

A Regime-Switching Analysis of the Relationship Between the Bond, Stock, and FX Markets

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Abstract:

Addressing the exchange rate determination puzzle, this research clarifies that deviations from macroeconomic theories—specifically the Uncovered Interest Parity and Uncovered Equity Parity conditions—are regime-dependent. Using a two-state regime-switching framework, we examine the relationships between bond-FX and stock-FX markets. Grounded in FX market microstructure, our model posits that investor heterogeneity, driven by varying risk aversion and expectations, explains how portfolio shifts—channeled through currency demand and FX order flow—shape exchange rate dynamics. Our findings reveal distinct behaviors: stock-FX linkages emerge in only one regime, supporting the risk-rebalancing hypothesis consistent with the UEP theory. High investor heterogeneity correlates negatively with the proportion of the exchange rate process that aligns with PBM expectations. A case-by-case analysis further allows for a re-evaluation of currency roles; specifically, we find that the Japanese Yen's positioning fluctuates between carry-trade unwinds and safe-haven seeking. This study demonstrates that investor heterogeneity reconciles mixed empirical evidence on UEP and divergent currency classifications. We conclude that while microstructural information transmission mechanisms are critical to exchange rate pricing, the informativeness and clarity of signals derived from currency demand are at the heart of the ability of FX order flow to permanently impact prices.

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