Global developments

The global tumble in equities this immediate week should be seen in the context of the rapid, and perhaps, unexplained ascent that they enjoyed in the first place. For January 2018, the Dow, S&P 500 and NASDAQ gained 5.6%, 5.8% & 7.3% respectively while since Jan 2017; the Dow is up 20%. Yes, economic fundamentals are getting better, but not exactly at the pace suggested by the markets, one of whose many virtues, is euphemism. Before the tumble happened, almost all of January saw dollar weakness, soaring bond yields, and high expectations from equities in general, on the back of a new low tax regime. As employment numbers both in January and February were more than encouraging, expectations that the federal reserve will be quicker in raising rates grew, and in the process, pushed bond yields down. As inflation fears picked up, it helped the USD stabilize a bit. Globally, the point is that inflationary pressures could mean that central banks around the world will start to remove their support for loose rates faster than expectations.

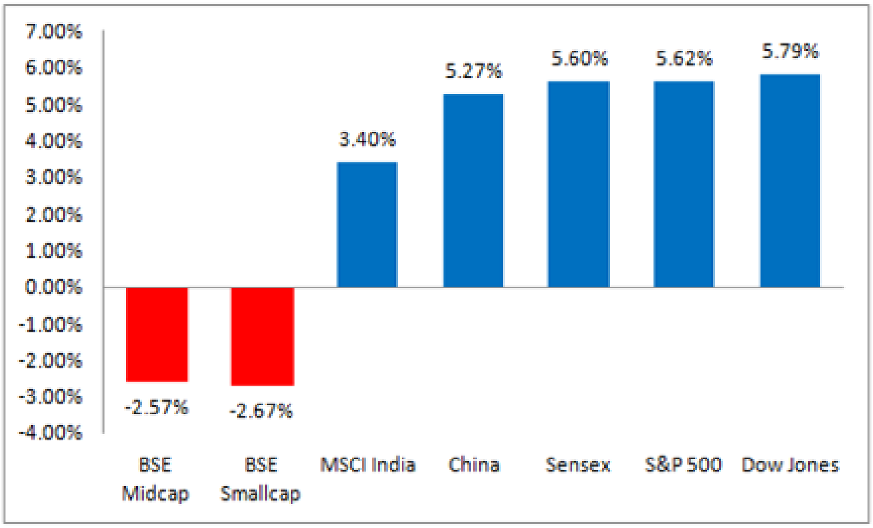
Though business surveys are indicating some of the best economic conditions across US and mainland Europe, the quest for equilibrium between certainty and the lack of it will continue to result in volatility like we are seeing now. Mainland Euro is expected to grow at around 2.2% for the coming year while China is unlikely to change its GDP aspirations for the coming year significantly from 6.5% for 2017. Over all, the prospects on the global front look healthy, and equities as an asset class should continue to draw comfort from this. However, prospecting should be a bottom-up affair, to avoid being trapped by momentum in moments like this week.

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 a good start to the year over all as the broader EM index notched 8.3% for the month. However, this was a mix of hardening USD and equities losing steam towards the end of the month.

MSCI (in %)	India	Brazil	Russia	Korea	China	Japan	US	Australia	EM Index	MSCI World
MoM (%)	3.40%	16.74%	12.52%	3.57%	12.48%	4.58%	5.63%	2.95%	8.30%	5.22%
CY-YTD (%)	3.40%	16.74%	12.52%	3.57%	12.48%	4.58%	5.63%	2.95%	8.30%	5.22%

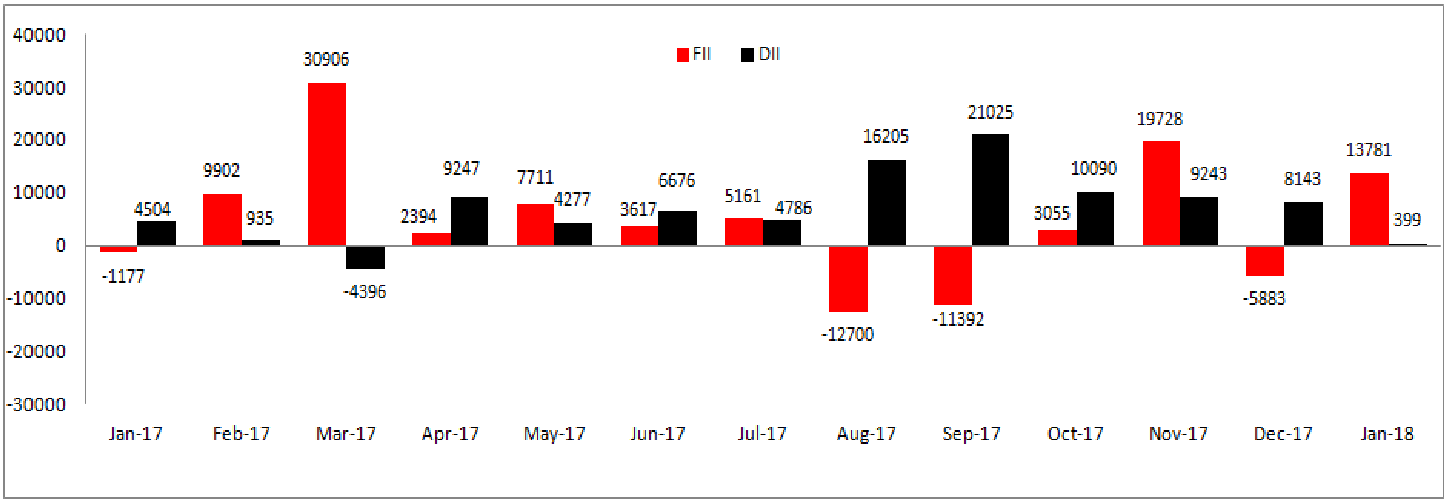


- Dow Jones was up 5.79%
- S&P 500 was up 5.62%
- Shanghai was up 5.27%

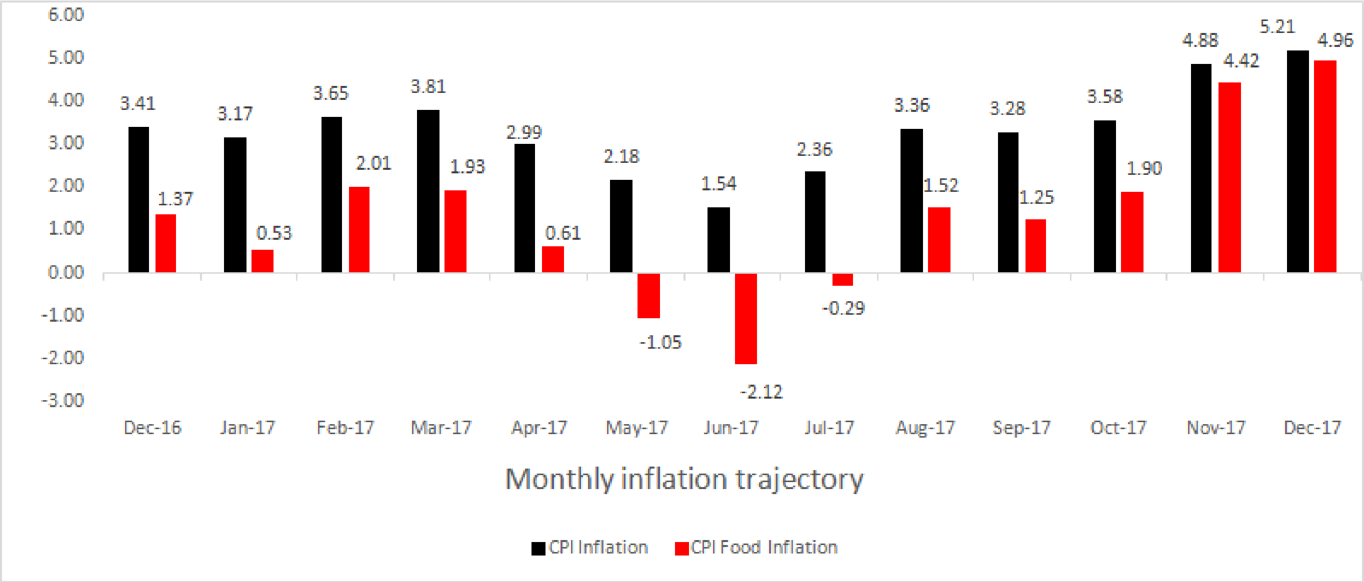
- BSE Sensex was up 5.60%
- BSE Mid-cap was down 2.57%
- BSE Small-cap - down 2.67%
- MSCI India was up 3.40%

Liquidities flow in India

FII's turned principal buyers in the month of January 2018 with a marked slowdown on the DII side which had been fueled the markets over the preceding 9 months. 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.



RBI Holds Fire but with a finger on trigger as inflation rears | Base rates Unchanged



After months of control, inflation has begun to rear its ugly head again. December witnessed up to a 30% MoM rise in the price of proteins, oils and vegetables as a result of which, the food inflation bucket spiked 12% month on month, translating to a 6.8% spike in overall inflation to 5.21. This obviously did not bode well for inflation watching as the RBI kept the base repo rates unchanged at 6% in its first the policy meeting for 2018. With the recent policy level development (budget for 2018), the *outlook is inflationary* as well. The Government has indicated hiking Minimum Support Prices on crops materially in its bid to boost the rural economy. We need to understand and appreciate, that if farm incomes are to rise through higher prices, food inflation is inevitable. And for the nation as such to graduate, higher farm gate prices may have to be the new normal. The recent crude price surge and marginally higher than expected fiscal slippages add to the outlook that interest rates may have seen its immediate bottom. CPI at 5.2% is significantly higher than the RBIs target of 4% and tightening, although not being discussed today, may be a possibility in the not too distant future. Meanwhile the RBI has signaled a GVA of 7.2% in 2018 vs 6.7% for 2017, indicating a nascent recovery in economic growth which needs to be nurtured carefully. This expected improvement in the growth prospects is expected to be supported by a boost from exports due to stronger global conditions, enhanced credit off take and better performance from sectors such as capital goods.

Union Budget | Several Positives over shadowed by LTCG concerns

Budget day in India is theatre. It is in a sense delightful, that everyone has expectations and a view. While the fine print is voluminous, we are capturing a few developments we thought were relevant and can impact us as stakeholders in the markets:

- Revenue is expected to grow at 12% while expenditure is expected to grow at a modest 10%
- Reasonable target from tax revenue growth is at 16.6%, given that the nominal GDP is expected to grow at 11%
- Capital expenditure is still a very small part of the over-all expenditure and is expected to grow at a modest 9.9%, which could be a cause for concern. Capex on roads to be increased by 10.5% while 56 unserved airports are planned on being connected.
- Fiscal deficit, intended at 3.2% for FY19 runs the risk of slippage on the back of aggressive income projections
- About 30% increase in urban development, irrigation, livelihood and employment generation schemes
- MSP for all crops to be increased by 1.5x of production cost; Increase in agricultural credit from 10Lakh crore to 11Lakhcrore. This is expected to give a definite fillip to rural incomes and consumption.
- And of course, 10% long term capital gains on equity gains of more than Rs.1 Lakh.

There have normally been gaps in the implementation of budgetary schemes as a result of which budget day euphoria at a stock level are seldom maintained. However, we like the consistent focus on irrigation, agriculture and aviation and these are a few sectors Unifi has significant investments in. Also, SEBI has mandated that large corporates meet 25% of their financial needs from the bond markets and we believe this will do its bit for deepening the fixed income market in India. Also, 24 PSU's have been identified for strategic divestment, a part of which may come via ETF's and these measures may spell in increased opportunities for our arbitrage / fixed income funds.

While LTCG reduces the long-term differential between debt and equities, as an asset class, it continues to be attractive in the context of the inflexion point that India continues to be in.

Unifi Strategy

So, we are in the middle of a correction. It was sharp, and brutal as they always are. Apart from India specific valuation concerns, in case you're still wondering what really hit us, here is a re-cap:

(1) Inflationary concerns are peaking globally, leading to increasing yields and potentially squeezing the supply of monies. This can affect flow of funds to Equities or/and see the flight of capital from equities to fixed income

(2) India's targeted fiscal deficit for FY-2019 may run the risk of deviating from its glide path given the expected short in tax collections. GST is still in its infancy and teething issues may take a time to normalize. Lack of

discipline in fiscal deficit weighs on the country's currency, which if depreciates, is cause of concern for institutional investors. Higher deficit translated to higher interest rates, and that can be bad for the consumption environment.

(3) Likely inflationary pressures due to MSP hikes and its consequent stalling of the rate reduction cycle and / or leading the rate hike cycle

(4) Introduction of 10% Long term capital gains and its implications for stock returns

While the Nifty slipped almost 5%, quality stocks in the mid cap space lost between 10%-25%+ as a knee jerk reaction. As we write this note to you, much of those losses have been made up. We used the ensuing panic to add positions in names we liked fundamentally, but had ceased buying on grounds of runaway valuations. We noticed that stocks with the framework of good earnings growth, good and consistent capital return ratios and good to improving balance sheets have gained back swiftly.

We will however not be surprised if the volatility is here to stay for a while. 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 should we do?

India was in the midst of a sharp earnings recovery cycle that was temporarily stalled due to the impact of GST in H1 of FY18. However, from Q3-FY18 onwards, the earnings cycle seems to be trending up. While the base effect of demonetization helped, on the ground execution was still necessary to drive growth. For the 9M of FY-2018, the broader BSE 500 returned 6.4% in earnings growth majority of which was contributed by Q3-FY18, at 22.7%. While sectors such as Auto's had a steep impact from the lower base, chemical companies seem to have positively benefited from the environmental and regulatory pressure on their Chinese competitors. Banks and Finance companies seem to be still marred with NPA issues. The following table showcases the earnings trajectory of the broader BSE 500 for companies that have declared results till the end of January 2018.

Particulars	Q3 FY18 PAT Growth	Q3 FY18 PBDIT Growth
BSE 500	22.7%	10.7%
FMCG	25.7%	11.4%
Banks and Finance	4.4%	1.8%
IT	7.4%	0.6%
Chemicals	81.4%	38.9%
Auto	30.2%	32.1%

As the numbers show, Q3 has been more good than not and there exists a fair universe of companies that are experiencing a reasonable rate of earnings growth. Rolling ahead into FY-2019, it is probable that earnings growth for the broader benchmark will be higher than the mid-to high teens that was earlier estimated, and this will broadly support benchmark valuations. In other words, a prolonged and steep correction may not be a probability.

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.

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.

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.

Baidik Sarkar

Yours truly
Baidik Sarkar
Head - Research

CHENNAI:
11, Kakani Towers
15 Khader Nawaz Khan Road
Nungambakkam High Road
Chennai - 600 006. INDIA
Ph: +91-44-3022 4466, 2833 1556
Fax: +91-44-2833 2732

HYDERABAD:
H No. 6-3-346/1, Road No. 1
Banjara Hills
Scotia Bank Building
Hyderabad – 500 034. INDIA
Ph: +91-40-6675 2622/23

BANGALORE:
511, Barton Centre
84, M.G. Road
Bangalore - 560 001. INDIA
Ph: +91-80-255 9418/19

MUMBAI:
Shiv Sagar Estate,
A-Block, 8th Floor,
Dr. Annie Besant Road
Worli, Mumbai - 400 018.
INDIA
Ph: +91-22-2492 7671

DELHI:
No.818, International Trade
Tower, Nehru Place.
Delhi - 110 019.
INDIA
Ph: +91-8800333799