

Business Cycles and Currency Returns

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Main Contribution

- Sort currencies according to output gap
- Two portfolio strategies
 1. Long high output gap, short low output gap currencies
 2. Long (short) currencies with output gap larger (smaller) than US
- Distinct from “traditional factors”: HML, momentum, NFA,...
- Currency returns mostly driven by nominal FX component

Economic Explanation

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- **How do we discipline existing macrofinance models?**

An organizational tool

- A two-factor LRR model

$$\Delta gdp_{t+1} = y_t + z_t + \sigma_{sr} \cdot \varepsilon_{sr,t+1}$$

$$y_t = \rho_y \cdot y_{t-1} + \sigma_y \cdot \varepsilon_{y,t}$$

$$z_t = \rho_z \cdot z_{t-1} + \sigma_z \cdot \varepsilon_{z,t}$$

where $\rho_y < \rho_z$ and $\sigma_y > \sigma_z$.

- Similar to the model used by Chabi-Yo and Colacito (2017)

Why?

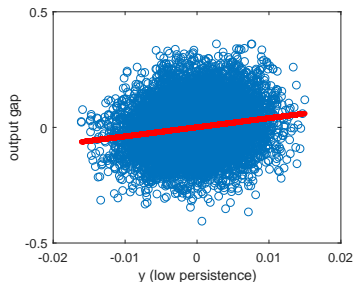
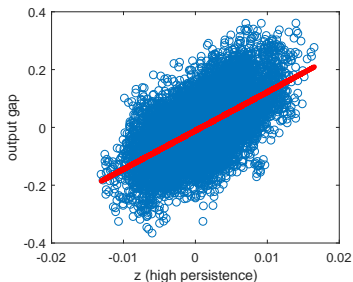
- Construct output gap as in the paper

$$gdp_t = \alpha + \sum_{j=0}^3 \beta_j \cdot gdp_{t-24-j} + \varepsilon_t, \quad gap_t = gdp_t - \widehat{gdp}_t$$

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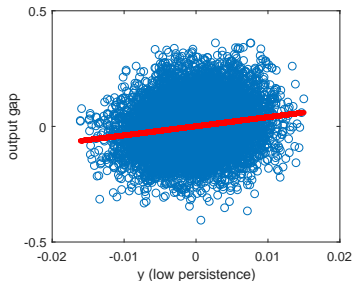
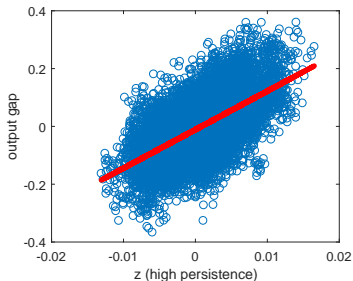
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- Bottom line: output gap tracks highly persistent component (z)

Proposed Strategy

1. Use z to explain the gap premium
2. Use y to explain the carry premium
 - ▶ y is a global factor
 - ▶ Heterogeneous exposure to y
 - ▶ Textbook LRV recipe...
3. Complete markets, recursive preferences

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In the interest of time: focus only on z

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- What else do we need?

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 - ▶ currency premium goes up
 - ▶ risk-sharing interpretation: correlation is higher in bad times

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2. Results driven by nominal FX predictability
 - ▶ Is this because the output gap is a good predictor of inflation?
3. Choice of countries
 - ▶ What happens if you exclude emerging countries?
 - ▶ How do you handle EU countries after 1999?

Conclusion

A great paper: must include addition to any reading list on currency risk premiums!