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Published in:
Journal of Empirical Finance

DOI:
10.1016/j.jempfin.2019.07.004

IMPORTANT NOTE: You are advised to consult the publisher's version (publisher's PDF) if you wish to cite from it. Please check the document version below.

Document Version
Publisher's PDF, also known as Version of record

Publication date:
2019

Link to publication in University of Groningen/UMCG research database

Citation for published version (APA):

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Download date: 20-09-2023
The role of technical indicators in exchange rate forecasting

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A R T I C L E   I N F O

JEL classification:
C53
C58
F31
G17

Keywords:
Exchange rate predictability
Principal components
Forecast combination
Technical indicators
Macroeconomic fundamentals

A B S T R A C T

Forecasting exchange rates is a subject of wide interest to both academics and practitioners. We aim at contributing to this vivid research area by highlighting the role of both technical indicators and macroeconomic predictors in forecasting exchange rates. Employing monthly data ranging from January 1974 to December 2014 for six widely traded currencies, we show that both types of predictors provide valuable information about future currency movements. To efficiently summarize the information content in candidate predictors, we extract the principal components of each group of predictors. Our findings suggest that combining information from both technical indicators and macroeconomic variables significantly improves and stabilizes exchange rate forecasts versus using either type of information alone.

1. Introduction

Exchange rate forecasting is one of the most fascinating and academically vivid research areas. The large number of currency crises during the past years have stimulated and challenged the existing academic literature. Numerous researchers tried to answer the generic question “Can exchange rates be predicted and under what assumptions?” This question led to a continuous effort for identification of deterministic relationships, primarily between economic fundamentals and exchange rates. In a very influential paper, Meese and Rogoff (1983) claim that structural models cannot outperform the random walk model, giving rise to the disconnect puzzle of exchange rates from fundamentals.

Rossi (2013) provides a comprehensive literature review on exchange rate forecasting showing that the choice of predictors is important for a good forecast, along with the type of the forecasting models and the evaluation methods employed, concluding that none of the predictors, models, or tests systematically produce superior exchange rate forecasts across all countries and time periods. Mark (1995) and more recently Chen and Chou (2010) claim that exchange rates can be predicted in the long run, in contrast to Molodtsova and Papell (2009), who find mixed evidence of exchange rate predictability dependent on the predictor under consideration. Engel et al. (2008) adopt an interesting approach focusing on the impact of expectations of fundamentals and find that expectations of future monetary conditions play an important role in determining current exchange rates. A stream of the literature focuses on capturing non-linearities in the predictive models and employ methodologies such as neural networks (see Sermpinis et al., 2014; Gradojevic, 2007; Preminger and Franck, 2007; Qi and Wu, 2003; Kuan and Liu, 1995), genetic programming (see Sermpinis et al., 2015), Markov switching models (see Panopoulou and Pantelidis, 2015; Dunis et al., 2011; Dueker and Neely, 2007; Engel, 1994), nearest neighbor regressions (see Gencay, 1999) etc. However, linear models tend to outperform non linear ones in general (Rossi, 2013). More recent approaches aiming at capturing uncertainty and time-varying predictability in a Bayesian framework deliver encouraging results (see Byrne et al., 2016, 2018).
Apart from macroeconomic predictors stemming from exchange rate fundamentals, technical indicators are an additional tool mainly used by professionals. Despite the fact that many technical indicators have been in use for more years than the most prominent macroeconomic models (Brock et al., 1992; Neely and Weller, 2011; Park and Irwin, 2007), academia has paid little attention. Gehrig and Menkhoff (2006) suggest that both technical analysis and order flow analysis have gained ground during the last decades at the expense of fundamentals. As a matter of fact, this relatively new forecasting approach has been reported to produce significant statistical and economic gains when applied to equity, bond and exchange rate markets (Buncic and Piras, 2016; Lin, 2018; Neely et al., 2014; Goh et al., 2013; Neely and Weller, 2011; Neely et al., 2009; De Zwart et al., 2009; Park and Irwin, 2007), but with unstable performance over time (Olson, 2004; De Zwart et al., 2009). A recent comprehensive review including numerous technical indicators over a large period of time by Hsu et al. (2016) provides evidence of their performance in both developed and emerging markets. The authors find that technical indicators exploit irrationalities in the financial markets; hence, they are able to generate statistically significant and profitable strategies. In addition, the authors argue that more volatile currencies are able to deliver equally profitable excess returns to less volatile ones, if the latter are subject to leverage. In a similar manner, Zarrabi et al. (2017) employ 7650 rules on six widely traded currencies and find that there are profitable opportunities, which do not persist over time as the performance of technical trading rules fluctuates throughout the sample. Their findings support Lo’s (2004) adaptive market hypothesis more than the efficient markets hypothesis.

Theoretical support in favor of the technical indicators grew recently based on the following arguments. First, due to the difference in the response timing of the investors (Han et al., 2016), it takes time for the prices to adjust to their efficient level (Lo, 2004). For example, during the recent crisis, the stock market was trending downwards for almost two years before reaching the bottom. Second, investors are not always rational and are subject to cognitive biases, rules of thumb, herding behavior and overconfidence. These irrationalities create or maintain ongoing trends and moments (Daniel et al., 1998). Third, information is expensive and not presumably available to all, leading to heterogeneity among traders and deviations from implied efficient market prices. Fourth, technical analysis can be viewed as a method of learning (Menkhoff and Taylor, 2007) rather than chaotic behavior, given its popularity among practitioners (Menkhoff, 2010). Fifth, technical analysis is so popular among practitioners that creates observed self-fulfilling outcomes (see among others Menkhoff, 2010; Neely et al., 2009; Menkhoff and Taylor, 2007; Cheung and Chinn, 2001; Taylor and Allen, 1992). Large scale trades, based on signals, distort prices from the efficient level, making fundamentals lose predictive ability. Finally, exchange rates are affected by Central Banks’ interventions (Charles et al., 2012). LeBaron (1999) and Silber (1994) find a positive correlation between central bank intervention and profitability of technical analysis. Such interventions are able to create trends or alter expectations on fundamentals. Menkhoff and Taylor (2007) claim that interventions distort markets and technical traders profit from this “inefficiency”. Reitz and Taylor (2008) give a different perspective by arguing in favor of a coordination channel from central banks to restore exchange rates when departing from their fundamental values.

In this paper, we use monthly data from January 1974 to December 2014 in order to construct forecasts for six widely traded currencies; namely the British Sterling, Japanese Yen, Norwegian Krone, Swiss Franc, Australian Dollar and Canadian Dollar. The base currency is the US Dollar, which is fairly standard in the literature. Our set of predictors includes both the most widely used macroeconomic (fundamental) predictors and technical indicators. Fundamental predictors stem from the Uncovered Interest Rate Parity, Purchasing Power Parity, Monetary fundamentals and Taylor rules. The technical indicators we employ are also the most widely employed in both academia and industry. These are simple moving average, momentum, relative strength index and exponential moving average rules. Following the literature we employ the Random Walk (RW) model as benchmark and evaluate the performance by the out-of-sample R² statistic and the MSFE-adjusted statistic (Clark and West, 2007).

The contribution of this paper to the exchange rate forecasting literature is that it brings together and evaluates the information that can be extracted from the most commonly used macroeconomic predictors and that of technical indicators on a monthly basis over an extensive period of time. In addition, it provides a comparative analysis of the two groups of predictors and the respective combined forecasts and principal components extracted from each group. In order to get a better insight on the sources of predictability, we check the performance over time with the use of the cumulative difference between the mean squared forecast errors of the random walk model and the candidate predictive model, identifying certain time periods when the rivals fail to outperform the benchmark. Interestingly, these periods seem to be closely connected to key developments in exchange rate markets. Our findings suggest that combining information from both technical indicators and macroeconomic variables (amalgam forecasts) significantly improves and stabilizes exchange rate forecasts versus using either type of information alone. Following, among others Abhyankar et al. (2005), Della Corte et al. (2009), Della Corte and Tsiakas (2012), Li et al. (2015), Ahmed et al. (2016), we assess the economic value of our forecasting strategy for two levels of risk aversion and find that our amalgam forecasts deliver sustainable economic benefits in comparison to their rivals, consistent with the statistical evaluation. Finally, we test whether our findings remain robust by changing the evaluation period, forecast horizon and extending the number of currencies by considering additional developed and emerging countries.

The remainder of the paper is organized as follows. In Section 2 we present the candidate predictors. The first part of the section is related to macroeconomic/ fundamental predictors and the second to technical indicators. Section 3 presents the predictive models, the forecast construction and the evaluation methods. In Section 4 we report the out-of-sample statistical evaluation findings, while Section 5 outlines our economic evaluation framework and results. Section 6 presents the robustness tests and Section 7 concludes the paper.

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1 Early contributions to the field include Taylor and Allen (1992) and Cheung and Chinn (2001) among others.

2 For a coherent approach on Taylor rules, see among others Orphanides (2003, 2008), Molodtsova and Papelli (2009), Byrne et al. (2016) and Byrne et al. (2018).
2. Candidate predictors

2.1. Fundamental predictors

Following the literature that links exchange rates with macroeconomic fundamentals (Engel and West, 2005; Molodtsova and Papell, 2009, 2012; Byrne et al., 2016), we employ 13 predictors, denoted by $x_{i,t}$, $i = 1, ..., 13$. We briefly describe them below.

1. The first candidate predictor is given by the uncovered Interest Rate Parity (IRP) as follows:

$$x_{1,t} = i_t - i_t^*$$  \hspace{1cm} (1)

where $i_t$ is the nominal interest rate in the domestic country and $i_t^*$ denotes the nominal interest rate for the foreign country.\(^3\)

2. The second predictor is given by the deviation of the nominal exchange rate from the Purchasing Power Parity (PPP) condition:

$$x_{2,t} = p_t - p_t^* - s_t$$  \hspace{1cm} (2)

where $p_t$ ($p_t^*$) is the logarithm of domestic (foreign) national price levels and $s_t$ is the logarithm of the nominal exchange rate.

3. The third predictor relates to the flexible price version of the monetary model, known as Frenkel–Bilson (FB) model (Meese and Rogoff, 1983). Under the assumption that PPP holds, the FB predictor is as follows:

$$x_{3,t} = a(m_t - m_t^*) - b(y_t - y_t^*) + c(i_t - i_t^*) - s_t$$  \hspace{1cm} (3)

where $m_t$ ($m_t^*$) is the log of the domestic (foreign) money supply, $y_t$ ($y_t^*$) is the log of the domestic (foreign) real output, proxied by the Industrial Production Index (IPI) and $s_t$ is the log of the nominal exchange rate. Due to first degree homogeneity of relative money supply, the parameter $a = 1$ (see Meese and Rogoff, 1983; Mark and Sul, 2001; Rapach and Wohar, 2002; Rossi, 2013). We further assume that the income elasticity of money demand and the interest rate semi-elasticity are 1, thus $b = c = 1$.

4. Under the assumption that both PPP and IRP hold, we get the basic form of the monetary model, denoted as BMF:\(^4\)

$$x_{4,t} = a(m_t - m_t^*) - b(y_t - y_t^*) - s_t$$  \hspace{1cm} (4)

where $a$ and $b$ are also assumed to be equal to 1.

Candidate predictors $x_5$ to $x_{13}$ are all Taylor rule variants (Taylor, 1993). Taylor rules unveil the mechanism with which each central bank determines the short-term nominal interest rate by taking into account variables, such as the inflation rate, the target inflation rate and the percentage deviation of actual real GDP from an estimate of its potential level. Assuming that both the domestic and the foreign central bank employs a Taylor rule and IRP holds, the general form of our Taylor rule predictors is given by the respective differences of short-term interest rates, as follows:

$$x_i = i_t - i_t^* = a_0 + a_1 x_1 + a_2 g_i - a_3 r_i^* + a_4 e_t + a_{4t-1} - a_{4t-1}^* + \eta_i$$  \hspace{1cm} (5)

where $x_i$ ($\pi_i^*$) is the domestic (foreign) inflation rate, $g_i$ ($g_t^*$) is the domestic (foreign) output gap, $e_t$ is the real exchange rate, i.e. $e_t = s_t - p_t + p_t^*$, and $\eta_i$ is the error term. The output gap is measured as the (percentage) deviation of real output from an estimate of its potential level and is computed with the use of the Hodrick–Prescott filter. At each point of the out-of-sample period, Eq. (5) is re-estimated to give the predictor (in general form) as follows:

$$x_i = \hat{\phi}_0 + \hat{\phi}_1 \pi_i + \hat{\phi}_2 g_i - \hat{\phi}_3 r_i^* + \hat{\phi}_4 e_t + \hat{\phi}_{4t-1} - \hat{\phi}_{4t-1}^*$$  \hspace{1cm} (6)

Several specifications, nested in Eq. (6), give rise to our predictors.\(^5\) First, Taylor rules can be homogeneous or heterogeneous depending on the response of central Banks to deviations from inflation rate, output gap and interest rate targets. If $\hat{\phi}_1 = \hat{\phi}_1^*$, $\hat{\phi}_2 = \hat{\phi}_2^*$, the rule is homogeneous, otherwise, the rule is heterogeneous. Second, Central Banks may want to avoid abrupt changes in the level of interest rates and choose to follow a smoothing interest rate adjustment policy, i.e. $\hat{\phi}_3 \neq 0$ and $\hat{\phi}_4^* \neq 0$. Finally, if Central Banks do not take into account possible deviations of the real exchange rate from its targeted level, so that $\hat{\phi}_3 = 0$, the specification is called symmetric ($\hat{\phi}_3 \neq 0$ for asymmetric). Specifically, we employ the following predictors:

5. the homogeneous asymmetric Taylor rule without interest rate smoothing and fixed weights (HOAfw):

$$x_{5,t} = \hat{\phi}_1 (\pi_t - \pi_t^*) + \hat{\phi}_2 (g_t - g_t^*) + \hat{\phi}_4 e_t$$  \hspace{1cm} (7)

The parameters $[\hat{\phi}_1, \hat{\phi}_2, \hat{\phi}_4]$ are set equal to [1.5,0.1,0.1] (Engel et al., 2008; Chen and Chou, 2010; Beckmann and Schüssler, 2016; Dellacorte and Tsiakas, 2012).

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\(^3\) In what follows, “*” denotes the variable in the foreign country.

\(^4\) For a more detailed discussion, see Rapach and Wohar (2002).

\(^5\) For a detailed discussion on Taylor rules, see Molodtsova and Papell (2009, 2012).
6. the homogeneous symmetric Taylor rule without interest rate smoothing (HOS):
\[ x_{6,j} = \phi_1 (\pi_t - \pi^*_t) + \phi_2 (g_t - g^*_t) \]

7. the homogeneous symmetric Taylor rule with interest rate smoothing (HOSS):
\[ x_{7,j} = \phi_1 (\pi_t - \pi^*_t) + \phi_2 (g_t - g^*_t) + \phi_4 (i_{t-1} - i^*_{t-1}) \] (8)

8. the homogeneous asymmetric Taylor rule without interest rate smoothing (HOS):
\[ x_{8,j} = \phi_1 (\pi_t - \pi^*_t) + \phi_2 (g_t - g^*_t) + \phi_3 e_t \] (9)

9. the homogeneous asymmetric Taylor rule with interest rate smoothing (HOAS):
\[ x_{9,j} = \phi_1 (\pi_t - \pi^*_t) + \phi_2 (g_t - g^*_t) + \phi_4 (i_{t-1} - i^*_{t-1}) \] (10)

10. the heterogeneous symmetric Taylor rule without interest rate smoothing (HES):
\[ x_{10,j} = \phi_1 \pi_t - \phi_1^* \pi^*_t + \phi_2 g_t - \phi_2^* g^*_t \] (11)

11. the heterogeneous symmetric Taylor rule with interest rate smoothing (HESS):
\[ x_{11,j} = \phi_1 \pi_t - \phi_1^* \pi^*_t + \phi_2 g_t - \phi_2^* g^*_t + \phi_4 i_{t-1} - \phi_4^* i^*_{t-1} \] (12)

12. the heterogeneous asymmetric Taylor rule without interest rate smoothing (HEA):
\[ x_{12,j} = \phi_1 \pi_t - \phi_1^* \pi^*_t + \phi_2 g_t - \phi_2^* g^*_t + \phi_3 e_t \] (13)

13. the heterogeneous asymmetric Taylor rule with interest rate smoothing (HEAS):
\[ x_{13,j} = \phi_1 \pi_t - \phi_1^* \pi^*_t + \phi_2 g_t - \phi_2^* g^*_t + \phi_3 e_t + \phi_4 i_{t-1} - \phi_4^* i^*_{t-1} \] (14)

2.2. Technical indicators

Technical rules can be split into two broad categories; charting and mechanical methods. Charting is the oldest method of the two and relies on graphs of historical prices over a specific time period. Chartists use subjective criteria to understand and identify patterns in spot prices. On the other hand, mechanical rules, which are the focus of our study, generate buy/sell signals based on simple or more complex mathematical functions of past and current data. We employ a few well-known mechanical rules, such as moving average rules, momentum indicators and relative strength indices. Moving average rules and momentum indicators signal a directional change subject to past prices, while relative strength indices take into account both the velocity and magnitude of directional price movements.

More in detail, we employ eleven technical indicators based on four simple and widely used trend following rules. The first rule is a moving-average (MA) rule that generates buying and selling signals comparing the moving averages of a long period with a short period. This rule is formed as follows:

\[ x_{i,j} = \begin{cases} 
1 & \text{if } MA_{i,j} \geq MA_{j,j} \\
0 & \text{if } MA_{i,j} < MA_{j,j} 
\end{cases} \quad \text{for } i = s,l \]

where \( S_t \) is the spot exchange rate and \( s,l \) denote the short and long period, respectively. The MA rule aims at identified changes in spot price trends. By construction, the indicator shifts more rapidly when it is created in the short-run, as recent price changes have comparatively more weight. For example, if during one period prices increase, then \( MA_s \) gets a faster upward trend and if it exceeds (crosses) \( MA_l \), it creates a buy signal, and vice versa. We consider \( s \) equal to [1,2,3] months and \( l \) equal to [9,12] months and denote the related rule by \( MA(s,l) \).

The second rule we apply is the momentum (MOM) technical indicator (see, for example Buncic and Piras, 2016; Neely et al., 2014). The signal is generated according to the relationship of current prices with the past prices, as follows:

\[ x_{i,j} = \begin{cases} 
1 & \text{if } S_t \geq S_{t-k} \\
0 & \text{if } S_t < S_{t-k} 
\end{cases} \]

If current prices are higher than \( k \) periods before, then a buy signal is generated, and vice versa. We set the \( k \) month lag equal to [9,12] and denote the related predictors by \( MOM(k) \).

For a comprehensive review of technical indicators see Zarrabi et al. (2017), Nazário et al. (2017) and Hsu et al. (2016).
The third rule is the Relative Strength Index (RSI).\(^7\) This rule is a momentum oscillator that measures the speed and change of price movements by taking into account the magnitude of recent gains or losses. It takes values between 0 to 100 and is given by the following formula:

\[
x_{j,t} = 100 - \frac{100}{1 + \frac{MA_{A_i}^{(n)}(uc_i)}{MA_{A_i}^{(n)}(dc_i)}}
\]

where \(MA_{A_i}^{(n)}\) denotes the n-period Moving Average of upclose or downclose measures, defined as:

\[
u_{c_i} = \begin{cases} \Delta S_i & \text{if } \Delta S_i > 0 \\ 0 & \text{otherwise} \end{cases} \quad \text{and } \quad d_{c_i} = \begin{cases} -\Delta S_i & \text{if } \Delta S_i < 0 \\ 0 & \text{otherwise} \end{cases}
\]

The higher the value of the index, the more intense the signal is regarding the presence of overbought conditions in the market, and vice versa. We employ two versions of the index for \(n = [7, 14]\), i.e. 7 and 14 months.

The last rule we apply is the Exponential Moving Average (EMA). This rule gives more weight on the more recent observations and as a result it responds faster in recent changes. The signals are generated by comparing the EMA of a long period with that of a short period, similar to the case of the simple MA, i.e.

\[
x_{j,t} = \begin{cases} 1 & \text{if } EMA_{A_{ij}} \geq EMA_{A_{ij}} \\ 0 & \text{otherwise} \end{cases} EMA_{A_{ij}} = (S_i - EMA_{A_{ij-1}}) + EMA_{A_{ij-1}}
\]

where \(m\) is a weighting multiplier, or else an accelerator, given by \(m = \frac{2}{j+1}\) where \(j = s, l\). The \(EMA(s,l)\) rule we employ sets \(s = 5\) and \(l = 12\).

3. Predictive models, forecast construction and evaluation

In this section, we describe the forecasting approaches we follow. One step ahead forecasts are generated by continuously updating the estimation window, i.e. following a recursive (expanding) window.\(^8\) More specifically, we divide the total sample of \(T\) observations into an in-sample portion of the first \(M\) observations and an out-of-sample portion of \(P = T - M\) observations used for forecasting. The estimation window is continuously updated following a recursive scheme, by adding one observation to the estimation sample at each step. Proceeding in this way through the end of the out-of-sample period, we generate a series of \(P\) out-of-sample forecasts for the exchange rates returns.

3.1. Univariate models

Our empirical analysis is based on the simple linear predictive model:

\[
\Delta s_{i,j,t+1} = a_i + \beta_i \Delta x_{i,j,t} + u_{i,j,t+1}
\]

where \(\Delta s_{i,j,t+1}\) is the 1-month log return of the exchange rate, \(\Delta x_{i,j,t}\) are the candidate predictors \(i\), in first differences, with \(i = 1, \ldots, 13\) for macroeconomic predictors and \(i = 14, \ldots, 24\) for technical indicators, \(a_i, \beta_i\) are constants to be estimated and \(u_{i,j,t+1}\) is the error term. Typically, Eq. (15) is estimated by least squares at each point of the out-of-sample period giving one-month ahead forecasts as follows:

\[
\Delta \hat{s}_{i,j,t+1} = \hat{a}_i + \hat{\beta}_i \Delta x_{i,j,t}
\]

3.2. Principal component models

In order to incorporate information from multiple variables/predictors, we estimate predictive regressions based on principal components. Extracting principal components is a simple technique that summarizes and extracts information from a large group of variables and at the same time reduces dimensionality. Via principal components, our set of predictors \(\Delta x = (\Delta x_{1,j}, \ldots, \Delta x_{N,j})\) are transformed to new uncorrelated variables, \(\hat{F}_{j} = (\hat{F}_{1,j}, \ldots, \hat{F}_{K,j})\). We consider three pools of predictors, \(j = ECON, TECH, ALL\), for macroeconomic/ fundamental predictors, technical indicators or the entire set of predictors taken together, respectively. In practice, we need to take into account the first few \(K\) principal components which incorporate most of the predictors’ information. To this end, at each point of the out-of-sample period, we select the optimal number of components (\(K\)) via the Schwarz Information Criterion (SIC).\(^9\) The monthly out-of-sample forecasts of principal component models extracted from the \(j\)th pool of predictors are denoted as \(PC - ECON, PC - TECH\) and \(PC - ALL\) and are given by the following equation:

\[
\Delta \hat{s}_{j,t+1} = \hat{a} + \sum_{k=1}^{K} \hat{b}_k \hat{F}_{k,j} \quad \text{for } j = ECON, TECH, ALL
\]

where \(\hat{F}_{k,j}\) is the \(k\)th principal component of the \(j\)th pool of predictors recursively estimated until time \(t\), \(\hat{a}\) and \(\hat{b}_k\) are constants estimated via least squares and \(K\) is the SIC-selected number of principal components.

---

\(^7\) See, for example, Buncic and Piras (2016).

\(^8\) In the robustness section we also include different out-of-sample periods and alternative forecast horizons.

\(^9\) For alternative ways of principal components’ selection, see Bai and Ng (2002). Neely et al. (2014) select \(K\) via the adjusted \(R^2\).
3.3. Combined forecasts

Another popular approach aiming at reducing model uncertainty and efficiently incorporating information from a large set of potential predictors is forecast combination (see, inter alia Timmermann, 2006; De Zwart et al., 2009; Rapach et al., 2010; Beckmann and Schüssler, 2016; Buncic and Piras, 2016). We employ the simplest combination scheme proposed in the literature, namely the naive equally weighted one and employ it for the three sets of predictors considered. Specifically, the combination forecasts are given by the following formula:

\[ \Delta s_{j,t+1}^{(f)} = \frac{1}{N_j} \sum_{j=1}^{N_j} \Delta s_{j,t+1} \quad \text{for } j = \text{ECON, TECH, ALL} \]  

(18)

where \( \Delta s_{j,t+1}^{(f)} \) is the combined forecast of the respective group \( j \), \( N_j \) is the number of predictors included in group \( j \) (\( N_{\text{ECON}} = 13 \), \( N_{\text{TECH}} = 11 \) and \( N_{\text{ALL}} = 24 \)) and \( \Delta s_{j,t+1} \) is the forecast computed from predictor \( i \) that belongs to the group \( j \). We refer to these forecasts as \( \text{POOL} - j \).

Finally, we create an amalgamation of forecasts (see Rapach and Strauss, 2012; Meligkotsidou et al., 2014). Specifically, we combine the \( \text{POOL} - \text{ALL} \) and \( \text{PC} - \text{ALL} \) forecasts computed from the forecast combination and principal component approaches under a naive combination scheme and form a new forecast, \( \text{FC} - \text{AMALG} \). This forecasting strategy can prove beneficial in the event that information contained in the two forecasting approaches is discrete.\(^\text{10}\)

3.4. Statistical evaluation

We evaluate the forecasting ability of our proposed models/specifications by comparing their forecasting performance relative to the random walk (RW) model, which sets \( \beta_0 = 0 \) in Eq. (15). This model is the standard benchmark in the literature on exchange rate predictability since the seminal work of Meese and Rogoff (1983). We first calculate the Campbell and Thompson (2008) out-of-sample \( R^2_{\text{OS}} \) statistic metric as follows:

\[
R^2_{\text{OS}} = 1 - \frac{\text{MSFE}_q}{\text{MSFE}_{\text{RW}}}
\]  

(19)

\( R^2_{\text{OS}} \) measures the proportional reduction in Mean Square Forecast Error (\( \text{MSFE}_q \)) of the \( q \) competing model/specification relative to that of the RW (\( \text{MSFE}_{\text{RW}} \)). If \( R^2_{\text{OS}} > 0 \) then the proposed model has better forecasting ability than the benchmark.

To test for the statistical significance of forecast improvements we employ the Clark and West (2007) \( \text{MSFE} - \text{adjusted} \) statistic. This statistic is suitable for comparisons of nested models, as it accounts for additional parameter estimation (bias) introduced by the larger model. In our case, the benchmark RW model is nested in all competing specifications. The test is calculated as follows:

\[
\text{MSFE - adjusted} = \left( \frac{1}{T} \right)^{\frac{1}{2}} \left\{ \sum_{t=1}^{T} \left[ (\Delta s_{t+1} - \hat{\Delta s}_{t+1})^2 - (\Delta s_{t+1} - \Delta s_{t+1}^{(\text{RW})})^2 - (\Delta s_{t+1} - \Delta s_{t+1}^{(q)})^2 \right] \right\}
\]

where \( P \) is the number of out-of-sample forecasts, \( M \) is the number of in-sample observations, \( T \) is the total number of observations and \( q \) is the proposed model under consideration. The null hypothesis of the test is \( H_0 : \text{MSFE}_{\text{RW}} \leq \text{MSFE}_q \) against the alternative \( H_1 : \text{MSFE}_{\text{RW}} > \text{MSFE}_q \). Clark and West (2007) show that critical values based on the standard normal distribution can provide a good approximation to the distribution of the test.

Following, among others, Meligkotsidou et al. (2014); Neely et al. (2014); Bergman and Hansson (2005); Rapach and Wohar (2002), we use encompassing tests in order to check whether the principal components and the combined forecasts contain distinct information or encompass each other. Specifically, consider forming a composite forecast, \( \hat{r}_{c,t+1} \), as a convex combination of model A forecasts, \( \hat{r}_{A,c,t+1} \), and the ones of model B, \( \hat{r}_{B,c,t+1} \), in an optimal way so that \( \hat{r}_{c,t+1} = \lambda_A \hat{r}_{A,c,t+1} + \lambda_B \hat{r}_{B,c,t+1} \). If the optimal weight attached to model A forecasts is zero (\( \lambda_A = 0 \)), then model B forecasts encompass model A forecasts in the sense that model B contains a significantly larger amount of information than that already contained in model A. Harvey et al. (1998) developed the encompassing test, denoted as \( ENC - T \), based on the approach of Diebold and Mariano (1995) to test the null hypothesis that \( \lambda_A = 0 \), against the alternative hypothesis that \( \lambda_A > 0 \). Let \( u_{A,t+1} = r_{t+1} - \hat{r}_{A,t+1} \) and \( u_{B,t+1} = r_{t+1} - \hat{r}_{B,t+1} \). The \( ENC - T \) statistic is given by:

\[
ENC - T = \sqrt{P} \frac{d}{\sqrt{\text{Var}(d)}}
\]

where \( d \) is the sample mean, \( \sqrt{\text{Var}(d)} \) is the sample-variance of \( \{d_{t+1}\}_{t=M}^{T-1} \) and \( P \) is the length of the out-of-sample evaluation window. The \( ENC - T \) statistic is asymptotically distributed as a standard normal variate under the null hypothesis. To improve the finite sample performance, the authors recommend employing Student’s \( t \) distribution with \( P - 1 \) degrees of freedom. To render a model as superior in forecasting ability, one also needs to test whether model A forecasts encompass model B forecasts (\( \lambda_B = 0 \)) by employing the \( ENC - T \) statistic based on \( d_{t+1} = (u_{A,t+1} - u_{B,t+1})u_{A,t+1} \). When both null hypotheses are rejected, then the competing models contain discrete information about the future and an optimal convex (\( \lambda_A, \lambda_B \in (0, 1) \)) combination forecast can be formed. In the event that none of the hypotheses of interest is rejected, both models contain similar information and the competing models are equivalent in terms of forecasting ability. When one of the null hypotheses is rejected, then the respective model forecasts dominate the forecasts of the competing model.

\(^{10}\) We address this issue in Section 3.4 where we present the test for model encompassing.
Table 1
Dataset and sources.

<table>
<thead>
<tr>
<th>Country</th>
<th>Nominal exchange rates</th>
<th>Industrial production index</th>
<th>Money supply</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>FRED, EXUSAL</td>
<td>OECD, AUSPROINDQSMIEI</td>
<td>OECD, MANMM101AUM189S</td>
</tr>
<tr>
<td>Canada</td>
<td>FRED, EXCAUS</td>
<td>OECD, CANPROINDQSMIEI</td>
<td>OECD, MANMM101CAM189S</td>
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<tr>
<td>Japan</td>
<td>FRED, EXJPUS</td>
<td>OECD, JPNPROINDQSMIEI</td>
<td>IMF, MYAGM2JPM189S</td>
</tr>
<tr>
<td>Norway</td>
<td>FRED, EXNOUS</td>
<td>OECD, NORPROINDQSMIEI</td>
<td>Norges Bank</td>
</tr>
<tr>
<td>Switzerland</td>
<td>FRED, EXSZUS</td>
<td>OECD, CHEPROINDQSMIEI</td>
<td>OECD, MABMM301CHM189S</td>
</tr>
<tr>
<td>UK</td>
<td>FRED, EXUSUK</td>
<td>FRED, GBRPROINDQSMIEI</td>
<td>FRED, MABMM402GBM189N</td>
</tr>
<tr>
<td>US</td>
<td>-</td>
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<td>IMF, MYAGM2USM52S</td>
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<td>Denmark</td>
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<td>FRED, MANMM101DKM189S</td>
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<td>Eurozone</td>
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<td>IMF, EA28+EA19, AIP,IX</td>
<td>IMF, FM3_SA_EUR</td>
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<td>Malaysia</td>
<td>FRED, EXMAUS</td>
<td>IMF, AIP,IX</td>
<td>IMF, FM1,XDC</td>
</tr>
<tr>
<td>South Africa</td>
<td>FRED, EXFUS</td>
<td>DATASTREAM, SAINPROJDH</td>
<td>IMF, FM1,XDC</td>
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<td>FRED, SWEPROINDQSMIEI</td>
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<td>New Zealand</td>
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<td>IMF, FM2,XDC</td>
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<td>India</td>
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</tr>
<tr>
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<td>DATASTREAM, PECURR</td>
</tr>
<tr>
<td>Philippines</td>
<td>IMF, ENDE_XDC,USD_RATE</td>
<td>IMF, AIPMA,IX</td>
<td>IMF, FM3,XDC</td>
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<tr>
<td>Thailand</td>
<td>IMF, ENDE_XDC,USD_RATE</td>
<td>IMF, PPI,IX</td>
<td>IMF, FM1,XDC</td>
</tr>
<tr>
<td>Brazil</td>
<td>IMF, ENDE_XDC,USD_RATE</td>
<td>FRED, BAPROINDQSMIEI</td>
<td>IMF, FM1,XDC</td>
</tr>
</tbody>
</table>

Notes: The data for the first six currencies are collected for the period January 1973 to December 2014. The sample period for the remaining currencies starts in the month they adopted the free floating scheme.

4. Empirical findings

In this section we provide a brief description of the data used in the empirical analysis and discuss key developments in the exchange rate market. Next, we present our findings regarding the statistical evaluation of our forecasting approaches. We also describe the performance of predictors/models over time, as well as the factors driving it.

4.1. Data

Our sample consists of monthly post-Bretton Woods data spanning from January 1974 to December 2014. We employ six of the most frequently traded currencies among industrialized economies that float freely; namely the British Sterling (GBP), the Japanese Yen (YEN), the Swiss Franc (CHF), the Norwegian Krone (NOK), the Australian Dollar (AUD) and the Canadian Dollar (CAD). Following the standard convention in the literature, we employ the US dollar as the base currency. Our main datasources are the OECD, IMF and FRED databases. Exchange rate returns are log-returns computed from differences in the log spot prices. Price levels are proxied by the Consumer Price Index (CPI) and inflation rates are calculated from the y-o-y growth rates of prices. We employ the industrial production index and the M3 monetary aggregate for the income and money supply levels. Interest rates are short-term rates. In order to estimate the output gap, we apply the Hodrick–Prescott filter on the monthly industrial production index. The data sources and codes of the variables employed are presented in Table 1.11

11 Table 1 also presents the datasources for an extensive set of currencies employed in the robustness section (Section 6.3).
One step ahead forecasts are generated by continuously updating the estimation window, i.e. following a recursive (expanding) window. More specifically, we divide the total sample of $T = 492$ observations (January 1974 to December 2014) into an in-sample portion of the first $M = 60$ observations (January 1974 to December 1978) and an out-of-sample portion of $P = T - M = 432$ observations used for forecasting (January 1979 to December 2014).\footnote{The authors attribute the inability of non-linear models to forecast accurately exchange rates to this phenomenon.}
Table 3 reports the out-of-sample performance ($R_{OOS}^2$ and level of statistical significance) of the proposed models/specifications. The Table is divided into four Panels. Panel A shows the forecasting performance of the individual predictors. Panels B and C report the pooled and principal components forecasts (Eqs. (18) and (17)). Specifically, Panel B presents the performance of principal component forecasts extracted from two distinct groups of predictors; macroeconomic predictors and technical indicators, as well as the corresponding combined forecasts. Panel C reports the related forecasts extracted from both macroeconomic predictors and technical indicators, along with the respective combined forecasts. Finally, Panel D presents the results for the amalgam of forecasts.
Our findings with respect to individual predictors (Table 3, Panel A) suggest that a few predictors provide consistently superior forecasts (relative to RW) irrespective of the currency under consideration. Overall, the best predictors in terms of $R^2_{OLS}$ are $BMF$, $PPP$, $MA(1,9)$, $RSI(7)$ and $RSI(14)$. Depending on the currency, the best predictor varies. For example, for GBP, YEN and CHF, the highest $R^2_{OLS}$ is attained by $PPP$, while for NOK and AUD $RSI(14)$ emerges as the most accurate one.\footnote{Our findings with respect to macroeconomic predictors are in line, among others, with Li et al. (2015), DellaCorte and Tsiakas (2012).}

More in detail, regarding macroeconomic predictors, $BMF$ and $PPP$ improve forecasts in all currencies under consideration, while $IRP$ and $PPP$ in three out of six currencies; namely GBP, NOK and CHF. Taylor rules emerge as the worst performing predictors. In particular, among this set of predictors the best performing ones are $HOAv$ and $HEA$ improving forecasts in all currencies but YEN and CAD. However, five Taylor rule variants are useful in predicting AUD and to a lesser extent CHF. On the other hand, most currencies tend to be predicted by technical indicators. $MA(1,9)$, $RSI(7)$ and $RSI(14)$ emerge as superior as they improve forecasts in all currencies under examination, followed by $MA(1,12)$, $MA(2,9)$ and $MOM(12)$. It is interesting to note that the highest $R^2_{OLS}$ values are achieved by the $RSI$ predictors exceeding 4.5% in all cases.

Overall, our findings so far suggest that both individual macroeconomic predictors and technical indicators can help forecasting exchange rates with the overall performance of technical indicators being superior to that of macroeconomic predictors. However, since a considerable amount of uncertainty exists with respect to the choice of the predictor, we next check whether combined forecasts and principal components forecasts can deliver a more consistent and reliable performance. Panel B reports the related findings. With the exception of the $PC – ECON$ predictors for CAD, combined forecasts and principal components ones extracted from both groups of predictors are associated with high positive $R^2_{OLS}$ values which are statistically significant at the 1% level. For $POOL – ECON$, $R^2_{OLS}$ values range from 0.98% (CAD) to 5.65% (AUD), while the respective values for $PC – ECON$ are 3.50% (NOK) and 11.04% (AUD). Interestingly, both $POOL – TECH$ and $PC – TECH$ are superior to $POOL – ECON$ and $PC – ECON$, with a few exceptions. Specifically, $PC – TECH$ improves forecast accuracy by 2.40% (CAD) to 6.95% (NOK) and $POOL – TECH$ by 1.33% (CAD) to 4.80% (CHF).

Next, we consider combined forecasts and principal components extracted from the entire set of predictors, shown in Panel C. Combined forecasts generated from all the predictors ($POOL – ALL$) show significant predictive accuracy, since $R^2_{OLS}$ values range from 1.18% to 5.10% and are statistically significant at the 1% level. More importantly, principal components extracted from the full information set ($PC – ALL$) dominate all specifications considered so far. For GBP, YEN, NOK and CHF, $R^2_{OLS}$ values are almost equally high at 6.06%, 6.49%, 7.76% and 6.67%, respectively. Even for CAD that was hard to predict so far, we get a respectable value of 3.63%. As expected, the corresponding value for AUD increases to 12.05%. Finally, when combining both $POOL – ALL$ and $PC – ALL$ into a “grand” forecast ($PC – AMALG$), our findings (Panel D) point to increased forecasting benefits for GBP, YEN and CHF, since $R^2_{OLS}$ rises to 7.81%, 6.81% and 7.57%, respectively. For NOK and AUD, $R^2_{OLS}$ are quite high at 7.38% and 10.17% respectively, although they are lower than the $PC – ALL$ counterparts of 7.76% and 12.05%.

Overall, there is compelling evidence so far that macroeconomic predictors and technical indicators work complementarily, i.e. they include different types of information that is mainly exploited by principal components, in contrast to combined forecasts. Furthermore, amalgam forecasts seem to offer a superior and consistent performance across the majority of the exchange rates considered. In order to shed light on these issues, we report the encompassing test results in Table 4.

<table>
<thead>
<tr>
<th>Table 4</th>
<th>HLN — encompass test.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>GBP</td>
</tr>
<tr>
<td>HLN (1998)</td>
<td></td>
</tr>
<tr>
<td>POOL-ECON encompasses POOL-TECH</td>
<td>0.10</td>
</tr>
<tr>
<td>POOL-TECH encompasses POOL-ECON</td>
<td>0.64</td>
</tr>
<tr>
<td>PC-ECON encompasses PC-TECH</td>
<td>0.00</td>
</tr>
<tr>
<td>PC-TECH encompasses PC-ECON</td>
<td>0.00</td>
</tr>
</tbody>
</table>

Notes: The table reports the p-values of the HLN (1998) test.
4.3. What drives the forecasting performance?

The statistical evaluation of our candidate predictors showed that technical indicators perform better than macroeconomic predictors and that the two groups of predictors contain different types of information that is exploitable if we extract principal components from all candidate predictors. Hence, $PC - ALL$ constitutes a fairly strong forecasting strategy. Moreover, the ‘grand’ predictor $FC - AMALG$ demonstrates better forecasting ability when $POOL - ALL$ and $PC - ALL$ do not encompass each other. In this section, we check whether the corresponding performance is consistent over time or our results tend to be sensitive to particular periods of time. As reported in Section 4.1, there are various historical periods considered as rather important for the course of exchange rates. To this end, we report the difference between the cumulative squared prediction error of the benchmark and the respective predictor. Over times of increase in this metric, the benchmark model is outperformed by the rival, and vice versa. In addition, since the metric is by default constructed as a cumulative difference between squared errors, a positive end-of-period value points to a better out-of-sample performance of the candidate specification over the RW benchmark model.

We begin the analysis with GBP. Fig. 2 presents the three best performing predictors ($PPP, RSI(14)$ and $BMF$) and the three worst performing ones ($HES, HEA$ and $MA(3,12)$). As shown in Fig. 2, the best performing predictors tend to outperform the benchmark almost throughout the entire period under consideration. However, the predictors experience some boosts in their performance, closely related to significant events around those periods. Specifically, these periods are during mid-1985, at the second half of 1992 and the second half of 2008, coinciding with the Plaza Accord, the events of Black Wednesday ending in the withdrawal of British sterling from the ERM mechanism, and finally, the recent financial crisis. It seems that the respective predictors react quicker than the benchmark during periods of crisis and abrupt changes. Excluding the turbulent periods, the benchmark and the candidate predictors do not deviate significantly in terms of squared errors over time. Quite importantly, while $RSI(14)$ is overall one of the best individual predictors, we have to note that during the period between mid-1992 to mid-2001, $RSI(14)$ is outperformed by the benchmark pointing to a quite unstable performance. Its performance further picks up with the outburst of the financial crisis, where significant gains are observed. Turning to the worst performing predictors, we observe that this is quite erratic showing some gains in the beginning of the out-of-sample period, but failing to adapt for the most part of the sample.

Since our focus is on alternative ways of summarizing predictor information, we report in Figs. 3–8 the performance of $POOL - j, PC - j$ and $FC - AMALG$ (for $j = ECON, TECH, ALL$) for all the currencies considered. Fig. 3 shows the respective performance for GBP. Overall, it is evident that combined forecasts and $FC - AMALG$ have a much smoother increasing path over time in comparison to principal components. All specifications benefit from crises but in calm periods, they display either modest improvements ($POOL$) or even losses ($PC$) in forecasting accuracy if compared to the benchmark. The performance over time for $POOL - ECON, POOL - TECH$ and $POOL - ALL$ is more or less similar. Likewise, the paths of $PC - j$ are quite similar. In particular, $PC - TECH$ manages to generate better forecasts during periods of crisis but loses predictability during relatively tranquil periods, in contrast to $PC - ECON$. $PC - ALL$ is much smoother than $PC - TECH$, but at the same time, suffers during
periods when returns do not fluctuate extensively. Observing closer the performance of $FC - AMALG$ that generates the highest $R^2_{OOS}$ performance, we note that $FC - AMALG$ follows a stable and increasing path with jumps during the 1992 and 2008 turmoils.

Next we turn to the respective results for YEN (Fig. 4). As the figure shows, combined forecasts maintain a stable upward trend throughout the whole period. Neither the YEN depreciation at the beginning of the sample, nor the ten-year appreciation after the Plaza Accord until 1995 seem to affect the forecasting superiority of combined forecasts over the benchmark. On the other hand, although principal components deliver higher $R^2_{OOS}$ values than combined forecasts and benefit from peaks and troughs, they are not consistently better than the RW. While the performance of $FC - AMALG$ is obviously smoother, it is still affected by the abrupt changes of $PC - ALL$. What is intriguing in this feature is that $POOL - ALL$ corrects the bad performance of $PC - ALL$ during the period 2004 to 2013 when combined.

In Fig. 5, we display the results for NOK. Overall, $POOL - j$ follow a steady and increasing path beating the benchmark in all periods followed by a significant jump at the outburst of the 2007–2009 crisis. Among the principal components under consideration, $PC - ECON$ suffers from losses at the beginning of the period that are reversed during the recent financial crisis. $PC - TECH$ outperforms the RW until 1995, when a five-year period of failures begins, ending in 2001. As far as $PC - ALL$ is concerned, it manages to neutralize the losses of $PC - ECON$ at the beginning of the sample and those of $PC - TECH$ at the period 2001–2008 and maintains a positive performance throughout the remaining periods. The path for $FC - AMALG$ does not differ significantly from that of $POOL - ALL$, exhibiting superior and stable performance over time.

The next currency considered is CHF (Fig. 6). Among the combined forecasts reported, the smoothest is $POOL - ALL$. The most noticeable features are the strong upward trends after 1992 for all specifications and the negative trend after 2011 for principal components forecasts. Overall, $PC$ forecasts appear more volatile than the $POOL$ ones. On the other hand and similar to our findings so far, $FC - AMALG$ rises steadily without any significant failures.

Turning to CAD (Fig. 7), we note that all combined forecasts, as well as $PC - TECH$ and $PC - ALL$ demonstrate some common patterns. There is no sizeable forecast improvement over the benchmark until 2007, when we start to observe a prolonged period of sizable benefits until the end of the sample. Extracting principal components from macroeconomic predictors shows the worst performance with a negative trend for almost the full out-of-sample period. $FC - AMALG$ neither beats nor is beaten by RW for the entire period until October 2008 when it picks up and significantly outperforms the benchmark up to the end of the sample.

The last currency under consideration is AUD, illustrated in Fig. 8. Apparently, our models benefit from the 1986 and 2008 AUD depreciations. Similar to the currencies considered so far, principal components appear to follow more volatile paths than combined forecasts, although they provide more sizable forecasting gains. The performance of $FC - AMALG$ is quite similar to the $POOL$ ones, attaining a positive increasing path throughout the out-of-sample period.
Fig. 4. YEN forecasts (PC, POOL, AMALG). Notes: See notes in Fig. 3.

Fig. 5. NOK forecasts (PC, POOL, AMALG). Notes: See notes in Fig. 3.
Summarizing our findings, we note that our proposed specifications can exploit periods of turbulence much more efficiently than the benchmark (we should not neglect that the RW with drift is by construction a slow adjusting predictor unable to capture abrupt changes). Aggregating predictor information via combination of pooled and principal components forecasts ($FC - AMALG$) can deliver not only superior forecasts in terms of $R_{OOS}^2$ but also forecasts that can consistently beat the RW without being significantly affected by long or short swings in exchange rates.
5. Economic evaluation

5.1. Univariate portfolio allocation

So far, we have evaluated the statistical significance of our proposed specifications. We now focus on the economic performance of our models, since statistical significance does not always imply profitability.\(^{15}\) We follow the most recent literature (e.g. Buncic and Piras, 2016; Ahmed et al., 2016; Panopoulou and Pantelidis, 2015; DellaCorte and Tsiakas, 2012; Thorton and Valente, 2012; Della Corte et al., 2009) and focus on the maximization of the investor’s expected utility. The investor relies on the information given by the one-month-ahead forecasts of our proposed specifications (Eqs. (16)–(18)) to rebalance her portfolio, which is compared to the portfolio created by the benchmark RW forecasts.

We assume that the investor is US based and allocates part of (or the entire) her portfolio to the US risk free asset (giving return \(i^*_t\)) and the rest on the risk free asset of the foreign country. In this case, her return is the sum of the foreign risk free rate (\(i^*_t\)) and the realized exchange rate return. Thus, the only risk the investor is exposed to are fluctuations of the exchange rates. Specifically, the investor re-balances her portfolio every month in the out-of-sample period and allocates the following portion of her wealth (\(w_t\)) to the risky (foreign) asset:

\[
w_t = \frac{1}{\gamma} \left( \frac{\hat{r}_{t+1}}{\hat{\sigma}^2_{t+1}} \right)
\]

where \(\gamma\) is the risk aversion coefficient, \(\hat{r}_{t+1}\) denotes the expected return of the investment in the risky asset and is calculated as the sum of the foreign risk free rate (\(i^*_t\)) and the forecast of the exchange rate return, i.e. \(\hat{r}_{t+1} = i^*_t + \Delta \hat{s}_{t+1}\), and \(\hat{\sigma}_{t+1}\) is the forecast of the variance computed by calculating the variance of the actual exchange rate returns under a rolling window of 60 observations. Intuitively, higher values of \(\gamma\) correspond to a more risk averse investor, resulting in lower exposure to the foreign risky position. We conduct the experiment for two levels of risk aversion (\(\gamma = 2\) and 5).\(^{16}\) Consistent with the literature (e.g. Welch and Goyal, 2008; Ferreira and Santa-Clara, 2011; Ahmed et al., 2016), the weights are winsorized, i.e. \(-1 \leq w_t \leq 2\) in order to prevent extreme and unrealistic investments and also to allow for 200% leverage and 100% short sales. Under this setting, the optimally constructed portfolio return over the out-of-sample period is equal to

\[
r_{p,t+1} = w_t(i^*_t + \Delta \hat{s}_{t+1}) + (1 - w_t)i_t
\]

\(^{15}\) Even modest statistically significant out-of-sample performance or small \(R^2_{\text{out}}\) values may have significant gains (Buncic and Piras, 2016; Neely et al., 2014; DellaCorte and Tsiakas, 2012).

\(^{16}\) Abhyankar et al. (2005) set \(\gamma = [2,5,10,20]\); Neely et al. (2014) set \(\gamma = 5\); Buncic and Piras (2016) set \(\gamma = 6\); Panopoulou and Pantelidis set \(\gamma = [2,5]\).
In order to assess the economic value of the candidate predictors, we calculate the Certainty Equivalent Return (CER) as follows:

\[ CER = \hat{r}_p - \frac{1}{2} \gamma \hat{\sigma}_p^2 \]

where \( \hat{r}_p \) is the average return of the portfolio (equal to \( \frac{1}{p} \sum_{i=0}^{p-1} (r_{p,i+1}) \)) and \( \hat{\sigma}_p^2 \) is the variance of the investor’s portfolio over the out-of-sample period. The difference between the CER of the proposed specification and that of the benchmark (denoted as \( \Delta CER \)) can be interpreted as the maximum fee that the investor is willing to pay in order to switch from the RW to the competing model. To test the statistical significance of \( \Delta CER \), we compute the \( p \)-value of \( \Delta CER \) relying on the asymptotic properties of functional forms of the estimators for means and variances (see also, Jobson and Korkie, 1981, Memmel, 2003 and DeMiguel et al., 2009).  

17 Let the vector of moments be \( u = (r_{t,i}, f_{RW, t}, \sigma_{i, RW}^2, \sigma_{RW}^2) \) and their estimates \( \hat{u} = (\hat{r}_{t,i}, \hat{f}_{RW, t}, \hat{\sigma}_{i, RW}^2, \hat{\sigma}_{RW}^2) \). The difference in the certainty equivalent return of the predictor \( i \) and the benchmark is given by the function \( f(u) = (\hat{r}_{t,i} - \frac{1}{2} \hat{\sigma}_{i, RW}^2) - (\hat{r}_{RW} - \frac{1}{2} \hat{\sigma}_{RW}^2) \) and the asymptotic distribution of the function is calculated as 

\[ \sqrt{v} (f(\hat{u}) - f(u)) \]

with a distribution \( \mathcal{N}(0, \frac{\partial f(u)}{\partial u} \theta U \theta^T) \), where \( \theta = \begin{bmatrix} \hat{\sigma}_{i, RW}^2 & \hat{\sigma}_{RW}^2 & 0 & 0 & 0 & 0 \\ \hat{\sigma}_{i, RW}^2 & \hat{\sigma}_{RW}^2 & 0 & 0 & 0 & 0 \\ \hat{\sigma}_{i, RW}^2 & \hat{\sigma}_{RW}^2 & 0 & 0 & 0 & 0 \\ \hat{\sigma}_{RW}^2 & \hat{\sigma}_{RW}^2 & 0 & 0 & 0 & 0 \\ \hat{\sigma}_{RW}^2 & \hat{\sigma}_{RW}^2 & 0 & 0 & 0 & 0 \\ \hat{\sigma}_{RW}^2 & \hat{\sigma}_{RW}^2 & 0 & 0 & 0 & 0 \end{bmatrix} \). The variance of the distribution is given as follows:

\[ \sigma^2 = \frac{\partial f(u)}{\partial u} \theta U \theta^T = \begin{bmatrix} 1 & -\gamma \hat{\sigma}_{i, RW} & \gamma \hat{\sigma}_{RW} & \gamma \hat{\sigma}_{i, RW} & \gamma \hat{\sigma}_{RW} & \gamma \hat{\sigma}_{i, RW} \\ -\gamma \hat{\sigma}_{i, RW} & 1 & -\gamma \hat{\sigma}_{RW} & \gamma \hat{\sigma}_{i, RW} & \gamma \hat{\sigma}_{RW} & \gamma \hat{\sigma}_{i, RW} \\ \gamma \hat{\sigma}_{i, RW} & -\gamma \hat{\sigma}_{RW} & 1 & -\gamma \hat{\sigma}_{i, RW} & \gamma \hat{\sigma}_{RW} & \gamma \hat{\sigma}_{i, RW} \\ \gamma \hat{\sigma}_{RW} & \gamma \hat{\sigma}_{i, RW} & -\gamma \hat{\sigma}_{RW} & 1 & -\gamma \hat{\sigma}_{i, RW} & \gamma \hat{\sigma}_{RW} \\ \gamma \hat{\sigma}_{i, RW} & \gamma \hat{\sigma}_{RW} & \gamma \hat{\sigma}_{i, RW} & -\gamma \hat{\sigma}_{RW} & 1 & -\gamma \hat{\sigma}_{i, RW} \\ \gamma \hat{\sigma}_{RW} & \gamma \hat{\sigma}_{i, RW} & \gamma \hat{\sigma}_{RW} & \gamma \hat{\sigma}_{i, RW} & -\gamma \hat{\sigma}_{RW} & 1 \end{bmatrix} \]

We also evaluate the economic value of our forecasts by computing the out-of-sample performance fee (\( \Delta CER \)) for two levels of risk aversion, \( \gamma = [2, 5] \). We also report the annualized portfolio excess return and annualized volatility, denoted as (\%)\( \mu \) and (\%)\( \sigma \), before and after accounting for transaction costs. We follow Chang and Osler (1999) and Neely et al. (1996) that use 5 basis points (bps) per change of position.  

18 Neely et al. (2009) argue that “Since the mid-1990s, electronic trading has lowered transaction costs...Recently, spot market participants have faced spreads of 2 bps or less for transactions in the $5 million to $50 million range”. The authors assume a linear decline from 10 bps in 1973 to 1.88 bps in 2005. In our case, we assume that the costs are stable over the entire sample period to 5 bps.

19 Specifically, we test whether the Sharpe ratio of the benchmark is equal to its rival, so that \( H_0 : \frac{\mu_{RW}}{\sigma_{RW}} = \frac{\mu_{i}}{\sigma_{i}} \). The respective test statistic is given by

\[ z = \frac{\bar{r}_{i, RW} - \bar{r}_{i, RW}}{\sqrt{\frac{\sigma_{i, RW}^2}{n} + \frac{\sigma_{RW}^2}{n}}} \]

where

\[ \theta = \frac{1}{P} \left( 2 \bar{r}_{i, RW} \sigma_{i, RW}^2 - 2 \bar{r}_{i, RW} \sigma_{RW}^2 + \frac{1}{2} \bar{r}_{i, RW}^2 \sigma_{i, RW}^2 + \frac{1}{2} \bar{r}_{i, RW}^2 \sigma_{RW}^2 + \frac{1}{2} \bar{r}_{i, RW} \sigma_{i, RW}^2 \right) \]
related exchange rate forecasts. In this case, the investor forms an equally weighted portfolio containing $N = 7$ assets (including the US risk free asset as well), so each asset is given a weight of $1/N$.

5.3. Economic evaluation findings

Table 5 reports the annualized $\Delta CER$ fees related to the univariate portfolios. Our findings are discussed with two perspectives; the first is connected to the performance of the models against the Random Walk, and the second is linked to the performance of the models by increasing the level of risk aversion. Overall, our findings are consistent with the statistical evaluation findings. For currencies that proved hard to predict, such as YEN and CAD, we get either negative or small positive values. In addition, we observe that models performing poorly in terms of $\Delta CER$ or $\Delta CER$ do not generate negative $\Delta CER$ values as frequently as macroeconomic predictors. Especially in the cases of CAD and AUD, all technical indicator strategies outperform the benchmark, which however are not statistically significant. The performance of $PP$ is outstanding as it delivers substantial gains ranging from 3.21% (CAD) to 16% (GBP) in the case of for $\gamma = 2$. In addition, macroeconomic predictors fall significantly to generate positive fees for YEN and AUD, irrespective of the level of risk aversion. With respect to the level of risk aversion, we observe that in the majority of cases, the performance of almost all predictors deteriorates when risk aversion increases.
Turning to the performance of combined and principal components forecasts, we note that \( PC - ECON \) and \( PC - TEC H \) generate significantly high gains, up to 11.15% for \( PC - ECON \) (AUD) and 11.21% for \( PC - TEC H \) (GBP). More importantly, \( PC - TEC H \) forecasts are associated with substantial gains that range from 2.17% (1.87%) for CAD to 11.21% (9.82%) for GBP for \( \gamma = 2 \) (\( \gamma = 5 \)). For almost all currencies, principal components generate higher performance fees than combined forecasts. In addition, a further piece of evidence regarding the superiority of technical indicators is given by comparing \( PC - ECON \) to \( PC - TEC H \). We observe that \( PC - TEC H \) outperform \( PC - ECON \) for four currencies out of six. The results are qualitatively the same when we compare combined forecasts.

The most interesting feature of Table 5 is Panel C, where we report the results for \( POOL - ALL \) and \( PC - ALL \) with \( PC - ALL \) generating high economic gains, irrespective of the level of risk aversion. Except for CHF, the aforementioned model is able to result in higher economic gains than the other principal components. These gains reach 14.37% for GBP and 13.79% for AUD. Even in the case of YEN for \( \gamma = 5 \), where eight out of thirteen macroeconomic predictors and four out of eleven technical indicators generate losses, \( PC - ALL \) delivers essential gains, equal to 376 basis points. With respect to \( POOL - ALL \) we observe that this strategy favors a relatively less risky investor, pointing to gains for four out of six currencies. The results for the combination of these two predictors, as shown in Panel D, are very promising, although the respective gains do not outperform \( PC - ALL \) for any currency. \( FC - AMALG \) generates sizable utility gains of 11.9% and 8.41% for \( \gamma = 2 \) and GBP and AUD, respectively.

Turning to the multivariate asset allocation framework, our findings, reported in Table 6, clearly support our proposed forecasting approaches. Similar to the univariate evaluation, \( PPP, RSI(7) \) and \( RSI(14) \) generate the highest utility gains (over the benchmark random walk) which can reach 776 bps (after transaction costs) per year for \( \gamma = 2 \). As expected, annualized mean returns are quite high and exceed 18% per year. Overall, more risk averse investors are willing to pay higher fees in order to have access to our forecasts in these cases. Pooling information of macroeconomic variables or technical indicators results in utility gains that range from 182 bps (\( POOL - ECON, \gamma = 2 \)) to 244 bps (\( POOL - TEC H, \gamma = 2 \)). In these cases, SRs exceed one and are statistically greater than the benchmark RW. More importantly, pooling information from both sets of predictors achieves similar performance to \( POOL - TEC H \), making it a valid alternative strategy not associated with uncertainty over the predictor set choice. Contrary to our univariate evaluation findings, \( PC - ECON \) and \( PC - TEC H \) do not provide any statistically significant gains to the investor after accounting for transaction costs. However, \( PC - ALL \) is superior to \( PC - ECON \) and \( PC - TEC H \) along with \( POOL - ALL \) generating positive \( CERs \) of 372 bps and higher than the benchmark SR value of 1.18. More importantly, our proposed amalgam forecasts are superior to all aforementioned sets of forecasts providing the investor with an annualized return that exceeds 15% and is associated with a significant SR of 1.22, while \( CER \) gains exceed 409 bps. Finally, Panel C of Table 6 reports the performance of the naive \( 1/N \) portfolio, which provides gains of 202 bps for a risk averse investor; albeit not statistically significant and is associated with losses for a less risk averse investor. To conclude, our univariate and multivariate economic evaluation findings suggest that by exploiting the information from the two groups of predictors we are able to provide sizable economic gains.

6. Robustness tests

In this section we assess further the statistical performance of the candidate predictors/ specifications by conducting a series of robustness tests. First, we consider alternative forecasting horizons. Second, we change the beginning of the evaluation period to January 1990 and January 2000. Third, we employ an extended dataset of developed and emerging countries' exchange rates and test whether our findings pertain to this dataset as well.

6.1. Alternative forecast horizons

Table 7 reports our findings for alternative forecast horizons. Specifically, we consider \( h \)-month-ahead forecasts for \( h = [3, 6, 12] \). Our results show that statistical significance weakens as we move to higher forecast horizons. This effect is more pronounced for technical indicators, since by construction they are trend following predictors and past trends have less impact as we move further. However, when aggregating the information content in all candidate predictors via \( FC - AMALG, PC - ALL \) and \( POOL - ALL \), we still attain a very good performance for all currencies and especially for the 3- and 6- month forecast horizons.

More in detail, for the 3-month-ahead forecasts, our findings remain qualitatively similar to the benchmark one-month forecasts. Technical indicators perform better than macroeconomic predictors, especially for combined and principal components forecasts. By comparing \( POOL - j \), \( PC - j \) and \( FC - AMALG \), we observe that the best performing predictors are \( FC - AMALG \) for GBP, which generates out-of-sample \( R^2 \) values of 3.15%, \( PC - TEC H \) for YEN (1.79%), \( PC - TEC H \) for NOK (2.47%), \( POOL - ECON \) for CHF (1.78%), \( PC - ALL \) for CAD (2.04%) and \( PC - ALL \) for AUD (2.11%). It is interesting to note that \( FC - AMALG \) outperforms both \( PC - ALL \) and \( POOL - ALL \) in all currencies considered with the exception of CAD.

Turning to the 6-month forecasts, we observe that the forecasting ability of most technical indicators deteriorates significantly, while the deterioration in the forecasting ability of macroeconomic predictors is not that intense. The predictors that yield the best performance are \( FC - AMALG \) for GBP (1.53%), \( FC - AMALG \) for YEN (0.32%), \( PC - TEC H \) for NOK (0.52%), \( POOL - ECON \) for CHF (0.69%), \( FC - AMALG \) for CAD (1.48%) and \( PC - ALL \) for AUD (0.56%).

Finally, for the 12-month horizon we note that technical indicators are outperformed by the benchmark with the exception of a few cases. Interestingly, despite the bad performance of individual technical indicators, \( PC - TEC H \) still beats \( PC - ECON \). Specifically, the best performing model for GBP is \( PC - ECON \) (1.62%), \( PC - TEC H \) for YEN (1.62%), \( PC - TEC H \) for NOK (0.99%), \( FC - AMALG \) for CHF (1.36%), \( FC - AMALG \) for CAD (1.01%) and \( PC - TEC H \) for AUD (0.99%). It is interesting to note that \( FC - AMALG \) loses gradually its superiority over \( PC - ALL \) and \( POOL - ALL \), but still manages to deliver accurate forecasts.
superior for GBP, YEN and CHF. However, we observe that \( \hat{P}_C \) outperforms both \( \hat{P}_C \) long out-of-sample period. The predictors that provided statistical significant results remain robust and some of them even enhance more evaluation periods by setting the beginning of our forecasts to January 1990 and January 2000, respectively.

### 6.2. Alternative evaluation periods

Fundamentals incorporate useful information. and amalgam forecasts improve forecastability lending support to our main finding that both technical indicators and macroeconomic weights her wealth among the risky assets. ***', '**' or '*' denote statistical significance at the 1%, 5% and 10% level, respectively.

Table 6

<table>
<thead>
<tr>
<th>Predictor</th>
<th>( \Delta CE R_{\gamma} )</th>
<th>( \Delta CE R_{\gamma} )</th>
<th>( % \mu_\gamma )</th>
<th>( % \sigma_\gamma )</th>
<th>( SR_{\gamma} )</th>
<th>( \Delta CE R )</th>
<th>( \Delta CE R )</th>
<th>SR</th>
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<td>1.01</td>
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<td>0.05</td>
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<td>1.84**</td>
<td>13.42</td>
<td>12.86</td>
<td>1.04**</td>
<td>2.43***</td>
<td>2.47***</td>
<td>1.11***</td>
</tr>
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<td>0.88</td>
<td>1.25</td>
<td>1.31</td>
<td>1.02</td>
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<td>-0.23</td>
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<td>12.42</td>
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<td>1.12</td>
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<td>11.66</td>
<td>12.56</td>
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<td>1.25</td>
<td>1.39</td>
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<td>0.78</td>
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<td>RSI(7)</td>
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<td>18.31</td>
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<td>1.37***</td>
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<tr>
<td>POOL-TECH</td>
<td>2.44***</td>
<td>2.40***</td>
<td>14.07</td>
<td>13.00</td>
<td>1.08***</td>
<td>3.34***</td>
<td>3.33***</td>
<td>1.17***</td>
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<td>PC-TECH</td>
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<td>2.29</td>
<td>13.93</td>
<td>12.93</td>
<td>1.08</td>
<td>4.31***</td>
<td>4.35***</td>
<td>1.26***</td>
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<tr>
<td>POOL-ALL</td>
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<td>2.30***</td>
<td>13.97</td>
<td>13.00</td>
<td>1.07***</td>
<td>3.01***</td>
<td>2.99***</td>
<td>1.15***</td>
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<tr>
<td>PC-ALL</td>
<td>3.72*</td>
<td>3.65*</td>
<td>15.37</td>
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<td>1.18*</td>
<td>5.84***</td>
<td>5.82***</td>
<td>1.37***</td>
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<td>1/N</td>
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<td>1.52</td>
<td>0.10</td>
<td></td>
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</table>

Notes: The table reports the portfolio performance for a mean–variance investor with relative risk aversion coefficient \( \gamma = 2 \) and \( \gamma = 5 \), who invests her portfolio in the risky assets and the risk free asset. The investor uses either the Random Walk with drift model or the forecasts generated by the proposed approaches to rebalance her portfolio. For each level of risk aversion we compute the measures for the forecasts of the 13 macroeconomic predictors and 11 technical indicators, PC-ECON, PC-TECH, PC-ALL and FC-AMALG. \( \Delta CE R \) is the annualized difference in the Certainty Equivalent Return for the investor that uses our proposed approaches instead of the RW model. SR is the annualized Sharpe ratio values. \( \mu \) denotes the annualized portfolio excess return in percentage points and \( \sigma \) denotes the annualized standard deviation in percentage points. The subscript \( \gamma \) denotes that we account for transaction costs equal to 5 basis points. In Panel B, we do not account for transaction costs. In Panel C, we show the economic performance of the Naive Portfolio, according to which the investor equally weights her wealth among the risky assets. ***", **" or "*" denote statistical significance at the 1%, 5% and 10% level, respectively.

Overall, the performance of individual technical indicators deteriorates as the forecasting horizon increases (in line with the results of Menkhoff and Taylor, 2007; Park and Irwin, 2007; Neely and Weller, 1999). However, principal components, combined and amalgam forecasts improve forecastability lending support to our main finding that both technical indicators and macroeconomic fundamentals incorporate useful information.

### 6.2. Alternative evaluation periods

The next check we perform is to evaluate the robustness of our model to changes in the out-of-sample period. We consider two evaluation periods by setting the beginning of our forecasts to January 1990 and January 2000, respectively.

Our findings, when the out-of-sample period starts in January 1990 are reported in Table 8 and remain qualitatively similar to the long out-of-sample period. The predictors that provided statistical significant results remain robust and some of them even enhance their forecasting ability. For example, macroeconomic predictors for GBP display improved forecasting performance. \( PC – ALL \) outperforms both \( PC – ECON \) and \( PC – TECH \), with the exception of GBP and AUD. In addition, \( FC – AMALG \) also emerges as superior for GBP, YEN and CHF. However, we observe that \( PC – ECON \) and \( POOL – ECON \) perform even better in this more recent period.

Next, we focus on the more recent period (out-of-sample forecasts begin in January 2000). Our findings, reported in Table 9, suggest that our proposed specifications remain robust to this part of the sample. Specifically, \( PC – ALL \) shows improved forecast
Table 7

Robustness tests: Alternative forecast horizons.

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<th>Predictor</th>
<th>h=3</th>
<th>h=12</th>
</tr>
</thead>
<tbody>
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<tr>
<td>YEN</td>
<td>0.55**</td>
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</tr>
<tr>
<td>NOK</td>
<td>0.99**</td>
<td>0.15**</td>
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<tr>
<td>CHF</td>
<td>0.22</td>
<td>0.13</td>
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<tr>
<td>CAD</td>
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<tr>
<td>AUD</td>
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<td>0.05**</td>
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<td>GBP</td>
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<td>YEN</td>
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</tr>
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<td>NOK</td>
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<td>CHF</td>
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<td>AUD</td>
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<td>Panel A: Macroeconomic predictors</td>
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Table 8


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<th>Macroeconomic variables</th>
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<td>Predictor</td>
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<td>AUD</td>
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<td>Panel B: Bivariate predictive regression forecasts</td>
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Table: The table reports the $R^2_{OOS}$ values for each currency. For further details see Table 3. The out-of-sample period begins in January 1990.

accuracy for NOK (12.08%), CAD (5.41%), GBP (3.66%) and AUD (14.53%), relative to $\mathcal{F}_C$. Notes: The table reports the Panel C: Principal components and combination forecasts per group (All predictors) Robustness test: Out-of-sample period begins in 1990. |

Accuracy for NOK (12.08%), CAD (5.41%), GBP (3.66%) and AUD (14.53%), relative to $\mathcal{F}_C$. Notes: The table reports the Panel C: Principal components and combination forecasts per group (All predictors) Robustness test: Out-of-sample period begins in 1990. |

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Accuracy for NOK (12.08%), CAD (5.41%), GBP (3.66%) and AUD (14.53%), relative to $\mathcal{F}_C$. Notes: The table reports the Panel C: Principal components and combination forecasts per group (All predictors) Robustness test: Out-of-sample period begins in 1990. |

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Accuracy for NOK (12.08%), CAD (5.41%), GBP (3.66%) and AUD (14.53%), relative to $\mathcal{F}_C$. Notes: The table reports the Panel C: Principal components and combination forecasts per group (All predictors) Robustness test: Out-of-sample period begins in 1990. |
6.3. Extended currency dataset

In this subsection, we check whether our forecasting strategy survives when tested on an extended set of currencies including both developed and emerging markets. Specifically, we include 13 additional currencies; namely the Colombian peso (COP), Danish krone (DKK), Eurozone’s euro (EUR),20 Indian rupee (INR), Malaysia ringgit (MYR), Mexican peso (MXN), New Zealand dollar (NZD), Peruvian sol (SOL), Philippine peso (PHP), South African rand (ZAR), Swedish krona (SEK) and Thai baht (THB) and Brazilian real (BRL). Data were collected from several sources (given in Table 1) such as Datastream, FRED, IMF, OECD and Central Banks databases. In Table 2 (Panel B) we report the related descriptive statistics along with the start date of the sample period which is the month/year that each currency started to float freely or entered a crawling peg.

Table 10 (left panel) reports the results for DKK, EUR, MYR, ZAR and SEK for the out-of-sample period that begins in January 1979 and ends in December 2014. Overall, our findings are consistent with our main dataset pointing to superior forecasting ability of the technical indicators employed. To this end, pooling or extracting information from the set of technical indicators always leads to statistically significant positive $R^2_{OOS}$. On the other hand, pooling information about fundamentals leads to benefits in all currencies but MYR and extracting the related factors benefits only EUR and ZAR. More importantly, when both predictor sets are employed (Panel E), $R^2_{OOS}$ are positive and statistically significant for all currencies but MYR and POOL – ALL. PC – ALL is associated with higher $R^2_{OOS}$ values reaching 8.47% for DKK, followed by 7.11% for SEK. Consequently, our proposed amalgam approach succeeds in improving forecasts in all currencies generating improvements ranging from 2.57% to 7.13%. Turning to the shorter out-of-sample period starting in 1990 (right Panel), our findings are qualitatively similar. In this set of results we also add NZD, since data are available. Overall, Panels D, E and F convey the same message. Information from both sets of predictors via principal components or amalgam forecasts generate superior forecasts for all currencies at hand.

Despite the short out-of-sample period of Table 11 (out-of-sample period begins in January 2000), we are able to come into some very interesting conclusions. The Table contains an adequate number of currencies, thirteen in total, from both emerging and developed markets, from almost every geographical continent. Overall, we observe that aggregating information from both sets of predictors works positively for all currencies with the exception of COP, MXN, PHP, THB and BRL, which are all currencies of developing countries. On the other hand, the remaining developing currencies, i.e. INR, MYR, SOL and ZAR benefit from both macroeconomic and technical information aggregation as depicted in the positive and statistically significant $R^2_{OOS}$ of FC – AMALG, PC – ALL and POOL – ALL. Finally, our findings with respect to the developed countries, i.e. DKK, EUR, NZD and SEK, are similar to our main set up and promote the use of either technical indicators or both sets of predictors. Specifically, $R^2_{OOS}$ for PC – ALL range from 5.58% (NZD) to 11.66% (SEK) and for FC-AMALG from 5.10% (NZD) to 9.22% (SEK). Overall, our forecasting approach succeeds in all developed countries, while evidence is mixed for the developing ones.

20 Data prior to its inception are proxied by the Deutche mark.
predictors can provide superior forecasts. However, technical indicators demonstrate superior predictive ability, irrespective of being constructed reliable exchange rate forecasts against the Random Walk benchmark. Overall, our findings suggest that both groups of market participants. In our study, we use the most widely used macroeconomic predictors and technical indicators in order to

7. Conclusions

The importance of forecasting exchange rates extends beyond academia, to policymakers, practitioners and international financial market participants. In our study, we use the most widely used macroeconomic predictors and technical indicators in order to construct reliable exchange rate forecasts against the Random Walk benchmark. Overall, our findings suggest that both groups of predictors can provide superior forecasts. However, technical indicators demonstrate superior predictive ability, irrespective of being

21 This set of results is available from the authors upon request.
used individually, in a forecast combination or a principal components framework. More importantly, forecasts generated from the first few principal components of the two sets of predictors do not encompass each other, suggesting that these predictors capture different types of information and work complementarily. In this respect, forecasts constructed employing principal components of the whole information set, both fundamental and technical can further improve predictability reaching 12.05% over the random walk benchmark. Finally, we propose a forecasting strategy generated by the combination of combined and principal components forecasts from the entire group of predictors. Our findings suggest that in the cases that combined and principal components forecasts from the full information set do not encompass each other, this approach is superior to its rivals and outperforms the random walk model by 10.17%.

Interestingly, the financial turmoil of 1994 and 2008 enhance the predictability of our models, as they tend to be more flexible than the benchmark and adjust faster during crisis periods. Our proposed approaches tend to outperform the random walk throughout the entire out-of-sample period delivering increasing and relatively smooth performance signaling that the investor should take into account both types of predictors in order to consistently benefit. Indeed, our economic evaluation findings show that the combined use of technical indicators and macroeconomic predictors can provide significant gains irrespective of the currency under consideration. Our findings are robust to the evaluation period, forecast horizon and pertain to an extended dataset of currencies from both developed and emerging markets.

Appendix A. Supplementary data

Supplementary material related to this article can be found online at https://doi.org/10.1016/j.jempfin.2019.07.004.


