The predictive power of the yield curve: a theoretical assessment

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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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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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