ABSTRACT

Global asset-pricing models have failed to capture the cross section of country equity returns. Emerging markets have displayed strikingly large and robust positive pricing errors. Country-level characteristics have played a significant role in pricing international equities, suggesting that financial markets may not be fully integrated. This paper offers a risk-based explanation that resolves these deviations from global asset pricing. A world credit risk factor explains the positive pricing errors in emerging market equities. Moreover, in the presence of this credit risk factor, country-level characteristics no longer play a role in pricing global equities. Factor models that include the world credit risk factor uniformly outperform, both in the time-series and the cross-section, competing specifications that exclude this factor. Over the 1989-2009 period, the risk premium for systematic credit risk exposure is 83 basis points per month and its importance has dramatically increased in recent years.

The World Price of Credit Risk