Macro, Markets & Strategy review

2015

June

UNIFI INVESTMENT MANAGEMENT

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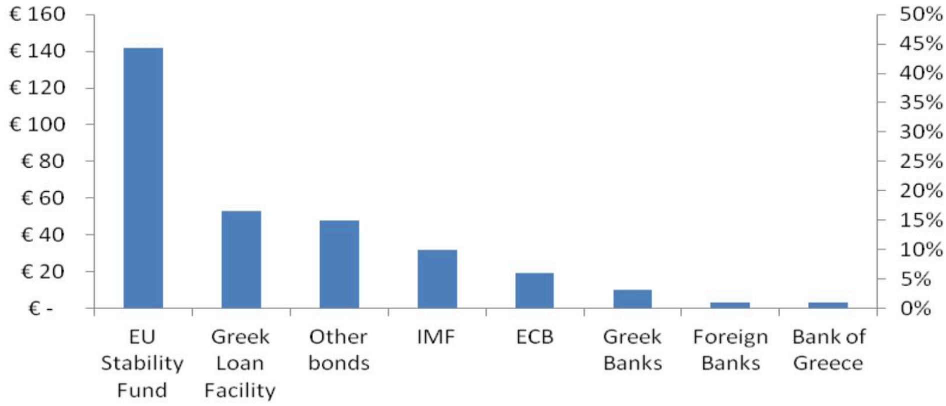
Global developments

It is late in the day but still the update on Greece is that they have committed a sovereign default and have sought to underwrite that through a domestic referendum. As things stand today, no one is really sure which way Greece, EU, and the Euro are headed. However, we would like to point out that over the course the past few years, various programs (such as the EU stability Fund - ESF, etc) have significantly reduced the exposure of the external banking sector debt to Greek government debt. As on date, the total Greek sovereign debt is about € 323bn and the bulk of this is financed by the EU member states through the ESF, ECB etc., the combined exposure of which along with the IMF is 76%. Hence the impact of the current crisis on the non- Government sector, i.e., banking is minimal. Foreign banks have a small €3bn exposure and this is not likely to result in a global monetary crisis.



Source: Open Europe, The Independent

However what remains to be ascertained is the impact of private Greek debt and the systemic risk it poses to the industry at large. The domestic economy has weakened significantly and one has to monitor this as it plays out in real time. Given that the size of the Greek economy at USD 250bn vs. that of the EU at USD 18 trillion, we believe the systemic risk as such will be low but it will be evident only as they play out. In the meanwhile, the fear of the unknown may continue to pop its head regularly.

While Greece provided drama, the real action was happening in China. The Shanghai Composite, the world's third largest stock exchange, has lost over 25% since June 12, till the first week of July. The pain was sharper on the smaller Shenzhen Composite, down roughly 35% in the same period. This did not draw as much as global newsprint as foreigners own just 1.5% of Chinese shares (as per Capital Economics). It may be borne in mind that post this fall, the Shanghai composite is still up 12% since January 1st. Keeping in perspective the fact that prices have gone much ahead of economic growth, and corporate profits are lower than what they were a year ago, a further slide may be imminent. Chinese regulators have reacted in offbeat ways to counter the slump but such panicked reactions are not taken too kindly by the markets and clearly points to structural weakness in China.

Amid all this, while there is nervousness of a US rate hike, we believe as and when the event does happen, global reaction will be restrained and tepid.

Indian Market

India witnessed a flat June amid fears of a deficient monsoon and global flight of capital given volatility across all global markets. Among sector indices, S&P BSE realty index fell 8% in the month, followed by IT (-4.2%) and metals (-4%) indices. FIIs were net sellers in the cash segment, offloading USD 883mn over the month while DIIs bought equities worth USD 1.9 bn. The benchmark BSE Sensex returned -0.2% for the month vs -0.07% of MSCI India. BSE Midcap and BSE Small cap returned, -0.3% and -1.8% respectively for the month.

MSCI (in %)	India	Brazil	Russia	Korea	China	Japan	US	Australia	EM Index
MoM (in %)	-0.07%	3.59%	-2.92%	-4.28%	-7.08%	-1.79%	-2.06%	-4.78%	-3.18%
CY - YTD (in %)	0.88%	-10.36%	26.65%	0.12%	12.65%	12.67%	0.68%	-5.35%	1.67%

Monthly Macro Review | Inflation is easing | IIP on expansion mode

Inflation update – it's easing

Consumer Price Inflation

- CPI for May 2015 came in at 5.01% in line with expectations and well within the RBI's comfort zone
- The acceleration in CPI inflation was limited only to rural inflation, while urban inflation remained static. Core inflation inched up slightly too, though it remained under control.
- Food group inflation declined YoY, but increased MoM. The MoM increase was largely limited to vegetables and pulses. Services inflation increased MoM due to higher transportation charges on account of higher oil prices.

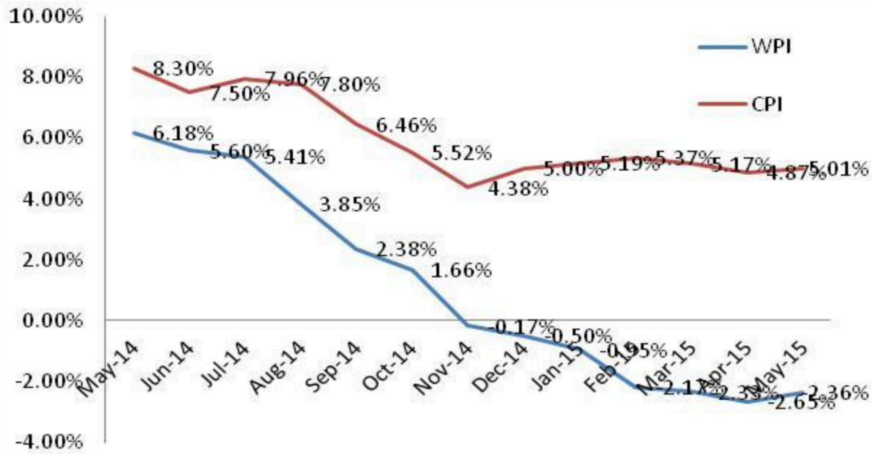
Outlook benign: In the coming months, the base effect would work to its advantage and CPI inflation is likely to soften. The government has already started taking policy and administrative actions to restrain food prices. While inflation is likely to rise in 2HFY16, it is widely expected to remain below RBI's target of 6% for Jan-16 there by setting the base for a low interest rate regime.

WPI: Continues in negative zone

- WPI for May 2015 stayed in the red for the seventh consecutive month, coming in at -2.36%. Core WPI at -0.6 signifies slack demand for input commodities
- Wholesale prices of all food articles, primary articles and manufactured products have seen a continued decline, dragging WPI down to -2.36% YoY. The global commodity index (CRB index) was down 27% YoY, which led to a decline in raw material prices across sectors. A decline in fuel of 10.51% has started moderating compared to previous months, as crude prices saw a marginal increase of 8.5% in May

Over all, inflationary expectations on projected trajectory

In its policy meeting in June 2015, the RBI cut the repo rate by 25 bps to 7.25% and revised CPI forecasts as at January 2016 by 20 bps to 6%. The major risks due to which CPI estimates have been revised emanated from the supply side including factors like sub-par monsoon estimates, volatility in oil prices and the external environment along with the effect of a higher services tax rate. As per the latest rain check, monsoons don't look like they will disappoint largely. Globally, food prices as well as prices of other raw material input commodities are down. The prospects of the same surging remain muted. This, in turn, tempers the domestic price increase. The RBI has already front loaded repo rate cuts (75 bps) and indicated a pause for a further rate cut in the near term. Also, a sell-off in the global bond market and rising yields across countries remain factors the RBI may remain watchful about.



IIP update

India's April IIP ascended to 4.1% YoY, far ahead of consensus vs a 5-months low number in March 2015 at 2.1% YoY. Strong growth was seen in capital goods, other use-based segments were muted. Robust growth was recorded in textiles, chemicals, machinery, basic metals, automobiles, and furniture.

- Manufacturing growth jumped to 5.1% vs 2.8% YoY; Sixteen out of the 22 industry groups within manufacturing showed positive growth. Electricity however de grew after 25 months of uptrend.
- Importantly, the consumer goods sector has turned around with positive growth of both durables (1.3% vs. -4.8% in Mar-15) and non-durables (4.4% vs. 2.4% in Mar-15). Overall consumer sector was up by 3.1% vs. marginal de-growth (-0.4%) in Mar-15.
- The upstream core and capital goods sector witnessed accelerated growth. Basic goods posted a 2.8% growth (vs. 2.6% in Mar-15) while capital goods posted an 11.1% growth (vs. 8.7% in Mar-15). Intermediate goods accelerated to 3.3% (from 2.9% in Mar-15).

Year on Year in %	Weight	FY 2013	FY 2014	FY 2015	April 2015
Classification by Economic activity					
Over all	**100**	**3.5**	**-0.1**	**2.8**	**4.1**
Mining	14	-2.1	-0.6	1.4	0.6
Manufacturing	76	4.3	-0.8	2.3	5.1
Electricity	10	3.5	6.1	8.4	-0.5
Classification by use					
Basic Goods	46	3.2	2.1	6.9	2.8
Capital Goods	9	9.6	-3.6	6.2	11.1
Intermediate Goods	16	2.1	3.1	1.6	3.3
Consumer Goods	30	1.8	-2.8	-3.4	3.1

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After no growth in FY14 and moderate recovery in FY15 (2.8%), it is broadly expected that IIP will recover well this year supported by good monsoons and policy aid—supported by both in the form of further easing of interest rates as and attempts to ease supply bottlenecks by the government.

Unifi Strategy

For a good part of June, developments in Greece continued to subdue investor sentiment apart from having to contend with a weak monsoon forecast, which in India is as scary as a European or Chinese contagion. Given how much the rain dependent rural India drives domestic consumption, India couldn't afford a second year of subpar monsoons. However, by the end of the month, the benchmarks recovered much of the lost ground due to a strong start to the Monsoons and appreciation of the fact that whatever happened to Greece would have a next to no real impact on the rest of Europe, leave alone India. The IMD has however maintained that, rainfall may be deficient in patches across July and August and this data point could be a potential disruptor in the days to come. Also, while a 'Grexit' would have limited economic implications, it could disrupt fund flows and cause a liquidity run on emerging markets, including India.

Amidst this scenario, there were a few positive factors in the domestic economy. There was a sharp jump in indirect tax collections, while customs duties and service tax revenues increased by 18.5% YoY & 10.3% YoY respectively. Service tax revenues will also see a noticeable jump from June since revised rates came into effect only from 1st June 2015. There are also early signs of improved economic activity as reflected by higher Government spending and strengthening macroeconomic indicators (IIP). Corporates in a few segments (power, mining, etc) are becoming more optimistic on order flows. Better-than-expected monsoon will bode well for inflation and interest rates. So as a summary, notwithstanding near term volatility which is not structural anyway, we remain positive on the markets.

With the onset of the earnings season, focus will shift to numbers and the tenor of managements on what the outlook in their respective industries is. The next leg up for the markets will necessarily be supported by the strength of corporate earnings. Along with monsoons, the monsoon session of parliament will also remain in focus. Currently, valuations of benchmarks, at 15x FY17 consensus earnings, are near the long term average. Our preference stays for aligning with companies having strong balance sheets and ethical managements who are the top tier players in their industry and have positive tailwinds going for them. The big factor to watch out for will be the progress on reforms front, especially the passage of important bills like GST; we are 9 months away from implementation of the same and delays in passing the same may be negative for markets. There is however concern that the opposition may prevent a smooth functioning of the house over petty issues. Over all, we expect market to trade range bound and test our conviction and one need's to keep an eye on the long term.

Risk: Indian markets as well as the INR continue to remains 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. 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

M. Ravvichandran

Head - Research

CHENNAI:
11, Kakani Towers
15 Khader Nawaz Khan Road
Nungambakkam High Road
Chennai - 600 006. INDIA
Ph: +91-44-3022 4466, 2833 1556
Fax: +91-44-2833 2732

HYDERABAD:
H No. 6-3-346/1, Road No. 1
Banjara Hills
Scotia Bank Building
Hyderabad – 500 034. INDIA
Ph: +91-40-6675 2622/23

BANGALORE:
511, Barton Centre
84, M.G. Road
Bangalore - 560 001. INDIA
Ph: +91-80-255 9418/19

MUMBAI:
Shiv Sagar Estate,
A-Block, 8th Floor,
Dr. Annie Besant Road
Worli, Mumbai - 400 0018.
INDIA