STUDY SESSION

4

Economics for Valuation

This study session builds on the principles of economics from Level I and links them to the valuation process.

The first reading describes theories of exchange rate determination and how these can be used to forecast exchange rates. Analysts and portfolio managers need to evaluate the currency risks faced by the companies they analyze and the portfolios they manage. This reading lays a foundation for understanding management of a portfolio's currency risk.

The second reading describes factors affecting economic growth and how economic growth affects investment decisions and stock market valuation. The final reading in the study session describes regulation, its purposes, and its potential effects on a company's operating environment.

READING ASSIGNMENTS

Reading 13	Currency Exchange Rates: Determination and Forecasting by Michael R. Rosenberg and William A. Barker, CFA
Reading 14	Economic Growth and the Investment Decision by Paul Kutasovic, PhD, CFA
Reading 15	Economics of Regulation by Chester S. Spatt, PhD

LEARNING OUTCOMES

READING 13. CURRENCY EXCHANGE RATES: DETERMINATION AND FORECASTING

The candidate should be able to:

a calculate and interpret the bid–ask spread on a spot or forward foreign currency quotation and describe the factors that affect the bid–offer spread;

b identify a triangular arbitrage opportunity and calculate its profit, given the bid–offer quotations for three currencies;

c distinguish between spot and forward rates and calculate the forward premium/discount for a given currency;

d calculate the mark-to-market value of a forward contract;

e explain international parity relations (covered and uncovered interest rate parity, purchasing power parity, and the international Fisher effect);

f describe relations among the international parity conditions;

g evaluate the use of the current spot rate, the forward rate, purchasing power parity, and uncovered interest parity to forecast future spot exchange rates;

h explain approaches to assessing the long-run fair value of an exchange rate;

i describe the carry trade and its relation to uncovered interest rate parity and calculate the profit from a carry trade;

j explain how flows in the balance of payment accounts affect currency exchange rates;

k describe the Mundell–Fleming model, the monetary approach, and the asset market (portfolio balance) approach to exchange rate determination;

l forecast the direction of the expected change in an exchange rate based on balance of payment, Mundell–Fleming, monetary, and asset market approaches to exchange rate determination;

m explain the potential effects of monetary and fiscal policy on exchange rates;

n describe objectives of central bank intervention and capital controls and describe the effectiveness of intervention and capital controls;

o describe warning signs of a currency crisis;

p describe uses of technical analysis in forecasting exchange rates.

READING 14. ECONOMIC GROWTH AND THE INVESTMENT DECISION

The candidate should be able to:

a compare factors favoring and limiting economic growth in developed and developing economies;

b describe the relation between the long-run rate of stock market appreciation and the sustainable growth rate of the economy;

c explain why potential GDP and its growth rate matter for equity and fixed income investors;

d distinguish between capital deepening investment and technological progress and explain how each affects economic growth and labor productivity;

e forecast potential GDP based on growth accounting relations;

f explain how natural resources affect economic growth and evaluate the argument that limited availability of natural resources constrains economic growth;

g explain how demographics, immigration, and labor force participation affect the rate and sustainability of economic growth;

h explain how investment in physical capital, human capital, and technological development affects economic growth;

i compare classical growth theory, neoclassical growth theory, and endogenous growth theory;

j explain and evaluate convergence hypotheses;

k describe the economic rationale for governments to provide incentives to private investment in technology and knowledge;

l describe the expected impact of removing trade barriers on capital investment and profits, employment and wages, and growth in the economies involved.

READING 15. ECONOMICS OF REGULATION

The candidate should be able to:

a describe classifications of regulations and regulators;

b describe uses of self-regulation in financial markets;

c describe the economic rationale for regulatory intervention;

d describe regulatory interdependencies and their effects;

e describe tools of regulatory intervention in markets;

f explain purposes in regulating commerce and financial markets;

g describe anticompetitive behaviors targeted by antitrust laws globally and evaluate the antitrust risk associated with a given business strategy;

h describe benefits and costs of regulation;

i evaluate how a specific regulation affects an industry, company, or security.