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A Subsidiary of National Bank of Pakistan

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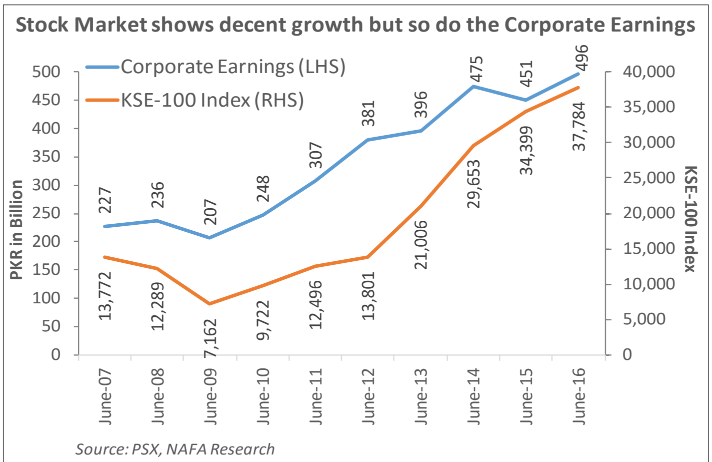
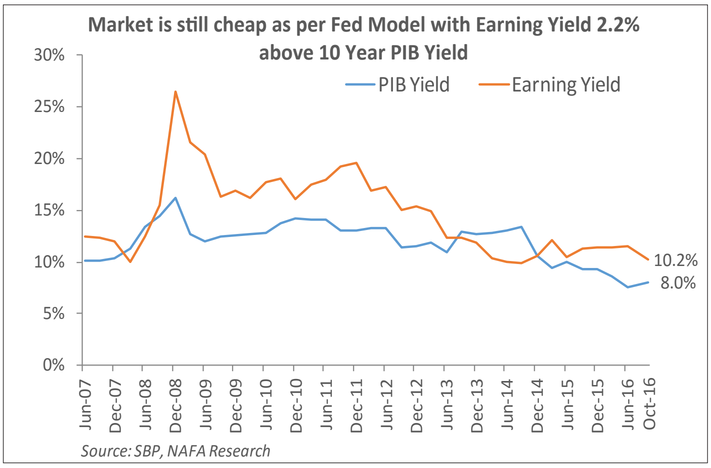
Is the Pakistani Stock Market Expensive?

Local stock market has delivered healthy returns over the last 9 years. The benchmark KSE 100 Index has risen by nearly three-fold from 13,772 level as on June 30, 2007 to around 39,894 points at present, translating into an average annualized return of 12.1%. Following this good performance, as the index level is near-all time high levels, many investors ponder whether the stock market is overvalued enough to deliver any gains going forward.

We would like to point out that simply looking at the Index level is often misguided without taking into account key stock market drivers such as corporate earnings growth, valuations (Price to Earning, Price to Book Value, dividend yield, etc.), macroeconomic prospects (GDP growth trend, inflation, interest rates, external account position, etc.), and geo-political & security situation. Corporate earnings growth and dividends have remained quite decent during the same period, driving all of the Index performance. For instance, earning of NAFA universe companies (70 stocks, representing 80% of market capitalization) have increased from Rs.227 billion in June 2007 to Rs.496 billion in June 2016. Consequently, market's Price to Earnings ratio has remained unchanged at around 9 times trailing earnings notwithstanding aforesaid increase in KSE-100 index.



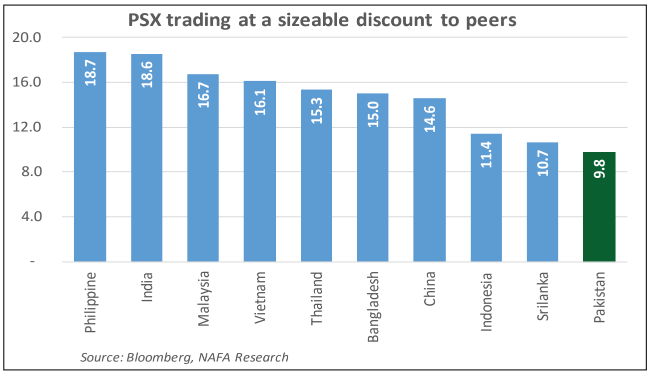
Source: PSX, NAFA Research



Source: SBP, NAFA Research

We expect corporate earnings and dividends to grow in line with nominal GDP growth (inflation + real growth) in the medium-term. Our estimate for this nominal growth rate is 11%, assuming 6% inflation and 5% real GDP growth. Real GDP growth hit an eight year high of 4.7% in FY16. Over the medium term, we expect economic growth of 5% driven by greater macroeconomic stability, ameliorating security and law and order condition, benign interest rate environment, higher development spending, implementation of infrastructure projects under the China-Pakistan Economic Corridor (CPEC), and resolution of structural bottlenecks, especially energy shortages.

Further, local stock market valuations, as captured in forward PE of 9.8 times and dividend yield of around 4.8%, are quite attractive vis-à-vis regional peers (average forward PE 15x) and a paltry 5-6% yield offered by the fixed income avenues. We expect Pakistan's market to rerate over the next 12 months on improving macroeconomic fundamentals, attractive stock market valuations, foreign portfolio inflows from funds tracking MSCI Emerging Market Index in 1HCY17, and local liquidity injection from the probable sale of strategic stake in PSX to a foreign operator by December 2016.



Source: Bloomberg, NAFA Research

We have also used a well-known valuation metric, the Fed Model to analyze the valuation of Pakistani stock market, based on market's forward earnings yield (reverse of PE ratio) and the 10-year PIB yield. The stock market is fairly valued when 1-year forward earnings yield on equities equals the 10-year bond yield. However, when earnings yield on stocks is more than that on bonds, investors generally switch from bonds to stocks. Likewise, when earnings yield on equities is below the long-term bond yield, investors generally sell stocks and buy bonds. As shown in the chart above, market's forward yield is still around 2.2% above that of 10-year PIBs, which corroborates our view that the stock market at these levels has room to offer attractive returns going forward.

In sum, based on the key drivers of the stock market, including the economic landscape, corporate fundamentals, inflation trends, and monetary policy backdrop, investors with medium to long-term investment horizon should still consider equities at the current levels.