Valentis Advisors

Positives emerging for medium-term

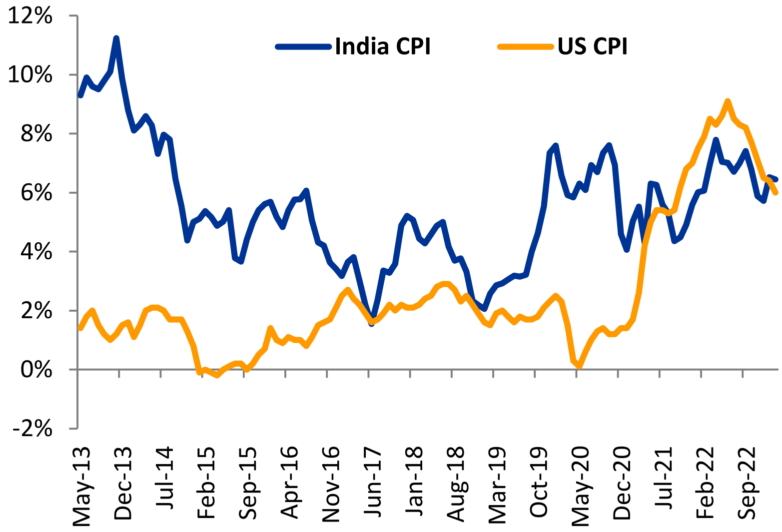
April 11, 2023

- **We started 2023 expecting (a) India to give a positive return for the year but back-ended and (b) India to underperform global markets in Q1 this year. Indeed, the best performers of last year (India and Brazil) have been the laggards of this year in the equity markets and India has given a negative return.**
- **While we have been cautious about equity markets for the past 18 months and still expect near-term weakness, we are getting more positive now and expect markets to give double-digit returns over the next 18 months. 3 positives are: (a) The Indian rate hike cycle is over with RBI going into what we believe is a long pause mode followed by a cut next year. (b) After 18 months of time correction, valuations for Indian markets, though not cheap are getting to the top end of the fair value range. In a relative context also, India is now trading at a near-average premium on PE multiples to Emerging Markets. (c) While earnings will see some downgrades, we expect to clock a double-digit EPS growth over the next few years. While we have been holding more than normal cash in our portfolios, we will use any market corrections to reduce cash in the current quarter.**
- **Globally too markets could surprise positively if the US economy does not get into a recession. With the first quarter being a positive year for the S&P, an interesting data point to look at is that in every instance of S&P giving a return of more than 7% in Q1, the calendar year was always positive with the average return being 21.6% and the median return being 26.3%. However, a better way to think is what markets did in 9 months post the first quarter. The next 9 months still gave an average 8% return (11% annualized) with a negative return only once out of 13 years.**

#1: India's monetary policy divergence has started

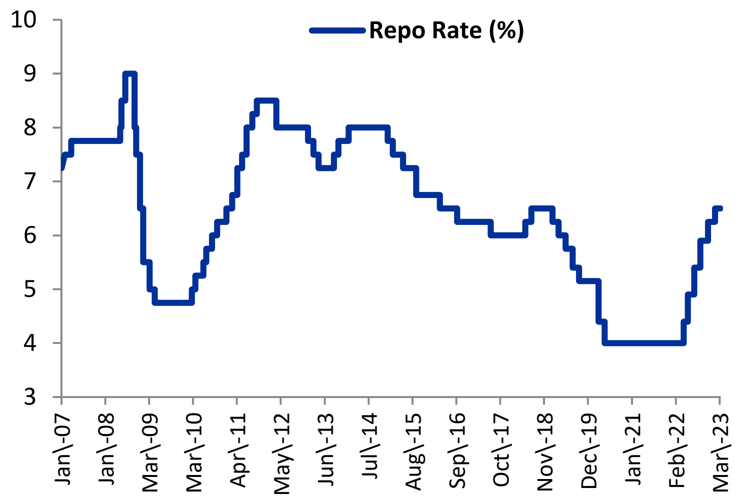
The Indian central bank has surprised the market by pausing interest rate hikes though they indicated that this should not be taken as a pivot in interest rates but a temporary pause. With the Indian inflation being consistently below US inflation for the past 18 months, we think RBI has gone into a longish pause mode.

Chart 1: India CPI was lower than US CPI for 18 months



Source: Investing.com, Valentis Research

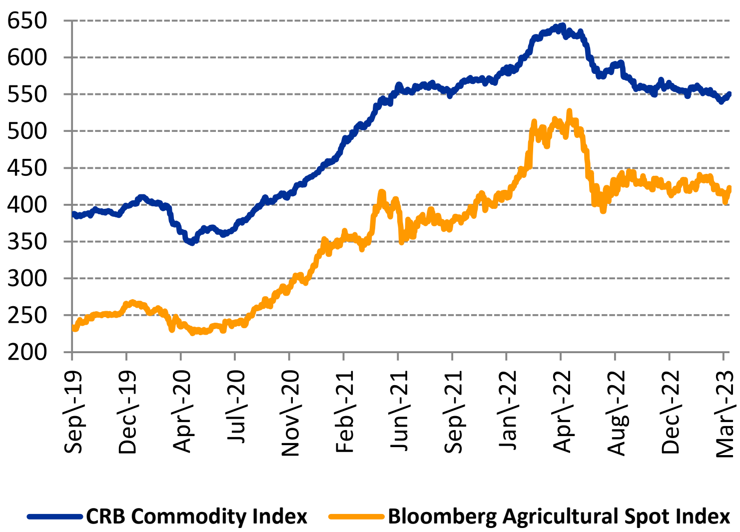
Chart 2: RBI Repo rate has risen sharply



Source: RBI, Valentis Research

Indeed we think the Fed is also likely to go into a pause mode after a hike in the May policy meet. While inflation in the US is well above the Fed goal of 2%, inflation has peaked and the trend is clearly downwards.

Chart 3: Commodity Prices are falling from the peak



Source: MOSL, Valentis Research

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

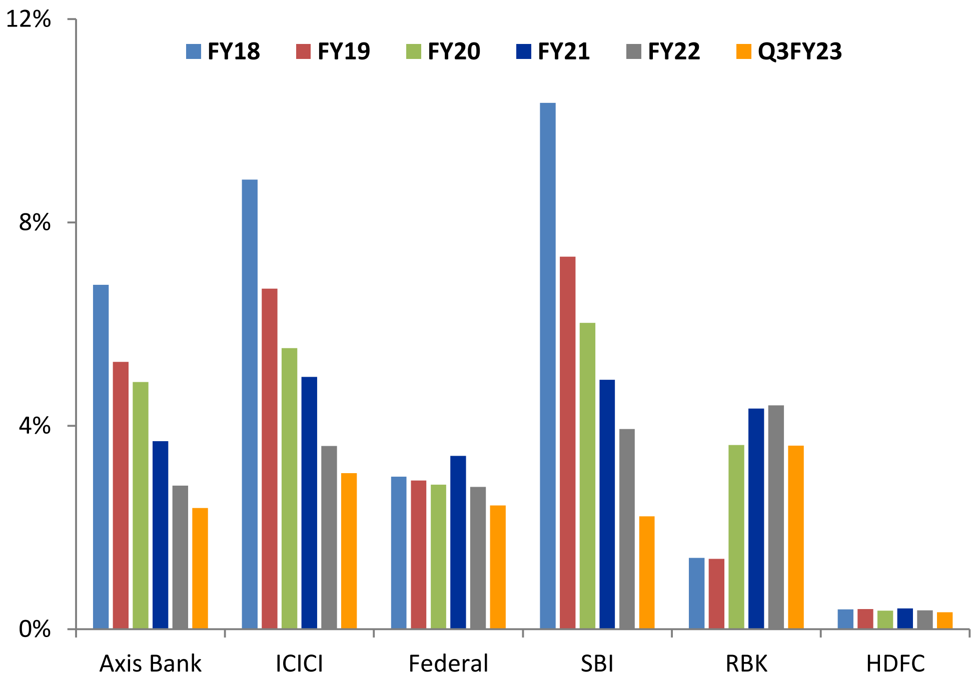
Name of Commodity	CMP	Drop from the Peak	YoY %
Crude Oil (bbl)	79.7	-40.48%	-25.24%
Palm Oil (MT)	938.7	-51.28%	-38.74%
Coal	133	-71.10%	-47.71%
Aluminium (MT)	2376.8	-38.70%	-31.71%
Copper (MT)	9003.5	-15.87%	-13.16%
Nickel (MT)	23685	-50.87%	-26.25%
Wheat (Bu)	692.3	-44.22%	-25.34%
Sugar (lbs)	22.3	0.00%	14.16%
Natural Gas (mmbtu)	2.2	-77.11%	-60.72%

Source: MOSL, Valentis Research

#2: The Indian banking system is stable

Last month saw a banking system scare both in the US (Silicon Valley Bank, Signature Bank) as well as Europe (CSFB). One thing that stood out was the relative stability of the Indian banks and the more strict policies of the RBI that provide a shield to the Indian banking system. While the Liquidity Coverage Ratio (LCR) requirement stands at 100% in high-quality liquid assets (HQLA)--most banks maintain a meaningfully higher number of mitigating risks of a run on the bank. Capital requirements follow the Basel Accord and RBI has also been proactive in raising risk weights in the event a segment of the market witnesses heightened lending activity. The deposits are guaranteed to the tune of Rs 5 lakhs after the Yes Bank fiasco (Rs 2 lakhs earlier), imparting higher depositor confidence even in smaller banks. Moreover, Indian Banks have been recovering from a prolonged NPL cycle (2015--2021) leading to sharp recoveries and upgrades and low slippages. Capital adequacy ratios of banks are meaningfully higher regulatory requirements given the strong profitability and capital raising by banks during COVID. As a result, the probability of a run on Indian Banks seems lower than witnessed in some of the developed markets.

Chart 4: Gross NPLs have fallen sharply



Source: Company Data, Valentis Research

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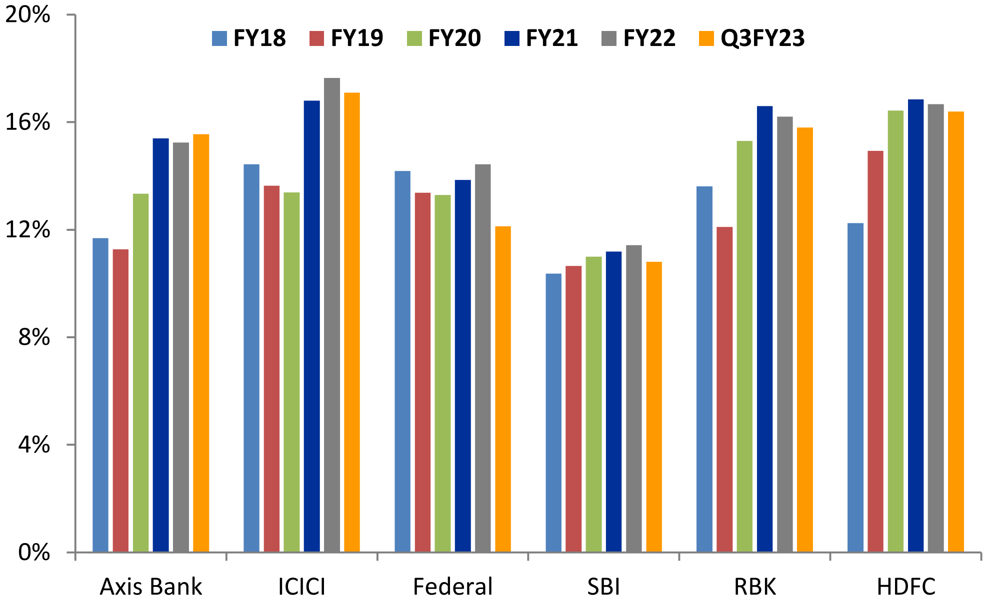
Chart 5: Capital adequacy (CET-1 Ratio) of banks is strong

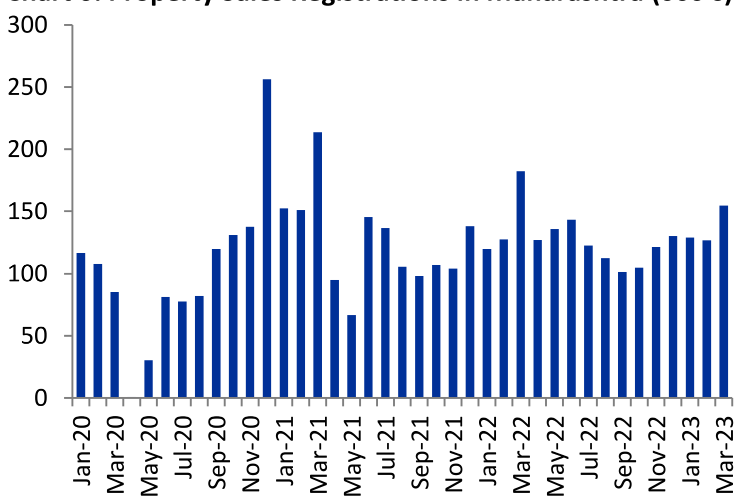


Source: Company Data, Valentis Research

#3: The Indian economy is slowing marginally but no recession

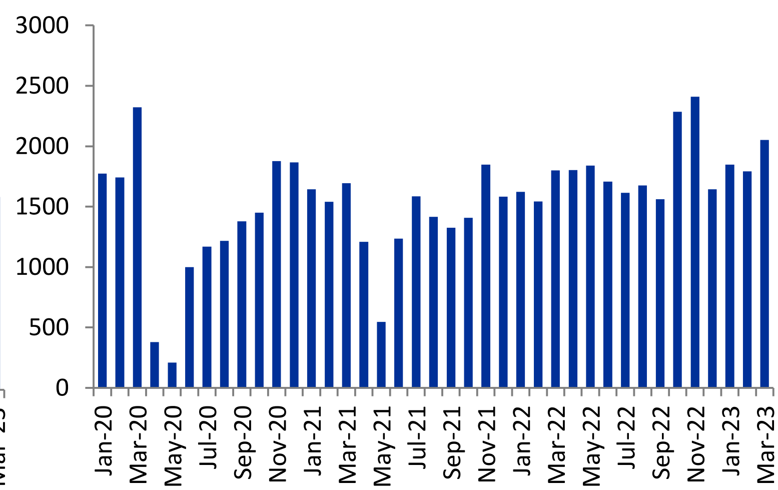
The Indian economy is relatively immune to a possible recession in the West but can't be totally isolated and will see some impact. However, near term the economy has seen a plateau but there are not many signs that the economy is slipping

Chart 6: Property Sales Registrations in Maharashtra (000's)



Source: Phillip Capital, Valentis Research

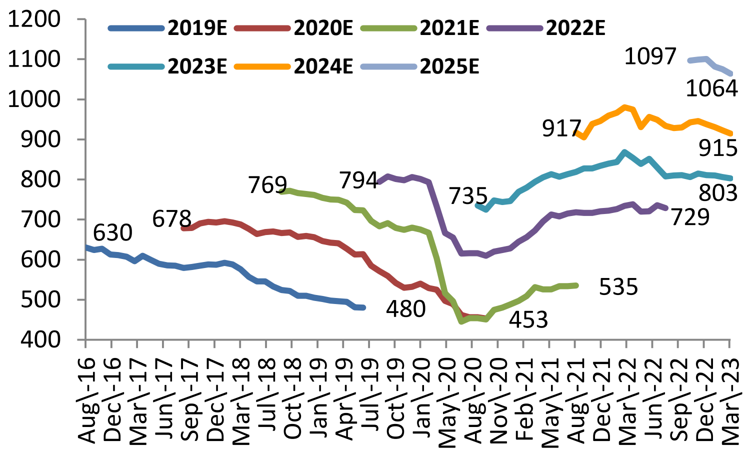
Chart 7: Vehicle Registrations (000's)



Source: Phillip Capital, Valentis Research

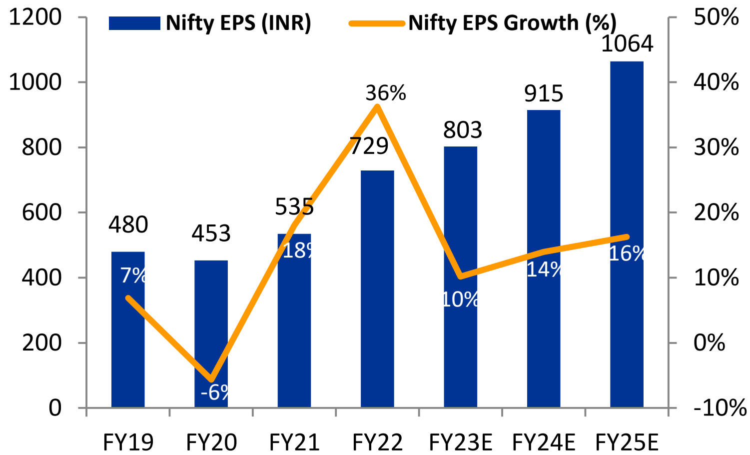
Earnings are seeing some downgrades, especially in global-related sectors. But overall, we still believe FY24 will see a double-digit earnings growth.

Chart 8: Nifty EPS estimates upgrades seeing a pause



Source: Kotak Institutional Equities estimates, Valentis Research

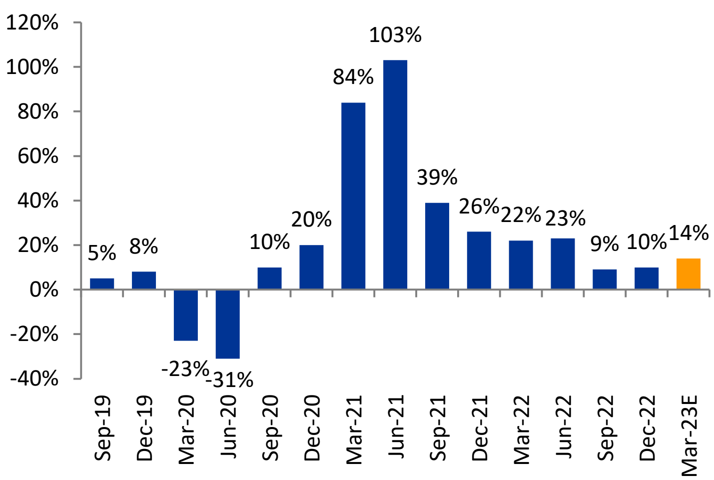
Chart 9: Nifty Earning growth (%) – Banks key driver



Source: Kotak Institutional Equities estimates, Valentis Research

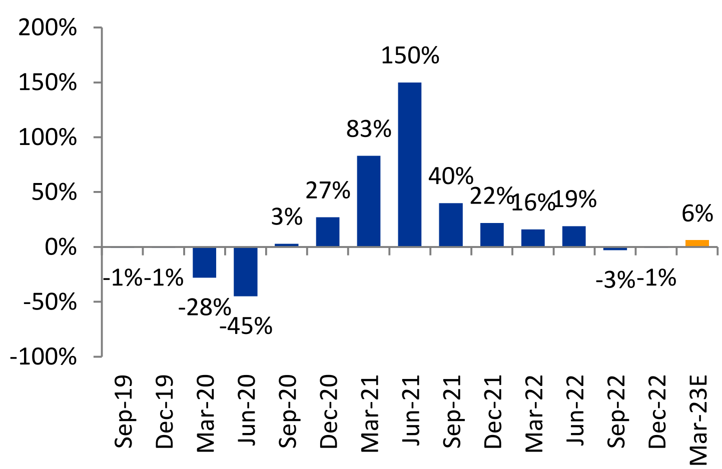
With the March 2023 quarter results season having started, we expect Nifty earnings to grow by a healthy 14% YoY in 4QFY23. However, growth is concentrated in a few sectors. Earnings growth would be fuelled by BFSI which is likely to account for nearly 60% of the earnings growth. However, growth is also dragged down by global commodities. Excluding global commodities (i.e. Metals and O&G), the Nifty should post 23% YoY earnings growth in 4QFY23.

Chart 10: Nifty Universe PAT Growth in double digit



Source: MOSL, Valentis Research

Chart 11: Nifty Ex-Financials PAT Growth is weak



Source: MOSL, Valentis Research

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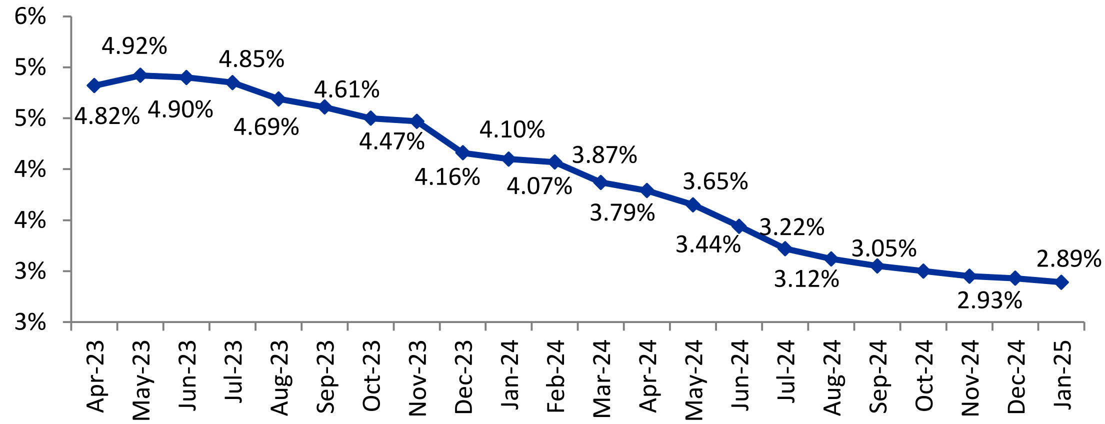
#4: The divide between Fed and the bond market is growing

However, the divide is not just between India and the US. Within the US, the bond market is clearly expecting a dramatically different Fed policy curve than what the Fed currently believes. The bond market is pricing for a steep cut of 84bps by CY23 end vs Fed guidance of no cut.

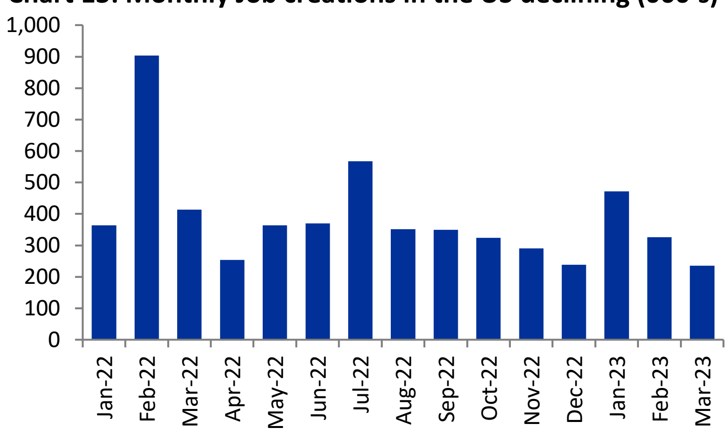
Chart 12: Market Expectations for Fed Funds Rate



Source: Fed Fund Futures Apr23-Jan25, Bloomberg, Valentis Research

Who is right is going to have implications for not just US but global markets. From our point of view, it is easier to predict a Fed pause soon, most likely post the May policy meeting, but a quick cut in Fed rates will depend on a sharp slow-down or a recession in the US economy. So far the data is indicating a softening but no real crash of the US economy. But this may change as the impact of the layoffs and the lag impact of interest rates hikes feed into the economy.

Chart 13: Monthly Job creations in the US declining (000's)



Source: US Bureau of Labor Statistics, Valentis Research

Chart 14: US ISM Manufacturing PMI data falling

Source: investing.com, Valentis Research

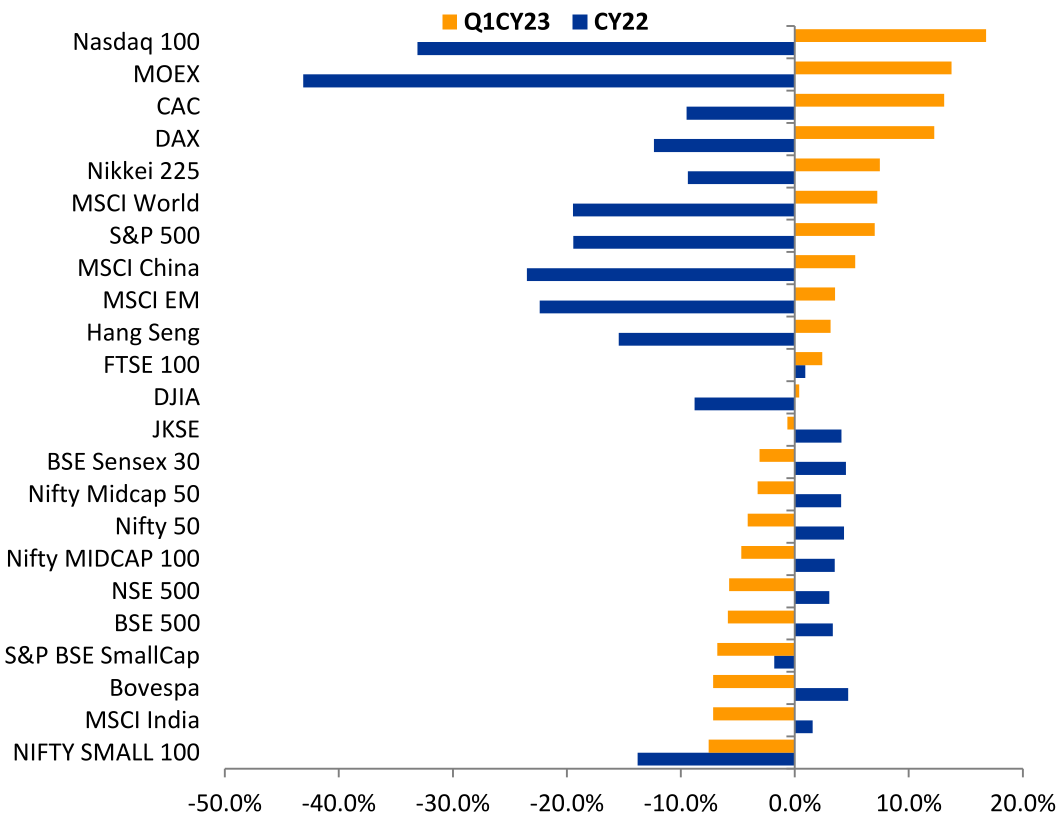
#5: Resilient markets – will Fed pause lead to a rally in this quarter

We started the year with 2 broad thoughts (https://www.valentisadvisors.com):

1. We think 2023 will continue to see consolidation with single-digit returns though the returns can be back-ended. We still continue to stick to this view though we are getting slightly more positive as we near the end of the Fed hiking cycle.
2. India after its sharp outperformance in 2022 and demanding relative valuations may slightly under-perform the EM index. After underperforming in Q1, India may now move in line with the EM index.

2022 laggards rally in Q1CY23: As we expected in our 2023 outlook note in January, the best performers of last year (India and Brazil) have been the laggards of this year in the equity markets. Europe and NASDAQ have performed strongly in spite of being at the centre of the banking crisis

Chart 15: Global Market Performance Last Year vs 1st Quarter Current Year



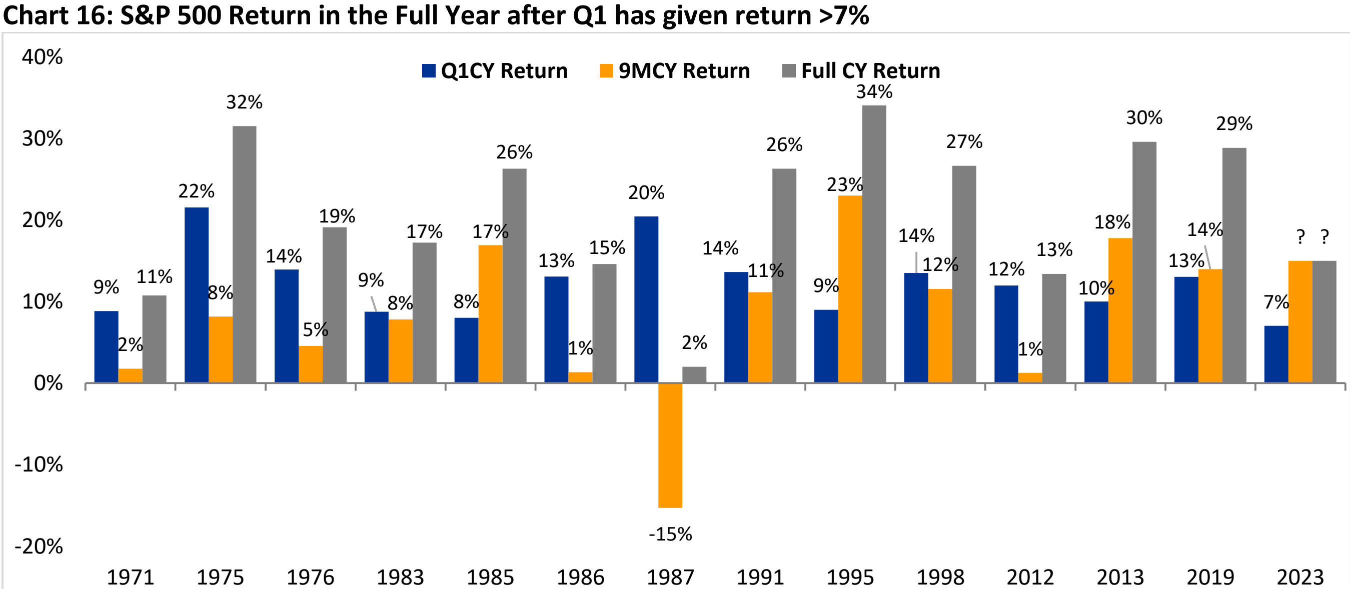
Source: investing.com, Valentis Research

This matches with our expectations that India will under-perform global markets in 2023. Going forward, we think India will perform relatively better: (a) valuations both on an absolute level as well as relative basis is getting closer to long-term averages (b) relative strength of the economy will help attract money if there is a global slow-down (c) post the FPI selling India is no longer a huge overweight.

Is a lot of bad news in the price in USA?

In our note in January (https://www.valentisadvisors.com), we highlighted 2 charts (a) Buying a 20% dip led to an average 17% return over 1 year with a positive double-digit return 7 times out of 10 (b) On an average, post a Fed pause, markets gave 4% return after 6 months and 12% return after 1-year with only 1 out of 6 returns being negative. With the first quarter delivering a positive return year for the S&P, an interesting data point to look at is that in every instance of S&P giving a return of more than 7% in Q1, the calendar year was always positive with the average return being 21.6% and the median return being 26.3%. However, a better way to think about is what markets did in 9 months post the first quarter. The next 9 months still gave an average 8% return (11% annualized) with a negative return only once out of 13 years.

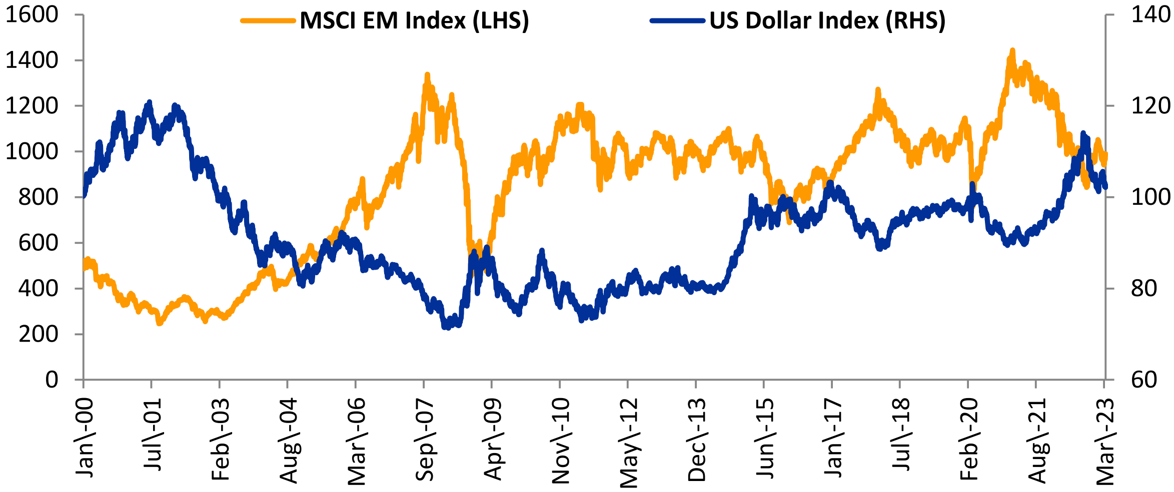
Chart 16: S&P 500 Return in the Full Year after Q1 has given return >7%



Source: investing.com, Valentis Research

Positive returns in India over the rest of the year: We continue to believe India as well as global markets will give a positive return this year though a lot of the returns may be back-end. While valuations are not cheap, they are getting closer to the fair value range (see Charts in Appendix). The other factor that is positive for Indian markets is that the peaking of the US$ will help better performance of EM.

Chart 17: Dollar Index Vs MSCI EM Index – has the $ index peaked?



Source: investing.com, Valentis Research

#6: Portfolio Performance and outlook

1. The first quarter of 2023 has seen negative returns in our portfolio though we have seen a 200-350 bps outperformance to benchmark in both our portfolios. For FY23, while the small-cap index gave a large negative return, we managed to generate a huge outperformance and gave a small positive return. The Multi-cap portfolio ended almost flat and again outperformed the market.
2. As we have indicated for past 15-18 months, we have been investing cautiously and are sitting on larger than normal cash. With valuations now getting into top end of fair value, we would be looking for opportunities to reduce cash in Q2.
3. Our basic theme has been "Buy local, avoid global" and this has worked well for us through the past year. We continue to favor the domestic names given the possible risk of a US recession. However, we are getting a bit more positive on pharma with a possible bottoming out of the US generics pricing pressure.
4. Within domestic names we prefer investment themes over consumer themes given the increasing proportion of Government expenditure to capital expenditure and their relative long-term underperformance. However, now valuations in some of these names are no longer cheap and hence the onus is on these companies to deliver on earnings. One benefit for some of these companies is that falling commodity prices are reducing cost pressures eg: in cement, we have not seen any significant price increases. But falling input cost pressure will lead to a Rs 150-200/tonnes EBIDTA increase.

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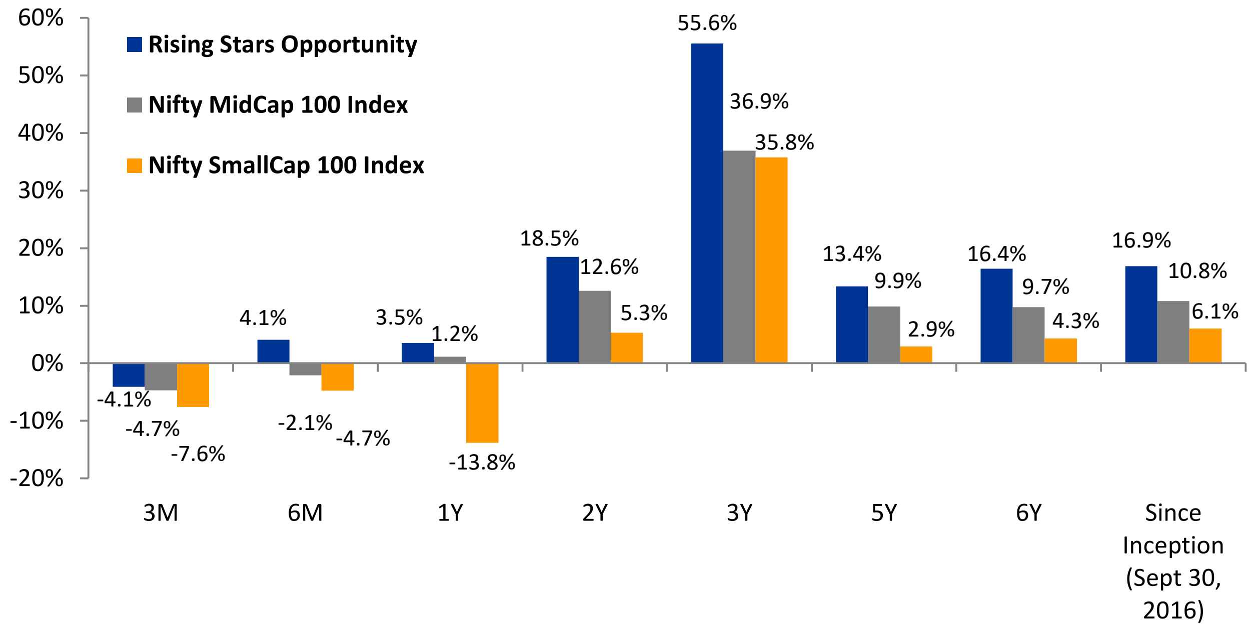
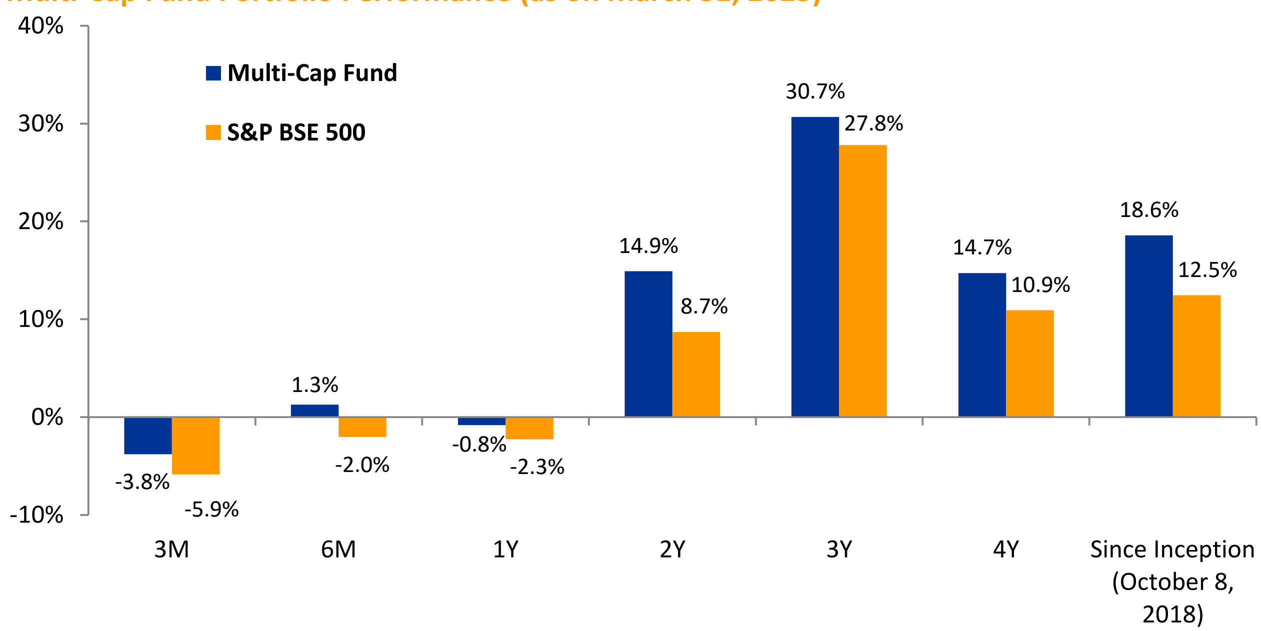
Rising Stars Opportunity Fund Portfolio Performance (as on March 31, 2023)



Multi-Cap Fund Portfolio Performance (as on March 31, 2023)



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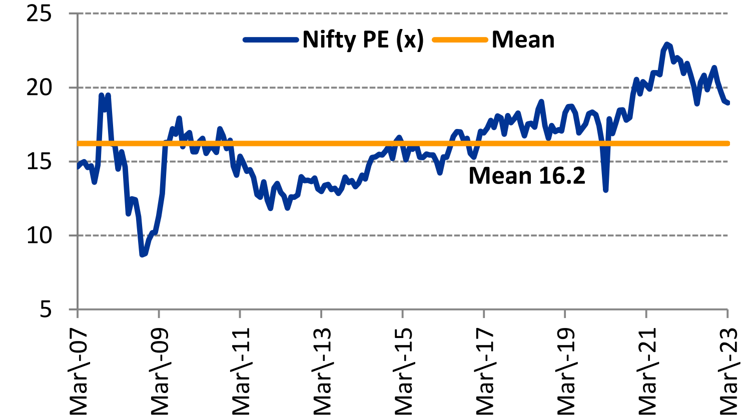
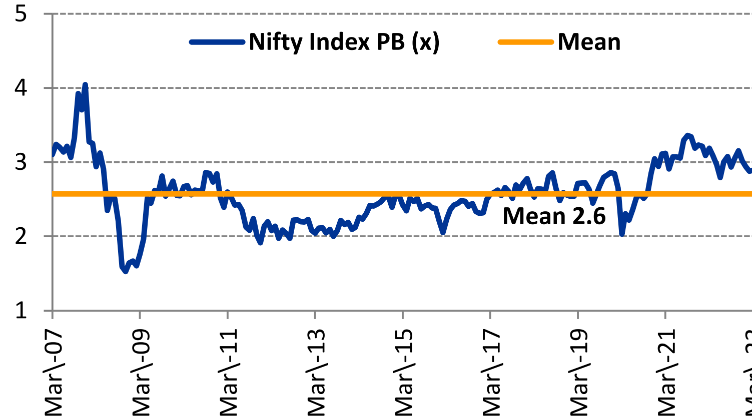
Appendix: Valuations

Chart 18: Nifty 12M Forward P/E (x)



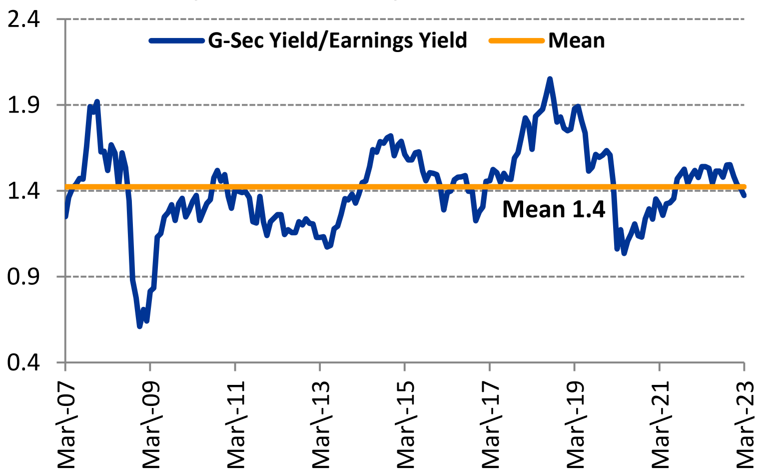
Source: Edel, Valentis Research

Chart 19: Nifty 12M Forward P/B (x)



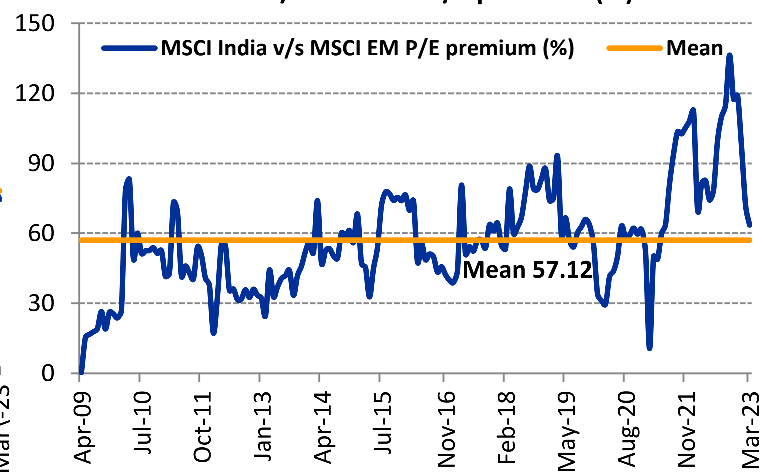
Source: Edel, Valentis Research

Chart 20: Bond yield Vs SENSEX yield



Source: MOSL, Valentis Research

Chart 21: MSCI India v/s MSCI EM P/E premium (%)



Source: Phillip Capital, Valentis Research

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