Macro, Markets & Strategy review

2017

January

UNIFI INVESTMENT MANAGEMENT

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Global developments | Dow Jones at an all-time high

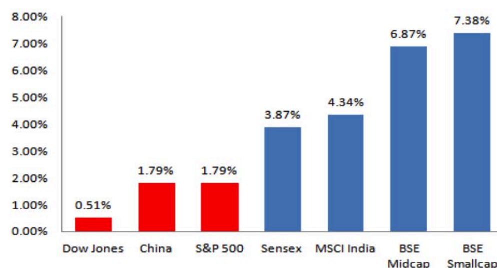
American equities continued to display the energy of teen spirit as the post-election fund flows into US equities propelled the Dow Jones index for the first time ever to levels of above 20,000. The DJIA, currently at an all-time high, is now up almost 10% since the 7th of Nov'16 and the rally was propelled by names that made America great in the first place: financial majors Goldman Sachs and JP Morgan were up 30% and 24% while Boeing, IBM and CAT were up 15%, 13% and 10% respectively. As the markets see signs of the new administration deliver on its intent, along with the promise of lower corporate taxes, a cut in regulation by 75% in certain sectors and more Government spending, a rough template for earnings growth is emerging and in the process attracting new capital to US equities. However, keeping all of this in perspective, and wiser by our recent experience of a hope rally in India, we remain cognizant of a potential pull back in the US if the quantum and timing of inflows continue to significantly precede an earnings recovery as a supply side revival in productivity are long term in nature and outcomes may take years to realize. Valuations in mature markets may not hold out to premiums (like in the case of emerging market) for long and an undesirable bout of skittishness may see a sell off of a magnitude and duration that would turn the thesis of this template upside down.

Meanwhile the Eurozone has now posted 14 consecutive quarters of growth, with unemployment rates having fallen to single digits and economic sentiment having reached the highest level in 6 years. For the full year 2016, Eurozone grew at 1.7%, outpacing US' growth of 1.6%. The headwinds of an almost decade old financial crisis is slowly but steadily becoming history and loose monetary policy encouraging firms and households to spend is showing up in better economic activity as the Eurozone PMI, currently at 54.4, witnessed the 43rd straight month of expansion. One hopes that Greece and Italy will not derail this momentum for the broader continent.

World Markets

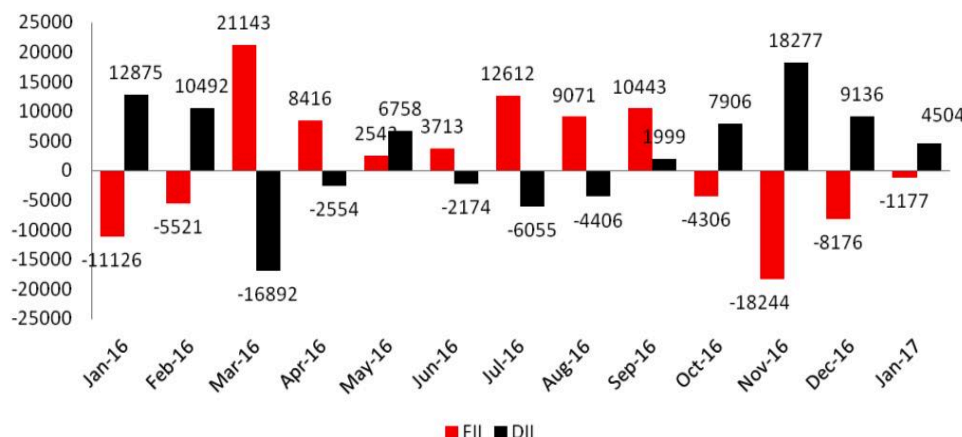
Emerging markets had a good start to the year over all as the broader EM index notched 5.4% for the month.

MSCI (in %)	India	Brazil	Russia	Korea	China	Japan	US	Australia	EM Index	MSCI World
MoM (in %)	4.34%	10.61%	-0.28%	7.67%	6.80%	3.72%	1.96%	4.27%	5.45%	2.35%
CY - YTD (in %)	4.34%	10.61%	-0.28%	7.67%	6.80%	3.72%	1.96%	4.27%	5.45%	2.35%



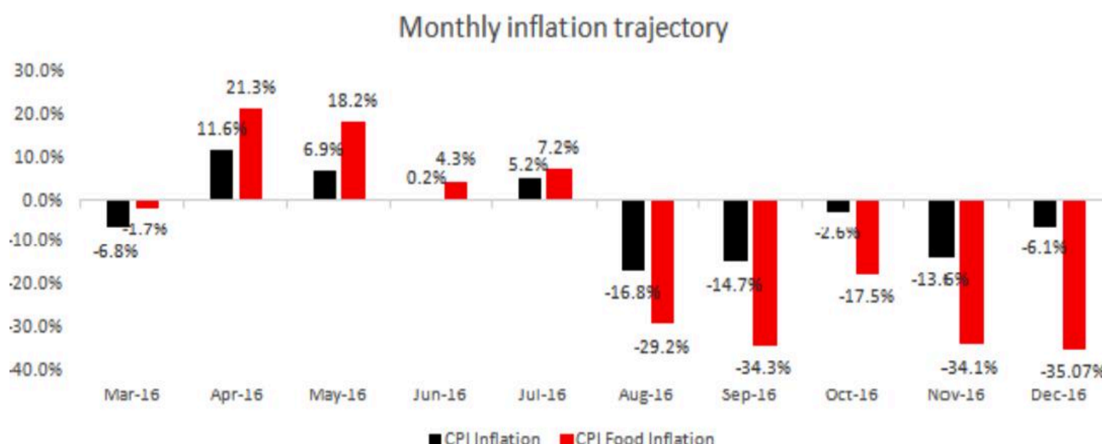
- S&P 500 was up 1.79%
- Shanghai was up 1.79%
- BSE Sensex was up 3.87%
- BSE Mid-cap was up 6.87%
- BSE Small-cap was up 7.38%
- MSCI India was down 4.34%

FII's continued to pull funds out of India for the 4th month in a row with Rs.1177cr exiting in January. FII's have pulled out a sum total of Rs.31,903cr in the last 4 months, but the trough was more than made up by Rs.39,823cr of flows from domestic institutions, as they sensed the value in pockets 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.



Inflation falls | CPI @ 3.41% vs 3.63% MoM | WPI @ 3.39% vs 3.15%

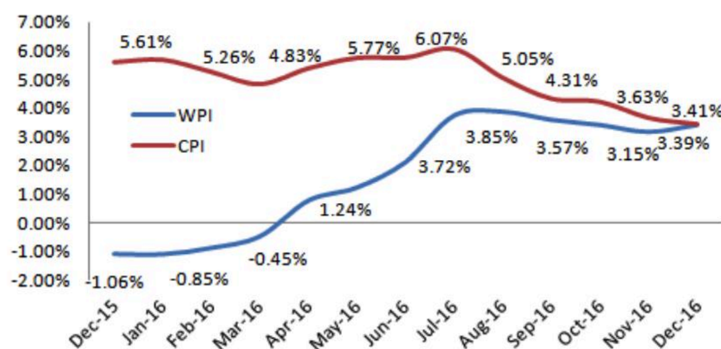
Consumer inflation contracted sharply and expectedly in December by 35%, following a steep 34% correction in the month of November. Of course, demonetization had a role to play as curtailed money supply suppressed pricing of perishables and consumer demand in general. This is the 5th month of contraction and as the following chart suggests, the magnitude of the fall has been material. CPI for December now stands at 3.4% vs 3.6% in Nov-16. The overall glide path looks comfortably poised in the context of RBI's CPI target of 5% by March 2017. However given the global currency and interest rate developments, it now remains to be seen how much of a close correlation interest rates have with inflation.



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.

Wt	CPI	Jun-16	Jul-16	Aug-16	Sep-16	Oct-16	Nov-16	Dec-16	MoM
45.9%	*Foods & Beverages*	7.38	7.96	5.83	4.12	3.71	2.56	1.98	-22.7%
2.4%	*Pan, Tobacco etc*	7.28	6.83	6.86	6.82	7.09	6.29	6.39	1.6%
6.5%	*Clothing Footwear*	5.01	5.23	5.21	5.19	5.24	4.98	4.88	-2.0%
10.1%	*Housing*	5.46	5.42	5.29	5.18	5.15	5.04	4.98	-1.2%
6.8%	*Fuel n Light*	2.92	2.75	2.49	3.07	2.81	2.80	3.77	34.6%
28.3%	*Miscellaneous*	3.85	4.01	4.18	4.51	4.58	4.83	4.73	-2.1%
100.0%	*CPI -Inflation*	5.77	6.07	5.05	4.31	4.20	3.63	3.41	-6.1%
	Change	0.2%	5.2%	-16.8%	-14.7%	-2.6%	-13.6	-6.1	

WPI for December 2016 came in at 3.39% vs 3.15% MoM. Disinflation was seen in food as well as non-food articles MoM. Within food, lower prices were seen in pulses, vegetables and fruits. Manufacturing inflation was up by a marginal 0.06% MoM, 5/12 (vs 7/12 last month) manufacturing industries recorded higher prices. Similarly, fuel inflation also rose up by 0.7% MoM.



The Union Budget for FY 2018 was nothing to write home about. Among the several reams, the focus on fiscal consolidation, higher allocation to affordable housing and better rural credit dispensation were noteworthy.

While a pinch of populism was expected (and would have been welcome), the Government resisted the temptation and instead focused on reducing the fiscal deficit and going for growth within the limitations they had. Sectors like affordable housing received a shot in the arm (increased allocation of 38%), and that should do its bit to rev up demand for sectors such as cement and steel. Alongside, it was decided to improve rural credit availability by 24% and improve access to irrigation infrastructure by setting up a Rs.5000cr micro irrigation fund,

However, the needed push on overall infrastructure investments was missing as investments have gradually fallen to 29% of GDP in 2017 from 34% in fiscal 2012. In its bid to improve the investment climate, the government has decided to abolish the Foreign Investment Promotion Board in fiscal 2018 and this should hopefully reduce the time lag for FDI flows into India.

The silver lining, should one look hard, is the focus on fiscal deficit, the target for which was kept at 3.2% of GDP, as opposed to the Fiscal Responsibility and Budgetary Management (FRBM) target of 3% (the number for 2017 was 3.5%). There however is an escape clause for deviations up to 0.5% of GDP, from the stipulated fiscal deficit target which could create a marginal extra spending space of Rs.337 billion for the government in 2018. At the same time, government has committed to achieving the 3% fiscal deficit target in fiscal 2019.

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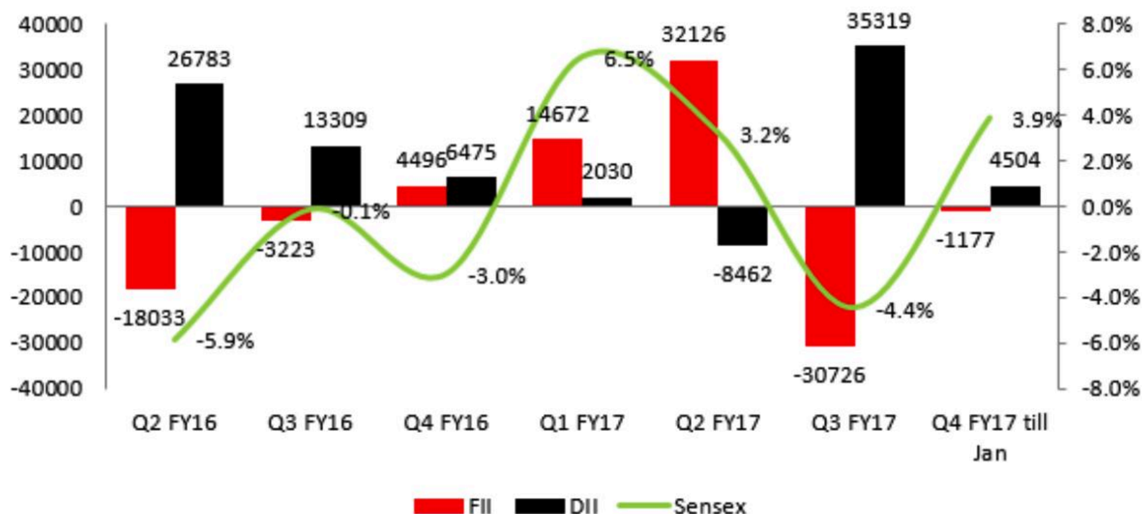
Unifi Strategy

Is the rally in India a party to global liquidity tailwinds?

A notable trend that has emerged in India over the past few months is the divergence between FII flows and index performance. Beginning Nov-16 (please refer the chart below), the lack of correlation between outflows of foreign capital and market performance is apparent. The trend coincides with a period of negative sentiment in India that was driven by discontent over demonetization. This divergence is important from the point of view of the support that foreign inflows have provided to benchmarks in the earlier periods. The point we are trying to make is, should capital flows back to the US accentuate and the quantum of global monetary easing further tighten, the resultant impact on Indian markets isn't likely to be dramatic.



Post the recent bout of negative sentiments, Indian markets have almost entirely been supported by domestic capital and as the domestic economy gets better, we expect this support to continue.

Will interest rates fall?

Among others, a common thread of interest between corporates and an individual's alike is the direction on future interest rates. Interestingly in this budget, the Government has restricted its net market borrowings to Rs.3.48 trillion for FY18 vs Rs.4.25 trillion YoY along with setting the target for fiscal deficit at 3.2% of GDP vs 3.5% YoY. This is a huge positive from a bond market perspective as the crowding out phenomenon that the Government of India displays every year will reduce, and thus forcing yields to come down and helping in the transmission of lower rates to borrowers and in the process doing its bit to aid the earnings recovery in India.

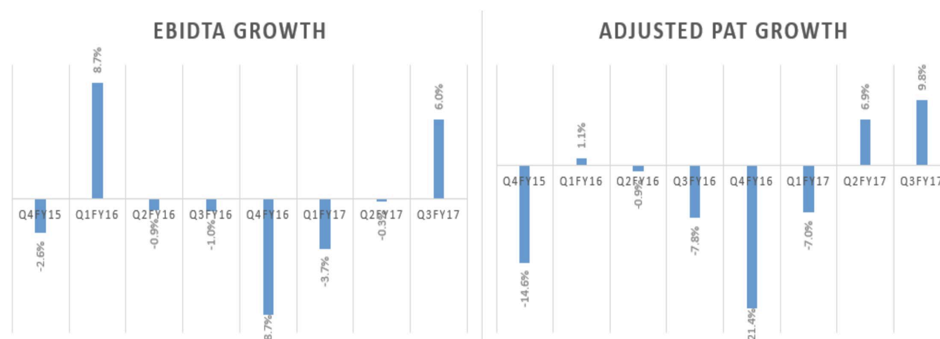
While this is a structural argument, the RBI in its first monetary policy review for the year (8th Feb'2017) held on to rates at 6.25% (reverse repo). So as things stand today, what is the broader argument for interest rates to come down or remain where they are?

For a cut		Against a cut
Inflation	At 3.4%, inflation is under control and supply side factors on the food front are looking good	Core Inflation is still high at 4.8% and the inflation target for FY18 is 4% anyway, so one should work in favor of that
Fiscal Deficit	Fiscal consolidation is further underway with the deficit expected to contract to 3.2% in FY18.	Banks are flush with liquidity post demonetization, use that to further credit and reduce rates
Other macros	The window to act may be now as later in the year US rates may move up and commodity prices are already up. So make use of this window to prepare for globally higher costs later in the year	Bank rate cuts announced in January are yet to play out in the system – one should wait for the same in addition to the further scope for transmission available in the system

Earnings growth momentum continues

India was in the midst of a sharp earnings recovery cycle that was temporarily stalled due to demonetization. For the H1 of FY-2017, the broader BSE 500 returned the best adjusted earnings in 2 years. There is little doubt that demonetization crippled demand in the initial days, but the organized segment (at least the ones in our portfolio) have

shown a remarkable resilience to weather the momentary slowdown. The following charts show case the earnings trajectory (for Q3-FY17) of the broader BSE 500 for all companies that have declared results till the end of January 2017.



As the charts above show, the result season has not been all the bad. The optical disconnect between what you may see or read on the ground and the above graph may be a tad conspicuous but that is because the listed universe represents leaders in the organized sectors on whom the impact at a top line level was limited and then quickly reversed and they had levers to adjust for the same in their P/L. Besides there were sectors that did not directly align with the domestic consumption story (such as the b2b space where exports were significant). And then there were Banks who benefited from the lower cost of funds as CASA improved for the entire system while the woes of poor assets qualities from a high base are seeing reversals while the NBFC segment in the personal finance and housing mortgage continued to witness growth in spite of the macro economic pressures of demonetization.

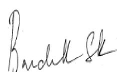
The next big shake up should ideally come from the 1st of July 2017, when GST actually sets in. It is expected that the quarter (Q1-FY18) will be a slow one as the industry adjusts to new logistics and paperwork, but the overall trend of consolidation and value migration among the organized segment will continue. Like in any trending marked, the culmination of what will eventually be is now resulting in PE's inching up in spite of earnings suffering hiccups for a period of 2-3 quarters in the interim.

The larger conclusion is that India remains a bottom up stock pickers market and we continue to look for stock specific and individual companies will continue to provide pockets of opportunity. As GST, power reforms, infrastructure spending etc. continue, and growth picks up, our focus segment of sector leaders and organized players will continue to do well. Like was have said earlier, the roll out of GST will be exciting as it offers immense prospect of consolidation.

As we expand our investment horizon into the Green side of things, we are excited about the opportunities the renewable energy, waste management and efficiency industries have to offer and we believe each of these industries will have strong tail winds. We continue to like select names in private banks, NBFC's, specialty chemicals, and select b2b players who offer a rate of earnings growth that is attractive relative to their valuations. As markets move up we are not hesitating to book profits where valuations have exceeded its margin of safety. In the meanwhile, as valuations across sector move up considerably, it is fair to expect that the timelines the broader index will take to deliver on absolute earnings will be high, and 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.

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

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