29th January 2013

MARKET STRATEGY NOTE: GLOBAL & INDIA EQUITY INDICES

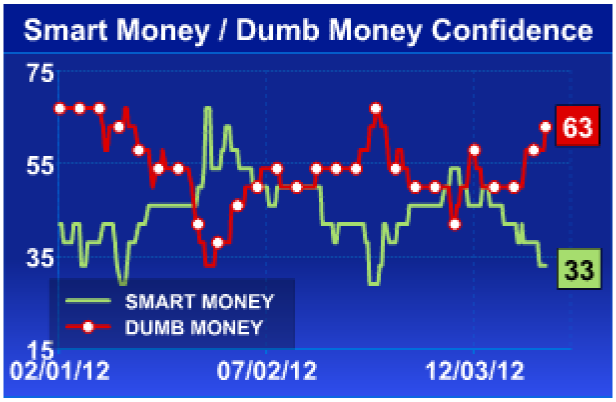
We issue these Market Strategy Notes from time to time, with an informal schedule of at least once a quarter. The time line is contingent on choosing a time when we feel that events in the marketplace require a thoughtful response and perhaps even some adjustment in portfolios.

We have been expecting and waiting for at least a 10 % to 15% correction in the Global (and Indian) Equity Indices since the beginning of the year and our initial time frame was for this correction to run from Mid-January to Mid- March. So far though, the market indices have been continuing to climb though with small but consistent & persistent upward moves. However, we are now able to see clearer signs that our expectation that a rapid sharp market decline of some severity in the near term time frame is beginning to be assigned a higher probability.

To elaborate we enclose an extract from John Hussman's (bold italics are ours) weekly letter released just this week:

"As of last week, market conditions joined 1929, 1972, 2000, 2007 and 2011 (less memorable, but still associated with a near-20% market decline) as one of the worst periods on record to accept market risk, based on the syndrome of overvalued, overbought, overbullish, rising-yield conditions presently in place. These conditions comprise the following: S&P 500 *overvalued* with the Shiller P/E (the ratio of the S&P 500 to the 10-year average of inflation-adjusted earnings) greater than 18; *overbought* with the S&P 500 within 3% of its upper Bollinger band (2 standard deviations above the 20-period average) at daily, weekly, and monthly resolutions, more than 7% above its 52-week smoothing, and more than 50% above its 4-year low; *overbullish* with the 2-week average of advisory bullishness (Investors Intelligence) greater than 52% and bearishness below 28%; and *yields rising* with the 10-year Treasury bond yield higher than 6-months earlier. The present instance may turn out differently than past ones. ***The enthusiasm of investors here certainly encourages that belief. Then again, virtually by definition of the foregoing syndrome, investors were equally enthusiastic at those prior market peaks."***

SentimenTrader a subscription service that tracks market data indicative of sentiment amongst traders and investors, as of 28th January 2013 had 63% of "Dumb" money (however they define them!) as confident of a rally and only 33% of "Smart" money as being confident of a rally. (see exhibit 1 below)



The second tell-tale to us is the increasingly narrow advance, at least in the Indian Equity Indices, with furious rotations between sectors (Oil & Gas on the diesel hike) and stocks (Infosys on the results not being as bad as they were expected) with sharp one day advances in individual stocks (mostly on speculative news of limited impact on long duration cash flows). Such actions hold the index up but really fail to help an average stock portfolio giving a misleading picture of strength to those that take their cues from the level of the index.

To us this is typical late cycle behavior

See exhibit 2 below:

	Peak Value	Peak Date	Current Value	Change
NIFTY	6082	21-Jan-13	6074	-0.1%
BSE 500	7764	21-Jan-13	7701	-0.8%
BSE Midcap	7336	8-Jan-13	6975	-4.9%
A sample portfolio	100	4-Jan-13	98.2	-1.8%

Of course the sharp dispersion in the pricing of stocks in terms of expectations for future earnings growth is another tell. As those of you who have received our quarterly newsletter know, we find the sharp disparity in the lofty expectations for earnings growth in the usually High Quality (HQ) Defensive names of 20% to 30% per annum going forward in sharp contrast to the negligible earnings growth expectations for the Industrial, Cyclical or Credit sensitive stocks. Interestingly to us, the HQ names which were the recipient of most of the FII investor flows, have recently also had sharp one day/one week sell-offs (Hindustan Unilever,Colgate, Nestle) and the beginning of some doubt whether they can continue to maintain their high past growth rates in the foreseeable future. This sell-off though, in no way comes close to what is required, for this particular sector at least, of an order of magnitude that would be required for investors to earn the requisite return on equity with any sort of “margin of safety”. It seems to us that there is a distinct possibility that these HQ stocks sell off further and in actual fact traditionally DEFENSIVE names contribute to a short, sharp decline in the equity indices!

We follow a broad list of stocks every day, beyond those in our portfolio and what we observe this month is a sharp bifurcation between individual stocks that have rallied anywhere from 10 % and 20% and another list of stocks that have declined between 8% and 15% with fewer stocks than one would ordinarily expect, showing little change. Again while not overwhelming all these “tells” inform us that the market is more speculative and more complacent than one would want it to be for a maximum equity exposure.

So what are our recommendations to investors?

One, we would definitely think in terms of reducing equity exposures to the minimum or at least to the “comfort-sleep well” zone that is implied by the investors specific long term investment plan.

Two, we would suggest a reduction the number of lines in a portfolio and try and concentrate the portfolio in fewer names that meet at least 2 characteristics: i) they are stocks that the investor feels is being held for the very long horizon in a portfolio and ii) they are stocks that are in the hitherto neglected sectors and so have not been the recipient of any “hot” money flows. In short, on our preferred metric, they would be cheap in terms of their price to “fair value” ratio.

Once the correction is out of the way though, we feel and see some incipient signs that globally, Natural Resource Stocks –see exhibit 3 and 4 below (including the Precious Metal mining companies-see exhibit 5 below), some of the large cap Technology Stocks and maybe even some of the select Financial Service stocks are developing constructive chart patterns close to our EBV low that suggest that they could enjoy sharp rallies.

In India, in such a list we would again include the Natural Resource Stocks (Metals and Mining as they are more popularly called!), Industrial Cyclicals, other Cyclicals and finally amongst the credit sensitive some select Public Sector Banks and select Institutional NBFC’s.

Above all we feel portfolios that focus on Value at this time rather than recent Momentum will fare well, both into and out of the correction that we now assign a very high and rising probability.

Prashant K Trivedi, CFA


VALE Companhia Vale do Rio Doce NYSE
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28-Jan-2013
Open 19.58 High 19.61 Low 19.32 Close 19.35 Volume 9.9M Chg -0.20 (-1.02%)
RSI(14) 51.66
VALE (Weekly) 19.35
MA(11) 19.41
MA(40) 18.47
Volume 9,884,977
MACD(12,26,9) 0.310, 0.087, 0.224


XME SPDR S&P Metals & Mining Index NYSE
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28-Jan-2013
Open 44.80 High 44.80 Low 43.73 Close 43.93 Volume 2.7M Chg -0.76 (-1.70%)
RSI(14) 49.63
XME (Weekly) 43.93
MA(11) 44.13
MA(40) 42.62
Volume 2,675,515
MACD(12,26,9) 0.267, 0.050, 0.216


GDX Market Vectors Gold Miners NYSE
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28-Jan-2013
Open 41.96 High 42.08 Low 41.39 Close 41.48 Volume 18.5M Chg -0.44 (-1.05%)
RSI(14) 34.05
GDX (Weekly) 41.48
MA(11) 45.06
MA(40) 46.30
Volume 18,548,848
MACD(12,26,9) -1.397, -0.725, -0.672

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