Valentis Advisors

Buy the dips

April 18, 2024

- **The India growth story looks robust and we think strong GDP growth will drive sustained long term returns for investors. Near term, however, markets may see volatility and investors should use dips to build their portfolio.**
- **Historically, election years have been positive for market performance with a strong performance in the run-up to elections as well as 6 months and 1-year after elections. With the likelihood of a stable Government at the Centre this trend could play out in 2024 as well.**
- **Yet, we continue to expect CY24 to be a year of consolidation and reiterate our key views as stated in our year-ahead report in January, 2024** (https://www.valentisadvisors.com):
  1. **Returns in CY24 will be muted relative to the past few years and we are looking at single digit returns for the year.**
  2. **Volatility will be higher than over past year.**
  3. **Large caps will do better than mid and small caps due to (a) sharp outperformance of the small and mid-caps and (b) historically high relative valuations.**
- **Near term caution stems from:**

1. **Starting valuations are not cheap at 20x 1-year forward earnings.**
2. **Earnings momentum is slowing.**
3. **Interest rate cut expectations in US are getting toned down.**
4. **Middle East tensions could pressure oil prices and affect economic stability in India.**
5. **Strengthening of the US $ is negative for emerging market equities.**

#1: Indian markets will deliver decent compounded returns

Q1 global markets – reverse of the CY23 performance

In Q1, we saw laggards of CY23 perform well led by developed markets like USA, France & Germany. The Indian market, especially the broader market lagged the developed world. However, India continued to outperform the Emerging Markets with China continue to perform poorly.

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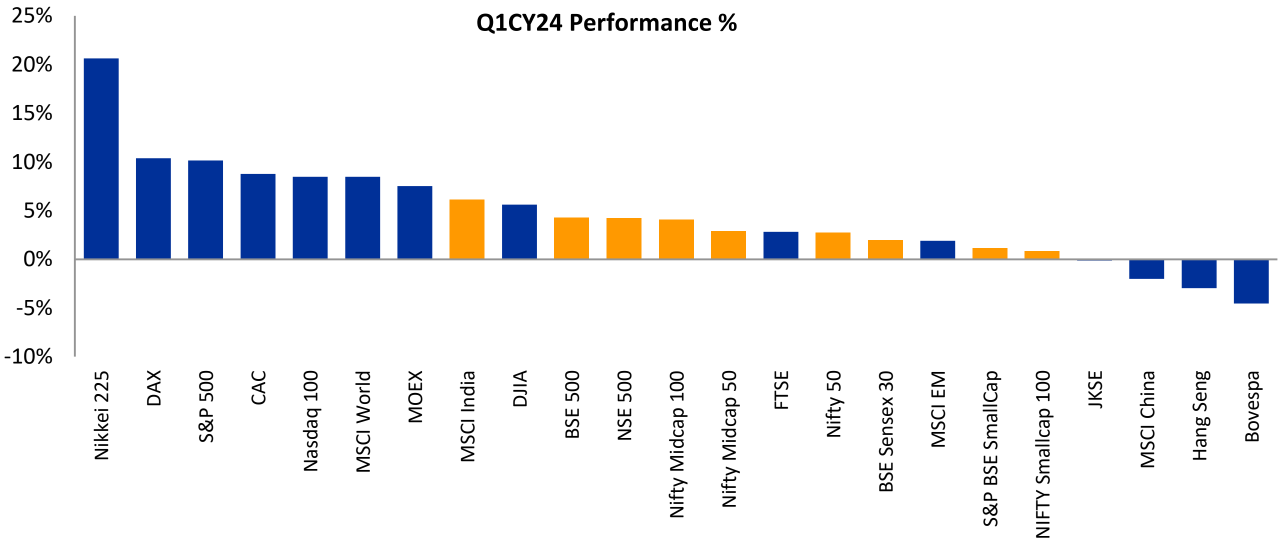
Chart 1: Indian indices were outstripped by Global indices in the Last Quarter

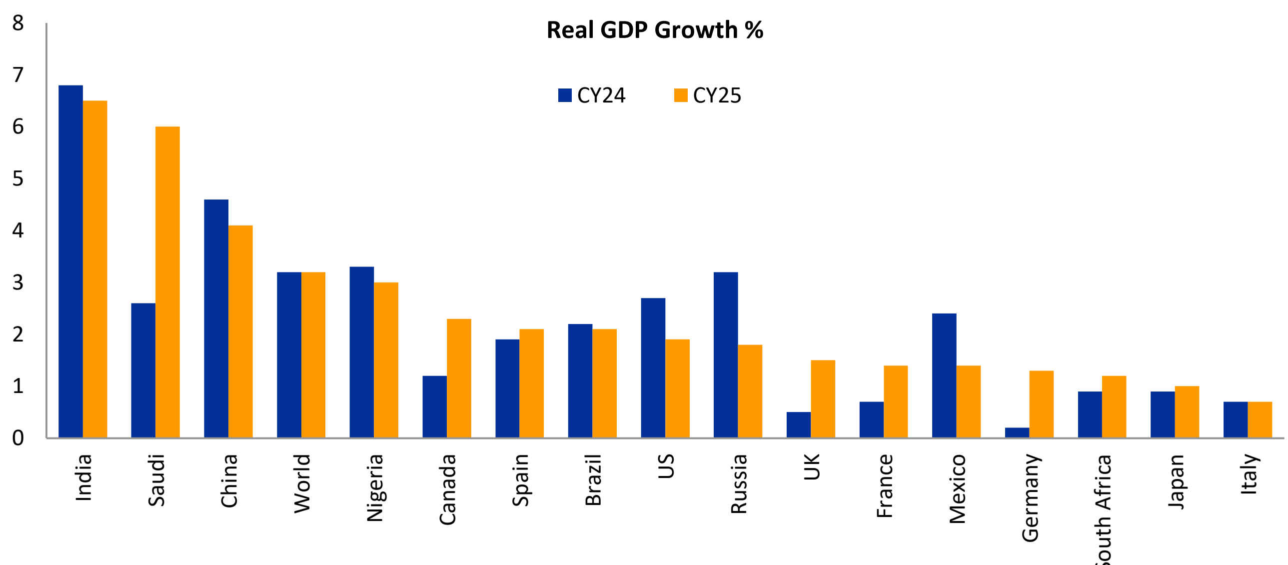


Source: Investing.com, Valentis Research

India continues to be the fastest growing economy in the world

We expect India to be probably the fastest growing economy in the world over the next few years and this will drive equity performance. We recommend investors to use every dip to increase their equity exposure.

Chart 2: IMF raises India's GDP growth forecast by 30 bps to 6.8% for FY25E



Source: Investing.com, Valentis Research
*India data and forecast are presented on a fiscal year basis (FY25E & FY26E)

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#2: Election years are good for markets

Election periods have generally been good for markets, both pre and post-election results. Opinion polls are currently forecasting that the Modi-led BJP will come to power with an easy majority. The market is also pricing this scenario. So any surprise from this could be negative for the markets.

- Based on election analysis (see Table 1), we have highlighted a few important points for markets:
  1. The run up to elections has generally been good for equity markets. Buying 6 months before elections and selling on the day before counting of results has mostly given a positive return.
  2. The day of counting leads to very volatile markets depending on the Government market perceives as reform friendly. So, the Vajpayee Government loss in 2004 (and UPA-1 came to power) led to a major negative day but when the same UPA got re-elected in 2009, markets rejoiced.
  3. Yet, the first day reaction of the market to any Government does not reflect how the equity markets will react to the Government a year later.
  4. Generally markets are positive 6 months and 12 months post elections as the market focus shifts to more fundamental issues.

Table 1: Stock Market returns (%) – Pre & Post elections: Why worry about Elections?

Result Date	Prime Minister	Ruling Party / Alliance	Pre - elections Return (%)		Post Elections Return (%)			
			6M	3M	3D	3M	6M	1 Yr
01-12-1989	V.P. Singh / Chandra Shekhar	National Front	*0*	*-6*	*0*	*0*	*16*	*75*
20-06-1991	P. V. Narasimha Rao	Congress	*25*	*14*	*-2*	*37*	*40*	*131*
10-05-1996	Dev Gowda / I.K. Gujral	United Front	*11*	*17*	*2*	*-5*	*-17*	*0*
27-02-1998	Atal Bihari Vajpayee	BJP & Allies	*-9*	*0*	*4*	*2*	*-20*	*-6*
06-10-1999	Atal Bihari Vajpayee	BJP & Allies	*32*	*8*	*7*	*15*	*4*	*-12*
13-05-2004	Manmohan Singh	Congress & Allies	*8*	*-9*	*-17*	*-5*	*10*	*19*
15-05-2009	Manmohan Singh	Congress & Allies	*30*	*29*	*17*	*27*	*38*	*38*
16-05-2014	Narendra Modi	BJP	*17*	*18*	*2*	*9*	*17*	*16*
23-05-2019	Narendra Modi	BJP	*11*	*8.2*	*1.6*	*-5.4*	*4*	*-21**
Average Return			*14*	*9*	*2*	*8*	*10*	*27*

Source: Election commission of India Ace Equity, Valentis Research
*includes Covid impact

Only 1 Negative in run-up to elections

First reaction to market is not necessarily correct

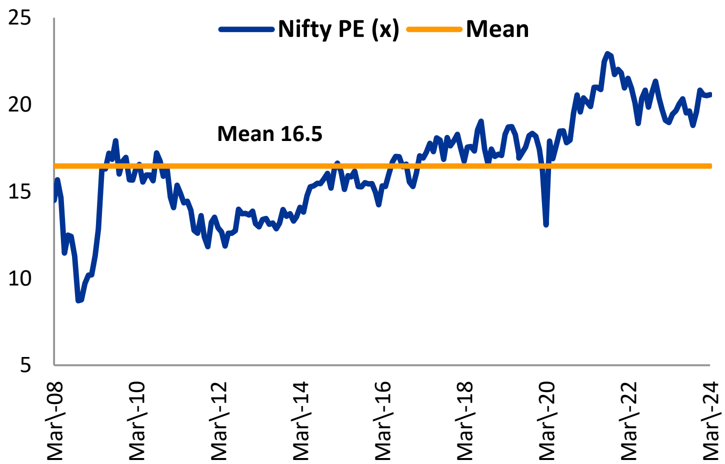
#3: Near term returns may be constrained by 4 factors

While we are positive on markets in the long term, current valuations make us expect a time and price correction. We continue to recommend investors to use dips to buy equities.

A. Valuations are expensive

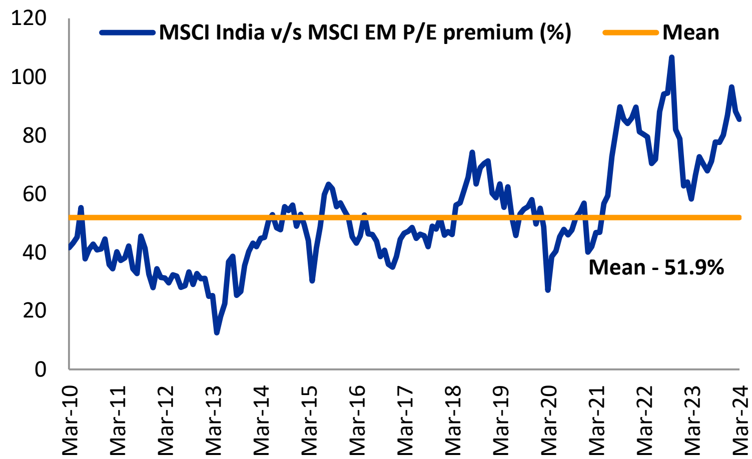
- Absolute valuations at 20x 1-year forward are expensive and historically returns have been low by investing at these levels.
- In a relative context too, India trades at 85% premium to EM valuations, way above historic averages. A correction in relative valuations would provide room for increased FII flows into India.

Chart 3: Nifty 12M Forward P/E (x) – still expensive



Source: Edel, Valentis Research

Chart 4: MSCI India v/s MSCI EM P/E premium (%)



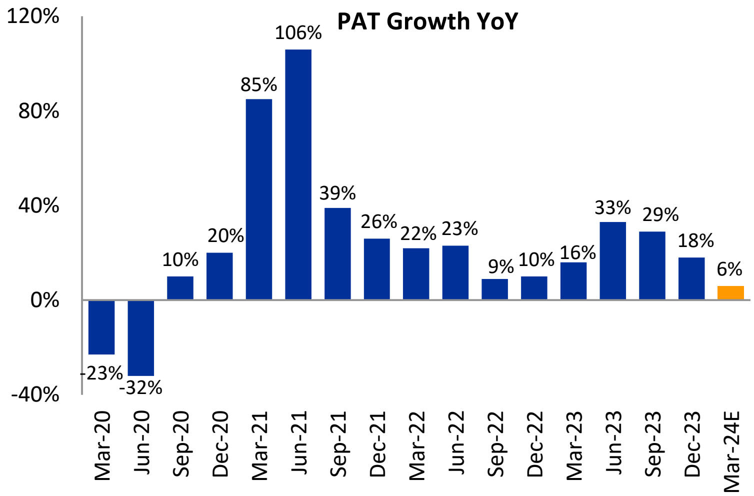
Source: ISEC, Valentis Research

B. Earnings momentum is slowing

- While India is likely to deliver strong GDP growth, earnings over past few years have far exceeded nominal GDP growth in India. We think earnings growth now is likely to edge closer to nominal GDP growth and could average around 12% over next 2 years.

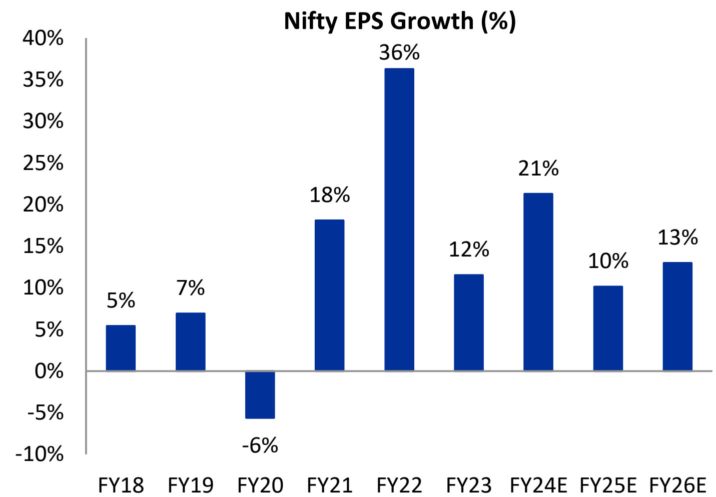
- Even near term, we see Q4FY24 to be a weak quarter with earnings growth likely to be in single digit only.

Chart 5: Expect Nifty's PAT to rise 6% YoY in Q4FY24



Source: MOSL, Valentis Research

Chart 6: Annual EPS Growth



Source: Kotak IE, Valentis Research

C. Should we worry about geo-political tensions?

A tend of all skirmishes over past 25 years show that the market falls on news of the strike but recovers over next few months.

Table 2: Market Reactions to Geopolitical Events

		S&P 500 Return					Nifty 50 Return				
Event	Event Date	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%	-9.0%	7.4%	14.9%	-3.4%
Iraq War	20-03-2003	-3.7%	2.0%	13.7%	18.3%	26.7%	-5.0%	-8.2%	7.3%	29.0%	68.3%
Arab Spring (Egypt)	25-01-2011	-1.2%	2.2%	3.4%	3.6%	2.7%	-4.0%	-6.7%	3.3%	-0.1%	-9.3%
Libya Intervention	19-03-2011	-4.8%	2.0%	-0.6%	-5.9%	4.5%	-1.7%	6.6%	-0.1%	-5.4%	-1.0%
Russia - Crimea	20-02-2014	-0.2%	1.8%	1.8%	8.0%	14.7%	0.3%	6.4%	19.4%	29.3%	45.0%
Intervention in Syria	22-09-2014	-9.4%	-3.4%	4.2%	5.5%	-2.6%	0.8%	-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%	-1.3%	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%	2.7%	-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%	2.5%	2.4%	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%

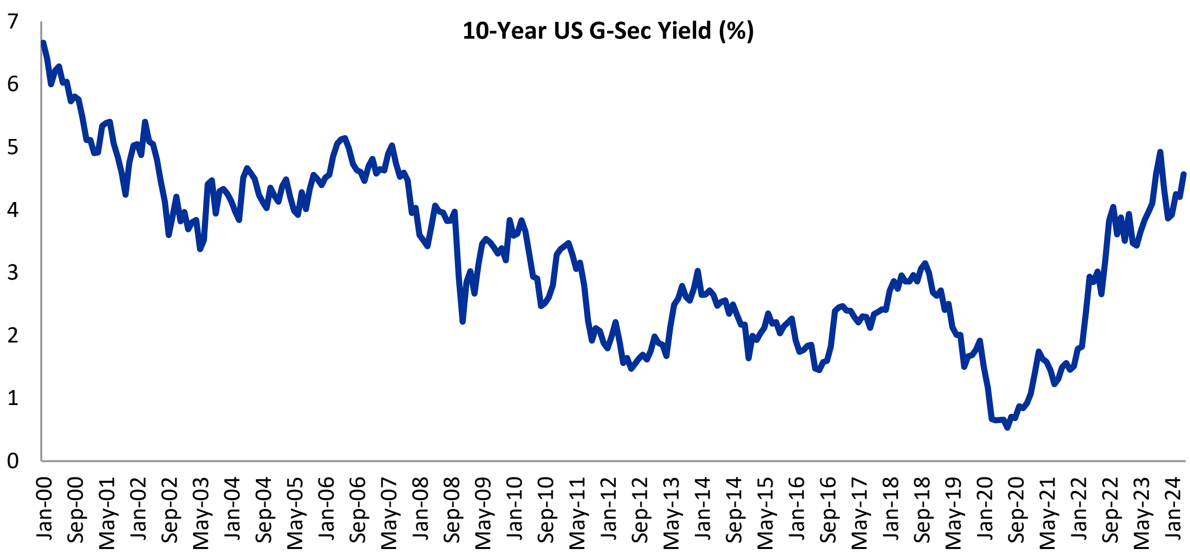
Source: Ace Equity, Investing.com, Valentis Research

Having said this, in case of any flare up in oil prices, India's economic stability could be negatively impacted. A higher oil price is negative for India's current account deficit with every $10/brl increase leading to an increase of ~0.5% in current account deficit. It also threatens inflation with a ~0.4% assuming the Government allows oil marketing companies to pass on the burden to the consumer.

D. Interest rate cuts in India may be delayed due to Fed

Bond yields in the US are reflecting a delayed start to the rate cut cycle by the Fed and also a shallower rate cut cycle following the CPI data which shows interest rates may be stickier than earlier believed. Powell has also said that it will take "longer than expected to achieve the confidence" that inflation is going to 2%. This will probably reflect in RBI too with rate cuts in India likely only in Q4CY24.

Chart 7 – US 10-year bond yields



Source: Investing.com, Valentis Research

Will Fed balance sheet shrinkage slow?

The Fed has shrunk its balance sheet by $1.5 trillion since they started the Quantitative tightening. The Fed is discussing whether they show reduce the pace of tightening. This could be marginally positive for the markets.

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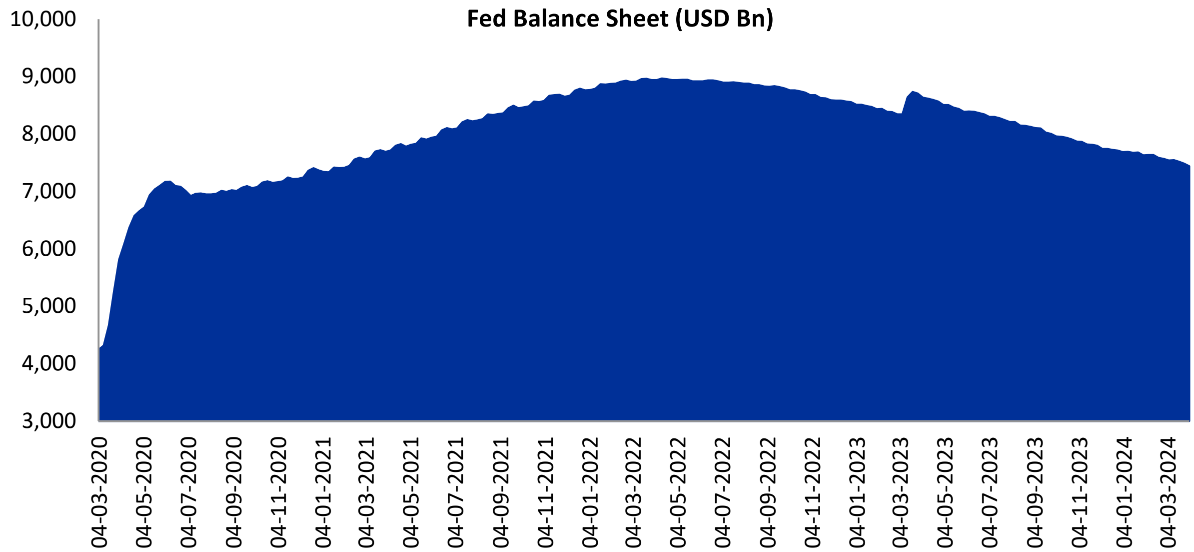
Chart 8– US Fed Balance Sheet

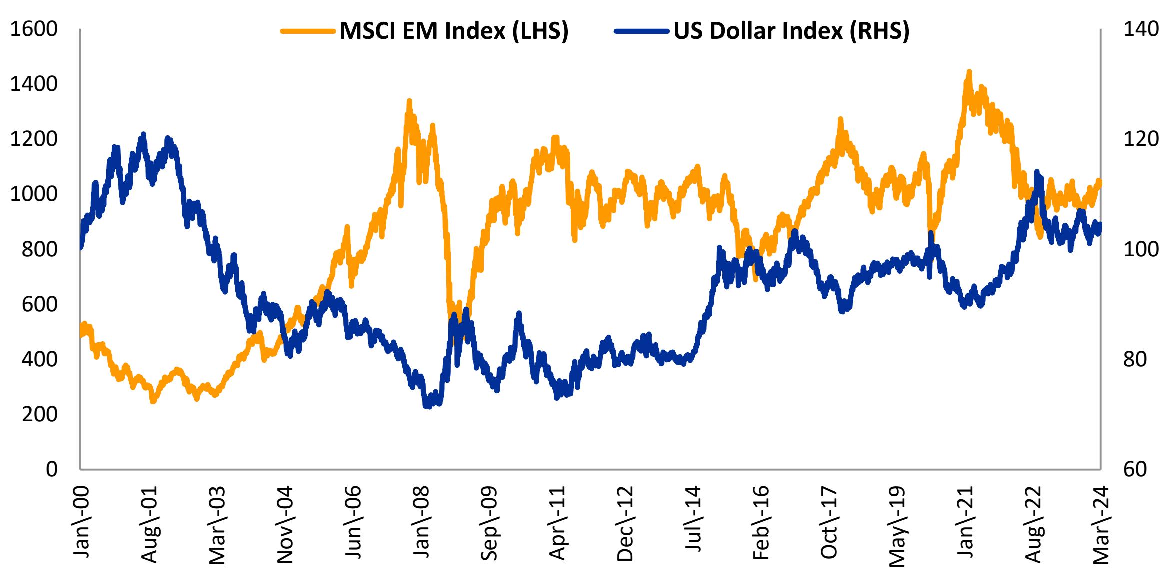


Source: Investing.com, Valentis Research

Strong US$ can be negative for EM

The US$ has strengthened in recent weeks. Traditionally, the strength of the US $ is negative for the emerging market economies.

Chart 9 – Dollar Index Vs MSCI EM Index – has the $ index peaked?



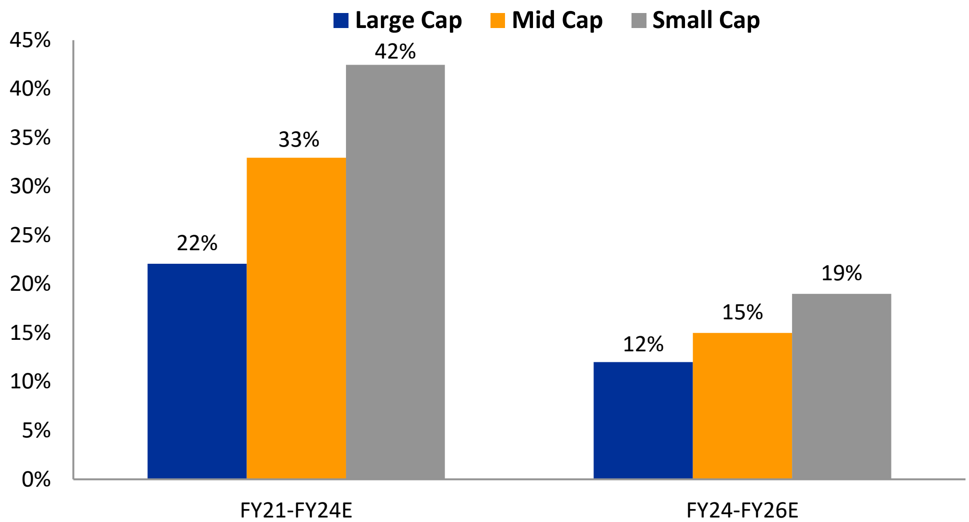
Source: Investing.com, Valentis Research

#4: Small caps may lag large caps in near term

- As expected by us, small caps were volatile in Q1 with a sharp fall of near 15% from mid-February to mid-March but the recovery from the lows as been as sharp.

- We like small-caps over the next few years since we think earnings growth will be faster for small caps over the large caps which will drive outperformance.

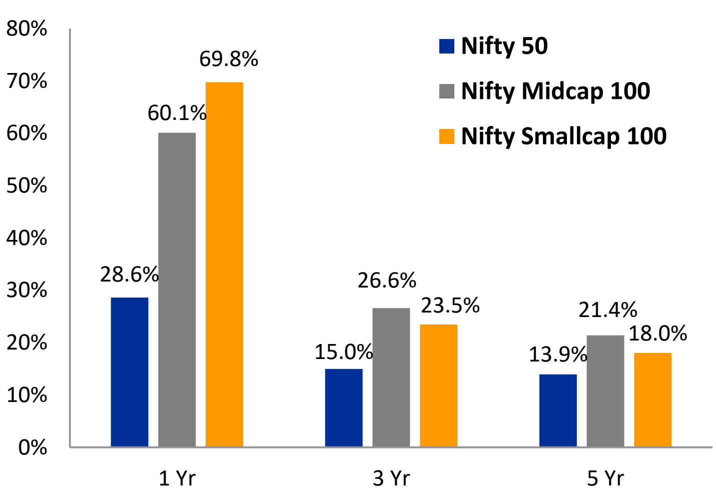
Chart 10 – Earnings forecast profile



Source: ISec, MOSL, Valentis Research

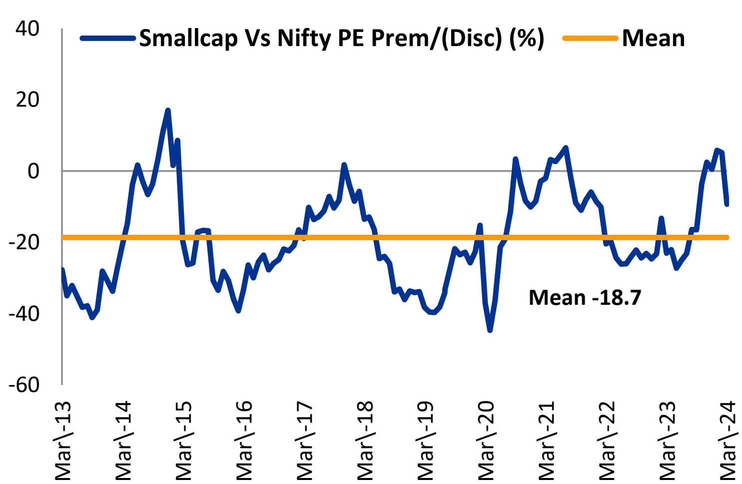
- However, over next few months, we are cautious on small-caps and are staggering our investments. 2 factors drive our caution (a) sharp outperformance of small caps over large caps and (b) expensive valuations with small caps trading at a 9.3% discount to large caps on a PE basis much lower than the historic 18-19%.

Chart 11: Indices Returns



Source: Ace Equity, Valentis Research

Chart 12: Smallcap Vs Nifty PE Prem(Disc)

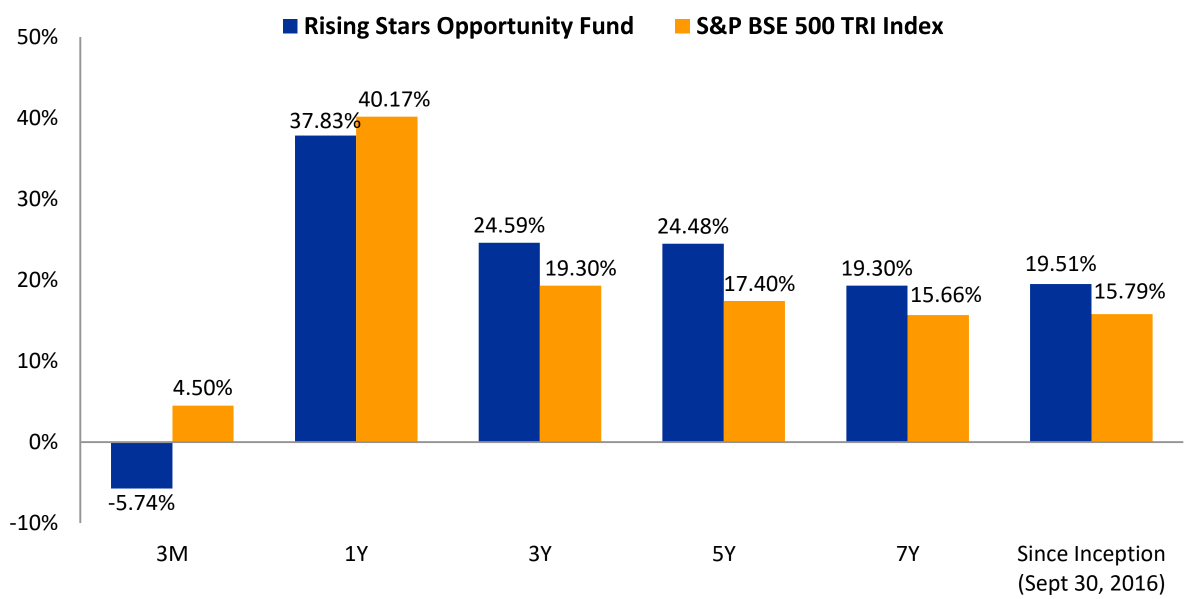


Source: MOSL, Valentis Research

Portfolio Performance and outlook

1. Q1CY24 turned out to be a challenging period for us and we under-performed the benchmark led by 2 factors (a) Our cautious stance on the market and the high cash levels partly due to strong inflows which we invest in a staggered manner hurt our returns in a rising market and (b) while we increased large caps in our portfolio, we still held more small and mid-caps than the benchmark. A relative under-performance of small-caps impacted our performance.
2. Some of our stocks under-performed sharply led by a cement stock (as demand weakened due to lower Government spending), an auto ancillary stock (lower margins in Q3) and a pipe company on non-business concerns. We have done a stress test on each of these companies and feel confident on long term growth prospects. We expect these stocks to recover over the next 2 quarters and help portfolio performance.
3. Over the next few months we will focus on downside risk in the companies to guard against a sharp de-rating on any change in earnings trajectory. The PE of our portfolio is under 15x. We will also continue to increase weight to larger cap companies in our multi-cap portfolio.
4. Our investment style has always focused on buying under-performers when they become under-valued. These take time to deliver results but ultimately give large returns. We are adding weight to financials and looking for opportunities in sectors like chemicals which have been sharp under-performers.

Valentis Rising Stars Opportunity Fund Performance (as on March 31, 2024)



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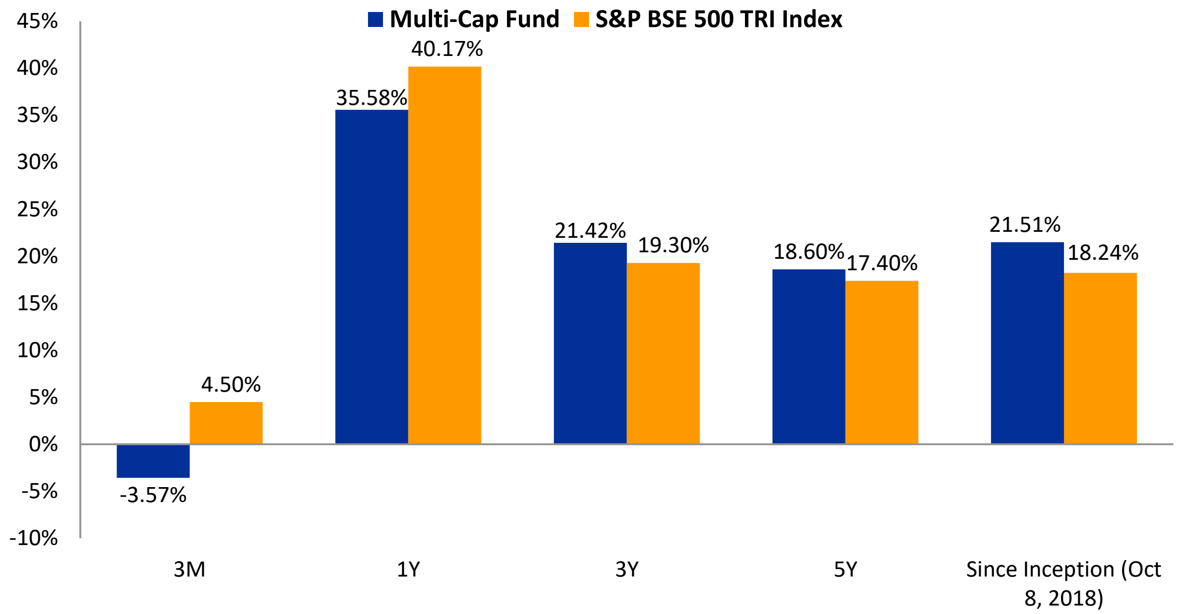
Valentis Multi-Cap Fund Performance (as on March 31, 2024)



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