Financial Market Introduction
Summary

- Financial Market Definition
- Financial Return
- Price Determination
- No Arbitrage and Risk Neutral Measure
- Fixed Income and Interest Rate Market
- Currency or FX Market
- Equity Market
- Historical Volatility vs Implied Volatility
A financial market is a market where people trade financial products.

Types of financial markets
- Fixed income and interest rate market
- Currency market
- Equity market
- Commodity market
- Credit market

There are the spot market and the derivative market within each market above.
Financial return

- Financial return is the measurement of profit and loss on an investment or an asset.
- Return is more important than value itself.
- Return types
  - Absolute return: \( R_A = V_t - V_{t-1} \)
  - Relative return: \( R_R = \frac{V_t}{V_{t-1}} - 1 \)
  - Log return: \( R_L = \ln\left(\frac{V_t}{V_{t-1}}\right) \)
Financial return (Cont)

Return attributes

- Log return is similar to continuously compounding.
- Log return is additive, i.e., $R_{02} = R_{01} + R_{12}$.
- For a short horizon, $R_R \approx R_L$
- Returns are nearly independent and similar to a random walk.
- Returns in future are unpredictable.
Market

Price Determination

- Actual market price determination
  - Determined by supply and demand.
  - Gauged in the real-world measure.
- Supply side determination factors:
  - Transaction costs
  - Liquidity
  - Risk/reward preferences of suppliers
  - Capital availability
  - Tax rules
  - Differential information
Market

Price Determination (Cont)

- Demand side determination factors:
  - Transaction costs
  - Liquidity
  - Accounting
  - Tax rules

- Model price determination
  - Determined by model and calibration.
  - Gauged in the risk neutral measure.
  - If a trade has the market price, then
    - Model is mainly used to compute risk, such as sensitivities.
    - The model price should be calibrated to the market price.
  - If a trade doesn’t have a market price, then
    - Model price is used for transaction.
    - Model should be calibrated to Vanilla products.
No Arbitrage and Risk Neutral Measure

- **No arbitrage**
  - The law of one price: The same cash flow should have the same price.
  - It is impossible to invest 0 today and receive positive tomorrow.
  - Two portfolios having the same payoff at a given future date must have the same price today.

- **Risk neutral probability measure or simply risk neutral measure**
  - Risk neutral probability measure is no arbitrage.
  - The Arrow security prices are so-called risk neutral probabilities.
  - A risk-neutral probability is not a real mathematical probability.
  - These prices are called probabilities as they fulfill the criteria of probabilities so that the probability theory can be used.
  - In finance, Martingale measure is equivalent to risk neutral measure.
Fixed Income and Interest Rate Market

- Fixed income and interest rate market mainly consists of bonds, notes, debentures, certificates, mortgages, money market funds and interest rate derivatives.
- Central to any interest rate related topics is to calculate accrued interest.
- One needs two factors to compute accrued interest: compounding and day count.
- Commonly used compoundings:
  - Annual compounding: the accrual interest is given by \( A(0, t) = (1 + r)^t \)
    where \( r \) is annual compounded interest rate and \( t \) is the accrual period in years.
Fixed Income and Interest Rate Market (Cont)

- N-time compounding per year, such as semi-annually (n=2), quarterly (n=4), monthly (n=12), etc.; the accrual interest can be expressed as
  \[ A(0, t) = \left(1 + \frac{r}{n}\right)^{nt} \]

- Continuously compounding: the accrual interest can be represented as
  \[ A(0, t) = \exp(rt) \]

- Simply compounding: the accrual interest is given by
  \[ A(0, t) = rt \]
Fixed Income and Interest Rate Market (Cont)

- Day count convention or day count fraction
  - Day count convention is used to determine accrual period.
  - Commonly used day count conventions are 30/360, Act/Act, Act/365, Act/360.
  - For example, the accrual period of 30/360 convention between $t_1$ and $t_2$ is
    \[ t_{12} = \{360 \times (Y_2 - Y_1) + 30 \times (M_2 - M_1) + (D_2 - D_2)\}/360 \]

- Interest rate curve:
  - Yield curve or zero-coupon curve is the term structure of interest rates.
  - Zero bond curve is the term structure of discount factors.
  - Bond curve is the term structure of bond yields.
  - Swap curve is the term structure of liquid instruments, such as futures and swap rates.
Currency or FX Market

- Currency market convention is one of the biggest sources of confusion for those new to the market.

- FX quotation
  - The quotation 1.25 EUR/USD means that one Euro is exchanged for 1.25 USD.
  - In this case, EUR (nominator) is the base currency and USD (denominator) is the quoted currency.

- Spot date
  - The spot date or value date is the day in which the two parties actually exchange the two currencies.
  - A currency pair requires a specification of the number of days between trade date and spot date, typically 2 business days.
Equity price is quoted by Exchanges.

Dividend convention
- Record date or cut-off date is the date of dividend payment eligibility. The shareholders of record as of the record date will be entitled to receive the dividend.
- Ex-dividend date is set exactly 2 business days before the record date. On and after the ex-dividend date, a buyer of the stock will not receive the dividend.
- The stock price usually drops at the ex-dividend date.

Dividend types:
- Discrete dividend.
- Dividend yield or continuous dividend.
**Market**

### Historical Volatility vs Implied Volatility

- **Historical volatility**
  - It is the standard deviation of the time series of an asset return.
  - It is calculated under the real world measure.

- **Implied volatility**
  - It is a model parameter used to back up the market price.
  - It is derived under the risk neutral measure.
  - Implied volatilities could be bigger or smaller than historical volatilities.
Thanks!

You can find more details at https://finpricing.com/lib/FxVolIntroduction.html