Global developments | Pulling it back

One can be forgiven for not remembering the last time phrases like 'trade war' were used with such gusto. As the U.S trumped its protectionist stand on a host of issues, fears of a full-fledged trade war engulfed most global economies and March of 2018 turned out be tumultuous one. The US has imposed tariffs on a total of $153 billion of Chinese products and a further $50 billion across other products are now being considered in the coming days. China on expected lines retaliated by levying 15% to 25% tariffs on $3 billion worth of American goods, including scrap aluminum, frozen pork, dried fruits, nuts and wine setting the path for further escalation. As decibel levels around this issue rose, the commodity driven economies that withstood the correction in February '18 were seen losing this month (Brazil -2.1% & Russia -3.8%).

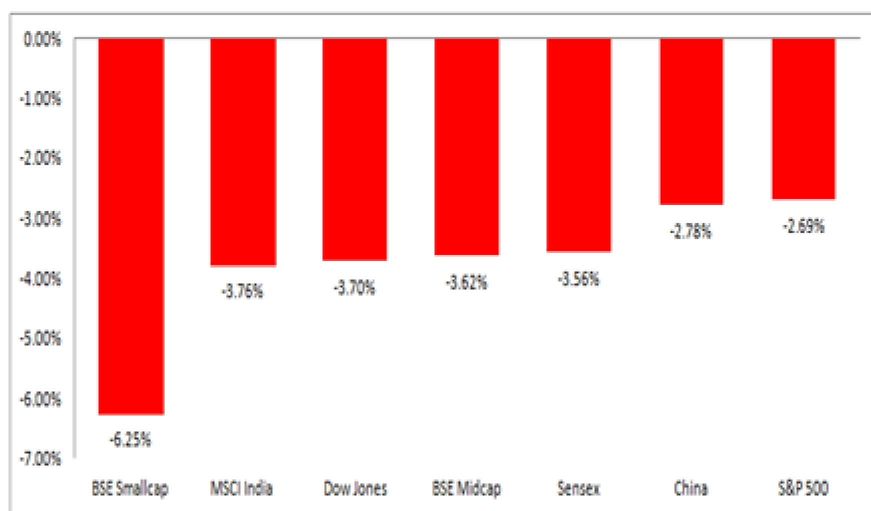
Meanwhile the Fed under the leadership of its newly elected chairman Jerome Powell's witnessed a widely expected quarter-point hike, and that now puts the benchmark fed rate at 1.5% to 1.75%. This was the 6th rate hike since the Fed began raising rates off near-zero levels in December 2015. The background of these actions lies in unemployment data, currently running currently at 4.1%, with expectations of it going down further in 2018 to 3.8%, and in 2019 falling to 3.6% and an increase in forecast for GDP (2018) to grow from 2.5% to 2.7% in 2018. Overall the inflation expectation remained moderate at around 2.1%. However, despite this relatively positive economic backdrop coupled with tax cuts, markets were volatile in trying to digest the effect of a trade war, if one did fructify.

Over the short term, one date we will eagerly watch is the 15th of May, when the US will decide on its stand on sanctions over Iran. Crude has rallied sharply this year (up 10% to $70/barrel) and geo-political instability may harden this rally.

World Markets

An amalgam of the global news flow as pointed above led to weak return across markets and geographies.

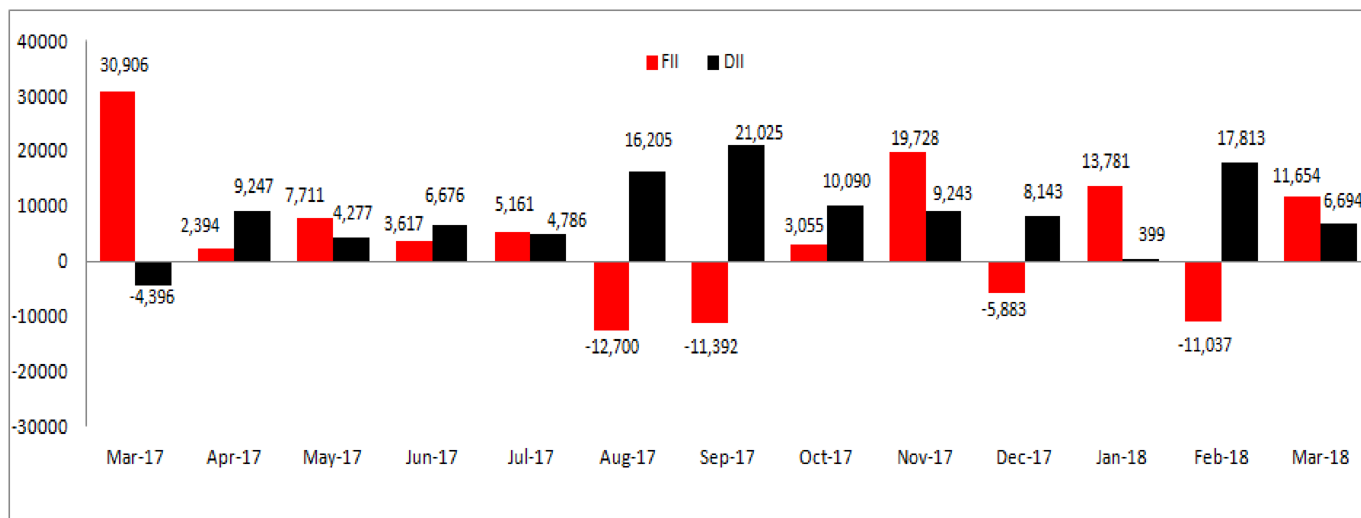
MSCI (in %)	India	Brazil	Russia	Korea	China	Japan	US	Australia	EM Index	MSCI World
MoM (%)	-3.76%	-2.06%	-3.75%	2.34%	-3.29%	-2.87%	-2.59%	-6.05%	-2.03%	-2.41%
CY-YTD (%)	-7.31%	11.19%	9.31%	-0.96%	1.81%	0.01%	-1.09%	-7.32%	1.07%	-1.74%



- BSE Smallcap was down 6.25%
- MSCI India was down 3.76%
- Dow Jones was down 3.70%
- BSE Midcap was down 3.62%
- BSE Sensex was down 3.56%
- China was down 2.78%
- S&P 500 was down 2.69%

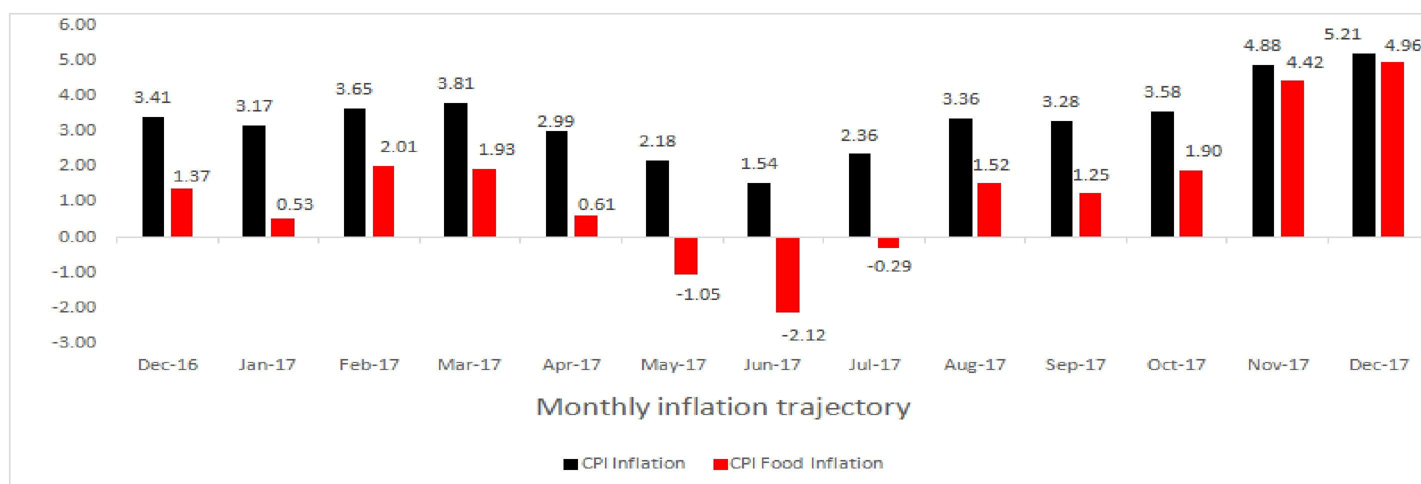
Liquidities flow in India

DII fund flows remain the key| FII inflows into India made a comeback in March 2018 after a negative month in February 2018. However, the more secular trend remains that of positive DII inflows over the last 12 months and we believe that this trend of higher participation of DII's will continue and the relevance of DIIs in Indian equities will continue to increase.



RBI holds interest rates | Signals Neutral Monetary Stance | GDP looking up

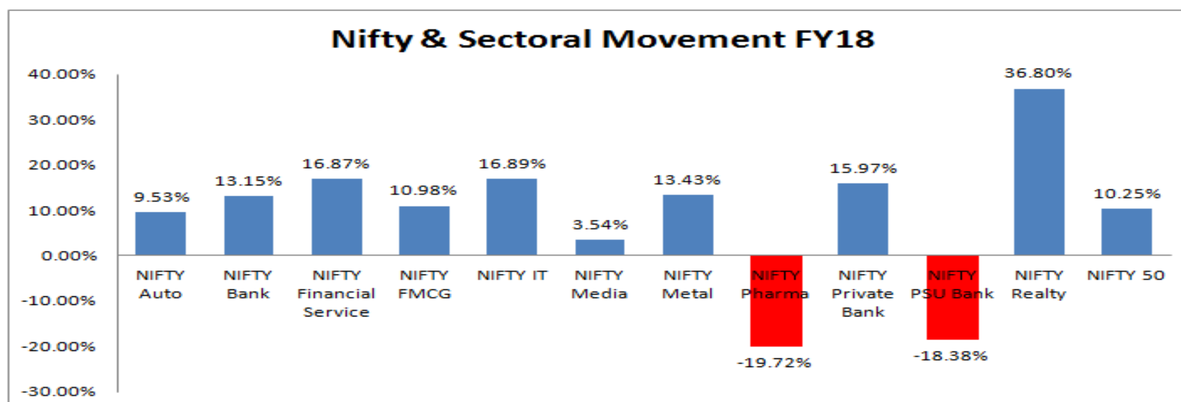
Consumer inflation in February came in at a benign 4.44% led by seasonal moderation of food inflation on account of fall in vegetable prices. The RBI kept in its March policy meet held the repo rate at 6% and reverse repo rate unchanged at 5.75% but more importantly signaled a lower inflation trajectory for H1 FY19 4.7%-5.1% as compared to 5.1%-5.6% earlier which can translate into a neutral interest environment at least for the next 6 months. This was a significant development and bond yields corrected sharply, and markets cheered the development. The prediction of a normal monsoon was also supportive of such a trajectory coupled with lower than expected government borrowing in H2 FY18, which was a positive surprise from the government's side. The major risks to these forecasts are the volatile crude prices, burden of increased farm MSP's and higher than expected fiscal slippage which limit the overall scope for any reduction in interest rate policy over the medium term.



The GDP growth projections for FY19 have come in at 7.4% as against 6.6% for FY18 and improvement is expected from a revival in investment activity, signs of which are already reflected in the sustained expansion in capital goods production. Overall the confidence about the economic revival seems much higher as compared to the commentary during the earlier meet.

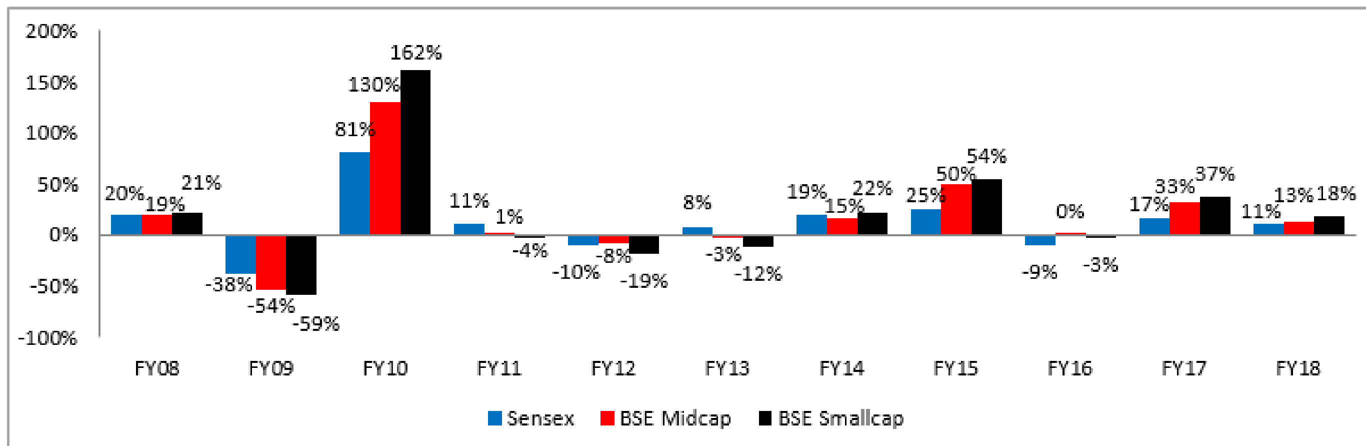
Unifi Strategy | Environment still ethereal

Despite positive sentiments, FY18 was a year of moderate returns, delivering 10.3% for the year. While the year started off on a positive note, implementation of long term capital gains tax, overshooting fiscal deficit, constant unveiling of fraud in the banking system coupled with rising NPAs and crude prices inching up in later half of the year provided a constant barrage of headwinds that kept the performance of Indian market in check. This news flow and sentiment related volatility which emerged in 4Q is likely to remain elevated in FY19 as well, until the delivery of earnings growth overcomes all the ancillary noise. Performance of majority of the sectors remained upbeat during the year with major exceptions being the pharma sector plagued by concerns of regulatory compliances and pricing pressures and PSU banks marred by rising NPA concerns.



Just as one assumed the end of banking sector woes related to bad asset quality, news of frauds within the sector hit news-flows with renewed alacrity. And as we pointed out in our opening remarks, global geo-economic negatives were much abound, and as things stand today, it would be fair to assume that news flow for the rest of the year would be similar. One can go on, drawing reference to the macros and alluding market performance to them. But the fact remains, that beneath the brouhaha, earnings and improving cash flows will drive markets and our focus remains on that. As the Q3-FY2018 earnings season indicated, economic activity has indeed begun to improve. Looking beyond the numbers, the confidence in commentary is better than the immediate past and one believes that numbers are bound to get better in a few quarters time. The primary data points, such as automotive sales, air traffic growth, and retail credit were optically stronger on a YoY basis. Over all, several economic indicators have finally started to look up and they should provide succor to the markets for the coming quarters, starting with the earnings numbers for Q4 of FY18. And as we move into a politically active year, the impact of political sentiment on the market cannot be wished away.

As we can see below, divergence between the large cap index vs the midcap Index has narrowed in FY18 as against the previous 2 years and given higher valuations of stocks on the mid cap side this trend should broadly continue.



In the ensuing correction, relative to large caps, the fall was sharper in the small-cap index thereby narrowing the premium of small-caps amid rising bond yields. The correction was especially sharper in levered and low RoE companies. The recent underperformance by midcaps has taken valuations closer to the long term averages and from here on we believe that quality midcap companies with low beta and good capital efficiency metrics will outperform. Summing it up, our focus for the time to come will continue to be similar to our approach across the cycle – alignment with opportunities which we believe are at reasonable valuations as against their growth prospects and fundamentals. Our focus will be to use this volatile market phase to look out for opportunities that fulfil our criterion on growth, value and valuations. In the meanwhile, as markets move up we are not hesitating to book profits in existing positions where valuations have exceeded their margin of safety. Alongside disciple, patience should now be a key virtue for all investors for the times to come.

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.

Yours truly
Baidik Sarkar
Head - Research

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