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Economics

How Bond Markets Can Predict Moves in Stocks

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July 31, 2017, 4:01 AM UTC Updated on July 31, 2017, 8:22 AM UTC

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The “smart” money may deserve its reputation after all.

High-yield bonds moving with the ebbs and flows of U.S. earnings announcements tend to predict stock returns for a slew of issuers -- particularly firms with a modest level of institutional equity ownership. So stock investors seeking an informational edge should keep their eyes on junk-bond prices on the heels of earnings reports.

That’s the conclusion of a [paper](#) by Omri Even-Tov of the University of California at Berkeley, who took a look at

the bond returns that followed a whopping 19,518 quarterly earnings announcements of 770 firms from 2005 to 2014.

“The bond price reaction provides incremental explanatory power for post-announcement stock returns over and above the information contained in the earnings surprise (the post-earnings announcement drift), the level of reported accruals (the accruals anomaly), and the immediate stock price reaction to the earnings announcement,” writes Even-Tov, an assistant professor at the Haas School of Business.



“This suggests that the sophistication of bond traders relative to stock traders is a driver of the ability of bond returns to predict post-announcement stock returns,” according to the paper, published this month in the Journal of Accounting and Economics.

Even-Tov is wading into three of the most contentious debates in finance: the efficiency of the credit market relative to its stock-market peer; the ability of active managers to exploit mispricing in asset classes; and whether the credit cycle’s tendency to presage turning points in equities and the economy stems from all the “smart” money invested in bonds.

The author calculates a given firm’s bond price reaction to earnings from the value-weighted average of its individual bond returns and finds a positive correlation with buy-and-hold stock returns 60 days after an earnings announcement, above what could be expected from the immediate earnings surprise.

In other words, when a company’s bond price moves in the aftermath of an earnings beat, for example, its share price will eventually follow suit as stock investors belatedly decipher the complex financial statements.

Predictive Ability

The study has a big exception: Junk bonds with low liquidity -- which tends to hike trading costs -- fail to foretell equity returns. That's because of the diminished pool of institutional investors punting on the issuer's prospects with the requisite speed.

“The predictive ability of bond prices is a function of bond liquidity: the earnings-announcement price reaction of the more liquid bonds are predictive of post-announcement stock returns, while those of the less liquid bonds are not,” the paper notes. What's more, investment-grade obligations are less sensitive to earnings information given their lower risk of default, according to the study.

Previous research has shown the different ways bonds and stocks dance to the earnings beat, but Even-Tov reckons his paper may be the first to supply evidence that the bond market's reaction to earnings releases can predict stock returns down the road.

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As markets gear up for higher interest rates over the next year, relatively late in the business cycle, stock investors would do well to take notice of their high-yield counterparts, according to this deep dive.

(Updates with quote on liquidity in ninth paragraph.)

