MARKET UPDATE – PAKISTAN

FEBRUARY 2020

STRATLINK

PAKISTAN MARKET UPDATE

| PAKISTAN BEGINS THE LONG AND BUMPY ROAD TO STRUCUTRAL REFORMS

POLITICAL OUTLOOK

Government Holds on By A Whisker as Coalition Sends Jitters

Pakistan's political landscape continues to be ever so happening. January 2020 saw two major political events with contrasting potential repercussions. A major coalition partner announced quitting the federal cabinet. It was not seen coming which came as a big shock. Almost on cue, two other coalition partners started to show dissent and raise demands, sending government on the backfoot. It is pertinent to note that the Pakistan government stands fallen without even one of the three coalition partners. We believe this looks more like a bargaining chip, with limited risk of it escalating any further.

Major Consensus in The Parliament Hints at Stability Ahead

On the other hand, the parliament showed a rare sign of unity in unanimously passing a controversial bill, relating to extension of the services chief's extension. This bodes well for political stability and law-making going forward, as the political heat seems to have cooled down considerably from late last year.

But.... Border Tensions Remain High

Military conflict with the neighboring India may not have touched the peaks of February 2019, when the two nuclear states were at the cusp of a full-blown war. That said, frequency of incidents on the Line of Control has increased in the recent past. The statements from fresh appointed Indian Army chief have also fueled fire. Luckily for Pakistan, the internal security situation has considerably improved over the years, allowing the forces to stay focused on the border. Restoration of bilateral ties with India to pre-February 2019 levels, seems implausible at the moment. Some of the food inflation in Pakistan is a result of no-trade policy with India since last year, and that may continue to be the case.

Bigger Role in Geopolitics Amid Iran-US Tensions

The recent Iran-US tensions had all what it takes for an all-out war. Apart from restraint showed from both sides, Pakistan stepped up to help diffuse tensions through high level diplomatic efforts. Prime Minister Khan himself spoke to the decision makers at both the sides. Pakistan can ill-afford another warzone in the region. The efforts also reflect how Pakistan has quietly climbed up the ladder in terms of diplomatic engagements and being part of reconciliatory process on more than one occasion. The Afghanistan war that found its way into Pakistan, ended up causing a loss of USD 120 billion over 15 years. Increased diplomatic efforts are a sign that Pakistan is committed not to let the region face another war.

Political and Military Consensus Evolves on Chinese Investment

Uncertainty surrounded the fate of China Pakistan Economic Corridor (CPEC) for much of 2019, as the new government was seen putting the CPEC projects on the backburner. Truth be told, the sluggish pace of CPEC in 2019 was more to do with the cooling down after completion of Phase-1. Pakistan, at the same time, was seen making deliberate efforts to focus on correcting the fiscal and external deficits, which led to the perception that CPEC is no more the game-changer.

The CPEC talks have gathered steam again, as Pakistan has established a designated CPEC Authority with a prominent retired military personnel at the helm. Phase-2 of CPEC is expected to yield long-lasting results, as more SEZs are planned to help boost industrial activity and exports.

Major infrastructure projects expected to be completed in Phase-2 are Gwadar Airport, 8 Special Economic Zones and the Gwadar Port with significantly increased traffic in 2020.

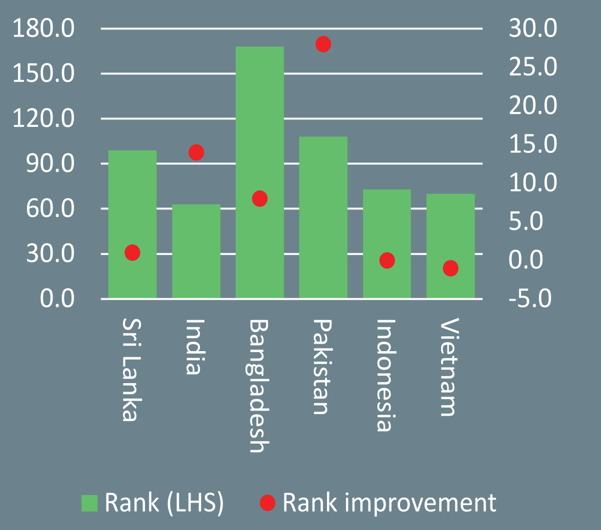
POLITICAL OUTLOOK

Pakistan Makes Huge Strides in Doing Business Rankings

The biggest boost Pakistan got on the global scale was undoubtedly the unprecedented 28 ranks improvement in the World Bank Ease of Doing Business Report. Pakistan was the region's best and world's sixth best improver, reflecting on the reform agenda taken up by the new government.

The improved business climate is down to policy actions taken by the government. Pakistan in 2019 made 294 business regulatory reforms, achieving improved rankings in six out of 10 broad categories.

Doing Business - Pakistan jumps



Source: World Bank

The ranking improvement is only the start of what appears a long path to structural reforms. The improved indicators bode well for attracting the much-needed FDI back to the country.

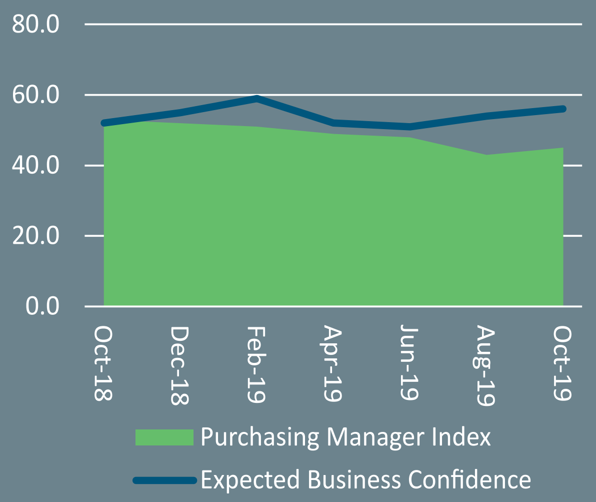
With entrepreneurship and urbanization picking pace, reforms such as starting a new business, electricity access, and dealing with construction permits, are going to go a long way to make Pakistan realize its 2025 dream of being ranked in top 50 countries in ease of doing business.

Business Confidence Down but Not Out

The consumer and business confidence have seen an uptick of late, having gone down in the negative territory for H1 2019. The significant rise in cost of business, and demand compression for most of 2019 kept the confidence of both industries and services, on shaky grounds.

The challenging operating environment remains a major cause of concern for businesses, specially in terms of current confidence. The current confidence is still reeling in the red, albeit, improved from 37 in the previous wave to 40 in the latest.

Business confidence shaky



Source: State Bank of Pakistan

The Purchasing Managers' Index continues to cut a sorry figure, despite slight improvement. This shows that much of the expected confidence comes from the services sector, as the manufacturing sector still sees tough times ahead.

A significant differential between current and expected confidence tells how businesses are hopeful of conditions improving drastically going forward. This seems to have stemmed from the currency's stability and significantly improved fiscal and external accounts in the last quarter.

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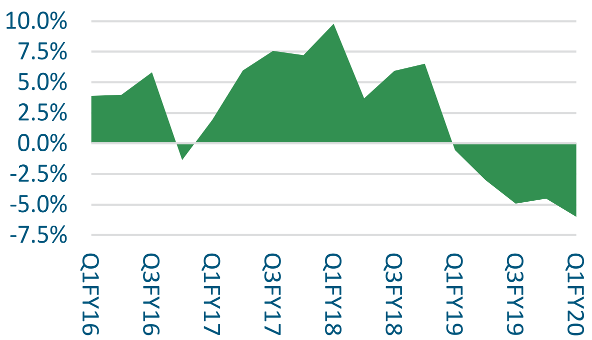
ECONOMIC OUTLOOK

Manufacturing Recession Deepens

Pakistan's large-scale manufacturing (LSM) contraction went deeper to five straight quarters and is well on the way to sixth consecutive quarter of negative LSM growth. The revised numbers reveal a scary picture, which should lead to revised and lower GDP growth estimates.

The LSM numbers have gone from bad to worse, as per the revised data. The sharp currency devaluation, which led to cost push inflation resulted in reduced demand for automobile and steel products. Oil refineries have also contributed, as the power generation has moved away from furnace oil to cheaper fuels.

Manufacturing struggle continues



Source: Pakistan Bureau of Statistics

The worst hit industrial sector remains automobile, as exchange rate devaluation, sharp reduction in real wages, imposition of duties, and persistently high interest rates weighed heavily on automobile demand. Government's fiscal constraints have also led to sharp slowdown in construction activities, which is reflected in downturn in steel, cement and allied industries.

There is no respite in sight for the LSM to recover in the near-term, as energy input costs, taxes and duties are due another round of upward revision.

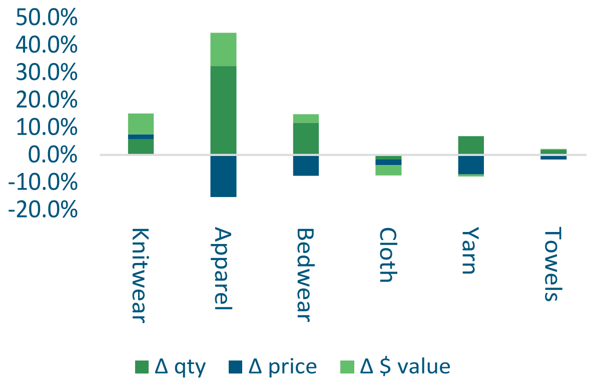
The only silver lining in the scenario is that the LSM growth may well have bottomed out. A fiscal impetus from the government around mid-year cannot be ruled out. Initial signs of support are evident, from the recent massive cut in fertilizer input taxes.

Textile Saves the Day but For How Long?

Almost the entire current account improvement owes to import compression, as exports have only grown by 3% year-on-year in H1 FY20. Textile remains the mainstay of exports, contributing 60% to total exports, in line with past trends.

There is little reason to rejoice a 4% year-on-year increase in textile exports. But it is the composition of exports that has instilled hopes of higher export values. Textile exports have improved in terms of both quantity and relative quality, geared more towards higher margin apparel segment.

Value added export surges (YoY chg)



Source: Pakistan Bureau of Statistics

The rupee depreciation leading to FY19 strengthened the textile exporters' price absorption power. Pakistan's textile took full advantage of low cost of production, as the government extended support package by reducing the energy price significantly, in addition to extending long-term finance facility at substantially discounted rates. Big textile companies have made sizeable investment in plant expansion owing to the window of opportunity that has opened up.

Textile sector's share in total private sector banking credit has increased from 20% in Q1FY19 to 25% by the end of Q2FY20. The share of fixed investment has also gone up from one-fourth earlier, to one-third, as expansions are underway and in pipelines.

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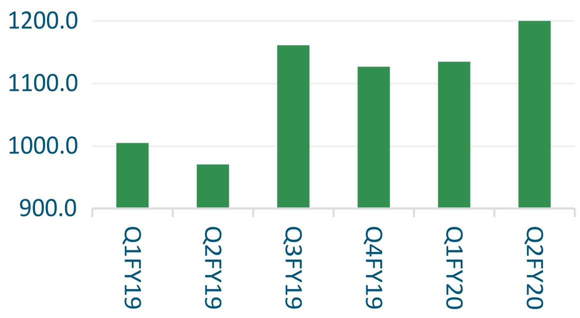
Credit to textile sector (PKR in Bln)



Source: State Bank of Pakistan

While Pakistan has done well to capture some of the Chinese market share in the EU and the USA, the textile sector faces the risk of input costs going up. The government, in a weird move, withdrew the concessional gas and power rates for export sector. There is pressure on government to reverse the decision, as much of textile's success of late has been built on the cost advantage, allowing the sector to compete with the likes of Bangladesh, Vietnam and Cambodia.

60%

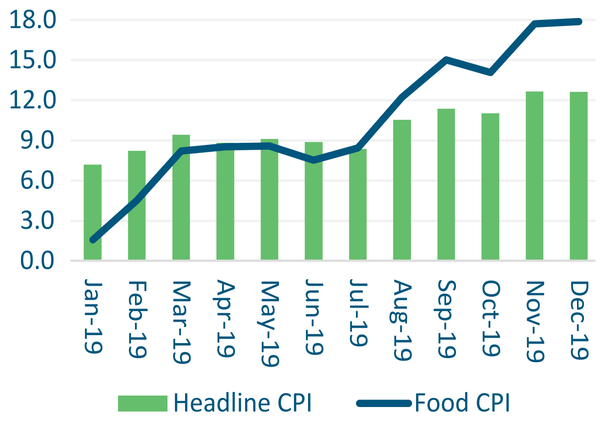
Textile's share in Pakistan's 1HFY20 total exports of USD 11.5 Bln

CPI Inflation Showing No Signs of Cooling

Headline consumer inflation has stayed over double-digits for five straight months, with December 2019 setting a 66-month high at 12.7%. H1FY20 inflation has averaged 11%, almost double the H1FY19 average. The persistently high inflation has further dampened the rate cut hopes in the market.

The central bank and the International Monetary Fund (IMF) have set a target of 11-12% for FY20. The alarming pace at which inflation has spiraled indicates the target is likely to be breached. Food inflation has been a major cause of concern, when the central bank had earlier predicted inflation to ease.

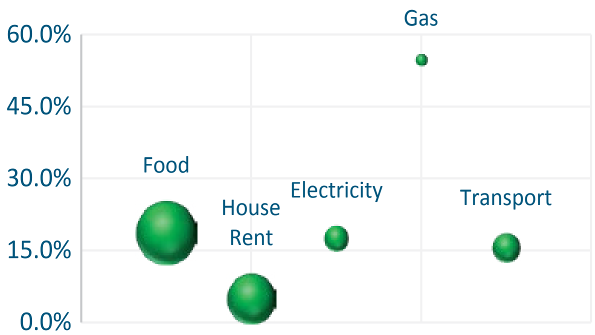
Inflation touches new highs



Source: Pakistan Bureau of Statistics

Recent wheat, sugar, and vegetable crisis, all resulting from supply chain distortions, have kept the food inflation high. The ongoing IMF program has led to massive energy price increase, as the price rationalization exercise is underway and expected to continue.

CPI break-up



Source: Pakistan Bureau of Statistics

The cash-strapped federal government is also likely to levy higher taxes on petroleum, and other essential use products, to raise indirect revenue (often the easiest source).

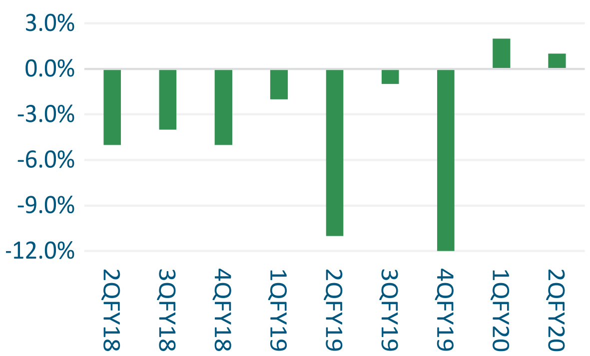
High base effect could possibly lead to lower inflation, but food and energy prices could team up to spoil the party beyond June 2020.

Currency Regime Changes to Market Based Mechanism

The single biggest policy level change has been on the exchange rate front. The central bank opted for a qualitative change in the way the exchange rate responds to external changes.

It is for the very first time that Pakistan has adopted a flexible market-determined exchange rate mechanism. Two quarters on, the market seems to have reacted well to the change, as against earlier apprehensions. The State Bank of Pakistan (SBP) had let the currency adjust to near equilibrium, before going for the market-based mechanism. This seems to have served the purpose of reduced volatility and improved price discovery.

PKR Periodic Change



Source: State Bank of Pakistan

CPI Inflation Showing No Signs of Cooling

The central bank has not indulged in the practice of foreign exchange sales – a tool it used in the past to help keep the currency overvalued. There have in fact been instances of occasional purchase of foreign exchange from the interbank market, ever since the approval of the IMF program.

32%

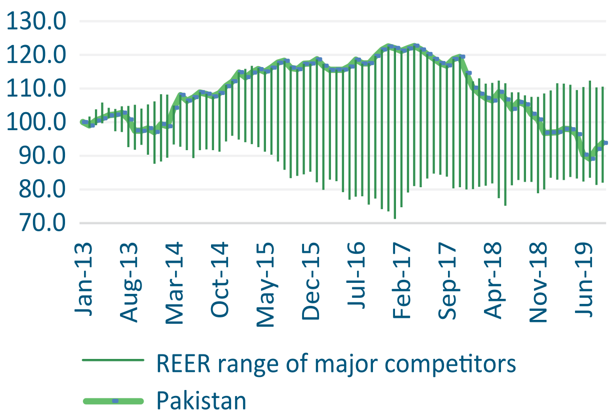
Value lost by PKR against the USD in FY19, the steepest rate of annual currency devaluation

PKR Journey from Overvalued to Fairly Valued

One oft-cited reason for Pakistan's sluggish export performance in the years leading to the massive round of currency devaluation, was the fixation with keeping currency artificially overvalued.

Pakistan's export sector lost ample ground in terms of competitiveness relative to peers, primarily because of unwarranted fixation with exchange rate being politically handled in the previous regime

Real Effective Exchange Rate

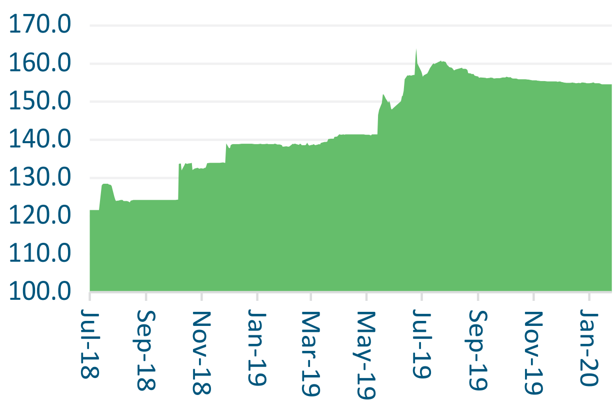


Source: Pakistan Bureau of Statistics

The PKR having traded at or over the higher range of regional REER for most part since 2013, has made a sharp adjustment, and is now seen trading near the lower band.

The immediate impact of stable rupee can be seen in improved import cover and forward swap position. The central bank has used the opportunity to shore up Net International Reserves (NIR) to build strong buffers.

Rupee's Ride to Stability



Source: State Bank of Pakistan

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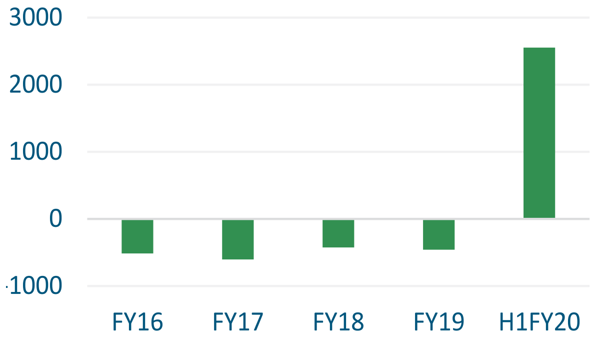
DEBT MARKET UPDATE

Foreign Portfolio Investment (FPI) Pours in

Pakistan's otherwise unattractive debt market has had sizeable activity form foreign portfolio investors, of late. Pakistan's interest rates and the differential with global yields are not attractive for the very first time. It is the deepening of the capital market, based on the market-based exchange rate, that seems to have spurred confidence among foreign investors.

There is no denying that the interest rate cycle in Pakistan gave birth to the opportunity to lure in foreign investors, at a time when yields on government papers across economies, were going southwards.

Hot Money Makes Inroads (FPI in USD Mln)



Source: State Bank of Pakistan

But the sudden inflow of foreign portfolio investors in debt market cannot be solely attributed to higher interest rates. The new SBP Governor has made concrete and deliberate efforts to entice foreign investors in the debt market, with an aim to deepen the market, and to build reserves, while building a longer-term yield curve.

While Pakistan may be struggling on the real market front, the externa sector has kept it afloat. The credit goes to the new team at the SBP, and the newly adopted mechanism of market-based exchange rate, which has reduced volatility.

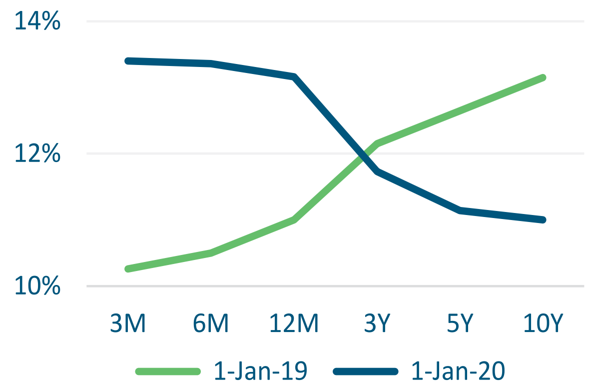
Pakistan's reform story has been sold rather well in the international market. Almost 90% of the USD 2.5 billion of FPI has come from the UK and the USA.

The IMF program, improved reserves, and the new exchange rate regime have all contributed to the massive FPI inflow, which has largely offset the dull FDI performance. We believe the FPI bonanza could fetch Pakistan close to USD 4-5 billion by June 2020.

Inverted Yield Curve

In most countries, an inverted yield curve would signal signs of recession. But Pakistan's debt market is thinly traded and moves with a lag. The yield curve inversion suggests the central bank maintains a bullish outlook on inflation in the short-term, expecting it to come down in the longer run.

Yield Curve Inverts



Source: State Bank of Pakistan

The government has smartly rejected bids at high rates for longer-tenor papers, aiming for a longer-term yield curve. The IMF has also vouched for Pakistan to convert debt from short-term treasury bills to long-term PIBs.

The monetary policy decision will be heavily based on inflation scenario. We expect the discount rate to stay in double digits for most of 2020, before starting to reverse by the year end.

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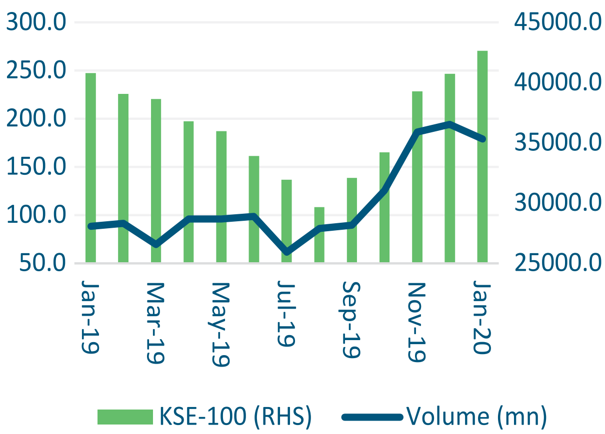
EQUITY MARKET UPDATE

Bull Run on Last Legs?

The benchmark KSE-100 index witnessed a see-saw ride in 2019, yielding a modest 7% annual return. But that is half the story. The real deal was the opportunity a long bear spell presented in the middle of 2019.

The index had lost 24% of the value in first eight months. What followed, made Pakistan Stock Exchange's KSE-100 one of the best performing indices in the world, in Q4 2019. From the lows of 28765 points in August 2019, the investors yielded a handsome 42% by the year end.

KSE-100 Bull Rally



Source: Pakistan Stock Exchange

The New Year also began well for the bourse with the index in the first three weeks inching up by 4.5%. The volumes are also back at the market, at 30-months high, averaging over 200 million in Q4 2019.

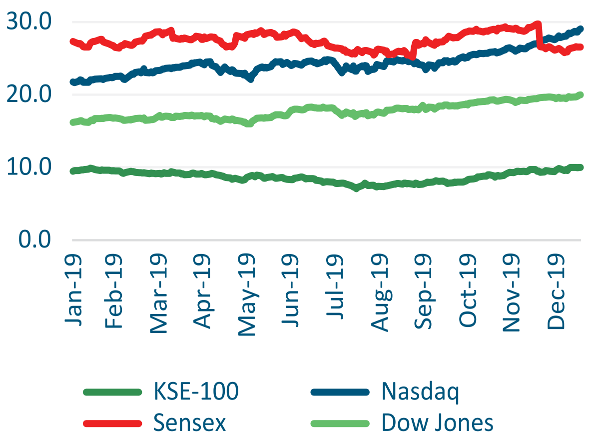
Much of the bull run owes to the fact that the uncertainty pertaining to a multitude of factors subsided by 4Q 2019. It was around that time, that more clarity arrived on the IMF program front as well.

What has perhaps stood out for investors of late, is the relative stability in the external sector. The regime change at the central bank leading to market-based exchange rate mechanism, primary surplus for first time in four years, improvement in ratings by Moody's, debt market deepening resulting in substantial foreign flows, and the IMF cushion, combined to boost the sentiments.

Earning Multiples at Discount – But What's New?

In terms of fundamentals, much has not changed, which clearly shows in the earning multiples. The real GDP growth is expected to stay under 3%, even by bullish estimates. The P/E multiple discount with other indices has grown a little, but largely remains in the historical band.

KSE-100 - Steep P/E Discount



Source: Bloomberg

Consensus estimate sees KSE-100 yielding a 25-30% return in 2020. The relative stability in macro indicators, and a likely reversal in the discount rate cycle in 2H 2020 make a strong case for such annual return.

That said, sell side bullish bias is also a fact, and Pakistani sell-side has in the past 5 years, overestimated the outlook by 18-20%. Banks and energy heavy index will need more impetus on the demand side to go past the historical P/E band of 10X. This year looks promising but could well be one for consolidating gains. Extremities aside, KSE-100 should aim for higher in 2021, after taking a 2020 breather.

STRATLINK ADVISORY GROUP - WHO WE ARE

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StratLink Advisory Group's head office is located in Dubai. The company has its Africa headquarters in Nairobi, Kenya, and its Asia headquarters in Karachi, Pakistan.

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