MULTIPLE CHOICE. Choose the one alternative that best completes the statement or answers the question.

1) Default risk is the risk that
   A) a bond issuer is unable to make interest payments.
   B) a bond issuer is unable to make a profit.
   C) a bond issuer is unable to pay the face value at maturity.
   D) all of the above.
   E) both A and C above.

2) The spread between the interest rates on default-free bonds and those with a positive default risk is called the
   A) junk premium. B) capitalized risk. C) default premium. D) risk premium.

3) Other things being equal, an increase in the default risk of corporate bonds shifts the demand curve for corporate bonds to the _____ and the demand curve for Treasury bonds to the _____.
   A) left; left B) left; right C) right; right D) right; left

4) An increase in the riskiness of corporate bonds will _____ the yield on corporate bonds and _____ the yield on Treasury securities.
   A) increase; reduce
   B) reduce; reduce
   C) increase; not affect
   D) reduce; increase
   E) increase; increase

5) Bonds with relatively low risk of default are called
   A) investment grade bonds. B) junk bonds.
   C) zero coupon bonds. D) none of the above.

6) Which of the following statements are true?
   A) A corporate bond's return becomes more uncertain as default risk increases.
   B) An increase in default risk on corporate bonds lowers the demand for these bonds, but increases the demand for default-free bonds.
   C) As their relative riskiness increases, the expected return on corporate bonds decreases relative to the expected return on default-free bonds.
   D) The expected return on corporate bonds decreases as default risk increases.
   E) All of the above are true statements.

7) An increase in the liquidity of corporate bonds will _____ the price of corporate bonds and _____ the yield of Treasury bonds.
   A) reduce; increase
   B) increase; reduce
   C) increase; not affect
   D) reduce; reduce
   E) increase; increase

8) An increase in marginal tax rates would likely have the effect of _____ the demand for municipal bonds, and _____ the demand for U.S. government bonds.

A) decreasing; increasing
B) decreasing; decreasing
C) increasing; increasing
D) increasing; decreasing

9) Interest rates on bonds of the same maturity will differ because of differences in

A) liquidity.
B) risk.
C) income tax treatment.
D) all of the above.
E) only A and B of the above.

10) According to the expectations theory of the term structure

A) interest rates on bonds of different maturities move together over time.
B) buyers of bonds do not prefer bonds of one maturity over another.
C) the interest rate on long-term bonds will equal an average of short-term interest rates that people expect to occur over the life of the long-term bonds.
D) all of the above.
E) only A and B of the above.

11) If the expected path of one-year interest rates over the next five years is 4 percent, 5 percent, 7 percent, 8 percent, and 6 percent, then the expectations theory predicts that today's interest rate on the five-year bond is

A) 8 percent.
B) 5 percent.
C) 4 percent.
D) 7 percent.
E) 6 percent.

12) If the expected path of 1-year interest rates over the next four years is 5 percent, 4 percent, 2 percent, and 1 percent, then the expectations theory predicts that today's interest rate on the four-year bond is

A) 5 percent.
B) 4 percent.
C) 1 percent.
D) 2 percent.
E) 3 percent.

13) According to the segmented markets theory of the term structure

A) buyers of bonds do not prefer bonds of one maturity over another.
B) the interest rate on long-term bonds will equal an average of short-term interest rates that people expect to occur over the life of the long-term bonds.
C) interest rates on bonds of different maturities do not move together over time.
D) all of the above.

14) The liquidity premium theory of the term structure

A) suggests that markets for bonds of different maturities are completely separate because people have preferred habitats.
B) indicates that today's long-term interest rate equals the average of short-term interest rates that people expect to occur over the life of the long-term bond.
C) assumes that bonds of different maturities are perfect substitutes.
D) does none of the above.

15) If 1-year interest rates for the next three years are expected to be 4, 2, and 3 percent, and the 3-year term premium is 1 percent, than the 3-year bond rate will be

A) 1 percent.
B) 2 percent.
C) 3 percent.
D) 4 percent.
E) 5 percent.

16) According to the liquidity premium theory of the term structure, a steeply upward sloping yield curve indicates that

A) short–term interest rates are expected to rise in the future.

B) short–term interest rates are expected to remain unchanged in the future.

C) short–term interest rates are expected to decline moderately in the future.

D) short–term interest rates are expected to decline sharply in the future.

17) According to the liquidity premium theory of the term structure, when the yield curve has its usual slope, the market expects

A) short–term interest rates to rise sharply.

B) short–term interest rates to stay near their current levels.

C) short–term interest rates to drop sharply.

D) none of the above.

18) Which of the following theories of the term structure is (are) able to explain all three empirical facts about the term structure?

A) The segmented markets theory

B) The expectations theory

C) The preferred habitat theory

D) All of the above

E) Both A and B of the above

19) When the yield curve slopes down,

A) the expectations theory suggests that short–term interest rates are expected to fall.

B) the segmented markets theory suggests that short–term interest rates are expected to rise

C) the expectations theory suggests that short–term interest rates are expected to rise

D) the liquidity premium theory suggests that short–term interest rates are expected to rise.

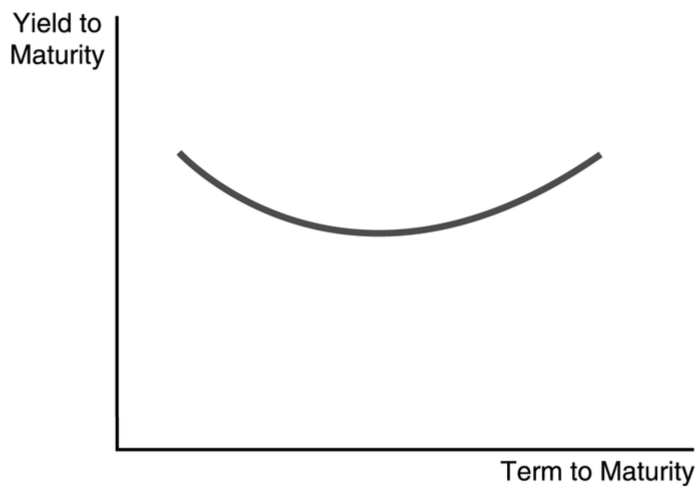

Figure 6–2

20) The U–shaped yield curve in Figure 6–2 indicates that
   A) short–term interest rates are expected to rise in the near term and fall later on.
   B) short–term interest rates are expected to fall moderately in the near–term and rise later on.
   C) short–term interest rates are expected to fall sharply in the near–term and rise later on.
   D) short–term interest rates are expected to remain unchanged in the near–term and rise later on.

21) When short–term interest rates are expected to fall in the future, the yield curve will
   A) be flat.
   B) be an inverted U shape.
   C) have a W shape.
   D) slope up.
   E) be inverted.

22) An increase in default risk on corporate bonds _____ the demand for these bonds, but _____ the demand for default–free bonds.
   A) does not change; greatly increases
   B) lowers; increases
   C) moderately lowers; does not change
   D) increases; lowers

Answer Key
Testname: CHAPTER 6 PQ.TST

1) E
2) D
3) B
4) A
5) A
6) E
7) E
8) D
9) D
10) D
11) E
12) E
13) C
14) D
15) D
16) A
17) B
18) C
19) A
20) C
21) E
22) B