MACKENZIE Investments

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Carry is making a comeback, just when investors need it

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Every investor knows the adage: stocks go up in the long run. But another source of long-term return is "carry", the strategy of buying high-yielding assets — notably currencies (FX) — and selling low-yielding ones. Carry is an alternative risk premium. It has a positive return most of the time, but, like stocks, tends to suffer nasty drawdowns when a crisis hits.

FX carry had a fairy-tale run in the 2000s, a period in which US stocks mostly traded sideways. From 2000 to 2007, the S&P 500 had an average annual return of 1.8%. Meanwhile the Goldman Sachs Carry Index, which implements a simple FX carry strategy, returned 10.8% per year, with less than half the volatility of US stocks. Both carry and equities had a brutal 2008 as the Global Financial Crisis (GFC) wreaked havoc in financial markets. But while US stocks transitioned into one of the longest bull runs in history, carry languished. Carry's underperformance could be explained by a distortion in interest rate dynamics caused by many central banks hitting the zero lower bound and implementing quantitative easing policies. In the emerging markets space, many high-interest-rate countries had painful post-GFC hangovers. Plus, the collapse in global oil prices in 2014-2015 upended the macro balance of commodity-exporting countries, weakening their currencies.

The good news for diversified multi-asset investors is that FX carry experienced its dry spell at the same time as stocks and bonds produced sparkling returns. A 60/40 portfolio of US equities and Treasuries returned 10.2% per year in the 10 years ending in 2021, the decade coinciding with carry's underperformance. The "alternative" risk premium was not needed in a period when "classic" risk premiums — stocks and bonds — made a killing.

The even better news for multi-asset investors is that carry came roaring back just when stocks and bonds floundered. Balanced stock-bond portfolios experienced one of their worst years in history in 2022. But it was a standout

HIGHLIGHTS

After hitting it out of the park in the 2000s, FX carry went through a dry spell in the 2010s.

Over the past two years, carry has made a comeback as an alternative risk premium, outperforming both stocks and bonds.

We think the resurgence of carry will persist, and so will its role as a prime portfolio diversifier.

year for FX carry, both in developed market and emerging market currencies. Figure 1 shows that carry blew equities and bonds out of the water on a risk-adjusted basis over the past two years. Plus, its best run occurred during the fixed income meltdown of the first half of 2022, providing much needed diversification.

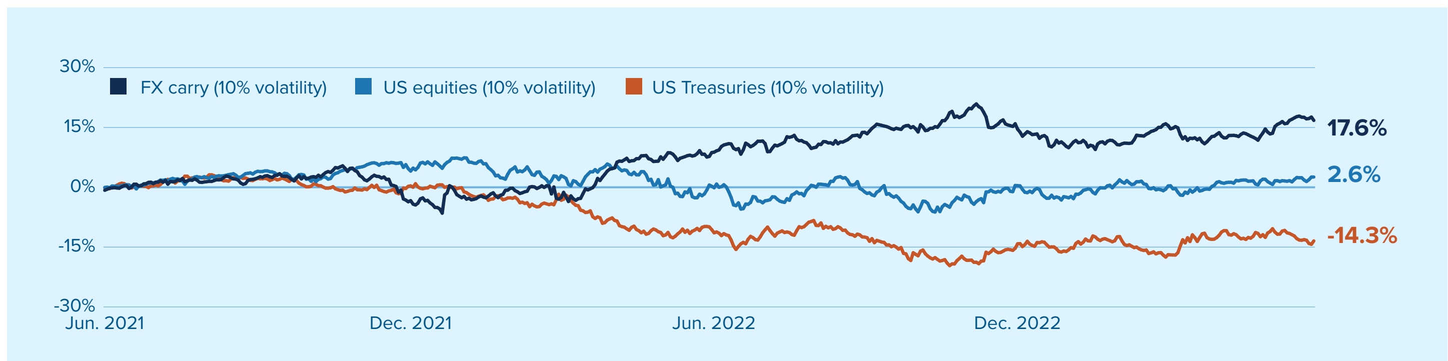
Figure 2 shows that carry tends to outperform classic risk premiums in periods of inflationary growth like the one we've lived in for the past two years. On the other hand, equities — especially US equities — tend to do well in a "goldilocks" macro environment, which combines solid growth and low inflation. In the prolonged goldilocks environment of the 2010s, the US 60/40 reigned supreme. But we expect more balance between macro environments going forward, and more opportunities for carry to shine.

Back in October, we highlighted the return of macro divergence between countries, after a few years of convergence driven by global COVID-19 trends, zero interest rates and across-the-board government deficits. This divergence partly explains the resurrection of carry, especially for developed market currencies. When G10 central banks were holding rates close to zero — for most of the 2010s, but especially in 2020 — there was little room to generate carry returns. Now that currency investors can once again exploit significant divergences in interest rates, carry's potential as a source of return improves (Figure 2).

Like stocks, FX carry will experience some rough patches, and those inevitable drawdowns justify its long-term excess return. No pain, no gain. But it remains a great diversifying risk premium for multi-asset investors, especially in times of high global inflation. In the Global Macro Fund, we offer our own twist on FX carry, which we implement alongside other currency strategies to produce a diversifying return stream with a low correlation to stocks and bonds.

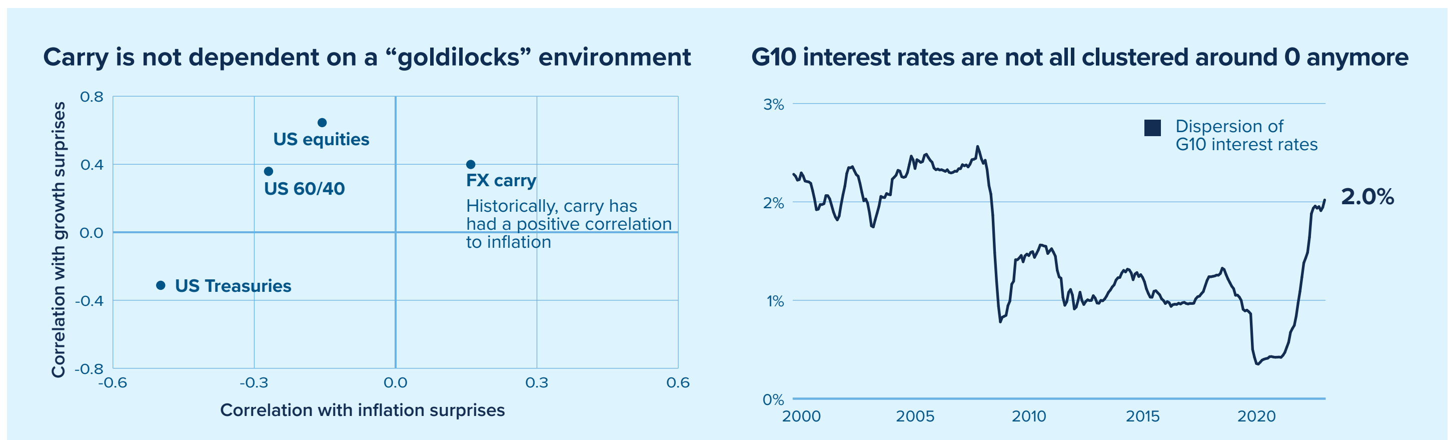
FIGURE 1. CARRY CAME BACK JUST WHEN STOCKS AND BONDS FLOUNDERED.

FX carry has outperformed in the last two years



Source: Bloomberg as of May 30, 2023. In order, the indices are: Goldman Sachs Asset Management FX Carry Index, S&P 500 total return, and US 10-year Treasury futures total return. The return series are scaled to 10% volatility to allow for comparison.

FIGURE 2. MACRO DIVERGENCE IMPROVES THE POTENTIAL FOR CARRY OUTPERFORMANCE.



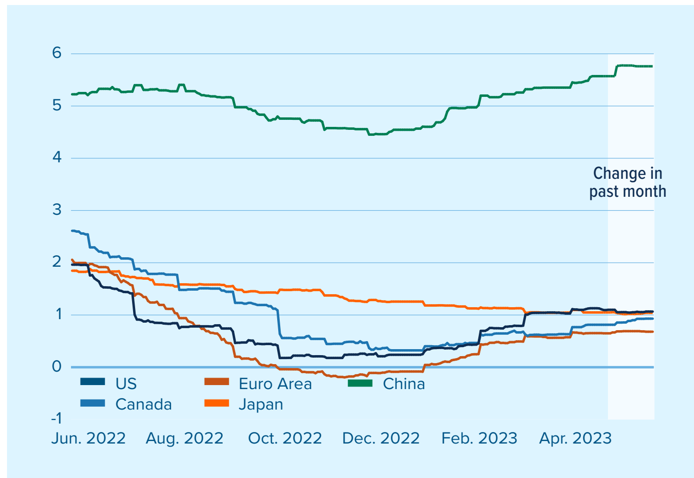
Source: Bloomberg as of May 30, 2023. In the chart on the left, the markers show the correlation of returns with macro surprises. See p. 22 in the 2023 Orange Book for more details on the methodology. "FX carry" represents the Goldman Sachs Asset Management FX Carry Index. The chart on the right shows the cross-sectional standard deviation of one-year swap rates for G10 currencies.

Global macro update

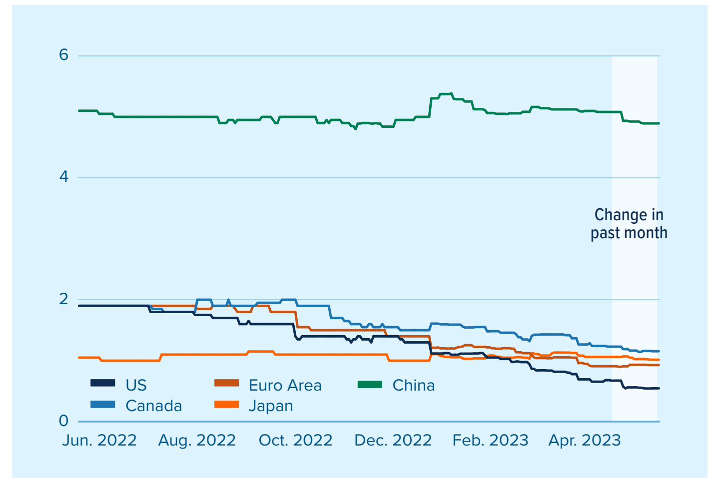
Forecasters expect the **US economy** to trail other major economies next year. But, in our view, Canada is clearly in a worse spot than the US. While both countries have had solid growth numbers to start the year, Canada's economy is showing more cracks. In the US, most sectors have maintained positive momentum and consumer spending has held up amazingly well (see *Emerging theme*). Rates are lower in Canada, which could suggest looser monetary policy. But the neutral rate is also lower in Canada, which means that monetary policy is effectively just as tight in Canada as in the US. Plus, the Bank of Canada will probably resume rate hikes in June or July, putting additional pressure on growth.

Germany formally entered a recession with the release of 2023Q1 GDP data on May 25. The energy crisis cause by Russia's invasion of Ukraine cramped consumer spending at the end of 2022 and into the first months of 2023. But energy prices have since eased significantly and German manufacturing has rebounded impressively. Data on household spending — never a strong point for Germany — is still mixed, but the German economy will probably return to positive growth in the second quarter of 2023.

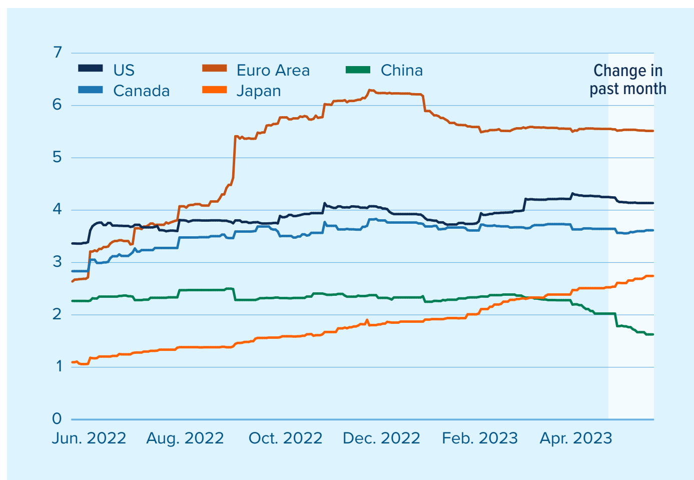
2023 REAL GDP GROWTH FORECAST (%, CONSENSUS)



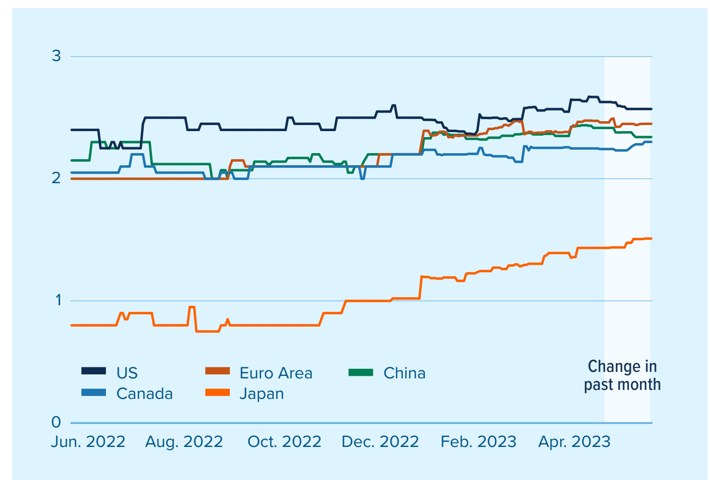
2024 REAL GDP GROWTH FORECAST (%, CONSENSUS)



2023 INFLATION FORECAST (%, CONSENSUS)



2024 INFLATION FORECAST (%, CONSENSUS)



Source: Consensus Economics as of May 31, 2023.

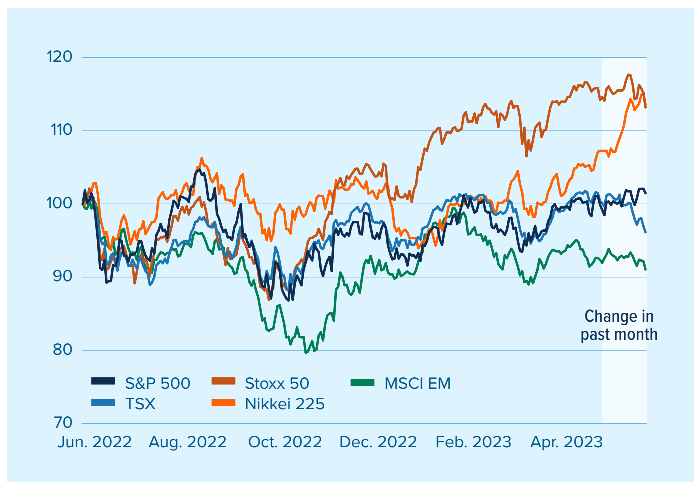
Capital markets update

Equities traded sideways in May. Only a narrow subset of US stocks — those exposed to artificial intelligence (AI) technology — experienced sizable gains. **Japanese stocks** surged by more than 8% last month, helped along by a weak currency, a firming domestic economy and AI optimism. The Nikkei index reached its highest level since 1990.

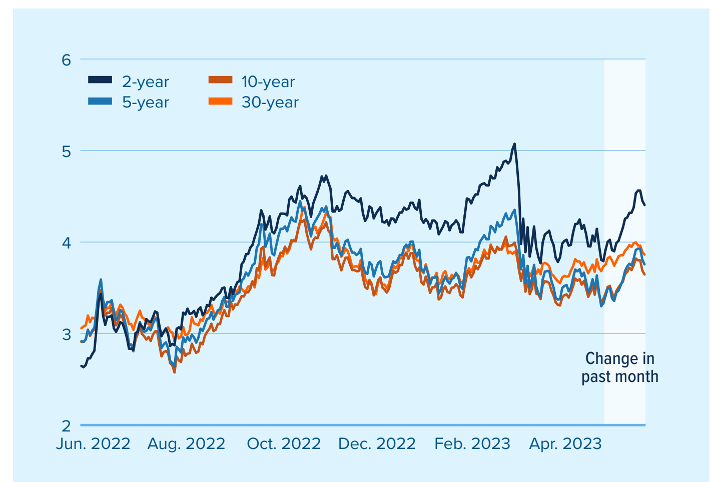
After moving sideways for a month and a half following the collapse of Silicon Valley Bank (SVB), **bond yields** broke their resistance levels and rose across the curve. Stronger than expected growth and inflation numbers, combined with an apparent lull on the banking front, suggest that the Federal Reserve is probably not done hiking rates just yet.

Gold had a rough patch in March following stellar performance in March and April. While we still like it as a passive diversifier, tactically, gold is looking overstretched. Gold purchases by central banks are drying up and rising yields could hurt the zero-yield asset's price.

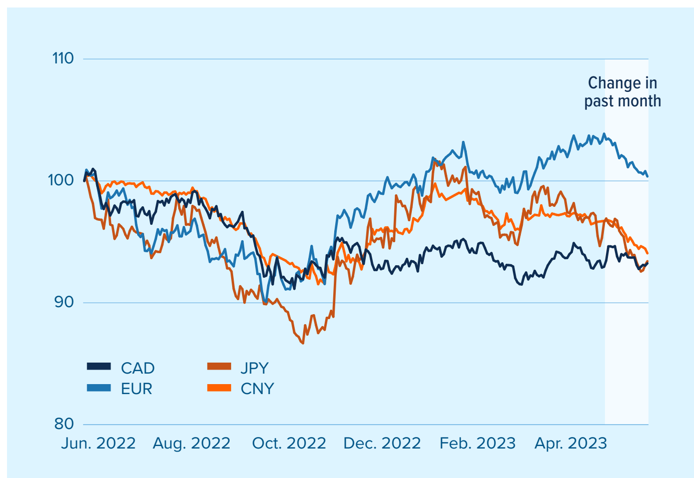
EQUITY INDICES (ONE YEAR AGO=100)



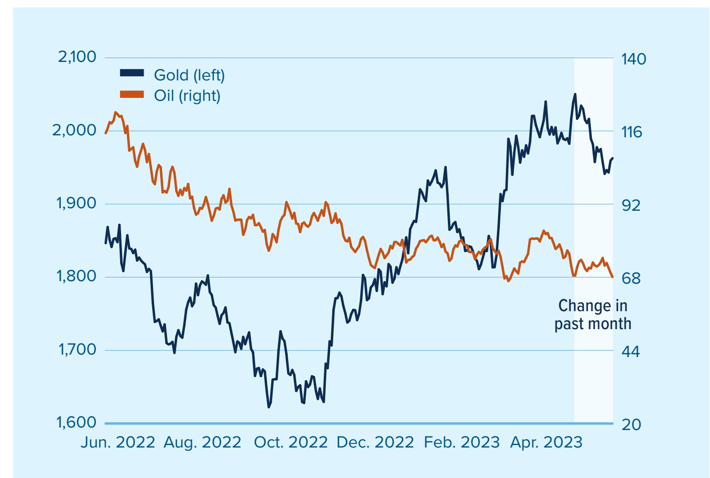
US TREASURY YIELDS (%)



CURRENCIES (RELATIVE TO USD, ONE YEAR AGO=100)



COMMODITY PRICES (USD)



Source: Bloomberg as of May 31, 2023. Total return equity indices are in local currencies, except MSCI EM, which is denominated in US dollars.

What we'll be watching in June

June 15: **US retail sales for May**

- In April, US retail sales, excluding autos and gas, grew 6.7% annualized, well above the 2.4% consensus forecast. Vehicle production and sales have recently picked up, which should turn autos from a headwind to a tailwind for retail sales.
- Consumer confidence is in the doldrums, but credit cards speak louder than words. Wages are growing at around a 4% annualized pace and job creation remains solid. As such, we expect consumer spending to stay above water in the second half of the year.

June 20: **US housing starts for May**

- Housing starts have largely exceeded economists' forecasts in 2023. Strong job growth, a collapse in prices of building materials, and a softening of Fed rhetoric at the start of 2023 are partial explanations for the rebound in construction activity.
- The backlog of started-but-incomplete construction projects suggests that, in the absence of a major growth shock, residential construction probably won't be a major source of layoffs for the rest of 2023. New housing starts are gravy.

June 30: **Bank of Canada's Business Outlook Survey**

- The Bank of Canada's Governing Council pays considerable attention to its staff's Business Outlook Survey. In particular, recent Surveys showed that executives' inflation expectations have risen sharply since the end of 2021. A lack of improvement on that end could mean higher-for-longer rates.
- The April Survey showed that the growth impulse in Canada was broadly neutral: the post-pandemic bonanza is a thing of the past, but businesses' outlooks don't reflect recession fears — yet?

Emerging theme

We've been pushing back against talk of a global recession for more than a year now. We positioned accordingly in Global Macro Fund throughout the past year, for instance by shorting government bonds and buying commodity currencies.

Where do we stand today? Same side of the alley: recession odds are still slightly overstretched in our view.

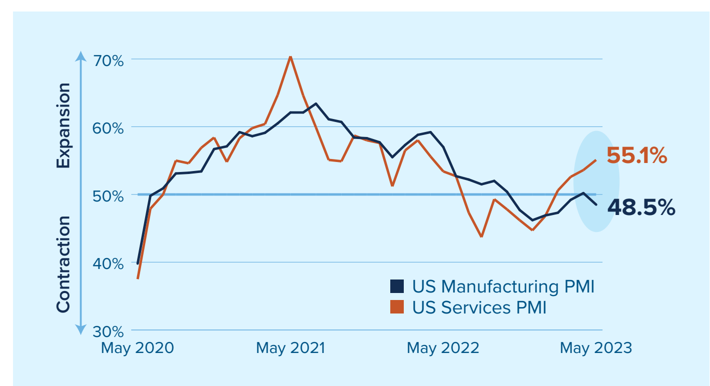
Combining China and Europe, one-third of global GDP moved from contraction to timid expansion over the past six months. Even if the resulting impulse is weak, it is clearly positive.

Still, global growth ultimately depends on the hitherto insatiable appetite of the US consumer. Someone needs to purchase those exports coming out of Germany and China.

The US economy — driven by a red-hot labour market and booming service sector — has shown very few signs of slowing down. A lending hangover from the recent bank failures will be a headwind to credit-fuelled consumer spending but should be outweighed by fast wage growth and a newly frisky residential real estate market.

To emphasize that view — overstretched recession odds post-SVB — we added a small short-2-year-Treasuries position in Global Macro Fund a few weeks ago.

THE US SERVICE SECTOR IS SOLIDLY IN EXPANSIONARY TERRITORY



Source: Bloomberg, May 31, 2023.

Capital market returns in May

Category	Index	Return
Major Asset Classes	Global Equity	-0.22%
	Global Bonds	-1.93%
Regional Equity (local)	S&P 500	0.43%
	TSX	-5.31%
	Nikkei	7.04%
	FTSE 100	-4.93%
	EuroStoxx 50	-2.21%
	MSCI EM	-1.68%
Styles	US Small Cap - Large Cap	-1.21%
	US Value - Growth	-8.52%
Sovereigns	USA 10-year Treasury Future	-1.39%
	CAN 10-year Gov't Bond Future	-2.90%
	GBR 10-year Gilt Future	-4.52%
	DEU 10-year Bund Future	0.36%
	JPN 10-year JGB Future	0.00%
Fixed Income	US High Yield Bonds	-0.95%
	US Investment Grade Bonds	-1.77%
	US Leveraged Loans	-0.51%
	CA Provincial Bonds	-1.84%
	CA Corporate Bonds	-1.37%
	CA Inflation-Linked Bonds	-0.54%
Alt	Gold	-1.37%
	Oil	-11.39%
	Global REIT	-4.62%
	Global Infrastructure	-5.61%
FX Spot	CAD/USD	-0.22%
	GBP/USD	-1.00%
	EUR/USD	-2.99%
	JPY/USD	-2.15%

Axis: -15, -10, -5, 0, 5, 10

Notes: Market data from Bloomberg as of May 31, 2023. Index returns are for the period: 2023-05-01 to 2023-05-31. In order, the indices are: MSCI World (lcl), BBG Barclays Multiverse, S&P 500 (USD), TSX Composite 60 (CAD), Nikkei 225 (JPY), FTSE 100 (GBP), EuroStoxx 50 (EUR), MSCI EM (lcl), Russell 2000 - Russell 1000, Russell 1000 Value - Russell 1000 Growth, USA 10-year Treasury Future, CAN 10-year Gov't Bond Future, GBR 10-year Gilt Future, DEU 10-year Bund Future, JPN 10-year JGB Future, BAML HY Master II, iBoxx US Liquid IG, Leveraged Loans BBG (USD), Provincial Bonds (FTSE/TMX Universe), BAML Canada Corp, BAML Canada IL, BBG Gold, BBG WTI, REIT (MSCI Local), Infrastructure (MSCI Local), BBG CADUSD, BBG GBPUSD, BBG EURUSD, BBG JPYUSD.

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