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State of the Markets - XXXI

In the last last edition of SOTM (no xxx, dtd Apr 21 2011), we had advocated that the equity markets were poised for a quantum decline, which was followed up by a special report dtd June 16 2011 – "Nifty precariously poised" (click here to view that report – http://www.bsplindia.com/files/archives/jun11/niftyh&s.pdf). The Nifty is now nearing a critical juncture where the bulls are likely to be on the ropes for a while and the outlook is likely to be distinctly cautious. In the previous SOTM edition, we advocated unwinding longs on Silver between the 72000 – 75000 levels and switching to Gold at the then prevalent levels. This switching strategy has paid off handsome gains even in a tumultuous market scenario as Silver slumped over 30% from peak prices whereas Gold is up by 8%.

The commodity angle

To the chagrin of equity analysts, commodity prices refuse to obey the law of gravity. They are not supposed to – atleast not in times of runaway inflation. The awareness (or the lack of it) towards commodities as an asset class is resulting in tunnel vision in many a portfolio. When fiat currencies lose buying power, commodities are a more "honest" investment towards the investor as paper assets witness a downward pressure in prices. Bank FDs yield negative real effective returns as the street level inflation is far higher than the interest rates and the investors wind up consuming their capital for survival. Equity shares maybe overall a better hedge against inflation over the years, but during actual hyper inflationary periods, are the most spooked out asset class. Unfortunately, the Indian investors are denied the luxury of commodity ETF's, which would have insulated them from shocks to the capital. The only available recourse is bullion (Gold & Silver) and to a very small degree electronic delivery format of Zinc and Copper. We are unhappy about the price discovery mechanism and the depth of e-copper & e-zinc and hope the future quarters will see better trader participation.

At the levels of Rs 60000 / Kg and Rs 23000 / 10 Gms Silver and Gold respectively, our bias is marginally tilted towards Silver with a view to average down for every Rs 4000 decline till the Rs 44000 level (if so required). As for Gold, we expect some profit sales by the weaker hands that may see the 21000 – 21750 band which will be an attractive entry point for the patient, long term investors. Inspite of the bravado witnessed in the equity markets in the current scenario, we feel any dithering by the US govt over the debt issue, a possible sovereign downgrade, US treasuries and / or Corporate debt will not be taken well by global financial markets. While the event risk is an open secret and many feel the market has discounted such an occurrence, we beg to differ. For our views on markets, kindly refer to the technical charts below.

The sum and substance of this segment is that investors should remain invested in safe havens of Gold and Silver.

Equities – what now

Are equities dead? We don't think so. Though we have pruned our equity allocation in the last two quarters, we don't suggest a complete abstinence from equities. We remain committed to our view that stock prices of companies engaged in agriculture support systems, agri output enhancement, food retailing, fertilizers and irrigation systems will continue to out perform the broader markets. Food, water and power remain our hot favourites in the equity markets due to the sheer "TINA" (there is no alternative) factor. Our criteria for investing in these companies is simple – the company should be able to pass any hike in input costs to the end user without impacting demand, demand growth should be constant / growing, organization should be light on debt, management proven investor friendly and the stock performance should be "strong market outperformer". We maintain a hold on all stocks recommended in the SOTM XXX.

Inflation & Jobs – our biggest concern

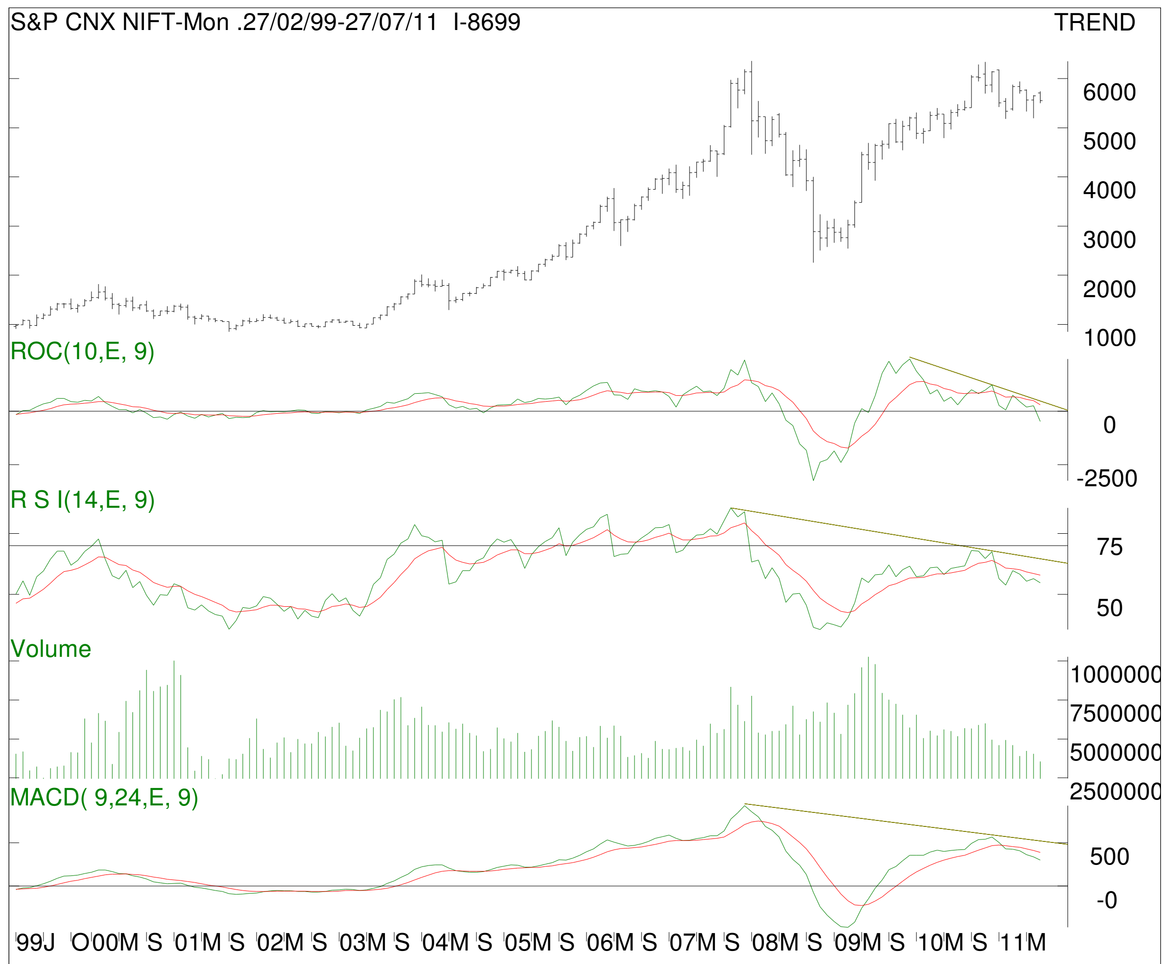
Whether it is our media columns or private advisories, we have been voicing our fears on the runaway inflation since late 2008. We do not feel any other party in power could have averted this spike in inflation, though the handling of the situation could have been nimbler. <u>During times of hyper inflation, all tools of an analyst (fundamental, technical, behavioral) must be tweaked to be in sync with the times</u>. A chart used in low inflation period **cannot** be used in high inflation periods. Same for models / screens to filter stocks fundamentally. The markets have been clearly indicating that inflation is unlikely to be reigned in anytime soon and it is just the items of food that are rotating on the inflation dartboard. We feel the coming quarter/s will witness price spikes in proteins (especially milk and to a degree, pulses) as the IFPRI (International Food Policy Research Institute) nudges the Indian govt to end it's reliance on starch and carbohydrates as primary sources of calorific solutions to end malnutrition. Milk prices are already on the run and we expect pulses to edge higher steadily here onwards.

We remain cautious on equities as long as inflation remains high (at the street level) and allocations to equities should not be stepped up unless this situation shows signs of reversing. The second big concern is pay cuts / job losses. Over the last 2 decades, the consumption story has seen the main players switching roles. Upto the 1990's the urban & semi urban rich fuelled the consumption story. In the last decade, it was (and remains even now) it is the working professional and middle income families that spur consumer spending. In the decade going forward, it will the rural masses that will lead the consumption growth. We feel, the middle income / working professionals remain vulnerable to pay / job cuts as India Inc cuts corners to cope with rising input costs. While the figures may not be reported as well as the 2008 market decline, as the pay / job cuts maybe more subtle and go unreported. Couple high inflation with pay / job cuts and you have a short / medium term crimping of demand that merits mention.

The export sector is the most vulnerable as business owners are no more as confident as 2009 / 2010 about inward remittances for goods & services exported to the US / Eurozone on a time bound basis. Any sustained rise in Crude Oil prices above the $ 110 / barrel can upset this equation even further. The July – September period is cyclically the "hurricane season" in the US and price spikes in this period should <u>not</u> be taken as seriously.

Technicals

The monthly chart of the Nifty shows a noteworthy pattern of divergence between the price and oscillators. The momentum oscillator (below price) shows a peak in 2009 that matched the 2008 peak, but the RoC has been in a decline after Sept 2009, raising red flags. The relative strength index (measuring internal strength of the index) actually shows a lower peak in 2010 as compared to 2007-08. Ditto with the monthly MACD which mirrors the concern of the RSI. Note the volumes which started tapering off from end 2009 and were unconvincing throughout 2010, which implies the rally in the second half of 2010 was induced by cheap liquidity (QE2). The larger picture is negative as of now.



Any dip below the 5350 - 5375 levels this time will see the 5177 – 5200 band which has proved to be a floor on two occasions in this calendar year being violated with a fair degree of probability backing this fall.

While temporary triggers (F&O expiry, short covering, govt announcements) may see some price rallies, the overall chart structure indicates a clear lack of buying conviction prevalent in the markets. Any upthrust must be accompanied by heavy volumes to convince us that the tide maybe turning.

The weekly chart takes a look at the picture with a slightly detailed view as the monthly chart above cannot be used by trading by many, barring a few old timer technicians. In the Nifty Head & Shoulder report mentioned on page 1 of this report (hyperlink http://www.bsplindia.com/files/archives/jun11/niftyh&s.pdf), we mentioned the probability of the head & shoulder pattern morphing into a "complex" pattern being high. What led us to make this prophecy was the twin shoulders to the left of the chart which raised the probability of twin shoulders on the right hand side as well. Our view has been vindicated by the markets as the Nifty has bounced on June 20 2011 from the neckline and logged a second shoulder that is likely to complete the pattern once the trendline is violated, a confirmatory decline of 1-1.5 % below the neckline is seen on heavy volumes and open interest expansion.

In case of this decline unfolding as per expectations in text book fashion, we do not expect the 5000 mark to hold this time and levels of 4700 – 4800 on the Nifty spot maybe expected. As mentioned in the April report, the price may take weeks to get there and this trade is for the extremely patient and disciplined trader who knows how to dig his heels into a position and stay there.

If you are short as per our previous recommendation, stay short. If not, await an opportunity to seek a fresh entry. Refer to the timing as per the daily chart below.

The daily chart shows a falling trendline that shows what could have been an inverse head and shoulder. This aspect was pointed out in the April report and the smart money did attempt to shake up the retail players in June and July into a lull on the breakout above this hurdle. Unfortunately, both occasions have flattered to deceive the bulls and any sustained trade below the 5350 will seal the fate of the bulls for the time being. Since the bulls are on the ropes and will take a while to recuperate, rallies will have a high probability of being dead cat bounces (volumes will be poor, open interest will see insipid changes) must be used to short the Nifty afresh. The first inflection point to start the short selling process for traders starting with a clean slate will be at the 5560 – 5580 band. Traders should note, this trade is for players who will be required to stay with the position and therefore committing all funds at this level is not advisable. Hypothetically, the Nifty can test the 5650 – 5700 in a best case scenario. That would be a tempting opportunity to add on to short positions.

Have a profitable day.

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The author of this piece is the author of "A Traders Guide to Indian Commodity Markets" – India's first commodity trading manual.