Global developments

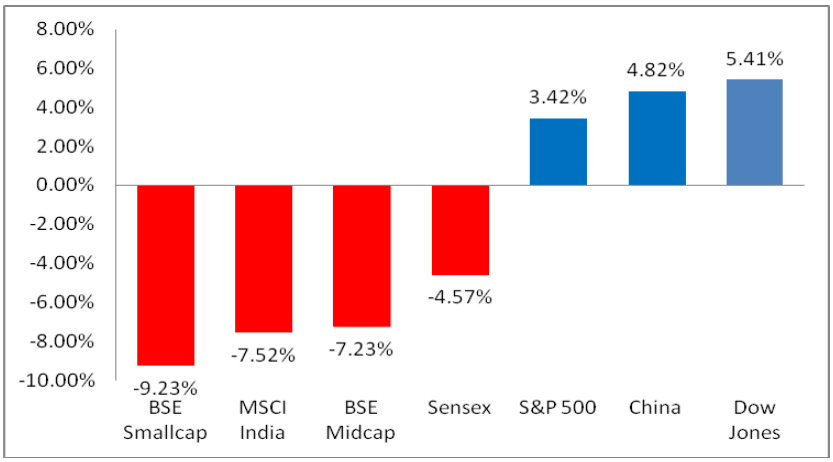
The development of the month was undoubtedly the steepening of the yield curve in the US, as a flurry of developments saw the American 10 year G-sec bond yields move up to 2.3%. After middling at a range of 1.7% for most of the year, this is the steepest appreciation the G-sec's have seen in a while and this has had a domino effect on emerging market currencies as well as equity markets around the world. To add to the optical depiction below, the yield jumped by 44bps in November, a steep *24% over October's close of 1.86%.*

The overall sentiment aiding the rally is that the US Fed will begin to start raising interest rates, and do so at a frequency higher than that of the recent past. Besides, with President elect Trump's promise of tax cuts and USD 1trillion in infrastructure spending, the inflationary expectations are generally high. A combination of these events should continue to aid the strengthening of yields in the near term. This has also resulted in an unprecedented strengthening of the greenback. More on this in our later sections.

In another move in the commodities world, and the first in eight years, OPEC has collectively agreed to cut its output by as much as 1.2 million barrels per day. The charge was led by Saudi Arabia, agreeing to shoulder 40% of the cut, followed by Iraq and UAE. Designed to support realizations in the future and lower global inventories, OPEC members as well as non-member Russia saw common ground in the strategic initiative and the resultant impact on the global energy market world was quick as benchmark oil prices gained almost 10%, touching $50 a barrel, and prompting a rally in energy stocks the world over. It may be noted that in the past, members of the consortium have not always stuck to agreements on this issue, citing respective fiscal constraints.

Like we have been saying, as much as we believe that over the long term sustainable earnings will be the sole driver of the markets, in the short term, the impact of near term geo-political events and the market's knee jerk reactions to the same will result in bouts of (sometimes immense) volatility.

November 2016 – A period of consolidation in India



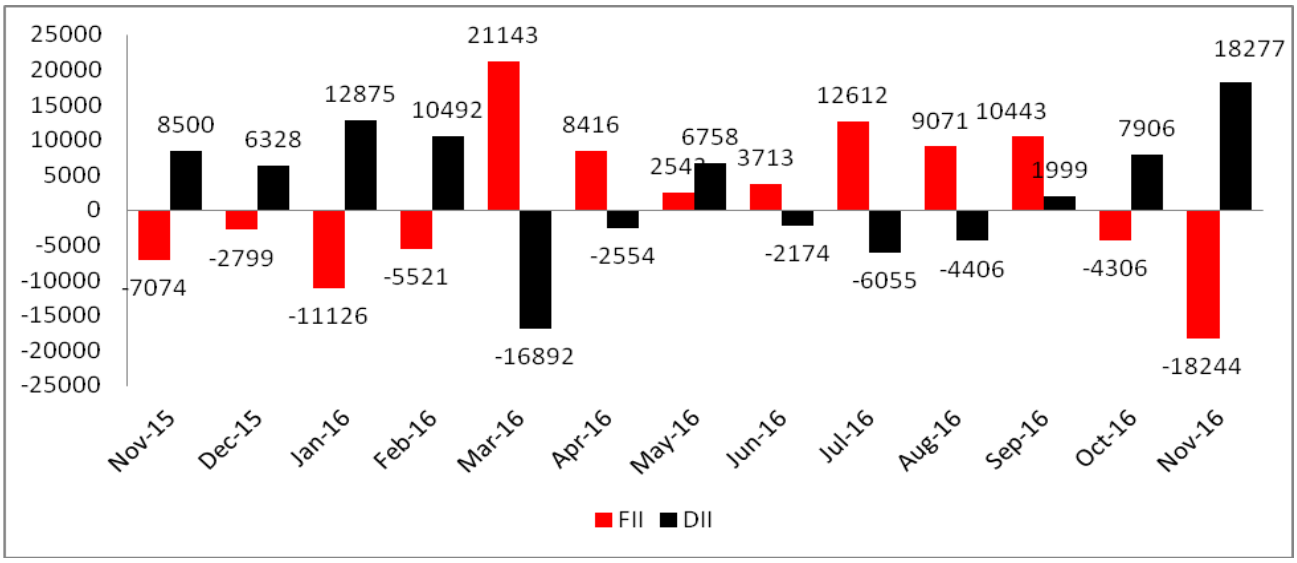
- Dow Jones was up 5.41%
- S&P 500 was up 3.42%
- Shanghai was up 4.82%

Following the sharp strengthening of the USD and resultant outflows, domestic equities experienced a weak month.

- BSE Sensex was down 4.57%
- BSE Mid and small cap was down 7.23% & 9.23% respectively
- MSCI India was down 7.52%

MSCI (in %)	India	Brazil	Russia	Korea	China	Japan	US	Australia	EM Index	MSCI World
MoM (in %)	-7.52%	-11.40%	4.76%	-2.60%	-1.21%	-2.41%	3.33%	-0.41%	-4.67%	1.25%
CY - YTD (in %)	-2.74%	60.94%	33.12%	7.74%	2.79%	-0.39%	7.38%	4.29%	8.65%	2.96%

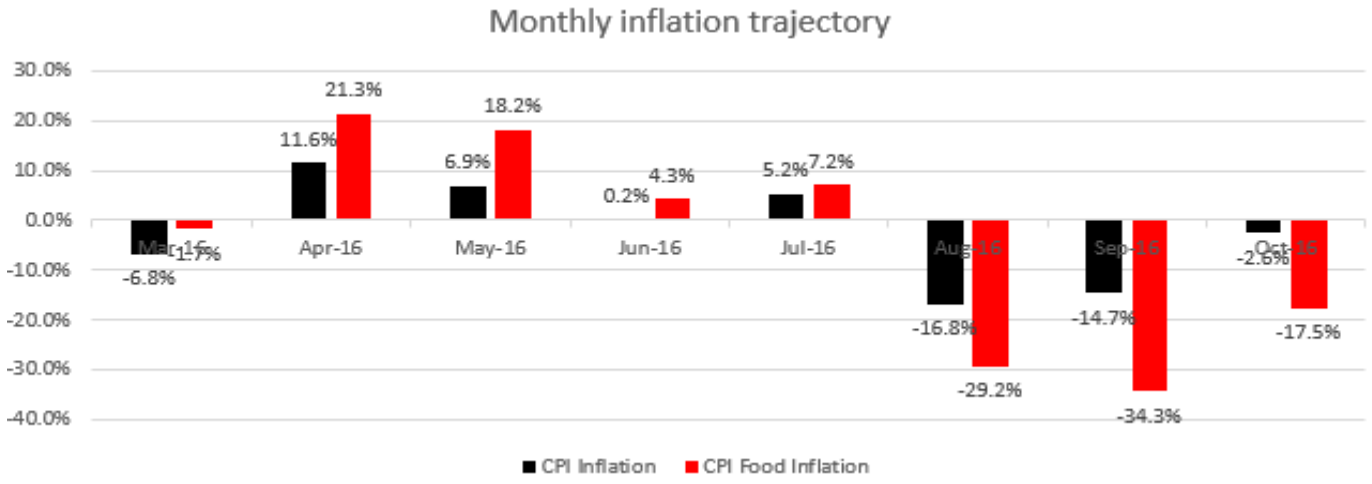
Led by developments in the US, Nov-16 witnessed outflows of Rs.18,200cr from the FIIs, but domestic investors showed remarkable faith in the India story, pumping in almost exactly an equal amount, to neutralize the flows.



Monthly Macro Review

Inflation continues to fall | CPI @ 4.20% vs 4.31% MoM | WPI @ 3.39% vs 3.57%

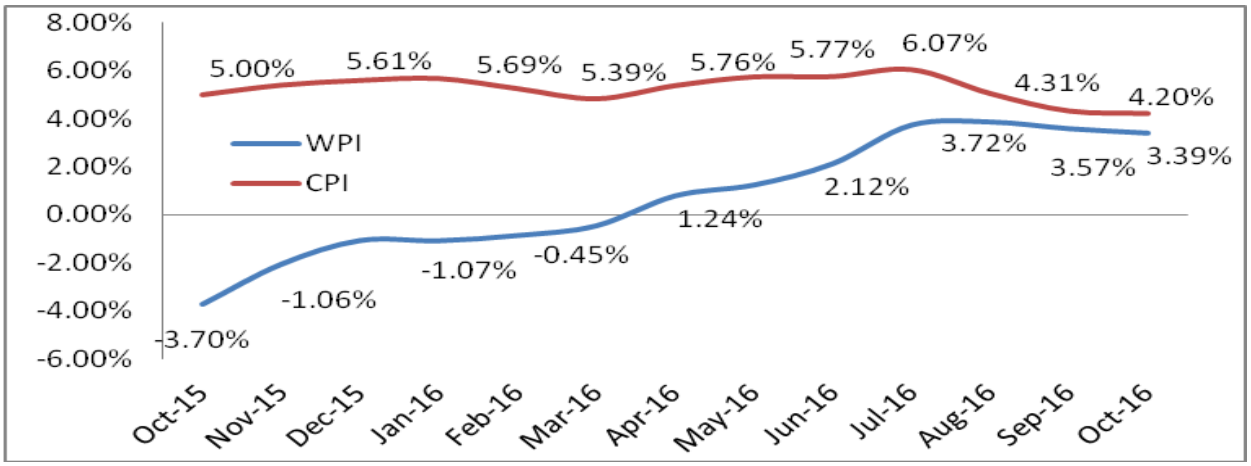
This was another good month for inflation watching as food inflation continued to fall, now down -17.5% for the month of October, following two preceding months of fall in the magnitude of almost -30% each. This is entirely on expected lines as almost all items in the food basket witnessed a healthy supply side scenario.



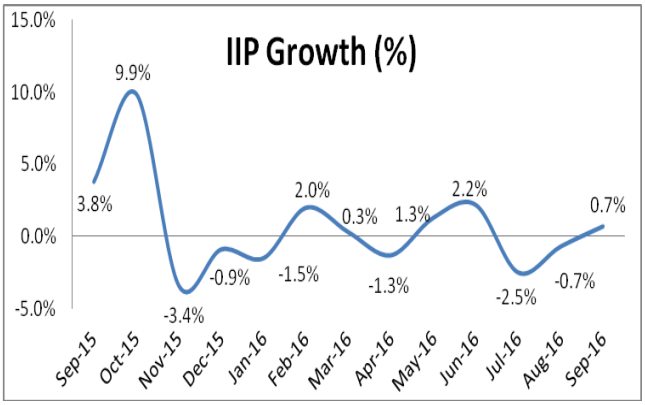
While the organic reasons for contraction in inflation was expected, the crunch in money circulation caused by demonetization is bound to affect real demand. Hence an inorganic but steep decline in certain baskets of consumer products may be a reality. But overall, this may be checked by rising commodity prices. The RBI will have to balance both these developments in charting the future course of interest rates in India.

Wt	CPI	Apr 16	May 16	Jun 16	Jul-16	Aug-16	Sep-16	Oct-16	MoM
45.9%	*Foods & Beverages*	6.21	7.20	7.38	7.96	5.83	4.12	3.71	-29.3%
2.4%	*Pan, Tobacco etc*	7.96	7.82	7.28	6.83	6.86	6.82	7.09	-0.6%
6.5%	*Clothing Footwear*	5.56	5.37	5.01	5.23	5.21	5.19	5.24	-0.4%
10.1%	*Housing*	5.37	5.35	5.46	5.42	5.29	5.18	5.15	-2.1%
6.8%	*Fuel n Light*	3.03	2.94	2.92	2.75	2.49	3.07	2.81	23.3%
28.3%	*Miscellaneous*	4.34	3.96	3.85	4.01	4.18	4.51	4.58	7.9%
100.0%	*CPI -Inflation*	*5.39*	5.76	5.77	6.07	5.05	4.31	4.20	-14.7%
	Change	11.6%	6.9%	0.2%	5.2%	-16.8%	-14.7%	-2.6%	-12.8%

WPI for October 2016 came in at 3.39% vs 3.59% MoM which is lowest in 4-months. Disinflation was seen in food as well as non-food articles MoM. Within food, lower prices were seen in cereals, fruits and spices. Manufacturing inflation was up by a marginal 0.2% MoM, 7/12 (vs 7/12 last month) manufacturing industries recorded higher prices. Similarly, fuel inflation also rose up 1% MoM.



Index of industrial production (IIP) up 0.7%



IIP for September rose to 0.7% vs -0.7% last month and 3.8% a year ago. Growth was muted across all segments (but much better than the last 2 months) with the following changes: mining (-3.1%), manufacturing (0.9%) and electricity (2.4%). FYTD, IIP growth is at 0.1% vs 4% last year.

Capital goods growth contracted for the eleventh successive month, at -22%. Negative growth was recorded in 10/22 industries vs 7/22 industries last month.

Monetary policy surprise

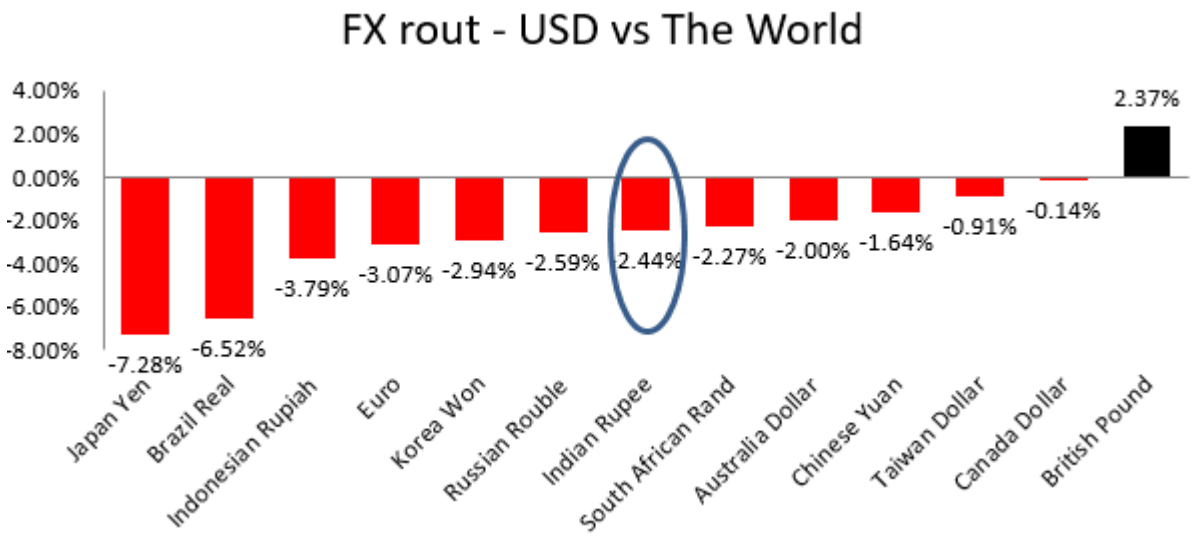
Given the dramatic pace of economic developments in India leading to a short term fall in economic activity, the street had discounted a base case 25bps cut from the Reserve Bank of India in its last monetary policy meeting for 2016 on the 7th of December. As a good central banker, the RBI surprised with none. In hind sight of course the move seems praise worthy as falling rates in India coupled with a rising rate scenario is the US would have accentuated the flight of capital from India, pressurising the rupee and leading to a further sell off in Indian equities. Anticipating another round of cuts, the Banks had slowly begun cutting lending rates as well. On another note, it withdrew the temporary CRR hike that it had introduced for a fortnight. Bond yields should now stop falling in India, limiting further MTM gains.

Another factor that may have held back the RBI from raising rates is the strong rally in commodities witnessed of late that which could eventually increase the inflationary pressure on the consumer side of things. Dr.Urjit Patel is the architect of inflation targeting in India and any move on monetary policy will weigh in the long term implication of the same on inflation, which for the moment, seems delicately poised.

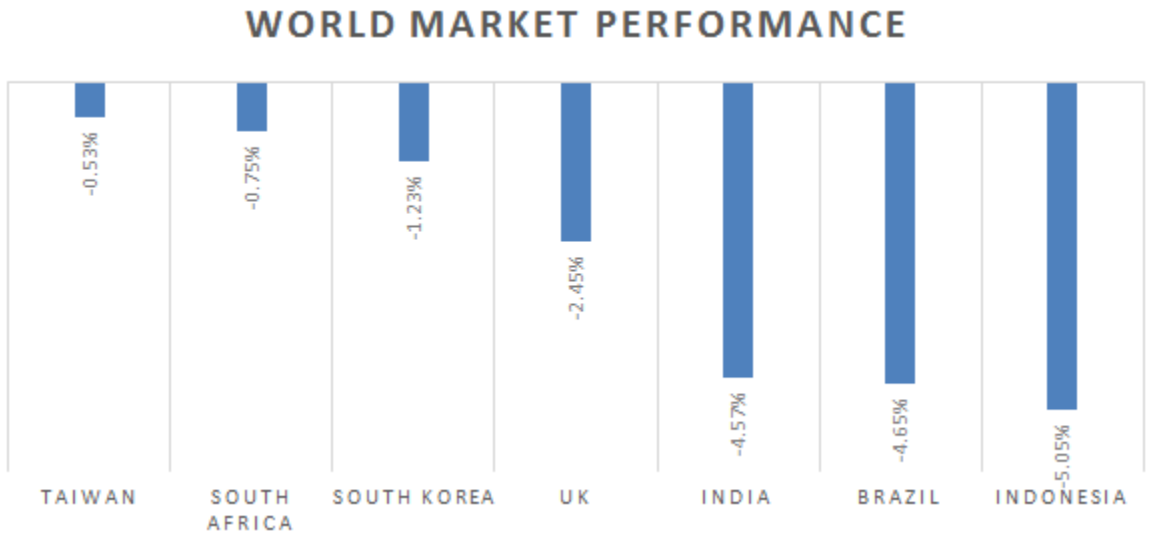
Unifi Strategy

What just happened in November?

The American dollar witnessed an unprecedented rally in the month of November and in the process, weakened almost every other world currency. The USD is now 40% above the lows of 2011 while most Asian currencies have plunged to depths not seen since the financial crisis of 1997-98. India meanwhile is seeing its Rupee reach an all-time low against the greenback. As it can be seen below, there was little exception to the rout the world over, barring of course the Pound, which is charting a course of its own.



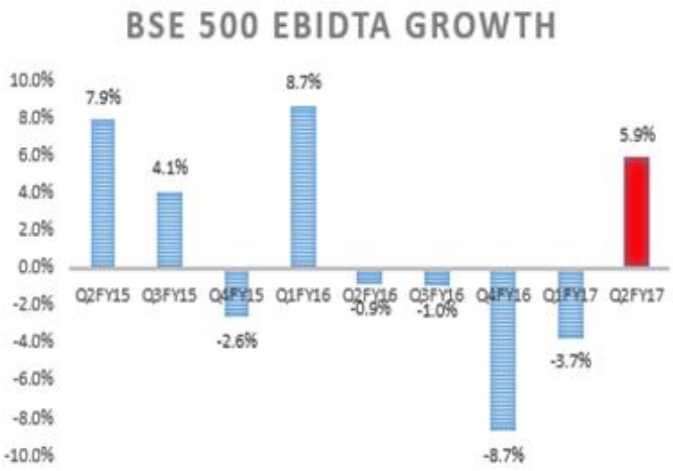
The strengthening US dollar as well as yields acted as a conduit to force redemptions in most emerging markets. Depreciating local currencies and the prospect of better fundamentals in the US along with better bond yield have been the primary motivator of global US based fund manager re-aligning their allocations. The result was unanimous across almost all non-commodity markets.

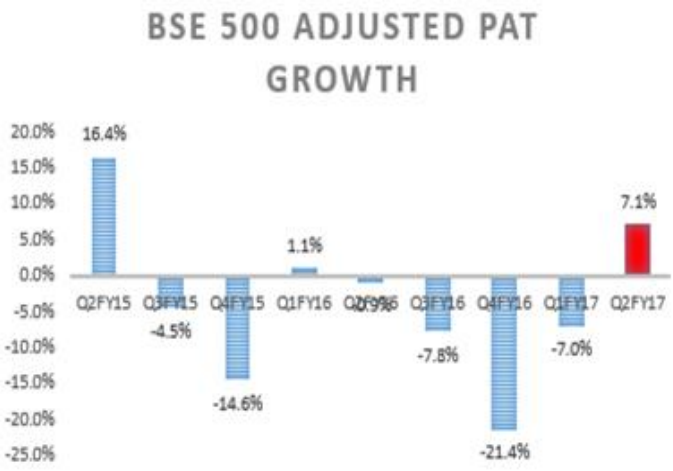


The markets in Russia, China & Australia however gained on the back of a strong commodity rally.

What does this mean for India?

We repeat one part of the fact on improving earnings growth that we communicated to you the last time around. 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.





At the level of the benchmark, earnings growth for the Sensex for H1-FY2017 was 10%. After conservatively discounting the effect of demonetization on the Auto universe, we believe earnings growth for the year FY-2017 can still be in excess of 10% over FY-2016 given support from other sectors and the low base effect of the Banking sector (courtesy: last year's aggressive NPA recognition).

Particulars	**H1 FY16**	**H1 FY17**	**YoY**	
Sensex EPS	730	804	10%	
	FY 2016	**FY 2017**	**YoY**	
Sensex EPS	1436	1578	10%	
FY 2017 EPS	**Multiple**	**SENSEX (est)**	**Sensex today**	**CHANGE**
- 1578	16.5	26,037	26,500	-2%
- 1578	17.0	26,826	26,500	1%
- 1578	17.5	27,615	26,500	4%
- 1578	18.0	28,404	26,500	7%

Over all, we believe barring short bouts of forced exits that will pressurize the markets, the Sensex will hold ground at current levels. Of course, sucking the system of physical liquidity will impair the earnings of the wider mid & small cap universe. As investors, the only hedge against this is to align with opportunities that have a magnitude of earnings that offers adequate margin of safety relative to its current valuations; as our experience has shown, if caught in the midst of a broader market meltdown, such opportunities offer immunity in the form of a swift reversal to normalcy.

What about demonetization?

As the scale of economic repercussions sink in by the day, the magnitude of long term economic consequences become more obvious. There is little doubt that over an extended period of time, building a more 'banked' and financially transparent society will only benefit the broader economy. However during times of such momentary distress, markets tend to exhibit an extraordinary obsession over the short term that are obviously not ever lasting and maybe this is a natural extension of behavioural finance.

Since this development, we have examined our portfolio holdings closely for long term negatives, if any. We have connected with our portfolio companies as well as industry bodies and we believe that in sum and substance, the period of stress is no doubt real, but should eventually cede to regularity over the next 5-6 weeks. As the new normal is digested, consumer and institutional spending will return to normalcy. Fundamentally, we believe there is no reason to change our views as all our holdings continue to be tested for resilience at periodic intervals.

Over all, we cannot underestimate the fundamental nature of human beings to adapt, especially in the harsh economic landscape of India where entrepreneurs are known for their resilience and we continue to look for opportunities that will benefit post this round of consolidation.

We continue to monitor our exposures and universe of ideas for value. We continue to like select names in building products, energy, 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

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