Valentis Advisors

2022: Earnings vs Valuation/Central Banks

January 27, 2022

After the sharp rally post March 2020, we believe 2022 will be a tough year for markets. We expect 2022 to be a tug of war between earnings on one hand and valuations and Central Bank tightening on the other. What are the key factors to watch for in 2022? We answer this and many more questions through easy-to-read charts in this report. Key points in brief:

#1: The 7-year itch?

- The Nifty and Sensex have given a positive return for past 6 years. The Nifty has never had 7 consecutive years of positive return with its shorter history while the Sensex has seen only 1 such instance from 1988 to 1994. We will have to fight history to eke a positive return in CY22.
- The markets will be more volatile with time as well as price corrections. Just remember that a 10-15% correction in markets is normal every year with only 2 years in the past 25 years (2014 and 2017) not seeing a double-digit drawdown.
- We think the correction will be largely led by global factors with a normalizing of monetary policy by Fed being the major driver.

#2: E vs VC (Earnings vs Valuation, Central Banks)

- Valuations are not cheap and 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.
- The bigger worry for the markets is that Central Banks, especially the Fed will normalize monetary policy and may be behind the curve with inflationary expectations being the highest in past 25 years.
- While tapering is likely priced in, markets will be challenged by a series of interest rate hikes and likely shrinking of the Fed Balance Sheet this year. Mind you, between 2004 and 2007 there were 17 rate hikes and we still saw Indian markets nearly going up 3 times with economic growth being strong.

#3: Earnings can double over 5 years

- The silver lining remains earnings which we think can double over the next 5 years.
- More importantly earnings have seen upgrades since the September 2020 quarter. Near term rising commodity prices and Covid related lockdown could lead to some slow-

down in earnings upgrades. But we think we can see strong earnings going forward and after a long spell of earnings downgrades a period of rising earnings momentum.

#4: 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 and could see better days ahead.
3. **Consumer staples likely to under-perform:** Markets since 2008 were characterized by the sharp re-rating in high quality (high RoE, low debt) companies. We think that trend has shifted and domestic economic plays will lead the next rally.

#5: Portfolio Performance and outlook

1. Both our portfolios were strong outperformers in CY21. Small and mid-caps rebounded strongly in the year and recovered the under-performance vs large caps over past 3 years. We were well positioned to benefit from this trend. The second trend was the rally in domestic cyclicals, a trend we were early to catch and benefit from.
2. In CY21, Our Valentis Rising Stars Opportunity Fund was the second-best performing PMS in the country out of the 250 odd PMS schemes tracked by PMS Bazaar.
3. CY22 will definitely be a more challenging year and we expect modest returns relative to the past 18 months. We will be adding to some sectors like financials and autos where we have been hugely under-weight last year. The banking sector that under-performed in CY21 could see better days as the economy recovers and lot of the NPL provisioning is behind us. In autos, easing of the chip shortage will be a key driver.

Jyotivardhan Jaipuria
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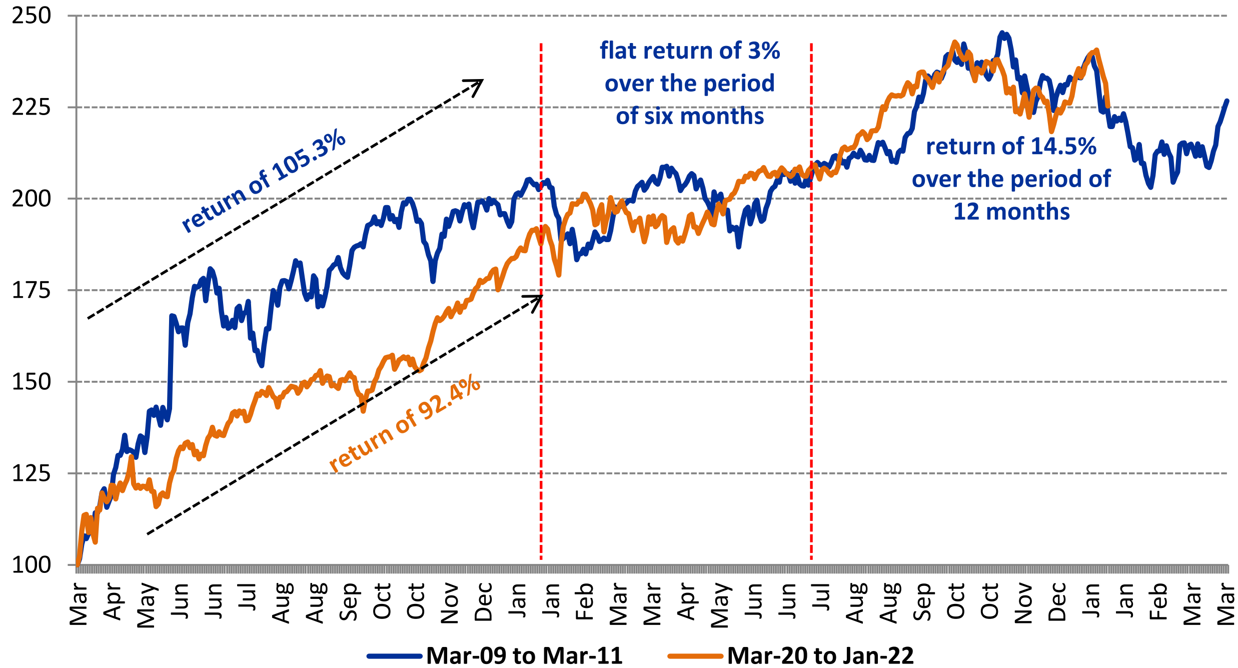
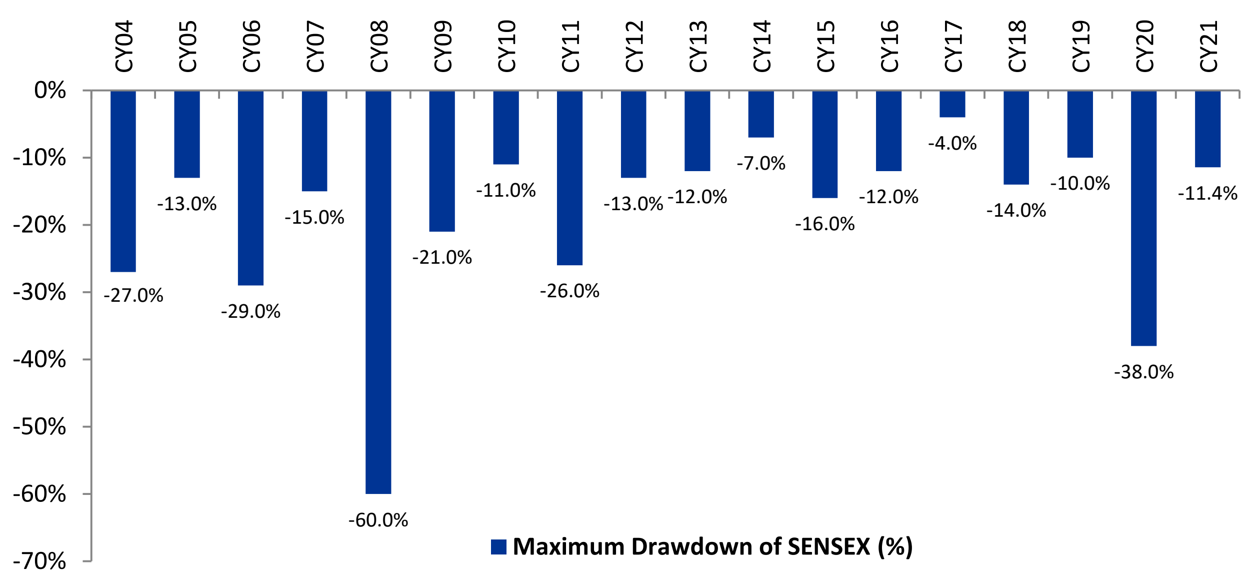
#1: Where are markets going?

Chart 1: Market movement in 2020 mirroring the 2009 rally - History does not repeat but rhymes



Source: ACE Equity, Valentis Research

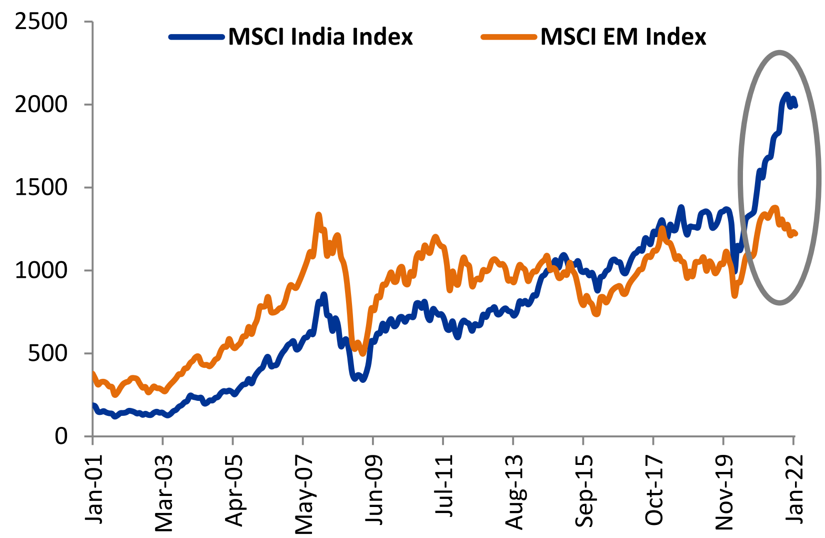
Chart 2: Maximum Drawdown of SENSEX (%) – a 10 to 15% correction every year is normal



Source: BSE, ACE Equity, Valentis Research

Indian markets are hugely co-related to global markets. The rally in India in 2020 and 2021 was part of a global rally. We think the correction will also be led by a global pullback in equities especially with the sharp outperformance over past 6 months (India up 11.8% vs EM down 10.4%)

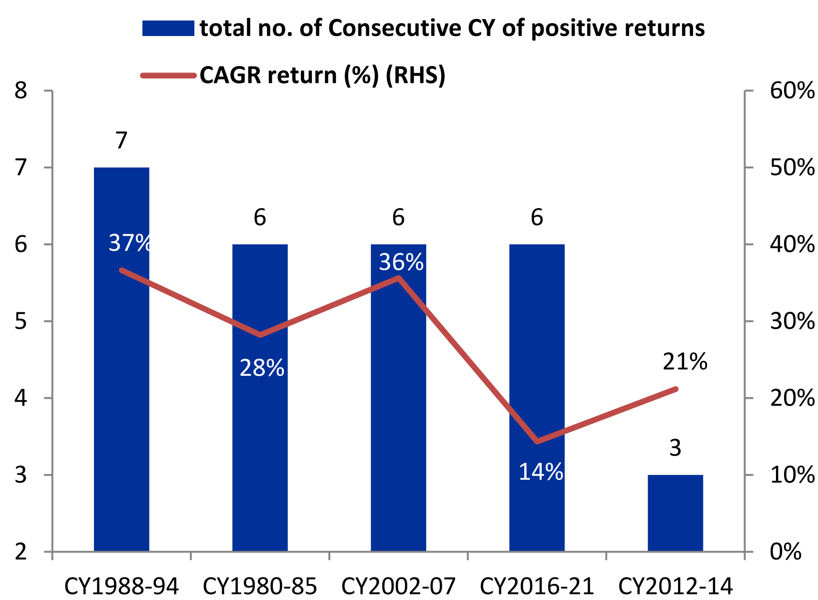
Chart 3: Sharp outperformance over past 6 months



Source: Investing.com, Valentis Research

Only once has the Sensex delivered 7 consecutive years of positive return. With 6 years of positive return already we are fighting with history now. The only positive is that this has been the weakest 6 year rally in terms of CAGR returns (14% vs 28-37% earlier).

Chart 4: Total no. of consecutive CY of positive return on SENSEX

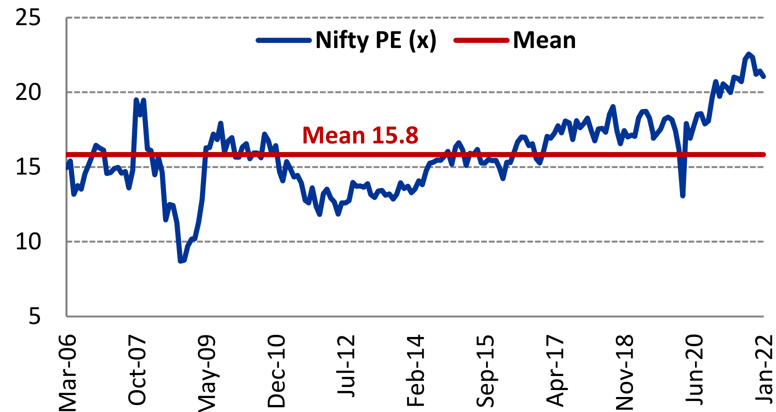


Source: BSE, Valentis Research

#2: Valuations expensive – re-rating behind us; onus on earnings

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.

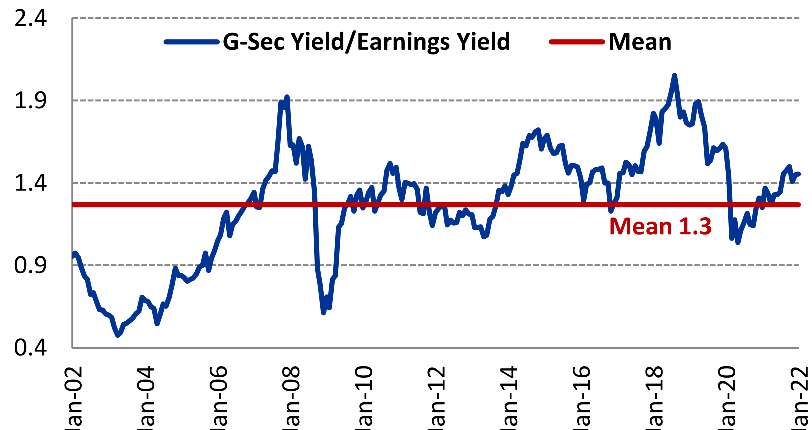
Chart 5: Nifty 12M Forward P/E (x)



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 expensive but not as much as PE or PB. We hope earnings recover before bond yield start reverting to mean.

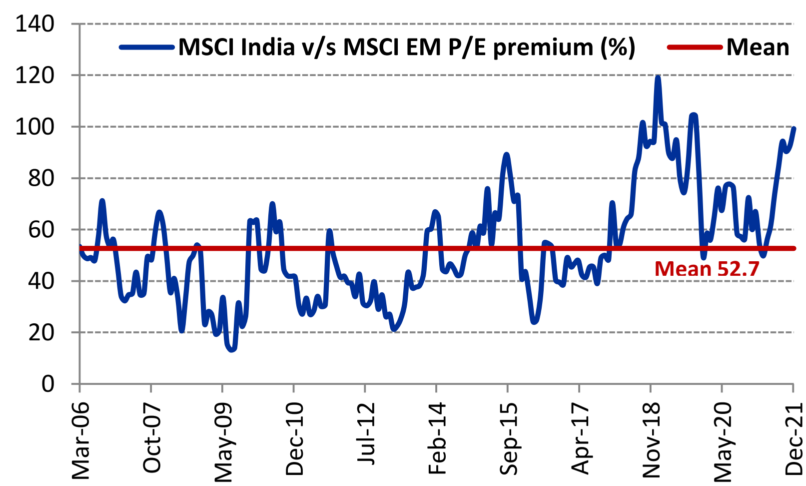
Chart 6: Bond yield Vs SENSEX yield



Source: MOSL, Valentis Research

While valuations look expensive in a historic context, India valuations relative to Emerging Markets are also at premium valuations. They trade at 100% premium to EM valuations vs a historic average of 55%.

Chart 7: MSCI India v/s MSCI EM P/E premium (%)



Source: MOSL, Valentis Research

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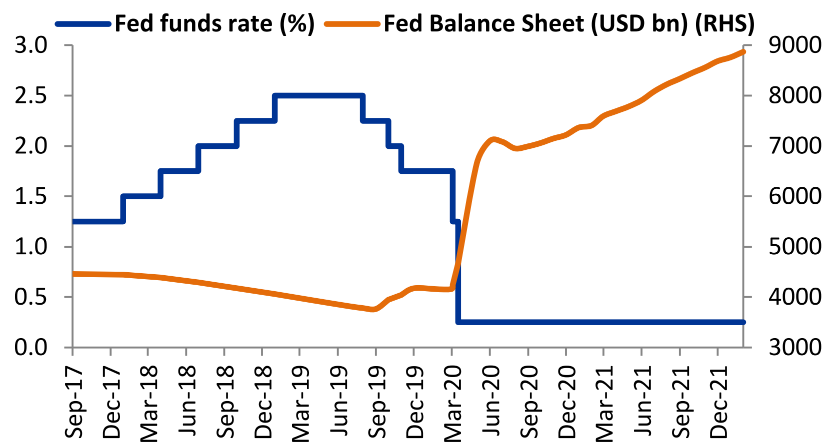
#3: Central Banks normalizing monetary policy are biggest risk to markets

The Fed balance sheet has expanded aggressively since the pandemic almost doubling in size. The Fed starts shrinking their balance sheet soon. There is a lot of room to reduce liquidity if they want to go to pre-pandemic levels

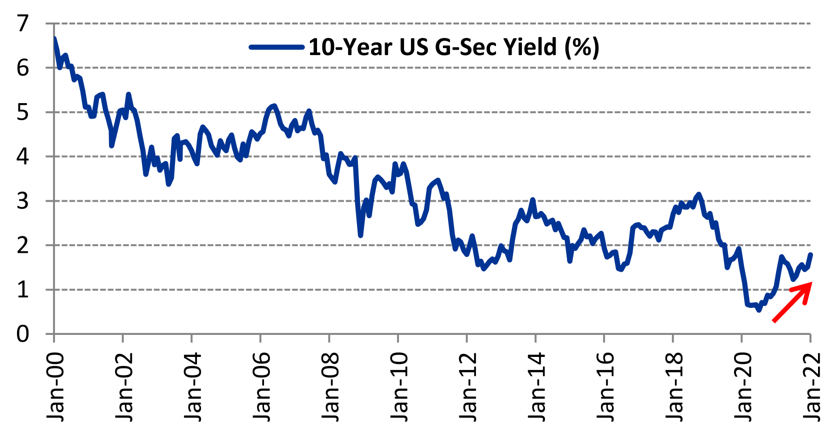
Chart 8: US Fed Rate & Balance Sheet Expansion



Source: Federal reserve, Valentis Research

The US 10-year bond yields have moved up in recent weeks anticipating an aggressive Fed interest rate hike.

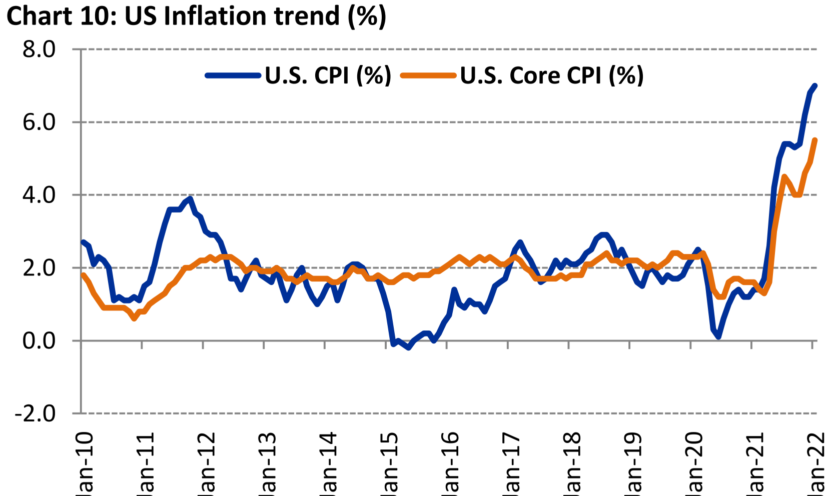
Chart 9: US 10 year bond yield (%)



Source: Investing.com, Valentis Research

The US CPI and core CPI both are at the highest levels since Feb 1991. The Fed rates at that time was 7%. This just indicates the Fed has a long way to go on rate hikes.

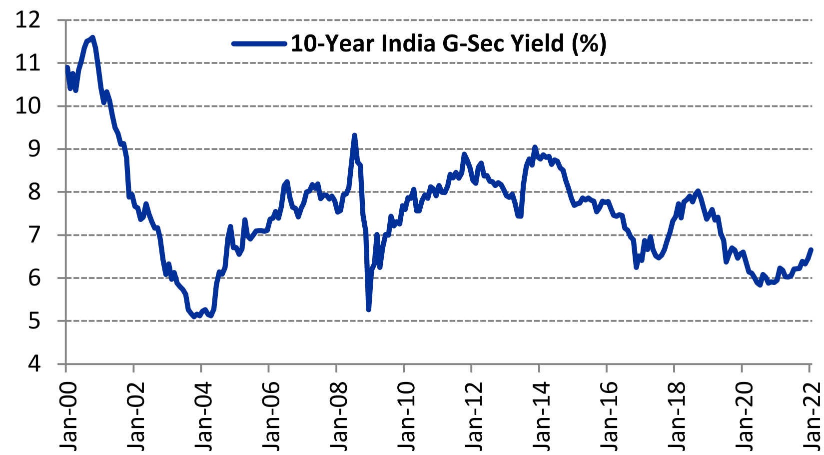
Chart 10: US Inflation trend (%)



Source: Investing.com, Valentis Research

Indian bond yields too have been moving higher with rising inflation and rising US bond yields.

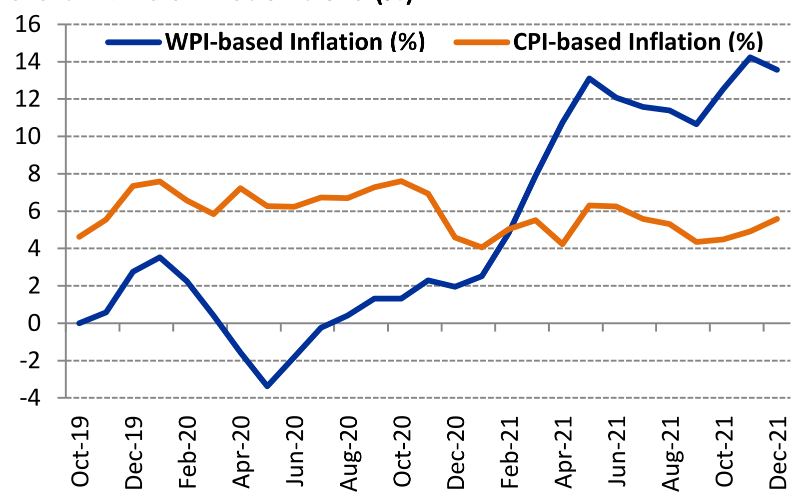
Chart 11: India 10 year bond yield (%)



Source: Investing.com, Valentis Research

Similarly in India inflation is rising…

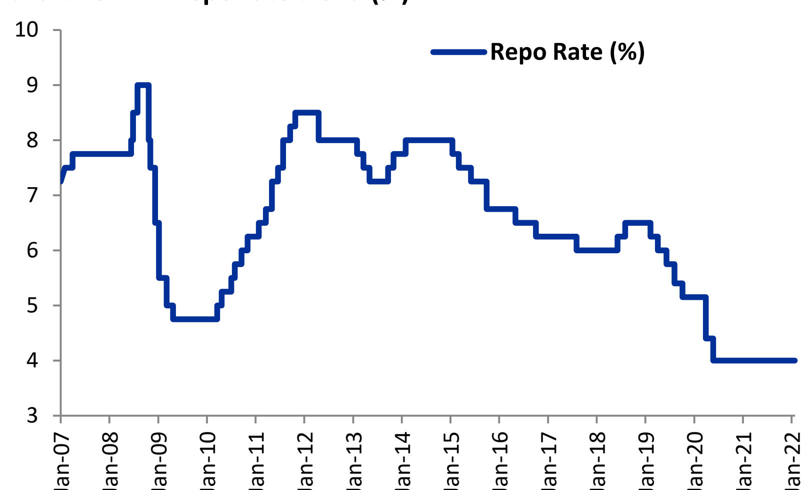
Chart 12: India Inflation trend (%)



Source: MOSPI, Valentis Research

…RBI too likely to hike rates this year

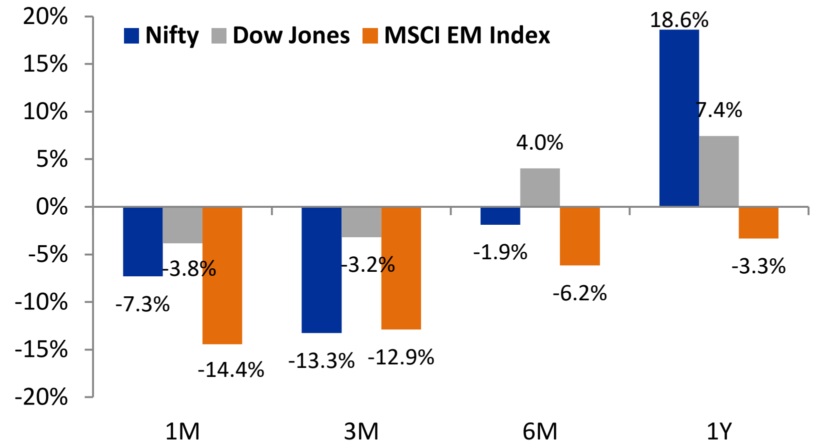
Chart 13: RBI Repo rate trend (%)



Source: RBI, Valentis Research

The Fed tapering in 2013 hurt the markets. This time the market reaction to tapering was muted with the Fed flagging the tapering well in advance.

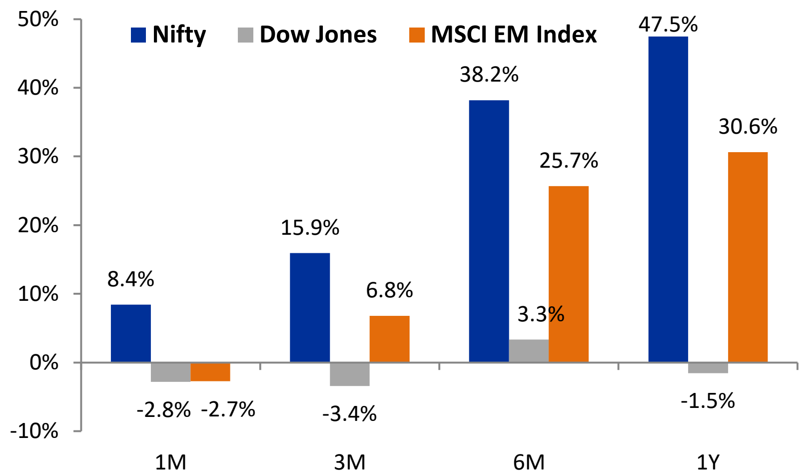
Chart 14: Stock market returns from Bernanke tapering announcement in 2013



Source: ACE Equity, Investing.com, Valentis Research

History of rate hikes is mixed. In spite of 17 rate hikes, Indian markets tripled between 2004 to 2007.

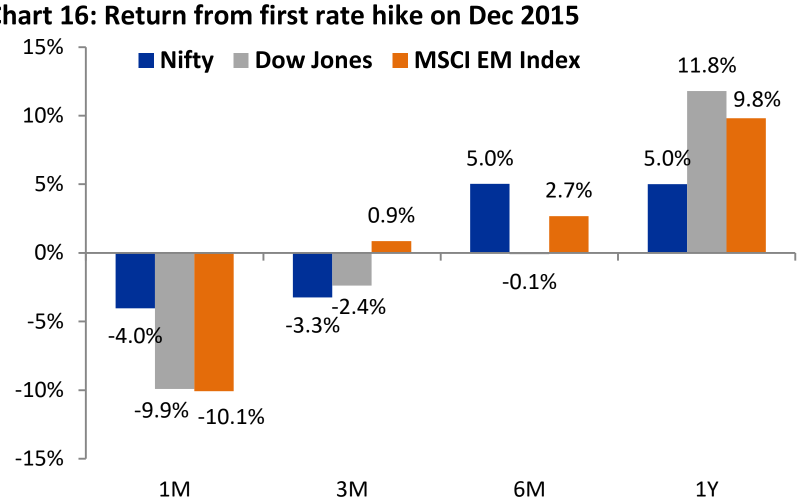
Chart 15: Return from first rate hike on June 2004



Source: ACE Equity, Investing.com, Valentis Research

But in 2015 the markets reacted negatively and the Fed was forced to abort rate hikes very quickly

Chart 16: Return from first rate hike on Dec 2015

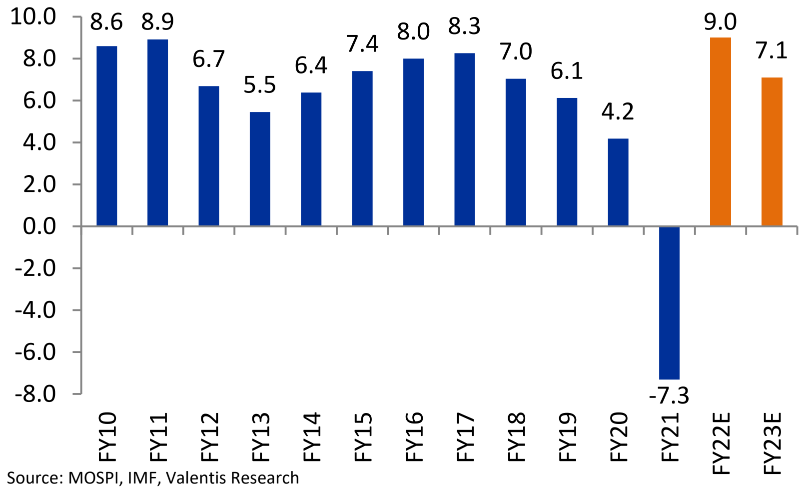


Source: ACE Equity, Investing.com, Valentis Research

#4: Earnings growth is the silver lining

GDP likely to see a sharp recovery …

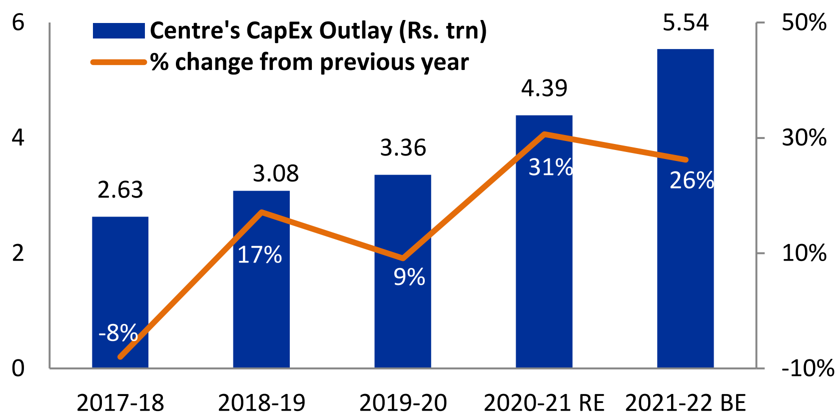
Chart 17: India's GDP growth (%)



Source: MOSPI, IMF, Valentis Research

… led by increased Government spend on infrastructure

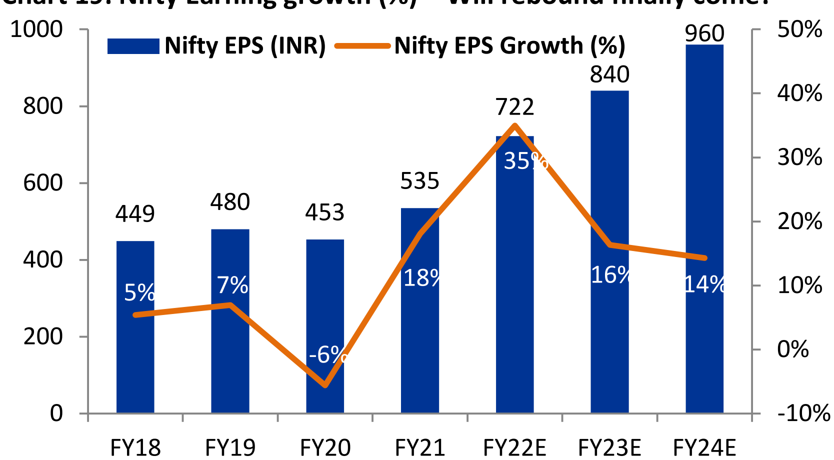
Chart 18: Centre's CapEx Outlay (Rs. trillion) is rising



Source: India Budget, Valentis Research   Note: RE – Revised Estimates, BE – Budget estimates

In spite of the pandemic, FY21 saw an earnings growth of 18%, the best in a decade. FY22 could see a 35% earnings growth as the economy opens up, partly due to base effect of the lock-down.

Chart 19: Nifty Earning growth (%) – Will rebound finally come?



Source: Kotak Institutional Equities estimates, Valentis Research

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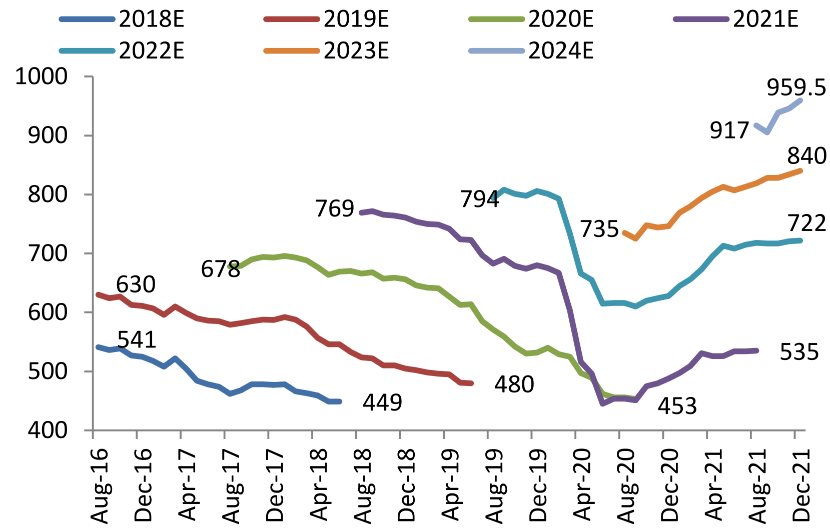
More encouraging is that we have seen earnings upgrades after many years of earnings downgrades. While we could see a near term pause due to rising commodity prices, we hope this trend continues next few years.

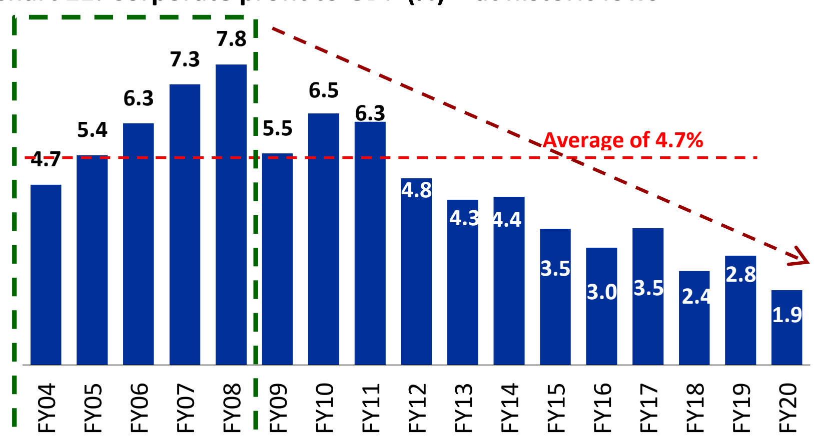
Chart 20: Nifty EPS estimates trend – could see a pause



Source: Kotak Institutional Equities estimates, Valentis Research

Can we witness 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

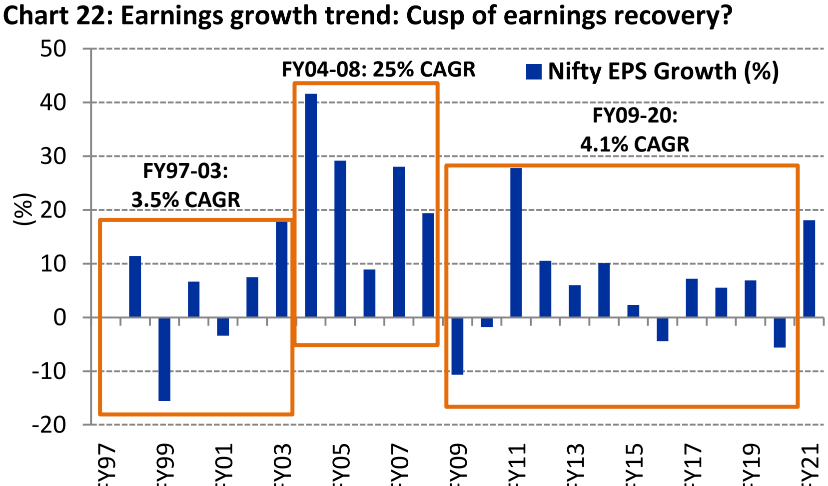
Chart 21: Corporate profit to GDP (%) – at historic lows



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 22: Earnings growth trend: Cusp of earnings recovery?

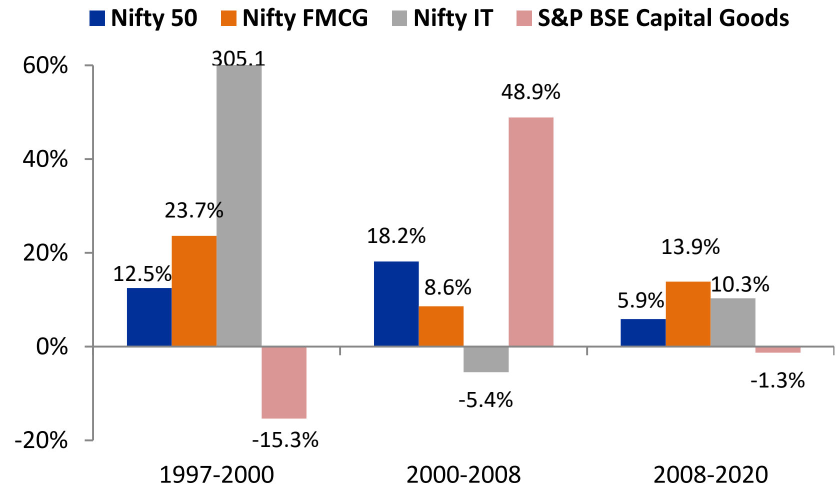


Source: MOSL, Valentis Research

#5: Will there be a sectoral rotation?

Big drops in market have signaled a major sector rotation. We think high quality but expensive consumer staples will under-perform this rally.

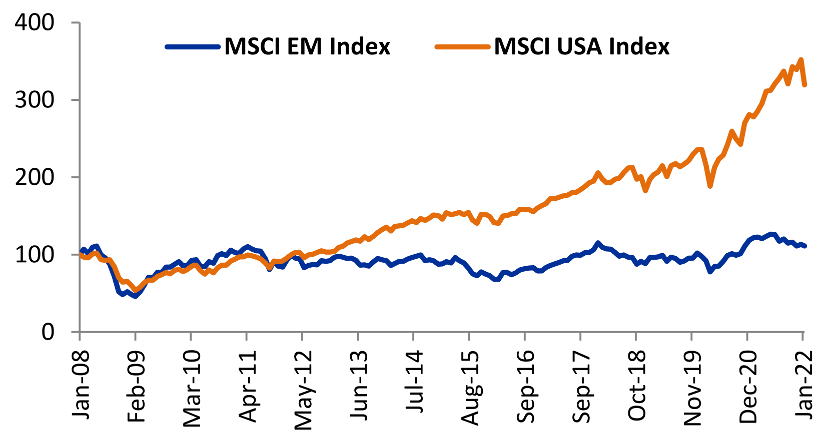
Chart 23: Sectoral indices return during different bull runs(%)



Source: BSE, ACE Equity, Valentis Research

Emerging markets have sharply under-performed developed markets since 2008. Globally, we think emerging markets will outperform developed markets as global growth recovers.

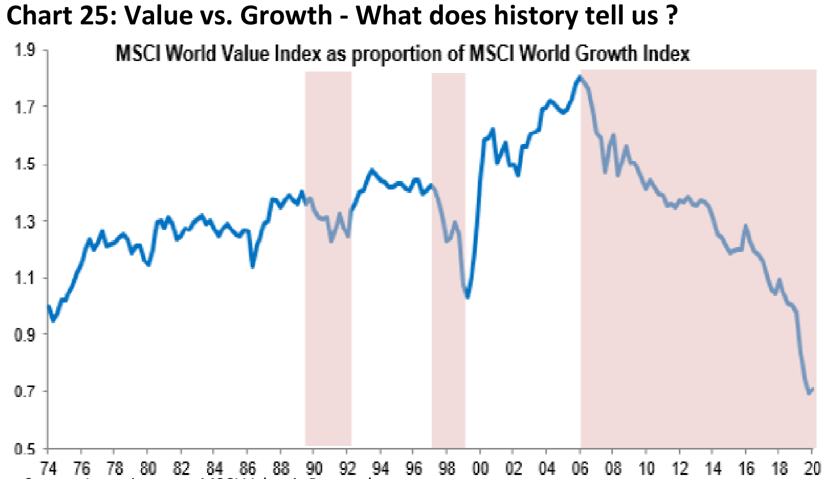
Chart 24: Will EM come back in favor?



Source: Investing.com, Valentis Research

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



Source: Investing.com, MSCI Valentis Research

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#6: Portfolio Update

1. Both our portfolios were strong outperformers in CY21. Small and mid-caps rebounded strongly in the year and recovered the under-performance vs large caps over past 3 years. We were well positioned to benefit from this trend. The second trend was the rally in domestic cyclicals, a trend we were early to catch and benefit from.
2. In CY21, Our Valentis Rising Stars Opportunity Fund was the second-best performing PMS in the country out of the 250 odd PMS schemes tracked by PMS Bazaar.
3. CY22 will definitely be a more challenging year and we expect modest returns relative to the past 18 months. We will be adding to some sectors like financials and autos where we have been huge under-weight last year. The banking sector that under-performed in CY21 could see better days as the economy recovers and lot of the NPL provisioning is behind us. In autos, easing of the chip shortage will be a key driver.
4. 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.

Chart 26: Valentis Rising Star Opportunity Fund Portfolio Performance (as on December 31, 2021)

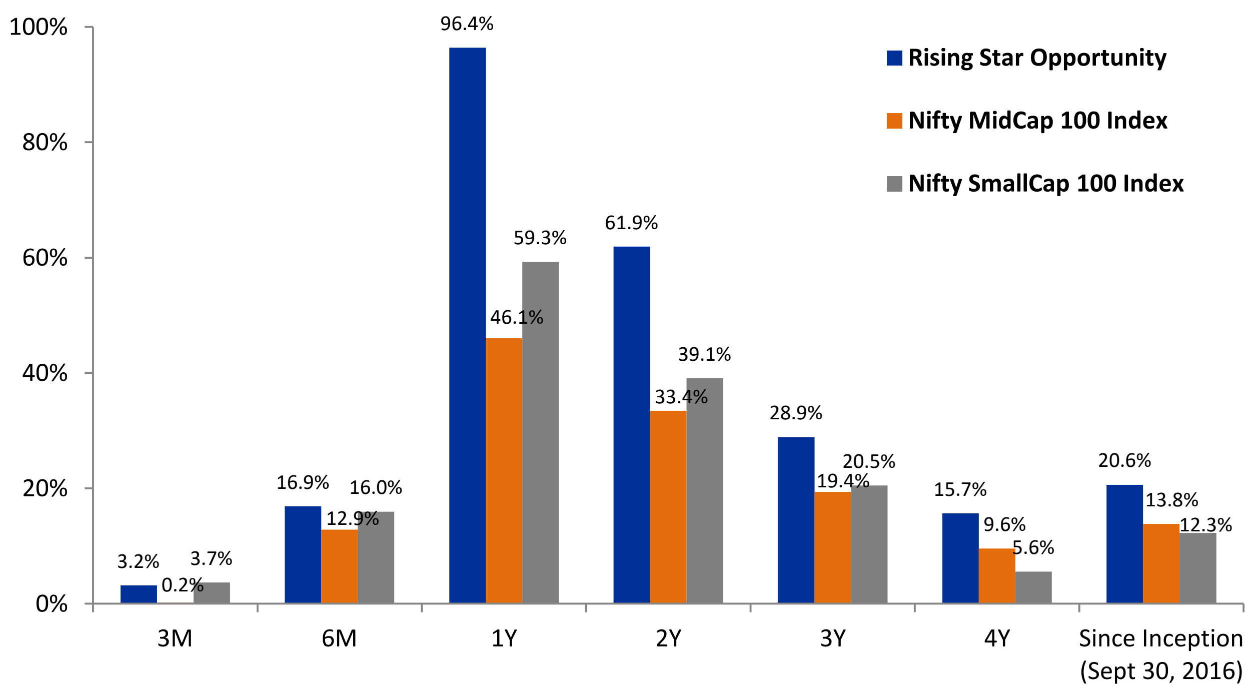

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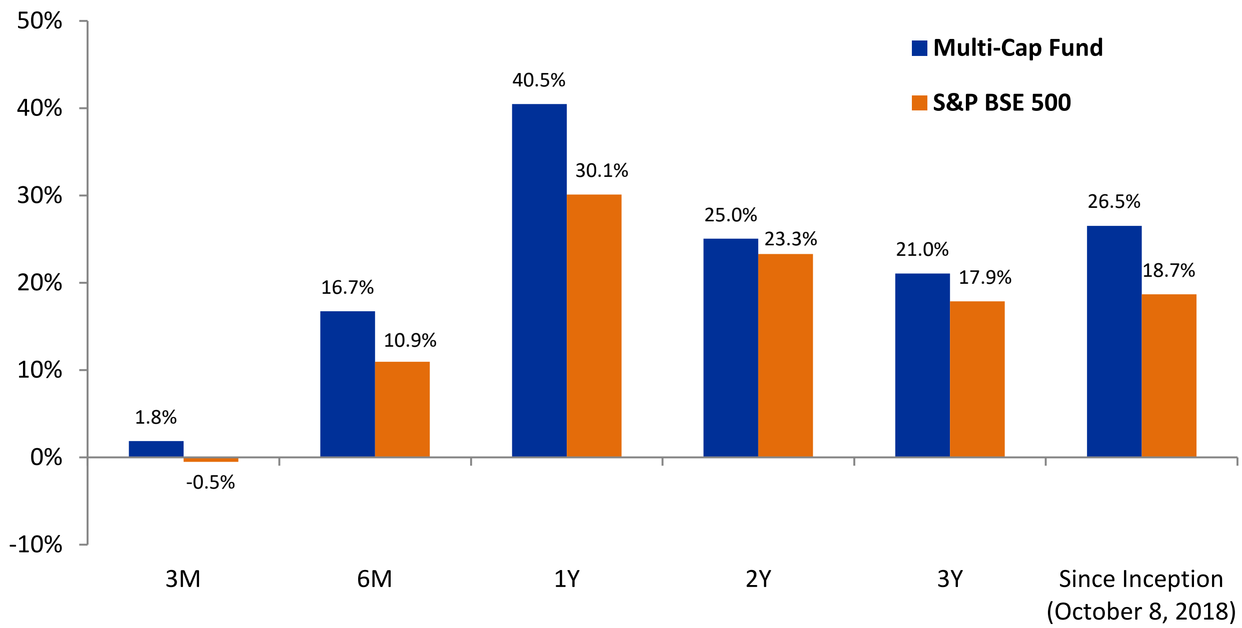
Chart 27: Valentis Multi-Cap Fund Portfolio Performance (as on December 31, 2021)



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