



FINANCIAL MARKETS AND INSTITUTIONS

FIN 390.1

SPRING, 2017

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TA Hours	Wednesday 5pm and Thursdays from 2:30 (for an hour) in the Atrium
Time:	M-W 3;30 pm
Place:	UTC 1.146
Pre-requisite:	Finance Department Prerequisites or permission

Course Objectives

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 anticipated economic environment 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 expectations.

Course Procedure

Fin 390.1 integrates current economic and financial market developments into the course. This requires not only an awareness of current economic and financial events but also the ability to interpret how these developments will likely affect financial market pricing. We do this by introducing updates and analysis of current issues as they occur over 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 if events cause us to interpret issues not contained in the planned course outline. 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 class regularly it will be difficult to attain a high grade. Pick up daily handouts as you enter the classroom.

Course Prerequisites

As determined by the Finance Department. Basic macro and micro economics and investments suggested.

Course Materials

1. The required reading materials are in the 3 volume course packet can be obtained from Jenn's Copy at 2518 Guadalupe. The readings in 3 Volumes will be available by Saturday. Call first: 512 482-0779
2. TheSpellmanReport.com Free sign-up on web site. The monthly blogs covers current financial market issues that will be discussed in class.
3. Subject matter outlines and readings will be provided in each class.
4. Subscribe to the Wall Street Journal for the 15 week semester for \$15. The Wall Street Journal subscription is obtained at WSJ.com/studentoffer
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. Check Canvas for additional readings and course information.

Recommended Sources of Financial Information

Both CNBC and the Bloomberg Channels often discuss course related financial market issues

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 or Abel, Bernanke and Croushore, Macroeconomics

Recommended Web Sites to keep abreast of financial market issues

- Pay especial attention to Bill Gross' Monthly Letter found at: <https://www.janus.com/bill-gross-investment-outlook>
- <http://johnhcochrane.blogspot.com/>
- <http://www.frontlinethoughts.com>
- <http://www.pimco.com>
- www.RealclearMarkets.com
- <http://www.cumber.com/default.aspx?n=Home>
- <http://ftalphaville.ft.com/>
- <http://www.project-syndicate.org/>
- <http://www.zerohedge.com/>
- <http://www.imf.org/external/index.htm>

Attendance

Attendance is VERY important to class performance as there are no textbooks to fall back on.

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 29th from 7 to 10pm in GSB 2.124. This is a three hour single session to present the interconnections of macroeconomics, financial markets and economic policy in a global setting.

There will be a Mid-term Summary and Review in class on Monday February 27. The course summary and review will be on Sunday April 23rd from 7 to 10 pm in GSB 2.124.

The Midterm is Wednesday March 1 from 3:30 to 5:30 in UTC 3.104. There will be no class the week following to conform to the MBA foreign travel schedule.

The Final exam will be on Wednesday April 26 from 3:30 to 6:30 in UTC 3.104 from 3:30 to 6:30.

Course Outline

1. Thumbnail of today's macro-finance issues
 - a. Questionable long term economic growth
 - b. Why is growth thwarted?
 - 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
 - e. Trumponomics: What will it be?
2. General background issues and frame of reference for macro finance
 - a. 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 interest rate and how it affects the economy and financial pricing
 - iii. Inflation and default effects on the market pricing of fixed income
 - b. Recent movements of markets (stocks, bonds, currency)
 - c. Financial valuations heavily influenced by global monetary policy
 - d. Cyclical vs. secular forces: Where are we in the cyclical and the secular cycles?
 - e. Why developed world economic growth hit a wall
 - 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. Does globalism move forward or backward from here
 - i. Exchange rate policy as a newly used policy tool in open global financial markets

- j. The combined use of theory and history as a frame of reference creating inferences of the future
- k. Theory follows observations: Theoretical frameworks are in revolutionary change as the current economic forces are not explained by post-Depression standard (textbook) economic theory

Reading

Graphs

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. Debt overhang: both government and private
 - v. Underfunded pensions both government and private
 - vi. Regulation: new firm formation and flexibility to produce
 - vii. Growth stymied by heavy regulation
 - viii. 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

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 ala 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

Leadership and this Course

The Texas MBA program is designed to develop influential business leaders. The MBA Program has identified four fundamental and broad pillars of leadership: knowledge and understanding, communication and collaboration, responsibility and integrity, and a worldview of business and society. While all four of those pillars are interwoven, this course focuses most on knowledge and understanding of what moves financial markets and on the worldview of business and society.

McCombs Classroom Professionalism Policy

The highest professional standards are expected of all members of the McCombs community. The collective class reputation and the value of the Texas MBA experience hinges on this.

Faculty are expected to be professional and prepared to deliver value for each and every class session. Students are expected to be professional in all respects.

The Texas MBA classroom experience is enhanced when:

- **Students display their name cards.** This permits fellow students and faculty to learn names, enhancing opportunities for community building and evaluation of in-class contributions.
- **Students respect the views and opinions of their colleagues.** Disagreement and debate are encouraged. Intolerance for the views of others is unacceptable.
- **Phones and wireless devices are turned off.** We've all heard the annoying ringing in the middle of a meeting. Not only is it not professional, it cuts off the flow of discussion when the search for the offender begins. When a true need to communicate with someone outside of class exists (e.g., for some medical need) please inform the professor prior to class.

Remember, you are competing for the best faculty McCombs has to offer. Your professionalism and activity in class contributes to your success in attracting the best faculty to this program.

Academic Dishonesty

My exam include the requirement that student sign a pledge that they neither give nor receive information regarding the exam.

The responsibilities for both students and faculty with regard to the Honor System are described on <http://mba.mcombs.utexas.edu/students/academics/honor/index.asp> and on the final pages of this syllabus. As the instructor for this course, I agree to observe all the faculty responsibilities described therein. During Orientation, you signed the Honor Code Pledge. In doing so, you agreed to observe all of the student responsibilities of the Honor Code. If the application of the Honor System to this class and its assignments is unclear in any way, it is your responsibility to ask me for clarification.

Students with Disabilities

Students with disabilities may request appropriate academic accommodation from the Division of Diversity and Community Engagement, Services for Students with Disabilities, 471-6259. Upon request, the University of Texas at Austin provides appropriate academic accommodations for qualified students with disabilities. Services for Students with Disabilities (SSD) is housed in the Office of the Dean of Students, located on the fourth floor of the Student Services Building. Information on how to register, downloadable forms, including guidelines for documentation, accommodation request letters, and releases of information are available online at <http://deanofstudents.utexas.edu/ssd/index.php>. Please do not hesitate to contact SSD at (512) 471-6259, VP: (512) 232-2937 or via e-mail if you have any questions.

Honor Code Purpose

Academic honor, trust and integrity are fundamental to The University of Texas at Austin McCombs School of Business community. They contribute directly to the quality of your education and reach far beyond the campus to your overall standing within the business community. The University of Texas at Austin McCombs School of Business Honor System promotes academic honor, trust and integrity throughout the Graduate School of Business. The Honor System relies upon The University of Texas Student Standards of Conduct (Chapter 11 of the Institutional Rules on Student Service and Activities) for enforcement, but promotes ideals that are higher than merely enforceable standards. Every student is responsible for understanding and abiding by the provisions of the Honor System and the University of Texas Student Standards of Conduct. The University expects all students to obey the law, show respect for other members of the university community, perform contractual obligations, maintain absolute integrity and the highest standard of individual honor in scholastic work, and observe the highest standards of conduct. Ignorance of the Honor System or The University of Texas Student Standards of Conduct is not an acceptable excuse for violations under any circumstances.

The effectiveness of the Honor System results solely from the wholehearted and uncompromising support of each member of the Graduate School of Business community. Each member must abide by the Honor System and must be intolerant of any violations. The system is only as effective as you make it.

Faculty Involvement in the Honor System

The University of Texas at Austin McCombs School of Business Faculty's commitment to the Honor System is critical to its success. It is imperative that faculty make their expectations clear to all students. They must also respond to accusations of cheating or other misconduct by students in a timely, discrete and fair manner. We urge faculty members to promote awareness of the importance of integrity through in-class discussions and assignments throughout the semester.

Expectations under the Honor System

Standards

If a student is uncertain about the standards of conduct in a particular setting, he or she should ask the relevant faculty member for clarification to ensure his or her conduct falls within the expected scope of honor, trust and integrity as promoted by the Honor System. This applies to all tests, papers and group and individual work. Questions about appropriate behavior during the job search should be addressed to a professional member of the Career Services Office.

Cheating

Cheating is wrongfully and unfairly acting out of self-interest for personal gain by seeking or accepting an unauthorized advantage over one's peers. Examples include, but are not limited to, obtaining questions or answers to tests or quizzes, and getting assistance on case write-ups or other projects beyond what is authorized by the assigning instructor. It is also cheating to accept the benefit(s) of another person's theft(s) even if not actively sought. For instance, if one continues to be attentive to an overhead conversation about a test or case write-up even if initial exposure to such information was accidental and beyond the control of the student in question, one is also cheating. If a student overhears a conversation or any information that any faculty member might reasonably wish to withhold from the student, the student should inform the faculty member(s) of the information and circumstance under which it was overheard.

Actions Required for Responding to Suspected and Known Violations

As stated, everyone must abide by the Honor System and be intolerant of violations. If you suspect a violation has occurred, you should first speak to the suspected violator in an attempt to determine if an infraction has taken place. If, after doing so, you still believe that a violation has occurred, you must tell the suspected violator that he or she must report himself or herself to the course professor or Associate Dean of the Graduate School of Business. If the individual fails to report himself or herself within 48 hours, it then becomes your obligation to report the infraction to the course professor or the Associate Dean of the Graduate School of Business. Remember that although you are not required by regulation to take any action, our Honor System is only as effective as you make it. If you remain silent when you suspect or know of a violation, you are approving of such dishonorable conduct as the community standard. You are thereby precipitating a repetition of such violations.

The Honor Pledge

The University of Texas at Austin McCombs School of Business requires each enrolled student to adopt the Honor System. The Honor Pledge best describes the conduct promoted by the Honor System. It is as follows:

"I affirm that I belong to the honorable community of The University of Texas at Austin Graduate School of Business. I will not lie, cheat or steal, nor will I tolerate those who do."

"I pledge my full support to the Honor System. I agree to be bound at all times by the Honor System and understand that any violation may result in my dismissal from the Graduate School of Business."