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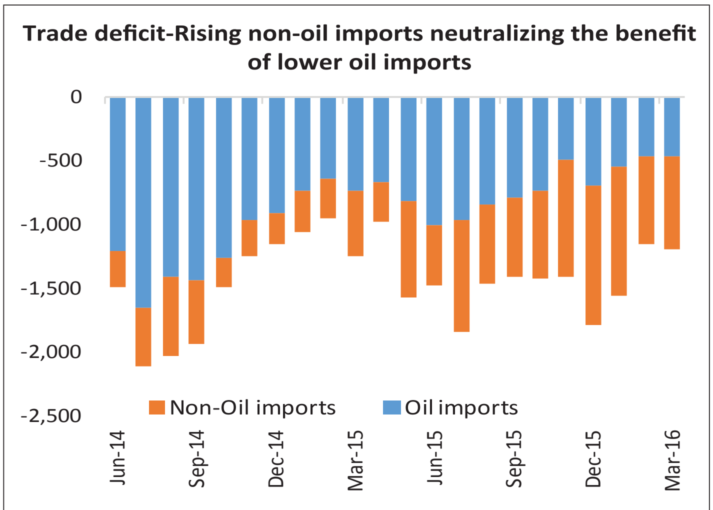
Pakistan Economic and Investment Outlook

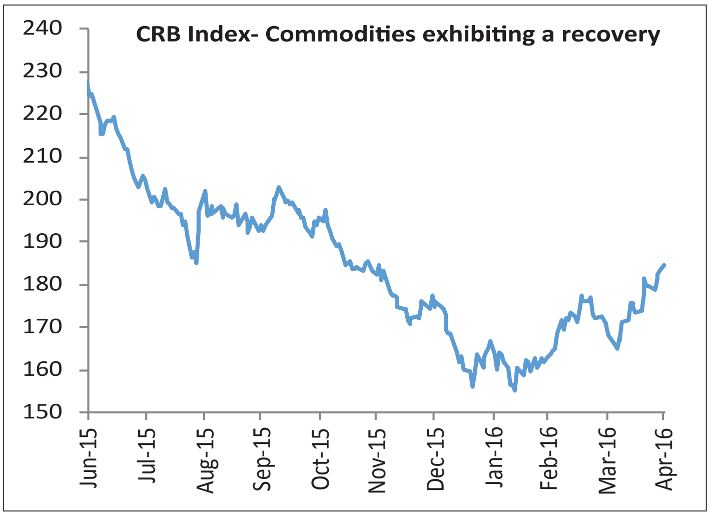
Benign FY16 but some concerns in FY17

With better part of the current fiscal year behind us, there is little doubt that Pakistan's economy, benefitting largely from commodity tailwinds, especially oil, and partly due to economic policy measures, would finish FY16 on an improving note. GDP growth is likely to touch 4.5% on the back of healthy consumption and investment demand, inflation to decline to about 3.0% and current account deficit to shrink to just 0.5% of GDP. The fiscal deficit is expected to remain around 5% of GDP in FY16.

On a forward looking perspective, we expect GDP growth to pick-up further in FY17, driven by improving power generation, rising investment demand, healthy consumption, and strong manufacturing activity. However, we see challenges to macroeconomic stability in the next fiscal year mainly driven by partial recovery in the commodity prices, especially oil, and probable policy complacency post current IMF program.

However, beneath the improved external account picture there are structural weaknesses that must be addressed for the recent improvement to gain traction. For instance, 9MFY16 data on external account reveals that 1) remittances growth is tapering off 2) rising non-oil imports have significantly offset the benefits of lower oil imports 3) exports are dwindling largely due to an overvalued exchange rate and global economic slowdown. Thus, despite USD3.8bn decline in oil import bill during 9MFY16, overall merchandize trade deficit remained unchanged at USD 13.2bn. Hence, even a moderate increase in oil prices to say USD55/bbl in FY17 would put substantial pressure on external current account.





The world leading research houses believe that the global food and non-food commodity prices have hit a bottom earlier in the year. We foresee a gradual rise in inflation during FY17 driven by (i) a partial recovery in commodity prices, which is already underway as reflected in the 19% jump in the broadly followed Thomson Jefferies CRB Commodity Index from February 2016 lows; (ii) expected devaluation of Pak rupee to address external vulnerability; (iii) rapid growth of monetary aggregates; and (iv) strong domestic demand in the economy. In view of the above, we think that the interest rate cycle has bottomed-out.

On the fiscal policy side, the current IMF program will conclude in early FY17. After that we see a serious risk of fiscal slippages as the government may opt for an expansionary fiscal policy rather than further consolidation. The government may also backtrack on necessary but tough structural reforms on taxation, loss making PSEs reforms, and governance, in view of strong public reaction. In the above scenario, the fiscal deficit is likely to exceed well above 5% of GDP in FY17 and beyond, which would pose a challenge to macroeconomic stability.

In this economic backdrop, we advise fixed income investors to avoid long duration instruments and keep their exposure in the short-end of the yield curve. The local stock market, being dominated by banks and commodity-related plays, has witnessed an earnings slowdown since 2015. The expected levy of one-off super tax applicable in the next quarter as well would further depress FY16 earnings by 4%-6%. However, we believe that the above is already priced in the present stock market valuations. Going forward, we expect the stock market to deliver a healthy double digit growth in FY17 driven by 5%-6% dividend yield, healthy corporate earnings growth, and strong possibility of Price-to-Earnings re-rating based on (i) attractive valuations vs. regional peers; (ii) expected inclusion of Pakistan in the MSCI EM Index; and (iii) resumption of double digit earnings growth. However, we also acknowledge that the stock market may exhibit volatility along the way on account of noise in domestic politics, and uncertainty on the global policy front.