Macro, Markets & Strategy review

2017

July

UNIFI INVESTMENT MANAGEMENT

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Global developments

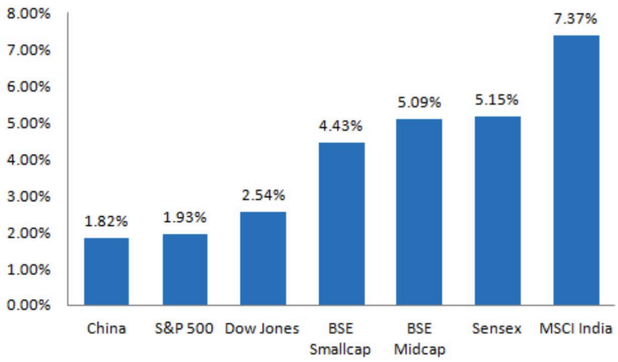
The US Federal Reserve kept rates unchanged (at 1%), but in an affirmative sign of domestic economic expansion, pointed to its plan of winding down its holdings of bonds 'relatively soon' in spite of the fact that overall inflation had declined; trends which have worried some policymakers. The Fed is widely expected to begin unwinding its $4.5 trillion balance sheet in Sept-2017 that would see them reducing its purchase of treasury and mortgage-backed securities by about $10bn a month and will gradually climb to $50 billion a month. Current market expectations are that the Fed will keep rolling off proceeds until the balance sheet hits around $2 trillion to $2.5 trillion, a process that could take four or five years. Fed Chair Janet Yellen said that the process will be akin to "watching paint dry" and won't be disruptive to markets. Interestingly, almost every time the central bank has trimmed its balance sheet, a recession has surfaced, sooner or later. For instance, the Fed has on six occasions embarked on reduction efforts in the past — in 1921-1922, 1928-1930, 1937, 1941, 1948-1950 and 2000. Of the 6 prior episodes, five have ended in a recession. The balance sheet trend mirrors what has happened much of the time when the Fed has tried to raise rates over a prolonged period of time, with 10 of the last 13 tightening cycles ending in recession. Besides, outside of the 1920s and 1930s, there is no precedent for double-digit annual declines in the balance sheet/base that will likely begin to occur late next year. Of course, each of the previous events of recession may be traced to different macroeconomic events.

The USD meanwhile depreciated a massive 2.9% against the Euro and 1.1% against the Pound. Crude prices rallied by 9% in July on the back of weaker dollar (crude oil is priced in dollars, a weaker USD makes crude oil less expensive). This is no structural worry as such as equities the world over continued to strengthen; the MSCI All World index is at a life time high, up 11.98% CYTD, while MSCI US & EU are up 10.51% & 17.78% respectively.

World Markets

Emerging markets continue to have a good 2017 as the EM index notched another 5.48% for the month and is now up 23.65% for the year.

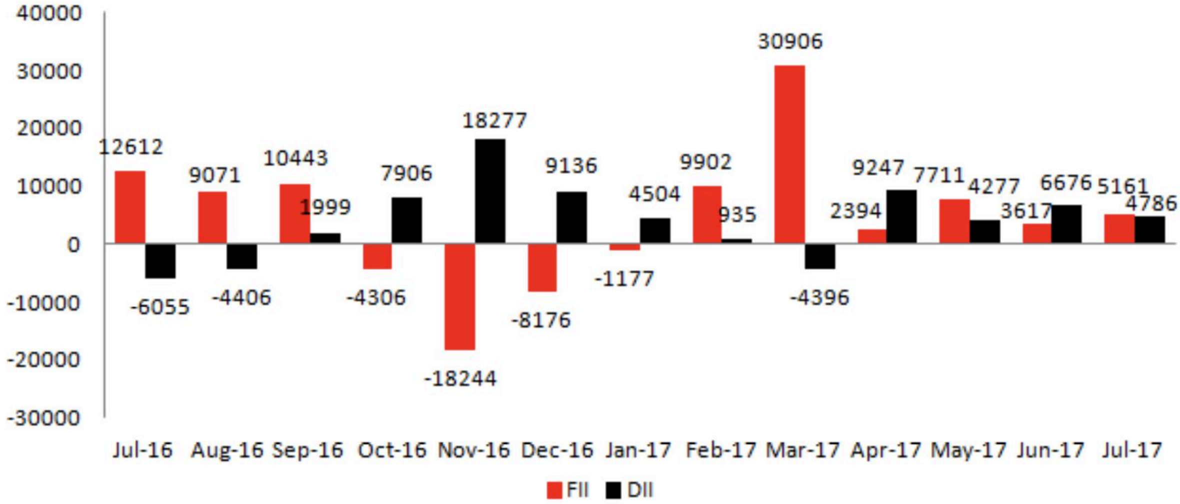
MSCI (in %)	India	Brazil	Russia	Korea	China	Japan	US	Australia	EM Index	MSCI World
MoM (in %)	7.37%	10.85%	1.83%	3.20%	8.33%	2.02%	1.92%	4.45%	5.48%	2.33%
CY - YTD (in %)	28.41%	12.73%	-13.84%	32.46%	33.97%	11.07%	10.51%	11.39%	23.65%	11.98%



India has been among the best performing markets globally with MSCI India up 28.41% in CYTD 2017, helped by a weakening USD.

Inflows abound

For FY-18YTD (beginning April 2017), inflows from domestic sources at Rs.24,986cr ($3.9bn) has outstripped FII inflow of Rs.18,883cr ($2.9bn) by a wide margin. The rising allocation of Indian households towards equities point to sustained flows and also reduce the prospect of volatility that may arise from sudden withdrawal of foreign monies. However it is important to note that liquidity is no hedge for valuations or market excesses. Bad news, or performance, will lead to a change in stance.



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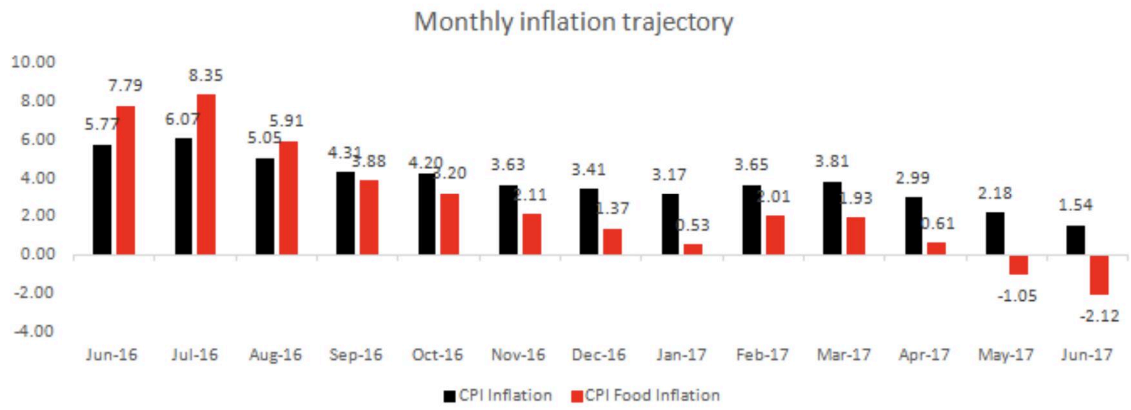
Inflation falls | CPI @ 1.54% vs 2.18% MoM | WPI @ 0.90% vs 2.17%

Consumer inflation is now more than in control, coming in at 1.54% for the month of June-17 vs 2.18% in the previous month. The food basket that consists of 45% of the CPI index saw steep deflation, falling -2.12% vs a fall of -1.05% MoM. Prices are in a range overall and they are not too uncomfortable. Yes, Onions did draw some tears, but these are temporary facets that happen in a market with an inefficient supply chain. As dispatches begin to come in from the next month, prices should revert to normalcy. However, like we pointed out last month, lower food inflation lends a very myopic view of comfort as farm income is a strong driver of consumption, and the broader economy.



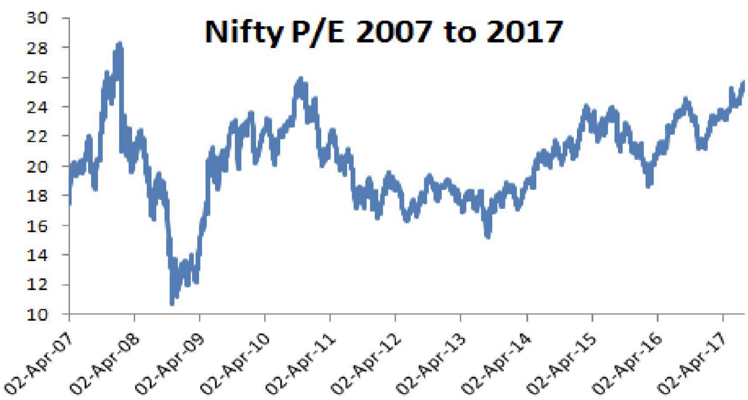
With 60% of India's employment and 17% of our GDP dependent on agriculture, higher structural food inflation is a requirement. Keeping this in perspective, the Government has increased its MSP for the Kharif crops by 6.8% this year vs 5% YoY and this is the highest growth witnessed in the last 5 years. Lower end produce prices have kept the dependents of this sector at the lowest level of the economic pyramid for long, and this dynamic needs to change. The RBI's vigil on 4% as a target for inflation has long been met and over emphasis on waiting for further optical evidence of it being structural can blindside the need to address other monetary policy requirements.

Softening rate cycle – 25bps; on expected lines

Following comforting reading on inflation, the Monetary Policy Committee (MPC) as expected reduced repo rate and reverse repo rate by 25 bps each to 6% and 5.75% respectively. The case for monetary easing was stronger in order to reduce the excessive real rates within the system and improve the investment climate. Balancing its views on the side of caution, the MPC mentioned that upside risks to inflation did exist keeping in mind various fiscal developments like bank loan wavers, price impact revisions following GST, etc. In a parallel development, India's largest lender SBI slashed interest rates on savings accounts, highlighting just how much liquidity was there in the system. It is possible that this sets in motion a more aggressive reduction in interest rates; and indirectly forces aggressive allocation away from debt to equity.

Unifi Strategy

At 10,000, a five digit Nifty was a sentimental triumph in every sense. However the rhetoric around the not so linear relationship between fundamentals and valuations have risen, with no clear answer to the nuts and bolts of the markets current state of affairs. Nifty's trailing PE at 25x has clearly proceeding towards unchartered territory. If it gave up around 10%, it would still trade at c.23x. Why is India so expensive?



India continues to be a unique proposition – 7-8%+ GDP growth outlook, driven by an increasingly prosperous demographic that will drive consumption further and a political leader who conveys this as much. This basically translates to growth in 5 sectors – realty and its varied value chain, consumer staples and durables, commercial and mortgage finance and autos. As we pointed out the last time we wrote to you, the composition of the sectors that constituted price to earnings of 23x ten years back vs 25x today, is vastly different. For instance, Autos were at 4% in 2007 vs 14% today, while BFSI was at 13% vs 23% today and that too all let by private lenders. But what justifies the high premium? The high premium is attributable not so much for the immediate visibility of earnings growth, but the fact that current growth rates can enjoy a window of similar or better growth rates for a sustained period of time without compromising on capital return metrics. And now with GST, the migration to demand for produce from the organized sector should only get stickier. The markets of course do not extend the courtesy to sectors that are not benefiting from internal demographics – both IT and Pharma have reversed sharply from their hey days, tracking the deceleration in their industry. Commodities, most of them smarting from Chinese excess for over a decade are witnessing sharp reversals as their macroeconomics turn supportive again.

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But what really is the significance of the broader trends to us? Global liquidity, flows, sentiment, et all, are and will continue to be key for the broader immediate term sentiments. But beyond the headlines, how does it affect a bottom up portfolio that is gearing for absolute returns? Irrespective of what the headlines are, core earnings will be the only driver of performance, and we have been paramount in judging our universe for investment opportunities keeping this as the core determinant in our decision making. In a space of two quarters, the broader Sensex is up 9.8%, and with it has lifted a large swathes of the market, like the proverbial tide. We however continue to ignore the sentiment related brouhaha and instead monitor the margin of safety between sustained earnings growth and price earnings in conjunction to capital return metrics closely. We thought you might find this another fact in our portfolio management interesting – we have stopped buying 90% of the names that we took active exposure to January 2017 and about 80% of the names we liked as late as March 2017 (APJ). In fact, over the last 2 months, in our actively managed APJ portfolio, we may have introduced as much as 50% of new portfolios to new names, ignoring our earlier exposures on grounds of valuation and fundamentals. In a rising market, this has often meant that our cash levels have risen to levels close to 50% before we have found an opportune proposition.

The headlines we believe we continue to communicate reasons for optimism and for the right reasons. The last fiscal has already reported tax disclosures of a quantum that is higher by 25% YoY, the supply side is formalizing fast, spending by the power sector has been at its best in years, cement prices in the West have begun to harden, political consolidation seems to be on course and with it, a likely expansion in reformist policies. And then there is the softening rate cycle that will have a non-liner pay off on moderately leveraged balance sheets. It is difficult to time the multiplier effects of any of these developments, except for playing it with sector leaders with a good track record of execution. However all of these are again headlines. The truth being, most, if not all businesses in India that have scaled up in size, have so far done so in far tougher economic conditions, and like they say, despite the system. The approach always has been to align with such managements that are in the midst of executing a vision for the next 3 years, irrespective of headlines. And this is what an optical glance at the managements of our businesses indicate. Our team continues to engage in actively unearthing newer businesses and in the interim, for a large part of the last month, our cash levels have been substantially higher than what they have been in the past. While we are excited to learn about new businesses, our guard on valuations and earnings continue to be up. India has always been a 'stock pickers' market, and will continue to be the way forward in our books as well.

As a sector, specialty chemicals and polymers continue to dominate our exposure; not by design, but standalone bottom up conviction. This apart we continue to like select names in building products, and metal by-products apart from other standalone names. It may be an exercise in futility to deep dive into the Q1-FY18 results reasons. It has now been 3 quarters of one-off's in the Indian economy - led by demonetization and GST and most of the earnings misses this quarter can be traced back to GST. Stabilization will take another quarter and Q3-FY18 may be an interesting time for earnings as the base effect of demonetization in the earlier year should prove to be favorable.

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

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