Expectations Theory

REVIEWED BY JAMES CHEN | Updated Jul 29, 2018

What is the Expectations Theory

The expectations theory attempts to predict what short-term interest rates will be in the future based on current long-term interest rates. The theory suggests that an investor earns the same amount of interest by investing in a one-year bond now and then another one-year bond after the first bond matures, as compared to purchasing a two-year bond in the present. This theory is also known as the Unbiased Expectations Theory.

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Breaking Down Expectations Theory

The expectations theory aims to help investors make decisions based upon a forecast of future interest rates. There are three primary theories associated with the expectations theory, which are preferred habitat theory, pure expectations theory and liquidity preference theory. Each one of these is considered a type of expectations theory.

Investors should be aware that the expectations theory is not always a reliable tool. A common problem with using the expectations theory is that it sometimes overestimates future short-term rates, making it easy for investors to end up with an inaccurate prediction of a bond's yield curve.

Consider that the present bond market provides investors with a two-year bond that has an interest rate of 20 percent and a one-year bond with an interest rate of 18 percent. The expectations theory can be used to forecast the interest rate of a future one-year bond. The first step of the calculation is to add one to the two-year bond's interest rate. The result is 1.2, or 120 percent.

The next step is to square the result, and then divide the result by the current one-year interest rate plus one. To get a predicted one-year bond interest rate for the following year, subtract one from that sum.

In this example, the investor is earning an equivalent return to the present interest rate of a two-year bond. If the investor chooses to invest in a one-year bond at 18 percent, the bond yield for the following year's bond would need to increase to 22 percent for this investment to be advantageous.

Expectations Theory vs. Preferred Habitat Theory

The preferred habitat theory expands upon the expectations theory. People sometimes use this theory to explain why longer-term bonds typically pay out higher interest than two shorter-term bonds that, when added together, result in the same maturity.

The theory states that investors have a preference for short-term bonds over long-term bonds, unless the latter pay a risk premium. When comparing the preferred habitat theory to the expectations theory, the difference is that the former assumes investors are concerned with maturity as well as yield, while the expectations theory assumes that investors are only concerned with yield.