

Signs of financial sector froth

CAPITAL RISKS. Higher retail participation in the F&O segment can impact long-term savings



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The Indian equity market is on a high: again. On August 1, Nifty 50, the benchmark index for the Indian equity market, hit the '25000' mark. The jump from 24000 to 25000 took just 24 trading sessions.

By September 24, it soared past '26000'. This unbridled bull run has, in fact, characterised the Indian equity markets since the March 2020. However, now the bullish frenzy has regulators concerned.

On March 12, the Securities and Exchange Board of India (SEBI) chairperson, Madhabi Puri Buch, underlined the 'stretched valuations' of small and mid-cap stocks, iterating there are "pockets of froth" in the market. On July 22, she shared her concerns about speculative trading in F&O segment and losses made by retail traders in this segment.

SEBI, earlier this week, tightened regulation to curb retail frenzy in equity options.

Are the concerns of the regulator regarding a 'froth' in the market valid?

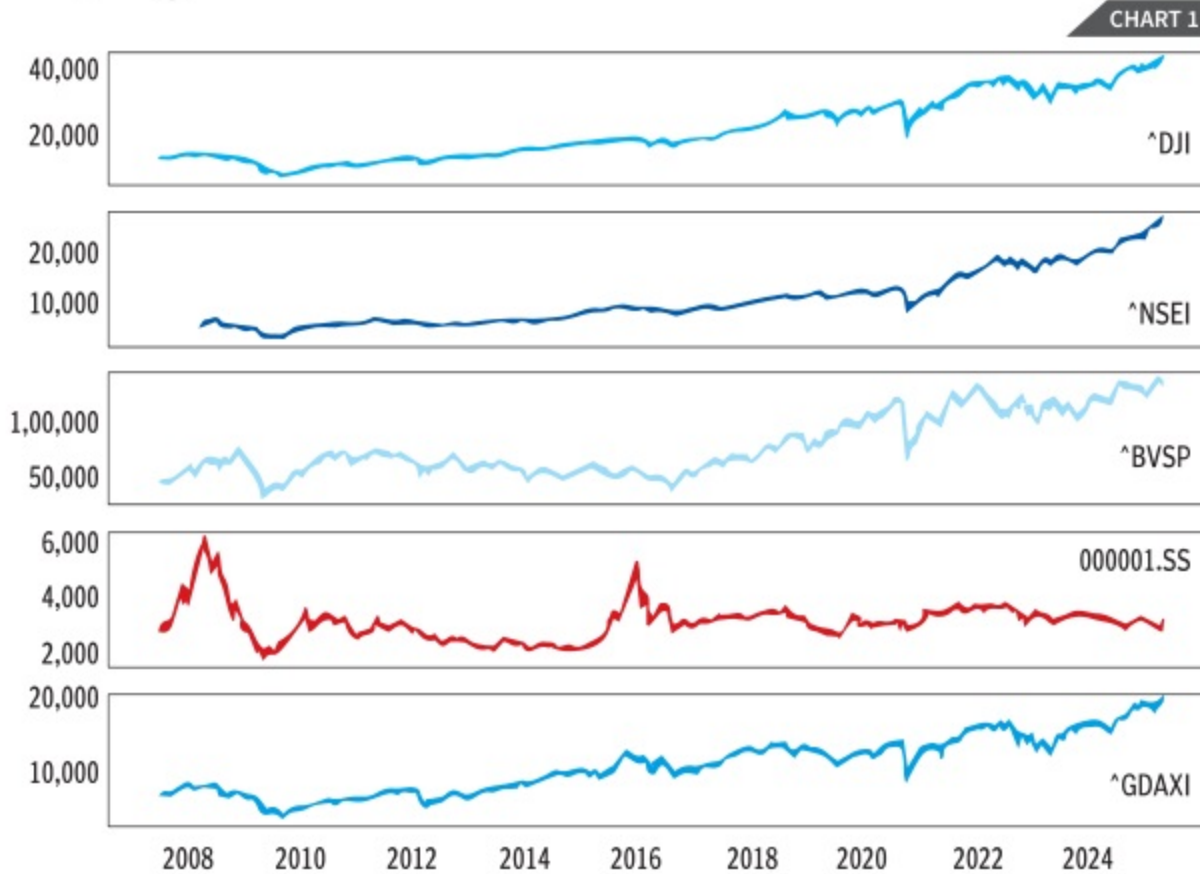
Chart 1 shows the six global markets: Nifty 50, India (NSEI), Dow Jones, United States (DJI), German Index (GDAXI), Bovespa Index, Brazil (BVSP), and SSE Composite Index, China (000001.SS) from 2015 to 2024.

For every market, we can see a sharp rally post the pandemic, an uncertain correction in 2022 and a sharper rally from late 2022 onwards. However, for both DJI and Nifty 50 (top two panels), the bullish spree in the last two years is extraordinarily strong.

The market capitalisation (mcap) as percentage of GDP (Buffet indicator) suggests the Indian markets are

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Major global stock markets and their movement



Raw data source: Yahoo finance

Market capitalization to GDP

TABLE 1

Country	2018	2019	2020	2021	2022
India	84	81	97	114	107
Brazil	48	63	67	49	41
China	46	60	84	81	64
Germany	44	54	59	59	46
US	147	158	195	206	157

Data source: World Bank

Annualised mean returns and standard deviation* for major markets

TABLE 2

Stock market	March 1, 2020 to April 30, 2022: expansionary (Dovish) phase	May 1, 2022 to August 31, 2023: contractionary (Hawkish) phase	September 1, 2023 to September 18, 2024: neutral phase
DJI	12.76 (0.27#)	3.94 (0.17#)	18.63 (0.11#)
NSEI	24.73 (0.25#)	10.27 (0.13#)	35.86 (0.13#)

*Standard deviation in brackets and italics

Raw data source: Yahoo finance, Calculations: Author

overvalued. The Buffet indicator for India increased substantially from 2019 to 2022, a pattern which matches the US' (Table 1).

India's mcap-to-GDP ratio reached a 15-year high of 140.2 per cent in May 2024. Values of the Buffet indicator above 100 is, by itself, an indicator of overvaluation but with values skirting 150 per cent, the financial sector has, it seems, decided to grow on its own. The concerns of the regulator about 'froth' in the market are evidently not unfounded.

What is leading to the continued bullish frenzy?

For one, the retail market participants have entered the stock markets in a big

way post Covid, especially in India. Moreover, there are concerns that credit growth in the real sector could be finding a route to the equity market. Table 2 presents the growth in the US and Indian equity markets during different monetary policy phases of the US Federal Reserve, broadly matched by central banks of major markets.

EXPANSIONARY PHASE

The sharp rally in both the markets post Covid coincides with the expansionary phase. From May 2022, Federal Reserve increased interest rates responding to inflationary pressures, leading to some correction: for both DJI and Nifty 50, we

see markets returns fall during contractionary phase.

However, with the rate hike paused from September 2023, the markets rallied sharply again. With the Fed's decision to slash interest rates by 50 basis points in September 2024, we are looking at another expansionary phase, which may stretch valuations on the upside.

How will the financialisation impact the real economy?

The symptoms of overvaluation bring forth concerns about financialisation: proliferation of financial assets and financial market growth unrelated to the real sector growth.

First, financialisation makes companies more concerned about 'share-holder value creation' than real capital accumulation. Financialisation can lead to 'distribute and disinvest' rather than 'retain and reinvest' for firms, which will jeopardize the real capital accumulation and employment generation.

SPECULATIVE SURGE

Second, the retail participation in the F&O segment and growth in intra-day trading shows the inclination to use the equity market for speculative gains rather than for long-term investment. This can be detrimental to retail participants' long-term saving behaviour, and adversely impact saving rates in the economy.

Furthermore, if the participation in the stock market is leveraged, a market crash can lead to substantial erosion of wealth for retail investors.

The Union Budget in 2024, increased short-term capital gains tax (STCG) and introduced a flat long-term capital gains tax (LTCG) across asset classes, discouraging short-term churning of portfolios. But have the market participants, especially the younger retail traders, taken the cue? The effects of the latest regulations by SEBI will have to be seen.

Going ahead, regulatory measures should not only discourage leveraged trading, but also create awareness on appropriate risk management strategies for intra-day trading and the pitfalls of shorter-term churning for long term financial goals.

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