Global developments | The ebb & flow of global macros

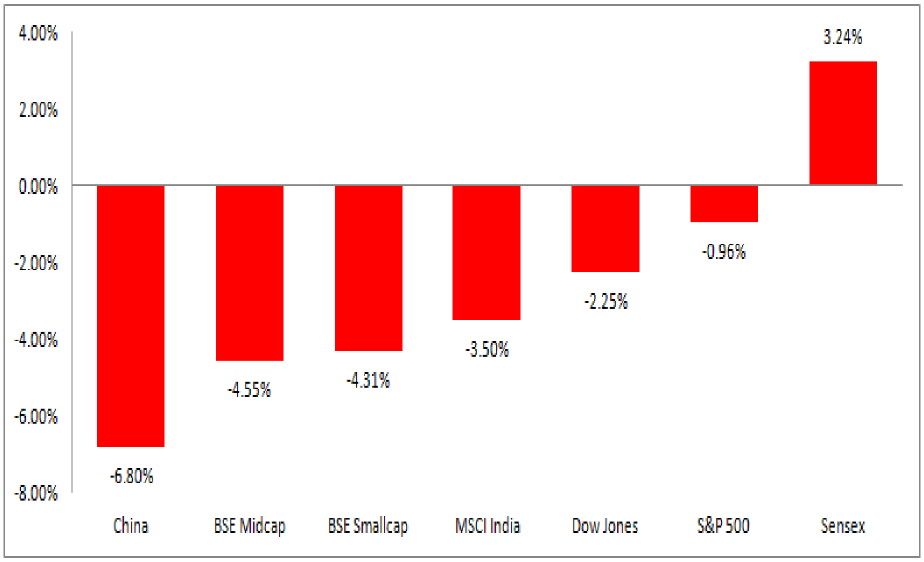
For the first time in almost 5 years, the US 10-year treasury yield rose above 3%, clearly pointing to the markets expectation of much higher interest rate hikes in the coming months. This is confirmed by their comments on steady US inflation that is now near the 2% mark. While rates were for the moment held at 1.5% - 1.75%, it is expected that it should move by 25bps by June 2018. And then, there is the case of rising US budget deficit. According to the Congressional Budget office, the deficit is projected to surpass $1Tn by 2020, a good two years sooner than expected, thanks to the tax cuts and spending increases announced by the Trump administration. On the back of these developments, the USD strengthened significantly against all pairs, including the INR gaining 1-2% on an average. The American economy seems to be on a good wicket generally as unemployment rate dropped below 4% to 3.9%, for the first time since Clinton’s presidency. The US is adding jobs at a healthy pace, with monthly payroll gains averaging 200,000 so far this year. And this is underpinning the Federal Reserve’s willingness to carry on lifting short-term rates.

On the other side, the European Central Bank (ECB) chose to stick to status quo with respect to its quantitative easing policy, in the face of weaker than expected economic data in the region and ongoing trade wars. While on a positive note, the threat of geo-political tensions eased significantly as the two Koreas came together for a dialogue, uncertainty over US position on the 2015 Iran nuclear deal is adding to stress. The possibility of sanctions has made the oil market jittery and prices have breached the $75 per barrel mark, marking a three-year high. The IMF estimates that for Saudi to balance its budget this year, Crude will have to be at $88 a barrel. As we know, OPEC and its recent ally Russia have been playing their part by gradually cutting down production. In response to the higher oil prices, the US energy companies have been adding new rigs, with the count at its highest level since March 2015. Nevertheless, prices continue to be on the boil and this is cause for stress to net importers like India.

World Markets

April was a month of mixed returns across markets and geographies with MSCI India outperforming its EM peers.

MSCI (in %)	India	Brazil	Russia	Korea	China	Japan	US	Australia	EM Index	MSCI World
MoM (%)	4.11%	-4.16%	-7.43%	2.75%	-0.05%	0.67%	0.29%	2.43%	-0.55%	0.95%
CY-YTD (%)	-3.50%	6.56%	1.19%	1.77%	1.76%	0.68%	-0.80%	-5.07%	0.52%	-0.81%

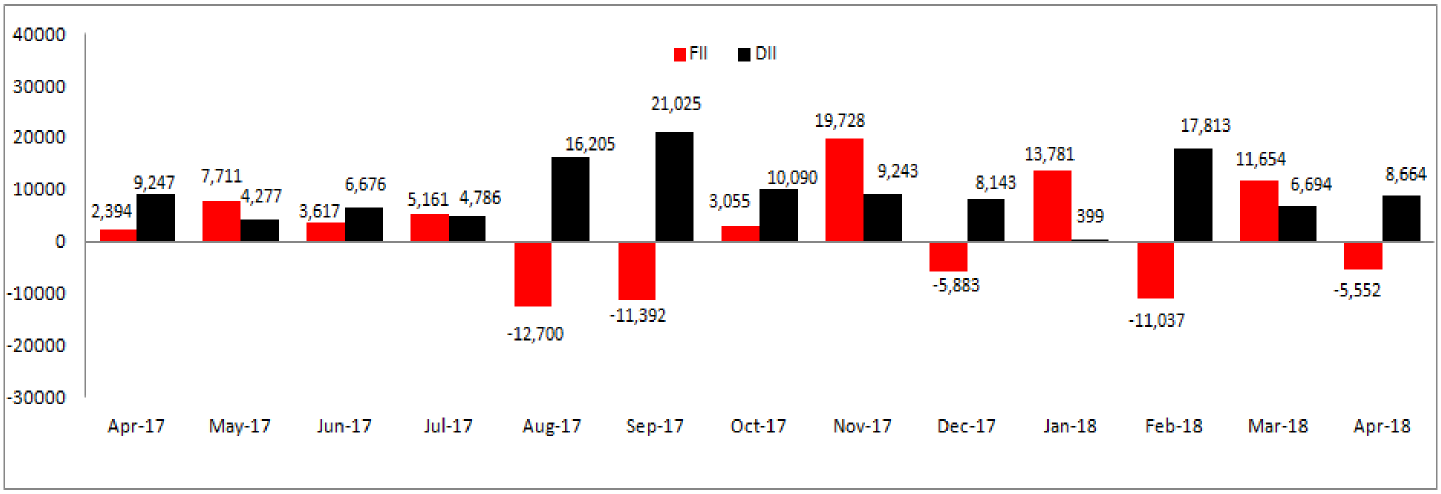


CY-YTD Returns

- China was down 6.80%
- BSE Midcap was down 4.55%
- BSE Smallcap was down 4.31%
- MSCI India was down 3.50%
- Dow Jones was down 2.25%
- S&P 500 was down 0.96%
- BSE Sensex was up 3.24%

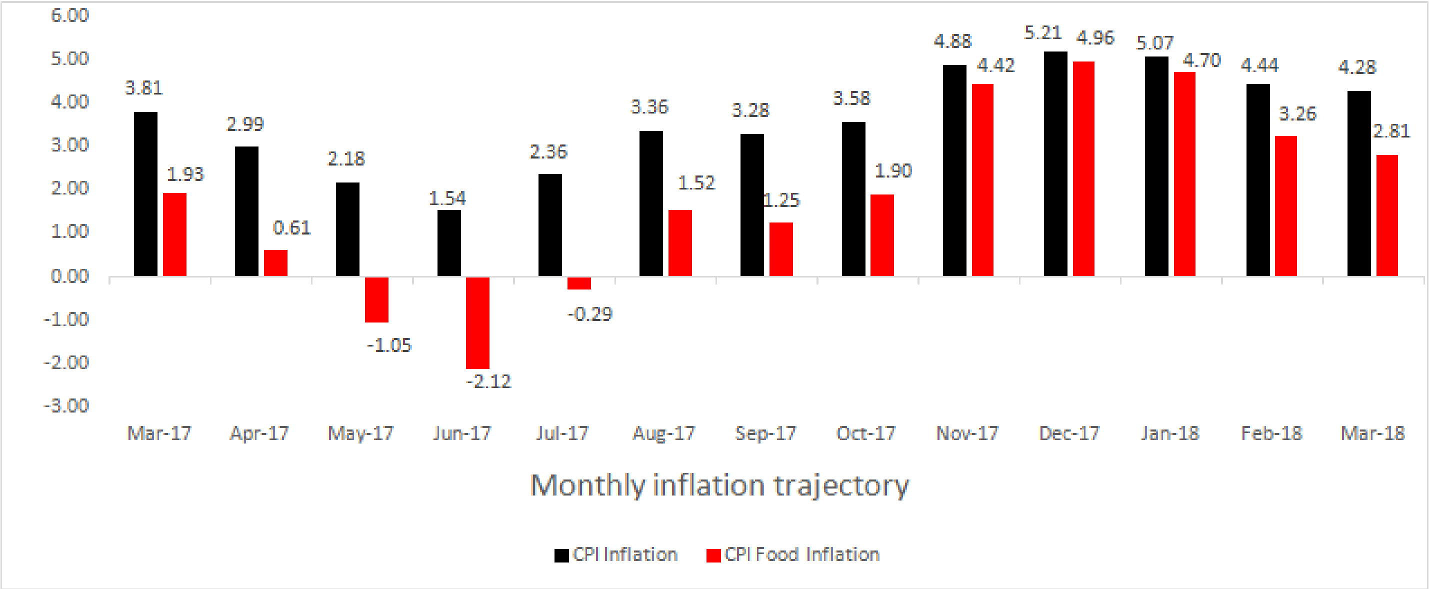
Liquidities flow in India

FII fundflows turn negative| FII inflows again turned negative in April on the back of increased talk of rising interest rates in the US. However, DII inflows continued their upward trajectory as they improved by a strong 29% on a monthly basis. We believe that the DII inflows would be crucial for the Indian markets going forward as the economy picks up further steam and the local population increases its exposure to equity as an overall share of their savings.



RBI sounds hawkish | Bond markets stubborn | Inflation Eases

What was initially construed by the markets as a neutral interest rate policy from the RBI, turned out to be one with a more hawkish tone, once the minutes of the RBI monetary policy committee (MPC) were released in mid – April. The MPC flagged concerns over increase in famer MSPs and higher trajectory of crude oil prices as the key risks for the economy. Two members of the six-member committee reinforced the need for acting decisively in inflation targeting. The market now expects a back ended rate hike in 2018 if the headline inflation were to exceed the RBI set trajectory. Retail inflation for the month of March came in at 4.28% sliding down for a third consecutive month after hitting a 17-month high in Dec 2017 at 5.21%. This was primarily on account of a moderation in prices of vegetables, milk & eggs. However, the core inflation, which strips the impact of food & fuel prices continued to rise & hit a 43-month high of 5.23%. The easing of 10-year G-sec yields to around 7.12% on the back of lower borrowing forecast from the government and RBI's neutral stance was short-lived as the yields again retraced to 7.7% levels. The hawkish tone of the central bank, higher crude prices and a weaker rupee are keeping the bond yields elevated.



Unifi Strategy | Wheels are turning

While the macro environment has become a bit challenging for the country on the back of high crude prices and lower than expected trend in GST collections, the pickup in consumer demand in the broader economy as evidenced by better corporate earnings, traction in demand for commercial vehicles, tractors and better management sentiment, give credence to the thesis that the country is returning to a growth trajectory.

With initial forecasts pointing to a normal monsoon in FY-2019, this will be the third consecutive year of normal monsoons and this is expected to boost the rural economy through lateral demand. With over 50% of the population dependent on the sector, monsoons remain key for the Indian economy's growth prospects, increasing the population's pricing power. As we have seen in the past, a deficit monsoon strips the populace of purchasing power while adding to inflation and leading to an interest rate cycle that adversely affects the economy. For instance, the severe drought in 2013 led to supply issues forcing the Food inflation to move to 14.72% in Nov 2013. The same hovered between 5-10% during 2014-15 as the weak rainfall conditions continued till 2016.

With higher MSPs and good output, the fillip from the rural economy should translate to strong tailwinds for mortgage loans, building materials, consumer durables, automobiles, FMCG and other items of discretionary spends. From the results season so far, we note that the Auto majors have had their best earnings ever this quarter and segments such as roofing (for rural housing) have recorded bumper numbers. The lead indicators so far bode well for the overall economy.

We however point to the fact that India's own dynamics are slightly more complicated given the sharp ascent of Crude, (up 12.7% CY 2018) and a parallel depreciation of the rupee which could lead to a high inflationary environment. As per rough estimates, a 10% rise in diesel and petrol prices leads to about 25bps impact on CPI and for every $1/bbl increase in crude oil price, under-recovery rises by Rs.1800 Cr. The coming months are marked with elections in key states which will finally culminate in National elections in mid-2019. The volatilities associated with elections and the outcomes of the same are expected to result in knee jerk reactions.

In a nutshell, economic activity has indeed begun to improve. Primary data points, such as IIP, automotive sales, air traffic and commentary from companies so far point to a better pace of economic activity. For instance, hotel occupancies have touched a 9-year high (over 67%) while air traffic growth continues to climb north of 20%. Of course, these are mere feelers and translation of macros to earnings demands execution of a different order. Tracking and analyzing these areas of execution is a continuous work in progress and we continue to do that to calibrate / re-calibrate our portfolios where necessary. While news flow and sentiment related volatility will remain elevated in FY19, the delivery of earnings growth will overcome the ancillary noise. Performance of a majority of the sectors continue to improve & remain upbeat during the year with major exceptions being the Pharma sector (regulatory compliances/pricing pressures), PSU banks (governance/asset qualities) and Telecom operations (poor pricing scenario). IT is turning out to be a mixed bag with client level execution being key while the commodities sector is benefiting from a recovery in both pricing and core demand.

Jeff Bezoz recently said, "those quarterly results were actually pretty much fully baked about 3 years ago. Today I'm working on a quarter that is going to happen in 2020. Not next quarter. Next quarter for all practical purposes is done already and it has probably been done for a couple of years."

As we look at newer companies and analyze their alignment/fitment into our portfolios, we are seeing how their earnings will play out over the medium term and what the relative value of that earnings is in the context of today's valuations. We continue to look out for opportunities that fulfil our criterion on growth, value and valuations. In the meanwhile, as markets move up we are not hesitating to book profits in existing positions where valuations have exceeded their margin of safety. Alongside discipline, patience should now be a key virtue for all investors for the times to come.

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.

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