Macro, Markets & Strategy review

2015

April

UNIFI INVESTMENT MANAGEMENT

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Global developments

The U.S. economy started the year on a slow footing with GDP expanding at a less than moderate pace of 0.2% YoY. Most businesses slashed investments and consumers showed signs of caution, marking a return to the uneven growth trajectory that has been a hallmark of the nearly six-year effort at economic expansion. Rather than use the savings from cheaper gasoline to buy more, American's have been saving for a rainy day as indicated by the spurt in savings rate at 5.5% vs 4.6% in the previous quarter; and the highest since 2012. As a reminder, GDP for the prior two quarters, i.e., Q3 & Q4 of CY14 expanded at 5% and 2.2% respectively. The first-quarter figures repeat a common pattern in recent years: one or two strong readings followed by a sharp slowdown. First-quarter GDP growth had averaged 0.6% since 2010 and 2.9% for all other quarters. That has worked out to moderate overall expansion but no growth breakout. The weakness in the US economy, if sustained, poses problems for global growth besides that of a rise in US borrowing costs. While the Fed gave no new explicit clues on the timing of interest-rate increases, the slower growth is likely to make decision making at the Fed's end a bit more uncertain.

Meanwhile, the ECB kept interest rates unchanged at record lows of 0.05% as it focuses on bond buying that is programmed to bolster the improving euro-area economy. The ECB embarked last month on its plan to spend Euro 60bn a month on sovereign and private sector debt and intends to continue until September 2016 or until they "see a sustained adjustment in the path of inflation" toward the medium term goal of inflation just under 2%. The ECB is claiming some early successes as the economy picks up saying "there's clear evidence that the monetary policy measures we've put in place are effective." But there was no such evidence of the same in the UK economy which experienced its weakest pace in three years as GDP grew just 0.3% in the first quarter of the year, half the pace of what it was in the last quarter of 2014.

Indian Market

FIIs bought stock worth USD1.7bn in the cash market while they sold stock worth USD250mn in the futuresmarket (for the 3rd month running). Moreover, they turned sellers in the debt market at USD181mn. Domestic Mutual Funds bought stock worth USD1.2bn (most since Jan-08) while Insurance companies turned buyers for the first time in 14 months at USD200mn. Year-to-date, FIIs have bought USD7.6bn and USD6.6bn in the cash and debt markets. DIIs have bought stock worth USD450mn. Over all, in April, MSCI India was the second worst performing emerging market. The benchmark BSE Sensex returned -3.4% for the month vs -6.5% of MSCI India. BSE Midcap and BSE Small cap returned, -1.6% and 0.5% respectively.

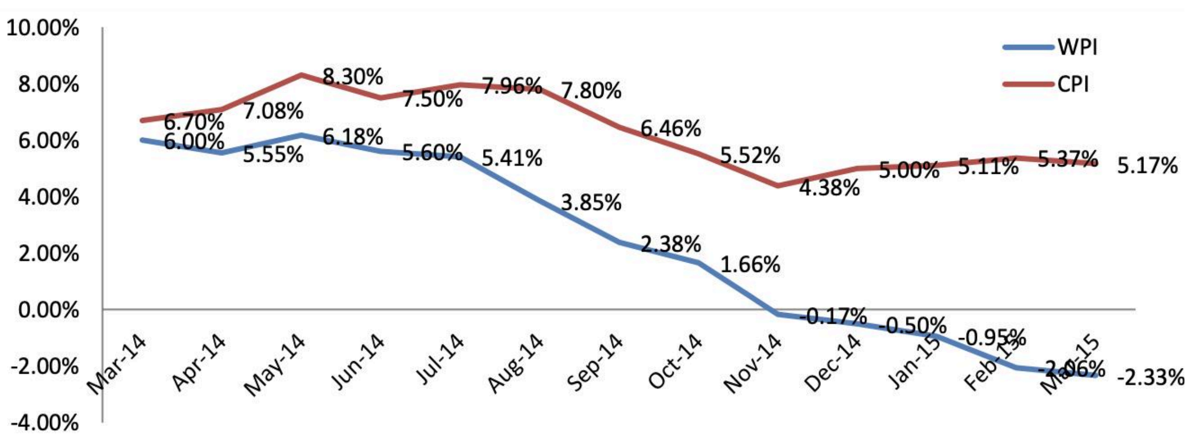
MSCI (in %)	India	Brazil	Russia	Korea	China	Japan	US	Australia	EM Index
MoM (in %)	-6.55%	16.29%	17.32%	6.65%	16.68%	3.51%	0.81%	1.15%	7.51%
CY - YTD (in %)	-1.71%	-1.74%	39.16%	10.93%	26.15%	13.31%	1.67%	2.95%	9.57%

Monthly Macro Review | Deflationary trajectory continues | IIP Grows

Inflation: CPI and WPI continue to moderate:

CPI for March 2015 came in at 5.17% and WPI at -2.3%, both moderating faster than expected on the back of easing food inflation which moderated to 6.1% YoY from 6.8% YoY. Sequentially though, WPI was up 0.17% MoM led by 3% MoM increase in the fuel index, thereby violating the four month declining trend. Markets had widely expected food inflation to inch up as a consequence of the crop damage caused by unseasonal rains, but healthy buffer stock ensured the contrary. The increase in price of petrol and diesel at the end of February led fuel and light inflation to move up to 5% YoY from 3.7% YoY in January. For most other core CPI components like housing, clothing & footwear, household goods & services, etc., inflation was seen easing reflecting the weak demand led price pull.

Going forward, it is expected that CPI will average close to 5% in FY16E partly on account of the base effect. Further, the steps taken by the government to curb inflation are playing out efficiently and this should structurally prevent price shocks in perishable items. Further, the outlook on global commodity prices remains soft. The decline reflects slowing demand in China, particularly for industrial commodities, and generally ample supply conditions. Hence, we believe inflationary expectations will also stay moderate. The spoilers to this can be poor monsoons or adverse currency movements. This broadly sets base for RBI to consider easing of interest rates further as RBIs' inflation target of 6% by January 2016 seems broadly plausible.



IIP – Good February, 5% growth YoY

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India's Industrial Production for February surprised with a 5.0% YoY growth topping the consensus estimates for a reading of 3.3%. Also, the November IIP was revised higher to 5.2% from 3.9% reported earlier and January growth was revised to 2.8% from 2.6%. The improving momentum in February against the low base of last year enabled a positive growth picture going forward. The cumulative April to Feb Industrial production growth stood at a modest 2.8% as against the April-Jan reporting of 2.5% and -0.1% during April-Feb last fiscal.

Growth was strong across all the components of the economy - Manufacturing growth expanded 5.2% YoY in February the most since May last year and accelerating from 3.4% in the previous month. Manufacturing activities contributed 1.8% or 64% to the cumulative IIP growth of 2.8% for the 11-months April through February. Industry-wise 15 out of 22 industries registered expansion as compared to 14 Industries in the previous month. Electricity generation growth improved to 5.9% YoY from a four-month low 3.3% increase in Jan. Mining grew by 2.5% YoY snapping two consecutive months of decline in Dec and January. On use-based classification consumer non-durables grew 10.7% YoY. Basic Goods expanded 5% improving from 4.7% in Jan. Capital Goods growth moderated to 8.8% from a five-month high of 12.5% expansion in Jan.

However, the most distinct feature of the moths IIP reading was the rebound in Consumer goods, up 5.2%, the most since October 2012, suggesting a pickup in domestic demand led growth. A recovery in the investment cycle will strengthen each of these numbers going forward. The prognosis for a durable growth recovery is based on recovery in investment cycle combined with policy rates easing to fuel the domestic demand.

Table 1: IIP, February, YoY, 2014-15

Year on Year in %	Weight	Feb 15	Jan 15	Feb 14	YTDFY15	YTDFY14
Classification by Economic activity						
Over all	**100**	**5.0**	**2.8**	**-2.0**	**2.8**	**-0.1**
Mining	14	2.5	-2.0	2.3	1.5	-0.7
Manufacturing	76	5.2	3.4	-3.9	2.2	-0.7
Electricity	10	5.9	3.3	11.5	9.1	6.2
Classification by use						
Basic Goods	46	5.0	4.7	4.5	7.4	1.8
Capital Goods	9	8.8	12.5	-17.6	6.0	-2.6
Intermediate Goods	16	1.1	-0.1	4.0	1.6	3.3
Consumer Goods	30	5.2	-1.8	-5.2	-3.7	-2.9

Unifi Strategy

April was a volatile month for the Sensex as there was a material sell off by FIIs who trimmed their positions on the possibility of being served notice for payment of Minimum Alternative Taxes by the Government. Although the government clarified its stance that companies covered under double taxation avoidance treaty will not have to pay MAT, sentiment remained impacted. Also, the earnings season did not help sentiments any which way with earnings coming in mostly softer than expected and managements were largely conservative in their growth guidance.

The markets have exhibited impatience with results so far but going forward, the markets will take cue from the following variables:

a. GST bill: the lower house of the parliament, Lok Sabha, has approved a constitutional amendment for establishing a goods and services tax (GST) which will replace multiple central and state taxes with one levy. As communicated earlier, the new indirect tax regime can add up to 1% to India's GDP helped by efficiencies in the organized sector over the informal sector and this will provide for a strong economic multiplier effect. However, the game-changing reform faces a major hurdle in the upper house of parliament, Rajya Sabha, where the central government lacks the numbers. Movement of this piece of legislation communicates the possibilities of broader economic efficiencies reflecting in corporate earnings by FY2017e numbers which will do its bit to pacify markets.

b. Normal monsoons: the vagaries of the monsoons still determine the fate of Indian agriculture and to a large extent, India's consumption behavior – FMCG, Auto and others. The initial forecast released by the Government agency IMD indicates a weak monsoon ahead but private agency Skymet forecast a normal monsoon with only a 2% probability of a drought. The street has its fingers crossed on this development. A good start to monsoons will ease nerves as the prospects of FMCG, Auto, Building products and the coterie of ancillary industries supporting the broader industries will take comfort from the same.

c. To tax or not to tax: Clarity on MAT applicability remains important for FII flow; the government has provided clarifications that no MAT will be applicable prospectively but the FII community remains skeptical on retrospective taxation of the same and regulatory clarification on the same will be keenly watched for.

Further, acceleration in government spending will be the most crucial driver of India's growth in the coming months and will provide the base for a broader macroeconomic push that will make the street comfortable. The US Federal Reserve's actions will also dictate how Indian markets behave; if American cost of capital gets expensive there may be a material capital flight from India inducing further volatility into the markets. And lastly, an interest rate cut and its translation; as and when this happens this should provide a fillip to earnings as well as cap-ex.

Over the next few quarters, there is no doubt that conviction will be tested. Markets are getting impatient with poor corporate performance and limited visibility in acceleration of growth. Anecdotal evidence suggests the cap-ex wheel is beginning to move but it's little to move to the macro needle. Besides, surge in issue of new paper through disinvestment/ IPO may cap the upward move in the market. Thus, it is fair to expect a tepid few quarters before the visibility of change is fast which will then again warrant greater street interest.

Currently, valuations of benchmark Sensex at 16x FY16 consensus earnings look reasonable. The market will continue to reward high quality names with good balance sheets and return ratios and we are accordingly invested in businesses that are benefitting from sustainable growth in consumption supported by Indian demographics as well as their market positioning. As we have been saying, an impending upturn in the earnings cycle and falling interest rates is likely to support valuations.

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Risk: Indian markets as well as the INR continue to remains vulnerable to the end of QE and consequent movement of asset allocation to the U.S. Sudden rises in global commodity prices may have a detrimental effect on the domestic macro. Interest rate hikes in U.S may be a huge event risk and affect liquidity conditions domestically. Market may turn volatile in parts due to challenges in passing reform bill in upper house (due to minority of the ruling Government), possible increase NPA in banking system and geo political issues.

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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