Macro, Markets & Strategy review

2016

June

UNIFI INVESTMENT MANAGEMENT

Macro, Markets & Strategy review

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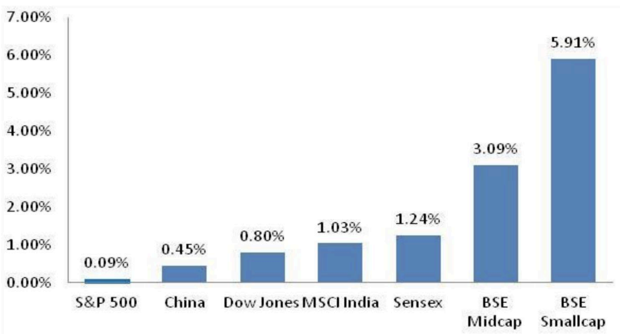
Global developments | A dis-united kingdom, and a not so great Britain

The comic irony of it all is that, in the end, the Brexiteers did not plan on winning. Now faced with the ignominy of undoing an economic pact, that kept the old continent from warring one another, they are now left virtually leaderless and without an idea of what the future holds economically. A day after the exit, the official leave campaign has walked back on both the key cornerstones of their argument: (a) immigration and (b) the absolution conformation that their EU budget of £350mn per week will be re-directed to public health care (which was a factual lie/error anyway). To close the argument, what is worrying isn't the probable monetary, constitutional or economic collapse; it is the political folding of the system that has heaved on itself the only workable economic order the world has known – free markets. Coming to the financial aspect of it, among others, the Pound lost a whopping 11%, and is now at a level last seen in three decades back. Given that the UK runs a trade deficit, this leaves them that much poorer already. In the real assets market, the dominoes may have just started as faced with an unprecedented (naturally) demand for redemptions, property funds have actually suspended withdrawals. Selling commercial assets in arduous circumstances is now bound to further pressurize the commercials of the fund as well as the real economy.

The following months and years will now see no dearth of news flows on various economic complications, complex treaties being re-worked, each have the potential to get into a tangential political debate. The immediate ramifications will be felt on American interest rates as the Federal Reserve has communicated that further rate hikes will stay until they have a handle on the consequences of Brexit. Signs of clear unease. But meanwhile, the liquidity party from US to Europe to Japan continues that are fueling equity rallies around the world. Thus, though short term and not structural, no one is complaining!

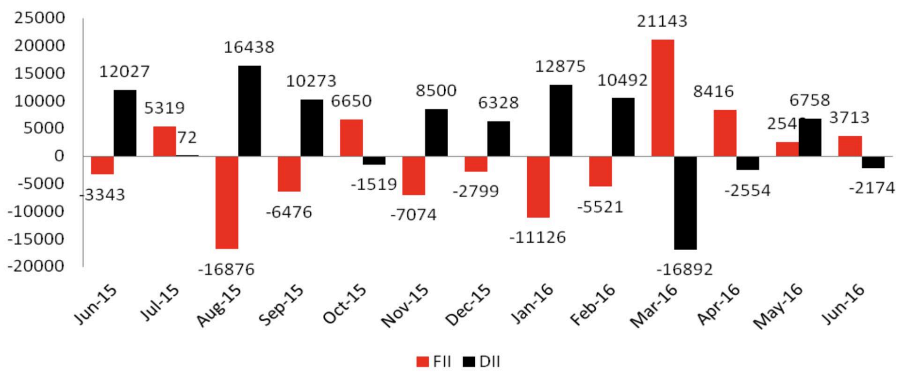
A good June as well as Q1-FY2017



- Dow Jones was up 0.80%
- S&P 500 was up 0.09%
- Shanghai was up 0.45%
- BSE Sensex was up 1.24%
- BSE Mid-cap was up 3.09%
- BSE Small-cap was up 5.93%
- MSCI India was up 1.03%

MSCI (in %)	India	Brazil	Russia	Korea	China	Japan	US	Australia	EM Index	MSCI World
MoM (in %)	1.03%	19.34%	1.72%	4.00%	-0.52%	-2.60%	0.09%	-0.11%	3.30%	-1.28%
CY - YTD (in %)	0.30%	44.31%	19.44%	3.44%	-6.45%	-6.50%	2.44%	0.30%	5.03%	-0.58%

Irrespective of how it turned out in Europe, Foreign Institutional investors found the calling for Indian equities attractive again.

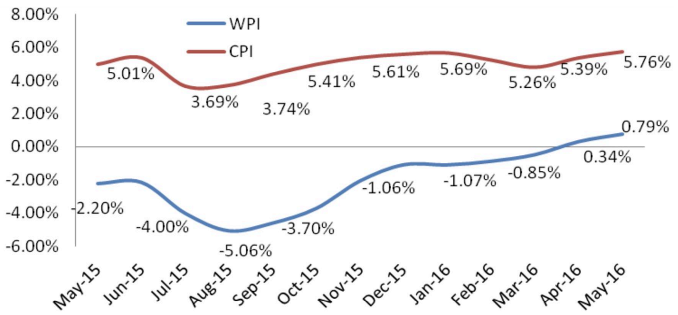


Monthly Macro Review

Inflation | CPI @ 5.76% vs 5.39% MoM | WPI @ 0.79% vs 0.34%

We aren't too pleased with the way consumer inflation has reversed in the last two months after falling sharply prior to that. The culprit has been food inflation which was up 16.3% month on month for May-16 while the non-food basket continued to depict deflationary trends. Fruits and Vegetables led the surge and we don't see why this shouldn't cool in the coming months as the Monsoons are progressing fairly well and in fact almost wiping away the deficit is started off with.

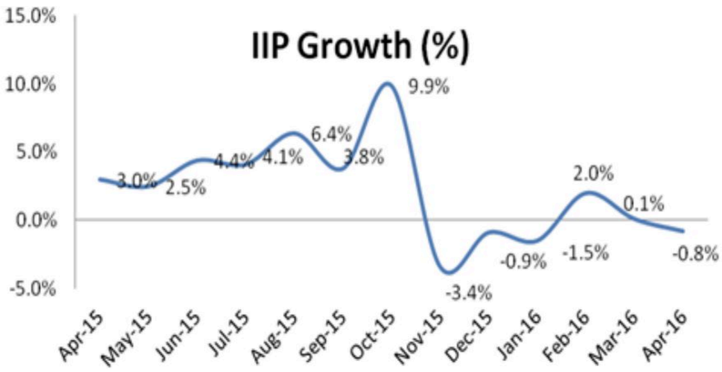
Weight	CPI	Jan-16	Feb-16	Mar-16	Apr- 16	May- 16	MoM
45.9%	Foods & Beverages	6.66	5.52	5.27	6.21	7.20	15.9%
2.4%	Pan, Tobacco & Intoxicants	9.03	8.39	8.51	7.96	7.82	-1.8%
6.5%	Clothing n Footwear	5.85	5.52	5.5	5.56	5.37	-3.4%
10.1%	Housing	4.86	5.33	5.31	5.37	5.35	-0.4%
6.8%	Fuel n Light	5.32	4.59	3.38	3.03	2.94	-3.0%
28.3%	Miscell	3.95	4.38	4.01	4.34	3.96	-8.8%
100.0%	CPI – Inflation	5.69	5.18	4.83	5.39	5.76	6.9%
	CPI – Food	6.85	5.30	5.21	6.32	7.35	16.3%



The RBI's CPI target of 5% by March 2017 is an important one for the economy but with the exit of Dr.Rajan from RBI, it now remains to be seen how much of a close correlation future reduction in interest rates are paired closely with the CPI number. Barring sharp reversals in commodity prices, and poor climatic conditions, not too many structural adjustments are needed for a sustained levels of moderate inflation, but a faster than expected progression to a lower rate regime might play an important role in assisting an overall consumption led macroeconomic recovery.

Also, the deflationary trend in WPI continued to be broken with help from food as well as non-food items, coming in at 0.79% vs 0.34% MoM.

Index of industrial production (IIP) | Down to -0.8%



Contradictory to the supposed GDP growth at levels of 7% and above, IIP continues to stagnate, coming in at -0.8% vs 0.1% MoM.

Manufacturing output declined -3.1% YoY while Capital Goods was down -25% YoY with 9/ 22 industries posting lower output YoY. This sustained weakness is worrisome and reflects the ongoing slump in private capex.

For the full year FY-2016, IIP recorded a growth of 2.4% vs 2.8% YoY and the FY-17 has now started on a weak note. Hopefully, both industrial and private consumption will improve as the year goes by

Unifi Strategy

Season of many positives | .... in Wonderland yet?

From India's perspective, connecting the dots from China to Europe and Japan to the US with the Middle East in between is a bit like plummeting down a rabbit hole of information, only to emerge with a swollen head full of facts, figures and information with ever changing consequences. While fund flows into India will continue to be driven by its share of global sentiment, we believe domestic micro's led by (a) earnings and (b) policy will have a far greater say over the medium to long term as against the global macroeconomic news flow. While the Q1-FY2017 earnings season is slated to start in a few days from now and commentary on earnings will drive the markets over the next 6 weeks, the developments on the policy front have been encouraging so far.

It is said that profit is an opinion, but cash is a fact. The markets celebrated the saying in its full spirit as it completely ignored the fear of Britons exit from the Union to celebrate the incremental collective pay-day as the Government cleared the long awaited 7 th Pay Commission. The total cash into the system courtesy the policy generosity is about Rs.84,993cr., or about $12.6 billion. This is about 19.6% higher than a business as usual scenario and the street is obviously excited about how this will

boost discretionary consumption and set in motion the other proponents of growth. About 1 crore employees (pensioners + those in service) will be the direct beneficiaries of this development, translating to toughly 4.5% of India's households. The spending season in India is typically from Dusserah to Holi {October – March} and we believe Q3-FY17 onwards the effect of this liquidity will be felt at the ground level. Also, while the Monsoon's have been progressing well and is completely priced into the markets today, the earnings impact from the same will also be felt only towards the end of Q2-FY2017.

Moving on, we have our fingers crossed, but it looks like we might just be ushering in the new GST regime soon. FM Jaitley last month convened a meeting of all State Finance Ministers and the noise from seems to be positive over all. Besides, the GoI is running out of time. If passed now, if would probably go live from 1st of April, 2017, given it a good one year of 2018 before they hit the polls in 2019. If you are wondering what the brouhaha is on the frenzied anticipation of the GST is, sample this:

	Pre GST			Post GST	
	Organized	**Un-Organized**		**Organized**	**Un-Organized**
Basic Price	100	100	**Basic Price**	100	100
Excise Duty (12.36%)	12.4%	0.0%	**VAT (25%)**	125	125
VAT (12.5%)	14.0%	12.5%			
Total Price	126	113	**Total Price**	125	125

As it can be seen above, GST completely neutralizes the pricing advantage of the unorganized sector over the organized players. In a nut shell, the duty led price differential between the organized and the unorganized sector will largely converge, thereby aiding the organized sector gain incremental market share within the industry, notwithstanding how the absolute demand for the industry grows. This will largely aid the listed universe apart from addressing other inefficiencies along the way such as State based production and movement of goods.

In another key development, the GoI has also now opened up multiple sectors (defence, pharma and aviation) to 100% FDI. Importantly, most of these sectors would be under the automatic approval route barring a small negative list. As a side note, India may soon have Apple's original stores; while we may not have access to Himachal's finest, this is of consolation to at least few.

While we are closely taking cues from the macros, we continue to align our exposure with a focus on near term and bottom up growth in earnings. The quarter has seen a steep appreciation in the prices of several stocks, notably in the BFSI space and the search for absolute comfort from valuation vs fundamentals is getting that much more difficult by the day. After a long pause, we have begun taking exposure in measured levels to the old economy banking space, driven by near time analysis of turnaround in earnings as they leave behind them an arduous season of provisioning and asset quality woes. We are examining the entire old private sector banks as well as the PSU Banking sector closely as the cleanup may throw up opportunities to ride the next phase of credit growth but with a better quality of borrowers.

We continue to like select names in chemicals, pharma and agri and do not hesitate to book profits in cases where valuations have run up ahead of fundamentals. We are cognizant of the fact that bulk of the upsides in a risk on market is by means of valuation expansion but at the same time it is important to maintain a balanced fundamental approach as given a possible Black Swan at every macroeconomic corner, downsides could be real and prolonged. 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, and not hesitating to book profits where valuations have exceeded its margin of safety.

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.

Baidik Sk

Yours truly

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