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An empirical investigation

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The relationship between equity and bond returns:**An empirical investigation**

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Abstract: The correlation between equity and corporate debt is ambiguous. News affecting the value of a firm's assets induces a positive correlation, whereas an increase in the volatility of a firm's assets induces a negative correlation. We examine the conditional correlation between these two securities. While the average correlation is positive, the conditional correlation increases with credit risk, and decreases with equity volatility. Our results are consistent with the thesis that the equity bond relation is dependent on the potential wealth transfer between stock and debt holders. Nevertheless, this relation seems to break down during periods of extreme market uncertainty.

Keywords:

Equity-bond correlation; distance to default; equity volatility

JEL classification:

G11; G12; G14

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