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Journal of Banking & Finance 28 (2004) 1023–1041

Journal of
BANKING &
FINANCE

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Futures trading activity and predictable foreign exchange market movements

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Received 8 October 2001; accepted 10 January 2003

Abstract

In this paper, we examine the relation between futures trading activity by trader type and returns over short horizons in five foreign currency futures markets – British pound, Canadian dollar, Deutsche mark, Japanese yen, and Swiss franc. Transforming trading activity into a sentiment measure, we find that speculator sentiment is positively related to future returns. In contrast, hedger sentiment covaries negatively with future returns. We also find that extreme sentiment by trader type is more correlated with future market movements than moderate sentiment. Our results suggest that hedgers lose to speculators in these futures markets, on average. Based on equilibrium pricing models that futures risk premiums are determined by both market risk and hedging pressure, we show that the profits to speculators are in general compensation for bearing risk.

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JEL classification: G13; F31

Keywords: Trading activity; Return predictability; Currency futures; Hedging pressure; Risk premiums

1. Introduction

The efficiency of foreign exchange (FX) markets has long been a central issue in international finance research. A large volume of literature applies technical trading rules in spot and futures FX markets and documents unexploited profit opportunities. Examples of this literature include Sweeney (1986), Taylor and Allen (1992),

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Levich and Thomas (1993), Kho (1996), and LeBaron (1999). Other FX puzzles such as forward bias and deviations from uncovered interest parity raise further questions about the efficiency of FX markets.¹

More recent research applies tools from the market microstructure literature to study currency price dynamics in terms of order flow between various types of FX dealers. These studies find that the information structure between FX dealers influences the dynamics of prices and the patterns of trades. The observed correlation between order flow and currency returns is generally interpreted to mean that some agents possess private information (e.g., Lyons, 1995; Evans, 2002; Evans and Lyons, 2002).

This paper adds to the recent literature by examining whether a specific trader type consistently beats the market in five actively traded foreign currency futures markets that include the British pound (BP), Canadian dollar (CD), Deutsche mark (DM), Japanese yen (JY), and Swiss franc (SF). We thus provide a test of FX market efficiency in the futures context. To accomplish this, we examine the relation between futures returns and lagged net positions of speculators and hedgers.² To facilitate comparisons across markets and to allow for an intuitive measure, we construct a sentiment index based on net trader positions. We then focus on the profitability of sentiment-based timing strategies.

We find that investor sentiment by trader type varies systematically with returns over short horizons in the futures markets in our sample. However, the relation between sentiment and future returns differs for speculators and hedgers. Whereas speculator sentiment varies positively with future returns, hedger sentiment varies negatively with future returns. We also find that extreme sentiment is more correlated with future market movements than is moderate sentiment. Our results suggest that speculators profit from trading currency futures, but hedgers lose money, on average.

At first glance, our results appear to contradict the efficient markets hypothesis (EMH). However, if speculator sentiment varies with expected risk premiums, the superior performance of speculators does not necessarily imply market inefficiency. Various asset pricing studies have documented evidence of time varying risk premiums in currency futures markets (e.g., McCurdy and Morgan, 1991, 1992; Bessembinder, 1992; Kho, 1996). Unless risk premiums implicit in sentiment-based timing strategies are properly addressed, concluding that the profits to speculators are unusual may be premature.

To adjust for risk, we analyze the sources of speculative profits based on the equilibrium pricing model of Hirshleifer (1990) who shows that futures risk premiums are determined by both systematic market risk and hedging pressure. Market risk arises from the correlation of the futures price with a market portfolio. Hedging pressure

¹ Hodrick (1987) and Engel (1996) provide surveys of the large literature in this area.

² These traders are categorized on the basis of whether a trader holds a reportable position to hedge a risk as defined by the Commodity Futures Trading Commission (CFTC). The trader position information has been published in the CFTC's weekly Commitments of Traders (COT) reports since October 1992. Data are described more fully in Section 2.

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