Review Category Capital Market Expectations

Done Reviewing

Correct

Correct Answer	Your Answe
A	
B	
C	✓

Confidence Level:
Not Selected

Time Spent:
1 min 14 secs

Difficulty Level:
Moderate

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Ptolemy Foundation Case Scenario

The Ptolemy Foundation was established to provide financial assistance for education in the field of astronomy. Tom Fiske, the foundation's chief investment officer, and his staff of three analysts use a top-down process that begins with an economic forecast, assignment of asset class weights, and selection of appropriate index funds. The team meets once a week to discuss a variety of topics ranging from economic modeling, economic outlook, portfolio performance, and investment opportunities, including those in emerging markets.

At the start of the meeting, Fiske asks the analysts, Len Tuoc, Kim Spenser, and Pier Poulsen, to describe and justify their different approaches to economic forecasting. They reply as follows.

> Tuoc: I prefer econometric modeling. Robust models built with detailed regression analysis can help predict recessions well because the established relationships among the variables seldom change.
> Spenser: I like the economic indicators approach. For example, the composite of leading economic indicators is based on an analysis of its forecasting usefulness in past cycles. They are intuitive, simple to construct, require only a limited number of variables, and third-party versions are also available.
> Poulsen: The checklist approach is my choice. This straightforward approach considers the widest range of data. Using a simple statistical method, such as time-series analysis, an analyst can quickly assess which measures are extreme. This approach relies less on subjectivity and is less time-consuming.

The analysts think that adding to US Treasuries would fit portfolio objectives, but they are concerned that the US Federal Reserve Board is likely to raise the fed funds rate soon. They assemble the data in Exhibit 1 in order to use the Taylor rule (giving equal weights to inflation and output gaps) to help predict the Fed's next move with respect to interest rates.

Exhibit 1

Current Data and Forecasts from the Fed

Statistic	Status	Value (%)
Fed funds rate	Current	3
	Neutral	2.5

[redacted]

Inflation	Target	2.5
	Forecast	3.2

To assess the attractiveness of emerging market equities, Fiske suggests that they use the data in Exhibit 2 and determine the expected return of small-cap emerging market equities using the Singer–Terhaar approach.

Exhibit 2

Data for Analyzing Emerging Markets

Asset Class	Standard Deviation	Correlation with GIM	Degree of Integration with GIM
Emerging small-cap equity	23%	0.85	65%
Global investable market (GIM)	7.00%		
Additional information			
Risk-free rate: 2.5%			
Illiquidity premium: 60 bps			
Sharpe ratio for GIM and emerging small-cap equity: 0.31			

Finally, after examining data pertaining to the European equity markets, the investment team believes that there are attractive investment opportunities in selected countries. Specifically, they compare the recent economic data with long-term average trends in three different countries, shown in Exhibit 3.

Exhibit 3

Relationship of Current Economic Data to Historical Trends: Selected European Countries

	Ireland	Spain	Hungary
Output gap	Above trend	Closing	Well above trend
Money market rates	Moving up at accelerated pace	Above average and rising	Bottoming, expecting to rise over short horizon
Other	Housing demand strong	Boom mentality	Confidence rising
Fiscal/monetary policies	Removing stimulus	Restrictive	Stimulative

Correct

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A	
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[redacted]

B. 2.6%.

C. 2.1%.

Correct

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A	
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Solution

C is correct. The Taylor rule is

$$R_{optimal} = R_{neutral} + [0.5 \times (GDPg_{forecast} - GDPg_{trend})] + [0.5 \times (I_{forecast} - I_{target})]$$

$$= 2.5 + [0.5 \times (3.0 - 4.5)] + [0.5 \times (3.2 - 2.5)]$$

$$= 2.5 - 0.75 + 0.35$$

$$= 2.10\%$$

A is incorrect. It incorrectly reversed the terms within the parentheses:

$$2.5 + [0.5 \times (4.5 - 3.0)] + [0.5 \times (2.5 - 3.2)] = 2.5 + 0.75 - 0.35 = 2.9$$

B is incorrect. It incorrectly uses the current rate of 3.0 for the first term instead of the neutral rate of 2.5%.

Capital Market Expectations, Part 1: Framework and Macro Considerations Learning Outcome

h. Discuss the effects of monetary and fiscal policy on business cycles

Discuss Filter

Discussion

CJ How hard is it to fix these mistakes that have plagued the curriculum for half a decade? Could the CFA Institute at least clarify if they want us to add expected inflation to the Taylor Rule equation on test day or should we just ignore target inflation like the answer bank implies? How the hell did the CFA Institute earn this platinum reputation in our industry when their curriculum is plagued with errors, typos, and inconsistencies that are continually brought to their attention, yet are simply ignored? Let us reflect on the amount of money that we have sunk into their war chest, the sheer amount of personal sacrifices we have had to endure to participate in this sadomasochistic dog and pony show, and the hundreds if not thousands of hours we have put into memorizing their dogmatic platitudes...we deserve better than this.

Tags: error, incorrect, cfainstitute, plzfix, wtf

1 reply | Last Activity: 10 days ago

Created a month ago by Christopher John Shackleton

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MD Why they did not add the expeced inflation rate?

[redacted]

correct answer is 5.3%.

Created 3 months ago by Szymon Franciszek Hennel 1 reply | Last Activity: 2 months ago

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EE Incorrectly refers to exhibit 3 instead of 1.

Tags: error 1 reply | Last Activity: 4 months ago

Created 4 months ago by engincan çelikyürekli

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ST not the data in the Exhibit 3, but in the Exhibit 1 - pls correct.

Tags: error 0 replies | Last Activity: 9 months ago

Created 9 months ago by Sofia Tynska

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[redacted]