Macro, Markets & Strategy review

2017

October

UNIFI INVESTMENT MANAGEMENT

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Global developments

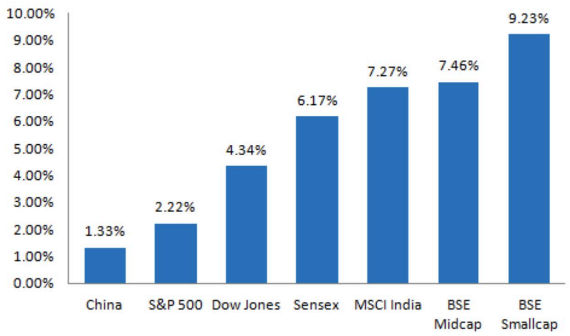
Despite a series of natural calamities, the U.S economy continued to exhibit an uptrend, delivering 3% in annual growth for Q3 of CY 2017, following 3.1% in Q2 of CY 2017. This makes it's the first 6 month stretch since 2014 in which the US GDP has grown at more than 3% sequentially. Consumer spending, which accounts for 70% of US GDP grew at 2.4%, but encouragingly, non-residential fixed investments grew at 3.9%. Optically, one would have thought these headline numbers would have comforted the Fed in furthering its hawkish stance, but it needs to be seen how much of a given that is; despite delivering on the strongest growth in years and falling unemployment, wage inflation along with real inflation is still weak, as a result of which, a school of thought questions, what if policy error on a rate uptick now is high? In an expected (and out of line) development, current Fed chief Janet Yellen does not get a second term, but it is expected that there will be continuity to her policies – meaning data from inflation & employment will continue to drive decisions. Across the pond however, the Bank of England raised rates for the first time in a decade, by 0.25% to 0.50%, signaling the start of gradual increase in borrowing costs, while the ECB kept rates at 0% and -0.4% for deposits.

Commodities meanwhile continue to hold up and rally, supported by a general return of global growth. Brent crude surpassed $60 for the first time in two years while Copper, Zinc and Aluminum strengthened in the last 2 months, gaining 3.1%, 7% and 2.4% in absolute terms. However, this does not look like the return of the commodity super cycle as yet; the last cycle had China as the black swan, while this time around, it is a much more distributed global effort. A lot of this optimism is perhaps a function of probable future demand, and not really a given. But given the general semblance of global growth, global equities over all continued to deliver well; US equites have gained 15.16% while China, UK, Germany and Japan are up 46.02%, 4.90%, 15.23% & 17.56% this year.

World Markets

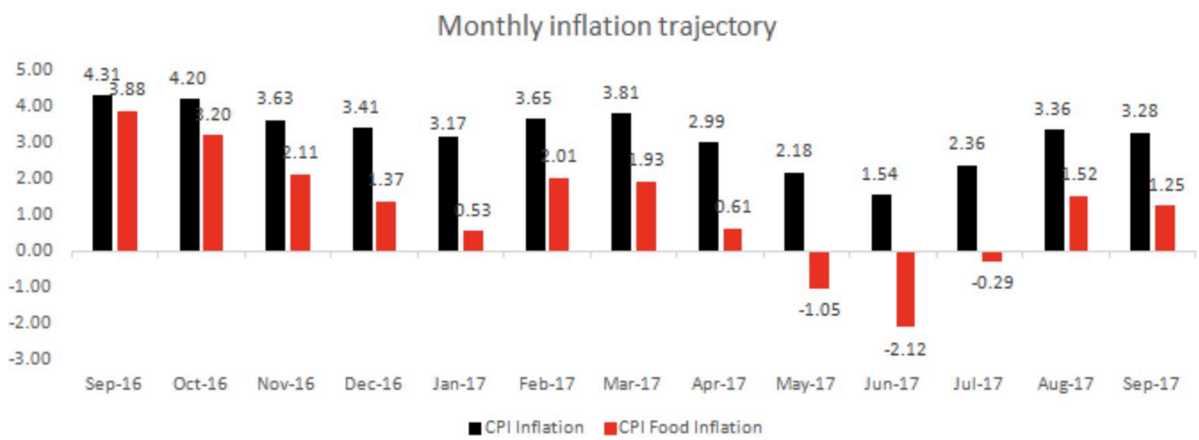
Emerging markets continue to have a good 2017 as the EM index notched another 3.45% for the month and is now up 29.78% for the year.

MSCI (in %)	India	Brazil	Russia	Korea	China	Japan	US	Australia	EM Index	MSCI World
MoM (in %)	7.27%	-3.36%	-2.28%	8.40%	3.96%	4.60%	2.18%	1.42%	3.45%	1.81%
CY - YTD (in %)	31.47%	20.29%	-5.02%	42.77%	46.02%	17.56%	15.16%	10.09%	29.78%	16.31%



India has been among the best performing markets globally with MSCI India up 31.47% in CYTD 2017, helped by a weakening USD.

Inflation falls | CPI @ 3.28% vs 3.36% MoM | WPI @ 2.60% vs 3.24%



Consumer inflation continues to be in control, coming in at 3.28% for the month of September-17 vs 3.36% in the previous month. The food basket that consists of 45% of the CPI index continued to witness moderation, falling to 1.25% for the month, following a month of incline. The new crop post Kharif kept vegetable prices in check over all. Fuel inflation grew by 12%, and rising crude may pose a risk to upsides in the near term.

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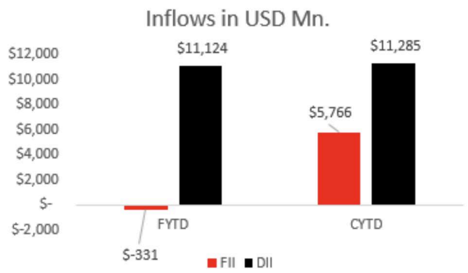
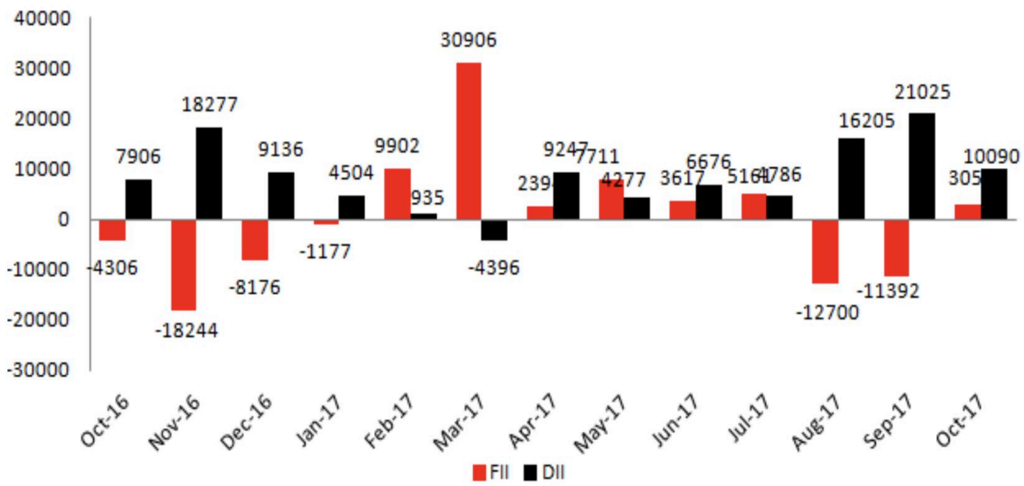
Unifi Strategy

For FY-18YTD (beginning April 2017), inflows from domestic sources at Rs.72,306cr. ($11.12bn) have completely shadowed outflows from FII's (Rs.-2,153 / $-0.33bn).



This represents a tectonic shift in India's household allocation to equities and this time around, perhaps suggesting a behavioral change in asset allocation in place of a tactical play.

The appetite and divergence in FII / Indian Domestic Investors' strategy have been the most pronounced in the last 3 months. Before we jump to the graph below, it may be worthwhile to mention that in 1999, 49% of Americans owned equities vs just 3% in 1980. In 2016 only 3% of Indians' owned equities. We'll leave the rest to your imagination.



While fund flows are a good thing to have, we are cognizant of the dangers of the market discounting liquidity for comfort in place of fundamentals and our bottom up portfolio construction continues to reflect that. Such liquidity results in rapid beta creation but if not led by fundamentals, a sharp reversal to mean has always been the norm.

Word of the Month

The word of the month was undoubtedly 'recapitalization'. As the NPA saga in the PSU banking industry continues, and as experts finally ceased their guesstimates on "asset quality woes are now behind us", the Government surprised with its booster shot of capital. The surprise was not in the policy per se, but the quantum of it – at INR 2.1 Trillion, it constituted about 48% of the PSU Banks's then market cap. While the fine print on recapitalization bonds is yet to be understood, this will go a long way in addressing the sector's capital adequacy constraints, encourage them to make the right provisions, and eventually kick start the lending process. And this this may be an important enabler of India's sovereign rating upgrade, which if it does happen, will loop back to benefit the sector. The imminent and obvious question of asset allocation to PSU Banks is probably on all minds now. While we continue to fine comb the sector for opportunities looking for right kind of risk adjusted opportunities, we believe it is only responsible to act with evidence of fundamental data at a micro level that suit our style of investment management. Besides, one still needs to ask the tough question – are the institutions in question willing to bring in the operating capabilities required to prevent a relapse? The jury on this is anything but definite. But for the record, we like one regional PSU in this space and have been adding that to our portfolios' at levels that are comfortable to us.

Moving on, the earnings season is not fully done as yet, but optically, the results have been more or less as per expectations. There is a lot to be read between the lines on expectations, as coming off a quarter of GST led disruptions, expectations per se were realistic. Unifi's portfolio companies have delivered more or less as per expectations, with minimal surprises so far, but then a bulk of them are yet to announce earnings as yet. In our note to you the next month, we must be able to demonstrate how earnings have delivered at a portfolio level. In any case, the markets are looking forward to H2-FY18, as on a low base of last year (demon, followed by GST), the pace of earnings should be much better than that of last year, and sector leaders should ideally deliver much better numbers.

The narrative around valuations at an index level has been shrilling for a while now and we aren't excessively obsessed with that given how little our portfolio construction draws from a macro top down approach. As a sector, specialty chemicals and polymers continue to dominate our exposure as we continue to find pockets of opportunity there, not so by design, but primary conviction. We continue to like select names in building products, and metal by-products apart from other standalone names in our Green styled thematic fund.

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.

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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

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