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“The Carry Trade Returns and Decomposed Foreign Exchange Market Volatilities”

Abstract:
We find that the cross sectional excess returns from the foreign exchange (FX) market can be explained by the FX volatility risk very well, the theoretical support of this finding is Chen (2003) version of Intertemporal Capital Asset Pricing (I-CAPM) model, which argues that risk-averse investors also want to directly hedge against changes in future market volatility and therefore market volatility risks are negatively priced.
Further, as inspired by Adrian and Rosenberg (2008), we decompose FX volatility into two components: a persistent component and a less persistent component and we find that both components are negatively and significantly priced when explaining the excess returns from the carry trade. This implies that investors pay for insurance against increases in FX market volatility, even if those increases have little persistence.