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Index Derivatives Markets and Price Discovery in the S & P 500

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Abstract

The derivatives markets for indices, specifically the S&P 500, should derive their value from the discounted cash flows of earnings, of the firms that compose the index. That being said, many forces including macroeconomic policy, fiscal policy and geopolitical disturbances may affect price discovery. Market participants utilizing index derivatives play an important role in price discovery, risk transference and creating liquidity. In these index derivatives markets dealers represent the sell side and structure products for asset managers, leverage funds and banks to meet client demands and manage risk. This project uses panel data including the Commodities Futures Trading Commission (CFTC) Commitment of Traders (COT) report, weekly index price data, and other macroeconomic data from 2006 to 2019 to identify the degree to which market participants are responsible for price discovery. We use a non-linear regression model specification to identify price leadership. Preliminary results suggest dealers, asset managers and leveraged funds all play a significant role in index price discovery. Additionally, leveraged funds appear to play a leading role in derivatives markets price discovery.