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Too fast, too furious?

July 14, 2023

Indian markets rally sharply; at new highs

We had turned positive on the markets in our last quarter note in April, 2023 (see attached - https://www.valentisadvisors.com). Yet even we were surprised by the pace of the rally. The Nifty rallied by 10.5% during the quarter with the broader markets faring even better – the Nifty Mid-cap index was up 19% and the Nifty Small Cap Index was up 20.5%. All the indices hit an all-time high during the quarter

Where do we go from here? We continue to remain bullish on the markets in longer term as reiterated in many of our previous notes. Firstly, India will be the best performing economy globally over the next few years. Secondly, India will see strong earnings growth on the back of rising GDP. Lastly, India will continue to attract long term foreign investors to the equity markets as its rising GDP and earnings growth is accompanied by high quality bottoms up companies with sustainable and consistent high RoCE and RoE ratios.

Yet, near term we think investors should stagger their investments and use dips to buy the market. Valuations have become expensive again and could lead to price and time correction. Secondly, inflation has been sticky and rising on the margin. With El Nino fears still existing, any failure of the monsoon could drive inflation higher. Thirdly, while a Fed rate hike in July is probably baked in the market already, we think the market still remains over optimistic of a Fed cut this year.

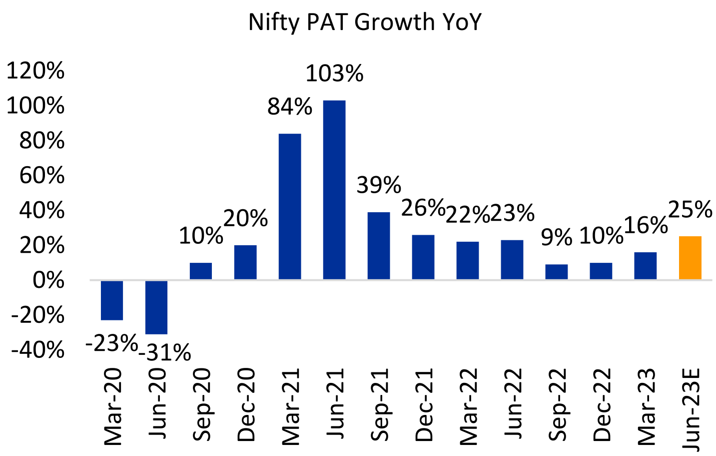
#1: Earnings in India continue to be robust

Earnings in India continue to be robust and we expect an earnings growth of 12-14% for FY24. While the street is expecting a higher growth, we think global commodity earnings may see downgrades in case of a slow-down in the global economies.

The current earnings season for the June quarter will again be strong with Nifty companies likely to grow earnings at 25% yoy. However, this may be exaggerating growth since the oil marketing companies' (OMC) profits are anticipated to surge to INR405b in 1QFY24 from a loss of INR185b in 1QFY23 owing to strong marketing margins. Ex-OMC, Nifty's earnings should rise 11% YoY for the quarter.

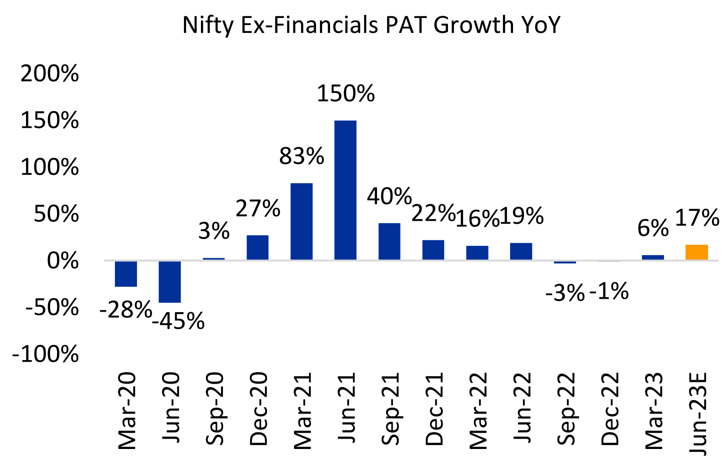
Overall earnings growth is likely to be driven once again by domestic cyclicals such as BFSI and Auto, which are expected to post 47% and 11x YoY jump. Metals and Cement are anticipated to drag the aggregates with a 53% and 17% YoY decline in earnings, respectively.

Chart 1: PAT growth for the Nifty Universe likely at 25%



Source: MOSL, Valentis Research

Chart 2: PAT to grow 17% for the Nifty Universe Ex Financials



Source: MOSL, Valentis Research

… In contrast USA is seeing a recession at least in earnings

Consensus expectations for US companies for the June quarter are bleak in contrast to India with consensus estimates projecting a decline of about 7% yoy in earnings per share among S&P 500 companies. Many of the leading Wall Street brokerages are echoing the bleak message. S&P 500 companies are expected to see zero YoY revenue growth for the first time in 10 quarters, as per Goldman Sachs. UBS expects earnings in this quarter to mark the steepest decline since 2020.

#2: Global Funds continue to favor Indian markets

Global fund managers continue to be bullish on the Indian markets and this reiterates our long-standing view that India will continue to see higher weights in most global equity indices. This was reiterated in our recent trip to Hong Kong where we met some of the large FPI investors in India. Most reiterated that India remains one of the most positive markets for them from a 3-5 year view with high valuations being the only near term negative.

It is not just equity market investors but also debt investors globally who are getting increasingly bullish on India. India has now overtaken China as the most attractive Emerging Market for investing in Emerging Market debt according to a survey done by US Invesco. The institutions they polled collectively manage approximately US$21 trillion in assets

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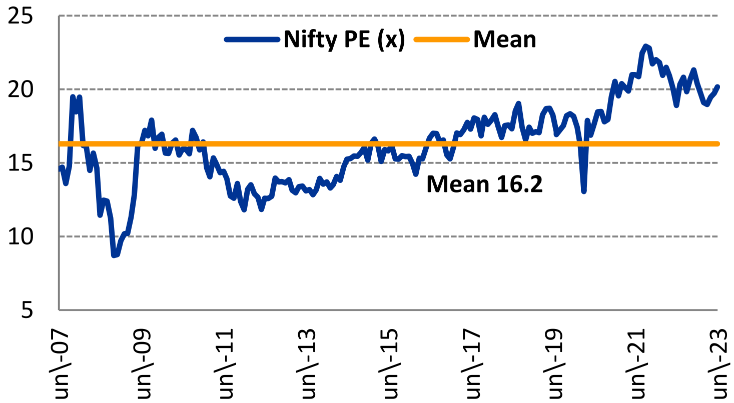
The reasons cited in the survey align with our themes for India. India was viewed increasingly positively for its improved business and political stability, favorable demographics, regulatory initiatives, and a friendly environment for sovereign investors. India is also benefitting from increased foreign corporate investment aimed at both domestic and international demand through "friend-shoring" and "near-shoring" (think of the China+1 theme that we have highlighted earlier).

#3: Valuations back in expensive territory – stagger investments

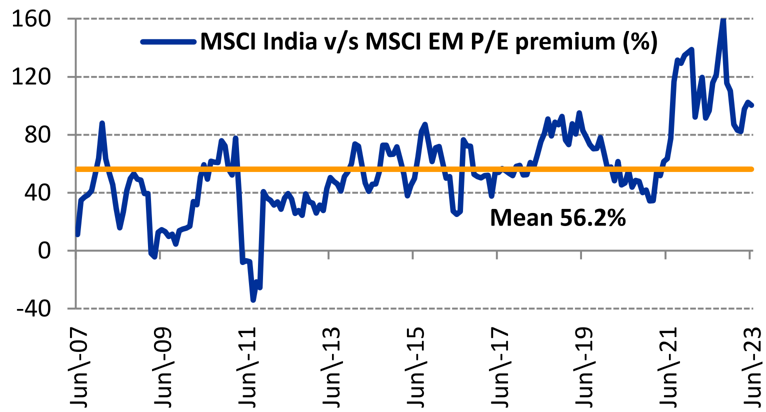
We had turned positive on markets 3 months ago since valuations had turned reasonable. With the sharp rally over past 3 months, valuations have again turned expensive with a 1-year forward PE of the Nifty at 20.2x, well above long term averages. Similarly in a relative context too valuations are getting expensive with India now trading a premium of 100% to the MSCI PE ratio well above the long term average of 56%. We think this could lead to a time and price correction in the markets and we would prefer to invest in a staggered manner.

Chart 3: Nifty 12M Forward P/E (x) – most expensive



Source: Edel, Valentis Research

Chart 4: MSCI India v/s MSCI EM P/E premium (%)



Source: MOSL, Valentis Research

#4: Inflation inching up in India while it is falling in USA

Our base case remains that RBI will be on pause for the rest of the year. However, inflation in India which was less than US inflation for 16 months in a row has proved stickier than US inflation. US inflation has fallen rapidly and now is well below Indian inflation.

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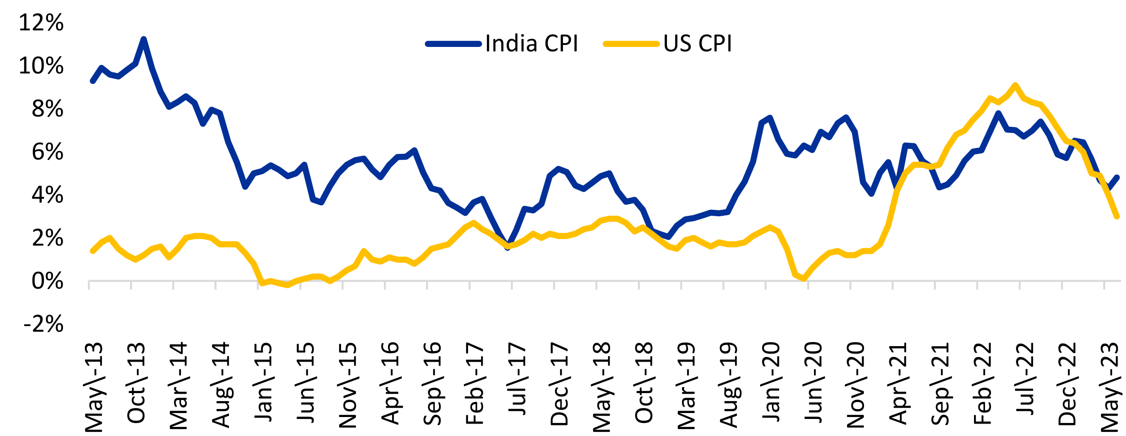
Chart 5: India CPI was lower than US CPI for 16 months



Source: Investing.com, Valentis Research

Weak agriculture crop could put pressure on inflation

While rains have hit India with a vengeance, the monsoon deficit has evaporated. But more critically, sowing data is lagging miserably and the heavy rainfall has affected sowing further. Moreover, forecasters still expect El Nino to hurt monsoons in the later part of the season. Any crop failure due to a weak monsoon could put pressure on inflation. The current sharp jump in tomato prices highlights how quickly agriculture commodities can react to small changes in production deficits.

Table 1: Latest Sowing Data (as on 07/07/2023)

Sr. No.	Crops	Area Sown (Lakh Ha)		Difference in Area Coverage Over	% of Increase (+)/Decrease (-) Over
		2023	2022	2022	2022
1	Rice	54.1	71.1	-17	-23.9
2	Total Pulses	32.6	43.9	-11.3	-25.8
3	Total Coarse Cereals	73.4	61.3	12.1	19.7
4	Total Oilseeds	61.1	71.3	-10.2	-14.3
5	Sugarcane	55.8	53.3	2.5	4.7
6	Total Jute and Mesta	5.8	6.9	-1.1	-15.3
7	Cotton	70.6	79.2	-8.6	-10.9
	Grand Total	**353.4**	**387**	**-33.6**	**-8.7**

Source: Phillip Capital, Valentis Research

Table2: Latest Rainfall Data (1/6/23- 9/7/23)

Region	Cumulative Rainfall (1/6/23-9/7/23)		
	Actual (mm)	Normal (mm)	% Dep.
EAST AND NORTH EAST INDIA	375.3	454	-17%
NORTH WEST INDIA	199.7	125.5	59%
CENTRAL INDIA	264.9	255.1	4%
SOUTH PENINSULA	166.7	215.4	-23%
Country	**243.2**	**239.1**	**2%**

Source: Phillip Capital, Valentis Research

#5: Fed hike discounted? Is the market too optimistic on a Fed cut?

The last Fed policy meeting surprised – they paused but sounded hawkish expecting 2 rate hikes in the rest of 2023. We think the market has largely discounted a hike in the July policy. While the market still expects Fed to cut rates this year, we thing there is scope for some disappointment. As Bank of America points out, it is pretty rare for Fed to cut with inflation being this high and unemployment being this low.

Table 3: Snapshot of US economy in month of first Fed rate cut (major easing cycles since 1957)

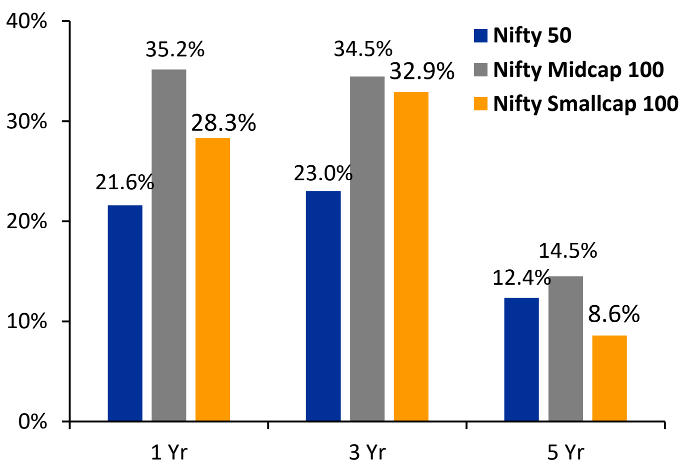
Month of First Fed Cut	CB policy rate as of last hike* (%)	Unemployment Rate (%)	Headline inflation (%)	Core Inflation (%)	Real GDP growth (%)
Nov-57	3.3	5.1	2.9%	-	0.4%
Jun-60	3.3	5.4	1.7%	1.7%	2.1%
Dec-66	5.4	3.8	3.5%	3.3%	4.5%
Oct-69	9	3.7	5.7%	6.0%	2.0%
Aug-74	12	5.5	10.9%	9.6%	-0.6%
May-80	11	7.5	14.4%	13.3%	-0.8%
Jul-81	19	7.2	10.8%	11.1%	4.3%
Sep-84	11.3	7.3	4.3%	5.1%	6.9%
Jun-89	9.5	5.3	5.2%	4.5%	3.7%
Dec-95	5.6	5.6	2.5%	3.0%	2.2%
Jan-01	6	4.2	3.7%	2.6%	2.2%
Sep-07	4.9	4.7	2.8%	2.1%	2.4%
Aug-19	2.1	3.7	1.7%	2.4%	2.3%
Nov-23*	4.6	4.3	3.4%	4.9%	-0.2%

** Estimates for Nov'23 based on Fed Funds Futures, BofA US Economics projections*
Source: BofA Global Investment Strategy, Bloomberg, Haver, GFDFinaeon

#6: We still prefer small caps but buy dips

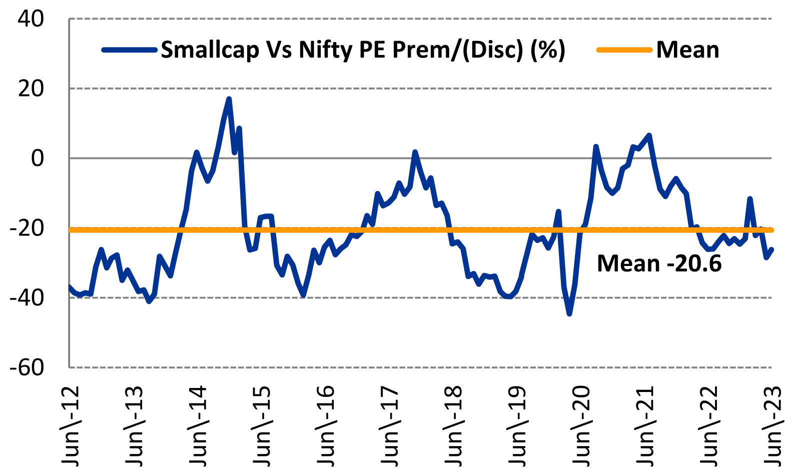
We still think over next few years small caps will out-perform large caps as they will grow earnings faster in a rising economy. However, just given the near term rally, we would wait for better entry points in any correction in the market. Small caps have rallied sharply over past year and the relative valuation discount to large caps is now pretty low in a historical context.

Chart 6: Nifty 50, Midcap 100 &SmallCap 100 Indices return



Source: ACE Equity, Valentis Research

Chart 7: Smallcap Vs Nifty PE Prem/(Disc)



Source: MOSL, Valentis Research

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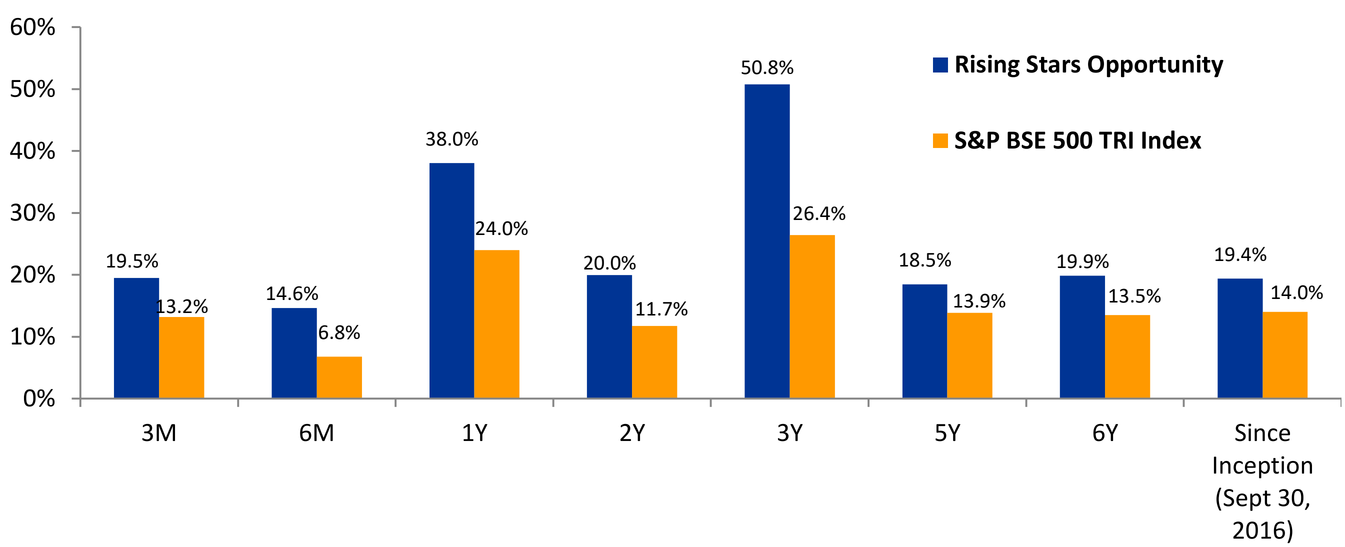
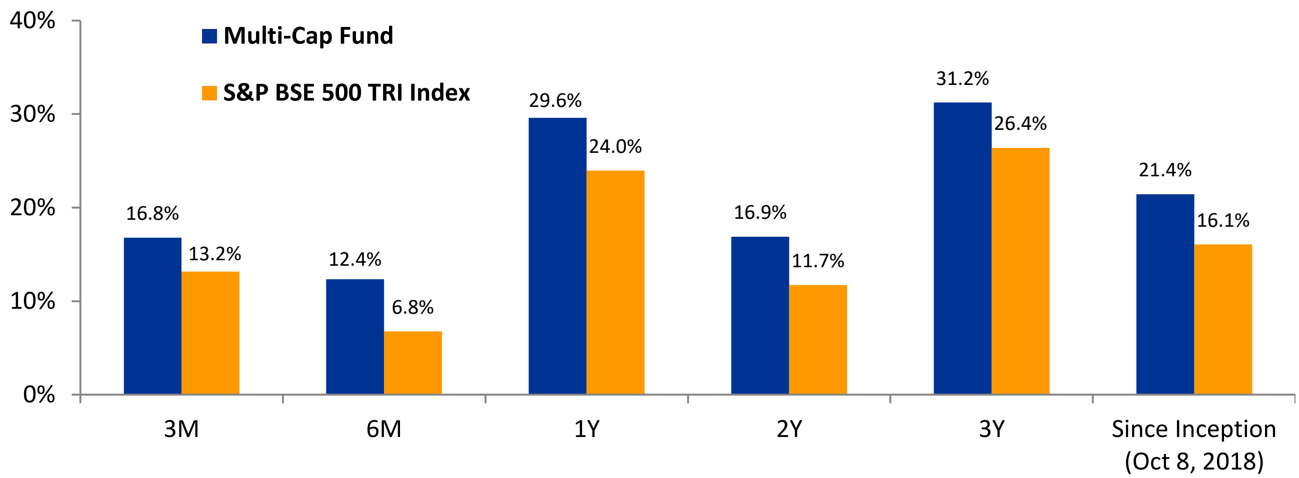
#7: Portfolio Performance and outlook

1. We were using the Nifty Small-cap index as a benchmark for our Rising Star small-cap scheme. Given the nature of our scheme, this appeared the most appropriate benchmark. Since April 2023, as per Sebi rules, we are only allowed to use one of the 3 benchmarks specified by APMI. Since there is no small-cap benchmark in the 3 options, we are using the BSE500 TRI index which is the most broad-based of the 3 indices.
2. Both of our portfolios continue to out-perform the benchmark during the quarter. Given the sharp rally in the quarter, 1-year returns in the portfolio are also at over 30%.
3. Our basic theme has been “Buy local, avoid global” and this has worked well for us through the past year. 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. While we have seen valuations get expensive within the space, we have not made any meaningful change in the weights or stocks in our portfolio.
4. However, the only exception is that we have added substantial weight to a Pharma company. Valuations were attractive here and we expect a possible bottoming out of the US generics pricing pressure to help re-rating of the stock.

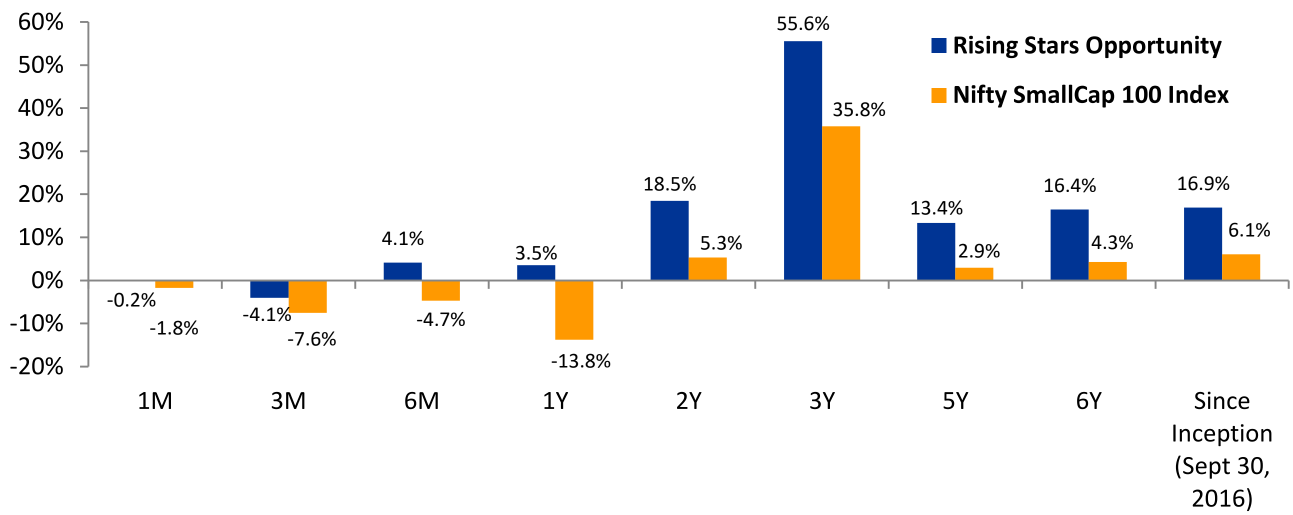
Rising Stars Opportunity Fund Portfolio Performance (as on June 30, 2023)



Multi-Cap Fund Portfolio Performance (as on June 30, 2023)



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



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