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Uncovering asymmetries in the relationship between fear and the stock market using a hidden co-integration approach

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Abstract

In this paper we implement the methodological approach of hidden co-integration in order to examine the relationship between the fear index and the stock market index. To this end, we employ daily data of the S&P 500, FTSE 100 and DAX 30 stock market indices and their respective implied volatility indices, i.e. CBOE VIX, FTSE Volatility Index and VDAX New Volatility Index, for the 2000-2014 period. Our empirical results indicate overall asymmetry in the reaction of the fear indicator to stock market innovations for the US market. For the UK and Germany our findings suggest the existence of specific types of asymmetry concerning mainly the size and the time span of the adjustment process. The findings have important implications for asset allocation, active investment and hedging strategies.

Keywords: fear index; stock market index; hidden co-integration; asymmetry.

JEL Classification: G12, G15

1. Introduction

According to Read (2009), “fear is an essential animal emotion”, which is associated with anxiety or aggression that evolved in order to serve survival. When it comes to investments, fear is associated with risk, i.e. uncertainty regarding an outcome and lack of control, and may

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