Benchmark interest rates when the government is risky

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First draft: May 2017
This draft: July 29, 2019

Abstract

Future interbank uncollateralized borrowing costs can be locked in using interest rate swap instruments tied to the effective federal funds rate (OIS) or LIBOR (IRS). Since the Global Financial Crisis, OIS and IRS rates have fallen below maturity-matched U.S. Treasury rates across different maturities. That is surprising, because Treasuries are deemed to have superior liquidity and safety associated with the safe haven status of the U.S. government. This should make Treasuries expensive and produce yields that are lower than those of maturity-matched swap rates. We suggest that U.S. sovereign default risk explains the negative difference between the OIS and Treasury rates. This explanation is supported using a quantitative equilibrium model that jointly accounts for macroeconomic fundamentals, as well as the term structures of OIS, IRS, and credit default swap (CDS) rates. In our model, we account for interbank credit risk, liquidity effects, and cost of collateralization. Thus, the sovereign risk channel complements existing explanations based on frictions such as balance sheet constraints, convenience yield, and hedging demand.

JEL Classification Codes: C1, E43, E44, G12, H60.

Keywords: sovereign credit risk, negative swap rates, recursive preferences, term structure.

*We thank Vadim di Pietro, Valentin Haddad, Michael Johannes, Arvind Krishnamurthy, Lars Lochstoer, Francis Longstaff, Renate Marold, and Guillaume Roussellet for comments on earlier drafts, and participants in seminars sponsored by McGill, UCLA, and the HEC-McGill 2019 Summer Finance Workshop. The authors acknowledge financial support from the Canadian Derivatives Institute. The latest version is available at https://sites.google.com/site/mbchernov/ACSS_NSS_latest.pdf.
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1 Introduction

The financial crisis of 2008 marked the beginning of a number of disruptions in financial markets that have persisted to date. In fixed-income markets, four phenomena stand out: i) a gradual switch from LIBOR to OIS as a reference discount rate for interbank transactions, ii) long-term swap rates linked to LIBOR fell below maturity-matched U.S. Treasury yields (Klingler and Sundaresan, 2018, Jermann, 2019), iii) short- to intermediate-term maturity swap rates linked to OIS also fell below maturity-matched U.S. Treasury yields (Klingler and Sundaresan, 2019), and iv) premiums on CDS contracts on the U.S. government have risen to at least 100 times their pre-crisis levels (Chernov, Schmid, and Schneider, 2015).

The first observation highlights the importance of OIS and LIBOR as benchmark interest rates in addition to those implied by the Treasury market. Observations ii) and iii) appear puzzling from the viewpoint of standard asset pricing theory. They imply that swap spreads (i.e., the difference between swap and Treasury rates) linked to LIBOR and OIS are negative, an irregularity often referred to as ‘negative swap spread puzzle’. While these puzzles did receive a fair amount of attention in the literature, they are typically studied in isolation. The last phenomenon is perceived as puzzling by many observers because of the sheer magnitude of U.S. CDS premiums.

In this paper, we argue that all these phenomena are interrelated and can be understood jointly by accounting for a change in the perceived credit quality of the United States, a truly new development since the crisis. In contrast, the factors behind extant explanations of (ii) and (iii), while absolutely valid, were also at work before the crisis, when swap spreads were positive.

Both U.S. dollar interest rate swaps and U.S. Treasury debt constitute some of the largest markets in the world, counting trillions of dollars in gross market value. The rates associated with these markets serve as benchmarks for a host of decisions and transactions, such as monetary policy, collateralized and uncollateralized borrowing, mortgage debt, and derivatives exposures. Thus, it is of paramount importance to identify the drivers behind the puzzling differences between these benchmark rates. In particular, it is critical to understand whether the observed discrepancies reflect traditional no-arbitrage pricing, frictions in the market place, or rather distortions associated with the onset of post-crisis regulation. This distinction has the potential to shape policy decisions related to money markets.

The puzzles stem from the no-arbitrage argument for the relative magnitude of interest rates. Consider a strategy that sells short a par Treasury bond borrowed via a reverse repo transaction, together with a position in a swap contract that receives a fixed rate of interest. The total cash flows are equal to the difference between the swap rate and the Treasury yield (coupon in the case of par), net of the difference between the floating payments in the swap and the reverse repo. Because we expect uncollateralized interest rates to be greater than collateralized ones, the present value of the floating payments (one-period interest
rates) is positive. Therefore, it must be that the difference between the swap rate and the Treasury yield is positive as well.

This argument applies to both IRS and OIS swaps. The relative magnitude of the two swap rates could be established by a similar argument whereby one receives a fixed rate of interest on an IRS and pays a fixed rate of interest on an OIS. The present value of the combined floating legs, the LIBOR-OIS spread, should be positive, implying a positive difference between the fixed payments.

As a first step of our analysis, we provide additional evidence on various interest rate spreads. The difference between OIS and Treasury rates continues to be negative at longer maturities. The difference between IRS and Treasury rates is negative between maturities of 7 years and up to 30 years. Finally, the spread between IRS and OIS rates is positive across all maturities for the entire sample, just as someone in 2007 would have expected. As a consequence, the negative swap spread puzzles must have a common source that lies with the relation between OIS and Treasury rates. Moreover, empirically, we provide suggestive evidence that OIS swap spreads and CDS premiums exhibit significant comovement.

Second, we argue heuristically that the negative difference between OIS and Treasury rates is driven by the credit riskiness of the U.S. government. If the Treasury can default, then a combination of a short Treasury bond and Treasury protection sold via a CDS contract becomes a short position in a riskless security. Thus, the original no-arbitrage argument reviewed above should be modified by introducing a CDS position. As a result, the difference between the swap rate and the Treasury yield minus the CDS premium should be positive, implying that negative swap spreads can persist even in the absence of arbitrage. Again, this argument applies to both IRS and OIS. The difference between the two swap rates is unaffected because the no-arbitrage argument does not involve a Treasury bond.

Third, we propose a realistic quantitative model that captures the evidence. That endeavor necessitates accounting for the sovereign credit risk of the U.S. government. As observed by Chernov, Schmid, and Schneider (2015), an equilibrium model is required to measure the credit risk premium in the absence of an observed risk-free reference rate. We follow their modeling strategy, but depart in two dimensions. Because the nature of our exercise demands high quantitative realism, we specify a more realistic model of the joint behavior of macroeconomic fundamentals. Furthermore, we simplify the modeling of the default trigger and switch from the structural approach to the intensity-based approach. The default intensity is driven by macroeconomic variables whose choice is inspired by the analysis of Augustin (2018) and Chernov, Schmid, and Schneider (2015).

To provide plausible quantitative guidance on swap spreads, our model has to account for other factors beyond sovereign credit risk that likely affect differences between interest rates in current markets. We focus on the most relevant factors such as a convenience yield on Treasuries, bank risk (credit and funding liquidity), and the opportunity cost of collateral associated with swap transactions. The first factor lowers Treasury yields. The second factor increases swap rates. The third factor increases swap rates if the short interest rate
and the cost of collateral are positively correlated (Johannes and Sundaresan, 2007). An important objective of our work is to evaluate the contributions of these different channels along with sovereign credit risk to the overall swap spreads.

Empirically, we identify the convenience yield and bank risk using observable interest rate spreads, and the unobserved collateral factor by matching one-year IRS and the term structure of CDS. Thus, we obtain all the ingredients needed for the valuation of OIS and IRS without using the data on their respective rates. As a result of this approach, the OIS and IRS valuation is truly a relative value exercise whereby we determine the theoretical value of the swap rates using the market values of other instruments. We estimate our model via Bayesian MCMC methods and thereby recover the model-implied time series for the relevant variables in our sample.

We find that our quantitative model provides an accurate account of the dynamics in both OIS and IRS markets. In particular, the model generates swap spread series that were positive before the crisis, and turned negative after the onset of the financial crisis in 2008. In counterfactual experiments, we can assess the role of the U.S. credit risk in the behavior of swap spreads. Critically, we find that they are uniformly positive in the absence of that risk. This result establishes the quantitative relevance of the sovereign risk channel in the pricing of Treasuries and swaps. Conceptually, this relative-value-based view differs from existing explanations of negative swap spread puzzles, all of which are based on limits to arbitrage.

Related literature

First, we contribute to a small but growing literature on the puzzling observation that the difference between interest rate swaps denominated in USD and U.S. Treasury rates, a.k.a. swap spreads, turned negative for multiple maturities, effectively suggesting that the U.S. government is riskier than a presumably safe AA-rated bank. Several explanations have been proposed for the apparent pricing anomaly in financial markets, including demand for duration by underfunded pension plans (Klingler and Sundaresan, 2018), dealer funding costs (Lou, 2009), or increases in regulatory leverage ratios (Boyarchenko, Gupta, Steele, and Yen, 2018). Klingler and Sundaresan (2019) consider fading demand for U.S. Treasury bonds as a leading explanation for negative OIS-Treasury spreads. Jermann (2019) proposes a theoretical equilibrium explanation for negative swap spreads by considering regulatory leverage constraints for dealer balance sheets. Table 1 summarizes the main differences between our and the existing contributions.

While explanations based on frictions have their merits, we argue that they fail to provide a unified explanation of Treasury spreads that exceed maturity-matched spreads of short-term and long-term funding instruments in interbank markets. Demand for duration by underfunded pension plans is a plausible explanation for 30-year negative swap spreads, but less so for shorter maturities, even though these have also been persistently negative for many
years. Second, limits-to-arbitrage arguments speak to the persistence of negative swaps and OIS-Treasury spreads, but they do not explain why they turned negative in the first place. Third, a focus on individual segments of the maturity structure or selective instruments ignores the inherent equilibrium relationships that must exist between benchmark interest rates. Importantly, we propose a model that explains both positive swap spreads before and negative swap spreads after the crisis.

We suggest that negative OIS-Treasury and swap spreads can be obtained without frictions (even though frictions may amplify the phenomenon). By incorporating sovereign default risk into the modeling of benchmark interest rates, we hope to provide a unified explanation of the price dynamics of various fixed income instruments during the financial crisis, which poses a challenge to existing partial equilibrium pricing models to date. Dittmar, Hsu, Roussellet, and Simasek (2019) propose sovereign default risk as an explanation for the pricing anomalies observed among inflation-indexed securities (Fleckenstein, Longstaff, and Lustig, 2013; Hilscher, Raviv, and Reis, 2014).

More generally, our study builds on the vast literature on no-arbitrage affine term structure modeling and credit-sensitive instruments, prominently summarized in Duffie and Singleton (2003). In addition, we relate to studies on the modeling of the term structure of overnight index swaps, interest rate swaps, or LIBOR rates (Duffie and Huang, 1996; Duffie and Singleton, 1997; Collin-Dufresne and Solnik, 2001; Grinblatt, 2001; He, 2001; Liu, Longstaff, and Mandell, 2006; Johannes and Sundaresan, 2007; Feldhutter and Lando, 2008; Filipovic and Trolle, 2013; Monfort, Renne, and Roussellet, 2016) and their empirical examinations (Litzenberger, 1992; Sun, Sundaresan, and Wang, 1993; Gupta and Subrahmanyam, 2000; Wang and Yang, 2018). Finally, we also relate to the literature that examines the convenience yield embedded in Treasury bonds (Krishnamurthy, 2002; Longstaff, 2004; Gurkaynak, Sack, and Wright, 2007; Goyenko, Subrahmanyam, and Ukhov, 2011; Krishnamurthy and Vissing-Jorgensen, 2012; Nagel, 2016; Du, Im, and Schreger, 2018).

2 Preliminary evidence

2.1 Benchmark interest rates in the U.S.

Our analysis is focused on four types of U.S. interest rates and their interaction: (i) Treasury yields; (ii) OIS premiums; (iii) IRS premiums; (iv) and CDS premiums. The U.S. Treasury borrows money on behalf of the government by issuing debt securities of different maturities. The effective annual interest that can be earned along the maturity spectrum characterizes the Treasury yield curve. The Treasury yield curve can be characterized using zero coupon, coupon, par, or forward rates. The most convenient way is to work with zero-coupon yields that are bootstrapped from coupon bonds (e.g., Gurkaynak, Sack, and Wright, 2007, henceforth GSW). Another popular indicator of the U.S. government’s borrowing costs is the constant maturity Treasury (CMT) yield curve, or par rates, which are bootstrapped
from coupon bonds as well. \( CMT_t^n \) denotes the coupon at time \( t \) of a bond maturing in \( n \) periods.

Overnight Indexed Swaps (OIS) are fully collateralized contracts in which a fixed rate payer exchanges a constant cash flow, i.e., the OIS rate, against a floating payment that is computed as the geometric average of the daily Effective Federal Funds Rate (EFFR). The Federal Funds Target Rate is determined by the Federal Open Market Committee in order to conduct monetary policy. The EFFR is the actual interest rate at which banks lend reserve balances to other banks overnight without collateral. Since March 1, 2016, it is measured as the volume-weighted median of the bilaterally negotiated transactions. Before that, it was measured as the volume-weighted average. OIS contracts with maturities up to one year have only one settlement (the geometric average is computed over the lifetime of the contract), while cash payments for contracts with maturities above one year arise quarterly (the geometric average is re-computed every quarter). Hull and White (2013) and Wang and Yang (2018) discuss the institutional details of OIS contracts. \( OIS_t^n \) denotes the rate at time \( t \) of a swap maturing in \( n \) periods.

Interest rate swaps (IRS) have arrangements similar to those of OIS but with a different reference floating rate, which is the 3-month London interbank offered rate (LIBOR) that is fixed at the previous settlement date of an IRS. LIBOR is the interest rate at which banks in the Eurodollar area are willing to lend to each other on an uncollateralized basis. See Duffie and Singleton (1997), Collin-Dufresne and Solnik (2001), and Johannes and Sundaresan (2007) for discussions on the institutional details of LIBOR swap contracts. \( IRS_t^n \) denotes the rate at time \( t \) of a swap maturing in \( n \) periods.

The definitions of LIBOR and EFFR are conceptually similar as they both relate to uncollateralized interbank lending. So, one should expect the overnight LIBOR to be similar to EFFR. The rates should not be literally the same, however. The banks in the LIBOR panel are not identical to the banks in the Fed system, and logistics of lending within the Fed system are different from that in the Eurodollar area. Figure 1 compares the two rates.

They are sitting right on top of each other with one exception: the onset of the banking crisis of 2008. The difference between the instruments linked to LIBOR and EFFR arises because of the term effect. The floating legs are linked to the three-month LIBOR and the daily EFFR compounded over three months. In the presence of banks’ credit risk, lending to banks without collateral for three months outright (at LIBOR) is more risky than lending overnight (at EFFR) and rolling that over daily for three months.

Another closely related rate is the interest earned on collateralized borrowing through a repurchase agreement contract, henceforth repo. We do not study repo in this paper as it has its own host of issues and puzzles. In the context of our analysis, one could be concerned about two issues. First, general collateral (GC) repo rates seem like a natural proxy for the risk-free rate. As Duffie and Stein (2015) point out, GC rates exhibit similar flight-to-quality spikes as Treasury bills and excess volatility due to the very short-term maturity of one day. Also, the GC repo market is not active at maturities beyond one
week, and so there is no readily available term structure information. Finally, the post-2008 quantitative easing program that involved the purchase of Treasury bonds affected the supply of collateral in repo transactions, leading to distortions in rates. A second concern is whether the repo rate should play some role in our analysis. We use repo rates only qualitatively without relying on the specific values or their dynamics.

The last rate we focus on is the premium on credit default swaps (CDS) associated with the U.S. government. CDS are effectively insurance contracts, in which the protection seller has to make payments in case of a credit event, which may include failure to pay, repudiation/moratorium, and restructuring. \( CDS^t_n \) denotes the rate at time \( t \) of a swap maturing in \( n \) periods.

If the U.S. government has no credit risk, one would expect these premiums to be approximately zero, which was the case prior to October 2007. The subsequent elevation in the CDS premiums is a prima facie evidence of U.S. credit risk, as argued by Chernov, Schmid, and Schneider (2015). In fact, there is a debate in the industry and in academia whether CDS premiums reflect compensation for credit risk at all. We argue that, on balance, both theory and evidence are favorable of the U.S. credit risk view.

First, existing theories imply the presence of credit risk, even in cases when it is not the main driving force behind CDS premiums. Chernov, Schmid, and Schneider (2015) attribute most of the CDS premium to credit risk in a model with a version of a Bansal and Yaron (2004) pricing kernel, an intertemporal government budget constraint, and a decline in government revenues when taxes are too high, also known as the Laffer curve. Lando and Klingler (2018) take a different view and attribute most of the CDS premium to regulatory frictions. The underlying reason is that uncollateralized counterparty risk exposures demand regulatory capital, computed based off credit valuation adjustment (CVA) charges that depend on the counterparty’s CDS premiums. These capital charges can be offset by purchasing CDS protection against that counterparty (a sovereign in this case), which artificially inflates the CDS premium. This argument, crucially depends on the presence of non-zero credit risk in the first place, because absent default risk, the CDS premium of the counterparty is zero, and there is no capital charge.

Second, from an empirical perspective, the United States defaulted before, both on external and domestic debt (Zivney and Marcus, 1989; English, 1996; Reinhart and Rogoff, 2008). Most recently, Standard & Poor’s stripped the U.S. off the highest AAA credit rating in 2011, suggesting the presence of some credit risk. In the modern times, we have also experienced effective defaults by high-quality sovereigns despite relatively low CDS premiums. Indeed Ireland, which still benefitted from a AAA credit rating going into the global financial crisis, saw its CDS premiums rise from about 2 bps in 2007 to north of 400 bps when it was bailed out by the Eurozone countries in 2010 (see discussions around Figure 1 in Acharya, Drechsler, and Schnabl, 2014). Similarly, Spain received a AAA credit rating in 2003 when its CDS premiums fluctuated around 3 to 4 bps. Yet, it was at the cusp of junk status in 2012 when it received financial support from the Eurozone, and CDS premiums reached levels close to 600 bps.
2.2 Data

We source data on LIBOR, IRS and OIS rates from Bloomberg, and U.S. CDS premiums from Markit. We start the sample on May 8, 2002, when data for OIS rates start having few missing observations, and end on September 26, 2018. The 30-year OIS rates are often discarded by researchers because of their low liquidity. Further, during the crisis, no OIS data are available for maturities beyond 10 years. Thus, longer-term OIS rates are available only for part of the sample period. Because swap rates are par rates, we use the constant maturity Treasury (CMT) rates published by the U.S. Federal Reserve Bank as a maturity-matched Treasury rate.

We report basic summary statistics for the term structure of all rates in Table 2, summarizing the information for maturities of 3 and 6 months, as well as 3, 5, 7, 10, 20, and 30 years. Panels A, B, and C in Table 2 show that, on average, CMTs are lowest, with an upward sloping term structure ranging from 1.25% at the short end to 3.95% at the 30-year horizon. OIS rates, reported in Panel A, are higher, ranging on average from 1.40% to 2.54% at the 5-year maturity. Average OIS rates with maturities above 5 years are not directly comparable to the CMTs, as there are fewer observations. OIS data for the 7-year and 10-year maturities start in May 2012 and August 2008, respectively, while those for the 20-year and 30-year maturities start in September 2011. LIBOR/swap rates reported in Panel B are the largest, ranging on average from 1.66% to 3.97% at the short and long end of the maturity spectrum. All interest rates exhibit a decreasing term structure of volatility, as the standard deviation for long-term maturities is lower than that for short-term maturities.

In Panel D, we report statistics for the Gurkaynak, Sack, and Wright (2007) zero coupon Treasury yields, which we use in our estimation. These are available for 1-year to 30-years, and are slightly larger than the CMTs, with an average yield of 1.50% to 4.07%.

In Panels E and F of Table 2, we report both USD and EUR denominated CDS premiums on the U.S. Treasury. We use USD denominated contracts in our empirical analysis. EUR contracts cover a longer span of data (from 2007 instead of 2010), so we use them for qualitative indication of the magnitude of the U.S. credit risk premium during the crisis. The average cost of insurance against a default by the U.S. Treasury ranges from 11 bps to 37 bps for USD contracts, and from 13 bps to 44 bps for EUR denominated contracts. The 5-year contract is the most liquid. At the 99th percentile of the distribution, the 5-year insurance premium is as high as 66 bps during the post-2010 period, but at the height of the global financial crisis (GFC), 5-year spreads jumped to a maximum of 95 bps (unreported in the Table).

2.3 Swap spreads

Figures 2 and 3 visualize the evidence on swap spreads, i.e., the difference between OIS or IRS rates and maturity-matched Treasury rates. In particular, Figure 2(a) confirms
the negative long-term IRS spreads observed in the post-crisis period, as emphasized by Jermann (2019) and Klingler and Sundaresan (2018). According to Boyarchenko, Gupta, Steele, and Yen (2018) and Jermann (2019), long-term swap spreads remain negative because regulatory caps on leverage ratios make it too costly for investors to arbitrage away the difference. Panel (c) of the same figure confirms the negative short-term OIS spreads observed in the post-crisis period, as emphasized by Klingler and Sundaresan (2019). They associate this inversion with a fading demand for U.S. Treasury notes and a corresponding decline in the convenience yield.

Panels (b) and (d) present additional evidence. Specifically, panel (b) shows that IRS swap spreads of maturities down to 7 years were persistently negative at irregular intervals after the crisis, while the 30-year maturity stayed negative throughout. Panel (d) shows that OIS swap spreads continued to be negative at longer maturities. The liquidity of OIS with maturities over 5 years declines. Nevertheless, the prices convey qualitative information about the relative magnitudes of OIS and Treasury rates. The difference is so large that it is hard to imagine that it could be explained away by liquidity effects.\footnote{In fact, the direction of liquidity effects could be ambiguous, ex ante. The reason is that for assets in zero net supply, such as swaps, the liquidity premium is earned by the marginal investor, who is either long or short swaps on average (see, e.g., Bongaerts, De Jong, and Driessen, 2011, Deuskar, Gupta, and Subrahmanyam, 2011, and Brenner, Eldor, and Hauser, 2001).}

Finally, to appreciate the importance of the additional evidence, we jointly plot in Figure 3 the same swap spreads, but match them by maturity and juxtapose them with (the negative of) the U.S. CDS premiums. There are two additional observations arising from these plots.

First, the IRS swap spread continues to be larger than the OIS swap spread after the crisis. Thus, there is nothing surprising about the relation between IRS and OIS rates, at least at a qualitative level. That implies that the negative swap spread puzzle is arising from the OIS swap spread puzzle. OIS contracts are less liquid than IRS ones, particularly at the longer end of the maturity spectrum. Nevertheless, our broad point is that the relative magnitude of IRS vs. OIS rates did not change after the crisis. So the puzzle must be emanating from how the OIS are valued relative to Treasuries.

Second, we observe that negative values of the OIS swap spread coincide with spikes in U.S. CDS premiums. That is suggestive of U.S. credit risk being related to the puzzling sign of the OIS swap spread. In the sequel, we develop this explanation. Our argument is consistent not just with the negative spreads after the crisis, but also with positive spreads in the pre-crisis period. The argument also applies to IRS in case one worries about a lack of liquidity in the OIS market. Finally the argument is also consistent with the preserved relative magnitude of IRS over OIS rates.

Table 3 provides additional evidence on the relation between OIS spreads and U.S. CDS by regressing monthly changes in the OIS swap spread on changes in the maturity-matched U.S.
CDS premiums and various controls.\textsuperscript{2} We run panel regressions by pooling all maturities, and match the 3-month swap spreads with the 6-month CDS premium, because there exists no CDS contract with a lower maturity. We add maturity-specific fixed effects to absorb time-invariant cross-maturity differences due to possible clienteles. The finding in column (1) is consistent with a negative relation between OIS swap spreads and CDS premiums reported in column (1) of Table 8 in Klingler and Sundaresan (2019). In column (2), we show that the economic magnitude is similar for maturities above 5 years, and in column (3), we pool all maturities together. The estimated coefficient suggests that a 10 bps increase in the CDS premium is associated with a 0.7 bps drop in the OIS swap spread.

In columns (4) to (9), we successively introduce lagged swap spreads, quarterly fixed effects to absorb the influence of common macroeconomic and financial factors, and controls.\textsuperscript{3} Even a conservative specification with the interaction of maturity and quarterly fixed effects in column (6) does not alter the significance or economic magnitude of the regression coefficient. Longer-term OIS contracts were less liquid around the crisis and became successively more liquid, as the discounting using OIS rates became more common practice over time. Thus, the negative relation between swap spreads and CDS premiums manifests itself in later years, as demonstrated by the larger magnitude of the regression coefficient, and a greater $R^2$ in column (10), in which we restrict the regression to the time period post 2014. This finding also suggests that our result is not merely driven by the U.S. debt ceiling episodes in August 2011 and in October 2013.

\textbf{2.4 U.S. credit risk and negative swap spreads}

In this section, we explain the intuition behind our thesis of the relation between negative OIS swap spreads and U.S. credit risk. We rely on the no-arbitrage bound type of argument. Although we use OIS for the discussion, our argument is generic and applies directly to IRS as well.

To appreciate the impact of credit risk, it is worth revisiting the case without credit risk first. A negative OIS-Treasury spread suggests that the Treasury is relatively less expensive. As an arbitrageur, one would want to exploit this by buying the Treasury via a repo transaction and take a position that pays the fixed (and receives the floating) rate in an OIS contract. The cash flows corresponding to these positions are displayed in Figure 4 (the upper left box). Denoting the three-month repo rate by $r_t$, and EFFR compounded from the beginning of month $t$ to the end of month $t + 2$ by $f_t$, one receives $CMT^n_0 - OIS^n_0 + (f_{t-3} - r_{t-3})$ at

\begin{footnotesize}
\textsuperscript{2}We examine the relation between swap spreads and U.S. credit risk at the monthly frequency, because the decision interval in our model is monthly. Results at the weekly frequency, which are stronger, are available upon request.

\textsuperscript{3}Control variables include the CBOE VIX index, the exchange rate of the USD against a basket of a broad group of major U.S. trading partners, the West Texas Intermediate oil price index, the economic policy uncertainty index, the high-yield and investment-grade bond indices, inflation, the TED spread, the 3-month Libor-Ois spread, the 3-month T-bill rate, the U.S. Treasury total cash balances, and CDS depth defined as the number of dealer quotes used to compute the mid-market spread.
\end{footnotesize}
each point \( t \). No-arbitrage implies that the present value of these cash flows has to be equal to zero. Because uncollateralized borrowing costs are greater than collateralized borrowing costs, the present value of the floating payments has to be positive. That implies a pure arbitrage opportunity if \( CMT^n_0 > OIS^n_0 \).

If the Treasury is credit risky, the no-arbitrage argument above no longer holds, because, upon default at a random date \( \tau \), the Treasury bond terminates, the future interest payments \( CMT^n_0 \) are no longer received, and the bond pays \( 1 - L \) instead of the full face value. That, in turn, affects the repayment of the repo loan. It is possible to hedge this risk by complementing a position in the bond with the purchase of default protection via a CDS contract. That affects the cash flows of the overall position. See last column and last row of Figure 4.

Specifically, in the case of default, the joint bond-CDS position has full recovery of par, which is used to close out the repo loan. The OIS contract either remains in place, or can be closed out at the market value \( OIS^n_{\tau-\tau} \). Regardless of the choice, one receives the present value of the remaining cash flows on the OIS. We are interested in tracking the highest possible value of that, which we denote by \( HPV \).

On balance, one receives \( CMT^n_0 - CDS^n_0 - OIS^n_0 + (f_{t-3} - r_{t-3}) \) every period \( t \) in which there is no default. If there is a default at time \( \tau \), one receives \( -OIS^n_0 + (f_{\tau-3} - r_{\tau-3}) + HPV \). Assuming a risk-adjusted default probability \( q \), the expected cash flow in any given period is

\[
(1 - q) \times [CMT^n_0 - CDS^n_0 - OIS^n_0 + (f_{t-3} - r_{t-3})] \\
+ q \times [-OIS^n_0 + (f_{t-3} - r_{t-3}) + HPV] \\
= CMT^n_0 - OIS^n_0 \\
- qCMT^n_0 - (1 - q)CDS^n_0 + qHPV \\
+ (f_{t-3} - r_{t-3}).
\]

As in the no-default case, the present value of the floating leg is likely to be positive. Therefore, it must be that

\[
OIS^n_0 - CMT^n_0 > -qCMT^n_0 - (1 - q)CDS^n_0 + qHPV. \quad (1)
\]

The question is under which conditions this bound on the swap spread can be negative.

If \( q = 0 \), then \( CDS^n_0 = 0 \), and we are recovering the credit-risk-free case. If both \( q \) and \( CDS^n_0 \) are positive, the combination of the first two terms in the bound is negative. We surmise that, in practice, it is numerically close to \( -CDS^n_0 \). In the argument above we can replace OIS/EFFR with IRS/LIBOR and reach the same conclusion. That prompts us to revisit Figure 3. The evidence is broadly consistent with the bound.

Which value of \( HPV \) could undo the negative terms and lead to a positive bound? It must be the case that

\[
HPV > CMT^n_0 + (q^{-1} - 1) \cdot CDS^n_0 = 0.02 + (0.005^{-1} - 1) \cdot 0.002 = 0.42,
\]

10
where we use average numbers reported in Chernov, Schmid, and Schneider (2015) for $n = 5$. A present value of 42% for the cashflows in an interest swap contract remaining after default appears to be highly unrealistic. For comparability, Gorton and Metrick (2012) report a value of 49% for sub-prime related BBB mezzanine CDOs during 2008, the worst moment of the financial crisis. Thus, it seems fair to conclude that the lower bound for the swap spread can be negative, and that observing a negative swap spread would not necessarily lead to arbitrage opportunities.

2.5 Discussion

The no-arbitrage argument highlights the economic intuition behind relative higher value of a swap relative to a Treasury bond. If the Treasury defaults, its bonds are affected. They either lose value or disappear from the market place altogether. That is not the case for a collateralized swap agreement. While the underlying interest rate may react to a default event, the payments on the swap would continue.

That the relative magnitude of IRS and OIS is not affected post-crisis is supportive of this intuition. That is because one could devise a similar no-arbitrage argument but it will not involve the defaultable Treasury. Thus, both swaps would continue even if entities linked to the underlying interest rates are in distress.

Last, but not least, the relationship that we have derived is a bound. There are well-recognized forces that drive swap spreads away from this bound. First, Treasury bonds are considered to be expensive and embed a convenience yield relative to other asset classes (e.g., Longstaff, 2004; Krishnamurthy and Vissing-Jorgensen, 2012; Nagel, 2016; Du, Im, and Schreger, 2018). Second, the swap rates typically reflect the credit and funding risk of financial intermediaries (e.g., Feldhutter and Lando, 2008). Third, as pointed out by Johannes and Sundaresan (2007), full collateralization of swaps increases the rates because of an opportunity cost of collateral (if the correlation between the short interest rate and the cost of collateral is positive). Thus, in order to reach a definitive conclusion about the sources of the negative swap spreads, one needs a quantitative model that accounts for all the highlighted forces.

3 A realistic model

The bound in Equation (1) tells us that a negative spread can obtain even in absence of arbitrage of opportunities, and may in fact be plausible in the context of current market data. In order to flesh out precisely and quantify what is happening in reality, we have to explicitly model additional forces that drive the magnitude of swap spreads. Furthermore, an important implication of perceived credit risk of the U.S. government is that we do not
get to observe a risk-free rate. Thus, an equilibrium model is required to identify a risk-free rate. We rely on a model of a representative agent with recursive preferences for this purpose.

Another, more subtle, advantage of using the equilibrium framework pertains to the change in how the industry approaches the discounting of cash flows associated with collateralized swap agreements. As we highlighted in the introduction, because of full collateralization, market participants started using the OIS rates instead of the LIBOR ones at the end of 2007, and the whole industry has switched to OIS by the end of 2008 (e.g., Cameron, 2013, Spears, 2019). Thus, a no-arbitrage model would have to address the choice of reference interest rate.4

Under the null of our model, we obtain an equilibrium pricing kernel that we use to discount cash flows of a given financial instrument. The reference interest rate is the theoretical real risk-free rate in this case. All other interest rates appear as derived quantities in this framework on an internally consistent basis.

3.1 Joint dynamics of macroeconomic fundamentals

As is well-known from the long-run risk literature, accounting for variation in conditional expectation and volatility of consumption growth is central for a quantitative success of the framework. That motivates us to identify these quantities from a rich model of the joint dynamics of consumption growth, inflation, output growth, and government expenditures.

This strategy has the following three attractive features. First, we identify risk-free rates (both real and nominal) without relying on asset price data. Second, we can exploit the rich joint interactions between the macro fundamentals to identify conditional moments of consumption growth (Zviadadze, 2016). Third, we identify the dynamics of macro variables other than consumption that we would need in our model: inflation to value nominal assets; output growth and government expenditures to model the default probability of the U.S. government (as in Chernov, Schmid, and Schneider, 2015); macroeconomic uncertainty as an important driver of sovereign credit risk in developed economies (as in Augustin, 2018).

Consistent with the description above, we introduce a vector \( z_t \) of macroeconomic fundamentals:

\[
z_t = (\Delta c_t, d_t, g_t, \pi_t)\top,
\]

where \( \Delta c_t = \log(C_{t+1}/C_t) \) is log consumption growth, \( d_t \) is log output growth, \( g_t \) is the government expenditure to output ratio, and \( \pi_t \) is inflation. Dynamics of state variables

---

4For example, Chernov and Creal (2016) reflect this change, by using OIS rates as a measure of reference rates starting in 2009, and by using a weighted average of LIBOR and OIS in 2008, with weights gradually shifting towards OIS by the end of 2008.
in many long-run risk models are specified as a VAR(1) process in observable macro and latent states, e.g., Bansal and Yaron (2004), or Bansal and Shaliastovich (2012). They are similar to VARMA(1,1) models in observable macro states only (they are literally the same in homoscedastic cases).

Thus, we assume that \( z_t \) follows a VARMA(1,1) process with time-varying variance:

\[
z_{t+1} = \mu_z + \Phi_z z_t + \Phi_z v_t + \Sigma_z \cdot V_{z,t}^{1/2} \cdot \varepsilon_{z,t+1} + \Theta_z \cdot \Sigma_z \cdot V_{z,t-1}^{1/2} \cdot \varepsilon_{z,t},
\]

(2)

where \( z_{t+1} \) denotes a \( N \times 1 \) vector (\( N = 4 \) in our case), \( \varepsilon_{z,t+1} \sim \mathcal{N}(0, I) \), \( \mu_z \) is an \( N \times 1 \) vector, \( \Phi_z \) is an \( N \times N \) matrix, and \( \Sigma_z \) is an \( N \times N \) matrix, where the diagonal elements of \( \Sigma_z \) are defined as \( \sigma_{z,i} \), for \( i = 1, 2, \ldots, N \). Denote the last term in equation (2) as \( w_{t+1} \),

\[
w_{t+1} = \Theta_z \cdot \Sigma_z \cdot V_{z,t}^{1/2} \cdot \varepsilon_{z,t+1},
\]

and stack the elements of \( z_t \) and \( w_t \) into a new vector \( y_t = \begin{bmatrix} z_t^\top, w_t^\top \end{bmatrix}^\top \).

We treat \( \pi_t \) as being Granger-caused by the other macro variables, but not vice-versa. This is a reduced-form representation of the exogenous and endogenous variables that allows us to be consistent with the setup of Chernov, Schmid, and Schneider (2015). To achieve that, we restrict to zero the off-diagonal elements of the last column of \( \Phi_z \) and \( \Theta_z \).

The vector \( y_t \) follows a VAR(1):

\[
y_{t+1} = \mu_y + \Phi_y y_t + \Phi_y v_t + \Sigma_y \cdot V_{y,t}^{1/2} \cdot \varepsilon_{y,t+1},
\]

where \( y_{t+1} \) denotes a \( 2N \times 1 \) vector, \( \varepsilon_{y,t+1} \sim \mathcal{N}(0, I) \), \( \mu_y \) is a \( 2N \times 1 \) vector, \( \Phi_y \) is a \( 2N \times 2N \) matrix, and \( \Sigma_y \) is a \( 2N \times 2N \) matrix, where the diagonal elements of \( \Sigma_y \) are defined as \( \sigma_{y,i} \), for \( i = 1, 2, \ldots, 2N \).

We assume that the volatility vector consists of autonomous univariate autoregressive gamma processes characterized by the bivariate vector \( v_t \), such that each element \( v_{i,t+1} \) follows an autoregressive gamma process

\[
v_{i,t+1} = \nu_i c_i + \phi_i v_{i,t} + \eta_{i,t+1}, \quad \text{var} \eta_{i,t+1} = \nu_i c_i^2 + 2c_i \phi_i v_{i,t}.
\]

In particular, the unconditional mean is \( Ev_{i,t} = \nu_i c_i (1 - \phi_i)^{-1} \), and we select \( c_i = (1 - \phi_i) \nu_i^{-1} \) to set it to 1 for identification purposes.

We augment the state vector \( y_t \) with the volatility vector to get \( x_t = \begin{bmatrix} z_t^\top, w_t^\top, v_t^\top \end{bmatrix}^\top \). With \( K = (2 \times N + 2) \), the \( K \times 1 \)-dimensional multivariate state vector \( x_{t+1} \) follows a VAR(1) process:

\[
x_{t+1} = \mu + \Phi x_t + \Sigma \cdot V_t^{1/2} \cdot \varepsilon_{x,t+1},
\]
where $\varepsilon_{x,t+1}$ defines a vector of independent shocks, $\Phi$ is a $K \times K$ matrix with positive diagonal elements, $\Sigma$ is a $K \times K$ matrix with strictly positive elements, and $V$ is a $K \times K$ diagonal matrix with elements given by:

$$V_{i,t} = a_i + b_i^T v_t,$$

where parameter restrictions are required to guarantee non-negativity of the volatility process.

### 3.2 The pricing kernel

We assume a representative agent with recursive preferences:

$$U_t = \left[ (1 - \beta) C_t^\rho + \beta \mu_t(U_{t+1})^\rho \right]^{1/\rho},$$

$$\mu_t(U_{t+1}) = E_t(U_{t+1})^{1/\alpha},$$

where $\rho < 1$ captures time preferences (intertemporal elasticity of substitution is $(1 - \rho)^{-1}$), and $\alpha < 1$ captures the risk aversion (relative risk aversion is $1 - \alpha$). Aggregate consumption is denoted by $C_t$. With this utility function, the real pricing kernel is:

$$\tilde{M}_{t+1} = \beta(C_{t+1}/C_t)^{\rho-1}(U_{t+1}/\mu_t(U_{t+1}))^{\alpha-\rho}.$$

We can approximate the (log) pricing kernel using the solution method outlined in Hansen, Heaton, and Li (2008) and Backus, Chernov, and Zin (2014). We log-linearize the scaled time-aggregator:

$$\log(U_t/C_t) \equiv u_t \approx b_0 + b_1 \log \mu_t(e^{\Delta c_{t+1} + u_{t+1}}),$$

where

$$b_1 = \beta e^{\rho \log \mu}((1 - \beta) + \beta e^{\rho \log \mu})^{-1},$$

$$b_0 = \rho^{-1} \log((1 - \beta) + \beta e^{\rho \log \mu}) - b_1 \log \mu,$$

with $\log \mu = E(\log \mu_t)$. We guess $u_t$ to be a linear function of the state $x_t$, substitute this guess into the log-linearized expression for $u_t$, and use the method of undetermined coefficients to solve for $u_t$. Then the log pricing kernel is:

$$\tilde{m}_{t,t+1} = \log \beta + (\rho - 1) \Delta c_{t+1} + (\alpha - \rho) \left[ \Delta c_{t+1} + u_{t+1} - \log \mu_t(e^{\Delta c_{t+1} + u_{t+1}}) \right]$$

$$= \log \beta - (\alpha - \rho) b_0 b_1^{-1} + (\alpha - 1) \Delta c_{t+1} + (\alpha - \rho) \left[ u_{t+1} - b_1^{-1} u_t \right].$$

See Appendix A for details.
3.3 Equilibrium risk-free rates

The price of a zero-coupon bond paying one unit of consumption \( n \)-periods ahead from now must satisfy the Euler equation

\[ \hat{P}^n_t = E_t \left[ \hat{M}_{t,t+n} \right]. \]

We show in Appendix B.1 that the term structure of real interest rates is affine in the state vector \( x_t \).

Similarly, the price of an \( n \)-period zero-coupon nominal bond is obtained from the nominal stochastic discount factor and must satisfy the Euler equation

\[ P^n_t = E_t \left[ M_{t,t+n} \right], \]

where the nominal (log) stochastic discount factor is defined as \( m_{t,t+1} = \hat{m}_{t,t+1} - \pi_{t+1} = \hat{m}_{t,t+1} - e^\top y_{t+1} \). We show in Appendix B.2 that the term structure of nominal interest rates is affine in the state vector \( x_t \).

3.4 The valuation approach for defaultable interest rates

To model the credit risk of the U.S. government, we use the Chernov, Schmid, and Schneider (2015) model as a motivation. Their model is based on the contingent claims approach (CCA) and requires numerical solutions. For tractability reasons, we do not want to model the whole elaborate structure of their default mechanism. Because of the equivalence between the CCA and compound Poisson approaches (Duffie and Lando, 2001), we model a default hazard rate.

Chernov, Schmid, and Schneider (2015) show that the U.S. credit risk is driven by the aggregate consumption growth rate, output growth, and the government expenditures to output ratio. Augustin (2018) also shows that macroeconomic uncertainty is an important driver of sovereign credit risk in developed economies. Thus, we assume that the government’s default risk is driven by a default intensity \( h_t \) defined as:

\[ h_t = h_c \Delta c_t + h_d d_t + h_y g_t + h_{v1} v_{1,t} + h_{v2} v_{2,t}. \]

To model default risk, we also need a corresponding loss given default (LGD), denoted by \( L \), which we assume to be constant.

One might think that inflation or the bank credit risk would affect the default probability of the U.S. government. The former may be relevant if one believes that the U.S. government may attempt to “inflate away” its nominal debt. The latter may be important because of the potential link between banks’ solvency and government default (see, e.g., Acharya, Drechsler, and Schnabl, 2014). For instance, if the Fed bails out the banks, it could be
forced into insolvency. That, in turn, could trigger government default because of the fiscal support provided by the Treasury (Reis, 2015).

As we discussed earlier in the case of $\pi_t$ and as we will show later in the case of the factor capturing bank risk, the two variables are being Granger-caused by macro variables, but not vice-versa. Nevertheless, inflation and bank credit risk are related to the default probability of the U.S. government, albeit implicitly.

Given these assumptions, we can follow the approach of Duffie and Singleton (1999) that implies, under the recovery-of-market-value assumption, that one could account for credit risk by augmenting the (log) discount factor with $L \cdot h_t$:

$$\tilde{P}_t^n \approx E_t e^{\sum_{j=1}^{n} m_{t+j-1,t+j} - L \cdot h_{t+j}}.$$  

However, $\tilde{P}_t^n$ does not correspond to an observable bond price. That is because Treasury prices also reflect the convenience yield.

Thus, to progress further, we have to address the following conceptual challenge. While our focus is on the U.S. credit risk, the swap spreads are affected by other factors, such as the aforementioned convenience yield, the cost of collateral, and credit risk of the banking sector. So, we have to model all these additional drivers of swap spreads.

Furthermore, there is no single asset that is sensitive to only one of these factors. Thus, in order to identify them, we have to use several assets simultaneously. Specifically, both Treasuries and U.S. CDS are informative about the U.S. credit risk. The former also reflects the convenience yield, while the latter does not. Similarly, the latter reflects the opportunity cost of collateral, which is irrelevant for Treasuries, but also impacts swap rates. IRS contracts are exposed to the opportunity cost of collateral as well, and the credit risk of banks in the Eurodollar area. Thus, the combination of these assets will help us identify all the needed factors. Once identified, we use all factors to evaluate the central object of the negative swap spread puzzle, i.e., the OIS-Treasury spread, as an “out-of-sample test” of our model.

### 3.5 Spread factors

Empirically, we identify the safety factor via the difference between the one-month OIS rate $o_t$ and (risky) Treasury rates $\tilde{y}_t^1$, $s_{1,t} = o_t - \tilde{y}_t^1$. As we discussed earlier, this factor reflects not just the ease of trading in Treasuries, but also the credit risk of banks in the Federal Reserve system. We identify the bank credit factor via the difference between 1-month LIBOR and OIS rates, $s_{2,t} = \ell_t - o_t$. We refer to $s_2$ as the LIBOR-OIS spread. The cost of collateral $s_{3,t}$ is treated as latent in the absence of an observable measure. We stack them into a vector $s_t = [s_{1,t}, s_{2,t}, s_{3,t}]^\top$.

The quantitative and conceptual evolution of these spreads is a rich topic for discussion. We necessarily limit ourselves to the key takeaways. Roughly speaking, the difference between
LIBOR and EFFR would represent the credit risk of banks in the Eurodollar area, while the difference between EFFR and a Treasury bill rate would represent the convenience yield.

The first point is consistent with the view of the LIBOR-OIS spread and its use as an indicator of the health of the banking sector in the wake of the financial crisis of 2008. The use of OIS here is subtle, because it reflects the credit risk of banks in the Federal Reserve system. Thus, the spread $s_{2,t}$, reflects the relative riskiness of the banks in the Eurodollar area. Practically speaking, the U.S. LIBOR is used for transactions between banks and other financial institutions, such as mutual funds, while EFFR is used for transactions between banks in the Fed system.

The second point assumes that the EFFR and the Treasury rate represent the same credit quality. Many researchers and practitioners treat the whole OIS curve as risk-free, because it is used to discount fully collateralized transactions. Full collateralization largely mitigates the counterparty risk, but not the cash flow risk of the underlying asset, the EFFR in this case. The credit risk of the U.S. Treasury is linked to that of the Federal Reserve system because of the fiscal support of the latter by the former (Reis, 2015). That means the Fed will never be insolvent separately from the Treasury. If one were to assume that the EFFR is risk-free while the Treasury is credit-risky, it would be much easier for us to explain the negative swap spread. Because of the aforementioned bank risk embedded in the EFFR, the spread $s_{1,t}$ would reflect that risk in addition to the convenience yield of Treasuries.

We assume that $s_t$ follows a multivariate Gaussian AR(1) process, and it may also be affected by the dynamics of the macro state vector $x_t$:

$$s_{t+1} = \mu_s + \Phi_{sy} y_t + \Phi_{s_1} v_t + \Phi_s s_t + \Sigma_s \varepsilon_{s,t+1},$$

where the innovations $\varepsilon_{s,t+1} \sim N(0, \mathbb{I})$. By construction, $s_t$ does not Granger cause the macro variables $(z_t, v_t)$. The conditional covariance of the one-period pricing kernel and the factor is zero, so there is no one-period risk premium associated with $s_t$. Their multi-period counterparts covary, thereby generating risk premiums, because of the presence of macro fundamentals in the conditional expectation of $s_t$. We introduce an extended state vector $\tilde{x}_t^T = [x_t^T, s_t^T]$.

### 3.6 Valuation of credit sensitive instruments

**Risky Treasury bonds.** Following Duffie and Singleton (1999), the resulting risky Treasury price is

$$\tilde{P}_t^n \approx E_t e^{\sum_{j=1}^{n} m_{t+j-1,t+j} - L \cdot h_{t+j} + s_{1,t+j}},$$

\[5\] The impact of macro innovations on $s_{t+1}$ was estimated imprecisely so we zeroed that out to save on cumbersome notation.
and we show in Appendix B.3 that the term structure of risky interest rates is affine in the extended state vector \( \tilde{x}_t \).

**Hypothetical LIBOR bonds.** We work with hypothetical zero-coupon LIBOR bonds \( L^n_t \) discounted at the continuously compounded yield \( \ell^n_t \) (defined at the monthly frequency), such that:

\[
L^n_t = \exp \left( -\ell^n_t \cdot n \right),
\]

where \( n \leq 12 \) corresponds to LIBOR rate maturities of up to 12 months.\(^6\) Using the approach of Duffie and Singleton (1999), the resulting price is:

\[
L^n_t \approx E_t e^{\sum_{j=1}^{n} m_{t+j-1,t+j-1} - L \cdot h_{t+j-1,s_{t+j}}},
\]

and we show in Appendix B.4 with the term structure of LIBOR rates is affine in the extended state vector \( \tilde{x}_t \), with rates \( \ell^n_t \) inferred from Equation (5).

**IRS.** The fixed rate payer pays the annual interest rate swap premium \( IRS_{t,T} \). The floating rate payer pays the LIBOR rate that has been realized at the previous coupon period. We assume monthly time intervals to match the frequency of macroeconomic data. Thus, in case of a quarterly IRS payment frequency, the floating leg would pay each period the 3-month LIBOR rate realized on the previous coupon period, \( \ell^3_{t-1} \). The one-month LIBOR rate is equal to \( \ell^1_t \equiv \ell^1_t = \tilde{y}_t^1 + s_{1,t} + s_{2,t} \).

We have valued the term structure of zero-coupon LIBOR rates in appendix B.4 and can thus directly use the three-month LIBOR rates for the computation of the LIBOR swap contracts.\(^7\) We discount all cash flows accounting for the cost of collateral \( s_{3,t} \) as in Johannes and Sundaresan (2007). Thus, the present value of expected future payments by the fixed leg is given by:

\[
\omega^\text{fix}_t = IRS_t^n \sum_{j=1}^{n\Delta^{-1}} E_t \left[ e^{m_{t+j\Delta} + s_{3,t+j\Delta}} \right],
\]

where \( \Delta \) defines the time interval between two successive coupon periods. The present value of expected future payments by the floating leg is given by:

\[
\omega^\text{float}_t = \sum_{j=1}^{n\Delta^{-1}} E_t \left[ e^{m_{t+j\Delta} + s_{3,t+j\Delta}} \left( e^{\Delta \ell^3_{t+j\Delta}} - 1 \right) \right],
\]

where \( \Delta \) defines the time interval between two successive coupon periods.

\(^6\)Because actual LIBOR rates \( \ell^{q,n}_t \) are periodic and quoted on an annualized basis, we map the data into continuously compounded rates according to the formula \( \ell^n_t = n^{-1} \log (1 + \ell^{q,n}_t \cdot n \cdot 30/360) \). The day count convention for LIBOR rates is act/360. We use 30/360 as the day count convention given that it is numerically close to act/360, and it simplifies the implementation.

\(^7\)For maturities up to one year, zero-coupon rates are equivalent to par rates. For the numerical implementation, we map the continuously compounded LIBOR rates into periodic rates assuming a 30/360 daycount convention for simplicity.
A LIBOR swap contract is priced fairly if both the fixed and the floating legs have the same value. The condition yields the formula for the IRS spread $\text{IRS}^n_t$:

$$\text{IRS}^n_t = \frac{\sum_{j=1}^{n\Delta - 1} E_t \left[ e^{mt_{t+j\Delta} + s_{3,t+j\Delta}} \left( e^{\Delta \ell^3_{t+(j-1)\Delta}} - 1 \right) \right]}{\sum_{j=1}^{n\Delta - 1} E_t \left[ e^{mt_{t+j\Delta} + s_{3,t+j\Delta}} \right]}.$$  \hspace{1cm} (6)

See Internet Appendix B.5 for the derivation.

**OIS.** The fixed rate payer pays the annual OIS premium $OIS^0_t$. The floating rate payer pays the geometric mean of daily overnight rates. Because of the assumed monthly minimal time interval in our model, there is no distinction between $o_t \equiv OIS^1_t$ and EFFR compounded over a month. Thus, the quarterly payment frequency corresponds to the floating leg paying the geometric average of three one-month OIS rates.

As was the case for IRS premiums, we discount all cash flows accounting for the cost of collateral $s_{3,t+1}$. The present value of expected future payments by the fixed leg is given by:

$$\pi^{fix}_t = OIS^n_t \sum_{j=1}^{n\Delta - 1} E_t \left[ e^{mt_{t+j\Delta} + s_{3,t+j\Delta}} \right],$$

where $\Delta$ defines the time interval between two successive coupon periods. The present value of expected future payments by the floating leg is given by:

$$\pi^{float}_t = \sum_{j=1}^{n\Delta - 1} E_t \left[ e^{mt_{t+j\Delta} + s_{3,t+j\Delta}} \left( \exp \left( \sum_{i=1}^{\Delta} o_{t+j\Delta-i} \right) - 1 \right) \right].$$

OIS swaps of maturity less than one year are subject to only one payment settlement, while those of maturities equal to and greater than one year are subject to quarterly payments.

An OIS contract is priced fairly if both the fixed and the floating legs have the same value. This condition yields the formula for the OIS spread $OIS^n_t$:

$$OIS^n_t = \frac{\sum_{j=1}^{n\Delta - 1} E_t \left[ e^{mt_{t+j\Delta} + s_{3,t+j\Delta}} \left( \exp \left( \sum_{i=1}^{\Delta} o_{t+j\Delta-i} \right) - 1 \right) \right]}{\sum_{j=1}^{n\Delta - 1} E_t \left[ e^{mt_{t+j\Delta} + s_{3,t+j\Delta}} \right]}.$$  \hspace{1cm} (7)

See Internet Appendix B.6 for the derivation.

**CDS.** To value CDS contracts, we need to model both the premium leg that pays the annual CDS premium $CDS^n_t$, and the protection leg that pays the loss given default $L$. We note the distinction between CDS contracts, which contractually recover a fraction of face value,
and risky Treasuries, which are usually modeled as recovering a fraction of market value. Duffie and Singleton (1999) find little difference across different modeling assumptions of recovery on the term structure of defaultable interest rates (see Figure 2 on p. 703).

A CDS contract with time to maturity \( n \) pays the annual premium until the earlier of default or the contract’s termination date. As is the case with other swap contracts, we account for the cost of collateral. Accordingly, the present value of the premium payments of a USD-denominated CDS contract is equal to:

\[
\pi^p_t = CDS^m_t \sum_{j=1}^{n-1} E_t \left[ e^{m_{t,t+j\Delta} + s_{3,t+j\Delta}} I(\tau > t + j\Delta) \right],
\]

where \( \Delta \) defines the time interval between two successive coupon periods, and \( I(\cdot) \) is an indicator function that is equal to one if the condition inside the brackets is met, and zero otherwise. For simplicity, we omit accrual payments in the notation, but account for them in the formal implementation of the model. The present value of expected future payments by the protection seller is given by:

\[
\pi^{ps}_t = L \cdot E_t \left[ e^{m_{t,\tau} + s_{3,\tau}} I(\tau \leq n) \right].
\]

A CDS contract is priced fairly if both the premium and the protection legs have the same value. This condition yields the formula for the CDS premium \( CDS^m_t \):

\[
CDS^m_t = L \cdot \frac{E_t \left[ e^{m_{t,\tau} + s_{3,\tau}} I(\tau \leq n) \right]}{\sum_{j=1}^{n-1} E_t \left[ e^{m_{t,t+j\Delta} + s_{3,t+j\Delta}} I(\tau > t + j\Delta) \right]}.
\]  

(8)

See Internet Appendix B.7 for the derivation of the CDS premiums.

4 Results

4.1 Estimation

We use macroeconomic fundamentals and financial asset data to estimate the model via Bayesian MCMC with diffuse priors. The outputs of the procedure are the state variables and parameter estimates. Posterior estimates are provided in Table 4 and Table 5.

The key feature of our approach is that we conduct a two-stage estimation. In the first stage, we estimate the macro dynamics described by the autonomous VARMA for \( z_t \). In the second stage, we use asset market data for the identification of the financial factors \( s_t \).

There are two advantages to doing so. First, we have a much shorter time interval with available data on CDS and interest rate swap premiums, which start in 2002 (USD-denominated
U.S. CDS start even later in 2010). Thus, the first stage allows for using a longer history of macroeconomic fundamentals to learn about $z_t$. Second, we can identify the dynamics of the macroeconomic factors and, therefore, of the pricing kernel, without relying on asset market data. Thereby, we are avoiding the “dark matter” critique of Chen, Dou, and Kogan (2017).

We provide a brief outline of our two-stage estimation procedure. See Appendix C for details. In the first stage, we use consumption growth, output growth, log government expenditure-to-output ratio, and inflation from 1982 to 2018. Except for inflation data, which are monthly, the other macro variables are quarterly.\(^8\) Because the decision interval is one month in our model, we estimate the monthly counterparts of the respective quarterly series. We adjust the state-space representation to address the mixed frequency of the observables. Posterior estimates from the first stage estimation are provided in Table 4.

The estimated AR matrix $\Phi_z$ and MA matrix $\Theta_z$ imply that consumption and output growth rates do not affect inflation and government expenditures. The latter affects all macro fundamentals (consumption is affected indirectly via output and the MA term). The two variance factors affect the conditional mean of inflation only. The other elements of the matrix $\Phi_{zv}$ are set to zero because they were poorly identified in our sample.

Having filtered out the estimates for $z_t$ and $v_t$ at the monthly frequency, we use data on the term structure of Treasury GSW zero-coupon rates (maturity of 1, 3, 5, 7, 10, 20, 30 years), the term structure of CDS premiums (maturity of 1, 3, 5, 7, 10, 20, 30 years), and the empirical measures of $s_{1,t}$ and $s_{2,t}$ to learn about the joint dynamics of $s_t$. We do not use the IRS and OIS data in the estimation so that we can evaluate the implied swap spreads as an out-of-sample test of our model. The one-year IRS is the only exception to the strategy, because it is helpful in identifying the latent cost of collateral, $s_3$.\(^9\) We use the bootstrap particle filter to estimate $s_{3,t}$.

To estimate the dynamics of the financial variables in the second stage, we condition on the filtered macroeconomic fundamentals from the corresponding period. Furthermore, these fundamentals exhibit visible shifts in level in this later part of our sample. Thus, we re-estimate the constant term $\mu_z$ to accommodate possible structural breaks in the level of macroeconomic fundamentals $z_t$. Relatedly, we impose a one-time structural break in the default intensity $h_t$ by assuming that it switched from zero to a positive value in December 2007 to reflect nearly zero U.S. CDS premiums prior to that date. Posterior estimates from the second stage estimation are provided in Table 5.

With the exception of the variance factors, other macro variables do not affect the financial ones (the matrix $\Phi_{sy}$ was poorly identified). The variances have a significant impact on the

\(^8\)In particular, our choice of using quarterly consumption growth avoids modeling measurement errors in monthly consumption growth (see Schorfheide, Song, and Yaron, 2018 for a detailed discussion). That significantly reduces the dimension of the state vector leading to a much more tractable estimation problem.

\(^9\)Using the one-year IRS data for estimation is innocuous, because it is the shortest maturity and does not exhibit any puzzles.
convenience yield $s_1$, perhaps reflecting the flight-to-safety effect, and the cost of collateral $s_3$, reflecting lenders’ collateral demand. With the exception of output growth, all other macro variables play an important role in the default intensity. Output growth affects forecasts of future $h_t$ via its impact on consumption growth (matrix $\Phi_z$).

Most studies on no-arbitrage modeling of credit-sensitive assets do not estimate the LGD separately from the default intensity because of a joint identification problem. We need the separation between the two for the sole purpose of simplifying the interpretation of the magnitude of the default rate. Thus, following Chernov, Schmid, and Schneider (2015), we calibrate the LGD to a specific value of $L = 0.3$.

Estimated risk aversion is $1 - \alpha \approx 5$. This value is clearly insufficient to match the equity premium, which is natural in a bond pricing model. Elasticity of intertemporal substitution $(1 - \rho)^{-1} \approx 1.33$ is in line with standard calibrations in the long-run risk literature.

### 4.2 Factors

Figures 5 and 6 display the factors that we use in our model. The first figure shows the macro variables $z_t$. We note a downward trend in inflation throughout the sample. While that can be attributed to the great moderation in the early part of our sample period, it may appear puzzling in the post-crisis sample when monetary policy was particularly accommodating. Our series are consistent, however, with the observation, sometimes labeled the ‘missing inflation puzzle’, that inflation is low in spite of expansionary monetary policies conducted by central banks around the globe (Arias, Erceg, and Trabandt, 2016).

We also note a gradual elevation in government expenditures (as a fraction of output) throughout the sample, consistent with stabilization policies put in place after the onset of the financial crisis. Log consumption and output growth are standard series. In particular, the latter part of the sample period exhibits lower consumption growth volatility, consistent with the period of great moderation, except for a bump in anticipation of a potential turmoil in 2008.

The second figure shows the observable finance variables, $s_1$ and $s_2$, together with the latent finance variable $s_3$. The convenience yield and the LIBOR-OIS factors exhibit familiar patterns with substantial spikes during the period surrounding the financial crisis of 2008, reflecting a flight to quality on the one hand, and rising perceptions of bank risk in the aftermath of Lehman’s collapse, on the other hand. The cost of posting collateral gradually rises during the overheating credit markets heading into the crisis, when investment opportunities were abundant.

Both $s_1$ and $s_3$ collapse after the crisis. This pattern is important as a decline in both of these factors diminishes their effects on swap spreads. Quantitatively, that leaves credit risk of the U.S. Treasury as the main force affecting the spreads.
The post-crisis pattern in $s_1$ and $s_3$ is natural. The decline in convenience is associated with an increase in the riskiness of Treasuries. In fact, our estimated parameters imply that both variance factors are associated with an increase in the default intensity and a decline in $s_1$. The cost-of-collateral is influenced by the cost of holding cash and lending out Treasuries in rehypothecation. Indeed, interest rates have been at historical lows since the financial crisis.

4.3 Fit

Figures 7 - 8 demonstrate the model fit to the financial data used in the estimation. We have an unusual setup in that our model is a hybrid of an endowment economy and a reduced-form no-arbitrage valuation. Formally, it belongs to the class of affine models, but we impose a host of additional economic restrictions not typically present in a traditional no-arbitrage model. So we do not expect as pristine of a fit as a regular affine no-arbitrage model would deliver. Nevertheless, a high degree of realism would be welcome. Otherwise, the implications for the OIS-Treasury spread would not be very plausible and relevant.

Figure 7 compares model-implied credit-risky and observed zero-coupon Treasury yields of different maturities, up to a 30-year horizon. The model is having some difficulty in matching the one-year rate, but performs well at longer horizons. That is not surprising. Our model does not explicitly account for the prolonged near-zero-bound interest rate experience after the crisis. The short end of the curve is much more sensitive to that than the long end.

Figure 8 shows observed and model-implied U.S. CDS rates. CDS premiums are stripped of the level of benchmark interest rates, so they naturally do not have a first-order sensitivity to the aforementioned misspecification of the short interest rates. The fit of the model is good throughout all maturities.

4.4 The U.S. “credit spread”

Having verified a reasonable fit of the model, we proceed with exploring its implications. Figure 9 displays nominal credit-risk-free interest rates (without convenience yield) against the risky nominal Treasury benchmark. Before the financial crisis, there is little difference between the riskless and the risky nominal rates. This is expected because the U.S. CDS premium was literally zero before the crisis. They are not identical because of the presence of the convenience yield.

U.S. CDS premiums jumped in the financial crisis and stayed elevated ever since. As we show in Figure 8, CDS premiums fluctuated between 20 and 60 bps at different maturities between 2011 and 2018. Accordingly, the ignition of U.S. credit risk is reflected in the difference between risky and riskless nominal Treasury interest rates. The difference between these
rates is small at short horizons, but becomes progressively more visible at longer horizons. For example, the difference averages around 44 bps (70 bps) at the 5-year (10-year) maturity during the post-crisis period, and reaches maximum levels of 74 bps (91 bps).

Focusing on the variation in the quantitative magnitude of credit risk, we plot the U.S. default intensity in Figure 10(A). The likelihood of a U.S. default spikes to 0.2% during the global financial crisis (GFC), and then flares up again in times of elevated fiscal stress. Over the last decade, the threats of government shutdowns have risen as anticipations of U.S. debt ceiling breaches are increasingly common. On August 5, 2011, the rating agency Standard & Poor’s stripped the U.S. off its AAA credit rating and lowered it by one notch to AA+. During the post-GFC period the average intensity is about 0.05%.

Figure 10(B) quantifies the impact of the credit risk premium on the CDS valuation. Specifically, we characterize the “distress” risk premium associated with unpredictable variation in the arrival rate $h_t$. To this end, we follow Longstaff, Mithal, and Neis (2005) and Pan and Singleton (2008), and report the difference between the model-based five-year CDS premium and a hypothetical premium for the case of a risk-neutral investor (denoted $CDS^{\dagger}$). We omit the cost of collateral $s_3$ to focus on the pure effect of credit risk premium.

The difference between $CDS$ and $CDS^{\dagger}$ is stable throughout the sample averaging 14 bps. The relative difference measuring the fraction of the CDS premium due to distress risk ranges between 20 and 80 percent. In contrast to the difference in levels, the relative measure is trending upwards throughout the sample. While CDS premiums have declined in the post-GFC period, the relative contribution of the risk premium has increased.

In Figure 11, we conduct an exercise that helps us better gauge the impact of modeling the default risk of the U.S. Treasury. We compare the sensitivity to all state variables of the “U.S. credit spread” that is displayed in Figure 9. We measure the sensitivities as factor loadings appearing in the theoretical linear relation between the credit spread and the state variables. To facilitate the quantitative interpretation of the results, we multiply these loadings by unconditional standard deviations of the respective state variables. Thus the reported numbers represent a monthly change in the credit spread (expressed in decimals) in response to a one standard deviation change in a given state variable.

Our discussion focuses on the four quantitatively most important variables. Higher government expenditures elevate the risky yield relative to the nominal one, and this effect is especially pronounced at the short end of the term structure. That is intuitive, as, in expectation, the government can balance its budget in the long run either by raising taxes or by issuing more debt. Either measure is likely accompanied with dimmer default prospects, either directly or through the negative effects of elevated taxes on growth projections, as in Chernov, Schmid, and Schneider (2015). Quantitatively, a one standard deviation increase in the government expenditures to output ratio increases the credit spread by approximately 20 bps at the 5-year maturity.

Higher macroeconomic uncertainty also leads to greater risky yields, as the representative agent in our model dislikes economic uncertainty that come with a higher likelihood of
extreme events. Inflation variance has a greater impact at the short end of the yield curve,
as inflation surprises are more relevant for that maturity segment. Consumption variance
has a greater impact at the long end of the curve. This is reminiscent of long-run risk
in volatility, which has an impact due to the combination of recursive preferences with a
preference for early resolution of uncertainty.

The convenience yield affects the risky Treasury directly. A higher convenience yield implies
a lower yield. This effect is especially pronounced for short-term bills, perhaps because of
the importance of Treasuries in short-horizon repo transactions, and impacts the credit
spread by as much as 45 bps in response to a one standard deviation move. At longer
maturities, this effect stabilizes around 10 bps.

Bank risk and the cost of collateral matter indirectly via the interactions with the macroe-
conomic fundamentals and all spread factors. The LIBOR-OIS spread captures bank risk.
Bank risk interacts positively with U.S. credit risk, and so the effect on the credit spread
is positive. The cost of collateral is indirectly reflected through a negative impact on the
credit spread.

4.5 Swap spreads

Figure 12 displays our headline result – the model-implied OIS-Treasury spread. Import-
tantly, we note that OIS information was not used in the model estimation. The model
captures both the positive spread before the crisis when U.S. credit risk was next to nil,
and the negative spread in the post-crisis period. The results are quantitatively realistic for
all maturities.

In Figure 13, we also plot the model-implied IRS-Treasury spread. Recall that we only use
the 1-year maturity in our estimation. As for OIS-Treasury spreads, we qualitatively fit the
evolution of the swap spreads well. We match positive swaps spreads before the crisis, and
negative ones thereafter.

In our analysis in section 2.4 we offer qualitative arguments and suggestive evidence linking
U.S. credit risk to swap spreads. Our quantitative model allows for a rich set of different
effects beyond the sovereign risk channel, including the convenience yield, bank risk, cost of
collateral, and time-varying risk premiums. Thus, a natural question is whether the quan-
titative effect due to a U.S. credit risk premium is large enough to support our qualitative
analysis.

In a counterfactual analysis, we can use our model to evaluate the contribution of U.S. credit
risk to the spreads. Figure 14 reports the results of a decomposition of the OIS-Treasury
spread into the respective contributions coming from default and non-default risk. That
helps to gauge the contribution of the default risk premium to the negative swap spreads
in our model. We plot the decomposition for maturities of 1, 3, 5, 10, 20, and 30 years. We
provide a similar decomposition for IRS-Treasury spreads in Figure 15.
The quantitative implication is clear. The model implied OIS-Treasury spreads are uniformly positive when we only account for liquidity and bank frictions. The few negative swap spread realizations are quantitatively tiny. Accounting for the U.S. credit risk premium, however, shifts the OIS-Treasury spread significantly downwards. That downward shift is increasing in maturity. This clearly illustrates the critical role of U.S. credit risk in matching negative OIS-Treasury spreads in an equilibrium model that explains multiple benchmark rates jointly, even if we account for realistic liquidity and bank frictions.

In Table 6, we report model-implied regressions of changes in swap spreads on changes in CDS premiums, similar to the ones reported in Table 3. In these regressions, we do not control for common time fixed effects because, by construction, our model is driven by a limited number of state variables that drive the common variation across swap spreads. The relation between swap spreads and U.S. credit risk in the model reflects the salient features of the data well. The relation is insignificant for short-term maturities (columns 1 and 2), significant for maturities above 7 years (columns 3 and 4), and becomes stronger over time (columns 6 to 9). The economic magnitudes are also similar than those in the data, but slightly stronger. For example, according to the results in column (7), a 10 bps increase in CDS premiums lowers swap spreads by 1.9 bps, with an $R^2$ of 29%. The most comparable regression in Table 3 is that in column (4), which indicates a 0.7 bps change for a 10 bps change in CDS premiums, with an $R^2$ of 2%. A regression at the weekly frequency (unreported results) yields an $R^2$ of 5% with a regression coefficient of 2.1 bps.

Thus, our model suggests that, quantitatively, sovereign credit risk is a relevant ingredient needed to account for negative swap-Treasury spread. The sovereign risk channel operates through the U.S. credit risk premium, which can be large, even if the physical default probability is small. Such a risk premium channel complements existing explanations based on frictions. We reach this conclusion based on a realistic model of benchmark interest rates, in which frictions are identified via observable quantities (convenience yield and LIBOR-OIS spread) and a latent factor (cost of collateral); time-varying risk premia are pinned down by the preferences of a representative risk averse agent and observed macroeconomic fundamentals.

5 Conclusion

Researchers have been struggling to explain the puzzling behavior of benchmark interest rates since the financial crisis. Most prominently, short-term and long-term overnight bank borrowing costs, reflected in overnight index and interest rate swap contracts, have been lower than maturity-matched Treasury rates. Leading explanations of these negative swap spread puzzles are based on frictions, such as demand for duration, caps on leverage, or fading convenience yields for U.S. Treasuries.

We show that it is important to account for high-quality sovereign credit risk to enhance our understanding of post-crisis pricing phenomena. A small probability of U.S. Treasury de-
fault lowers no-arbitrage bounds of swap spreads to negative levels. Specifically, accounting for a U.S. credit risk premium in Treasuries is crucial if one wants to explain the dynamics of the term structures of multiple benchmark interest rates jointly. Even if the probability of a U.S. credit event is small, the risk premium associated with it may be large.
References


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Spears, Taylor, 2019, Discounting collateral: quants, derivatives and the reconstruction of the 'risk-free rate' after the financial crisis, *Economy and Society, forthcoming*.


Figure 1: **USD overnight LIBOR and EFFR**

Notes: In this figure, we report the time series of the difference between the overnight London Interbank Offered Rate (LIBOR) and the Effective Federal Funds Rate (EFFR). LIBOR is the average interest rate at which leading banks borrow funds of a sizeable amount from other banks in the Eurodollar area. The EFFR is calculated as a volume-weighted median of overnight federal funds transactions provided by domestic banks and U.S. branches and agencies of foreign banks, as reported in the reporting form FR 2420. The data frequency is weekly based on Wednesday rates. All spreads are expressed in percent. The sample period is 8 May 2002 to 26 September 2018. Source: Federal Reserve Bank of St. Louis. The y-axis is in annualized percentage terms.
Figure 2: Libor/Swap-Treasury spreads

Notes: In these figures, we report the time series of USD denominated Libor/Swap-Treasury spreads, defined as the difference between the interest rate swap (IRS) rates and the maturity-matched constant maturity Treasury (CMT) rates for maturities 20 and 30 years (Subfigure 2.a) and for maturities 3, 5, 7, and 10 years (Subfigure 2.b). We also report the time series of USD denominated OIS-Treasury spreads, defined as the difference between the overnight index swap (OIS) rate and the maturity-matched constant maturity Treasury (CMT) rate for maturities of 6 months, 1, 3, and 5 years (Subfigure 2.c) and 7, 10, 20, and 30 years (Subfigure 2.d). The data frequency is weekly based on Wednesday rates. All spreads are expressed in percent. The sample period is 8 May 2002 to 26 September 2018. Source: Bloomberg (OIS and IRS) and FRED (CMT).
Figure 3: IRS-Treasury and OIS-Treasury spreads

Notes: In these figures, we report the time series of the USD denominated IRS-Treasury and OIS-Treasury swap spreads, defined as the difference between the interest rate swap (IRS) rate or the overnight index swap (OIS) rate and the maturity-matched constant maturity Treasury (CMT) rate. Spreads for the 6-month maturity are based on LIBOR. Spreads for maturities of 5 years and higher are based on IRS rates. We overlay the (negative of the) USD maturity-matched U.S. CDS premium, i.e., the CDS premium multiplied by (-1). The data frequency is weekly based on Wednesday rates. All spreads are expressed in percent. The sample period is 8 May 2002 to 26 September 2018. Source: Bloomberg (OIS, IRS, LIBOR), FRED (CMT), Markit (CDS).
Figure 4: **Cash flows to various interest-rate-linked instruments**

<table>
<thead>
<tr>
<th>Start, 0</th>
<th>During the term, t</th>
<th>Maturity, T</th>
<th>Credit event, τ</th>
</tr>
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<tr>
<td>1</td>
<td>1</td>
<td>CMT</td>
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</tr>
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<td>Swap transaction</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>0</td>
<td>0</td>
<td>( f_{t-3} )</td>
<td>OIS</td>
</tr>
<tr>
<td>CDS transaction</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>0</td>
<td>0</td>
<td>CDS</td>
<td>CDS</td>
</tr>
</tbody>
</table>

**Notes:** In this figure, we represent the cash flows from a trading strategy that finances a long position in a U.S. Treasury via a repurchase transaction in which the Treasury bond is used as collateral. The cost of the three-month (collateralized) repo loan is \( r_{t-3} \). For simplicity, we consider a face value of $1. The fixed coupon \( CMT \) earned on the Treasury bond is swapped into a floating rate via an interest rate swap that pays fixed \( OIS \) and receives floating interest, that is, the EFFR compounded daily over the past three months, denoted by \( f_{t-3} \). The upper left corner considers the case without the possibility of U.S. default. The remaining boxes are added when we allow for default risk. Dashed boxes emphasize the uncertainty associated with credit events. The risky Treasury bond can be hedged via a CDS contract at an annual fixed cost of \( CDS \). Upon random default \( \tau \) before maturity \( T \), the bond is worth \( 1 - L \), but the CDS hedge pays \( L \) and terminates. The repo contract is not rolled over, yet requires the payment of interest \( r_{\tau-3} \) plus capital 1. The swap contract either continues until \( T \) or is closed out at current market value.
Figure 5: **Macro factors**

Notes: In these figures, we plot the dynamics of the macroeconomic state variables in our model: log consumption growth ($z_1$), output growth ($z_2$), government expenditures to output ratio ($z_3$), and inflation ($z_4$), as well as consumption volatility ($v_1$) and inflation volatility ($v_2$). All variables are annualized and represented in percentage terms, except for the government expenditures to output ratio, which is represented in logs. The sample period is 1982 to 2018. The data frequency is quarterly for $z_1$, $z_2$, and $z_3$, and monthly for $z_4$. Source: Federal Reserve Bank of St. Louis H.15 Report.
Figure 6: **Finance factors**

Notes: We plot the spread factors: $s_1$ is the convenience yield, defined as the one-month OIS-Treasury spread; $s_2$ captures the interbank credit and funding liquidity risk, defined as the one-month LIBOR-OIS spread; $s_3$ is latent and captures the opportunity cost of collateral. The sample period is May 2002 to September 2018. All variables are plotted at a monthly frequency, and are expressed in percent. Source: Bloomberg (OIS, LIBOR), FRED (CMT).
Notes: In these figures, we plot the model-implied risky zero-coupon bond yields (green line with bullets) together with their 90% confidence bands, and compare them with the observed nominal zero-coupon Treasury yields (solid black line) from Gurkaynak, Sack, and Wright (2007). We plot observed and model-implied yields for maturities of 1y, 3y, 5y, 10y, 20y, and 30y. All variables are plotted at a monthly frequency and are expressed in annualized percentage terms. The sample period is May 2002 to September 2018.
Figure 8: **Model-implied and actual CDS premiums**

Notes: In these figures, we plot the model-implied (green line with bullets), their 90% confidence bands, and observed (solid black line) CDS premiums. We plot observed and model-implied CDS premiums for maturities of 1y, 3y, 5y, and 10y. All variables are plotted at a monthly frequency, and are expressed in annualized percentage terms. The sample period is May 2002 to September 2018. Source: Markit.
Figure 9: Model-implied zero-coupon yields

Notes: In these figures, we plot the model-implied zero-coupon yields for nominal bonds (gray line with bullets), real bonds (green line with squares), and risky Treasury bonds (solid black line). We plot model-implied zero-coupon yields for maturities of 1y, 3y, 5y, and 10y. All variables are plotted at a monthly frequency, and are expressed in annualized percentage terms. The sample period is May 2002 to September 2018. Source: Authors’ computations.
Figure 10: Default intensity and credit risk premium

(A) Default intensity

(B) Model-implied CDS premiums under the risk-neutral and physical measures

Notes: In Panel (A), we plot the model-implied physical default intensity for U.S. credit risk from January 2008 to September 2018. In Panel (B), we plot the model implied CDS premiums for maturity 5 years under the risk-neutral $CDS$ and physical $CDS^\dagger$ measures from January 2008 to September 2018. The $y$-axis is expressed in annualized percentage terms. Source: authors’ computations.
Figure 11: Credit/safety spread loadings: Risky - nominal rate

Notes: In these figures, we examine the sensitivity of model-implied risky zero-coupon Treasury yields (which incorporate the convenience yield) to all state variables over and above the sensitivity of model-implied nominal Treasury yields (which exclude the convenience yield). Specifically, we plot the difference of the sensitivity loadings with respect to the state variables as a function of the maturity horizon, up to 20 years. The state variables are log consumption growth ($z_1$), inflation ($z_2$), output growth ($z_3$), government expenditures to output ratio ($z_4$), the convenience yield ($s_1$), the LIBOR-OIS spread ($s_2$), the opportunity cost of collateral ($s_3$), consumption volatility ($v_1$), and inflation volatility ($v_2$). Source: Authors’ computations.
Figure 12: Model-implied spread between OIS and CMT

Notes: In these figures, we plot the model-implied (green line with bullets), their 90% confidence bands, and observed (solid black line) OIS-Treasury spreads, where we use the constant maturity Treasury par rates. We plot observed and model-implied OIS-CMT spreads for maturities of 1y, 3y, 5y, 10y, 20y, 30y. All variables are plotted at a monthly frequency and are expressed in annualized percentage terms. The sample period is May 2002 to September 2018. Source: Bloomberg (OIS) and FRED (CMT).
Figure 13: Model-implied spread between IRS and CMT

Notes: In these figures, we plot the model-implied (green line with bullets), their 90% confidence bands, and observed (solid black line) IRS-Treasury spreads, where we use the constant maturity Treasury par rates. We plot observed and model-implied IRS-CMT spreads for maturities of 1y, 3y, 5y, 10y, 20y, and 30y. All variables are plotted at a monthly frequency, and are expressed in annualized percentage terms. The sample period is May 2002 to September 2018. Source: Bloomberg (IRS) and FRED (CMT).
Figure 14: Model-implied spread between OIS and CMT: Counterfactual

Notes: In these figures, we compare the fitted OIS-CMT spreads (black line) with their counterfactual values when U.S. credit risk is shut down (gray boxes). All rates are expressed on a par basis. We plot the OIS-CMT spreads for maturities of 1y, 3y, 5y, 10y, 20y, 30y. All variables are plotted at a monthly frequency, and are expressed in annualized percentage terms. The sample period is May 2002 to September 2018. Source: Authors’ computations.
Figure 15: **Model-implied spread between IRS and CMT: Counterfactual**

Notes: In these figures, we compare the fitted IRS-CMT spreads (black line) with their counterfactual values when U.S. credit risk is shut down (gray boxes). All rates are expressed on a par basis. We plot the IRS-CMT spreads for maturities of 1y, 3y, 5y, 10y, 20y, 30y. All variables are plotted at a monthly frequency, and are expressed in annualized percentage terms. The sample period is May 2002 to September 2018. Source: Authors’ computations.
Table 1: Literature on negative swap and OIS-Treasury spreads

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<th>Focus</th>
<th>Type</th>
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<td>Lou (2009)</td>
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<tr>
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Notes. This table summarizes the main studies explaining negative OIS-Treasury or IRS-Treasury swap spreads. We describe the focus of the paper (OIS-Treasury or IRS-Treasury), the type of study (empirical or theoretical), and the main explanation proposed by each study.
Table 2: **Descriptive statistics of USD interest and CDS rates.** In this table, we report summary statistics (mean, sd, p1, p50, p99) and the number of observations (Obs.) for the term structure of various U.S. interest and credit default swap (CDS) rates with maturities ranging between 3 months and 30 years. We use weekly observations based on Wednesday rates. Statistics are reported for USD denominated overnight index swap (OIS) rates (Panel A), USD denominated interest rate swap (IRS) rates, where maturities below one year correspond to London interbank offered (LIBOR) rates (Panel B), USD denominated constant maturity Treasury yields (Panel C), USD denominated zero coupon Treasury (ZCT) yields from *Gurkaynak, Sack, and Wright (2007)* (Panel D), USD denominated CDS spreads (Panel E), and EUR denominated CDS spreads (Panel F). All rates are expressed in percentage terms. The sample period is May 8, 2002 through September 26, 2018. Source: Bloomberg (OIS, IRS), *Gurkaynak, Sack, and Wright (2007)* (ZCT), Federal Reserve Bank of St. Louis (CMT, LIBOR), Markit (CDS).

<table>
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| **Panel C: Constant Maturity Treasury Rates** |    |    |    |    |    |    |     |     |     |    |    |    |    |    |    |     |     |     |
| Mean     | 1.25 | 1.37 | 1.49 | 1.99 | 2.48 | 2.87 | 3.23 | 3.81 | 3.95 | – | – | 1.50 | 1.73 | 1.99 | 2.50 | 2.93 | 4.04 | 4.07 |
| SD       | 1.56 | 1.60 | 1.55 | 1.37 | 1.22 | 1.11 | 1.04 | 1.06 | 0.93 | – | – | 1.53 | 1.44 | 1.34 | 1.19 | 1.12 | 1.06 | 0.91 |
| P1       | 0.01 | 0.04 | 0.10 | 0.32 | 0.64 | 1.04 | 1.54 | 1.90 | 2.29 | – | – | 0.11 | 0.22 | 0.34 | 0.67 | 1.07 | 2.05 | 2.49 |
| P50      | 0.52 | 0.66 | 0.89 | 1.52 | 2.23 | 2.79 | 3.12 | 3.96 | 4.13 | – | – | 0.90 | 1.22 | 1.53 | 2.23 | 2.83 | 4.36 | 4.18 |
| P99      | 5.12 | 5.17 | 5.09 | 5.02 | 5.03 | 5.06 | 5.14 | 5.55 | 5.58 | – | – | 5.04 | 5.00 | 4.95 | 4.95 | 5.03 | 5.86 | 5.82 |
| Obs.     | 856 | 856 | 856 | 856 | 856 | 333 | 530 | 366 | 366 | – | – | 856 | 856 | 856 | 856 | 856 | 856 |

| **Panel E: USD CDS Spreads** |    |    |    |    |    |    |     |     |     |    |    |    |    |    |    |     |     |     |
| Mean     | – | 0.11 | 0.13 | 0.14 | 0.18 | 0.24 | 0.27 | 0.36 | 0.37 | – | – | 0.13 | 0.14 | 0.16 | 0.22 | 0.29 | 0.32 | 0.43 | 0.44 |
| SD       | – | 0.08 | 0.11 | 0.12 | 0.16 | 0.16 | 0.18 | 0.15 | 0.16 | – | – | 0.10 | 0.12 | 0.14 | 0.18 | 0.18 | 0.21 | 0.18 | 0.19 |
| P1       | – | 0.01 | 0.01 | 0.01 | 0.02 | 0.02 | 0.03 | 0.03 | 0.03 | – | – | 0.01 | 0.01 | 0.01 | 0.02 | 0.02 | 0.03 | 0.03 |
| P50      | – | 0.09 | 0.10 | 0.13 | 0.15 | 0.24 | 0.28 | 0.37 | 0.38 | – | – | 0.11 | 0.12 | 0.14 | 0.19 | 0.27 | 0.33 | 0.41 | 0.42 |
| P99      | – | 0.38 | 0.61 | 0.67 | 0.66 | 0.72 | 0.74 | 0.80 | 0.85 | – | – | 0.50 | 0.63 | 0.64 | 0.66 | 0.72 | 0.74 | 0.80 | 0.85 |
| Obs.     | – | 502 | 538 | 681 | 747 | 677 | 721 | 527 | 513 | – | – | 575 | 608 | 720 | 755 | 685 | 729 | 557 | 572 |
Table 3: Link between OIS-Treasury spreads and CDS premiums.

In this table, we report the results from a regression of monthly changes in OIS-Treasury spreads ($\Delta SS$) on monthly changes of the maturity-matched U.S. CDS premium (USD, CR restructuring clause). The 3-month OIS-Treasury spread is matched with the 6-month CDS spread. Maturities for OIS-Treasury spreads are 3/6 months, and 1/2/3/5/7/10/20/30 years to maturity. The sample period is January 2010 to September 2018. All specifications include maturity and/or week fixed effects. In row Mat., we indicate maturity restrictions; in row YEAR, we indicate sample period restrictions. Standard errors are heteroscedasticity-robust (RO), clustered by time (CL) or adjusted for cross-sectional dependence and serial dependence up to 3 weeks using Driscoll-Kraay standard errors. We report the within $R^2$ of the regression. Control variables include the CBOE VIX index, the exchange rate of the USD against a basket of a broad group of major U.S. trading partners, the West Texas Intermediate oil price index, the economic policy uncertainty index, the high-yield and investment-grade bond indices, inflation, the TED spread, the 3-month Libor-Ois spread, the 3-month T-bill rate, the U.S. Treasury total cash balances, and CDS depth defined as the number of dealer quotes used to compute the mid-market spread. ***, **, and * denote significance at the 1%, 5%, and 10%, respectively. CDS data is from Markit; OIS data is from Bloomberg; constant-maturity Treasury rates are from the Federal Reserve Bank of St. Louis H.15 report.

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<tr>
<td>$\Delta SS_{t-1}$</td>
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<td>$\Delta IG$</td>
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<td></td>
</tr>
<tr>
<td>$\Delta TLIQ$</td>
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</table>

OBS. | 591 | 347 | 968 | 935 | 935 | 923 | 935 | 935 | 935 | 411 |
MATURITY FE | YES | YES | YES | YES | YES | NO | YES | YES | YES | YES |
QUARTER FE | NO | NO | NO | NO | YES | NO | YES | YES | YES | YES |
MATURITY-QUARTER FE | NO | NO | NO | NO | NO | NO | YES | NO | NO | NO |
CLUSTER TIME | NO | NO | NO | NO | NO | NO | NO | NO | NO | NO |
SE | RO | RO | RO | RO | RO | RO | RO | CL | DK-3 | RO |
MAT | <=5 | <=7 | ALL | ALL | ALL | ALL | ALL | ALL | ALL | ALL |
WITHIN R^2 | 0.02 | 0.01 | 0.01 | 0.02 | 0.09 | 0.20 | 0.24 | 0.24 | 0.34 | 0.32 |
We provide the estimates for the dynamics of the macroeconomic fundamentals $z_t$. We set $\Sigma_z$ to be an identity matrix for identification reasons.

### Table 4: Parameter estimates: Macroeconomic factors

$$z_{t+1} = (\Delta c_{t+1}, d_{t+1}, g_{t+1}, \pi_{t+1})^\top$$

$$z_{t+1} = \mu_z + \Phi_z z_t + \Phi_z v_t + \Sigma_z V_{z,t}^{1/2} z_{t+1} + \Theta_z \Sigma_z V_{z,t-1}^{1/2} z_{t-1}$$

\[
\begin{bmatrix}
0.0000 \\
[-0.0003, 0.0004] \\
-0.0019 \\
[-0.0032, -0.0011] \\
0.0181 \\
[0.0134, 0.0197] \\
-0.0007 \\
[-0.0009, -0.0003]
\end{bmatrix} + 
\begin{bmatrix}
0.78 \\
[-0.07, -0.04] \\
0.39 \\
[0.29, 0.43] \\
0.00 \\
[-0.02, 0.01] \\
0.00 \\
[-0.07, 0.04]
\end{bmatrix} = 
\begin{bmatrix}
2.84 \\
[1.29, 2.64] \\
2.38 \\
[1.00, 1.97] \\
0.13 \\
[0.10, 0.25] \\
0.12 \\
[0.09, 0.22]
\end{bmatrix}
\]

$$v_t + 10^{-3} \text{Diag}$$

\[
\begin{bmatrix}
-1.23 \\
[-1.44, -0.94] \\
0.44 \\
[0.36, 0.62] \\
0.01 \\
[-0.09, 0.00] \\
0.05 \\
[-0.02, 0.10]
\end{bmatrix} + 
\begin{bmatrix}
0.68 \\
[0.62, 0.75] \\
0.75 \\
[0.43, 1.07] \\
-0.01 \\
[-0.03, 0.04] \\
0.01 \\
[-0.01, 0.03]
\end{bmatrix} = 
\begin{bmatrix}
0.908 \\
[0.951, 0.992] \\
1.008 \\
[1.001, 1.97] \\
4.92 \\
[1.102, 2.34] \\
0.17 \\
[0.11, 0.21]
\end{bmatrix}
\]

\[
\begin{bmatrix}
5.30 \\
[3.01, 7.08] \\
1.39 \\
[1.00, 1.97] \\
0.10 \\
[0.05, 0.90]
\end{bmatrix}
\]

$$v_{1,t+1} \sim ARG(\nu_1, \phi_1, \frac{1-\phi_1}{\nu_1}) = ARG(\begin{bmatrix}2.43 \\
[1.04, 5.99] \\
0.908 \end{bmatrix}, 0.908, 0.0377)$$

$$v_{2,t+1} \sim ARG(\nu_2, \phi_2, \frac{1-\phi_2}{\nu_2}) = ARG(\begin{bmatrix}2.43 \\
[0.75, 5.43] \\
0.998 \end{bmatrix}, 0.998, 0.0008)$$

**Notes:** We provide the estimates for the dynamics of the macroeconomic fundamentals $z_t$. We set $\Sigma_z$ to be an identity matrix for identification reasons.
Table 5: Parameter estimates: Finance factors, default intensity, preferences

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<th>Estimate</th>
<th>Standard Error</th>
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<td>$s_{t+1}$</td>
<td>$\mu_s + \Phi_{sy}y_t + \Phi_{sv}v_{t} + \Phi_s s_t + \Sigma_s \varepsilon_{s,t+1}$</td>
<td>\begin{bmatrix} -0.20 &amp; -0.04 \ [-0.33,0.09] &amp; [-0.08,0.06] \end{bmatrix}</td>
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<tr>
<td>$v_t$</td>
<td>$10^{-4}$</td>
<td>\begin{bmatrix} 0.00 &amp; 0.00 \ [-0.00,0.00] &amp; [0.00,0.00] \end{bmatrix}</td>
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<tr>
<td>$\varepsilon_{s,t+1}$</td>
<td>$10^{-4}$</td>
<td>\begin{bmatrix} 0.20 &amp; -0.17 \ [0.13,0.28] &amp; [-0.23,0.08] \end{bmatrix}</td>
</tr>
<tr>
<td>$h_t$</td>
<td>$h + h_c \Delta c_t + h_d d_t + h_g g_t + h_{v_1} v_{1,t} + h_{v_2} v_{2,t}$</td>
<td>\begin{bmatrix} \beta \ \beta \end{bmatrix}</td>
</tr>
<tr>
<td>$U_t$</td>
<td>$[(1-\beta)C_{t}^{\rho} + \beta \mu_t(U_{t+1})^{\rho}]^{1/\rho}$</td>
<td>$\mu(U_{t+1}) = E_t(U_{t+1}^{\rho})^{1/\rho}$</td>
</tr>
<tr>
<td>$\beta$</td>
<td>$0.9984$</td>
<td>\begin{bmatrix} 0.0981,0.9990 \end{bmatrix}</td>
</tr>
<tr>
<td>$\alpha$</td>
<td>$-3.91$</td>
<td>\begin{bmatrix} -4.90, -2.12 \end{bmatrix}</td>
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<td>$\rho$</td>
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<td>$L$</td>
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Notes: We provide the estimates for the dynamics of the financial variables $s_t$ and the default intensity $h_t$. We set $\mu_s, \Phi_{sy}$ to zero for parsimony. Risk aversion is $1 - \alpha$ and intertemporal elasticity of substitution is $(1 - \rho)^{-1}$. We calibrate the value of $L$. 

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Table 6: Model-implied link between OIS-Treasury spreads and CDS premiums.

In this table, we report the model-implied results from a regression of monthly changes in OIS-Treasury spreads ($\Delta SS$) on monthly changes of the maturity-matched U.S. CDS spread denominated in USD. Maturities for OIS-Treasury spreads are 1, 3, 5, 7, 10, 20, and 30 years to maturity. The sample period is January 2009 to September 2018. All specifications include maturity fixed effects. In row Mat., we indicate maturity restrictions; in row YEAR, we indicate sample period restrictions. Standard errors are heteroscedasticity-robust. We report the within $R^2$ of the regression. ***, **, and * denote significance at the 1%, 5%, and 10%, respectively. Source: Authors’ computations.

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<td>-0.17**</td>
<td>-0.57**</td>
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<td>(0.12)</td>
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<td>(0.07)</td>
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<td>0.57***</td>
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<td>0.06</td>
<td>0.13</td>
<td>0.00</td>
<td>0.02</td>
<td>0.29</td>
<td>0.30</td>
<td>0.33</td>
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A Derivation of the real pricing kernel

Since utility is defined by a constant elasticity of substitution recursion and the certainty equivalent is homogeneous of degree one, we can scale utility and take logs:

$$\log \left( \frac{U_t}{C_t} \right) \equiv u_t = \rho^{-1} \log \left[ (1 - \beta) + \beta \mu_t \left( e^{\Delta c_{t+1} + u_{t+1}} \right) \right].$$

Taking a first-order Taylor approximation of $u_t$ around the point $E[\log \mu_t] = \log \mu$, we obtain the log-linearized form

$$u_t \approx \rho^{-1} \log \left[ (1 - \beta) + \beta e^{\rho \mu} \right] + \rho^{-1} \frac{\beta e^{\rho \mu}}{(1 - \beta) + \beta e^{\rho \mu}} \left[ \log \mu_t \left( e^{\Delta c_{t+1} + u_{t+1}} \right) - \log \mu \right]$$

$$\approx b_0 + b_1 \log \mu_t \left( e^{\Delta c_{t+1} + u_{t+1}} \right),$$

where

$$b_1 = \beta e^{\rho \mu} \left( (1 - \beta) + \beta e^{\rho \mu} \right)^{-1}$$

$$b_0 = \rho^{-1} \log \left[ (1 - \beta) + \beta e^{\rho \mu} \right] - b_1 \log \mu.$$

The state vector $x_t = (\Delta c_t, \pi_t, d_t, g_t, \alpha_{c,t}, \alpha_{\pi,t}, \alpha_{d,t}, \alpha_{g,t}, v_{1,t}, v_{2,t})$ describes the economy, where $\Delta c_t = \log(C_{t+1}/C_t)$ is log consumption growth, $\pi_t$ is inflation, $d_t$ is log output growth, $g_t$ is the government expenditure to output ratio, $\alpha_t = [\alpha_{c,t}, \alpha_{\pi,t}, \alpha_{d,t}, \alpha_{g,t}]^\top$ is the vector of moving average components, and $v_t = [v_{1,t}, v_{2,t}]^\top$ is a vector of common stochastic variance processes.

Guess that the log scaled utility is affine in the state vector $x_t$:

$$u_t = \log u + P_y^\top x_t = \log u + P_y^\top y_t + p_v^\top v_t$$

$$= \log u + p_c^\top \Delta c_t + p_{\pi}^\top \pi_t + p_d^\top d_t + p_g^\top g_t + p_v^\top v_{1,t} + p_v^\top v_{2,t},$$

which implies that $P_y = [P_y^\top, p_y^\top]^\top = [p_c, p_{\pi}, p_d, p_g, 0, 0, 0, 0, p_v^\top]^\top$.

Next compute $\log \left( e^{\Delta c_{t+1} + u_{t+1}} \right)$ and $\log \mu_t \left( e^{\Delta c_{t+1} + u_{t+1}} \right)$, plug terms into the log-linearized scaled utility $u_t$ and verify. Given the initial guess, this results in a system of seven equations, which can be solved using the method of undetermined coefficients for the constant and the loadings of the log scaled utility on $x_t$. For the derivations, define the coordinate vectors $e_i$ ($i = 1, 2, \ldots 8$) and $e_{v_i}$ ($i = 1, 2$) with all elements equal to zero except element $i$, which is equal to one.

**Step 1: Compute $\log \left( e^{\Delta c_{t+1} + u_{t+1}} \right)$:**

$$\log \left( e^{\Delta c_{t+1} + u_{t+1}} \right) = \Delta c_{t+1} + u_{t+1} = e_1^\top y_{t+1} + \log u + (P_y + e_1)^\top \mu_y + (P_y + e_1)^\top \Phi_y y_t + (P_y + e_1)^\top \Phi_y v_t$$

$$+ (P_y + e_1)^\top \Sigma_y V_{y,t}^{1/2} \varepsilon_{y,t+1} + p_v^\top v_{t+1}.$$
where $\Omega_{y,t} = \Sigma_y V_{y,t} \Sigma_y^T$. 

Step 3: Plug into $u_t$ and verify:

$$
u_t \approx b_0 + b_1 \log \mu_t \left( e^{\Delta v_{t+1} + u_{t+1}} \right)$$

$$= b_0 + b_1 \left[ \log u + (P_y + e_1)^T \mu_y - \sum_{j=1}^2 \frac{v_{yj}}{\alpha} \log \left( 1 - \alpha_p c_{vj} \right) \right] + b_1 \left[ (P_y + e_1)^T \Phi_y y_t \right] + b_1 \left[ (P_y + e_1)^T \Phi_y e_t \right] + \alpha \left[ (P_y + e_1)^T \Sigma_y \left( I \otimes \left( 1^T \otimes A \right) \right) \Sigma_y^T \right] (P_y + e_1)$$

Given the initial guess, this results in a system of seven equations:

$$\log u = b_0 + b_1 \left[ \log u + (P_y + e_1)^T \mu_y - \sum_{j=1}^2 \frac{v_{yj}}{\alpha} \log \left( 1 - \alpha_p c_{vj} \right) \right]$$

$$p_c = b_1 \left( P_y + e_1 \right)^T \Phi_y e_1$$

$$p_x = u_1 \left( P_y + e_1 \right)^T \Phi_y e_2$$

$$p_d = b_1 \left( P_y + e_1 \right)^T \Phi_y e_3$$

$$p_y = b_1 \left( P_y + e_1 \right)^T \Phi_y e_4$$

$$p_{v1} = b_1 \left[ (P_y + e_1)^T \Phi_y \epsilon v_1 + \frac{\alpha}{2} (P_y + e_1)^T \Sigma_y \left( I \otimes \left( 1^T \otimes B_1 \right) \right) \Sigma_y^T \left( P_y + e_1 \right) + \frac{p_{v1} \Phi_{v1}}{1 - \alpha p c_{v1}} \right]$$

$$p_{v2} = b_1 \left[ (P_y + e_1)^T \Phi_y \epsilon v_2 + \frac{\alpha}{2} (P_y + e_1)^T \Sigma_y \left( I \otimes \left( 1^T \otimes B_2 \right) \right) \Sigma_y^T \left( P_y + e_1 \right) + \frac{p_{v2} \Phi_{v2}}{1 - \alpha p c_{v2}} \right]$$

where $\otimes$ defines the Kronecker product, $\odot$ the Hadamard product, $I$ is the identity matrix, and $1$ is a column vector of ones, and where we have defined the column vectors $A$, $B_1$, $B_2$ as follows:

$$A = [a_c, a_x, a_d, a_y, 0, 0, 0]^T$$

$$B_1 = [b_{e11}, b_{e1v1}, b_{e12}, b_{y1v1}, 0, 0, 0]^T$$

$$B_2 = [b_{e2v1}, b_{e2v2}, b_{e22}, b_{y2v2}, 0, 0, 0]^T.$$

$$\text{(A.1)}$$

Since, the equations for $p_c$, $p_x$, $p_d$, and $p_y$ are linear, their solutions are given by

$$p_c = -e_1^T \left( b_1^2 \Phi_z - I \right)^{-1} \phi_c$$

$$p_x = -e_2^T \left( b_1^2 \Phi_z - I \right)^{-1} \phi_c$$

$$p_y = -e_3^T \left( b_1^2 \Phi_z - I \right)^{-1} \phi_c$$

$$p_y = -e_4^T \left( b_1^2 \Phi_z - I \right)^{-1} \phi_c.$$

The equations for $p_c$ are quadratic and have two roots. We choose the root such that $\lim c_j p_{v1j} = 0$ as $c_j \to 0$. We have that for $j = 1, 2$:

$$b_1 \left( \phi_{v1j} - \alpha c_{v1j} \left( P_y + e_1 \right)^T \Phi_y \epsilon v_1 + \frac{\alpha}{2} (P_y + e_1)^T \Sigma_y \left( I \otimes \left( 1^T \otimes B_1 \right) \right) \Sigma_y^T \left( P_y + e_1 \right) \right) - 1 \left[ \left( P_y + e_1 \right)^T \Phi_y \epsilon v_1 \right]$$

$$+ \alpha c_{v1j} \left( P_y + e_1 \right)^T \Phi_y \epsilon v_1 + \frac{\alpha}{2} (P_y + e_1)^T \Sigma_y \left( I \otimes \left( 1^T \otimes B_1 \right) \right) \Sigma_y^T \left( P_y + e_1 \right) = 0,$$
where the roots to the quadratic equation are determined by:

\[ p_{v_j} = \frac{-B_j^* + \sqrt{(B_j^*)^2 - 4A_j^*C_j^*}}{2A_j^*}. \]

Finally, we have that

\[ \log u = (1 - b_1)^{-1} \left[ b_0 + b_1 \left( (P_y + \epsilon_1)^T \mu_y + \frac{\alpha}{2} (P_y + \epsilon_1)^T \Sigma_y \left[ I \otimes \left( 1^T \otimes A \right) \right] \Sigma_y^T (P_y + \epsilon_1) \right. \right. \]
\[ \left. \left. - \sum_{j=1}^{2} \frac{\epsilon_{v_j}}{\alpha} \log \left( 1 - \alpha p_{v_j} c_{v_j} \right) \right) \right]. \]

Plugging terms into the expression for the marginal rate of substitution, we obtain the final solution to the real pricing kernel

\[
\hat{m}_{t,t+1} = \bar{m} + (\rho - 1) \epsilon_1^T \Phi_y \phi_t + (\rho - 1) \epsilon_1^T \Phi_y v_t
\]
\[ - \sum_{j=1}^{2} \frac{\alpha (\rho - \alpha)}{1 - \alpha p_{v_j} c_{v_j}} (P_y + \epsilon_1)^T \Sigma_y \left[ I \otimes \left( 1^T \otimes B_j \right) \right] \Sigma_y^T (P_y + \epsilon_1) v_{j,t} \]
\[ + \left[ (\rho - 1) \epsilon_1 + (\alpha - \rho) (P_y + \epsilon_1) \right]^T \Sigma_y V_{y,t+1/2} \epsilon_{y,t+1} + (\alpha - \rho) p_{y} v_{t+1,1}, \tag{A.2} \]
where

\[ \bar{m} = \log \beta + (\rho - 1) \epsilon_1^T \mu_y + (\alpha - \rho) \sum_{j=1}^{2} \frac{\epsilon_{v_j}}{\alpha} \log \left( 1 - \alpha p_{v_j} c_{v_j} \right) \]
\[ - \frac{\alpha}{2} (\rho - \alpha) (P_y + \epsilon_1)^T \Sigma_y \left[ I \otimes \left( 1^T \otimes A \right) \right] \Sigma_y^T (P_y + \epsilon_1). \tag{A.3} \]

The numerical solution to the mean log certainty equivalent \( E [\log \mu_t] = \log \mu \) depends on the approximated constants from the log-linearization of the scaled log utility \( b_0 \) and \( b_1 \), which themselves depend on the mean log certainty equivalent \( \log \mu \). Model consistency thus requires to solve a fixed-point equation for the mean log certainty equivalent. More specifically, using a convergence criterion of \( 10^{-12} \), we solve for the fixed-point equation \( \log \mu = f (\log \mu) \).

**B Valuation**

**B.1 Term structure of real interest rates**

The price of an \( n \)-period real zero-coupon bond must satisfy the Euler equation \( \hat{P}_{t}^n = E_t \left[ \hat{M}_{t,t+n} \right] \). To derive closed-form solutions for the term structure of real interest rates, we conjecture that log zero-coupon bond prices \( \hat{p}_t \) are affine in the state vector \( x_t \)

\[ \hat{p}_t^n = \log \hat{P}_t^n = -\hat{A}_n - \hat{B}_{y,n} y_t - \hat{B}_{v,n} v_t, \]
where the coefficients of the vectors \( \hat{B}_{y,n} \) and \( \hat{B}_{v,n} \) measure the sensitivity of real bond prices to the risk factors and where \( n \) refers to the maturity of the bond. Since the real pricing kernel is an affine function of the state vector, log bond prices are fully characterized by the cumulant-generating function of \( X_t \). The law of iterated expectations implies that \( \hat{P}_{t}^n \) satisfies the recursion

\[ \hat{P}_t^n = E_t \left[ \hat{M}_{t,t+1} \hat{P}_{t+1}^{n-1} \right]. \]
It can be shown that for all n, the scalar \( \hat{A}_n \) and the components of the column vectors \( \hat{B}_{ij,n} \) for \( j = 1, 2, \ldots, 8 \) and \( \hat{B}_{ij,n} \) for \( j = 1, 2, \) are given by

\[
\hat{A}_n = \hat{A}_{n-1} - \bar{m} + \hat{B}^{\top}_{y,n-1} \mu_y + \sum_{j=1}^{2} v_{e_j} \log \left( 1 - \left( (\alpha - \rho) p_{v_j} - \hat{B}_{v,j,n-1} \right) c_{v_j} \right) \\
- \frac{1}{2} \left( (\rho - 1) e_1 + (\alpha - \rho) (P_y + e_1) - \hat{B}_{y,n-1} \right) \Sigma_y \left[ I \odot \left( 1^{\top} \otimes A \right) \right] \Sigma_y^{\top} \\
\times \left[ (\rho - 1) e_1 + (\alpha - \rho) (P_y + e_1) - \hat{B}_{y,n-1} \right] \\
\hat{B}_{y,n} = \left[ \hat{B}_{y,n-1} - (\rho - 1) e_1 \right]^{\top} \Phi_n e_j \\
\hat{B}_{v,n} = \left[ \hat{B}_{v,n-1} - (\rho - 1) e_1 \right]^{\top} \Phi_n e_j \\
+ \frac{(\alpha - \rho) p_{v_j} \Phi_n e_j}{1 - \alpha p_{v_j} c_{v_j}} + \frac{1}{2} (\alpha - \rho) (P_y + e_1) \Sigma_y \left[ I \odot \left( 1^{\top} \otimes B_j \right) \right] \Sigma_y^{\top} (P_y + e_1) \\
- \frac{1}{2} \left( (\rho - 1) e_1 + (\alpha - \rho) (P_y + e_1) - \hat{B}_{y,n-1} \right) \Sigma_y \left[ I \odot \left( 1^{\top} \otimes B_j \right) \right] \\
\times \Sigma_{y}^{\top} \left[ (\rho - 1) e_1 + (\alpha - \rho) (P_y + e_1) - \hat{B}_{y,n-1} \right] - \frac{\left( (\alpha - \rho) p_{v_j} - \hat{B}_{v,j,n-1} \right) \Phi_n e_j}{1 - \left( (\alpha - \rho) p_{v_j} - \hat{B}_{v,j,n-1} \right) c_{v_j}},
\]

with initial conditions \( \hat{A}_0 = 0, \hat{B}_{y,0} = 0, \) and \( \hat{B}_{v,0} = 0, \) and where \( \odot \) defines the Kronecker product, \( \otimes \) the Hadamar product, \( I \) is the identity matrix, \( 1 \) is a column vector of ones, \( e_i \) \((i = 1, 2, \ldots, 8)\) and \( e_{v_i} \) \((i = 1, 2)\) are coordinate vectors with all elements equal to zero except element \( i = 1, \) the column vectors \( A \) and \( B_j \) for \( j = 1, 2 \) are defined in Equation (A.1), and \( \bar{m} \) is defined in Equation (A.3).

It follows naturally that the term structure of real interest rates is given by:

\[
\tilde{y}_t^n = n^{-1} \left( \hat{A}_n + \hat{B}_{y,n} y_t + \hat{B}_{v,n} v_t \right).
\]

### B.2 Term structure of nominal interest rates

The price of an n-period nominal zero-coupon bond must satisfy the Euler equation \( P_t^n = E_t \left[ M_{t,t+n} \right] \), where \( M_{t,t+1} \) defines the nominal stochastic discount factor defined in logs as

\[
m_{t,t+1} = \hat{m}_{t,t+1} - \pi_{t+1} = \hat{m}_{t,t+1} - \bar{e}_2 y_{t+1},
\]

with the real pricing kernel \( \hat{m}_{t,t+1} \) defined in Equation (A.2). To derive closed-form solutions for the term structure of nominal interest rates, we conjecture that log zero-coupon bond prices \( p_t \) are affine in the state vector \( x_t \)

\[
p^n_t = \log P^n_t = -A_n - B^n_{y,n} y_t - B^n_{v,n} v_t,
\]

where the coefficients of the vectors \( B_{y,n} \) and \( B_{v,n} \) measure the sensitivity of nominal bond prices to the risk factors and where \( n \) refers to the maturity of the bond. Since the nominal pricing kernel is an affine function of the state vector, log bond prices are fully characterized by the cumulant-generating function of \( x_t \). The law of iterated expectations implies that \( P^n_t \) satisfies the recursion

\[
P^n_t = E_t \left[ M_{t,t+1} P^{n-1}_{t+1} \right].
\]

It can be shown that for all n, the scalar \( A_n \) and the components of the column vectors \( B_{y,j,n} \) for \( j = 1, 2, \ldots, 8 \) and \( B_{ij,n} \) for \( j = 1, 2, \) are given by

\[
A_n = A_{n-1} - \bar{m} + \left[ e_2 + B^n_{y,n-1} \right]^{\top} \mu_y + \sum_{j=1}^{2} v_{e_j} \log \left( 1 - \left( (\alpha - \rho) p_{v_j} - B^n_{v,j,n-1} \right) c_{v_j} \right)
\]

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U.S. default risk is driven by a default intensity

\[ B_{t_{ij},n} = \left[ B_{t_{ij},n-1} + e_2 - (\alpha - \rho) (P_y + e_1) - e_2 - B_{t_{ij},n-1} \right] \]

\[ B_{t_{ij},n} = \left[ B_{t_{ij},n-1} + e_2 - (\rho - 1) e_1 \right] \Phi_y e_j \]

\begin{align*}
\mathbf{B} &= \left[ B_{t_{ij},n-1} + e_2 - (\alpha - \rho) (P_y + e_1) - e_2 - B_{t_{ij},n-1} \right] \\
\mathbf{B} &= \left[ B_{t_{ij},n-1} + e_2 - (\rho - 1) e_1 \right] \Phi_y e_j \\
\Phi_y &= \frac{(\alpha - \rho) P_v \phi_v}{1 - \alpha p_v e_v} + \frac{\alpha}{2} (\alpha - \rho) (P_y + e_1) \Sigma_y \left[ \mathbf{I} \otimes \left( \mathbf{1} \otimes \mathbf{B} \right) \right] \\
\Phi_y &= \frac{(\alpha - \rho) P_v \phi_v}{1 - (\alpha - \rho) P_v} + \frac{\alpha}{2} (\alpha - \rho) (P_y + e_1) \Sigma_y \\
\Sigma_y &= \left[ (\rho - 1) e_1 + (\alpha - \rho) (P_y + e_1) - e_2 - B_{t_{ij},n-1} \right] \Sigma_y \\
\Sigma_y &= \left[ (\rho - 1) e_1 + (\alpha - \rho) (P_y + e_1) - e_2 - B_{t_{ij},n-1} \right] \\
&\text{with initial conditions } A_0 = 0, B_{t,0} = 0, \text{ and where } \otimes \text{ defines the Kronecker product, } \mathbf{I} \text{ is the identity matrix, } \mathbf{1} \text{ is a column vector of ones, } c_i \ (i = 1, 2, \ldots, 8) \text{ and } v_j \ (j = 1, 2) \text{ are coordinate vectors with all elements equal to zero except element } i = 1, \text{ the column vectors } \mathbf{A} \text{ and } \mathbf{B} \text{ for } j \text{ are defined in Equation (A.1), and } m \text{ is defined in Equation (A.3).} \\
\text{It follows naturally that the term structure of nominal interest rates is given by:} \\
y^n_t &= \left( A_n + B^n_{t,0} y_t + B^n_{t,v} v_t \right).
\end{align*}

**B.3 Term structure of risky treasury yields**

U.S. default risk is driven by a default intensity \( h_t \) defined as

\[ h_t = h + h_d \Delta t + h_a d t + h_g y_t + h_v v_{1,t} + h_{v2} v_{2,t} = h + h_z z_t + h_v v_t, \]  

(B.1)

such that \( h_z = [h_z, h_y, h_d, h_g] \) and \( h_v = [h_{v1}, h_{v2}] \). We adopt the convention that \( h_z = [h_z, 0, 0, 0] \) and \( h_v = [h_{v1}, h_{v2}, h_{v3}, h_{v4}] \). We connect the default intensity to \( H_t \), the conditional default probability of a given reference entity at day \( t \) via \( H_t \equiv \text{Prob}(\tau > t \mid F_t) = 1 - e^{-h_t} \), where \( F_t \) denotes all the available information available at time \( t \), with the exception of credit events. This implies that the probability of survival (no credit event) until time \( t \) is:

\[ S_t \equiv \text{Prob}(\tau > t \mid F_t) = S_0 \prod_{j=1}^{t} (1 - H_j), \quad t \geq 1. \]  

(B.2)

To price risky zero coupon Treasury bonds, we take into account the convenience yield \( s_{1,t} \) with dynamics defined in Equation (4), and loss given default \( L \). Using the law of iterated expectations, it is possible to show that risky bond prices follow the recursion

\[ \tilde{P}_t^n = E_t \left[ M_{t,t+1} e^{s_{1,t+1}} [I(x \geq m_{t+1})] \cdot \tilde{P}_{t+1}^{n-1} \right] \]

\[ = E_t \left[ M_{t,t+1} e^{s_{1,t+1}} [1 - LH_{t+1}] \cdot \tilde{P}_{t+1}^{n-1} \right] \]

\[ \approx E_t \left[ e^{s_{1,t+1} \cdot \tilde{P}_{t+1}^{n-1}} \right], \]

where we follow Duffie and Singleton (1999) by applying a first order Taylor approximation of \( \log(1 - LH_t) \) around 0 such that \( \log(1 - LH_t) \approx -L \cdot h_t \). Since all elements of the bond pricing equation are affine functions of the extended state vector, log bond prices are fully characterized by the cumulant-generating function of \( x_t \). The law of iterated expectations implies that \( \tilde{P}_t^n \) satisfies the recursion

\[ \tilde{P}_t^n = E_t \left[ M_{t,t+1} e^{-L h_{t+1} s_{1,t+1}} \tilde{P}_{t+1}^{n-1} \right]. \]
To derive closed-form solutions for the term structure of risky Treasury rates, we conjecture that log prices of risky zero-coupon bonds \( \bar{p}_t \) are affine in the extended state vector \( \bar{x}_t = [y_t, s_t^\top, v_t^\top] = [\bar{y}_t, v_t^\top]^\top \):

\[
\bar{p}_t = \log \bar{P}_t^n = -\bar{A}_n - \bar{B}_{g,n}^\top 1_{g,n} - \bar{B}_{c,n} v_t.
\]

where the coefficients of the vectors \( \bar{B}_{g,n} \) and \( \bar{B}_{c,n} \) measure the sensitivity of risky bond prices to the risk factors and where \( n \) refers to the maturity of the bond. It can be shown that for all \( n \), the scalar \( \bar{A}_n \) and the components of the column vectors \( \bar{B}_{g,j,n} \) for \( j = 1, 2, \ldots, 11 \) and \( \bar{B}_{c,j,n} \) for \( j = 1, 2 \), are given by

\[
\bar{A}_n = \bar{A}_{n-1} + L \cdot h - \bar{m} + \left[ \bar{e}_2 + L \cdot h - \bar{e}_0 + \bar{B}_{g,n-1} \right]^\top \bar{p}_0
\]

\[
+ \sum_{j=1}^{2} v_{\ell j} \log \left( 1 - \left[ (\alpha - \rho) p_{\ell j} - L \cdot h_{\ell j} - \bar{B}_{c,j,n-1} \right] \right)
+ \left( \bar{B}_{s1,n-1} + 1 \right) v_{s1,v_j} + \bar{B}_{s2,n-1} + \bar{B}_{s3,n-1} \nu_{s3,v_j} \right) c_{v_j}
\]

\[
- \frac{1}{2} \left[ (\rho - 1) \bar{e}_1 + (\alpha - \rho) \left( \bar{P}_y + \bar{e}_1 \right) - \left( \bar{e}_2 + L \cdot h - \bar{e}_0 + \bar{B}_{g,n-1} \right) \right] ^\top \bar{Y}_y \left[ \bar{I} \otimes \left( \bar{I}^\top \otimes \bar{A} \right) \right]
\]

\[
\times \bar{Y}_y \left[ \left( \rho - 1 \right) \bar{e}_1 + (\alpha - \rho) (\bar{P}_y + \bar{e}_1) - \left( \bar{e}_2 + L \cdot h - \bar{e}_0 + \bar{B}_{g,n-1} \right) \right]
\]

\[
- \sum_{j=1}^{2} \left( \bar{B}_{s1,n-1} + 1 \right) v_{s1,v_j} + \bar{B}_{s2,n-1} + \bar{B}_{s3,n-1} \nu_{s3,v_j} \right) v_{v_j} c_{v_j}
\]

\[
\bar{B}_{g,j,n} = \left[ \left( \bar{e}_2 + L \cdot h - \bar{e}_0 + \bar{B}_{g,n-1} \right) - (\rho - 1) \bar{e}_1 \right] ^\top \bar{Y}_y \left[ \bar{I} \otimes \left( \bar{I}^\top \otimes \bar{A} \right) \right]
\]

\[
\times \bar{Y}_y \left[ \left( \rho - 1 \right) \bar{e}_1 + (\alpha - \rho) (\bar{P}_y + \bar{e}_1) - \left( \bar{e}_2 + L \cdot h - \bar{e}_0 + \bar{B}_{g,n-1} \right) \right]
\]

\[
- \sum_{j=1}^{2} \left( \bar{B}_{s1,n-1} + 1 \right) v_{s1,v_j} + \bar{B}_{s2,n-1} + \bar{B}_{s3,n-1} \nu_{s3,v_j} \right) \phi_{v_j}
\]

with initial conditions \( \bar{A}_0 = 0 \), \( \bar{B}_{g,0} = 0 \), and \( \bar{B}_{c,0} = 0 \), and where \( \otimes \) defines the Kronecker product, \( \odot \) the Hadamard product, \( \bar{I} \) is the identity matrix, \( \bar{I} \) is a column vector of ones, \( \bar{e}_i \) (\( i = 1, 2, \ldots, 11 \)) and \( c_{v_j} \) (\( i = 1, 2 \)) are coordinate vectors with all elements equal to zero except element \( i = 1 \), \( \bar{m} \) is defined in Equation (A.3), and the column vectors \( \bar{A} \) and \( \bar{B}_j \) for \( j = 1, 2 \) are given by

\[
\bar{A} = \left[ a_{c}, a_{s1}, a_{d}, a_{g}, 0, 0, 0, 0, 1, 1, 1 \right]^\top
\]

\[
\bar{B}_j = \left[ b_{c,v_j}, b_{s1,v_j}, b_{d,v_j}, b_{g,v_j}, 0, 0, 0, 0, 0, 0, 0 \right]^\top.
\]

It follows naturally that the term structure of risky interest rates is given by

\[
\bar{y}_t^n = n^\top \left( \bar{A}_n + \bar{B}_{g,n} 1_{g,n} + \bar{B}_{c,v} v_t \right)
\]

**B.4 Term structure of LIBOR rates**

We work with hypothetical zero-coupon LIBOR bonds \( L^n_t \) discounted at the continuously compounded yield \( \ell^n_t \) (defined at the monthly frequency), such that \( L^n_t = \exp (-\ell^n_t \cdot n) \), where \( n \leq 12 \) corresponds to LIBOR
rate maturities of up to 12 months. To price LIBOR bonds, we take into account the convenience yield \( s_{1,t} \) and bank risk \( s_{2,t} \), with dynamics defined in Equation (4), and loss given default \( L \). The LIBOR rate is defined as \( \ell_t = \frac{y_t}{y_t + s_{1,t} + s_{2,t}} \). Using the law of iterated expectations, it is possible to show that LIBOR bond prices follow the recursion

\[
L_t^n \approx E_t \sum_{j=1}^m s_{t+j-1, t+j} - L \cdot h_t \cdot s_{2,t+j}.
\]

Following the logic developed for risky Treasury bonds in appendix B.3, it is straightforward to show that the log price of a risky \( n \)-period zero coupon LIBOR bond is affine in the extended state space \( \tilde{x}_t \):

\[
\log L_t^n = -\tilde{A}_n - \tilde{B}_{y,n} \tilde{y}_t - \tilde{B}_{v,n} v_t.
\]

(B.4)

where the constant \( \tilde{A}_n \) and the coefficients of the column vectors \( \tilde{B}_{y,n} \) and \( \tilde{B}_{v,n} \) measure the sensitivity of LIBOR bond prices to the risk factors and where \( n \) refers to the maturity of the bond. It can be shown that for all \( n \), the scalar \( \tilde{A}_n \) and the components of the column vectors \( \tilde{B}_{y,n} \) for \( j = 1, 2, \ldots, 11 \) and \( \tilde{B}_{v,n} \) for \( j = 1, 2 \), are given by

\[
\tilde{A}_n = \tilde{A}_{n-1} + L \cdot h - \tilde{m} + (\tilde{c}_2 + L \cdot \tilde{h}_y + \tilde{c}_{10} + \tilde{B}_{y,n-1})^\top \tilde{\mu}_y
\]

\[
+ \sum_{j=1}^2 v_{y,j} \log \left(1 - (\alpha - \rho) p_{y,j} - L \cdot h_{y,j} - \tilde{B}_{v,j,n-1}\right)
\]

\[
+ \sum_{j=1}^2 v_{y,j} \left( (\tilde{B}_{y,n-1} v_{y,j} + (\tilde{B}_{y,n-1} - 1) v_{y,j}) (\tilde{B}_{s,2,n-1} v_{y,j} + \tilde{B}_{v,n-1} v_{y,j}) c_{v,j} \right)
\]

\[
- \frac{1}{2} \left((\rho - 1) \tilde{c}_1 + (\alpha - \rho) (P_y + \tilde{c}_1) - (\tilde{c}_2 + L \cdot \tilde{h}_y + \tilde{c}_{10} + \tilde{B}_{y,n-1}) \right)^\top \sum_y \left[I \otimes \left( I^\top \otimes \tilde{A} \right) \right]
\]

\[
\times \sum_y \left[ (\rho - 1) \tilde{c}_1 + (\alpha - \rho) (P_y + \tilde{c}_1) - (\tilde{c}_2 + L \cdot \tilde{h}_y + \tilde{c}_{10} + \tilde{B}_{y,n-1}) \right]^\top \tilde{\mu}_y
\]

\[
+ \sum_{j=1}^2 (\tilde{B}_{y,n-1} v_{y,j} + (\tilde{B}_{y,n-1} - 1) v_{y,j}) v_{y,j} c_{v,j}
\]

\[
\tilde{B}_{y,n} = \left[(\tilde{c}_2 + L \cdot \tilde{h}_y + \tilde{c}_{10} + \tilde{B}_{y,n-1}) - (\rho - 1) \tilde{c}_1 \right]^\top \tilde{\Phi}_y \tilde{c}_y
\]

\[
\tilde{B}_{v,n} = \left[(\tilde{c}_2 + L \cdot \tilde{h}_y + \tilde{c}_{10} + \tilde{B}_{y,n-1}) - (\rho - 1) \tilde{c}_1 \right]^\top \tilde{\Phi}_y \tilde{c}_y
\]

\[
+ \frac{(\alpha - \rho) p_{y,j} \phi_{y,j}}{1 - \alpha p_{y,j} c_{v,j}} + \frac{\alpha}{2} \frac{(\alpha - \rho) (P_y + \tilde{c}_1)^\top \sum_y \left[ I \otimes \left( I^\top \otimes \tilde{B} \right) \right] \sum_y \left[ (P_y + \tilde{c}_1) \right]^\top}{(\rho - 1) \tilde{c}_1 + (\alpha - \rho) (P_y + \tilde{c}_1) - (\tilde{c}_2 + L \cdot \tilde{h}_y + \tilde{c}_{10} + \tilde{B}_{y,n-1}) \right)^\top \sum_y \left[ I \otimes \left( I^\top \otimes \tilde{B} \right) \right] \sum_y \left[ (P_y + \tilde{c}_1) \right]^\top \sum_y \left[ I \otimes \left( I^\top \otimes \tilde{B} \right) \right]
\]

\[
+ \sum_{j=1}^2 (\tilde{B}_{y,n-1} v_{y,j} + (\tilde{B}_{y,n-1} - 1) v_{y,j}) v_{y,j} c_{v,j}
\]

with initial conditions \( \tilde{A}_0 = 0 \), \( \tilde{B}_{y,0} = 0 \), and \( \tilde{B}_{v,0} = 0 \), and where \( \otimes \) defines the Kronecker product, \( \odot \) the Hadamard product, \( I \) is the identity matrix, \( \tilde{I} \) is a column vector of ones, \( \tilde{c}_i \) (\( i = 1, 2, \ldots, 11 \)) and \( c_{v,i} \) (\( i = 1, 2 \)) are coordinate vectors with all elements equal to zero except element \( i = 1 \), \( \tilde{m} \) is defined in Equation (A.3), and the column vectors \( \tilde{A} \) and \( \tilde{B}_j \) are defined in Equation (B.3). It follows naturally that the term structure of risky LIBOR rates is given by

\[
\ell_t^n = n^{-1} \left( \tilde{A}_n + \tilde{B}_{y,n} \tilde{y}_t + \tilde{B}_{v,n} v_t \right).
\]
B.5 Term structure of IRS rates

To price IRS rates, we take into account the convenience yield $s_{1,t}$, bank risk $s_{2,t}$, and cost of collateral $s_{3,t}$, with dynamics defined in Equation (4). The formula for an $n$-period IRS rate is given by

$$\text{IRS}_t^n = \left( \sum_{j=1}^{n/\Delta} \left( \tilde{\Psi}^\ell_{j,t} - \Psi^\ell_{j,t} \right) \right) \left( \sum_{j=1}^{n/\Delta} \Psi^\ell_{j,t} \right)^{-1},$$

where the one-month LIBOR rate is defined as $\ell_t = \tilde{y}_t + s_{1,t} + s_{2,t}$, $\Delta$ defines the time interval between two successive coupon periods, and where the expressions for $\tilde{\Psi}^\ell$ and $\Psi^\ell$ are defined as

$$\tilde{\Psi}^\ell_{j,t} = E_t \left[ e^{\rho \Delta t + \eta \Delta t + \rho e^{\Delta t/2}} \right] \text{ and } \Psi^\ell_{j,t} = E_t \left[ e^{\rho \Delta t + \eta \Delta t + \rho e^{\Delta t/2}} \right].$$

To derive closed-form solutions for the term structure of IRS rates, we conjecture that the expressions for $\tilde{\Psi}^\ell$ and $\Psi^\ell$ are exponentially affine in the extended state vector $\tilde{x}_t = [y_t, \eta_t, \nu_t]$. The formula for the term structure of IRS rates is given by

$$\tilde{\Psi}^\ell_{j,t} = e^{A^\ell_{\eta,1}} + \tilde{B}^\ell_{\eta,1} \tilde{y}_t + \tilde{B}^\ell_{\nu,1} \nu_t$$

and $\Psi^\ell_{j,t} = e^{A^\ell_{\eta,1}} + \tilde{B}^\ell_{\eta,1} \tilde{y}_t + \tilde{B}^\ell_{\nu,1} \nu_t$.

It can be shown that for all $n$, the scalars $A^\ell_{\eta,n}$ and $A^\ell_{\nu,n}$, and the components of the column vectors $\tilde{B}^\ell_{\eta,n}$ and $B^\ell_{\eta,n}$ for $j = 1, \ldots, 11$, and $\tilde{B}^\ell_{\nu,n}$ and $B^\ell_{\nu,n}$ for $j = 1, 2$, follow the same recursion and are given by

$A^\ell_{\eta,n} = A^\ell_{\eta,n-1} + \tilde{\phi}_j - \tilde{\psi}_j - \tilde{\psi}_j \left( \tilde{\phi}_j - \tilde{\psi}_j \right) \tilde{\phi}_j$.

$B^\ell_{\eta,n} = \left[ \tilde{\phi}_j - \tilde{\psi}_j \right] \tilde{\phi}_j$.

$B^\ell_{\nu,n} = \left[ \tilde{\phi}_j - \tilde{\psi}_j \right] \tilde{\phi}_j$.

where $\odot$ defines the Kronecker product, $\odot$ the Hadamard product, $\tilde{I}$ is the identity matrix, $\tilde{I}$ is a column vector of ones, $\tilde{e}_i$ $(i = 1, 2, \ldots, 11)$ and $c_{ij}$ $(i = 1, 2)$ are coordinate vectors with all elements equal to zero except element $i = 1$, $\tilde{n}$ is defined in Equation (A.3), and the column vectors $\tilde{A}$ and $\tilde{B}$ are defined in Equation (B.3).
While the expressions $\tilde{\Psi}^e$ and $\Psi^e$ have the same recursions, they have different starting conditions. For $\Psi_{n,t}^o$, the recursion starts at 0, with initial condition given by $A_o^t = 0$, and all elements of $B_o^t,v = 0$ and $B_o^t,v = 0$, except for $B_{o,0}^t,v = 1$. For $\Psi_{n,t}^i$, the recursion starts at $n = \Delta$ (i.e., $\Delta = 3$ for quarterly coupon payments), with starting condition given by:

$$
\Psi_{n,t}^i = e^{\Delta j t} E_t \left[ e^{m_{1.t+\Delta+s,t+\Delta}} \right].
$$

Since $\log E_t \left[ e^{m_{1.t+\Delta+s,t+\Delta}} \right] = A_\Delta + B_{\Delta,v} \tilde{y}_t + B_{\Delta,v}^T v_t$, and $l^2 = \frac{1}{3} (\tilde{A}_3 + B_{\tilde{A},3} \tilde{y}_t + B_{\tilde{A},v} v_t)$, the initial condition for $\Psi_{n,t}^o$ is given by:

$$
\Psi_{n,t}^o = e^{\frac{j}{3} \tilde{A}_3 + \frac{1}{3} B_{\tilde{A},3} \tilde{y}_t + \frac{1}{3} B_{\tilde{v},v}^T v_t + A_{\Delta} + B_{\Delta,v} \tilde{y}_t + B_{\Delta,v}^T v_t} = e^{A_{\Delta,n+1}^i + (B_{\Delta,v}^i)^T \tilde{y}_t + (B_{\Delta,v}^{i,n})^T v_t},
$$

where the constant $A_{\Delta,n+1}^i$ and the elements of the column vectors $B_{\Delta,v}^{i,n}$ for $j = 1, 2, \ldots, 11$ and $B_{\Delta,v}^{i,n}$ for $j = 1, 2$ are given by:

$$
A_{\Delta,n+1}^i = \frac{\Delta}{3} \tilde{A}_3 + A_{\Delta},
$$

$$
B_{\Delta,v}^{i,n} = \frac{\Delta}{3} B_{\tilde{A},3} + B_{\tilde{A},v} v_t,
$$

$$
B_{\Delta,v}^{i,n} = \frac{\Delta}{3} B_{\tilde{v},v} + B_{\tilde{v},v}^T v_t.
$$

### B.6 Term structure of OIS rates

To price OIS rates, we take into account the convenience yield $s_{1,t}$ and cost of collateral $s_{3,t}$, with dynamics defined in Equation (4). The formula for an n-period OIS rate is given by

$$
OIS_t^n = \left( \sum_{j=1}^{n/\Delta} (\tilde{\Psi}_{j,t}^o - \tilde{\Psi}_{j,t}^i) \right) \left( \sum_{j=1}^{n/\Delta} \Psi_{j,t}^i \right)^{-1},
$$

where the one-month OIS rate is defined as $o_t = \tilde{y}_t + s_{1,t}$, $\Delta$ defines the time interval between two successive coupon periods, and where the expressions for $\Psi^o$ and $\Psi^i$ are defined as

$$
\tilde{\Psi}_{n,t}^o = E_t \left[ e^{m_{1.t+n+s,t+n}} \exp \left( \sum_{j=1}^{\Delta} o_{t+n\Delta-j} \right) \right] \quad \text{and} \quad \Psi_{n,t}^i = E_t \left[ e^{m_{1.t+n+s,t+n}} \right].
$$

To derive closed-form solutions for the term structure of OIS rates, we conjuncture that the expressions for $\Psi^o$ and $\Psi^i$ are exponentially affine in the extended state vector $\tilde{x}_t = [\tilde{y}_t^T, \tilde{s}_t^T, v_t] = [\tilde{y}_t^T, v_t]$: $\tilde{\Psi}_{n,t}^o = e^{A_o^t + B_o^T \tilde{y}_t + B_o^T v_t}$ and $\Psi_{n,t}^i = e^{A_i^t + B_i^T \tilde{y}_t + B_i^T v_t}$.

It can be shown that for all $n$, the scalars $A_o^n$ and $A_i^n$, and the components of the column vectors $B_o^n$ and $B_o^n$ for $j = 1, 2, \ldots, 11$, and $B_i^n$ and $B_i^n$ for $j = 1, 2$, follow the same recursion and are given by:

$$
A_o^n = A_o^{n-1} + \tilde{c}_2 - B_o^{n-1} \tilde{c}_1 - \tilde{c}_1^2 + B_o^{n-1} \tilde{c}_2 + B_o^{n-1} \tilde{c}_3 + B_o^{n-1} \tilde{c}_4 + (B_o^{n-1} + 1) \tilde{c}_5
$$

$$
+ \frac{1}{2} \left( (\rho - 1) \tilde{c}_1 + (\alpha - \rho) (P_o + \tilde{c}_1) - [\tilde{c}_2 - B_o^{n-1} \tilde{c}_1] \tilde{S}_y \left[ \mathbf{I} \otimes \left( \mathbf{I}^T \otimes \tilde{A} \right) \right] \right)
$$

$$
\times \tilde{S}_y \left[ (\rho - 1) \tilde{c}_1 + (\alpha - \rho) (P_o + \tilde{c}_1) - [\tilde{c}_2 - B_o^{n-1} \tilde{c}_1] \right]
$$

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where \( \otimes \) defines the Kronecker product, \( \odot \) the Hadamard product, \( \mathbf{I} \) is the identity matrix, \( \mathbf{1} \) is a column vector of ones, \( \tilde{e}_i \) (\( i = 1, 2, \ldots, 11 \)) and \( e_{v_i} \) (\( i = 1, 2 \)) are coordinate vectors with all elements equal to zero except element \( i = 1 \), \( m \) is defined in Equation (A.3), and the column vectors \( \mathbf{A} \) and \( \mathbf{B} \) are defined in Equation (B.3).

While the expressions \( \tilde{\Psi}^o \) and \( \Psi^o \) have the same recursions, they have different starting conditions. For \( \Psi^o_{n,t} \), the recursion starts at \( n = \Delta \) (i.e., \( \Delta = 3 \) for quarterly coupon payments), with starting condition given by:

\[
\tilde{\Psi}^o_{n,t} = E_t \left[ e^{m_{t,\Delta} + s_{t,\Delta} + \sum_{j=1}^{\Delta} \delta_{t,j} + \Delta - j} \right] = e^{\tilde{\mathbf{A}}^o_\Delta + \tilde{\mathbf{B}}^o_\Delta \tilde{y}_t + \tilde{\mathbf{C}}^o_\Delta \tilde{v}_t},
\]

where the expressions for \( \tilde{\mathbf{A}}^o_\Delta, \tilde{\mathbf{B}}^o_\Delta, \) and \( \tilde{\mathbf{C}}^o_\Delta \) are obtained recursively. Observe that

\[
\tilde{\Psi}^o_{n,t} = e^{\alpha_t} E_t \left[ e^{m_{t,1} + s_{t,1} + \sum_{j=1}^{\Delta} \delta_{t,j} + \Delta - j} \right] = e^{\tilde{\mathbf{A}}^o_1 + \tilde{\mathbf{B}}^o_1 \tilde{y}_t + \tilde{\mathbf{C}}^o_1 \tilde{v}_t},
\]

and define \( \tilde{\Psi}^o_{n,t} \) to be equal to \( \tilde{\Psi}^o_{n,t} \) characterized as

\[
\tilde{\Psi}^o_{n,t} = E_t \left[ e^{\tilde{\mathbf{A}}^o_1 + \tilde{\mathbf{B}}^o_1 \tilde{y}_t + \tilde{\mathbf{C}}^o_1 \tilde{v}_t \tilde{y}_t} \right],
\]

It can be shown that for all \( n = 1, 2, 3, \ldots, \Delta \)

\[
\tilde{\Psi}^o_{n,t} = e^{A^o_{n,t} + B^o_{n,t} \tilde{y}_t + C^o_{n,t} \tilde{v}_t \tilde{y}_t}.
\]

where the scalar \( A^o_{n,t} \) and components of the column vectors \( B^o_{j,n} \) for \( j = 1, 2, \ldots, 11 \) (except for \( B^o_{21,n} \)) and \( B^o_{v_i,n} \) are given by:

\[
A^o_{n,t} = \tilde{\mathbf{A}}_1 + A^o_{n-1} + \tilde{m} - \left[ \tilde{e}_2 - B^o_{n-1} - \tilde{e}_11 \right] \tilde{\mu}_y - \sum_{j=1}^{2} v_{v_j} \log \left( 1 - \left[ (\alpha - \rho) p_{v_j} + B^o_{v_j,n-1} \right] \right)
+ B^o_{v_1,n-1} v_{v_1} + B^o_{v_2,n-1} v_{v_2} + \left[ B^o_{v_3,n-1} + 1 \right] v_{v_3} e_{v_j} \right) c_{v_j}
+ \frac{1}{2} \left[ (\rho - 1) \tilde{e}_1 + (\alpha - \rho) (P_{v_1} + \tilde{e}_1) - \left[ \tilde{e}_2 - B^o_{v_1,n-1} - \tilde{e}_11 \right] \tilde{\mu}_y \left[ \mathbf{I} \otimes \left( \tilde{\mathbf{A}}_1 + \tilde{\mathbf{B}}_1 \right) \right] \right]
\times \tilde{\Sigma}_y \left[ \mathbf{1} \otimes \left( \tilde{\mathbf{A}}_1 + \tilde{\mathbf{B}}_1 \right) \right]
\]

(61)
\[ -2 \sum_{j=1}^{2} (B_{s_{j}, n-1}^{\text{init}} v_{s_{1} v_{j}} + B_{s_{2}, n-1}^{\text{init}} v_{s_{2} v_{j}} + (B_{s_{3}, n-1}^{\text{init}} + 1) v_{s_{3} v_{j}}) v_{v_j c_{v_j}} \]

\[ B_{s_{j}, n}^{\text{init}} = \begin{bmatrix} (\rho - 1) \bar{c}_{1} - (\bar{c}_{2} - B_{s_{j}, n-1}^{\text{init}} - \tilde{c}_{11}) \end{bmatrix}^\top \tilde{\Phi}_{y} \bar{c}_{1} + \tilde{B}_{s_{j}, 1} \]

\[ B_{s_{1}, n}^{\text{init}} = \begin{bmatrix} (\rho - 1) \bar{c}_{1} - (\bar{c}_{2} - B_{s_{1}, n-1}^{\text{init}} - \tilde{c}_{11}) \end{bmatrix}^\top \tilde{\Phi}_{y} \bar{c}_{9} + \tilde{B}_{s_{1}, 1} + 1 \]

\[ B_{s_{2}, n}^{\text{init}} = \begin{bmatrix} (\rho - 1) \bar{c}_{1} - (\bar{c}_{2} - B_{s_{2}, n-1}^{\text{init}} - \tilde{c}_{11}) \end{bmatrix}^\top \tilde{\Phi}_{y} \bar{c}_{9} + \tilde{B}_{s_{2}, 1} + 1 \]

\[ \left( \frac{\alpha - \rho}{1 - \alpha p_{v_j} c_{v_j}} - \frac{\alpha}{2} \right) (P_{y} + \bar{c}_{1})^\top \tilde{\Phi} \bar{c}_{1} \]

\[ + \frac{1}{2} \left[ (\rho - 1) \bar{c}_{1} + (\alpha - \rho) (P_{y} + \bar{c}_{1}) - \left( \bar{c}_{2} - B_{s_{j}, n-1}^{\text{init}} - \tilde{c}_{11} \right) \right] \Sigma_{y}^\top \left[ \mathbf{1} \circ \left( \mathbf{1}^\top \otimes \mathbf{B}_{y} \right) \right] \Sigma_{y} \]

\[ + \frac{1}{2} \left[ (\rho - 1) \bar{c}_{1} + (\alpha - \rho) (P_{y} + \bar{c}_{1}) - \left( \bar{c}_{2} - B_{s_{j}, n-1}^{\text{init}} - \tilde{c}_{11} \right) \right] \Sigma_{y}^\top \left[ \mathbf{1} \circ \left( \mathbf{1}^\top \otimes \mathbf{B}_{y} \right) \right] \Sigma_{y} \]

\[ - \left( B_{s_{j}, n-1}^{\text{init}} v_{s_{1} v_{j}} + B_{s_{2}, n-1}^{\text{init}} v_{s_{2} v_{j}} + (B_{s_{3}, n-1}^{\text{init}} + 1) v_{s_{3} v_{j}} \right) c_{v_j}, \]

with starting condition \( \Psi_{s_{j}, t}^{\text{init}} = e^{\alpha} E_{t} \left[ e^{m_{t, t+1}+s_{3, t+1}} \right]. \) Since \( E_{t} \left[ e^{m_{t, t+1}+s_{3, t+1}} \right] = \Psi_{t, t}^{\text{init}} = e^{A_{t}^0 + B_{t}^0 \tilde{z}_{t}}, \)

\[ a_{t} = \bar{y}_{t} + s_{1, t}, \text{ with } \bar{y}_{t} = \tilde{A}_{t} + \tilde{B}_{t} \tilde{z}_{t}, \text{ we have that:} \]

\[ \Psi_{s_{j}, t}^{\text{init}} = e^{a_{t}} E_{t} \left[ e^{m_{t, t+1}+s_{3, t+1}} \right] e^{A_{t}^0 + B_{t}^0 \tilde{z}_{t}} \tilde{y}_{t} + (\bar{B}_{s_{j}, 1} + B_{s_{j}, 1}^0) \tilde{y}_{t} \]

\[ = e^{A_{t}^0 + (B_{s_{j}, 1}^{\text{init}})^\top \tilde{z}_{t} + (B_{s_{j}, 1}^{\text{init}})^\top v_{j}}, \]

where the constant \( A_{t}^{\text{init}} \) and the elements of the column vectors \( B_{s_{j}, 1}^{\text{init}} \) for \( j = 1, 2, \ldots, 11 \) (except for \( B_{s_{1}, 1}^{\text{init}} \)) and \( B_{s_{j}, 1}^{\text{init}} \) for \( j = 1, 2 \) are given by:

\[ A_{t}^{\text{init}} = \tilde{A}_{t} + A_{t}^0 \]

\[ B_{s_{j}, 1}^{\text{init}} = \tilde{B}_{s_{j}, 1} + B_{s_{j}, 1}^0 \]

\[ B_{s_{1}, 1}^{\text{init}} = \tilde{B}_{s_{1}, 1} + B_{s_{1}, 1}^0 + 1 \]

\[ B_{s_{j}, 1}^{\text{init}} = \tilde{B}_{s_{j}, 1} + B_{s_{j}, 1}^0. \]

### B.7 Term structure of CDS premiums

To price CDS premiums rates, we take into account the cost of collateral \( s_{3, t}, \) with dynamics defined in Equation (4), the hazard rate defined in Equation (B.1), and the corresponding survival probabilities defined in Equation (B.2). The formula for an \( n \)-period CDS premium is given by

\[ CDS_{t}^{n} = \frac{L \left( \sum_{j=1}^{n} (\Psi_{j, t}^{\text{c}} - \Psi_{j, t}^{\text{c}}) \right)^{\frac{n}{\Delta}} \sum_{j=1}^{\Delta} \Psi_{j, t}^{\text{c}} + \sum_{j=1}^{\Delta} \left( \frac{j}{\Delta} - | \frac{j}{\Delta} | \right) (\Psi_{j, t}^{\text{c}} - \Psi_{j, t}^{\text{c}})^{-1}}{S_{t+n-1}^{\text{ex}} S_{t}} \]

where the floor function \( | \cdot | \) rounds to the nearest lower integer, \( \Delta \) defines the time interval between two successive coupon periods, and where the expressions for \( \Psi^{\text{c}} \) and \( \Psi^{\text{c}} \) are defined as

\[ \Psi_{j, t}^{\text{c}} = E_{t} \left[ e^{m_{t, t+n+s_{3, t+n}} \frac{S_{t+n-1}^{\text{ex}}}{S_{t}}} \right] \text{ and } \Psi_{j, t}^{\text{c}} = E_{t} \left[ e^{m_{t, t+n+s_{3, t+n}} \frac{S_{t+n}^{\text{ex}}}{S_{t}}} \right]. \]
The law of iterated expectations implies that $\Psi_{t,t}^c$ and $\Psi_{j,t}^c$ satisfy the recursions

$$
\Psi_{n,t}^c = E_t \left[ e^{m_{t,t+1} + v_{t+1}} (1 - H_{t+1}) (1 - H_{t+1}) \Psi_{n-1,t+1}^c \right],
$$

starting at $n = 1$ for $\Psi_{0,t}^c$ and at $n = 0$ for $\Psi_{n,t}^c$. To evaluate the expressions for $\Psi^c$ and $\Psi^c$, we conjecture that they are exponentially affine functions of the extended state vector $\tilde{x}_t$:

$$
\Psi_{n,t}^c = e^{A_n^c \tilde{x}_t + (B^c_{y,n} \tilde{y}_t + (B^c_{c,n} \tilde{v}_t)^\top v_t)}
$$

It can be shown that for all $n$, the scalars $A_n^c$ and $A_n^c$, and the components of the column vectors $\tilde{B}_{y,n}^c$ and $\tilde{B}_{c,n}^c$, for $j = 1, 2, \ldots, 11$, and $\tilde{B}_{c,n}^c$ for $j = 1, 2$, follow the same recursion and are given by

$$
\tilde{A}_n^c = \tilde{A}_{n-1}^c - h + \tilde{m} - \left[ \tilde{e}_2 + h \tilde{y} - \tilde{B}_{y,n-1}^c - \tilde{e}_{11} \right]^\top \tilde{\mu}
$$

$$
\tilde{B}_{y,n}^c = \frac{1}{1 - \alpha p_{v_j} e_{v_j}} - \frac{\alpha}{2} (\alpha - \rho) (P_{y} + \tilde{e}_1)^\top \tilde{\Sigma}_y \left[ (1 \otimes (1 \otimes \tilde{B}_j)) \right] \tilde{\Sigma}_y (P_{y} + \tilde{e}_1)
$$

$$
\tilde{B}_{c,n}^c = \frac{1}{1 - \alpha p_{v_j} e_{v_j}} - \frac{\alpha}{2} (\alpha - \rho) (P_{y} + \tilde{e}_1)^\top \tilde{\Sigma}_y \left[ (1 \otimes (1 \otimes \tilde{B}_j)) \right] \tilde{\Sigma}_y (P_{y} + \tilde{e}_1)
$$

where $\otimes$ defines the Kronecker product, $\odot$ the Hadamar product, $\tilde{I}$ is the identity matrix, $\tilde{I}$ is a column vector of ones, $\tilde{e}_i (i = 1, 2, \ldots, 11)$ and $\tilde{e}_v (i = 1, 2)$ are coordinate vectors with all elements equal to zero except element $i = 1$, $\tilde{m}$ is defined in Equation (A.3), and the column vectors $\tilde{A}$ and $\tilde{B}_j$ are defined in Equation (B.3).

Even though the expressions for $\Psi^c$ and $\Psi^c$ follow the same recursion, they have different initial conditions. The initial condition for $\Psi^c$ is given by $log \Psi_{0,t}^c = A_0^c + B_{y,0}^c \tilde{y}_t + B_{c,0}^c \tilde{v}_t$, where the scalar $A_0^c = 0$ and the elements of the column vectors $B_{y,0}^c = 0$ for $j = 1, 2, \ldots, 11$, and $B_{c,0}^c = 0$ for $j = 1, 2$, except for $B_{c,2}^c = 0$.

The initial condition for $\Psi^c$ is given by:

$$
\Psi_{1,t}^c = E_t \left[ e^{m_{t,t+1} + v_{t+1}} \right] = e^{A_1^c + B_{y,1}^c \tilde{y}_t + B_{c,1}^c \tilde{v}_t},
$$

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where the scalar \( \tilde{A}_j \) and components of the column vectors \( \tilde{B}_{y,j} \) for \( j = 1, \ldots, 11 \) and \( \tilde{B}_{v,j} \) for \( j = 1, 2 \) are given by:

\[
\tilde{A}_j = \tilde{m} + [\tilde{e}_{11} - \tilde{e}_2]\top \tilde{\nu} - \sum_{j=1}^{2} \nu_{v,j} \log \left( 1 - \left[ (\alpha - \rho) p_{v,j} + v_{s3v,j} \right] c_{v,j} \right) - \sum_{j=1}^{2} v_{s3v,j} v_{v,j} \nu_{v,j}
\]

\[
+ \frac{1}{2} \left[ (\rho - 1) \tilde{e}_1 + (\alpha - \rho) (P_y + \tilde{e}_1) + \tilde{e}_{11} - \tilde{e}_2 \right]\top \tilde{\Sigma}_y \left[ \tilde{I} \odot \left( \tilde{I}^\top \otimes \tilde{A} \right) \right]
\]

\[
\times \tilde{\Sigma}_y^\top \left[ (\rho - 1) \tilde{e}_1 + (\alpha - \rho) (P_y + \tilde{e}_1) + \tilde{e}_{11} - \tilde{e}_2 \right]
\]

\[
\tilde{B}_{y,j,1} = \left[ (\rho - 1) \tilde{e}_1 + \tilde{e}_{11} - \tilde{e}_2 \right]^\top \tilde{\Phi}_y \tilde{c}_j
\]

\[
\tilde{B}_{v,j,1} = \frac{(\alpha - \rho) p_{v,j} \phi_{v,j}}{1 - \alpha p_{v,j} c_{v,j}} - \frac{\alpha}{2} \left( (\alpha - \rho) (P_y + \tilde{e}_1) \right)^\top \tilde{\Sigma}_y \left[ \tilde{I} \odot \left( \tilde{I}^\top \otimes \tilde{B}_j \right) \right] \tilde{\Sigma}_y^\top \left( P_y + \tilde{e}_1 \right)
\]

\[
+ \frac{1}{2} \left[ (\rho - 1) \tilde{e}_1 + (\alpha - \rho) (P_y + \tilde{e}_1) + \tilde{e}_{11} - \tilde{e}_2 \right]\top \tilde{\Sigma}_y \left[ \tilde{I} \odot \left( \tilde{I}^\top \otimes \tilde{B}_j \right) \right]
\]

\[
\times \tilde{\Sigma}_y^\top \left[ (\rho - 1) \tilde{e}_1 + (\alpha - \rho) (P_y + \tilde{e}_1) + \tilde{e}_{11} - \tilde{e}_2 \right] + \frac{[(\alpha - \rho) p_{v,j} + v_{s3v,j}] \phi_{v,j}}{1 - [(\alpha - \rho) p_{v,j} + v_{s3v,j}] c_{v,j}} - v_{s3v,j} \phi_{v,j}.
\]

### C Estimation

We provide two different state-space representations. The first one, shown in Section C.1, is used when macroeconomic fundamentals are only used in the estimation. The second one, shown in Section C.2, is an extended state-space representation for which we can (potentially) jointly use macroeconomic fundamentals and asset data.

#### C.1 State-space representation

The underlying state transition dynamics run at a monthly frequency. We first provide the case in which all observables are available at the monthly frequency. The corresponding state-transition dynamics are shown in Section C.1.1 and the measurement equation is presented in Section C.1.2. In the presence of mixed-frequency observables, i.e., some observables are available at the quarterly frequency, we explain how to adjust the state space in Section C.1.3 with an illustrative example. Finally, in Section C.1.4, we explain the availability of data and provide our state-space representation that we estimate.
C.1.1 State transition dynamics

Define $x_t = [z^T_t, \alpha^T_t, \nu^T_t]^T$. We describe the joint dynamics of $x_t$ below

$$
\begin{bmatrix}
\zeta_{1,t+1} \\
\zeta_{2,t+1} \\
\zeta_{3,t+1} \\
\zeta_{4,t+1} \\
\alpha_{1,t+1} \\
\alpha_{2,t+1} \\
\alpha_{3,t+1} \\
\alpha_{4,t+1} \\
\upsilon_{1,t+1} \\
\upsilon_{2,t+1}
\end{bmatrix}
= 
\begin{bmatrix}
\mu_{z1} \\
\mu_{z2} \\
\mu_{z3} \\
\mu_{z4} \\
0 \\
0 \\
0 \\
0 \\
\nu_{v1} c_{v1} \\
\nu_{v2} c_{v2}
\end{bmatrix}
+ 
\begin{bmatrix}
\phi_{z11} & \phi_{z12} & \phi_{z13} & \phi_{z14} \\
\phi_{z21} & \phi_{z22} & \phi_{z23} & \phi_{z24} \\
\phi_{z31} & \phi_{z32} & \phi_{z33} & \phi_{z34} \\
\phi_{z41} & \phi_{z42} & \phi_{z43} & \phi_{z44}
\end{bmatrix}
\begin{bmatrix}
1 & 0 & 0 & 0 \\
0 & 1 & 0 & 0 \\
0 & 0 & 1 & 0 \\
0 & 0 & 0 & 1 \\
0 & 0 & 0 & 0 \\
0 & 0 & 0 & 0 \\
0 & 0 & 0 & 0 \\
0 & 0 & 0 & 0 \\
0 & 0 & 0 & 0 \\
0 & 0 & 0 & 0
\end{bmatrix}
\begin{bmatrix}
\zeta_{1,t} \\
\zeta_{2,t} \\
\zeta_{3,t} \\
\zeta_{4,t} \\
\alpha_{1,t} \\
\alpha_{2,t} \\
\alpha_{3,t} \\
\alpha_{4,t} \\
\upsilon_{1,t} \\
\upsilon_{2,t}
\end{bmatrix}
$$

$$
= 
\begin{bmatrix}
1 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\
0 & 1 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\
0 & 0 & 1 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\
0 & 0 & 0 & 1 & 0 & 0 & 0 & 0 & 0 & 0 \\
\theta_{a11} & \theta_{o12} & \theta_{o13} & \theta_{o14} \\
\theta_{o21} & \theta_{o22} & \theta_{o23} & \theta_{o24} \\
\theta_{o31} & \theta_{o32} & \theta_{o33} & \theta_{o34} \\
\theta_{o41} & \theta_{o42} & \theta_{o43} & \theta_{o44} \\
0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\
0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0
\end{bmatrix}
\begin{bmatrix}
\phi_{v11} & \phi_{v12} & \phi_{v13} & \phi_{v14} \\
\phi_{v21} & \phi_{v22} & \phi_{v23} & \phi_{v24} \\
\phi_{v31} & \phi_{v32} & \phi_{v33} & \phi_{v34} \\
\phi_{v41} & \phi_{v42} & \phi_{v43} & \phi_{v44} \\
0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\
0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\
0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\
0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\
0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\
0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0
\end{bmatrix}
\begin{bmatrix}
\nu_{v1} & \nu_{v2} & \nu_{v3} & \nu_{v4} \\
\nu_{o1} & \nu_{o2} & \nu_{o3} & \nu_{o4} \\
\nu_{o1} & \nu_{o2} & \nu_{o3} & \nu_{o4} \\
\nu_{o1} & \nu_{o2} & \nu_{o3} & \nu_{o4} \\
0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\
0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\
0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\
0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\
0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\
0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0
\end{bmatrix}
\begin{bmatrix}
\zeta_{s,t} \\
\alpha_{s,t} \\
\upsilon_{s,t}
\end{bmatrix}
= 
\begin{bmatrix}
V_{1,t} & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\
0 & V_{2,t} & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\
0 & 0 & V_{3,t} & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\
0 & 0 & 0 & V_{4,t} & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\
0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\
0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\
0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\
0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\
0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\
0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\
0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0 & 0
\end{bmatrix}
\times
\begin{bmatrix}
1/2 \\
\nu_{v1,t} \omega_{v1,t} \\
\nu_{v2,t} \omega_{v2,t}
\end{bmatrix}
$$

$$
V_{i,t} = a_i + b_{1i} v_{1,i} + b_{2i} v_{2,i}, \quad \omega_{v,j,t} = \nu_{v,j} e_{v,j}^2 + 2c_{v,j} \phi_{v,j} v_{j,t}
$$

with $\varepsilon_{x,t+1} \sim N(0, 1)$ and $\eta_{v,j,t+1}$ being a zero mean unit variance shock. In vector notations, we express the state space by

$$
\begin{bmatrix}
\zeta_{s+1} \\
\alpha_{s+1} \\
\upsilon_{s+1}
\end{bmatrix}
= 
\begin{bmatrix}
\mu_{z} \\
0 \\
\nu_{v} \odot c_{v}
\end{bmatrix}
+ 
\begin{bmatrix}
\Phi_{z,4 \times 4} & \Phi_{z,4 \times 4} \\
\Phi_{v,4 \times 4} & \Phi_{v,4 \times 4}
\end{bmatrix}
\begin{bmatrix}
\nu_{v} \odot c_{v} \\
\nu_{o} \odot c_{o}
\end{bmatrix}
\begin{bmatrix}
\zeta_{s} \\
\alpha_{s} \\
\upsilon_{s}
\end{bmatrix}
= 
\begin{bmatrix}
\nu_{v} \odot c_{v} \\
\nu_{o} \odot c_{o}
\end{bmatrix}
\begin{bmatrix}
\Phi_{z,4 \times 4} & \Phi_{z,4 \times 4} \\
\Phi_{v,4 \times 4} & \Phi_{v,4 \times 4}
\end{bmatrix}
\begin{bmatrix}
\zeta_{s} \\
\alpha_{s} \\
\upsilon_{s}
\end{bmatrix}
$$

$$
(C.1)
$$

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C.1.2 Measurement equation

For ease of illustration, assume that the observables are available at a monthly frequency. Define \( o_t = [\Delta c_t, d_t, g_t, \pi_t]^\top \). Then, the measurement equation becomes

\[
o_t = \beta^\top x_t + u_t, \quad u_t \sim N(0, \Sigma_u) \tag{C.2}
\]

where \( \beta = [1, 1, 1, 1, 0, 0, 0, 0, 0, 0]^\top \) and \( \Sigma_u \) is a measurement error (diagonal) variance-covariance matrix.

C.1.3 Dealing with the mixed-frequency issue

When some observables are available at a quarterly frequency, we need to adjust both measurement and transition equations to deal with the mixed-frequency issue. We provide an example whereby the dimension of \( z_t, \alpha_t, \) and \( v_t \) are reduced to half for ease of illustration. We assume that the first observable is available at a quarterly while the second observable is available at a monthly frequency. We introduce the superscript \( q \) to indicate if the observable is available at the quarterly frequency. Thus, \( o_t = [z^q_{1,t}, z_{2,t}]' \). Also for simplicity, we do not allow for measurement errors. There are two cases to consider.

1. If \( z^q_{1,t} \) is expressed in growth rates, adjust the measurement loading \( \beta \) and state vector to

\[
\beta = \begin{bmatrix}
\frac{1}{3} & \frac{2}{3} & 1 & \frac{2}{3} & \frac{1}{3} & 0 & 0 & 0 & 0 & 0 \\
0 & 0 & 0 & 0 & 0 & 1 & 0 & 0 & 0 & 0
\end{bmatrix}, \quad x_t = \begin{bmatrix}
z_{1,t} \\
z_{1,t-1} \\
z_{1,t-2} \\
z_{1,t-3} \\
z_{1,t-4} \\
z_{2,t} \\
z_{2,t-1} \\
z_{2,t-2} \\
z_{2,t-3} \\
z_{2,t-4} \\
\alpha_{1,t} \\
\alpha_{2,t} \\
v_{1,t}
\end{bmatrix}. \tag{C.3}
\]

We can relate the mixed-frequency observables to the state vector by

\[
o_t = \begin{bmatrix}
z^q_{1,t} \\
z_{2,t}
\end{bmatrix} = \begin{bmatrix}
z_{1,t} + 2z_{1,t-1} + 3z_{1,t-2} + 2z_{1,t-3} + z_{1,t-4} \\
z_{2,t}
\end{bmatrix} = \beta^\top x_t. \tag{C.4}
\]
2. If \( z_{q,t} \) is expressed in levels, adjust the measurement loading \( \beta \) and state vector to

\[
\beta = \begin{bmatrix}
\frac{1}{3} & \frac{1}{3} & \frac{1}{3} & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\
0 & 0 & 0 & 0 & 0 & 1 & 0 & 0 & 0 & 0 \\
\end{bmatrix},
\quad x_t = \begin{bmatrix}
z_{1,t} \\
z_{1,t-1} \\
z_{1,t-2} \\
z_{1,t-3} \\
z_{1,t-4} \\
z_{2,t} \\
z_{2,t-1} \\
z_{2,t-2} \\
z_{2,t-3} \\
z_{2,t-4} \\
\alpha_1,t \\
\alpha_2,t \\
v_{1,t} \\
\end{bmatrix}.
\] (C.5)

We can relate the mixed-frequency observables to the state vector by

\[
o_t = \begin{bmatrix}
z_{q,t}^1 \\
z_{2,t} \\
\end{bmatrix} = \begin{bmatrix}
\frac{z_{1,t+1} + z_{1,t-1} + z_{1,t-2} + z_{1,t-3} + z_{1,t-4}}{3} \\
\frac{z_{2,t+1} + z_{2,t-1} + 3z_{2,t-3} + z_{2,t-4}}{3} \\
\frac{z_{3,t+1} + z_{3,t-1} + z_{3,t-2}}{3} \\
\pi_t \\
\end{bmatrix} = \beta^T x_t.
\] (C.6)

### C.1.4 Implementation

We use quarterly consumption growth (\( \Delta c_t^q \)), output growth (\( d_t^q \)), and log government expenditure-to-output ratio (\( g_t^q \)), and monthly inflation (\( \pi_t \)) in the estimation. Except for consumption growth data, we are using the highest available frequency. Our choice of using quarterly consumption growth avoids modeling measurement errors in monthly consumption growth (see Schorfheide, Song, and Yaron (2018) for a detailed discussion), which significantly reduces the dimension of the state vector leading to a much more tractable estimation problem. Note that \( \Delta c_t^q \) and \( d_t^q \) are expressed in growth rates, but \( \pi_t \) and \( g_t^q \) are expressed in levels. Following the idea described in Section C.1.3, we modify the measurement equation loading \( \beta \) and state vector \( X_t \) to equate the observables to our state variables

\[
o_t = \begin{bmatrix}
\Delta c_t^q \\
d_t^q \\
g_t^q \\
\pi_t \\
\end{bmatrix} = \begin{bmatrix}
z_{1,t+1} + z_{1,t-1} + 3z_{1,t-2} + 2z_{1,t-3} + z_{1,t-4} \\
2z_{2,t+1} + 2z_{2,t-1} + z_{2,t-3} + 2z_{2,t-4} \\
z_{3,t+1} + z_{3,t-1} + z_{3,t-2} \\
\pi_t \\
\end{bmatrix}.
\] (C.7)

The most efficient characterization of the state vector is

\[
x_t = \begin{bmatrix}
z_{1,t} & z_{1,t-1} & z_{1,t-2} & z_{1,t-3} & z_{1,t-4} & z_{2,t} & z_{2,t-1} & z_{2,t-2} & z_{2,t-3} & z_{2,t-4} & z_{3,t} & z_{3,t-1} & z_{3,t-2} & z_{4,t} & \alpha_1,t & \alpha_2,t & \alpha_3,t & \alpha_4,t & v_{1,t} & v_{2,t} \\
\end{bmatrix}^T.
\] (C.8)

The coefficient matrices in (C.1) are adjusted accordingly to match the dimension of (C.8). It is easy to deduce the form of \( \beta \) from (C.7) and (C.8).

Because of the conditionally linear structure of our state-space form, we can directly apply the Rao-Blackwellization particle filter as in Schorfheide, Song, and Yaron (2018). The details are omitted for brevity.

### C.2 State-space representation: Extended form

We now introduce an extended state-space representation in which we additionally introduce \( s \) factors which are crucial elements for asset prices. We allow the \( s \) factors to depend on the lagged values of \( z \) and \( v \) factors to model inter-dependence.
C.2.1 State transition dynamics

\[
\begin{pmatrix}
    z_{1,t+1} \\
    z_{2,t+1} \\
    z_{3,t+1} \\
    z_{4,t+1} \\
    \alpha_{t+1} \\
    \sigma_{t+1} \\
    v_{t+1} \\
    v_{2,t+1}
\end{pmatrix}
= 
\begin{pmatrix}
    \mu_1 \\
    \mu_2 \\
    \mu_3 \\
    \mu_4 \\
    \alpha_1 \\
    \alpha_2 \\
    \nu_v \odot \nu_v \\
    \nu_v \odot \nu_v
\end{pmatrix}
\begin{pmatrix}
    \phi_{11} \phi_{12} \phi_{13} \phi_{14} \\
    \phi_{21} \phi_{22} \phi_{23} \phi_{24} \\
    \phi_{31} \phi_{32} \phi_{33} \phi_{34} \\
    \phi_{41} \phi_{42} \phi_{43} \phi_{44} \\
    0 0 0 0 \\
    0 0 0 0 \\
0 0 0 0 \\
0 0 0 0
\end{pmatrix}
+ 
\begin{pmatrix}
    \epsilon_{t+1} \\
    \epsilon_{t+1} \\
    \epsilon_{t+1} \\
    \epsilon_{t+1} \\
    v_{1,t} \\
    v_{2,t} \\
0 \\
0
\end{pmatrix}
\begin{pmatrix}
    1 0 0 0 0 0 0 0 0 0 0 0 0 0 \\
0 1 0 0 0 0 0 0 0 0 0 0 0 0 \\
0 0 1 0 0 0 0 0 0 0 0 0 0 0 \\
0 0 0 1 0 0 0 0 0 0 0 0 0 0 \\
0 0 0 0 1 0 0 0 0 0 0 0 0 0 \\
0 0 0 0 0 1 0 0 0 0 0 0 0 0 \\
0 0 0 0 0 0 1 0 0 0 0 0 0 0 \\
0 0 0 0 0 0 0 1 0 0 0 0 0 0 \\
0 0 0 0 0 0 0 0 1 0 0 0 0 0 \\
0 0 0 0 0 0 0 0 0 1 0 0 0 0 \\
0 0 0 0 0 0 0 0 0 0 1 0 0 0 \\
0 0 0 0 0 0 0 0 0 0 0 1 0 0 \\
0 0 0 0 0 0 0 0 0 0 0 0 1 0 \\
0 0 0 0 0 0 0 0 0 0 0 0 0 1
\end{pmatrix}
\begin{pmatrix}
    \nu_{t+1} \\
    \nu_{t+1}
\end{pmatrix}
\begin{pmatrix}
0 \\
0 \\
0 \\
0 \\
0 \\
0 \\
0 \\
0
\end{pmatrix}
\begin{pmatrix}
0 \\
0 \\
0 \\
0 \\
\nu_v \odot \nu_v \\
\nu_v \odot \nu_v \\
0 \\
0
\end{pmatrix}
\begin{pmatrix}
0 \\
0 \\
0 \\
0 \\
0 \\
0 \\
0 \\
0
\end{pmatrix}
\begin{pmatrix}
0 \\
0 \\
0 \\
0 \\
\phi_{v,1,t} \\
\phi_{v,2,t} \\
0 \\
0
\end{pmatrix}
\begin{pmatrix}
\omega_{v,1,t} \\
\omega_{v,2,t}
\end{pmatrix}
\frac{1}{2}
\begin{pmatrix}
\epsilon_{1,t+1} \\
\epsilon_{2,t+1} \\
\epsilon_{3,t+1} \\
\epsilon_{4,t+1} \\
\sigma_{t+1} \\
\nu_v
\end{pmatrix}
\begin{pmatrix}
\mu_2 \\
\mu_3 \\
\mu_4 \\
0 \\
\alpha_1 \\
\alpha_2
\end{pmatrix}
\begin{pmatrix}
\Phi_{z \times 4} \Phi_{v \times 4} \\
I_{4 \times 4} \Phi_{o \times 4} \\
0_{4 \times 4} \Phi_{o \times 4} \\
0_{4 \times 4} \Phi_{o \times 4} \\
0_{4 \times 4} \Phi_{o \times 4} \\
0_{4 \times 4} \Phi_{o \times 4} \\
0_{4 \times 4} \Phi_{o \times 4} \\
0_{4 \times 4} \Phi_{o \times 4} \\
\Phi_{s \times 4} \\
\Phi_{s \times 4} \\
\Phi_{s \times 4} \\
\Phi_{s \times 4} \\
\nu_v \\
\nu_v
\end{pmatrix}

\begin{pmatrix}
\alpha_t \\
\sigma_t \\
\nu_v \\
\nu_v
\end{pmatrix}
\begin{pmatrix}
\phi_{z,14} \phi_{z,13} \phi_{z,12} \phi_{z,11} \\
\phi_{v,14} \phi_{v,13} \phi_{v,12} \phi_{v,11} \\
\phi_{o,14} \phi_{o,13} \phi_{o,12} \phi_{o,11} \\
\phi_{s,14} \phi_{s,13} \phi_{s,12} \phi_{s,11}
\end{pmatrix}

\text{for } i \in \{1, 2, 3, 4\}, l \in \{1, 2, 3\} \text{ and } j \in \{1, 2\}.

\[V_{v,t} = a_i + b_{i1} v_{1,t} + b_{i2} v_{2,t}, \quad \omega_{v,t} = \nu_{v} c_{v,t}^2 + 2 \nu_{v} \phi_{v} v_{j,t}\]

with \(\epsilon_{x_{i,t+1}} \sim \mathcal{N}(0, 1), \epsilon_{s_{t+1}} \sim \mathcal{N}(0, 1), \) and \(\nu_{v} v_{j,t}\) being a zero mean unit variance shock.

In vector notations, we express the state space by

\[
\begin{pmatrix}
\begin{pmatrix}
    z_{t+1} \\
    \alpha_{t+1} \\
    \sigma_{t+1} \\
    v_{t+1}
\end{pmatrix}
\end{pmatrix}
= 
\begin{pmatrix}
\mu_2 \\
\mu_3 \\
\mu_4 \\
0
\end{pmatrix}
\begin{pmatrix}
\Phi_{z \times 4} \Phi_{v \times 4} \\
I_{4 \times 4} \Phi_{o \times 4} \\
0_{4 \times 4} \Phi_{o \times 4} \\
0_{4 \times 4} \Phi_{o \times 4}
\end{pmatrix}
\begin{pmatrix}
\begin{pmatrix}
    \alpha_t \\
    \sigma_t \\
    \nu_v \\
    \nu_v
\end{pmatrix}
\end{pmatrix}^{1/2}
\]
Consider various different maturities of the risky Treasury zero-coupon yields (T), interest rate swap premiums (I), CDS premiums (C), and OIS spreads (O). We introduce new notations to relate the observed rates to our state variables. Define

\[ y_{m,T}^T = \Xi^T(A_{m,T}^T, B_{m,T}^T, \tilde{A}_{m,T}^T, \tilde{B}_{m,T}^T, \tilde{x}_t) = \Xi^T(A_{m,T}^T, B_{m,T}^T, \tilde{x}_t) \]
\[ y_{m,C}^C = \Xi^C(A_{m,C}^C, B_{m,C}^C, \tilde{A}_{m,C}^C, \tilde{B}_{m,C}^C, \tilde{x}_t) \]
\[ y_{m,T}^T = \Xi^T(A_{m,T}^T, B_{m,T}^T, \tilde{A}_{m,T}^T, \tilde{B}_{m,T}^T, \tilde{x}_t) \]
\[ y_{m,O}^O = \Xi^O(A_{m,O}^O, B_{m,O}^O, \tilde{A}_{m,O}^O, \tilde{B}_{m,O}^O, \tilde{x}_t) \]

to match the \( m \)-maturity rate of the observable to our state variables \( \tilde{x}_t \). We provide the derivation of solution coefficients \( A_{m,T}^*, B_{m,T}^*, \tilde{A}_{m,T}^*, \tilde{B}_{m,T}^* \) and an expression for \( \Xi^j() \) in Appendix B for \( j \in \{T, I, C, O\} \). We select the maturities of 1y, 3y, 5y, 7y, 10y, and 15y in the estimation, which are collected in

\[ y_t^I = \begin{bmatrix} y_{1,T,t}^I \\ \vdots \\ y_{15,T,t}^I \end{bmatrix} = \begin{bmatrix} \Xi^I(A_{1,T}^I, B_{1,T}^I, \tilde{A}_{1,T}^I, \tilde{B}_{1,T}^I, \tilde{x}_t) \\ \vdots \\ \Xi^I(A_{15,T}^I, B_{15,T}^I, \tilde{A}_{15,T}^I, \tilde{B}_{15,T}^I, \tilde{x}_t) \end{bmatrix} \]

We consider \( y_t^I, y_t^C, y_t^T \) in the estimation and use \( y_t^O \) as out-of-sample validation. We have defined \( s_{1,t} \) and \( s_{2,t} \) as observables in the main body of our paper. Define vectors \( e_{s_1} \) and \( e_{s_2} \) that select \( s_{1,t} \) and \( s_{2,t} \) from \( \tilde{x}_t \), respectively. Put together,

\[ \begin{bmatrix} s_{1,t} \\ s_{2,t} \end{bmatrix} = \begin{bmatrix} e_{s_1}^T \\ e_{s_2}^T \end{bmatrix} \tilde{x}_t \]  

(C.12)
disciplines the dynamics of the \( s \) factors. In sum, our state-space representation is comprised of state transition equations (C.9) and measurement equations (C.11) for \( j \in \{T, I, C, O\} \) and (C.12). There are two ways in which we can proceed.

1. A joint estimation of macroeconomic observables and prices:

We augment our measurement equations with (C.7) and adjust the state transition equation (C.9) to deal with mixed-frequency observations as explained in Section C.1.3. While the joint estimation approach can be appealing, it is computationally challenging since we have to increase the dimension of our state vector substantially. More importantly, because the system no longer preserves the conditionally linear structure, e.g., (C.11), we cannot apply the solution proposed by Schorfheide, Song, and Yaron (2018), and thus the non-linear filtering algorithm can be highly inefficient.
2. Two-stage estimation in which macroeconomic observables and prices are separated:
For this, we treat the filtered estimates of $\hat{x}_t$ and $\hat{\alpha}_t$ from the first stage estimation, which only involves macroeconomic data, as observables for the second stage estimation. Among our state vector $\hat{x}_t$, we are assuming that $x_1, \alpha_t, s_{1,t}, s_{2,t}$ are observed factors and treating $s_{3,t}, v_{1,t}, v_{2,t}$ as latent factors. We can then partition the state vector into

$$\hat{x}_t = (\hat{x}_t^0, \hat{x}_t^1)^T$$

(C.13)

where the superscript o and l indicate “observed” and “latent” respectively. The non-linear filtering technique only deals with $\hat{x}_t^1$ in the state transition equation (C.9), since the other variables are observed. In this case, the measurement equations are (C.11) for $j \in \{T, C, I\}$ and (C.12).

C.2.3 Particle filter

We use a particle-filter approximation of the likelihood function and embed this approximation into a fairly standard random walk Metropolis algorithm. In the subsequent exposition, we omit the dependence of all densities on the parameter vector $\Theta$. In slight abuse of notations, we denote all observables with $y_t$ as

$$y_t = [y_{t}^{C,T}, y_{t}^{T,T}, y_{t}^{I,T}, s_{1,t}, s_{2,t}]^T$$

(C.14)

The particle filter approximates the sequence of distributions $\{p(\hat{x}_t^j|y_{1:t})\}_{t=1}^T$ by a set of pairs $\{\hat{x}_t^j(i), \pi_t^j(i)\}_{i=1}^N$, where $\hat{x}_t^j(i)$ is the ith particle vector, $\pi_t^j(i)$ is its weight, and $N$ is the number of particles. As a by-product, the filter produces a sequence of likelihood approximations $\hat{p}(y_t|y_{1:t-1})$, $t = 1, \ldots, T$.

- Initialization: We generate the particle values $\hat{x}_0^j(i)$ from the unconditional distribution. We set $\pi_0^j(i) = 1/N$ for each $i$.
- Propagation of particles: We simulate (C.9) forward to generate $\hat{x}_t^j(i)$ conditional on $\hat{x}_{t-1}^j$ and observed $\hat{x}_{t-1}^0$. We use $q(\hat{x}_t^j(i)|\hat{x}_{t-1}^j, \hat{x}_{t-1}^0, y_t)$ to represent the distribution from which we draw $\hat{x}_t^j(i)$.
- Correction of particle weights: Define the unnormalized particle weights for period $t$ as

$$\pi_t^j(i) = \pi_{t-1}^j(i) \times \frac{p(y_t|\hat{x}_t^j(i), \hat{x}_{t-1}^0)p(\hat{x}_t^j(i)|\hat{x}_{t-1}^j, \hat{x}_{t-1}^0)}{q(\hat{x}_t^j(i)|\hat{x}_{t-1}^j, \hat{x}_{t-1}^0, y_t)}.$$

The term $\pi_{t-1}^j(i)$ is the initial particle weight and the ratio $\frac{p(y_t|\hat{x}_t^j(i), \hat{x}_{t-1}^0)p(\hat{x}_t^j(i)|\hat{x}_{t-1}^j, \hat{x}_{t-1}^0)}{q(\hat{x}_t^j(i)|\hat{x}_{t-1}^j, \hat{x}_{t-1}^0, y_t)}$ is the importance weight of the particle.

The approximation of the log likelihood function is given by

$$\log \hat{p}(y_t|y_{1:t-1}) = \log \hat{p}(y_{t-1}|y_{1:t-2}) + \sum_{i=1}^N \log \left( \frac{\pi_t^j(i)}{\sum_{j=1}^N \pi_t^j(i)} \right).$$

- Resampling: Define the normalized weights

$$\pi_t^j(i) = \frac{\pi_t^j(i)}{\sum_{j=1}^N \pi_t^j(i)}$$

and generate $N$ draws from the distribution $\{\hat{x}_t^j(i), \pi_t^j(i)\}_{i=1}^N$ using multinomial resampling. In slight abuse of notation, we denote the resampled particles and their weights also by $\hat{x}_t^j(i)$ and $\pi_t^j(i)$, where $\pi_t^j(i) = 1/N$. 70