NBP Fullerton Asset Management Ltd.
A Subsidiary of National Bank of Pakistan

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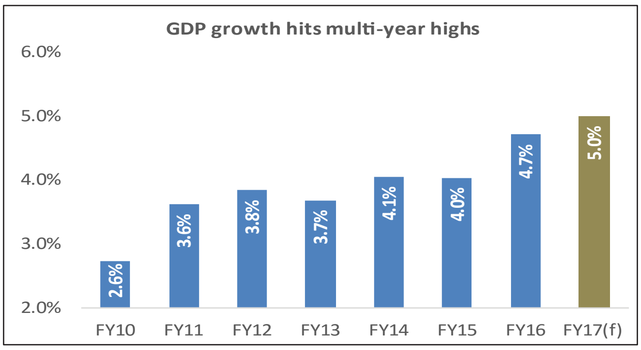
Pakistan Economic and Investment Outlook 2017

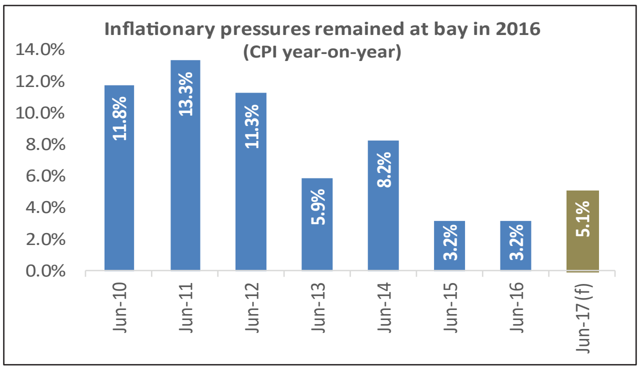
Pakistan's economic performance has remained fairly robust in 2016 mainly supported by the favourable global economic environment and partially due to some economic reforms measures undertaken by the government under the IMF programme. GDP growth reached an eight year high of 4.7%; external account position remained comfortable, as captured in healthy foreign exchange reserves accumulation though primarily on the back of fresh loans and a stable exchange rate; inflation averaged at around 3.7% during the calendar year mainly helped by the steep fall in global oil prices, which allowed SBP to continue with its accommodative monetary policy; and fiscal deficit stayed contained, narrowing to 4.6% of GDP during the last fiscal year.

Prospects for the domestic economy look sanguine in 2017 as well due to easing of energy supply situation, accelerating progress on CPEC related projects, improving business confidence, ameliorating security situation, a stable political environment, low global commodity prices and new-found focus of federal/provincial governments on development projects in view of upcoming general elections in early 2018. From a structural perspective, Pakistani economy, being mainly domestic demand (consumption/investment) driven with limited international financial and trade linkages, is among the few economies better placed to withstand probable global economic ramifications, such as rising protectionism, currency wars and capital flight, stemming from the recent events (Brexit, Trump victory).

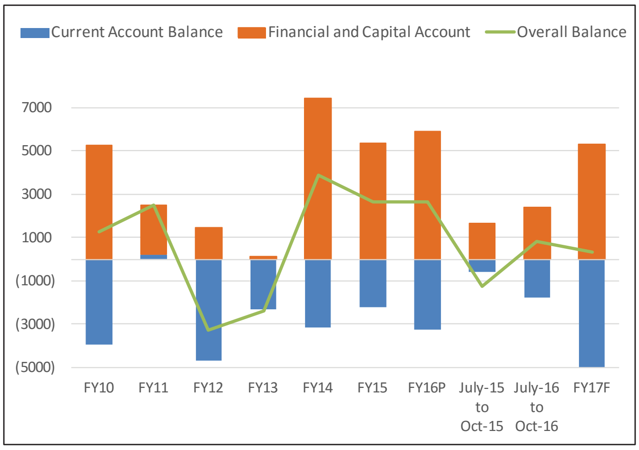
We expect GDP growth to touch the 5% mark in FY17, driven by strong consumption and rising investment expenditures under CPEC related projects, higher PSDP spending and private sector capacity expansions. On the supply side, we expect continuation of robust performance of the industrial sector, especially construction, with 7% expected growth, and a healthy 5% growth of the services sector. Helped by the Kissan package & pro-agriculture federal budget 2016, agriculture growth is likely to clock in at 2.5% as against 0.2% contraction recorded in the previous year.



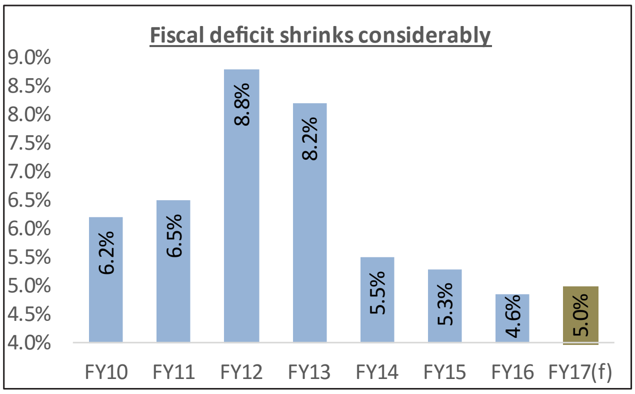
On account of reversal of the base effect, partial recovery in commodity prices from their trough, notably crude oil, and measured PKR depreciation, we see some pick-up in inflation during the next calendar year to 5.1% by June 2017.



On the external account front, we expect the current account deficit to widen to around USD5.0bn (1.6% of GDP) in FY17 due to higher imports, especially plant & equipment and energy-related machinery, subdued exports and stagnating remittances. However, overall balance of payments position is likely to remain comfortable on account of higher external loan inflows and some increase in FDI. Nonetheless, if remain unaddressed, sluggish exports would eventually pose serious risks to medium-term balance of payments sustainability and threaten the recent economic gains.

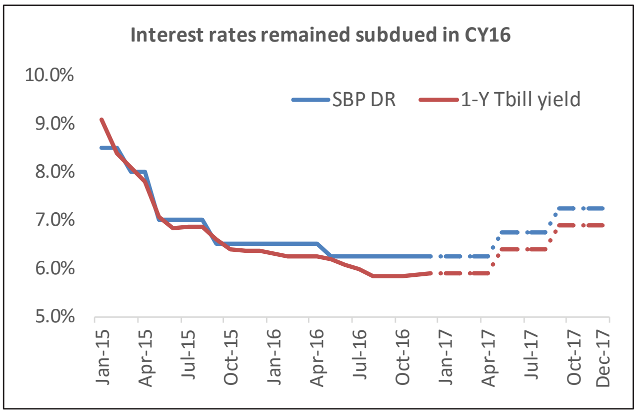


In our opinion, FY17 fiscal deficit would come in the vicinity of 5.0% of GDP, exceeding the government target of 3.8%, due to slippages on the expenditures side amid higher spending by federal and provincial governments before next general elections scheduled in early 2018, no IMF oversight and government's reluctance to implement further revenue mobilization measures because of election considerations.

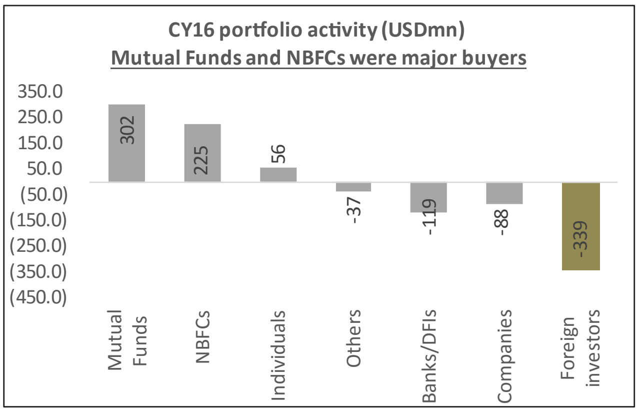


Foreign Exchange Market: In the foreign exchange market, Pak Rupee has essentially maintained parity against US Dollar in CY16 vis-à-vis Greenback's sizable appreciation against major developed and emerging market currencies, especially during the second half of the year due to likely monetary tightening in the US and looser monetary policy in other systematically important economies & capital outflows from Emerging Markets . Resultantly, an overvalued PKR is eroding our export competitiveness as manifested in around 7.2%YoY decline in exports during 11MCY16. Going forward, barring any shock to the external account, we expect around 5%-6% PKR depreciation against the US Dollar in CY17 to partially restore export competitiveness and avert rising pressures on the external current account.

Fixed Income Market: During CY16, yields on fixed income avenues declined further in line with 25 bps cut in the policy rate and significant liquidity injection by SBP. For instance, yield on 1 year T-bill decreased by around 34bps from 6.4% to 6.06% during the calendar year. We think interest rates have bottomed out now and due to expected rise in inflation, incessant government borrowing and rising private sector credit off-take we expect around 50bps-100bps rise in SBP policy rate in CY17. In the above backdrop, we prefer floating corporate debt securities and shorter-term fixed income avenues considering unattractive term premium & expected increase in fixed income yields.



Stock market: After remaining lackluster in 2015, the local stock market finally responded to improving macroeconomic fundamentals in 2016, as captured in a remarkable 46% rise in the benchmark KSE 100 Index during the year. We attribute this stellar performance to ample liquidity available with local institutions, mainly mutual funds and insurance companies, which fully absorbed sizable foreign selling during the year. Dearth of yield on the alternative fixed income avenues powered this shift to equities.

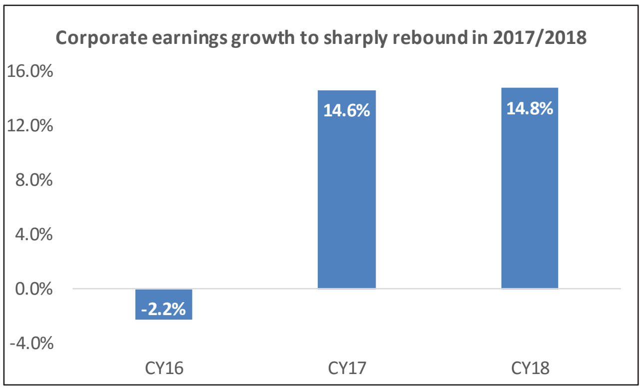


Further, notwithstanding robust performance in CY16, we believe domestic equity market could deliver a solid double digit return in 2017 as well based on:

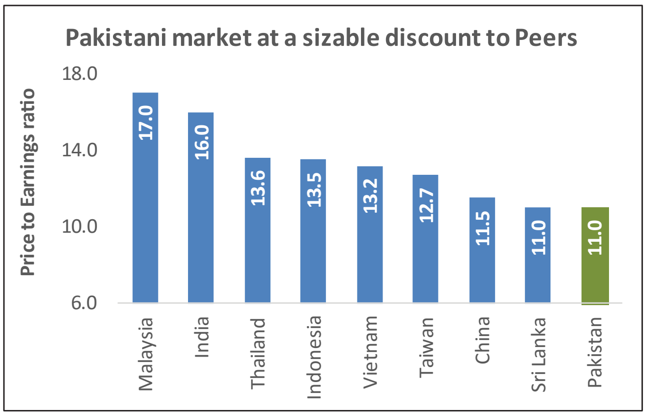
- PSX is slated to join MSCI EM Index from May 2017. It is estimated that around US Dollar 1.5 trillion of emerging market funds follow MSCI EM Index. Though Pakistan would have a small 0.13% weight in the Index, it still equates to around US Dollar 2 billion. We expect the local bourse to receive sizable MSCI EM related flows in 2017 and beyond which should buttress its performance.

- Shanghai Stock Exchange led consortium has recently won the bid for 40% strategic stake of Pakistan Stock Exchange. The above coupled with 20% public offering should bring further liquidity to the local bourse through brokers. In addition, the new operator would likely launch new products, bring technological improvements, improve PSX perception and introduce cross listings.

- After remaining stagnant in 2015 and 2016 amid a drag from the Oil & Gas and Banking sectors, corporate (listed) earnings growth is expected to rebound sharply (around 15% per annum) in 2017 and in 2018 that would not only validate the recent performance but trigger the next performance leg.



- Despite robust stock market performance in 2016, local valuations, as captured in the forward Price to Earnings (PE) of 11 times and dividend yield of around 4%, are quite attractive vis-à-vis regional peers (average forward PE 13.6 times).



We are bullish on equities, while closely monitoring global & local economic, political, and policy developments with the intent to rebalance our portfolios, if warranted by our economic and financial outlook. Alhamdulillah, NAFA Stock Fund has been the best performing Fund in the country in CY 2016, providing 51.5% return versus average peer return of 38.7% and 45.7% rise of the stock market (KSE 100 Index).