Executive Summary:

We use a unique data-set to study liquidity effects in the US corporate bond market, covering over 30,000 bonds. Our analysis explores time-series and cross-sectional aspects of corporate bond yield spreads, focusing on the impact of liquidity factors, while controlling for credit risk. We examine three different regimes, the GM/Ford crisis in 2005, when a segment of the corporate bond market was affected, the sub-prime crisis since mid-2007, which was much more pervasive across markets, and the period in between, when market conditions were more benign.

We employ a variety of liquidity measures and find that liquidity effects explain approximately one third of market-wide corporate yield spread changes, and are even more pronounced during crisis periods. We also examine liquidity effects in segments of the market: financial sector vs. industrial firms, investment grade vs. speculative grade bonds, and retail vs. institutional trades. These results yield insights regarding the liquidity drivers of corporate yields, particularly during crisis periods and, thus, are relevant for many applications such as bond pricing, risk management, bond issuance, investment and portfolio optimization decisions, and financial market regulation.