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A Causal Link between Bond Liquidity and Stock Returns

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Abstract

I investigate the causal relationship between bond liquidity and stock returns. An improvement in bond liquidity can positively impact stock returns by reducing funding costs and improving profitability. To investigate this effect, I construct a natural experiment around the implementation of the Trade Reporting and Compliance Engine (TRACE). I find a 2.2% cumulative average abnormal equity return for firms that appeared in TRACE on the first dissemination date (July 1, 2002). Moreover, average abnormal returns are significantly related to the improvement in bond liquidity, the probability of informed trading, leverage, growth opportunities, and propensity to access corporate debt.

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