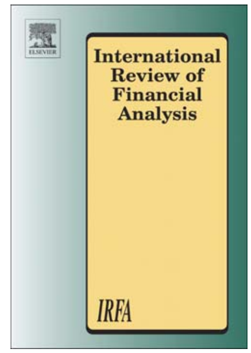

Corporate Yield Spreads and Real Interest Rates

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Corporate Yield Spreads and Real Interest Rates

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Abstract

The effect of inflation on the credit spreads of corporate bonds is investigated utilizing real instead of nominal interest rates in extensions of the models proposed by Longstaff and Schwartz (1995) and Collin-Dufresne et al. (2001). Inflation is a critical, non-default, component incorporated in nominal bond yields, whose effect has not been considered by existing credit spread theory. In this sense the only true test of models of credit spread pricing must utilise real rates. To illustrate these requirements the Canadian bond data of Jacoby, Liao and batten (2009) is utilized. This Canadian data accommodates callability and the tax effects otherwise present in U.S. bond markets. The relation with historical default rates of both U.S. and Canadian bonds is also investigated since this approach is clean of both callability and tax effects. Overall, the analysis provides additional insights into the theoretical drivers of credit spreads as well as helping to explain observed corporate bond yield behaviour in financial markets.

JEL: C22, C13, C53, G12.
Keywords: Credit spreads; Corporate bonds; Real interest rates; Reduced-form models; Structural models