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Elections and stock prices

Macro-forecasting is the area where more effort is required

SNAKES & LADDERS

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We have seen big election-related moves of the stock market in the past. But with the benefit of hindsight, the market's forecast of future profit growth has been poor. This is part of a larger pattern, where the Indian stock market is often good at sizing up one company at a time, but fails to understand the macro forces that are shaping the entire country and influence all firms. Finance players need more macroeconomics and political science expertise. Election results may also be particularly important for 'politically connected firms' (PCFs).

In 2004, everyone had expected the NDA to be re-elected, but in fact the UPA won. The CPI(M), which was part of the UPA, was on television promising that there would be no more privatisation of PSUs. On 17 May 2004, Nifty had its biggest ever one-day decline, giving a scare to the managers of exchanges.

But in hindsight, this rapid assessment was wrong. We constructed an index of the net profit of all listed companies (excluding finance and oil companies). This did pretty well in the UPA-1 period. The index of net profit tripled: it went up from 264 to 808 between Q2, 2004 and Q2, 2009.

In 2009, the stock market was delighted when the election results came in: strong profit growth was expected in the future. Look forward into time, and we see that the rapid assessment was wrong. The index of net profit went up from 808 in Q2, 2009 to 954 in Q2, 2014. If you take inflation out, this was a decline in net profit.

From 2013 onwards, the stock market was optimistic that with the expected change in government, strong net profit growth would come back. We do not yet know the net profit index for Q2, 2019. The latest value for the net profit index, for Q4, 2018, stands at 875. When the Q2, 2019 results are out, it is unlikely that strong net profit growth would be visible over the five year period.

These three experiences suggest that the Indian stock market has fared poorly in absorbing the information from an election outcome and thinking about its impact upon net profit. So we should be cautious about how well the stock market will parse the election outcome of May 2019.

This is part of a larger pattern of weak macro-forecasting by the Indian stock market. When we look back at the big moves of the overall market P/E ratio, we find it fares poorly at anticipating the big moves of net profit. The main story of earnings in India is that there was a strong increase in the period 2002-08. By and large, the P/E of the market rose after — not before — this profit growth came through. The market failed to anticipate what was coming. And later, the P/E ratio was high for a sustained period, thus forecasting that high profit growth would come about in the future, but this anticipated profit growth did not come about.

The Indian stock market fares better when looking at one company at a time. When averages of hundreds of companies are made, a company with a high P/E ratio tends to produce more profit growth, in the future, when compared with a company with low P/E ratio. But it has not fared well at thinking about the macroeconomic and political outlook.

Going from the macro to the micro, how might election results impact upon individual companies? Some linkages between political parties and certain firms might exist. When institutions are weak, personalities matter. Certain persons and companies could have strong relationships with certain political figures. The priorities in licencing, regulation-making, and enforcement activities can change owing to election results, particularly for a class of firms that are termed 'politically connected firms' (PCFs).

Relatively little is known about India on these themes. But there are several studies for other countries which are illuminating.

- A paper (Mobarak and Purbasari, 2006) shows that in Indonesia, firms connected with the Suharto regime preferentially got import licences.
- A paper on Pakistan (Khwaja and Mian, 2005) found that ex-politicians shape bank loans to PCFs.
- A paper (Faccio and Parsley, 2009) found that when a politician dies, there is a 1.7 per cent decline in the stock price of companies headquartered in the politician's hometown, and this rapid assessment is the correct one as earnings growth and access to credit is adversely affected in the period after the death.
- A paper (Claessens *et al*, 2008) finds that Brazilian firms which engaged in election funding got better stock market returns in the 1998 and 2002 elections.
- In Indonesia (Fisman, 2001), rumours about Suharto's ill health induced negative returns of PCFs.
- In 1933, when Hitler rose to power, the firms with strong links to the Nazis got strong returns (Ferguson and Voth, 2008).
- In Malaysia, when the government ran out of money to give subsidies to PCFs, in the 1997 crisis, the PCFs got negative stock market returns (Johnson and Mitton, 2003).

These examples, of fascinating research projects from other less developed countries, help in thinking about stock prices in the coming week.

The Indian stock market is getting firm valuations right, when averaged across a few hundred companies. On average, low P/E firms produce lower profit growth in the future than high P/E firms. In this micro-forecasting, there is a role for thinking more about political connections of PCFs. But the Indian stock market is weak at macro/political thinking, at anticipating aggregate earnings growth of listed companies. In the past, the aggregate P/E ratio has been a poor forecaster of future aggregate earnings growth. In an emerging market, the overall market index is a rather important factor in shaping the returns of individual firms and portfolios, which amplifies the importance of correct thinking about the overall index valuation.

Macro-forecasting is thus the area where more effort is required. The finance fraternity in India needs to strengthen its capabilities in macroeconomics and political science.

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