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# Financial Economics

## Session I: Introduction

**Postgraduate Class**  
**Economics Department Stellenbosch**

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Department of Economics

DEPARTMENT OF  
ECONOMICS



# Aim of the course

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- Being a *financial economics* course, this program is designed to first give you a broad overview of the following concepts:
  - The core theory underlying the need for investing in financial assets
    - Introduction to Markowitzian theories, CAPM and other valuation methods
  - Defining financial assets :
    - Defining risk in holding a financial asset
    - Valuation of assets (what is an asset's “fair” value)
    - How do we compare one financial asset to another (relative valuation)
    - Creation of financial assets (as derived from other asset classes)
  - Investment choices:
    - Financial ratios
    - Products
    - Defining and choosing between financial markets, investment avenues and relevant instruments – and what factors affect each
  - Corporate finance theories
  - Regulators and institutional oversight



# Aim of the course

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- We will also cast a **critical eye on the investment spectrum as a whole**, while in the process discussing which factors investors and investment intermediaries look at when making their investment choices.
  - In particular we will be looking at the most common and widely used ratios, techniques, products, and all the Greek lingo that investors use in an effort to share in the profit of companies.
- We will also be covering the most topical issues at hand. The outline is therefore able to adapt to news and information surrounding real world events.



# The Financial Market

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- In very few markets do we see Adam Smith's idea of socially beneficial self-interested collective actions by individuals as in the financial market. At least, in theory.
  - Investors provide firms with the means of starting a business, thereafter accumulating capital and ultimately profit— providing, then, a positive return for both the firm owners and the investors. A win-win situation, in theory.
  - In such a perfect scenario, the traditional role of the financial system is to be an efficient conduit for the transfer of funds between excess holders (investors) and capital seekers (firms with viable business ideas).
  - In recent decades (even years), the global financial system has arguably drifted far from this ideal of being an efficient intermediary – to being a highly profitable industry for intermediaries, where the cost to society far outweighs the benefit (Bogle, 2010).



# What in the (Finance) world is going on?!

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- The global financial industry has in recent years been plagued by over-inflated management fees and bonuses, intermediary and investor hubris and a general sense of understanding (and predictability) of a market that does not display any clear form, structure or underlying natural law.
- Unlike a natural science, however, the financial-science requires a different approach – to be exact, a less exact approach!
- *Ideally* the financial industry regulations should be broader and more focussed on making information publically available than trying to regulate all financial behaviour.



# What in the (Finance) world is going on?!

## Recap of 2014



- **Stock markets soar:**
  - JSE breezes past 50 000 mark
  - S&P500 reaches all-time highs.
- **Political instability**
  - Crisis in Ukraine
    - Sanctions against Russia and talks of possible asset freezes aimed at Russian oligarchs
  - Crisis in the Middle East
    - Israel retaliates as Hamas remains relentless in their assault on Tel Aviv and Jerusalem
- **ECB cuts borrowing rates to negative territory amid deflationary fears and economic stagnation in Europe**
  - Europe's woes continue
- Emerging market currencies tumble further
- BRICS nations consider IMF type fund for their developing needs
- Janet Yellen at the helm of the FED – will she be the eternal dove?
- **OIL PLUMMETS**



# What in the (Finance) world is going on?! **Recap of 2015**



- Grexit still on the cards? – undoubtedly most agree that Greece has merely kicked the can down the road.
  - Although Greece made its most recent repayments to the IMF – let's not kid ourselves that these repayments was made by bailout funds and the problem remains.
- Oil slump persists
  - Towards the end of 2014, price of oil halved. Many oil bulls emerged, with many in SA buying SASOL as a means of profiting off the “inevitable” oil price rebound. Well, the chickens have not come home to roost, and it seems it might not any time soon either...
  - Iranian deal adds downward pressure on oil prices...
- China's International development bank:
  - set to challenge traditional Western monetary institutions (IMF, World Bank, etc.)
- At home: the Nenegate Saga causes Rand to crash.



# What in the (Finance) world is going on?! **Recap of 2016 so far**

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- Market fears turn from China's slowdown, to the Fed's "imminent" rate hike and what it would mean for emerging markets to (most recently): **Brexit.**
- Brexit shook markets as Britain votes to exit EU.
  - Uncertainty never a good thing in financial markets, and equity markets wipe off record values following Brexit.
  - But markets quickly recovered, as bond yields dip below 0 across Europe, and it seems more and more likely the Fed will keep rates low in the foreseeable future.



# This makes for a really interesting time to be studying financial topics!

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- Today there are more questions than answers and theorists as well as practitioners are reconsidering even the fundamentals of what we thought we knew of the inner workings and dynamics within a modern financial system.
  - Such a system is today characterized by millions of institutional- and private investors, firms, banks and all forms of intermediaries that attempt (essentially) to earn a profit by buying and selling assets.
  - These assets, in addition, include various forms shapes and sizes and are (more often than not) inexorably linked to other assets and them again to others... building an intricate web of interlinked buyers and sellers of **assets with values that are essentially only in the eye of the beholder.**
  - Such asset values, although mostly backed by fundamentals (although some are almost purely speculative), can vary wildly and cause other asset values to follow suit.
  - In fact, we have seen stranger things happen than entire markets follow a downward spiral... (think 2008)



# This makes for a really interesting time to be studying financial topics!

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- Despite the negative press surrounding equity markets and investment intermediation over the past few years since the Great Recession, it remains a vital sector – vital for business and for the economy as a whole.
- Securing assets safely over time (while earning a little extra along the way) is arguably one of our greatest needs as human beings.
- Doing so in an **uncertain environment** creates challenges, but with it comes certain opportunities.
- In this course we hope to see how, when and where we secure our assets in a modern financial system.



# What to expect from the course

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- Every week we will start the session by discussing what's making finance news. I urge students to stay abreast of the latest financial news headlines and bring discussions to class.
- **There will also be an essay on a topic to be confirmed.**
  - The essay will be due after the break. Ideally students should communicate topics to me that interest them and with which they want to broaden their understanding of some field in finance.



# Type of topics, e.g.... (you can choose variants or your own topic)

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- High frequency trading: making markets more unstable?
- The many facets of determining the oil price.
- The future of commodity prices
- Will China's development bank challenge the traditional model of western financial institutions?  
What are the costs and benefits to global trade and financial flows.
- Global interest rates: set for a rise, but when?
- Has Abenomics succeeded or failed: too soon to judge?



# What to expect from the course

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- Prescribed reading will be posted on the website
  - Always refer to the departmental site for additional information and readings on the course
- A thorough background in finance is **not required**, and this is seen as a broad introduction to the field of finance, with some applied sections.
  - Students with a keen interest and / or background in finance should still find the course stimulating, as we will be discussing some highly relevant and topical issues, with a focus on intuitive understanding of events



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**Hope you find the course useful!**

END



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