Study Questions No. 2 (January 21, 2010)
Economics 130
Winter 2011

These key terms and questions are designed to help you in your understanding of the material covered in class and in the textbook.

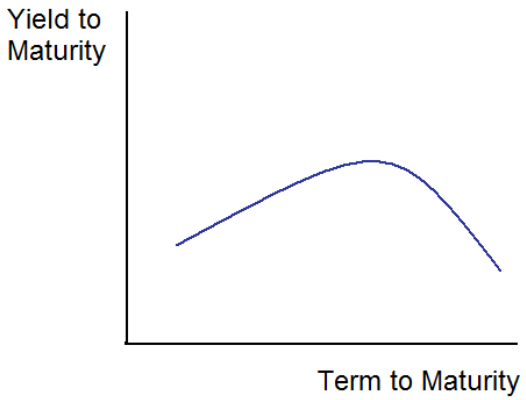
Key terms:

Expectations theory of interest rates
Liquidity Premium theory of interest rates
Segmented markets theory
Yield curve
Inverted yield curve
Risk structure of interest rates
Term structure of interest rates
Risk premium
Adaptive expectations
Rational expectations
Efficient markets theory
Generalized dividend model of asset valuation
Gordon growth model of asset valuation
Optimal forecast

Questions:

1. Which should have the higher risk premium on its interest rates, a corporate bond with a Moody's Baa rating or a corporate bond with a C rating? Why?
2. Risk premiums on corporate bonds are usually anticyclical; that is, they decrease during business cycle expansions and increase during recessions. Why is this so?
3. If yield curves, on average, were flat, what would this say about the liquidity (term) premiums in the term structure? Would you be more or less willing to accept the expectations theory?
4. Assuming that the expectations theory is the correct theory of the term structure, calculate the interest rates in the term structure for maturities of one to five years, and plot the resulting yield curves for the following series of one-year interest rates over the next five years:
    a. 5%, 7%, 7%, 7%, 7%
    b. 5%, 4%, 4%, 4%, 4%

    How would your yield curve change if people preferred shorter-term bonds over longer-term bonds?
5. If a yield curve looks like the one shown in the figure below, what is the market predicting about the movement of future short-term interest rates? What might the yield curve indicate about the market's predictions for the inflation rate in the future?



6. What effect would reducing income tax rates have on the interest rates of municipal bonds? Would interest rates of Treasury securities be affected, and if so, how?
7. Compute the price of a share of stock that pays a $1 per year dividend and that you expect to be able to sell in one year for $20, assuming you require a 15% return.
8. After careful analysis, you have determined that a firm's dividend should grow at 7% on average in the foreseeable future. The firm's last dividend was $3. Compute the current price of this stock, assuming the required return is 18%.
9. "Forecasters' predictions of inflation are notoriously inaccurate, so their expectations of inflation cannot be rational." If this statement true, false, or uncertain? Explain your answer.
10. "If stock prices did not follow a random walk, there would be unexploited profit opportunities in the market." Is this statement true, false, or uncertain? Explain your answer
11. If the public expects a corporation to lose $5 per share this quarter and it actually loses $4, which is still the largest loss in the history of the company, what does the efficient market hypothesis say will happen to the price of the stock when the $4 loss is announced?
12. If you read in the *Wall Street Journal* that the "smart money" on Wall Street expect stock prices to fall, should you follow that lead and sell all your stocks?
13. Can a person with rational expectations expect the price of a share of Google to rise by 10% in the next month?
14. How might behavioral finance explain bubbles and crashes in stock markets?
15. Why is the Generalized Dividend Growth Model difficult to test? Why might it be consistent with virtually every rise of fall in stock prices?
16. What are the three "important empirical facts" about the term structure of interest rates?
17. The yield curve in 1981 was inverted and in 2011 it is upward sloping. What does this imply about the future short term interest rates? How are these two different yield curves related to monetary policy?