



ISS3080-Lecture 1

Why Study Financial Markets and Institutions?

Mingzhu Wang

SKKU ISS 2018



Agenda

1. Why Study Financial Markets?
2. Why Study Financial Institutions?
3. Applied Managerial Perspective
4. How Will We Study & Assess FMI course?



Jargons of the day!

- KOSPI / FTSE
- Exchange rate
- Mortgage rate
- Foreign exchange market
- Primary Market
- Secondary market
- OTC
- Eurobond
- IPO / SEO
- Direct / indirect finance
- Financial intermediation
- Transaction cost
- Liquidity service
- Risk sharing



1. Why Study Financial Markets?

- A case study of Brexit
 - UK announced that Britain voted to leave the European Union at around 2am on 24 June 2016.
 - Brexit vote outcome affected financial markets across the world.
 - For example, over 47 trillion won (US \$40 billion) has been erased from the Korean stock market in the week after the announcement.



KOSPI in the week after the announcement






















Americas >

Name ▲	2 Days	Last	Net Chng	% Chng
 S&P 500		2,037.41	-75.91	-3.59 %
 DJI		17,400.75	-610.32	-3.39 %
 NASDAQ 100		4,285.70	-181.78	-4.07 %
 S&P/TSX		13,891.88	-239.50	-1.69 %
 BOVESPA		50,105.26	-1,454.56	-2.82 %
 MXSE IPC		44,885.82	-1,260.10	-2.73 %

Europe >

Name ▲	2 Days	Last	Net Chng	% Chng
 STXE 600		321.98	-24.36	-7.03 %
 FTSE 100		6,138.69	-199.41	-3.15 %
 DAX		9,557.16	-699.87	-6.82 %
 CAC 40		4,106.73	-359.17	-8.04 %
 FTSE MIB		15,723.81	-2,242.36	-12.48 %
 SMI		7,747.18	-275.87	-3.44 %
 AEX		424.20	-25.66	-5.70 %
 IBEX		7,787.70	-1,097.60	-12.35 %
 OMXS 30		1,360.73	6.13	0.45 %

Asia >

Name ▲	2 Days	Last	Net Chng	% Chng
 NIKKEI 225		14,952.02	-1,286.33	-7.92 %
 S&P/ASX 200		5,113.18	-167.50	-3.17 %
 HANG SENG		20,259.13	-609.21	-2.92 %

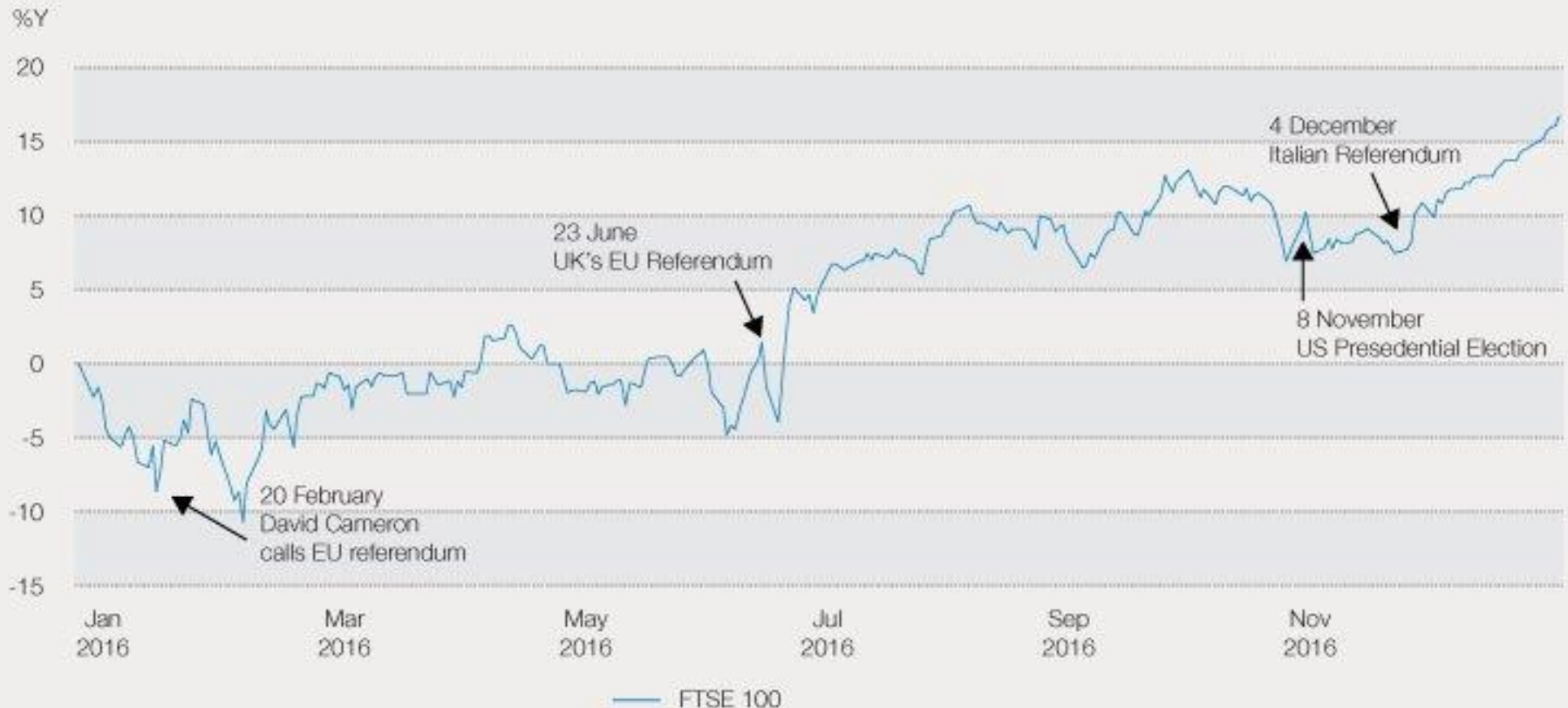


FTSE 100 Index (2016)

FTSE All-Share 2016 total return



FTSE All Share Total Return (%). Rebased 0 on 1 January 2016



Source: Thomson Reuters Eikon, 1 January 2016 to 28 February 2017. Rebased to 0 on 1 January 2016.



10 biggest FTSE 100 winners since the referendum

Company	Price change (June 23 - March 28)
Glencore PLC	104%
Antofagasta PLC	81%
Anglo American PLC	75%
Burberry Group PLC	56%
Rio Tinto PLC	54%
Ashtead Group PLC	54%
HSBC Holdings PLC	44%
Coca-Cola HBC AG	44%
Smiths Group PLC	42%
Mondi PLC	42%

Source: Hargreaves Lansdown



10 biggest FTSE 100 losers since the referendum

Company	Price change (June 23 - March 28)
Land Securities Group PLC	-13%
Babcock International Group PLC	-14%
Intu Properties PLC	-14%
Mediclinic International PLC	-19%
British Land Co PLC	-21%
Royal Mail PLC	-22%
Next PLC	-23%
Pearson PLC	-26%
BT Group PLC	-26%
easyJet PLC	-35%



1. Why Study Financial Markets?

The case study of Brexit shows that financial markets are crucial in our economy.

- Market activity affects personal wealth, the behavior of business firms, and economy as a whole.
- The main function of these markets is to channel funds from savers to investors, thereby promoting economic efficiency.

KOSPI

KRX: KOSPI

2,357.88 +0.66 (0.028%) ↑

Jun 25, 6:03 PM GMT+9 · Disclaimer

1 day 5 days 1 month 1 year 5 years Max



Open	2,351.89	Low	2,337.22
High	2,361.39		

FTSE 100 Index

INDEXFTSE: UKX

7,509.84 -172.43 (2.24%) ↓

Jun 25, 4:45 PM GMT+1 · Disclaimer

1 day 5 days 1 month 1 year **5 years** Max



Open	7,682.27	Low	7,508.32
High	7,682.27		



Function of Financial Markets

- Financial Markets channel funds from person or business without investment opportunities (i.e., “Lender-Savers”) to one who has them (i.e., “Borrower-Spenders”).

Lender-Savers

1. Households
2. Business firms
3. Government
4. Foreigners

Borrower-Spenders

1. Business firms
2. Government
3. Households
4. Foreigners

- Improves economic efficiency



Direct and Indirect Finance

1. Direct Finance

- Borrowers borrow directly from lenders in financial markets by selling financial instruments which are claims on the borrower's future income or assets

2. Indirect Finance

- Borrowers borrow indirectly from lenders via financial intermediaries (established to source both loanable funds and loan opportunities) by issuing financial instruments which are claims on the borrower's future income or assets

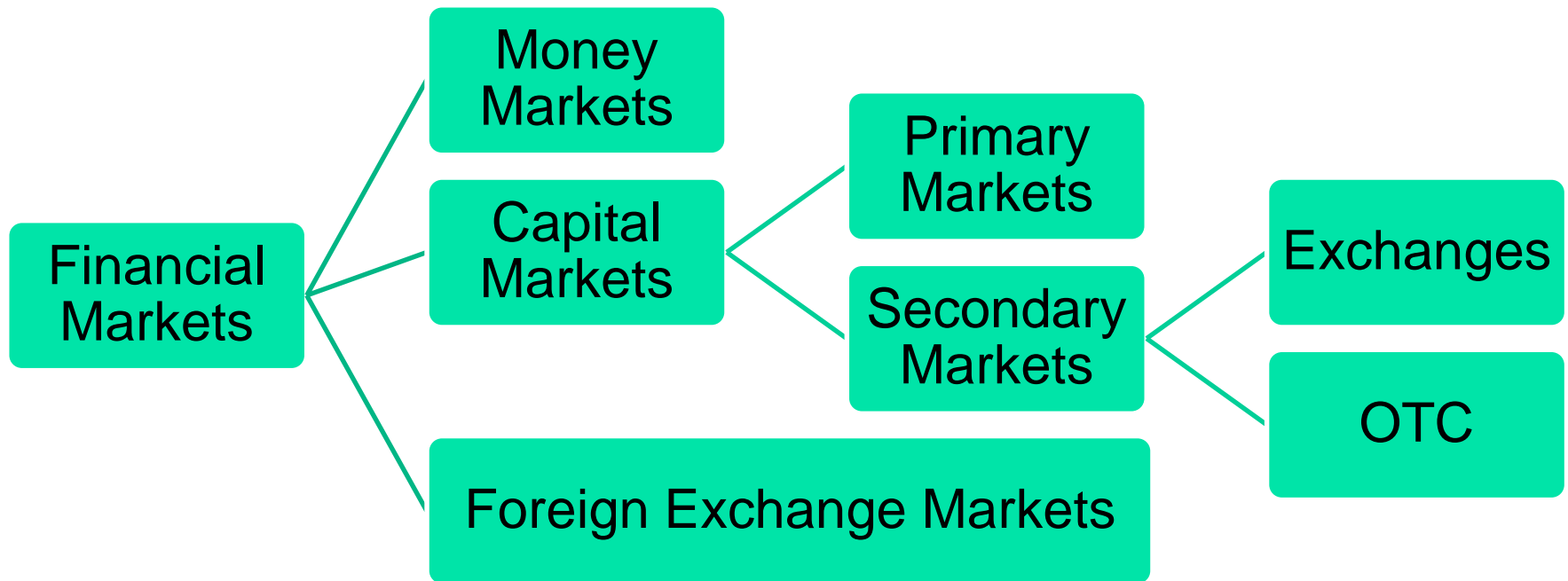


1. Why Study Financial Markets?

- Well functioning financial markets, such as the bond market, stock market, and foreign exchange market, are key factors in producing high economic growth.
- We will briefly examine each of these markets, key statistics, and how we will examine them throughout this course.



Categories of Financial Markets (v1)





Structure of Financial Markets

1. Primary Market

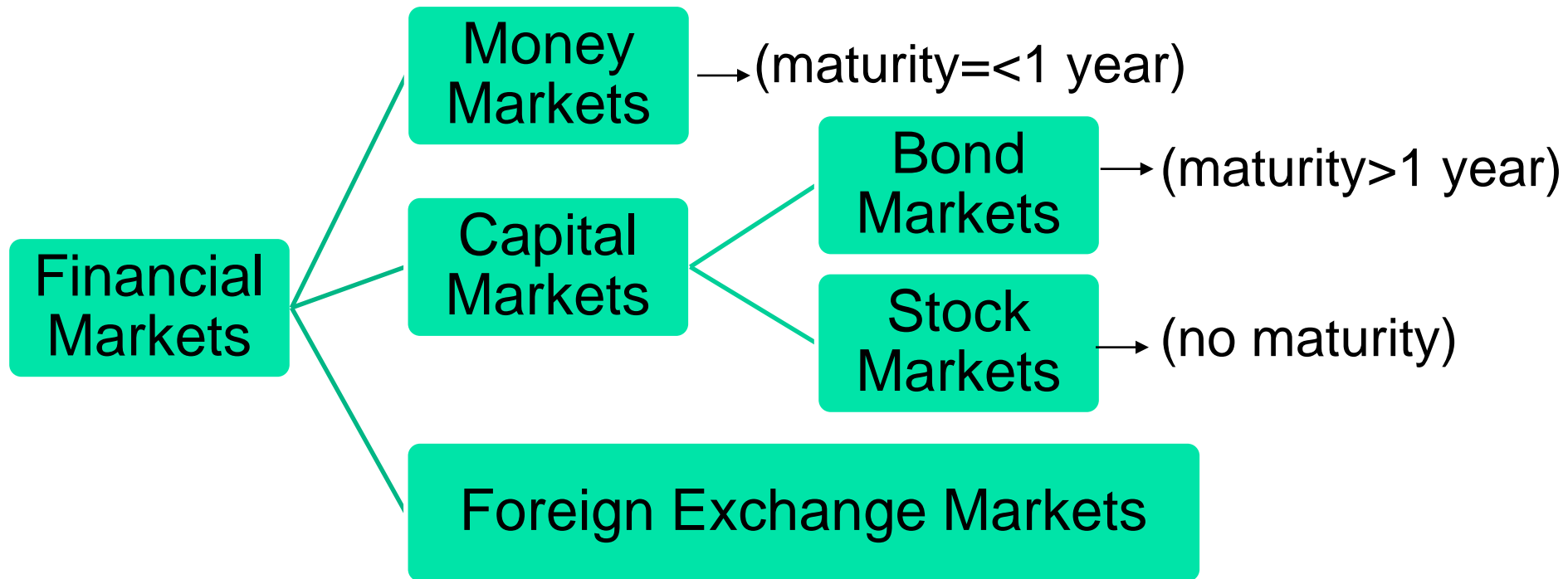
- New security issues sold to initial buyers
- Typically involves an investment bank who underwrites the offering

2. Secondary Market

- Securities previously issued are bought and sold
- Examples include the NYSE and Nasdaq
- Involves both brokers and dealers



Categories of Financial Markets (v2)





1. Why Study Financial Markets?

Debt Markets & Interest Rates

- Debt/bond markets, allow governments, corporations, and individuals to borrow to finance activities.
- In these market, borrowers issue a security, called a bond, that promises the timely payment of interest and principal over some specific time horizon.
- The interest rate is the cost of borrowing.



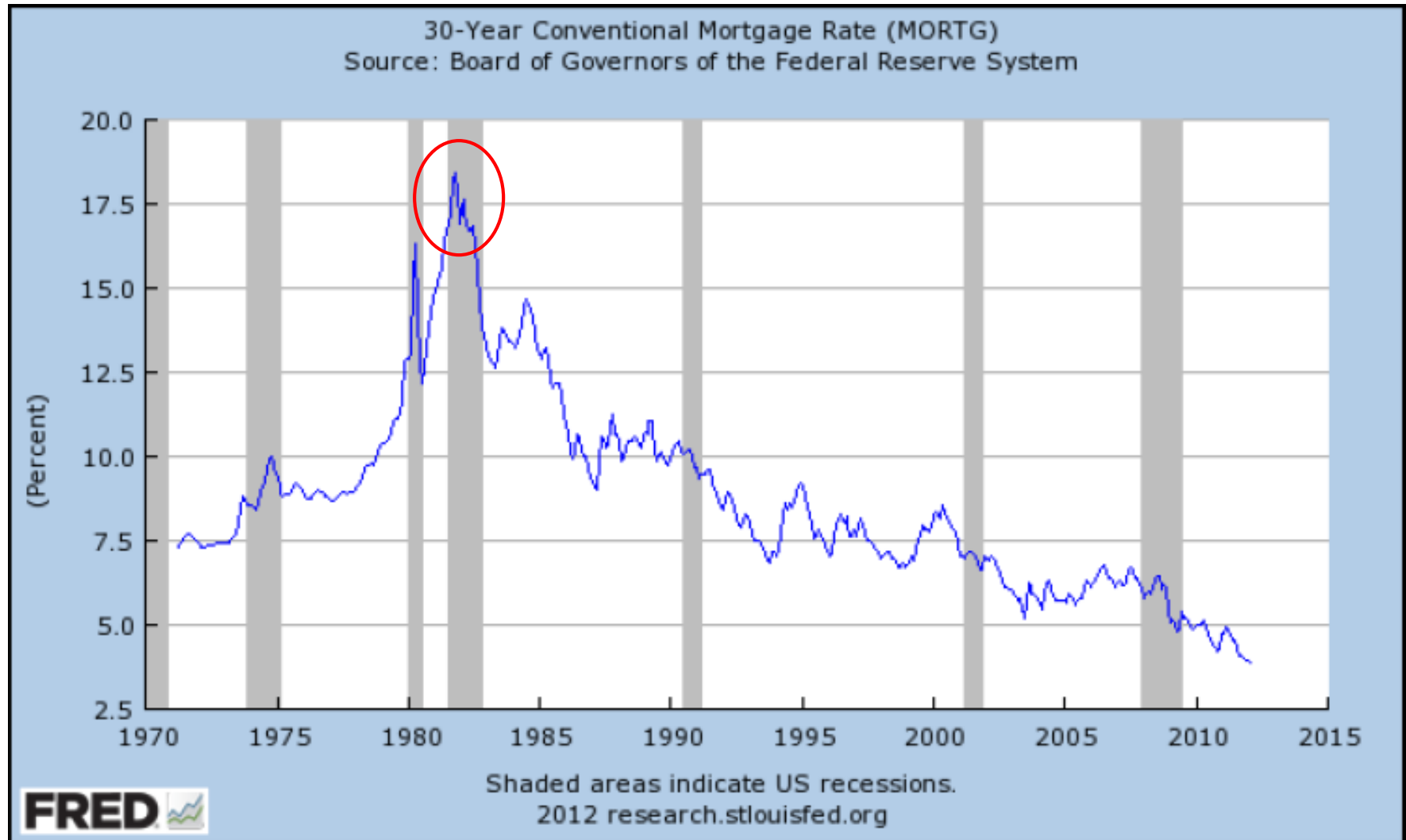
1. Why Study Financial Markets?

Debt Markets & Interest Rates

- There are many different types of market interest rates, including mortgage rates, car loan rates, credit card rates, etc.
- The level of these rates are important. For example, mortgage rate exceeded 17% in the UK in November 1979 and soon afterwards in the US in early 1983.



Historical Mortgage Rate in the US





1. Why Study Financial Markets? Interest Rates

- Types of Bonds and Interest Rate
 - Long-term Bond v.s. Short-term Bond
 - Government Bond v.s. Corporate Bond
- Because interest rates are important to individuals and business, understanding the history of interest rates is beneficial.



Bond Market and Interest Rates

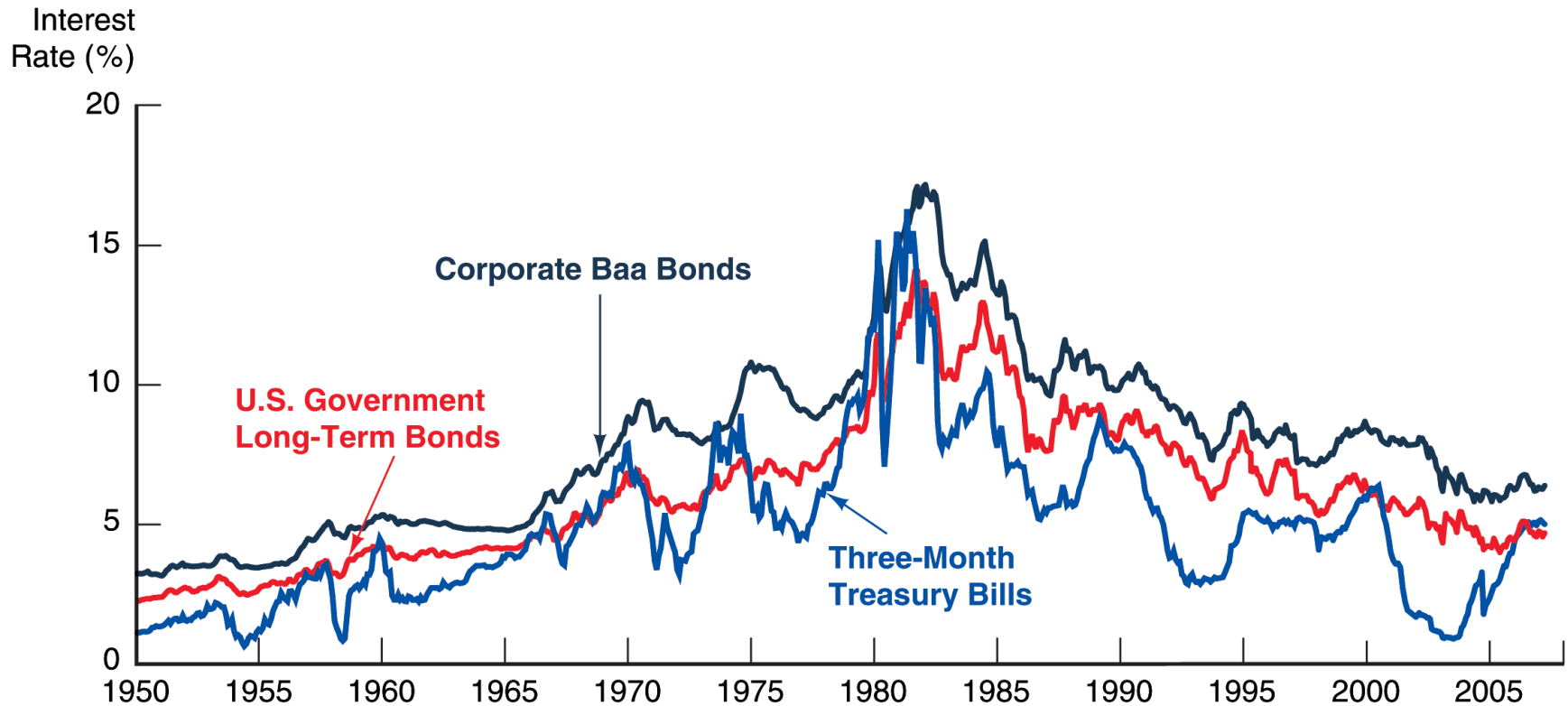


Figure 1.1 Interest Rates on Selected Bonds, 1950–2007

Sources: Federal Reserve *Bulletin*; www.federalreserve.gov/releases/H15/data.htm.



International Bond Market

- The internationalization of financial markets is an important trend.
- International Bond Market
 - Eurobond
 - Denominated in one currency, but sold in a different market
 - now larger than U.S. corporate bond market
 - Over 80% of new bonds are Eurobonds.



1. Why Study Financial Markets?

The Stock Market

- The stock market is the market where (common) stock or (ordinary) shares, representing ownership in a company, are traded.
- Companies initially sell stock (in the primary market) to raise money. But after that, the stock is traded among investors (secondary market).
- Of all the active markets, the stock market receives the most attention from the media, probably because it is the place where people get rich (and poor) quickly.



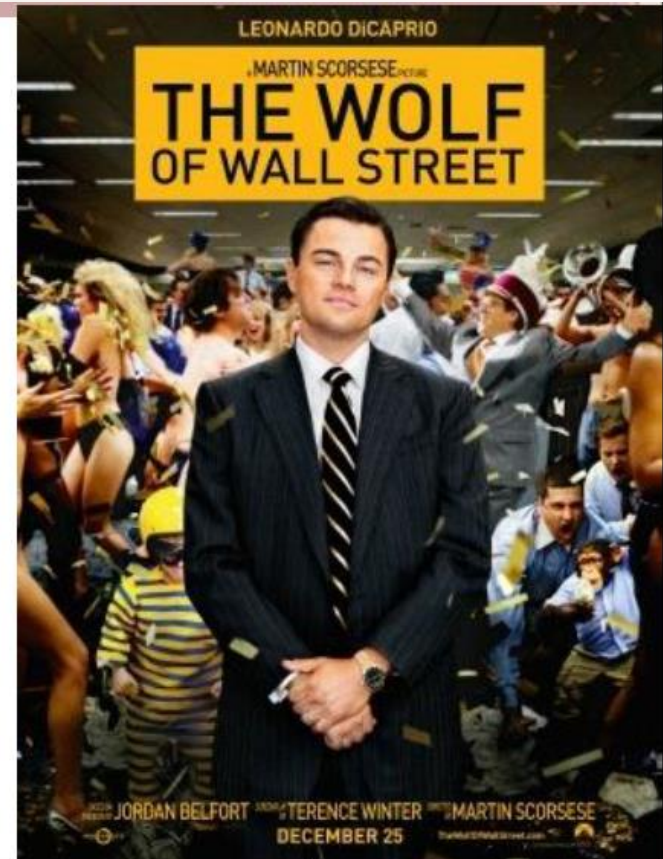
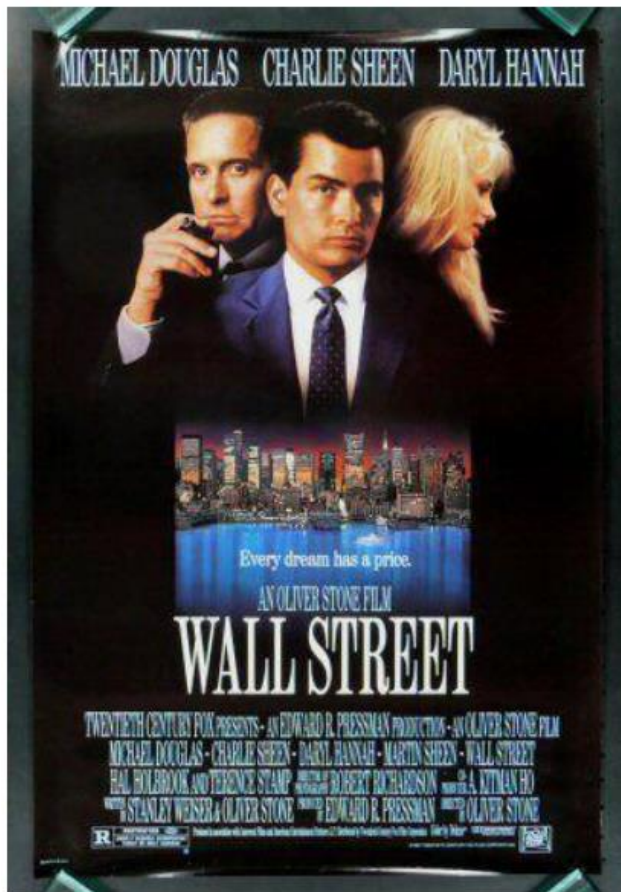


The casino view of stock market

- The fundamental determinants of prosperity are savings, education, and innovation.
- Finance plays little role in shaping these determinants.
- Finance's bigger role is in shaping fragility leading to financial crises.



This view is popular in Hollywood





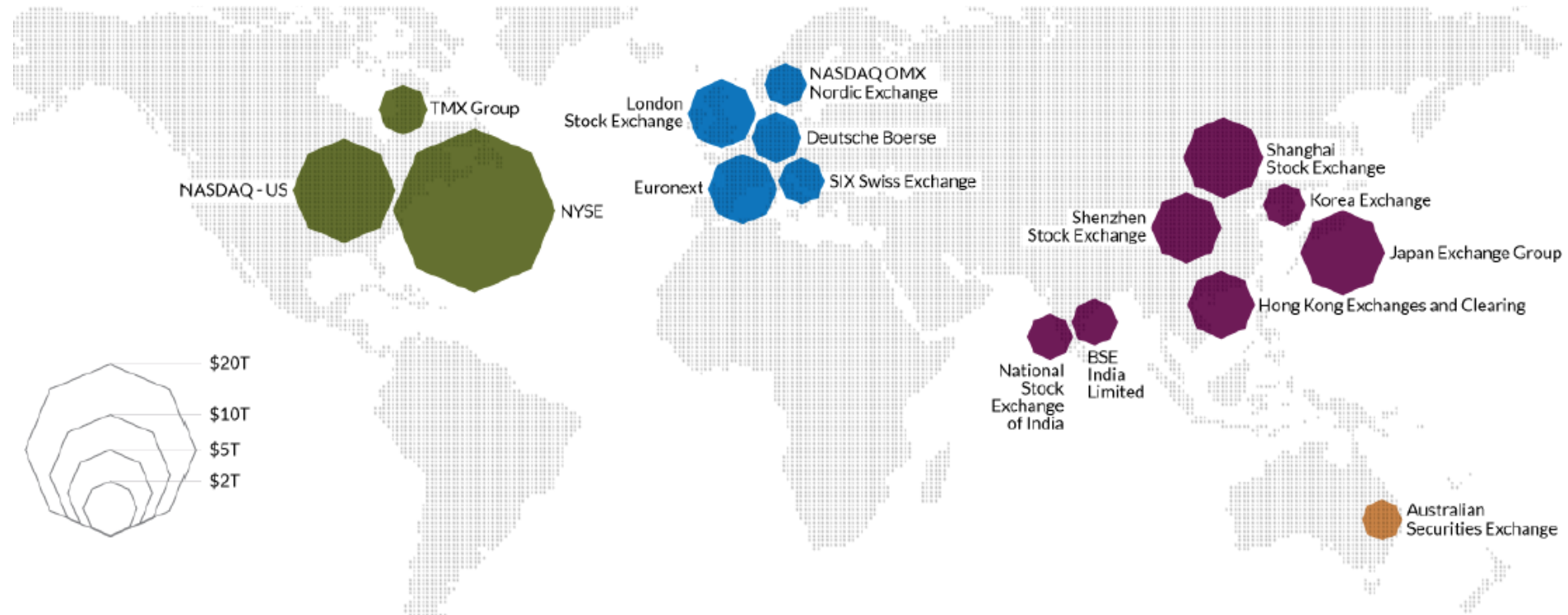
1. Why Study Financial Markets?

The Stock Market

- Companies, not just individuals, also watch the market.
- Although non-financial corporations don't typically "invest" in the market, they often seek raising equity fund through **initial public offering (IPOs)** and additional funding through **seasoned-equity offerings (SEOs)**. The success of SEOs is very dependent on the current price of the company's stock.



World's Stock Exchanges by Size



Source: <http://www.visualcapitalist.com/all-of-the-worlds-stock-exchanges-by-size/>



1. Why Study Financial Markets?

The Foreign Exchange Market

- The foreign exchange market is where international currencies trade and exchange rates are set.
- Although most people know little about this market, it has a ***daily*** trading volume around \$1 trillion!

View historical financial data and forecasts at <http://www.forecasts.org/data/index.htm>



Foreign Exchange Rate

Sterling Pound Against US Dollar (1970-2015)





Brexit Vote's Effect on Exchange Rate

19 Jun 2016 08:15 UTC - 26 Jun 2016 08:23 UTC

GBP/USD close:1.36754 low:1.34101 high:1.50056





1. Why Study Financial Markets?

The Foreign Exchange Market

- These fluctuations matter!
 - Now, foreign consumers will find that vacationing in the UK will be more economic, due to a strengthening dollar relative to the pound sterling.
 - When the dollar strengthens, purchase of domestic goods in the US falls, and US manufacturers experience a decreased demand for their goods.



2. Why Study Financial Institutions?

- Central Banks and the Conduct of Monetary Policy
- Structure of the Financial System
 - Helps get funds from savers to investors
- Banks and Other Financial Institutions
 - Includes the role of insurance companies, mutual funds, pension funds, etc.



2. Why Study Financial Institutions? Financial Intermediation

- The indirect finance process is called financial intermediation, which is actually the primary means of moving funds from lenders to borrowers.
 - More important source of finance than securities markets (such as stocks)
 - Needed because of transactions costs, risk sharing, and asymmetric information



2. Why Study Financial Institutions? Benefits of Financial Intermediaries

- Transactions Costs
 - Financial intermediaries make profits by developing expertise and taking advantage of economies of scale to reduce **transactions costs**.
 - Low transaction costs enable a financial intermediary to provide its customers with **liquidity services**.
 - Low transaction costs help reduce the exposure of investors to risk through **risk sharing**.
- Financial intermediaries also help individuals and businesses to **diversify** their asset holdings.



2. Why Study Financial Institutions? Global Perspective

- Studies show that firms in the U.S., Canada, the U.K., and other developed nations usually obtain funds from financial intermediaries, not directly from capital markets.
- In Germany and Japan, financing from financial intermediaries exceeds capital market financing 10-fold.
- However, the relative use of bonds versus equity does differ by country.



3. Applied Managerial Perspective

- Financial institutions are among the largest employers in the world and often pay high salaries.
- Knowing how financial institutions are managed may help you better deal with them.



4. How to study FMI course

- Read the relevant chapters of the book ideally before the lecture or immediately afterwards
- Engage in discussions during lectures
- Practice the end of chapter questions after each lecture
- Explore the internet that provides an enormous resource for present and historical information on financial markets and institutions.



4. How FMI course is assessed?

1. *Attendance:* (Total 30%)

2% mark for each daily attendance of the course.

2. *Final Test:* (Total 40%)

On 16 July (Monday), two hours, all taught topics. Most multiple Choice Questions and the last question is a word problem requires calculations.

3. *Group Project Presentations:* (Total 30%)

Each group gives a 20-minute presentation on 17 July depending on the class size.



Group Project

- Allocated groups of 3-5 students. Please let the TA know if you want to form a group with your friends
- The presentation will last for 20 minutes followed by about 5 minutes' questioning time with the rest of the class.
- The range of topics will be announced tomorrow.



Summary

- Why Study Financial Markets?: the three primary markets (bond, stock, and foreign exchange) were briefly introduced
- Why Study Financial Institutions?: the market, institutions, and key changes affecting these were outlined
- Applied Managerial Perspective
- How to learn the course efficiently and pass the assessments successfully



Next Topic

- What Do Interest Rates Mean and What Is Their Role in Valuation?
- Readings:
 - Mishkin and Eakins, Chapter 3