Valentis Advisors

Global headwinds, local tailwinds

October 20, 2023

We had turned cautious on the markets in our last quarter note in July, 2023 (see attached). While the Nifty has since corrected slightly, the small and mid-cap indices have continued to give a positive return. Though we are entering a seasonally strong quarter for equities, valuation worries continue to make us expect a price and time correction. Small and mid-caps stocks may be more vulnerable near term in a correction. We, therefore, are staggering our investments so that we can take advantage of any pull-back in the markets.

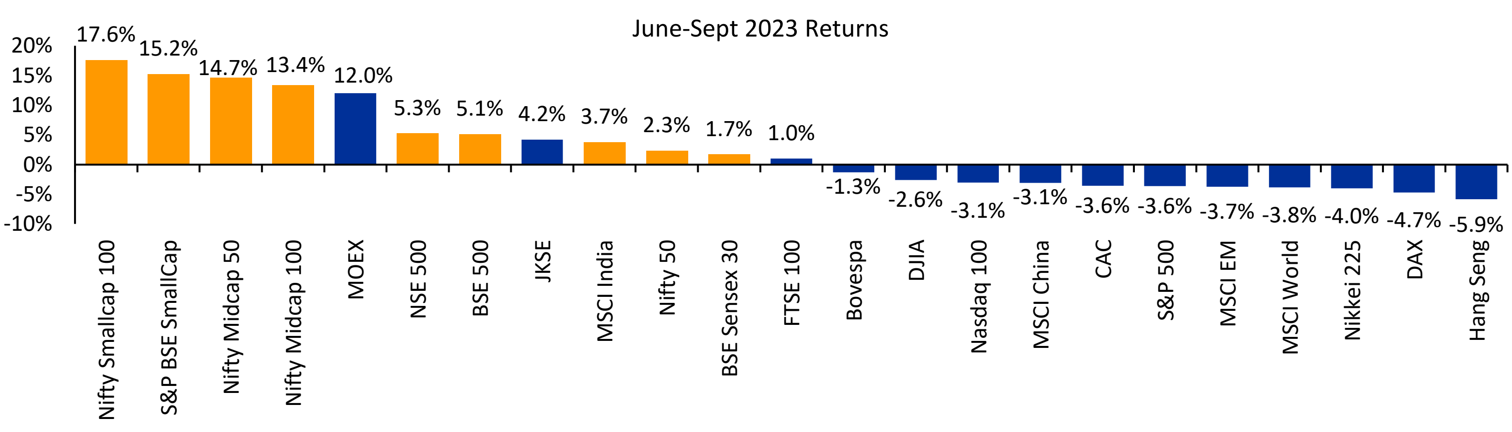
Fundamentals for the Indian economy continue to remain strong and is remains poised to be the fastest growing economy in the world over next few years. Earnings are likely to grow over 20% in the September, 2023 quarter and FY24 earnings are still seeing upgrades. Secondly, domestic flows to equities continue to remain strong with SIPs now aggregating close to $2 bn per month. Lastly, while FIIs have been selling near term, we expect them to be buyers if we see valuations contracting.

Apart from valuations, we think risks over the quarter are stemming from global developments. Firstly, any spike in oil prices in the background of the Middle East war could hurt India's macro stability. Secondly, with US 10-year bond yields hitting close to 5% and Fed likely to keep interest rate higher for longer, we could see worries of a slow-down in US emanate again.

We still expect time and price correction

Over the past quarter, the large cap indices have seen a small pullback but the mid-cap and small-caps have continued to rally. India has been one of the best performing markets last quarter.

Chart 1 – Indian indices outshined Global indices in the Last Quarter



Source: Investing.com, Valentis Research

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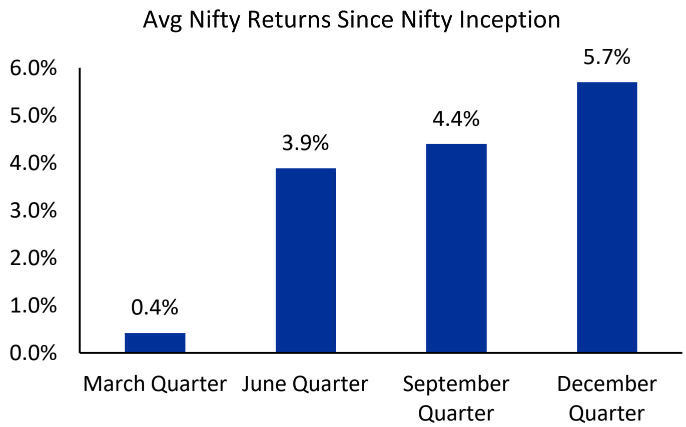
Entering seasonally strong quarter?

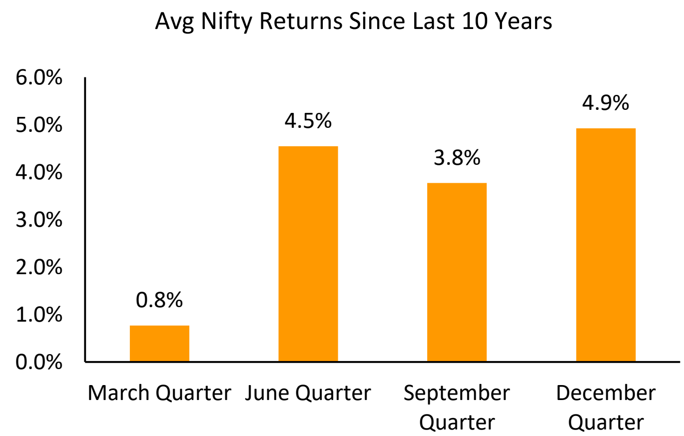
The October to December quarter has been the best quarter seasonally since the Nifty index was launched in April 1996 (base date Nov 1995) driven by the traditional Santa Clause rally. Even over the past 10 years, this quarter has been the best quarter though the seasonality is getting reduced.

Chart 2 – Quarterly performance since Nifty launch



Source: NSE, Valentis Research

Chart 3 – Quarterly performance for last 10 years



Source: NSE, Valentis Research

Domestic tailwinds, valuation and global headwinds – stagger investments

We think the market will continue to grapple with strong Indian economy and earnings on one hand with higher than fair value valuations on the other. Global headwinds in terms of rising US bond yields and higher oil prices are risks to markets and economy.

#1: Earnings in India continue to be robust

Earnings in India continue to be robust and we expect an earnings growth of close to 20% for FY24. Moreover, we are also starting to see earnings upgrades again after a lean spell for a few quarters.

Nifty earnings are likely to grow 21% YoY in 2QFY24. Overall earnings growth is projected to be driven once again by domestic cyclicals, such as BFSI and Auto, while oil and gas sector earnings are likely to surge 2.2x YoY underpinned by strong marketing margins of the OMCs. Auto sector's earnings are anticipated to surge 87% YoY during the quarter on a low base. Ex-TAMO, the Auto universe is likely to post 39% YoY earnings growth. BFSI earnings are predicted to remain buoyant with 26% YoY growth for 2QFY24.

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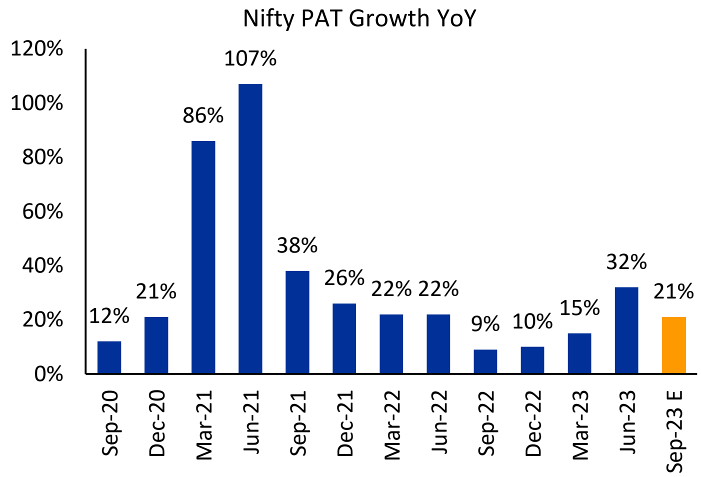
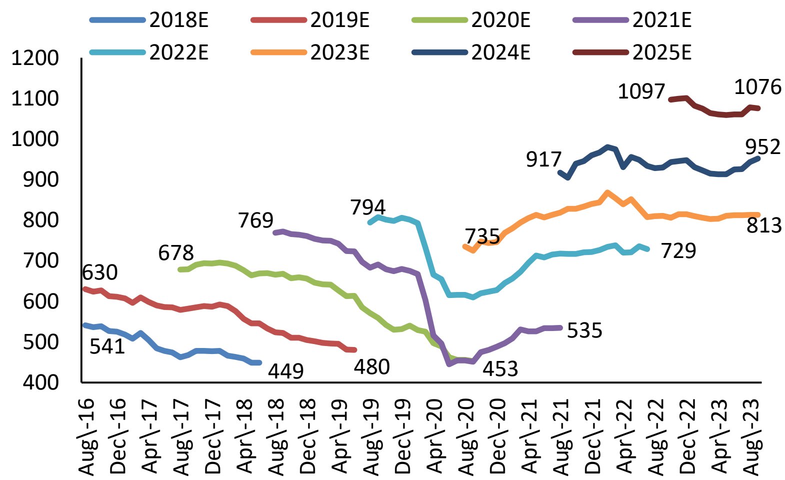
Chart 4: PAT growth for the Nifty Universe likely at 21%



Source: MOSL, Valentis Research

Chart 5: Nifty EPS estimates starting to see some upgrades



Source: Kotak Institutional Equities, NSE, Valentis Research

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

Consensus expectations for US companies for the September quarter are bleak in contrast to India with consensus estimates projecting a growth of 1.3% yoy in earnings per share among S&P 500 companies.

#2: Keep an eye on elections

Elections to 5 assembly states are to be held in November and December. These are the last lot of elections before the Lok Sabha polls in May, 2024. While investors will watch the results in Madhya Pradesh, Rajasthan and Chhattisgarh closely to gauge if the BJP is still strong in North India, we caution that voter preferences between State elections and Lok Sabha elections are different. BJP has done well in the Lok Sabha elections in these states 5 months later irrespective of whether they did well or badly in the assembly elections.

Table 1: Assembly election seats vs Lok Sabha seats since 2003 elections

State Election									
Rajasthan	**2003**	**2008**	**2013**	**2018**	**Madhya Pradesh**	**2003**	**2008**	**2013**	**2018**
Seats (%)					*Seats (%)*				
BJP	60%	39%	82%	37%	BJP	75%	62%	72%	47%
INC	28%	48%	11%	50%	INC	17%	31%	25%	50%

Lok Sabha Election									
Rajasthan	**2004**	**2009**	**2014**	**2019**	**Madhya Pradesh**	**2004**	**2009**	**2014**	**2019**
Seats (%)					*Seats (%)*				
BJP	84%	80%	100%	96%	BJP	86%	55%	93%	97%
INC	16%	16%	0%	0%	INC	14%	41%	7%	3%

Source: Election Commission of India, Valentis Research

#3: Crop likely to show small growth in spite of patchy monsoon

El Nino fears proved true to some extent with prolonged spells of very weak monsoon. However, monsoons overall turned out to be normal. More important, crop sowing has been slightly higher than last year which has assuaged fears of a sharp rural slow-down.

Table 2: Sowing data (till 15/9/2023)

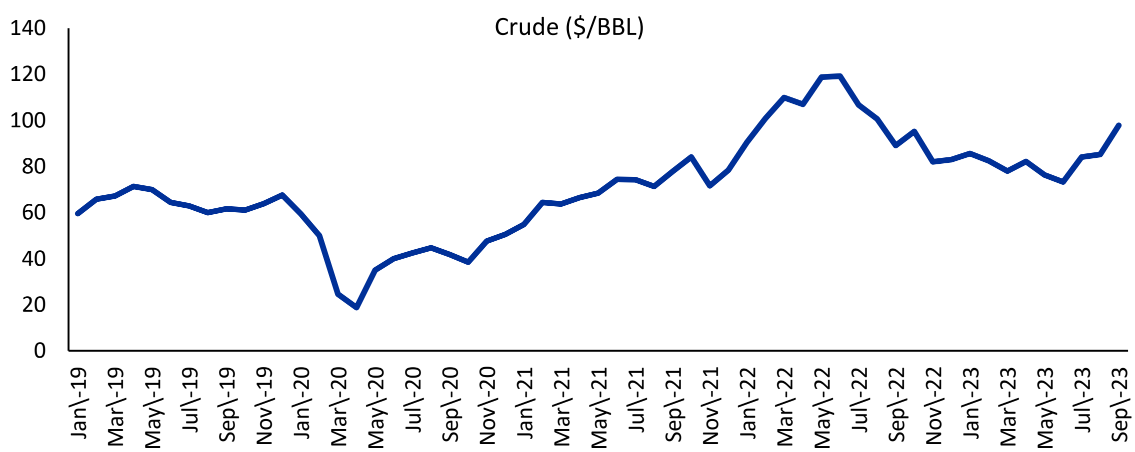
Sr. No.	Crops	Area Sown (Lakh Ha)		Difference in Area Coverage Over	% of Increase (+)/Decrease (-) Over
		2023	2022	2022	2022
1	Rice	409.4	398.6	10.8	2.7
2	Total Pulses	121	127.6	-6.6	-5.2
3	Total Coarse Cereals	183.1	181.5	1.6	0.9
4	Total Oilseeds	192.2	194.3	-2.1	-1.1
5	Sugarcane	59.9	55.7	4.3	7.7
6	Total Jute and Mesta	6.6	7	-0.4	-5.7
7	Cotton	123.2	127.3	-4.1	-3.2
	Grand Total	**1095.4**	**1091.9**	**3.6**	**0.3**

Source: PC, Valentis Research

#4: Have oil prices peaked?

The conflict between Israel and Hamas has not had any significant impact on oil prices so far. Oil prices, however, are higher by approximately $25/brl in Q3 vs Q2 of CY23. A higher oil price is negative for India's current account deficit with every $10/brl increase leading to an increase of ~0.5% in current account deficit. It also threatens inflation with a ~0.4% increase though it is likely the Government will not allow oil marketing companies to pass on the burden to the consumer.

Chart 6: Increasing Oil Prices are a threat to Indian Economy



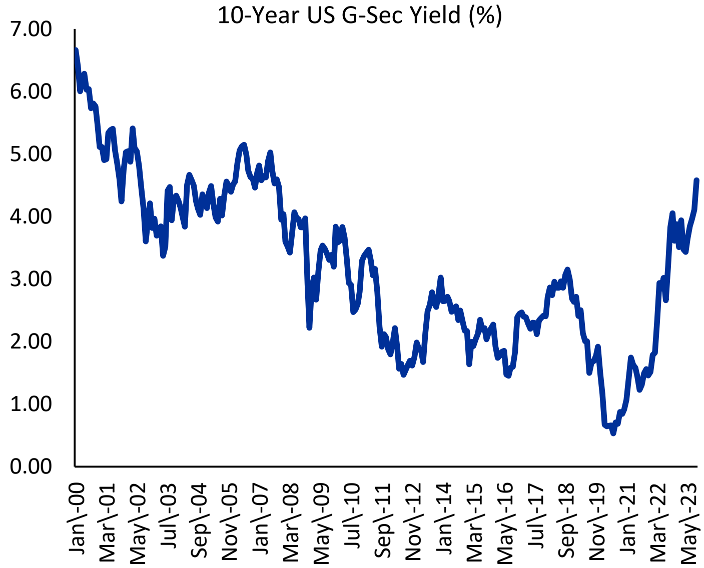
Source: Investing.com, Valentis Research

#5: Higher for longer US interest rates – the 10-year yield near 5%

The US 10-year bond yields are the highest since the Global Financial Crisis (GFC) and flirted with 5% recently as worries on inflation and budget deficits as well as indebtedness of the US came to fore. The Fed has indicated that interest rates will be "higher for longer" though a rising bond yield probably means that there may not be a Fed increase this year. Rising bond yields are negative for earnings and the economy as well as stock valuations.

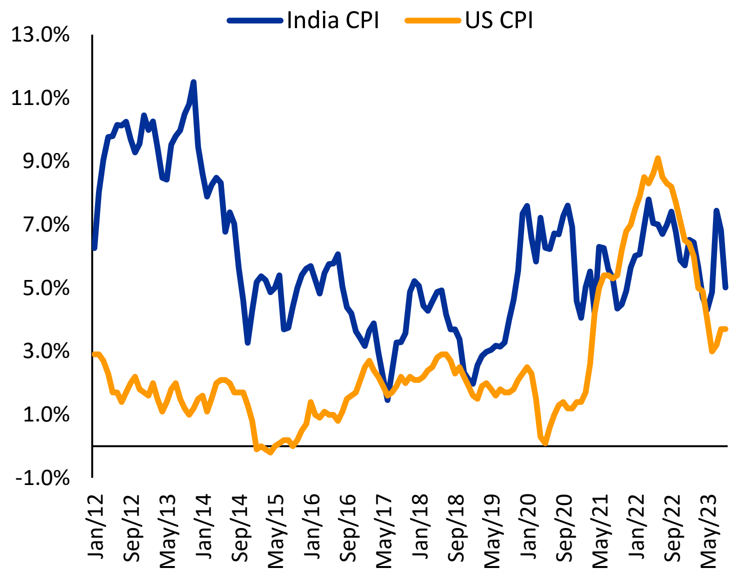
Yet, the debate now is whether bond yields have peaked and we start seeing the bond market get worried on a slow-down in the US economy next year. We think that the US economy will see slower growth next year which may lead to a less aggressive Fed and hence softening of the bond yields.

Chart 7: US 10 year bond yields near GFC levels



Source: Investing.com, Valentis Research

Chart 8: US CPI vs India CPI



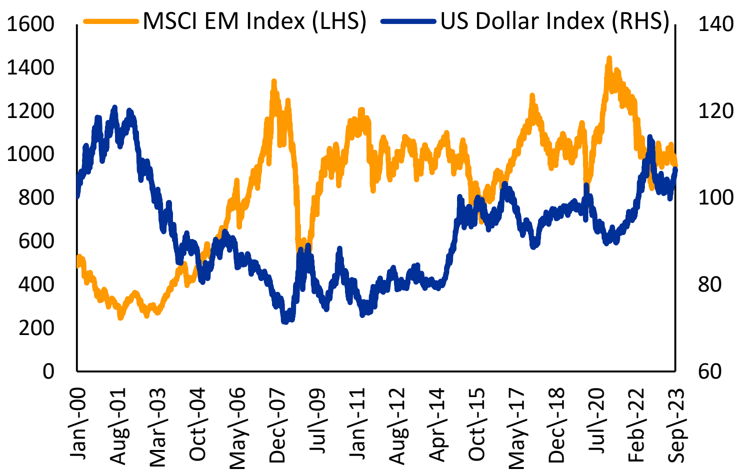
Source: Investing.com, Valentis Research

#6: Has the US Dollar peaked?

The strength of the US $ is negative for the emerging market economies. It was reflected in a weaker EM in the September quarter as the US $ strengthened.

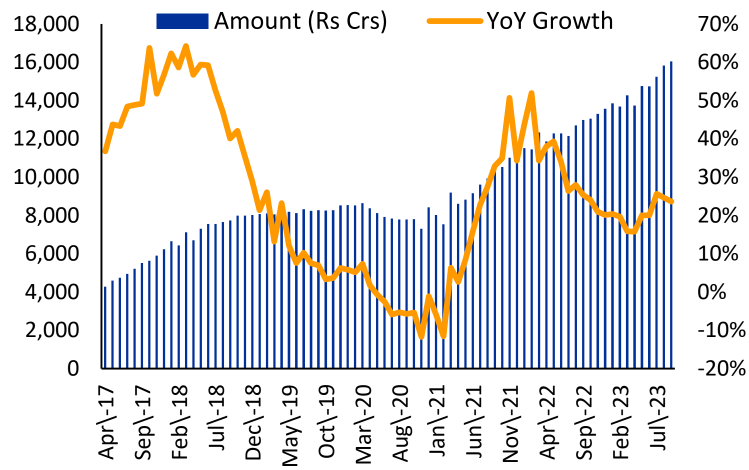
However, in India retail flows to equity continue to be strong with monthly SIPs now bringing in flows of Rs 160 bn. This is providing support to the markets from the selling pressure from the FPIs.

Chart 9: Dollar Index vs MSCI EM Index



Source: Investing.com, Valentis Research

Chart 10: Monthly SIP inflow continues to increase in MFs

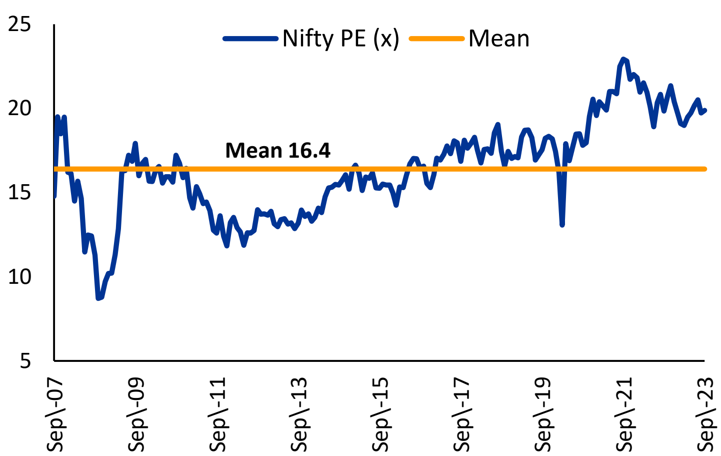


Source: AMFI, Valentis Research

#7: Valuations continue to provide no margin of safety

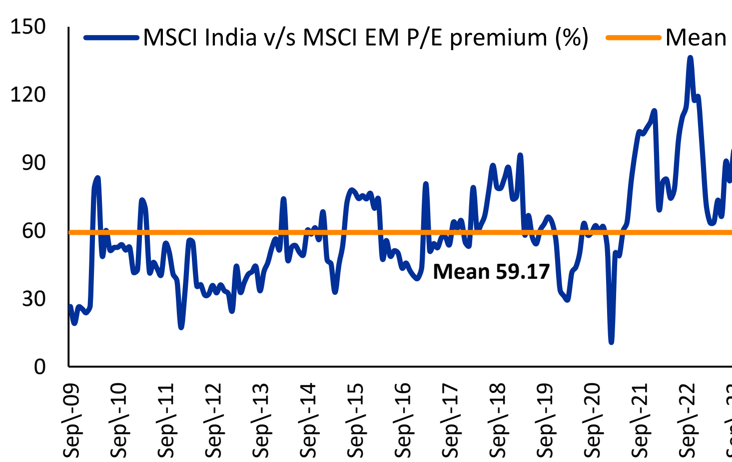
While valuations have corrected over past 3 months, they still remain above long term averages with a 1-year forward PE of the Nifty at close to 20x. Similarly in a relative context too while valuations have corrected from the peak, they remain are still expensive with India now trading a premium of 90% to the MSCI PE ratio well above the long term average of 59%. 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 11: Nifty 12M Forward P/E (x) – most expensive



Source: Edel, Valentis Research

Chart 12: MSCI India v/s MSCI EM P/E premium (%)

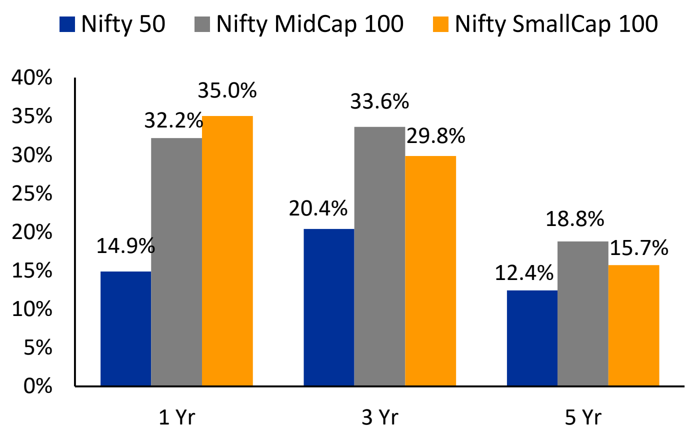


Source: PC, Valentis Research

#8: Stagger investments in mid and small-caps

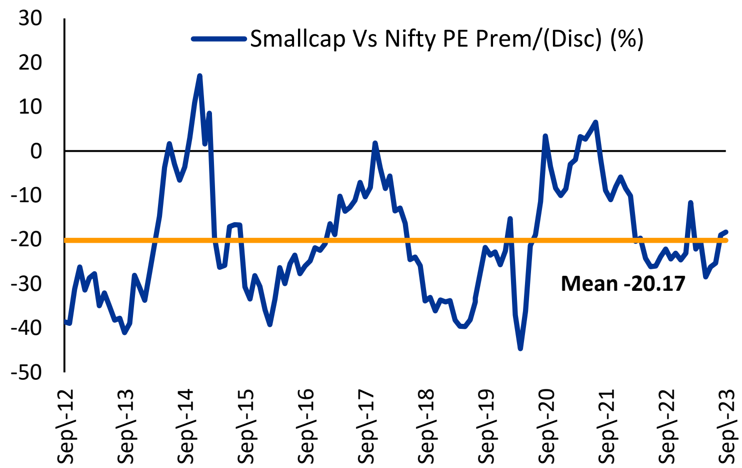
We still think over next few years small caps will out-perform large caps as they will grow earnings faster in a rising economy. However, just given the near term rally, we would wait for better entry points in any correction in the market. Small caps have rallied sharply over past year and the relative valuations to the large caps is not attractive at these levels.

Chart 13: Nifty 50, Midcap 100 & SmallCap 100 Indices return



Source: ACE Equity, Valentis Research

Chart 14: Smallcap Vs Nifty PE Prem/(Disc)



Source: MOSL, Valentis Research

#9: Portfolio Performance and outlook

1. 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 above trend at close to 30% and 40% in the Multi-cap and Rising Star portfolio respectively.
2. We have been cautious on the markets past few weeks and deploying new money in a staggered manner even if we risk a small under-performance near term. We are currently having cash levels in aggregate of close to 20%.
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 continue to like the space, we have booked partial profit in one of our best performing names in this space.
4. We have also exited a domestic pharma company which was a strong performer for us. While the stock continues to deliver strong earnings growth, we think at current valuations stock price returns may be more muted. We have, meanwhile, added to our existing positions in the banking and the cement space.

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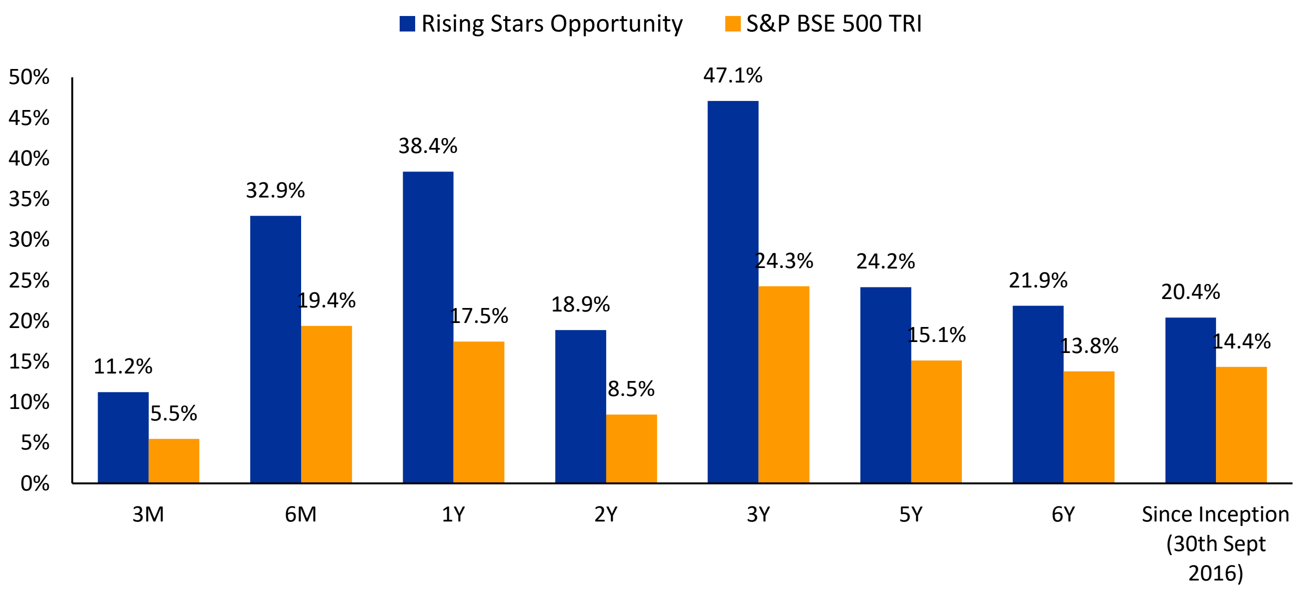
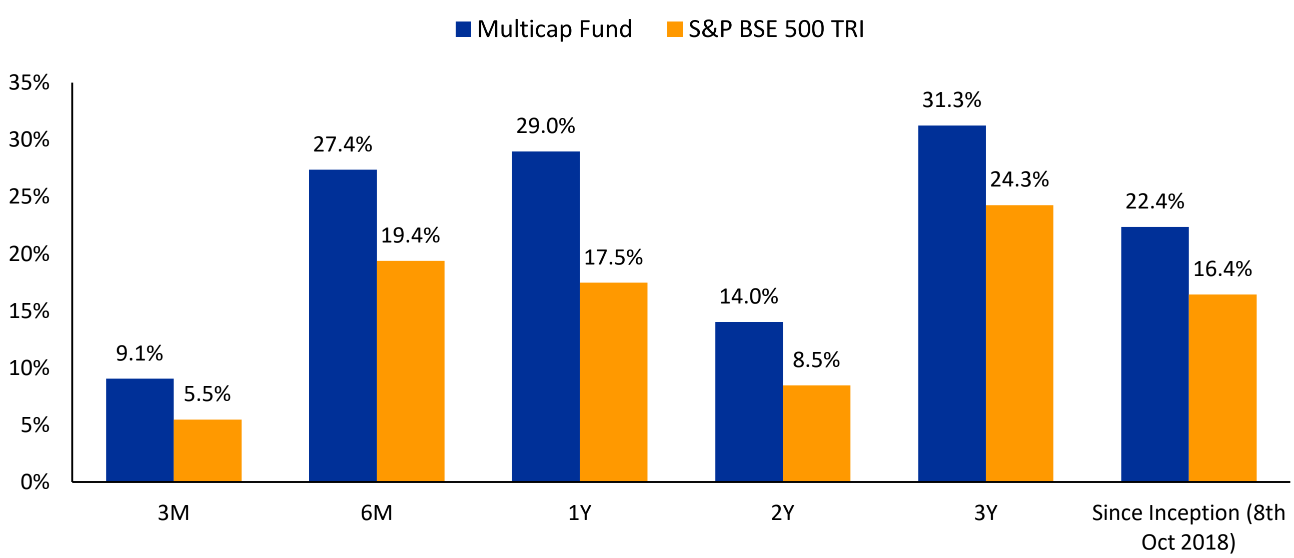
Rising Stars Opportunity Fund Portfolio Performance (as on September 30, 2023)



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



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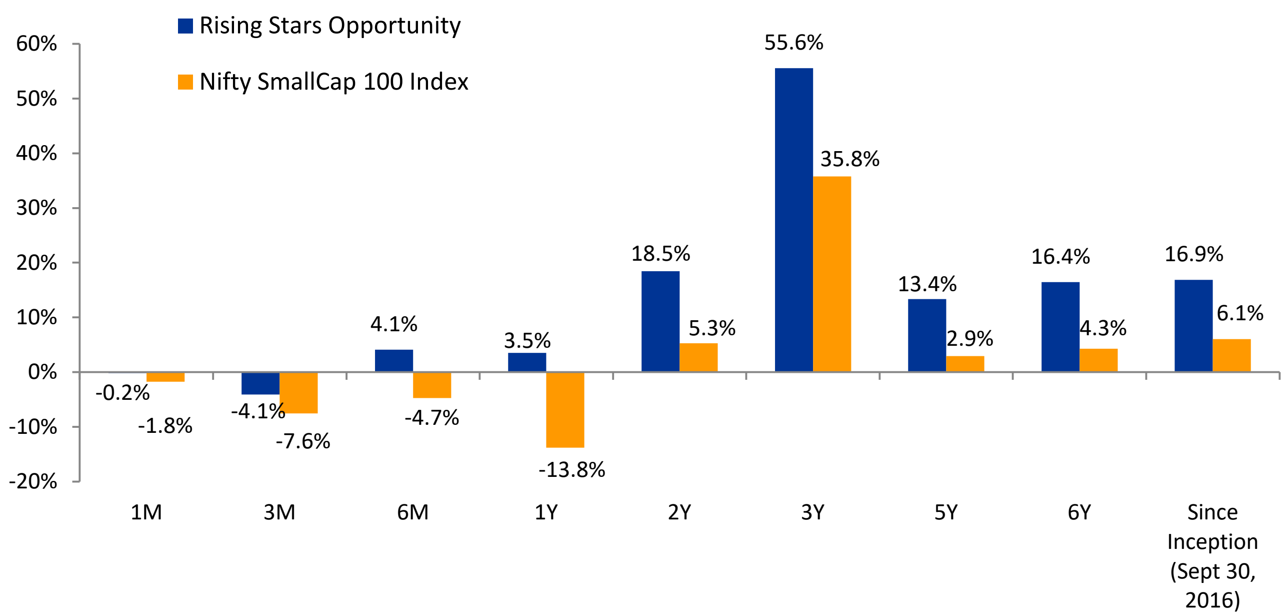
Rising Stars Opportunity Fund Portfolio Performance (as on March 31, 2023)



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