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Sovereign rating actions and the implied volatility of stock index options

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Abstract

This paper examines the interaction between the equity index option market and sovereign credit ratings. S&P and Moody's signals exhibit strong impact on option-implied volatility while Fitch's influence is less significant. Moody's downgrades reduce the market uncertainty over the rated countries' equity markets. Strong causal relationships are found between movements in the option-implied volatility and all credit signals released by S&P and Fitch, but only actual rating changes by Moody's, implying differences in rating agencies' policies. The presence of additional ratings tends to reduce market uncertainty. The findings highlight the importance of rating information in the price discovery process and offer policy implications.

JEL classification: G14; G15; G24

Keywords: Sovereign ratings; Implied volatility; Stock index options; Price discovery process.

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