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# The predictive power of the yield curve: a theoretical assessment<sup>☆</sup>

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## Abstract

Although the empirical evidence about the leading indicator property of the term spread (LIPTS) is powerful, this property lacks a rigorous theoretical foundation. This paper investigates whether dynamic equilibrium asset pricing models are able to provide a theoretical underpinning for the LIPTS. We study an endowment and a production economy. The endowment economy is unable to account for the LIPTS. On the other hand, a model with endogenous production provides a reasonable theoretical justification for the LIPTS.

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## 1. Introduction

The yield curve has long been monitored for the information it contains about future economic activity. Looking at [Fig. 1](#), it is striking how closely the current term

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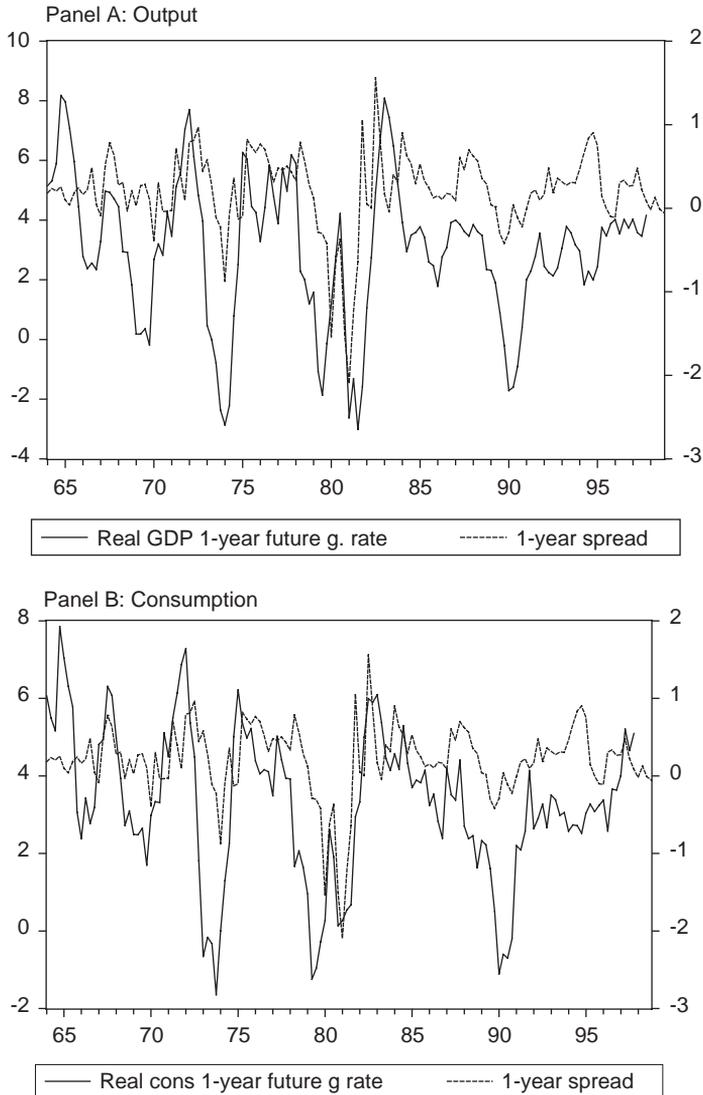


Fig. 1. Predictive power of the term spread for future output and consumption growth rates. GDP and consumption growth rates are shown on the left scale, the term spread is on the right scale. All values are annualized and shown in %. The 1 year spread is defined as  $spread_t^4 = r_t^4 - r_t^1$ , and 1 year consumption and output growth rates as  $c_t^4 = \ln(c_{t+4}/c_t/4) \times 400$  and  $y_t^4 = \ln(y_{t+4}/y_t/4) \times 400$ , respectively.

spread (the difference between the long and short interest rates, i.e. a measure of the slope of the yield curve) tracks movements in the future output and consumption growth rates. Since in both graphs at each point in time  $t$ , the spread is known but future growth rates are not, the term spread appears to contain predictive information about future economic activity. Based on this observation, numerous

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