Valentis Advisors

Will bad news become bad news?

January 10, 2023

2022 was a year of consolidation for the Indian market with a low single digit return but a sharp outperformance to global markets. In 2022, markets welcomed all bad news on the economy as good news signaling a pause in Fed rate hikes. But as recession fears grow, will bad news on the economy be bad news for the markets? We answer this and many more questions through easy-to-read charts in this report. Key points in brief:

1. **We think 2023 will continue to see consolidation with single digit returns. We think the returns can be back-ended but this is getting a consensus view.**
2. **Emerging markets may outperform developed markets with the US$ peaking. India after its sharp outperformance in 2022 and demanding relative valuations may slightly under-perform the EM index.**
3. **Small caps under-performed in 2022 (NSE small cap index down -14% vs Nifty up 4.3%). We think small-caps will outperform in 2023 though they may lag in the early part of 2023.**
4. **The key debate in global markets will be easing inflation and a pause in Fed rate hikes versus a possible recession in the USA and the developed world.**
5. **India will also see a slower economy relative to 2022 but earnings would be helped by margin recovery.**

#1: Inflation has peaked – Fed will pause in H1CY23; RBI rate hikes will be lower

- We believe inflation has peaked both in the US as well as India and should see a meaningful downturn over the next few months. However, inflation will likely remain above the Fed range of 2% in 1H2023.
- There are 3 reasons for the easing of inflation (a) The Ukraine-Russia war has been localized and many commodity prices are already gone below pre-war levels (b) Supply bottlenecks post-Covid are now easing (China opening up will further help) 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. But one near-term factor to watch on inflation is the opening up of the Chinese economy and any pent-up demand that pushes up prices.
- With the Fed having front-loaded rate hikes, we expect them to pause in the first half of 2023 after probably another 75-100 bps further rate hikes.

- Inflationary pressures in India have been relatively lower with Indian inflation being below US inflation for over a year which is a record. While inflation breached the RBI target, we think it will settle below 5% again as global commodity prices fall.
- We think RBI rate hikes have almost peaked and another 25-50 bps hike is possible before RBI goes in a long pause mode.

#2: Recession in the USA? India too will see slower growth

- We think a slowdown and a likely recession in the USA will be a fall-out of the Fed hikes as well as the shrinkage of the Fed balance sheet. The inverted bond yield curve has generally been the precursor to a recession.
- India too will see slower GDP growth as export-oriented sectors see a slowdown. We expect India's GDP to fall from 7% in FY23 to 6% in FY24.
- Earnings in India saw a constant upgrade cycle since September, 2020. We think FY24 will likely see downgrades from the current estimate of around 15% to the 10-12% range. FY23 is likely marked by strong top-line growth but weak margins. We think FY24 will be the reverse. Top-line growth will weaken with a slowing economy but margins will recover with falling commodity prices.
- Longer term, we continue to believe that a robust earnings cycle in India has just started and we can see earnings doubling over the next 5 years.

#3: Dollar peaking will help EM/India; India may under-perform in the near term

- Since 2008 developed markets are up 278% sharply outperforming emerging markets which are up a more modest 69%. During this period, US$ appreciated 45% (DXY Index). Going forward we think a peak in the US$, as interest rate hikes in USA pause, could lead to emerging market outperformance going ahead.
- India is now the second largest weight in the MSCI and will be a gainer of the EM rally. India has seen a substantial increase in its index weight within the EM index double over past few years.
- Near term, however, India may under-perform EM as (a) Valuations are expensive: it trades at over 100% premium to EM index on a PE basis (b) India was a major outperformer last year.

#4: How much of the bad news is already in the price?

- **Buy the 20% correction:** The S&P index was down nearly 19% last year and is discounting a lot of the bad news. Should we buy the fall? Historically, in the last 50 years, there are only 2 instances of 2 consecutive negative years in the S&P 500. The second data point is that S&P has fallen more than 20% on 10 occasions after WWII. Buying a 20% dip led to an average 17% return over 1 year with a positive double-digit return 7 times

- **Buy towards end of recession:** This is probably the most flagged recession in history. What do markets do in a recession?
  - An average recession in the USA lasts for 12.5 months and including the Great Depression (1929-1933), it lasts for 15 months. Typically, the markets tend to correct 6 months before the recession with average fall of -1.4% (excluding the Great Depression). The average stock market returns during the recession have 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.
- **Buy the Fed pause:** Post the last Fed hike, markets have generally been positive. There have been 6 Fed cycles in the last 40 years. On an average, markets gave 4% return after 6 months and 12% return after 1-year with only 1 out of 6 returns being negative.
- **India will have to fight history:** The Nifty and Sensex have given a positive return for the past 7consecutive years. Neither the Sensex nor Nifty has ever given 8 consecutive positive years. We will have to fight history to eke a positive return in CY23
- **Valuations still expensive:** India continues to remain expensive in a historic as well as global context. Markets are trading at 19.8x 1-year forward earnings, more than 20% premium to historic averages.
- **Will retail India slow purchases?** Rising interest rates may lead to some shift in the margin from equity to debt instruments. However, after a sharp outflow of ~$15.2 Bn in 2022, FII flows should stabilize and compensate for lower retail inflows.

#5: Small-caps can do better than large caps

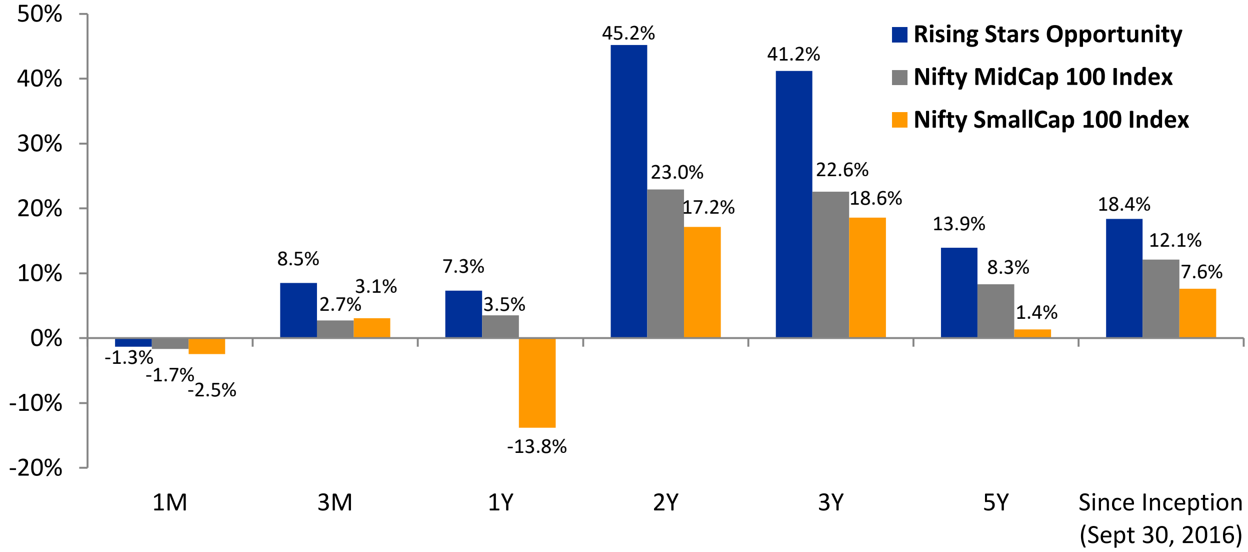
- We think small-caps can do better than large caps in 2023 due to 2 reasons. First, they have underperformed considerably in 2022 falling -14% vs a 4.3%gain for the large caps.
- Secondly, they are trading at more reasonable valuations being at a 29.2% PE discount to the large caps in valuations.

#6: Portfolio Performance and outlook

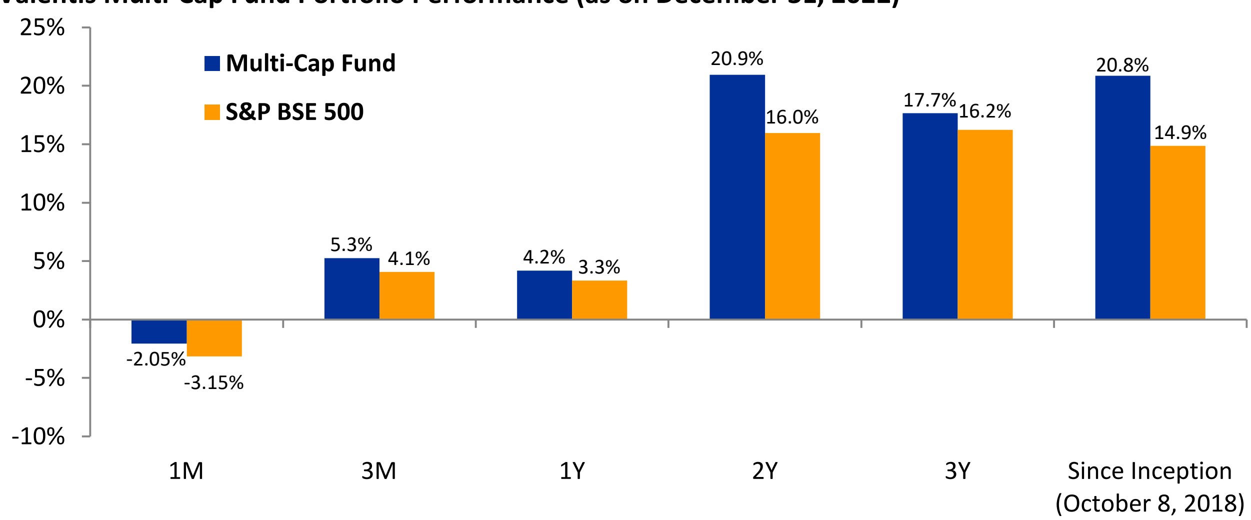
1. As expected CY22 was a tough year for markets. While the small-cap index gave a large negative return, we managed to generate a huge outperformance and close to double- digit return. The Multi-cap also outperformed the market though not by as high a margin.
2. Our basic theme of “Buy local, avoid global” worked well for us through the year. Going into 2023 we continue to play the same theme though we are cognizant that there has been a sharp under-performance of the global names.
3. During the last quarter also we added a financial name that looks cheap and could benefit from the cleaning up of its balance sheet.

4. One theme we would look for in the current year is companies where margins were hurt by high commodity prices last year. Given falling input costs, we see margin normalization in these companies which will drive earnings growth. We are positive on cement and home building ancillary companies on this theme.

Valentis Rising Stars Opportunity Fund Portfolio Performance (as on December 31, 2022)



Valentis Multi-Cap Fund Portfolio Performance (as on December 31, 2022)



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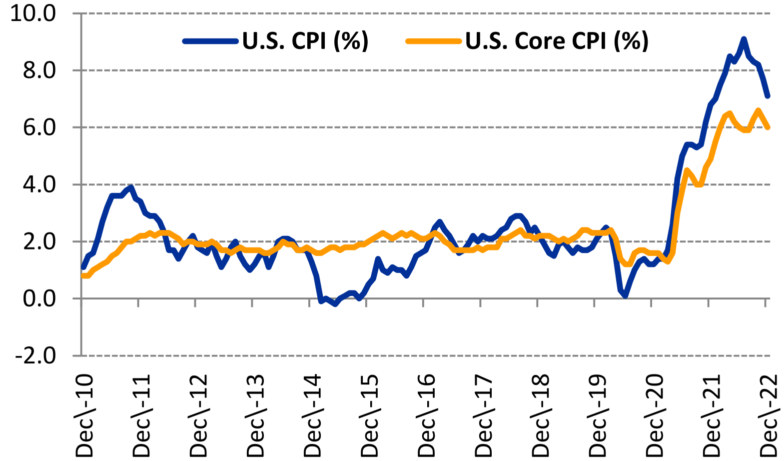
#1: Inflation has peaked – Fed will pause in H1CY23; RBI rate hikes will be lower

After rising to 40-year highs, the US CPI and core CPI both are starting to trend down….

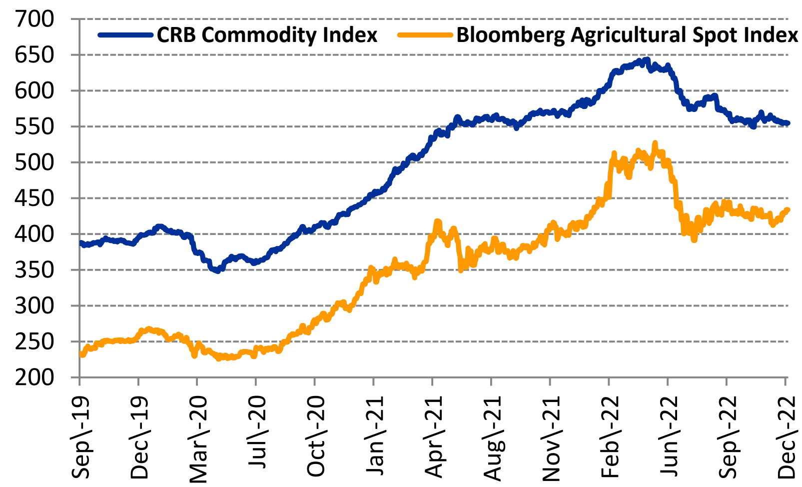
Chart 1: US Inflation trending down



Source: Investing.com, Valentis Research

…due to falling commodity as well as agricultural prices.

Chart 2: Commodity Prices well below the peak



Source: MOSL, Valentis Research

Many commodities are now negative over a 1-year basis. The opening up of China may lead to some reversal

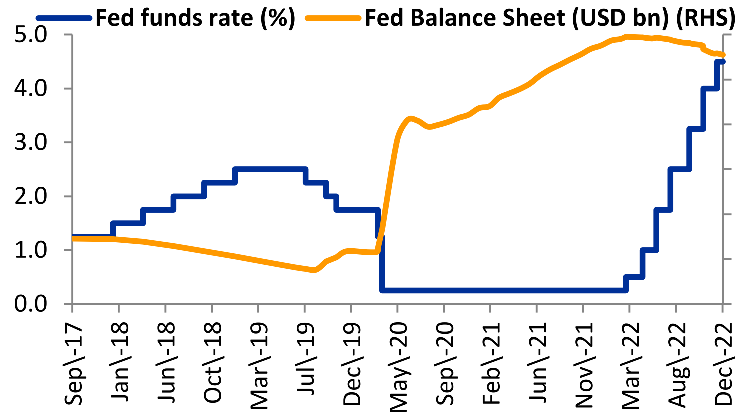
Table 1: Prices of Some Key Commodities are lower yoy also

Name of Commodity	CMP	Drop from the Peak	YoY %
Crude Oil (bbl)	85	-36.5%	9.7%
Palm Oil (MT)	915.4	-52.5%	-26.5%
Coal	205.6	-55.3%	49.7%
Aluminium (MT)	2349.5	-39.4%	-16.3%
Copper (MT)	8364.8	-26.0%	-14.1%
Nickel (MT)	29901	-38.0%	43.2%
Wheat (Bu)	792	-38.1%	2.6%
Sugar (lbs)	20	-1.9%	6.1%
Natural Gas (mmbtu)	4.5	-52.0%	20.0%

Source: MOSL, Valentis Research

The Fed has upfronted rate hikes in an effort to curb inflation. We think there is another 75 to 100 bps rate hike possible. Meanwhile they are gradually reducing their balance sheet with a target of US$95 bn per month

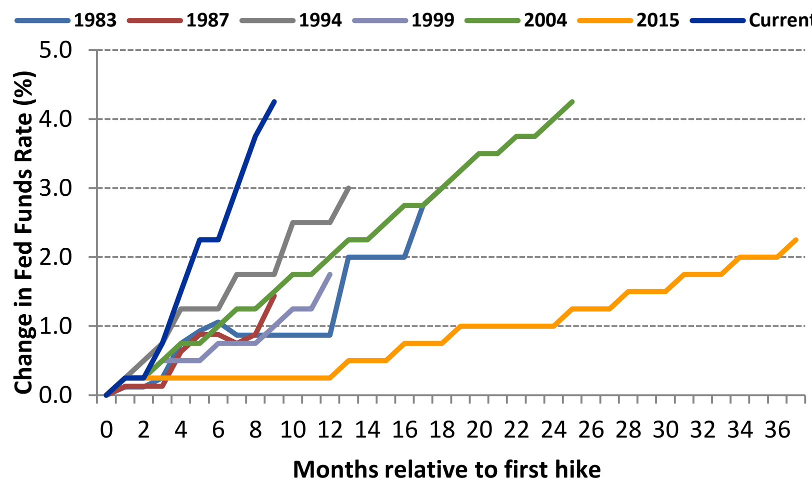
Chart 3: US Fed Rate & Balance Sheet Reduction



Source: Federal reserve, Valentis Research

This is the fastest rate hike since the Volker period

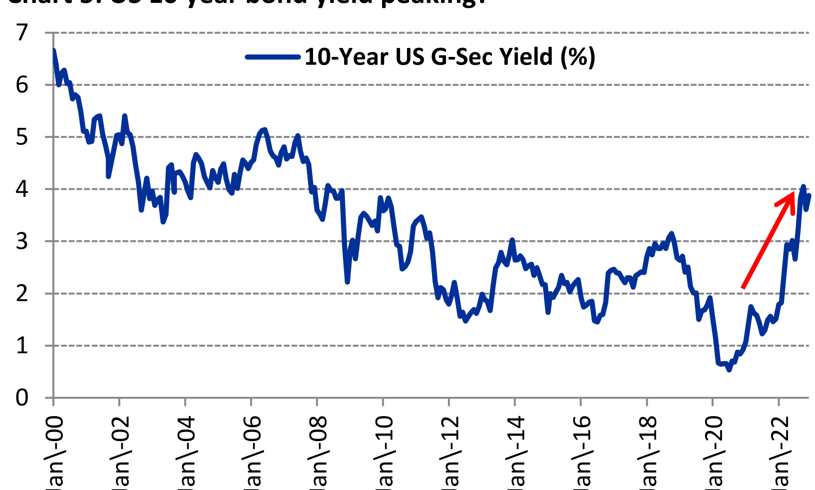
Chart 4: Fastest Fed rate hike cycle



Source: Investing.com, Valentis Research

The US 10-year bond yields have moved up in line with the Fed hikes. But the last 2 Fed hikes did not have much impact on 10-year bond yields. The market is anticipating a peaking of Fed rates.

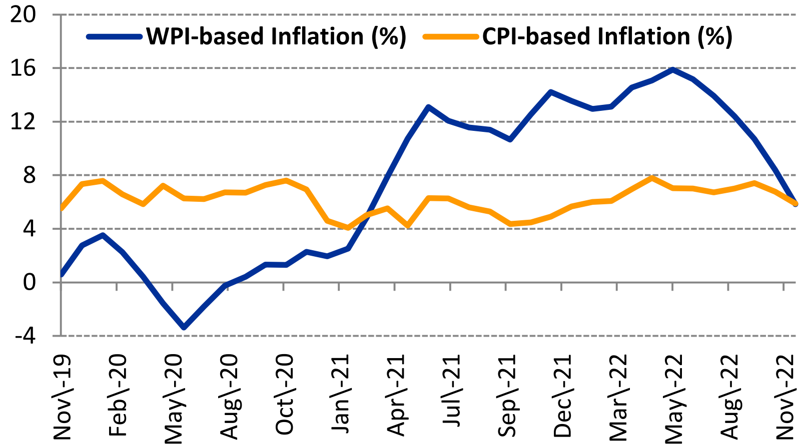
Chart 5: US 10 year bond yield peaking?



Source: Investing.com, Valentis Research

Indian inflation is also trending down but CPI which was relatively stable is also seeing a slow decline

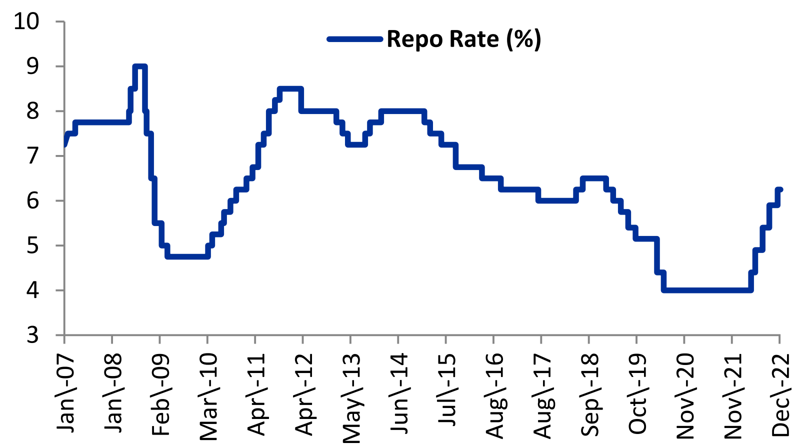
Chart 6: India Inflation trend



Source: MOSPI, Valentis Research

RBI has also hiked rates but a large part of RBI hike could be behind us

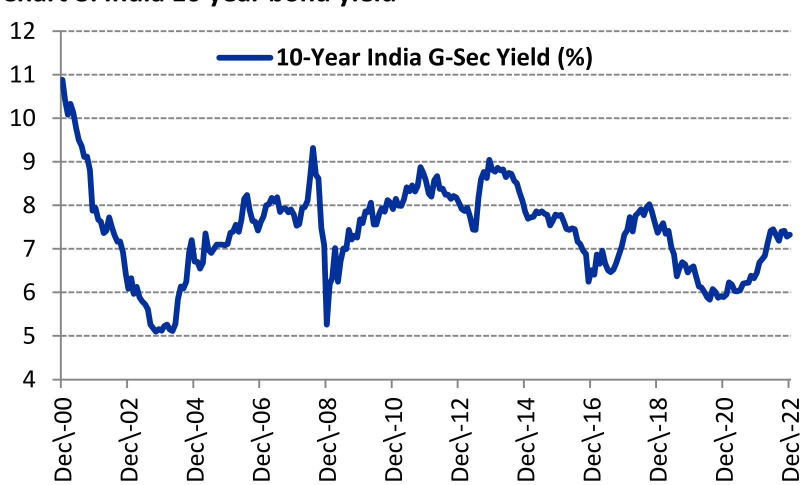
Chart 7: RBI Repo rate trend



Source: RBI, Valentis Research

Indian bond yields too have been moving higher but are starting to peak

Chart 8: India 10 year bond yield

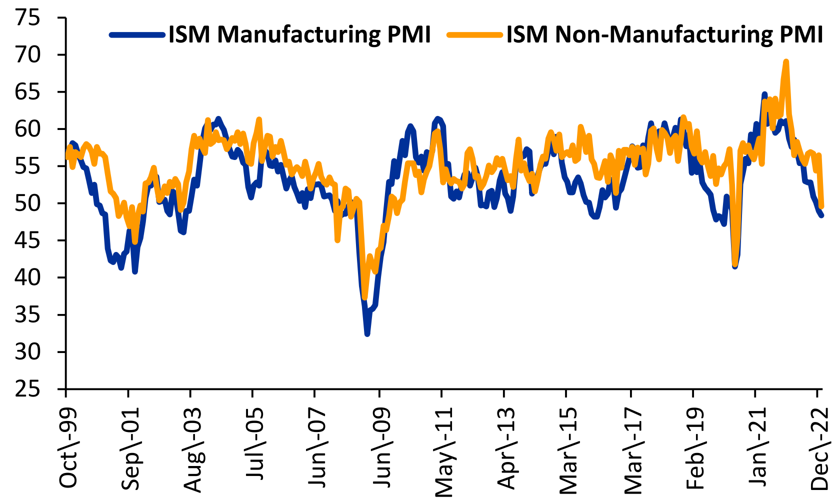


Source: Investing.com, Valentis Research

#2: Recession in the USA? India too will see slower growth

Both services as well as manufacturing ISIM seem to be reflecting a slow-down

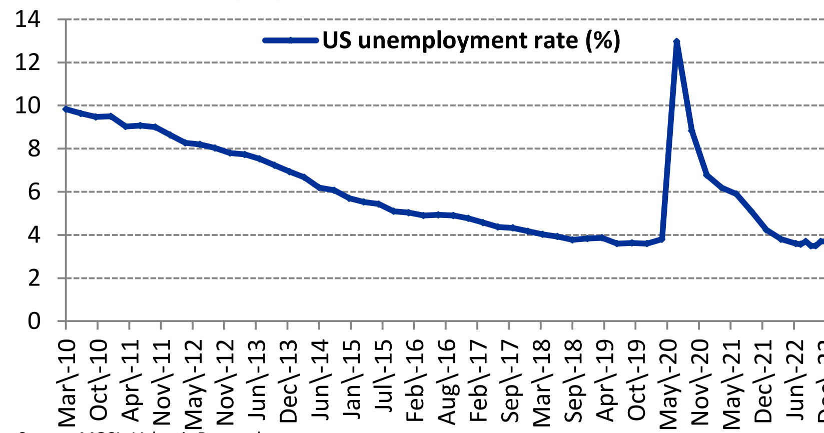
Chart 9: US ISM Purchasing Managers Index (PMI) data



Source: Investing.com, Valentis Research

But US unemployment rate is still at historic lows. With layoffs just starting, this may move higher in the coming months.

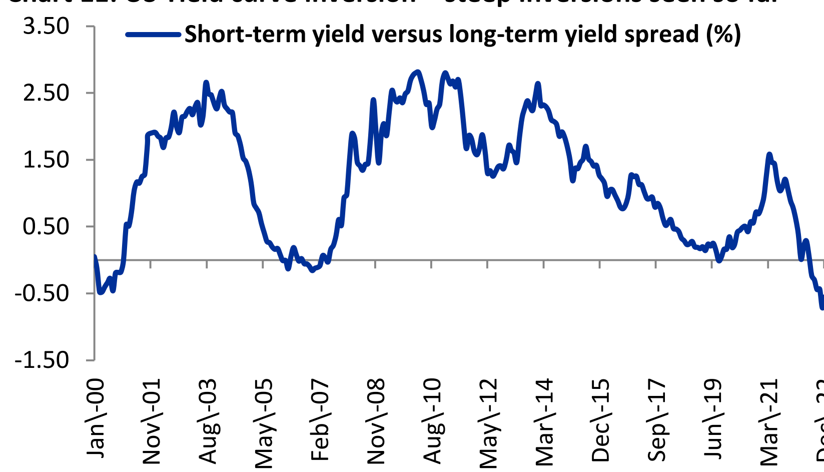
Chart 10: US unemployment rate



Source: MOSL, Valentis Research

The US yield curve is inverted signalling a recession. Every recession has been preceded by a bond yield curve inversion. But every inversion has not necessarily led to a recession.

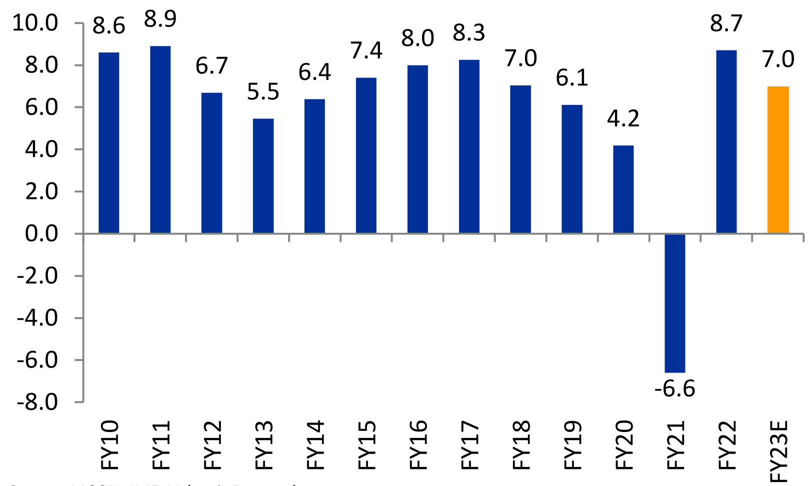
Chart 11: US Yield curve inversion – steep inversions seen so far



Source: Investing.com, Valentis Research

After a sharp recovery post Covid, we expect GDP to weaken in line with a global slow-down. However, India will still be one of the fastest growing economies in the world …

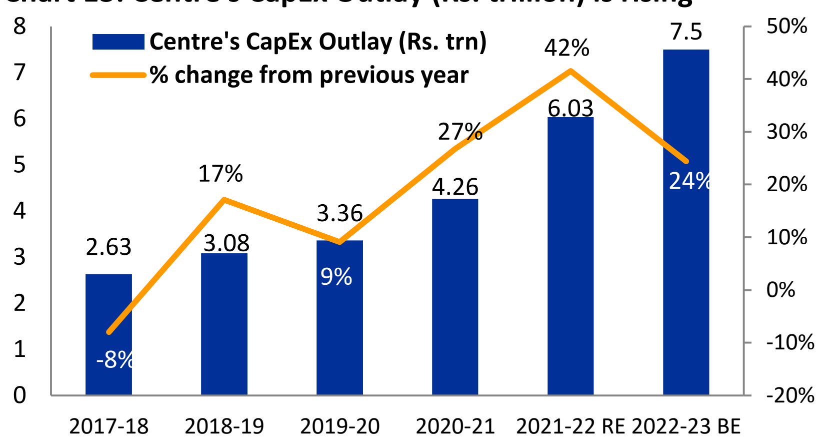
Chart 12: India's GDP growth



Source: MOSPI, IMF, Valentis Research

Government has led the capex revival through budgetary spends…

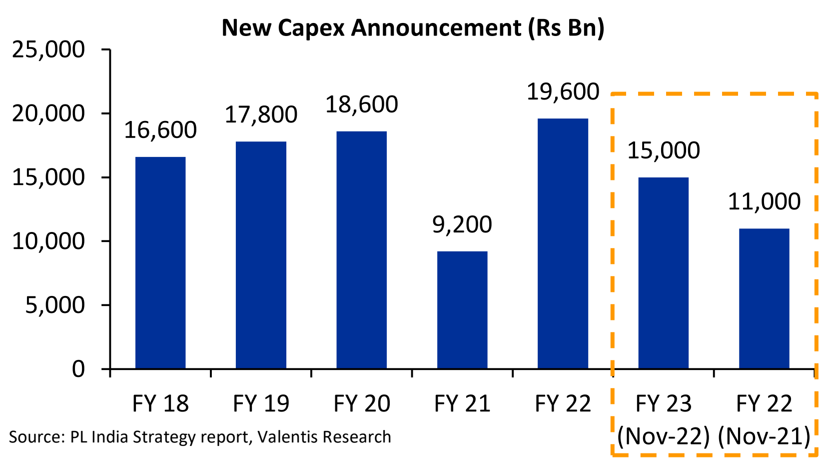
Chart 13: Centre's CapEx Outlay (Rs. trillion) is rising



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

…private capex is now looking up

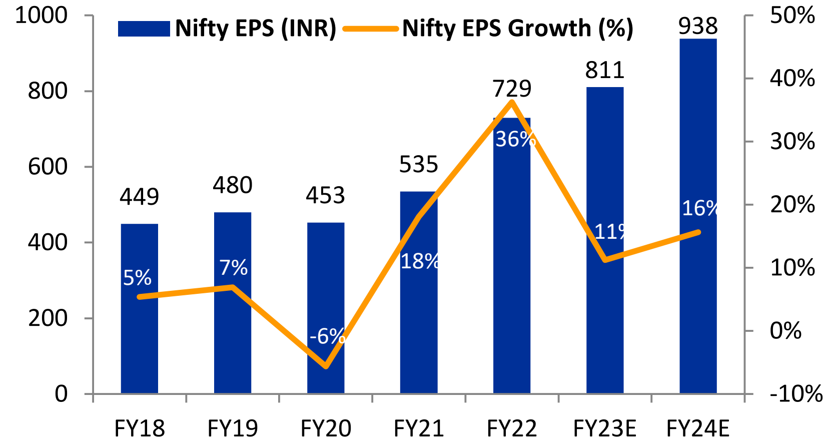
Chart 14: New CapEx announcements picking up (Rs. Bn)



Source: PL India Strategy report, Valentis Research

Earnings has risen mainly due to banks. Going into FY24, we see weaker topline but better margins

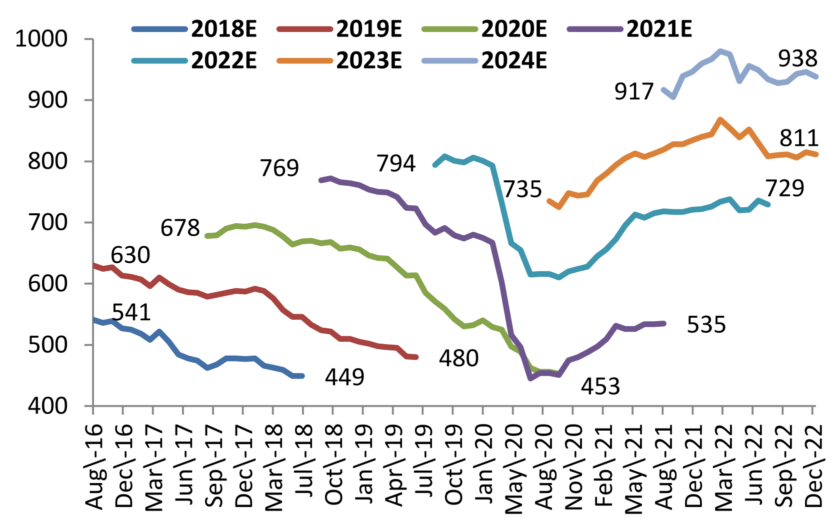
Chart 15: Nifty Earning growth (%) – Banks key driver



Source: Kotak Institutional Equities estimates, Valentis Research

We expect some downgrades in earnings given the likely global slow-down.

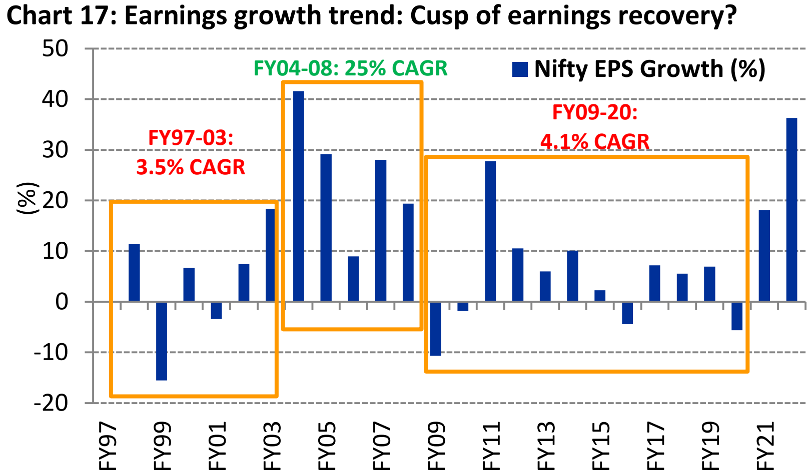
Chart 16: Nifty EPS estimates trend – seeing a pause



Source: Kotak Institutional Equities estimates, 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 17: Earnings growth trend: Cusp of earnings recovery?



Source: MOSL, Valentis Research

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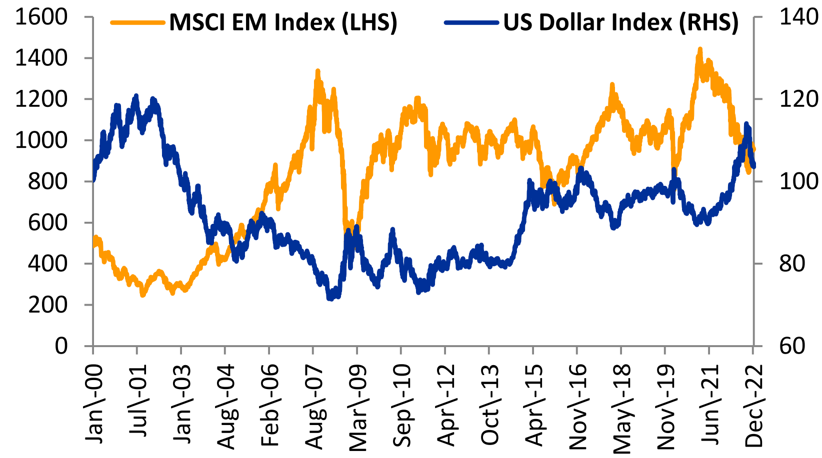
#3: Dollar peaking will help EM/India; India may under-perform in the near term

A strong US$ led to weak EM stock market performance. We think the $ has peaked and this helps EM outperform.

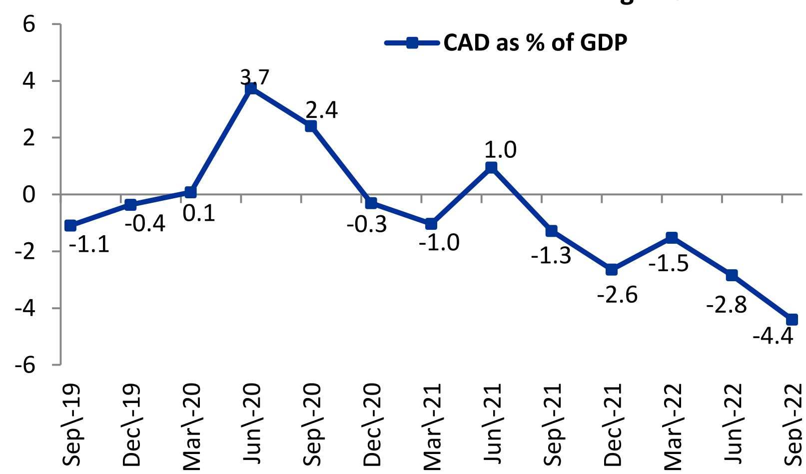
Chart 18: Dollar Index Vs MSCI EM Index – has the $ index peaked?



Source: Investing.com, Valentis Research

While a peaking of the US$ will help, India has seen a sharp deterioration in the CAD. We hope this reverses as oil prices fall.

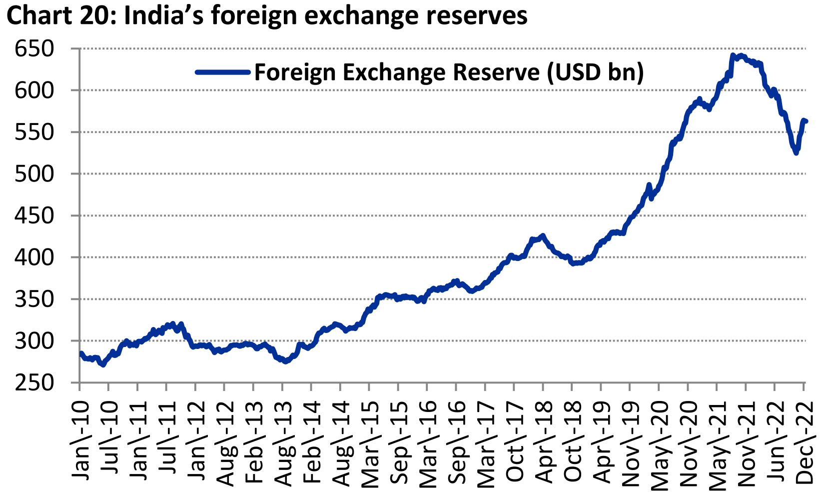
Chart 19: India's Current Account Deficit weakening as % of GDP



Source: RBI, Valentis Research

Forex reserves too have fallen partly due to defending the INR and partly due rising US bond yields and cross-currency movements

Chart 20: India's foreign exchange reserves



Source: RBI, Valentis Research

Table 2: FII Outflows analysis – domestic flows reduce impact of FII flows

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	0.90%	5.20%	-57%
Jun\13	Sep\13	Taper Tantrum	-4	1.2	0.40%	2.00%	-9%
Apr\15	Feb\16	Asset Quality Review guidelines by RBI	-8	1.6	0.50%	2.50%	-17%
Oct\16	Jan\17	Fed Hikes/Demonetization	-5	1.7	0.30%	1.60%	-3%
Feb\18	Nov\18	IL&FS Crisis	-9	2.4	0.40%	1.90%	-2%
Feb\20	May\20	Covid-19	-9	2.1	0.40%	2.00%	-23%
Oct\21	Jun\22	Current	-28	3.4	0.80%	4.20%	-7%

Source: MOSL, SEBI, ACE Equity, Valentis Research

Table 3: India's weightage in MSCI EM Index on the Rise

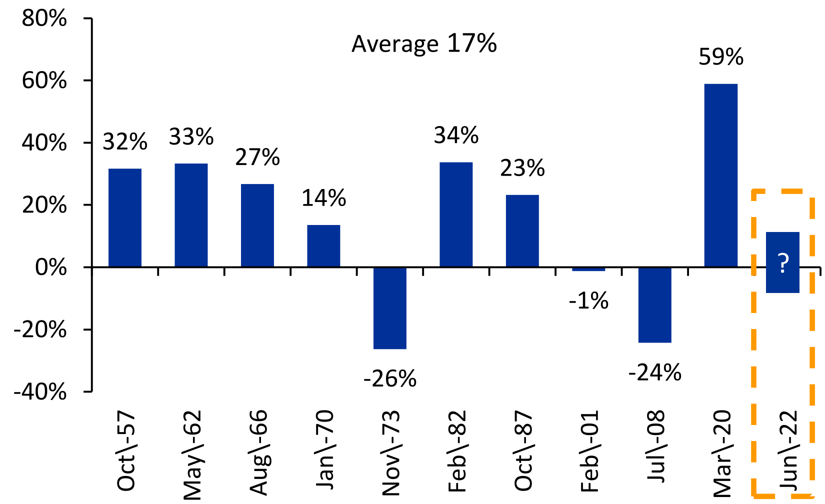
Top 15 Countries	30\Nov\22	31\Mar\22	31\Mar\21	31\Mar\20
China	30.4	27.5	35.5	36.1
India	14.8	12.8	9.6	7.7
Taiwan	14.4	15.5	13.7	12.1
South Korea	11.9	12.3	13.3	11.7
Brazil	5.4	5.7	4.5	4.8
Saudi Arabia	4.1	4.1	2.8	2.5
South Africa	3.8	3.9	3.7	3.6
Russia	-	1.8	3.0	3.2
Mexico	2.4	2.3	1.7	1.9
Indonesia	2.0	1.7	1.2	1.5
Thailand	2.1	1.8	1.9	2.2
Hon Kong	-	1.9	2.3	4.0
Malaysia	1.5	1.5	1.4	1.9
United Arab Emirates	1.3	1.4	0.6	0.5
Qatar	1.1	0.9	0.7	0.9

Source: brokerage report, Valentis Research

#4: How much of the bad news is already in the price?

S&P has fallen more than 20% on 10 occasions after WWII. Buying a 20% dip led to an average 17% return over 1 year with a positive double-digit return 7 times

Chart 21: S&P 500 1 Yr Return after Falling 20% from Record Highs



Source: Investing.com, Valentis Research

Table 4: USA Recession History – how do markets behave?

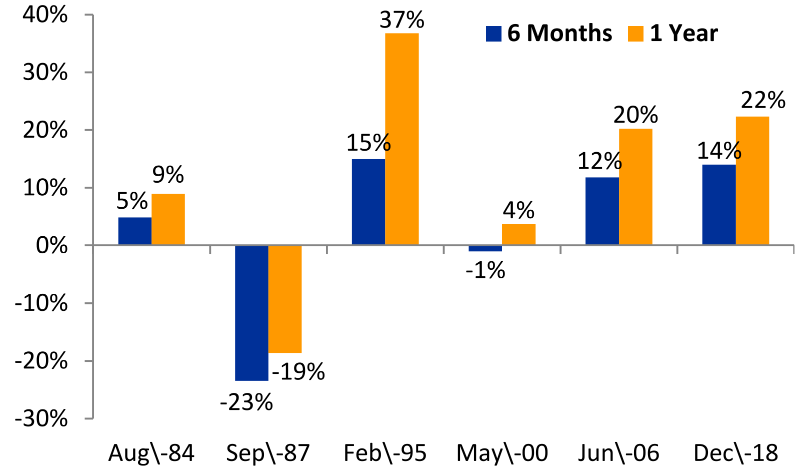
Sr. No.	Start	End	Duration	6M Return Pre	Return During	1 Yr Return Post
1	Aug\29	Mar\33	3 yrs 7 months	20%	-85%	81%
2	May\37	Jun\38	1 yr 1 month	-5%	-23%	-2%
3	Feb\45	Oct\45	8 months	9%	16%	-9%
4	Nov\48	Oct\49	11 months	-10%	11%	19%
5	Jul\53	May\54	10 months	-5%	19%	30%
6	Aug\57	Apr\58	8 months	4%	-6%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

	Avg duration	Avg Return	Avg Return	Avg Return
All	15	0.1%	-7%	19%
ex 29-33	12.5	-1.4%	-1%	15%
ex 29-33, 09	12.0	-1.4%	2%	14%

Source: Investing.com, Valentis Research

Post Fed pause, US markets gave an average 4% return after 6 months and 12% return after 1-year with only 1 out of 6 returns being negative

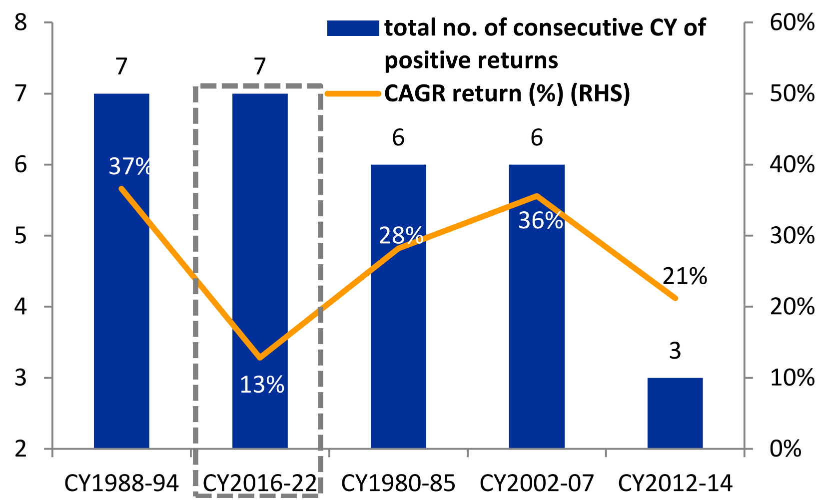
Chart 22: Dow Jones return post pause in fed hikes



Source: Investing.com, Valentis Research

Both the Nifty and the Sensex have delivered 7 consecutive years of positive return. We are fighting with history to get a positive return in 2023. The only positive is that this has been the weakest 7 year rally in terms of CAGR returns (13% vs 28-37% earlier).

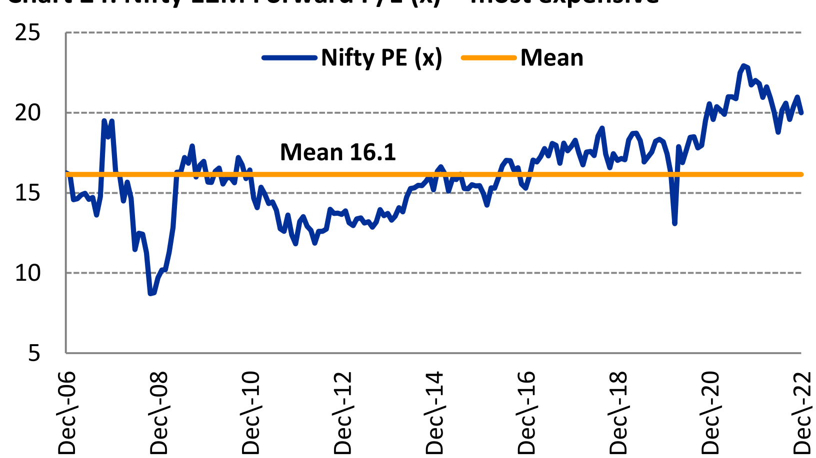
Chart 23: Total no. of consecutive CY of positive return on SENSEX



Source: BSE, Valentis Research

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.

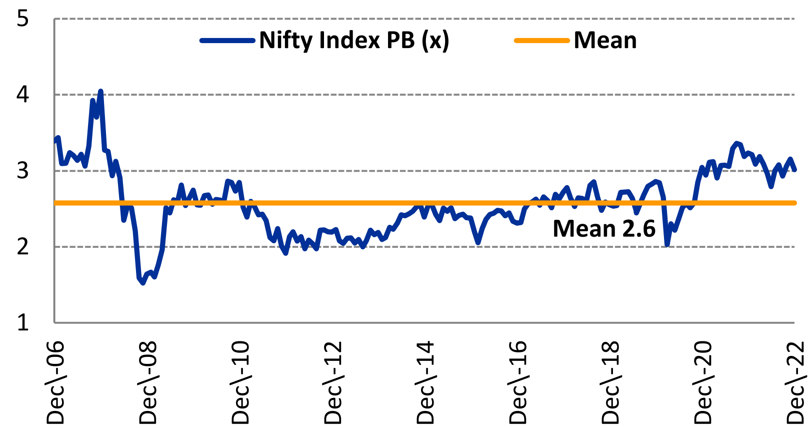
Chart 24: Nifty 12M Forward P/E (x) – most expensive



Source: Edel, Valentis Research

Chart 25: Nifty 12M Forward P/BV (x) – in expensive territory

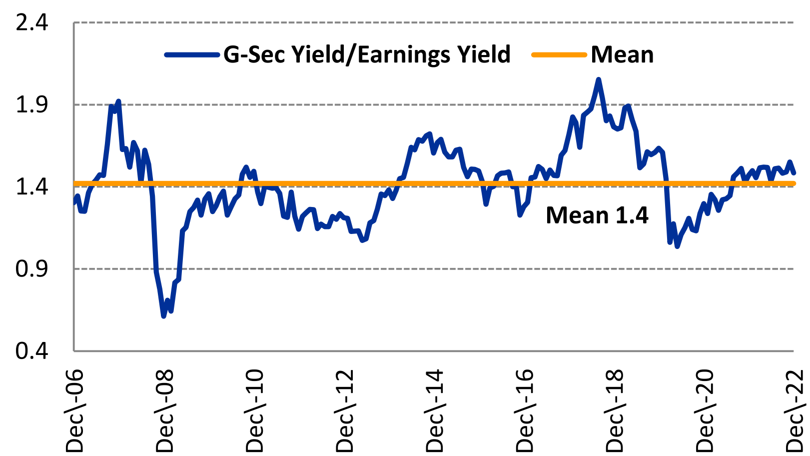
The P/B is also in expensive territory



Source: Edel, Valentis Research

Chart 26: Bond yield Vs SENSEX yield – at average valuations

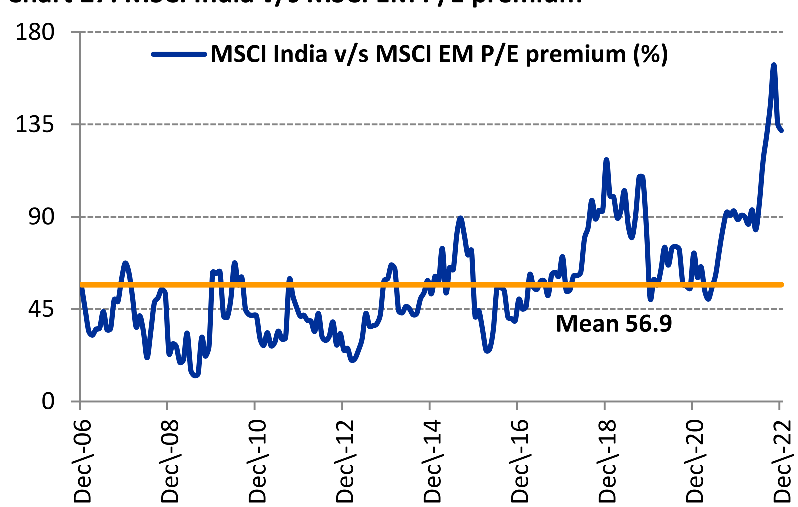
The bond yield vs Sensex yield is expensive but not as much as PE or PB.



Source: MOSL, Valentis Research

Chart 27: MSCI India v/s MSCI EM P/E premium

While valuations look expensive in a historic context, India valuations relative to Emerging Markets are in extreme territory. They trade at over 100% premium to EM valuations vs a historic average of 57%.

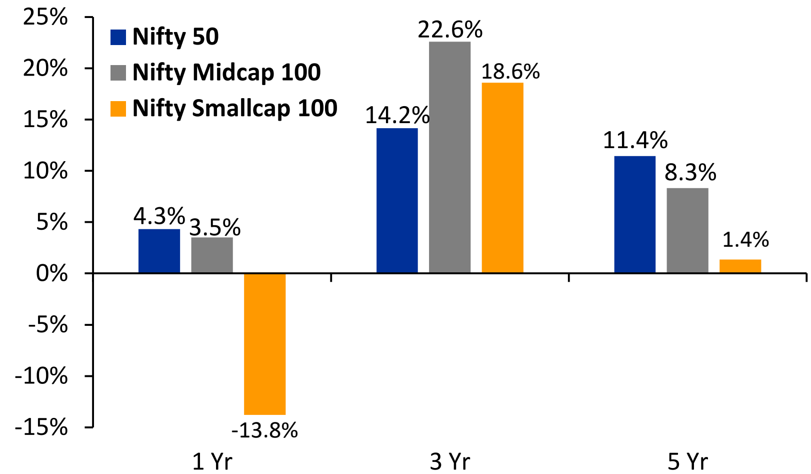


Source: MOSL, Valentis Research

#5: Small-caps can do better than large caps

Though the small and mid-caps did very well in the post Covid phase, they have still under-performed large-caps over a 5-year period

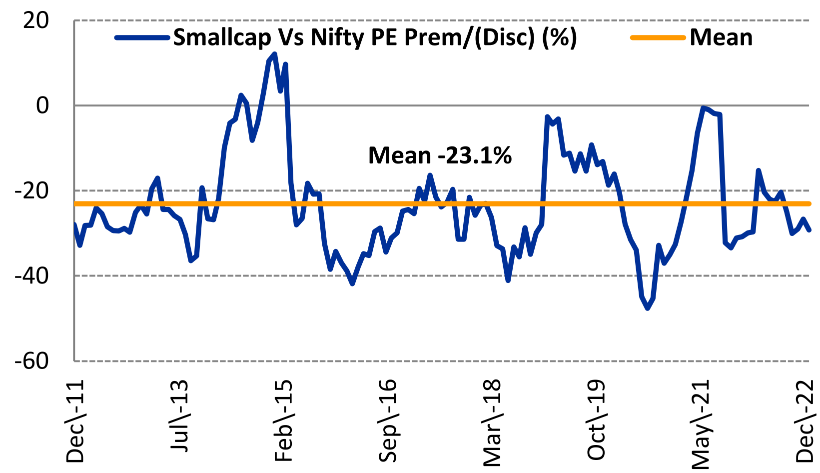
Chart 28: Nifty 50, Midcap 100 & SmallCap 100 Indices return



Source: ACE Equity, Valentis Research

With the small-caps trading at steep discount to large caps, we could see them outperforming in 2023.

Chart 29: Smallcap Vs Nifty PE Prem/(Disc)



Source: MOSL, Valentis Research

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