Conditional Risk Premia in Currency Markets and Other Asset Classes

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The downside risk CAPM (DR-CAPM) can price the cross section of currency returns. The market-beta differential between high and low interest rate currencies is higher conditional on bad market returns, when the market price of risk is also high, than it is conditional on good market returns. Correctly accounting for this variation is crucial for the empirical performance of the model. The DR-CAPM can jointly rationalize the cross section of equity, equity index options, commodity, sovereign bond and currency returns, thus offering a unified risk view of these asset classes. In contrast, popular models that have been developed for a specific asset class fail to jointly price other asset classes.

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