Valentis Advisors

Oil headwinds vs earnings tailwinds

July 24, 2026

Our positive view on markets, especially the small caps, (see report https://www.valentisadvisors.com) have borne out with a rally of 21.9% in the small cap index in FY27 YTD. With markets being flat over past 2 years, we continue to remain positive on markets and expect small caps to outperform large caps over the next 18-24 months. However, near term markets could see some volatility and consolidation if oil prices continue to remain high due to the Middle East crisis.

1. **Earnings revival: Earnings over past few 2 years have grown at 5% CAGR. What is changing? We see earnings aggregating 15% CAGR over next 2 years. The small cap earnings will grow at 22%, faster pace than the large caps. Earnings for the June quarter are likely to exceed 10% YoY and are likely to be the best growth in the last 8 quarters.**
2. **India's huge underperformance starting to ease: The Indian market in the first 6 months has been one of the worst performing global markets, under-performing EM index by 37% (in $ terms). Even last year, the Indian market underperformed emerging markets by 26.7% (in $ terms). What is changing? With the volatility in AI stocks globally, we are starting to see Indian markets outperform (India has outperformed emerging markets 8.3% over past 1 month – in $ terms). A record under-performance to global markets and extreme under-ownership should help better performance of India.**
3. **The bulk of FII selling is behind us? FIIs sold US$ 28.9 bn in the first 6 months of CY26 on top of a selling of US$ 18.8 bn in CY25. What is changing? In this ongoing July month, FIIs have bought US$ 1.7 bn of Indian stock. We think FII selling will ease going into the rest of the year led by both a push from worries on AI stocks and pull from a revival in earnings in India.**
4. **Rupee stability will ease macro concerns; but rising oil prices are a big risk: The rupee has depreciated more than 10% over the past year and nearly 7% in CY26YTD. What is changing and what is not? We think the rupee will stabilize with the FCNR flows likely to aggregate US$50-70 bn. However, oil has rallied sharply with the Middle East conflict flaring up again. This could again create concerns on macro stability.**

#1: Turn in earnings cycle – small caps to recover faster

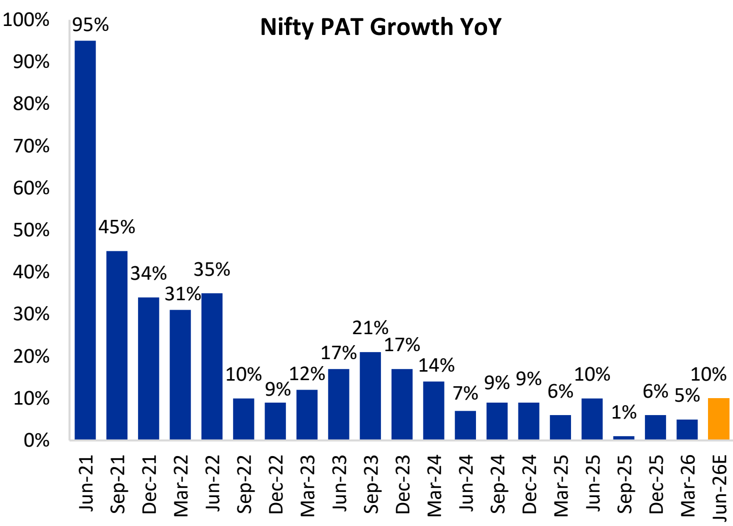
We have seen a prolonged spell of weak earnings with single-digit growth or low double-digit growth for the past 8 quarters. Nifty earnings have grown at a CAGR of 5% over past 2 years. Earnings were set to recover from the Q4FY26, but the Iran conflict led to a lower growth than expected. However, we are seeing topline of domestic corporates being largely insulated though margins may come under pressure.

What is changing?

Despite some conflict-related weakness in Q1FY27, we think earnings growth at over 10% YoY will be the fastest over past 8 quarters. For the full year of FY27e as well, we see a sharp revival in earnings to over double digit though there could be some downgrades to the consensus 15% estimates.

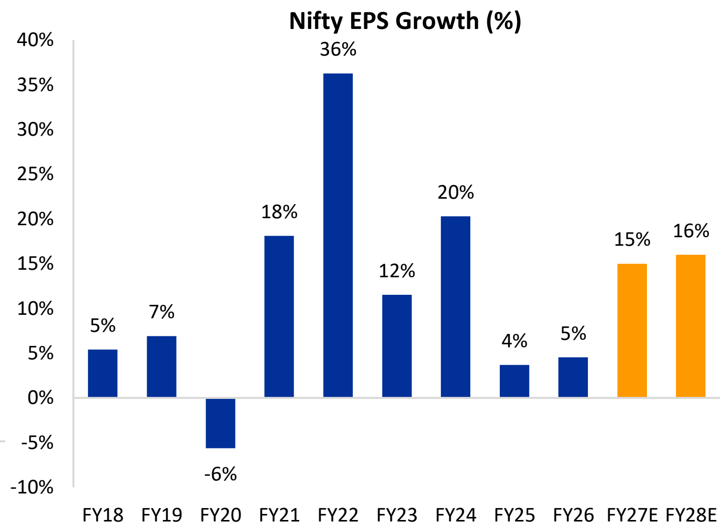
The overall earnings growth will be driven by financials mainly led by NBFCs which will grow 27% YoY. Metals (+31% YoY) and Telecom (3.3x YoY jump in profit, driven by Bharti Airtel and reduction in losses of Vodafone Idea) are the other contributors to earnings. Amongst the smaller sectors, building materials (36% YoY) and EMS (+29% YoY) will show strong growth.

Chart 1: Expect Nifty PAT to grow by 10% in Q1FY27e



Source: MOSL, Valentis Research

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

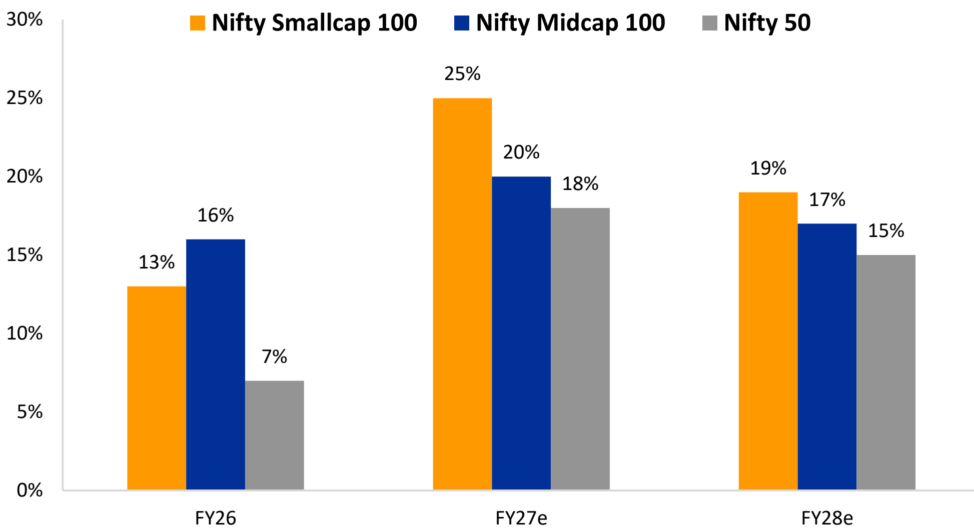


Source: MOSL, Valentis Research

SMID will lead earnings revival

While earnings will recover for corporate India in general, we see the fastest growth in the small-cap segment. The small cap segment lagged in Q1FY26 but has seen a sharp recovery in earnings over the past 3 quarters. We see this trend continuing.

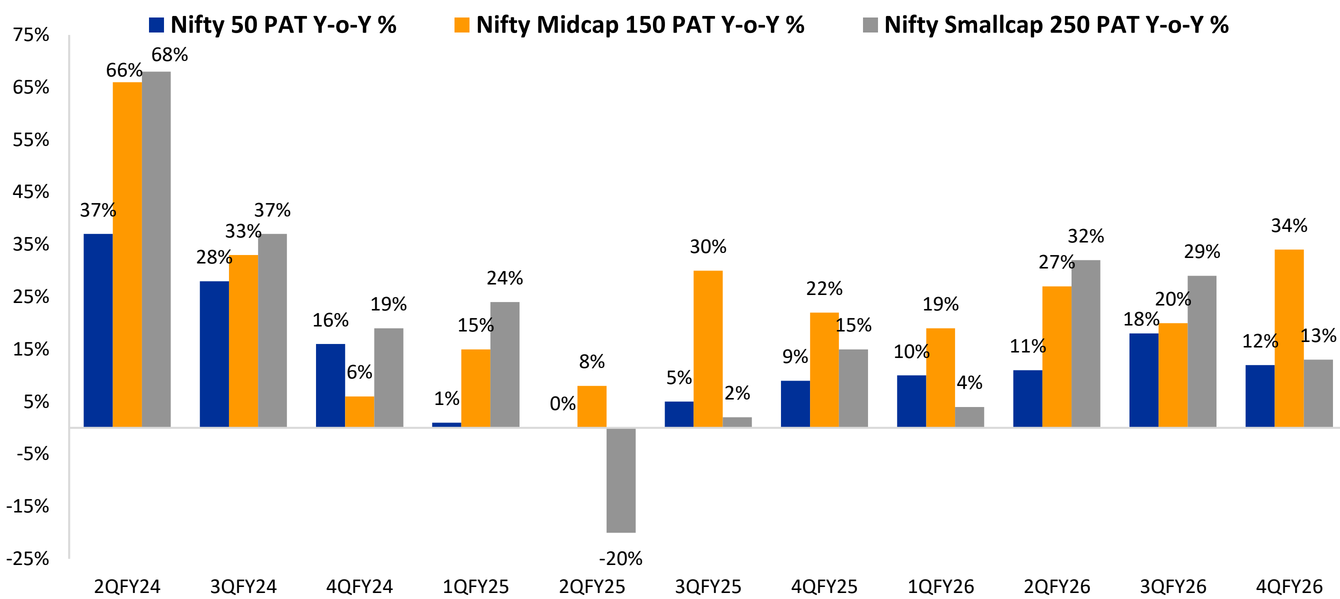
Chart 3: Earnings forecast profile – PAT growth YoY



Source: ISec, Valentis Research

These are not just forecasts, as signs of earnings recovery are also visible. We have already seen the past 3 quarters lead to a rebound in small cap earnings growth.

Chart 4: Midcap and Smallcap earnings reviving

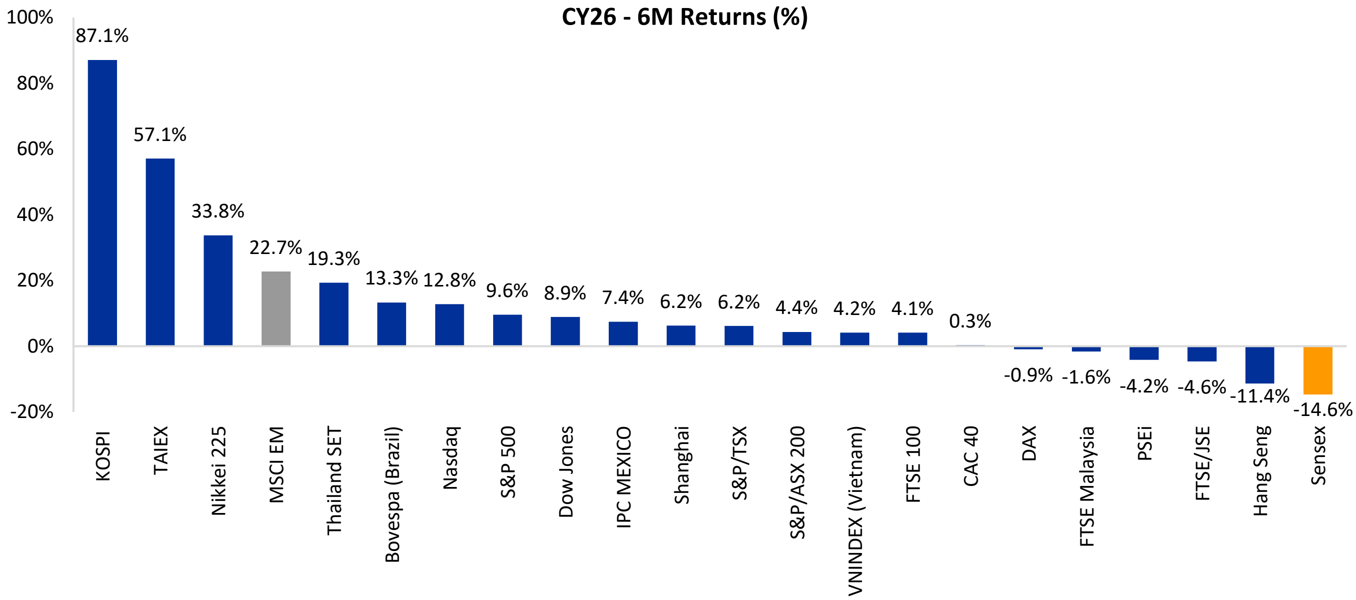


Source: MOSL, Valentis Research

#2: Light positioning can lead to better performance

India has been one of the worst performing markets in the world, underperforming emerging markets by nearly 37% (in $ terms) in the first 6 months of this CY. This follows a dismal CY25 in which India underperformed emerging markets by a whopping 27% (in $ terms).

Chart 5: India - the worst performer in the first 6 months of CY26 (in $ terms)



Source: MOSL, Valentis Research. Data as on 30th June 2026

What is changing?

India has been a relatively strong performer over the past month outperforming emerging markets by 8%. We think 2 factors are driving this better performance:

1. Firstly, we are seeing a pullback in markets that have performed well since the beginning of the year (and indeed in the last year), especially Korea. Relative underperformers like India have stood their ground. One thing we must remember is that a large part of the negative returns in India this year is a function of the currency depreciation. Local investors have been resilient (reflected in the stable SIP flows) since they have not seen a sharp negative return YTD, though returns over the past 2 years have been mediocre.

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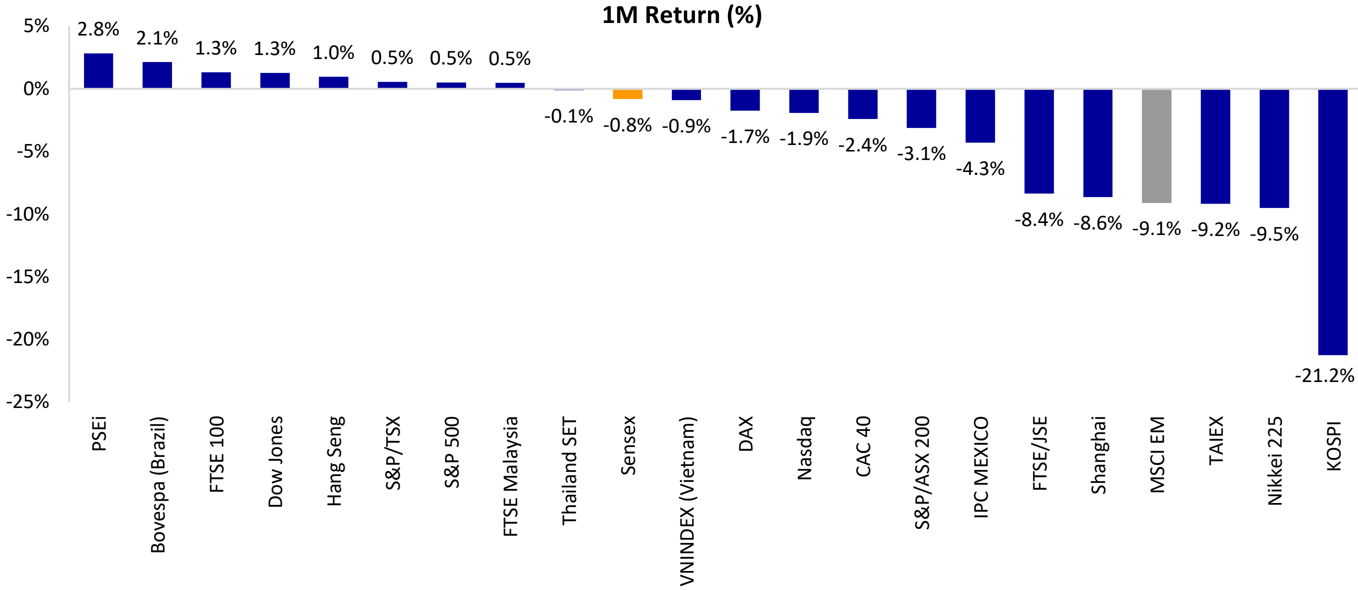
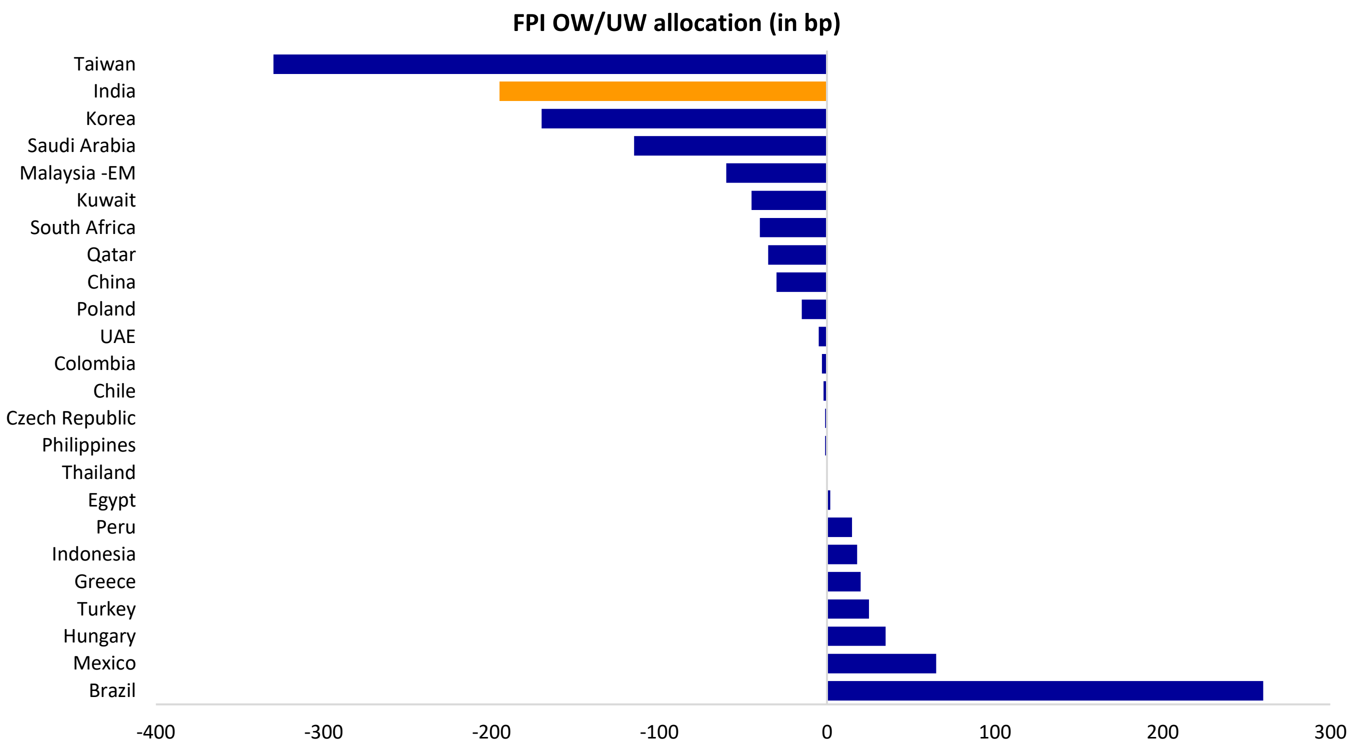
Chart 6: India – Turnaround in the performance in the past 1 month



Source: MOSL, Valentis Research. Mote: Data considered – 17th June-17th July 2026

2. Secondly, the extreme low positioning on India probably means incrementally we will probably see an increase in India weight to cut down on a record underweight.

Chart 7: India one of the most underweight markets in EM Funds



Source: EPFR, Various reports, Valentis Research

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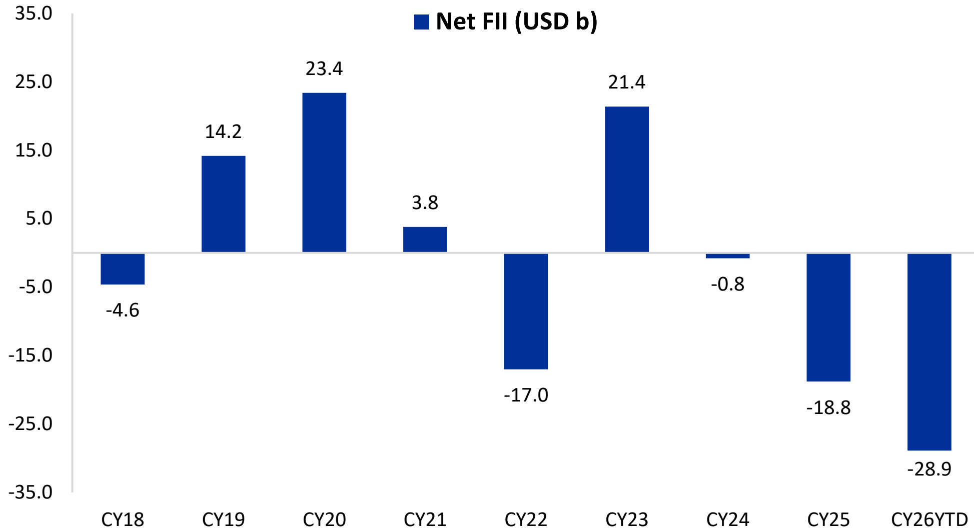
#3: Bulk of FPI selling behind us?

We have seen FPI selling nearly US$ 28.9bn in the first 6 months of CY26 so far, a record negative figure. Even in the last year we saw selling of nearly US$ 18.8bn.

Chart 8: FII outflows has been the highest in the last few years

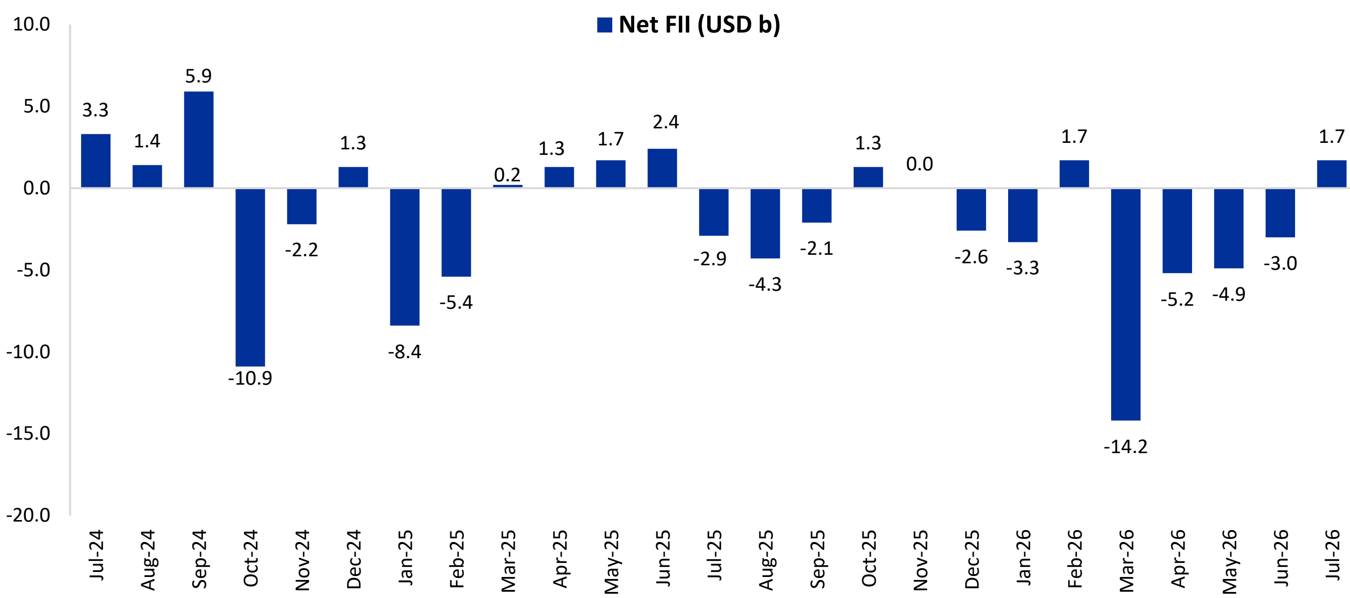


Source: MOSL, Valentis Research. Data as on 30th June 2026

What is changing?

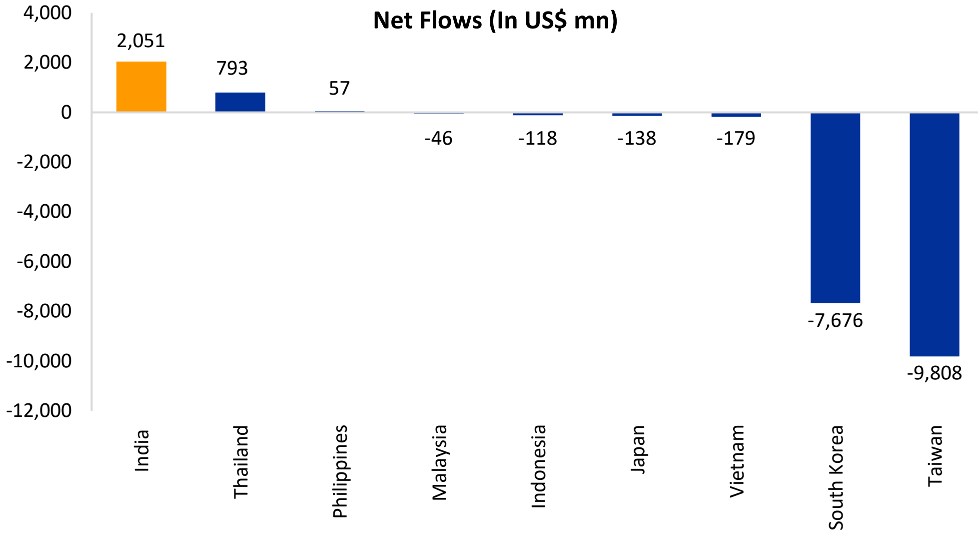
The good news is that FPI selling has reversed with positive net flows of US$1.7 bn in this ongoing July month. Even on a relative basis, India has seen the best flow in the region (see chart).

Chart 9: FII flows which were weakened in the past 4 months have started to turnaround



Source: MOSL, Valentis Research

Chart 10: India records Highest FPI inflows in Asia so far in July



Source: FE, Valentis Research. Note: India – includes primary and secondary markets – includes provisional data on 10th July 2026. Data as on 10th July 2026

So, is this sustainable?

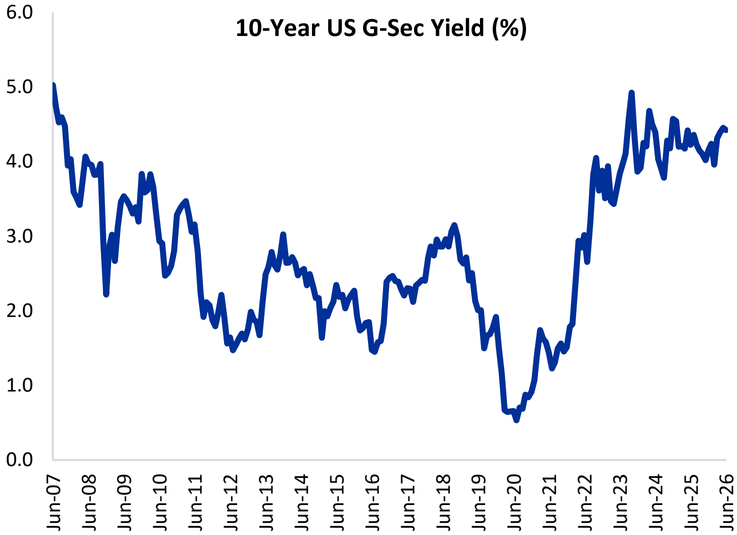
We think FPIs are unlikely to increase their UW position on India in any meaningful way. Extreme negative positioning means it is likely they will raise India weight in their portfolio to less underweight or neutral. 2 factors will drive this:

1. A revival in India's earnings growth as discussed earlier.
2. A moderation of the extreme focus on the AI trade: We believe AI is here to stay and will materially alter the world. Yet stocks have probably discounted a fair bit of good news. If we see the hyperscalers vs the pick and shovel companies (eg TSMC, SK Hynix etc.), the pick and shovel companies have outperformed the hyperscalers. SK Hynix with DRAM exposure is one standout within the emerging market space. The Mag-7 companies in the USA have already under-performed the S&P500 this year as investors take some profit off the table. The profitability of the huge capex they are undertaking is already being questioned. However, till a month ago the DRAM companies have been on a dream run. The recent volatility will lead to investors starting to look at some non-AI names to better balance their portfolio.

While we are positive on relative flows to India, we are cautious on overall equity flows in general on 2 counts:

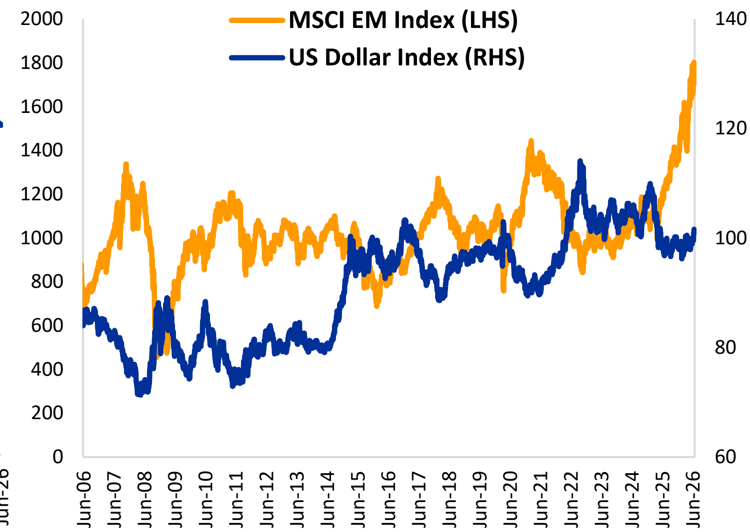
- The rise in bond yields in the US with the Fed worried about inflation could lead to lower flows to equities in general.
- Strengthening of the US dollar is generally negative for flows to emerging markets.

Chart 11: US Bond Yield is near pre-GFC levels



Source: Investing.com, Valentis Research

Chart 12: Strong dollar is negative for EM equities



Source: Investing.com, Valentis Research

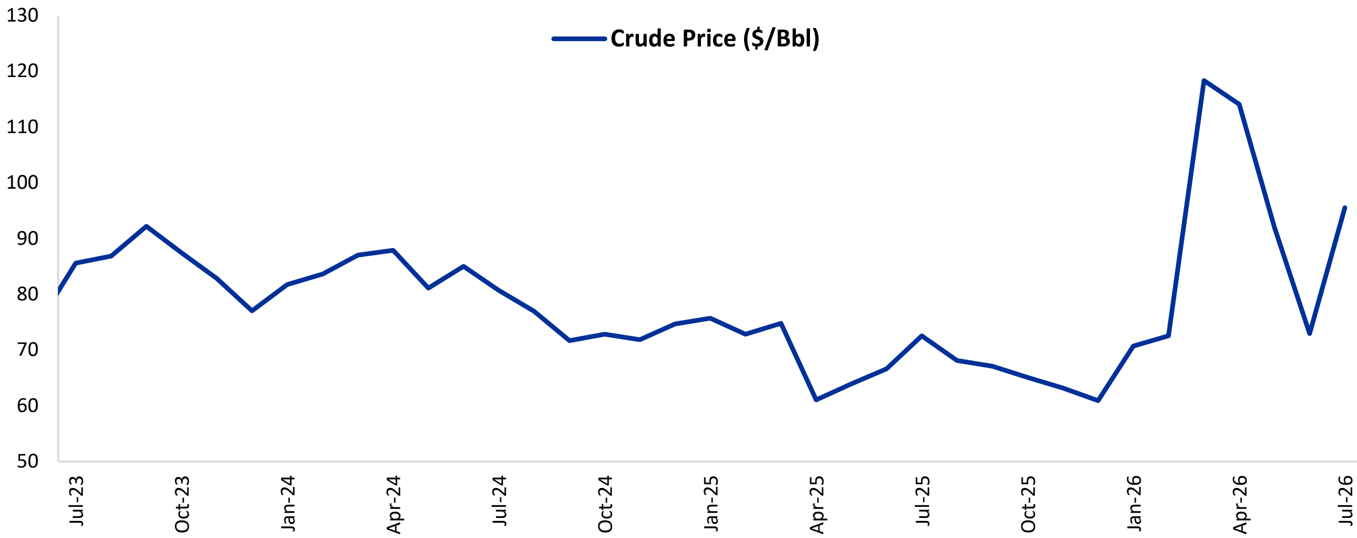
#4: Can oil disrupt macro stability?

The start of the Gulf war had led to fears of India's twin deficit coming under pressure. This was reflected in a sharp depreciation of the rupee which fell 7% this year.

What is changing?

Oil prices fell sharply as soon as the MoU was signed between Iran and USA. Oil has rallied again with the start of hostilities, but the rally has been less sharp than what we had witnessed at the start of the conflict in March. However, with Houthis also jumping into conflict, prices are now heading back towards the peak we saw a few months ago. We hope that there is some pause in the conflict in the Middle East. Oil prices can also correct sharply as we saw in June. However, higher prices remain a big risk with every $10/brl increase leading to an increase of ~0.4% in current account deficit (see report https://www.valentisadvisors.com).

Chart 13: Crude oil prices have surged once again



Source: Oilprice.com, Valentis Research. Data as on 22nd July 2026

Will the fiscal deficit targets be met?

We think the Government has levers to manage the fiscal deficit to achieve its target of 4.3%

- There will probably be additional subsidies in form of cuts in oil excise duty and subsidy measures to help alleviate the poor monsoon. This could increase fiscal deficit by around 0.2% of GDP.
- However, this can be offset by increasing disinvestments and better tax collections. The Government's estimates for revenue collection had been conservative.
- One encouraging feature has been that through the conflict crisis over the past few months; the Government did not cut down on capital expenditure. The Government capex is up by 18.8% vs last year.

Rupee will benefit from FCNR flows but oil is a risk

We have already seen a fall in the rupee of over 10% over the past year. If oil prices had stabilized, we would have been positive on the rupee with FCNR inflows likely to lead to inflows of $50-70 billion. However, rising oil prices can lead to pressure on the currency though the depreciation is unlikely to be as sharp as the past few months.

Monsoon remains a risk with El Nino – but sowing looking encouraging

With the IMD predicting a El Nino for this year and a below normal monsoon, one risk factor to the India growth revival story is poor rural demand driven by subdued kharif crop.

Rainfall continues to weaken

The bad news is that rainfall continues to weaken after a good spell towards end of June. The all-India cumulative rainfall deficit has widened progressively over the past three weeks, from -15% as of 8th July to -17.8% as of 12th July, and further to -23.8% as of 19th July.

The spatial distribution of rainfall has also turned less favorable with the share of the country's area recording deficient rainfall increased sharply to 65%, from 43% in the previous week. However, there is likely to be a revival in monsoon over next 2 weeks as per forecast.

Table 1: Rainfall Status

Region	Season Actual (mm)	Season Normal (mm)	Season Departure (%)
East & Northeast India	387.3	595.5	-35
Northwest India	152.0	198.5	-23
Central India	309.2	359.0	-14
South Peninsula	207.0	283.2	-27
Country as a Whole	**253.2**	**332.5**	**-24**

Source: IMD, Dolat Capital, Valentis Research. Season = 1st June-19th July 2026

Reservoir status is mixed news

While the reservoir level is only 34.5% of capacity vs 56.6% last year, it is not so bad as it looks. The normal storage at this time of the year taking a 10-year trend is only 35.1%, in line with current reservoir levels. So, while substantially lower than last year, the reservoir level is close to normal levels.

Table 2: Reservoir Levels (% of Total Capacity)

Region	Current Year (%)	Last Year (%)	Normal Storage (%)
Northern Region	33.1	44.8	36.5
Eastern Region	28.5	49.3	29.4
Western Region	44.5	60.4	35.4
Central Region	36.8	51.9	35.7
Southern Region	28.4	65.3	36.2
Country as a Whole	**34.5**	**56.6**	**35.1**

Source: UPAg, Dolat Capital, Valentis Research. Data as on 20th July 2026

Cropping paints a positive picture

While the aggregate monsoons are dismal, sowing so far paints a more optimistic picture. Total crops are only 6% lower than last year and has seen a sharp jump from the 16% shortfall in the early part of the month. This is giving hope that agriculture crops may turn out to be better than feared.

Table 3: Crop-Wise Acreage

Crop (in Lakh Hectare)	2026	2025	YoY Change (%)
Rice	166.4	167.8	-1
Pulses	69.2	81.5	-15
Shri Anna cum Coarse cereals	119.0	134.1	-11
Oilseeds	147.1	155.7	-6
Sugarcane	57.6	56.7	2
Jute & Mesta	6.3	6.2	2
Cotton	92.5	98.4	-6
Total	**658.2**	**700.5**	**-6**

Source: UPAg, Dolat Capital, Valentis Research. Data as on 20th July 2026

Portfolio Performance and outlook

1. Our portfolio saw a sharp rally in the June quarter as the small caps bounced back from the war fears and our portfolio companies saw a strong growth in earnings.

2. We have not changed our long-standing theme of “buy local, avoid global”. In line with that theme nearly 88% 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

3. The high US export companies are in the pharma sector where tariffs are currently not applicable. While import tariffs on generics in the USA can rise sharply after 2 years, it is zero till then. We think with elections in the USA likely in 30 months, we are not unduly concerned about the proposed tariffs. The other sector with global exposure is chemicals. We think Q1FY27 and Q2FY27 will be impacted by lower sales given the hike in freight rates and insurance costs post the Middle East conflict. While we remain comfortable with longer term growth prospects, we expect near term weakness led by renewed conflict in the Middle East and tariff concerns in USA.

4. Our overall theme remains buying growth at a reasonable price. Going forward we have tried to maintain a portfolio with high earnings growth of nearly 30% while keeping valuations below the market at a PE of 18x. We think this will help us achieve a good return in the portfolio despite the likely volatility in the markets.

5. Near term market may see some volatility but we are positive on outsized returns over the next 18-24 months in the small cap space. For new investors we are deploying money in a staggered manner over next few weeks.

6. During the quarter, our increase in pipe exposure in the previous quarter paid rich dividends. We continue to like the pipe space as demand from the Jal Jeevan scheme recovers and rising raw material prices provide relief from inventory losses. We have added exposure to real estate during the quarter following under-performance in share prices. We have also added weight to a recycling company where we had reduced our stake last year due to steep valuations. Cheap valuations following a sharp drop in share prices and a recovery in earnings will lead to a rally in share prices.

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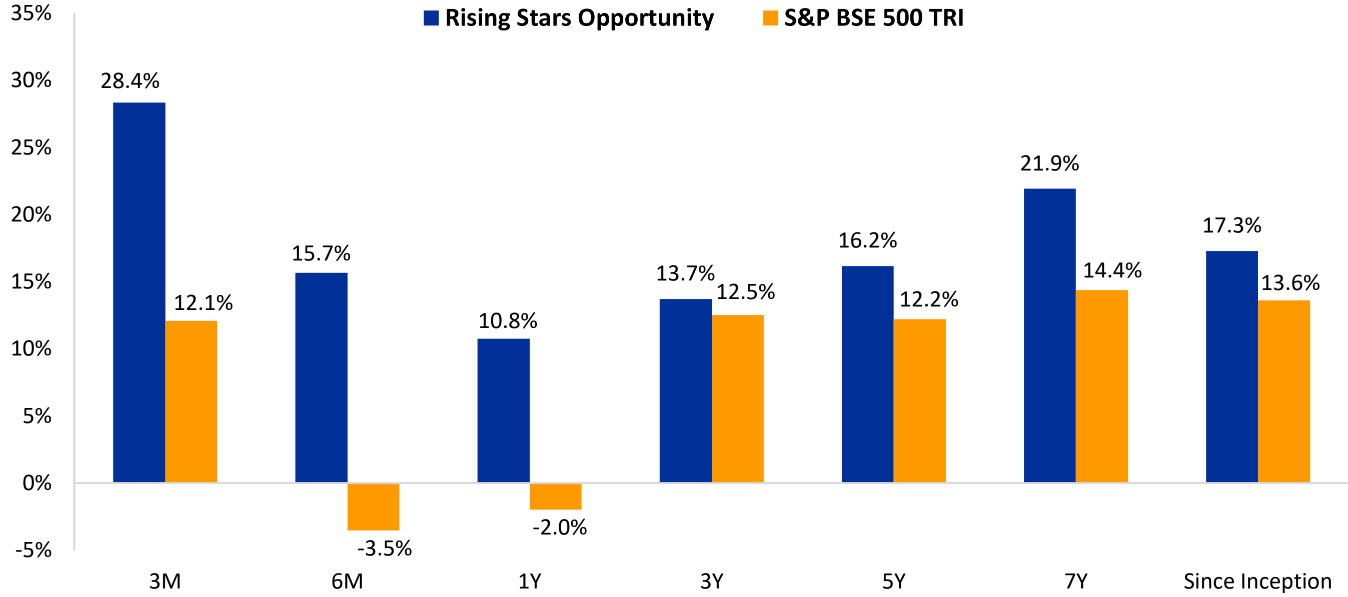
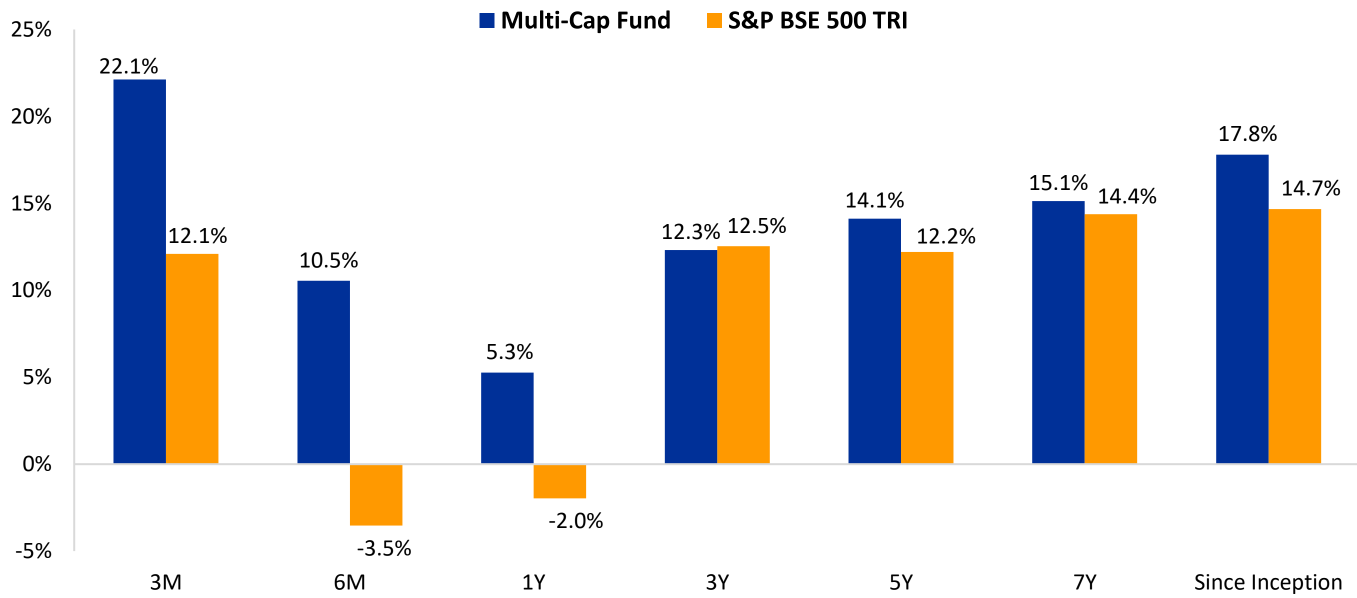
Valentis Rising Stars Opportunity Fund Performance (as on June 30, 2026)



Valentis Multi-Cap Fund Performance (as on June 30, 2026)



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