

# Finance Matters

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# **Lecture#2**

## **Financial Markets**

# Definition

- ♦ A **financial market** is a market where people trade financial securities, derivatives or commodities at low transaction costs
- ♦ Securities include stocks, bonds, and also derivatives such as Futures, Options and Swaps
- ♦ Commodities include wheat, sugar, cattle, precious metals ( gold, silver ... )

# Merchants and Courtiers

- ◆ The merchants of Venice were trading government securities as early as the 13<sup>th</sup> century.
- ◆ Soon after, bankers in the nearby Italian cities of Pisa, Verona, Genoa, and Florence also began trading government securities, as well.

# The Origins of Stock Exchanges

- ♦ Antwerp had the world's first stock market system.
- ♦ Antwerp was the commercial center of Belgium and it was home to the influential Van der Beurze family.
- ♦ Early stock markets were typically called Beurzen ( la bourse in French)



# Antwerp

- ◆ Antwerp had the world's first financial market system
- ◆ These markets missed one instrument: stock



# Corporation

- ◆ In 1600s, a **corporation** was created “Governor and Company of Merchants of London trading with the East Indies”
- ◆ Instead of owning the entire ship, you own a “share” of the ship.
- ◆ East India Company became the first publicly traded company. Its shares were traded on the Amsterdam Stock Exchange.

# London

- ◆ The Royal Exchange had been founded by English financier Thomas Gresham and Sir Richard Clough on the model of the Antwerp Bourse, as a stock exchange. It was opened by Elizabeth I of England in 1571
- ◆ Early on, traders, courtiers and investors made deal in coffee shops.
- ◆ In many cases, companies were able to make thousands of pounds before a single ship had ever left harbor.

# London Stock Exchange

- ◆ London Stock Exchange was officially formed in 1801
- ◆ There was a total lack of regulation. Fraud and illegitimate companies flourished
- ◆ Up until 1825, companies were not allowed to issue shares

# LSE

- ◆ In 2007, the London Stock Exchange, LSE, merged with Borsa Italiana to create the London Stock Exchange Group
- ◆ As of April 2018, London Stock Exchange had a market capitalisation of US\$4.59 trillion

# New York



# NYSE

- ◆ Before, securities exchange had been intermediated by the auctioneers who also conducted more mundane auctions of commodities such as wheat and tobacco.
- ◆ On May 17, 1792 twenty four brokers signed the **Buttonwood Agreement** which set a floor commission rate charged to clients and bound the signers to give preference to the other signers in securities sales
- ◆ New York Stock Exchange (NYSE) officially opened in 1817
- ◆ However, the Philadelphia Stock Exchange is the oldest stock market, in the US

# NYSE and Financial crises

- ◆ The 1929 Crash
- ◆ Stock Market Crash of 1973-1974
- ◆ Black Monday of 1987
- ◆ Dot-com Bubble of 2000
- ◆ Stock Market Crash of 2008
- ◆ If the Composite drops by a specific number of points in a specific period of time, then the circuit breaker will automatically halt trading

- ◆ <https://www.investopedia.com/ask/answers/042115/what-caused-black-monday-stock-market-crash-1987.asp>

# TSX

- ◆ Toronto Stock Exchange,TSX, opened its doors in 1861 (few years before the confederation)
- ◆ It is the largest in Canada and the third largest in North America by market capitalization. It includes businesses based in Canada and the rest of the world.
- ◆ TSX hosts more oil and gas companies than any other stock exchange in the world, which is one major reason why it has such a high market cap

# MSE

- ◆ The Board of Stock and Produce Brokers was set up in Montreal in 1842 and the Montreal Stock Exchange (MSE) in 1874. The MSE listed 63 securities, including stock in banks, gas utilities, railways and mining companies and government debentures.
- ◆ Today, Montreal is the trading ground for all futures and options

# 1987 Market Crash in Toronto



# Financial Markets

- ♦ Market, or **exchange** can be in two categories (physical or computerized)
  - New York Stock Exchange, NYSE
  - London Stock Exchange, LSE,
  - Toronto Stock Exchange, TSX
  - NASDAQ (the second biggest in the world)

National Association of Securities Dealers Automated Quotations

# The Top Stock Markets

- ◆ New York Stock Exchange
- ◆ NASDAQ
- ◆ Tokyo Stock Exchange
- ◆ London Stock Exchange Group
- ◆ Euronext (Amsterdam, Paris and Brussels) since 2000.
- ◆ Hong Kong Stock Exchange
- ◆ Shanghai Stock Exchange
- ◆ Toronto Stock Exchange
- ◆ Frankfurt Stock Exchange
- ◆ Australian Securities Exchange

# Composite Index

- ◆ The Dow Jones Industrial Average is arguably the most important index in the world.
- ◆ The index was one of several indices first created by the Wall Street Journal editor, Charles Dow in 1885.
- ◆ The Dow Jones Industrial Average is made up of 30 large publicly-owned American companies who play a key role in the American economy. The index started as a list of companies involved in heavy industry, which is why it's called the "Industrial" Average.

# In and Out

- ◆ American Express
- ◆ 3M
- ◆ Goldman Sachs ( remember 2008)
- ◆ General Electric (one of the first introduced since 1907)
- ◆ Coca-Cola
- ◆ IBM
- ◆ Bank of America and Hewlett-Packard, removed in September 2013

# The 30 companies

- ◆ <https://www.cnbc.com/dow-30/>

# Blue Chips

- ◆ blue chip stocks usually offer steady earning results year after year.
- ◆ They won't shoot up in value overnight
- ◆ Usually they provide investors with a stable return on their money.
- ◆ Blue chip stocks tend to offer good diversification during recessions since their household name status likely means continued demand even in down times.

# Penny Stock

- ◆ a penny stock is a security issued by a company with small market value that trades for less than \$5 per share. Some experts set the cut-off even lower: at \$1 or less.
- ◆ Investors who buy penny stock shares count on the company making a turnaround so they can get a return on the money

# Electronic Trading

- ◆ NASDAQ has always been organized differently from traditional stock exchanges
- ◆ NASDAQ is held entirely on a network of computers and all trades are performed electronically
- ◆ In 2007, for example, the NYSE merged with Euronext to create NYSE Euronext – the first transatlantic stock exchange in the world
- ◆ In 2014, Euronext spun off and is back as stand alone

# Footsie

- ◆ The Financial Times Stock Exchange (FTSE) 100 Share Index, or "Footsie", is the dominant index, containing 100 of the top “blue chips” on the LSE
- ◆ Royal Dutch Shell
- ◆ BP
- ◆ Vodafone
- ◆ HSBC

# Equity vs. Debt

- ♦ **Equity markets:** A market where ownership of securities are issued and subscribed is known as equity market. An example of a secondary equity market for shares is the New York (NYSE) stock exchange.
- ♦ **Debt market:** The market where funds are borrowed and lent is known as debt market. Arrangements are made in such a way that the borrowers agree to pay the lender the original amount of the loan plus some specified amount of interest.
- ♦ These two markets are called **Capital Markets**

# Commodities

- ◆ A **commodities exchange** is an exchange, or market, where various commodities are traded.
- ◆ Most commodity markets around the world trade in agricultural product like wheat, barley, sugar, cotton, oil, milk products, pork bellies
- ◆ raw materials: silver, copper, palladium
- ◆ Oil, gas

# Chicago Board of Trade

- ◆ The Chicago Board of Trade (CBOT) is a commodity exchange established in 1848 where both agricultural and financial contracts are traded. The CBOT originally traded only agricultural commodities such as wheat, corn, and soybeans.
- ◆ The CBOT offers options and futures contracts on a wide range of products including gold, silver, U.S. Treasury bonds, and energy.

# CBOT

- ◆ CBOT is part of the Chicago Mercantile Exchange (CME) Group
- ◆ The CME Group is the world's leading and most diverse derivatives marketplace, made up of four exchanges: CME, CBOT, NYMEX, and COMEX (commodity exchange)
- ◆ CBOT is an open-outcry trading platform (on the decline, almost the only place around the world)

# Primary vs. Secondary

- ◆ Primary markets ( Initial Public Offers) where the ownership of securities is firstly issued for the public
- ◆ Secondary market: where the ownership is constantly being traded

# Example: Facebook

- ◆ In 2012, Facebook Inc. made its first Initial Public Offering.
- ◆ It was the largest IPO of an online company and one of the largest IPOs in the technology sector.
- ◆ Many believed the stock's value would very quickly increase on the secondary market due to the company's popularity.
- ◆ Underwriters priced the stock at \$38 per share, at the top of the targeted range, and raised the stock offering level by 25% to 421 million shares. The stock valuation became \$104 billion, the largest of any newly public company.
- ◆ Facebook raised \$16 billion through the primary market

# Another Example

- ◆ In June 2016, the Republic of Argentina announced it was selling \$2.75 billion worth of debt in a two-part U.S. dollar bond sale.
- ◆ Funding was going toward liability management purposes.
- ◆ Joint **underwriters** included Morgan Stanley, Bank of America, Merrill Lynch, Deutsche Bank and Credit Suisse.

# Secondary Market

- ♦ **Secondary market:** A market for secondary sale of securities. In other words, securities which have already passed through the new issue market are traded in this market. Generally, such securities are quoted in the stock exchange and it provides a continuous and regular market for buying and selling of securities.

- ◆ The stock of Facebook did not increase much in value the day of the IPO.
- ◆ After 460 million shares were sold and turnover exceeded 100%, the stock closed at \$38.23.
- ◆ However, Facebook still raised funding and investors purchased stock at a discount through the primary market.

# Other Type of Markets

- ◆ Foreign exchange market
- ◆ Cryptocurrency market
- ◆ Spot market ( for immediate delivery as opposed to Future markets)
- ◆ Interbank lending market: The interbank market is the global network utilized by financial institutions to trade currencies between themselves. Banks use the interbank market to manage exchange rate and interest rate risk. The rates used at this market is called LIBOR (London interbank offered rate)

# Over the Counter

- ♦ The over-the-counter (OTC) market is a securities market made up of dealers who may or may not be members of a stock exchange, and the types of securities traded are ones not listed on any recognized stock exchange, as well as bonds and debentures.
- ♦ The OTC market is also called the "unlisted market," the "street market" or the "between-dealer market."
- ♦ It is a telephone and computer-linked network of dealers, each one working for financial institutions

# The Bond Market

- ◆ Its main goal is to provide long-term funding for public and private expenditures. The bond market has largely been dominated by the United States, which accounts for about 39% of the market
- ◆ As of 2017, the size of the worldwide bond market (total debt outstanding) is estimated at \$100.13 trillion, according to Securities Industry and Financial Markets Association (SIFMA)

# Type of bond markets

- ◆ Corporate
- ◆ Government and agency
- ◆ Municipal
- ◆ Mortgage-backed, asset-backed, and collateralized debt obligations

- ◆ Companies and governments are major issuers of bonds. Probably the best-known bonds in Canada are CANADA SAVINGS BONDS, issued by the federal government; they can be redeemed for their face value at any time.
- ◆ A rise in interest rates is equivalent to a fall in bond prices, as the given series of payments will represent a higher rate of interest

# Bond Indices

An index is a mathematical construct, so it may not be invested in directly.

A number of bond indices exist for the purposes of managing portfolios and measuring performance, similar to the S&P 500 for stocks.

The most common American benchmarks are the **Barclays Capital Aggregate Bond Index**, **Citigroup BIG** and **Merrill Lynch Domestic Master**.

# Bond Indices

- ◆ Bond indices can be categorized based on their broad characteristics, such as whether they are composed of government bonds, municipal bonds, corporate bonds, high-yield bonds, mortgage-backed securities, etc
- ◆ They can also be classified based on their credit rating or maturity.
- ◆ Bond indices generally include more individual securities than stock market indices do, and are broader and more rule-based. This allows portfolio managers to predict which type of issues will be eligible for the index.

# Your Thoughts

