Fixed Income Analysis

Term Structure

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Outline

- Term Structure of Interest Rates
  - Expectations Theory
  - Liquidity Preference Theory
  - Market Segmentation Theory

Term Structure of Interest Rates

- What defines the shape of the Spot Rate Curve?
- What is the relationship between Short Term Rates and Long Term Rates?

Short Term rates are very volatile while Long Term rates are stable. Exception –last 4 years

Historical Yield Curve

Expectations Theory

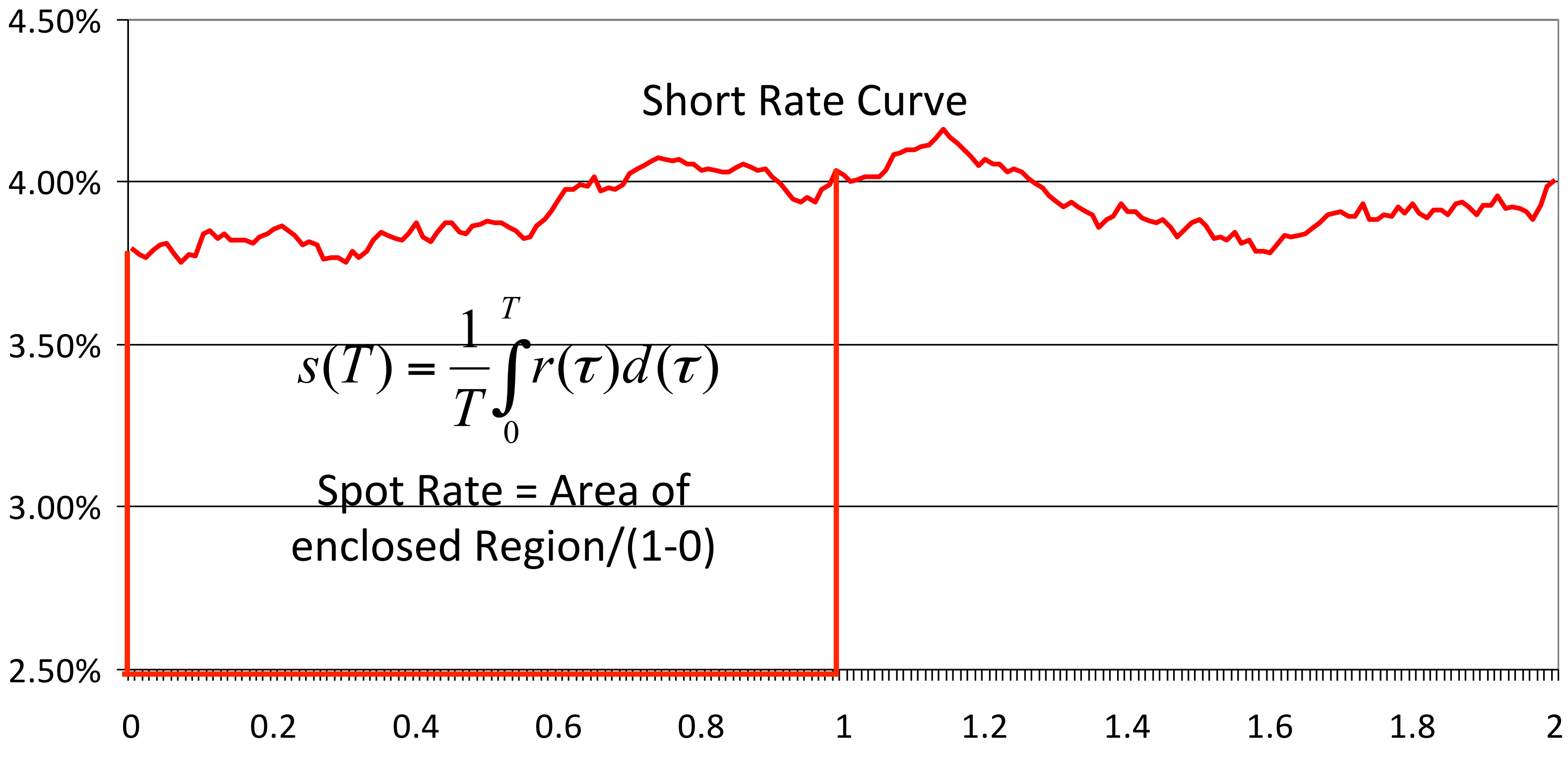
- The hypothesis that long-term interest rates contain a prediction of future short-term interest rates.
- Same amount is earned:
  - By investing in a one-year bond today and rolling that investment into a new one-year bond a year later
  - By investing in a two-year bond today.

$$s(T) = \frac{1}{T}\int_0^T r(\tau)d(\tau)$$

Long Term rate is the average of Short Term rates.

Expectations Theory

- Spot Rate is the 'average' of short rates!



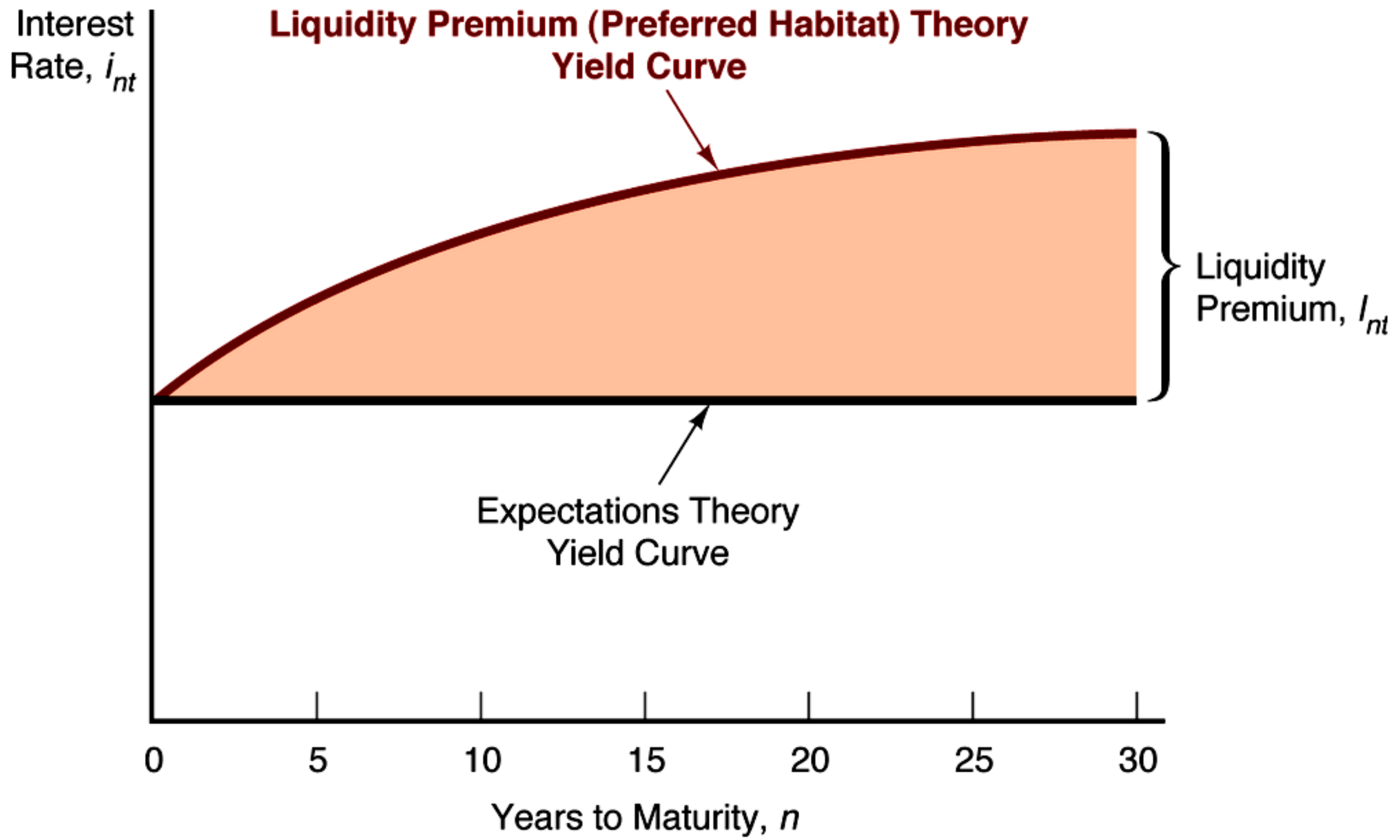
Liquidity Preference Theory

- Investors demand a premium for securities with longer maturities, which entail greater risk, because they would prefer to hold cash, which entails less risk.
- Economist John Maynard Keynes described that people:
  - Value money for ‘the transaction of current business.’
  - Value money for ‘its use as a store of wealth’

Should I keep money in Savings Account or deposit in FD. Both the rates are same and I don't think that short term rates would decrease

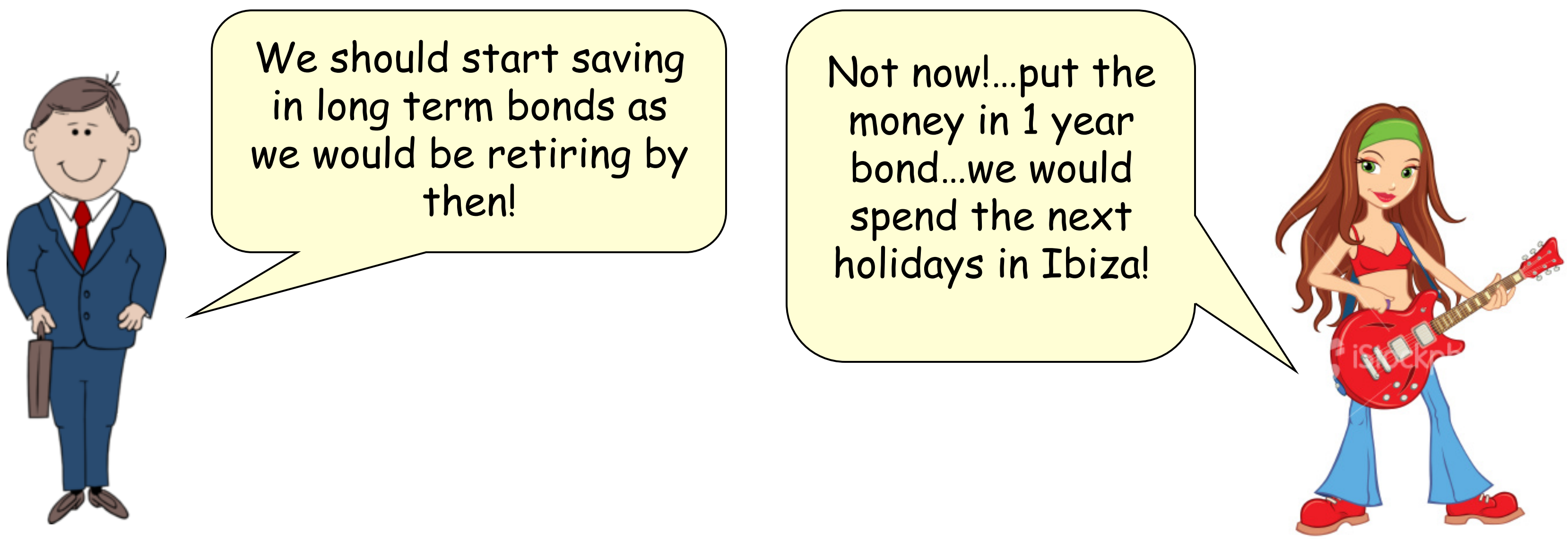
Saving Account… Both would earn the same… And What if you urgently need money

Liquidity Preference Theory



Markets Segmentation Theory

- A modern theory pertaining to interest rates stipulating that there is no necessary relationship between long and short-term interest rates.
- Short and Long-term markets fall into two different categories
- Yield curve is shaped according to the supply and demand of securities within each maturity length.



Questions