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Stock Market - Out of Sync with other Financial Markets

Lately, the stock market and other financial markets are moving in opposite directions. In an abnormal relationship, the stock market is scaling new highs, while bond and foreign exchange markets have turned bearish as depicted by a marked increase in bond yields and decline in PKR/USD parity. Historically, Pakistani stock market and foreign exchange reserves have moved in the same direction. However, since February, 2012 we are witnessing an anomaly where net foreign exchange reserves of the country have continuously declined, whereas the stock market has continuously risen (see Chart 1). A possible rationale for this is investors' expectations that IMF will approve the loan facility for Pakistan in September, following which foreign flows from World Bank, ADB, US Coalition Support Fund, Saudi Arabia, and foreign direct investments will start pouring in. Expectations of better governance and resolution of energy crises over the next few years by the present government are other key reasons for the upbeat performance of the stock market recently.

Forex market: After remaining reasonably stable in 2HFY13, Pak Rupee has depreciated by 2.9% in the interbank market and 2.7% in the open market during the last one month. We expect rupee depreciation to continue in the coming months due to lumpy IMF loan repayments, SBP's continued hands-off approach, currency devaluation of our competing countries like India, and IMF insistence to the government to devalue the currency. Pakistani currency is expected to devalue against key currencies by about 8% in FY 13-14.

Inflation: After hitting a multi-year low of 5.1% in May, headline inflation (CPI) has started rising again. We expect inflationary pressures to further intensify and headline inflation to hit double-digits by December 2013, driven by increase in GST rate, energy prices hike, reversal of base effect, continuation of strong growth in money supply, and currency devaluation.

Bond market: The yield curve has considerably steepened during July, suggesting that the bond market is expecting an interest rate hike in the near-future (see Chart 2). Bid patterns, with T-bills participation concentrated in the 3 and 6 month papers in the recent auctions, also corroborate this view. 10-year PIB yield has increased by 83bp to 11.76% in the last one month. However, short-term yields continue to drift lower due to ample liquidity injected in the system through massive government borrowing from the central bank. We expect interest rates to rise in the coming months due to: (i) rising inflation; (ii) expected restriction on government borrowing from SBP under the upcoming IMF program; and (iii) IMF persuasion to the government to raise the discount rate.

Stock market: Ignoring negative signals from bond/forex markets, the stock market has continued to show strong performance. The benchmark KSE-100 Index has risen by around 11% during July. After recent performance, stock market's price-to-earnings ratio has risen to about 8.9 times on 1-year forward earnings, as per our estimates. Given the expected rise in inflation and interest rates, we see slim chances of further re-rating of the stock market. In the immediate term, we expect the market to remain sideways in view of the tough decisions being undertaken by the government. However, on a one-year or longer investment horizon, we believe that the stock market will provide double digit returns to investors.

Chart -1 SBP Foreign Exchange Reserves versus the Stock Market

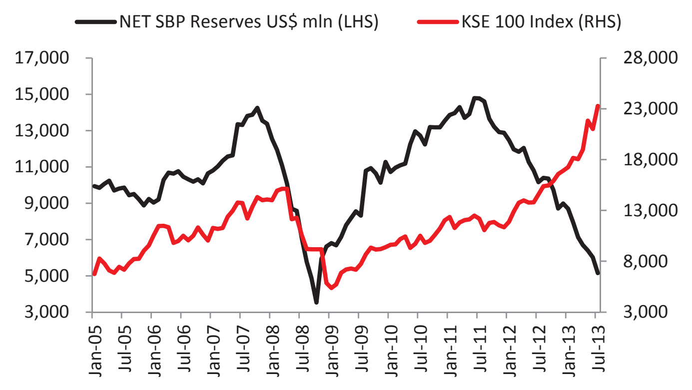

Chart -2 Yield curve steepens sharply