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Indian Capital Market Able to Get Faith or Still the Doom Continues...?

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Why is the Indian stock market falling? Well, this question has been bothering many who have invested in the stock market. The benchmark Sensex has corrected by about 14% from its peak in Nov 10. The sentiment seems to have reversed quite abruptly. Why is this happening?

Table showing quarterly BSC trends

Year	High	Low	Year	High	Low
Sep 10	20268	18027	Dec 10	20552	19074
April 11	19811	18976	July 11	19131	18732
Sep 11	16964	17908	Dec 11	17004	15136
April 12	17664	17010	June 12	17448	15749

The reason:

There can be no one specific reason for this fall. At the surface, it look like the Foreign Institutional Investors(FII) are selling for so many reason like the Euro crisis, Indian macro indicators, improving performance of the developed markets, geo-political risk etc. And there are very few buyers. Indian Mutual Funds (MF) has no money to buy because distributors are not selling their products. Insurance companies are cautious for some reason and retail investors are waiting on sidelines.

The underlying cause:

But there is need to delve a little deeper in to the dynamics of this current fall to try and understand the probable causes. it is common knowledge that GREED and FEAR are the two most dominant emotions in the stock market. When the market is going up, GREEN fuels its rise and when there is a correction, FEAR fuels it. And it is also common knowledge that the market reacts more to NEWS than to EVENTS. Which are the NEWS that is worrying the market right now and causing FEAR?

a) High Valuations:

The Indian stock market has had an exuberant run in the last year or so causing the valuations to become rich from the historical and comparative perspective. The market cannot keep rising forever. It has to readjust to the reality at some point in time.

b) High Inflation:

The government's statistic say it is still in the single digits or low double digits. But one can feel the pinch in daily lives and those handling their home finances will vouch that it much higher. Food prices are soaring and the reasons could be many including poor production, long term neglect of agriculture, increasing wages and cost of input etc. But food inflation is likely to remain high in the foreseeable future. Commodity price like crude, copper etc are rising due to high demand and also speculation that the huge liquidity that the developed countries have unleashed. High inflation is likely to affect the purchasing power of people and cause interest rate to rise thus affecting economic activity. And there is very little resistance to high price from the Indian public. A few years ago , the Delhi government was sent packing because of high opinion prices. But now no one seem to be too bothered about the high prices because people are earning more and investments in the stock market and real inflation is likely to remain higher till this "feel good factor" persists.

c) High fiscal deficit:

The government is spending much more than what it earns. So it is borrowing a Hugh amount which may affect the financial health of the government in the long run. It is pertinent to note that government is borrowing about 4.50 lakh corers this year as against about 1.50 lakh crores a couple of year back. This may cause interest rate to rise and thus affecting economic activity.

d) High current account deficit:

India is importing more than what it exports. So there is a shortfall of foreign exchange which is being met from the inflows from FII and FDI. But FII money being very volatile could reverse direction any time causing a Balance of Payment (BoP) problem for India. This deficit also cause the Indian currency to depreciate, making important costlier. At a time of soaring crude oil price, this could become a big headache.

e) Governance deficit:

Scams are flying thick and fast. From Adarsh to CWG to 2G, They are tumbling out of the cupboards in an unending stream. Such poor governance will someday make investors lose faith in the country and economy apart from weakening its financial health due to such revenue leakages and causing high fiscal deficit.

f) Shrinking IPO's :

The IPO market hasn't exactly been running at full throttle this year. And lately, it cann't seem to get out of first gear. There was a flurry of initial public offerings. But activity has slowed to a crawl as investors remain on edge. Some firms have postponed their plans going public. The pace is down sharply from six months.

With investors growing increasingly pick about IPOs, the big banks that mange offerings for companies looking to go public have also grown nervous. As more companies flop in their market debuts that has led to more IPOs being shelved. That's more bad news for investment banks. Many of them are already struggling because of subprime exposure. A further slump in IPOs activity would lead to fewer underwriting fees, a lucrative business for BSE firms.

Was this fall expected?

One always needs to expect the unexpected in the stock market. But whenever there is a dream run, as the market has been in for the last year or so, it is only natural that a correction would follow.

What is ahead?:

This is a million dollar question. Stock market movement cannot be predicted. But it looks the FEAR factor is likely to continue for some more time and the market could move downward or sideways till then because the underlying cause of this fall will not vanish overnight.

What to do?

This depends on individual circumstances. There is no need to panic and sell holdings unless one needs the money in the immediate future. Stocks, though volatile in the short term, are good wealth creators over the long term. If one has a long term investment horizon of about 7 years and has the conviction in the Indian economy, this is a good time to increase one's equity exposure in line with one's risk profile. And those with ongoing SIPs should not make the mistake of stopping them as this a good time to average down NAVs.

CONCLUSION:

The Annual Policy for 2012-13 is set a challenging macroeconomic environment. At the global level, concerns about a crisis have abated somewhat since the Third Quarter Review (TRQ) in January 2012. The US economy continues show signs of modest recovery. Large scale liquidity infusions by the European Central Bank (ECB) have significantly reduced stress in the global financial markets. However, recent developments, for example in Spain, indicate that the euro area sovereign debt problem will continue to weigh on the global economy. Growth risk have emerged in emerging and developing economies(EDEs). And amidst all these, crude oil prices have risen by about 10 per cent since January and show signs of persisting at current levels.

Domestically, the state of economy is a matter of growing concern. Though inflation has moderated in recent months, it remains sticky and above the tolerance level, even as growth has slowed. Significantly, these treads are occurring in a situation in which concerns over the fiscal deficit, the current account deficit and deteriorating asset quality loom large.

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