Investment Outlook FY 2012-13

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FY12 ended with subdued economic performance of the country. Economic growth has been merely 3.7% during the year, inflation (CPI) has averaged 11%, while the budget and current account deficits have been alarmingly high at 6% and 1.85% of GDP respectively. The Federal Budget for FY 2012-13 has been populous in nature with no serious attempt to tax those sectors which are under-taxed or not taxed at all. Also, no systematic efforts are being made to rationalize government expenditures. Thus, the budget deficit and the associated government borrowing are expected to remain elevated in this Fiscal Year as well. The Balance of Payment situation is also expected to remain under pressure due to the scheduled payments to the IMF. Moreover, the expected continuation of muted Foreign Direct Investment (FDI) and Foreign Portfolio Investment (FPI) flows will exacerbate this situation. Resultantly, the expected deterioration of the balance of payment position will leave no option with the government but to approach IMF for a new package within the next six months.

The positive news for the Pakistan economy and consumers is that the price of oil and other commodities have declined in international markets. Notably, the government has shared this benefit with the consumers. This move will contribute to contain inflation. However, sporadic and large government borrowing is still expected to stoke up inflationary pressures in FY12-13. As a result, we expect inflation and interest rates to remain at the present levels till December 2012 if commodity prices including oil remain at the current levels. However, if an agreement is not finalized with the IMF by December 2012, and the fiscal discipline of the government does not improve; inflation and interest rates are expected to rise and the Pakistan rupee may experience significant devaluation due to deterioration in the balance of payments and foreign exchange reserves position.

The Pakistani stock market is trading at a forward price-to-earnings of 7.2 times. The historical (last 10 years) price-to-earnings ratio of the stock market is 9.4 times. As a comparison, the price-to-earnings ratio of the Bangladesh stock market is 12.9 times, and Indian stock market is 14.4 times (see Chart 1). We believe that the economic and political risks are already reflected in the stock market. Sentiments related to the upcoming elections that are expected in March 2013 is likely to give a boost to the stock market. Despite muted economic growth rate of around 3% p.a. over the last 5 years, corporate earnings have risen by 17% per annum during the same period (see Chart 2). Moreover, corporate earnings are expected to rise by 15% in FY13. We expect the stock market to rise in line with corporate earnings during the FY13. For investors with an investment horizon of over a year we recommend investing in the stock market at the present levels.

Chart 1

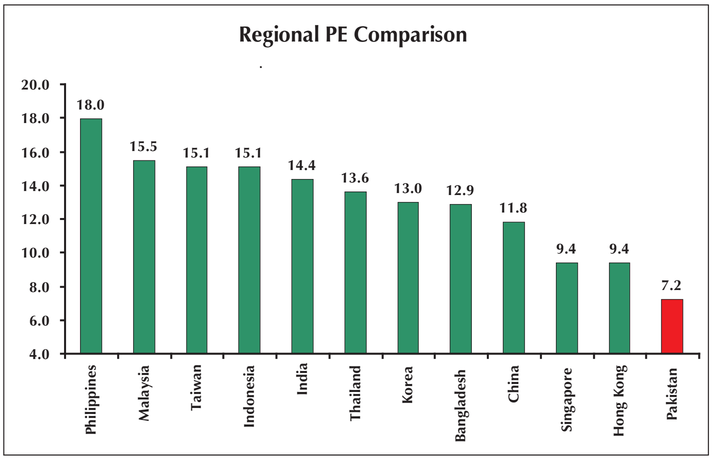

Chart 2