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Abstract

We investigate the term structure of sovereign yield spreads for five advanced economies against the US and provide novel insights on the key drivers of the term structure. We show that the spread term structure dynamics are driven by three latent factors which can be labeled as spread level, slope and curvature similar to common interpretations found in the yield curve literature. We further show that these estimated spread factors have predictive power for exchange rate movements and excess returns, above the predictability of an uncovered interest rate parity approach. As the yield curve contains information about expected future economic conditions we conjecture that these yield spread factors reflect expected macroeconomic differentials which in turn drive exchange rates. Using the information content of yield spread curves may thus be a promising approach to improve the forecasting accuracy of exchange rate models.

Key words: Sovereign Yield Spreads, Term Structure Modeling, Principal Component Analysis, Macroeconomic Fundamentals, Exchange Rate Forecasts

JEL: G15, E43, E44, F37, C58

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