The stock market situation: What to do about it?

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Bangladesh's stock market performance, measured in terms of the stock price index, has been one of the best globally for a number of years. Its upward surge defied

global and regional market developments. When almost all markets across the globe collapsed during the global economic crisis, DGEN was perhaps one of the very few which defied the global trend and maintained its upward progression fueled by local developments/conditions.

When it started its upward trend in 2007, the market was certainly undervalued, and there were fundamental economic reasons for it to go up. At that time the average Price/Earning (P/E) ratio was in single digit and the market capitalization was less than 10 per cent of gross domestic product (GDP). The sustained upward surge, however, went beyond what could be justified by economic fundamentals by early 2010.

Since mid-2010, as the index crossed the 5000 mark, the market has clearly been driven by speculative forces. During the last two-month period leading up to the peak, the index increased by more than 2000 points before crossing the 8900 level on December 5. To put it in proper perspective, the index level was at about 1500 until this recent surge started in 2007. Daily market turnover increased 30 fold about Tk. 1.0 billion to Tk. 33 billion over the three-year period. Clearly, economic fundamentals cannot support this level of valuation gain and turnover, and the market is bound to correct itself once it runs out of steam.

The recent drop in the stock market index needs to be evaluated in this context. Even after a more than 2500 point decline, the index is still well above its mid-2010 levels. The corrections and volatility in the price index that we have experienced in recent days is

nothing uncommon, and fully in line with what has been observed in many other important, and much larger stock markets across the globe. For the market to start consolidating, it needs to shed itself of speculative elements, and that can only happen once market valuations come back to their fundamental levels.

Global experience indicates that once stock markets get into a bubble phase, there is very little that regulators or policy makers can do to stabilize it. This has been seen in major markets in the US (NASDAQ in particular) and Japan, and in emerging markets like China and the Gulf Co-operation Council (GCC) countries in recent years. A broad and deep market in the US did not prevent the NASDAQ index from crossing the 5,000 level and crashing back to the 1,600 level in a matter of weeks. The experience of Japan is even more pathetic, with the Nikkei crossing the 33,000 level in 1991, and following the crash, is currently flirting with the level of 10,000 after almost 20 years. More recently we have seen the Shanghai stock index crossing the 7,000 level, crashing down to well below 3000 after the correction. We saw an even worse development in Bangladesh in 1996 when the index dropped from 3,600 to below 800.

The authorities should not panic due to the overdue correction observed in Bangladesh market in recent weeks. Their main concern should continue to be ensuring macroeconomic stability and sustaining real economic activity and employment generation. The stock market collapse would not necessarily hurt Bangladesh's growth and employment prospects if the process is well managed. The recent tumble in the index should be seen as the inevitable outcome of irrational exuberance on the part of market participants. What worries me is not the correction, but the panic created by both in the streets and at the level of policy makers. What the retail investors are doing in the street is certainly not going to change the course of the market. It only shows how illiterate the Bangladeshi retail investors are as a class. Time and again, informed analysts and policy makers have warned against the state of market overvaluation. We can have sympathy for them, but there is very little the government can do to save those investors who are driven by greed and speculation, and ignore professional advice. Certainly the market is not for these types of investors, and the sooner they realize their mistakes and get out of the market, the better it will be for the market itself and for themselves. When we see people in every office have the stock market tickers on, and

people leaving their productive jobs and becoming day-traders, we know there is something fundamentally wrong with what was happening. The stock markets should be the domain for long-term investors and market oriented professionals. Retail investors should invest in the market through instruments like mutual funds which are managed by professionals.

As regards policy makers, their objective should be to help ensure a softer landing, and let the market find its fundamental valuation level. It is bothersome to observe the administrative interventions undertaken a few weeks back when the index fell to 7200 level to engineer artificially a massive 16% rebound in the index in one day. As reported in the press, Bangladesh Bank directly intervened through Investment Corporation of Bangladesh (ICB). The Securities and Exchange Commission (SEC) and other authorities might have also pressured state owned commercial banks (Shonali, Rupali, etc.) and other financial institutions to get into the market and provide an artificial support. Such a policy never works when the market is misaligned, as we observed last week. Public money may have only bailed out some smart/lucky investors but weakened the financial institutions further.

To put it into perspective, countries like Saudi Arabia, Kuwait, the UAE, and China, with enormous amounts of financial resources could have bought the entire stock market several times if they wanted to do so. But those authorities did not try it because such interventions create morale hazards, and if continued would tantamount to nationalizing a large segment of the economy. Certainly, Bangladesh, with its meager resources and with the size of its stock market at 45-50% of its GDP, cannot afford to get into such misadventure.

What should the authorities do now? This is not the time to panic and bring about short sighted regulatory changes. The experience of the last few weeks clearly indicates that whatever sensible move the SEC and Bangladesh Bank may consider would act against them and trigger a negative development for which the regulators will be blamed. This is a perfect example where you intend to do good things, you will be blamed, and if you don’t do anything, you will still be blamed (for inaction). The policy makers and regulators would, however, need to prepare themselves for two initiatives: 1) assess the impact of a major stock market correction on the domestic economy and determine what kind of policy response the government may have to undertake to mitigate the dampening effect on the real economy through various transmission channels; and 2) the SEC and other policymakers should prepare a comprehensive set of reform measures which can be initiated once the

market settles down at the proper level. Nothing major should be done now, when the market is in a correction mode.

The market will find its floor when stock prices would become attractive for the institutional investors, who are probably waiting in the side lines with lots of cash and other liquid assets for future investment at attractive prices. The critical issue is should we call the prices attractive at the average price/earning (P/E) ratio of 23? This reported P/E ratio of 23 should also be taken with a grain of salt since much of the record profit gains recorded by the financial institutions would certainly disappear in 2011 and the adjusted or prospective P/E ratio will be much higher than the reported level. It is normally believed that an average P/E ratio of 12-15 would be attractive for long-term investors. Thus it would be irrational to expect institutional investors to jump into the market and provide a floor for the index at the current level.

Policymakers should therefore not push or force the financial institutions to buy at these high prices. Commercial banks and their subsidiaries have certainly made hefty profit gains in this episode and these institutions should therefore be expected to provide some floor to the market and also protect valuation of their own shares. It would be much more prudent however if Bangladesh Bank first determines how much adversely these banks and other financial institutions have been impacted through their un-cashed portion of stock holdings, the losses incurred by their borrowers through margin and other form of borrowings, and indirect exposures of their clients to the stock market. In some instances, the capital base of the banks may have been significantly eroded and it would be the first order of priority for the Government and Bangladesh Bank to recapitalize these financial institutions by preventing all financial institutions from distributing their profits. The record profits earned by financial institutions should first be used for loan loss provisions and to boost their capital base. Healthy financial institutions are must for a healthy real economy and only healthy financial institutions will provide the floor for the stock market when the valuations would become attractive.

It would be a serious mistake to force or pressure the financial institutions to enter the stock market prematurely. Bad assets (in terms of valuation) to be accumulated by these

institutions in this process would only weaken their balance sheet and may lead to collapse of weak financial institutions, thereby transmitting the impact of the stock market collapse to the real economy on a bigger scale. As a matter of fact, Bangladesh Bank may have to be ready to inject liquidity to the financial system in the event some banks are hit seriously by their direct and indirect exposures to the stock market. The emergence of liquidity crisis in the financial system in recent weeks may be an early manifestation of that problem.

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