Macro, Markets & Strategy review

2017

May

UNIFI INVESTMENT MANAGEMENT

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Global developments

For the first time since 1989, Moody's has downgraded China, publicly calling on the countries potential asset liability mismatch, pointing out that as growth slows & debt continues to accelerate, China's financial status will eventually weaken. This view on risk was however a tad late in arriving, as a series of actions by policy makers in China have already indicated a redressal of these issue for a while now. For instance, China has raised its short term rates and tightening regulatory supervision and aiming for lower growth, but the need to deliver on a rate of growth that is more than what organic demand points to may still result in areas of financial excess. Global markets did not make a lot of this development in spite of that fact it would increase the cost of borrowing for the Chinese Government, given the flow of worthy political news from America and Europe this month, and pointing to how much of the market sentiment is driven by what is topical and not so much by what impacts earnings at a structural level.

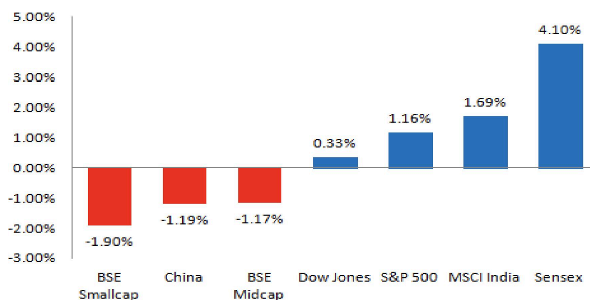
Meanwhile OPEC has continued with its drive for lower output, so that Saudi can do its bit towards the listing of Aramco. But the consensus on Oil's long term justified weakness has led to falling prices as they adjust to eventual reality, and not trade on an immediate equation of demand and supply. With Oil now at $50 a barrel, and Shale continuing to grow, indicating a lower break even for the latter, a new structural low is a more of a realty than ever. The downside is instability in the middle east, but great news for a net importer like India.

Things continue to get better economically in the West generally, with US continuing to raise rates & shrink its balance sheet. But it is never too early to question when the tailwinds of an expansionary monetary policy will eventually fade. Rising populist policies and diminishing returns from conventional economic policies are a new reality and a shrinking western population can only slow down demand. While productivity led economic expansion may be a force, is it too early to ask what the next phase of recession may look like?

World Markets

Emerging markets continue to have a good 2017 as the EM index notched another 2.80% for the month and is now up 16.59% for the year.

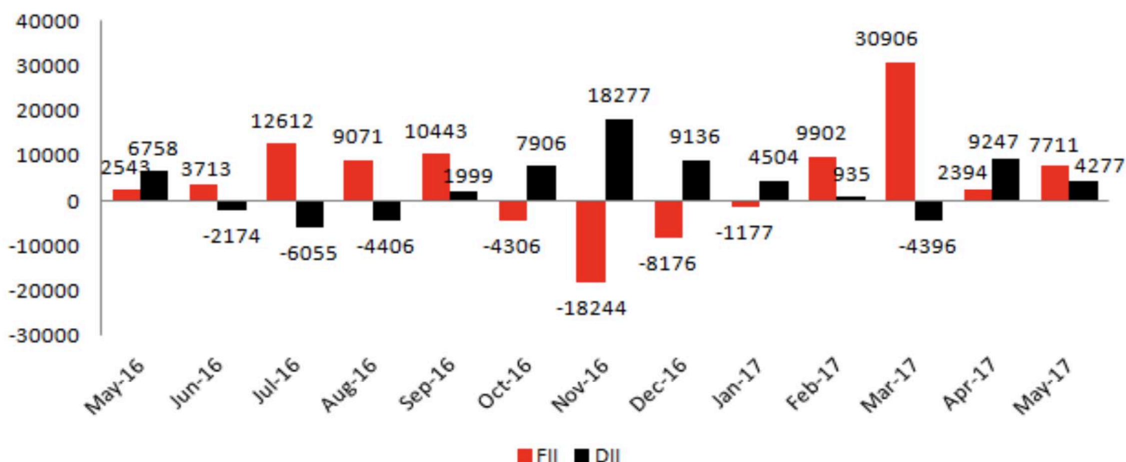
MSCI (in %)	India	Brazil	Russia	Korea	China	Japan	US	Australia	EM Index	MSCI World
MoM (in %)	1.69%	-5.20%	-6.43%	8.04%	5.08%	2.95%	1.11%	-4.63%	2.80%	1.78%
CY - YTD (in %)	20.89%	3.58%	-10.99%	27.31%	21.81%	7.85%	7.91%	3.84%	16.59%	9.17%



India has been among the best performing markets globally with MSCI India up 20.89% in CYTD 2017, helped by a weakening USD.

Inflows abound

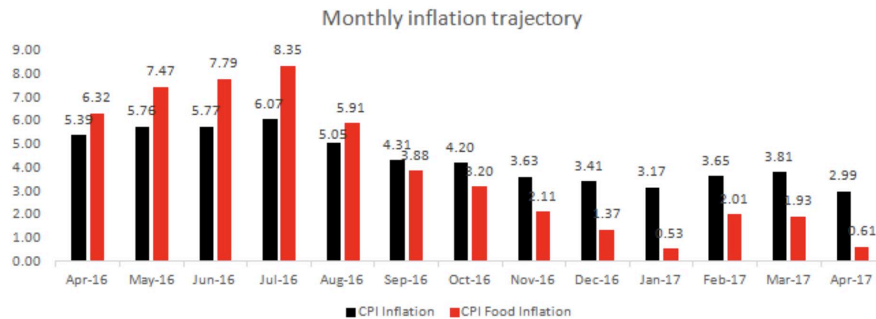
If we haven't already, it is highly probable that India is now attracting a lot of hot money. Irrespective of immediate fundamentals, valuations and resultant opportunities, inflows into Indian equites continue unabated. Domestic investors have pumped in about $2bn over the last 2 months and growing rising allocation of Indian households towards equities point to towards sustained flows.



Interestingly though, in spite of Rs.11,000cr (or $1.84bn) flowing in May, the mid-cap and small-cap indices lost 1% and 2% respectively, indicating that liquidity is no hedge against news flow or event based sell off. As liquidity continues to chase lofty valuations, the markets will not be bound by fundamentals, posing a serious risk that investors need to be cognizant of more than ever.

Inflation falls | CPI @ 2.99% vs 3.81% MoM | WPI @ 3.85% vs 5.29%

Consumer inflation is largely in control, coming in at 2.99% for the month of April-17 vs 3.81% in the previous month. The food basket that consists of 45% of the CPI index saw a bit of moderation, as it fell to 0.61% vs 1.93% MoM. Prices are in a range overall and they are not too uncomfortable.

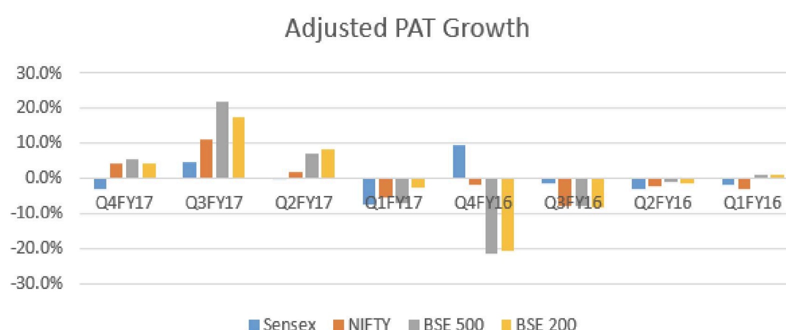


We have been comfortable with falling inflation – good for interest rates narrative for a while now, and for whatever reasons, have ignored an important tangential result of this - farm income. With 60% of India's employment and 17% of our GDP dependent on the sector, low end produce prices have kept the dependents of the s-FY7ector at the lowest level of the economic pyramid for long. This begs the question, if farm output is not repriced upwards, how does a majority of the population move significantly up the consumption chain?

The RBI's vigil on 4% as a target for inflation has completely blindsided the need to address food pricing in India in a manner that is sustainable from all angles. This is more than ever relevant today, given the agitations for farm loan waivers in different parts of the country. Signs of rural distress, a flipside of structurally low food inflation in India has always been there, but ignored. This issue needs to structural redressal to prevent a larger socio-economic fall out.

Complete reversal of earnings some time away

There continues to be a clear wedge between earnings and markets. The spillover of demonetization into Q4 of FY17 has impacted industrial growth over all. This was amply reported in the India's GVA slow down to 5.6% YoY in Q4-17 vs 6.7% YoY in Q3 FY2017, while GDP growth eased from 7.0% YoY to 6.1% YoY. Obviously, this translated to a slowdown in earnings, once again. As the chart below shows, Q4 has trailed Q3 in earnings, though the trend from a 2 year perspective is much better.



Valuations however discount most of the present and price the future. And the outlook, optically, is bright. Several important reforms such as GST, RERA, the UDAY scheme and the JAM trinity (Jan Dhan-Aadhar-Mobile) have been put in motion and the fundamentals of our economy have strengthened with a relentless focus on inflation by RBI leading to lower interest rates, more capital flows, strong reserves and lower deficits. These initiatives are expected to manifest in demand at a consumer as well as an industrial level which will eventually show up in corporate profits. UDAY for instance is steadily reflecting in rising order and bid books for incumbents in the power sector while small regional players in the realty sector are seeing a much improved demand environment. And on GST, a lot has been written. We will try to summarize in a simple table on what the excitement is.

Industry	Unorganized %	Size of the Industry(INR,CR)
Plywood	65%	25,000
Tiles	50%	22,500
Jewellery	75%	3,00,000
Dairy	80%	5,00,000
Footwear	60%	34,000
Apparel	73%	3,50,000
Plastic	40%	90,000

Clearly, the share of the shadow economy in India is large and mainstream corporate India has been a long standing dwarf, at an industry level. With the GST, the organized industry will be forced to consume from tax compliant sources, and the entire chain of demand & supply will force compliance among one and another as a result of which the organized industry will gain at the expense of the unorganized one. It is but natural that over time, non-complaint firms will move towards compliance and as a result, tax buoyancy will witness an overall increase. We believe this change will result in an eventual step function in growth and valuations currently are factoring in a lot of this step function as earnings for the organized sector step towards consolidation.

Over all, the macros supporting the economy are looking good. While RBI maintained status quo in its latest policy assessment, the stance is seen slightly dovish given cut in inflation forecast. This has increased the probability of a rate cut going ahead. Normal monsoon and no significant price impact of GST should mean inflation under check and given the sluggish growth environment, there would be room for rate cut. Housing finance companies have got a boost with a cut in their risk weights and this specific sub-segment is expected to continue doing well while the Government's efforts to resolve NPA structurally continue. The Software sector is losing ground fast on constant pressure of pricing and absolute growth prospects and a similar outcome is awaiting the Pharma industry as well.

It may be important to point out that select States are emerging as the new drivers of cap-ex in India. It is estimated that the cap-ex of States' in India as a segment may grow by 15% to Rs.5.6tn in FY18, vs. 12% growth in FY17 and the same is reflecting in terms of new order inflows of the EPC companies. UP, Telangana, AP, Rajasthan & Jharkhand have emerged as the new capex drivers in India whereas Gujarat, TN and WB take a back seat. For example, Telangana has budgeted its capex at Rs. 411bn in FY18, nearly 2x of TN's capex. States have provided higher allocation for Urban infra, Irrigation & Roads in FY18 whereas allocation for energy has declined across most states in FY18 budgets and this is reflected in lower conventional power cap-ex and the emergence of renewable energy.

Unifi Strategy

One of the greatest challenges in the investment business today is the ability to distinguish between the thorough knowledge of a company's business and how much it will earn, with how much it is worth. Valuation excesses have the ability to slowly sneak in and blur the zone in which good companies should be avoided and this is true for India more than ever. Post the Q4 earnings season, and the realization that the next 2 quarters will be volatile on the back of transitory issues associated with GST, we are cognizant of valuations more than ever and have taken to cut positions in several of our holdings. In terms of new deployments we are not averse to holding cash and are comfortable doing so, unless investment ideas that merit our parameters present themselves. 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.

We continue to like select names in agriculture, specialty chemicals, polymers, and select manufacturers in the B2B space catering to infrastructure creation 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.

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

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