Financial markets and institutions

Finance

Financial Markets and s Number: Lecturer: Financial Markets and s 8. Variable-Rate Bonds. Are variable-rate bonds attractive to investors who expect interest rates to decrease? Explain. Would a firm that needs to borrow funds consider issuing variable-rate bonds if it expects that interest rates will decrease? Explain.

A bond is an instrument used by governments, local authorities and institutions to secure finances to meet its budget. Bonds offered by governments and local authorities are called treasury bonds, while those offered by institutions are called corporate bonds. The bonds have an interest that it pays so that it can attract investors to invest their money. The interest can either be fixed or variable. Fixed-rate pays interest irrespective of the institution making enough money to pay, but variable rates can vary depending on the market conditions prevailing. The bonds which interest rate are expected to reduce can either be attractive or not depending on the view of the investor. A reducing rate bond will earn less hence unattractive, but on the other side it can be a tax haven vehicle as corporate bonds are subject to federal taxes in mark up. Low-rate bond will either be tax exempt or attract low taxes hence it can be attractive from this viewpoint. To a firm a reducing rate bond is attractive as it will cost less to issue and service the bond. Conversely, a firm expecting the rates to increase has to consider other cheaper sources of financing like bank loan if it has less interest rate than what they will pay on bonds (Zacks ETF Research, 2012).

14. Bond Downgrade. . Explain how the downgrading of bonds for a particular corporation affects the prices of those bonds, the return to investors that currently hold these bonds, and the potential return to other investors who may invest in the bonds in the near future.

Downgrading a bond would mean that the price of the bond will reduce significantly to market equilibrium set by sentiment about the company's ability to service the bond. Downgrading arises from the ability of the company to service the bond which can be observed from the financial status of the company. If the company is facing financial difficulties, it might be able to pay the bonds when they mature or service current interest rates. Current investor will lose the value of their investment hence can offload the bond which can further reduce the price because of the low demand. When the price will have fallen to the least possible, it can be attractive to new investors who think that the price will rise in future.

15. Junk Bonds. Merrito Inc. is a large U. S. firm that issued bonds several years ago. Its bond ratings declined over time, and about a year ago, the bonds were rated in the junk bond classification. Yet, investors were buying the bonds in the secondary market because of the attractive yield they offered. Last week, Merrito defaulted on its bonds, and the prices of most other junk bonds declined abruptly on the same day. Explain why news of Meritto's financial problems could cause the prices of junk bonds issued by other firms to decrease, even when those firms had no business relationships with Merrito. Explain why the prices of those junk bonds with less liquidity declined more than those with a high degree of liquidity (Ftse Global Markets, 2012).

A junk bond is a bond that is high-yielding or non-investment grade bond. They are fixed-income instruments with a rating of ' BB' or lower status by some rating agencies or ' Ba' by some. They have a high ability to default, hence considered risky to invest in it when compared to investment-grade bonds. There appeal comes from the fact that they are speculative in nature offering higher yields than investment-grade safer bonds. In order to compensate investors who would like invest, the bonds offer a risk premium and if a company can turn around in its financial woes to improve the rating, the prices of the bonds will increase consequently. Bonds by companies in similar industry as Merrito lost value because investors view the industry as having similar problems as Merrito's. Bonds with less liquidity will fall that those with high liquidity because the bond cannot be easily sold or transferred which increases its risk. If a bond is easily transferrable, it will be attractive as investors can easily offload it when they feel to sell to recoup their investment (Goodman, 2013).

1. Inflation-Indexed Treasury Bond. An inflation-indexed Treasury bond has a par value of $1, 000 and a coupon rate of 6 percent. An investor purchases this bond and holds it for one year. During the year, the consumer price index increases by 1 percent every six months. What are the total interest payments the investor will receive during the year?

The interest payment which an investor will receive is calculated as follows;

1, 000 + (1% × 1, 000) = 1, 010

1, 010 × 3% = 30. 30

1, 010 + (1% × $1, 010) = $1, 020. 10

1, 020. 10 × 3% = 30. 60

= 30. 30 + 30. 60

= $60. 90

2. Inflation-Indexed Treasury Bond. Assume that the U. S. economy experienced deflation during the year, and that the consumer price index decreased by 1 percent in the first six months of the year, and by 2 percent during the second six months of the year. If an investor had purchased

inflation-indexed Treasury bonds with a par value of $1, 000 and a coupon rate of 5 percent, how much would she have received in interest during the year?

1, 000 – (1% × $1, 000) = 990

990 × 2. 5% = 24. 75

990 – (2% × 990) = 970. 20

970. 20 × 2. 5% = 24. 26

= 24. 75 + 24. 26

= $49. 01

Works Cited

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