Valentis Advisors

5 Burning Investor Questions

July 29, 2021

Answering key investor questions

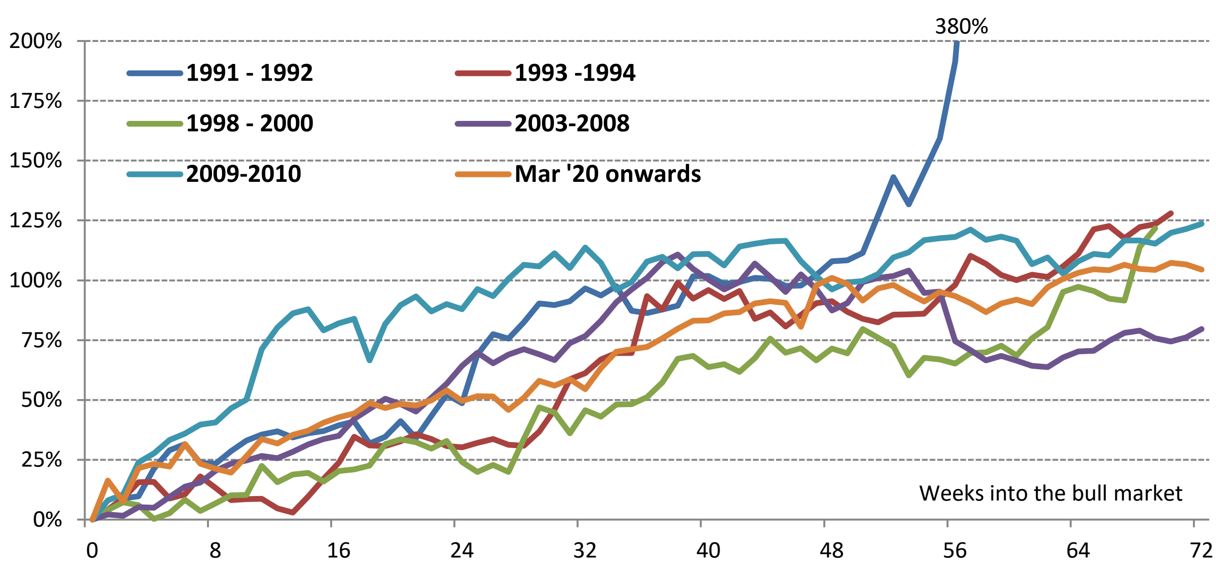
Over the past quarter, investor questions have largely focused around speed of the rally, whether we would get a correction given the stretched valuations and what are the key factors that would drive markets going forward. Here we address some of the most common questions we have fielded from investors recently.

Overall we believe market over next few years will be driven by earnings growth doubling. Near term we are in a consolidation phase with markets likely to see a time and price correction. Fed tapering and rate hikes could drive short term pullbacks in the market.

#1: Is this rally unprecedented? Nothing unique about rally

Whenever we are in a bull market or indeed a bear market, we feel we have never seen anything like this. Yet there have been 6 occasions over the past 35 years where markets doubled in 65-75 weeks. Indeed, if anything, this is the slowest rally save the bull market from 2003-2008. Incidentally, the 2003-08 rally was the longest rally ever in the past 35 years and the one that delivered the largest return (market up over 6x). The fastest rally was the Harshad Mehta bull run that ended in April 1992.

Chart 1: – How does this rally compare to other bull runs?



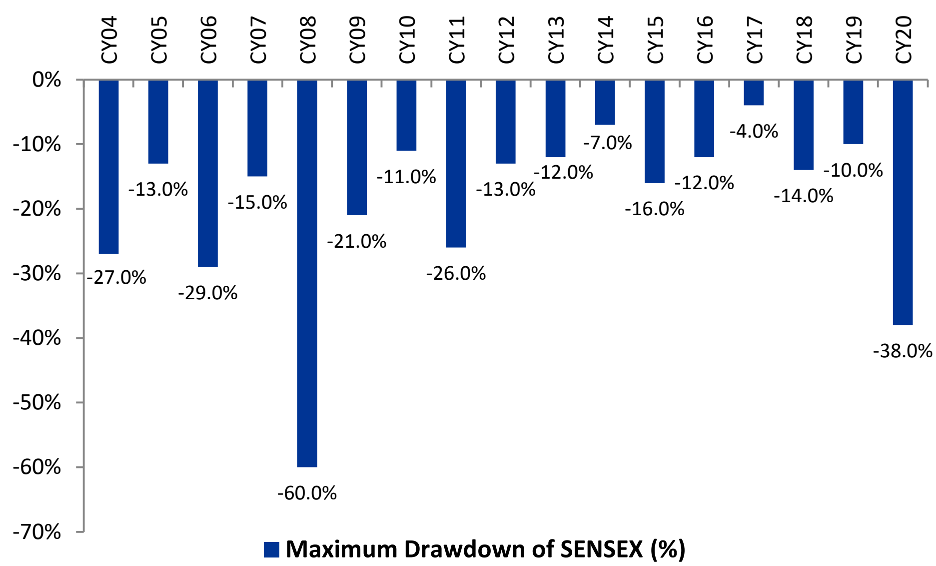
Source: BSE, ACE Equity, Valentis Research

#2: Will we get a correction? Possible but more a 10% one

A 10-15% correction in the market is normally and we have seen it practically every year. Over the past 16 years there are only 2 years when we did not have a double-digit correction (2014 and 2017). Yet the average annual return in the market is 17% during this period.

The last time we had a 10% correction was in May, 2020. Since then, markets have risen nearly 80% without a meaningful correction. In that sense, a double digit correction is probable.

Chart 2: Maximum Drawdown of SENSEX (%)



Source: BSE, ACE Equity, Valentis Research

However, we do not expect a deep correction (40-50%) which happens once in 8 years on an average. We are in a very early stage of an earnings upcycle while most of these corrections (except the Covid induced 2020 correction) have happened at the peak of the earnings cycle.

Table 1: Four major drops in the market

Years	x times	Months	CAGR return	% subsequent fall
1988 - 1992 (Harshad Mehta)	11.4	50	80%	-54.40%
1997 - 2000 (IT Boom)	2.2	39	27%	-56.20%
2003 - 2008 (Infra & Global Liquidity)	7.1	57	51%	-59.50%
2017 – 2020 (Covid-19 Pandemic)	1.6	38	17%	-38.10%

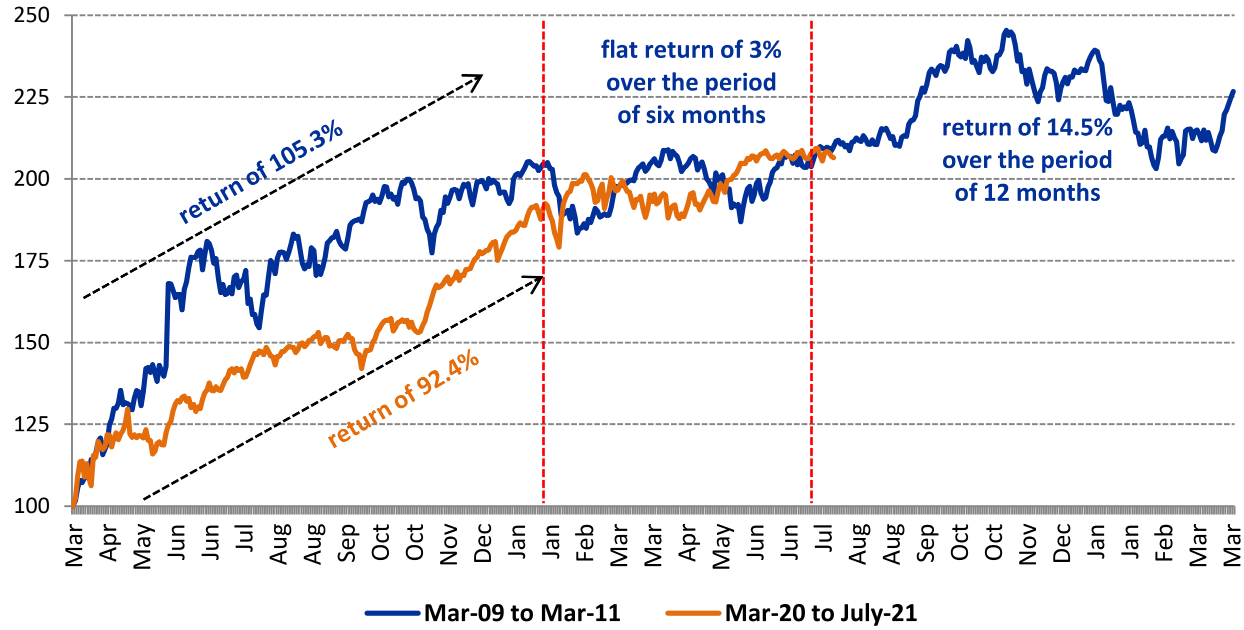
Source: ACE Equity, Valentis Research

#3: So how do we expect markets to behave? Price and time correction

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.

We think after the sharp rally in markets till mid-Feb 2021, we have been in a consolidation phase. We continue to expect a price and time correction near term.

Chart 3: Market movement 2009=2020?



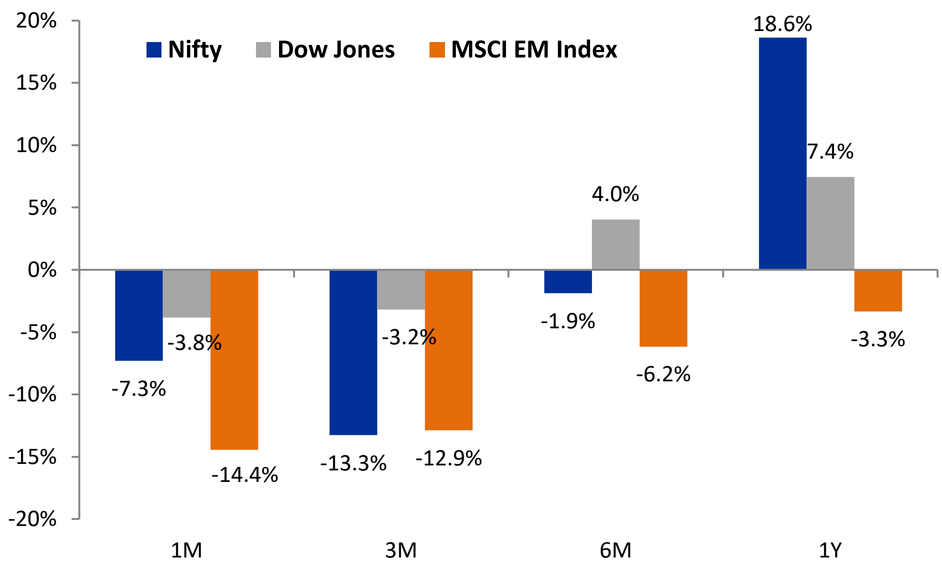
Source: ACE Equity, Valentis Research

#4: How big a risk is "taper tantrum"? Short Term impact likely

In May 2013, Ben Bernanke indicated that the Fed was looking to taper the Quantitative Easing (QE). The markets reacted negatively to this with EM down 12.9% in 3 months, India down 13.3% and US markets down 3.2%. The worst hit were the "fragile five" emerging markets (Turkey, Brazil, India, South Africa and Indonesia) where high current account deficits were a risk.

However, markets recovered over a 12-month period with the US markets being positive and the EM being practically flat. We are ignoring the India sharp rally since it was partly attributed to the expectations of election of Mr. Narendra Modi as Prime Minister.

Chart 4: Stock market returns from Bernanke tapering announcement in 2013



Source: ACE Equity, investing.com, Valentis Research

We expect a similar trend this time with a possible correction likely on fears of Fed tapering. However, we want to highlight 3 points:

1. The markets were actually up over 1 year though Fed tapered their balance sheet from December 2013, around 7 months after the Fed announcement. Similarly, the market correction this time too may be short-lived.
2. Given the lessons from 2013, we think the Fed will prepare the market a bit more this time resulting in a slower fall in the market.
3. EMs are arguably in a better shape now and hence the impact may be less pronounced (eg India current account deficit was 0.9% of GDP in FY21 and a current account surplus of 0.9% in FY21 compared to a current account deficit of 4.8% in FY13). Similarly, forex reserves if India have more than doubled from $294 bn in May 2013 when tapering was announced to $613 bn currently.

#5: Will Fed rate hikes burst the rally? Depends on the economy

Rising inflationary expectations have raised fears of a reversal of the falling interest rate environment. Will this be negative for markets? History points out that interest rate increases have had only a temporary impact on markets. An increase in interest rate is generally a function of a strong economy which is positive for markets. An analysis of the rate hikes in USA in the last 35 years is below. While it shows that markets are mixed over a 3 month period, it is generally been positive over a 6 month and 12 month period.

Table 2: US market performance and Fed rates hike

Date of First Hike	S&P 500 Index returns (%)		
	3M	6M	1Y
16-Dec-15	-1.1%	0.1%	9.1%
30-Jun-04	-2.3%	6.4%	5.2%
30-Jun-99	-7.6%	6.6%	6.0%
25-Mar-97	13.6%	20.6%	39.6%
4-Feb-94	-5.9%	-2.5%	2.4%
11-May-88	3.4%	8.6%	20.7%
1-Apr-87	3.6%	10.1%	-11.7%

Source: Investing.com, Valentis Research

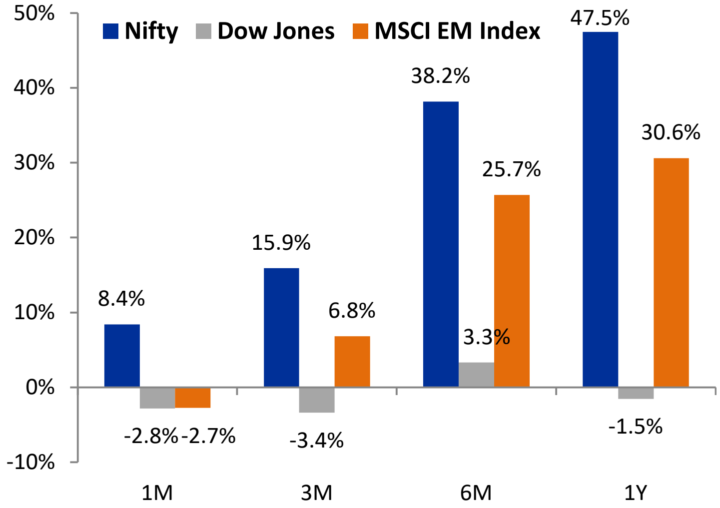
Impact on India and Emerging Markets

The last 2 Fed rate hike cycles have been a mixed picture of equity markets.

Between June 2003 and June 2006, we saw the Fed rates move from 1% to 5.25% with 17 rate increases of 25 bps each. However, markets were rallying through this period expect for a stutter in the first month. Emerging markets and India were great performers while the US markets were flattish.

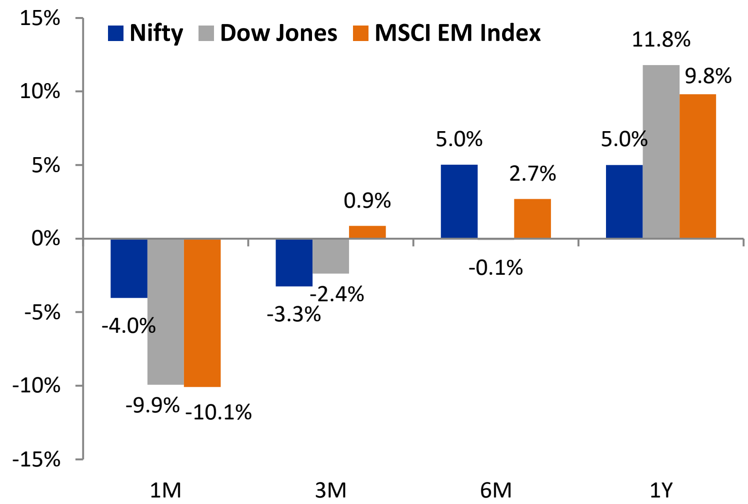
The 2015 rate hike cycle was much slower than the 2003 cycle. After the first rate hike In Dec 2015, it took the Fed another 12 months before the next hike. The negative reaction of markets was much more severe initially. While markets recovered after few months, the US turned out to be the best performer over a year.

Chart 5: Return from first rate hike on June 2004



Source: ACE Equity, investing.com, Valentis Research

Chart 6: Return from first rate hike on Dec 2015

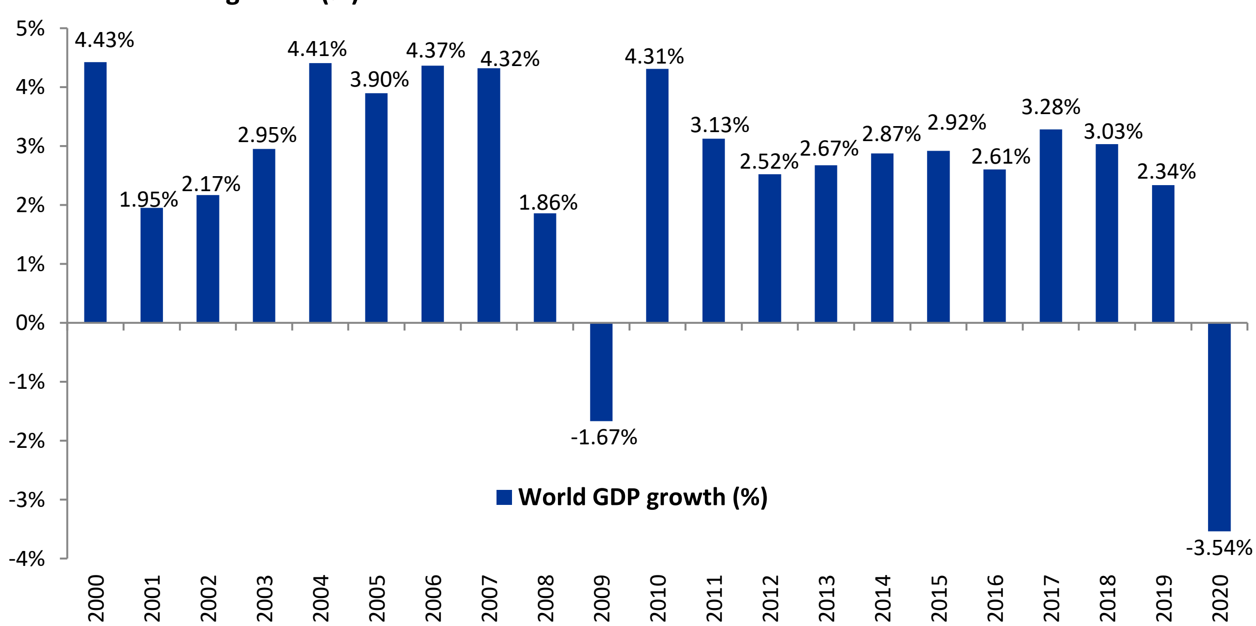


Source: ACE Equity, investing.com, Valentis Research

Does Economy explain the differing reaction?

One reason for the differing reaction is explained by the economy. Global growth was strong from 2003 to 2007 averaging over 4%. This helped drive a sustainable stock market rally. On the other hand growth remained anemic in the 2015-2017 phase.

Chart 7: World GDP growth (%)

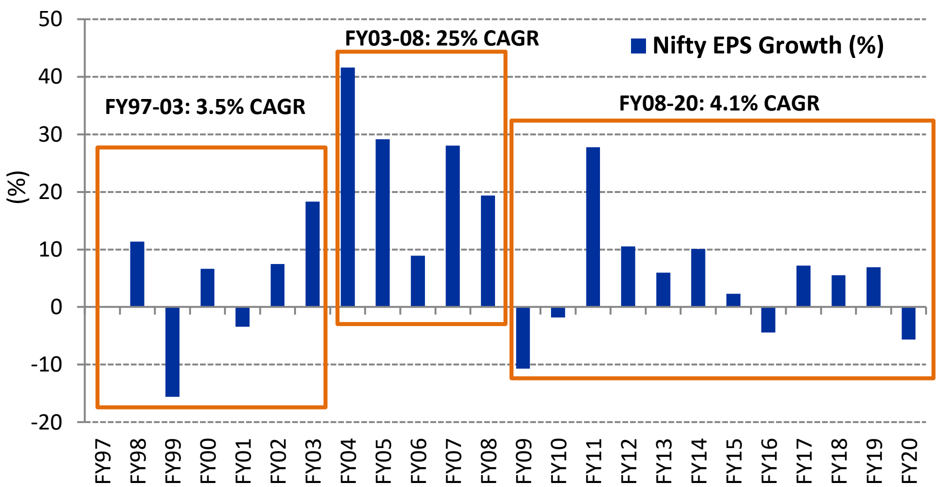


Source: World Bank national accounts data, and OECD National Accounts data, Valentis Research

We see strong growth driving markets

We think we are entering an earnings cycle similar to the 2003-08 cycle where earnings can double over the next 5 years. With valuations not cheap, we think returns in the market over next few years will be driven by earnings growth. While we think market is vulnerable to near term corrections, we remain focused on identifying companies that will see accelerated earnings growth trajectory. For details, please read our earlier notes on April (https://www.valentisadvisors.com/insights/market-update-20th-april-2021/) and January (https://www.valentisadvisors.com/insights/outlook-2021-jan-2021/).

Chart 8: Earning growth trend: Cusp of earnings recovery?



Source: MOSL, Valentis Research

Portfolio Update

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 quarter, we have added to 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 9: Valentis Rising Star Opportunity Fund Portfolio Performance

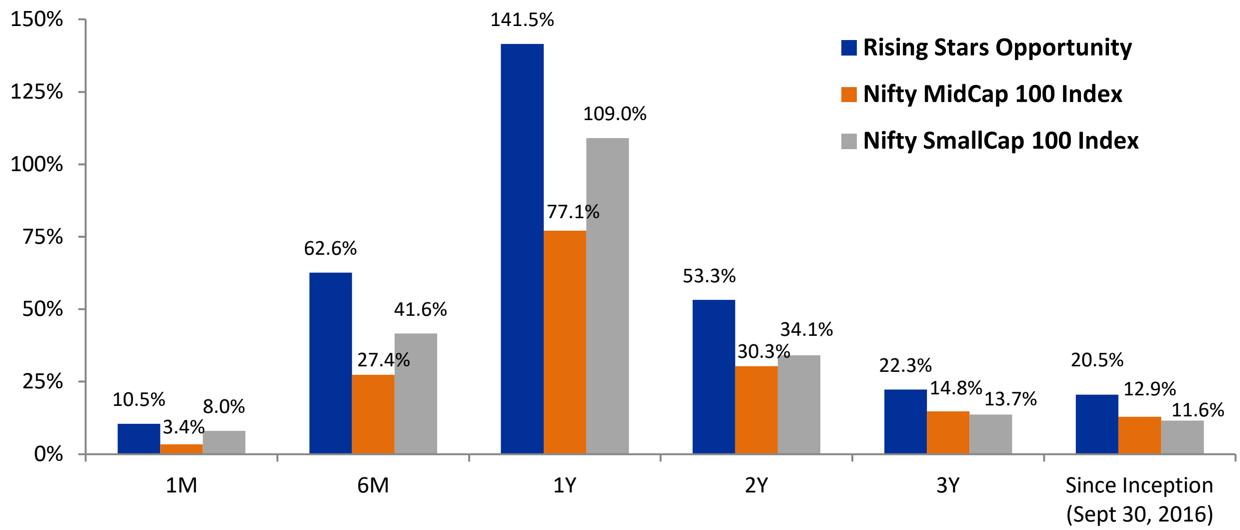
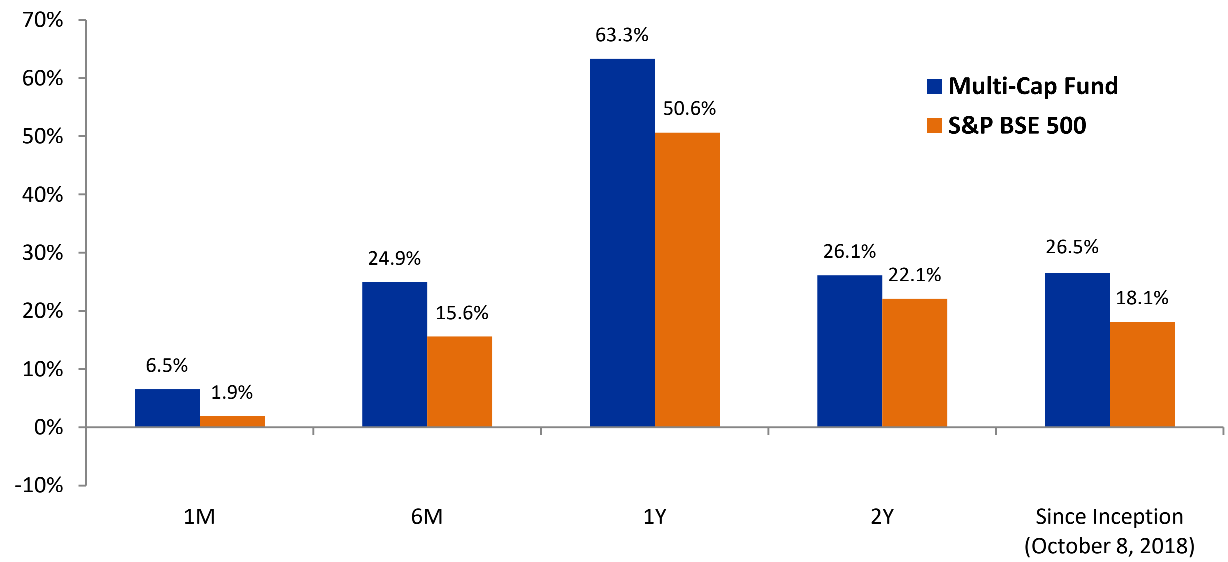


Chart 10: Valentis Multi-Cap Fund Portfolio Performance



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