U.S. Populist Rhetoric and Currency Returns

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Abstract

We develop a novel measure of U.S. populist rhetoric. Aggregate Populist Rhetoric (APR) Index spikes around populist events. We decompose the APR Index into sub-indices. We show that APR Index and International Relations sub-index are negatively priced in the cross-section of currency excess returns. Currencies that perform well (badly) when U.S. populist rhetoric is high yield low (high) expected excess returns. Investors require high risk premium for holding currencies which underperform in times of rising U.S. populist rhetoric, especially in the post-crisis period. A long-short strategy that buys (sells) currencies with high (low) exposure to U.S. populism offers strong diversification benefits.

Objectives

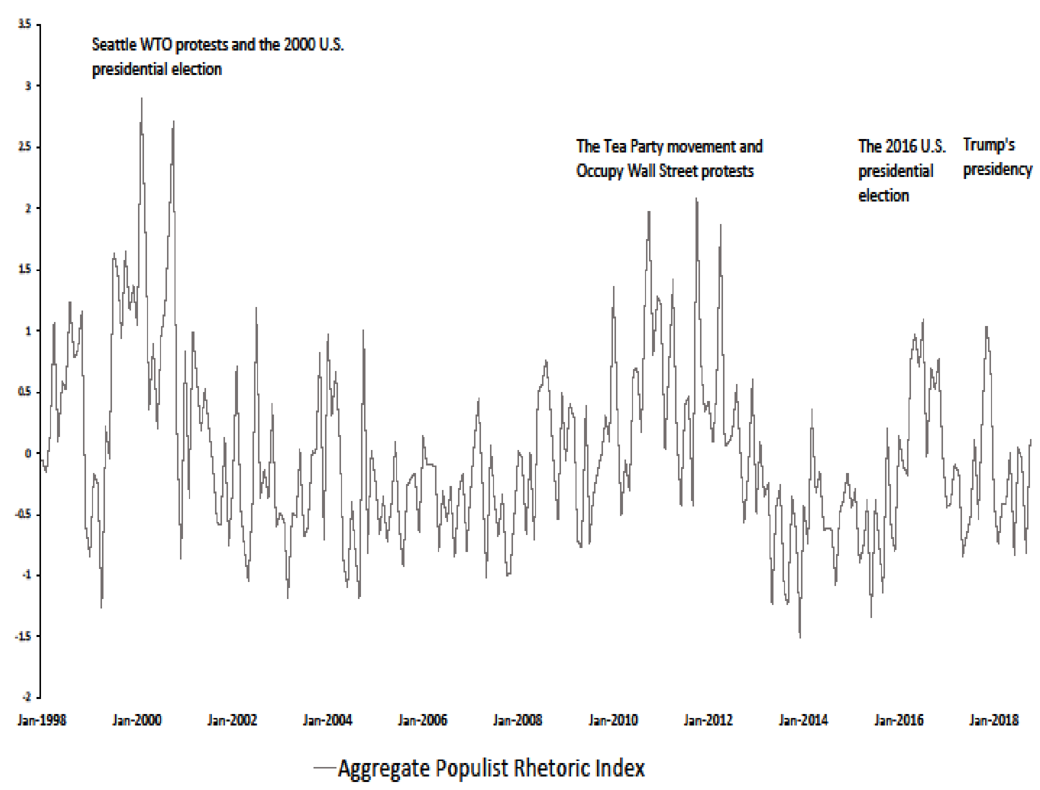
- We implement textual analysis to construct a novel index of U.S. populism by assessing the overall populist rhetoric reported by leading newspapers
- We then decompose this main index into sub-indices, each of which corresponding to a topic identified by LDA Algorithm
- Our empirical findings show that U.S. populist rhetoric is negatively priced in the cross-section of currency excess returns

Methodology

- We follow the same methodology as in Baker, Bloom, and Davis (2016) to construct our Aggregate Populist Rhetoric (APR) Index
- We use 26 populist terms in the dictionary constructed by Bonikowski and Gidron (2015) (e.g., special interest, top 1 percent, average American taxpayer)
- We search for all articles containing at least one of terms and define them as ‘populist’ articles
- For each newspapers, we construct the monthly counts of populist articles divided by the counts of U.S. politics articles and our APR index is the weighted average of 5 newspapers based on circulation
- We then implement LDA Algorithm developed by Blei et al (2003) to discover the topics of our corpus, and construct the International Relations (IR) sub-index
- Populism-sorted portfolios are formed based on exposure of each currency to APR Index (or IR sub-index)
- Country-level asset pricing tests are carried out to investigate the risk price of APR Index (and IR sub-index)

Results

Aggregate Populist Rhetoric (APR) Index



International Relations topic identified by LDA Algorithm

- The populism portfolio, which goes short portfolio of low APR Index beta and goes long portfolio of high APR Index beta, yields an annualized average excess returns of 4.95% with a Sharpe ratio of 0.76
- The similar strategy based on IR sub-index generates even better performance, with 5.27% excess returns annually and a Sharpe ratio of 0.82
- For developing countries, those with higher vulnerability to U.S. Dollar denominated debt have more exposure to U.S. populist rhetoric
- For developed countries, those with lower holding of U.S. assets experience higher sensitivity to U.S. Populist rhetoric than those with higher holding of U.S. assets
- In cross-sectional regressions, the risk price of APR Index (and IR sub-index) is negative and statistically significant

Conclusion

- In this paper, we construct a novel index of U.S. populism. Our APR Index spikes around key events featuring populism in the U.S. politics, such as Seattle WTO protests, the Tea Party movement, and the 2016 U.S. presidential election
- We then implement LDA Algorithm to discover topics conveyed in populist articles. Of those sub-indices, we are particularly interested in the International Relations (IR) component in the context of foreign exchange market
- We show empirical evidence that U.S. populist rhetoric is negatively priced in the cross-section of currency returns, which suggests that investors require high risk premium for holding currencies underperforming in times of rising U.S. populist rheotric
- Our empirical findings are in line with theoretical framework in Pastor and Veronesi (2018)

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