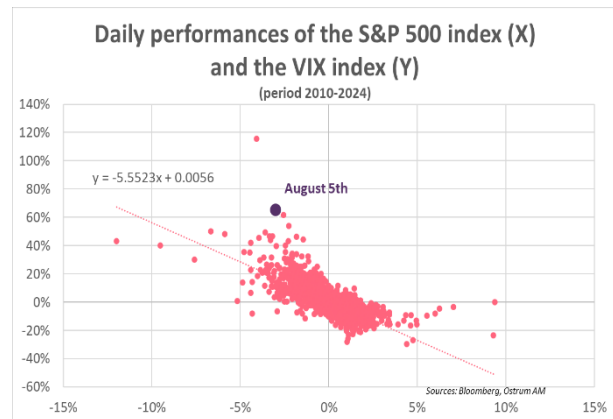
uncertainty generally lead to a surge in market volatility, making dollar funding markets very vulnerable. This was the case in March 2020, during the height of the Covid crisis, when a shortage of dollars forced the Fed to activate currency swaps with other central banks to ensure the smooth functioning of the international monetary system.

Review of the brief but intense volatility shock on August 5

An unusually high peak of volatility

The necessary and sufficient condition for profitable carry trade strategies is the absence of volatility. However, during the "sell-off" on August 5, the VIX increased quite unusually compared to the daily performance variation of the American S&P 500 stock index, as shown in the graph below.

At the end of February 2020, during the Covid crisis, the daily variation of the VIX was 46%, well below its variation of over 64% on August 5 for a similar performance of the S&P 500. This peak of volatility acted as a catalyst for the unwinding of carry trade strategies and also the "sell-off" in global stock markets.



Risk management related to "Value at Risk" models and the increase in margin calls exacerbated the volatility in financial markets.

Risk management, particularly "Value at Risk" rules and increased margin calls, also contributed to amplifying volatility and the decline in global stock markets. In the so-called "Value at Risk" models, volatility is a key element for assessing the potential loss of a portfolio of financial assets. The higher the volatility, the greater the risk of loss. Furthermore, when volatility is high, asset prices can fluctuate significantly and unpredictably. This can lead to significant losses for investors, especially those using leverage or operating on margin accounts. Brokers may then request margin calls from investors using leverage. Indeed, margin calls aim to ensure that investors have the necessary funds to cover potential losses due to market volatility. When volatility is high, brokers may be inclined to request additional funds to cover these risks

The unwinding of carry trade on the yen penalized high-yield currencies

The classic unwinding of carry trade penalized high-yield currencies such as the Mexican peso (MXN), which recorded the worst performance against the dollar of over -6% from August 1st to 5th. The yen (JPY) and the Swiss franc (CHF) appreciated the most against the dollar. We can also note the appreciation of Asian currencies such as the Malaysian ringgit (MYR) and the Chinese yuan (CNY), as well as the Swedish krona (SEK), which are not necessarily currencies used for financing these types of strategies.

The unwinding of the carry trade on the yen particularly penalized the Mexican peso, the highest-yielding currency (10.75%).

Conclusion

August 5, 2024 will be remembered. While the unwinding of carry trade strategies on the yen is primarily highlighted to explain the strong intensity of the "sell-off," other factors must also be considered. "Off-balance sheet" transactions via the foreign exchange swaps market facilitated carry trade strategies, making it difficult to quantitatively evaluate this practice. Risk management, such as "Value at Risk" models and the increase in margin calls, also contributed to exacerbating volatility. The ongoing evolution of financial markets requires continuous efforts to adapt to better identify the emergence of new risks.

Zouhoure Bousbih

- **Market review**

US job market to dictate market direction

Investors' attention remains focused on American employment, as it appears crucial for the pace of future Fed rate cuts. The steepening of the curve, the decline of the dollar and stocks reflect a scenario of significant weakening of activity that is spreading to European markets.

The economic scenario favored by market participants is a sharp slowdown in the US economy. Reassuring signals such as the latest GDP release (3% at annualized rate in Q2), service surveys, or the stability of layoffs seem to be disregarded by financial markets, which are always quick to anticipate central bank action. The ECB, which will likely opt for a 25 bp cut this week, will have to contend with the possibility of a 50 bp move at the upcoming FOMC meeting. In this context, the US yield curve continues to steepen beyond 5 years' maturities. Credit and sovereign spreads weathered the volatility of rate markets, but high yield and stocks are experiencing sell-offs. The restrictive stance of the BoJ points to further appreciation in the yen.

Activity is slowing in the United States, as indicated by the anecdotes gathered in the Fed's Beige Book. The manufacturing ISM is in contraction territory (47.2), and service surveys are mixed. Labor demand continues to normalize, almost linearly since 2022, resulting in a decrease in job openings to 7.6 million (July). The ability to create jobs has decreased, but labor reallocations between sectors seem to allow for an improvement in productivity (+2.5% in the 2nd quarter). Employment rose by 142k in August with a slight decline in the unemployment rate to 4.2%. In the euro area, GDP growth ultimately only reached 0.2% in the three months to June. Household consumption is still lacking despite disinflation and real wage increases.

The path for the Fed funds rate priced in by the markets (to 3% in September 2025) may seem excessive considering the Fed's current projections. Christopher Waller hinted at a 25 bp cut in September. The T-note yield decreases by 20 basis points to 3.70%. The steepening reflects both the expected easing and the long-term evolution of the public deficit. The Bund partially follows the T-note's rally (-12 bp). The German bond is trading at levels close to equilibrium (estimated at 2.24%). Swap spreads oscillate around 30 bp, their floor for 2024. Sovereign and credit spreads weathered interest rate volatility and the decline in risky assets. The spread on French OATs is trading at 70 bp after Michel Barnier's appointment as Prime Minister.

In the credit market, appetite for primary issuance (including AT1, real estate...) is fueled by steady inflows into credit mutual funds. However, the automotive and cyclical sectors are suffering. High yield is more volatile, but the absence of primary issuance and demand for the asset class limit the spread widening to 13 bp. Stocks lost nearly 3% last week, with cyclical stocks suffering due to concerns about activity in the US or China. European technology stocks lost 8%. Flows reversed after positive net equity fund inflows throughout the summer.

Axel Botte

● Main market indicators

G4 Government Bonds	09-Sep-24	1 wk (bp)	1m (bp)	2024 (bp)
EUR Bunds 2y	2.25%	-17	-13	-15
EUR Bunds 10y	2.22%	-12	-1	+19
EUR Bunds 2s10s	-3.9bp	+5	+13	+35
USD Treasuries 2y	3.69%	-23	-36	-56
USD Treasuries 10y	3.75%	-16	-19	-13
USD Treasuries 2s10s	5.2bp	+7	+17	+42
GBP Gilt 10y	3.92%	-14	-3	+38
JPY JGB 10y	0.9%	-1	-8	-44
€ Sovereign Spreads (10y)	09-Sep-24	1 wk (bp)	1m (bp)	2024 (bp)
France	72bp	+2	-1	+18
Italy	146bp	+2	+6	-22
Spain	83bp	+2	-1	-14
Inflation Break-evens (10y)	09-Sep-24	1 wk (bp)	1m (bp)	2024 (bp)
EUR 10y Inflation Swap	1.97%	-7	-7	-17
USD 10y Inflation Swap	2.27%	-10	-7	-13
GBP 10y Inflation Swap	3.46%	-1	-9	-8
EUR Credit Indices	09-Sep-24	1 wk (bp)	1m (bp)	2024 (bp)
EUR Corporate Credit OAS	118bp	+1	-6	-20
EUR Agencies OAS	65bp	+1	-4	-5
EUR Securitized - Covered OAS	61bp	+1	-4	-18
EUR Pan-European High Yield OAS	378bp	+18	-24	-21
EUR/USD CDS Indices 5y	09-Sep-24	1 wk (bp)	1m (bp)	2024 (bp)
iTraxx IG	56bp	+3	-6	-3
iTraxx Crossover	303bp	+14	-26	-11
CDX IG	53bp	+4	-5	-3
CDX High Yield	343bp	+21	-25	-13
Emerging Markets	09-Sep-24	1 wk (bp)	1m (bp)	2024 (bp)
JPM EMBI Global Div. Spread	388bp	+0	-34	+4
Currencies	09-Sep-24	1 wk (%)	1m (%)	2024 (%)
EUR/USD	\$1.104	-0.208	1.154	0.0
GBP/USD	\$1.309	-0.403	2.570	2.8
USD/JPY	JPY 144	2.221	2.075	-1.8
Commodity Futures	09-Sep-24	-1 wk (\$)	-1m (\$)	2024 (%)
Crude Brent	\$71.6	-\$5.9	-\$7.3	-4.9
Gold	\$2 497.4	-\$3.2	\$66.1	21.1
Equity Market Indices	09-Sep-24	-1 wk (%)	-1m (%)	2024 (%)
S&P 500	5 408	-3.28	1.20	13.4
EuroStoxx 50	4 783	-3.82	2.30	5.8
CAC 40	7 411	-3.07	1.95	-1.7
Nikkei 225	36 216	-6.42	3.40	8.2
Shanghai Composite	2 736	-2.65	-4.39	-8.0
VIX - Implied Volatility Index	20.94	39.60	2.80	68.2

Source: Bloomberg, Ostrum AM

Additional notes

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