Valentis Advisors

Q4FY21 - Looking back, looking ahead

April 20, 2021

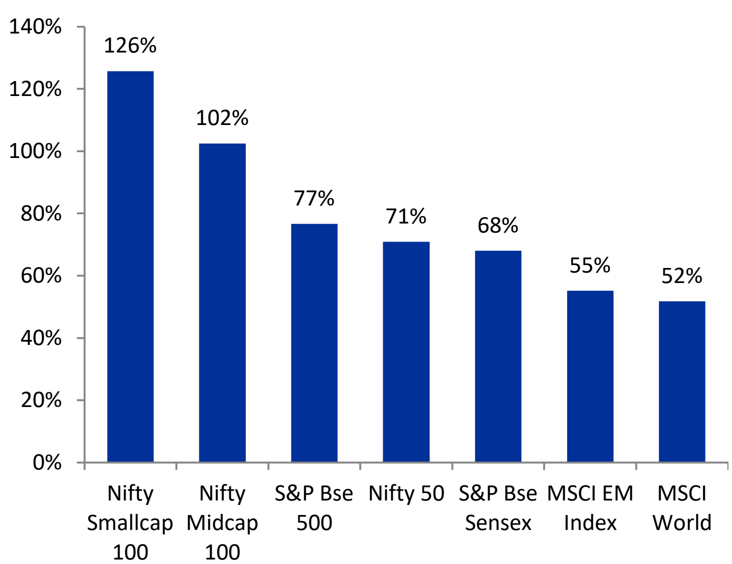
Looking back….

FY21 has turned out to be an unbelievable year – the fastest drop in markets in history followed by a breath-taking rally in the wake of a once in 100 year pandemic. In our note dated April 4, 2020 (https://www.valentisadvisors.com/insights/market-update-4th-april-2020/) we had stated that based on past trends, we would expect markets to reach its earlier highs in 12-24 months. Ultimately, it reached there in less than 8 months!

A quick recap of FY21:

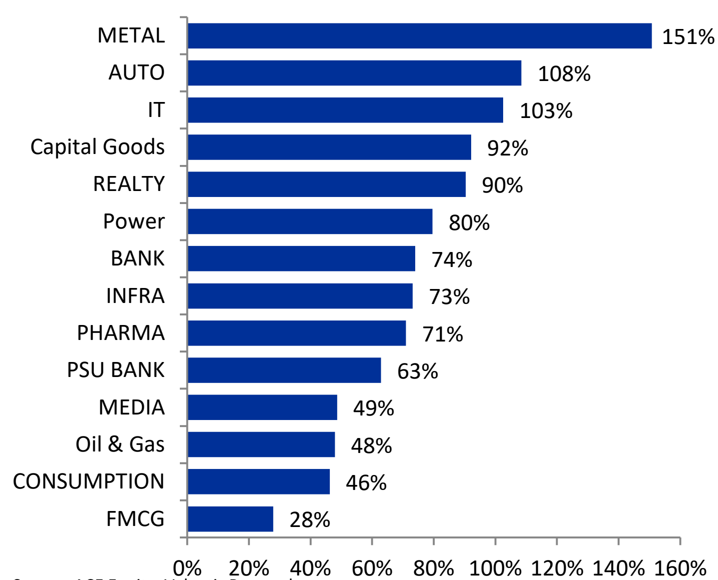
1. Nifty rallied 71% beating the MSCI Emerging market index which was up 55%
2. The broader markets outperformed the large caps with the small cap index being the best performing followed by the mid-caps indices.
3. FIIs pumped in over Rs 270 bn into the markets while the domestic institutions sold nearly Rs130 bn of stock.
4. Metals were the best performing sector by far followed by autos and Software. FMCG under-performed due to expensive valuations. Other laggards included oil and gas and banks.

Chart 1: Indices performance for FY21



Source: ACE Equity, Valentis Research

Chart 2: Sectoral performance for FY21



Source: ACE Equity, Valentis Research

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Looking ahead – a pause before a steady climb up

In our Year Ahead note (2021: The year of Normalization dated January 20, 2021 https://www.linkedin.com/posts/valentis-advisors-pvt-ltd_where-will-markets-go-in-2021-activity-6757592909400326145-XFE9) we had highlighted our key themes for the market for CY2021

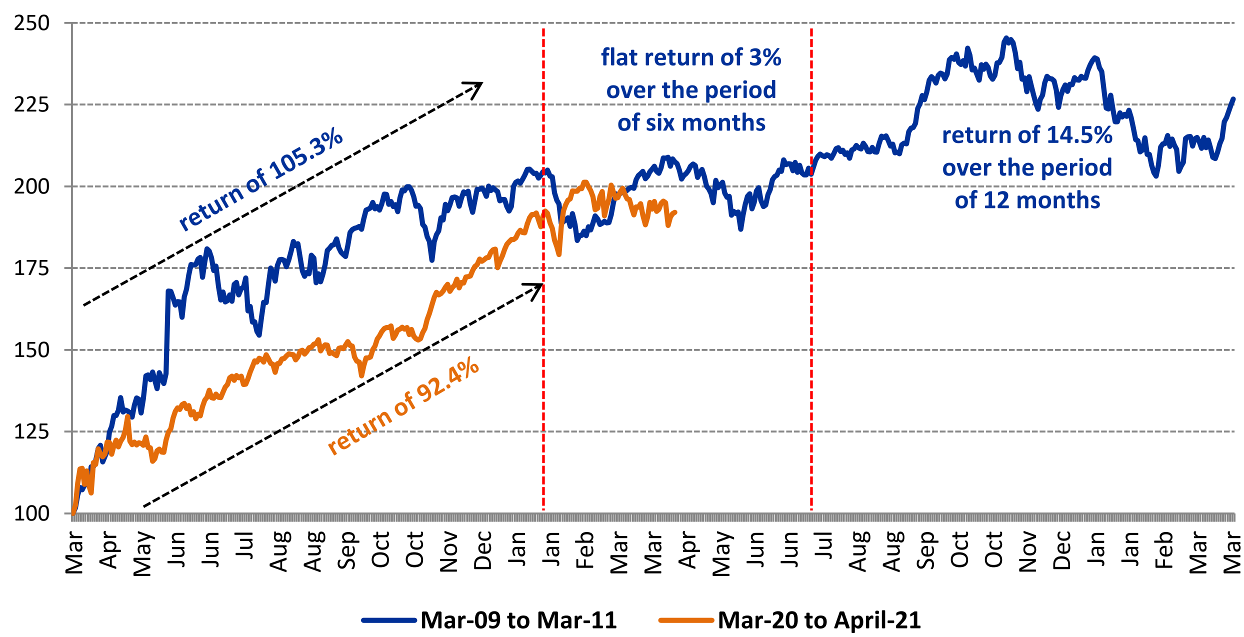
1. We would see CY2021 give a positive return of low double digit.
2. Returns would be led by earnings growth with valuations already expensive.
3. Small caps and mid-caps would outperform large caps.
4. Economic revival would be a battle between virus wave vs vaccination
5. Rise in bond yields on the back of worries of inflation coming back can spook the markets.

Near term we can see a time and price correction – similar to the 2009-10 markets?

While there is no change in our broad themes for the market outlined above, we think after the sharp rally in FY21, we could see a near term price and time correction as the market takes a breather.

The market move in 2009-10 provides a template of how we see the market moving this year. After a 100%+ return between March 2009 and January, 2010, markets had a flat period over the next 6 months (also gave a price correction of 10% correction within that period). Post the market consolidation, we saw double digit returns again in the next 12 months.

Chart 3: Market move



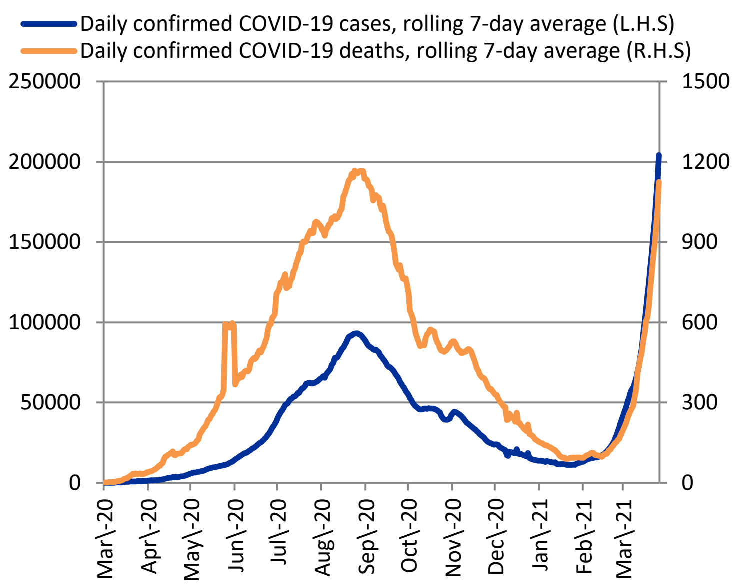
Source: ACE Equity, Valentis Research

Key market drivers

#1: Virus 2nd wave is hitting India hard

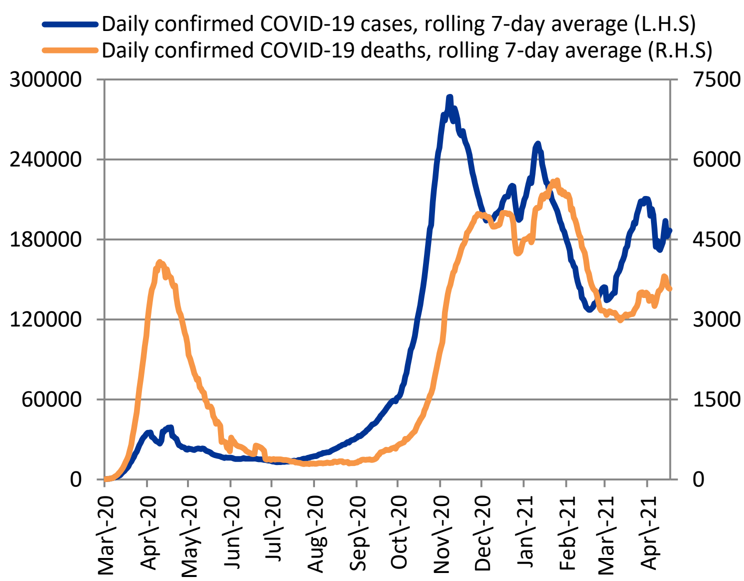
The second wave of the virus has hit India hard and the virus seems to be spreading much faster than earlier. Probably a bit of complacency had crept in and India opened up too fast in allowing cricket matches with spectators, election rallies, religious gatherings etc. The second wave is similar to what we have seen in other countries and hence it should not be that big a surprise.

Chart 4: India covid cases



Source: ourworldindata.org, Valentis Research; updated as of 18th April 2021

Chart 5: Europe covid cases



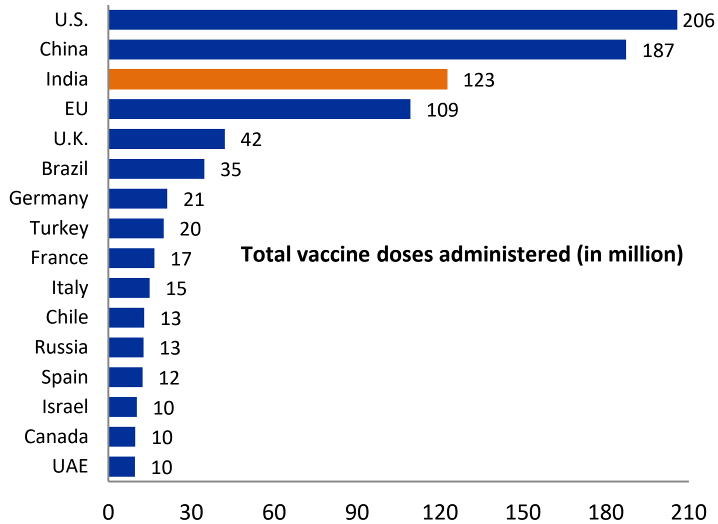
Source: ourworldindata.org, Valentis Research; updated as of 18th April 2021

The virus strain this time seems to be a new double mutated strain which is (a) hitting the younger population (under 45 years) more than the earlier strain (b) It is more infectious and spreading faster and (c) RT PCR tests are often not able to detect it.

Unlike the national lockdown of March 2020, we are seeing local lockdowns which are not as severe. But it will hurt the fledging recovery to some extent. We are hoping we will be able to control the virus faster than last year since:

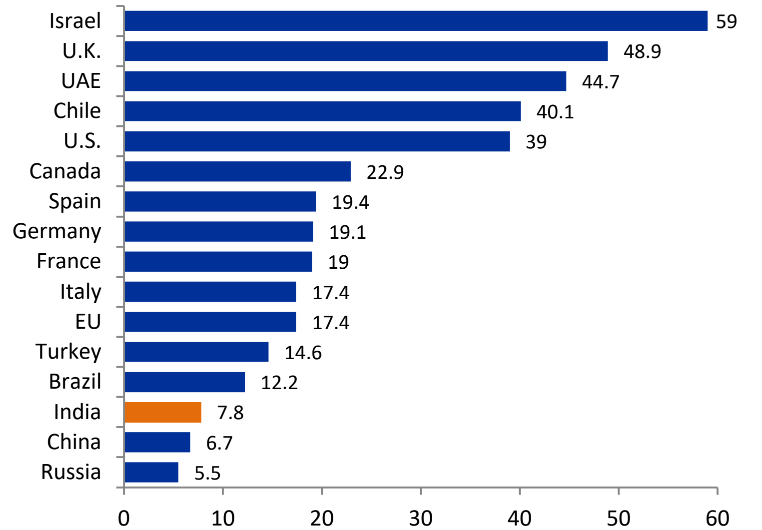
(a) We have a better understanding of the virus and the protocols to be followed (masks, social distancing, washing hands regularly).
(b) Vaccination will provide some safeguard against a severe infection

Chart 6: The road to end the pandemic has started



Source: Bloomberg.com, Valentis Research; updated as of 18th April 2021

Chart 7: Covid vaccination doses administered per 100 people



Source: Bloomberg.com, Valentis Research; updated as of 18th April 2021

#2: Rupee depreciation not great for markets

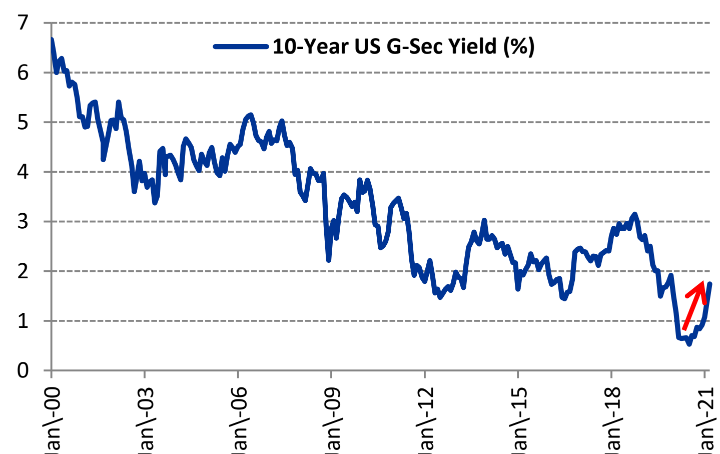
After being stable for a long period, the rupee depreciated by nearly 4% as RBI attempt to cap rising bond yields (through the announcement of G-SAP) resulted in a weaker currency. INR is now at a 9-month low. There can be some pressure on the Current Account Deficit due to rising oil prices and increased gold imports. Rising US bond yields and increase in Covid cases could put some pressure on the FII flows. But overall we think the currency is unlikely to weaken substantially. Periods of weakening rupee, however, have seen weaker stock markets.

Table 1: Rupee vs SENSEX 30

Period	Rupee depreciation	SENSEX Performance
Aug 2013	16.5%	-8.9%
Mar 2012	10.3%	-4.8%
Oct 2008	9.3%	-30.2%
Sep 2011	8.8%	-4.7%
May 2010	7.3%	-9.7%
Mar 2009	7.1%	-12.6%
Mar 2020	6.7%	-35.2%
Sep 2018	5.6%	-3.8%
Sep 2015	4.9%	-11.8%

Source: investing.com, Valentis Research

Chart 8: US 10 year bond yield (%)



Source: investing.com, Valentis Research

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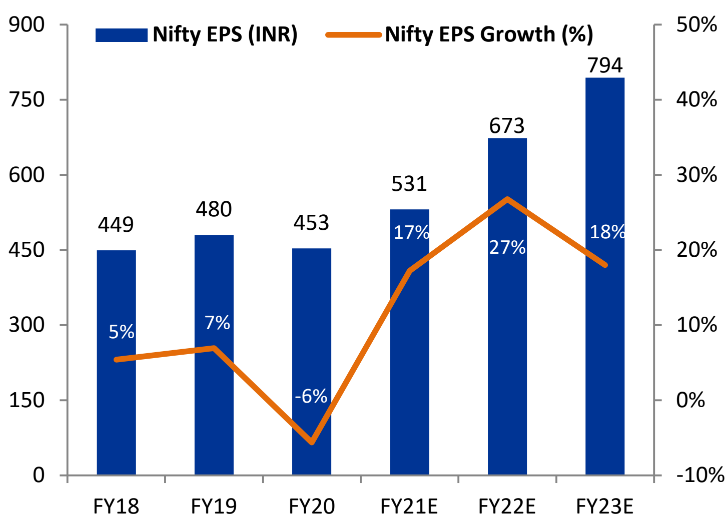
#3: Earnings upgrades could see a pause

In spite of nearly 2 months of a strict lockdown in April and May 2020, FY21 is likely to see an earnings growth of over 15% which is the highest since FY11. We are expecting a 27% growth for FY22. More significantly, earnings have seen upgrades since Sept 2020 after a long spell of over 5 years of earnings downgrades. While we continue to believe that earnings are set to double over next 4-5 years, we could see a sequential slow-down in earnings this quarter and some downgrades led by:

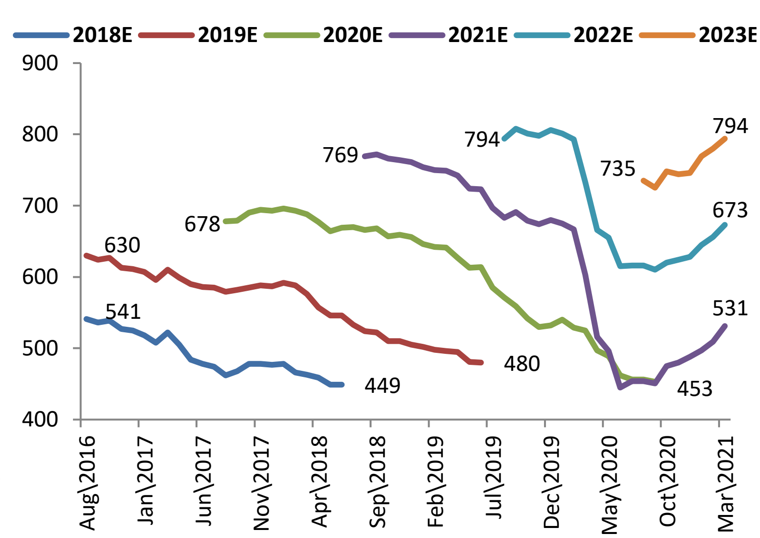
1. Lock-downs in many parts of the country will lead to slowing sales. Unlike the first wave of Covid19 a year ago, this time rural India also has seen a surge in Covid19 cases.
2. Cost pressure is increasing with a rise in commodity prices as well as logistic costs. Salary costs have also normalized for most companies.

Chart 9: Nifty Earning growth (%)



Source: Kotak Institutional Equities estimates, NSE, Valentis Research

Chart 10: Nifty EPS estimates trend, 2018E-23E (Rs)

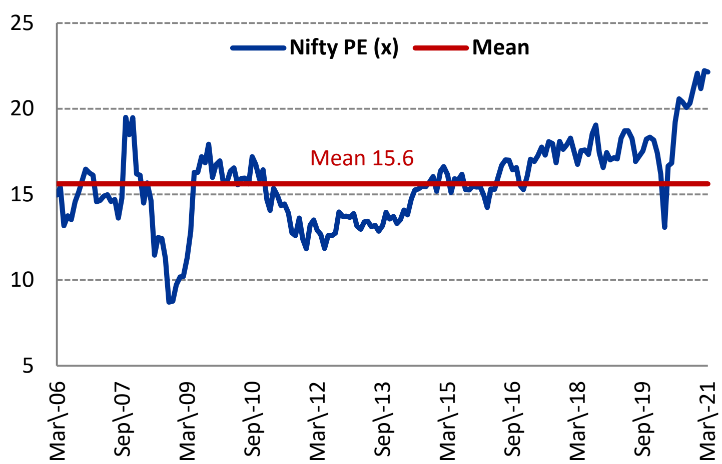


Source: Kotak Institutional Equities estimates, NSE, Valentis Research

#4: Valuations not cheap especially if earning comes under pressure

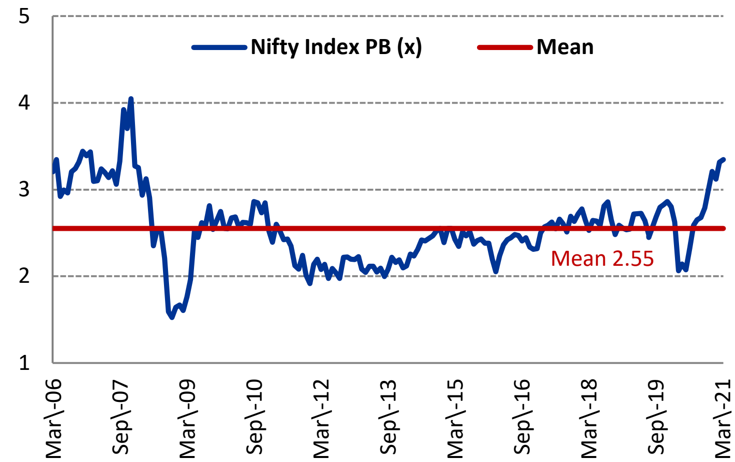
Valuations in India were not cheap and our view was that stock market returns would be driven by earnings growth with valuations likely to gradually compress slightly. Valuations were justified by (a) revival in earnings which are at the bottom of the cycle and (b) low interest rates. In case earnings slow near term, we could see valuations being questioned.

Chart 11: Nifty 12M Forward P/E (x)



Source: Edel, Valentis Research

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

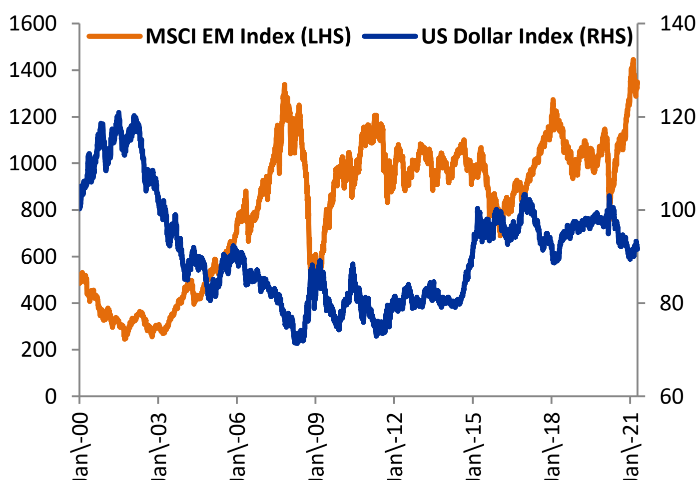


Source: Edel, Valentis Research

#5: Dollar strength signaling back to developed markets vs EM?

While we think EMs will outperform US over the next few years, near term we think Emerging markets will lag as (a) US Dollar has seen some strengthening from its low past few weeks (b) The developed world has been vaccinating their population much faster and (c) The US remains focused on stimulus plans to revive growth.

Chart 13: Dollar Index vs Emerging Market index



Source: Investing.com, Valentis Research

Table 2: US Govt. announces yet another stimulus plan in March

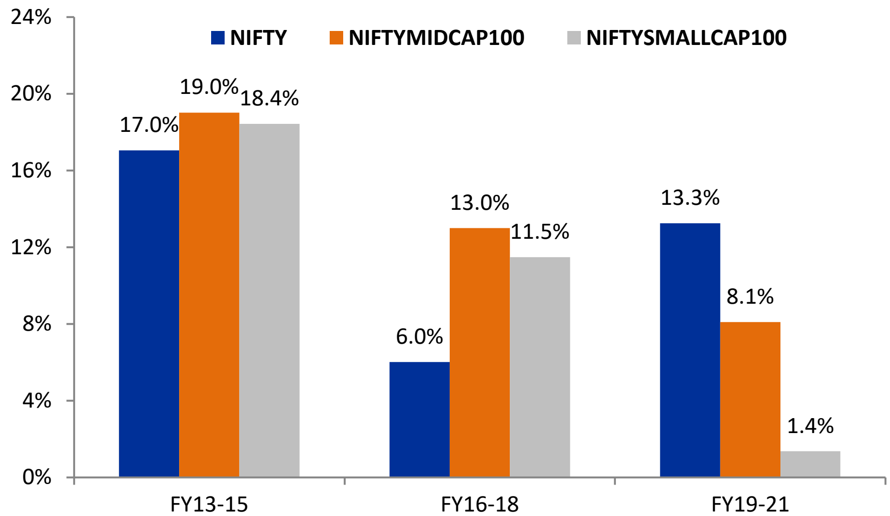
Stimulus and relief package	Date of release	Size
Phase one	March 6, 2020	USD 8.3 Bn
Phase Two	March 18, 2020	USD 3.4 Bn
Phase 3–The CARES Act	March 27, 2020	USD 2.3 Trn
Phase 3.5	April 24, 2020	USD 484 Bn
Phase 4	December 21, 2020	USD 900 Bn
Phase 5 –American Rescue Plan Act	March 11, 2021	USD 1.9 Trn

Source: Edelweiss Investment Strategy report April 2021, Valentis Research

Portfolio Update

Our Rising Stars portfolio was well positioned to benefit from the revival in small and mid-caps over past year. The 169% return in FY21 placed us 3rd in overall returns across all PMS portfolios in India (Source: PMS Bazaar). While, small caps and mid-caps outperformed large caps over the past 1-year, they have under-performed sharply over a 3-year period. We think an economic revival will continue to drive small and mid-cap outperformance over next 12-18 months.

Chart 14: 3 year CAGR performance of Indices



Source: NSE India, Valentis Research

Our philosophy through last year was adopting a barbell portfolio with one end having sectors like pharma which were "gainers from lock-down" and on the other end of the barbell have economy-related value plays which would gain from the "opening up trade". We had added weight to the opening up trade towards the end of first half of FY21 which played out well. Over the past few weeks, we have built some cash in the portfolios to gain from a possible correction in markets. We think the barbell portfolio combined with the cash that we have built in the portfolios position us to benefit from any near term market corrections.

Chart 15: Valentis Rising Star Opportunity Fund Portfolio Performance

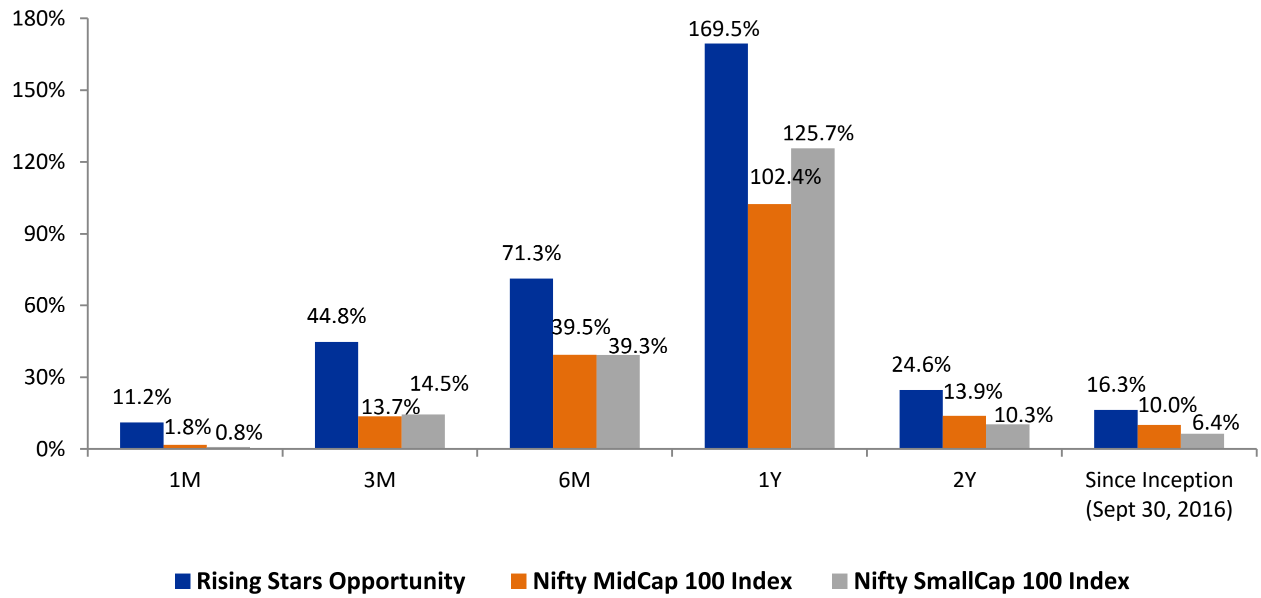
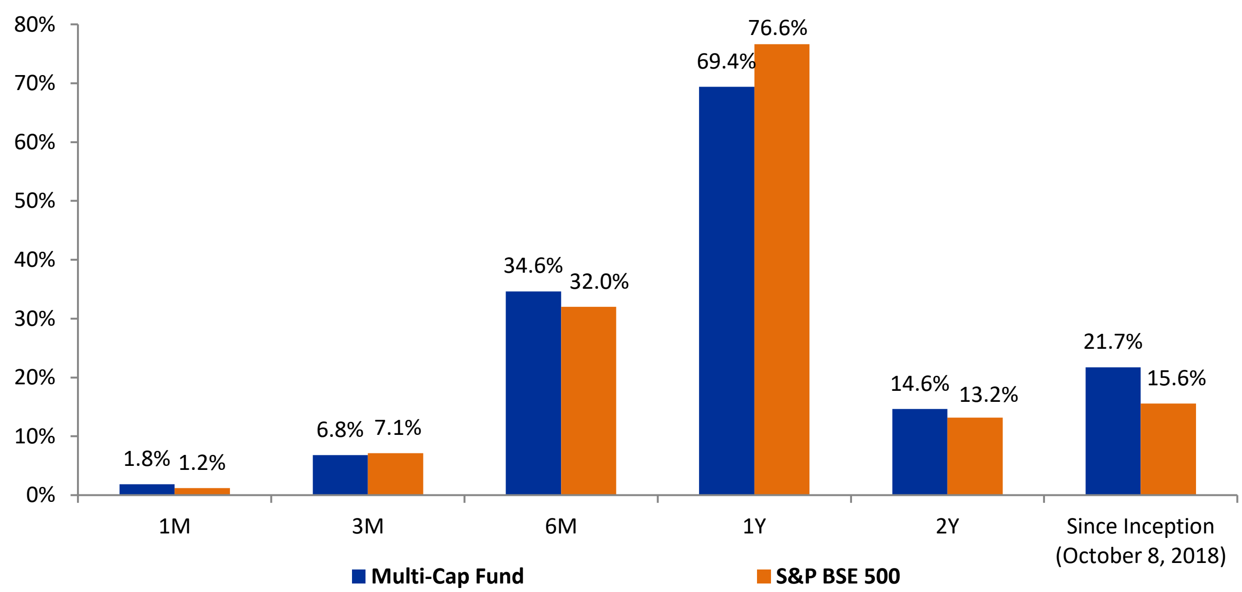


Chart 16: Valentis Multi-Cap Fund Portfolio Performance



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