Paper presented at the International Conference on **C**ontemporary **E**conomics and Finan**c**ial Governan**ce** (Inter4C), held in Indonesia, Bali 2016.

Dependency of Bond Returns on the Sovereign Default Risk

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Abstract

The default of a country on its debt obligations is referred to as the sovereign default. The increase in the risk of sovereign default, usually gives rise to a significant increase in the borrowing costs. In this note, the dependency of bonds to sovereign default risk is studied using several bond indices and the credit default swap. The correlation structure of the bond and credit default swap market is empirically derived. The correlation relationships suggest that the credit risk bearing bonds react the strongest to the instantaneous default risk changes. Furthermore, the empirical results suggest that the effective repricing of default risk by the bond market only occurs after 8-months. For the sample of bond data considered it was interesting to note that the repricing of the sovereign default risk does not occur at a much stronger level to the credit bonds than to the government bonds.

Keywords: Sovereign default; bonds, credit default swaps; bond market correlations
JEL Classification: C52, D40, D53, G12, G23