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# Foreign Exchange Predictability and the Carry Trade: A Decomposition Approach\*

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## Abstract

In this paper, we decompose currency returns into multiplicative sign and absolute return components, which exhibit much greater predictability than raw returns, and use the joint conditional distribution of these components to obtain forecasts of future exchange rate returns. Our results suggest that the decomposition model produces higher forecast and directional accuracy than any of the competing models. We undertake trading exercises using carry trade returns and show that the forecasting gains translate into economically and statistically significant (risk-adjusted) profitability when trading individual currencies or forming currency portfolios based on the predicted returns from the decomposition model.

**Keywords:** Exchange rate forecasting; Carry trade; Return decomposition; Copula; Joint predictive distribution.

**JEL classification codes:** F31, F37, C32, C53, G15.

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