Valentis Advisors

2021: The year of normalization

January 20, 2021

2020 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. With markets now expensive, what does 2021 hold for investors? We answer this and many more questions through easy to read charts in this report. Key points in brief:

#1: Re-rating behind us; earnings to drive stock market returns

1. GDP growth, both in India and globally, has recovered much faster than expected. We expect GDP growth to be over 10% for FY22 as a vaccine helps a V-shaped recovery.
2. Earnings growth is likely to be close to 30% in FY22 after surprising with a positive double digit growth in FY21 in spite of a lock-down in April and May.
3. More importantly earnings have seen upgrades in the September 2020 quarter after over 4 years.
4. Spoiling the pretty picture, however, are valuations which seem to have priced in most of the good news. Re-rating of markets is behind us and onus is now on earnings to drive stock market returns.

#2: Time and price correction likely but we see no major crash

We expect markets to see a price as well as time correction. A 10-15% price drawdown is a normal event practically every year. We could see a correction followed by a dull and boring range-bound market for a few months.

#3: Sharp falls typically lead to big sectoral shifts

Typically after we see a 30-50% fall in markets, the next rally is rarely led by the same stocks or sectors. What could we see going forward?

1. **Emerging market could outperform developed markets:** Since 2008 developed markets are up 325% sharply outperforming emerging markets which are up a more modest 250%. A period of dollar depreciation and better global growth could lead to emerging market outperformance going ahead.
2. **Value outperforms growth:** The market since 2008 has been characterized by high quality stocks becoming more and more expensive. Value performance vs growth is at a

multi-decade low. We could see high quality but expensive consumer stocks under-perform next few years.

3. **Small caps can out-perform large caps:** Over past 3 years, small caps have been major laggards – the small cap index is down 2% CAGR vs a 12% rally in the large caps. With a pickup in growth outlook, we could see small-caps outperform large caps.

#4: Risks to watch out for

1. **V(accine) shaped recovery stalls:** The premise of a continued economic recovery is based on expectations of the pandemic being behind us as the population is vaccinated. However, the past few weeks have shown that logistics may mean a slower than expected vaccine roll-out even as another wave of virus leads to further lock-downs. In case lock-downs persist or the vaccine fails, growth could stall again.
2. **Interest rate rises as inflation worries surface:** Low interest rates and easy liquidity have been one of the primary drivers of markets. Low interest rates help justify current valuations since they lower the discount rate for the future cash flows. However, a rising trend in inflation could lead to a surge in bond yields and make equity markets nervous. We are already seeing bond yields rising in USA from very low levels. The Fed has stated that they are in no hurry to withdraw easy monetary conditions. Rising inflation rates may start making investors believe they may change their stance.
3. **Fiscal stimulus is withdrawn:** But we believe the bigger risk is of fiscal stimulus being reduced as debt burden of countries become unsustainable. Tax hikes both in the USA and in India could lead to a correction.
4. **Regulatory action against big tech companies:** The FAANG stocks have characterized the stock market rally in the USA this decade. But there has been intense call for more stringent regulatory action globally. Any mandate to break-up these companies for abuse of their monopolistic positions could be negative for markets.

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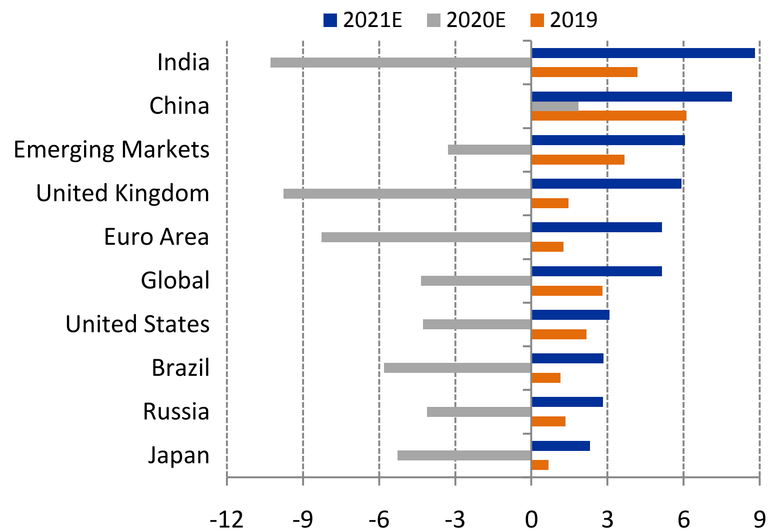
#1 : Re-rating behind us; earnings to drive stock market returns

Just like India, the economy weakened in most large economies on the back of the pandemic. India which was worst hit will be the fastest growing economy in FY22

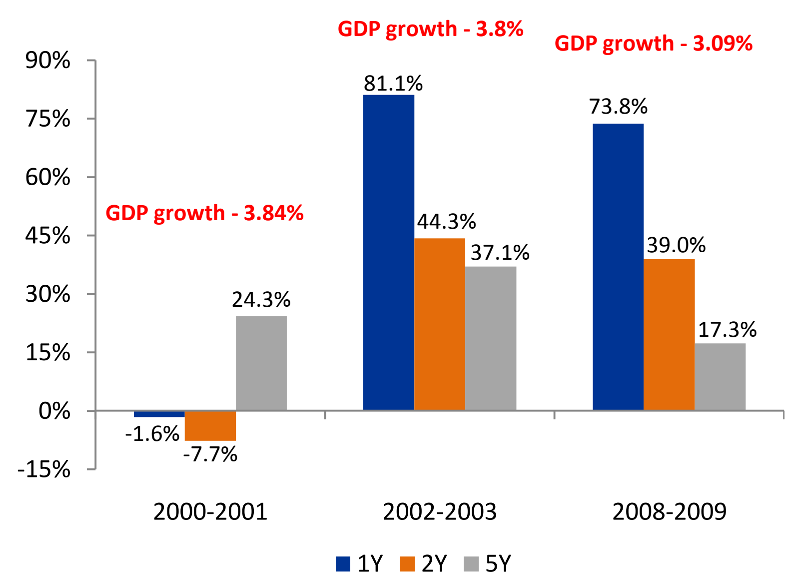
Chart 1: Growth in GDP (%)



Source: IMF, Valentis Research

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

Chart 2: GDP growth and Nifty Index return (CAGR %)



Source: MOSPI, NSE, Valentis Research

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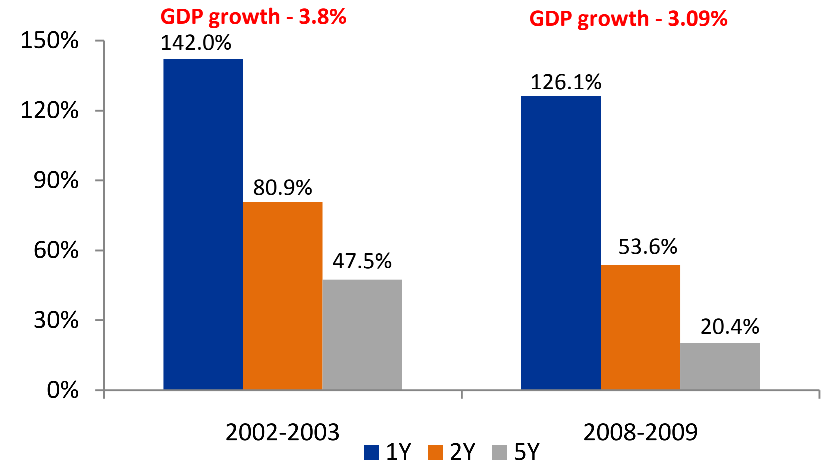
Mid-caps have seen a stronger rebounded than the large cap indices in phases where markets play for an earnings recovery. The average return in 1 year is 95% and the average in 5 years is 29%.

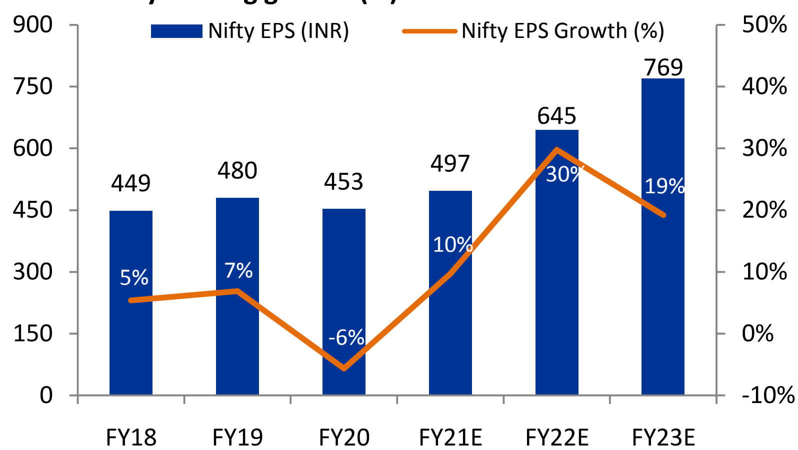
Chart 3: GDP growth and Nifty MidCap Index return (CAGR %)



Source: MOSPI, NSE, Valentis Research

In spite of the pandemic, FY21 will see an earnings growth of 10%, the best in many years. FY22 could see a 30% earnings growth as the economy opens up, partly due to base effect of the lock-down.

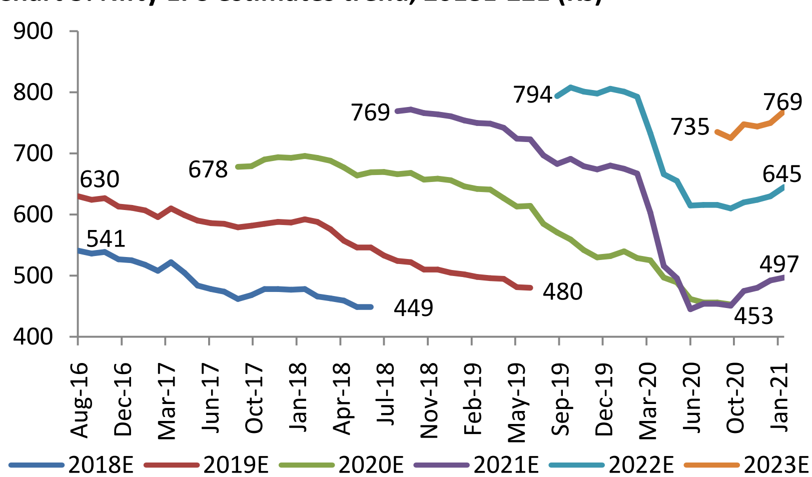
Chart 4: Nifty Earning growth (%)



Source: Kotak Institutional Equities estimates, NSE, Valentis Research

More encouraging is that we have seen earnings upgrades after many years of earnings downgrades. We hope this trend continues next few quarters.

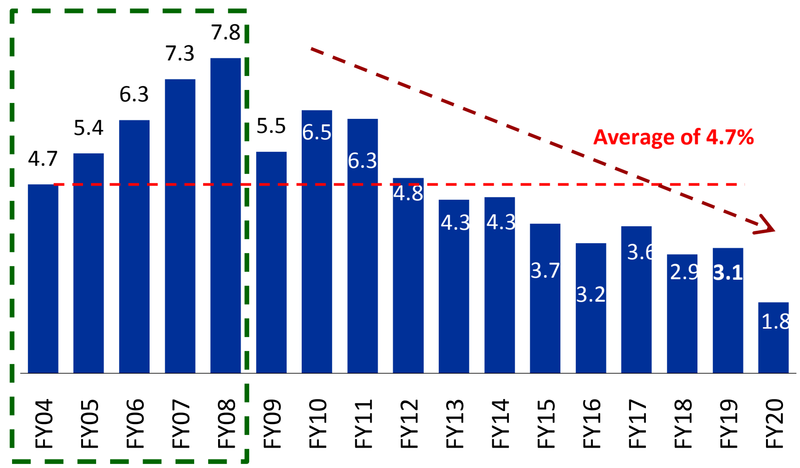
Chart 5: Nifty EPS estimates trend, 2018E-22E (Rs)



Source: Kotak Institutional Equities estimates, NSE, Valentis Research

Can we see a few years of strong earnings? If we look at corporate profit to GDP they are way below average and at levels from which earnings rebounded sharply from FY03 onwards

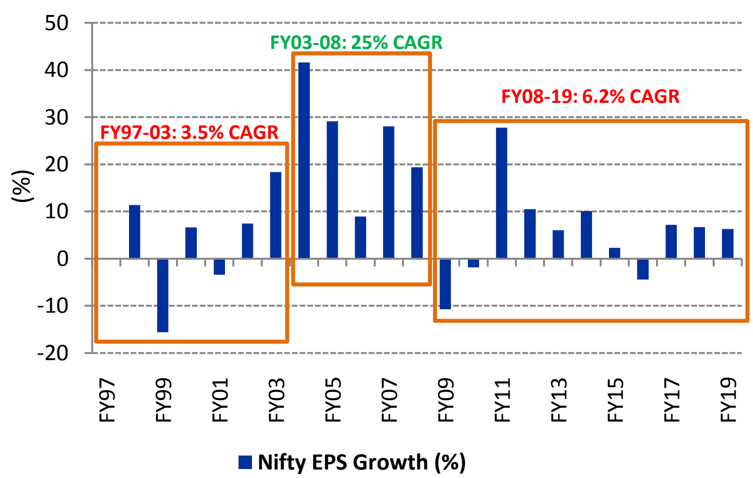
Chart 6: Corporate profit to GDP (%)



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 over next 5 years.

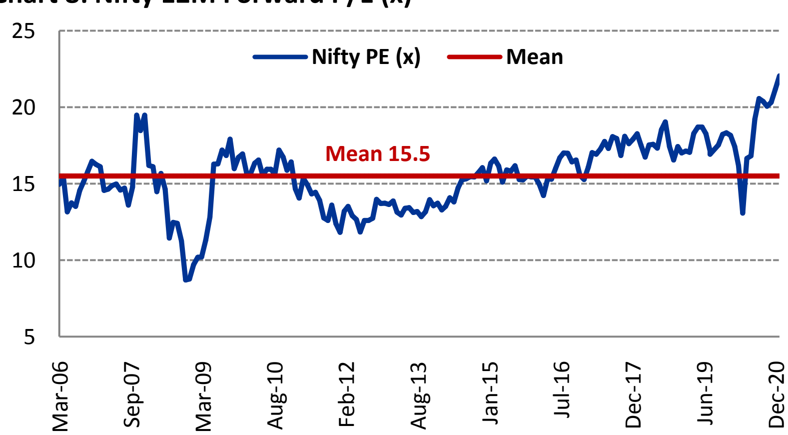
Chart 7: Earnings growth trend: Cusp of earnings recovery?



Source: MOSL, Valentis Research

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.

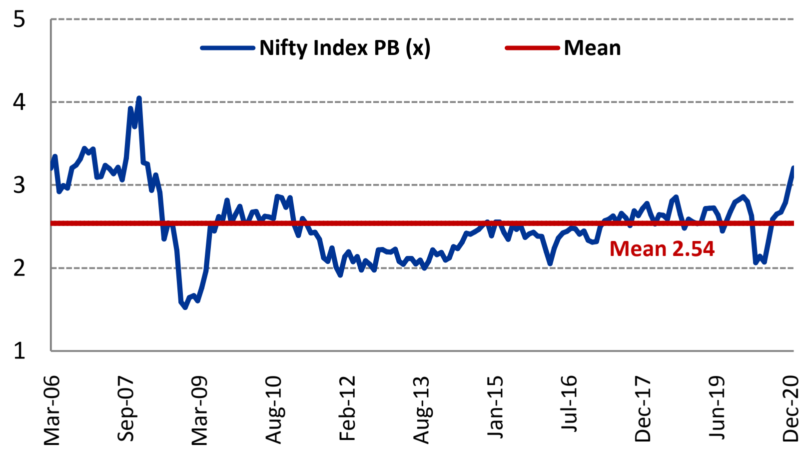
Chart 8: Nifty 12M Forward P/E (x)



Source: Edel, Valentis Research

Valuations on a P/B are also expensive though less demanding than PE ratios.

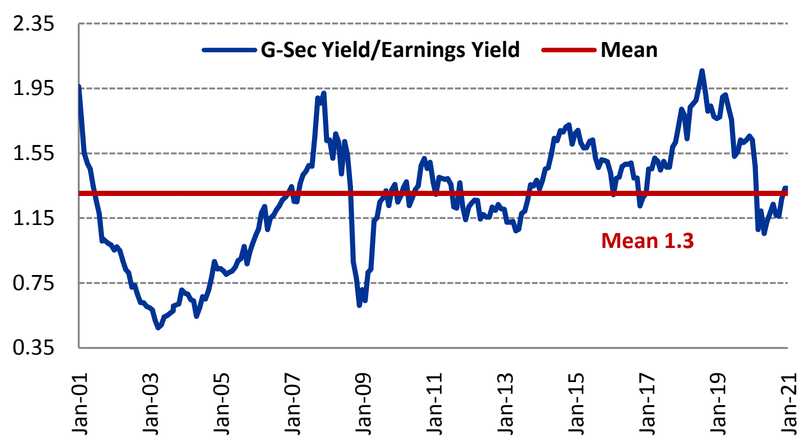
Chart 9: Nifty 12M Forward P/B (x)



Source: Edel, 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.

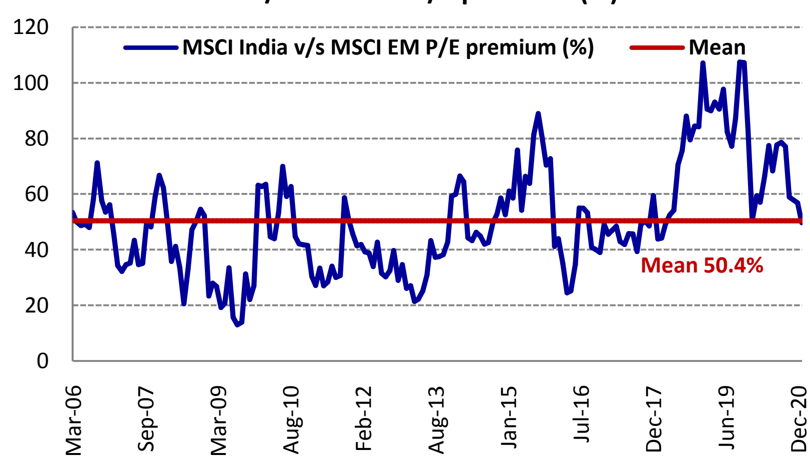
Chart 10: Bond yield Vs SENSEX yield



Source: MOSL, Valentis Research

While valuations look expensive in a historic context, India valuations relative to Emerging Markets are at their average premiums. This reflect the globally stretched valuations on the back of low interest rates

Chart 11: MSCI India v/s MSCI EM P/E premium (%)



Source: MOSL, Valentis Research

2: Correction likely but a 10-15% drawdown is normal

After a sharp rally, a correction is likely. But a 10-15% correction is normal and occurs in most years.

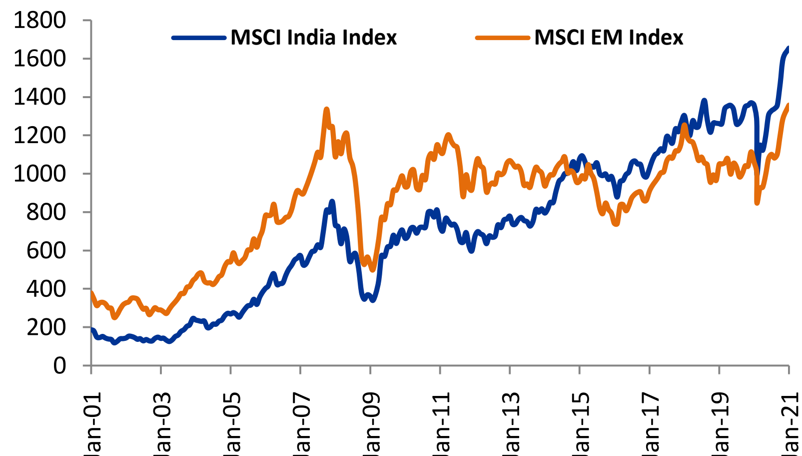
Table 1: Drawdown in line with history

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%
CY19	-10%	14%	-19%	-5%	-20%	-7%
CY20	-38%	16%	-42%	25%	-40%	32%
Average	**-19%**	**17%**	**-27%**	**19%**	**-28%**	**24%**

Note:- MDD means Maximum Drawdown Source: ACE Equity, Valentis research

Indian markets are hugely co-related to global markets. The rally in India in 2020 was part of a global rally. We think the correction will also be led by a global pullback in equities.

Chart 12: Indian markets huge co-related to global markets

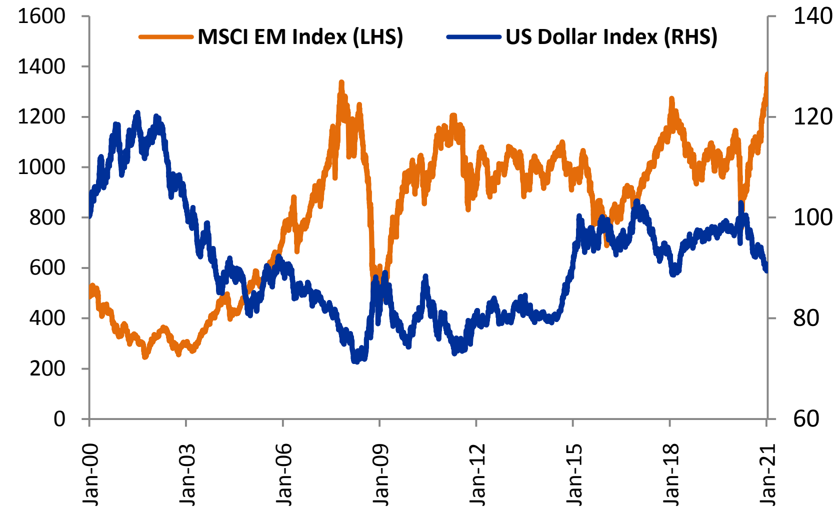


Source: MOSL, Valentis Research

3: Sharp falls typically lead to big sectoral shifts

Emerging markets have under-performed developed markets sharply since 2008. Our first theme is that emerging markets will out-perform developed markets as the dollar appreciation is behind us.

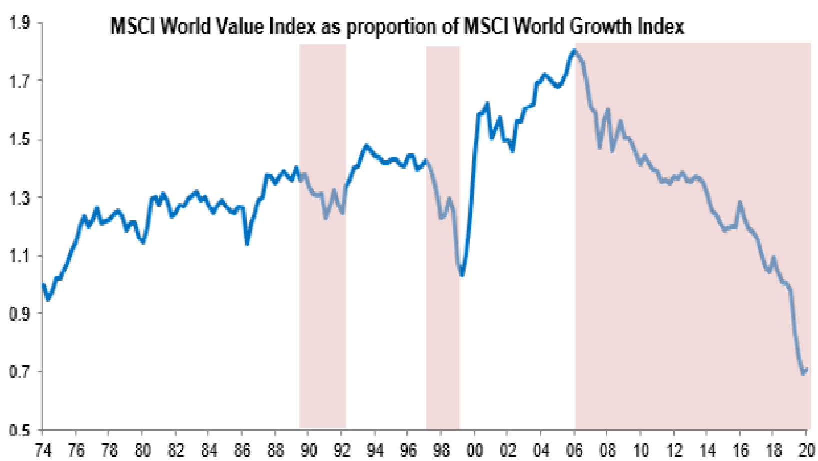
Chart 13: Dollar Index vs Emerging Market index



Source: Investing.com, Valentis advisors

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. Our second theme is that we think cyclical stocks start to out-perform expensive good quality stocks.

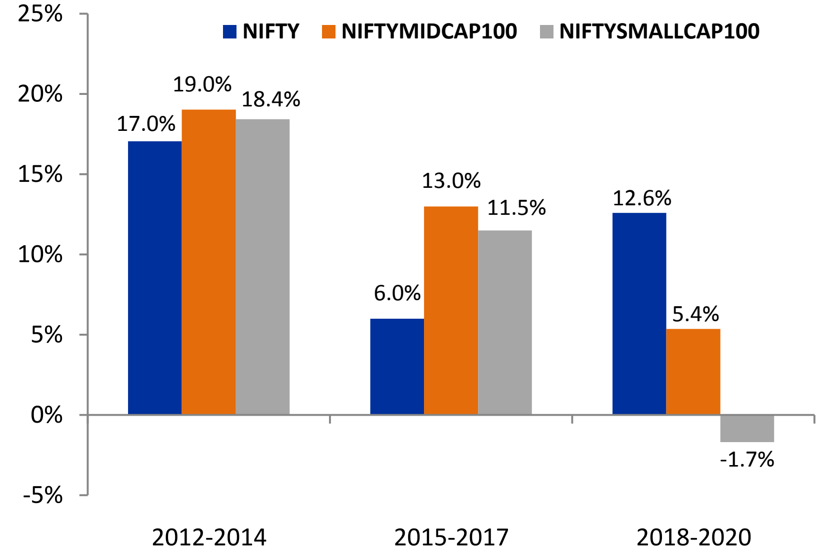
Chart 14: Value vs. Growth - What does history tell us ?



Source: Investing.com, MSCI, Valentis advisors

Lastly, last 3 years have seen small-caps underperform massively. We think mean reversion will help small and mid caps out-perform large caps in a reviving economy.

Chart 15: 3 year CAGR performance of Indices



Source: NSE, Valentis advisors

The probability of 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 12 out of 20 years…

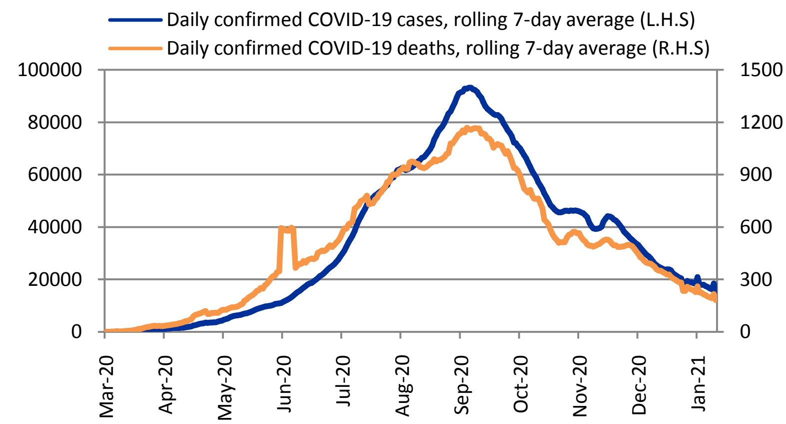
Year	Nifty Index	MidCap Index	Difference	SmallCap Index	Difference
CY01	-16%	-30%	-15%	N.A.	N.A.
CY02	4%	25%	21%	N.A.	N.A.
CY03	74%	143%	70%	N.A.	N.A.
CY04	11%	25%	15%	35%	25%
CY05	34%	33%	-1%	61%	27%
CY06	41%	28%	-14%	41%	0%
CY07	53%	78%	25%	85%	32%
CY08	-51%	-59%	-8%	-70%	-20%
CY09	72%	97%	25%	106%	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%
CY20	15%	22%	7%	21%	7%
Average	**17%**	**24%**	**7%**	**22%**	**5%**

Source: ACE Equity, Valentis research

4: Risks to watch out for

The biggest risk to earnings is the V-shaped recovery not materializing either because the vaccine is not effective or the virus mutates. India is seeing a sharp drop in cases After hitting a peak of close to 95,000 cases every day, we are now seeing daily cases reduce to below 16,000. Daily deaths are now below 200.

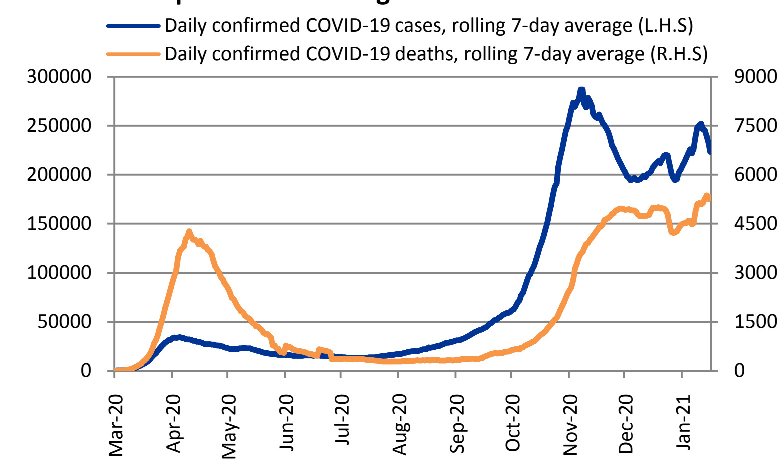
Chart 16: India covid cases drop sharply



Source: ourworldindata.org, Valentis Research

But Europe is having another lock-down as cases mount….

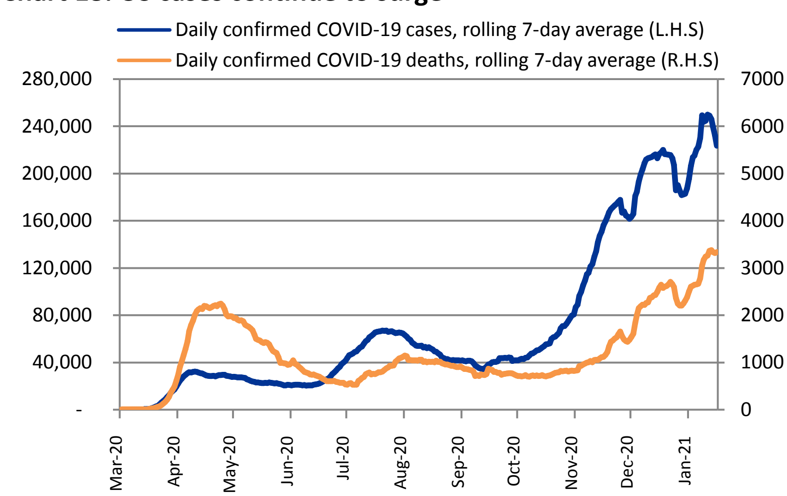
Chart 17: Europe cases till at high



Source: ourworldindata.org, Valentis Research

….as does cases in USA

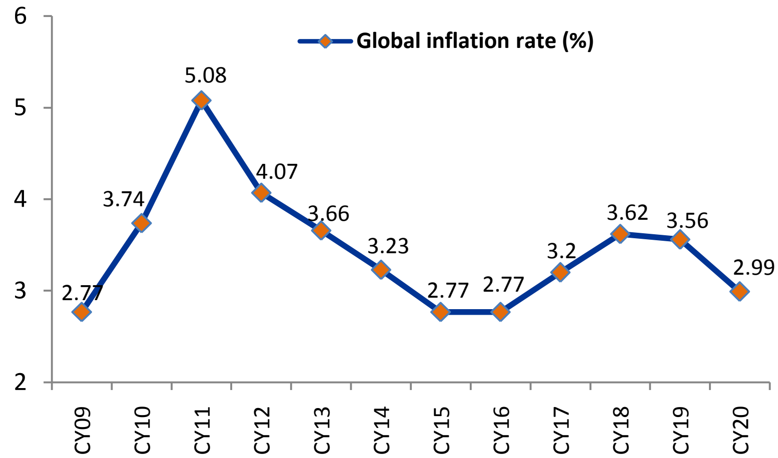
Chart 18: US cases continue to surge



Source: ourworldindata.org, Valentis Research

Second risk is inflation starts to pick up and raises worries on easy monetary policies.

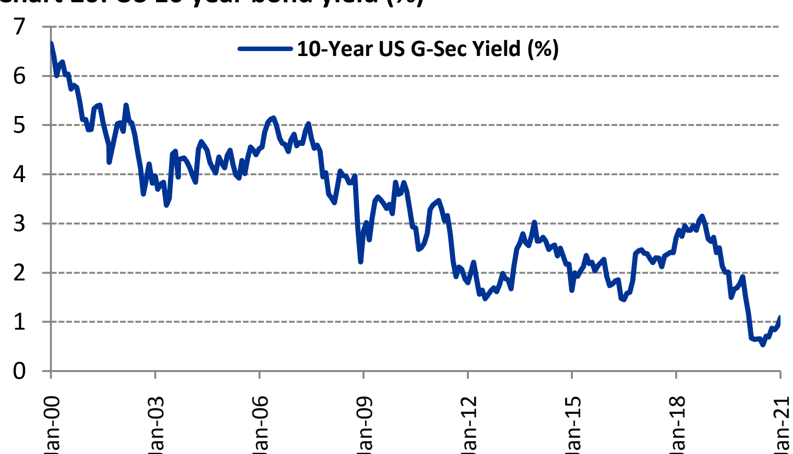
Chart 19: Global Inflation rate (%)



Source: statista.com, Valentis Research

While the US 10-year bond yields are still at a low, they have moved up in recent weeks

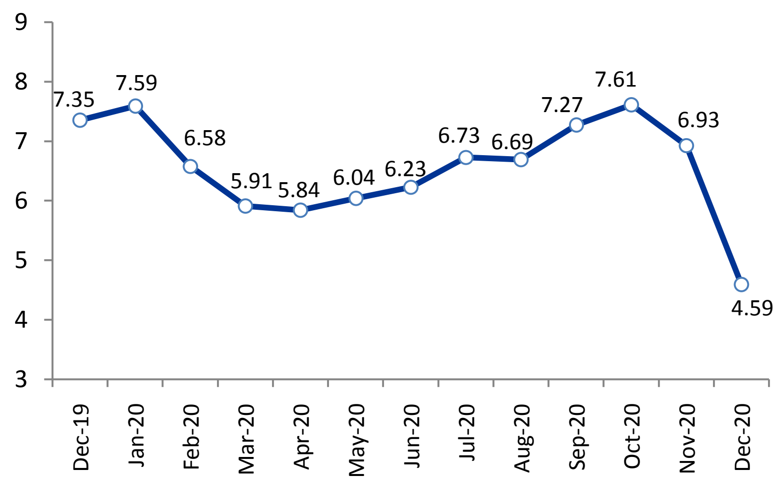
Chart 20: US 10 year bond yield (%)



Source: investing.com, Valentis Research

Similarly in India inflation is near historic lows …

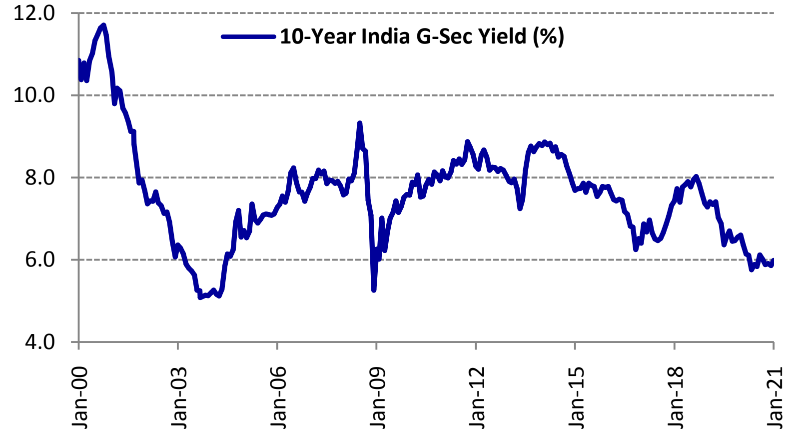
Chart 21: CPI Inflation (%)



Source: MOSL, Valentis Research

Chart 22: India 10 year bond yield (%)

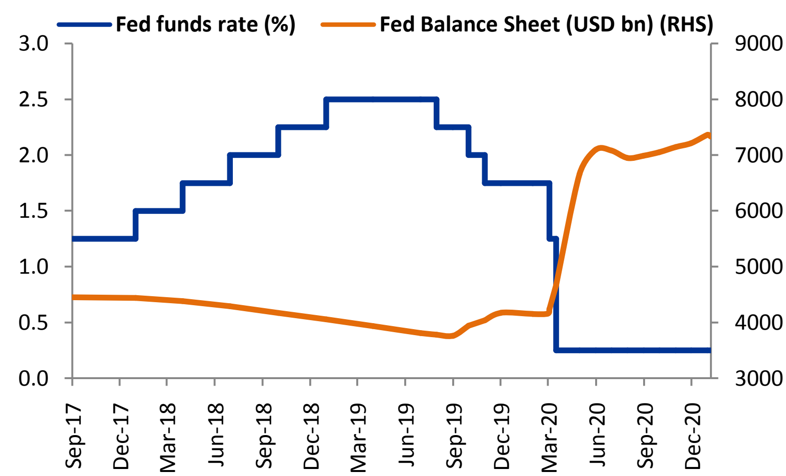
… as our bond yields



Source: MOSL, Valentis Research

Chart 23: US Fed Rate & Balance Sheet Expansion

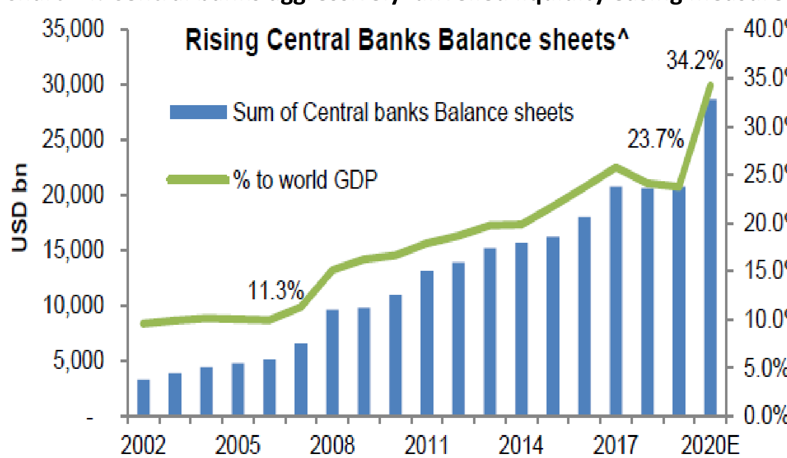
The Fed is unlikely to change its stance this year unless inflation spooks them..



Source: Emkay, Valentis Research

Chart 24: Central banks aggressively unveiled liquidity easing measures

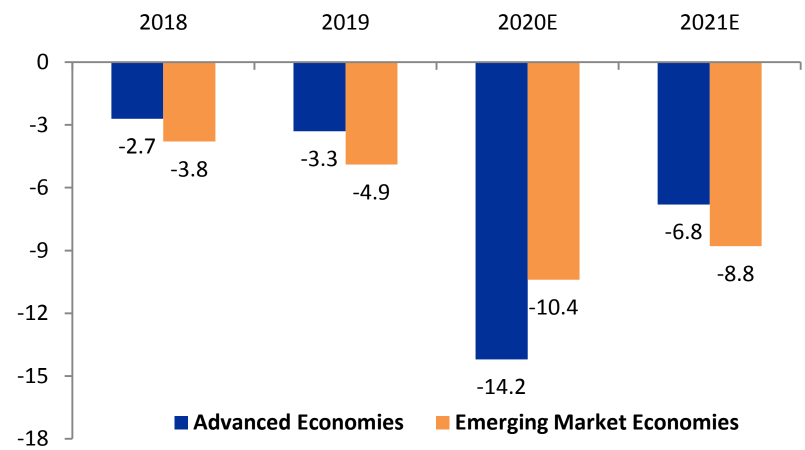
… neither are other global Central banks



Source: JM Financials, Valentis research

The greater risk probably comes from fiscal policy changes like tax increases both is USA and in India. Fiscal deficits (FD) are set to widen across board on back of lower revenues and fiscal stimulus

Chart 25: Fiscal Deficit as % of GDP

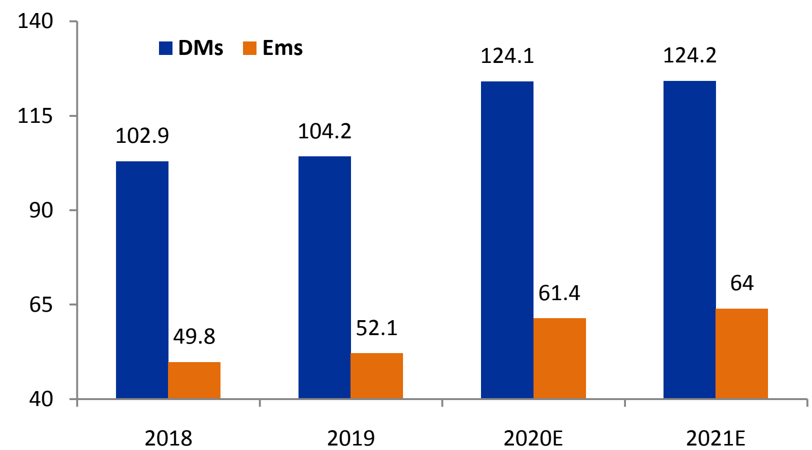


Source: IMF World Economic Outlook October 2020, Valentis Research

Public debt to GDP is at record levels. Sovereign debt likely to jump by ~20% from pre-covid levels.

Fiscal consolidation is likely over the next couple of years. DMs likely to add more debt in CY19-21 than in last 9 years.

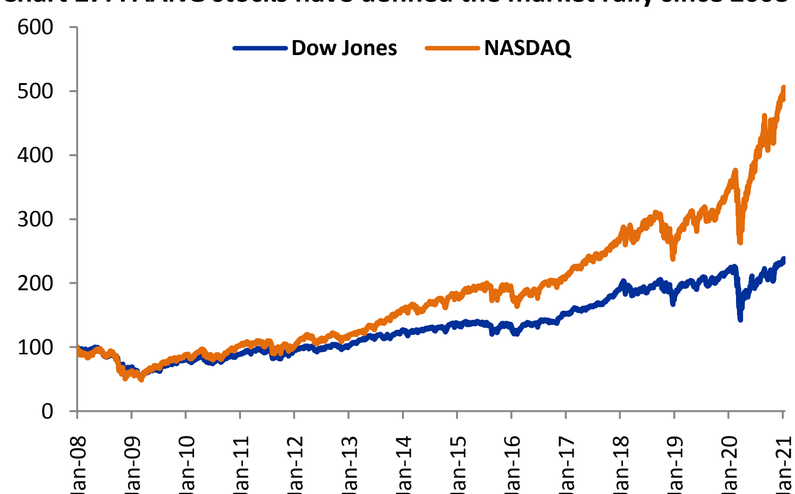
Chart 26: Government Debt as % of GDP



Source: IMF, Valentis Research

The Nasdaq led by the Big Tech companies have driven equity markets since 2008. Any move to break-up the Big Tech companies or other regulatory measures could lead to a correction.

Chart 27: FAANG stocks have defined the market rally since 2008



Source: Investing.com, Valentis Research

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