Valentis Advisors

5 burning questions

July 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, valuations at 21x 1-year forward earnings are not cheap and may lead to a spell of consolidation and time correction. Markets may see volatility and investors should use dips to build their portfolio. We look at some key questions that investors should focus on:**
- **Q1 – Will earnings momentum slow down? We will still have a healthy 12% CAGR but slower than earnings growth over past few years as margins have risen and corporate profit/GDP ratio is above long term averages.**
- **Q2 – Can growth surprise? Consumption spend should pick up as better monsoons and possibly higher budget allocations provide a booster. However, a major surprise would need a start in the private sector capex cycle.**
- **Q3 – Does the budget matter? While fiscal consolidation and higher public sector capex are positives from the budget, we think the budget is unlikely to alter the course of markets. The only major negative could be an increase in capital gains tax on equities.**
- **Q4 – Will domestic flows continue? While longer term they would, near term we are seeing rise in redemption pressure as well as supply pipeline is burgeoning.**
- **Q5 – Will Fed cuts be positive for markets? We think the Fed will cut from September which caps a major downside to markets. But the history of market returns post Fed cuts is mixed. High starting valuations and a slowing US economy could be a constraint to any major upside.**

Valuations are suggesting moderate returns going forward

While there are good reasons for India to trade at premium valuations given macro stability and visible growth, we think current valuations mean that returns going forward will be more moderate than past few years. Earnings growth will drive returns with re-rating behind us. We continue to expect high single digit returns over next 12 months as we a consolidation phase in markets.

Growth and macro stability will drive long term equity returns

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

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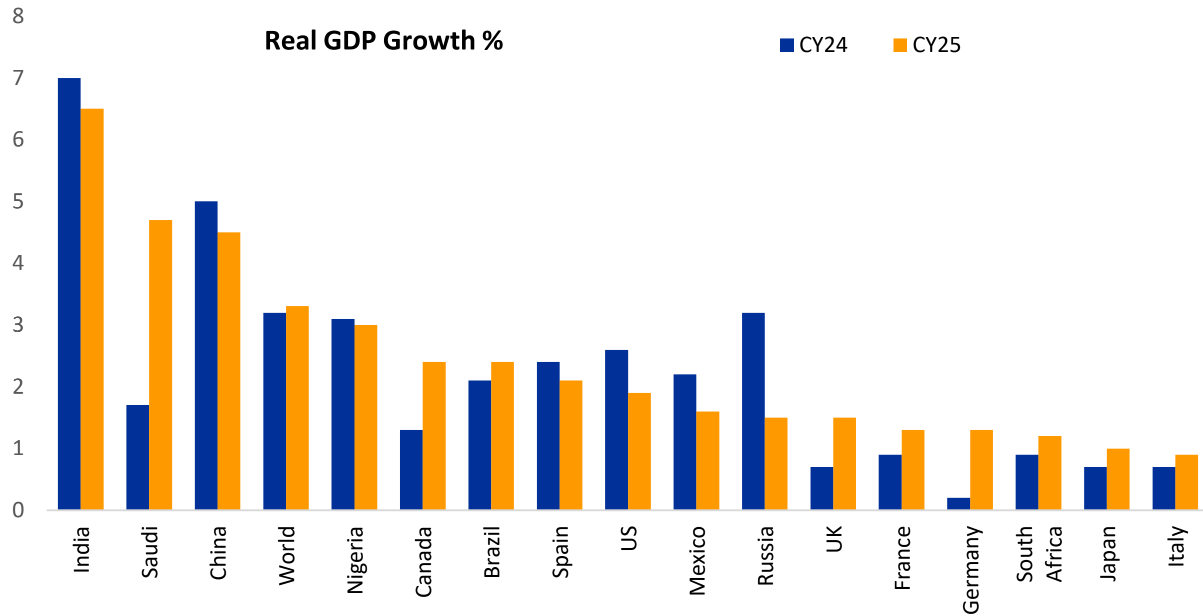
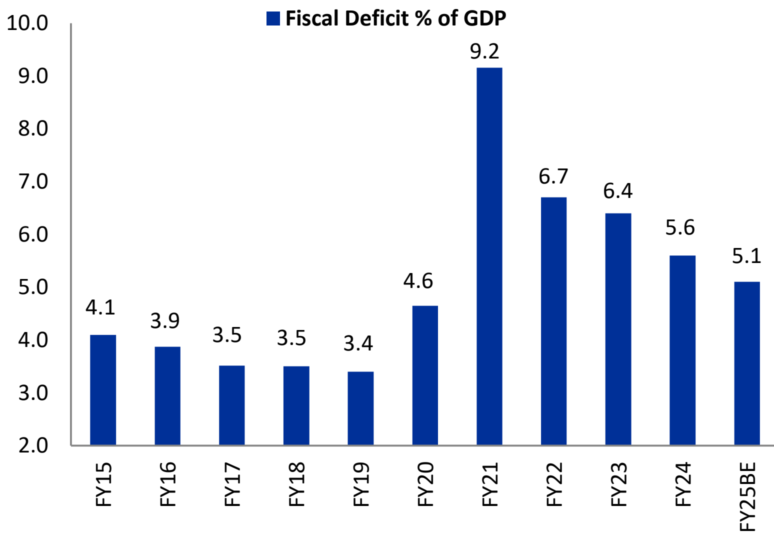
Chart 1: India will be the fastest growing economy in the world



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

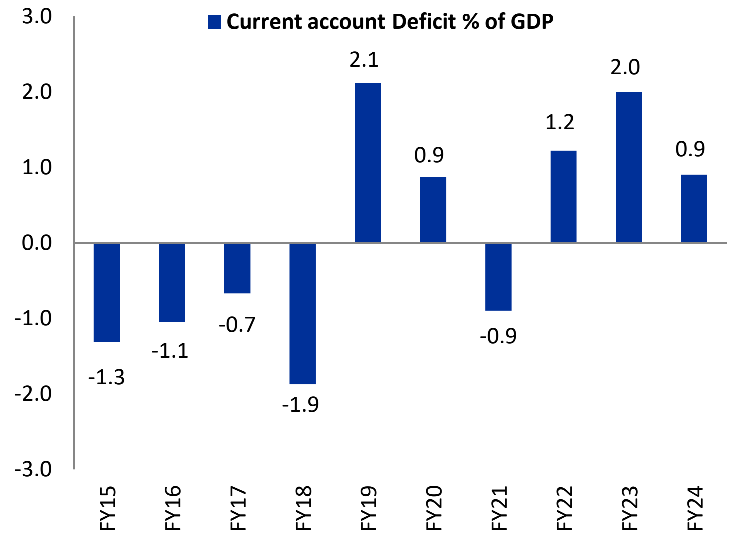
Moreover, the macro looks stable with fiscal deficit being brought under control and the current account deficit being positive last quarter.

Chart 2: Fiscal deficit % of GDP



Source: MOSL, NSO, Ministry of finance

Chart 3: Current account deficit % of GDP



Source: MOSL, NSO, Ministry of finance

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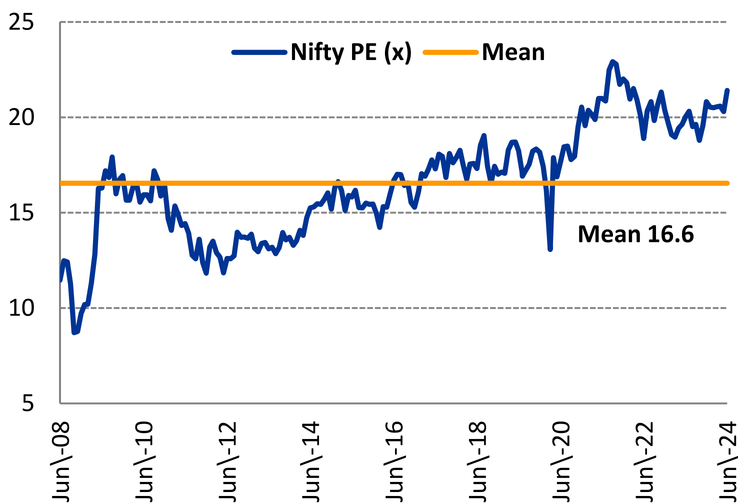
However, valuations are expensive and will lead to lower returns ahead

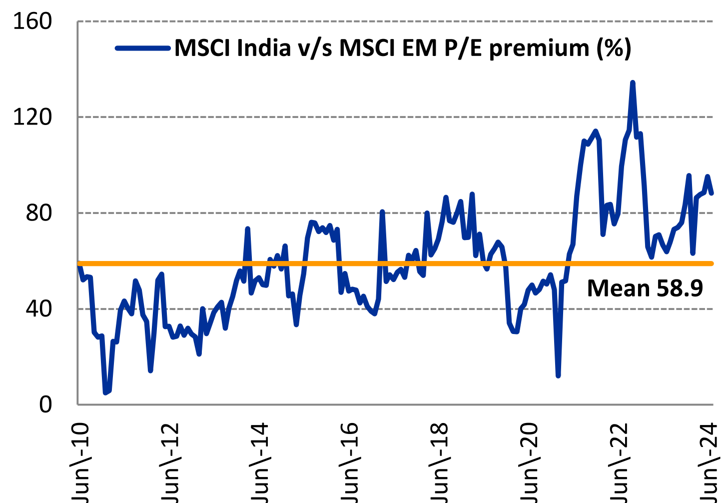
- Absolute valuations at 21x 1-year forward are expensive and historically returns have been low by investing at these levels.
- In a relative context too, India trades at 88% premium to EM valuations, way above historic averages. A correction in relative valuations would provide room for increased FII flows into India.

Chart 4: Nifty 12M Forward P/E (x) – still expensive



Source: Edel, Valentis Research

Chart 5: MSCI India v/s MSCI EM P/E premium (%)



Source: B&K sec, Valentis Research

Q1: Will earnings momentum slow-down?

- 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.

- With margins have rallied sharply, we think further increase in corporate profits due to margin increases will be slow.

- Also, corporate profits to GDP ratio have gone well above the long term averages. This means that profit growth will now start inching closer to nominal GDP growth.

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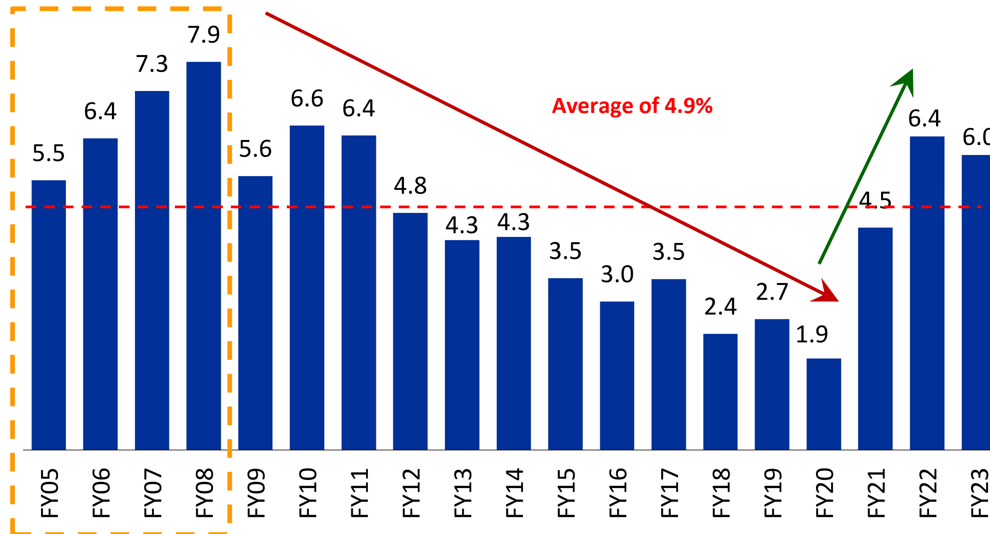
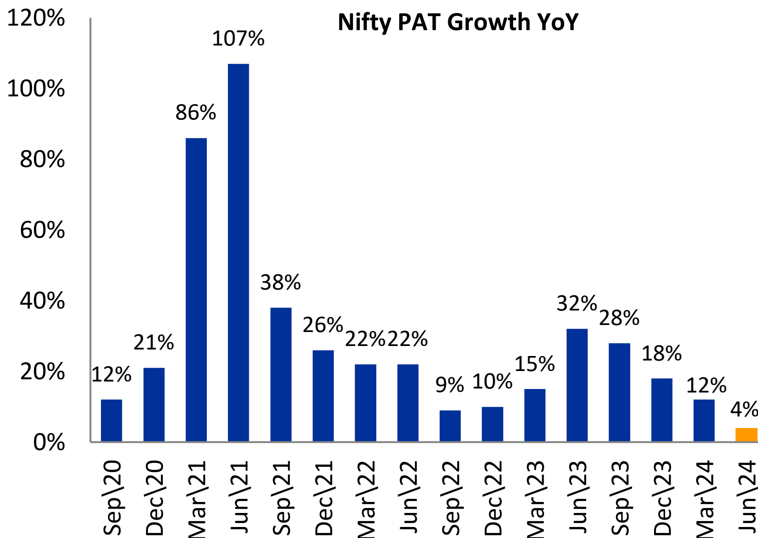
Chart 6: Corporate Profit to GDP Ratio:



Source: MOSL, Valentis Research

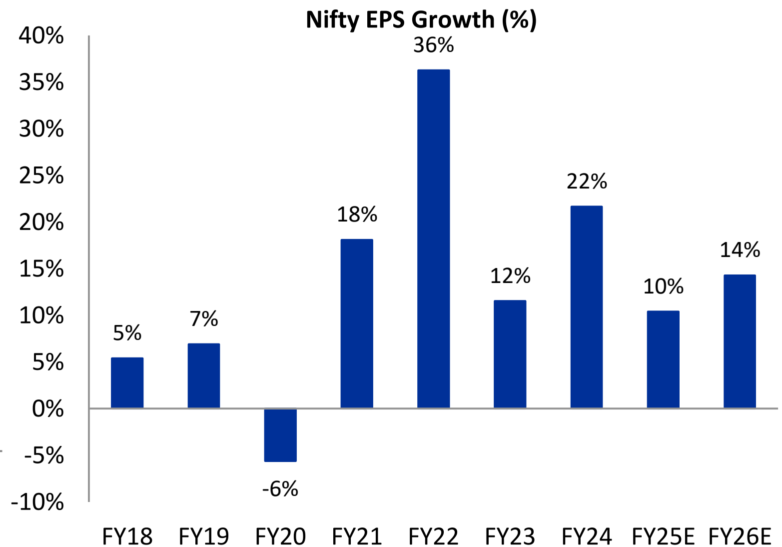
- Q1FY25 results will also be a mixed bag. Overall Nifty earnings may be weak at single digit. But excluding oil and marketing companies, earnings will be closer to 10%. Domestic cyclicals like banks and autos will continue to drive yoy earnings growth but at a much slower pace. Pharma will be a big contributor and metals will see growth after a long period of declining earnings.

Chart 7: PAT growth to be low single digit on high base



Source: MOSL, Valentis Research

Chart 8: Annual EPS Growth



Source: MOSL, Valentis Research

Q2: Can improving consumer demand and private capex create growth surprise?

- As the Government moves to fiscal constraint, the sharp increase in public capex will see a slower growth. Will this lead to GDP growth momentum slowing down?

- Firstly, we think private capex could fill the gap. 4 factors make us optimistic on private capex – (a) low debt:equity levels in corporate India (b) rising capacity utilization (c) bank balance sheets are in better shape and they can lend for capex (d) rising demand.

- Secondly, we could see an increase in consumption spend led by (a) better monsoons helping rural demand and (b) likely increase in rural spends and hopefully tax cuts in the budget can help consumption spend.

- While monsoons so far are 2% below normal, July has seen a sharp recovery in monsoons and we think monsoons will be above normal by the end of the month. More significantly, we have seen a sharp increase in kharif sowing which is up over 10% compared to last year.

Table 1: Kharif Sowing

Kharif Sowing	Area sown in 2023-24 (Lakh Ha)	Area sown in 2024-25 (Lakh Ha)	Growth (YoY %)
Coarse Cereals	105.0	97.6	(7.0)
Paddy	95.8	115.6	20.7
Pulses	49.5	62.3	26.0
Oilseeds	115.1	140.4	22.0
Cotton	93.0	95.8	3.0
Sugarcane	56.9	57.7	1.4
Jute and Mesta	6.0	5.6	(6.5)
All Crops	**521.3**	**575.1**	**10.3**

Source: Ministry of Agriculture, Valentis Research

Q3: Will budget create negative surprise for equity markets?

- We think the budget will continue to be on the lines of fiscal consolidation seen in the interim budget. We think the Government will stick to a fiscal deficit target of 5.1% for FY25 or probably even slightly lower and forecast FY26 fiscal deficit of 4.6%.

- The better than expected tax collections and a higher than expected dividend by RBI has given the Finance Minister additional resources of around 0.4% of GDP. We expect this to be used partly for rural development programs and a possible income tax relief. This will help consumption spend.

- The worry for the markets from the budget will be on any increase in capital gains tax. Any increase in capital gains tax on equity in the budget would be negative for equities and probably for the economy also. Firstly, retail investment has risen over past few years and with valuations now not cheap, any change in legislation could hurt equity markets and reverse the retail inflows into equities. Secondly, FIIs have been sellers of Indian equities over past year and an increase in capital gains tax (very few EM have capital gains tax) will lead to acceleration of the selling as post-tax returns in India become unattractive. Lastly, privatization of PSUs will be difficult in a coalition era. Hence, disinvestment through secondary market is required to meet fiscal deficit targets. This is easier in a buoyant equity market.

- Overall, our view remains that apart from any negative surprise from the capital gains tax, the budget is unlikely to be a major event for markets. Indeed, markets have been flat on any average post budgets over the past decade.

Table 2: Markets have not moved much post budget

Year	Budget Date	Budget Day	1W	1M	3M	6M	1Y
2014–15	10-Jul-14	-0.2%	1.0%	0.0%	3.9%	9.5%	10.5%
2015–16	28-Feb-15	0.6%	0.4%	-4.6%	-5.3%	-10.5%	-21.0%
2016–17	29-Feb-16	-0.6%	7.1%	10.8%	16.8%	25.7%	27.1%
2017–18	01-Feb-17	1.8%	0.6%	2.6%	6.7%	16.0%	26.4%
2018–19	01-Feb-18	-0.1%	-4.0%	-5.1%	-2.5%	3.0%	-1.1%
2019–20	05-Jul-19	-1.1%	-2.2%	-8.0%	-5.4%	3.5%	-10.2%
2020–21	01-Feb-20	-2.5%	3.7%	-3.9%	-15.5%	-5.0%	22.5%
2021–22	01-Feb-21	4.7%	5.8%	3.4%	2.5%	10.4%	23.1%
2022–23	01-Feb-22	1.4%	-1.8%	-4.5%	-2.7%	-1.3%	0.2%
2023–24	01-Feb-23	-0.3%	1.4%	-0.9%	2.5%	12.0%	23.2%
	10 Yrs Average	**0.4%**	**1.2%**	**-1.0%**	**0.1%**	**6.3%**	**10.1%**

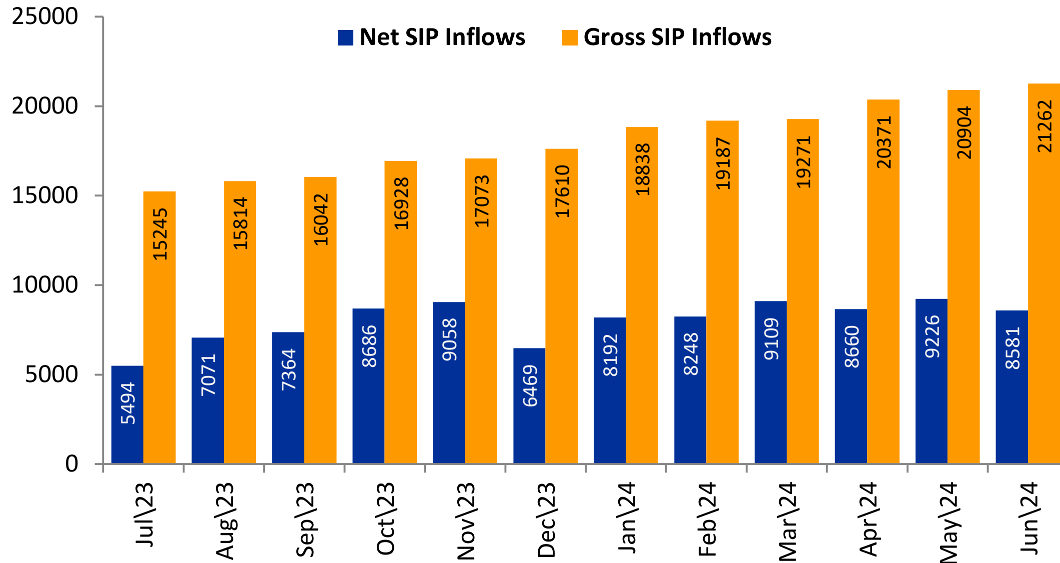
Source: ACE Equity, Valentis Research

Q4: Will domestic flows continue?

- On a secular basis, Indians are under-invested in equity markets with less than 10% of financial savings being in equities. However, near term, we could see a slow-down in retail flows if the equity markets correct. While SIP flows are strong, redemptions are also rising.

- However, promoters have been selling over the past 18 months. Supply of new paper is also strong. The IPO pipeline till the end of the year will exceed Rs 100,000 crores. The supply may absorb some part of the liquidity driving the markets.

Chart 9: SIP flow (Rs. Crore)

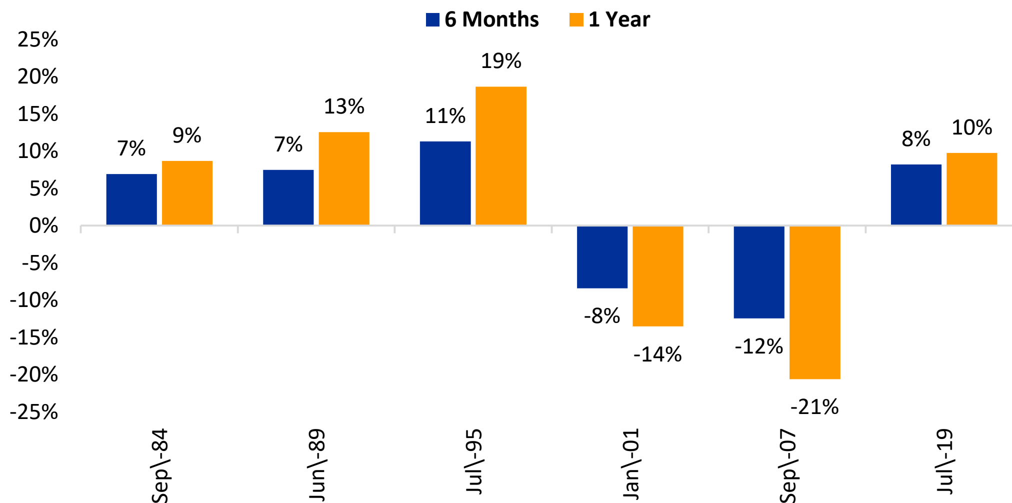


Source: AMFI, Valentis Research

Q5: Will Fed rate cuts be positive for markets?

- The Fed is likely to start a rate cut cycle this year with the first rate cut likely in September, 2024. Fed rate cuts have generally been positive for markets.
- However, the USA economy seems to be slowing down. Any rate cuts driven by a slowing economy may mean that we will see the markets not holding on to any gains from the cut in rates. Moreover, starting valuations are not cheap. Both the negative returns post Fed cuts were when valuations on a PE basis were 20+ times.

Chart 10: Fed rate cut and market returns: a mixed bag



Source: investing.com, Valentis Research

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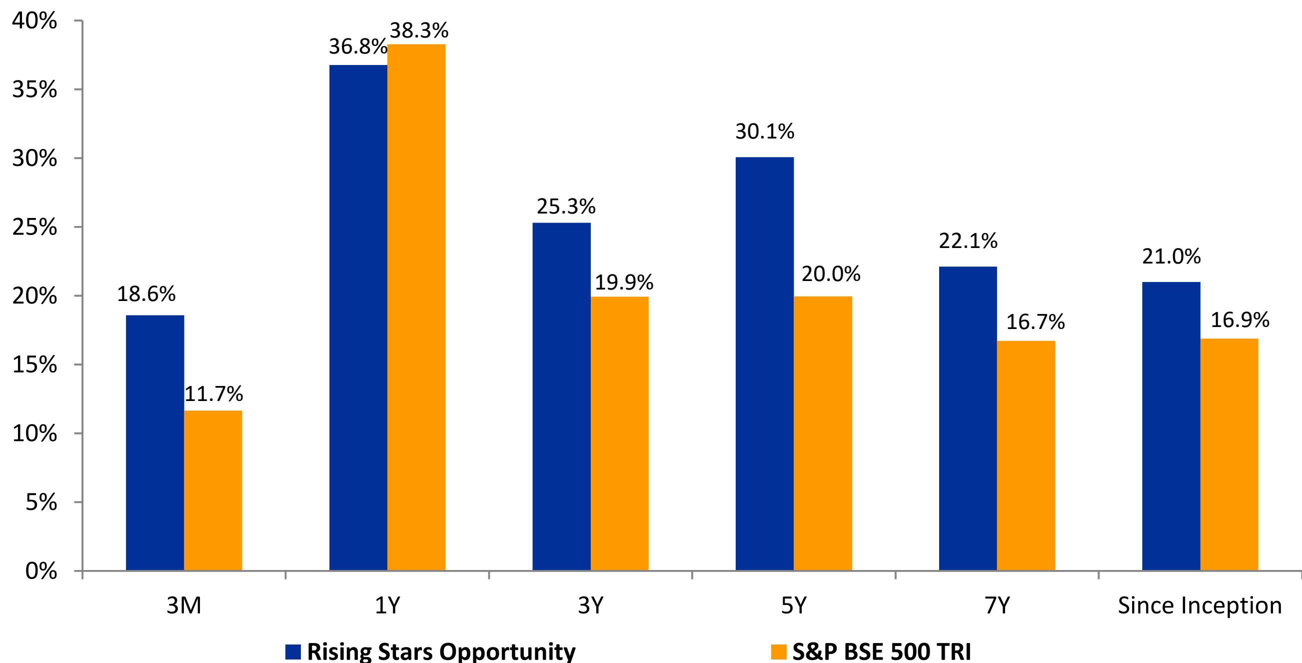
Portfolio Performance and outlook

1. Q2CY24 saw a revival of the small and mid-caps helping our portfolio outperform the BSE500 TRI benchmark in both the schemes. Moreover, our cautious stance on the elections was justified in the election results. We were buyers on the market fall on the election result day and deployed cash aggressively over next few days.

2. 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 have adding weight to financials during the quarter and nibbled into sectors like chemicals which have been sharp under-performers. We have also added a company which is an ancillary to the oil and gas sector.

3. We are looking to again increase cash in our portfolio to prepare some dry powder for any correction in the markets. We have also prepared for any possible downside in markets by (a) keeping the valuations of our portfolio in attractive zone (the PE of our portfolio is under 15x) and (b) will continue to increase weight to larger cap companies in our multi-cap portfolio.

Valentis Rising Stars Opportunity Fund Performance (as on June 30, 2024)



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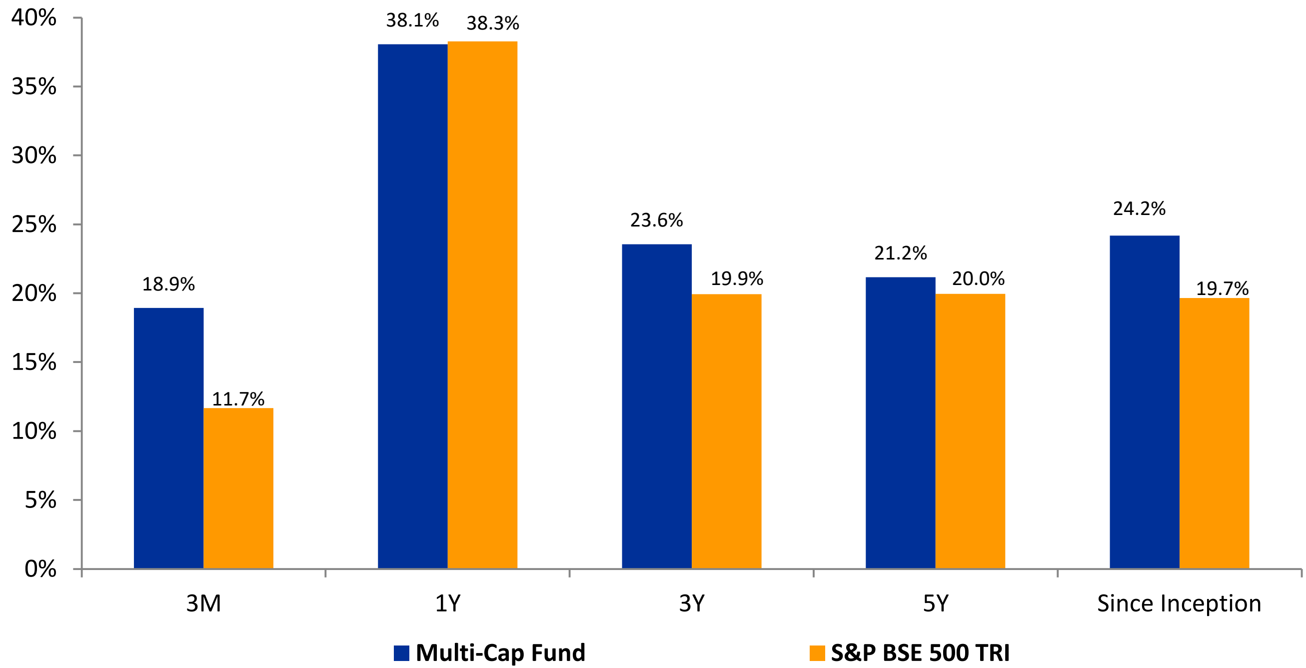
Valentis Multi-Cap Fund Performance (as on June 30, 2024)



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