STRATLINK

MARKET UPDATE – PAKISTAN

JUNE 2020

PAKISTAN MARKET UPDATE

| Economy reopens but GDP tanks to lowest ever

COVID-19 SITUATIONER

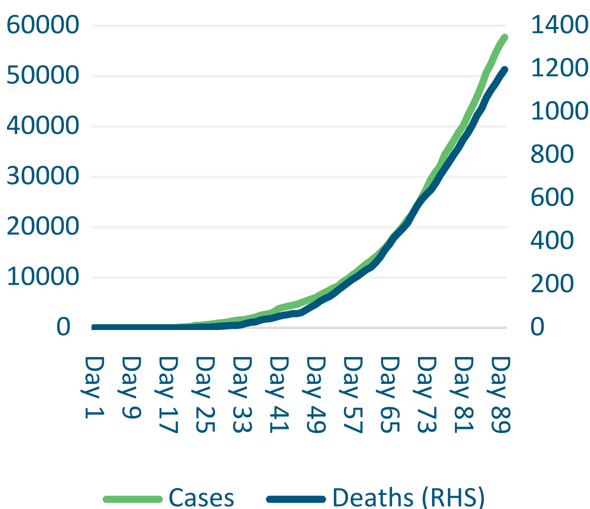
(These numbers are as of May 27, 2020 and are subject to substantial change by the time the report reaches readers)

Covid Cases Rise; Deaths Under Control

Pakistan expectedly witnessed a sharp rise in coronavirus cases in May 2020. The journey from 14000 to 60000 cases was taken in a month, as the testing capacity was increased.

Pakistan nearly doubled the testing capacity in May over April, which naturally led to more positive new cases. Bear in mind that for countries with massive outbreak, number of fresh cases will remain a factor of number of tests conducted.

Covid Cases Climb



Source: Government of Pakistan

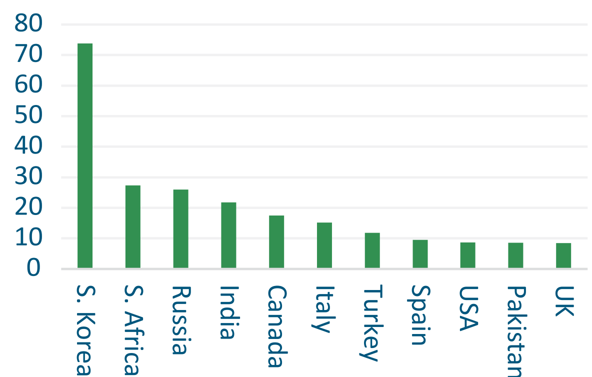
The lockdown was considerably eased in phases across the country, as Eid approached, and people's patience worn out. This was bound to lead to higher virus prevalence, which is evident in a considerably higher incidence of positive cases per test.

It took 12 tests for every positive case in April. The number came down to 8.6 tests for every confirmed positive case, putting Pakistan in the league of US, UK, and Spain. The last few weeks have seen positive cases per test soaring from 9% last month to 15% and rising.

Government's response to the pandemic has invited a lot of criticism from political opponents, some of which is unwarranted. The government has rightly shifted the focus on mortality incidence, instead of number of infections, to gauge the ability of the system to cater to potential patients.

Two of the four provincial authorities have announced pool testing, which should better indicate the prevalence of virus on a mass scale.

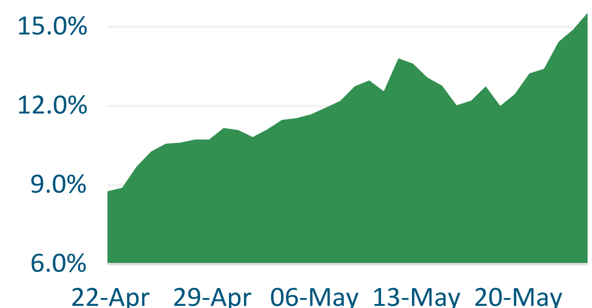
Tests per Confirmed Case



Source: Oxford Martin School

While the cases continue to rise, Pakistan seems to be doing rather well on the mortality front. The virus just seems to be working differently in Pakistan, for whatever reason, but it has sure caused significantly lesser deaths, at the same stage for other countries around the globe.

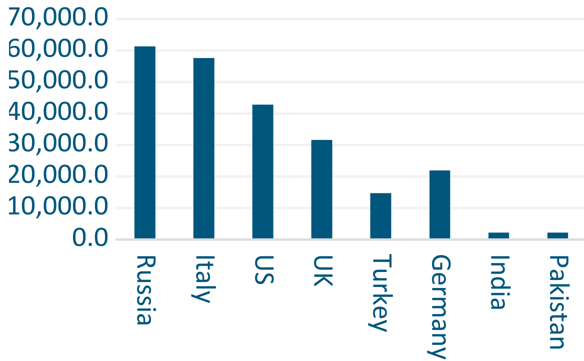
Positive Cases per Test



Source: Government of Pakistan

Pakistan may well have ramped up the testing capacity and still has one of the best tests per million ratios in the region, it pales in comparison to global standard of best practice. Pakistan's test per million stands at an extremely low 2200.

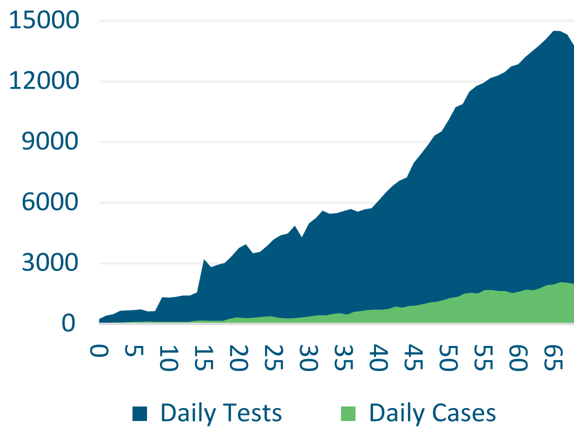
Covid Tests per Million



Source: Oxford Martin School

Pakistan's case to fatality rate is amongst the lowest for countries with at least 1000 cases. The actual rate of mortality would be much lower, given that Pakistan's testing per million is on the lower side, based on the assumption that the incidence of more cases being missed because of non-reporting will be higher, than chances of deaths being missed.

New Cases Rise With Testing
***Days since 1st 5-daily deaths**
****7-day rolling average**



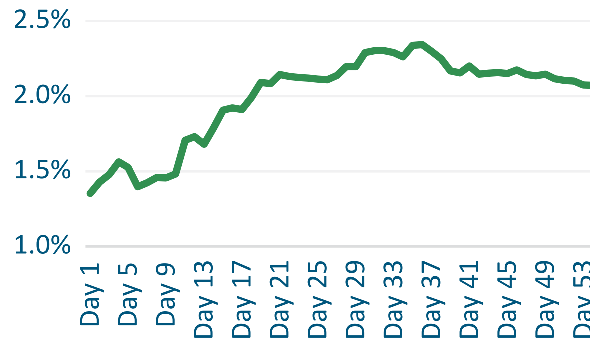
Source: Government of Pakistan

Pakistan's Covid mortality curve has not gone out of control, even when cases are doubling swiftly. Early warnings from experts had put Pakistan's expected deaths to be near half a million, but that now seems highly unrealistic.

Unless there is another peak later, Pakistan seems to have already achieved the peak. Pakistan's Covid death peak may not be as pronounced, for the simple reason, that the daily deaths never really got out of control.

The curve looks more like a plateau, than a peak. The curve may not bend like other countries and could very well be a long period of a flat line.

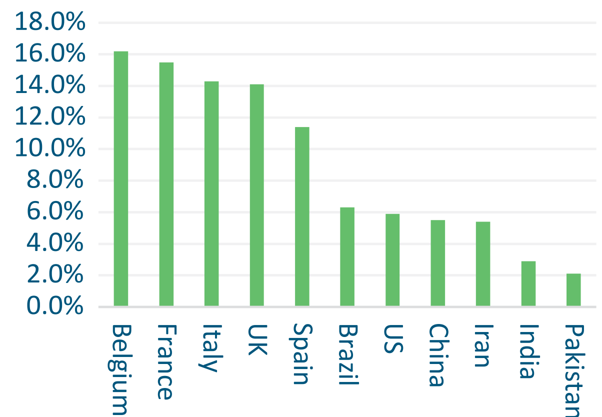
Case-Fatality Rate
(since 1st instance of 5 daily deaths)



Source: Government of Pakistan

Most countries with at least 1000 deaths saw the curve starting to flatten or bend around 40 to 50 days since the first instance of five daily deaths. There are a very few exceptions to the rule, such as Brazil and Mexico.

Mortality Rate Comparison

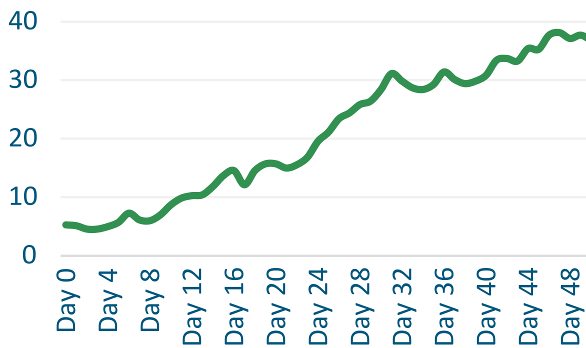


Source: John Hopkins University

Exceptions aside, if Pakistan can achieve the peak around 35-40 daily deaths, as is the case (as on May 27, 2020), it would have done a great job, without overwhelming the healthcare system's capacity.

In terms of preparedness, Pakistan may have responded slowly at the beginning, but seems to have covered good ground. The number of Covid dedicated hospital beds has quadrupled in less than two months.

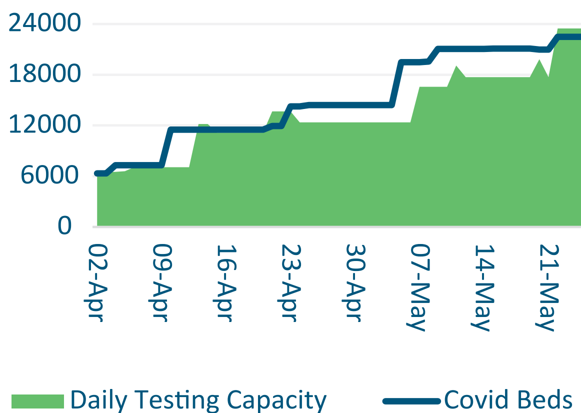
Daily Covid Deaths (7-day rolling average)



Source: Government of Pakistan

The federal government has set up a central command and control agency that tracks the situation round the clock, and jointly formulates and recommends policy actions, in consultation with provinces.

Pakistan Ramps Up Capacity



Source: Government of Pakistan

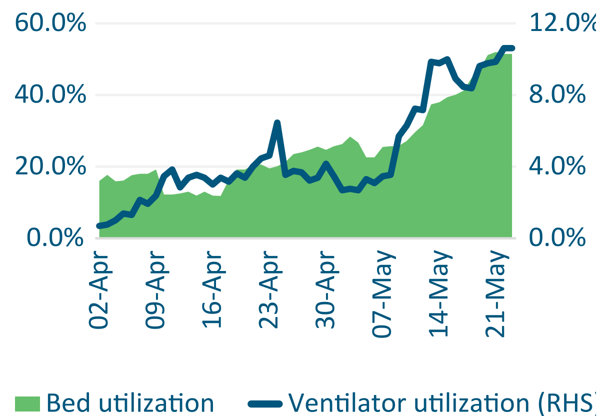
After much deliberation, the government announced gradual easing in lockdown, which has resulted in much increased economic activity. The decision was politically challenging, but the federal government insisted that the capacity to fund the underprivileged is limited, and continued closure of economic activity would be more disastrous than the pandemic.

Government's unannounced strategy seems to be circling around the herd immunity concept. Pakistan has also started to make PPEs on its own, and ventilator manufacturing is next in line.

Healthcare spending has been prioritized for fund releases, and all provinces are allowed to exceed the previously allocated health budgets.

The government has dedicated 1300 ventilators for Covid. So far, the ventilator utilization has stayed at or under 10%. The hospital bed utilization is also under 20%, which shows the system has room to combat any worse situation.

Ventilators Not a Concern



Source: Government of Pakistan

Having earlier announced direct cash support for the underprivileged, the government has now shifted the focus on small retail businesses and those who have lost their jobs in the pandemic. The two groups will be next in line to receive cash support from the stimulus package.

Industries have been allowed to start manufacturing with SOPs in place. More workplaces are now opening up, and markets, other than essentials are also allowed to operate, for shorter hours.

Monetary and fiscal responses have both been adequate, given the space. More relief on a broader scale is expected in the upcoming federal budget, as the government plans tax relief for consumers and businesses.

All said, government officials have warned of re-imposing the lockdown with stricter measures, if SOPs are not followed, the number of cases and deaths rise exponentially, or there is another wave, after a brief lull.

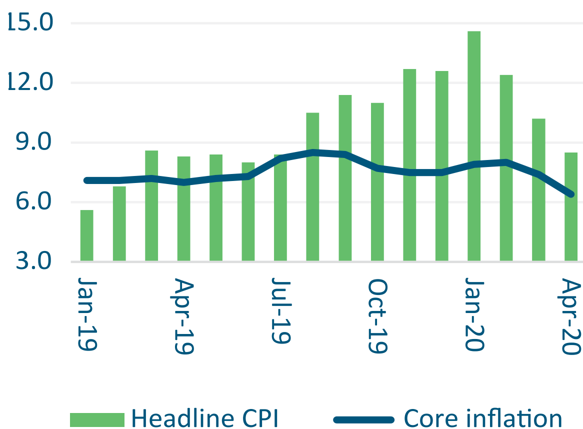
ECONOMIC OUTLOOK

Demand Collapse Brings Inflation Down

The inflation slide has been rather swift in Pakistan, coming down from a decade high of 14%, to single digits in three months. Recall that Pakistan's economy was facing headwinds even before the Covid-19 hit the country.

The government had made efforts to curb demand via monetary mechanism. That did play a role in reducing non-essential consumption, but food prices remained volatile. And then came Covid-19, where demand side pressure was eased, and government's earlier monetary easing, coupled with substantial relief in energy and transport prices, led to sizeable decline in national CPI inflation.

CPI Inflation Goes South



Source: Pakistan Bureau of Statistics

Core demand side non-food non-energy (NFNE) inflation has also accelerated the decline. Core inflation was significantly lower than the headline inflation and became a flash point as the central bank disregarded core inflation for monetary policy inflation targeting.

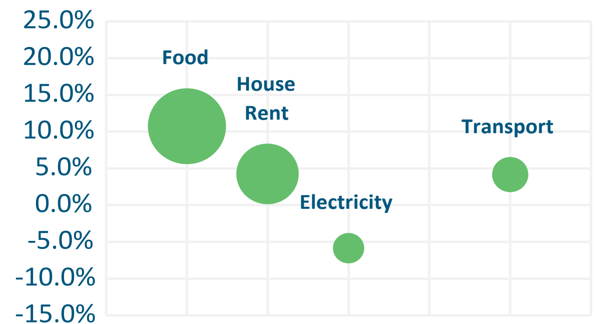
Core inflation generally has good predictive power. Having stayed sticky for much of pre-Covid era, the sharp fall indicates a sizeable drop in NFNE demand, which could likely accelerate the inflation decline.

Energy tariffs for all consumer categories have either been frozen or reduced, as part of the Covid-19 relief package. The domestic and commercial consumer categories have been allowed massive relief to the tune of 50% in some cases, which is likely to pull down energy inflation further in the coming months.

Stricter price control by local governments, coupled with improved supply and suppressed demand, have combined to keep the food prices in control, in the month of Ramadan, otherwise known for steep price increase.

The sharp decline in global crude oil prices also bodes well for transport sub-index of inflation. The government has decided to pass on the benefit to end users, despite taking the petroleum levies to record high.

CPI break-up



Source: Pakistan Bureau of Statistics

The central bank has also revised the inflation projection downwards for FY21 to 5-7%. That said, the upside risks have not completely faded.

The major crops have been projected at below target, and the recent locusts attack on some smaller crops could create shortage, leading to higher prices.

The interest rates have been brought down by the central bank, which should lead to lower cost of business. Demand management is not the intent of monetary easing right now, but low interest rates will surely keep inflation in check.

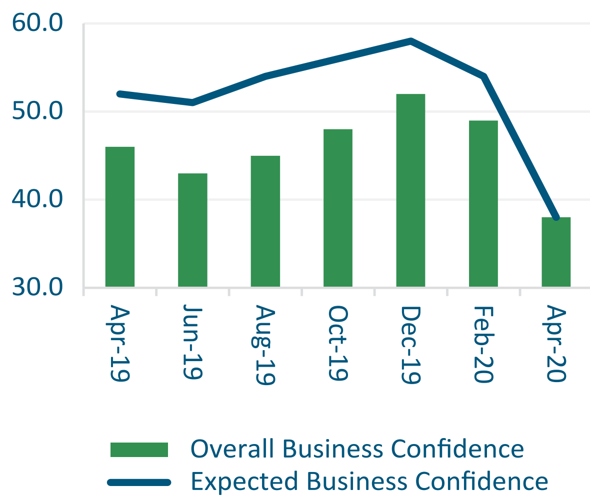
Against earlier fears of trade disruption, import flow has been rather smooth in Pakistan. Internal goods' transport is also allowed to move without restrictions, which should keep prices under control.

Covid Shatters Business Confidence

As highlighted in the April version of the Pakistan Market Update, the business confidence has come down crashing in the latest wave of the survey conducted by the central bank.

The business confidence index had very briefly touched 50, which signifies neutrality, before the pandemic hit Pakistan. Come April 2020, and all bets went off, as Pakistan was virtually at a standstill, with strict lockdown across the breadth and width of the country.

Business Confidence Jittery



Sources: State Bank of Pakistan

While the government has offered and already doled out a substantial portion of PKR 300 Bln in lieu of industrial support package, the expected business confidence refused to rise. This shows the industrial sector sees the pandemic having a lasting impact on the economy.

This is also the first instance in the history of business confidence survey, that the expected and current business confidence have both converged at one point. Historically, the expected business confidence has remained visibly higher than current confidence.

Negativity surrounding the expected business confidence should not come as a surprise, as these are unprecedented times, which have taken the confidence to historic lows.

Consumer Confidence Down

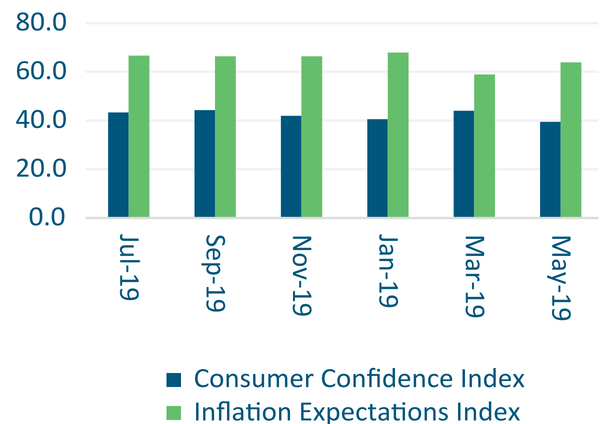
Consumers have historically held a comparatively more optimistic view of current and expected economic conditions than businesses. The central bank's consumer survey conducted in May 2020 shows the confidence is at an all-time low.

The previous wave of the consumer confidence survey had seen the index values surge, which came as a surprise, as Cvid-19 had hit Pakistan and it was approaching towards the lockdown.

The purchasing intentions have undergone massive changes, with food items taking precedence over all other items. The expected consumer confidence for the next six months has also dwindled, primarily at the back of higher inflation expectations.

This comes as a surprise, as inflation projections for the next six months have been significantly revised downwards, by central bank, multilateral agencies, and economic experts alike.

Consumers Lose Confidence



Source: State Bank of Pakistan

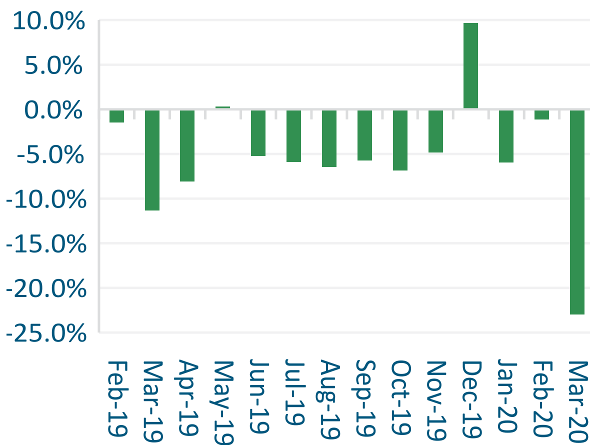
The fear of job losses seems to be weighing in the minds of consumers, which would invariably lead to reduced purchasing power. Over 70 percent survey respondents fear that unemployment is expected to rise. This seems closer to reality, as short-term job losses already run in millions.

Manufacturing Recession Deepens

Most productive numbers made all-time lows in April 2020 and Large-Scale Manufacturing (LSM) needed no second invitation to claim the top spot. The large-scale industrial production nosedived by 23% YoY in March 2020, with virtually all major industries reporting contraction.

And this massive decline came at the back of an already low base. Recall that Pakistan's LSM sector has now had seven consecutive quarters of negative growth, having entered recession way before any signs of Covid-19.

Large Scale Manufacuting (YoY Growth)



Source: Pakistan Bureau of Statistics

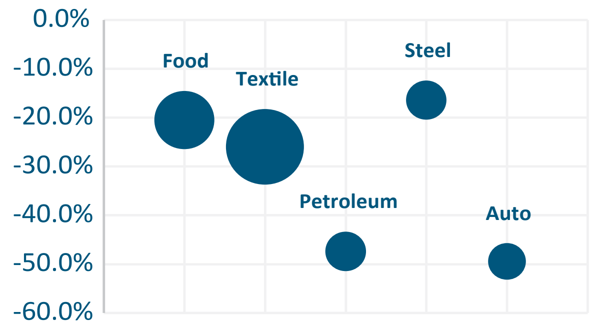
March LSM numbers are a telltale sign that the industrial drop would be worse than the one reported in the previous decade's recession.

The two biggest subsectors in terms of weight, textile, and food, have shown considerable production decline. This is first such instance for both food and textile in the last ten years.

Textile's drop is reflective of how badly the pandemic has hit Pakistan's largest exporting sector. It is worth mentioning that LSM only measures the first step of the textile value chain, such as raw cotton and cloth. Actual production decline in textile could well be far greater than the one reported in LSM, which has reflected well in latest textile export numbers.

Lower interest rates, sizeable industrial support package, reduced duties, subsidized energy tariffs are steps that the government has taken since Covid-19. April LSM numbers are yet to be released, but channel checks suggest these relief measures have not revived industrial activity.

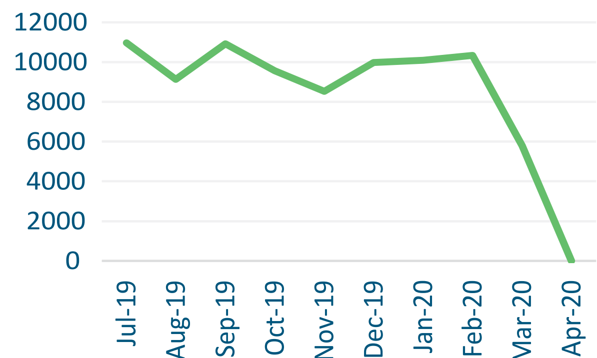
Manufacuting Tanks to New Lows



Source: Pakistan Bureau of Statistics

Expectedly, the automobile sector has come under immense pressure. The automobile demand had been dwindling well before the pandemic, owing to variety of reasons, such as skyrocketing prices and higher interest rates. The 50% YoY production decline in auto is all set to worsen in April, as automobile companies reported zero car sales in April – which is a first.

Car Sales Down to "Zero"



Source: Pakistan Auto Manufacturers Association

Petroleum refineries are all set to record the worst ever quarter, having witnessed the production slide to half in March 2020.

Pakistan had stopped imports of crude oil in April, due to sluggish demand and furnace oil requirement for power generation also came to a standstill, which led refineries to significantly cutback the operations.

We believe, the petroleum sector production would revive faster than automobiles and textile, as the economy opens, and more vehicles are out on the road.

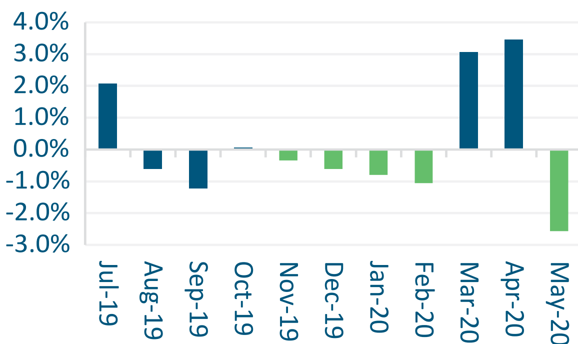
The bureau of statistics has revised manufacturing numbers for FY19, which may bring some respite to the growth figures, but production in absolute terms remain abysmal. We expect a swift revival in food, beverages, pharmaceutical and cement sectors, given the inherent strength and essential nature of the local demand falling in these categories.

Rupee Stays Firm

The rupee showed immense resilience versus the greenback for much of May 2020, taking back much of the lost ground in April 2020. Having touched 170 in the intraday trading in April, the rupee briefly went under 160 in May 2020, showing signs of inherent strength.

The central bank's new leadership has brought about a policy shift in foreign exchange management. The currency now moves on a market-based mechanism, with limited to no central bank intervention. The central bank has only intervened in times of dire needs, to send the right signals, in case of unwarranted panic.

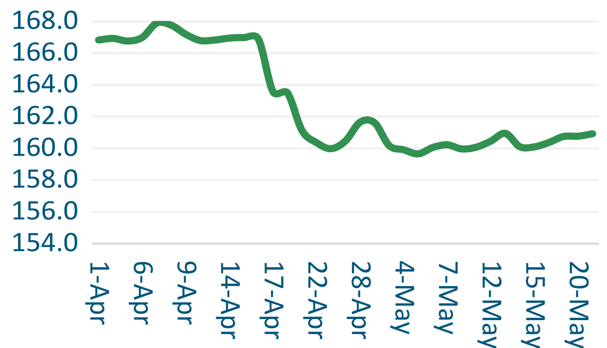
Rupee vs USD (MoM Growth)



Source: State Bank of Pakistan

Despite the dollar outflow from the debt market, lower export earnings, and expected drop in home remittances, the rupee showed remarkable resilience. The confidence seems to have stemmed from the IMF's support and the government's claims of having sufficient capacity to meet external debt obligations, brushing aside the rumors of sovereign default.

Rupee Shows Resilience



Source: State Bank of Pakistan

The likely support from the World Bank, ADB, and G20 countries should further strengthen the rupee against the dollar. Downside risk remains potent, should the export slide continue longer than expected, and remittances fail to show the resilience demonstrated last month.

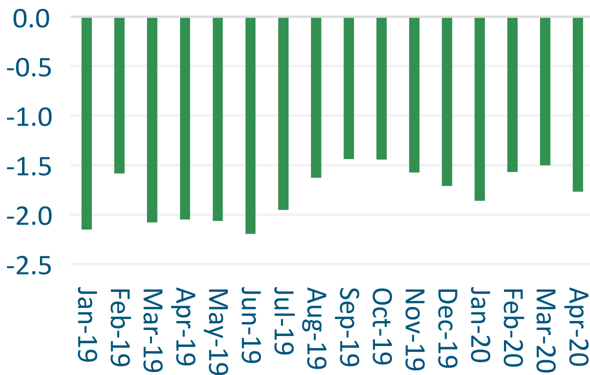
Current Account Turnaround

Covid may not have exactly created a balance of payment crisis, just yet, as against earlier expectations. But the current account deficit is worsening, after having significantly improved in the lead up to Covid.

April showed the current account in deficit of over half a billion dollars, highest in ten months. In perspective of the ongoing situation, current account has still held on well, primarily owing to resilience shown by home remittances.

Imports did come down 33% year-on-year in April, but the slide somewhat arrested in comparison to exports. Pakistan's imports had contracted sharply in the 12 months prior to Covid, leaving little room for further decline.

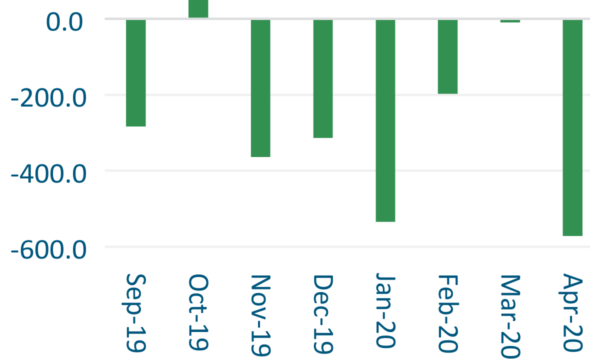
Trade Deficit (USD in Bln)



Source: Pakistan Bureau of Statistics

Massive respite also came on account of significantly reduced oil price and volumetric crude oil imports. Oil imports are back in the equation, as demand surges. Food import has also remained sticky, which could keep pressure on trade balance, despite lower expected imports in machinery and automobile segments.

Covid Hits Current Account (USD in Bln)



Source: State Bank of Pakistan

Covid Takes Exports Down

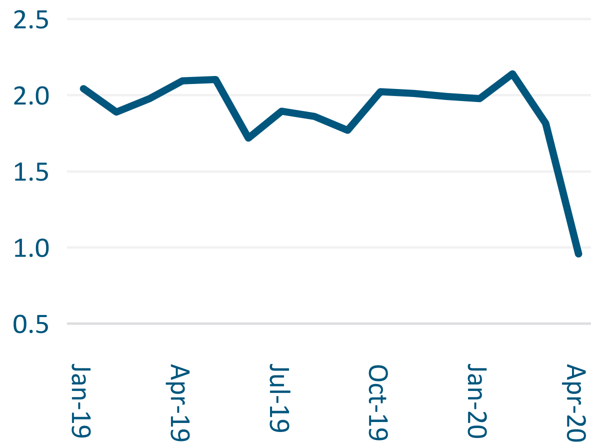
There were ample early signs of the havoc Covid was going to play on Pakistan's exports, back in March, as textile's export went down by 20% month-on-month. What followed in April was nothing short of nightmarish, but largely expected, as monthly exports halved over previous year. Monthly exports were recorded at under less than a billion dollar for the first time in 15 years.

Textile is the lifeline of Pakistan's export, and it faltered as half the world shut down due to Covid. Textile industry had warned of a steep decline as orders were being cancelled and new ordered were non-existent in March.

The textile exports went down by 65% year-on-year in April and the numbers for May could be worse, as most of Pakistan's export destinations have been slow in reopening the economies.

Even with reopened economies, the purchasing patterns may change significantly, and Pakistan's low value-added textile exports, which are heavily reliant on the health of hospitality industry, may take longer to resurrect.

Decade Low Monthly Exports (USD in Bln)



Source: Pakistan Bureau of Statistics

Big textile players were at various stages of capacity expansion when Covid hit. Pakistan's textile exports can make a rebound, particularly in the apparel segment, as Pakistan has reopened faster than most other textile competitors.

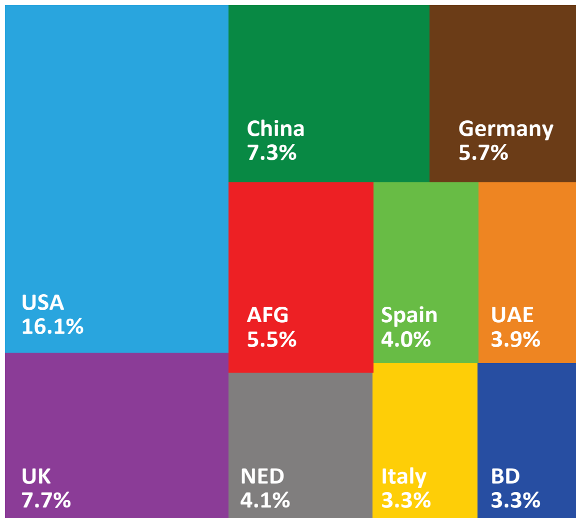
That said, going back to pre-Covid textile exports anytime soon, seems unrealistic, given the export composition, tilted towards low value-added hotel industry demand.

Food exports have remained rather sticky, with the share in exports soaring from traditional 20% to over 35%. Rice exports continue to be the saving grace and exporters have signaled strong demand to continue despite the pandemic.

Remittances Solid but Risks Ahead

Pakistan's saving grace has often been the workers' remittances in tough times. With exports down drastically, the onus of keeping the current account afloat rests once again with the workers' remittances.

Paksitan's Top Export Destinations



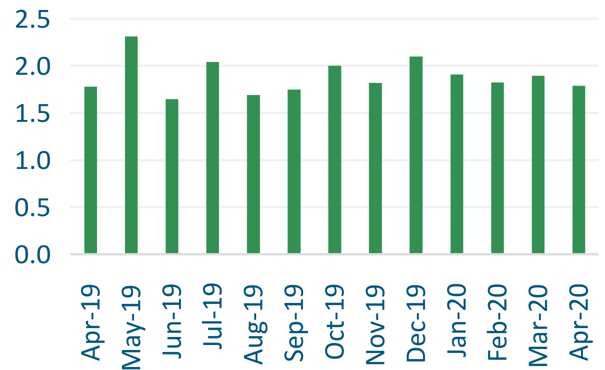
Source: Pakistan Bureau of Statistics

Contrary to fears, remittances in April held on, slipping only 6% month-on-month, and gaining a solitary 1% year-on-year. The remittance story is not as straightforward, as job losses in the Middle East for the low-skilled Pakistani labor have been plenty.

At the same time, Pakistan's labor export to the Middle East has gone up by a third in the last three years. There is an element of seasonality with home remittances, as the month of Ramadan and Eid festivals necessitate higher spending requirement.

With flight operations gathering pace, more Pakistanis are coming back home. The nature of job losses could be permanent specially in low to medium skilled jobs. The impact is inevitable and could be felt soon after Eid.

Home Remittances Hold On (USD in Bln)



Source: State Bank of Pakistan

Remittances also face the same dilemma that the exports face, in terms of geography. While Pakistan's exports are aimed at the worst hit Covid countries, more than 50% remittances originate from the Middle East, which faces a double whammy of global economic slowdown and low oil prices.

The World Bank has projected workers' remittance in South Asia to drop by 22% in 2020. Neighboring India and Bangladesh have already showed signs, registering double-digit drop-in April remittances. Pakistan is soon expected to follow the pattern after Eid.

Balance of Payment (% of GDP)

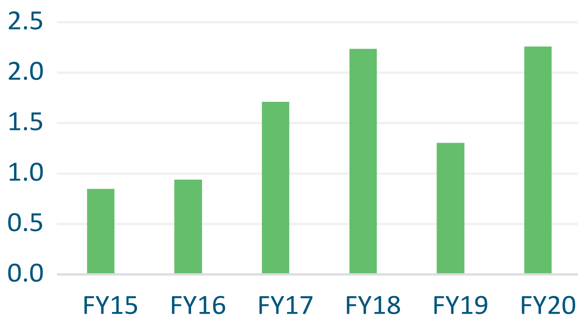
Source: State Bank of Pakistan

At a time when exports are likely to remain under massive pressure, any loss in remittance growth is going to hit the balance of payment hard. Remittances and exports combined, have historically equaled the country's imports. Imports are not expected to go down as sharply, and a much-worsened current account seems just around the corner.

FDI Holds On

Foreign Direct Investment (FDI) in 10MFY20 has been recorded at the highest in seven years. Foreign investment is up by 70% year-on-year at USD 2.2 Bln. The growth is built on an extremely low base, and the dollar value does not instill much confidence, as it does not even account for average one-month imports.

One-offs Keep FDI Strong (USD in Bln) *10M data



Source: IMF Country Report

The FDI composition has shifted in FY20, from all power to nearly all telecom. China had been the major investor, accounting for two-thirds of all FDIs for much of FY15-FY19, on account of China Pakistan Economic Corridor energy projects.

Most of those projects are either online or have achieved financial close, and now Pakistan relies on one-off events to keep the FDIs coming.

Telecom license renewal was due this year, which makes the FDI numbers look decent. But the central bank, IMF and the World Bank have all voiced concerns over the FDI inflows' future, as post-Covid investments are slated to decline in emerging countries, which carry significantly higher risk exposure, in uncertain times.

Pakistan Seeks Debt Servicing Relief

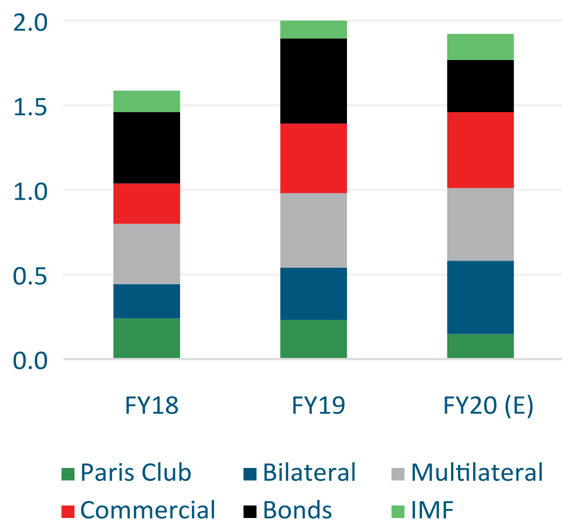
Pakistan's public debt to GDP has worsened from 68% in Q1FY19 to 80% by the Q3FY20. Pakistan was among the first major debt-ridden countries to ask for debt relief for poor countries in the aftermath of Covid-19.

Pakistan's external debt profile of over USD 70 Bln is dominated by multilateral agencies, followed by bilateral and Paris Club loans, respectively. The moment Pakistan formally requested for immediate debt relief, it sent mostly negative signals to rating agencies.

Pakistan's plea for debt servicing relief contributed to the credit rating being put for downgrade review from stable. The Government of Pakistan has since communicated better in ruling out any negotiations or relief on commercial loans, putting enough faith on the existing capacity to repay obligations.

Should Pakistan be granted waiver for a year, it could be in the range of USD 2-2.5 Bln, which is also the amount, Pakistan has reportedly sought. Recall that Pakistan is already under a long-term IMF program, which is currently suspended on account of Covid.

Exteranl Debt Interest Servicing (USD in Bln)

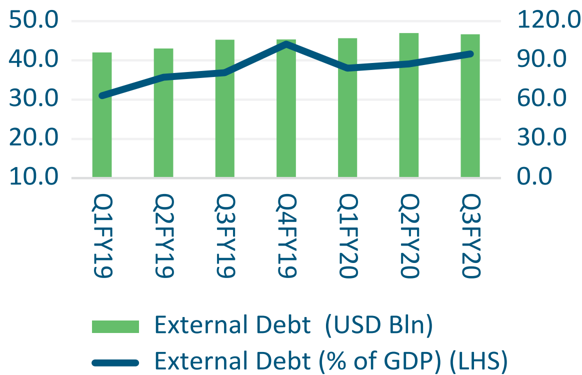


Source: State Bank of Pakistan

Pakistan's capacity to repay could well be tested as export and remittance dollars are increasingly becoming hard to come by. Pakistan has also utilized the IMF's emergency facility to combat external financing pressures.

While Pakistan has categorically denied seeking any relief in commercial loans, Pakistan could well leverage its historically friendly connections with major creditors China and Saudi Arabia, to arrange for further relief in the bilateral category, which is a sizeable chunk of overall external debt.

Pakistan's External Debt & Liabilities



Source: State Bank of Pakistan

Pakistan's dollar pipeline may appear sufficient to sail in the near-term, but if the dollar inflow spell remains dry for a little longer, Pakistan will be considering alternate strategies to meet international debt obligations.

The fact that local currency has so far stayed resilient in the last month, tells Pakistan's repayment capacity does not read crisis, just yet. The IMF also has enough confidence in Pakistan's ability to repay, terming it "adequate" and the debt "sustainable."

IMF Program Takes Backseat

Pakistan wasted no time in approaching the IMF for emergency support. The IMF responded swiftly with approving and later disbursing USD 1.39 Bln Rapid Financing Instrument (RFI) to address the pandemic in April.

Uncertainty surrounded the fate of Pakistan's long-term USD 6 Bln Extended Finance Facility (EFF) as Pakistan received the RFI amount. The IMF has since cleared the air and maintains that the EFF remains in effect.

That said, the discussions on the EFF have been on hold since March 2020 and are unlikely to resume anytime soon. Even before the RFI and Covid, Pakistan had deviated from the IMF program conditionalities, requesting waivers on energy pricing among other things.

With the federal budget due early June 2020, Pakistan is likely to take liberty of making its own budget, without much IMF input. This is a rare occurrence for Pakistan during an IMF program. The IMF has encouraged social and development spending, but Pakistan is likely to but the development spending on the backburner come budget and focus solely on social security of the vulnerable.

Similarly, the structural reforms could take a backseat as the pandemic shows no signs of having peaked in Pakistan. The government, in all likelihood, will delay all tariff adjustments, privatization plans, and other bold measures related to price rationalization.

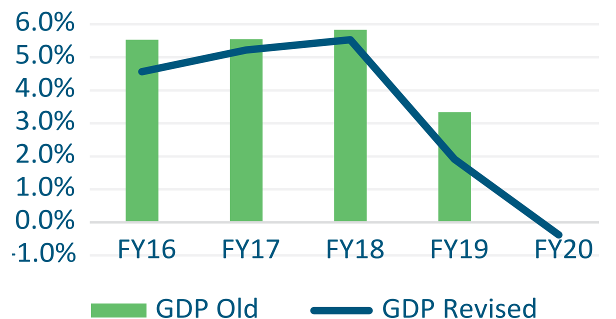
It may be too premature at this juncture, but an early exit from the EFF cannot entirely be ruled out in the post Covid scenario, We believe, Pakistan will be desperately looking for more fiscal room to maneuver, which is easier without an IMF program.

GDP Surprise

The central bank, World Bank and the IMF had all significantly lowered Pakistan's GDP projections for FY20, as Covid spread across Pakistan. The IMF led the way with forecasting negative 1.5% GDP growth – which was widely hailed a realistic estimate.

Then came the GDP provisional numbers for FY20, which took everyone by surprise. Pakistan's GDP for FY20 has been estimated at negative 0.38% - a whole 1.1 percentage point better than IMF forecast in April.

GDP Contracts



Source: Pakistan Bureau of Statistics

But the devil lies in details, as the GDP growth misleads due to massive revision in FY19 growth figures – down from 3.3% to 1.9%, significantly lowering the base.

Had the GDP not been revised, the growth would have been closer to the IMF projection at negative 1.7%. The nominal GDP provisional estimate at USD 265 Bln, are much in line with the IMF's forecast of USD 275 Bln.

Revisions aren't new, but FY19's is on the bigger side, mainly due to unexpectedly worse Q4FY19. The authorities claim to have incorporated the Covid fallout in provisional GDP estimates, having accounted for the impact of business closure due to the lockdown.

We believe, the authorities may well have underestimated the impact, especially on manufacturing sector. The lockdown has been almost entirely lifted, but industries are still struggling for demand.

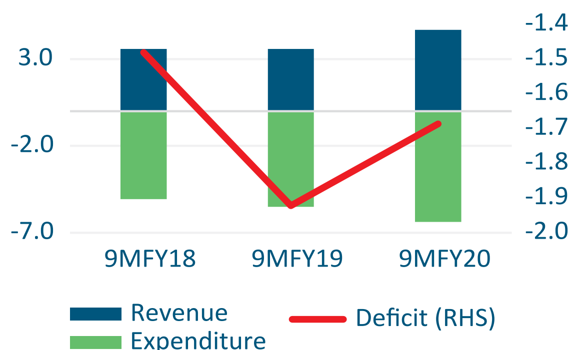
Agriculture output may also be subject to further downward revision, as livestock, the biggest GDP contributor, has anecdotally witnessed significant downside, because of Covid.

Fiscal Slippages Grow

Pakistan recorded the highest ever fiscal deficit of 8.9% in FY19 and was well on its way to register a sharp decline in FY20. The fiscal deficit stood at a manageable 3.8% during 9MFY20. And then Covid hit the country.

The tax collection for April 2020 reported by the central tax agency, Federal Board of Revenue (FBR) was down 14% year-on-year. April was the first month of complete lockdown, and the collection is much better than earlier anticipated. That said, much of the drop in consumption-based GST may be recorded later, as retail purchase went down.

Fiscal Concerns Rise (PKR in Trn)

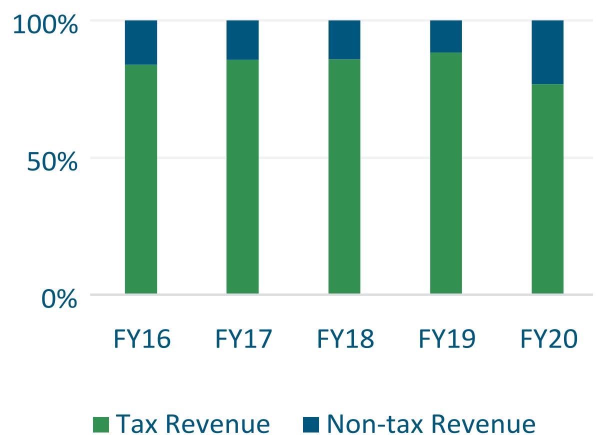


Source: Federal Board of Revenue

Pakistan has already revised the tax collection target down twice, from PKR 5,555 Bln to PKR 3,950 Bln. The government may still collect advance tax on corporate income in the last month of the fiscal, to butter the tax collection at the far end. But much reduced economic activity would also lead to reduced corporate income, which may reflect in Q4 numbers.

A bigger slippage is expected on the expenditure front, as 75% of the PKR 1.2 trillion fiscal stimulus package is out of budget. Some respite is expected on account of domestic debt servicing after interest rate decline, but Covid relief efforts are sure to inflate current expenditure in Q4, and the fiscal deficit is expected to soar to double digits at the end of FY20.

Non-Tax Share Goes Up (All numbers are 9M)



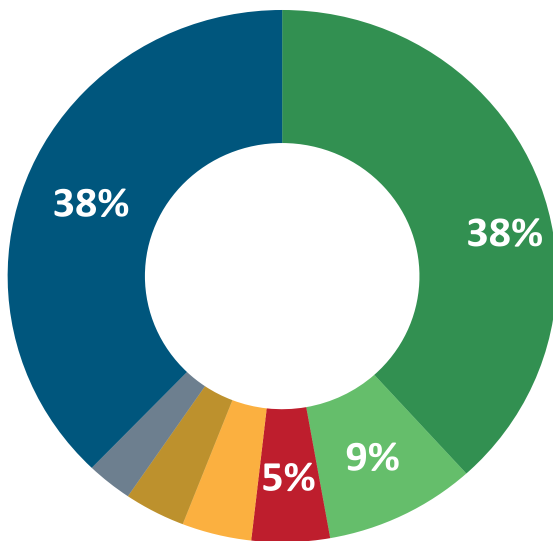
Source: Federal Board of Revenue

In FY20 so far, non-tax collection has made a quarter of total revenues, mostly based on one-off license fee and dividend income from central bank. Going forward, non-tax avenue is expected to dry faster, and revert to historical average of 10% of total revenues.

Import stage tax collection has also taken a setback, as imports have gone down by a third in FY20 to date. Import stage GST has historically accounted for 60% of total GST, and reduced furnace oil and petroleum demand is going to have a big impact on import stage collection.

Similarly, significantly reduced domestic demand and prices of petroleum products are going to have a toll on domestic GST collection. Substantial relief has also been offered on electricity prices, and power demand has also gone down by 25% year-on-year, in April and May, which will lead to lower GST collection.

Domestic GST Composition



Source: Federal Board of Revenue

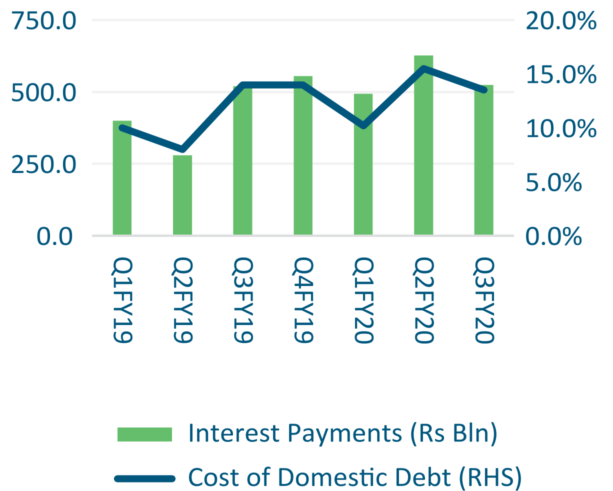
The government has made an effort to not entirely pass on the benefit of oil price reduction to consumers. The indirect tax in the form of Petroleum Levy (PL) has been stretched to the maximum limit, for the last quarter. The PL revenues have already surpassed the budgeted amount of PKR 230 Bln. But the fall in GST revenues would still be higher than the gain on account of PL.

The upcoming budget may well be a relief budget, should the economy continue to struggle. . There are proposals hinting at more taxation relief on account of salary income tax, to the middle class which is not eligible for direct cash support.

We believe the upcoming budget could indeed offer tax relief to consumers, both in form of direct and indirect taxes.

Pakistan has little to no room in terms of curtailing expenditure, as debt servicing provincial share takes away a large chunk. There could be a massive cut in development spending, to limit the fiscal deficit in a slowing down economy for FY21.

Domestic debt servicing



Source: Pakistan Bureau of Statistics

Amid all the mayhem, the interest rate reduction has offered a much-needed breather to the otherwise tight fiscal space. The rate cut could save up to PKR 300-400 Bln in 4Q alone, on account of domestic debt servicing. On an annualized basis, the saving could be to the tune of PKR 1200-1300 Bln, after adjusting for the loss on central bank's dividend income.

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DEBT MARKET UPDATE

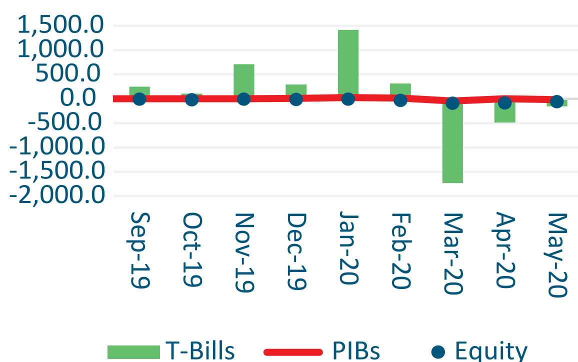
Pakistan's debt market investment is likely to be a zero-sum game by the end of the fiscal year. With a month to go, Foreign Portfolio Inflows (FPI) sat at USD 0.3 Bln, having earlier reached USD 2 Bln in January 2020.

The debt market inflow at the start of 2020 was widely hailed by the IMF and other donors, as it played a role in strengthening the reserves, and at the same time, helped build Pakistan's image among the international investors. Pakistan had not attracted any sizeable FPI in the past decade.

Covid-19 has led to a global selling trend, which is more pronounced in the emerging markets. The selling peaked in March despite Pakistan offering the most lucrative rates. The interest rates have been slashed by a massive 525 basis points in less than two months, reducing the returns proportionally.

Pakistan's rates are still among the best in emerging markets, but the Covid-19 has led to greater risk for countries like Pakistan, and international rating agencies have also either downgraded or placed Pakistan's rating on consideration for downgrade.

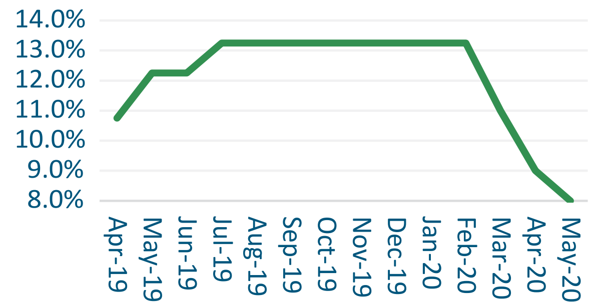
Hot Money Outflow Slows (USD in Mln)



Source: State Bank of Pakistan

Pakistan's rate cut has been the most aggressive in the region, further reducing the interest rate differential. The equity market flows have not been anything to write home about, and with weaker fundamentals and higher market risks, we believe, fresh FPI flows in the debt and equity markets alike, are unlikely to come by.

Interst Rates Slashed

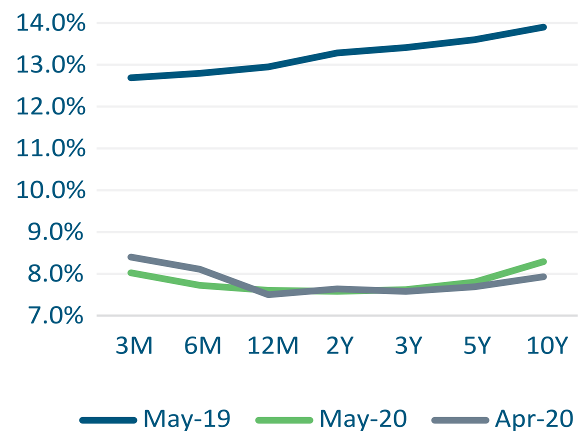


Source: State Bank of Pakistan

The monetary easing continued in May, as the State Bank of Pakistan slashed the discount rate by another 100 basis points, bringing it down to 8%, from the high of 13.25% in March 2020.

The central bank has briefly held a positive real interest rate, departing from its earlier stated policy of 2-3 percentage point positive interest rates. Inflation projections have been revised downwards in the wake of lower commodity prices and reduced demand.

Yield Curve



Source: State Bank of Pakistan

The yield curve naturally looks completely different from last year. The government's debt office has laid out the plan to gradually build a long-term yield curve, the seeds of which have been sown in, as the government in the latest auctions rounds, has rejected massive bids in the shorter-term papers, above the cut-off yields.

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EQUITY MARKET UPDATE

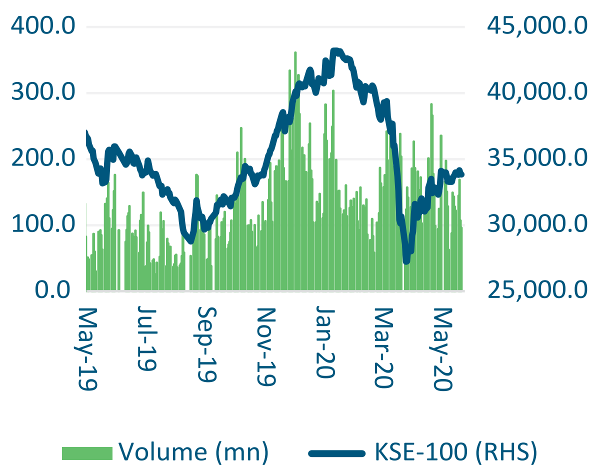
The Pakistan Stock Exchange (PSX) witnessed a month of expected dull activity. The month of Ramadan is historically known for low trading volumes at the PSX, and May 2020 was no different, with KSE-100 benchmark index trading volumes down by 30% month-on-month.

The economy sent mixed signals throughout the month, and the overall sentiment was largely neutral, as the index stayed range bound for much of the month.

The considerable ease in lockdown was countered by ever rising spread of the virus across the country. The good news on the inflation front had a GDP contraction figure to counter. The relative stability in the currency was overshadowed by a drastic fall in exports.

The stock market was nowhere near the panic stage it witnessed in March 2020. Foreign selling pressure has largely eased, as bulk of the buying has been done by local mutual funds and banks, of late, limiting chances of panic selling.

Stocks Market Consolidates



Source: Pakistan Stock Exchange

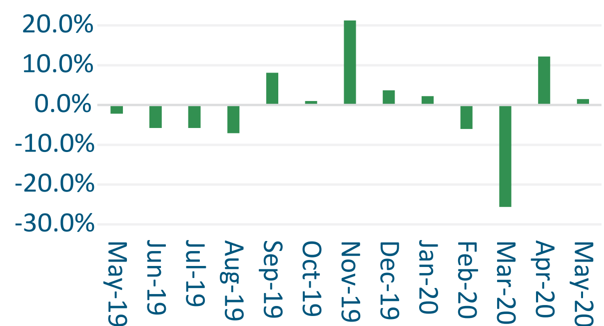
The sell-side analyst community continues to sound bullish on KSE-100, citing cheap multiples as the key reason. The price-earnings multiple on forward basis, is hovering around 5.5x, as per consensus estimates.

The low multiples have been made the base case for the bottoming out of the benchmark index.

But earnings multiples alone, in times of high uncertainty would not cut the deal. We believe, the optimism carries the natural sell-side bullish bias, as the benchmark index failed to respond positively to massive interest rate cuts, IMF support, currency stability and other seemingly positive news.

The rebound from the lows of March 2020 were largely on the cards. But, finding momentum from this point on, will require nothing short of major triggers, of which a degree of certainty around Covid-19's future tops the list.

KSE-100 (monthly returns)



Source: Pakistan Stock Exchange

The KSE-100 index is dominated by banking sector stocks. The massive slide in interest rates and a sizeable drop in appetite for fresh loans, are going to hit banks' profitability going forward. Banking spreads have been squeezed of late, and banks face an ever-rising threat of rising NPLs, due to disruption in economic activity.

We believe the stock market will continue to be range-bound in the near-term, as the federal budget is around the corner. A lot will depend on how the situation around Covid-19 pans out, and the likely steps in the deferral budget. The stock market has historically remained jittery close to the budget. The budget could well be a dampener for the stock market, as the focus may well be on public welfare, rather than the corporate sector.

STRATLINK ADVISORY GROUP - WHO WE ARE

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Where we are based

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