The Floods and Capital Markets

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Total Losses estimated at 5.8% of GDP. The floods have caused unprecedented devastation to Pakistan's economy, agriculture, infrastructure, and above all to human lives and dignity. Around 15% of the Pakistani population has been affected by the floods. According to some initial estimates agricultural losses may exceed Rs 250 billion whereas infrastructure losses may exceed Rs 600 billion. Thus total estimated losses of around US$10 billion will equal 5.8% of Pakistan's GDP.

Economic Growth rate expected to be subdued. Our initial estimate was that of 4% GDP growth in FY11. However, now we expect agriculture sector to show a negative growth, and industry and services sector to grow by about 3%. We project corporate earnings to rise by 14% over the next four quarters, down from our previous estimates of 18% growth.

Fiscal Deficit is expected to balloon to 7.5% of GDP in FY11. The slowdown in economy as a result of the floods will make tax collection target of Rs 1.7 trillion extremely difficult to achieve. On the other hand, government expenditures are expected to rise substantially to re-build the infrastructure in the floods-affected areas and rehabilitate the effected families. Donor fatigue seems to be setting in as they are already supporting Pakistan on the war on terror and now aid is being sought for the floods. The aid / grants portion from donors is not expected to cross one billion US dollars. Financing from Asian Development Bank, the World Bank and other such institutions is only going to increase the budget deficit and external debt of Pakistan. Domestic Government borrowing in the form of Treasury Bills and National Savings Schemes is also expected to rise substantially. In the months of July and August 2010, the Government Treasury Bills stock has already risen by about Rs 137 billion. This will also continue to crowd out the private sector. As a result, the budget deficit is estimated to cross 7.5% of GDP in FY11.

Inflation and Interest Rates are expected to rise further. The imposition of value added tax from October, damage to crops from floods, projected rise in utility prices and expected additional taxes to support people affected with floods may result in inflation rising to around 15% in FY11. Interest rates are also expected to creep up as a result of excessive government borrowing and higher inflation.

Stock Market performance expected to remain lackluster in FY11. Floods are expected to have a negative impact on the banking industry, auto industry and oil marketing companies, at least in the short run. However, the direct impact of the floods on listed companies is not substantial. The indirect impact due to slowdown of the economy, and expected rise in inflation and interest rates is going to be material. Historically, in periods of high inflation and interest rates the stock market has underperformed Fixed Income instruments. Thus, in the remaining period of FY11 the stock market may not be able to show a double digit growth from the current levels. The Margin Trading System, even if implemented, is not going to make a significant difference to the performance of the Pakistani stock market, in my opinion, as the economic and political fundamentals will take time to improve.

Trade and Current Account Deficit are expected to Rise. Pakistan's exports will suffer due to damage to the key crops and textile sector resulting from floods, as well as power shortfall and high inflation. Pakistan's imports, on the other hand, are expected to show an increase due to import of around 2-3 million bales of cotton and food products. This will put some pressure on the Pakistani rupee as well relative to other currencies.

Investors are advised to remain conservative and prefer money market funds relative to equity funds for the time being.