Macro, Markets & Strategy review

2017

April

UNIFI INVESTMENT MANAGEMENT

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Global developments

Unemployment rate in the US is at the lowest it have been in the past 10 years, coming in at 4.4%, and supporting the Federal reserve's view that the American economy is getter better and that June should see another round of rate hikes. This will be the 4th such hike and will push interest rates to a grand 1%. While the fall in unemployment rate is small in absolute terms (vs 4.5%), it lays the foundations for an upward trend in wages and with that the potential for a higher multiplier effect for consumption across the economy. This development and the commentary from the Fed on the sign of things to come is at a slight contrast with America's Q1 GDP that grew at just 0.7% vs 2.1% in Q4 of last year. This was largely attributed to weather-induced slowdown in spending, and deemed as transitory. {However, as global warming gains pace, we doubt the 'transitory' part}.

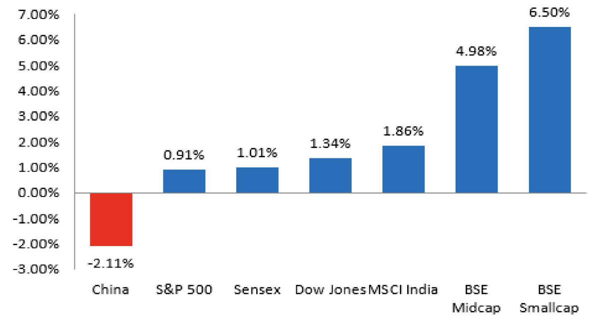
Things seem to be getting better in the EU as well. Eurozone Manufacturing PMI rose to a six-year high of 56.7 in April 2017 from 56.2 in March. Also, the rate of job creation accelerated to its fastest in six years, probably indicating a further expansion in output over the coming months. And on the price front, input costs continued to rise, indicating economic buoyancy. In a nut shell, things haven't been this good for the EU in about a decade and it is ironical that Britain's exit from the union is coinciding with such times for the region.

As China slows down, one would have expected further strain in commodity prices but this has now coincided with China's severe environmental stress as a result of which several mines, smelters and plants are witnessing forced shutdowns, thus curtailing the glut and in the process, firming up prices. This privilege is however not extended to crude, as oversupply and alternative fuels continue to suppress oil prices. At $45/barrel, this is the weakest in the last 6 months. This is crude for producers, but great news for a massive net importer like India.

World Markets

Emerging markets continue to have a good 2017 as the EM index notched another 2.04% for the month and is now up 13.42% for the year.

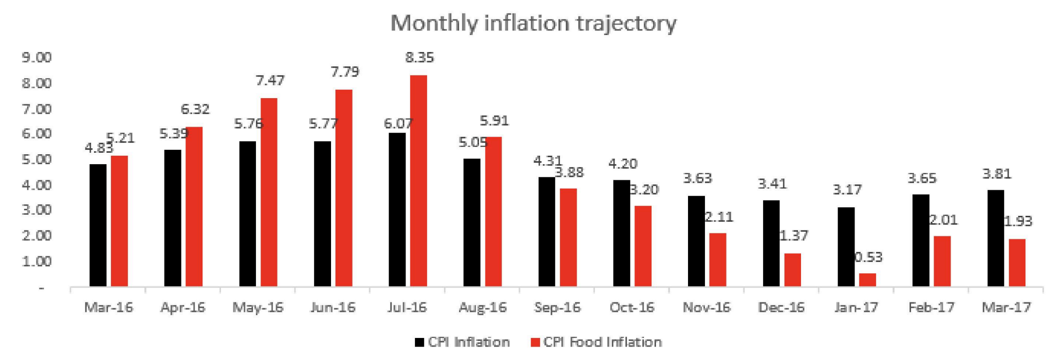
MSCI (in %)	India	Brazil	Russia	Korea	China	Japan	US	Australia	EM Index	MSCI World
MoM (in %)	1.86%	-0.44%	-0.26%	1.00%	2.66%	1.05%	0.96%	-0.72%	2.04%	1.33%
CY - YTD (in %)	18.88%	9.27%	-4.87%	17.84%	15.94%	4.76%	6.73%	8.88%	13.42%	7.26%



India has been among the best performing markets globally with MSCI India up 18.88% in CYTD 2017, helped by a weakening USD.

Inflation falls | CPI @ 3.81% vs 3.65% MoM | WPI @ 5.70% vs 6.55%

Consumer inflation is largely in control, coming in at 3.81% for the month of Mar-17 vs 3.65% in the previous month. The food basket that consists of 45% of the CPI index saw a bit of moderation, as it fell to 1.9% vs 2% MoM. Prices are in a range overall and they are not too uncomfortable. In any case, the RBI continues to maintain a hawk eye on the same in determining its interest rate trajectory.



Over all, we are seeing a slight trend reversal after 6 months of falling prices. The overall glide path in the context of RBI's CPI target of 5% by March 2017 has already been achieved and the Central bank will now track its target of 4% by March of 2018. This new range may not be a given as the RBI has increased its inflation expectation to average 4.5% from 4-4.5% in H1 FY18 previously while H2FY18 expectations are retained at 5%.

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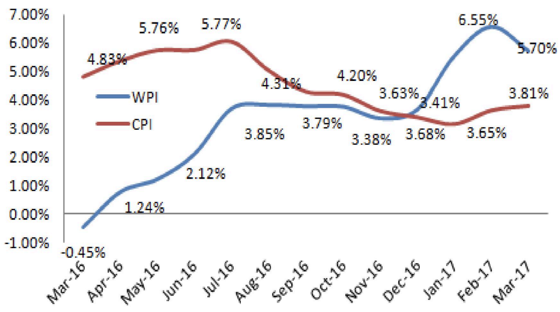
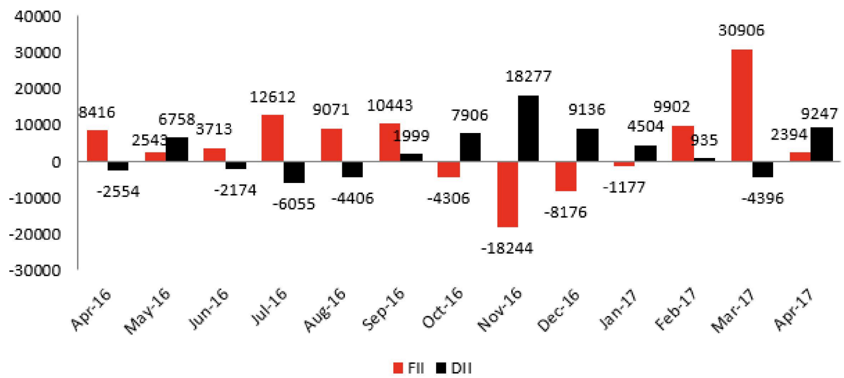


WPI for March 2017 came in at 5.70% vs 6.55% MoM. Disinflation was seen in all categories. Within food, lower prices were seen in cereals, pulses, spices and oilseeds. Manufacturing inflation was down marginally by -0.06% MoM, 9/12 (vs 4/12 last month) manufacturing industries recorded higher prices. FYTD average WPI stood at 3.7% vs -2.4%.

Inflows abound

Inflow's into Indian equites continue unabated as domestic investors continue to up the ante, probably displaying their behavioral side of having missed a bit of the ride that Indian equities have offered so far. Domestic investors have pumped in about $1.4bn in April-17 and going by the flows domestic mutual funds are witnessing into their monthly investment plans, the pace of flows should only head north.



Flows of this force meant that the broader benchmarks continue to remain buoyant and the buoyancy at least hitherto hasn't exactly been shackled to fundamentals. This is also noteworthy in the context of the fact that the earnings season is yet to fully communicate the state of immediate fundamentals, but yet, the street is prepared to buy ahead of time. A large part of this move has to do with rising liquidity domestically. And then there is the case of the rupee. As the INR displays a strengthening trend (led by better fiscal state of affairs), we suspect international capital allocators would want to ride this appreciation in addition to drawing comfort from a better macro-economic policy frame work, governance and of course return of earnings.

Green shoots of good news

In a corresponding show of strength that addresses in part the optimism in the street, India saw a sharp rise in the growth rate to 6.4% (average) in March for the eight sectors — coal, crude oil, natural gas, refinery products, fertilizers, steel, cement and electricity. In fact, output in refinery products, fertilizer, cement and electricity jumped by 10.8%, 22.9%, 11.9% and 11.35 respectively. These core sectors point to the health of demand of an economy in general and these numbers can only be interpreted positively.

But there is no better way to address trickling doubt than with earnings. Though the earnings season isn't over, the results from older generation banks, after years of rancid outcomes, was pleasant and is said to get increasingly better. In other words, the quantum of slippages from non-performing assets is closer to plateauing. Coupled with a new bad loan ordinance that will direct the aggressive redressal of existing bad loans, it points to faster clean-up of the system as against the present status of a gridlock. Another sector that has witnessed massive stress, commodities, seems to be on the cusp of much better times. Amid stronger supply-side tightening, returns in commodities have improved over the past year pointing to significantly better outlook over the foreseeable period. While uncertainties remain, with China showing intent on clamping down polluting commodities, the worst may be behind us. As we re-look our portfolios in the months to come, it will not be reasonable to initiate exposure to these sectors given the sharp earnings bounce they are likely to witness along with support in valuations as things stand today. While the broad tea-leaf reading is comforting, stock selection in any of these sectors will be a strictly bottom up proposition.

Over all, the policy environment continues to evolve well. Several developments are underway which we believe will have a positive impact on economic cycle. For instance, the housing for all initiative of 50mn low cost houses over the next 5 years is likely to create 2mn additional jobs, cumulative housing loan disbursal of more than $500bn., and 10-12mn tons of incremental demand in cement. The government is intent on delivering this to keep their political mandate going and accordingly incentives have been given to all constituents - developers, home-loan borrowers and lenders. The rationalisation of provisions to encourage affordable housing has seen several developers enter the fray with a mighty benefit of 100% deduction on profits for a period of five years on development of affordable housing (metro areas 320 sq. feet and 650sq. ft otherwise). This should see rapid scale up in supply and the multiplier effects of these into other subsectors of the economy will be very material given the deep sectoral links the industry has on paints, steel, wood panels, tiles, plastics, pipes, adhesives, construction chemicals, electrical consumable housing. Moving on, the new National Steel Policy – a very recent initiative of the Government, represents the long term vision of the Government to give required momentum to the steel sector. Among others, it seeks to increase steel-making capacity by almost 3x to 300mn in the coming decade outlining an additional investment of Rs.10 lakh crore by 2030-31 with the aim of increasing per capita steel consumption to the level of 160 Kgs by 2030 from existing level of around 60 Kg. This has the potential to redefine the entire value chain from mining to processing with the prospect of material employment creation. And then there is the prospect of bringing governance led productivity in States such as Uttar Pradesh (UP) which has the potential to improve growth from a low base. For example, the State is seeing better supply of power and consequently lower spends on diesel generated power. A combination of such efficiency led gains will eventually add to the overall economic arithmetic.

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Unifi Strategy

As we scan the universe for value, we are careful to correlate the macros with the micro opportunity in hand. GST as a theme is yet to be fully discounted and value unlocking from this change in scene will play out for the next few years. We continue to see value among sector leaders and in emergent themes such as green where the policy environment is favorable. Valuations in the meanwhile will continue to pose a challenge. As at the end of April 2017, just the top 7 mutual fund schemes in India hold cash in excess of Rs.3000cr and for the mutual fund industry as a whole, we suspect the number to be in a range of Rs.5000cr. This number is only rising with a change in asset allocation among Indian households and this trend will continue to rub off on the broader markets. As we align our investments with our framework of value, cash positions may rise. It is imperative to note that Q4-FY17 as well as Q1-FY18 (quarter of GST) is likely to see softness in earnings as the industry adjusts slowly to new paperwork.

We continue to like select names in agriculture, specialty chemicals, polymers, and select manufacturers in the B2B space catering to infrastructure creation who offer a rate of earnings growth that is attractive relative to their valuations. As markets move up we are not hesitating to book profits where valuations have exceeded the margin of safety. In the meanwhile, as valuations across sectors move up considerably, it is fair to expect that the timelines the broader index will take to deliver on absolute earnings will be high, and in the mean while we are likely to pay a premium for earnings visibility and growth, especially for firms that have a track record of strong balance sheet discipline and high capital return ratios.

Risk: Key risks to our portfolio would come from geo-political concerns globally, materially high foreign outflows, sharp currency movements, American and Fed policy announcements, steeper Chinese devaluation, spike in commodity prices and a prolonged delay in fiscal reforms. Global re-allocation of equity, which is not India centric will continue to happen and may result in turbulence from time to time. Indian markets as well as the INR will continue to remain vulnerable to global events, however unrelated to India. Interest rate hikes in the U.S may be a huge event risk and affect liquidity conditions domestically. NPA in the banking system and new IPO's may also hamper liquidity in the market.

Please do let us know if you'd like any clarifications regarding your Portfolio account with us. Thank you for placing your trust in Unifi

Yours truly

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