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Stock and bond market interaction: Does momentum spill over?☆

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Abstract

This paper examines the interaction between momentum in the returns of equities and corporate bonds. We find that investment grade corporate bonds do not exhibit momentum at the three- to 12-month horizons. Instead, the evidence suggests that they exhibit reversals. However, significant evidence exists of a momentum spillover from equities to investment grade corporate bonds of the same firm. Firms earning high (low) equity returns over the previous year earn high (low) bond returns the following year. The spillover results are stronger among firms with lower-grade debt and higher equity trading volume, seem robust to various risk and liquidity controls, and hold even after controlling for past earnings surprises. In examining the source of the spillover, we find that the bond ratings of firms with positive (negative) equity momentum continue to improve (deteriorate) in the future, suggesting underreaction to the information in past equity prices about changing default risk is a likely

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source of the spillover effect. Overall, our results suggest that both equity and debt underreact to firm fundamentals, but past equity returns is a better proxy of firm fundamentals than past bond returns.
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1. Introduction

Jegadeesh and Titman (1993) show a pervasive momentum effect in stock returns at the three- to 12-month horizons. The momentum effect is robust across different time periods and stock markets, and it has proven difficult to reconcile with existing rational asset pricing models.[1] Recent behavioral theories (see Barberis et al., 1998; Daniel et al., 1998; Hong and Stein, 1999) argue that momentum is the result of initial underreaction to private or public news on the part of naïve investors with biased expectations.[2] These theories are a source of great controversy in the finance literature because, taken at face value, they present a challenge to market efficiency. This debate, however, has focused on equity markets with little attention paid to the possibility of momentum in other asset classes.[3] Investigating other asset classes is of interest not only because they can provide important out-of-sample evidence unavailable in tests based on equities, but also because they can provide potential clues as to the sources of the observed momentum in equity markets due to the differences in the investor clientele and the information environment between the equity market and the other asset markets.

In this paper, we evaluate the underreaction hypothesis and examine the robustness of the momentum phenomenon using corporate bonds. Corporate bonds provide a logical setting to examine these issues given that bonds and stocks are different claims to the same underlying operating cash flows and are affected by the same firm fundamentals. It is natural to ask, therefore, whether the momentum effect in stocks extends to bonds. In other words, do corporate bond prices also underreact to fundamental news? Furthermore, is information about firm fundamentals better

[1]See Chan et al. (1996), Fama and French (1996), Fama (1998), Rouwenhorst (1998), Grundy and Martin (2001), Moskowitz and Grinblatt (1999), Conrad and Kaul (1998), Hong et al. (2000), Lee and Swaminathan (2000), Jegadeesh and Titman (2001), and Bhojraj and Swaminathan (2004).

[2]In Barberis et al. (1998), investors underreact to public earnings news because of the ‘‘conservatism’’ bias, while in Daniel et al. (1998), investors overreact to private news and underreact to public news because of the ‘‘overconfidence’’ bias. Hong and Stein (1999) model the underreaction as occurring when boundedly rational agents each observe some private information but fail to extract other agents’ information from prices, resulting in a gradual diffusion of information.

[3]Cutler et al. (1991) examine predictability in stocks, bonds, currencies, real estate, and metals, and they find that most markets are positively autocorrelated at intermediate horizons of two to 12 months and negatively autocorrelated at longer horizons. Their findings, however, focus on the time-series predictability of aggregate returns not cross-sectional predictability, as in studies of stock momentum.

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