

Abstract for Ang and Bekaert
“The Term Structure of Real Rates and Expected Inflation”

Time-variation of the nominal term structure must be due to either movements in real interest rates or expected inflation, or both. We develop a term structure model with regime switches, time-varying prices of risk and inflation to identify these essentially unobserved components of the nominal yield curve. Our full specification has separate regimes in a real factor and inflation and we cannot reject that the real and inflation regimes are independent. We find that the unconditional real rate curve is fairly flat at 1.44% but slightly humped but in one regime is steeply downward sloping. Conditional means of inflation, but not conditional volatilities, differ significantly across regimes, and inflation enters real short rates with a significant coefficient of -0.523. Contrary to the standard view, we find that expected inflation drives about 75% of the variation of nominal yields at both short and long maturities.