# Macro, Markets & Strategy review

## 2016
December

UNIFI INVESTMENT MANAGEMENT

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## Global developments

To round off a year of black swans, an unprecedented Trump rally gripped America towards the end of the year, following the president elect's USD 1 Trillion plan (for now, a promise) to rebuild the country's infrastructure, some of which he termed 'third world'. As a man who has built infrastructure all his life, the promises of new roads, airports, pipelines, et all, along with thousands of jobs, sent Wall Street into a frenzy. The end result of its all was that the Dow gained a good 8% since he was elected on the 7th of November'16, helping the Dow Jones return 13% for the full year 2016. This is a good number in the context of Dow's lackluster performance over 2014 & 2015 where it notched 8% and -2% respectively. Back here in India, we draw a parallel with the unprecedented Modi rally of 2014, where a brief period of euphoria discounted the future economic potential of policy intent, before eventually reconciling with underlying earnings. As another parallel, the American Dollar had a great year, appreciation against almost every major world currency, and in the process, exerting pressure on almost every emerging economy. The US dollar index, a relative measure of the greenback to a basket of other foreign currencies, is at a 14 year high. The FOMC has taken note of the Dollar's undue strength and pointed to it posing a downside risk to economic growth as such apart from inflation. This comment is an important one in the context of FOMC's future call on the Fed's interest rates, as we have seen how US rate movements have recalibrated liquidity around the world, causing volatility across EMs, including India. In all, the Fed's rate trajectory will continue to be a volatility inducing & closely watched affair in 2017.

2016 also marked the beginning of the end of the extraordinary period of liquidity intervention around developed economies. While the Fed finally ended almost a decade of zero rates in Dec-15, maintaining the cost of funds at 0.25%, the year end (Dec-2016) saw another round of hike by 25bps, to 0.50% and in their own words, 2017 is expected to see 3 rounds of rate hikes. The European Central Bank also added that it will cut its purchases by €20bn a month to €60bn from April 2017 and may call it an end by December 2017, but should the economic outlook "becomes less favorable", it would expand the size or length of its bond-buying program. The ECB however left the refinancing rate at zero with a - 0.4% charge on deposits it takes from banks, aggressively encouraging Banks to lend more.

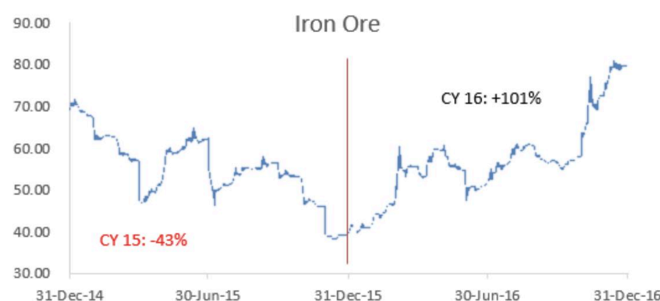
Meanwhile the China Academy of Social Sciences has recently forecasted the country's economic growth for the next year at 6.5% which would be the lowest growth in the last 25 years. Add to it the fact that as the economic outlook of US improves on the back of policy measures introduced by Trump administration, there is increasing fear of flight of capital from the Chinese economy which will further heighten pressure on its currency. The notorious shadow banking system which has doubled over the last 5 years and now is as big as 82% of the GDP combined with the speculative bubbles in the stock and property markets, don't help matters. As the policymakers get ready to tighten monetary policy in order to combat the rampant growth in local credit and speculative activities in property, the unintended consequences would be rise in bad loans, currency volatility, higher inflation and lower consumption – all key parameters to watch out for in 2017. In fact, as we are writing to you in the first week of January, we learn that the People's Bank of China (PBoC) set the yuan reference rate at 6.8668 vs 6.9307 to the USD, a 0.9% accretion, to stem the flight to capital out of China. If Trump indeed delivers on taxing Chinese exports to the US, the resultant policy reaction from China may be dramatic as it has not failed to act aggressively in the past to do what they feel is right. However subjective that may be.l constraints.

Overall, 2016 in general was a year of mean reversion from what was witnessed in the prior year. As a roundup of the year, we capture a few of them. The infographics are self-explanatory.

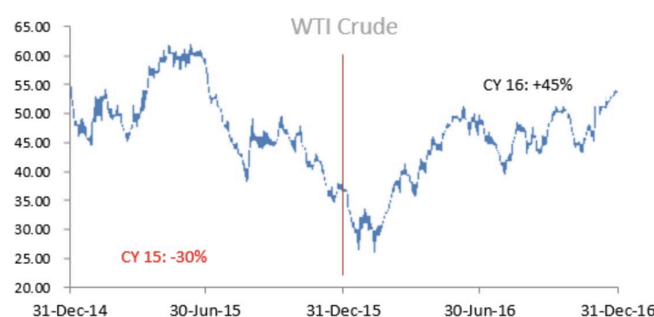
## 2016 vs 2015: The year of incline vs decline

**Commodity bounce.** The real surprise of 2016 was the rally in industrial metals spanning Iron ore, Zinc, Tin, Nickel, Copper and Aluminum as all of them moved up by anywhere between 18-90% in anticipation of a pickup in demand. Note the word anticipation here, as there is no evidence, or lead indicator of an absolute increase in the size of demand as China continues to stall from a higher base and the demand elsewhere in the world does not really move the needle.

A series of operating and corporate actions such as temporary to permanent mine closures, etc. contributed to the healthy rally in commodity prices.




**Oil splash.** As OPEC came together and disciplined itself in limiting supply, crude prices staged a strong rally in 2016. The consensus for now is that levels of $60 to a barrel must hold. The rally is a welcome move as it provides the commodity dependent economies that much extra room to shore spending, the ripple effects of which will be felt in all major emerging economies, including India.



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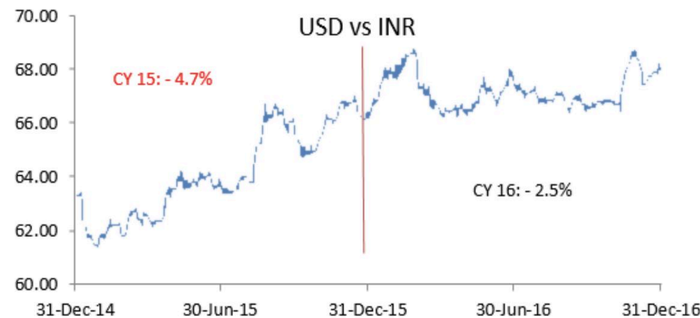
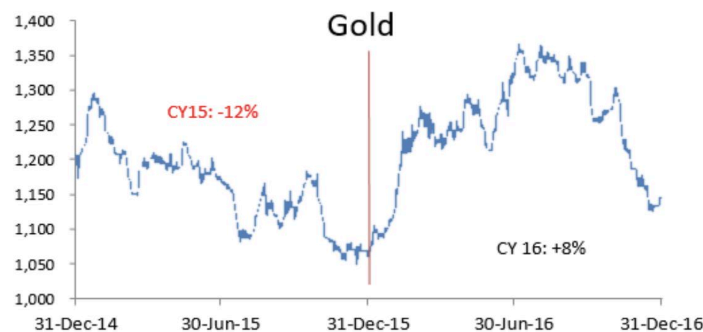
**INR pressurized.** As pointed out in the earlier sections, the USD continued to appreciate in 2016, resulting in further weakening of the INR, relative to 2015 levels as well. The spate of FII's redeeming Indian equities post Trump's victory further accentuated the move. It may however be noted that currency weakening has been a global affair and the INR is one of the better performing currencies among the emerging markets. In comparison, the British Pound lost 20%, Chinese Yuan was down 7%, the Euro lost 3.6% and the Korean Won slipped by 2.5%.



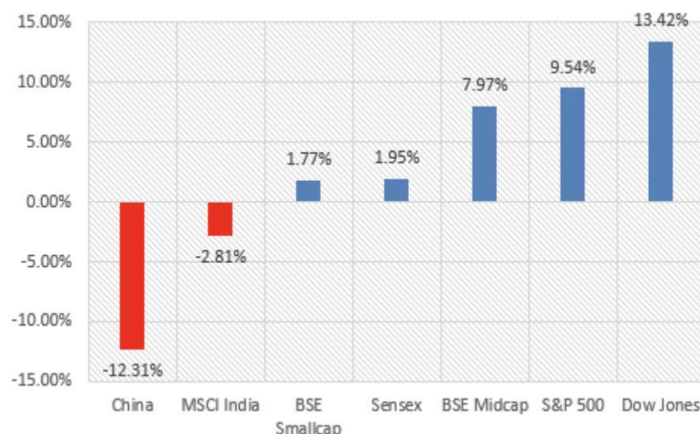

**Status quo on the sheen.** In spite of the fact that it gained in 2016, Gold lost a bit of its safe haven status in the middle of the year as the dollar regained its strength hitting a 14 year high.




## World Markets – an average year

Global markets as such had a middling year around the world with the exception of Russia and Brazil, which saw it recouping the losses it suffered in the past years.

| MSCI (in %) | India | Brazil | Russia | Korea | China | Japan | US | Australia | EM Index | MSCI World |
|---|---|---|---|---|---|---|---|---|---|---|
| MoM (in %) | -0.08% | 0.25% | 11.84% | -0.71% | -4.11% | 0.85% | 1.71% | 2.35% | -0.06% | 2.29% |
| CY - YTD (in %) | -2.81% | 61.34% | 48.89% | 6.98% | -1.43% | 0.46% | 9.21% | 6.74% | 8.58% | 5.32% |

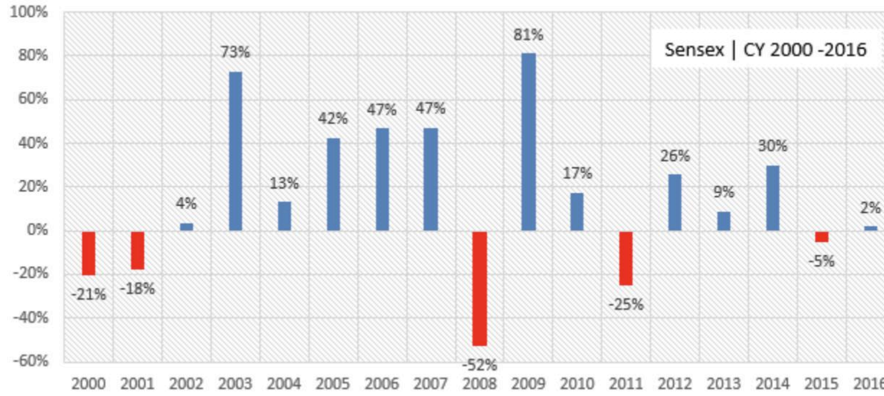



India saw a divergent trend in performance for the year as the benchmark Sensex and Small-cap ended flat for the year at 1.77% and 1.95% respectively, whereas Mid-cap was up by 7.97%.

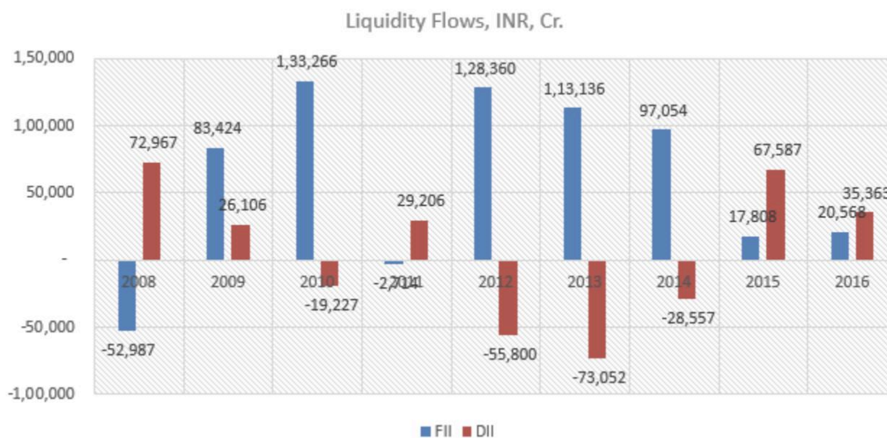
MSCI India was down 2.81%.

## 2016 | A promising year, cut short by non-market related headwinds

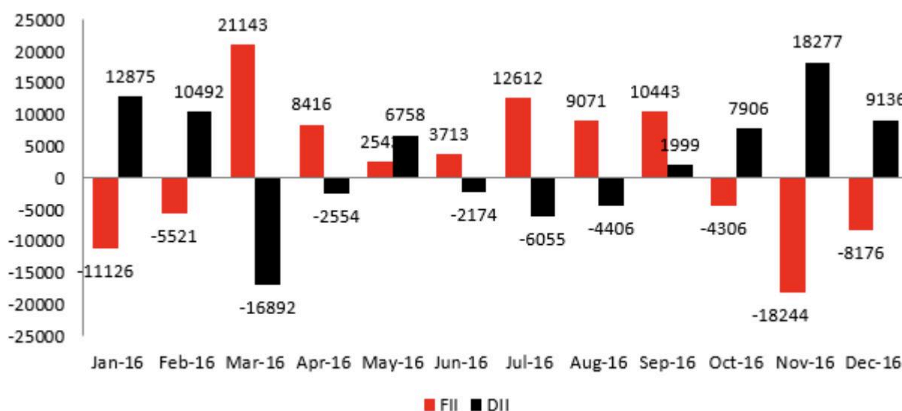
The Sensex and small cap closed flat for the year, delivering 2% for the year. The mid cap however demonstrated greater resilience, delivering 8% for 2016. It may be noted that the Sensex was 5% (CY) up till the date of announcement of the demonetization drive, and poised to do well with the recovery in earnings. As it can be seen below, it is for the first time since 2000 that the Sensex has given 2 consecutive years of negative/flat returns.




Apart from performance, a significant driver of market performance in India has been global liquidity flows. For the first time in several years, the quantum of domestic institutional capital flowing into the Indian markets over took foreign institutional investments for two years in a row. We believe this is a structural positive as India moves away from dependence of external liquidity in its quest for supporting value. As it can be seen below, the total FII inflow (equities) for 2016 was Rs.20,568cr. This is after witnessing outflows of Rs.26,421cr in the month of Nov and Dec of 2016. We believe most of whatever short term focused money had to leave India has already left.

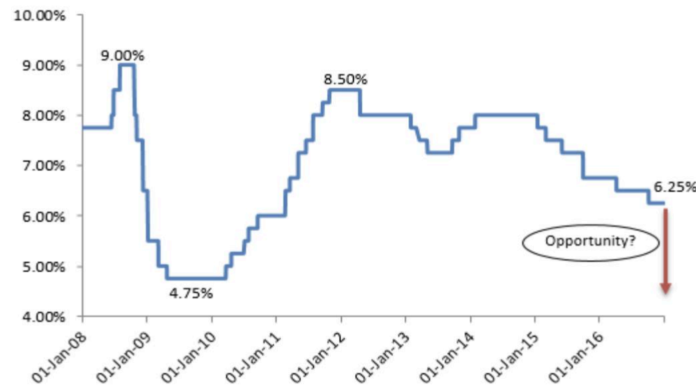



It may be of interest to spend a minute on the infographic below; as it can be seen, DIIs have displayed a divergent behavior vs the FIIs. In events where FIIs have exited (Jan, Feb, Nov), they have come in strongly, sensing the value created by pressured selling. We believe that the relevance of DIIs to Indian equities relative to FIIs have been increasing by the year and will continue to do so.



## Monetary Policy: an accommodative stance?

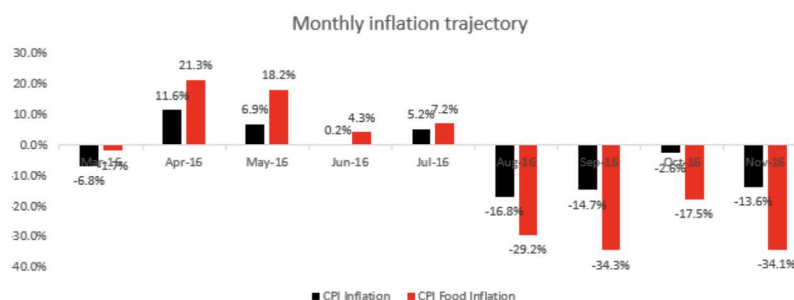
RBI transitioned to a monetary policy committee structure in 2016. After easing by 125 bps in 2015, the central bank followed it up by another 50 bps cut in 2016 with policy stance continuing to be accommodative for CY 2017. However, banks haven't passed on the benefit from the lower rates to the customers as they still grapple with rising bad loans on their balance sheet (transmission of only 71 bps out of the total 175 bps downward movement). Given the uncertainty over the economic consequences of demonetization, and developments in the US, the RBI has now chosen to wait for hard facts before working on the rates further.




However, in the context of recent global macro-economic developments, domestic facts are not the only ones RBI has to keep in mind in determining the future course of action. The strengthening USD has meant a flight a capital from India, impacting the INR and weakening the domestic debt markets. Should the RBI bring down rate without calculating the impact of this on further capita flight, it might just be counter-productive to do so. As the effects of demonetization wane by Q1 of FY18, we expect RBI to continue its accommodative stance and ease the rates further by 25-50 bps in 2017. As can be seen in the rate trajectory since 2008, there is scope for materially lower rates. So there again, RBI's thoughts on the determinants and trajectory of rates will be a key variable to watch out for in 2017.

## CPI – A year of disinflation continues to fall | WPI – reversals with rally in commodities

This was another good year for inflation watching as food inflation continued to fall, now down -69.2% for the year and down -34.1% for the month of November, following three preceding months of fall in the magnitude of strong double digits each. This is entirely on expected lines as almost all items in the food basket witnessed a healthy supply side scenario. CPI for Nov-2016 stood at 3.63% vs. 4.20% last month well below the RBI's CPI target of 5% by March 2017 which is an important one for the economy, it now remains to be seen how much of a close correlation future reduction in interest rates are paired closely with the CPI number




While the organic reasons for contraction in inflation was expected, the crunch in money circulation caused by demonetization is bound to affect real demand. Hence an inorganic but steep decline in certain baskets of consumer products may be a reality. But overall, this may be checked by rising commodity prices. The RBI will have to balance both these developments in charting the future course of interest rates in India.

| Weight | CPI | May-16 | Jun-16 | Jul-16 | Aug-16 | Sep-16 | Oct-16 | Nov-16 | MoM-16 |
|---|---|---|---|---|---|---|---|---|---|
| 45.9% | Foods & Beverages | 7.20 | 7.38 | 7.96 | 5.83 | 4.12 | 3.71 | 2.56 | -31.0% |
| 2.4% | Pan, Tobacco etc | 7.82 | 7.28 | 6.83 | 6.86 | 6.82 | 7.09 | 6.29 | -11.3% |
| 6.5% | Clothing n Footwear | 5.37 | 5.01 | 5.23 | 5.21 | 5.19 | 5.24 | 4.98 | -5.0% |
| 10.1% | Housing | 5.35 | 5.46 | 5.42 | 5.29 | 5.18 | 5.15 | 5.04 | -2.1% |
| 6.8% | Fuel n Light | 2.94 | 2.92 | 2.75 | 2.49 | 3.07 | 2.81 | 2.80 | -0.4% |
| 28.3% | Miscellaneous | 3.96 | 3.85 | 4.01 | 4.18 | 4.51 | 4.58 | 4.83 | 5.5% |
| 100.0% | CPI – Inflation | 5.76 | 5.77 | 6.07 | 5.05 | 4.31 | 4..20 | 3.63 | -13.6% |
| | Change | 6.9% | 0.2% | 5.2% | -16.8% | -14.7% | -2.6% | -13.6% | |

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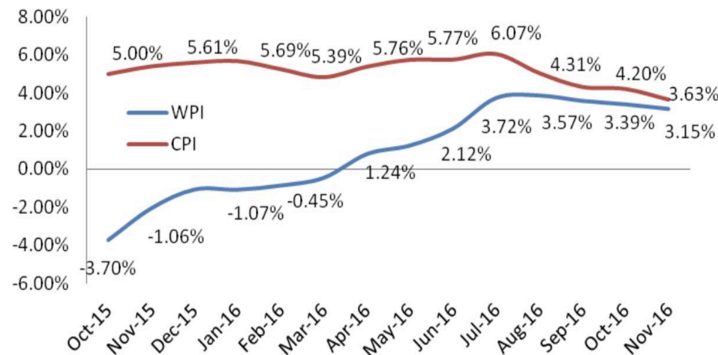
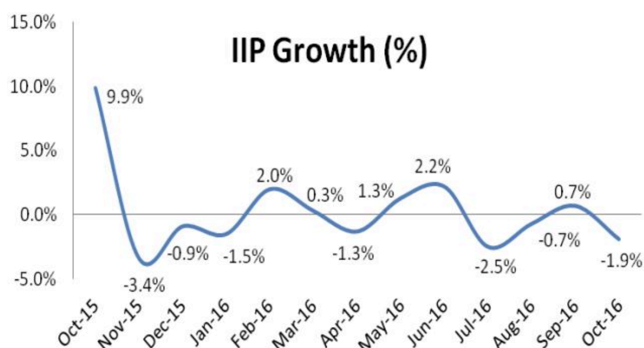
WPI for November 2016 came in at 3.15% vs 3.39% MoM which is lowest in 5-months. Disinflation was seen in food as well as non-food articles MoM. Within food, lower prices were seen in rice, vegetables, fibre, fruits and spices. Manufacturing inflation was up by a marginal 0.3% MoM, 7/12 (vs 7/12 last month) manufacturing industries recorded higher prices. Similarly, fuel inflation also rose up 1.8% MoM.




## Index of industrial production (IIP) down -1.9%




IIP for October worsened to -1.9% vs 0.7% last month and 9.9% a year ago. Weak performance across all segments with: mining (1.1%) although better than last month's -4.5%, manufacturing (-2.4% vs 0.9% last month) and electricity (1.1% vs 2.4% last month). FYTD, IIP growth fell to -0.3% vs 4.9% last year.

Capital goods growth contracted for the twelfth successive month, at -26%. Negative growth was recorded in 12/22 industries vs 10/22 industries last month.

## Current and Fiscal Account Deficit – a good score

The Current Account Deficit which had moderated sharply from highs of 5% in FY13 to about 1% of GDP for FY16 continued to stay under control and was recorded at 0.1% and 0.6% of the GDP in Q1 and Q2 of FY17 respectively. This was on account of lower trade deficit on the back of decline in merchandise imports relative to exports. The combined imports of gold, silver and precious/semi-precious stones declined to $26.4 Bn in 1H FY16 compared to $33.2 Bn last year. While gold demand is expected to remain subdued during the rest of the year due to the clampdown on gold holdings by the Income tax department, higher crude price can potentially inflate the import bill over the last quarter of FY16. This provides the Government a decent enough safety net to pursue large scale welfare spending for the coming year. The GoI had estimated the fiscal deficit to be at 3.54% of the GDP. Despite falling short in meeting the Disinvestment and Spectrum sale revenue targets, thanks to the higher tax collections compared to budgetary estimates, we maybe able to contain the fiscal deficit at 3.51% of GDP for FY 16-17.

## Unifi Strategy

**Much ado |** Unexpected set of macroeconomic and geopolitical developments competed hard for attention for almost all of 2016. Should the veil of the actual development be lifted, the common theme running thorough most events have been the sheer unpredictability of things to come. For instance, US stocks are at a life time highs, U.S treasury bond yields are at the highest rates seen in a while, and yet, the unknown is so unquantifiable, that a paltry 0.25% hike in rates took an year to be determined, and may be rightly so, for fear of collapsing the entire system. While there is no shortage of analysis paralysis, what the future holds in terms of economic growth across most regions and how much of betterment is probable is anything but remotely predictable and this state of being does not look like changing anytime soon; a spate of geo-political surprises may be the new normal. We haven't seen any policy decision from the new Government in the U.S but if promises are to be kept (such as duties on Chinese exports), there will be no shortage of surprises. And then there may be a Frexit or alike, however improbable it may sound at this juncture. The weakness in the Chinese economy along with a strong US dollar will continue to pressurise the global commodity economies, barring non-structural pull backs. Also, as much as OPEC disciplines itself, with the advancement of renewables and greener technologies, Crude may have seen its best cycle ever.

**Look within |** While the world has much to chew on, what do these developments mean for India? Fortuitously, India continues to be an internal consumption oriented economy and given the global context, India's economic positioning seems to be relatively safe. With 50% of the population dependent of Agriculture, we are better off fixing our farm lands rather than focusing excessively on the global. The drivers for consuming credit, housing mortgage, autos, personal effects, healthcare, et al are almost entirely internal.

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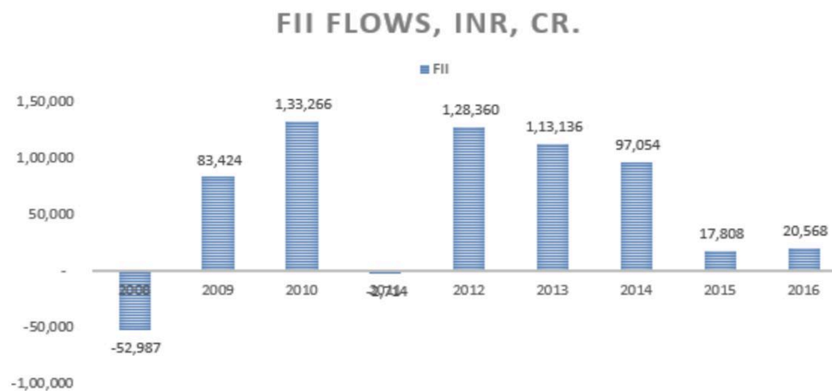
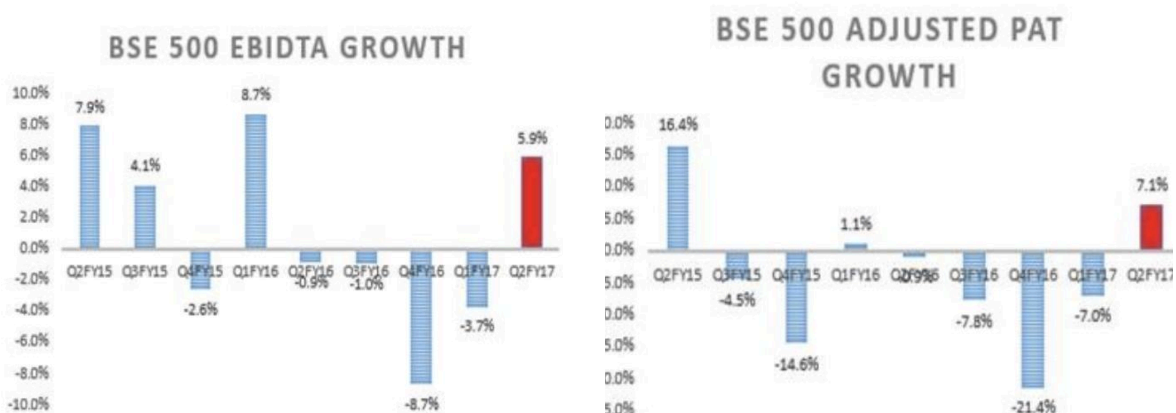
**Macro & Micro |** As we pare our expectations for 2017, we can view how India is positioned from two lenses: the macro and the micro. In the final analysis, we equate all the complex macroeconomic factors globally and locally into one final number that impacts us as investors – flow of money into the markets. Any negative global event that transpires will ultimately boil down to fund flows leaving India. As we can see in the chart below, India has received a net inflow of approximately $3Bn a year over the last 2 years – this is not a lot of money in an absolute sense.




Over the last 2 months of CY 2016, outflows have been to the tune of $4bn. We believe whatever money had to leave India, has almost entirely left. From here on, based on news flows, it is fair to expect that volatility will be in a range of not more than 10%. To put this 10% in context, the recent lows post the demonetizations blues were -6%. Given that fundamental earnings drivers barring this phase of demonetization are still in place, we strongly believe that this is a range that will hold and in the event of that being broken, reversals to current levels will be swift driven by opportunity in value. In other words, as investors and fund managers, our interpretation of market levels at any given point in time is fixated on the earnings cycle of our investee companies and the investment universe. While the liquidity argument is not great, it is not worrisome picture either.

Everything else from a micro perspective that can impact us can be crystalized into the earnings of the listed companies in our investment universe.

Coming to the micros, India was actually in the midst of a sharp earnings recovery cycle that is now temporarily stalled. For the H1 of FY-2017, the broader BSE 500 returned the best adjusted earnings in 2 years.




Barring the unforeseen event of demonetization, bottom up earnings were actually looking incrementally better with every quarter aided by the return of real demand, and better Government spending. The culmination of what could have been executed better has now resulted in 2-3 quarters of delayed earnings. In the interim, obviously PE's will inch up, but as earnings return, normalcy will prevail.

From a sectoral perspective, things are looking up. Thanks to the AQR drive, the banking industry is closer to being better off than where they were a few quarters back. This will support the markets in a major way given their sheer weight in the indices. Thanks to good monsoons, the 7th pay commission, Government spending and the resilience of the private sector in general, domestic sentiment has been the best since 2014 and they will continue to do well. As an aside, as domestic interest rate continue to fall, households will incrementally add to their equity exposures, adding support to the markets.

The overall conclusion is that the bottom up argument is still the most relevant one to us and irrespective of where the market is, stock specific and individual companies will continue to provide pockets of opportunity. As the pace of transformations led by GST, Power reforms, infrastructure spending etc. continue, we believe the pace of consolidation by the organized players over the unorganized market will continue and therein lies our opportunity. We are especially excited about the roll out of GST (which will now be delayed for sure) but the prospect of consolidation this offers is immense. The tax reform is expected to incrementally contribute an additional 1% to the country's GDP. The ease of doing business due to free flow of goods between states will usher in efficiencies which will help boost margins of organized players. The trail of tax payments from the factory to the end customer will make life difficult for some of the unorganised players who were hitherto running their business solely based on tax arbitrages. Businesses will become leaner and efficient as they cater to customers across the country through hub & spoke structures. Tax compliance would definitely increase and the government tax kitty will see a fillip. Rollout of GST would also attract more foreign investments across sectors as it rapidly cuts down tax-bureaucracy. There is little doubt that there will be teething problems as GST rollouts world over have established and the initial quarters can see some hiccups.

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On the financial side of things, passing the new bankruptcy law, constituting an independent Banks board bureau, merging PSU banks, giving licenses for Small finance banks & Payment banks, allowing Aadhar based e-KYC for account opening, Jan dhan accounts, rolling Unified Payment Interface are some of the key banking reforms undertaken over the last 2 years, driven by a collective effort from the Government & the RBI. The banks are still grappling with bad loans and it will take a few more quarters for the stress to end. However, as the economy gathers pace and credit growth picks up, Indian banking industry is much better placed in terms of capabilities, efficiencies and risk management practices to ride the oncoming economic cycle. Demonetization will lead to a short term pain as companies and citizens come to terms with the concept of cashless banking and embrace it in their daily operations. As cashless transactions increase in number, the tax compliance among the economy would rise in parallel. Also, organized credit which was hitherto unavailable to majority of the business community due to the absence of transaction records would now be within reach.

Power reforms continue to be in full swing. The Ujjwal Discom Assurance Yojana (UDAY) scheme which was launched to bailout debt ridden state power companies has seen further signups from States and till now 16 state governments have signed up for the scheme. Some of the early entrants like Discoms of Rajasthan, Haryana and UP are already showing signs of turnaround. This will kick start the power cap-ex cycle once again.

Direct Benefit Transfer (DBT) in case of LPG has resulted in a saving of Rs 36,000 Cr for the central government. The scheme's success prompted the govt to introduce the DBT model for other Centrally sponsored programs. Currently, 78 schemes across 17 ministries are using the DBT model. The key would be rolling out the same in PDS schemes which have been known for high leakage and corruption. Pilot projects are already underway. While DBT ensures that the subsidy reaches the intended targeted segments of the society, it also delivers monetary savings to the government by the elimination of fraudulent accounts.

Over all, the Government's rapid undertaking of administrative, regulatory, and legislative reforms will continue to aid consumption as well as earnings.

We continue to monitor our exposures and universe of ideas for value. We continue to like select names in building products, energy, chemicals, financial services, etc., and are closely monitoring the near as well as mid to long term potential of their fundamentals in making portfolio decisions. We continue to maintain an eye on a favourable risk reward in terms of valuation, as demonstrated by its price earnings multiple being lower than the rate of earnings growth, adjusted for its scale, and not hesitating to book profits where valuations have exceeded its margin of safety. Net of all, there are levers to move the needle for the year ahead in the next few quarters. However what we need to be patient about, are the timelines it will take the economy to deliver on the promise. 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.

**Wish you a great 2017 and do whatever it takes to stay healthy !**

**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

**Baidik Sarkar**
**Head - Research**

**This is neither an offer to sell nor a solicitation of any offer to buy any securities in any fund managed by us. Any offering is made only pursuant to the relevant information memorandum, together with the current financial statements of the relevant fund, if available, and the relevant subscription application, all of which must be read in their entirely. No offer to purchase securities will be made or accepted prior to receipt by the offeree of these documents and the completion of the appropriate documentation. Please refer to the Private placement memorandum before making a decision.**

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