UNIFI Capital

Global developments | New Year, New QE | Greece votes against austerity

Mario Draghi welcomed the new year with a 1.1 trillion Euro (USD1.3 trillion) gift to the Euro zone, committing a massive push at monetary policy to counter the deflationary spiral of Europe. The Germans were reportedly against this but the ECB fought them off to pledge purchase of €60bn beginning the next month until Sept-2016 to put more cash into circulation and revive inflation. Monthly purchases will probably comprise about 45bn Euro of sovereign debt, 5bn Euro of bonds issued by institutions, and €10bn under existing programs for asset-backed securities. The regions 19 national banks will make 80% of these purchases and take on any risk that they carry. One could argue that this monetary policy approach should have been applied much earlier, which would have gotten Europe on a similar kind of platform the U.S. was on, but its better late than never. While the policy prescription is all well, it remains to be seen if the Euro QE would be as effective work as the one in US and will work the way it is supposed to in Japan given how much more complex and fragmented the Euro Zone is; it is an amalgam of 19 moving parts! A 1% addition to the euro zone economy across 19 economies adds about 0.05% to the respective countries GDP's on an average; whom does that help? Hopefully the outcome is not this linear.

Meanwhile the Greeks bogged by a long spell of austerity, in trying to vote it out, chose the supposedly radical left anti austerity party Syriza as their new ruling party. Syriza has pledged to negotiate a write down of Greece's debt which stands at 175% of its GDP and go after Greek Oligarchs among other micro budgetary measures. Analysts have doubted if they can get away with the re-negotiation as it would show Germany (its largest creditors) and other nations in poor light domestically. Greece's current bailout program has been extended to the end of February. If Syriza is not able to negotiate an extension of the program while it settles into government and launches an economic reform program, Greece's fragile banks could face a potentially debilitating deposit run. Greece will also have to find enough money to repay 1.4-trillion Euro to the IMF in March and faces an ECB bond repayment in June.

Indian Market

FIIs bought stock worth USD2bn and debt worth USD3.4bn for the month of January. Domestic mutual funds were marginal buyers in January at USD39mn while insurance companies remained sellers of equities for the 11th month running at USD1.3bn. India was the best-performing market within the MSCI Indices with BSE Sensex up by 6.1% outperforming the mid- and small-cap indices that were up 3.5% and 2.2% for the month respectively.

MSCI (in %)	India	Brazil	Russia	Korea	China	Japan	US	Australia	EM Index
MoM (in %)	7.91%	-6.62%	-0.77%	2.33%	2.27%	2.33%	-2.92%	-1.78%	0.55%
CY - YTD (in %)	7.91%	-6.62%	-0.77%	2.33%	2.27%	2.33%	-2.92%	-1.78%	0.55%

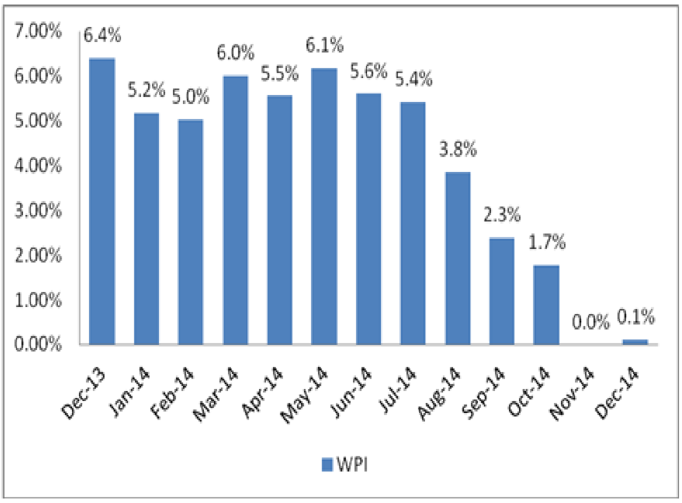
Monthly Macro Review | Surprise rate cut | Inflation

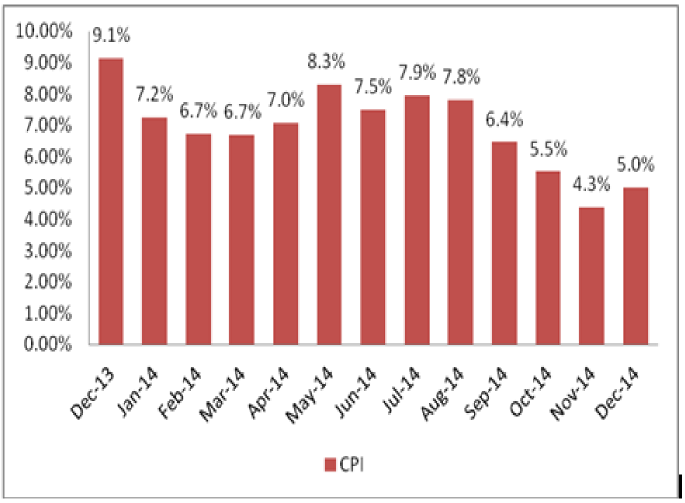
The surprise - In an out-of-turn policy move, the RBI surprised all on timing of an otherwise imminent reversal of policy stance. RBI frontloaded the change of stance and cut the benchmark repo rates by 25bps, with the repo currently at 7.75%. Broadly, the considerations that the surprise monetary policy formulation are as follows:

- No dramatic change in the global oil outlook; prices to remain stable over the course of this year and aid India's inflationary trajectory favorably
- Further, correction in global commodity prices will help in moderating core inflation in India
- Governments focus on "high quality" fiscal consolidation
- Both near-term and longer-term inflation expectations of households finally being adapted into the single digits
- January 2016 target on CPI at 6% likely to be met.

The RBI had consistently maintained that once the monetary policy stance shifts, subsequent policy actions will be consistent with this stance. Consequent to this, one may assume that the rate cycle in India has turned after five consecutive policy decisions by the RBI to pause on the benchmark policy rates throughout 2014 and India has now structurally moved into a low-rate regime and the cycle could be longer than being anticipated currently. Keeping this in perspective, the possibilities of deeper cuts are real as and when macro data points improve.

Inflation: both CPI and WPI at multi-year lows: Consumer Price Inflation for December accelerated to 5% primarily due to a weakening base. On a month on month basis, CPI was down 0.4% while just the food inflation component within this was down 1.32%. Food inflation has now been on a declining trend since September 2014. For the full year CY 2014, core inflation has moderated to 5.3% from 8.1% YoY (December 2013) helped by moderating food inflation and fall in crude which helped petrol and diesel inflation fall to 1% from 7% YoY. Also, Wholesale Price Inflation for the month was flat at zero following the month of November 2014 where it was zero as well. Primary articles inflation inched up 2.2% YoY on a fading high base while the fuel index registered a sharp 7.8% deflation. Core WPI moderated to 1.5% from 2.2% aided by a sequential drop in price of major raw material commodities like rubber, metal, minerals, etc.





Over all, both CPI as well as WPI for December 2014 have beaten the market expectations positively. Going ahead, as the benefit of favorable base effect wanes off, we may see CPI marginally picking up in the next couple of months. However, lower global commodity prices and the government's action in the form of rational utilization of buffer stocks, immediate action on import allowance of commodities facing supply pressure, creation of price stabilization fund, etc, to control domestic price shocks may cumulatively deter domestic inflation from accelerating at a faster pace. CPI is broadly hovering around the RBI's projection of 6% and has well stayed on its deflationary path. Hence, we believe the RBI will cut rates by 25 bps (provided the central bank is happy with fiscal targets in forthcoming budget) in the upcoming policy and utilize the limited room to push growth.

IIP – strong November: The IIP for the month of November rebounded with a 3.8% (YoY) growth, the most in five months, and a wide swing from -4.2% in the previous month. The normalization of activities post Diwali festive month enabled pick-up in manufacturing growth thus elevating the industrial growth. The eight months April - Nov YTD Industrial growth improved to 2.2% from 1.9% in April to October period and a comparable 0.1% in April-Nov last fiscal. Manufacturing growth acceleration to 3% from a contraction of 7.6% in October can be linked to the fact that 16 out of 22 industries registered expansion as compared to only 5 Industries witnessing growth in the previous month.

Consumer durables continue to remain in negative territory for the six-month in a row, declining 14.5% (YoY) but at a slower pace from 35.5% contraction in Oct. IIP Ex- Consumer Durables stood at 6.3% as compared to headline IIP reading.

Table 1: IIP, November, YoY, 2014-15

Year on Year in %	Weight	Nov - 2014	Oct - 2014	Sep - 2014	Aug - 2014	July - 2014	June - 2014	May - 2014	Apr - 2014
Classification by Economic activity									
Over all	**100.0**	**3.8**	**-4.2**	**2.5**	**0.5**	**0.9**	**4.3**	**5.6**	**3.7**
Mining	14.2	3.4	5.2	0.3	2.0	0.1	4.8	2.5	1.7
Manufacturing	75.5	3.0	-7.6	2.9	-1.3	-0.3	2.9	5.9	3.0
Electricity	10.3	10.0	13.3	3.9	12.9	11.7	15.7	6.7	11.9
Classification by use									
Basic Goods	45.7	7.0	5.8	5.1	9.2	7.0	10.2	7.5	8.6
Capital Goods	8.8	6.5	-2.3	12.5	-9.8	-3.9	23.3	4.2	13.4
Intermediate Goods	15.7	4.3	-3.1	2.2	-0.1	2.9	2.6	3.5	3.0
Consumer Goods	29.8	-2.2	-18.6	-3.6	-6.5	-5.9	-8.8	4.6	-4.8

PMI – January: The HSBC India Manufacturing Purchasing Managers' Index (PMI) fell to 52.9 in January 2015 from December's two-year record high of 54.5, but the data indicated that the Indian manufacturing sector continued to grow solidly during the month. The current set of data indicates sustained growth of India's manufacturing economy with new orders rising simultaneously for the fifteenth consecutive month. A reading above 50 shows expansion in economic activity.

Unifi Strategy

A high current account deficit, high inflation, high fiscal deficit and a vulnerable rupee, have been the scourge of the Indian economy for much of the last few years. A complete turnaround for the better on these fronts over the past year has led to India's outperformance against global indices with 30% plus returns in local currency terms over this period.

While most of these positive macro developments are to an extent priced in, the question is, are there further bull case upsides to the market's macro ecosystem going forward? Keeping in perspective the following developments of the past few months, we believe there is.

- The Governments focus on fiscal consolidation via disinvestment has been in display and we believe it is more or less on track to achieve its fiscal deceit target if 4.1% for the financial year ended March 2015;
- The visibility of current phase of low inflation is sustainable for the foreseeable year;
- A combination of the above will pave the way for interest rates to fall meaningfully in the remainder of the year;

We also need to keep in mind the following broad headwinds that took place between 2012-2014 that dragged growth below its immediate trend: (1) the threat of a sovereign downgrade and runaway inflation saw a significant cut down in government expenditure, leading to fiscal austerity; (2) cost headwinds on account of rapid bunched-up increases in administered prices of crude and currency depreciation; (3) the resultant impact of point 2 on consumption; (4) slowdown in the broad infrastructure investment cycle on account of poor policy; and (5) a tight monetary stance, i.e., high interest rates. We have noticed over the past quarter that each of these headwinds have been addressed and importantly there will be continued relief in all of these parameters. So, to the extent that this is not baked into current multiples, we believe that the combination of reversal of macro negatives, lower cost of capital and higher growth can be a significant driver of earnings as well as multiple expansions in the medium term.

The earnings season for the markets has been a mixed bag so far. For instance, while Information Technology has done well on the back of sustained economic improvement in the U.S., earnings of public sector banks leave a lot to be desired as asset qualities continue to deteriorate and one does not yet know when the rot will stop. Consumption based companies are also yet to witness a sustained uptick in volumes while they have set themselves well to take advantage of the fall in raw material pricing in the coming quarters. It the same with the Auto players who are in search of the elusive volume numbers which can significantly aid their operating leverage going forward. However, this is no indication of things at the ground level. Approvals from the project management group (directly monitored by the Prime Minister) are at all time highs and an overall improvement in the investment sector is across the horizon. As far as timelines are concerned, there cannot be a quick fix and progress will be gradual but firm with high multiplier effects as and well the cycle turns.

The government is due to present what will be its first full fledged fiscal budget this month (February 28th, 2015). In India, this is an event people look up across industries, markets and the general populace. It is widely expected that the Government, chosen to power on the back of promise of growth, will initiate a series of policy measures that will aid the development of both the industry and the market in general. Of course, several reform initiatives will continue to happen outside the budget as well.

At current valuations, the market is trading at 16x FY16e EPS of Rs.1813. It is not cheap but it is not too expensive either keeping in perspective the probability of high growth in a few quarters from now. On the back of these developments, we will continue to align ourselves with sectors having a high leverage to a revival in the domestic economy as well as sectors that have strong visibility of growth irrespective of the domestic macros.

Accordingly, across sectors, we are invested in businesses that are benefitting from sustainable growth in consumption supported by Indian demographics. The quantum of earnings recovery and economic growth at this point in time are not supporting the market rally and further delay in recovery may lead to the market losing its patience temporarily which may result in a bit of volatility. Also, supply of paper through the

Government's disinvestment program could act as another trigger for weakness and volatility. Keeping this in perspective, we may raise cash levels to about 10% if we deem fit.

Risk: Indian markets as well as the INR continue to remains vulnerable to the end of QE and consequent movement of asset allocation to the U.S. Sudden rises in global commodity prices may have a detrimental effect on the domestic macro. Interest rate hikes in U.S may be a huge event risk and affect liquidity conditions domestically. Market may turn volatile in parts due to challenges in passing reform bill in upper house (due to minority of the ruling Government), possible increase NPA in banking system, geo political issues and increase in US Fed rate.

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
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