Macro, Markets & Strategy review

2015

May

UNIFI INVESTMENT MANAGEMENT

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Global developments

EU Economy: Consumer price inflation, a key variable used by policy makers at the ECB to monitor resumption of economic growth in the European Union, rose for the first time in six months from a record low of 0.6% to 0.9% during May-2015. This is a significant development in the context of the European Central Banks campaign to avert a further slide into deflation besides acting as proof that the €60bn per month of easing is showing results; as a reminder, the ECB is pumping in €1 trillion up till September 2016 and hopes to shore inflation up to 2%.

Greek Crisis update: in yet another maneuver that does not yet signal a formal default, Greece postponed the payment of the €300mn loan, buying time to ensure that their debt is essentially refinanced. Greece's bailout expires at the end of June and if no cash-for-reforms deal is done by then, default would seem certain, shunting the Euro zone into a period of volatility and probably opening the way for Greece to exit the single currency.

US Economy: Meanwhile, the American economy continued to recover from a harsh winter as employment grew by a healthy 280,000, ahead of predictions of 225,000; however, both the unemployment rate (5.5%) and the number of un-employed persons (8.7 million) have shown little movement since February, meaning there is no short term indicator of a US rate hike as yet.

Indian Market

FII's sold stock worth USD0.4bn in the cash market while they bought stocks worth USD0.7bn in the futures market. Moreover, FII's also turned sellers in the debt market (at USD1.3bn) – for the first time since April-14. Domestic Mutual Funds however remained buyers for 13th month in a row, buying stock worth USD0.7bn. In May, MSCI India was the best-performing market among emerging markets and on a YTD basis, India's performance ranking has improved to 8th position from 16th position until the end of April 2015. The benchmark BSE Sensex returned 3.0% for the month vs 2.7% of MSCI India. BSE Midcap and BSE Small cap returned, 2.9% and 3.1% respectively for the month.

Monthly Macro Review | Rate Cut | Inflation in control | IIP update

Interest Rate Cut by the RBI

The RBI heeded to consensus and reduced the benchmark repo rate by 25bps (to 7.25%) on the back of comfort from the following developments:

- ✓ Evolution of headline inflation as expected; the fact that unseasonal rains did not distort the food price regime added much comfort to the central banks view on inflation
- ✓ Low buildup in the cap-ex cycle, weak credit off take and slow domestic growth
- ✓ Signals of normalization of the US Fed monetary policy being pushed back.

Going forward, further cuts will depend on how the inflation scenario emerges in the months to come. The RBI feels that the inflation trajectory, as things stand today, is not so benign and holds multiple avenues of upside risks on account of:

- Probability of a below-par Southwest Monsoon – Indian agriculture is highly dependent on the vagaries of nature and an below par rainfalls run the risk of resulting in increased food prices
- Crude prices inching northwards
- Overall volatility in the external environment spawned through volatility in the FX movements

Overall, it looks like the RBI will take a long pause in order to see how the above pan out before determining the subsequent course of monetary policy easing.

GDP Performance

India's GDP accelerated to 7.3% in FY15 vs. 6.9% in FY14. The economic growth was broad based with growth in

- ✓ Government consumption of 6.6%,
- ✓ Private consumption of 6.3% &
- ✓ Gross capital formation of 5.4%

In Q4 FY15, while consumption and investment growth doubled, government consumption contracted by 7.9%. Exports and imports too steeply contracted while Agriculture shrank for the second quarter at -1.4% following the unseasonal Rabi rains.

Over all, India's economy has improved considerably in the past 12-18 months. From 5.1% in FY13, GDP growth rose to 6.9% in FY14 and further to 7.3% in FY15. Despite the scepticism about the new GDP series, India's growth has accelerated in the past three years. The RBI estimates GDP growth to come in at 7.5% for FY2015-16, down from the projection of 7.8% in April this year. The growth story would be a slow and sustainable one rather than a sharp and sudden turnaround.

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Inflation update – it's easing

Key readings as follows..

- ✓ CPI for April 2015 came in at 4.87% in line with expectations while
- ✓ WPI for April 2015 stayed in the negative territory at -2.65% for the fifth consecutive month. Core WPI at -0.5 signifies a slack in demand for input commodities

The outcome of these numbers has seemed to address RBI's nerves on inflation thus resulting in a minor but accommodative monetary policy stance. The prospective numbers on inflation will however have to continue on such lines for further monetary easing.

Favorable base leads to lower readings…

- Prices of vegetables have been declining each month (especially that of potatoes). Coupled with a high base, it has led CFPI to ease to 5.1% dragging the headline also below 5%
- The recent hike in petrol and diesel prices in May will lead to a marginal uptick in the transport & communication index (April 2015 at -0.9%) and the fuel index (April 2015 at 5.6%), thereby pulling the headline CPI
- WPI coming in the negative zone was supported by benign global commodity prices (CRB commodity index: down 25% YoY) in addition to fall in prices of all non-food articles and liquid fuels. Sequentially, WPI was down 0.06% MoM led by a 1.66% MoM decline in the fuel index.

IIP update

India's March Industrial Production descended to a five-month low of 2.1% YoY.

- Manufacturing growth moderated to 2.1% YoY during March from a nine-month high of 5.2% in Feb.
- Industry-wise 13/22 industries registered expansion as compared to 15 Industries in the previous month.
- Electricity generation slumped to a 17-month low of 2% YoY increase from 5.9% increase in Feb.
- Mining grew 0.9% YoY from a downwardly revised 1.9% in the previous month which was stated at 2.5% earlier.

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

Over all, India's FY15 Industrial Output at 2.8% is a marked turnaround from the stalled and negative growth in FY14. We expect this pick-up in trend to carry further with more strength led by mining, electricity, capital goods and consumer goods. The fiscal expansion mode announced in the Union Budget combined with early signs of recovery In India's Capex Cycle and easing of the interest rates are the essential ingredients to push this growth framework steadily higher.

Unifi Strategy

FY2016 got off to a poor start on the back of one of the weakest earnings seasons in the recent past; Q4-FY15 adjusted net profits of the benchmark BSE-30 Index and Nifty-50 Index witnessed a YoY decline of 11% and 14.4%, respectively. The disappointment was largely sector agnostic with PSU banks continuing to report poor asset quality, IT companies depicting relative weakness in growth, industrials continuing to show lack of demand pick up and cement volumes weakening over all. The weakness at the core earnings level can be seen at Q4- FY15 EBITDA of BSE-30 Index and Nifty-50 Index declining by 11.5% and 12.4% respectively. For the year as a whole, FY2015 net profits grew just 1.9% for the benchmark BSE-30.

While it is difficult to paint a resoundingly positive picture on the basis of the earnings season just gone by, we believe easing fiscal and monetary condition with higher spending on investment is likely to translate to better growth once the transmission of easing comes into the system. In the medium term higher capacity utilization, lower interest cost and higher gross margin will help corporate post relatively better numbers. As a parallel, corporate balance sheets are healing which is evident from the fact the rating upgrades are higher than rating downgrade. Indian corporate profits, measured in aggregate terms as a percentage of GDP, is at a historic low and perhaps signaling a bottom. However, monsoons can throw a spanner in the works as India employs around 50% of its work force in agriculture and a subpar monsoon can severely constrain a broad based consumption demand and thus hamper economic growth. The markets have obviously readjusted to this reality and unless there is resounding proof of good monsoons combined with pick up n industrial activity, it is fair to expect volatility in the street.

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In view of the limited scope of earnings upgrades and monetary easing, next leg of the up move will largely depends on passage of legislative reforms like GST and land acquisition bill. Market will also take cue from other actions like coal auction, adding more items into direct transfer of subsidy, resolution of bank NPA issues, addressing power sector issues etc. While the economy is growing above 7%, at the cost of repetition, if the monsoon led agriculture sector does not do well enough, corporate profitability and growth will remain a question mark.

Currently, valuation of the benchmark at a PE of 16.5x, is close to the long term average of around 17x PE. However the valuations of quality growth stocks that have been delivering earnings growth in an environment like this are expensive, and not completely free from underlying risks. We believe the market will continue to reward such high quality names and we shall continue to focus on such bottom up fundamental names with good return ratios. For the portfolio as such we are invested in such names that will benefit from sustainable growth in consumption supported by Indian demographics as well as their market positioning. An upturn in the economy will benefit these names first and continue to support valuations. However huge supply of paper in terms of disinvestment, IPO's and FPO's can make the market volatile in the short 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.

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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