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## Systematic Consumption Risk in Currency Returns

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# Systematic Consumption Risk in Currency Returns\*

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## Abstract

We sort currencies into portfolios by countries' past consumption growth. The excess return of the highest- over the lowest-consumption-growth portfolio — our consumption carry factor — compensates for negative returns during world-wide downturns and prices the cross-section of portfolio-sorted and of bilateral currency returns. Empirically, sorting currencies on consumption growth is similar to sorting currencies on interest rates. We interpret these stylized facts in a habit formation model: sorting currencies on past consumption growth approximates sorting on risk aversion. Low (high) risk-aversion currencies have high (low) interest rates and depreciate (appreciate) in times of global turmoil.

JEL Classification Numbers: E44, F31, F44, G12, G15

Keywords: foreign exchange, uncovered interest parity, carry trade returns, consumption risk, asset pricing, habit model

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