Global developments

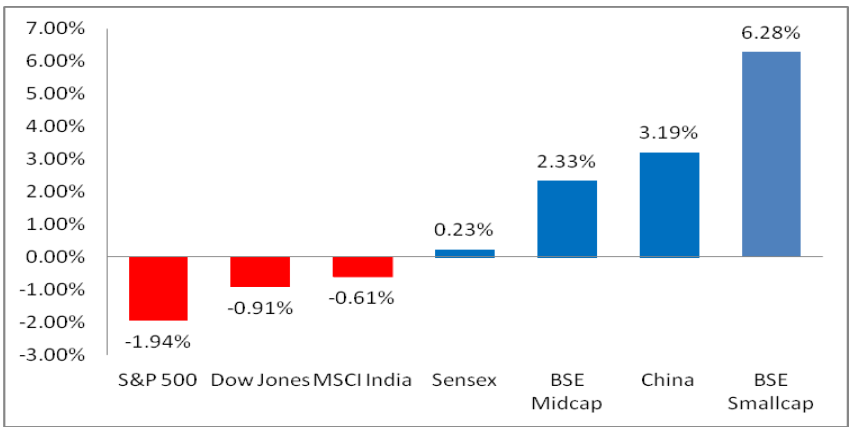
It has been a year of black swans. Henceforth, the odds of the odd one *triumphing* should probably be the least surprising outcome. Besides, #1 is an odd number.

Not that an update on monetary policy really matters given the general and unexplained euphoric mood in the US and of course India, but in perhaps the least surprising Fed decision in a long time, there was neither a rate hike nor an explicit signal of an imminent change of rates in the future. While inflation increased "somewhat", it remained below the threshold 2% and was not enough to warrant an out of line action. U.S. economic growth rose to an annual rate of 2.9% between July and September, and unemployment has fallen from 10% at the worst of the recession to 5% today. But given the Fed's tendency to also act keeping in perspective political events, the decision was a foregone one. The Fed last raised interest rates to 0.25% in Dec 2015 and when they meet again in December this year, it is widely expected that another round may be in the offing. Will they in the influence of a new political narrative? Sucking liquidity off the table continues to be a global risk to EM's but given the expectations around the event, will volatility ensue?

In the East, news flow from China was positive as manufacturing activity rose to its highest level in the past 2 years as strong domestic demand more than offset a slight drop in new export orders. This uptick represents the momentum of the smaller and private enterprises as against the larger state owned enterprises. The services sectors also witnessed an improvement in performance and the two put together point to evidence of the stimulus working, but not strong enough to sustain by itself after the stimulus are withdrawn. Further east, the Bank of Japan kept its negative interest rates unchanged at -0.1%, but abandoned its target for expanding the monetary base, saying it aimed to expand the base until consumer inflation moved beyond its 2% target.

Meanwhile, as global uncertainness as well as risk in EM equities rise, Gold quietly gained, rising 7% YoY, and now up 20% for the year. Over all, as much as we believe earnings will drive the markets over the long term, in the near term, the impact of near term geo-political events and the markets knee jerk reactions to the same are difficult to ignore.

October 2016 – Big gains for Small caps!

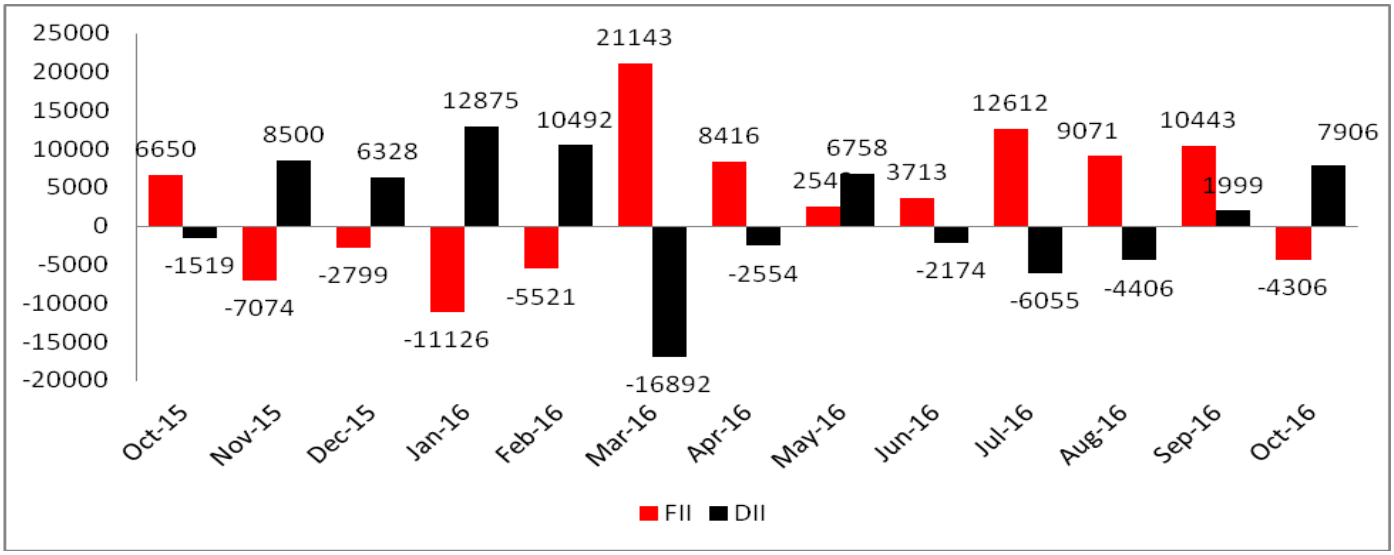


- Dow Jones was down 0.91%
- S&P 500 was down 1.94%
- Shanghai was up 3.19%

- BSE Sensex was up 0.23%
- BSE Mid-cap was up 2.33%
- BSE Small-cap was up 6.28%
- MSCI India was down 0.61%

MSCI (in %)	India	Brazil	Russia	Korea	China	Japan	US	Australia	EM Index	MSCI World
MoM (in %)	-0.61%	13.68%	0.45%	-3.65%	-1.95%	1.32%	-2.01%	-2.15%	0.18%	-2.01%
CY - YTD (in %)	5.18%	81.64%	27.07%	10.62%	4.06%	2.07%	3.92%	4.72%	13.97%	1.69%

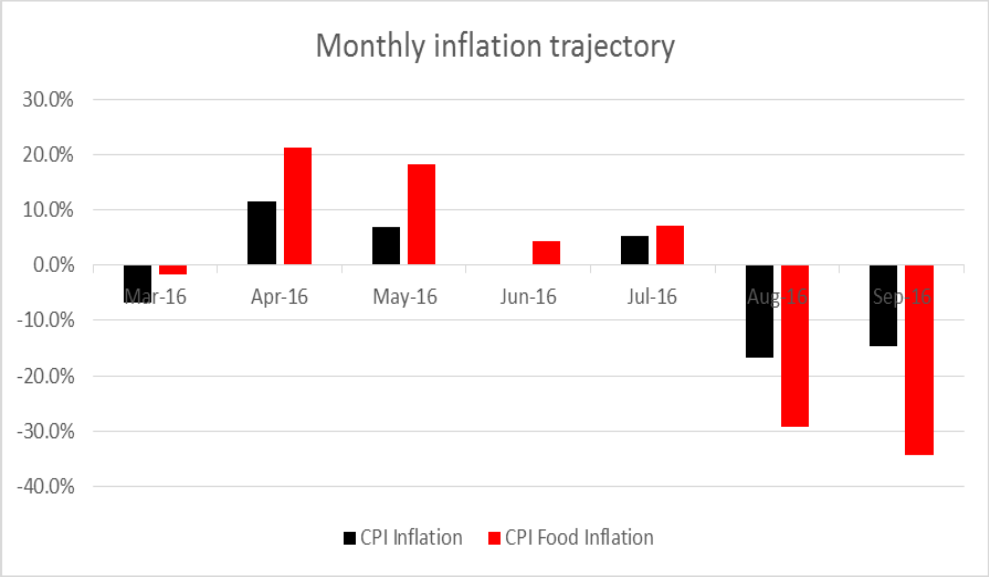
October witnessed inflows of Rs.3700cr of flows into India equities. Buying continues to be supported by domestic institutional investors. Domestic flows from SIP's also continue to be strong.



Monthly Macro Review

Inflation falls hard | CPI stable @ 4.31% vs 5.05% MoM | WPI @ 3.57% vs 3.74%

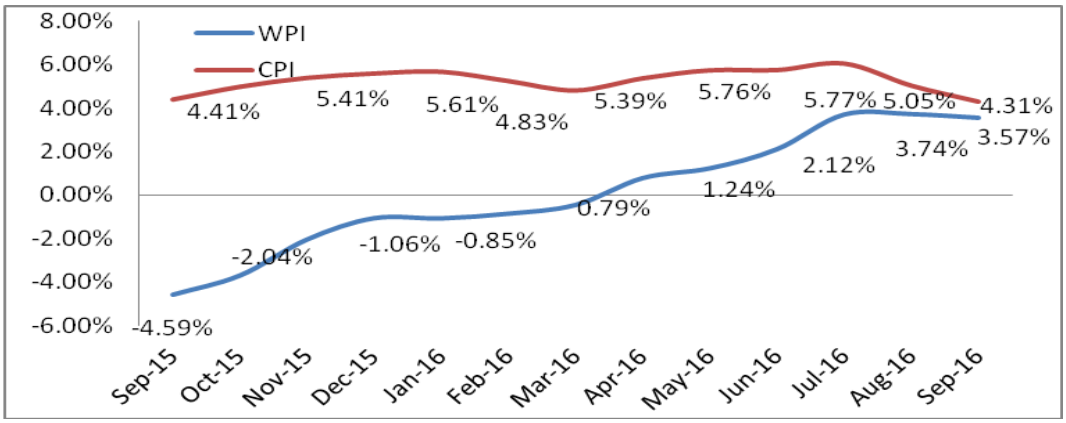
After 4 months of rising inflation, where headline CPI moved from 4.83% in March to as much as 6.07% in July, the subsequent months witnessed a rapid cool down by -16.8% and -14.7% for August and September respectively. The current fall was expectedly driven by a cool down in prices of pulses and vegetables and as things stand today, the Rabi crop is widely expected to be good. The trajectory was more or less expected as the spikes we witnessed in April and May were thus not too alarming.



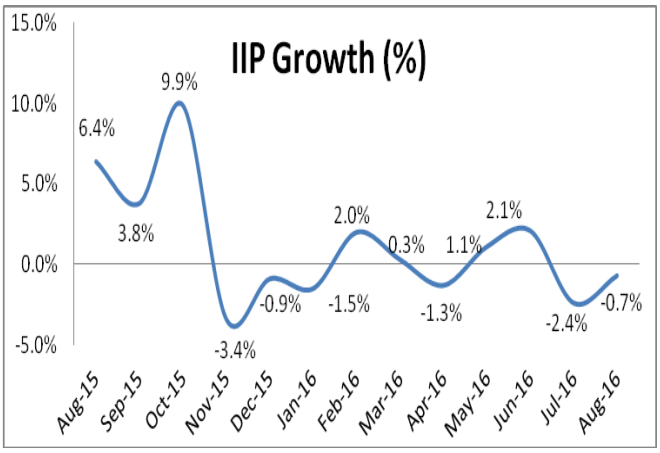
This correction provides the grounds for real comfort as the interest rate trajectory in India will eventually draw confidence from this and the RBI will *reason* on further grounds for monetary easing. As the agri produce from the on-going season continues to hit the markets, there is sufficient head room for the overall headline CPI number to remain close to RBIs benchmark of 5% for the year.

Wt	CPI	Feb 16	Mar 16	Apr 16	May 16	Jun 16	Jul-16	Aug-16	Sep-16	MoM
45.9%	*Foods & Beverages*	*5.52*	5.27	6.21	7.20	7.38	7.96	5.83	4.12	-29.3%
2.4%	*Pan, Tobacco etc*	*8.39*	8.51	7.96	7.82	7.28	6.83	6.86	6.82	-0.6%
6.5%	*Clothing Footwear*	*5.52*	5.50	5.56	5.37	5.01	5.23	5.21	5.19	-0.4%
10.1%	*Housing*	*5.33*	5.31	5.37	5.35	5.46	5.42	5.29	5.18	-2.1%
6.8%	*Fuel n Light*	*4.59*	3.38	3.03	2.94	2.92	2.75	2.49	3.07	23.3%
28.3%	*Miscll*	*4.38*	4.01	4.34	3.96	3.85	4.01	4.18	4.51	7.9%
100.0%	*CPI -Inflation*	*5.18*	*4.83*	*5.39*	5.76	5.77	6.07	5.05	4.31	-14.7%
	YoY	-9.0%	-6.8%	11.6%	6.9%	0.2%	5.2%	-16.8%	-14.7%	-12.8%

WPI for September 2016 came in at 3.57% vs 3.74% MoM. Disinflation was seen in food as well as non-food articles MoM. Lower prices were recorded for pulses (-5.4% MoM), vegetables (-10.7% MoM), eggs & meat (-1.3%), spices (-1.2%), fibre (-3.9% MoM) and oilseeds (-2.4%), whereas 7/12 (vs 9/12 last month) manufacturing industries recorded higher prices.



Index of industrial production (IIP) down to -0.7%



IIP for August fell to -0.7% vs -2.4% last month and 6.4% a year ago. Growth was muted across all segments with mining (-5.6%) worst in 39 months partially impacted by monsoon, manufacturing (-0.3%) and electricity (0.1%) remaining weak. FYTD, IIP growth is at 0.3% vs 4.1% last year.

Capital goods growth contracted for the tenth successive month, at -22%. Negative growth was recorded in 7/22 industries vs 12/22 industries last month.

We do not know what to make of this conflicting trend, i.e., falling IIP, but better GDP and corporate earnings. Is there an anomaly in the way IIP is competed? For example, IIP tracks consumption of *cables* in India through the production numbers a certain public sector undertaking which in turn counts a PSU telecom player as its major client. We know for a fact that cable consumption in India is not entirely representative of this.

In the interim we intend to deconstruct the many layers from where IIP is *sourced* and understand how representative (or not) it is of the real economy.

Unifi Strategy

Taurus holding it tight

A lot of things happened since we wrote to you last. Among others, the GST went through with clarity on actual rates, India had a little Lee Kuan Yew moment in its recent economic history & BSE-500's earnings growth moved closer to a 2 year high.

GST. The GST council has finalised five brackets of GST rates – 0%, 5%, 12%, 18%, and 28% and levied a cess on four sin items (drinks, luxury cars, tobacco products) to fund losses of states. While the item-wise list is not yet out, the 5-tier structure largely implies a continuation of current tax rates implying zero impact on consumers. However, it would be a positive for corporates due to logistics and administrative ease of doing business. It is believed that companies to benefit will be the ones catering to the mass consumers such as basic staples and some of the white goods. As and when clarity emerges, it is fair to expect a sharp rerating in these counters.

White strikes back.

You, the reader, know it all by now. So we'll get to the broader economic implications of it all. In 2007, the World Bank estimated the size of India's shadow economy at 23.2% of GDP. Assuming this ratio still holds, that's about $479 billion unaccounted for. Much of this money will now get mainstreamed because of the demonetisation move. The improvement in the **tax to GDP ratio** can improve materially as new avenues of income enter the system. Declaration of unaccounted income because of demonetisation is liable to be taxed / penalised at a rate of 30 to 120% depending on the source. Currently direct tax collections are just about 5.5% of GDP and about 50% of total tax collections, and this contribution is expected to rise going further. Also importantly at the end of this 50 day period, it is expected that a certain quantum of the cash economy will not enter the system, and will thus stand naturally extinguished. This offers the Government that much more leg room to divert the same towards other avenues of capital and revenue expenditure.

RESERVE BANK OF INDIA BALANCE SHEET AS ON JUNE 30, 2016

(Amount in ₹ billion)

Liabilities	Schedule	2014-15	2015-16	Assets	Schedule	2014-15	2015-16
Capital		0.05	0.05	Assets of Banking Department (BD)			
Reserve Fund		65.00	65.00	Notes, rupee coin, small coin	5	0.11	0.14
Other Reserves	1	2.22	2.24	Gold Coin and Bullion	6	578.84	662.23
Deposits	2	5,186.86	5,065.28	Investments-Foreign-BD	7	7,276.29	6,727.84
Other Liabilities and Provisions	3	8,905.03	10,220.38	Investments-Domestic-BD	8	5,174.97	7,022.85
				Bills Purchased and Discounted		0.00	0.00
				Loans and Advances	9	802.32	520.41
				Investment in subsidiaries	10	13.20	23.20
				Other Assets	11	313.43	396.28
Liabilities of Issue Department				Assets of Issue Department(ID)			
Notes issued	4	14,732.43	17,077.16	Gold Coin and Bullion (as backing for Note issue)	6	637.23	729.07
				Rupee coin		1.99	1.71
				Investment-Foreign-ID	7	14,082.75	16,335.92
				Investment-Domestic-ID	8	10.46	10.46
				Domestic Bills of Exchange and other Commercial Papers		0.00	0.00
Total Liabilities		28,891.59	32,430.11	Total Assets		28,891.59	32,430.11

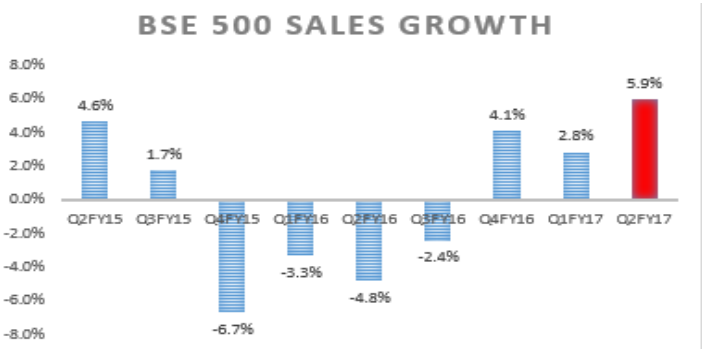
$255 billion

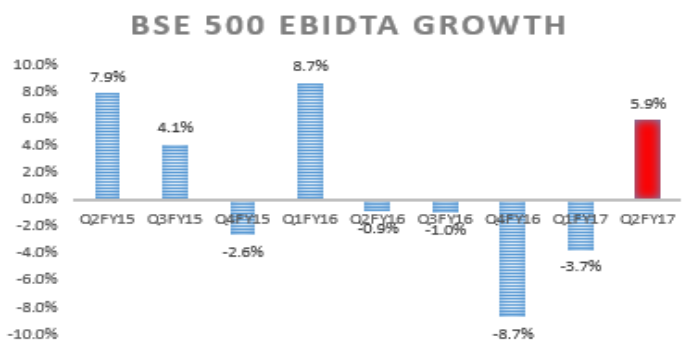
As it can be seen in the RBI's balance sheet, the total money in circulation of Rs.17Lakh Cr. It is estimated that 40% of this is unaccounted for. Adjusting that to a more conservative 30-35%, our base case calculations suggest that the impact of this specific action on GDP could be in the range of Rs.100,000cr. That is, this is the amount that the RBI will write back, and print as much for the Government to spend without resorting to additional borrowings.

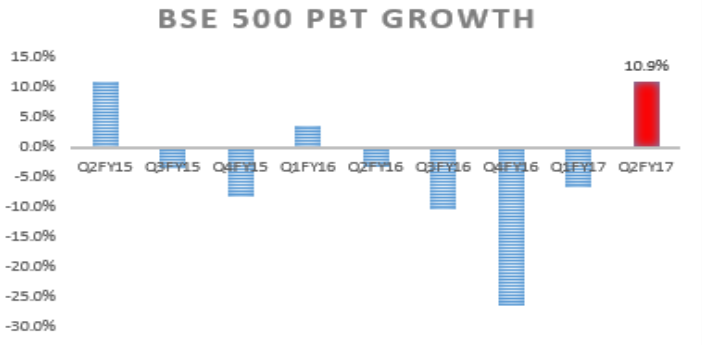
Extinguishment Calculator	INR, Lakh, Cr.	INR, Lakh, Cr.	INR, Lakh, Cr.	INR, Lakh, Cr.
Money in Circulation	17	17	17	17
% in Rs.500 / Rs.1000	84%	84%	84%	84%
De-monetized amount	14.28	14.28	14.28	14.28
Proportion of unaccounted money	25%	30%	35%	40%
Unaccounted money	3.57	4.284	4.998	5.712
As a % of total money in circulation	21%	25%	29%	34%
Proportion not declaring	10%	10%	10%	10%
Extinguishment	0.357	0.4284	0.4998	0.5712
Total in Cr	35,700	42,840	49,980	57,120
GDP Multiplier	2.0	2.0	2.0	2.0
Impact on GDP	71,400	85,680	99,960	1,14,240

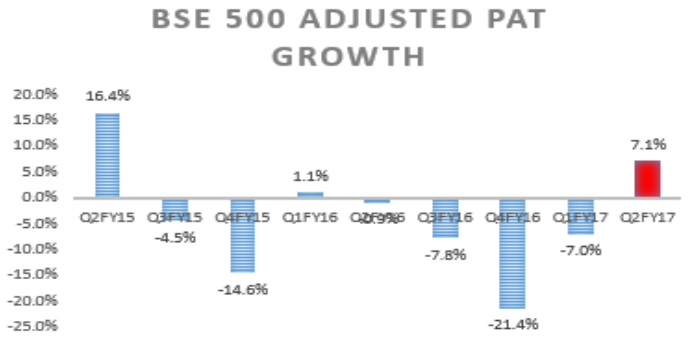
Earnings redux

In the context of the general market euphoria about the expectant improvement in macros, the small matter of immediate earnings growth often takes a back seat. But however inconsequential that is to a bull market, as bull markets are essentially about an expansion in the underlying price earnings to growth ratio, it is critical to maintain a hawk eye on them. And as it is optically visible, the semblance of growth in the broader BSE-500 companies have witnessed this quarter has been the strongest in a rolling 8 quarters (2 year) period.









Although much of the performance is due to initiatives at a firm level, and not exactly due to a swinging macro, the point is things are getting better and this is pretty much explains the above numbers, most of which are at a two year high. Yes, improvement is relative and an absolute sense of growth is not exactly encompassing at the moment, but we should get there.

As a result, the rally in the markets have been unprecedented. While the broader benchmark's Sensex 30 & Nifty 50 have delivered 10% this FYTD-2017, the even broader and representative BSE Midcap has delivered 27% so far this year. With this, BSE Midcap's trailing 12 month PE has hit a mammoth 30x. This is pricey by any yardstick and is reflected in our fund management process of adhering to price limits that are in the realm of our comfort.

At the end of it all we continue to stick to the basics. We continue to monitor our exposures and universe of ideas for value. We continue to like select names in building products, chemicals etc., 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

Yours truly
Baidik Sarkar
Head - Research

CHENNAI:
11, Kakani Towers
15 Khader Nawaz Khan Road
Nungambakkam High Road
Chennai - 600 006. INDIA
Ph: +91-44-3022 4466, 2833 1556
Fax: +91-44-2833 2732

HYDERABAD:
H No. 6-3-346/1, Road No. 1
Banjara Hills
Scotia Bank Building
Hyderabad – 500 034. INDIA
Ph: +91-40-6675 2622/23

BANGALORE:
511, Barton Centre
84, M.G. Road
Bangalore - 560 001. INDIA
Ph: +91-80-255 9418/19

MUMBAI:
Shiv Sagar Estate,
A-Block, 8th Floor,
Dr. Annie Besant Road
Worli, Mumbai - 400 018.
INDIA

DELHI:
No.818, International Trade
Tower, Nehru Place.
Delhi - 110 019.
INDIA