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## Yield Curve Predictors of Foreign Exchange Returns

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### Abstract


In a no-arbitrage framework, any variable that affects the pricing of the domestic yield curve has the potential to predict foreign exchange risk premiums. The most widely used interest rate predictor is the difference in short rates across countries, known as carry, but the short rate is only one of many factors affecting domestic yield curves. We find that in addition to interest rate levels other yield curve predictors have significant ability to forecast the cross section of currency returns. In particular, changes of interest rates and term spreads significantly predict excess foreign exchange returns, exhibit low skewness risk, and are lowly correlated with carry returns. Predictability from these yield curve variables persists up to 12 months and is robust to controlling for other predictors of currency returns.

**Keywords:** carry trade, cross section of foreign exchange rates, predictability, term structure, uncovered interest rate parity

**JEL Classification:** E43, F31, F37, G15, G17

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