Valentis Advisors

Synchronized rate cuts vs slowing earnings

October 15, 2024

- **We continue to believe investors should temper return expectations going ahead and will not see outsized returns like in the past few years. High starting valuations and slowing earnings growth means we could see a period of consolidation with time and price correction in the market.**
- **The good news is that we believe inflation and interest rates have peaked. This will drive interest rate cuts globally except Japan. In India, we think rate cuts will be more measured with a likely cut in December dependent on inflation data.**
- **Earnings momentum in India is slowing and we think earnings growth will now start mirroring nominal GDP growth with margins having peaked. We would look for (a) rural recovery post the better monsoon (b) increased capex spending by Government and (c) probably a more benign monetary policy by the RBI to lead to better earnings momentum.**
- **The Fed cuts will be positive for emerging markets. However, China which is likely to be a bigger beneficiary with the stimulus measures they have announced and cheap valuations. Longer term, a surge in Chinese markets will reduce the valuation premium of Indian markets over EM markets and help flows back in India.**

Will the markets correct?

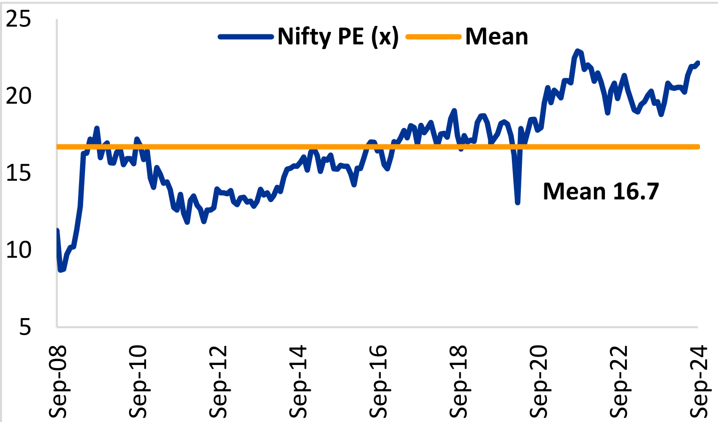
Most investors have been waiting for a correction since the beginning of the year. Even our view was that returns this year will be muted in the market. The markets, however, are headed for the 9th consecutive positive year for the Nifty.

Will we see a correction in the markets? The risk clearly exists though it is very tough to time these corrections. We have been advocating staggered investments to provide for a possibility of correction. However, what is more likely is that we have small corrections accompanied by a longish range-bound time correction. Overall, the easier forecast is that returns will be moderate compared to the past few years.

Valuations expensive though partly justified by lower interest rates

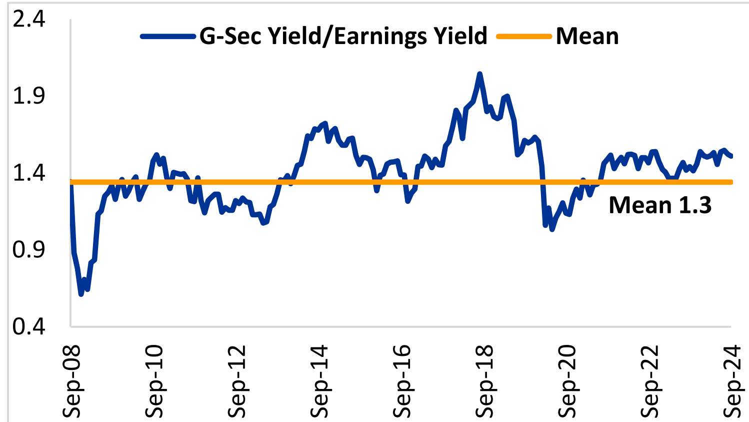
- Most of our absolute valuations measures like PE (India trades at 22x 1-year forward) and P/B (India trades at 3.5x 1-year forward) are expensive and trade at 2x standard deviation over mean. Historically returns have been low by investing at these levels.
- Interestingly, however, on bond yield vs earnings yield measure, markets are trading at close to long term average valuations. In fact, a 50-bps reduction in bond yield could mean that markets are cheap at current valuations also.

Chart 1: Nifty 12M Forward P/E (x) – still expensive



Source: Edel, Valentis Research

Chart 2: Bond yield Vs SENSEX yield - at average valuations



Source: B&K sec, Valentis Research

Can a strike on Iran by Israel cause a correction?

It's possible that there will be fears of a flare up in the Middle East conflict. But we believe this correction will be bought into. History of conflicts shows that market corrections are very short-lived. A flare up in oil prices can be negative for India. But we think its unlikely that oil prices rise sharply for a sustained period.

Table 1 – Market in conflict times

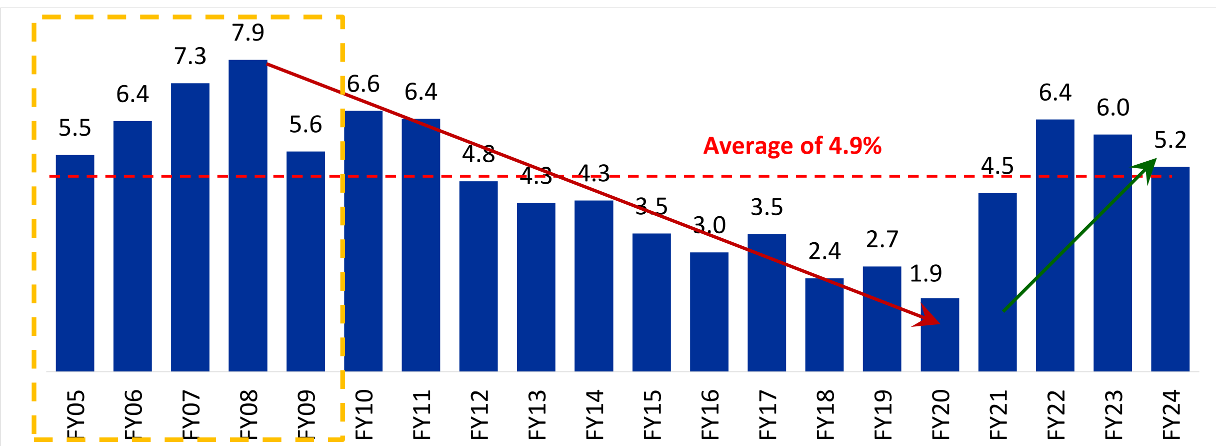
		S&P 500 Return					Nifty 50 Return				
Event	**Event Date**	**Size of Sell Off**	**1M**	**3M**	**6M**	**1Y**	**Size of Sell Off**	**1M**	**3M**	**6M**	**1Y**
9/11 attack	11-09-2001	-13.5%	0.4%	4.3%	6.9%	-17.3%	-17.8%	-9.0%	7.4%	14.9%	-3.4%
Iraq War	20-03-2003	-3.7%	2.0%	13.7%	18.3%	26.7%	-5.0%	-8.2%	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%
Israel - Hamas war	07-10-2023	0.6%	1.0%	8.3%	20.0%	31.4%	-0.7%	-0.5%	11.3%	15.4%	27.1%

Source: Ace Equity, Investing.com, Valentis Research

Are earnings peaking?

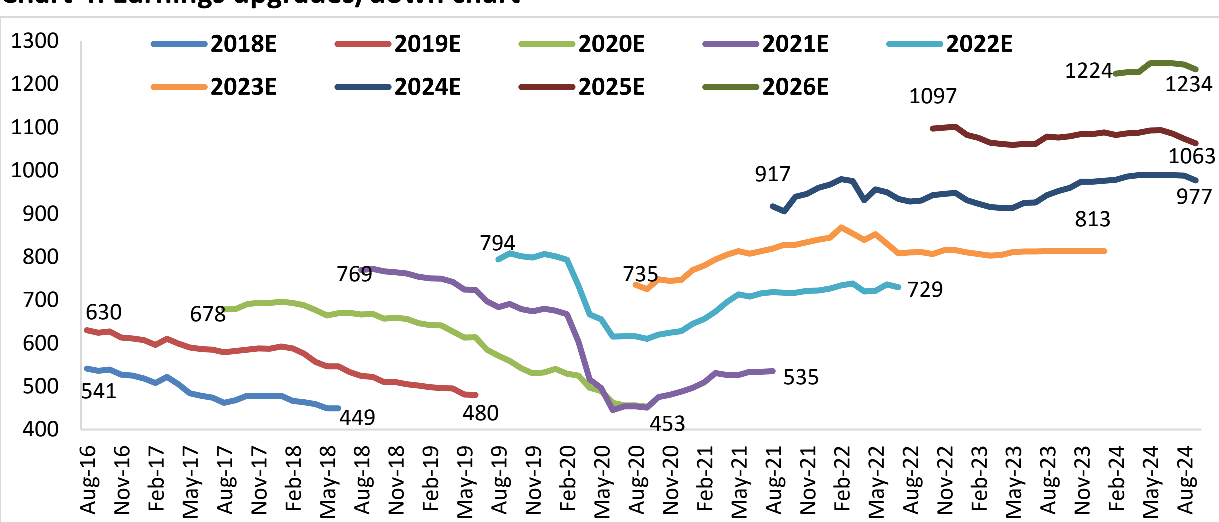
- The peak of corporate earnings has coincided with major corrections in markets. We are currently clearly seeing a slow-down in earnings as well as in earnings momentum with downgrades and upgrades being nearly equal.
- Has earnings peaked? We think there are 2 negative factors (a) With margins have rallied sharply, we think further increase in corporate profits due to margin increases will be slow. (b) 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.
- Overall, we think earnings will clearly slow from levels seen over the past few years and inch closer to nominal GDP growth. But we do not expect any negative growth in earnings over the next 2 years though current quarter will be a tough quarter.

Chart 3: Corporate Profit to GDP Ratio Trend:



Source: MOSL, Valentis Research

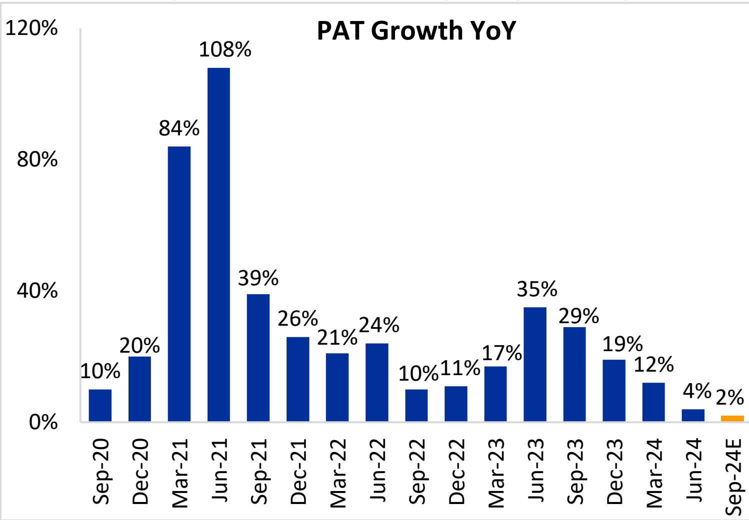
Chart 4: Earnings upgrades/down chart



Source: Kotak Institutional Equities, Valentis Research

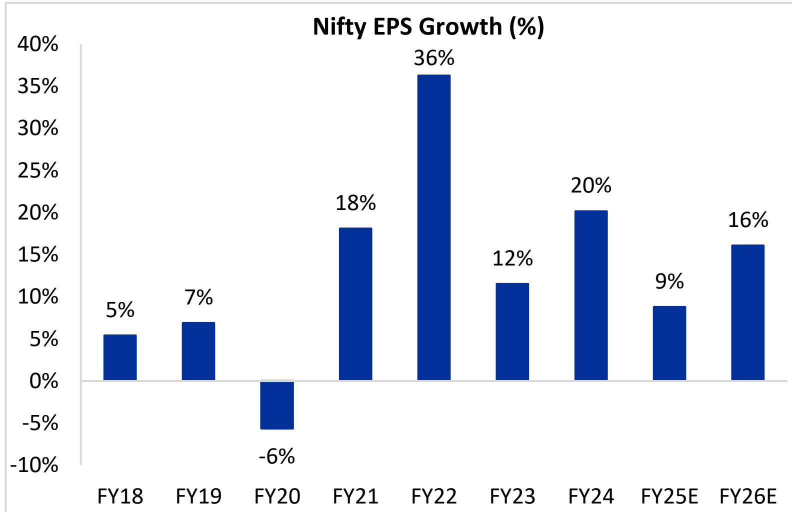
- Q2FY25 results will also be a mixed bag. Overall Nifty earnings may be weak at single digit. But excluding oil and marketing companies, earnings will be closer to 10%. Banks (Private + PSB) would mainly lead BFSI's earnings, with 10% YoY growth. The earnings growth of Private and PSU banks, at 5% and 17% YoY, respectively, while healthy, is the lowest for Private banks in 12 quarters. The Auto sector's earnings are likely to rise 7% YoY, the lowest in ten quarters. Pharma will be a big contributor.

Chart 5: PAT growth to be low single digit on high base



Source: MOSL, Valentis Research

Chart 6: Annual EPS Growth



Source: Kotak Institutional Equities, Valentis Research

What can increase earnings growth?

We think near term the earnings and the economy slowed as the Government spending was dampened by the pre-election constraint. We are watching the following factors which lead to better GDP growth and help topline growth for corporates

- Firstly, the Government will start spending its capital expenditure budget which should help GDP growth.

- Secondly, over the next few years it is essential that private capex start reviving. 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.

- Thirdly, a better monsoon has led to a rise in crop sowing. This should help rural incomes and rural consumption towards the end of the year.

- Lastly, monetary conditions are tight with Government balances with RBI at high levels. As the Government spends, we could see an increase in money supply and lower interest rates help the economy.

Table 2 – Cumulative Capex trends down YoY so far

Months (INR Bn)	2024-25		
	Monthly	Year to date	*YoY (%)*
April	992	992	*26%*
May	444	1,436	*-14%*
June	374	1,811	*-35%*
July	802	2,613	*-18%*
August	397	3,010	*-19%*

Source: CEIC, ISec, Valentis Research

Table 3: Sowing for most crops higher than last year

Kharif Sowing	Area sown in 2023-24 (mn ha)	Area sown in 2024-25 (mn ha)	Growth (YoY %)
Coarse Cereals	18.6	19.3	3.8%
Paddy	40.5	41.4	2.2%
Pulses	11.9	12.9	8.4%
Oilseeds	19.1	19.4	1.6%
Cotton	12.4	11.3	-8.9%
Sugarcane	5.7	5.8	1.8%
Jute and Mesta	0.7	0.6	-14.3%
All Crops	**108.8**	**110.5**	**1.6%**

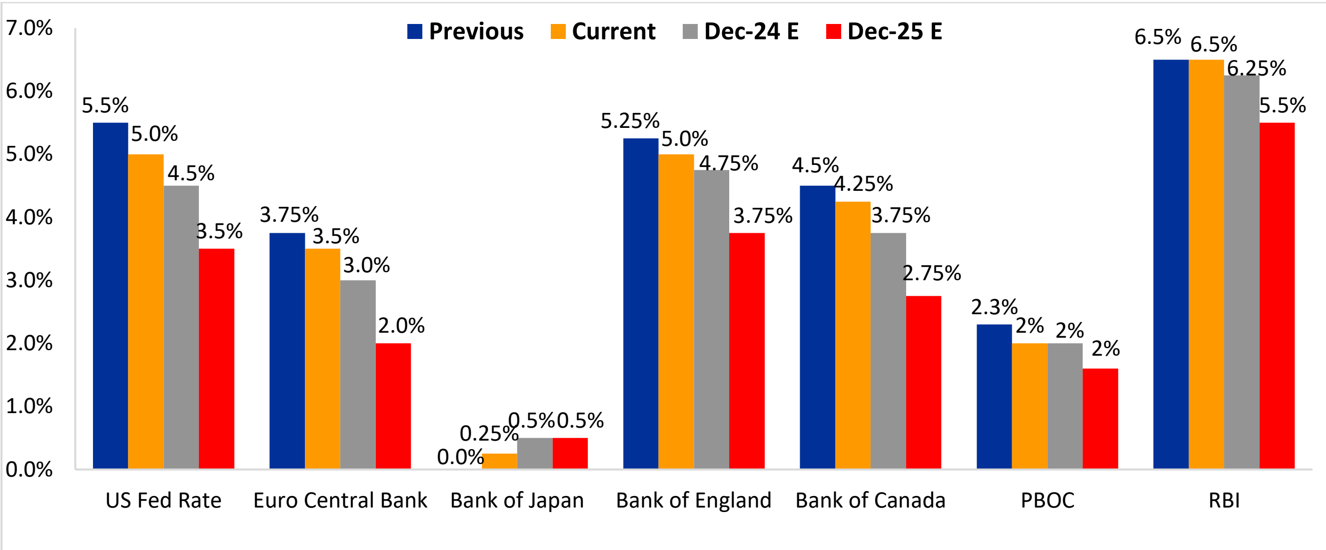
Source: Ministry of Agriculture, Emkay, Valentis Research

Synchronized rate cut cycle will support equity markets

- The Fed has started a rate cut cycle with a bang cutting 50 bps. Other central banks are also lowering rates with 6 of the Top 8 economies having seen a rate cut already. We think except for Japan, all central banks will see 100-200 bps of rate cuts over the next year.

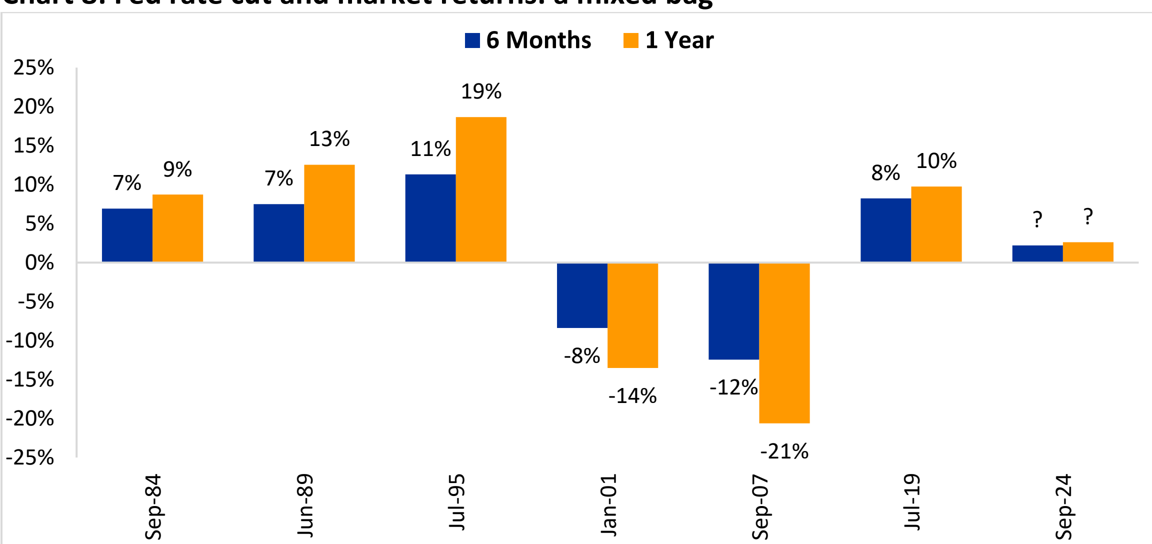
- Fed rate cuts have generally been positive for markets. However, the USA economy seems to be slowing down. Any rate cuts driven by a slowing economy may mean that we will see the markets not holding on to any gains from the cut in rates. Moreover, starting valuations are not cheap. Both the negative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

Chart 7: Fed drives global push to cut rates despite uncertainties over 2025



Source: Bloomberg Economics, Valentis Research

Chart 8: Fed rate cut and market returns: a mixed bag



Source: investing.com, Valentis Research

India rate cuts will be slower

Inflation in India has increased but still within the RBI range. We expect a rate cut by the RBI in December but it will be a call dependent on inflation data over the next few weeks. Our call is that food inflation will reduce due to better crops and that will provide room for RBI to cut rates.

Fed cuts are good for emerging market equities

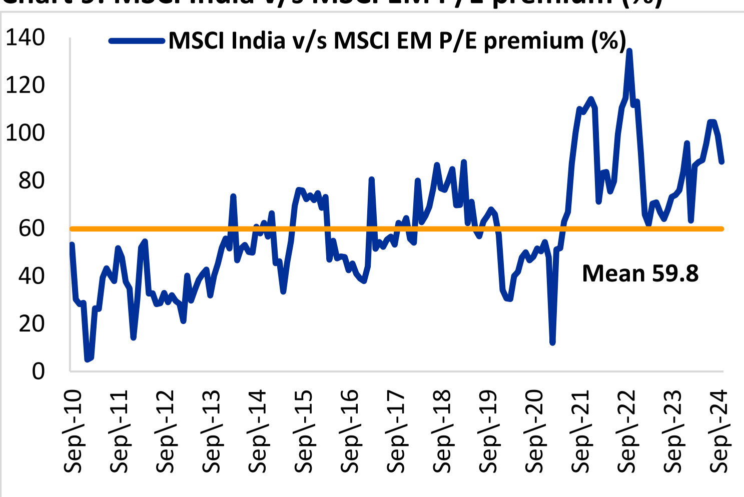
Fed cuts are positive for emerging market equities. However, inflows to India will be muted near term at least since:

1. Valuations in India trade at an 80%+ premium to Emerging markets. This combined with the sharp out-performance of Indian markets may mean India relatively under-performs other EM markets.

2. Second factor is the stimulus in China. While this may not be enough to turn around the economy from its structural problems, Chinese equity markets were very undervalued, under-owned and under-performing. Indeed, it was almost an "non-investable" asset class for some investors. China's weight in the MSCI fell from a peak of 43% in October 2020 to nearly 23% last month before the sharp rally in the equity markets. Given the volatility in markets, we think investors will be wary of a big overweight in China. But a floor for the market has been created.

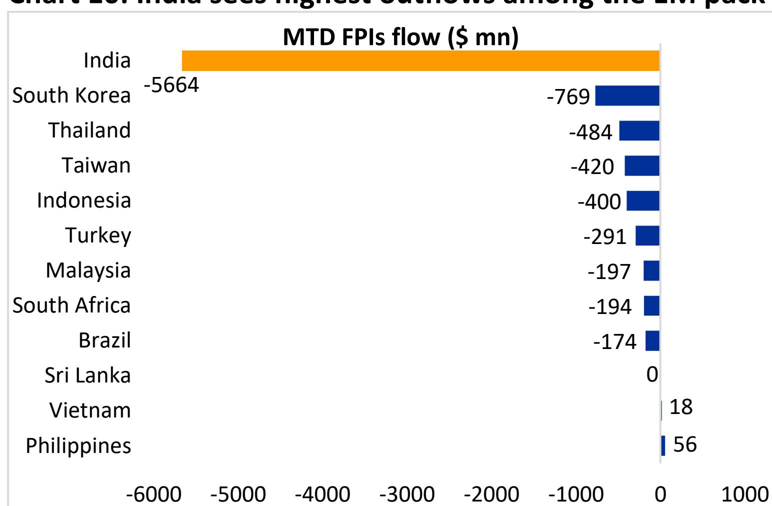
3. Just on a positive note for India – a rally in Chinese equity is reducing India's PE premium to the EM. This will help FPI flows to India longer term.

Chart 9: MSCI India v/s MSCI EM P/E premium (%)



Source: Isec, Valentis Research

Chart 10: India sees highest outflows among the EM pack



Source: Business Standard, Valentis Research

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Portfolio Performance and outlook

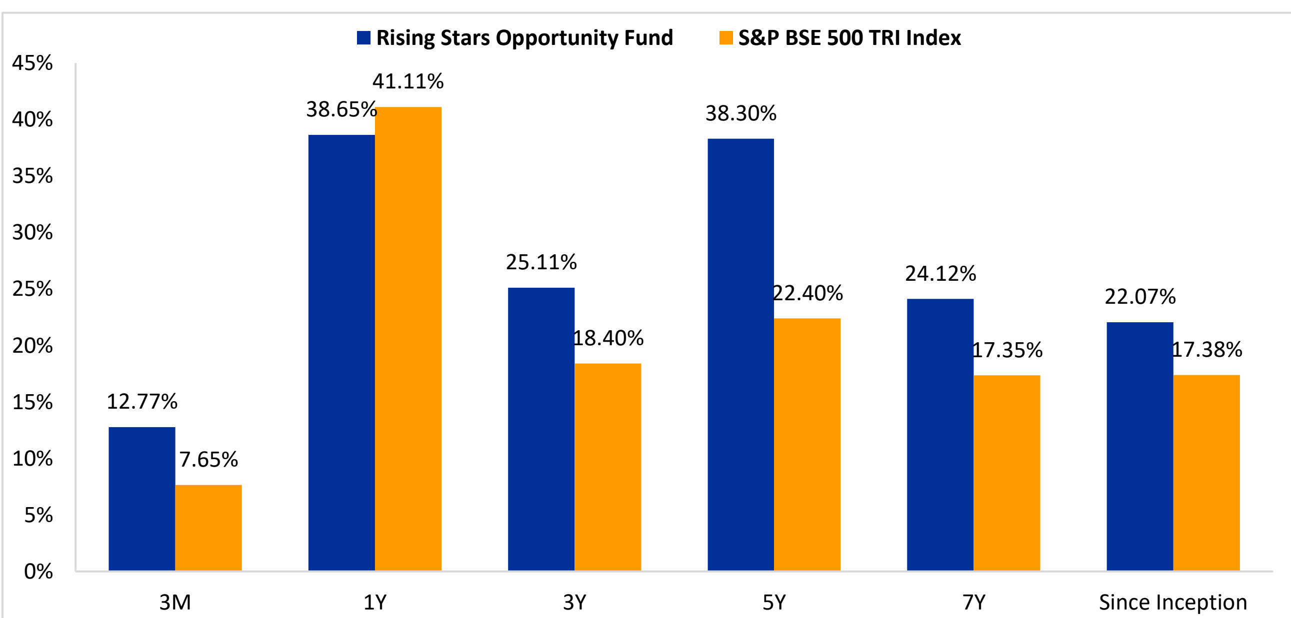
1. Our portfolio outperformed the BSE500 TRI benchmark in both the schemes during the Q3FY25 with small and mid-caps performing better than the large caps. Our caution on a likely hike in capital gains turned out to be correct but the market brushed aside the negative.

2. During the quarter, we bought a real estate company. The high-end real estate segment is seeing strong demand. As the company monetizes its land bank, we will see increased earnings and return ratios. We also added weight to a pipe company where capacity expansion over the next 2 years will drive sharp growth.

3. We have taken some profit from a cement company post the acquisition of India Cement. Near-term earnings are struggling, and valuations became fair as stocks adjusted to the acquisition price. We also booked profits in a chemical company where valuations reached the fair zone and near term earnings could be under pressure.

4. 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 an 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 September 30, 2024)



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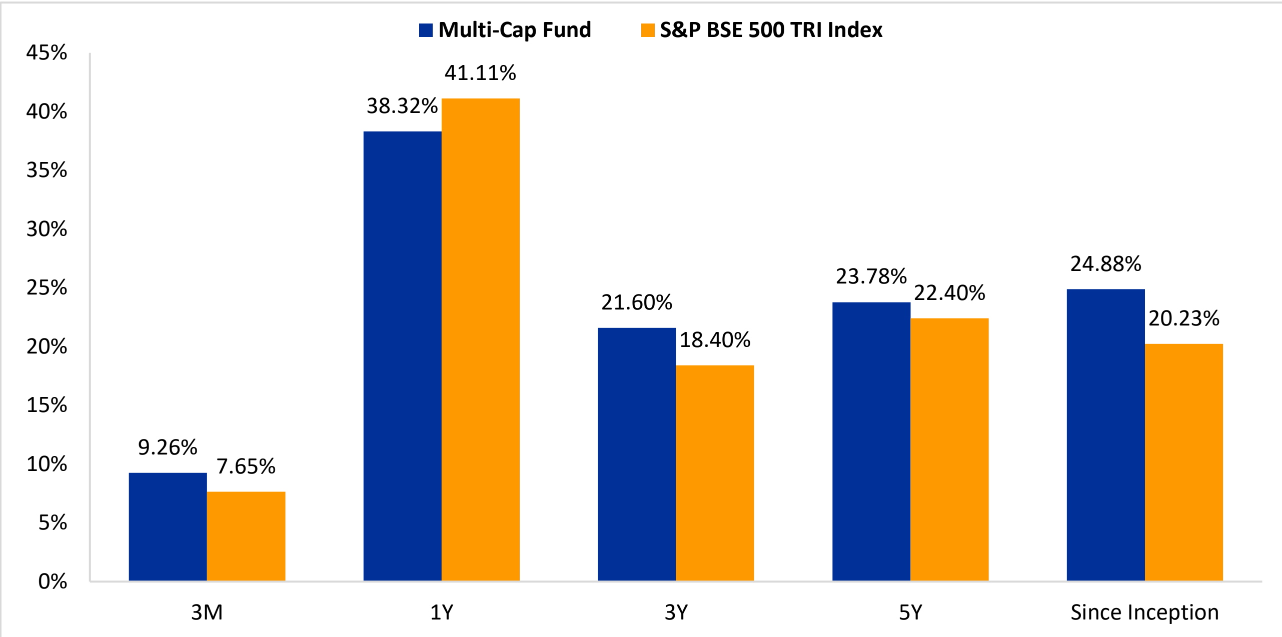
Valentis Multi-Cap Fund Performance (as on September 30, 2024)



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