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Carry Trade Strategies Based on Option-Implied Information: Evidence from a Cross-Section of Funding Currencies

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Abstract

We document carry trade returns based on the moments extracted from options on the underlying currencies. We establish three important results. First, a currency pair is predicted to have greater excess returns if option-implied returns are more volatile, are more left-skewed, and have fatter tails than the returns of other currency pairs. Second, strategies based on option-implied information improve on benchmark strategies based on realized market returns and macroeconomic data. Third, if the option-implied returns of a currency pair are more left-skewed than in the past, anti-carry trades rather than carry trades perform better.

Keywords: Carry trade, Currency options, Option-implied moments, Funding currencies, Carry trade unwinding.

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