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*Sentiment-prone investors and volatility dynamics between spot and futures markets*

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**Abstract**

This paper analyses the role of investor sentiment in the contemporaneous dynamics of spot and futures markets and in volatility spillovers between them. To explore this issue, we analyse spot and futures markets on stock market indexes in different countries: the S&P500 for the US, and a representative set of European indexes (CAC40, DAX30, FTSE100, IBEX35 and Eurostoxx50). Consistent with expectations, we have shown that the correlation is not stable with the level of investor sentiment. More specifically, the correlation between the two markets diminishes significantly during periods of high investor sentiment. Moreover, volatility shocks in either market are also found to have less impact during these periods. These results are compatible with behavioural finance theories suggesting that high investor sentiment leads to an increase in noise trading and a decline in arbitrage activity due to institutional investors' attempts to limit their risk exposure.

**Keywords:** Investor Sentiment, noise traders, spot-futures correlation, volatility spillovers

**JEL:** G10, G13, G14

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