6.6: Further Discussion of Interest Rate Determinants

Consider a Treasury Note with two years remaining to maturity vs. a 20-year, callable bond issued by a small firm with a BB bond-rating. The corporate bond should have a higher interest rate (bond yield) due to a larger maturity premium, larger default risk premium, larger liquidity premium, and larger special characteristics premium. The real rate of interest should be essentially the same on both bonds. The inflation premium will likely be different (as the expected annual rate of inflation over the next 2 years is likely to be different than that of the next 20 years), but it is not clear which bond will have the higher inflation premium as that depends on the particular economic environment and investors' expectations regarding inflation over these two time periods.

Another thing to consider when discussing the differences in yields on these two bonds in terms of the various premiums is that the exact size of the various premiums is likely to fluctuate over time. For instance, in periods of economic turmoil, default risk premiums tend to increase (as corporate bankruptcies are more likely). In periods where interest rates are highly volatile, we might see maturity risk premiums increase as well. The premiums give us a framework for explaining why different bonds have different yields. Also, if we have enough bonds, we can estimate what the various premiums are in the current economic environment. However, we should keep in mind that in a real world environment, these premiums do fluctuate and are only ballpark estimates instead of exact values that we can look up and plug into the formula.