

Short-term patterns in government bond returns following market shocks: International evidence

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Abstract

We employ government bond portfolios from 17 countries in order to investigate the short-run reaction of investors to price shocks. Our findings indicate a uniform return reversal pattern across countries, that persists irrespective of various robustness tests such as different datasets (Datastream/J.P. Morgan), different maturity bands, and day-of-the-week effects. Simulated trading strategies based on our results suggest that this pattern can be employed to generate economically significant profits for many country portfolios. We also demonstrate that significant zero-investment profits are possible even when instead of the expensive to replicate country bond portfolios we employ directly tradable and low transactions cost instruments, such as Bond Futures Contracts. © 2007 Elsevier Inc. All rights reserved.

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1. Introduction

In informationally efficient markets, prices incorporate news quickly and accurately and investors cannot predict future returns. Several studies, however, find that asset returns are predictable, using historical information. [Poterba and Summers \(1988\)](#) document serial correlation in US stock returns, while [Baytas and Cakici \(1999\)](#), [Richards \(1997\)](#), [Brouwer, Van der Put, and Veld \(1997\)](#), [Rouwenhorst \(1998, 1999a,b\)](#), [Chan and Hameed \(2000\)](#), among others, report that

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predictable patterns exist for a large number of international markets as well. [McInish, Ding, Pyun, and Wongchoti \(in press\)](#) and [Fung, Leung, and Patterson \(1999\)](#) obtain similar results for winner and loser stocks in Asian equity markets. [DeBondt and Thaler \(1985\)](#) find long-term price reversals and [Bremer and Sweney \(1991\)](#) and [Lehman \(1990\)](#) find that price reversals exist in the short-term as well. For the medium-term, empirical evidence suggests that investors underreact to information and this underreaction produces ‘momentum’ profits, ([Jegadeesh & Titman, 1993](#)).

There are several possible explanations for this evidence, some of which are consistent with the Efficient Market Hypothesis. For example, short-term reversals may be induced by prices bouncing between bid and ask quotes. [Jegadeesh and Titman \(1995\)](#) show that inventory imbalances may cause negative short-term serial correlation in prices, while [Roll \(1984\)](#) shows that due to dealers’ order processing costs the bid–ask bounce may explain short-term negative serial correlation (see also [Cox & Peterson, 1994](#); [Park, 1995](#)). [Copeland and Galai \(1983\)](#) and [Glosten and Milgrom \(1985\)](#) argue that reversals due to the bid–ask bounce may occur because of adverse information costs. [Fama and French \(1996\)](#) find that long-term equity return reversals can be explained within the context of a multifactor asset pricing model¹ and [Zarowin \(1990\)](#) reports that contrarian profits may be due to a size effect in stock returns. Possible explanations for the underreaction findings are book-to-market effects ([Asness, 1997](#)), size ([Hameed & Kusnadi, 2002](#), find that momentum profits are not significant for 6 Asian markets when firm size and turnover effects are accounted for), analyst coverage ([Hong, Lim, & Stein, 2000](#)), transaction costs ([Lesmond, Schill, & Zhou, 2004](#)), the legal structure of a country ([Chui, Titman, & Wei, 2003](#)) and trading volume ([Lee & Swaminathan, 2000](#); [Fung et al., 1999](#); [Chan & Hameed, 2000](#)). For example, [Ding, McInish, and Wongchoti \(in press\)](#) find that high (low) volume winners have contrarian (momentum) profits and high (low) volume losers have momentum (contrarian) profits. Other authors attempt to explain these phenomena with behavioral biases ([Barberis, Schleifer, & Vishny, 1998](#); [Daniel, Hirshleifer, & Subrahmanyam, 1998](#); [DeBondt & Thaler, 1985](#); [Lakonishok, Shleifer, & Vishny, 1994](#); [Odean 1998](#); [Scott, Stumpp, & Xu, 2003](#)) and present different channels through which investor psychology can lead to inefficiencies in securities’ returns. The rationale for these studies originates in evidence of empirical psychology that individuals tend at times to underreact or overreact ([Kaheman & Tversky, 1982](#)). Consider, for example, the model developed by [Barberis et al. \(1998\)](#) which is based on representativeness and conservatism and where investors will overreact to strong and salient information and underreact to information low in weight.

The vast majority of the empirical studies on short-term asset return behavior document and attempt to explain inefficiencies in equity returns; very few studies examine international bond markets which have been neglected to a large extent by researchers. Note that although [Khang and King \(2004\)](#) argue that bond markets may be less prone to behavioral biases compared to equity markets, [Cutler, Poterba, and Summers \(1991\)](#) report evidence of medium-term momentum and long-term reversals in bond returns, a finding suggesting that possible return predictability exists in the market for fixed income securities. Our paper aims to address this gap in the literature and investigate the short-run reaction of international government bond investors to extreme (market-moving) events; i.e. events that proxy for unobservable information. We employ daily data on clean price bond indexes from 17 markets for the period 1989–2004 and find a delayed reversal in government bonds prices that is stronger following negative shocks. The pattern persists

¹ [McInish, Ding, Pyun, and Wongchoti \(in press\)](#) report that momentum profits in 5 out of 7 sample markets become insignificant when they account for the Fama–French factors (they remain significant only for Hong Kong and Japan).

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