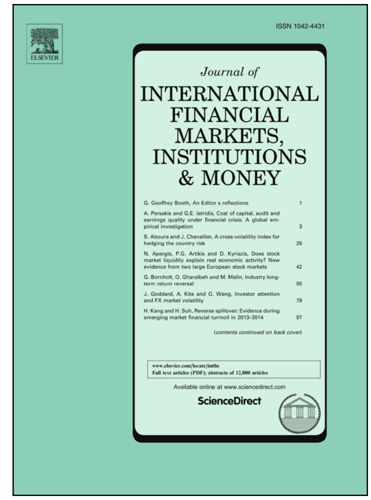

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Is Default Risk Priced Equally Fast in the Credit Default Swap and the Stock Markets? An Empirical Investigation

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Abstract

We examine whether default risk is priced equally fast in the credit default swap (CDS) and the stock markets in the main economic sectors of North America, Europe, the UK, and Asia. We find significant evidence in all of these regions and economic sectors that the stock market leads the price discovery process because it reflects default risk faster than the CDS market. We also find weak evidence that the documented lead-lag relation is not regime-dependent and that is stronger for negative stock market news. Our findings do not confirm the theoretical prediction that the CDS market responds faster than the stock market to changing credit conditions. Consistent with the market selection theories, our findings imply that informed traders prefer to trade default risk mostly in the stock market but uninformed traders mostly in the CDS market.

JEL: G12

Keywords: Credit default swaps; Informational efficiency; Lead-lag relation; Price discovering

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