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A Subsidiary of National Bank of Pakistan

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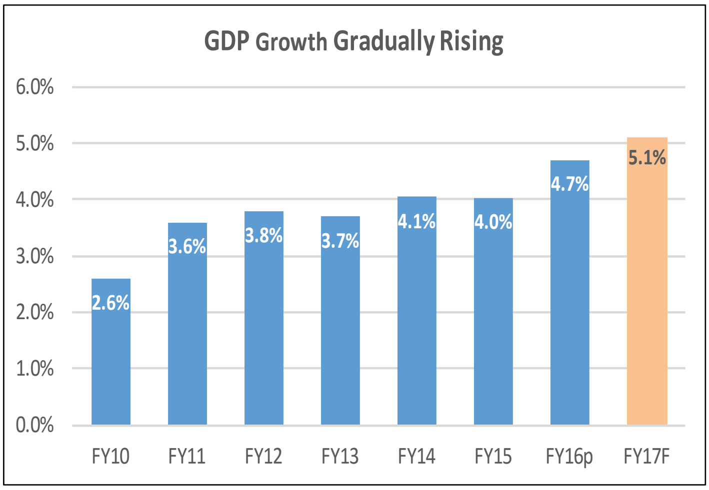
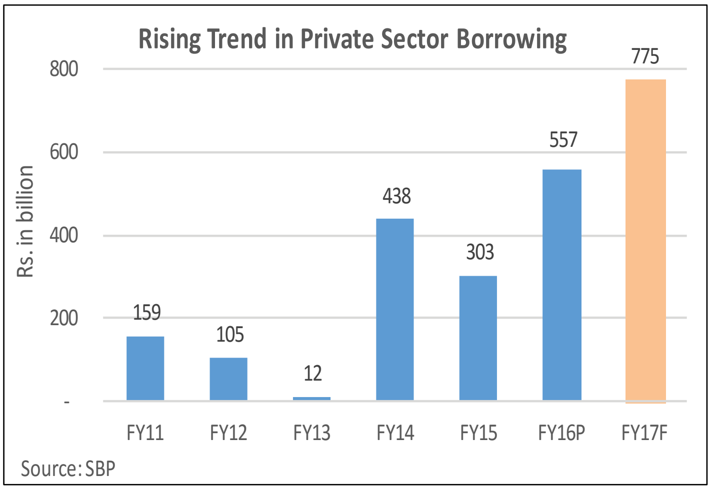
What Lies Ahead for the Stock Market

Pakistan economy is on a cyclical upswing with the real GDP growth well poised to touch the 5% mark in FY17, due to improved agriculture output and better industrial growth. Large Scale Manufacturing (LSM) growth during 8-Months of FY17 has clocked in at 4.1%. Inflation during 10MFY17 inched up to 4.1% compared to 2.8% in the corresponding period last year, due to low base effect and recovery in crude oil and food prices. Overall, FY17 inflation is expected to be around 4.3%. As historically fiscal deficit remains more lopsided in the second half of fiscal year due to higher development expenditure, we anticipate overall FY17 fiscal deficit to exceed 5% of GDP due to shortfall in the tax revenue target and rise in subsidies. In addition to the China Pak Economic Corridor (CPEC), the ameliorating law and order situation is now resulting in higher domestic private sector credit growth, and likely to boost Foreign Direct Investment (FDI).





However, we see mounting risks to the external account emanating from stagnant exports, rising imports, and slowdown in remittances growth. The current account deficit has reached USD6.1bn (2.2% of GDP) in 9-Months of FY17. Resultantly, the foreign exchange reserves have dropped to USD21.6 billion as of mid -April compared to a high of USD24 billion reached in Oct-16

Chronic issue of energy shortages for the industry has eased somewhat with the import of LNG, and we see significant improvement in the coming months as more power plants and LNG terminals come online. Due to price level remaining on the lower side and better supply side management, we expect interest rates to remain anchored at the current levels in the near term, and expect a marginal rise of 50 basis points in 1HFY18 as the external account pressures become pronounced. With FY18 being an election year, we are anticipating a pro-growth budget with focus towards developmental activities and enhancement of subsidy schemes especially targeted towards the rural sector. In order to bridge the revenue shortfall and buttress the deteriorating external account, a foreign assets amnesty scheme is under government consideration.

After muted return of 10% in FY16, the stock market has delivered a handsome return of 30% during 10MFY17. However, the performance remained skewed towards the first half of this fiscal year where the benchmark gained by 27%, driven by improving economic fundamentals such as controlled inflation, low interest rates, and record high foreign exchange reserves, together with announcement of reclassification of PSX into MSCI Emerging Market Index effective June 2017. Stock market performance during January-April 2017 has been lukewarm as investors' sentiments were rocked by rising political noise as much publicized verdict of the Panama Leaks case drew near. However, a relatively clement judgment which did not indict the incumbent Prime Minister was cheered by the euphoric investors. As a result, in April-17, the market surged the most in the last 4-months delivering a 2.4% returns. Overall, the benchmark KSE 100 Index rose by around 3.1% during 4MCY17.

While political noise will continue to remain elevated as we head into an election year and uncertainty linked to the Panama Leaks investigation may send jitters in the market, investors should take into account robust corporate earnings growth, as many companies are turning towards capacity enhancement in order to fulfill the rising domestic demand as economic growth picks up and electricity shortages decline going forward. Introduction of a new leverage product in the coming months, and probable foreign inflow post inclusion in MSCI Emerging Market are expected to be the key liquidity triggers for the market. From a valuation standpoint, with the KSE-100 Index price-to-earnings ratio of 10.4 times, and the interest rates still at a record low level, we expect the stock market to deliver healthy double digit returns over the next 12 months.