

Interpreting the Term Structure

- Since the yield curve reflects expectations of future short rates, we can use the term structure to infer the expectations of other investors in the economy and use those expectations as benchmarks for our own analysis.
- Unfortunately, it is hard to extract information on interest rate expectations. Why?
 - The term structure also has information about liquidity premiums.
 - forecast of interest rate changes may be coming from changes in inflation expectations or the real interest rate, which has different implications for proper interpretation of the term structure
 - Changes in economic events can complicate analysis

Forward Inflation Rates

- Forward rates from bonds are nominal rates
- Using price-level indexed bonds such as Treasury inflation protected securities (TIPS) we can calculate the forward real interest rate and forward inflation rates
 - TIPS guarantees you a real, rather than a nominal return. The principal accrues with inflation throughout the lifetime and the coupon payment is based on a real rate of return

- Does this mean that TIPs will outperform bonds?
 - The yield on a bond may be high enough to beat the yield on TIPS even with inflation because the price of TIPs depend on the market's expectations of inflation and whether those expectations are realized
 - TIPs usually carry interest rates lower than other government or corporate securities so they may be less optimal for investors especially when inflation is minimal or nonexistent

The Break-Even Inflation Rate

- The inflation rate that makes neither the nominal or real bond more attractive is called the break-even inflation rate
- The break-even inflation rate is a market based measure of expected inflation. It is the difference between the yield of a nominal bond and an inflation linked bond of the same maturity.

Caveat

- Inflation compensation = expected inflation + inflation risk premium + other factors
- So for example, we can have a falling break even rate even when inflation expectations are stable given that we have a large liquidity premium