



# The Equity Differential Factor in Currencies

## Equity momentum can predict currencies, too

What is the relationship between a country's currency and the performance of its stock market? A survey of the literature quickly leads to an economist's familiar refrain: "It depends." There is, however, one particular relationship between these two markets that we find to be incredibly consistent, intuitive, and relevant for currency investing. And yet it has been rarely (if ever) discussed. In the brief summary that follows, we describe this equity differential factor and show how it has predicted currency returns over time.

It turns out that currencies tend to rise in value when their country's stock market has done well recently, say, over the past year. Now, there are a few important caveats to seeing this relationship clearly. First, it is important to consider every currency pair—like USD-GBP, JPY-AUD, CHF-EUR and so forth—rather than looking narrowly at just a single base currency like the US dollar. Second, it is the performance of each stock market denominated in its own home (local) currency that matters. And third, the currency effect happens after the local stock market has performed well.

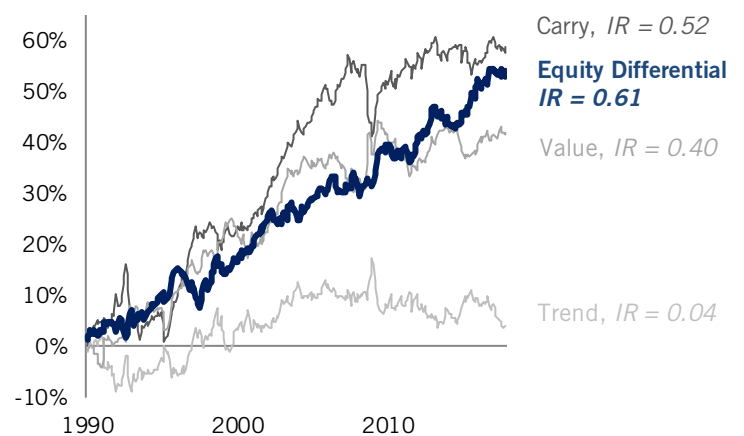
The chart above shows the historical performance of the equity differential factor applied to all 45 pairs of the major G10 currencies. It has a higher information ratio than the "traditional" currency strategies of carry, value and trend, and it is essentially uncorrelated to them. Moreover, it has worked well recently, as the others have faltered.

The most likely explanation for this factor is intuitive. It aligns with two of the most well-known predictive effects in finance: the momentum effect in stocks, and the carry trade in currencies. Momentum implies that investors chase positive performance. If so, the currency of the market they crave should see higher incremental demand which may cause it to rise. This is the same logic as investors chasing higher bond yields which benefits the FX carry trade. There could be other explanations, too. But whatever the reason, this effect has been surprisingly persistent over time.

For more on this topic, see our 2019 working paper on SSRN:

**"The Equity Differential Factor in Currency Markets"** by David Turkington and Alireza Yazdani.

## Currency factors: Returns and information ratios



Source: State Street Global Markets. Notes: Results span Jan 1990 to Dec 2017. The carry, value, trend and equity differential factors rank 45 G10 currency pairs according to the differential in their interest rate, inverse of 60-month spot return, 12-month trailing spot return, and 12-month trailing local equity market return differential, respectively, and assumes investment in one-month forward contracts.

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