Liquid Insight

Carry trades after the first rate cut

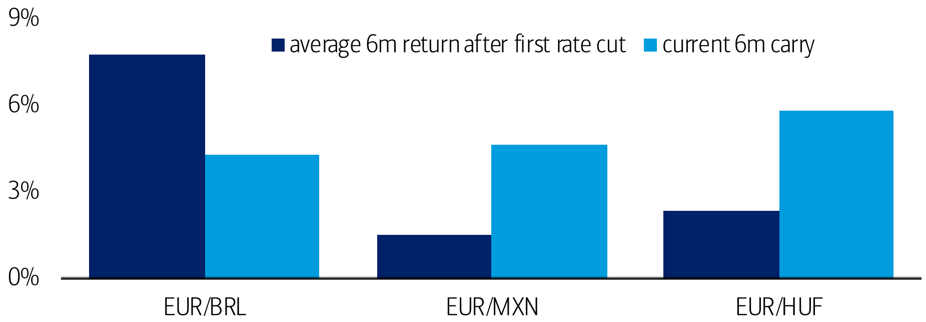
Key takeaways

- Among popular EMFX carry trades this year, historical EM central bank rate cut analogs see BRL more at risk than MXN and HUF.
- We are more optimistic on BRL and more cautious on MXN this year vs historical analogs.
- Within G10 FX, we see shrinking carry to be more bearish USDJPY only in 2024.

By Howard Du, Vadim Iaralov, Antonio Gabriel, and Christian Gonzalez

Chart of the Day: Among the top carry FX trades in 2023, historical analogs suggest EUR/BRL has higher risk of unwinding after first BCB rate cut

Avg historical 6m EUR/FX return after first EM central bank rate cut vs current forwards-implied 6m carry



Source: BofA Global Research, Bloomberg. Due to data availability, the analysis was from 1999-2023 for EUR/BRL, from 2008-2023 for EUR/MXN, and from 2004-2023 for EUR/HUF.

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What happens to carry after central banks cut rates

Long BRL, MXN, and HUF vs EUR have been some of the popular FX carry trades since 2021. With the market now expecting several EM centra banks to cut rates in 2023, we examine historical FX price actions for BRL, MXN, and HUF vs EUR when each EM central bank first cuts rates after a rate hike cycle. Historical analogs see BRL more at risk than MXN and HUF. The historical average 6m loss after first rate cut for MXN and HUF would still be well-contained by the current level of carry, but not for BRL (Chart of the Day). For this year, we are more optimistic on BRL than in the past, partly due to supportive real rate and fiscal upside. To the contrary, MXN carry unwind in this cycle could turn out to be worse than in the past, due to overcrowded position and MXN's sensitivity to US-originated risk-off shocks. Investors may consider owning relatively cheap 1y EUR/BRL skew as hedge, in our view. Within G10 FX, we expect shrinking carry to become bearish USDJPY only in 2024 when the Fed rate cuts begins.

Refer to important disclosures on page 7 to 9.

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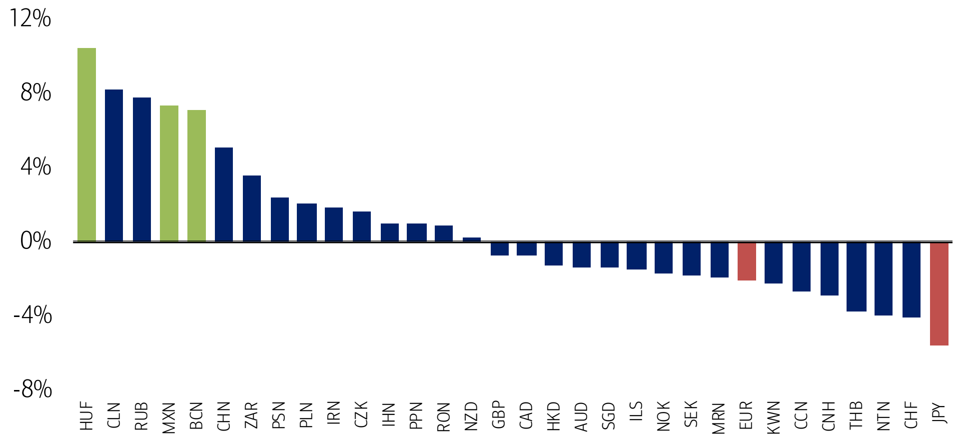
Two ends of the global carry spectrum

Global central banks have been aggressively hiking policy rates over the past two years, but at a different pace and reaching different terminal levels. Many investors are now taking advantage of the widened FX carry with long HUF, MXN, and BRL positions (Exhibit 1), given high yields and relative economic stability for these currencies. At the other end of the spectrum, EUR has been the main funding currency for long EM FX positions, largely due to better liquidity for EUR-pairs. Within liquid G10 space, USDJPY would have the widest rate differential. Although carry trades, particularly in EM are becoming more crowded, falling FX vol and benign skew can offer cheap hedges in case of rapid positioning unwind.

Exhibit 1: HUF, MXN, and BRL have some of the highest carry returns, while JPY has the worst carry among major global FX

Latest annualized 3m carry vs USD



Source: BofA Global Research, Bloomberg

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What historically happened after the first EM central bank rate cut

As policy rates reached peak levels for many EM central banks this year and domestic inflations show cooling signs, investors are starting to focus on the timing of rate cuts (What's priced in, 14 May 2023). Carry return naturally shrinks after EM central banks lower policy rate, but the effect on FX is less obvious. In this note, we examine historical FX price actions for BRL, MXN, and HUF against the EUR when each EM central bank first cut rates after a rate hike cycle.

Exhibit 2: FX correlation to EM central bank policy rate is generally negative but MXN is the exception

EUR/FX correlation to EM central bank policy rates

	FX correlation to local CB policy rate	FX correlation to policy rate differential (ECB vs. local CB)
EUR/BRL	-49%	-41%
EUR/MXN	16%	33%
EUR/HUF	-84%	-77%

Source: BofA Global Research, Bloomberg. Due to data availability, the analysis was from 1999-2023 for EUR/BRL, from 2008-2023 for EUR/MXN, and from 2004-2023 for EUR/HUF.

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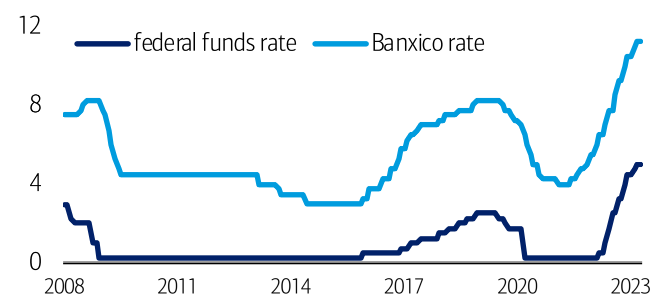
Exhibit 3: Banxico policy rate historically has tracked federal funds rate with a long-term correlation of 88%

Historical federal funds rate and Banxico policy rate



Source: BofA Global Research, Bloomberg. Due to data availability, the analysis was from 1999-2023 for EUR/BRL, from 2008-2023 for EUR/MXN, and from 2004-2023 for EUR/HUF.

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Historical rate cuts suggest BRL longs more at risk than MXN and HUF positions

We first ran a simple correlation between the three EUR/EM pairs against the respective policy rate of each EM central bank, as well as against each EM central bank's policy rate differential vs the ECB. The correlation appears to be negative for EUR/BRL and EUR/HUF and positive for EUR/MXN (Exhibit 2). The result implies when the BCB or NBH cut rates, EUR/BRL and EUR/HUF tend to rally, but EUR/MXN tends to depreciate when the Banxico cuts rates. The result may appear surprising at first glance. However, it should be noted that the historical policy rate for Banxico has tracked the federal funds rate closely with an 88% correlation (Exhibit 3). So because the Federal Reserves would also cut rates when Banxico was cutting, global financial conditions in fact would ease and become more supportive for an EM currency like MXN.

Exhibit 4 shows when EM central banks conducted the first rate cut after a hiking cycle in the past, the local currencies tend to weaken vs the EUR over the next 6 months, but at varying magnitude. Both average and median returns from historical analogs suggest among these three EM currencies, the BRL may see sharper depreciation after the first BCB rate cut (Exhibit 4). The average 6m loss after first rate cut for MXN and HUF would still be well-contained by the current level of carry, but not for BRL (see Chart of the Day).

Options offer a cheap hedge in EUR/BRL skew

Historically, EUR/BRL skew would widen more than EUR/MXN skew during shocks and ensuing cutting cycles (Exhibit 5). Given current EUR/BRL skew is more than 10% below EUR/MXN, the entry level is attractive for investors to pick up EUR/BRL skew to hedge for potential BRL weakness after the first BCB rate cut, in our view.

Exhibit 4: EUR/EM tend to broadly rally after first EM central bank rate cut, with BRL weakening the most in the past

EUR/FX 6m return statistics after first EM central bank rate cut

	average 6m return	median 6m return	6m return % up
EUR/BRL	8%	7%	62%
EUR/MXN	2%	1%	67%
EUR/HUF	2%	2%	70%

Source: BofA Global Research, Bloomberg. Due to data availability, the analysis was from 1999-2023 for EUR/BRL, from 2008-2023 for EUR/MXN, and from 2004-2023 for EUR/HUF.

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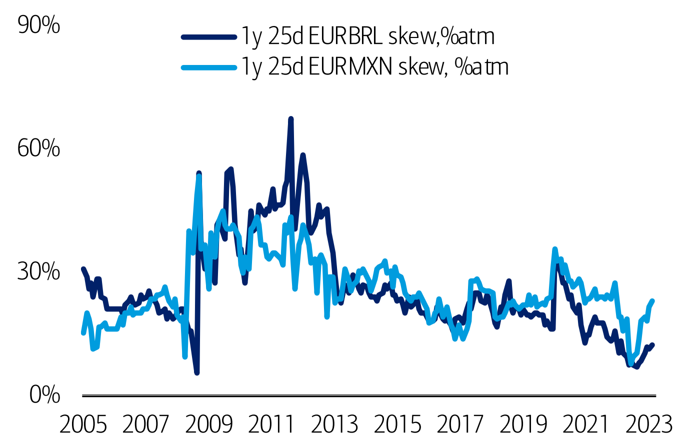
Exhibit 5: Current 1y EURBRL skew is cheap relative to EURMXN skew

EURBRL skew had historically widened by more during cutting cycles



Source: BofA Global Research, Bloomberg

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BRL likely to remain resilient despite BCB rate cuts in 2023

In Brazil, fiscal risks took center stage since Lula's runoff election victory. An initial push to remove social spending from the spending cap led to the eventual ditching of the spending cap. Coupled with the administration's rhetoric for unorthodox policies, including directed credit, were the main triggers for Brazil's selloff earlier this year.

More recently, the news flow has been more supportive. The fiscal framework unveiled by the administration was, even if imperfect, better than expected. Furthermore, positive changes have been introduced before the vote in the Lower House next week. These include removing certain spending exceptions in the original bill, as well as strengthening the enforcement for compliance with fiscal targets.

Additionally, while the government certainly exhibits a preference towards a more interventionist policy mix, this has been mostly noise so far. At the same time, tensions between the BCB and the government around the inflation target have significantly cooled from their peak. And while uncertainty still lingers, the balance of risks has tilted towards a more benign scenario, which could potentially involve minor modifications to the framework, like moving it to a 12-month rolling horizon while keeping the numerical target and the band unchanged. Also on the BCB front, we believe the decision to appoint Galipolo to the BCB board should be read as marginally positive news, since it rules out tail risk scenarios, and signals some moderation from within the government.

In Brazil, monetary policy cycles do not tend to be heavily synchronized with the US, which historically has led to somewhat sizable depreciations around easing cycles as the rate spread shrinked. However, despite the rate cuts that we currently see as starting in August, we expect BRL to be more resilient this time, supported by still high real rates, some further upside remaining on the fiscal side, and a potentially virtuous resolution of the inflation target saga. However, the recent BRL rally, which led BRL closer to its fair value, has limited upside for long positions, in our view.

Remain cautious about MXN despite attractive carry

The recent outperformance of the Mexican peso (MXN) has been supported by Mexico's tight monetary and fiscal policy, a narrow current account balance on the back of strong remittances, low policy uncertainty relative to the rest of the region, as well as the positive sentiment driven by the nearshoring narrative. However, in our view, the main driver of MXN strength has been the market's perception that carry-to-vol remains attractive.

Historically, MXN has a low sensitivity to easing cycles given that domestic monetary policy is usually heavily correlated with US monetary policy. In that sense, MXN carry tends to be particularly resilient, which helps limit peso depreciation when monetary policy eases. This has increased the market's perception that MXN is an attractive carry trade.

However, we believe it could be misleading to focus on MXN's high carry-to-vol ratio. In our view, carry-to-vol is not as attractive if we condition on the fact that the probability of an adverse global backdrop is currently high. As observed during the short-lived US banking turmoil over the past few months, the Mexican peso remains highly vulnerable to global risk-off shocks. We are particularly concerned about the potential impact of a deeper-than-expected US recession on the MXN. In such a scenario, MXN could be directly hit by the risk-off shock, the current account could widen due to slowing remittances, and carry could decline as Banxico cuts rates from the widest spread it has had against the Fed in recent history. Finally, heavy long MXN positioning could amplify the impact.

Therefore, we remain cautious about MXN exposure despite the high carry. In our view, risk-reward of long MXN positions is not attractive as volatility would like rise vs what the market currently prices. Finally, we believe that current valuation seems stretched. The Mexican peso is the strongest it has been in real terms since 2008, which in our view is inconsistent with Mexico's deteriorating productivity.

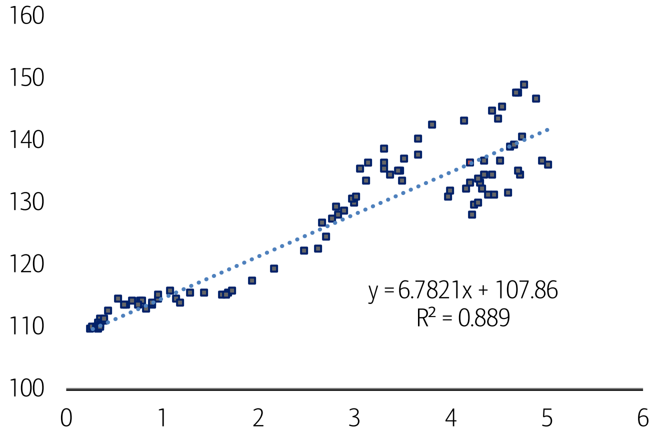
More material JPY rally to take place once the Fed also starts cutting in 2024

Within the liquid G10 space, while USDJPY now has an annualized carry of more than 5%, carry trade demand for this pair has been more muted due to elevated uncertainty with BoJ monetary policy. Regressing USDJPY spot vs 2y US-JP rate differential since the Fed turned more hawkish in June 2021 shows the JPY as fairly valued (Exhibit 6). We maintain a bearish JPY view vs the USD for rest of 2023 and expect the carry factor to be against the JPY as long as the Fed keeps a hawkish guidance and holds the federal funds rate at current level.

Performing the same USDJPY vs rate differential regression but covering an entire rate cycle since 2019 (federal funds rate last peaked in Dec 2018) would suggest JPY as cheap vs interest rate differential (Exhibit 7). We would expect more material JPY rally to occur in 2024, given we see the first Fed rate cut to take place in Q1 2024 (US Economic Weekly: 05 May 2023). Our official forecast is for USDJPY to rise to 140 by year-end 2023, before falling to 125 by year-end 2024 (Global FX weekly: 05 May 2023). The risk to our bearish JPY view for this year is an earlier than expect Fed rate cut or BoJ entering a proper rate hiking cycle in 2023.

Exhibit 6: JPY appears to be fairly valued vs rate differential at a 2y lookback

2y US-JP rate differential vs USDJPY since June 2021



Source: BofA Global Research, Bloomberg. Chart plots rate differential along the x-axis and USDJPY along the y-axis.

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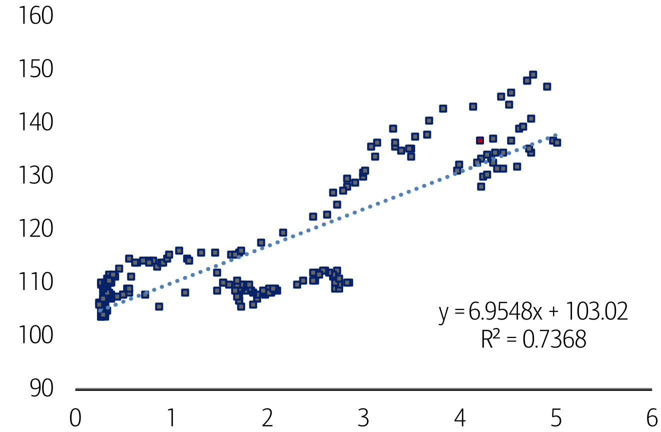
Exhibit 7: But looking at USDJPY vs rate differential for a whole cycle would suggest JPY is still cheap vs US-JP rate differential

2y US-JP rate differential vs USDJPY since Jan 2019



Source: BofA Global Research, Bloomberg. Chart plots rate differential along the x-axis and USDJPY along the y-axis.

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List of acronyms used in this publication

EM: emerging markets

CB: central banks

ECB: European Central Bank

NBH: National Bank of Hungary

BCB: Central Bank of Brazil

BoJ: Bank of Japan

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 – Year Ahead 2023: Pivot ≠ Peak**, 20 Nov 2022
- What to expect when pausing, **Global FX Weekly**, 12 May 2023
- The long and short of it**, Global Rates Weekly**, 12 May 2023
- Corporates buying USD/Asia FX, **Liquid Cross Border Flows**, 9 May 2023

Rates, FX & EM trades for 2023

For a complete list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, see the reports below:

Global FX Weekly: What to expect when pausing 12 May 2023

Global Rates Weekly: The long and short of it 12 May 2023

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