Journal of Banking & Finance 62 (2016) 191–212

Contents lists available at ScienceDirect

Journal of Banking & Finance

journal homepage: www.elsevier.com/locate/jbf

Flight-to-quality and correlation between currency and stock returns

Jin-Wan Cho [a,*], Joung Hwa Choi [b,1], Taeyong Kim [c,2], Woojin Kim [b,3]

[a] International Arbitration and Alliance Group, 7th Floor, 555 Nonhyun Ro, Gangnam Gu, Seoul 135-907, Republic of Korea
[b] Seoul National University Business School, 1 Gwanak Ro, Gwanak-Gu, Seoul 151-916, Republic of Korea
[c] Morningstar Associates Korea, 4F Dabo Bldg., 140 Mapo-Dong, Mapo-Gu, Seoul 121-714, Republic of Korea

ARTICLE INFO

Article history:
Received 24 July 2013
Accepted 8 September 2014
Available online 28 September 2014

JEL classification:
G10
G11
G15
G23

Keywords:
Flight-to-quality
Capital flows
Correlation between currency and stock returns
Currency hedging

ABSTRACT

We document that capital flows in and out of emerging or developed markets are sensitive to global equity market conditions. Capital tends to move out of emerging into developed countries in global down markets, leading to depreciation (appreciation) of emerging (developed) currencies. This generates a positive (negative) correlation between currency and equity in emerging (developed) markets which is amplified by the magnitude of the capital movement. We also verify that hedging currency risks may undo the natural hedge and increase the total return volatility under negative correlation.

1. Introduction

Understanding the relationship between equity and currency markets is an essential component of international portfolio management, since investments in foreign stocks inevitably involve investments in foreign currencies. Surprisingly, however, this issue has received relatively little attention from both academics and practitioners, perhaps because the theoretical determinants of exchange rates suggested by macroeconomists have failed to outperform a simple random walk process (Meese and Rogoff, 1983). If exchange rates were indeed random, we would observe no systematic correlation between equity and currency markets.

A notable exception to this negligence is a recent study by Hau and Rey (2006), who develop a theoretical model that generates a systematic negative relationship between equity and currency returns through order flows in the foreign exchange (hereafter 'FX') market. Investors in their model face limited hedging opportunities and must thus "rebalance" their foreign equity position following a gain, leading to capital outflows and the subsequent depreciation of the relevant foreign currency. Using data from 17 OECD countries, they provide evidence of such a negative correlation between currency and stock returns. Although this explanation sounds persuasive, the universal negative correlation implied in their model holds only when equity markets are uncorrelated across countries. If equity markets are positively correlated, however, a negative correlation in one market may imply a positive correlation in another.

This paper examines a broader set of equity-currency pairs and tests whether Hau and Rey (2006)'s prediction of a universal negative correlation still holds in a more general setting. In particular, we analyze pair-wise correlations between currency and stock returns using 9 developed and 12 emerging markets occurring between 1996 and 2009 that are neither under fixed nor managed float exchange rate system. In contrast to Hau and Rey (2006)'s universal *negative* correlation observed within developed markets, we find that currency returns are *positively* correlated with stock returns in emerging markets and, thus, that an emerging country's currency tends to appreciate when its stock market is bullish. For example, in a pair-wise analysis of Korea and the U.S., the Korean Won tends to strengthen against the U.S. dollar when the Korean stock market gains and vice versa. This relationship remains quite

* Corresponding author. Tel.: +82 2 538 9969
E-mail addresses: npvcho@interaag.com (J.-W. Cho), choijh@snu.ac.kr (J.H. Choi), Kevin.Kim@morningstar.com (T. Kim), woojinkim@snu.ac.kr (W. Kim).
[1] Tel.: +82 10 4713 2730.
[2] Tel.: +82 2 3771 0771.
[3] Tel.: +82 2 880 5831.

http://dx.doi.org/10.1016/j.jbankfin.2014.09.003
0378-4266/

stable over time and intensifies during down markets. For emerging countries, not only is the correlation between currency and stock returns positive, but it is also larger in magnitude.[4] In contrast, for developed markets such as the U.S., the correlation is negative but weak. That is, Hau and Rey (2006)'s prediction is empirically supported, only when we restrict our attention to developed markets.

A key contribution of this paper is that we provide an alternative mechanism that could potentially affect the correlation between equity and currency markets, based on capital movements induced by flight-to-quality. We suggest a plausible channel through which positive (negative) correlation between currency and equity in emerging (developed) markets may jointly arise, and provides empirical evidence consistent with this conjecture. Specifically, international portfolio rebalancing may create capital flows in and out of emerging market stocks in a procyclical way, which would create demand and supply in their respective currencies. These capital movements tend to be more pronounced in down markets. For example, during the 2008 global financial crisis, world financial markets witnessed a flight-to-quality phenomenon in which capital moved from emerging market stocks to a market of a higher "quality" or developed markets.

We use balance of payments information to test these hypotheses. Although the data employed in this analysis are somewhat crude in terms of its frequency, we are nevertheless able to document that the capital flows in and out of emerging market stocks are procyclical on average. Specifically, MSCI world index returns are positively correlated with net capital flows for equity investments in emerging markets but negatively correlated with those in developed markets. When we partition the sample into up markets and down markets, we find that net capital flows are sensitive to overall stock market conditions only in down markets, consistent with the flight-to-quality arguments.

We next examine if such net capital movements, potentially driven by flight-to-quality, can explain the degree of correlation between equity and currency returns, especially in emerging markets. Our results suggest that the positive correlation between equity and currency returns observed in emerging markets becomes stronger when there is a larger capital movement for stock investments in and out of the economy. On the other hand, net capital flows for stock investments in and out of developed countries do not explain the degree of correlation between equity and currency returns in these markets. Presumably, exchange rates in developed markets are determined through a much more complex mechanism involving a host of real and financial factors.

These results have important implications for hedging strategies in international portfolio management. Note that currency return volatility is a key component of overall risk in international stock investments.[5] Our findings suggest that the way the currency return affects overall risk is asymmetric depending on whether the investors are from an emerging or a developed country. Since stock markets around the world are generally positively correlated and an emerging country's currency is positively correlated with its own stock market, the developed country's currency is likely to be negatively correlated with the two stock markets. Therefore, when investors in developed countries invest in emerging markets, hedging currency risk may reduce the overall volatility since currency return amplifies total return volatility. In contrast, when investors in emerging countries invest in developed markets, currencies provide a natural hedge since they tend to move in the opposite direction to that of the underlying foreign asset. Thus, hedging currency risk may actually increase the overall volatility by undoing the natural hedge.

Our final set of analyses explicitly tests this implication on currency hedging. We provide an interesting empirical analysis of open-ended international mutual funds, where currency hedging adversely affects total return volatility. Using a sample of 32 Korean "Siamese Twin" fund pairs holding identical underlying foreign assets but offering different currency hedging alternatives, we find that the hedged portfolios exhibit larger total return volatility than their non-hedged counterparts, largely because the values of the foreign currency and the underlying assets are negatively correlated, and the hedging schemes effectively undo the natural hedge provided by the currency markets.

The rest of this paper is organized as follows. Section 2 provides a review of the literature on the relationship among exchange rates, stock returns, and capital flows from which we derive our main hypotheses. Section 3 describes our data sources and the construction of our key variables. Section 4 offers a pair-wise analysis of currency and stock returns around the world and provides evidence that emerging market currencies tend to move together with their stock returns. Section 5 investigates how market conditions may affect capital movements in line with flight-to-quality and how such capital movements may affect the relationship between the currency and stock returns using balance of payments data for each country. Section 6 presents robustness checks for our empirical results based on dynamic conditional correlations (DCC). Section 7 presents empirical analyses of 32 Siamese Twin international mutual funds sold in Korea for which currency hedging turned into a 'friendly fire' by inadvertently increasing total return volatility. Section 8 concludes the paper.

2. Literature review and hypothesis development

Our key focus is on the relationship between equity and currency markets potentially linked through cross-border capital flows triggered by flight-to-quality. Accordingly, we build on two broad categories of research: cross-border capital flows from equity investment, and time varying risk premia and flight-to-quality.

Traditional macroeconomic theories on FX rate based on purchasing power or interest rate parity, unfortunately, have not been much successful in explaining short- and medium-term movements in exchange rates. In a seminal paper, Meese and Rogoff (1983) initially showed that sophisticated structural exchange rate models based on fundamentals underperform a simple random walk benchmark in a variety of empirical tests.[6] It is somewhat surprising that equity market variables have never been seriously considered in this strand of literature as a potential macro-level factor that might be correlated with exchange rates. This might partly reflect the relative neglect of the stock market by macroeconomics literature due to the perception that stock markets are too volatile to have a meaningful influence on real sectors of the economy (Fischer and Merton, 1984).[7]

A line of research has developed to explore how equity market returns may influence (and be influenced by) cross-border capital flows. The main difficulty with this research is that cross-country capital flow data are generally available at quarterly or monthly

[4] Parsley and Popper (2006) examine foreign exchange exposure of firms in Asia–Pacific region. They find that firms in this region are more significantly exposed to foreign exchange risks than the firms in the developed countries, and the extent of the exchange rate exposure is persistent.

[5] The total return from an international investment consists of the return from the underlying foreign asset and the return from the corresponding currency.

[6] Frankel and Rose (1995) provide a comprehensive survey of empirical research on nominal exchange rates, and conclude that structural models based on macroeconomic fundamental variables such as inflation rate and interest rate differentials generally do not outperform well in sample, let alone forecasting out of sample.

[7] A notable exception is Pavlova and Rigobon (2007), who develop a formal model where stock returns and exchange rates may co-move due to demand shocks and trade in goods.

intervals at best. Brennan and Cao (1997) examine U.S. investors' portfolio investment abroad at a quarterly frequency and find that host countries' equity returns are positively correlated with U.S. investors' equity purchases, especially when the host country is an emerging market.[8] Subsequently, Froot et al. (2001), Griffin et al. (2004) and Richards (2005) all document that equity returns and currency returns may be linked through movements in capital flows, precisely the view this study takes.

The most recent financial crises have revitalized research on the notion of "flight-to-quality," which is supported by both the empirical and theoretical literature. For example, Vayanos (2004) and Caballero and Krishnamurthy (2008) suggest that increased volatility and uncertainty during economic recessions make investors more risk averse and lead them to sell risky assets and purchase relatively safe assets instead. In addition, Lettau and Ludvigson (2010) and Lustig and Verdelhan (2012) show that the U.S. stock market exhibits countercyclical risk premia. Verdelhan (2010) develops a habit model to explain the uncovered interest rate parity puzzle in which the countercyclical risk premia are endogenously determined. Since emerging stock markets are generally riskier than developed markets, the notions of flight-to-quality can be explained if investors require countercyclical risk premia. However, these studies do not explore the effects of these capital flows on the relationship between equity and currency markets.

The work arguably most closely related to ours is Hau and Rey (2006), who provide a formal model under which exchange rates, capital flows, and equity returns are endogenously determined in response to random dividend shocks. A key prediction of their model is that bullish equity markets imply weaker (rather than stronger) currency, which is somewhat counterintuitive. This prediction is based on the strong assumption that currency risk is not hedgeable, so that mean–variance optimizing investors will pull out of a bullish foreign market to reduce increased exposure in foreign equity and rebalance their portfolios. Consistent with this prediction, they find that foreign equity returns (in local currencies) and currency returns (in dollars) are negatively correlated for most developed markets from U.S. investors' perspective.[9]

Although Hau and Rey (2006) seem to provide a coherent view of the link between equity and currency markets through capital flows, we challenge their perspective on the following empirical and theoretical grounds. First, their model predicts a *universal* negative correlation across all the countries, which critically hinges on the assumption that the dividend shocks are random across them. However, if dividend shocks are positively correlated (as evidenced by the positively correlated equity markets across the world), a negative correlation between equity and currency for one country would imply a positive correlation for the other in a bilateral context.[10] Our results indicate that such a negative correlation applies mostly to emerging market investors investing in developed markets, while a positive correlation prevails for developed market investors investing in emerging markets.

Previous research also highlights the importance of the numeraire currency used to evaluate currency returns; even for a single destination, the correlation between equity and currency returns may critically depend on which home currency is used to evaluate the currency return. As emphasized in Schmittmann (2010), an investor's base currency matters significantly in drawing implications for currency hedging policy, which provides a warning against generalizing results obtained using one base currency (e.g., U.S. dollar to another currency). This study employs a full pair-wise analysis that allows the numeraire to vary across home countries.

Second, Hau and Rey's (2006) argument depends on portfolio rebalancing in which a bullish host stock market leads to a capital outflow from the market. However, this prediction contradicts the empirical findings in Brennan and Cao (1997), Froot et al. (2001), Griffin et al. (2004), and Richards (2005), who all report a positive relationship between capital inflows and equity returns, especially in emerging markets. This again suggests that Hau and Rey (2006) may reflect specific characteristics of certain regions, namely developed markets. On the other hand, our results are consistent with the literature reporting a positive relationship between capital flows into emerging markets and their equity returns.

Finally, Hau and Rey (2006) is based on the key assumption that currency hedging option is unavailable to international investors. However, given the full menu of financial contracts and derivative products available, especially to institutional investors, this assumption seems too strong. Even emerging market retail investors such as in Korea are provided with an easy option of hedging or not hedging their currency risk when investing overseas, as we elaborate in Section 7. This study considers a full nonsymmetric matrix of bilateral relationships between 21 countries, including both developed and emerging markets, to provide a more complete picture of the link between currency and equity through capital movements.

In studies investigating FX exposure at the firm level, Bartov and Bodnar (1994) find that only a few U.S. firms are exposed to FX risks. He and Ng (1998) find similar results for a sample of Japanese firms. To the contrary, Parsley and Popper (2006) find that firms in eleven Asia–Pacific countries exhibit stronger FX exposure than those in developed countries. Even though the results at the firm level may not be generalized to the aggregate level in a straight forward manner, these firm level findings underscore a stronger link between equity and currency markets for the emerging countries than the developed.

3. Data and variable construction

Our first empirical analysis focuses on the pair-wise correlation structure between currency and stock markets. We obtain weekly returns on stock market indices and exchange rates for 21 countries between 1996 and 2009 from Datastream. The sample period is conditioned largely by data availability. All exchange rates are first extracted in U.S. dollars, and, whenever necessary, we calculate cross-rates in the units of other currencies. For Germany, the exchange rates are based on the Deutsche Mark until December 31, 1998, after which it switches to euro. For the U.S., we use the trade-weighted exchange rates obtained from the Federal Reserve. Both our currency returns and stock index returns are log returns.

We classify 21 countries into 9 developed and 12 emerging markets based on the Economic and Financial Indicators section of *The Economist*.[11] Countries are excluded from the sample if they are under either a fixed or managed float exchange rate regime. This filter excludes most of the countries in the Eurozone, except Germany, which has the largest market capitalization in the region and is thus selected as the stock market representing the Euro.

Parsley and Popper (2006) show that even when a country is under fixed/pegged exchange rate regime, firms in that country

[8] Brennan and Cao (1997) examine whether capital flows are related with currency returns but do not find any evidence for U.S. investors investing overseas.

[9] Such a negative correlation between equity and currency returns has been documented in other studies as well. Brooks et al. (2004) report a negative relationship between equity and currency returns from the eurozone investors' perspective when investing in U.S. equities. Lane and Milesi-Ferretti (2003) document results similar to those provided in Hau and Rey (2006) for a sample of developed markets.

[10] Campbell et al. (2010), Schmittmann (2010), Eun and Resnick (1994), Brooks et al. (2004) suggest that the predominance of negative correlations may be driven by certain sub-regions within the global equity market.

[11] More specifically, we use the April 13, 2002, issue.

may well be exposed to currency risks against various currencies. This is because even when the home currency is pegged to a foreign currency, e.g. the U.S. dollar, it can fluctuate against another foreign currency, e.g. Euro, since the two foreign currencies may not be pegged to each other. However, most of the governments that adopt fixed/pegged exchange rate regime also typically control the capital flows in and out of their country. Since our main hypothesis is that capital flows are a key channel through which equity and currency returns may be correlated, it cannot be effectively tested when capital flows are controlled by the government. Therefore, we exclude the countries that adopt fixed/pegged exchange rate regime.

Our main empirical tests examine how global stock market conditions affect international capital movements, which in turn affect the correlation structure between the currency and stock markets. Our proxy for global stock market conditions is the MSCI world index return obtained from Datastream. We resort to the Balance of Payments (BOP) account to construct our net capital flow data. Quarterly BOP data for 1996–2009 are obtained from the International Financial Statistics (IFS) reported by the International Monetary Fund (IMF). Net capital flows for investment in stocks are defined as increases in equity liabilities minus increases in equity assets during a given quarter.

In addition, we consider a number of country-level control variables, including market capitalization, value of shares traded, GDP, and FX market size. The first two are obtained from the World Federation of Exchanges, the third from the BIS Triennial Central Bank Survey, and the last from the IFS. The BIS Triennial Central Bank Survey provides the average daily FX market turnover in April for all countries in our sample. The triennial surveys we use are those published every three years from 1998 to 2010.[12]

Our final analysis examines the effect of currency hedging when the underlying foreign assets and their currencies are negatively correlated, based on Korean Siamese Twin international mutual funds. We obtain weekly per share return series on these funds from the Morningstar Korea Financial Investment Association. There are 32 fund pairs between March 2007 and December 2013 offering both hedged and non-hedged classes.

4. Pair-wise analyses of currency and stock markets

4.1. Correlations between international stock markets

It is widely argued that world equity markets are rapidly being integrated. This integration naturally increases the correlation between stock markets, reducing the magnitude of benefits from international diversification. Indeed, Longin and Solnik (1995) show that the international correlation between markets increased from 1960 to 1990.

Before we examine the relationship between stock returns and currency returns, we first verify whether such correlation exists across stock markets in our sample. Table 1 presents the correlation among international stock markets based on weekly index returns denominated in local currencies. The first column shows the averages of correlations between the home country's stock market with twenty other destination markets. The first column represents the correlation over the entire sample period, from January 1996 to December 2009, based on 720 weekly returns. Columns (A) and (B) present the corresponding numbers for two subperiods of equal length. The last column, (B–A), presents the correlation changes over the two subperiods. The last four lines of the table report the average correlations for all countries, emerging markets, and developed markets, as well as the difference between emerging and developed markets. The *p*-values are given in parentheses.

A number of stylized facts emerge from the table. First, all 21 countries in our sample experience an increase in average correlation, as in Longin and Solnik (1995), all of which are statistically significant at the 1% level. The countries with a higher than 0.2 increase in the second half of the sample period are Brazil, the Czech Republic, Korea, and Turkey among emerging markets and Australia and Japan among developed markets. These are the countries that have rapidly integrated into the global capital market in recent years.

Second, developed markets exhibit higher correlations on average than emerging markets. For example, the overall average for all countries in our sample is 0.472, while the corresponding numbers for developed and emerging markets are 0.536 and 0.425, respectively. This relationship holds in both subperiods, where the average of correlations is about 0.1 higher for developed markets.

The strong positive correlation across stock markets around the world raises a critical challenge to the key assumption in Hau and Rey (2006) that stock returns in each country are randomly generated. This also implies that, as long as the returns from the currency markets are not considered or the currency returns can be hedged away, investors in developed markets may gain a higher diversification effect by including emerging market stocks in their portfolios.

4.2. Correlation between currency and domestic stock markets

Once currency markets are taken into account, however, the gains from international diversification are not so straightforward, as the return from currencies constitutes an integral part of the "total return" from an international investment. Studies that explicitly consider currency risks in their analyses include Eun and Resnick (1988, 1994) and Jorion (1989). Using U.S. and Japanese bond and equity market returns, Eun and Resnick (1994) find that, when the exchange rate risks are taken into account, the gains from international diversification from the U.S. investors' perspective occur mainly in terms of higher returns and, from the Japanese investors' perspective, in terms of lower risk. In other words, they show that currency returns provide different channels of diversification benefits depending on the origination of the investors.

We now investigate the correlation between each stock market in our sample and the local currency based on weekly currency returns and stock index returns. For all countries except the U.S., the currency values are initially measured in U.S. dollars.[13] For the U.S., trade-weighted exchange rates are used. The results are reported in Table 2. In Panel A, we report the correlations for the entire sample period and two subperiods, as well as the correlation changes from the first half to the second half, as in Table 1. The upper section presents the correlation between equity and currency returns for each country, while the lower section reports the average correlations across all countries as well as within emerging and developed markets. The last row shows the difference in correlation between developed and emerging markets; *p*-values are given in parentheses. In Panel B, we report the results separately for up markets and down markets within each country. Specifically, we

[12] Our final data set is an unbalanced panel since the IMF database started covering some of the countries in our analysis only after our sample period began. In addition, there are some missing observations for some of the control variables. If it were a fully balanced panel without any missing observations, the total number of observations in the regressions would have been 1176 (56 quarters for 21 countries). For BOP related variables, we have 12 observations missing for Switzerland, 16 for Poland and 21 for New Zealand, leaving us with 1127 observations. Further, for 'Market Cap' variable, we lose all 56 observations for Czech and 16 for Hungary, for 'Foreign Exchange Market Size' variable, 21 for Israel and Turkey, respectively, for 'GDP Growth' variable, 32 for Chile, for 'Turnover' variable, all 56 for Czech, 16 for Hungary, and 4 for New Zealand, and finally for 'Changes in Foreign Reserves' variable, 1 for Australia, which reduces the total number of observations used in our regressions to 976.

[13] This analysis is from U.S. investors' perspective. In the next subsection, we allow the investor's home country and the numeraire to vary.

Table 1
Average correlation coefficients among stock market indices. This table presents the average correlations among international stock markets. The first column presents the average correlations between the indicated country's weekly stock market index return with the twenty other markets' weekly index return. All averages are significantly positive at the 1% level. The Overall Period column presents the correlations over the entire sample period, from January 1996 to December 2009 based on 720 weekly returns. The next two columns, (A), and (B), report the results for two subperiods of equal length. The last column, (B–A), reports the increases in correlations over the two subperiods. The lower section of the table shows the summary statistics of the average correlations for all sample countries, emerging markets and developed markets. The last row reports the difference in averages between the emerging markets and developed markets. The *p*-values are given in the parentheses.

	Country	Overall period	(A) 1996–2002	(B) 2003–2009	(B–A) 2nd half–1st half
Emerging markets	Brazil	0.492	0.397	0.617	0.221
	Chile	0.423	0.362	0.493	0.131
	Czech Republic	0.438	0.322	0.556	0.235
	Hungary	0.484	0.425	0.572	0.147
	Israel	0.364	0.333	0.412	0.079
	Korea	0.382	0.298	0.544	0.246
	Mexico	0.507	0.427	0.620	0.194
	New Zealand	0.398	0.342	0.473	0.131
	Philippines	0.358	0.279	0.471	0.193
	Poland	0.435	0.377	0.538	0.161
	South Africa	0.489	0.436	0.560	0.124
	Turkey	0.326	0.267	0.471	0.204
Developed markets	Australia	0.525	0.423	0.628	0.205
	Canada	0.550	0.470	0.639	0.169
	Germany	0.579	0.507	0.668	0.161
	Japan	0.432	0.297	0.576	0.279
	Norway	0.519	0.437	0.607	0.170
	Sweden	0.551	0.488	0.637	0.150
	Switzerland	0.533	0.446	0.639	0.193
	UK	0.580	0.485	0.682	0.197
	U.S.	0.557	0.470	0.662	0.192
Overall Avg. (21 countries)		0.472 (0.000)	0.395 (0.000)	0.575 (0.000)	0.180 (0.000)
Emerging Mkt. Avg. (12 countries)		0.425 (0.000)	0.355 (0.000)	0.527 (0.000)	0.172 (0.000)
Developed Mkt. Avg. (9 countries)		0.536 (0.000)	0.447 (0.000)	0.638 (0.000)	0.191 (0.000)
Avg. (developed)–Avg. (emerging)		0.112 (0.000)	0.092 (0.003)	0.110 (0.000)	0.019 (0.369)

calculate two sets of correlations for each country (and each subperiod), one using only positive stock index returns and the other using only negative returns. The last column within each subperiod reports the differences in correlation between down market and up market.

The results from Panel A indicate that stock returns are generally positively correlated with the currency returns. The average correlation is 0.204, which is statistically significant at 1%. Only three countries, the U.S., Japan and Switzerland, exhibit negative correlations throughout the whole sample period. This finding is broadly consistent with the findings in Campbell et al. (2010), who demonstrate that the values of the U.S. dollar, the euro, and the Swiss franc are negatively correlated with the stock markets, while the Australian dollar, Canadian dollar, British pound, and Japanese yen are positively correlated with their domestic stock markets.[14] On the other hand, our results contrast with those provided in Hau and Rey (2006), who document negative correlations for most of their sample of developed countries.

The average correlation between equity and currency returns increased from 0.117 in the first half of the sample period to 0.292 in the second half. The increase of 0.175 is statistically significant. Taken together with the results from Table 1, this implies that the relationship between the currency and stock markets has become tighter as the international stock markets have integrated over recent years. A careful examination reveals that both the positive correlation between currency and stock markets and increases in the correlation over time are mostly being driven by emerging markets.

For example, the average correlation for the developed countries as a whole is not significantly different from zero for the full sample period or for each subperiod. For the U.S., the correlation is actually negative for both subperiods and becomes more negative in the second half. For Japan, the correlation turns negative, to −0.3510, in the second half after a positive correlation of 0.0360 during the first half. All emerging markets, in contrast, exhibit positive correlation over the whole sample period, and all but New Zealand and the Philippines exhibit a stronger correlation in the second half. Even for New Zealand and the Philippines, the decrease is somewhat modest, at −0.003 and −0.05, respectively.

The results from the last row of Panel A indicate that, for both subperiods, the average correlation among the emerging countries is larger than that across the developed countries. However, the difference-in-difference between the two periods is not significantly different from zero. Specifically, the difference in the first half is 0.221, while the corresponding number for the second half is 0.257, a difference that is statistically insignificant. This implies that emerging markets exhibit stronger ties between their local currency and the stock markets than the developed countries and that this relatively tighter relationship has been stable over time.

The correlations in Panel A, may be interpreted as those between foreign equity and destination currency returns from U.S. investors' perspectives, and thus are directly comparable to those reported in Hau and Rey (2006). Our correlations, however, appear to be quite different from those in Hau and Rey (2006). For example, a cross-examination of correlations reported in Table 3 column (C) in Hau and Rey (2006) and those in our Table 2 Panel A column (A) reveal that out of 7 countries that are common in both studies, 3 have equal signs while 4 exhibit opposite signs, even though the covered sample periods are roughly similar. This is mainly due to the differences in the way equity returns are measured. Hau and Rey (2006) use return *differentials* between foreign and U.S. stock indices while we use *raw* returns. Hau and Rey (2006)'s theory essentially builds on portfolio rebalancing based on return differentials. In contrast, our key hypothesis asserts that capital flows between emerging and developed markets driven by flight-to-quality may affect the correlation between equity and currency returns. As flight-to-quality is more likely to reflect global

[14] The only cases for which the results of Campbell et al. (2010) differ from ours are Germany (euro) and Japan. For Japan, however, we also find the correlation to be positive for the first half, which overlaps with their sample period.

Table 2
Correlation between currency and domestic stock markets. This table reports the correlation between weekly stock market index returns and weekly domestic currency returns measured in U.S. dollars. For the U.S., the trade-weighted exchange rate is used. Panel A reports the results for the full sample, while Panel B reports subpanel results conditional on market conditions. We classify each weekly return pair as up (down) market if the stock index return for that week is positive (negative). Using these up (down) market returns, we calculated two sets of correlations. In both Panels, the overall period column presents the correlations over the entire sample period, from January 1996 to December 2009 based on 720 weekly returns. The next two columns in Panel A, (A) and (B), report the results for two subperiods of equal length. The last column, (B–A), reports the increases in correlations over the two subperiods. In Panel B, up (down) market correlations and the differences between the two are reported separately for the whole sample period and also for each of the subperiods. The lower section of Panels A and B reports the summary statistics of correlations for all sample countries, emerging markets and developed markets. The last row reports the differences in average correlations between the developed markets and the emerging markets. The *p*-values are given in parentheses.

Panel A: full sample correlation

	Country	Overall period	(A) 1996–2002	(B) 2003–2009	(B–A) 2nd half–1st half
Emerging markets	Brazil	0.380	0.163	0.663	0.500
	Chile	0.258	0.180	0.314	0.134
	Czech Republic	0.121	−0.037	0.243	0.280
	Hungary	0.216	−0.024	0.418	0.442
	Israel	0.232	0.227	0.250	0.023
	Korea	0.430	0.368	0.575	0.207
	Mexico	0.485	0.473	0.522	0.049
	New Zealand	0.212	0.220	0.217	−0.003
	Philippines	0.351	0.367	0.317	−0.050
	Poland	0.272	0.166	0.403	0.237
	South Africa	0.253	0.231	0.286	0.055
	Turkey	0.311	0.200	0.617	0.417
Developed markets	Australia	0.391	0.177	0.504	0.327
	Canada	0.412	0.306	0.489	0.183
	Germany	0.048	0.020	0.139	0.119
	Japan	−0.144	0.036	−0.351	−0.387
	Norway	0.187	−0.044	0.314	0.358
	Sweden	0.169	0.040	0.285	0.245
	Switzerland	−0.223	−0.333	−0.114	0.219
	UK	0.036	−0.255	0.211	0.466
	U.S.	−0.111	−0.031	−0.174	−0.143
Overall Avg. (21 countries)		0.204 (0.000)	0.117 (0.0014)	0.292 (0.000)	0.175 (0.002)
Emerging Mkt. Avg. (12 countries)		0.293 (0.000)	0.211 (0.000)	0.402 (0.000)	0.191 (0.005)
Developed Mkt. Avg. (9 countries)		0.085 (0.291)	−0.009 (0.890)	0.145 (0.184)	0.154 (0.120)
Avg. (developed) – Avg. (emerging)		−0.208 (0.027)	−0.221 (0.008)	−0.257 (0.019)	−0.037 (0.713)

Panel B: correlation by market condition

	Country	Overall period			1996–2002			2003–2009		
		Up market (A)	Down market (B)	Down–up (B–A)	Up market (A)	Down market (B)	Down–up (B–A)	Up market (A)	Down market (B)	Down–up (B–A)
Emerging markets	Brazil	0.111	0.352	0.241	−0.039	0.088	0.128	0.416	0.678	0.262
	Chile	0.097	0.285	0.188	−0.015	0.208	0.223	0.190	0.334	0.143
	Czech Republic	0.125	0.142	0.016	0.039	−0.116	−0.155	0.186	0.335	0.149
	Hungary	0.144	0.189	0.045	−0.004	0.000	0.003	0.355	0.362	0.007
	Israel	0.035	0.217	0.182	0.009	0.299	0.290	0.088	0.165	0.077
	Korea	0.367	0.453	0.086	0.335	0.438	0.103	0.554	0.530	−0.024
	Mexico	0.394	0.443	0.049	0.367	0.342	−0.025	0.446	0.549	0.102
	New Zealand	0.029	0.258	0.230	0.074	0.196	0.123	0.001	0.306	0.305
	Philippines	0.224	0.387	0.162	0.307	0.406	0.099	0.057	0.343	0.286
	Poland	0.094	0.290	0.196	0.029	0.164	0.135	0.247	0.444	0.197
	South Africa	0.159	0.345	0.186	0.122	0.312	0.190	0.205	0.425	0.221
	Turkey	0.086	0.311	0.225	0.136	0.276	0.140	0.512	0.433	−0.079
Developed markets	Australia	0.170	0.506	0.336	0.102	0.218	0.116	0.208	0.613	0.405
	Canada	0.220	0.433	0.213	0.218	0.339	0.121	0.262	0.483	0.221
	Germany	0.108	0.111	0.003	0.170	−0.119	−0.289	−0.009	0.323	0.332
	Japan	0.042	−0.210	−0.253	0.203	−0.041	−0.244	−0.146	−0.378	−0.231
	Norway	0.132	0.240	0.108	0.007	0.059	0.052	0.176	0.319	0.143
	Sweden	0.136	0.205	0.069	0.100	0.056	−0.044	0.204	0.332	0.128
	Switzerland	−0.158	−0.122	0.036	−0.155	−0.315	−0.159	−0.142	0.062	0.204
	UK	−0.002	0.138	0.140	−0.163	−0.178	−0.015	0.087	0.283	0.196
	U.S.	0.019	−0.231	−0.249	−0.088	0.037	0.124	0.060	−0.397	−0.457
Overall Avg. (21 countries)		0.121 (0.000)	0.226 (0.000)	0.105 (0.004)	0.084 (0.017)	0.127 (0.010)	0.044 (0.203)	0.188 (0.000)	0.312 (0.000)	0.123 (0.010)
Emerging Mkt. Avg. (12 countries)		0.155 (0.001)	0.306 (0.000)	0.151 (0.000)	0.113 (0.020)	0.218 (0.001)	0.104 (0.011)	0.271 (0.000)	0.409 (0.000)	0.137 (0.003)
Developed Mkt. Avg. (9 countries)		0.074 (0.085)	0.119 (0.214)	0.045 (0.509)	0.044 (0.405)	0.006 (0.928)	−0.038 (0.500)	0.078 (0.162)	0.182 (0.163)	0.105 (0.287)
Avg. (developed)–Avg. (emerging)		−0.081(0.127)	−0.187 (0.072)	−0.106 (0.156)	−0.069 (0.300)	−0.212 (0.020)	−0.142 (0.041)	−0.194 (0.016)	−0.226 (0.100)	−0.033 (0.747)

market conditions, focusing on index return differentials between two stock markets may not allow us to pick up capital flow from emerging to developed markets during global downturns.

The results reported in Panel B suggest that the correlation between equity and currency returns is generally stronger in down markets. For example, for all emerging markets, the correlation in down markets is more positive than those in up markets. On the other hand, for U.S., Swiss, and Japan, we observe a negative correlation only during down markets. This pattern suggests that flight-to-quality, which occurs in down markets, could be related with the correlation structure between equity and currency.

The results from Tables 1 and 2 can be summarized as follows: (i) the international stock markets have become more integrated; (ii) the correlation between their local currencies and stock markets is more pronounced during down markets; and, (iii) for emerging markets, the correlation is positive and has become stronger over time. We conjecture that increases in cross-border investments seeking flight-to-quality during market downturns, which we document in the following section, may be a common factor in these findings. Accordingly, portfolio rebalancing can generate a correlation structure between currency and stock markets, as Hau and Rey (2006) argue.

4.3. Pair-wise analysis between the currency and stock markets

Table 3 presents an extension of the analysis in the previous subsection by expanding the numeraire of the destination's currency from U.S. dollars to all other currencies, except its own, as in Schmittmann's (2010) analysis of five developed markets. Specifically, we calculate pair-wise correlations between weekly stock index returns and local currency returns for 21 countries in our sample, where currency returns are measured as the home currency price of the destination currency. We report the results in three Panels: Panel A reports the results for developed market destinations, while Panel B reports the results for emerging market destinations. Bold letters indicate statistical significance at the 5% level. Panel C presents the averages of the correlations for developed and emerging market destinations (separately) for each home country in our sample. Bold letters indicate statistical significance at the 5% level, and ***, **, and * indicate statistical significance at the 1%, 5% and 10% levels, respectively. Note that the structure of the table is non-symmetric and that the diagonal cells are all empty by design.

A number of interesting and significant observations can be made. Panel A indicates that, when the destination is a developed market, the currency and the corresponding stock index are generally negatively correlated. There is a total of 180 correlations, of which 149 (83%) are statistically significant. Out of the 149 significant correlations, about 72% (108) are negative. If we restrict home countries to emerging markets, the proportion of negatively significant correlations becomes even larger, at 86% (77 out of 90 significant correlations). On the other hand, correlations are mostly positive when the home country is the U.S. (6 out of 8).[15] This provides a clear warning against using a single currency such as the U.S. dollar as the sole numeraire and thus validates our approach of using multiple numeraires.

The negative correlation between destination currency and its stock index is more conspicuous when the currency of the destination is considered to be a hard currency (i.e., the U.S., the U.K., Germany representing the eurozone, Japan, and Switzerland). Out of 100 correlations, 88 (88%) are significant, and about 92% (81 out of 88) are negative. This is consistent with Hau and Rey's (2006) observation that correlations are mostly negative within developed markets. When the home country is an emerging market, out of 60 correlations, 55 (about 98%) are all negatively significant. For example, investors from most of the countries in our sample (all of 12 emerging markets and 6 out of 8 developed markets) investing in the U.S. equity market face a negative correlation between the value of the underlying stocks and the value of the dollar. The U.S. dollar returns measured in these home country currencies therefore provide a natural hedge for the investments in U.S. stocks. Specifically, at least part of the loss from the underlying stocks might be offset from gains in the currency position and vice versa. Therefore, volatility-minimizing investors should not hedge the currency risks. In fact, Campbell et al. (2010) suggest that it may be optimal to take even long positions in the U.S. dollar to optimize risk-return tradeoff when investing in the U.S. stocks. We observe similar negative correlations when emerging home countries invest in developed destinations.

The results for emerging market destinations provided in Panel B are quite different from what we observe in Panel A for developed destinations. First, the number of significant correlations is smaller. Out of 240 correlations, 164 (68%) are statistically significant. In contrast to the findings in Panel A, most of the significant correlations, 139 out of 164 (85%), are positive. Moreover, most of the positive correlations affect developed market investors investing in an emerging market. Out of 86 significant correlations conditional on developed home markets, 79 (92%) are positive. Taking Japan, Switzerland, the U.K., and the U.S. as home countries, the value of all emerging market destination currencies measured in Japanese yen, Swiss franc, British pound, or U.S. dollar is positively correlated with the value of the destination stock market. Except for the U.K.–Czech pair, all cases are significant. Therefore, for most of these developed-country investors investing in emerging markets, currency returns will add volatility to the total return, and volatility minimizing investors should hedge the currency risks by taking short positions in the destination currency.

The results from pair-wise analyses in Panels A and B characterize the currency market as an agent that shifts risks from the investors in emerging markets to those in developed ones. This characterization is summarized in Panel C. First, Emerging Home Average and Developed Home Average in Panel C clearly indicate that, for emerging market investors investing in the developed markets, the destination currency and stocks are on average negatively correlated, while for the developed market investors investing in the emerging, the two are on average positively correlated. For investments within developed markets, the currency and stocks are not significantly correlated. The last column, (A–B), indicates that, for all home countries, the correlation between destination currency and stocks is more positive when they invest in emerging markets. The differences are mostly significant at the 10% significance level (at the lowest), except for Japan and Switzerland.

We believe that these correlation patterns between equity and currency markets are interesting in themselves but also suggest a number of important practical implications with respect to international portfolio management. In the next section, we explore what may be driving these patterns in international stock and currency returns. Specifically, we formally test the conjecture that international capital movements, especially during down markets, are one of the important factors behind the correlation structure between currency and stock returns.

5. Capital flows and the correlation between currency and stock returns

A number of factors may be responsible for the patterns we document in the previous section. We believe that providing a possible explanation for these patterns is one of the main contributions of this paper. In what follows, we explore the possibility that

[15] Note that the correlations reported in the last line of Panels A and B of Table 3 (with the U.S. as the home country) are identical to those reported in the first column of Panel A in Table 2 by design.

international capital movements, especially during market downturns, are important in determining the correlation between currency and stock returns. We test this conjecture in two steps. First, we examine whether the capital movements accompanying international equity investments in and out of emerging countries are influenced by the global stock market conditions. We hypothesize that, during bullish global stock market, capital moves into riskier emerging stock markets and moves out of these countries during bearish markets. The latter phenomenon is widely known as the "flight-to-quality." To describe the former phenomenon, we coin the term "flight-to-risk."

Once we establish that the capital flows in and out of the emerging markets are procyclical, we test whether the correlation between the currency and stock returns depends on the magnitude of these capital flows. We argue that the relationship between the currency and the stock markets is tighter for the emerging countries, since the market for FX is far smaller and simpler. For example, bond markets for most emerging countries are relatively inactive and small compared to those of developed countries. Therefore, if investors want to invest in emerging countries, their choice is largely restricted to equity investments. This will make the capital flows in and out of emerging countries induce a more direct influence on the correlation between currency and stock returns. In the case of developed markets, however, the process of exchange rate determination is far more complicated, and, with significantly large bond markets, the capital flows associated with stocks alone may not be enough to explain the movements in their currency values.

Unfortunately, testing these conjectures empirically is not easy, mainly because of the lack of appropriate data. Data on pair-wise capital flows appear to be publicly available only at an annual frequency.[16,17] Since global stock markets can fluctuate significantly within a calendar year, we would lose too much information if we estimated the relationship between stock markets and capital flows over yearly intervals. Even if daily data were available, they would be inadequate for a reliable estimate of the correlation between stock and currency returns. As an alternative, we use information provided in the Balance of Payment (BOP) data, available quarterly, to construct a measure of capital flow and match them with the correlation between weekly stock and currency returns calculated for each calendar quarter. Although this measure of capital flows is admittedly somewhat crude, it biases against finding any meaningful statistical relationship between capital flows and the degree of correlation between the stock and currency markets.[18]

5.1. Trends in market sizes and international capital flows

Before we formally test our capital flow hypothesis based on a multivariate framework, we first provide a quick glance at trends in global capital markets and international capital flows. Fig. 1 illustrates the trends in average market sizes of debt securities (domestic and international) and equities from 1996 to 2009 for all countries in our sample.[19] Panel A presents average market sizes across the developed countries and Panel B presents them across the emerging countries. For Panel B, due to data availability, domestic bond outstanding and equity market capitalization are averaged over eight countries, excluding Israel and Chile. First, the market sizes of the developed countries in our sample are roughly more than ten times as large as those of emerging countries. In 2009, developed countries' average stock market capitalization was about USD 3 trillion, and the average debt securities outstanding was USD 5 trillion, while the corresponding amounts for emerging countries were only USD 0.4 trillion and USD 0.3 trillion, respectively.[20] The market sizes of both stocks and bonds exhibit an upward trend for both developed and emerging countries over the whole sample period. Bond markets show a relatively steady increase in their values, while stock markets have a couple of troughs, indicating that equity market sizes are more volatile than bonds. For example, in 2008, in the midst of the global financial crisis, both developed and emerging stocks lost approximately 50% of their values. Even though the crisis was triggered mostly by developed country capital markets, emerging countries' stocks took the most damage, giving up more than 50% of their market capitalization. On the other hand, the value of developed countries' bonds actually increased in 2008. Out of the four asset classes, only this class saw its value increase. This is broadly consistent with flight-to-quality, where riskier emerging countries' stocks lose their values while the less risky bonds of developed countries gain value in bear markets. We conjecture that, during this period, international portfolio rebalancing may have facilitated capital flows from emerging countries' stocks to developed countries' bonds.

Fig. 2 presents the trends in average international net capital flows for stocks and bonds as well as the trends in MSCI world index returns during our sample period. Net capital flows for investment in stocks (bonds) are obtained by subtracting increases in equity (debt) assets from increases in equity (debt) liabilities using the IMF's BOP data. Panel A reports the average net capital flows for nine developed countries, while Panel B presents the corresponding numbers for 12 emerging countries.

Note that net capital flows in developed markets are about ten times as large as those in emerging markets, similar to the difference reported in Fig. 1. On the other hand, we do not observe a clear time-series trend in net capital flows, except for net debt flows into developed markets, where it increases steadily until 2008. This is again broadly consistent with the view that increases in world-wide demand for safer securities may have been one of the fallouts from the 2008 global financial crisis.

More important is the clear contrast between Panel A and Panel B concerning capital flow in response to global stock market conditions. Specifically, net equity flows are procyclical for emerging markets and countercyclical for developed markets. This implies that net equity flows generally move in opposite directions for developed and emerging markets. Thus, when there is a positive net equity flow in emerging markets, we observe a negative net equity flow in developed markets. These results are consistent with Griffin et al. (2004) and Richards (2005), who report that equity flows into emerging markets are positively correlated with stock returns in the home market as well as markets abroad.

We also observe large negative net equity flows in emerging markets in 2007 and 2008. In contrast, net bond flows in developed markets are positive, and the magnitude is largest during the same period. When the stock market recovers in 2009, net investment in

[16] The IMF Coordinated Portfolio Investment Survey (CPIS) provides data on pair-wise capital flows for equity and debt instruments for 1997 and from 2001 to 2009.

[17] Two exceptions are Griffin et al. (2004), who use aggregate equity flows in nine emerging markets at a daily frequency, and Richards (2005), who uses a similar dataset for six Asian emerging markets.

[18] Since we are using data over quarterly intervals, information loss would be more serious than when we use finer data, for example, over monthly intervals. Not only the number of observations is reduced, but also inter-temporal changes in variables within the quarter are netted out, making the power of statistical tests smaller. Therefore, we conjecture that if we are able to use data at higher frequency, we might be able to obtain more significant results.

[19] The data for Fig. 1 are obtained from BIS International Banking and Financial Market Developments.

[20] We also investigated the trends using median values. We find that the distributions of market sizes are skewed to the right for both equity and bond markets. For developed countries, the 2009 median values for equity and bond markets are roughly about the same at $1.3 trillion for developed countries. For emerging countries, the 2009 median market capitalizations are $230 billion for equity markets and $140 billion for bond markets. The median values are smaller than the averages indicating right-skewed distribution. The median of emerging country equity markets is about 60% of the average, while the medians of the other three cases are less than 50% of the average values.

Table 3
Correlation between foreign stock returns and currency returns. This table presents pair-wise correlations between weekly returns of a destination country's stock index and its currency for 21 countries in our sample. Currency returns are based on the home currency price of the destination currency. Panel A reports the results for developed market destinations while Panel B reports the results for the emerging market destinations. Panel C reports the averages of correlations for developed and emerging market destinations as well as the differences between the two, separately for each home country in our sample. Bold letters indicate statistical significance at the 5% level, and ***, **, and * correspond to statistical significance at the 1%, 5%, and 10% levels, respectively.

Panel A: developed market destinations

		Destination countries								
		Australia	Canada	Germany	Japan	Norway	Sweden	Switzerland	UK	U.S.
Home countries	Brazil	−0.030	**−0.191**	**−0.211**	**−0.273**	**−0.215**	**−0.193**	**−0.417**	**−0.337**	**−0.369**
	Chile	**0.142**	−0.018	**−0.115**	**−0.306**	**−0.115**	**−0.124**	**−0.439**	**−0.266**	**−0.317**
	Czech Republic	**0.274**	**0.099**	**0.024**	**−0.168**	0.064	**0.114**	**−0.285**	**−0.070**	**−0.096**
	Hungary	**0.188**	0.003	−0.056	**−0.228**	−0.069	−0.005	**−0.359**	**−0.210**	**−0.227**
	Israel	**0.262**	**0.118**	−0.059	**−0.199**	0.003	0.007	**−0.337**	**−0.165**	**−0.295**
	Korea	0.009	**−0.078**	**−0.152**	**−0.318**	**−0.096**	**−0.118**	**−0.325**	**−0.255**	**−0.287**
	Mexico	**0.108**	−0.059	**−0.152**	**−0.313**	**−0.141**	**−0.143**	**−0.461**	**−0.323**	**−0.455**
	New Zealand	**0.108**	**−0.117**	**−0.136**	**−0.335**	**−0.143**	**−0.149**	**−0.417**	**−0.305**	**−0.326**
	Philippines	**0.240**	**0.129**	−0.015	**−0.236**	0.045	0.040	**−0.260**	**−0.102**	**−0.161**
	Poland	**0.100**	**−0.078**	**−0.147**	**−0.254**	**−0.155**	**−0.133**	**−0.442**	**−0.310**	**−0.299**
	South Africa	0.041	**−0.133**	**−0.171**	**−0.248**	**−0.158**	**−0.134**	**−0.366**	**−0.295**	**−0.287**
	Turkey	0.051	**−0.091**	**−0.167**	**−0.252**	**−0.114**	**−0.158**	**−0.325**	**−0.263**	**−0.285**
	Australia		**−0.249**	**−0.198**	**−0.387**	**−0.233**	**−0.221**	**−0.500**	**−0.427**	**−0.402**
	Canada	**0.207**		**−0.116**	**−0.286**	**−0.122**	**−0.096**	**−0.423**	**−0.307**	**−0.398**
	Germany	**0.192**	0.055		**−0.076**	−0.019	0.056	**−0.155**	−0.037	−0.059
	Japan	**0.397**	**0.344**	**0.164**		**0.291**	**0.277**	−0.005	**0.184**	**0.209**
	Norway	**0.230**	**0.074**	0.010	**−0.197**		**0.145**	**−0.324**	**−0.117**	**−0.133**
	Sweden	**0.204**	0.003	−0.060	**−0.231**	−0.072		**−0.438**	**−0.205**	**−0.246**
	Switzerland	**0.391**	**0.322**	**0.168**	**−0.079**	**0.333**	**0.406**		**0.190**	**0.122**
	UK	**0.290**	**0.196**	0.023	**−0.219**	**0.090**	**0.136**	**−0.288**		**−0.109**
	U.S.	**0.391**	**0.412**	0.048	**−0.144**	**0.187**	**0.168**	**−0.223**	0.036	

Panel B: emerging market destinations

		Destination countries											
		Brazil	Chile	Czech	Hungary	Israel	Korea	Mexico	New Zealand	Philippines	Poland	South Africa	Turkey
Home countries	Brazil		**−0.158**	**−0.169**	−0.065	**−0.166**	**0.135**	−0.039	−0.053	−0.064	0.045	−0.011	**0.097**
	Chile	**0.170**		**−0.106**	0.014	−0.022	**0.248**	**0.149**	0.070	0.016	**0.083**	**0.089**	**0.176**
	Czech Republic	**0.248**	**0.146**		**0.196**	**0.101**	**0.298**	**0.192**	**0.175**	**0.129**	**0.231**	**0.087**	**0.266**
	Hungary	**0.175**	0.021	**−0.157**		0.034	**0.273**	**0.092**	**0.088**	**0.082**	**0.137**	0.036	**0.205**
	Israel	**0.271**	**0.100**	−0.012	**0.094**		**0.345**	**0.246**	**0.148**	**0.205**	**0.148**	**0.155**	**0.243**
	Korea	**0.122**	−0.054	**−0.149**	−0.034	−0.054		0.021	−0.029	**−0.085**	−0.015	−0.014	**0.121**
	Mexico	**0.113**	**−0.113**	**−0.151**	**−0.082**	−0.068	**0.268**		0.006	0.035	0.037	0.054	**0.155**
	New Zealand	**0.119**	−0.071	**−0.115**	−0.014	−0.041	**0.191**	0.048		0.006	0.072	−0.009	**0.206**
	Philippines	**0.282**	**0.096**	0.006	**0.097**	0.039	**0.331**	**0.259**	**0.100**		**0.132**	**0.134**	**0.283**
	Poland	**0.094**	−0.056	**−0.267**	**−0.089**	−0.040	**0.200**	0.003	0.070	0.061		−0.047	**0.168**
	South Africa	0.032	−0.071	**−0.191**	**−0.126**	**−0.073**	**0.187**	−0.028	0.009	−0.003	−0.071		**0.099**
	Turkey	**0.103**	−0.046	**−0.202**	**−0.078**	−0.064	**0.138**	−0.016	0.020	−0.019	−0.045	−0.013	
	Australia	**0.084**	**−0.166**	**−0.200**	**−0.093**	−0.070	**0.154**	−0.002	**−0.093**	−0.072	0.003	**−0.077**	**0.174**
	Canada	**0.193**	−0.002	**−0.096**	0.007	0.003	**0.303**	**0.150**	0.072	**0.109**	**0.110**	0.072	**0.219**
	Germany	**0.246**	**0.113**	−0.005	0.059	0.066	**0.210**	**0.244**	0.051	0.033	0.046	0.038	**0.205**
	Japan	**0.382**	**0.308**	**0.208**	**0.247**	**0.257**	**0.355**	**0.391**	**0.249**	**0.231**	**0.299**	**0.231**	**0.312**
	Norway	**0.222**	**0.082**	−0.042	**0.103**	0.065	**0.309**	**0.189**	**0.089**	**0.105**	**0.176**	0.056	**0.232**
	Sweden	**0.213**	**0.090**	**−0.082**	**0.096**	0.000	**0.280**	**0.131**	**0.077**	**0.107**	**0.153**	0.047	**0.221**
	Switzerland	**0.365**	**0.246**	**0.198**	**0.363**	**0.239**	**0.398**	**0.357**	**0.264**	**0.237**	**0.358**	**0.226**	**0.338**
	UK	**0.281**	**0.139**	0.036	**0.179**	**0.122**	**0.341**	**0.285**	**0.191**	**0.172**	**0.265**	**0.157**	**0.275**
	U.S.	**0.380**	**0.258**	**0.121**	**0.216**	**0.232**	**0.430**	**0.485**	**0.212**	**0.351**	**0.272**	**0.253**	**0.311**

Panel C: differences in correlation between developed and emerging destination groups

		Destination groups		
		Developed market (Avg., A)	Emerging market (Avg., B)	(A–B)
Home countries	Brazil	**−0.248**	**−0.041**	−0.208***
	Chile	**−0.173**	**0.081**	−0.254***
	Czech Republic	**−0.005**	0.188	−0.193***
	Hungary	**−0.107**	0.090	−0.197***
	Israel	**−0.074**	0.177	−0.251***
	Korea	**−0.180**	**−0.015**	−0.165***
	Mexico	**−0.216**	**0.023**	−0.239***
	New Zealand	**−0.202**	**0.036**	−0.238***
	Philippines	**−0.036**	0.160	−0.195***
	Poland	**−0.191**	**0.009**	−0.200***
	South Africa	**−0.194**	**−0.021**	−0.173***
	Turkey	**−0.178**	**−0.020**	−0.158***
	Australia	**−0.327**	−0.030	−0.298***

(*continued on next page*)

Table 3 (*continued*)

Panel C: differences in correlation between developed and emerging destination groups			
	Destination groups		
	Developed market (Avg., A)	Emerging market (Avg., B)	(A–B)
Canada	**−0.193**	**0.095**	−0.288***
Germany	**−0.005**	0.109	−0.114**
Japan	0.232	**0.289**	−0.057
Norway	**−0.039**	0.132	−0.171**
Sweden	**−0.131**	0.111	−0.242***
Switzerland	0.232	**0.299**	−0.068
UK	**0.015**	0.204	−0.189**
U.S.	0.109	0.293	−0.184*
Overall average	−0.095	0.106	−0.201***
t-Stat	−6.050	11.370	−10.990
p-Value	<.0001	<.0001	<.0001
Emerging home average	−0.150	0.055	−0.206***
t-Stat	−9.430	5.010	−10.610
p-Value	<.0001	<.0001	<.0001
Developed home average	−0.012	0.167	−0.179***
t-Stat	−0.410	12.380	−5.660
p-Value	0.680	<.0001	<.0001
Difference (emerging vs. developed)	−0.139	−0.112	
t-Stat	4.230	6.400	
p-Value	<.0001	<.0001	

emerging market stocks turns positive while net investment in developed market bonds turns negative. Overall, Fig. 2 suggests that net capital flows in and out of developed and emerging markets exhibit distinct patterns that may be able to explain the tight correlation between stocks and currency in emerging markets.

5.2. Global stock market conditions and movement of capital

We now examine how international equity capital movement is correlated with global equity market conditions in a multivariate framework. Our hypothesis can be summarized in the notions of flight-to-quality and flight-to-risk. Table 4 presents the OLS estimates of the panel regressions of each country's quarterly net equity flow in USD billion on quarterly MSCI world returns.[21] The first two columns report the results for the full panel set, while the remaining columns exclude Japan. Columns (5)–(8) report subpanel results based on market conditions, where up (down) markets are those quarters during which MSCI world return is positive (negative). Every second column includes additional control variables, the total stock market capitalization of each country in USD trillions, the turnover measured by the value of shares traded divided by year-end market capitalization in percentages, and the annual GDP growth rate (percentage). We also include Relative Equity Flows defined as the absolute value of net capital flows for stocks over the absolute sum of the net capital flows for stocks plus bonds as an additional control variable. Standard errors are adjusted for clustering at the country level, and the corresponding *t*-statistics are presented in parentheses; ***, **, and * indicate statistical significance at the 1%, 5% and 10% levels, respectively.

The notions of flight-to-quality and flight-to-risk imply that net capital flows in and out of emerging countries' stocks are positively related to the MSCI world returns. Therefore, the key variable of interest is the interaction term between MSCI world return and the emerging market dummy. When Japan is included, as in columns (1) and (2), this term is not statistically significant. However, once we exclude Japan in columns (3) and (4), not only the interaction term but the MSCI return itself also become significant, indicating that global stock return has opposite effects on the net equity flows into developed and emerging markets: when stock markets are bullish (bearish), international equity investments are directed towards emerging (developed) markets. These results imply that Japan behaves more like an emerging country, at least in terms of net equity flows. These observations are corroborated by previous research on Japanese capital flows. Brennan and Cao (1997), Brooks et al. (2004), and Hau and Rey (2006) all find that Japan differs from other developed countries as far as capital flows are concerned. Brennan and Cao (1997) show that capital moves out of Japan when the Japanese yen appreciates. Brooks et al. (2004) find that capital flows associated with stocks cannot explain the yen–U.S. dollar exchange rate. Similarly, Hau and Rey (2006), in footnote 28, argue that "Japan on the other hand is special because international portfolio flows concern mostly bonds as opposed to equity." Therefore, it appears that, for Japan, equity capital flows due to flight-to-quality is obscured by bond capital flows, unlike in other developed countries.

The analyses in the previous section suggest, however, that the correlation between yen and Japanese stocks is negative, similar to other developed countries. We conjecture that yen-carry related investment strategies that take advantage of extremely low interest rates may reconcile both procyclical equity capital flows and the negative correlation observed in Japan. When the global economy is bullish, even though capital moves into Japanese stocks, a large amount of yen-carry related capital, possibly more than the net flow into stocks, moved out of Japan. Therefore, in these periods, even though the capital flows into Japanese stocks similarly to what is observed in emerging market stocks, the yen would likely lose its value. On the contrary, when the global economy is bearish, a large amount of capital flows into Japan in order to unwind yen-carry transactions. We present the supporting evidence for this argument in Appendix 1. In what follows, we focus on the empirical results excluding Japan.

Having confirmed our conjecture that capital flows in and out of emerging stock markets are procyclical, we next explore whether these procyclical capital movements are largely due to flight-to-quality or flight-to-risk. Specifically, we divide the sample into two subsets based on whether the MSCI world return for a given quarter is positive or negative and report the results for up markets in columns (5) and (6) and those for down markets in columns (7) and (8). There are 575 up-market quarters and 345 down-market quarters. The results clearly indicate that coefficient estimates

[21] In what follows, we use the terms "net equity flow", "net capital flows for stocks", "net portfolio investment in stocks", and "capital flows in and out of the stock market" interchangeably.

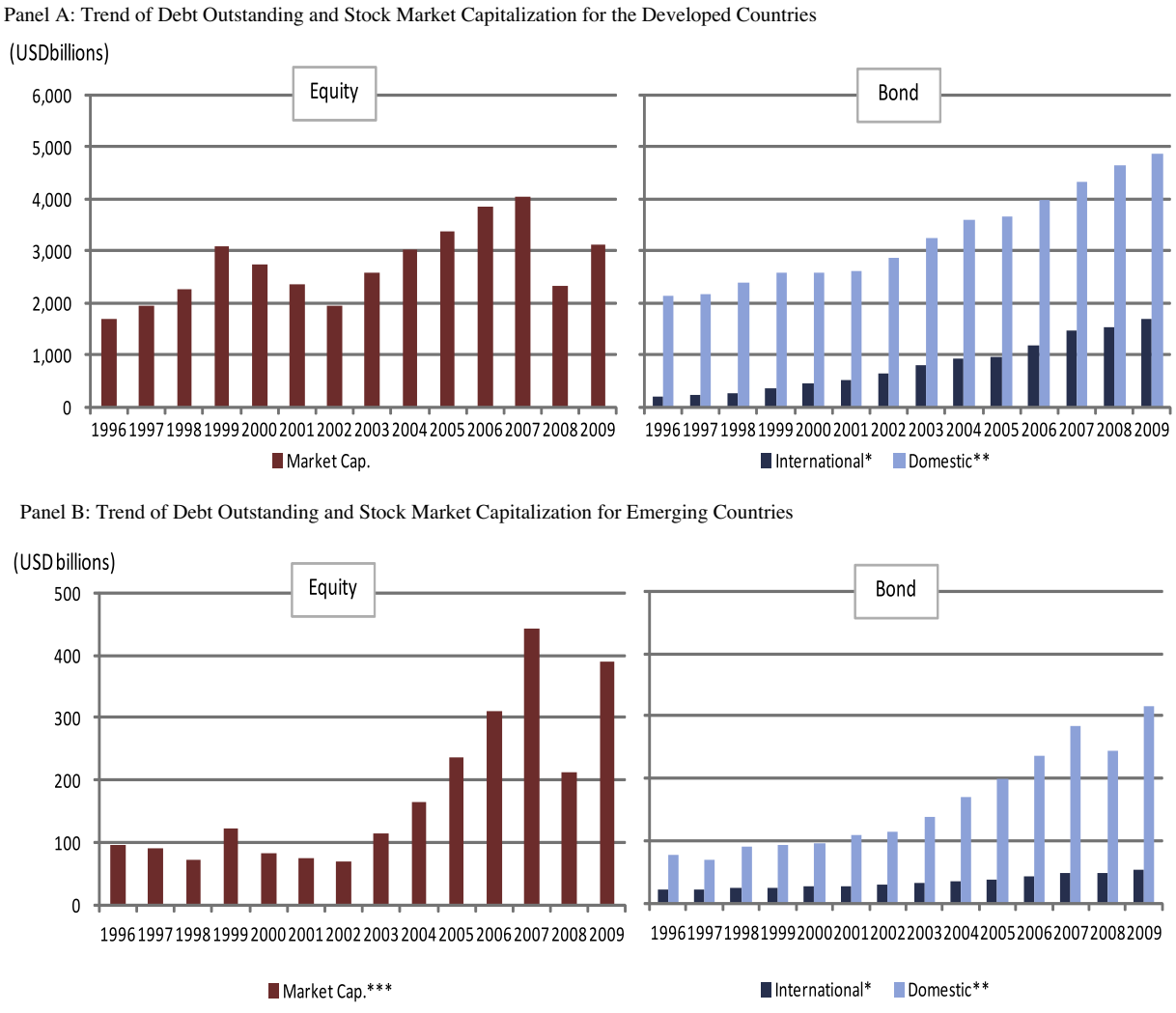

Fig. 1. Market capitalizations of global equity and bond markets over time. This figure presents the market sizes of debt securities, both domestic and international, and stocks over the period from 1996 to 2009. Panel A shows the averages across the developed countries in our sample and Panel B the averages across the emerging countries. For Panel B, domestic bond outstanding and equity market capitalization are averaged over eight countries excluding Israel and Chile, respectively, due to data availability.

from the whole sample are driven by flight-to-quality rather than flight-to-risk. In fact, estimates of the key variables lose statistical significance in up-market regressions. This is largely consistent with the results reported in Panel B of Table 2, that correlation between equity and currency returns is more pronounced during market downturns. The coefficient on Relative Equity Flows also turns marginally significantly negative in columns (7) and (8), indicating that net equity flows are more negative where bond markets are less developed. In contrast, we do not find these patterns in the up-market sample. In sum, Table 4 suggests that flight-to-quality drives international capital to flow in and out of developed stock markets countercyclically and in and out of emerging stock markets procyclically.[22]

5.3. Net capital flows and correlation between currency and stock returns

In this subsection, we examine how net capital flows in and out of each country are related to the degree or strength of the correlation between stocks and currency in that market. Table 5 presents the OLS estimates of panel regressions where the dependent variable is each country's quarterly correlation between weekly currency returns based on U.S. dollar values and weekly stock index returns. The key explanatory variable is the absolute value of quarterly Net Equity Flow, as defined in the previous subsection. As in Table 4, we report the results with and without Japan and also for two subpanels based on market conditions. Additional control variables include FX market size measured by the average daily FX market turnover, the total stock market capitalization of each country, changes in foreign reserves (proxying for FX market intervention), and the annual GDP growth rate. The level control variables are all in USD trillions. Standard errors are adjusted for clustering at the country level, and the corresponding *t*-statistics are presented in parentheses.[23]

As in Table 4, our baseline discussions focus on results excluding Japan. Unlike in Table 4, however, we obtain similar results even

[22] In an unreported analysis, we control for the 2008 global financial crisis period and find similar results.

[23] Since our key hypothesis inherently depends on both cross-sectional (emerging vs. developed) and time-series (up vs. down) variations, an attempt to focus on either within-country or within-time variation would render our main hypothesis largely meaningless. As such, neither country nor time fixed effects are considered in our analyses.

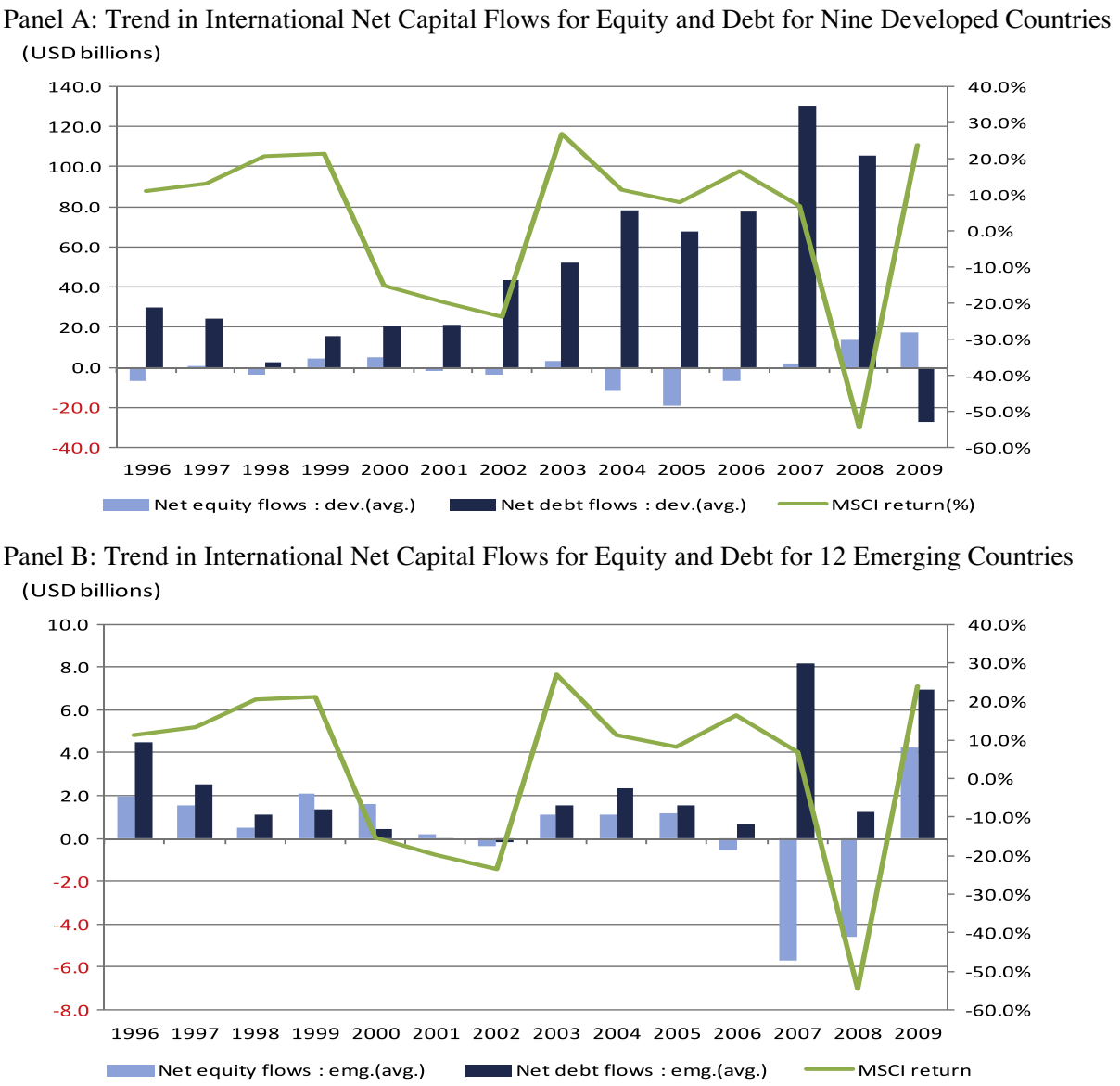

Fig. 2. International net capital flows for equity and debt over time. This figure presents the trends in international net capital flows for foreign equity and debt during the sample period. Net capital flows for stocks (bonds) are obtained by subtracting increases in equity (debt) assets from increases in equity (debt) liabilities from each country's balance of payment account. The net capital flows for equity and debt are averaged across the nine developed countries in Panel A, and 12 emerging countries in Panel B. We also plot MSCI world index returns to proxy for general stock market conditions.

when we include Japan. This is somewhat expected, since what makes Japan different from the other developed countries is how global market conditions affect net equity capital flows. As far as the correlation between currency and stock returns are concerned, Japan behaves similarly to the other developed countries.

For all regressions, coefficients on two variables, Emerging Dummy and the interaction term between the absolute value of Net Equity Flow and Emerging Dummy, are consistently significant. By contrast, the absolute value of the Net Equity Flow itself is insignificant in all specifications. These results suggest that (i) the correlation between currency and stock returns are higher on average for emerging countries, and (ii) this correlation becomes stronger when there are large net capital flows but only for the emerging countries.[24] For developed countries, however, capital flows in and out of stock markets do not seem to affect the correlation between currency and stock returns. Figs. 1 and 2 show that the bond markets are relatively better developed in developed countries, providing a viable candidate as an investment outlet for interested foreign investors. Therefore, the commonality between currency and stock values will be weaker for developed countries than for emerging countries.

The constant term reflecting the unconditional correlation for developed markets is also insignificantly different from zero. This is partly due to the fact that only the U.S., Switzerland, and Japan exhibit a negative correlation, while all other developed countries exhibit a positive correlation, as reported in Table 2. In Campbell et al. (2010), only the values of the U.S. dollar, the euro, and the Swiss franc are found to be negatively correlated with the stock markets. In their analysis, even the Japanese yen is found to be positively correlated with the domestic stock market, as are the Australian and Canadian dollars and the British pound.

The estimates of the coefficient on Emerging Dummy imply that the quarterly correlation between weekly currency and stock returns are, on average, between 0.22 and 0.27 higher in emerging

[24] We also ran a Tobit regression in which the dependent variable is truncated at −1 and +1 and found similar results. In fact, the overall significance of the coefficients and R^2 actually improves under Tobit specification.

Table 4
MSCI World Index Returns and Net Capital Flows. This table presents the OLS estimates of panel regressions of each country's net equity flows on MSCI world index returns. Net equity flows (in USD billion) are obtained from the Balance of Payment account of each country by subtracting the increases in equity assets from increases in equity liabilities. Relative Equity Flows are calculated as the absolute value of net equity flows over the absolute sum of net equity flows plus net debt flows. Net debt flows are obtained in a manner similar to net equity flows. The first two columns, (1) and (2), report the results for the full panel set, while the remaining columns exclude Japan. Columns (5), (6), and (7), (8) report subpanel results based on market conditions, where up (down) markets are those quarters during which MSCI world return is positive (negative). Every second column includes additional control variables; the total stock market capitalization of each country in USD trillions (Market Cap), Turnover measured by the value of shares traded divided by year-end market capitalization in percentages, and the annual GDP growth rate are in percentages. Standard errors are adjusted for clustering at the country level, and the corresponding *t*-statistics are presented in parentheses. Finally, ***, ** and, * indicate statistical significance at the 1%, 5%, and 10% levels, respectively.

	Full sample (incl. JP)		Full sample (excl. JP)		UP market		Down market	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
MSCI return	1.636	5.959	−20.342**	−15.671**	−5.191	−2.003	−52.100*	−43.314*
	(0.073)	(0.275)	(−2.500)	(−2.154)	(−0.408)	(−0.144)	(−1.994)	(−1.852)
MSCI return*	2.972	0.85	25.241***	22.399***	9.095	8.938	56.311**	52.694**
Emerging dummy	(0.130)	(0.039)	(3.121)	(3.146)	(0.713)	(0.726)	(2.153)	(2.164)
Emerging dummy	0.342	2.342*	0.809	2.719*	0.849	3.054	5.082***	5.490**
	(0.291)	(1.855)	(0.653)	(1.945)	(0.361)	(1.392)	(2.893)	(2.757)
Relative equity flows (Abs.)	−1.533	−1.343	−2.972	−2.885	−2.084	−1.887	−3.564*	−4.285*
	(−0.533)	(−0.474)	(−1.064)	(−1.072)	(−0.451)	(−0.426)	(−1.834)	(−1.768)
Market Cap		0.370		0.318**		0.526***		−0.132
		(1.655)		(2.227)		(4.317)		(−0.552)
Turnover (%)		0.017		0.018		0.02		0.014
		(0.817)		(0.887)		(0.952)		(0.611)
GDP growth (%)		−0.036		−0.019		0.024		−0.067*
		(−0.941)		(−0.552)		(0.464)		(−2.025)
Constant	0.332	−2.738	0.424	−2.723	0.144	−4.086	−3.788*	−4.212
	(0.456)	(−1.257)	(0.532)	(−1.153)	(0.163)	(−1.488)	(−2.028)	(−1.707)
R^2	0.001	0.015	0.012	0.027	0.003	0.023	0.104	0.117
N	976	976	920	920	575	575	345	345

countries than in developed ones. The coefficient for the interaction term for the whole sample in columns (3) and (4) is 0.019, implying that a one billion dollar net equity flow into an emerging country is expected to increase the correlation by roughly 2%. The subsample analyses indicate that the sensitivity of correlation to net equity flows in emerging markets is little different between up and down markets, although the coefficients for down markets is slightly larger. The GDP growth rate returns a negatively significant coefficient, except in the up-market sample, indicating that higher GDP growth is expected to weaken the correlation between currency and stock returns. It appears that the real sector performance of a country affects the link between currency and financial sector, stocks in this case. This point warrants further investigation, which we leave for a future study.

6. Robustness check

In Section 5, we measure the quarterly Pearson correlations between equity and currency returns from weekly observations. This simple and parsimonious method forces us to lose information on potential intertemporal changes in the correlation within quarters. In this section, we estimate dynamic conditional correlation (DCC) between equity and currency returns. Engle (2002) proposes a DCC model that imposes heavier structure on data generating process than Pearson correlation, but preserves information on weekly variations within each quarter.

First, the weekly correlations using the DCC model with GARCH (1,1) specification are estimated for each country. Then, the quarterly averages of weekly DCC correlations are evaluated to compare them against the quarterly Pearson correlations estimated from weekly observations. Then for each calendar quarter, the cross-sectional averages across countries are taken, separately for these two quarterly correlation series. Fig. 3 shows the correlations together with the returns on MSCI world index. Panel A shows the dynamics of these two measures averaged over all 21 countries in our sample, while Panels B and C report those for 9 developed and 12 emerging countries, respectively.

We first find that red bars, or Pearson correlations, and blue bars, or DCC correlations, generally comove in the same direction over time, more so for emerging markets, and especially following the global financial crisis. Second, both Pearson and DCC correlations are mostly positive among the emerging countries, while often times negative for the developed markets. In addition, the correlations tend to be larger and more stable in emerging markets than in developed markets. This is precisely consistent with our hypothesis that the relationship between equity and currency markets is stronger and positive for the emerging countries, and weaker and negative for the developed countries.

Even though it is fairly clear from Fig. 3 that the two measures of correlation between equity and currency generally comove in the same direction over time, and both measures increased after the global financial crises, statistical significance of such comovement has yet to be established. A formal test of significance in comovement between the two quarterly correlation measures is presented in Table 6. Specifically, for the two quarterly correlation series obtained for each country, we first calculate cross-sectional averages across all of the 21 countries in the sample, 9 developed countries, and 12 emerging countries for each calendar quarter. We then calculate the full sample period Pearson correlations among quarterly MSCI World index return series, quarterly Pearson correlation series, and quarterly DCC correlation series.

We first find that the full sample period Pearson correlation between two quarterly correlation measures is highly significant at 1% level, with a coefficient of 0.66. We find similar results within developed and emerging markets, respectively, where the corresponding numbers are 0.65 and 0.64, both of which are significant at 1%. We also find that all six quarterly correlation measures are negatively related with the quarterly MSCI World index return, five of which are statistically significant at least at 10% level.

These findings suggest that the standard Pearson type correlation used in the previous sections largely capture the dynamics represented in more sophisticated DCC estimation that explicitly takes into account potential intertemporal changes in correlation within quarters. The finding also suggests that the correlation between equity and currency, regardless of how it is measured, tends to get stronger in down markets.

Table 7 replicates Table 5 by replacing the original parsimonious Pearson type correlation with the newly obtained quarterly

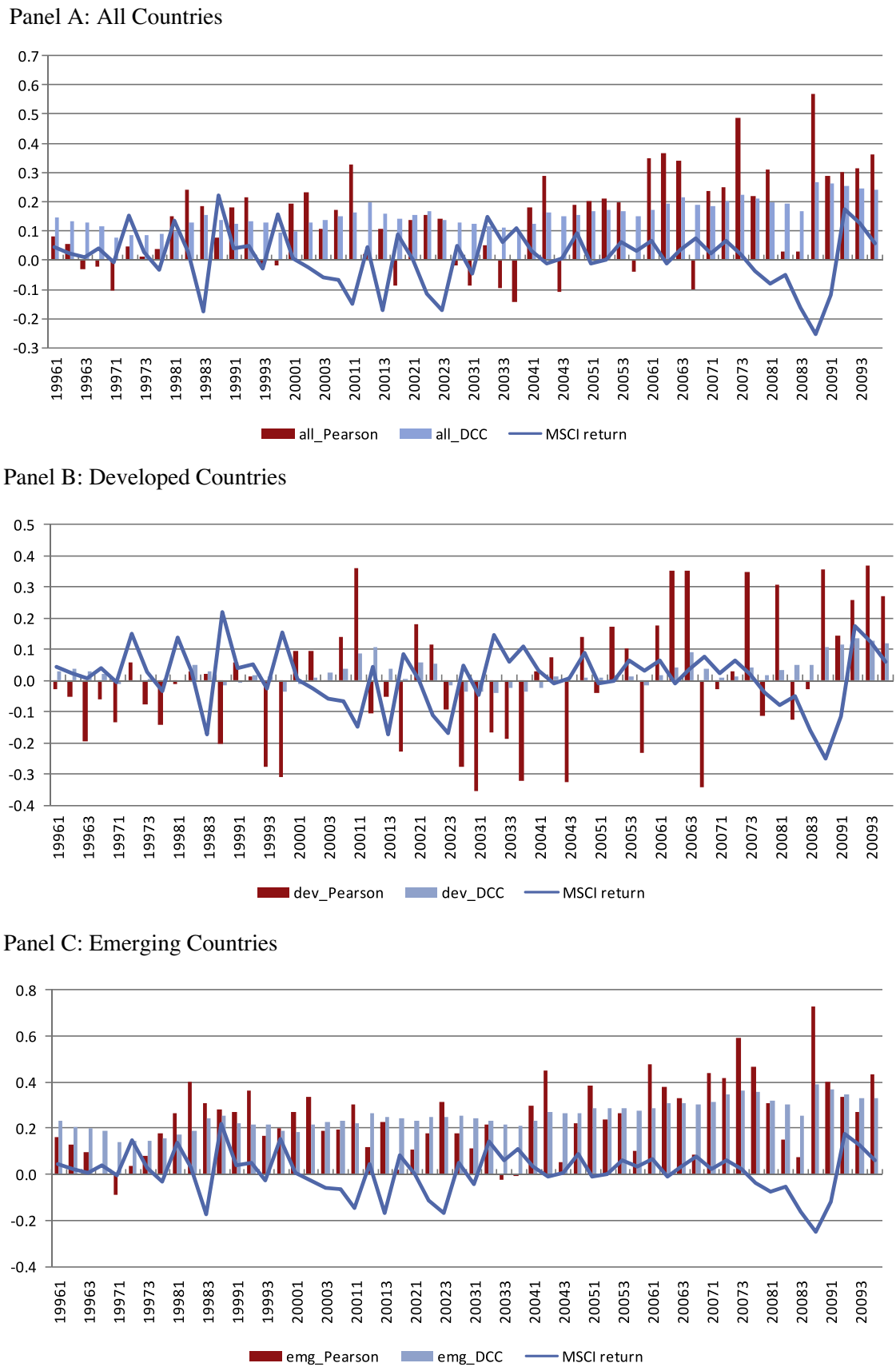

Fig. 3. Dynamics in global stock market correlations and MSCI world index. This figure presents the trends in correlation measures between equity and stock returns and MSCI world Index over quarterly intervals. The correlations are measured in two ways: first by measuring Pearson correlation from weekly observations of equity and currency returns during the quarter, and by averaging weekly correlations from the dynamic conditional correlation (DCC) estimation with GARCH (1,1) specification. Panel A shows the dynamics of these measures averaged over all the 21 countries in our sample, Panel B, 9 developed countries, and Panel C, 12 emerging countries. Panel A: all countries, Panel B: developed countries, Panel C: emerging countries.

Table 5
Net capital flows and correlation between currency and stock returns. This table shows the OLS estimates of panel regressions of each country's quarterly correlations between weekly currency and stock returns on absolute values of Net Equity Flows (in USD billion), as defined in Table 4. The first two columns, (1) and (2), report the results for the full panel set, while the remaining columns exclude Japan. Columns (5), (6), and (7), (8) report subpanel results based on market conditions, where up (down) markets are those quarters during which MSCI world return is positive (negative). Every second column includes additional control variables; Foreign Exchange Market Size measured by the average daily foreign exchange market turnover, the total stock market capitalization of each country (Market Cap), changes in Foreign Reserves which proxies for foreign exchange market intervention, and the annual GDP growth rate. The level control variables are all in USD trillions. Standard errors are adjusted for clustering at the country level, and the corresponding *t*-statistics are presented in parentheses. Finally, ***, **, and * correspond to statistical significance at the 1%, 5%, and 10% levels, respectively.

	Full sample (incl. JP)		Full sample (excl. JP)		Up market		Down market	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Net equity flow	−0.001	−0.001	0.000	0.000	−0.001	−0.001	0.002	0.003
(Absolute)	(−0.978)	(−1.076)	(−0.284)	(−0.096)	(−0.859)	(−0.702)	(1.046)	(1.051)
Net equity flow (Abs.)*	0.020***	0.021***	0.019***	0.019***	0.018***	0.013**	0.019**	0.018**
Emerging dummy	(3.465)	(3.325)	(3.327)	(3.292)	(2.978)	(2.653)	(2.451)	(2.516)
Emerging dummy	0.247***	0.251***	0.249***	0.246***	0.271***	0.267***	0.228**	0.213**
	(3.370)	(3.151)	(3.267)	(2.998)	(3.481)	(3.150)	(2.486)	(2.423)
Foreign exchange market size		−0.090		−0.092		−0.118		−0.100
		(−1.346)		(−1.197)		(−1.462)		(−1.016)
Market Cap		0.009		0.008		0.013**		0.003
		(1.684)		(1.525)		(2.342)		(0.389)
Δ Foreign reserves		0.580		−3.269		−7.838		1.303
		(0.312)		(−0.799)		(−1.522)		(0.308)
GDP growth (%)		−0.004***		−0.004***		−0.002		−0.008***
		(−3.293)		(−3.380)		(−1.383)		(−5.108)
Constant	0.024	0.055	0.022	0.057	−0.001	0.017	0.043	0.093
	(0.398)	(0.814)	(0.347)	(0.806)	(−0.012)	(0.231)	(0.579)	(1.297)
R^2	0.143	0.170	0.134	0.163	0.163	0.178	0.097	0.184
N	976	976	920	920	575	575	345	345

averages of weekly correlations estimated through DCC. Note that we are not able to directly incorporate more refined weekly correlations obtained through DCC since the international capital flow variable is only available at quarterly frequency. The results indicate that even when DCC correlations are substituted for Pearson correlations as the dependent variable, the main results in the previous section still remain valid. Specifically, the key variables of interest, *Emerging Dummy* and the interaction term between the absolute value of *Net Equity Flow* and *Emerging Dummy*, remain positive and statistically significant.

As an alternative robustness check, an analysis on an updated sample period is undertaken. This new sample period partly overlaps with the original one. We take this approach since the IMF changed the way they compile the BOP data in 2009, which made pre- and post-2009 BOP data incomparable. IMF has updated (or backdated rather) their pre-2009 BOP data based on the new definition up to (or back to) 2005, which allows us to assemble a consistent BOP dataset from 2005 to 2013.

In unreported results, we find that our main findings still hold in this sub-sample. Specifically, capital flows out of emerging markets into developed markets during market downturns, and the effect of capital flow on correlation between equity and currency is stronger in emerging markets. These findings suggest that the effect of flight-to-quality on the correlation between equity and currency is clearly not spurious and remains valid across different time periods.

7. Empirical analyses of international mutual funds: shooting yourself in the foot by currency hedging

The previous sections have shown that, when an investor in an emerging country invests in stocks in a developed country, the value of the destination currency tends to move in a direction opposite that of the stocks. On the other hand, when an investor in a developed country invests in an emerging country's stocks, the value of the destination currency tends to move together with the stocks. This finding has important implications for hedging strategies in international portfolio management. For example, investors from developed countries investing in the stocks of emerging countries should hedge the currency risks, while investors from emerging countries investing in the stocks of developed countries should not if their objective is to reduce the overall volatility of the total return. In this section, we provide empirical analyses that illustrate how hedging may adversely affect total return volatility when currency and underlying foreign asset values are negatively correlated.

We use a sample of Siamese Twin international mutual fund pairs in Korea holding identical underlying foreign assets but offering different currency hedging alternatives. A total of 32 such funds from March 2007 to December 2013 are included in the sample. Table 3 suggests that Korea is one of the countries for which most of the destination currencies and stocks are negatively correlated. Therefore, currency positions should provide a natural hedge for Korean investors investing in foreign currency denominated assets. Hedging currency risks under such a negative correlation would actually increase the volatility of the total return since the hedging activity unwinds the natural hedge.

7.1. Institutional background

Investing in global assets is a relatively recent phenomenon in Korea. Formerly, most of the available international funds were offshore funds created and managed abroad. Since 2006, however, both the number and assets under management (AUM) of onshore overseas funds have rapidly increased. First-generation offshore funds did not provide a hedging mechanism against currency risks. As the Korean won strengthened, however, distribution channels such as commercial banks and investment banks started requiring fund managers to provide hedges against currency risks. In response, most of the subsequent onshore overseas funds decided to provide hedges against currency risks. The typical hedging strategy adopted by these funds is the dynamic hedging scheme in which target hedge ratios are often set around a prespecified level (e.g., 100% or 80%) or within a prespecified range (e.g., between 80 and 100%) of the underlying value.

Unlike most of these onshore funds, which offered only hedged portfolios, some foreign currency denominated funds were made available to investors in two separate forms: one with a hedging option and the other without. These two types of funds share the same underlying assets with the same portfolio weights, as well as

Table 6
Comovement between quarterly correlation measures and MSCI world returns. This Table presents the full sample period correlations among two quarterly correlation measures between equity and stock returns and quarterly MSCI world index return. The quarterly correlations are measured in two ways for each country; first by measuring Pearson correlation from weekly observations of equity and currency returns during the quarter, and by averaging weekly correlations from the dynamic conditional correlation (DCC) estimation with GARCH (1,1) specification. Then for each calendar quarter, we take the cross-sectional averages across all of the 21 countries in the sample, 9 developed countries, and 12 emerging countries, respectively, to obtain three different quarterly correlation series. The symbols, ***, **, and * correspond to statistical significance at the 1%, 5%, and 10% levels, respectively. The sample period is from January 1996 to December 2009.

		Quarterly MSCI return	Quarterly correlation between Equity and currency returns					
			All countries		Developed		Emerging	
			Pearson	DCC	CCKK	DCC	CCKK	DCC
Quarterly MSCI return		1	−0.240**	−0.214*	−0.210*	−0.236**	−0.221*	−0.165
All	Pearson		1	0.660***	0.890***	0.556***	0.903***	0.600***
	DCC			1	0.572***	0.780***	0.611***	0.942***
Developed	Pearson				1	0.649***	0.607***	0.429***
	DCC					1	0.356***	0.524***
Emerging	Pearson						1	0.640***
	DCC							1

Table 7
Net capital flows and dynamic conditional correlation between currency and stock returns. This table replicates the analysis provided in Table 5, where dependent variable, quarterly Pearson correlations between equity and currency returns, are replaced by quarterly averages of weekly correlations obtained through dynamic conditional correlation (DCC) estimation with GARCH (1,1) specification. The first two columns, (1) and (2), report the results for the full panel set, while the remaining columns exclude Japan. Columns (5), (6), and (7), (8) report subpanel results based on market conditions, where up (down) markets are those quarters during which MSCI world return is positive (negative). Every second column includes additional control variables; Foreign Exchange Market Size measured by the average daily foreign exchange market turnover, the total stock market capitalization of each country (Market Cap), changes in Foreign Reserves which proxies for foreign exchange market intervention, and the annual GDP growth rate. The level control variables are all in USD trillions. Standard errors are adjusted for clustering at the country level, and the corresponding *t*-statistics are presented in parentheses. Finally, ***, **, and * correspond to statistical significance at the 1%, 5%, and 10% levels, respectively.

	Full Sample(incl. JP)		Full Sample(excl. JP)		Up market		Down market	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Net equity flow	−0.003**	−0.002*	−0.002*	−0.001	−0.002**	−0.001	−0.002	0.000
(Absolute)	(−2.128)	(−2.042)	(−1.884)	(−1.147)	(−2.280)	(−1.565)	(−0.853)	(−0.062)
Net Equity flow (Abs.)*	0.015**	0.015**	0.014**	0.013**	0.015**	0.011**	0.013*	0.012*
Emerging dummy	(2.577)	(2.486)	(2.483)	(2.336)	(2.589)	(2.442)	(1.960)	(1.751)
Emerging dummy	0.227***	0.213**	0.222**	0.205**	0.225***	0.205**	0.217**	0.203**
	(3.044)	(2.646)	(2.849)	(2.441)	(2.974)	(2.460)	(2.399)	(2.256)
Foreign exchange market Size		−0.031		−0.038		−0.032		−0.057
		(−0.535)		(−0.574)		(−0.432)		(−0.896)
Market Cap		−0.005		−0.005		−0.004		−0.005
		(−1.218)		(−1.002)		(−0.906)		(−1.099)
Δ Foreign Reserves		0.257		−4.083*		−6.358**		−1.435
		(0.179)		(−2.071)		(−2.397)		(−0.730)
GDP growth (%)		−0.001		−0.001		0.000		−0.003***
		(−1.320)		(−1.603)		(−0.264)		(−2.974)
Constant	0.066	0.088	0.071	0.095	0.066	0.083	0.077	0.102
	(1.007)	(1.236)	(1.027)	(1.267)	(0.981)	(1.112)	(0.975)	(1.287)
R^2	0.417	0.433	0.386	0.412	0.409	0.434	0.347	0.398
N	976	976	920	920	575	575	345	345

the same management fees.[25] Therefore, all differences between them depend solely on whether they are hedging currency risks. We believe that these Siamese Twin funds provide a natural experimental setting for an investigation of the effects of foreign currency hedging on a fund's return distribution. The results from this empirical analysis can then be used to infer the effect of hedging in the remaining majority of funds that provide only the hedging alternative.

In our sample of 32 fund pairs, the financial instruments used for hedging consists of both futures and forward contracts. Relatively smaller funds with AUM of less than KRW 2 billion (roughly USD 2 million) used only futures contracts, while most of the larger funds used a mixture of forward and futures, on a roughly 50:50 basis. The typical maturities of forward contracts ranged from three to six months, while those of futures contracts lasted for two to three months. The most important factors in determining maturity seemed to be the liquidity of the contracts.

Table 8 presents the descriptive statistics of the mutual fund pairs in our sample. For each fund in the sample, the first six columns report the type, its numerical ID,[26] the number of paired weekly returns available, average AUM separately for non-hedged assets and hedged assets, and the currency the fund targets to hedge. There are 23 regional funds and nine sector funds, out of which seven are energy funds.[27] On average, weekly returns are available for 284 weeks, or five and a half years. The average AUM for hedged funds is about three times larger than that of nonhedged funds. This implies that investors' demand for a hedging option was much stronger than that for a non hedging option during the sample period. Note, however, that even the average AUM of the hedged funds was KRW 54 billion (roughly USD 50 million), which would be

[25] For hedged funds, however, transaction costs from implementing hedging activities are additional.

[26] Appendix 2 provides the fund names associated with the IDs.

[27] The sample includes funds that invest in commodities. Even though these funds do not hold international equities, they still serve our purpose, as, just like equities, returns on commodities are negatively correlated with returns on foreign currencies from the Korean investor's point of view. Daskalaki and Skiadopoulos (2011) provide evidence that return correlations between commodity and U.S. equities was exceptionally high from 2005 to 2009. Note that this period encompasses the sample period of these empirical analyses. Apparently, we observe negative correlation between commodities and currencies because of the high correlation between commodities and equities.

Table 8
Descriptive statistics of "Siamese Twin" mutual funds in Korea. This table presents the descriptive statistics of the mutual funds in our sample. The sample includes all foreign currency denominated mutual funds available in the Korean market that provide both hedging and nonhedging options for retail investors. For each fund in the sample, the table shows the type, its ID, and the number of paired weekly returns available. The next two columns present the weekly averages of total asset under management separately for nonhedged and hedged assets. The next column presents the currency that the fund targets to hedge (for hedged assets). The last two columns report the correlation between weekly currency return and two proxies of underlying return, respectively. The first proxy is the weekly return of the hedged portfolio, and the second is the implied underlying return defined as the nonhedged return minus the currency return divided by one plus the currency return. The sample period is from March 2007 to December 2013.

Fund type		Fund ID (masked)	Number of weeks	Asset under Mgmt (KRW bil)		Hedging currency	Correlation between FX and	
				Hedged	Non-hedged		Hedged	Implied underlying
Regional	China	1	251	1.9	0.5	HKD	−0.563	−0.790
		2	251	150.3	38.4	HKD	−0.251	−0.302
		3	248	248.6	16.0	HKD	−0.280	−0.332
		4	283	74.8	0.7	HKD	−0.580	−0.730
		5	320	20.1	0.8	HKD	−0.578	−0.660
		6	319	1.0	0.1	HKD	−0.557	−0.723
		7	167	62.4	7.3	USD	−0.277	−0.310
		8	216	158.2	308.0	USD	−0.166	−0.333
		9	216	15.4	45.3	USD	−0.328	−0.379
		10	199	122.2	7.5	USD + HKD + CNY; equally	−0.244	−0.321
	Japan	11	352	30.6	18.5	JPY	−0.650	−0.758
		12	348	1.9	0.9	JPY	−0.401	−0.704
		13	356	146.6	58.3	JPY 50%	−0.631	−0.450
	Latin America	14	271	7.8	1.7	USD	−0.674	−0.685
		15	335	15.6	0.3	USD	−0.595	−0.664
		16	297	1.0	0.1	USD	−0.362	−0.748
	Emerging	17	284	7.6	1.6	USD	−0.557	−0.638
		18	311	19.2	0.4	USD	−0.586	−0.647
		19	257	2.1	3.1	Euro	−0.498	−0.577
	BRICs	20	177	2.6	2.1	USD	−0.695	−0.756
	Europe	21	347	14.4	0.4	Euro	−0.297	−0.466
	Middle East	22	295	7.2	1.1	USD	−0.295	−0.352
	Global	23	304	12.6	2.8	USD	−0.503	−0.584
Sector	Energy	24	243	1.0	0.1	USD	−0.394	−0.551
		25	334	7.9	0.1	Euro 50% + USD 45% + JPY 5%	−0.425	−0.584
		26	271	33.3	1.1	USD	−0.568	−0.599
		27	346	220.6	0.8	SF + GBP + Euro; equally	−0.412	−0.623
		28	335	50.9	0.5	SF + GBP + Euro; equally	−0.290	−0.455
		29	306	6.0	0.1	USD	−0.524	−0.606
		30	271	243.9	2.3	USD	−0.614	−0.628
	Commodities	31	271	11.4	2.8	USD	−0.530	−0.557
		32	294	20.9	6.9	USD	−0.647	−0.717
Average			283.6	53.8	16.6		−0.468	−0.570

considered small by U.S. standards. There were 17 funds that targeted to hedge the U.S. dollar, six funds targeting the Hong Kong dollar, three funds targeting the Japanese yen, two funds targeting the euro, and the remaining four targeting a basket of currencies. For the last four funds, we develop a matching currency index using the weights declared by the funds.

The final two columns present the correlation between weekly currency return based on the KRW denominated price and the weekly underlying asset return. Since the underlying return net of the currency return is not directly observable, however, we need proxies for the true underlying return. We employ two different proxies for this purpose. Our first candidate is the hedged return itself. Although dynamic hedging may not be able to perfectly unbundle the currency return and hence replicate the true underlying return, it could be used as a reasonable proxy for estimating the correlation structure. In our second approach, we infer the "implied" underlying return by removing currency return from the nonhedged return, both of which are directly observable. Note the nonhedged total return from an international investment: $1 + r^{nh}$ equals $(1 + r^{a})\,(1 + e)$, where r^{a} represents the return from the foreign asset measured in the foreign currency, and e is the home currency return of the destination currency. Therefore, the "implied" underlying asset return r^{a} can be inferred from

$$\hat{r}^{a} = \frac{r_t^{nh} - e}{1 + e}. \tag{1}$$

As can be seen from the final two columns of Table 8, the correlations between the underlying return and currency return are all negative, regardless of which measure is used to proxy for the true underlying return. This is consistent with the previous results reported in Table 3, where the home country is Korea. The average correlation is −0.47 when a hedged return is used as the proxy for the true underlying and −0.57 when implied underlying is used instead. The prevalence of a negative correlation indicates that currency hedging may increase return volatilities. Moreover, since the correlations range from −0.166 to −0.695 based on hedged returns and from −0.302 to −0.790 based on implied underlying returns, not only the direction but also the magnitude of hedging effects can be reasonably estimated by exploiting the cross-sectional variation in correlations.

For all 32 fund pairs, however, the correlations based on implied underlying is almost unilaterally more negative than the correlations based on hedged returns, suggesting a potential underestimation of the true covariance structure when implied underlying is used. In what follows, we use the correlations obtained from hedged returns as the baseline since they exhibit less extreme values. Nevertheless, our basic results are robust to using correlations based on implied underlying returns instead.

7.2. Effects of currency hedging on return volatility

Since the correlation between underlying assets and the corresponding currency is all negative, as reported in Table 8, we expect the volatility of a hedged fund to be larger than that of its nonhedged counterpart. Table 9 presents a comparison of return volatilities between hedged and nonhedged funds. The first four

Table 9
Distribution of weekly return volatility: hedged vs. nonhedged. This table presents a return volatility comparison between foreign assets that hedge against the foreign currency risk and those that do not hedge. The first four columns present the type, its ID, and the number of paired weekly returns available. The next two columns present the standard deviation of the weekly returns for both hedged and nonhedged assets in each of our sample funds. The final column presents the difference in volatility between the hedged and nonhedged group. The last four rows show the means and medians as well as the corresponding test statistics. The sample period is from March 2007 to December 2013.

Fund type		Fund ID (masked)	Number of weeks	Standard deviation of weekly returns		
				Hedged (A)	Non-hedged (B)	Difference: (A–B)
Regional	China	1	251	2.46%	2.32%	0.14%
		2	251	2.54%	2.59%	−0.05%
		3	248	2.52%	2.43%	0.08%
		4	283	2.48%	2.00%	0.48%
		5	320	3.50%	2.77%	0.73%
		6	319	2.50%	2.11%	0.39%
		7	167	2.36%	2.46%	−0.10%
		8	216	2.31%	2.32%	−0.01%
		9	216	2.69%	2.52%	0.17%
		10	199	2.55%	2.54%	0.00%
	Japan	11	352	3.09%	2.12%	0.97%
		12	348	3.79%	2.31%	1.47%
		13	356	3.01%	2.17%	0.84%
	Latin America	14	271	4.71%	4.01%	0.70%
		15	335	4.10%	3.49%	0.60%
		16	297	3.50%	3.34%	0.16%
	Emerging	17	284	3.00%	2.51%	0.49%
		18	311	2.79%	2.25%	0.54%
		19	257	4.30%	3.94%	0.36%
	BRICs	20	177	4.56%	3.66%	0.90%
	Europe	21	347	2.49%	2.62%	−0.12%
	Middle East	22	295	2.77%	2.92%	−0.15%
	Global	23	304	2.19%	1.97%	0.23%
Sector	Energy	24	243	2.36%	2.22%	0.14%
		25	334	2.79%	2.47%	0.32%
		26	271	3.33%	2.85%	0.48%
		27	346	2.79%	2.19%	0.60%
		28	335	3.64%	3.29%	0.35%
		29	306	3.87%	3.86%	0.01%
		30	271	5.95%	4.56%	1.38%
	Commodities	31	271	5.42%	4.86%	0.55%
		32	294	4.14%	3.43%	0.71%
Mean				3.26%	2.85%	0.42%
t-Stat				–	–	5.75
Median				2.89%	2.53%	0.37%
p-Value				–	–	0.000

columns repeat the type, fund ID, and number of paired weekly returns available. The next two columns present the standard deviation of the weekly returns for both hedged assets and their nonhedged counterparts. The final column presents the difference in volatilities between each pair of funds. The last four rows present the means, medians, and corresponding test statistics.

As expected, volatility is generally greater in hedged than in nonhedged assets. For 27 out of 32 funds, dynamic hedging increases return volatility. The average increase in the weekly standard deviation is 0.42% points, and the corresponding median is 0.37% points, both statistically significant. These differences in weekly standard deviations translate into 2.7–3% per annum. These differences also amount to an approximately 15% increase from nonhedged mean and median volatility.

To investigate the magnitude of the effect of negative correlation on hedged fund volatility, we first plot the relationship between correlation and differences in return volatilities in Fig. 4. In both Panels A and B, the horizontal axis measures the correlation between the underlying return and the currency return, while the vertical axis measures the differences in standard deviations between hedged and nonhedged assets using the weekly returns for each of the 32 fund pairs in our sample. In Panel A, the underlying return is proxied by the hedged return to calculate its correlation with the currency return, while, in Panel B, we infer the "implied" underlying return, as in Eq. (1), and use this measure to obtain the correlation with the currency return. Each dot in the figure represents one mutual fund pair.

The results from both Panels A and B strongly suggest that hedged fund return volatility increases relative to nonhedged volatility, as the correlation between the underlying asset and the corresponding foreign currency becomes more negative. In fact, the five funds for which the volatility of the hedged funds was lower than the nonhedged funds in Table 9 are among those with the least negative correlation in absolute terms in Table 8.[28]

We would expect that, as the correlation between destination currency and asset returns becomes more negative, currency hedging would adversely affect the total return volatility to a greater extent. Table 10 reports the results from cross-sectional analyses that formally test this hypothesis, controlling for other fund characteristics. We report the OLS regression results where the dependent variable is the difference in volatility between hedged asset and nonhedged asset measured as the standard deviation of weekly returns from the hedged fund minus that from its nonhedged counterpart. The correlation between the underlying and the currency return are calculated for each mutual fund using weekly returns, where the underlying return is proxied by the hedged return. We take the natural log of assets under management (KRW million) to control for any potential size related effect. To examine whether the results are influenced by the target currency itself, we introduce a non-U.S. dollar dummy.

[28] The IDs of these five funds are 2, 7, 8, 21, 22.

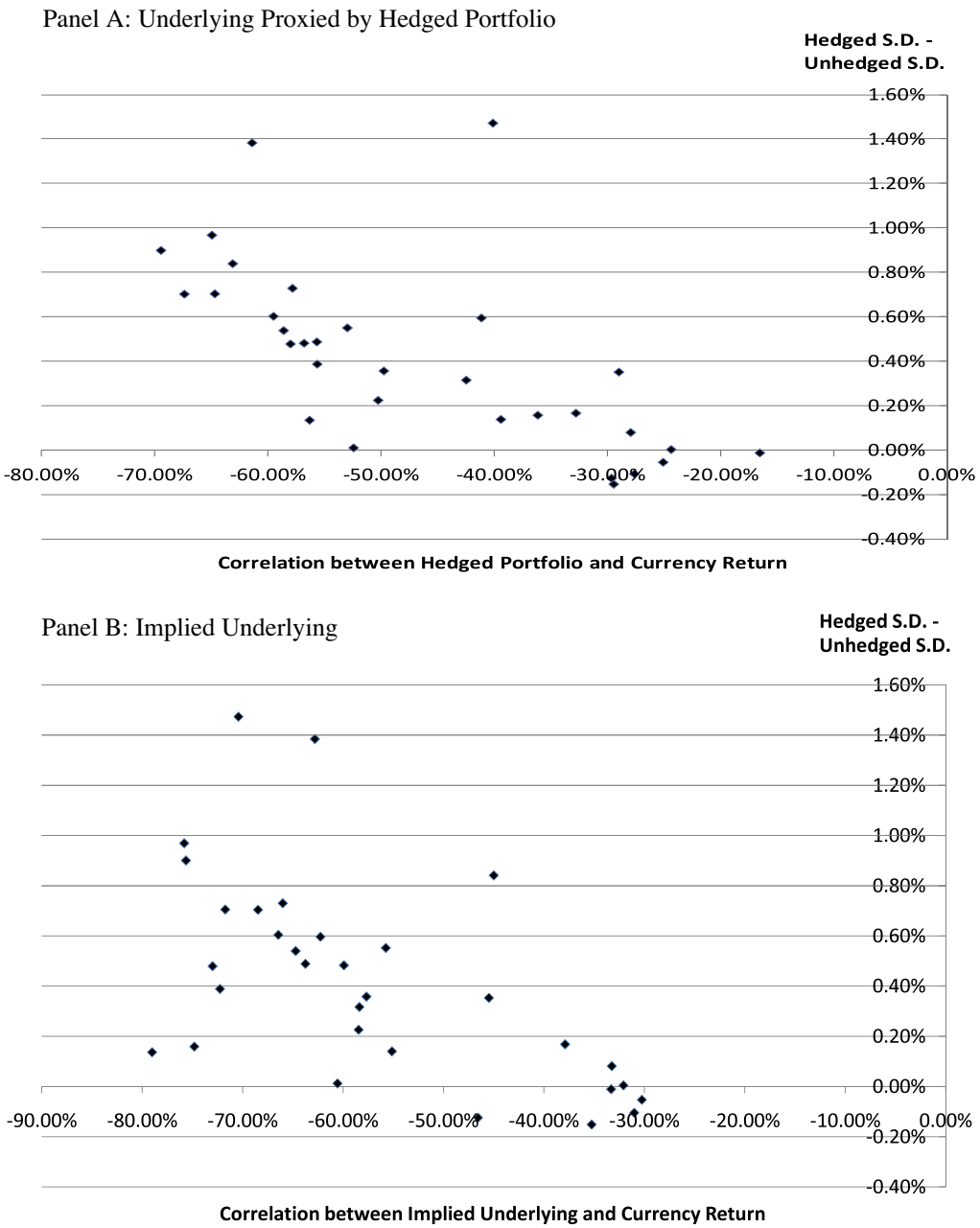

Fig. 4. Relationship between Differences in volatility (hedged vs. nonhedged) and return correlation (underlying vs. currency). The *Y*-axis represents differences in standard deviations between hedged and nonhedged assets using the weekly returns for each of the Siamese Twin mutual funds in the sample. In Panel A, the *X*-axis represents the correlation between the underlying (proxied by hedged portfolio return) and currency return for each of the mutual funds in our sample. In Panel B, the underlying return is inferred as the nonhedged return minus the currency return divided by one plus the currency return. Each dot in the figure represents one mutual fund. The sample period is from March 2007 to December 2013.

The results from Table 10 clearly indicate that a more (less) negative correlation leads to a larger (smaller) volatility of the hedged return relative to the nonhedged return. Even though the sample size is only 32, the correlation between the underlying asset and currency returns turns out to be the most important factor in explaining the differences between hedged and nonhedged return volatilities. The R^2 value in specification (1), where we include only the correlation and a constant, amounts to 0.437, implying that close to half of the variation in volatility differences is explained by the correlation between the underlying and currency only. These results provide strong evidence in support of our conjecture that a negative correlation between destination currency and asset returns would undermine the effectiveness of currency hedging. We refer to this phenomenon as "shooting yourself in the foot" or "friendly fire" incurred by currency hedging.

The results of these empirical analyses strongly suggest that currency hedging strategies should be carefully designed according to the correlation structure between destination currency and underlying asset returns. When the correlation between the currency and asset values is negative, currency hedging may actually increase return volatility. The results in the previous sections indicate that this may well apply to most of the emerging country investors investing in the stocks of developed countries. For investors in developed countries investing in the stocks of emerging

Table 10
Cross-sectional analysis on differences in volatilities between hedged and nonhedged funds. This table presents OLS regression results where the dependent variable is the difference in volatility between the hedged and nonhedged asset within each of the mutual fund pairs in our sample. The difference is measured as the standard deviation of weekly returns of the hedged portfolio minus the corresponding number of the nonhedged portfolio. Correlations between the underlying and the currency return are calculated for each mutual fund using the weekly return. The underlying return is proxied by the hedged portfolio's return. We take the natural log of assets under management (KRW million) to control for the potential size related effect. Non-USD Currency is the dummy variable set to one if the currency being hedged is other than the U.S. dollar and zero otherwise. The *t*-statistics are presented in parentheses, and ***, **, and * correspond to statistical significance at the 1%, 5%, and 10% levels, respectively. The sample period is from March 2007 to December 2013.

	(1)	(2)	(3)	(4)	(5)
Correlation between	−0.018***	−0.019***	−0.019***	−0.017***	−0.018***
Underlying and currency return	(−4.829)	(−4.963)	(−4.951)	(−4.349)	(−4.421)
ln (asset under Mgmt, hedged)		0.000			0.000
		(0.733)			(0.265)
ln (asset under Mgmt, unhedged)		0.000			0.000
		(0.413)			(1.022)
Non-USD currency			0.001		0.000
			(1.084)		(0.345)
Number of weeks				0.000	0.000
				(1.314)	(1.326)
Constant	−0.004**	−0.009**	−0.005**	−0.008**	−0.014**
	(−2.328)	(−2.129)	(−2.573)	(−2.404)	(−2.566)
R^2	0.437	0.468	0.459	0.469	0.518
N	32	32	32	32	32

countries, however, currency hedging may contribute to reducing total return volatility.

8. Conclusion

This paper has examined pair-wise correlations between currency and stock markets. We have formed pairs with nine developed and 12 emerging countries spanning 1996–2009. The results show that currency returns are generally positively correlated with an emerging country's stock returns. In other words, when an emerging country is paired with a developed country, the emerging country's currency returns measured against the developed country's currency are positively correlated with the emerging country's stock returns. The value of the developed country's currency measured in the units of the emerging country's currency will then be negatively correlated with its own stocks. For emerging countries, we also find that the return correlation between currency and stock is not only positive but also stronger. For developed markets such as the U.S., we find that the correlation is negative and weak.

The main contribution of this paper is that we provide an explanation of the above findings based on capital movements induced by flight-to-quality. We provide a plausible mechanism through which positive (negative) correlation between currency and equity in emerging (developed) markets may jointly arise. In a series of formal empirical analyses, we provide evidence that international capital flows motivated by flight-to-quality play an important role in determining correlations between currency and stock returns. Specifically, we document that capital tends to move out of emerging into developed countries in global down markets, leading to depreciation (appreciation) of emerging (developed) currencies. This generates a positive (negative) correlation between currency and equity in emerging (developed) markets which is amplified by the magnitude of the capital movement.

These findings have important implications for hedging strategies in international portfolio management. Currency returns add risks asymmetrically on the total return from an international investment depending on whether the investors are from an emerging or a developed country. In particular, investors in developed countries investing in emerging markets find that the currency market adds risks to the total return, while those in emerging countries investing in developed markets find that it provides a natural hedge. This issue is further explored in an interesting empirical analysis of open-ended international mutual funds, in which the effects of currency hedging on fund performance are examined. Using a sample of 32 Korean Siamese Twin fund pairs holding identical underlying foreign assets but offering different currency hedging alternatives, we find that the hedged portfolios provide higher return volatility than their nonhedged counterparts. This is largely because the values of the foreign currency and the underlying assets are negatively correlated, and the hedging schemes effectively undo the natural hedge provided by the currency markets. The results suggest that currency hedging strategies should be designed carefully after the correlation structure between destination currency and asset returns is thoroughly examined.

The findings of our paper have important implications as to the process by which exchange rates are determined. Capital flows in and out of a country's stock market affect the value of a currency. This, however, is only a part of the whole system of exchange rate determination. Balance of payments of a country provides information on demand and supply of a currency, and even within the capital account, capital flows in bond markets are equally as important as those in stock markets. It would be interesting to see how the bond capital flows affect the exchange rates, and examine the relative importance of bond capital flows against equity capital flows in emerging and developed countries.

Acknowledgments

We would like to thank two anonymous referees, Rick Green, Allaudeen Hameed, Andrew Karolyi, Jae Uk Khil, Hyun Suk Lee, Wenchao Liao, Guido Mantovani Ca Foscari, and other seminar participants of the 2010 Joint Conference, Allied Korea Finance Associations (Dogo, Korea, May 2010), 2010 CAFM Meetings (Seoul, Korea, December 2011), 2011 FMA Asian Conference (Queenstown, New Zealand, April 2011), 2012 FMA Annual Meetings (Atlanta, October 2012), Ajou University, Case Western Reserve University, Hanyang University Ansan Campus, Korea University, Seoul National University, and the University of Cincinnati for their

helpful comments. Cho gratefully acknowledges the financial support of a KUBS Faculty Research Grant. Kim wishes to thank the Institute of Management Research at Seoul National University for their financial support. All remaining errors are ours.

Appendix A

Japanese net capital flows

This Appendix provides evidence that capital flows in and out of Japan were uncharacteristic for a developed country. We conjecture that yen-carry related investment strategies that take advantage of extremely low interest rates in Japan were the main reason for the uncharacteristic flows. A typical developed country would witness countercyclical net capital flows in and out of its stock market. In other words, the correlation between the MSCI world index and net capital flows to a developed stock market is generally negative, as illustrated in Fig. 2. If we measure the correlation using quarterly observations over the sample period, the average over the developed countries excluding Japan is −0.111. The correlation for Japan is, however, 0.592. In fact, this is the largest for all the countries in our sample, including the emerging countries. The emerging country average is 0.163, with South Africa having the highest correlation among the emerging countries, at 0.489. Therefore, as far as capital flows are concerned, Japan behaved more like an emerging country.

Nevertheless, Japan has a negative correlation between currency and stock returns, just like a typical developed country. Table 1 shows that the Japanese stock market is highly correlated with the other stock markets around the world. When the MSCI world index gains, it is highly likely that Japanese stocks will also gain. The high correlation of 0.592 between the MSCI world index and net capital flows then predicts that the Japanese stock market will receive net capital inflows. Since this inflow should create demand for Japanese yen, we expect the Japanese yen to gain value. This should therefore lead the correlation between currency and stock returns to be positive. Surprisingly, however, Table 2 shows that it was negative, at −0.144, over the whole sample period, and −0.351 over the second half of our sample period. The clue to this seemingly contradictory result lies in the capital flows for bonds. The yen-carry related investment strategies yielded significant capital flows in and out of the Japanese bond market. The bond-related capital flows were countercyclical: outflows when the return to MSCI world index was positive and inflows otherwise. The following table shows capital flows in and out of Japanese capital markets over the second half of the sample period. The U.S. flows are also provided as a benchmark of a developed country over the same period. The data are constructed similarly to those in Tables 4 and 5, but the quarterly observations are summed over a year.

Year	Japan		U.S.	
	Net equity flows	Net debt flows	Net equity flows	Net debt flows
2002	−19,594	−140,557	−142,559	19,594
2003	157,454	−227,486	−229,489	−157,454
2004	92,047	−94,191	−96,195	−92,047
2005	338,882	−55,071	−57,076	−338,882
2006	27,040	−35,165	−37,171	−27,040
2007	−72,114	72,011	70,004	72,114
2008	−310,889	61,017	59,009	310,889
2009	−126,033	−347,973	−349,982	126,033

As can be seen from the table, the U.S. and Japan exhibit strikingly different patterns. For the U.S. (except for 2002 and 2009), net equity flows and net debt flows have the same sign. When investors find the U.S. attractive, they invest in both stocks and bonds, and vice versa. For Japan, however (except for 2002 and 2009), net equity flows and net debt flows have different signs. We believe this to be a consequence of yen-carry trades. When the global economy was booming, for example from 2002 to 2006, large net outflows were initiated from Japanese debt instruments in order to find riskier investment opportunities; when the global economy was lagging, for example in 2007 and 2008, large net inflows were made in order to unwind the positions. We observe a negative correlation between the Japanese yen and its stock index because net debt flows are negatively correlated with the stock index. We conclude that Japan is quite different from the other developed countries as far as net equity flows are concerned and exclude Japan from the empirical analyses of Tables 4 and 5.

Appendix B

Sample funds

This Appendix provides the actual names of the "Siamese Twin" international mutual funds in Korea that provide the investors with the option of either hedging or not hedging the currency risks.

Fund ID	Fund name
1	Tongyang Dual Index Feeder Equity
2	MiraeAsset China A Share Feedr Equity
3	Samsung China 2.0 Mainland Feeder Equity
4	Samsung China Feeder Equity
5	Samsung Great China Feeder Equity
6	Shinyoung China Value Plus Feeder Equity
7	Tongyang China Mainland Feeder Equity
8	East Spring China Dragon A Share Feeder Equity
9	Hanwha Dream China A Share Feeder Equity
10	Korea Investment Navigator China Mainland Feeder Equity
11	Samsung FouU N Japan Conversion Feeder Equity
12	HanaUBS Japan Feeder Equity
13	Franklin Templeton Japan Feeder Equity
14	BlackRock Latin America Feeder Equity
15	Samsung Latin America Feeder Equity
16	Woori Brazil Explorer Feeder Equity
17	Franklin Templeton Asian Growth Feeder Equity
18	Hanwha Southeast Asia Conversion Feeder Equity
19	BlackRock Emerg Eurp Fdr Eq
20	Franklin Templeton BRIC Feeder Equity
21	Hanwha Euro Conversion Feeder Equity
22	Franklin Templeton MENA Feeder Equity
23	Franklin Templeton Frontier Market Feeder Equity
24	Daishin Vitamin Feeder Equity
25	Daishin GlbWarming Theme Eq
26	BlackRock World Energy Feeder Equity
27	Samsung Global Water Feeder Equity
28	Samsung Global Alternative Energy Feeder Equity
29	Hanwha Global Natural Resources Conversion Feeder Equity
30	BlackRock World Mining Feeder Equity
31	BlackRock World Gold Feeder Equity
32	Schroders Emerging Raw Materials Feeder Equity

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