Informational Efficiency of Credit Default Swap and Stock markets: The impact of Adverse Credit Events

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Abstract

We investigate credit default swap (CDS) and stock price reactions to a variety of credit events, including news of economic distress, financial distress, M&A, SEC probes or accounting irregularities, and leverage buyouts (LBO). The CDS spread shows a large spike of 37% to 96% depending on the event type on a single day and stays fairly flat the month after, supporting efficiency of the CDS market. The stock price drops by 2% to 9% upon the first four types of credit news but rises by 7% on the LBO news, consistent with wealth transfer effects from bondholders to equity holders. With the exception of LBO news, the stock market seems to reveal information about negative credit events before the CDS market. But we find stock price over-reaction for news of a SEC probe, and under-reaction for financial distress news. This may arise from trading behaviors of uninformed investors in the stock market.

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