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 Jim Caron
 Derivatives Strategist
 MLPF&S
 (1) 212 449-5647
 Karen Kostanian
 MLPF&S
 Derivatives Strategist

Derivatives

Cross-Market Relative Value

Rising ¥ Short Rates May Catalyze an Unwind to Yen-Carry Trades Which Could Put Upward Pressure on US Rates

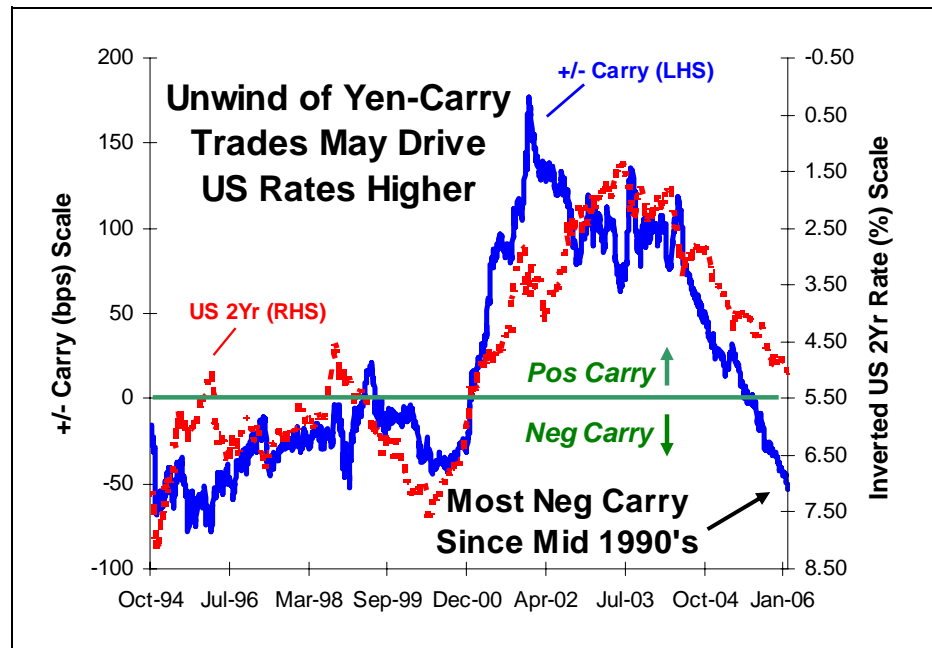
Global

Cross-Market Relative Value

US rates are vulnerable to a significant rise upon an unwind of long-term and structural yen-carry trades. It is negative carry to own US 2Yr rates vs. ¥2Yr by ~52bps over a 1-year period. That is as negative carry as it has been since the mid 1990's and makes for an unappealing breakeven spread to hold this trade. It is also interesting to note that the negative 'carry' imbedded in this structure explains 70% of the rise in US rate levels ($R^2=70\%$).

Rising ¥ short rates may catalyze an unwind to long held macro yen-carry trade positions which can define a trading flow that puts upward pressure on US rates.

Chart 1: Carry is Shown as Difference Between 1-Year Forward (US 2Yr – ¥2Yr Swap Rates) vs. Spot (US 2Yr – ¥2Yr Swap Rates). Neg Carry in this Trade Argues for Higher US Rates.



Source: Merrill Lynch, MLX Website

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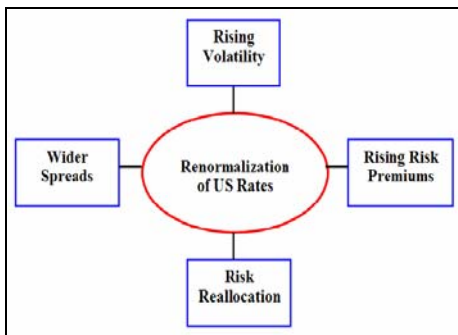
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The Tipping Point: Unwinding the Yen-Carry Trade – Impact on US Rates

■ Summary: Risk Reallocation & Unwind of Yen-Carry Trades to Contribute to Higher US Rate Structure

Figure 1: Schematic Risk Flow for 2006... Risk Reallocation May Drive US Rates Higher



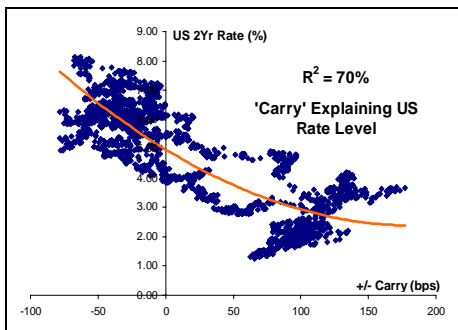
Source: Merrill Lynch, Bloomberg

US rates are vulnerable to a significant rise upon an unwind of yen-carry trades. For many years it has been advantageous to borrow ¥ at low Japanese interest rates, convert yen to dollars and then invest in higher yielding UST's – this is called the yen-carry trade. This trade has taken on many forms from real money to leveraged investors. However, the flows from Asia that have dominated this trade may reverse due to the high degree of negative carry now associated with this trade, which may contribute to pushing US rates higher (Chart 1). The Asia based investor now has better alternatives to earn carry as their rate structure rises. This is consistent with our macro themes of risk reallocation that is expected to 'renormalize' the level of US rates (Figure 1).

■ Getting 'Carried' Away

It is negative carry to own US 2Yr rates vs. ¥2Yr by ~52bps over a 1-year period. This is the case even though US 2Yr spot rates are 455bps higher than ¥ rates because the US curve is so flat vs. a much steeper ¥ term structure. In addition, ¥ forward rates are moving much faster than US forward rates which also makes for a greater breakeven hurdle in this yen-carry trade structure.

Chart 2: The 'Carry' in the Yen-Carry Trade Explains 70% of US 2Yr Rate Levels

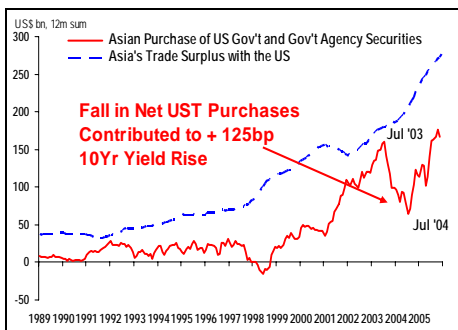


Source: Merrill Lynch, MLX; Regression since 1994

To put some historical precedent on it, a 52bp negative carry hurdle to the yen-carry structure is as big as it has been since the mid 1990's (Chart 1). This structure was positive carry from 2001 – mid 2005 which attracted investors, both fast money and macro, to this trade. Some short-term investors may have already unwound this position but longer-term macro investors may not have because this trade only became meaningfully negative carry in 4Q05. That is when it became clearer that rising inflation in Japan may cause the BoJ to hike rates sooner rather than later. This may define a steady flow of selling and contribute to upward pressure on US rates.

The cost of carry between US and ¥ rates provides an interesting relationship to its explanatory powers of the level of US 2Yr rates with an $R^2 = 70\%$ (Chart 2). Negative carry in this structure appears to contribute to higher US rates. It is well known that flows from Asia have been a dominant theme in determining the level of the US rates market. Thus to capture potential factors that might influence flows from Asia, such as from the yen-carry trade, are nonetheless important. In Chart 3 we keep track of net UST purchases from Asia and illustrate how a fall in those purchases can contribute to upward pressure on bond yields.

Chart 3: Net UST Purchases from Asia are Important Determinants to US Rate Levels



Source: Merrill Lynch, Hong Kong Economics Team

■ Conclusion & Trade Ideas

There are many factors that drive the performance of the yen-carry trade such as monetary policy and foreign exchange to name a few. The 'carry' aspect of this trade is also quite important because it determines the breakeven level in the spread between US and ¥ rates. In general, this could put upward pressure on US rates due to selling pressure from unwinding structural yen-carry trades.

As a result, we recommend considering the following trades:

1. Exiting yen-carry trades as we believe the negative carry associated with this trade generates unappealing breakeven spreads.
2. Selling ¥ 1Y-2Yr payers vs. buying US 1Y-2Y payers. ¥ vol is historically rich relative to US vol. The ratio of US/¥ implied vols is 1.5 which has been higher 99% of the time over the past 5-years.

View the MLX website to see our Cross Rates & Cross Rate Volatility reports for more details: <https://www.mlx.ml.com/debt/bin/prodPage.asp?pageid=65>.

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