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What is Carry Trade? The Relationship Between Interest Rates and Carry Trade

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Article Level: Advanced

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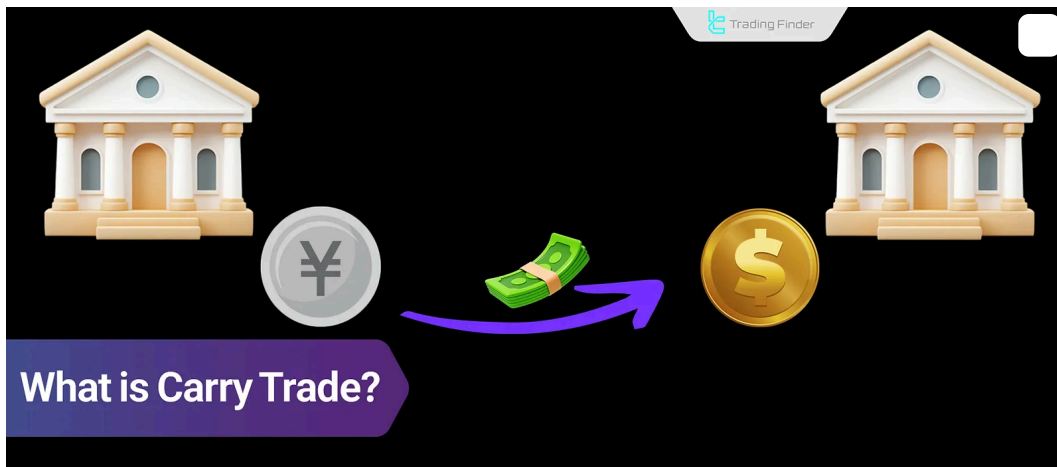
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Carry traders borrow a currency with a low interest rate and invest it in higher-yielding markets (e.g., bonds, gold, stocks, etc.).

This strategy **primarily applies to low-interest-rate currencies** (e.g., the Swiss franc and yen). Additionally, the capital flows of carry traders vary depending on **market sentiment**, **risk appetite**, and **risk aversion**.



Carry trade is a trading strategy based on fundamental analysis that uses interest rate differentials to generate low-risk profits.

What is the Carry Trade Strategy?

Carry trade is a trading strategy based on **fundamental analysis**. In this strategy, traders profit from the interest rate differential between the two economies. Specifically, they borrow from an economy with a low interest rate (e.g., Japan) and invest the funds in an economy with a higher interest rate.

By doing so, the interest on the borrowed funds from Japan is easily covered by the yield from the invested bonds, allowing the trader to earn a profit.

Advantages and Disadvantages of the Carry Trade Strategy

One key advantage of the **Carry Trade** strategy is earning low-risk profits in stable market conditions (low volatility and minimal uncertainty).

Advantages	Disadvantages		
		Low-risk profits from bond investments	Risk of interest rate fluctuations
		Profiting from currency appreciation	Sensitivity to market sentiment

Factors Influencing Carry Trade

Interest rate differentials are the core of the **Carry Trade** strategy. **Changes in interest rates** and central bank monetary policies significantly impact these trades.



Interest rate differentials, market sentiment, and central bank policies are key factors affecting carry trade

Key Factors Affecting Carry Trade:

- ⚡ **Interest rate differentials:** The greater the differential, the higher the potential profit;
- ⚡ **Market sentiment:** Since borrowed funds are invested in financial markets, **risk aversion** or **risk appetite** sentiment impacts carry trades;
- ⚡ **Monetary policy:** Central banks' **monetary policy stance** on interest rate changes influences market sentiment and, consequently, the **Carry Trade** strategy.

The Impact of Market Sentiment on Carry Trade and the Japanese Yen's Performance

Carry traders invest borrowed funds in high-yield financial markets. In other words, these trades increase during bullish markets and risk-on conditions as investors expect higher returns.

Conversely, carry traders are less motivated to borrow and invest in other markets during **economic recessions** and risk-off sentiment.

The Inverse Relationship Between the Yen and Global Investment Markets

Due to **capital flows from carry traders**, the **Japanese yen** often behaves **differently** from global markets. During **global market rallies**, the **yen weakens** because investors borrow and sell yen to buy higher-yielding, riskier assets.



The yen surged against the USD following Japan's rate hike and weak U.S. jobs data

As shown in the image, on July 31, 2024, two factors—**Japan's rate hike** and **weak U.S. jobs data** (fears of a recession)—triggered a **sharp decline in global markets** and a **strong yen rally**.

The Link Between the Japanese Yen and Carry Trade

Japan has maintained **significantly lower interest rates** than its peers for decades, making it an attractive funding source for carry traders.

Carry trades lead to **currency depreciation** because traders convert borrowed funds into the destination country's currency for investment.

For example, if you borrow yen to invest in U.S. bonds, you must **sell yen for USD**, creating **downward pressure on the yen**.



The yen's sharp depreciation against the USD from 2022 to 2024 due to interest rate differentials. Source: TradingView

The image shows the **yen's steep decline against the USD** in 2022, driven by **Fed rate hikes** and **borrowing cost disparities** between the two economies.

The Relationship Between the Yen and U.S. Bond Yields

The **US10Y index (U.S. 10-year bond yields)** correlates with the **USD/JPY** pair. Below are the key reasons for this correlation:



U.S. bond yields and USD/JPY are correlated due to their similar nature as safe-haven assets.

Key Reasons for the Correlation Between the Yen and U.S. Bond Yields:

- ⚡ **Safe-haven status:**The yen and bonds are safe-haven assets in recessions, demand rises, boosting bond prices (lowering yields), and strengthening the yen (pushing USD/JPY down);
- ⚡ **Carry traders:**Rising U.S. yields attract carry traders, leading them to selling yen. Rate hike expectations widen the yield gap, weakening the yen further.

Overall, the yen's trend is more influenced by **central bank interventions, global economic conditions,** and **Carry Trade** activity than economic data.

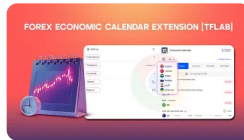
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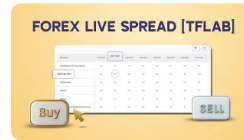
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Conclusion

The **Carry Trade** strategy capitalizes on interest rate differentials between two economies. Traders sell low-yielding currencies and invest in higher-yielding markets to profit from the spread.

Monitoring carry trade capital flows is crucial for analyzing the **forex market**, especially the yen. Market sentiment and global economic trends also significantly impact carry trade activity.

FAQs

What is the Carry Trade strategy? ▼

Carry trade is a fundamental trading strategy targeting currency interest rate differentials. Traders sell low-yielding currencies and invest in higher-yielding markets.

What factors influence Carry Trade? ▼

Interest rate differentials, central bank policies, and expectations of future rate changes affect this strategy.

How does market sentiment impact carry traders? ▼

During bullish markets and risk-on sentiment, carry trades increase as investors seek higher returns. Low-yielding currencies may weaken as traders sell them to invest elsewhere.



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Factors Influencing Carry Trade



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Conclusion

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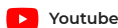
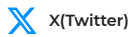


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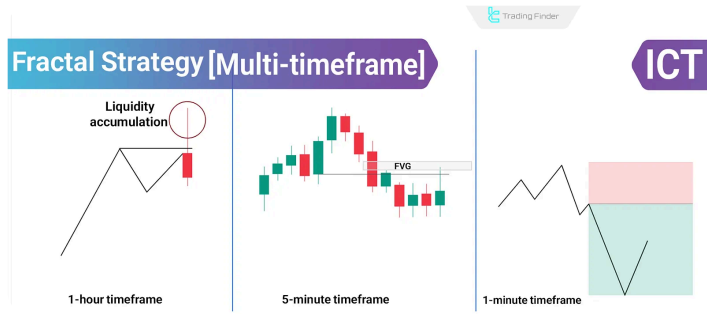
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