Module 1

The Role of Global Capital Markets

The Derivatives Market
(Where business risks can be traded…)

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Derived value

A derivative is an instrument whose value is derived from the price of an underlying asset:

- Share price
- Interest rate
- Exchange rate
- Commodity price.

The derivatives market is intricately linked to the markets we discussed.

An insurance market?

Rather than trading in the present, and be exposed to future risk…

…why not trade in the future and eliminate that risk?

Derivatives markets trade risk – transferring future price risks to market participants who are willing to assume those risks in expectation of a risky return.

An insurance market for CFOs?

CFOs make many decisions now, where the payment or receipt only occurs some time later:

1. Don't need the primary commodity now, but at some point in the future – and you expect prices to rise

2. Have to wait for overseas invoices to be paid – and you expect your currency to depreciate

3. Need to borrow in the future – and you expect interest rates to rise.

Hedging on the derivatives exchange

Buying and selling for future delivery provides continuous future price discovery which allows CFOs to lock in a fair and transparent future price – which is the market's best expectation of that future price.

Corporations can then focus on their "core business" in planning for the future.

What else happens on derivatives markets?

Speculation

Buying or selling future assets based on a private expectation of future prices that is different from the market's expectation.

Arbitrage

Simultaneous buying & selling of future assets based on a misalignment of derivatives prices without incurring any risk.

Derivatives markets are everywhere

Virtually every asset can be traded as a derivative … on multiple platforms (wholesale and retail):

- Open Outcry
- Floor
- OTC
- Automated Exchange
- Internet.

And in various derivative forms:

- Futures, Forwards and Swaps
- Options.

Emerging derivatives markets

New York, London, Chicago are the traditional derivatives centers.

Physical exchanges are being replaced by automated trading platforms.

Exchanges merge (CBOT, CME and NYMEX).

New markets emerge:

- Dalian Commodity Exchange, Intercontinental Exchange (ICE).

Derivatives trading is truly global, allowing risks to be pooled efficiently, and thereby reducing the cost of risk.

Summary

Traditional markets have seen enormous growth in the last four decades facilitated by deregulation of markets, advancements in technology and strong economic development …

… but what exactly did these markets contribute to economic growth?

In the next module …

Source list

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