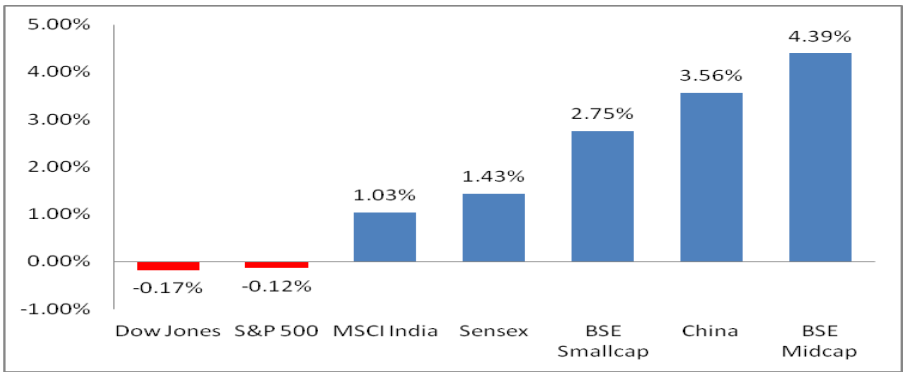
Global developments | Again, bad data equals good data

As the pace of new job creation (150,000 in August vs estimates of 180,000) slowed down in the US, marking a sharp deceleration after two strong months, it was widely implied that the data dependent Federal Reserve would hold rates, again. The availability of unrestrained liquidity the world over (USA, EU, Japan) has propelled emerging market equities around the world, and in several cases, has done so without meaningful support from core economic growth. For example, let us look at Brazil; the Bovespa is now up a staggering 35% in CY-16 in spite of a stressed economy: GDP continues to contract in absolute terms, fiscal deficit is running at 10%, unemployment is at 12% and interest rates are at an overwhelming base of 14%. Added to this is the fact that the outlook for commodities continues to be benign. This has not prevented foreign institutional flows in the country as FII's invested as much as USD4b+ over the past year, hoping to ride a return to normalcy, and in the process discounting the future several times over.

As negative yield's continue to envelop itself around the world, liquidity has pushed itself into equities, especially across emerging markets, hoping for positive returns. The pace and flow of these developments have continued to significantly raise the dependence of markets globally on that singular affair – risk of monetary policy reversal in the US of A, and hence the monthly tribulation around this event. As per the US Beige book, the Fed sees moderate wage growth for the coming months; this dampens inflation expectations, and with it consumerism; a simple reading of which suggests that the Fed will abstain from hiking rates this time around. While this will continue to propel the global liquidity largesse, the risk of equities over heating as an asset class emerges. We have elaborated on this later in our note.

The Beige Book, more formally called the Summary of Commentary on Current Economic Conditions, is a report published by the United States Federal Reserve Board eight times a year.

A strong August

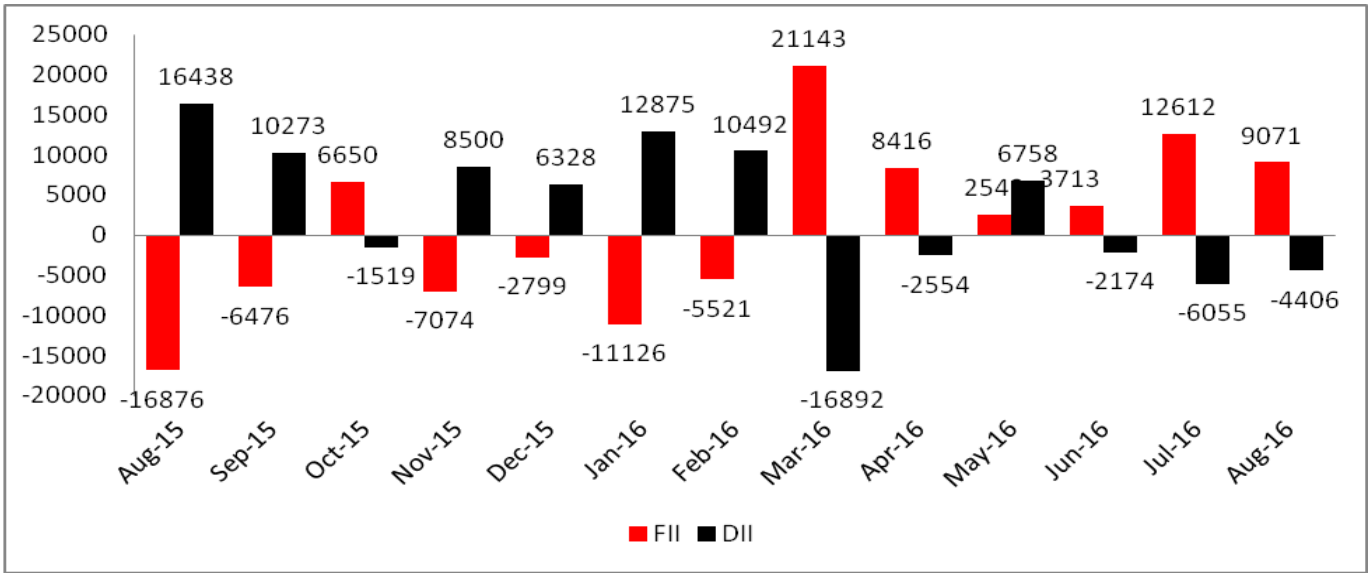


- Dow Jones was down 0.17%
- S&P 500 was down 0.12%
- Shanghai was up 3.56%

- BSE Sensex was up 1.43%
- BSE Mid-cap was up 4.39%
- BSE Small-cap was up 2.75%
- MSCI India was up 1.03%

MSCI (in %)	India	Brazil	Russia	Korea	China	Japan	US	Australia	EM Index	MSCI World
MoM (in %)	1.03%	0.55%	2.48%	3.18%	7.37%	0.35%	-0.10%	-3.37%	2.31%	-0.13%
CY - YTD (in %)	6.85%	59.35%	21.91%	13.26%	3.79%	-0.10%	6.10%	4.83%	12.53%	3.41%

Easy global liquidity continues to translate to Foreign Institutional flows into India. August witnessed inflows of USD1.3bn into India while the year CY-2016 has seen inflows of USD6.1bn into domestic equities.



Monthly Macro Review

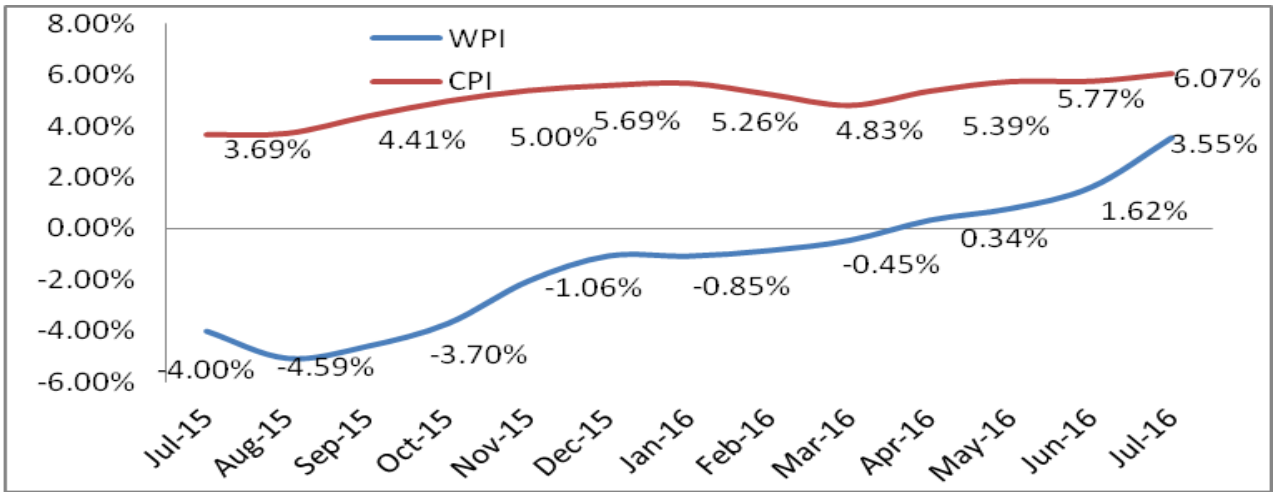
Inflation | CPI stable @ 6.07% vs 5.77% MoM | WPI @ 3.55% vs 1.62%

Food inflation witnessed a material spike in July, rising 7.19% MoM, pushing overall inflation above the 6% mark to 6.07% for the month. Cereals, Diary and Fruits were all up by more than 20% for the month but one hopes that this is the fag end of the spike before fresh produce hits the markets in a month from now.

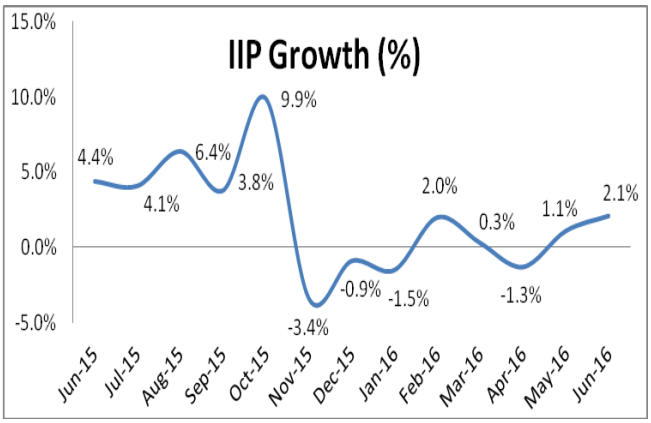
Weight	CPI	Jan-16	Feb-16	Mar-16	Apr-16	May-16	Jun-16	Jul-16	MoM
45.9%	*Foods & Beverages*	*6.66*	*5.52*	5.27	6.21	7.20	7.38	7.96	7.9%
2.4%	*Pan, Tobacco etc*	*9.03*	*8.39*	8.51	7.96	7.82	7.28	6.83	-6.2%
6.5%	*Clothing n Footwear*	*5.85*	*5.52*	5.5	5.56	5.37	5.01	5.23	4.4%
10.1%	*Housing*	*4.86*	*5.33*	5.31	5.37	5.35	5.46	5.42	-0.7%
6.8%	*Fuel n Light*	*5.32*	*4.59*	3.38	3.03	2.94	2.92	2.75	-5.8%
28.3%	*Miscll*	*3.95*	*4.38*	4.01	4.34	3.96	3.85	4.01	4.2%
100.0%	*CPI -Inflation*	*5.69*	*5.18*	*4.83*	*5.39*	5.76	5.77	6.07	5.2%

WPI continued to spike as well driven by food and non-food inflation, coming in at 3.66% vs 1.62% MoM which is at a 23-month high. Food inflation was up 2.4% MoM, non-food inflation up 2.3% MoM and minerals up 5.0% MoM. Higher prices were seen in vegetables, fibre, pulses, cereal, fruits and minerals.

We don't think there are serious risks to RBI's CPI target of 5% by March 2017 unless there is a sharp reversal in commodity prices.



Index of industrial production (IIP) | Surprised positively up 2.1%



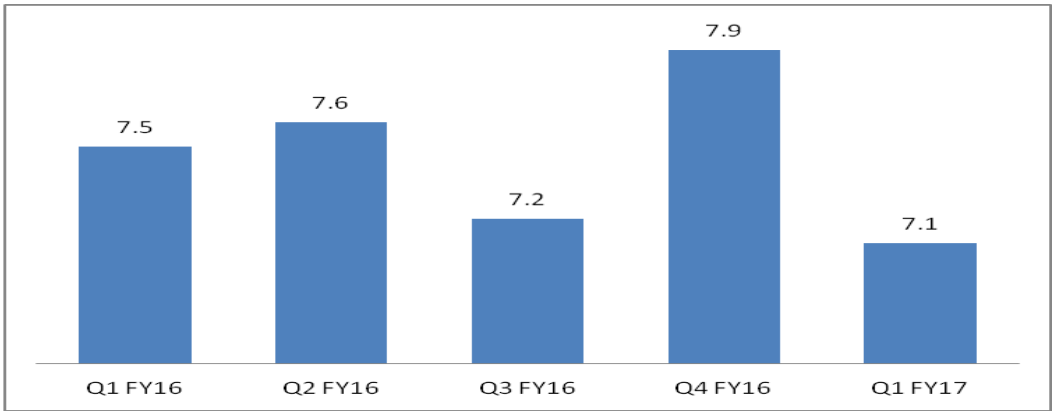
IIP for June surprised positively on the upside, coming in at 2.1%, driven by higher mining and electricity output. FYTD, IIP growth is at 0.6% vs 3.3% last year. While the June print signals show some improvement, it remains to be seen if the pickup is sustainable.

Mining growth touched a fourth-month high of 4.7% YoY in Jun'16.

The pickup was broad-based, with growth in 18 of the 22 industries.

GDP… above 7% but could be a lot better

India's GDP reading for the 1st quarter of FY-17 came in at 7.1% vs 7.5% YoY. This is how India has now trended over the last 5 quarters.



Growth was primarily driven by the services sector (9.6% vs 8.8%) while manufacturing GDP grew 9.1% vs 7.3% YoY. The Mining sector however fell -0.4% vs 8.5% YoY while the Agriculture sector grew at 1.8% vs 2.6% last fiscal – this is however mostly on account of a time overlap in the season and is expected to pick up going ahead. Over all, vastly improved rural incomes thanks to better monsoons, the lagged impact of interest rate transmission, pay outs from the pay commission and bettering economic conditions should support demand growth in the months to come.

Unifi Strategy

Hopefully not a house of cards

Taking nothing away from the improving economic scenario & improvement in earnings, the inference of external liquidity on the broader indices are hard to miss. India has seen its share of the global liquidity largesse as well.

Year	FII into Equities (INR, Cr.)	CY Returns - Sensex
CY 2011	-2,714.3	-24.6%
CY 2012	128,360	25.7%
CY 2013	113,136	9.0%
CY 2014	97,055	29.9%
CY 2015	17,806	-5.0%
CY 2016 (Aug-2016)	43,031	8.9%

As per estimates, FII's hold roughly 25% of Indian equities (as a percentage of free float market cap). As an extension of the above numbers, the correlation between the absolute flows into Indian equities and the run up in markets for CY-2016 now stand at 0.89. However, the correlation over a longer year period (from January 2011) points to a correlation of 0.47 while the number from January 2015 stands at 0.60.

Should the pace of flows ebb, or reverse, it is fair and correct to expect a period of consolidation and correction – whether it is time, absolute or a combination, will be difficult to determine. As fund managers (and we aren't surely the only ones), we are debating if the largesse is a **problem**, an **aberration** or the **new reality.** It is easy to reference this to 2008, and predict the emergence of another bubble and call for the end. But is the future this linear? As excessive flows chase a finite set of good ideas, discounting more than a reasonable period of outlook and thereby spiking valuations, it translates to a problem for active fund management. Like we have said earlier, bouts of speculative titillation are a challenging period for fund managers as benchmarks, and opportunities across sectors trend up without any apparent fundamental backing. A sustained period of such a development eventually snowballs into a **problem** as asset bubbles are created across the markets. However if the conditions responsible for the current loose monetary are temporary, and the proverbial light at the end of the economic tunnel is visible, it is fair to expect a reversal in liquidity and with it a reversal to normalcy in valuations. But given the uncertainties that are now on loop, and have been so for a while, will it be right to term the current state of being as an **aberration?** If it is not, then is this the new **reality?** There has been no alternative solution to current state of low growth rates in most parts of the developed world and easy money has been projected as the only panacea to this problem. It is unclear where this journey will end but it looks like it will be long before monetary policy makers, under political and Keynesian pressure come up with something different, if at all there is a different option.

As active fund managers, we have been cognizant of these global macroeconomic risks to India. While we continue to monitor valuation excesses, to our rescue, fundamentals are indeed getting better. Auto sales, a good indicator of economic health, have witnessed strong dispatch numbers so far. Overall demand and consumption trends are expected to get better as arrears and absolute pay outs from the 7th pay commission take effect and farm incomes recover after 2 years of lull. The Governments fillip on infrastructure continues to be good and then of course there is GST that will see

organized players consolidate. In all, there are pockets of macro opportunities available apart from individual players continuing to consolidate their scope of operations.

We continue to monitor our exposures and portfolios accordingly and have not hesitated to book profits where situations merit or look at new sectors as the core of the economy witnesses a change. We continue to like select names in chemicals, auto, Banking and NBFCs and are closely monitoring the near as well as mid to long term potential of their fundamentals in making portfolio decisions. We continue to maintain an eye on a favourable 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, and not hesitating to book profits where valuations have exceeded its margin of safety.

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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