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Information Content of Equity Volatility for Default and Liquidity Risks in Corporate Bond Market

Idiosyncratic equity volatility (idiosyncratic volatility, hereafter) refers to the firm-specific risk or volatility adjusted for the portfolio and market-wide effects. It represents the diversifiable component of risk from holding a stock. In this paper, we examine the specific channels through which the idiosyncratic volatility affects the corporate bond spreads. We study how idiosyncratic volatility affects different components of bond spreads. We address the following questions. Does a higher idiosyncratic volatility imply a higher default risk or liquidity risk? What is the effect of idiosyncratic volatility on bond spreads once we control for

(a) default risk? and

(b) both default and liquidity risks?

What is the relative impact on default and liquidity risk components of the bond spread, for movements in idiosyncratic volatility. By exploring these questions, we hope to better understand the relationship between the credit and liquidity components of corporate bond spreads, and the underlying firm specific news events.