The Insensitive Sensex*

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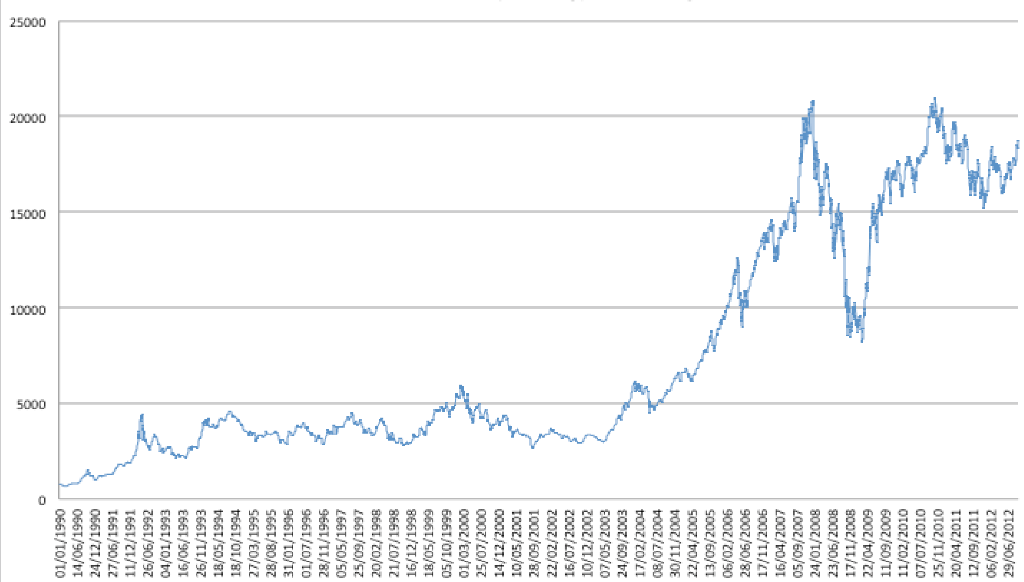
This is by no means the best of times, even if as yet not the worst. Gloom pervades the world economy as Europe totters on the brink of another crisis. In India, growth has slowed, inflation is still high and threatens to accelerate and political uncertainty increases in the run up to the next general election less than two years from now. Yet, one index that seems to be faring well is the Sensex.

Consider Chart 1, which provides a long view of movements in the Sensex since liberalisation began, and Chart 2, which focuses on trends over the last decade that began with a bull market run that lasted for a long stretch. These charts reveal four features of “market performance” since liberalisation as indicated by the Sensex. The first is that, liberalisation, which changed the rules of the game in stock markets, replaced the Controller of Capital Issues with the Securities and Exchange Board of India, and allowed Foreign Institutional Investors (FIIs) to invest in India’s equity markets, did substantially increase market activity. The Sensex, which was well below the 1000 mark in 1990, moved up to 4000 by the first quarter of 1992 and remained (despite fluctuations) in the 3000 to 4000 range through most of the period till 2003. This was the decade when the Indian stock market had reportedly “arrived”.

Chart 1: BSE Sensex (Closing): The Long View



The second feature is that a remarkable boom began in 2003, which took the Sensex 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.

Third, we observe a 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.

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 approach its post-crisis trough of 8000-plus. In sum, notwithstanding the poor real economy trends, the Sensex has fluctuated in the 15000-20000 band since June 2009, as brought out more clearly by Chart 2.

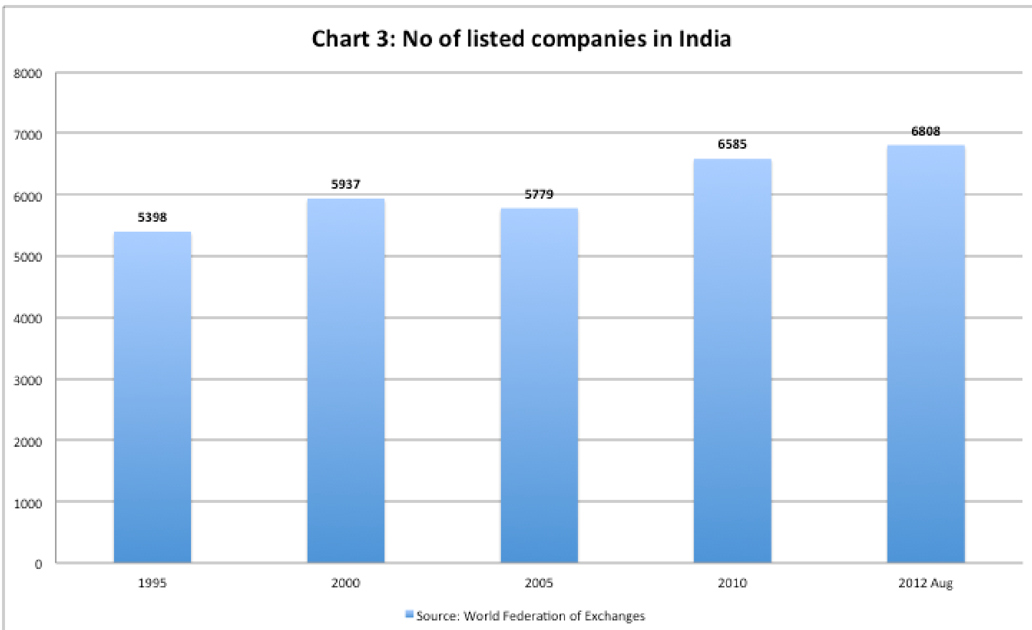
Chart 2: BSE Sensex (Closing): Recent Trends

Explaining some of these features is not difficult. Liberalisation not merely facilitated increased trading in the market, but also engineered such increased activity by allowing for investment by pure portfolio investors in equity markets. While initially this did not result in any foreign portfolio investment boom, it did attract some investors willing to risk a small portion of their globally available capital. The net result was the moderately enhanced activity during the 1992-2002 period noted earlier.

The government helped sustain the trend with measures adopted from time to time in the form of relaxation of ceilings on foreign ownership in individual industries and allowing for the greater presence in a single firm of individual FIIs and FIIs as a group. 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 sectoral cap for foreign investment in any sector as of September 2001.

However, these and other measures such as tax benefits provided through the tax treaty with Mauritius did not result in any runaway boom. That had to wait till 2003, when two events favoured such a boom. The first was the global spike in cross-border capital flows that found capital flowing in larger measure to many emerging markets. The second was domestic policy change that ensured that India emerged as a special favourite among investment destinations at the time of this cross-border capital flow surge.

To recall, in an explicit statement of intent, the Indian Finance Minister's Budget speech for 2003-04 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. This proposal should facilitate investment in equities."
Long-term capital gains tax was being levied at the rate of 10 per cent up to that point in time.



This significant tax concession, which made the Indian market a tax haven, is likely to have contributed to the remarkable rise of the Sensex, given the structural features of the Indian stock market. As Chart 3 indicates, the number of shares listed in India's stock markets, which increased significantly in the immediate aftermath of liberalisation, has seen only marginal increase over the past decade. Moreover, only the shares of a very small proportion of these companies are actively traded. Finally even in the case of the actively traded companies the proportion of shares that are free-floating, or are readily available for trading in the market, is a fraction of the total. The free-float fraction provided by the Bombay Stock Exchange for companies included in the Sensex (which are among the most actively traded in the market) "excludes promoters' holding, government holding, strategic holding and other locked-in shares that will not come to the market for trading in the normal course."

As Chart 4 shows, in the case of 16 of the 30 companies included in the Sensex, only 50 per cent or less of shares are available for regular trading. The number goes up to 25 out of 30 if a free-float factor of 75 per cent or less is considered. Some time back the Securities and Exchange Board of India's committee on market making had concluded that: “The number of shares listed on the BSE since 1994 has remained almost around 5800 taking into account delisting and new listing. While the number of listed shares remained constant, the aggregate trading volume on the exchange increased significantly. For example, the average daily turnover, which was around Rs.500 crore in January 1994 increased to Rs.1000 crore in August 1998. But, despite this increase in turnover, there has not been a commensurate increase in the number of actively traded shares. On the contrary, the number of shares not traded even once in a month on the BSE has increased from 2199 shares in January 1997 to 4311 shares in July 1998.” This does make the market susceptible to boom-bust cycles.

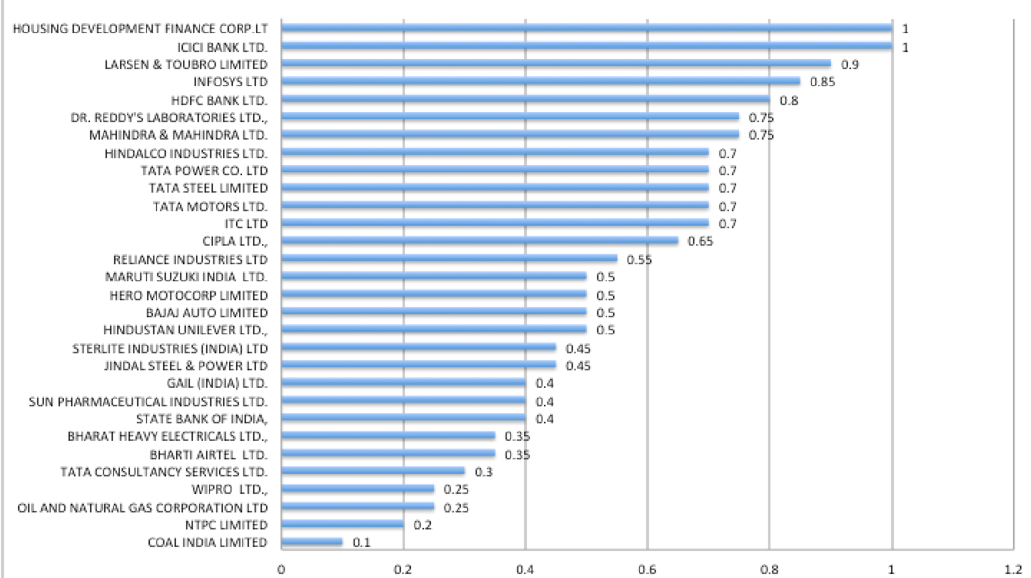


Chart 4: Free-float Factor of Sensex Companies

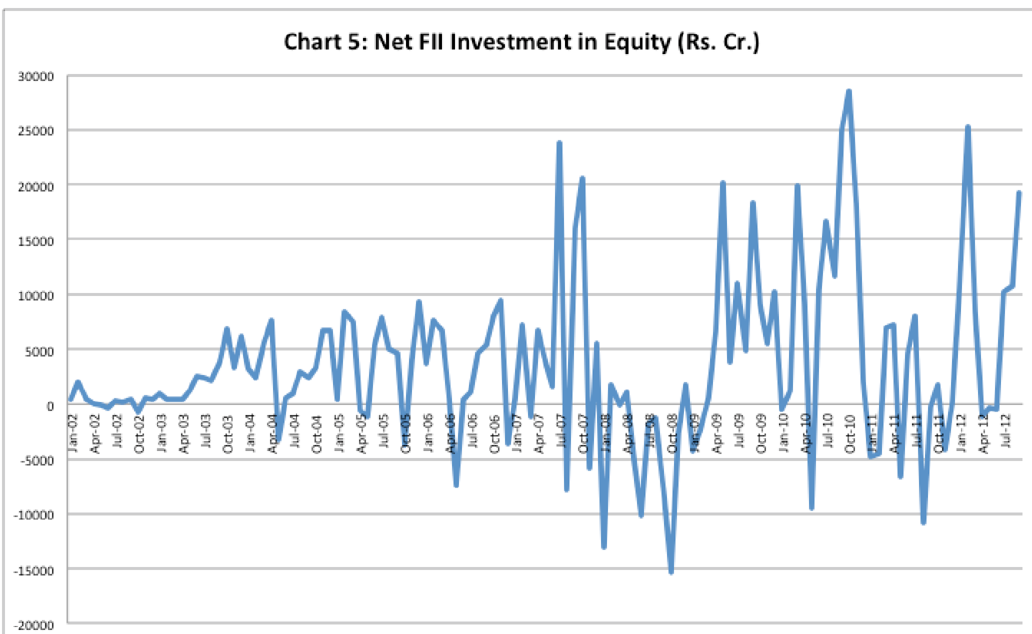
With only a limited proportion of the shares of even actively traded companies available for trading at any given time, any increase in demand for equity in the secondary market would result in a spike in share values. This is exactly what happened when there was a surge in capital flows into India after 2003. On the other hand, 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 collapse of the market and the index. It was the huge infusion of liquidity by central banks and governments in the developed countries, especially the US, which 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.

Growth has been low and inflation high. 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 asset and commodity markets in developing countries, leading to asset and commodity price booms even when the real economy is sluggish across the globe.

However, the way in which the effects of this cheap-liquidity overhang are transmitted to countries like India is complex. As Chart 5 shows, one effect since the 2008 crisis is that, in rupee terms, the net inflows of FII investment every month have become much more volatile since the crisis. The amplitude of the monthly variations in net inflows has increased hugely. This suggests that what is being experienced is not a stable and rising inflow of FII capital into the country. Rather, there are even signs of a reduction of the stock of foreign portfolio investments in the country. But that reduction occurs through short-term movements that are large. What appears to be happening is that whenever stock prices fall, investors are buying into Indian equity in the expectation that the fall would get reversed, offering opportunities for profit. Their actions, supported with financing by the cheap liquidity available in international markets, result in fluctuations that ensure the expected short-term gains are realised. But this also would imply that there is a temporary floor to the prices of actively traded stocks, depending on mere expectations of when any price decline would hit its trough.



Given the nature of the market noted above, the actions of such speculators do trigger a rise in the Sensex. But that rise would be followed by a decline when short-term investors book profits, till such time as expectations encourage another bull run. Such runs are also facilitated by periodic bouts of liberalisation by the government. This appears to be having two effects. One is increased volatility in stock price movements, around a medium term (say annual) trend, in which medium and long term returns are low or even negative. The other is the persistence of a relatively high range within which the Sensex fluctuates, 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.

The net result would be that for medium term investors the Indian market is a poor destination. And real economy factors do suggest that there are no grounds to expect a boom in the Indian market. However, this does not deter short-term speculators armed with cheap capital. As a result, the Sensex remains relatively high though volatile. There is a divergence between market performance and real economy trends. This only goes to prove once again that the market is a casino and does not reflect in any way trends in the real "fundamentals" of the economy.

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