Macro, Markets & Strategy review

2017

September

UNIFI INVESTMENT MANAGEMENT

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Global developments

Shrugging off back to back hurricanes, U.S. GDP growth is reckoned to grow at 2.4% in CY 2017 as against 2.1% in CY 2016 as per its central bank projections. The unemployment rate has recently hit a 16 year low of 4.2% while the wage rate accelerated to 2.9%. Inflation is expected to be around 1.6% in CY 2017 closer to the Fed's target rate of 2.0%. After years of taper tantrum to which market has become quite blasé, US Fed is finally starting its exit from the monetary maze it had built to itself since the time of subprime crisis. Through this never attempted before massive monetary normalization exercise, U.S. Fed, starting from October 2017, plans to reduce its $4.5 tn balance sheet to $3 tn by 2020 /21 by a combination of selling the securities held by it in the secondary market as well as not reinvesting the scheduled periodical redemptions of its treasury bond holdings and Mortgage Back Securities. Needless to say, this would trigger the increase in U.S. interest rates which has remained unchanged at 1.25-1.5% for a while. In fact, Fed has guided one increase in this year and 3 more in CY 2018. If the recent uptrend in economic growth and fall in unemployment rate is not sustainable on their own, then the balance sheet reduction could cause stagflation and adversely impact the capital markets. Amidst this, markets will also keenly watch if the current incumbent Fed Governor is given another term in Feb 2018 or it's going to be new blood and course change.

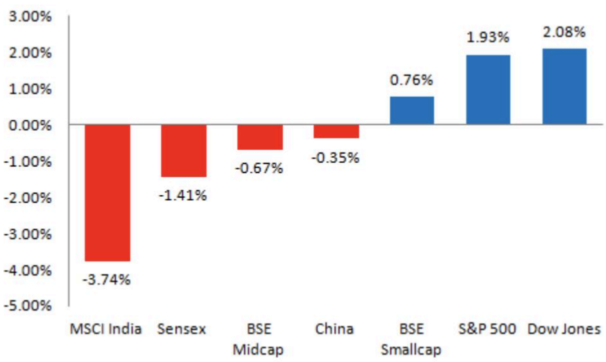
Close on the heels of US, the Euro region also posted a favourable GDP growth of 0.6% in Q2 CY17 vs 0.5% in Q1 CY17, with early signs of stronger growth in Q3 CY17. The Euro area purchasing managers' index (PMI) for manufacturing soared to its highest reading in more than six years. This despite the headwinds due to UK's Brexit related slowdown, risk of default from Greece and adverse electoral results in France. However, the German elections sprung a surprise with incumbent Chancellor Angela Merkel's party suffering some electoral setbacks contrary to expectations of an easy victory. She will now have to lead a coalition government of left wing parties.

The latest assessment by WTO indicates a significant improvement in global trade in 2017 over the lacklustre growth in 2016, backed by a resurgence of Asian trade flows and rising imports by North America. Crude oil hit a 2 year high in September on account of the combined effect of a pick-up in demand, tightening supplies due to production cuts by OPEC and declining crude oil inventories in the US.

World Markets

Emerging markets continue to have a good 2017 though they hit a speedbump of -0.55% for the month after notching 5.5% & 2.0% in the previous two months. The index is now up 25.45% for the year.

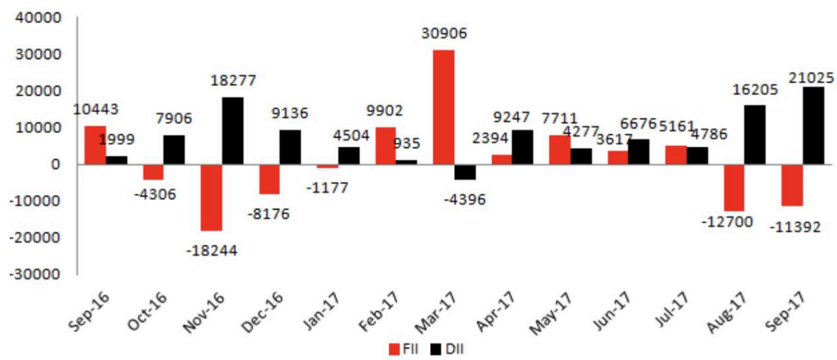
MSCI (in %)	India	Brazil	Russia	Korea	China	Japan	US	Australia	EM Index	MSCI World
MoM (in %)	-3.74%	4.16%	4.32%	1.97%	0.84%	1.27%	1.90%	-1.57%	-0.55%	2.08%
CY - YTD (in %)	22.56%	24.47%	-2.79%	31.71%	40.45%	12.39%	12.71%	8.56%	25.45%	14.24%



India has been among the best performing markets globally with MSCI India up 22.56% in CYTD 2017, helped by a weakening USD.

Inflows abound

For FY18 YTD (beginning April 2017), inflows from domestic sources at Rs.62,216 Cr ($9.57 Bn) has outstripped FII inflow of Rs.-5,209 Cr ($-0.80 Bn) by a wide margin. The rising appetite of Indian households towards equities is increasing the share of financial instruments in the savings wallet of Indian citizens. The 'SIP' book alone has inched to around Rs 5,000 Cr ($ 0.77 Bn) a month which is a record high for the mutual fund industry. Equity mutual funds witnessed inflows of Rs 20,362 Cr ($ 3.13 Bn) in the month of September. However, with earnings expected to be subdued in the near term on account of GST related adjustments, it remains to be seen as to how long the current liquidity surge would persist.



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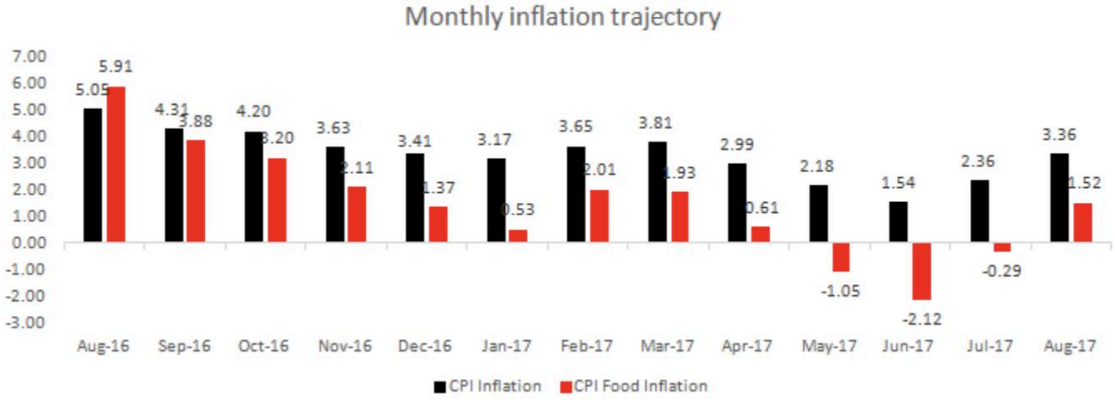
Inflation falls | CPI @ 3.36% vs 2.36% MoM | WPI @ 3.24% vs 1.88%

Consumer inflation continues to be in control, coming in at 3.36% for the month of August-17 vs 2.36% in the previous month. The food basket that consists of 45% of the CPI index rose to 1.52% for the month, following 3 preceding months of decline. Prices are in a range overall and they are not too uncomfortable. An uptick in food prices from here on should not cause alarm as we head into the festive season. And like we have been saying, sustained low food inflation lends a very myopic view of comfort as farm income is a strong driver of consumption, and the broader economy.



RBI Policy- No rate cut: on expected lines

After cutting benchmark repo rates by 25 bps in its August bi-monthly meet, the monetary policy committee chose to maintain status amid emerging inflationary pressures on the back of higher prices of food items and implementation of HRA hikes for Central government employees. The Central bank has thus upped its inflation guidance which is expected to move from 3.4% in Aug 2017 to 4.2% in Q3 FY18 and 4.6% in Q4 FY18. Major upside risks to the same would be increase in salaries by State governments, possible fiscal slippages due to farm loan waivers, other stimulus measures from Central government, GST impact and decline in Kharif production.

Coming to GDP growth projections, the lower growth of 5.7% in Q1 FY18 and lower foodgrain production estimates in Kharif season , together with the prevailing uncertainty over GST have prompted RBI to revise its GVA growth projection from the earlier 7.3% to 6.7% for FY 18. But the bank noted that the firms it surveyed expect an improvement in business sentiment in Q3. The Governor in a separate interview has remarked that MoM improvement in Nikkei India PMI index by over 3% in September combined with a 4.9% rise in core sector IIP in August and robust automobile monthly sales in September point to a sharp economic upturn in Q3 FY18 post the hiccups related to GST implementation.

Unifi Strategy

While much has been written, debated & argued on the reasons behind the lower GDP growth of 5.7% in Q1 FY18, we need to put things under the right context to see the full picture. On the macro front, the country is on a strong wicket with stable inflation levels, fiscal prudence, lower current account deficit and record high foreign exchange reserves. While private capital formation has been stuck for various reasons, the government has loosened its purse strings considerably and the effects of the same will percolate to the overall economy in months to come. About 16,000 KMs of roads have been awarded in FY 17 which is higher than the total length of roads awarded between FY 11-14. Similarly railway related projects like Direct Freight Corridor, Bullet train, Electrification & Doubling of existing lines are being taken up at a rapid pace. Renewable power and Power transmission sectors are witnessing unprecedented investments. Thus, the narrative in the public expenditure continues to be strong.

Coming to the private capex cycle, it cannot be denied that companies are stuck with debt raised at the peak of the previous economic cycle while earnings growth is yet to play out. The demonetization and GST rollout only made matters worse for the industry. But the silver lining among all these gloomy signs are the benefits the economy will accrue from these structural reforms. GST is expected to favour the organized players compared to the unorganized players who have hitherto made good use of the tax arbitrage. This would ensure that organised players would gain market share and thereby bring economies of scale benefit to all the stakeholders. The imposition of Insolvency & bankruptcy code on defaulting companies is another structural change which is reaching a critical stage, as we speak. Errant promoters are now being forced to part with their assets either by equity dilution or outright liquidation. This move would also lead to the migration of valuable assets from weaker hands to stronger players within the segment. Telecom is another sector wherein smaller players are being edged out by strong players leading to consolidation of the market, thus enabling the survivors to invest heavily in future technologies. Banking & Financial services is another segment where we are witnessing the marginalization of weak PSU players by nimble footed, professionally managed private banks & NBFCs. In a nutshell, we are at an inflection point in the economy wherein future growth will hinge on cleaner, meaner & efficient allocation of capital by the private enterprises. This it will lead to a far more robust earnings cycle which would have lower susceptibility to systemic shocks. These reforms are also expected to spread the tax net far & wide thereby giving the government that much more elbow room to expand public expenditure and welfare initiatives.

We would be keenly looking for greenshoots in Q3 FY18 especially given the fact that Q3 last year was heavily impacted by demonetisation. A successive year of normal monsoon, strong festive sales of automobiles, strong growth in rural wages at 5% and improvement in global economic outlook, all point to much better economic prospects from Q3 FY18. In these conflicting times, where mid-term trends are relatively easier to discern and short term macros are mixed, we are choosing to strengthen the fundamentals of our portfolio and steer it with a twin engine –

- Companies with high ROE, low or no debt and reasonable earnings growth prospects typically higher than the valuation ask
- Selected from Sectors that have the maximum tail winds given the evolving global and domestic macros.

We believe that such a disciplined approach would help us to navigate the near term volatility and stay afloat to pace up when the dynamics turns favorable.

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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.

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