Question #1 of 20

Question ID: 1577672

Calculate the short-term interest rate target given the following information.

Neutral rate	4%
Inflation target	2%
Expected inflation	4%
GDP long-term trend	3%
Expected GDP	5%

A) 10%.

B) 8%.

C) 6%.

Explanation

$$\begin{aligned} \mathrm{n_{target}} &= 4.0\% + 4.0\% + [0.5 \times (5\% - 3\%) + 0.5 \times (4\% - 2\%)] \\ &= 8.0\% + [1.0\% + 1.0\%] = 10.0\% \end{aligned}$$

The higher-than-targeted growth and higher-than-targeted inflation argue for a targeted interest rate of 10%. This rate hike is intended to slow the economy and inflation.

(Module 1.4, LOS 1.h)

Question #2 of 20

Question ID: 1551545

An analyst has accurately estimated a real growth rate of 3% in his discounted cash flow model by examining the growth of the economy. Population growth is expected to be 1%, labor force participation is expected to grow by 0.5% and capital expenditures are expected to grow by 1%. Which of the following *best* describes the analyst's estimate of growth? The analyst:

A) is anticipating technological progress.

B) is forecasting unrealistic growth.

C) has not accounted for inflation in the forecast.

Explanation

Total factor productivity, such as technological progress, can reasonably explain the differential between the inputs to economic growth and the analyst's growth rate in the discounted cash flow model. (Inflation is not a concern since the analyst is working with real numbers.)

(Module 1.2, LOS 1.d)

Question #3 of 20

Question ID: 1577661

To forecast equity returns, an analyst examines historical returns from several countries. However, a few of the countries previously in the database were removed due to political changes. The problem represented here is *best* described as:

A) ex post/ex ante dissonance. ✗

B) nonstationary data. ✗

C) survivorship bias. ✓

Explanation

The removed countries experiencing political changes likely had low equity returns compared to the remaining countries. Therefore, the database might bias the return on equity markets as a result of including only the survivors. Ex post/ex ante dissonance would not be the best answer because there is no ex post data for the countries removed. Nonstationary data is an inappropriate answer because the data was not just potentially different, but it was dropped from the database entirely.

(Module 1.1, LOS 1.b)

Xavier Fellows works in the research department of Multinational, Inc. (Multinational), a large investment bank. He is tasked with forecasting economic conditions to support the bank's money managers and traders.

Fellows takes his work seriously and is considered to be an excellent forecaster. His economic forecasts are updated monthly and sent to most of Multinational's analysts and money managers. The analysts use Fellows's forecasts as the basis for their own research on specific securities or asset classes.

However, Fellows is concerned that his forecasts are not accurate enough. In an effort to avoid making mistakes, Fellows follows a detailed process to develop accurate and usable forecasts.

Fellows hopes that this process will help him avoid some of the common problems of forecasts. Here is his system:

1. Establish a benchmark for market expectations. Multinational serves thousands of clients with different investment goals and constraints, and Fellows knows that analysts will need the different benchmarks for various different types of investors.
2. Look at the historical returns of numerous asset classes to act as a check on forecasts for each asset class.
3. Assemble data on historical returns and valuations for all relevant asset classes, considering potential biases, adjusting the numbers to account for different calculation methods, and ensuring that data definitions match those used by the company that collected the data.
4. Interpret the data. Fellows uses his years of experience to extrapolate that data into growth and valuation assumptions for each asset class. This step is the most subjective.
5. Distill assumptions into top-down forecasts, detailing the assumptions and methods for interpreting historical data in the event that individual analysts want to use data to create their own industry-specific forecasts.
6. Monitor performance. If Fellows's forecasts prove to be inaccurate, he works to improve his models.

This month's forecast dwells heavily on inflation projections and their expected effect on the returns of different asset classes. Fellows projects a decline in inflation and predicts that bond yields have bottomed out.

Question #4 - 6 of 20

Question ID: 1551561

Fellows skipped a step in his technique for producing forecasts. He forgot to:

A) identify a valuation model used in his analysis. ✔

B) identify where he obtained his data. ✘

C) assure that the underlying data is accurate. ✘

Explanation

Fellows's plan mirrors the seven-step process for formulating capital market expectations in every aspect except one: identifying the valuation model used in the analysis. Assuring the accuracy of data and identifying its source are important, but they would presumably fall under Step 3 and Step 5 of Fellows's process.

(Module 1.1, LOS 1.a)

Question #5 - 6 of 20

Question ID: 1551562

Due to the decline in inflation and the low bond yields, Fellows should conclude that the economy is *most likely* in what stage of the business cycle?

A) Late expansion.

B) Initial recovery.

C) Slowdown.

Explanation

In general, inflation rises in the latter stages of an expansion and falls during a recession and initial recovery. Bond yields peak during a slowdown and fall during a recession; however, they bottom out during the initial recovery stage.

(Module 1.3, LOS 1.f)

Question #6 - 6 of 20

Question ID: 1551563

Which of the following is *least accurate* regarding inflation?

A) Highly levered firms are most affected by declining inflation rates.

B) Declining inflation results in declining economic growth and asset prices.

C) Low inflation affects the return on cash instruments.

Explanation

Low inflation can be beneficial for equities if there are prospects for economic growth free of central bank interference. Declining inflation usually results in declining economic growth and asset prices. The firms most affected are those that are highly levered because they are most sensitive to changing interest rates. Low inflation does not affect the return on cash instruments.

(Module 1.3, LOS 1.g)

Question #7 of 20

Question ID: 1577679

Which of the following is consistent with a likely weak economy in the future?

A) Monetary policy is restrictive, while fiscal policy is expansive.

B) Monetary policy is restrictive, and fiscal policy is restrictive.

C) Monetary policy is expansive, and fiscal policy is expansive.

Explanation

When both fiscal and monetary policies are restrictive, the yield curve is downward sloping (i.e., it is inverted as short-term rates are higher than long-term rates), and the economy is likely to contract in the future.

(Module 1.4, LOS 1.i)

Question #8 of 20

Question ID: 1577675

Which of the following regarding the use of monetary policy to stimulate growth or rein in inflation in an economy is *most accurate*?

A) Neither the direction of a change in interest rates nor the level of interest rates is important.

B) Only the direction of a change in interest rates is important.

C) Both the direction of a change in interest rates and the level of interest rates are important.

Explanation

Both the direction of a change in interest rates and the level of interest rates are important. If, for example, rates are increased to 4% to combat inflation but this is still low compared to the neutral rate of 6% in a country, then this rate may still be low enough to allow growth and inflation to continue.

(Module 1.4, LOS 1.h)

Question #9 of 20

Question ID: 1551544

Which of the following is *least likely* to be considered an exogenous shock?

A) Discovery of a new natural resource to be used in production.

B) Political tensions arising between two neighboring countries.

C) Strong economic recovery following a slow recession.

Explanation

Normal business cycle activity is not considered exogenous since the activity is built into asset prices. The other items are considered exogenous in that they arise outside of the normal economic cycle.

(Module 1.2, LOS 1.c)

Question #10 of 20

Question ID: 1577667

In the early expansion phase of the business cycle, stock prices are:

A) stagnant, as they are in the later stages of an expansion.

B) rising at a faster rate than they are in the later stages of an expansion.

C) rising at a slower rate than they are in the later stages of an expansion.

Explanation

In the early expansion phase of the business cycle, stock prices are increasing. This is due to the fact that sales are increasing, but input costs will be fairly stable. Labor will not ask for wage increases because unemployment is still high. Idle plant and equipment will be pushed into service at little cost. Further, firms usually emerge from recession leaner because they have shed their wasteful projects and excessive spending. Later on in the expansion, the growth in earnings and stock returns slows because input costs start to increase. Interest rates will also increase during late expansion, which is a further negative for stock valuation.

(Module 1.3, LOS 1.f)

Question #11 of 20

Question ID: 1577668

During an economic recession, which of the following items will increase?

A) Bond prices.

B) Inflation.

C) Interest rates.

Explanation

Bond prices increase during a recession as inflation decreases and interest rates decline (this causes bond prices to increase because they are inversely related to the change in interest rates).

(Module 1.3, LOS 1.f)

Question #12 of 20

Question ID: 1551546

When using economic indicators, examining the number of indicators increasing versus decreasing in a composite is *most accurately* referred to as a:

A) diffusion index.

B) checklist assessment.

C) lagging indicator.

Explanation

Diffusion indices provide a check on economic indicators by quantifying the number of increasing components in the composite indicator versus decreasing. Lagging economic indicators reflect recent past economic activity. Checklist assessments consider a wide range of economic data to assess an economy's future position.

(Module 1.2, LOS 1.e)

Question #13 of 20

Question ID: 1551556

During the initial recovery phase of the business cycle, which of the following items will be increasing?

A) Stock prices.

B) Short-term interest rates.

C) Bond yields.

Explanation

Stock prices generally increase in the initial recovery phase of the business cycle as the economy goes into an expansion. However, bond yields and short-term interest rates are still very low.

(Module 1.3, LOS 1.f)

Question #14 of 20

Question ID: 1551557

Which phase of the business cycle is characterized by rising stock prices but increased investor nervousness?

A) Slowdown.

B) Late expansion.

C) Initial recovery.

Explanation

The late expansion phase of the business cycle is characterized by high confidence and employment, increases in inflation, rising bond yields, and rising stock prices. Investor nervousness increases risk during this period. The central bank also limits the growth of the money supply.

(Module 1.3, LOS 1.f)

Question #15 of 20

Question ID: 1577666

Which of the following descriptions is *most likely* to be a characteristic of econometric models as used in economic forecasting? Econometrics:

A) may provide reasonably reliable output.

B) may be able to forecast turning points accurately.

C) may be relatively easy and efficient to develop with the right inputs.

Explanation

The econometric models approach can result in models that are quite reliable, which include numerous variables that mimic real-life conditions.

The economic models approach is more likely to result in models that are complicated and time intensive to create. It very infrequently predicts turning points with accuracy.

(Module 1.2, LOS 1.e)

Maggie Schadler is an emerging market analyst for Hunt Asset Management (HAM). HAM uses economic growth analysis when formulating capital market expectations for its individual and institutional clients' portfolios. Shu Xu is her research assistant and is a graduate student in finance.

One of the countries Schadler is investigating is the emerging market of Pirata. With its stock returns of 19% last year, Pirata has attracted much investor interest. As a result, Schadler is forecasting its stock returns over the next year for HAM's clients. Until a few years ago, Pirata had low levels of technology applied to its capital and labor. Increasingly, however, its use of technology has expanded, and productivity has increased with GDP growth peaking in the first quarter of last year at 7.2%, on an annual basis. Further, foreign capital inflows into Pirata's stock market doubled last year due in part to government reforms that made the investment climate more favorable.

To forecast the future economic growth of the markets that HAM currently recommends, Xu uses a structural model based on economic theory that uses several variables from each market, including fundamental valuations, currency values, central bank interest rates, past GDP growth, and government spending. In their annual review of current operations, Xu asks Schadler to critique his forecasting approach and suggest alternatives for consideration. Schadler states that the advantage of Xu's structural model is that it can incorporate many input variables and can be reused once it has been established. However, Schadler describes how Xu's approach can be complex and time-consuming to construct.

Schadler offers an alternative economic forecasting approach to Xu, which is simpler and has data inputs that are often readily available from third parties. She explains that using this approach, a diffusion index can be created to predict turning points in an economy—and that this approach can be tailored to meet specific forecasting needs.

Schadler asks Xu to investigate the emerging market of Kingsland because several HAM clients have expressed an interest in investing there. Xu researches the business cycle of Kingsland to determine its attractiveness as an investment. Xu states that he believes it is likely that Kingsland is in an economic slowdown because slowdowns are characterized by inflation that is rising, declining business confidence, and low short-term interest rates. Schadler replies that Xu has misstated one of the characteristics of an economic slowdown.

Question #16 - 19 of 20

Question ID: 1562883

Using only the provided analysis, Schadler's forecasted stock returns for Pirata over the next year should *most likely* be:

A) less than last year’s return. ✓

B) approximately the same as last year’s return.

C) more than last year’s return.

Explanation

High rates of growth in capital investment and economic growth are not necessarily linked to favorable equity returns. This may be the case if growth rates are already factored into equity prices. Pirata's stock returns were 19% last year, and it has attracted much investor interest. GDP growth is apparently slowing, as it peaked in the first quarter of last year. Thus, it is likely that Pirata's strong past growth rates are already factored into its equity prices and that Schadler's forecasted stock returns should be less than last year's 19%.

Further, because the growth rate of capital last year was 100% (it doubled) and is faster than the rate of economic growth (7.2% last year and declining), the return on capital may decrease. Thus, using only the provided analysis, the forecasted stock returns for Pirata over the next year should likely be less than last year's 19%.

(Module 1.2, LOS 1.d)

Question #17 - 19 of 20

Question ID: 1562884

Xu's economic forecasting approach is *best* described as:

A) a checklist approach.

B) an economic indicators approach.

C) an econometric modeling approach.

Explanation

One form of the econometric modeling approach for economic forecasting is the structural model, which is based on economic theory. The econometric modeling approach can incorporate many input variables and can be reused once it has been established. However, it can be complex and time-consuming to construct.

(Module 1.2, LOS 1.e)

Question #18 - 19 of 20

Question ID: 1562885

A disadvantage of Schadler's alternative forecasting approach is *most likely* that it can:

A) be difficult to interpret.

B) appear to forecast better than it actually did.

C) only be used with one input variable at a time.

Explanation

One form of the economic indicators approach is the diffusion index, which reflects several indicators. To predict turning points in an economy, the analyst examines if most of the variables forecast a recession or expansion in an economy. The economic indicators approach is easy to interpret and can be tailored to meet specific forecasting needs.

However, a disadvantage of the economic indicators approach is that it can appear to forecast past business cycles better than it actually did when the data were first released because indicators are subsequently revised frequently.

(Module 1.2, LOS 1.e)

Question #19 - 19 of 20

Question ID: 1562886

Xu's characterization of an economic slowdown is *least accurate* regarding:

A) inflation.

B) business confidence.

C) short-term interest rates.

Explanation

Xu states that slowdowns are characterized by inflation that is rising, declining business confidence, and low short-term interest rates.

A slowdown is characterized by, in part, inflation that is still rising as well as declining confidence. However, a slowdown is not characterized by low short-term interest rates, but by short-term interest rates that are at a peak.

(Module 1.3, LOS 1.f)

Question #20 of 20

Question ID: 1577659

Which of the following regarding the formulation of capital market expectations is *least accurate*? An analyst should:

A) investigate assets' historical performance and their determinants. ✗

B) consider the investor's tax status, allowable asset classes, and time horizon. ✗

C) vary his assumptions when interpreting data and drawing conclusions. ✓

Explanation

In the fifth step of the formulation of capital market expectations, the analyst should use a consistent set of assumptions when interpreting data and drawing conclusions.

(Module 1.1, LOS 1.a)