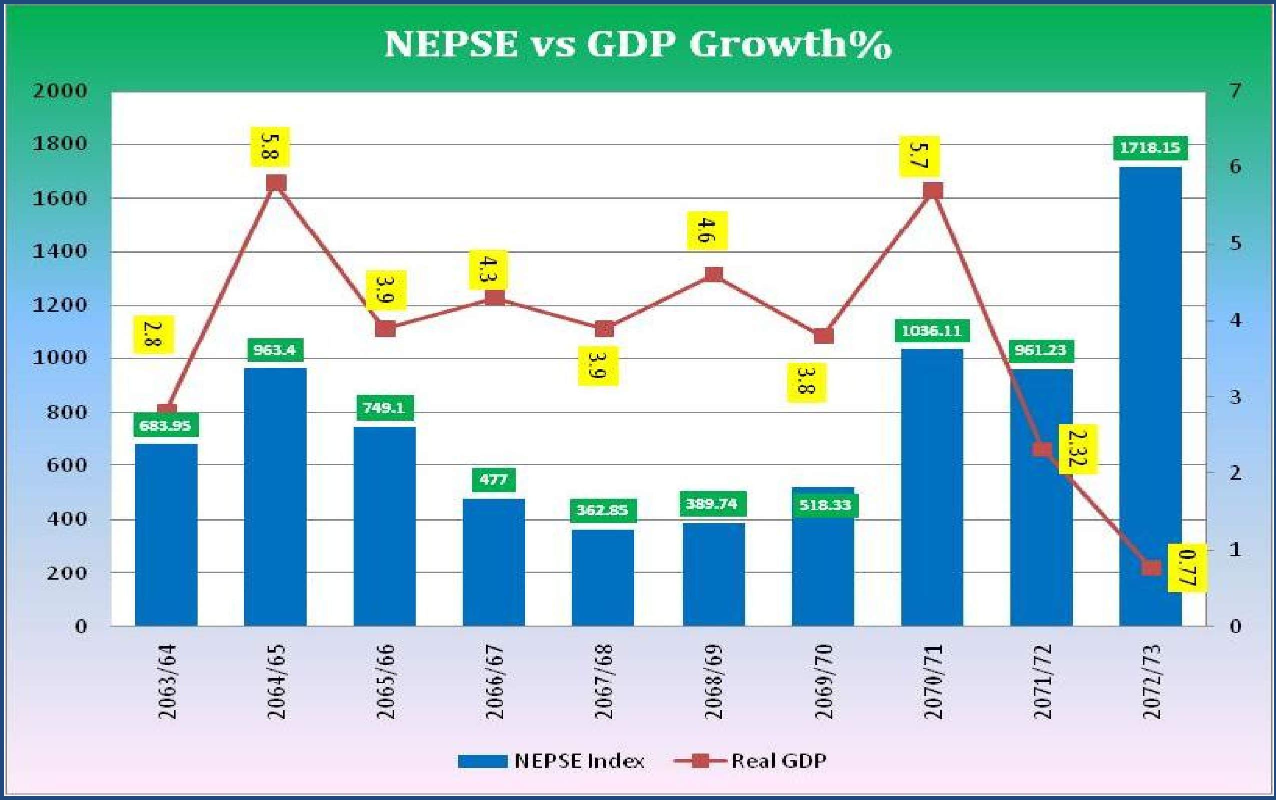
Does GDP growth predict the stock market Direction

It is always a viable truth that stock market reflects a country's economic situtation. In general, when the economy is growing the production or output will rise and majority of companies or industries should be experiencing increased profitability. Hence, the growing profitablility of the company makes their shares more attractive as they are expected to provide high dividend. On the contrary, when economy faces sluggish growth, the stock market generally falls as the industries production come down resulting decrease in profitability resulting no or less dividend.



Source: Nepal Stock Exchange

The correlation coefficent between NEPSE index and GDP growth rate considering last 10 years data is estimated to be -0.38 which indicates weak negative relationship between stock market and GDP growth. According to emperical research, over a sufficiently long time horizon, the growth rate of aggregate equity valuation equals the potential GDP growth rate. Growth in potential GDP is the main driver of aggregate equity valuation. However in the context of Nepal the stock market trends is not seen to be in aligned with the Real GDP growth rates. The above chart illustrates the discrepancy in growth of economy and market Index since last two years. Some of the main causes of non-alignment are connected with the followings:

Source: Nepal Stock Exchange

- Earthquake aftermath, the stock price of majority of companies dipped down to subsistence level and market correction observed for short span for 1 month by approx. 10% which created the opportunity to buy good companies shares at the lowest price. The anticipation of market to recover soon, many large investors were seen active to play right game in the market.

- The Banks and Financial Institutions, offering the lowest rate of interest of deposit also caused to divert the flow of money from Bank's Cash Vault to publicly open stock market. The lucrative return in stock market attracted many of the small scale investors as well.

- Though the economic outook remains unfavourable and polictical instability continues, the stock market keeps on behaving technically odd. Several reformative programs have been launched to build the market standard. CDSC implementation of dematerialization of shares resticted the trading of demat shares which created supply shortage and pull the demand up.

- Nepal Rastra Bank (NRB) increased the paid up capital requirement for Banks and Financial Institutions (BFIs) to meet the BASEL III requirement. This obligatory requirement also has put pressure on Banks to seek serveral options to raise paidup such as merger & acquisition, issuance of rights shares, FPOs and declaring of attractive dividends. This latest provision also triggered the bullish trend in stock market when economy noticed with delining output.

- Huge inflow of remmittance in the economy, resulting in excess liquity is a major factor causing a boom-bust cycle in the equity market. The remittance income is considered to be the mainstay of the economy which grew by more than 15% in 8 months period last year as compared to preceeding year (FY 2071/72). The ratio of remittance to GDP accounted to be 32.10 as compared to 29.10 previous year, that interpretes remittance income occupied majority proportion in revenue source of economy.

- Limited number of Industries thriving in Nepalese economy where Banking Industry is found to be highly dominant. The real productive sectors in an economy are still found to be undiscovered which result to channelize the fund from financial intermediaries to lucrative sectors of economy such as stock market, real estate, bullion market etc. Limited number of investment opportunities also caused the economy to suffer stagnant or diminishing growth and hype the stock market at unrealistic level.

- The ending of terai unrest created the atticipation effect and majority of investors became optimistic as well as speculative toward stock market to rise. This herding behaviour has been inflating the growth rates in the stock trading despite of continous political instability resulting in less development work.

- Plus with the improvization and innovation in the capital market sectors **"perfectly timed"** the excessive money supply period with Security Exchange Board of Nepal complementing by regulating the market which encouraged more participation in the trading activities.

Generally, period of uncertainity might trigger the investors to seek most protective and stable avenues of investments providing more security. But the stock market in nepal seems highly driven up by investors sentiments subjected to political instability, rumors, anticipation, herding mentality, speculation etc. The country with a consistent high rate of economic growth generally has better performing stock market than the country with low rate of economic growth. The link may not be perfect but there is definitely some degree of correlation. The effective mobilization of liquidity in develoment context might increase the chance for of long run rate of the stock markets appreciation to be in align with the sustainable growth rate of the economy as real growth will outcast current overprice/hyped stock market reverting them back to actual growing economy to be fairly valued.