# Impact of Economic Growth and Corporate Earnings on the Stock Market

NBP Fullerton Asset Management Limited

Dr. Amjad Waheed, CFA
Chief Executive Officer

A concern that I commonly hear from investors is whether the stock market will continue to perform well considering the economic and security risks facing Pakistan. The concern arises as the stock market represents large corporations of Pakistan, and no company can be fully immune to the macro-economic dynamics in which it operates. However, it is a question of extent to which a company can continue to perform well despite macro-economic uncertainties.

Over the last 10 years, Pakistan's real economic (GDP) growth has averaged 4.6% per annum whereas; the nominal economic growth rate (that includes inflation) averaged 15.3% per annum. The stock market posted average return of 26.5% per annum during the same period. Table 1 compares the real and nominal economic growth rate of Pakistan with corporate earnings growth over the last 10-years and the last 3-years. Table 2 shows that 11 percent of the variation in corporate earnings is explained by the real economic growth rate. This means that 89% of the variation in corporate earnings is related to factors other than economic growth. Thus, to a large extent these companies have been able to grow despite the slow economic growth rate of the country. Of special importance are the last three years where earnings grew by 19% per annum whereas, the real GDP depicted only 2.6% per annum growth (see Chart – 1 below). This is partly explained by relatively high inflation rate over the last three years, where companies have raised their output prices to compensate for high inflation.

Table – 1

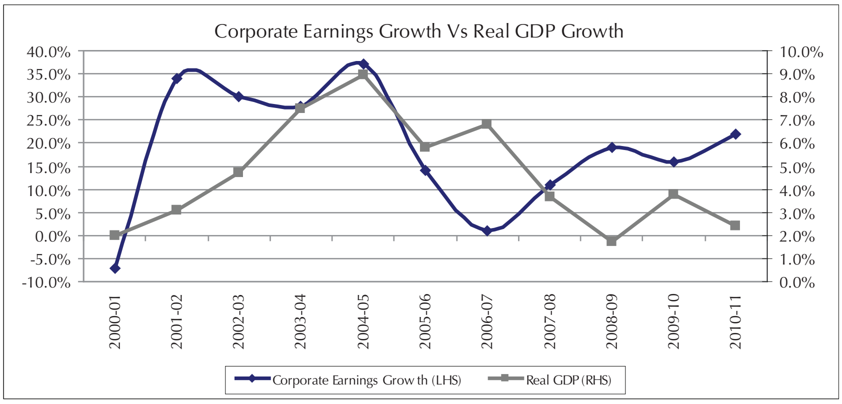
| | Last 10 years (Average) | Last 3 years (Average) |
|---|---|---|
| Nominal GDP growth rate | 15.3% | 20.9% |
| Real GDP growth rate | 4.6% | 2.6% |
| Corporate earnings growth rate | 18.6% | 19% |

Table – 2

| | $R^2$ | Significance |
|---|---|---|
| Nominal GDP and corporate earnings growth | 1% | No |
| Real GDP and corporate earnings growth | 11% | No |
| KSE-100 and corporate earnings growth | 21% | Yes |

Our projection of the real economic (GDP) growth is 4% per year over the next 5 years and nominal economic growth rate is 15% per year for the same period. Corporate earnings are expected to rise by 20 % per annum, on average, over the same period. However, this is based on a status quo scenario. Continued fiscal indiscipline and deterioration in the law and order situation will cause economic and corporate earnings growth to slow down considerably. On the other hand, efforts on the part of the government to address structural issues, especially energy shortages and tax collection; and rationalization of government expenditures, may result in the real economic growth rate rebounding to 6% per annum or higher.

Chart – 1




Corporate earnings have grown well over the last several years and are expected to continue to grow at a healthy rate in the coming years. However, there are question marks about the quality of corporate earnings. The Oil Marketing and Power sub-sectors have shown decent profitability trends. However, where is the CASH behind those earnings! Several of these companies are stuck in the circular debt. Similarly, what would have been the earnings growth of banks if the State Bank of Pakistan had not relaxed provisioning rules over the last few years. Further, the vulnerability of highly leveraged companies has increased as their debt servicing costs have risen substantially due to the high interest rate environment.

Corporate earnings growth is a key driver of stock market performance. Earnings have grown at around 19% over the last three years despite downturns in real GDP growth rate. Currently, the stock market seems fairly priced, trading at forward earnings of 7.3 times. The stock market is expected to rise in line with projected corporate earnings growth of 20% per annum in the coming years.