Assume that you can buy or sell the following securities:

Security	Price Today	Payoff one year from today if the economy is:		Payoff two years from today if the economy is:	
		Strong	Weak	Strong	Weak
TaxCut	$65	$15	$5	$100	$0
Market	$100	$10	$0	$150	$50

Assume also that you can buy or short-sell risk-free bonds that mature either a year from today or two years from today for whatever amount you chose. The return on these bonds is 2.5% per year.

a. What investment in the market and risk-free bonds will generate cash flows identical to those generated by TaxCut?

b. Calculate the no-arbitrage price for TaxCut?

Note: Feel free to answer parts "c" and "d" with a table

c. What set of transactions today will generate an arbitrage profit today?

d. What cash flows (each trade and total) will your transactions produce today, a year from today, and two years from today? Note: Use a "+" for inflows and a "-" for outflows.

a. Buy market, buy bond that matures for $5 in one year, short sell bond that matures for $50 in two years.

b. $100 + \dfrac{5}{1.025} - \dfrac{50}{(1.025)^2} = 100 + 4.878 - 47.591 = 57.287$
$\qquad\qquad\qquad \underline{\$1} \qquad\qquad\qquad\qquad\qquad\qquad \underline{\$2}$

c & d

Trans	$0	S	W	S	W
short TaxCut	+65	−15	−5	−100	−0
buy market	−100	+10	+0	+150	+50
Buy 1-yr bond	−4.878	+5	+5	0	0
short 2-yr bond	+47.591			−50	−50
Total	**(+7.713)**	Ø	Ø	Ø	Ø