Economic perspective of the Indian stock market performance

With the Indian stock markets taking a sharp dip from the heights of April 2006, the doomsday predictions abound, we believe that there is no reason to panic with these doomsday predictions prevalent in the market today. Markets will be range bound over time with a gradual upward trend and they will await expectations of increase in economic growth for their next big upswing.

A) Background

The Indian retail investors generally believe that the Indian stock markets follow unpredictable patterns governed primarily by investor psychology and market manipulations and are therefore unpredictable. This age old belief has its foundations in the pre-reform stock market trends. However, reforms have changed all that.

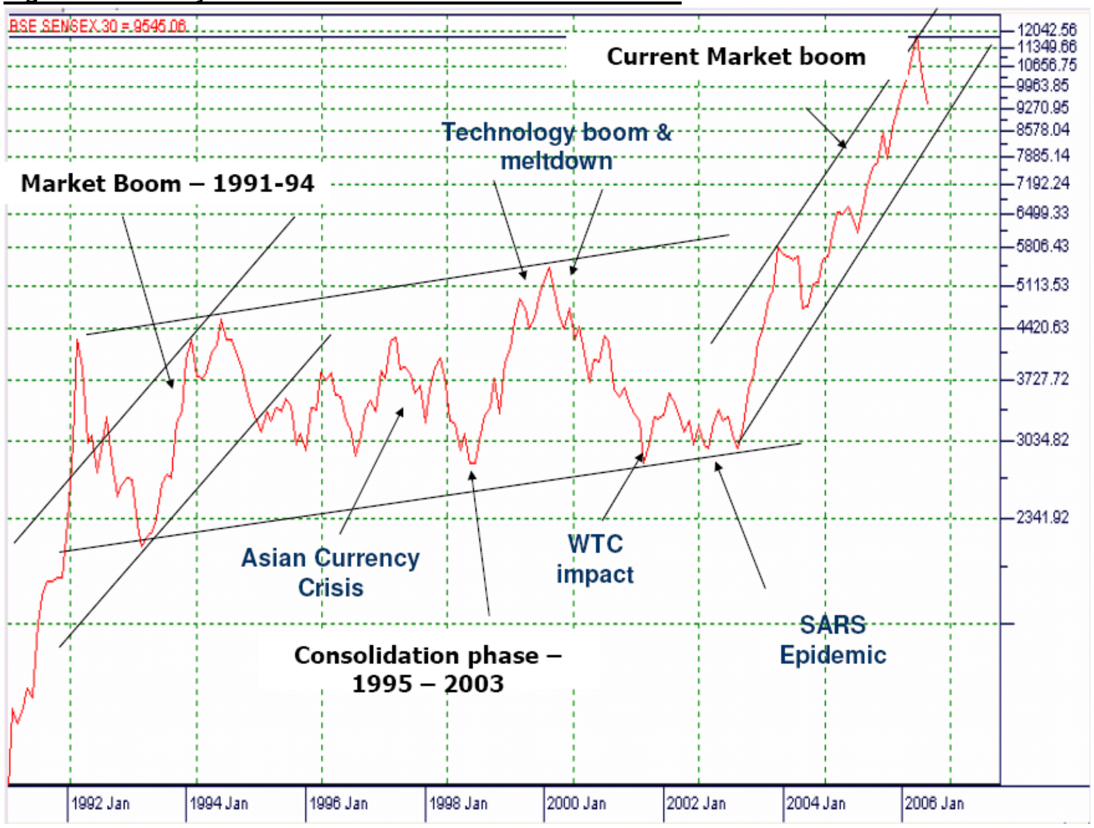
Today, the stock markets closely follow economic trends and are aligned to the global economic and financial market performances. Since the stock markets move in anticipation of future events, market movements actually precede the economy movements. As such therefore, shifts in market trends are seen ahead of major shifts in economic trends.

This 2-part article tries to establish a link between the Indian stock market performances and the economy, by analyzing the post-reform market behaviour and takes a peek into the likely future market trends. In the first part today, we shall discuss the Indian economic scenario and the markets from 1991 to 1994 including and the reasons for the boom.

B) The early boom (1991 – 94)

The Indian economic scenario witnessed a transformation from 1991 through economic liberalization, the like of which we witness today. However, this phase ended in 1994. The period from 1995-2003 was one of consolidation, characterized by largely horizontal movement of the markets with periodic peaks and troughs. From 2003, the market is again witnessing a major bull run (see **fig 1**).

Figure 1: Monthly Sensex Movement Jan 1991- June 2006



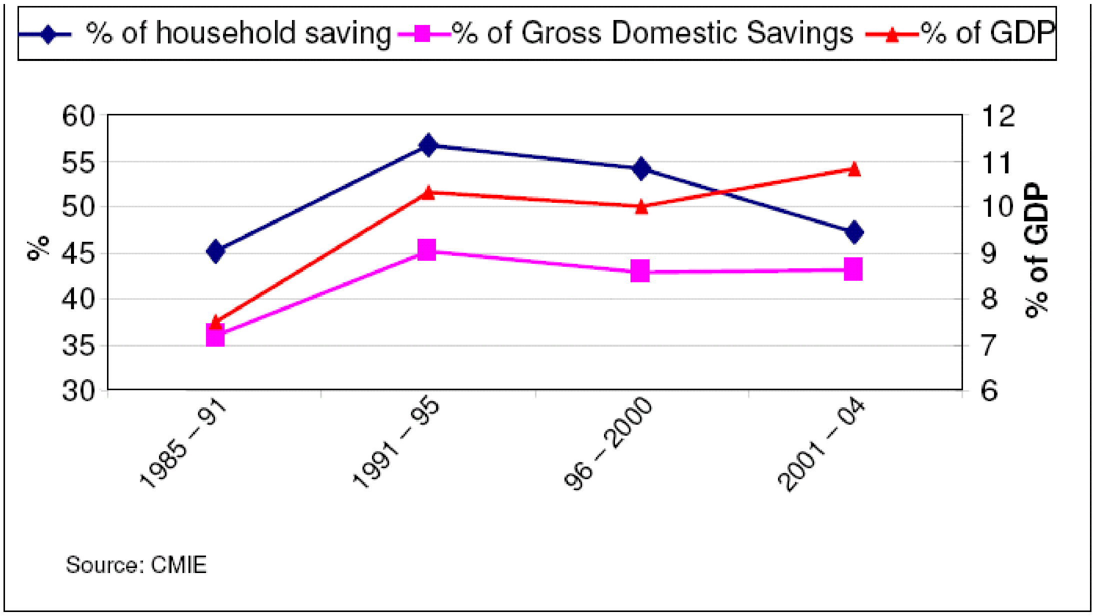
During this period, the Indian capital markets have transformed into being sophisticated transparent and efficient markets, on the back of on-going comprehensive reforms, which commenced in the early 1990s, and encompassed infrastructure, systems, regulation and improved penetration.

The economic liberalization of the early 90s focused on:

(i) Industrial de-licensing;
(ii) Tariff reduction;
(iii) Deregulation of capital and financial markets; and
(iv) Fiscal reforms.

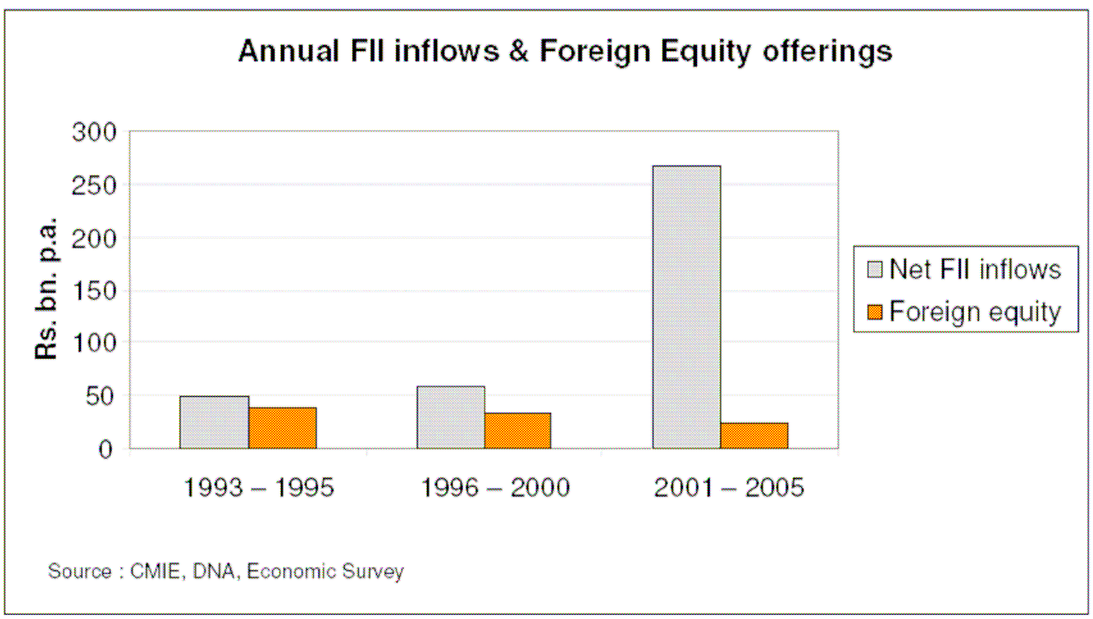
In early 90s, de-licensing saw a flurry of activity in the manufacturing sector. Significant manufacturing capacities were planned. Capital market reforms eased the norms for equity issues and increased the opportunities for the corporate sector to raise equity capital at market prices. The markets readily provided the necessary funds for the industry. As seen in **Fig 2**, the households diverted significantly more of their savings to financial assets during the period from 1991-95 as compared to the previous or the preceding periods.

Figure 2: Financial Savings by Households



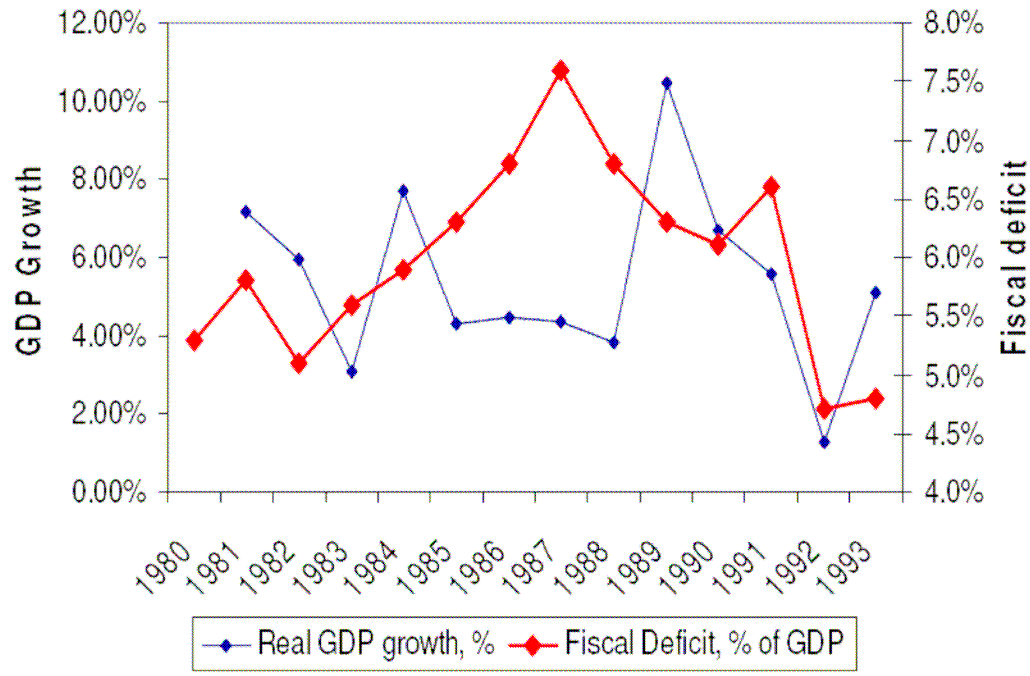
The hitherto depressed stock markets immediately recognized the unlocking of potential of the Indian economy through the liberalization process and entered a bull phase. From 1993, significant foreign investment flowed into the country through FII and foreign equity routes (see **Fig 3**).

Figure 3: FII Inflows & Foreign Equity Offerings



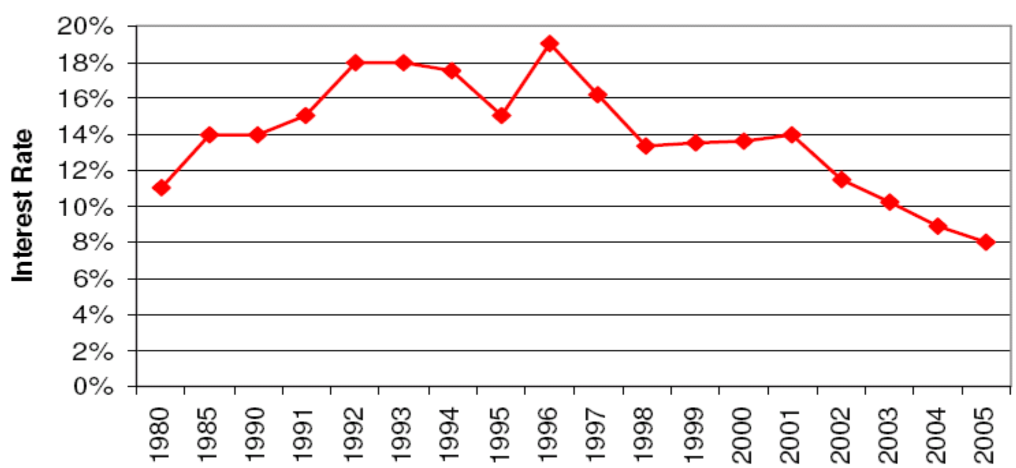
Notwithstanding these strong inflows into the capital markets, the rising markets gobbled up all available funds and still demanded more. This increased demand for funds strained the already tight liquidity. Industry was competing with a very high governmental demand for funds arising out of a long period of fiscal imprudence; slow economic growth (see **Fig. 4**) and high inflation in the 80s.

Figure 4: Fiscal performance 1980-1993



Consequently, the interest rates shot-up. The prime lending rates of the financial institutions peaked at 18% p.a. in 1992 up from 12% in 1991 (see **Fig. 5**).

<u>Figure 5: IDBI long term interest rate history</u>



As reforms progressed, economic weaknesses came to the fore. The industrial sector, which contributed a major chunk to the market capitalization, was small, fragmented and globally uncompetitive. With reduction in duty protection and de-licensing, the industrial sector became uncompetitive and corporate profitability declined.

As is evident, the market infrastructure did not support the extended bull run of 1991-94. However, the market players continued pushing up the market without an apparent cause. During this period, the market was manipulated by a coterie of manipulators between 1991-94***,** (they exploited the strong sentiments created by widespread reforms, to over-expose themselves in the market and funded their excesses though fraudulent diversion of funds from money markets). These operators systematically manipulated the entire market till it was pushed up to unrealistic levels.

Not backed by fundamentals, once the scam was exposed, the market collapsed as dramatically as it climbed. In the end analysis, this "**Great Indian stock market scam**"* caused a major upheaval in the Indian markets, and dented the confidence of small investors. More importantly, it prompted the exchanges, with the aid of SEBI, to lead a major reform of the Indian capital markets.

***Refer** – The Great Indian Stock Market Scam, by Verma & Barua

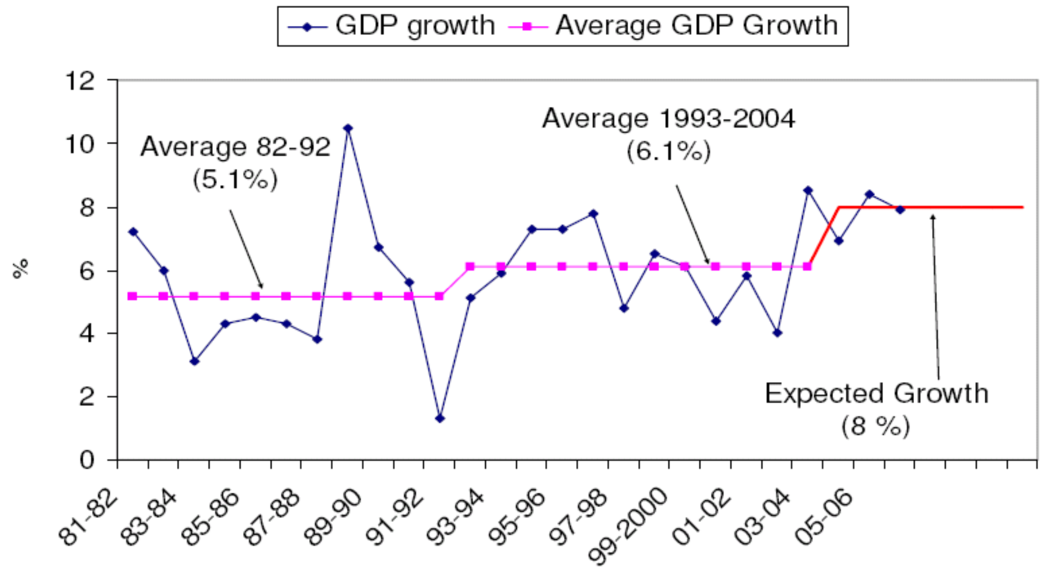
C) Economic performance (1994-2005)

By 1995, the Indian stock markets were busy restructuring their systems. The industry continued to consolidate/restructure, improved its efficiency and shifted focus from capacity creation to cost competitiveness. The highlights of the economy and markets during this period are as under:

1. Economy overview

- The drop in tariff protection forced a competitiveness drive in the economy, while simultaneously catalyzing a demand surge.
- Globalization provided an unprecedented growth opportunity to India's very large and educated middle class through a services boom.
- The economy recorded steady and robust growth led by the services sector. GDP growth averaged 6.1% between 1992 and 2005, 1.0% point higher than the previous 10 years (see **Fig. 6**).
- The share of services in GDP increased from 42.77% in 1993-94 to 52.40% in 2004-05
- Industry restructuring led to significant consolidation and M&A activity, post 1995.
- The currency stabilized due to healthy investment inflows, which led to an improvement in current account and in turn bolstered the real economic growth rates

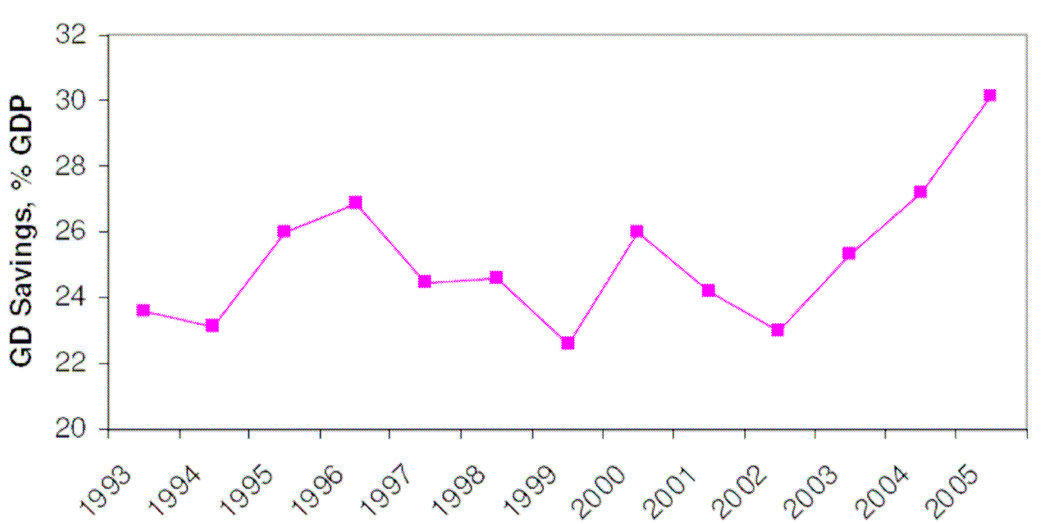
Figure 6: GDP Growth rate trends



2. **Investment and Money supply**

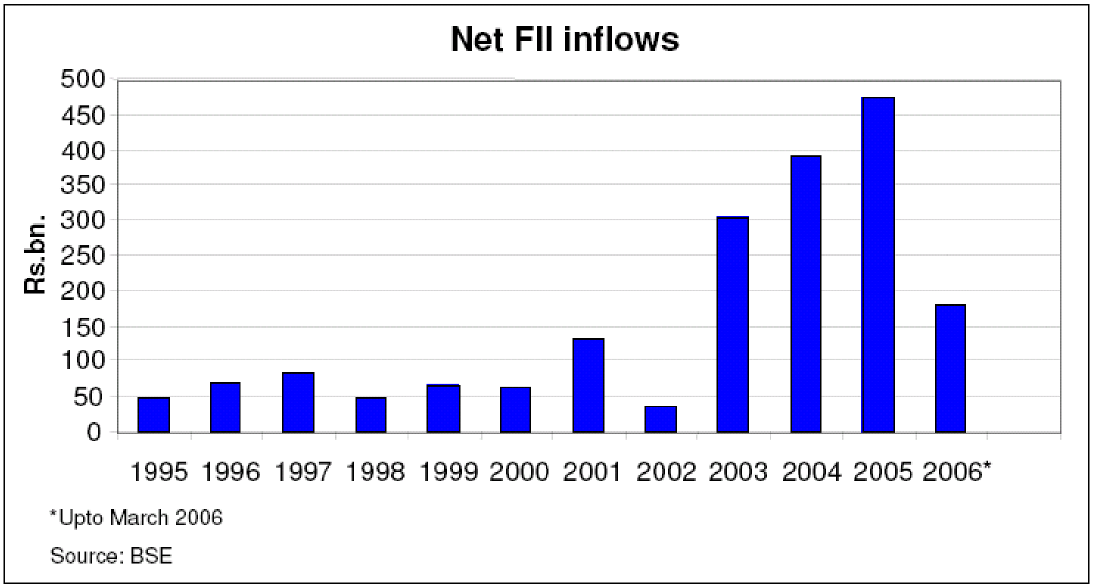
- Growing middle class and higher disposable incomes lead to improvement in savings rate. See **Fig. 7**.

Figure 7: Gross Domestic Savings, % of GDP



- However, the investment in capacity declined significantly post 1994 and remained low through till 2003. Activity in primary capital market also remained low in this period.
- High economic growth, reforming markets and significant economic potential of the country attracted a steady flow of FIIs investments in the Indian stock markets. See **Fig. 8**.

Figure 8: FII Inflow History



- Growth through services and easy money supply led to a crash in interest rates by 2004, PLR fell to 9% p.a. and the bank rates touched 6% p.a.
- Large fiscal deficits remained the economic weak link. The high fiscal deficits required heavy government borrowings. The Govt. diverted large amount of small savings away from the market to finance Govt. expenditure. The Govt. borrowed between 17 – 25% of the total economy's credit and 30 – 40% of the economy's deposits, between 1995 and 2005.
- Government borrowings offered high interest rates on retail investments, such as provident fund and tax-free bonds. In contrast, fixed deposit rates remained lower for most of this period. This prevented interest rates from dropping below inflation rates despite low capital market demand.

3. **Market behavior**

- Despite strong economic performance and high liquidity, the market movement between 1995 – 2003 was largely horizontal due to several dampness as under:
  - ⇒ Market was awaiting the impact of restructuring activity in industry.
  - ⇒ Services sector, the growth driver, was not adequately represented on the markets.
  - ⇒ Poor activity on primary capital markets with the Government sector dominating over 50% of the funds raised upto 2003.
  - ⇒ With globalization and growing FII presence, Indian markets integrated with global economy and were impacted by several global phenomena (1998 – Asian currency crisis, 2000 – technology meltdown, 2001 – WTC and Iraq war, 2003 – SARS).
- The market, which is driven by changes in economic growth, awaited an economic trend change and remained in a virtual sideways movement during this entire period.

D) Post 2003 economy and markets

By 2003, the Indian market was poised for a major upswing, based on expectations of higher growth.

- The economy growth accelerated post 2003, and industrial sector joined the services boom. Real GDP grew at ~ 7 - 8% in 2004 and 2005.
- Industry went into a capacity creation phase, leading to overall economic upswing and capital issues jumped.
- Robust economic performance and sophisticated capital markets were an irresistible attraction for FII investments. India emerged as the hottest developing market. FII funds poured in. 882 FIIs are today invested in India.

- With a lot of money chasing few stocks, the markets swelled. In tow with the global economy and markets, the Indian stock market breached all the past barriers. The BSE sensex crossed the 10000 point mark on Feb 7, 2006 for the first ever time and 12000 point mark in April 2006.

With the markets on a roll, the bandwagon has joined in. Funds continue to pour seeking high returns and pushing the markets up ever so rapidly.

E) Market Outlook

A shift in the average GDP growth rate from 5.1% to 6.1% from 1991 saw a bull run in the Indian Stock Market from 1991-1994 (see **fig 1**). But during the period of 1994-2003, the markets stabilised on the back of a steady GDP growth of 6.1%. The market once again went into a bull run in 2003 on the expectation of increase in the GDP growth rate to 8% p.a. As the growth rate expectation stabilizes, we expect the Sensex to move within the levels of around 9000 and 12000 until there is a next jump in the average GDP growth rate.

Market watchers should also keep in mind the following:

- Stock market performance is closely linked to the global and Indian economic performance, and their relative valuations. The Indian markets are rising on the back of strong economic performance and a continued strong inflow of FII funds.
- Rising P/E ratios make the Indian markets uncompetitive, forcing withdrawal of FII money, rapid capacity creation plans in the industry have resulted in new IPO offerings and have increasing the supply of stocks in the market to balance the FII inflows. Moreover, the increase in capacity will provide the economy with the supply needed to fuel future growth.

In conclusion, we believe that there is no reason to panic with the doomsday predictions prevalent in the market today. Markets will be range bound with a gradual upward trend and they will await expectations of increase in economic growth for their next big upswing.

ABOUT THE AUTHORS

Vikram M. Sampat is a strategist with a Fortune 500 company.

Prerak Parekh and Kekin Maru are 2nd year students at MET Institue of Management, Mumbai