Sand In The Market Machine: Negative Carry In A Lot Of Places

By Vineer Bhansali| October 2nd, 2023

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Carry is the lubricant of investing. Carry, as we define it here, is the difference between what one can earn on an asset and what one pays to finance the asset purchase. When carry is negative, it costs more to finance an investment than the expected cashflow on that investment.

> "Rationally no one should take on a negative carry investment for too long unless they are confident of a payoff later, because the negative carry will literally burn a hole through their wallet while they wait."

In a paper I coauthored a few years ago, we demonstrated that across a range of markets, the best strategy combines trading in the direction of the trend, and doing so when the carry is positive. The worst strategy is to fight the market; i.e. go against the trend, and pay carry to do so. This should not be very surprising, since anyone who has survived in the markets knows that it is always best to (1) not fight the market's direction, (2) not pay too much to invest, and negative carry, fees and bid-offer spreads are all costs.

Today, we are in a world of negative carry (almost) everywhere, and by most metrics, financial assets are in a negative trend. This is not an environment where one should be trying to fight the markets and catch the bottom, since the carry cost of doing so is quite high. Let us take inventory of the carry situation as of this writing (October 2023). Readers can check out the trend or momentum situation themselves by looking at price charts and see if the prices are trending up or trending down – most, especially bonds are trending down.

As of this writing, the short-term interest rate as measured by the Fed Funds rate (the rate at which banks lend to each other), is at 5.5%, one-month T-Bills are at 5.25%, the two-year Treasury note is at 5.10%, the five-year at 4.70%, the ten-year at 4.7%, and the thirty-year bond at 4.79%. So the yield-curve is “inverted”, and by extending maturity to longer bonds from T-bills one loses yield, so unless one believes that prices will be higher (yields will be lower), there is no reason to extend duration. If one finances an asset using Fed Funds as reference, then buying anything longer than the shortest Treasuries is negative carry, which makes holding them less attractive for a US dollar-based investor with no currency risk.

What about carry for foreign investors? Let’s take Japan as an example since the Japanese are one of the largest buyers of US Treasuries. The short rate in Japan is almost 5.5% lower than that in the US, so for a Japanese investor who buys a US Treasury, the yield, after currency hedging is also negative. For example, if a Japanese investor buys a US 10 year note at 4.7%, but then pays 5.5% of negative carry to hedge the US dollars back into the Yen using the currency hedging market, he locks in a minus 0.80% yield. Again, negative carry. Since the same investor can just stay in Japan and earn a 0.70% positive yield in Japan, going to the US on a currency hedged basis does not make much sense either.

Bonds, especially risk-free assets like Treasuries are foundational to all other asset prices, since every asset’s present value requires using the risk-free yield curve for discounting. So, the negative carry in the bond market naturally finds its way into everything else.

Moving first to the stock market, we see that because dividend yields are lower than interest rates, buying the stock market at current prices and dividend yields again is negative carry, since the implicit financing cost exceeds the dividend income one will likely realize. For growth stocks the situation is worse, since most of them pay no dividends, and due to the AI-fueled rally the prices are already pretty high, so owning these stocks is betting on earnings to beat the negative carry, or betting on someone else’s desire to pay a higher price in the future.

"One simple way to quantify the carry in markets with futures contracts is to look at the shape of the futures contracts as a function of time. When the contracts are upward sloping — i.e. later contracts have higher price than the shorter ones — a buyer of the stock market futures suffers negative carry as the futures "roll-down" to the spot index level. Equity index futures curves in the US are upward sloping today."

Switching gears to actual businesses, we see that banks are also faced with the negative carry problem. Banks are still getting away with paying less on deposits than the risk-free Treasury market, but this is because the public has not yet realized that they are being pick-pocketed where they get less yield with lower credit quality, and that they would be better off opening a Treasury Direct account, or just go ahead and buy a Treasury money market fund.

The conventional thinking is that as long as there is no bank run, banks should be borrowing short and lending long, which is what the banks have done with glee, and in the process levered up their portfolios. But the situation today is quite different: When long term yields are lower than short term yields, and there is a distinct possibility of a bank run (recall what happened at Silicon Valley Bank and First Republic Bank earlier this year), then banking on the collective inertia of retail investors in an era of online banking and fast money is very dangerous. The sticky money isn't sticking anymore and it creates a negative carry hole for all but the most dominant banks.

We also know anecdotally that commercial real estate markets are facing a big reset of their borrowing costs, the so-called "refinancing wall". With the economy slowing, vacant properties, and increasing borrowing costs, the cashflow situation of commercial real estate, especially office properties still empty from remote work, is also beset with problems from negative carry.

And to top this all off, even the Federal Reserve is running negative carry, since what the Fed pays via its reverse repo facility to investors is less than the yield on the bonds it holds that it bought via various rounds of QE. But the Fed can print more money, so their negative carry is not really a problem for them. For most of us without a legal printing press it is a problem.

The astute reader simply has to look further afield and find even more examples of negative carry across asset classes and investments. Which speaks to why today the safest place to be is in the shortest duration assets such as T-bills which not only are the most protected from negative carry, but also from the negative bond market trend. When carry is this negative, it simply does not pay to take too much duration risk. As long as there is negative carry, betting on risk assets to do well is betting on the greater fool theory to hold true; i.e. buy assets despite negative cash-flow in the hopes that someone would pay you more in the future to take that same asset. Unfortunately fighting negative carry, just like fighting gravity, very rarely ends well. The financial market machinery and economic machinery does not work well when the positive carry lubricant is replaced with negative carry sand in the works.

Important Disclosures

Vineer Bhansali, Ph.D. is the Founder and Chief Investment Officer of LongTail Alpha, LLC, an SEC-registered investment adviser and a CFTC-registered CTA and CPO. Any opinions or views expressed by Dr. Bhansali are solely those of Dr. Bhansali and do not necessarily reflect the opinions or views of LongTail Alpha, LLC or any of its affiliates (collectively, "LongTail Alpha"), or any other associated persons of LongTail Alpha. You should not treat any opinion expressed by Dr. Bhansali as investment advice or as a recommendation to make an investment in any particular investment strategy or investment product. Dr. Bhansali's opinions and commentaries are based upon information he considers credible, but which may not constitute research by LongTail Alpha. Dr. Bhansali does not warrant the completeness or accuracy of the information upon which his opinions or commentaries are based.

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