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The KSE index as barometer?

The rise and fall of stock market indices are perceived to predict the upcoming boom and bust in an economy. Why are stock market indices used to predict the upcoming boom-bust in the economy? And can the KSE index be used to predict these boom-busts in Pakistan?

Under-representation of the agriculture and services sectors on the KSE index and the larger influence of the bigger firms on the changes in index value make it difficult to rely on the KSE index as a predictor of Pakistan's economy.

Generally stock market indices are created in a way that they represent the movement in prices of shares quoted in that specific market. A rise in the price of share X theoretically implies that the profit of the firm is expected to increase in future. If profits of most of the firms in an economy are expected to increase this would mean that a booming economy is likely in the times ahead.

It is worth emphasising that if at all the changes in a stock market index predict something about the economy that would show the expected long-term trend of the economy rather than the current state of the economy or the state in the near future. Therefore, it may not be appropriate to use the KSE index to reflect upon the economic management of a regime.

Can we use the KSE index to predict the boom or recession in Pakistan's economy? To answer this we need to answer: one, is the KSE index broad enough to represent all sectors of the economy – industry, agriculture and services, preferably in proportion to their contribution to the GDP – and two, does the change in the KSE index represent on aggregate the expected profitability changes in the KSE itself?

The fact is that other than some agro-based industries, the agriculture sector is completely missing from the KSE, though at times the changes in the index value bear some

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correlation with change in cotton prices and the weather changes that may affect agriculture one or the other way.

The services sector, though represented at the KSE, is dominated by financial services, energy and telecom firms. No firm representing retail, wholesale and a number of other services, for example the services of professionals that contribute significantly to the GDP are in KSE. The KSE index cannot predict anything about the sectors of the economy that are not represented in the KSE market or the KSE 100 Index.

Moreover, by construction the weight that the share of a company enjoys in the KSE index is determined by the size of the firm – the larger the firm the greater the weight. The KSE index being a weighted index, firms with greater weight influence the index relatively more. Out of the 100 scrips included in the KSE index, 20 scrips enjoy a combined weight of around 65 percent and thus the index is more sensitive to changes in the share prices of these 20 companies. Out of these 20 scrips, 6 are energy firms, (with a combined weight of 30), 4 are banking firms (combined weight: 15.5), 3 are fertiliser firms (combined weight: 9.5) and 5 others (combined weight: 11).

All this is not to say that the index is wrongly constructed. In fact, the KSE index resembles some of the popular stock market indices around the world. The problem lies with the market structure – some firms quoted on the KSE are too large relative to the rest. There is not much that can be done about this at the moment, except to wait for the smaller firms on the KSE index to grow big and also wait for bigger firms to enter the KSE.

However, the tilt of the index towards large firms makes the KSE index an inefficient predictor of the movement of aggregate stock prices even within the KSE market. An index that does not adequately represent the very market for which it is constructed cannot be expected to predict the state of the country's economy.

Finally, given the small capitalisation of the KSE relative to other stock markets and huge amount of investable funds available with local and foreign investors, the KSE is very volatile. This also makes the KSE index not so suitable a predictor of the long-term trend of the economy.

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