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The King of Carry Trades

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The carry trade with the best mark-to-value and the most valuable optionality is the one that no one is doing.

Carry trades are everywhere, and the biggest ones don't make any sense. Consider record **crude oil inventories**, despite no present supply/demand imbalances. Consider the **10-year Treasury bond**, priced to **yield** just over 4% with **CPI inflation** running at 3.5%. There's no shortage of rationales for these things (see "Efficient Equals Wrong" June 10, 2005). In fact, there's such a profusion of rationales that they are tripping over each other. For instance, if low **Treasury yields** are justified because of a **slowing global economy**, then why hold oil inventories in the face of the collapse in demand that would come at the same time? The only authentic reason for all the carry trades is that **the Fed** deliberately created them starting in 2002 by keeping **short-term rates** so low for so long, a strategy designed to combat a perceived **deflation** threat. Mission accomplished, and then some: today the world is awash in dollar liquidity, and all the excess dollars have become hot potatoes that have to go somewhere -- *anywhere*. Or almost anywhere. Anywhere but **stocks**, it seems. And that makes stocks the king of carry trades -- the only good one left.

Take a look at what has happened since February 8 of this year. We pick that date because that's when we happened to make a remark about **equity valuation** that attracted a number of tough questions from clients. The remark, made almost *en passant* in an unrelated context, was that "our model shows equities to be extraordinarily undervalued -- almost 40% below fair value" (see "The 3% Finesse" February 8, 2005). That was calculated based on the comparison of **consensus forward earnings yield** to the yield of **long-term Treasury bonds**, to determine the **relative risk premium** between stocks and bonds. Over the last several months the model has shown stocks to be **undervalued** relative to bonds to a near-record extent. Since February 8:

- An investment in the **S&P 500** has returned 0.55% (0.67% dividend yield minus 0.12% capital loss).
- An investment in the 10-year Treasury bond has returned 1.08% (1.38% coupon yield minus 0.30% capital loss).

Not a big difference, really. Both stocks and bonds have had positive total returns despite capital losses. But apparently you would have been better off in bonds. Based on the fed funds rate, financing costs from February 8 would have been 1.00%. So the canonical carry trade in which you buy the 10-year Treasury with money borrowed at the funds rate would have netted a gain of 8 basis points (1.08% minus 1.00%). If, on the other hand, you'd bought stocks with money raised from either selling or shorting the 10-year Treasury, you'd have netted a loss of 53 basis points (0.55% minus 1.08%). But those calculations are made only on a superficial **mark-to-market** basis, and they don't tell the whole story.

Let's look at the same period on a **mark-to-value** basis. If you'd bought bonds on February 8, those bonds would be no different in character today than they were the day you bought them (because their yield never changes). But stocks *do* change character through time, because **expected earnings** change. That's why stocks are riskier than bonds, by definition. But in the present case, risk is good: earnings are way up. On February 8 the **consensus earnings forecast** for the S&P 500 was $691 billion; since then it has grown 5% to $725 billion (and the economy is supposed to be slowing -- hmmm...). All else equal, when expected earnings rise by 5% equity values rise by 5% as well. So while you've gained only 0.55% since February 8 in an accounting sense, in a value sense you've gained an additional 5% as well. To put a finer point on it, on February 8 our model said that stocks were 39.1% undervalued relative to bonds -- today is says they are 46.4% undervalued. In other words: considering all the factors the model looks at, since February 8 you've gained *both* 0.55% (in mark-to-market) *and* 7.30% (in mark-to-value) by holding stocks.

To be sure, you don't have to actually have held stocks since February 8 to have earned that mark-to-value gain -- that gain is embedded in *today's* stock prices, and you could capture it by buying stocks *today*. With perfect foresight, on February 8 one would have bought bonds, not stocks, and waited until *now* to switch (or wait even longer, if that's what your perfect foresight tells you to do). But by holding stocks since February 8, while you paid a small **opportunity cost** of 53 basis points versus holding bonds, you did obtain something of value: an ***option*** that assured you that you wouldn't miss the potentially huge capital gains that would accrue from the **convergence** from today's state of extreme relative equity undervaluation back to a state more like the long-term average **equilibrium**.

Bottom line: We can't predict to what relative extents stocks will rise and bonds will fall to restore equilibrium, nor when it will happen -- only that from here stocks have little downside and great upside, and bonds have little upside and great downside. But each frustrating day that it does not happen is just one day closer to the day that it will happen. And as earnings grow, the disequilibrium gets progressively more pronounced -- and the low-cost option on not missing the return to equilibrium when it finally occurs gets progressively more valuable. Stocks, then, are the king of carry trades. They represent the best value, and the most valuable optionality. When the canonical carry trades fall apart, the hedge funds will whine. We'll say, "Long live the king!" TM