Wealth Management Advisory
Sardar Hassan Ali | 11 September 2018

Pakistan Market Outlook

State Bank of Pakistan likely to continue monetary tightening. We prefer shorter tenor government bonds. Long term government bonds remain our least preferred asset class.

Equities remain our most preferred asset class supported by development on China Pakistan economic corridor related projects, earnings growth and strong consumer demand

We believe the PKR has room for some further weakness, due to high trade imbalances

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Macro overview

Challenges on the horizon

- Pakistan recorded an impressive GDP growth of 5.8% in FY18 vs. 5.3% in FY17. This is the highest growth recorded in the last thirteen years
- We believe GDP growth is likely to slow in FY19, with policy focus on correcting the rising trade and fiscal deficits
- SBP is expected to hike interest rates in H2-2018 and PKR is likely to weaken further in order to make local exports more competitive and control the rising trade deficit
- KSE100 Index has had a strong start in 2018 driven by rebound in global oil prices and economic growth. Equities remain our most preferred asset class on the back of tax breaks to businesses, higher consumer spending and attractive valuations
- We prefer short tenor government bonds. Long term PIB's remain our least preferred asset class

PTI turns to bat 2018:

PTI (Movement for Justice Party) has emerged victorious in 2018 elections and Imran Khan (former cricketer) is the new prime minister of Pakistan. According to the pre-election polls it was forecasted that Pakistan will have a hung parliament, but the actual outcome has been better than expected, with Imran Khan led PTI managing to get a simple majority. However they face strong opposition from PML-N (former ruling party) and Pakistan People's Party (PPP).

The new government will possibly enter into an IMF programme for balance of payments support. Corrective measures will probably include fiscal and monetary tightening, including further exchange rate flexibility.

Macro – Challenges on the horizon

Pakistan's GDP recorded growth of 5.8% in FY 2018, the highest in the last thirteen years. Economic growth has been on the rise mainly due to the investments related to China-Pakistan economic corridor (CPEC), strong private sector credit growth and strong pickup in manufacturing sector.

The consensus GDP growth forecast for FY19 is 5.1%, down from 5.8% in FY18. The medium term growth outlook remains positive. In our opinion CPEC activities will gain further momentum and support growth.

However, we see near term challenges to the growth outlook due to widening trade and fiscal deficits. SBP FX reserves have declined to USD 10.3bn (approx 2

IMPLICATIONS
FOR INVESTORS

GDP growth is expected to slow down to 5.1% in FY19, from 5.8% in FY18

PTI will possibly enter into an IMF programme for balance of payment support

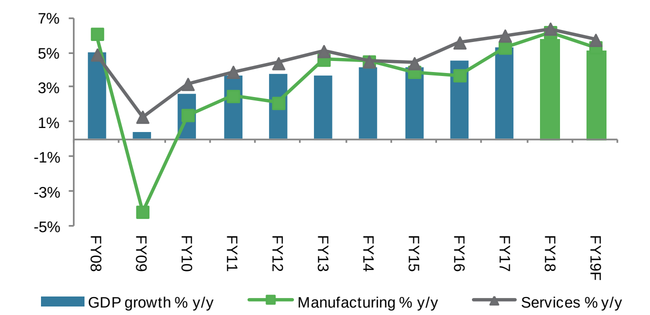
CPEC related projects and domestic demand will boost economic activities months of import cover), from around USD 19bn at the end of the last IMF Program in October 2016.The sharp deterioration in Pakistan's balance-of-payments in FY18 was due to the rise in oil prices and strong domestic demand for imported goods, particularly capital goods and raw material (as part of the CPEC programme) and higher consumer imports. Current account has widened to USD 17.9bn in FY18 from USD 12 bn in FY17.

The SBP has already started monetary tightening, raising interest rates by 175bps since January 2018. This has been supplemented by a PKR depreciation of 17%. We believe there is a high probability of the SBP continuing to raise rates in H2-2018 on the back of rising inflation.

Figure 1

GDP growth likely to slow down in FY19

Pakistan real GDP, manufacturing and services growth and consensus forecasts (Bloomberg consensus)



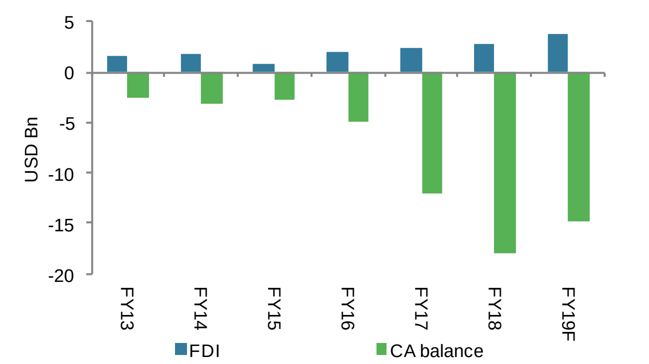
Source: PBS, SBP, Bloomberg, Standard Chartered

The rising fiscal deficit remains a key risk. The fiscal deficit is projected around 6.5% of GDP in FY18, compared to 5.8% in FY17. Unless corrective steps are taken by the new government the fiscal deficit could rise further in FY19, primarily due to the populist measures announced in the FY19 budget by the outgoing PML-N government. This is clearly an unsustainable path and we expect corrective measures from the new government.

Figure 2

Balance-of-payment sustainability biggest concern for 2018; FDI unlikely to offset ballooning current account deficit

Foreign direct investment (FDI) and current account (CA) balance



Source: PBS, SBP, Bloomberg, IMF, Standard Chartered

The previous government PML-N had announced its 6th and last budget for FY19 on 27th April-2018. Various populist measures were announced in the budget including tax breaks for the corporate sector through reduction in tax rates (Corporate tax, Super tax and Withholding tax). Similarly, big tax breaks have been handed out to the individual tax payers through reduction in income tax rates (maximum of 15%, from 30% earlier).

In summary, while the Pakistan economic outlook improved in FY18, we expect the growth to slightly slow down in FY19 as the new government will need to take corrective measures to curtail the widening of external and fiscal deficits.

Bonds

PKR Bonds- Prefer shorter tenors

- We view shorter tenor bonds as preferred holdings because they yield a fixed return and are less volatile
- Rising oil prices and a widening fiscal deficit, along with prospects for an increase in inflation are key risks to the bond markets

Bond Tenors	View	Rates policy	Macro factors
2 Year bond	▲	●	●
10 Year bond	▼	●	●

Source: Standard Chartered Pakistan Investment Committee

Legend: ● Supportive ● Neutral ● Not Supportive ▲ Preferred ▼ Less Preferred ◆ Core

Rising fiscal deficits and prospects for rising inflation are key risks to the bond markets. We anticipate the SBP to continue hiking rates in FY19, which makes the long-term Pakistan Investment Bonds (PIBs) our least preferred asset class. Instead, we prefer short-term paper or floating rate instruments in order to take advantage of or at least mitigate the impact of rising interest rates.

Two factors likely to be key drivers in SBP interest rate decision are inflation and the fiscal deficit. We expect domestic inflation to rise as a result of higher import prices following the PKR's depreciation. While average headline inflation in FY18 has remained low at 3.9%, from 4.2% in FY17, we expect it to inch upon the back of the recent PKR devaluation. Core inflation has accelerated to 7.6% on the back of strong domestic demand. We expect CPI inflation will rise gradually in FY19 on the back of persistent core inflation, higher oil prices and further PKR depreciation.

Second, the fiscal deficit is projected around 6.5% of GDP in FY18, from 5.8% in FY17. If not managed Budget FY19 will lead to a further widening of the deficit and higher deficit financing needs of the government may lead to rise in yield curve.

IMPLICATIONS
FOR INVESTORS

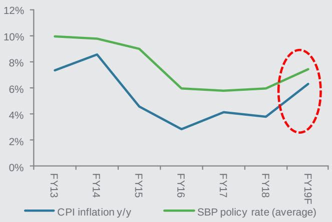
SBP likely to continue hiking rates in FY19. Currently the policy rate stands at 7.5%

We expect inflation to rise in the near term and cross SBP's target range of 5.5 - 6.5% in FY19

Figure 3

Inflation likely to rise going forward

Pakistan CPI y/y and SBP discount rate (FY average)



Source: PBS, SBP, Bloomberg, Standard Chartered

BONDS
EQUITIES
FX

Equities

PK Equities remain our preferred asset class

- KSE100 Index is up by 3% in first eight months of CY18
- Key risks are delay in CPEC related projects, political uncertainty and balance of payments issue

Pakistan Equities – Worst is likely behind us

KSE100 Index is up by 3% in CY18 (Jan-Aug) compared to a decline of approximately 15% in 2017. The rebound in local equities has most likely been driven by a rebound in oil prices and robust economic growth. Political certainty and PKR deprecation will likely help to improve sentiments of foreign investors.

The local bourse posted a return of 8.8% in the month of Jan'2018 due to improving prospects of Banking and Cement sector stocks. However, pre-election political uncertainty, deteriorating balance of payments and continued foreign selling weighed on the KSE100 index.

In the near term, we expect the market to remain volatile until the newly elected government takes initiatives to address rising trade and fiscal deficits which pose macro-economic risks.

However, we believe the market is likely to rally post elections on the back of tax breaks in FY19 budget to businesses and individuals, strong earnings of the listed companies, and tightening of controls around investment in real estate market – which in our view will lead to higher inflows in the equity markets.

With respect to earnings, consensus estimates are for a 13% growth in corporate earnings in 2018. We continue our liking for E&Ps, banking and export sector which will benefit from higher oil prices, interest rate hike and PKR devaluation.

Pakistan equities are trading at a forward PE of 8.9x, which is at a significant discount compared to its regional peers. Alongside attractive valuations, Pakistan market is offering an attractive dividend yield of 6% which is highest in the region. In our opinion, most of the returns from the local equity market are likely to come from earnings growth as opposed to P/E multiples.

IMPLICATIONS
FOR INVESTORS

Local equities our preferred asset class

Pakistan market is offering attractive dividend yield of 6.0%

Figure 4

Regional Multiples

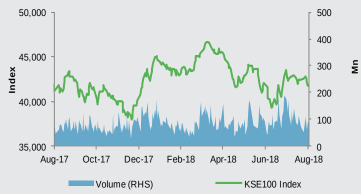
Regional Multiples		
Country	Forward PE	Dividend Yield
Pakistan	8.9	6.0
China	11.0	2.9
Hong Kong	11.4	3.6
Brazil	11.8	3.9
Thailand	16.0	3.1
Japan	16.2	1.9
Vietnam	17.3	1.6
Philippines	18.2	1.6
India	20.7	1.4

Source: Bloomberg, Standard Chartered

Figure 5

KSE100 Index showing signs of stabilization

KSE100 index and Volume (RHS)



Source: Bloomberg, Standard Chartered

FX

PKR- Room for further adjustment

- PKR may remain under pressure in the near term
- Widening current account deficit, higher oil prices and declining FX reserves remain key risks to the PKR

PKR – Room for further adjustment

Rising trade deficit and declining FX reserves have increased pressure on PKR. Since Dec 2017, USD/PKR has risen by 17% to 123.03 in August 2018 (from 105.5 in December 2017). The corrective measures follow several years of stability, USD/PKR had remained broadly unchanged around 105 from 2015 to 2017. This period of stability is likely explained by the authorities using FX reserves to defend the PKR, even as oil prices rose and the trade deficit worsened.

Despite this, we believe the PKR's adjustment lower may not be complete and the imbalance in the country's balance of payments will lead to further devaluation. The current account deficit widened to 5.7% of GDP in FY18, from 4% of GDP in FY17. Although exports grew by approx 14% in FY18, surging imports have led to a widening current account deficit and a considerable decline in FX reserves.

Import demand remains strong, driven by strong domestic demand, and capital goods imports under the CPEC projects. Similarly, rising oil prices will also keep pressure on the import bill.

We expect an uptick in FDI from China, as part of CPEC projects, but this is unlikely to be sufficient enough to fill the required funding gap. As a result, there is a strong possibility of Pakistan moving towards another IMF programme.

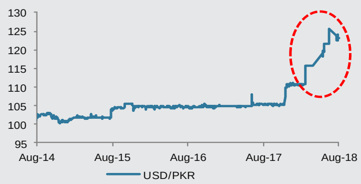
IMPLICATIONS
FOR INVESTORS

China will possibly continue to provide financial support but it may not be an alternative to the IMF programme

Figure 6

Currency devaluation amid rising balance-of-payment issues

USD/PKR spot

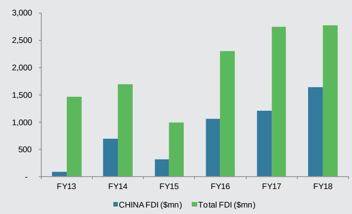


Source: Bloomberg, Standard Chartered

Figure 7

Foreign direct investments continue

Foreign direct inflows from China & Pakistan's total FDI



Source: Bloomberg, Standard Chartered

Summary

Overall, we expect H2-2018 to be a challenging period for the Pakistan economy given the economic risks and uncertainty post 2018 general elections. A lot of the risks may have already been priced in as the KSE 100 index is trading around 41,742 levels on 31st August, down 21% from peak levels of 52,876 seen on 24th May-2018.

We believe a combination of a pickup in earnings growth and attractive valuations are likely to be a catalyst for stabilization and recovery. This suggests investors should start to build cautious exposure towards the local equity market.

We believe there is a high probability of the SBP hiking rates in H2-2018, and therefore prefer short maturity papers in the fixed income space. We believe the PKR has room for further weakness, as the balance of payments is likely to remain under pressure through most of 2018.

Disclosure appendix

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