Sohum India Opportunities Fund: Investor Update Newsletter, December 2023

It is that time of the year when many brokerage houses and star fund managers will come up with their 2024 outlook, only to find that the reality has turned out to be materially different from what they had initially envisaged. For instance, at the beginning of last year, most economists predicted a US recession and a strong come-back by China post its opening. However, even after 100bps of Fed rate hike last year (following 425bps of rate hike in 2022), the US economy remained resilient led by acceleration in consumer spending. And just when a consensus was being built around rates being higher for longer, the Fed took an unexpected dovish turn in its Dec meeting, giving the clearest signal yet that the policy tightening cycle is over, by gearing towards more aggressive rate cuts in 2024. Back home in India, after BJP's loss in Karnataka, even the best of opinion polls could not forecast a clean sweep for BJP in three of the recently concluded State elections.

In fact, the best forecaster of 2023 turned out to be none other than our honourable Prime Minister, Shri Narendra Modi. In August of last year, speaking at the Lok Sabha, the PM had remarked –

"Here's a guru mantra for those who follow the stock markets: Place your bets in those PSUs which they (the opposition) abuse. Your money will surely grow."

Since then, the Nifty PSE Index is up by a whopping 50%!

However, to be honest, in a world dominated by QE (quantitative easing), QT (quantitative tightening), AI (technology) and Gen-Z, macro trends and market forecasts tend to become redundant very fast. Nonetheless, we shall try our best.

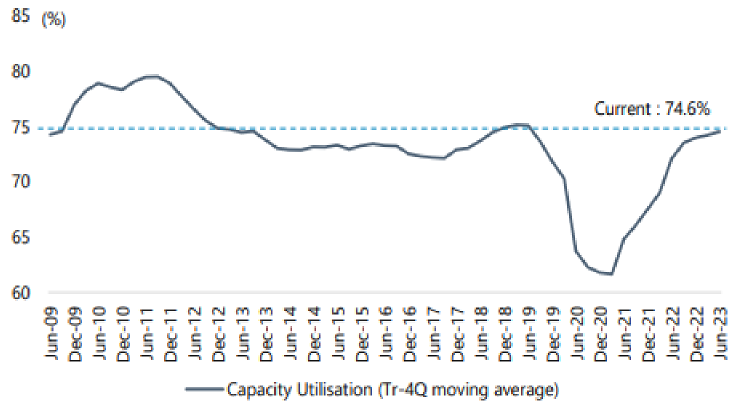
Twelve months ago, recession was the solid call for the US in 2023. Instead, the economy has confounded expectations, with full-year growth set to come in around 2.5% while unemployment is still only 3.9%. The consensus opinion was that the most aggressive series of interest rate increases in 40 years would eventually take its toll while lingering concerns over the state of both the Chinese and European economies added to downside risks. The stress in the small banks sector in March and April only intensified the worries for the economy. However, the US consumers' willingness to spend was insatiable, fuelled by a glut of savings accrued during the pandemic. This kept the US economy on a strong footing despite extremely tight financial conditions.

However, with excess savings now depleting and the lagged effect of monetary policy beginning to bite, the consensus is that the US economy will stage some kind of landing in 2024 – a soft one mostly, where both growth and inflation will decelerate but recession is unlikely. Overall, we characterize the global economy in 2024, with (1) softening growth outlook among major economies (US, Eurozone, China), although at differential speeds and (2) rate cut cycles across major DMs (mostly toward 2HCY24). Growth and inflation uncertainties should continue in 1HCY24 across major economies, keeping rates and FX markets volatile. 2HCY24 is likely to be more stable, assuming better clarity on inflation and definite turns in rate cycles.

Coming to India, FY24 is likely to be the third consecutive year of 7%+ GDP growth. ***The commendable part of this strong growth has been that it has come without the usual macro imbalances like high inflation or high CAD or burgeoning fiscal deficit.*** This is because after almost a decade, growth is being led by capacity creation rather than private or government consumption. India's capex (GFCF) to

GDP ratio bottomed out in FY20 and has since risen by 270bps but is still 500-600bps lower than the previous peak seen around 2010. ***With our thesis around clean balance sheets of all major stake holders (households, corporates, banks, government) as highlighted in our previous letters, we expect capex to continue to be the key driver of growth for the foreseeable future***. In fact, as per RBI OBICUS survey, ***capacity utilization across sectors is trending higher and at 74.6% in Jun-23, is near a 10-year high (Exhibit 1).*** This further lends credence to the view that the Indian economy is entering a period of full-blown capex cycle.

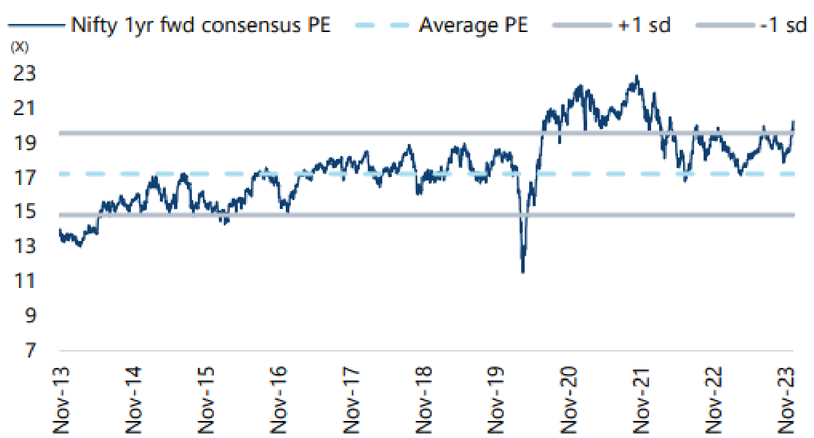
Exhibit 1: Capacity utilization at decadal highs.



Source: Jefferies

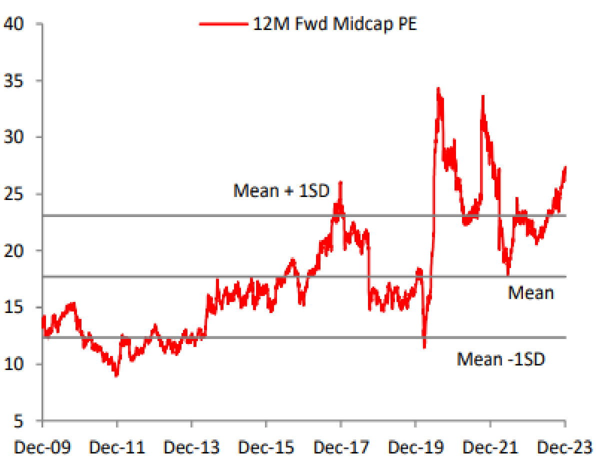
In consonance with a strong domestic economy, 2023 turned out to be a dream run for Indian equities, with Nifty returning 20% yoy while the small and midcap index surged 56% and 47% respectively. This begets the question – will 2024 be another year of stellar gains? For this, one needs to look at the starting point of valuations. With Nifty EPS estimates of 975 for FY24, 1100 for FY25 and 1250 for FY26, the headline index is currently trading at 20x one-year forward earnings, which is one standard deviation above long-term average of 17.5x but in line with last five-year average (Exhibit 2). In contrast, mid-cap and small-cap indices are trading more than one standard deviation above their long-term average (Exhibit 3). Thus, markets are by no means cheap, with the small and mid-cap space even susceptible to a sharp sell-off. We continue to believe that large caps offer better margin of safety at this juncture and are positioned accordingly. ***At FY26 EPS of 1250 and 20x multiple, we believe that the Nifty can head to 25,000 over the next 15 months which would generate a return of 15% from current levels.***

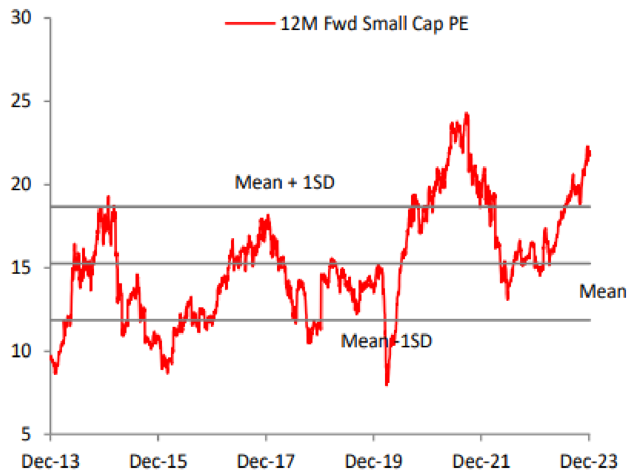
Exhibit 2: Nifty trading close to 1 standard deviation above mean.



Source: Jefferies

Exhibit 3: Mid-cap and small-cap valuations in uncharted territory.





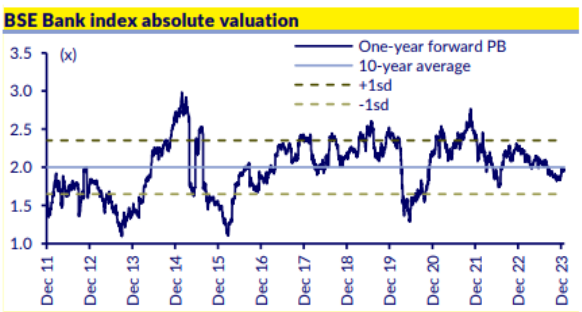
Source: Phillip Capital research

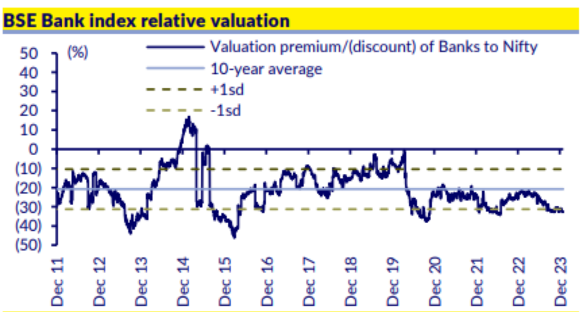
While near-term warrants caution on the back of high starting point of valuations, continuous supply of paper and excessive exuberance seen in IPO markets, from a medium-term perspective, we remain extremely optimistic about Indian markets. This is because a multi-year capex cycle implies robust 6-7% GDP growth over the next 5-7 years without any major macro imbalances. ***Another portent theme which is likely to keep our markets well-anchored is financialization of household savings. Currently, only 4-5% of incremental household savings goes into equities. We, therefore, believe that the equity culture amongst the Indian households is at the initial stage and can sustain and grow meaningfully from hereon.*** Thus, retail flows can continue to provide a strong cushion to our markets.

<u>Portfolio Composition & Performance</u>

As we enter 2024 on the back of demanding valuations, our endeavour remains to cherry-pick a portfolio that does not compromise on growth momentum, but also has enough built-in safety to withstand any adverse global event, financial or otherwise, that may shock the markets. We are overweight on financials and large pharma as these offer growth as well as safety. We also remain invested in real estate, cement/infra, auto and select power plays for continued growth momentum. We are underweight IT and consumer, wherein neither growth momentum nor valuation comfort is offered. While overweight financials is a consensus call, we believe there is merit in the same. This is because our bottom analysis shows that the banking sector is poised to deliver 15% pat growth in FY25 vs. 13% for the nifty index and perhaps is the only sector which is still trading at mean valuations vs. all other major sector trading above mean (Exhibit 4).

Exhibit 4: In an expensive market, financials are cheap.





Source: CLSA research

Overall, as of 31st Dec 2023, our flagship Sohum India Opportunities Fund has since its inception (20th May 2022), gained 48.67% (pre-tax), net of applicable fees. In the same period, the Nifty Index has delivered 33.6% and Nifty TRI Index has returned 36.32%. Despite markets being close to their all-time highs, there are significant divergences in performance of large-caps vs. mid/small-caps and across sectors. We believe valuations will become an important driver for stock picking to drive outperformance given the divergence seen in 2023. ***Our approach remains the same – buying fundamentally strong companies which are available at reasonable valuations relative to their growth (GARP). Our portfolio companies across all segments large, mid and small cap are well poised to deliver industry-leading earnings growth (Portfolio companies earnings growth at 21% over FY22-25, with PE of 16.4x on FY25 and ROE at 16%). and we anticipate the same to translate into benchmark outperformance in the near to medium term.***

Wishing you all a very Happy New Year!

Warm Regards,

Sanjay H Parekh

(With help of Sohum Research team).