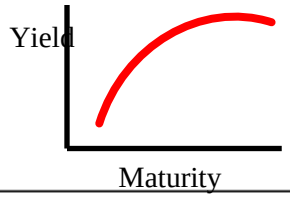
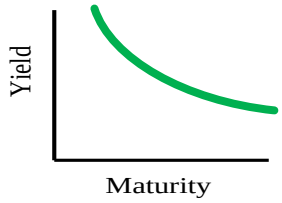
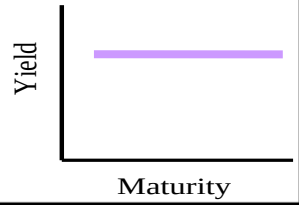
Name…… ID……

FN 211: Practice Questions

(Yield Curve)

1. Use the 3 theories of Term Structure to explain the following yield curves.

	Pure Expectation	Liquidity Preference	Market Segmentation
	Investors expect ST rates will rise.	Investors expect ST rates will rise or not change but premium increase with maturity fast enough.	Demand > Supply for ST bonds Supply > Demand for LT bonds
	Investors expect ST rates will fall.	Investors expect ST rates will fall.	Supply > Demand for ST bonds Demand > Supply for LT bonds
	Investors expect ST rates will not change.	Investors expect ST rates will fall.	Supply and Demand for both ST and LT bonds are in equilibrium.

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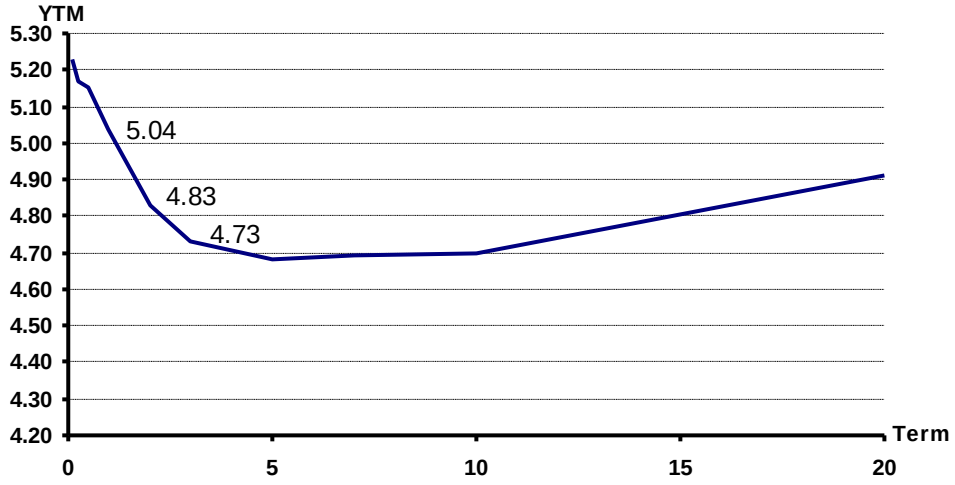
2. Use the term structure (or yield curve) below to answer the following 3 questions.



(a) DISCUSS how the unbiased expectations hypothesis could explain the <u>0 - 5 year maturity segment</u> of the term structure shown above?

The term structure indicates an downward sloping yield curve. The unbiased expectations hypothesis contends that investors are expecting lower short-term rates in the future.

(b) DISCUSS how the liquidity premium view could explain the <u>5 - 20 year maturity segment</u> of the term structure shown above?

The liquidity premium view of the yield curve suggests that there is a bias toward positively-sloped yield curves. This is because longer-term securities tend to have more volatile market prices and hence, greater risk of capital loss. So, investors must be paid an interest rate premium (the liquidity premium) to encourage them to purchase long-term securities.

(c) As seen from the term structure above, the 1-, 2-, and 3-year maturity yields are 5.04%, 4.83% and 4.73% respectively. Based on the unbiased expectation hypothesis, DETERMINE one-year interest rate today, expected one-year interest rate one year from today and expected one-year interest rate two years from today.

One-year interest rate today is 5.04%
The expected one-year interest rate one year from today is

$(1.0483)^2 = (1.0504)(1 + x)$
$1.0462 = 1 + x$
$X = 4.62\%$

The expected one-year interest rate two years from today is

$(1.0473)^3 = (1.0504)(1.0462)(1 + y)$
$1.1487 = (1.0989)(1 + y)$
$1.0453 = 1 + y$
$Y = 4.53\%$