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Cross Markets Equilibrium Relationship : An Indian Evidence

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Abstract

The understanding towards the two markets, debt and equity, is important as they both comprise the optimum portfolio. The present study focused on the general paranoia among the investors that a little change in the equity markets, would cause them to switch themselves to the debt market, in order to secure their returns. This process of continuous arbitrage helps in determining the prices of the assets. Further to this explanation, the relationship between interest rates and bond prices, helped in determining the short run cointegration, running from bond markets towards equity markets. Infact, in the long run also, it was seen the yield to maturity and stock prices co-move, and direction of this relationship runs from YTM to stock markets. This indicates that bond prices and yield to maturity of bond index play an important role in determining the direction of the BSE market. This helps in understanding that investors are continuously involved in the process of arbitrage, until they achieve some equilibrium price.

I. Introduction

FINANCIAL MARKET MAINLY comprises of two types of securities, debt and equity. These are the fundamental securities which are included in any portfolio. An optimal portfolio is considered when it trades off the risk and returns from the investment. It is suggested to include both fixed income securities and risky securities in the portfolio, as it maintains the trade-off between the risk and return will be maintained. The judgment of the portfolio depends on the complexities of each security. In fact, the understanding of the nature of each security would help to know the returns which can be derived from them. Furthermore, the interdependence between the securities or markets would help to know the accurate relationship between the two.

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