Macro, Markets & Strategy review

2017

June

UNIFI INVESTMENT MANAGEMENT

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Global developments

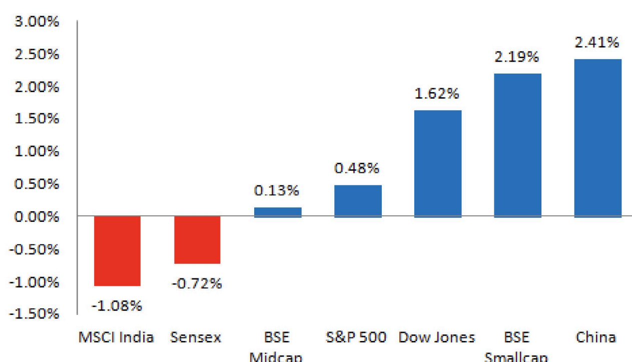
In a reflection of the progress the U.S economy has made, the Fed raised short-term interest rates again by 25bps in June, making it the 3rd such hike since December 2016. The Fed's key rate is now at 1% amidst the significant economic ground the economy has gained on two key monitorable fronts; (a) U.S unemployment at 4.3% is the lowest in the last 16 years and (b) the economy has added jobs for 80 consecutive months now. In the context of unemployment peaking at 10% post June 2009, this is a significant change in scenario in an absolute sense. In further sign of belief that the U.S. economy is on good ground, the Fed now expects real GDP to grow 2.1%-2.2% in 2017, compared to its previous outlook of 2%-2.2%. In a parallel move aimed at significantly reducing liquidity in the system, the Fed also communicated its intent to start reducing its balance sheet later this year. Meanwhile in an interesting political development, the Fed has been questioned on the qualitative discretion it has used in managing the rate cycle vs a more rules based system and it will be interesting to note the arguments on both the sides.

Crude prices fell by 5.6% for the month of June on the back of an overall increase in rig count in the US, now at a consecutive weekly increase of 23 as of the end of June 2017. Over all, the consensus of crude's long term downturn remains intact, which is great news for all EM's, including India. Combined with a general weakness in the USD what this means is that inflationary trends across most emerging markets will be under check, and provide that much of a support for boosting consumption as such and contributing to tailwinds for the local capital markets.

World Markets

Emerging markets continue to have a good 2017 as the EM index notched another 0.54% for the month and is now up 17.23% for the year.

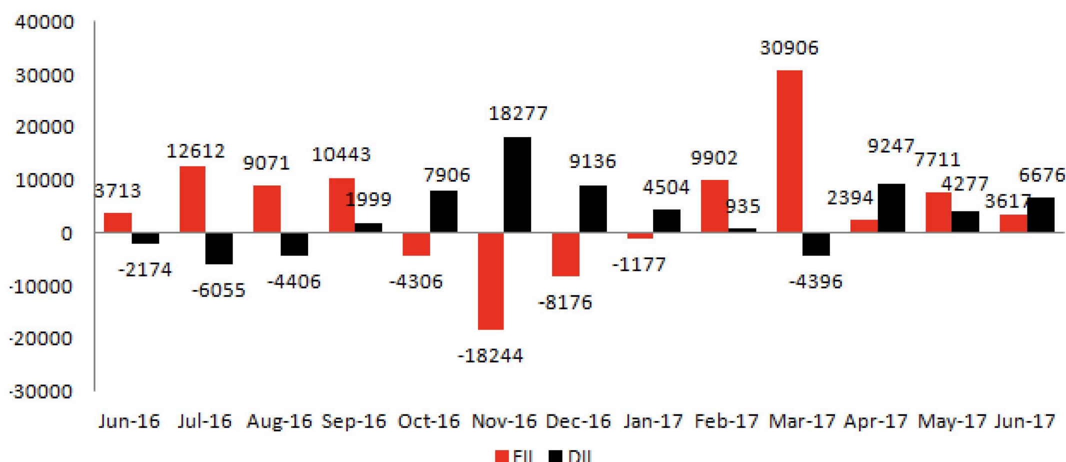
MSCI (in %)	India	Brazil	Russia	Korea	China	Japan	US	Australia	EM Index	MSCI World
MoM (in %)	-1.08%	-1.82%	-4.94%	0.82%	1.53%	0.95%	0.48%	2.70%	0.54%	0.25%
CY - YTD (in %)	19.59%	1.70%	-15.38%	28.36%	23.67%	8.88%	8.43%	6.65%	17.23%	9.43%



India has been among the best performing markets globally with MSCI India up 19.59% in CYTD 2017, helped by a weakening USD.

Inflows abound

For FY-18YTD, inflows from domestic sources at Rs.20,200cr ($3.1bn) has outstripped FII inflow of Rs.13,722 ($2.1bn) 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.



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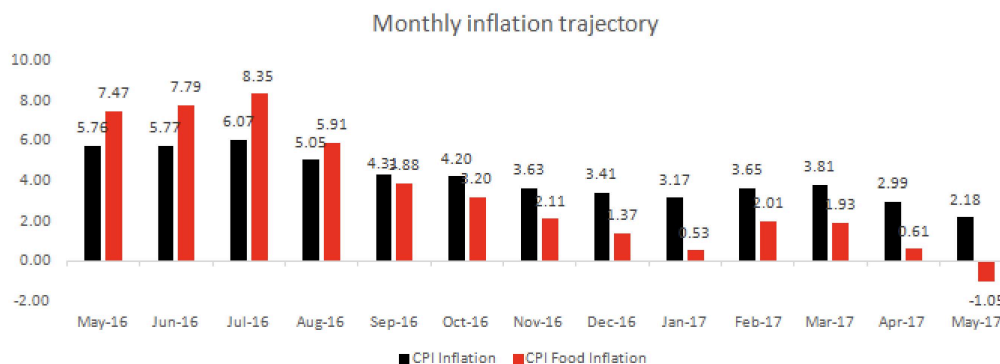
Inflation falls | CPI @ 2.18% vs 2.99% MoM | WPI @ 2.17% vs 3.85%

Consumer inflation continues to be in control, coming in at 2.18% for the month of May-17 vs 2.99% in the previous month. The food basket that consists of 45% of the CPI index saw steep deflation, falling 1.05% vs 0.61% MoM. Prices are in a range overall and they are not too uncomfortable. 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.



As repetition from our past commentary, with 60% of India's employment and 17% of our GDP dependent on agriculture, 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. It is hoped that the next time RBI meets in August-17, a 25bps rate cut materializes.

A good and smart tax?

The brouhaha in the launch up to GST was deafening. From an end consumer's perspective on the 1st July, 2017, we believe he purchased what he had to. We are told that the confusion following the implementation of MRP regulations several decades back and that of Service Tax in the mid-1990's reeked of a similar melee. There may be some justified anguish about the hurried implementation and the lack of readiness of smaller businesses to adapt to a new era. But truth be told, most Indian businesses are behind the curve in adapting to best practices. The intermittent disruption in business, will be just that, 'intermittent disruption' and is unlikely to be the end of trade, unless of course smaller players refuse to adapt to the new age of compliance. We don't see the need to take a more vocal stand on this. Across our portfolio companies we are reasonably aware of the impact GST has had on its business and we don't expect "shocks" in their results in the forthcoming earnings season.

Over all, we are excited, as we believe that the organized sector will gain at the cost of unorganized (meaning noncompliant) sector and that can only be a good thing as national tax buoyancy will improve, and support every other corresponding economic metric. The coming few quarters have a lot to offer us in terms of expectations. For instance, (A) the seasonal festive spending is expected to start from early September this year and better monsoons is likely to improve the base here; (B) re-stocking post GST is expected to benefit larger organized players; and (C) the base effect of demonetization in Q3 of last year should provide a good YoY jump on effect.

A change in thought

Over the past several years, asset light businesses in India with low leverage and strong return ratios have done well. The cycle was such that asset intensive business where witnessing significant fundamental stress and they fared poorly on most financial metrics. However, with a confluence of a mild change in commodity cycles and better domestic policy environment, the fundamentals of these asset heavy industries have changed, and with it, the operating leverage in the P/L's are set to experience a strong bout of change. These companies may continue to deliver capital return ratios that are in limited band, but in some cases, the pace of their earnings growth relative to valuations seem to offer a compelling proposition. We believe there exists a few opportunities that offer compelling value in the current cycle and are tracking the specifics of the same closely, to benefit from the same

Unify Strategy

It has now been 3 quarters of one-off's in the Indian economy. While Q3-FY 17 and Q4-FY17 were impacted by demonetization, Q1 of FY18 has borne the imprint of slow primary sales owing to transition into the GST regime. However, each of these developments have been/will be purely transient in nature for the organized industry and not dent the organic outlook for any of them. While the earnings we have witnessed in the last 2 quarters have been weak, and the one that we are about to witness for Q1-18 will also bear a stamp of weakness that is not fundamental in nature. From a sectoral perspective, we believe:

- Wholesale sales in the month of June have generally been impacted by destocking across all consumption baskets (whether b2b or b2c) owing to the uncertainties prior to GST implementation. As per the conversations we have had with industry players, off-take in the last 2 weeks of June was at a virtual standstill. In segments like processed sheet metals, building materials and consumer electricals, the decline in June is said to have been quite steep. However, a reversal to normalcy is said to be started by the 2nd week Of July-17. What is of interest to us in these industries is the quantum of gains they garner from the unorganized industry over the next few quarters.

- Pharma and IT will continue to face headwinds as a combination of regulatory headwinds and slowdown in core business opportunities will continue to affect both industries fundamentally. The appreciating INR will continue to stress the margins of the sector, notwithstanding pressure from higher regulatory costs and increased op-ex. IT leaders have resorted to managing expectations at a stock level by aligning towards aggressive pay-outs while the pharma sector is yet to communicate what a new and consistent growth path can look like. We continue to be wary of these industries at a macro level, but are following developments at a firm level closely to take advantage of mispricing, if any

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- Auto's continue to be a mixed bag. While the country's largest passenger car maker continues with business like nothing is wrong with the macros, the 2-wheeler segment has been a mixed bag. The change from BS-3 to BS-4 has impacted the pace of business across 2'Ws and CV's and normalization will just take a while. A lot will depend on how good farm income is post Khariff so as to enable better Auto consumption.

- In BFSI, asset quality continues to be the key monitorable. With the passage of time it is clear that private banks and new age NBFC's will continue to take market share from the older PSU's and we continue to play this theme.

Over all, the macros supporting the economy continue to look good. Q1-FY2018 may throw up some volatility in earnings and that may give us a good entry point into stocks we like fundamentally. While in the long term, markets track and reflect earnings, in the short term it is an amalgam of various economic and non-economic phenomenon. As we scan the universe for value, we are careful to correlate the macros with the micro opportunity in hand. It has been a strong year for equities as such. But therein lies a catch-22 situation; as markets have risen with higher valuations, the expectation of a correction looms more than ever around the corner, and asking aloud if current levels deserve fresh exposure? The only way to address this paradox is to resist the temptation of following sectors that are 'trending' from a sentiment perspective and align with underlyings that have a comfortable equation between earnings growth and valuation. In a rising market such an equation is not a given as a result of which our cash levels may have been higher off late, as we bide our time in diligence of newer opportunities or wait for valuations at which we are comfortable taking exposure in names we otherwise like fundamentally.

We continue to like select names in chemicals, building materials, and select manufacturers in the B2B space who offer a rate of earnings growth that is attractive relative to their valuations. We are excited about the developments in the Green industry and believe that consumption habits in areas such as irrigation, waste management, water management, wind-energy and gas consumption point to several opportunities in the times to come and are closely tracking the space to ride emergent opportunities.

Bull markets are expensive

A lot has been made of the valuations of the benchmarks as such. While markets are at an all-time high, are they expensive? Does a market high necessarily mean a market peak? We don't think so. Between 2007 -2017, the spine of the Sensex's composition has undergone a sea change. As it can be seen below, the broader "industrial" and "commodity" bucket comprising of cap-goods, metals, cement, oil & gas, comprised of 40% of the Index while they are at 28% now. On the other hand, industries that continue to consolidate as sector leaders – private banks, automobiles and FMCG's have increased their presence from 23% to 46%. The broad rhetoric that markets 10 years apart are at similar or "higher highs" is incorrect.

Sector	Mar - 07	Mar - 17	Change
Auto	4%	11%	7%
BFSI	13%	22%	9%
Cap Goods	6%	4%	-2%
FMCG	6%	13%	7%
Cement	2%	0%	-2%
IT	20%	17%	-3%
Metals	1%	4%	3%
Oil & Gas	22%	15%	-8%
Pharma	3%	6%	4%
Power	8%	5%	-3%
Steel	2%	1%	-1%
Telecom	13%	3%	-11%
Textiles	1%	0%	-1%
Total	100%	100%	
P/E	18.2	21.9	

In other words, 2007's market PE of 18x that came from a large base of cyclical industries (who were at their peak) vs valuations of 21x today that has come from sector leaders in non-cyclical (and non-volatile) industries are completely un comparable.

Do you know (or do you remember), that in March 2007: (a) ONGC had the 2nd highest market cap in India along with the biggest weight at 11% (along with RIL) and (b) Reliance Communication (market cap Rs.85,000cr) at 5% had a higher weight than ITC at 3% (market cap Rs.56,000cr)!

How times change!

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

This is neither an offer to sell nor a solicitation of any offer to buy any securities in any fund managed by us. Any offering is made only pursuant to the relevant information memorandum, together with the current financial statements of the relevant fund, if available, and the relevant subscription application, all of which must be read in their entirely. No offer to purchase securities will be made or accepted prior to receipt by the offeree of these documents and the completion of the appropriate documentation. Please refer to the Private placement memorandum before making a decision.

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