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CARRY TRADE RETURNS AND SEGMENTED RISK PRICING

Abstract:

The carry trade strategy, which exploits the forward premium puzzle, shows a persistent outperformance compared to a passive benchmark strategy, even on a risk-adjusted basis. So far, the literature has not come up with a consistent explanation and controversially discusses a risk-based approach as well as peso problems and crash risk. This paper introduces a different view and examines if carry trade returns could be explained by persistent differences in risk pricing between carry trade countries. I empirically analyze a data set over the period January 2008 to March 2017 that covers the U.S. dollar as numeraire currency, the Japanese yen and the Swiss franc as funding currencies, while the Australian dollar and the New Zealand dollar are considered as investment currencies. I show that there are large and persistent differences in country risk aversion in the interest rate market compared to the market-implied risk aversion in the equity market. As a result, investment currencies are more sensitive to U.S. consumption risk, while funding currencies provide a hedge. The country interest rate differential plays a leading part for the carry trade performance. Thus, persistent differences in country risk aversion seem to offer a risk-based explanation of carry trade returns.

Keywords:

Carry trade returns, forward premium puzzle, risk aversion, stochastic discount factor

JEL Classification: E20, F31, G15