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Persistent exchange-rate movements and stock returns



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ABSTRACT

We hypothesize that persistent exchange-rate movements are a distress risk and a state variable in the Merton (1973) sense. To test our hypothesis, we use the tracking portfolio approach of Lamont (2001) to capture news about future persistent exchange-rate movements. We find empirical evidence that supports our hypothesis, which has important implications for both international finance and empirical asset pricing. For international finance, our evidence provides an alternative explanation for the exposure puzzle and suggests researchers focus on persistent, instead of contemporaneous, exchange-rate movements. For empirical asset pricing, our findings imply a fresh and plausible perspective of exchange-rate risk, a state variable underlying the Fama–French factors.

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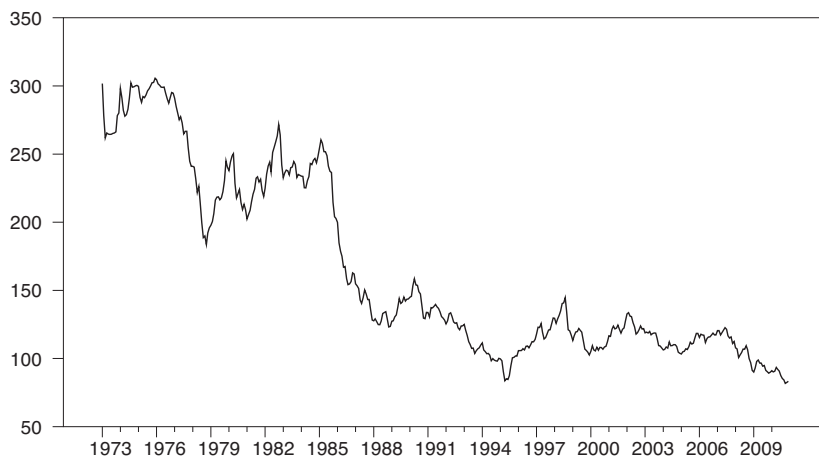
1. Introduction

There has been a persistent appreciation of Japanese yen against the United States (U.S.) dollar since 2007 (see Panel A of Fig. 1). For instance, in 2011, the exchange rate of Japanese yen to one U.S. dollar appreciated from 81.94 at the end of February to 77.58 on December 9. A major headline in the *The Wall Street Journal* on December 10, 2011 stated “Toyota Slams on the Brakes: Car Maker Cuts Profit Goal by 54%; Strong Yen Is ‘Destroying’ Japanese Industry.” The article points out that persistent strong yen (together with two natural disasters) “have eroded Toyota’s position against global rivals. . . and

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Panel A Japan / U.S. Foreign Exchange Rate



Panel B Major Currencies Index (MCI)

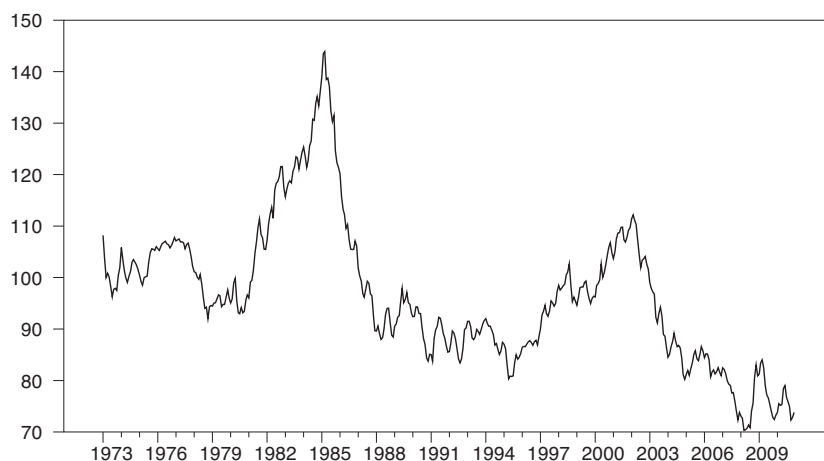


Fig. 1. The Japan/U.S. foreign exchange rate and the Major Currencies Index (MCI) from the Board of Governors of the U.S. Federal Reserve System.

pose longer-term worries. . . Toyota has lost 2.5% points of the U.S. auto market. . . Its stock price in New York has fallen 33% since the end of February.”

The Toyota story manifests a real yet not well-studied link between exchange-rate movements and stock returns. Specifically, persistent exchange-rate movements can push firms into financial distress and change the investor’s risk-return tradeoff. Put differently, persistent exchange-rate movements are a distress risk and a state variable in the [Merton \(1973\)](#) sense. This inter-temporal perspective is different from that of the International Capital Asset Pricing Model (ICAPM) of [Solnik \(1974\)](#), [Sercu \(1980\)](#), and [Adler and Dumas \(1983\)](#), which focuses on contemporaneous exchange-rate changes.

[Chan and Chen \(1991\)](#) and [Fama and French \(1996\)](#) argue that the size and value factors mimic underlying distress risk. [Kapadia \(2011\)](#) presents evidence that supports this idea. Therefore, to test our hypothesis that persistent (not contemporaneous) exchange-rate movements are a state variable and a distress risk, we focus on the comparison among four asset-pricing models. They are the Capital Asset Pricing Model (CAPM) of [Sharpe \(1964\)](#) and [Lintner \(1965\)](#), an enhanced version of the CAPM that

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