Model uncertainty and exchange rate forecasting

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[Abstract] In this paper, we propose a theoretical framework where investors focus on only a subset of the economic fundamentals that drive the exchange rate. We show that the fundamentals chosen by investors feed back into the actual equilibrium exchange rate process. Any adjustment in the set of predictors used by investors leads to a change in the relation between the exchange rate and fundamentals. To test the validity of this framework empirically we design a backward elimination model selection rule, with the aim to capture the current set of fundamentals that best predict the exchange rate. Out-of-sample forecasting tests show that the backward elimination rule significantly beats a random walk for four out of five currencies. Further, the currency forecasts generate economically meaningful investment profits.