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Interest Rates under Falling Stars

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Article Information

Abstract

Macro-finance theory implies that trend inflation and the equilibrium real interest rate are fundamental determinants of the yield curve. However, empirical models of the term structure of interest rates generally assume that these fundamentals are constant. We show that accounting for time variation in these underlying long-run trends is crucial for understanding the dynamics of Treasury yields and predicting excess bond returns. We introduce a new arbitrage-free model that captures the key role that long-run trends play in determining interest rates. The model also provides new, more plausible estimates of the term premium and accurate out-of-sample yield forecasts.

Citation

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Additional Materials

Replication Package

Supplemental Appendix

Author Disclosure Statement(s)

JEL Classification

E31 Price Level; Inflation; Deflation

E43 Interest Rates: Determination, Term Structure, and Effects

E47 Money and Interest Rates: Forecasting and Simulation: Models and Applications