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India Strategy

The Anatomy of Bull Market Corrections

Conclusion: The market may be coming to the end of its four-year long bull run but, until the evidence appears, we have to assume that this is just another correction in the bull market. There have been eight corrections of 5% or more from peak to trough. Our analysis reveals that the recent correction (the ninth one in four years) is slightly different from the past eight corrections.

What's New: Five points to note about the past eight declines. 1) The average fall has lasted 15 days causing 15% damage to the market top. 2) Seven out of the eight corrections and subsequent rallies have been "V" shaped with the May 2004 drop being the exception. 3) The rise subsequent to the fall has averaged a 36% return with 20%-plus rallies in six out of eight occasions. 4) Realized inter-day volatility has always increased during the descents with one exception – the average increase measures 65%. 5) India has always underperformed EM in the corrections with an average underperformance of 7% points. Telecoms, materials and consumer discretionary have been the worst sectors to own during a correction whereas technology, energy and staples are the best sectors. In the subsequent rallies, financials and telecoms do the best while healthcare and staples do the worst. India has outperformed emerging markets in six out of the eight rallies following market corrections.

Implications: The recent correction is different in three ways. For the first time India has outperformed emerging markets in a decline. If the August 6, 2007 low was indeed the bottom of this bull market dip, then the recent fall would end up being the smallest correction (just 7% from peak to trough) in the four-year bull market. The spike in inter-day realized volatility has been sharper than usual. At the sector level, the key differences have been the outperformance by utilities and the underperformance of the technology sectors. Hence, from a trading perspective it makes sense to sell utility stocks and buy technology names.

How Have Past Corrections Behaved?

The market may be coming to the end of its four-year long bull run but, until the evidence appears, we have to assume that this is just another correction in the bull market. Over the past four years, the market (measured using the BSE Sensex) is up 410% on a cumulative basis. Along the way, there have been eight corrections of 5% or more from peak to trough (Exhibit 1). The recent correction is the ninth one. We have analyzed the past corrections to enable investors to predict what is in store during and after this correction, if it indeed is another one.

Five points to note about the past eight corrections. Each of these dips has lasted for less than thirty days. Six of the eight have produced double-digit corrections with the sharpest one being in May 2004 followed by May 2006. The swiftest decline was in December 2006, which lasted just four days and caused the market to fall 9% from its top. The average fall has lasted 15 days causing 15% damage to the market top. The second notable feature is that seven out of the eight corrections have been "V" shaped. The only exception to this was the drop in May 2004. The market on that occasion peaked on January 9, 2004 moved sideways for four months with a net fall of 4% (from January 9 to April 23). The real dip took place between April 23 and May 17 when the market fell 29%. One could argue that the peak to trough was from January 9 to May 17 but we think that would be misleading given the market behaved until the end of April 2004. Hence, we have used the period from April 23 to May 17 as the correction phase.

The third observation is that the rise subsequent to the fall has averaged 36%. Only on two occasions was the rise less than 20%. These two coincide with the rise coming after the single digit corrections in January 2005 and December 2006. The fourth point to note is that realized inter-day volatility has usually increased during the descents. January 2005 was the only the exception when the inter-day realized volatility remained unchanged during the six day correction. The average increase in volatility over the preceding period of rise is about 65%. The fifth and final point is that India has always underperformed emerging markets in the corrections. The average underperformance has been 7% points.

From a sector perspective, telecoms, materials and consumer discretionary have been the worst sectors to own during a market dip. Conversely, technology, energy and consumer staples have been the best sectors to own. Incidentally, financials and telecoms have been the best sectors in the rally following the fall over the past four years. Not surprisingly, healthcare and consumer staples have been consistent underperformers in the rallies. India has outperformed emerging markets in six out of the eight rallies following market corrections (Exhibit 2).

Exhibit 1

Anatomy of Bull Market Corrections

DATE	Peak	Trough	Correction	Days of Correction	Realized inter-day volatility during correction	Realized inter-day volatility during the rally	Rise from low to high	Relative Valuation #	Correlation*
23-Apr-04	5,979					1%	106%	1.12	0.57
17-May-04		4,228	-29%	15	3.36%				
4-Jan-05	6,696					1.22%	58%	1.45	0.61
12-Jan-05		6,070	-9%	6	1.23%				
9-Mar-05	6,955					0.97%	15%	1.36	0.58
18-Apr-05		6,118	-12%	26	1.20%				
5-Oct-05	8,822					0.89%	44%	1.37	0.66
28-Oct-05		7,656	-13%	16	1.23%				
11-May-06	12,671					1.08%	66%	1.54	0.61
14-Jun-06		8,799	-31%	24	3.08%				
5-Jul-06	10,940					2.45%	24%	1.44	0.73
24-Jul-06		9,875	-10%	13	2.20%				
6-Dec-06	14,035					0.83%	42%	1.49	0.75
12-Dec-06		12,802	-9%	4	1.5%				
9-Feb-07	14,724					1.13%	15%	1.51	0.78
16-Mar-07		12,316	-16%	24	1.9%				
24-Jul-07	15,869					1.10%	29%	1.36	0.70
6-Aug-07		14,706	-7%	9	2.0%				

* Correlation between MSCI India and MSCI EM based on 52-week trailing weekly returns # MSCI India trailing P/E relative to MSCI EM
Source: Bloomberg, FactSet, MSCI, Morgan Stanley Research

Exhibit 2

Relative Sector Performances during Corrections and Rallies

Sectors	23 Apr 2004 to 17 May 2004	5 Jan 2005 to 12 Jan 2005	9 Mar 2005 to 18 April 2005	6 Oct 2005 to 28 Oct 2005	12 May 2006 to Jun 14 2006	6 Jul 2006 to 24 Jul 2006	7 Dec 2006 to 12 Dec 2006	10 Feb 2007 to 16 Mar 2007	25 Jul 2007 to 6 Aug 2007	Average#	No of down periods
Consumer Discretionary	2.0%	-0.2%	-0.2%	-0.4%	-0.6%	-5.4%	-2%	-1%	-1%	-1.0%	7
Consumer Staples	4.3%	2.9%	2.9%	0.7%	-3.2%	-2.2%	0%	0%	7%	0.6%	3
Energy	-6.4%	2.8%	2.8%	2.4%	8.1%	-3.2%	0%	7%	-1%	1.7%	3
Financials	-1.8%	1.0%	1.0%	1.1%	-2.0%	1.2%	-1%	-4%	0%	-0.6%	4
Healthcare	16.4%	-6.6%	-6.6%	-7.4%	-0.9%	3.5%	2%	6%	3%	0.7%	4
Industrials	-1.9%	2.2%	2.2%	-3.3%	-8.0%	-4.3%	-1%	-3%	0%	-2.2%	6
Technology	11.0%	-1.4%	-1.4%	3.7%	5.2%	6.8%	4%	3%	-1%	3.9%	2
Materials	-5.7%	-0.6%	-0.6%	-6.4%	-5.0%	-1.9%	-2%	-9%	-1%	-3.9%	8
Telecom	-14.3%	-6.9%	-6.9%	-11.5%	-10.6%	-2.5%	-5%	-7%	-2%	-8.0%	8
Utilities	-27.4%	-2.7%	-2.7%	-3.8%	4.1%	0.4%	1%	0%	3%	-4.0%	5
MSCI India$	-11.4%	-4.9%	-0.5%	-7.0%	-10.8%	-4.8%	-5%	-10%	2%	-6.9%	8
Sectors	**28 Apr 2003 To 22 April 2004**	**18 May 2004 to 4 Jan 2005**	**13 Jan 2005 to 8 Mar 2005**	**19 Apr to Oct 5 2005**	**31 Oct 2005 to 11 May 2006**	**15 Jun 2006 to 5 Jul 2006**	**25 Jul 2006 to 6 Dec 2006**	**13 Dec 2006 to 9 Feb 2007**	**17 Mar 2007 to 24 Jul 2007**	**Average***	**No of down periods**
Consumer Discretionary	32.1%	-5.3%	-7.6%	8.0%	-4.1%	-1.5%	-3%	3%	-17%	-3.5%	6
Consumer Staples	-24.4%	-8.0%	-3.0%	2.3%	-3.9%	4.5%	-21%	-13%	-12%	-6.8%	6
Energy	1.5%	-8.3%	0.9%	2.8%	-19.3%	2.4%	-5%	1%	11%	-1.9%	3
Financials	3.6%	1.8%	3.9%	1.1%	14.6%	-4.5%	16%	7%	9%	6.2%	1
Healthcare	-17.9%	-12.4%	-10.4%	-9.3%	1.4%	-6.2%	-11%	-6%	-21%	-9.3%	7
Industrials	40.0%	4.5%	7.3%	2.5%	-18.6%	-2.2%	3%	0%	18%	1.7%	3
Technology	-1.2%	16.0%	1.2%	0.1%	19.3%	2.6%	1%	-2%	-21%	2.2%	2
Materials	18.1%	14.7%	1.0%	-8.7%	-15.6%	0.8%	-6%	-4%	18%	0.0%	4
Telecom	-12.3%	6.9%	-12.8%	1.9%	3.0%	3.1%	26%	1%	16%	5.7%	1
Utilities	40.9%	6.2%	-1.6%	-4.4%	27.7%	-2.8%	-13%	2%	13%	3.3%	4
MSCI India$	27.2%	8.5%	-1.4%	12.9%	-11.1%	5.9%	16%	7%	6%	5.5%	2

#The average excludes the latest correction, *The average excludes the first leg of the bull run $ Relative to MSCI EM; Sector Performance measured relative to MSCI India
Source: Factset, MSCI, Morgan Stanley Research

What is Unique about the Recent Decline?

Firstly, this is the first time in a bull market correction that India has outperformed emerging markets. We are not surprised. In our note of July 27, 2007 ("Gulping Snake?"), we argued there were four factors in India's favor if the market was going through a mild fall in global risk appetite. Firstly, the Central Bank, through some aggressive tightening since the end of 2006, has built ammunition to counter a crisis in domestic liquidity. Second, the trailing correlation of returns on Indian equities versus emerging markets was lower than in recent corrections. Thirdly, valuations were off their highs and, in fact, at two-year lows relative to emerging markets. Finally, our proprietary sentiment indicator suggested that market participants were not as bullish as they were at the start of May 2006 or in February 2007. Things could change if the correction in global markets gets more aggressive.

The second distinguishing feature is that if August 6, 2007 were indeed the bottom of this bull market dip, then it would end up being the smallest correction (of just 7%) in the four-year bull market. At nine days, it would be only the third time that a correction has lasted for less than 10 days, as is the case with the quantum of the fall, which is also only the third occasion of a single digit correction. The spike in inter-day realized volatility has been sharper than usual. With inter-day volatility doubling from the preceding rally, this spike matches the one that the markets underwent in May 2006 (when realized volatility tripled from the preceding period of rise).

At the sector level, the key differences in this dip compared with history have been the outperformance of the utilities sector and the underperformance of the technology sector. In the past corrections, the utilities sector has tended to underperform whereas technology has outperformed. Hence, from a trading perspective it makes sense to sell utility stocks and buy technology names.

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