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Equity and debt market responses to sovereign credit ratings announcement ☆

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Abstract

We study the impact of changes in sovereign ratings and outlooks on international capital markets using a comprehensive database of 34 countries, covering the major regions in the world over the period 1990–2000. We find the rating agencies provide financial markets with new tradable information. Specifically, they affect not only the instrument being rated (bonds) but also stocks. Interestingly, bond markets react differently than stock markets in many respects. We find, only for bond market returns, a positive impact is significant when the economic outlook is upgraded and outlook changes appear to be at least as important as rating changes. In addition, downgraded ratings and economic outlooks occur mainly during bond market downturns, raising a possibility that rating agencies may exacerbate a bond bear market. Only downgrade has a discernible impact on equity and bond returns and the effects of rating announcement are significantly asymmetric. On *equity* returns, the market responses of downgrade are more pronounced in the cases of high inflation, low fiscal balance, and local currency debt; in contrast, the market responses of downgrade *across class* are more pronounced in the cases of low current account and foreign currency debt. On *bond* returns, the market responses of downgrade are more pronounced in the cases of a relatively ailing economy as proxied by emerging market, high inflation, and low current account; on the other hand, the market responses of downgrade *across class* are more pronounced in the cases of a relatively healthy economy as proxied by low inflation, high liquidity, and during non-crisis period. This study has important implications for investors' international asset allocation and for regulatory agents such as the Basel

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Committee increasingly depending on credit rating agencies such as Moody's and S&P's in their regulatory deliberations.

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1. Introduction

Credit ratings have been widely studied in the context of financial market information processing. But the literature has left several issues still outstanding, including the efficiency of international information assimilation. Sovereign credit risk is a particularly important subject in this general area. Frequent debt crises, defaults, and renegotiations point to the importance of assessing sovereign risk. Sovereign ratings are supposed to indicate the likelihood that a debtor central government will fail to fully discharge its obligations, so the accuracy of such ratings are extremely important to investors.

The information used by rating agencies to assess sovereign risk ranges over macroeconomic data, government fiscal policies, balance of payments, and the level and historical experience of the country's external debt. The same information is normally available to the public. Consequently, one could ask: "Does a sovereign credit rating simply mirror the international market's assessment of a country's risk, or does it provide additional insights?" Prior research has not fully answered this question.

Kaminsky and Schmukler (2002) examine whether changes in ratings of one type of security affect other asset. News about one type of security can affect yields of other securities through various channels. They explain a downgrade of sovereign bonds which might have negative impact on stock markets due to the expectation of an increase in tax rate on firms to offset negative budgetary impact of higher interest rate caused by a downgrade.[1] The present paper extends this study by investigating the reactions of global *bond and stock* markets to sovereign credit rating changes and also the difference of such reactions under macroeconomics and rating characteristics (hereafter, country characteristics).

Unlike previous research, this study also examines announced changes in the economic outlook provided by rating agencies. Rating agencies typically issue periodic outlook, often termed a "watchlist" containing implicit information about prospective short term changes in ratings. Outlooks forecast the likely direction of an issuer's credit quality over the medium term, typically over a 12- to 18-month horizon. Outlooks are modified when a change in an issuer's risk profile has been observed but it is not yet regarded as permanent enough to warrant a new credit rating. Kaminsky and Schmukler (2002) find a large proportion of changes in outlook are followed by changes in rating.[2] This implies the rating changes are not often complete surprises

[1] Additionally, they explain the effects of sovereign credit rating changes are not limited only to the parties acquiring such sovereign debts but also to all involved parties who acquire the other debt instruments that are more likely to be downgraded. Any financial institutions in a country rated below investment grade may have difficulty to issue financial products internationally and any corporations in such country may have difficulty to raise debt internationally due to damaged credibility of their country.

[2] Kaminsky and Schmukler (2002) examine sovereign credit rating announcements of emerging market countries between 1990 and 2000 and find hat 78% of changes in S&P's outlook were followed by changes in ratings. Rating changes by Moody's followed outlook changes 69% of the time and by Fitch-IBCA 50% of the time.