

Sovereign Credit Risk and Domestic Stock and Bond Market Co-movement

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The primary objective of this study is to investigate the dynamic relationship between sovereign credit risk and the co-movement of stock and bond markets, focusing on market-based measures of sovereign credit risk, specifically sovereign CDS spreads. We utilize the DCC-GARCH model to measure stock and bond market correlations, and the ARDL-bounds testing approach to assess the impact of sovereign credit risk. We have identified several key findings.

First, we find that emerging markets and countries severely affected by financial crises typically experience positive co-movements between their domestic stock and bond markets. In contrast, financially stable countries are more likely to experience negative co-movements. This suggests that market stability significantly influences the nature of stock-bond correlations.

Second, sovereign credit risk, as measured by sovereign CDS spreads, predominantly causes domestic stock and bond markets in the selected countries to move in tandem, both in the short and long term. This indicates that sovereign credit risk exerts contagion effects on domestic financial markets, leading to increased correlations between asset classes. However, in a few stable countries, sovereign credit risk triggers negative co-movements between stock and bond markets, providing evidence for the flight-to-quality phenomenon and the decoupling of financial markets. These findings align with the literature on financial contagion and flight-to-quality, where increased sovereign risk either pulls asset classes together or drives them apart depending on the market's perceived safety of sovereign bonds (Baur & Lucey, 2009; Beirne & Fratzscher, 2013).

Third, our results reveal that asset correlations are more strongly linked to sovereign CDS spreads in the long run than in the short run. Nonetheless, a larger number of countries exhibit a short-run relationship between stock-bond co-movement and sovereign CDS spreads compared to the long run. This disparity highlights the complex and dynamic nature of the relationship between sovereign credit risk and asset correlations over different time horizons.

Fourth, we observe that while some countries display consistency in the short-term and long-term results, others exhibit a divergence between these timeframes. This inconsistency suggests

that the impact of sovereign credit risk on stock-bond correlations is not uniform across countries and can evolve differently depending on a country's specific economic and financial conditions.

Finally, our findings emphasize that sovereign credit risk is a crucial determinant of both the long-term and short-term relationship between stock and bond markets. The heterogeneous responses of stock and bond markets to sovereign credit risk have significant implications for portfolio management. Specifically, our study reveals that increased sovereign credit risk diminishes diversification benefits in most domestic markets, particularly in emerging markets and those that have already faced financial turbulence. In these countries, both stocks and bonds may be perceived as risky during periods of heightened sovereign credit risk, making them less effective as alternative investment options.

For more financially stable countries, however, bond markets may still provide diversification benefits during periods of increased sovereign risk. This finding underscores the importance for investors and portfolio managers to carefully consider alternative investment strategies during periods of elevated sovereign credit risk, rather than relying solely on domestic stock and bond markets. The differential impact of sovereign credit risk on financial markets should guide investors in constructing portfolios that are resilient to the adverse effects of such risks, particularly in volatile economic environments.

Our findings suggest that sovereign credit risk has the potential to destabilize domestic financial markets by increasing the correlation between stock and bond returns, thus to mitigate these risks, policymakers should consider implementing adequate measures to enhance financial stability. Especially, in emerging markets and economies with a history of financial turbulence, there is a need for stronger regulatory oversight and the development of robust financial infrastructures to cushion the effects of sovereign credit risk.

Overall, this study contributes to the literature on financial market co-movements by providing new evidence on the role of sovereign credit risk in shaping the dynamics between stock and bond markets. Future research could explore the transmission channels of sovereign credit risk among domestic financial markets and how other financial assets respond to sovereign credit risk, thereby offering a more comprehensive understanding of the effects of sovereign credit risk on domestic markets.