



Return reversals in the bond market: Evidence and causes [☆]

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Abstract

The finance literature has shown that equity returns are predictable using past returns. This study extends that literature by examining bond return predictability. Using returns constructed from dealer bid prices, we find short- to intermediate-term reversals in investment grade corporate bond returns. These reversals are larger in the first half of the sample period and consistent with the predictions of dealer inventory cost models. This supports Jegadeesh and Titman's [J. Financ. Intermed. 4 (1995) 116] assertion that daily, weekly, and monthly reversals in equity returns come from dealer inventory considerations, not behavioral biases. Finally, unlike equity returns, we find no evidence of momentum in bond returns.

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1. Introduction

The predictability of equity returns based on past returns is a popular subject in both the academic literature and the investment community (see Dremen, 1977, 1979). Empirical research shows evidence of reversals over short horizons (1 week

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to 3 months); momentum over intermediate horizons (3–12 months); and reversals again over long horizons (3–5 years). Though the existence of these patterns in equity returns is well established, the explanation for why these patterns exist remains controversial. Many argue that investor irrationality is the primary cause and offer behavioral models consistent with the empirical findings. Daniel, Hirshleifer, and Subrahmanyam (DHS, 1998) and Odean (1998) are examples. Others argue for rational explanations that either take issue with empirical methodologies as in Conrad and Kaul (1998) or develop rational models consistent with the phenomena as in Berk et al. (1999). Still others differentiate the short horizon from the longer horizon patterns and argue these are separate phenomenon with distinct causes. For example, Lehman (1990) attributes the short horizon reversals to investor overreaction; Roll (1984) points to measurement issues such as bid–ask bounce; and Lo and MacKinlay (1990) suggest the cause is cross-autocorrelation across securities. Finally, Stoll (1989) and Jegadeesh and Titman (1995) show that dealer responses to inventory imbalances can cause negative serial correlation in returns and may be responsible for reversals in daily, weekly, and monthly equity returns.

The purpose of this paper is to expand the scope of this research by examining the predictability of bond returns based on past returns by looking at the intertemporal bid pricing of Treasury and corporate bonds in the dealer market. There are two main reasons why we might find patterns in bond returns. First, the bond market is largely a dealer market. Hence, the dealer inventory cost models of Stoll (1978), Amihud and Mendelson (1980), and Ho and Stoll (1981) should apply. These models predict negative serial correlation in prices as dealers adjust bid–ask spreads relative to the “true” price to encourage transactions that will even out their inventory positions. Although these models are usually applied to equity data of a daily or weekly frequency, Jegadeesh and Titman (1995) show these models have implications for longer horizon equity returns as well. They provide evidence equity market dealers on the NYSE take several days to balance out their inventory positions and suggest that the monthly reversals in equity returns found by Jegadeesh (1990) are due to this phenomenon. If true, reversals in bond returns over longer horizons may be affected as well, since the corporate debt market is less liquid than the equity market, lengthening the time it takes for dealers to rebalance their inventories.

A second reason we might find patterns in bond returns is found in behavioral models that predict patterns in risky asset returns due to investor irrationality. These models were crafted to explain patterns in equity returns, but imply we should find similar patterns in the returns of other risky assets. If the patterns in equity returns are due to overreaction, it is not unreasonable to expect similar patterns in bond returns. After all, if investors overreact to information in analyzing equity values, perhaps they do so in analyzing risky bonds as well, causing overreaction in the price adjustment behavior of dealers in the corporate bond market. This may make sense given psychological evidence showing experts are more prone to overreact than others due to greater overconfidence (see Griffin and Tversky, 1992).

In this study, we use dealer bid prices to calculate returns. The use of bid prices has advantages for our purpose because we eliminate the influence of bid–ask bounce and adverse information costs, which can cause spurious negative serial correlation

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