Macro, Markets & Strategy review

2015

November

UNIFI INVESTMENT MANAGEMENT

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Global developments

Policy hustle: As the Fed marches towards its first interest rate hike in a decade, Fed chief Janet Yellen gave an upbeat assessment of where the US economy stands. She repeated the case that unemployment is low, growth continues at a modest pace, and inflation will return to Fed's target of 2% over time. Though there was no specific reference to the possibility of a rate hike in December, it was mentioned in the same breath that "were the FOMC to delay the start of policy normalization for too long, we would likely end up having to tighten policy relatively abruptly to keep the economy from significantly overshooting both of our goals. Such an abrupt tightening would risk disrupting financial markets and perhaps even inadvertently push the economy into recession." We therefore think there is reason to believe that rates are likely to go up in mid-December (15/16) when they meet again. It needs to be kept in perspective that the Fed's job is challenging in the context of the moves by other major central banks to continue easing financial conditions; and a significant divergence could pose a drag on US growth by shoring up the value of the dollar beyond its current high levels. Staying with monetary policy, in order to fight stubbornly low inflation, the ECB cut its deposit rate deeper into negative territory from -0.2% to -03% and extended its asset buys by six months.

Crude rout to continue: In a significant commodity development, OPEC pledged to increase production by 1.5mbpd, over and above current levels of 30mbpd. The ceiling, though, is seen as largely symbolic as the organization's members have been overshooting it for months. In September, OPEC produced 31.57 million barrels a day, according to its own data. This is an indication that there is little, if not nothing, that OPEC can do in the medium term to influence prices upwards. As Iran looks to increase its own production in the months to come, along with the new limits, the rout is oil prices are likely to continue. As a remainder, WTI is down 11% for the month of November and 22% for the year so far. The global commodity index, CRB, fell 6.7% for the month, and has now lost 21% for the year.

Indian Market

In November, MSCI India was down -4.82% while the MSCI Emerging Market index was down by -3.96%.

- The benchmark BSE Sensex was down returned -1.9% for the month of November 2015;
- BSE Midcap & Small cap were up 0.14% and 2.84% respectively.
- On the back of sustained redemptions in emerging market funds, FII's remained sellers for the second consecutive month (USD 1.64bn); YTD FIIs have bought in USD 11.83bn into India

MSCI (in %)	India	Brazil	Russia	Korea	China	Japan	US	Australia	EM Index
MoM (in %)	-4.82%	-3.25%	0.57%	-3.51%	-3.40%	-1.03%	0.11%	0.00%	-3.96%
CY - YTD (in %)	-9.62%	-39.97%	12.06%	-5.25%	-8.84%	7.53%	1.11%	-16.47%	-14.85%

Monthly Macro Review

Monetary Policy Update: Accommodative stance reiterated

In an expected move, the Reserve Bank of India paused on key policy rates and announced that interest rates (REPO) will be retained at 6.75%. Not to be misread, Governor Rajan reiterated that the overall policy stance remains accommodative, thus conveying a degree of stability in the way monetary policy will interpret incoming economic data points. The liquidity stance is also accommodating.

De – facto target on headline CPI set to 5% by March 2017

Considering that fact that inflation is likely to undershoot January 2016 target of 6%, the RBI has set its motions on the future year target – 5% by March 2017. The major narrative of CB commentary around the inflation outlook today includes the following considerations:

- Developments on commodity prices, especially food and oil, even while tracking inflationary expectations and external developments and external developments (US Fed rate hike / China / geopolitical tensions)
- The implementation of the Pay Commission proposals, and its effect on wages and rents, will also be a factor in the Reserve Bank's future deliberations, though its direct effect on aggregate demand is likely to be offset by appropriate budgetary tightening as the Government stays on the fiscal consolidation path.
- Governments at the Center & States will work in tandem to ensure apt supply management and stem sudden price spirals in key agricultural commodities, especially after a likely shortfall in Rabi crops

Over all, while keeping the economy anchored to the projected disinflation path, the RBI will use the space available for further monetary easing

Inflation in control

- Consumer Inflation for October 2015 came in at 5.0% while CPI food inflation (CFPI) spiked up to a multimonth high of 5.26% given the rise in prices of pulses and waning of the positive base effect. Core CPI is hovering around 4.5% YoY (0.4% MoM).
- Core inflation was at -2.04% signaling a weak demand scenario. The global commodity index (CRB index) is down 28% YoY, supported by a continuous decline in raw material prices across sectors.
- Wholesale inflation for October 2015 came in at -3.81%, now in the red for the twelfth consecutive month.

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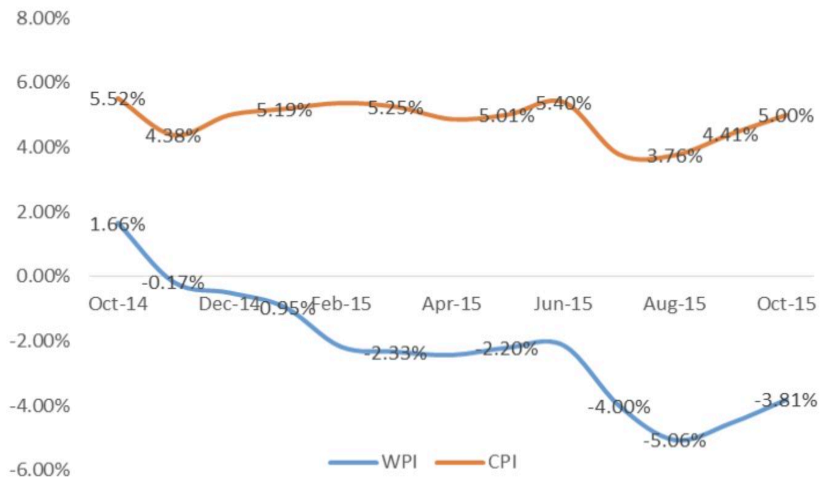
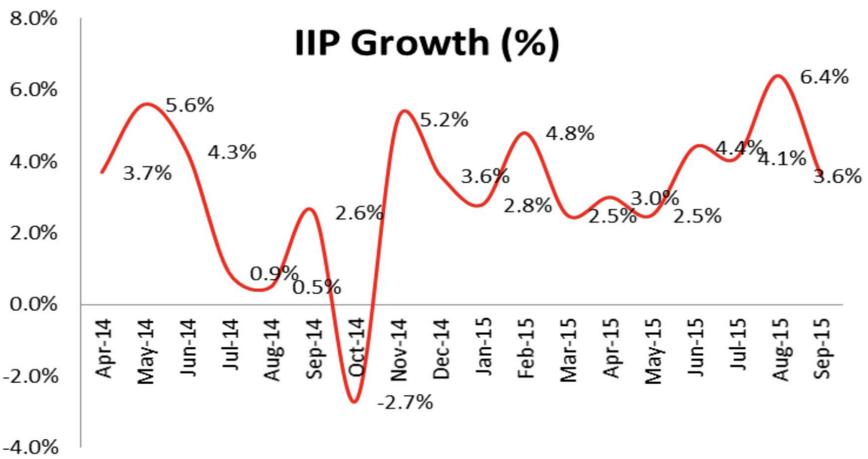
Outlook on Inflation

In the short-term, headline inflation faces upside risks due to soaring pulses prices across the country and extreme flooding witnessed in the south Indian city of Chennai. However, the seasonal unwinding in vegetables prices and likely reversal in petrol prices may provide a marginal offset. Though elevated pulses inflation remains a cause for concern, we expect measures taken by the government to crack down on hoarding, increase in imports, sale at subsidized prices through government outlets, etc., to support easing of prices in the coming months. In the long term, the overall inflation situation in the economy remains favorable on the back of weak global commodity prices and government steps on reducing supply constraints. India's steep inflation correction over the past year:



Index on Industrial Production zooms

After IIP for August-15 zoomed to 6.4%, growth moderated to 3.6% for Sept-2015 vs 2.6% a year ago.



Capital Goods key driver

Strong growth was recorded in capital goods (up 10.5% yoy, 7.7% mom).

Basic goods output rose by 4% while intermediate goods growth fell to 2%.

Number of industries recording negative growth increased to 11/22 vs. 7/22 last month, on annual basis.

FYTD, IIP growth is at 4% vs. 2.9% last year. It needs to sustain above an average of 5% for broad based industrial recovery to find firm footing. Deficient monsoons have led to weak rural demand and delayed the scope of substantial pick-up in industrial output while Government enabled cap-ex is taking time for the multiplier effect to be felt across the economy. Going ahead, any improvement will only be slow and gradual.

Unifi Strategy | Patience is key

So, with a month to go for the year to end, the story from India thus far is lackluster economic dataflow, average to poor corporate earnings, political setback for the central government in state elections and some unwarranted rise in social tension. But that's a slightly pessimistic view for a forward looking investor. On the flipside, (a) a large domestic market (temporarily hit by a poor monsoon), (b) a government rapidly undertaking administrative, regulatory, and legislative reforms (GST, FDI etc.), improved external account developments on the back of declining energy prices, (c) a credible central bank that is targeting low and stable inflation, and (d) high levels of consumer confidence aided by the impending 7th pay commission to come into effect are some of the characteristics that continue to excite us for the times ahead. However what we need to be realistic, and patient about, are the timelines it will take the economy to deliver on the promise.

Recently released GDP data indicates that economy is turning around but revival in private sector capital expenditure is required to sustain the recovery. The Government is doing its bit on improving the investment climate by reviving stuck projects, easing the award process along with increasing FDI limits in various sectors. The macroeconomic data points as such indicate some improvement, but the quantum must get better.

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Growth in GVA at constant prices (YoY % changes)			
	Jun-15	Sep-15	Growth
GVA at basic prices	7.07	7.39	5%
Agri, forestry & fishing	1.91	2.18	14%
Indutry	6.51	6.85	5%
Mining & quarrying	3.97	3.15	-21%
Manufacturing	7.15	9.30	30%
Elec, gas, water	3.22	6.70	108%
Construction	6.91	2.60	-62%
Services	8.86	8.81	-1%
Source: CMIE			

Looking ahead, the domestic demand drivers will play a significantly greater role than external drivers. And by that we mean a decent agricultural season for the remainder of the year, followed by a strong one for the coming summer in 2016, and significant trickledown effect of the Government cap-ex. It will be incorrect to expect green shoots any sooner than mid-2016, i.e., FY-2017. On sentiment grounds, a successful passage of the GST bill would certainly boost investor and corporate sentiment. With RBI having likely front-loaded the cuts, a transmission of the same will also do its bit for abetting retail and housing consumption.

Meanwhile, decisions on rate hike by US Fed, and data flow from Europe, China and global commodity markets will continue to have its effects on the markets. Currently, valuations of benchmarks, at 15.5x FY17 consensus earnings, are near the long term average of 15x; so to that extent, we are really not concerned about a deep slide from here on. What we do have to keep in mind is the probability of a time correction. Our preference stays for companies having strong balance sheets, good governance and the best proxies for growth in their respective sectors. Our portfolio is aligned with companies that are able to deliver above average earnings and have the construct to continue doing so in the near to medium term. We continue to maintain a hawk eye on a favorable 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.

Risk: Key risks to our portfolio would come from geo-political concerns globally, decline in foreign inflows, sharp currency movements, spike in commodity prices and a prolonged delay in fiscal reforms. Global reallocation 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 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

Research

CHENNAI:
11, Kakani Towers
15 Khader Nawaz Khan Road
Nungambakkam High Road
Chennai - 600 006. INDIA
Ph: +91-44-3022 4466, 2833 1556
Fax: +91-44-2833 2732

HYDERABAD:
H No. 6-3-346/1, Road No. 1
Banjara Hills
Scotia Bank Building
Hyderabad – 500 034. INDIA
Ph: +91-40-6675 2622/23

BANGALORE:
511, Barton Centre
84, M.G. Road
Bangalore - 560 001. INDIA
Ph: +91-80-255 9418/19

MUMBAI:
Shiv Sagar Estate,
A-Block, 8th Floor,
Dr. Annie Besant Road
Worli, Mumbai - 400 0018.
INDIA