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State of the Markets - XXIX

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In the previous edition of this report dtd July 16 2010, I had advocated a bullish breakout, citing various parameters like the weight of evidence approach, collateral triggers and technical summations. While many in-house coined studies suggested a confirmed breakout around Oct 2010, the markets preferred to rally in September itself. Click here to view / download that report in pdf format from our website - http://bsplindia.com/files/archives/jul10/sotmxxviii.pdf.

Ten weeks and a breakout rally later, our outlook remains largely unchanged, save for a few tweaks and knick knacks. A time / price continuum study shows a rally should have occurred in / after Oct 2010. This rally is marginally early, like a premature baby, there are possibilities of a few teething troubles. I am not suggesting a failed attempt at a rally (science seems to indicate that premature babies are statistically more intelligent than full term babies!), but higher volatility and a possible abrupt ending when this upthrust phase terminates. Those of you who have followed my writings in DNA Money will recollect my article in late November 2006, advocating a decline around valentines day in 2007 (10 weeks in advance) and that the Nifty would test the 3250 – 3500 band. The Nifty did keep it's date with the bears but that week saw a low of 3965 – far higher than the required dip. This incomplete pattern led to a weak rally till Aug 2007 and another extended rally till Dec 07 – Jan 08, and we all know the consequences of the fall thereafter. The sum and substance of this point is not an "I-told-you-so" but that a premature and / or over extension on any move results in an equally forceful counter move during a corrective phase. The challenge for any trader / investor is to have discerning abilities to judge whether a decline hereafter is a violent but routine correction or a termination of the upthrust. And the challenge will be challenging indeed.

Retail participation has been wanting and there is a general feeling of being left out. That means a late entry of the retail investor / trader. Long entry by the retail segment is marked by higher than usual bouts of volatility as paper changes hands from strong hands to weak hands. One of the many ways we gauge this phenomena is to monitor the ticket size per transaction. In a bull market, strong hands may camouflage their actions by initiating many small sized transactions but a retail investor is just not capable of initiating big ticket transaction/s. So when ticket sizes per trade go up sharply, sit up and take notice. Currently, the ticket size per trade is not earth shattering but number of transactions are rallying, indicating a stealthy buying since 4 – 6 months by smart money. It is for this reason (among many others) that I have suggested a buy-and-hold approach (strategic / tactical investments) since atleast 2 quarters. In the last SOTM newsletter, I had therefore mentioned that the opportunity to recoup losses of the 2008 falls was knocking on your doors. Having said that, I feel rushing in afresh at this late juncture without a proper plan will be riddled with risks. If you have bought in July, continue to hold your investments. The markets have rallied and some juice is out of the fruit, buying has to be a lot more careful and selective. You will be required to play your moves like a game of chess – every move well thought out, planned and prepared. Back up plans in place, ample spare cash to average buy positions in stocks / commodities / ETF's / Indices if the situation demands. Buying at one go is ruled out now. Pyramid buying is the way to go.

Refer here – http://www.bsplindia.com/files/archives/jan06/pyramid.htm to understand the pyramid system. The current market scenario is conducive for buying relatively smaller stakes in the stock market and awaiting bigger price moves rather than buying by the truck load and selling at a 2% profit. This is a directional market and playing with the larger flow is to your advantage. Let us now take a look at our usual metrics –

Inflation & interest rates

Both are on the ascent and are unlikely to be good news for the bulls. Easy and cheap money is like mothers milk for a bull market and the RBI rate tightening will ultimately have an impact on the liquidity availability in the hands of the market players. Inflation has never been a welcome guest in the home of the stock market bulls, and this time will be no different. The tweaking of the WPI base year and adding composite items for the inflation index computation will at best statistically mute the harsh ground reality – food price inflation is here to stay. That means our early 2010 recommendation of buying Silver 99.99 bars is still valid for the remaining part of the year and beyond. If and when interest rates on bank FD's test 9 % p.a; I suggest you start looking at fixed income allocations as well (not necessarily only FDs). That will ensure insulation of some portion of your capital in case of a market decline. We will continue to opt for companies that are in the niche business segments that can pass on costs to the end users and are therefore relatively inflation proof. Stand by for updates.

Commodities

All industrial / base metal prices are up since the last SOTM edition and that adds to the bullish weight of evidence approach. That bullion is rallying confirms our hypothesis that the inflation figures are convincing no one in the bullion markets in particular. That implies a positive outlook for cyclicals and metal stocks. Both ferrous and non-ferrous should rally in varying degrees. Companies associated in improving food harvests, seeds, irrigation and farm productivity will out perform the broader benchmarks. The days of cheap food and water are over and food price inflation will get tougher on the citizens. Hedging against such an event by investing in agri related stocks is your insurance.

Overseas triggers

The US "presidential cycle" is a fairly reliable and popular indicator followed worldwide by many investors. The financial markets are buoyant, data points indicate optimism and the economic outlook looks greener than the previous year. Whether the election is mid term or general, the cycle is almost unfailing in nature. With elections due next month, expect the markets to head higher for the next few weeks (interspersed by routine corrective cuts). The calendar year end is the financial year ending for western economies and fund managers compute their take home performance bonuses. This factor will probably see a reluctance to upset the global equity apple cart in a hurry. The November / December 2010 timetable does not indicate that the markets are infallible, just a probability that they are more likely to be bullish rather than bearish.

Technicals

The much awaited breakout since the last edition is in place and the channel top at the 5650 will be the significant support to watch out for. Patient traders may want to provide for a 2% leeway to provide for whipsaws / fade plays. The 6357 will be an academic resistance which is the life high of the Nifty 50 Index. The probability of that high being overcome is fair and our guess is, a lot of retail buying can probably get triggered after the highs are cleared, thereby opening the floodgates of a corrective decline thereafter. While this is one of the likely scenarios, this possibility cannot be written off entirely. Investors will have to take money management initiatives to provide for such a contingency. Buying in staggered lots, leaving room for averaging down in counters where personal conviction levels are high is a good idea for strategic investors.

Your call of action - continue to hold oil & gas, heavy engineering, capital goods, infrastructure and agri commodity related stocks. Silver bars are the favoured alternate asset class investment, followed by Gold ETFs in relatively smaller lots as compared to Silver.

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