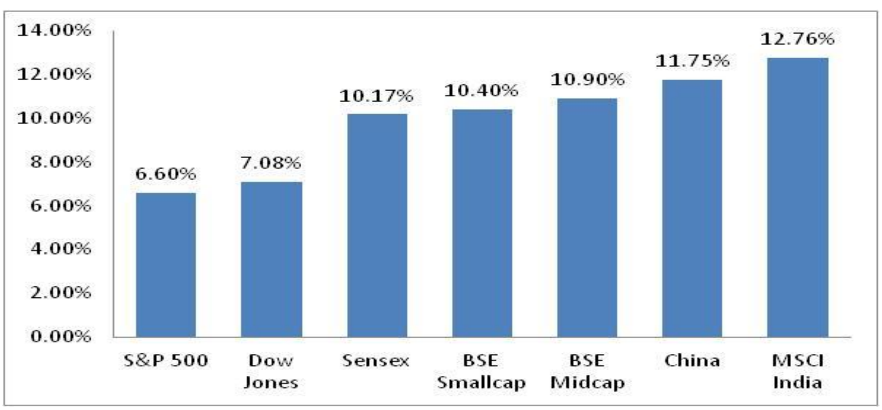
Global developments

It has been a quarter into the new year 2016, and so far, there hasn't been anything real to cheer about. While real economic data hasn't worsened, talk of recession hasn't gone away either, as a result of which policy makers continue to push measures that will fight deflation. The European Central Bank has slashed interest rates to fresh record lows of -0.4%, in its latest attempt to prevent the EU from slumping into a Japan-style deflation. While the headline borrowing cost is now zero, banks are being forced to pay 0.4% for leaving cash at the ECB which now expects inflation to average just 0.1% this year, and warns that growth risks are "to the downside". A broad based recovery in the EU continues to be dampened by no new standalone growth drivers in the region, subdued growth prospects in emerging markets and volatile financial and commodity markets. The ECB is widening its QE program to €80bn per month, and will also start buying up debt issued by companies in its bid to boost money supply and inflation.

Extending the tone, Fed head Janet Yellen also sounded extremely dovish in her most recent commentary on monetary policy and placed Fed's ability to respond to any macro event as asymmetric. Simply put, the Fed may have indicated the return to near to near zero rates. Given the risks to the outlook, the Fed now considers it appropriate for the Committee to proceed cautiously in adjusting policy, saying that it "expects that economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate". This caution is especially warranted because, with the federal funds rate so low, the FOMC's ability to use conventional monetary policy to respond to economic disturbances is asymmetric, meaning, there is little upside risks to Fed's current rates of 0.25%.

Meanwhile, China, undistracted by most of the world's problems, which ironically it may have in part caused, formally unveiled its growth target for the current year, putting it at 6.5-7%. Most official Chinese targets, once set, have a way of delivering itself. It would be great if they indeed deliver, but not so much, if it heats up an already heated economy, bursting at its seams with excess capacity.

A smart recovery in March



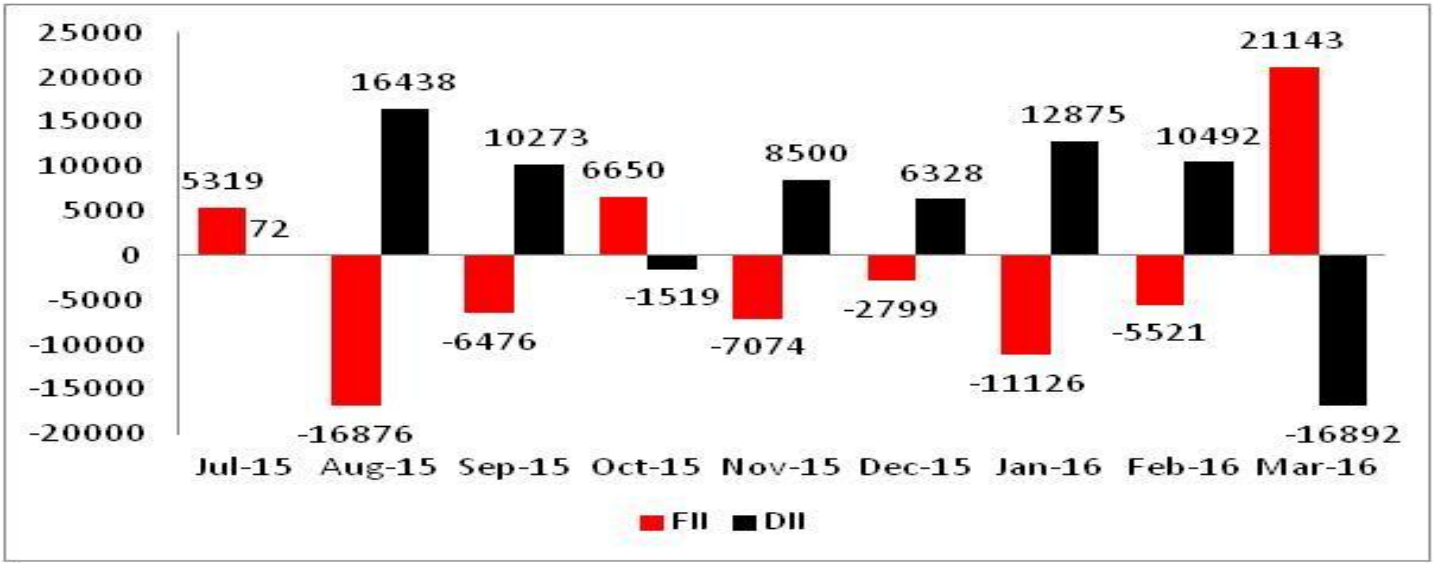
- Dow Jones was up 7.08%
- S&P 500 was up 6.60%
- Shanghai was up 11.75%

- BSE Sensex was up 10.17%
- BSE Mid-cap was up 10.90%
- BSE Small-cap was up 10.40%
- MSCI India was up 12.76%

MSCI (in %)	India	Brazil	Russia	Korea	China	Japan	US	Australia	EM Index	MSCI World
MoM (in %)	12.76%	30.33%	14.68%	13.93%	11.89%	3.88%	6.66%	12.17%	13.03%	6.52%
CY - YTD (in %)	-2.90%	27.38%	15.66%	4.82%	-4.81%	-7.32%	0.39%	0.81%	5.37%	-0.88%

After FII liquidity left Indian markets and Domestic Indian funds sustained buying for most of the year, the inverse happened in March; FIIs came back in good amount while Domestic funds saw some profit booking.

The chart below showcases FII and DII behavior for the full year FY-2016, with inflows peaking in March at Rs.21,143cr., and in part aiding the Sensex's 10% rally for the month.

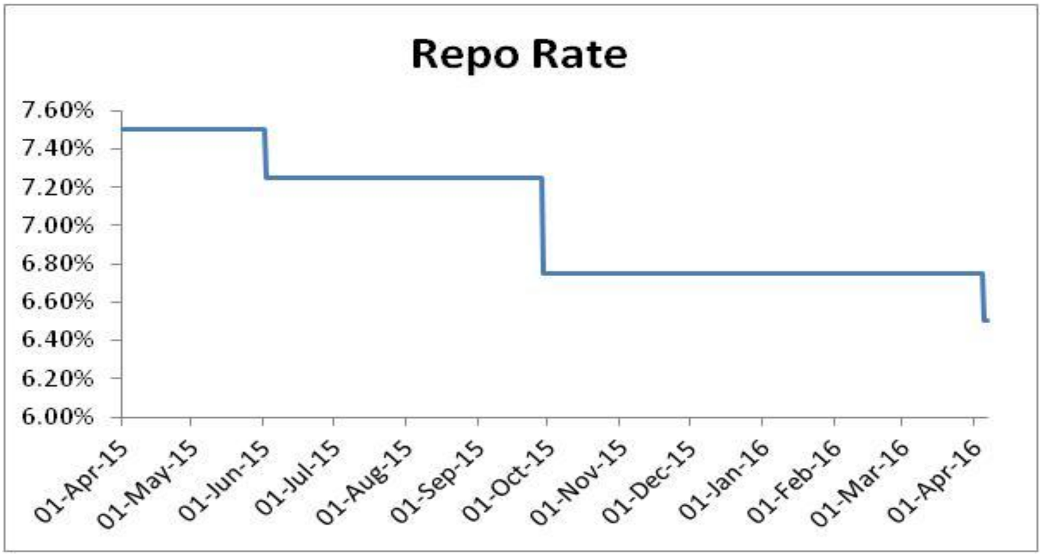


Monthly Macro Review

Bi-monthly monetary policy review | Borrowing rates will now incrementally fall further

Given the headway India has made in controlling inflation, and the general glide path being in control, combined with the need to boost domestic private spending, the consensus pointed to a 25bps rate cut in the April policy review. Some quarters hoped for a larger 50bps cut, but the Reserve Bank of India didn't think so, and settled for a 25bps cut to 6.5%, i.e., the new rate banks would pay to RBI to borrow under the LAF window.

The RBI has now delivered a cumulative cut of 150bps as follows.



However, the story isn't really in the quantum of cuts as the transmission of the drop in interest rates to lending rates have not really happen. Before this April's cut, the 125 bps had resulted in a reduction of a mere 70bps in borrowing costs. The primary reason for the same were tight liquidity conditions, keeping which in perspective, the RBI has now increased liquidity into the system by reducing the minimum daily maintenance of Cash Reserve Ratio (CRR) from 95% to 90% with the added assurance that the systemic liquidity would be improved from a deficit of 1% to neutral. The financial year also saw the introduction of Marginal Cost of funds based Lending Rate (MCLR) framework which will further improve the monetary policy transmission. All these developments are expected to bring down lending rates while addressing liquidity stress being faced by banks, thus facilitating higher credit offtake in the coming quarters.

RBI maintained the inflation projection for Mar'17 at 5% with small inter-quarter variations. Assuming a normal monsoon in 2016, it estimates CPI inflation to fall to about 4.5% by Jun'16 before picking up to 5% by the end of FY17 on account of likely higher MSP increase for Kharif (6%) and implementation of the 7th Pay Commission recommendations. The RBI also expects FY17 GDP to grow at 7.6%, stating, *"the uneven recovery in growth in 2015-16 is likely to strengthen gradually into 2016-17, assuming a normal monsoon, the likely boost to consumption demand from the implementation of the 7th Pay Commission recommendations and OROP, and continuing monetary policy accommodation."*

Over all, the short to medium term drivers concerning inflation, monsoons and steady pace of economic recovery seem to be looking good, and with it, the prospect of another 25bps of cut in interest rates.

Inflation cools, CPI @ 5.18% vs 5.69% MoM, WPI still in negative territory @-0.91% vs -0.8%

Consumer price inflation for February 2016 dropped to 5.18% vs 5.69% in the previous month as the prices of milk products, vegetables and pulses fell well for the month. The fall was more or less anticipated as vegetable and pulses inflation peaked in the past few months following a poor Rabi season and was expected to normalize as supplies regularized. With normal monsoons anticipated over the next few months, we don't think there are any reasons for inflation to move up materially from the current range.

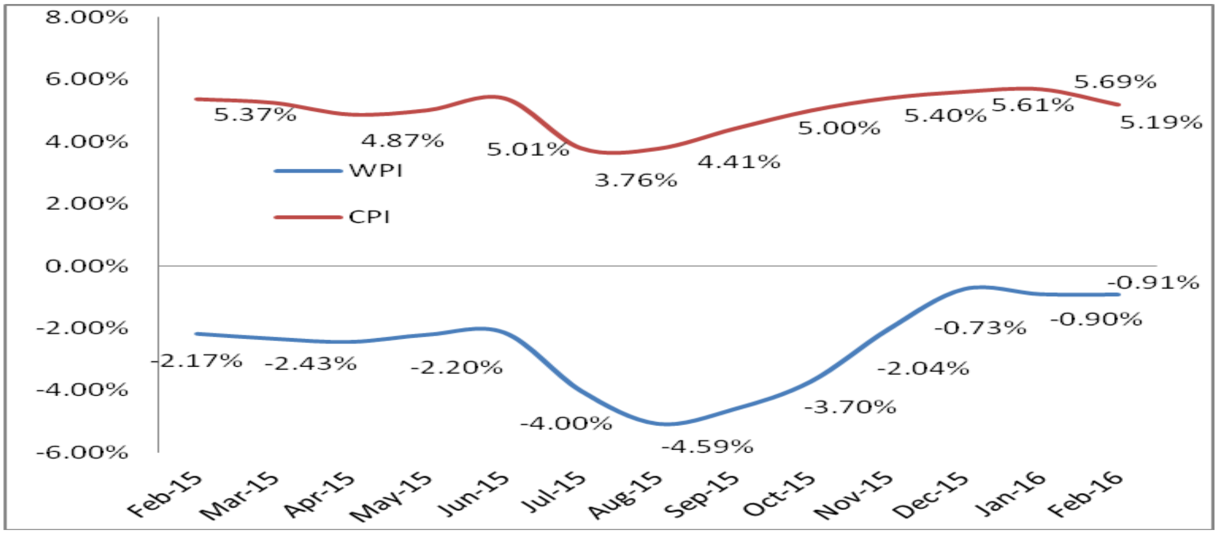
The following table should give a good indication of the main movers of current inflation.

Weight	Consumer Price Inflation	Jan-16	Feb-16	MoM
45.9%	*Foods & Beverages*	*6.66*	*5.52*	*-17.1%*
2.4%	*Pan, Tobacco & Intoxicants*	*9.03*	*8.39*	*-7.1%*
6.5%	*Clothing n Footwear*	*5.85*	*5.52*	*-5.6%*
10.1%	*Housing*	*4.86*	*5.33*	*9.7%*
6.8%	*Fuel n Light*	*5.32*	*4.59*	*-13.7%*
28.3%	*Miscellaneous*	*3.95*	*4.38*	*10.9%*
100.0%	*CPI – Inflation*	*5.69*	*5.18*	*-9.0%*
	CPI – Food inflation	*6.85*	*5.30*	*-22.6%*

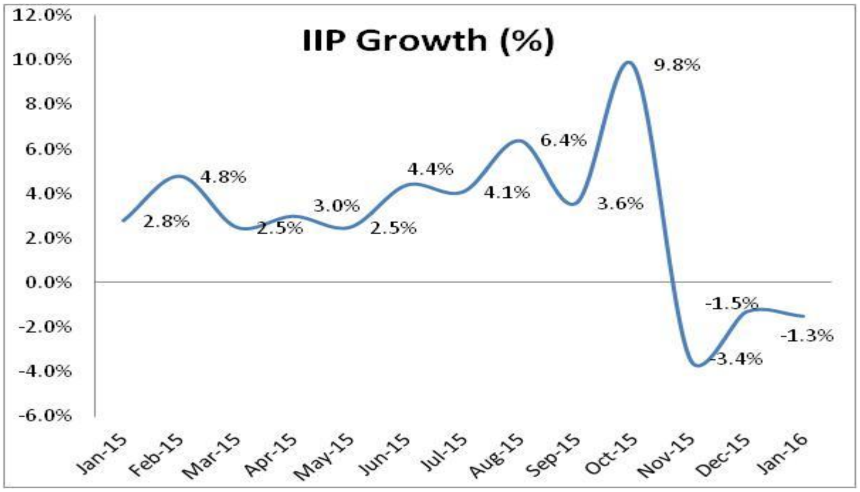
Over the next few months, CPI inflation falling to well below 5% is a realistic probability as the cost of Pulses get back to realistic level; as it can be seen below, pulses were up almost 40% over the last few months, having an almost 1% impact on the headline CPI number of 5.18%

Weight	CPI	Dec-15	Jan-16	Feb-16	MoM
2.38%	Pulses	45.92	43.32	38.30	-11.6%

The deflationary trend also continued on the wholesale front with WPI down -0.9%, now in the negative territory for 16 consecutive months. Minerals were down by 8.13%, non-food articles were down -2.94% and Food articles were down -3.18%, resulting in the continuation of the slide.



Index of industrial production (IIP) | Down for 3rd month in a row



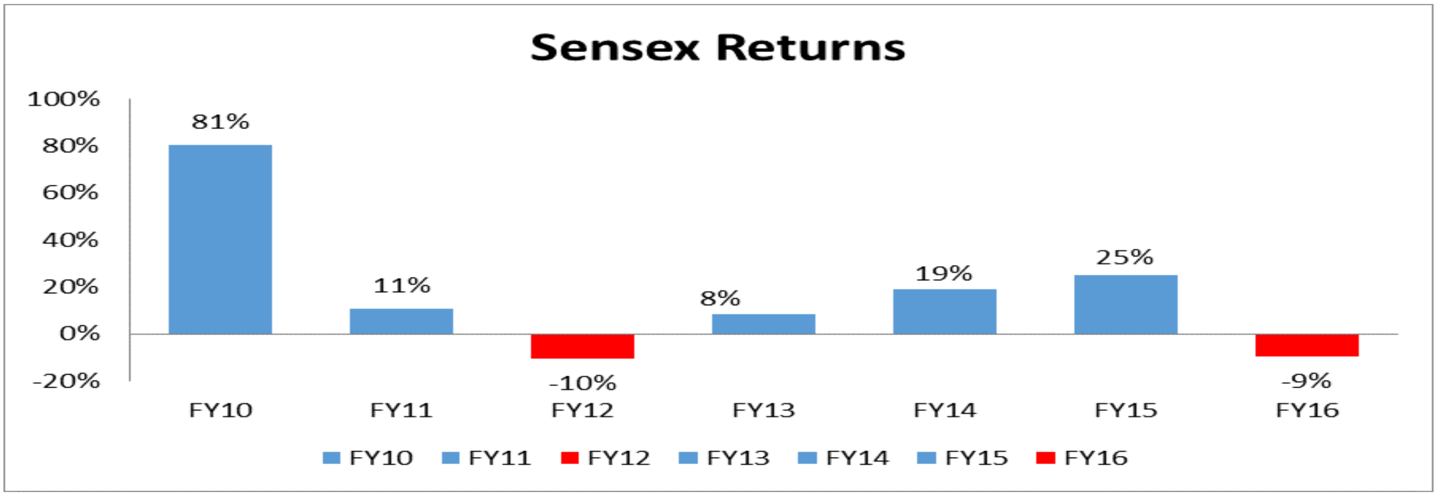
January 2016 IIP growth came in below expectation at -1.5% vs. -1.2% last month and 2.8% a year ago. This is the third month of contraction in industrial output, largely being led by manufacturing. 10 out of the 22 industries recorded negative growth as manufacturing output fell sharply by -2.8%.

FYTD, IIP growth is almost similar to last year at 2.8%, falling from 5% output growth until April-October 2015.

Unifi Strategy

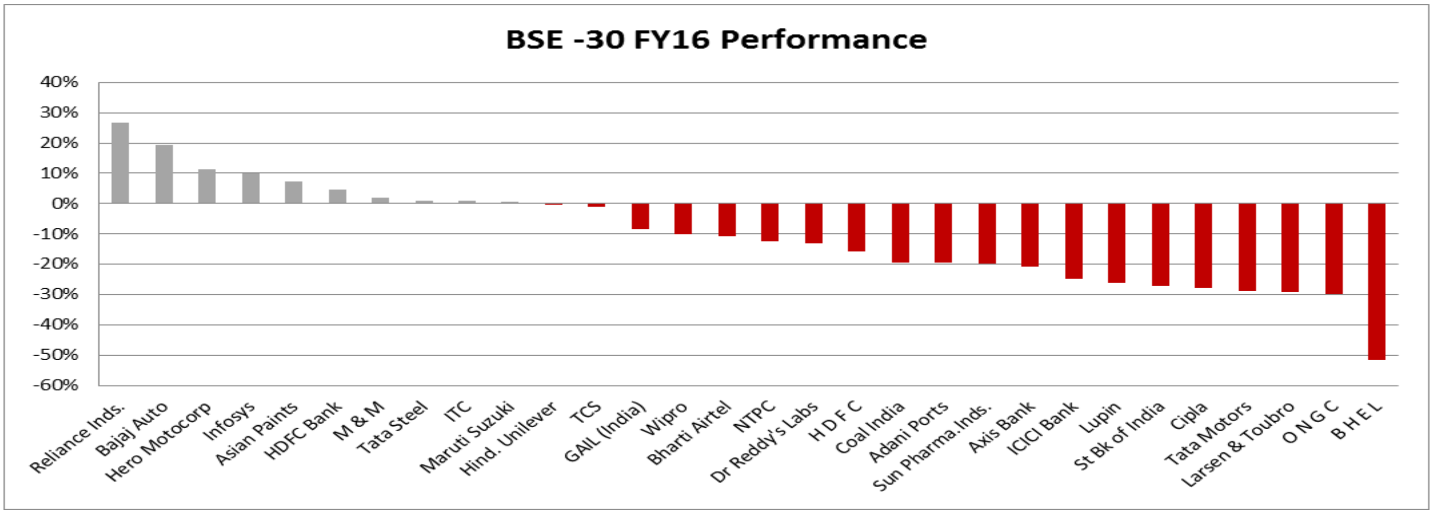
FY2016, a -9.4% year

FY-2016 has come to a stuttering close and the benchmark BSE-30 Sensex has witnessed a negative -9.4% year. This translates to being one among poorer years over the last 6 years.



While no one enjoys a negative year, a return of -9% after three year positive years, <u>with an absolute return of 52% (over FY13-FY15)</u> may be explained as a period of consolidation (albeit following a year of consolidation in earnings as well).

In the context of actual stock returns, this is how the constituents of BSE-30 have behaved over the year



<u>Further, in the wider BSE-200, which is more representative of the multitude of sectors with 200 stocks, the number of stocks that had negative returns were 64% (127 companies) to 36% (73 companies) returning positive returns.</u>

Over the next few days, the earnings season for Q4-2016 is set to begin and while we don't expect major positive surprises, they are estimated to be incrementally better than that of the previous quarter. In any case, it would not significantly add to the earnings for the full year FY-2016, which is now fully discounted by the street and looking forward to FY-2017.

Rolling over, while it's early days, we believe that it will be a significantly better year over FY-2016. On a full float basis, assuming banks have a 'normal' year, that is, no incremental asset shocks and limited devolution of the stressed asset provisioning to actual write offs, the coming year could actually deliver a 14.3% kind of earnings growth for BSE-30 Sensex as a whole. However, should there be significant stress in the Banks (that is Axis, SBI and ICICI bank reporting a 50-100% cut in earnings), the earnings growth for the Sensex could be anywhere between 11-9% approximately.

As for the market sentiment in itself, it will continue to look for global cues across commodities, and interest rates, which could then significantly drive FII inflow into India. For instance, after the Oil basket saw a pull-back in March, Indian markets pull back sharply, gaining 10% for the month. The pull back in commodity prices have to that extent lessened the fears of a dramatic deflation, and the probability of exporting itself throughout the world. Brent crude has enjoyed a run of close to 40% from the lows of late-January. Other industrial commodity prices such as copper, aluminium and iron ore have recovered sharply as well. However, any high beta rally on the back of low quality stocks (volatile earnings and poor balance sheet) is unlikely to sustain, while it provides short bursts of relief to the index as a whole. The first of the Monsoon predictions are due in mid-April and a good enough outlook should also do its bit to cheer sentiment in most consumption driven industries. Like we have said in the past, reforms in power and banking, increase in money supply via MNREGA, Direct Benefit Transfers (of subsidy), Agri spending and the 7th pay commission, etc., are the levers available to improve earnings for the years ahead.

As and when GST comes in, (may be by April 2017), the earnings upgrade will only strengthen as markets may in part discount the year ahead as well.

Until then, our strategy will be consistent with what we have been communicating for a while now: 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. This continues to be a stock pickers market and we continue to dig deep and wide to un-earth sectors and stocks that are turning up.

As a sector, we continue to like the specialty chemicals space, along with select names in NBFCs, Auto and Pharma. We are not averse to higher than usual cash levels in the interim as we look for the ideal balance between risk and reward. We continue to maintain an 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.

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