Default exposure to downside risks and the cross-section of expected returns

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Abstract:

Intertemporal consumption-based equilibrium asset pricing, featuring downside risks through disappointment aversion preferences, implies that investors value assets through their undesirable exposure to two regular risk factors (market return and volatility), and three downside risk factors (the disappointment factor, the market downside factor, and the volatility downside factor). We show that these factors have both a predictive and a contemporaneous relationship with credit derivative swap spreads. Our results are robust to including macroeconomic factors, firm characteristics and other tail risk factors in the literature. We measure individual firm credit risk exposure to regular and downside risk factors using the CDS term structure. We find that these exposure information are also incorporated in the cross-section of expected stock returns.

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