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Indian Markets – Bubble in the Making?

The recent spike in food grain prices and the simultaneous rally in the equity markets in an unwelcome phenomena. While I have been advocating spiraling inflation after the election results were announced, from as early as Feb / Mar 2009, the runaway prices are more than a cause for concern. In Nov 2007, I had written in my article in DNA Money titled "Bulls have overstayed their welcome" that prices of essentials (grains, pulses, clothing, homes and medication) were rising almost fortnightly, whereas prices of non essentials (air conditioners, TVs, mobile phones, watches and washing machines) were falling. No stock market can rally for long under such circumstances, perpetually. Something had to give, either the markets decline or the essential commodities become cheaper. The markets fell hard and sharp from January 2008. Here are my arguments why a similar and bigger fall is in the offing once this bull run ends (probably 2011 / 2012) –

1. Higher inflation invariably means less purchasing power in the hands of the retail investor. This curtails his / her investible surplus and means lower / zero buying capability in a falling market as existing investments are bleeding. In the absence of buying cushions, markets decline sharply and rapidly.
2. During asset price inflation, prices of raw materials invariably rise and impact the bottomlines of corporates. While emerging markets invariably rise the waves of economic progress on the tailcoat of higher inflation, these economies are relatively more vulnerable to shocks. The current rally (both in stock prices and improving corporate earnings) is enjoying the benefits of a lower base effect. As the base effect gets bloated, inflation will choke the growth prospects, ultimately resulting in a 2008 type decline.
3. Ralph Nelson Elliot, the father of the Elliot wave theory emphasizes on extreme caution while chart reading during periods of higher inflation. He advocated using ratio scale charts rather than arithmetic charts in hyper inflationary periods. That meant tighter stop losses on long positions and quicker exits. Exits from longs means declines
4. With the advent of technology, not only do long orders get stopped out, system based shorts are also initiated. This is especially true of alogrhythmic trading systems. Hedge funds are one of the biggest deployers of such systems and can exert sizable downward pressure on the markets due to their sheer size. Remember retail guys have scant averaging / cushioning power, so the selling causes high impact costs and steeper declines.
5. Take the example of the most developed markets in the world which are hard hit when the inflation spikes by even 2 % - USA, Japan, UK and Germany have got pummeled when inflationary forces rallied. Can we buck the trend for long? True, we are a frontier market where aggression and risk taking capabilities are higher then average, but when sanity returns, it returns with a vengeance that drives prices to depression like levels.
6. The true value of a market is what buyers are willing to pay – as per some neuro economists. The quality of buyers in frontier markets is more emotional than intellectual. Which means high greed in upthrusts and highly fearful in declines. Case in point – Nifty high in 2008 at 6357 and Nifty low in 2008 at 2250!!!

7. Unless an average investor starts to allocate higher amounts towards non-equity exposure (FD's, PPF, commodity ETF's), which can be accessed during falling equity markets, there will be no cushioning the declines in equity indices. Our system of asset allocation is highly skewered and inefficient to say the least.

So far the bad news. Is there a silver lining in this period at all? Yes. During times of above normal inflation, commodity prices tend to inflate faster than the inflation. Should you be able to buy industrials / consumer staples and energy counters in the prompt / mid / far month series where the cost of carry is under 1 % per month, I suggest you go for them. Treat even this futures exposure (Indian commodities markets lack an efficient delivery based settlement mechanism) as an investment exposure. Keep ample funds for fuelling the longs by way of mark-to-market payouts and take a medium term approach if not longer. The pay-offs have been invariably significantly higher than equities. Go ahead and try it. If you don't manage that over the next 6 months, give me a call.

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The analyst is the author of the book – "A Traders Guide to Indian Commodity Markets" – the first technical trading guide for commodity markets in the country.