

Option-implied Sentiment Measures and Credit Default Swap Spreads

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Abstract

This study sheds light on the role of option-implied investor sentiment in the credit default swap (CDS) market. Due to the limits to arbitrage caused by credit or counterparty risk and margin requirements, CDS spreads may deviate from fundamentals under the influence of sentiment-driven investors who possess excessively bearish or bullish perceptions to the market or to the firms. We derive several systematic and firm-specific sentiment measures from index options and individual stock options, respectively, and we investigate their impacts on CDS spreads. The sentiment influence is significant, even after controlling the fundamental variables, and is more pronounced for lower-rated CDS obligors during a turbulent period, which is consistent with the limits to arbitrage theory.

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