Practice Problems: Asset Prices

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Blanchard / Johnson, Macroeconomics, 6th ed., ch. 15

1 Bonds

1. Explain how the yield curve can be used to estimate interest rate expectations.

2. Would you expect the yield curve to steep or flat in a recession?

   A: A bit of a trick question. It depends on how long investors expect the recession to continue. Towards the end of a recession, investors might expect a recovery soon. That would be accompanied by tighter monetary policy and rising interest rates, which would lead to an upward sloping yield curve.

2 Stocks

1. Explain how a stock price can be derived as the discounted present value of dividends.

2. Redo that derivation with a risk premium. What happens when the risk premium on stocks rises?

3. Imagine the Fed Chair is replaced with someone of questionable inflation fighting credentials. How would that affect stock prices?

   A: Investors expect high interest rates (nominal). Given inflation, that would depress stock prices. But lose monetary policy leads to a short-run output expansion, which increases stock prices. Higher expected inflation undoes some of the effect of higher nominal interest rates. The net effect is not clear.

A missing piece: The market would likely expect higher volatility in the future as the Fed fails to control inflation and then steps on the brakes when things get out of hand. A negative for stock prices.