Examination on the Relationship between OVX and Crude Oil Price with Kalman Filter

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Abstract

Chicago Board Option Exchange publishes the Crude Oil Volatility Index (OVX) in 2007, which is regarded as a new barometer to research the variance of oil future prices. This paper explores how OVX changes are influenced by crude oil price returns with time-varying coefficients achieved by Kalman filter. The results indicate a negative and asymmetric contemporaneous relationship between OVX changes and crude oil price returns.

Keywords: Crude Oil Volatility Index; Crude oil price; Kalman filter; Asymmetric effect

1. Introduction

How to estimate market risk is a widely discussed topic in academia [1-4]. Chicago Board Option Exchange (CBOE) publishes the Crude Oil Volatility Index (OVX), which can be regarded as risk gauge of the market. OVX is an up-to-the-minute market estimate of expected 30-day volatility of crude oil futures prices. The OVX is applied to options on the United States Oil Fund. It uses real-time bid/ask quotes of nearby and second nearby options with at least 8 days to expiration, and weights these options to derive a constant, 30-days measure of expected volatility. It’s believed that OVX provides a new barometer to research the variance of oil future prices. This study examines the information content of OVX regarding the crude oil spot returns.

Academics are interested in the relationship of implied volatility between underlying stock market returns of the underlying stock market. It has been well documented in that there is a strong asymmetric negative contemporaneous relationship between the changes of the implied volatility index and the underlying index.

Many econometric problems require estimation of the state of a system that changes over time using a sequence of noisy measurements made on the system [4]. Previous research has analyzed the relationship either by using static linear regression model, or by dividing sample periods into several distinct sub-periods. This static method cannot seize the time evolvement of the relationship. Many researchers have applied the Kalman filter to evaluate the dynamic evolvement. Crude oil is the most important raw material in the world. Its prices can impact the development of global economy, therefore it is necessary to examine the relationship between OVX and crude oil returns.

This research concentrates on the dynamic relationship of OVX with both crude oil returns using Kalman filter. Other sections of this study are structured as follows. The second section provides a brief introduction of Kalman filter. The third section examines the relationship between crude oil price returns and changes of OVX. Finally, a brief conclusion is provided.

2. Methodology

Kalman filter can describe a recursive solution to the discrete data linear filtering problem and assumes the posterior density at every time step is Gaussian and can be parameterized by a mean and covariance [14]. The kernel idea of Kalman filter is to estimate the state of a process, in a way that minimizes the mean of the squared error [15].

The basic form of Kalman filter is as follows

\[ x_t = A_t x_{t-1} + w_{t-1} \]  
\[ z_t = H_t x_t + v_t \]

\( A_t \) and \( H_t \) are known matrices defining the linear functions. The random variables \( w_{t-1} \) and \( v_t \) represent the process and measurement noise respectively. They are assumed to be independent, random walk and follow normal distributions, in other words, \( w_t \sim N(0, Q_t) \) and \( v_t \sim N(0, R_t) \).

For the constant \( R_t \), we can take some off-line sample measurements in order to determine the variance of the measurement noise. If \( R_t \) is time-varying we can use maximum likelihood estimation in each step to get \( R_t \) [16].

If the elements of \( Q_t \) are set with very small numbers, it will take more data to achieve an accurate estimation and the state variables cannot provide a rapid response to the new measurement. \( Q_t \) can be also estimated by a maximum likelihood estimation step by step [16].

We define \( \hat{x}_t \in \mathbb{R}^n \) to be a prior state estimate at step \( t \) given knowledge of the process prior to step \( t \), and \( \hat{x}_t \in \mathbb{R}^n \) to be a posterior state estimate at step \( t \) given measurement \( z_t \). And we define prior and a posterior estimate errors as \( e_t = x_t - \hat{x}_t \) and \( e_t = x_t - \hat{x}_t \).

The prior estimate error covariance is given by \( P_t^{-1} = E[e_t' e_t'] \).

And the posterior estimate error covariance is \( P_t = E[e_t' e_t'] \).

For deriving the equations for the Kalman filter, we begin with the goal of finding an equation that computes posterior state estimate \( \hat{x}_t \) as a linear combination of prior \( \hat{x}_t \) and a weighted difference between an actual measurement \( z_t \) and a measurement prediction \( H \hat{x}_t \) as shown below.
\[ \hat{x}_t = \hat{x}_{t-1} + K(z_t - H\hat{x}_{t-1}) \]

(3)

The difference \((z_t - H\hat{x}_{t-1})\) is called the measurement innovation, or the residual. The matrix \(K\) is chosen to be the gain that minimizes the posterior error covariance. One form \(K\) that minimizes \(P_t\) is given by [17, 18]:

\[ K_t = P_t^{-1}H'(HP_tH' + R)^{-1} \]

(4)

The aim of filtering is to find the expected value of the state vector \(x_t\) conditional upon the information available at time \(t\). In a further step, we can use smoothing to get a more accurate estimation of the state vector given the whole set of information. The mean of the distribution of \(x_t\), conditional upon all the samples, may be written as \(E(x_t|Y_T)\). The corresponding estimator is called smoother.

In smoother the recursion starts from the last time step \(T\) with \(\hat{x}_T^E = \hat{x}_T\) and \(P_T^E = P_T\). In this research, we focus on the contemporaneous relationship between volatility index changes and the corresponding stock returns. In order to obtain a better and more accurate description of this relationship, we bring smoothing into this research. The smoothing algorithm is the discrete-time Kalman smoother, also known as the Rauch-Tung-Striebel-smoother (RTS), [19-21]. It can be used for computing the smoothing solution for model Equations (1) and (2) given as distribution:

\[ P(x_t|y_{1:T}) = N(x_t|\hat{x}_t^E, P_t^E) \]

(5)

3. Relationship between OVX and oil price return

3.1. Data

In this study, daily data of OVX and oil prices, from May 2007 to November 2014, are used to examine the relationship. OVX used in this study is downloaded from Yahoo finance. This research uses WTI spot prices to represent the oil price and the data is downloaded from Energy Information Administration.

For the empirical analysis, Siriopoulos and Fassas [22] use the daily changes of the volatility index. Whaley [7] use the daily rate of change of the VIX. Since the daily logarithmic returns approximately equal to the daily rate of index returns and the use of logs is consistent with the positive skewness in IV data [8], this study uses daily logarithmic returns for OVX and oil price. An obvious advantage of using logarithms is the logarithms can avoid negative estimation of volatility and oil price.

Table 1 Descriptive statistics of implied volatility indices and stock index returns

<table>
<thead>
<tr>
<th>Statistic</th>
<th>OVX</th>
<th>Logarithm returns of OVX</th>
<th>Oil Prices</th>
<th>Logarithm returns of oil prices</th>
</tr>
</thead>
<tbody>
<tr>
<td>Obs.</td>
<td>1906</td>
<td>1905</td>
<td>1906</td>
<td>1905</td>
</tr>
<tr>
<td>Mean</td>
<td>35.662</td>
<td>0.0002</td>
<td>88.271</td>
<td>0.0000</td>
</tr>
<tr>
<td>Max</td>
<td>140.420</td>
<td>0.425</td>
<td>145.310</td>
<td>0.164</td>
</tr>
<tr>
<td>Min</td>
<td>14.500</td>
<td>0.440</td>
<td>30.280</td>
<td>0.128</td>
</tr>
<tr>
<td>Median</td>
<td>32.830</td>
<td>0.003</td>
<td>91.115</td>
<td>0.001</td>
</tr>
<tr>
<td>Std</td>
<td>14.712</td>
<td>0.049</td>
<td>18.218</td>
<td>0.024</td>
</tr>
<tr>
<td>Skewness</td>
<td>1.638</td>
<td>0.855</td>
<td>0.382</td>
<td>0.045</td>
</tr>
<tr>
<td>Jarque-Bera</td>
<td>1763.3</td>
<td>1171.1</td>
<td>111.57</td>
<td>3190.2</td>
</tr>
<tr>
<td>ADF test</td>
<td>0.211</td>
<td>0.001</td>
<td>0.498</td>
<td>0.001</td>
</tr>
<tr>
<td>(p-value)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>KPSS Test</td>
<td>0.010</td>
<td>0.100</td>
<td>0.010</td>
<td>0.100</td>
</tr>
<tr>
<td>(p-value)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Descriptive statistics for OVX and their crude oil price are provided in Table 1. The table reports that the daily logarithm changes of OVX are stationary time series with mean approximately equal to zero. The Jarque-Bera test rejects the null hypothesis of a normal distribution for OVX, and \( \Delta OVX \). Table 1 also contains summary statistics of daily logarithm returns of oil prices. The means of logarithm returns are very close to zero and their standard deviations are 4.9\% and 2.4\%, respectively. The Jarque-Bera statistic robustly rejects the normal distribution hypothesis for all logarithm returns. For the unit root test, this research uses both augmented Dickey-Fuller (ADF) test [23] and KPSS test [24] with an intercept. Results of the ADF tests (Table 1) indicate that time series data of OVX and oil prices are non-stationary but their logarithm returns are stationary. Results of KPSS test show that none of the implied volatility indices are stationary in the levels. Combining these two results, we can conclude that time series data of logarithm returns is stationary.

3.2. Empirical Analysis

Implied volatility index is regarded as “investor fear gauge” since it spikes during periods when the market is in turmoil. Associated with this proposition, the asymmetric effect was also tested by the researchers. The asymmetric effect assumes that the change in implied volatility rises at a higher absolute rate when the stock market falls than when it rises. Siriopoulos and Fassas [22] test the relationship between stock market returns and implied volatility by a regression analysis of daily changes of the volatility index (\( \Delta IV_t = IV_t - IV_{t-1} \)) against the daily positive returns (\( \Delta S^+_t \)) and negative returns (\( \Delta S^-_t \)) of the corresponding underlying stock index.

This section analyzes the relationship between logarithm returns of OVX and oil price with Kalman filter which assumes the coefficients are time-varying instead of static. The simple regression model that refers to Siriopoulos and Fassas [22], is as follows:

\[
\Delta IV_t = \alpha + \beta_1 \Delta S^+_t + \beta_2 \Delta S^-_t + \epsilon_t
\]

(6)

Where \( \Delta S^+_t \) equals to the daily return when the daily return is positive, and equals to 0 when the daily return is negative. \( \Delta S^-_t \) goes just the opposite.

Time varying modification with Kalman filter method, the transition function is given by

\[
\begin{bmatrix}
\alpha_{t+1} \\
\beta_{1,t+1} \\
\beta_{2,t+1}
\end{bmatrix} =
\begin{bmatrix}
1 & 0 & 0 \\
0 & 1 & 0 \\
0 & 0 & 1
\end{bmatrix}
\begin{bmatrix}
\alpha_t \\
\beta_{1,t} \\
\beta_{2,t}
\end{bmatrix} + w_t
\]

(7)

The measurement function is given by

\[
\Delta IV_t = [1 \hspace{0.5cm} \Delta S^+_t \hspace{0.5cm} \Delta S^-_t]
\begin{bmatrix}
\alpha_t \\
\beta_{1,t} \\
\beta_{2,t}
\end{bmatrix} + v_t
\]

(8)

As Harvey [25] indicated, when the process equation is non-stationary the initial distribution of the state variables should be specified in terms of diffuse prior. Here we consider the case when \( Q \) and \( R \) are determined by the first four hundred data points. We try to obtain a much accurate estimate of the relationship between contemporaneous logarithm volatility changes and logarithm stock index returns by Kalman filter, so Kalman smoothing is used after filtering in this section.

Estimates of \( \alpha_t \), \( \beta_{1,t} \) and \( \beta_{2,t} \) are described in Fig.1. This paper also takes VIX and S&P 500 as a comparison and the results are shown in Fig.2. For VIX and S&P 500, both \( \beta_{1,t} \) and \( \beta_{2,t} \) are negative, which prove the negative relationship between volatility changes and equity market returns. For OVX and crude oil spot price, although \( \beta_{2,t} \) is always negative, \( \beta_{1,t} \) fluctuates around zero and sometimes it is positive which indicate the positive relationship between OVX changes and crude oil spot returns.
For VIX and S&P 500, the absolute value of $\beta_{2t}$ is always larger than the absolute value of $\beta_{1t}$, which confirms the asymmetric effect that the change in volatility indices rises at a higher absolute rate when the stock market falls than when it rises. However, for OVX and crude oil spot price, the absolute value of $\beta_{2t}$ is not always larger than the absolute value of $\beta_{1t}$ according to time-varying coefficients, the asymmetric effect is not significant.

![Image of time-varying coefficients between daily OVX changes and crude oil spot returns](image1)

![Image of time-varying coefficients between daily VIX changes and S&P 500 returns](image2)

Numerical results (Table 2) provide a comparison between Kalman filter estimation and Ordinary Least Square estimation. Mean squared error and correct directional forecasting percentage present Kalman filter estimation dominant OLS estimation. It indicates that the mean value of $\beta_{1t}$ for the first data set is positive, which is different from previous researches. The results achieved from Ordinary Least Square suggest that $\beta_1$ is not significant which is consistent with $\beta_{1t}$ which fluctuates around zero.
Table 2: Kalman filter estimation and the comparison with OLS estimation

<table>
<thead>
<tr>
<th></th>
<th>Coefficients</th>
<th>MSE</th>
<th>Correct Directional Prediction</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$\alpha$ $\beta_1$</td>
<td>$\beta_2$</td>
<td></td>
</tr>
<tr>
<td>OVX and Crude Oil Spot Price</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kalman Filter mean</td>
<td>-0.0153</td>
<td>0.2871</td>
<td>-1.9234</td>
</tr>
<tr>
<td>Std. dev.</td>
<td>0.0060</td>
<td>0.6966</td>
<td>0.8724</td>
</tr>
<tr>
<td>OLS</td>
<td>(0.0000 )</td>
<td>(0.4718 )</td>
<td>(0.0000 )</td>
</tr>
<tr>
<td>VIX and S&amp;P 500</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kalman Filter mean</td>
<td>-0.0060</td>
<td>-4.7472</td>
<td>-6.5640</td>
</tr>
<tr>
<td>Std. dev.</td>
<td>0.0075</td>
<td>2.1750</td>
<td>1.9688</td>
</tr>
<tr>
<td>OLS</td>
<td>(0.0328 )</td>
<td>(0.0000 )</td>
<td>(0.0000 )</td>
</tr>
</tbody>
</table>

4. Conclusion

Implied volatility (IV) is a new measure of markets’ expected risk derived from the price of a market traded option and it has attracted much attention in recent years because of its importance for financial markets. This research examines the relationship between OVX and crude oil spot returns. The results indicate that, firstly, the time-varying coefficients only confirm the negative relationship between negative crude oil spot returns and OVX changes. Secondly, the asymmetric effect is not as significant as the results got from VIX and S&P 500 index. Finally, the relationship between positive crude oil spot returns and OVX changes is not significant, although the coefficient is positive.

Acknowledgements

This work is supported by the National Natural Science Foundation of China (NSFC nos. 71201054, 91224001 and 71433001) and the Fundamental Research Funds for the Central Universities in BUCT.

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