BA 311 – Money and Banking

LEARNING OUTCOMES

- LO 1 – Understand economic interaction in determining asset prices and interest rates.

INTEREST RATE ANALYSIS

What market factors or theories impact interest rates?

- Loanable Funds Theory
- Liquidity Preference Theory
- Term Structure
- Default Risk
- Tax Structure
- Geopolitical Factors

WHAT IMPACTS "INVESTABLE CAPITAL"?

- Government budget deficits or surpluses (Public Savings)
- Investor Confidence
- Alternative Investment Opportunities
- Geopolitical factors – Foreign Interest and Exchange Rates and Rates of Inflation
- Technology changes
- Changes in patterns of Private Savings

LOANABLE FUNDS THEORY

- Classical Economics
- Real Interest Rate is set by supply and demand for LOANS
- A “Demand for Loans” is investment opportunities (Positive NPV projects looking for funding)
- A “Supply for Loans” is capital looking for return

LOANABLE FUNDS THEORY

- What causes rates to rise?
- Shortage of investable capital
- Excess of high NPV projects
- Impacts of a rise in rates?
- Impacts of a fall in rates?

LIQUIDITY PREFERENCE THEORY

Classical Economics

Nominal Interest Rates determined by supply and demand for MONEY

Supply of money is set by the central bank.

Demand for money is the amount of money the actors in the economy want to hold

LIQUIDITY PREFERENCE THEORY

An increase in interest rates reduce the amount of money demanded – would rather invest than spend (become a net saver versus a net spender)

Changes in supply occur when central bank changes the money supply

Changes in demand occur when technology or spending patterns change

TERM STRUCTURE OF INTEREST RATES

The relationship between interest rates and bond maturity

Generally the longer the maturity the ________ the rate.

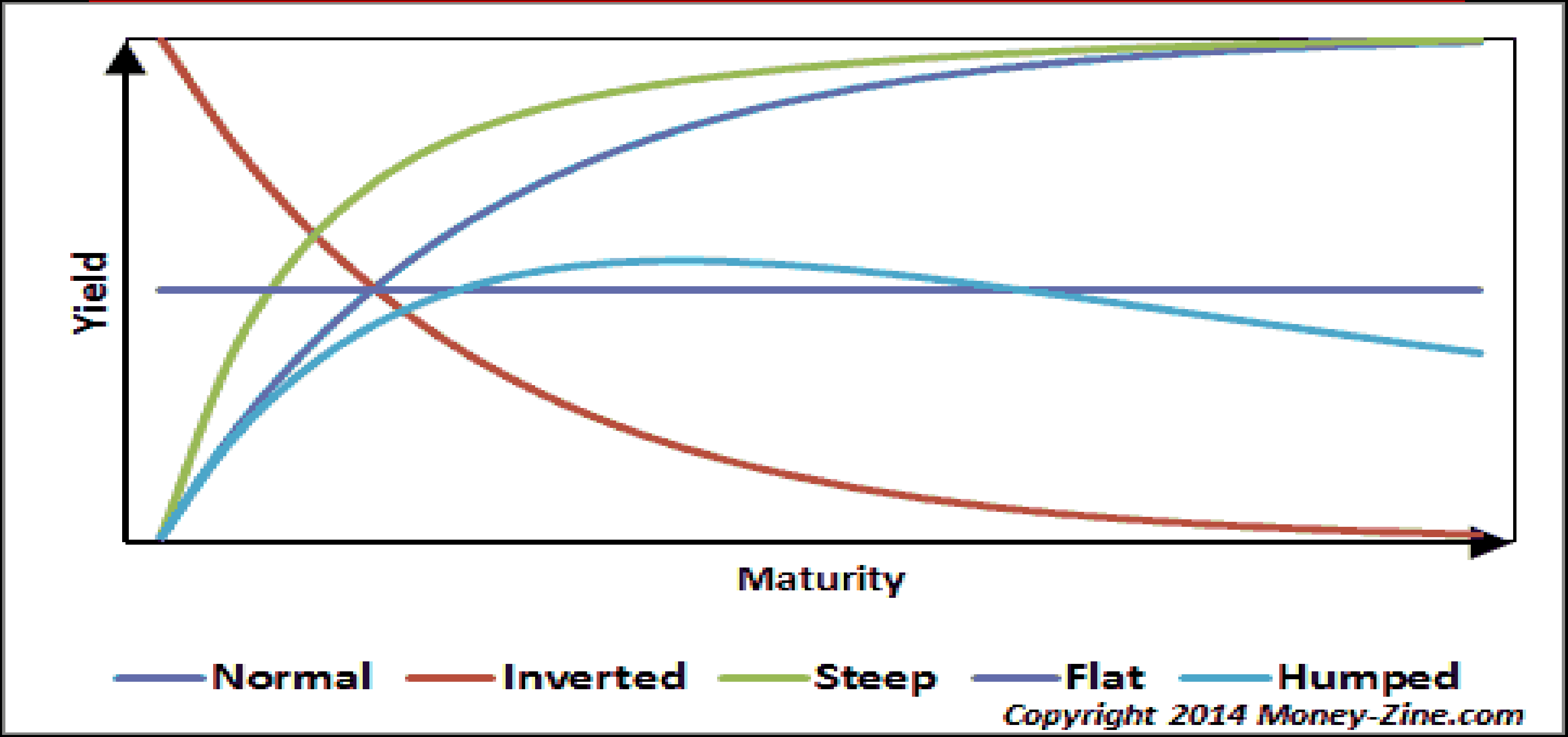
When does that not hold?

Based on ex ante rate expectations

Risk premiums

- Term risk premium (risk of price changes)

YIELD CURVE



http://www.money-zine.com/definitions/investing-dictionary/yield-curve/

DEFAULT RISK

Default risk causes rates to rise. Why?

Required return	=	Risk-free return	+	Risk premium for systematic risk
r_j	=	r_{RF}	+	$(r_M - r_{RF})\ \beta_j$

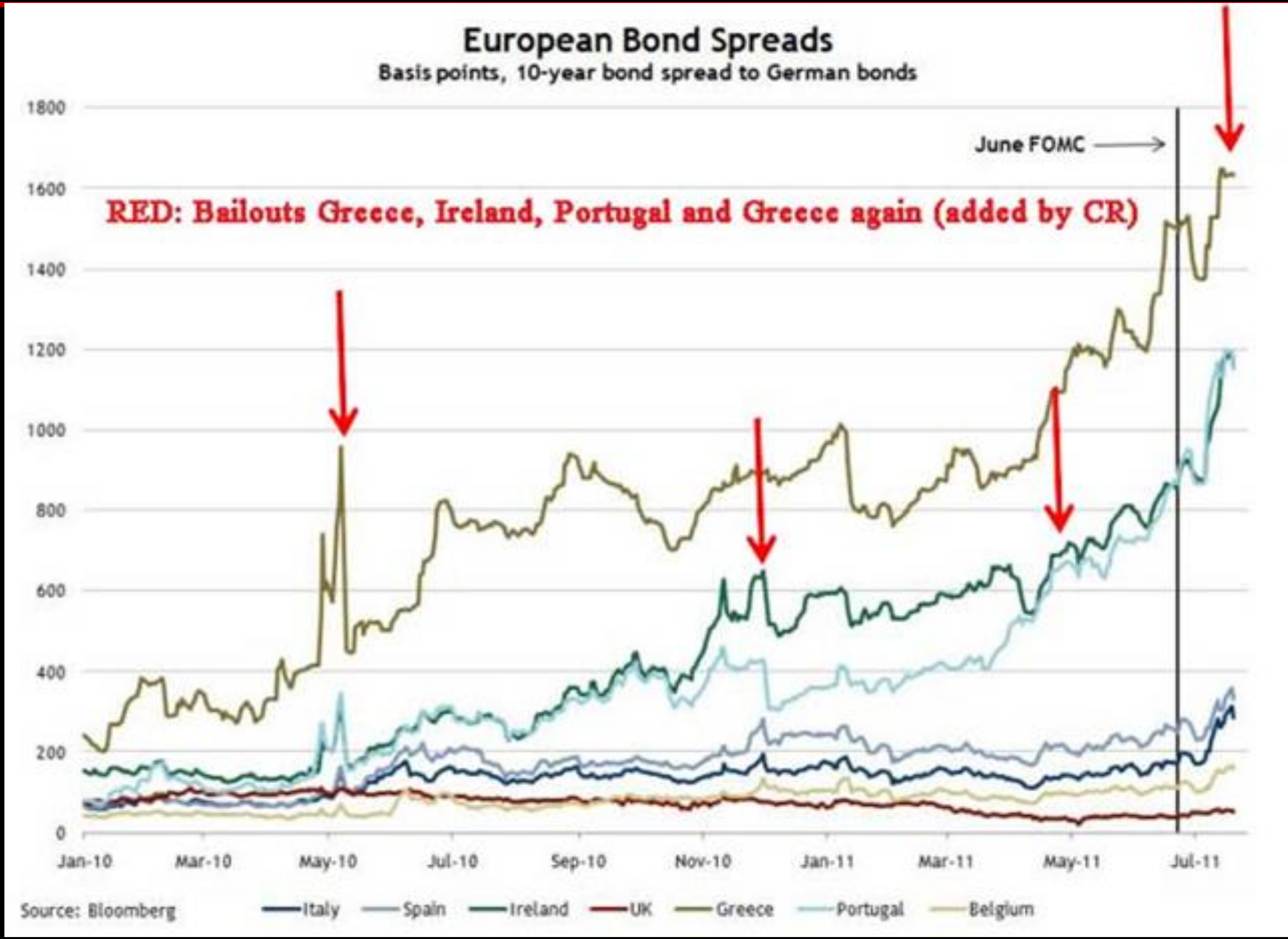
Any Bond may default

- US Debt Ceiling
- Other Governments/Agencies
- Corporate Bonds

DEFAULT RISK

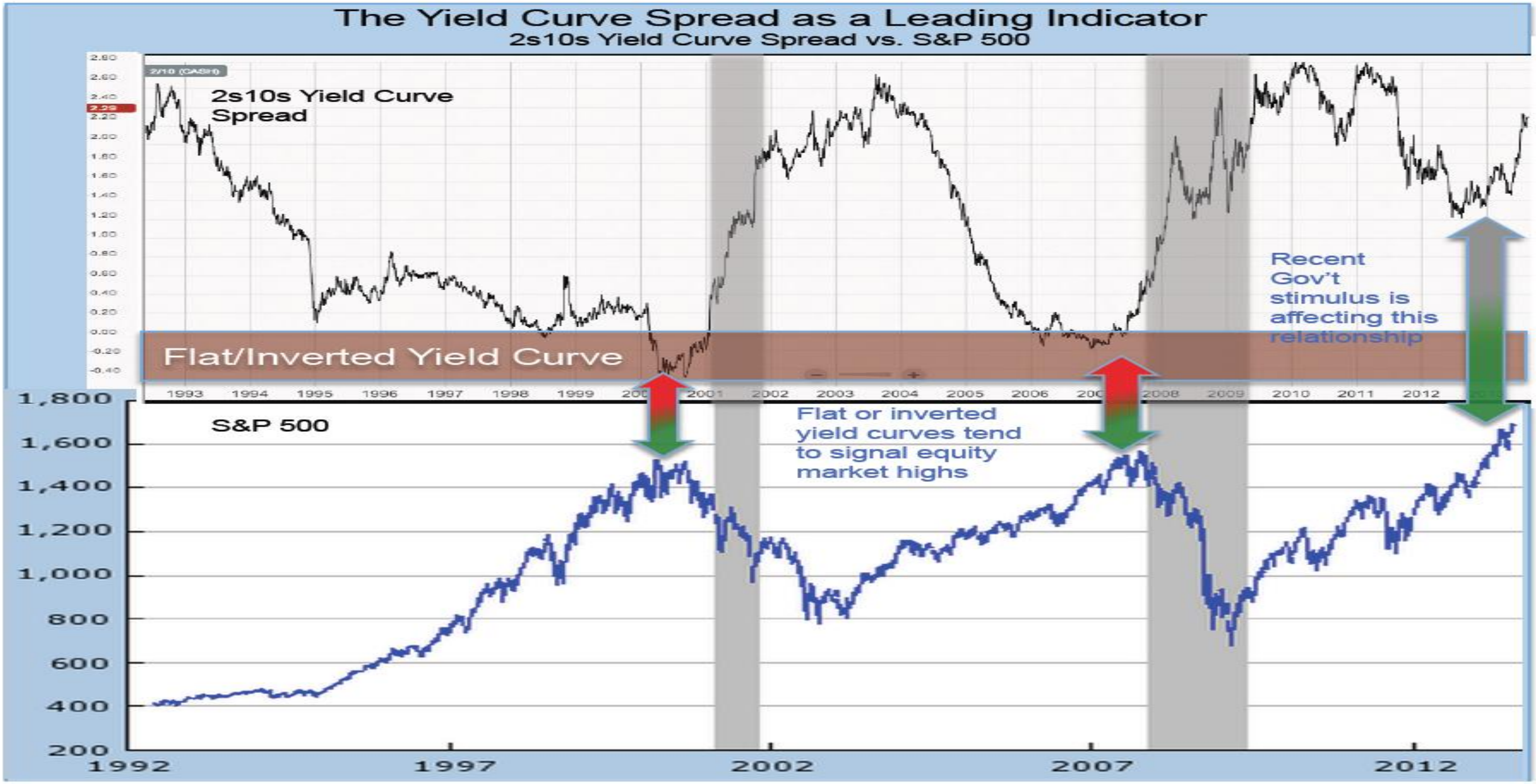
- Measures of default risk – Moody's, S&P, Fitch, Equifax, TransUnion, Experian
- Yield spread indicates potential economic shifts (ex ante or ex post)

YIELD SPREADS - SOVEREIGNS



http://www.desdemonadespair.net/2011/12/50-doomiest-graphs-of-2011.html

YIELD SPREADS



Source: CurveTrades LLC, Federal Reserve Bank of St. Louis FRED

https://mrtopstep.com/yield-curve-spreads-a-little-known-way-to-trade-profitably/

YIELD SPREADS