QUEST INVESTMENT ADVISORS
SEBI Registered PMS & AIF managers

"If something looks irrational – and has been so for a long time – odds are you have a wrong definition of rationality"- Nassim Nicholas Taleb

Dear Investors,

Market corrections in a bull market are inevitable but they are always sharp, swift and short lived

The current bull run in Indian markets against a mixed performance by developed and emerging markets in FY2024, has been called as an '**Irrational Exuberance'** by some, **'Euphoria'** by many and **'Overvalued'** by most people. Also, typically after a stellar close to FY2024 its quite normal to be skeptical of what lies ahead considering we have the general elections in the next 2 months spread over seven phases in what would be the biggest show of democratic power by the largest number of people on earth. Common question emerges that will there be a correction in the market anytime soon after this stellar run-up? Our view is that **market corrections in a bull market are inevitable, but they are always sharp, swift and short lived.** So, timing your entry and exit for such corrections is next to impossible for anyone. We often get questions around our allocations towards midcaps and small-caps and whether we intend to trim down the exposure there and increase large-caps. Also some of the recent investor queries are around which sectors would do well and whether elections would have any major impact on markets. Let's try answering some of these pertinent questions.

Are Smallcaps overheated and is it in bubble territory?

Higher ROE and strong EPS growth in small-caps over the next 3 years is supporting the current valuations

Last couple of months a common view building up is that small-caps are in frothy zone and overall markets are heated up and over-valued. We believe **it would not be right to paint all companies in the smallcap space with the same brush**. There are definitely some pockets of irrational euphoria without the backing of earnings where any investor should strictly avoid venturing into. However good quality small-caps are available at reasonable valuations and those showing strong earnings growth. Nifty SmallCap - 100 trades at 22.5x currently on 1-yr forward basis, higher than historical 5-year average of 19.0x. However, looking at only P/E ratios to conclude that Nifty Small Cap is richly valued will not be right and it cannot be looked at in isolation without taking into account growth & RoE estimates. We observe that for Nifty-50 last 5-year average RoE at 17% has been historically higher than Nifty SmallCap-100 RoEs at 10%. However, Nifty Smallcap-100's 1 year forward expected ROE at 15% is currently similar to Nifty-50's and higher than its own last 5-year average of 10%. At the same time, Nifty SmallCap-100 EPS CAGR at 16% for the next 3yrs is also strong and should provide enough earnings cushion to support valuations. Thus, **while Nifty Smallcap-100 looks overvalued based on historical PE ratios, it will not be right to assume that it is in bubble territory as current smallcap PE is building in strong growth and RoE expectations.**

EPS growth and ROE profile of key indices in last 5 yrs and forecast for next 3 yrs

Index	Nifty 50	Nifty Next50	Nifty Midcap 100	Nifty Smallcap 100
Current Index Level	22,327	60,624	48,076	15,270
Next 3 yr Forecasted EPS CAGR	12%	13%	18%	16%
Last 5 Yr EPS CAGR	15%	18%	24%	24%
Last 5 Yr Avg ROE	17%	14%	8%	10%
1 Yr Forward ROE	16%	17%	13%	15%

Source: Bloomberg

None of the current market and economic indicators show signs that small-caps in general are in bubble territory

Also, empirical evidence from Indian markets over the past two decades indicates that **a more than 20% slump in small-cap indices (bear market indicator) has fundamentally been triggered by a spike in interest rate, or liquidity tightening environment, or a sharp deceleration in growth, or a combination of both**. Also, such triggers have been preceded by high relative valuations of small caps. India's GDP growth continues to remain on a strong footing and by all global estimates we should be growing at 6.5% +/- over the next 2 years. Global growth estimates for developed markets seem to have bottomed out thereby allaying fears of a recession in US. Also, while expectations are being tempered on interest rate cuts immediately, the consensus view is that interest rates will moderate hereon, even if it remains 'higher for longer'. Thus all the pre-conditions which usually triggers a bear market in small-caps seems to be missing currently.

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Election outcome, Institutional flows and a good Monsoon presenting a Goldilocks situation

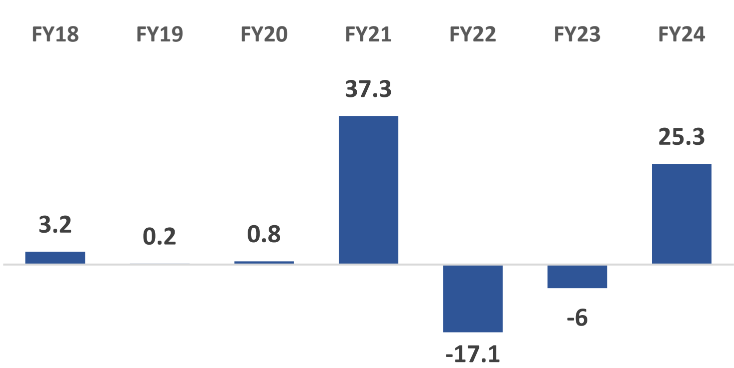
Elections if they don't throw a major negative surprise, should be mostly priced in the markets

Data from the last five elections suggests that **after a pre-election rally, markets typically remain flattish over the actual period of the election**, with the months immediately following witnessing a drop as the valuations typically build in the outcome of the elections in the run up to the actual elections. After a brief pause then markets do tend to start their upward journey again. With Lok Sabha elections scheduled in Apr-Jun'24, and **a consensus view predicting a return of the BJP-led NDA government with full majority for an unprecedented third term, it augurs well for sustained economic reforms and continued policy momentum, with a focus on capex, manufacturing, and infrastructure development.** This could also keep the equity market multiples elevated, in our view and expecting lower multiples in the headline index might be asking for too much. One big risk factor here we would like to highlight is that BJP forming government with a lesser number of seats compared to the last elections of 2019 when it won 303 seats on its own, would be seen as a weak government formation and it might delay any strong policy action as planned by the new government.

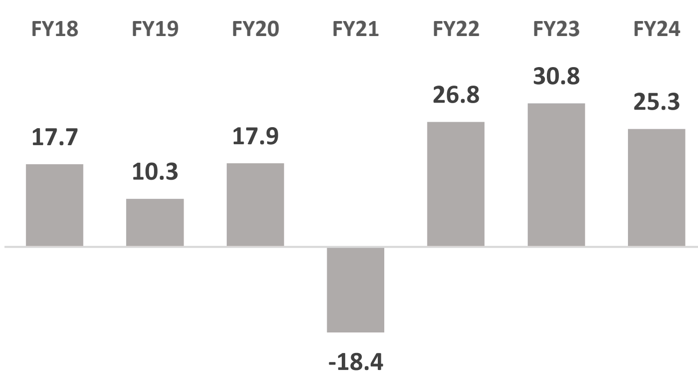
On Institutional flows, **DII + FII flows stood at ~USD50.6 bn in FY24, the highest ever in any financial year**. The continued rise in retail participation, along with increasing SIP contributions and the addition of new demat accounts (over 3.6 mn accounts per month during Oct'23-Mar'24) amid the ongoing trend of financialization of savings, has supported the markets in the face of global volatility and we see that trend continuing in the near to medium term.

Institutional flows remain strong both from FII and DII and also retail participation. Unlikely to change anytime soon

FII flows (USD bn) remained volatile but positive



DII flows (USD bn) continued to remain strong



Impact of monsoons on the economy are felt mostly in rural consumption patterns as was seen in the last financial year. Currently El-Nino is in a moderate stage and in the next 2-3 months it is expected to weaken further and reach at neutral levels. La Nina conditions are likely to occur in the later parts of the monsoon, while its impact on monsoon majorly depends on how early it develops over the pacific. **As per the forecasts released by IMD on 1st April, the estimated production of wheat is expected to be highest since the last 6-7 years** and that would bore well for taming the sticky food inflation this year.

Sectoral outlook and earnings expectations in near term

Sector	Our View
Auto and Auto Anc.	Capex cycle to drive demand for CV. 2-wheelers seeing demand recovery from rural India and could continue to do so. PV is seeing some moderation in demand. Margin improvement likely due to lower input costs and operating leverage.
Capital Goods	We believe that there are enough levers for the capex cycle to sustain over the long term, despite near-term election-related disruptions. Consequently, a couple of quarters of moderation in government ordering activity cannot be ruled out. However, we are seeing green shoots in private sector capex, particularly from auto, cement, metals and PLI-led capex. Companies' order books are already quite buoyant, which provides visibility for a healthy revenue CAGR. Strong demand and RM tailwinds are positive catalysts
Specialty Chemicals	Selective companies in the specialty chemicals space are seeing margin improvements and also volume uptick. However we do not see that happening for the whole sector. Sector wide improvement we could see by end of H1FY25 as destocking which has been a major factor is behind us.
Consumption (Discretionary and Staples)	Urban markets continued to see improvement, and rural markets have also started witnessing recovery. We continue to believe that discretionary categories/companies have better growth potential, driven by factors such as market penetration, deeper distribution reach, GDP multiplier, higher wallet share, etc. We believe volume growth has bottomed out and expect a better trajectory in FY25. Paints and adhesive companies are expected to report high single-digit volume growth. Consumer Retail would report robust industry leading growth as unorganized to organized shift continues. We anticipate volume growth for staples companies to bottom out, with limited risk of earnings cuts.
Banks	While credit growth has been robust, deposit growth too has gathered pace on the back of aggressive competition, a push for deposits, and competitive TD rates offered by banks. As a result, the gap between credit and deposits has narrowed to ~3.4% in Mar'24. The CD ratio stays elevated at 80% as most banks will see healthy credit volumes amid the seasonally strong 4th qtr.

Sector	Our View
Non Bank Financials	We see Asset Management and Wealth Management businesses to continue to deliver strong growth on the back of robust capital market and increasing allocation towards financial assets in the Indian households. Platform businesses catering to the financial markets would also be big beneficiaries.
Hospitality	With continued strong traction in the travel and tourism sector we see both ARR and occupancy maintaining the strong trajectory it has been delivering for the last couple of years. ARR could see industry wides 7-9% growth while occupancies could remain at decadal highs. Addition of new room keys in new destinations would be leading to widening the market opportunity which for long time has been primarily limited to the metros.
Real Estate	Although the pace of new launches picked up in 3QFY24, it could not be sustained in 4Q, despite a strong project pipeline, as many companies faced delays in approval. Hence, few companies witnessed moderation in bookings on sequential basis. However, most real estate companies signed off FY24 with yet another strong performance, delivering 20-50% bookings growth. We don't see the sector growth peaking out yet and see more legs of growth there.
Pharma & Healthcare	The moderating pricing pressure complemented by increased traction in limited competition products such as g-Revlimid, g-Spiriva is likely to strengthen the YoY growth of the US generics segment. Domestic business would remain strong, and we see margin improvement across the sector a key trigger for re-rating of many companies.
IT & IT Services	While discretionary spends continue to be under pressure, there is no meaningful change in industry spending patterns. We factor in demand improvement in FY25 on the back of positive outlook from US fed and large order backlog; however, the certainty of this translating into tangible growth remains uncertain. However, we believe the worst is behind us and many companies providing good valuations for entry.

Current Portfolio construct & Performance

In line with our outlook on the different sectors, we have concentrated our portfolio investments into the following sectoral allocations. The portfolio has an earnings CAGR of 24% over FY24-26 and trades at a ROE of 18%.

Sectors/Themes	Weightage		Sectors/Themes	Weightage
Urban Consumption	**34.9%**		**Financials**	**23.9%**
Auto & Auto Anc.	4.3%		Banks	16.2%
Consumer Discretionary	16.6%		Housing Finance	5.3%
Hospitality	7.1%		Exchange	2.4%
Real Estate & Ancillaries	6.9%			
			Others	**17.5%**
India Manufacturing & Industrials	**18.5%**		Diversified	2.4%
Cement	2.1%		IT & ITeS	4.5%
Chemicals	3.2%		Logistics & Shipping	5.0%
Defence & Industrials	9.9%		Pharma & Healthcare	5.6%
Energy & Utilities	3.3%		**Cash & Cash Equivalent**	**6.2%**

We remain under-weight in financials owing to the concerns of NIM compression which we see ahead in banks. Within financials we have a mix of Private Banks, PSU Banks and other non-bank financial service companies. After avoiding any exposure in IT & IT Services, Pharma and Chemicals for the last 4-6 quarters, we have started adding exposure to these in our portfolio selectively as we see . We remain biased towards midcaps and small-caps currently for reasons elaborated in our discussion above and do not see that changing anytime soon.

	1 Month	3 Months	6 Months	1 Year	3 Years	5 Years	Since inception
Quest Multi PMS	-0.03%	12.38%	25.43%	52.79%	21.52%	18.70%	16.68%
BSE 500 TRI	0.86%	4.49%	17.40%	40.03%	19.28%	17.38%	14.57%

Month Ended	Large cap	Midcap	Small cap	Cash
31-March-24	45.5%	8.7%	39.6%	6.2%

Way ahead for our markets

Inflation cooling off could trigger rate cut cycle and increase consumer spending. Geopolitical risks could derail the current momentum is escalation happens

Corporate earnings, Inflation, monsoon forecast, rural recovery, policy decisions by central banks and upcoming general elections are key monitorable in the near to medium term. We expect interest rates to come down in the second half of the year, on account of the government's focus in managing inflation and in line with global rate cycle. Core inflation has been steadily tracking downward, while food inflation still remains a wild card but with the likelihood of improved monsoons this year, we could see this coming down, bringing headline inflation to within the RBI's comfort zone for rate cuts. This could lead to consumption trends to bottom out and contribute to growth in 2HFY25. We expect a strong Capex upswing from Private companies which should adequately complement Government spending.

Market is not devoid of risks and we need to keep an eye on the same too. Geopolitical tensions in Middle East is one of the big triggers for near term volatility and that is one factor we cannot be prepared for. Any escalation in that region could lead to near term panic sell-offs but like in the past also, these would be short lived and opportune times to increase equity allocations for investors. Project execution weakness across infra and capex cycle could lead to some multiple contractions as market goes through a period of time correction. On the consumer retail and real estate side, sharp out-performance in the last one year has led to valuations being on the upper side and hence could again see some time correction. Nevertheless we continue to focus on our bottom up approach looking for mispriced opportunities across sectors and market caps and would be keeping a close watch on market dynamics around elections.

Happy Investing !!

Yours Sincerely

Team Quest

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