FIN 371M

MONEY AND CAPITAL MARKETS

Unique numbers: 03465 (2pm) 03470 (3:30pm)

Spring, 2013

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OFFICE HOURS:	Tu-Th 5pm or shortly thereafter or call in the morning or e-mail any time
TAs	TA hours and contact information will be posted on Blackboard
Course Notices	See Blackboard
Blackboard	See Course Document Tab on Blackboard for class posting of readings
Course Prerequisites	As set by the Finance Department

<u>OBJECTIVES OF THE COURSE</u>

Use will be made of economic and finance theory in the context of current economic and market conditions to understand the major forces affecting prices and price expectations in debt, foreign exchange and equity markets in the US and abroad. We analyze the risks and expectations being priced in these markets and the source of those risks and expectations. The objective of the course is for you to gain an understanding of how to interpret and analyze the economic and financial environment in order to make informed investment allocations. This is the perspective of the investment strategist.

<u>COURSE ROUTINE</u>

The course will be conducted in a manner that encourages class participation by the students, consistent with the objectives of the course, the time available, and the number of students in the class. A portion of each class will be devoted to the discussion and illustration of selected current events, as they pertain to the course subject matter. It is expected that students maintain a current awareness of financial and economic events from following daily events in selected newspapers and other periodicals and from financial market reporting on television and recommended web sites. Students are encouraged to ask questions and to be involved in the discussion.

Please ask questions and offer observations as appropriate during lecture. If you are speaking, identify yourself as we want to know you and **be sure to speak clearly** and at a level so that you are heard by all, and, if necessary, face the class so that as many people as possible can hear your questions or comments. Please don't be a "mumbler."

PERFORMANCE EVALUATION

A high academic standard will be maintained with respect to grades. A working familiarity with Money and Banking (Fin 354 or equivalent) concepts is very helpful. Fin 357 is required. Semester grades will be determined using the following relative weights: mid-term 50%, and 50% comprehensive final. Grades will be assigned based on the final distribution of grades with grades assigned to each mode of the distribution. There is no set distribution of grades but there will be a maximum class average GPA of approximately 3.33. Examinations will be multiple choice. Attendance is not required but STRONGLY recommended. Subjects discussed in class will be emphasized on exams. There will be an interest rate/bond price exercise distributed in class. Failure to turn in the interest rate exercise will reduce the final computed grade by 5 points on the final exam.

COURSE REVISIONS and MATERIALS

Fin 371 attempts to integrate current economic and financial market developments into the course so that these developments can be understood in the larger context of economic-financial interactions presented in the course material. This requires not only an awareness of current events but also the adaptive ability to address these issues when they arise. We do this with introducing updates of current events as they occur which covers most class sessions. There are no textbooks that cover this material so attendance is extremely important and anticipate that the course outline will be revised as events occur. For these reasons subjects discussed in class and materials distributed in class have a high weight on the exams so that if you do not believe you will attend regularly it will be difficult to attain a high grade. Pick up handout as you enter the classroom.

SCHEDULING ISSUES

The course is heavily front-loaded with extra Sunday evening sessions from 7 to 10 pm on Jan 21th in Jester A121A and Feb 3 in GSB 2.126 from noon to 2 in order to cover important background theory so we can get into the subject matter more quickly and facilitate our ability to discuss and understand current issues in financial markets. There will be a Sunday night course review Feb 24th prior to the mid-term from 7 to 10 in GSB 2.124. The mid-term is on Wednesday evening February 27th from 7 to 10 in UTC 2.102A. After the mid-term we will break until after Spring break. The final exam is on Wednesday April 24th also in UTC 2.102A from 7 to 10 pm.

COURSE MATERIALS

1. The required reading materials are in the 4 volume course packet (3 basic volumes and 1 supplemental packet of very recent materials which can be obtained from Speedway Printing

715 W. 23rd St, (between San Gabriel and Rio Grande) Suite N. See: Speedwayprinters.com for a map.

2. Additional outlines and readings will be provided in class on an on-going basis.
3. Subscribe to www.TheSpellmanReport.com from which assignments will be made as the course unfolds. It's free. Brows the blogs and videos at the outset of the course to provide a head start understanding of the topics covered and the course point of view.
4. Subscribe to the Wall Street Journal for the semester. The Wall Street Journal subscription is obtained on www.wsj.com/studentoffer or https://buy.wsj.com/shopandbuy/order/subscribe.jsp?trackCode=aap5ue00&mg=inert-wsj $29.95 for semester.

5. **Please indicate my name (Lewis Spellman) as Referring instructor in order to be able to receive educational items from Dow Jones for the class**.

6. Blackboard will be utilized to post notices, distribute digital handouts, posting of grades etc. Blackboard is accessed through http://courses.utexas.edu

Recommended

The Financial Times

For background in money and banking issues, you might consult any money and banking textbook. One recommend is Mishkin, The Economics of Money, Banking and Financial Markets, Addison-Wesley, 9th Edition, 2009.

Reference is made to

Mauldin, John

Endgame

John Wiley & Sons

Recommended Web Sites to keep abreast of financial market issues

- http://www.pimco.com
- www.RealclearMarkets.com
- http://www.cumber.com/default.aspx?n=lHome
- http://ftalphaville.ft.com/
- http://www.project-syndicate.org/
- http://www.zerohedge.com/

- http://www.imf.org/external/index.htm
- https://www.grneam.com/Publications
- http://www.frontlinethoughts.com/

Course Outline

1. Introduction: Frame of Reference
    a. Interconnections of economy, financial markets and policy
    b. Secular vs. cyclical change
        i. Importance of detecting secular patterns and asset class movement

Reading
Graphs
Macro-Investing Point of View: Secular Forum
Current Macro Financial Issues
Financial Market Stability and Financial Risk (on Blackboard)
Investing Thoughts and Paradigms

    c. Expectations and Financial Pricing
        i. Past history vs. theory
        ii. Current bi-modal distributions of expected outcomes: what alternative outcomes are being priced?
    d. Unexpected macroeconomic paradigm change: how can it happen?
        i. Systemic adjustment in risk assessment during growth: The Minsky Moment
        ii. The Austrians and asset bubbles
        iii. Over-investment in physical capital theories of booms and busts
        iv. Role of Intangibles such as Confidence or the "Bang Point"

Reading (optional)
Boombustology
Boombustology book Chapter 1 and 2 (optional)
Video: Why Economists Missed It

2. Noting the secular issues being gauged and priced by the markets
        i. Balance sheet driven economic growth and contraction
            1. Consumer mortgage debt build-up and deleveraging: Progress
            2. Developed world sovereign debt overload: Just beginning
        ii. Dynamics of how consumer deleveraging takes down the economy and ramps up government deficits and debt so total debt does not decline
        iii. Age related entitlements pushing expansionary fiscal policy, deficits and debt accumulation (the good and the bad for the economy) to the point of extreme leveraging and extreme containment policies

iv. Austerity policies vs. economic growth: Debt ceiling is next. What are the effects of austerity on both the economy and debt containment
v. Large scale asset purchases by central banks known as "Quantitative Ease" to sustain financial prices, institutional balance sheets, the economy and government debt markets
vi. Effects of QEs on asset prices, the real economy, capital flight, exchange rates and inflation
vii. Problems associated with QEs and zero interest rate policy
viii. Asset bubbles and detachment of asset pricing from underlying "fundamentals"
ix. Commercial banks role as a transmitter of monetary policy being adversely affected via its holdings of assets, the zero interest rate floor, and a ramp up of regulatory required capital ratios and regulation reducing its risk assets

Reading: Mauldin Chapter 1, 2, 5 and 6
Investing Thoughts and Paradigms

3. Structural Flows and Stocks of the Economy and Financial Markets: Stock/Flow Analysis (see more detailed outline)
    a. Domestic leakages and financial reservoirs
    b. Global leakages and interactions
    c. De-coupling?
    d. How central bank expansion over-flows to other financial markets
    e. Exchange rate effects
    f. How central banks affect flow rates and prices in contrast to government influences

Reading
Flows and Stocks

4. Banking and Finance: The Old Fashioned Way (see more detailed outline)
    a. Central bank/commercial bank interactions
    b. The money supply or banking multiplier of central bank base money
    c. Why it no longer multiplies
    d. Monetary statistics (the M's): What do they measure?
    e. Progress in commercial bank recovery of capital adequacy

Reading
Interest Rate Mechanics
Bank Survivability

5. Quantitative Ease
    a. Why did the Fed resort to "Large Scale Asset Purchases"?
        i. Playing defense: Prevent financial implosion (a la 2008):
        ii. Stimulate economy and employment
        iii. Support financial institution balance sheets
        iv. Support government and mortgage finance
    b. QE issues

        i. Supporting financial institution balance sheets and hence net worth
        ii. Consumer wealth effects on spending
        iii. Economic and inflation effects
        iv. Capital flight effects and exchange rates
        v. How have the QEs affected the role of the central bank?
        vi. What are the possible ill consequences of ZIRP?
    c. How have QEs have been funded and effects
        i. Borrowed money
        ii. Printed money
    d. Alternatives to QE: Targeted use of money such as purchasing commercial bank stock

Reading:
Quantitative Easing
QEs and Pricing Implications
Currency Wars

6. Financial Intermediation: The New Fashioned Way (Shadow Banking)
    a. Factors that influenced the development of financial intermediation
    b. Securitization as a transmission mechanism
    c. The Carry Trade and financial intermediation
    d. The Shadow Banking System
        i. How funded
        ii. Objectives: Spreads vs. Total Returns
    e. Migration of financial intermediation from commercial banks to shadow banks: Why?
    f. Vulnerabilities arising out of a funding run (financial crisis)
        i. Liquidity issues
        ii. Solvency issues
    g. Flight to safety assets in a financial crisis

Readings
Financial Leveraging via Hedge Funds
The Carry Trade and the Repo Market
Shadow Banking and Financial Leverage
Black Swan Events and Financial "Collapse"
Flight to Safety Assets
Financial Market Stability and Systemic Risk (on Blackboard)

7. Secular Issues
    a. Demographics and Developed Country deficits and debt
        i. Entitlements how they came about
        ii. Strains with today's demographics

Reading:
Government Debt Strains and the Economy

    b. Dynamics of how a government becomes insolvent and implications
        iii. Deficits slows income growth rate so the debt to income ratio rises

    iv. Chronic increase in government debt relative to everything
    v. When sovereign risk gets priced the costs and debt ratios rise
    vi. Growing US obligations due to financial guarantees
    vii. Monetization when government debt can't be sold? The case of the UK vs. California
    viii. Regime change: Central Bank is placed under Treasury control for the purpose of printing money to pay the bills when debt can't be sold (loss of independence)
    ix. Sovereign default and private wealth meltdown
  c. Possible fixes
      1. Accelerate growth
      2. Austerity (The Fiscal Cliff)
      3. Wealth confiscation
      4. Cram the debt onto someone else's balance sheet: Such as:
          a. IMF
          b. Euro Bailout Funds
          c. EU
          d. Change regs to cram onto private balance sheets
          e. Central bank

Reading:
Sovereign Default
Euro Zone Breakup Implications
Private Costs of Sovereign Default
ECB and Euro Currency Meltdown
Government Debt Recovery

  d. Globalism
    i. How globalism came about
    ii. Implications: Developed world lost market share and income
    iii. Developing country savings transferred to developed countries via shadow banking system
    iv. Over -leveraging in the developed world followed by crash
    v. Developing country financial systems and policies
    vi. Global economic convergence coming
    vii. Manufacturing renaissance in developed world
    viii. Implications for developing countries

Reading:
Convergence

  e. Long term commodity supply issues

8. The Business Cycle, the Inflationary Gap and Systematic Risk Pricing
  a. Inflationary and Deflationary Gaps in goods markets
  b. Default risk relative to the Gap
  c. Cyclical labor costs and profit margins
  d. Fixed income and equity pricing over the cycle

Reading
Potential GDP and Financial Cycles
Mauldin Chapter 7 and 8
Debt Market Risk Factors

Risk on/Risk Off Trade

9. Theories of Inflation and effects on asset pricing
    a. The Potential GDP spending gap
    b. Money flows
        i. Old fashioned linkages
        ii. New fashioned linkages
    c. Interest rates and inflation
    d. The eras of high and low interest rates
    e. New Normals
        i. PIMCO: Slow Growth
        ii. Rosenberg: Money driven asset markets vs. fundamentals
    f. Debt vulnerability in today's environment

Reading
Inflation

10. Intangibles and Macro-Risk Pricing
    a. Confidence
    b. Risk-On, Risk-Off Trade
    c. Credit Ratings
    d. Reserve Currency Premiums
    e. Flight to Safety Currencies and Assets
    f. Capital Inflows/Outflows
    g. Domestically Controlled Money Supply

Reading
Macro Risk Premiums

11. The Four Quads and the Generation of Income and Inflation
    a. Determining Quad Positioning
    b. Dynamics in Quad Space
    c. Directional vs. Position
    d. P/Es in Quad Space
    e. Bond vs. Stocks Relative Yield in Depression vs. Inflationary Growth

Reading
Quad II: The Deflationary Boom
Quad III: The Deflationary Depression
Quad IV: Stagflation How it Occurs
Financial Market Pricing During Capital Flight
Financial Returns in the Four Quads
Long Term Asset Class Returns and Portfolio Management

NOTICES:

Scholastic Dishonesty

The McCombs School of Business has no tolerance for acts of scholastic dishonesty. The responsibilities of both students and faculty with regard to scholastic dishonesty are described in detail in the Policy Statement on Scholastic Dishonesty for the McCombs School of Business:

By teaching this course, I have agreed to observe all of the faculty responsibilities described in that document. By enrolling in this class, you have agreed to observe all of the student responsibilities described in that document. If the application of that Policy Statement to this class and its assignments is unclear in any way, it is your responsibility to ask me for clarification. Policy on Scholastic Dishonesty: Students who violate University rules on scholastic dishonesty are subject to disciplinary penalties, including the possibility of failure in the course an/or dismissal from the University. Since dishonesty harms the individual, all students, and the integrity of the University, policies on scholastic dishonesty will be strictly enforced. You should refer to the Student Judicial Services website at http://deanofstudents.utexas.edu/sjs/ or the General Information Catalog to access the official University policies and procedures on scholastic dishonesty as well as further elaboration on what constitutes scholastic dish

See Link to University Honor Code: http://registrar.utexas.edu/catalogs/gi09-10/ch01/index.html)

Privacy

Password-protected class sites will be available for all accredited courses taught at The University. Syllabi, handouts, assignments and other resources are types of information that may be available within these sites. Site activities could include exchanging e-mail, engaging in class discussions and chats, and exchanging files. In addition, class e-mail rosters will be a component of the sites. Students who do not want their names included in these electronic class rosters must restrict their directory information in the Office of the Registrar, Main Building, Room 1. For information on restricting directory information see: http://www.utexas.edu/student/registrar/catalogs/gi02-03/app/appc09.html.

Disabilities

Students with Disabilities see http://utexas.edu/diversity/ddce/ssd/

Religious Holidays

By UT Austin policy, you must notify me of your pending absence at least fourteen days prior to the date of observance of a religious holy day. If you must miss a class, an examination, a work assignment, or a project in order to observe a religious holy day, you will be given an opportunity to complete the missed work within a reasonable time after the absence.