Carry Trade and Rollovers

Concept of Carry Trade

Carry trade is a kind of trade that is peculiar to the Forex market. In other markets, traders trade with the intention of benefitting from capital appreciation. However, in case of carry trade, traders have two expectations.

They want to earn cash from capital appreciation as well as from the interest rate differentials that arise from buying or selling currency. Since interest rate differentials are peculiar to the Forex market, so is the concept of carry trade.

It must be understood that the concept of rollovers and carry trade is in stark contrast to that of settlement. Therefore, rollovers only take place in case settlement does not. This is the reason rollover is preferred by speculators who want to avoid giving deliver of the actual underlying currency and would rather simply pay interest to avoid such a situation. In this article, we will have a look at this concept in greater detail.

Rollovers

The concept of carry trade is closely linked to the concept of rollovers. Rollover is the amount of money that an investor obtains or has to pay to hold the currency overnight i.e. through to the next trading day. Since, the Forex market operates 24 by 7, a day is considered to end at 5 PM Eastern Standard Time in most cases i.e. the money becomes due at 5 PM EST. Hence if a position is open at that time, it is considered to have been open throughout the preceding day.

The quotations for rollovers also change moment to moment. The rollovers for buying and selling currency pairs are listed along with the quotation. A positive number denotes that the amount will be received as a result of the transaction whereas a negative number denotes that the amount will have to be paid. Also, there are separate rollovers that are quoted for buy as well as sell transactions.

Two interest rates: Currencies are always traded in pairs. Also, each currency has an interest rate attached to it. Therefore, there are always two interest rates involved when Forex trading occurs. Now, obviously if one currency has a higher interest rate than the other, one side of the trade would benefit by holding the currency.

To avoid this from happening, the side that holds the currency with the lower interest rate has to pay rollover to the counterparty so as to mitigate the effect of interest on the trade. The amount of interest received is abysmally small (say 2% per annum) in most cases. However, since Forex trading involves placing highly leveraged bets, the amount of interest received in rollovers can have a significant impact on the profitability.

Case #1: Earning Rollover Interest

In case we buy the Eurodollar pair, this means that we buy the Euro and sell the dollar. Let's say the interest rate on the Euro is 3% and that on the dollar is 1%, then there is a 2% differential in the interest rates of the two currencies. Therefore, in this case, the person holding the Euro will receive an interest credit at the rate of 2% per annum at 5 PM EST each day that the trade is open. The interest will be equivalent to Euros in terms of value. However, generally it will be paid in US dollars regardless of the currencies being traded because of the liquidity provided by the dollar.

Case #2: Paying Rollover Interest

On the other hand, if an investor were to sell a Eurodollar pair, i.e. sell the Euro and buy the dollar and the interest rates of the respective currencies were 3% and 1%, then such a trader would face a debit equivalent to 2% annually as a result of the trade. The money debited from the account of such a trader is the one that is credited to the account of trader mentioned above. This transaction is usually a very small adjustment to the trader's account and is undertaken by the brokers automatically.

Predicting Directions and Risk

Carry trades only work when the traders are able to predict the direction of the trade correctly. For instance, if they go long on a currency pair in order to earn $5 in interest and end up losing $40 as a result of an adverse market movement, the trade would not make sense at all.

It is for this reason that carry traders need to be reasonably certain about the direction in which the trade is going to progress. They could be incorrect about the magnitude. However, the magnitude will only affect the quantum of profit that is being made. It will not end up converting a profit into a loss.

Risk Mitigation

Since carry traders have to take a large amount of risk for a small amount of interest income, they must ensure that they have adequate risk mitigation mechanisms in place. This means that they need to be aware of the exact points where they will cut their losses and exit the trade. If possible, automated stop loss or trailing stop orders should be placed to avoid operational issues during execution.

There have been entire trading houses that have built their strategies around these interest rates and carry trade. Carry trade is an effective way to trade the Forex market short term and generate cash flow. However, one needs to be cognizant of the risks as well.