CHAPTER 15: THE TERM STRUCTURE OF INTEREST RATES

1. Expectations hypothesis: The yields on long-term bonds are geometric averages of present and expected future short rates. An upward sloping curve is explained by expected future short rates being higher than the current short rate. A downward-sloping yield curve implies expected future short rates are lower than the current short rate. Thus bonds of different maturities have different yields if expectations of future short rates are different from the current short rate.

Liquidity preference hypothesis: Yields on long-term bonds are greater than the expected return from rolling-over short-term bonds in order to compensate investors in long-term bonds for bearing interest rate risk. Thus bonds of different maturities can have different yields even if expected future short rates are all equal to the current short rate. An upward sloping yield curve can be consistent even with expectations of falling short rates if liquidity premiums are high enough. If, however, the yield curve is downward sloping and liquidity premiums are assumed to be positive, then we can conclude that future short rates are expected to be lower than the current short rate.

2. d.

3. In general, the forward rate can be viewed as the sum of the market’s expectation of the future short rate plus a potential risk or ‘liquidity’ premium. According to the expectations theory of the term structure of interest rates, the liquidity premium is zero so that the forward rate is equal to the market’s expectation of the future short rate. Therefore, the market’s expectation of future short rates (i.e., forward rates) can be derived from the yield curve, and there is no risk premium for longer maturities.

The liquidity preference theory, on the other hand, specifies that the liquidity premium is positive so that the forward rate is less than the market’s expectation of the future short rate. This could result in an upward sloping term structure even if the market does not anticipate an increase in interest rates. The liquidity preference theory is based on the assumption that the financial markets are dominated by short-term investors who demand a premium in order to be induced to invest in long maturity securities.

4. True. Under the expectations hypothesis, there are no risk premia built into bond prices. The only reason for long-term yields to exceed short-term yields is an expectation of higher short-term rates in the future.
5. Uncertain. Expectations of lower inflation will usually lead to lower nominal interest rates. Nevertheless, if the liquidity premium is sufficiently great, long-term yields may exceed short-term yields despite expectations of falling short rates.

6. 

<table>
<thead>
<tr>
<th>Maturity</th>
<th>Price</th>
<th>YTM</th>
<th>Forward Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$943.40</td>
<td>6.00%</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>$898.47</td>
<td>5.50%</td>
<td>(1.055^2 / 1.06) – 1 = 5.0%</td>
</tr>
<tr>
<td>3</td>
<td>$847.62</td>
<td>5.67%</td>
<td>(1.0567^3 / 1.055^2) – 1 = 6.0%</td>
</tr>
<tr>
<td>4</td>
<td>$792.16</td>
<td>6.00%</td>
<td>(1.06^4 / 1.0567^3) – 1 = 7.0%</td>
</tr>
</tbody>
</table>

7. The expected price path of the 4-year zero coupon bond is shown below. (Note that we discount the face value by the appropriate sequence of forward rates implied by this year’s yield curve.)

<table>
<thead>
<tr>
<th>Beginning of Year</th>
<th>Expected Price</th>
<th>Expected Rate of Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$792.16</td>
<td>($839.69 / $792.16) – 1 = 6.00%</td>
</tr>
<tr>
<td>2</td>
<td>$839.69</td>
<td>($881.68 / $839.69) – 1 = 5.00%</td>
</tr>
<tr>
<td>3</td>
<td>$881.68</td>
<td>($934.58 / $881.68) – 1 = 6.00%</td>
</tr>
<tr>
<td>4</td>
<td>$934.58</td>
<td>($1,000.00 / $934.58) – 1 = 7.00%</td>
</tr>
</tbody>
</table>

8. a. \((1 + y_4)^4 = (1 + y_3)^3 (1 + f_4)\)
    \((1.055)^4 = (1.05)^3 (1 + f_4)\)
    \(1.2388 = 1.1576 (1 + f_4) \Rightarrow f_4 = 0.0701 = 7.01\%\)

b. The conditions would be those that underlie the expectations theory of the term structure: risk neutral market participants who are willing to substitute among maturities solely on the basis of yield differentials. This behavior would rule out liquidity or term premia relating to risk.

c. Under the expectations hypothesis, lower implied forward rates would indicate lower expected future spot rates for the corresponding period. Since the lower expected future rates embodied in the term structure are nominal rates, either lower expected future real rates or lower expected future inflation
rates would be consistent with the specified change in the observed (implied) forward rate.

9. You would expect the yield on a callable bond to lie above the yield curve for noncallable bonds because the callable bond must offer a premium to investors in order to compensate them for the option granted to the issuer.

10. The given rates are annual rates, but each period is a half-year. Therefore, the per period spot rates are 2.5% on one-year bonds and 2% on six-month bonds. The semiannual forward rate is obtained by solving for $f$ in the following equation:

$$1 + f = \frac{1.025^2}{1.02} = 1.030$$

This means that the forward rate is $0.030 = 3.0\%$ semiannually, or $6.0\%$ annually. Therefore, choice d is correct.

11. The present value of each bond’s payments can be derived by discounting each cash flow by the appropriate rate from the spot interest rate (i.e., the pure yield) curve:

Bond A: $$PV = \frac{10}{1.05} + \frac{10}{1.08^2} + \frac{110}{1.11^3} = 98.53$$

Bond B: $$PV = \frac{6}{1.05} + \frac{6}{1.08^2} + \frac{106}{1.11^3} = 88.36$$

Bond A sells for $0.13 (i.e., 0.13\% of par value) less than the present value of its stripped payments. Bond B sells for $0.02 less than the present value of its stripped payments. Bond A is more attractively priced.

12. a. We obtain forward rates from the following table:

<table>
<thead>
<tr>
<th>Maturity</th>
<th>YTM</th>
<th>Forward Rate</th>
<th>Price (for parts c, d)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 year</td>
<td>10%</td>
<td>$1,000/1.10 = $909.09</td>
<td></td>
</tr>
<tr>
<td>2 years</td>
<td>11%</td>
<td>(1.11^2/1.10) = 12.01%</td>
<td>$1,000/1.11^2 = $811.62</td>
</tr>
<tr>
<td>3 years</td>
<td>12%</td>
<td>(1.12^3/1.11^2) = 14.03%</td>
<td>$1,000/1.12^3 = $711.78</td>
</tr>
</tbody>
</table>

b. We obtain next year’s prices and yields by discounting each zero’s face value at the forward rates for next year that we derived in part (a):

<table>
<thead>
<tr>
<th>Maturity</th>
<th>Price</th>
<th>YTM</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 year</td>
<td>$1,000/1.1201 = $892.78</td>
<td>12.01%</td>
</tr>
<tr>
<td>2 years</td>
<td>$1,000/(1.1201 × 1.1403) = $782.93</td>
<td>13.02%</td>
</tr>
</tbody>
</table>
Note that this year’s upward sloping yield curve implies, according to the expectations hypothesis, a shift upward in next year’s curve.

c. Next year, the 2-year zero will be a 1-year zero, and will therefore sell at a price of: $1,000/1.1201 = $892.78

Similarly, the current 3-year zero will be a 2-year zero and will sell for $782.93.

Expected total rate of return:

\[\text{2-year bond: } \frac{892.78}{811.62} - 1 = 1.1000 - 1 = 10.00\% \]

\[\text{3-year bond: } \frac{782.93}{711.78} - 1 = 1.1000 - 1 = 10.00\% \]

d. The current price of the bond should equal the value of each payment times the present value of $1 to be received at the “maturity” of that payment. The present value schedule can be taken directly from the prices of zero-coupon bonds calculated above.

Current price = \((120 \times 0.90909) + (120 \times 0.81162) + (1,120 \times 0.71178)\)

\[= 109.0908 + 97.3944 + 797.1936 = 1,003.68 \]

Similarly, the expected prices of zeros one year from now can be used to calculate the expected bond value at that time:

Expected price 1 year from now = \((120 \times 0.89278) + (1,120 \times 0.78293)\)

\[= 107.1336 + 876.8816 = 984.02 \]

Total expected rate of return =

\[\frac{120 + (984.02 - 1,003.68)}{1,003.68} = 0.1000 = 10.00\% \]

13. a. A 3-year zero coupon bond with face value $100 will sell today at a yield of 6% and a price of:

\[\frac{100}{1.06^3} = 83.96 \]

Next year, the bond will have a two-year maturity, and therefore a yield of 6% (from next year’s forecasted yield curve). The price will be $89.00, resulting in a holding period return of 6%.

b. The forward rates based on today’s yield curve are as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Forward Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Using the forward rates, the forecast for the yield curve next year is:

Maturity | YTM
---|---
1  | 6.01%
2  | \((1.0601 \times 1.0803)^{1/2} - 1 = 7.02\%\)

The market forecast is for a higher YTM on 2–year bonds than your forecast. Thus, the market predicts a lower price and higher rate of return.

14. a. \[ P = \frac{9}{1.07} + \frac{109}{1.08^2} = 101.86 \]

b. The yield to maturity is the solution for \( y \) in the following equation:

\[ \frac{9}{1 + y} + \frac{109}{(1 + y)^2} = 101.86 \]

[Using a financial calculator, enter \( n = 2; \ FV = 100; \ PMT = 9; PV = -101.86; \) Compute \( i \) ] \( \text{YTM} = 7.958\% \)

c. The forward rate for next year, derived from the zero-coupon yield curve, is the solution for \( f_2 \) in the following equation:

\[ 1 + f_2 = \frac{(1.08)^2}{1.07} = 1.0901 \Rightarrow f_2 = 0.0901 = 9.01\%. \]

Therefore, using an expected rate for next year of \( r_2 = 9.01\% \), we find that the forecast bond price is:

\[ P = \frac{109}{1.0901} = 99.99 \]

d. If the liquidity premium is 1% then the forecast interest rate is:

\[ E(r_2) = f_2 - \text{liquidity premium} = 9.01\% - 1.00\% = 8.01\% \]

The forecast of the bond price is:

\[ \frac{109}{1.0801} = 100.92 \]
15. The coupon bonds can be viewed as portfolios of stripped zeros: each coupon can stand alone as an independent zero-coupon bond. Therefore, yields on coupon bonds reflect yields on payments with dates corresponding to each coupon. When the yield curve is upward sloping, coupon bonds have lower yields than zeros with the same maturity, because the yields to maturity on coupon bonds reflect the yields on the earlier, interim coupon payments.

16. a. The current bond price is:

\[
(\$85 \times 0.94340) + (\$85 \times 0.87352) + (\$1,085 \times 0.81637) = \$1,040.20
\]

This price implies a yield to maturity of 6.97%, as shown by the following:

\[
[\$85 \times \text{Annuity factor (6.97%, 3)}] + [\$1,000 \times \text{PV factor (6.97%, 3)}] = \$1,040.17
\]

b. If one year from now \( y = 8\% \), then the bond price will be:

\[
[\$85 \times \text{Annuity factor (8\%, 2)}] + [\$1,000 \times \text{PV factor (8\%, 2)}] = \$1,008.92
\]

The holding period rate of return is:

\[
\frac{\$85 + (\$1,008.92 - \$1,040.20)}{\$1,040.20} = 0.0516 = 5.16\%
\]

17. 

<table>
<thead>
<tr>
<th>Year</th>
<th>Forward Rate</th>
<th>PV of $1 received at period end</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>5%</td>
<td>$1/(1.05) = $0.9524</td>
</tr>
<tr>
<td>2</td>
<td>7%</td>
<td>$1/(1.05\times1.07) = $0.8901</td>
</tr>
<tr>
<td>3</td>
<td>8%</td>
<td>$1/(1.05\times1.07\times1.08) = $0.8241</td>
</tr>
</tbody>
</table>

a. Price = ($60 \times 0.9524) + ($60 \times 0.8901) + ($1,060 \times 0.8241) = \$984.10

b. To find the yield to maturity, solve for \( y \) in the following equation:

\[
$984.10 = [\$60 \times \text{Annuity factor (y, 3)}] + [\$1,000 \times \text{PV factor (y, 3)}]
\]

This can be solved using a financial calculator to show that \( y = 6.60\% \)

c. 

<table>
<thead>
<tr>
<th>Period</th>
<th>Payment received at end of period:</th>
<th>Will grow by a factor of:</th>
<th>To a future value of:</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$60.00</td>
<td>1.07 \times 1.08</td>
<td>$69.34</td>
</tr>
<tr>
<td>2</td>
<td>$60.00</td>
<td>1.08</td>
<td>$64.80</td>
</tr>
<tr>
<td>3</td>
<td>$1,060.00</td>
<td>1.00</td>
<td>$1,060.00</td>
</tr>
</tbody>
</table>

\[
\frac{\$984.10 \times (1 + y_{\text{realized}})^3}{\$984.10} = \$1,194.14
\]

\[
1 + y_{\text{realized}} = \left( \frac{\$1,194.14}{\$984.10} \right)^{1/3} = 1.0666 \Rightarrow y_{\text{realized}} = 6.66\%
\]
d. Next year, the price of the bond will be:

\[
\text{Price} = \left( 60 \times \text{Annuity factor (7\%, 2)} \right) + \left( 1,000 \times \text{PV factor (7\%, 2)} \right) = 981.92
\]

Therefore, there will be a capital loss equal to: 
\[
984.10 - 981.92 = 2.18
\]

The holding period return is:
\[
\frac{60 + (-2.18)}{984.10} = 0.0588 = 5.88\%
\]

18. The following table shows the expected short-term interest rate based on the projections of Federal Reserve rate cuts, the term premium (which increases at a rate of 0.10% per 12 months), the forward rate (which is the sum of the expected rate and term premium), and the YTM, which is the geometric average of the forward rates.

<table>
<thead>
<tr>
<th>Time</th>
<th>Expected short rate</th>
<th>Term premium</th>
<th>Forward rate (annual)</th>
<th>Forward rate (semi-annual)</th>
<th>YTM (semi-annual)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>5.00%</td>
<td>0.00%</td>
<td>5.00%</td>
<td>2.500%</td>
<td>2.500%</td>
</tr>
<tr>
<td>6 months</td>
<td>4.50%</td>
<td>0.05%</td>
<td>4.55%</td>
<td>2.275%</td>
<td>2.387%</td>
</tr>
<tr>
<td>12 months</td>
<td>4.00%</td>
<td>0.10%</td>
<td>4.10%</td>
<td>2.050%</td>
<td>2.275%</td>
</tr>
<tr>
<td>18 months</td>
<td>4.00%</td>
<td>0.15%</td>
<td>4.15%</td>
<td>2.075%</td>
<td>2.225%</td>
</tr>
<tr>
<td>24 months</td>
<td>5.00%</td>
<td>0.20%</td>
<td>5.20%</td>
<td>2.600%</td>
<td>2.300%</td>
</tr>
<tr>
<td>30 months</td>
<td>5.00%</td>
<td>0.25%</td>
<td>5.25%</td>
<td>2.625%</td>
<td>2.354%</td>
</tr>
</tbody>
</table>

This analysis is predicated on the liquidity preference theory of the term structure, which asserts that the forward rate in any period is the sum of the expected short rate plus the liquidity premium.

19. a. The return on the one-year zero-coupon bond will be 6.1%.

The price of the 4-year zero today is:
\[
\frac{1,000}{1.064} = 780.25
\]

Next year, if the yield curve is unchanged, today’s 4-year zero coupon bond will have a 3-year maturity, a YTM of 6.3%, and therefore the price will be:
\[
\frac{1,000}{1.063^3} = 832.53
\]

The resulting one-year rate of return will be 6.70%.

Therefore, in this case, the longer-term bond is expected to provide the higher return because its YTM is expected to decline during the holding period.

b. If you believe in the expectations hypothesis, you would not expect that the yield curve next year will be the same as today’s curve. The upward slope in today's curve would be evidence that expected short rates are rising and that the yield curve will shift upward, reducing the holding period return on the four-year bond. Under the expectations hypothesis, all bonds have equal expected holding period returns. Therefore, you would predict that the HPR for the 4-year bond would be 6.1%, the same as for the 1-year bond.
20. a. Five-year Spot Rate:

\[
\$1,000 = \frac{\$70}{(1 + y_1)^1} + \frac{\$70}{(1 + y_2)^2} + \frac{\$70}{(1 + y_3)^3} + \frac{\$70}{(1 + y_4)^4} + \frac{\$1,070}{(1 + y_5)^5}
\]

\[
\$1,000 = \frac{\$70}{1.05} + \frac{\$70}{1.0521^2} + \frac{\$70}{1.0605^3} + \frac{\$70}{1.0716^4} + \frac{\$1,070}{(1 + y_5)^5}
\]

\[
\$1,000 = \$66.67 + \$63.24 + \$58.69 + \$53.08 + \frac{\$1,070}{(1 + y_5)^5}
\]

\[
\$758.32 = \frac{\$1,070}{(1 + y_5)^5}
\]

\[
(1 + y_5)^5 = \frac{\$1,070}{\$758.32} \Rightarrow y_5 = \sqrt[5]{1.411} - 1 = 7.13\%
\]

Five-year Forward Rate:

\[
\frac{(1.0713)^5}{(1.0716)^4} - 1 = 1.0701 - 1 = 7.01\%
\]

b. The yield to maturity is the single discount rate that equates the present value of a series of cash flows to a current price. It is the internal rate of return.

The spot rate for a given period is the yield to maturity on a zero-coupon bond that matures at the end of the period. A spot rate is the discount rate for each period. Spot rates are used to discount each cash flow of a coupon bond in order to calculate a current price. Spot rates are the rates appropriate for discounting future cash flows of different maturities.

A forward rate is the implicit rate that links any two spot rates. Forward rates are directly related to spot rates, and therefore to yield to maturity. Some would argue (as in the expectations hypothesis) that forward rates are the market expectations of future interest rates. A forward rate represents a break-even rate that links two spot rates. It is important to note that forward rates link spot rates, not yields to maturity.
Yield to maturity is not unique for any particular maturity. In other words, two bonds with the same maturity but different coupon rates may have different yields to maturity. In contrast, spot rates and forward rates for each date are unique.

c. The 4-year spot rate is 7.16%. Therefore, 7.16% is the theoretical yield to maturity for the zero-coupon U.S. Treasury note. The price of the zero-coupon note discounted at 7.16% is the present value of $1,000 to be received in 4 years. Using annual compounding:

\[
PV = \frac{\$1,000}{(1.0716)^4} = \$758.35
\]

21. The price of the coupon bond, based on its yield to maturity, is:

\[
[\$120 \times \text{Annuity factor (5.8%, 2)}] + [\$1,000 \times \text{PV factor (5.8%, 2)}] = \$1,113.99
\]

If the coupons were stripped and sold separately as zeros, then, based on the yield to maturity of zeros with maturities of one and two years, respectively, the coupon payments could be sold separately for:

\[
\frac{\$120}{1.05} + \frac{\$1,120}{1.06^2} = \$1,111.08
\]

The arbitrage strategy is to buy zeros with face values of $120 and $1,120 and respective maturities of one year and two years, and simultaneously sell the coupon bond. The profit equals $2.91 on each bond.

22. a. The one-year zero-coupon bond has a yield to maturity of 6%, as shown below:

\[
\$94.34 = \frac{\$100}{1 + y_1} \Rightarrow y_1 = 0.06000 = 6.000\
\]

The yield on the two-year zero is 8.472%, as shown below:

\[
\$84.99 = \frac{\$100}{(1 + y_2)^2} \Rightarrow y_2 = 0.08472 = 8.472\%
\]

The price of the coupon bond is:

\[
\frac{\$12}{1.06} + \frac{\$112}{(1.08472)^2} = \$106.51
\]

Therefore: yield to maturity for the coupon bond = 8.333%
[On a financial calculator, enter: n = 2; PV = –106.51; FV = 100; PMT = 12]

b. \[
f_2 = \frac{(1 + y_2)^2}{1 + y_1} - 1 = \frac{(1.08472)^2}{1.06} - 1 = 0.1100 = 11.00\%
\]
c. Expected price = \( \frac{\$112}{1.11} = \$100.90 \)

(Note that next year, the coupon bond will have one payment left.)

Expected holding period return =

\[
\frac{\$12 + ($100.90 - $106.51)}{$106.51} = 0.0600 = 6.00\%
\]

This holding period return is the same as the return on the one-year zero.

d. If there is a liquidity premium, then: \( E(r_2) < f_2 \)

\[
E(\text{Price}) = \frac{\$112}{1 + E(r_2)} > $100.90
\]

\( E(\text{HPR}) > 6\% \)

23. a.

<table>
<thead>
<tr>
<th>Maturity (years)</th>
<th>Price</th>
<th>YTM</th>
<th>Forward rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$925.93</td>
<td>8.00%</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>$853.39</td>
<td>8.25%</td>
<td>8.50%</td>
</tr>
<tr>
<td>3</td>
<td>$782.92</td>
<td>8.50%</td>
<td>9.00%</td>
</tr>
<tr>
<td>4</td>
<td>$715.00</td>
<td>8.75%</td>
<td>9.50%</td>
</tr>
<tr>
<td>5</td>
<td>$650.00</td>
<td>9.00%</td>
<td>10.00%</td>
</tr>
</tbody>
</table>

b. For each 3-year zero issued today, use the proceeds to buy:

\( $782.92/$715.00 = 1.095 \) four-year zeros

Your cash flows are thus as follows:

<table>
<thead>
<tr>
<th>Time</th>
<th>Cash Flow</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>$ 0</td>
</tr>
<tr>
<td>3</td>
<td>-$1,000</td>
</tr>
<tr>
<td>4</td>
<td>+$1,095</td>
</tr>
</tbody>
</table>

This is a synthetic one-year loan originating at time 3. The rate on the synthetic loan is 0.095 = 9.5%, precisely the forward rate for year 3.

c. For each 4-year zero issued today, use the proceeds to buy:

\( $715.00/$650.00 = 1.100 \) five-year zeros

Your cash flows are thus as follows:

<table>
<thead>
<tr>
<th>Time</th>
<th>Cash Flow</th>
</tr>
</thead>
</table>

15-10
The 4-year zero issued at time 0 matures; the issuer pays out $1,000 face value.

The 5-year zeros purchased at time 0 mature; receive face value.

This is a synthetic one-year loan originating at time 4. The rate on the synthetic loan is 0.100 = 10.0%, precisely the forward rate for year 4.

24. a. For each three-year zero you buy today, issue:

\[
\frac{782.92}{650.00} = 1.2045 \text{ five-year zeros}
\]

The time-0 cash flow equals zero.

b. Your cash flows are thus as follows:

<table>
<thead>
<tr>
<th>Time</th>
<th>Cash Flow</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>$0</td>
</tr>
<tr>
<td>3</td>
<td>$1,000.00</td>
</tr>
<tr>
<td>5</td>
<td>-$1,204.50</td>
</tr>
</tbody>
</table>

The 3-year zero purchased at time 0 matures; receive $1,000 face value.

The 5-year zeros issued at time 0 mature; issuer pays face value.

This is a synthetic two-year loan originating at time 3.

c. The effective two-year interest rate on the forward loan is:

\[
\frac{1,204.50}{1,000} - 1 = 0.2045 = 20.45\%
\]

d. The one-year forward rates for years 4 and 5 are 9.5% and 10%, respectively. Notice that:

\[
1.095 \times 1.10 = 1.2045 = 1 + \text{(two-year forward rate on the 3-year ahead forward loan)}
\]

The 5-year YTM is 9.0%. The 3-year YTM is 8.5%. Therefore, another way to derive the 2-year forward rate for a loan starting at time 3 is:

\[
f_3(2) = \left( \frac{1 + y_3}{1 + y_3} \right)^{\frac{5}{3}} - 1 = \frac{1.09^5}{1.085^3} - 1 = 0.2046 = 20.46\%
\]

[Note: there is a slight discrepancy here due to rounding error in the YTM calculations above.]

25. a. i. The two-year implied annually compounded forward rate for a deferred loan beginning in 3 years is calculated as follows:
\[ f_3(2) = \left( \frac{(1+y_5)^5}{(1+y_5)^3} \right)^{1/2} - 1 = \left( \frac{1.09^5}{1.11^3} \right)^{1/2} - 1 = 0.0607 = 6.07\% \]

ii. The expectations theory holds that the shape of the yield curve results from the interest rate expectations of the market. The theory holds that any long-term interest rate simply represents the geometric mean of the current and future one-year interest rates expected to prevail over the maturity of the issue. The equilibrium long-term rate is the rate the long-term bond investor would expect to earn through successive investments in short-term bonds over the term to maturity of the long-term bonds. This implies that forward rates are equivalent to expected future interest rates. Thus, given an expected 3-year rate of 11% and an expected 5-year rate of 9%, the expected 2-year (implied forward) rate three years from now is 6.07%.

b. Assuming a par value of $1,000, the bond price is calculated as follows:

\[
P = \frac{90}{(1+y_1)^1} + \frac{90}{(1+y_2)^2} + \frac{90}{(1+y_3)^3} + \frac{90}{(1+y_4)^4} + \frac{1090}{(1+y_5)^5} = \frac{90}{1.13^1} + \frac{90}{1.12^2} + \frac{90}{1.11^3} + \frac{90}{1.10^4} + \frac{1090}{1.09^5} = 987.10
\]