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ACCEPTED MANUSCRIPT

The Value of Credit Rating Changes across Economic Cycles

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HIGHLIGHTS

- Credit rating change announcements are more valuable during a recession.
- Equity market reacts more sharply to credit downgrades during contractions.
- Speculative grade bonds are more sensitive to rating change announcements.
- Small firm shares react to bond ratings changes more in downturns than expansions.
- Large firm shares react similarly in downturns and expansions.

ABSTRACT

This paper examines how credit rating changes of US based firms affect equity markets in differing economic conditions and across different bond types. This study examines cross-sectional reactions upon a rating change, controlling for potential variance changes on the event day. Consistent with earlier works, we document a negative wealth effect for downgrades and no reaction for upgrades. Interestingly, however, we find there is a significant difference in stock price reaction to downgrades during periods of contraction versus periods of expansion. Reactions to downgrades are driven by smaller firms. Speculative firms are also more likely to hold higher risk of default and these firms see significant stock price reactions following a credit rating change due to both higher information asymmetry and default likelihood.

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Keywords: rating changes, economic cycle, debt quality

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