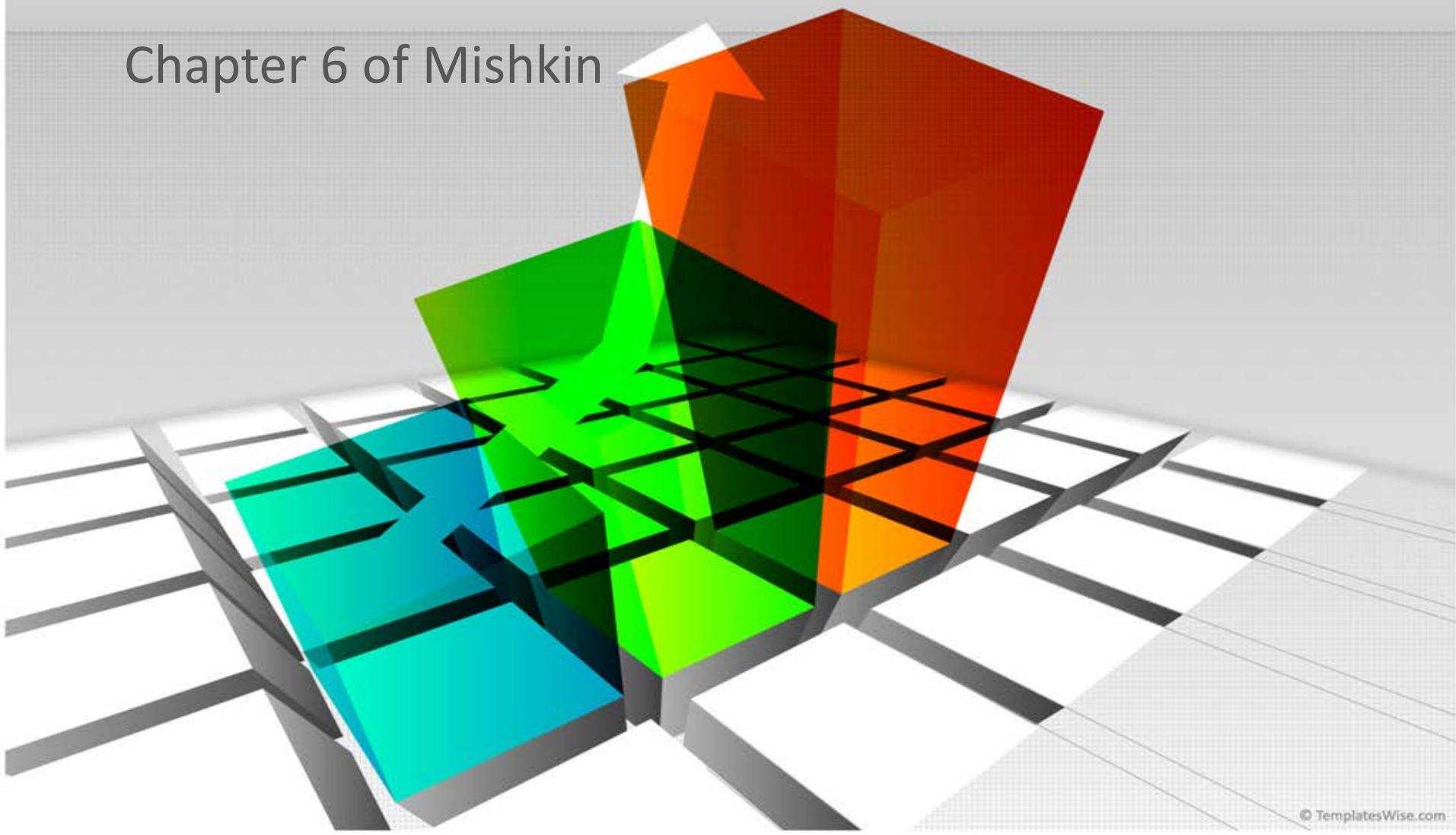
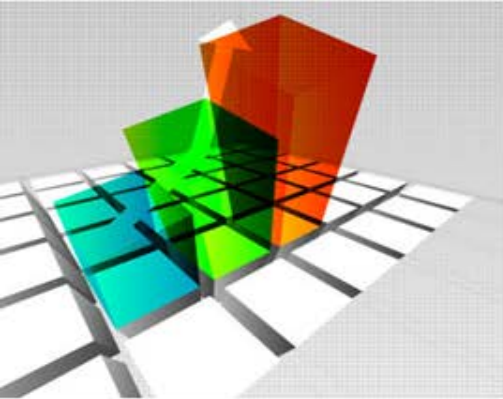


The Risk and Term Structure of Interest Rates

Chapter 6 of Mishkin





Previous Lecture (1)

- 2 frameworks to analyse movement in the interest rate:
 - Loanable Funds Framework
 - Liquidity Preference Framework.
- Loanable Funds Framework looks at the bond market.



Previous Lecture (2)

- Liquidity Preference Framework looks at money market.
- We have already known what shifts demand or supply in these two markets.
- The shifts in demand or supply will change the interest rate.

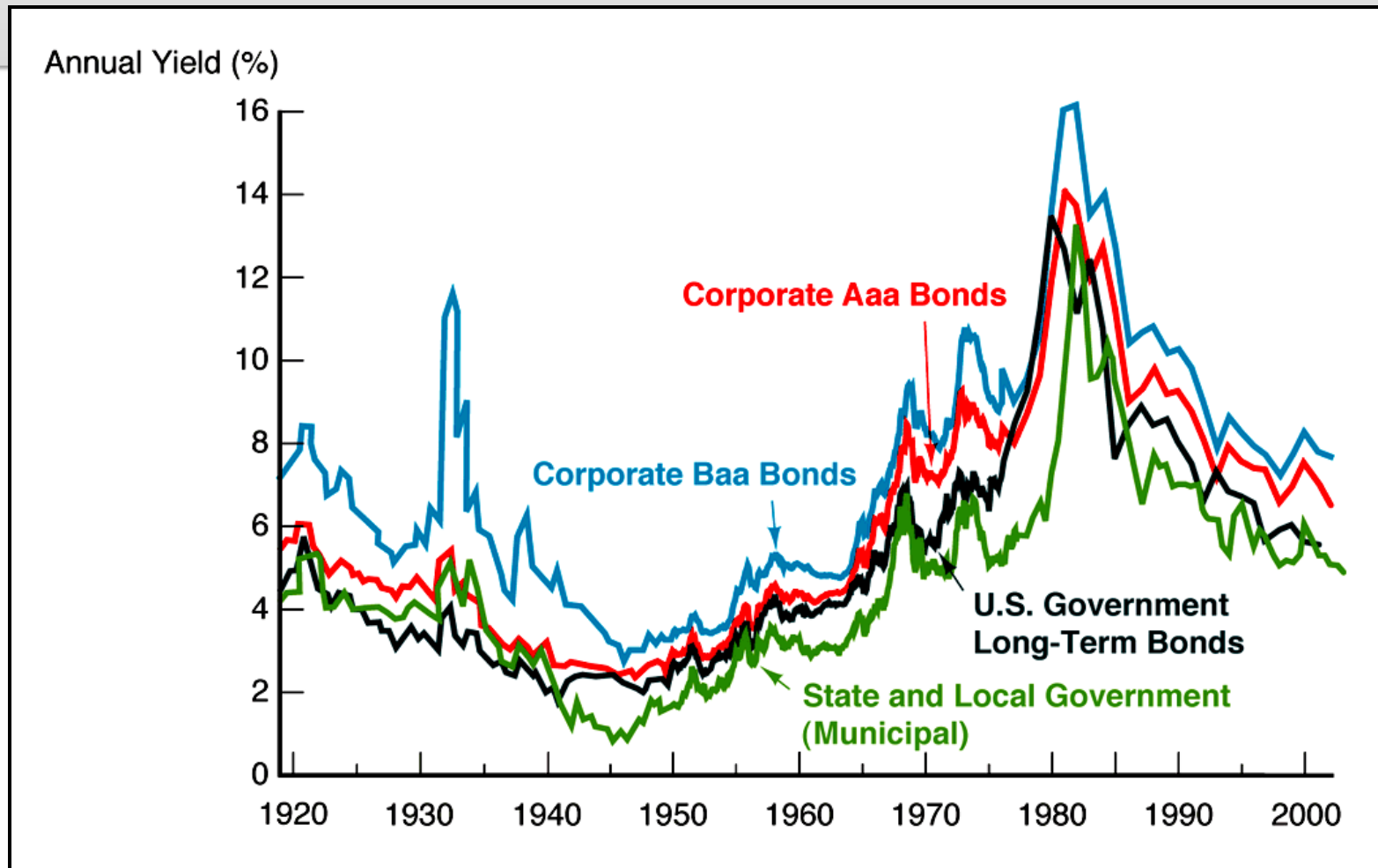
Risk Structure of Interest Rates (1)

- Suppose there are 3 options in the market:
 - Option 1: Government bond with 4 % interest rate
 - Option 2: PTT bond with 4 % interest rate
 - Option 3: TRUE bond with 4 % interest rate.

Assume that they have the same maturity date.

- Which one is your 1st choice?
- Which one is your 2nd choice?
- Why?

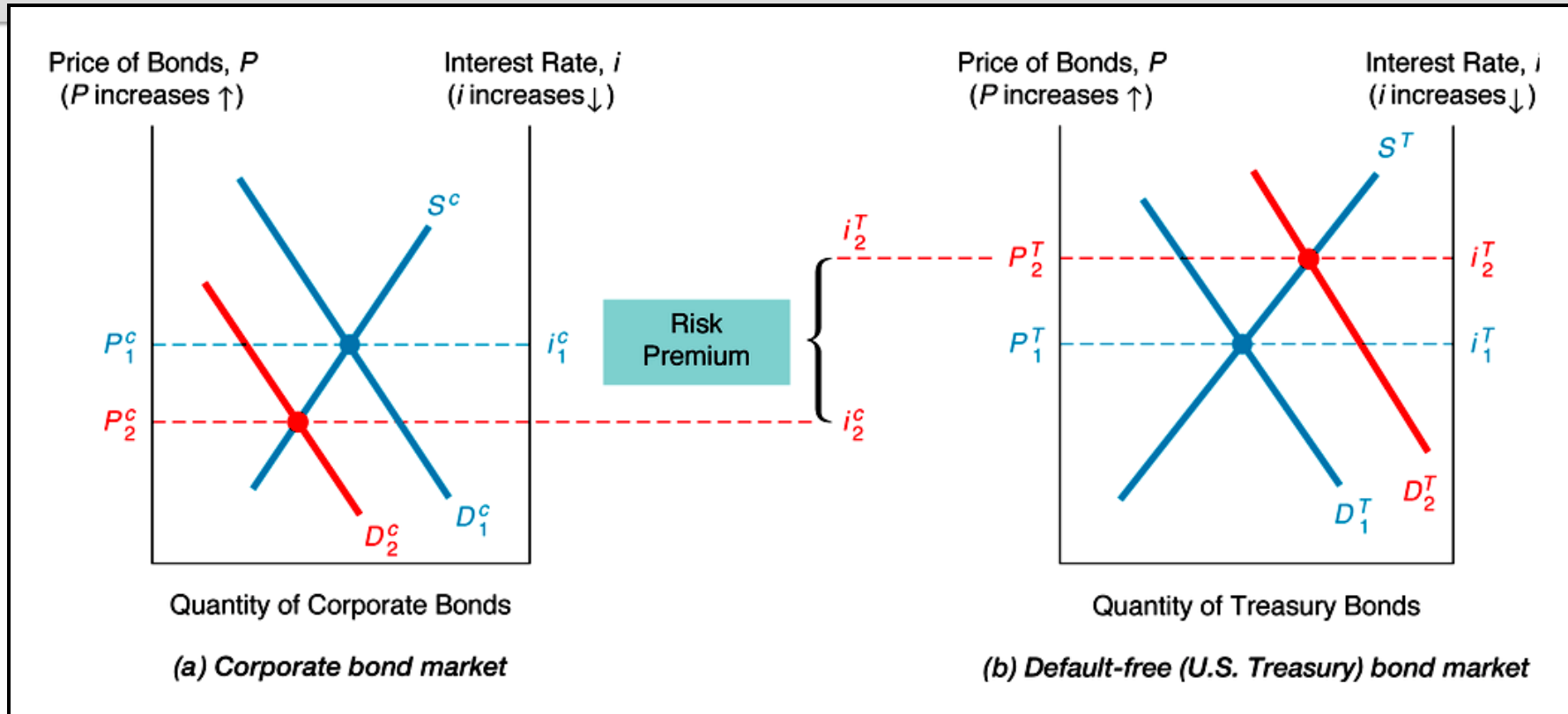
Risk Structure of Interest Rates (2)



Risk Structure of Interest Rates (3)

- Default Risk
 - **Default** occurs when the issuer of the bond is unable or unwilling to make payments when promised.
 - Corporate suffering big losses might be more likely to suspend interest payments on its bonds. This means its bonds have high default risk.
 - Treasury or BOT bonds are usually considered to have no default risk. They are called **default-free bonds**.
 - The spread is called **risk premium**.

Risk Structure of Interest Rates (4)



Risk Structure of Interest Rates (5)

Corporate Bond Market

1. Risk of corporate bonds \uparrow (Rel expected return \downarrow), $D^c \downarrow$, D^c shifts left
2. $P^c \downarrow$, $i^c \uparrow$

Treasury Bond Market

3. Relative risk of Treasury bonds \downarrow (Rel expected return \uparrow), $D^T \uparrow$, D^T shifts right
4. $P^T \uparrow$, $i^T \downarrow$

Outcome:

Risk premium, $i^c - i^T$, rises

Risk Structure of Interest Rates (6)

Source: <http://www.trisrating.com/>

	TRU108A: Bt3,000 mil sr debs due 2011	A+	
True Corporation PLC	Company TRUE112A: Bt6,750 mil sr secrd partially guaranteed debs due 2011 TRUE107A: Bt2,000 mil sr secrd debs due 2010 TRUE117A: Bt2,413 mil sr secrd debs due 2011 TRUE127A: Bt1,000 mil sr secrd debs due 2012 TRUE144A: Bt6,183 mil sr secrd debs due 2014 TRUE151A: Bt7,000 mil sr secrd debs due 2015	BBB/Stable A BBB BBB BBB BBB BBB	
Univentures PLC	Company	BBB/Stable	
Vinythai PLC	Company	A-/Stable	
GOVERNMENT-RELATED AGENCIES AND STATE ENTERPRISES			
Aeronautical Radio of Thailand Ltd.	Company	AA/Stable	
Bangkok Metropolitan Administration	Issuer	AA+/Stable	
PTT Exploration and Production PLC	Company PTEP102A: Bt3,500 mil sr debs due 2010 PTEP106A: Bt6,000 mil sr debs due 2010 PTTEP125A: Bt18,300 mil sr debs due 2012 PTEP126A: Bt3,500 mil sr debs due 2012 PTTEP135A: Bt5,000 mil sr debs due 2013 PTTEP145A: Bt11,700 mil sr debs due 2014 PTEP183A: Bt2,500 mil sr debs due 2018 PTTEP195A: Bt5,000 mil sr debs due 2019 PTEP226A: Bt3,000 mil sr debs due 2022	AAA/Stable AAA AAA AAA AAA AAA AAA AAA AAA AAA	
Thai Airways International PLC	Company	A/Stable	

Risk Structure of Interest Rates (7)

TRIS Rating uses eight letter rating symbols for announcing medium- and long-term credit ratings. The ratings range from AAA, the highest rating, to D, the lowest rating. The medium- and long-term debt instrument covers the period of time from one year up. The definitions are:

AAA

The highest rating, indicating a company or a debt instrument with smallest degree of credit risk. The company has extremely strong capacity to pay interest and repay principal on time, and is unlikely to be affected by adverse changes in business, economic or other external conditions.

BBB

The rating indicates a company or a debt instrument with moderate credit risk. The company has adequate capacity to pay interest and repay principal on time, but is more vulnerable to adverse changes in business, economic or other external conditions and is more likely to have a weakened capacity to pay interest and repay principal than debt in higher-rated categories.

BB

The rating indicates a company or a debt instrument with a high credit risk. The company has less than moderate capacity to pay interest and repay principal on time, and can be significantly affected by adverse changes in business, economic or other external conditions, leading to inadequate capacity to pay interest and repay principal.

Risk Structure of Interest Rates (8)

- Liquidity
 - As before, a liquid asset is one that can be quickly and cheaply converted into cash.
 - The more liquid an asset is, the more desirable it is (holding everything else constant).

Risk Structure of Interest Rates (9)

If corporate bonds become less liquid:

Corporate Bond Market

1. Less liquid corporate bonds $D^c \downarrow$, D^c shifts left
2. $P^c \downarrow$, $i^c \uparrow$

Treasury Bond Market

1. Relatively more liquid Treasury bonds, $D^T \uparrow$, D^T shifts right
2. $P^T \uparrow$, $i^T \downarrow$

Outcome:

Risk premium, $i^c - i^T$, rises

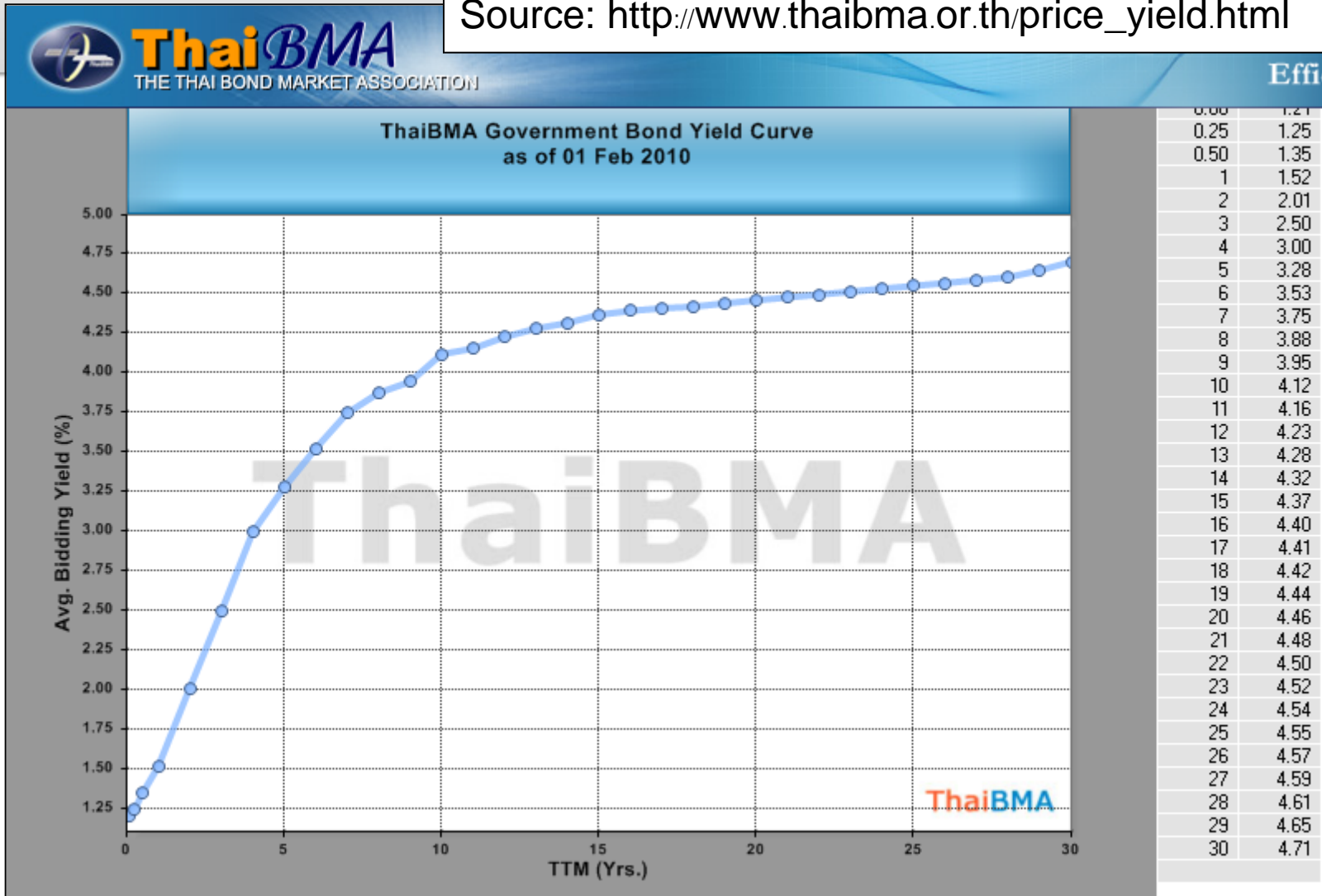
Risk premium reflects not only corporate bonds' default risk, but also lower liquidity

Term Structure of Interest Rates (1)

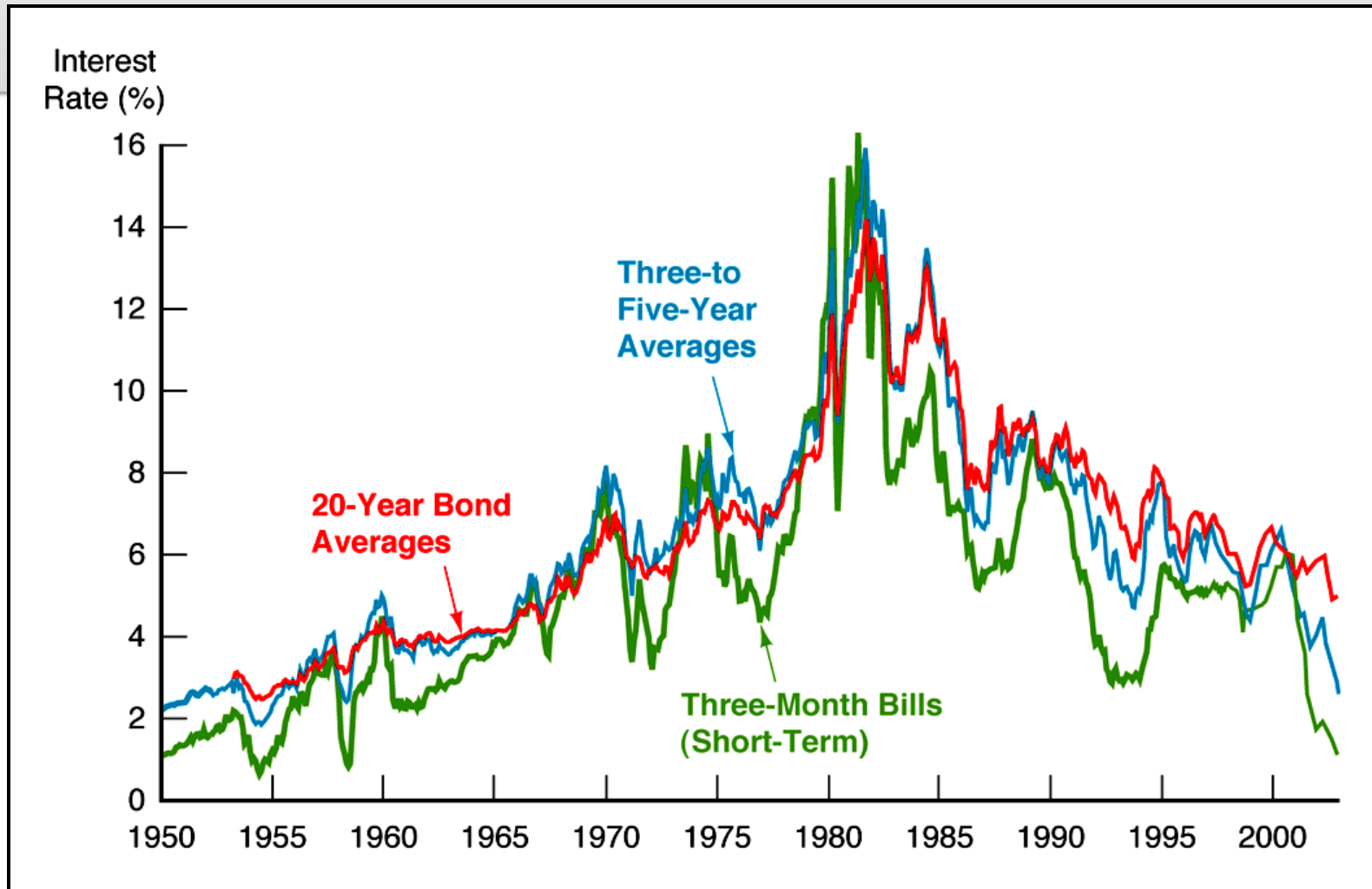
- Suppose there are 3 options in the market:
 - Option 1: 1-Year G. bond with 3 % interest rate
 - Option 2: 3-Year G. bond with 3 % interest rate
 - Option 3: 10-Year G. bond with 3 % interest rate.
- Which one is your 1st choice?
- Which one is your 2nd choice?
- Why?

Term Structure of Interest Rates (2)

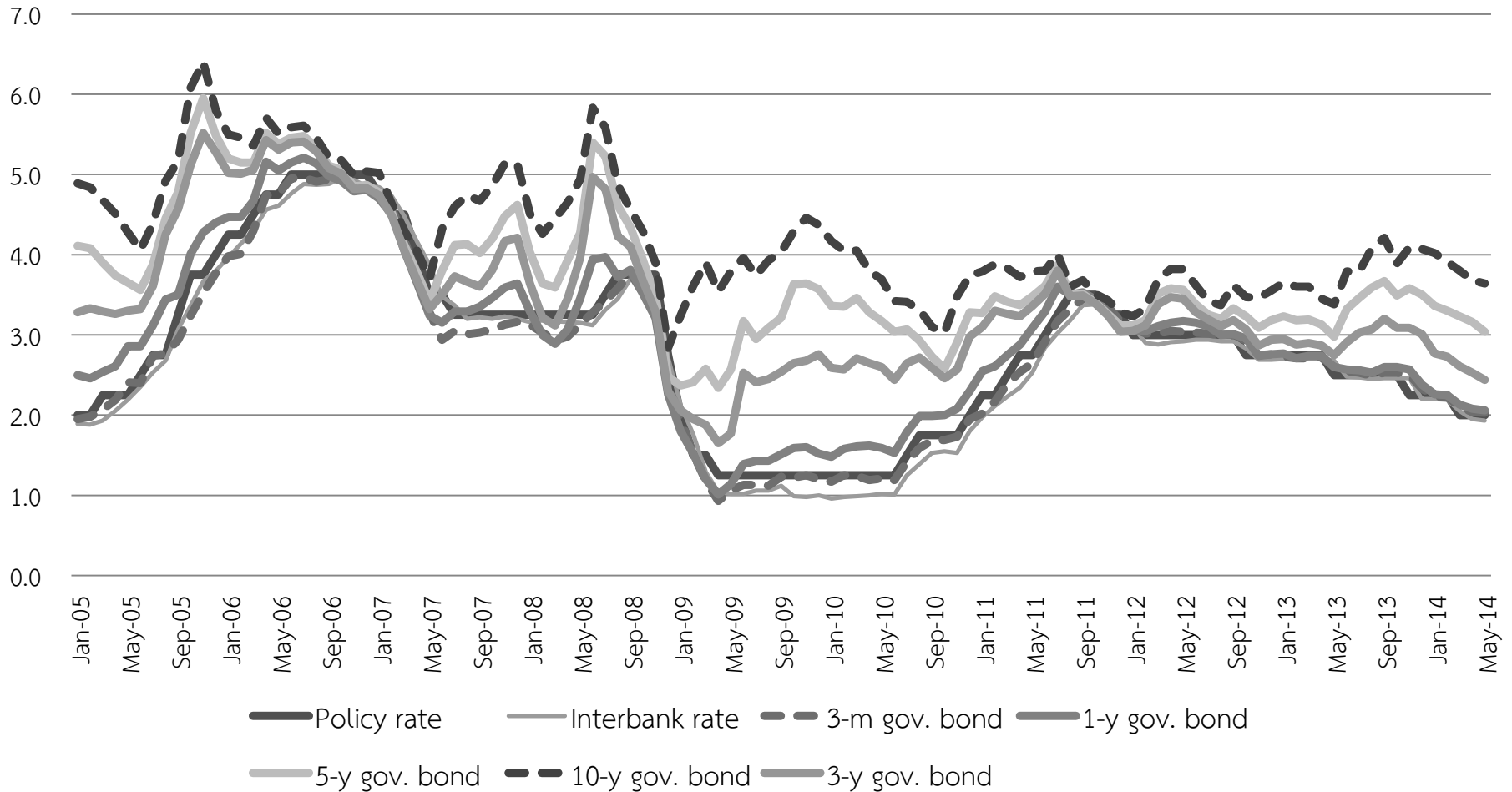
Source: http://www.thaibma.or.th/price_yield.html



Term Structure of Interest Rates (3)



Term Structure of Interest Rates (4)



Term Structure of Interest Rates (5)

Yield curve is a plot of the yields on the same bonds with differing terms to maturity.

1. Interest rates for different maturities move together over time.
2. Yield curves tend to have steep upward slope when short rates are low and downward slope when short rates are high.
3. Yield curve is typically upward sloping.

Term Structure of Interest Rates (6)

Three Theories of Term Structure

1. Expectations Theory
2. Segmented Markets Theory
3. Liquidity Premium (Preferred Habitat) Theory
 - A. Expectations Theory explains 1 and 2, but not 3
 - B. Segmented Markets explains 3, but not 1 and 2
 - C. Solution: Combine features of both Expectations Theory and Segmented Markets Theory to get Liquidity Premium (Preferred Habitat) Theory and explain all facts

Expectations Hypothesis (1)

Key Assumption: Bonds of different maturities are perfect substitutes

Implication: RET^e on bonds of different maturities are equal

Investment strategies for two-period horizon

1. Buy \$1 of one-year bond and when it matures buy another one-year bond
2. Buy \$1 of two-year bond and hold it

Expected return from strategy 2

$$\frac{(1 + i_{2t})(1 + i_{2t}) - 1}{1} = \frac{1 + 2(i_{2t}) + (i_{2t})^2 - 1}{1}$$

Since $(i_{2t})^2$ is extremely small, expected return is approximately $2(i_{2t})$

Expectations Hypothesis (2)

Expected Return from Strategy 1

$$\frac{(1 + i_t)(1 + i_{t+1}^e) - 1}{1} = \frac{1 + i_t + i_{t+1}^e + i_t(i_{t+1}^e) - 1}{1}$$

Since $i_t(i_{t+1}^e)$ is also extremely small, expected return is approximately

$$i_t + i_{t+1}^e$$

From implication above expected returns of two strategies are equal:

$$2(i_{2t}) = i_t + i_{t+1}^e$$

Solving for i_{2t}

$$i_{2t} = \frac{i_t + i_{t+1}^e}{2}$$

Expectations Hypothesis (3)

More generally for n -period bond:

$$i_{nt} = \frac{i_t + i_{t+1}^e + i_{t+2}^e + \dots + i_{t+(n-1)}^e}{n}$$

In words: Interest rate on long bond = average short rates expected to occur over life of long bond

Numerical example:

One-year interest rate over the next five years 5%, 6%, 7%, 8% and 9%:

Interest rate on two-year bond:

$$(5\% + 6\%)/2 = 5.5\%$$

Interest rate for five-year bond:

$$(5\% + 6\% + 7\% + 8\% + 9\%)/5 = 7\%$$

Interest rate for one to five year bonds:

5%, 5.5%, 6%, 6.5% and 7%.

Expectations Hypothesis and Term Structure Facts (1)

Explains why yield curve has different slopes:

1. When short rates expected to rise in future, average of future short rates = i_{nt} is above today's short rate: therefore yield curve is upward sloping
2. When short rates expected to stay same in future, average of future short rates are same as today's, and yield curve is flat
3. Only when short rates expected to fall will yield curve be downward sloping

Expectations Hypothesis and Term Structure Facts (2)

Expectations Hypothesis explains Fact 1 that short and long rates move together

1. Short rate rises are persistent

2. If $i_t \uparrow$ today, i_{t+1}^e, i_{t+2}^e etc. $\uparrow \Rightarrow$ average of future rates \uparrow
 $\Rightarrow i_{nt} \uparrow$

3. Therefore: $i_t \uparrow \Rightarrow i_{nt} \uparrow$, i.e., short and long rates move together

Expectations Hypothesis and Term Structure Facts (3)

Explains Fact 2 that yield curves tend to have steep slope when short rates are low and downward slope when short rates are high

1. When short rates are low, they are expected to rise to normal level, and long rate = average of future short rates will be well above today's short rate: yield curve will have steep upward slope
2. When short rates are high, they will be expected to fall in future, and long rate will be below current short rate: yield curve will have downward slope

Expectations Hypothesis and Term Structure Facts (4)

Doesn't explain Fact 3 that yield curve usually has upward slope

Short rates as likely to fall in future as rise, so average of future short rates will not usually be higher than current short rate: therefore, yield curve will not usually slope upward

Segmented Markets Theory

Key Assumption: Bonds of different maturities are not substitutes at all

Implication: Markets are completely segmented: interest rate at each maturity determined separately

Explains Fact 3 that yield curve is usually upward sloping

People typically prefer short holding periods and thus have higher demand for short-term bonds, which have higher price and lower interest rates than long bonds

Does not explain Fact 1 or Fact 2 because assumes long and short rates determined independently

Liquidity Premium Theories (1)

Key Assumption: Bonds of different maturities are substitutes, but are not perfect substitutes

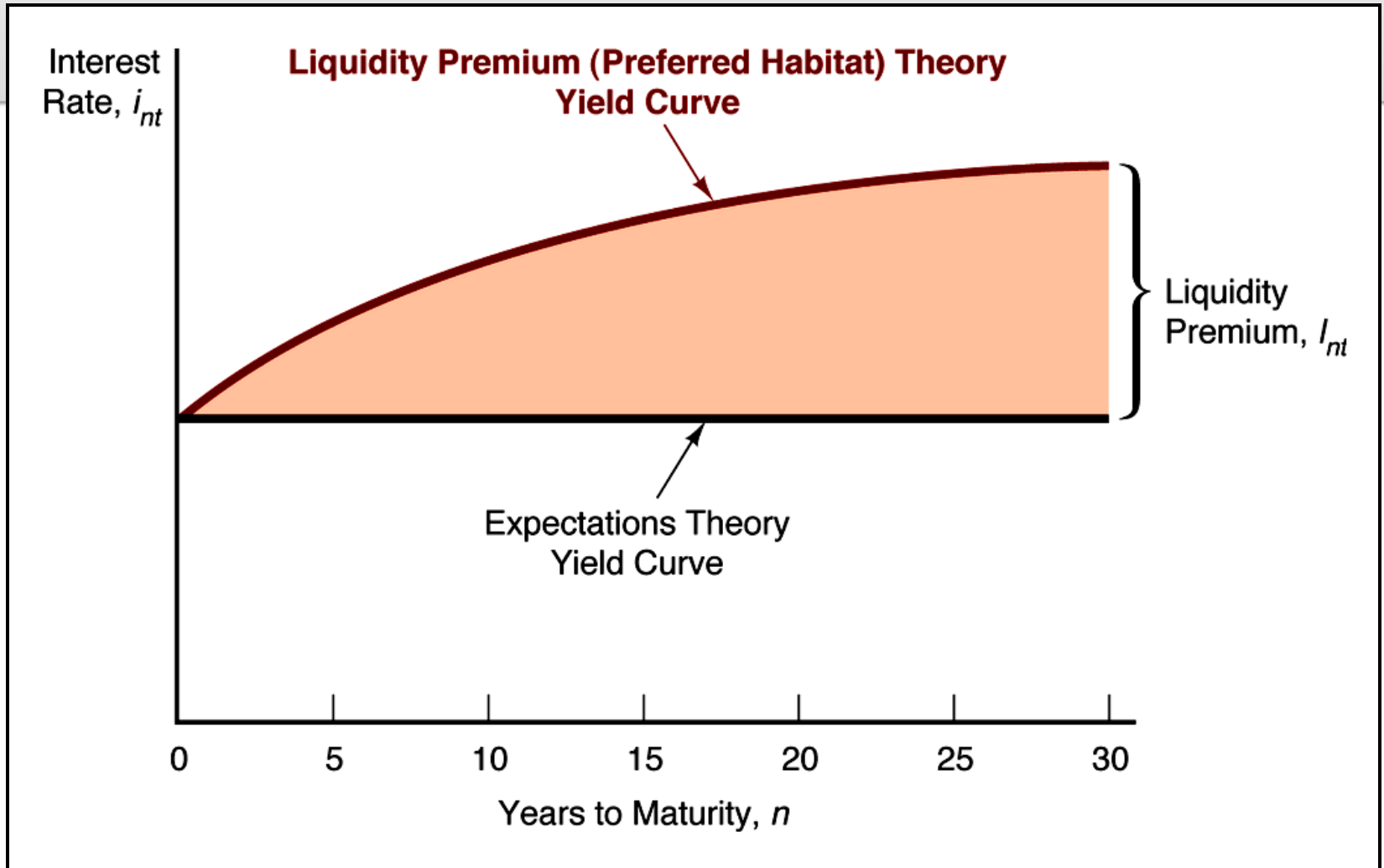
Implication: Modifies Expectations Theory with features of Segmented Markets Theory

Investors prefer short rather than long bonds \Rightarrow must be paid positive liquidity (term) premium, l_{nt} , to hold long-term bonds

Results in following modification of Expectations Theory

$$i_{nt} = \frac{i_t + i^e_{t+1} + i^e_{t+2} + \dots + i^e_{t+(n-1)}}{n} + l_{nt}$$

Liquidity Premium Theories (2)



Liquidity Premium Theories (3)

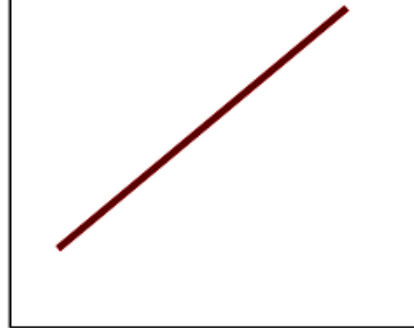
Explains all 3 Facts

Explains Fact 3 of usual upward sloped yield curve by investors' preferences for short-term bonds

Explains Fact 1 and Fact 2 using same explanations as expectations hypothesis because it has average of future short rates as determinant of long rate

Market Predictions of Future Short Rates

Yield to Maturity



Term to Maturity

(a) *Future short-term interest rates expected to rise*

Yield to Maturity



Term to Maturity

(b) *Future short-term interest rates expected to stay the same*

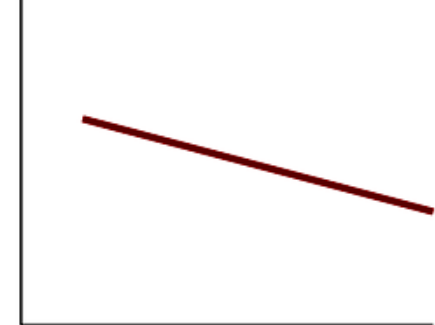
Yield to Maturity



Term to Maturity

(c) *Future short-term interest rates expected to fall moderately*

Yield to Maturity



Term to Maturity

(d) *Future short-term interest rates expected to fall sharply*