FIXED INCOME

Financing Investment With Long-Term Debt and Uncertainty Shocks

February 6, 2012

Working paper

This paper proposes a model of financing and investment for firms that attempts to explain both the weak correlation of Tobin's Q with investment, and the higher correlation of bond yields with investment. The model augments the standard neoclassical model with financing frictions. Specifically, it assumes that firms fund their investment by issuing equity or long-term defaultable debt.

These features imply a higher probability of default and lower leverage. Consistent with intuition, the volatility shocks generate higher correlations between credit spreads and investment. However, shocks fail to weaken the correlation between Q and investment. Overall, the authors conclude, the correlation between spreads and investment is still too small, and the correlation between Q and investment is still too high, compared to the data.

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