FINANCIAL MARKETS

India Equities

Make No Mistake, We Are Not in a Bubble Yet!

While Indian stock market may still not be in a bubble like situation, investors would, nevertheless, do well to have a plan to escape the wrath in case a market crash does happen.

M R Raghu, CFA, FRM, FCMA, CEO, MARMORE MENA Intelligence

A financial bubble is an economic cycle characterized by rapidly increasing prices of an asset to a point that is unsustainable, causing the asset to burst or contract in value. Financial bubbles follow five stages: displacement, boom, euphoria, profit taking and bust.

– Gartner Finance

Recently, the Indian capital market regulator SEBI warned investors about froth building up in the small cap space. They ordered mutual fund houses managing small cap funds to conduct a stress test post which some funds came out better than others. However, the warning by the regulator led to a fall in the price of small cap stocks and some panic in the market.

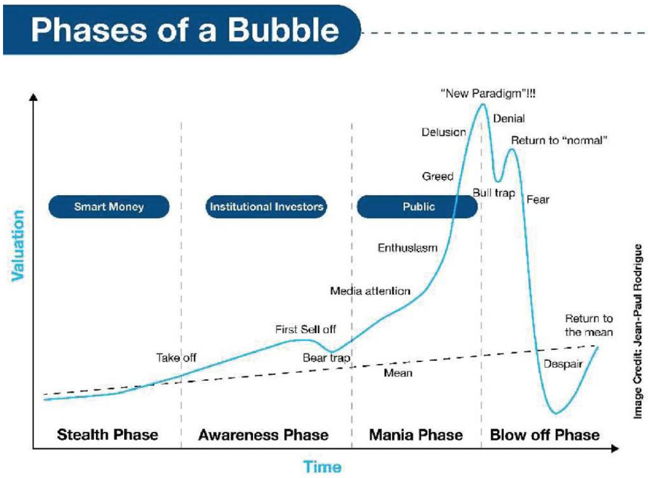
Post-Covid, Nifty has been hitting new highs repeatedly. After touching a low of 8,745 on March 20,2020 (due to Covid), Nifty reached 22,493 on March 7, 2024, implying a return of 257% between the periods. Of course, there were minor corrections along the way, but the ascendancy was very clear. Such a rapid rise in the stock index begs the question - "Are we in a Bubble"?

All markets have cycles and so does the stock market. The description of a bubble by Jean-Paul Rodrigue aptly describes the four key phases, i.e., stealth phase (when smart money finds its way), awareness phase (when institutional money gets in), Mania phase (when retail public join the frenzy) and finally the blow off phase when all run for cover. The question now is: Where are we in this chart? While the rapid rise in Nifty during the last four years tempts us to flag Nifty in the Mania phase, going by various metrics that I have compiled it probably indicates that we are in the enthusiasm phase.

We have considered ten important metrics that can measure the Bubble. In this, except for three, all other metrics point to normality suggesting that we are sometime away from reaching a bubble.

1. Market Cap/GDP ratio (**Normal**): As the formula implies, this measures the relationship between market capitalization and the broader economy. When the stock market runs itself ahead (a sign of bubble), this surely will range between 150 to 200%. But right now, it is below 100 indicating a normal trend.
2. Sector Concentration among Nifty Top10 (**Normal**): Financial services (mainly banks) continues to be the largest sector currently with a share of 43.8% in the Nifty top 10 and that has not changed much when benchmarked with the 3-year average.
3. Valuation (**Normal**): The three commonly followed valuation measures i.e., p/e, p/b, and dividend yield all plot lower than the 3-year average. Normally, in bubble situations, valuation metrics stretch way beyond the average. For e.g., in the Covid rebound, the p/e ratio touched 42!

4. Foreign flows (**Above Normal**): Foreign portfolio investors are known to cause bubbles and burst, and hence it is important to watch the flows from foreign investors. Presently, this number is above normal but by no measure indicates a bubble.
5. SIP (**Above Normal**): While FPI's measure foreign investment, Systematic Investment Plan (SIP) measure the domestic flows into the stock market. Retail investors have been embracing this most recommended investment route for many years now and hence keep this tap flowing well above the long-term average. A strong flow of this will imply abundant liquidity in the market that can in fact cause a bubble. Presently the numbers are way above the long-term average.
6. Nifty Top10 (**Normal**): This measures the share of Nifty top 10 companies as a % of total Nifty. Any shoot up in this number will clearly indicate froth in the market (like how we are observing now in the US). Presently, this metric is well aligned with the long-term average.
7. 75th Percentile (**Below Normal**): This expresses the value of the largest stock (HDFC Bank) to the 75th percentile stock in the Nifty 500. Presently, it is 31 times. The wider the gap, the higher the probability of a bubble manifesting. Presently this is below normal as compared to the long-term average. It is interesting to observe the same metric in September 2020, when the largest stock (Reliance) share price was nearly 80 times that of the stock in the 75th percentile.
8. Derivatives (**Above Normal**): India's derivative market growth is incredible thanks to Covid when retail investors found immense time to dabble in markets. Many brokerage firms offer low-cost leverage through derivatives, and this can distort financial markets. The current traded volume in derivatives clearly indicates a bubble though only 27% of the notional turnover is represented by retail investors. When markets do cross sensible limits, regulators take several actions like increasing margin level, zero days to expiration, investor education and increasing minimum contract size among other things to warn investors sufficiently in advance. It is good to remember that derivatives trading is a cocktail of risky bets and rare profits.




M R Raghu

The Many Phases of a Market
Where does India stand?

S. No.	Parameter	Current	3Y Avg	Peak Value (Since 2019)	Peak Value - Period	Reading
1	Nifty 50 Market Cap / India GDP	95.5%	98.9%	119.7%	Jan 2021 (COVID rebound)	Normal
2	Sector Concentration (Financial)	43.8%	42.2%	51.7%	Oct 2020 (post COVID rebound and 5 out of 10 top stocks in N50 were banks)	Normal
3	Nifty 50 Valuation - P/E - P/B - Div Yield %	 22.77x 3.86x 1.22%	 23.36x 4.19x 1.27%	 42.0x 4.88x 0.95%	 Feb 2021 (COVID rebound) July 2023 (Pre HDFC Merger) Jan 2021 (COVID rebound)	Normal
4	FPI Yearly Net Inflow (INR Crores)	₹77,612	₹51,446	₹237,062	2023	Above Normal
5	SIP Avg Monthly Inflow (INR Crores)	₹19,187	₹13,046	₹19,187	Feb 2024 (Current)	Above Normal
6	Top 10 Companies	56.5%	54.7%	62.6%	Oct 2020 (Surge in Reliance Price)	Normal
7	75th Percentile	31.44x	44.42x	79.16x	Sep 2020 (Surge in Reliance Price)	Below Normal
8	Derivatives Traded Volume (Billions)	91.17	50.07	91.17	2023	Above Normal
9	Nifty 50 Avg. Daily Value Traded (INR Crores)	₹23,016	₹24,378	₹78,523	Nov 2020 (COVID rebound)	Normal
10	IPOs - No. of Issues - Amount Raised (INR Crores)	 - 70 (2024 YTD) - ₹14,781	 - 170 (2021-23) - ₹78,997	 - 240 - ₹1,19,882	 2023 2021 (Zomato,PayTM,PowerGrid)	Normal

For FPI net inflows - YTD 2024 is taken as current value and 3Y average is taken as 2021-23 average; For Div Yield least value is considered as peak

Source: Reuters, Author Calculations

9. Market Liquidity (**Normal**): During bubble times, market liquidity as measured by value traded normally spikes to unreasonable levels. Presently, this metric indicates parity.
10. IPOs (**Normal**): A good indication of bubble is also the unrelenting flows of IPOs in the market. However, a reading of present numbers indicates normalcy.

Caution is the key

Hence, on a balance of considerations, the Indian stock market is yet to be qualified as a market in bubble. However, that stage may not be far off and when that happens, investors should have a plan/strategy to escape the wrath of a market crash. Professional money managers will manage this risk by active allocation between equity and debt and hence avoid steep fall in the market (also called drawdowns). However, retail investors will go through several emotional states like denial, fear, despair, etc., before they can deal with this. Most of the time, retail investors do not see a bubble about to burst coming due to the high level of market frenzy surrounding them. Even when they see one, they fail to act in time leading to losses. It takes some experience to look beyond the noise when market frenzy leads to metrics discussed above going haywire. Till then, staying invested is the best option. ■

Happy Investing!

***Disclaimer:** This article is for informational purpose only and should not be construed as professional financial advice.*

Reference # 20M-2024-04-04-01