Valentis Advisors

Market returns to mirror earnings growth January 21, 2026

In our year ahead outlook in January 2025 we had characterized 2025 as a year of consolidation where markets will shift from T20 to a Test Match mode (https://www.valentisadvisors.com). We think markets in 2026 will continue to be in a Test Match mode. We expect the large caps to deliver a return of high single digits. But after being negative on small and mid-caps last year, we expect the broader market (especially small-caps) to perform better than they did in 2025 and probably deliver returns in line or higher than the large-caps.

1. **We expect markets to give an 11th consecutive year of positive returns led by (a) stable macros (b) revival in earnings which should grow at 12-14% in FY27 (c) Valuations in line with 10-year averages. However, markets will continue to be volatile, and we recommend investors to stagger investing additional money and using corrections to buy.**
2. **We expect better FII flows: After selling nearly US$ 31 bn of stock since October 2024, we think FII outflows will be lower in CY26 led by (a) Sharp under-performance of India: 28% under-performance in CY25 (b) Pessimistic positioning: India is the most under-weight emerging market at more than 2.5% underweight (c) Relative valuations are now at long term averages. Recovery in earnings, an Indo-US trade deal and a move away from AI theme could be triggers for better FII interest in India.**
3. **Contrary to consensus, we think mid and small-caps will perform in line or better than large caps in CY26 though it could be back-ended. Firstly, in line with our expectations last year, small and mid-caps have under-performed large caps in CY25 with small caps under-performing the Nifty by 16%. Secondly, we think earnings growth in the mid and small caps will be stronger than large caps by 7-8%. Thirdly, balance sheet risk in the small caps has eased considerably.**
4. **The biggest risk is global, with a trade war led by tariffs reversing globalization benefits of low inflation. Second biggest risk could be an unwinding of the AI trade in a disorderly manner. However, the biggest risk is the high debt levels in the developed world resulting in elevated bond yields. Watch USA and Japanese bond yields.**

#1: Earnings recovery to drive market returns in CY26

After nearly 16 months of consolidation, we think markets will be better in CY26 in terms of breadth. While CY25 gave near double digit returns, it was a narrow market led by select heavyweights. We think CY26 will be a better year for the broader markets though volatility from global events will continue. Better earnings and low interest rates will keep valuations around current levels.

A) Macro-economy continues to be strong

- The twin deficit in India continues to be under control. Fiscal deficit has been trending down, and the Government has met its budget targets for the fiscal deficit. The Current Account deficit has inched up but is not in any stressful situation despite the recent depreciation of the rupee. In fact, longer term, with oil prices staying low and India reducing its oil intensity, we are not worried on any external shock.
- Inflation is low, in fact too low, since it is affecting corporate earnings. This is giving room to RBI to cut rates.
- Real GDP growth continues to be strong, and India is amongst the fastest growing economies in the world. However, low inflation means that nominal GDP growth in FY26 will be the 3rd lowest over the past 25 years.

B) Cyclical recovery in earnings in FY27

Corporate earnings growth over the past 6 quarters has been in single digits. We see earnings improving slightly in the December 2025 quarter and edge closer to double digits. We see earnings continue to revive in subsequent quarters and expect earnings to grow strongly at 12-14% (consensus analyst estimate at 17%) in FY27 which will help market returns. 4 reasons why we expect earnings revival (https://www.valentisadvisors.com)

- Corporate topline is co-related to nominal GDP growth. With low inflation, low nominal GDP growth is keeping growth constrained. As we get pricing power returning it will reflect in better topline.
- Banks which account for nearly a third of the index have seen flat earnings growth given the lead-lag impact of interest rate cuts on Net Interest Margins (NIMs). We see bank earnings improving significantly next year at around 15% as NIMs normalize and due to improvement in credit growth momentum.
- Consumption spend will pick up as (a) better crop helps rural income (b) GST cuts of nearly 0.5% of GDP helps demand (c) Income tax cuts in budget 2025 feeds in consumption spend and (d) lower EMIs due to falling interest rates help demand.
- Government capex did most of the heavy lifting post-Covid and we think Government capex will now grow in line with nominal GDP growth as higher govt. capex growth could push inflation. Private capex will need to grow faster than it has in the past. However, contrary to the consensus belief, we are seeing some revival in private capex with corporate capex having doubled over past 4 years.
- While earnings downgrade continues, the pace of downgrades has slowed and we expect a possible earnings upgrade cycle by the end of the year.

C) Valuations getting reasonable

Post time correction in markets over the past 16 months, valuations, though not cheap, are getting reasonable especially in the large cap space.

- On a PE basis, the Nifty trades at 21.2x closer to the 10-year average of 20.8x, though above 20-year average.
- Interestingly, on bond yield vs earnings yield measure, markets are trading at close to long-term average valuations.
- In the relative context, India trades at their historic average of 63.2% premium to EM valuation, way below their previous level of 90% premium
- The small and mid-caps are relatively still expensive, and we would be wary of some of the thematic names which would need sustained growth of 30-50% over a long period to justify current valuations. We think overall growth in earnings will be superior in the small and mid-cap space but would prefer to hunt for cheaper valuation stocks.

#2: FPI flows to improve – India the pain trade of 2026

FPIs have sold nearly US$ 31 bn in the markets since October 2024. We think FPI outflows will ease in CY2026 and indeed could turn positive later in the year.

- India underperformed the MSCI by 28% in CY25, the worst relative performance by India in the past 30 years.
- Positioning is ripe to make India a "pain trade" for CY26. India is the most underweight market for EM funds and the current underweight at over 2.5% is the highest in a long time.
- Lastly, valuations on a relative basis have become in line with long-term averages. India trades at a premium of 63.2% to MSCI EM index vs the long-term average of 63.3%.
- Recovery in earnings, an Indo-US trade deal and a move away from AI theme could be triggers for better FII interest in India.
- While FPI flows will be relatively better, we could see some slow-down in domestic flows given poor returns over past 16 months. Also, the likely supply of primary papers will continue to put pressure on the secondary markets.

#3: Small and mid-caps will perform better

CY25 was marked by a huge dispersion in performance of the small and mid-caps compared to the large caps. While the large cap indices gave a return of 10.5%, the small cap index fell 5.6%, creating an under-performance of nearly 16.1%. Indeed, the broader market was worse with nearly 59% of stocks falling over 30%. We expect small caps to be broadly in line to slightly better than large caps in CY26 though the outperformance can be back-ended.

- Given the 16.1% under-performance, historically small and mid-caps have bounced back in the subsequent years. CY18 and CY19 are the only periods when small and mid-caps under-performed the large caps for the 2nd consecutive year.
- Balance sheets of small caps have become much better which reduces their risk in a downcycle.
- A revival in earnings helps the small caps much more than the large caps. We expect 3Yr earnings CAGR of 20% in small-caps and 13% for large caps.
- But what about valuations? Mid-cap trade at 28.4x and small cap trade at 24.3x, both at premium to large cap as well as their history. We think valuations will contract with earnings growth being higher than share price returns.

#4: Trade barriers leading to de-globalization and high debt levels are key risks

- CY25 saw an unwinding of the global trade system with trade deals being done with USA on a bilateral basis to reduce impact of the high tariffs. We think the market impact of this has largely played out in most parts of the world. For India, however, tariffs into USA are amongst the highest in the world and an Indo-US trade deal would be a sentimental positive.
- The other risk is the high debt in the developed world and how this will get funded. We see central banks being forced to embark on Quantitative Easing. However, there is a divergence in global monetary policy with the US cutting rates and the Japanese central bank hiking rates. Bond yields, however, in US are not reacting to the rates and continue to hover at multi-year highs. Bond yields in Japan which are rising steadily will also be in focus.
- The other risk is a fall in AI stocks in a disorderly manner. While a slow move away from the AI stocks will be positive for India, any sudden crash will hurt markets all over the world including India.

#5: Portfolio Performance and outlook

1. CY25 turned out to be a difficult year for our portfolio largely due to the 16.1% under-performance of the small caps compared to the large caps. Going forward, we think the small caps will perform much better in CY26 and are optimistic of outperforming during the year.

2. Our overall theme remains buying growth at a reasonable price. Going forward we have tried to maintain a portfolio with high earnings growth of around 23-25% (currently we expect close to 32%) while keeping valuations below the market at a PE of 14x. We think this will help us achieve a good return in the portfolio despite the likely volatility in the markets.

3. We continue with our theme of "buy local, avoid global". In line with that theme nearly 80% of our portfolio has very minimal exposure to USA exports

US exports as % sales	Weightage	No. of stocks
Nil	72%	12
>0-10%	5%	1
10-20%	0%	0
20-40%	8%	2
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 believe the tariffs on generics will not be onerous and indeed it may continue to be zero which is currently applicable.

5. We will look to add weight on some export-oriented sectors, especially chemicals, if the India-US deal on tariffs sees the light of the day.

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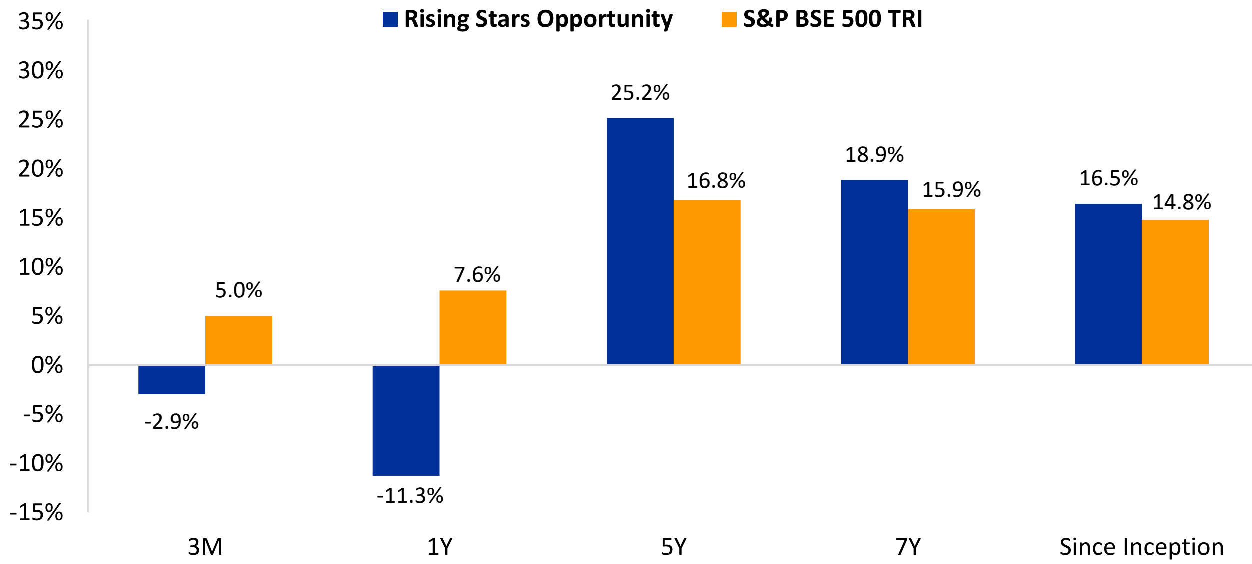
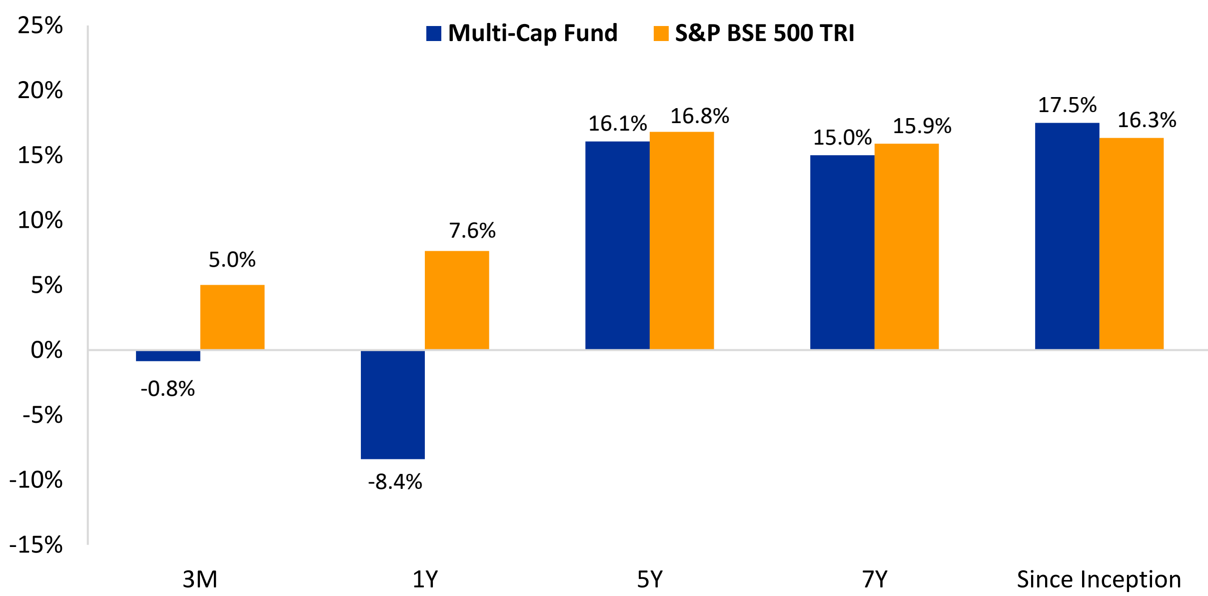
Valentis Rising Stars Opportunity Fund Portfolio Performance (as on December 31, 2025)



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



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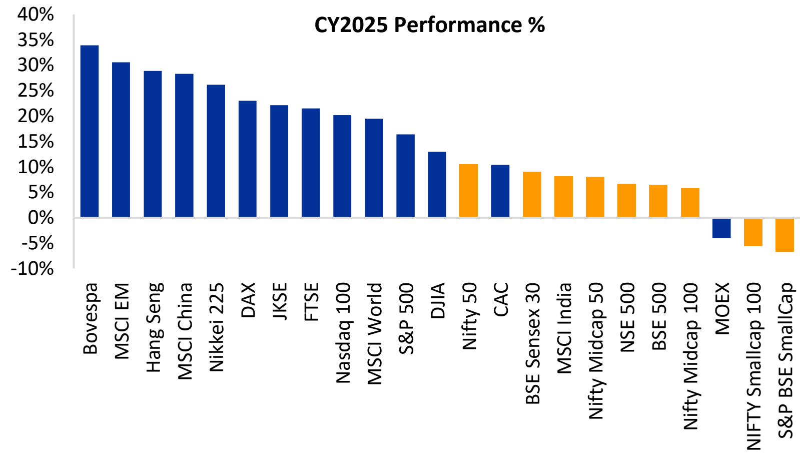
#1: Market Highlights

Indian indices underperformed global indices (in local currency)

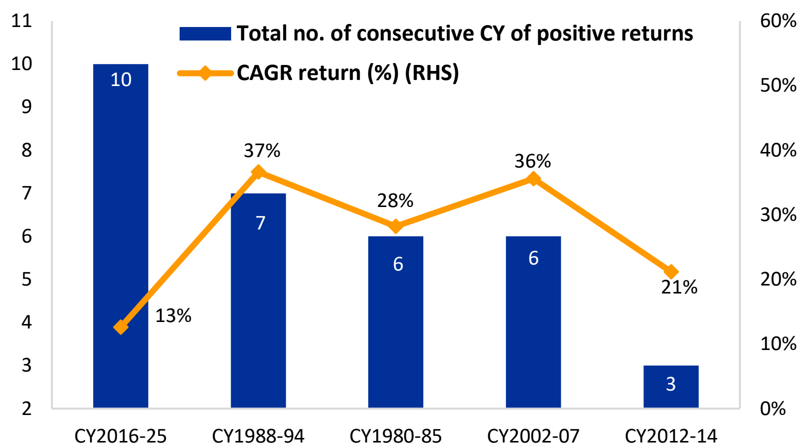
Chart 1: India - amongst the worst performers in CY25



Source: Investing.com, Valentis Research

First instance of consecutive 10 years of positive return (CAGR), although the return is much lower vis-à-vis earlier instances

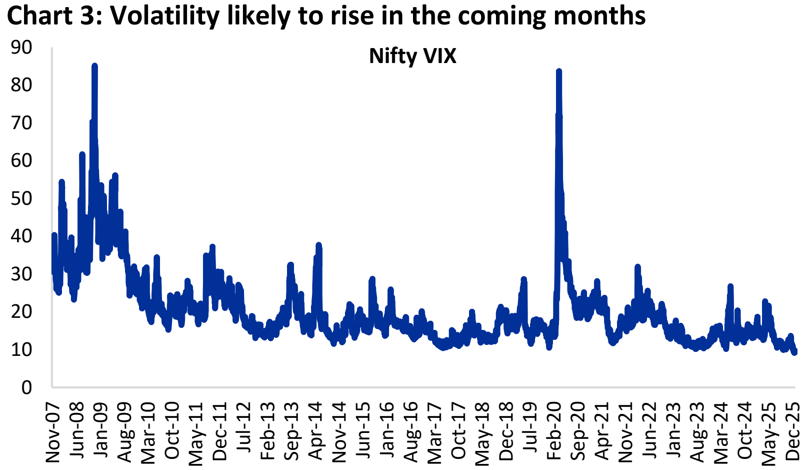
Chart 2: 10th Consecutive Year of Positive Returns in Sensex 30



Source: AceEquity, Valentis Research

The markets will be volatile in CY26.

Chart 3: Volatility likely to rise in the coming months

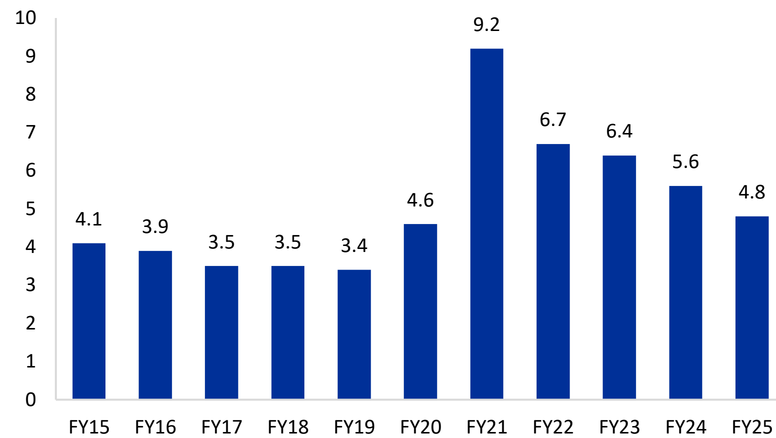


Source: Investing.com, Valentis Research

#2: Stable Macro Economy

Fiscal Deficit is under control

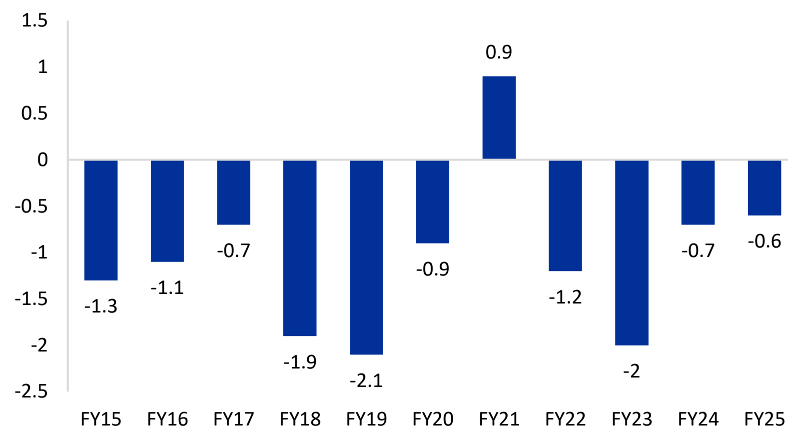
Chart 4: Fiscal Deficit as % of GDP is falling



Source: MOSL, Valentis Research

Current Account deficit is also under control due to low oil prices, the recent rise notwithstanding

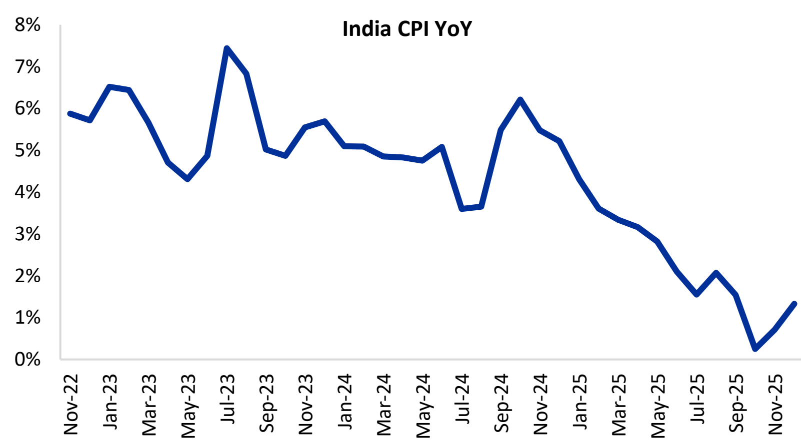
Chart 5: Current Account as % of GDP also under control



Source: MOSL, Valentis Research

Inflation is low, probably too low…

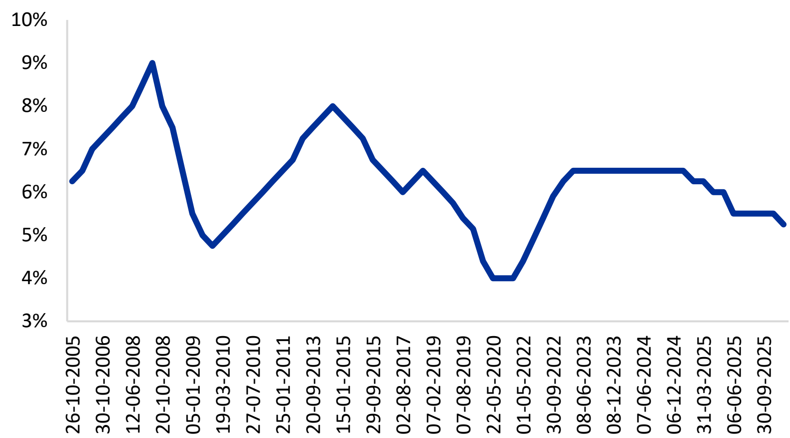
Chart 6: Inflation falling, at multi-year lows



Source: RBI, Valentis Research

...giving room to RBI to cut down rates further?

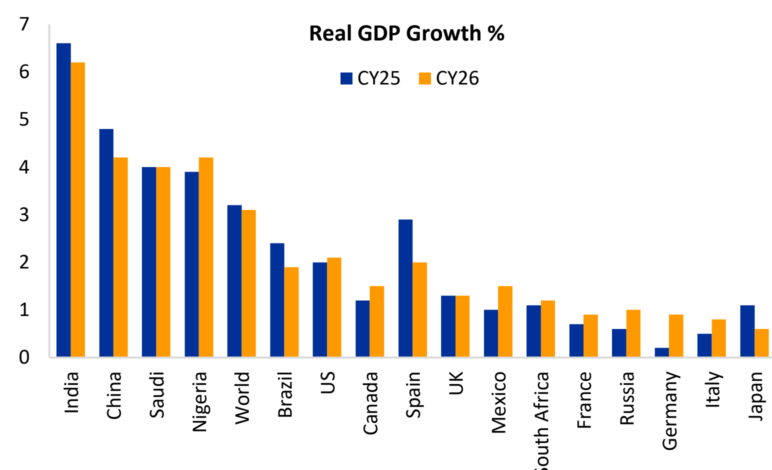
Chart 7: RBI Repo Rate has seen cuts



Source: RBI, Valentis Research

India continues to be the fastest growing economy in the world

Chart 8: India continues to be the fastest growing economy

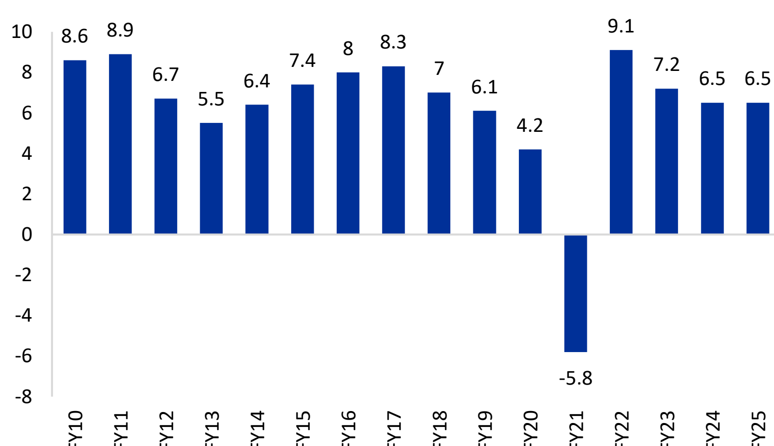


Source: IMF, World Economic Outlook, Valentis Research

For India data forecasts is based on Fiscal Year basis, so CY25 is FY26 and CY26 is FY27

GDP growth rate is stable in the 6.5-7% range over past few years

Chart 9: India's Real GDP growth YoY



Source: IMF, Valentis Research

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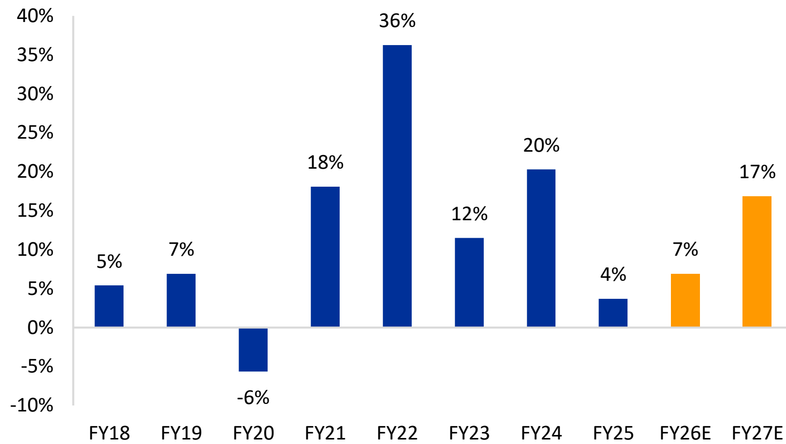
#3: Cyclical rebound in earnings likely

We think earnings have bottomed and we expect double digit growth over next few quarters

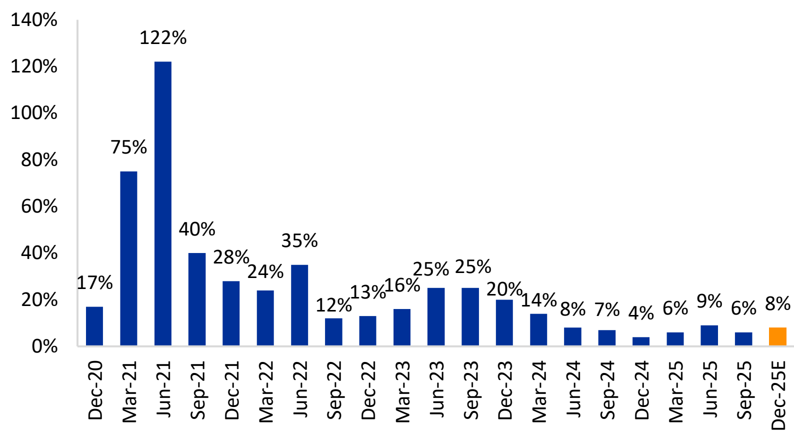
Chart 10: Nifty earnings to grow in double digit in FY27E



Source: MOSL, Valentis Research

Q3FY26 will see some improvement in earnings growth

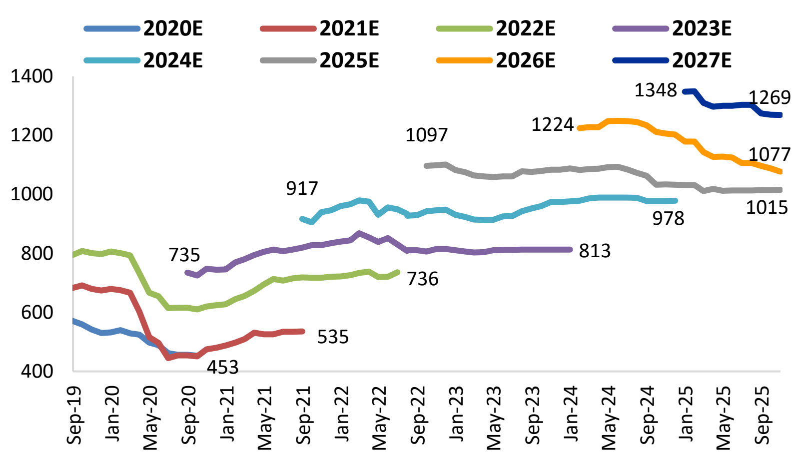
Chart 11: Expect Nifty PAT to grow by 8% in Q3FY26E



Source: MOSL, Valentis Research

Earnings downgrade in the last few months has slowed down

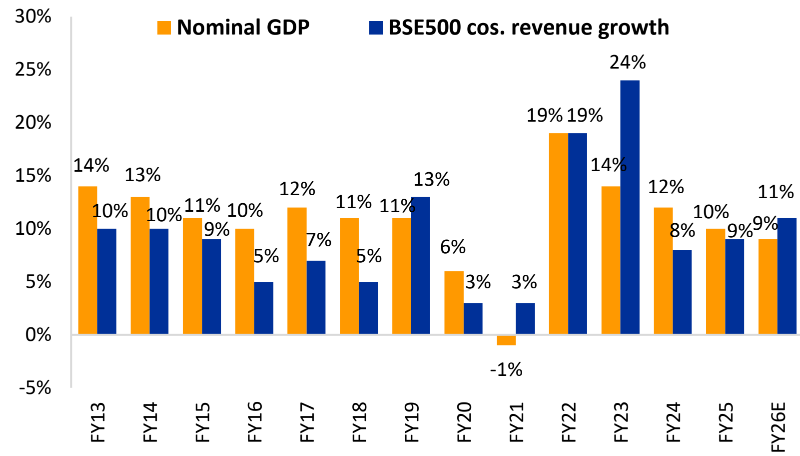
Chart 12: Weak Nifty Earnings momentum to change the direction?



Source: Kotak IE, Valentis Research

Corp profit to move in line with the Nominal GDP growth rate

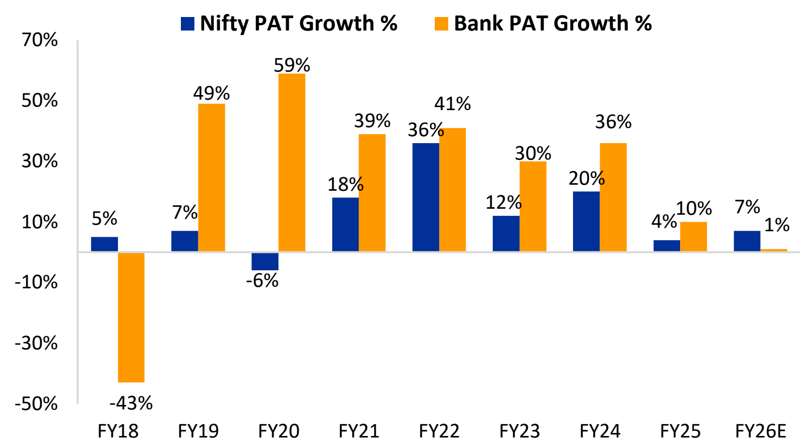
Chart 13: Corporate topline is co-related with nominal GDP growth



Source: MOSL, Valentis Research, NOTE: FY25 earnings from unlisted companies are yet to be available

A revival in bank earnings in FY27 will help aggregate earnings growth by approx. 500 bps.

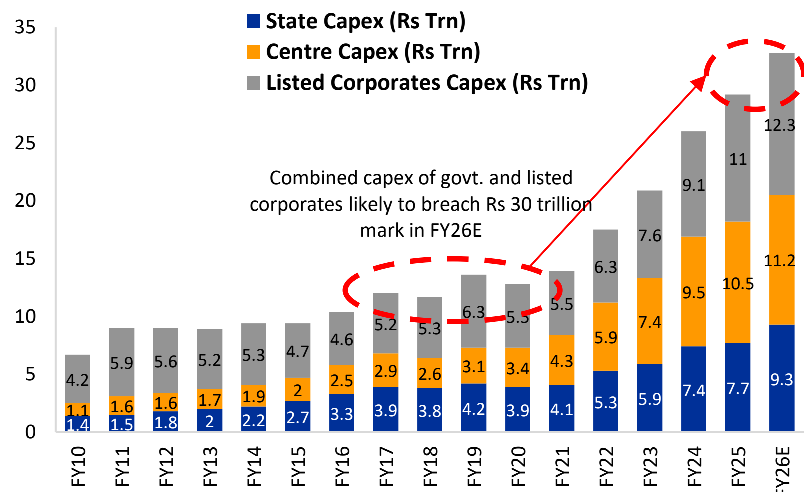
Chart 14: Banks to drag down the overall Nifty earning growth



Source: AceEquity, Valentis Research

Listed corporate capex has doubled over past 4 years

Chart 15: Private capex is better than consensus beliefs

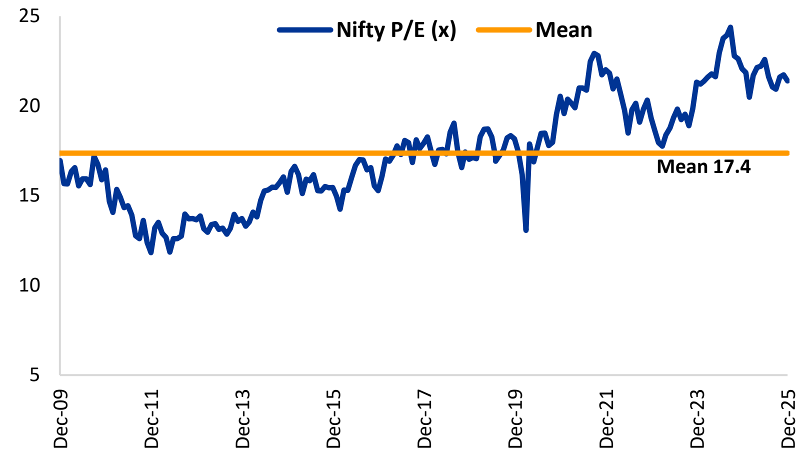


Source: ISec, Valentis Research

#4: Valuations getting reasonable?

On a PE basis, the Nifty trades at 21.4x, near the 10-year average of 20.8x

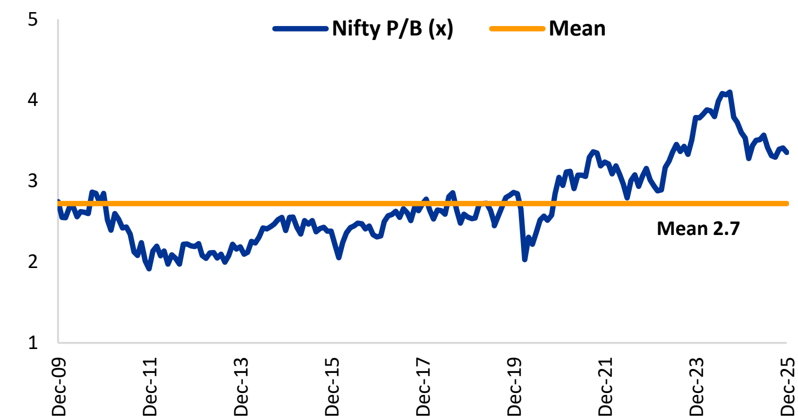
Chart 16: Nifty 1Yr Fwd P/E (x) – still expensive



Source: MOSL, Valentis Research

On a PB basis, the Nifty trades at 3.35x, above the 10-year average of 2.95x

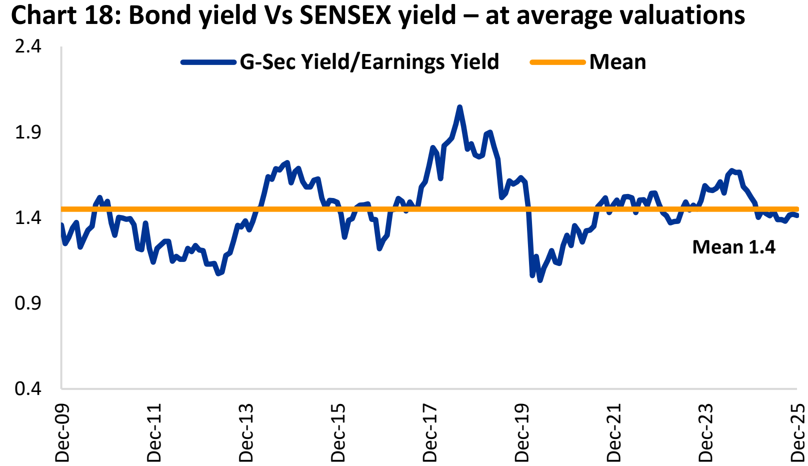
Chart 17: Nifty 1Yr Fwd P/B (x) – in expensive territory



Source: MOSL, Valentis Research

Market is looking reasonably priced on G-sec yield/Earnings yield given the low interest rates

Chart 18: Bond yield Vs SENSEX yield – at average valuations



Source: MOSL, Valentis Research

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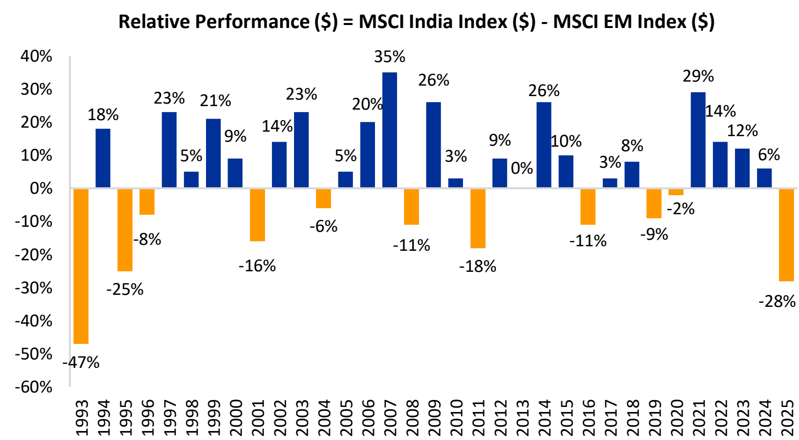
#5: FPI flows to improve

Indian markets underperformed EMs by -28% in CY25 - Worst underperformance since we got meaningful FPI participation

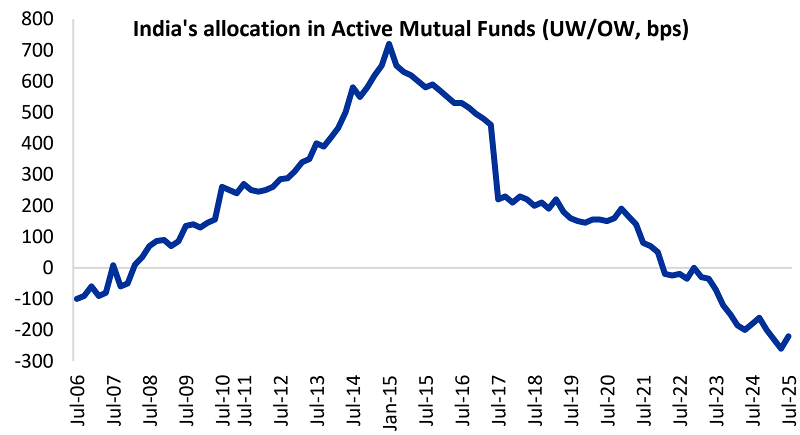
Chart 19: India – worst performance in 30 years vs EMs



Source: Bloomberg, Valentis Research

India's allocation in active mutual funds globally is at a 2-decade low

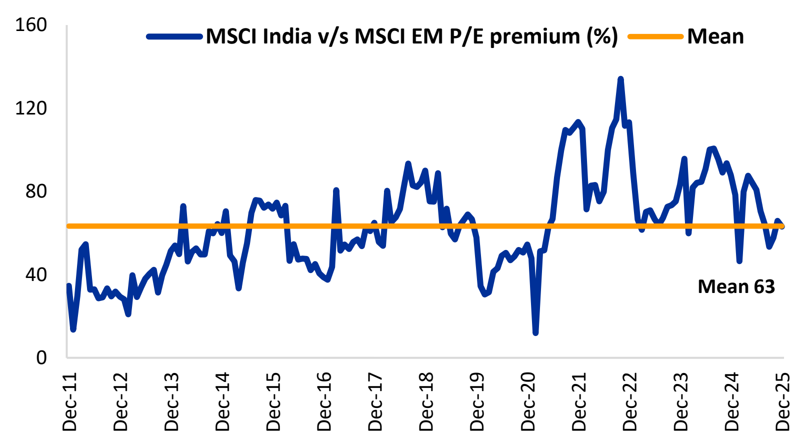
Chart 20: India's allocation in active mutual funds



Source: Brokerage Reports, Valentis Research

While valuations look expensive in the historic context, India valuations relative to Emerging Markets are trading at their historic average of 63%.

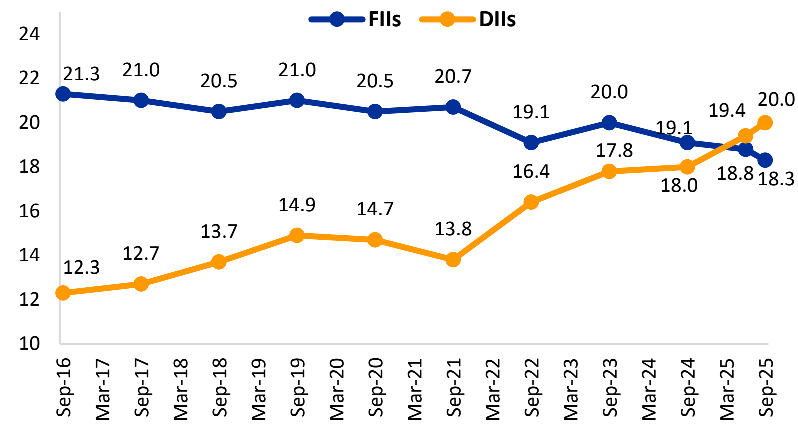
Chart 21: Chart 13: MSCI India v/s MSCI EM P/E premium (%)



Source: B&K, Valentis Research

Since Oct'24 FIIs have sold US$ 31 bn. The domestic funds now own more of the market than FIIs

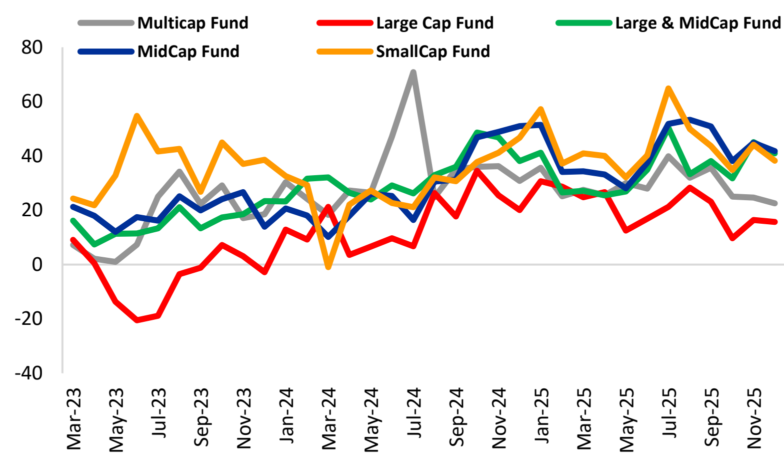
Chart 22: Trend in FII/DII holdings for Nifty 500 (%)



Source: MOSL, Valentis Research

Domestic retail flows could see some slow-down

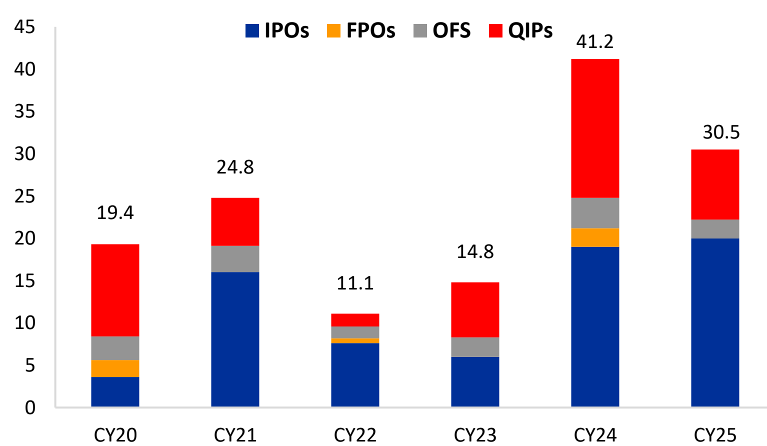
Chart 23: Net Inflows in MFs (in Rs Bn)



Source: AMFI, Valentis Research

Approx. US$ 65-70 Bn of primary capital was raised in the last 2 years, making India one of the largest primary markets in the world. The supply of primary paper can be an overhang on secondary markets

Chart 24: Primary market activity remains elevated (money raised in $Bn)

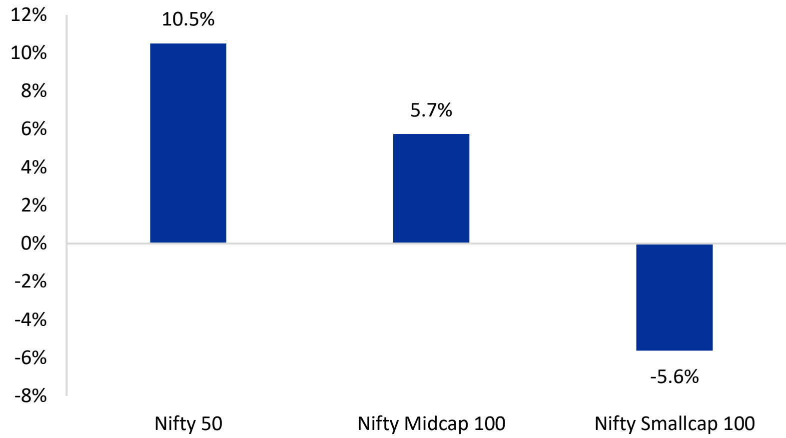


Source: Capitaline, Dam Capital, Valentis Research

#6: Small and mid-caps will perform better

Small cap has been lagging Large and Midcaps since 2 years now. CY25 saw a 16% underperformance of small-cap relative to large cap

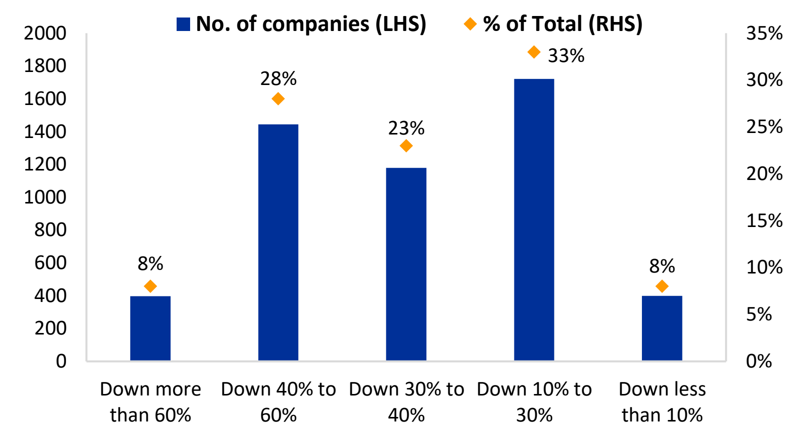
Chart 25: Small and Midcap underperformed Large cap in CY25



Source: AceEquity, Valentis Research

~60% of the total listed companies are down by more than 30% from their 52-week highs

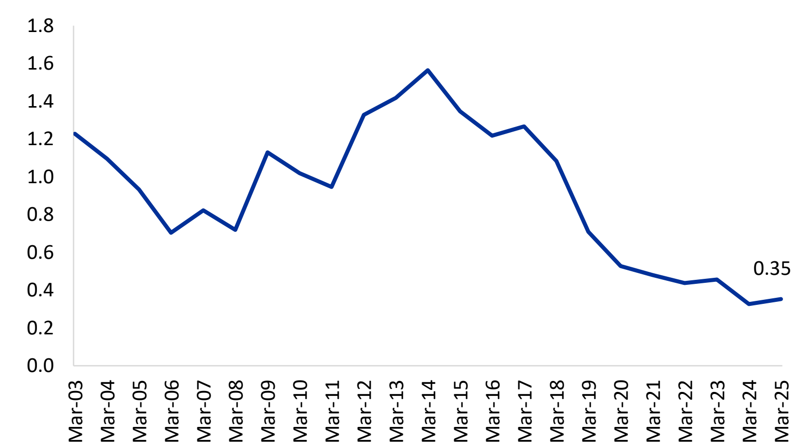
Chart 26: Companies down from their 52 week Highs



Source: AceEquity, Valentis Research

Corporate balance sheets of small caps are in good shape

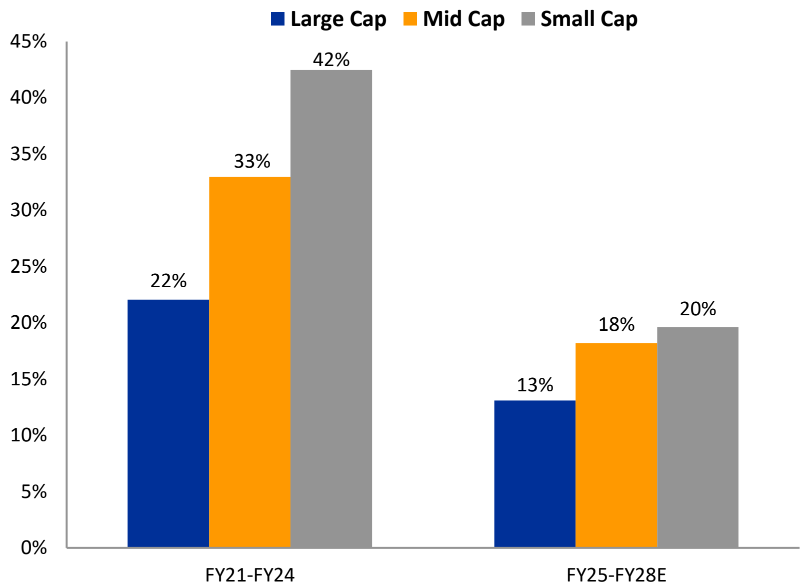
Chart 27: Small cap net debt / equity (x) trend



Source: ISec, Valentis Research

Small cap more expensive but with much faster earnings growth

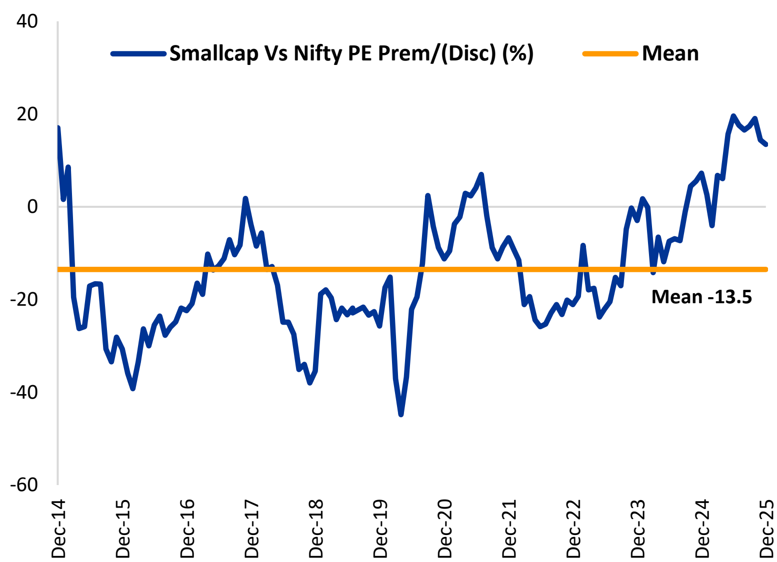
Chart 28: Earnings forecast profile



Source: AceEquity, ISec, Valentis Research

Small caps trades at a premium of 13.5% to large caps

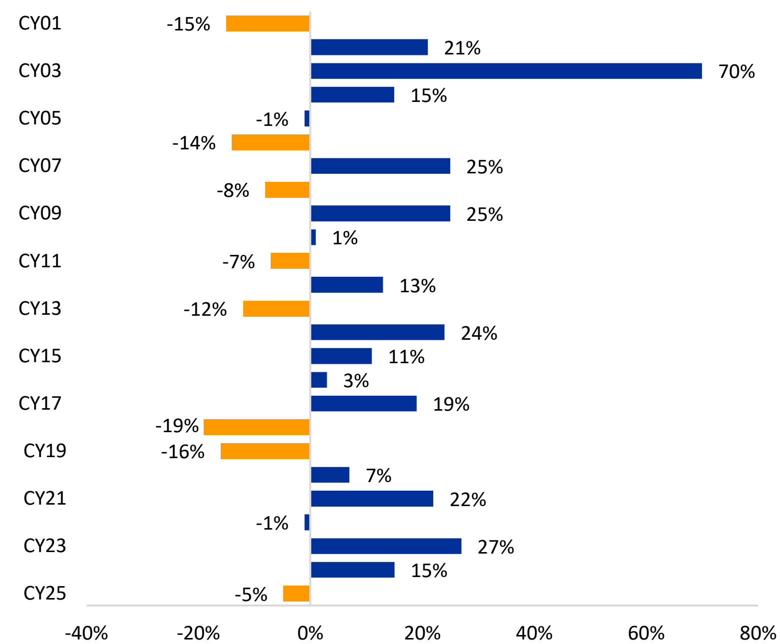
Chart 29: Small caps are expensive relative to large caps



Source: MOSL, Valentis Research

Chart 30: Outperformance/Underperformance of Nifty Midcap 100 vs Nifty 50

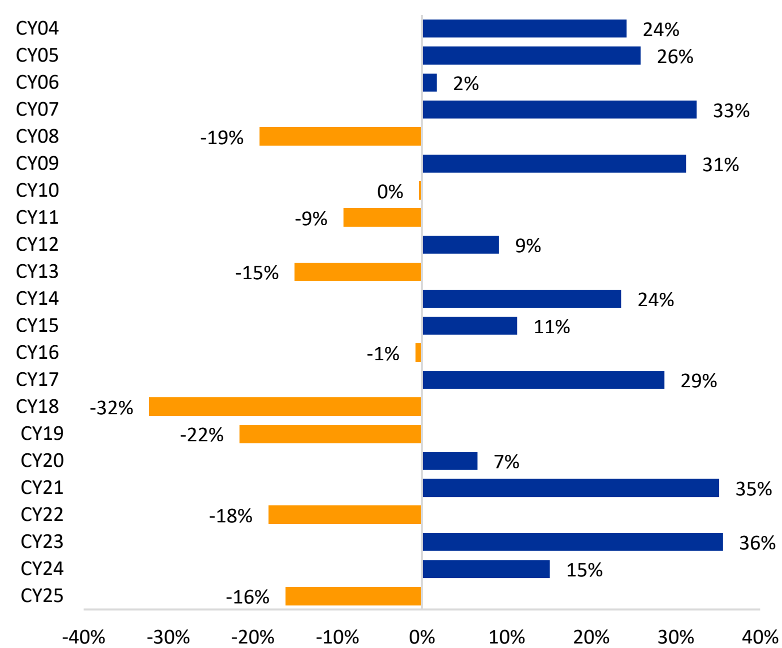
Nifty Midcap 100 has outperformed Nifty 50 after every year of underperformance except in CY19



Source: AceEquity, Valentis Research

Chart 31: Outperformance/Underperforance of Nifty Smallcap 100 vs Nifty 50

Nifty Smallcap 100 outperformed Nifty 50 13 out of 22 years. CY19 was the only year it underperformed Nifty for 2nd consecutive year



Source: AceEquity, Valentis Research

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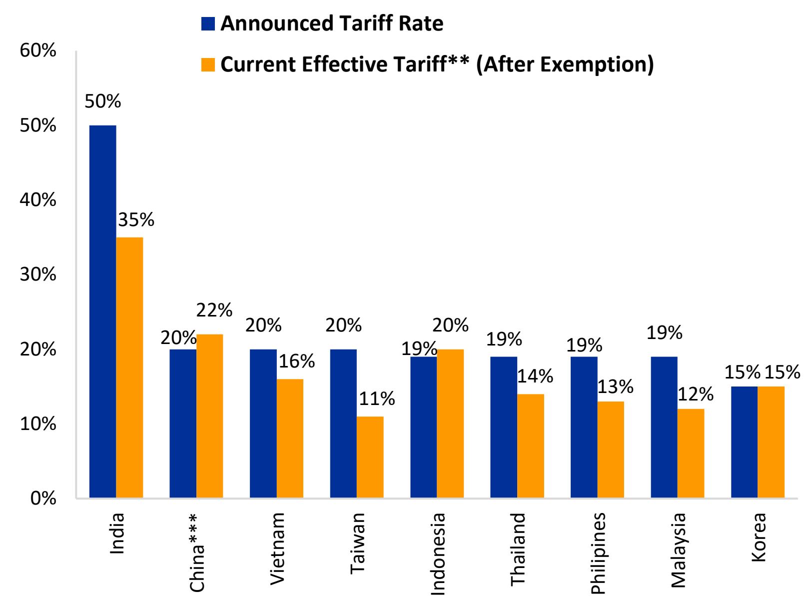
#7: Global Risk

Exemption of pharma generics and services has cushioned impact of tariffs.
Excluding IT and Pharma, ~22%^ revenues of NIFTY 100 companies come from exports (both US and non-US markets)

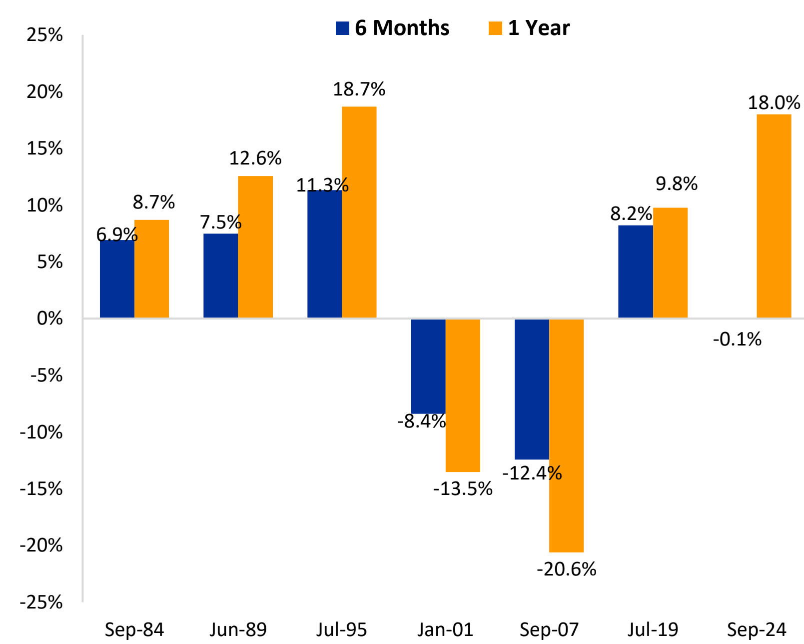
Chart 32: US tariffs on India are higher than that on Peers



Source: Capitaline, ISec, UBS, Valentis Research; *Announced Tariff Rate as of April 01, 2025; **Current Effective Tariff as of August 27, 2025. Effective Tariff is exports weighted tariff rate considering differential tariff rates and exemptions for certain sectors. ***The fentanyl tariff on China lowered from 20% to 10%, while the 24% pending reciprocal tariffs will be postponed for one year. These measures lowered the weighted average additional US tariff on China in 2025 from 32% to 22%

Fed rate cut cycles have typically been positive for markets

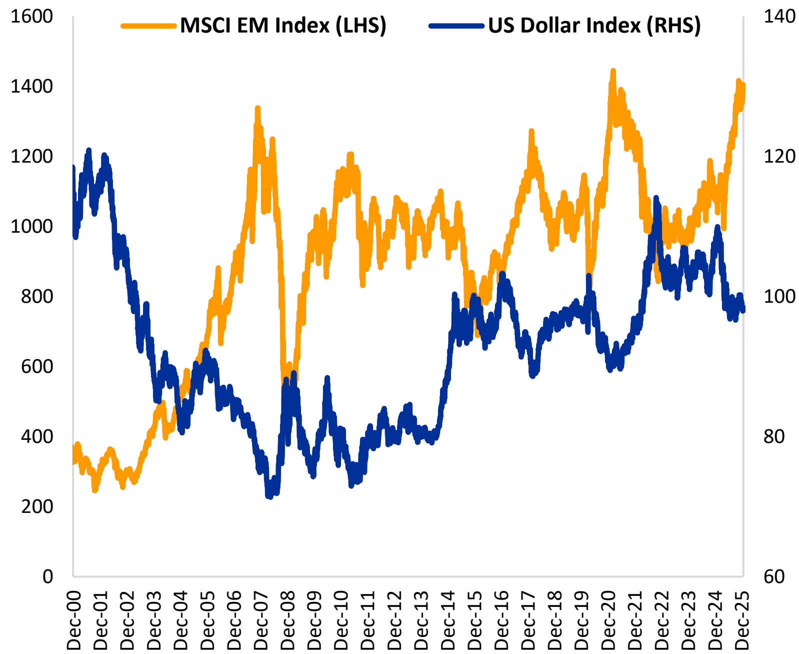
Chart 33: S&P 500 return post first cut in fed rate



Source: Investing.com, Valentis Research

Weak dollar is typically positive for EM equities

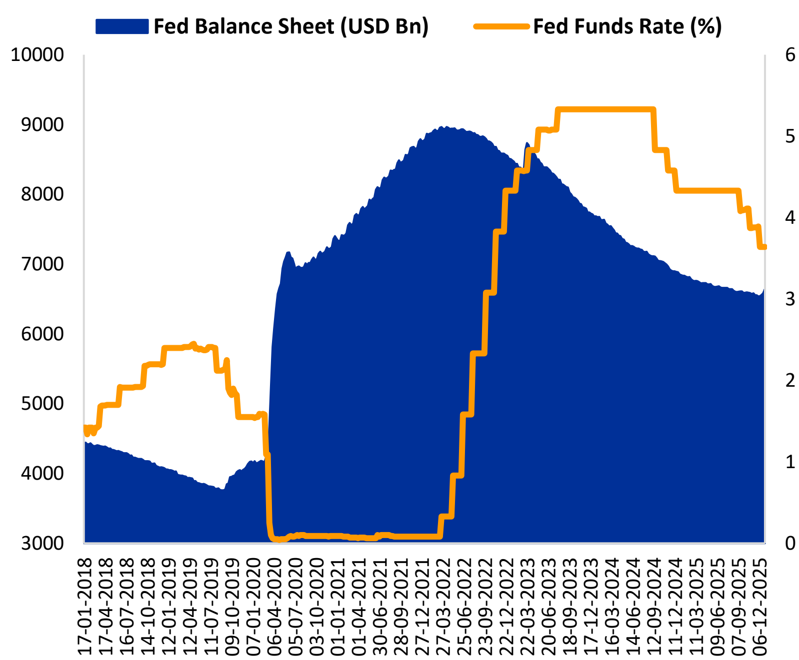
Chart 34: Weak dollar is positive for EM equities



Source: Investing.com, Valentis Research

Fed likely to start a QE cycle

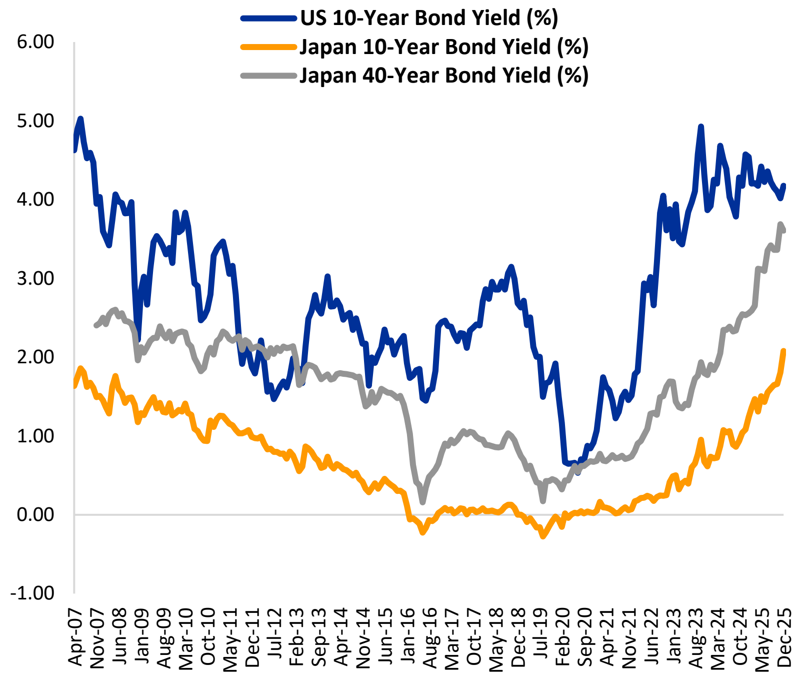
Chart 35: Fed likely to start another QE cycle



Source: Federal Reserve, Valentis Research

Central bank policies in USA and Japan are diverging. But bond yields in both countries are way above levels seen after the GFC. The US bond yields are not reflecting the Fed cuts.

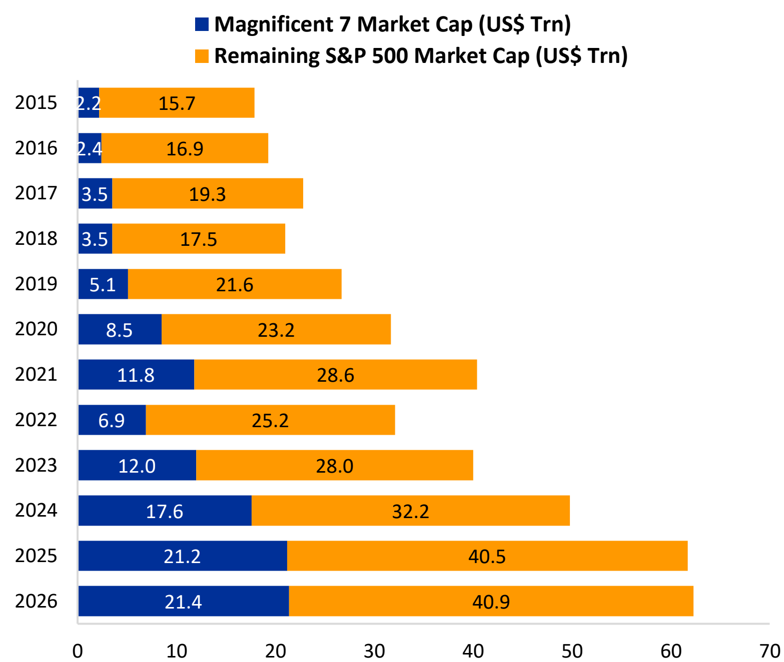
Chart 36: US Bond Yield are near pre-GFC levels



Source: Investing.com, Valentis Research

Bull run in USA has been narrow. Will AI unwind?

Chart 37: Performance of Magnificent 7



Source: S&P 500, Valentis Research

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