

**FIN 371M
MONEY AND CAPITAL MARKETS
Spring, 2016**

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OFFICE HOURS: **Tu-Th 5 pm or shortly thereafter or call** in the morning or
e-mail any time
TA Contact sabrina.harliman@yahoo.com or (512) 201-3290
TA Hours To be posted on Canvas
Course Notices See **Canvas**
Prerequisites As set by the Finance Department

OBJECTIVES OF THE COURSE

The purpose of the course is to establish the linkages from domestic and global economic forces to financial market pricing. It is macro-finance. This is typically the domain of the financial strategist who recommends a portfolio allocation among asset classes consistent with the economic environment ahead to produce positive total returns. A general framework will be built to analyze how macro finance variables affect financial pricing and, in addition, we will closely observe how the market prices current economic and financial conditions.

COURSE ROUTINE

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 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 3.55. 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.

Exams and Grading

Mid-term 50% and Final Exam 50%.

There will be a Bond Price Exercise. Failure to turn it in will result in a 10% reduction in final exam grade.

Grading is within the guidelines established by the Finance Department and the Associate Dean for Graduate Programs.

SCHEDULING

There is a Sunday evening lecture on Jan 31 from 7 to 10pm in GSB 2.124. This is a single session to effectively teach the background on what you need to know about macroeconomics and economic policy.

There will be Sunday evening summary and reviews from 7 to 10 on the Sunday prior to the midterm and final exam. The midterm review is Sunday March 6, 2016 and the Final exam Summary and Review session is April 24th. Both will also be held in GSB 2.124.

The Midterm is Tuesday March 8 from 8 to 10 in WCH 1.120. There will be no class on Thursday following the midterm.

The Final exam will be on Wednesday April 27 from 7 to 10 pm in UTC 2.102A.

COURSE MATERIALS

1. The required reading materials are in the 3 volume course packet which can be obtained from **The Copy Center on the third floor of GSB.**
2. Subscribe to **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.
3. Additional outlines and readings will be provided in class on an on-going basis.
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&mq=inter-wsj> \$15 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. Canvas will be utilized to post notices, distribute digital handouts, posting of grades etc.

Recommended

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.

Recommended Web Sites to keep abreast of financial market issues

- <https://www.janus.com/bill-gross-investment-outlook>
- <http://johnhcochrane.blogspot.com/>
- <http://www.frontlinethoughts.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>

Course Outline

Course Outline

1. Thumbnail of today's macro-finance issues
 - a. US cyclical recovery status
 - b. Questionable long term economic growth
 - c. The oil and commodity shock and its effect on the economy, exchange rates and financial prices
 - d. Stock market sustainability in the face of weak economic growth and the end of the Fed's QE
2. General background issues and frame of reference for macro finance

- a. The interrelationships between the economy, economic policy and financial market pricing
- b. Financial valuations today are a reflection of expected future economic outcomes
- c. Economic variables of greatest interest to market pricing:
 - i. Economic growth as it infers an earnings growth rate, affecting equity valuation
 - ii. The exchange rate and how it affects the economy and financial pricing
 - iii. Inflation and default valuation of fixed income
- d. Cyclical vs. secular forces: Where are we in the cyclical and the secular cycles?
- e. The global interactions among countries
- f. The importance of a secular view for an investment manager
- g. Economic and financial policy by governments and central banks that affects the economy and financial pricing outcomes
- h. Exchange rate policy as a newly used policy tool
- i. The combined use of theory and history as a frame of reference creating inferences of the future
- j. Theory follows observations: Theoretical frameworks are in revolutionary change as the current economic forces are not explained by post-Depression standard (textbook) economic theory
- k. The logical conclusion of Globalism
- l. Interest rate movements in the past year

Reading

Graphs

Interest Rate Mechanics

Samples of the Secular Investment Point of View

The Current Environment

3. The Basics I: Structural flows and stocks of the economy and financial markets:
 - 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 affecting not just prices but also economic growth
 - e. Exchange rate are affected
 - f. Playing offense and defense with an exchange rate policy

Reading

Asian Contagion II

4. Secular growth issues
 - a. Supply side as measured by Potential GDP
 - i. Slowdown of population/labor force growth
 - ii. Education and labor force quality
 - iii. Slowdown in productivity growth
 - iv. Regulation: new firm formation and flexibility to produce
 - v. Growth stymied by heavy regulation
 - vi. Effects of globalism on Potential GDP

Reading:
Supply Side/ Secular Stagnation
See Potential GDP in Vol. III

- g. Demand side
 - i. Over indebtedness and implications, private economy
 - ii. Over indebtedness and implications, governments
 - iii. Funding of future entitlements via taxes, bonds or monetized bonds
 - iv. The realization that low interest rates no longer elicit a meaningful response
 - v. The economic weakness of the commodity exporting countries
 - vi. US trade deficit still large

Reading:
Demand Side

- 5. Evidence of secular stagnation
 - a. Business investment response to interest rates is weak
 - b. Trade and current account deficits negative since globalism began
 - c. Still more low wage competition ahead
 - d. Cyclical recoveries have become progressively longer and weaker
 - e. Evidence of flat wages and prices and effects on economy: The loss of the middle class
 - f. Inflation rate refuses to rise despite all the money being injected

Readings
Secular Stagnation

- 6. The Basics II: The Balance Sheets of Banking and Finance: The Old Fashioned Way
 - a. Central bank/commercial bank interactions
 - b. The money supply or bank credit multiplier of central bank base money
 - c. Why it no longer multiplies (for now)
 - d. Monetary statistics (the M's): What do they measure?
 - e. Progress in commercial bank recovery of capital adequacy lost in the Great Recession

Reading
Monetary Policy/QE

Bank Survivability

- 7. Extreme Monetary Policy: Quantitative Ease
 - a. Why the Fed resorted to "Large Scale Asset Purchases" (QE)
 - i. Because small support had a weak response they ramped it up
 - ii. Supports asset prices and hence private balance sheets (Net Worth)
 - iii. Stimulate cheap funding to generate spending and employment

- iv. Market support for government bonds and mortgage finance: Is that enough?
- v. Consumer wealth effects: will that help?
- vi. Generate positive inflation: why is this important?
- vii. Reduces the price of the US dollar and helps exports
- h. Currency Wars and Direct Exchange Rate intervention
 - i. Exchange Rates, capital flows and financial prices are all affected
 - ii. Which central bank forces others to respond?

Reading:

Quantitative Ease

Financial Price Extremes under QE

Divergence of QEs

Currency Wars

8. Financial Intermediation: The New Fashioned Way (Shadow Banking)

- a. The development of non-bank financial intermediation
- b. The Carry Trade and financial leverage
- c. The Shadow Banking System
- d. How funded-Repo
- e. The spread objective
- f. Why the migration to shadow banks from commercial banks

9. Financial crisis vulnerability of Shadow Banks

- a. Vulnerabilities when the collateral values diminish
- b. How to measure the vulnerability of financial collapse a la the Mortgage meltdown of 2008
- c. The "Run on the Bank"
 - i. Liquidity issues
 - ii. Solvency issues
- d. Balance sheet meltdown and flight to safety assets in a financial liquidation

Readings

Shadow Banking and Financial Leverage

Financial Implosions

Flight to Safety Assets

10. Developed Country fiscal deficits and debt accumulation

- a. Entitlements and Demographics: government financial obligations
- b. Dynamics of how a government becomes insolvent and implications
- c. Possible fixes

Reading:

Sovereign Debt Remediation and Sovereign Default
Private Costs of Sovereign Default

11. The Business Cycle and the Inflationary Gap

- a. Inflationary and Deflationary Gaps in goods markets
- b. Cost-push inflation
- c. Profit margins and profits over the business cycle
- d. Default risk pricing relative to the Gap
- e. Fixed income and equity pricing over the cycle

Reading:

Potential GDP and Financial Cycles

Business and Financial Cycle

12. Theories of Inflation and effects on asset pricing

- a. How money in the commodity money era produced inflation
- b. The Potential GDP- Spending gap (Keynesian inflation)
- c. The institutional mechanism for money to generate spending
- d. Why has QE not produced inflation?
- e. Imported inflation
- f. History of inflation and fixed income pricing
- g. Inflation Expectations as opposed to actual inflation and interest rates

Readings

Inflation and Interest Rates

13. **The Four Quads** and Financial Market Pricing

- a. Quad positioning: Inflationary growth vs. deflationary depression
- b. Dynamic movements in Quad space
- c. P/Es in quad space
- d. Total returns to equity, debt and other assets in each Quad

Reading

The Four Quads

Deflationary Depression

Stagflation

Financial Return in the Four Quads

Financial Market Pricing During Capital Flight

NOTICES

Students with Disabilities

Students with disabilities may request appropriate academic accommodations from the Division of Diversity and Community Engagement, Services for Students with Disabilities, 512-471-6259, <http://www.utexas.edu/diversity/ddce/ssd/>.

Religious Holy Days

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.

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

Campus Safety

Please note the following recommendations regarding emergency evacuation, provided by the Office of Campus Safety and Security, 512-471-5767, <http://www.utexas.edu/safety>:

- Occupants of buildings on The University of Texas at Austin campus are required to evacuate buildings when a fire alarm is activated. Alarm activation or announcement requires exiting and assembling outside.
- Familiarize yourself with all exit doors of each classroom and building you may occupy. Remember that the nearest exit door may not be the one you used when entering the building.
- Students requiring assistance in evacuation should inform the instructor in writing during the first week of class.
- In the event of an evacuation, follow the instruction of faculty or class instructors.
- Do not re-enter a building unless given instructions by the following: Austin Fire Department, The University of Texas at Austin Police Department, or Fire Prevention Services office.

- Behavior Concerns Advice Line (BCAL): 512-232-5050
- Further information regarding emergency evacuation routes and emergency procedures can be found at: <http://www.utexas.edu/emergency>.

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>.