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A Subsidiary of National Bank of Pakistan

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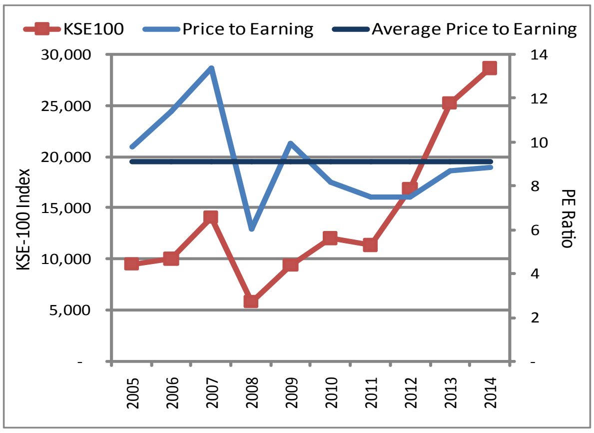
Is the Pakistani Stock Market Getting Expensive?

When 2014 began, our view was that the stock market is fairly valued and is expected to perform in line with the corporate earnings growth of around 20% during CY14. During the CY14 through April the benchmark KSE-100 has posted around 15% return to close at 28,913 levels. On a longer perspective, the KSE 100 Index has risen by 500% from the trough level of 4815 hit in January 2009 following severe exogenous and endogenous shocks facing global and domestic economy in 2008. Therefore, a key question on the mind of investors is whether the stock market is overvalued at current levels.



We think that looking at the market level in isolation, without taking into account its earnings multiple, can be misleading. The key driver of market performance is corporate profitability growth. Corporate earnings have grown at 16% on an average during the last five years. Thus, though the market has risen by 500% since January 26, 2009, the forward price to earnings multiple (PE) has merely increased from 5.0 times corporate earnings to 8.9 times corporate earnings. This is significantly below the peak PE multiple of 14.9 touched in April 2008. The present re-rating of the stock market has its roots in perked up investors' sentiments on the back of improving economic indicators, abundant domestic liquidity, healthy foreign portfolio inflows, political stability and a thaw in domestic security situation. On the macroeconomic front, signs of an economic revival are quite visible. For instance, Large Scale Manufacturing (LSM) growth has recovered to a 5-year high of 5.16% during July-February FY14; private sector credit has also picked up rising by Rs323bn during July-April FY14; fiscal indicators also depict considerable improvement as fiscal deficit was measured 2.1% (% of GDP) in 1HFY14; Inflation has also remained subdued clocking at 8.5% during the July-March, well below initial forecasts of double-digit price increases. Above all, the external account concerns have been largely addressed in the last two months following USD1.5bn aid received from Saudi Arabia, Eurobond issue of USD2bn and a successful 3G/4G spectrum auction in which the government raised USD1.1bn. Consequently, country's foreign exchange reserves have jumped to USD11.7bn and PKR has gained 6.1% against USD in the last two months. Improving external position, along with benign inflation numbers, makes a case for a rate cut in the upcoming monetary policy review meeting. With foreign flows expected to remain strong in the coming months (GDRs, higher multilateral lending), an upgrade of Pakistan sovereign rating is also likely.

While foreign portfolio flows, adding up to USD92mn just in April, have been driven by rising foreign investor comfort with the domestic economy, considerable increase in Pakistan's weight in the MSCI Frontier Market Index, and relative attraction of Pakistani market valuations vis-à-vis other frontier markets. As per the recent changes, Pakistan's weight in MSCI FM Index would soon increase from 4.29% to 8.88%, making the country the third largest constituent of the Index. Further, even after its strong performance, Pakistani equity market remains attractively valued compared to other emerging/frontier markets as depicted in the adjacent table.

Valuation Snapshot of Selected Emerging / Frontier Markets

	Price to Earning	Price to Book Value	Dividend Yield (%)
Pakistan	**8.9**	**2.2**	**5.6**
Vietnam	11.6	2.0	2.8
Thailand	12.0	1.8	4.0
Morocco	12.3	1.9	4.9
India	12.4	2.0	2.0
Qatar	12.5	2.1	4.5
Indonesia	12.9	2.4	2.9
Saudi Arabia	12.9	2.0	3.5
UAE	13.2	1.9	4.2
Malaysia	15.0	2.0	3.4
Philippines	16.1	2.4	2.4
Average	**13.1**	**2.0**	**3.4**

We hold a sanguine outlook on Pakistani stock market, especially in the medium term, given the country's immense unexploited growth potential. However, we will look for further structural reform measures in the upcoming budget to sustain and strengthen the budding economic recovery.