Question 1
L2R13TB-AC019-1512
LOS: LOS-6430
Lesson Reference: Lesson 2: The Yield Curve and the Business Cycle
Difficulty: medium

Given the following table, an analyst is asked to evaluate the direction of the domestic exchange rate relative to the country's largest trading partner based on their central banks' policy actions. The analyst decides to model the exchange rate movements based on the Taylor rule.

Data from the Central Banks

	Domestic	Foreign
Current policy rate	2.00%	3.50%
Neutral real policy rate	2.50%	2.50%
Current inflation rate	0.00%	1.50%
Target inflation rate	2.00%	2.50%
Current output gap	1.00%	–0.50%

Assuming that the inflation mandate is weighted at 0.75 and the output mandate is weighted at 0.25, the *most likely* effect of monetary policy on the exchange rate is:

- (selected) a depreciation of the domestic currency.
- an appreciation of the domestic currency.
- no change in the domestic exchange rate.

Rationale

a depreciation of the domestic currency.

Use the Taylor rule to estimate the target interest rates for the domestic and foreign countries.

$$I = r_n + \pi + \alpha(\pi - \pi^*) + \beta(y + y^*)$$
$$I_d = 2.50 + 0.00 + 0.75(0.00 - 2.00) + 0.25(1.00) = 1.25\%$$
$$I_f = 2.50 + 1.50 + 0.75(1.50 - 2.50) + 0.25(-0.50) = 3.13\%$$
$$\Delta I_d - \Delta I_f = (1.25 - 2.00) - (3.13 - 3.50) = -0.375$$

Since interest rates are expected to fall more in the domestic currency than in the foreign currency, capital will be expected to flow out of the domestic economy and into the foreign economy. The lower demand will put downward pressure on the domestic currency, thus causing it to depreciate against the foreign currency.

Rationale

❌ **an appreciation of the domestic currency.**

Use the Taylor rule to estimate the target interest rates for the domestic and foreign countries.

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Rationale

❌ **no change in the domestic exchange rate.**

Use the Taylor rule to estimate the target interest rates for the domestic and foreign countries.

$$I = r_n + \pi + \alpha(\pi - \pi^*) + \beta(y + y^*)$$
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Question 2
L2EC-PQ5504-1511
LOS: LOS-10860
Lesson Reference: Lesson 2: The Yield Curve and the Business Cycle
Difficulty: medium
If the term structure of interest rates (slope) is positive, this means the shape of the yield curve is:

- (selected) Upward sloping.
- Flat.
- Downward sloping.

Rationale

This Answer is Correct

A positive slope for the term structure of interest rates means the yield curve is positively (or upwardly) sloped.

Question 3
L2EC-PQ5506-1511
LOS: LOS-10880
Lesson Reference: Lesson 3: Credit Premiums and the Business Cycle
Difficulty: medium
At the later stages of a recession, credit spreads relative to Treasuries are likely to:

- ○ Go up.
- ○ Stay flat.
- ◉ Go down.

Rationale

This Answer is Correct

After the initial shock of a recession when credit spreads expand rapidly, economic conditions stabilize and monetary stimulus usually comes into play, both of which reduce economic uncertainty and increase growth prospects, causing spreads to narrow.

Question 4
L2EC-PQ5502-1511
LOS: LOS-10840
Lesson Reference: Lesson 1: Framework for the Economic Analysis of Financial Markets and the Discount Rate on Real Risk-Free Bonds
Difficulty: medium
If the consensus earnings per share estimate for GYZ stock was $1, but then actual earnings came in at $1.01, the price of GYZ would likely:

- (selected) Go up.
- Stay the same.
- Go down.

Rationale

This Answer is Correct

Investors perceive new information relative to their expectations when determining if news is good or bad. In this instance, expectations were beaten, which would be considered good news to an investor.

Question 5
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LOS: LOS-10950
Lesson Reference: Lesson 5: Commercial Real Estate
Difficulty: medium
If the economy is expected to head into a recession, which source of commercial real estate returns is expected to suffer the most?

- ○ Capitalization rate.
- ○ Returns from income.
- ◉ Returns from property values.

Rationale

This Answer is Correct

Returns from property values are far more volatile to changes in GDP than returns from income. Moreover, capitalization rates are not a fundamental aspect of commercial real estate, but rather a method for valuing properties.

Question 6
L2EC-PQ5501-1511
LOS: LOS-10830
Lesson Reference: Lesson 1: Framework for the Economic Analysis of Financial Markets and the Discount Rate on Real Risk-Free Bonds
Difficulty: medium
If the U.S. gross domestic product (GDP) growth becomes far more volatile than it has been in the past, the discount rate used to value a risky asset would:

- (•) Go up.
- ( ) Stay the same.
- ( ) Go down.

Rationale

This Answer is Correct

Given the asset in question is risky and not default-free, economic volatility would decrease the certainty of future cash flows and investors would require a higher discount rate.

Question 7

L2EC-PQ5510-1511

LOS: LOS-10920

Lesson Reference: Lesson 4: Equities and the Equity Risk Premium

Difficulty: medium

If the PE ratio on the S&P 500 is currently 20 and the economy is expected to grow more quickly going forward, the S&P 500's PE ratio is likely to:

- (x) Go up.
- ( ) Go down.
- ( ) Remain the same.

Rationale

This Answer is Correct

Valuation multiples and economic growth have a direct relationship. As the pace of economic growth increases, valuations should rise.

Question 8

L2EC-PQ5507-1511

LOS: LOS-10890

Lesson Reference: Lesson 3: Credit Premiums and the Business Cycle

Difficulty: medium

An analyst has identified three corporate bonds for potential investment. If the goal is to hold the bond with the least sensitivity to economic recessions, which bond should the analyst choose?

- ○ Bond A (AA rating).
- ◉ Bond B (AAA rating).
- ○ Bond C (BAA rating).

Rationale

This Answer is Correct

The bond with the least sensitivity to an economic recession is the one with the highest credit rating, or in this instance, Bond B with an AAA rating: the highest of the three choices.

Question 9
L2EC-PQ5509-1511
LOS: LOS-10910
Lesson Reference: Lesson 4: Equities and the Equity Risk Premium
Difficulty: medium
Relative to investment grade corporate bonds, the consumption-hedging properties of equities are?

- ○ Higher.
- ○ The same.
- ◉ Lower.

Rationale

This Answer is Correct

During bad economic times, equities have poor consumption-hedging properties and performance relative to investment-grade corporate bonds.