Equilibrium Credit Spreads and the Macroeconomy

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March 2009‡

ABSTRACT

Credit markets play an important role in the macroeconomy and credit market data is often used to predict both future macroeconomic and stock market performance. In this paper we propose a tractable general equilibrium asset pricing model with heterogeneous firms that links movements in stock and bond markets to macroeconomic activity. The model suggests that movements in risk premia in corporate bond markets are an important determinant of aggregate fluctuations. We show that movements in credit spreads forecast recessions by predicting future movements in corporate investment. Endogenous movements in credit markets allow our model to quantitatively match the observed conditional and unconditional movements in stock market returns and credit spreads with a reasonable amount of aggregate volatility.

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