CHAPTER 12

Financial Markets
SAVING AND CAPITAL FORMATION

- Saving money makes economic growth possible.
- One person’s savings can represent another person’s loan.
- Savings make investments possible.
A financial system consists of a network of savers, investors, and financial institutions that work together to transfer savings to investors.
Financial assets include savings accounts, certificates of deposits, and government and corporate bonds.

Financial assets represent claims on the borrower.
Financial intermediaries are financial institutions that bring together savers and lenders.

The circular flow of funds shows how funds are transferred from savers to borrowers.
Any part of the economy can supply and borrow savings, but governments and businesses are the largest borrowers.
Nonbank financial institutions are nondepository institutions that channel savings to borrowers.
Finance companies buy installment contracts from merchants, who sell goods on credit, and make the loans directly to consumers.
Many finance companies offer bill consolidation loans to consumers who use these loans to pay off other bills immediately, and then pay off the finance company over time.
NONBANK FINANCIAL INTERMEDIARIES (continued)

- *Life insurance* companies receive money by selling life insurance for a premium.

- The *premium* is the price the insured pays for this policy and is usually paid for monthly, quarterly, or annually for the length of the protection.
Life insurance companies can invest the premiums with nonbank financial institutions.

NONBANK FINANCIAL INTERMEDIARIES (continued)
Nonbank Financial Intermediaries

(continued)

- **Mutual funds** are companies that sell shares of their own stock to individual investors and invest the money they receive in corporate stocks and bonds.
Mutual funds give people the ability to invest in the markets at low risk.
Pension funds receive money from employers and invest the money in corporate stocks and bonds to be disbursed among the employees eligible for retirement, old-age, or disability.
One of the first steps in preparing a budget is to complete which task?

A. Decide whether or not to buy a new car
B. Make a list of one’s fixed expense
C. Invest in stocks and bonds
D. Open a checking account
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BASIC INVESTMENT CONSIDERATIONS

- **High risk investments** pay higher rates of return than low risk investments.

- The type of investment chosen depends on the goals of the investor.
BASIC INVESTMENT CONSIDERATIONS (continued)

- *Consistent investing* can yield large returns.

- Investors should avoid complex investments they do not understand.
A 401(k) plan is a tax-deferred investment plan that acts as a personal pension fund for employees.
BONDS HAVE THREE MAIN COMPONENTS

1. *The coupon* – the stated interest on the debt.


3. *The par value* – the principal or the total amount initially borrowed that must be repaid to the lender at maturity.
BONDS AS FINANCIAL ASSETS

- *Bond prices* are determined by *supply and demand*.

- The *current yield* on a bond is the *annual interest rate* divided by the *purchase price*.
BOND RATINGS

- Most bonds are rated on the **financial health of the issuer**, the ability to make future coupon and principal payments, and the issuer’s past credit history.
BOND RATINGS (continued)

- Bond ratings, ranging from D (lowest) to AAA (highest), indicate the quality of the bond.

- If a bond is in *default*, it means the issuer has not kept up with the interest or the par value payments.
Certificates of deposit are issued by financial institutions and are the most common form of investments available.
• Corporate bonds are issued by corporations and are usually used for long-term investment because they can be liquidated quickly.
FINANCIAL ASSETS AND THEIR CHARACTERISTICS (continued)

- Municipal bonds are bonds issued by state and local governments, and are regarded as a safe, tax-exempt investment.
FINANCIAL ASSETS AND THEIR CHARACTERISTICS

(continued)

- Savings bonds are low-denomination, nontransferable bonds issued by the federal government, and are very attractive because they have virtually no risk of default.
Treasury notes and bonds are large long-term obligations issued by the federal government, and are seen as the safest of all financial assets.
FINANCIAL ASSETS AND THEIR CHARACTERISTICS (continued)

- *Treasury bills* are large short-term obligations issued by the federal government.
Individual Retirement Accounts (IRAs) are long-term, tax-sheltered time deposits intended for retirement.
MARKETS FOR FINANCIAL ASSETS

- **Capital markets** are markets in which money is loaned for more than one year.

- **Money markets** are markets in which money is loaned for less than one year.
MARKETS FOR FINANCIAL ASSETS

(continued)

- Primary markets are markets in which only the original issuer can repurchase or redeem a financial asset.
Secondary markets are markets in which financial assets can be resold to new owners.
Why would an investor willingly put money into speculative stock or junk bonds?
A. He wants to hide income from the government.
B. He is sure his money is safe.
C. He may become wealthy if the business succeeds.
D. He realizes any profit from these will be taxed at a high level.
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MARKET EFFICIENCY

- The *Efficient Market Hypothesis* states that it is not possible to “beat the market” regularly.

- Investors should diversify their portfolios by holding a large number of stocks, or enlist the assistance of a stockbroker.
ORGANIZED STOCK EXCHANGES

- The New York Stock Exchange (NYSE) lists the shares of about 2,800 large companies, and has 1,400 seats or memberships with access to the trading floor.

- The American Stock Exchange (AMEX) lists the shares of about 750 companies.
Regional stock exchanges list shares that are too small or too new to be listed on the NYSE or AMEX.

Global stock exchanges include stock exchanges around the world.
THE OVER-THE-COUNTER MARKET

The Over-the-Counter Market (OTC) is an electronic marketplace for securities not listed on organized exchanges such as the New York Stock Exchange.
THE OVER-THE-COUNTER MARKET (continued)

- Most shares are not traded on exchanges but in electronic over-the-counter (OTC) trades.
THE OVER-THE-COUNTER MARKET (continued)

- The most important OTC market is the National Association of Securities Dealers Automated Quotation (NASDAQ).

- The NASDAQ is the world’s largest electronic stock market.
THE OVER-THE-COUNTER MARKET (continued)

- NASDAQ trading is executed with a sophisticated computer and telecommunications network that connects investors in more than 80 countries.
MEASURES OF STOCK PERFORMANCE

- The *Dow-Jones Industrial Average (DJIA)* is a statistical series of 30 representative stocks used to monitor price changes on the New York Stock Exchange.
MEASURES OF STOCK PERFORMANCE (continued)

- The **Standard & Poor’s 500 (S&P 500)** is a statistical series of 500 stocks used to monitor prices on the NYSE, American Stock Exchange, and Over-The-Counter market.
MEASURES OF STOCK PERFORMANCE (continued)

- **A bull market** is a market in which prices are rising.

- **A bear market** is a market in which prices are falling.
TRADING IN THE FUTURE

- A *spot market* is a market in which transactions are made at the prevailing price.

- A *futures market* is a market in which futures contracts are bought and sold.
TRADING IN THE FUTURE

(continued)

- **Futures contracts** are agreements to sell at a specific date at a predetermined price.

- An **options market** is a market in which *put and call options* are bought and sold.
A call option gives the owner the right to buy a share of stock at a specified price some time in the future.
A put option gives the owner the right to sell a share of stock at a specified price in the future.

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Section 3, Chapter 12
In the circular flow model of a market economy, what are the two markets involved?

A. the resource (factor) and product markets

B. the stock and assets markets

C. the retail and wholesale markets

D. the labor and management markets.
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