ING INVESTMENT MANAGEMENT

Bond Notes

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What Is the Carry Trade, Its Impact, and Its Potential Consequences?

Monetary policy is often cited as a blunt instrument: the Federal Reserve pegs the overnight lending rate in the hope of either stifling or engendering the animal spirits of economic players. A low Fed Funds rate decreases the cost of capital for corporations and governments, lowers mortgage rates for consumers, and diminishes the financing costs of leveraged bond investors, such as hedge funds and lending institutions. Furthermore, low overnight interest rates usually precipitate a phenomenon know as a steep yield curve: a situation where the yield pick-up from short to intermediate maturities is historically high, which, in turn, encourages investors to extend out that yield curve. While low rates are a powerful stimulus, the Fed has little or no control over the application of that stimulus by investors, and the result may be speculative buying utilizing leverage, a dramatic rise in the prices of the riskiest assets in capital markets, and the potential for a nasty unwind of those purchases when monetary policy once again becomes restrictive. While we do not believe that a change in Fed policy is imminent, both bond investors and bond managers need to monitor the extent and nature of the carry trade exhibited in the present market.

The Carry Trade Broadly Defined

In its most rudimentary form, "carry trade" is simply buying one security with more yield, or carry, than that which is sold. No leverage is employed. For example, a bond manager may sell a five-year Treasury and buy a five-year corporate bond. From a portfolio standpoint, this may be expanded to many securities and sectors by initiating overweights in corporate bonds, mortgages, and other spread product. Additionally, a steep yield curve presents other opportunities, such as *rolldown*. In short, a five-year bond becomes a four-year bond over the course of a year as it rolls down the yield curve, and during that year the holder earns interest. In an environment of stable rates and a steep yield curve, the rolldown can produce capital appreciation as well. The blunt instrument of easy money encourages investors to make use of these trades.

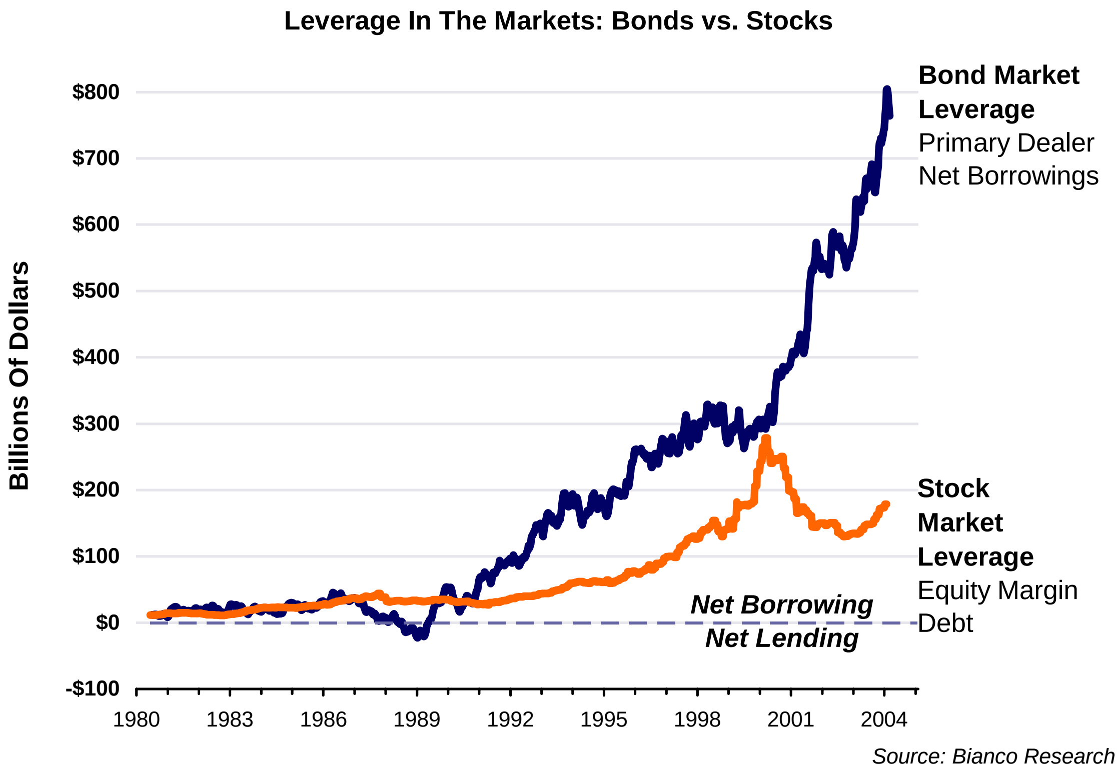
On the other hand, hedge funds, banks, and other financial intermediaries generally employ leverage to deploy the carry trade. In its simplest form, it is borrowing short and lending long. Borrowing at or near the cheap Fed Funds rate, these entities purchase many types of bonds including longer-dated Treasuries, investment-grade and high yield corporate debt, emerging market debt, convertible bonds, and mortgage-backed securities.

As long as their financing rate is low and the value of the securities purchased is relatively stable or rising, they collect the additional carry. In 2003 the carry was augmented by a generous increase in the prices of the assets bought.

However, a sufficient rise in borrowing costs, or a drop in the price of the acquired asset, or both can make such a position very unprofitable. The swiftness and magnitude of such a change in the interest rate regime, such as occurred in 1994, would amplify the price deterioration particularly if many players – or just one very large one – attempt to exit the strategy simultaneously.

Size of Leveraged Carry Trade

Unfortunately, there is no pure way to gauge the amount of leveraged buying in the many bond sectors; however, a number of approximations point to a very large number. As the chart below suggests, leverage in the bond market eclipses that of the equity market by a wider margin today than any other period in recent history.

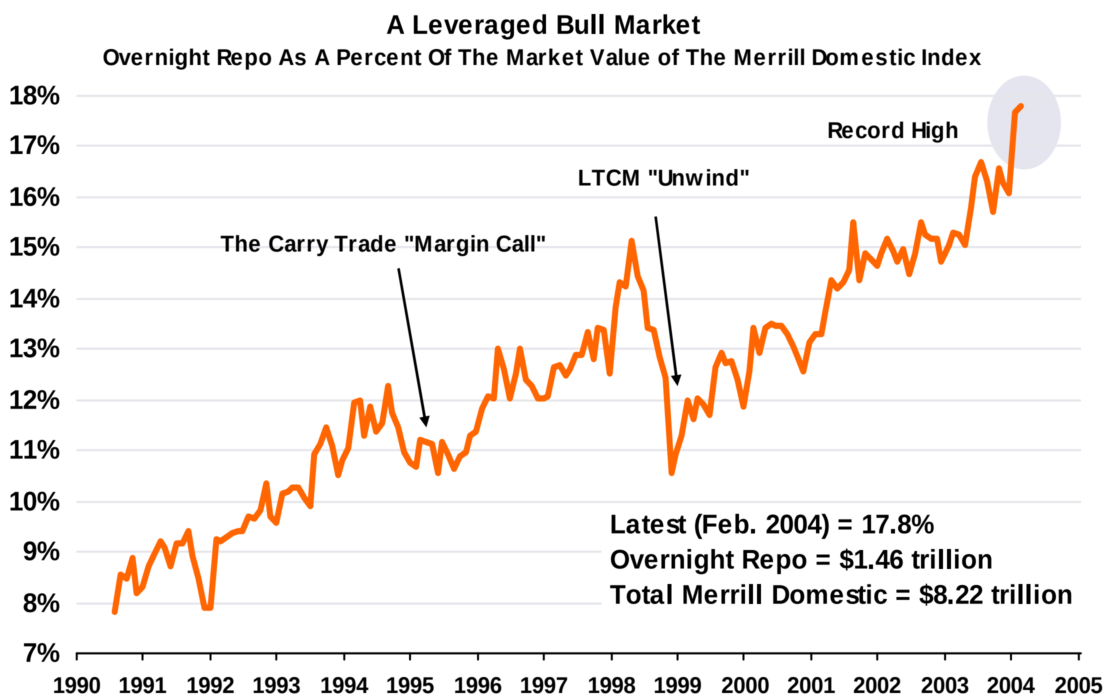


Moreover, the amount of repo, or repurchase agreements, emanating from Caribbean tax havens – a favorite location for hedge funds – complements our assertion that leverage is high. Repo is a common financing technique wherein bonds are used as collateral; however, not all repo transactions employ leverage. The interest rate charged is influenced, in part, by the Federal Funds rate.

Ramifications for Bond Investors

As long as the Fed is on hold, or perceived to be on hold, the carry trade will cause valuations in corporate bonds, mortgages, and other spread product to remain stretched. Indeed, our current outlook is for a patient Fed well into the final months of 2004 especially as the economy has been slow to add new jobs. Hence, much of this year should be propitious for portfolios that earn additional yield.

However, should the inevitable unwind of the carry trade be precipitous and/or the result of an unexpected event, the consequences could be painful in the short term. In recent history, the bond markets experienced two large abrupt "regime changes" that hint at what we might expect. In 1994 the Federal Reserve began a round of monetary tightening that exposed ill-conceived levered bets to a rapid increase of borrowing costs and depreciating prices of the securities held. A couple of prominent banks experienced distress in their securities lending programs, and Orange County, California lost millions of dollars. During that episode, hedge funds were in their infancy. Many of us may also remember when the mother-of-all leveraged traders, Long Term Capital Management, witnessed a rout in the value of its holdings in the fall of 1998.



Source: Bianco Research

In conclusion, the magnitude of leveraged bets in the bond market is a cause for concern; yet, an abrupt and deleterious unwinding of that speculation is not imminent — albeit timing in capital markets is never certain. We would expect the riskiest components of the bond market to bare the brunt of the selling pressure in such an environment. Fortunately for the investment team at ING, the total return disciplines we employ and our ability to discover value in multiple arenas of the bond market may allow us to offset the short-term trauma relative to our peers. For individual investors, the need for astute, professional advice in the management of bonds remains strong if, indeed, a period of increased volatility is on the horizon.