A Tale of Two Stock markets: Crashing for Different reasons

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Different market reactions, yet strangely enough, they produced the same result.

That happened early this month in the stock markets of two countries: one in the most advanced country with the largest GDP of US$ 19.4 trillion; and another in an emerging economy, the seventh largest now, predicted soon to overtake UK and France to become the fifth largest economy with GDP of US$ 2.4 trillion.

The stock markets in both countries crashed for two diametrically opposite reasons.

One was the reaction, along the familiar and expected lines, to the government's seemingly not-so-investor-friendly fiscal policy change: re-imposition of tax on long term capital gains: That was India.

The other was the unusual and the most unexpected reaction to a welcome fiscal policy change; a cut in corporate tax. That was USA.

India's stock market crash

The Indian stock market had a jolt on February 1, soon after the presentation of Budget 2018. India's major stock market index, the Sensex which tracks the performance of the 30 major companies listed on the Bombay Stock Exchange (BSE), fell 900 points or by 2.5%. That was the impact from the 2018 budget proposing a 10% long-term capital gains (LTCG) tax on equities effective from April 1, 2018. Efforts were made to comfort the market by referring to positives of the so called "grandfathering" clause for the purpose of computing capital gains: the higher of two prices: the acquisition cost or the actual purchase price and the maximum traded price as on Jan 31, 2018 would be taken into account. That would mean any gains accumulated before Jan 31 would not be taxed when the asset is sold. The stock market was shaken up so much that there was no sign of any "calming down result", from the so called comforting clause.

The re-introduction of long term capital gains tax, after 14 years was a rude shock to small investors. That was a day after the budget announcement. The Sensex index fell to 35,000 in just one trading session. The broader Nifty fell 256 points (2.33%) to close at 10,760. It is the biggest tremor, after 48 months of an upward trend in stock prices with the BSE index doubling over the period. For a market that rose 14 months without a pause, the "jolt" was severe.

In fact, just a month ago, Indian stocks were hailed as the best performers among the key global markets, with market capitalization soaring high. The market cap to GDP ratio touched a close to an eight year high of 90% in 2017 beating not only those of other BRIC countries (Brazil, Russia and China) but also the developed countries including the US and UK.

The heavy sell- off resulted in a major stock market crash.
India's was just a mini-tremor, compared to what happened in USA in the morning of Monday Feb 5. That is late evening of Feb 5 in India since India is ahead of USA (east coast) by 10½ hours.

"Tremor" in USA

What happened as the simple bearish sentiment in the last trading session on Friday, Feb 2 in USA, based on fears of inflation assumed major proportions when the next week opened on Monday Feb 5.

Reports of more than expected job increases by 200.000 in the last quarter of 2017, the unemployment rate falling from 4.7% in the third quarter to 4.1% in the fourth quarter and the growth rate at 2.5% in the same quarter and the hourly wage registering increases, all fanned the fears of inflation further. Meanwhile, Jerome Powell was sworn in as the new Chairman of the US Federal Reserve (the Fed).

Would he do what the Fed was saying all along: take away the punch bowl and normalize the benchmark interest rate?

Irrational fears indeed, just as the exuberance behind bullish expectation was also irrational.

The core inflation, which does not include the volatile items of food and fuel was below the Fed's target rate of 2%.

Gripping fears

The Dow index lost 1,175.21 points on Monday. It closed below 25,000, giving up all its gains for 2018, aside from being the biggest fall in one single session. It was also the biggest percentage drop in a single day since Aug 2011. The S&P500 dipped 113.2 points, the biggest percentage decline on a single day since Aug 18, 2011.

The common man was surprised at the stock market turmoil. He was wondering how stock markets could crash when the American economy was doing well and there are no signs of recession or any downturn.. Jobs have been rising; unemployment is below targeted level; growth is good and the US economy has recovered from the Great Recession. President Trump's corporate tax rate cut and his promise to make America Great again by protecting jobs, levying import duties on imports including washing machines from Korea and China, should have been music to the investors' ears.

We can understand it. Only 49% of American households belonging to upper middle class and above hold stocks.

On Wednesday, Feb 7, President Trump summed it up on Twitter so well. He lamented:

"In the 'old days' when good news was reported, the stock market would go up. Today, when good news is reported, the stock market goes down."

That brings us to the good old question: which is the real market or the "false". Everybody knows that the stock markets could create paper millionaires who suddenly become paupers.

Why did India's stock market crash?

Is India's stock market crash of Feb 1 part of a global backlash emanating from the US stock market of Monday Feb 5?

Clearly not so; India's stock market crash was purely "Made in India"!

The Indian stock market participants did not expect the re-introduction of LTCG, which was discontinued 14 years ago. The belief that government is anti-investment is clearly wrong.

The only purpose is for seeking a new revenue source for bridging the budget deficit in the face of expected revenue shortfall from the current direct and indirect taxes including GST. The stock markets know very well that government cannot create jobs without boosting private sector investment. Further, any jobless growth when elections are around the corner would only affect the re-election prospects of the government.

Low investment

The Reserve Bank of India (RBI) Governor, Urjit Patel made it clear in his Feb 7 Press Conference soon after the Monetary Policy Committee's decision to keep the benchmark interest rate unchanged, that investment to GDP ratio (currently at 26.4% having fallen from the peak of

35.6% in 2007) would increase only when capacity utilization (presently: 71.2%) and credit growth improve.

When asked about the likely impact of the re-introduction of LTCG on economic growth, the Governor referred to the four already existing taxes on capital: (i) a corporate tax (ii) a dividend distribution tax (iii) a tax on dividend income above Rs 10 lakh; (iv) a securities transaction tax. With the LTCG, there will be another tax, which would have some marginal impact as well, both in terms of savings and investment.

That was food for thought.

Will the Finance Minister reduce the proposed rate of LTCG or withdraw it altogether?

Some comforting words

In the meanwhile, RBI has comforted the nation: although the estimated fiscal deficit for 2018-19 would be at 3.5% of GDP for 2018-19, which is higher than budget estimate of fiscal deficit of 3.2% for 2017-18, there are inflation mitigating factors. They are:

- Inflation is lower than RBI's target: 4% plus 2%.
- capacity utilisation is subdued
- oil prices have moved both ways in the recent period
- they may soften from current levels based on production response; and
- rural real wage growth is moderate.

The needless panic reaction of the stock market has done one good thing. It has brought about the much required and often expected but often ignored correction in the overvaluation of Indian shares.

As this is written, the process of market correction is still ongoing in both markets. The stock market turmoil has not come to an end.

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