EQUITY MARKET INTERGREATION AND DEVELOPMENT IN NEW INDIA 2017

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Abstract

In India, there has been a conscious effort by the RBI and the Government of India to develop and integrate various financial market segments in a phased manner. In this paper, the authors analyze the macro-economic dependence, current liquidity, volatility, efficiency, and integration level of key financial market segments—money, government securities, forex and equity.

Keywords: Mutual Funds, Domination in Commerce, Brokers, Investors

I. INTRODUCTION

To say that the year 2016 went by without much ado would be a complete misnomer, for there would have hardly been a dull moment in the past 12 months. From concerns around hard landing of the Chinese economy to Brexit event to a rise in the negative yield-bearing assets globally to the stupendous demonetization drive in India to the US presidential election victory of Donald Trump, the year has been action-packed to say the least.

On the macroeconomic front, while there was a sharp recovery in the global crude oil prices (23%), consumer price index (CPI) inflation remained benign and twin deficits remained contained. Metals rallied in 2016, bouncing back from the 2015 lows and on expectation of a revival in Chinese demand. Weak credit growth during the year further aggravated by demonetization move, posed headwinds for the Banking sector. Discretionary spending showed a negative growth trend in Nov-Dec period on muted demand on account of the note ban move.

FPI (Foreign Portfolio Investors) flows into Indian equity markets for CY2016 stood at a 5-year low of USD 2.90bn (INR 187.82bn). Further, FPIs remained net sellers to the extent of USD 6.5bn (INR 442.97bn) into fixed income markets during the year. Interestingly, DIIs (Domestic Institutional Investors) ploughed in INR 372bn into Indian equities during the year surpassing the net flows from FPIs.

On the equity market front, a slowdown in the Chinese economy, UK’s vote to exit the EU, weakness in global trade growth, policy normalization by the US Federal Reserve, rise in global commodity prices and the US elections weighed on the market movements during the year.

Indian fixed income markets which started the year on a cautious note, had a lot to cheer in 2016 especially post demonetization. The steep drop in 10-year benchmark yield by around 113 bps during the year stands out amongst developed and emerging markets.

Equity Market

With the establishment of the Securities and Exchange Board of India (SEBI) in 1992, reforms to enhance regulatory effectiveness and competitiveness as well as modern technological infrastructure to reduce informational asymmetries and transaction costs were undertaken. Foreign equity investments in the form of FIIs were allowed from 1992 onwards and Indian companies were allowed to raise foreign capital in the form of American depositary receipts (ADRs), global depository receipts (GDRs), foreign currency convertible bonds (FCCBs), external...
commercial borrowings (ECBs), and investments through NRIs and overseas corporate bodies (OCBs). The establishment of the National Stock Exchange (NSE) in 1994 further increased the competitiveness and led to the development of volumes in the equity market in India. During 2000–2001, index futures, index options, and options and futures on individual securities were introduced to shape the Indian capital market. Currently, the Indian capital market is one of the most active and growing capital markets in the world. Futures and options of about 223 individual stocks and 4 stock indices were traded on the NSE as of March 2011. Large cap stocks/futures and index futures of Indian equity are fairly liquid and efficient.

**Deep and Diverse Indian Equity Market:**

With more than 5,000 listed companies, the Indian equity market is globally ranked second, with the U.S. equity market being the top runner. The diverse nature of stocks allows investors to gain exposure to a wide range of sectors such as automotive, banking, and pharmaceuticals, to name a few. The S&P CNX Nifty (Nifty 50), one of the most widely quoted indices, comprises stocks covering the entire spectrum—financial, industrial, and energy companies—thereby offering investors exposure to the key drivers of domestic growth, i.e., domestic consumption and infrastructure capital expenditure (capex). One of the peculiarities of the Indian equity market that reduces its depth is that more than 55% of the equity market is held by promoters (principals of companies), thereby reducing the overall free float of the stock. In order to address this peculiarity, the SEBI mandated all listed companies to raise public shareholdings to 25% by mid-2013. Another peculiarity is the higher proportion of FII holdings than domestic holdings, which renders stock prices quite volatile and vulnerable to global developments (Hubbis, 2013).

**Equity Markets Our Outlook For 2017**

Major themes to impact Indian markets in 2017 include resurrection in consumption demand, growth led by policy reforms, move towards digitization, monetary stance of global central banks and economic policy decisions.

The impact of demonetization may weigh on consumption demand and on the growth of various industries in the near term, dragging down the GDP growth for FY17 by 50 bps. The approval of promulgation of the Special Bank Notes (SBNs) (Cessation of liabilities) ordinance by the President of India could likely bring about a gain to the government on account of allowance given to the RBI to extinguish its liability towards unreturned SBNs. We expect the impact of this currency replacement program to be short lived as new notes come into circulation (45% back in circulation as on December 17th). Additionally, this move should help to increase the share of formal economy and digital economy. Improvement in consumption demand is expected to be a major theme for 2017 supported by a gradually rising rural wage level, implementation of the 7th pay commission, lowering of interest rates in the Indian economy and continued government spending.

Fiscal deficit dropped by 52.3% YoY in Nov on pick-up in tax receipts (direct and indirect) even as non-tax revenue was down. However, the achievement of fiscal deficit target for FY17 would warrant a tradeoff between government spending to counter the slowdown from demonetization and expectation of a fall in tax revenue in H2FY17.

Policy reforms led growth – Interest subvention of 3% and 4% for housing loan announced in December 2016 may boost low cost housing segment. Post the fixation of tax structure by the GST council, GST law now awaits implementation in 2017. This simplification of tax structure along with reforms pertaining to land, labor, infrastructure sectors and
Modification in FDI policy could contribute to sustainable growth over medium term.

Global factors including commodity price movements, economic policies of the new government in the US and monetary policy stance of global central banks could have a bearing on capital flows to emerging markets like India. A likely rise in inflation pressure in the US from wage rise and expansion in the economy should elicit future interest rate hike actions by the US Federal Reserve in 2017. Global growth rate is likely to improve, led by the US and other emerging economies in 2017 which could benefit the Indian export oriented sectors. That said, India’s lower linkage to global economies makes the domestic macro factors and fiscal trends the key catalysts to determine growth.

Improving fiscal situation, inflation rate, exports growth, rising FDI flows point towards fundamental stability in the economy which augurs well for long term equity investing. Domestic corporate earnings volatility may increase as corporate attempt to tide over the impact of currency replacement program. Earnings for FY17 are expected to be lower than estimate with EPS growth likely at around 10%. Consensus earnings growth for FY18 is expected to be healthy at high teens. The fundamental strength of the economy and attractive valuation levels of the market (1 year forward P/E for BSE Sensex at 14.7x, moderate levels implying low risk) present a positive outlook for equity. Periods of interim weakness in equity market should be considered as investment opportunities for long term investors. We recommend a systematic investment in diversified equity funds & hybrid funds to benefit from the current volatility and participate in the growth potential of Indian equities.

Equity Markets Extended their Rally in May

Not only did the old market saying (which, by the way, is a little simplistic and rather poorly backed) “sell in May and go away” not prove true, but equities gained 1.9% (MSCI AC World index in US dollars) over the month of May.

Emerging equities continued to outperform developed markets (with a 2.8% gain for the MSCI Emerging in US dollars), driven by strength in Asian markets.

Exhibit 1: Both developed and emerging equities extended their rally in May (performance as of 31 May 2017) with emerging equities outperforming their developed peers

Index 100 = 1 January 2016.

Temporary Nervousness

Nevertheless, markets were on edge for most of the month, as reflected in a spike in the VIX index (Chicago Board Options Exchange Volatility Index) which measures volatility on S&P 500 options to close to its 2017 highs (the VIX reached 15.6% on 17 May before falling back to end the month below 10%).

Exhibit 2: Performance of a selection of asset classes in May 2017 (%).
A Rich Month for Politics in Every Sense of the Term

During the month of May major equity markets were pulled in different directions by a number of factors. The influence exercised by political events was changeable – initially rather reassuring for investors (Emmanuel Macron’s victory after the second round of the French presidential election on 7 May), then uncertain (UK opinion polls in the run-up to 8 June general elections and an increased likelihood of early elections in Italy) or downright worrisome.

In the US, the firing of FBI Director James Comey and the circumstances surrounding it, have, some observers believe, increased the likelihood that the president will be impeached. This overreaction was the cause of the 17 May dip in equity markets (-1.8% by the S&P 500).

Subsequently, it became clear that impeachment is unlikely, given that it would be, above all, a political act requiring the assent of the Republicans who control both Congress and the White House. Other political events, whose implications are harder for investors to fathom, had a rather short-lived impact on the markets. These events included the latest revelations on the financial scandal in Brazil, which is threatening President Tamer and caused a drop of 9% in the Bovespa index and 7% in the real on 18 May, followed by a steady rally.

Economy is perception really reality

On the macroeconomic front, economic surprise indices continued to decline, particularly in the United States, where they moved back into negative territory, suggesting that economic data has mostly disappointed in recent weeks. Although conditions in the global economy do not appear to have worsened significantly, the slippage in momentum fed doubts as to how sustainable economic growth will be. Against this backdrop, equity investors were less afraid that central banks would be moving rapidly to wind down their highly accommodative monetary policies.

Exhibit 4: Surprising to the downside – economic surprise indices indicate that economic data has been below expectations in recent weeks

A strong earnings season On the corporate front, momentum remained favorable, with solid quarterly results leading analysts to maintain their positive views on the outlook for earnings.

What are Markets Telling us:

Current concerns do not appear to be priced fully into the main equity markets. Political risk and growth concerns have dominated discussions in the US but have not kept US indices from outperforming their European peers (+1.2% by the S&P 500 vs. -0.1% by the EuroSTOXX 50). Relative performances appear to have been driven mainly by currency markets. European indices were hit by the 3.1% gain in the euro vs. the dollar, while the Tokyo market benefited from a weaker yen in the first half of the month to generate a 2.4% gain on the month (as measured by the Nikkei 225). Meanwhile, the 4.4% gain in the FTSE-100 should be seen against the backdrop of sterling’s 3.4% decline against the

![MSCI EMU - Sectors monthly change in May 2017 (%)](image)

**II. CONCLUSION**

Going ahead, the authorities should focus on the derivative segment of the forex and equity markets, in terms of both potential market participants as well as product development. With regard to the GSM, further development is required to increase transparency (level of disclosures); additionally, the development of newer instruments and regulatory incentives to increase the size of the trading books could be undertaken. In the money market segment, our recommendation is to develop a market mechanism for participants to take a medium-long term perspective on interest rate and liquidity.

**III. REFERENCE**

2) Nse financial market book