Université PANTHÉON - ASSAS (PARIS II)

Droit - Economie - Sciences Sociales 7041

Assas

Session : Janvier 2019

Année d'étude : Magistère Banque - Finance, Deuxième année

Discipline : *Anglais magistère Banque-Finance 2ème année*
(Structure 1er semestre)

Titulaire(s) du cours : Mme Elizabeth DODARD

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Durée de l'épreuve : **1h30**

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1. Explain the following. Write 3 to 6 lines (double spaced) in full sentences **(/4)**

a. Futures vs forwards
b. Pay-as-you-go

2. Translate the following into English **(/4)**

Les places boursières asiatiques s'inquiètent toujours du risque de récession au niveau mondial. Si Wall Street était fermée hier pour cause de deuil national, l'indice américain avait plongé de 3 % mardi, entraînant dans son sillage les places européennes et asiatiques mercredi. Donald Trump n'a pas manqué de rappeler qu'en l'absence d'accord avec la Chine, il relèverait sans hésiter les droits de douane sur de nouveaux produits chinois importés aux Etats-Unis.

3. Essay: Comment on the following sentence (2 to 4 pages double-spaced – about 250 words) **(/10)**

Credit ratings is a business which is likely to dissatisfy its client unless it cuts corners. Ideally the rating agency should report to – and be paid by – the investor.

4. Read the article, then answer the following questions. **(/12)**
Write 3 to 6 lines (double spaced) in full sentences for each answer. Use your own words

a) What 'conventional' explanation is given for recent stock market performance? And why does the columnist discount it? (/2)
b) Why does she equally dismiss the traditional notion of 'leverage' as potential explanation? (/2)
c) Explain 'psychological leverage' and its impact on recent market performance (/3)
d) Explain 'algorithmic leverage' and its impact on recent market performance (/3)
e) Explain her conclusion. (/2)

Wild market swings hinge on a different kind of leverage

By Gilian Tett, *The Financial Times*, Dec 6 2018

Many American stock market investors are feeling seasick. That is not simply because a tumble on Thursday reflected that equity markets are down on the year; more unnerving are recent, wild swings.

While such swings have occurred before, they usually only happen after dramatic events. Now, it seems they are being sparked by modest developments, say, a (slightly) dovish remark from Jay Powell, US Federal Reserve chairman, or Donald Trump tweeting that he is a "Tariff Man". Why? One explanation is that skittish investors keep changing their minds about the outlook.

But this does not seem a sufficient explanation, given the volatility. A better bet is to borrow an idea from Seth Klarman, founder of Baupost hedge fund, and ponder the slippery notion of "leverage".

When investors today toss that word around, it is often a shorthand for "debt". No wonder: in 2008, we re-learnt the lesson that when financial institutions or investors use debt to make market bets, they suffer disproportionate losses when prices decline. This tends to create forced sales, and thus wild market swings, particularly when debt is embedded (and concealed) in derivatives.

But debt alone cannot explain the current lurches. As the Office of Financial Research observed last month, risks from solvency and leverage are low among banks and insurance companies. And while hedge fund leverage is rising — their debt is now $2.7tn on $3.1tn of assets, up from $1.9tn and $2.7tn in 2015 — it is not extreme (yet) by historical standards.

So we need to think about leverage in a broader sense — beyond debt. The term appeared first in the 18th century, taken from the root "lever", meaning an agricultural or industrial instrument that magnifies force. In the 1930s, financiers borrowed it to describe force-maximising debt.

But a device with a force-maximising market effect — in other words a lever — can take many forms. Mr Klarman, for example, is intrigued by the concept of "psychological leverage" — a situation in which everybody is so heavily invested in the assumption that markets will move in one way that a small reversal can spark a self-reinforcing panic. "In 2008 we had massive disguised [debt] leverage," he suggests. "Now we have less financial leverage, but there is psychological leverage."

Terry Duffy, chief executive of the Chicago Mercantile Exchange, agrees. "Seventy-one million people in America are millennials and never saw a downtick in their lives," he says. "So if the market wobbles they don't know how to handle it, particularly since information moves so fast." Or as Ray Dalio, founder of Bridgewater fund, recently observed: "The world by and large is leveraged long. When there is a downturn, I don't think there's much to protect investors."

Then there is what Mr Klarman describes as "algorithmic leverage". Twenty years ago, investors learnt the hard way that complex, opaque derivatives structures can magnify losses. Remember Long-Term Capital Management? Now, algorithmic trading structures, exchange traded funds and passive investment strategies can sometimes have equally unpredictable and mysterious impacts.

To be fair, these innovations are useful and can create deep market liquidity in calm times. But in times of uncertainty, "there is the question of whether [these structures] might add to destabilising price dynamics by amplifying investors' trading patterns", as a report from the Bank for International Settlements observes. The deep irony of supposedly rational computer programs is that all-too-human coders and financiers tend to structure them similarly. This creates the problem of "computer herding", when robo-programs react to the same small signals in the same way, creating a cumulatively large impact; or, if you like, robo-leverage.

Is there any solution? Not obviously in a world where investors have been wildly bullish for several years. But here is one crumb of comfort: history suggests that bull markets usually end with a sudden crash, not a series of disorientatingly wild swings. In that sense, then, today's markets are indeed unusual. But they also give seasick investors opportunities to jump ship.