Valentis Advisors

Playing a Test match

January 22, 2025

We would advise investors to treat CY25 as a year of consolidation and keep return expectations low. Hence, we think of this in cricket terms as shifting from T20 to a Test Match mode. The good news is that post a near 13% correction in markets, valuations in the large caps are slowly getting close to the top-end of fair value zone and any sign of a revival in the economy can help improve market sentiment.

1. **We have seen 9 consecutive years of positive returns, already a record. Do we get a 10th consecutive year? We think yes but with a likely single digit return.**
2. **Second is that volatility will be higher. As we highlight, a 10%+ correction in any calendar year is the norm and not an exception.**
3. **Thirdly, large caps will do better than mid and small caps due to (a) sharp outperformance of the small and mid-caps and (b) high relative valuations.**
4. **Probably for investors, a staggered approach to investing additional money and using corrections to invest makes sense.**
5. **Can earnings re-bound? After the first 2 quarters of the year we had a 3% earnings growth, we see a slightly better Q3FY25. But 4Q and FY26 could see double digit earnings growth that would provide support to markets. Better rural demand and higher Government capex could drive earnings.**
6. **We think currency and bond markets could provide the biggest shock to markets:**
   (a) Will tariffs on China by the Trump administration lead to a weak yuan and a round of competitive devaluation by emerging markets?
   (b) Will tariffs bring back inflation in the US and mean that Fed is on hold through the year? Remember that the 10-year bond yield rose nearly 100 bps from the day Fed cut rates by 100 bps

#1: Earnings recovery is the key for returns in market

We have seen a slowdown in earnings and a marked downward trend in earnings revision with the economy showing signs of sluggishness. Earnings growth over the past 2 quarters have averaged only 3%. We expect the ongoing 3rd quarter to be slightly better with earnings likely to grow at 6%. We are expecting 4th quarter to average closer to 10%. We think FY26 will see double digit growth in line with nominal GDP growth.

So why will earnings grow?

- Firstly, the Government has been slow on capital expenditure. If they have to meet their budget we need a near 50% yoy increase in spending in the last few months of the year. We think the Government will do

close to a 30% yoy growth and this should revive the economy (actual capital expenditure will be lower than budget).
- Secondly, a better monsoon has led to a rise in crop sowing. This should help rural incomes and rural consumption.
- Lastly, the cut in CRR will help ease the monetary conditions slightly. But maybe the central bank should be ready to pump in more liquidity in the system if required.
- On a longer term view, over 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.

#2: Valuations are getting better

Through the past 18 months we have been very concerned about valuations. We are getting a bit more comfortable with the large cap valuations. The small and mid-cap space is still expensive, especially in certain pockets.

- While the markets are not cheap, the recent correction has brought the large caps near to the top end of the fair value zone. On a PE basis, the Nifty trades at 19.1x closer to the 10-year average of 18.4x. Interestingly, on bond yield vs earnings yield measure, markets are trading at close-to long-term average valuations.
- In a relative context, however, India trades at near 90% premium to EM valuations, way above historic averages of 60.4%. A correction in relative valuations would provide room for increased FII flows into India.
- Retail investors have provided strong support to markets. However, investors since Covid have profited by buying every dip. Any prolonged time and price correction will test the durability of these flows. We are sensing cancellation of SIP mandates which nullify some of the strong inflows through SIPs.
- The small and mid-caps are relatively still expensive and we would be vary of some of the thematic names which would need sustained growth of 30-50% over a long period to justify current valuations. We think overall growth in earnings will be superior in the small and mid-cap space but would prefer to hunt for cheaper valuation stocks.

#3: Politics in USA will impact global economies

- With the Trump administration just assuming office, there are many global policies that could see a change. One policy that will be very significant for Indian software would be on immigrants and the amendments to the H1B.

- The other policy that would affect the whole world and could affect globalization is the threat of putting tariffs on imported goods coming into the USA. While the general feel is that it will be more targeted at China, the BRIC countries could also see some impact.
- There are 3 broad impacts of the tariff increases. Firstly, India may gain in some products if Chinese goods are hit with an import tariff and Indian goods correspondingly become cheaper. Secondly, this may lead to competitive tariffs by other countries (say China) on imports in their country thereby slowing global trade. Thirdly, we could see China devaluing its currency to ease the impact of tariffs in the USA. This could put other emerging market currencies including the Indian rupee under pressure.
- Lastly, tariff increases will raise the cost of goods in USA. This could mean that inflation in the USA could see an uptrend and may mean that Fed rates would need to slow.

#4: Bond and currency market worries: Will Fed cut rates any more? Will Dollar index continue uptrend?

- The Fed has already indicated that they will go slow on rate cuts and the market is now pricing in only 2 rate cuts for the year. US CPI is showing a small uptick indicating perhaps that the easy downtrend is over. But more significantly, any increase in tariffs could lead to inflation showing an uptrend again which could make the Fed cutting job even easier. It will also be interesting to see if Trump goes ahead with his promise of cut in corporate tax rates to 15% and its impact on fiscal deficit. While no one is talking of a Fed rate hike this year but rising inflation and a higher fiscal deficit could pressure the bond markets.
- As it is, after the Fed started its pivot in Sept, 2024 and cut rates by 100 bps, we have seen the 10-year bond yields in US rise by 80 bps (it was 100 bps a few weeks ago).
- Higher US bond yields would also lead to further favorable tailwinds for the US dollar. A rising US$ is negative for emerging market currencies as well as emerging market equities.

#5: Will interest rates in India be cut?

- The good news is that inflation in India is coming down from its highs. A better crop should keep food inflation in check and help lower inflation. However, a falling rupee may lead to inflation pressure.
- With a change in RBI Governor, the hope is that a rate cut is round the corner. However, we think the rate cut is getting more complicated given (a) falling rupee and the strength of the US$ (b) a pause by the Fed which could mean further pressure on the rupee if we cut rates.
- Given that RBI has spent nearly US$80 bn in the forward markets to defend the currency and that the rupee is over-valued based on REER, we think RBI will cut rates over next 6 months even at the cost of some currency depreciation risk.

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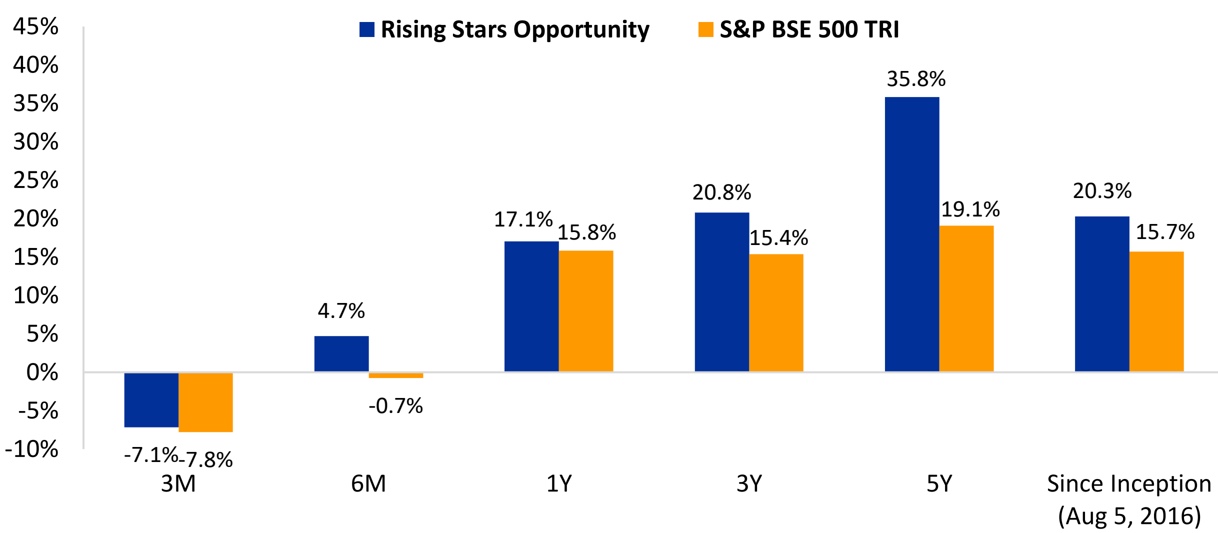
#6: Portfolio Performance and outlook

1. CY24 turned out to be a mixed year for markets. While Nifty ended up with high single digit returns as expected by us, the mid-cap and small cap stocks had a sharp rally during the year which seems to be faltering over the past few weeks. Both our portfolios outperformed the benchmark helped by the rally in the small and mid-cap names. However, with our focus on valuations, we stayed away from some of the high growth, high valuation stocks in this space and hence our returns were not as high as some of our peers.
2. Our overweight on capital goods worked well for us in 2024. But we have been trimming weight on the sector given the sharp outperformance.
3. Pharma was the sector we turned bullish on nearly 2 years ago. We continue to favor this sector outside of the domestic names and continue to hold some of our winners from last year.
4. Looking forward, we will continue to guard risk in the portfolio. Our focus will be on ensuring higher than market growth (currently we expect 20% growth in our portfolio) while maintaining valuations below market.
5. We believe investors should keep return expectations tempered during the year and look at this year as a year of consolidation where we build our portfolio for the next few years. We will continue to invest additional money in a staggered manner while being aggressive on any significant dips in the market.

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



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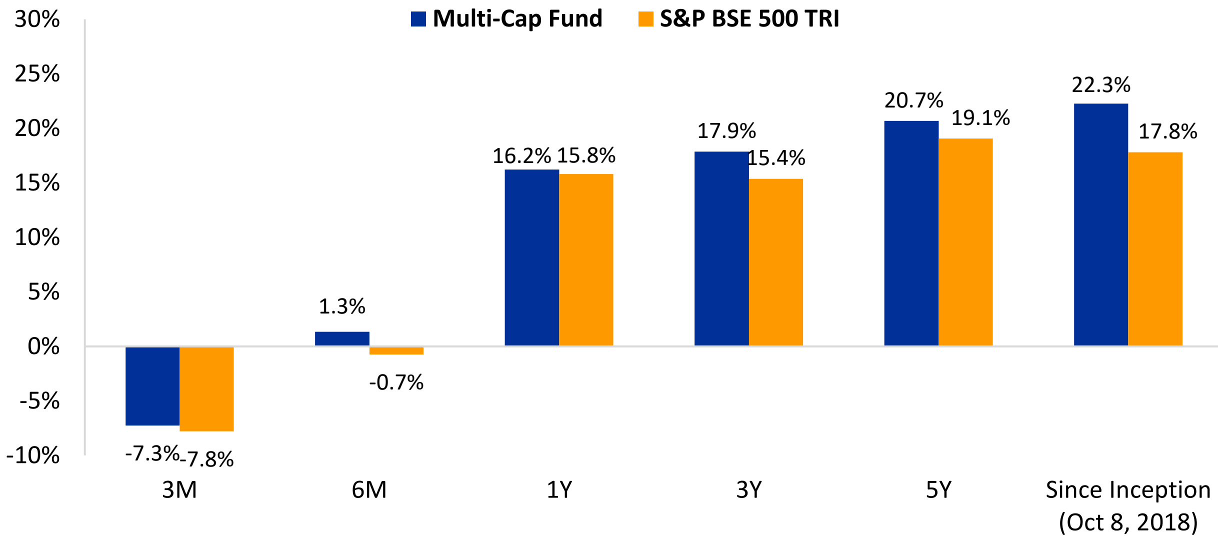
Valentis Multi-Cap Fund Portfolio Performance (as on December 31, 2024)



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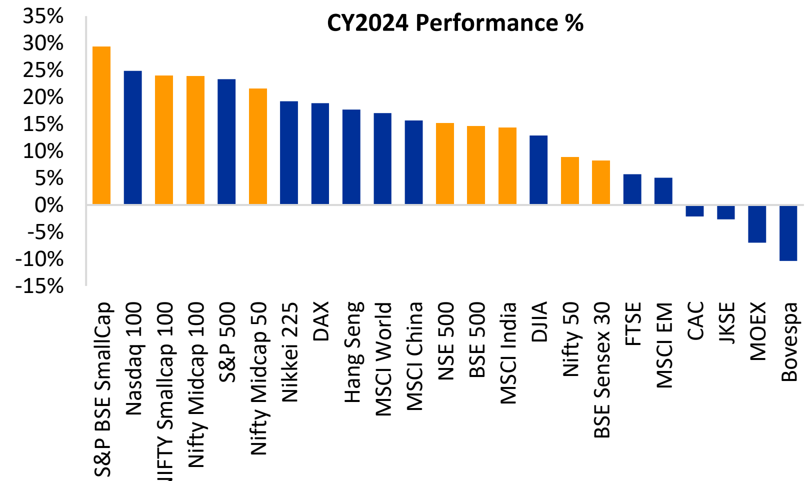
#1: Market Highlights

Indian Smallcap and Midcap indices outperformed global indices (in local currency)

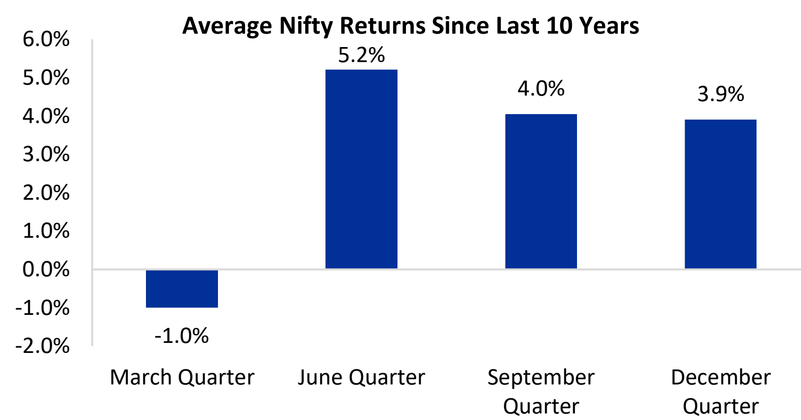
Chart 1: Mixed Performance by Indian markets in CY24



Source: Investing.com, Valentis Research

Q1 of any calendar year has traditionally been the weakest quarter

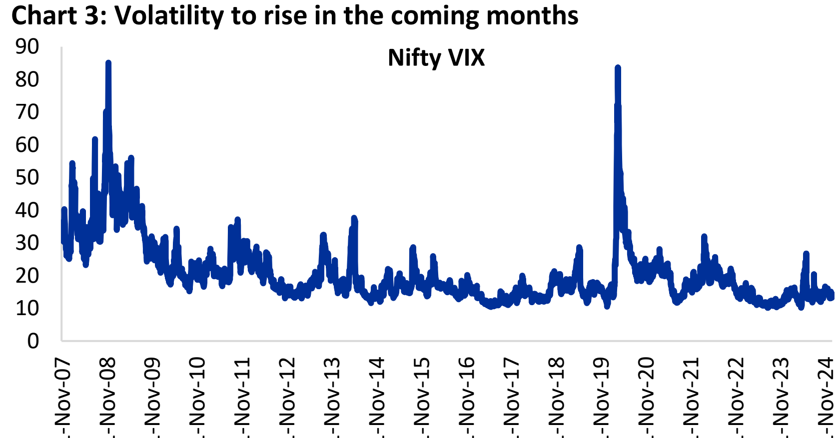
Chart 2: Entering Seasonally Weak Quarter



Source: AceEquity, Valentis Research

The VIX has started to rise.

Chart 3: Volatility to rise in the coming months

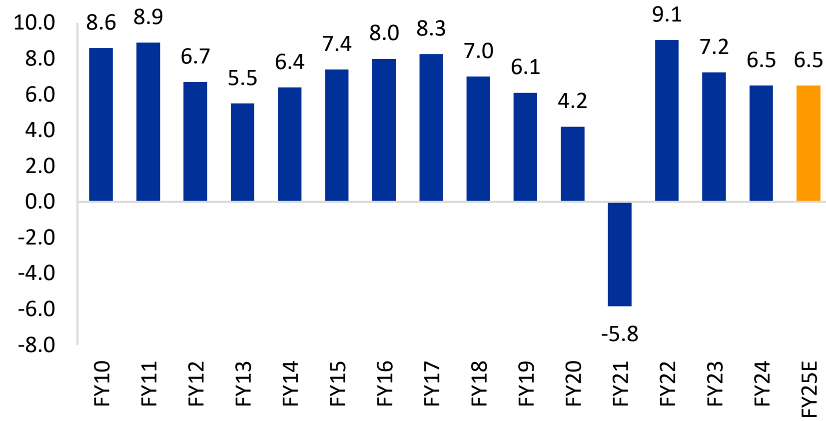


Source: Investing.com, Valentis Research

#2: Will the slowdown in earnings and economy reverse?

India will probably be the fastest growing economy in the world

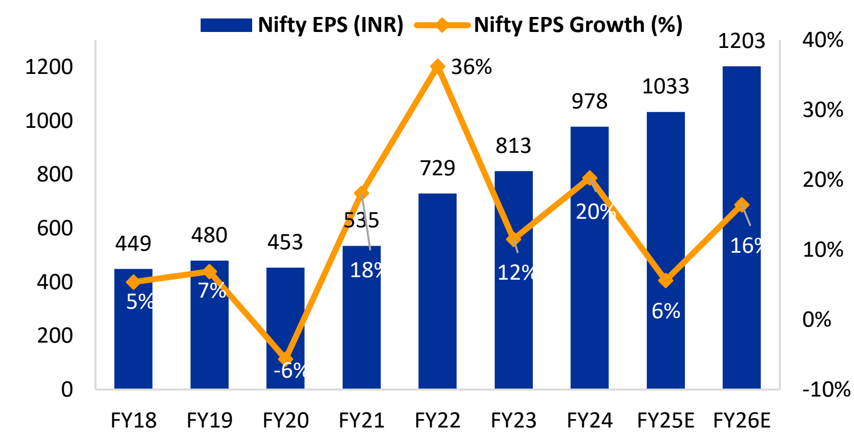
Chart 4: India's GDP growth



Source: IMF, Valentis Research

FY25 marked a slowdown in earnings. We see earnings recovering from Q4FY25 and moving in line with nominal GDP growth

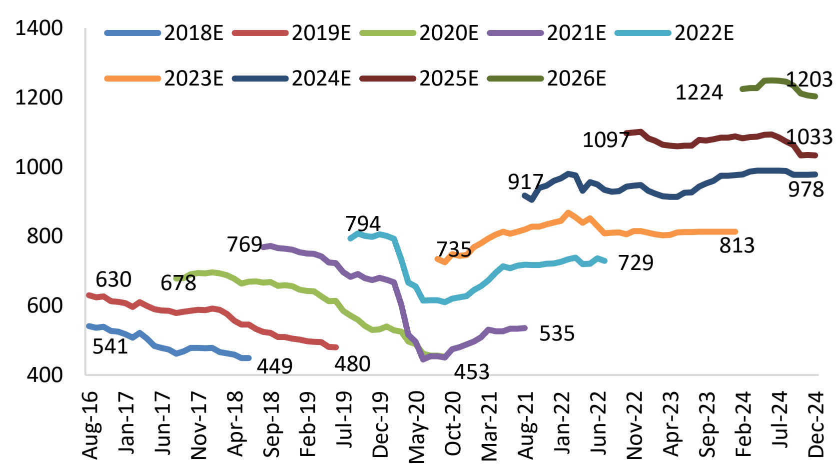
Chart 5: Nifty Earning growth to be in double digit in FY26E (%)



Source: Kotak Institutional Equities estimates, Valentis Research

Earnings downgraded in the last few months

Chart 6: Nifty earnings momentum has turned weak



Source: Kotak Institutional Equities estimates, Valentis Research

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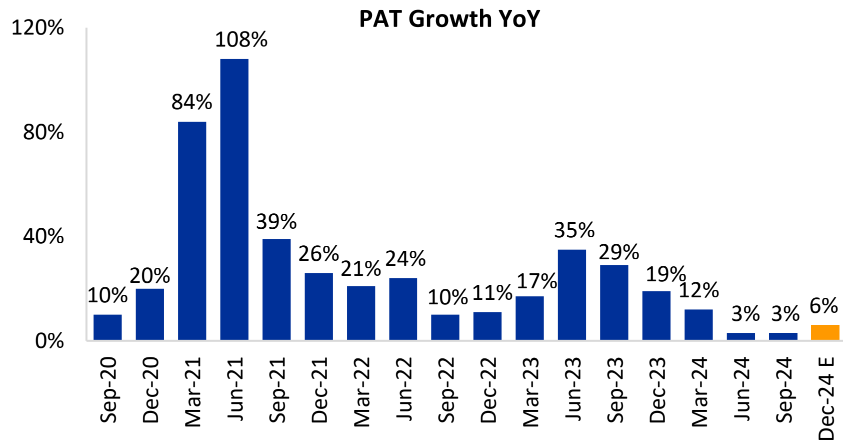
Earnings growth over the last 2 quarters were lowest since covid

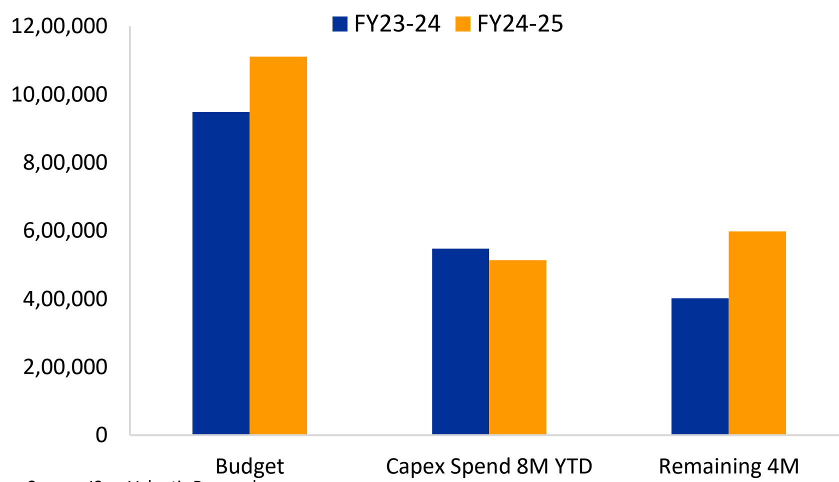
Chart 7: Expect Nifty's PAT to rise by 6% in Q3FY25E



Source: MOSL, Valentis Research

Government capex needs to rise 50% YoY in the last 4 months to meet the budget estimates

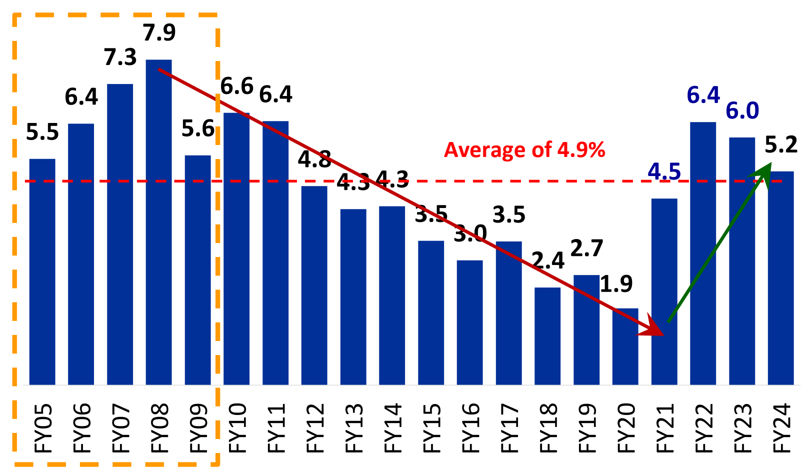
Chart 8: Cumulative government Capex trend (in Rs Crs)



Source: ISec, Valentis Research

Corp profit to move in line with GDP growth

Chart 9: Corp profit to GDP is at long term average

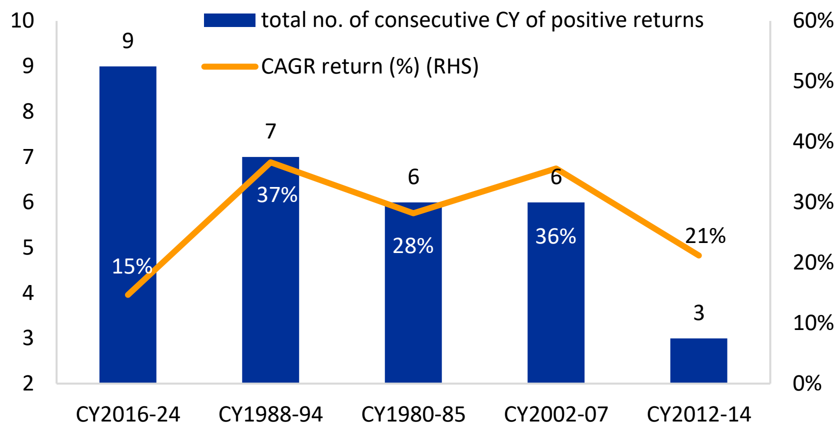


Source: MOSL, Valentis Research

#3: Valuations are getting better now

Both the Nifty and the Sensex have delivered 9 consecutive years of positive return, a new record. However, the rally has been weak in terms of CAGR returns (15% vs 28-37% earlier).

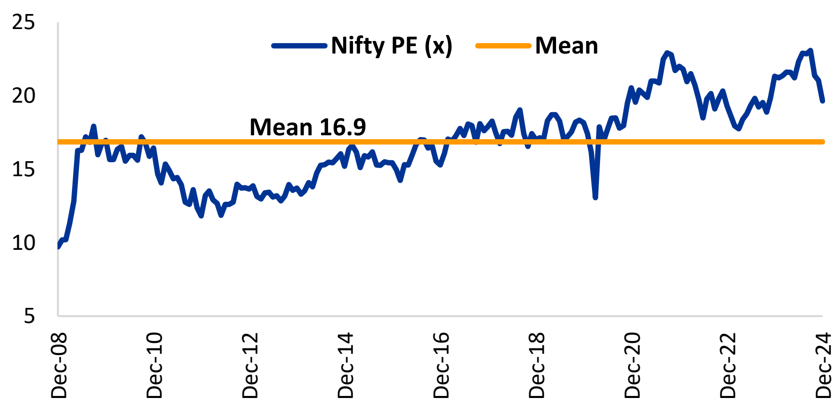
Chart 10: Total no. of consecutive CY of positive return on SENSEX



Source: AceEquity, Valentis Research

On a PE basis, the Nifty trades at 19.1x closer to the 10-year average of 18.4x.

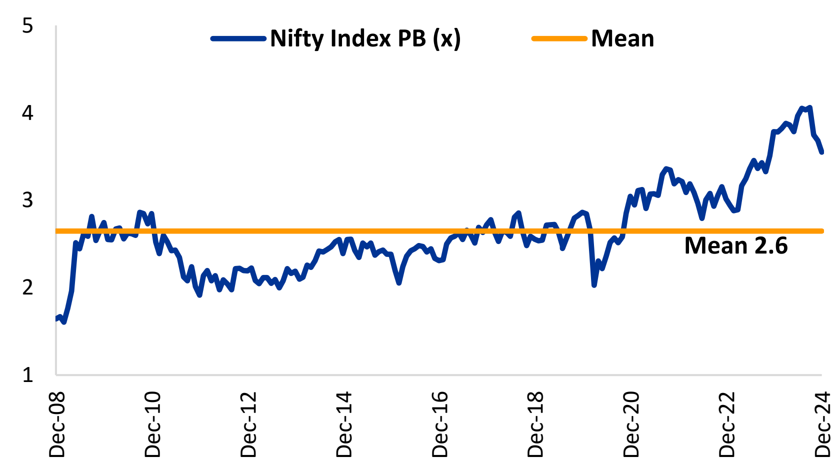
Chart 11: Nifty 12M Forward P/E (x) – getting near fair value zone



Source: MOSL, Valentis Research

On a PB basis, the Nifty trades at 3.6x, still expensive vis-a-vis 10-year average of 2.9x

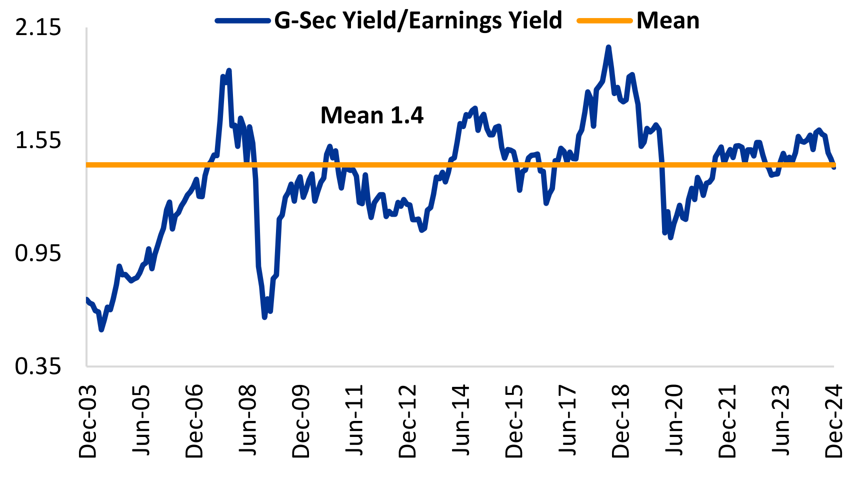
Chart 12: Nifty 12M Forward P/BV (x) – still expensive



Source: MOSL, Valentis Research

Chart 13: Bond yield Vs SENSEX yield – at average valuations

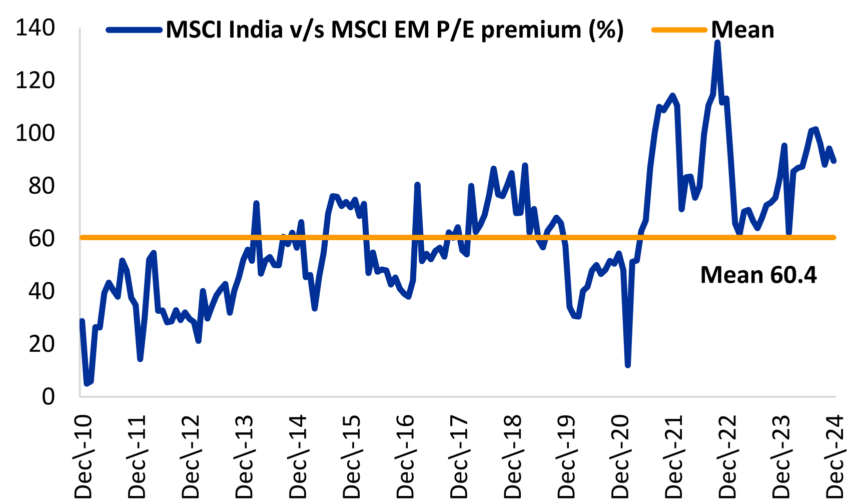
Market is looking reasonably priced on G-sec yield/Earnings yield



Source: MOSL, Valentis Research

Chart 14: MSCI India v/s MSCI EM P/E premium

While valuations look expensive in a historic context, India valuations relative to Emerging Markets are in extreme territory. They trade at over 90% premium to EM valuations vs a historic average of 60.4%.

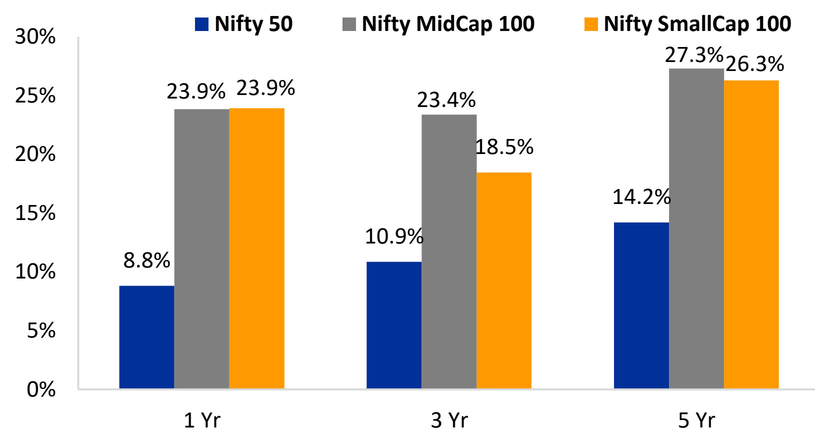


Source: Phillip Capital, Valentis Research

#4: Large caps provide a better margin of safety

Following the stunning rally in CY24, small and mid-caps out-performed large-caps over a 3 and 5-year period also

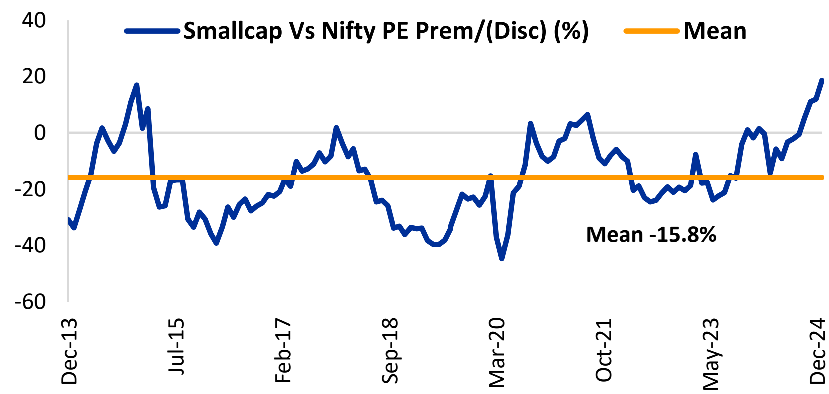
Chart 15: Nifty 50, Midcap 100 & SmallCap 100 Indices return



Source: ACE Equity, Valentis Research

Small caps trades at a premium of 19% to large caps

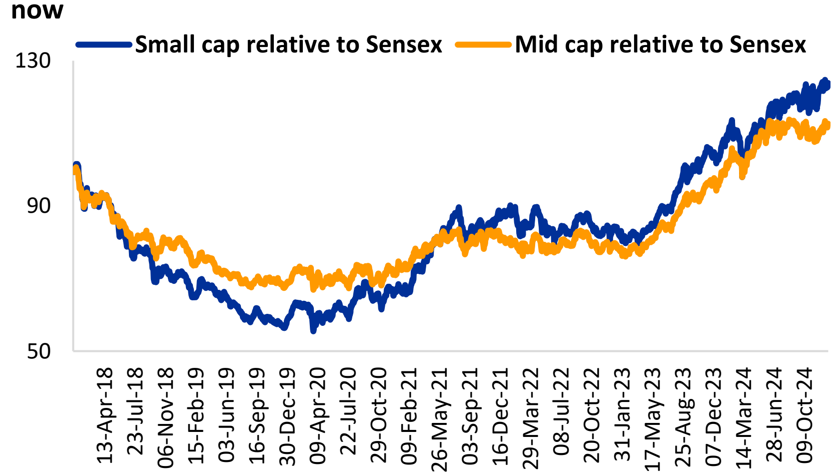
Chart 16: Smallcap Vs Nifty PE Prem/(Disc)



Source: MOSL, Valentis Research

Relative performance of Midcap and Largecap is at a 6 year high

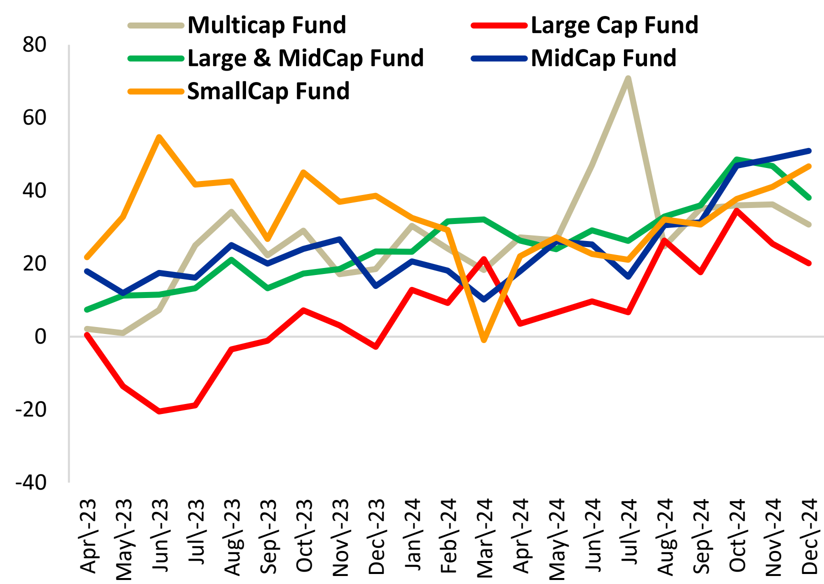
Chart 17: Relative broad market performance may have peaked for now



Source: AceEquity, Valentis Research

Small and mid-caps are vulnerable to retail selling

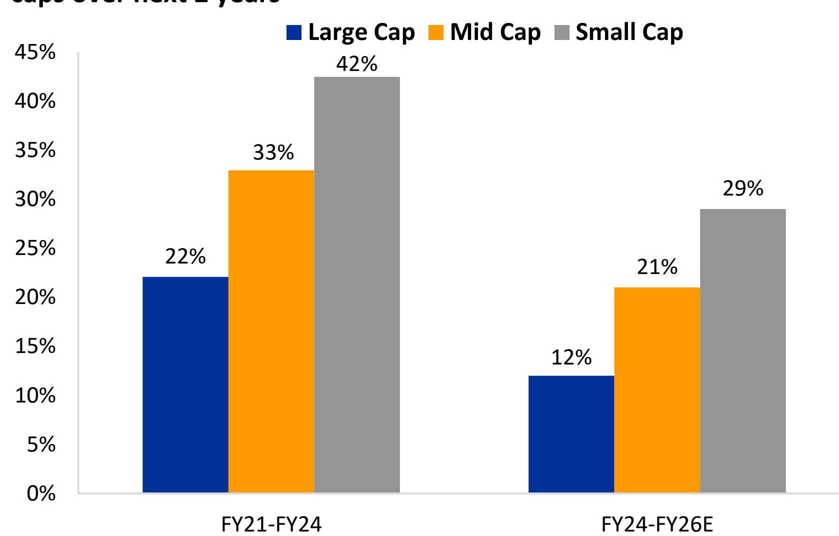
Chart 18: Net inflows in MFs (in Rs bn)



Source: AMFI, Valentis Research

Analysts expect MidCap and SmallCap earnings to grow faster than large caps

Chart 19: Small and mid-caps can grow 10% higher CAGR than large caps over next 2 years

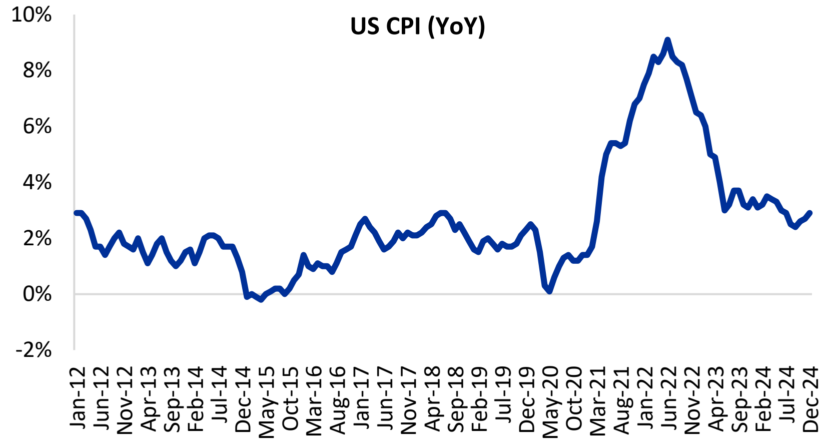


Source: Bloomberg, ISec, Valentis Research

#5: Watch for Bond and Currency Market

Tariff increase by Trump administration will be inflationary in nature

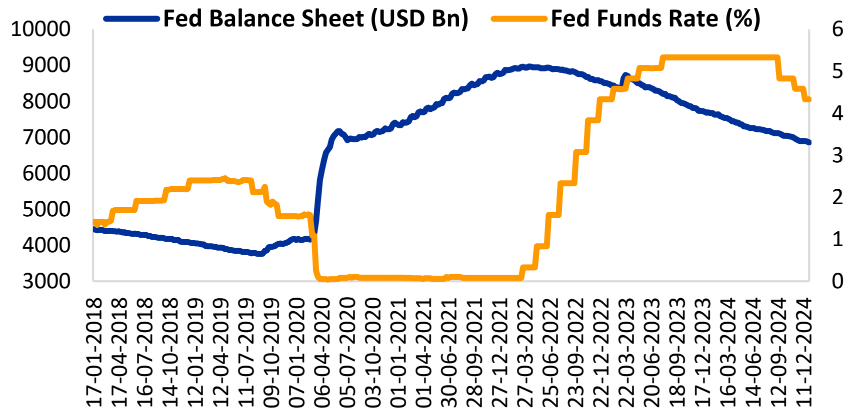
Chart 20: US Inflation starting to inch up



Source: Investing.com, Valentis Research

Expecting Slow rate cuts by Fed

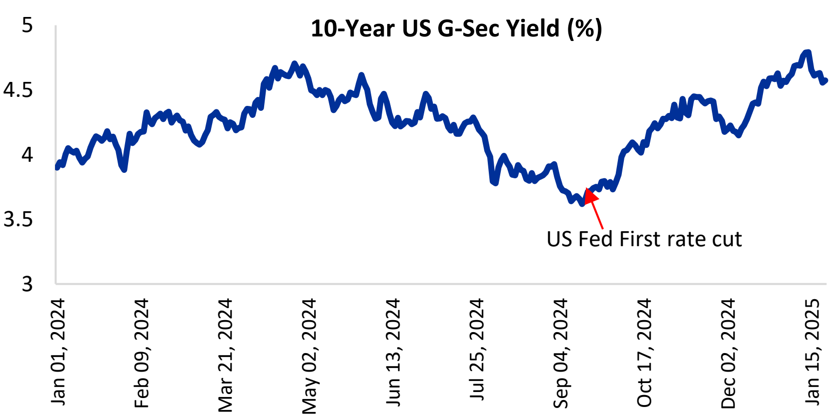
Chart 21: US Fed Rate & Balance Sheet Reduction



Source: Federal reserve, Valentis Research

After the Fed started its pivot in Sept, 2024 and cut rates by 100 bps, we have seen the 10-year bond yields in US rise by 80 bps (it was 100 bps a few weeks ago).

Chart 22: US 10-year bond yield peaking?



Source: Investing.com, Valentis Research

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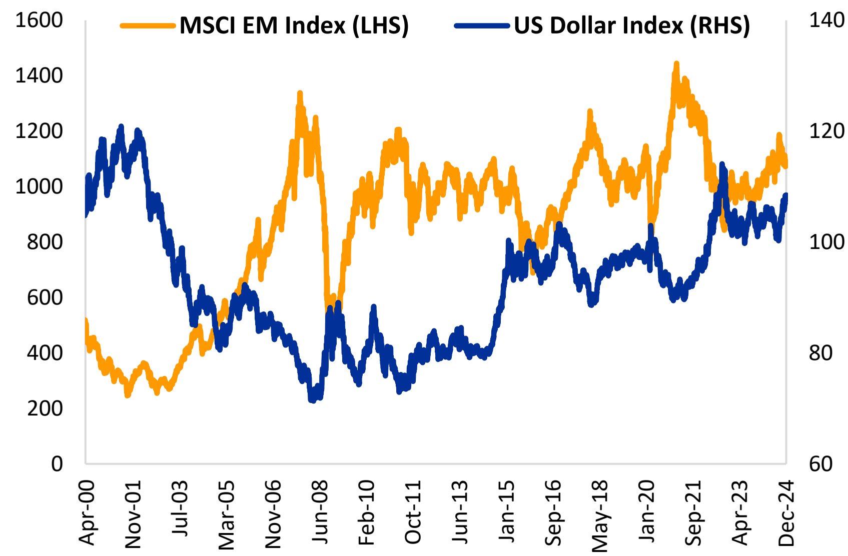
Dollar appreciation will hurt the emerging market equities

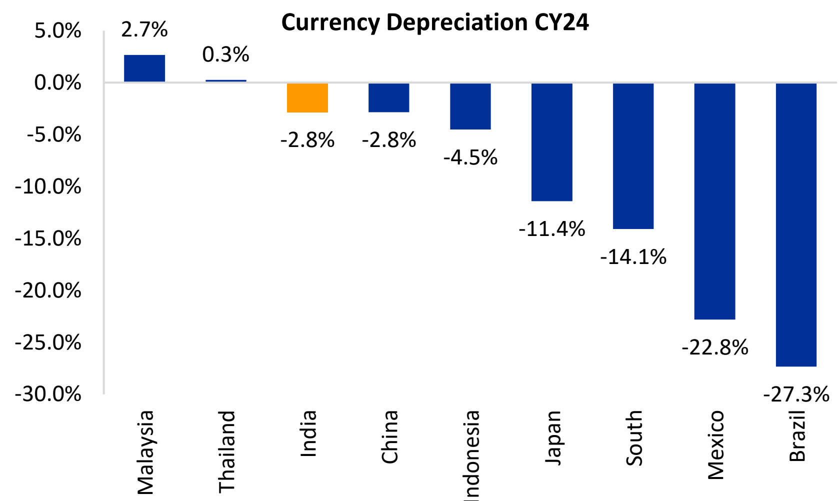
Chart 23: MSCI EM vs USD



Source: Investing.com, Valentis Research

INR amongst the lesser volatile EM currency in CY24 despite recent fall

Chart 24: Global Currency Movement against USD



Source: Investing.com, Valentis Research

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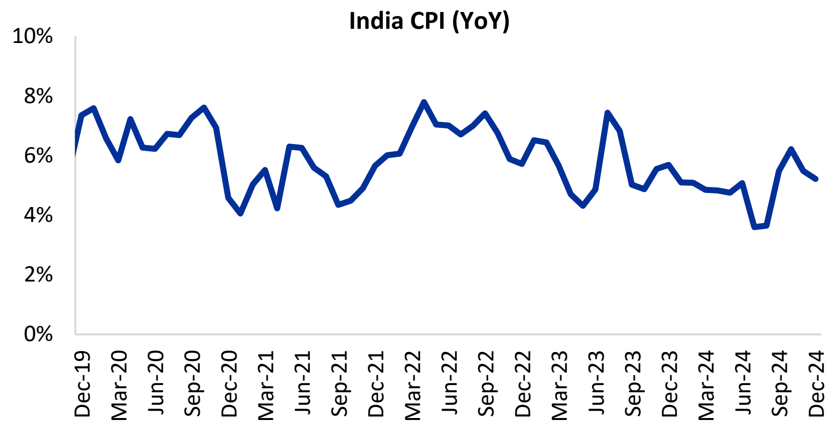
#6: Will RBI Cut interest rates?

Indian inflation starting to trend down

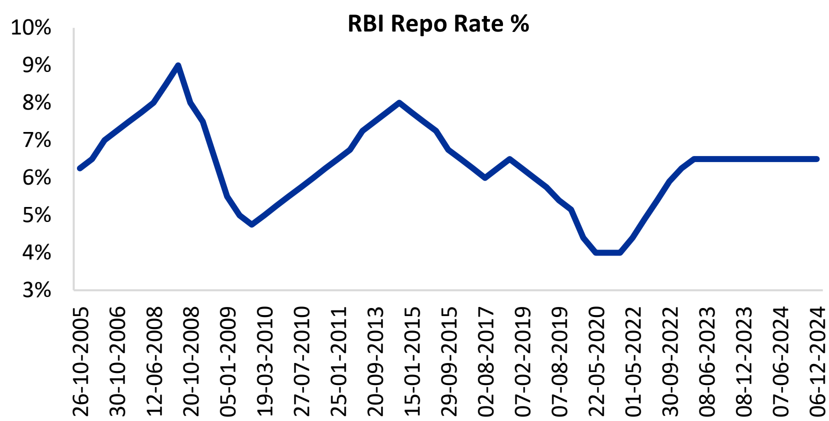
Chart 25: India Inflation trend



Source: Investing.com, Valentis Research

RBI may possibly cut rates this year

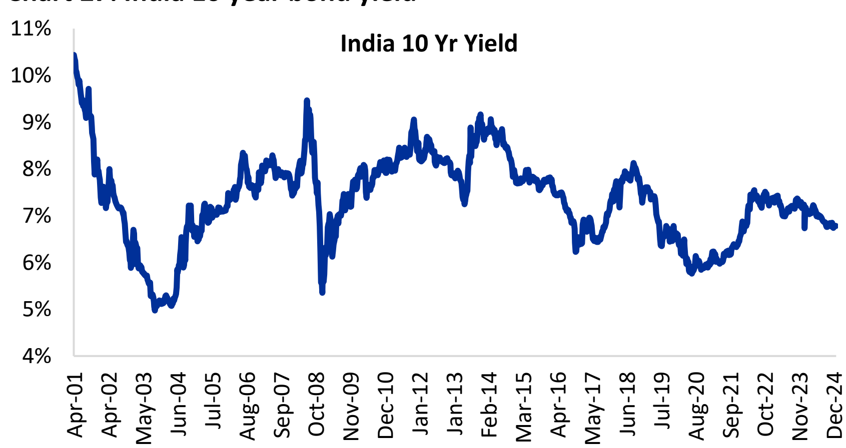
Chart 26: RBI Repo rate trend



Source: RBI, Valentis Research

Indian bond yields too have peaked and starting to come down

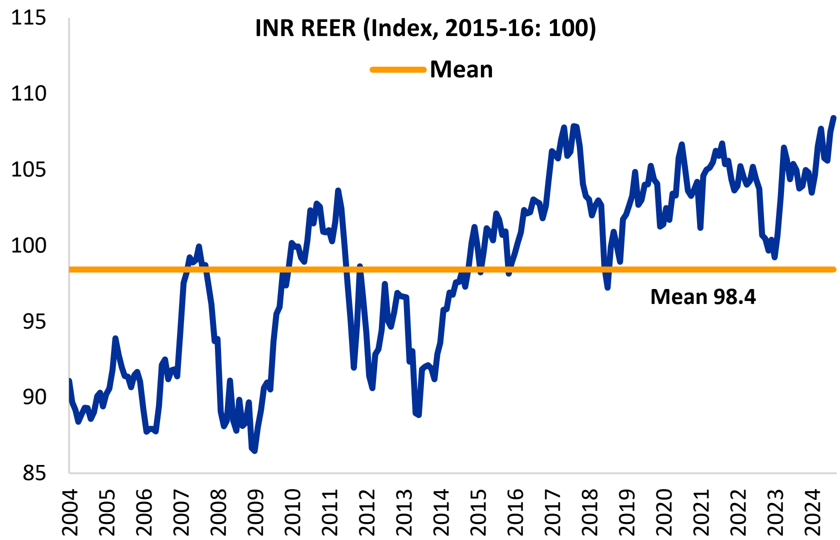
Chart 27: India 10 year bond yield



Source: Investing.com, Valentis Research

Despite of Rupee depreciation, it still remains overvalued on REER basis

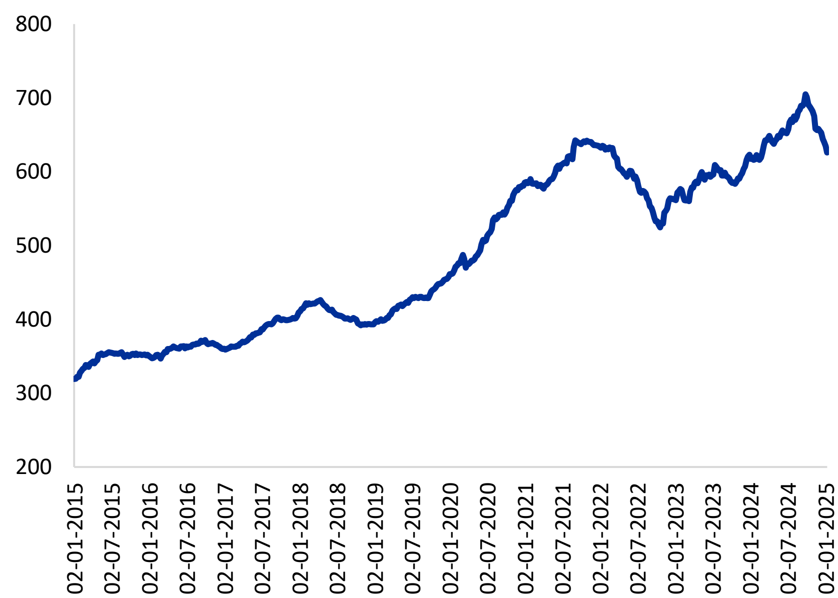
Chart 28: INR trade weighed REER remains overvalued vs history



Source: RBI, Valentis Research

Forex reserves have fallen $80 bn from peak as we tried to stabilize the currency

Chart 29: Forex reserves (in USD Bn)



Source: Investing.com, Valentis Research

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