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An Application of Arbitrage Pricing Theory to Futures Markets: Tests of Normal Backwardation

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Abstract

Keynes (1923) and Hicks (1939), hypothesized that futures prices are downward biased estimates of expected spot prices. Any empirical study that employs returns on futures contracts is actually a joint test of both the Keynes-Hicks hypothesis and of the assumed model of returns. Models based on the Capital Asset Pricing Model have been used to test the hypothesis, with different models implying different conclusions. As shown in this article, these models are all special cases of a general linear model. Arbitrage Pricing Theory provides the most powerful test for this class of linear models. No other linear model will provide greater explanatory power or account for more systematic risk. An Arbitrage Pricing Theory model is estimated in this article and the results appear inconsistent with the Keynes-Hicks hypothesis.

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