

Stock Market: A ticking time bomb

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The bulls in the Dhaka Stock Exchange (DSE) are surging ahead with the DSE all share price index crossing 5,800-mark last week. Generally strong stock market performance is associated with strong economic fundamentals, and one should be pleased with the outcome. However, the surge in the price index and the associated increased market volatility, somehow reminds us about the boom and bust of 1996. A sudden influx of funds and a surge in retail investors are pushing the DSE index forward without regard to economic fundamentals; the unfolding scenario is virtually a reenactment of the first part (constituting/representing the bull run) of the 1996 stock market episode. We are drawing on the 1996 episode, since lessons of 1996 is very much relevant today

During the second half of 1996, the DSE all share index increased by 139 per cent, a robust growth by any measure, fueled by the herd mentality of the non-professional retail investors and a huge influx of funds.

Participants in the overheated market were aggressively chasing a few available stocks. The hike in market capitalization and market turnover were also aberrant as the number of listed companies and available shares of good companies remained almost unchanged during this period. During June to November

1996, the DSE all share price index increased more than three folds from 959 to 3065 or by 220%!

The newly elected government of that time, initially misinterpreted this formation of the stock market bubble as fundamental strength of the economy and a manifestation of people's confidence in the new government.

However, policymakers' enthusiasm was short-lived and was soon replaced by concerns about the demise of the bubble and the impending market crash. When the market index more than doubled in one month to 3000 in October 1996, efforts were made to stabilize the market, but it was too little and too late. As the bubble busted in November 1996, the DSE general index collapsed to its post-peak lowest level of 957 in April 1997, stabilizing at about the same level where it was some 10 months back (See Fig 1). By the end of April 1997, the stock market price index plunged by almost 70% from its peak of November 1996.

During this bubble period only few traders and market manipulators who had knowledge and inside information gained, while general investors paid heavily. The bear market that started with the busting of the bubble lasted for seven years, the DSE general index rarely crossing the 1000-point mark during this period. The market started a recovery from April 2004, when it was fairly underpriced with the average price-earnings ratio at about 10, and thereafter the DSE index steadily gained through July 2009.

No two bubble episodes are exactly the same across countries or across time. A sharp rise in stock prices does not necessarily mean formation of a bubble. Stock prices may also rise across the board when something change fundamentally in the economy or in the economic outlook, such as the developments in the

Spanish and Irish stock markets on the eve of their joining the European Union (EU). Such price surges cannot be characterized as bubbles since the indices may stabilize at their new high levels with earning potentials realized over time. However, generally most stock market bubble episodes have some common characteristics. Some of these characteristics include: exuberant demand manifested through weak correlation between price and economic value; high price volatility; acceleration in money and margin lending; narrow market leadership; structural weaknesses like lack of institutional investors and weak regulatory regime.

Assessing the existence and size of exuberant demand is a difficult task. However, as we notice record levels of market turnover and new records for the DSE general index week after week, we really wonder whether “irrational exuberance” is also dominating Bangladesh stock market. The index, which was at 2941 in August 2009, has crossed 5800 points in February 2010 (see figure 1), growing by 98 % since August. The index has increased by 28.5% since the beginning of the year. This surge is certainly not normal and cannot be explained by economic fundamentals.

Similar movements have been recorded in market capitalization, price-earnings ratio, market volatility and in other indicators during this period. Market capitalization (total number of shares times the average market price of shares) in August 2009 was TK 1307 billion (US\$18.9 billion) and on February 17 it has risen to TK 2366 billion (US\$ 34.2 billion) (See figure 2), exhibiting a rise of 81% within five months! Just to put it in proper perspective, the market capitalization was only Tk 97 billion (US\$ 1.7 billion) in Dec 2003

before the beginning of the current bull-run. The daily average turnover showed a similar trend, increasing from Tk. 0.14 billion in Dec 2003 to Tk. 12 billion in January 2010 and further to Tk. 14 billion in the first half of February. In 2009, daily turnover did not fall below Tk. 10 billion which was a miniscule 0.26 billion in 2004.

As the supply of stocks is almost unchanged, except for the launching of Grameen Phone IPO in November

2009, pressures in stock prices are obviously coming from the demand side. Among many factors, huge number

of new investors with fresh funds is primarily responsible for this price pressure. In January 2009, some 0.115

million (1.15 lakh) new Beneficiary Owners' (BOs) accounts have been opened while the number was 58,000 in

December 2009. The increase in the number of BO account holders has accelerated further to 0.123 million

(1.23 lakh) in the first 10 days of February. This means 12,000 new investors are joining the market every day.

Huge amounts of fresh money are being channeled into the stock market through these accounts, undoubtedly

pumping the stock market balloon to grow bigger almost every day. If the average account size is Taka 0.1

million (1.0 lakh), everyday Tk. 1.2 billion is being poured into the market, mostly by the first time retail

investors while foreign portfolio investors are withdrawing from the market realizing their profits.

This excess demand is causing price earnings (P/E) ratio to rise and making stocks riskier to purchase/hold. The

P/E ratio can be defined as:

That is, the P/E ratio of a stock is a measure of the price paid for a share relative to the annual net income or

profit earned by the firm per share. It is a financial ratio used for valuation: a higher P/E ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower P/E ratio. The P/E ratio can be interpreted as “number of years of earnings to pay back purchase price”, ignoring the time value of money. In other words, P/E ratio shows current investor demand for a company share.

A high P/E ratio also implies that the share has high growth potentials. That’s why its market price is expected to be higher than other equivalent shares. Market P/E ratio at the DSE has been rising gradually, meaning many shares have become overvalued. In August 2009 the market (weighted average) P/E ratio was 17.5 and by February 2010 it has risen to 30 (see figure 3), meaning a share on average takes 30 years to give back (through dividends) its purchase price to the investor. It is also reported that, a few companies which are not even properly managed, their securities are being actively traded in the market at P/E ratios well above 75!! Isn’t it insane to invest in such shares?

Moreover, what we are observing at the DSE is that companies like banks with higher growth potentials, stable income base and established track records have lower P/E ratios compared with shares of many other companies without proven track records! These findings clearly indicate that some shares of questionable quality are extremely overvalued in recent times.

The Security and Exchange Commission (SEC), the regulatory authority for overseeing the stock market, has been taking some steps to contain the market instability. To limit investor funds flowing into

these already overvalued shares and help the market to calm down, the SEC has undertaken several initiatives, including tightening of the conditions for margin loans. Initially, the SEC set the limit of equity to loan ratio at 1:1.5 and restricted such lending only for stocks with P/E ratio not more than 75.

More recently, the SEC further tightened the criteria by setting the loan limit at 1:1 in shares which have P/E ratios lower than 50. This means with margin loan facilities 50% of the share price should be borne by the investors and other shares which have P/E ratio over 50 can be purchased only with cash. These are good moves. But the market is in a defying mood and simply shrugged off the message.

Now the question is why this is happening and what else the government can do to prevent a repeat of 1996 stock market debacle. Obviously when there is a lot of liquidity in the system, and money being fungible, there is no way to prevent people from borrowing on one account (for the officially stated purpose of trading, housing, agriculture and other uses) and investing in the stock market. As surging flood water cannot be contained by a putting a small/weak dam downstream and water simply bypasses or overwhelms/washes away the barrier, money keeps pouring into the stock market ignoring the SEC signals lured by quick capital gains.

With broad money (M2) expanding by more than 20% last fiscal year and once again this year, fueled by inflow of workers' remittances, certainly there is more than enough liquidity (like surging flood water) to shrug off the limited efforts by the SEC. The budgetary provision to allow whitening of undisclosed money into the stock

market is also playing an important role in flooding the market with liquidity.

People of all walks of life are moving toward the market but the market is not for everyone. Professionals and market manipulators are expected to gain, while others must lose at the end. The market is already overheated, and in the midst of the stock market frenzy market manipulators are very active. This is clearly visible in the performance of the index of “bottom 20 small cap companies”. Since May 2008 the price index of these companies has increased several times more than the DSE general index and the P/E ratio for these companies is now 100 or more, compared with DSE market P/E of about 30.

All these uncomfortable indicators send one clear message that the stock market is currently not a good time for new and uninformed investors. It is imperative on the part of policy makers to send clear warning signals and highlight the heightened risks in order to protect ordinary investors. Measures also need to be taken to minimize the exposure of banks to the stock market in order to safeguard depositors’ interest. Ordinary investors should be reminded what Warren Buffet said: “The market, like the Lord, helps those who help themselves. But unlike the Lord, the market does not forgive them who do not know what they do.”

Currently the market is entirely being driven by mob frenzy, and how long this will continue is to be seen.

However, if this frenzy continues for a few more months, the bubble would become much bigger and it would be too late to defuse this ticking bomb. The bubble will explode like it did in 1996. Should we allow the market to give investors such a hideous solution? Should not the government come forward to give people a better

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