Valentis Advisors

Green Light Turns amber

July 13, 2020

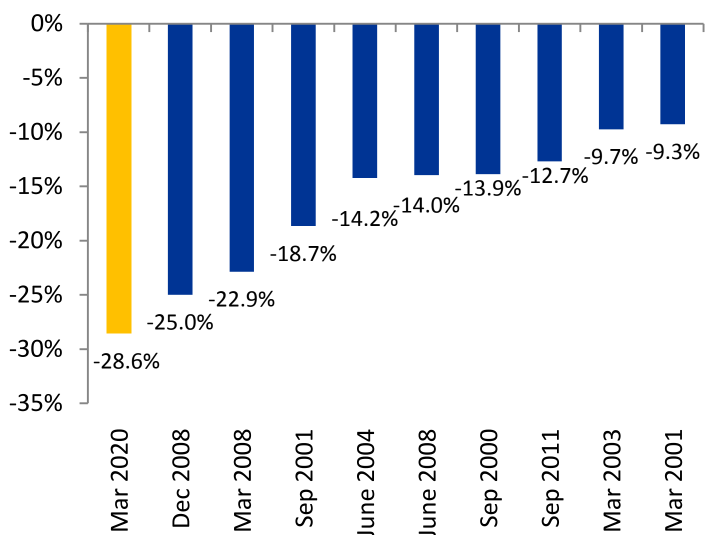
Key points

- **The pandemic is far from over. Near term, all eyes of the market will be monitoring developments on the vaccine front as well any medical cure. Longer term, we remain positive that we are at a low point of the earnings cycle and see a strong spell of earnings over next few years.**
- **Yet, near term, after a strong performance of near 45% from the lows in March we expect a consolidation and correction phase. We see 3 factors driving a correction: (a) Valuations are no longer cheap (b) Increase in virus infections and consequent lockdowns in India and USA could stall the fledging economic recovery (c) The Fed is starting to slow its monetary stimulus as panic subsides.**

What a change a quarter makes!

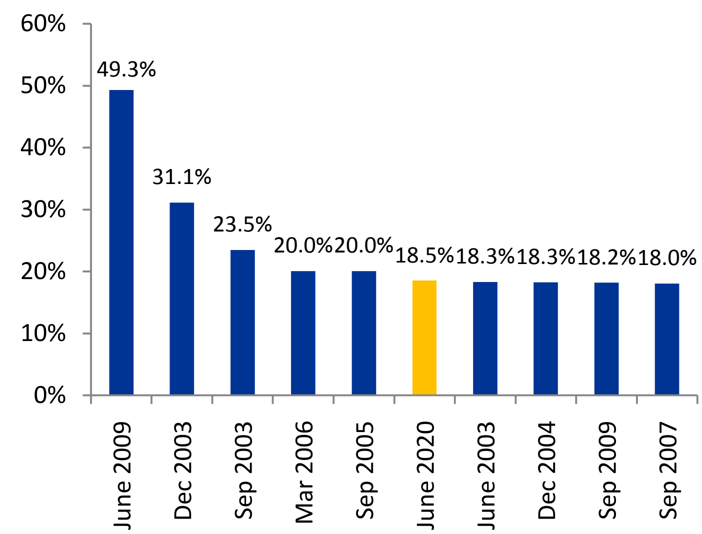
The March 2020 quarter was the worst in history. We have seen a strong rebound since then with the June quarter being the best quarter for stock market performance since the June 2009 quarter.

Chart 1: Worst quarters for markets (% fall)



Source: ACE Equity, Valentis Research

Chart 2: Best quarters for markets (% rise)

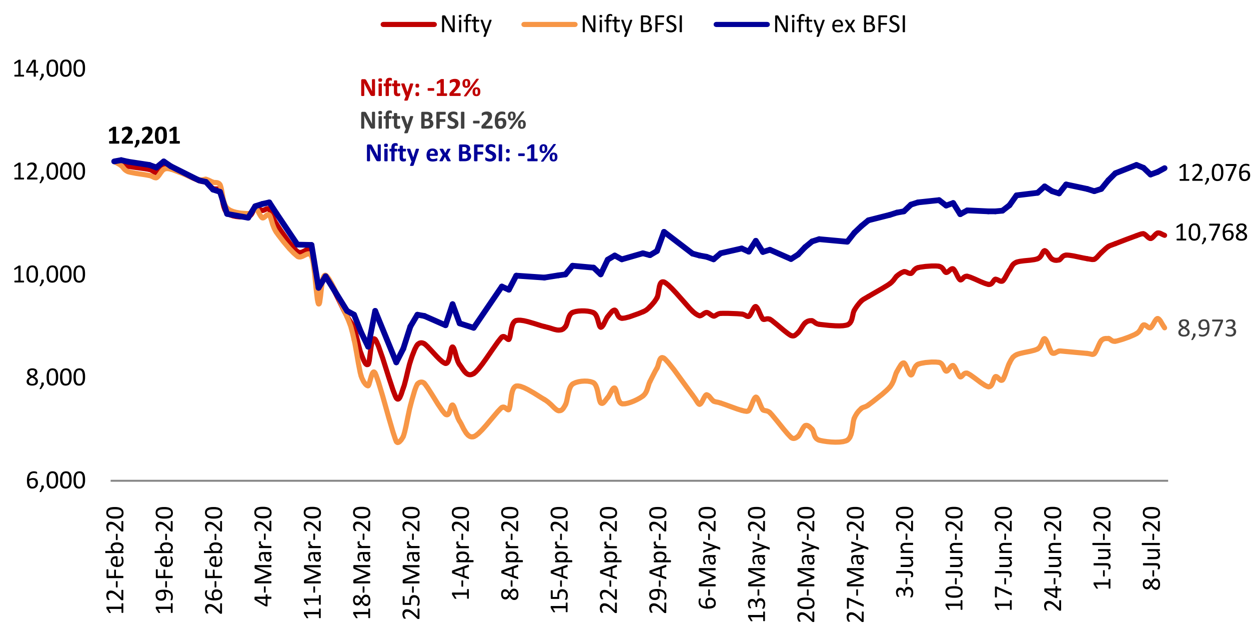


Source: ACE Equity, Valentis Research

Nifty ex-BFSI near highs

Interestingly, while the Nifty is still 13.4% lower than its all time highs that it hit in Jan 2020, the banking and financial sector stocks have been the prime culprit of the fall. If we construct a Nifty ex-BFSI index, that index is just 1% below its all time high (Reliance is a big contributor to the performance).

Chart 3: Nifty, Nifty BFSI & Nifty ex BFSI



Source: MOSL, Valentis Research

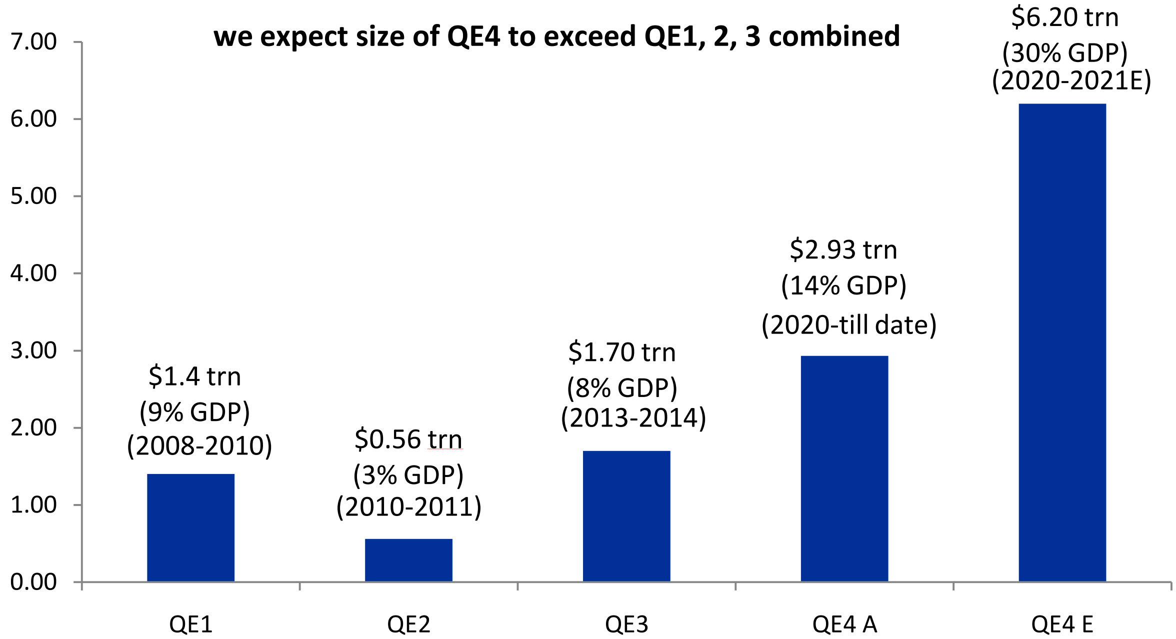
What is driving the market rally?

In our earlier note dated **April 4, 2020** titled **Fear, uncertainty and opportunity**, we had pointed out that investors should buy the market since we had a rare convergence of (a) attractive valuations (b) bottom of the cycle earnings and (c) weak sentiment. The sharp rally has borne out this framework. Near term, however, some of the parameters, especially valuations, are no longer as positive for a further rally indicating we could see some consolidation phase. However, we are still far away from where these factors tend to peak out. We would look at a temporary pause in the rally

1. Easy global liquidity

Most global central banks have provided a strong monetary stimulus to combat the economic weakness led by the pandemic. This has had a positive effect on asset prices. We believe the Fed will have a larger stimulus this time than QE1, QE2 andQE3 combined.

Chart 4: Fed liquidity



Source: Federal Reserve, Valentis Research

2. Economic activity reviving from the lows

Post the lifting of lockdown in most parts of the world, we are seeing economic activity reviving from its lows though it is still far from normalized levels. In India too, economic activity had ground to a halt in April. While companies struggled with labour and logistic issues in May, we have seen a better than expected revival in June and economic activity has reached 60-70% of normal.

3. Positive hope on vaccine and medicines

One eye of the market remains focused on the availability of a vaccine or a medical treatment which would put the fear of the pandemic behind us. While the medicines have still not been very conclusive, there is hope on the vaccine front with few companies starting Phase 3 trials in next few weeks.

Investment outlook: a short term correction ahead?

For all the positive momentum on the economy, we have to remember that the pandemic is far from over. Looking at the example of the Spanish flu, we must guard against a second wave. For countries like India and USA, we are probably seeing an acceleration of cases in the first wave itself.

From a medium term outlook, we are still positive. If we look at our 3 key market driver model, (a) we are still at a low point of the earnings cycle and that will remain the primary driver for markets (b) valuations are at fair value levels though no longer cheap (c) trailing returns in equities are still poor and hence mean reversion is likely.

Near term, we think the key positive would be the availability of a medical cure or a vaccine. There is lot of focus on the Oxford vaccine which has entered Phase 3 trials. There is a possibility that we hear some positive news by end September if the trials go well. Of course, the actual availability of the vaccine in terms of production and distribution will take many more months. But the market will start discounting an end to the pandemic if we see a green light on the vaccine.

Meanwhile, we think after a 43.4% rise in the nifty from its lows in March, 2020 we are entering a correction and consolidation phase in the markets. We have held some cash in the portfolios and hope to use corrections as better buying opportunities. We think the correction will be led by:

1. **History indicated re-test to the lows**

As seen in the table below, sharp corrections were always followed by a quick rally. But the market re-tested the lows over a 4-6 month period following 20-25%. It is likely that we get a correction phase even if we don't go to the panic lows of March.

Table 1: Past market meltdowns

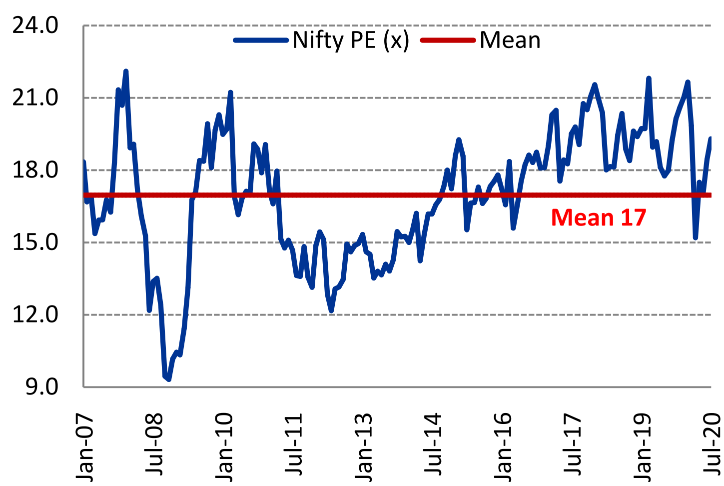
Bottom date	Bottom Price	Correction	Retest Bottom date	Retest Bottom Price	Retest correction	Period between two bottom (in months)
06-Aug-92	2529.59	-43.4%	19-Nov-92	2479.56	-27.3%	4
22-May-00	3920.18	-33.9%	23-Nov-00	3852.40	-22.4%	6
20-Nov-08	8451.01	-59.5%	09-Mar-09	8160.40	-21.0%	4

Source: ACE Equity, Valentis research

2. Valuations no longer cheap

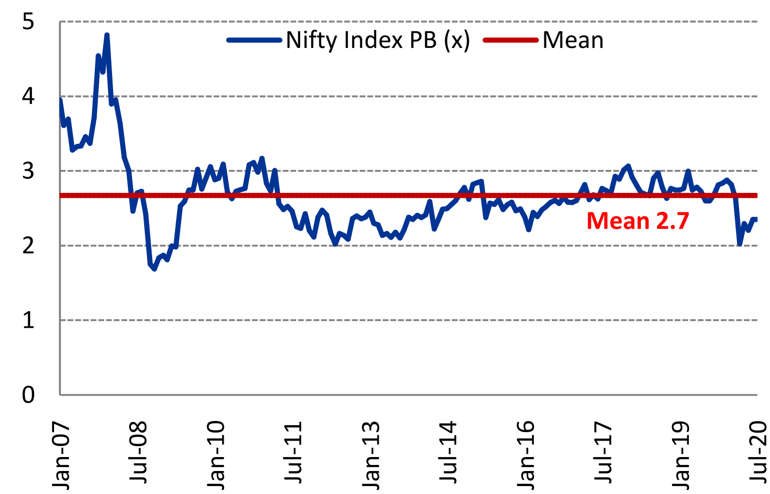
After the sharp rally, valuations are no longer cheap but have inched closer to fair value. On a PE multiple markets are trading at 19.3x, well above long term valuations. However, given current extra-ordinarily depressed earnings, we think the P/B is a better measure. The P/B is currently at 2.4x, below a long term average of 2.7x but well above the lows of 1.7x.

Chart 5: 12M forward Nifty PE



Source: MOSL, Valentis Research

Chart 6: 12M forward Nifty Index PB (x)

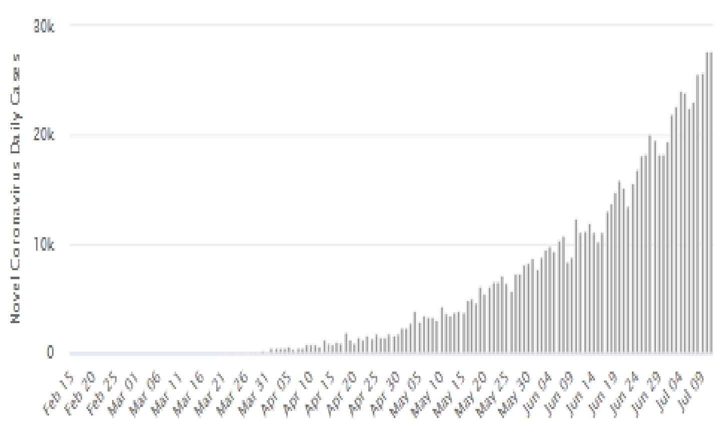


Source: MOSL, Valentis Research

3. Another spate of lockdowns may hamper economic recovery

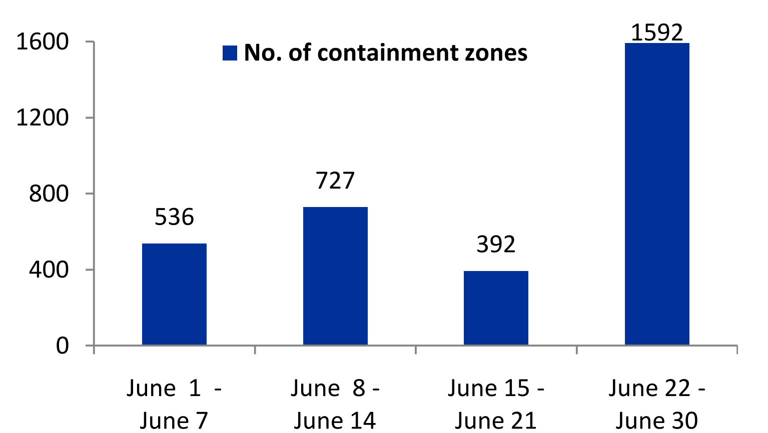
The rise of corona cases in India is leading to a renewed phase of lockdowns in many states. While there is no national lock-down like in March and April, there have been a reversal of the opening up in many places like Orissa, Assam, Bengaluru etc, This could reverse the positive momentum in the economy.

Chart 7: Daily new cases in India



Source: www.worldometers.info, Valentis Research

Chart 8: Containment zones in India on the rise



Source: Legistify, Valentis Research

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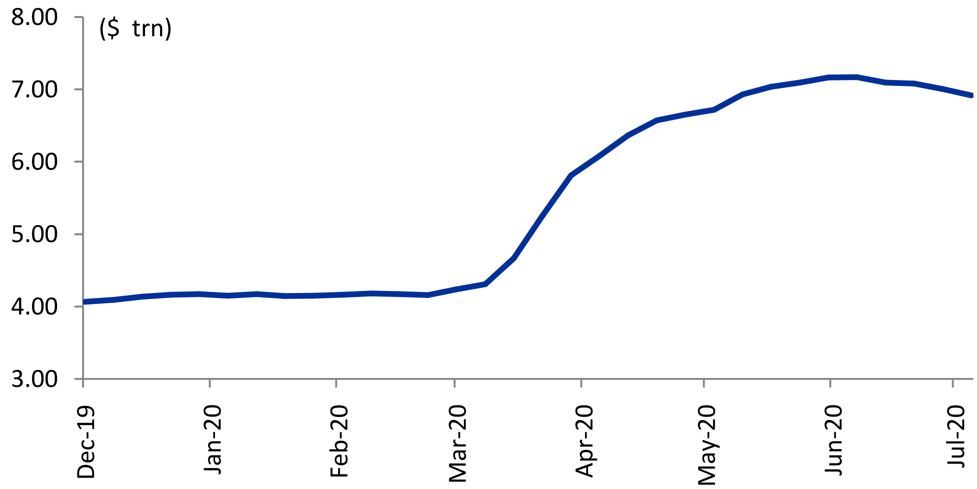
4. Fed going slow on balance sheet expansion

The rally in the stock market has eased the pressure on the Fed to continue to add to the monetary stimulus. We have seen the Fed balance sheet stagnate over the past 8 weeks.

Chart 9: Federal Reserve Balance Sheet (USD Trillion)



Source: Federal Reserve, Valentis Research

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