Market Watch

Time to reduce FX risk

Summary

Event: FX 'carry trades', borrowing in low interest rate currencies (CHF, JPY) to buy higher yielding assets, are popular. However, recent events show they remain susceptible to (i) volatility, driven by safe-haven demand, and (ii) a reversal if the USD weakens.

Market reaction: Since 2 April, the CHF has gained over 7% against the USD while the JPY has gained 4.5%. The USD index is testing the bottom of its range since late 2022.

Investment strategy: Risk management is likely to be key to the outlook for FX carry trades in today's unusually uncertain environment. (i) Diversifying funding currencies, and (ii) limiting the magnitude of cross-currency risk are two strategies that can help.

Understanding FX 'carry trades'

What is a carry trade in currency markets?

An FX 'carry trade' is used to describe a strategy where investors borrow in a currency with low interest rates and invest proceeds in a currency with higher interest rates.

Such a strategy delivers the sum of two returns: (i) the gap in interest rates and (ii) the underlying currency pair price movement.

For example, one popular carry trade in the early 2000s was to borrow in JPY (where borrowing costs were almost zero) and invest in the AUD (where borrowing costs were high). This carry trade remained profitable for about 7 years until the 2008 crisis caused a sharp decline in the AUD/JPY pair.

Do FX carry trades follow similar patterns through history?

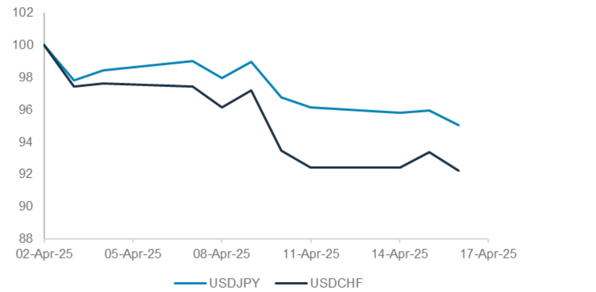
Studies on the topic show that cross currency carry trades tend to follow a common pattern – a long period of small, but consistent, returns, followed by a sharp loss at the end. The AUD/JPY pair is one of the more dramatic examples in history. This pair saw a consistent uptrend from Sep 2001 to July 2008, supported by both the interest rate differential and a rise in the currency pair. However, it gave up almost all these gains over Jul-Oct 2008 amid the 2008 crisis.

Carry trades have not been the exclusive preserve of institutional investors trading in liquid currency markets. In the mid-2000s, many home mortgages in Poland were converted from Polish Zloty to Swiss Franc, aiming to benefit from lower CHF borrowing costs. However, CHF strength against the Zloty eventually resulted in significant losses that outweighed the interest rate savings.

While many other carry trades were less dramatic and were usually profitable over the full period, history suggests the risk of a loss from a sharp reversal in currencies rises the longer a carry trade persists.

CHF and JPY, popular sources of funding today given their low rates, strengthened sharply in April

USD/CHF and USD/JPY returns since 2-Apr-2025



Source: Bloomberg, Standard Chartered

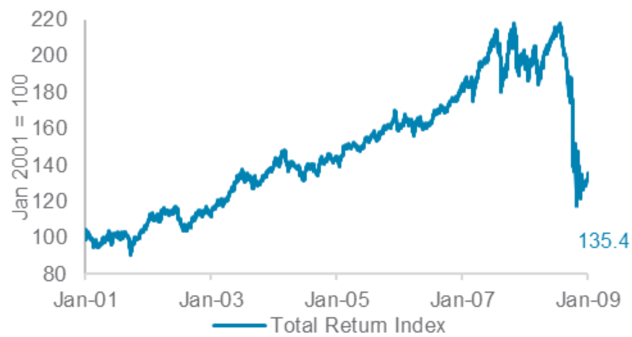
USD breaching the bottom of its range since 2022 amid fears trade wars could lead to fund outflows

USD Index (DXY)

Source: Standard Chartered

AUD/JPY is a dramatic example of risks in carry trade; it sharply reversed 7 years of gains in 2008

AUD/JPY



Source: Bloomberg, Standard Chartered

What does this mean for investors?

Which currencies have been attractive sources of funding in recent years?

In recent years, the JPY and CHF have been popular sources of funding for carry trades. That remains the case today, given they both offer very low or close to zero interest rates. As the Fed lifted interest rates, carry trade investors were able to borrow at low rates in the CHF and JPY and earn a higher yield in the USD.

What could go wrong?

The main risk with carry trades lies in the second source of return – the currency pair. A change in economic or market conditions can result in a sharp reversal in the pair (either temporarily or following a long-term trend change), with losses often more than offsetting gains from the gap in interest rates. The 2008 reversal in the AUD/JPY currency pair is an example of this risk.

Often the impact is worsened by the fact that any carry trade unwind can involve forced selling of the underlying asset, compounding investor losses during periods of market stress. For example, an unwind of carry trades that use JPY or CHF to fund holdings of higher-yielding USD bonds would likely result in both currency losses (as JPY or CHF strengthen) and bond losses (as bond prices fall) at the same time.

What strategies can investors adopt to mitigate the risks?

The first option is diversifying funding currencies. This can help mitigate risks of a poor outcome during temporary volatility. This can be illustrated using an example of the JPY (a low interest rate but high volatility currency) and the SGD (a more moderate interest rate but lower volatility currency).

Since 2012, a carry strategy using JPY alone for funding results in positive risk-adjusted returns, but high volatility (which raises the chance of a poor outcome). However, a basket that mixes JPY and SGD results in similar risk adjusted returns, but lower volatility (and hence a lower chance of a poor outcome). This is despite SGD having higher interest rates over this period than the JPY.

A second strategy is just limiting the extent of cross currency risk altogether. This can help mitigate risks should currencies exhibit a longer-term trend reversal. For example, in a scenario where the USD weakens, any carry strategy is likely to suffer from losses in currency movement, regardless of interest rate advantages.

What is your view on the CHF and JPY?

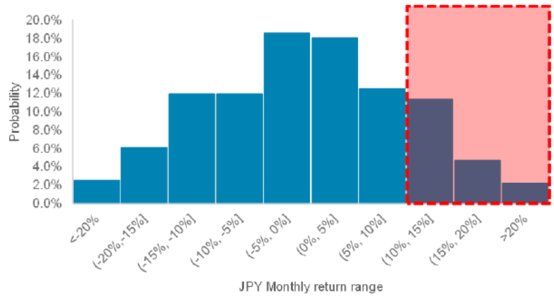
In our base case, USD/CHF and USD/JPY may rebound in the short term towards initial resistance (0.862 and 148, respectively) given strong gains in the CHF and JPY in April have resulted in oversold USD conditions.

However, a key assumption behind this view is that the USD index (DXY) does not break into a long-term downtrend. The DXY index has recently breached the bottom of a 100-110 range it has held since 2022. A decisive or sustained break lower would likely result in JPY and CHF strength, making a carry trade that relies on investing into USD assets unprofitable.

Market uncertainty is arguably higher than usual today, given recent US policy decisions. This means FX carry trade investors will need to consider a wider range of scenarios for currencies beyond a baseline forecast alone. Risk management is likely to be key to the outlook for FX carry trade strategies.

10%+ JPY gains in a single month are not unusual.

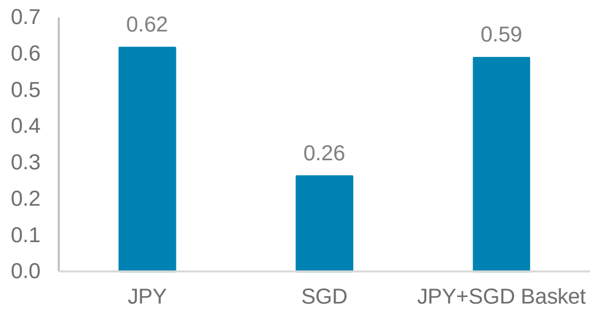
Distribution of 1-month returns of the JPY since 1994



Source: Bloomberg, Standard Chartered

Funding a carry trade via a basket of the JPY (low borrowing cost, high volatility) and SGD (moderate borrowing cost, low volatility) offers similar risk-adjusted returns as the low borrowing cost currency alone…

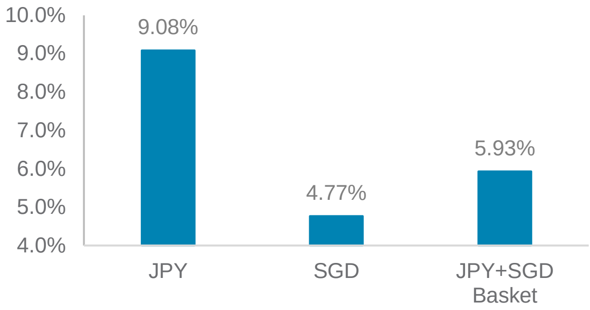
Risk-adjusted daily returns, annualised (2012-2025)



Source: Bloomberg, Standard Chartered

…but with lower volatility than a single currency as diversification benefits kick in

Annualised daily volatility (2012-2025)



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