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Forecasting U.S. Bond Returns

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It is difficult to forecast bond market fluctuations, although some research shows that these fluctuations are not fully unpredictable: It is possible to identify in advance periods when the reward for duration extension is likely to be abnormally high or abnormally low.

In this article, we first describe a few variables that have the ability to predict near-term bond market performance. We then show how to combine the information that these predictors provide into a single forecast and, further, into implementable investment strategies. Finally, we back-test the historical performance of these strategies in a realistic out-of-sample setting.

We show elsewhere that intermediate- and long-term bonds earn higher average returns than short-term bonds. This evidence suggests that the long-run bond risk premium is positive. If the risk premium is constant over time, the long-run average risk premium is also our best forecast for the near-term bond market performance.

Steeply upward-sloping yield curves tend to precede high excess bond returns, and inverted yield curves tend to precede negative excess bond returns. It follows then that the risk premium is not constant, and that the current shape of the yield curve provides valuable information about the time-varying bond risk premium. In this article, we show that other variables can enhance the yield curve's ability to forecast near-term excess bond returns.

The predictability of excess bond returns has important implications for investors who are willing to use so-called tactical asset allocation strategies.

be relied on in making an investment or other decision. There can be no assurance that an investment strategy will be successful. Historic market trends are not reliable indicators of actual future market behavior or future performance of any particular investment which may differ materially, and should not be relied upon as such. Diversification does not eliminate the risk of experiencing investment losses.

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