

How to Benefit from Financial Crisis!*

By

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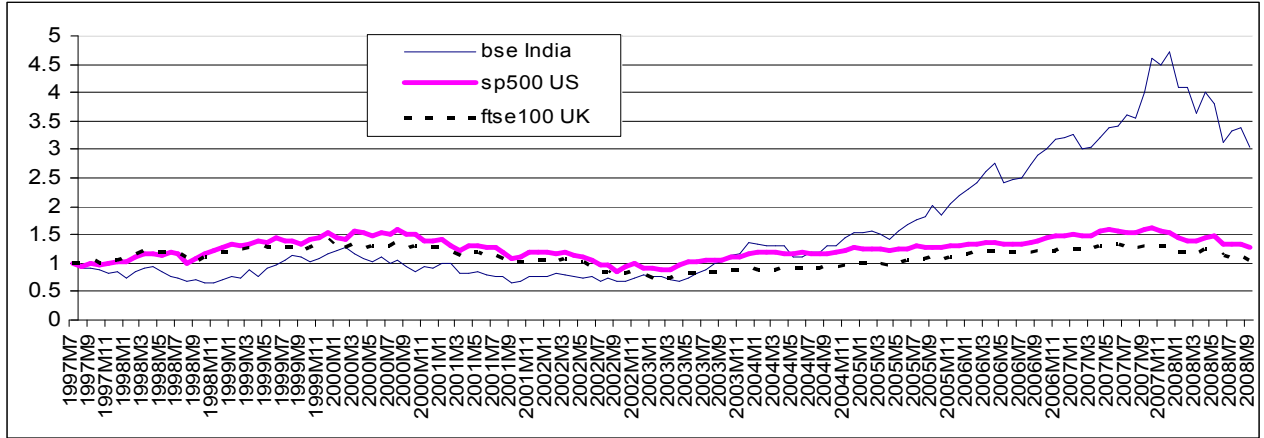
We are in amidst of financial turmoil with large investment banks at the center stage. Government is thinking of providing bailout to financial sectors, especially banks, in order to stimulate credit, which on the supplier's side is expected to provide working capital to businesses, and provide consumer credit to create demand. The plan is noble but can it revive the stock market? If we can answer this question then we can make money by investing in put or call index options depending on expected direction of the stock market.

I think the stock market will continue to decline, and here is why: The root cause of this financial turmoil is the declining value of real estate across the USA. This newly sold property is financed by sub-prime credit; this situation is made worst by credit swaps on this credit. By some estimates (from the internet) sub-prime loans is about 9.4 trillion dollars. To highlight the magnitude of the problem, GDP of USA is about 14 trillion dollarsⁱ. The purposed bailout amount of \$700 billion (\$0.7 trillion) will not be enough to revive the stock market. Therefore, stock market of USA is expected to decline further.

This means if we buy put index option on S&P 500 we stand to gain. But, we can go a step further and maximize the gain by investing in Indian stock market. This is because Indian stock market has been following the trend of US stock market. I believe Indian stock market is following US because developing stock market cannot derive the developed stock market – total market capitalization of US stock market is substantially greater than Indian stock marketⁱⁱ. This co-movement of two stock markets is evident from the graph, which plots stock market indices of US, UK and India for a decade starting in 1997. In the mid-1998 US stock market was increasing and so was Indian stock market. In 2000 when US stock market declined, Indian stock market followed suit. In 2004 when US stock market improved, the Indian stock market also improved, and by a far greater magnitude. Now in 2008, when US stock market is declining Indian stock market is declining as well, but again, by far greater magnitude.

From the above analysis we know that the US stock market is expected to decline; we also know that recently the changes in US market are followed by Indian stock market by far greater magnitude. Therefore, it is expected that Indian stock market would greatly lose value. My 'gut' feeling is that the India's BSE Sensex would decline below 10,000 points in a two month period from present 13,102 points as of September 26, 2008. Hence buying put index option on BSE Sensex for the strike value of 10,000 points or above would be profitable.

* Disclaimer: Information in the article is very time sensitive and ONLY applies as of September 26, 2008. Moreover, the author takes NO responsibility of ANY loss due to following this advice.



The figure plots stock market indices of US (SP500 US), India (BSE India) and UK (FTSE 100 UK). The indices are normalized for July of 1997. Data Source: Yahoo Finance

ⁱ http://wiki.answers.com/Q/How_much_money_would_the_bailout_plan_need

ⁱⁱ <http://www.diehardindian.com/overview/stockmkt.htm>