Cyprus University of Technology

Department of Commerce, Finance and Shipping

<u>Seminar Talk</u>

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Liquidity Risk of Corporate Bond Returns: A Conditional Approach

by

Yakov Amihud

Stern School of Business

New York University

<u>Abstract</u>

We study the exposure of the U.S. corporate bond returns to liquidity shocks of stocks and treasury bonds over the period 1973-2007 in a regime switching model. In one regime, liquidity shocks have mostly insignificant effect on bond prices, whereas in another regime, a rise in illiquidity produces significant but conflicting effects: Prices of investment-grade bonds rise while prices of speculative grade (junk) bonds fall substantially (relative to the market). Relating the probability of these regimes to macroeconomic conditions we find that the second regime can be predicted by economic conditions that are characterized as "stress." These effects, which are robust to controlling for other systematic risks (term and default), suggest the existence of time-varying liquidity risk of corporate bond returns conditional on episodes of flight to liquidity. Our model can predict the out-of-sample bond returns for the stress years 2008-2009. We find a similar pattern for stocks classified by high or low book-to-market ratio, where again liquidity shocks play a special role in periods characterized by adverse economic conditions.

*** Joint work with Viral V. Acharya and Sreedhar Bharath.**

Department of Commerce, Finance and Shipping
115, Spyrou Araouzou Street, 3606, P.O.Box. 50329, 3603, Lemesos
Tel. 25002489   Fax. 25002637   Email. cfs.seminars@cut.ac.cy