# Monetary Policy, Segmentation, and the Term Structure*

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**Abstract**

We develop a segmented markets model which rationalizes the effects of monetary policy shocks on the term structure of interest rates. As in the preferred habitat tradition, habitat investors and arbitrageurs trade bonds of various maturities. As in the intermediary asset pricing tradition, the wealth of arbitrageurs is a state variable which affects equilibrium term premia. When arbitrageurs' portfolio features positive duration, an unexpected fall in the short rate revalues wealth in their favor and compresses term premia. A calibration to the U.S. economy accounts for the effects of monetary shocks along the yield curve while simultaneously rationalizing classic evidence on bond return predictability which does not condition on identified shocks.

**JEL codes**: E44, E63, G12

**Keywords**: monetary policy, term structure, segmented markets

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