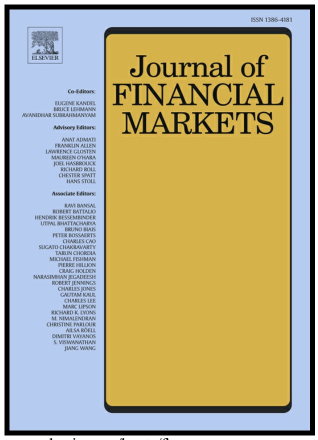

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PII: S1386-4181(15)30123-3
DOI: http://dx.doi.org/10.1016/j.finmar.2017.08.001
Reference: FINMAR443

To appear in: *Journal of Financial Markets*

Received date: 7 December 2015
Revised date: 14 August 2017
Accepted date: 16 August 2017

Cite this article as: Amer Demirovic, Cherif Guermat and Jon Tucker, The relationship between equity and bond returns: An empirical investigation, *Journal of Financial Markets,* http://dx.doi.org/10.1016/j.finmar.2017.08.001

The relationship between equity and bond returns:

An empirical investigation

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Abstract: The correlation between equity and corporate debt is ambiguous. News affecting the value of a firm's assets induces a positive correlation, whereas an increase in the volatility of a firm's assets induces a negative correlation. We examine the conditional correlation between these two securities. While the average correlation is positive, the conditional correlation increases with credit risk, and decreases with equity volatility. Our results are consistent with the thesis that the equity bond relation is dependent on the potential wealth transfer between stock and debt holders. Nevertheless, this relation seems to break down during periods of extreme market uncertainty.

Keywords:

Equity-bond correlation; distance to default; equity volatility

JEL classification:

G11; G12; G14

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