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Runaway Bull Market: It's Time to Pause and Reflect

Dear Investors:

The market indices are posting all time high closes, and the mood is one of extreme buoyancy. Discussions are on in the media to explain the power of domestic investors especially the mutual funds who have got nearly Rs 18,000 crore at their disposal and the might of the domestic investors who would take this market further upwards even if the FIIs were to start booking profits and pull out some money out of India.

This invincibility thesis making a case for continuity of the bull market is hardly anything new; we have seen this is 1994/95 and also in year 2000. However, on both occasions it miserably failed. Let us try and see what happened in the recent past—the FIIs pulled out US$ 700 million from the emerging markets including India in the first half of March. Along with other Asian markets, Indian market also fell sharply only to recover very quickly. They have withdrawn money for the first time since November 2005. When they partly bailed out in last October, we saw even Indian stock market fell around 14% from the then top close to 9,000. Even if as per statistics the FIIs own only 20% of our market their concerted market action would produce a magnified effect as it does on the upside.

With most of the developed economies increasing interest rates a la the United States, the last to follow is Japan, chances are we are on the last leg of the global easy money regime. When this happens, the most to get affected by it are the markets that got this easy money as its staple diet—the emerging markets. These markets produce mouthwatering returns for sure but their garden path can also be filled by whole host of landmines—since the driving force is liquidity today, its drying up would create havoc to these markets. Most vulnerable in this regard are India and Turkey—the two markets, which have gone up the most in the last one year and happen to be the two most expensive emerging markets of any reasonable size.

With Ben Bernanke resorting to rate hike again, albeit in another baby step, it signals a continuity in sucking liquidity. Any monetary measures taken by central banks tend to produce delayed effects—the effect of which are sometimes felt 9 – 18 months later. In our economy, the interest rates have shown a sharp spike of 100 basis points (1 percentage point) in too short a time of about two months, and there is talk of a liquidity crunch. The paucity of liquidity in the banking system is such that despite the coaxing

and cajoling of the finance minister to continue with a low interest rate regime, the bankers pleaded their helplessness regarding rising rates. One should take note of the impact of rising rates in US and Japan on countries like Iceland and New Zealand where interest rates have moved up really sharply leading to a sell off. Now, emerging market strategists feel Hungary could be the next in line in this contagion effect.

Interest rates are a key driver to stock market movements over the long term and they tend to exhibit an inverse relationship with the stock market. Sooner or later they will reassert this relationship here in our markets as well. Beware!

With so much of a craze going on in the IPO and NFO (New Fund Offering) market, I feel we are at the last stages of this liquidity driven bull market. Most of the issues are that are hitting the market are coming at a premium; quite a few of them would not have succeeded had their not been such a heady bull market. This is an all too familiar pattern, we have seen it in a big scale in 1994 and saw it in its sectoral avatar in IT in 2000. Mostly, we are being given the same old refrain, "this time it is different." It is NOT. Period! It is the same old story being repeated, and initial stages of the bear market would be mistaken with a bull market correction. As we said earlier, there is a stealth bear market going on in large part of the midcap and smallcap universe, it would now cover all the remaining parts—that day is not very far.

"I can feel it coming, S.E.C. or not, a whole new round of disastrous speculation, with all the familiar stages in order—blue chip boom, then a fad for secondary issues, then an over-the-counter play, then another garbage market in new issues, and finally the inevitable crash. I don't know when it will come, but I can feel it coming, and damn it, I don't know what to do about it." –thus spake Bernard J. Lasker, Chairman of the New York Stock Exchange in 1970 quoted in 1972 in John Brooks, ***The Go-Go Years***.

Now, to revisit the power of the Mutual Funds and their still to be invested corpus we would humbly put that don't be mistaken that all would be invested in the market. We have seen in case of bailing out of the then troubled Unit-64 scheme—the corporates and the HNIs got out of it leaving poor retail investors to hold the baby as always—huge redemption pressure either leads to distress sale of assets or liquid money getting used up. Here, at the first clear sign of market's weakness from the top, these sections will bail out again from mutual funds as well just as they withdraw from direct participation in equity markets, and then a substantial portion of this newly-raised money would have to be used to meet the redemption pressure. It does not take much time to reverse the flow; we have seen that in the last IT bull run in 2000.

Let us not play this momentum game to no ends as there could be stampede at the gates when the party would be over. True, we have been thinking this party being over for quite some time yet it continues but it is already far too overstretched; just because there had been some failed calls about the onset of the bear market, don't think that the cyclical bear market won't happen—as Barton Biggs puts it, it could be a "violent cyclical

correction (read cyclical bear market) in a secular bull market." These large corrective swings are albeit very nasty and they can be weathered by very few investors whose horizons are very long. If you are one among them, remain invested in companies with otherwise sound businesses. Else, if you can't take the subsequent pain, start getting out by either book profits or cut your losses till such time you still can do it.

Another warning: some advisors are suggesting to get into midcaps whose valuations have become quite attractive again. Please do not commit this mistake. Remember 1995/96, the midcaps and smallcaps were just ignored; the large caps went-down-went-up while their mid/smallcap brethren have been left in the cold in the bottom. When the goings are tough, the market shrinks—interest remains only at the top end quality stocks and known devils. It would be quite a while before some contrarians would try to pick up undervalued gems in the midcap and smallcap variety. Thus, don't be lured into investing here unless you are willing to be there for the long haul and understand the company's business very soundly.

I have not been able to find any scrip that shows low risk and high gain potential that you can buy for keeps; despite professionally being a technical analyst, I am unable to recommend playing this momentum game to investors since past experience suggests in spite of giving clear stop-losses people tend to hang in there like a Abhimanyu eventually meeting the poor fellow's fate.

An argument being made in favour of commodities like sugar and cement—here, the current rally may continue for some time but even these stocks would suffer since people suffering losses elsewhere would be selling these to offset that loss. When the IT meltdown happened it is not just that IT stocks were the only ones to suffer though they suffered the most.

By virtue of my profession of advising traders, I might continue to suggest to short term traders to play this momentum game but that would be because for them it would be trading positions; not investment positions.

If I sounded like a party pooper, I couldn't help it. Now, it is your call.

Thank you.

Regards.

Rajat K Bose

Disclosure: The analyst and his family do not have any short positions in the market. This is also not an invitation to short sell the market. This is only a caution to take corrective steps if you are convinced that you should take them.