Global developments

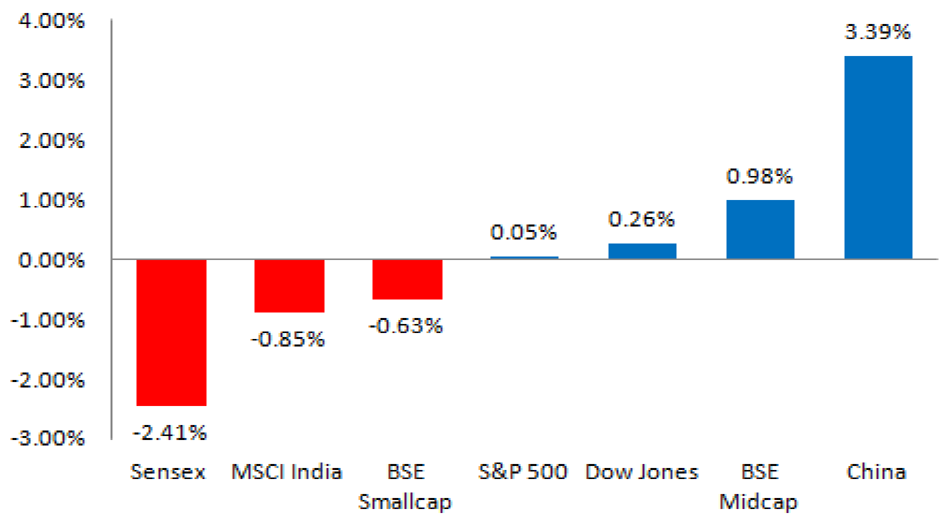
Without as much as a gun shot being fired, geo-political headlines dominated the outcomes of global equities in August. Before recovering, Wall Street saw a momentary decline as America's strong verbal rebuttal (obliteration!) to North Korean jawboning spooked investors. Given the constant state of geo-political affairs today, one may believe that that such rhetoric is best discounted, but one can never discount the risk of strikes on possible supply chain disruptions, and of course regional fall in consumption, that can have unintended multiplier effects as a result of which selling has been broad-based on 'fear'. (It is another matter that Wall Street started rising from the moment Iraq was invaded in 2003). Besides, lack of support from earnings, and generally frothy markets mean that such news flow are amplified in their probable effects. As the smart investor played into dips, the market's almost recovered the losses it made in August.

In real economic news, the U.S GDP growth picked up at an annualized rate of 3% in Q2 of CY17 vs 1.2% in Q1-17. However, the Fed's preferred measure of core inflation was only 1.4% in the year to July, well short of its 2% target. The unemployment rate has averaged 5% over the past three years, comparable to the three years before the crisis, yet price growth has been markedly lower at 1.5% over the most recent three-year spell compared with 2.2% from 2004 to 2007. Keeping this in perspective, the prudence of the Fed in hurriedly raising rates must be watched carefully. The ECB however forecasted that EU is expected to grow by 1.8% for 2018 and 1.7% for 2019 as recovery of the bloc continues. The extent of the recovery has helped the Euro reach multiyear highs, but given that the recovery is mostly domestic consumption driven, it is unlike to post any problems over all. The USD has depreciated by 11% vs the Euro in CY 2017.

World Markets

Emerging markets continue to have a good 2017 as the EM index notched another 2.01% for the month and is now up 26.14% for the year.

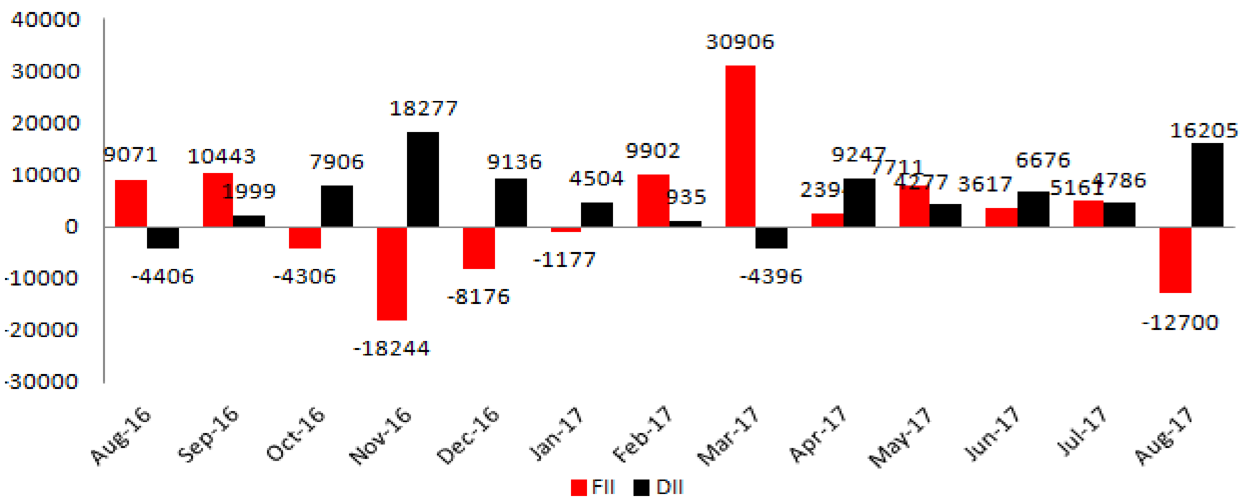
MSCI (in %)	India	Brazil	Russia	Korea	China	Japan	US	Australia	EM Index	MSCI World
MoM (in %)	-0.85%	6.01%	8.14%	-2.49%	3.96%	-0.08%	0.08%	-1.00%	2.01%	-0.06%
CY - YTD (in %)	27.32%	19.50%	-6.82%	29.16%	39.28%	10.98%	10.60%	10.28%	26.14%	11.91%



India has been among the best performing markets globally with MSCI India up 27.32% in CYTD 2017, helped by a weakening USD.

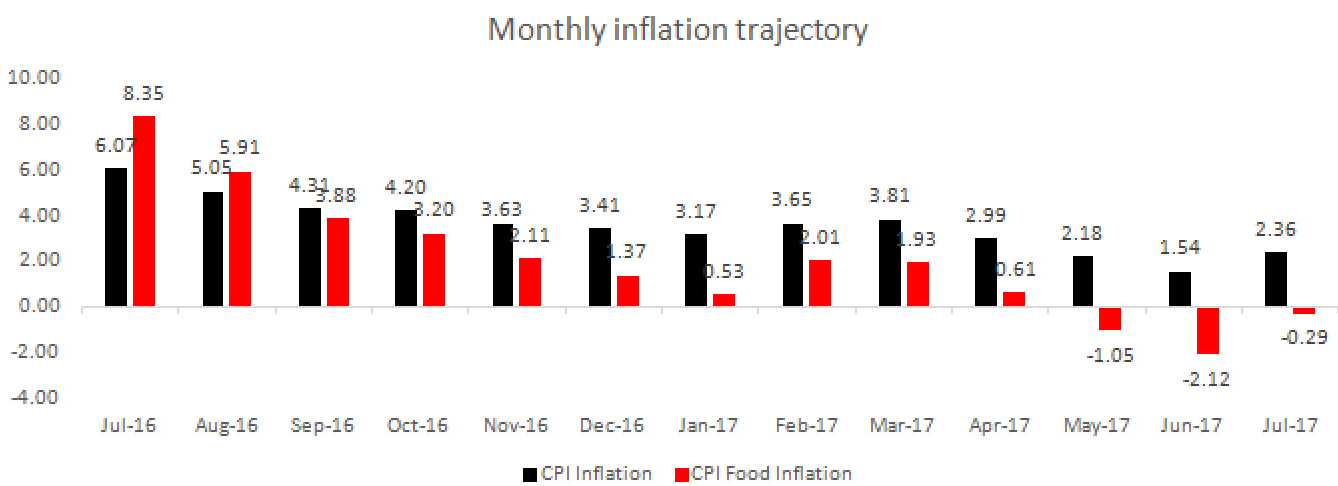
Inflows abound

For FY-18YTD (beginning April 2017), inflows from domestic sources at Rs.41,191cr ($6.43bn) has outstripped FII inflow of Rs.6,183 ($0.96bn) by a wide margin. The rising appetite of Indian households towards equities is both heartening and a tad worrying as we are not sure if risk reward at this juncture is entirely understood in deciding on the genre of exposure to equities. Commentary that liquidity will support unwarranted valuations is a not good to hear as this is no hedge for valuations or market excesses. Only fundamental performance, rather than lack of bad news, will lead to a change in stance.



Inflation falls | CPI @ 2.36% vs 1.54% MoM | WPI @ 1.88% vs 0.90%

Consumer inflation continues to be in control, coming in at 2.36% for the month of August-17 vs 1.54% in the previous month. The food basket that consists of 45% of the CPI index continued to witness moderation, falling -0.29% for the month, following 2 preceding months of decline. Prices are in a range overall and they are not too uncomfortable. An uptick in food prices from here on should not cause alarm as we head into the festive season. And like we have been saying, sustained low food inflation lends a very myopic view of comfort as farm income is a strong driver of consumption, and the broader economy.



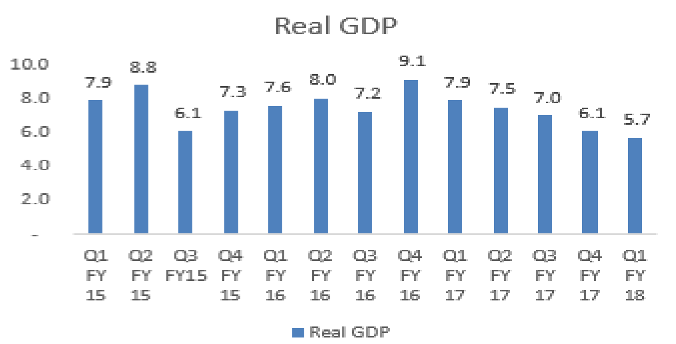
Like we communicated the last time, the Government's increased its MSP for the Kharif crops by 6.8% this year vs 5% YoY is welcome and we believe more needs to be done to broad base farm income. Lower end produce prices have kept the dependents of this sector at the lowest level of the economic pyramid for long, and this dynamic needs to change. The RBI's vigil on 4% as a target for inflation has long been met and over emphasis on waiting for further optical evidence of it being structural can blindside the need to address other monetary policy requirements. Like you will see in the charts we have shared in the next page, Gross Capital Formation, and Private Consumption has fallen and this needs to be arrested, and a deflationary spiral will be hard to arrest.

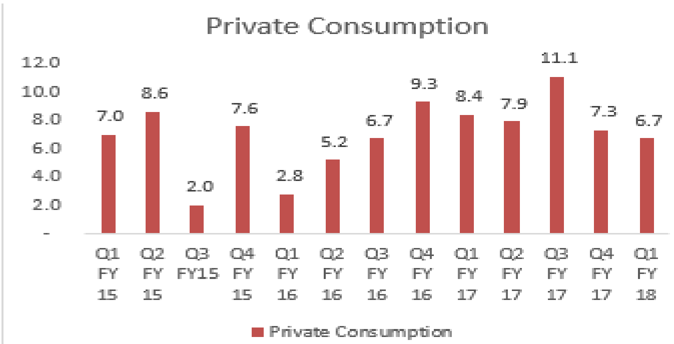
Other key developments

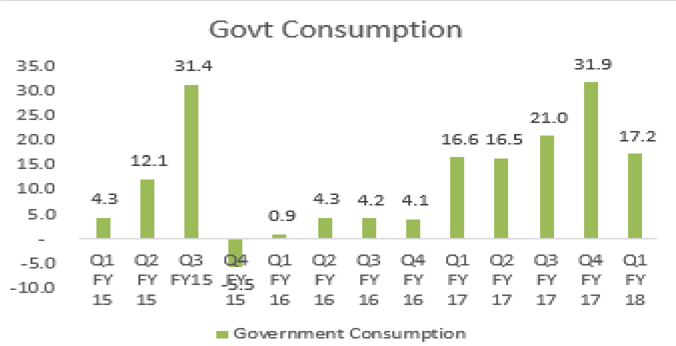
- The RBI cut repo rate by 25 basis points to 6% in its latest credit and monetary policy review, reducing the key policy rates for the first time in this fiscal year. It is time interest rate transmissions kick in to (A) move the needle on consumption as well as (B) have balance sheets benefit from leverage and use the surplus in capital or operational reinvestment
- Q1 GDP growth was disappointing at 5.7% as GST implementation impacted inventory stocking and manufacturing output. Jun IIP contracted by 0.1% vs 1.7% rise in May. Manufacturing output contracted by 0.4% in the month vs 1.2% growth in May as Capital goods continued to remain subdued.
- RBI's annual report in Aug provided the much awaited details on demonetisation, with 99% of old notes (Rs1000, Rs500 notes) back in the banking system. Against a printing costs of Rs200bn, the RBI gained Rs160bn (1% of currency not returned).
- Monsoon progress is on track after a lull in July – this is good for food inflation, and abetting rural recovery, the impact of which should be seen in Q2 and Q3 of FY-18.

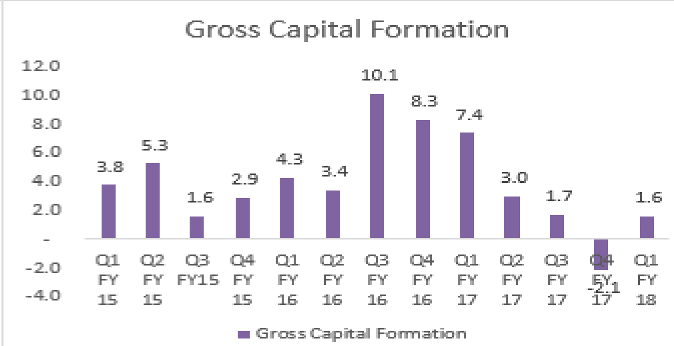
Unifi Strategy

We have captured a few key economic trends for a quick snapshot of the real economy and as you can see optically, most of them have been sloping down. The macros are not suggestively positive.









While the street has largely blamed demonetization and GST as the reasons behind a weak 1QFY18 GDP growth of 5.7%, there may be a case for core weakness in several other variables. We are tempted not to drawing too much of a reference to Q1-FY18's earnings as the effects of GST have distorted real fundamentals.

Overall, our line of thought is distancing itself from regular management's commentary on the environment. In India, the environment has always been challenging, and superior on the ground execution has been the difference between good and not so good managements. As we stick to neutral bottom up evaluation, negating the size of a company, and seeing if their P/L growth seeks investor attention backed by B/S and valuation comfort, we believe there will continue to be opportunities out there. One such sector may be Metals.

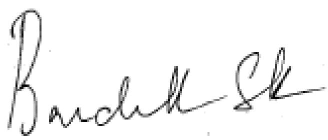
After a deep downgrade cycle of almost 7 years, the metals sector may now have reasons for fundamental optimism. After record capex in 2010 when China was growing at break neck speed, there followed a period of extended lull for years where project expenditure slowed down sharply. This was a period where China used all its surplus capacities for exports; and more often than not, at pricing that was drastically lower than the breakeven price of not just its export destination, but its own cost of production. This process of dumping, to keep its plants running, wrecked the economics of the metals industry in India. While India was a beneficiary of lower input costs, the detrimental multiplier effect of the stress on the domestic metals sector was traumatic in more ways than one. The Indian banking sector witnessed its worst period of recent operating history, and it remains to be seen how the shareholder value that has been impaired, can be made up for. However, there *seems* to be a structural shift in the metals industry in India. The imposition of Anti-Dumping Duty in almost all classes of processed metals, has significantly, reduced the competitive pressures of Chinese imports vs Indian mills. And then there is the case of a real rebound in Chinese domestic prices (and consequently their export prices) as their domestic sentiments seem to be witnessing improvement. As a result, Steel prices have generally witnessed improvement in pricing as demonstrated by the fact that global steel prices are above the reference prices set in the anti-dumping duties on HRC. India's steel consumption is estimated to have grown 4.4% YoY in April-July'17 to 27.9MT, better than the 3.0% consumption growth in FY17. Steel imports over the same period were higher marginally by 4.7% YoY to 2.5MT due to the anti-dumping duty imposition while exports increased by 65.5% to 2.8MT with higher domestic steel production. This has broadly resulted in capacity utilizations of Steel Mills in India inching higher, and as we know, that is the only panacea to the sector. Of course, these are the broad stoke thematic takeaways, but our conversations with people on the street and the companies themselves have us believe that this time, it is not a false start. Over the last month, we have taken measured exposure to the sector, and continue to watch the micro's closely. While this sector will turn, there is no telling if the mainstream Indian banking will do so in the short term or interim, as the turnaround in the Indian metals industry still cannot accommodate the capital erosion that they have suffered. In one of the first case under the bankruptcy resolution code, (Synergies-Dooray automotive), lenders have been asked to take a haircut that is > 90%! If the quantum of capital to be written off is this material, banks may still want to continue restructuring and then there will be no telling as to how long 'surprises' will continue. Which is why we are not yet seeing deep value in public sector financials.

Over all, we are pleased to move closer to Q3-FY18 as on a low base of last year (demon, followed by GST), the pace of earnings should be much better than that of last year, and sector leaders should optically deliver much better numbers. GST collections for July (the first month) came in at Rs.923bn (vs.Rs.1069bn YoY) suggesting a good start over all. It is believed that out of the 5.9mn GST registrations, only 3.8mn taxpayers have filed returns thus far. This is on the back of reported subdued activity at an absolute level due to destocking and lower sales. It is given to understand that GST returns can be filed without first making the tax payment; so there is a theoretical chance that eventual collections will be higher. Over all, as tell-tale signs of compliance increase, collections will increase progressively, and create the financial base for the Government to increase its spending pool.

As a sector, specialty chemicals and polymers continue to dominate our exposure; as we continue to find pockets of opportunity there, and the least so by design. We continue to like select names in building products, and metal by-products apart from other standalone names. It may be an exercise in futility to deep dive into the Q1-FY18 results reasons. It has now been 3 quarters of one-off's in the Indian economy - led by demonetization and GST and most of the earnings misses this quarter can be traced back to GST. Stabilization will take another quarter and Q3-FY18 may be an interesting time for earnings as the base effect of demonetization in the earlier year should prove to be favorable.

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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