Valentis Advisors

2020: Looking back, looking ahead

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Why are stock markets doing well in spite of a weak economy? Will expensive stocks continue to perform better? We answer these and many more questions through easy to read charts in this report. Key points in brief:

1. **Rally in markets was part of global rally:** The number of Central Banks easing is the highest since the Global financial crisis. India participated in the consequent global rally but under-performed given the sluggish economy. Secondly, the rally was the narrowest rally we have seen**.**
2. **Markets anticipating a turn in the economy and earnings cycle:** Slowing growth, slipping fiscal deficit and now rising inflation dominated headlines. Amidst this gloom and doom, we see some green shoots with PMI rising steadily past few months raising hopes of a gradual economic recovery. Over the past 2 decades we had 3 years of sub-4% GDP. The markets gave an average return of 43% next year and a CAGR of 23% next 5 years (Chart 15) as markets anticipated a bottoming of the economy.
3. **The elusive earnings recovery:** Similarly earnings are clearly at a low point of the cycle with corporate profit to GDP at 3.1% way below average of 5% and similar to FY03 where a strong earnings up-cycle started. In the last earnings up-cycle from FY03 to FY08, earnings tripled (CAGR of 25%). We could see earnings doubling over next 5 years.
4. **Valuations are neutral to expensive:** While returns over the past few years have been largely driven by valuation re-rating, we think returns in CY2020 and indeed next couple of years will be driven by an acceleration in the earnings cycle rather than re-rating. Globally PE ratios are elevated given low interest rates. We hope earnings catch up in India before interest rates globally start to mean revert (and bring down PE ratios).
5. **Value, mid and small caps can outperform**: India as well as globally we have seen a surge in performance of growth stocks relative to value since 2008. The outperformance of growth stocks is at a multi-decade high (see Chart 22) and we think we could see a mean reversion as the economy picks up. Mid-caps do better in anticipation of economic recovery (see Chart 16) and after 2 negative years should recover in 2020 (Table 2).

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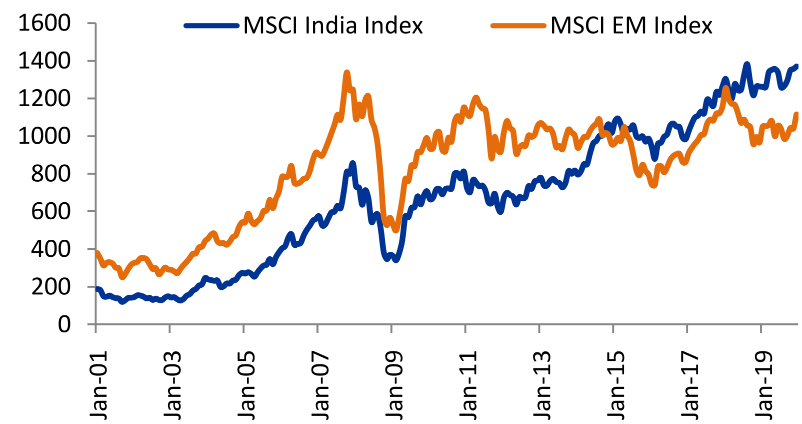
Chapter1 : Weak economy but rising markets? #1: Global markets

Indian markets are hugely co-related to global markets. The rally in India in 2019 was part of a global rally

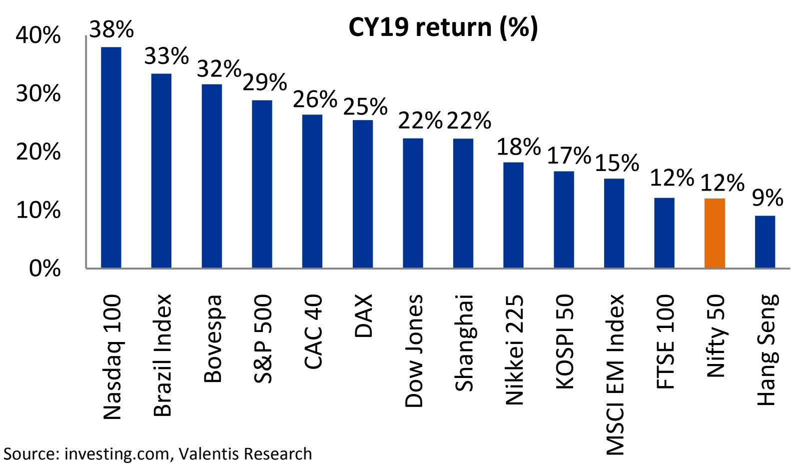
Chart 1: Indian markets huge co-related to global markets



Source: MOSL, Valentis Research

Given the weak economy, however, India under-performed global markets.

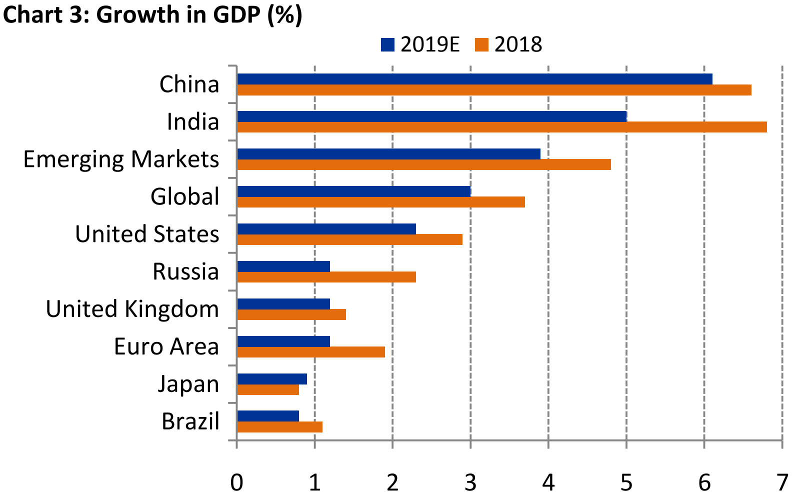
Chart 2: Indices return during CY19



Source: investing.com, Valentis Research

Just like India, the economy weakened in most large economies….

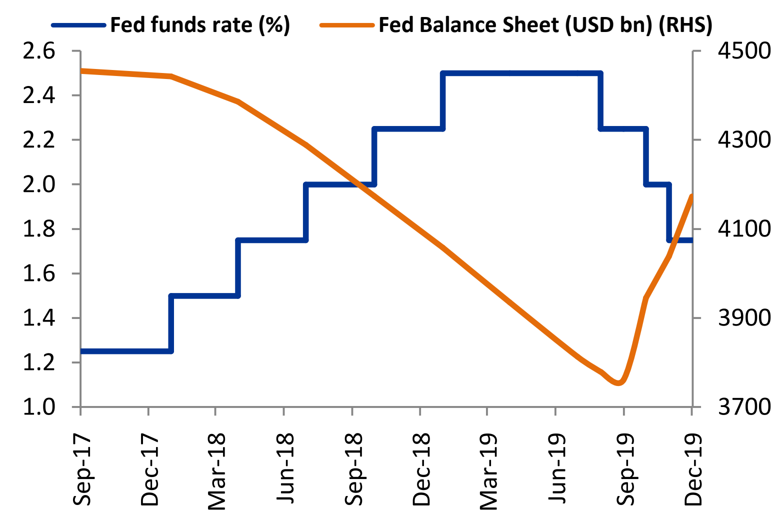
Chart 3: Growth in GDP (%)



Source: IMF, Valentis Research

....but a change in Fed stance to rate cuts and quantitative easing provided a boost to markets

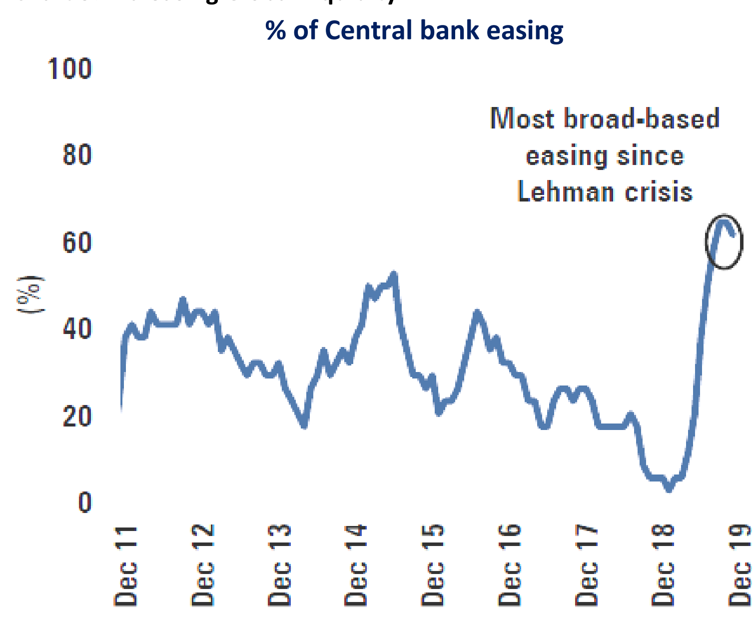
Chart 4: US Fed Rate Hike & Balance Sheet Expansion



Source: Emkay, Valentis Research

The Fed was not alone. The number of Central banks easing is the highest since the Global Financial crisis in 2008.

Chart 5: Increasing Global Liquidity

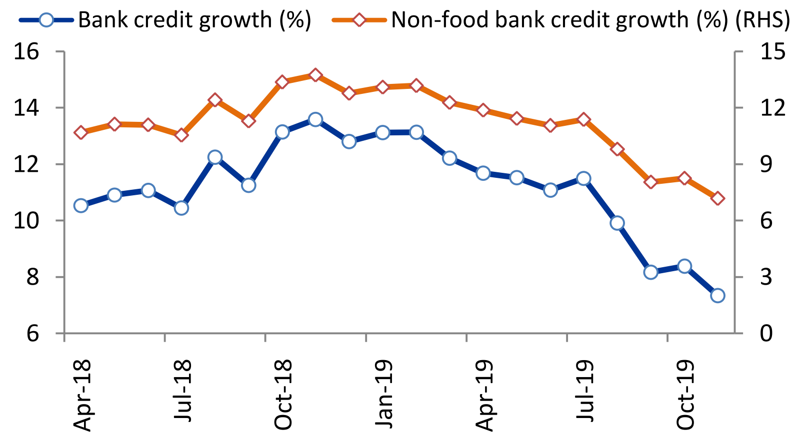


Source: Edelweiss, Valentis Research

Chapter2: Why the rally? #2: Markets anticipating change in earning cycle

There is lot of negative news on the economy. Credit growth has collapsed.

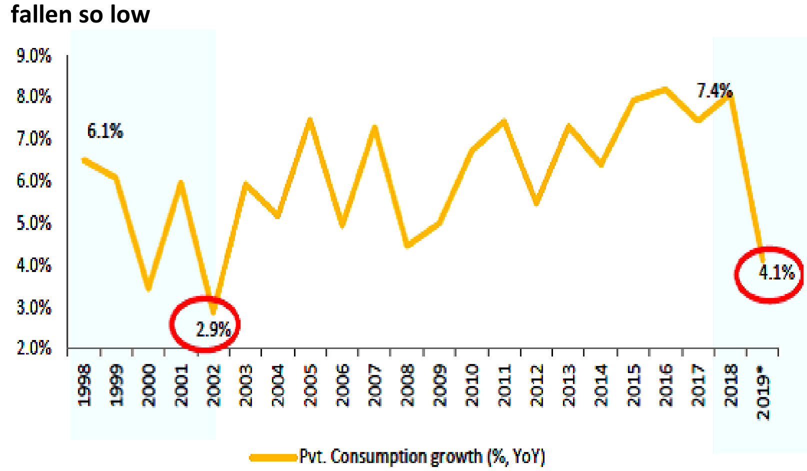
Chart 6: Credit growth



Source: MOSL, Valentis Research

While industrial capex has understandably been weak, private consumption growth has fallen to its lowest since 2002. Is this the bottom?

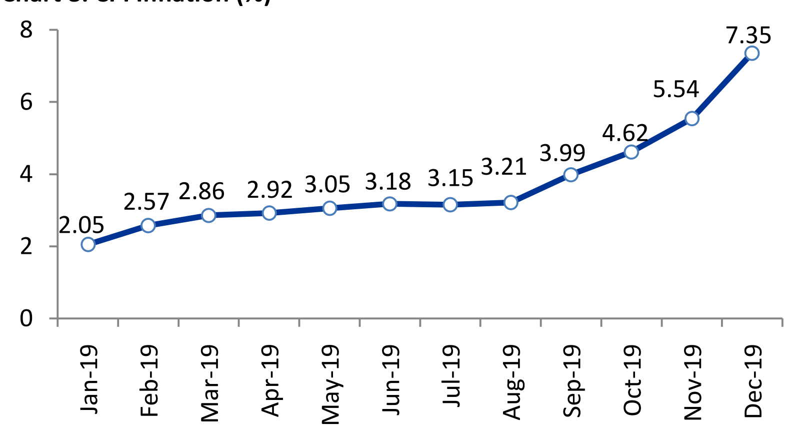
Chart 7: For the first time since 2002, Pvt. Consumption growth has fallen so low



Source: GOI, Valentis Research

To compound the problems, the benign inflation , has suddenly flared up. While we think this is temporary, it puts RBI on pause mode.

Chart 8: CPI Inflation (%)



Source: MOSL, Valentis Research

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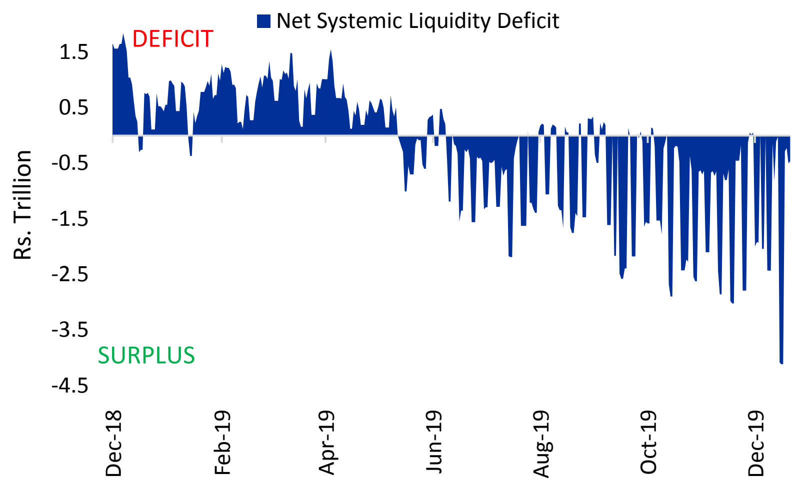
But we see some positives. Since the middle of 2019, liquidity has turned surplus….

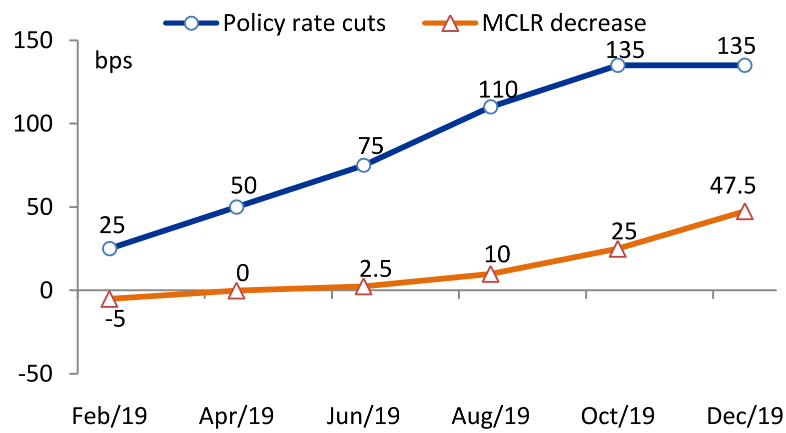
Chart 9: Net Systemic Liquidity Deficit



Source: Edelweiss, Valentis Research

… leading to transmission in the economy improving. Borrowers could see lower rates even if the RBI pauses.

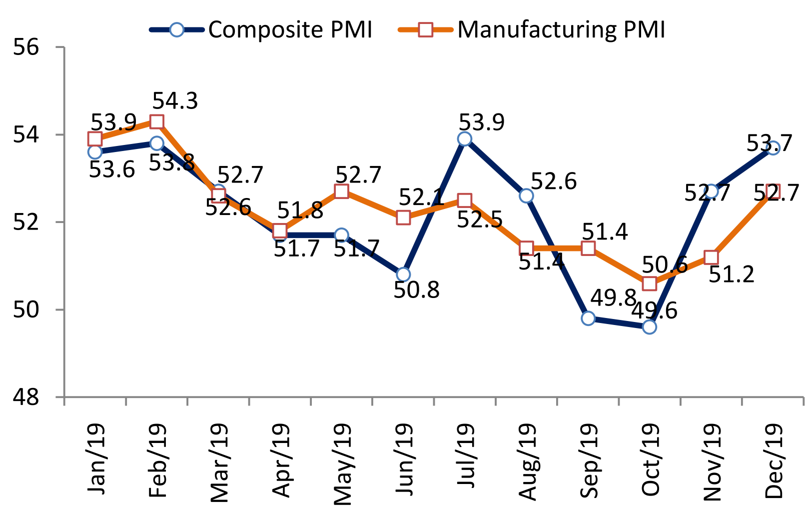
Chart 10: Allowance of excess liquidity has supported transmission



Source: RBI, Valentis Research

Amidst the gloom and doom on the economy, we see some green shoots. The PMI has picked up in the past few months raising hopes that we could be bottoming out on the economy

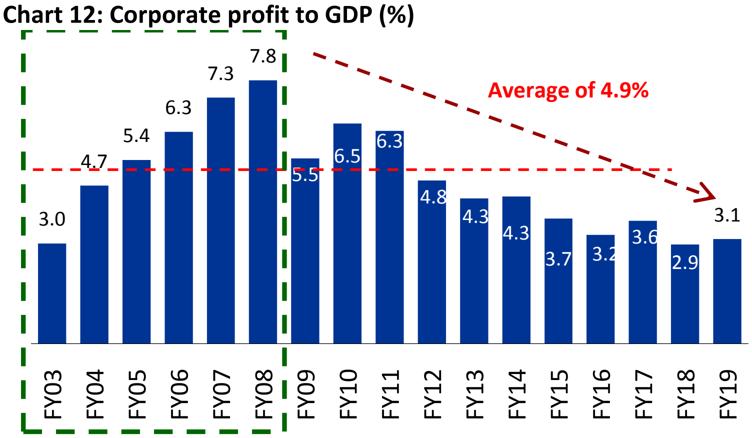
Chart 11: PMI data



Source: MOSL, Valentis Research

Earnings have disappointed for the last many years seeing downgrades every year. Are earnings close to a bottom? If we look at corporate profit to GDP they are way below average and at levels from which earnings rebounded sharply from FY03 onwards

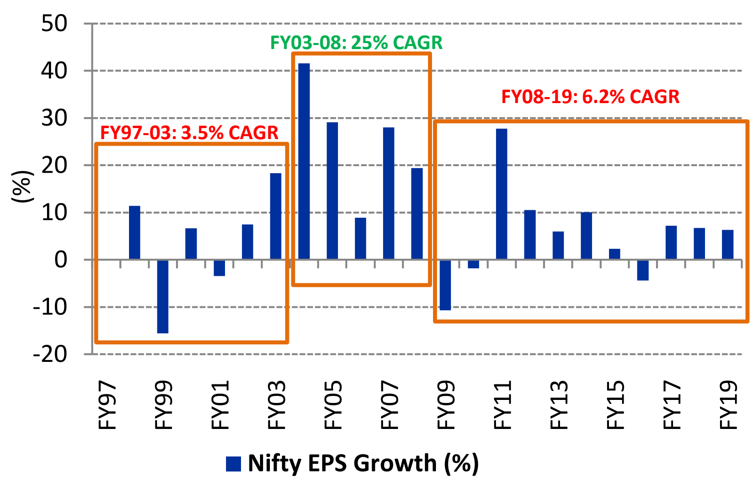
Chart 12: Corporate profit to GDP (%)



Source: MOSL, Valentis Research

Earnings typically see cycles of weak and strong phases. This is a longer than historic cycle of weak spell. Last time earnings tripled in 5 years growing at a compounded 25%. We could see a 15% CAGR this time.

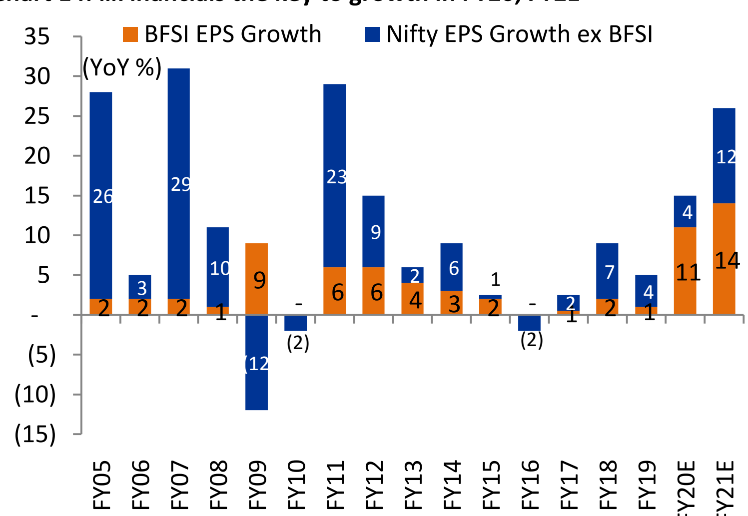
Chart 13: Earnings growth trend: Cusp of earnings recovery?



Source: MOSL, Valentis Research

Financials account for nearly half the expected earnings recovery as they rebound from a spell of accelerated NPL recognition.

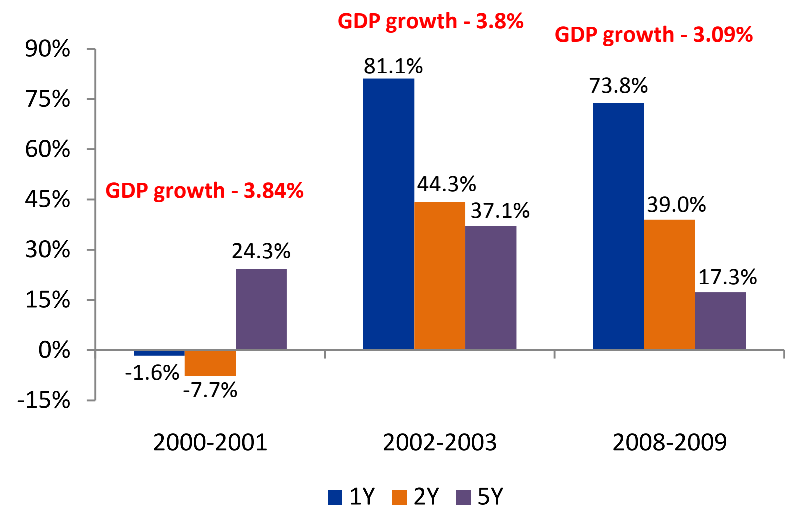
Chart 14: …Financials the key to growth in FY20, FY21



Source: MOSL, Valentis Research

Chart 15: GDP growth and Nifty Index return (CAGR %)

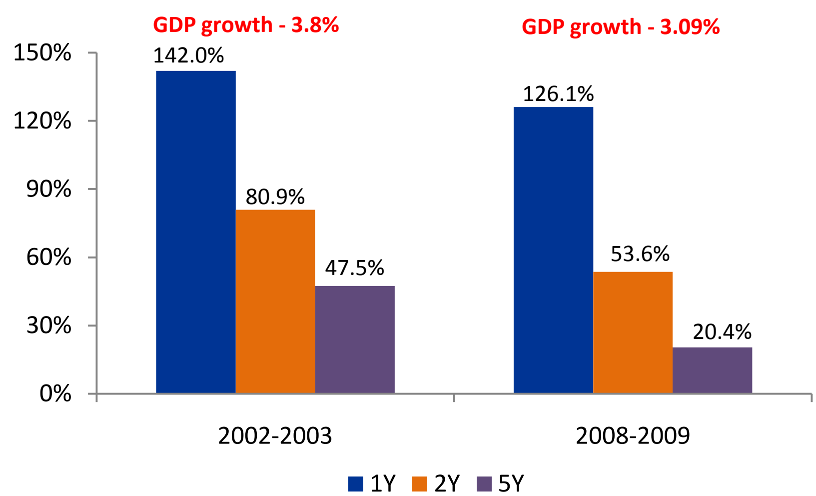
Typically markets have rebounded sharply after a sub-4% GDP growth annually or quarterly). The average return in 1 year is 43% and the average in 5 years is 23%.



Source: MOSPI, NSE, Valentis Research

Chart 16: GDP growth and Nifty MidCap Index return (CAGR %)

Mid-caps have seen a stronger rebounded than the large cap indices in phases where markets play for an earnings recovery. The average return in 1 year is 95% and the average in 5 years is 29%.



Source: MOSPI, NSE, Valentis Research

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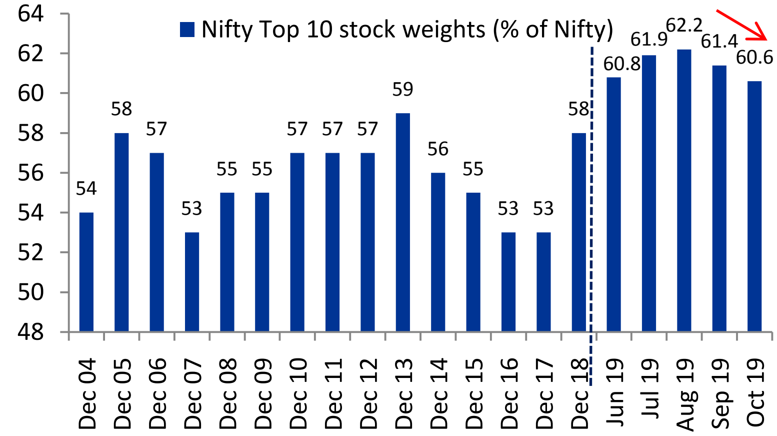
Chapter3: Why the rally? #3: Very narrow rally

This is the narrowest rally we have seen over past 15 years with bulk of the rally even within the Nifty being driven by just 10 stocks. We see the rally broadening in 2020, a trend already visible over the past few months.

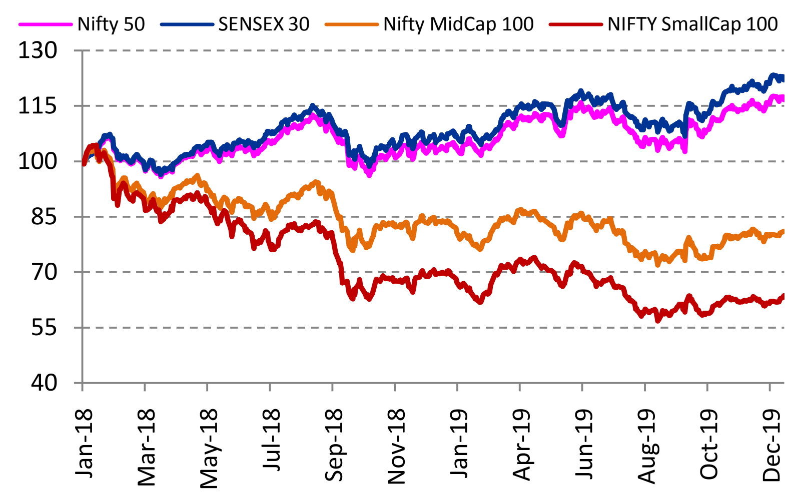
Chart 17: Weightage of top-10 Nifty components over time in the index



Source: NSE, Valentis Research

The rally over past 2 years was led only by large cap stocks. From Jan 2018 to December 2019, the mid-cap index was down 19% and the small cap index 36% vs the 17% rise in the Nifty

Chart 18: Relative Index return (%) - Sharp Under-performance by the mid and small caps



Source: ACE Equity, Valentis Research

Over the past 2 years, 48% of the stocks are still down over 50%.

Table1: Stock performance since LTCG introduced

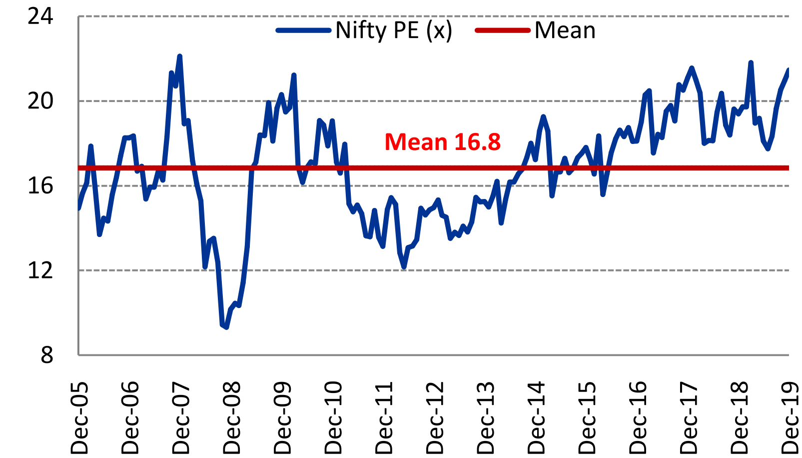
Return (%)	% of Stocks
50% +	4%
20% - 50%	4%
10%-20%	3%
0-10%	3%
(10%) - 0%	5%
(20%) - (10%)	5%
(20%) - (50%)	28%
(50%) +	48%
Total	**100%**

Source: ACE Equity, Valentis Research

Chapter4: Valuations in neutral to slightly expensive

Returns in the market over past few years have been driven by re-rating rather than earnings growth. This has resulted in valuations, especially earnings based like PE ratio becoming expensive in a historic context.

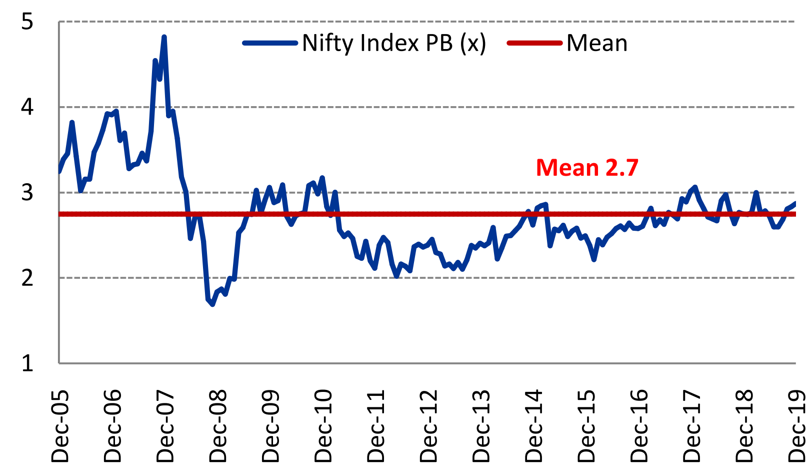
Chart19: Nifty 12M Forward P/E (x)



Source: MOSL, Valentis Research

Valuations on a P/B are not looking that expensive though falling RoEs are leading P/B ratios lower.

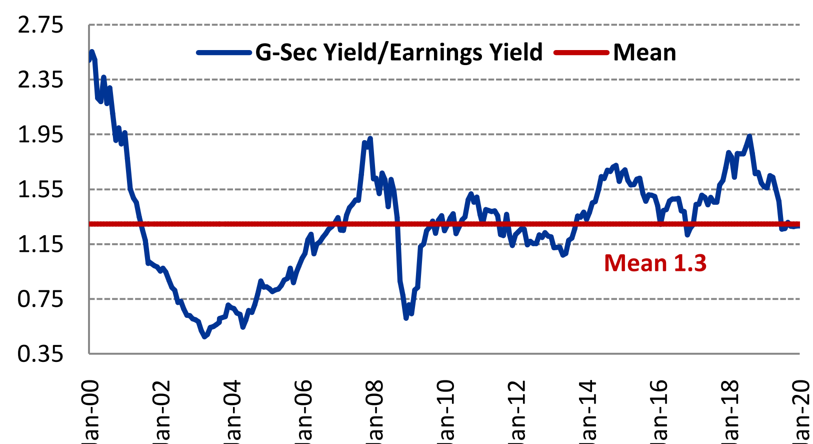
Chart 20: Nifty 12M Forward P/B (x)



Source: MOSL, Valentis Research

However, high PE ratios are a norm globally given the low interest rates. In India too the bond yield vs Sensex yield is in neutral territory. We hope earnings recover before bond yield start reverting to mean.

Chart 21: Bond yield Vs SENSEX yield



Source: MOSL, Valentis Research

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Chapter5: Will good quality continue to perform?

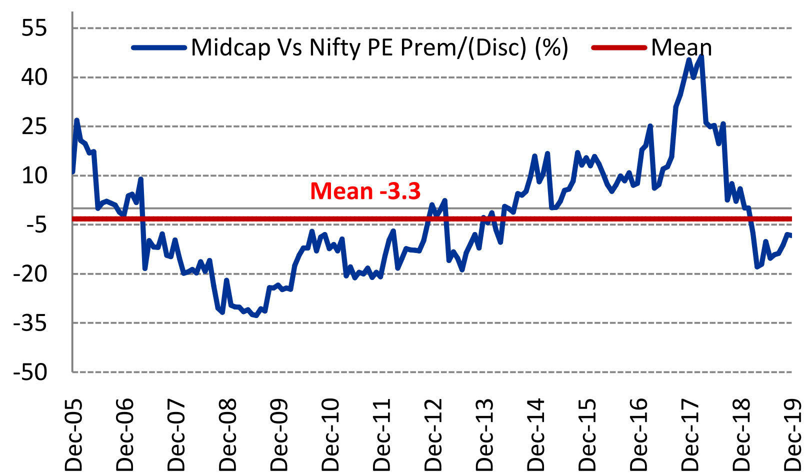
Since the global financial crisis we have seen high quality growth stocks in India become more and more expensive as they have outperformed substantially. This is true across the world as value stocks peaked in 2007 and their performance relative to growth stocks is at a multi-decade low. We think this will reverse as the economy revives

Chart 22: World Value Index as proportion of World Growth Index

Source: Valentis Research

Mid-caps are looking attractive from a valuation perspective…

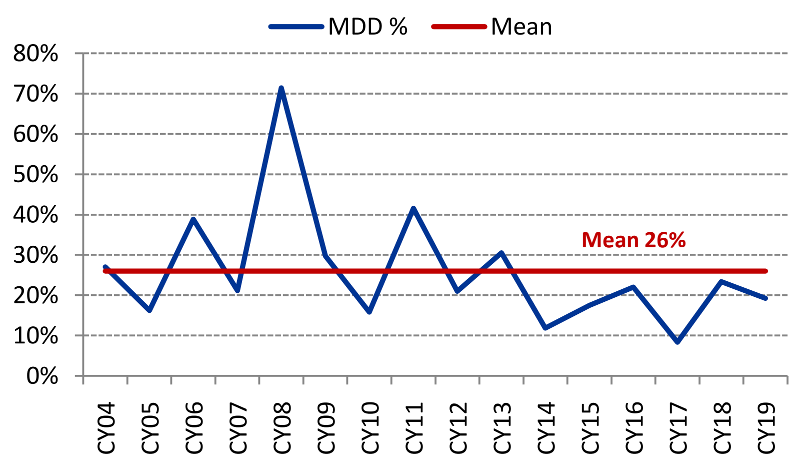
Chart 23: Midcap Vs Nifty PE Prem/(Disc) (%)



Source: MOSL, Valentis Research

… though volatility in mid-caps is a given. The average drawdown (fall from the peak) every year in mid-caps is 26%.

Chart 24: Maximum Drawdown of MidCap Index



Source: ACE Equity, Valentis Research

Till CY19, we had not seen 2 consecutive years where:

1. *The mid-cap index gave a negative return*
2. *The mid-cap index under-performed the large cap index.*

Given this the probability of a mean reversion is very high with a strong positive performance from the mid and small caps as well as an outperformance to the large caps.

Table 2: Midcaps outperformed 11 out of 19 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%
CY19	12%	-4%	-16%	-10%	-22%
Average	**17%**	**24%**	**7%**	**22%**	**5%**

Source: Valentis research, ACE Equity

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