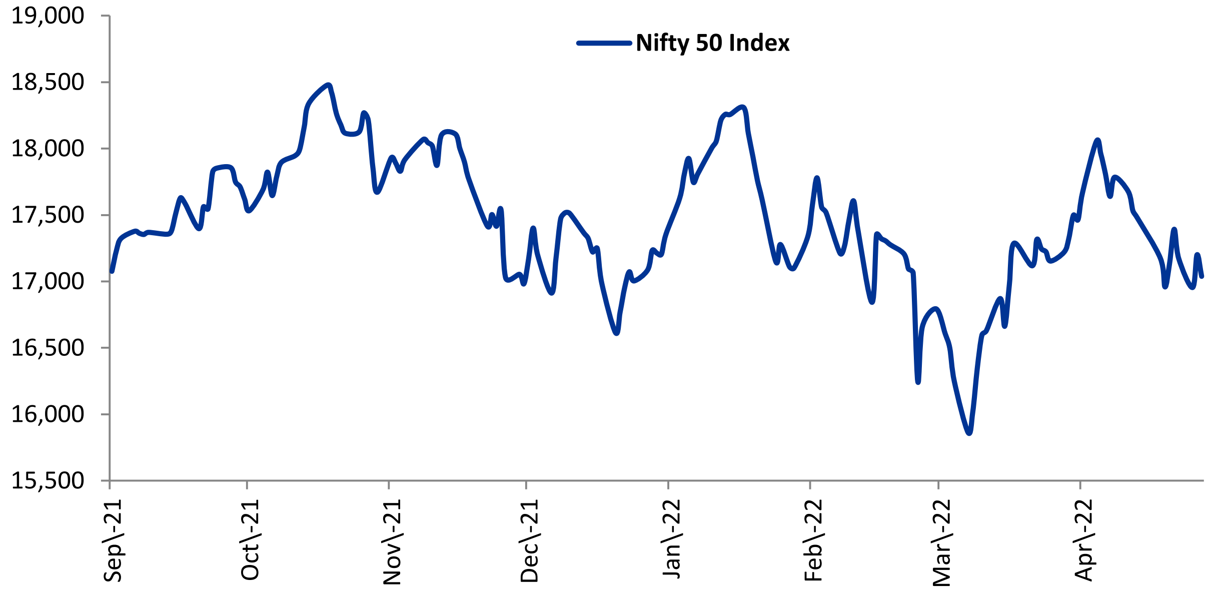
Valentis Advisors

7 burning questions from investors

April 27, 2022

We had expected 2022 to be a year of consolidation for the markets with a likely correction in the first half of the year. (CY22 outlook https://www.valentisadvisors.com/insights/outlook-2022-jan-2022/). So far markets have behaved in line with our expectations moving in a narrow range and practically flat over past 8 months.

Chart 1: Nifty 50 Index past 8 months



Source: ACE Equity, Valentis Research

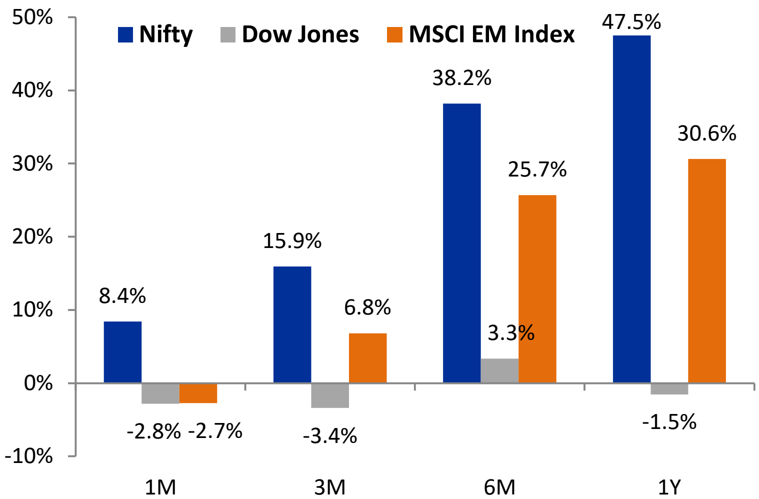
We believe the market will continue to see a time and probably some price correction. While the focus of the market will be on the Fed hike and the likely reduction in the Fed balance sheet, we would be looking for any signs of a weakening of the economy. In this report we seek to answer some of the key questions we get from investors.

#1: Is Fed the biggest factor to watch for the markets?

- We think near term the Fed remains the biggest risk for markets. A normalization of the Fed policy is inevitable and partly priced into markets. We should see a 50 bps increase in rates in May, 2022 and a start of the balance sheet reduction with probably close to $100 bn reduction per month.

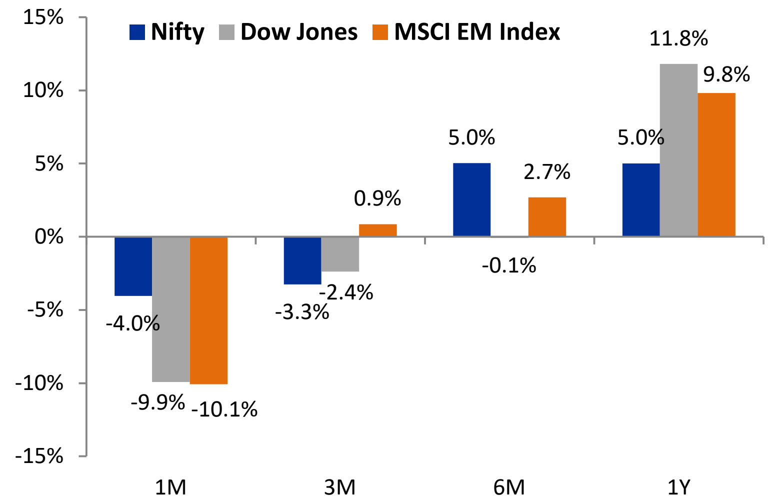
- Are the rate increases necessarily bad for markets? In the 2004 to 2006 cycle Fed hiked rates 17 times by 25 bps each. During the same period, Nifty went up 99.1% though the Dow Jones went up only 7.2%. During the 2015 cycle which was more sober, Fed hiked rates by 2.25%. Markets went up during this period too with Nifty rising 40.1% and Dow Jones rising 31.4%.
- However, in both these cycles, we have seen markets correct initially in the first few months.

Chart 2: Return from first rate hike on June 2004



Source: ACE Equity, Investing.com, Valentis Research

Chart 3: Return from first rate hike on Dec 2015

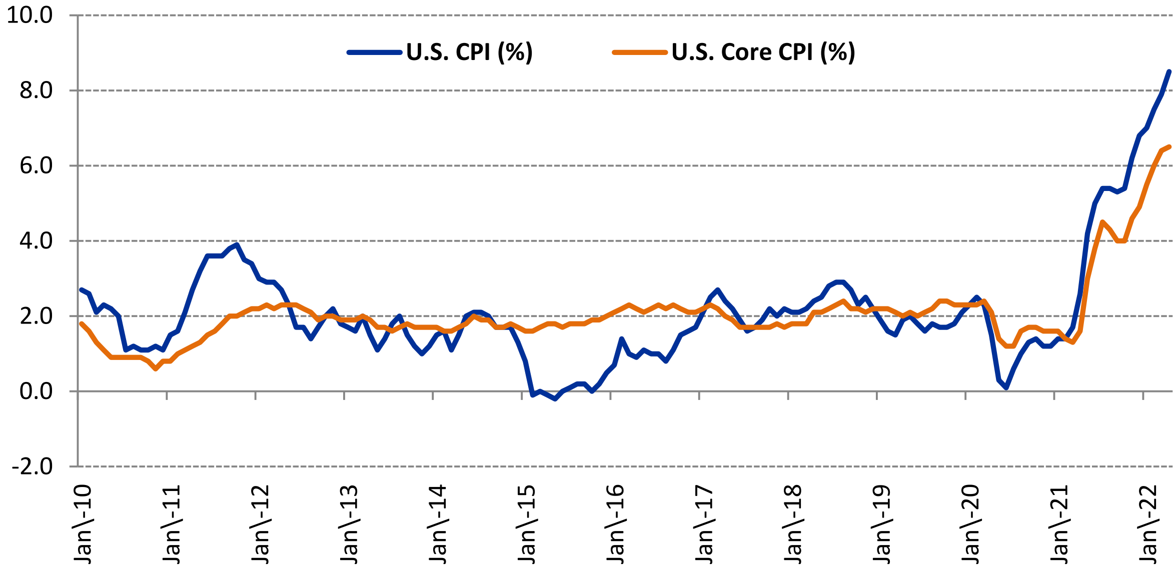


Source: ACE Equity, Investing.com, Valentis Research

#2: Are we at a peak of inflation?

- Inflation in the USA currently at 8.5% is at its highest since 1982. Fed rate at that time hit a high of more than 10% compared to the 0.25-0.50% currently. Hence, even with a slightly lower inflation, we may continue to see multiple Fed rate increases though possibly at a slower pace.
- There are 2 factors that may ease current inflation. First is the war between Russia and Ukraine. If this eases, we could see oil, gas and other commodity prices ease. Second is an easing of the logistic bottlenecks that started with Covid. While we saw some improvement in the logistic chain, the strict lock-down in China following the resurgence of Covid has raised worries on logistic issues again.
- Overall, our view is that we will hopefully see some easing of inflation as we progress into the year and these cyclical factors start benefitting inflation. But we will still see inflation being higher than normal for this year.

Chart 4: US Inflation trend (%)

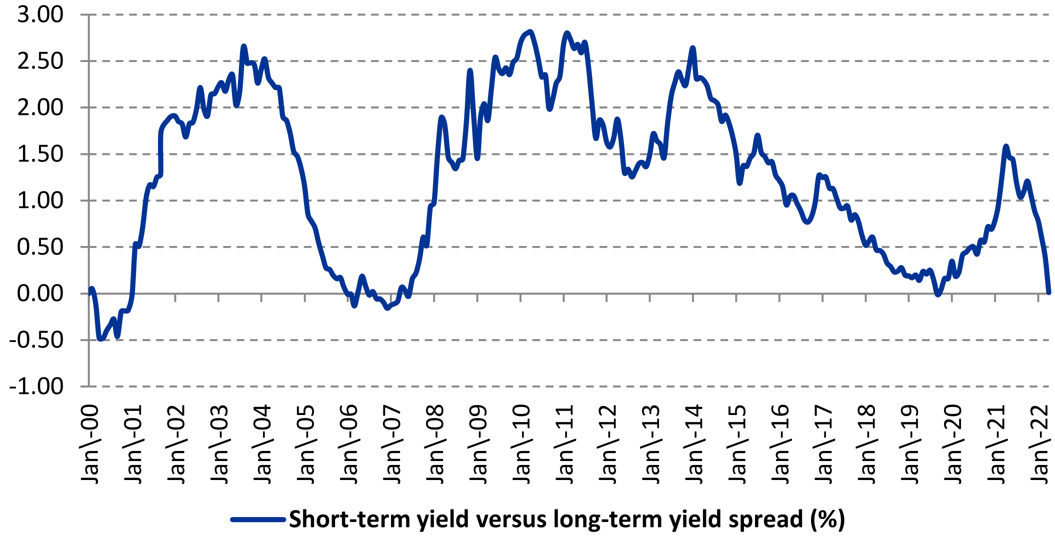


Source: Investing.com, Valentis Research

#3: Should we worry about recession?

- While the general consensus is of 6-7 Fed rate hikes this year, there are some who expect lower rate hikes and a slow-down in the economy.
- We think there are 2 options: (a) the economy remains strong, we see Fed hikes and inflation gradually eases (b) The Fed hikes near term but the economy slows and inflation reduces sharply. The Fed stops hiking in the next 6 months.
- We think the second option will be worse for the markets since the economy and earnings will stall. As we saw in the charts earlier, the markets recover in spite of a Fed hike as long as the economy continues to be buoyant.
- One of the important factors to watch will be the bond yields and see if it inverts. We saw that for a couple of days last month. But we must remember that while all US recessions have been preceded by an inversion of the bond yield, not all bond yield inversions have led to a recession.

Chart 5: US Yield curve inversion

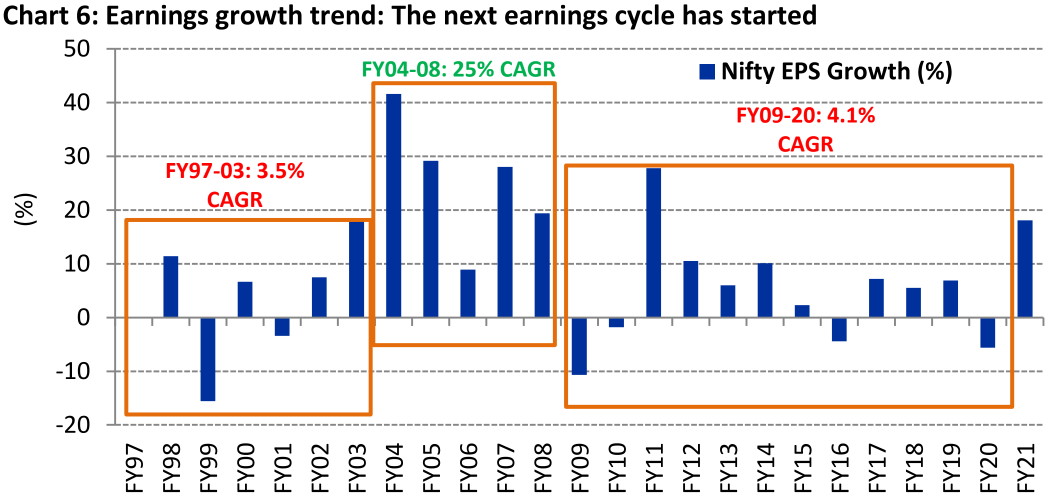


Source: Investing.com, Valentis Research

#4: Can earnings fall sharply? Near term risk but we still expect doubling in 5 years

- Our broad thesis of an earnings recovery is intact and we believe earnings can double over 5 years. This is slower than the tripling of earnings in the previous cycle from FY03 to FY08.
- Near term earnings can see some margin pressure and some downgrades as high commodity prices cannot be passed on immediately. However, just remember that this will benefit commodity producers which have an equally large weight in the index. Hence, overall earnings downgrades may not be very high. But this will hit some of our stocks which are users of commodities.

Chart 6: Earnings growth trend: The next earnings cycle has started

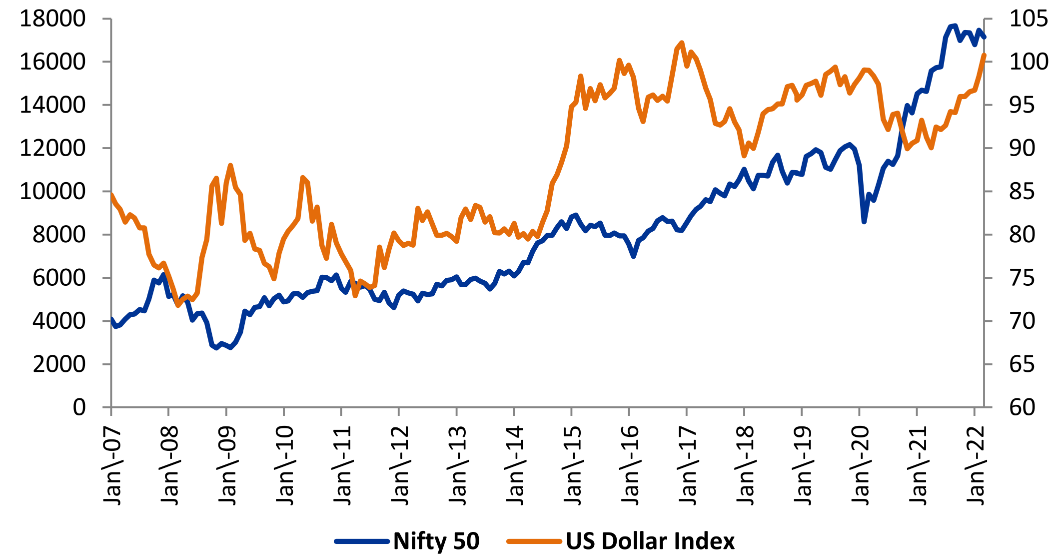


Source: MOSL, Valentis Research

#5: Strengthening dollar is negative for Emerging Markets and India

The dollar has strengthened vs most currencies as the dollar index is at a level last seen in March 2020. Historically, a strong dollar has been negative for markets.

Chart 7: Dollar Index vs Nifty 50 Index



Source: Investing.com, Valentis Research

#6: Should we worry about the Russia-Ukraine war?

- Historically, markets have not been adversely hit over a 1-year period due to most military conflicts.
- Secondly, the conflict has so far been localized and it appears highly unlikely that it will spread even to neighbouring Europe.
- However, the conflict is reinforcing the inflation fears with commodity prices spiking due to sanctions on Russia.
- Longer term there may be issues about reversal in pace of globalization and also diversification of holdings of Central Banks.

Table 1: Market reaction to geopolitical events

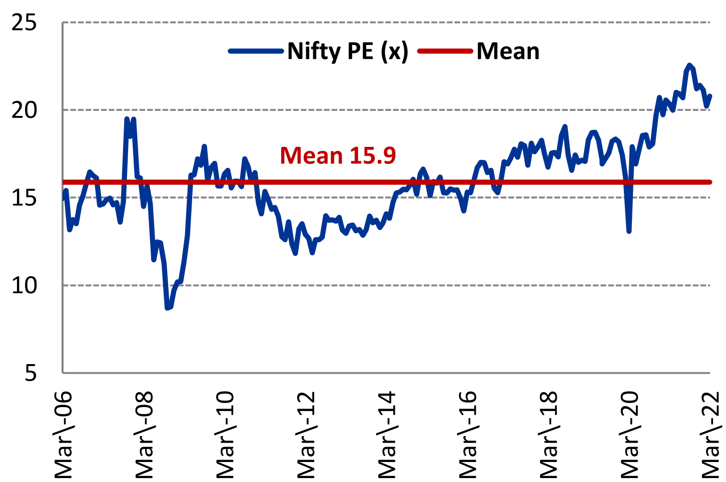
		S&P500 return					Nifty50 return				
Event	Event Date	Size of Sell Off	1M	3M	6M	1Y	Size of Sell Off	1M	3M	6M	1Y
9/11 attack	11\09\2001	-13.5%	0.4%	4.3%	6.9%	-17.3%	-17.8%	-9.0%	7.4%	14.9%	-3.4%
Iraq War	20\03\2003	-3.7%	2.0%	13.7%	18.3%	26.7%	-5.0%	-8.2%	7.3%	29.0%	68.3%
Arab Spring (Eqypt)	25\01\2011	-1.2%	2.2%	3.4%	3.6%	2.7%	-4.0%	-6.7%	3.3%	-0.1%	-9.3%
Libya Intervention	19\03\2011	-4.8%	2.0%	-0.6%	-5.9%	4.5%	-1.7%	6.6%	-0.1%	-5.4%	-1.0%
Russia - Crimea	20\02\2014	-0.2%	1.8%	1.8%	8.0%	14.7%	0.3%	6.4%	19.4%	29.3%	45.0%
Intervention in Syria	22\09\2014	-9.4%	-3.4%	4.2%	5.5%	-2.6%	0.8%	-1.8%	2.2%	5.2%	-4.1%
Air strike on Syrian Air Base	07\04\2017	-1.2%	1.9%	3.0%	8.2%	10.6%	-1.3%	0.9%	5.1%	8.5%	12.3%
North Korea missile crisis	28\07\2017	-1.5%	-1.1%	4.4%	15.4%	14.8%	2.7%	-1.0%	3.1%	10.5%	12.6%
Saudi Aramco drone strike	13\09\2019	-5.1%	-1.4%	5.4%	-9.9%	11.1%	2.5%	2.4%	9.1%	-10.1%	3.5%

Source: ACE Equity, Investing.com, Valentis Research

#7: Have valuations become cheaper?

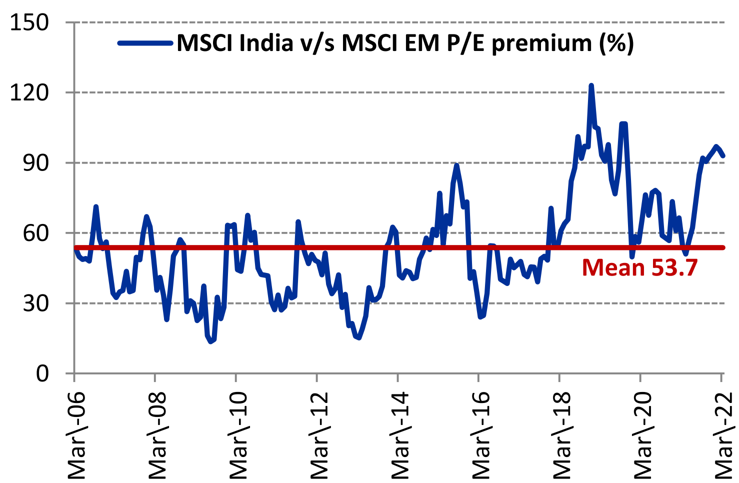
- With markets being flat for 8 months, valuations are cheaper than they were at the peak. But valuations are still 15-20% higher than long term averages.
- Even in a global context, India is trading at relatively expensive valuations eg. India has traded at a PE premium of 55% to its emerging market peers. The current premium is close to 80%.
- Given that we are at the cusp of an earnings recovery cycle, valuations will likely trade at some premiums to historic averages. But over next 6 months we see a compression in valuations as market sees a time correction.

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



Source: Edel, Valentis Research

Chart 9: MSCI India v/s MSCI EM P/E premium (%)



Source: MOSL, Valentis Research

Portfolio Performance and outlook

1. We continue to believe CY22 will definitely be a more challenging year and we expect modest returns relative to the past 18 months. As mentioned in our earlier notes, we have been building cash in the portfolios so that we can buy at more attractive valuations if the markets correct. For new portfolios, we are staggering buying over 8-12 weeks though we are ready to deploy cash more aggressively if the markets correct meaningfully.
2. However, we continue to remain optimistic that we are at the start of an earnings cycle that will drive reasonable stock returns over next 3-5 years. We think any volatility in markets near term will provide us a great opportunity to buy stocks at attractive valuations.
3. We have continued to outperform markets without any large holdings in global commodity companies that have rallied sharply due to the Ukraine conflict. There are 3 areas we are focused on:
    a. Sectors like cement and other home building sectors where near term earnings will be under pressure due to the spike in commodity prices. We think the fall in share prices offer us an attractive entry price.
    b. The financial sector where we were under-weight during the Covid crisis is headed for better days as the economy recovers and lot of the NPL provisioning is behind us.
    c. Auto also is an under-weight sector for us. But we thinking we are close to a bottom of the cycle and could see sharp earnings growth over next few years especially as the chip shortage eases.

Chart 10: Valentis Rising Star Opportunity Fund Portfolio Performance (as on April 26, 2022)

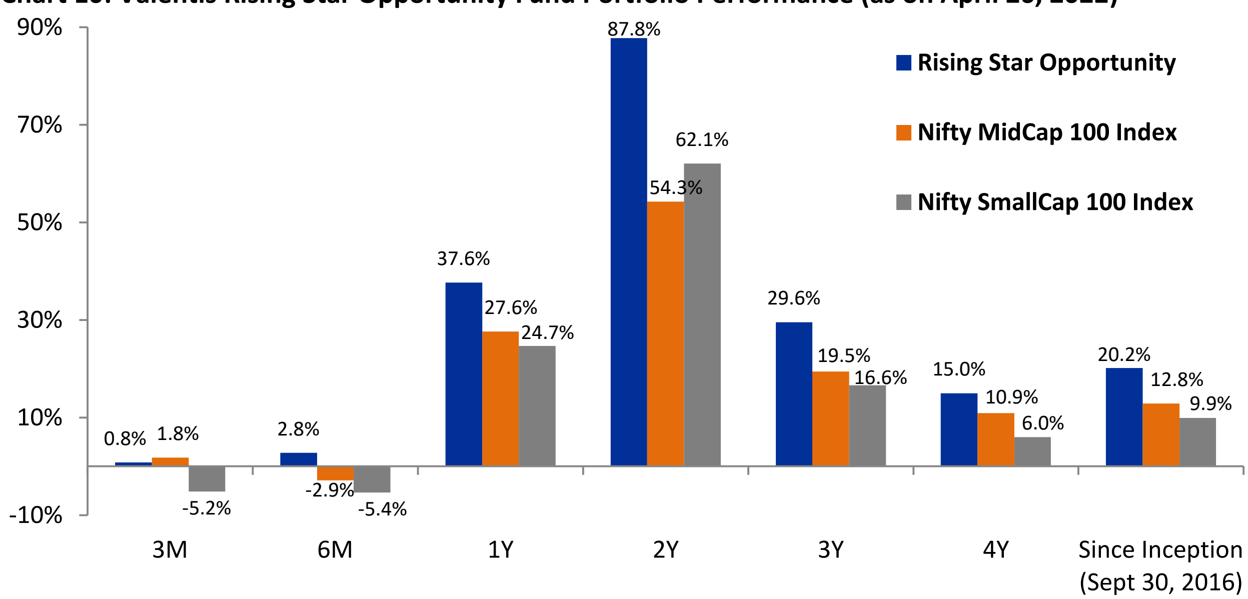
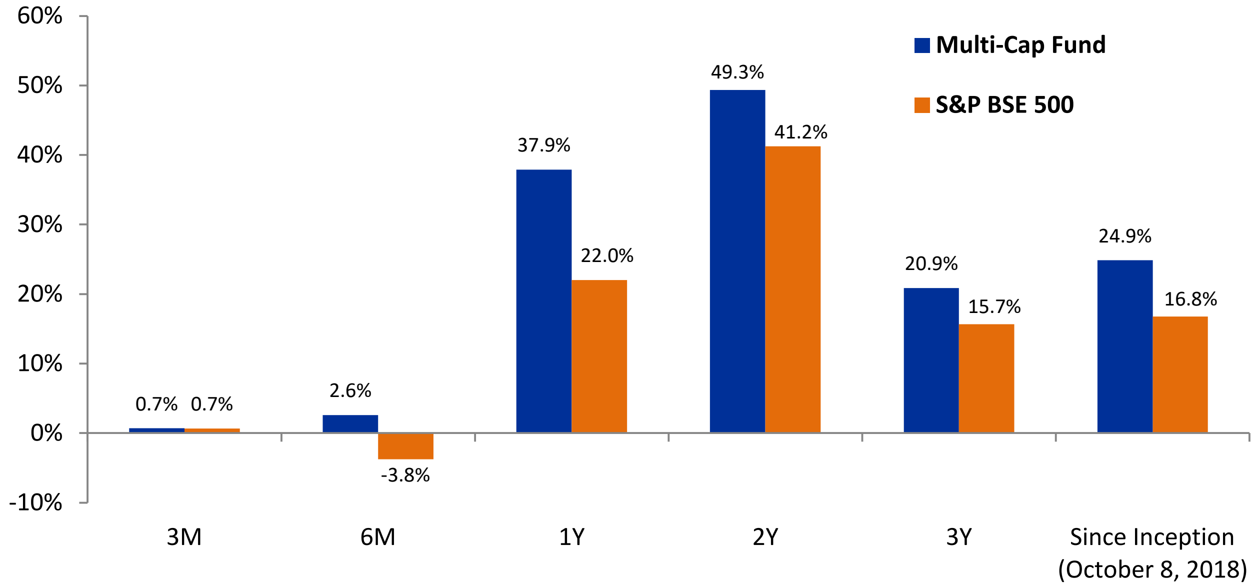


Chart 11: Valentis Multi-Cap Fund Portfolio Performance (as on April 26, 2022)



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