

# Do Peso Problems Explain the Returns to the Carry Trade?

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*The Review of Financial Studies*, Volume 24, Issue 3, March 2011, Pages 853–891,  
<https://doi.org/10.1093/rfs/hhq138>

**Published:** 22 December 2010

## Abstract

We study the properties of the carry trade, a currency speculation strategy in which an investor borrows low-interest-rate currencies and lends high-interest-rate currencies. This strategy generates payoffs that are on average large and uncorrelated with traditional risk factors. We argue that these payoffs reflect a peso problem. The underlying peso event features high values of the stochastic discount factor rather than very large negative payoffs.

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