Valentis Advisors

2019: Looking back, looking ahead

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Key points in brief

- While valuations have eased off since the beginning of CY2018, valuations at close to 18x 1-year forward PE still remain higher than long term averages. We would expect single digit returns from the market at these levels over the year. Near term, we think we are headed for a long spell of time correction or more likely a price correction closer to the recent lows of 10,000-10,200 on the Nifty which takes markets to valuations in line with historic averages of 16x.
- While returns over the past few years have been largely driven by valuation re-rating, we think returns in CY2019 and indeed next couple of years will be driven by an acceleration in the earnings cycle.
- The other big driver of markets in CY2019 is likely to be the Fed. An easing of the Fed rate hike and the end of the US$ appreciation could see Emerging markets outperform DMs.
- The elections in India, of course, remain an imponderable. Elections impact markets near term though it does not really have any significant long term impact.
- Lastly, we think mid-caps and small caps will (a) outperform large caps and (b) give positive returns in the entire CY2019. However, the early part of the year may continue to see some weakness in mid-caps that provide better buying opportunities.

Looking back to 2018: High valuations magnify negative news

With valuations at the start of the year being excessive, you didn't need much to get a market correction. There were enough negative factors we can look back on. Some were outside our control (spike in oil prices and the consequent rupee depreciation, tightening Fed policy and a US-China trade spat). But other factors were more domestic (imposition of long term capital

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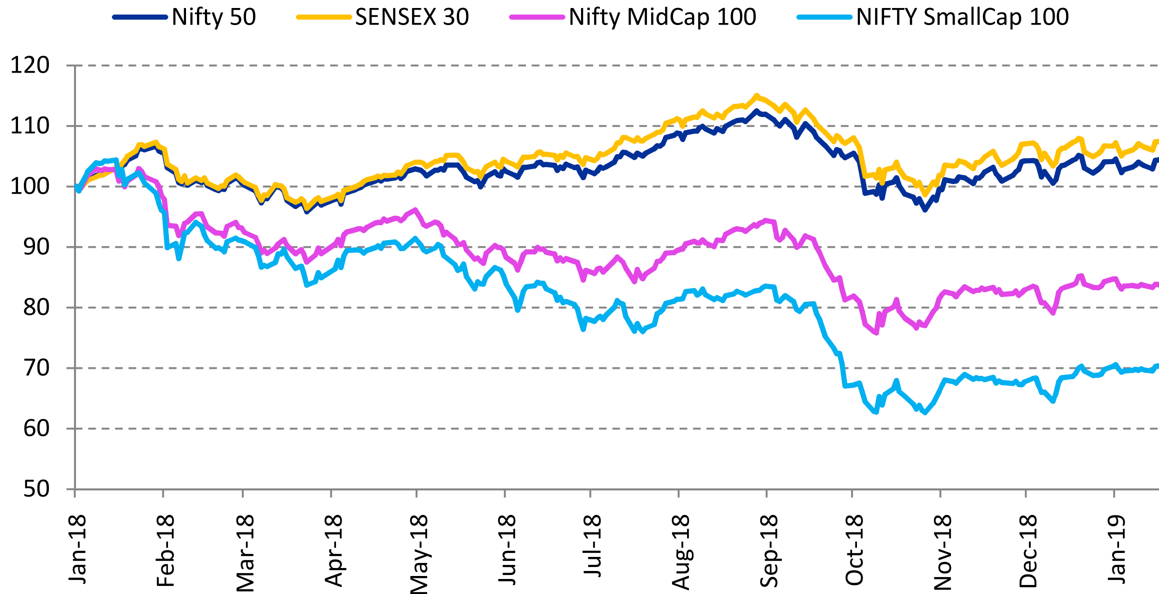
gains tax, the classification norms for mutual funds by SEBI, the ASM framework and finally the IL&FS blow-up). But what stood out in CY2018 was the narrowness of the markets.

Chart 1: Relative Index return (%) - Sharp Under-performance by the mid and small caps



Source: Valentis research, ACE Equity

CY2018 - high volatility or normalization of volatility?

Given the pain in all portfolios, CY18 would seem like an abnormal year. But actually, it was just a return to a normal year. It was 2017 that was an abnormal year!

Looking at drawdown every year (that is fall in markets from peak to bottom) 3 things stand out:

1. The drawdown in CY18 was less than the 15-year average drawdown in case of the nifty and the mid-cap indices. It is only in case of the small caps that the drawdown was higher than average.
2. One reason why this felt so much more painful is that CY17 was an extra-ordinary year having the lowest drawdown in the last 15 years. This had numbed investors into a sense of complacency since volatility has practically disappeared from equity markets. Indeed this is true of the world also - we had 12 consecutive months of positive monthly returns in CY17!

3. The other reason it was painful was that markets did not bounce after the draw-down. While average draw-down was not very different from an average year, the year-end returns were dramatically lower especially in case of mid-caps and small caps.

Table 1: Drawdown history of various indices: CY18 was a normal year

CY	SENSEX		NIFTY MIDCAP 50		BSE SMALLCAP	
	MDD %	Return %	MDD %	Return %	MDD %	Return %
CY04	-27%	-1%	-27%	30%	-34%	38%
CY05	-13%	42%	-16%	37%	-23%	73%
CY06	-29%	59%	-39%	25%	-42%	16%
CY07	-15%	47%	-21%	72%	-21%	94%
CY08	-60%	-52%	-71%	-65%	-77%	-72%
CY09	-21%	81%	-30%	100%	-27%	127%
CY10	-11%	17%	-16%	10%	-22%	16%
CY11	-26%	-25%	-42%	-40%	-44%	-43%
CY12	-13%	26%	-21%	35%	-14%	33%
CY13	-12%	9%	-31%	-3%	-33%	-11%
CY14	-7%	30%	-12%	46%	-9%	69%
CY15	-16%	-5%	-17%	2%	-14%	7%
CY16	-12%	2%	-22%	7%	-20%	2%
CY17	-4%	28%	-8%	51%	-7%	60%
CY18	-14%	6%	-23%	-11%	-33%	-24%
Average	**-19%**	**18%**	**-26%**	**20%**	**-28%**	**26%**

Source: Valentis research, ACE Equity

2019 - Looking ahead

- Over the past few years, most of the returns in the equity markets have come from valuation re-rating. We think returns over the next few years have to come from earnings growth.
- As we enter CY19 the good news is that valuations are not as expensive as they were at the start of CY18. The bad news is at a PE of 18x 1-year forward earnings they still remain higher than long term averages (and we are already factoring a 20% EPS growth for FY20). We could either see a long spell of time correction or more likely a price correction closer to the recent lows of 10,000-10,200 on the Nifty which takes markets to fair value.

#1: Global markets and global central banks

Our view is that we generally tend to under-estimate the impact of global events on our markets. Indeed in spite of the huge influx of retail India in equity markets, there is still a very tight co-relation between the Indian markets and emerging markets.

The bad news is that Central Banks are tightening liquidity. However, the good news is that we believe we are coming close to the end of the Fed rate hikes. A Goldilocks scenario for India is when the US economy slows down enough to stop rate hikes but does not go into a recession since that hurts Indian economic growth too. We could see that scenario play out in CY19 helping EMs outperform DMs. A possible recession in the USA, though that is not our base case, would be the key risk to this view.

a) Global Central Banks tightening liquidity: Are we close to the end of Fed rate hikes?

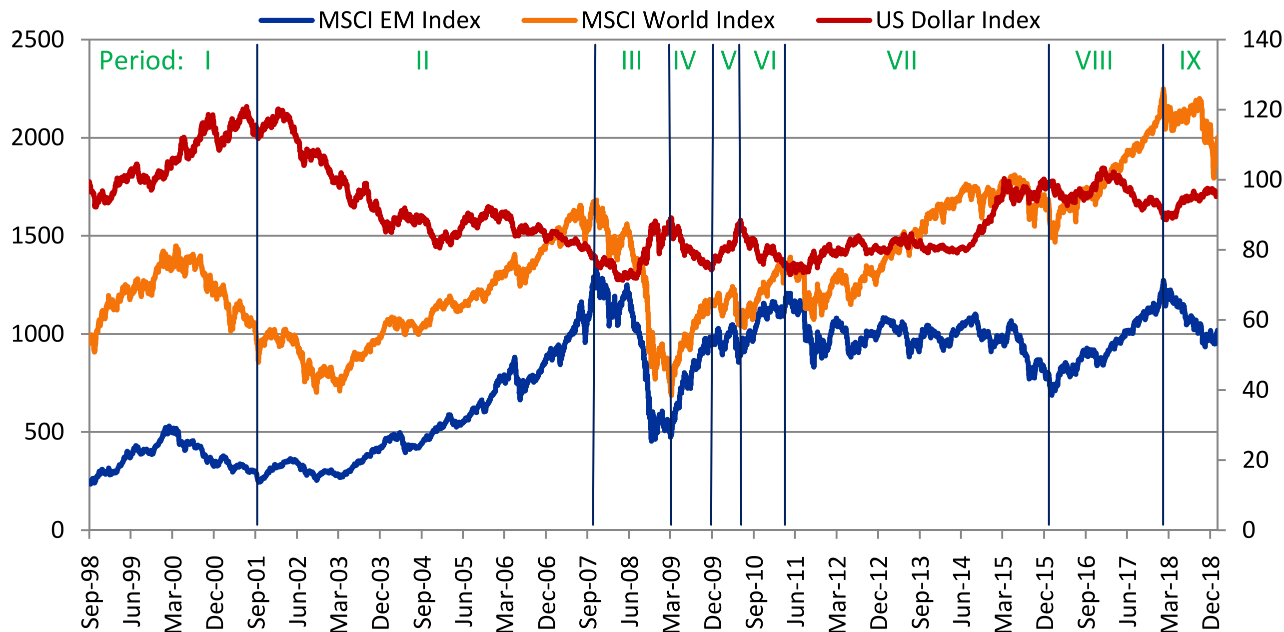
First the bad news. Global central banks are tightening liquidity and shrinking their balance sheet as the world normalizes a decade after the 2008 global financial crisis. The size of the balance sheet of 4 large central banks (China's PBoC, the Fed, ECB and Bank of Japan) was around US$7 trillion (18% of GDP) in mid-2008. By March 2018, this had swelled to US$20.6 trillion (40% of GDP). The combined balance sheet posted its first contraction since 2003 in October 2018 and fell at a faster pace in November 2018 to end at US$19,5 trn. While the Fed has been tightening since early 2018, the PBoC has started tightening too in past couple of months.

The good news is that we are probably close to the end of the Fed rate increases. While the US economy has been strong partly led by the tax cuts, the momentum is faltering now. There are already some who fear a recession though we think it is unlikely. We think the Fed will hike only once this year and this will provide some support to the equity markets from a falling liquidity environment.

b) Can the EM again start out-performing the DM?

Since 2008, the developed markets (especially USA) have out-performed emerging markets. falling 18% vs a 25.9% rally in DMs. We think 2019 could see this change as Fed eases on the interest rate hikes and the long spell of US dollar appreciation comes to an end.

Chart 2: EM outperforms DM in a depreciating US$ environment



Period	I	II	III	IV	V	VI	VII	VIII	IX
Dollar Index	13.8%	-35.0%	14.1%	-16.7%	19.0%	-17.5%	35.8%	-9.8%	7.9%
MSCI EM	1.6%	287.6%	-62.1%	100.5%	-9.1%	35.6%	-42.9%	84.2%	-19.7%
MSCI World	-10.4%	50.5%	-58.2%	67.1%	-11.0%	33.7%	7.6%	49.2%	-10.4%

Source: MOSL

#2: How significant is elections for the markets?

Elections and politics probably occupy more attention and mind space of equity market investors than it deserves.

1. The run up to elections has generally been good for equity markets. Buying 6 months before elections and selling on the day before counting of results has mostly given a positive return.
2. The day of counting leads to very volatile markets depending on the Government market perceives as reform friendly. So the Vajpayee Government loss in 2004 (and UPA-1 came to power) led to a major negative day but when the same UPA got re-elected in 2009, markets rejoiced.
3. Yet, the first day reaction of the market to any Government does not reflect how the equity markets will react to the Government a year later. The chart below shows enough instances where the first day reaction has proved wrong a year later.

4. Generally markets are positive 6 months and 12 months post elections as the market focus shifts to more fundamental issues.

Table 2: Stock market returns (%) – Pre & post elections: Why worry about elections?

Result Date	Prime Minister	Ruling Party/Alliance	Pre-elections		Returns (%) post-elections			
			6m	3m	3D	3m	6m	12m
1-Dec-89	V.P. Singh/Chandra Shekhar	National Front	0	-6	0	0	16	75
20-Jun-91	P. V. Narasimha Rao	Congress	25	14	-2	37	40	131
10-May-96	Dev Gowda/I.K. Gujral	United Front	11	17	2	-5	-17	0
27-Feb-98	Atal Bihari Vajpayee	BJP & Allies	-9	0	4	2	-20	-6
6-Oct-99	Atal Bihari Vajpayee	BJP & Allies	32	8	7	15	4	-12
13-May-04	Manmohan Singh	Congress & Allies	8	-9	-17	-5	10	19
15-May-09	Manmohan Singh	Congress & Allies	30	29	17	27	38	38
16-May-14	Narendra Modi	BJP	17	18	2	9	17	16
Average Return			**14**	**9**	**2**	**10**	**11**	**33**

Source: Valentis research, Election Commission of India, ACE Equity

Only 1 negative in run-up to elections

First reaction of market is not necessarily correct

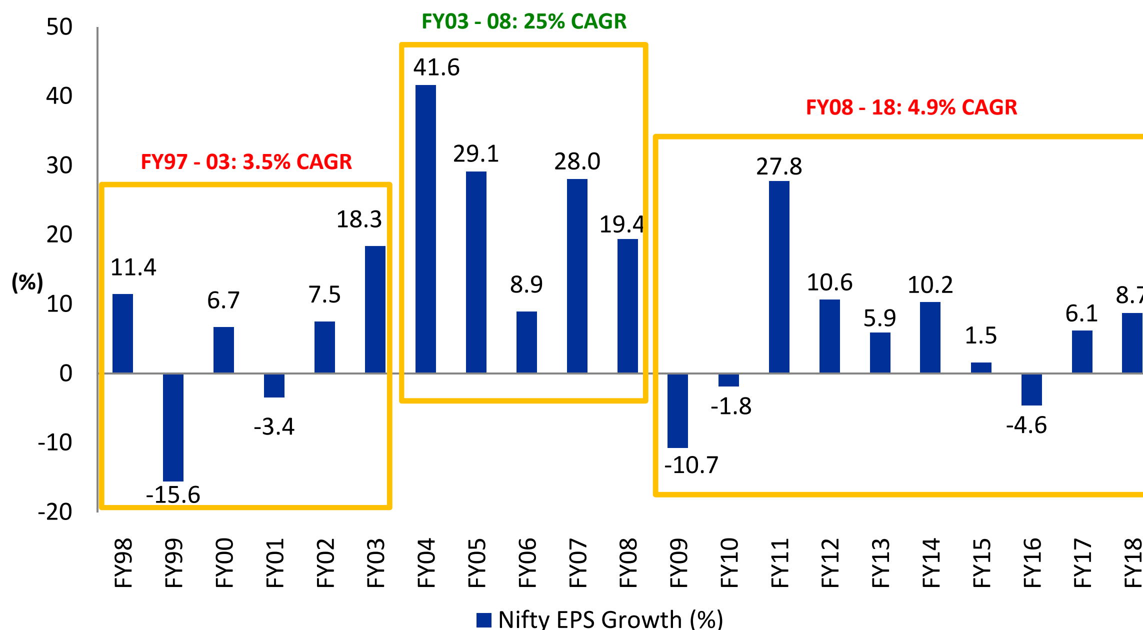
#3: Will earnings finally deliver? We think earnings can double in next 4-5 years

The earnings recovery in India has been an elusive hope for the market. Yet, like the wolf which finally comes when everyone has given up, we think FY20 will see a surge in earnings growth in India. Indeed, earnings growth was recovering in India but the squeeze on NBFCs post the ILF&S fiasco has put pressure on near term earnings recovery.

We must point out that the 20% growth we expect in FY20 is largely dependent on a surge in earnings of corporate banks as NPL provisioning eases. More than 50% of the earnings growth is driven by corporate banks and hence some may argue that this is not a real earnings recovery. However, by a similar argument, a large part of the slow earnings growth was also driven by a sharp reduction in profitability of banks due to high provisioning requirements.

Typically when earnings momentum picks up, we tend to start seeing upgrades. Even if earnings do not expand at the 26% CAGR that we saw in the previous cycle from FY03-08 given that global economies won't be as supportive, we think a 15-16% CAGR over next 5 years is likely.

Chart 3: Earnings growth trend: Cusp of earnings recovery?



Source: MOSL

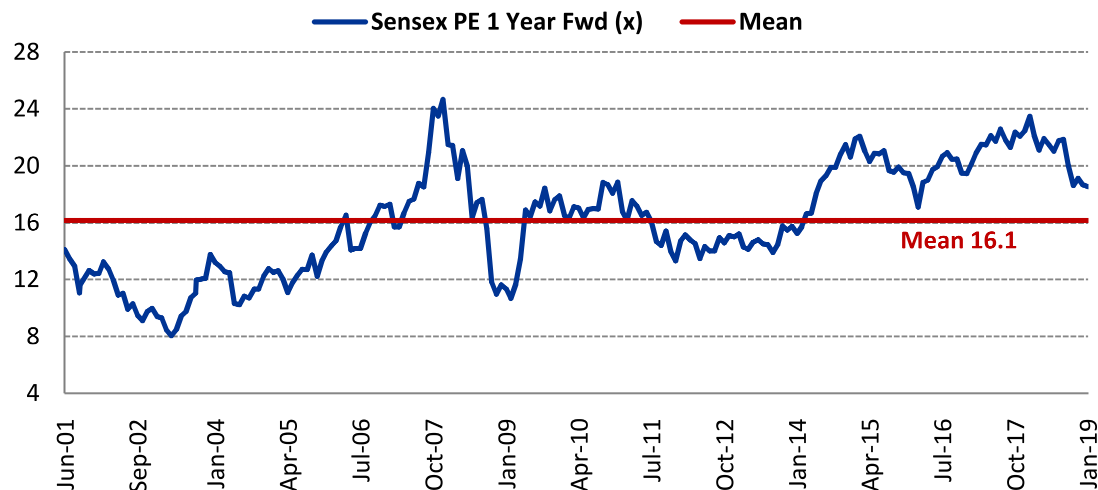
Why we think earnings can accelerate?

1. With no capex over the past 10 years, we are seeing capacity utilization levels pick up. Even assuming growth remains sluggish, we could see capacity utilization hit close to 80% in India.
2. Thus volume growth will probably be accompanied by pricing power for corporates. We see a sharp improvement in margins led by operating leverage as capacity utilization picks up. In the initial stage, free cash flows will be strong as companies don't need to add capacity. Over 24 months, probably capex cycle will start again.
3. Banks have dragged earnings growth as RBI tightened NPL recognition norms. We think a large amount of provisioning is behind us. As the IBC stabilizes over next 6-12 months, we think there is a possibility of recoveries being higher than the written down value of the loan. Banks will provide a huge fillip to earnings growth.

#4: Valuations still slightly higher than fair value

At the beginning of CY18, valuations were clearly expensive. After a year of time correction, we are seeing valuations cheaper but at a 18x 1-year forward earnings still higher than historical averages. This puts lot of onus on earnings. Assuming our view of earnings recovery in FY20 holds, we would expect FY20 Nifty EPS at around Rs630. Over the course of 2019 we expect single digit returns from the market. Near term, we could either see a long spell of time correction or more likely a price correction closer to the recent lows of 10,000-10,200 on the Nifty which takes markets to valuations in line with historic averages of 16x. This would provide a better buying opportunity.

Chart 4: P/E Valuation - Still at premiums to historic averages



Source: MOSL

#5: In 2019, small and mid-caps will outperform large caps

We think over the next 2 years, small and mid-caps will do better than large cap led by:

1. Valuation differential now in line with averages: Mid and large caps were expensive relative to large caps at the beginning of CY18. But after the sharp under-performance of mid and large caps, relative valuation differentials are now in line with long term averages.
2. Typically mid-caps do better in an earnings recovery phase than the large caps. Given we expect an accelerating earnings over next few years, we think mid-caps and small-caps will show better growth than large caps.

History favors small and mid-caps

The table below maps out the performance of small, mid and large cap indices over the past 18 years (since data is available for the mid-cap index). Based on these trends, there is a very high probability that mid-caps and small-caps will outperform the large caps as well as give a positive return.

1. There have been 5 negative years for the mid-cap indices over the past 18 years. But there are no consecutive negative years. Thus, if history holds, the year after a negative year will be a positive for mid-caps.
2. There have been 6 occasions when the mid-cap indices under-performed the large cap indices (including 2018). In the next year, the mid-caps always outperformed the large caps and recouped the under-performance of the previous year,
3. The 19% under-performance of the mid-caps (and the 32% of the small caps) to the large cap index is the largest under-performance we have seen since the indices began.

Table 3: Midcaps outperformed 11 out of 18 years

Year	Nifty Index	MidCap Index	Difference	SmallCap Index	Difference
CY01	-16%	-30%	-15%	N.A.	N.A.
CY02	4%	25%	21%	N.A.	N.A.
CY03	74%	143%	70%	N.A.	N.A.
CY04	11%	25%	15%	35%	25%
CY05	34%	33%	-1%	61%	27%
CY06	41%	28%	-14%	41%	0%
CY07	53%	78%	25%	85%	32%
CY08	-51%	-59%	-8%	-70%	-20%
CY09	72%	97%	25%	106%	33%
CY10	18%	18%	1%	17%	-1%
CY11	-25%	-32%	-7%	-34%	-10%
CY12	28%	41%	13%	39%	10%
CY13	6%	-6%	-12%	-8%	-14%
CY14	31%	56%	24%	54%	23%
CY15	-4%	7%	11%	7%	11%
CY16	3%	6%	3%	1%	-2%
CY17	29%	47%	19%	57%	29%
CY18	3%	-15%	-19%	-29%	-32%
Average	**17%**	**26%**	**8%**	**24%**	**7%**

Source: Valentis research, ACE Equity

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