Does the Tail Wag the Dog?
The Price Impact of CDS Trading*

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ABSTRACT

We investigate empirically whether credit default swaps (CDS) spreads are influenced by shifts in demand/supply dynamics in the market. We find that while changes in CDS spreads are insensitive to accumulated trading volume, net buying interest (NBI), a measure we construct to measure latent trade imbalance between consecutive trades, significantly affects CDS price changes. This price impact appears to be statistically significant even in the absence of concomitant stock price changes, but its economic magnitude is on par with the average bid-ask spread. While changes in fundamental information contribute to the price impact of net buying interest, liquidity of CDS contracts is another factor. We show that the effect of NBI is three times stronger in the least liquid CDS contracts than in the most liquid CDS contracts. Furthermore, exogenous supply shocks attenuate the initial price impact and accelerate the subsequent price reversal.

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