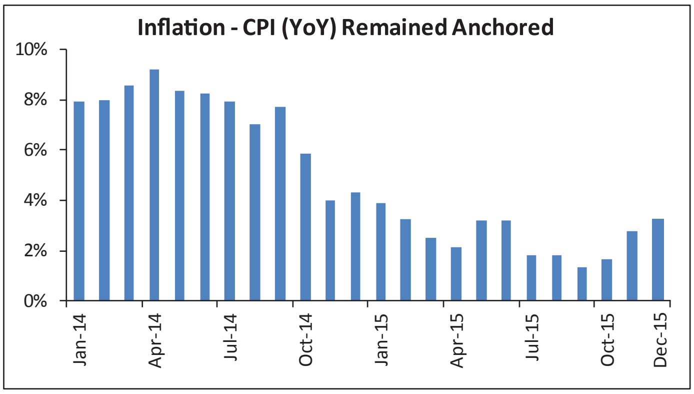
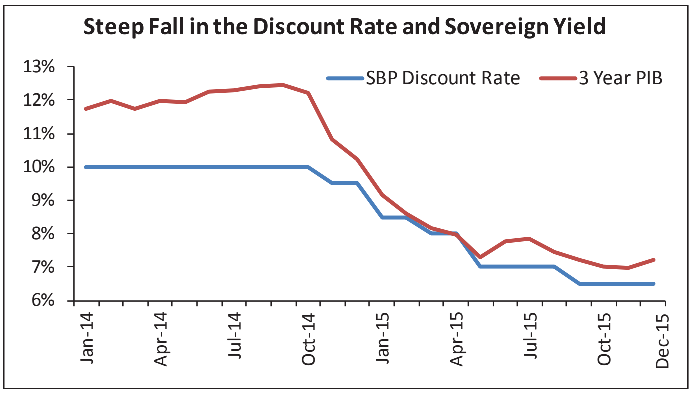
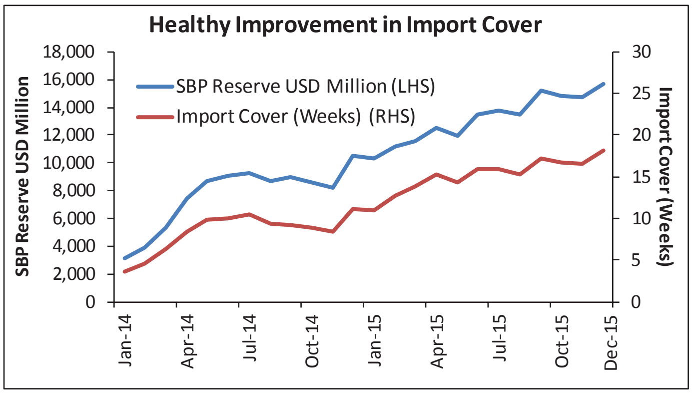
Dr. Amjad Waheed, CFA
Chief Executive Officer

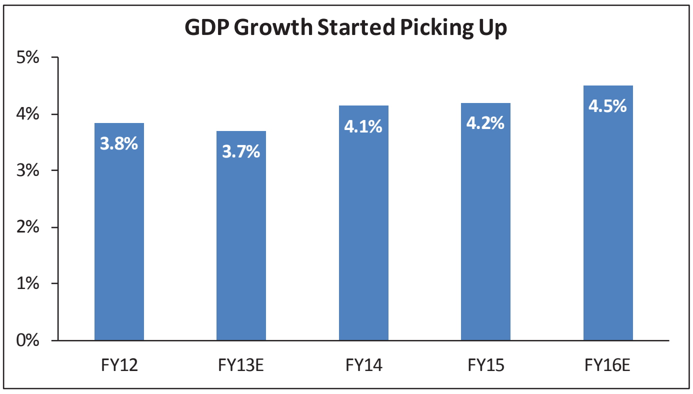
Pakistan Economic and Investment Outlook 2016

Economic Performance 2015: The year 2015 concluded with notable signs of improving domestic economy primarily helped by a precipitous decline in global commodity prices, notably crude oil. Inflationary pressures remained at bay as reflected in just 2.5% average headline inflation during CY15. External account position further strengthened as captured in record foreign exchange reserves at year end. The fiscal deficit has shrunk due to lower subsidy burden, interest rates have declined to multi-year lows, and GDP growth has started picking up marginally on improving macroeconomic environment and security situation. However, transition from assisted growth to self-sustainable growth entails (i) critical structural reforms in energy generation and distribution; (ii) privatization and/or restructuring of loss making Public Sector Enterprises costing the country Rs.600 bln per annum; and (iii) widening of tax net & improvement in tax administration. However, progress on these reforms have been slow.









Economic Outlook 2016: With 2015 now behind us, many investors wonder how local economy and financial markets would fare in 2016. We hold an upbeat economic outlook for 2016 premised on expected persistent weakness in commodity prices over the next 12 months, further progress on structural reforms, a stable political and security situation, and tangible development on CPEC related projects. We anticipate GDP growth to accelerate to 5.0% in 2016 driven by lower input costs, enhanced household income, benign interest rates outlook, and, a modest pick-up in private and public sector investment activity, particularly due to expected progress on CPEC related development ventures.

We see some increase in headline inflation numbers during the next year owing to reversal of the base effect, bottoming out of commodity prices, levying of new taxes and some PKR depreciation. However, we expect inflation to still stay subdued at 6% in 2016. External accounts position is also expected to remain comfortable due to a manageable trade deficit, healthy remittances, steady multilateral loan flows, and rising CPEC related inflows from China. Fiscal deficit is likely to remain under 5% of GDP due to lower subsidies and expected additional revenue measures.

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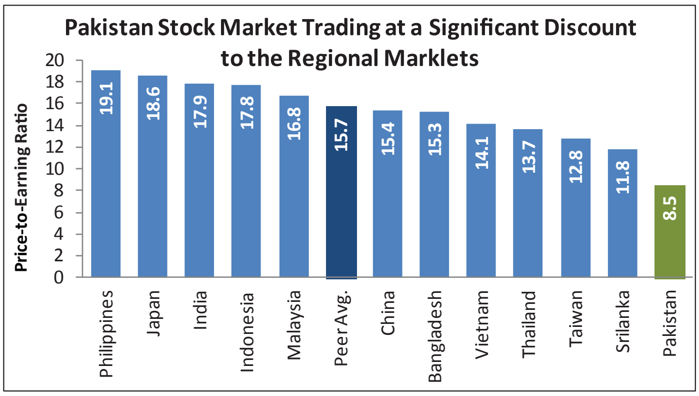
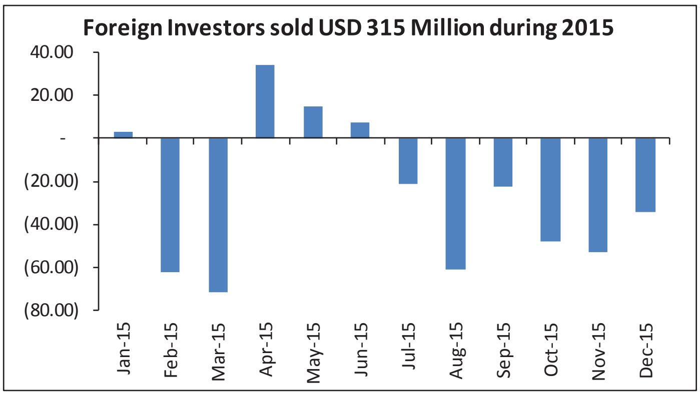
Foreign Exchange Market: In the foreign exchange market, Pak Rupee saw a modest depreciation during CY15 compared to a sharp decline in the emerging and regional currencies on tightening global financial conditions amid strengthening of US dollar. Resultantly, an overvalued PKR vis-à-vis regional currency has eroded our export competitiveness as reflected in around 9% decline in exports in CY15. Going forward, notwithstanding a benign external account position and healthy reserves accretion, rupee is likely to witness measured 6% depreciation against USD during 2016 to retain local competitiveness.

Bond Market: During CY15, yield on fixed income avenues declined sharply driven by falling inflation, massive liquidity injections by SBP, and subdued private sector credit growth. For instance, yield on 1 year T-bill decreased by around 290bp from 9.3% in December 2014 to 6.4% at 2015 end. We think interest rates have bottomed out now and expect around 100bp rise in SBP policy rate in CY2016. Accordingly, we expect sovereign yields to move up by 100bps in 2016 driven by higher interest rates, restricted injections by SBP, and healthy credit demand from both public and private sector. In this backdrop, we prefer shorter maturity of the fixed income portfolio considering the upside risks to inflation and interest rates.

Stock Market: Uncertainty on the global economic and financial fronts overwhelmed the improving domestic investment landscape, leading to a lackluster performance of the local stock market in 2015 with a paltry 2% return amid heightened volatility. During CY15, Investors in our NAFA Stock Fund earned a decent return of around 11%, net of management fee and other expenses. Thus our Fund out-performed the stock market by 9% during CY15. We attribute the dismal performance of the stock market in CY15 to significant foreign selling and corporate earnings slowdown, led by index-heavy Oil & Gas and banking sectors. Moreover, concerns on the global economic growth slowdown, rout in the emerging markets triggered by plummeting commodity prices & currencies, and rising geopolitical risks also weighed on the performance of the stock market. Going forward, we expect foreign selling to gradually subside due to (i) improving growth prospects of the Pakistani economy in a low commodity prices environment; (ii) Pakistan's expected re-entry into widely tracked MSCI EM Index in Mid-2016; and (iii) reasonable stock market valuations as captured in 8.5 times forward earnings.





The stock market is trading at a cheap forward earnings multiple of 8.5x, which is attractive in comparison with regional peers and historical levels. We believe that expected slowdown in corporate earnings growth in 2016 due to the drag from Oil & Gas and Banking stocks is already priced in the present valuations. We see strong possibility of Price –to-Earnings multiple rerating due to improving macroeconomic fundamentals, scarcity of yield on alternative fixed income avenues, and easy monetary conditions. Based on the above, we expect the stock market to deliver a decent double digit return in 2016, which will be better than the 4-7% yield expected on bank deposits and treasuries.