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Oil Volatility Risk and Expected Stock Returns*

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Abstract

After the financialization of commodity futures markets in 2004-05 oil volatility has become a strong predictor of returns and volatility of the overall stock market. Furthermore, stocks' exposure to oil volatility risk now drives the cross-section of expected returns. The difference in average return between the quintile of stocks with low exposure versus high exposure to oil volatility is significant at 0.66% per month, and oil volatility risk carries a significant risk premium of -0.60% per month. We also find that increases in oil price uncertainty predict tightening funding constraints of financial intermediaries suggesting a link between oil volatility risk and the stock market.

JEL Classifications: G12, G13, E44, Q02

Keywords: option-implied volatility; oil prices; volatility risk; cross-section; factor-mimicking portfolios; financial intermediaries.

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