Macro, Markets & Strategy review

2017

March

UNIFI INVESTMENT MANAGEMENT

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Global developments | Pulling it back

Following up on her speech earlier in the month, Janet Yellen delivered on the 3 rd installment of a 25bps rate cut, hiking Fed rates up to 0.75%. The rising cost of debt however does not seem to have an impact on investor sentiment as buoyed by a firm belief in an uptick in real spending, the Dow Jones continued to rally and is up almost 2% since the hike in mid-March. The Fed is likely to hike its rates two times more in 2017, and possibly end the year with 1.25% in rates as the U.S expects to grow its economy in excess of 2% for the year. It suddenly seems that deflation is a thing of the past as the EU zone expects to grow at 1.5-2% for the year while world GDP growth is now estimated to be in the range of 2.75- 3.25%, up from 2.6% in 2016.

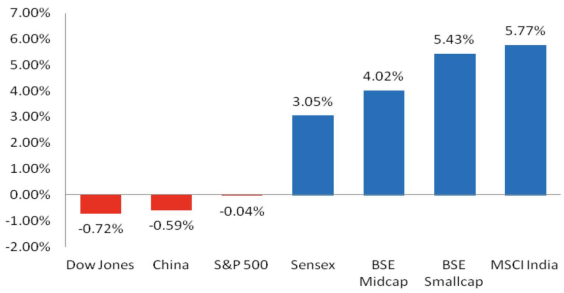
A combination of these anecdotes, notwithstanding geo-eco-political risks, continue to rub positively on all global markets. Thus far in 2017, US equities are up 4.5%, MSCI EU is up 6.7% and MSCI Japan is up 3.6% while MSCI emerging markets are up a big 11.1%. As a parallel, commodities also strengthened hoping that increasing consumption will eventually rub off on better prices. As forecasters and analysts see sunshine, it is important to note that America's vaunted fiscal package is estimated to come only in 2018 as repealing and replacing Obamacare will keep Congress busy for a while, and comprehensive tax reform will take its time, besides being hard to do anyway. The point being, the benefits to the cycle from these policy initiatives will be heavily back ended.

Meanwhile it looks like Euro separatist Le Penn's chances of winning France is down but it may be a race to the line. It will be a closely watched affair till the first week of May as EU can do without further distraction even as Britain finally triggered Article 50 to leave EU. And as a welcome measure in China, ignoring concerns of capital outflows, policy makers opted for financial stability over economic stimulus suggesting that the risk of a hard landing has now receded as they communicated an official growth target of 6.5% for 2017 vs 6.7% in 2016.

World Markets

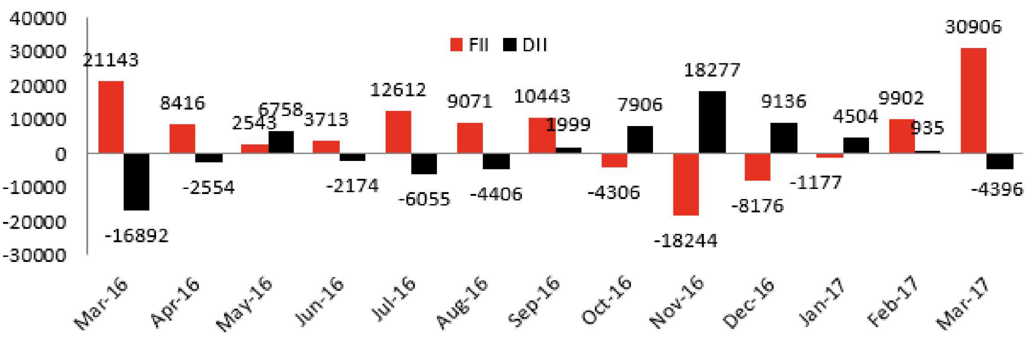
Emerging markets continue to have a good 2017 as the EM index notched another 2.35% for the month and is now up 11.14% for the year.

MSCI (in %)	India	Brazil	Russia	Korea	China	Japan	US	Australia	EM Index	MSCI World
MoM (in %)	5.77%	-4.60%	2.13%	5.18%	2.13%	-1.11%	-0.02%	2.05%	2.35%	0.82%
CY - YTD (in %)	16.72%	9.75%	-4.62%	16.67%	12.94%	3.67%	5.71%	9.67%	11.14%	5.85%



India has been among the best performing markets globally with MSCI India up 16.72% in CYTD 2017, helped by a weakening USD.

Trend Reversal in foreign fund flows | FII inflows into India snowballed into a considerable Rs.30,000cr or USD4.6bn in Mar-2017 alone. This is material by any standards given that India's total foreign fund inflows for the whole year 2016 and 2015 were USD 3.1bn and USD 3.2bn respectively. As usual DIIs booked some profits and held on to cash while the foreigners bought India. The graph below captures the roughly incongruent relationship India has experienced between domestic and foreign fund flows. We were building the opinion that the relevance of domestic investors to Indian equities relative to FIIs have been increasing, guarding Indian markets from swings of volatility, but with this flush of foreign money, it reverses a bit of that argument as India is now open to the option of reversal of such funds in the event of domestic or global geo-political-economic developments.



RBI holds interest rates amid marginally rising inflation

Consumer inflation was in control over all, coming in at 3.65% for the month of Feb-17 vs 3.17% in the previous month. The food basket that consists of 45% of the CPI index saw a bit of stress as fruits and vegetable prices rose sharply but that was just the mathematics of it depending on where base prices were. Prices are in a range overall and they are not too uncomfortable. In any case, the RBI continues to maintain a hawk eye on the same in determining it's interest rate trajectory.

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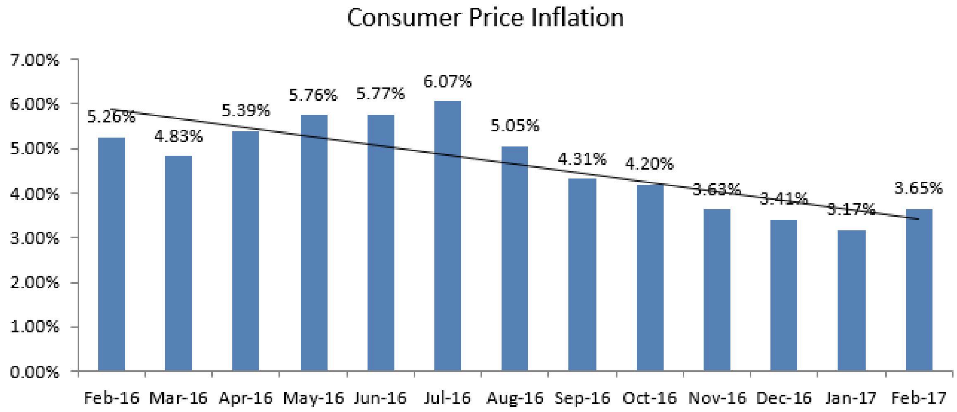
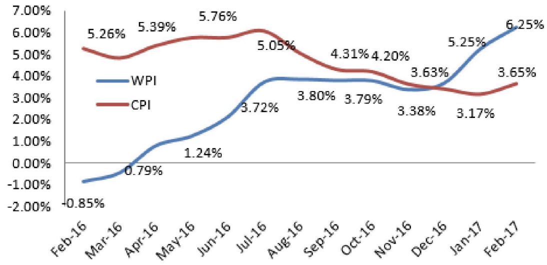


Over all, we are seeing a slight trend reversal after 6 months of falling prices. The overall glide path in the context of RBI's CPI target of 5% by March 2017 has already been achieved and the Central bank will now track its target of 4% by March of 2018. This new range may not be a given as the RBI has increased its inflation expectation to average 4.5% from 4-4.5% in H1 FY18 previously while H2FY18 expectations are retained at 5%. Keeping the revised inflationary expectations in perspective, the RBI did not offer a rate cut in its first meet of the current fiscal year. It kept the policy repo rate unchanged while retaining its neutral stance. It however increased the reverse repo rate by 25 bps to 6.0% and narrowed the corridor between repo and reverse repo rate to 25 bps from 50 bps.

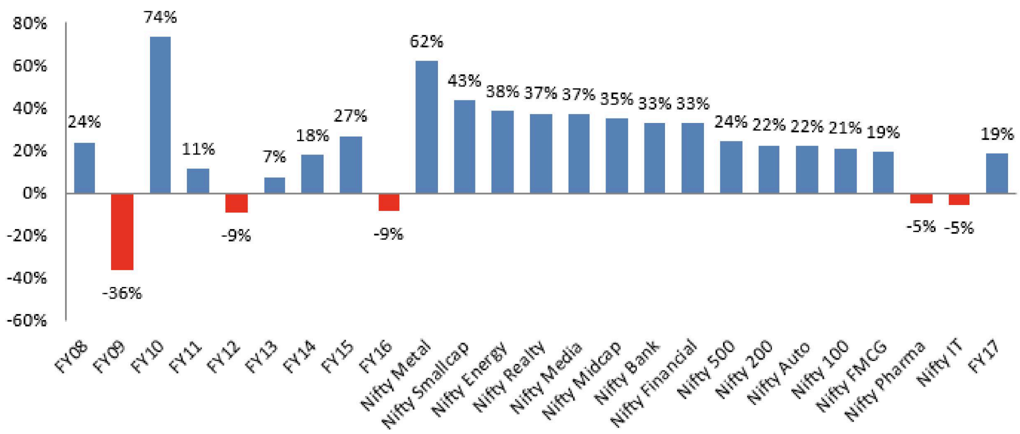


WPI for February 2017 came in at 6.25% vs 5.25% MoM. Inflation was seen in food as well as non-food articles. Within food, higher prices were seen in wheat, vegetables and fruits. Manufacturing inflation was down marginally by -0.07% MoM, 5/12 (vs 5/12 last month) manufacturing industries recorded higher prices.

FYTD average WPI is at 3.4% vs -2.6%.

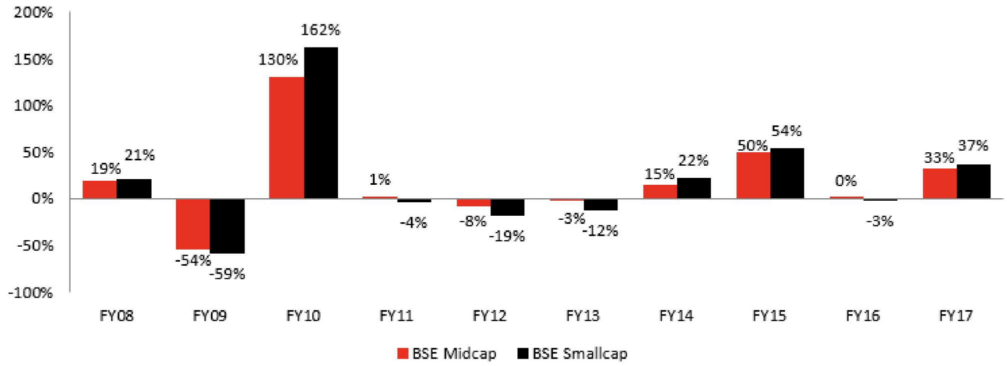
Unifi Strategy | Prices are ethereal

… and FY-2017 was a 19% year. As the chart below indicates, barring IT and Pharma, all sectors contributed to the benchmark doing well in FY 2017.

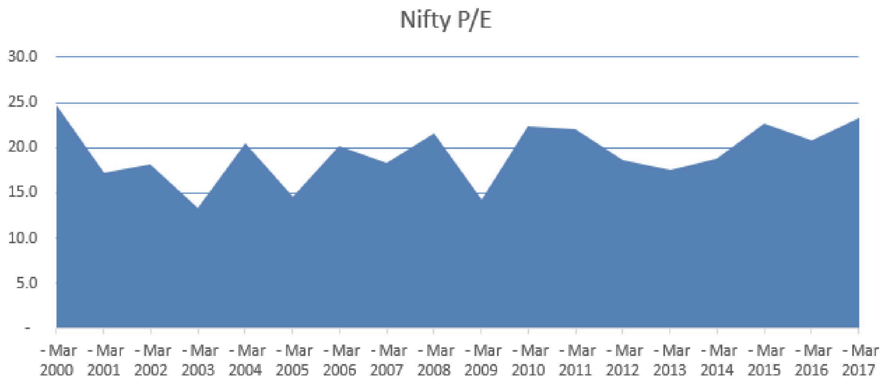


The bullishness over things to come led by consolidation of political strength at the center has seen the street show little regard for earnings over the immediate term, instead, reposing faith on the goodness of things to come over the medium-long term. Following the benchmark, the BSE Midcap posted a stellar 33% return for FY-17. More than 50 stocks in BSE 200 and 280 stocks in small cap index rallied above the 50% mark. And here in comes the part where one needs to take stock of how things are to turn up in the immediate future.

As the following chart indicates, a euphoric mid and small cap year is generally followed by a period where some of the gains are given up. As valuation excesses see a reversal to normalcy, keeping the gains that are unsubstantiated by earnings is not a given.

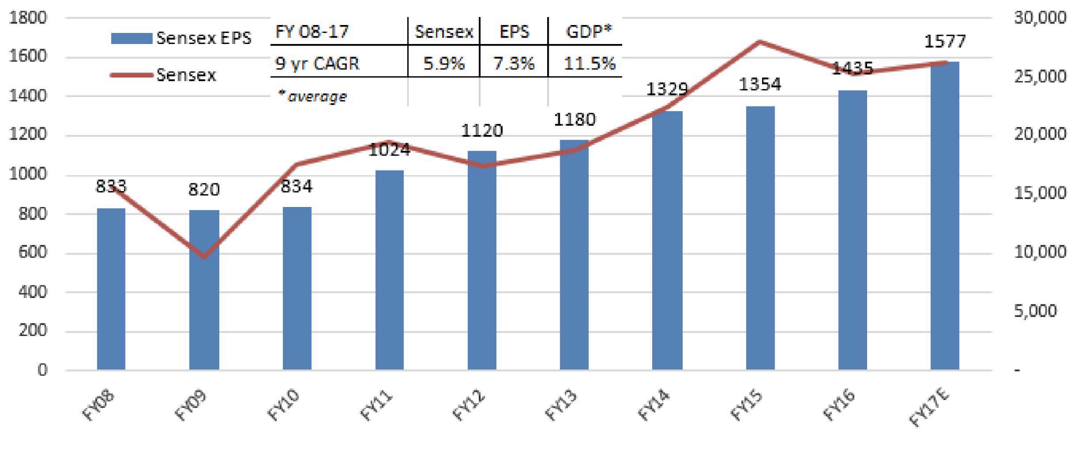


As we put together these numbers in opening weeks of April, the new financial year started on a memorable note as Nifty touched a new life time high. As it can be seen, Nifty is close to taking out its highest PE since 2000.



Source: https://www.nseindia.com/products/content/equities/indices/historical_pepb.htm

There is little debate about the zone in which markets currently are but the recent run up needs to be understood in the context of the absolute underperformance Indian benchmarks have delivered: over a 9 year period, the Sensex has witnessed an earnings growth (CAGR) of mere 7.3% with the benchmark returning under 6% and lagging nominal GDP growth by a margin of 5.6%. To put it in perspective, a massive phase of low earnings growth among the large caps has made companies appear expensive. Going back to the earlier cycle, we have seen how India has been privy to a strong multiyear earnings growth phase (25% CAGR) on the back of supportive macros. Given the economic framework that is currently shaping up in India coupled with generally improving macros on all fronts (fiscal, currency, tax administration, spending at the grass roots and multi sector reform among others) we believe that the next round of earnings growth is nearer than farther away and it is keeping this expectant progress in mind that the markets have recalibrated their risk premium expectations from the markets in India.



As valuations rise, an interesting phenomenon playing out is the marginal PE expansion in stocks that are set to experience less than moderate earnings growth. For instance, a forward PE of 9x on a company with 10% earnings growth rate seemed reasonable in the middle of the year. However, as liquidity engulfed the markets, and relative valuations grew, the marginal adjustment in PE on account of sentiment has resulted in huge up moves in absolute valuations. By way of a simple illustration below, a change in PE from 9x for the current year to 10x for a year ahead, results in an absolute valuation growth of 22%. This re-rating has been the prime mover in several of the small cap names.

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For illustrative purposes only*	FY 17	FY 18	Change
Earnings growth in %	10	11	10%
PE	9	10	11%
Market cap	90	110	22%

*Not representative of our assessment of valuations

As valuations climb across the street, prices are ethereal, but understanding of an opportunity needs to be absolute as we look for value in what is otherwise a largely fully valued market. As interest rates in India and around the world continue to fall or remain low in absolute terms, the over bearing hunt for real returns continue to see increased allocation to equities at a domestic level as well as by FIIs to emerging markets such as India. In fact, this shift in allocation has already been a large driver of returns in FY-2017 as much of the environment focuses on active asset allocation. Unless there is an unforeseen geo-economic/political crisis, we believe that investors will generally continue to be constructive on equities as an asset class, notwithstanding their own complaints about valuation.

As the policy framework continues to improve, markets will track the macros and extrapolate them to benefits at a stock level. We have been writing to you about GST for a while now and it is now completely certain that the 1st of July 2017 will see the end of India's cascading multitier system of local taxation as India moves towards a simple unified state of taxation. This will immensely benefit the organized sector as demand will now encourage consumption from tax compliant industry participants as the new system demands a vastly greater degree of tax compliance. Interestingly in FY2017, the Government's tax collections grew 18%, a number that is far higher than the earnings growth of the overall benchmarks, indicating the vast pockets of growth the India is privy to beyond the headlines. Meanwhile, given the USD13Bn in fund flows India has received in CY17, the INR touched a 20 month high, appreciating against all major currencies – the USD, Euro, Pound and the Yen. This trend is expected to keep course for the time being and will eventually lead to lower cost of goods for the economy in the coming fiscal, translating to better margins for industry leaders. A lower fiscal deficit (though not entirely appreciated in Jaitley's last budget), controlled CAD and continued policy reform should continue to lay the ground work for equities to perform in the coming year.

Finding value in a rising valuation environment is an attentive exercise and as valuations in our portfolio rise, we have not hesitated to pause, book profits, and momentarily raise cash levels before we zero in on an opportunity that fulfills our metric of what constitutes value. There continue to be segments in the economy that offer opportunities as specific industry related macros such as in building materials, seeds, and infrastructure. For instance, the Government's new Hybrid Annuity Model (HAM) of infrastructure creation is bound to strengthen the overall infrastructure environment of the country and this may well see a new wave of investment opportunities in the Infra segment. But given the velocity of movement in markets, it is reasonable to expect some fatigue to set in. For instance, 112 out of the 200 stocks in BSE 200 now trade at a trailing 12m PE of more than 20x and the balance 88 that don't are largely constituted of PSU banks, Utilities and EPC companies that may be rightly valued given their existential risks.

To sum it up, while the macros will continue to be positive, select stocks will move based on news flow or ETF allocation, and international as well as domestic liquidity will continue to pump up the headline benchmark. As we align our investments with our framework of value, cash positions may rise. Our continuing research into the Green industry remains positive and we are enthused by opportunities in the renewable energy and waste management space. It is imperative to note that Q4-FY17 as well as Q1-FY18 (quarter of GST) is likely to see softness in earnings as the industry adjusts slowly to new paperwork.

We continue to like select names in private banks, NBFCs, 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 the margin of safety. In the meanwhile, as valuations across sectors 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 aff

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

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