The Herd Instinct at Work?

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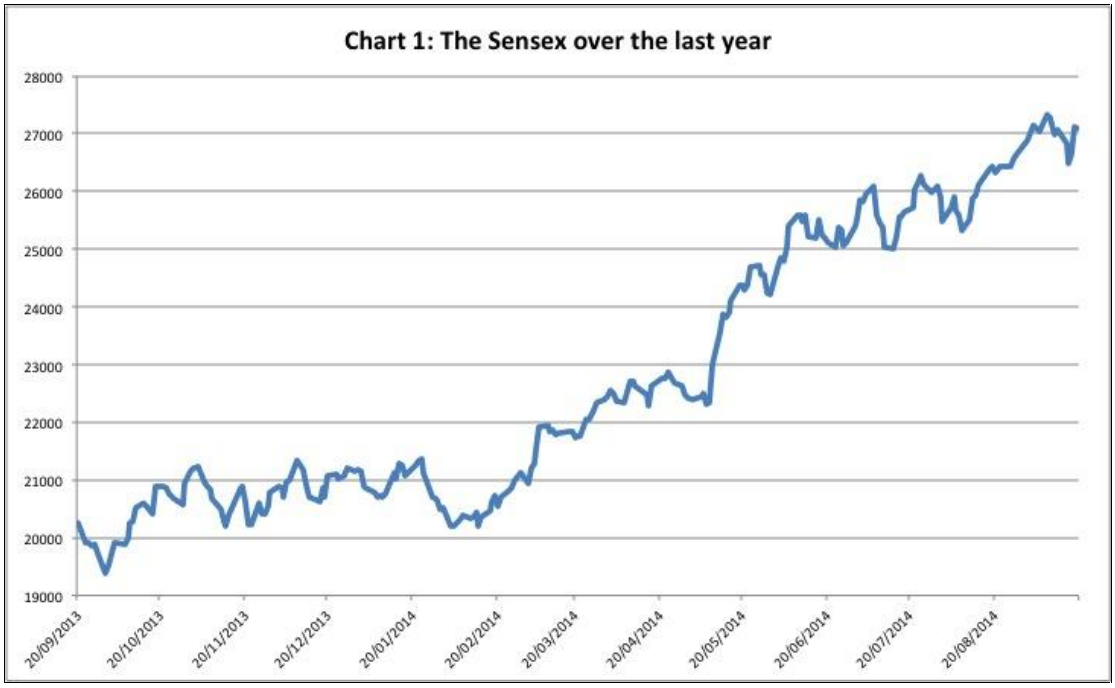
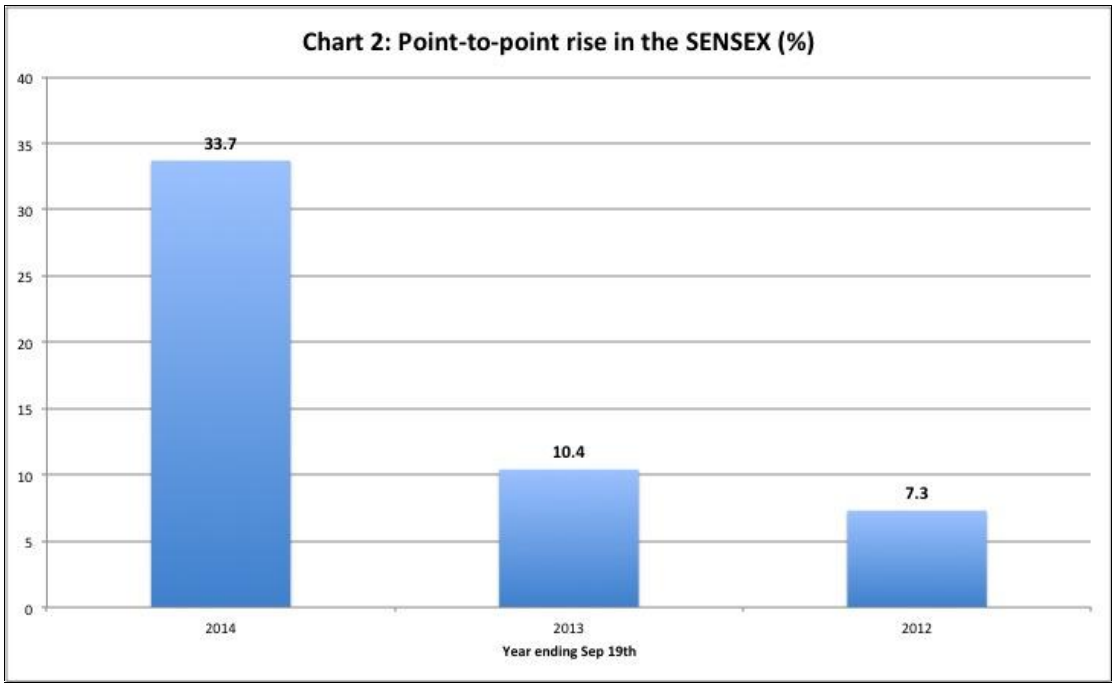


On September 17, the Financial Times reported that over nine working days starting 8th September its emerging market index had fallen 5 per cent. The rout, if it could be called that, varied in strength. Between September 8th and 19th, the leading index in Turkey fell by 5.8 per cent, while that in Brazil declined 2.4 per cent. India's index had fallen only by 0.8 per cent, which, when seen in light of the fact that the SENSEX had risen by 2.7 per cent over the previous month, was no fall at all. India's stock markets are at record highs with the SENSEX having risen by 33.7 per cent point-to-point over the year ending September 19th, as compared with 10.4 and 7.3 per cent respectively in the previous two years. All of this increase has occurred between the beginning of February and mid-September (See Charts 1 and 2). Overall, India's market has been doing disconcertingly too well, even in comparison with its peers.

The factor that has driven the SENSEX, it is widely accepted, is the persistent inflows of foreign institutional investment into India's markets. Cumulative net FII flows into equity markets rose from $13.8 billion over the two years ending September 19th 2012, to $24.4 billion over the year ended September 19th 2013, and $21.5 billion over the last year. These enhanced large inflows are indeed surprising because it is over the last two years that fears of the so-called "taper" have affected markets. In fact, initial talk of a taper by the US Federal Reserve, or a phase out of its quantitative easing policy that infused liquidity into the system through the purchase of bonds, had resulted in the net outflow of FII capital from equity markets of $3.8 billion over three months starting early June 2013, with half of that occurring over June alone. During those three months the SENSEX recorded an 11 per cent collapse in value.

It is not surprising that an announcement of the taper, or a gradual end to the policy of infusing cheap liquidity, and its subsequent implementation should trigger an outflow of FII capital. The impact of the move would be a rise in interest rates, since purchases of bonds

by the Federal Reserve and other central banks raise bond prices. Given the inverse relationship between bond prices and yields, this implies lower interest rates. Conversely, a retreat from the policy of bond purchases would raise interest rates and discourage the use of the available liquidity to earn quick returns in asset markets, including Indian stock markets. In fact, long years of the pursuit of an easy money policy in the form of quantitative easing has resulted in asset purchases that have taken asset prices to levels that seem to be completely irrational given fundamentals. This is, for example one of the arguments used by the Reserve Bank of India governor Raghuram Rajan against monetary policy in the United States.



Moreover, the Bank of International Settlements (BIS) argues in its quarterly report released September, that the behaviour of asset managers has exaggerated the effects that cheap liquidity would have on emerging stock markets. In its view, "the concentrated use (by asset managers) of benchmarks and the directional co-movement of investor flows can generate correlated investment patterns that may create one-sided markets and exacerbate price fluctuations." In simple English, the herd instinct characteristic of speculative asset managers who come to dominate flows to emerging market stocks tends to result in extreme swings in either direction, because such flows move together both when they come in and when they go out. In India, the direction in June to August last year was out of the market and country, while in recent months and weeks it is into the country and market.

As noted earlier, this is indeed surprising, given recent developments in the US. Though the signals are a bit confused, the indication seems to be that the Fed would complete its taper of the quantitative easing policy in October with a final $15 billion worth of bond purchases. It has, however, decided to delay tinkering with interest rates that have been close to zero for the last six years. But, as of now, it would appear that starting June 2015 rates would be pushed upwards, with a target of around 1.25 per cent by the end of next year.

Among the factors often cited as explaining the high investment flows into India despite the possibility of an end to the era of cheap and easy money, two are worth noting. One is that India is a relatively better bet than other emerging markets because its growth though lower than earlier is still reasonable by developing country standards, and fears that the rupee is

prone to depreciation have receded because of the sharp fall in the country's current account deficit. The second is that the coming of a new government has raised hopes of greater decisiveness in economic policy-making with an emphasis on economic "reform" of the kind preferred by foreign investors, which would accelerate growth, enhance profits and raise earnings.

There are three difficulties with this line of reasoning. First, it presumes that India is experiencing a surge in capital inflows because of its domestic performance, ignoring the obvious role of global factors in influencing capital flows, or assuming without adequate justification that India's economic performance neutralises any adverse effects on capital inflows of developments in countries from where those flows originate. Second, it asserts that an economy whose situation has worsened, with lower growth and high inflation, can attract large and rising capital inflows because its relative condition is better than that of competing destinations for foreign investment. Third, even if right in its assessment that the new government will push ahead with policies of reform, it ignores the fact that the belief that this in itself will raise growth and earnings is purely speculative.

If such dubious reasoning is abjured, it is clear that the current spike in India's equity market driven by FII investments is speculative and tenuous. It is the result of behaviour of the kind that the BIS warns is irrational and speculative. When a more-than-likely rise in interest rates in the developed countries actually occurs, herd behaviour could trigger a quick and simultaneous exit of investors that delivers a crash that would have implications outside the stock markets as well.

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