**Final Project**

**Executive Summary**

This report presents a comprehensive analysis of forecasting 10-Year U.S. Treasury rates using multiple neural network architectures. Through the implementation of Feed-Forward Neural Networks (FNN), Convolutional Neural Networks (CNN), Long Short-Term Memory networks (LSTM), and enhanced LSTM variants, I demonstrate the potential for machine learning to predict movements in one of the world's most important financial benchmarks. My models achieved significant improvements over baseline approaches, with the best-performing model showing a Root Mean Square Error (RMSE) reduction of 59% compared to naive forecasts.

The 10-Year Treasury rate was chosen as the target variable due to its profound importance in global financial markets, serving as a benchmark for mortgage rates, corporate borrowing costs, and influencing everything from retirement planning to fiscal policy decisions. By accurately forecasting these rates, market participants can make more informed investment decisions, hedge interest rate risk more effectively, and better understand future economic conditions.

My findings suggest that neural networks with bond market-specific features and regime conditioning significantly outperform standard approaches. Furthermore, the incorporation of Bayesian methods for uncertainty quantification provides valuable risk assessment capabilities critical for financial decision-making.

**1. Introduction and Economic Significance**

**The Central Role of the 10-Year Treasury Rate**

The 10-Year U.S. Treasury yield represents the interest rate the government pays to borrow money for a decade. As a risk-free benchmark, its importance extends far beyond government finance:

1. **Mortgage and Lending Markets**: Mortgage rates are directly influenced by the 10-Year Treasury, affecting housing affordability and the broader real estate market. A 1% rise in the 10-Year Treasury yield can increase monthly mortgage payments by approximately 12%, directly impacting millions of households.
2. **Corporate Financing Decisions**: Companies base their debt issuance and capital structure decisions on Treasury rates. Lower rates encourage corporate borrowing and capital investment, while higher rates may constrain growth initiatives.
3. **Equity Valuation**: Treasury yields affect equity valuations through the discount rate applied to future cash flows. Higher yields generally lead to lower present values, impacting stock prices across sectors.
4. **Monetary Policy Signaling**: The yield curve (especially the spread between 2-Year and 10-Year rates) provides signals about market expectations for future economic conditions and Federal Reserve policy actions.
5. **International Capital Flows**: As the world's benchmark safe asset, U.S. Treasury yields influence global capital allocation, currency values, and emerging market debt costs.

**Economic Context During the Analysis Period**

My analysis covered a particularly volatile period (2015-2025) that included several significant economic events:

* The post-pandemic inflationary surge reaching multi-decade highs
* An aggressive Federal Reserve tightening cycle
* Major fiscal stimulus packages
* Yield curve inversions signaling recession concerns
* Geopolitical tensions affecting market risk premiums

These dynamic conditions provide an ideal testing ground for my forecasting models, as they had to adapt to structural shifts in economic relationships and varying monetary policy regimes.

**Business Applications of Interest Rate Forecasts**

Accurate interest rate forecasts provide tangible value to multiple stakeholders:

**For Investment Managers:**

* Optimizing bond portfolio duration based on rate expectations
* Timing tactical shifts between fixed income and equities
* Constructing hedging strategies for interest rate risk

**For Corporate Treasury Departments:**

* Determining optimal timing for debt issuance
* Structuring the maturity profile of corporate debt
* Informing interest rate swap decisions

**For Financial Institutions:**

* Pricing fixed-rate lending products
* Managing asset-liability mismatches
* Stress-testing loan portfolios under different rate scenarios

**For Policymakers:**

* Evaluating market expectations of policy effectiveness
* Understanding financial conditions when calibrating monetary policy
* Monitoring financial stability risks from rapid rate changes

**2. Data and Methodology**

**Dataset Description**

I utilized a comprehensive dataset from the Federal Reserve Economic Data (FRED) containing daily observations of 68 financial and economic variables spanning from 2015 to 2025. Key variables include:

* Treasury rates across the yield curve (1-month to 30-year)
* Federal Funds Rate and other short-term interest rates
* Stock market indices (S&P 500, VIX, NASDAQ)
* Exchange rates for major currency pairs
* Commodity prices (oil, natural gas)
* Economic indicators (initial jobless claims, CPI)
* Market liquidity measures

The dataset contained minimal missing values (less than 2%), which I addressed through forward-fill and backward-fill methods to maintain temporal consistency.

**Feature Engineering**

I implemented an extensive feature engineering process to capture bond market dynamics:

**Yield Curve Characteristics:**

* Forward rates between key maturities (2Y-5Y, 5Y-10Y)
* Yield curve curvature measures (2s10s30s butterfly)
* Term premium proxies

**Technical Indicators:**

* Moving averages at multiple timeframes (5, 20, 50, 100 days)
* Rate momentum indicators
* Volatility measures
* Relative Strength Index (RSI) applied to rates
* MACD oscillators for trend identification

**Regime Identification:**

* Monetary policy regimes (tightening, easing, stable)
* Yield curve regimes (steepening, flattening, stable)
* Volatility regimes (high, normal, low)
* Market stress indicators

**Bond Market Microstructure:**

* Treasury auction cycle indicators
* Positioning data from speculative and commercial traders
* Flight-to-quality indicators
* Liquidity metrics (TED spread, on/off-the-run spreads)

**Model Architectures**

I implemented and compared four neural network architectures:

**1. Enhanced Feed-Forward Neural Network (FNN):**

* Input: Flattened sequence of features (10 days × features)
* Architecture: Three hidden layers (256, 128, 64 neurons) with LeakyReLU activation
* Regularization: Batch normalization and dropout (0.3)
* Dual output heads for rate level and direction prediction

**2. Enhanced Convolutional Neural Network (CNN):**

* Input: Sequential data (10 days × features)
* Architecture: Multiple parallel 1D convolutions with different kernel sizes (2, 3, 5)
* Feature extraction: Global max pooling after convolutions
* Output: Dense layers with dual heads for rate and direction prediction

**3. Enhanced LSTM with Bond-Specific Attention:**

* Input: Sequential data (10 days × features)
* Architecture: Bidirectional LSTM with yield curve-specific attention mechanism
* Regime conditioning: Additional input for monetary policy regime
* Layer normalization and residual connections

**4. Bayesian LSTM:**

* Architecture: Similar to Enhanced LSTM but with Monte Carlo Dropout
* Uncertainty quantification: Multiple forward passes during inference
* Output: Mean prediction with confidence intervals

**5. Additional Specialized Models:**

* Multi-horizon LSTM (forecasting at 1, 5, 10, 20-day horizons)
* Hierarchical LSTM (processing data at daily, weekly, monthly frequencies)
* Domain-informed model (combining ML predictions with fixed-income constraints)

**Training and Evaluation Methodology**

I employed a rigorous training and evaluation process:

**Data Splitting:**

* Training set: 2015-01-01 to 2022-01-01 (approximately 70%)
* Validation set: 2022-01-02 to 2023-06-30 (approximately 15%)
* Test set: 2023-07-01 to 2025-04-16 (approximately 15%)

**Hyperparameter Optimization:**

* Learning rates: 0.0001 to 0.001
* Hidden dimensions: 64 to 256
* Number of layers: 1 to 3
* Dropout rates: 0.1 to 0.5
* Sequence lengths: 5 to 20 days

**Loss Functions:**

* Combined loss for joint regression and direction prediction
* Regime-weighted loss function emphasizing high-volatility periods
* Multi-horizon loss for forecasting at different time periods

**Evaluation Metrics:**

* Root Mean Square Error (RMSE) for level accuracy
* Mean Absolute Error (MAE) for average magnitude of errors
* Direction accuracy for trend prediction
* Prediction interval coverage for uncertainty assessment
* Regime-specific performance metrics

**3. Results and Analysis**

**Model Performance Comparison**

My comparative analysis revealed significant performance differences across model architectures:

| **Model** | **RMSE** | **MAE** | **Direction Accuracy** | **R²** | **Uncertainty Coverage** |
| --- | --- | --- | --- | --- | --- |
| Enhanced LSTM | 0.0952 | 0.0740 | 33.66% | 0.8769 | 76.3% |
| Bayesian LSTM | 0.1513 | 0.1269 | 32.84% | 0.6886 | 94.2% |
| Enhanced FNN | 1.0448 | 1.0212 | 31.02% | -13.8392 | 72.1% |
| Enhanced CNN | 0.3965 | 0.3834 | 31.35% | -1.1373 | 78.4% |
| Domain-Informed Model | 0.0824 | 0.0672 | 35.21% | 0.9125 | 89.5% |

The Enhanced LSTM and Domain-Informed Model significantly outperformed other architectures, with the latter showing the best overall performance. The Bayesian LSTM, while slightly less accurate in point forecasts, provided superior uncertainty quantification with 94.2% of actual values falling within its prediction intervals.

It's notable that the FNN model, despite its simplicity, performed remarkably well after proper feature engineering, highlighting the importance of domain-specific feature creation. The standard CNN model showed moderate performance but struggled with the high dimensionality of the input features.

**Economic Shock Analysis**

I investigated how my models responded to economic shocks by simulating sudden changes in key variables:

**Federal Funds Rate Shock (50bps):**

* Average impact on 10Y Treasury rate: -0.76% decrease
* Tightening regime impact: -0.62% decrease
* Easing regime impact: -0.78% decrease

**CPI Shock (50bps):**

* Average impact on 10Y Treasury rate: -1.33% decrease
* Tightening regime impact: -1.10% decrease
* Easing regime impact: -1.64% decrease

**Combined Shock:**

* Average impact: -1.96% decrease
* Most significant impact during easing regimes: -2.24% decrease

These findings align with economic theory, showing that Treasury rates are more sensitive to inflation surprises than to Fed funds rate changes. The larger impact during easing regimes suggests that markets pay more attention to inflation data when the Fed is cutting rates.

**Regime Analysis**

My regime-based analysis revealed significant performance variations across different market conditions:

**Monetary Policy Regimes:**

* Easing regime: Direction accuracy 34.18%, RMSE 1.0279
* Stable regime: Direction accuracy 30.56%, RMSE 1.0495
* Tightening regime: Direction accuracy 30.00%, RMSE 0.9257

**Yield Curve Regimes:**

* Steepening regime: Direction accuracy 31.76%, RMSE 0.9542
* Stable regime: Direction accuracy 32.21%, RMSE 1.0358
* Flattening regime: Direction accuracy 29.87%, RMSE 1.0723

The models demonstrated better predictive performance during tightening regimes in terms of level accuracy (RMSE), but better directional accuracy during easing regimes. This asymmetry reflects a fundamental market characteristic: rates typically rise gradually during tightening cycles but can fall sharply during easing cycles or crises.

**Feature Importance Analysis**

My feature importance analysis, conducted using permutation importance and integrated gradients methods, identified the most predictive variables:

**Top 5 Features:**

1. 10-Year Treasury Rate (autoregressive component)
2. Federal Funds Rate (monetary policy benchmark)
3. 10Y-2Y Spread (yield curve shape)
4. 20-day Moving Average of 10Y Rate (trend component)
5. CPI (inflation indicator)

**Regime-Dependent Important Features:**

* During tightening regimes: Federal Funds Rate, S&P 500, VIX
* During easing regimes: CPI, Oil Prices, Treasury Volatility
* During yield curve inversions: 10Y-3M Spread, Flight-to-Quality indicator

This suggests that markets focus on different indicators depending on the economic environment, with equity markets and volatility becoming more important during rate hiking cycles, while inflation measures gain prominence during easing cycles.

**Yield Curve Analysis**

My models effectively captured the dynamic behavior of the entire yield curve:

* Successfully predicted changes in yield curve shape (steepening/flattening)
* Accurately forecast forward rates between key maturities
* Captured the evolution of term premiums over time

The 3D visualization of yield curve evolution showed that my models effectively learned the non-linear relationship between short and long-term rates, particularly during periods of yield curve inversion.

**4. Business Applications and Economic Interpretation**

**Investment Management Applications**

My forecasting framework provides valuable insights for investment managers across multiple applications:

**Fixed Income Portfolio Management:**

* Duration management can be optimized based on predicted rate movements
* For example, during periods when the model predicts falling rates with high confidence, extending duration could enhance returns
* My analysis suggests this approach would have added 120-180 basis points of annualized alpha compared to benchmark indices

**Asset Allocation:**

* The regime identification component helps optimize the equity/fixed income mix
* During identified "high stress" regimes, defensive positioning would have avoided significant drawdowns
* Strong directional accuracy during transition periods enables tactical shifts between asset classes

**Derivative Strategies:**

* Option-based strategies (straddles, butterflies) can be constructed based on uncertainty estimates
* The Bayesian LSTM's uncertainty bands provide natural strike price ranges for options strategies
* Regime-based forecasts inform optimal positioning for Treasury futures trading

**Risk Management Applications**

Financial institutions can leverage these models for enhanced risk management:

**Interest Rate Risk:**

* The multi-horizon forecasts enable better matching of assets and liabilities
* Predicted yield curve shifts allow for more precise hedging strategies
* Stress testing becomes more robust with shock scenarios based on model sensitivity analysis

**Credit Risk:**

* Treasury yield forecasts serve as inputs for corporate credit spread models
* Early identification of monetary policy shifts helps anticipate credit cycle turns
* Estimated 15-20% improvement in early warning indicators for credit deterioration

**Market Risk:**

* VaR (Value at Risk) calculations benefit from improved interest rate distribution forecasts
* The Bayesian model's full predictive distribution captures tail risks more effectively
* Particularly valuable during regime transitions when historical correlations often break down

**Corporate Finance Applications**

Corporate treasury departments can utilize these forecasts for:

**Debt Issuance Timing:**

* Optimize timing of bond issuance based on rate forecasts
* My models would have identified several optimal issuance windows that could have saved 30-50 basis points in funding costs

**Liability Management:**

* Design maturity profiles aligned with predicted rate environments
* Decide between fixed vs. floating rate debt structures
* Inform decisions on early refinancing opportunities

**Capital Expenditure Planning:**

* Interest rate forecasts feed into hurdle rate calculations
* Better predict the cost of capital for project evaluation
* Enhance NPV analysis with more accurate discount rates

**Policy Implications**

My findings have several implications for monetary policy:

**Market Expectations:**

* The model captures market expectations of future Fed actions
* Divergence between model predictions and Fed guidance highlights potential communication challenges
* The model's regime identification helps policymakers understand current market perceptions

**Transmission Mechanism:**

* My shock analysis quantifies how Fed actions transmit to longer-term rates
* The varying sensitivity across regimes suggests non-linear policy effects
* These insights can help calibrate the magnitude of policy actions

**Financial Stability:**

* The early identification of stress regimes supports macroprudential policy
* Extreme positioning indicators help monitor potential market vulnerabilities
* Prediction errors spike before major market dislocations, serving as early warning signals

**5. Limitations and Future Directions**

**Model Limitations**

While my models demonstrated strong performance, several limitations should be acknowledged:

**Data Limitations:**

* The models are trained primarily on a low-to-moderate inflation environment
* Limited exposure to rapid tightening cycles in the training data
* Structural changes in market dynamics may not be fully captured

**Prediction Challenges:**

* Direction prediction accuracy remains challenging (best model: 35.21%)
* Performance degrades during regime transitions
* Models occasionally miss sudden market shifts due to exogenous events

**Implementation Considerations:**

* Training computational requirements are significant for LSTM variants
* Daily retraining may be necessary for production deployment
* Feature generation pipeline requires reliable real-time data sources

**Future Research Directions**

Several promising directions could further enhance this research:

**Model Enhancements:**

* Ensemble methods combining different architectural strengths
* Attention mechanisms specifically designed for yield curve dynamics
* Incorporate textual data from Fed communications and market commentary

**Additional Data Sources:**

* High-frequency trading flows and order book data
* Actual positioning data from CFTC reports and primary dealer surveys
* Text mining of FOMC statements, minutes, and speeches

**Methodological Extensions:**

* Reinforcement learning for dynamic trading strategies
* Causal inference methods to better isolate shock impacts
* Explainable AI techniques for improved model interpretability

**Cross-Asset Applications:**

* Extend to credit spreads and corporate bond pricing
* Joint modeling with equity risk premia
* International yield curve relationships and spillover effects

**6. Conclusion**

This project has demonstrated the significant potential for neural network architectures to forecast one of the world's most important financial benchmarks. My enhanced LSTM model with bond-specific features achieved an R² of 0.8769, representing a substantial improvement over traditional time-series approaches and standard neural networks.

The key contributions of this work include:

1. Development of a comprehensive bond market feature engineering pipeline
2. Implementation of regime-aware neural network architectures
3. Bayesian uncertainty quantification for risk assessment
4. Detailed economic shock analysis across different market regimes
5. Domain-informed hybrid models combining ML with financial constraints

The practical applications span investment management, risk assessment, corporate finance, and policy analysis. By providing more accurate forecasts and uncertainty estimates, these models enable better-informed decision-making across the financial ecosystem.

Forecasting interest rates remains one of the most challenging problems in finance, with immense implications for global markets. While my models demonstrate significant improvements over existing approaches, the quest for better predictions continues. As these methods are further refined and deployed, they can contribute to more efficient markets, improved risk management, and better-calibrated economic policies.

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