

The CAD as a High Yielder

Industry returns for 2019 are coming in and, after some lean years in 2017/2018, FX investment returns improved a little. Carry trade strategies out-performed, data suggest. And within that space, Carry strategies based around the G-10 currencies did as well as EM carry for much of the year—but with less volatility. As unlikely as it sounds, one of the reasons behind the CAD's strong 2019 performance (it was the best performing major currency just behind the GBP through 2019) seems to have been its attractiveness from a Carry trade perspective.

A look at industry returns for 2019 suggest that FX investors had a better time of it overall through 2019 after a couple of very poor years in 2017/2018—and a couple of years of declining returns prior to that. FX hedge funds returned 1.6% last year (versus negative 0.2% returns in both the 12 months through Dec 2017 and Dec 2018), even with monthly returns weakening significantly in the latter part of 2019. Improving returns reflect—but generally lag—better performances in the CTA and Global Macro universes which might indicate that the backdrop of discretionary trading may be improving somewhat.

Looking at stylized strategies (via the CS FX Metrics series) for FX investors, Carry trades out-performed other FX investment approaches (Growth- or Momentum-focused strategies, for example) by quite a margin in 2019. This is not too surprising in a world where broad market volatility measures for currencies (as well as other asset classes) remain suppressed. What is a little surprising is that core, that is to say G-10 currency, Carry trades out-performed broader EM FX-themed Carry strategies.

Bloomberg data show that G-10 Carry returns out-performed EM FX Carry returns and did it with less volatility, in fact. That rather implies that better Carry returns overall last year likely centered around the USD and/or CAD long positions (the two highest yielding G-10 currencies) funded by short positions in the EUR and the CHF where negative term rates persist.

| Long | Short | Sharpe | Spot | Interest | Total Rtn |
|----------|----------|--------|-------|----------|-----------|
| USD | EUR | 0.8 | 1.0% | 2.8% | 3.8% |
| USD | CHF | 0.1 | -2.6% | 3.2% | 0.6% |
| CAD | EUR | 0.7 | 5.4% | 2.3% | 7.7% |
| CAD | CHF | 1.5 | 1.6% | 2.6% | 4.2% |
| USD, CAD | EUR, CHF | 0.9 | 1.4% | 2.7% | 4.1% |

Source; Bloomberg, Scotiabank FICC Strategy

Digging a little deeper into the data and trends, we note via Bloomberg's FX Strategy Workbench function that adding CAD to the long component of the G-10 Carry trade strategy generally lifted returns and reduced risk in 2019. A 50/50 basket of long USD and CAD versus a short, equally-weighted EUR and CHF basket delivered a total return of 4.1% in 2019, with a Sharpe ratio of 0.9. A single currency strategy long CAD funded by EUR or CHF exclusively delivered better outright returns (short EUR) or very solid risk-adjusted returns (short CHF) relative to USD-based strategies.

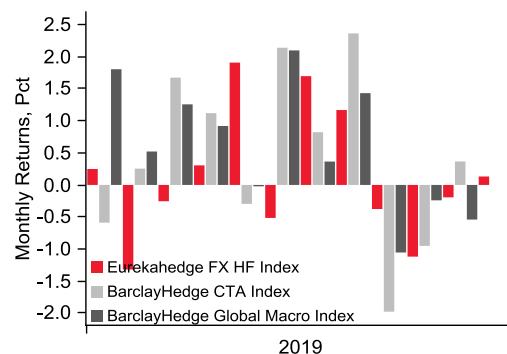
Further, we note that G-10 Carry returns correlated with CADCHF's spot performance much more positively and consistently from March (around 60%) through Dec (+75%) last year than USDCHF over the same period (+58% and +64% respectively) using a rolling 100-day correlation study of daily returns.

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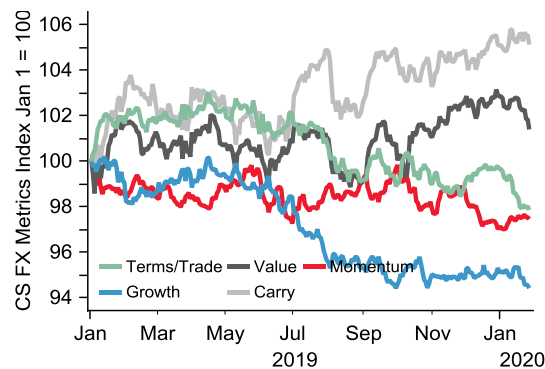
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FX Returns Weak in Q4, Better over Year



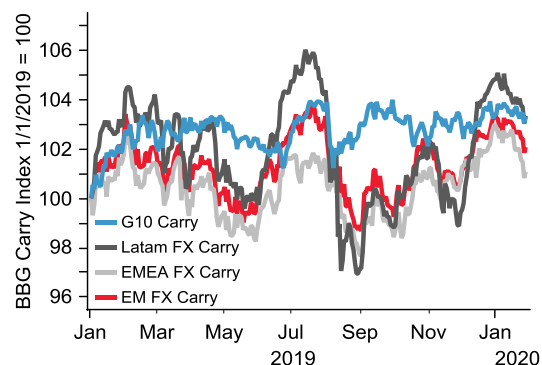
Source: Macrobond, Scotiabank FICC Strategy

Carry Strategies Outperform



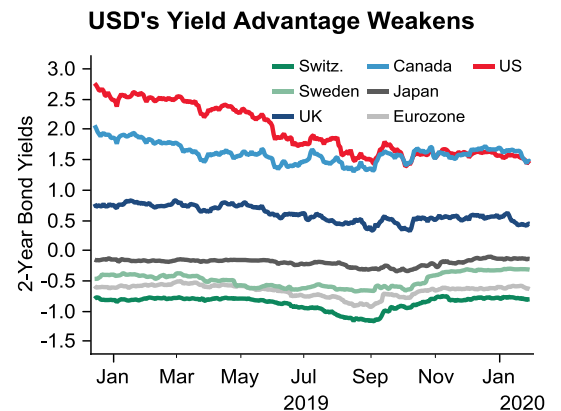
Source: Macrobond, Scotiabank FICC Strategy

EM FX Carry Subject to High Volatility



Source: Macrobond, Scotiabank FICC Strategy

While global yields are poised to remain low and the Bank of Canada's "dovish hold" last week supports the outlook for somewhat lower rates in Canada this year, markets are pricing in about the same degree of easing into the CAD OIS curve over the coming 12 months as the USD OIS curve at moment. Short-term yields in Canada and the US remain close to par (at the 2Y sector of the curve). Yield differentials may not move that much and, if they do diverge somewhat, the CAD is set to remain a relatively high yielder in the G-10 space. A repeat performance for G-10 Carry strategies this year might still involve the CAD.



Source: Macrobond, Scotiabank FICC Strategy

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