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Volatility spillovers between agricultural commodity and financial asset markets

IATRC Annual Meeting, 10 December 2012

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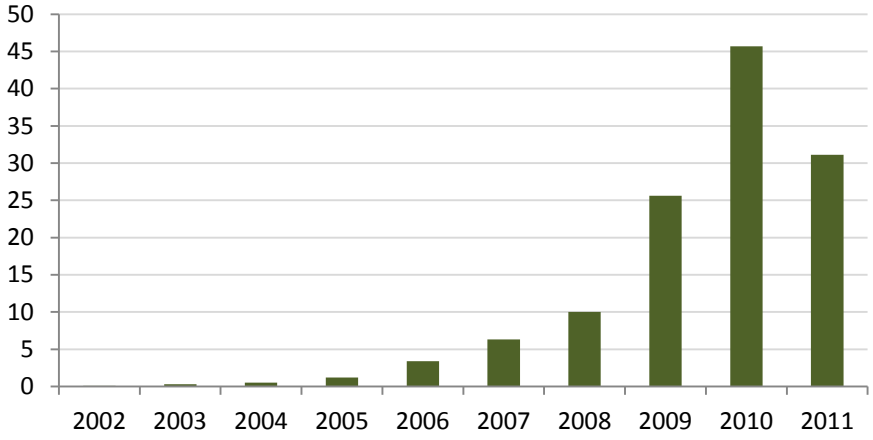
Structure

- Background and research objective
- Methodology
- Results and conclusions

Growing importance of commodities as portfolio assets

More investment vehicles available

Growth in Commodity ETF assets
2002-11, bn USD



Use of agricultural commodities as portfolio diversifiers facilitated

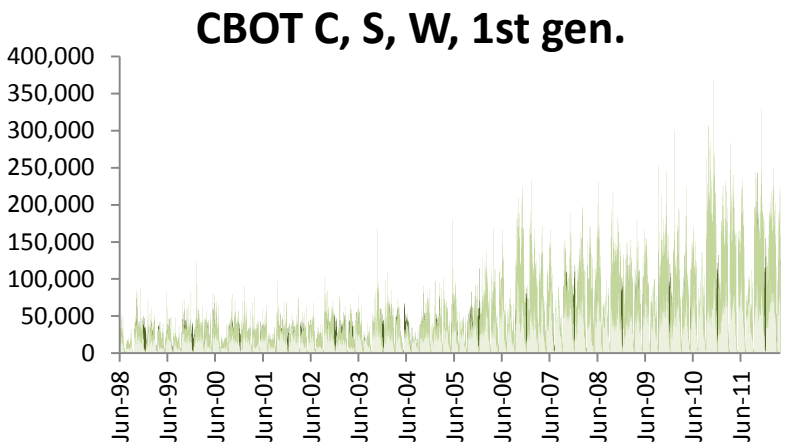
Global financial crisis

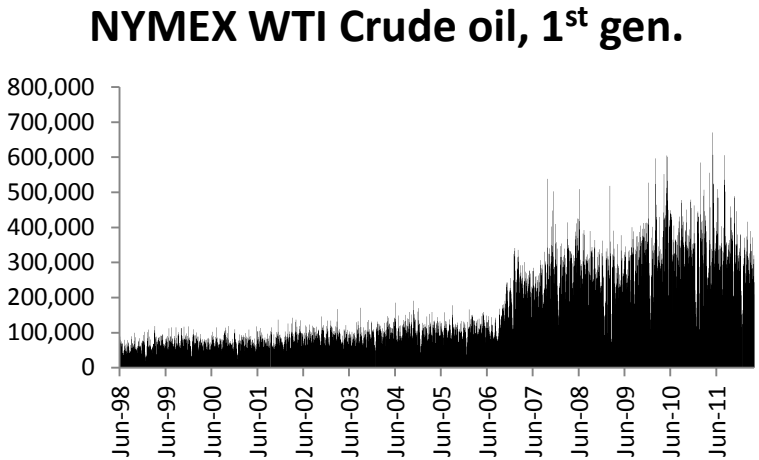
- 2007-2012 global financial crisis
  - Subprime mortgage crisis (2007/2008)
  - Sovereign debt crisis (from ~2010)

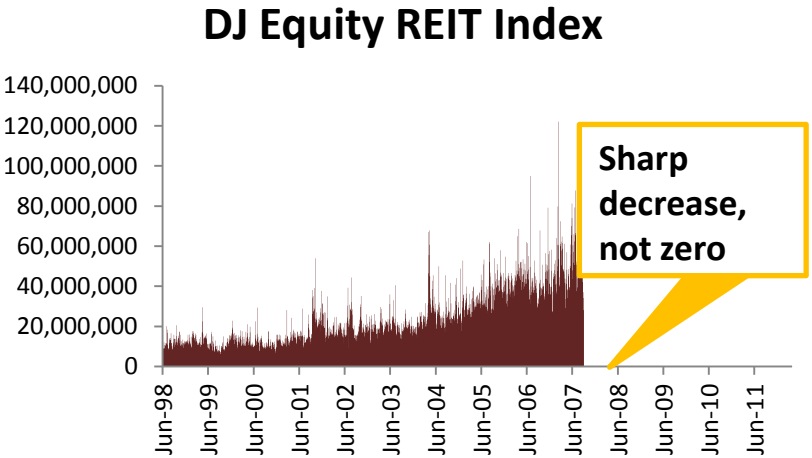
Higher importance of agricultural commodities as refuge assets or real asset substitutes

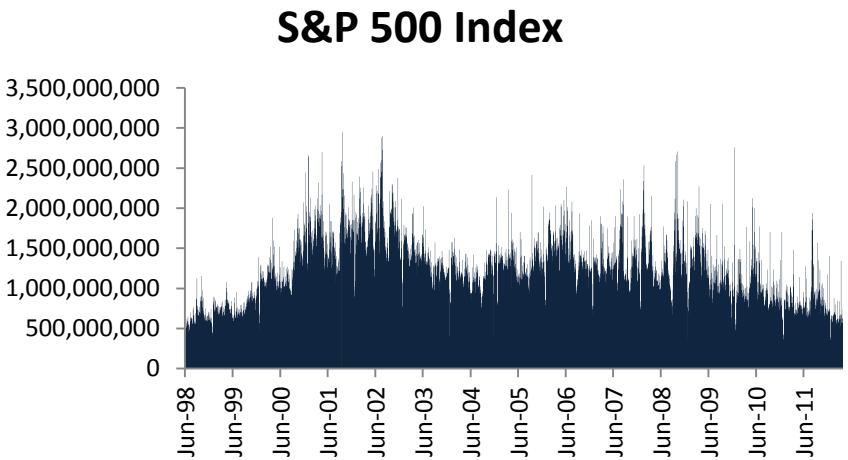
Source: BlackRock (2011); Conover et al. 2010, Chong and Miffre 2010, Gorton and Rouwenhorst 2006, Ankrim and Hensel 1993

Development of trading volume in asset markets









Significant increase in commodity trading volume after 2006

Source: Bloomberg

Research objective

Investigate whether market interdependence and volatility transmission between agricultural commodity markets and financial asset markets increases…

A **In normal markets:**

As a result of portfolio rebalancing and asset weight adjustments.

B **In crisis markets:**

As s a result of real asset substitution and use of agricultural commodities as refuge assets.

Methodology

Selection criteria

- Multivariate (~8 variables)
- Link to economic theory
- Account for potential regime-switches

Methodology

- Structural VAR (rolling estimation)
- *Generalized* Forecast Error Variance Decompositions (Pesaran and Shin, 1998)
- Volatility spillover indices

Application examples

- Diebold and Yilmaz (2009, 2012)
- Dimpfl and Jung (2012)

Modeling steps

1	▪ Selection of included financial and commodity assets ▪ Data gathering
2	▪ Computation of volatility proxies
3	▪ Estimation of rolling VAR models ▪ Generalized variance decompositions
4	▪ Calculation of volatility spillover indices

1 Assets included in the analysis

Assets			Time/ Aggregation
Com-modity	**Agricultural commodities** ▪ Corn, CBOT* (C1) ▪ Soybeans, CBOT* (S1) ▪ Wheat, CBOT* (W1)	**Other** ▪ Crude Oil, NYMEX* (CL1)	3 June 98 – 30 Mar 2012/ Daily
Financial	**Equity** ▪ S&P 500 Index (SPX) **Fixed income** ▪ 10-y U.S. Treasury* (TY1)	**Real estate** ▪ DJ Equity All REIT Index (REI) **Foreign exchange** ▪ ICE Futures US Dollar Index (DXY)	

* Future contracts, 1st generic (Bloomberg), rolling "relative to expiration", contracts rolled after last trading day of front month

2 Volatility proxies

Range-based volatility*

$$\hat{\sigma}_{Range,it} = \sqrt{\frac{1}{4\ln 2}\left[\ln\left(\frac{P_{it}^{High}}{P_{it}^{Low}}\right)\right]^2}$$

Pro:

- Captures intraday movements

Con:

- May show high volatility in times of a persistent trend in returns
- May be inflated due to intraday periods of low trading volume

Return-based volatility

$$\hat{\sigma}_{Return,it}(m) = \sqrt{\frac{1}{m-1}\sum_{n=1}^{m}(R_{it-n} - \bar{R}_i(m))^2}$$

with $R_{it} = \ln\left(\frac{P^{Close}_{it}}{P^{Close}_{it-1}}\right)$

and *m = 5, 30, 90, 180*

Pro:

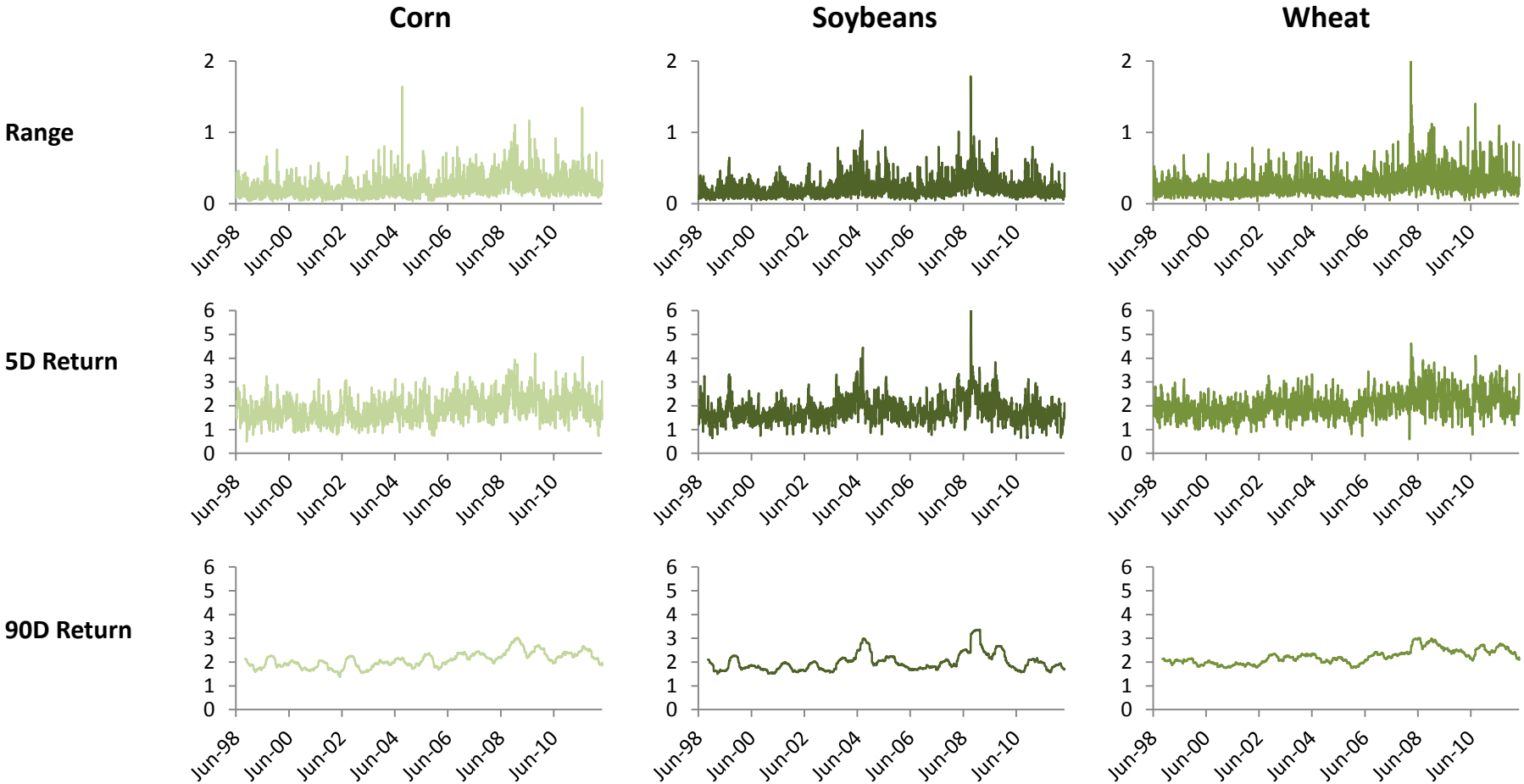
- Captures trends

Con:

- Neglects intraday movements
- Sensitive to included no. of observations/ time period of investigation

* based on Parkinson (1980)

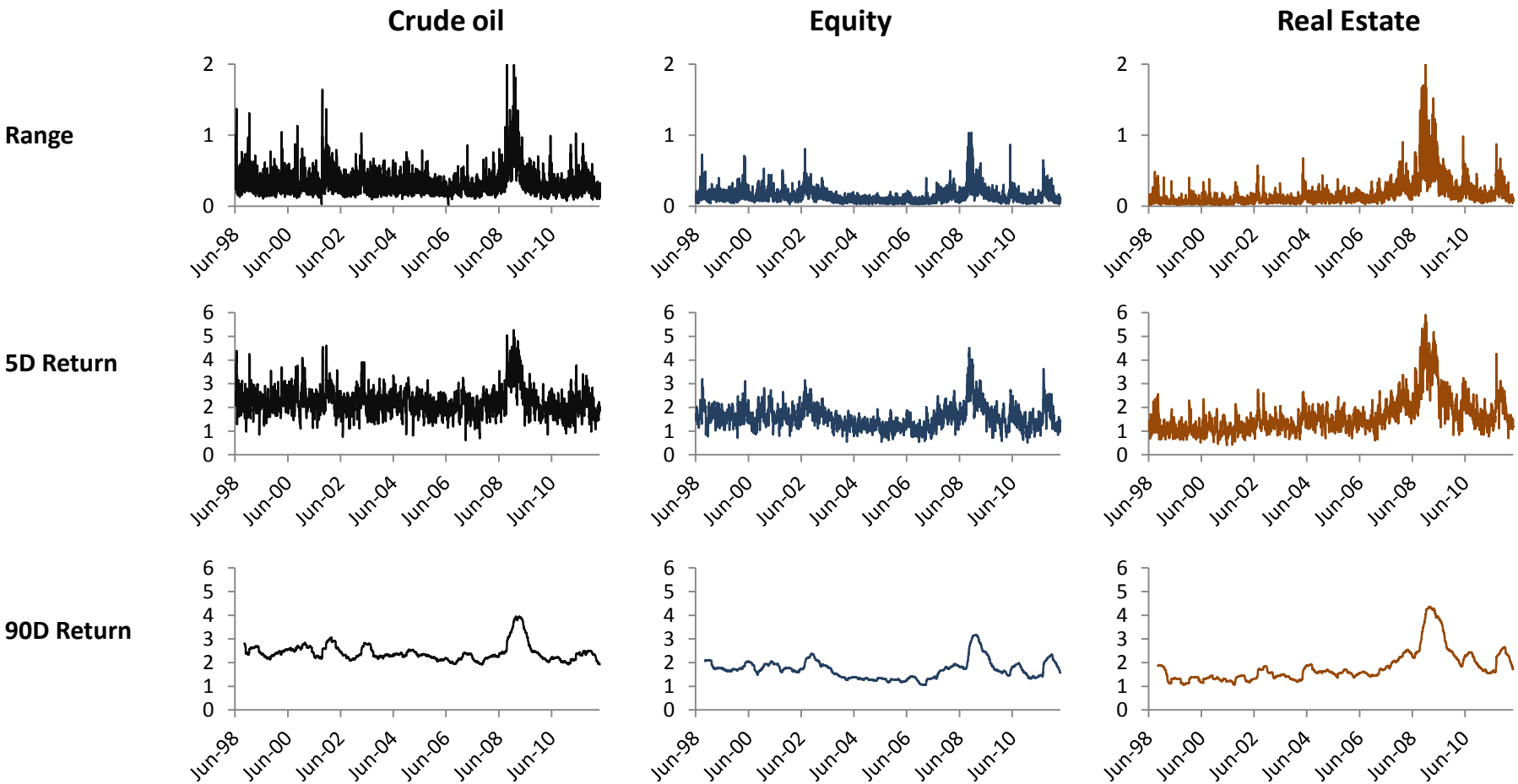
2 Asset volatility profiles: Grains and oilseeds (Annualized*)



* Multiplied by $252^{0.5}$

Source: Own calculations

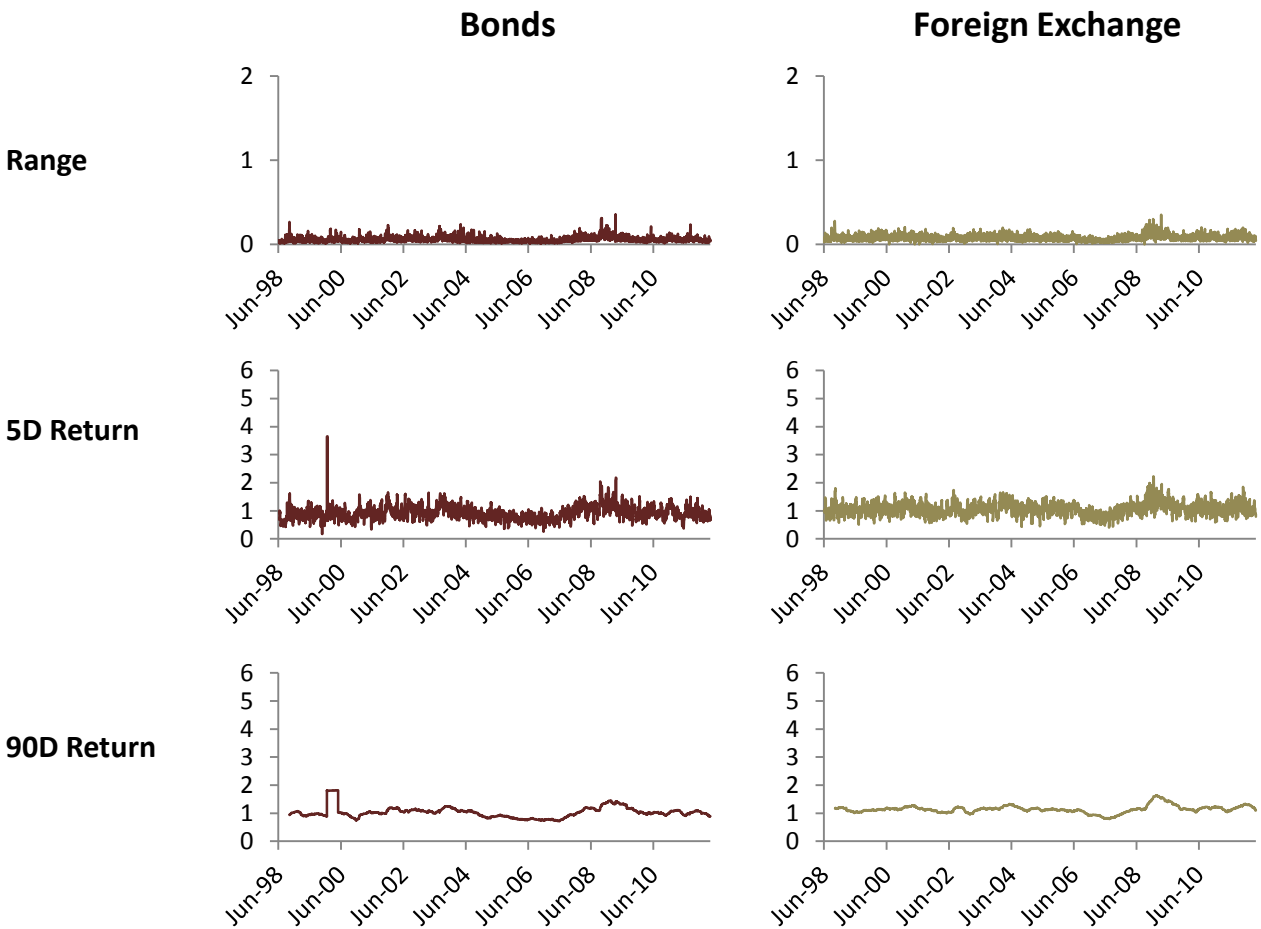
2 Asset volatility profiles: Other assets (1/2) (Annualized*)



* Multiplied by $252^{0.5}$

Source: Own calculations

2 Asset volatility profiles: Other assets (2/2) (Annualized*)



* Multiplied by $252^{0.5}$

Source: Own calculations

3 Estimation of VARs – Rolling regression

Model	Specification*	Included observations (No. per variable = T)				No. of windows
		w = 252				(T-w + 1)
$\log \hat{\sigma}_{Range}$	VAR(4)	06/03/98	…	03/30/12	(3,488)	3,237
$\log \hat{\sigma}_{Return}(5)$	VAR(1)	06/10/98	…	03/30/12	(3,483)	3,232
$\log \hat{\sigma}_{Return}(90)$	VAR(1)	10/09/98	…	03/30/12	(3,398)	3,147

* Lag length selected with SBC, VAR models for 30 and 180 day return-based volatilities estimated, results not reported

4 Variance decompositions and volatility spillovers

Background

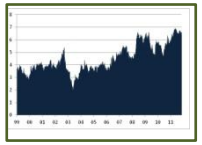
Forecast error variance (FEV) decomposition:

- **Own variance shares:** fraction of H-step ahead FEVs for one asset class (i) that are due to shocks to this asset class (i).
- **Spillovers (cross variance shares):** fraction of H-step ahead FEVs for one asset class (i) that are due to shocks to another asset class (j).

Indices

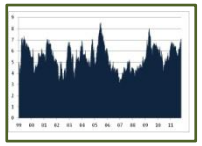
- **Total spillovers (H)**

  = sum of spillovers across all asset classes in relation to the total forecast error variance.



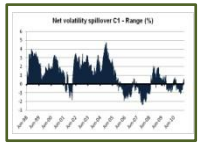
- **Directional spillovers *FROM* (H)**

  = spillovers received by asset i from all other assets j = 1,…,N , j≠i in relation to the total forecast error variance.



- **Directional spillovers *TO* (H)**

  = spillovers transmitted by asset i to all other assets j = 1,…,N , j≠i in relation to the total forecast error variance.



- **Net (pair wise) spillovers (H)**

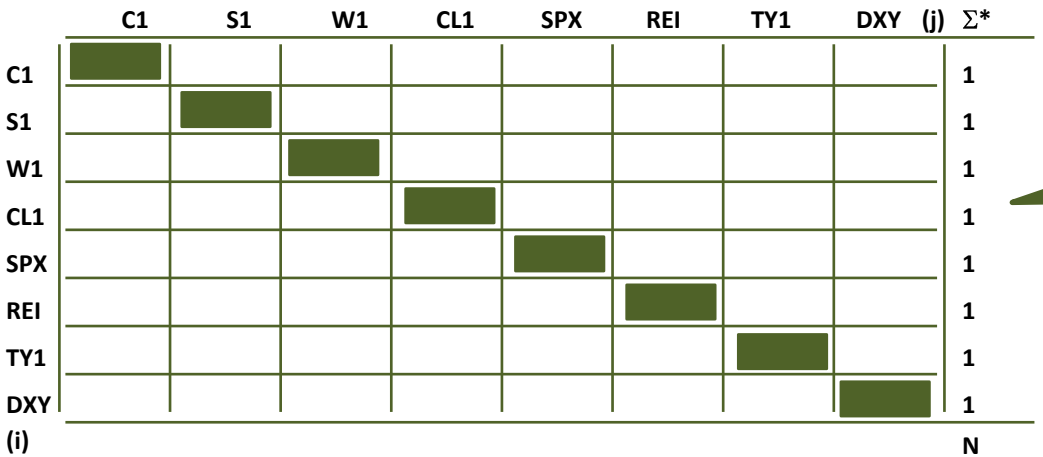
  = spillovers transmitted by asset i to all other assets j = 1,…,N , j≠i (one asset j) – spillovers received by asset i from all other assets j = 1,…,N , j≠i (one asset j) in relation to the total forecast error variance.

Source: Diebold and Yilmaz (2012, 2009)

4 Index calculations based on FEVDs

Own variance share

Cross variance shares (spillovers)



Matrix with FEVDs for a given forecast horizon H

* Entries have been normalized with row sum

Total spillover index =
Sum of cross-variance shares rows 1:N / Sum of all variance shares rows 1:N (=N) * 100

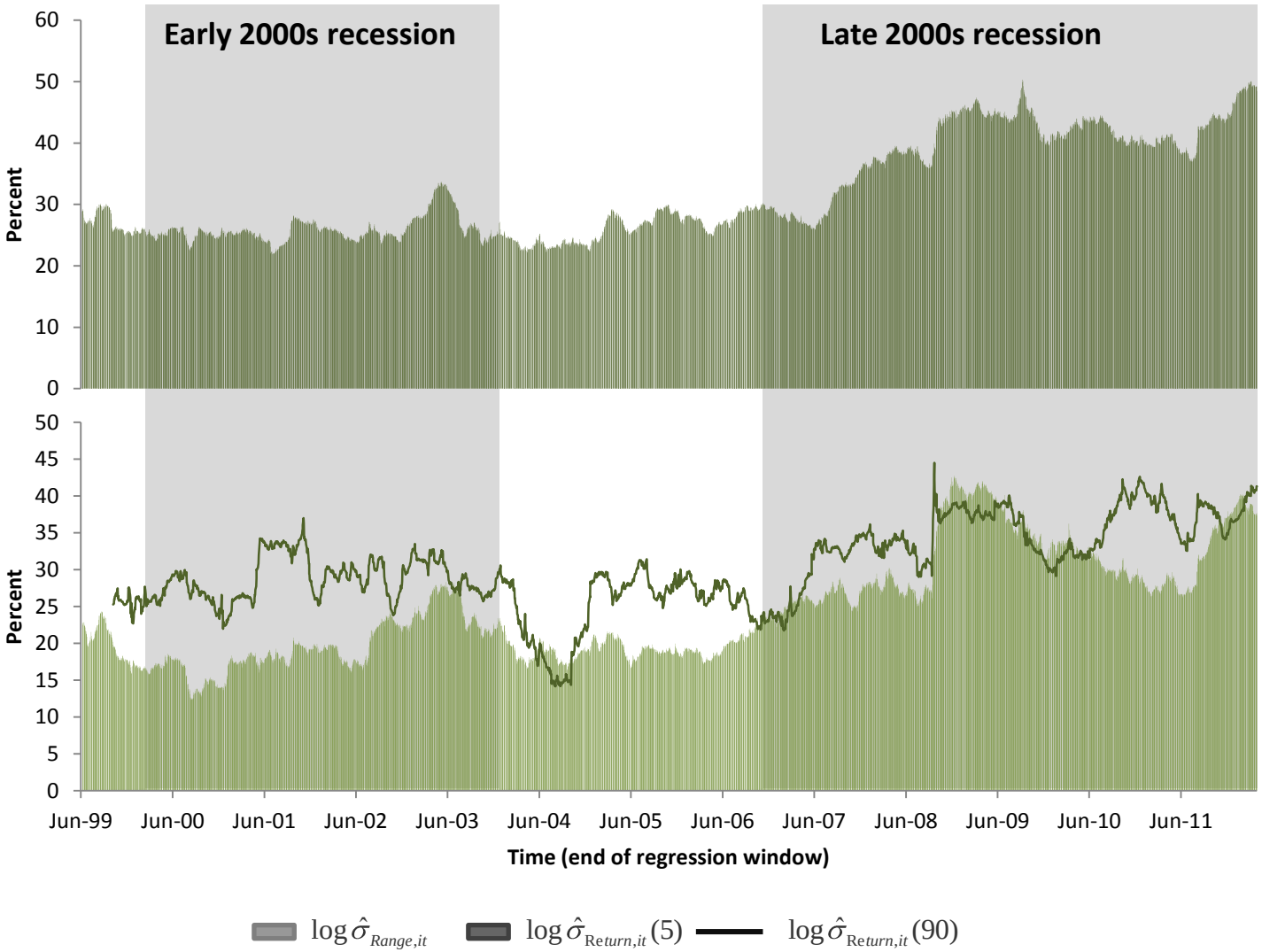
Spillover index FROM all j to i =
Sum of cross variance shares in row (i)/ sum of all variance shares in rows 1:N (= N) *100

Spillover index from i TO all j =
Sum of cross variance shares in column (i)/ sum of all variance shares in columns 1:N (= N) * 100

Net (pairwise) spillover index i=
Spillover index from i TO all j (one j) – spillover index FROM all j (one j) to i

Source: Diebold and Yilmaz (2012, 2009)

4 Results – Total volatility spillover index, H = 10

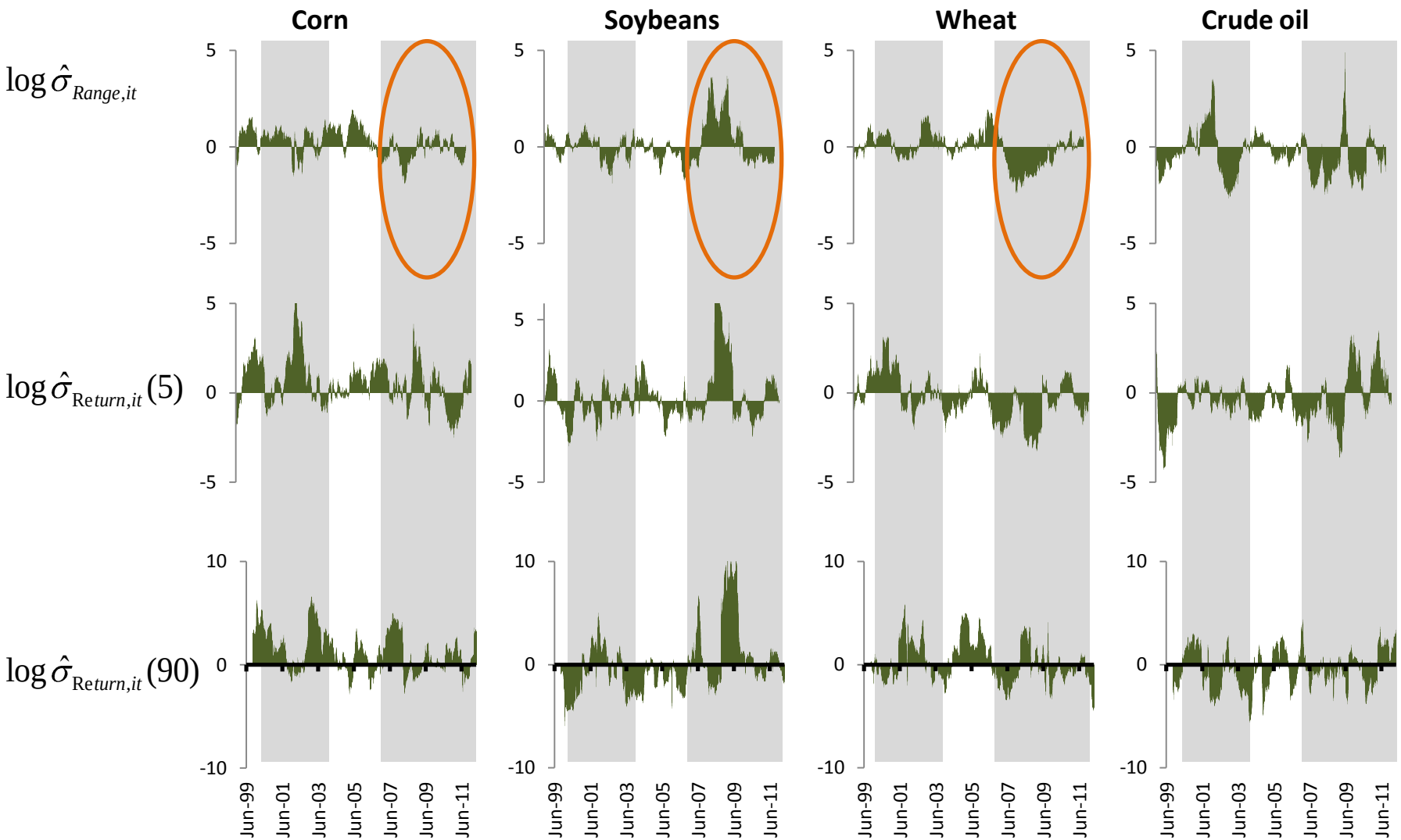


4 Two periods of volatility spillover peaks

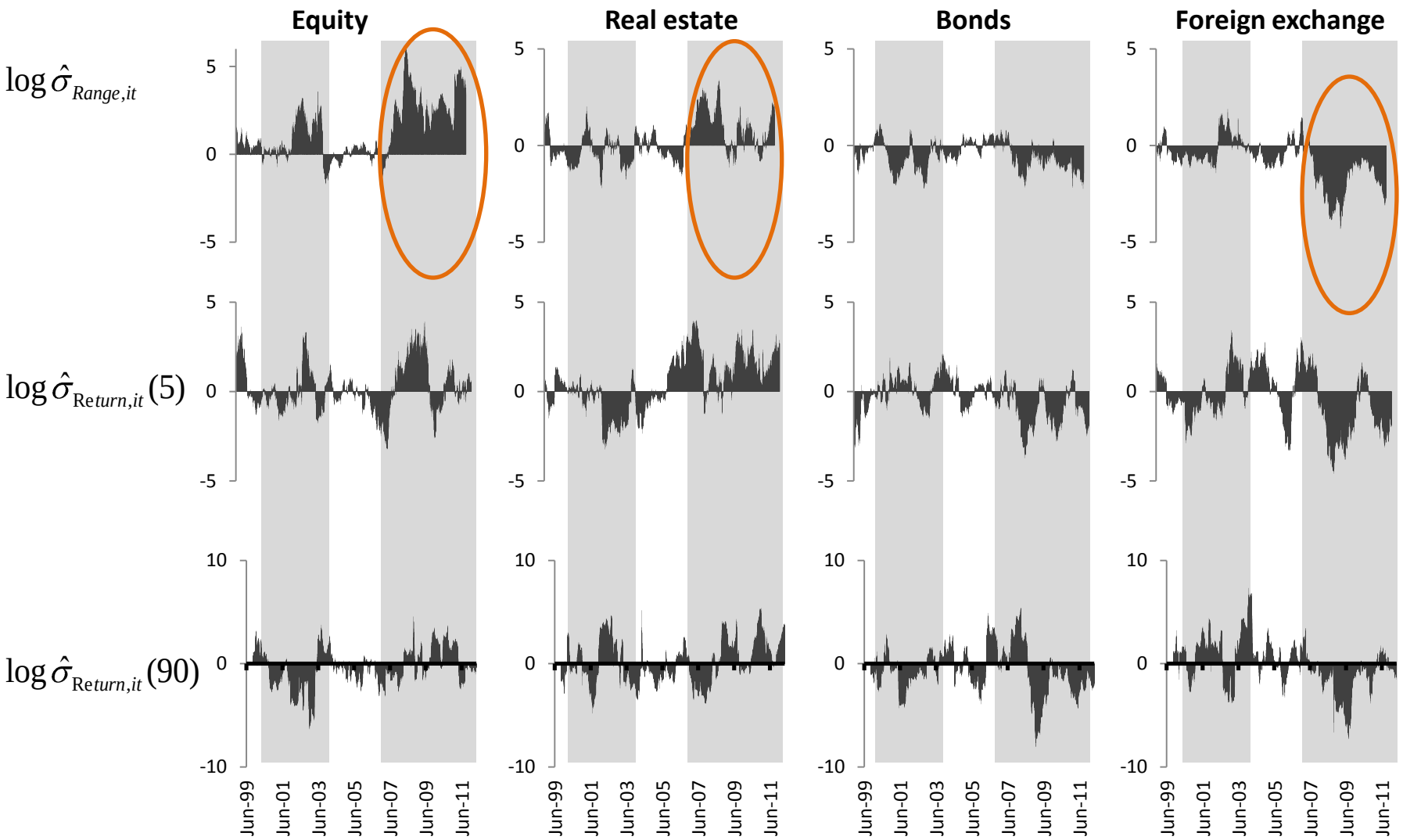
	Early 2000 (Mar 2000 – Dec 2003)	Late 2000 (from Jan 2007)
One-off events		
Financial economy	▪ Nasdaq crash, end of dot.com bubble (March 2003) ▪ Stock market downturn of 2002	▪ Subprime crisis (2007/08) ▪ Sovereign bond crisis (from 2009)
Real economy	▪ Relatively low real GDP growth in EU 27 in 2002/2003 and in US in 2001/2002	▪ Low /negative real GDP growth in 2008/2009 in EU27 and US
War/ conflict	▪ September 11 ▪ Beginning of war in Afghanistan, Invasion in Iraq	▪ Aftermath of Afghanistan/ Iraq wars
Policy environment	▪ Fed decreases interest rate 15 times b/w Jan 01 and Jun 03	▪ Fed decreases interest rate 12 times b/w Aug 07 and Dec 08
Structural changes to commodity markets		
Policy	▪ Continued reduction of EU buffer stocks	▪ Biofuel mandates in EU and US
Fundamental environment	▪ Growth in imports from China (esp. Soybeans) and India	▪ Further growth in imports from China and India ▪ Low stock levels (see backup)
Financial environment		▪ Commodity ETP, Trading volume growth

Source: Fed; EuroStat ; Piesse and Thirtle (2009)

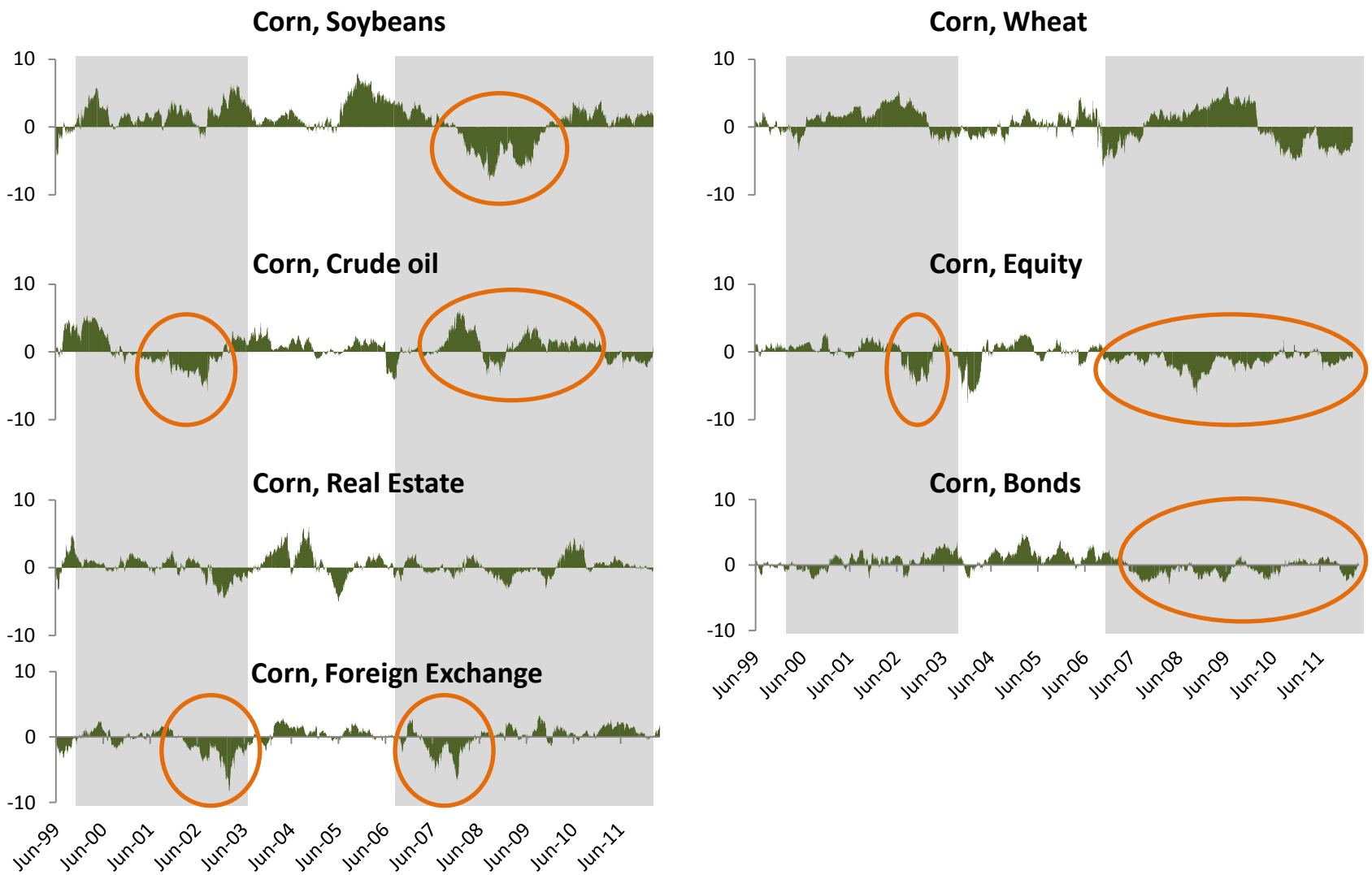
4 Net directional spillover indices: Commodities



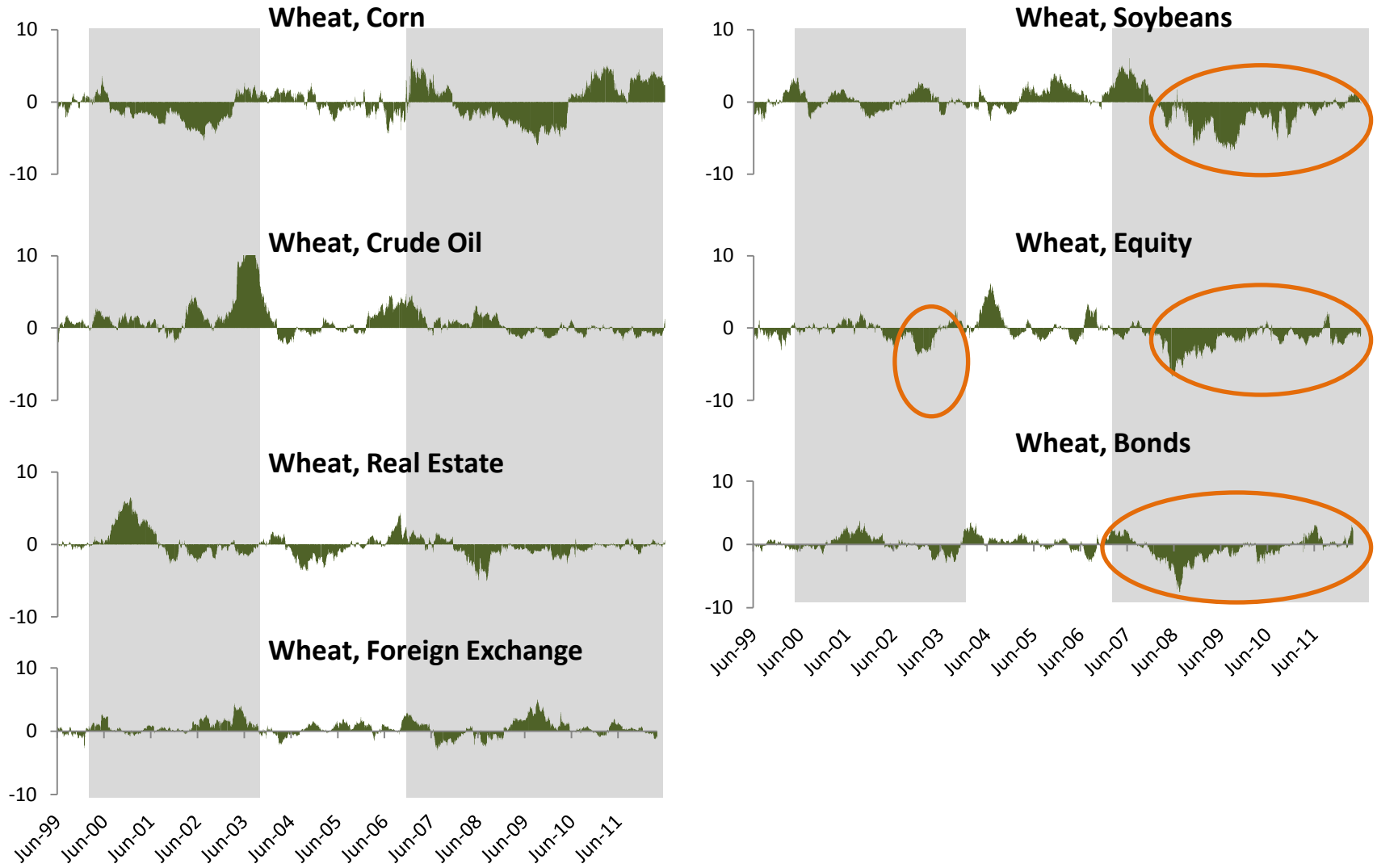
4 Net directional spillover indices: Financial assets



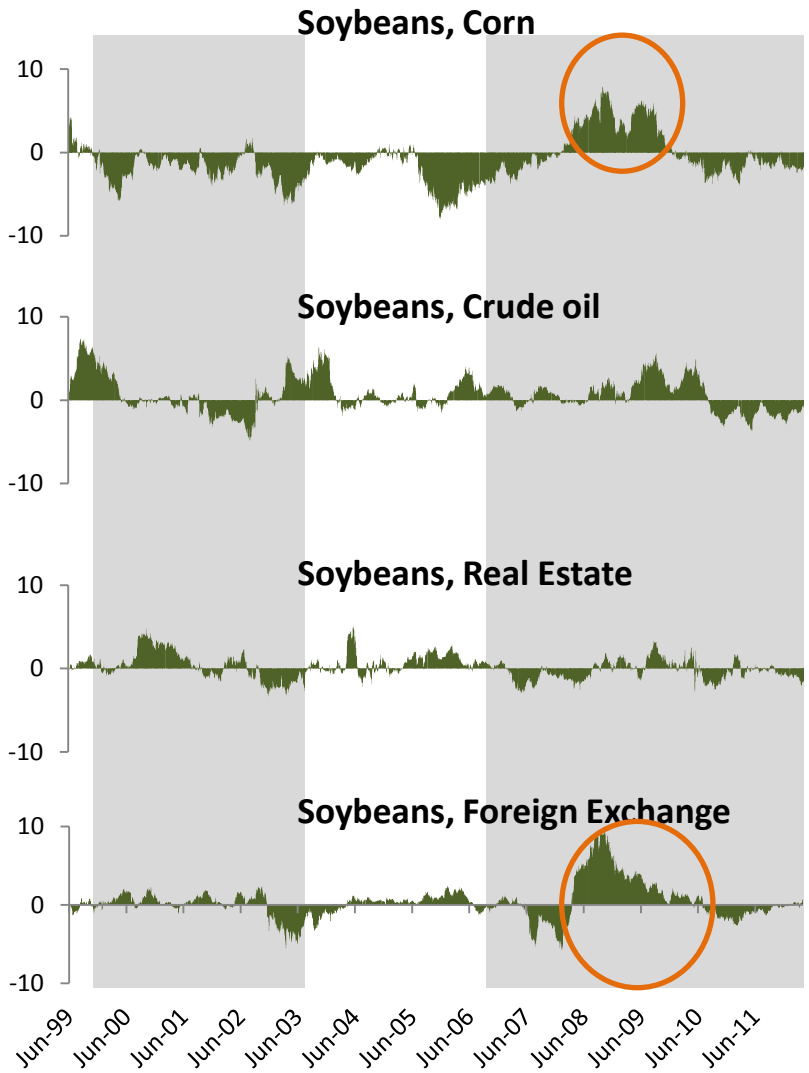
4 Pairwise analysis (Range-based): Corn

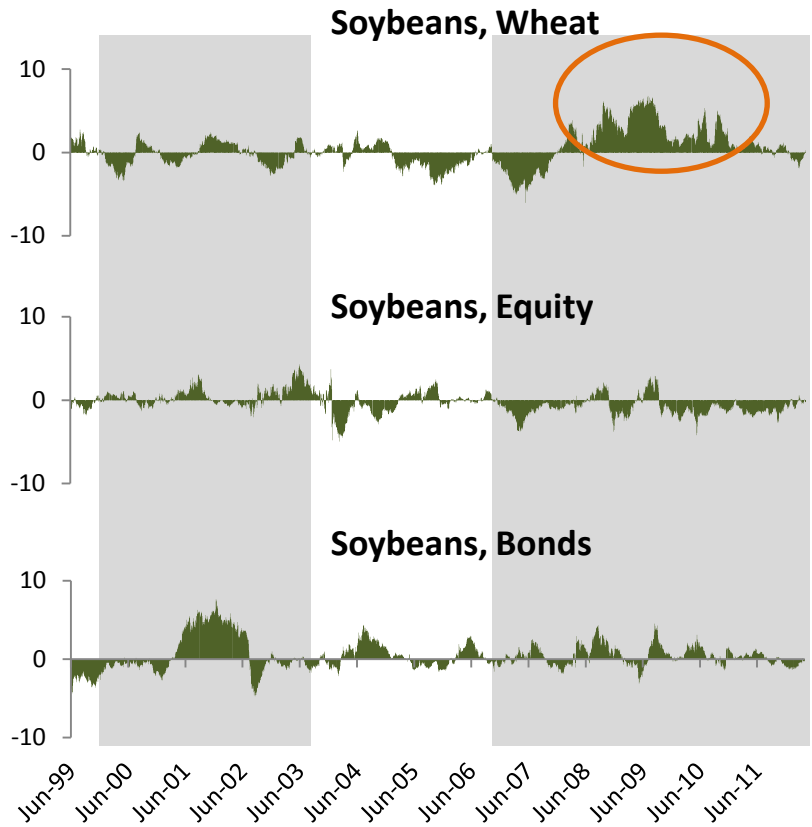


4 Pairwise analysis (Range-based): Wheat

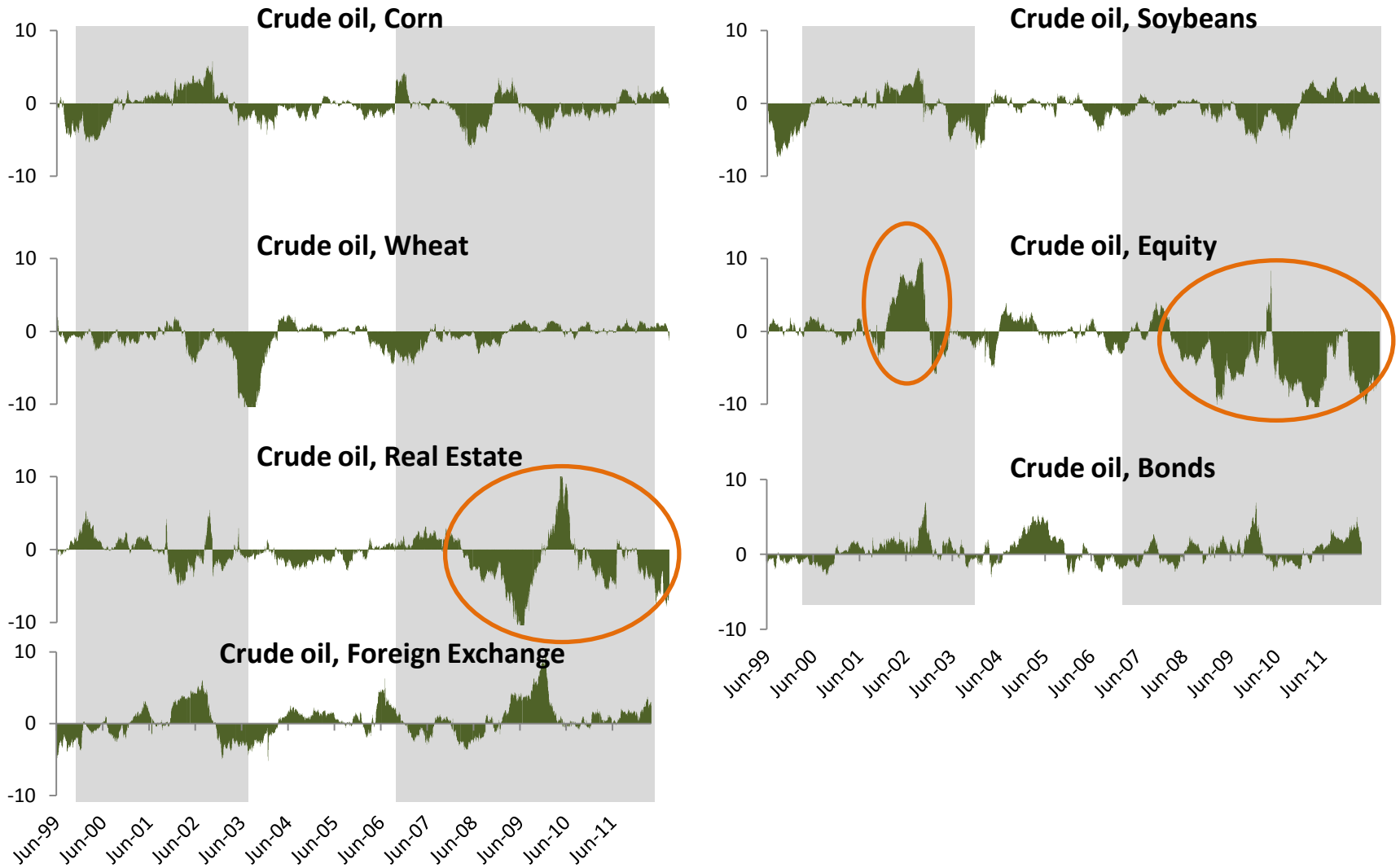


4 Pairwise analysis (Range-based): Soybeans





4 Pairwise analysis (Range-based): Crude oil



First insights and preliminary conclusions

- Total volatility spillovers generally increase during times of financial crises
- Net volatility spillovers from equity and real estate markets reached unprecedented levels during and after the subprime crisis
- Commodities (except soybeans) were mostly net receivers of volatility spillovers (from equity, real estate and bonds) during and after subprime crisis ⇔ crude oil net transmitter of volatility during early 2000 crisis
- Most effects more pronounced in the short-term (range-based / 5D return-based)
- No general evidence on effects of financial crises on *intra-commodity* market spillovers

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- Some evidence for closer integration of commodity and financial asset markets during times of crises (especially crude oil market as net volatility receiver)
- Some evidence for a structural change in volatility spillovers in *soybean-corn* and *soybean-wheat* market pairs, soybean market net volatility transmitter

Robustness checks and possible extensions

Robustness checks

- Sensitivity analysis (e.g. different lag lengths (HQ, AIC criteria), different forecast horizons, different window size, different variable measurements (where possible))
- Check for whiteness of residuals for each window (Ljung Box Test, Breusch-Godfrey LM Test)
- Check for structural breaks within the *windows*

Possible extensions

- Check for structural breaks within *volatility spillover indices*
- Orthogonalized variance decompositions
- Complementary structural analysis (e.g. Impulse responses, Granger Causality Analysis)
- Inclusion of more details on “fundamental events” in the specific commodity markets
- Inclusion of more variables (e.g. Harvest dummies for C1, S1, W1; Metal markets)
- Linkage to IFPRI food price volatility early warning system: periods of excessive volatilities?

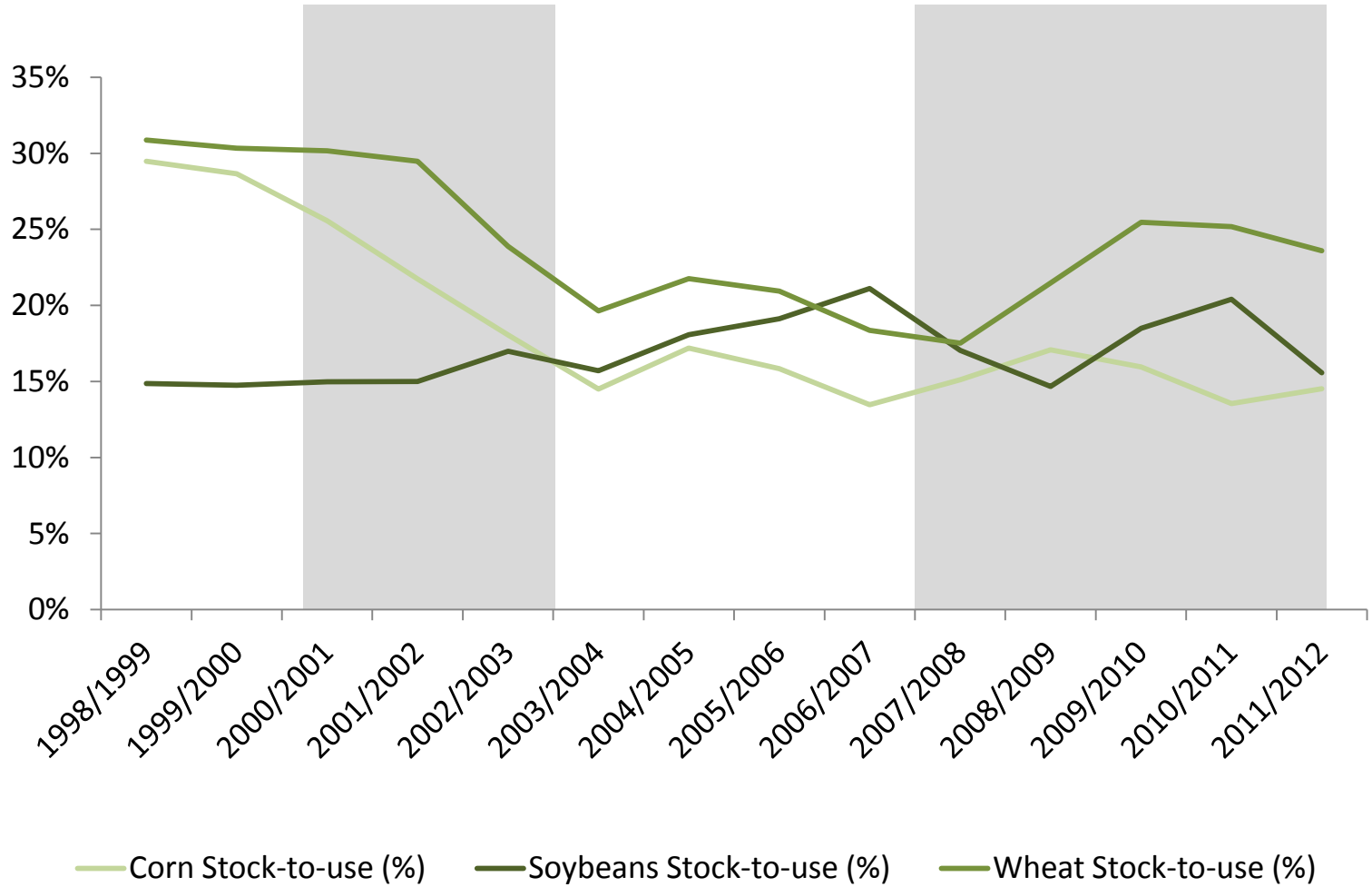
BACKUP

BACKUP | WORK IN PROGRESS

Selection of econometric model

Candidate models	Selection criteria: Multivariate (~ 8 variables)	Theory link	Regime switches	...
Granger causality in variance - Two stage S-test, Cheung & Ng (1996) - Two stage Q-test, Hong (2001)	~	✓	✗	
Multivariate GARCH **a) w/o regime-switching** -DCC , BEKK	✗	✓	✗	
b) with regime-switching, e.g. -SWARCH model, Edwards and Susmel (2001) -Markov-switching, Chan et al. (2011)	~	✓	✓	(limited no. of regimes)
Focus **Structural VAR, variance decompositions** - Diebold and Yilmaz (2009, 2012) - Dimpfl and Jung (2012)	~	✓	✓	(but may have to be complemented with break tests)
Multiplicative Error Model (MEM) - Engle et al. (2012)	~	✓	~	
Copula approaches -Rodriguez (2007) -TVLCARR(X) model, Chiang and Wang (2011)	✗	~	✓	
Stochastic volatility models - with Merton Jump, Du et al. (2011)	✗	✓	~	

5 Stock-to-use ratios



Source: USDA

5 Results from previous studies

Diebold and Yilmaz (2012)	▪ Overall increase of volatility spillovers to the commodity market (DJ UBS Index) after the year 2006 (break in 2007)
Du et al. (2011)	▪ Volatility spillovers between crude oil and agricultural commodities increased after 2006 ▪ Volatility in the wheat market significantly affects volatility in the corn market before 2006 and vice versa after 2006
Trujillo-Barrera et al. (2011)	▪ Strong volatility spillovers from U.S. crude oil to corn markets
Chan et al. (2011)	▪ Flight from quality during „tranquil“ market regimes ▪ Evidence of contagion between stocks, bonds and real estate during „crisis“ market regime