New Minerva Report

A Right Carry On

Readers will recall that back in March we warned about the amount of money that was being borrowed at the low short term US interest rates and then invested on longer term interest rates for a profit. What we were not sure about was how much the investing had spread into other assets. The term given to this borrowing and investing is 'Carry Trade'. It is now fairly certain that the investment side had not been confined to just longer term US fixed interest. It had spread into virtually every financial asset. This can be seen by the way that, with the fear of rising interest rate, we saw a fall in fixed interest, equities, commodities and currencies. The largest falls were in the more speculative areas. It seems that money was being borrowed to invest into just about everything. What is not clear is the extent to which this has unwound. From the front page one can see that there are arguments for quite a large rise in US interest rates. But the Fed is not stupid. It has been trying to engineer some level of inflation, just like the Bank of Japan. The Fed does not want to get caught in the deflationary trap that has had Japan in its grip for the last 12 years.

We think that much of the excesses in speculative trade have been unwound. That is where money was invested into Asian equity markets and into speculative junk bonds. What is not clear is the amount that has unwound where it is in less risky markets. Think of the interest rate differentials. The ten year US Treasury bonds have seen their yield rise to over 4.6%. Even if the Fed raised rates by 2% by the end of the year, which seems unlikely, There is still a gain to made in the 'Carry Trade'.

There is another problem that the Fed has. It does not know the impact that the price rise in oil is likely to have on the economy. As we have said in the past, a rise in oil price is like a tax on economic growth. That means that it will slow economic growth down. The Fed does not want to produce a double whammy on the economy by raising rates at the same time that oil is putting downward pressure on the economy. The other impact that the price of oil has on the economy is that it increases inflationary pressures. This creates an opposite reaction from the Fed to the one that forestalls an increase in rates because of economic fragility. Finally, just to compound the uncertainties surrounding the need for an interest rate move, the level of the US dollar is effected by interest rate expectations. Going back a couple of weeks when everyone was expecting interest rates to rise in the US, the dollar started to strengthen against other currencies. Part of this could be explained by the unwinding of the 'carry trade', but the size of the foreign exchange markets means that it was the expectation of rising interest rates that was attracting monies into the dollar.

It is our view that the world economy is currently going through a cyclical inflationary pick-up at the same time as it remains in a secular deflationary era. It was only a year ago when markets were worried about deflation. Now it is worried about inflation. We think that this time next year it will be more worried about deflation again rather than inflation. It will probably be several years before we really have to worry about inflation. That will be when governments start to try and induce inflation to whittle away the level of debt that has been accumulated. One reason for our 'deflation' view is the capacity that has been building up in China is deflationary. The cost of building that capacity may well have been inflationary but once that capacity starts to produce it becomes deflationary.

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