



## *Earnings recovery will drive small cap cycle*

April 17, 2026

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The markets have recovered from the Middle East war as expected in our earlier note “Buy the canons” of March 2, 2026. Given the prolonged time and price correction over the past 18 months and our expectation of a recovery of earnings, we continue to remain positive on markets. We think over the next 18-24 months, small caps will outperform the large caps:

1. **Earnings will recover faster for small caps:** We expect earnings to grow 22% over next 2 years, much faster than the large cap earnings growth of 16% helping drive small cap stock performance.
2. **Better positioned for downturns:** The health of the balance sheet of the small caps is in much better shape with net debt: equity of 0.35x, which should help them withstand downturns better. This will also justify a higher than past valuation multiples.
3. **Underperformance will help future returns:** Small caps underperformed large caps by 16% in CY25. Historically, a year of underperformance in small caps is followed by a year of sharp outperformance.
4. **Buy pessimism, sell euphoria:** Small caps have boom and bust cycles deeper than large caps. Historically, in any upcycle, small caps have doubled in around 2 years. We see this upcycle being weaker than history but still giving a 50-60% return since starting valuations are much higher and the downturn also was amongst the weakest ever.
5. **Valuations - not deep value but reasonable:** Valuations for small caps are in line with 5-year averages both on a PE as well as a PB basis though at around 10-15% premium to long term averages. Given an earnings recovery cycle and better balance sheets, we regard this as reasonable risk: reward.

### **Buy the sound of canons**

In our report dated March 2nd, 2026, post the start of the Iran conflict, we had mentioned that markets typically recover over a period of 1 month and the average correction is around 6-8% (see report enclosed <https://www.valentisadvisors.com>). The correction in this case lasted for nearly 4 weeks, falling 11.5%. The market has since seen a sharp recovery rising around 10% from the lows at the end of March. The small-cap index is above the levels it was before the start of the war while the large cap and mid-cap indices are near there.



**Table 1: Market Reaction to Geopolitical events**

Event	Event Date	S&P 500 Return					Nifty 50 Return				
		Size of Sell Off	1M	3M	6M	1Y	Size of Sell Off	1M	3M	6M	1Y
9/11 attack	11-09-2001	-13.5%	0.4%	4.3%	6.9%	-17.3%	-17.8%	-6.7%	8.2%	14.1%	-2.4%
Iraq War	20-03-2003	-3.7%	2.0%	13.7%	18.3%	26.7%	-9.3%	-8.1%	7.5%	31.1%	68.6%
Arab Spring (Eqypt)	25-01-2011	-1.2%	2.2%	3.4%	3.6%	2.7%	-9.8%	-6.7%	3.3%	-0.1%	-9.3%
Libya Intervention	19-03-2011	-4.8%	2.0%	-0.6%	-5.9%	4.5%	-0.5%	6.8%	-0.1%	-6.4%	-2.2%
Russia - Crimea	20-02-2014	-0.2%	1.8%	1.8%	8.0%	14.7%	-1.1%	6.4%	19.4%	29.3%	45.0%
Intervention in Syria	22-09-2014	-9.4%	-3.4%	4.2%	5.5%	-2.6%	-4.9%	-1.8%	2.2%	5.2%	-4.1%
Air strike on Syrian Air Base	07-04-2017	-1.2%	1.9%	3.0%	8.2%	10.6%	-2.0%	0.9%	5.1%	8.5%	12.3%
North Korea missile crisis	28-07-2017	-1.5%	-1.1%	4.4%	15.4%	14.8%	-3.3%	-1.0%	3.1%	10.5%	12.6%
Saudi Aramco drone strike	13-09-2019	-5.1%	-1.4%	5.4%	-9.9%	11.1%	-2.8%	2.1%	9.1%	-10.1%	3.5%
Russia invasion of Ukraine	24-02-2022	-2.6%	5.4%	-8.1%	-3.4%	-7.4%	-8.2%	6.0%	-0.8%	8.4%	7.5%
West Asia war	28-02-2026	-8.2%	-5.1%	?	?	?	-11.5%	-11.3%	?	?	?

Source: AceEquity, Investing.com, Valentis Research

As we write this note, the war has not yet ended but there seems to be an indefinite ceasefire. However, the Strait of Hormuz is still not operational due to the Iranian side as well as the US blockade. Any long blockade on the Strait could lead to a disruption in the oil market and a consequent pullback in the equity markets. However, we would be buyers on every dip in the market and are positive of an earnings revival driving stock prices.

### Will anything change?

While we think the market will recover, there could be some fundamental impact on the Indian economy even after the war ends:

- Oil prices may remain higher than pre-war levels:** Given the damage to oil and gas infrastructure, it is likely that oil prices remain higher than pre-war levels of around USD60/brl. We think the increase will not be substantial, but a higher oil price is negative for India's current account deficit with every \$10/brl increase leading to an increase of ~0.4% in current account deficit.
- Remittances from Gulf may be at risk:** India gets around ~\$51.5bn (FY25) of remittances from Gulf countries which may be at risk. However, this may be partly offset by the participation of Indian companies in the rebuilding of infrastructure in the Middle East.



## Market coming from a long consolidation – always positive for markets

We have seen a long consolidation in the markets from the peak in September 2024. If we look at past periods where markets give flattish or negative returns, outsized returns have followed. Detailed tables are in the Appendix. Key conclusions are:

- In the 13 times when markets were flat for 18 months, they gave an average of 30% return over next 1 year and 75% over next 3 years.
- In the 35 times when markets gave a negative return over 18 months, they gave an average of 36% return over next 1 year and 85% over next 3 years.

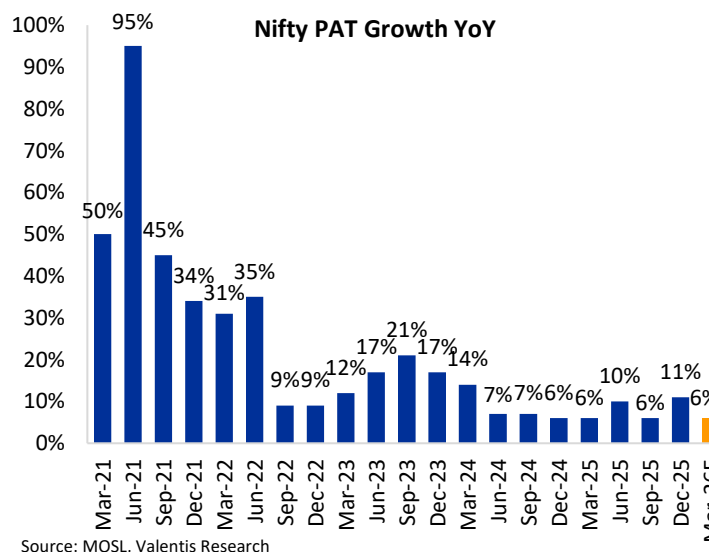
## Why do we prefer small caps over large caps?

While we are positive on markets, we think small caps will do better than large caps over the next 18-24 months after the poor showing in CY25 where the small cap index fell 5.6%, creating an underperformance of nearly 16.1% to the large cap index which was up 10.5%.

### #1: Earnings will recover – small caps to recover faster

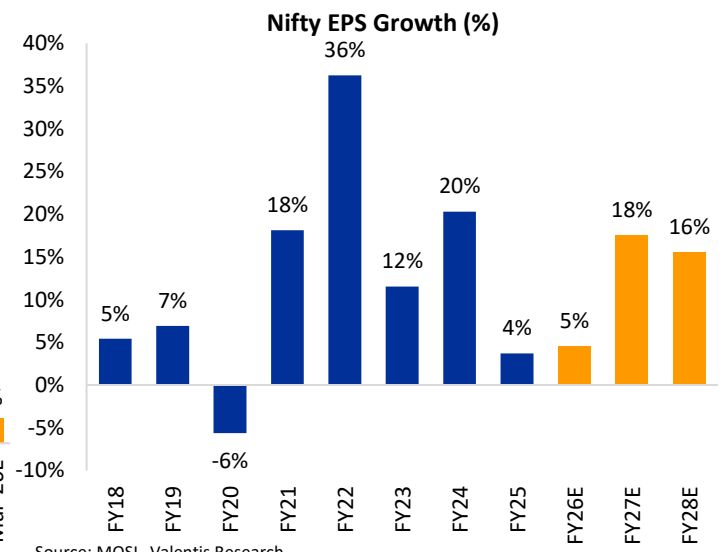
We have seen a prolonged spell of weak earnings with 7 quarters in a row of single-digit growth or low double digit growth. Earnings were set to recover from the March quarter (see note <https://www.valentisadvisors.com>), but the Iran conflict will lead to a lower growth than expected in the month of March. However, we have seen topline of domestic corporates being largely insulated though margins may come under pressure. While we may see conflict related weakness in Q1FY27 as well, we see the full year leading to a double-digit growth though may be slightly lower than current forecasts.

**Chart 1: Expect Nifty PAT to grow by 6% in Q4FY26e**



Source: MOSL, Valentis Research

**Chart 2: Nifty earnings to grow in double digit in FY27E**

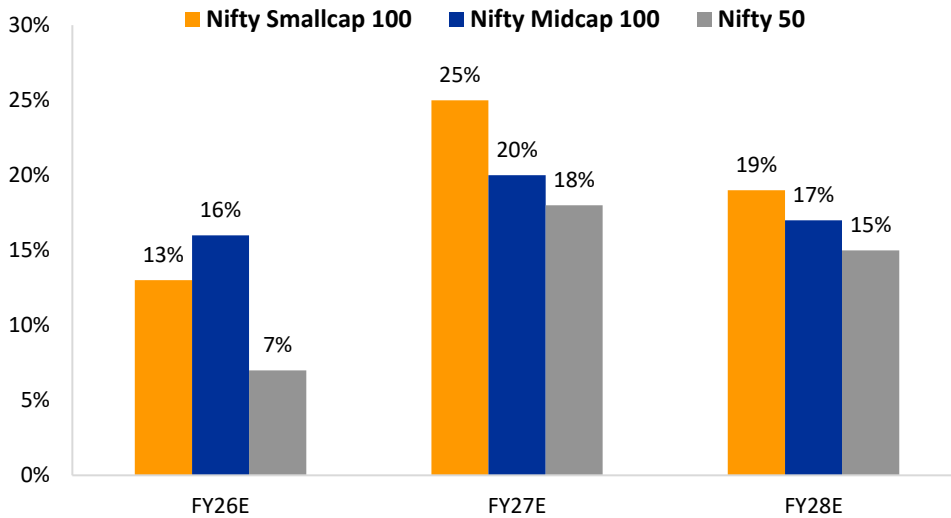


Source: MOSL, Valentis Research



While earnings will recover for corporate India in general, we see the fastest growth in the small-cap segment that had lagged earnings growth over the past year.

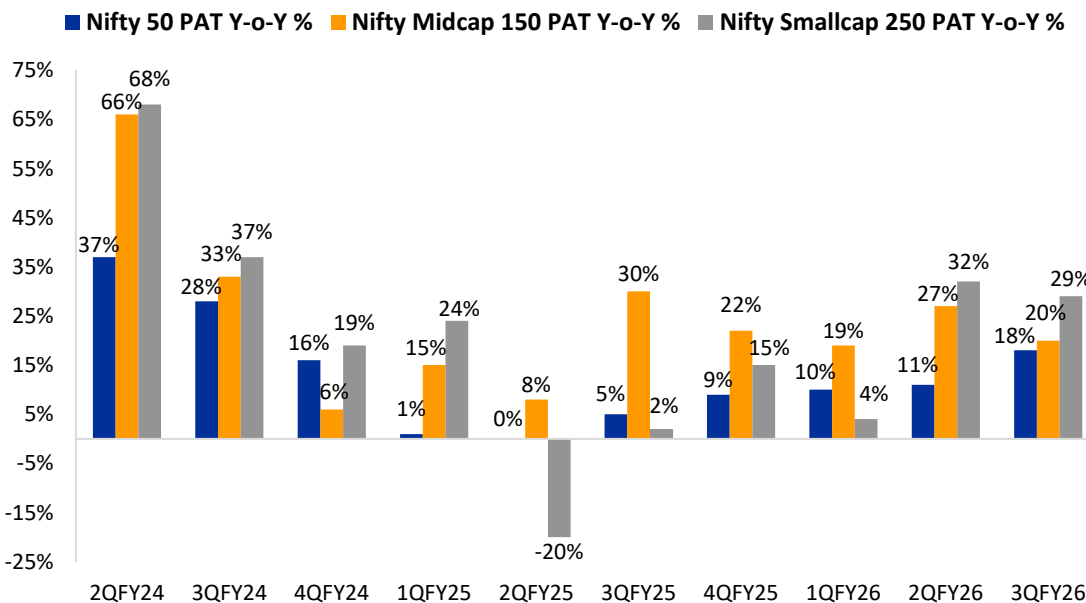
**Chart 3: Earnings forecast profile – small caps lead the way**



Source: ISec, Valentis Research

The forecast of a sharp recovery in small cap earnings is being justified by the early signs of growth in small caps. We have already seen the past 2 quarters lead to a rebound in small cap earnings growth.

**Chart 4: Midcap and Small cap earnings reviving**



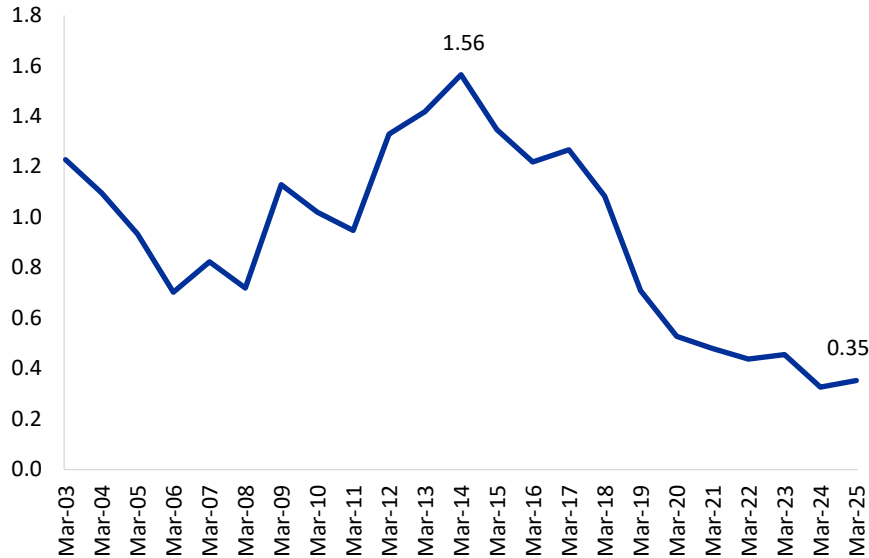
Source: MOSL, Valentis Research



## #2: Health of small cap balance sheets much better

Small caps have generally been more vulnerable to boom-and-bust cycles in the economy. However, we think the health of the balance sheets is much stronger now and will help them withstand weak spells in the economy. A better balance sheet may also justify higher valuation multiples for small caps than the past cycles.

**Chart 5: Small cap net debt / equity (x) trending down**



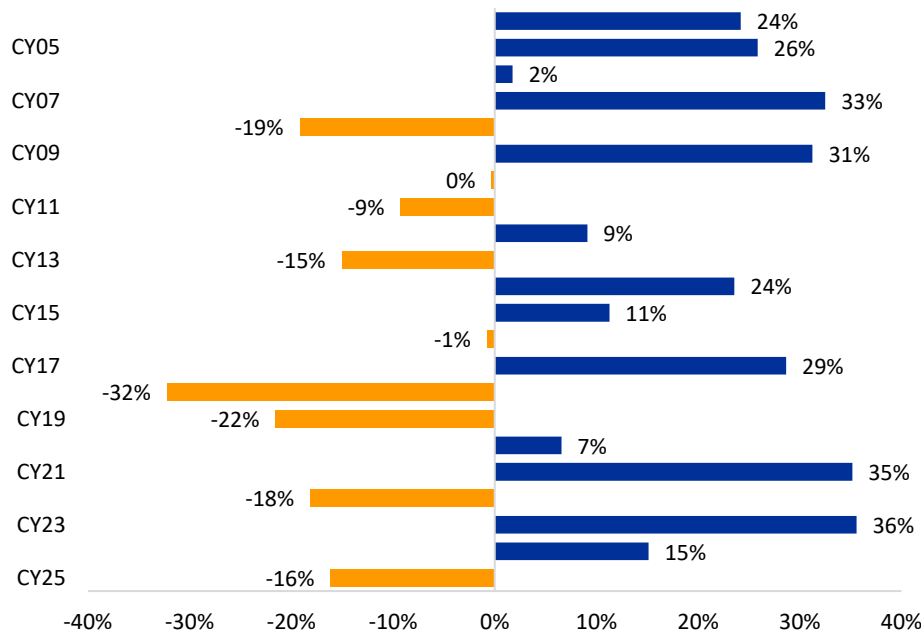
Source: ISec, Valentis Research

## #3: Sharp under-performance of small caps leads to better returns going forward

Historically, after any year of an underperformance of small caps relative to large caps we have seen the subsequent year belong to the small caps. The only 1 exception over the past 22 years has been in CY19 where we saw small caps continue to underperform after their poor show in CY18. Given the sharp underperformance in CY25, we think probability of CY26 belonging to the small caps is high, especially with a likely rebound in the earnings cycle.



**Chart 6: Outperformance/Underperformance of Nifty Smallcap 100 vs Nifty 50**



Source: AceEquity, Valentis Research

#### #4: Cycle of small caps also indicate longish spell of strong returns

Small caps are a classic “buy pessimism, sell euphoria” trade. If we see small cap cycles, median downturns last for around 15 months while upturns last for around 23 months. Median drawdown in a downturn is 31% while median returns in an upcycle is 137% (excluding outlier).

One reason we expect a lower than median return in this upcycle is that starting valuations are higher than in historic upturns. However, we would still expect returns in the small caps of around 20-25% compounded over next 2 years.

**Table 2: Small cap Downturn Cycle**

Date		Nifty Smallcap 100	No. of Days	CAGR
Beginning	Ending	Loss (%)		
01-01-2004	24-06-2004	-26%	175	-46%
04-01-2008	06-03-2009	-77%	427	-72%
05-10-2010	30-12-2011	-41%	451	-35%
04-07-2014	26-02-2016	-21%	602	-13%
12-01-2018	03-04-2020	-64%	812	-36%
14-01-2022	17-06-2022	-31%	154	-58%
13-09-2024	27-03-2026	-20%	560	-13%

Source: AceEquity, Valentis Research

**Table 3: Small cap Upturn Cycle**

Date		Nifty Smallcap 100	No. of Days	CAGR	P/E (X) at beginning
Beginning	Ending	Gain (%)			
24-06-2004	04-01-2008	712%	1289	81%	6.4
06-03-2009	05-10-2010	232%	578	114%	13.0
30-12-2011	04-07-2014	103%	917	33%	9.1
26-02-2016	12-01-2018	119%	686	52%	21.4
03-04-2020	14-01-2022	242%	651	99%	13.9
17-06-2022	13-09-2024	137%	819	47%	24.7
27-03-2026	?	?	?	?	28.4

Source: AceEquity, Valentis Research

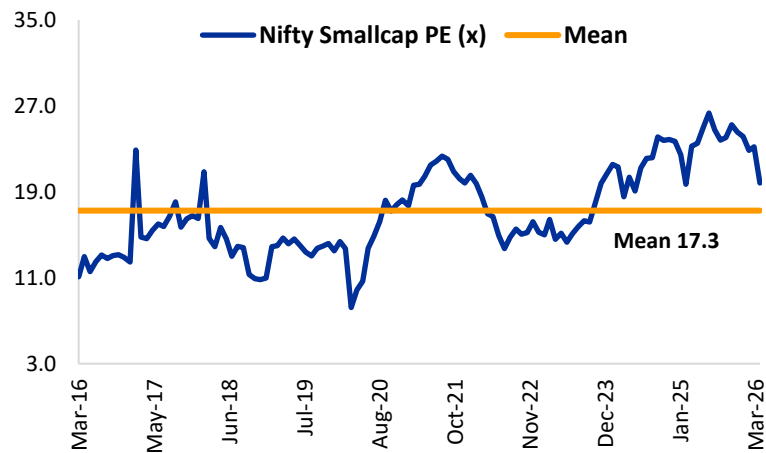


## #5: Valuations – not deep value but provides favorable risk: reward

For the past 2 years we have been worried about stretched valuations in the small cap space. The good news is that valuations have been reasonable though they are not cheap like in some of the other periods from where small caps had a strong rally.

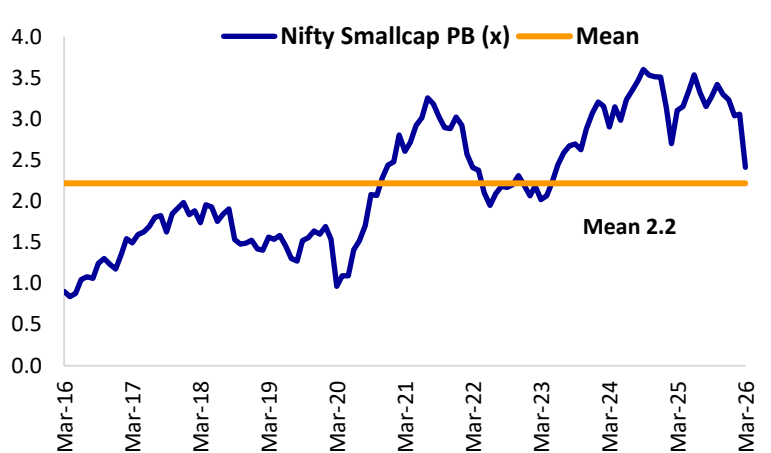
The small-cap trades at a 1 Yr Fwd PE of 19.8x, in line with 5-year average of 19.9x but still at a 15% premium to long term averages of 17.3x. Similarly, on a P/B small caps trade at 2.4x, below the 5-year average of 2.8x but at a 10% premium to long term average of 2.2x.

### Chart 7: Smallcap 12M P/E(x) – at 5Y average



Source: MOSL, Valentis Research

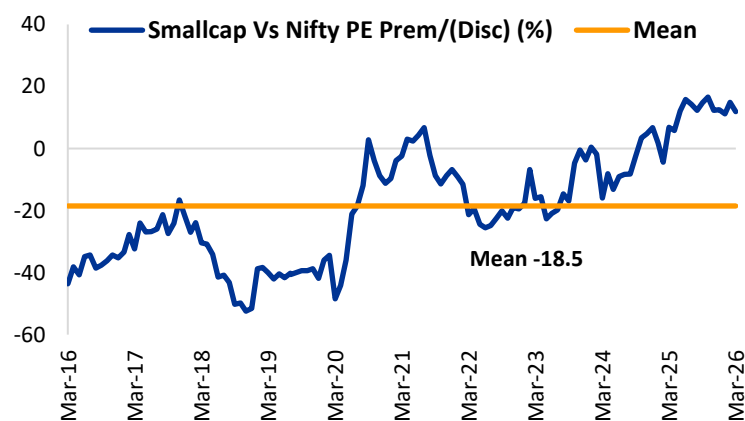
### Chart 8: Nifty Smallcap P/B (x) – below 5Y average



Source: MOSL, Valentis Research

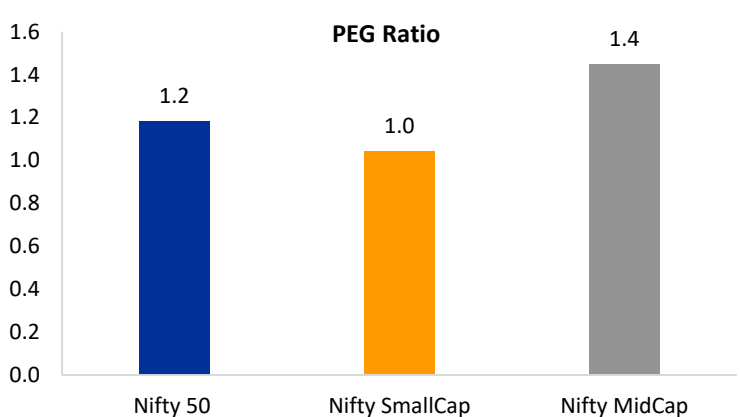
On a relative basis, however, small caps are still expensive trading at a 12% premium to large caps vs the 5-year average discount of 5.2%. But if we look at a PEG ratio, small caps appear cheaper than large and mid-caps. We must confess we are not great fans of PEG ratio. But our overall view is that despite not so cheap valuations small caps will deliver high returns if the earnings cycle revives as we expect.

### Chart 9: Smallcap PE at high vs Nifty PE



Source: MOSL, Valentis Research

### Chart 10: PEG Ratio – Smallcap appears cheapest



Source: MOSL, Valentis Research



## Portfolio Performance and outlook

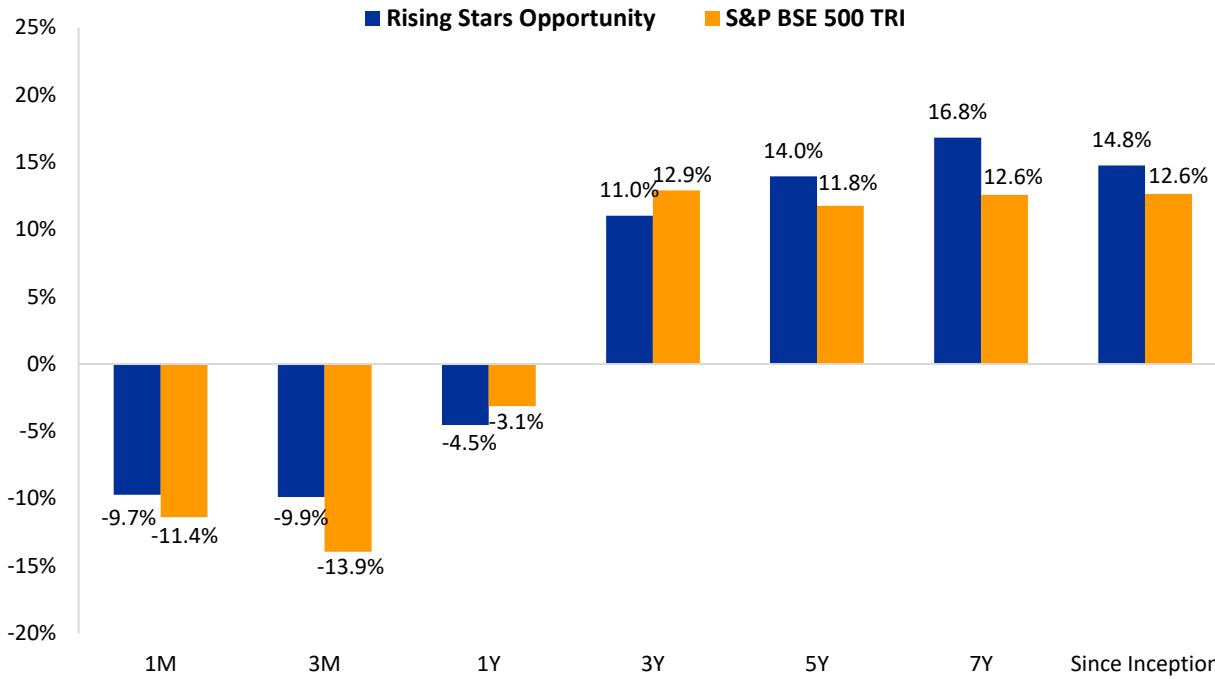
1. We continue with our theme of “buy local, avoid global”. In line with that theme nearly 90% of our portfolio has very minimal exposure to USA exports

US exports as % sales	Weightage	No. of stocks
Nil	74%	12
>0-10%	5%	1
10-20%	0%	0
20-40%	6%	2
40-50%	5%	1
Above 50%	0%	0

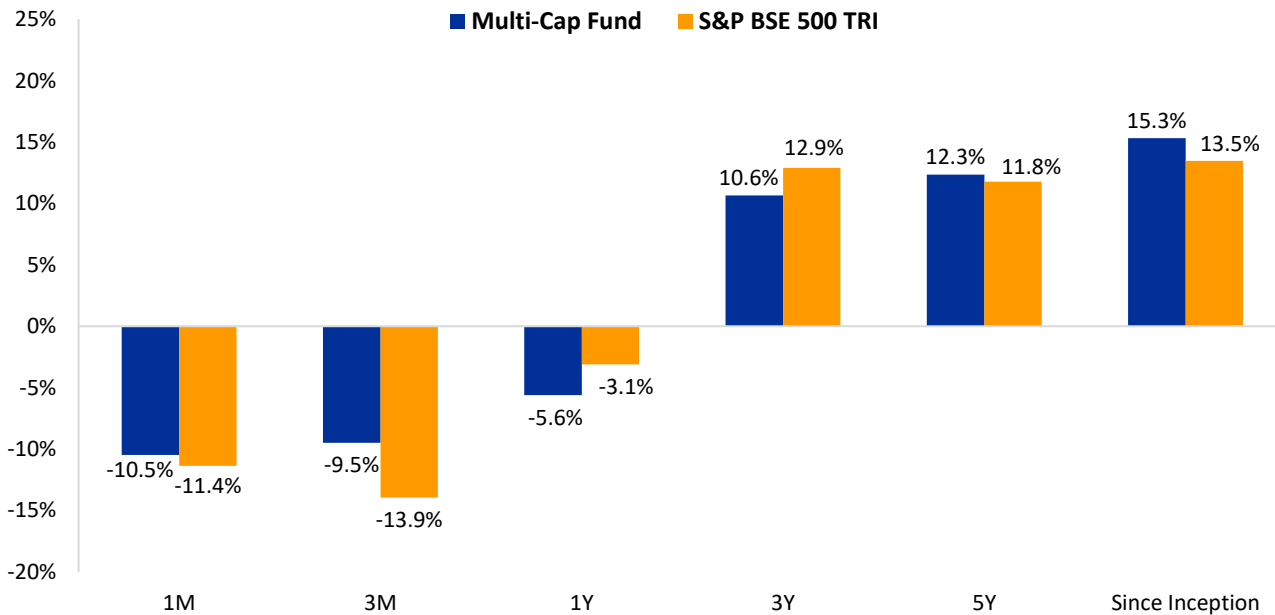
2. The high US export companies are in the pharma sector where tariffs are currently not applicable. We believe the tariffs on generics are unlikely. The other sector with global exposure is chemicals. We think Q4FY26 and Q1FY27 will be impacted by lower sales given the hike in freight rates and insurance costs post the Middle East conflict. However, we remain comfortable with longer term growth prospects and would look to add to our positions on any share price weakness post March results.
3. Our overall theme remains buying growth at a reasonable price. Going forward we have tried to maintain a portfolio with high earnings growth of near 30% 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.
4. While we have been cautious on the markets, we are currently positive on outsized returns over the next 18-24 months in the small cap space. We have reduced cash in the portfolio in the market weakness due to the Middle East crisis.
5. During the quarter, we reduced positions in the banking space following the sharp rally over past 1 year. We are adding to some underperformers in the pipe space. We expect the pipe segment to give share price returns of 30-50% this year as demand from the Jal Jeevan scheme recovers and rising raw material prices provide relief from inventory losses.



## Valentis Rising Stars Opportunity Fund Performance (as on March 31, 2026)



## Valentis Multi-Cap Fund Performance (as on March 31, 2026)



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## Appendix

**Table 4: Returns when market was flat for 18m**

Start	End	Return 18M (%)	Next 12M (%)	Next 36M (%)
7/31/2001	12/31/2002	1.92	71.9	159.4
8/31/2001	1/31/2003	-1.13	73.71	188.05
10/31/2001	3/31/2003	0.65	81.14	247.84
1/31/2007	6/30/2008	-1.03	6.2	39.77
3/31/2008	8/31/2009	-1.53	15.88	12.79
4/30/2008	9/30/2009	-1.59	18.61	12.18
2/28/2011	7/31/2012	-1.95	9.81	63.18
4/30/2011	9/30/2012	-0.8	0.56	39.37
5/31/2011	10/31/2012	1.07	12.09	43.53
12/31/2014	5/31/2016	-1.48	17.91	46.11
6/30/2015	11/30/2016	-1.72	24.34	46.59
9/30/2021	2/28/2023	-1.78	27.04	45.51
10/31/2021	3/31/2023	-1.76	28.61	28.64
8/31/2024	1/31/2026	-0.3	?	?
<b>Average</b>		<b>-0.8</b>	<b>30</b>	<b>75</b>
<b>Median</b>		<b>-1.3</b>	<b>18.6</b>	<b>45.5</b>

Source: Ace Equity, Valentis Research

**Table 5: Returns when market was negative for 18m**

Start	End	Return 18M (%)	Next 12M (%)	Next 36M (%)
30/11/2001	30/04/2003	-12.5	92.3	337.7
31/12/2001	31/05/2003	-4.9	47.4	326.7
31/05/2007	31/10/2008	-32.8	63.3	94.7
30/06/2007	30/11/2008	-36.2	82.7	113.4
31/07/2007	31/12/2008	-34.7	75.8	99.6
31/08/2007	31/01/2009	-35.6	69.8	109.9
30/09/2007	28/02/2009	-45.0	78.1	106.0
31/10/2007	31/03/2009	-48.8	73.8	88.1
30/11/2007	30/04/2009	-39.7	51.9	70.7
31/12/2007	31/05/2009	-27.5	14.3	34.5
31/01/2008	30/06/2009	-16.5	23.8	36.1
29/02/2008	31/07/2009	-11.2	15.8	23.8
31/05/2008	31/10/2009	-3.3	27.7	33.7
31/03/2010	31/08/2011	-4.7	5.1	59.4
30/04/2010	30/09/2011	-6.3	15.4	60.8
30/06/2010	30/11/2011	-9.0	21.7	64.2
31/07/2010	31/12/2011	-13.8	27.7	71.8
31/08/2010	31/01/2012	-3.8	16.1	45.5
30/09/2010	29/02/2012	-10.7	5.7	29.7
31/10/2010	31/03/2012	-12.0	7.3	46.1
30/11/2010	30/04/2012	-10.5	13.0	49.6
31/12/2010	31/05/2012	-19.7	21.6	65.7
31/01/2011	30/06/2012	-4.1	10.7	57.0
31/03/2011	31/08/2012	-9.9	4.1	67.1
31/08/2014	31/01/2016	-4.9	13.2	58.2
30/09/2014	29/02/2016	-12.3	27.1	60.3
31/10/2014	31/03/2016	-7.0	18.5	11.1
30/11/2014	30/04/2016	-8.6	18.5	25.6
31/01/2015	30/06/2016	-5.9	14.9	24.3
28/02/2015	31/07/2016	-3.0	16.7	28.2
31/10/2018	31/03/2020	-17.2	70.9	159.7
30/11/2018	30/04/2020	-9.3	48.4	129.3
31/12/2018	31/05/2020	-11.8	62.7	135.2
31/01/2019	30/06/2020	-4.9	52.6	133.1
30/04/2019	30/09/2020	-4.3	56.6	129.5
30/09/2024	28/02/2026	-2.4	?	?
31/10/2024	31/03/2026	-7.7	?	?
<b>Average</b>		<b>-14.9</b>	<b>36.1</b>	<b>85.3</b>
<b>Median</b>		<b>-10.5</b>	<b>23.8</b>	<b>64.2</b>

Source: Ace Equity, Valentis Research



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