Global developments

Fed hikes rates

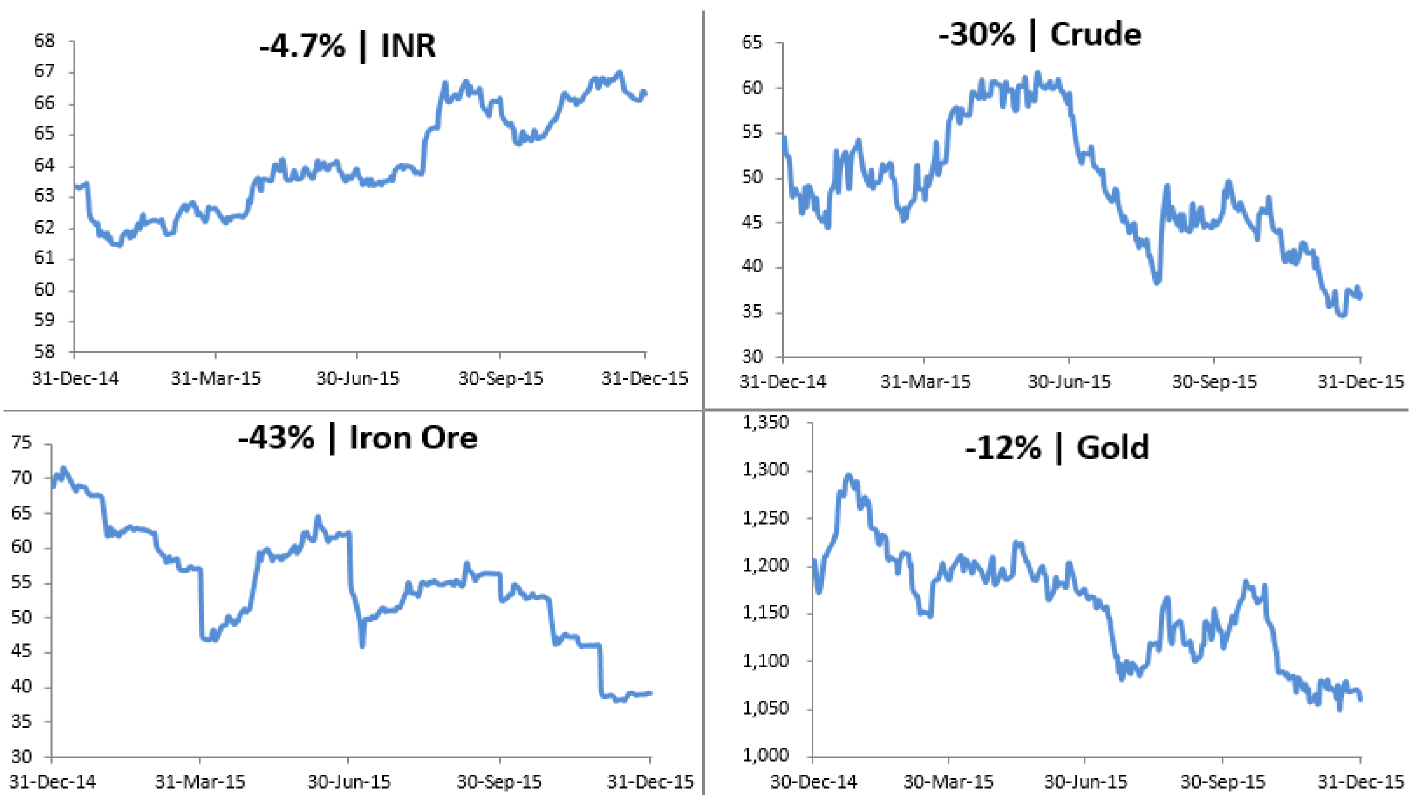
Ending an extraordinary period of Government intervention, the Fed finally ended almost a decade of zero rates as interest rates were hiked to 0.25%. This is the first rake hike since 2006. Stepping into the new year, the Fed signaled further hikes to come “with gradual adjustments in the stance of monetary policy” and argued that “economic activity will continue to expand at a moderate pace and labor market indicators will continue to strengthen”. The US has now added new jobs every month since October 2010. Net of all data points, given the pace of inflation, and GDP growth, it can be concluded that QE as a strategy has worked.

China trips world markets

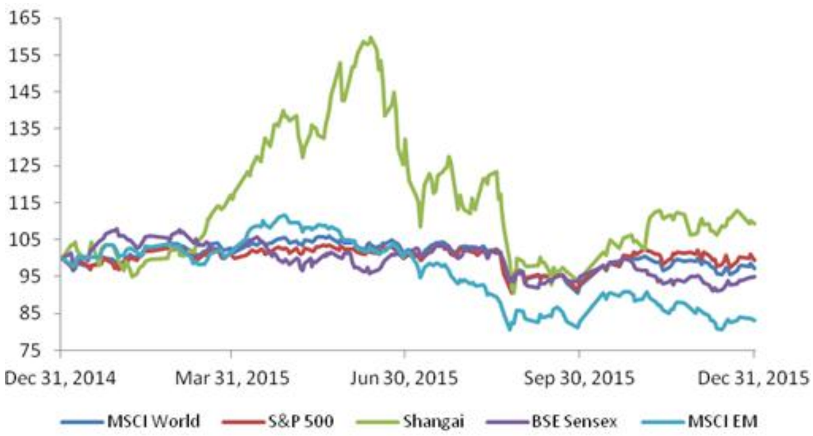
While the broader state of the world is clearly at unease, news from China accentuated the gloom as their manufacturing sector shrank for the 10th consecutive month. The benchmark Caixin PMI that is used to gauge nationwide manufacturing activity fell to 48.2 in December, from 48.6 in November. Levels below 50 indicate contraction and is worrisome as it accompanies a reduction in employment and a further fall in production requirements which together add up to further weakening of both the supply and domestic consumer demand ecosystem. As this was among the first piece of economic data coming in for the new year, it tripped markets around the world (4th Jan) while China suffered a rout, crashing 7% for the day, triggering a market wide circuit breaker with trading having to be suspended for the rest of the day.

The year 2015 in general has not been one of too many positive outcomes. If the year had to summarize as a single image, it had to be that of a negative slope, and as a roundup of the year, we capture a few of them. The infographics are self-explanatory.

2015: Year of the slope



World Markets: an average year



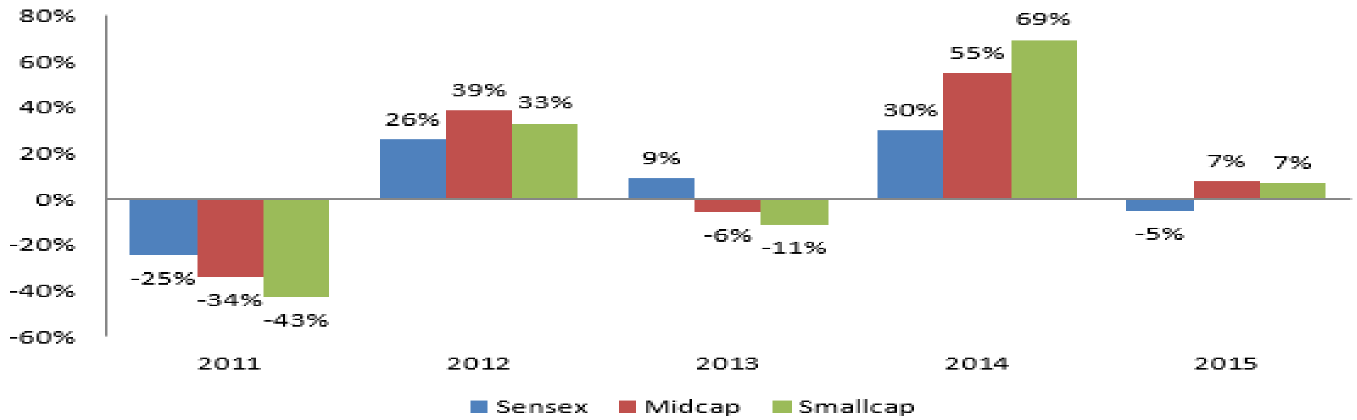
- MSCI world was down 3%
- S&P 500 was more or less flat
- MSCI emerging market was down 17%
- China was a real see-saw; rising 58% till June and then losing 50% from there on. They may not have bottomed out completely

MSCI (in %)	India	Brazil	Russia	Korea	China	Japan	US	Australia	EM Index
MoM (in %)	2.43%	-5.80%	-10.80%	-2.84%	-1.31%	0.21%	-1.86%	2.88%	-2.48%
CY - YTD (in %)	-7.42%	-43.45%	-0.05%	-7.94%	-10.04%	7.76%	-0.76%	-14.07%	-16.96%

2015 in review

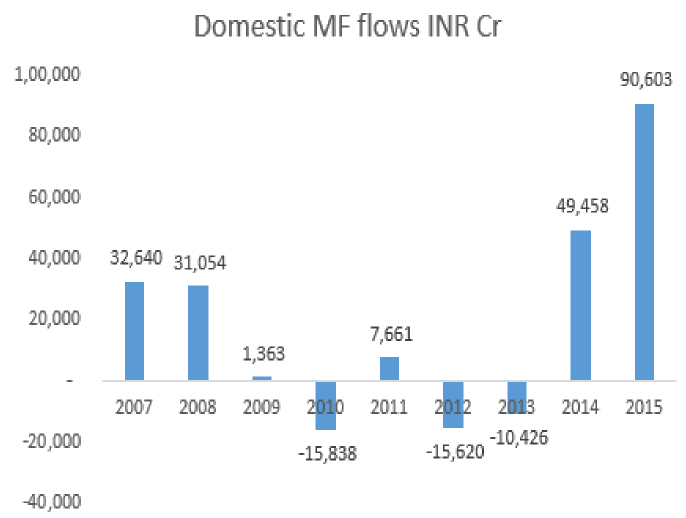
A middling year for Dalal Street

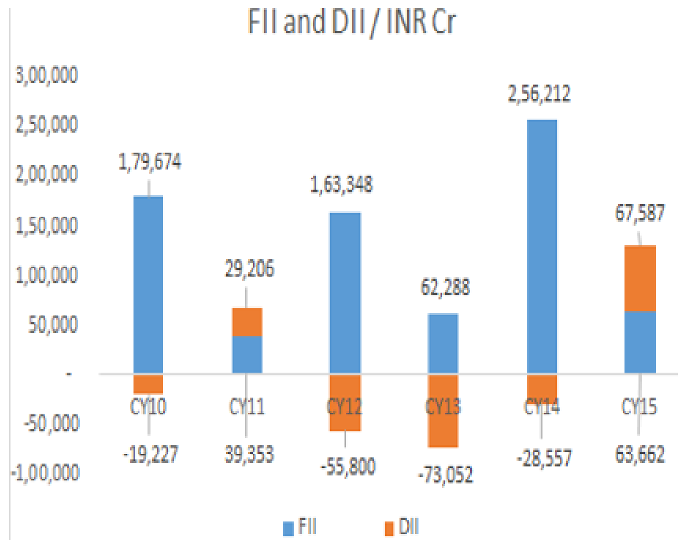
Since 2011, this was the first year that the Sensex closed in the red, losing 5% for the year. The mid and small caps however demonstrated greater resilience, delivering 7% for the year.



For the first time in several years, the quantum of domestic institutional capital flowing into the Indian markets over took foreign institutional investments.

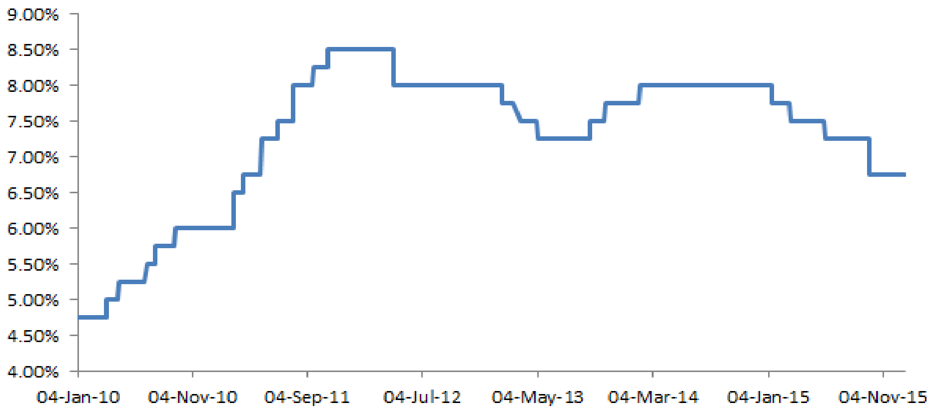
For 3 years between 2012-2014, while FII monies supported Indian markets, in 2015, a massive surge in retail participation by domestic investors India has helped reverse the trend.





Monetary Policy: beginning of an accommodative stance

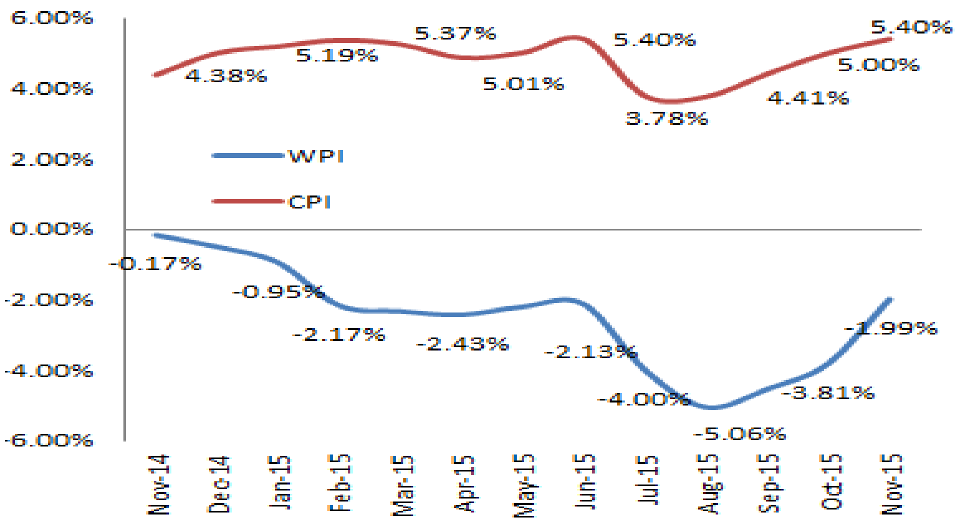
Ending a period of sustained hard policy regime, starting 2015, the RBI eased a good 125bps (to 6.75%) in interest rates with clarity that 2016 will see continuance of the same, barring external macroeconomic shocks. Of the 125 bps, more than 50%, nearly 65bp, have been passed on by banks into the lending rates. Considering the previous two easing cycles, transmission in the ongoing easing cycle is better than at least the previous two.



As a reminder, among other things, the RBI had anchored to a CPI target of 6% by January 2016 (which will be under shot) and a March 2017 target of 5% as one of the determinants of the future course of action. As things stand today, the Governments has delivered well on its inflation management strategy and continuation of the same should see the RBI deliver another healthy quantum of interest rate reduction, which should we hazard a guess, should in the range of about 25-50bps for the whole year.

A year of disinflation

India has been a major beneficiary of the global fall in all commodity prices. In spite of a poor agricultural season, the Government's active price management of essential commodities coupled with tempered demand as such, has resulted in India witnessing inflation soften for the year. CPI for Nov-2015 stood at 5.4% vs. 5% last month while WPI inflation rose to -2% vs. -3.8% for the previous month.



The extent of disinflation due to extraneous factors may have largely played out, but then going by the consistency in China's slowdown, there might just be some more tailwinds to softening input costs. The upside risks to inflation, would majorly accrue from a reversal in commodity prices, the direct and indirect impact of the 7th pay Commission payouts and higher than normal MSP hikes.

CAD & Fiscal deficit – a good score

India's Current Account Deficit has moderated sharply from highs of 5% in FY13 to about 1% of GDP for FY16. This is largely due to lower commodity prices, especially oil, metals and gold. With global deflation continuing, we expect CAD to broadly remain in the range of 1% of GDP for the coming year as well. This will be the lowest CAD in over a decade. Also, given how much India subsidizes crude imports, the fall in prices have also helped the government in its endeavor of bring down the fiscal deficit to 3.9% of GDP in 2015-16.

With absolute level of CAD likely below USD20bn for the second consecutive year, FDI flows alone can comfortably fund India's CAD. If portfolio flows remain reasonably benign, India will continue to add to its FX reserves, which have already risen by USD 30bn in CY2015. Barring a steep devaluation of the Chinese yuan and its relative effect on the INR, the Indian rupee will continue to outperform most other emerging market currencies as it has done in the last two years.

UNIFI Capital

A poor harvest

India has now had two consecutive years of poor agricultural harvest. With 16% of the GDP and over 50% of the population directly dependent on agriculture, the effect has been telling. However therein lies a silver lining: the prospect of agri economy growing from a low base and the statistical improbability of 3 years of poor monsoons in a row. The weather Gods are already looking kindly to India with the weather man predicting a La Nina year of bountiful rainfall as against the preceding two El Nino years. While rural distress may haunt India Inc till the quarter ended March 2016, things should begin to look up from there. Among other things, the fortunes of the Indian consumer and auto segment will largely depend on the same.

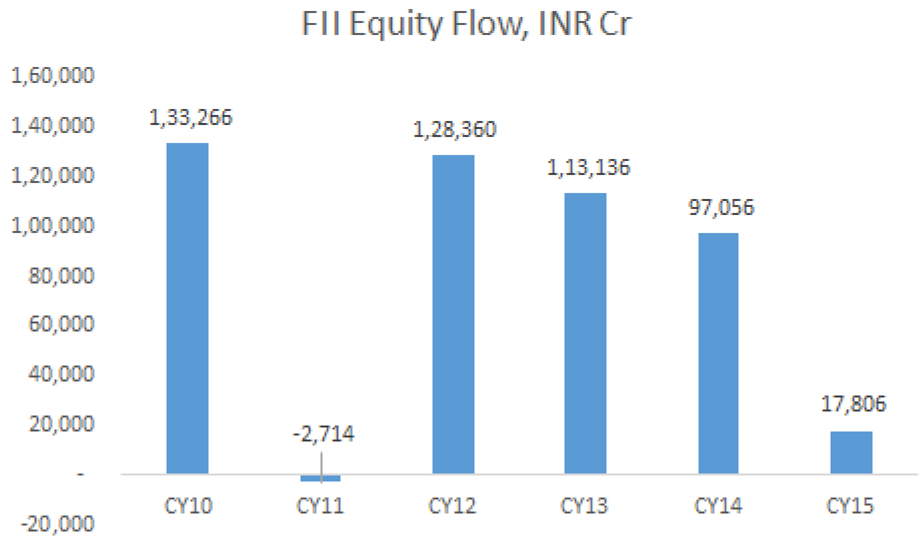
Unifi Strategy

Poor set of economic data flow competed hard for attention for almost all of 2015. While Europe continued to grapple with its set of fiscal and low growth problems, almost all of Latin America and the Middle East wrestled with a runaway fall in the value of their currencies and steep and deteriorating fall in macroeconomic fundamentals, given the fall in global commodity prices. For instance, the following has been the impact of the fall in crude on OPEC economies; countries where crude is the mainstay of the economy.

OPEC Members	Fiscal break-even/barrel*	Fiscal deficit (% of GDP/CY15)	Output Mn barrels/day
Qatar	$ 55.50	4.50%	0.67
Kuwait	$ 49.10	1.20%	2.73
Nigeria	$ 122.70	-2.80%	1.90
Iran	$ 87.20	-2.90%	2.88
Angola	$ 110.00	-3.50%	1.79
UAE	$ 72.60	-5.50%	2.89
Algeria	$ 96.10	-13.90%	1.11
Saudi Arabia	$ 105.60	-21.60%	10.25
Iraq	$ 81.00	-23.10%	4.20
Venezula	$ 117.50	-24.40%	2.38
Libya	$ 269.00	-79.10%	0.43

*Price per barrel in order to break even at the Government's fiscal budget level at current levels
Sources: IMF Regional Economic Outlook and others

The above arithmetic does not look like changing anytime soon barring geo-political shocks. The weakness in the Chinese economy along with a strong US dollar will continue to worry all global commodity economies. As a result, the commodity-dollar based asset creation cycle is bound to weaken, if not halt, along with a sharp erosion in forex reserves with worsening CAD that will continue to aid a sell off at a country level, and the sentiment is bound to rub off on global equity markets as well. Theoretically, even though India still continues to be an internal consumption oriented economy, it is difficult to escape the global sentiment, as a result of which asset allocation to India did suffer in 2015. Of course, rising US interest rates gave further fillip to the cause. This resulted in massively decreased equity asset allocation to India as well.



Given the global context, India's economic positioning seems to be relatively safe. Yes, there have been issues, and some rather pertinent ones: poor infrastructure creation, slack industrial and auto demand and a weak agri economy cum consumption. A culmination of all of this has been a year of lost earnings. But off all these, there is not a single internal issue that cannot be fixed, albeit with some serious effort.

We continue to believe that ….

(a) The Government's rapid undertaking of administrative, regulatory, and legislative reforms (GST, FDI etc.), along with improved external account developments on the back of declining energy prices will continue to aid consumption as well as earnings.

After witnessing subdued planned investment in FY13-14, planned investments grew 16.9% YoY in FY15 and 20.5% YoY in H1FY16, thereby showing signs of green shoots in the investment cycle. However, the improvement in capex was only driven by the government as its share in investment has increased from 50% in FY10 to 60% in H1FY16. The tendering activity of the last 18 months clearly indicates that capex from the government side will kick start and accelerate the cycle as more a majority of the tenders have been floated by government agencies. Going ahead, we believe sectors like power T&D, renewable, road, Railways and defence would be clear beneficiaries of the government's capital spending and will be the source of order inflows for industrial players.

Power reforms are another key area of impending growth. The Ujjwal Discom Assurance Yojana (UDAY) scheme of the GoI involves a massive bailout plan for debt ridden state power companies that seek to once for all align consumer tariff with generation cost and promote energy efficiency. As per the Power Ministry, the UDAY scheme, if implemented, can eventually lead to a saving of Rs. 1,80,000 crore annually and gradually improve the capex implementation power of SEB's. There is already significant action in this space as visible from the pick-up in ordering done by Power Grid, which has listed down investments of Rs.100,000 crore in the 12th and 13th Five Year Plan. In H1FY16, Power Grid's ordering is up 67% YoY at Rs.9610 crore. Initiatives like UDAY and other government programs wherein eight troubled SEBs have been registered will go a long way to initiate the process of revival of discoms over the next three to five years, which, in turn, will drive capex in the power sector.

(b) A large domestic market that has been temporarily hit by a poor monsoon thus affecting consumption *should* see reversals in the coming year. India has suffered 2 bad agricultural years and though very early, it is predicted that 2016 will see *good* rains. Two years and four seasons of poor harvest have severely affected rural spending, and taken a relative toll on off take in the consumer, auto and rural housing industries. Rural demand contributes to about 35-40% of

FMCG sales in India and lower discretionary spends in the last years have affected the industry adversely. Similarly, the rural markets contribution to the two wheeler industry is upwards to 50% and softness in the same is visible in 2-wheeler sales this year. With over 50% of rural household's dependent of agriculture, a better harvest in the coming summer crop will support a vast reversal in one shot across several sectors.

(c) High levels of consumer confidence aided by the impending 7th pay commission, impacting 1.4cr Government employees will have a cascading effect on consumption. Post the hikes, the lowest average salary of a Central Government employee will be Rs.29,000 per month, while the distribution of employees earning between Rs.50,000-Rs.100,000per month will move to 36% from 23% hitherto. As experienced from previous pay commission exercise, this will have a material impact on items of discretionary consumption.

Other tailwinds include the RBI and GoI's fast track initiatives to help PSU banks clean up their books and initiate recoveries against bad assets (Strategic Debt Restructuring, Bankruptcy bill, etc.), regulations to improve mining, relaxing FDI norms for the defence, fruits from the Make in India push and many others. Over and above, the fiscal budget in February 2016 will be another avenue to bring in newer policy initiatives to kick start the domestic consumption cycle.

Net of all, there are levers to move the needle for the year ahead. However what we need to be patient about, are the timelines it will take the economy to deliver on the promise. The inconsistency between expectations and earnings has started to test the streets patience and until there is delivery of actual earnings, 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.

Hence, our strategy will continue to be that of a more focused, bottom up approach and alignment with companies that exhibit strength at a firm level, with reasonably strong earnings growth outlook for the short to medium term, along with healthy balance sheets and good capital return metrics. A few of the key investment themes we like at the moment include: (a) pharma & speciality chemicals, (b) affordable housing and select NBFC's, (c) private banks with stable asset quality and proxy for rising retail assets, (d) auto players that will benefit from revival in domestic consumption and (e) select mid-cap players across sectors with strong earnings visibility.

Meanwhile, decisions on rate hike by US Fed, and data flow from Europe, China and global commodity markets will continue to have its effects on the markets. Currently, valuations of benchmarks, at 14.5x FY17 consensus earnings, are near the long term average of 15x; so to that extent, we believe the downsides may be protected. What we do have to keep in mind is the probability of a time correction. We continue to maintain a hawk eye on a favorable risk reward in terms of valuation, as demonstrated by its price earnings multiple being lower than the rate of earnings growth, adjusted for its scale.

As we step into the New Year, we leave you with a little 'un'stock tip – *stay healthy*.

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
Research

Risk: Key risks to our portfolio would come from geo-political concerns globally, decline in foreign inflows, sharp currency movements, 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.

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