Macro, Markets & Strategy review

2016

January

UNIFI INVESTMENT MANAGEMENT

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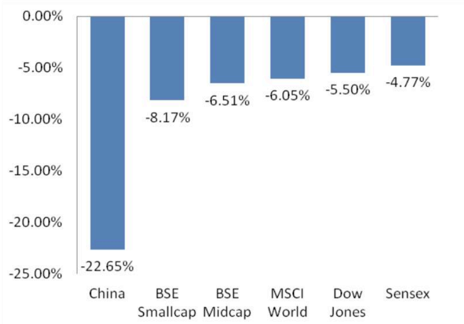
Global developments | Armageddon? | "D" for Deflation

2016 has seen one of the worst ever starts to global markets with indices around the world witnessing a wholesale sell off. Dow ended the month down 5.5%, China crashed another 22.6% while the EM basket lost 6.5%, without any meaningful global exceptions. The rout was almost fully led by that slippery thing, Crude, falling to a 12 year low of $27 a barrel. Historical analysis indicate that a 10% fall in oil prices boost growth by 0.1-0.5% points, which in the context of today's world growth rates 3.2% is a lot. Perhaps the benefits of ultra-cheap oil still outweigh the costs, but markets have fallen so far so fast and the deterioration of liquidity across all world markets has been so dramatic, that all bets are off. The bet now points to the grievous state of affairs of the Middle Eastern financial system, and risks of them exporting systemic deflation {in lieu of the vastly reduced power purchasing power of the Oil economies} to large parts of the world. The word to note is, Deflation. Cut to the east: China is still growing, maybe at 6-7%, or lesser, but the fact is they are growing. However, the delta between a double digit growth and a now single digit one has created such a void on a huge base, that it has worsened the deflationary outlook of all commodities that fueled the growth years for them. To counter the spiral of its commodities dependent economy, China devalued the Yuan again by 0.5% to support exports, further squeezing almost the entire basket of world currencies, resulting in a steep depreciation almost all global currencies and weakening their purchasing power in an already deflationary scenario. Further east, Japan entered an era of negative interest rates, cutting benchmark rates for new reserves from zero to -0.1%, to fight, (you guessed it right), Deflation. The Bank of Japan kept the downsides open, saying it would lower rates still further if needed. As a reminder, ECB in its fight against deflation also has –ve rate regime of -0.3%.

When we wrote to you the same time last year, Greece was the poster boy of the world's woes. While absolutely nothing has changed at their end, newer pain points have emerged around the world, confounding an already complicated state of affairs.

An overall down month

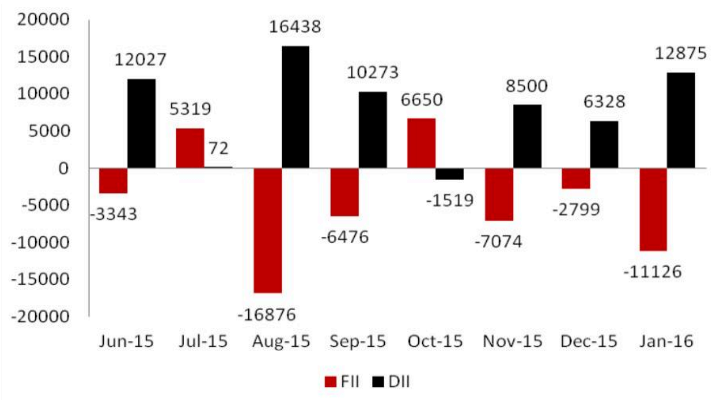


- Dow Jones was down 5.5%
- S&P 500 was down 5.0%
- Shanghai was down 22.6%
- BSE Sensex was down 4.8%
- BSE Mid-cap was down 6.5%
- BSE Small-cap was down 8.2%
- MSCI India was down 6.9%

MSCI (in %)	India	Brazil	Russia	Korea	China	Japan	US	Australia	EM Index	MSCI World
MoM (in %)	-6.93%	-7.46%	-0.94%	-5.66%	-12.71%	-8.23%	-5.43%	-8.53%	-6.52%	-6.05%
CY - YTD (in %)	-6.93%	-7.46%	-0.94%	-5.66%	-12.71%	-8.23%	-5.43%	-8.53%	-6.52%	-6.05%

Meanwhile liquidity continues to dry up in the Indian markets as FIIs continue to withdraw funds from India as sovereign funds dip into reserves to manage their fiscal accounts, while other funds feel the pressure of a depreciating Indian Rupee versus the USD in addition to taking a call on equity allocation in the context of several deflationary indicators globally. Buying has almost entirely been 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.



This is more or less in sync with the drain on equities the world over, which has seen USD20BN ++ being pulled out of global markets, out of which ETFs alone contribute to approximately USD 16bn.

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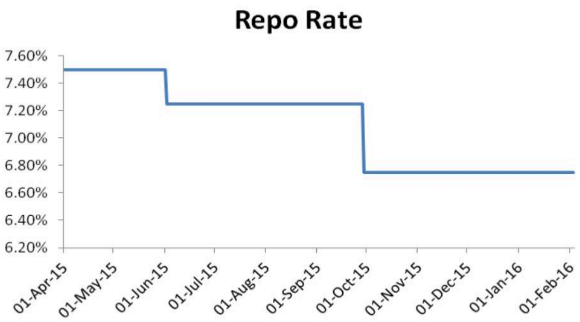
Monthly Macro Review

Monetary Policy Update: Accommodative stance reiterated

The Reserve Bank of India announced a pause on key policy rates, holding interest at 6.75%, which was more or less in line with consensus. This is how the rate trajectory now looks in India over the past year:



So, when is the next rate cut? Governor Rajan has left scope for further easing, conditional on (1) the evolution of prices in the economy, i.e., the trajectory of inflation and (2) the upcoming budgetary moves later this month, particularly adherence to preset Fiscal Responsibility targets, i.e., a signal to the government to control expenses, lest the recently gained macro stability gives way to higher prices.

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.

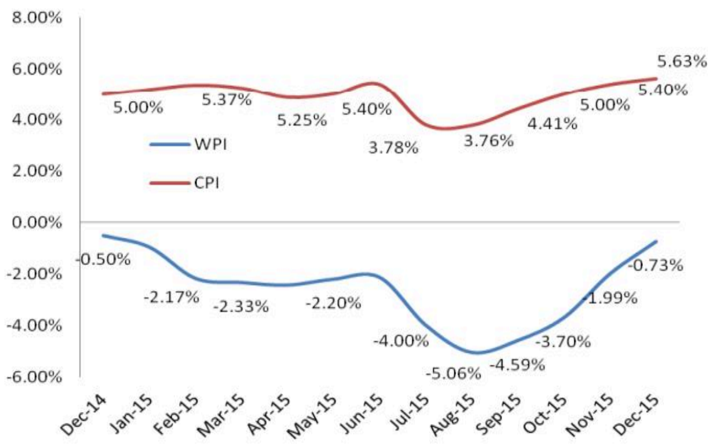
Inflation spikes, probably a blip. CPI up to 5.61%, WPI still in negative territory @-0.73%

Consumer price inflation for December-15 came in at a 15 month high of 5.6%. A spurt in consumer food inflation is the primary reason for the same. This did scare the markets, although 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 45.92%, resulting in a 1.09% impact for the full month's number. 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%	6.31%
Pan, Tobacco & Intoxicants	2.38%	9.27%
Clothing & Footwear	6.53%	5.74%
Housing	10.07%	5.06%
Fuel and Lighting	6.84%	5.45%
Miscellaneous	28.32%	3.95%
Total	**100%**	**5.61%**

The deflationary trend however continued on the wholesale front with WPI down -0.73%, now in the negative territory for 14 consecutive months. While there was agri inflation within the WPI basket, falling fuel & power prices negated the effect of the same.



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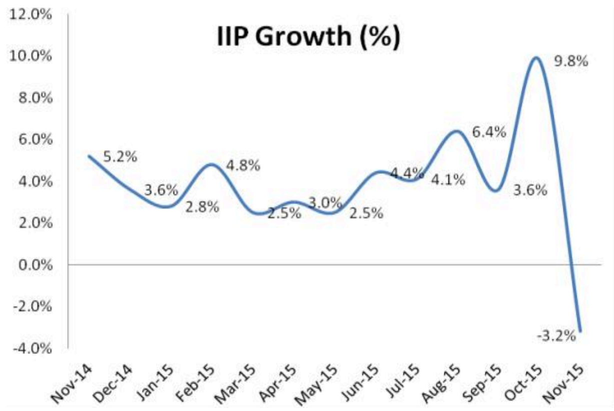
IIP scare, down 3.2%



The Index of Industrial Production for November 2015 came in at 166.6, recording a contraction of 3.2% YoY. 17 of the 22 industry groups in the manufacturing sector have recorded negative growth during the period. The steepest declines were led by electrical machinery', that was down 46.5%, followed by a 13.8% fall in luggage's and 13.1% fall in wood products. Growth was led by Furniture Products at 102%.

- Capital goods consumption fell by -24.4%
- Consumer durables consumption grew by 12.5% while consumer non-durables fell -4.7%. Overall consumer goods grew by 1.3%

The cumulative growth for the period April-November 2015 now stands at 3.9% YoY.

Unifi Strategy

It's the earnings (i.e., lack of it!) Nifty earnings at 5%

While global news flows aren't great, the news coming in from the ongoing earnings season in India isn't all that cheerful either. Simply put, there just isn't enough demand for bikes, soaps, power equipment's, etc., while the quality of banking sector assets in the industrial sector has gotten from back to worse. Ideally, we would have liked to give you a single number, highlighting the state of affairs, but that would not be showing the entire picture. So we have charted a table below to highlight the state of anaemia in key constituents of corporate India.

	Sales	**PAT**			**Sales**	**PAT**
	YoY %	YoY %		YoY %	YoY %	YoY %
Consumer	**5.1**	**9.7**		**Technology**	**16.4**	**5.3**
Colgate	1.8	7.6		TCS	11.7	12.2
Emami	13.9	6.2		Infosys	15.3	6.6
Hind. Unilever	2.7	7.2		HCL Tech	11.4	-0.2
ITC	2.6	0.7		Mindtree	33.2	7.2
Dabur	2.4	12.6		Persistant	19.7	4.1
Marico	7.3	23.7		Wipro	7.2	1.9
	YoY %	YoY %		YoY %	YoY %	YoY %
Capital Goods	**1.4**	**5.0**		**Telecom**	**4.3**	**-12.7**
Bharat Electronics	-5.7	8.8		Airtel	3.7	-22.2
Havells India	7.8	0.3		Idea Cellular	12.4	-0.4
Larsen & Tubro	8.3	19.4		Reliance Comm	3.1	-15.4
Siemens	5.9	7.5				
Thermax	-9.4	-11.1				
Auto Volumes	**Q3 FY16**	**YoY**		**Private Banks**	Poor Assets*	YoY %
Hero	16,90,918	2.5%		Axis Bank	3.99%	25.9%
Bajaj	951,498	3.4%		ICICI Bank	7.24%	29.1%
TVS	702,109	7.1%		*GNPA + Restructured assets in% terms		

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You will notice

FMCG	Usually a sector with all the right ingredients of growth, has struggled to grow revenues beyond very low single digits. All cases of earnings growth being stronger than revenue growth is due to lower crude prices.
Information Technology	Growth slowing down for the entire sector and in almost all cases earnings growing < revenues. Intense competition & automation is moderating the earnings outlook of the sector
Capital Goods	Poor growth outlook for all the companies, indicating weakness at the macro level; L&T has witnessed next to no growth in its order books for the whole year
Auto	Demand has been absolutely flat for well over a year now; back to back monsoon failures and low purchasing power in the economy as such has dented industry prospects
Telecom	Without exception, the entire industry is under stress. But of course, a lot of it has to do with the impending entry of a potential disruptor – Reliance Jio
Private Banks	The poster boys, rather ladies, of India Inc have disappointed immensely on simple prudent lending

Given how the sector elders have performed, one can imagine the stress on B2B businesses within the respective eco systems that constitute the bulk of the mid cap and mall cap universe in India. Almost without exception, most cases of non-liner earnings growth has been due to lower energy prices, the base effect of which will begin to play out in a few quarters time now. For the short term, we expect the remaining results to portray sluggish trends as such. There are emerging pockets of strong growth, for instance, power transmission, but we need to wait for signs of secularity.

One of the chief worries of the economy has been the lack lustre private sector ramp up of capex. While the Government is working on improving the investment climate and doing its bit on public sector investment, lot more on monetary transmission has to be done to improve money flow in the economy. It is in this context that we are deeply awaiting the February 29th annual budget exercise by the GoI that will spell the future discourse on fiscal consolidation v/s growth spending. And of course, passage of the crucial GST Bill which can really move the earnings needle for corporate India.

We believe, as reforms continue (power, banking) and the Government increases money supply in the economy (welfare spending, 7th pay commission, etc.,) the prospects of investable industries would gradually increase. But until then, our strategy will 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. The inconsistency between expectations and earnings will test everyone's patience and until there is delivery of actual earnings, we are likely to pay a premium for earnings visibility and growth, and possible even go through a PE contraction cycle as capital flight out of India continues. This however is an integral part of price discovery in the market.

Among the brouhaha of China, Oil and everything else, the fact remains that this remains a bottom up stock pickers market. There are pockets of opportunities, far and wide, 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 favorable 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

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