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Currency Returns, Intrinsic Value, and Institutional-Investor Flows

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ABSTRACT

We decompose currency returns into (permanent) intrinsic-value shocks and (transitory) expected-return shocks. We explore interactions between these shocks, currency returns, and institutional-investor currency flows. Intrinsic-value shocks are: dwarfed by expected-return shocks (yet currency returns overreact to them); unrelated to flows (although expected-return shocks correlate with flows); and related positively to forecasted cumulated-interest differentials. These results suggest flows are related to short-term currency returns, while fundamentals better explain long-term returns and values. They also rationalize the long-observed poor performance of exchange-rate models: by ignoring the distinction between permanent and transitory exchange-rate changes, prior tests obscure the connection between currencies and fundamentals.

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