Supplement to
“A New Perspective on Gaussian DTSMs”

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These notes supplement Joslin, Singleton, and Zhu (2010b, JSZ).

1 Example: Arbitrage-Free Nelson-Siegel Model

JSZ shows that restrictions that only affect $Q$-parameters are irrelevant for forecasting the portfolio of yields $P$. An immediate implication of this observation is that forecasts of $P$ using an arbitrage-free Nelson-Siegel (AFNS) model are equivalent to forecasts based on an unconstrained VAR(1) representation of $P$. To see this, we show that the AFNS model of Christensen, Diebold, and Rudebusch (2007) is an invariant transformation of a special case of the JSZ normalization (and indeed of the DS normalization) with the additional constraint that $\lambda^Q = (0, \lambda, \lambda)$ and $r^Q_\infty = 0$. The AFNS(3) model with latent state vector $X_t = (X^1_t, X^2_t, X^3_t)'$ has a feedback matrix $K^Q_{1X}$ of the form

$$K^Q_{1X} = \begin{pmatrix} 0 & 0 & 0 \\ 0 & -\lambda & \lambda \\ 0 & 0 & -\lambda \end{pmatrix},$$

and the short rate depends only on the first two latent pricing factors: $r_t = X^1_t + X^2_t$. This model is obtained by starting with the Jordan form underlying the JSZ normalization chosen

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1Christensen, Diebold, and Rudebusch (2007) also impose zero drift of the non-stationary factor under $Q$. 
to be the three-factor case with \( r_t = r_{\infty}^Q + \iota Y_t \) and \( K_{1Y}^Q \) having two equal eigenvalues:

\[
\Delta Y_t = \begin{pmatrix} -\alpha & 0 & 0 \\ 0 & -\lambda & 1 \\ 0 & 0 & -\lambda \end{pmatrix} Y_{t-1} + \Sigma_Y \epsilon_t^Q. \tag{2}
\]

Applying the invariant transform

\[
B = \begin{pmatrix} 1 & 0 & 0 \\ 0 & 1 & 1 \\ 0 & 0 & 1/\lambda \end{pmatrix}
\]

to \( Y \) gives \( X_t = BY_t, \Sigma_X = B \Sigma_Y, r_t = r_{\infty}^Q + (1,1,0)X_t \), and

\[
\Delta X_t = \begin{pmatrix} -\alpha & 0 & 0 \\ 0 & -\lambda & \lambda \\ 0 & 0 & -\lambda \end{pmatrix} X_{t-1} + \Sigma_X \epsilon_t^Q. \tag{3}
\]

Therefore, the AFNS model is the constrained special case of the JSZ normalization with \( \lambda^Q = (0, \lambda, \lambda) \) and \( r_{\infty}^Q = 0 \). Proposition 3 of JSZ implies that these restrictions do not affect the ML estimates of \( K_{0p}^P \) and \( K_{1p}^P \) and, hence, they cannot improve the forecasts of \( P \) relative to an unconstrained VAR(1). It follows that the forecast gains that Christensen, Diebold, and Rudebusch (2007) attribute to the structure of their AFNS pricing model must in fact have been a consequence of restrictions that they imposed directly on the \( P \)-distribution of bond yields – the no-arbitrage restrictions implicit in the AFNS model played no role in their forecasts of the first three PCs of bond yields.

2 Additional Details for Proof of Proposition 1

The only remaining step in the proof of Proposition 1 of JSZ is the following. For any \( 2n \times 2n \) Jordan block

\[
J_i = \begin{pmatrix} R & I_2 & \cdots & 0 \\ 0 & R & \cdots & 0 \\ \vdots & \vdots & \ddots & I_2 \\ 0 & \cdots & 0 & R \end{pmatrix}
\]
with

\[ R = \begin{pmatrix} \beta & -\mu \\ \mu & \beta \end{pmatrix}, \]

and any \(2n \times 1\) vector \(\rho\), there exists an invertible matrix \(B\) such that

\[ BJ_i B^{-1} = J_i \quad \text{and} \quad (B^{-1})' \rho = \vec{1}. \]

We prove this claim in a series of lemmas.

**Lemma 1.** For \(A \in \mathbb{R}^{2n \times 2n}\) with a strictly complex eigenvalue \(\lambda\) of algebraic multiplicity \(n\) and geometric multiplicity 1, there exists \(U \in \mathbb{R}^{2n \times 2n}\) so that \(U^{-1}AU = J\) where

\[
J = \begin{pmatrix}
B & I_2 & 0 & \cdots & 0 \\
0 & B & I_2 & \cdots & 0 \\
0 & 0 & B & \ddots & 0 \\
\vdots & \vdots & \vdots & \ddots & I_2 \\
0 & 0 & 0 & \cdots & B
\end{pmatrix}
\]

where \(B_{1,1} = B_{2,2} = \text{real}(\lambda)\) and \(B_{2,1} = -B_{1,2} = |\text{imag}(\lambda)|\).

Proof of Lemma 1: There exist eigenvectors \(x_1, x_2, \ldots, x_{2n} \in \mathbb{C}^{2n}\) such that, for \(U_0 = [x_1, \ldots, x_{2n}]\),

\[
U_0^{-1}AU_0 = \begin{pmatrix} J_0 & 0 \\ 0 & \bar{J}_0 \end{pmatrix}, \quad \text{where} \quad J_0 = \begin{pmatrix}
\lambda & 1 & 0 & \cdots & 0 \\
0 & \lambda & 1 & \cdots & 0 \\
0 & 0 & \lambda & \ddots & 0 \\
\vdots & \vdots & \vdots & \ddots & 1 \\
0 & 0 & 0 & \cdots & \lambda
\end{pmatrix}
\]

and \(\bar{J}_0\) denotes the complex conjugate of \(J_0\). It is easy to verify that for \(x_i = \bar{x}_{i+n} (i = 1, 2, \ldots, n)\) and

\[ U = [\text{real}(x_1), \text{imag}(x_1), \ldots, \text{real}(x_n), \text{imag}(x_n)], \]

the matrix \(U^{-1}AU\) has the desired form.
Next, consider the sets of matrices

\[
M_O = \left\{ \begin{bmatrix} \alpha & \beta \\ -\beta & \alpha \end{bmatrix} : \alpha, \beta \in \mathbb{R} \right\}, \quad M_O^+ = \left\{ \begin{bmatrix} \alpha & \beta \\ -\beta & \alpha \end{bmatrix} : \alpha, \beta \in \mathbb{R}, \beta \neq 0 \right\},
\]

(4)

\[
M_D = \left\{ \begin{bmatrix} \alpha & \beta \\ \beta & -\alpha \end{bmatrix} : \alpha, \beta \in \mathbb{R} \right\}.
\]

(5)

Let \([A, B] = AB - BA\) denote the lie bracket. Then we have the following lemmas:

**Lemma 2.** For any \(A \in M_O^+\), \(\{B : B^{-1}AB = A\} = \{B : [A, B] = 0\} = M_O\).

Proof: The proof is immediate from

\[
\begin{pmatrix} c & d \\ e & f \end{pmatrix} \begin{bmatrix} \alpha & \beta \\ -\beta & \alpha \end{bmatrix} - \begin{bmatrix} \alpha & \beta \\ -\beta & \alpha \end{bmatrix} \begin{pmatrix} c & d \\ e & f \end{pmatrix} = \beta \begin{pmatrix} e + d & f - c \\ f - c & -(e + d) \end{pmatrix}.
\]

(6)

**Lemma 3.** For any \(A \in M_O, B \in \mathbb{R}^{2 \times 2}\), \(AB - BA \in M_D\).

Proof: This is also immediate from (6).

**Lemma 4.** If \(A \in M_C, C\) and \(E\) are in \(\mathbb{R}^{2 \times 2}\), \(AC + E = CA\), and \(AE = EA\), then \(E = 0\) and \(C \in M_O\).

Proof: Follows immediately from previous lemmas since \(E \in M_D \cap M_O\).

**Lemma 5.** If \(A \in M_O^+\) and

\[
\begin{pmatrix}
0 & A & I_2 & 0 & \cdots & 0 \\
0 & 0 & A & I_2 & \cdots & 0 \\
\vdots & \vdots & \vdots & \ddots & \ddots & \ddots \\
0 & 0 & 0 & 0 & \cdots & A
\end{pmatrix} B = 0,
\]

then \(B\) has the form

\[
B = \begin{pmatrix}
E_1 & E_2 & E_3 & \cdots & E_n \\
0 & E_1 & E_2 & \cdots & E_{n-1} \\
\vdots & \vdots & \vdots & \ddots & \ddots \\
0 & 0 & 0 & \cdots & E_1
\end{pmatrix},
\]

where each \(E_i \in M_O\).
Proof: We prove this lemma for the case \( n = 3 \). The general result can be proven by induction. The result is obtained by repeated application of Lemma 4.

\[
\begin{pmatrix}
A & I \\
A & I \\
A & 0
\end{pmatrix}
\begin{pmatrix}
C & D & E \\
F & G & H \\
J & K & L
\end{pmatrix}
- 
\begin{pmatrix}
C & D & E \\
F & G & H \\
J & K & L
\end{pmatrix}
\begin{pmatrix}
A & I \\
A & I \\
A & 0
\end{pmatrix}
= (7)
\]

\[
\begin{pmatrix}
\end{pmatrix}
= (8)
\]

\((3, 1) \Rightarrow J \in M_O \)

\( J \in M_O \& \ (2, 1) \Rightarrow J = 0 \) and \([A, F] = 0\) and \( F \in M_O \)

\( F \in M_O \& \ (1, 1) \Rightarrow F = 0 \) and \( C \in M_O \)

\( J = 0 \& \ (3, 2) \Rightarrow K \in M_O \)

\( K \in M_O \& \ F = 0 \& \ (2, 2) \Rightarrow K = 0 \) and \([A, G] = 0\) and \( G \in M_O \)

\( G - C \in M_O \& \ (1, 2) \Rightarrow G - C = 0 \) and \( D \in M_O \)

\( K = 0 \& \ (3, 3) \Rightarrow L \in M_O \)

\( L \in M_O \& \ G \in M_O \& \ (2, 3) \Rightarrow L - G = 0 \) and \([A, H] = 0\) and \( H \in M_O \)

\( H - D \in M_O \& \ (1, 3) \Rightarrow H - D = 0 \) and \( E \in M_O \)

This establishes the result for \( n = 3 \).

**Lemma 6.** For any \( \rho \in \mathbb{R}^{2n} \) with \( \rho_1^2 + \rho_2^2 \neq 0 \) and \( J_C \), there exists a \( B \) such that \( BJ_C B^{-1} = J_C \) and \((B^{-1})^T \rho = \mathbf{1} \). Conversely, if for any \( J_C, B \), \( BJ_C B^{-1} = J_C \) and \((B^{-1})^T \mathbf{1} = \mathbf{1} \), it must be that \( B = I_{2n} \).

Note that for \( E_i \in M_O \), then

\[
\begin{pmatrix}
E_1 & E_2 & E_3 & \cdots & E_n \\
0 & E_1 & E_2 & \cdots & E_{n-1} \\
0 & 0 & E_1 & \cdots & \cdot \\
\vdots & \vdots & \vdots & \ddots & E_2 \\
0 & 0 & 0 & \cdots & E_1
\end{pmatrix}
\begin{pmatrix}
F_1 & 0 & 0 & \cdots & 0 \\
F_2 & F_1 & 0 & \cdots & 0 \\
F_3 & F_2 & F_1 & \cdots & 0 \\
\vdots & \vdots & \vdots & \ddots & \cdot \\
F_n & F_{n-1} & F_{n-2} & \cdots & F_1
\end{pmatrix}
\]

for some \( F_i \in M_O \).
Proof: Let $F_i = \begin{pmatrix} \alpha_i & \beta_i \\ -\beta_i & \alpha_i \end{pmatrix}$. Notice that

$$F_i \begin{pmatrix} \rho_{1,1} \\ \rho_{1,2} \end{pmatrix} = \begin{pmatrix} \rho_{1,1} & \rho_{1,2} \\ -\rho_{1,2} & \rho_{1,1} \end{pmatrix} \begin{pmatrix} \alpha_i \\ \beta_i \end{pmatrix}$$

and $\begin{pmatrix} \rho_{1,1} & \rho_{1,2} \\ -\rho_{1,2} & \rho_{1,1} \end{pmatrix} = \rho_{1,1}^2 + \rho_{1,2}^2 \neq 0$, since otherwise the model can be reduced to an $(N-2)$-dimensional model.

It must be that

$$\begin{pmatrix} 1 \\ 1 \end{pmatrix} = \sum_{j=1}^{i} F_j \begin{pmatrix} \rho_{1,2i-2j+1} \\ \rho_{1,2i-2j+2} \end{pmatrix}$$

$$= F_i \begin{pmatrix} \rho_{1,1} \\ \rho_{1,2} \end{pmatrix} + \sum_{j=1}^{i-1} F_j \begin{pmatrix} \rho_{1,2i-2j+1} \\ \rho_{1,2i-2j+2} \end{pmatrix},$$

$$\begin{pmatrix} \rho_{1,1} & \rho_{1,2} \\ -\rho_{1,2} & \rho_{1,1} \end{pmatrix} \begin{pmatrix} \alpha_i \\ \beta_i \end{pmatrix} = \begin{pmatrix} 1 \\ 1 \end{pmatrix} - \sum_{j=1}^{i-1} F_j \begin{pmatrix} \rho_{1,2i-2j+1} \\ \rho_{1,2i-2j+2} \end{pmatrix},$$

$$\begin{pmatrix} \alpha_i \\ \beta_i \end{pmatrix} = \begin{pmatrix} \rho_{1,1} & \rho_{1,2} \\ -\rho_{1,2} & \rho_{1,1} \end{pmatrix}^{-1} \left( \begin{pmatrix} 1 \\ 1 \end{pmatrix} - \sum_{j=1}^{i-1} F_j \begin{pmatrix} \rho_{1,2i-2j+1} \\ \rho_{1,2i-2j+2} \end{pmatrix} \right).$$

Inductively we can construct $(\alpha_i, \beta_i)$, since by assumption the required matrix inverse exists. The uniqueness follows as well.

### 3 Fully Flexible GDTSM

In JSZ, we assume that (i) the eigenvalues under $Q$ are non-zero and (ii) bond yields follow a Markov process. The first assumption is purely for simplicity. When there is a zero eigenvalue, the models take the same form except that the non-stationarity now allows one to include a deterministic time-trend in the short rate within the fully flexible model. This might seem to introduce a new equivalence class of models. In fact, however, by letting $\lambda_1 \to 0^-$ and $r_{\infty}^Q = -\alpha/\lambda_1$ (which will go to $\infty$ as $\lambda_1 \to 0^-$), we see that the 0 eigenvalue model with time trend $\alpha$ can be viewed as the limit of a strictly negative eigenvalue model. With these generalizations, our framework now captures all possible cases of positive, negative, zero, or complex eigenvalues with arbitrary geometric multiplicities.

The non-Markovian case does introduce new issues. For example, we could suppose that
the yield curve is 3-dimensional (i.e., there are 3 factors that are relevant for pricing so that $N^Q = 3$), but that there are additional factors that are relevant for predicting future bond prices (i.e. $N > 3$). Joslin, Priebsch, and Singleton (2010a) make such an assumption. However, they also assume that, although the yield curve alone does not follow a Markov process, when the yield curve is augmented with macro variables the joint process is Markov. More generally, one could augment the GDTSM given by (1–3) in JSZ with macro variables $M_t$ through the expression $M_t = \delta_0 + \delta'_1 X_t$. For a non-degenerate model where the maximal rank of $[B_W, \delta_1]$ is less than the dimension of $X_t$, there will be some factor which predicts future yields and/or macro variables but that is not determined by the current $y_t^o$ and $M_t$. For example, we may have $N^Q = 3$ while $N = 4$ so that there exists a latent factor which predicts future bond returns but is not determined by current bond yields. In the absence of identification through macro variables, such a factor must be filtered. An analog of our main normalization continues to apply, though we no longer have informed priors over all of the parameters. We plan to analyze such models in more detail in future research.

References

