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Market Rate Expectations and Forward Rates

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Three main forces determine the term structure of forward rates: the market's rate expectations; required bond risk premia; and the convexity bias. Many market observers believe that the first force is the dominant one. This article focuses on the impact of the market's rate expectations on the yield curve shape but emphasizes the consequences of ignoring the two other forces.

The impact of rate expectations on today's yield curve shape is best isolated by assuming that the pure expectations hypothesis holds. According to this hypothesis, all government bonds have the same near-term expected return (that is, all bond risk premia are zero). If the near-term expected returns are equal across maturities, initial yield differences must offset any expected capital gains or losses that are caused by the market's rate expectations.

For example, if the market expects rates to rise and long-term bonds to suffer capital losses, long-term bonds must have an initial yield advantage of the one-period bond (to offset the expected capital losses). Therefore, expectations of rising rates tend to make today's yield curve upward-sloping. Conversely, expectations of declining future rates tend to make today's yield curve inverted. In a similar way, the market's expectations of future curve flattening or steepening influence the curvature of today's yield curve.

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