Macro, Markets & Strategy review

2017

February

UNIFI INVESTMENT MANAGEMENT

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Global developments | A Fed rate hike in the offing

The Fed has now more or less indicated to a hike in interest rates in its next meeting in mid- March, citing the fact that employment and inflation are evolving in line with their expectations. The Fed has set itself a forecast of three rate hikes in 2017 and with the US economy's inflation, measured by private consumption expenditure (PCE) reaching 1.9% and unemployment at 4.9%, the FED has the numerical reasons to act on the first of its raises shortly. As a reminder, the US Federal Reserve believes that PCE inflation at 2%, along with unemployment at 4.5 to 5% indicate a stable state of being in the economy. It is however important to note that these numbers should be seen in the context of how they are moving structurally; so what matters is not the absolute level of where economic indicators are, but the Fed's collective judgement of how they are evolving and it is in that respect that the Fed believes that things are indeed getting better. Irrespective, the Dow definitely believes that things are better as the DJIA gained 4.77% for the month, and is now up 5.31% for 2017. Placebo effect?

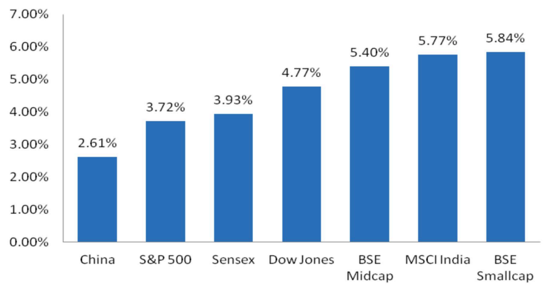
Over all, global growth seems to be looking good as well, reflected in the fact that the global manufacturing PMI reached a 69-month high in February, backed by expansionary forces in the US, the EU and China. These tailwinds imply that the risks of a Fed rate hikes are minimized, giving the Committee sufficient headroom to hike rates. With global news flow seemingly settled, the next bout of negativity will perhaps come from the political developments in France that is headed for polls the next month, in April. This is news because the contender Ms. Marine Le Penn is a border line Euro separatist, having promised to conduct a referendum in line with their neighbor within 6 months of assuming office on whether to leave the EU or not. France is much wiser with the template seen next door, but should the French hint at leaving, the European markets led by the Banking sector will have years of economic, regulatory and compliance related complications to deal with and that cannot be good for world markets.

World Markets

Emerging markets continued to have a good 2017 as the EM index notched another 3% for the month and is now up 8.6% for the year.

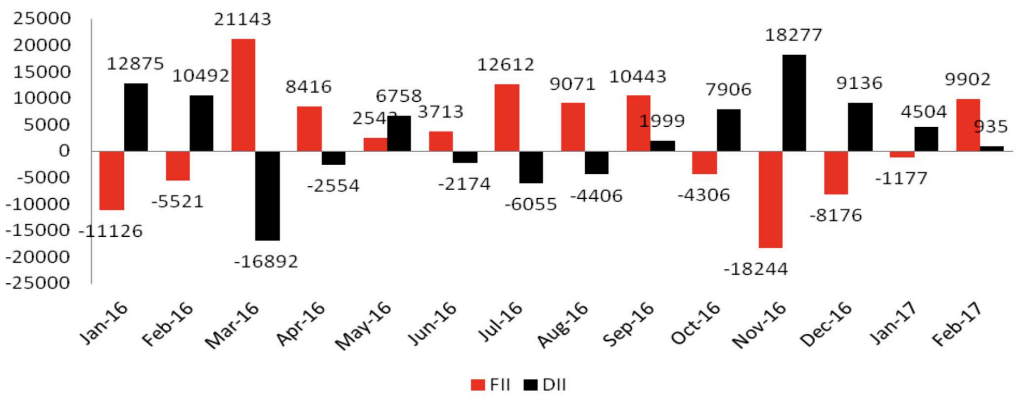
MSCI (in %)	India	Brazil	Russia	Korea	China	Japan	US	Australia	EM Index	MSCI World
MoM (in %)	5.77%	4.01%	-6.35%	3.02%	3.54%	1.09%	3.69%	3.06%	2.99%	2.58%
CY - YTD (in %)	10.36%	15.04%	-6.61%	10.92%	10.58%	4.84%	5.73%	7.46%	8.59%	5.00%

India has been one of the best performing markets globally with MSCI India up 10.3% in CYTD 2017.



- S&P 500 was up 3.72%
- Shanghai was up 2.61%
- Dow Jones was up 4.77%
- BSE Sensex was up 3.93%
- BSE Mid-cap was up 5.40%
- BSE Small-cap was up 5.84%
- MSCI India was up 5.77%

Trend Reversal | After a slew of exits from October 2016 to January 2017, the FII's reversed momentum and turned net buyers, investing Rs.9900cr or USD1.4Bn for the month of February 2017. Given the absolute quantum of inflows or otherwise, we believe that the relevance of DIIs to Indian equities relative to FIIs have been increasing, guarding Indian markets from swings of volatility.



Inflation continues to falls | CPI @ 3.17% vs 3.41% MoM | WPI @ 5.25% vs 3.39%

Consumer inflation continued with its deflationary trend in 2017 as the CPI food basket fell by 61% month on month. The fall was across almost all food categories, except oils and fruits. May be the effects of demonetization is still being felt on the ground as curtailed money supply is suppressing the pricing of perishables and consumer demand in general.

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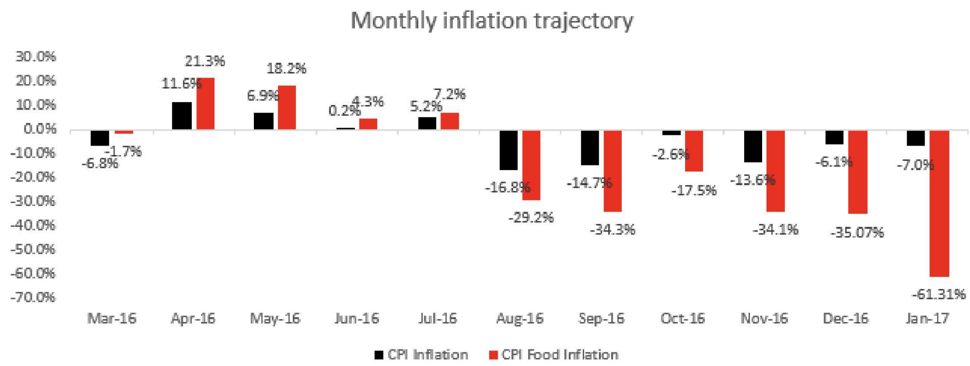
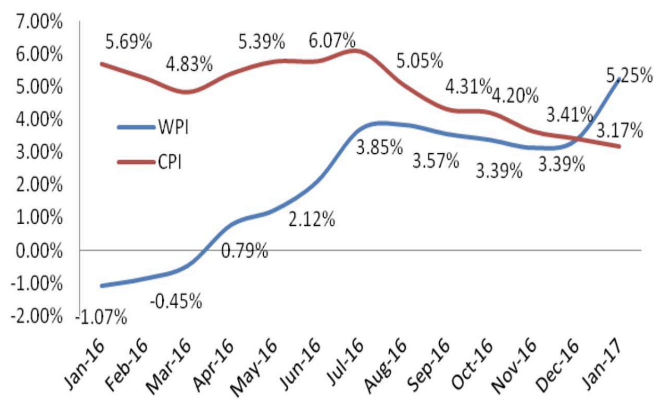


Over all, this is the 6th month of CPI contraction and as the above chart suggests, the magnitude of the fall has been steep. The overall glide path in the context of RBI's CPI target of 5% by March 2017 has already been achieved and the RBI will now track its 4% target by March of 2018. However it is not a given if this will translate rate cuts as the RBI is also cognizant to global currency and interest rate developments.

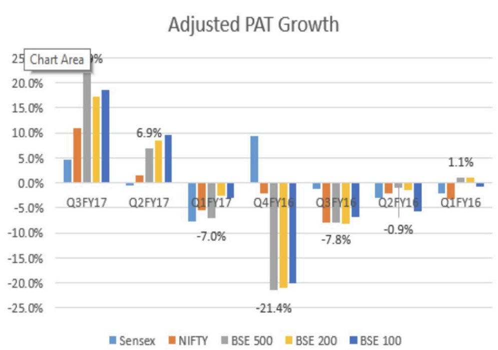
Wt	CPI	Jul-16	Aug-16	Sep-16	Oct-16	Nov-16	Dec-16	Jan-17	MoM
45.9%	*Foods & Beverages*	7.96	5.83	4.12	3.71	2.56	1.98	1.29	-34.8%
2.4%	*Pan, Tobacco etc*	6.83	6.86	6.82	7.09	6.29	6.39	6.36	-0.5%
6.5%	*Clothing Footwear*	5.23	5.21	5.19	5.24	4.98	4.88	4.71	-3.5%
10.1%	*Housing*	5.42	5.29	5.18	5.15	5.04	4.98	5.02	0.8%
6.8%	*Fuel n Light*	2.75	2.49	3.07	2.81	2.80	3.77	3.42	-9.3%
28.3%	*Miscellaneous*	4.01	4.18	4.51	4.58	4.83	4.73	5.06	7.0%
100.0%	*CPI -Inflation*	6.07	5.05	4.31	4.20	3.63	3.41	3.17	-7.0%
	Change	5.2%	-16.8%	-14.7%	-2.6%	-13.6	-6.1	-7.0	

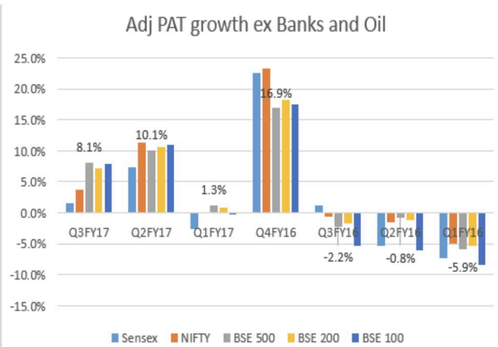


WPI for December 2016 came in at 3.39% vs 3.15% MoM. Disinflation was seen in food as well as nonfood articles MoM. Within food, lower prices were seen in pulses, vegetables and fruits. Manufacturing inflation was up by a marginal 0.06% MoM, 5/12 (vs 7/12 last month) manufacturing industries recorded higher prices. Similarly, fuel inflation also rose up by 0.7% MoM.

Unifi Strategy

Contrary to perception and intuition, the earnings for Q3 FY17 came in much stronger than most expectations. The adjusted PAT numbers for a broad number of indices ranging from the Nifty to BSE-500 are as below.





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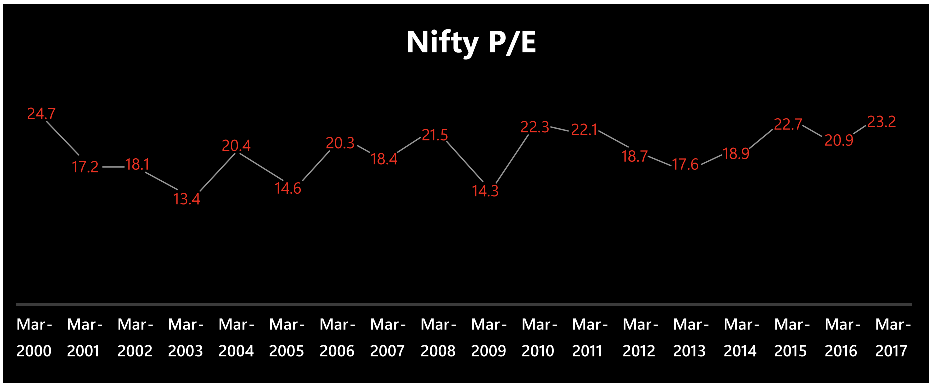
The numbers shown in % in the graph refer to the adjusted earnings numbers of BSE-500.

From all the commentaries, the take away is that while consumer facing companies saw the impact of demonetization, the impact was not as bad as feared and normalcy is returning at a fast clip. As the base is reset, earnings for Q4 of FY17 may see downgrades but the gist is that it is not structural. The markets have however continued to ignore the prospect of the carryforward effect of this along with a growth slowdown in Q1-FY18 (due to GST) & the Nifty PE has steadily inched up from 21.9x in Dec 2016 to 23.2x in the first week of March, up 6.1%.

As per the NSE, which discloses Nifty PE on a trailing 12 month basis, we are almost at the top end of the PE band now.

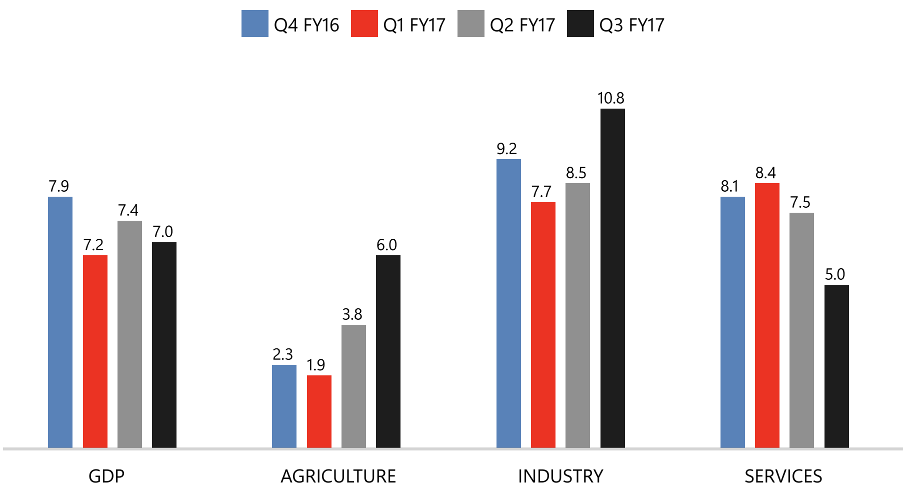


It is important to note here that a bulk of the movement in CY 2017 (in the past 2 months, benchmark Nifty and Sensex are up 8.4% and 7.9% respectively) has been led by a series of one offs and events that may only have a long structural influence, with little or no earnings impact for the short to medium term. For instance, non-earnings led developments such as buy backs in the IT sectors and price developments in the telecom sector have had a positive sentiment effect on firms irrespective of the fact that both sectors face immense earnings headwinds. As a representative example:

Particulars	Feb - MTD	CYTD' 17 R	Reason
Reliance Industries	18.7%	14.6%	Decision to commence charging for Jio from April'17
Bharti Airtel	5.0%	19.6%	Acquisition of Telenor/ Decision to divest holdings in Ghana
Idea	4.8% 5	56.1%	Discussions for merger with Vodafone
TCS	10.6%	4.4%	Rs.16,000cr. buyback, amounting to div yield of c.3.2%
Tech Mahindra	10.6%	2.3%	Acquisition of a US based IT services provider in healthcare
Infosys	8.9%	0.2%	Announcement of decision to consider buy back

The combined weights of these stocks in Nifty is about 20% and they helped in a weighted average move of roughly 2% for the month out of the 3.7% for the month.
The point we are trying to drive home is that the quality of factors driving stock movement (though sector specific) is not related to their immediate earnings and fundamentals and we may not have reasons for such euphoria to sustain. In parallel, as FII inflows make their way back into India after a 4 month break, the headline benchmark stocks continue to get expensive. For instance, Nifty private banks such as Axis, HDFC Bank, Indusind & Yes Bank, are up between 12.5%-25% between them and we suspect they are so due to ETF additions.

A few positives that are happening at the macro level that is probably supporting the resilience is that of strong GDP and falling unemployment. GDP for Q3-FY2017 rose by 7% vs. 7.4% in Q2 and 6.9% in Q3FY16 while private consumption spending picked up surprisingly faster to 10% (at 17-quarter high) vs. 6% in Q2 and 7% in Q3FY16. Government spending expectedly remained robust at 17% vs. 13% in Q2. Gross Fixed Capital Formation (investments) growth also picked up, against expectations, to 3% at 4-quarter high.



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Another interesting facet that came out this quarter was falling unemployment rates - the unemployment in India fell almost 50% from 9.5% in September to 4.8% in February with Uttar Pradesh registering the sharpest decline. Obviously the Government's efforts in providing new employment opportunities in rural areas vis MNREGA has been working well as household allocated work under MGNREGA, increased from 83 lakh households in October 2016 to 167 lakh households in February 2017. Moreover, the number of works completed under MGNREGA increased by a whopping 40 per cent to 50.5 lakh in 2016-17 compared to 36.0 lakh in 2015-16. This is an important development has it will do its bit to push consumption on the ground and improve money circulation.

So while the macro's swing, and select stocks move based on news flow or ETF allocation, and domestic liquidity continue to pump up the headline benchmark, we believe India continues to be a bottom up stock pickers market more than ever. As we scan the investable universe deeper, we continue to be enthused by the value we see in select opportunities, that is a quantum of earnings growth that is favorably aligned to valuations and we continue to monitor the same more than ever in our current portfolios. As pockets of valuation excess build up, our cash levels in portfolios may rise and we are comfortable with that as we firm deployments against value. Our continuing research into the Green industry remains positive and we are enthused by opportunities in the renewable energy and waste management space. As GST, power reforms, infrastructure spending etc. continue, and growth picks up, our focus on sector leaders and organized players will continue as we believe they will benefit disproportionately from the consolidation of the organized industry. It is however imperative to note that the quarter of GST (Q1-FY18) is likely to see softness in earnings as the industry adjusted slowly to new paperwork.

To repeat what we have said earlier, like in any trending marked, the culmination of what will eventually be is now resulting in PE's inching up in spite of earnings suffering hiccups for a period of 2-3 quarters in the interim. We continue to like select names in private banks, NBFC's, specialty chemicals, and select b2b players who offer a rate of earnings growth that is attractive relative to their valuations. As markets move up we are not hesitating to book profits where valuations have exceeded its margin of safety. In the meanwhile, as valuations across sector move up considerably, it is fair to expect that the timelines the broader index will take to deliver on absolute earnings will be high, and in the mean while we are likely to pay a premium for earnings visibility and growth, especially for firms that have a track record of strong balance sheet discipline and high capital return ratios.

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