

**BA 311 – MONEY AND BANKING**

## LEARNING OUTCOMES

- LO 1 – Understand structure and impacts of Securities and Foreign Exchange Markets.

## SECURITIES MARKETS

Who are the main players?

- Mutual Funds
- Hedge Funds
- Brokers
- Dealers
- Investment Banks
- Pension Funds
- Insurance Companies
- Commercial Banks

## STOCK & BOND MARKETS

- Primary Market – Direct to the end holder from the issuer
- Secondary Market – Where securities trade after issue (NYSE, NASDAQ, OTC/Dealer markets, Pink Sheets)
- Trading – Stocks and Bonds – the combo of which is the corporate *capital structure* or *capital stack*.

## STOCKS VS BONDS

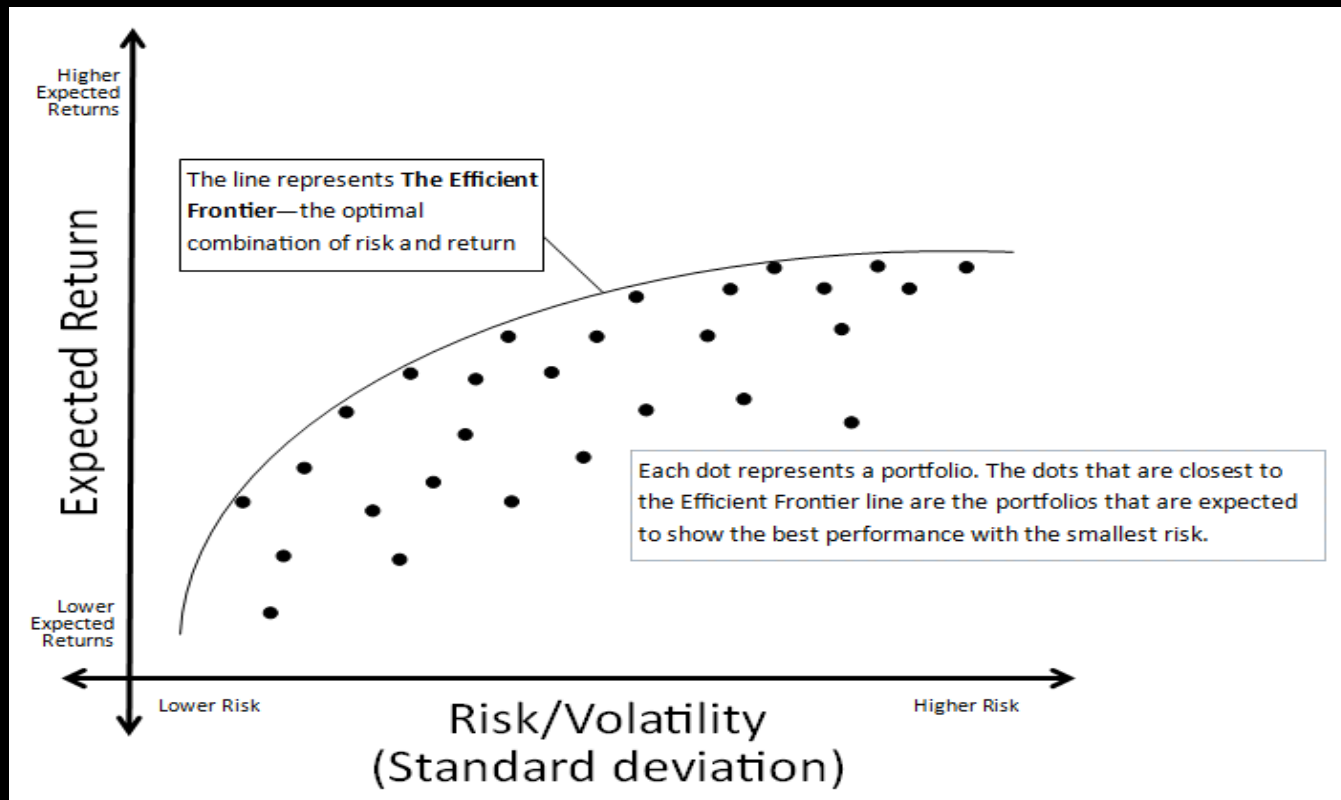
- Pros and Cons of each?
- Modigliani- Miller theorem says the market doesn't care. Why? Do you think this really holds up?
- Bonds – reduce taxes & adverse selection. Increases fixed payments and financial risk.
- Stocks – more upside and downside. Dividends are not contracted. More flexible cash flow streams.

## ASSET ALLOCATION THEORY

- Net savers must split assets between cash, stocks, bonds and other investments
- Mathematically should reside on the “efficient frontier”. In practice, most portfolios are inefficient.
- How does risk tolerance shift as time tables shift?

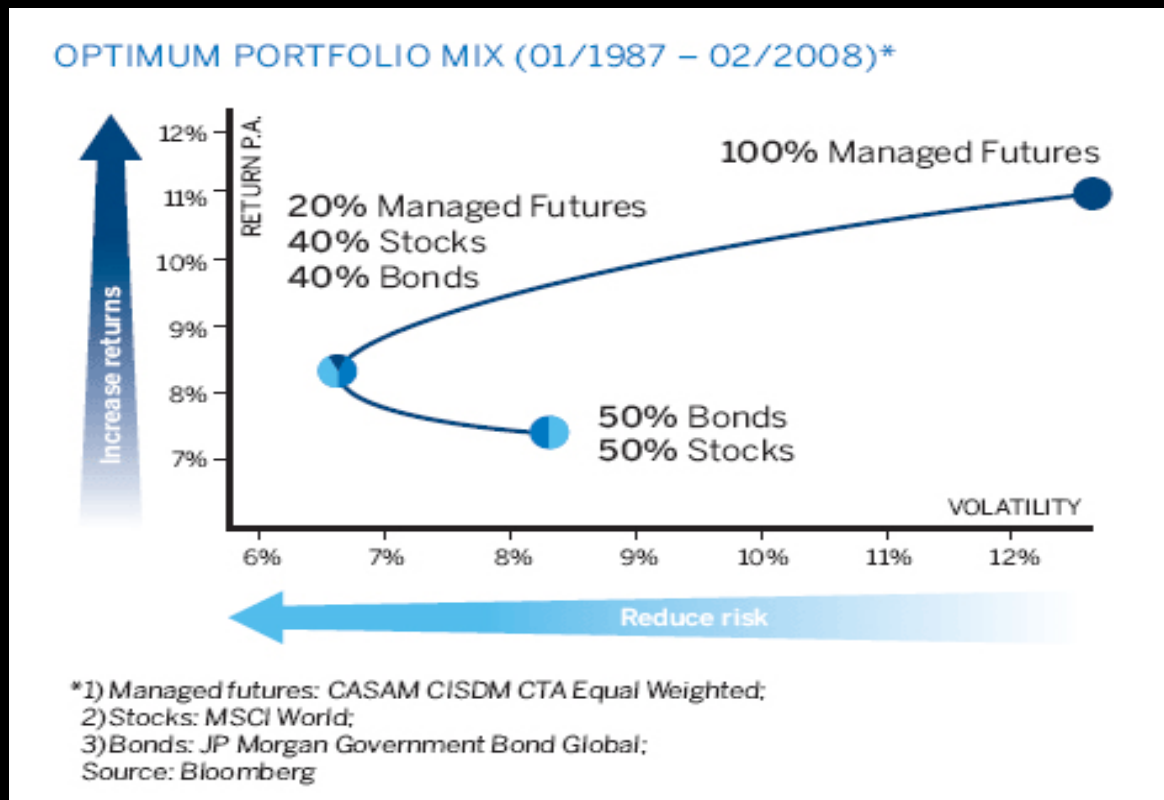
# ASSET ALLOCATION THEORY

- Efficient Frontier



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- Efficient Frontier





## EFFICIENT MARKET HYPOTHESIS

Markets reflect all known information (strong form)

Markets reflect all public information instantaneously (semi-strong form)

Markets eventually reflect all public information (weak form)

Cannot “beat” the market with information (fundamental or technical)

What does that mean for “actively managed portfolios”?

Sometimes doesn't hold (Buffett effect)

## DERIVATIVES

### ARE NOT INHERENTLY BAD

Futures – contract to buy or sell an asset at an agreed price at a point in time in the future

Options – right (“option to”) trade an asset at a certain price on or before (usually) a set point of time in the future

Credit Default Swap (CDS) – “default insurance”

Used to hedge or can be used to speculate

## FOREX (FOREIGN CURRENCY EXCHANGE)

Critical for acquiring goods & services or satisfying debts.

Traded on electronic interbank markets. Banks serve as both dealers and brokers.

Rise in price is currency appreciation, decline in price is currency depreciation.

Pricing is always relative

## WHAT DO EXCHANGE RATES DO?

An appreciation of the (dollar) will cause the relative price of imports to \_\_\_\_\_ and exports to \_\_\_\_\_.

Why do politicians generally advocate for a “strong dollar” policy?

Can use futures contracts to hedge against currency exchange fluctuations.

Real exchange rate is the relative price of domestic and foreign goods.

May have significant influence on industries (US Steel/Auto)

# REAL EXCHANGE RATE & PPP

## THE BIG MAC INDEX

Coined 'Burgernomics,' the Big Mac Index has become a global standard of determining purchasing power between two currencies by comparing the cost of the McDonald's burger in any two countries.

### 1 OVERVIEW

The average price of a Big Mac is compared to demonstrate the value of a currency. For example, a Big Mac costs \$4.07 in the U.S. compared to \$2.27 in China. The burger is 44% cheaper in China, which suggests the yuan is 44% undervalued against the dollar.

#### HOW WAS IT CREATED?

The Big Mac Index was introduced in *The Economist* in September 1986 as an illustration demonstrating exchange-rate theory.



#### WHAT IS IT?

An informal way of measuring the Purchasing Power Parity (PPP) between two currencies - a comparison of currency value.



#### VARIANTS

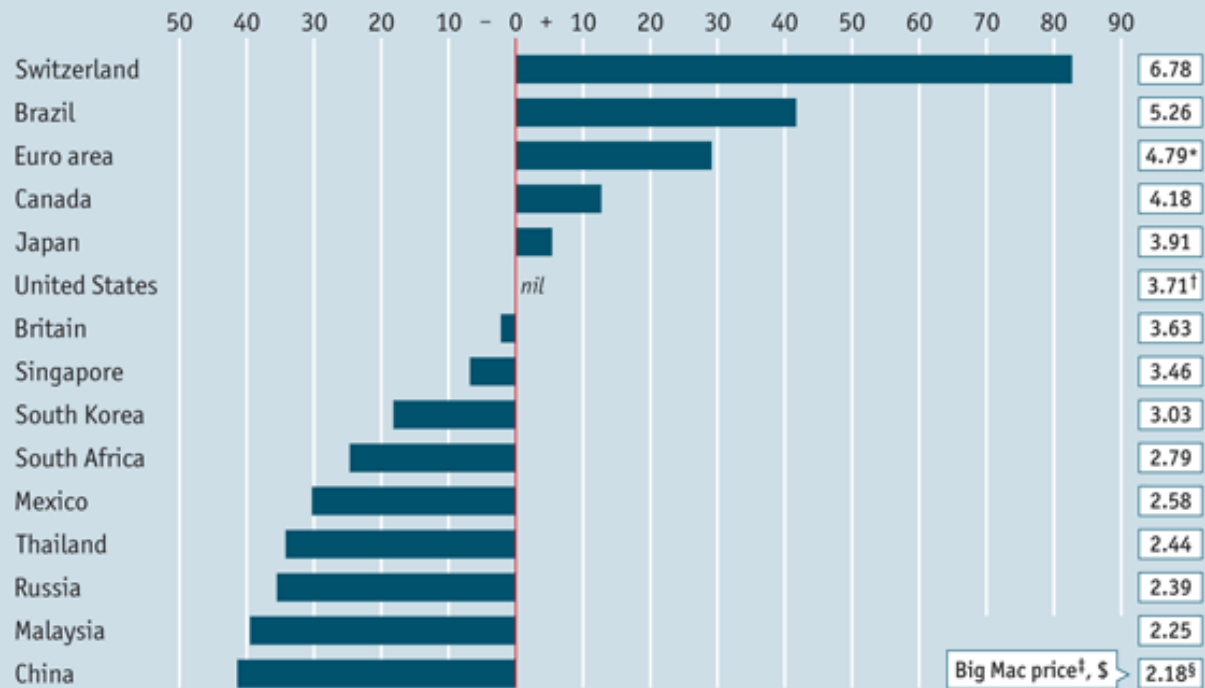
In 2004, the Tall Latte index featured a Starbucks Coffee. In 2007, the iPod Index was considered more consistent, but criticized for ignoring shipping costs. IKEA also made an appearance in 2009 with Bloomberg's Billy Index.



# REAL EXCHANGE RATE AND PPP

## Big Mac index

Local-currency under(-)/over(+) valuation against the dollar, %



Sources: McDonald's; *The Economist*

\*Weighted average of member countries    <sup>†</sup>Average of four cities  
<sup>‡</sup>At market exchange rate (October 13th)    <sup>§</sup>Average of two cities

## SHORT RUN EXCHANGE RATES

Driven by supply and demand of money

PPP will eventually take over and equalize over time

Equilibrium point is where net exports equal net capital outflows – or net imports equal net capital inflows.

Rise in net capital outflows reduces the exchange rate.

Why?

Rise in net exports raises the exchange rate. Why?

## CURRENCY SPECULATION

More than half the FOREX market is speculation versus hedging.

Speculators use economic forecasts, technical analysis, Ouija boards, monitoring order flows, PPP indices, and other tools of varied effectiveness.

Technical analysis (charting) looks for market psychology in price history

What types of market efficiency do these tools imply?