Macro, Markets & Strategy review

2017

November

UNIFI INVESTMENT MANAGEMENT

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Global developments

What better encouragement for private consumption and the investment cycle, than to perhaps cut some taxes? Policy makers in the U.S have unveiled plans to slash corporate tax rates from a high of 35% to 20% by 2019, without interfering with the highest tax slabs for individuals. This would be the lowest rate of taxation since 1939, with the idea that lower taxes will allow businesses to increase capital investment and create more jobs. Euphoric to the idea of steep tax leverage, the Dow Jones and S&P 500, reacted absolutely and continued their momentum in reaching new lifetime highs; the DJIA is up 22.8% while the S&P 500 is up 18.2% this CY 2017. Lower tax rates may in parts lead to the creation of an asset bubble, but in an economy where 70% of the GDP is driven by consumption, lower tax rates is likely to transmit across to eventually higher corporate / consumer spends and aid the broader cycle of economic recovery. As things stand today, the American Confidence index is at its highest in 17 years and unemployment is the lowest in 16 years, already showing relatively better signs of money circulation.

China meanwhile, has surprised (again). While their GDP is up 6.8% for the first 9m-CY17, it may be on course for its first yearly acceleration since 2010. It has been a decade now that various facets of the Chinese economy have been expected to blow up, but nothing has. In fact, considering pollution issues, the Government has actually come down heavily on tightening the capacities of several of their core industries such as metals and chemicals, aiding a global rally in many of these commodities. On the fiscal side, tight monetary policy continues to control the flight of Chinese capital outside as Chinese non-financial offshore investments fell by 40% YoY for the year so far.

Equities otherwise continue to perform well across geographies; MSCI Asia, USA, EU & World have returned 36.5%, 18.3%, 20.4% & 18.6% for the year so far.

World Markets

Emerging markets continue to have a good 2017 as the EM index notched 0.15% for the month and is now up 29.98 % for the year.

MSCI (in %)	India	Brazil	Russia	Korea	China	Japan	US	Australia	EM Index	MSCI World
MoM (in %)	-0.77%	-3.19%	3.39%	0.00%	1.55%	2.97%	2.79%	-0.18%	0.15%	1.99%
CY-YTD (in %)	30.46%	16.46%	-1.80%	42.77%	48.28%	21.06%	18.37%	9.89%	29.98%	18.62%

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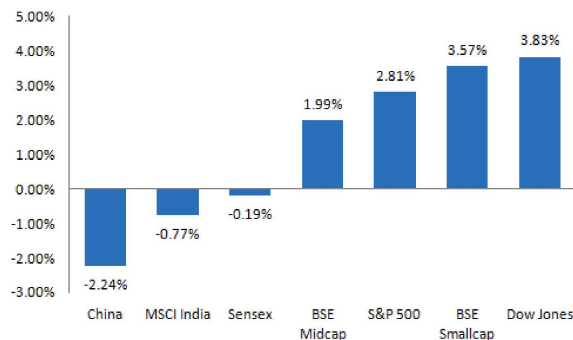
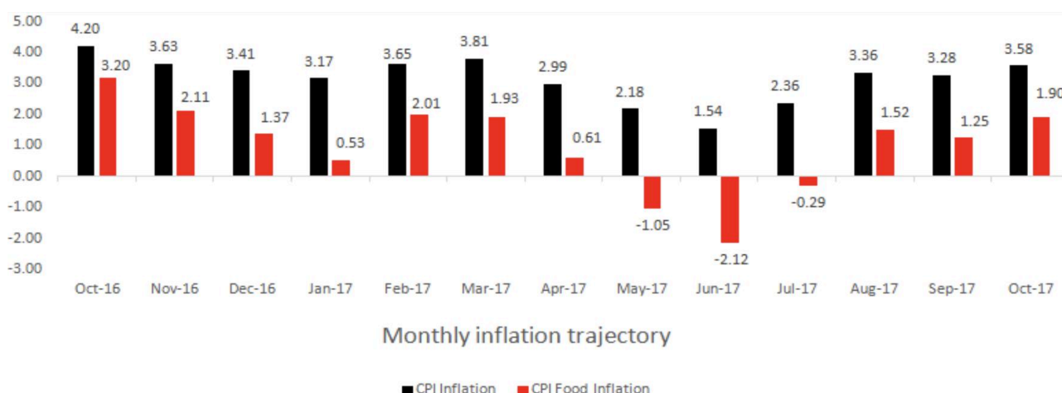


India has been among the best performing markets globally with MSCI India up 30.46% in CYTD 2017.

Inflation rises | CPI @ 3.58% vs 3.28% MoM | WPI @ 3.59% vs 2.60%



Consumer inflation accelerated to 3.58% for the month of October against 3.28% in September due to rising food & fuel prices. The food basket that consists of 45% of the CPI index increased marginally, stood at 1.90% for the month, as against 1.25% in September. Vegetable inflation moved rapidly to 7.47% in October from 3.92% in September. Fuel inflation grew by 14%, and rising crude may pose a risk to upsides in the near term.

Keeping this in perspective, the RBI held rates in this latest monetary policy review and this may just signal the trough on interest rates in India for the time being.

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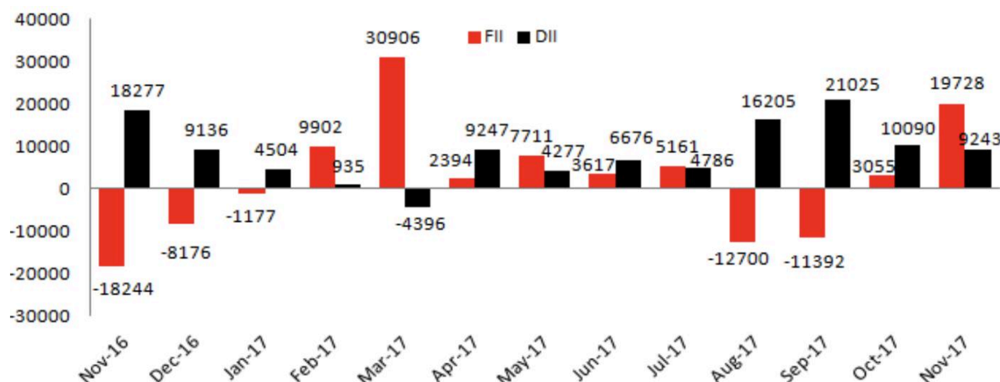
Capital flows remain strong

For FY-18YTD (beginning April 2017), inflows from domestic sources at Rs.81,550cr. ($12.6bn) have completely shadowed FII's inflows Rs.17574cr. ($2.7bn). The stamp of approval from the rating agencies helped the foreigners in recommencing their participation in Indian equities.



India's equity mutual fund AUMs have seen a 3 year CAGR growth of 34% to touch Rs.6.0tn (US$92bn) while flows in pure equity MFs have been at an all-time high with US$14bn of inflows in Apr-Oct-17 vs USD 9bn in full FY17. The reallocation of asset classes in India has been material over the last few years, starting 2014. In Sept-10, MF AUM was 10.7% of bank deposits; this has now grown to 18.3% of deposits as MF AUM's have swelled to Rs.20.9 Lakh cr. Vs Rs.114.52 Lakh cr of deposits. As a result, liquidity, and not necessarily earnings, has continued to be the primary driver of the indices in India. And in the few cases where earnings growth has been as per expectations, the PE multiples have steepened by a margin that is higher than the rate of earnings growth. In either case, the margin of safety across several segments of the market has shrunk. We continue to be cognizant of the excesses of liquidity on valuations across the broader indices and our portfolios.

Unifi Strategy

FY-2018 will be remembered for the impact of initial GST arrangements, the protracted fall out of demonetization and continuation of the NPA issues, among others. The last few months have seen policy initiatives address most of these hindrances. In the case of a few categories that fell within the highest band of GST & witnessed a contraction in demand, the Government was swift to re-calibrate their rates in its bid to boost consumption. In any case, we expect understand that the shift away from the un-organized is underway and this will benefit the organized sectors in the quarters to come. Consequently, FY-19 is also expected to see better tax collections and as a result, higher government spending (+ve for infra and social sectors) in general

Moving on, Moody's finally took cognizance of India's tight fiscal discipline and notched up its sovereign rating by a point up from Baa3 (low investment grade) to Baa2 (stable grade; as a reference point, Italy enjoys a similar rating). This is likely to enhance India's structural credit strengths and reflect well on its global competitiveness as an investment destination. India's debt-to-GDP at 68% (FY16) is high in absolute terms and so is the interest outgo, which forms 22% of Government revenues. This rating upgrade will be a key determinant in lowering the cost of borrowings for India as a whole. It is estimated that interest costs under the new environment may drop in the range of about 30-50bps. This is likely to continue to boost the operating levers for the larger BFSI sector and firms that use leverage wisely.

And like we wrote to you the last time, calling on the sectors inability to address the NPA issues, the central Government finally unveiled a massive recapitalization plan that will now give the sector the necessarily variables to re-capitalize, recognize the shortfall in bad assets and finally, re-commence lending. On a low base, and with the macro's being supportive, we believe this should get incrementally better. In FYTD-18, the addition to banking credit was moderately better at 9.6% YoY.

Over all, we believe FY-19 will be the beneficiary of the stress seen in FY-18 with cheaper external borrowing, and the lack of one time uncertainties (like demonetisation/GST) while no incremental (anticipated) negative surprise on CAD and fiscal deficit will help. The path designed to resolve the banking NPA mess will likely support better credit growth and facilitate growth plans of corporates. A key risk may be political with several crucial States heading for elections over the next 12 months (Gujarat, Rajasthan, MP, Karnataka) and sentiments here will definitely rub off on market sentiments, depending which way the prospects of the incumbent is expected to turnout. Political shocks aside, we believe the quality of data flow in the coming fiscal should be materially better than the current year. We are cognizant of the above thoughts in constructing our portfolios and they will evolve as we access the flow of data.

As a sector, we continue to like the Building Products space given the Governments thrust and execution in the affordable housing segment. It is indicated that land prices have been correcting in segments and so have end-product prices. As a result, an upturn is likely to be witnessed in the calendar year and beyond and the ancillaries supporting the sector should see new opportunities opening up for them. The Ministry of Housing & Urban affairs highlighted that the Government's entire annual budget for the 'Housing for all' scheme is already over with nearly 4 months to spare. The Central Government has committed to spend Rs.444bn on 2.9m urban houses and the balance to be spent over the next three years (FY19-21) amount to Rs.322bn., in addition to other regular spends on real estate. We hold a select few building product names in our portfolios, each with a unique set of drivers and continue to track the space closely. Specialty chemicals continues to be another key sector of our exposure. China continues to come down hard on the sector, in order to address its pollution woes and with capacities in several key molecules going down, India will continue to benefit from the development. This is of course in addition to the organic efforts of the firms by themselves to address newer high growth areas. Other select names that we like draw from a cross section of industries that have earnings levers going into the next fiscal, supported by strengthening a balance sheet and relatively favorable valuations.

At the end of the H1-FY2018 earnings season, here is an update on Unifi's various funds, for the earnings season just gone by. We have compiled the earnings growth for H1-FY2018 (vs just Q2 of FY18):

- Unifi DVD Fund - Earnings growth of 18%
- Unifi APJ Fund - Earnings growth of 28%
- Unifi Green Fund - Earnings growth of 16% (81%, including Shreyas)

Please bear in mind, your portfolios' with us, depending on which time frame they have come in, will likely have a composition that is different with other clients.

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Over the past quarter, we have booked profits in a number of positions as valuations have adequately reflected the earnings growth that we invested in them for. Rolling into FY-19, we believe earnings growth for our portfolios on an average will be above 20%. At a portfolio level, we hold them at valuations with a margin of safety to their earnings and quality of balance sheet. We hold no sectoral biases as such as we continue to invest only on bottom up conviction, and not participate in momentum led beta opportunities. Our cash levels on new inflows may have been high as we carefully screen the environment for value. We continue to meet an interesting cross section of companies across industries and like what we see, but will invest only when where are comfortable with parameters on valuations and growth within which we work.

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.

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

DELHI:
No.818, Internationa Trade
Tower, Nehru Place.
Delhi - 110 019.
INDIA
Ph: +91-8800333799