



THE ANALYSIS OF RISK THAT ARE RUN BY FINANCIAL MARKETS

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ABSTRACT

Financial risk management is difficult at the best of times, but especially so in the presence of economic uncertainty and financial crises. In recent decades the structure of financial markets has changed from a bank-based to a market-based financial system in which systemic risks arise in the capital markets. Financial regulation and crisis management have not kept pace with these changes. This seminar will highlight the current proposals within the European Parliament on EU financial regulation and how they address the risks posed to global financial markets and exchanges. The research has highlighted the few risks which are observed in financial markets.

Introduction

The FRM is a qualification for risk management professionals, particularly those who are involved in controlling, analyzing, or evaluating potential credit risk, liquidity risk and market risk as well as non-market related financial risks. FRM holders perform a large array of functions connected with risk management within asset management firms, investment banks as well as in government agencies and corporations. Top employers of FRM holders include global financial services firms UBS, Deutsche Bank and HSBC, as well as auditing firms Ernst & Young (EY), PricewaterhouseCoopers (PwC) and KPMG.

A career as a financial risk manager is for people who have the ability to take calculated risks on a regular basis. They usually are able to work under massive pressure and undertake great monetary transactions. Financial risk managers must be able to use financial applications with ease, and they must enjoy working under the field of economics and accounting. They must have great understanding of the state of affairs of the market as well as the condition of industries in the region where they work. Having the same knowledge about international markets is an added bonus.

Associated benefits and risks

Multiple factors reinforce the integration of financial markets. Integration not only allows the government machinery to transmit key price signals, but also promotes domestic savings and investments. In turn, these create opportunities for the financial sector of a nation to emerge



as a financial centre at the regional or the international level. Integrated financial markets enhance equal access to financial services (for the public as well as for companies, and institutions) by innovative and cost-effective intermediation, informational efficiency, and market discipline. Global financial integration is beneficial for international risk-sharing, consumption smoothing, and enhancement of the depth and breadth of domestic financial markets. This competitive environment discourages the exorbitant profits that are associated with monopolistic/cartelised markets by decreasing costs and increasing market efficiencies. International studies such as (Ayuso and Blanco, 1999) confirm that a higher degree of financial market integration leads to higher efficiency of financial markets and thereby leads to higher availability of better risk-return combinations to investors. A number of prior studies (such as Kaminsky and Schmukler, 2002) were conducted to evaluate and understand the level of integration of international financial markets in various economies of the world.

However, on the flip side, integrated financial markets pose grave risks, which could lead to catastrophic developments if they are not analysed prudently. Highly integrated domestic and international financial markets run the risk of contagion due to informational asymmetry from one market to the other markets, with the possibility of systemic instability (Mohan, 2007). Such volatility risks and surprising reversals in capital flows in the context of highly open capital accounts are likely to occur at significant costs (Jain and Bhanumurthy, 2005). Macroeconomic stability could also be jeopardised due to the pro-cyclical nature of short-term capital flows, with high chances of abrupt reversals. Capital flow volatility leads to exchange rate instability (similar to the recent episode of INR depreciation in July 2013), fluctuations in official reserves, or in extreme situations, currency crises (such as the East Asian crisis). High capital inflows can result in inflationary pressures, rapid monetary expansion, widening of the current account deficit, and real exchange rate appreciation. Hence, a phased progressive integration of financial markets is required for the economic stability of a country (Mohan, July 2007). In light of the global financial crisis of 2008, great emphasis is being laid on two elements of macro-prudential regulation (Gopinath, 2010):

- The existence of common/correlated exposures, arising either because institutions are exposed to the same/similar asset classes or because of indirect exposures associated with linkages among them (counter-party relationships, for instance).

- Collective homogeneous actions on the part of institutions, leading to risk amplification owing to interconnectedness (the pro-cyclicality element). Key channels of risk propagation include maturity mismatches and leverage. Both these elements require an assessment of the market integration levels for appropriate regulatory steps to be devised

Types of financial markets

Within the financial sector, the term "financial markets" is often used to refer just to the markets that are used to raise finance: for long term finance, the Capital markets; for short term finance, the Money markets. Another common use of the term is as a catchall for all the markets in the financial sector, as per examples in the breakdown below.

- Capital markets which to consist of:
 - Stock markets, which provide financing through the issuance of shares or common stock, and enable the subsequent trading thereof.
 - Bond markets, which provide financing through the issuance of bonds, and enable the subsequent trading thereof.
 - Commodity markets, which facilitate the trading of commodities.
 - Money markets, which provide short term debt financing and investment.
 - Derivatives markets, which provide instruments for the management of financial risk.[1]
 - Futures markets, which provide standardized forward contracts for trading products at some future date; see also forward market.
 - Foreign exchange markets, which facilitate the trading of foreign exchange.
 - Spot market
 - Interbank lending market



The capital markets may also be divided into primary markets and secondary markets. Newly formed (issued) securities are bought or sold in primary markets, such as during initial public offerings. Secondary markets allow investors to buy and sell existing securities. The transactions in primary markets exist between issuers and investors, while secondary market transactions exist among investors.

Liquidity is a crucial aspect of securities that are traded in secondary markets. Liquidity refers to the ease with which a security can be sold without a loss of value. Securities with an active secondary market mean that there are many buyers and sellers at a given point in time. Investors benefit from liquid securities because they can sell their assets whenever they want; an illiquid security may force the seller to get rid of their asset at a large discount.

Risks of the Financial Markets In 2016

Professional investors have dubbed 2015 as “The year nothing worked.” Investments in stocks, bonds, etc., were disappointing as the markets provided little help building wealth. In this article, we will reveal the top eight risks facing global financial markets in 2016.

1 Strong Dollar

From mid-2001 through mid-2008, the U.S. dollar trended lower relative to most major currencies. A weak dollar is a tailwind for U.S. exports as it makes American-made products less expensive to foreign consumers. Around the middle of 2014, a few months before the Fed ceased its monetary expansion, the dollar began to strengthen. As the dollar gained strength, large U.S. companies that derive a significant portion of revenue overseas saw profits decline. From the third quarter 2014 through the first quarter 2015, U.S. corporate earnings fell 20%. What causes the dollar to gain strength? Let's look at this now.

2 The Federal Reserve, Interest Rates, and the Dollar

If the U.S. floods the world with dollars, it could produce an oversupply thereby causing its value to fall. Interest rates are another factor that affects a currency's value. For example, when the Fed raises interest rates, the dollar becomes more appealing, which increases demand and causes its value to rise. In late 2015, the Fed raised its short-term interest rate for the first time in nearly a decade. Normally the Fed raises rates when economic activity is improving. Although the U.S. economy is faring better than the rest of the world, it is far from overheating. Why did the Fed raise rates if the economy is still a bit sluggish? So it will be better prepared if the economy slows. In other words, the Fed has “reloaded its gun,” even



if only slightly. If the Fed continues to raise rates, it should have a suppressing effect on the economy and eventually cause the dollar to strengthen further.

3 Oil Prices and the Energy Sector

After peaking in July 2014, crude oil prices began to collapse. Even though cheaper oil reduces gasoline prices, which helps U.S. consumers and businesses, it also hurts the energy sector and related industries. The oil decline has led to an increase in bankruptcies, loan defaults, and unemployed workers. Think of it as an energy tsunami rippling through the U.S. economy. Where is the benefit of cheaper gasoline? We will address this in Risk #8 (fiscal policy).

4 Middle East

The Middle East has been a hotbed of conflict for thousands of years and many OPEC members are located in the region. As crude prices fell, the U.S. fracking industry found that it could no longer extract oil at a profit and many companies closed. Even though there are fewer oil companies today, Russia, Brazil, Venezuela, and others continued to drill and export because their economies are suffering. In short, they need the revenue. This is a chief reason that the supply will remain strong, keeping oil prices at the low end of the spectrum throughout 2016. Of course if a natural disaster or conflict occurs, disrupting the extraction or transportation of oil, prices would likely spike. In the absence of such an event, I expect the status quo to continue.

5 China

The Chinese government spent many years building infrastructure. This was a key factor in China's incredible, but unsustainable, economic growth. Since the construction noise has ceased, the structures (a.k.a. "ghost cities") remain unoccupied. This caused a dramatic slowdown in China's GDP and triggered fear in the financial markets in the region and around the globe. Ironically, from January 1, 2014 to June 12, 2015, the Shanghai Composite rose 144.2%, even though the economy was slowing. Many believe the Chinese government contributed to the meteoric rise. In any event, as is the case with all bubbles, eventually the selling accelerated, the bubble burst, and stock prices plummeted. Because China is the second largest economy in the world, the fallout has been felt around the globe.

6 Inflation/Deflation

Most understand that inflation exists when prices are rising. Conversely, deflation is a prolonged period of falling prices and can be destructive to an economy. The Fed has established an inflation target of 2.0%. Through the end of November 2015, inflation was



0.5% for the trailing 12 months, well below the Fed's target rate. A strengthening dollar also tends to keep inflation low since we import a great deal of what we consume. Inflation is a bit like Goldilocks and the Three Bears. If it is too high, it hurts consumption. If it is too low, deflation may result. However, deflation is much worse than inflation unless inflation is extremely elevated.

7 U.S. Stock Market Risk: The VIX

The VIX is not really a risk per se, but a measure of stock market risk. The VIX (Volatility Index) measures the expected volatility (i.e. risk) of the stock market over the next 30 days. When the VIX rises, stocks have a very strong tendency to fall and vice versa. To explain, the VIX reached an all-time high of 80.86 during the 2008 financial crisis. The long-term average of the VIX is 19.40. As of this writing, the VIX is 23.21. Although the current reading is slightly elevated, unless we experience a serious negative event, the current level of the VIX is not much of a concern. However, this can change rapidly. Therefore, it is worth watching.

8 U.S. Fiscal Policies

Many people wonder why the Fed was so aggressive when it reduced interest rates to zero and massively expanded the money supply. There is also confusion over why such aggressive Fed policy failed to stimulate the economy as it has in the past. The reason for the ineffectiveness of the Fed's easy-money policy is fiscal policy. Fiscal policy lies in the realm of the government and involves government spending, regulations, and tax policy. Last July, I asked two Fed District Presidents why the Fed has been so aggressive with monetary policy. Their answer was quite revealing. First, the Fed wanted to let individuals and businesses know that it would do whatever was necessary to help the economy grow. Secondly, the Fed acted in the extreme because fiscal policy has been a drag on the economy. More concisely, massive new regulations and higher taxes are suppressing economic growth.

Conclusion

There are always risks in the world. With a stronger dollar, a tightening Fed, an oversupply of oil, a weak global economy, and anti-growth U.S. fiscal policy, what should investors do? It depends on your time horizon and willingness to accept risk. In general, you should consider a low allocation to U.S. stocks, high-quality short-term U.S. bonds, and cash. Add to that a few specific alternative investments such as certain commodities, select currencies, etc. For those willing to assume the risk, shorting an index could produce a positive result. Remember, if you decide to invest in foreign markets, be sure to hedge the dollar. The U.S. financial markets will likely experience some degree of pain this year but the majority of the



fallout should be overseas. In short, the financial markets in 2016 may look similar to 2015 with a little twist. The global economy should improve but only slightly (0.3%). There is not much to get excited about at the moment.

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