Economics and Investment Markets - Questions

Reading 1 Q1.1–Q1.4

Sharon Kincaid, a senior manager with High Value Consulting (HVC), has been asked to give a presentation on the fundamental determinants of risk and return for investors in the United Kingdom.

In the first part of her presentation, Kincaid analyzes the determinants of risk premiums and volatility for fixed-income securities that carry default risk. She gives the example of a one-year, zero-coupon bond issued by a corporation based in the United Kingdom and currently trading at GBP 93.56 per 100 par value.

Kincaid notes that the one-year real risk-free rate is currently 1.5% and inflation is expected to be 2.0% over the next year. She estimates that investors require 75 basis points as compensation for inflation uncertainty.

Later in her presentation, Kincaid shares her expectation that, over the next decade, the UK economy will experience average annual economic growth that matches the long-term trend rate. However, she forecasts an increase in the volatility of economic growth.

Question 1.1

The credit premium for the UK corporate bond is *closest* to:

A. 1.88%.

B. 2.63%.

C. 3.38%.

Question 1.2

Per 100 of par value, the difference between the price of the UK corporate bond and a one-year, zero-coupon nominal bond issued by the UK government is *closest* to:

A. GBP 2.19.

B. GBP 2.36.

C. GBP 3.05.

Question 1.3

The breakeven rate of inflation in the UK is *most likely*:

A. 2.00%.

B. 2.75%.

C. 3.50%.

Question 1.4

If Kincaid's forecast for the UK economy is accurate, the country's default-free interest rates will *most likely*:

A. increase.

B. decrease.

C. remain unchanged.

Reading 2 Q2.1–Q2.4

The Mayfair University Foundation's trustees are considering investment opportunities in each of the following countries:

- Country A has a large and developed economy that is not overly reliant on any single sector. GDP growth has been steady over the last three decades. The nominal yields on the country's latest sovereign bond issues are 3.5% for the 5-year maturity (Bond X) and 4.2% for the 20-year maturity (Bond Y).
- Country B has a developing economy that has been able to maintain relatively stable growth rates even as it has increasingly moved toward convergence with developed country levels of GDP on a per capita basis.
- Country C has a rapidly emerging economy that has experienced relatively high levels of volatility as foreign investment has increased significantly in the decade since the last remaining restrictions on capital flows were removed.

Question 2.1

Which country *most likely* has the highest real interest rates?

A. Country A

B. Country B

C. Country C

Question 2.2

Which country *most likely* has the lowest marginal product of capital?

A. Country A

B. Country B

C. Country C

Question 2.3

The *most* accurate interpretation of Country A's upward-sloping yield curve is that investors:

A. may be expecting interest rates to fall.

B. must be expecting interest rates to rise.

C. must be expecting interest rates to rise and require risk premiums that are positively related to maturity.

Question 2.4

Compared to the total return on Bond Y, Bond X's total return is *most likely*:

A. less negatively correlated with Country A's GDP growth.

B. more positively correlated with Country A's GDP growth.

C. more negatively correlated with Country A's GDP growth.