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Testing Times to the mantra of 'Buy the Dip'; Will it hold this time?

By Mazhar Mohammad

In the aftermath of the recent crash, it looks prudent to quote a celebrated fund manager who delivered 29 percent CAGR in 13 years of his career surviving a flash crash of 19th October 1987 on which day markets were down by 22 percent in a single session.

Peter Lynch in his book -- One Up on Wall Street famously said that "People who succeed in stock markets also accept periodic losses, setbacks, and unexpected occurrences. Calamitous drops do not scare them out of the game"

It is true that recent flash crash took everyone by surprise as Dow Jones lost around 1,850 points in two days in a row which can easily shake the confidence even of a diehard bull.

Till now investors across the globe are conditioned to buy on dips and suddenly this crash appears to have left an enigma in front of investor community who appears to have run out of clues whether to buy the dip or make use of rallies to exit.

In this kind of tough situations, some data mining will throw up its own conclusions thereby faciliating rational decision making.

For technology-driven markets like Dow, this kind of behaviour is not unusual as in the past there were several occasions on which this kind of flash crashes was witnessed without any negative fundamental developments in the economy.

The worst of such crashes being in 1987 on October 19 which was blamed on program trading and a new product called Portfolio Insurance gave a false sense of hope to institutions and brokerages.

Under this scheme buyers of portfolio, insurance are obliged to short sell S&P futures when the market drops by some agreed percentage. If it falls more the buyer of portfolio insurance is obliged to short more under this agreement which is mathematically programmed.

As the nature of the beast started feeding on itself prices were driven lower and lower to hit a floor only after a cut of around 22 percent. Post this crash, the best which bears got was a double-dip kind of thing whereas bull market slowly resumed and went on for several years.

Similarly, it appears that the present flash crash is led by confusion relating to volatility related trading strategies which triggered a sell button across the globe.

Huge demand for VIX product is believed to have created this flash crash as cross-asset class contagion is not visible as of now. These kind of single drops are not uncommon on Dow Jones Index.

On 24th of August 2015, Dow Jones witnessed 6.6 percent intraday crash before closing with a cut of 3.5 percent which led to bottoming of the market thereby typically acting as a climatic candle to end the selloff.

Bloomberg carried out an interesting piece of research in this regard which concludes that a crash of more than 4 percent on the S&P 500 index since 1928 during a non-recessionary year failed to aggravate follow up selling and eventually bulls managed to gain upper hand with the resumption of bull markets.

Historical Analysis of US 10 year yield and its impact on Bull Market:

Everybody on the street is worried about yields heading higher as the era of easy money is coming to an end which is going to impact the bull market.

Historical data analysis is suggesting no such negative impact on a strong bull market. In the past, Dow witnessed a strong bull market between the period starting from the year 1980 – 2000.

During this period, the US 10 year yield after hitting a top of 15.84 in September quarter of 1981 was on a falling spree. But, in between, there were several intermittent multi-month rallies which have seen decent appreciation in the yields.

For instance, yields moved higher from 6.98 to 10.23 from September 1986 quarter to December quarter of 1987. During this period Dow saw decent appreciation from the lows of 1737 to a top of 2736 before crashing in October 1987.

During December quarter of 1993 to December 1994 yields rallied from 5.19 to 8.05 whereas Dow remained in a range of 3553 – 3985.

From December quarter of 1998 to March 2000 yields rallied from 4.16 – 6.79 whereas Dow rallied from 7467 to 11750. Again when yields bottomed out at 3.13 in June quarter of 2003 they rallied up to 5.26 by June 2007 during this time Dow rallied from 7979 to 13692.

Hence one can remain unperturbed as marginal raise in yields is not going to derail the bull market with immediate effect especially when market-friendly Fed leads from the front.

Trend Check on Nifty50:

Indian markets are no exception to global factors and hence it also bowed down to global turmoil as it plunged by around 8 percent from recent top of 11171.

However, the long-term trend is still intact and will not be damaged unless Nifty closes below 10300 on monthly charts. In the near-term 10,028 looks like worst case target.

Hence long term investors can selectively start nibbling by making use of these panic selling.

Conclusion:

In the light of favourable conclusions thrown up by historical price behaviour of markets accompanied with strongly improving fundamentals of the global economy and visible earnings recovery, these kind of crashes should only provide buying opportunities to the long-term investors.

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