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## Speculation, Risk Aversion, and Risk Premiums in the Crude Oil Market

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## Abstract

Speculative activity in commodity markets has increased dramatically since 2002. This paper investigates how aggregate risk aversion and risk premiums in the crude oil market covary with the level of speculation. Using crude oil futures and option data, we estimate aggregate risk aversion in the crude oil market and find that it is significantly lower between 2005 to 2008 when speculative activity increases dramatically. Risk premiums implied by the state-dependent risk aversion are also negatively correlated with speculative activity and are on average lower and more volatile during this period. These findings, together with the increased index fund and managed-money infusion in the commodity market, suggest that speculators who demand commodity futures for the purpose of portfolio diversification are willing to accept lower compensation for their positions. Decreasing speculation after 2009 amid increased producers' hedging demand has a reverse impact on the market risk aversion and risk premiums.

JEL Classification: G13; G17

Keywords: Crude Oil; Futures; Options; Speculation; Risk Aversion; Risk Premium

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