Timing foreign exchange markets

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Abstract

Priced carry, dollar, and volatility risk factors recently proposed in the finance literature help explain long-standing puzzles related to the cross-section of carry trade returns. We show that conditional linear and Bayesian treed Gaussian process (BTGP) models with perfect foresight of these factors substantially outperform the random walk with respect to accuracy and market timing statistics out-of-sample at one-month horizons. Simple directional trading strategies based on conditional BTGP forecasts achieve superior average Sharpe ratios and profitability compared to those based on random walk forecasts in simulated real-time trading exercises for individual currencies.