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Understanding Term Premium

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SUMMARY

- Term premium is the extra yield investors demand to hold longer-term bonds rather than repeatedly invest in shorter-term bonds over the same period.
- It compensates investors for longer-term risks and uncertainties, including inflation, Federal Reserve policy and Treasury supply.
- Term premium is estimated using models, so estimates can differ. It is generally easier to isolate in Treasuries than in bonds whose yields also reflect credit, liquidity and other risks.



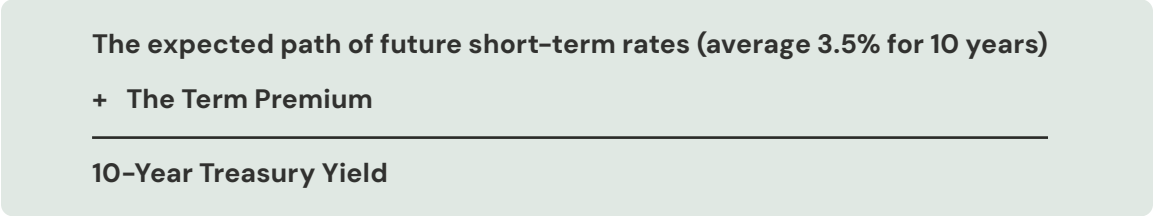
As long-term rates rise, the U.S. Treasury increases long bond buybacks, and uncertainty across a number of fronts increases, we are hearing the phrase term premium spoken of with increasing frequency. It is one of those phrases that sounds precise to professionals but can obscure more than it clarifies for a general audience.

Part of the reason for that ambiguity is that the term premium is estimated based on variables that can change depending on who is calculating it. At its simplest, the term premium is the extra yield investors demand to commit money to a longer-term bond rather than repeatedly investing in shorter-term bonds over the same period.

For example, using illustrative figures, if investors expect short-term interest rates (bonds maturing in one year or less) to average, say, 3.5 percent over the next decade, but the 10-year Treasury yields 4.5 percent, part of that difference can be interpreted as compensation for the risks and uncertainties of locking money up for 10 years.

In this simple example, the 10-year U.S. Treasury bond yield can be thought of as having two broad components:

FIGURE 1: IDENTIFYING THE TERM PREMIUM



For illustrative purposes only. The interest rates shown are hypothetical and may not represent actual market conditions. Term premium is not directly observable, and estimates depend on the model and assumptions used. Actual interest rates and term premiums may differ from those illustrated.

So, the difference between short-term bond yields and, in this case, the 10-year bond's term premium is the amount of yield over and above the expected path of short-term interest rates.

The phrase is most used in connection with Treasuries and government yield curves because Treasuries have generally been considered a "risk-free security", stripping away most credit/default risk. However, Treasury securities remain subject to interest-rate risk, and their market values can fluctuate. Although, removing other risks from consideration is a cleaner way to isolate maturity-related compensation.

But the concept is broader than Treasuries. Investors in corporate, municipal, mortgage, and other long-duration bonds also demand compensation for holding longer maturities. In those markets, however, the observed yield generally includes several premiums at once—credit risk, liquidity risk, optionality, tax effects, and so forth—so term premium is harder to observe separately.

Economists estimate term premium using models. That is one reason you can hear different commentators give different explanations for the same term premium rise in long yields. Commentators may also refer to different parts of the yield curve (e.g. 10-year, 30-year) which can alter the term premium context meaningfully. This gets to the part that often gets lost when someone merely says, "The term premium is changing."

What is that extra investor compensation for? An investor who buys a 30-year Treasury is taking risks that someone holding a three-month Treasury bill is not. Over the course of 30 years: 1) inflation could be higher than expected; 2) the Federal Reserve's (Fed's) future policy path could be very different from current expectations; 3) enormous amounts of new Treasury supply could have to be absorbed; 4) fiscal deficits could remain large; 5) The proportion of price-sensitive holders vs price-insensitive could change; 6) the investor could become stuck holding a lower-yielding bond over a longer period of time after yields rise.

The investor therefore says, in effect: "If you want me to lend you money for 20 or 30 years rather than three months, I want additional compensation for all the things that can go wrong during that time."

That additional compensation is the term premium.

Historically, the term premium has been positive the vast majority of time. In other words, there is usually additional compensation for those risks mentioned above. However, there have been periods of time when there was no additional compensation, term premium was negative. Most recently, the period from June 2016 to August 2024[1] was a length of time when term premium remained negative following global central bank quantitative easing and strong demand from other price-insensitive buyers like pensions and life insurers. A return to historical normalcy in term premium can be positive for investors looking forward although getting here may have been uncomfortable. The return of term premium means bond investors are once again being compensated for many of the risks associated with the duration risk of long-duration bonds, although this additional compensation does not eliminate interest-rate risk or guarantee higher returns.

1. What is the term premium and why has it been negative?; Eco3min; October 20, 2026; https://eco3min.fr/en/qa/term-premium-negative/

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