Macro, Markets & Strategy review

2016

February

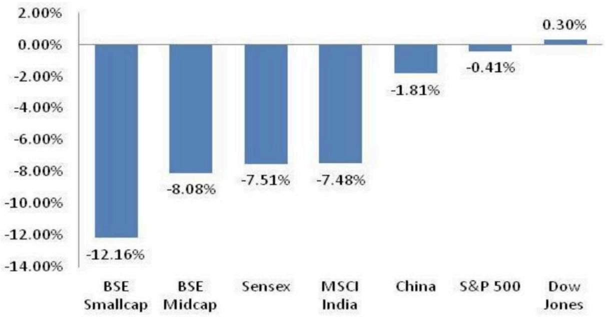
UNIFI INVESTMENT MANAGEMENT

Global developments | EU banks join the fall

European Banks as a category joined the list of instruments / asset classes that are in rapid deceleration mode, with the benchmark Stoxx EU 600 Banks index now down -19% for the year. The collapse of 2008 was all about the American banking sector, and obviously, if European economies are in trouble, there is bound to be stress in their circles. The sluggish performance of European economies over several years means there are worries about bad debts on bank balance sheets; it is estimated that c.16.7% of Italian bank loans are non-performing, against a European average of 5.6%. And then there were specific worries on Deustche Bank's ability to pay coupons on its $5 billion convertible capital bonds which the management later clarified was unwarranted. We haven't heard a lot about Greece in the last few quarters but nothing has changed there and it's just a matter of time before their stress resurfaces, coinciding with loan repayment dates. Finally, the prospect of a long period of negative interest rates in the euro zone is weighing on bank profits. Negative rates have been imposed by central banks on reserves held with them by the commercial banking sector, but the commercial banks are unwilling to pass these on to customers. So negative rates are for now acting as a tax on bank profits as a result of which their RoE's from levels of 20% in 2008 are now down to 6%. When will the structural tide change? Doesn't look like any time soon. But, to do their bit, institutions are doing what they do when faced with a crisis, lay off people, thus indirectly aiding an already deflationary state of being.

Across the pond, Bank of America ML calculates that, so far, US financial companies have reported a 4.2% decline in quarterly profits. Fourth quarter profits for S&P 500 companies are down 2.3% QoQ and 4.3% YoY. Even if energy stocks are excluded, companies managed only a 0.4% quarterly, and 1.7% annual, earnings increase. But the US economy is probably the best placed in relative terms among the developed nations, recording continues improvements in employment data, a key monitor able to economic health.

An overall down month

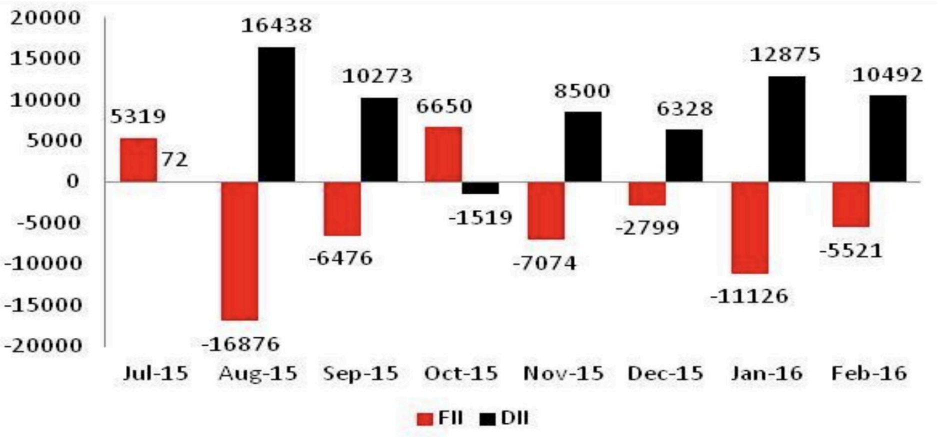


- Dow Jones was up 0.30%
- S&P 500 was up 0.4%
- Shanghai was up 1.81%
- BSE Sensex was up 7.51%
- BSE Mid-cap was up 8.08%
- BSE Small-cap was up 12.16%
- MSCI India was up 7.48%

MSCI (in %)	India	Brazil	Russia	Korea	China	Japan	US	Australia	EM Index	MSCI World
MoM (in %)	-7.48%	5.61%	1.82%	-2.48%	-2.55%	-2.78%	-0.48%	-1.75%	-0.28%	-0.96%
CY - YTD (in %)	-13.89%	-2.26%	0.86%	-8.00%	-14.93%	-10.78%	-5.88%	-10.13%	-6.78%	-6.95%

Liquidity continues to leave Indian markets, as FIIs continue to move funds to relative safer havens. Buying continues to be supported by domestic funds, thanks to the continuing momentum of retail investors in India increasing the proportion of their savings in equities. But it remains to be seen how long this can be sustained.

The chart below showcases FII and DII behavior over the last 8 months.



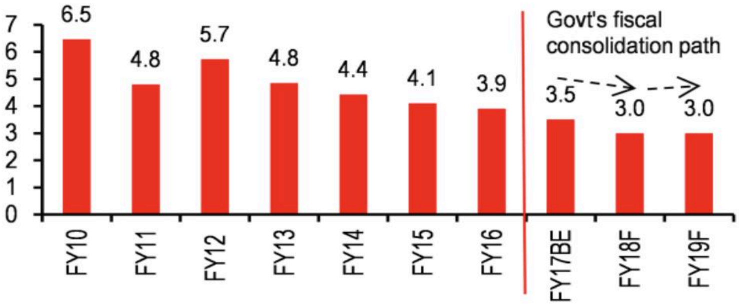
Monthly Macro Review

Annual Budget Review | Nothing fancy, incrementally positive

The Financial Budget presented by the Indian Finance Minister on the last day of every February, is a bit of a frenzied event every year, encompassing a multitude of announcements, intentions and data points. Our key takeaways from this year's budget were (a) the government's commitment towards fiscal consolidation and (b) comprehensive set of growth measures to support a more balanced growth trajectory, led by Rural India.

3.5% | No deficit on macro stability

The government demonstrated considerable restraint by sticking to the pre-announced fiscal deficit target of 3.5% of GDP in FY17 from 3.9% in FY16. This is not as easy as an announcement, as the tradeoff between growth spending and preserving macro stability is always a difficult one. Yet, the Government bit the bullet and along with this year's target, the deficit target of 3% for the next year was retained. But of course it needs to be pointed out that the disinvestment target of Rs.565bn (although more realistic than last year's Rs.695bn) and spectrum sales target of Rs.990bn are a tad rich and relying on funding these asset sales (c.1.03% of GDP) makes budgetary targets dependent on market conditions. However at a policy level, the intended glide path is comforting.



Rural focus

As mostly expected, the emphasis on the rural sector in the current budget was unmistakable, but not bordering on populism, partly reflecting consecutive years of bad monsoon and faltering agriculture growth and the need to provide for 16% of India's GDP and 50% of rural households. Among others:

- ✓ The total allocation for Agriculture and Irrigation increased to Rs.542bn in FY17 vs. Rs.260bn in FY16
- ✓ The Finance Minister announced a Krishi Kalyan (Agriculture Welfare) cess, at 0.5% on all taxable services, effective 1 June 2016, the proceeds of which would be exclusively used for financing initiatives for improvement of agriculture and welfare of farmers.
- ✓ Importantly, the government has set a target to double farmer incomes in five years; this could be a real deal for India's domestic consumption led economy.

In other areas, the government's allocation to infrastructure funding was focused on roads and highways, followed by railways and rural infrastructure. On the flip side however, there was an irritant in the form of dividends being taxed at the hands of the receiver @ 10% in excess of Rs.1 Million. The Government retained its commitment to lower corporate tax rates over the next few years.

The RBI will meet in next month in April for its monetary policy review and we hope the forward guidance on fiscal deficit enables them to take a view on further monetary easing sooner than later.

As a reminder, among other things, the RBI had anchored to a CPI target of 6% by January 2016 (which will be under shot, but not by a material margin) and a March 2017 target of 5% as one of the determinants of the future course of action. The RBI did caution on possible upside risks to this as a result of the implementation of the 7th pay commission and this would in time reflect the RBI's revised inflation forecast. Of course, the trajectory of the coming Monsoons will also be key, as a literally parched economy needs some respite. Over all it is fair to guess that the rate easing cycle is not over and further easing if 25-50bps is a possibility over the next 12-15 months.

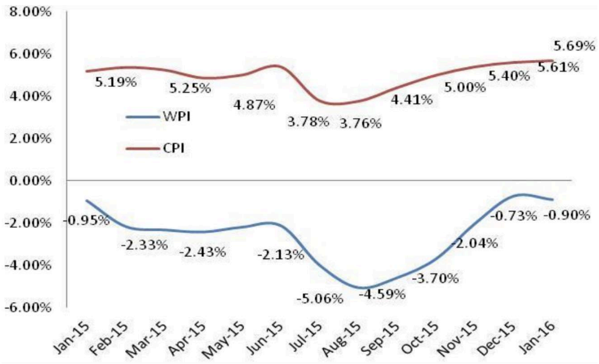
Inflation marginally up, CPI up at 5.69% vs 5.61% MoM, WPI still in negative territory @-0.90%

Consumer price inflation for January–16 came in at a 16 month high of 5.69%, led predominantly by the food component that inched up to 6.85% vs 6.40% MoM. Delving into the reasons for the same, we would like to believe that there may not be any structural reasons for a sustained up trend.

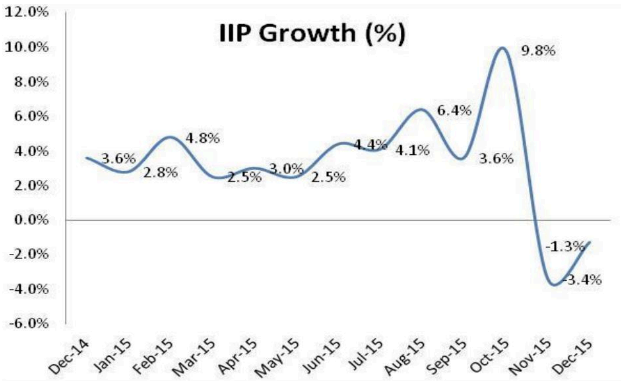
The food and beverages basket accounts for 45.86% of the CPI index, of which Pulses & products constituting 2.38%, was up 43.32%, resulting in a 1.03% impact for the full month's number. This was marginally lower than the previous month's number of 45.92% in Pulse inflation. We expect this number to normalize in the months to come due to better inventory management by the GoI, until the rains show up in a few months from now. The rest of the components of CPI don't look like suffering an upward stress at this point in time.

Particulars	Weight	Inflation
Food & Beverages	45.86%	6.66%
Pan, Tobacco & Intoxicants	2.38%	9.03%
Clothing & Footwear	6.53%	5.71%
Housing	10.07%	5.20%
Fuel and Lighting	6.84%	5.32%
Miscellaneous	28.32%	3.95%
CPI - General	**100%**	**5.69%**
CPI - Food Inflation	**45.86%**	**6.85%**

The deflationary trend however continued on the wholesale front with WPI down -0.9%, now in the negative territory for 15 consecutive months. While there were pockets of agri inflation within the WPI basket, falling fuel & power prices negated the effect of the same



IIP down scare, down -1.3%



The Index of Industrial Production for December 2015 contracted by -1.35, mainly due to the flooding in Chennai. 10 of the 22 industry groups in the manufacturing sector have recorded negative growth during the period. Manufacturing output fell 2.4% led by contraction in capital goods output and sluggishness in other sectors. Highest IIP contribution came from automobiles, furniture, textiles, chemicals, coke, and refined petroleum products. Negative contributors were food products, tobacco products, metals, and machinery.

The cumulative growth for the period April-December 2015 now stands at 3.2% vs 2.6% YoY

Unifi Strategy

Earnings have probably bottomed out

Among all the noise from China, Europe, commodities and the rest of the world, there is also the small fact that India has had a very poor earnings year. Nifty Q3 FY16 revenue declined 2% YoY, driven by global commodity-linked sectors. Excluding global commodities, revenue was up 9% YoY, with muted growth in many sectors (power, consumer, telecom, pharma, infra & cap goods and autos). EBITDA margins (overall) were largely in line with expectations, though ex-global commodities they were slightly weaker, with EBITDA growth disappointing. While all sectors were weak, the banking sector was particularly so.

The recent 3QFY15/16 earnings releases by the banks suggest that banks continue to grapple on asset quality and capital levels. Earnings were punctured with aggressive provisioning under prudential norms of the RBI as a result of which, several marquee banks reported losses. RBI's asset quality review (AQR) conducted in the quarter was responsible for about half of the fresh slippages recorded in the quarter. The RBI has additionally set a timeline for banks to clean up their balance sheet by Mar17, suggesting that banks are likely to report high credit costs until the next fiscal year.

Asset quality aside, the bigger challenge for the Public Sector Banks is raising capital, especially against weak internal capital generation and the poor capital market environment. With the AQR currently underway, it has become even more critical for the government to play a bigger role in providing capital (over and above the Rs.25000cr as per it's budget) into the weaker banks as these banks currently do not have access to the capital market.

For the full year FY2016, earnings growth isn't anything to write home about, but it looks like FY2017 could possibly be a better earnings year over all, touching mid-teens for most sector ex-Banking. At an index level, the key Banks - SBI, Axis Bank and ICICI Bank – are expected to report break even earnings as they continue to take provisions on stressed assets for the whole of FY-2017. However, the other key industry components of the Sensex, i.e., Auto, IT, Pharma and FMCG will report around mid-teens and above in earnings.

We believe, as reforms continue (power, banking) and the Government increases money supply in the economy by a higher amount towards MNREGA, Agri spending, 7th pay commission, etc., the actual impact of the same on deeper parts of the economy may be meaningful going well into the year. As and when GST comes in, (may be by April 2017), the earnings upgrade will only strengthen.

Until then, our strategy will be consistent with what we have been communicating for a while now: continue to be that of a more focused, bottom up approach and alignment with companies that exhibit strength at a firm level, with reasonably strong earnings growth outlook for the short to medium term, along with healthy balance sheets and good capital return metrics. Given the fall in markets in January and February this year, we believe the PE compression cycle is almost over and this will now track earnings from here on.

We continue to monitor the economics in China very closely, especially their actions on the currency. Over the past few quarters, we have increased our exposure to the specialty chemicals industry, the opportunities being strictly bottom up. While there is no immediate threat to their competitiveness viz-a-viz the strength of the respective currencies (INR and Yuan), a rapid deceleration of the Yuan may significantly alter the balance of trade. 'Experts' attribute a further fall in the Yuan at a level between 5%-30%, so there is little to do but actively watch the economic dashboard apart from maintaining a close level of communication with our portfolio holdings to gauge their competitiveness from time to time. We continue to like the Auto space broadly along with select names in the mid cap space across pharma, NBFCs etc.

We believe there continues to be pockets of opportunities that offer the prospects of earnings growth for the medium term as well as long term. Our portfolio construction draws from reversible short term trends such as a normal monsoon, leading to a demand uptick in the agri value chain, select consumer discretionary names that have micro tail winds, housing finance space that are benefitting from India's vast demand for housing mortgage, and pharma and chemical names that have firm specific demand drivers.

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.

Risk: Key risks to our portfolio would come from geo-political concerns globally, decline in foreign inflows, sharp currency movements, Fed 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

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