National Fullerton Asset Management Limited

Investment Outlook

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Capital Markets – Finally Recovering

In my "Investment Outlook" of December 2008, I had stated that I expect stock market performance in 2009 to be similar to that of 1999. In 1998, following the nuclear tests conducted by Pakistan, the Pakistani stock market dropped by 52.5% in a short span of 4 months. However, over the next 12 months, despite US economic sanctions, the stock market provided a 48% total return to investors. My prediction has been correct as the KSE 100 index has already risen 42% from its bottom on January 26, 2009.

I expect that the recovery in the stock market will continue in the coming months as well. My expectation is based on the following: (i) inflation and interest rates are already showing a declining trend, and it is expected that both of these indicators will show further significant reduction in the coming months; (ii) Pakistan's current account position has improved from a US$ 2.3 billion deficit in October 2008, to a US$145 million surplus in February 2009; (iii) the budget deficit is expected to remain around the target of 4% of GDP for FY08-09; (iv) the liquidity position has improved considerably in the market; (v) the stock market is trading at attractive valuations – the price-to-earnings ratio of the stock market is around 5.7 times on FY09-10 earnings versus a historical average of 9 times (see Chart 1); (vi) global stock markets are also in a recovery phase. The law and order situation in the country is dismal, and worsening of it is a major risk to the stock market and the country. However, the present law and order situation, in my view, is already reflected in the low stock market valuation. Pakistani stock market price-to-earnings ratio of 5.7 times is about half of the Indian stock market ratio of around 10.1 times.

The cash / income funds in the market are also benefiting from improved liquidity and reduction in risk aversion of TFC investors. TFC prices have risen substantially over the last couple of months. As a result, the performance of cash / income funds has improved considerably. The annualized return in March 2009 on NAFA Cash Fund is 19.63%, and on NAFA Income Fund is 28.55%. TFC prices are, in general, still below par, and are expected to rise further as inflation and interest rates recede. Based on our estimates, inflation (Consumer Price Index) is expected to decline to around 10% by June 2009 (see Chart 2). This does not mean that the prices of consumer and commodity prices will decline. This only means that the prices of these items are expected to rise at a slower pace than was the case a year ago.

In the medium term (3-5 years), the major risk is that as the global economy recovers, international oil prices may touch US$ 150/barrel once again. This will have severe repercussions on Pakistan's current account deficit and foreign exchange reserves. Pakistan has one of the world's largest coal reserves in the Thar region. It is imperative that we move quickly to utilize these reserves towards power generation to reduce our dependence on imported oil in the future.

Chart 1
Stock Market Valuation (Price-to-Earning Ratio)

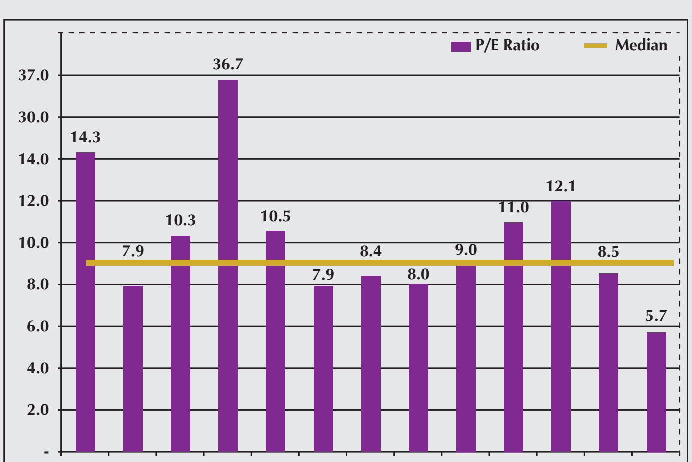

Chart 2
Inflation (CPI)