Context - Arguably the most prominent FX strategy, the carry trade, is a setup that takes long positions in high interest rate currencies (called target currencies) financed by borrowing in low interest rate currencies (funding currencies). If uncovered interest rate parity (UIP) holds, the interest differential (called carry) is supposed to be offset by corresponding exchange rate movements. But failure of uncovered interest rate parity has translated into considerable gains from this form of currency speculation. It is a well-known industry fact that FX carry trades have shown to be highly profitable, albeit large drawdowns, and are widely used among professional currency fund managers.

Goal – A naïve currency carry strategy offers promise but is vulnerable to large idiosyncratic currency devaluations (or peso problem) and flight to safety effects. Goal of the study was to explore other signals that can control tail characteristics of the strategy thereby improving it's expected return and return on risk characteristics

Solution – Currency carry trade uses local interest rate differentials while ignoring the FX market. So, the solution was to use cross market signals from FX spot market to side-step drawdowns of the naïve strategy. Application of following signal suite helped in getting in/out of carry trades opportunistically thus limiting sensitivity to downside:

1. **Momentum**: Tendency for markets to under-react to information on a certain horizon
2. **Mean Reversion:** Tendency to over-react to information on a different horizon
3. **FX Skewness Preference:** Investors tend to over-sell negatively skewed currency
4. **FX Lottery Seeking Preference**: Leverage constrained investors tend to bid up more volatile currency in a search for yield thereby reducing its expected return

Strategy was further optimized in consideration of January effect and by establishing certain stop loss constraints

Final Comments and Further Work - Style-based investing in foreign exchange markets is gaining steam and accounts for a noticeable fraction in trading volumes. It would be beneficial to enhance our knowledge in this domain, explore signals and their implications on portfolio allocation. For instance, one could make the strategy more robust by using information from curve dynamics of both rates/FX forward market