

Capital Market Expectations, Part I: Framework and Macro Considerations - Questions

Reading 1

Q1.1–Q1.4

Jan Cambo is chief market strategist at a US asset management firm. While preparing a report for the upcoming investment committee meeting, Cambo updates her long-term forecast for US equity returns. As an input into her forecasting model, she uses the following long-term annualized forecasts from the firm's chief economist:

- Labor input will grow 0.5%.
- Labor productivity will grow 1.3%.
- Inflation will be 2.2%.
- Dividend yield will be 2.8%.

Based on these forecasts, Cambo predicts a long-term 9.0% annual equity return in the US market. Her forecast assumes no change in the share of profits in the economy, and she expects some contribution to equity returns from a change in the price-to-earnings ratio (P/E).

At the investment committee meeting, the firm's chief economist predicts that the economy will enter the late expansion phase of the business cycle in the next 12 months.

Cambo compares her business cycle forecasting approach to the approach used by the chief economist. Cambo bases her equity market forecast on a time-series model using a composite index of leading indicators as the key input, whereas the chief economist uses a detailed econometric model to generate his economic forecasts.

Question 1.1

Calculate the implied contribution to Cambo's US equity return forecast from the expected change in the P/E.

Question 1.2

Based on the chief economist's prediction about the economy in the next 12 months, **discuss** the implication for the following:

1. Bond yields
 2. Equity returns
 3. Short-term interest rates
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Question 1.3

Discuss strengths and weaknesses of the economic forecasting approach used by Cambo.

Question 1.4

Discuss strengths and weaknesses of the economic forecasting approach used by the chief economist.

Victoria Drew and David Garnett are currency analysts with Winchester Bank. The two colleagues use a number of different proprietary models to forecast exchange rates for various currency pairs.

While discussing one of her current assignments, Drew tells Garnett that she has decided to use a data series of weekly values for the CHF/EUR exchange rate rather than a data series of monthly values. She justifies this decision on the grounds that she is able to base her analysis of the last three years on 156 data points rather than 36. Garnett offers the following comment: "Compared to a set of monthly observations, a set of weekly observations is more likely to be asynchronous and it does not improve the precision of the sample mean."

For a separate assignment, Drew has been asked to provide a one-year forecast for the EUR/USD exchange rate. After analyzing some newly issued employment data, Drew maintains her target of 0.8293 but revises her range downward from +/-12 pips to +/-8 pips. The consensus target is 0.8290 with a range of 0.8250 to 0.8330.

Garnett mentions that his preferred quantitative model generated a one-year forecast of 1.4155 for the CAD/EUR exchange rate. This result, which was based on 12 months of daily data, was inconsistent with Garnett's prior expectations. He tells Drew that, when he did not get the result that he had been expecting, he responded by running the data through a different model and using its output as a check on his original forecast.

During a discussion of their forecasts for the NZD/USD rate, Garnett shares his latest macroeconomic expectations: "My analysis indicates that, over the next year, real interest rates will rise in New Zealand and fall in the United States."

Question 2.1

Garnett's comment about using higher frequency data is *most likely*:

- A. correct.
 - B. incorrect with respect to asynchrony.
 - C. incorrect with respect to the precision of the sample mean.
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Question 2.2

In revising the range of her EUR/USD forecast, Drew has *most likely* exhibited:

- A. prudence bias.
 - B. status quo bias.
 - C. overconfidence bias.
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Question 2.3

In using the results of an alternative model as a check on his CAD/EUR forecast, Garnett is *most likely*:

- A. assessing the level of model uncertainty.
 - B. exhibiting the influence of data-mining bias.
 - C. attempting to mitigate the impact of nonstationary data.
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Question 2.4

Given his conclusion about real interest rates in the United States, Garnett *most likely* believes that the country's fiscal policy will:

- A.** loosen and nominal interest rates will increase.
- B.** tighten and the trend rate of real GDP growth will fall.
- C.** loosen and the trend rate of real GDP growth will rise.