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Investor Sentiment, Flight-to-Quality, and Corporate Bond Comovement

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Abstract

We examine the dynamics of bond correlation using a broad sample of US corporate bonds, and document that bond correlation varies heavily over time. We attribute this variation in bond correlation to variation in risk factor correlation reflecting time-varying flight-to-quality behavior of investors. We show that risk factor correlation increases when investor sentiment worsens, i.e., corporate bond investors exhibit stronger flight-to-quality when their sentiment is bad. Thus, bad investor sentiment leads to flight-to-quality behavior and, ultimately, high bond correlation. Very good sentiment, in contrast, can cause risk factor correlation and bond correlation to be negative.

JEL classification: G11; G12

Keywords: bond correlation; risk factor correlation; flight-to-quality; investor sentiment

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