The Sensex and the Economy

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Some would have us believe that India's leading stock index, the BSE Sensex, is passing through volatile times. Short-term upswings are followed by sharp declines, influenced largely, we are given to understand, by the uncertainty gripping foreign investors. Such uncertainty is also easy to explain. Gloom pervades the world economy as Europe confronts another crisis in Cyprus and prepares for yet another elsewhere. In India, growth has slowed, inflation is still high and threatens to accelerate, the current account deficit is at alarming levels and political uncertainty increases in the run up to the general election a year from now.

However, the evidence on medium term volatility seems to be to the contrary. Consider Chart 1, which provides a view of movements in the Sensex since just before the post-2003 economic boom. It shows that the Sensex recorded an unprecedented surge starting early 2003, which took the index from 3100 in March 2003 to a closing peak of close to 20700 at the beginning of April 2008. That remarkable run was cut off and reversed only by the onset of the global financial crisis, which saw the Sensex slump to around 8200 by early March 2009.

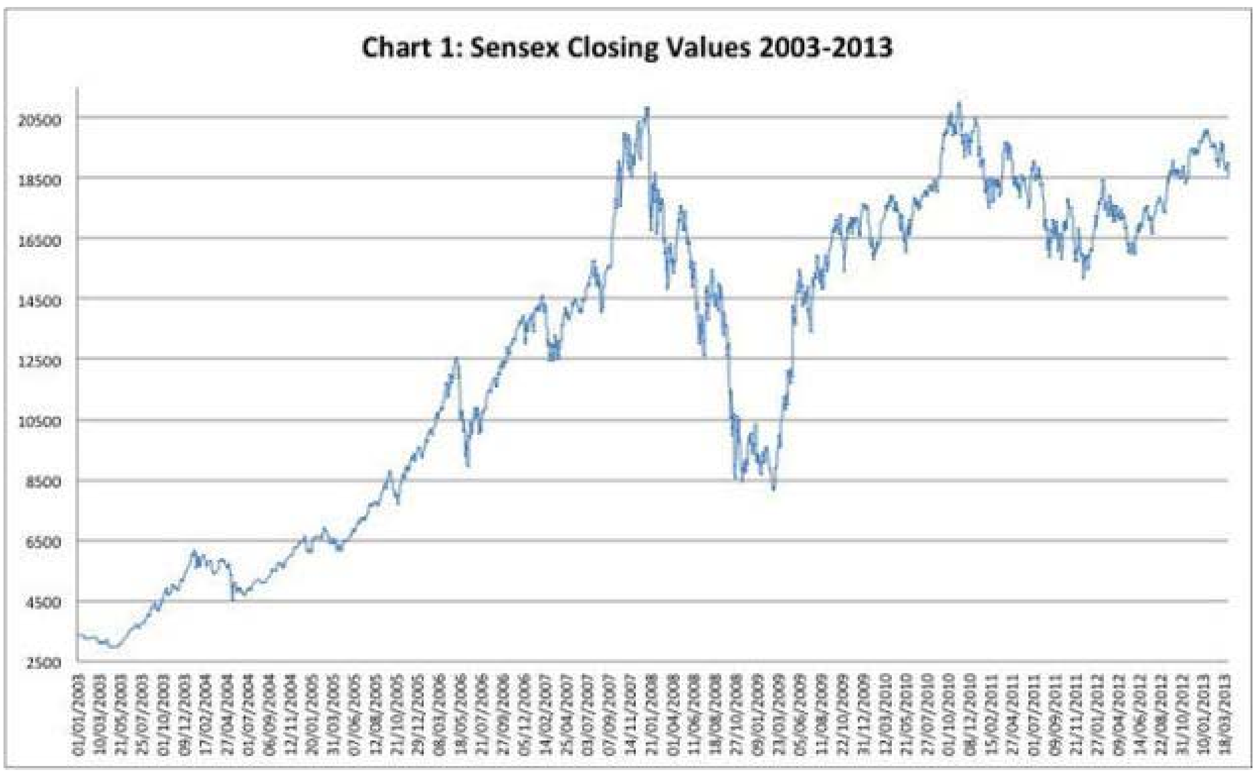
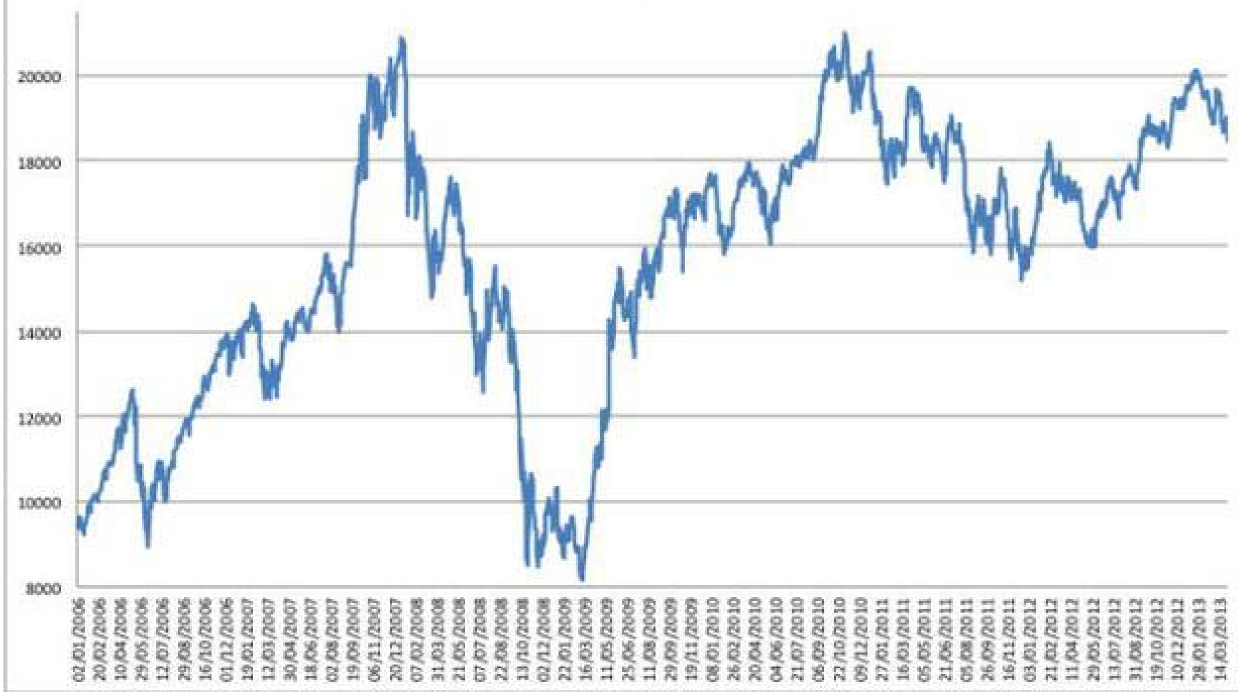


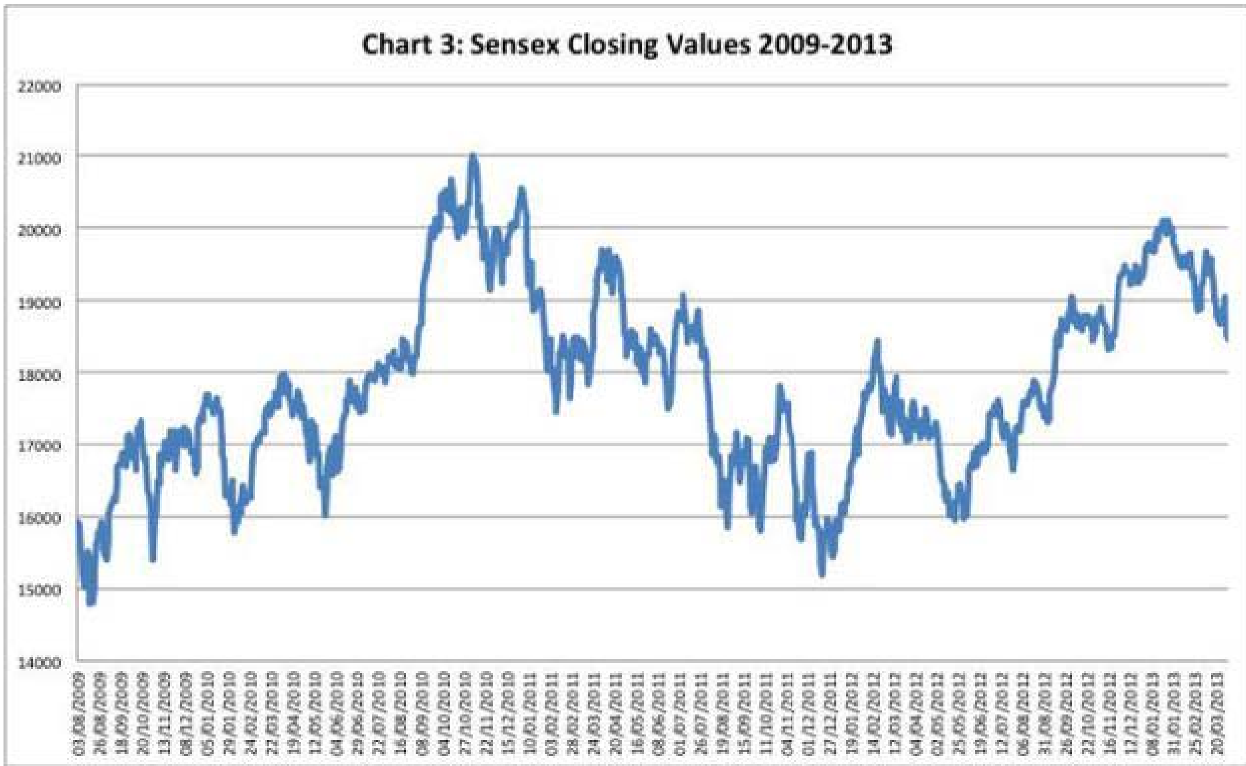
Chart 1: Sensex Closing Values 2003-2013

Compared with this steep long-term rise, and the associated level of returns, subsequent fluctuations have been of smaller amplitude. For example, after the crisis-induced slump, there was a quick and smart recovery after March 2009 with the Sensex crossing the 15000 mark in June 2009. After that, the Sensex almost never fell significantly and in fact climbed to a new peak of close to 20900 in November 2010. But even this rise, which fuelled expectations that the index would touch new highs, is smaller than the 2003 to 2008 trend. As Chart 2 shows, the Sensex, that did not sink to anywhere near the low levels recorded prior to 2003, quickly returned to its earlier peak, even if for a brief period.

Chart 2: Sensex Closing Values 2006-2013



Finally, after this recovery and despite the recent difficulties in the global economy and India, the Sensex has never fallen below 15000, let alone even approached its post-crisis trough of 8000-plus. In sum, poor real economy trends notwithstanding, the Sensex has fluctuated in a narrow (15000-20000) range since June 2009, as brought out more clearly in Chart 3.



Explaining the post-2003 boom is not difficult. The government facilitated it with measures adopted from time to time in the form of relaxations of ceilings on foreign ownership in individual industries and allowing for a greater presence for individual FIIs and for FIIs as a group in a single firm. As per the original September 1992 policy permitting foreign institutional investment, registered FIIs could individually invest in a maximum of 5 per cent of a company's issued capital and all FIIs together up to a maximum of 24 per cent. The 5 per cent individual-FII limit was raised to 10 per cent in June 1998. As of March 2001, FIIs as a group were allowed to invest in excess of 24 per cent and up to 40 per cent of the paid up capital of a company with the approval of the general body of the shareholders granted through a special resolution. This aggregate FII limit was raised to the (often higher) sectoral cap for foreign investment in any sector as of September 2001. This expanded the scope for foreign investment in the secondary market.

Moreover, the markets were provided a boost in the Budget for 2003-04. In his speech presenting that Budget the Finance Minister declared: "In order to give a further fillip to the capital markets, it is now proposed to exempt all listed equities that are acquired on or after March 1, 2003, and sold after the lapse of a year, or more, from the incidence of capital gains tax. Long term capital gains tax will, therefore, not hereafter apply to such transactions."Long-term capital gains tax was being levied at the rate of 10 per cent up to that point of time.

This market stimulus came at a time when international conditions had also improved, and there was a global spike in cross-border capital flows that found capital flowing in larger measure to many emerging markets. Such policy changes in India ensured that it became a favoured investment destination at the time of this cross-border capital flow surge. The result was the 2003 to 2008 boom in the stock markets.

It was only when there was a sudden exit of capital immediately after the crisis the index collapsed. At that time, foreign investors, who had experienced losses at home and needed resources to cover those losses or meet commitments that fell due, booked profits in emerging markets including India and pulled out their capital. The net result was a sharp decline in the index. But, quite soon, the huge infusion of liquidity by central banks and governments in the developed countries, especially the US, halted and reversed this tendency.

"Emerging markets" like India benefited hugely from this infusion of liquidity, inasmuch as investors accessing near-zero interest rate capital used part of those resources to invest in asset markets in these countries. This explains the V-shaped movement of markets in many emerging markets with the immediate post-crisis downturn being followed by a quick recovery.

The real puzzle is why this recovery persisted when the global crisis refused to go away, the focus of the crisis shifted to Europe and its effects began to be felt in India with greater intensity. This also coincided with a period when developments within India were resulting in the emergence and intensification of stagflationary tendencies. The only explanation is that, though the fiscal stimulus resorted to in countries across the globe immediately after the onset of the 2008 crisis has not been continued because of rising fiscal conservatism, central banks have persisted with their cheap credit and easy money policies. The most recent initiatives by the ECB and the Federal Reserve, especially the latter's announcement of a third round of quantitative easing, involving unlimited lending against poor collateral, have kept the cheap and easy liquidity situation going in global markets. It is this cheap money that is finding its way to developing countries like India.

However, the impact of this inflow of liquidity into countries like India is complex. What appears to be happening is that whenever stock prices fall, investors are buying into Indian equity in the expectation that the fall would reverse itself and offer opportunities for profit. Their investments ensure that the expected short-term gains are realised. But the effort of investors to book profits before another downturn occurs also triggers a subsequent downturn. But there is a medium-term floor to the prices of actively traded stocks depending since investors soon decide there is value in buying into the lower valued stocks.

This behaviour appears to be having two effects. One is cyclical movements in stock prices in a range that seems smaller than earlier. This occurs around a medium term (say annual) trend, in which medium and long-term returns are low. The other is the persistence of a relatively high level of the Sensex, since there is a temporary psychological floor to the prices of leading shares and declines in their values provide the incentive for another speculative foray.

One fall-out of this syndrome is that there is a divergence between stock market performance and real economy trends. Markets seem reasonably positioned even as the economy sinks. This only goes to prove once again that the market does not reflect in any way the real "fundamentals" of the economy.

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http://www.thehindu.com/opinion/columns/Chandrasekhar/the-sensex-and-the-economy/article4591247.ece