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Decomposing the Yield Curve

AFA 2010 Atlanta Meetings Paper

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Abstract

We construct an affine model that incorporates bond risk premia. By understanding risk premia, we are able to use a lot of information from well-measured risk-neutral dynamics to characterize real expectations. We use the model to decompose the yield curve into expected interest rate and risk premium components. We characterize the interesting term structure of risk premia -- a forward rate reflects expected excess returns many years into the future, and current slope and curvature factors forecast future expected returns even though they do not forecast current returns.

Keywords: affine model, term structure

JEL Classification: E43

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