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Stagflation or transient inflation?

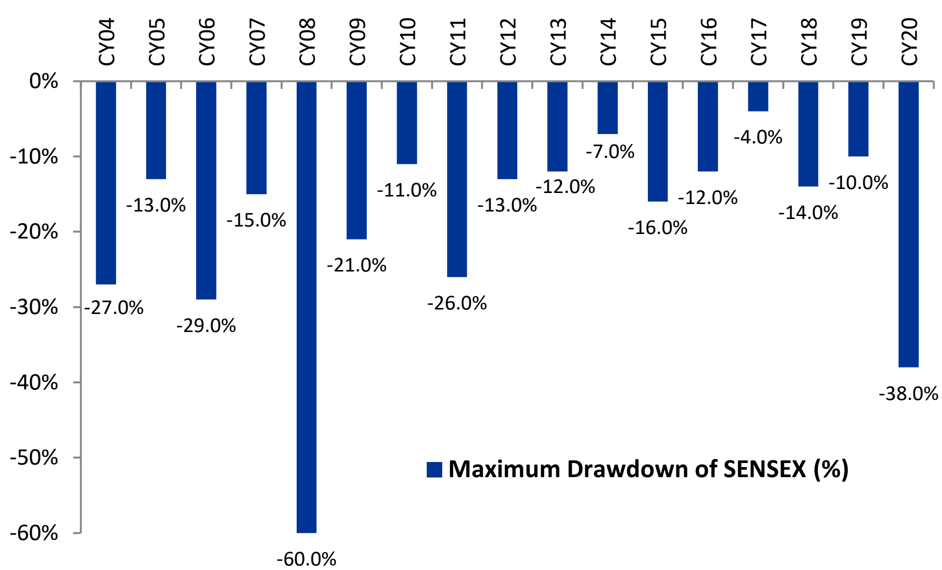
October 29, 2021

- **Investor attention currently is very focused on whether we get a correction in the markets. We do expect a correction given the sharp outperformance of India to global markets and demanding valuations. We have built 15-18% cash in our portfolios to buy on a correction.**
- **However, we think the more important questions for investors are two – First, whether we will see a multi-year period of strong earnings growth and what can disrupt that view. We expect earnings to double in the next 4 to 5 years. However, the sharp rise in commodity prices could reverse the current spell on earnings upgrades and raise worries of a stagflation type of scenario.**
- **Secondly which sectors will lead the current rally in market? Our view is that high quality consumer staples peaked in March 2020 and will under-perform in the next few years.**

Investor attention is focused on likely correction….

Our interaction with investors indicates that most of them are worried about a possible correction in the market. A correction, indeed, is long overdue. The last time we had a 10%+ correction was in Mar 2020 and the market has since doubled. It's rare to have a doubling of the market without a 10% correction. As we have pointed out in our past returns a 10-15% correction is par for course and in this decade only 2 years did not see at least a 10% correction. We have gradually built cash of close to 15-18% in portfolios to benefit from the correction.

Chart 1: Maximum Drawdown of SENSEX (%)



Source: BSE, ACE Equity, Valentis Research

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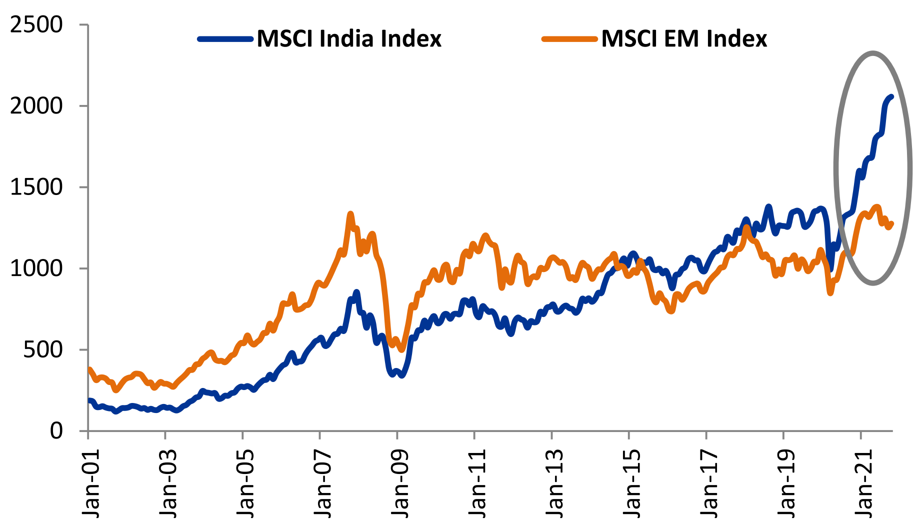
What will drive the correction?

We think the correction will be led by global factors as the market consolidates its sharp gains and central banks start to tighten monetary policy. India will be part of global correction given its sharp outperformance and expensive valuations.

A) India has outperformed sharply

The Indian markets have a sharp co-relation to global markets. But over the past 6 months India has outperformed sharply - In last six months MSCI India Index up 22.1% against a 5.3% fall in the MSCI EM Index.

Chart 2: Sharp outperformance over past 6 months



Source: Investing.com, Valentis Research

B) Valuations are very expensive

Indian valuations are very expensive both in a historic Indian context as well as relative to MSCI. We see this cooling off with a time and price correction.

Chart 3: Nifty 12M Forward P/E (x) – most expensive

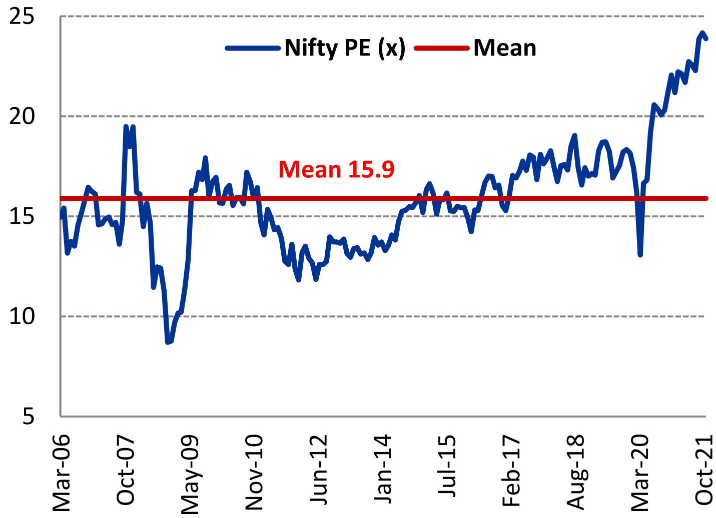
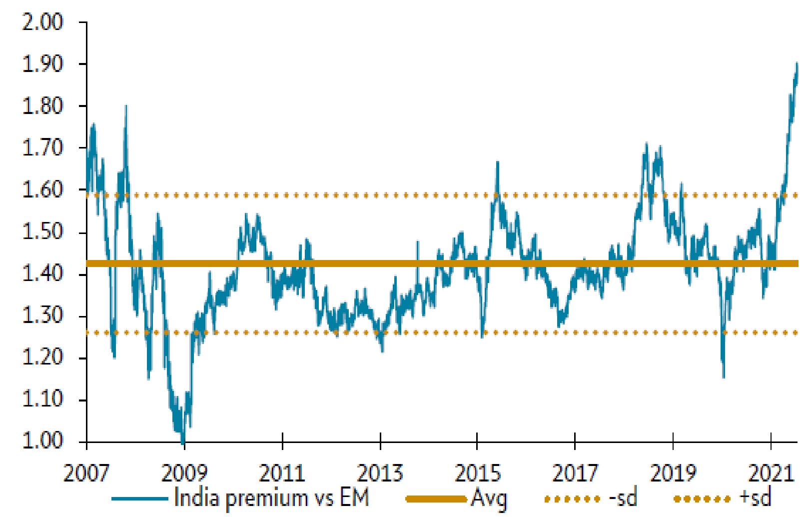


Chart 4: India's valuation premium is close to 90%, a 15-year high



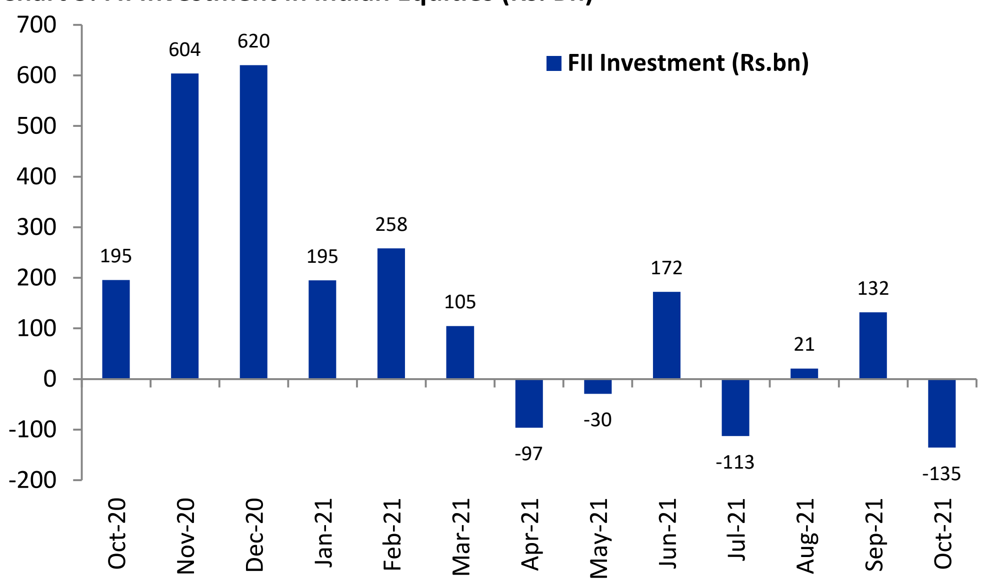
Source: Edel, Valentis Research

Source: Bloomberg Finance L.P., data as on 13 October, 2021, Julius Baer.

C) Markets vulnerable to FII selling

Over the past year FIIs have been strong buyers in the market pumping in just under $24 bn in the markets. India remains vulnerable if the FII selling seen in the past month continues.

Chart 5: FII Investment in Indian Equities (Rs. Bn)

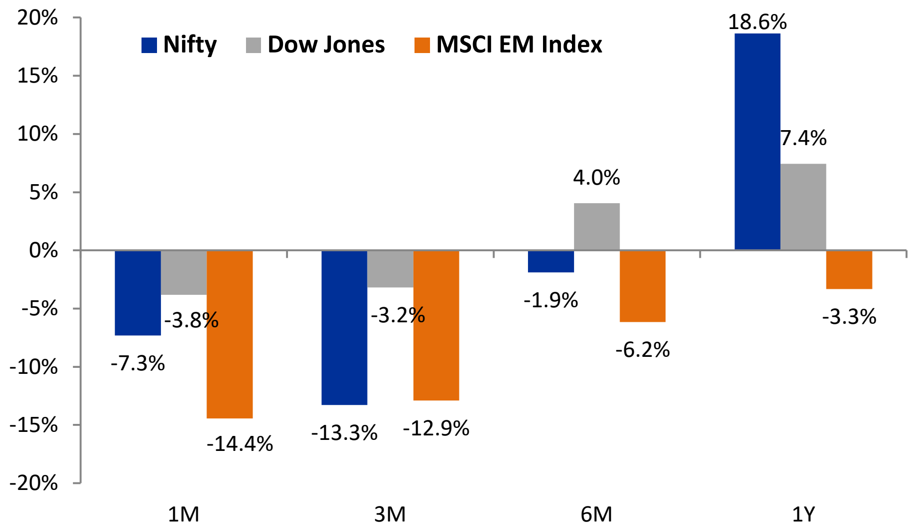


Source: ACE Equity, Valentis Research

D) Fed tapering can lead to a short-term sell-off

As we have argued in the past, markets are unlikely to react as sharply to the Fed tapering since it is a well flagged event and a tapering in November appears imminent. Also, India is better positioned with India's current account deficit at 0.9% of GDP in FY21 and a current account surplus of 0.9% in FY22 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. However, the tapering may be the excuse stock markets need for a correction.

Chart 6: Stock market returns from Bernanke tapering announcement in 2013



Source: ACE Equity, investing.com, Valentis Research

We think 2 questions are more important

We think investor attention should be more focused on 2 questions:

1. Can we see sustained economy and earnings growth and what are the risks?
2. Which sectors will drive the next cycle?

#1: Stagflation or Reflation?

Our key thesis as we have spelt out earlier is that we are headed for a strong spell of economic growth which will lead to earnings doubling in the next 4-5 years. Returns in the market will mirror earnings growth.

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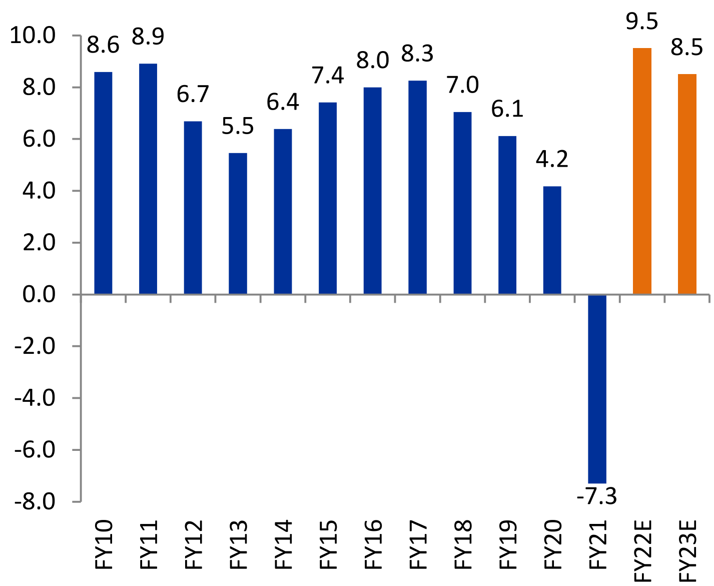
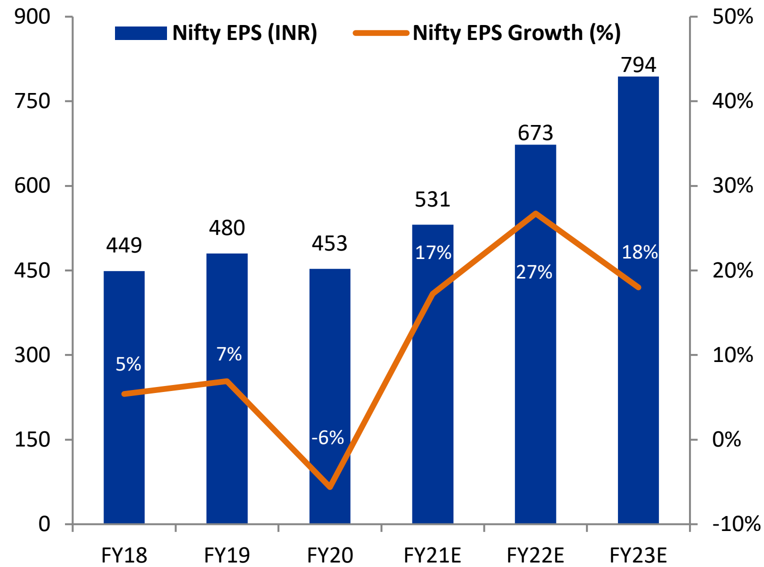
Chart 7: India's GDP growth (%)



Source: MOSPI, IMF, Valentis Research

Chart 8: Nifty Earning growth (%) – Will rebound finally come?

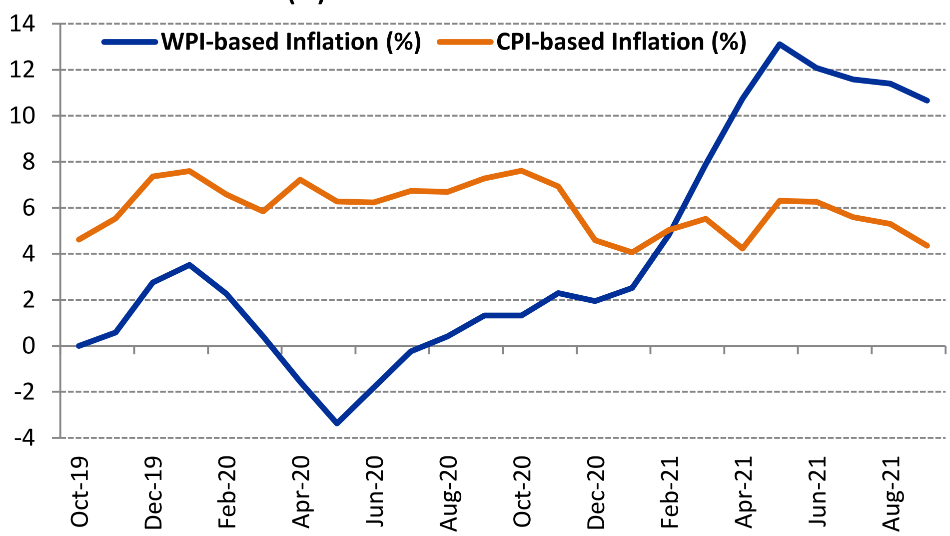


Source: Kotak Institutional Equities estimates, NSE, Valentis Research

High Inflation is posing near term risks to this view – stagflation anyone?

On the margin, over the past few weeks, risks to the sustained growth expectations have been rising. The Fed has so far maintained that inflation is transitory. What if the inflation is structural and the Fed is behind the curve?

Chart 9: Inflation trend (%)



Source: MOSPI, Valentis Research

#1: Commodity prices going through the roof

While inflation so far has been rising but within tolerance limits, the fear is the sharp rise in commodity prices, especially energy prices, could lead to high inflation and put pressure on economic growth. We have seen some drop in commodity prices like coal recently and would be tracking these closely over next few months to see if we get a normalization here (See charts 14 to 17 in Appendix).

#2: Risks of stagflation rising

The last time we had a stagflation scenario was in the 1980s. Hence, there is general complacency that inflation will be transient. But we need to be careful that we do not see some re-run of 1973 where an oil shock saw the Fed behind the curve and the world plunged into a recession.

#3: From globalization to localization?

A negative fallout of Covid is going to be a reversal of globalization that arguably led to a structural decline in inflation. As the world gets relatively more insular, we could see some inflation becoming more structural.

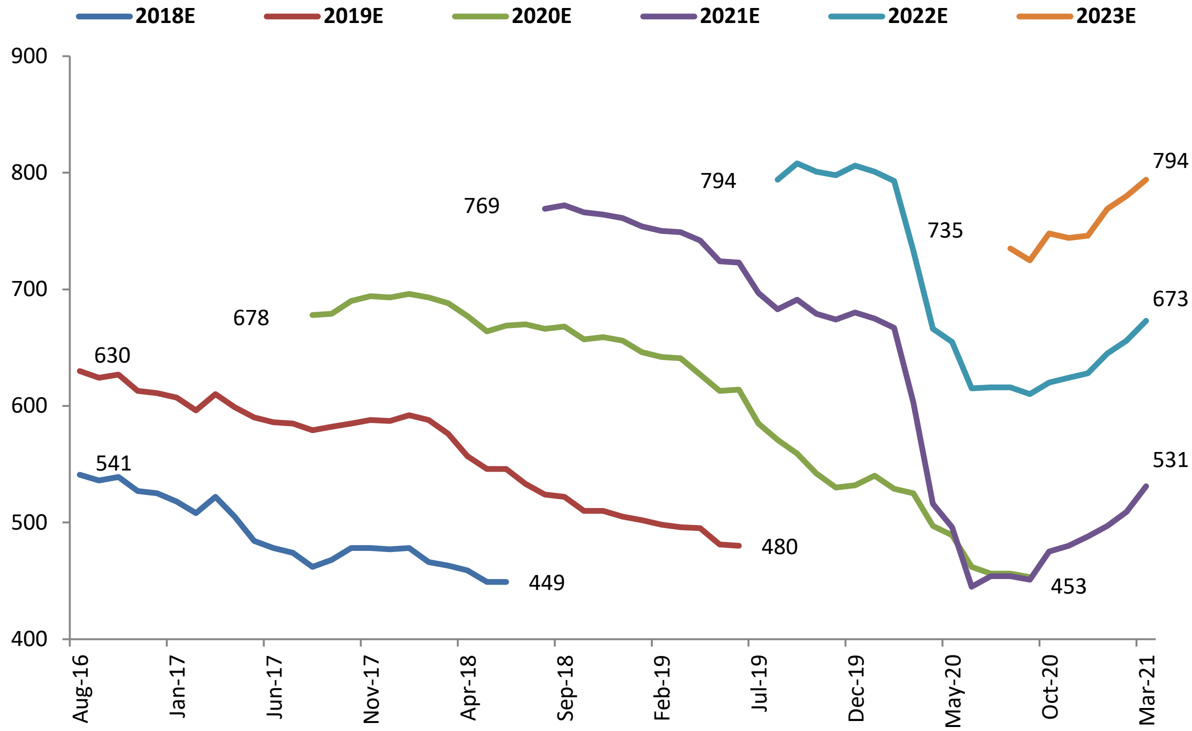
#4: Inflation vs Reflation – Where do we stand?

We still expect domestic growth to be strong over the next few years which could mean the reflation trade continues. However, rising commodity prices are a clear threat. We are hoping for some cooling off in prices are normalization of the supply chain over the next 6 months to lead to a smoother transition to a tighter monetary policy without a large disruption in growth.

#5: Near term earnings vulnerable to downgrades:

We had a strong spell of earnings upgrades since Sept 2020. However, rising commodity prices are likely to put pressure on margins and could lead to some earnings downgrades near term.

Chart 10: Nifty EPS estimates upgrade trend – could see a pause

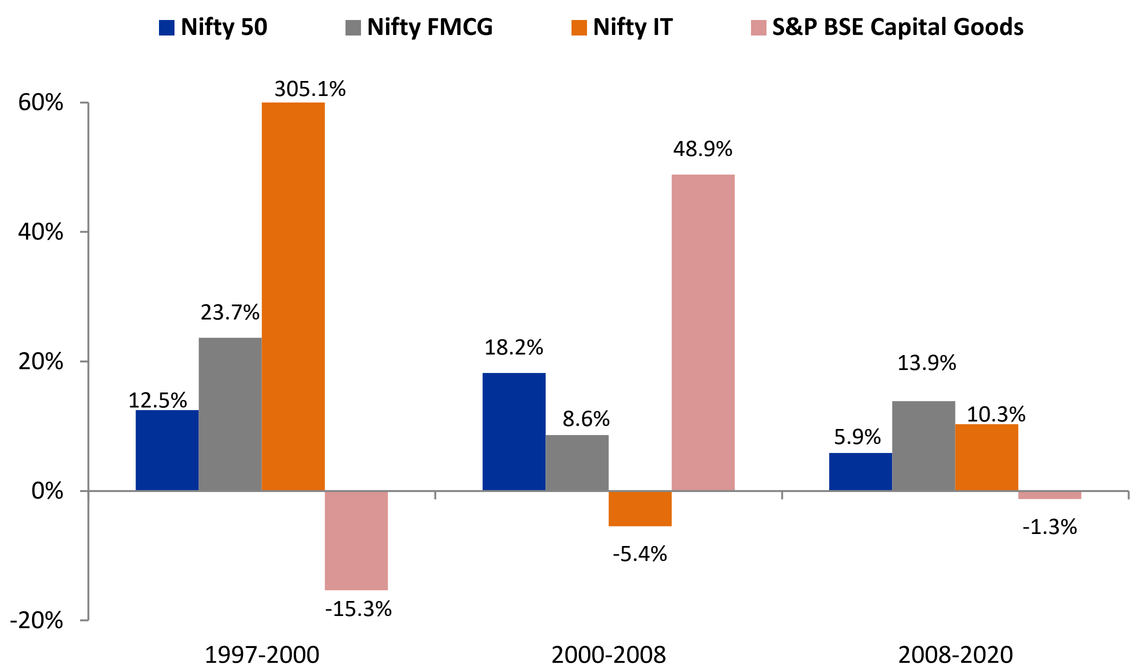


Source: Kotak Institutional Equities estimates, NSE, Valentis Research

#2: Have we seen a change in sector leadership?

Based on our past analysis, every big drop in the market leads to a change in sector leadership. As seen in the Chart below, software which led the tech bull run upto CY2000 under-performed sharply after that. Similarly, capital goods that drove the CY2003-08 rally have been the worst performing sector since then. The 2008-20 bull run was driven by high quality, high RoE, low debt companies. We think given the sharp valuation re-rating, these will under-perform the next few years while the manufacturing sector takes the sector leadership.

Chart 11: Sectoral indices return during different bull runs (%)



Source: BSE, ACE Equity, 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. 2 thoughts on our positioning:

1. Over the past quarter, we have further added to cash in the portfolios to gain from a possible correction in markets. We would look to a steep correction to reduce our cash position.
2. Financials have been a big underweight sector for us and that has worked out well so far. We would look to add weight to this sector in weakness over next few months.

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Chart 12: Valentis Rising Star Opportunity Fund Portfolio Performance (as on October 27, 2021)

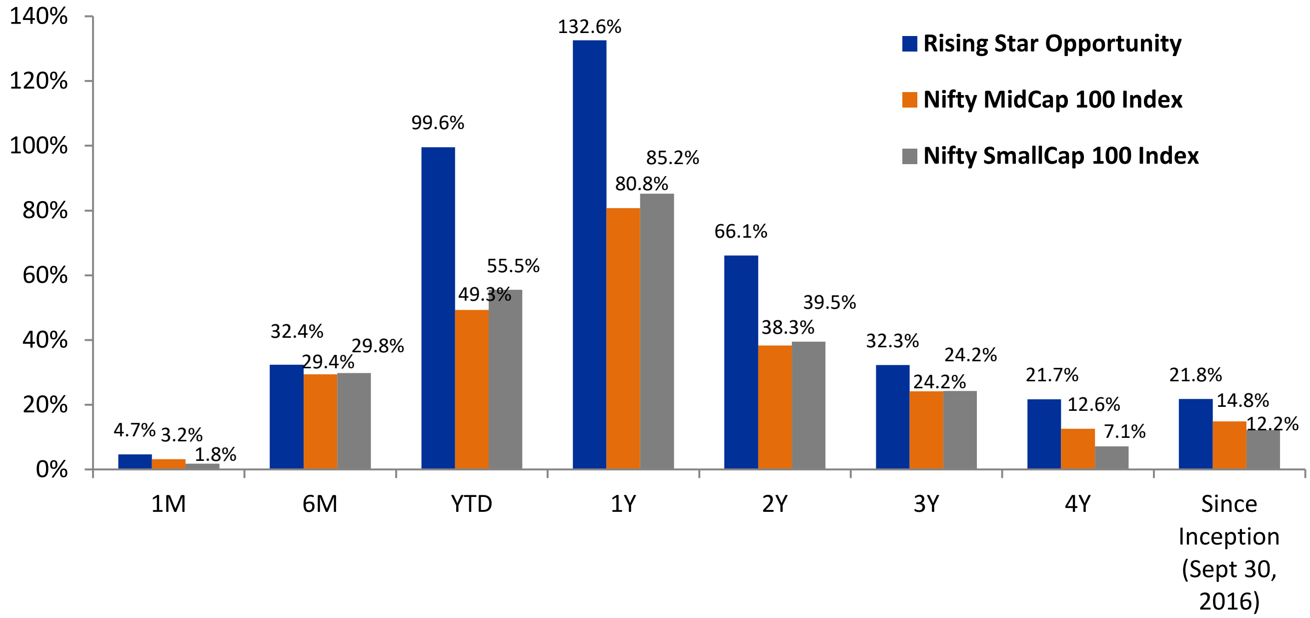
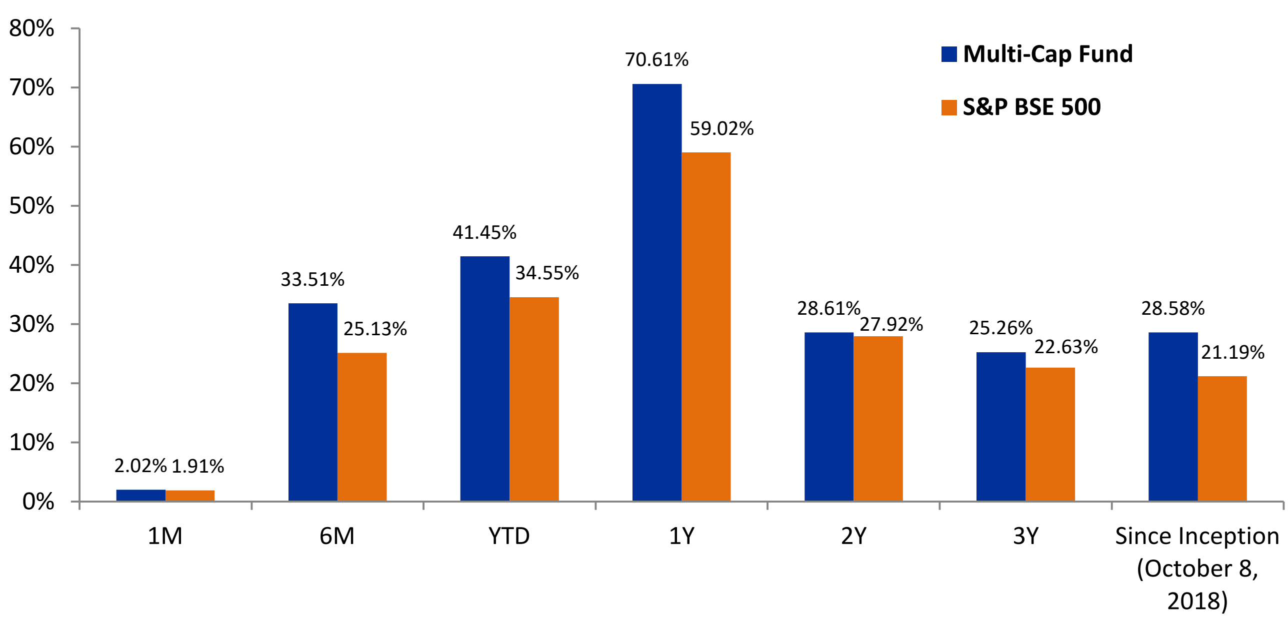


Chart 13: Valentis Multi-Cap Fund Portfolio Performance (as on October 27, 2021)



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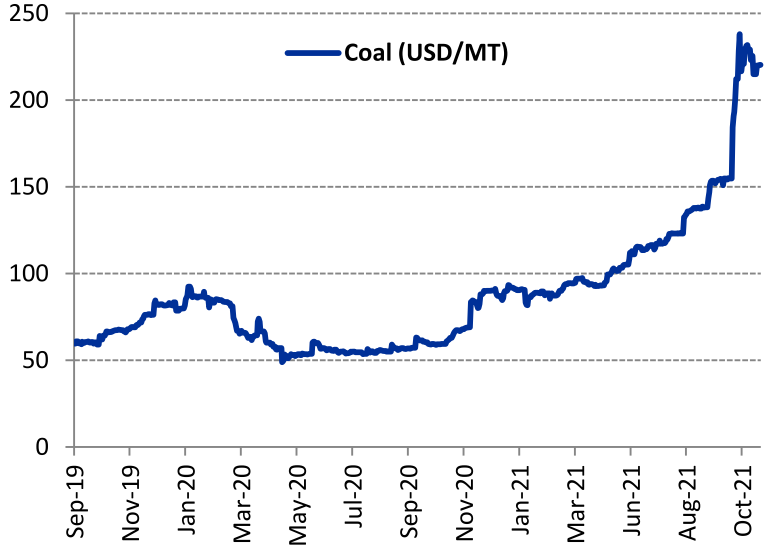
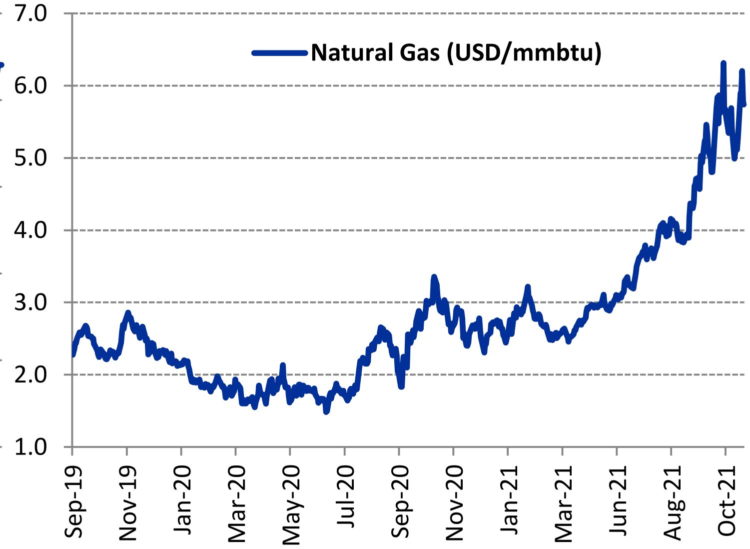
Appendix

Chart 14: Coal prices



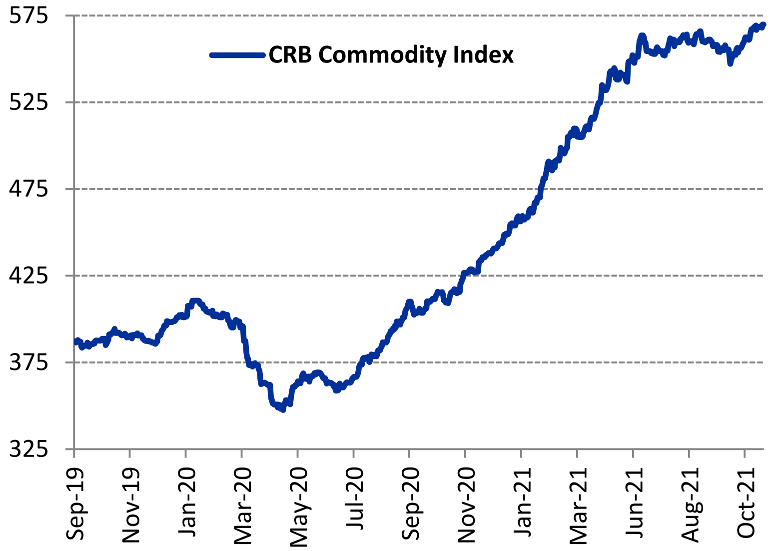
Source: MOSL, Valentis Research

Chart 15: Natural gas prices



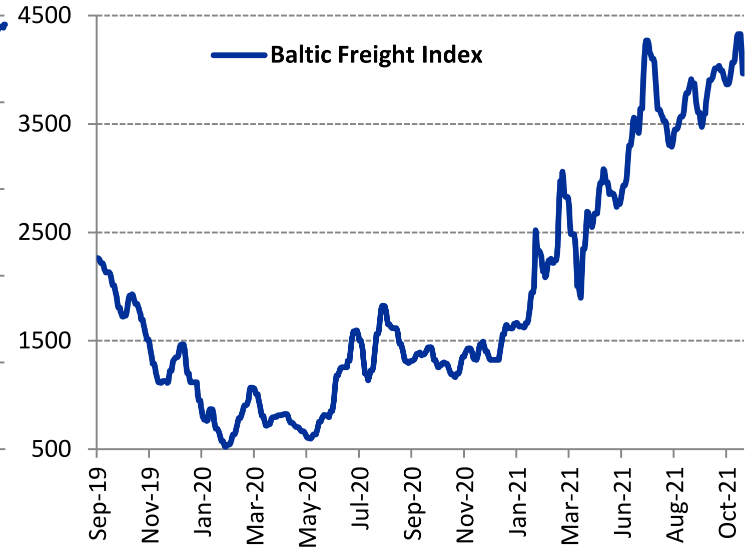
Source: MOSL, Valentis Research

Chart 16: CRB Commodity Index



Source: MOSL, Valentis Research

Chart 17: Baltic Freight Index



Source: MOSL, Valentis Research

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