Information in the yield curve

Comments on a paper by Dewachter, Iania and Lyrio

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- 'Benchmark' model distinguishes:

  macro and latent variables
  expectations and risk premia
  stationary and non-stationary influences

Adding financial factors

- This paper adds latent variables reflecting bank default and liquidity factors
- Adding significantly to the explanatory power of the model, especially at the short end and at high frequency
- Helping to resolve the yield gap 'conundrum' of the mid 2000's
- And throw light on the initial stage of the credit crunch 2007-2008

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- This adds an extra factor but saves a large number of parameters compared to the general Duffee (2002) approach

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- The long term yield asymptote is not well defined if there is a unit root (Campbell, Lo, MacKinlay (1997))
- Making it difficult to model longer maturities

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- Bayesian macro models (Justiniano and Primaceri (2009), Benati and Surico (2009) and many others) also support the heteroskedastic model
- Heteroskedastic MF models suggest that the yield curve contains useful information about future movements in macroeconomic volatility. as well as inflation and activity

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- It is now strongly mean reverting
- Thus we should allow for changes in monetary policy regime when modelling the macroeconomy and the yield curve over long runs of data