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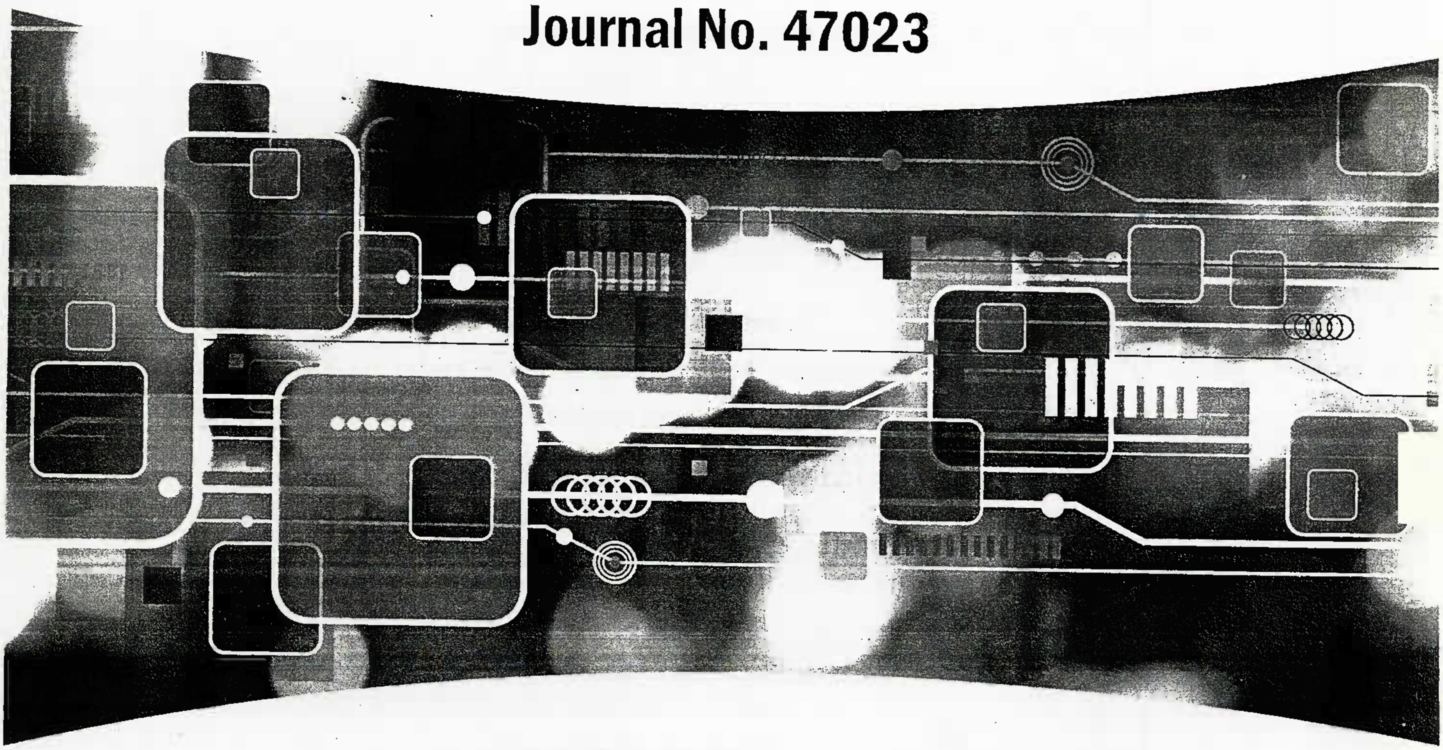

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Price Discovery and Volatility Spillover among MCX Commodity Markets and BSE SENSEX Market

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Abstract

This study analyses the linkages and volatility spillover among the MCX commodity markets and BSE SENSEX market. The commodity markets taken for the study are MCXAGRI, MCXCOMDEX, MCXENERGY and MCXMETAL and the equity market taken is BSE SENSEX market. The study considers the daily data from 15thJanuary 2004 to 31stMarch 2015. The empirical results show that there exists long-term relationship between MCX commodity markets and BSE SENSEX market. The presenceof long-run relationship between two markets has major impact for the traders in markets. Cointegrationrelationship suggests that although both markets may be in disequilibrium during the short term but such deviations are very quickly corrected through arbitrage process and the hedgers may take long term positions to hedge market risk to the maximum extent.The VECM results show mixed results in the short term and long term dynamics between the MCX commodity markets and BSE SENSEX market. The empirical results from the Bivariate EGARCH model also reveals mixed evidence in the case of volatility spillover with regard to BSE SENSEX and all the MCX commodity markets.Commodities serve both as volatility diversification agents and return diversifier at the same time. Commodities provide the benefit to equity investors in terms of portfolio diversification.

Keywords: Price Discovery, Cointegration, VECM, EGARCH, Volatility Spillover.

1) Introduction

India is a commodity dependent economy wherein more than two thirds of the populace are dependent on agriculture and agricultural commodities for their livelihood. Most surprisingly, Indian commodity markets are underdeveloped, however, in recent years investing in commodities has undergone a sea change and has witnessed sturdy growth with many innovations.

In India, the commodity derivatives market plays a pivotal role in futures trading, risk sharing and information pooling, thereby, drawing extensive attention towards itself. The trading in commodity derivatives accomplishes two key functions, in particular, price risk management and price discovery, with reference to any given commodity. The commodity derivatives market offers an effective mechanism for price risk management that covers all stakeholders who are participants in the commodity trading process. The stakeholders range from the producers, traders and processors up to the exporters and importers and the consumers of a commodity. The commodity derivatives market presents trading, hedging and arbitrage opportunities to the market players. It is also useful to all sectors of the economy, as it assures stability in supply and demand positions and also eliminates the perils of price uncertainty, promotes competition and plays the role of a price guide, to the farmer and other stakeholders in the economy.

Commodities play a significant role in the economic growth of the country. After liberalization of Indian economy in 1991, a series of steps were taken by the Government to liberalize the commodity futures market and one of the steps in that direction to the setup national level multi commodity exchanges as per the recommendation of the then commodity market regulator, Forwards Market Commission (FMC).

The market has since then made enormous evolvement in terms of transparency, technology, and trading activity. Since the inception of modern electronic trading platform, combined with establishment of national commodity exchanges, India has become one of the fastest growing commodity derivatives market in the world.

The issue of linkages and volatility spillover is of great interest to traders, financial economists and analysts. Although commodity markets and stock markets react to same information, the major question is which market reacts first and from which market volatility spills over to other markets. The process of linkages facilitates the inter-temporal inventory allocation function by which market participants are able to compare the commodity and stock prices and decide the optimal allocation. The investigation of linkages and volatility spillover will throw light on the possibility of commodity and stock markets as an efficient linkagesvehicle and this will be immensely useful for the traders to hedge their market risk. Besides, it provides useful insights to the arbitrageurs, who are formulating their trading strategies based on market imperfections. Further, the subject is immensely helpful for the investors and portfolio managers to develop effective trading and hedging strategies in the Indian commodity derivatives and stock markets.

Keeping in view the above, the present study examines the linkages in Indian commodity markets and stock market and to investigate whether the volatility spills over from commodity markets to stock market or vice versa. The remainder of the paper is organized as follows: Section 2 provides the review of literature. Section 3 describes the methodology and data used for empirical analysis. Section 4 offers empirical results and discussion of the study. Conclusions are presented in section 5.