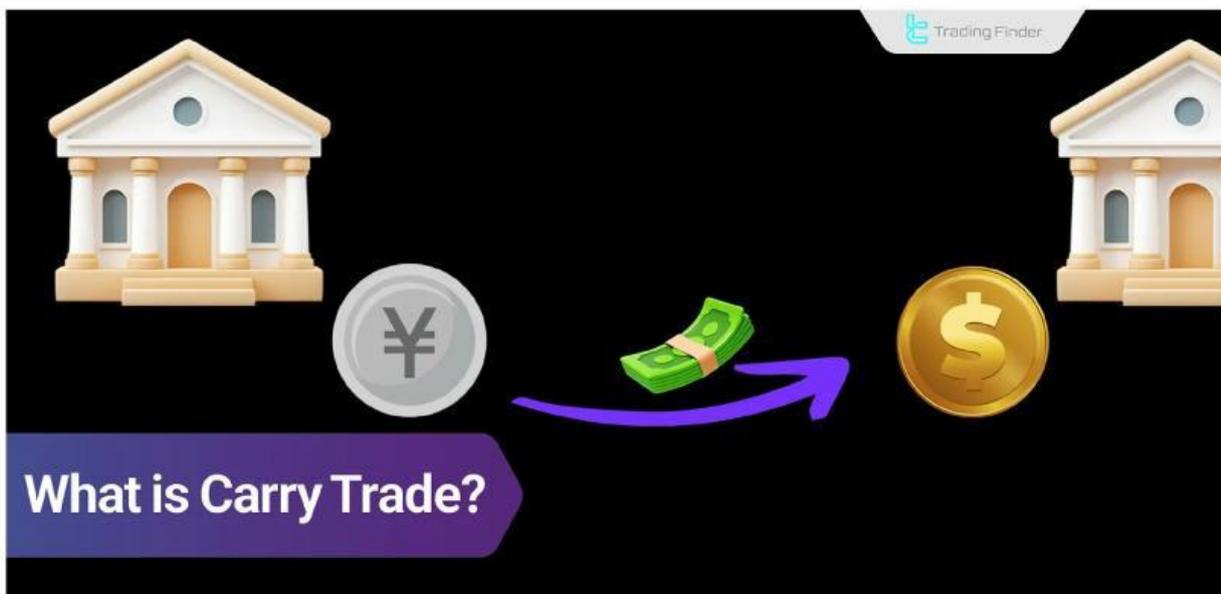


What is Carry Trade? The Relationship Between Interest Rates and Carry Trade

Carry traders borrow a currency with a low interest rate and invest it in higher-yielding markets (e.g., bonds, gold, stocks, etc.).

This strategy **primarily applies** to **low-interest-rate currencies** (e.g., the Swiss franc and yen). Additionally, the capital flows of carry traders vary depending on **market sentiment**, **risk appetite**, and **risk aversion**.



Carry trade is a trading strategy based on fundamental analysis that uses interest rate differentials to generate low-risk profits.

What is the Carry Trade Strategy?

Carry trade is a trading strategy based on **fundamental analysis**. In this strategy, traders profit from the interest rate differential between the two economies. Specifically, they borrow from an economy with a low interest rate (e.g., Japan) and invest the funds in an economy with a higher interest rate.

By doing so, the interest on the borrowed funds from Japan is easily covered by the yield from the invested bonds, allowing the trader to earn a profit.

Advantages and Disadvantages of the Carry Trade

Strategy

One key advantage of the **Carry Trade** strategy is earning low-risk profits in stable market conditions (low volatility and minimal uncertainty).

Advantages	Disadvantages	Low-risk profits from bond investments	Risk of interest rate fluctuations
		Profiting from currency appreciation	Sensitivity to market sentiment

Factors Influencing Carry Trade

Interest rate differentials are the core of the **Carry Trade** strategy. **Changes in interest rates** and central bank monetary policies significantly impact these trades.

Factors Affecting the Carry Trade Strategy

01.

Interest Rate
Difference

02.

Market Sentiment

03.

Central Bank Position
and Interest Rate
Expectations

Interest rate differentials, market sentiment, and central bank policies are key factors affecting carry trade.

Key Factors Affecting Carry Trade:

- ⚡ **Interest rate differentials:** The greater the differential, the higher the potential profit;
- ⚡ **Market sentiment:** Since borrowed funds are invested in financial markets, **risk aversion** or **risk appetite** sentiment impacts carry trades;
- ⚡ **Monetary policy:** Central banks' **monetary policy stance** on interest rate changes influences market sentiment and, consequently, the **Carry Trade** strategy.

The Impact of Market Sentiment on Carry Trade and the Japanese Yen's Performance

Carry traders invest borrowed funds in high-yield financial markets. In other words, these trades increase during bullish markets and risk-on conditions as investors expect higher returns.

Conversely, carry traders are less motivated to borrow and invest in other markets during **economic recessions** and risk-off sentiment.

The Inverse Relationship Between the Yen and Global Investment Markets

Due to **capital flows from carry traders**, the **Japanese yen** often behaves **differently** from global markets. During **global market rallies**, the **yen weakens** because investors borrow and sell yen to buy higher-yielding, riskier assets.



The yen surged against the USD following Japan's rate hike and weak U.S. jobs data

As shown in the image, on July 31, 2024, two factors—**Japan's rate hike** and **weak U.S. jobs data** (fears of a recession)—triggered a **sharp decline in global markets** and a **strong yen rally**.

The Link Between the Japanese Yen and Carry Trade

Japan has maintained **significantly lower interest rates** than its peers for decades, making it an attractive funding source for carry traders.

Carry trades lead to **currency depreciation** because traders convert borrowed funds into the destination country's currency for investment.

For example, if you borrow yen to invest in U.S. bonds, you must **sell yen for USD**, creating **downward pressure on the yen**.



The yen's sharp depreciation against the USD from 2022 to 2024 due to interest rate differentials.
Source: TradingView

The image shows the **yen's steep decline against the USD** in 2022, driven by **Fed rate hikes** and **borrowing cost disparities** between the two economies.

The Relationship Between the Yen and U.S. Bond Yields

The **US10Y index (U.S. 10-year bond yields)** correlates with the **USD/JPY** pair. Below are the key reasons for this correlation:



U.S. bond yields and USD/JPY are correlated due to their similar nature as safe-haven assets.

Key Reasons for the Correlation Between the Yen and U.S. Bond Yields:

- ⚡ **Safe-haven status:** The yen and bonds are safe-haven assets in recessions, demand rises, boosting bond prices (lowering yields), and strengthening the yen (pushing USD/JPY down);
- ⚡ **Carry traders:** Rising U.S. yields attract carry traders, leading them to selling yen. Rate hike expectations widen the yield gap, weakening the yen further.

Overall, the yen's trend is more influenced by **central bank interventions**, **global economic conditions**, and **Carry Trade** activity than economic data.

Conclusion

The **Carry Trade** strategy capitalizes on interest rate differentials between two economies. Traders sell low-yielding currencies and invest in higher-yielding markets to profit from the spread.

Monitoring carry trade capital flows is crucial for analyzing the **forex market**, especially the yen. Market sentiment and global economic trends also significantly impact carry trade activity.

Sources:

1. our website link :

<https://tradingfinder.com/education/forex/what-is-carry-trade/>

2.all education :

<https://tradingfinder.com/education/forex/>



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