

Option-based Sentiment Measures and Credit Default Swap Spreads

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Abstract

Our study sheds light on the role of investor sentiment in the credit default swap (CDS) spreads. In particular, we examine both broad market-wide and firm-specific sentiment measures and analyze their influences on the CDS spreads. Sample period covers from 2004 to 2007. We use 5-year CDS for US senior corporate bond and only include the sample firms with complete 5-year quote data on their stocks, options, and credit ratings. Several sentiment measures mainly from options markets are proposed and they have significant impacts on the CDS spreads, especially for speculative-grade firms. Furthermore, the sensitivity of CDS spreads to investor sentiments is regime-dependent. The sentiment measures become more pronounced during turbulent periods in CDS market. We suggest that managers of high-yield bond portfolios should be more concerned about the changes in investor sentiments. Moreover, to seek an improved model for CDS pricing, we had better understand the sources of systematic and idiosyncratic sentiments.

Keyword : Investor sentiment; Credit default swap; Risk-neutral skewness; Credit risk