Dr. Amjad Waheed, CFA
Chief Executive Officer

Tighter liquidity conditions ahead

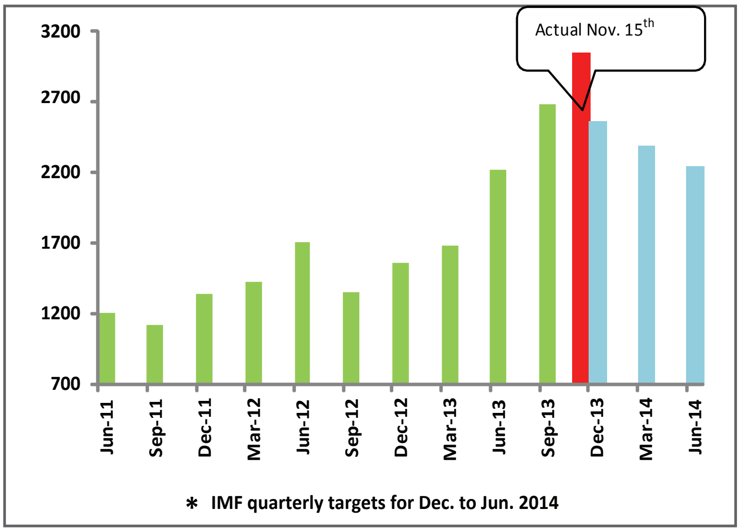
Local liquidity conditions remained notably easy over the last 2 years. Interest rates and money market yields declined to single-digits following 300bp cut in SBP discount rate to 9.0% on falling inflation. Further, due to subdued private sector credit demand and ample loanable funds with yield-seeking commercial banks, corporate debt issues were scarce and tightly priced. Resultantly, different long-term asset classes such as bonds, stocks and real estate delivered solid capital gain income.

The improvement in liquidity was solely brought about by excessive note printing by State Bank of Pakistan (SBP) to fund a sizable chunk of the ballooning fiscal deficit, which more than offset the external liquidity crunch created by a precarious balance of payments position. Thus, despite considerable decline in Net Foreign Assets (NFAs) of the system and corresponding foreign exchange reserves attrition, money supply (M2) growth remained robust due to substantial jump in Net Domestic Assets (NDAs). Amid subdued inflation numbers and moribund private sector credit demand, the aforesaid liquidity created by SBP kept the yield curve depressed during all this time.

Since June 30, 2011, NFAs of the banking sector have shrunk by nearly 95% or Rs738bn to just Rs42bn due to an adverse balance of payments position. In simple terms, this means Rs738bn have been converted into dollars and have left the system. However, more than making up for the dollar outflow, SBP has injected Rs1849bn in the system through note printing to fund the fiscal deficit. The above has resulted in sufficient growth in money supply to meet both public and private sector credit demand at lower rates.

The above situation is about to change now as the new IMF loan agreement bars further government borrowing from the central bank. Moreover, under increasingly stringent quarterly borrowing targets, the government will have to retire Rs809bn to SBP by June 2014 to reduce its borrowing to Rs2,240bn from Rs3,049bn at present. Further, SBP has also increased policy rate by 100bp in the last two bi-monthly monetary policy reviews mainly on account of rising inflationary pressures. On the credit demand side, we foresee ample government demand to finance its fiscal deficit as well as a pick-up in private sector appetite due to improving macroeconomic environment. With restricted monetary expansion, the above should culminate into higher interest rates and wider credit spreads.

Net outstanding Govt. borrowing for budgetary support from SBP (PKRbn) *



Being cognizant of the above, we have kept maturities of our money market funds short and totally avoided investment in fixed rate instruments. Further, we have kept exposure to corporate bonds to a minimal due to less attractive yield spreads. Thus, our fixed income funds are well positioned to take full benefit of higher expected yields in the coming months. Further, we have reduced our exposure in equities as stock market may react negatively to tighter liquidity conditions in the short-term. We are however bullish on the stock market over an investment horizon exceeding one year.

Disclaimer: This publication is for informational purposes only and nothing herein should be construed as a solicitation, recommendation or an offer to buy or sell any fund. All investments in mutual funds are subject to market risks. The NAV based prices of units and any dividends/returns thereon are dependant on forces and factors affecting the capital markets. These may go up or down based on market conditions. Past performance is not necessarily indicative of future results.