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**Asymmetric Price Transmission and Volatility Spillovers in Alberta Cattle,
Feed Barley and U.S. Corn Markets**

Miao Zhen
University of Alberta
mzhen@ualberta.ca

Feng Qiu
University of Alberta
Feng.qiu@ualberta.ca

James Rude
University of Alberta
James.rude@ualberta.ca

James Unterschultz
University of Alberta
Jim.Unterschultz@ualberta.ca

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Asymmetric Price Transmission and Volatility Spillovers in Alberta Cattle, Feed Barley and U.S. Corn Markets

Miao Zhen, Feng Qiu, James Rude and James Unterschultz

Department of Resource Economics and Environmental Sociology, University of Alberta, Canada



Background and Objectives

- The Canadian cattle industry has faced a number of shocks over the last decade – BSE, feed price surges and overall consolidation in herd size.
- This study aims to assess:
 - Price volatilities in the Alberta cattle, feed barley and the U.S. corn markets.
 - Market interdependencies among the aforementioned markets.
 - We included the U.S. corn market as Alberta feedlot owners are starting to import U.S. corn as a substitute for barley (Crawford et al 2012), this would potentially create a direct link between the Alberta cattle and the U.S. corn markets.

Methodology (Price Volatility)

- We used the diagonal Asymmetric Generalized Dynamic Condition Correlation GARCH (AG-DCC GARCH) model (Cappiello et al 2006).
- Two stage estimation is utilized.
- The first stage is to build the mean and variance models.
 - For mean equations, we estimated a penta-variate VAR model and included error correction terms where appropriate.
 - For variance equations, we selected proper conditional variance structures among the Exponential and GJR GARCH models (Nelson 1991; Glosten et al 1993).

- In the second stage, the dynamic conditional correlation model is build upon the standardized residuals from the first stage.

- To illustrate, assuming a bivariate Vector Error Correction model:

$$Z_t = \omega + \sum_{i=1}^p \Pi_i Z_{t-i} + \Phi ECT_{t-1} + E_t;$$
$$Z_t = \begin{bmatrix} \Delta p_{1,t} \\ \Delta p_{2,t} \end{bmatrix}, E_t | \Omega_{t-1} \sim (0, H_t), H_t = \begin{bmatrix} h_{11,t} & h_{12,t} \\ h_{21,t} & h_{22,t} \end{bmatrix};$$
$$E_t = \begin{bmatrix} e_{1,t} \\ e_{2,t} \end{bmatrix}, ECT_{t-1} = \begin{bmatrix} ect_{t-1} \\ ect_{t-1} \end{bmatrix}, \Pi_i = \begin{bmatrix} \gamma_{11}^{(i)} & \gamma_{12}^{(i)} \\ \gamma_{21}^{(i)} & \gamma_{22}^{(i)} \end{bmatrix}, \Phi = \begin{bmatrix} \theta_1 \\ \theta_2 \end{bmatrix};$$
$$\ln(h_{11,t}) = c_{10} + \alpha_{11} \left| \frac{e_{1,t-1}}{\sqrt{h_{11,t-1}}} \right| + \beta_{11} \ln(h_{11,t-1}) + d_1 \frac{e_{1,t-1}}{\sqrt{h_{11,t-1}}};$$
$$h_{22,t} = c_{20} + (\alpha_{21} + \gamma D) e_{2,t-1}^2 + \beta_{21} h_{22,t-1} \quad \text{where} \quad \begin{cases} D = 1 \text{ if } e_t < 0 \\ D = 0 \text{ if } e_t \geq 0 \end{cases}$$

Methodology (Conditional Correlation)

- To build the time-varying correlation model, we will need to decompose the Correlation matrix R_t from the first stage as follows:

$$R_t = D_t^{-1} H_t D_t^{-1}$$

- Where $D_t = \text{diag}(\sqrt{h_{11,t}}, \sqrt{h_{22,t}})$, $\sqrt{h_{ii,t}} \forall i = 1, 2$ are the conditional standard deviations (or conditional volatilities) estimated from univariate GARCH models from the first stage, and H_t is the variance-covariance matrix.

- H_t can be estimated as the following specification:

$$H_t = \bar{R} \circ (ii' - aa' - bb') - \bar{N} \circ gg' + aa' \circ \varepsilon_{t-1} \varepsilon_{t-1}' + gg' \circ n_{t-1} n_{t-1}' + bb' \circ H_{t-1};$$
$$\bar{R} = E[\varepsilon_t \varepsilon_t'], \bar{N} = E[n_t n_t']$$

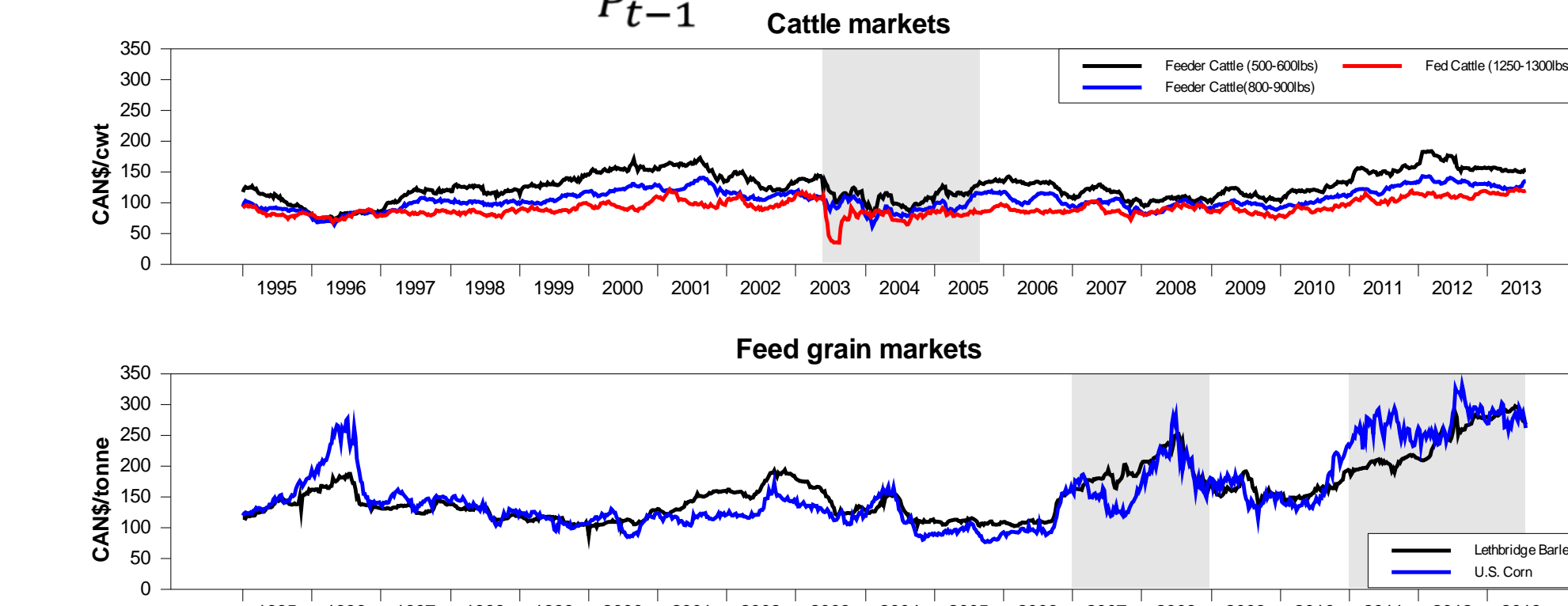
- Where ε_t is the vector of standardized residuals from the first stage, $n_t = I[\varepsilon_t < 0] \circ \varepsilon_t$, $I[\cdot]$ is a $k \times 1$ indicator function (in our case, $k = 2$), a, b, g are parameter vectors and \circ denotes the Hadamard product.

- Finally, for any covariance ($h_{ij,t} \forall i \neq j$) and correlation ($\rho_{ij,t} \forall i \neq j$), they have the following specifications:

$$h_{ij,t} = (1 - a_i a_j - b_i b_j) E[\varepsilon_{i,t} \varepsilon_{j,t}] - g_i g_j E[n_{i,t} n_{j,t}] + a_i a_j \varepsilon_{i,t-1} \varepsilon_{j,t-1} + g_i g_j n_{i,t-1} n_{j,t-1} + b_i b_j h_{ij,t-1};$$
$$\rho_{ij,t} = \frac{h_{ij,t}}{\sqrt{h_{ii,t}} \sqrt{h_{jj,t}}}$$

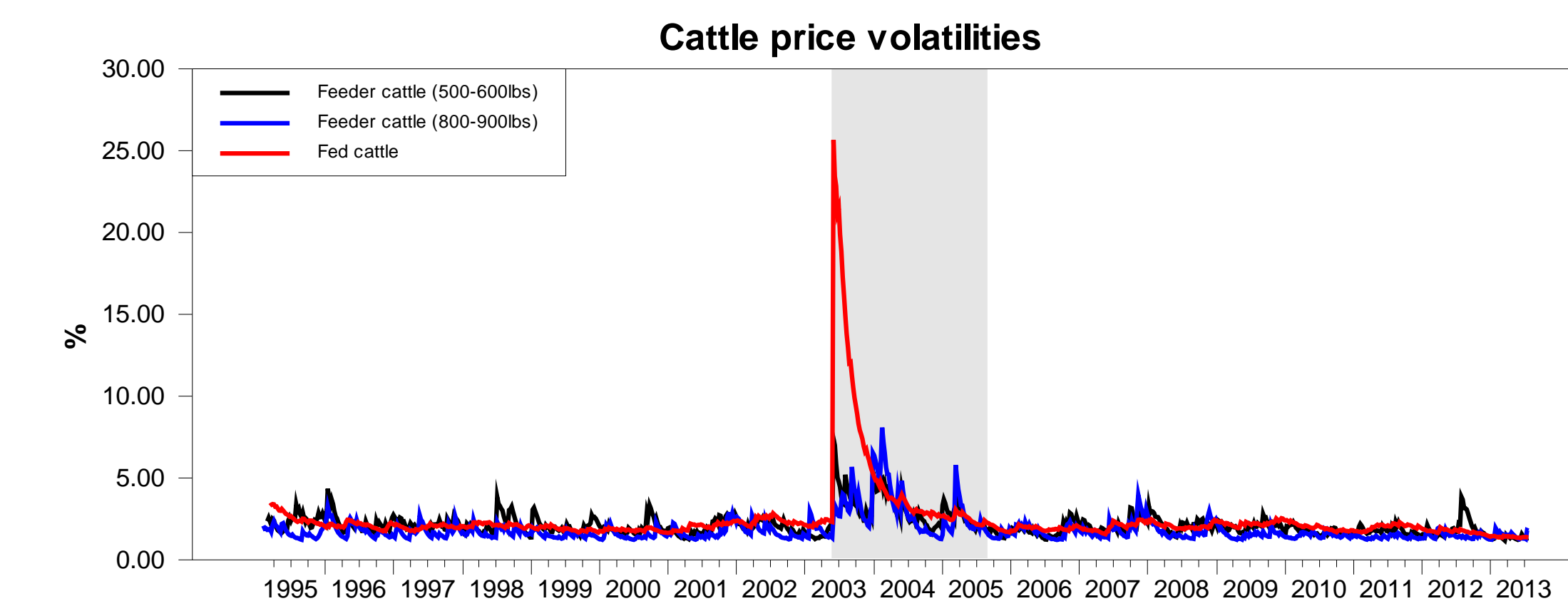
Data

- Weekly nominal prices from January 4, 1995 to July 24, 2013 of Alberta fed steers, feeder steers (500-600lbs), feeder steers (800-900lbs), Lethbridge barley and the U.S. corn, from January 4, 1995 to July 24, 2013 are used in this study
- Data used for model estimation is in price changes, hence, $\Delta P_t = \ln\left(\frac{P_t}{P_{t-1}}\right) \times 100$.



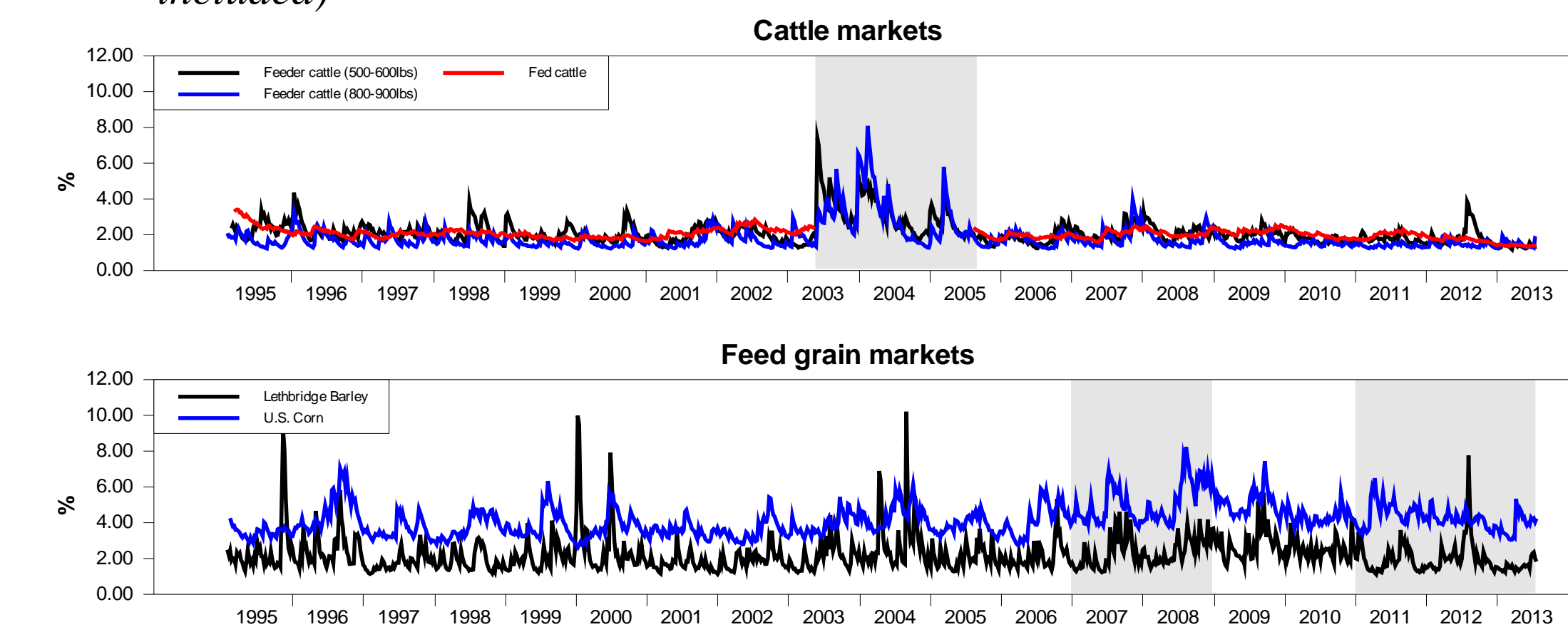
Notes: the shaded areas indicating the time periods of three major market incidents
Figure 1. Price Movements (1995-2013)

Results (Price Volatility)



Notes: the shaded area indicating the time period of the Canadian BSE crisis

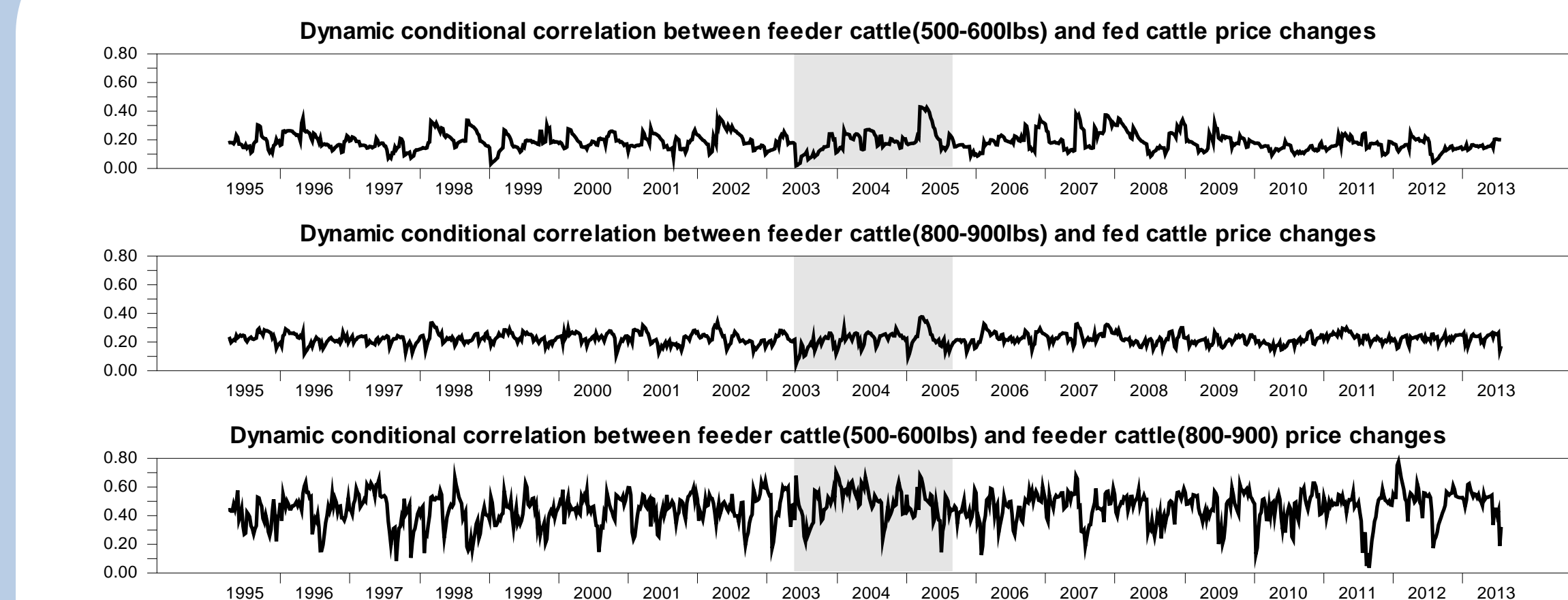
Figure 2. Conditional Volatility Estimated for Cattle Markets (BSE period included)



Notes: the shaded areas indicating the time periods of three major market incidents

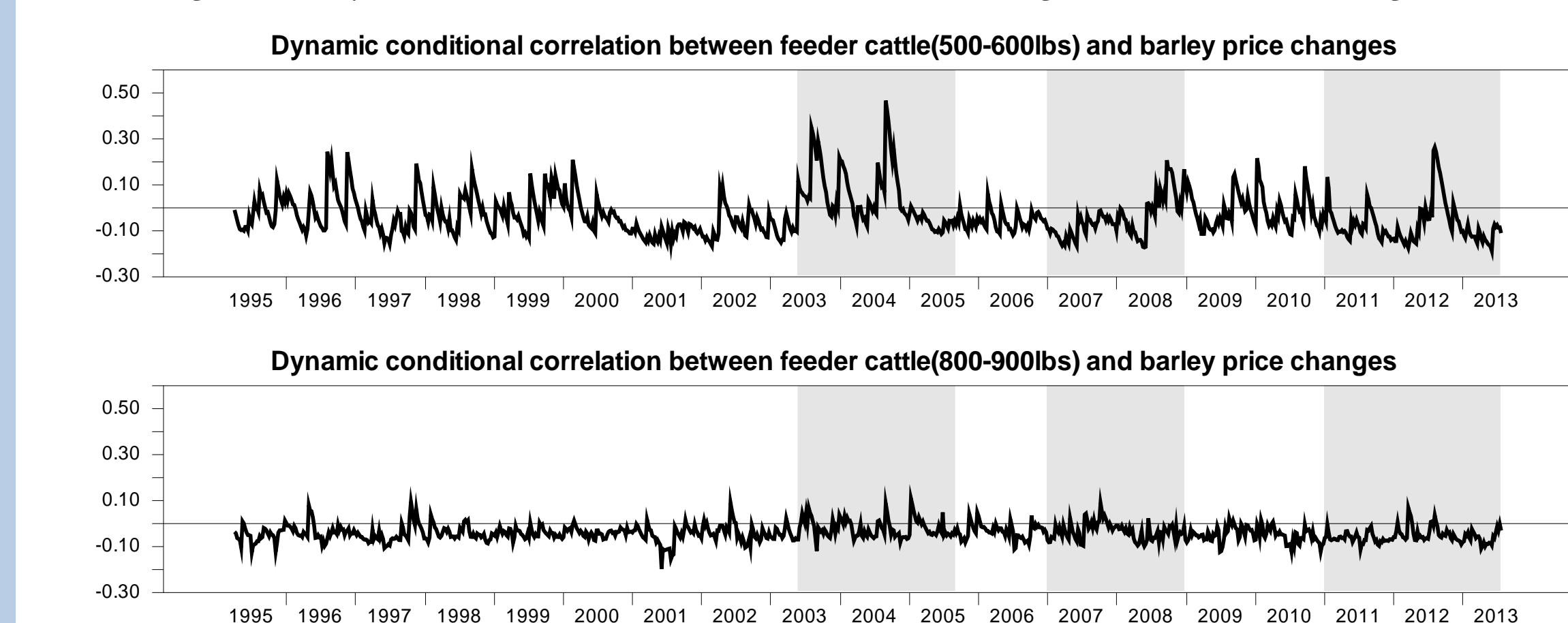
Figure 3. Conditional Volatility Estimated for Cattle and Feed Grain Markets (BSE period excluded)

Results (Conditional Correlation)



Notes: the shaded area indicating the time period of the Canadian BSE crisis

Figure 4. Dynamic Conditional Correlations among Cattle Price Changes



Notes: the shaded areas indicating the time periods of three major market incidents

Figure 5. Dynamic Conditional Correlations Between Feeder Cattle and Barley Price Changes

Conclusions

- Pairwise Johansen cointegration tests (Johansen 1988) indicated the existence of a long-run relationship in price changes between two feeder cattle markets. Likewise in we found the same results in price changes between two feed grain markets.
- Results from univariate GARCH models imply:
 - The barley price volatility is the most susceptible to market shocks, while the feeder cattle (800-900lbs) price volatility is found to be the least among all five markets.
 - General shocks have larger impacts on feed grain price volatilities than cattle price volatilities.
 - Cattle price volatilities are more persistent than feed grain price volatilities.
 - Asymmetric effects are only found in cattle price volatilities.
- Results from AG - DCC GARCH models suggest:

- Cattle supply chain:** Time-varying conditional correlations between feeder cattle and fed cattle price changes dropped substantially at the beginning of the 2003 Canadian BSE crisis.
- Between cattle and barley markets:** in general, the feeder cattle (500 – 600 lbs) and the feed barley price changes, and the feeder cattle (800 – 900 lbs) and the feed barley price changes have negative and near zero dynamic conditional correlations over the study period.

Acknowledgement

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