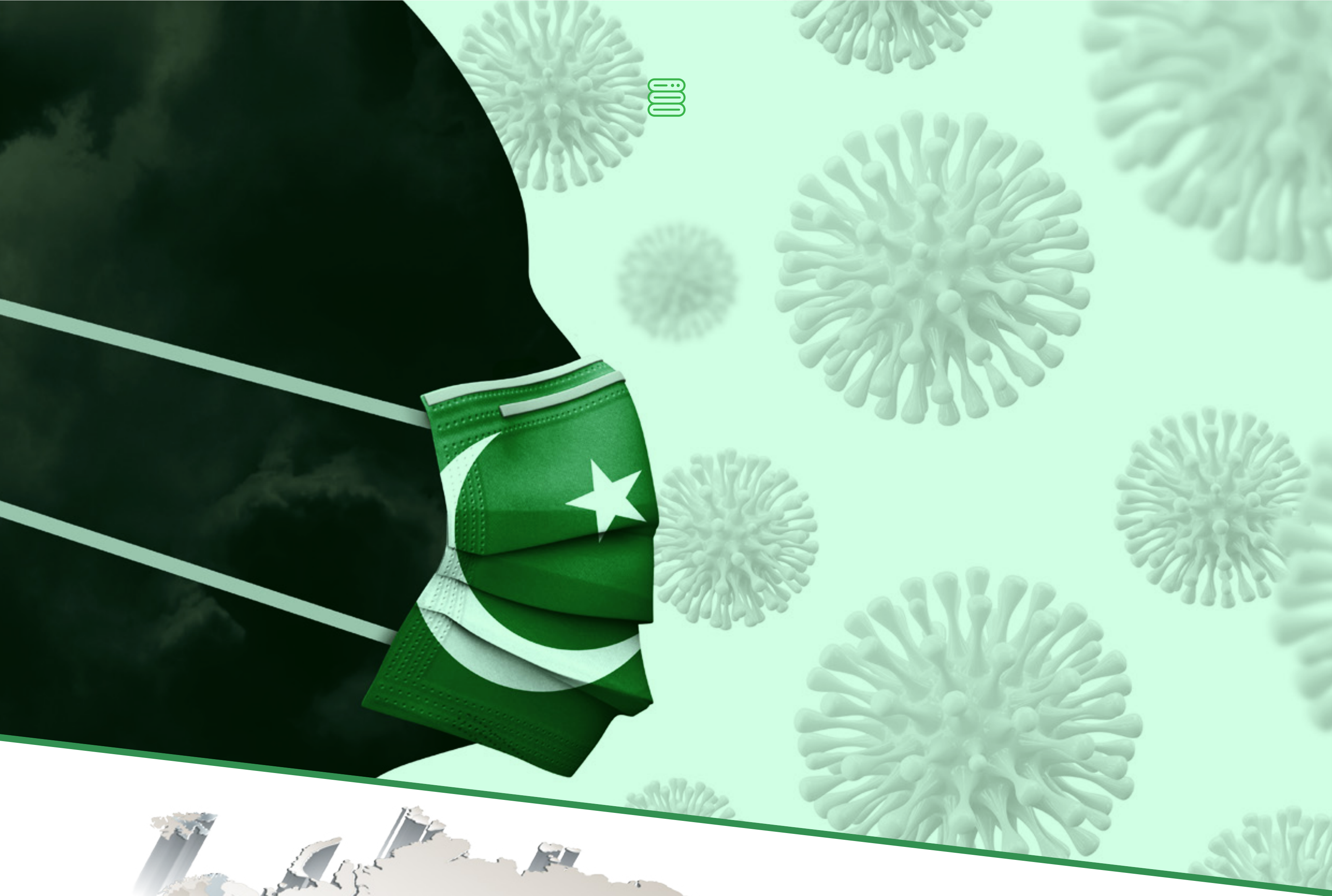
MARKET UPDATE – PAKISTAN

DECEMBER 2020



PAKISTAN MARKET UPDATE

| Macros Improve but Covid-19 Lingers

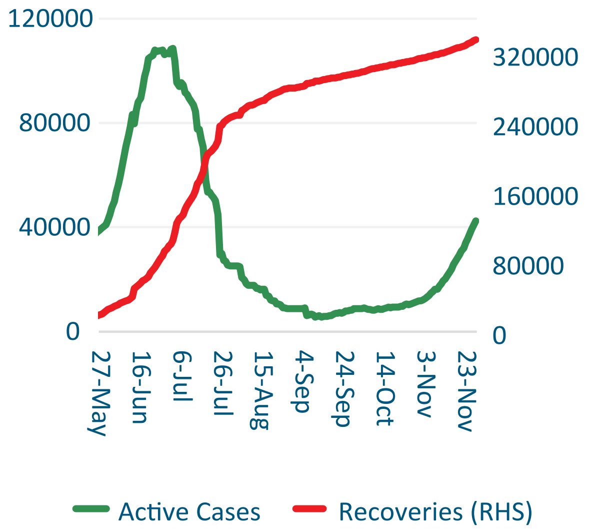
COVID-19 Watch

(These numbers are as of November 29, 2020 and are subject to change)

Second Wave Reignites Fears

From being primed out as an example of successful Covid strategy and flattening to the curve to resurgence of the virus, Pakistan has come full circle in four months. Having kept the positivity rate under 2% for most part of three months, it is back to 7% and rising.

Active Cases Rise Again



Source: Government of Pakistan

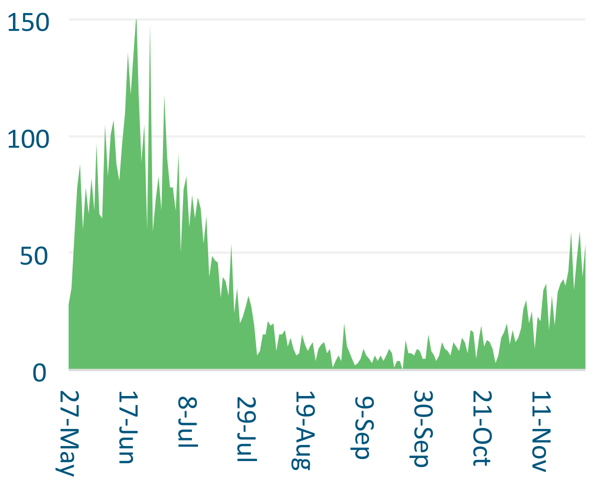
Recall that Pakistan had lifted the countrywide lockdown in less than a month and adopted a smart lockdown strategy. The case to fatality rate was also significantly lower, and the country's not-so-strong healthcare infrastructure managed the first peak without being overburdened.

The share of positive cases to daily tests has been on a gradual rise in the last six weeks, and both the cases and positivity rates have entered the highest range since July. This is particularly shocking, as observers had pinned hopes on chances of herd immunity, as earlier scientific studies had signaled chances of herd immunity.

The rise in positivity rate has coincided with the drop in temperatures and a considerable rise in mass gathering, as both the wedding season and political rallies were at their respective peaks from late October till mid-November.

There have been at least a dozen super-spreader events in the last four weeks, attended by tens of thousands, across the country.

Deaths Rise

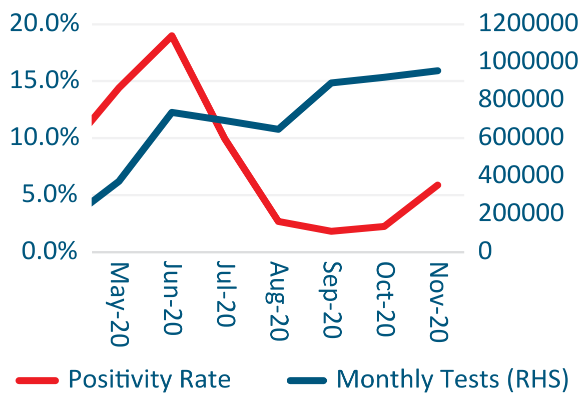


Source: Government of Pakistan

The government has ruled out a nationwide lockdown, as the fiscal space is not there to combat economic consequences of halted activity. That said, targeted measures have been taken, with the educational institutions closed for40 days all over the country.

What could be worrying is the death rate, which has doubled from the previous peaks a percentage of active cases. The healthcare system has been beefed up in the first peak, and should be able to hold on in case the second peak is anywhere as bad as the first one, but more lives are feared to be lost in winters.

The Second Wave



Source: Government of Pakistan

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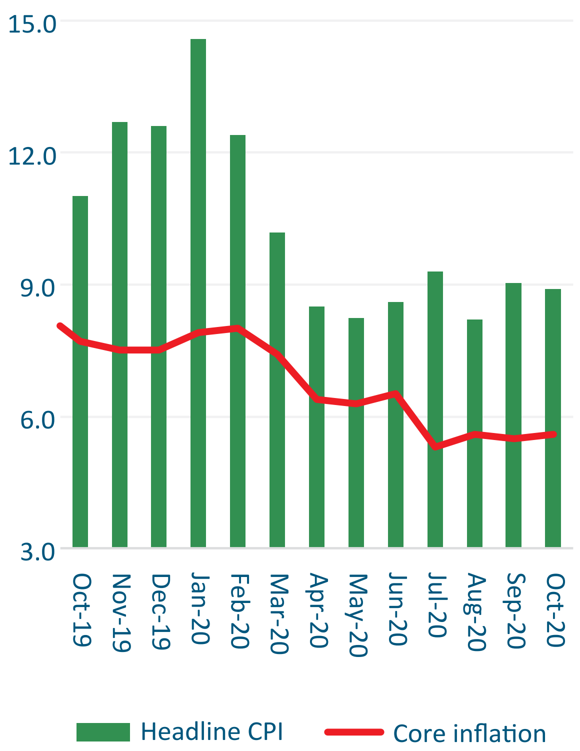
ECONOMIC OUTLOOK

Food Prices Keep Inflation Up

Food prices have continued to maintain the upward trend fourth month into FY21 and have shown no signs of abating. The inflation target of 7% aimed at the start of the fiscal year is becoming increasingly distant with every passing month.

The benchmark headline CPI inflation has so far averaged 8.9% during the first four months of FY21, inching up from 12-month moving average of 7.7%. All signs point towards high food inflation, which disproportionately affects the rural and lower income class segment.

Inflation stays Up



Source: Pakistan Bureau of Statistics

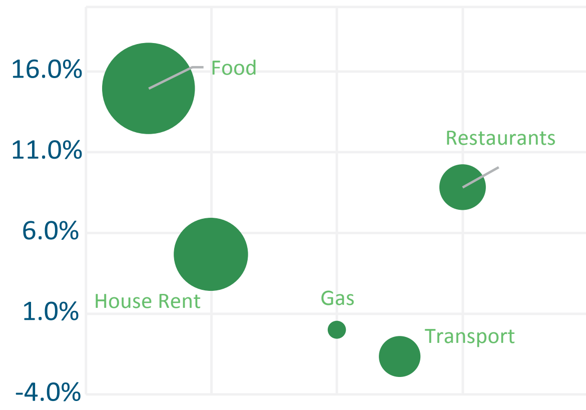
The headline inflation so far has been primarily driven by supply side pressures, as the real wages took a sever hit to cause any demand side and cost push inflationary pressures anytime soon.

But all this may well change soon as the economic recovery picks up pace, and imports are getting higher, which could put more pressure on core inflation. Core inflation has so far stayed subdued having followed a flat trend since the beginning of FY21.

A big reason why non-food non-energy core inflation has stayed well under control is the persistently lower international crude oil prices.

Not only has this kept the transport sub-index under control, but it has also led to a trickledown effect to supply chain, in keeping the non-food prices stable. On the wholesale level, diesel prices play a key role, and the impact is evident from minimal movement in non-food wholesale prices, as depicted in a largely flat Wholesale Price Index (WPI).

Urban CPI break-up



Source: Pakistan Bureau of Statistics

Food basket has by far the largest contribution in the consumption basket, and more pronounced in the rural basket with a little over 40% weight. For most part of 2020, perishable food prices kept the authorities on toes, but subsequent supply chain disruptions, ill-advised policy actions leading to supply crunch, and ineffective administrative control leading to profiteering by middlemen have led to an irreversible increase in non-perishable food prices.

The increase has bene felt across the board, with key staple items such as wheat, rice, sugar, and cooking oil facing the brunt.

Recall that Pakistan grows most of its food crops domestically, but a crop season hit hard by heavy rains and locust attack resulted in less multiyear low food crops. This coupled with allowance of exports, without effective procurement ensured the prices in the local market went skyrocketing.

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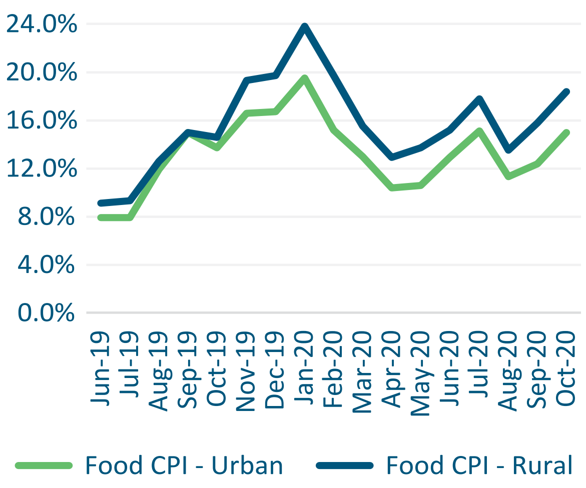
What has so far also kept the core inflation in check is the government's unwillingness to revise the electricity tariffs, despite the IMG pressure. The government has so far resisted the IMF recommendations, to jack up the tariffs by 15-20%, and that seems unlikely in the near future.

Low oil prices have also helped the government maximize the tax incidence on petroleum products, without having to increase the retail prices. Oil prices remain critical to the core inflation trend going forward.

Rural Food Inflation Rises



Source: Pakistan Bureau of Statistics

All in all, for the government to keep inflation within the target of 6.5-7% now looks increasingly unlikely. Higher imports, a potential increase in global crude oil prices, both pose great upside risks to the inflation outlook.

Manufacturing Rises

Pakistan was officially in manufacturing recession long before the pandemic hit. The Large-Scale Manufacturing saw an unprecedented eight consecutive quarter of negative growth, which only reversed in Q1FY21.

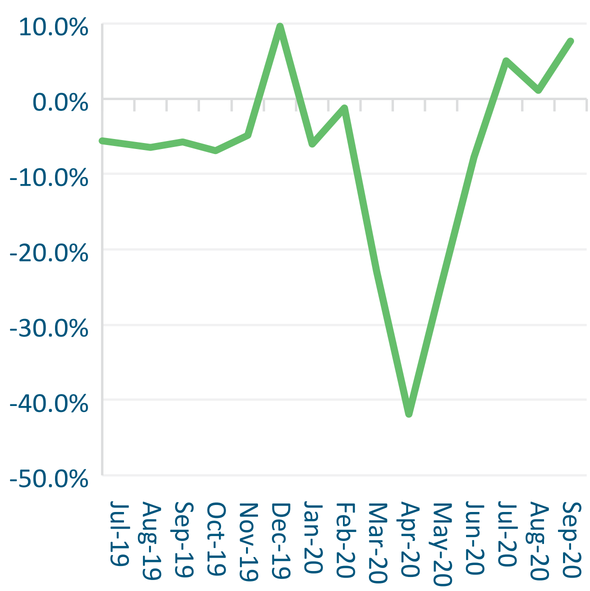
After slight recovery in the previous quarter, Q2 fY21 started on a positive note, with the LSM registering a healthy 8% growth. The high LSM growth is due to a confluence of factors, ranging from the low base effect of last year to early opening of the economy.

Recall that Pakistan was among the first few countries in the region that decided to open the industries in the pandemic aftermath. The move received criticism at that point, but it sure has contributed significantly to a very swift recovery in leading industrial sectors, at a time when major regional competitors are struggling with double digit negative growth, for two consecutive quarters now.

The economic recovery has also been fast tracked due to timely actions by both the government and the central bank. The central bank stepped in to slash the interest rates by cutting them to half in less than three months, which kept the momentum going, even in tough times.

The government then chipped in with a relief package in excess of USD 1.5 Bln, of which a sizeable part was kept for industries. The financing arrangements were rescheduled, and utility payments were deferred, which kept several industries running.

Large Scale Manufacuting (YoY Growth)

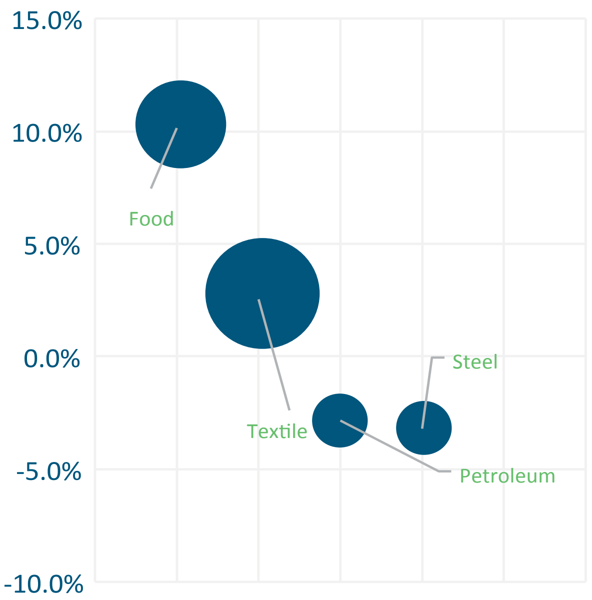


Source: Pakistan Bureau of Statistics

The early opening up ensured the demand was back to almost normal, and there was another opportunity to capture the export market which was open for grabs as other competitors struggled to decide on opening the industries.

The cumulative Q1 FY21 LSM growth stood at 4.81%, which is the first period of positive quarterly growth in over two years. The growth has picked momentum in key contributing sectors, buoyed by low interest rates and faster than expected economic Covid-19 recovery.

LSM breakdown



Sources: Pakistan Bureau of Statistics

High growth numbers still need to be looked at with the caveat that Pakistan's LSM dipped to a historical low of 7.8%. Even the slightest of improvement from multiyear low thus needs to be viewed in context.

The domestic demand has resumed rather swiftly, evident from the surge in food, textile, and beverages sectors.

The growth in textile is rooted in the early opening of the economy and the resultant increase in export demand. The textile sector has grabbed the opportunity with both hands in capturing the competitors' market share leading to production of higher end garments.

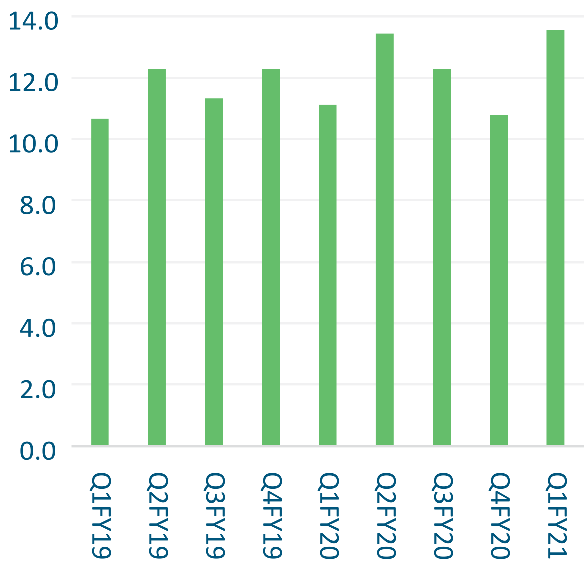
Another area which has witnessed mushroom growth is the construction and allied industries.

The central bank has mandated the banks to lend at least 5% of the loan portfolio to housing and construction related activities.

The mortgage is being offered at concessional rates, increasing demand for houses.

The government aims to construct 5 million houses in the next 5 years. We believe, even achieving 25% of the target will tremendously transform the LSM growth in glass, cement, steel, paint, and allied industries.

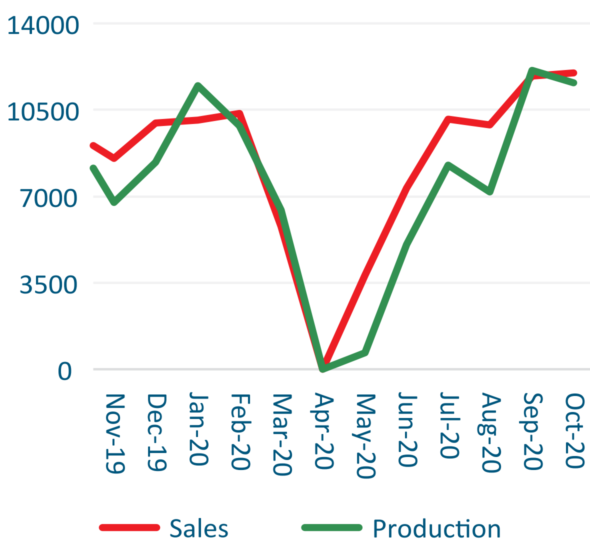
Cement Sales (Mln tons)



Source: Pakistan Bureau of Statistics

The immediate impact of substantially lower interest rates is also showing on the resurgence in automobile sales, which have surpassed the pre-Covid levels.

Passenger Cars' Strong Comeback

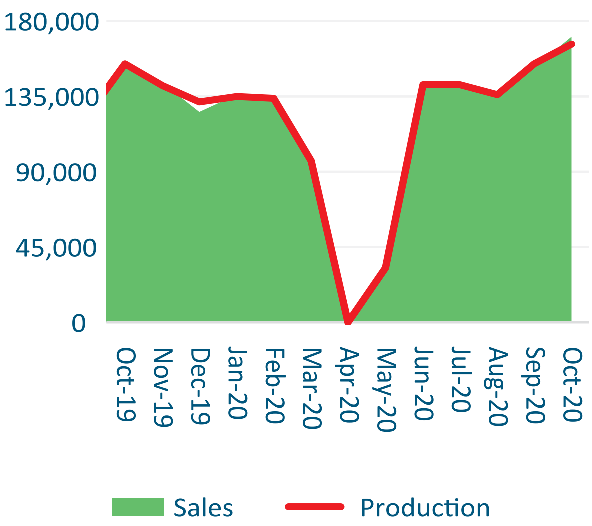


Source: Pakistan Auto Manufacturers Association

Having descended to virtually zero sales and production, the resurgence is remarkable, as newer entrants have also hit the market, sowing optimism in the indigenous nature of the demand.

While all the crops may not have done exceptionally well in terms of achieving the production target, the cost of farm production has been largely under control. Good farm economy has had strong correlation with four-wheeler sales, and the sales pattern confirm the continuation of the trend.

Two-Wheelers Make Strong Comeb



Source: Pakistan Auto Manufacturers Association

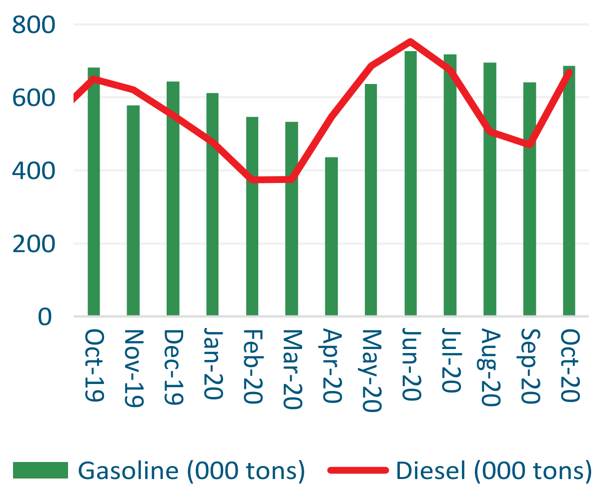
The comeback of the two-wheeler category also underscores that the demand resurgence is deep-rooted, as the lower and lower-middle income segments are back buying motorbikes. This underlines the inherent strength of the economic recovery, signaling the Covid-19 was treated rather well by the authorities, and the early lifting of the lockdown ensured the wage and wealth loss was not on a massive scale.

The petroleum products demand has been a surprise story so far. Even in the peak of Covid-19 when the countrywide lockdown was in place, Pakistan registered highest monthly petroleum consumption. The demand has kept pace, also due to the government's strategy to keep prices either unchanged or revising them lower, whenever possible.

The High-Speed Diesel sales have also been encouraging, which shows the farm activity did not struggle as much as earlier feared. The inter-city goods communication is also well reflected in higher HSD consumption. Importantly, the lower international oil prices alongside stable currency has enabled the government to levy maximum taxes, helping it on the fiscal front.

There has been significant growth in production of other LSM key sectors such as refineries, steel, and cigarettes. The LSM numbers come with a lag, and some of the data for October and November already out, suggests the LSM growth momentum will most definitely be carried to Q2FY21 and beyond.

Petroleum Sales Remain Bouyant



Source: Oil Companies Advisory Committee

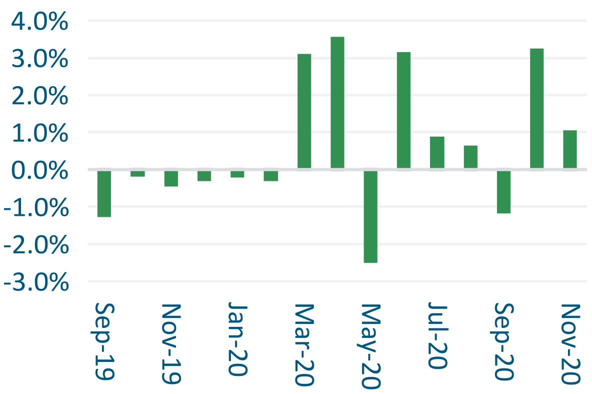
PKR Gains versus Dollar

Positive current account, higher foreign exchange reserves and potential delay in future principal payments on external debt, have all combined to strengthen the local currency against the greenback.

The reserves have strengthened over the past few months as the rupee continues to strengthen. The foreign exchange reserves with the central bank have continued to strengthen, and the current account surplus has led to a major comeback for PKR against the greenback.

Current account surplus entering fourth consecutive month provided more impetus to the market. The dollar supply was also high in the open market, as individuals came out to sell fearing the greenback losing further value against the PKR.

PKR Monthly Change

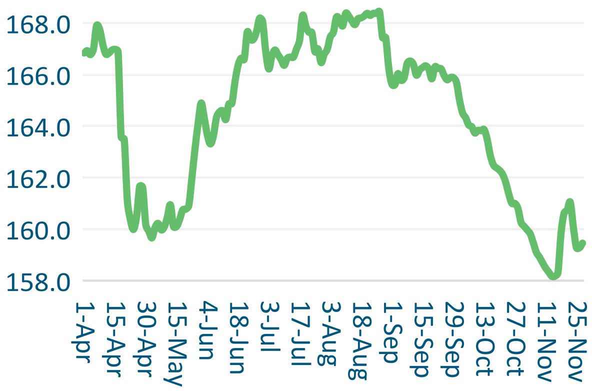


Source: State Bank of Pakistan

The foreign exchange dealers have signaled enough liquidity, despite the central bank making efforts to buy dollars from the open market, in a bid to keep the market balanced, and not put the exporters at a steep disadvantage.

The market that now runs on demand and supply mechanism, sees Covid keeping the imports in check, and also sees Pakistan's debt repayments being rescheduled, to further ease the pressure. Even an upcoming principal payment of USD 1 Bln to Saudi Arabia did not dent the exchange rate, as the reserve buffer has been built well enough – at a 26-month high.

PKR Strngthens



Source: State Bank of Pakistan

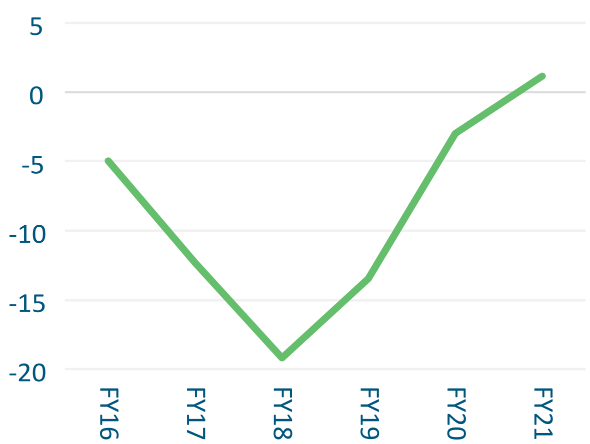
We believe, the PKR should move in a more volatile and a broader range of 155-165 to the greenback in the next two to three quarters. The fate of the currently suspended IMF program will also be a big determinant in deciding which direction does the currency take.

Current Account Bonanza Continues

For the fourth month running, Pakistan's current account ended in surplus. Last five out of six months have seen the current account in the green zone with October 2020 reporting a surplus of USD 382 Mln, up 5x from October 2019.

The current account surplus for 4M FY 2021 at USD 1.16 Bln constitutes 1.3% of GSP, in stark contrast to a deficit of USD 1.4 Bln in 4M FY2020. While the government claims credit of the dramatic turnaround, the current account has been heavily impacted by exogenous factors.

Current Account Balance (USD in Bln)



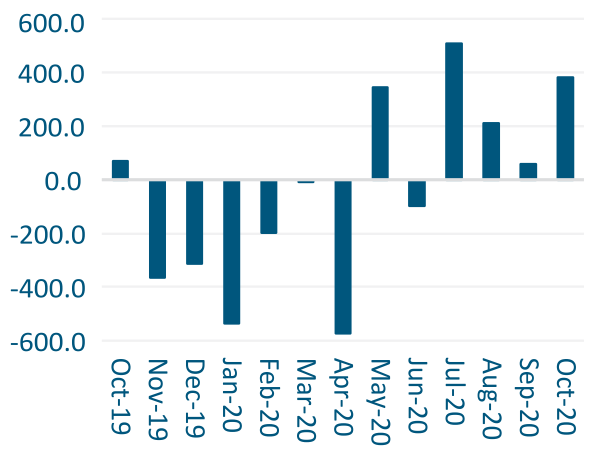
Source: State Bank of Pakistan

The goods' trade deficit has stayed largely unchanged year-on-year, it is the sizeable saving on account of trade of services, that has contributed significantly towards current account surplus.

The import of services has more than halved in the post pandemic world, making one-third of the contribution to the current account surplus. The services import is down by $695 Mln in 4m FY2021, mainly on account of significantly reduced travel.

A significant chunk of travel spending is related to religious tourism to Saudi Arabia and other Gulf countries, which has come to anear halt. The air ticketing spending has gone down by USD 171 Mln, whereas the import of other travel services, such as hotel booking has come down by USD 181 Mln during 4M FY2021.

Current Account Recovers (USD in Mln)



Source: State Bank of Pakistan

Another significant contribution has been made by the home remittances, which continue to be a mystery. Reduced travel to and from major remittance origins could also be a key reason for persistently high remittances. It is believed that a lot of cash used to travel along with the passengers instead of formal banking channels in the pre Covid world.

All said, the current account surplus may not continue for much longer, as imports have steadily started to rise. Current transfers and services trade are not going to support the current account forever.

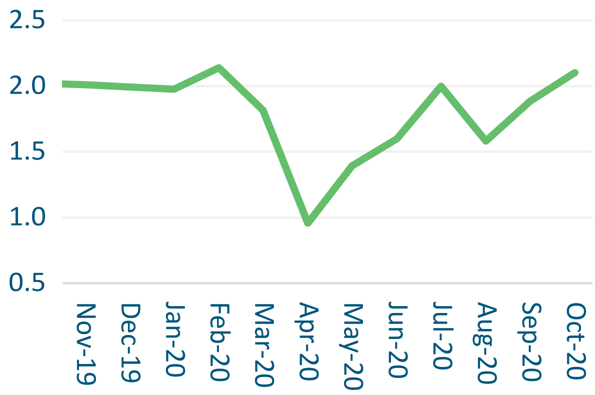
As the demand gradually picks up, and as the world will move closer towards an effective vaccine, Pakistan would not take long to be back to its old ways of sizeable current account deficits, as the current improvement is not policy induced. We believe, the current account surplus would not last beyond Q2 FY 2021.

Exports Hit Multi-month High

Having stuttered briefly, goods' exports resurged to cross USD 2.1 Bln, highest in nine months.

The 12-month moving average of USD 1.78 Bln was also comfortably surpassed in October 2020. October 2020 exports at USD 2.1 Bln were 11% clear sequentially and 4% higher over the same period last year. The 4M cumulative exports at USD 7.5 Bln were a modest 1% higher Y-o-Y.

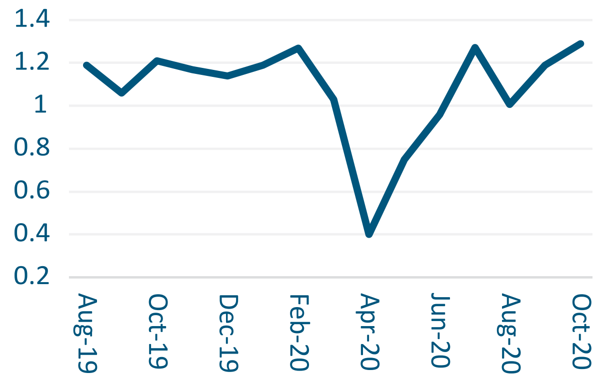
Exports Show Strong Resistance (USD in Bln)



Source: Pakistan Bureau of Statistics

The growth was led primarily by the textile sector, which continues to outshine its regional competitors. Textile has long been the mainstay of Pakistan's export earnings, and the shar in the pie has of late gone up from 5-year average of 54% to 61% in FY 2021 so far.

Textile Exports (USD in Bln)



Source: Pakistan Bureau of Statistics

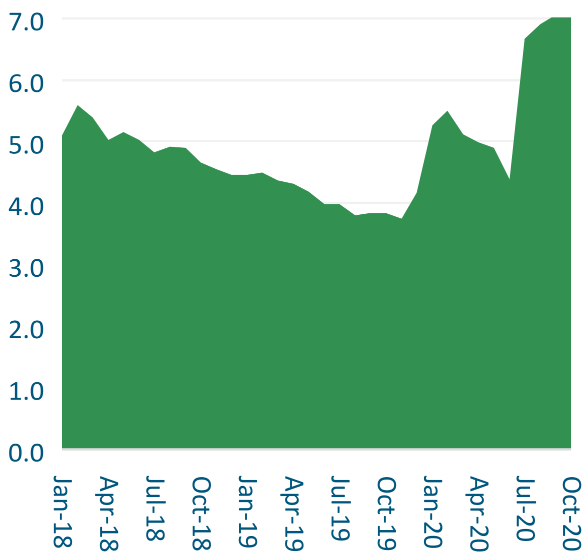
Pakistan was facing stiff regional competition before Covid-19 in terms of energy pricing and market penetration in the European markets. Luckily, was the first one in the region to lift lockdown and the textile sector responded well by penetrating higher end markets.

Although, the volumes have come down significantly for major textile categories, in some cases by 50%, it is the newer markets that have kept the boat afloat. Pakistan's readymade garments have found ways into high-end brands, as evident by a 95% increase in unit prices year-on-year.

The average unit export price for readymade garments has increased from an FY20 average of USD 4.5 per piece to the highest ever USD 7.2 per piece.

The textile industry sources reveal that they are well booked for the next seven to eight months, and eve the deadly second ongoing wave of the pandemic in Europe may not hurt the exports a great deal. The Christmas orders are usually booked five to six months in advance, for which the big industry players have undertaken significant capacity expansions.

Readymade Garment Export Unit Price (USD/piece)



Source: Pakistan Bureau of Statistics

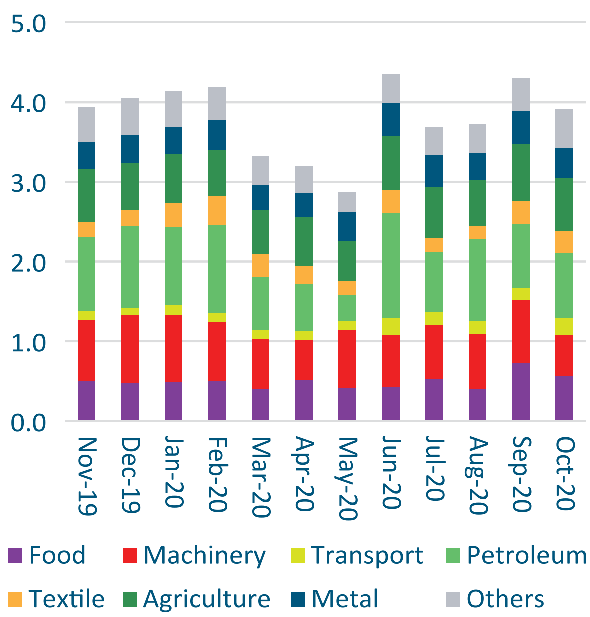
It should be only a matter of time before volumes also rise to pre-Covid levels, and the recovery would be two-pronged. The government has continued with export support packages, ensuring energy at regionally competitive rates, offering concessional long-term loans for plant expansion, deferment of interest payments, and swift settlement of long overdue tax rebates.

The trade deficit has stayed range bound but Q1 FY21 saw the highest quarterly deficit in eight quarters. Exports are believed to be nearing the full potential, as most expansions would take six to eight months to come online.

Imports on the other hand, may well have stayed flat year-on-year at USD 15 Bln for 4M FY21, but could be reaching an infection point. Food group imports have risen sharply, with a 15% share in imports, up from the 5-year average share of 11%.

Pakistan's agriculture output has bene hit hard by a confluence of factors in the last growing season, and that is now reflecting in higher food group imports. Staple items such as wheat are now being imported after a decade, as mismanagement of affairs and crop below target have led to skyrocketing flour prices, becoming the key reason for higher CPI inflation.

Monthly Imports (USD in Bln)

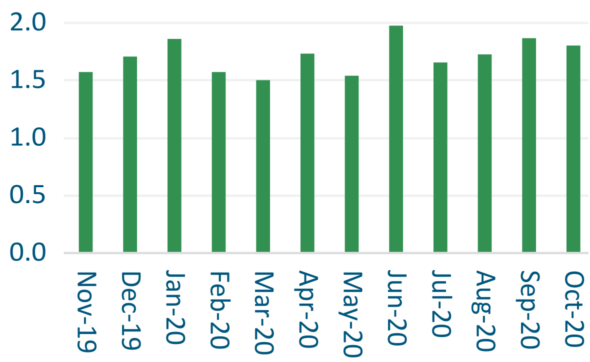


Source: Pakistan Bureau of Statistics

As textile and energy sectors enter another round of capacity expansion, an uptick is visible in machinery imports, which is only going to pick pace in the coming months. Low oil prices have kept petroleum imports in check, but RLNG imports are picking up, as Pakistan plans to run power plants at higher load.

Petroleum products' consumption has reached all-time highs in the last few months, and that will have a bearing on the import bill, especially if international crude oil prices decide to break the bear run.

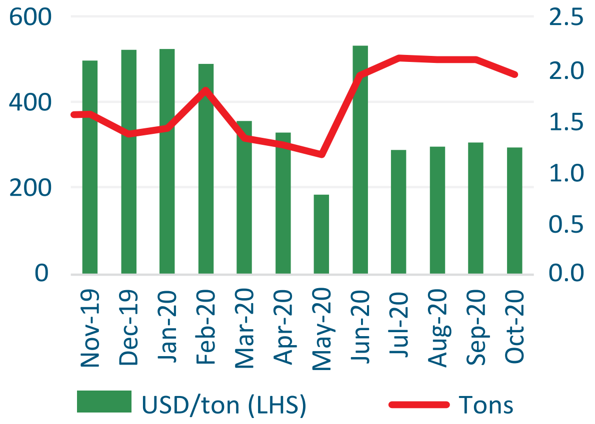
Trade Deficit Consolidates (USD in Bln)



Source: Pakistan Bureau of Statistics

The central bank's concessionary long-term financing for fixed investments has led to capacity expansions in cement, steel, and automobile sector to name a few. Automobile demand has spiraled back to pre-Covid levels.

Petroleum Products' Imports



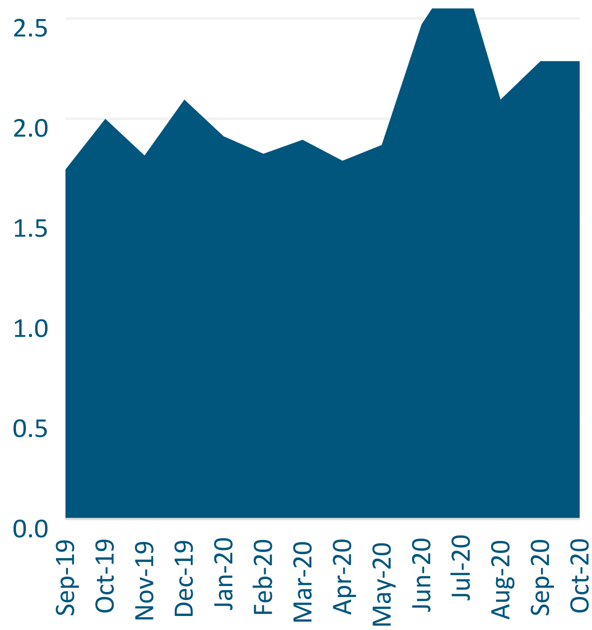
Source: Oil Companies Advisory Committee

The domestic automobile sector is heavily reliant on imported components, as the level of localization remains under 30% for the leading players. New players have also entered the market, with even lower localization levels. Low interest rates have meant the demand stays high for both locally assemble and imported vehicles, and this will keep the pressure high transport group imports in the near run.

Steady Remittances

What was being termed as one-off, has surprised all and sundry, as workers' home remittances have stayed sharp and maintained the growth momentum. The expatriates have been sending over USD 2 Bln for five consecutive months – a feat that has never been achieved before.

Home Remittances Stay Upbeat (USD in Bln)



Source: State Bank of Pakistan

The longest previous instance of monthly remittances crossing USD 2 Bln had at best stretched to two months. As refreshing and critical it is to Pakistan's current account balance and in currency relative to the greenback, it is as surprising to all experts.

Ever since the change in reporting mechanism of workers' remittances, the contribution from the Middle East has become more pronounced.

There are various theories making rounds in a bid to explain the unprecedented growth in remittances, when the World Bank is calling for a drastic expected drop in remittance flow to South Asia, to the extent of 25% for countries like Pakistan and Bangladesh.

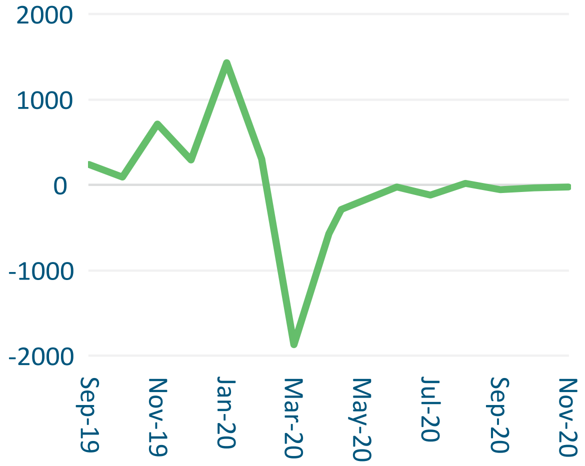
It can be argued that a number of workers abroad have lost jobs and have sent the savings back home. But channel checks conform the average transaction size has stayed by and large the same, which makes one look for another explanation.

DEBT MARKET UPDATE

Ever since the massive investor pullout in late March 2020, Pakistan's debt portfolio has seen investors flocking away month after month. The post pandemic investment landscape has little to no space for emerging markets, and Pakistan has witnessed just that.

The five months of the fiscal year FY 2021 have seen the Foreign Portfolio Investment (FPI) dwindle by USD 150 Mln. This is in stark contrast with the multibillion-dollar FPI inflows in FY 2020, which proved to be one-off, much against expectations.

Foriegn Portfolio Investment (USD in Mln)



Source: State Bank of Pakistan

The disinterest was seen coming, as it is a product of both, the international investors pulling out of emerging markets with higher country risk, and also a sharp decline in interest rates, as Pakistan reacted to provide impetus to the Covid affected economy.

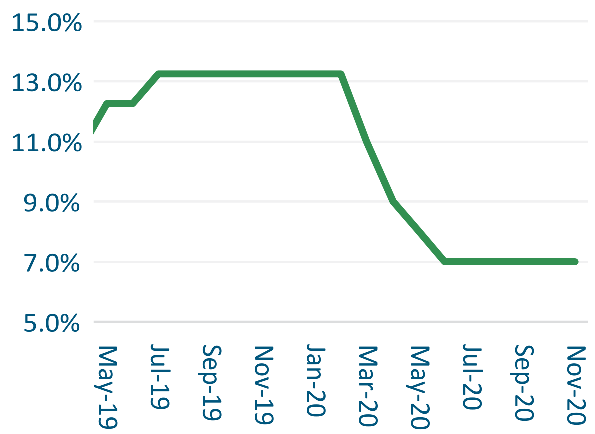
The central bank has slashed the interest rates by half since the advent of Covid-19. Pakistan comfortably carried one of the highest interest rates in the region at 13.5% by March 2020. Ever since, the policy rate has been cut by half as part of the Covid relief support.

The latest monetary policy announcement in November was the third policy in a row where the central bank opted to keep the policy rate unchanged at 7%.

This came at the back of five consecutive policy rate cuts in less than three months, as the central bank had earlier preponed policy decisions.

The State Bank of Pakistan has continued with the policy of negative real interest rates, which is a visible departure from its earlier stated policy of maintaining positive real interest rates. The change stems from the situation, and does not look like a policy shift, as demand driven pressures are not driving inflation.

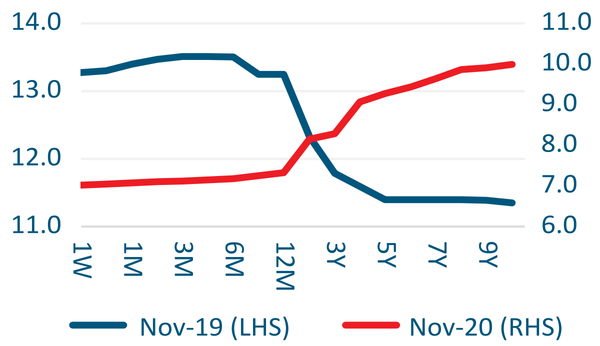
Interst Rates



Source: State Bank of Pakistan

On the sovereign front, the government has continued with its cautious effort to elongate the yield curve. Having accepted bids at higher rates for shorter tenure papers earlier in the year, the government now is principally following the strategy of building a long-term yield curve. The participation in treasury bills has reduced significantly over the last six months, as most investors have shifted the portfolio from T-bills to 10-year PIBs.

Building Long-Term Yield Curve



Source: State Bank of Pakistan

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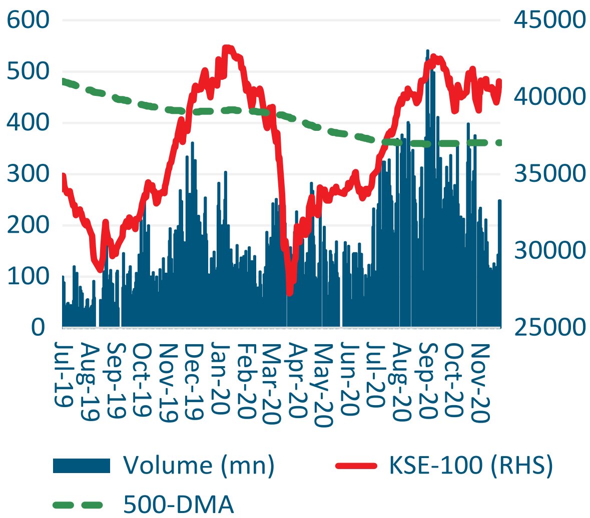
Equity Market Update

With all the bull rallies and headlines for being the one of the best performing stock exchanges post the first Covid wave – the Pakistan Stock Exchange's benchmark KSE-100 index is highly likely to end the calendar year with a negative yearly return.

For much part of Q2 and Q3, the KSE-100 index was largely a mirror reflection of Pakistan's response to Covid. As the lockdown was lifted earlier than expected, and the cases went down with Pakistan successfully flattening the curve, the stock index rose from the lowest of lows, and set regional records for fastest growth in the post pandemic scenario.

KSE-100 Index - Resistance at 40k



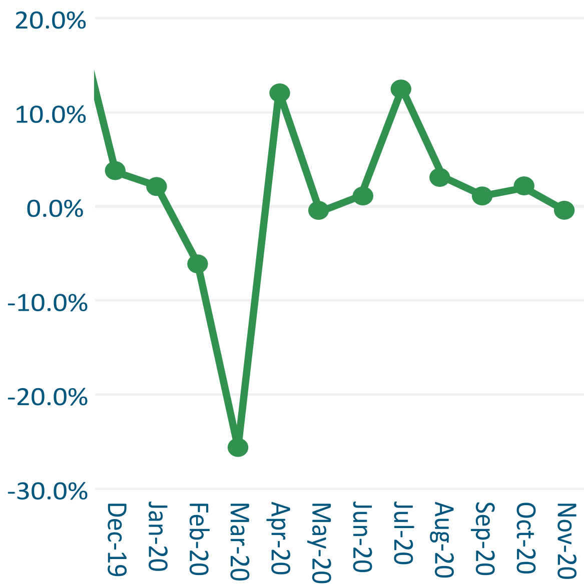
Source: Pakistan Stock Exchange

The bull rally seems to have lost steam in the last two months, despite significantly positive news on the macroeconomic front, with a stable currency and current account surplus. The resurgence of Covid has not yet led to a sharp correction but has proved enough to apply brakes on the upside.

The political temperature is only expected to rise as Pakistan moves closer towards the Senate elections scheduled in March 2021. The KSE-100 index has historically responded negatively to events that carry potential of political instability, chaos, and long movements which have the potential to delay investments in the country.

So far, the stock market has resisted to act negatively towards the opposition movement, largely because the country's establishment is openly siding with the current government, and the ruling party's overwhelming victory in one of the recent elections also raise hopes that the political upheaval will not las long.

KSE-100 Monthly Returns



Source:Pakistan Stock Exchange

Another important factor is the PSX's response to global stock markets. The US and Asian stock markets have so far not reacted overly negatively to the second Covid wave, as the US election results seem to have made up for the potential negative impact of Covid.

The KSE-100 index has also maintained the direction with global markets, disregarding local realities. The government has ruled out any lockdown, which could be one reasons for bears not making an entry yet.

Another element of uncertainty besides Covid's second spell is Pakistan's fate with the Financial Action Task Force (FATF), the failure to comply with which could keep Pakistan in the grey list, which have potentially adverse consequences. We believe the KSE-100 index would stay rangebound till there is more clarity on health, political, and FATF fronts.

STRATLINK ADVISORY GROUP - WHO WE ARE

StratLink is an emerging markets focused financial advisory company with Capital Raising Advisory, Corporate Advisory and Market Research as our core business lines. We believe in the growth potential of emerging markets and partner with our clients to execute their vision by providing quality services and access to capital. We recognize opportunities in the region and connect the fastest growing middle market companies with leading global investment banks, private equity firms and family offices. We value the importance of making informed decisions and leverage our regional knowledge to the advantage of our clients.

Our guarantee: Competent team, reliable data

Our research is anchored in a competent and versatile team traversing the fields of economics and finance with qualifications from globally recognized institutions. The team is backed by subscription to reliable databases such as Business Monitor International, Bloomberg, Thomson One Research, World Economics and The World Today. As such, our guarantee is reliable and up to date data in an increasingly dynamic region. Further, we reach out to relevant bodies in concerned markets including Central Banks, ministries and state departments.

Where we are based

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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