Rethinking Cointegration and the Expectation Hypothesis of the Term Structure

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Abstract

We show that the expectations hypothesis implies that as the time spread between long and short term yields increases, it becomes increasingly less likely to find that the spread is stationary; even if the two yields are cointegrated. In the data, we find that as the time spread increases, rejection rates for cointegration also increase in line with this theoretical prediction. Our results suggest that cointegration tests may not be appropriate tests of the expectations hypothesis.

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