Macro, Markets & Strategy review

2016

April

UNIFI INVESTMENT MANAGEMENT

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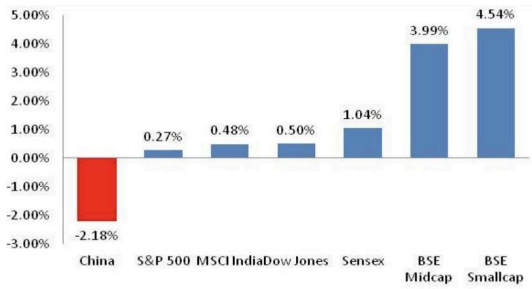
Global developments |Status Quo

Confronted with a record rally of the Yen (up 20% in 2016) and falling inflation (rather, persisting deflation), it was widely expected that the Bank of Japan will continue its expansionist monitory policy. However, despite data underlying continuing economic problems with GDP growth expected to fluctuate around zero in the first half of 2016, there was no further easing of policy. While the BoJ kept its negative interest rate policy (-0.1%) in place and voted to continue with its massive asset purchase scheme, the bank's policymakers refrained from any extra measures to kickstart the stagnating economy. The structurally deflationary imbalance of the Japanese economy would probably stand out with the following fact: large Japanese conglomerates continued to hoard cash, now holding close to ¥250 trillion ($2.2 trillion) in cash, a massive 50% of GDP! As a result, capital investment by firms is 7% below its level eight years ago and the gap between corporate cash flow and investment is at record high levels. The BoJ Governor was asked to justify his negative rate policy to the Japanese parliaments as many as 30 times this year, and that may have in part resulted in a pause! Meanwhile, the US Fed also maintained status quo on interest rates, holding them at 0.25%. The commentary that read, "the committee expects that economic conditions will evolve in a manner that will warrant only gradual increases in federal funds rate" could be interpreted either ways, and is one that creates enough wriggling room for the Fed given the low pace of US economic recovery. The US economy witnessed the slowest pace of growth in two years as consumer spending softened and a strong dollar continued to undercut exports, resulting in Q1CY2016 growth of just 0.5% vs 1.4% QoQ.

May be it is time to just reconcile to the fact that poor economic growth is the new global order. The IMF, has cut its economic growth outlook for 2016 for the 4th time in a year citing low oil prices and chronic demand weakness in the advanced economies. It now expects global growth of 3.2% vs forecasts of 3.4% earlier. Brazil & Russia are in recession, South Africa is barely growing, China is in a structural slowdown, and India is, well, the one eyed king in the kingdom of blind.

After smart recovery in March, consolidation in April

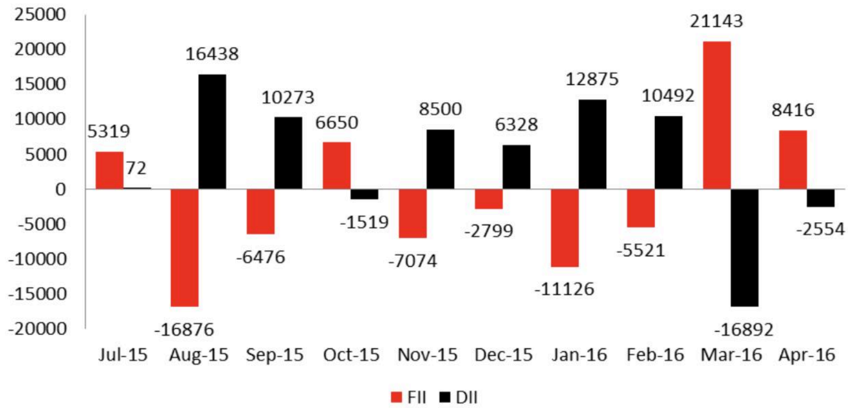


- Dow Jones was up 0.50%
- S&P 500 was up 0.27%
- Shanghai was down 2.18%
- BSE Sensex was up 1.04%
- BSE Mid-cap was up 3.99%
- BSE Small-cap was up 4.54%
- MSCI India was up 0.48%

MSCI (in %)	India	Brazil	Russia	Korea	China	Japan	US	Australia	EM Index	MSCI World
MoM (in %)	0.48%	10.15%	7.77%	-0.44%	-0.21%	4.64%	0.38%	2.83%	0.41%	1.38%
CY - YTD (in %)	-2.44%	40.32%	24.65%	4.35%	-5.00%	-3.02%	0.77%	3.66%	5.80%	0.48%

After FII liquidity left Indian markets for most of last year and Domestic Indian funds sustained buying, the inverse that started in March continued in April as well; FIIs continued to come in and DIIs continued to book some profits.

As you can see below, the 'reds' are clearly holding up the markets.

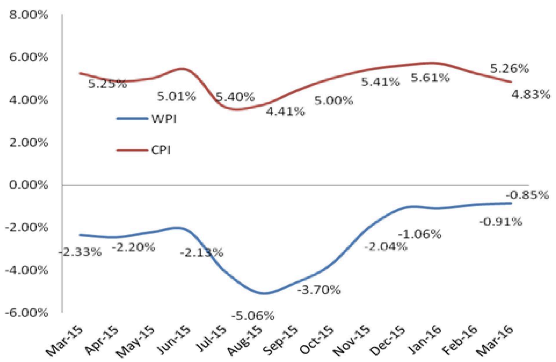


Monthly Macro Review

Cooling inflation | CPI @ 4.83% vs 5.26% MoM, WPI still in negative territory @-0.9% vs -0.8%

In this hot Indian summer, a constantly cooling consumer price inflation trajectory has largely been the only macroeconomic constant in India. Consumer price inflation for March 2016 dropped sharply to 4.83% vs 5.26% month on month. While a fall was expected, breaking into the psychological sub 5% range was helped by a more than 50%, 20% and 10% fall in Fruits, Vegetables and Pulses basket, that soared following the last season's drought in India. Sugar price however soared sharply, led by globally speculative reasons, as India's sugar inventory remained more or less reasonable.

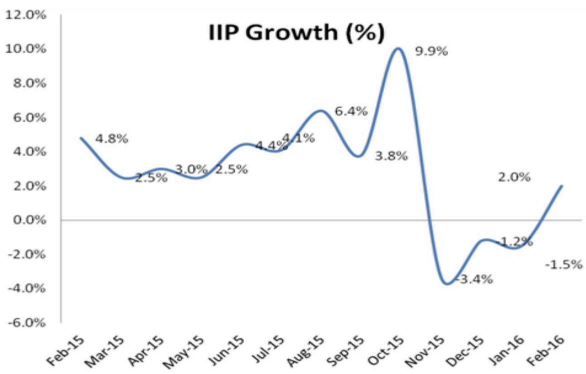
Weight	CPI	Dec-15	Jan-16	Feb-16	Mar-16	MoM
45.9%	Foods & Beverages	6.31	6.66	5.52	5.27	-4.5%
2.4%	Pan, Tobacco & Intoxicants	9.27	9.03	8.39	8.51	1.4%
6.5%	Clothing n Footwear	5.74	5.85	5.52	5.5	-0.4%
10.1%	Housing	5.06	4.86	5.33	5.31	-0.4%
6.8%	Fuel n Light	5.45	5.32	4.59	3.38	-26.4%
28.3%	Miscell	3.95	3.95	4.38	4.01	-8.4%
100.0%	CPI – Inflation		5.69	5.26	4.83	-6.8%
	CPI – Food		6.85	5.30	5.21	-1.7%



If current year's monsoons are supportive, and crude does not reverse sharply, RBI's March 2017 CPI target of 5% does not seem implausible, and this bodes very well for India's short to medium term interest rate trajectory.

The deflationary trend continued for the 17th month in a row now, with WPI coming in at -0.85% vs -0.91% MoM.

Index of industrial production (IIP) | Rises to 2.0%

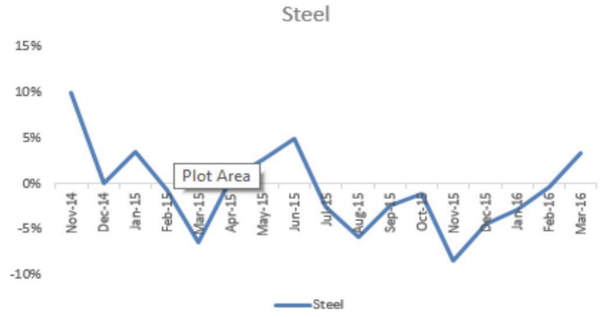


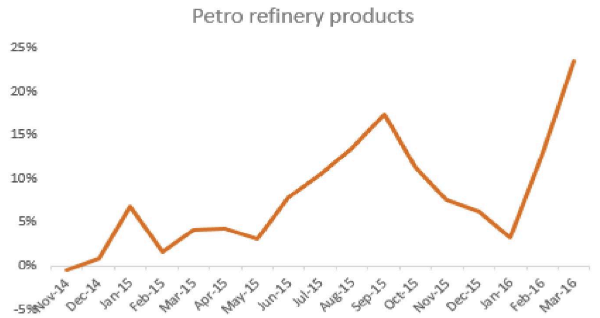
After three months of consecutive degrowth of -1.5% vs. -1.2%, IIP for February came in at 2%, largely driven by Electricity that grew by 9.6% for the month. Electricity has a weight of 10.32% in overall index. Core Manufacturing, which has a weight of 75.52% also grew at 0.7% while Mining with a 14.16% weight grew 5%. For the year to date up to February 2016, IIP growth was at 2.6% YoY. 16 out of the 22 industries, accounting for 80% of the index recorded growth.

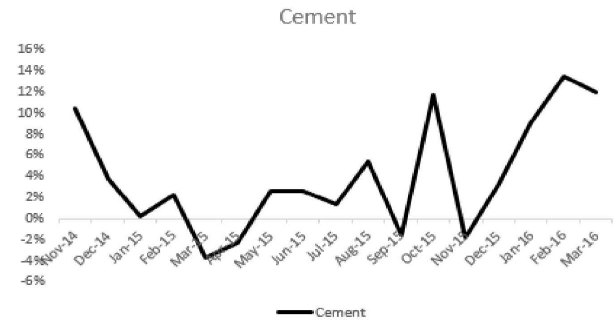
Unifi Strategy

Good tell-tale signs

Our regular readers will recall how over the past 1 year we have argued that only a broader pick up in the investment cycle will drive markets structurally. While we cannot conclude that the structural U turn is certain, and climbing north, what we can however point to is the tell-tale signs of change. We point to the following growth rates in a few key sectors – Steel, Cement, Petro products and Commercial Vehicles - that are real activity indicators for growth in the industrial economy







You will notice that the March -2016 ending period has witnessed a steep upward reversal in all the above key industrial categories. Apart from what the above graphs are suggesting, our secondary research also suggests a slight betterment in demand for several core product categories. While the economy is still fighting the effects of two uninterrupted and failed monsoons, a global slowdown and poor private capex spending, we believe the economy is looking forward to investing for the next cycle of growth.

We also note that incremental budgeted spending in FY17F by just two ministries — Roads and Railways — at INR600bn compares rather favourably with credit growth of 10.7% by the banking system in FY16. We are inclined to believe that the trickle down effects of Government capex is starting to lead the overall capex spending cycle. Potentially favourable monsoons this year and additional spend in the economy by way of pay commission awards may add to this recovery later this year. As that happens, the likelihood of a follow through pick up by the private sector will increase, and thereby sustain this recovery. Fingers crossed.

Meanwhile, the commentary from the ongoing earnings season for Q4-2016 has been a tad better than the previous few quarters, although we will have a better sense of the same only this month as the smaller companies that feed b2b consumption in India declare their numbers. But either ways, this is a stock specific market and there is no one-brushpaints-all sector. For instance:

- BFSI: PSU Banks along with aggressive newer age private banks ICICI Bank and Axis still continued to comment on stressed lending while the retail focused Banks and NBFCs continued to report good growth
- IT sector: While Infosys conveyed positive momentum in revenues as well as margins, peers Wipro and HCL Tech were not as vocal; sector leader TCS is facing challenges from its high base
- Auto: two wheeler players are talking about a much improved high single digit volume growth number vs the flat year just gone by while Tractor players are looking at a double digit growth number after 2 years of weak off-take. Interestingly, the midst of the positivity, Maruti is also looking ahead for to a season of double digit growth vs that of single digit guided earlier.

Once the earnings season ends this year, we should be in a position to communicate what the earnings outlook for FY17 looks like, coming off a 5-6% kind of earnings growth rate for FY-2016. Our initial feel is that it will incrementally be a much stronger number.

The broader markets will continue to be stable 'if' the resurgent commodity prices don't give up their recent gains (WTI Crude up 20% & Iron Ore up 7% in April), helping the broader EM basket. However, a sustained and north bound growth in markets can only happen with earnings are upgraded and like we said, we expect that number to be good for FY-2017. While we are closely taking cues from the macro's, our strategy continues to be that of a sector agnostic, focused, bottom up approach and alignment with companies that exhibit strength at a firm level, with strong earnings growth outlook for the short to medium term while maintaining balance sheet discipline.

Over the past few quarters, we have increased our exposure to the specialty chemicals industry, the opportunities being strictly bottom up and we continue to believe that opportunities still exist. We continue to like the Auto space given the resurgence of broad based demand in the sector along with select names in the mid cap space across pharma, NBFCs etc. We continue to maintain an 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, and not hesitating to book profits where valuations have exceeded its margin of safety.

Risk: Key risks to our portfolio would come from geo-political concerns globally, decline in foreign inflows, sharp currency movements, Fed 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

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