Pre-election Euphoria?

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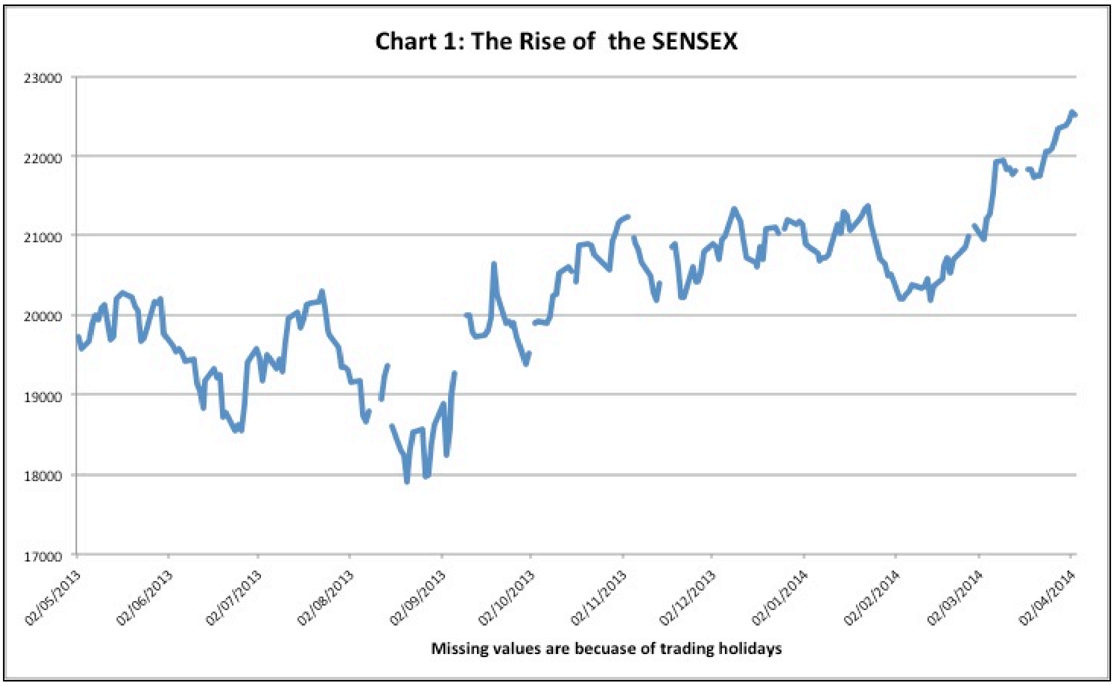


Chart 1: The Rise of the SENSEX

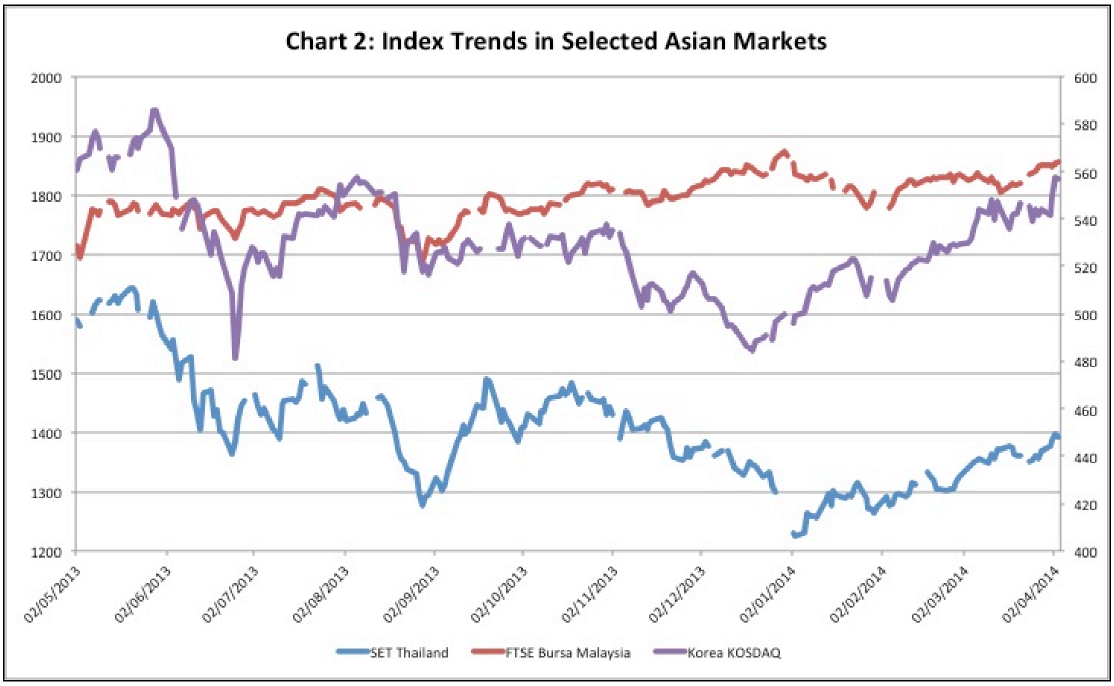
Since early February, the BSE Sensex has risen by more than 11 per cent level, taking an already inflated index to record highs. The Bombay Stock Exchange that experienced one rally between August-end last year and January-end this year (which delivered a 19 per cent rise in the Sensex), has witnessed another bull run (Chart 1). Given the nature of this market it does not taken rocket science to establish that the surge in the index is because of a spike in investor demand for the limited amount of actively traded stocks.

If financial investors are seen as even vaguely rational, this would be surprising. Rising equity values imply that investors are expecting the returns from the underlying assets to rise sharply. But all other indicators point to flagging demand, a deceleration in growth and a profit squeeze. Once again, with a vengeance, the stock market seems to be daring the real economy to go against its predictions and take a turn for the worse from its already sagging levels.

As is normal, in search of explanations for these contrary trends in the “markets”, on the one hand, and the real economy, on the other, analysts have been grabbing at straws. The weakest of them is the argument that expectations that a stable government with a business friendly Prime Minister will be delivered by the elections in April and May, is driving investors to grab stocks of firms that would profit from the coming boom.

Underlying even this explanation is the presumption that the Bull Run the market is experiencing is driven by speculation about the outcome of the election and about the nature of the next government and speculation that when that government does what it is expected to do, profits would rise enough to warrant the high valuations. Despite these extremely tenuous grounds, the explanation of why the 'market' is behaving as it is implicitly justifies its irrational exuberance.

There are many reasons why the final outcome, let alone the sequence of events leading up to it, may not coincide with expectations. To start with, though the psephologists are near unanimous in predicting a one-sided result, the election outcome may be more divided, throwing up another government that cannot wantonly reward Indian business as markets expect it to do. Second, even if a government with a comfortable majority is formed, the task of addressing the current stagflationary tendencies in the economy is unlikely to prove easy. Pushing growth with government spending and transfers to the private sector could aggravate inflation. On the other hand attempts to rein in inflation may dampen growth further. Finally, there is no evidence that any government that is likely to come to power will deviate from the UPA's neoliberal economic agenda, which does seem to have generated the current growth slow down and the associated cost-push inflation. So reversing the downturn would require more than just 'any' change in government.



If expectations are belied, a collapse of the current bubble is inevitable. As noted earlier, the current spike in markets began from index levels that were already high, which is why it took just a few days for the index to cross its previous record high. Clearly there are many investors rushing into the market believing that the boom would last long enough for them to book profits. That could prove true for some time. But, when the euphoria is shown to be what it is, the market can experience a sudden and sharp downturn as it has often in the past.

What then is the real cause for the current irrational rally? One is that India is a beneficiary of a continuing search for speculative profits on the part of international finance. In the month of March 2014, for example, net FII inflows totalled more than Rs.20,000 crore, which was close to the Rs.22,168 crore in May 2013, and well above the previous peak of Rs.15,706 crore in October 2013. But it was clearly not just FIIs who were rushing into the market, and driving the index. The band of domestic investors too included a fair share of speculators. The herd instinct keeps them all going.

However, there is one difference between the current trend and what was witnessed during much of the period when “Quantitative easing” in the US and elsewhere was injecting large volumes of cheap liquidity into internal markets. During those years, most emerging markets (barring those with special problems) were recipients of cross-border capital flows and experienced buoyancy in their equity markets. This time around, with the Federal Reserve’s decision to taper its easy money policy having reduced liquidity injection and threatening to raise interest rates, investors seem more selective. In Asia, Thailand and South Korea (besides India) are experiencing buoyancy in markets (Chart 2), whereas Malaysia is not. Elsewhere, the US S&P 500 has gained more than 25 per cent since December, whereas Brazil’s Bovespa and Russia’s Micex have experienced large losses. With less liquidity around investors are targeting particular countries, but can shift attention on the flimsiest grounds. That makes the speculative bubble fragile.

It needs noting that gains in India’s markets have been significantly larger than in other “successful” emerging markets. This may not be unrelated to the elections. Not because the hope of a stable government the election holds enthuses investors. Rather, funds for financing elections could indeed be transferred to some recipients through purchases of shares at inflated prices. It could be possible that “illicit” money being brought back to the country to fund election expenses is being routed through the market. There is no evidence or proof of this. But if true, it imparts some rationality to market behaviour.

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http://www.thehindu.com/opinion/columns/Chandrasekhar/preelection-euphoria/article5876465.ece