

# The Structure of Risks in Equilibrium Affine Models of Bond Yields \*

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April 27, 2013

## Abstract

Equilibrium term structure models (*ETSMs*) in which the state of the economy follows an affine process typically imply that expected excess returns on bond portfolio positions are determined entirely by the conditional variances of the state variables. We show that these two assumptions alone— an affine state process with conditional variances that span expected excess returns— are sufficient to econometrically identify the factors determining risk premiums from the term structure of bond yields. We proceed to derive maximum likelihood estimates of these “quantities of risk” and use them to evaluate the constraints on the structure of risks implied by affine *ETSMs*. These assessments of fit are fully robust to the values of the parameters governing preferences and the evolution of the state, and to whether or not the economy is arbitrage free. Consistent with the structure of *ETSMs*, the information in the US Treasury yield curve about bond excess returns is spanned by the time varying quantities of risk. These spanned premiums are driven largely by inflation risk, more so than the real side of the economy. However, contrary to the structure of *ETSMs*, there is substantial variation in risk premiums that is unspanned by bond yields. Our findings suggest that this variation arises from a time-varying market price of inflation risk and from liquidity or flight-to-quality risks in the Treasury market.

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\*We thank Christian Heyerdahl-Larsen (EFA discussant), Greg Duffee, Ivan Shaliastovich (AFA discussant), and seminar participants at the 2012 EFA meetings, 2013 AFA meetings, Bank of Canada, Imperial College London, Kenan-Flagler Business School, Warwick Business School, and University of Wisconsin-Madison for helpful comments.

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# 1 Introduction

Equilibrium affine dynamic term structure models (*ETSMs*) imply that time-variation in expected excess returns on nominal risk-free bonds is driven by changes in the conditional variances of the models' real economic and inflation risks.<sup>1</sup> Within the long-run risks (*LRR*) models of [Bansal, Kiku, and Yaron \(2007\)](#) and [Bansal and Shaliastovich \(2012\)](#), risk premiums are exact affine functions of the time-varying quantities of priced risks. Risk premiums in the habit-based *ETSMs* of [Wachter \(2006\)](#) and [Le, Singleton, and Dai \(2010\)](#) are well approximated by affine functions of the variance of surplus consumption. In affine models with “rare disasters,” it is the time-varying arrival rate of a disaster that induces variation in risk premiums ([Gabaix \(2012\)](#), [Wachter \(2013\)](#)).

We argue in this paper that the term structure of bond yields is particularly revealing about the structure of time-varying risks in these models. The availability of a broad spectrum of maturities provides a market-based parsing of the effects of short- and long-lived risk factors on excess returns.<sup>2</sup> In fact we show that, *knowing only* the properties of *ETSMs* that (i) the state  $z_t$  follows an affine process and (ii) the conditional variances of  $z_t$  span expected excess returns, we can fully identify (extract) the risk premiums from the cross-section of yields on default-free bonds. These extracted variances  $\zeta_t^2$  span the time-varying volatilities of long-run risks or surplus consumption and the volatility of inflation in any *ETSMs* that are nested within the presumed affine structure of  $z_t$ . Using this result, we compute maximum likelihood estimates of the time-series process  $\zeta_t^2$  and assess the goodness-of-fit of a large family of *ETSMs*. These assessments are valid regardless of the true values of the parameters governing preferences and the evolution of the state.

Our approach to model assessment blends the structure of the consumption risks embodied in typical models with habit formation or *LRR* with the focus on factor structures and market prices of risk in reduced-form, affine term structure models ([Dai and Singleton \(2003\)](#), [Piazzesi \(2010\)](#)). We highlight two robust features of recent *ETSMs*: First, they imply that the only sources of variation in expected excess returns on bonds are the time-varying volatilities of the risk factors associated with consumption growth. Second *ETSMs*, as typically formulated, imply full spanning of the quantities of risk  $\zeta_t^2$  by bond yields. Together, these two features of *ETSMs* lead to expressions for  $\zeta_t^2$  in terms of the cross-section of bond yields that can be estimated with a high degree of precision.

The *ML* estimates of  $\zeta^2$  explain a strikingly high percentage of the variation in risk premiums in the US Treasury market. Indeed, consistent with most *ETSMs*,  $\zeta^2$  largely subsumes the forecast power of the term structure for excess bond returns. Moreover, variation in  $\zeta_t^2$  shows strong co-movement with the conditional covariances between yields and

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<sup>1</sup>This follows, either exactly or to a good approximation, from the assumptions that the state of the economy follows an affine process and that agents' marginal rate of substitution in an exponential-affine form. See, for instance, [Eraker and Shaliastovich \(2008\)](#) and [Eraker \(2008\)](#) for discussions of equilibrium affine pricing models based on recursive preferences and long-run risks (*LRR*), and [Le, Singleton, and Dai \(2010\)](#) for a nonlinear model with habit formation that admits affine pricing.

<sup>2</sup>We focus on default-free debt and abstract from the segmentation effects explored by [Greenwood and Vayanos \(2010a\)](#), [Krishnamurthy and Vissing-Jorgensen \(2012\)](#), and [Vayanos and Vila \(2009\)](#), among others.

inflation, whereas there is much less co-movement with the conditional covariances between yields and real GDP growth, a proxy for real growth. This suggests that inflation risk is a significant (and perhaps the dominant) risk underlying risk premiums in U.S. Treasury markets. These findings are robust to the structure of agents' preferences and, as such, they strengthen the complementary findings in B-S for a model with long-run risks.

Viewed within the broader family of affine dynamic term structure models, these results may seem surprising. The affine models with stochastic volatility examined in [Dai and Singleton \(2002\)](#) typically fail to produce risk premiums that replicate the failure of the expectations theory of the term structure. [Ahn, Dittmar, and Gallant \(2002\)](#) and [Collin-Dufresne, Goldstein, and Jones \(2009\)](#) conclude that the fitted volatilities of yields from their affine models bear limited resemblance to the time-varying volatilities estimated from semi-parametric time-series models. The novelty of our analysis is that we show how to extract the volatility factors, that according to *ETSMs* underlie variation in risk premiums, very precisely from the cross-section of bond yields. Not only does our  $\zeta^2$  subsume the information in the entire yield curve about time-varying yield volatility, it also spans virtually all of the information in yields about risk premiums.

While encouraging, this evidence represents only a partial vindication of *ETSMs* as they imply that no incremental information beyond the current yield curve should be useful for forecasting excess returns. To explore this strong proposition we focus on variables identified in the literature as having predictive power for excess returns after controlling for the information in bond yields.<sup>3</sup> Not only are we able to identify conditioning information with substantial incremental predictive power for excess returns, but this information has virtually no forecast power for  $\zeta^2$ . Thus, on both fronts, this evidence challenges the structure of many *ETSMs*. Instead, the evidence suggests that there is a time-varying market price of inflation risk that is unspanned by bond yields,<sup>4</sup> a substantial priced liquidity risk that has heretofore been omitted from *ETSMs*.

Central to our empirical analysis of *ETSMs* is a new dataset of yields on US Treasury zero-coupon bonds constructed from daily data on a large cross-section of coupon yields. The Fama-Bliss CRSP and [Gurkanyak, Sack, and Wright \(2007\)](#) (GSW) datasets are the most widely used. The former only includes maturities out to five years (a limitation in our view for studying risk premiums in equilibrium models), while a limitation of the latter is that the authors construct smoothed fitted yields using an extended [Nelson and Siegel \(1987\)](#) model. Using the extensive CRSP database on yields on individual Treasury coupon bonds, and applying the same filter to remove bonds that are illiquid or have embedded options, and the same Fama-Bliss bootstrap method as CRSP (see [Bliss \(1997\)](#)), we construct a consistent set of zero-coupon bond yields with maturities out to ten years over a sample period from 1972 through 2007. As we document subsequently, there is substantial predictive power of long-dated forward rates for excess returns relative to what is found with the smoothed GSW

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<sup>3</sup>For example, see [Joslin, Priebsch, and Singleton \(2013\)](#), [Cieslak and Povala \(2011\)](#), [Wright and Zhou \(2009\)](#), and [Huang and Shi \(2011\)](#) among many others.

<sup>4</sup>This evidence also runs counter to a large class of Gaussian macro-finance term structure models that imply that macro risk factors are spanned by the current yield curve. See [Joslin, Le, and Singleton \(2012\)](#) and the references therein.

data. This feature of our data will play a key role in the subsequent assessment of the nature of the economic forces underlying risk premiums.

The remainder of this paper is organized as follows. [Section 2](#) provides further motivation of our analysis within the factor structures of a large family of *ETSMs*. Robust estimation of the volatility factors underlying variation in excess returns is explored in [Section 3](#). The relationships between our extracted volatility factors, excess returns on bonds, and yield volatilities are explored in [Section 4](#). Finally, the economic importance and statistical significance for forecasts of excess returns of factors that are unspanned by bond yields are explored in [Section 5](#). The construction of our yield data and the importance of including long-maturity yields when exploring the properties of risk premiums in the US Treasury market are discussed in [Appendix A](#).

## 2 The Factor Structure of *ETSMs*

As in most of the extant literature we consider an endowment economy with  $c_t \equiv \log C_t$ , the logarithm of real per-capita consumption  $C_t$ , following the process

$$\Delta c_{t+1} = \mu_g + x_t + \eta_{t+1} \tag{1}$$

$$x_{t+1} = \rho x_t + e_{t+1}, \tag{2}$$

where  $x_t$  is the *LRR* factor and the mean-zero shocks  $(\eta_{t+1}, e_{t+1})$  follow affine processes with conditional variances  $Var_t[\eta_{t+1}] = \sigma_{ct}^2$  and  $Var_t[e_{t+1}] = \sigma_{xt}^2$  (see, e.g., [Duffie, Pan, and Singleton \(2000\)](#)). This specification nests the consumption processes in the models of [Bansal, Kiku, and Yaron \(2007\)](#), [Bollerslev, Tauchen, and Zhou \(2009\)](#), [Drechsler and Yaron \(2011\)](#), and [Bansal and Shaliastovich \(2012\)](#); as well as the habit-based models of [Wachter \(2006\)](#) and [Le, Singleton, and Dai \(2010\)](#). The conditional variances of the shocks  $(\eta_{t+1}, e_{t+1})$  may have a multi-dimensional factor structure, as for instance in [Bollerslev, Tauchen, and Zhou \(2009\)](#). These shocks may also embody jump components with state-dependent arrival intensities as in [Drechsler and Yaron \(2011\)](#). [Table 1](#) summarizes the features of these models that are particularly relevant to the goals of our analysis.  $N$  denotes the dimension of the set of priced risks  $z_t$ , and  $\mathcal{R}$  is the implied dimension of the factor-space for excess returns on bonds.

The logarithm of the kernel for pricing nominal bonds typically takes the form

$$m_{t+1} = \gamma_0 \log \delta - \gamma_1 \Delta c_{t+1} - \gamma_2 \varphi_{t+1} - \pi_{t+1}, \tag{3}$$

where  $\pi_{t+1}$  is the log of the inflation rate,  $\log(P_{t+1}/P_t)$ . In the models of habit formation with external habit level  $H_t$ ,  $\varphi_{t+1}$  is the growth rate of the consumption surplus ratio  $s_t = \log[(C_t - H_t)/C_t]$  and  $\varphi_{t+1} = (s_{t+1} - s_t)$ . [Wachter \(2006\)](#) and [Le et al. \(2010\)](#) examine models with two priced risks ( $N = 2$ ),  $s_t$  and  $\pi_t$ , and with  $\Delta c_{t+1}$  conditionally perfectly correlated with  $s_t$  as in [Campbell and Cochrane \(1999\)](#).

In models with *LRR*, the real pricing kernel is given by (3) without the term  $-\pi_{t+1}$  and  $\varphi_{t+1} = r_{c,t+1}$ , the one-period return on a claim to aggregate consumption flows. The models of [Bansal and Yaron \(2004\)](#) and [Bansal, Kiku, and Yaron \(2007\)](#) have three priced risks ( $N = 3$ )

Recursive Preferences	LRR	$N$	Priced ( $z_t$ )	$\mathcal{R}$	RP	MPR
Bansal, Kiku, and Yaron (2007)	yes	3	$x_t, \sigma_{ct}^2, \bar{\pi}_t$	1	$\sigma_{ct}^2$	const
Bollerslev, Tauchen, and Zhou (2009)	no	3	$\sigma_{ct}^2, q_t, \bar{\pi}_t$	2	$\sigma_{ct}^2, q_t$	const
Drechsler and Yaron (2011)	yes	6	$x_t, \sigma_{ct}^2, q_t, \pi_t$ Jump Risks	1	$\sigma_{ct}^2$	const
Bansal and Shaliastovich (2012)	yes	4	$x_t, \sigma_{xt}^2, \sigma_{\bar{\pi}t}^2, \bar{\pi}_t$	2	$\sigma_{xt}^2, \sigma_{\bar{\pi}t}^2$	const
Habit Formation	LRR	$N$	Priced Risks	$\mathcal{R}$	RP	MPR
Wachter (2006)	no	2	$s_t, \bar{\pi}_t$	1	$s_t$	t-vary
Le, Singleton, and Dai (2010)	no	2	$s_t, \bar{\pi}_t$	1	$s_t$	t-vary
Rare Disasters	LRR	$N$	Priced Risks	$\mathcal{R}$	RP	MPR
Wachter (2013), Tsai (2013)	no	3	$\lambda_{ct}, \lambda_{\pi t}, \bar{\pi}_t$	2	$\lambda_{ct}, \lambda_{\pi t}$	const

Table 1: Features of *ETSMs*. The column “LRR” indicates whether the model has *LRR*;  $N$  is the number of priced risks which are indicated in column four;  $\mathcal{R}$  is the model-implied dimension of expected excess returns on nominal bonds, and the factors driving these risk premiums are indicated in column six; and the column “MPR” indicates whether the market prices of risk are constant or time-varying (t-vary).

under the assumption that  $\sigma_{ct}^2 = \sigma_{xt}^2$ . Drechsler and Yaron (2011) include a stochastic drift to  $\sigma_{ct}^2$  (denoted  $q_t$  in Table 1) and affine jumps in both  $\sigma_{ct}^2$  and  $x_t$  giving  $N = 6$ . Bollerslev et al. (2009) allow for a time-varying conditional variance of  $\sigma_{ct}^2$  (denoted  $q_t$ ). Finally, Bansal and Shaliastovich (2012) assume that  $(\Delta c_t, \pi_t)$  is a conditionally homoskedastic process, and their sources of time-varying quantities of risk are  $\sigma_{xt}^2$  and the conditional variance  $\sigma_{\bar{\pi}t}^2$  of expected inflation ( $\bar{\pi}_t = E_t[\pi_{t+1}]$ ), so  $z'_t = (x_t, \sigma_{xt}^2, \sigma_{\bar{\pi}t}^2, \bar{\pi}_t)$  and  $N = 4$ .

Within the literature on rare disasters, building upon Wachter (2013), Tsai (2013) develops a model with recursive preferences, a constant growth in the diffusing portion of consumption, and Poisson jumps in consumption and inflation with state-dependent intensities  $(\lambda_{ct}, \lambda_{\pi t})$ . Expected inflation is state-dependent, so his setting has constant market prices of the risks  $(\lambda_{ct}, \lambda_{\pi t}, \bar{\pi}_t)$  that drive bond excess returns.<sup>5</sup>

The expected excess return over a horizon  $h$  on a  $\tau$ -period zero-coupon bond with yield to maturity  $y_t^\tau$  is

$$er_t^h(\tau) = -(\tau - h)E_t[y_{t+h}^{\tau-h}] + \tau y_t^\tau - y_t^h. \quad (4)$$

All but one of the *ETSMs* summarized in Table 1 imply that  $y_t^\tau$  is an affine function of  $z_t$ :

$$y_t^\tau = A(\tau) + B(\tau) \cdot z_t, \quad \forall \tau \geq 0. \quad (5)$$

<sup>5</sup>Many of the equilibrium models with rare-disaster risk have *CRRA* preferences, and constant  $\lambda$  or zero market prices of  $\lambda$  risk. Therefore, the implied term structures are relatively trivial. Gabaix (2012) studies rare disasters, but in a non-affine, “linear generating” setting. Bond excess returns in his model are, to a first-order approximation, linearly determined by the one-dimensional inflation risk premium.

The exception is Wachter’s model which does not admit affine pricing but, to a good approximation, [Le et al. \(2010\)](#)’s affine pricing model nests her model (see below). Accordingly, we take (5) as given in our subsequent analysis. Then, together, (4) and (5) imply that  $er_t^h(\tau)$  is an affine function of  $z_t$ .

Common to all of these equilibrium models are the features that the dimensions ( $\mathcal{R}$ ) of the expected excess returns or risk premiums are less than the dimensions of the risk factors underlying bond yields ( $N > \mathcal{R}$ ), and time variation in risk premiums is induced entirely by variation in the quantities of risks listed in column *RP* of [Table 1](#):

$$er_t^h(\tau) = \mathcal{A}(\tau, h) + \mathcal{B}(\tau, h) \cdot \zeta_t^2, \quad (6)$$

where  $\zeta_t^2$  is a strict subset of the state  $z_t$  comprised of the  $\mathcal{R}$  volatility factors. In the habit-based models of [Wachter \(2006\)](#) and [Le et al. \(2010\)](#) expected excess returns lie in a one-dimensional space determined by  $\zeta_t^2 = s_t$ . Similarly, among the *LRR* models, [Drechsler and Yaron \(2011\)](#) have the largest number of priced risks, but the structure of their model is such that expected excess returns on all bonds of all maturities are proportional to  $\zeta_t^2 = \sigma_{ct}^2$ .

These observations lead us to the following robust implication of many *ETSMs*:

**RIETSM:** *The dimensionality  $\mathcal{R}$  of the expected excess returns  $er_t^h(\tau)$  is common for all horizons  $h$  and all bond maturities  $\tau$ . Moreover, the set of risk factors  $\zeta_t^2$  underlying variation in the  $er_t^h(\tau)$  is a subvector of the state  $z_t$  determining bond yields, and  $\zeta_t^2$  is the sole source of time-varying volatilities in bond yields. That is, the  $\zeta_t^2$  listed under “RP” in [Table 1](#) span the time-varying volatilities of bond yields.*

At the heart of *RIETSM* for *ETSMs* other than habit-based models is the assumption that the market prices of risk  $\Lambda$  for the risk factors  $z_t$  are state-independent (the weights on  $t + 1$  variables in (3) are constants). If information other than  $\zeta_t^2$  is incrementally useful for forecasting excess returns, then either these *ETSMs* have omitted time-varying quantities of risks that impact bond yields or the market prices  $\Lambda_t$  of the risks  $\zeta_t^2$  are time varying.

In habit-based models surplus consumption  $s_t$  is a source of a time-varying market price of consumption risk. In the model of [Le et al. \(2010\)](#), for instance,  $m_{t+1}$  has a non-affine structure and expected excess returns  $er_t^1(\tau)$ , for all  $\tau$ , are approximately affine functions of  $s_t$  and  $\sqrt{s_t}$ . The accuracy of (6), now viewed as a linearization of the model-implied nonlinear interplay between the time-varying quantity and market price of  $s_t$  risk, is parameter-value dependent. However, when valued at their maximum likelihood estimates, virtually all of the variation in  $er_t^1(\tau)$  is induced by  $s_t$ , so the affine approximation is very accurate. Since their model effectively nests Wachter’s model, we proceed under the assumption that (6) is a reliable approximation for all of the *ETSMs* summarized in [Table 1](#).

### 3 Robust Evaluation of the Constraint that Expected Excess Returns are Spanned by Volatility Factors

*RIETSM* is a powerful implication of *ETSMs*. When combined with the assumption that  $z_t$  follows an affine process, it allows us to extract a set of  $\mathcal{R}$  risk factors from the term

structure of bond yields that fully span expected excess returns. Moreover, it leads to tests of goodness-of-fit of affine *ETSMS* that are robust to values of the parameters governing agents preferences and the distributions of the non-volatility factors impacting bond yields.

That the risk factors in *ETSMS* can be extracted from market returns has long figured prominently in the literature on pricing equity portfolios. For instance, [Bansal, Kiku, and Yaron \(2007\)](#), [Constantinides and Ghosh \(2009\)](#), and [Marakani \(2009\)](#) explore the fits of two-factor models with *LRR* using the price-dividend ratio for the aggregate stock market and the nominal risk-free rate to extract a *LRR* factor from asset returns and consumption data. Our complementary analysis shows that the tight linkages in the cross-section among expected excess returns on bonds of different maturities identifies the time-varying quantities of risk underlying variation in risk premiums with a high degree of precision and without facing measurement issues associated with consumption.<sup>6</sup>

For this purpose we suppose that model assessment is based on a collection of  $J$  yields  $y_t$  ( $J > N$ ), and we partition the state  $z_t$  into the  $N - \mathcal{R}$  non-volatility factors  $\nu_t$  and the  $\mathcal{R}$  factors  $\zeta_t^2$  governing the time-varying volatility in  $z_t$ . *ETSMS* imply that the yield on an  $n$ -period zero-coupon bond has the affine representation

$$y_{nt} = (A_n + B_n\nu_t + C_n\zeta_t^2)/n, \quad (7)$$

and we let  $(A, B, C)$  denote the stacked up loadings on  $(1, \nu_t, \zeta_t^2)$  from (7) for  $y_t$ . Additionally, we assume that there exists an  $N \times J$  full-rank weight matrix  $W$  such that the  $N$  portfolios of yields  $\mathcal{P}_t = Wy_t$  are measured without error. We provide an in depth justification for this approach as part of our empirical analysis in [Section 4](#).

To show that the structure of *RIESTM* leads to the precise extraction of  $\zeta_t^2$  from  $y_t$  we proceed in three steps. First, the counterparts of (7) for the  $N$  portfolios  $\mathcal{P}_t$  are inverted to express  $\zeta_t^2$  as an affine function  $\mathcal{P}_t$ . The spanning of  $z_t$  by  $\mathcal{P}$  is typically assumed in dynamic term structure models ([Joslin, Le, and Singleton \(2012\)](#)); it is not specific to *ETSMS*. Second, we show that *ETSMS*, through their property *RIESTM*, imply a strong restriction on how the  $B_n$ 's are linked across maturities  $n$ . Finally, we argue that (and provide intuition for why) the weights that determine  $\zeta_t^2$  as a linear combination of  $\mathcal{P}_t$  can be estimated very precisely from the cross-section of the yield curve. These derivations are subsequently used to compute maximum likelihood estimates of the unknown weights for  $\zeta_t^2$ .

Step 1: an immediate implication of (7) is that, outside degenerate cases discussed in [Section 5](#),  $\zeta_t^2$  is fully spanned by bond yields. Partition the loading matrix  $W$  determining the yield portfolios  $\mathcal{P}$  into  $W_\nu$  ( $(N - \mathcal{R}) \times J$ ) and  $W_\zeta$  ( $\mathcal{R} \times J$ ) and let  $\mathcal{P}_{\nu t} = W_\nu y_t$  and  $\mathcal{P}_{\zeta t} = W_\zeta y_t$ . Constructing  $W_\nu y_t$  using (7) and solving for  $\nu_t$  gives

$$\nu_t = (W_\nu B)^{-1}(\mathcal{P}_{\nu t} - W_\nu(A + C\zeta_t^2)). \quad (8)$$

Substituting back into (7) leads to an expression for  $y_t$  in terms of  $\mathcal{P}_{\nu t}$  and  $\zeta_t^2$ :

$$y_t = B_{\mathcal{P}}\mathcal{P}_{\nu t} + \phi_\nu(A + C\zeta_t^2), \quad (9)$$

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<sup>6</sup>Much of the debate about the goodness-of-fit of *LRR* models to macroeconomic data has focused on measurement issues associated with consumption. See, for instance, the discussions in [Bansal, Kiku, and Yaron \(2007\)](#) and [Beeler and Campbell \(2009\)](#).

where  $B_{\mathcal{P}} = B(W_{\nu}B)^{-1}$  and  $\phi_{\nu} = I_J - B_{\mathcal{P}}W_{\nu}$ . Finally, premultiplying both sides of (9) by  $W_{\zeta}$  and solving for  $\zeta_t^2$  gives

$$\zeta_t^2 = (W_{\zeta}\phi_{\nu}C)^{-1} \left( \mathcal{P}_{\zeta t} - W_{\zeta}B_{\mathcal{P}}\mathcal{P}_{\nu t} - W_{\zeta}\phi_{\nu}A \right). \quad (10)$$

The assumption of full spanning of  $\zeta_t^2$  by  $y_t$  ensures that the leading matrix  $W_{\zeta}\phi_{\nu}C$  in (10) is invertible. Thus, up to an affine transformation,  $\zeta_t^2$  is determined by  $\mathcal{P}_{\zeta t} - W_{\zeta}B_{\mathcal{P}}\mathcal{P}_{\nu t}$ . Since  $W_{\zeta}$  is known, it remains to determine the weights  $B_{\mathcal{P}}$  in order to extract (a nonsingular rotation of)  $\zeta_t^2$  from  $y_t$ .

In Step 2 we exploit the restrictions on the  $B_n$  (and hence  $B$ ) implied by *RIESTM*. Let

$$E_t[\zeta_{t+1}^2] = \rho\zeta_t^2 \quad \text{and} \quad E_t[\nu_{t+1}] = K_{1\zeta}\zeta_t^2 + K_{1\nu}\nu_t \quad (11)$$

represent the conditional means of  $\zeta_{t+1}^2$  and  $\nu_{t+1}$  (ignoring constants) under the data generating process.<sup>7</sup> Substituting the factor representation (7) for yields into (4) leads to the following generic (under affine pricing) expression for expected excess returns:

$$er_t^1(n) = (B_n - B_{n-1}K_{1\nu} - B_1)\nu_t + (C_n - C_{n-1}\rho - B_{n-1}K_{1\zeta} - C_1)\zeta_t^2. \quad (12)$$

Now when only  $\zeta_t^2$  predicts excess returns, as under *RIESTM*, the loadings on  $\nu_t$  must be zero or, equivalently,  $B_n$  must satisfy the recursion

$$B_n = B_{n-1}K_{1\nu} + B_1. \quad (13)$$

Moreover, (13) implies that  $B_n = B_{n-h}K_{1\nu}^h + B_h$  for any horizon  $h$  and, therefore, from (12) it follows that the  $h$ -period expected excess return of an  $n$ -period bond ( $er_t^h(n)$ ) depends only on  $\zeta_t^2$ ; that is,  $\zeta_t^2$  completely spans  $er_t^h(n)$ , for all  $h > 0$ .

With this constraint enforced, expression (12) simplifies to

$$er_t^1(n) = (C_n - C_{n-1}\rho - B_{n-1}K_{1\zeta} - C_1)\zeta_t^2. \quad (14)$$

Notice that  $er_t^1(n)$  does not require (or imply) arbitrage-free pricing (though the key ingredient (6) underlying our derivation of (14) is typically derived in a no-arbitrage setting). Nor was it necessary in deriving (14) to specify the  $\zeta_t^2$  process, beyond that it is affine. Further, anticipating our analysis of unspanned risks in Section 5, even if  $\zeta_t^2$  is completely unspanned by yields ( $C_n \equiv 0$  for all  $n$ ), (13) and (14) still hold as implications of *RIESTM*.

The restrictions on (13) can be exploited to extract precise estimates of the volatility factors  $\zeta_t^2$  from the cross-sectional information in the yield curve. Here we highlight a very convenient representation of  $B_{\mathcal{P}}$  in terms of the eigenvalues of  $K_{1\nu}$ . Without loss of generality, we can rotate  $\nu$  so that  $B_1$  is a vector of ones and  $K_{1\nu}$  has the Jordan form. Whence  $B$  (and therefore  $B_{\mathcal{P}}$ ), are completely determined by the eigenvalues of  $K_{1\nu}$ . In the context of risk-neutral pricing, these eigenvalues are the persistence parameters  $\lambda^{\mathbb{Q}}$  that [Joslin, Singleton,](#)

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<sup>7</sup>To maintain admissibility, the conditional means of  $\zeta_{t+1}^2$  cannot be dependent on the non-volatility factor  $\nu_t$  as its support is typically  $\mathbb{R}^{N-\mathcal{R}}$ .

and Zhu (2011) show are estimable with considerable precision from the cross-section of bond yields. Similarly, we anticipate (and subsequently confirm) that our identification strategy will reveal the time variation in and predictive content of  $\zeta_t^2$  very precisely through  $\mathcal{P}_{\zeta t} - W_\zeta B_{\mathcal{P}} \mathcal{P}_{\nu t}$ .

To help build intuition for this claim, recall that in arbitrage-free affine term structure models the loadings in (7) are governed by the parameters of the pricing (risk-neutral) feedback matrix  $K_{1z}^{\mathbb{Q}}$  and they satisfy recursions of the same form as (13).<sup>8</sup> Moreover,  $K_{1z}^{\mathbb{Q}}$  is typically estimated very precisely from the cross-section of bond yields. Now suppose in our setting that there is a pricing measure  $\tilde{\mathbb{Q}}$  (not necessarily equivalent to the risk-neutral measure since we do not enforce no-arbitrage) that gives rise to (13). Then  $K_{1\nu}$  governs the feedback of  $\nu_t$  under both the historical and  $\tilde{\mathbb{Q}}$  measures. This implicit assumption of *ETMSs* ensures that  $\nu_t$  does not impact risk premiums (the market price of  $\nu$  risk is constant) and (heuristically) that estimates of  $K_{1\nu}$  inherit the precision of estimates of  $K_{1\nu}^{\tilde{\mathbb{Q}}}$ .

Up to this point our derivations do not exploit the fact that  $\zeta^2$  is a volatility process, beyond the autonomous structure of its conditional mean (11). To proceed with estimation and, most importantly, to ensure that  $\zeta_t^2$  is interpretable as the conditional volatility of  $z_t$ , we adopt a parametric affine model for the conditional distribution of  $z$ . Specifically, we assume that  $\zeta^2$  follows a multivariate autoregressive gamma (*ARG*) process (Gourieroux and Jasiak (2006), Le, Singleton, and Dai (2010)), and the remaining  $N - \mathcal{R}$  factors  $\nu_t$  are Gaussian conditional on  $\zeta_t^2$ :

$$\zeta_{t+1}^2 | \zeta_t^2 \sim ARG(\rho, c, \gamma), \quad (15)$$

$$\nu_{t+1} - \phi_\zeta \zeta_{t+1}^2 | z_t \sim N \left( K_0 + K_{1\zeta} \zeta_t^2 + K_{1\nu} \nu_t, H_{0\nu} + \sum_{i=1}^M H_{i\nu} \zeta_{it}^2 \right). \quad (16)$$

See Appendix C for a more detailed construction of the density  $f(\zeta_{t+1}^2 | \zeta_t^2)$  and the definition of the parameters  $(\rho, c, \gamma)$ .

The ARG distribution is the discrete-time counterpart to the multivariate square-root diffusion (the  $A_{\mathcal{R}}(\mathcal{R})$  process of Dai and Singleton (2000)). Several recent *ETSMs* (e.g., Bollerslev, Tauchen, and Zhou (2009) and Drechsler and Yaron (2011)) assume that the innovation in  $\zeta^2$  is Gaussian, a specification that is logically inconsistent with the non-negativity of conditional variances. In contrast, by adopting an ARG process<sup>9</sup> we ensure that  $\zeta_t^2$  is an autonomous non-negative process governing the conditional variance of  $z_{t+1}$  and that the conditional mean of  $\zeta_{t+1}^2$  is affine in  $\zeta_t^2$  ( $E_t[\zeta_{t+1}^2] = \rho \zeta_t^2 + \gamma c$ .) The positive semi-definite matrices  $H_{0\nu}$  and  $H_{i\nu}$  ( $i = 1, \dots, M$ ) govern the time-varying volatility of  $\nu$ .

For econometric identification we normalize  $z$  so that, without loss of generality,  $\nu_t$  and  $\zeta_t^2$  are conditionally independent ( $\phi_\zeta = 0$ ). Additionally, the intercepts  $K_0$  in (16) are normalized

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<sup>8</sup>More precisely,  $K_{1z}^{\mathbb{Q}}$  is such that:  $E_t^{\mathbb{Q}}[z_{t+1}] = K_{1z}^{\mathbb{Q}} z_t$ , ignoring constants. Due to admissibility requirements in standard no-arbitrage models, the volatility factors  $\zeta_{t+1}^2$  cannot be forecastable by the non-volatility factors  $\nu_t$  under the  $\mathbb{Q}$  and  $\mathbb{P}$  measures. It immediately follows that the recursions for the loadings on the non-volatility factors ( $B_n$ ) cannot be dependent on the volatility factors' loadings ( $C_{n-1}$ ).

<sup>9</sup>The following derivations are easily modified for other choices of non-negative affine distributions for  $\zeta_t^2$ .

to zero; and  $B_1$ , the loadings on  $\nu_t$  for the yield on a one-period bond, are normalized to the row vector of ones. Further, we rotate  $\nu$  so that  $K_{1\nu}$  has the Jordan form; and  $c$  is fixed at  $\frac{1}{2}\Delta t$ . Finally, to prevent  $\zeta_t^2$  from being absorbed at zero we require that  $\gamma \geq 1$ . The joint density of  $(\nu_t, \zeta_t^2)$  given by (15) and (16) gives the conditional density of  $(\mathcal{P}_{\nu t}, \mathcal{P}_{\zeta t})$ , after a Jacobian adjustment implied by (8) and (10). This is one of many equivalent normalization schemes that ensure that the extracted  $\zeta_t^2$  span the  $er_t^h(n)$ .

Having characterized the joint density of the  $N$  yield portfolios  $(\mathcal{P}_{\nu t}, \mathcal{P}_{\zeta t})$ , the construction of the likelihood function for all  $J$  yields  $y_t$  is completed by including an additional  $J - N$  yield portfolios  $\mathcal{P}_{et} = W^e y_t$ , with  $W^e$  linearly independent of  $W$ , that are measured with additive errors. For simplicity we assume that these portfolios are observed with *i.i.d.* errors with zero means and common variance:

$$\mathcal{P}_{et} - W^e B_P \mathcal{P}_{\nu t} - W^e \phi_\nu (A + C \zeta_t^2) \sim N(0, \sigma_e^2 I_{J-N}). \quad (17)$$

The parameter set is  $(A, C, \rho, \gamma, K_{1\zeta}, K_{1\nu}, H_{0\nu}, H_{i\nu}, \sigma_e)$ . Quasi Maximum Likelihood (QML) estimates of these parameters will serve as inputs into goodness-of-fit tests of affine *ETSMs* that are robust to specification of the remaining economic structure of these *ETSMs*.<sup>10</sup>

Model assessment can be based on any set of  $\mathcal{R}$  volatility factors that are a basis for the  $\mathcal{R}$ -dimensional space of admissible volatilities  $\zeta_t^2$ . When the volatility factors  $\zeta_t^2$  are fully spanned by bond yields we can, without loss of generality, base our empirical analysis on the spanning vector

$$V_t \equiv \mathcal{P}_{\zeta t} - W_\zeta B_P \mathcal{P}_{xt} = \beta \mathcal{P}_t. \quad (18)$$

Since  $\mathcal{P}_{\zeta t}$  corresponds to the first  $M$  entries of  $\mathcal{P}_t$ , the first  $M \times M$  block of the  $M \times N$  matrix  $\beta$  is the identity matrix. The fitted  $V_t$  we obtain are not literally the volatility factors in an *ETSM*, as the structural volatility factors are not identified under the minimal structure we have imposed. Rather, *ETSMs* imply that  $V_t$  is a non-singular rotation of  $\zeta_t^2$  and, hence, that projections of yields or excess returns onto our fitted  $V_t$  must be identical to those onto  $\zeta_t^2$ .

Equipped with *ML* estimates of the parameters  $\beta$  and the resulting fitted  $V_t$ , we proceed to examine the implications of *RIETSM*. First, we investigate whether  $V_t$  fully captures the information about volatility spanned by yields; that is, whether yields have incremental forecasting power for the conditional variances of bond yields beyond the information in  $V_t$ . The answer should be no, since *ETSMs* imply that yield volatilities are fully determined by  $V_t$ . Second, and similarly, after conditioning on  $V_t$ , information in the yield curve should have no predictive content for realized excess returns. Third, all of the *ETSMs* we have discussed also imply that the conditional variances of inflation and consumption growth are fully determined by  $\zeta_t^2$ . As such, after conditioning on  $V_t$ , information in the yield curve should have no predictive content for the conditional volatilities of these macro variables.

As we set out to explore these implications we emphasize that this strategy for extracting  $\zeta_t^2$  presumes that the time-varying volatilities of bond yields are spanned by the yields themselves,  $y_t$ . Outside of knife-edge cases, this is a direct implication of *ETSMs* and therefore is an

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<sup>10</sup>In our setting the volatility process is likely to be tightly determined by the cross-section of bond yields; essentially, the likelihood function is searching for the two  $\mathbb{Q}$  eigenvalues that describe volatility. Thus, our QML estimates are likely to be robust to a wide variety of affine specifications of the volatility process.

assumption that we maintain in our initial econometric analysis of risk premiums. However, as noted in the introduction, the literature on reduced-form affine term structure models casts doubt on the validity of this assumption. There is substantial evidence of unspanned (by yields) volatility in bond markets (e.g., [Collin-Dufresne, Goldstein, and Jones \(2009\)](#)). Additionally, using high-frequency data to estimate time-varying second moment and jump components of bond yields, [Wright and Zhou \(2009\)](#) and [Andersen and Benzoni \(2010\)](#), among others, provide evidence that there is information about bond excess returns embodied in yields that is not well captured by monthly data on the shape of the yield curve. In [Section 4](#) we maintain the spanning assumption enforced by *ETSMs* to explore what is learned about risk premiums under *RIETSM*. We then relax this assumption in [Section 5](#) where we explore the implications of unspanned yield volatility for risk premiums.

The affine process (15) - (16) is an approximation to the distribution of yields implied by *ETSMs* that include jumps. The state-dependent arrival rates of jumps in these models are assumed to depend on ARG processes and so, if such intensities are driving bond yields, then they are subsumed by our ARG process  $\zeta_t^2$ . However, we do not capture the Poisson components of the innovation in  $z_t$ . This omission is likely to be innocuous for studying  $\zeta_t^2$  since the effects of jumps on the distribution of shocks over monthly intervals are typically small (see [Das and Sundaram \(1999\)](#) and [Singleton \(2006\)](#)).

## 4 Volatility Factors and Expected Excess Returns

With the models summarized in [Table 1](#) in mind, we explore the nature of risk premiums in models with  $N = 4$  risk factors governed by an affine process with  $\mathcal{R} = 2$  sources of time-varying conditional variances. Expanding the number of such risks will add “dimension” (and thereby flexibility) to risk premiums. Yet, since these models have been put forth as successful representations of observed variation in expected excess returns, we proceed to evaluate their goodness-of-fit taking as given the assumed dimensions of the priced risks and the implied structure of risk premiums. Moreover, as documented in [Duffee \(2011\)](#) and [Joslin, Singleton, and Zhu \(2011\)](#), models of the term structure with  $N > 4$  are potentially over-parameterized and this can severely distort the model-implied risk premiums.

### 4.1 Extracting the Volatility Factors From the Current Yield Curve

While the information sets generated by  $z_t$  and any  $N$  linearly independent yield portfolios  $\mathcal{P}_t$  are (according to *ETSMs*) theoretically identical, there is the issue in practice of accurate measurement of yields (pricing of bonds). For instance, even though in theory  $z_t$  is spanned by  $y_t$ , the sample projections of realized excess returns onto the information set generated by the observed yields  $y_t^o$  are in general consistent estimators of their true theoretical counterparts only when  $y_t^o$  is priced (nearly) perfectly by the *ETSMs*. It is now standard practice to accommodate measurement errors on all bond yields and to using filtering in estimation of macro-finance *DTSMs*. The errors  $y_t^o - y_t$  can be large in macro-finance *DTSMs*, especially when  $N$  is small ([Joslin, Le, and Singleton \(2012\)](#)).

Fortunately for our purposes the diversification that comes from using “portfolios” of yields, and in particular from setting  $\mathcal{P}$  to the first  $N$   $PC$ s of bond yields, substantially mitigates these measurement issues. Joslin et al. (2012) show that the Kalman filter estimates of the model-implied low-order  $PC$ s in reduced-form  $DTSM$ s are (nearly) identical to their observed counterparts, even when the model-implied pricing errors  $y_t^o - y_t$  become large. With this evidence in mind, we exploit the theoretical equivalence of the information sets generated by  $z_t$  and  $\mathcal{P}_t$  and conduct our analysis using the  $PC$ s  $\mathcal{P}_t$ . Proceeding under the assumption of no measurement errors on  $\mathcal{P}_t$  amounts to holding  $ETSM$ s to the same (high) standards of fit as for reduced-form arbitrage-free models.

We use historical yields on US Treasury bonds constructed as described in Appendix A. Using the CRSP treasury bond data and similar algorithms as described by Fama and Bliss (1987), we construct a consistent set of “Fama-Bliss” zero yields out to ten years to maturity through to the end of 2007. Our sample period starts in January, 1984 after the abandonment of the monetary policy experiment between 1979 and 1982. To avoid the extreme market conditions of the ongoing crisis, we end our sample in December, 2007. Principal components of bond yields are constructed using yields on bonds with maturities of one through five, seven, eight, and ten years.

Setting  $N = 4$ , the joint distribution of  $\mathcal{P}_t$  is determined by the joint density (15) - (16) along with the relevant Jacobian, as described in Section 3. The remaining  $J - 4$   $PC$ s of the  $J$  yields  $y_t$ ,  $\mathcal{P}_{et}$ , are assumed to be priced up to additive errors according to (17). With these distributions in hand, and after imposing normalizations, we estimate the parameters by quasi-maximum likelihood ( $QML$ ). The resulting estimates of the free parameters in the  $2 \times 4$  matrix  $\beta$  that determines the volatility-spanning vector  $V_t$  in (18) are

$$\beta = \begin{bmatrix} 1 & 0 & 10.48 & 58.66 \\ & & (1.408) & (0.141) \\ 0 & 1 & -0.780 & -14.87 \\ & & (0.647) & (1.445) \end{bmatrix}, \quad (19)$$

where robust standard errors are given in parentheses. With one exception, all parameters are estimated with considerable precision. This was anticipated owing to the fact that the last  $2 \times 2$  block of  $\beta$  is fully determined by the Jordan form of  $K_{1\nu}$  which, in turn, is identified primarily from the cross-sectional restrictions in (13). We stress that our ability to exploit cross-sectional information is key to this precision. By way of contrast, the loadings from the time-series projection of squared residuals (from the projection of  $PC1_{t+1}$  onto  $\mathcal{P}_t$ ) onto  $\mathcal{P}_t$  are estimated much less precisely. Thus, our approach to extracting  $V_t$  is both conceptually and practically very different than those typically pursued in the literature on  $ETSM$ s.

Since  $V_t$  is one among an infinity of spanning vectors for the volatilities in any affine model with  $N = 4$  and  $\mathcal{R} = 2$  that imposes  $RIETSM$ , there is not a natural economic interpretation of the components of  $V_t$ . More informative are the correlations between  $V_t$  and the  $PC$ s of bond yields. Projecting each of the first four  $PC$ s of bond yields onto  $V_t$  gives the adjusted  $R^2$ s of (0.72, 0.57, 0.05, 0.64). Thus, the information in  $V_t$  is highly correlated with the first, second, and fourth  $PC$ s of yields. The high correlation between  $V_t$  and  $PC4$  is intriguing

as *PC4* shows substantial correlation with the forward rate factor constructed by [Cochrane and Piazzesi \(2005\)](#) and also with real economic growth ([Joslin et al. \(2013\)](#)). Both of these variables are known to have strong predictive power for excess bond returns.

## 4.2 Measuring the Risks Underlying Variation in $z_t$ and $y_t$

When  $\zeta_t^2$  is spanned by  $y_t$ , the volatility factors  $V_t$  span the conditional variances of the state  $z_t$ . This includes not only the conditional variances of bond yields, but also the conditional variances of inflation and real economic growth. A natural approach to assessing the empirical support for this implication of *RIETSM* is to compute the forecast error  $\epsilon_t$  from the projection of any element of  $z_t$  or any portfolio of bond yields onto  $\mathcal{P}_{t-}$ , as *ETSMs* imply that  $z_t$  follows a first-order Markov process under  $\mathbb{P}$  and that  $z_{t-1}$  is spanned by  $\mathcal{P}_{t-1}$ . Then one can examine projections of the form

$$E_t \left( \sum_{j=1}^H \epsilon_{t+j}^2 \right) = \text{constant} + \beta_{\mathcal{P}} \mathcal{P}_t \quad \text{and} \quad E_t \left( \sum_{j=1}^H \epsilon_{t+j}^2 \right) = \text{constant} + \beta_V V_t. \quad (20)$$

According to the risk-structure of *ETSMs*,  $\mathcal{P}_t$  and  $V_t$  should have the same explanatory power for the squared forecast errors. Additionally, given that  $V_t = \beta \mathcal{P}_t$ , *ETSMs* imply the “reduced-rank” constraint  $H_0 : \beta_{\mathcal{P}} = \beta_V \beta$ .

While this approach is feasible for bond yields, which are reliably measured over monthly intervals, there are potentially severe measurement issues with macro variables. Consequently, the first-stage projection of a macro component of  $z_t$  onto  $\mathcal{P}_{t-1}$  might lead to unreliable estimates of  $\epsilon_t$ . To mitigate these measurement issues we construct measures of risk using the Blue-Chip financial (BCFF) survey forecasts of bond yields, inflation, and output growth, as constructed by Wolters Kluwer. We cannot use the survey forecasts directly to construct  $\epsilon_t$ , because they are forecasts of three-month moving averages.

To fix ideas, consider the case of bond yields. Except for the three-month and six-month maturities, the BCFF forecasts are for averages of par yields over *calendar* quarters (see [Appendix B](#) for details of the construction of zero yield forecasts).<sup>11</sup> Let

$$Q_{h,t}^{y(i)} = E_t^{(i)} [y_{t+h} + y_{t+h+1} + y_{t+h+2}]$$

denote the  $h$ -month ahead forecast of average yields formed by the  $i^{\text{th}}$  forecaster, and  $Q_{h,t}^y = \text{median}(Q_{h,t}^{y,i})$  be the corresponding cross-sectional median forecast. We use the median as opposed to the mean forecast to minimize possible effects of outliers. For each horizon  $h$ ,  $Q_{h-1,t+1}^y - Q_{h,t}^y$  is the revision due to new information arriving within month  $t+1$ . We construct our aggregate “innovations” in yields by summing over all forecast horizons

$$\epsilon_{t+1} = \sum_h (Q_{h-1,t+1}^y - Q_{h,t}^y), \quad (21)$$

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<sup>11</sup>We follow the interpolation approach of [Chun \(2010\)](#) to build forecasts for non-calendar quarters. The same interpolation technique is used to construct forecasts for horizons not provided by the BCFF newsletter.

where we include the horizons  $h = 12, 15,$  and  $18$  months. (Shorter horizon forecasts appear to contain a sizable amount of high-frequency noise.) Additionally, to purge these innovations of all information in yields, we project  $\epsilon_{t+1}$  onto  $\mathcal{P}_t$  and use the orthogonalized residuals. *ETSMs* imply that the  $Var_t[\epsilon_{t+h}]$  are affine in  $V_t$ , for all  $h > 0$ . Accordingly, for each yield maturity, we compare the projections

$$E_t \left( \sum_{j=1}^H \epsilon_{t+j}^2 \right) = \text{constant} + \beta_{\mathcal{P}} \mathcal{P}_t \quad \text{and} \quad E_t \left( \sum_{j=1}^H \epsilon_{t+j}^2 \right) = \text{constant} + \beta_V V_t, \quad (22)$$

for  $H = 2, 4,$  and  $6$ . We omit  $H = 1$ , because the BCFF surveys are conducted over a two-day period somewhere between the 20th and 26th of a given month  $t$  and so  $\epsilon_{t+1}$  is not, strictly speaking, a surprise relative to the information set at the end of month  $t$ . Inference is based on the constraints  $\beta_{\mathcal{P}} = \beta_V \beta$  implied by *ETSMs*.

Turning to macro factors, though much of the econometric literature has focused on inflation directly,<sup>12</sup> the monthly CPI inflation data appears quite noisy (choppy) and there are frequent, material revisions. Analogously to our treatment of yield forecasts, we let

$$Q_{h,t}^{\pi(i)} = E_t^{(i)} [\pi_{t+h} + \pi_{t+h+1} + \pi_{t+h+2}],$$

as survey forecasts of inflation are for quarterly horizons. Similarly,  $Q_{h,t}^{\pi}$  denotes the  $h$ -month median inflation forecast. Then we project the  $\epsilon_{t+1}^2$  in (21) (with  $Q^{\pi}$  in place of  $Q^y$ ) onto  $\mathcal{P}_t$  and  $V_t$  as in (22) and compare the fits of the two sets of regressions. This approach amounts to assessing whether the volatility factors  $V_t$  span the time-varying volatility of expected inflation  $\sigma_{\pi t}^2$  as is implied by *ETSMs*.

A central construct in all of *ETSMs* is aggregate per-capital consumption growth. There are, however, well known and severe measurement problems with monthly consumption data, and we do not have access to a systematic and reliable set of survey forecasts on real aggregate consumption. Real growth in GDP, which arguably is better measured than consumption growth, is only available quarterly, but fortunately there are BCFF survey forecasts of real GDP growth. This is what we focus on to shed some light on the connection between  $V_t$  and real economic shocks. Real GDP forecast errors are constructed using the same approach used for constructing inflation forecast errors. Then the squared GDP forecast errors are projected onto  $\mathcal{P}_t$  and  $V_t$  as in (22) and the fits of these two sets of regressions are compared.

In using surveys to construct forecast errors we are mindful of the fact that the survey forecasts should subsume at least as much information as the yield curve ( $\mathcal{P}_t$ ). On the one hand, the construction of  $\epsilon_t$  from the BCFF data mitigates measurement issues with macro variables. On the other hand, it might be that the survey forecasts embody information that is not encompassed by the theoretical constructs within an *ETSM*. For instance, [Ludvigson and Ng \(2010\)](#) and [Joslin, Priebisch, and Singleton \(2013\)](#) identify macro factors that have forecasting power for yields over and above the yields themselves. Initially, we proceed under the presumption that the spanning conditions of *ETSMs* hold, deferring further exploration of unspanned risks to [Section 5](#).

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<sup>12</sup>See, for examples, the analyses of time-varying inflation volatility in [Engle \(1982\)](#) and [Stock and Watson \(2007\)](#).

	$H = 2$			$H = 4$			$H = 6$		
	Adj $R^2$			Adj $R^2$			Adj $R^2$		
	4 PCs	$V_t$	pval	4 PCs	$V_t$	pval	4 PCs	$V_t$	pval
1-y	0.122***	0.114***	0.496	0.240***	0.217***	0.279	0.338***	0.301***	0.303
3-y	0.132***	0.134***	0.832	0.296***	0.287***	0.461	0.404***	0.392***	0.523
5-y	0.128***	0.133***	0.969	0.283***	0.284***	0.871	0.408***	0.409***	0.937
7-y	0.135***	0.138***	0.895	0.271***	0.267***	0.577	0.362***	0.356***	0.677
10-y	0.136***	0.138***	0.853	0.253***	0.249***	0.615	0.316**	0.310***	0.683

Table 2: Regressions of squared residuals constructed from BCFF yield forecasts on PCs and  $V_t$ . The superscripts (\*, \*\*, \*\*\*) denote the level of significance (at 10%, 5%, 1%, respectively) of the  $\chi^2$  test of joint significance of the regression slopes.

### 4.3 Does $V_t$ Encompass the Information in Yields ( $\mathcal{P}_t$ ) About Risk?

The adjusted  $R^2$ s for the projections in (22) based on the yield-forecast revisions  $Q_{h,t}^y$  are reported in Table 2 for maturities  $n = 1, 3, 5, 7$ , and 10 years. Across all horizons  $H$  and all maturities,  $V_t$  has virtually the same forecasting power as  $\mathcal{P}_t$ . For example, for  $H = 4$  and the five-year yield, the adjusted  $R^2$  from conditioning on  $\mathcal{P}_t$  ( $V_t$ ) is 28.3% (28.4%). In fact, in many cases the projections based on  $V_t$  have larger adjusted  $R^2$ s. To formally evaluate the differences in fits, we conduct  $\chi^2$  tests of  $H_0 : \beta_{\mathcal{P}} = \beta_V \beta$ . The probability values (“pvals”), which accommodate serial correlation of projection errors using the Newey-West procedure with twelve lags, confirm that the small differences in  $R^2$ s are statistically insignificant.

We verify in Appendix D that the results in Table 2 are not driven by our use of survey forecasts of future bond yields. Using the realized yields  $y_t$  we estimate the projections in (20) with residuals constructed by projecting yield PCs onto  $\mathcal{P}_t$  and test the null hypothesis  $H_0 : \beta_{\mathcal{P}} = \beta_V \beta$ . The pvals for these tests are comparable, as are the adjusted  $R^2$ s.

Next we examine whether  $V_t$  also encompasses the information in the yield curve (in the PCs  $\mathcal{P}_t$ ) about expected excess returns in Treasury markets. Comparisons of the projections of realized excess returns onto  $V_t$  and  $\mathcal{P}_t$  are displayed in Table 3 for holding periods of lengths  $h = 3, 6$ , and 12 months. Overall,  $V_t$  captures a substantial portion of the predictive content of  $\mathcal{P}_t$ , particularly for longer maturity bonds. For example, the adjusted  $R^2$  from regressing twelve-month excess returns on a ten-year bond on  $\mathcal{P}_t$  is 32.5%, compared to 28.1% when  $V_t$  is used as the predictor, and the difference is not significant (pval= 0.175). For shorter maturity bonds there is predictive information in yields that is not fully captured by  $V_t$ . The three-month and six-month excess returns on a one-year zero are predicted by  $\mathcal{P}_t$  with adjusted  $R^2$ s of 16.5% and 31.3%, compared to 9.9% and 21.3% by  $V_t$ . For both cases, the pvals of the difference tests are smaller than 1%, indicating rejection of the constraint  $\beta_{\mathcal{P}} = \beta_V \beta$  at conventional significance levels.

Summarizing, we find that there exists a strictly positive volatility process extracted from the yield curve under the constraint *RIETSM* that fully encompasses the information in the entire yield curve about interest rate volatility. This result is an implication of *ETSMS* and

	$h = 3$ months			$h = 6$ months			$h = 12$ months		
	Adj. $R^2$			Adj. $R^2$			Adj. $R^2$		
	4 PCs	$V_t$	pval	4 PCs	$V_t$	pval	4 PCs	$V_t$	pval
mean(xr)	0.088	0.063	0.198	0.250	0.196	0.145	0.367	0.315	0.256
xr(1)	0.165	0.099	0.003	0.313	0.213	0.004			
xr(3)	0.113	0.077	0.140	0.267	0.201	0.192	0.371	0.287	0.597
xr(5)	0.086	0.055	0.082	0.262	0.196	0.127	0.375	0.312	0.431
xr(7)	0.096	0.071	0.225	0.253	0.199	0.133	0.369	0.316	0.205
xr(10)	0.054	0.042	0.374	0.190	0.153	0.176	0.325	0.281	0.175

Table 3: Projections of bonds excess returns onto  $\mathcal{P}_t$  and  $V_t$  for holding periods of length 3, 6, and 12 months on bonds of maturities 1, 3, 5, 7, and 10 years.  $mean(xr)$  is the cross-sectional average of the excess returns.

it shows that reduced-form affine models are fully capable of replicating yield volatilities conditioned on  $y_t$ . Equally notable is our finding that  $V_t$  largely spans the information in bond yields about expected excess returns (risk premiums). We stress that these findings are not built in through the construction of  $V_t$ . Moreover, the estimates of  $\beta_{\mathcal{P}}$  and  $\beta_V$  are jointly significant for almost all choices of maturity and  $H$ . Therefore the similar forecasting power of  $V_t$  and  $\mathcal{P}_t$  is not a manifestation of lack of predictive power of  $V_t$ .

Notably, there is a component of risk premiums on one-year bonds that varies with the shape of the yield curve and is not fully spanned by  $V_t$ . This is anticipated by recent studies on liquidity factors in Treasury markets. Bond supplies, foreign demands, and clientele have been shown to affect the shape of the U.S. Treasury curve (e.g., [Greenwood and Vayanos \(2010b\)](#) and [Krishnamurthy and Vissing-Jorgensen \(2012\)](#)). Nevertheless, it is notable how much of the variation in risk premiums is captured by the two-dimensional  $V_t$  extracted from the cross-section of US Treasury yields.

#### 4.4 Is $V_t$ Capturing Inflation or Output Volatility?

Of equal interest are the connections between our volatility factors  $V_t$  and macroeconomic risks, in particular consumption and inflation risks. As we discussed in [Section 2](#), the literature on equilibrium pricing models has adopted a wide variety of distinct (non-nested) specifications of conditional variances of these macro risks. All of these *ETSMS* imply that the time-varying conditional variances of both  $(\Delta c_t, \pi_t)$  and their expected values  $(x_t, \bar{\pi}_t)$  are linearly spanned by bond yields. Moreover, as summarized by *RIETSM*, they imply that our  $V_t$  derived from yields must be as powerful as  $\mathcal{P}_t$  in predicting their conditional variances. In fact, given the affine structure of *ETSMS*, we know in addition that the conditional covariances between  $(\Delta c_t, \pi_t)$  or  $(x_t, \bar{\pi}_t)$  and  $y_t$  are linear in  $V_t$ . This can be explored by examining whether  $\mathcal{P}_t$  and  $V_t$  have equal forecasting power for the products of innovations in  $y_t$  and these macro factors.

Consider first the role of inflation volatility. [Piazzesi and Schneider \(2007\)](#), [Rudebusch and Wu \(2007\)](#), [Doh \(2011\)](#), and [Wright \(2011\)](#) argue, within the context of affine term structure

	$H = 2$			$H = 4$			$H = 6$		
	Adj. $R^2$			Adj. $R^2$			Adj. $R^2$		
	4 PCs	$V_t$	pval	4 PCs	$V_t$	pval	4 PCs	$V_t$	pval
$e_{CPI}^2$	0.099***	0.098***	0.218	0.270***	0.264***	0.318	0.372***	0.353***	0.226
$e_{GDP}^2$	0.089***	0.085***	0.211	0.242***	0.213***	0.261	0.333***	0.280***	0.139
$e_{CPI}e_{GDP}$	0.023*	0.025	0.592	0.018	0.022	0.966	0.024	0.026	0.897

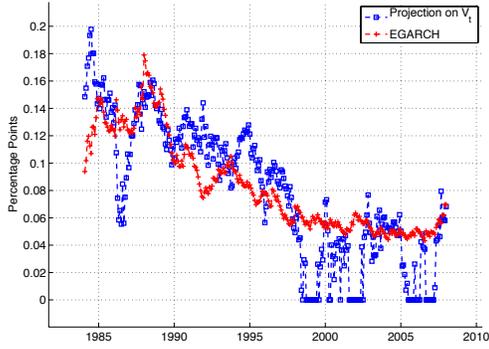
Table 4: Regressions of squared inflation residuals ( $e_{CPI}^2$ ), squared real GDP residuals ( $e_{GDP}^2$ ), and the product of inflation and real GDP residuals ( $e_{CPI}e_{GDP}$ ) on  $\mathcal{P}_t$  and  $V_t$ .

models, that a decline in inflation uncertainty was partially responsible for the decline in term premiums during the past twenty years. [Doh \(2011\)](#) and [Bansal and Shaliastovich \(2012\)](#) in particular focus on *ETSMs* with *LRR*. In contrast to these studies, we link measures of inflation volatility directly to the extracted  $V_t$ , the volatility factors that *ETSMs* identify as the determinants of excess returns.

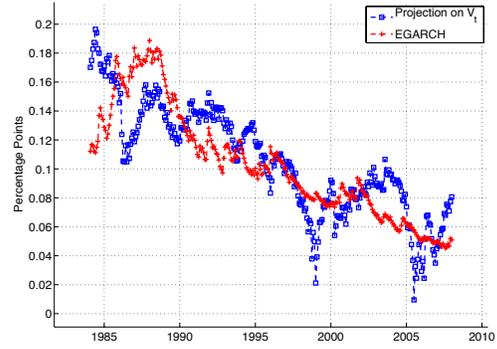
From the first row of [Table 4](#) it is seen that  $V_t$  captures almost all of the time variation in the inflation volatility that is spanned by  $\mathcal{P}_t$ . For example, for  $H = 4$ ,  $\mathcal{P}_t$  and  $V_t$  forecast squared average inflation residuals with adjusted  $R^2$ s of 27.0% and 26.4%, respectively, and the difference is not statistically significant. Panel (a) of [Figure 1](#) displays the fitted volatilities of inflation conditional on  $V_t$ . Consistent with the view that inflation risk declined in the late 1980's and 1990's, there is a persistent decline in fitted volatility over this portion of our sample. Interestingly, while the downward trend is also visible in the univariate EGARCH-fitted volatility constructed from our residuals  $\epsilon_t$ , the latter declines much more rapidly in the late 1980's. The two measures subsequently catch up with each other a decade later. During the later portion of our sample the EGARCH estimates seem to stabilize whereas the  $V$ -implied volatilities are relatively more choppy.

Under *RIETSM* our extracted  $V_t$  encompasses the sources of both time-varying inflation and real economic risks. In the model of [Bansal, Kiku, and Yaron \(2007\)](#) the  $\mathcal{R} = 2$  dimensions of  $V_t$  are both required to span consumption risk. On the other hand, under the specification in [Bansal and Shaliastovich \(2012\)](#)  $V_t$  encompasses both inflation risk ( $\sigma_{\pi t}^2$ ) and *LRR* ( $\sigma_{xt}^2$ ) and, as such, its dimension exceeds that of the one-dimensional quantity of consumption risk. Given the limited structure we have imposed in extracting  $V_t$ , we can not distinguish between these non-nested formulations of aggregate risks. Nevertheless, the implication of *RIETSM* that  $V_t$  and  $\mathcal{P}$  constitute the same information about real economic risks is testable using  $V_t$ . In the habit-based model of [Campbell and Cochrane \(1999\)](#), [Wachter \(2006\)](#), and [Le, Singleton, and Dai \(2010\)](#) the source of time-varying risk is stochastic volatility in the surplus consumption ratio. Again, the current yield curve should be informative about this real economic risk.

As discussed previously, we do not have survey data on consumption growth so we instead examine growth in real GDP. While real GDP growth is an imperfect surrogate for consumption growth, these findings are of interest both because GDP growth is correlated



(a) Inflation Volatility



(b) GDP Volatility

Figure 1: Fitted conditional volatilities of inflation (Panel (a)) and GDP growth (Panel (b)) from projections of squared forecast errors onto the yield-curve extracted volatilities  $V_t$ . For comparison, each panel includes the fitted values from an EGARCH(1,1) model of volatility estimated using the same series of residuals. Negative fitted values were truncated at zero.

with  $\Delta c_t$  and it is a key ingredient in the Federal Reserve’s setting of monetary policy (e.g., through the “Taylor rule”). These linkages have been explored by, among others, [McCallum \(1994\)](#) and [Gallmeyer, Hollifield, and Zin \(2005\)](#) within *ETS*Ms that include a monetary authority’s rule for setting a short-term rate.

Most notable about the second row of [Table 4](#) is the finding that both  $\mathcal{P}_t$  and  $V_t$  have substantial predictive content for the volatility of real GDP growth, with adjusted  $R^2$ s ranging from 8% to 33%.  $V_t$  accounts for well over 80% of the conditional variation in real GDP growth that is spanned by yield *PC*s, and the constraint that it accounts for 100% is not rejected at conventional levels. Panel B of [Figure 1](#) plots the  $V$ -implied volatility estimates together with their EGARCH counterparts. The downward trend in both series is symptomatic of the “Great Moderation” observed by [Stock and Watson \(2002\)](#) and others.

A central thesis of *ETS*Ms is that the fitted volatilities (based on  $V_t$ ) of inflation and GDP growth have predictive content for risk premiums in Treasury markets. When we project the 3-, 6-, and 12-month average excess returns onto the fitted volatility of GDP we get  $R^2$ ’s of 4%, 13%, and 22%, respectively. Using the fitted volatility of inflation as a predictor gives comparable (slightly lower) adjusted  $R^2$ ’s. Thus, fitted volatility from the real side of the economy roughly matches the explanatory power of inflation risk for excess returns in bond markets. This finding supports the inclusion of both  $\sigma_{xt}^2$  and  $\sigma_{\pi t}^2$  as quantities of risk in the model of [Bansal and Shaliastovich \(2012\)](#).

Additional insights into the effects of real and inflation shocks on risk premiums come from inspection of the links between  $V_t$  and the conditional *covariances* between yields, real GDP, and inflation. In the prototypical *LRR* model,  $V_t$  fully determines the conditional covariance between output growth and inflation. From the last row of [Table 4](#) it is seen that

	$H = 2$			$H = 4$			$H = 6$		
	AdjR2			AdjR2			AdjR2		
	4 PCs	$V_t$	pval	4 PCs	$V_t$	pval	4 PCs	$V_t$	pval
<b>Panel A: Conditional Covariance of Inflation and Yields</b>									
1-y	0.060*	0.053	0.210	0.151***	0.119***	0.042	0.212**	0.146***	0.097
3-y	0.061**	0.059*	0.293	0.166***	0.146***	0.045	0.238***	0.197***	0.099
5-y	0.066***	0.064***	0.350	0.184***	0.166***	0.205	0.257***	0.217***	0.214
7-y	0.066***	0.060**	0.144	0.183***	0.157***	0.130	0.256***	0.205***	0.136
10-y	0.045***	0.041**	0.155	0.146***	0.126***	0.120	0.212***	0.167**	0.105
<b>Panel B: Conditional Covariance of Real GDP and Yields</b>									
1-y	-0.008	-0.007	0.713	-0.003	-0.003	0.980	-0.003	-0.003	0.995
3-y	-0.002*	-0.006	0.420	0.016	0.006	0.879	0.029	0.013	0.926
5-y	-0.001**	-0.007	0.165	0.021	-0.006	0.493	0.039	-0.005	0.549
7-y	-0.002*	-0.005	0.231	0.015	-0.001	0.644	0.030	0.002	0.640
10-y	0.007***	0.000	0.027	0.039*	0.015	0.313	0.070*	0.027	0.290

Table 5: Regressions of the products of CPI inflation forecast residuals and yield forecast residuals (Panel A) and the products of real GDP forecast residuals and yield forecast residuals (Panel B) on  $\mathcal{P}_t$  and  $V_t$ .

neither  $\mathcal{P}_t$  nor  $V_t$  has predictive power for the product of the inflation and GDP residuals. Since  $V_t$  and  $\mathcal{P}_t$  have strong predictive power for the conditional volatilities of these variables we infer that there is a canceling effect that renders the covariance largely time-invariant.

Quite different patterns emerge from examining the conditional covariances between the survey-forecast revisions of yields with those of inflation or GDP growth (Table 5, Panels A and B, respectively). Across all yield maturities and horizons, the conditional covariances between inflation and yields are quite strongly time-varying. Most of the  $\chi^2$  statistics of the joint test of zero regression coefficients are significant at the 1% level. Moreover, the predictive content of  $\mathcal{P}_t$  is well captured by  $V_t$ , consistent with the structure of many *ESTMs*.

In contrast, for the products between real GDP and yield forecast errors, the adjusted  $R^2$ 's in Panel B are very small and, without exception, significantly lower than their counterparts in Panel A. More importantly, the corresponding  $\chi^2$  test statistics are mostly insignificant. Evidently  $V_t$  is substantially more informative about the conditional covariances between yields and inflation than about the covariances between yields and real GDP growth.

To help with the interpretation of these results, suppose that the innovation to the nominal pricing kernel decomposes into a real and a nominal part:

$$m_{t+1} - E_t[m_{t+1}] = \epsilon_{R,t+1} + \epsilon_{\pi,t+1}, \quad (23)$$

and that the innovation to the n-period bond yield takes the form:

$$y_{n,t+1} - E_t[y_{n,t+1}] = B_{n,R}\epsilon_{R,t+1} + B_{n,\pi}\epsilon_{\pi,t+1}. \quad (24)$$

The inflation shock  $\epsilon_{\pi,t+1}$  is driven by innovations to inflation and inflation expectations, while the real shock  $\epsilon_{R,t+1}$  is governed by innovations to the consumption process. For conditionally Gaussian shocks and ignoring (largely negligible) Jensen terms we can write:

$$\frac{1}{n}er_t^1(n+1) \approx Cov_t(m_{t+1}, y_{n,t+1}) \approx Cov_t(\epsilon_{R,t+1}, y_{n,t+1}) + Cov_t(\epsilon_{\pi,t+1}, y_{n,t+1}). \quad (25)$$

Thus, in this simplified setting, bond-return predictability arises through the real channel, via the time variation in  $Cov_t(\epsilon_{R,t+1}, y_{n,t+1})$  or through the inflation channel,  $Cov_t(\epsilon_{\pi,t+1}, y_{n,t+1})$ . An implication of *ETSMS* is that  $V_t$  drives the time variation of both of the right-hand side terms. Thus, up to this approximation, the results in [Table 5](#) indicate that inflation risks represent the dominant source of variation in bond risk premiums.

Why does the inflation channel seem relatively more important? This is despite the similarities between the conditional variances of real GDP and CPI observed so far: both display similar patterns (in [Figure 1](#)), both are strongly predictable by  $V_t$  (as seen in [Table 4](#)), and both can forecast future excess returns reasonably well. To the extent that shocks to real GDP largely capture the time variation in  $\epsilon_{R,t+1}$ , the weak predictability of  $V_t$  for the conditional covariances between shocks to real GDP and CPI, documented in the last row of [Table 4](#), suggests that the time variation in  $Cov_t(\epsilon_{R,t+1}, \epsilon_{\pi,t+1})$  implied by *ETSMS* is inconsequential. As a result, ignoring constants, we have:

$$Cov_t(\epsilon_{R,t+1}, y_{n,t+1}) = Cov_t(\epsilon_{R,t+1}, B_{n,R}\epsilon_{R,t+1} + B_{n,\pi}\epsilon_{\pi,t+1}) \approx B_{n,R}Var_t(\epsilon_{R,t+1}). \quad (26)$$

The relative importance of the real channel depends not only on the time variation in the conditional variances of the real shocks but also on how important the real shock is as part of the shocks to nominal bond yields. If  $B_{n,R}$  is very close to zero (or very small relative to  $B_{n,\pi}$ ), so that nominal shocks are more important for nominal bond yields, then inflation risks will be the more dominant determinant of predictability in excess returns. Of course, to the extent that consumption shocks are different from GDP shocks, a more decisive verification of this requires reliable monthly data on aggregate consumption.

## 5 “Unspanned” Risks and Excess Returns on Bonds

A maintained assumption in virtually the entire literature on affine *ETSMS* is that the state of the economy is spanned by returns on bonds and certain equity claims. This observation is central to the empirical strategy used in many prior studies of *LRR* and equity returns. However, for the bond market, there is an extensive literature documenting the existence of unspanned stochastic volatility of bond yields (USYV) (e.g., [Collin-Dufresne and Goldstein \(2002\)](#), [Li and Zhao \(2006\)](#), and [Joslin \(2011\)](#)). More broadly, we are interested in the possibility of unspanned quantities of risk (USQR): time varying volatilities that are not spanned by bond yields and that have predictive content for excess bond returns. The potential presence of USQR raises the important possibility that *ETSMS* have mis-specified the conditional distribution of  $y_t$  in a way that may have distorted estimated risk premiums for bond markets. This section explores this possibility for US Treasury bond markets.

## 5.1 Further Evidence on the Predictability of Excess Returns

Up to this point we have focused on the predictability of excess returns based on yields ( $y_t$ ), because *ETSMS* imply that  $\varsigma_t^2$  (and hence the  $er_t^h(n)$ ) are spanned by  $y_t$ . Prior to exploring the implications of USQR for *ETSMS* we examine whether other conditioning information has predictive content for returns. We can always decompose excess returns  $er_t^h(n)$  as

$$\underbrace{ny_{n,t} - hy_{t,h} - (n-h)E[y_{n-h,t+h}|y_t]}_{\text{spanned by } y_t} - \underbrace{(n-h)(E_t[y_{n-h,t+h}] - E[y_{n-h,t+h}|y_t])}_{\text{unspanned by } y_t}. \quad (27)$$

So additional information will be useful for forecasting excess returns if it forecasts the component of future yields that is unspanned by  $y_t$ .

With this in mind, we approach the potential presence of USQR from two econometric perspectives. First, we focus on the special case of USYV and use relatively higher frequency (than monthly) data to construct semi-nonparametric estimates of the volatilities of US Treasury yields and ask whether these estimates have incremental forecast power for excess returns relative  $V_t$ . This approach is motivated by the possibility that high-frequency data embodies more information about yield volatility than that captured by  $V_t$  extracted from the cross-section of monthly data on yields through our parametric affine model of  $y_t$ .

The data we constructed in [Appendix A](#) is available daily. Using this daily time-series we compute measures of realized variance over the horizons of one, three, and six months. Time-series models for these realized variances are then estimated by one of the following two approaches: *MIDAS* estimates using equation (4.2) in [Andreou, Ghysels, and Kourtellos \(2010\)](#), and *EGARCH* estimates using the framework in [Nelson \(1991\)](#).<sup>13</sup> The first column of [Table 6](#) indicates the horizon (in months) over which the realized variances that serve as inputs into the forecasting equations are computed. Estimation is with daily data and then the fitted variances ( $H$ ) are sampled at a monthly frequency for estimation of the forecasts of excess returns. The columns with the headings  $PCj$ ,  $j = 1, \dots, 4$ , present the adjusted  $R^2$ s from projections of the realized variances of the first four  $PC$ s of bond yields onto  $V_t$ . For the first three  $PC$ s these  $R^2$  are quite low indicating that  $V_t$  bears little resemblance to the alternative measures of variance based on higher frequency data. There is a higher correlation of the variance of  $PC4$  with  $V_t$ , but still it is well below 50% for most cases.

Given these differences, a question of interest is whether  $H$  has incremental forecasting power relative to  $V_t$  for excess bond returns. For the holding periods of six and twelve months, we average the realized excess returns for the bonds with original maturities of one through ten years (excluding the one year for the twelve-month holding period), and project these returns onto  $V$  alone and onto  $(V, H)$  where  $H$  includes the forecasted realized volatilities for the first four  $PC$ s. The high-frequency  $H$  add a small, though statistically significant, amount of predictive power for six-month returns, and the same is true for three-month

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<sup>13</sup>For the *MIDAS* estimates of  $PC1$  for example, the regressors used are lagged realized variances of  $PC1$  for the following horizons: one day, two weeks, one month, three months, and six months. For the *EGARCH* estimates, we first fit the daily time series of  $PC1$  through an AR(1) process to extract a daily series of residuals which are then used to estimate an EGARCH(1,1) model. We then compound the estimated model to compute variance forecasts at desired horizons.

	$R^2$ s for $PC$ s				$R^2$ s for $\bar{x}r_t(6m)$			$R^2$ s for $\bar{x}r_t(12m)$		
	$PC1$	$PC2$	$PC3$	$PC4$	V	V+H	pval(H)	V	V+H	pval(H)
MIDAS 1M	0.168	0.201	0.120	0.288	0.196	0.238	0.000	0.315	0.323	0.731
MIDAS 3M	0.214	0.197	0.136	0.375	0.196	0.235	0.003	0.315	0.323	0.803
MIDAS 6M	0.217	0.171	0.167	0.475	0.196	0.250	0.009	0.315	0.326	0.868
EGARCH 1M	0.116	0.133	0.092	0.295	0.196	0.252	0.002	0.315	0.338	0.319
EGARCH 3M	0.116	0.134	0.094	0.297	0.196	0.253	0.001	0.315	0.339	0.327
EGARCH 6M	0.116	0.134	0.096	0.300	0.196	0.253	0.003	0.315	0.338	0.340

Table 6: The adjusted  $R^2$ s from projecting high frequency measures of the volatilities of yields ( $H$ ) onto  $V$ , and projecting excess returns onto  $V$  and  $H$ .  $\bar{x}r_t(T)$  denotes the average excess return over the holding period of length  $T$  across bonds with maturities of one through ten years at annual intervals.

holding periods (not shown). On the other hand, for the one-year holding period the  $H$  show no incremental explanatory power relative to  $V$ . Overall, while there is some useful information about yield risk premiums in the high-frequency data, our extracted  $V$  appears to subsume the vast majority of the information in cash bond prices about excess returns.

As a second approach to examining USQR we focus on broader information sets: (i) the yield forecast factor (YF); (ii) the GDP forecast factor (GF); and (iii) the inflation forecast factor (IF). At each point in time, these factors are simply the median forecasts across all Blue-Chip professional forecasters and all forecast horizons, excluding (as before) the first two quarters. The yield forecast factor is also a median across all yield maturities. Assuming that market professionals condition on more information than  $y_t$ , these forecast factors may be informative about the last term in (27). We proceed by projecting cross-maturity average excess returns on the first  $n$  yield PCs for  $n = 4, 5, 6$ , augmenting the projection with each of the four conditioning variables. The adjusted  $R^2$ s are reported in Table 7, where “pval” is the probability value for the t-statistic of the estimated coefficient on the included conditioning variable. Neither YF nor GF show any significant predictive power in the presence of yield PCs. In contrast, IF shows substantial predictive power for risk premiums, much stronger than the yield PCs. Moreover, the results are similar across horizons, and as the number of included PCs (up to six) is increased. Therefore, a further increase in the number of yield-based factors is unlikely to overturn these results.

Finally, considerable attention has recently been given to modeling risk premiums (e.g., [Bollerslev and Todorov \(2011\)](#)) and to forecasting volatility (e.g., [Hansen \(2011\)](#)) using ultra high-frequency data on cash and derivative prices. In principle, these high-frequency constructs applied to US Treasury data should embody at least as much information about risk as  $V$ , since they are computed non-parametrically using intra-day data from derivatives markets. To explore this possibility, in our case as a means of revealing USQR, we consider the realized jump means (JM) constructed by [Wright and Zhou \(2009\)](#) and extended by [Huang and Shi \(2011\)](#), and the measure of realized volatility (RV) constructed by [Mueller,](#)

Forecast factor	PC1-4	PC1-4, F		PC1-5	PC1-5, F		PC1-6	PC1-6, F	
	$R^2$	$R^2$	pval	$R^2$	$R^2$	pval	$R^2$	$R^2$	pval
<b>Panel A: 3-month excess returns</b>									
YF	0.088	0.092	0.241	0.121	0.123	0.313	0.156	0.153	0.865
GF	0.088	0.086	0.770	0.121	0.118	0.843	0.156	0.153	0.858
IF	0.088	0.158	0.000	0.121	0.192	0.000	0.156	0.209	0.001
JM	0.088	0.151	0.004	0.121	0.194	0.001	0.156	0.225	0.001
(IF, JM)	0.088	0.194	0.006 0.047	0.121	0.237	0.003 0.016	0.156	0.255	0.011 0.013
<b>Panel B: 12-month excess returns</b>									
YF	0.367	0.377	0.115	0.382	0.390	0.142	0.431	0.430	0.669
GF	0.367	0.374	0.483	0.382	0.388	0.531	0.431	0.437	0.522
IF	0.367	0.584	0.000	0.382	0.601	0.000	0.431	0.616	0.000
JM	0.367	0.555	0.000	0.382	0.583	0.000	0.431	0.625	0.000
(IF, JM)	0.367	0.695	0.000 0.000	0.382	0.723	0.000 0.000	0.431	0.739	0.000 0.000

Table 7: Adjusted  $R^2$ s from regressions of cross-maturity average bonds excess returns on the first  $n$  yield PCs (PC1- $n$ ) and the forecast factors F. Specifications YF, GF, IF, JM correspond to regressions in which F is the yield forecast factor, GDP forecast factor, inflation forecast factor, and the jump amplitude factor, respectively. “pval” is the probability value for the t-statistic of the estimated coefficient on F. (IF,JM) refers to regressions in which excess returns are projected onto PC1- $n$  and both the inflation forecast factor and the jump amplitude factor with the corresponding probability values provided in the “pval” column.

Vedolin, and Yen (2011).<sup>14</sup> Both series are computed from intra-day data on thirty-year Treasury bond futures. JM is a measure of the time-varying amplitude of jumps in the US Treasury bond market, and RV is a measure of the historical realized volatility over a day.

The row “JM” in Table 7 reveals that JM has substantial incremental forecasting power for excess returns relative to the yield PCs, confirming a similar finding by Wright and Zhou (2009) using different yield data. On the other hand, we find that inclusion of RV as a conditioning variable has a relatively small impact on fitted excess returns. RV has no incremental explanatory power relative to our extracted volatilities  $V$  for excess returns over six-month holding periods. For a one-year holding period the adjusted  $R^2$  increases from 32% to 34%. Thus, once again we find that high-frequency measures of volatility reveal limited new information about risk premiums in Treasury markets relative to  $V$ .

Focusing on the two variables with substantial incremental forecasting power, JM and IF, inclusion of both in the projections (see the last rows of each panel of Table 7, specification (IF,JM)) leads to a sizable increase in the adjusted  $R^2$  relative to when they appear separately. For example, when the holding period is twelve months, the  $R^2$  statistics increase by more than 10% regardless of the number of yield PCs included. The reason for the complementary

<sup>14</sup>We thank the authors of these papers for providing us with their data series.

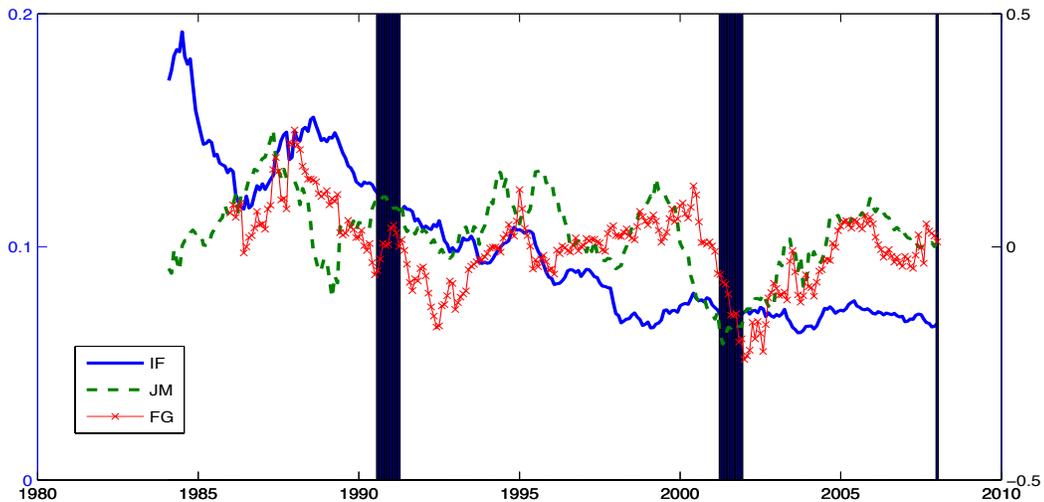


Figure 2: Time series of the inflation forecast factor (IF) and the mean jump amplitude factor (JM), compared to the liquidity factor constructed by Fontaine and Garcia (2012) (FG). Shared areas indicate NBER recessions.

forecast powers of JM and IF is visually clear in Figure 2 where it is seen that they operate at different frequencies. Whereas IF is trend-like, JM shows more cyclical variation.

Conceptually, the jump-mean JM could represent a variety of economic phenomena, including liquidity and fear of large unforeseen events. We found that JM correlates rather strongly, and particularly so since the mid 1990's, with the market liquidity factor that Fontaine and Garcia (2012) constructed using a dynamic term structure model that accommodated differing liquidities across individual Treasury bonds. In fact, when their liquidity factor is substituted for JM in the projections in Table 7 we obtain quantitatively very similar results. This suggests that JM is capturing the effects of financial frictions or flight-to-liquidity phenomena as documented in Greenwood and Vayanos (2010b) and Krishnamurthy and Vissing-Jorgensen (2012).

These findings represent a major challenge for those *ETSMs* that imply that the volatility factors  $V$  fully span all relevant information about expected excess returns in bond markets. Indeed it seems that to rationalize our findings within this class of affine *ETSMs*, it is necessary to introduce quantities of risk that are unspanned by bond yields. Since  $V$ , by construction, is spanned by  $y_t$ , it would then be possible for both risk premiums to be fully determined by  $\zeta_t^2$  and yet for other conditioning variables beyond our constructed  $V$  to have predictive power for bond excess returns.<sup>15</sup>

<sup>15</sup>An alternative rationalization could be that a higher dimensional  $\zeta_t^2$  is needed. However, our choice of  $(N = 4, \mathcal{R} = 2)$  encompasses the majority of *ETSMs*, as illustrated in Table 1. Furthermore, given the spanning properties of these models, we have found that the coefficients of the projections of squared yield-forecast errors onto  $y_t$  are well approximated a matrix of rank two, which implies that a larger  $\mathcal{R}$  is not

## 5.2 USQR in the Context of *ETSMS*s

To develop the implications of unspanned risks within *ETSMS*s, consider again the stacked yield pricing equations (7). The presence of unspanned risks is equivalent to the rank of the loading matrix  $[B, C]$  being less than the number of risk factors:

$$r_Z = \text{rank}([B, C]) < N. \quad (28)$$

At one extreme, suppose that  $\zeta_t^2$  is fully *unspanned* by bond yields. In this case the loadings  $C$  are zero for all maturities, as  $y_t$  cannot depend directly on  $\zeta_t^2$ . For our empirical implementation with  $(N = 4, \mathcal{R} = 2)$ , this means that only the two non-volatility factors  $\nu_t$  are spanned by  $y_t$  and that  $r_Z = 2$ . Further, following the reasoning in [Joslin, Le, and Singleton \(2012\)](#), this implies that the first two yield PCs fully span the information generated by  $\nu_t$ .

More generally, when  $r_Z < N$ , it can be shown that there are  $N - r_Z$  linear combinations of  $(\nu_t, \zeta_t^2)$  that cannot be inverted from bond yields. The information set generated by the  $r_Z$  linear combinations of  $(\nu_t, \zeta_t^2)$  that *can* be inverted from bond yields should be well approximated by the first  $r_Z$  yield PCs, particularly for small  $r_Z$ .

Now if  $r_Z = 1$  (yields depend on a single linear combination of the state  $z_t$ ), then yields at all maturities are perfectly correlated, conditionally and unconditionally. Whence, for our choice of  $N = 4$ , realistic values of  $r_Z$  are 2 and 3. The larger is  $r_Z$  the richer is the information set generated by the spanned components, and the more difficult it is to rationalize our prior evidence on the predictability of excess returns. Therefore, we set  $r_Z = 2$  in our subsequent analysis and use the first two yield PCs to control for the spanned components. This way, we give IF and JM the best chances to exhibit their predictive power for squared residuals. Though not reported here, we repeated the same analysis with  $r_Z = 3$  (and  $r_Z = 4$  to account for models with  $N > 4$ ) and obtained comparable results.

The first question we address is whether the correlation between  $(IF, JM)$  and expected excess bond returns is through their correlations with unspanned yield volatility (USYV). The projections of yield squared residuals onto the first two PCs and IF (JM) are displayed in Panel A of [Table 8](#) ([Table 9](#)) for three maturities. Interestingly, despite their predictive power for excess returns, neither IF nor JM has significant incremental predictive power for yield squared residuals. Evidently, the predictive power of  $(IF, JM)$  does not originate from USYV; there may be USYV, but its origins are other than time-variation in  $(IF, JM)$ .

To see how this might arise, consider an environment with  $(N = 4, \mathcal{R} = 2, r_Z = 2)$  and suppose that: (a) one of the non-volatility factors ( $\nu_{1t}$ ) and one of the volatility factors ( $\zeta_{1t}^2$ ) are unspanned and hence do not enter the affine pricing expression (7), for all maturities  $n$ ; (b) the remaining factors ( $\nu_{2t}, \zeta_{2t}^2$ ) are fully spanned by  $y_t$ ; (c) the time varying volatility of  $(\nu_{2t}, \zeta_{2t}^2)$  is driven entirely by  $\zeta_{2t}^2$ ; and (d) both volatility factors have predictive content for bonds excess returns. In such a setting, if IF and JM are informative about  $\zeta_{1t}^2$ , they would be able to forecast excess returns beyond the yield PCs without showing any incremental power in predicting the conditional variance of  $y_t$ .

Pursuing this scenario, within the structure of *ETSMS*s, there remains the question of which unspanned risk is being captured by the quantity  $\zeta_{1t}^2$ . Panels B of [Table 8](#) and [Table 9](#) address

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likely to overcome this challenge.

	$H = 2$			$H = 4$			$H = 6$		
	AdjR2			AdjR2			AdjR2		
	PC1-2	IF	pval	PC1-2	IF	pval	PC1-2	IF	pval
<b>Panel A: Squared yield residuals</b>									
1-y	0.115	0.114	0.467	0.231	0.228	0.921	0.326	0.324	0.887
5-y	0.126	0.124	0.490	0.275	0.272	0.919	0.386	0.384	0.914
10-y	0.137	0.137	0.454	0.253	0.252	0.683	0.306	0.304	0.849
<b>Panel B: Macro residuals</b>									
$e_{CPI}^2$	0.099	0.113	0.050	0.257	0.299	0.089	0.352	0.397	0.190
$e_{GDP}^2$	0.094	0.094	0.410	0.238	0.242	0.495	0.312	0.321	0.432
$e_{CPI}e_{GDP}$	-0.001	-0.004	0.655	0.008	0.005	0.674	0.019	0.017	0.748
<b>Panel C: Cross inflation-yield residual products</b>									
1-y	0.050	0.062	0.138	0.130	0.154	0.253	0.167	0.196	0.318
5-y	0.060	0.077	0.044	0.171	0.203	0.132	0.232	0.276	0.185
10-y	0.043	0.052	0.129	0.135	0.152	0.282	0.185	0.210	0.359
<b>Panel D: Cross GDP-yield residual products</b>									
1-y	-0.001	-0.003	0.558	0.004	0.013	0.384	0.003	0.013	0.451
5-y	0.005	0.002	0.872	0.021	0.022	0.539	0.035	0.035	0.691
10-y	0.016	0.014	0.472	0.043	0.055	0.193	0.073	0.091	0.234

Table 8: Regressions of various squared residuals and residuals products constructed from BCFF yield forecasts on on the first two yield PCs and the inflation-forecast factor (IF).

the possibility that it captures the influence of unspanned volatility in inflation or real output growth, respectively. Neither JM nor IF has predictive power for the conditional second moments of these macro variables. Panels C and D examine the conditional covariances of yields with inflation and GDP growth, and again  $(IF, JM)$  fail to show any predictive power for these conditional second moments beyond the yield  $PCs$ .

Taken together, these results suggest that the predictive power of  $(IF, JM)$  for bond excess returns does not arise as a consequence of unspanned conditional second moments of bond yields, inflation, and output growth.

## 6 Concluding Remarks

In this paper, we set out to explore in depth the nature of risk premiums in US Treasury bond markets over the past thirty years through the lens of investors' pricing kernels as parameterized in studies of preference-based  $ETSMs$ . Many prominent  $ETSMs$  in which the state of the economy  $z_t$  follows an affine process imply that the variation in expected excess returns on bond portfolio positions is fully spanned by the set of conditional variances  $\zeta_t^2$  of  $z_t$ . We show that these two assumptions alone—spanning of expected excess returns by the variances  $\zeta_t^2$  of affine processes  $z_t$ —are sufficient to econometrically identify the quantities of risk that span risk premiums from the term structure of bond yields. Using this result

	$H = 2$			$H = 4$			$H = 6$		
	AdjR2			AdjR2			AdjR2		
	PC1-2	JM	pval	PC1-2	JM	pval	PC1-2	JM	pval
<b>Panel A: Squared yield residuals</b>									
1-y	0.115	0.116	0.131	0.231	0.237	0.125	0.326	0.334	0.242
5-y	0.126	0.122	0.824	0.275	0.273	0.702	0.386	0.384	0.944
10-y	0.137	0.135	0.477	0.253	0.251	0.581	0.306	0.307	0.466
<b>Panel B: Macro residuals</b>									
$e_{CPI}^2$	0.099	0.101	0.268	0.257	0.270	0.278	0.352	0.368	0.397
$e_{GDP}^2$	0.094	0.104	0.147	0.238	0.265	0.199	0.312	0.348	0.223
$e_{CPI}e_{GDP}$	-0.001	0.005	0.138	0.008	0.032	0.172	0.019	0.049	0.195
<b>Panel C: Cross inflation-yield residual products</b>									
1-y	0.050	0.050	0.385	0.130	0.137	0.370	0.167	0.194	0.320
5-y	0.060	0.063	0.279	0.171	0.185	0.300	0.232	0.269	0.312
10-y	0.043	0.048	0.182	0.135	0.157	0.202	0.185	0.240	0.196
<b>Panel D: Cross GDP-yield residual products</b>									
1-y	-0.001	-0.005	0.778	0.004	0.003	0.700	0.003	0.003	0.717
5-y	0.005	0.001	0.889	0.021	0.017	0.952	0.035	0.032	0.878
10-y	0.016	0.013	0.734	0.043	0.040	0.814	0.073	0.072	0.763

Table 9: Regressions of various squared residuals and residuals products constructed from BCFF yield forecasts on on the first two yield PCs and the jump means variable.

we derive maximum likelihood estimates of  $\zeta_t^2$  and evaluate the goodness-of-fit of the family of affine *ETSMs* that imply this tight link between premiums and quantities of risk. These assessments are fully robust to the values of the parameters governing preferences and the evolution of the state  $z_t$ , and to whether or not the economy is arbitrage free.

Our main findings are four-fold: (i) time variation in two quantities of risk (yield volatilities) fully subsume the information in the yield curve about both the conditional variances of yields and bond excess returns; (ii) inflation risk is a significant (and perhaps a dominant macroeconomic) risk underlying risk premiums in U.S. Treasury markets; (iii) there is a second, distinct “flight to quality” risk manifested in a sizable impact of yield-jump amplitudes on excess returns; and (iv) there is a significant unspanned (by bond yields) component of risk premiums in the US Treasury market that is not accommodated by extant *ETSMs* and that is not explained by unspanned volatility in yields, inflation, or output growth.

These results are premised on our extracted  $V_t$  being reasonable proxies for the volatility factors underlying conditional variation in bond yields. To assess this, we examined a discrete-time canonical  $A_2(4)$  affine term structure model (Dai and Singleton (2000)). Unlike our presumed data-generating process, this  $A_2(4)$  model: (i) imposes no-arbitrage so the loadings in (7) are determined by the parameters of the risk-neutral, pricing distribution of  $z_t$ ; and (ii) does not constrain the model-implied bond risk premiums to be spanned by the quantities of risks  $\zeta_t^2$ . Upon estimating an  $A_2(4)$  model and projecting  $V_t$  onto the two fitted conditional variances from this model, we obtained adjusted  $R^2$ s of over 0.995. This finding reinforces our

assertion that our robust, model-free (beyond Condition *RIETSM*) approach to extracting  $V_t$  produces a precise and reliable spanning vector for the conditional variances of bond yields. Moreover, the fact that the implied volatility factors are nearly perfectly correlated, even though the  $A_2(4)$  does not contain the risk premiums as in *ETSMs*, is fully anticipated by our findings in Section 4.3 and is supportive of this aspect of the structure of *ETSMs*.

Nevertheless, our findings cast doubt on the presumptions of many affine term structure models. At one extreme, finding (i) runs counter to the presumption in the large class of Gaussian models that time variation in risk premiums arises entirely through variation in the market prices of risks. The quantities of risk  $V_t$  span the information in the yield curve upon which many of these Gaussian models have relied on in explaining excess bond returns. This is consistent with the implications of recent *ETSMs* that have emphasized the importance of volatility movement on asset prices (e.g., Bansal, Kiku, Shaliastovich, and Yaron (2012)). At the other extreme, our finding challenge the presumption in many *ETSMs* that time-varying quantities of risk are sufficient to capture the state-dependence of risk premiums in the Treasury market. Both an inflation factor and measures of liquidity in the Treasury market have substantial explanatory power for bond excess returns. To reconcile this evidence with *ETSMs*, one could rely on unspanned (by yields) quantities of risk. However, in exploring this possibility, we were able to rule out (for our data and sample period) the possibilities of these factors affecting expected excess returns through unspanned volatilities in bond yields, inflation, or output growth.

Two plausible, alternative explanations of our findings are time-varying market prices of inflation risk or policy risks that are correlated with inflation expectations,<sup>16</sup> and flight-to-quality or specialness of Treasury bonds. Our analysis suggests, when modeling bond yields, it may be important to extend *ETSMs* to allow for both time-varying quantities and market prices of inflation risks.

As for an important role for liquidity, broadly construed, neither *ETSMs* nor reduced-form affine models of Treasury yields have typically accommodated financial frictions or flight-to-quality considerations as explicit sources of variation in risk premiums. However, the contribution of jump amplitudes to explained variation in risk premiums is large, plays a distinct role relative to inflation risk, and its effects are present for holding periods of at least one year. Thus, accommodating a liquidity factor when studying the pricing of Treasury bonds within *ETSMs* may well be essential for obtaining a reliable assessment of how macroeconomic factors impact risk premiums in this market.

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<sup>16</sup>The importance of policy risk/uncertainty for the pricing of bonds has recently been explored by Wright (2011), Ulrich (2013), and Pastor and Veronesi (2013), among others.

# Appendices

## A The Information in Long-Maturity Yields

This appendix discusses the importance of using long-maturity bond yields in assessing the dynamic properties of risk premiums in Treasury markets. We raise this issue, because our prior is that the choice of splines underlying the construction of the zero-coupon bond yields typically used in the analysis of *ETSMS* may well matter for the properties of the fitted risk premiums. [Cochrane and Piazzesi \(2005\)](#), [Duffee \(2011\)](#), and [Bansal and Shaliastovich \(2012\)](#), among others, chose to focus on maturities out to five years when studying risk premiums.

To shed light on whether longer maturity yields contain non-redundant information about risk premiums, we estimate the unconstrained linear projections of realized excess returns  $xr_{t+h}^h(\tau)$  onto yield-curve information at date  $t$ . We set  $h$  to six or twelve months and consider three choices of conditioning information: (i) yields on maturities from one to five years ( $J = 5$ ); (ii) yields on maturities from one to five years plus the seven-, eight-, and ten-years ( $J = 8$ ); and (iii) yields on maturities from one to ten years ( $J = 10$ ). Of interest is the incremental predictive power of the latter cases ( $J = 8$  and  $J = 10$ ) relative to when only yields up to five years are used in prediction.

The adjusted  $R^2$ 's from the projections are reported in [Table 10](#), along with the probability values (*pvals*) of the chi-square tests of joint significance of the yields with maturities beyond five years. BIC ([Schwarz \(1978\)](#)) scores are used to select the preferred forecasting model among these three specifications. From these results it is clear that long maturity yields contain substantial extra predictive power over and above the first five yields. For example, for the annual holding period and the cross-sectional average of the excess returns ( $\text{mean}(xr)$ ), the adjusted  $R^2$  increases by 4% (6%) to 42% (44%) by including three (five) longer-maturity yields. Moreover, for both this average and the individual excess returns, the BIC selection criterion always chooses information sets that include the long-maturity yields.

We explored the robustness of these findings in two ways. First, we re-estimated the projections with yields back to March, 1972. Earlier data was discarded owing to the relative sparseness of long-maturity bonds. Using this longer data set there is even stronger evidence that long-maturity yields have predictive content for excess returns in Treasury markets.

Second, we re-estimated the projections using the GSW dataset from the Federal Reserve's website.<sup>17</sup> For the long sample, the long-term GSW yields embodied much less incremental forecasting power than our constructed UFB data. For the shorter sample period the patterns were comparable, but with GSW data the BIC criterion selected the specification  $J = 5$  for both the  $\text{mean}(xr)$  and the excess returns on the seven- through ten-year bonds.

Based on this evidence we conclude that long-dated yields are informative about risk premiums and that the prior literature may have overlooked this information owing to the highly smoothed forward rates implicit in spline used to construct the GSW data. The weights on forward rates in the projections with our UFB data are displayed in [Figure 3](#). Clearly

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<sup>17</sup><http://www.federalreserve.gov/Pubs/feds/2006/200628/200628abs.html>

Panel A: Six-Month Holding Period								
	R(1-5)		R(1-5,7,8,10)			R(1-10)		
	Adj $R^2$	BIC	Adj $R^2$	pval	BIC	Adj $R^2$	pval	BIC
mean(xr)	0.26	-10.51	0.29	0.01	-10.62	0.31	0.00	-10.63*
xr(3)	0.28	-13.56	0.32	0.00	-13.74*	0.32	0.00	-13.66
xr(5)	0.25	-10.69	0.30	0.00	-10.88*	0.31	0.00	-10.83
xr(7)	0.25	-9.04	0.27	0.04	-9.09*	0.29	0.00	-9.09
xr(10)	0.20	-7.12	0.26	0.02	-7.23	0.29	0.00	-7.31*

Panel B: Twelve-Month Holding Period								
	R(1-5)		R(1-5,7,8,10)			R(1-10)		
	Adj $R^2$	BIC	Adj $R^2$	pval	BIC	Adj $R^2$	pval	BIC
mean(xr)	0.38	-8.55	0.42	0.02	-8.79	0.44	0.00	-8.81*
xr(3)	0.35	-12.25	0.40	0.02	-12.60*	0.40	0.04	-12.54
xr(5)	0.36	-9.21	0.42	0.00	-9.58*	0.43	0.00	-9.55
xr(7)	0.38	-7.60	0.42	0.05	-7.82	0.43	0.04	-7.82*
xr(10)	0.36	-5.69	0.41	0.02	-5.89	0.43	0.00	-5.95*

Table 10: Adjusted  $R^2$  (Adj $R^2$ ) from regressing six- (Panel A) and twelve-month (Panel B) excess returns  $xr(n)$  of bonds with  $n$  years to maturity on yields with 1-5 years to maturity (R(1-5)), 1-10 years to maturity (R(1-10)), and 1-5, 7,8,10 years to maturity (R(1-5,7,8,10)). Yields are extracted from the UFB dataset. pval’s are for the joint significance tests of the loadings on longer-than-5-year maturities. The models chosen by the BIC scores (divided by 100) are indicated by an “\*.”

visible is the “tent-shape” pattern of loadings for the first five forward rates documented by [Cochrane and Piazzesi \(2005\)](#). The pattern of these loadings is essentially unchanged when all ten forward rates are included as predictors. Interestingly, the loadings on the long-maturity forwards for years six through ten form an inverted “tent-shape” pattern which is also robust to whether the first five forward rates are included or not.

## B Construction of Zero Yield Forecasts

In this appendix, we give details of the construction of the zero yield forecasts used in the paper. We first show how to interpolate the raw forecasts (of yields over calendar quarters) obtain forecasts for non-calendar quarters. Next, we show how to construct zero yield forecasts from forecasts of par yields. To fix notation, let’s denote the  $n$ -period zero yields and  $n$ -period par yields by  $y_{n,t}$  and  $\tilde{y}_{n,t}$ , respectively.

### B.1 Non-Calendar Quarter Forecasts

Recall that from the Blue Chip surveys, we obtain forecasts of average par yields over calendar quarters. For example, the one- and two-quarter forecasts as of the end of December, January,

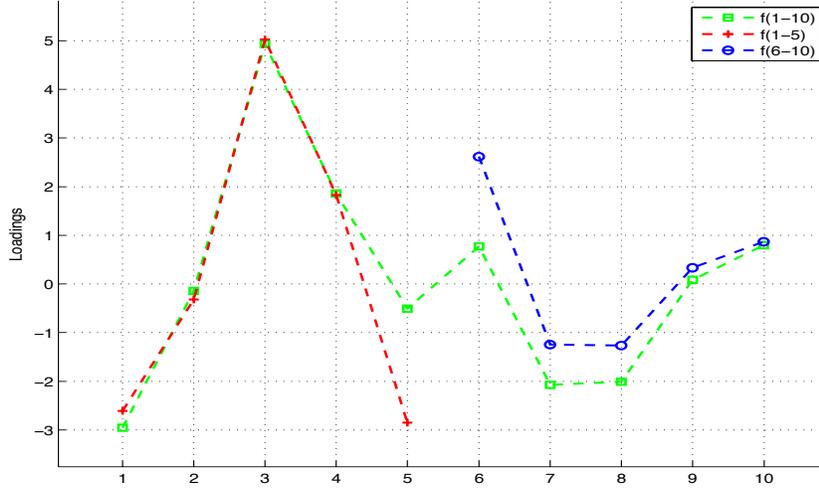


Figure 3: Loadings from the projections of  $mean(xr_{t+h})$  with  $h = 12$  (annual holding period) onto the first five one year forward rates (f(1-5)), the first ten one-year forward rates (f(1-10)), and the set of forward rates from 5 years to 6 years, 6 years to 7 years, ... 9 years to 10 years (f(6-10)). The UFB data are used to construct forward rates and excess returns.

and February are all:

$$\tilde{F}_{1,t} = E_t[\tilde{y}_{120,Jan} + \tilde{y}_{120,Feb} + \tilde{y}_{120,Mar}] \text{ and } \tilde{F}_{2,t} = E_t[\tilde{y}_{120,Apr} + \tilde{y}_{120,May} + \tilde{y}_{120,Jun}].$$

Obviously, the forecast horizons are different from one month to another depending on which month of the quarter at which the forecasts are formed. To equate the forecast horizons throughout the sample, we follow the approach of [Chun \(2010\)](#) and interpolate the raw forecasts such that the one-quarter forecasts are always for the average par yields of the first three months from  $t + 1$  to  $t + 3$ , the two-quarter forecasts are for the average par yields from  $t + 4$  to  $t + 6$ :

$$\tilde{Q}_{1,t} = E_t[\tilde{y}_{120,t+1} + \tilde{y}_{120,t+2} + \tilde{y}_{120,t+3}], \quad \tilde{Q}_{2,t} = E_t[\tilde{y}_{120,t+4} + \tilde{y}_{120,t+5} + \tilde{y}_{120,t+6}],$$

and so on. Specifically, for the first month of each quarter (Jan, Apr, Jul, Oct), we compute the q-quarter forecasts as:

$$\tilde{Q}_{q,t} = \frac{2}{3}\tilde{F}_{q,t} + \frac{1}{3}\tilde{F}_{q+1,t}.$$

Likewise, for the second month of each quarter (Feb, May, Aug, Nov), we compute the q-quarter forecasts as:

$$\tilde{Q}_{q,t} = \frac{1}{3}\tilde{F}_{q,t} + \frac{2}{3}\tilde{F}_{q+1,t}.$$

For the third month of each quarter, we leave the raw forecasts intact. The same treatment is applied to bonds of all maturities.

## B.2 Zero Yield Forecasts

For each day  $t$  and each forecast horizon  $q$ , we have forecasts for par yields of various maturities. The set of maturities has changed from time to time. For the first four years of the sample (1984-1987), there are only three maturities included: 3-month, 3-year, and 30-year. For the remaining twenty years of the sample, forecasts of eight different maturities are reported each month. Except for some brief changes,<sup>18</sup> this set includes: 3-month, 6-month, 1-year, 2-year, 5-year, 7-year, 10-year, and 30-year.

To fix to a set of maturities over time, and more importantly, to convert forecasts of par yields into forecasts of corresponding zero yields, we simply apply the standard Fama-Bliss bootstrap technique<sup>19</sup> to the set of par yield forecasts on each day  $t$  and each forecast horizon  $q$ . In so doing, we treat the par yield forecasts as if they were actual observed par yields. Additionally, in the bootstrapping calculations, we ignore the fact that the forecasts are for averages over three successive months. The output of the bootstrap, for example for the 10-year maturity and one-quarter forecast horizon, is interpreted as:

$$Q_{1,t} = E_t[y_{120,t+1} + y_{120,t+2} + y_{120,t+3}].$$

In applying the bootstrapping techniques to the average forecasts directly,<sup>20</sup> the resulting zero yield forecasts suffer from the Jensen effect. However, we now show that this effect is economically very negligible.

To prove that the Jensen effect is very minimal, we perform the following exercise. We fit yields data over our sample period to three prominent term structure models:  $A_0(4)$ ,  $F_1(4)$ , and  $F_2(4)$ . The first model is the standard gaussian affine with no-arbitrage. The next two models have one and two stochastic volatility factors, respectively but without no-arbitrage imposed. To be consistent with the models considered in this paper, we choose four factors in each model. Next, we use each model to generate par yield forecasts for six different maturities,<sup>21</sup> averaged over three-month windows, corresponding exactly to the forecasts reported in the BCFF newsletters. To each set of forecasts, we apply the bootstrapping technique described above to obtain an approximate set of zero yield forecasts averaged over three-month windows. Finally, we compare these bootstrapped forecasts to the true forecasts of zero yields generated by each model.

Figure 4 plots the bootstrapped forecasts and the true forecasts generated by the  $F_2(4)$  model for the 1-year and 10-year bonds:

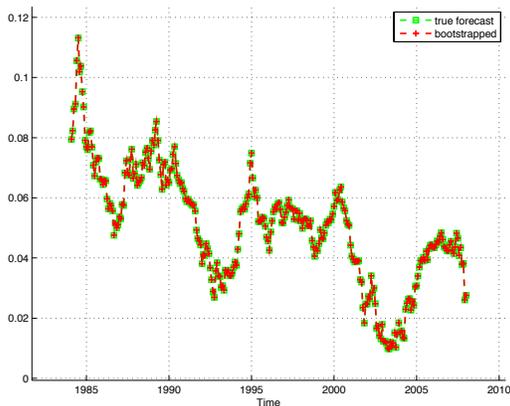
$$E_t[y_{12,t+16} + y_{12,t+17} + y_{12,t+18}] \text{ and } E_t[y_{120,t+16} + y_{120,t+17} + y_{120,t+18}].$$

<sup>18</sup>For example, the 30-year series were replaced briefly by the 20-year series when the former was discontinued and resumed again.

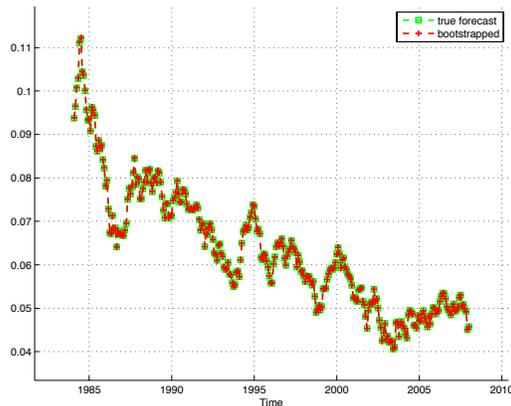
<sup>19</sup>Specifically, we assume that the forward rates are piece-wise constant between any two successive maturities.

<sup>20</sup>The more proper approach is to apply the bootstrapping technique to each future realization of the par yield curve and take average over all resulting zero curves. But such a method is not feasible since we do not observe the dynamics underlying each forecast.

<sup>21</sup>They are 6-month, 1-year, 3-year, 5-year, 7-year, and 10-year.



(a) 1-yr bond,  $F_2(4)$



(b) 10-year bond,  $F_2(4)$

Figure 4: Comparison of bootstrapped forecasts versus true forecasts of average zero-yields averaged over the sixth quarter.

Note that these forecasts are for six quarters out. Visually, the bootstrapped and the true forecasts are essentially identical. Very similar pattern obtains if we use the other two models, any forecast horizon or any bond maturity.

To show this more concretely, we regress the approximate forecasts on the true forecasts and report the loading, the adjusted R-squared statistics in [Table 11](#). Evidently, regardless of the forecast horizons (three quarters or six quarters out), bond maturity (1-year, 3-year, 5-year, or 10-year), or the true underlying models ( $A_0(4)$ ,  $F_1(4)$ , or  $F_2(4)$ ), the adjusted R-squared is always perfect and the loading is essentially one. The average differences as well as the RMSEs between the bootstrapped and true forecasts are, for all cases, less than or equal to three basis points.

## C $ARG(\rho, c, \gamma)$ Processes

Following [Le, Singleton, and Dai \(2010\)](#) we assume that, conditional on  $\varsigma_t^2$ , the components of  $\varsigma_{t+1}^2$  are independent. To specify the conditional distribution of  $\varsigma_{t+1}^2$ , we let  $\varrho$  be an  $N \times N$  matrix with elements satisfying

$$0 < \varrho_{ii} < 1, \varrho_{ij} \leq 0, 1 \leq i, j \leq N.$$

Furthermore, for each  $1 \leq i \leq N$ , we let  $\rho_i$  be the  $i^{\text{th}}$  row of the  $N \times N$  non-singular matrix  $\rho = (I_{N \times N} - \varrho)$ . Then, for constants  $c_i > 0$ ,  $\gamma_i > 0$ ,  $i = 1, \dots, N$ , we define the conditional density of  $\varsigma_{i,t+1}^2$  given  $\varsigma_t^2$  as the Poisson mixture of standard gamma distributions:

$$\frac{\varsigma_{i,t+1}^2}{c_i} | (P, \varsigma_t^2) \sim \text{gamma}(\gamma_i + P), \quad \text{where } P | \varsigma_t^2 \sim \text{Poisson}(\rho_i \varsigma_t^2 / c_i). \quad (29)$$

		Three-quarter forecasts				Six-quarter forecasts			
		Loading	Adj R2	Ave. Diff.	RMSE	Loading	Adj R2	Ave. Diff.	RMSE
$A_0(4)$	1-yr bond	1.000	1.000	-2.436	2.436	1.000	1.000	-0.999	0.999
	3-yr bond	1.000	1.000	-2.446	2.463	1.000	1.000	-0.251	0.317
	5-yr bond	1.000	1.000	-2.426	2.439	1.000	1.000	-0.206	0.268
	10-yr bond	1.001	1.000	-2.388	2.401	1.001	1.000	-0.576	0.608
$F_1(4)$	1-yr bond	0.999	1.000	2.018	2.027	1.001	1.000	-0.752	0.799
	3-yr bond	1.000	1.000	2.931	2.943	1.001	1.000	-0.380	0.417
	5-yr bond	1.000	1.000	3.034	3.042	1.001	1.000	-0.584	0.624
	10-yr bond	0.999	1.000	2.778	2.796	1.001	1.000	-1.119	1.144
$F_2(4)$	1-yr bond	1.000	1.000	-0.425	0.446	1.000	1.000	-0.274	0.292
	3-yr bond	1.001	1.000	-0.515	0.559	1.001	1.000	0.274	0.327
	5-yr bond	1.001	1.000	-0.812	0.866	1.001	1.000	0.174	0.299
	10-yr bond	1.002	1.000	-1.175	1.250	1.002	1.000	-0.227	0.408

Table 11: Regression of bootstrapped forecasts on true forecasts. Average differences (Ave. Diff.) and root mean squared errors (RMSE) are in basis points.

Here, the random variable  $P \in (0, 1, 2, \dots)$  is drawn from a Poisson distribution with intensity modulated by the current realization of the state vector  $\zeta_t^2$ .

The conditional density function of  $\zeta_{i,t+1}^2$  takes the form:

$$f^{\mathbb{Q}}(\zeta_{i,t+1}^2 | \zeta_t^2) = \frac{1}{c_i} \sum_{k=0}^{\infty} \left[ \frac{\left(\frac{\rho_i \zeta_t^2}{c_i}\right)^k}{k!} e^{-\frac{\rho_i \zeta_t^2}{c_i}} \times \frac{\left(\frac{\zeta_{i,t+1}^2}{c_i}\right)^{\gamma_i+k-1} e^{-\frac{\zeta_{i,t+1}^2}{c_i}}}{\Gamma(\gamma_i+k)} \right]. \quad (30)$$

Using conditional independence, the distribution of  $\zeta_{t+1}^2$ , conditional on  $\zeta_t^2$ , is given by  $f(\zeta_{t+1}^2 | \zeta_t^2) = \prod_{i=1}^N f(\zeta_{i,t+1}^2 | \zeta_t^2)$ . When the off-diagonal elements of the  $N \times N$  matrix  $\varrho$  are non-zero, the autoregressive gamma processes  $\{\zeta_i^2\}$  are (unconditionally) correlated. Thus, even in the case of correlated  $\zeta_{it}^2$ , the conditional density of  $\zeta_{i,t+1}^2$  is known in closed form.

## D Does $V_t$ Encompass the Information in Yields About Risk? Replication Using Actual Yields

In [Table 12](#) we report the adjusted  $R^2$  statistics of the two sets of projections in [\(20\)](#) for the forecast errors associated with each of the first four  $PC$ s comprising  $\mathcal{P}_t$ . Across all horizons  $H$  and all  $PC$ s,  $V_t$  has virtually the same forecasting power as  $\mathcal{P}_t$ . For example, for  $H = 2$  and  $PC1$ , the adjusted  $R^2$  from conditioning on  $\mathcal{P}_t$  ( $V_t$ ) is 18.8% (18.4%). To formally

	$H = 2$			$H = 4$			$H = 6$		
	Adj. $R^2$		pval	Adj. $R^2$		pval	Adj. $R^2$		pval
	4 PCs	$V_t$		4 PCs	$V_t$		4 PCs	$V_t$	
PC1	0.188***	0.184***	0.750	0.302***	0.288***	0.532	0.366***	0.353***	0.644
PC2	0.073*	0.047	0.653	0.130	0.096	0.675	0.154*	0.143	0.912
PC3	0.088***	0.051	0.142	0.186**	0.141	0.323	0.242**	0.200*	0.376
PC4	0.268***	0.255***	0.612	0.388**	0.379***	0.798	0.442**	0.429***	0.654

Table 12: Comparison of projections of squared forecast errors, obtained from a  $VAR(1)$  model of  $\mathcal{P}_{t+1}$ , onto  $\mathcal{P}_t$  versus  $V_t$ . “pval” is the robust probability value for the chi-square test of the null hypothesis  $\beta_{\mathcal{P}} = \beta_V \beta$ . The superscripts (\*, \*\*, \*\*\*) denote the level of significance (at 10%, 5%, 1%, respectively) of the  $\chi^2$  test of joint significance of the slope coefficients.

evaluate the differences in fits, we conduct  $\chi^2$  tests of  $H_0 : \beta_{\mathcal{P}} = \beta_V \beta$ .<sup>22</sup> The probability values (“pvals”) confirm that the small differences in  $R^2$ s are statistically insignificant.

<sup>22</sup>The probability values of this test reported in Table 12 are adjusted to account for the use of first-stage estimates of  $\beta$  as well as  $\epsilon_t$  in estimating the regressions in (20). To account for the serial correlation of errors, we use the Newey-West estimates of the large-sample variance matrix with twelve lags.

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