Valentis Advisors

India: safe haven amid tariffs uncertainty?

April 17, 2025

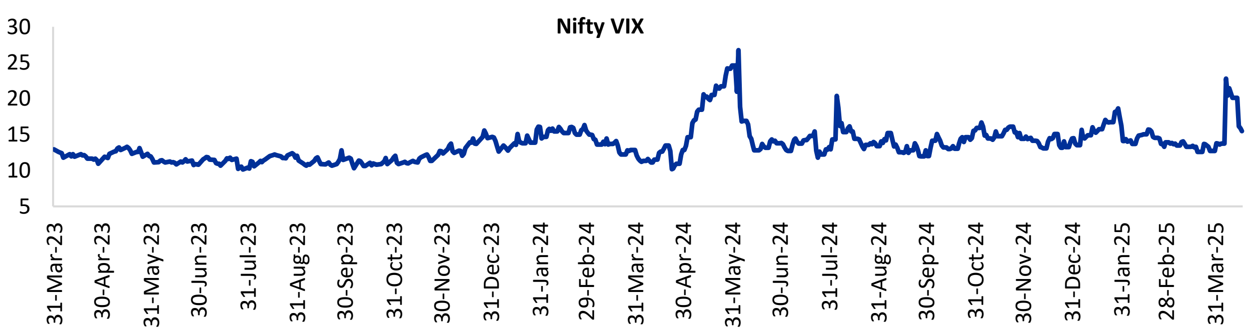
We continue to expect CY2025 to be a year of lower returns than past few years accompanied by higher volatility. The tariff imbroglio is like to keep markets volatile though near term the market is celebrating the 90-day pause by the Trump Government.

- **Apart from the tariff uncertainty, there are some positives for India:**
  1. **Easy monetary policy: RBI has infused over $5 bn of liquidity and cut rates by 50 bps. We expect further 50 bps rate cuts over the next 6 months.**
  2. **Falling oil prices will help current account deficit and inflation as well as the budget deficit to the extent Government absorbs the oil price fall through excise duty increase.**
  3. **FII flows should be better after a $25 bn outflow since September as valuations ease.**
  4. **Indian earnings continue to disappoint but we expect double digit earnings growth for next 2 years.**
- **While small caps are still not cheap relative to large caps, a recovery in earnings will be positive for growth in small caps. History favors buying the correction in small caps.**
  1. **If we look at the small cap index since inception, there has been a median drawdown of 23%. The median return a year later was 39%.**
  2. **Similarly, the average drawdown (excluding Covid and GFC) was 22% and the average return a year later was 44%.**

Trump tariffs will continue to make markets volatile

In our year ahead report in January 2025 we had mentioned that volatility will be a theme for the markets in 2025. With uncertainty currently on the status on tariffs in the US, where we have seen a pause for 90 days, so far no deals have actually been finalized with any country, we think volatility in markets will continue. We continue to expect CY25 to be a year of consolidation for the market with higher volatility. We will use dips to build the portfolio.

Chart 1: Volatility rising



Source: Investing.com, Valentis Research

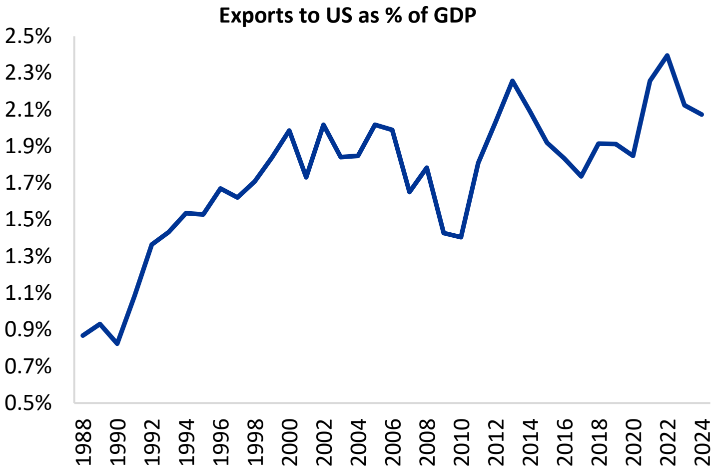
Where do tariffs go after the pause?

- The market has celebrated the 90-day pause on the reciprocal tariffs with a 7-8% rally. However, what happens to tariffs post the pause remains uncertain. There are many countries trying to work out bilateral deals but so far nothing has got signed.
- There has been softening of stand with electronics being exempt from tariffs. This means over one-fourth of Chinese exports are not subject to reciprocal tariffs. However, the Government has said they would come with specific duties specifically for electronics, semi-conductors, etc.
- Where do we go from here? Even if tariffs continue at 10%, this is still an increase over the pre-April 2nd date. So, inflation in the USA is likely to creep up.
- Second question is will manufacturing return to the US? We think it is highly unlikely since (a) it takes 2-4 years to put up a manufacturing plant. Any plant whose viability depends on high tariffs is very vulnerable to a change in Government policies (b) the ecosystem for manufacturing including availability of manpower is also a challenge.
- So, what will tariffs achieve? The historical precedent of the Smoot Hawley Act, 1930 led to a negative impact with global growth slowing. We think while the return of manufacturing to the USA is unlikely it may help in terms of (a) better profitability and capacity utilization for existing manufacturing assets in USA (b) lower tariffs for USA goods in most other countries as US negotiates trade deals.
- However, near-term uncertainty can lead to a slow-down in the USA. There will be supply chain disruption as well as an increase in the cost of most goods. Fed seemed to indicate that they are worried about a stagflation scenario. We would watch the bond markets for further signs of stress.

For India, tariffs have been a mixed bag.

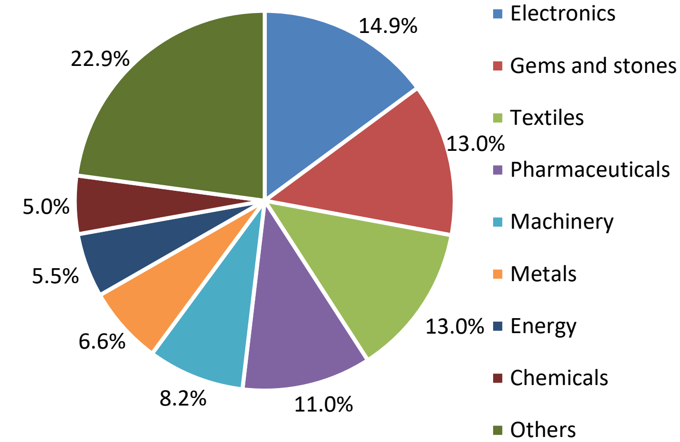
1. Firstly, India’s exports to the US (excluding services which do not have tariffs) are only 2.1% of GDP.
2. Secondly, the reciprocal tariffs for India as announced initially were lower for India than competing countries like Bangladesh, Vietnam, and Pakistan etc.
3. Thirdly, China is still facing massive tariffs relative to India. We see a long term move away from China to other countries and India will be a big beneficiary.
4. On the negative side, we see gems and jewelry and autos being vulnerable to tariffs while pharma may be relative less affected by tariffs given India’s high share in the US generics market. So far, electronics and pharma that account for nearly 25% of our exports are not impacted by tariffs.

Chart 2: US exports as % of GDP is low for India



Source: IMF, World Bank, Niryat, Valentis Research

Chart 3: Composition of India exports to US



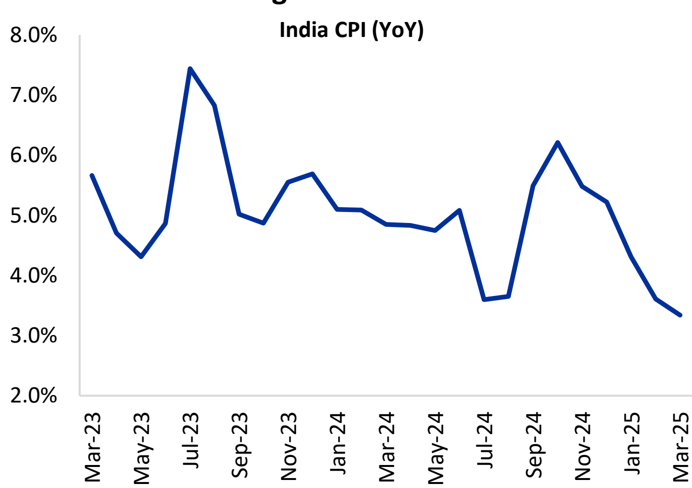
Source: Kotak IE, Valentis Research

#1: Falling oil prices provide space for easy monetary policy

Inflation in India is coming down. Moreover, falling oil prices will help the current account deficit as well as inflation. A lower oil price is positive for India's current account deficit with every $10/bbl reduction leading to a fall of ~0.5% in current account deficit. It also leads to a reduction in inflation of around ~0.4% assuming the Government allows oil marketing companies to pass on the reduction to the consumer.

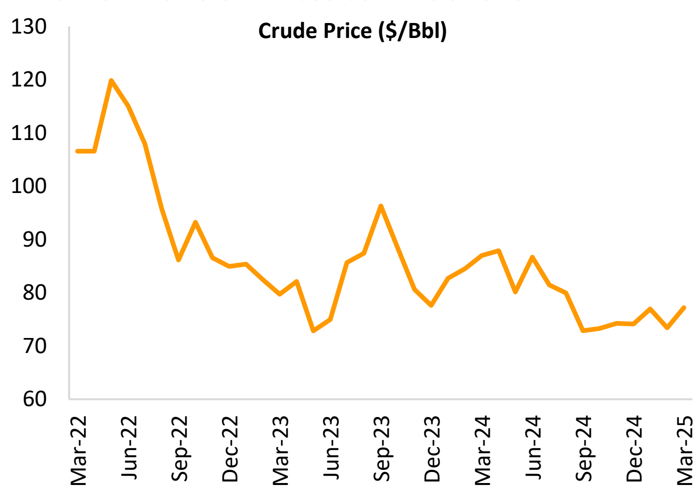
Another month of correction in vegetable prices resulted in a sharp fall in headline inflation to 3.3% in March, lowest in the 5 years. FY25 average CPI was restrained at 4.6% vs. 5.4% in the previous year. A positive base effect for food prices and a healthy (expected) monsoon put downside comfort on FY26E headline CPI of 3.8-3.9%.

Chart 4: CPI is coming down



Source: Investing.com, Valentis Research

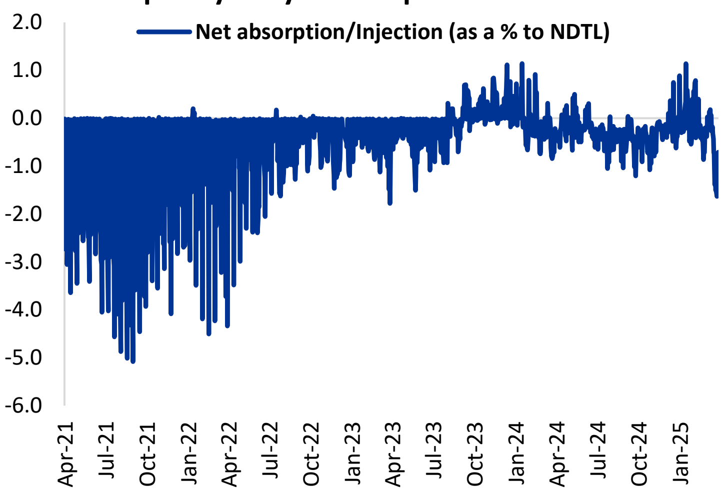
Chart 5: Crude oil Prices continue to fall



Source: Investing.com, Valentis Research

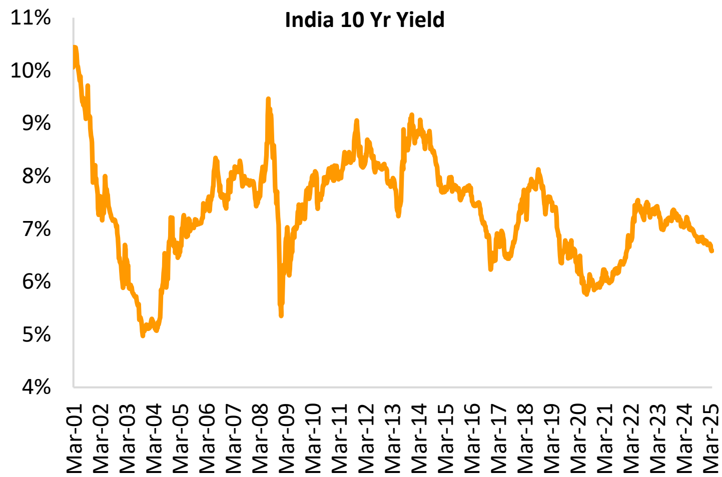
RBI has been very active in pumping more liquidity in the system with recent measures adding Rs 5trn to liquidity. Also, rates are coming down with 10-year bond yields now at 6.6%. We have already seen a 50-bps rate cut by the RBI and expect another 50 bps over the next 6 months.

Chart 6: Liquidity in System improves



Source: RBI, Valentis Research

Chart 7: India 10-year bond yields at 40-month low



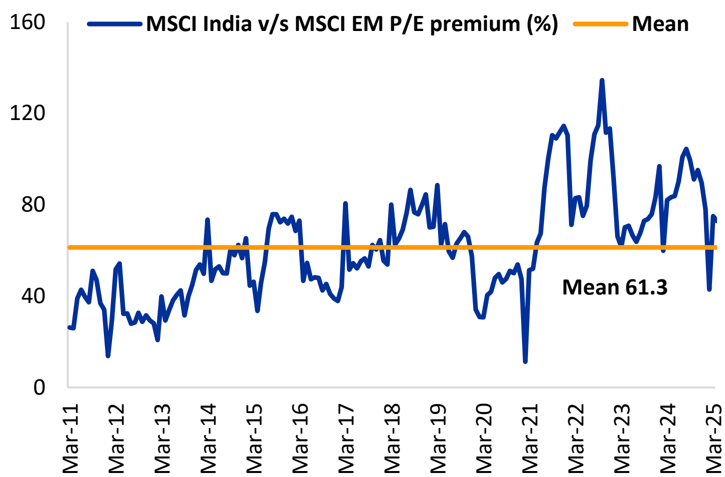
Source: Investing.com, Valentis Research

#2: FII outflows will slow

While domestic buying in the market is likely to slow, it will be partly compensated for by a slowing supply of paper. But the significant change we believe will be the move away from China by FPIs into India. FIIs have sold US$25 bn of Indian equity since September 2024. We think FII selling will slow since:

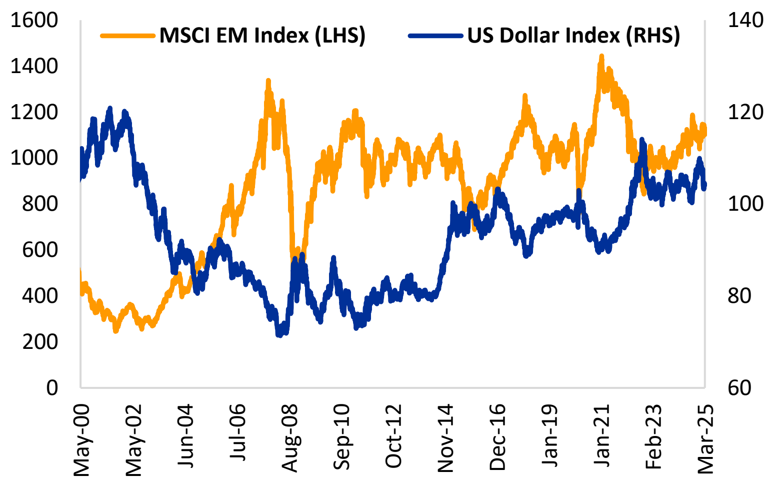
1. Weakening USD is good for flows to emerging markets
2. India's valuations are looking better in the emerging market space following the rally in China. We now trade at a premium of 75% to the EM Index closer to long term averages of 61%.
3. FIIs are now under-weight India. With tariff uncertainty hitting China the most, we see India coming back in the investor preference list.

Chart 8: MSCI India v/s MSCI EM P/E premium (%)



Source: B&K, Valentis Research

Chart 9: Weakening US$ helps flows to EM

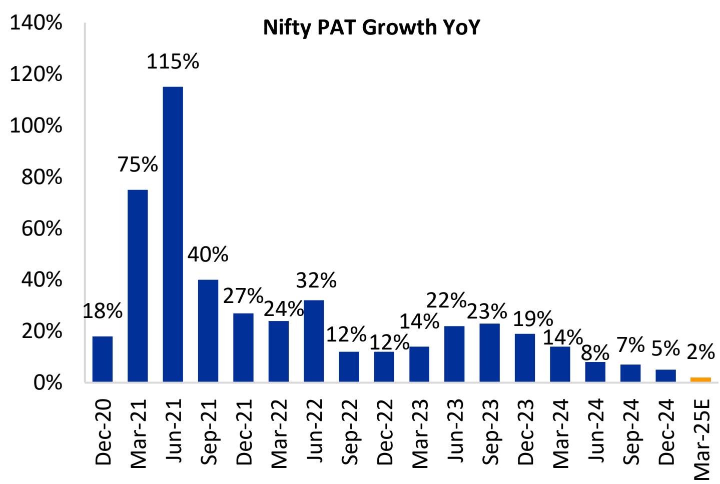


Source: Investing.com, Valentis Research

#3: Have earnings bottomed?

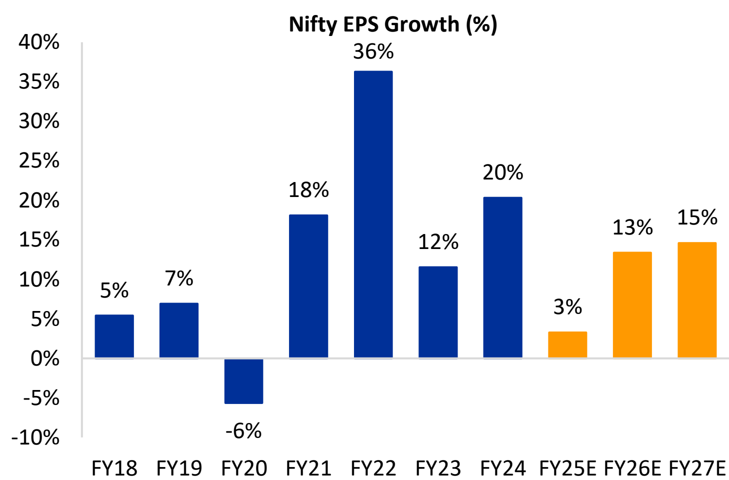
FY25 will see earnings growth at 3%, the weakest in the post-Covid period. Expectations that Q4FY25 could show some recovery will not be met. However, expectations are that the next 2 years could see double-digit earnings growth, which will be good for markets

Chart 10: PAT growth was low in single digit as expected



Source: MOSL, Valentis Research

Chart 11: Annual EPS Growth



Source: Kotak IE, Valentis Research

There are both negatives and positives that can influence earnings growth

- Firstly, a slowing global economy can drag GDP as well as earnings growth in India.
- Secondly, private sector capex has been elusive, and the uncertain economic cycle could further delay and meaningful capex.

- On the positive side, rural consumption can improve with monsoons likely to be normal again. Urban consumption can get a boost from the income tax cuts of around Rs 1 lakh crores.
- The other positive is that monetary policy in India is loose, and interest rates are coming down.
- Also, falling oil prices will help Government revenues since they are hiking excise duties. This should provide some space for Government capex.

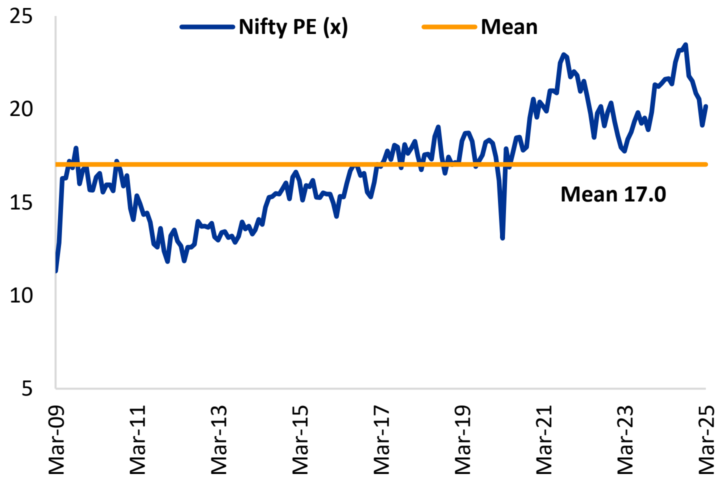
Q4FY25 will be a weak set of earnings

Overall Q4 Nifty earnings are likely to be weak at only 2% growth, a post Covid low. Excluding metals and oil and marketing companies, earnings will be closer to 4%. The Pvt. Banks sector is projected to report the first quarter of earnings decline since Mar'20, while the PSU Banks sector is likely to report moderate earnings growth (4%), the lowest in 19 quarters. The Auto sector is likely to report a muted growth of 1% YoY. Pharma to report 11% YoY, subsiding after posting 7 consecutive quarters of 15%+ earnings growth. The chemical sector is expected to report 13% YoY growth after declining for 7 consecutive quarters.

#4: Better valuations provide support to markets

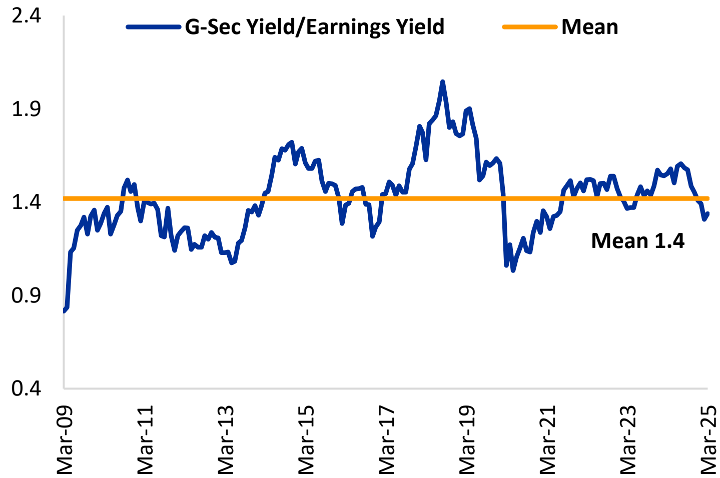
Markets, while not cheap, are in the fair value zone with the Nifty trading at 20.1x 1-year forward earnings. This is lower than the 5-year average of 20.3x but higher than the 10-year average of 18.5x. On an earnings yield to bond yield ratio, markets are starting to look attractive.

Chart 12: Nifty 12M Forward PE (x) – still not cheap



Source: Edel, Valentis Research

Chart 13: Bond yield vs earnings yield looking attractive

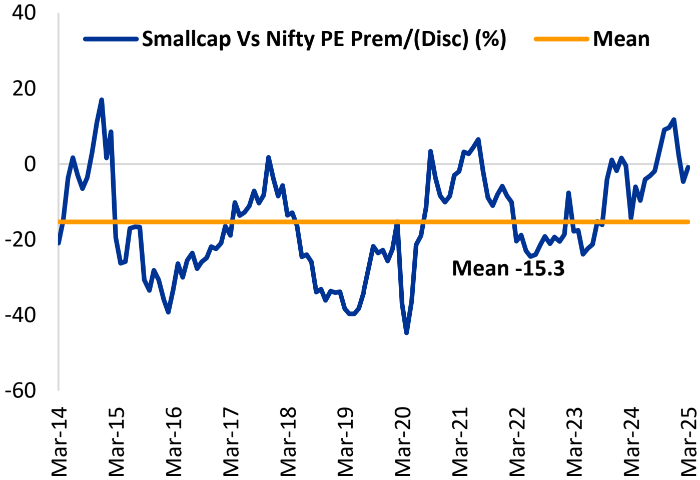


Source: MOSL, Valentis Research

Small Caps look expensive, but history says buy the dip

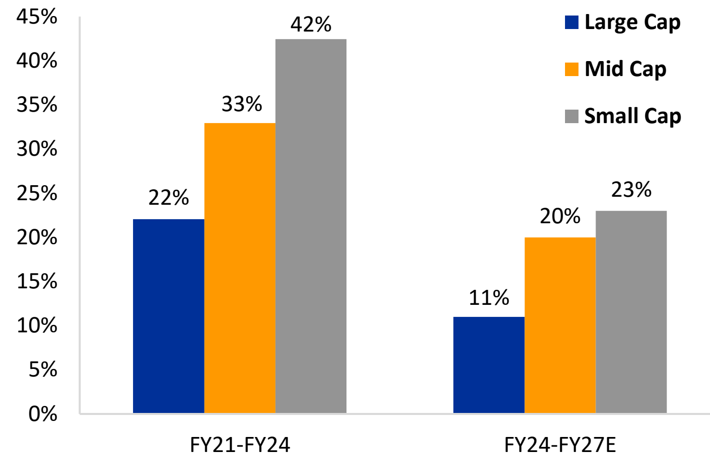
Despite the recent correction, small and mid-cap stocks remain pricier than large-cap indices. However, growth is also expected to be stronger for the small and mid-cap companies.

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



Source: MOSL, Valentis Research

Chart 15: Earnings forecast profile



Source: ISec, Valentis Research

History says buy the dip in small caps

We have tried to look at drawdowns in the small cap indices and what has been subsequent return earned by investors in the Table below

Table 1: Smallcap drawdown

Period	Max DD Nifty SmallCap 100	Returns after DD		
		6M	1Y	2Y
CY04	-29%	58%	117%	106%
CY05	-16%	56%	65%	58%
CY06	-35%	53%	77%	37%
CY07	-15%	37%	40%	-31%
CY08	-76%	95%	131%	70%
CY09	-24%	126%	162%	59%
CY10	-19%	0%	-19%	0%
CY11	-35%	22%	39%	11%
CY12	-11%	16%	-11%	27%
CY13	-35%	26%	101%	53%
CY14	-13%	26%	15%	15%
CY15	-20%	-2%	29%	28%
CY16	-24%	37%	53%	41%
CY17	-9%	25%	11%	-3%
CY18	-40%	14%	-3%	2%

CY19	-23%	18%	9%	37%
CY20	-47%	65%	142%	76%
CY21	-11%	-23%	-4%	18%
CY22	-33%	26%	36%	51%
CY23	-11%	45%	75%	-
CY24	-14%	36%	-	-
Median	***-23%***	***26%***	***39%***	***37%***
Average	***-26%***	***36%***	***53%***	***34%***
Avg (Excl. CY08 & CY20)	***-22%***	***31%***	***44%***	***30%***

Source: AceEquity, Valentis Research

- If we look at the small cap index since inception, there has been a median drawdown of 23%. The median return a year later was 39%.
- Similarly, the average drawdown (excluding Covid and GFC) was 22% and the average return a year later was 44%.
- We got a positive return buying the drawdown in 17 of the 21 years, over 80% chances of not losing money.
- In Table below, we looked at when the index goes back to peak levels. If we look at all instances of more than 25% fall in the small-cap indices, it has gone back to peak levels in 12-15 months excluding the GFC.

Table 2: Smallcap drawdown

Bottom (Closing)	Nifty SmallCap 100 fall from peak (%)	Bearish phase	Recovery phase	5 Yr Return (CAGR)
17-05-2004	-29.30%	4 months	4 months	23%
14-06-2006	-34.70%	1 months	5 months	13%
09-03-2009	-77.50%	1 yr, 2 months	7 yrs, 4 months	20%
20-12-2011	-41.90%	1 yr, 1 month	2 yrs, 5 months	16%
06-08-2013	-35.10%	7 months	8 months	25%
12-02-2016	-27.90%	10 months	5 months	13%
24-03-2020	-65.10%	2 yrs, 2 months	8 months	37%
20-06-2022	-33.40%	5 months	1 yr, 2 months	-

Source: AceEquity, Valentis Research

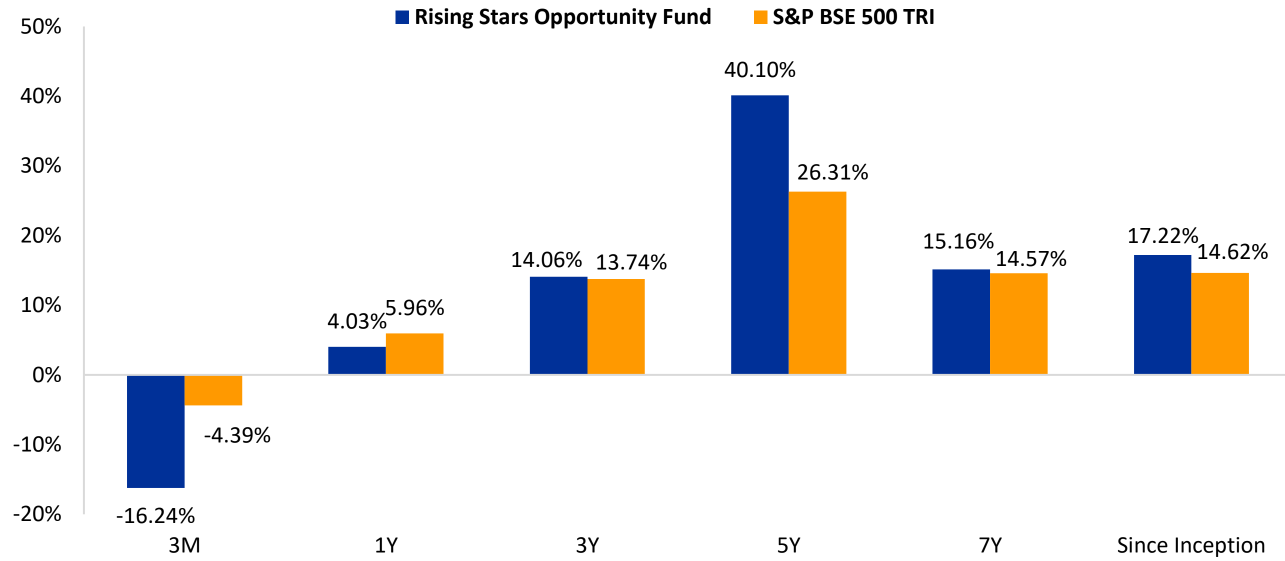
Portfolio Performance and outlook

1. During the quarter our portfolio under-performed the BSE500 given the sharp fall in the small and mid-caps which have a lower weight in the BSE500.
2. Going forward we have tried to maintain a portfolio with high earnings growth of 20%+ while keeping valuations below the market at a PE of 16x. We think this will help us achieve a good return in the portfolio despite the likely volatility in the markets.
3. Our focus is on domestic stocks and avoiding stocks that can be hurt badly if the tariffs in USA are back to a high level. The good news is that nearly 80% of our portfolio has very minimal exposure to USA exports

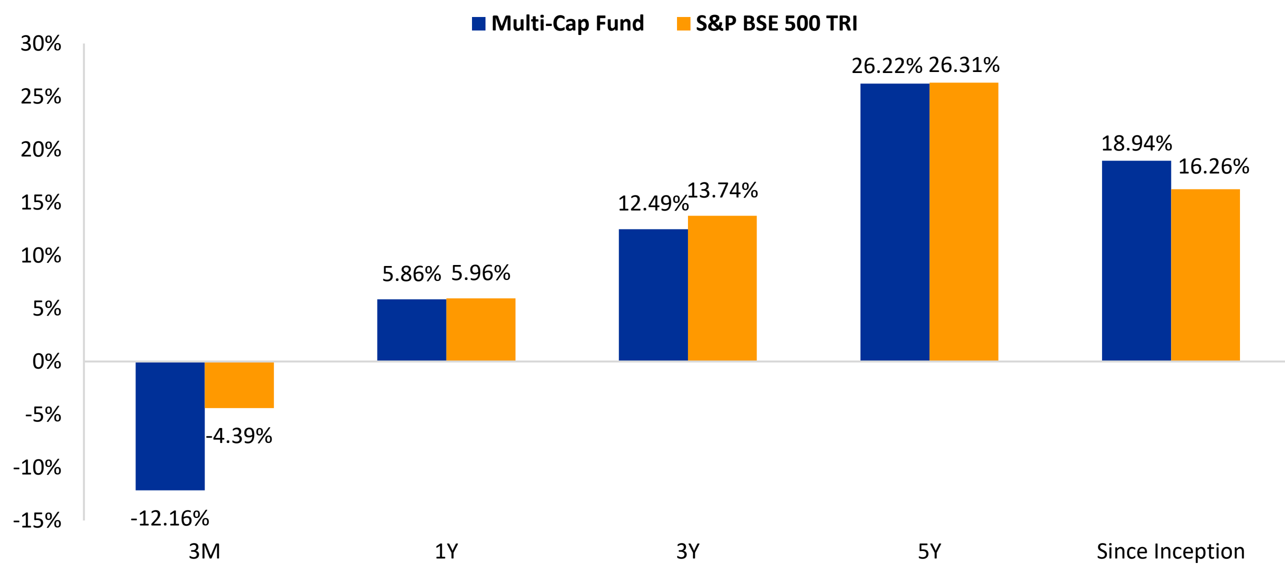
US exports as % sales	Weightage	No. of stocks
Nil	76%	13
>0-10%	3%	1
10-20%	2%	1
20-40%	5%	1
40-50%	7%	1
Above 50%	0%	0

4. The high US export companies are in the pharma sector where tariffs are currently not applicable. We are aware of the possibility of tariffs in the sector but we believe these will not be onerous.
5. During the quarter, we added to a chemical company given the sharp fall in the share prices of this sector. Our view is that de-stocking in the sector is behind us, and this should help decent earnings growth in the sector.
6. We believe investors should keep return expectations tempered during the year and look at this year as a year of consolidation where we build our portfolio for the next few years. We will continue to invest additional money in a staggered manner while being aggressive on any significant dips in the market.

Valentis Rising Stars Opportunity Fund Performance (as on March 31, 2025)



Valentis Multi-Cap Fund Performance (as on March 31, 2025)



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