Evidence for Commodity Market Risk Sharing from a Bayesian Perspective

Key points

* KF is forward algorithm so without smoother (backwards algorithm) so
* Correlation is only direction, not magnitude like beta

Abstract

As financialization allowed more speculators enter the commodity market, greater risk-sharing occurs whereby commodity returns become more closely integrated with the returns of conventional assets. Previous studies have tested risk-sharing between commodity and equity markets using panel regressions or rolling correlations, which leave room for improvement on the granularity and interpretability of results. Turning to Bayesian modelling, this paper tests for co-integration between commodities and equities by the estimation of time-varying betas using Kalman filtering, which yields more comprehensive results. The findings suggest that financialization has eroded the diversification benefits of commodities for equity investors in the face of a secular, albeit oscillating, convergence towards a ‘market of one’.