Valentis Advisors

Safe Haven but a stormy world

October 18, 2022

Market Outlook – Range-bound markets; a fall in the US$ will lead to risk-on rally

We started CY2022 expecting markets to be a range-bound with flattish returns. So far, the market has been in line with our expectations, almost flat for the year. However, what has surprised us has been the resilience of the India markets in the global turmoil. While an almost flat market looks disappointing, it is remarkable in the context of most global markets being down 15-20%.

Fundamental news flow will be incrementally negative…

As we explain later in the note, we think fundamental news both in India and especially in the US will be negative and valuations are not cheap.

1. The Fed is determined to kill inflation even at the cost of a slow-down in the economy.
2. We think a recession in the US and Europe appears inevitable.
3. While India will be the fastest growing economy, we will also see slower economic growth.
4. We think more than growth the stress point of India could be the external account with a rising Current Account Deficit and falling foreign exchange reserves.

…. but markets bottom before the economic news turns positive

While valuations are not cheap and the economic outlook remains clouded, markets have fallen this year in most parts of the world. Markets will rally ahead of the economic news turning positive. While we still stick to our view of a range-bound market, we must point out that after a 20% fall in the Dow Jones, it rallied on an average 17% in the next one year and given a double digit return in 7 of the 10 instances. A positive global market will help India too.

Table: 1 Year S&P 500 return after falling 20% from record high (since 1950)

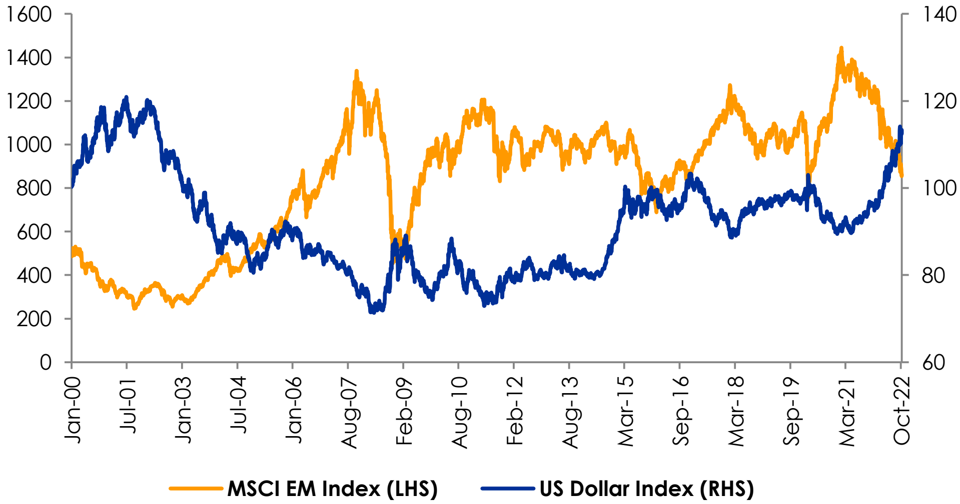
Date	1 Yr Return
Oct\57	32%
May\62	33%
Aug\66	27%
Jan\70	14%
Nov\73	-26%
Feb\82	34%
Oct\87	23%
Feb\01	-1%
Jul\08	-24%
Mar\20	59%
Jun\22	?
Average	**17%**

Source: investing.com, Valentis Research

Peaking of dollar will be signal bottoming of the equity markets…

The currency markets have seen turmoil that is even greater than the equity and debt markets. As an example, the yen and pound are trading at 25-35 year lows versus the US$. We think a peaking of the dollar index will signal a bottoming of the equity markets.

Chart 1: Dollar Index Vs MSCI EM Index when will the $ index peak?



Source: investing.com, Valentis Research

…. which can help flows to India

A peaking of the dollar index will help flows to emerging markets including India. The other positive for India is that our weight in the MSCI indices is rising. However, on the negative side, valuations are expensive on a relative basis. India now trades at over 100% premium to PE multiples of the MSCI EM index (see chart in Appendix).

Table 2: India's weightage in MSCI EM Index on the Rise

Top 15 Countries	05\Sep\22	31\Mar\22	31\Mar\21	31\Mar\20
China	29.1	27.5	35.5	36.1
India	14.1	12.8	9.6	7.7
Taiwan	13.7	15.5	13.7	12.1
South Korea	10.8	12.3	13.3	11.7
Brazil	5.3	5.7	4.5	4.8
Saudi Arabia	4.5	4.1	2.8	2.5
South Africa	3.3	3.9	3.7	3.6
Russia	3.0	1.8	3.0	3.2
Mexico	2.0	2.3	1.7	1.9
Indonesia	2.0	1.7	1.2	1.5

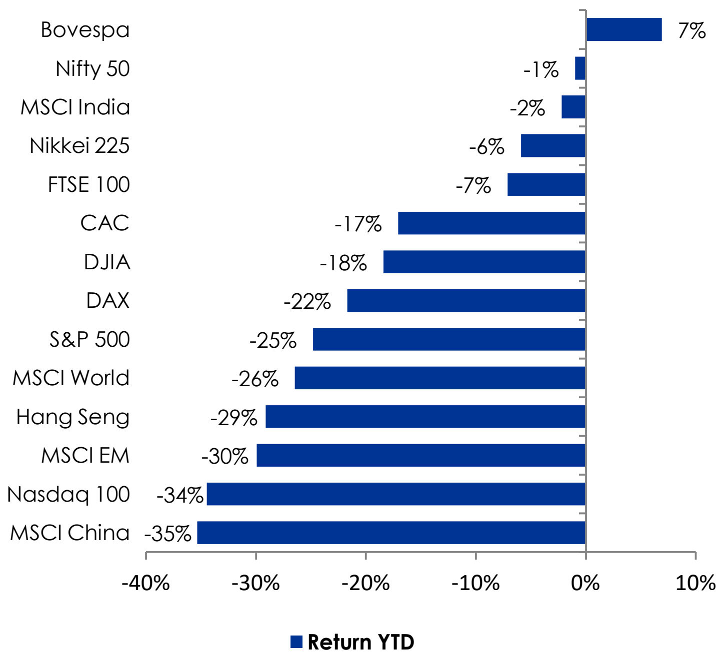
Thailand	2.0	1.8	1.9	2.2
Hon Kong	1.9	1.9	2.3	4.0
Malaysia	1.5	1.5	1.4	1.9
United Arab Emirates	1.3	1.4	0.6	0.5
Qatar	1.1	0.9	0.7	0.9

Source: brokerage report, Valentis Research

India has been a safe haven

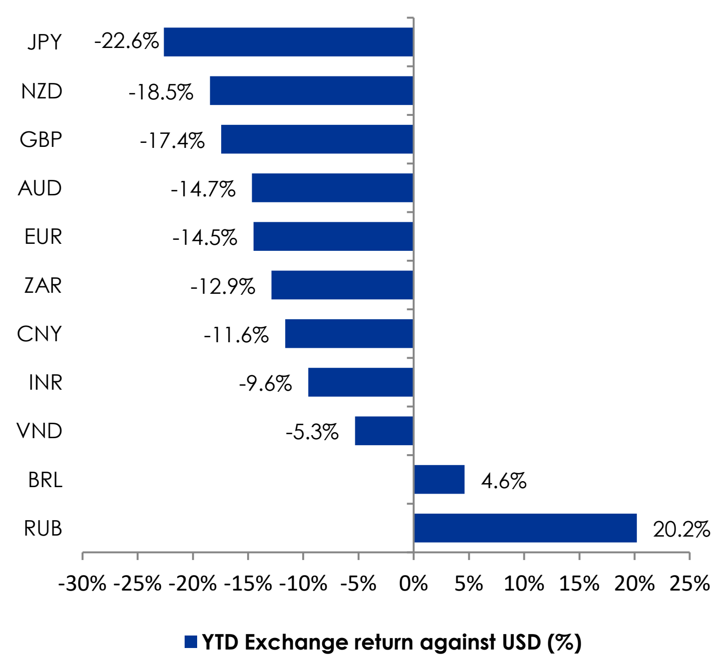
The world has clearly been in turmoil in all asset classes – equity, debt, commodities. The Indian stock market has behaved like it belongs to another planet, partly a function of its domestic economy appeal and partly as retail India continues to increase allocations to the market. While the rupee has weakened against the US$, it has appreciated against most other developed market currencies.

Chart 2: YTD return of Indices (%)



Source: investing.com, Valentis Research

Chart 3: YTD return of currencies against USD (%)

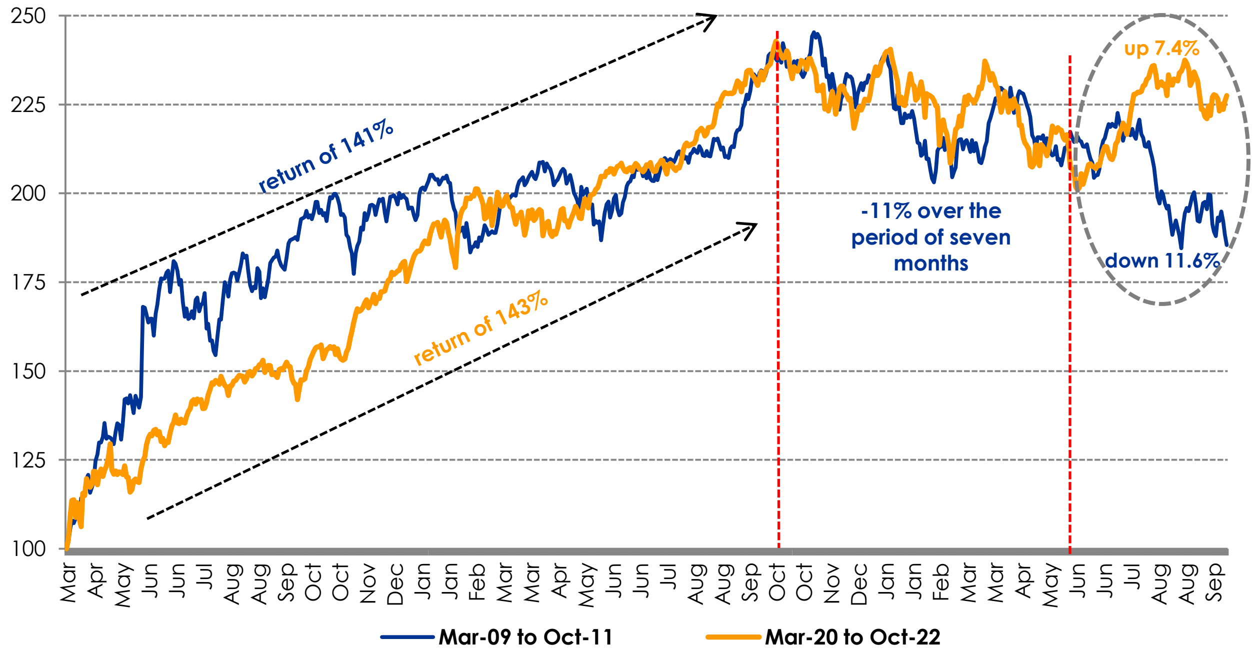


Source: investing.com, Valentis Research

History does not repeat itself but rhymes

Interestingly the trajectory of the Indian market from the lows of CY2009 and CY2020 were almost aligned till 3 months ago. Post that we have seen a sharp rally in markets now compared to a drop in 2011.

Chart 4: Market movement in 2020 mirroring the 2009 rally

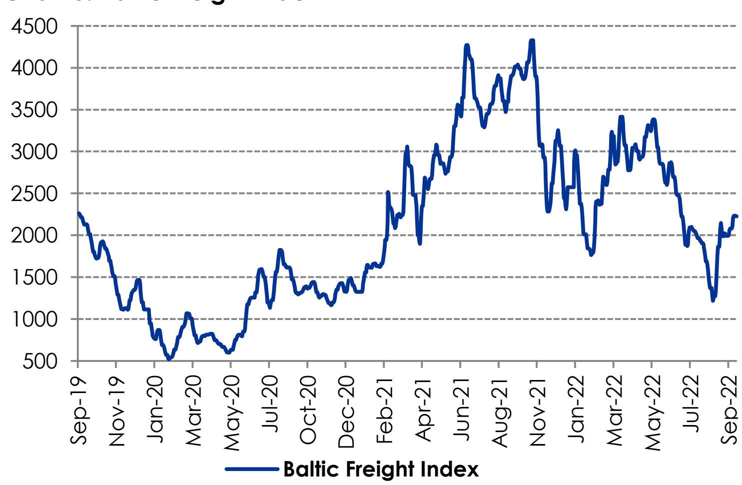


Source: ACE Equity, Valentis Research

#1: The Fed is determined to kill inflation

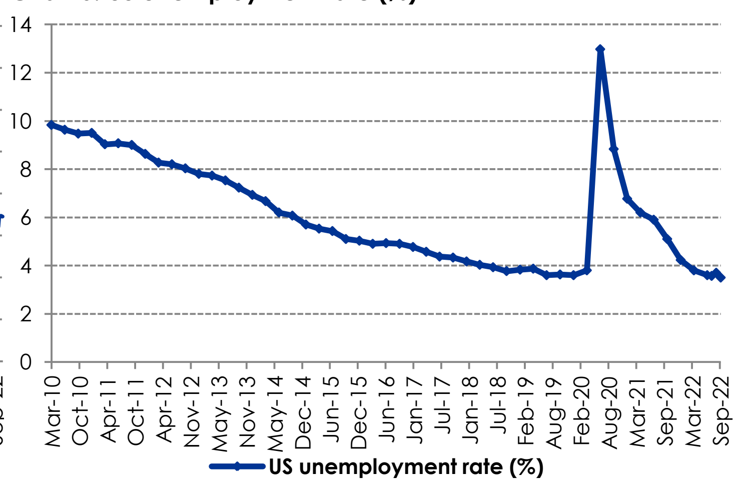
In our last report (https://www.valentisadvisors.com/insights/market-update-20th-july-2022/), we had stated that inflation has peaked but would not be anywhere near the Fed rate of 2%. Some cyclical parts of the inflation have clearly peaked – commodity prices are coming down and Covid related logistic bottlenecks are clearly easing (see chart 5 on global freight rates). But from the Fed point of view employment continues to remain strong and this means structural inflation will remain high.

Chart 5: Baltic Freight Index



Source: MOSL, Valentis Research

Chart 6: US unemployment rate (%)



Source: MOSL, Valentis Research

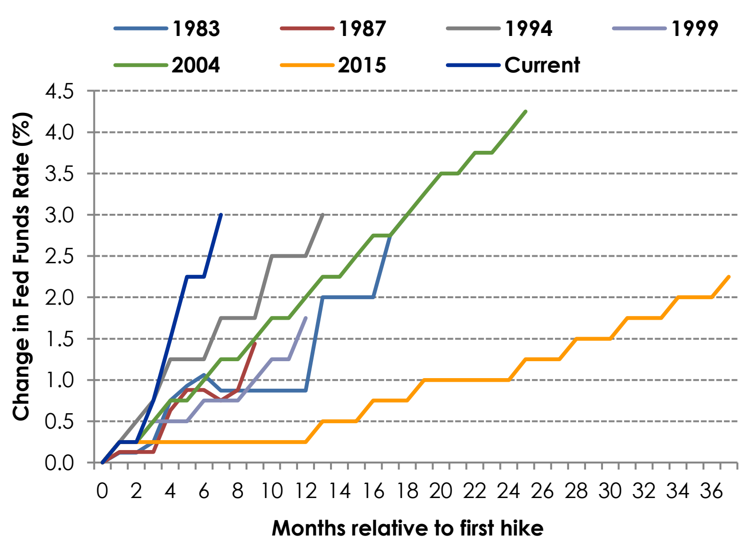
Fed is hiking rates as well as Quantitative tightening

The Fed stated very explicitly over the past couple of months that (a) they were determined to reduce inflation to their target of 2% (b) that they were willing to endure pain in the economy and even risk a recession as they try to control growth. Ideally wants to weaken the job market.

The Fed has hiked at the fastest pace in the past 50 years and they are not done yet. We expect a 75 bps increase in November and another 50-75 bps hike in December.

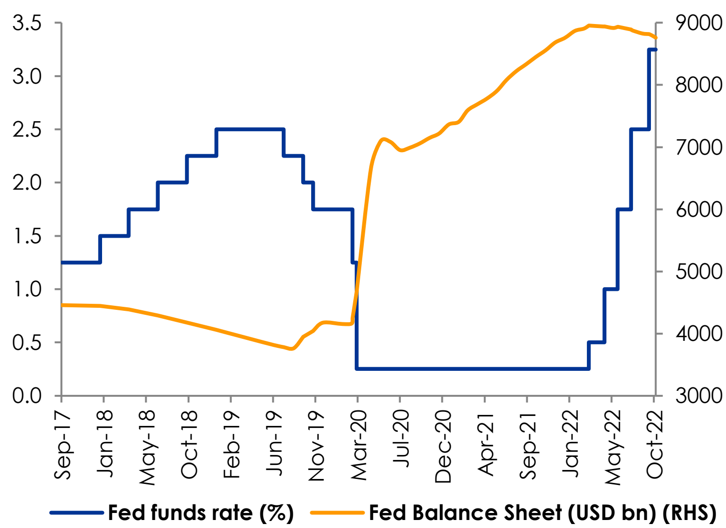
They are to start cutting their balance sheet by US$95 bn every month from September 2022. In the previous 3 months, we didn't see the US$47.5 bn decrease in June and July but August saw them going ahead with the reduction in the balance sheet as promised.

Chart 7: Fastest Fed rate hike cycle (%)



Source: Investing.com, Valentis Research

Chart 8: US Fed Rate & Balance Sheet Reduction



Source: Federal reserve, Valentis Research

#2: A US recession looks inevitable

A recession in the USA looks inevitable as the Fed rate increase as well as Quantitative Tightening (QT) starts to hurt consumer demand. We are starting to see hiring freezes and will likely see layoffs also by the end of the year. The question is how deep is the slow-down and a possible recession. Past history is that the probability of a Fed induced soft-landing is low. Yet this is a strange recession. Everyone is expecting a recession at a time when unemployment in the US is at historic lows. So it may not follow earlier cycles though they are useful to give us a perspective.

- An average recession in the USA lasts for 12 months and including the Great Depression (1929-1933), it lasts for 15 months.
- The average stock market returns during the recession has been flat excluding the Great Depression and -7% including the Great Depression period. However, the average masks a wide variation in the return with the Global Financial crisis producing the worst returns since the Great Depression.
- Post the recession, markets have seen a rebound with average returns aggregating 15% post the Great Depression period.

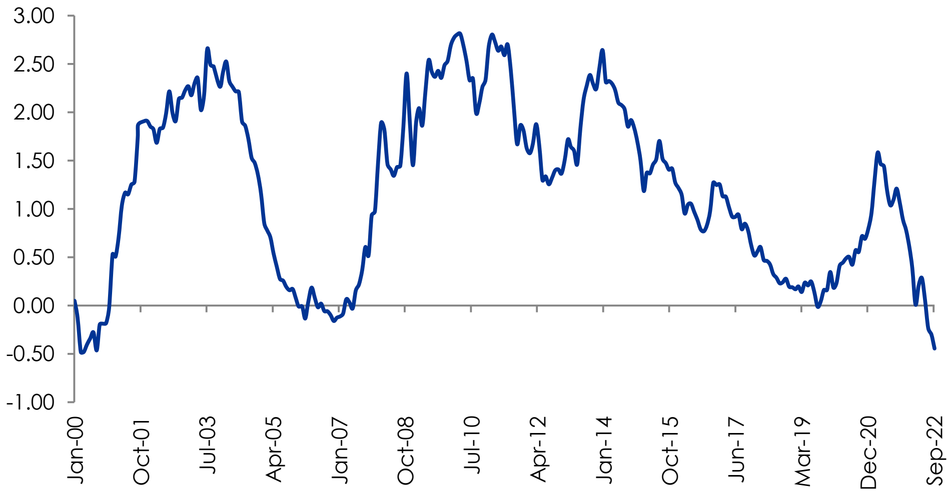
Table 3: USA Recession history – how do markets behave?

USA Recession History						
Sr. No.	Start	End	Duration	1Y DJI Return Pre	DJI Return During Recession	1Y DJI Return Post
1	Aug\29	Mar\33	3 yrs 7 months	58%	-85%	81%
2	May\37	Jun\38	1 yr 1 month	14%	-23%	-2%
3	Feb\45	Oct\45	8 months	18%	16%	-9%
4	Nov\48	Oct\49	11 months	-5%	11%	19%
5	Jul\53	May\54	10 months	-1%	19%	30%
6	Aug\57	Apr\58	8 months	-4%	-6%	37%
7	Apr\60	Feb\61	10 months	-4%	10%	7%
8	Dec\69	Nov\70	11 months	-19%	-1%	5%
9	Nov\73	Mar\75	1 yr 4 months	-19%	-7%	30%
10	Jan\80	Nov\82	2 yrs 11 months	4%	19%	23%
11	Jul\90	Mar\91	8 months	9%	0%	11%
12	Mar\01	Nov\01	8 months	-10%	0%	-10%
13	Dec\07	Jun\09	1 yr 6 months	6%	-36%	16%
14	Jan\20	Jun\20	6 months	13%	-9%	34%

Source: investopedia.com, investing.com, Valentis Research

The bond yield has been inverted for a couple of months now. The bond yield inversion has proceeded all US recessions (though not all bond yield inversions have led to a recession).

Chart 9: US Yield curve inversion – brief inversions seen so far

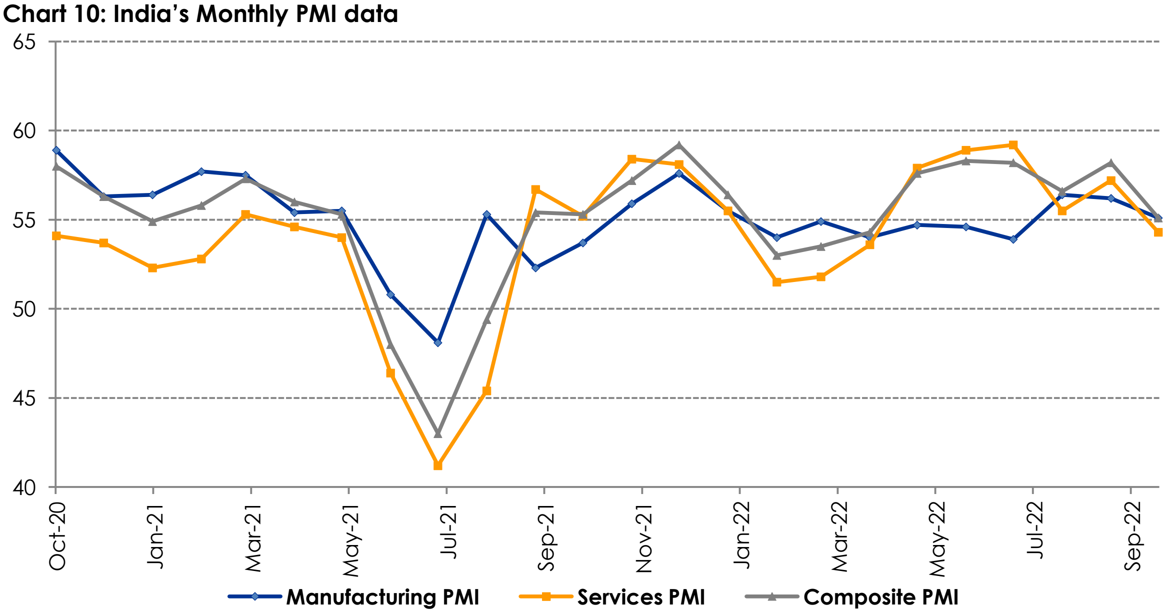


Source: Investing.com, Valentis Research

#3: Indian economy strong and relatively insulated – will be fastest growing large economy over next 3-5 years

There is no change to our broad thesis that the Indian economy will be one of the fastest growing economies in the world in this year as well as next few years. Domestic consumption as well as investment spend coupled with China+1, Taiwan+1 and now even Europe+1 are providing strong tailwinds to the economy. The PMI is in expansion mode still but the services PMI is showing a downturn and possibly the manufacturing PMI will also follow.

Chart 10: India's Monthly PMI data



Source: MOSL, Valentis Research

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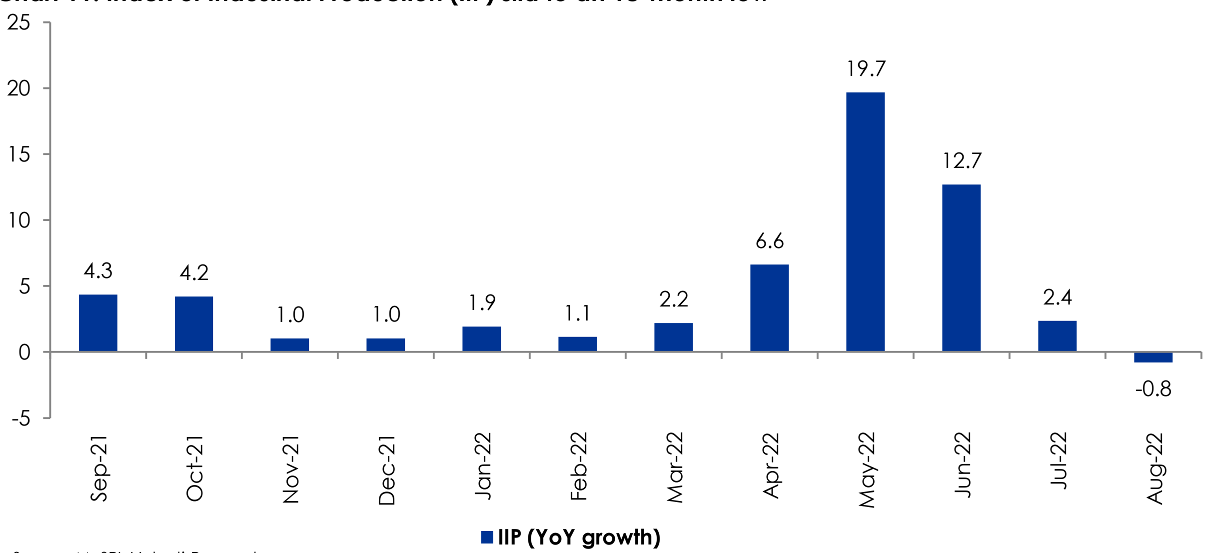
….but in an absolute level India too will feel the pinch of the global turmoil

a) **Some slow-down in economy:** The economy is starting to see some headwinds now. IIP growth is also starting to see mild slow-down. With a global recession, India too will see some impact and we think GDP growth could be 100-150 bps lower next year.

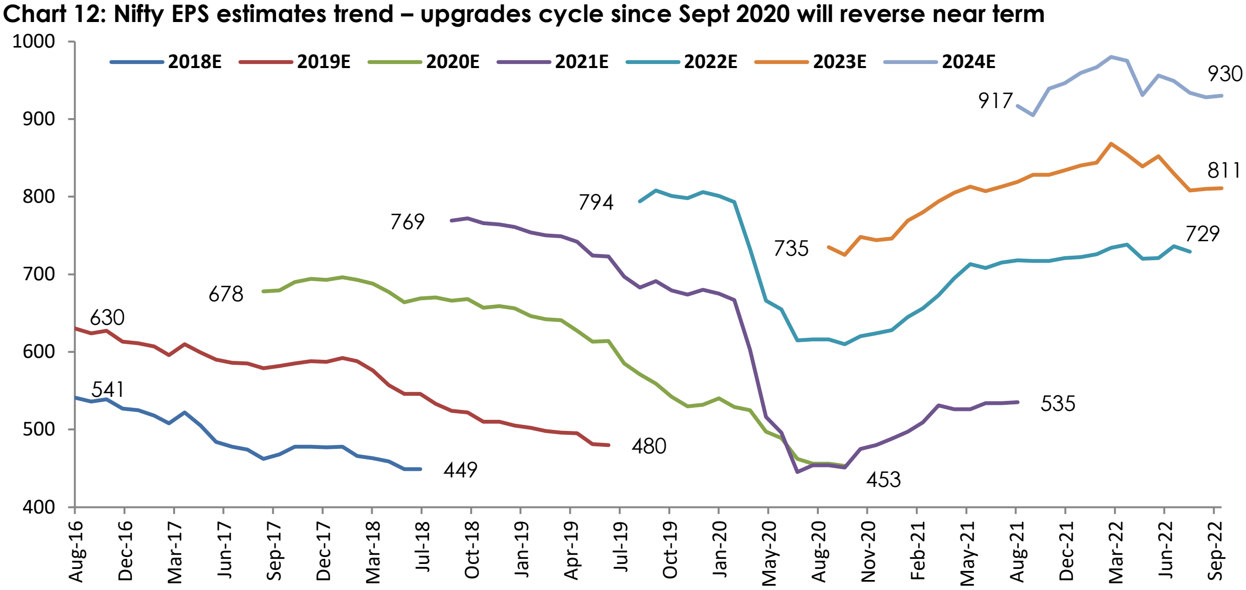
Chart 11: Index of Industrial Production (IIP) slid to an 18-month low



Source: MoSPI, ValentisResearch

b) **Earnings also starting to see some downgrades:** After a long spell of earnings upgrades since Sept 2020, we have seen some downgrades in earnings past couple of months.

Chart 12: Nifty EPS estimates trend – upgrades cycle since Sept 2020 will reverse near term



Source: Kotak Institutional Equities estimates, NSE, ValentisResearch

Result season……

As the earnings season gains momentum we expect overall earnings growth to remain subdued with aggregate profit growth for the Nifty almost flat. However, this masks, the divergence between global and domestic companies. Earnings for NIFTY Companies (ex-oil and Gas and Metals) are likely to witness a solid 30% growth for Q2FY23 implying that the underlying trends remain strong. While metals and oil and gas, cement and pharma sectors could report subdued earnings, we expect strong earnings from consumption related sectors and financial services sectors.

Table 4: Q2FY23 expected result summery

	Nifty	SENSEX	MOSL Universe
Revenue growth			
YoY	17.40%	15.00%	19.80%
QoQ	-3.00%	-2.50%	-5.50%
EBIDTA growth			
YoY	3.40%	5.60%	-8.10%
QoQ	-3.90%	-0.40%	-8.60%
PAT growth			
YoY	-0.30%	6.90%	-16.60%
QoQ	-2.50%	1.10%	-8.90%

Source: MOSL India strategy report, ValentisResearch

#4: Bigger concern is on the external account

However, the bigger red flag is on the external account. Given the US$ strength, currencies across the world are in turmoil. The Indian rupee has held up relatively well. But we are starting to see some concerns here:

1. The Current account Deficit (CAD) is the lowest in past few years.
2. Forex reserves over the past 3 months are down US$110 bn. Around 60% of this is a function of (a) adverse movement in the Pound and Euro vs the US$ (b) fall in bond prices especially in the US as yields rise. The balance 40% is largely an effort to defend or stabilize the rupee decline.
3. Interest rate increases may continue if the US$ continues to strengthen.

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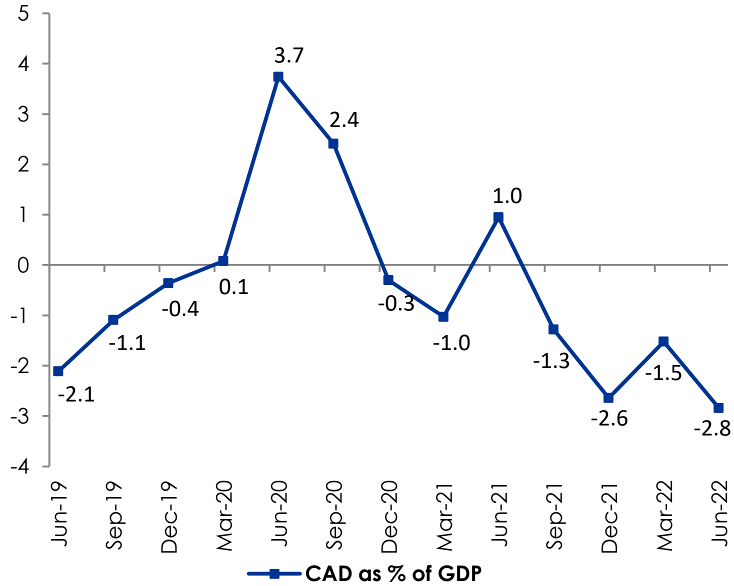
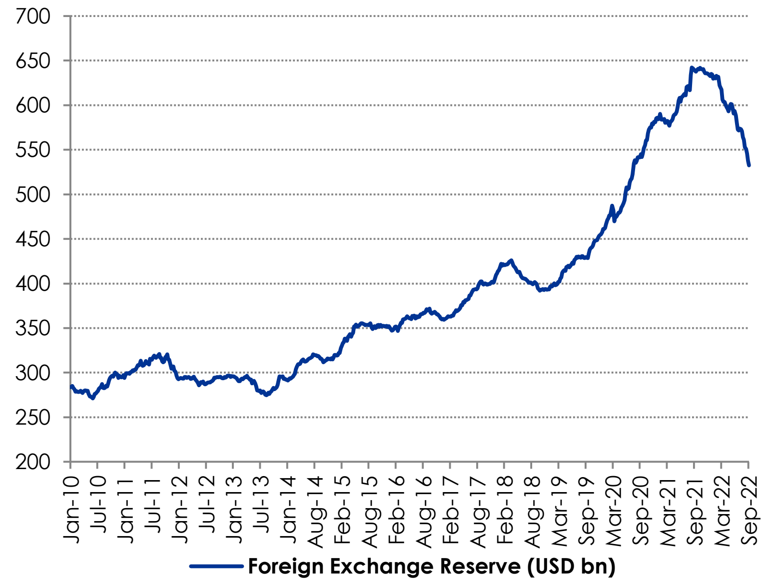
Chart 13: India's Current Account Deficit as % of GDP (%)



Source: RBI, Valentis Research

Chart 14: India's foreign exchange reserves (USD bn)



Source: RBI, Valentis Research

Portfolio Performance and outlook

1. From late CY21, we have been holding high cash levels. While we reduced cash levels during the quarter, we are still holding double digit cash levels. This led to our PMS seeing a small under-performance to the benchmarks during the September quarter. We are looking at weakness in markets to invest further. For new portfolios, we continue to stagger buying over 8-12 weeks though we are ready to deploy cash more aggressively if the markets correct meaningfully.
2. We continue to focus on our 3 "U"s of Under-valued, Under-performing, Under-owned and expect weak results to provide a buying opportunity in some stocks.
    a. During the quarter we continued to build positions in couple of China+1 stocks where we think valuations are attractive.
    b. Apart from that, our theme has been "buy local, avoid global". A possible recession in USA and Europe is likely to lead to earnings downgrades in exporting companies.
    c. We think the cost pressure in the cement sector has peaked and poor results this quarter would offer an attractive buying opportunity. We also continue to add to our overweight sectors like financials and capital goods.

Chart 15: Valentis Rising Stars Opportunity Fund Portfolio Performance (as on September 30, 2022)

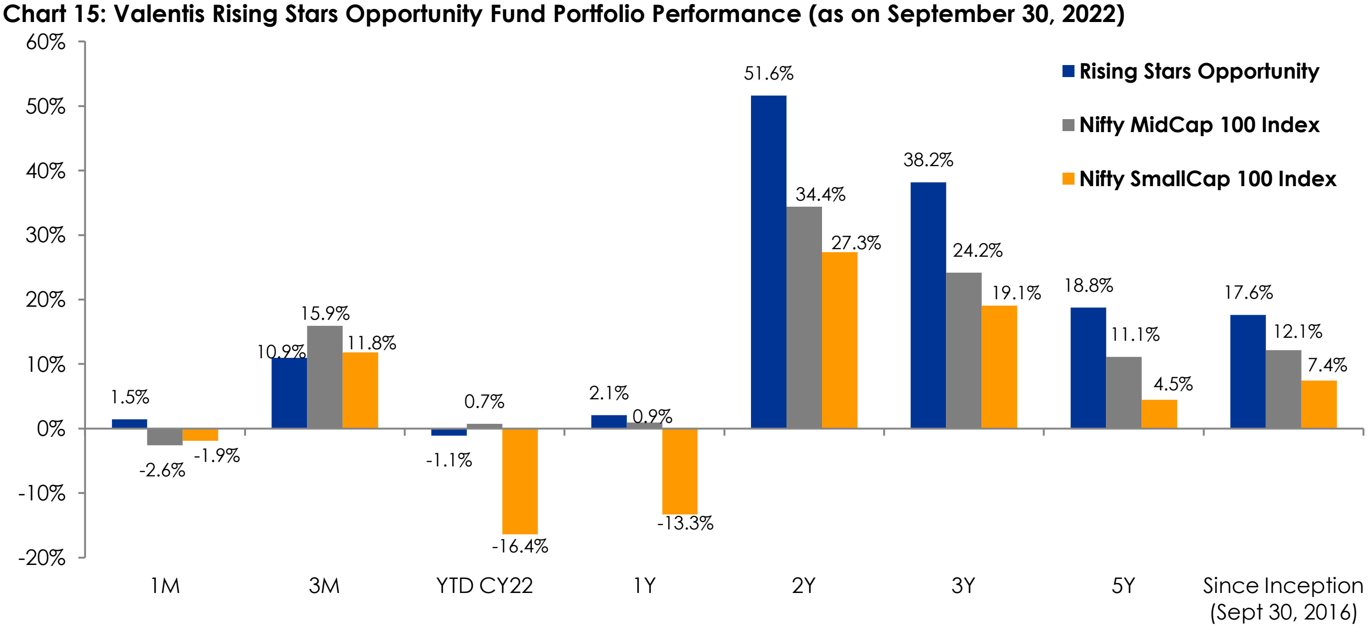
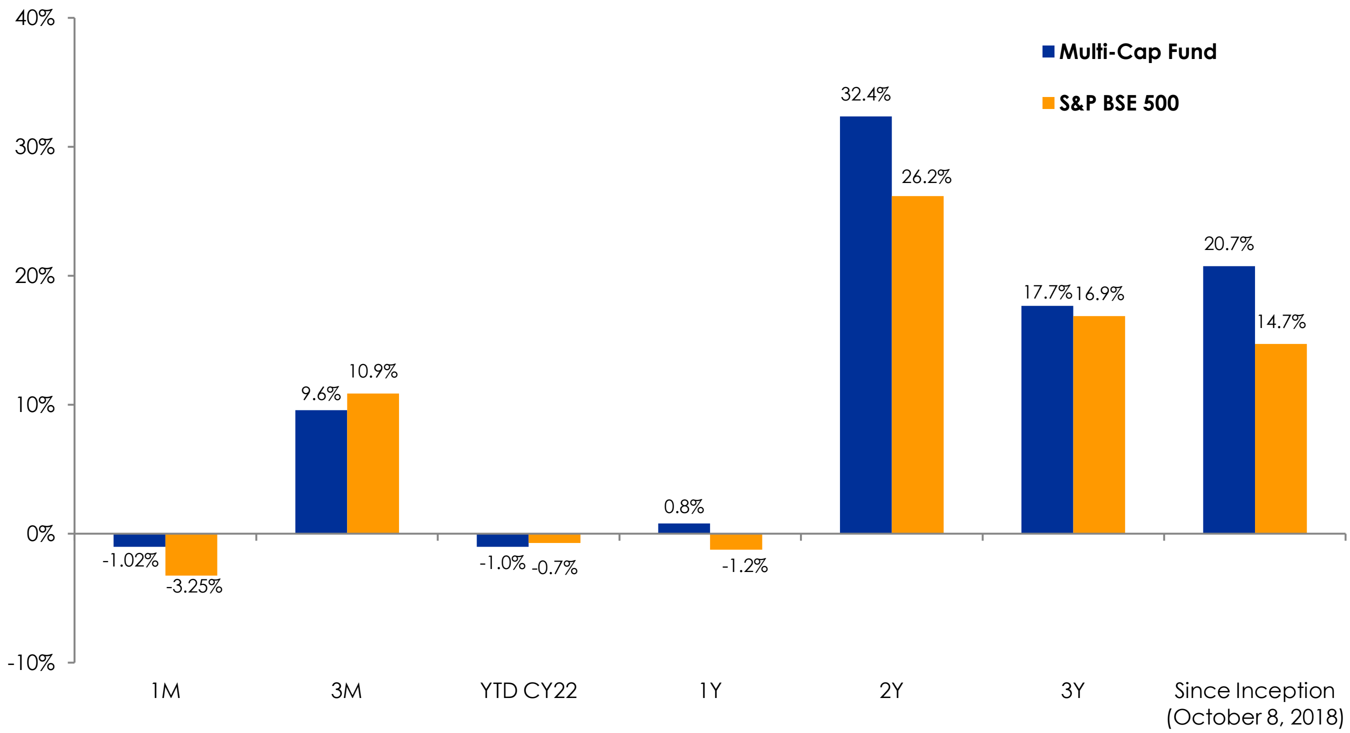


Chart 16: Valentis Multi-Cap Fund Portfolio Performance (as on September 30, 2022)



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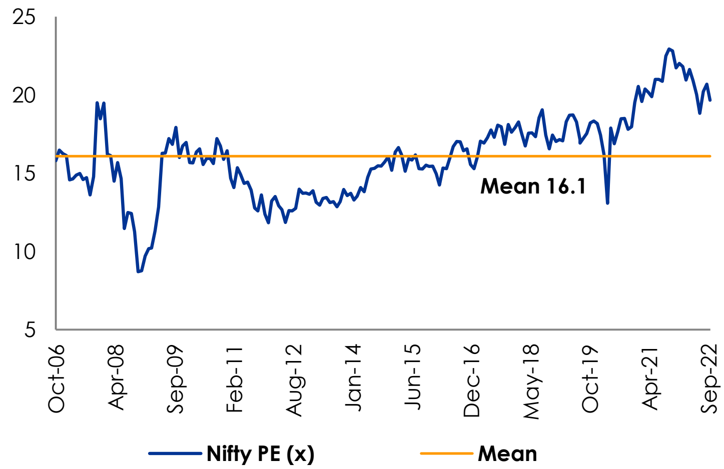
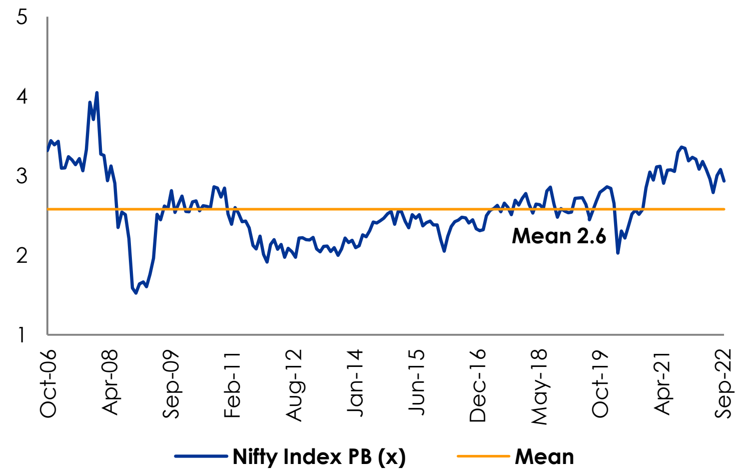
Appendix: Valuation Charts

Chart 17: Nifty 12M Forward P/E (x)



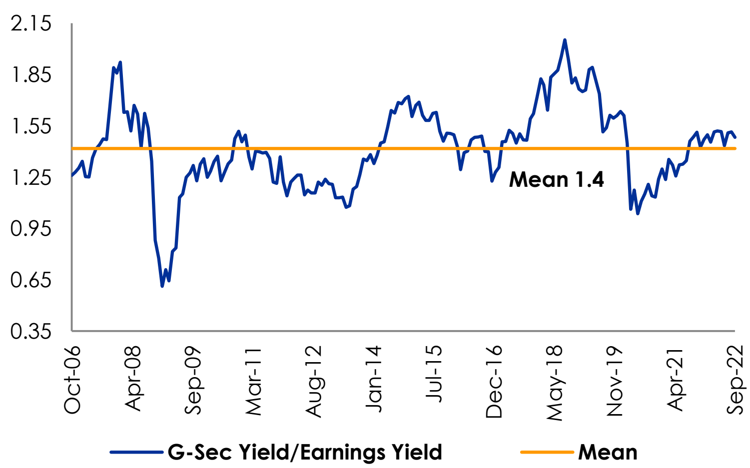
Source: Edel, Valentis Research

Chart 18: Nifty 12M Forward P/B (x)



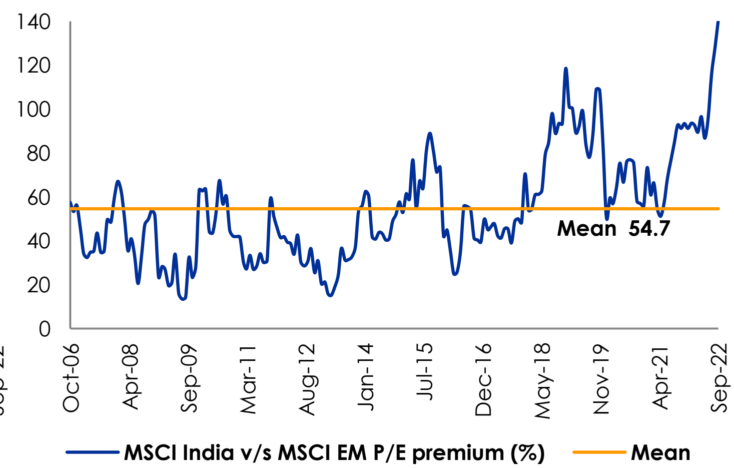
Source: MOSL, Valentis Research

Chart 19: Bond yield Vs SENSEX yield – at average valuations



Source: MOSL, Valentis Research

Chart 20: MSCI India v/s MSCI EM P/E premium (%)



Source: MOSL, Valentis Research

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