

Stock Market Volatility

Why in news?

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Stock indices witnessed an extraordinary swing recently, due to a panic sell-off by investors.

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What happened?

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- The Sensex moved 1,500 points between its high and low during the day and eventually lost around 280 points.

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- The Nifty fluctuated between 370 points and lost around 90 points at the end of the day.

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- The overall market breadth was extremely weak with almost 2,200 stocks in the red as against only 542 gainers.

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- Also, the Sensex to plunge 1,785 points in the five trading days.

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What is the reason?

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- Infrastructure Leasing & Financial Services Ltd. (IL&FS) is an infrastructure development company, which provides finance and loans for major infrastructure projects.

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- One of the projects is the Chenani-Nashri tunnel — India's longest road tunnel at 9 kilometers (5.6 miles).

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- The company describes itself as the pioneer of public private partnerships.

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- IL&FS group of companies has a total consolidated debt of close to Rs 1 lakh crore, and it started to miss deadlines on its debt obligations beginning last week of August 2018.
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- Fears grew among the investors that the default problem will spread to other NBFCs, leading to a sharp fall in the stocks of housing finance companies (HFCs) and NBFCs (which operate on borrowed funds).
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- With this underlying fear, debt papers of DHFL were sold by DSP Mutual Fund, at the discount rate of 11% in the secondary market. (Normal yield was 10%).
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- This was viewed as a precursor to higher borrowing costs for NBFCs.
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- Hence investors sold their stocks in housing finance firms, leading to stock market plunge.
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- A bunch of algorithmic trades also quickly escalated the magnitude of the fall.
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Why IL&FS defaulted?

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- Commercial Paper (CP) is an unsecured money market instrument issued in the form of a promissory note with a maximum validity of one year.
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- IL&FS have raised a huge amount through CPs.
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- But the interest rates have soared to multi-year highs for short-term borrowings.
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- Additionally, some of IL&FS's construction projects have faced cost overruns amid delays in land acquisition and approvals.
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- Disputes over contracts have locked about 90 billion rupees of payments due from the government.
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- These have made IL&FS run short of cash.
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How did the IL&FS default play out?

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- It has already defaulted on around Rs 450 crore worth of inter-corporate deposits to SIDBI and more defaults are likely in the coming weeks.

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- Insurance companies, state-owned banks and their provident funds and pension funds, and mutual funds (MFs) have exposure to the debt papers of IL&FS; state-owned banks have also extended term loans to IL&FS.

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- Following the defaults, rating agencies ICRA, India Ratings and CARE abruptly downgraded IL&FS and its subsidiary from high investment grade (AA plus and A1 plus) to junk status, indicating actual or imminent default.

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Could this spill over into the broader market?

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- Despite the fluctuations, there was a significant recovery from the lows due to strong institutional buying.

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- Hence the fall was believed to be a temporary correction in a bull market.

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- However, the panic in the fixed income market due to the IL&FS default has led to a liquidity freeze.

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Source: The Hindu, The Indian Express

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Quick Fact

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Discount Rate

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- In finance, discount refers to a situation when a bond is trading for lower than its par or face value.

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- For example, if a bond with a par value of \$1,000 is currently selling for \$990 dollars, it is selling at a discount of $(\$1000/\$990) - 1 = 1\%$, or \$10. The reason a bond will trade at a discount is if it has a lower interest or coupon rate than the prevailing interest rate in the economy.

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- In other words, since the issuer is not paying as high of an interest rate to the bondholder, the bond must be sold at a lower price to be competitive, or else no one would buy it. **(Invsetopedia)**

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