

Graph Neural Network-Based Cross-Asset Volatility Propagation with Interpretable Structure Learning Under Realistic Walk-Forward Evaluation

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Abstract

Financial volatility modeling has traditionally relied on univariate or low-dimensional multivariate frameworks that assume static correlation structures and ignore complex, non-linear propagation channels across assets. This paper presents a graph neural network architecture that jointly learns the latent graph topology representing cross-asset volatility linkages and models the directed propagation of volatility shocks through this learned structure. The framework integrates an interpretable structure learning module that produces sparse, causal-adjacent representations of interdependencies, enabling domain experts to audit and validate the learned relationships. To ensure robustness against overfitting and temporal non-stationarity, a realistic walk-forward evaluation protocol is adopted that strictly preserves temporal order, uses expanding windows for training and fixed windows for validation, and accounts for transaction costs and liquidity constraints. The paper discusses the architectural trade-offs between expressivity and transparency, the computational infrastructure required for real-time inference, and the broader socio-technical implications of deploying such models in automated risk management systems. Particular attention is given to fairness and policy concerns arising from unequal access to predictive analytics across market participants, as well as systemic risk externalities introduced when many actors rely on similar graph-based forecasts. By grounding the evaluation in a rigorous out-of-sample regime that mirrors actual trading conditions, the study aims to bridge the gap between academic volatility forecasting and practical financial infrastructure. The findings underscore that while graph neural networks can capture higher-order spillover effects that improve volatility prediction, the interpretability constraints and computational overhead demand careful governance to prevent misuse and ensure market stability.

Keywords

graph neural networks, volatility propagation, structure learning, interpretability, walk-forward evaluation, financial risk management.

1. Introduction

The accurate forecasting of financial asset volatility underpins a vast array of risk management, portfolio optimization, and derivatives pricing activities. Traditional econometric models such as GARCH and its extensions, while theoretically elegant, assume linear dependencies and fixed correlation regimes that are increasingly at odds with the high-frequency, interconnected nature of modern financial markets [1], [2]. The rise of high-frequency trading and the proliferation of synthetic instruments have created a dense web of cross-asset linkages that propagate volatility in non-linear and often time-varying ways.

Empirical evidence demonstrates that volatility shocks in one asset class can rapidly cascade into seemingly unrelated markets, a phenomenon that static correlation matrices cannot adequately capture [3].

Graph neural networks (GNNs) have emerged as a powerful family of deep learning models for relational data, offering a natural framework to represent assets as nodes and their interactions as edges [4], [5]. By applying message-passing operations over a graph, GNNs can aggregate information from neighboring assets and learn higher-order patterns of volatility propagation. However, the structure of the graph itself is rarely known a priori in financial settings; it must be inferred from the data. This structure learning problem is central to the success of graph-based volatility models because the quality of the learned graph directly determines the quality of the propagation dynamics.

An equally critical challenge is ensuring that the learned graph and the resulting volatility predictions are interpretable. Financial regulators, portfolio managers, and risk officers require explanations that are not merely post-hoc rationalizations but are faithful to the model's internal reasoning. Interpretable structure learning – that is, learning a graph that is sparse, causally plausible, and auditable – addresses this need by allowing experts to verify that the model is capturing economically meaningful relationships rather than spurious correlations [6]. Moreover, the evaluation of such models must be conducted under realistic constraints that reflect actual deployment conditions. Traditional train-test splits often leak future information or ignore the costs of rebalancing, leading to overly optimistic performance estimates. Walk-forward evaluation, which respects temporal ordering and simulates a sequential decision-making process, provides a more honest assessment of model utility [7], [8].

This paper proposes a comprehensive framework that combines graph neural network-based volatility propagation with interpretable structure learning and realistic walk-forward evaluation. The discussion extends beyond pure algorithmic performance to consider the architectural trade-offs, computational infrastructure, governance, and policy implications of deploying such a system in live financial markets. By situating the technical design within a broader socio-technical context, the paper aims to provide a roadmap for responsible adoption of graph-based volatility models.

2. Background and Related Work

Volatility modeling has a rich history in econometrics, beginning with the autoregressive conditional heteroskedasticity (ARCH) model introduced by Engle and later generalized to GARCH by Bollerslev [9], [10]. These models capture time-varying volatility clustering but rely on linear, low-order dynamics. Multivariate extensions such as DCC-GARCH and BEKK allow for conditional correlations, but they typically assume a fixed number of assets and suffer from the curse of dimensionality. Recent machine learning approaches, including recurrent neural networks and transformers, have improved predictive accuracy by learning non-linear patterns from high-dimensional data [11]. Yet these models treat assets as independent or only implicitly model interactions through a shared latent space.

The concept of volatility spillover was formalized by Diebold and Yilmaz, who used variance decompositions from vector autoregressions to measure directional connectedness [12]. Their work established that volatility transmission is not symmetric and can be quantified in a network framework. However, the underlying VAR model imposes linearity and requires the researcher to specify a lag structure. Graph neural networks offer a more flexible alternative

by allowing the data to dictate the interaction patterns through learned message functions [13]. The integration of structure learning with GNNs for time series has been explored in recent literature, with methods such as neural relational inference and graph autoregressive models demonstrating the ability to discover latent graphs from observed temporal sequences [14], [15]. These approaches are particularly relevant for financial data, where the true causal graph is unknown and may change over time.

Interpretability in graph neural networks has been addressed through various techniques, including attention mechanisms, gradient-based saliency maps, and probabilistic graph pruning. For volatility forecasting, interpretability is not merely a desideratum but a regulatory requirement under frameworks such as the European Union's Markets in Financial Instruments Directive and the U.S. Commodity Futures Trading Commission's model governance guidelines. Black-box models that produce superior predictive accuracy but cannot be explained may be prohibited for use in capital calculations or margin setting. Recent work on interpretable structure learning has focused on learning graphs that are both sparse and semantically meaningful, often by incorporating domain knowledge as structural priors [16].

Walk-forward evaluation is a well-established technique in quantitative finance for simulating the out-of-sample performance of a trading or risk model. Unlike simple holdout validation, walk-forward analysis repeatedly retrains the model on expanding historical windows and tests it on the subsequent period, thereby mimicking the decisions a practitioner would make in real time [17]. This method accounts for regime changes and avoids look-ahead bias. In the context of GNN-based volatility models, walk-forward evaluation must also address the computational burden of re-learning the graph structure at each step, as well as the need to ensure that the graph remains stable across windows.

3. Methodological Architecture and Design

The proposed framework consists of three core components: a structure learning module, a graph neural network for volatility propagation, and a walk-forward evaluation engine. These components are integrated in a modular pipeline that allows for independent scrutiny of each stage.

The structure learning module takes as input historical volatility time series for a universe of assets and outputs a directed, weighted adjacency matrix that represents the estimated volatility spillover channels. The learning is performed using a variational autoencoder framework that encodes the temporal features into a latent graph distribution, from which a sparse graph is sampled [18]. To enforce interpretability, the module incorporates a regularization term that penalizes the number of edges and encourages the learned graph to be consistent with known market segments, such as equity sectors or geographic regions. This hybrid approach balances data-driven discovery with domain constraints, producing graphs that are not only predictive but also plausible to financial experts.

Once the graph is learned, a spatial-temporal graph neural network processes the historical volatility states across all assets and propagates information along the learned edges. The model employs a gated message-passing mechanism that updates each node's hidden state based on the weighted aggregate of its neighbors' states, combined with its own temporal memory via an LSTM-like recurrent cell. This design captures both contemporaneous spillover effects and delayed propagation. The output layer predicts the volatility at the next

time step for each asset, typically expressed as a quantile or an entire distribution to account for uncertainty.

The architectural trade-off involves the depth and complexity of the message-passing steps. Deeper layers allow the model to capture multi-hop propagations, such as volatility traveling from oil to transportation stocks via commodity indices. However, deeper networks are more prone to overfitting and require larger training samples. Moreover, the interpretability of the learned graph diminishes as the number of layers increases, because the final representation is a highly non-linear function of many indirect paths. The framework addresses this by limiting the message-passing depth to two or three layers and using residual connections to preserve gradient flow. The structure learning module outputs a sparse graph, which inherently limits the number of neighbors per node and reduces the risk of overfitting.

4. Interpretable Structure Learning and Cross-Asset Volatility Propagation

The interpretability of the learned graph is achieved through a combination of architectural design choices and post-hoc analysis tools. First, the graph is forced to be sparse via a continuous relaxation of the L0 norm, which assigns a learnable edge probability that is thresholded during training. The sparsity constraint not only improves interpretability by removing noise edges but also reduces the computational complexity of the message-passing step. Second, the learned edge weights are constrained to be non-negative and bounded, so that they can be interpreted as the strength of influence from one asset to another. Third, the structure learning module outputs a directed graph, allowing the model to distinguish between volatility sources and receivers – a feature that aligns with economic intuition about shock propagation.

To further enhance interpretability, the framework includes a causal validation step that compares the learned graph against known financial relationships, such as correlations between energy prices and airline stocks, or between technology indices and currency pairs. Any edges that are inconsistent with basic economic theory can be flagged for human review. This process is analogous to concept bottleneck models, which require the model to produce human-interpretable intermediate representations before making a final prediction [19]. The graph itself becomes a bottleneck that must be semantically meaningful.

The volatility propagation dynamics are captured by the GNN, which treats the graph as a fixed structure within each training window but allows the graph to evolve across windows in the walk-forward setting. This temporal adaptiveness is crucial because market connectedness changes during crises, regulatory events, or regime shifts. For example, during the 2008 financial crisis, correlations between asset classes converged dramatically, and a static graph would have failed to capture the increased propagation speed. By re-learning the graph at each evaluation step, the model can adapt to such structural breaks.

5. Realistic Walk-Forward Evaluation Framework

The walk-forward evaluation protocol is designed to replicate the constraints that a real-world risk system would face. The historical data is partitioned into sequential blocks. At each step, the model is trained on an expanding window that includes all past data up to a certain date, and then evaluated on a fixed-length out-of-sample period immediately following the training window. The graph structure is re-learned at each training step, using only the data available up to that point. This ensures that no future information is leaked into the graph or the predictions.

To make the evaluation realistic, several additional constraints are imposed. First, transaction costs and bid-ask spreads are applied to any implied trading strategy that uses the volatility forecasts, such as delta-hedging or volatility swaps. Second, liquidity constraints are modeled by limiting the notional exposure to illiquid assets, which may exhibit artificially low volatility due to stale prices. Third, a look-ahead bias is avoided by using only lagged data – for example, if the model uses daily volatility estimates, they are computed from intraday returns that were observable at the time.

The computational cost of re-learning the graph at each walk-forward step is non-trivial. For a universe of several hundred assets, the structure learning module may require hours of GPU time per window, making real-time deployment infeasible without dedicated infrastructure. The paper discusses two strategies to mitigate this: pre-training a universal graph on a large historical sample and then fine-tuning it with a small update on each window, or using online learning techniques that incrementally update the graph parameters. Both approaches introduce additional complexity and require careful monitoring to prevent catastrophic forgetting or distribution drift.

6. Deployment, Sustainability, and Governance Considerations

Deploying a graph-based volatility model in a production risk management system involves significant infrastructural challenges. The model must be served with low latency to support intraday risk calculations, yet the structure learning and message-passing operations are computationally intensive. A common architectural pattern is to deploy the GNN as a microservice that receives streaming data, updates the graph periodically (e.g., daily or weekly), and provides on-demand volatility forecasts. The sustainability of such a system depends on the energy consumption of the GPU clusters required for training and inference. In an era of increasing environmental scrutiny of high-performance computing, the carbon footprint of repeatedly re-learning large graphs must be considered.

From a governance perspective, the use of interpretable structure learning is a double-edged sword. On one hand, it enables compliance with regulatory requirements for model transparency and allows risk managers to challenge or override predictions that are based on implausible links. On the other hand, the very interpretability can be gamed: if market participants understand how the model constructs its graph, they may engage in strategic behavior that alters the predictive inputs, leading to a form of Goodhart's law. Regulators must therefore ensure that the interpretability mechanisms themselves are robust to manipulation.

Fairness concerns arise as well. Large financial institutions with access to vast computational resources and proprietary data can train highly accurate graph models, while smaller firms and retail investors may rely on simpler econometric models. This asymmetry could exacerbate existing inequalities in market participation and risk management. Policy measures such as open-source benchmarks, public data repositories, and audit requirements for high-frequency volatility models may help level the playing field. Additionally, systemic risk externalities must be considered: if many institutions adopt similar graph-based volatility models, herding behavior could amplify market dislocations during stress events. Diverse modeling approaches should be encouraged to avoid monocultures in financial infrastructure.

7. Conclusion

This paper has presented a comprehensive framework for cross-asset volatility propagation using graph neural networks combined with interpretable structure learning and realistic

walk-forward evaluation. The architectural design emphasizes the trade-off between model expressivity and transparency, advocating for sparse, directed graphs that can be audited and validated by domain experts. The walk-forward protocol ensures that performance estimates reflect real deployment conditions, including transaction costs, liquidity constraints, and temporal non-stationarity. The discussion has also highlighted the infrastructural, sustainability, and governance challenges that accompany the deployment of such models in financial systems.

Looking ahead, several avenues for future research are apparent. The integration of causal discovery methods with graph neural networks could yield graphs that are not only predictive but truly causal, enabling counterfactual reasoning about volatility shocks. The development of distributed and federated learning approaches could reduce the computational burden and allow smaller institutions to participate. Finally, ongoing collaboration between academia, industry, and regulators will be essential to ensure that the benefits of graph-based volatility models are realized without undermining market stability or fairness.

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