Global developments | A lot happened

An unprecedented Trump rally that gripped the U.S towards the beginning of 2017, following the promise of a USD 1 Trillion capex to rebuild America's infrastructure, continued almost unabated for the whole year. The Dow Jones Industrial average gained 25%, while the S&P 500 followed at 19%. These are the best ever numbers over the past four years and the much-feared reverse trade in equities, should rates harden, did not materialize. The Fed increased rates three times in 2017, all the while continuing to be wary of a pick-up in inflation. US GDP picked up well in the latter half, touching an annualized rate of 3.1% and 3.2% for Q2 and Q3 of CY-17, vs 1.4% and 3.5% YoY. In a significant other development, tax policies saw a drastic revamp with large corporations now stated to enjoy a material cut to their rates – down to 21% vs 35% with the expectation that this will translate to better reinvestments or flow back to stake holders and enable better consumer sentiment. This development gave a further fillip to American equities towards the fag end of the year, which, in early 2018, continues to march up.

The US Dollar however did not have a great year. The dollar index, which benchmarks the greenback against a basket of six global currencies, fell 10% to 92.1% as the Euro and the Pound strengthened significantly, with their respective economies looked up. Besides, the USD's own weakness came from the fact that the hikes in interest rates were not as steep as anticipated. As a reminder, in CY 2016, the dollar index was at a 14-year high, appreciating against all global currencies.

The ECB continued on its path of easing, with the firm intent of an accommodative stance for as long as required. This could mean all of 2018; though the economic indicators including growth - are starting to look better.

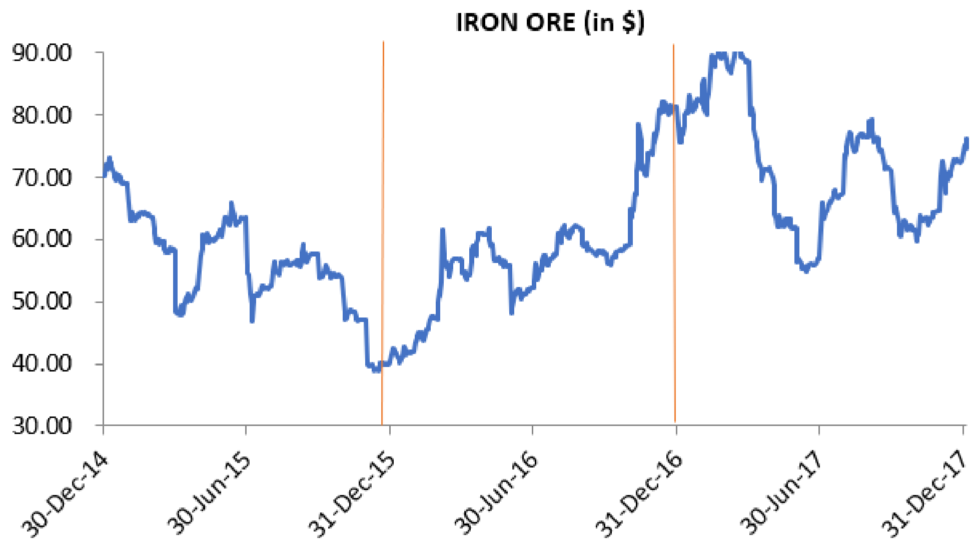
Meanwhile, China is unlikely to change its GDP aspirations for the coming year significantly from 6.5% for 2017. The Chinese Government is likely to continue its focus on containing financial risk, along with severe measures to structurally tackle their severe environmental crises. The Chinese base metal processing and chemical industry has seen a severe clamp down in production as the Government gives social health a priority over economic growth and this has led to a global rebound in base metal prices.

As a roundup of the year, we capture a few of the trends from 2017. The infographics are self-explanatory.

2017 vs 2016: A year of consolidation

Commodity bounce | Chilly winter / Hot prices

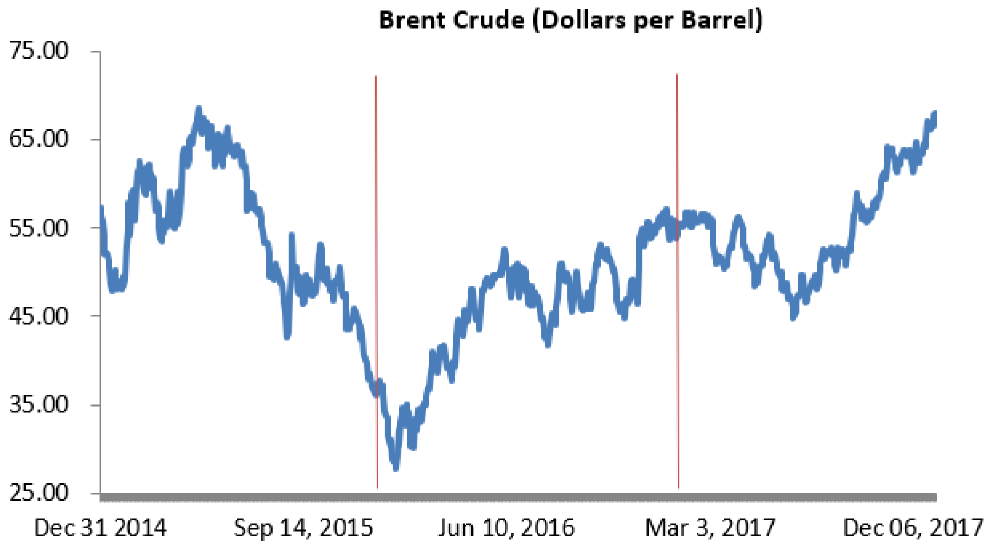
The much-awaited winter cuts in China have finally started showing results. Led by falling inventory levels, metal prices have consolidated in 2017. China continues to be committed to the overall environmental infrastructure and as a result, fulfilled its target of cutting back steel capacity by 50 million tons in 2017. China is in the process of phasing out another 120 million tons of low-tech steel product capacity. Over all, it plans to meet the 2016-2020 capacity cutback target of eliminating up to 150 million tons ahead of schedule in 2018. A series of operating and corporate actions such as temporary to permanent mine/manufacturing unit closures, etc., are likely to contribute to the healthy trend in commodity prices going forward.



Oil splash

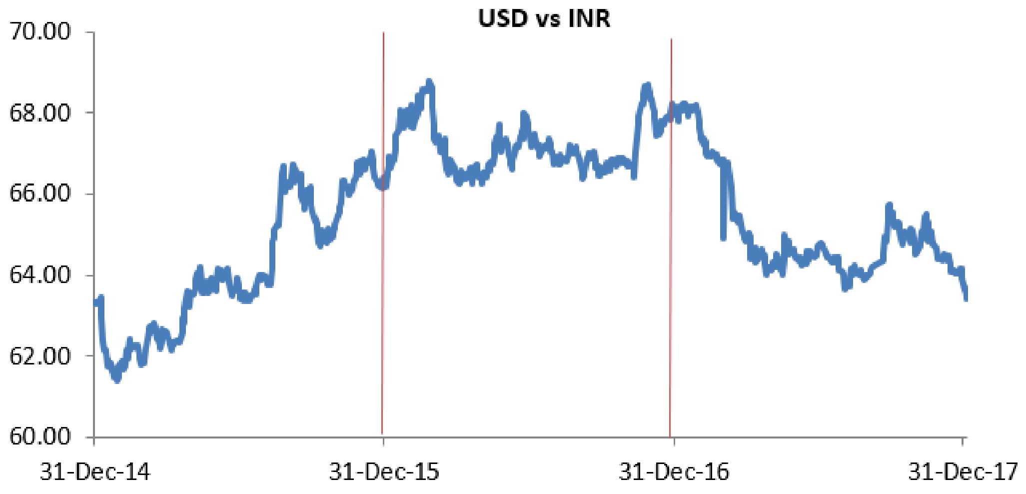
Alarmed by a mid-year plummet, OPEC came together and disciplined itself in limiting supply, as a result of which crude staged a strong comeback rally in 2017. OPEC has now extended the cut in supplies till the end of 2018. At the end of the 2017, a few one-off supply side constraints lead to a spike in crude oil prices. IEA expects crude demand to slow down in 2018 to 1.3mb/d from 1.5mb/d in 2017. The consensus for now is that levels of high $60s to a barrel will be the new range for the year ahead. The rally is a welcome move as it provides the commodity dependent economies that much extra room to shore spending, the ripple effects of which will be felt in all major emerging economies, including India. As a net importer of crude however, this is not great news for India. A strong INR has helped shield the hardening environment by a bit.

At above $60/barrel, it is also profitable for shale to come into the market and this should limit crude to broadly the aforesaid range.



INR recovers lost ground

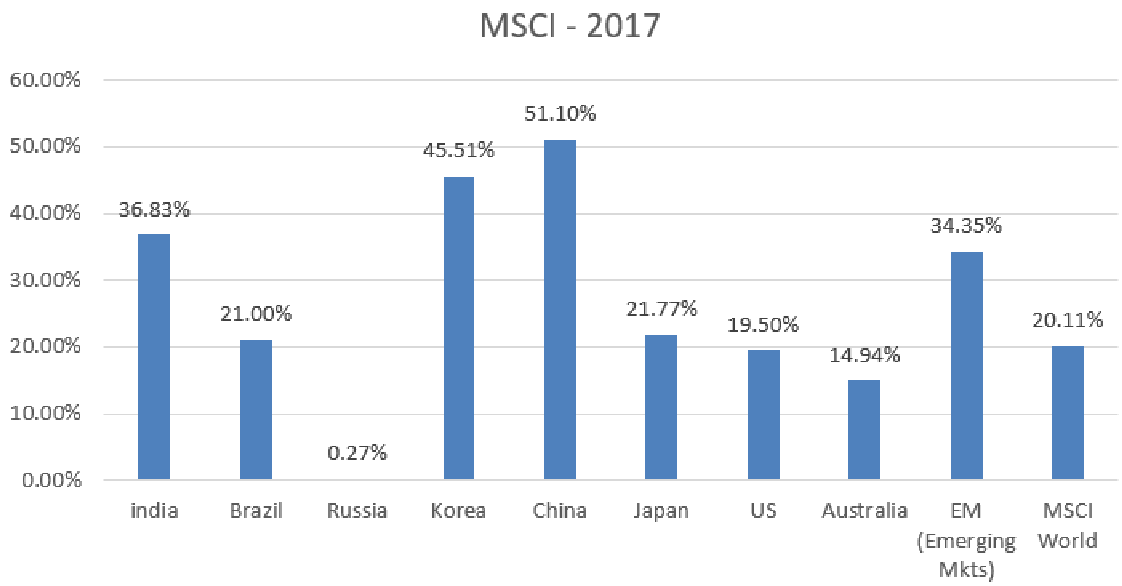
As pointed out in the earlier sections, the Dollar index gave up quite a bit against almost every major global pair. The INR was no exception as it traded the year with a positive bias against a weak USD, appreciating 6% for the year. If the easy money stance continues, flows into equities in Indian shores could further bolster the currency.



While exporters will be under stress, with crude going up and given what that can do to the inflation index, regulators may be pleased with a stronger INR.

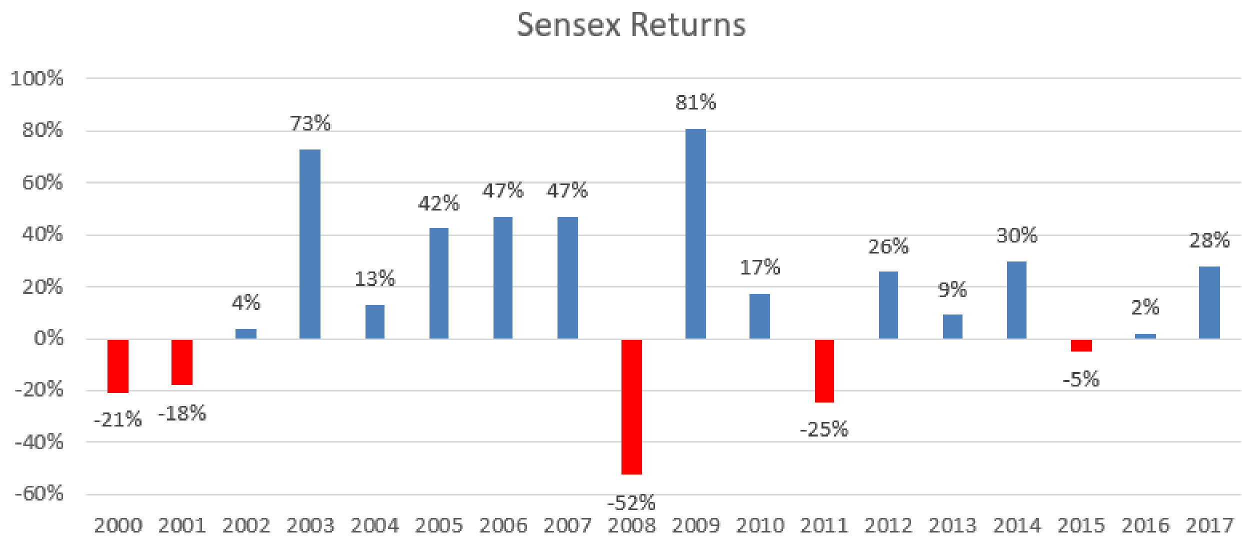
World Markets: a strong year

Over all, global growth, relatively accommodative monetary policy across developed nations, new tax legislation, low volatility and the general exuberance for equities have helped the asset class soar across the globe. One research shows that of the 73 bourses tracked globally all but nine have recorded gains, in 2017.



2017 | A year of mean reversals

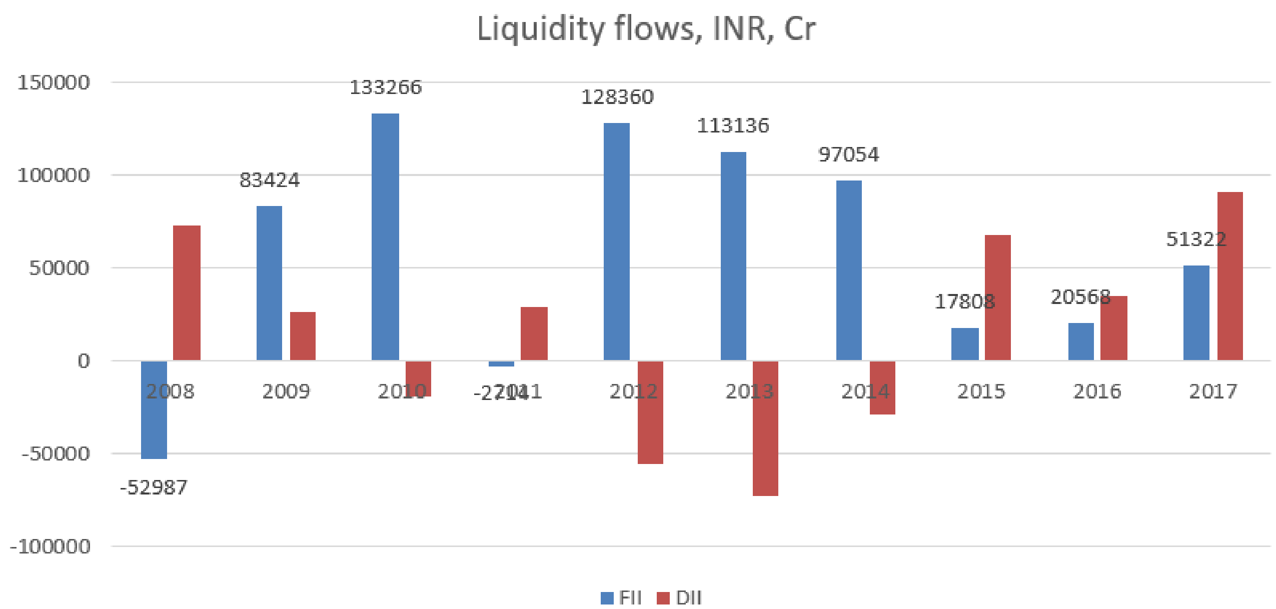
Whether you invested in large caps or otherwise, your returns for 2017, in absolute terms, will have turned out to be good. While the benchmark, after 2 weak years delivered well, the mid and small cap numbers delivered 48% and 59% respectively.



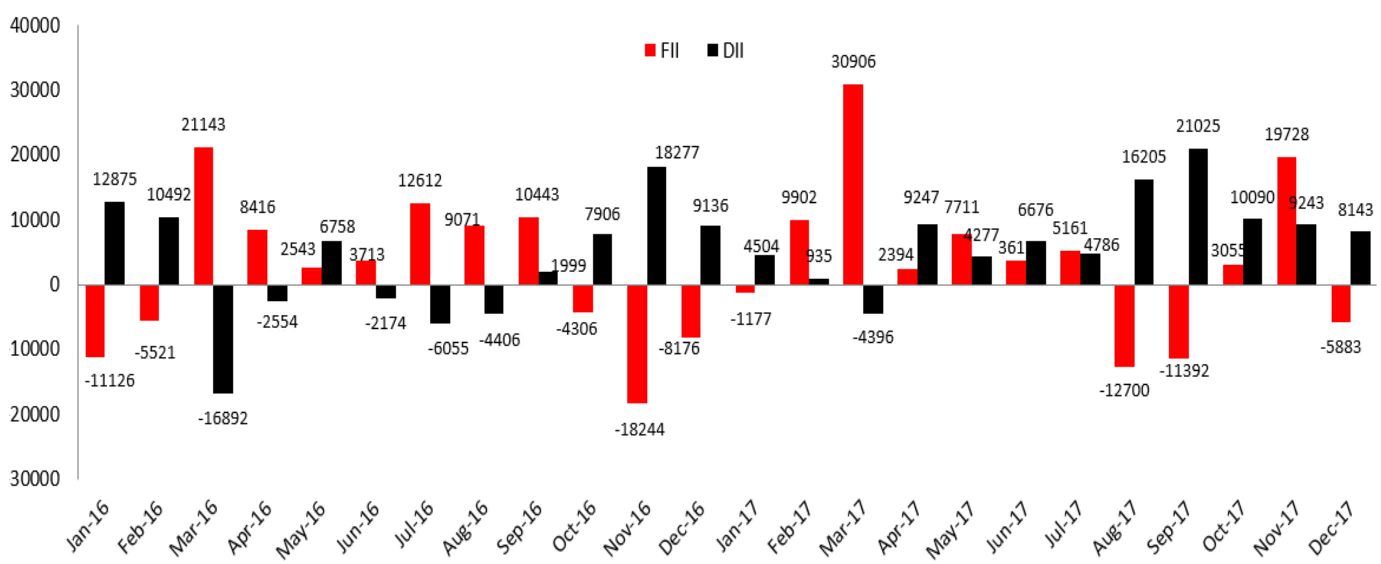
This was a year where the supposedly low P/E but high beta sectors, vastly outstripped the supposed high quality and 'safe' sectors. As you will note in the chart below, the perennial backbenchers of yester years, triumphed all in 2017, while previous leaders have had a faltering year.

Sector	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Auto	-12	8	2	2	5	6	5	4	6	4	9
Banks-Pvt	9	9	5	1	12	1	7	2	5	6	4
Banks-PSU*	5	3	7	7	9	2	12	1	12	3	7
Capital Goods	3	11	4	8	11	8	8	5	10	9	6
FMCG	10	1	12	5	1	5	4	8	4	7	10
Finance	7	7	6	4	7	4	10	3	8	5	5
Helath Care	11	2	11	3	2	7	2	6	1	12	13
IT	-13	5	3	6	4	12	1	9	2	11	12
Metals	2	12	1	11	10	9	9	13	13	1	3
Power	1	10	8	12	9	11	11	7	9	8	11
Oil & Gas	4	6	9	10	6	10	6	10	7	2	8
Realty	8	13	10	13	13	3	13	12	11	10	1
Telecom	6	4	13	9	3	13	3	11	3	13	2

Cyclicals across paper, metals and agri-commodities, after years of sector specific stress, came together in breaking out this year. The down cycle in any commodity is a function of supply significantly exceeding demand and in the process, stripping a commodity of its pricing power. Through a variety of reasons, but mostly rationalization of supply, as the equation between supply and demand changes, the resultant catch-up in pricing, as well as volume growth is quick and sharp. As a mix of these events played out in 2017, almost all commodity stocks played catch up. The most significant driver of returns in general for the year was liquidity. Foreign liquidity has always been a big mover of India indices. However, for the third year in a row, domestic money flow not just led the surge of flows, but significantly outstripped foreign money by a factor of almost 2x. We believe this might just be a new structural positive as Indian household significantly upped their exposure to equities as an asset class. The performance of the asset class, over a very short term helps in abetting this shift, however incorrect that may be. During FY 16-17, a total amount of ₹43,921cr (USD 6.8bn) was collected through SIPs. For the 8 months ended Nov-2017, the industry has already collected ₹40,780cr (USD 6.3bn) with the quantum growing organically month on month.

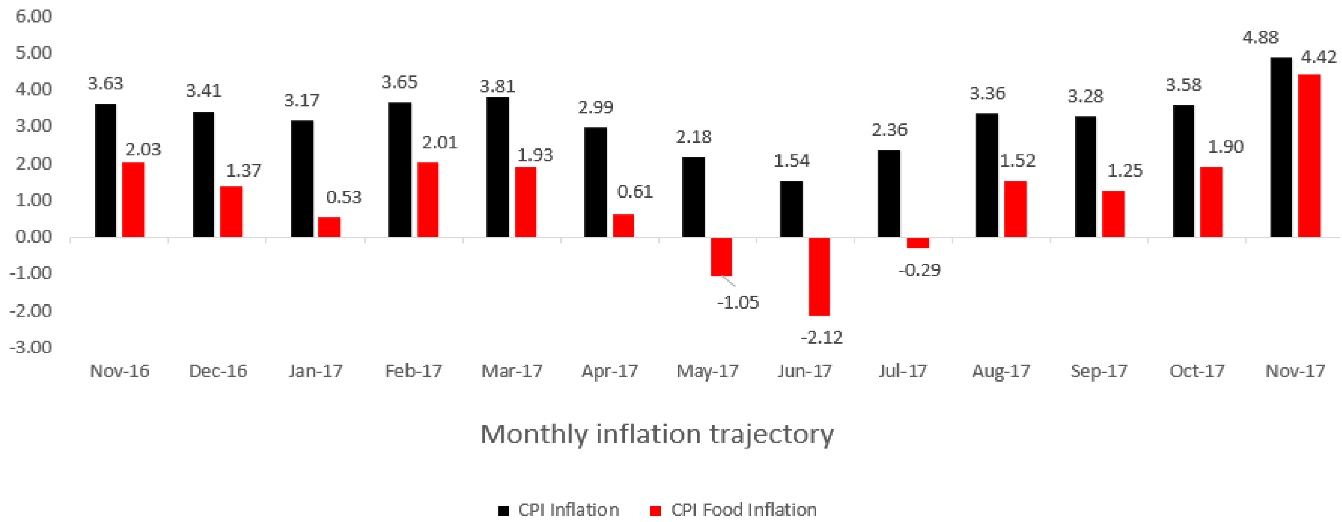


It may be of interest to spend a minute on the infographic below; as it can be seen, while FII's have been opportunistic in taking money out across specific time periods, the deluge of domestic liquidity has meant that DII's have only supported the markets across every time frame. The relevance of DIIs to Indian equities relative to FIIs have been increasing by the year and will continue to do so.



Consumer Inflation – a year in control | WPI – reversals with rally in commodities

This was another good year for inflation watching as food inflation continued to fall throughout 2017. This was more or less on expected lines, as almost all items in the food basket witnessed a healthy supply side scenario following good monsoons. While the RBI's CPI target of 5% for March 2017 was surpassed and maintained comfortably, the new benchmark of 4% seems like a tough act to follow in the context of which, *it remains to be seen how much of a close correlation future reduction in interest rates are paired closely with the CPI number*.

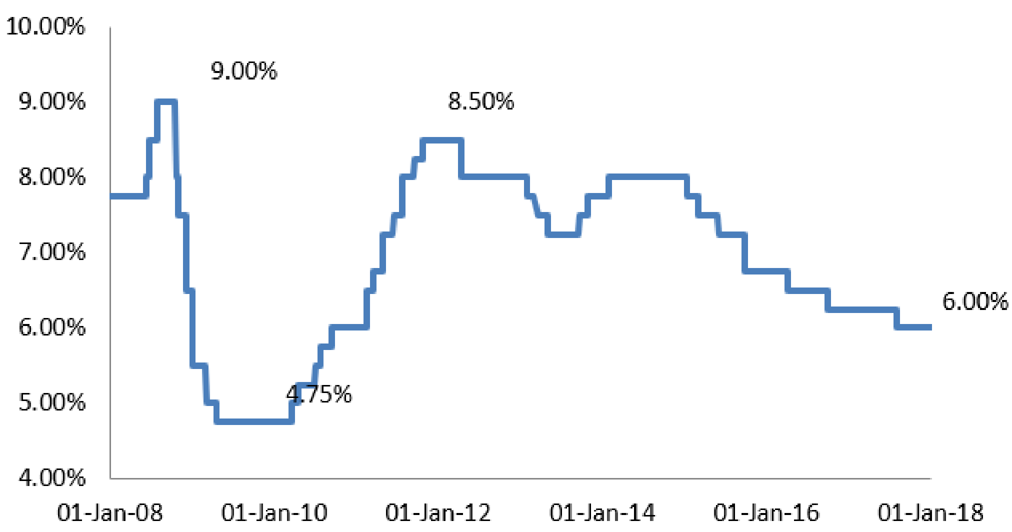


While the organic reasons for contraction in inflation was expected due to the crunch in money circulation, a rebound cannot be entirely ruled out. And then, there is the concern over rising commodity prices. RBI will have to balance these developments in charting the future course of interest rates in India.

Monetary Policy: end of an accommodative stance?

On the last monetary policy committee meeting for 2017, RBI kept rates unchanged while noting risks to inflation from rising food & fuel prices, increase in input costs, hike in HRA of central government employees and farm loan waivers in some states. The central bank also took note of the rollback in the GST rates which could risk the Central govt missing its targeted fiscal deficit for FY-18. As a result, the bank raised its second-half inflation estimate range marginally to 4.3-4.7%. It may be noted that the RBI has a stated medium-term CPI-based inflation target of 4%. The RBI also felt that economic growth had bottomed out with the bank maintaining its GVA forecast for FY 18 at 6.7%, while the Government later on revised its own forecast to 6.5%. Governor Urjit Patel reiterated that the bank would follow a neutral stance, meaning that the stance would be highly dependent on the dataflow over the coming quarters.

In line with RBI's inflationary expectations, the CPI reading for November accelerated to a 15-month high of 4.88% on the back of higher food and crude prices. The fiscal situation is not too rosy as well, with the government's cumulative fiscal deficit between April – Nov 2017 ballooning to 112% of the full year target, with four months yet to go. Indirect tax receipts were also adversely affected by lower GST collections with December netting in only Rs.808bn compared to Rs.833bn in November-17. The other factor responsible for the worsening fiscal math is weak non-tax revenues (spectrum receipts, dividends/ profits from the Reserve Bank of India, and public-sector companies etc.), which disappointed at only 37% of the full-year target compared with over 60% last year. All these factors have led to an increased risk of missing the fiscal deficit by the Centre. The government has now indicated that it will be borrowing about Rs.50,000cr from the market instead of the earlier expectation of only Rs.25,000cr in the Q4 of FY18. In the context of these developments, money market expectations have now undergone a complete volte face and have started pricing in a rate hike over the next 2 quarters. The G-Sec has inched up by almost 75bps since Oct and is within striking distance of the 7.5% mark.



As can be seen in the rate trajectory since 2008, there is scope for materially lower rates, but the macro's may just prevent from such an occurrence.

Unifi Strategy

Return of Beta | Except the traditionally safe sectors of IT and Pharmaceuticals, almost every other sector rallied hard in 2017. Towards the end of the year, and as things stand today in early Jan 2018, companies with lumpy growth and of limited quality are seeing returns that are not explained by underlying fundamentals. Persistence of this trend at play is a classic indication of a bubble in a bull market amid clearly unsustainable valuations. In the other end of the spectrum with good quality companies having visibility of growth, the margin of safety between their earnings growth and earnings multiple cannot be reconciled. Index valuations, at 24x, is still at a premium to earnings expectations without factoring in the probability of downside-risks. Earnings growth at an index level for FY 18 has been weak (high single digits), and for the year ahead (FY-2019), growth estimates are pegged in the range of high-teens. *This cycle is yet to see earnings beat at an overall level and until that happens, there continues to be a growing risk of a material correction and it will be difficult to foretell the same until the event actually materializes.*

Internally at Unifi, we have tried to look through the brouhaha and stuck to more of what we have always done; look beyond businesses in the traditional limelight and invest in opportunities that are at a combination of earnings and valuation driven inflexion points. You will appreciate that there is no one filter that perfectly identifies such a proposition. Recognizing such an idea is a function of continually monitoring the investable universe and across a cross section of industries. For the year gone by, our returns have come from consumables that are a proxy to commodity industries, to smelters of lead, to fledging building products companies to speciality chemical players. And a common thread binding all of them is that relative to the quantum of their earnings growth, they *were* available at attractive valuations. Our strategy for the year ahead will be similar, that is, continually comb the universe in the way we have, horizontally and vertically. While opportunities metamorphize across a spectrum of places, we would like to point to one nook of where they may emanate from: *#SME-exchange.* In 2017, 132 companies listed in the SME Exchange (for small and medium enterprises), raising a total of Rs.17.32bn. The SME platform is a window for prospecting high quality and high growth companies at a nascent stage but a long tail of growth. Given their size, this is traditionally out of the reach of larger institutional investors. For the first time, Unifi made two investments in the SME exchange which have done well for the portfolios and we are excited about their growth prospects. We continue to be remain agnostic about market capitalization and sectors in our quest for inflexion of earnings, in conjunction with valuations and associated fundamental risks.

From a sectoral perspective, things are looking up. Thanks to the AQR drive, and intended re-capitalization, the banking industry is closer to being better off than where they were for two years. From a policy perspective, the push on roads, rural housing, power reforms and railway capex has been strong and will continue to drive several sectors of the economy. India has enough addressable areas in the economy to lift them up to acceptable standards and these drivers will eventually translate to demand for infrastructure, credit, mortgage, automobiles and other sectors, translating to opportunities from an investment point of view. As long as the environment does not surprise negatively on interest rates, inflation and fiscal discipline, the environment will continue to be conducive for businesses to consolidate, and create bottom up opportunities for investors like us. Over all, the Government's rapid undertaking of administrative, regulatory, and legislative reforms will continue to aid consumption as well as earnings.

The overall conclusion is that the bottom up argument is still the most relevant one to us and irrespective of where the market is, stock specific and individual companies will continue to provide pockets of opportunity. We continue to monitor our exposures and universe of ideas for value. We continue to like select names in building products, chemicals, financial services, and a few emerging green themes, among others and are closely monitoring the near as well as mid-term potential of their fundamentals in making portfolio decisions. We continue to maintain an eye on a favorable-risk-reward equation 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. In select cases, we are willing 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.

As India's USD2 trillion-dollar economy grows at a reasonable pace, the base will ensure that opportunities of an absolute scale arise and we are cognizant of monitoring the environment of such opportunities.

Wish you a great 2018. And may you please do whatever it takes to stay healthy!

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
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