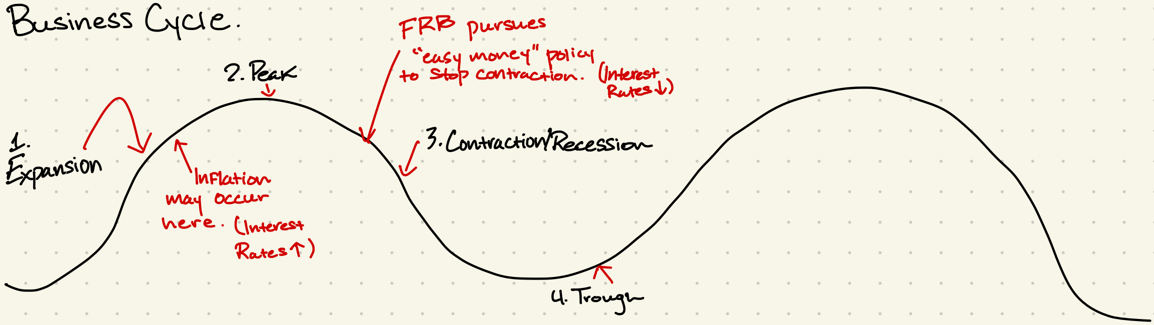
Economic Factors: Chapter 19

Economic Terms

Gross Domestic Product (GDP)	Measurement of the output of goods and services produced within the U.S. (disregards origin of producer) ▪ Key measure of aggregate economic activity
Consumer Price Index (CPI)	Measures the change in prices of goods purchased by a typical consumer ▪ Key measure of inflation
Inflation Prices ↑	"Too much money chasing too few goods" ▪ Leads to a rise in prices of goods and services ▪ High inflation usually accompanies high interest rates
Deflation Prices ↓	A general decline in prices, often caused by a reduction in the supply of money or credit ▪ Interest rates trend downward

GDP vs. GNP: GDP, measure within U.S borders.
GNP, can include other nations.

Business Cycle.



Economic Indicators

Leading Economic Indicators	Coincident Economic Indicators	Lagging Economic Indicators
▪ Building permits, private housing units ▪ Manufacturers' new orders, consumer goods, non-defense capital goods ▪ S & P 500 Index ▪ Initial claims for unemployment insurance ▪ Interest rate spreads, 10-year T-bonds less federal funds	▪ The Index of Industrial Production ▪ Employees on non-agricultural payrolls ▪ Personal income less transfer payments	▪ Change in the Consumer Price Index for services ▪ Average prime rate charged by banks ▪ Average duration of unemployment

"Stock Prices"

Activity

Match each term to the appropriate description.

CONSUMER PRICE INDEX	Personal income
FRB EMPLOYS A TIGHT MONEY POLICY	During periods of contraction
FRB EMPLOYS AN EASY MONEY POLICY	Key measure of inflation
LEADING INDICATOR	Prime rate
COINCIDENT INDICATOR	S&P 500 Index
LAGGING INDICATOR	As the peak is approached in the business cycle

Measuring Interest Rates

Prime Rate

- The rate charged by commercial banks to their best corporate clients

Discount Rate

- The rate charged by the FRB when a member bank borrows from it

Federal Funds Rate

- The rate charged on an overnight loan of reserves between member banks

Call Money Rate

- The rate charged by commercial banks on collateralized loans to broker-dealers

Classifications of Stock

Cyclical	Defensive
Performance tends to run parallel to changes in the economy ▪ Includes machine tool companies, construction firms, transportation and automotive ▪ These tend to do well during the expansion phase of the business cycle	Have smaller reactions to changes in the economy ▪ Examples include utility, tobacco, alcohol, cosmetic, pharmaceutical and food companies ▪ These tend to do better during contraction
Growth	**Value**
Companies whose sales and earnings are growing at a faster rate than the economy ▪ They reinvest most of their earnings and pay little or no dividends ▪ Tend to be riskier than other stocks, but offer greater potential for appreciation	Stocks that trade at lower prices relative to the issuing company's fundamentals ▪ The risk is that investors may ignore these companies ▪ Investors who buy value stocks are considered contrarians

Market Capitalization of Stocks

: Value of all outstanding Shares.

Large-Cap: More than $10 billion

Mid-Cap: Between $2 billion and $10 billion

Small-Cap: Between $300 million and $2 billion

Micro-Cap: Between $50 million and $300 million

Nano-Cap: Below $50 million

Activity

Read each statement and determine whether it is TRUE/FALSE.

DISCOUNT RATE!

THE FEDERAL RESERVE BOARD SETS THE FEDERAL FUNDS RATE	F
A VALUE STOCK IS ONE THAT IS OFTEN OVERLOOKED BY INVESTORS	T
DEFENSIVE STOCKS TEND TO PERFORM WELL DURING PERIODS OF CONTRACTION	T
A MICRO-CAP STOCK IS CONSIDERED LESS RISKY THAN A SMALL-CAP STOCK	F

Monetary and Fiscal Policy

	Keynesian	Monetarist
Principally attempt to influence	Taxes & Expenditures	The Money Supply
Type of policy	Fiscal	Monetary
Responsible for implementation	President and Congress	The Federal Reserve Board (FRB)

Monetary: Controlled by the FED.

Fiscal: Controlled by president and Congress (taxes and Spending)

Tools of the Fed

The following "tools" are listed from the least to the most used

Regulation T	Extension of credit by broker-dealers % that investors deposit on margin trade (50%)
Discount Rate	The only rate that's directly controlled by the Fed
Reserve Requirement	Amount of money that a bank must maintain based on a percentage of deposits
Federal Open Market Committee (FOMC)	Trades U.S. Treasuries through "primary government dealers"

"Tightening"
"Easing" - Reduce Discount Rate.

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Actions of the FOMC

To increase money supply and ease credit → The FOMC will → BUY SECURITIES and Engage in Repos

- This will cause deposits and reserves to increase

"Easing"
"Raise inflation"

To decrease money supply and tighten credit → The FOMC will → SELL SECURITIES and Engage in Reverse Repos

- This will cause deposits and reserves to decrease.

"Tightening"
"Stop inflationary trend"

The goal of these actions is to influence the fed funds rate

International Economic Factors

Interest Rates
- An inverse relationship exists between the U.S. dollar and foreign currencies
- Rising interest rates in U.S. will normally be accompanied by a strengthening of the dollar in relation to other currencies

Balance of Trade
- System of recording all of a country's economic transactions with the rest of the world over a specific period
  - Favorable balance of trade:
    - A decline in the dollar (relative to other currencies)
    - When the U.S. exports more than it imports
  - Unfavorable balance of trade
    - An increase in the dollar (relative to other currencies)
    - When the U.S. imports more than it exports

U.S. Dollar and foreign currencies have an inverse relationship.

Foreign Interest Rates ↑ ∴ USD gets weaker.

Foreign Exchange

Companies that receive revenue and incur costs in foreign currencies will have exchange-rate risk

Costs	Revenues
A U.S. company that manufactures overseas will have higher costs if the U.S. dollar falls (FC rises) and lower costs if the U.S. dollar rises (FC falls)	A U.S. company that has sales overseas will have higher revenue if the U.S. dollar falls (FC rises) and lower revenue if the U.S. dollar rises (FC falls)

Activity

Fill in the blank with the correct answers.

1. The Federal Reserve Board changes and provides lending through the discount rate.
2. Regulation T is the rate used by the Federal Reserve Board to control the extension of credit by broker-dealers.
3. The Federal Open Market Committee will increase the money supply when it buys securities, which should increase deposits and reserves.
4. The reserve requirement. dictates the amount that member banks must keep on deposit.
5. Higher interest rates in the U.S. generally leads to a strong dollar.
6. The balance of trade tends to become more favorable with a declined/ weak. dollar relative to foreign currencies.

The Balance Sheet

Assets	Liabilities and Equity
Current Assets • Cash • Marketable Securities • Accounts Receivable • Inventory	**Current Liabilities** • Accounts Payable • Dividends Payable • Interest Payable
Fixed Assets • Land • Buildings • Equipment	**Long-Term Liabilities** • Notes and Bonds
Intangibles • Goodwill • Patents • Trademarks	**Shareholders' Equity** • Preferred Stock and Common Stock • Retained Earnings • Paid-In Capital or Capital Surplus

Total Assets = Total Liabilities + Shareholders' Equity

The Income Statement

Revenue (Sales)

−Cost of Goods Sold

Gross Profit

−Operating Expenses (SG&A, D&A)

Operating Income

+ Other Income or Expenses

Earnings Before Interest and Taxes (EBIT)

−Interest

Taxable Income

−Taxes

Net Income or Loss

Activity

Which statements are TRUE regarding balance sheets and income statements? Circle all that apply.

I. The balance sheet equation is total assets = total liabilities + shareholders' equity.
II. Accounts receivable is considered a current liability.
III. Paid-in capital is part of shareholders' equity.
IV. In order to determine a company's earnings per share, its income statement must be examined.

Chapter 19 Quiz.

- Reverse Repurchase: Matched Sale.
- Prime Rate: Lagging indicator.

Leading Indicators.

- Stock Prices (S&P 500)
- Building permits.
- Avg. weekly unemployment claims.

Discount Rate: Controlled by Fed.
- Rate that the Federal Reserve charges depository institutions.

Foreign Interest Rates ↑: USD gets weaker.

FRB action w/ most impact on money supply: Changing reserve requirements

Interest Rate that fluctuates the most: Federal Funds rate.

Federal Funds Rate: Between banks, overnight lending rate.

Long Term Liabilities: Balance Sheet, not income statement.

FOMC enters repurchase agreement: Money in banking system increases.

Market Cap: # of common Shares outstanding X (MARKET PRICE of stock)

Rates Charged.

Bank-to-Corp: Prime Rate

FRB-to-Bank: Discount Rate.

Bank-to-Bank: Federal Funds Rate.

Bank-to-B/D: Call Money Rate.

CPI: Measure avg. change in prices for specific goods and services purchased by consumers in certain cities

Leading	Coincident.	Lagging.
· Predict.	· Same time	· After
· Before.	· Measure current activity	· Confirm past trends.

Chapter 20 : Investment Risks.

Systematic Risks

Systematic risks are those that affect the value of all securities and cannot be avoided through diversification, including:

Market Risk	Risk inherent in all securities due to market fluctuation
Interest-Rate Risk	Risk that the value of a fixed income investment (bond) will decline due to a rise in interest rates
Inflation Risk	Risk that an asset or the purchasing power of income may decline over time, due to the shrinking value of the country's currency ▪ To find a bond's real interest rate, the formula is: Nominal Yield – Inflation Rate
Event Risk	Risk that a significant event will cause a substantial decline in the market "COVID"

Measuring Systematic Risk

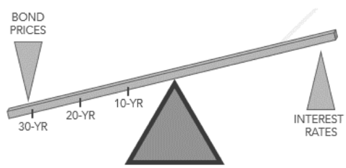
Beta measures the volatility of an asset (typically an equity) relative to the entire market

- A stock's beta is compared to the beta of the S&P 500, which is always 1.00
- If a stock's beta is more than 1, it's expected to outperform when the market is up and underperform when the market is down
- If a stock's beta is less than 1, it's expected to underperform when the market is up and outperform when the market is down

The Impact of Interest-Rate Risk

Fixed income investors (bondholders) are most affected by interest-rate risk

- Rising interest rates result in falling bond prices
  - Cannot be avoided by diversifying
  - Long-term debt is more vulnerable than short-term debt
  - Duration is used to measure the change in a bond's price based on a given change in interest rates
    - Measured in terms of years; the higher the duration, the higher the risk



- Equities of highly leveraged companies (e.g., utilities) and preferred stocks are susceptible to interest-rate risk

The Impact of Inflation Risk

Inflation risk, also referred to as purchasing power risk, is most detrimental to investments that offer fixed payments

- Inflation leads to increasing interest rates, thereby causing fixed payment securities to fall in value
- Rising prices diminishes the purchasing power of these same securities
- Common stock, variable annuities, real estate, and precious metals tend to perform better during times of inflation

What is Inflation? Inflation occurs when there's a continual increase in consumer prices or decline in a currency's purchasing power, caused by an increase of currency and credit beyond the availability of goods and services.

Activity

Match each term to the appropriate description.

RISING INTEREST RATES	Investment underperforms a rising market and outperforms a falling market
FALLING INTEREST RATES	Investment outperforms a rising market and underperforms a falling market
REAL INTEREST RATE	Bond prices are increasing
HIGH BETA	Purchasing power is diminished
LOW BETA	Factors in the rate of inflation when determining return

Less Volatile.

More Volatile.

Unsystematic Risks

These risks are unique to a specific security and can managed through diversification

BUSINESS RISK	▪ Risk that a company may perform poorly causing a decline in the value of the stock
(FDA Risk) **REGULATORY RISK**	▪ Risk that new regulations may have a negative impact on an investment's value
POLITICAL RISK	▪ Risk that political event outside of the U.S. could adversely affect the domestic markets
LIQUIDITY RISK	▪ Stemming from a lack of marketability, this is risk that an investment cannot be bought or sold quickly enough to prevent or minimize a loss

DPP's, Hedge Funds, OTC Equities.

Additional Risks

CAPTIAL RISK	CREDIT RISK	CURRENCY RISK	LEGISLATIVE RISK
▪ Risk of investors losing their invested capital (lower for bonds)	▪ Risk that a bond may not repay its obligation	▪ Risk of loss when converting an investment that's made in a foreign currency into U.S. dollars	▪ Risk that new laws may have a negative impact on an investment's value (e.g., tax code changes)

Additional Risks

OPPORTUNITY RISK	REINVESTMENT RISK	PREPAYMENT RISK
▪ Risk of passing on the opportunity of making a higher return on another investment	▪ Risk that interest rates will fall and semiannual coupons will be reinvested at a lower rate	▪ Risk that mortgages will be paid off early due to lower interest rates, resulting in reinvestment in lower yielding investments

Activity

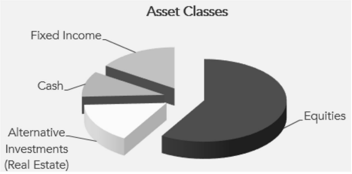
Read each statement and determine which type of risk it describes.

THE COST OF IMPORTING GOODS IS INCREASING	Currency Risk
MORTGAGE-BACKED SECURITIES ARE MATURING EARLY	PrePayment Risk
NEW LEADERSHIP ASSUMES CONTROL IN A FOREIGN COUNTRY	Political Risk.
CONGRESS HAS MADE CHANGES TO THE TAX CODE	Legislative Risk

Asset Allocation

Asset allocation focuses on a portfolio constructed of various asset classes

An optimal portfolio (one producing the greatest return for a given amount of risk) is based on a client's goals, expected return, and risk tolerance



Passive (Strategic) Asset Allocation

Assumes that markets are efficient and creating an optimal portfolio requires allocating assets based on a client's risk tolerance and investment objectives

Buy-and-Hold (do nothing)	Indexing	Systematic Rebalancing
▪ Minimizes transaction costs and tax consequences ▪ However, the asset mix of the portfolio may drift over time	▪ Maintaining investments in companies that are part of major stock (or bond) indexes ▪ Infrequent rebalancing	▪ Involves buying and selling assets on a periodic basis ▪ More frequent rebalancing keeps the portfolio closer to its strategic allocation ▪ May result in higher transaction costs as well as tax consequences

Tactical (Active) Asset Allocation

Assumes that markets are inefficient

Involves altering the asset mix in anticipation of changing economic conditions/events (market timing)

- **Sector Rotation** is one example
  - Money is moved from one industry or sector to another in an attempt to beat the market
  - A portfolio manager who employs a sector rotation strategy will try to anticipate the next turn in the business cycle and shift assets into the sectors that will benefit

Dollar Cost Averaging

Involves making the same periodic investment regardless of share price over a fixed period of time

- Investors will purchase more shares when price is low and fewer shares when price is high
- Advantage:
  - Results in the average cost of shares being less than their average price

> With dollar cost averaging, the good news is that:
> - When share prices are up, the previously purchased shares are worth more
> - When shares prices are down, the investor will be able to purchase more shares at a lower price

Sector Rotation: Moving $ from one industry to another. (trying to beat the market)

Hedging Risk

Options are popular investments to use as a hedge (protection):

- Equity options can protect individual stocks
- Index options can protect an entire portfolio
- Currency options can protect against exchange-rate risk
  - To hedge the U.S. dollar, investors must take the opposite position on the currency option

If an investor *anticipates an increase*, in the underlying asset's value, *but fears a decrease*, he should: →

If an investor *anticipates a decrease*, in the underlying asset's value, *but fears an increase*, he should: →

Activity

✓ Which statements are TRUE regarding different types of portfolio strategies? Circle all that apply.

I. A buy-and-hold strategy may result in portfolio drift.
~~II.~~ Indexing is utilized to take advantage of market inefficiencies.
✓ III. Sector rotation will try to anticipate the next move in the business cycle.
~~IV.~~ Dollar cost averaging results in realized profits on the investment.

Chapter 20 Quiz.

ETN'S have issuer credit risk.

Term Duration: Measure of a fixed-income security's relative interest-rate risk.

Diversifiable (unsystematic)

- Business Risk
- Credit-Risk
- Liquidity Risk

Non-Diversifiable (Systematic)

- Interest-Rate Risk.
- Market.
- Inflation

Risk Measurement:

- Duration
- Beta.
- Alpha.

High Yield Bonds: Junk Bond.

- Dangerous.

OTC and Non-Listed Stocks have more liquidity risk than listed stocks.

Call Risk: Investors lose money when interest rates fall. Rates fall, Issuers call.

Bonds have less capital risk than:

- Stocks
- Warrants
- Options.

Bonds w/ longer maturity: Bigger interest-rate risk.

Yen val. falls: Buy Yen puts.
Yen val. rises: Buy yen calls.

Treasury Notes have less credit risk than:

- Preferred Stock
- Mortgage Bonds.
- Revenue Bonds

- Risk for Young married couple: Market Risk.
- Alpha: Expected vs. Actual Return.

Bonds are more susceptible to inflation risk than equities.

All investments have market risk.

Systematic Portfolio Rebalancing: Buying and Selling Securities periodically to reset a portfolios risk + reward characteristics.