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# Interest Rate Volatility, the Yield Curve, and the Macroeconomy<sup>☆</sup>

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## Abstract

This paper provides theory and evidence that a low-dimensional term structure model can simultaneously price bonds and related options. It shows that a component of volatility risk largely unrelated to the shape of the yield curve is a determinant of expected excess returns for holding long maturity bonds. It also finds evidence for this return relationship both in the model and directly in the data through regression analysis. The paper also identifies a link between corporate earnings performance and interest rate volatility, providing a channel driving interest rate volatility. The structure of risk in the model that gives rise to these features of volatility is distinct from that inherent in recent models with unspanned stochastic volatility.

*Keywords:* macro-finance term structure model, interest rate volatility, no-arbitrage model, macroeconomy

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