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Discussion of:

Exchange Rate Expectations and Currency Demand

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What the Paper Does

Basic idea: Use relative allocations between hedged and unhedged ETFs to infer investors' pure currency demand and back out exchange rate expectations.

Three key building blocks:

1. Large cross-section of 350 matched ETF pairs across six currency areas (2014–mid-2025).
2. Anderson–Danthine style mean–variance framework to map optimal hedging into beliefs.
3. Portfolio-implied FX expectations are compared to survey, macro, and factor expectations.

Three main findings:

1. Survey expectations explain cross-sectional hedging choices best.
2. Portfolio-implied expectations are the only ones that significantly forecast future FX excess returns.
3. Dispersion in portfolio-implied beliefs both explains a large share of FX option-implied volatility and helps predict future volatility.

Contribution

- It provides a novel belief-extraction mechanism related to actual invested capital.
- Documents granular heterogeneity across ETF pairs (normally unobservable).
- Offers policy-relevant insights: almost a real-time measure of foreign investors' USD sentiment.
- It adds to the literature on heterogeneous beliefs and FX return predictability.

Policy and Research Implications

- ETF hedging choices offer a high-frequency "measure"of international demand for USD exposure.
- Relevant for monitoring capital flow pressures or shifts in global risk sentiment.
- It has a strong potential to act as a market-based expectations indicator for central banks.
- It is a useful complement to survey-based expectations in policy models that require forward-looking FX belief inputs.

Key Strengths

- Data construction is very detailed; ETF matching across currencies is nontrivial.
- There is a clear economic interpretation of the mapping from holdings to expectations.
- Prediction results are strong: portfolio implied expectations significantly forecast FX returns.

Comments I: Identification

1. **Investor composition**
   - The paper acknowledges that mapping ETF domicile to investor currency may be affected by cross-border institutional ownership (25% on average).
   - Institutional share is used in heterogeneity analysis, but the core belief-extraction results are not re-estimated on funds with predominantly retail/domestic ownership.
   - **Suggestion:** consider a robustness check on low-institutional-share funds and explore whether institutional ownership varies over time with FX conditions.
2. **Hedged vs. unhedged ETF arbitrage**
   - Paper documents that mispricing of hedged and unhedged ETFs comoves, including in stress episodes (e.g. March 2020).
   - Remaining question: do hedging-cost spikes in the forward market ever differentially affect hedged share classes?

Comments II: Interpretation of Predictability

Portfolio-implied expectations predict FX returns; surveys do not (at one-month horizon).

Two interpretations:

1. *Belief channel:* ETF flows capture marginal informed investors; surveys capture broad expectations.
2. *Risk-premium channel:* portfolio-implied expectations may reflect time-varying risk compensation.

Suggestion:

- Consider decomposition into expected appreciation vs. risk premium.
- Examine whether predictability concentrates in periods of high disagreement.

Comments III: Dispersion and Volatility

Very interesting and strong result: the mean absolute deviation of portfolio-implied expectations explains about 27% of the variation in option-implied FX volatility and is correlated with it up to 71% for the aggregate USD basket.

- To what extent does dispersion reflect genuine **belief heterogeneity** versus **heterogeneity in constraints** or product platforms?
- Could flows into specific ETF families (cost or distribution channels) create mechanical dispersion?
- It would be useful to decompose dispersion by asset class (equity vs. bonds).

Overall Assessment

- Innovative and well-executed paper with strong empirical content.
- Provides a new and policy-relevant approach to measuring FX expectations.
- Suggestions aimed at reinforcing identification and interpretation.
- I expect strong interest from both academic and policy audiences.

Thank You

Questions & Discussion