Boltzmann Distribution and Market Temperature

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The minute fluctuations of of S&P 500 and NASDAQ 100 indices display Boltzmann statistics over a wide range of positive as well as negative returns, thus allowing us to define a market temperature for either sign. With increasing time the sharp Boltzmann peak broadens into a Gaussian whose volatility $\sigma$ measured in $1/\sqrt{\text{min}}$ is related to the temperature $T$ by $T = \sigma/\sqrt{2}$. Plots over the years 1990–2006 show that the arrival of the 2000 crash was preceded by an increase in market temperature, suggesting that this increase can be used as a warning signal for crashes. A plot of the Dow Jones temperature over 78 years reveals a remarkable stability through many historical turbulums, interrupted only by short heat bursts near the crashes.

PACS numbers: 11.10.Kk, 71.10.Hf, 11.15.Ha

It is by now well-known that financial data do not display Gaussian distributions [1, 2, 3, 4, 5, 6, 7, 8, 9, 10, 11, 12, 13]. Most importantly, the tails of the distributions are power-like [14], since large fluctuations are much more frequent than in a Gaussian distribution. This is of great importance for financial institutions who want to estimate the risk of market crashes.

In this note we would like to focus on the opposite regime of the most frequent events near the peak of the distribution. The logarithms of the stock prices $x(t) = \log S(t)$ and thus also of NASDAQ 100 and S&P 500 indices have a special property: the minute returns $z(t) = \Delta x(t)$ show an exponential distribution [15] for positive as well as negative $z(t)$, as long as the probability is rather large [16, 17].

$$B(z) = \frac{1}{2T} e^{-|z|/T}. \quad (1)$$

In Fig. 1 we show that the data are fitted well by the distribution [18]. Only a very small set of rare events of large $|z|$ does not follow the exponential law, but displays heavy tails. If the exponential distribution is interpreted as a Boltzmann distribution, the parameter $T$ in (1) plays the role of a market temperature, and there are statistical considerations to support this interpretation [19, 20].

The purpose of this note is to determine the market temperatures for the S&P 500 and NASDAQ indices over many years.

In principle, there are different temperature $T_{\pm}$ for positive and negative returns, but to a good approximations we may equate both $T \approx T_{+} \approx T_{-}$.

At larger time scales, the distribution becomes more and more Gaussian, as required by the central limiting theorem of statistical mechanics which states that the convolution of infinitely many arbitrary distribution functions of finite width always approaches a Gaussian distribution. This is illustrated by the the weekly data of the two indexes in Fig. 2.

![FIG. 2: Gaussian distributions of S&P 500 and NASDAQ 100 weekly returns.](image)

The transition from Boltzmann to Gaussian distributions is shown for the S&P 500 index in Fig. 3.

The time dependence of the distribution is found in the usual way [4, 13]. We calculate the Fourier transform of $B(z)$:

$$B(p) = \int_{-\infty}^{\infty} dz e^{ipz} \frac{1}{2T} e^{-|z|/T} = \frac{1}{1 + (Tp)^2}, \quad (2)$$

FIG. 1: Boltzmann distribution of minute returns of S&P 500 and NASDAQ 100 indices.
and identify the Hamiltonian as

\[ H(p) = \log[1 + (Tp)^2]. \quad (3) \]

This has only even cumulants \((n = 2, 4, \ldots)\):

\[ c_n = -i^n H^{(n)}(0) = 2^{n/2}T^n(n - 1)!. \quad (4) \]

As a function of time, the distribution widens as follows:

\[ \tilde{B}(z; t) = \int_{-\infty}^{\infty} \frac{dp}{2\pi} e^{ipz - tH(p)} \]

\[ = \frac{1}{T \sqrt{\pi T(t)}} \left( \frac{|z|}{2T} \right)^{t-1/2} K_{t-1/2}(|z|/T). \]

where \( t \) is measured in minutes. For \( t = 1 \) this agrees, of course, with the minute distribution [1].

The variance of this distribution increases linearly in time as

\[ \sigma^2(t) \equiv \langle z^2 \rangle_c(t) = \sigma^2 t = 2T^2 t, \quad (6) \]

whereas the kurtosis decreases with \( 1/t \)

\[ \kappa(t) \equiv \frac{\langle z^4 \rangle_c(t)}{\langle z^2 \rangle_c^2(t)} - 3 = \frac{3}{t}, \quad (7) \]

and goes to zero for large times where the distribution becomes Gaussian.

These quantities are plotted in Figs. 4 and 5. The time dependence of \( \sigma^2(t) \) in Eq. (6) allows us to extract the temperature of the initial Boltzmann distribution as \( T = \sqrt{\sigma^2(t)/2t} \) from any later distribution in which the sharp Boltzmann peak is no longer visible, in particular from the asymptotic Gaussian limit. The result of this analysis is contained in the plots in Fig. 6. The temperature depends, of course, on the selection of stocks, but changes only very slowly with the general economic and political environment. Near a crash, however, it increases significantly.

It is interesting to observe the historic development of Dow Jones temperature over the last 78 years (1929-2006) in Fig. 7. Although the world went through a lot of turmoil and economic development in the 20th century, the temperature remained rather constant except for short heat bursts. The temperature was highest in the 1930’s, the time of the great depression. These temperatures have never been reached again. An especially hot burst occurred during the crash year 1987.

FIG. 4: Variance of S&P 500 and NASDAQ 100 indices as a function of time. The right-hand side amplifies the small relative deviation from the linear shape in percent.

FIG. 5: Kurtosis of S&P 500 and NASDAQ 100 indices as a function of time. The right-hand side shows the relative deviation from the \( 1/t \) behavior in percent.

FIG. 6: Fits of convolution of Boltzmann distribution to S&P 500 returns in Fig. 1 over time intervals of 1 hour, 4 hours, and 1 day, respectively.

The lesson from this analysis is that an increase in market temperature before a crash may be a useful signal for investors to shorten their positions.

Acknowledgement:
The authors are grateful to P. Haener and D. Sornette for useful comments.

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