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

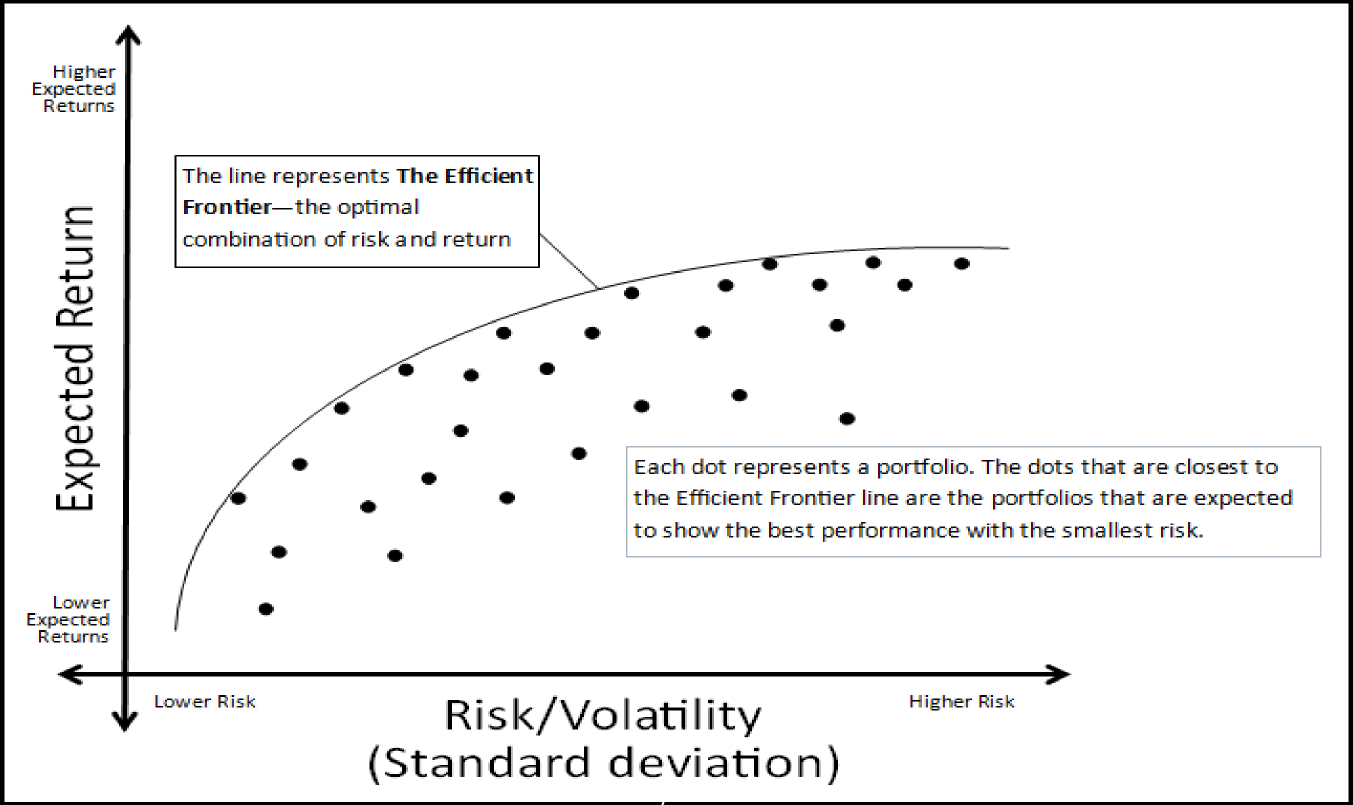
- Pros and Cons of each?
- Modigliani- Miller theorem says the market doesn't care. Why? Do you think this really holds up?
- Bonds – reduce taxes & adverse selection. Increases fixed payments and financial risk.
- Stocks – more upside and downside. Dividends are not contracted. More flexible cash flow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

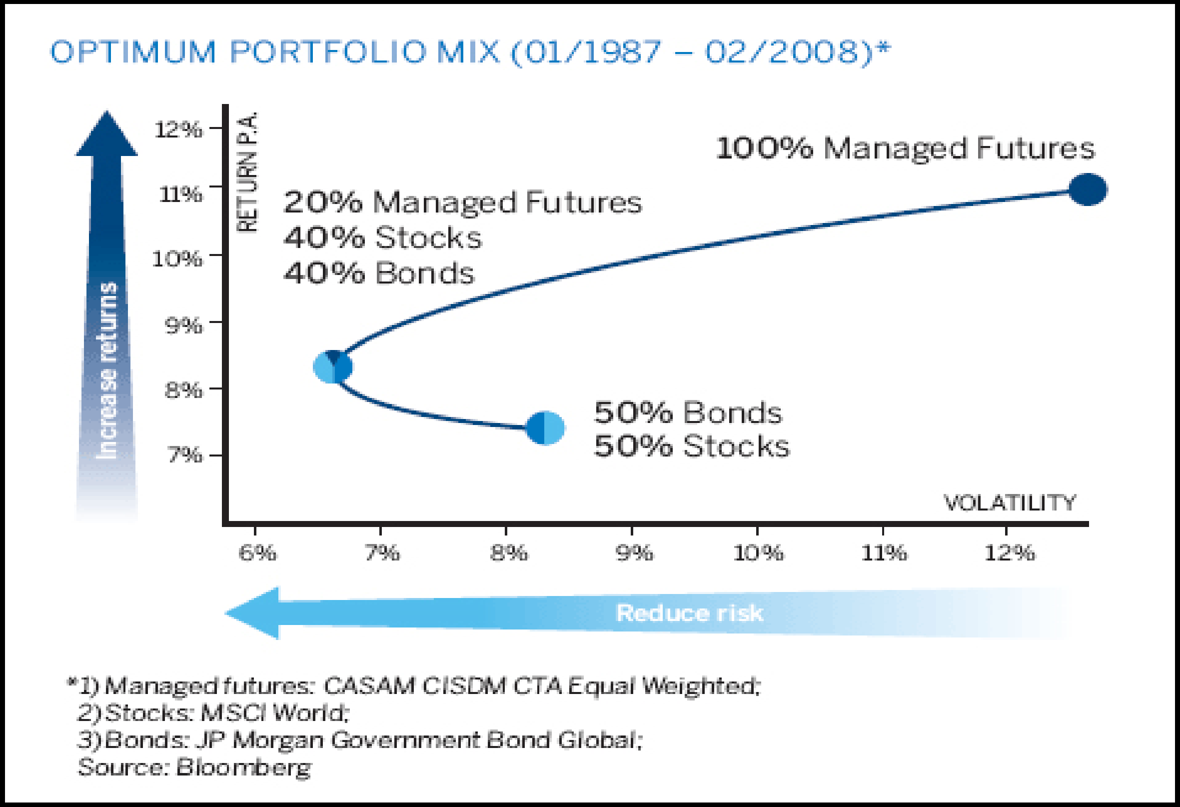
ASSET ALLOCATION THEORY

- Efficient Frontier



ASSET ALLOCATION THEORY

- 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 ______.

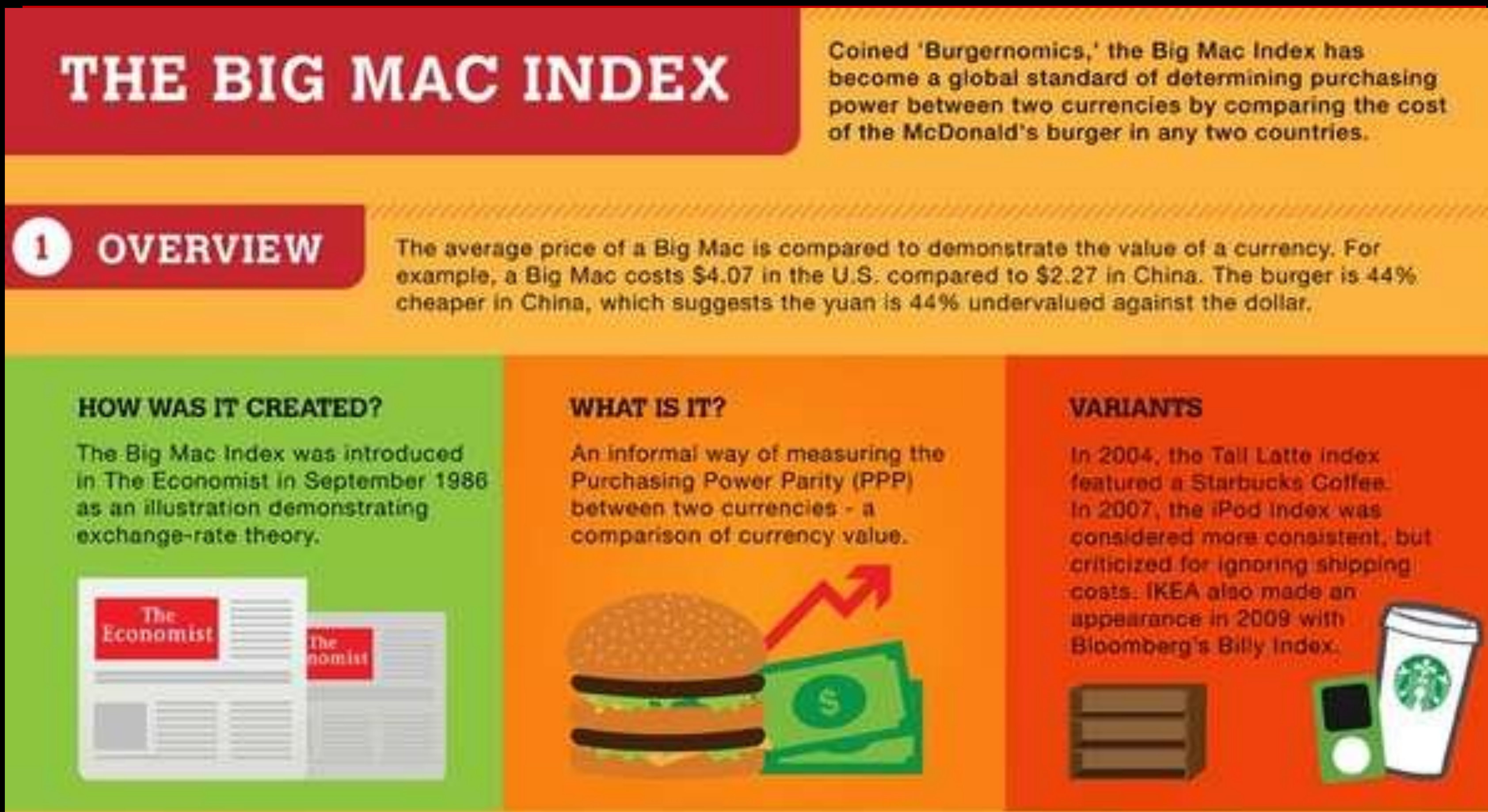
Why do politicians generally advocate for a "strong dollar" policy?

Can use futures contracts to hedge against currency exchange fluctuations.

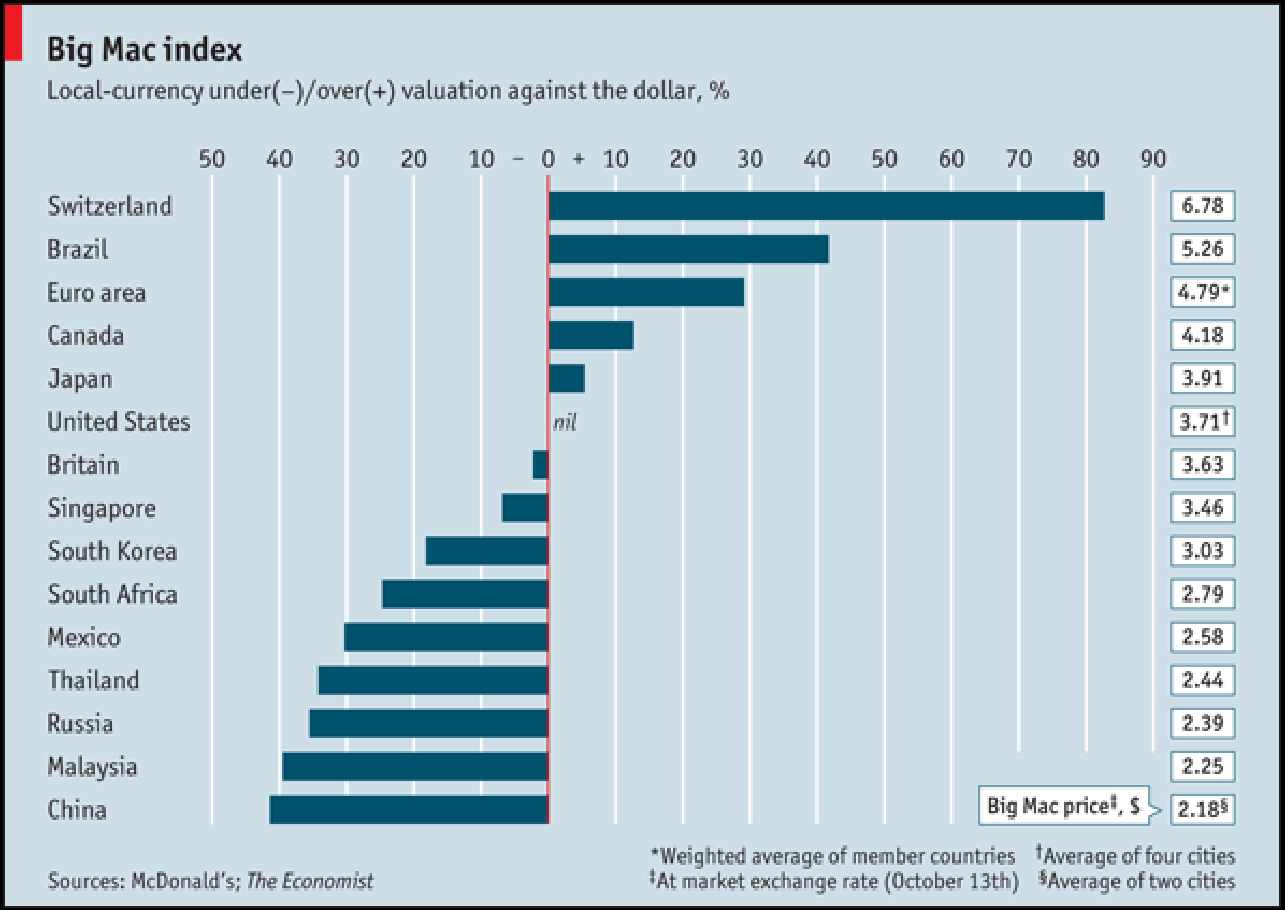
Real exchange rate is the relative price of domestic and foreign goods.

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

REAL EXCHANGE RATE & PPP



REAL EXCHANGE RATE AND PPP



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?