Macro, Markets & Strategy review

2018

February

UNIFI INVESTMENT MANAGEMENT

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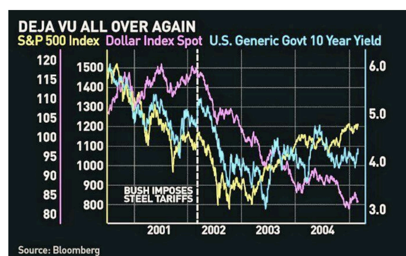
Global developments

As an after effect of an easy monetary regime & expected impact of the $1.5 trillion cut in taxes, the US economic outlook has started to look up & there are a few indicators supporting the same. For instance, a 2.9% increase in average hourly wages for January and an unexpectedly strong 0.5% monthly gain in the consumer price index point to a much better demand environment. While at the industrial level, a pick up in the volumes of class 8 truck orders (up by 76% YoY for Feb) indicate a healthy environment for movement of commerce on the ground. A combination of these factors mean that inflation can head closer to the Fed's target rate of 2% which it has been targeting since 2009. On the back of this comfort, the Fed is expected to raise benchmark rates to around 2.8% as against current levels of 1.25% - 1.5%.

Meanwhile in a material protectionist development, the US is stated to impose tariffs of 25% and 10% on steel and aluminum imports respectively. If this goes through, it could lower profits for every company that remotely consumes the metal, be it trucks or cans, resulting in higher prices for consumers. While they may not neutralize the impact of the tax cuts, and have a marginal impact on earnings, it may trigger a potential trade war among commodity exporters and key US allies - Canada, the EU, Australia, Mexico and China. The key justification to this move is the existing trade deficit of US on the global front and how these measures are needed to support the US workers and industry. We have a similar case study in the year 2002 when the Bush administration imposed tariffs on Steel imports. This lead to stocks and dollar slipping and yields on 10-year treasury almost halved post this because of retaliatory measures by trade partners. We have highlighted the same for you in a graph below.



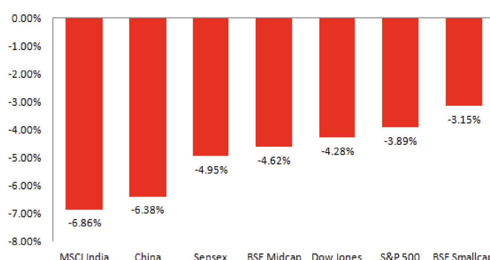
Though the direct impact on Indian exports of steel and aluminum imports is expected to be minimal, as steel exports to US account for only 2% of production, the potential impact on other trade partners like Canada which contributes 16- 20% of US imports, and the European Union which is facing a steel supply gut can be big.

Overall February remained weak for the global markets and this fall should be seen in the context of the rapid, and perhaps, unexplained ascent the global markets experience in FY17. For February 2018, the Dow, S&P 500 were down by 4.28%, 3.89% respectively. Though economic fundamentals the world over the looking better, the markets seems to be factoring in steeper interest rates. And with skittishness around the break out of trade wars, the sentiment has been fundamentally poor. If inflation in the US hardens faster than anticipated, we may see multiple rate hikes this year and that could well weigh on fund flows into emerging markets like India.

World Markets

Emerging markets had to be content with a modest February which saw a decline of -4.73% after the good start in January 2018. This was a mix of hardening USD and equities losing steam due to inflationary fears and also compensating for the euphoria and rise in the markets during CY 2017.

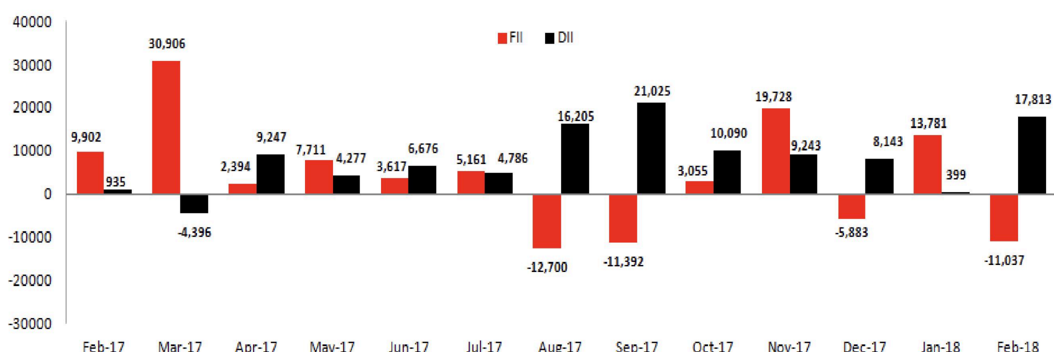
MSCI (in %)	India	Brazil	Russia	Korea	China	Japan	US	Australia	EM Index	MSCI World
MoM (%)	-6.86%	-2.75%	0.93%	-6.56%	-6.41%	-1.54%	3.87%	-4.18%	-4.73%	-4.30%
CY-YTD (%)	-3.69%	13.53%	13.57%	-3.22%	5.28%	2.97%	1.54%	-1.35%	3.17%	0.69%



- MSCI India was down 6.86%
- China was down 6.38%
- Sensex was down 4.95%
- BSE Midcap was down 4.62%
- Dow Jones was down 4.28%
- S&P 500 was down 3.89%
- BSE Smallcap was down 3.15%

Liquidities flow in India

DII's returned in month of February 2018 as principal buyers whereas FII's turned net sellers for the month which was in contrast with their activity in the month of January 2018. Barring knee jerk reactions, we continue to believe that the relevance of DIIs in Indian equities relative to FIIs has increased by the year and will continue to do so.



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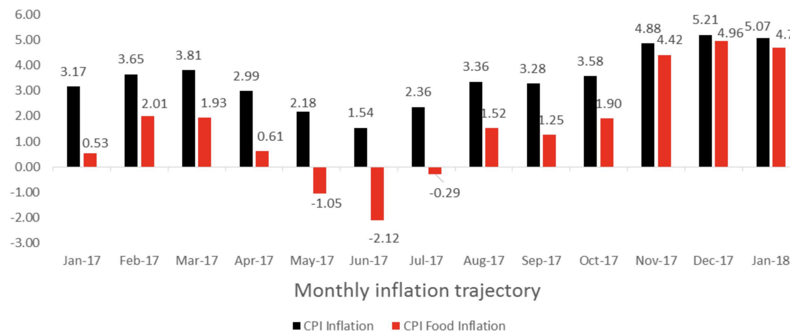
Monetary Policy expected to be Neutral to Hawkish



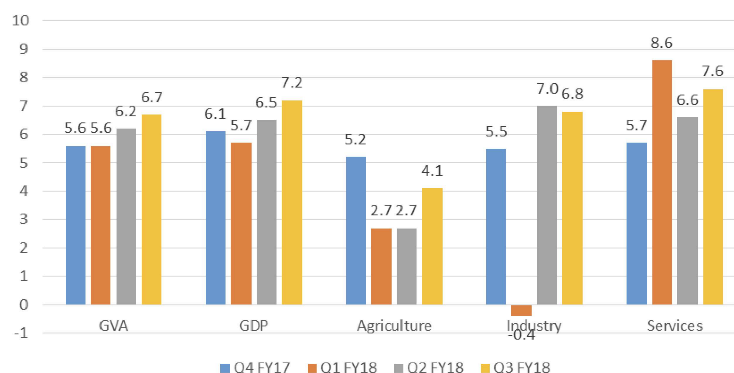
Consumer inflation came in at 5.07% for January 2018 rising from already strong base of 5.21% in December 2017. January 2018 witnessed a 26% YoY rise in the price of vegetables, 8.7% rise in price of eggs which was partially compensated by a 20% drop in the prices of pulses and products as a result of which, the food inflation ended up marginally lower at 4.70% YoY (as against 4.96% in December 2017). The overall inflation spike was however much higher at 5.07% YoY on account of inflation in pricing for housing coming in at 8.33% and Fuel and Light at 7.33%. Obviously CPI at 5.07% is significantly higher than the RBIs target of 4%. Though the RBI chose to keep the base repo rates unchanged at 6% in its first policy meeting for 2018, given the prospects of marginally higher than expected fiscal slippages, we should expect RBI stance to be Neutral to Hawkish in its monetary policy going forward and we should not be surprised with operating in a marginally higher interest rate regime going forward. This cannot be too good news for the markets, unless it happens in the back drop of stronger than expected GDP growth. The GDP expectations for the coming year are at 7.2%.

GDP Growth Revival : Improvement in Gross Fixed Capital formation a key factor.

Q3FY18 GVA came in at 6.7%, led by higher services output: Agriculture at 4.1% YoY growth fared better than expectations on already high base of Q3 FY17 where a growth of 7.2% had been registered, though the problem of raising farmer incomes still remains a challenge on the ground. Industry growth came in at 6.8% and services at 7.6%. Manufacturing fared well while mining growth fell substantially to a multi-quarter low. Within services, the construction sector picked-up after many quarters at 6.8% which was the real positive surprise; it seems that the government spending on roads and infrastructure projects is finally showing up in these numbers. Trade, hotels, transport & communication was stable at 9%; financials, real estate and insurance growth remained stable QoQ at 6.7%, however, a weak base from last year, supported these numbers. Non-agriculture GVA growth stood at 7.3% (5-quarter high) vs. 6.7% last quarter.

Q3FY18 GDP at 7.2% – led by higher Gross Fixed Capital formation (GFCF): Private consumption at 5.6% was lower than last quarter's number of 6.6% while Government spending improved to 6.1% vs. 2.9% in the last quarter. However, the real kicker was on GFCF (investments) where growth surged to 12% vs. 6.9% in last quarter and sharp improvement is expected for the 4th consecutive quarter as a result of the government's spending on infrastructure projects.

The consensus is broadly constructive on GVA expectation of 7.0-7.5% for FY-2019. However, strong GDP data along with inflationary pressures due to measures taken by the government to accommodate higher farm incomes and expectation of marginally higher slippage will keep the RBI's stance more on the hawkish side.



Unifi Strategy

We are in middle of an intermediate correction which is playing out on account of excesses on the valuations front and we need to digest a part of this keeping in perspective the superior returns the markets delivered in CY 2017. A consolidatory phase is crucial before moving ahead. On the domestic front, the issues of limited manoeuvrability on the monetary front and un-ending asset quality issues with public sector banks remain the primary concerns whereas global issues like protectionist policies may hinder the progress of global trade. Domestic and international markets need to deal with these issues. However, despite these challenges we expect the major consumption led companies to do well. While the BSE Sensex slipped 4.95%, quality stocks in the mid cap space lost around 10% and the basket of stocks that seem to have been impacted the most are banks and commodities. The reason for this sector specific valuation diminution in the case of banks has been largely related to the hit they had to take because of increase in treasury yields and also the higher provisions put out for covering for the non-performing assets which continues to haunt their profitability. While we assumed that the turn of the commodity cycle meant well for their lenders, the Gems and Jewellery sector opened up a new can of worms. In the mid-cap basket, instances where valuations discounted future years earnings significantly, have witnessed a reversal to more rational levels.

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We continue to use the declines in markets to add to positions in names we like fundamentally, as and when opportunities present themselves. However, we have noticed that for stocks with the framework of good earnings growth, good and consistent capital return ratios and good to improving balance sheets the corrections have been mild, and patience is warranted to build meaningful positions in them at the right valuations.

Like we said last month, except IT and Pharmaceuticals, almost every other sector rallied hard in 2017. Till January 2018, companies with lumpy growth and of limited quality saw returns that could not be explained by underlying earnings and fundamentals. As expected valuations of such companies have experienced significant declines.

So, what are we doing?

India has been in the midst of an earnings recovery cycle that was temporarily stalled due to the impact of GST in H1 of FY18. However, for Q3-FY18, ex-Banking, the earnings have been good. With the base effect of demonetization aiding growth across consumption themes, FMCG, Auto, and Building materials did well and this performance is largely expected to extend into Q4 FY18. Chemical companies have positively benefited from the environmental and regulatory pressure on their Chinese competitors and this tailwind is expected to continue driving their earnings growth at least for the next 2-3 quarters. NBFC's seem to have put up a decent performance despite the bad performance from their banking counterparts. The global IT environment seems to be getting more conducive and FY19 is expected to be a far better year.

The following table showcases the earnings trajectory of the broader BSE 500 for companies for Q3 FY18:

Segments	Revenue Growth	EBITDA Growth	PAT Growth
BSE 500	10%	4%	5%
BSE 500 (Excluding Banks)	12%	19%	20%
Auto	19%	25%	22%
Chemicals	9%	17%	46%
Banks	1%	-20%	-150%
NBFC's	13%	17%	20%
Capital Goods	5%	11%	19%
Building Materials	21%	20%	22%
Pharmaceuticals	5%	10%	0%
Metals	23%	24%	43%
FMCG	12%	16%	29%
IT	6%	1%	8%

Rolling ahead into FY-2019, it is probable that earnings growth for the broader benchmark will be higher than the mid-to high teens and this can broadly support benchmark valuations. Street estimates expect earnings growth in the mid 20's, while we believe a number close to 20% is realistic. Though a steep correction might not be a high probability, a time correction of 2-3 quarters cannot be ruled out.

The larger conclusion is that India remains a bottom up stock pickers market and we continue to look for stock specific opportunities. As GST, power reforms, infrastructure spending, measures to boost rural incomes, etc., continue, and growth picks up, our focus segment of sector leaders and organized players will continue to do well. We continue to like select names in 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. While disciple always was, patience will also now be a key virtue. Across each of the strategies that Unifi manages, the endeavor has been to closely track and create a universe of firms that are in the midst of earnings growth and available at valuations that are at a margin of safety relative to growth. We have practiced this for long and will continue to do so in the future.

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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