Valentis Advisors

Inflation vs Recession

July 20, 2022

Market Outlook – We expect time correction with some price correction

Though the market has fallen 5.8% YTD and 12.2% from the peak, valuations while more reasonable than a year ago are still not compelling (see Charts in Appendix). We expect markets to be flattish over next 6 months which will help reduce valuations. There is no doubt that we are faced with lot of macro uncertainties that could drive markets. Our range-bound view of the market is based on the following assumptions that we spell out in detail in the note:

1. Inflation has peaked though will not reach the 2% Fed target. Focus of the markets is likely to shift to slowing growth.
2. Global economies will slow and India too will be affected. For equity markets the extent of the slow-down in the US will determine returns over next 6 months. On an average recessions post the Great depression have last for 12 months on USA and surprisingly produced flattish returns in the markets (though there is a lot of divergence in returns).
3. Earnings are likely to see some downgrades as margins come under pressure. However, we continue to expect 15% CAGR in earnings over next few years.
4. We expect the dollar strength to peak over next few months and that will be positive for emerging market equities including India.

So what should investors do? As we have mentioned earlier, we were sitting on larger than normal cash levels. We have invested some part of that cash over past 4 weeks. We think further weakness would provide us an opportunity to invest in stocks at reasonable valuations. We continue to invest new money in a staggered manner.

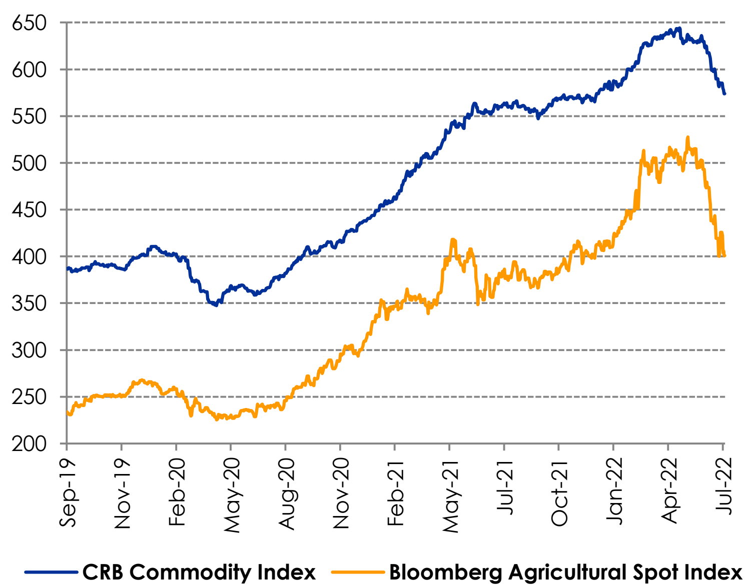
#1: Inflation has peaked but will remain higher than central bank target

- We believe inflation has peaked both in US as well as India and should see a meaningful downturn over next few months. However, inflation will likely remain above the Fed range of 2% over the course of next 6 months at least. With the Fed having front loaded rate hikes, we expect them to slow rate hikes to 25 bps or even pause rate hikes before the end of the year.
- There are 3 reasons for the easing of inflation (a) The Ukraine-Russia war has been localized (b) Supply bottlenecks post-Covid are now easing and we are starting to see

ocean freight rates come down as well as port congestion ease (c) demand is starting to slow and this is bringing down prices of commodities.

- While commodity prices are falling from the peak, they are still higher yoy. This means that inflation will trend down but is unlikely to go to the Fed target of 2% for this year at least.

Chart 1: Commodity Prices are falling from the peak



Source: MOSL, Valentis Research

Table 1: Prices of Some Key Commodities have seen significant fall

Name of Commodity	CMP	Drop from the Peak	YoY %
Crude Oil (bbl)	104.96	-21.6%	41.4%
Palm Oil (MT)	892.76	-53.7%	-10.1%
Coal	352.00	-23.5%	191.1%
Aluminium (MT)	2324.00	-40.1%	-7.1%
Copper (MT)	7160.00	-36.6%	-24.2%
Nickel (MT)	19342.00	-59.9%	3.1%
Wheat (Bu)	793.25	-38.0%	15.6%
Sugar (lbs)	18.95	-7.2%	9.3%
Natural Gas (mmbtu)	6.63	-28.9%	83.4%

Source: MOSL, Valentis Research

#2: Economies will slow – do we get a recession?

A slow-down in the USA is inevitable as inflation starts to hurt consumer demand. We are starting to see hiring freezes and will likely see layoffs also by the end of the year. The question is how deep is the slow-down and a possible recession.

- An average recession in the USA lasts for 12 months and including the Great Depression (1929-1933), it lasts for 15 months.
- The average stock market returns during the recession has been flat excluding the Great Depression and -7% including the Great Depression period. However, the average masks a wide variation in the return with the Global Financial crisis producing the worst returns since the Great Depression.
- Post the recession, markets have seen a rebound with average returns aggregating 15% post the Great Depression period.

Table 2: USA Recession history – how do markets behave?

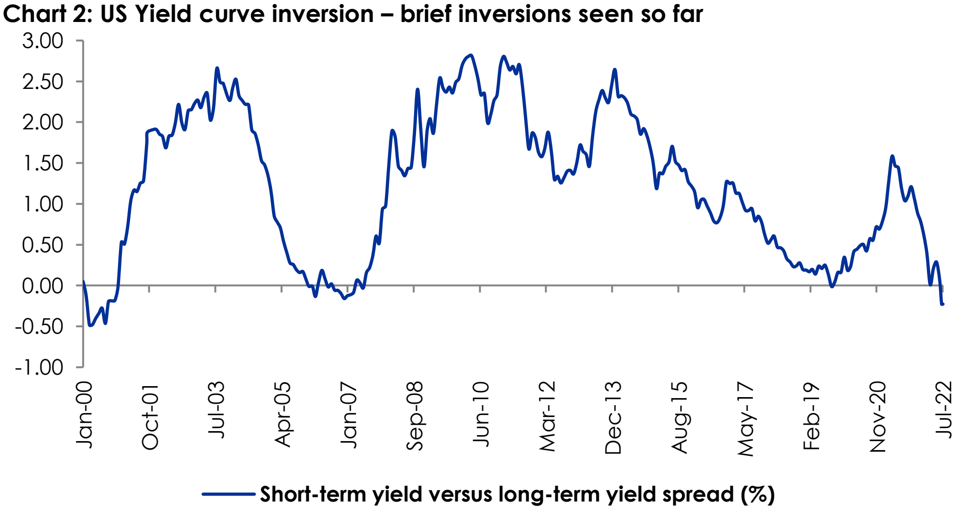
USA Recession History						
Sr. No.	Start	End	Duration	1Y DJI Return	DJI Return	1Y DJI Return
				Pre	During Recession	Post
1	Aug\29	Mar\33	3 yrs 7 months	58%	-85%	81%
2	May\37	Jun\38	1 yr 1 month	14%	-23%	-2%
3	Feb\45	Oct\45	8 months	18%	16%	-9%
4	Nov\48	Oct\49	11 months	-5%	11%	19%
5	Jul\53	May\54	10 months	-1%	19%	30%
6	Aug\57	Apr\58	8 months	-4%	-6%	37%
7	Apr\60	Feb\61	10 months	-4%	10%	7%
8	Dec\69	Nov\70	11 months	-19%	-1%	5%
9	Nov\73	Mar\75	1 yr 4 months	-19%	-7%	30%
10	Jan\80	Nov\82	2 yrs 11 months	4%	19%	23%
11	Jul\90	Mar\91	8 months	9%	0%	11%
12	Mar\01	Nov\01	8 months	-10%	0%	-10%
13	Dec\07	Jun\09	1 yr 6 months	6%	-36%	16%
14	Jan\20	Jun\20	6 months	13%	-9%	34%

Source: investopedia.com, investing.com, Valentis Research

We expect India to weather the storm better than most developed economies. However, India too will see some growth slow-down over the next year as global economies struggle.

The bond yield has not yet signaled a recession though we have seen it invert recently for a brief period – the second time in this calendar year. The bond yield inversion has proceeded all US recessions (though not all bond yield inversions have led to a recession).

Chart 2: US Yield curve inversion – brief inversions seen so far



Source: Investing.com, Valentis Research

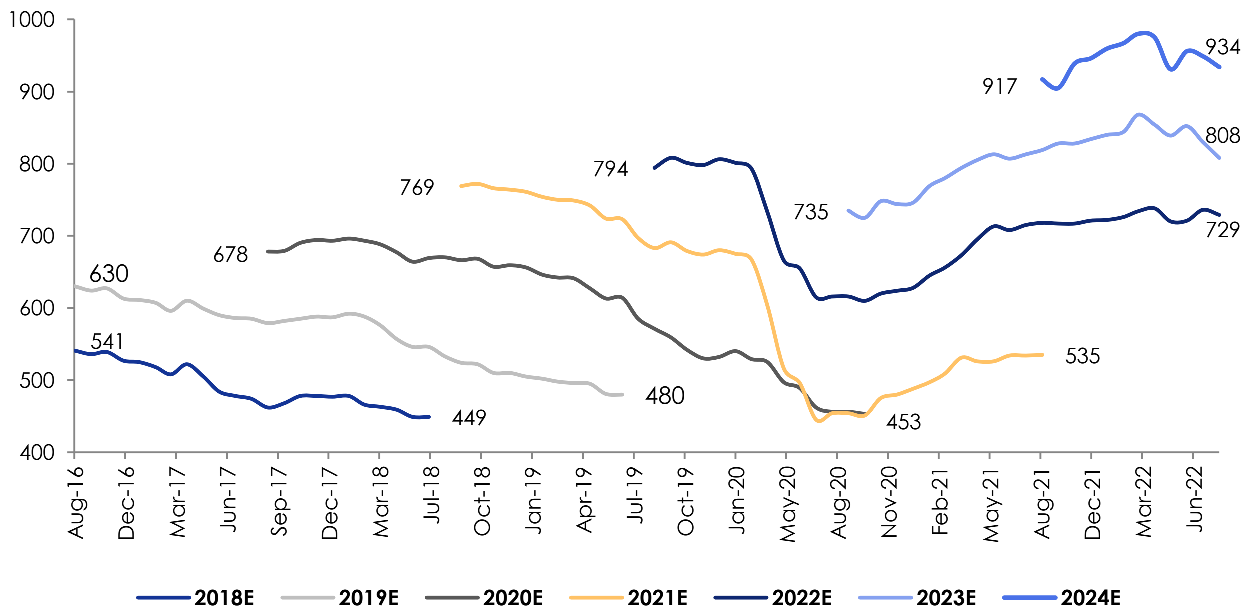
#3: Near term we see earnings risk in India

Earnings have seen a sharp upgrade cycle in India since September 2020. However, we see risk of earnings downgrades near term led by 3 factors:

1. With rising input cost pressure, especially oil, we could see margins come under pressure in commodity users.
2. Steel earnings will see downgrades with fall in prices. These stocks had been a reasonably large contributor to earnings upgrades.
3. Slowing demand could put some pressure on earnings.

While there is near term pressure on earnings, we believe topline will still be strong and as margins normalize, earnings will still grow at a healthy 15% CAGR over next few years.

Chart 3: Nifty EPS estimates trend – upgrades cycle since Sept 2020 will reverse near term

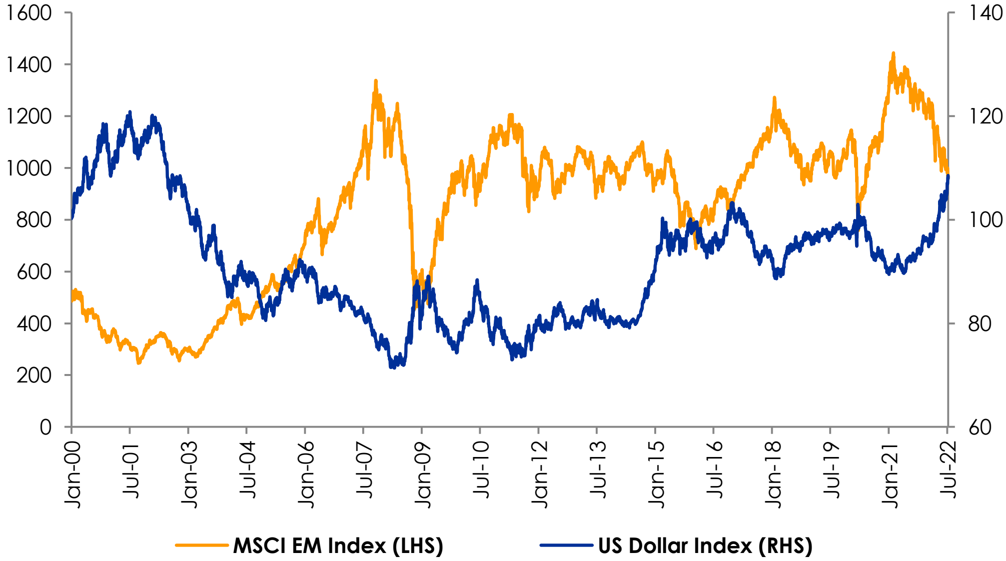


Source: Kotak Institutional Equities estimates, NSE, Valentis Research

#4: Dollar strength is close to its peak – this could be good for EM flows

There is a negative co-relation between a strong dollar and emerging market stock performance. A strong dollar leads to a move back to safety and dollar assets. We think the dollar could be close to a peak and hence emerging market equities should see better performance going forward.

Chart 4: Dollar Index Vs MSCI EM Index – has the $ index peaked?



Source: investing.com,Valentis Research

If the dollar strength peaks we could also see a reduction in FII outflows. As the Table below shows, we have seen the largest FII outflows in absolute $ terms but the Global Financial Crisis had seen FII flows being bigger as a % of market cap.

The positive take-away is that in spite of such large FII outflows markets have held up relative to the sharp fall in the GFC. This has been on the back of strong retail inflows.

Table 3: FII Outflows analysis

Start Date	End Date	Event Tag	FII Outflows ($ Bn)	Indian Market Cap at Start of Outflows ($ Tn)	FIIs Outflows		Nifty Return (%)
					As % of India Market Cap	As % of FII Holdings	
Jan\08	Mar\09	GFC	-15	1.8	0.9%	5.2%	-57%
Jun\13	Sep\13	Taper Tantrum	-4	1.2	0.4%	2.0%	-9%
Apr\15	Feb\16	Asset Quality Review guidelines by RBI	-8	1.6	0.5%	2.5%	-17%
Oct\16	Jan\17	Fed Hikes/Demonetization	-5	1.7	0.3%	1.6%	-3%
Feb\18	Nov\18	IL&FS Crisis	-9	2.4	0.4%	1.9%	-2%
Feb\20	May\20	Covid-19	-9	2.1	0.4%	2.0%	-23%
Oct\21	Jun\22	Current	-28	3.4	0.8%	4.2%	-7%

Source: MOSL, SEBI, ACE Equity, Valentis Research

Portfolio Performance and outlook

1. From late CY21, we have been holding high cash levels. Our portfolio also gave a negative return in the June quarter and YTD but out-performed the benchmark partly due to the cash we hold. As we have mentioned earlier, while the cash helps out-performance in weak markets, a greater advantage is the ability to buy stocks at attractive levels in weak markets. We have invested part of the cash over the past quarter and are looking at weakness in markets to invest further. For new portfolios, we continue to stagger buying over 8-12 weeks though we are ready to deploy cash more aggressively if the markets correct meaningfully.
2. We continue to focus on our 3 "U"s of Under-valued, Under-performing, Under-owned and expect weak results to provide a buying opportunity in some stocks.
   a. During the quarter we built position in a China+1 stock benefitting from outsourcing. We think valuations are attractive and it is undiscovered by the market.
   b. We think poor quarterly results could provide a buying opportunity in the home building sectors where near term earnings will be under pressure due to the spike in commodity prices. Copper prices are down already while margin pressure due to gas price hikes may ease over next 2 quarters.
   c. The financial sector, as we highlighted in our earlier notes, is looking attractive and we will continue to look at opportunity to add to our weight.

Chart 5: Valentis Rising Stars Opportunity Fund Portfolio Performance (as on June 30, 2022)

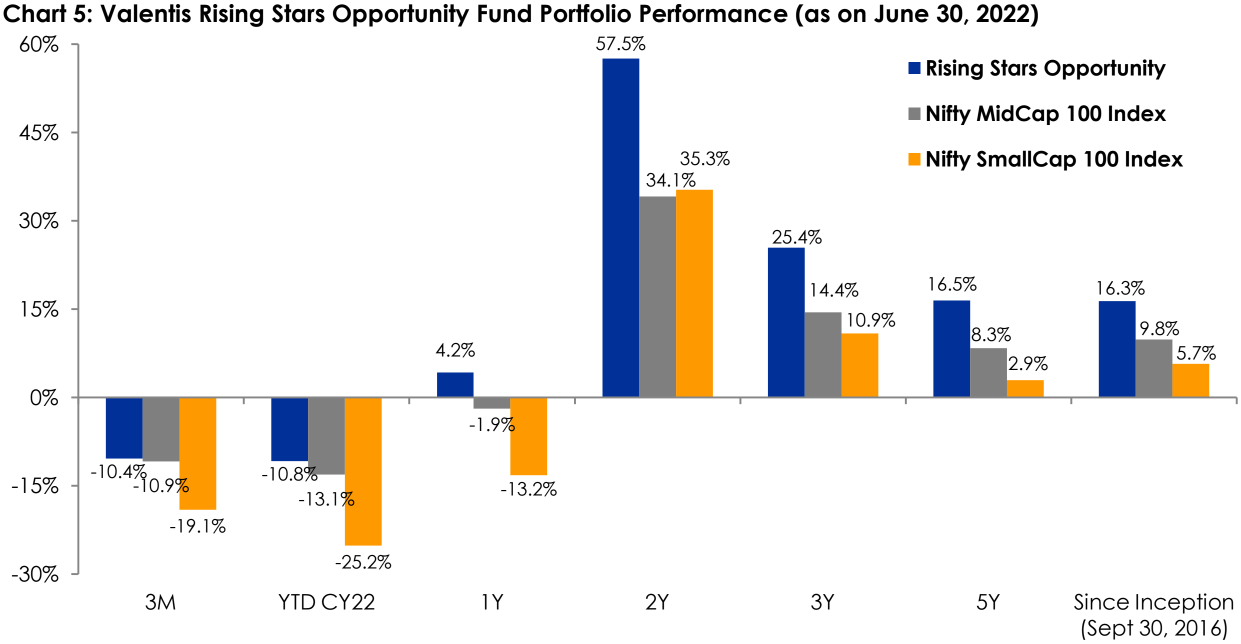
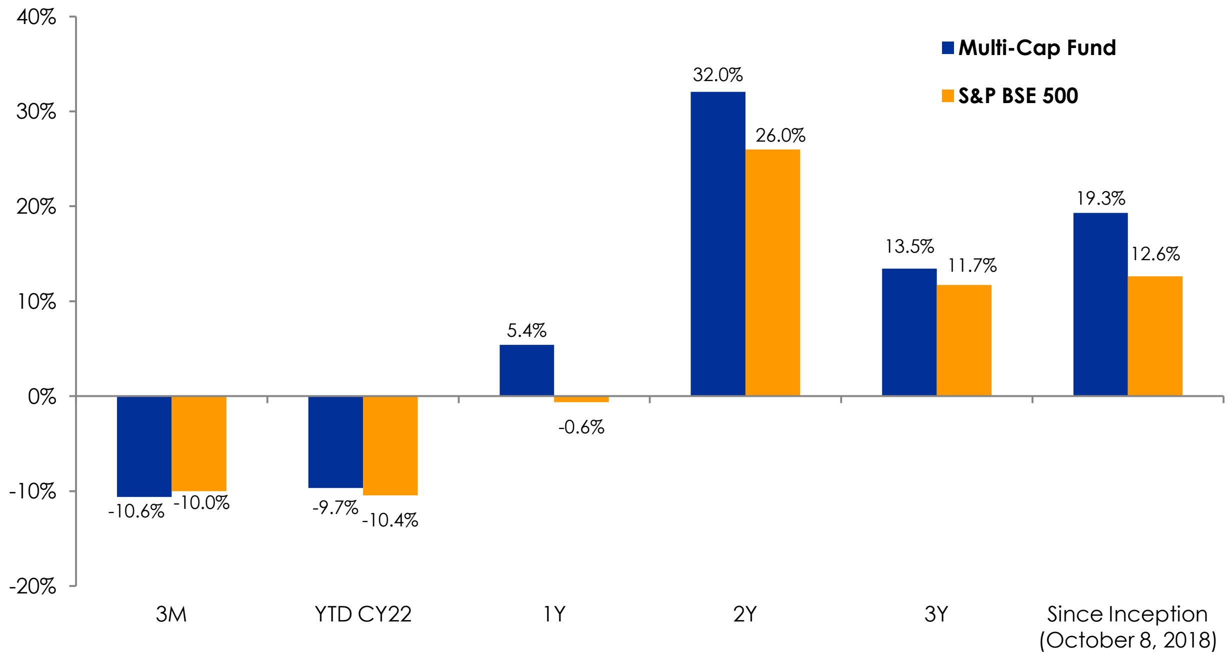


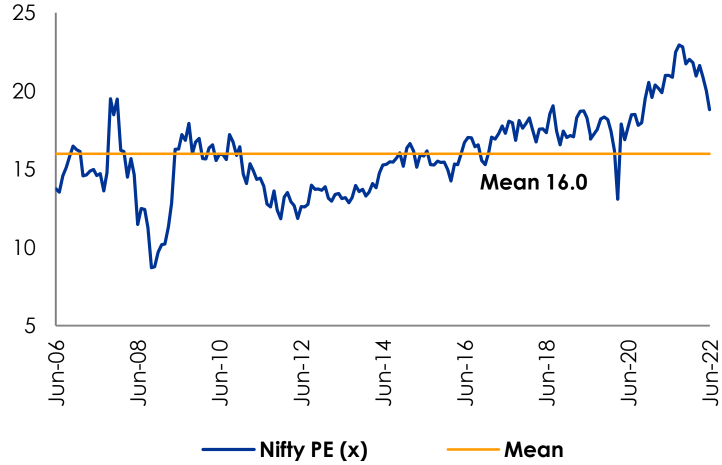
Chart 6: Valentis Multi-Cap Fund Portfolio Performance (as on June 30, 2022)



Jyotivardhan Jaipuria
jyoti.jaipuria@valentisadvisors.com

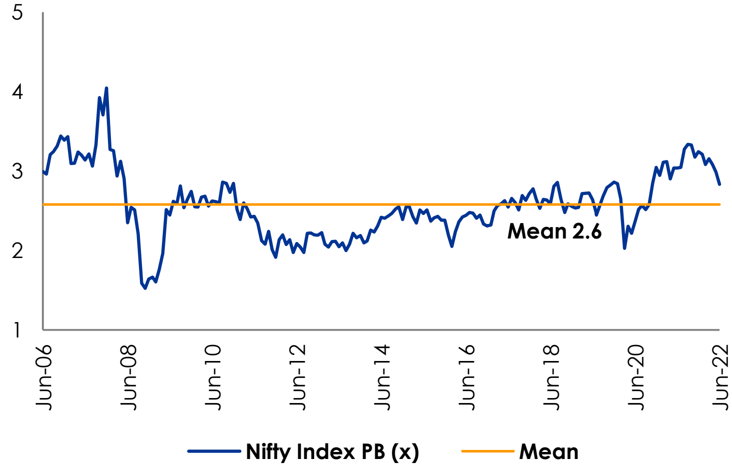
Appendix: Valuation Charts

Chart 7: Nifty 12M Forward P/E (x)



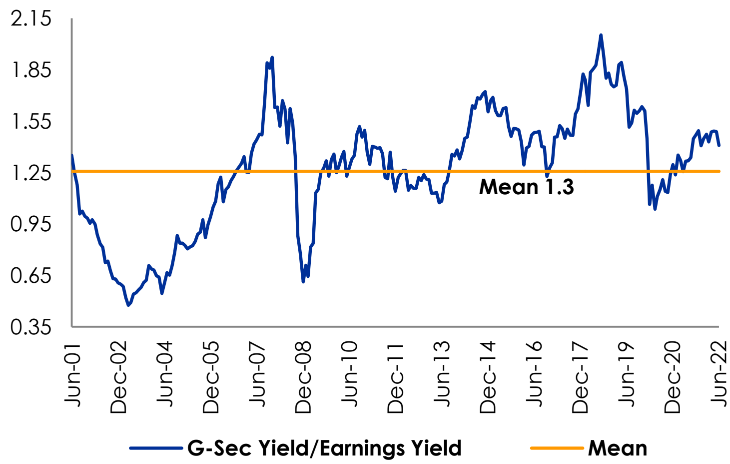
Source: Edel, Valentis Research

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



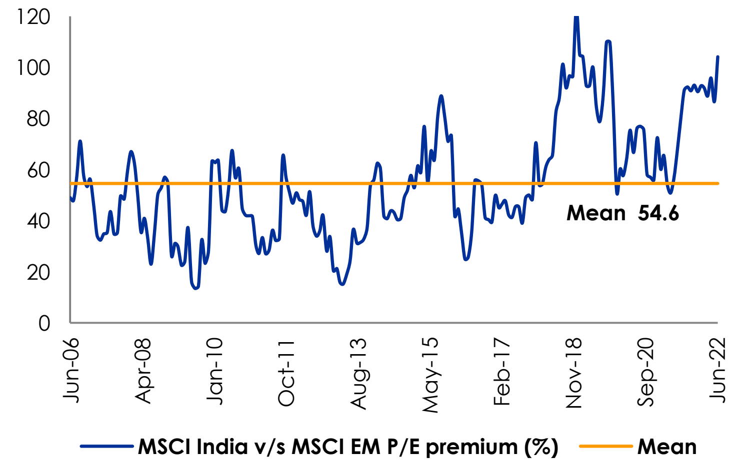
Source: MOSL, Valentis Research

Chart 9: Bond yield Vs SENSEX yield – at average valuations



Source: MOSL, Valentis Research

Chart 10: MSCI India v/s MSCI EM P/E premium (%)



Source: MOSL, Valentis Research

Valentis Advisors

Disclaimer

- Valentis Advisors Pvt Ltd. (Valentis) is a registered Portfolio Manager with Securities and Exchange Board of India.
- This report/presentation is strictly for information and illustrative purposes only and should not be considered to be an offer, or solicitation of an offer, to buy or sell any securities or to enter into any Portfolio Management agreement.
- This report/presentation is not intended for distribution to public and is not to be disseminated or circulated to any other party.
- Valentis does not offer any guaranteed returns nor is there any capital guarantee in the Valentis PMS. Valentis Advisors shall not be liable for any losses that the client may suffer on account of any investment or disinvestment decision in the Valentis PMS or based on the information or recommendation received from Valentis Advisors on any product.
- Investments in the Valentis PMS, as in any other equity product, may go up or down due to various factors affecting the market. There are market risks, political risks, financial risks etc in equity investments. Investors should take into consideration all their risk factors and their risk profile before investing. Clients should also take professional legal and tax advice before making any decision of investing.

Valentis Advisors Private Limited

+91-22-67470251

pms@valentisadvisors.com