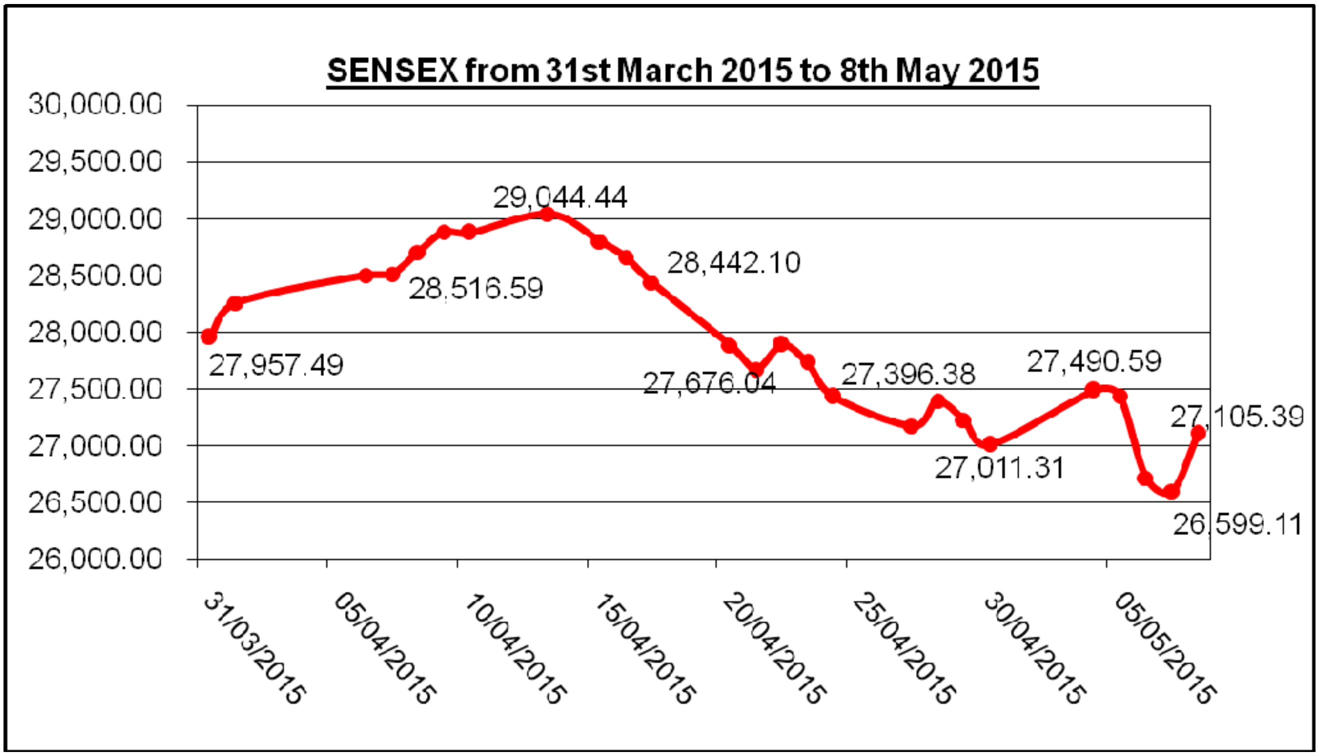
AXIS Equities Pvt. Ltd.
58, Mittal Chambers, 228, Nariman Point, Mumbai - 400 021
Tel. : 6115 1919 Fax : 6115 1999 Email : dipanmehta@vsnl.com

Deeper Correction in April – Technical Factors in Focus



Markets Remain in Corrective Phase

April turned out be another down month for the markets with the Sensex declining by 3.38 %. This is the second consecutive month of negative returns for the benchmark index. At the present level of 27,105.35(08/05/2015), the fall from its recent all time high of 30,024.74 (04/03/2015) is a steep 9.72 %. At the lows of 26,423.99 on 7th May, the decline is 11.99%. This correction was anticipated by us and we have been cautioning investors since the beginning of 2015 through our monthly newsletters.

Several reasons can be attributed to this correction:

1. Slow revival of the economy despite several measures by the new government and a half percent cut by RBI.
2. Notice for demand of Minimum Alternate Tax (MAT) on FIIs.
3. Sharp upswing in the Chinese markets; now competing for foreign flows.
4. Rally in Crude Oil Prices and poor outlook for monsoons, which may ignite inflation, therefore tempering expectations of a further interest rate cut by RBI.

PE Ratios have Expanded

These reasons do justify the fall in equities, but in our view (also discussed in earlier newsletters), the main cause for this slide in equities is the unwarranted expansion of Price Earnings (PE) Multiples and their contraction at this point of time.

DEFINITION of 'Price Earnings Multiple' by Investopedia
A valuation ratio of a company's current share price compared to its per-share earnings. i.e. Share Price / Earnings Per Share. In general, a high P/E suggests that investors are expecting higher earnings growth in the future compared to companies with a lower P/E.

PE multiples had increased beyond comfort levels and with corporate profit growth not matching investor expectations, a compression in these valuation ratios is dragging stocks lower. That, in our opinion, is the principle reason for this recent fall in stock prices.

The key questions now are

- Whether this correction is over?
- Will stocks rally?
- Will this fall continue?

Stocks have Corrected more than the Sensex

Although, difficult to answer, there are some important fundamental and technical indicators which may be considered to provide an answer. On the fundamental side, although the Sensex has declined by nearly 10 %, the reversal in individual stocks has been severe. In our previous newsletter, we had presented a chart which had a sample of the market favorites. These stocks are the leaders in this bull market and have delivered both on price and financial performance. From the adjoining chart, it is evident that a deeper correction has already taken place in most of these stocks. One could take a view that fairly attractive levels have been reached.

Sample of Market Favourites

Company Name	Fall from Recent Highs (%)
HDFC Bank	-11.48%
Infosys	-16.18%
Sun Pharma.Inds.	-21.70%
H D F C	-15.47%
Hind. Unilever	-8.75%
HCL Technologies	-12.56%
Maruti Suzuki	-6.78%
Kotak Mah. Bank	-9.88%
Lupin	-16.30%
Asian Paints	-17.68%
Bosch	-22.80%
Cipla	-13.04%
Dabur India	-9.11%
IndusInd Bank	-16.19%
Motherson Sumi	-9.16%
Eicher Motors	-8.25%
Aurobindo Pharma	-10.29%
Godrej Consumer	-12.65%
Yes Bank	-9.11%
Bharat Forge	-9.90%
Pidilite Inds.	-10.27%
United Breweries	-24.45%
Bharat Electron	-25.09%
Britannia Inds.	-8.38%
Marico	-13.76%
Cummins India	-10.65%
Emami	-20.75%
LIC Housing Fin.	-18.55%
Wockhardt	-35.63%
Bajaj Fin.	-7.55%
UPL	-0.85%
Havells India	-19.66%
Page Industries	-9.95%
Amara Raja Batt.	-13.81%

Contraction of PE Multiples

However, this is a subjective observation, because the earnings forecasts for these companies have not been materially upgraded or downgraded. All that has changed is that valuation ratios have declined over the past few weeks. This narrowing of valuation ratios could be attributed to a negative view on interest rates. Since PE Ratios and interest rates have a close co-relation, any change in view on the interest rates could have a bearing on PE multiples.

Important Technical show Market Vulnerability

As this argument does not lead us to any conclusive answer to the questions posed; perhaps a few technical indicators may throw more light.

Being long term investors, we generally prefer not to follow technical indicators. However, there are 2 parameters which we watch quite closely, because of their accuracy in predicting long term trends. These are

- The Sensex closing and the 200 Day Moving Average (DMA) and
- The crossing of the 50 DMA of the 200 DMA

In our April 2011 newsletters, we had presented a study of the 200 DMA and trends which emerges once the Sensex ***conclusively*** closes above / below the 200 DMA. In our April 2012 newsletter, we had discussed the importance of the crossover of the 50 DMA of the 200 DMA.

> ***DEFINITION of 'Moving Average' by Investopedia***
> A simple, or arithmetic, moving average that is calculated by adding the closing price of the security for a number of time periods and then dividing this total by the number of time periods.

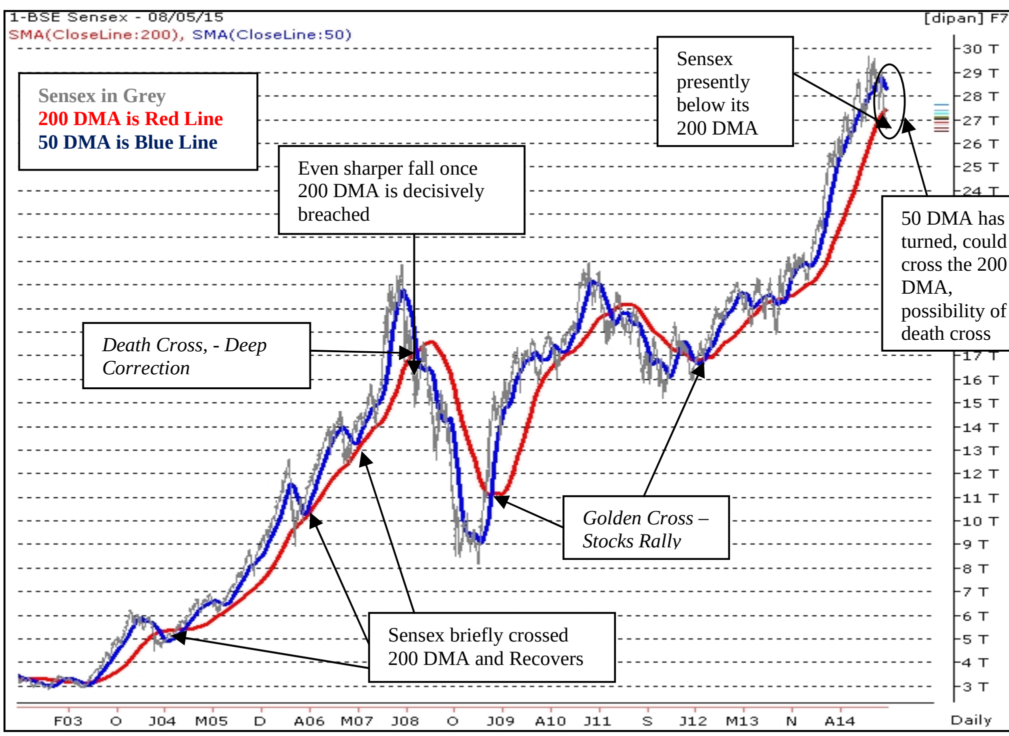
The conclusions we had drawn then are that:

1. When the Sensex / any widely traded security rallies and trades above its 200 DMA in a conclusive manner, then the rally gains momentum and even higher levels are achieved (see chart). The vice versa is also true i.e., when the index / security slides below the 200 DMA, then the bearish trend persists as is also apparent from the graph below.

2. When the 50 DMA breaches the 200 DMA from the top it creates, what in technical parlance, is known as the *"death cross"*. This is a very negative formation and signals that a sharper decline in prices will follow. The opposite is also true and technical analyst call that the"*golden cross*" (marked on the graph).

Sensex Below its 200 Day Moving Average

At the present level, the Sensex is trading below its 200 day moving average. That indicates that it is vulnerable to deeper cuts unless, it turns around from these levels and starts trading above the 200 day moving average.



200 Day Moving Average a Support Level

Past trading patterns suggest that the 200 Day moving average is a support level and after a few days of trading below it, the bull market does revives as can be seen from the graph above. However, if any stock / index continues to trade below its 200 DMA, for an extended period, then further declines are inevitable as is also visible from the graph above.

Another ominous sign to watch out for is the breach of the 200 DMA by the 50 DMA from above and the formation of a *death cross*. Since the 50 DMA trend has also turned negative, this pattern may also emerge and this correction could intensify.

The 50 and 200 Day Moving Average

We are watching both these trends with great anticipation and a certain degree of trepidation. We do hope that markets revive and the Sensex starts trading above its 200 DMA and the 50 DMA does not breach the 200 DMA. Or even if it does; then this pattern is reversed quickly. Should this not occur, we are quite certain that stocks will fall even more and investors will experience pain not witnessed since this bull market started on 28th August 2013 when the Sensex touched a low of 17,448.71.

The reason we have chosen this date and not the more recent lows of February 2014 (19,963.12), is because since then, the Sensex has not corrected materially (i.e. by more than 10%). Therefore, the August 2013 lows could be taken as the beginning of this bull market.

Our Advise to Investors

Our advice to investors would be to wait and watch. One may be tempted to buy into stocks because they have corrected from their recent highs. However, unless we see a clear improvement in the technical parameters of the market, we would not like to rush into buying stocks. Furthermore, at the micro level, the earnings season so far has not thrown up any positive surprises. That too is a factor to consider before increasing exposure to equities.

Long term investors have reaped outsized gains in the past 2-3 years and once again their faith in this class of assets is being tested. If they are able to ride out this rough period, the returns which follow will more than justify their staying invested in blue chips.

As has been our recent practice, we end this communiqué with a quote from Warren Buffet, who's AGM, we just attended in Omaha:

" … keep the mind open to good accidents and get by the bad accidents."

– Warren Buffet, 2nd May 2015 at the 50th AGM of Berkshire Hathway.

Dipan Mehta