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MARKET UPDATE – PAKISTAN

MARCH 2020

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PAKISTAN MARKET UPDATE

PAKISTAN FACES FISCAL CHALLENGES AS GROWTH TAPERS

POLITICAL OUTLOOK

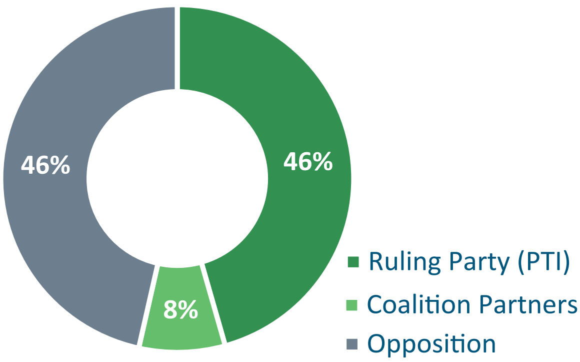
Government Appeases Key Coalition Partners

The agitated coalition partners are a worry on political front for the government. The threat has considerably subsided from last month, where two of the three major coalition partners showed public dissent and upped the ante. Things have settled since, with ongoing negotiations on specific demands and terms for different coalition partners.

The political noise from the opposition is in stark contrast to last year, where the opposition was on the streets, protesting and having sit-ins to remove the government. That demand seems to have taken a backstage as possible backdoor settlement with the leadership of the two main opposition parties is seemingly in works.

There has been a strange, almost unprecedented silence from the leadership in exile and out of prison. The recent multiyear high inflation did not see nationwide protests from the major opposition parties. The path for the government seems clear, in terms of political noise.

Parliament Position



Source: Election Commission of Pakistan

Major Consensus in The Parliament Hints at Stability Ahead

Global financial watchdog, The Financial Action Task Force (FATF), extended the deadline for Pakistan by another four months, to fully comply with the action plan.

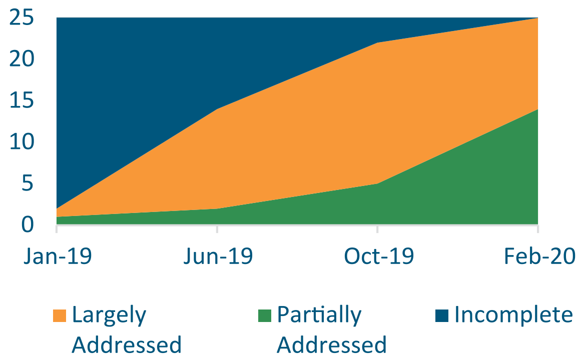
Pakistan continues to be on the 'grey' list of the FATF but avoided a downgrade to the 'black' list as was being feared earlier.

Massive diplomatic efforts have been put in by Pakistan and its friends, mainly China, to help gain more time to comply with the action plan.

The extension till June 2020 rings a new lease of life for Pakistan to expedite work on 13 of the 27 actionable plans to combat terror financing and money laundering.

The lifeline could well be the last, as the FATF may be left with no option come June 2020. Meanwhile, this means there is no near-term threat to the continuation of IMF program, and Pakistan's access to global financing from other multilateral donors.

FATF Compliance Progress



Source: Financial Action Task Force

Taliban-USA Deal Raises Peace Hopes

The 18-year long war could well be nearing an end, if the recent deal between the USA and Taliban goes well. Pakistan has been on the receiving end of the unrest in Afghanistan and would welcome the move.

Pakistan has played an active role, albeit, behind the scenes, to facilitate negotiations between the two parties. Any stability in Afghanistan would help reduce tensions with Afghanistan, and help Pakistan focus more on domestic peace.

Pakistan may still be required to continue mediating between the two parties to help ensure swift closure of the deal. Islamabad can potentially leverage its position with the US to its advantage.

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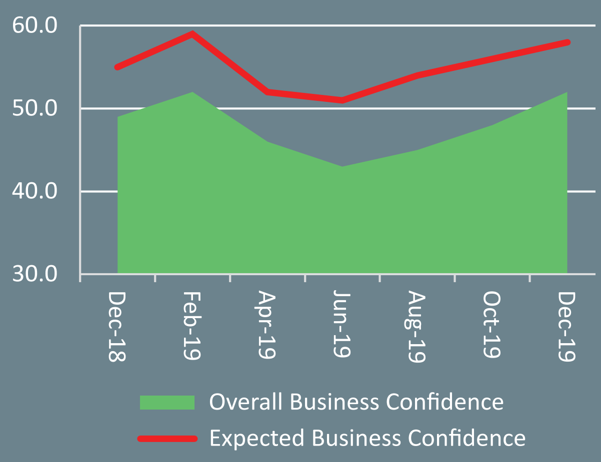
BUSINESS ENVIORNMENT

Business Confidence Coming Back

The popular media narrative may well be built around inflation and slow economic growth, the stabilization process seems to have started bearing fruit. The benchmark Consumer Confidence Survey conducted by the central bank, shows business and consumer confidence at a 2-year high.

The latest wave is only the second time in the current government's tenure, that the overall business confidence is in positive territory. The first instance was right after the government took office, as there was a feelgood factor around.

Business Confidence Returns



Source: State Bank of Pakistan

The most noticeable improvement of 8 percentage points has been reported in the Industries sector. The wave results also coincide with the IMF's largely positive first review.

The central bank's hint in the monetary policy statement that the interest rates may have peaked, is also likely to have played a role in augmenting confidence of the industrial sector.

46%

Share of businesses with positive views of expected business activities

IMF Sings Praises

The IMF team had long and hard discussions with Pakistani authorities in February. Much like the first review, the IMF acknowledged Pakistan's ability to meet all quantitative targets. But much unlike the first review, the IMF team left the country without inking the Staff Level Agreement, needed to release the next tranche of the USD 6 billion program.

That said, the Fund commended Pakistan on "considerable progress" and advancing reforms and continuing with sound economic policies." Pakistan's progress in H1FY20. The IMF sees the economic activity stabilizing and on a recovery path.

The strong positive wordings do come as a little surprise, given that the Fund stopped shy of signing the Staff Level Agreement. The IMF's endorsement has come at a time when Pakistan was looking to defer energy price increase for at least six months.

The IMF has historically been stringent on structural benchmarks, especially energy pricing. To Pakistan's comfort, there is strong precedence of the IMF waiving energy pricing benchmarks, in the previous two programs.

USD 6 Billion

Pakistan's loan program with the IMF spread over 39 months

Pakistan had signed an Extend Fund Facility in July 2019 for USD 6 billion, subject to quarterly performance reviews. While Pakistan is moving towards recovery and stability, the IMF is not likely to offer waivers on other fiscal measures, such as taxation and development spending. We believe, Pakistan would succeed in getting the IMF Board's approval for the release of third tranche, which is vital for continued access to all financing avenues.

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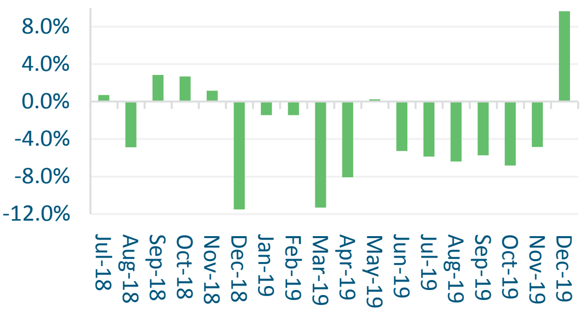
ECONOMIC OUTLOOK

Manufacturing Comeback?

The Large-Scale Manufacturing (LSM) posted a 9% year-on-year increase for December 2019. This was the first such instance after 15 consecutive months of LSM decline.

The H1FY20 LSM growth now reads a negative 3.3%. The LSM growth target of 1.3% for FY20 seems elusive, even after the December growth. Nearly one-third of the December 2019 LSM growth stems from a 100% rise in sugar production, which is likely to be evened out in the coming months, as the total sugarcane crop production is lower than last year.

Large Scale Manufacuting (YoY Growth)



Source: State Bank of Pakistan

Pakistan is currently on an unwanted spree of six consecutive quarters of LSM contraction, which is the longest such spell in the country's history. The low base effect could possibly mean an end to the long spell of LSM contraction.

There are early signs of recovery in the worst hit automobile sector. A more stable currency and likely reduction in interest rates, bode well for automobile demand going forward.

Textile Sector Hit by High Energy Prices

Textile sector contributes 60% to Pakistan's exports, and has shown resilience in times of global demand slowdown. The support package extended to textile sector in 2019, offered energy prices at 7 cents per unit, which enabled the export players to compete with regional players.

In a bizarre move, the Ministry of Power, withdrew the concessionary electricity tariffs, and imposed surcharges, taking the tariff up from 7 cents to 13 cents per unit. To make matters worse, the increase has been put in place in retrospect from January 2019.

Textile industry has made a smooth transition towards high value-added products in the last year. Volumes have increased in double digits across categories, keeping exports alive in times of low unit prices.

The move is likely to be challenged in the courts but will surely irk the industry. Many large textile players are already undergoing expansion, on the promise of concessional energy tariffs.

Power Tariffs Freeze May Lead to Fiscal Crunch

While Pakistan has taken care of energy availability part of the equation, energy affordability has been a big problem. Lopsided contracts with power producers have resulted in capacity payments becoming the biggest component of power tariffs.

The government has decided to freeze all energy tariffs till at least June 2020. The freeze may or may not extend beyond FY20. The government was fast losing political capital as inflation touched a multiyear high. The move will have fiscal implications to the tune of PKR 200-250 Bln for H2FY20, for electricity and gas, combined.

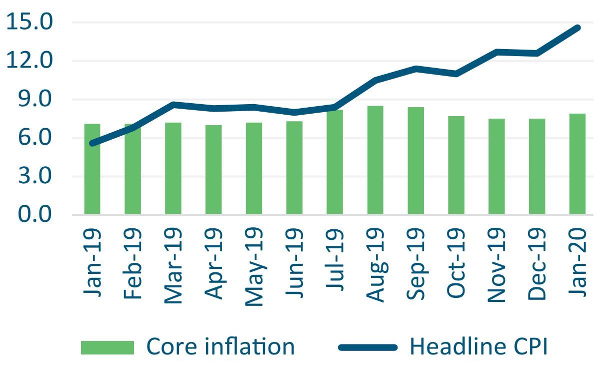
The move is likely to push the energy sector reforms ack to square one. The energy sector circular debt has crossed PKR 1.2 trillion, and price freeze will further add to the stock. Government has little room to allocate subsidy midway in the financial year. The move may save consumers from direct increase in prices, but the fiscal implications will reflect in inflation, in the form of printing money, or new taxes.

CPI Inflation Reaches 10-Year High

The CPI inflation reading at over 14% for January 2020 caught the government by surprise. Crisis like situation in the main food staple wheat caused the retail prices to surge exponentially.

The crisis stemmed from hoarding practices and provincial government's miscalculation as regards timely procurement of the all-important grain. Wheat was singlehandedly responsible for one-third of the inflation in January.

10-Year High Inflation



Source: Pakistan Bureau of Statistics

All eyes are now on inflation projections, which the central bank has not changed, even after higher than expected reading for January 2020. Wheat and key vegetable prices have now been pulled back after government's intervention and active supervision. Inflation may well have peaked in January, as the central bank and the IMF, have not revised projections.

We believe that any immediate surge in inflation is unlikely, as the government has decided to freeze electricity and gas tariffs for at least six months. The global crude oil prices are also expected to remain on the lower side, for multiple reasons, which would offer a breathing space to the government for petroleum pricing.

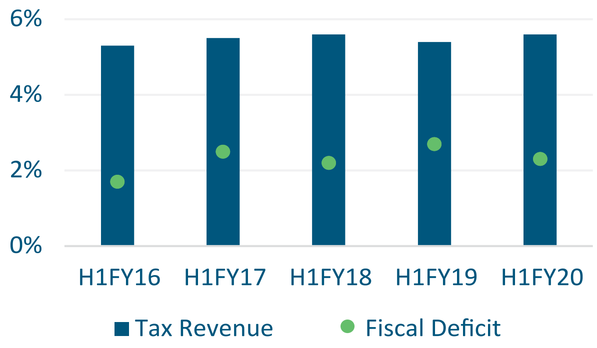
Tax Collection Target Remains Elusive

Pakistan aimed for an overly ambitious tax collection target of PKR 5500 Bln for FY20 at the start of the year. The slowdown in economic activities and a considerable drop in imports have left the government high and dry, leading to downward target revision.

Total tax collection in 7MFY20 has gone up by 20% year-on-year. This is nothing short of an achievement in a low growth economy, facing manufacturing contraction.

The Federal Board of Revenue (FBR) has put in the hard yards to have more filers in the system and has also focused on increasing collection on demand.

Tax Revenue Challenge

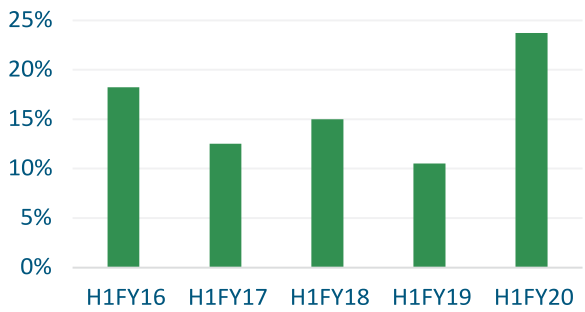


Source: Ministry of Finance

But even the revised target at Rs5200 Bln is a tall order, as imports have shrunk by 15% during 7MFY20. Sales tax on import stage has historically been 50-55% of total sales tax collection. That is going to come down, even with higher rates of duties in some cases.

The government finds comfort in non-tax revenues, up three times year-on-year. Profits from the central bank and long overdue telecom license fee have buffered the account. This would prove vital to mitigate some of the tax revenue shortfall but is not sustainable.

Non-Tax Revenue (as & of Total Revenue)



Source: Federal Board of Revenue

We believe Pakistan's authorities are likely to fall significantly short of tax collection target, leading to high fiscal slippage.

Government is not too keen on passing on energy prices which could put more fiscal burden on the expenditure side. The full year FY20 fiscal deficit could well mirror the highs of FY19 at near 9%.

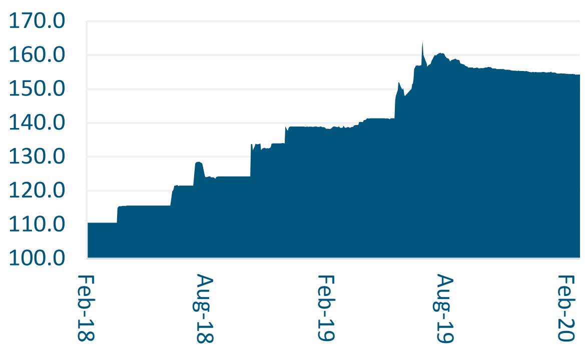
The government may still want to keep the screws tight on non-essential imports, as reserve buffer is still in process of being built. We flag the Budget for FY2020-21 as the next defining trigger in terms of fiscal developments.

Currency Stable; Forex Reserves Growing

From the high of 164 to a dollar in June 2019, the rupee has found remarkable strength and stability. While a mere 4% appreciation against the greenback in the fiscal year to date may not be a big deal for many currencies, but for PKR, it is a first.

The ongoing spell of currency stability is the longest in over 3 years, and is importantly, more organic. Recall that the central bank had adopted a market-based foreign exchange mechanism, letting the market determine fair value of currency, with minimal intervention, only in extreme scenarios.

PKR Strengthens

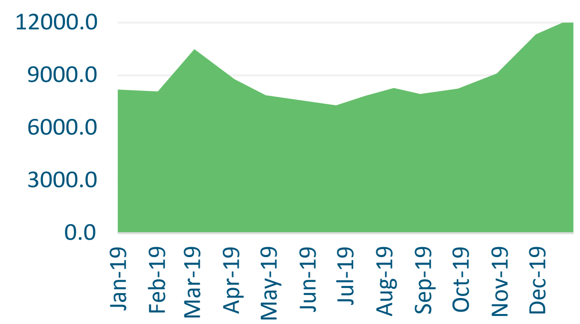


Source: State Bank of Pakistan

Tight monetary policy and policy-driven import compression have both contributed to significant improvement in current account deficit, lending credence to a stable currency. Tight monetary policy and policy-driven import compression have both contributed to significant improvement in current account deficit, lending credence to a stable currency.

While the export growth has been rather slow at 3% year-on-year, consolidation of remittance growth and significant contribution from foreign portfolio investments have contributed to keep the dollar demand down in the open market.

Central Bank Forex Reserves (USD Mln)



Source: State Bank of Pakistan

We believe the currency is trading close to equilibrium, as evidenced by Real Effective Exchange Rate, which has hovered under 100 for a few months. A relatively undervalued currency bodes well for the economy, which may open up later in FY21, as the government may offer growth stimulus.

The gradual buildup of central bank foreign exchange reserves is a welcome sign, as the import cover has gone up from a critically low 1.8 months right before the IMF program in June 2019, to a much comfortable 3.5 months.

Pakistan seems to have averted the external balance of payments crisis, which was looming over in FY19. The challenge now remains at the fiscal front, and the pace of fiscal reforms on both revenue and expenditure front is critically slow. We believe, the government would make efforts to increase development spending in a bid to spur growth, in the near future.

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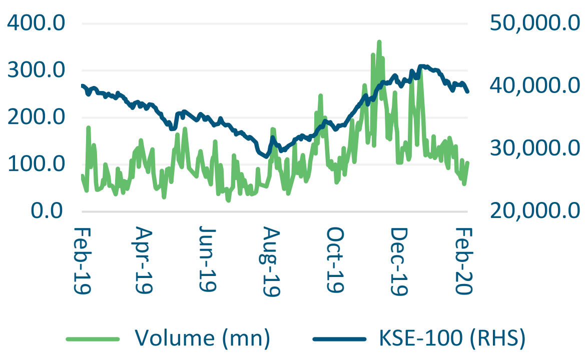
EQUITY MARKET UPDATE

The equity market having soared over 40 percent in last four months was overdue correction and the index seems to have obeyed the technical indicators. The benchmark KSE-100 index yielded negative monthly returns, after five consecutive positive monthly returns.

Stock market consolidates



Source: Pakistan Stock Exchange

The rates on offer in the bond market are still lucrative. The expectations of reduction in the discount rate have been hit hard and the market now expects the status quo on interest rates to last longer than previously anticipated.

The KSE-100 index is expected to yield 20-25% annual return in 2020, according to consensus analysts' estimates. The earnings multiples remain attractive in comparison to regional bourses.

Much improved country image could well lead to multiple rerating. The interest rates are expected to be on a downward trend, starting H2-2020, which should start getting priced in sooner than later.

Foreign portfolio investment in equity market has shown net outflow recently. Large number of foreign investors cashed out the massive returns offered in Q4-2019. We believe, the foreign equity portfolio investment should return soon, as the market readies itself for another rally, having undergone correction.

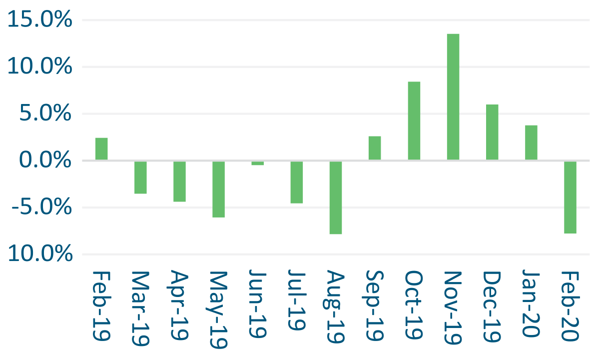
There is an element of uncertainty in the market, as regards the potential fallout of the Coronavirus and its impact on Pakistan. We believe, Pakistan stands to be a net gainer from any Coronavirus related fallout, as it opens a short-term window for Pakistan to capture the export market.

We believe the foreign portfolio investment bonanza in treasury bills is nearing a considerable slowdown by H2-2020. This could mean more potential inflow form foreign investors in the equity market.

The KSE-100 index has historically witnessed low volumes in the month of Ramadan, which is less than two months away. The period of consolidation could stretch till Ramadan, and there could potentially be more correction in the pre-budget jitters.

The banking and oil stocks remain the driving forces of the index. Both sectors face challenges, as banks are still waiting for genuine credit demand to resurface, as the earning spreads have further squeezed.

Correction at KSE-100 (avg monthly returns)



Source: Pakistan Stock Exchange

Energy sector could face short-term challenges as crude oil prices face a sharp slide in the wake of Coronavirus. That said, the P/E multiples indicate that there is enough juice in values, and the index should be back yielding positive returns, as confidence from the IMF and FATF should bode well for the market.

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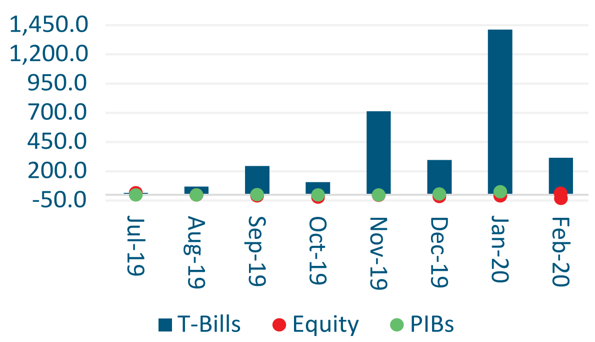
DEBT MARKET UPDATE

The foreign investment portfolio (FPI) in the debt market cooled off from the record highs seen in January 2020. That said, almost the entire FPI is concentrated in treasury bills. The yield curve is shaping up in the manner that indicates the reversal in the monetary tightening cycle can wait.

T-Bills Lead FPI (USD in Mln)

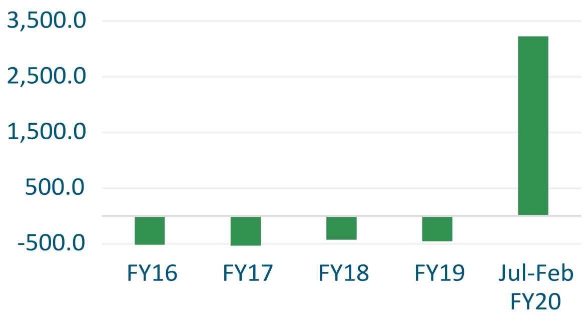


Source: State Bank of Pakistan

The investment in treasury bills has now almost entirely shifted towards the 3-month papers. The last three auctions have seen 80% concentration in 3M T-bills. This underpins that the market participants are eager to cash in the opportunity on offer, however long it lasts.

The rates are marginally higher in 3M papers, over 6M and 12M. The rate cut expectations have now been delayed, with the earliest expectation in May 2020. Foreign investors have also flocked in, especially as the government ironed out the transaction and tax related issues regarding FPI.

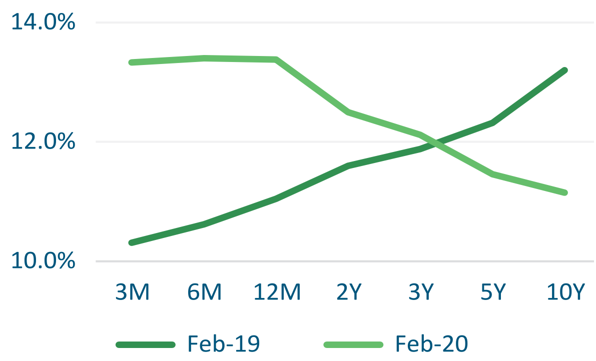
Foriegn Portfolio Investment (USD in Mln)



Banks have started shifting the investments towards longer tenor government papers. The government has rejected short-term bids at high rates in a bid to deepen the longer-term yield curve. The development of a longer-term yield curve is also one of the IMF's long-held desires and is part of the ongoing Fund program that Pakistan is part of.

The government has not been too keen on accepting all the bids in 3M treasury bills, as it is committed not to repeat the mistakes of past, which led to windfall profits for commercial banks, at the expense of high interest servicing cost. The T-bill amount accepted in the latest February 2020 auction at PKR 273 Bln, is the lowest in last seven auctions, with the highest rejection for 3M papers.

KSE-100 - Steep P/E Discount



Source: Bloomberg

We believe the inevitable reversal of the interest rate cycle will result in significantly altering the current yield curve from the inverted state, towards a conventional one.

Gradual expected recovery in economic activities should open more avenues for commercial banks to lend to the private sector.

The Advances to Deposit Ratio (ADR) should go up as manufacturing activities have slowly started to pick. Banks' focus on real sector lending should be instrumental in reversing the yield curve, towards longer tenor papers.

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