Valentis Advisors

Time for consolidation

January 24, 2024

CY23 turned out to be a year of stellar returns with Nifty delivering a return of 20.0%. More significant was the performance of the broader markets with Nifty Mid cap delivering a 46.6% return and Nifty Small-cap delivering an even more stunning 55.6% return. India also outperformed global markets during the year. So where do we go from here?

1. **There seem to be a couple of easier calls to our mind. First is that returns will be more muted this year relative to last year with high starting valuations clearly being a constraint. We think we could end the year with a high single digit return for the large caps. Indeed, this would also be remarkable since we have seen a record 8 years of consecutive positive returns in the market already.**
2. **Second is that volatility will be higher. The VIX is at historic lows and we will see a higher degree of volatility.**
3. **Thirdly, large caps will do better than mid and small caps due to (a) sharp outperformance of the small and mid-caps and (b) historically high relative valuations.**
4. **Probably for investors, a staggered approach to investing additional money makes sense. Q1 of any calendar year has traditionally been the weakest quarter and we would look for price corrections to deploy money.**
5. **Politics creates the possibility of a Black Swan event with 40% of the world's population voting in CY24. In India the consensus view is of a continuation of a majority Government but any unexpected outcome could create extreme reactions in the market.**
6. **Inflation which was last year's major concern has receded and we think the Fed is ready to cut rates through the year. Yet, the bond market seems to be pricing close to 150 bps rate cuts which may not be achieved in a soft landing scenario**
7. **At the start of CY23, the consensus was that US was heading into recession. No one now expects a recession in CY24 and that could create a headwind for the market. Indeed in India while we see a structurally strong economy which will be the fastest in the world over next few years, earnings, though still decent, looks set to slow with growth in H2FY24 being 8% vs the 30% in H1FY24.**

#1: Politics will occupy centre-stage

- CY24 is a heavy political calendar with elections in 40 countries spanning over 40% of the world population. The market will be focused mostly on the Indian elections obviously followed by the US elections.
- On the margin, we believe elections and politics probably occupy more attention and mind space of equity market investors than it deserves. Our analysis is that there is no meaningful difference in the stock market performance or GDP growth in regimes headed either by the Congress or the BJP.
- However, the reason for the election focus is that they have the tendency to create huge moves (both positive and negative) on the election result date. Generally, the market prefers continuity of the Government and any adverse outcome from this expectation can create huge negative correction.
- Most opinion polls show a convincing win for the Modi-led NDA Government, especially after the strong showing in the assembly elections. While we also expect a comfortable return of the NDA, there are only 2 caveats we want to point out (a) Election results of assembly and Lok Sabha vary significantly (b) The Vajpayee Government had a similar strong showing in the assembly elections but faltered in the Lok Sabha elections.
- Based on election analysis (see Table 2), we have highlighted a few important points for markets:
    1. The run up to elections has generally been good for equity markets. Buying 6 months before elections and selling on the day before counting of results has mostly given a positive return.
    2. The day of counting leads to very volatile markets depending on the Government market perceives as reform friendly. So, the Vajpayee Government loss in 2004 (and UPA-1 came to power) led to a major negative day but when the same UPA got re-elected in 2009, markets rejoiced.
    3. Yet, the first day reaction of the market to any Government does not reflect how the equity markets will react to the Government a year later.
    4. Generally markets are positive 6 months and 12 months post elections as the market focus shifts to more fundamental issues.

#2: Inflation has peaked – Fed will cut rates; RBI will follow in H2CY24

- The Fed has signaled that inflation has peaked and they are ready to cut rates. However, the bond market has started pricing in close to 150 bps rate cuts this year which does not square up with a soft landing scenario. Equity markets may be disappointed if the soft landing scenario comes into question or the rate cuts are slower than currently expected.

- Can inflation rise sharply? We think it is unlikely except with the war in the Middle East intensifies raising (a) oil prices (b) freight rates as insurance costs rise and ships take a longer route than the Suez Canal.
- India will similarly benefit from falling inflation and we see RBI cutting rates by 50 bps in the second half of the year.
- Finally, a last question here is whether rate cuts are good for the markets? Markets do well after a pause in the Fed rates which we have already seen. But post the first cut by Fed, the market returns have been mixed.

#3: How will USA economy do? Are earnings slowing in India?

- Consensus expected a recession in the USA in CY23 but the growth remained strong. Most of the economists no longer expect a recession in CY24. We see growth slowing given the way M2 has fallen.
- While a weakness in the global economies will hurt the Indian economy too, we think India will still see GDP growth of around 7%, probably the fastest in the world and the structural story is unlikely to be impacted.
- However, earnings are likely to go on a slower track. After growing at 30% in H1FY24, we see earnings growing at only ~8-10% in the second half as base impact of the banks catch up.
- Overall, however, we still see earnings doubling in 5 years.

#4: Is too much good news in the price short term?

- While we continue to remain excited by the long-term India story, we think a correction in the markets would be healthy to create a margin of safety.
- Absolute valuations at 20x 1-year forward are expensive and historically returns have been low by investing at these levels.
- In a relative context too, India trades at near 100% premium to EM valuations, way above historic averages. A correction in relative valuations would provide room for increased FII flows into India.
- Retail investors have provided strong support to markets. However, investors since Covid have profited by buying every dip. Any prolonged time and price correction will test the durability of these flows.

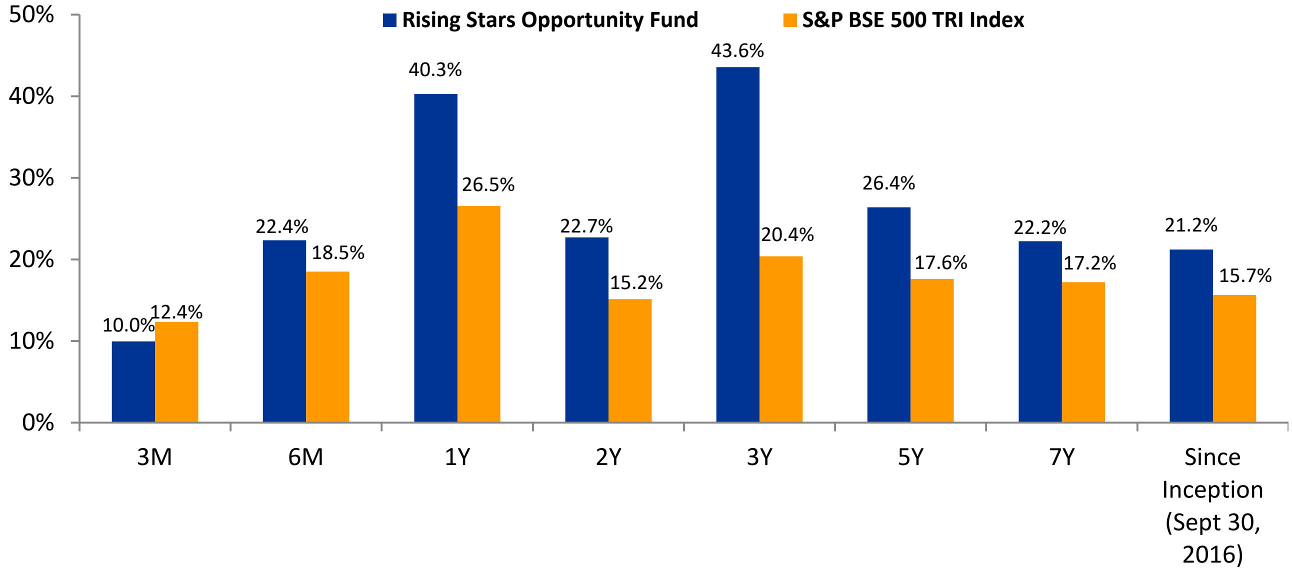
#5: Large caps provides better margin of safety – to outperform in H2

- The 3 "O"s are near term headwinds for performance of mid and small-caps. First they have outperformed – The mid-cap and small cap index have given a return of 46.6% and 55.6% respectively vs the large cap index of 20.0%.
- Secondly, they are overvalued relative to large-caps. Small-caps trade flat on valuations relative to large caps compared to a historic average of a 19.3% discount.
- Lastly, they are over-owned. Flows to small-caps have far outstripped the large caps.
- While we are cautious on small-caps near term, we think they remain attractive from a longer term and a better way to play the Indian economic growth story. We see the small-caps delivering earnings growth nearly 10% higher than large caps over next 2 years. This will drive superior returns.

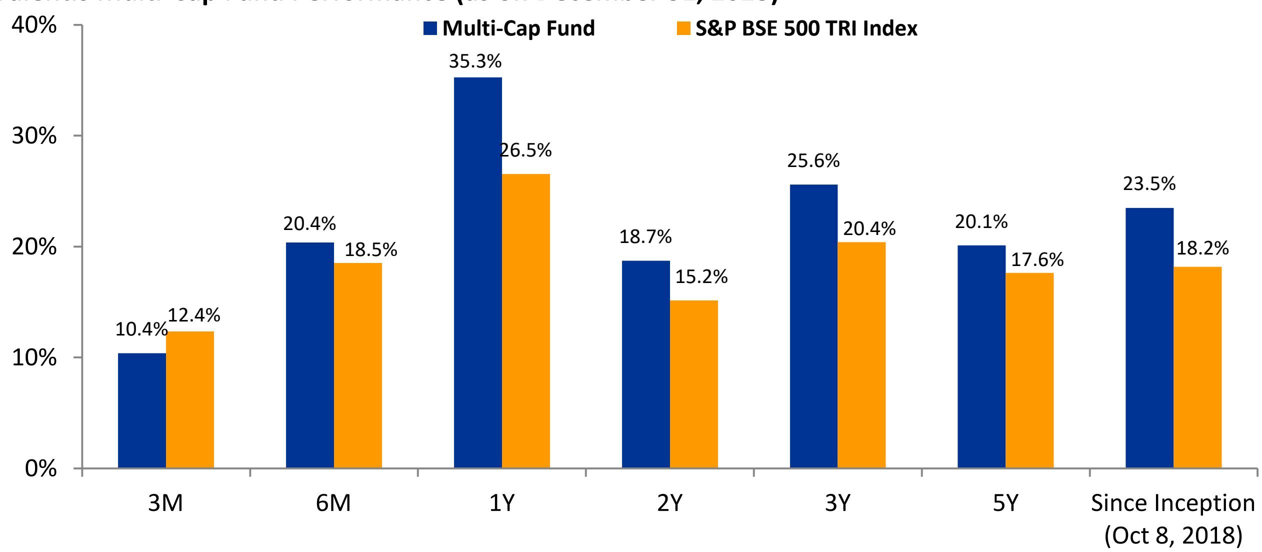
#6: Portfolio Performance and outlook

1. CY23 turned out to be a great year for markets contrary to the caution at the start of the year. Both our portfolios outperformed the benchmark helped by the rally in the small and mid-cap names. However, our large cash due to strong inflows which we invest in a staggered manner meant that our returns were not as high as some of our peers during the year.
2. Our basic theme of "Buy local, avoid global" and "buy investment over consumer theme" continued to work well for us through the year. Going into 2024 we continue to play the same themes though we are cognizant that there has been a sharp under-performance of the global names.
3. Pharma was the sector we turned bullish on early 2023. We continue to favor this sector outside of the domestic names and continue to hold some of our winners from last year.
4. During the last quarter, we added a financial name that looks cheap and could benefit from the cleaning up of its balance sheet and infusion of a new CEO.
5. During the year, our focus will be on ensuring that we focus on downside risk in the companies to guard against a sharp de-rating on any change in earnings trajectory. We also hope to buy under-performers in sectors like chemicals and software on any change in the business cycle during the course of the year.

Valentis Rising Stars Opportunity Fund Performance (as on December 31, 2023)



Valentis Multi-Cap Fund Performance (as on December 31, 2023)



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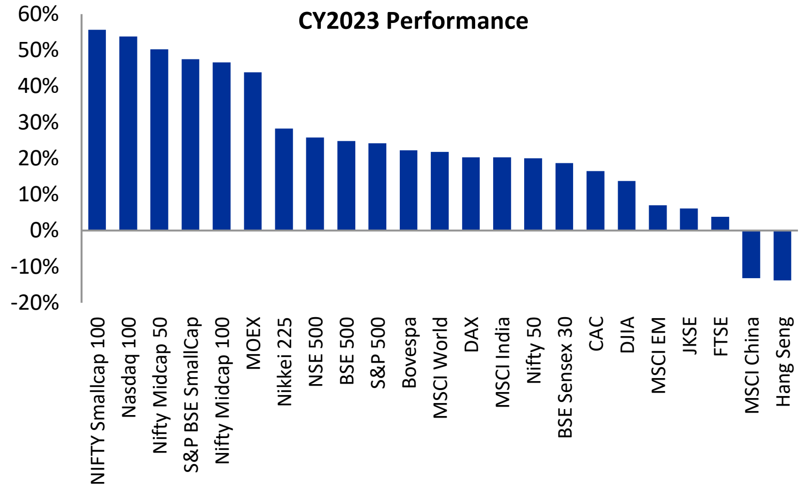
Market Highlights

Majority of the Indian indices, especially SmallCap and MidCap outperformed major Global Indices

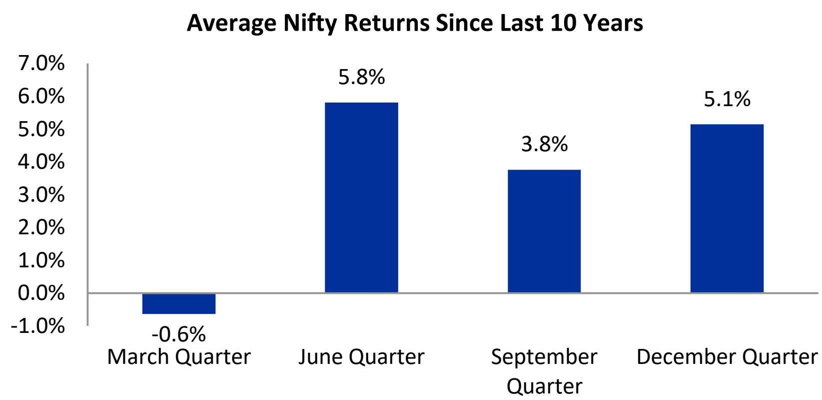
Chart 1: Indian markets dominated global markets last year



Source: Investing.com, Valentis Research

Q1 of any calendar year has traditionally been the weakest quarter

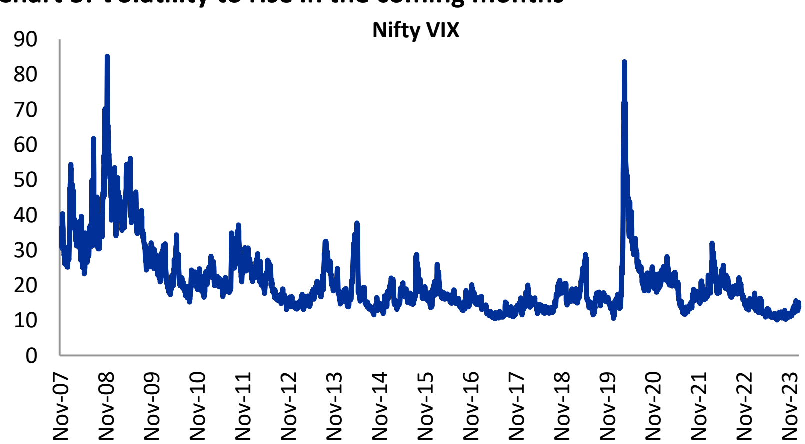
Chart 2: Entering Seasonally Weak Quarter



Source: Ace Equity, Valentis Research

The VIX is at historic lows and we can see a higher degree of volatility.

Chart 3: Volatility to rise in the coming months



Source: MOSL, Valentis Research

#1: Politics will occupy centre-stage

Voter preferences between State elections and Lok Sabha elections are different. BJP has done well in the Lok Sabha elections in the last assembly win states like MP, Rajasthan and Chhattisgarh irrespective of whether they did well or badly in the assembly elections 6 months ago.

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

Table 2: Stock Market returns (%) – Pre & Post elections: Why worry about Elections?

Result Date	Prime Minister	Ruling Party / Alliance	Pre - elections Return (%)		Post Elections Return (%)			
			6M	**3M**	**3D**	**3M**	**6M**	**1 Yr**
01-12-1989	V.P. Singh / Chandra Shekhar	National Front	*0*	*-6*	*0*	*0*	*16*	*75*
20-06-1991	P. V. Narasimha Rao	Congress	*25*	*14*	*-2*	*37*	*40*	*131*
10-05-1996	Dev Gowda / I.K. Gujral	United Front	*11*	*17*	*2*	*-5*	*-17*	*0*
27-02-1998	Atal Bihari Vajpayee	BJP & Allies	*-9*	*0*	*4*	*2*	*-20*	*-6*
06-10-1999	Atal Bihari Vajpayee	BJP & Allies	*32*	*8*	*7*	*15*	*4*	*-12*
13-05-2004	Manmohan Singh	Congress & Allies	*8*	*-9*	*-17*	*-5*	*10*	*19*
15-05-2009	Manmohan Singh	Congress & Allies	*30*	*29*	*17*	*27*	*38*	*38*
16-05-2014	Narendra Modi	BJP	*17*	*18*	*2*	*9*	*17*	*16*
23-05-2019	Narendra Modi	BJP	*11*	*8.2*	*1.6*	*-5.4*	*4*	*-21**
Average Return			*14*	*9*	*2*	*8*	*10*	*27*

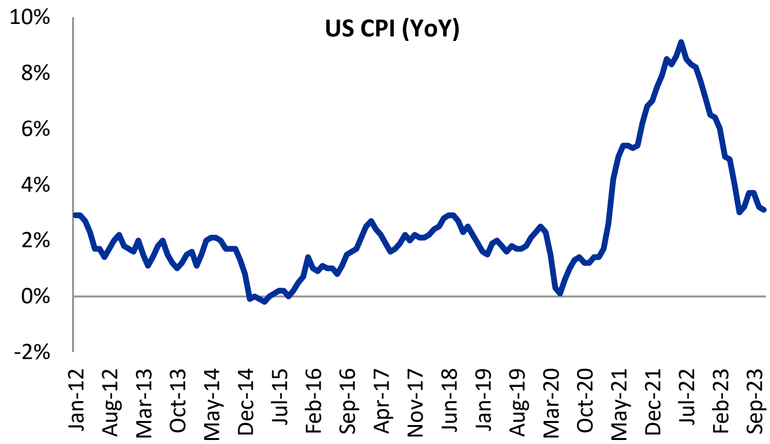
Source: Election commission of India Ace Equity, Valentis Research
*includes Covid impact

Only 1 Negative in run-up to elections

First reaction to market is not necessarily correct

#2: Inflation has peaked – Fed will cut rates; RBI will follow in H2CY24

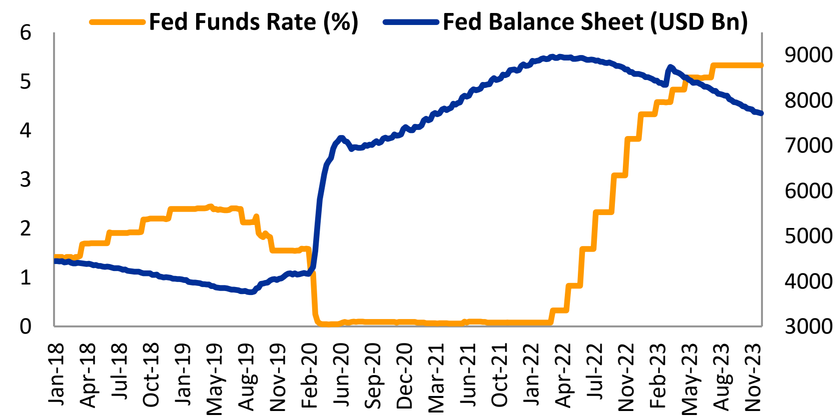
Chart 4: US Inflation trending down



Source: Investing.com, Valentis Research

After rising to 40-year highs, the US CPI is starting to trend down due to falling commodity as well as agricultural prices.

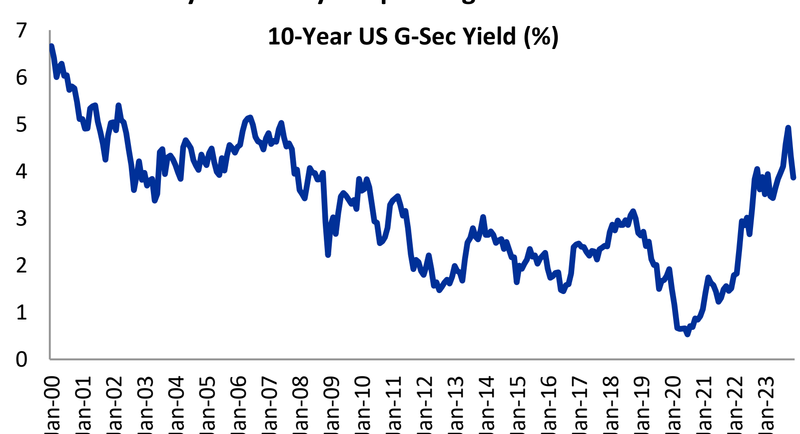
Chart 5: US Fed Rate & Balance Sheet Reduction



Source: Federal reserve, Valentis Research

After the fastest rate increase in history, Fed is set to cut rates this year. Meanwhile they are gradually reducing their balance sheet with a target of US$95 bn per month

Chart 6: US 10 year bond yield peaking?

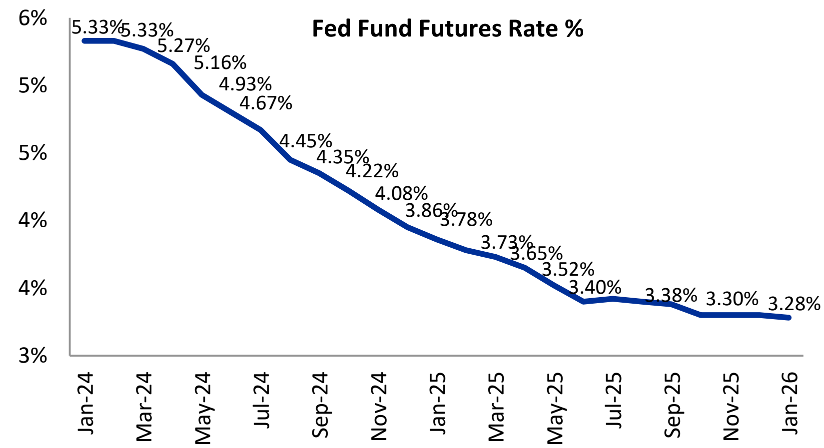


Source: Investing.com, Valentis Research

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 and bond yields have already corrected from the peak.

The market may be too optimistic on pace of Fed cuts. Market is building in close to 150 bps reduction in rates this year vs Fed indication of 75 bps

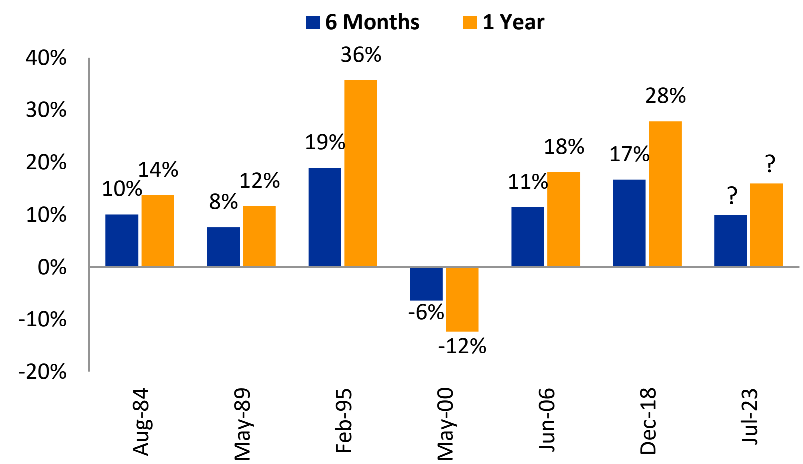
Chart 7: Market expectations for Fed Funds Rate (Fed Fund Futures, Jan 2024-Jan 2026



Source: Bloomberg, Valentis Research

Post Fed pause, US markets gave an average 10% return after 6 months and 16% return after 1-year with only 1 out of 6 returns being negative

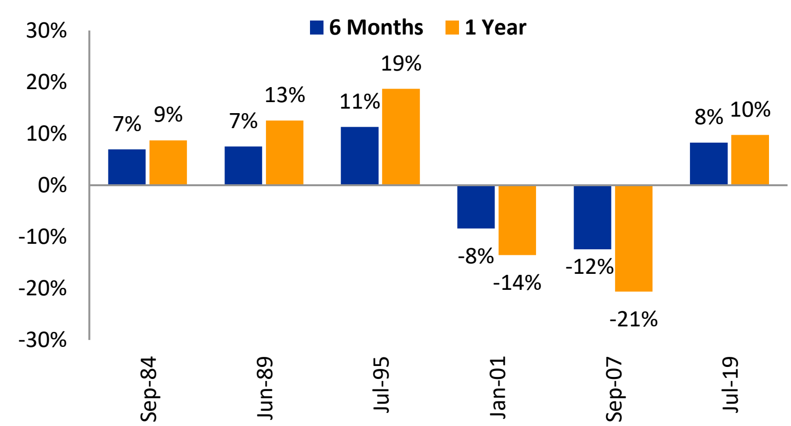
Chart 8: S&P 500 return post pause in fed hikes



Source: Investing.com, Valentis Research

Post first cut in Fed rate, US markets gave an average 2% return after 6 months and 3% return after 1-year

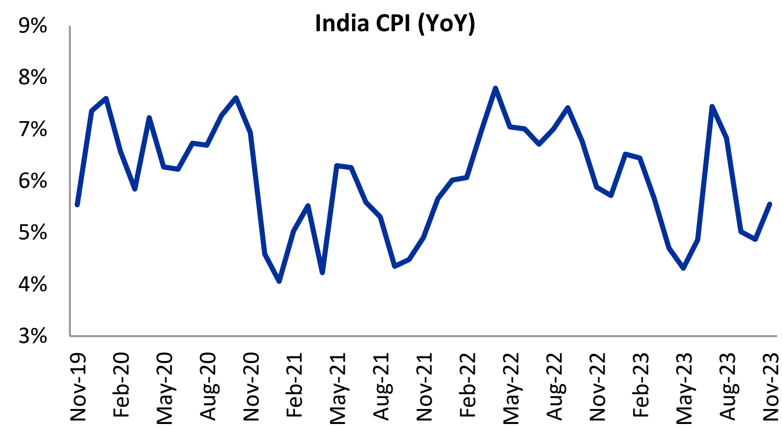
Chart 9: S&P 500 return post first cut in fed rate



Source: Investing.com, Valentis Research

Chart 10: India Inflation trend

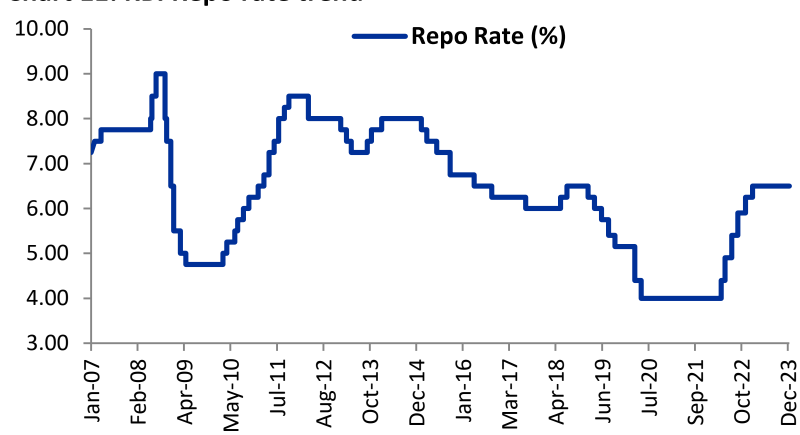
Indian inflation is also trending down but CPI which was relatively stable is also seeing a slow decline



Source: MOSPI, Valentis Research

Chart 11: RBI Repo rate trend

RBI will also cut rates probably in H2



Source: RBI, Valentis Research

Chart 12: India 10 year bond yield

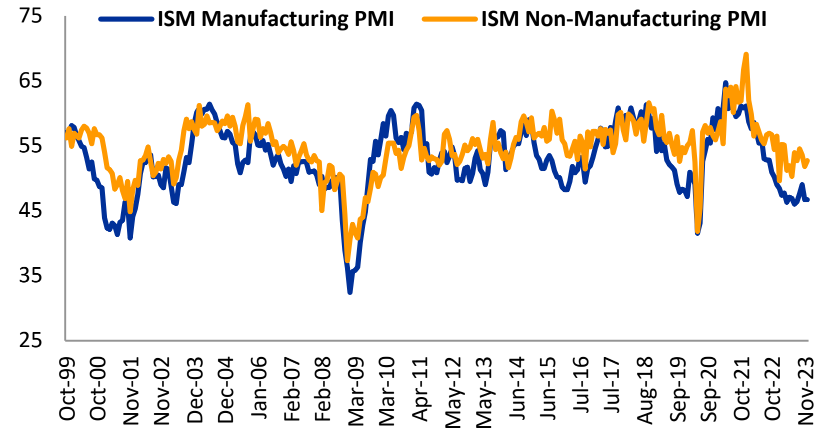
Indian bond yields too have peaked and starting to come down

Source: Investing.com, Valentis Research

#3: How will USA economy do? Are earnings slowing in India?

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

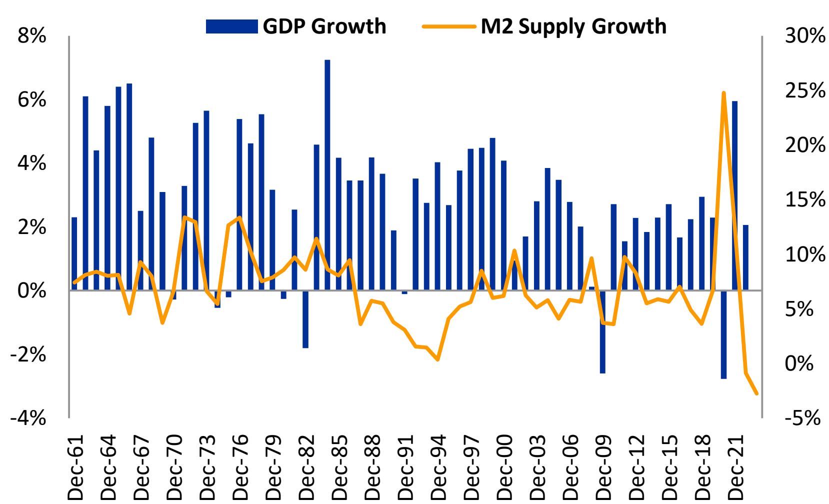
Chart 13: US ISM Purchasing Managers Index (PMI) data



Source: Investing.com, Valentis Research

Falling M2 may cause a slow-down in the US economy. The Fed may need to pause the Quantitative tightening if the economy slows.

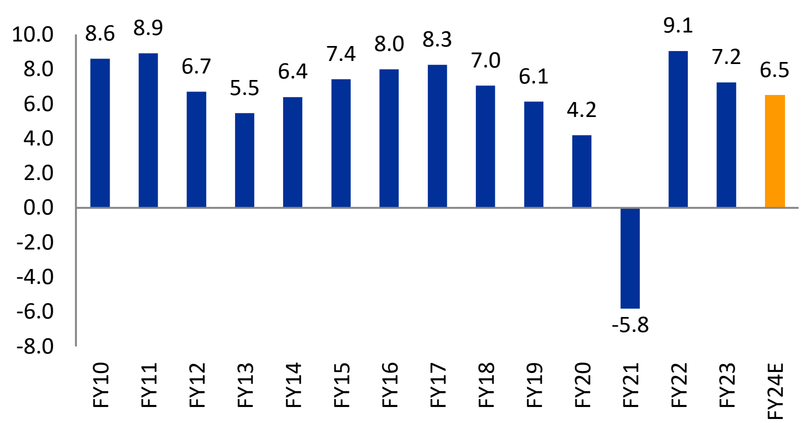
Chart 14: M2 Supply vs US GDP



Source: Federal reserve, Valentis Research

India will probably be the fastest growing economy in the world

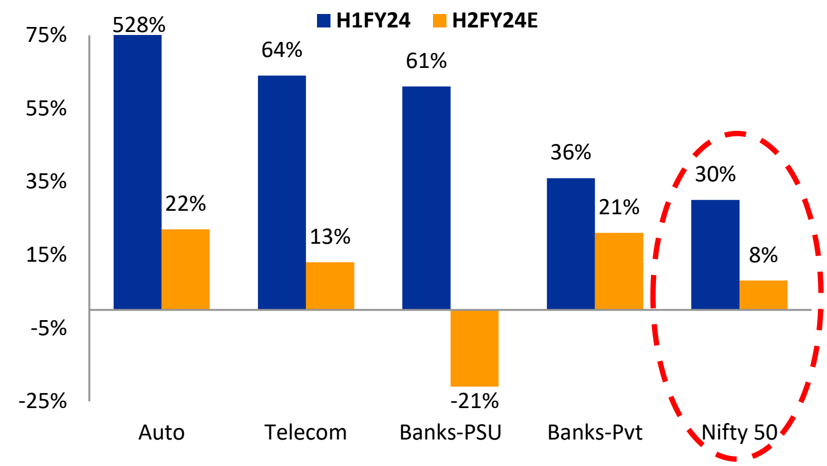
Chart 15: India's GDP growth



Source: MOSPI, IMF, Valentis Research

After growing at 30% in H1FY24, we see earnings growing at only ~8-10% in the second half as base impact of the banks catch up.

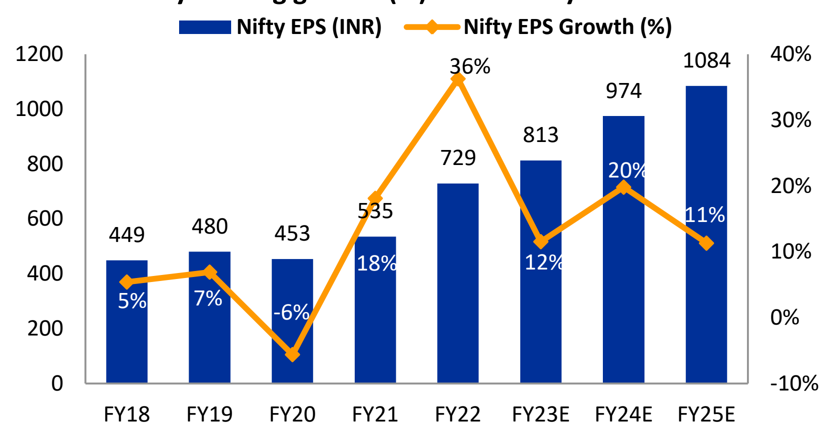
Chart 16: Autos, Banks & Telecom among other sectors lead slower growth in H2



Source: MOSPI, Valentis Research

Earnings has risen mainly due to banks. Going into FY25, we see earnings starting to slow

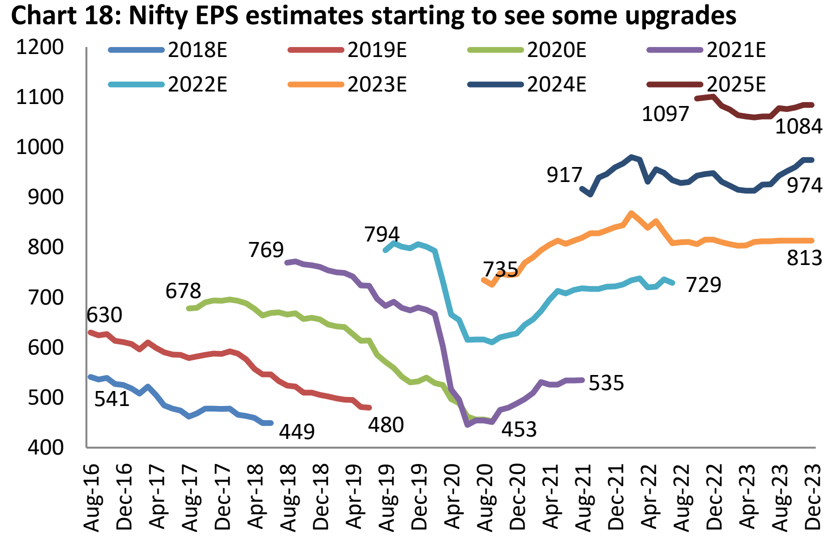
Chart 17: Nifty Earning growth (%) – Banks key driver



Source: Kotak Institutional Equities estimates, ValentisResearch

Earnings upgrades starting to flatten out

Chart 18: Nifty EPS estimates starting to see some upgrades

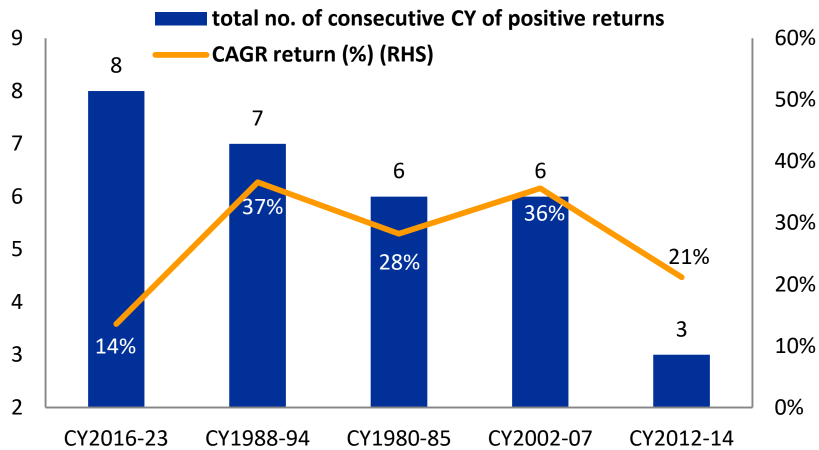


Source: Kotak Institutional Equities estimates, ValentisResearch

#4: Is too much good news in the price short term?

Chart 19: Total no. of consecutive CY of positive return on SENSEX

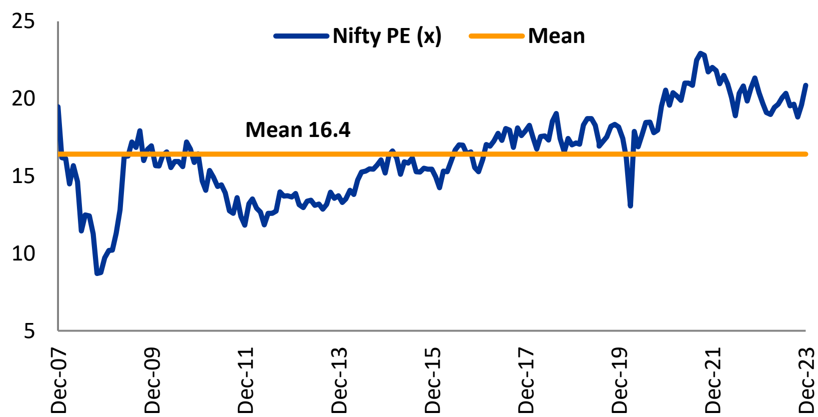
Both the Nifty and the Sensex have delivered 8 consecutive years of positive return, a new record. However, the rally has been weak in terms of CAGR returns (13.6% vs 28-37% earlier).



Source: BSE, Valentis Research

Chart 20: Nifty 12M Forward P/E (x) – most expensive

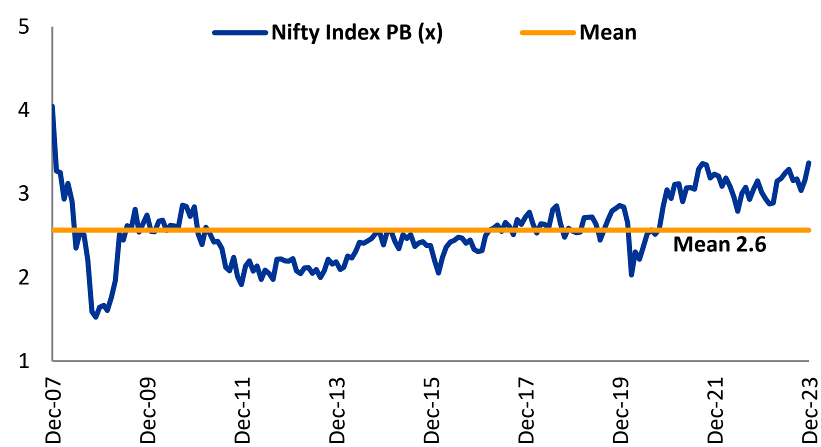
Valuations, especially earnings based like PE ratio becoming expensive in a historic context.



Source: Edel, Valentis Research

Chart 21: Nifty 12M Forward P/BV (x) – in expensive territory

The P/B is also in expensive territory



Source: Edel, Valentis Research

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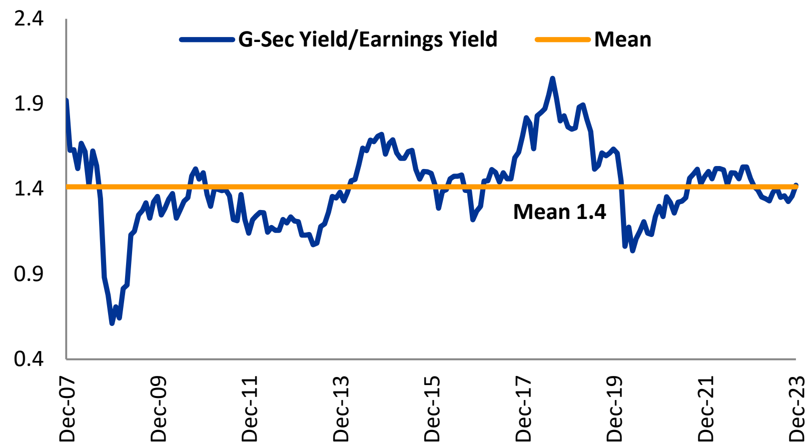
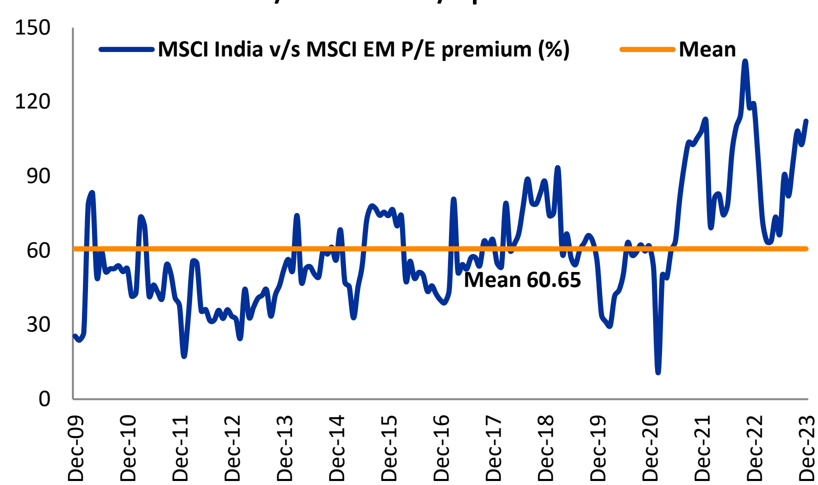
The bond yield vs Sensex yield is looking relative better.

Chart 22: Bond yield Vs SENSEX yield – at average valuations



Source: MOSL, Valentis Research

Chart 23: MSCI India v/s MSCI EM P/E premium



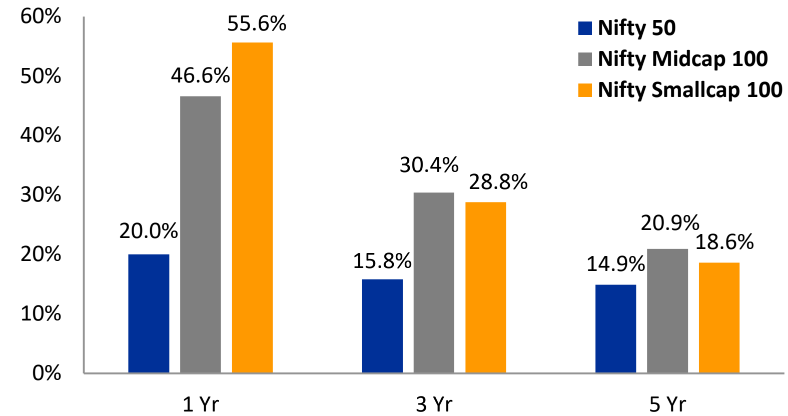
Source: Phillip Capital, Valentis Research

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 60.65%.

#5: Large caps provide better margin of safety – to outperform in H2

Following the stunning rally in CY23, small and mid-caps have out-performed large-caps over a 3 and 5-year period also

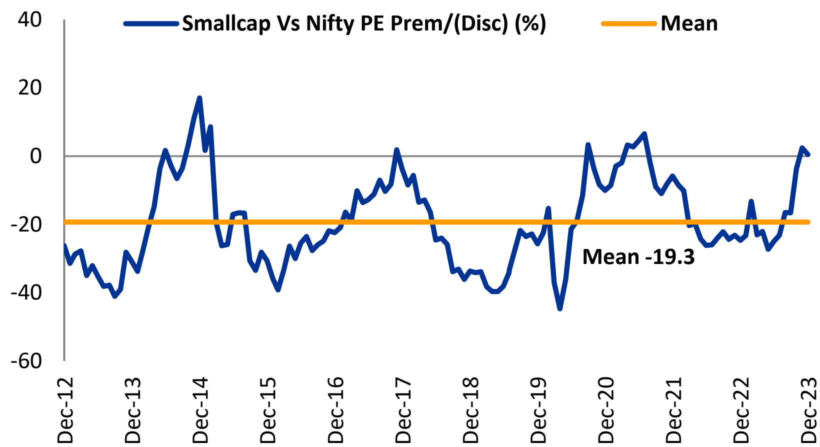
Chart 24: Nifty 50, Midcap 100 & SmallCap 100 Indices return



Source: ACE Equity, Valentis Research

Small caps trades at PE parity to large caps compared to an average historic near 19% discount.

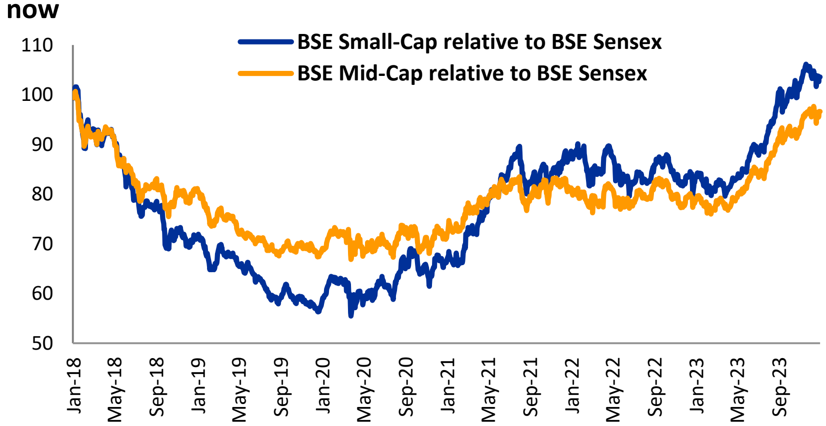
Chart 25: Smallcap Vs Nifty PE Prem/(Disc)



Source: MOSL, Valentis Research

Relative performance of Midcap and Largecap is at a 6 year high

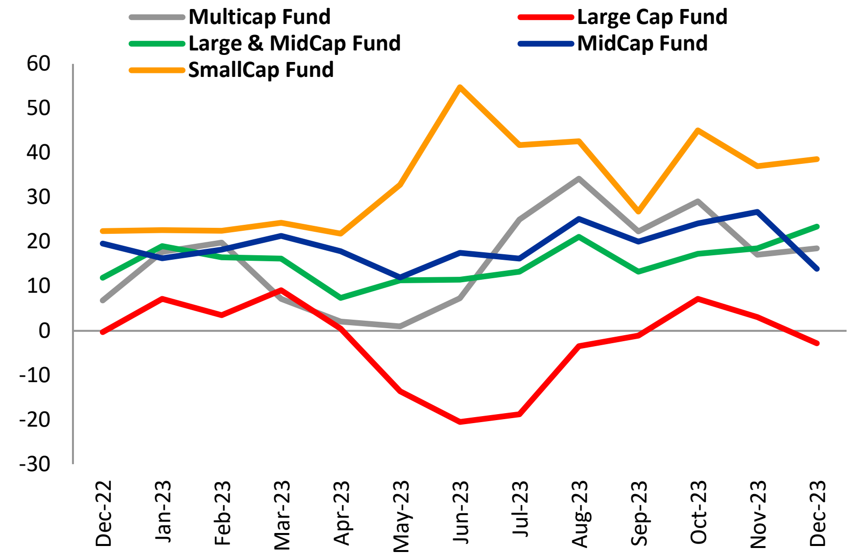
Chart 26: Relative broad market performance may have peaked for now



Source: Ace Equity, Valentis Research

Retail India has invested heavily in small caps in CY23. Small and mid-caps are vulnerable to retail selling

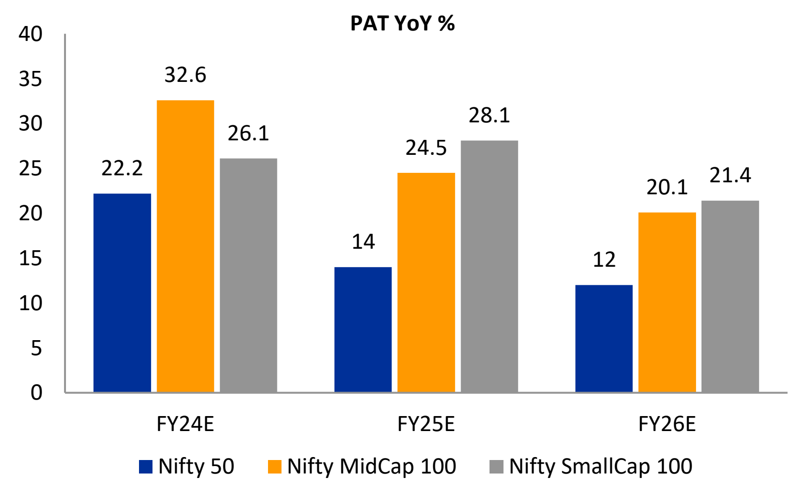
Chart 27: Net inflows in MFs (in Rs bn)



Source: AMFI, Valentis Research

Analysts expect MidCap and SmallCap earnings to grow faster than large caps

Chart 28: Small and mid-caps can grow at 10% higher CAGR than large caps over next 2 years



Source: Bloomberg, Antique, Valentis Research

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