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When Polls Exit, Bulls Enter!

Markets do not just love stability, they love authority too.

Sensex has, for the first time, crossed the coveted 40,000 mark with the initial break of this dream run starting on 20 May, a day after the exit polls were announced. The rise looks spectacular partly because of a relatively lower base, as a result of adverse global economic and trade predictions. However, the market fell by 400 points after the Reserve Bank of India (RBI) announced a rate cut on 6 June.

Notwithstanding the fall, an unprecedented rally such as this means that none of the major policy pronouncements of either the National Democratic Alliance or the United Progressive Alliance-II government could drive the stock markets in the same way as the exit polls. Why? Stock market movements factor in two components: long-term fundamentals of the corporations whose stocks are being traded, and immediate unexpected shocks to the system. A useful way of looking at the current movement would be to see, in Keynes' terms, what part of the rise is speculative (short-term gain) and what part is due to enterprise (fundamentals). A greater weight on the former means the markets are overvalued and will require corrections, while the latter means that even though the current price–earnings (PE) ratios may be high, it is based on better expectations about the future of the economy. It is difficult to separate the wheat (enterprise) from the chaff (speculation) because what may seem like chaff today (overvalued market with high PE ratio) may actually not be so because it may be based on expected earnings, which may well turn out to be true. But what drove these sentiments in the last few weeks?

First, a key short-term factor for such a high one-day trade rally of course was the comfortable majority predicted in favour of the Narendra Modi-led government by almost all the exit polls. Second, though linked to the first, is a more long-term view of the investors about the political stability of a majority government because it can provide a predictable business climate. But this expectation is not enough, especially from an incumbent government which has not really managed to deliver on the economic front in its first term. A repeat of an incompetent government surely is not a good sign for the investors to put their money in. Then, why did they? A "strong" leader in Prime Minister Modi, who seems to have the absolute faith of the people and, therefore, can take decisive steps, gives corporates a lot of hope in favour of otherwise politically difficult but market-friendly economic reforms. Big ticket disinvestment of public sector units or labour market reforms are some of the steps that the big corporates would expect Modi to deliver in his second stint. And in having this expectation, at least the markets would not be that off the mark, given the past experience of Modi pulling off the hugely unpopular demonetisation.

Third, the expectations about the immediate performance of the Indian economy, which is partly driven by the International Monetary Fund predictions of India being one of the fastest-growing economies in the world, played a significant role. This is surprising since in the last quarter, the economy has not fared all that well but the investors are perhaps hedging their bets on an uncertain future over a not so good past. One of the reasons for this buoyancy was the expectation of an accommodative monetary policy in the immediate run as a result of low oil prices. A lower bond yield under normal circumstances makes buying stocks more lucrative. There was also an expectation that a lower interest rate can kick-start corporate and/or household investment, thereby injecting growth in the economy. But, the RBI has given mixed signals. While reducing the interest rates, it has also revised the expected rate of growth downward even as the presser did nothing to directly address a looming liquidity crunch facing non-banking financial companies.

Fourth, there has been a huge net inflow of foreign portfolio investment in 2019 so far. Part of this inflow was to do with push factors, that is, factors emanating primarily at the source of these funds. In this case, these could be the Sino–United States (US) trade war, bleak economy recovery in the US, expectation of an easing of the monetary policy in the US which would lead to a decline in the US bond yields. The latter increases the possibility of arbitrage, provided the exchange rate risks do not rise *pari passu*. As for the pull factors, they are essentially the ones that the domestic investors are driven by.

Whether the bulls have got it right or not, one thing is clear: wide stock market fluctuations in the very short term, like we saw in the aftermath of the exit polls, are almost always chaff. But, other than that if this is indeed an overvalued stock market, it could be perilous for any economy, especially in a volatile global environment. To minimise the risks of overvaluations, Keynesians often argue for a short-term capital gains tax. At the same time, policies should not discourage stock markets altogether since they also play an important role of making large chunks of indivisible capital divisible, thereby decreasing the risk of investment. Ideally, the government should keep the lever of the economy in its own hands through an active fiscal policy instead of trying to indirectly influence corporate or household investment through interest rate changes. Unfortunately, the current government swears by the Fiscal Responsibility and Budget Management Act even in the worst economic conditions, which severely limits the policy space and makes the economy subservient to the movements in the stock markets or decision-making of corporations, which need not always be correctly aligned with the fortunes of the economy.