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Question 1

Question Type: MultipleChoice

If the CHF/USD spot rate is 1.1010 and the one year forward is 1.1040, what is the annualized forward premium or discount, and the one year swap rate?

Options:

- A- An annualized forward discount of 30 basis points and a swap rate of 27 points
- B- An annualized forward premium of 30 basis points and a swap rate of 27 points
- C- An annualized forward premium of 27 basis points and a swap rate of 30 points
- D- An annualized forward discount of 27 basis points and a swap rate of 30 points

Answer:

C

Explanation:

If the spot rate is 1.1010 and the forward is 1.1040, the swap rate is 30 'points' ($= 1.1040 - 1.1010$). The annualized swap premium is the swap premium divided by the spot rate, and therefore $= 0.0030 / 1.1010 = 0.27\%$, or 27 basis points.

Question 2

Question Type: MultipleChoice

A currency with a lower interest rate will trade:

Options:

- A- at a forward discount
- B- at a forward premium
- C- at the same prices for forwards as for the spots
- D- cannot be determined solely on the basis of interest rates

Answer:

B

Explanation:

Given covered interest parity, the currency with a lower interest rate will trade at a forward premium. Choice 'b' is the correct answer.

For an intuitive reasoning, consider a currency forward contract that matures in 3 months. The seller has agreed to sell, say JPY 1,000,000 in exchange for USD 10,000 in the future. In order to cover himself, he borrows the USD right now and converts it to JPY at spot which he puts in a JPY deposit. Assuming JPY interest rates are less than USD interest rates, he pays more on his USD borrowing than he receives on his JPY deposit. Therefore he has to price the forward contract at a premium to spot to cover the interest rate differential.

Question 3

Question Type: MultipleChoice

By market convention, which of the following currencies are not quoted in terms of 'direct quotes' versus the USD?

Options:

A- EUR

B- INR

C- KWD

D- CAD

Answer:

A

Explanation:

Remember how exchange rates are generally quoted. Most exchange rates are quoted in terms of how many foreign currencies does USD 1 buy. Therefore, a rate of 99 for the JPY means that USD 1 is equal to JPY 99. These are called 'direct rates'. However, there are four major world currencies where the rate quote convention is the other way round - these are EUR, GBP, AUD and NZD. For these currencies, the FX quote implies how many US dollars can one unit of these currencies buy. So a quote of '1.1023' for the Euro means EUR 1 is equal to USD 1.1023 and not the other way round.

Question 4

Question Type: MultipleChoice

Using covered interest parity, calculate the 3 month CAD/USD forward rate if the spot CAD/USD rate is 1.1239 and the three month interest rates on CAD and USD are 0.75% and 0.4% annually respectively.

Options:

A- 1.1249

B- 1.1229

C- 1.1278

D- 1.1200

Answer:

A

Explanation:

Forward rates can be calculated from spot rates and interest rates using the formula $\text{Spot} \times (1 + \text{domestic interest rate}) / (1 + \text{foreign interest rate})$, where the 'Spot' is expressed as a direct rate (ie as the number of domestic currency units one unit of the foreign currency can buy). In this case the forward rate will be $1.1239 \times (1 + 0.75\% \times 90/360) / (1 + 0.4\% \times 90/360) = 1.1249$.

It can be confusing to determine which interest rate should be considered 'domestic', and which 'foreign' for this formula. For that, look at the spot rate. Think of the spot rate as being x units of one currency equal to 1 unit of the other currency. In this case, think of the spot rate 1.1239 as 'CAD 1.1239 = USD 1'. The currency that has the '1' in it is the 'foreign' and the other one is 'domestic'.

It is also important to remember how exchange rates are generally quoted. Most exchange rates are quoted in terms of how many foreign currencies does USD 1 buy. Therefore, a rate of 99 for the JPY means that USD 1 is equal to JPY 99. These are called 'direct rates'. However, there are four major world currencies where the rate quote convention is the other way round - these are EUR, GBP, AUD and NZD. For these currencies, the FX quote implies how many US dollars can one unit of these currencies buy. So a quote of

'1.1023' for the Euro means EUR 1 is equal to USD 1.1023 and not the other way round.

Question 5

Question Type: MultipleChoice

The gamma in a commodity futures contract is:

Options:

A- zero

B- always negative

C- parabolic

D- dependent upon the convexity

Answer:

A

Explanation:

Futures contracts carry no gamma. Only options have gamma. Choice 'a' is the correct answer. Any instrument whose price varies in a linear fashion with respect to the underlying will have gamma equal to zero.

Question 6

Question Type: MultipleChoice

If the spot price for a commodity is lower than the forward price, the market is said to be in:

Options:

- A-** contango
- B-** backwardation
- C-** a short squeeze
- D-** disequilibrium

Answer:

A

Explanation:

When the forward prices are greater than the spot prices, the market is said to be in contango. When forward prices are lower than spot prices, the market is said to be backwarded. A short squeeze may contribute to backwardation. Choice 'a' is the correct answer.

Question 7

Question Type: MultipleChoice

A currency with a lower interest rate will trade:

Options:

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- B- at a forward premium
- C- at the same prices for forwards as for the spots
- D- cannot be determined solely on the basis of interest rates

Answer:

B

Explanation:

Given covered interest parity, the currency with a lower interest rate will trade at a forward premium. Choice 'b' is the correct answer.

For an intuitive reasoning, consider a currency forward contract that matures in 3 months. The seller has agreed to sell, say JPY 1,000,000 in exchange for USD 10,000 in the future. In order to cover himself, he borrows the USD right now and converts it to JPY at spot which he puts in a JPY deposit. Assuming JPY interest rates are less than USD interest rates, he pays more on his USD borrowing than he receives on his JPY deposit. Therefore he has to price the forward contract at a premium to spot to cover the interest rate differential.

Question 8

Question Type: MultipleChoice

A futures clearing house:

Options:

- A- provides a dispute settlement forum for the buyers and sellers
- B- guarantees the obligations associated with physical delivery
- C- guarantees the cash settlement of a futures contract
- D- all of the above

Answer:

C

Explanation:

It is important to note the distinction between the clearing house and the exchange itself. The clearing house does not get involved with physical delivery, nor does it provide any dispute settlement services. It only makes sure that cash is settled as and when due between the members. Therefore Choice 'c' is the correct answer

Question 9

Question Type: MultipleChoice

Using covered interest parity, calculate the 3 month CAD/USD forward rate if the spot CAD/USD rate is 1.1239 and the three month interest rates on CAD and USD are 0.75% and 0.4% annually respectively.

Options:

A- 1.1249

B- 1.1229

C- 1.1278

D- 1.1200

Answer:

A

Explanation:

Forward rates can be calculated from spot rates and interest rates using the formula $\text{Spot} \times (1 + \text{domestic interest rate}) / (1 + \text{foreign interest rate})$, where the 'Spot' is expressed as a direct rate (ie as the number of domestic currency units one unit of the foreign currency can buy). In this case the forward rate will be $1.1239 \times (1 + 0.75\% \times 90/360) / (1 + 0.4\% \times 90/360) = 1.1249$.

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Question 10

Question Type: MultipleChoice

Profits and losses on futures contracts are:

Options:

- A- settled upfront
- B- settled upon the expiry of the contract
- C- settled by moving collateral
- D- settled daily

Answer:

D

Explanation:

Profits and losses on futures contracts are settled daily. (P&L on forward contracts is often settled upon the expiry of the contract, and may even be collateralized.) Therefore Choice 'd' is the correct answer.

Question 11

Question Type: MultipleChoice

Futures initial margin requirements are

Options:

A- determined based on the client's credit history

B- determined by the members based on the SPAN framework

C- determined based on the length of the settlement period

D- determined by the exchange

Answer:

D

Explanation:

Futures initial margins are determined by the exchange. SPAN is the name of a framework the CME uses to determine margins. Only Choice 'd' is correct.

Question 12

Question Type: MultipleChoice

It is October. A grower of crops is concerned that January temperatures might be too low and destroy his crop. A heating-degree-days futures contract (HDD futures contract) is available for his city. What would be the best course of action for the grower?

Options:

- A- In October, sell January HDD contracts
- B- In October, buy January HDD contracts
- C- In October, buy September HDD contracts
- D- In January, buy January HDD contracts

Answer:

B

Explanation:

This question is based upon a weather derivative contract traded on the CME in the US. For each day, 'Heating-Degree-Days' (HDD) is calculated as equal to 65 degrees Fahrenheit minus the daily average temperature. The daily average temperature is based upon the temperature reported by the Earth Satellite Corporation using a specified automated weather station. Based upon daily values of HDD, an aggregated number called the 'CME degree days index' is calculated for each contract month. In other words, the index for a particular month is just the aggregation of the 'HDD' value for each of the days of that month. Each contract settles at the end of the month at a value equal to \$20 x Degree Days Index. (In a similar way, 'Cooling Degree Days' are also calculated and a futures contract offered, except that CDD is equal to the average daily temperature minus 65 degrees). (Source: CME's website at CMEGroup.com)

In the given question, we are interested in hedging against the possibility of the temperature being too low. This means we should buy the HDD futures contract (the lower the temperature, the higher the difference of the average temperature from 65 degrees, and the higher the settlement). Therefore Choice 'b' is the correct answer. The lower the actual temperature turns out to be, the higher the

payout to the grower. It would not be wise to wait till January to buy the contract as by then the prices of the contract would have already risen if the grower's fears of a colder January appear to be coming true. He can hedge his exposure by immediately locking in the January prices.

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