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Contrarian strategy and overreaction in foreign exchange markets

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Abstract

This paper investigates patterns to assist investors to forecast future exchange rate movements. We test for overreaction and underreaction examining exchange rate changes following excess 1-day fluctuations for currencies in two emerging (Turkey, Brazil) and two developed (US, UK) countries. Using euro as the base currency, we identify that the Turkish lira, the Brazilian real and the US dollar overreact, while the British pound underreacts. In the case of British pound, asymmetric responses and lack of volatility are two crucial factors to reject overreaction. Also, we find that contrarian strategy can be used in all currency markets for profitable investments.

JEL classification: F31; G14

Keywords: Overreaction; Underreaction; Exchange rate; Contrarian investment

1. Introduction

Overreaction and underreaction phenomena have been widely studied during the last decade. However, most of the studies focus on stock markets. Hence, it is of great interest to examine whether these phenomena can be applied in currency markets where large fluctuations occur mainly when national economic cycles are out of synchronisation. Increasing synchronisation and convergence during the last years, made these fluctuations to appear rarely. Hence, in this

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paper we study not only extreme movements for developed markets (EU, US, UK), but also for two emerging markets which during the last decade experienced at least one blow-out. Particularly, we study the Turkish lira, i.e. TR (collapse in 2001) and the Brazilian real, i.e. BRL (collapse in 1999). In this study, the exchange rates are defined as the number of foreign currency units per euros.

In an overreaction event the price level is way beyond where it should be. A key feature of the overreaction is that this phenomenon conveys a contrarian or a momentum strategy (see Nam et al., 2001). The response in the price of a currency to these phenomena is of great interest for fund managers who during the last years undertake diverse approaches to managing assets. Indeed, hedge funds are growing in popularity and attract a large portion of investor's portfolios, and as a consequence the contrarian style of managing funds is becoming more and more prevalent.

The objective of this study is to determine whether: (i) exchange rates respond properly to information, giving rise to overreaction hypothesis; and (ii) a contrarian strategy can be used in currency markets.

Studying extreme 1-day fluctuations, our findings provide sufficient evidence that all currencies except for the British pound, overreact. Moreover, we find that contrarian investment strategy holds for all exchange rates.

This paper contributes to the existing literature in two ways: (i) sheds more light to exchange rate fluctuations, studying overreaction hypothesis which so far has not been used widely in the academic society; and (ii) investigates that contrarian strategy can be used very profitable from investors to foreign exchange markets.

The structure of the paper is organized as follows: Section 2 briefly presents the literature review. Section 3 presents the data. Section 4 analyzes methodological issues. The empirical results are reported in Section 5. Section 6 contains the concluding remarks.

2. The literature review

DeBondt and Thaler (1985) are among the first who find that stock prices behaved as if individual investors overreacted to given information. They find that in the stock market a contrarian strategy which buys losers and sells winners based on their returns over a 3- to 5-year horizon performs well in subsequent holding periods of 3–5 years. Their finding provides assistance on security selection for practitioners.

The phenomenon of overreaction and underreaction has also been studied from Clare et al. (1995), Barberis et al. (1998) and Nam et al. (2001), among others, providing supportive results for the overreaction hypothesis for the UK and the US stock markets. Akhigbe et al. (1998) and Peterson (1995) examined post-event abnormal returns with extreme 1-day stock prices changes for US stocks. Their findings support the overreaction hypothesis. Also, Larson and Madura (2003) used extreme 1-day returns for a sample of losers and winners by selecting daily stock price returns in excess of 10%. They found that for winners, there is overreaction in response to uninformed events but no overreaction on average in response to informed events. This finding according to Larson and Madura (2003) suggests that the degree of overreaction to new information depends on whether the cause of the extreme stock price change is publicly released.

Moreover, Fung et al. (2000) and Grant et al. (2005) used futures market as "lead" contract to assess the question of intraday price reversals following large price changes at the market open. They find highly significant intraday price reversals as well as significant intraday reversals in yearly and day of the week investigations.