

Macro, Markets & Strategy review

2015

February

Global developments

All seems well with the American economy with the U.S. labour market leapfrogging in January, registering the highest three-month jobs gain in 17 years and delivering the biggest wage increase since 2008. Payrolls advanced by 257,000 in January following increases in December and November that were even bigger than previously reported. However the unemployment rate rose to 5.7% from 5.6% as more than a million Americans streamed into the labor force seeking work, but, the number of Americans filing new claims for unemployment benefits also seems to suggest that the labour markets are structurally gathering steam. In fact it is now feared that if jobs continue to improve at this rate, an impending rate hike is around the corner and that is making markets jittery. The Fed however has continued to signal its willingness to keep interest rates low for longer, given risks to the U.S. economy ranging from a stronger dollar to tepid wages and a sluggish housing market. Many officials indicated that their assessment of the balance of risks associated with the timing of the beginning of policy normalization had inclined them towards keeping rates near zero "for a longer time".

Moving on to Europe, Greece's inability to meet their sovereign commitment and the lack of a feasible alternative saw the German parliament give its overwhelming approval to the four-month extension of Greece's financial bailout, despite unease over the new government in Athens. Heads of EU nations are still figuring out on how to deal with Greece which continues to remain the weakest link to the Eurozone and is a literally a spanner in the works towards their fiscal consolidation. Greece is trying it's best to replace the bailout with a new loan that would give it time to find a more permanent solution that eliminates strict austerity measures. While Germany and the European Commission said that talk of a next bailout for Greece was premature, Spain's Economy Minister was more maintained a realistic insistence that further support was almost inevitable. Greece will have to find enough money to commence repayment of their total dues of Euro 1.4-trillion to the IMF starting early this year and also face an ECB bond repayment in June.

Indian Market

FII's bought stock worth USD989mn in the cash market, while they sold stock worth USD1.8bn in the futures market. Moreover, they also bought debt worth USD1.7bn for the month of February. Domestic Mutual Funds bought stock worth USD582mn while Insurance companies remained sellers of equities at USD203mn for the 12th month running. For the month, BSE Sensex was up 0.61% while the mid-cap and small-cap index returned 0.67% and -0.55% respectively.

MSCI (in %)	India	Brazil	Russia	Korea	China	Japan	US	Australia	EM Index
MoM (in %)	1.82%	2.23%	22.82%	0.38%	3.24%	6.04%	5.59%	6.86%	2.98%
CY - YTD (in %)	9.88%	-4.53%	21.87%	2.72%	5.59%	8.51%	2.50%	4.96%	3.55%

Monthly Macro Review | RBI cuts rates out-of-policy again | Inflation in control

Rate cut - surprise, again. In yet another out-of-turn move, the Reserve Bank of India reduced the benchmark repo rate by 25bp to 7.5% on account of:

- Lower-than-anticipated inflation data points,
- Major intent of "high quality" fiscal consolidation in the budget, and
- A need to offer guidance on the basis of the newly constituted monetary policy framework and the monetary policy committee which will have both the RBI and the Government on board

The overall dovish bias that the Governors commentary carries together with the formal announcement of its new mandate to bring CPI inflation in the 4±2% within a two-year period, beginning in FY17, means monetary easing would most possibly run further ahead with a pause. The formation of the monetary policy committee and veto powers (if any) will be key to watch in 2015. The RBI's further moves will be conditional on

- Incoming data, keeping in focus the easing of supply constraints
- Scale of improvement in availability of key inputs such as power, land, minerals for infrastructure
- Continuing progress on high quality fiscal consolidation
- Extent of the pass-through of past rate cuts into lending rates, and
- Outcome of the upcoming Monsoon

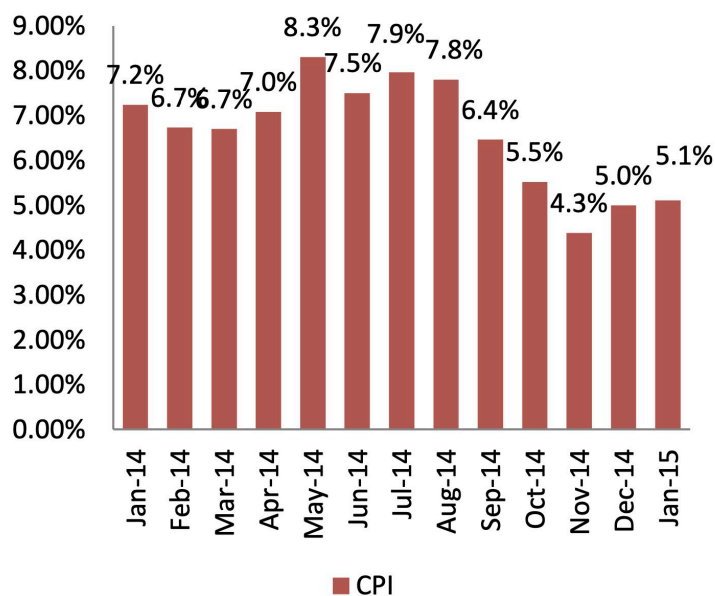
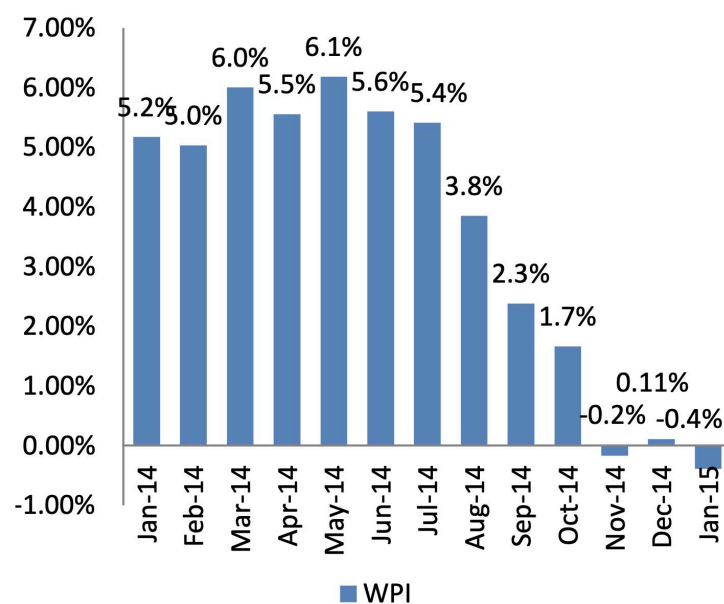
For now, the risks to most of the above factors are a directional change in crude process, slow policy change and the lack of a good Monsoon.

Inflation: CPI and WPI continue to moderate:

CPI for January 2015 was the first reading to be declared on a revised base. The base year has been changed from 2010=100 to 2012=100. Due to a change in consumption pattern, weights have undergone a marginal change. Food and beverage weight has been reduced to 45.8% vs 47.5% in the previous series. Fuel and light now weighs 6.8% vs 9.4% while core CPI now has a higher share of 44.9% vs 40.8%. On a revised base (2012=100 earlier 2010=100), CPI for January 2015 came in at 5.11%, softer than market expectation of 5.4%.

CPI under the new series came in at 5.1% YoY with Consumer Food Inflation at 6% and core CPI at 3.5%. Major commodity items that have contributed to 5% YoY inflation include vegetables like brinjal, cauliflower, cabbage and tomato registering 15%+ inflation along with other items like milk (inflation 10%) and house rent, medicine charges & education expenses. A decline in petrol & diesel prices, decline in air fares and a fall in precious metals like gold and silver have cushioned the headline CPI.

WPI: Again in negative zone at -0.39%: WPI contracted by 0.39% as the fuel group index declined 10.6% YoY; this is the lowest since August 2009. Also, the WPI index continued to decline for a fourth consecutive month by 1%. Core WPI further eased to 0.9%, aided by a drop in global commodity prices.



Revised CPI to stay on RBI's disinflationary

The base revision of the CPI series is a good exercise as it captures the revised consumption pattern. The increase in income levels over the past decade has led to the consumption shift from food to non-food category. The weights of the sub-components within the new CPI basket are now based on the Consumer Expenditure Survey (CES) of 2011-12 against the old basket individual weights based on CES of 2004-05. It looks like the new CPI will stay on the RBI's trajectory of January 2016 CPI at 6% on an assumption of a good monsoon and a stable currency. A benign outlook on international commodity prices and commitment of the government to prevent price shocks in seasonal commodities (effective price monitoring of essential commodities, utilisation of food stocks, creation of price stabilisation fund and improvement in the supply chain infrastructure and moderate MSP hikes) give us comfort that inflation may not accelerate at a faster pace going forward.

IIP – moderate December

India's Industrial Production for December moderated to 1.7% (YoY) from an upwardly revised 3.9% in November. The YTD growth (April - December) at 2.1% continues to ease from 2.2% as of last month. Manufacturing witnessed a strong sequential pick-up in activities large enough to offset an unexpected 3.2% contraction from the mining segment. Industry wise 13 out of 22 industries registered an expansion as compared to only 16 Industries witnessing growth in the previous month.

- Electricity growth slowing to 4.8% in Dec from 10% in Nov was primarily owing to 13% (YoY) decline in hydro electricity generation.
- Mining growth contraction was led by 3.5% decline in Natural Gas Production and 1.4% de growth in crude oil production.
- The narrowing of contraction in consumer durables to -9% from -14.5% in the previous month and a stable growth of 5.7% in Consumer non-durables compared to 6% in November enabled consumer goods segment to emerge in the positive territory.

The RBI has started with its easing cycle and benign inflation trajectory makes us that the turnaround in rates cycle remains a key underlying factor as boost to the sentiments. The Jan Auto Production suggests an encouraging picture for further boost to Capital Goods as the off take of Commercial Vehicles has shown improvement in the past few months.

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

Year on Year in %	Weight	Dec -	Nov -	Oct -	Sep -	Aug -	July -	June -	May -
Classification by Economic activity									
Over all	100.0	1.7	3.9	-4.2	2.5	0.5	0.9	4.3	5.6
Mining	14.2	-3.2	3.9	5.2	0.3	2.0	0.1	4.8	2.5
Manufacturing	75.5	2.1	3.0	-7.6	2.9	-1.3	-0.3	2.9	5.9
Electricity	10.3	4.8	10.0	13.3	3.9	12.9	11.7	15.7	6.7
Classification by use									
Basic Goods	45.7	2.4	7.0	5.8	5.1	9.2	7.0	10.2	7.5
Capital Goods	8.8	4.1	6.5	-2.3	12.5	-9.8	-3.9	23.3	4.2
Intermediate Goods	15.7	0.1	4.3	-3.1	2.2	-0.1	2.9	2.6	3.5
Consumer Goods	29.8	0.7	-2.2	-18.6	-3.6	-6.5	-5.9	-8.8	4.6

Unifi Strategy

FY2015-16 Financial Budget, a well balanced act.

NDA's first full-fledged Budget was a good effort to rejuvenate and revive the economy. Though there were no big-bang reforms as was expected by some sections of the market, the Government managed to meet the key expectation of a substantial increase in the allocation (up by 0.5% of the GDP) for capital spending in the infrastructure segments, namely roads, railways and irrigation. This is probably the biggest positive of the budget (which is also in sync with the higher capital spending envisaged by the railway minister in the rail budget earlier) since it is essential to revive industrial activity and investment cycle, and put the economy on a virtuous growth cycle. On the other hand, the target to achieve a fiscal deficit of 3% of the GDP by FY2017 has instead been extended by one year to FY2018 which is negative in terms of influencing the pace of monetary easing by the RBI. However, it needs to be viewed in the light of the fact that the finance minister had limited fiscal space to balance both growth as well as maintain fiscal discipline.

While there were several incremental initiatives in the budget that will over all aid the growth of several components of the economy, we'll mention just two key data points that have the potential to impact India's long term economic standing in a material manner. Firstly, (a) corporate taxes are to be reduced to 25% from 30% over the next four years in a phased manner (starting from FY2017), and (b) producing a definitive road map in moving towards GST from the next financial year and preparing the economy for a higher indirect tax rate regime by hiking service tax rates from 12.36% to 14%.

Strategy

Overall, the fiscal estimates appear quite credible and the RBI endorsed the same with a surprise rate cut. Among other things, the budget will be remembered for its attempt to re-orient the nations focus to the small things that matter without resorting to any jingoistic initiatives. The markets clearly liked the tone of the Government and have shown remarkable patience and maturity to participate in a qualitative journey rather than look at short term goal posts. While markets may trade in a narrow range for a bit and wait for earnings to catch up, we believe the bull market is intact and not in danger. Of course, the markets are keenly watching movement in key policy areas such as Land Acquisition Act, GST, Coal Mining, and FDI limit in insurance and we like the noise being made on this front. The cut in corporate tax rates and higher than expected fiscal deficit implying more spending, will kick start the investment cycle once again and this augurs well for earnings growth over the next few years.

At current valuations, the market is trading at 16.4x FY16e EPS of Rs.1703. It is not cheap but it is not too expensive either keeping in perspective the probability of high growth in a few quarters from now. On the back of these developments, we will continue to align ourselves with sectors having a high leverage to a revival in the domestic economy as well as sectors that have strong visibility of growth irrespective of the domestic macros. Accordingly, across sectors, we are invested in businesses that are benefitting from sustainable growth in consumption supported by Indian demographics. As we have been saying, an impending upturn in the earnings cycle and falling interest rates is likely to support valuations. However huge supply of paper in terms of disinvestment, IPO's and FPO's can make the market volatile in the short term.

Risk: Indian markets as well as the INR continue to remain 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

M. Ravvichandran

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