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## *Is Economic Revival Around the Corner?*

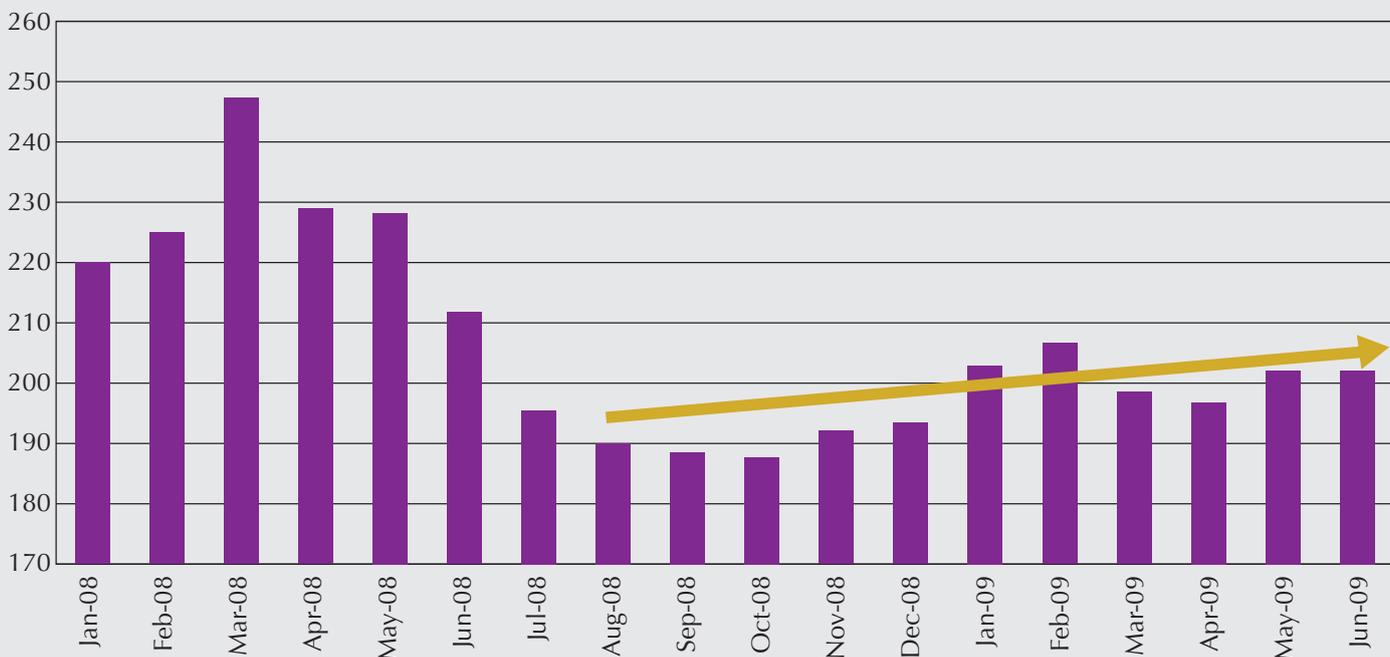
Large Scale Manufacturing (LSM) contracted by over 8% in FY09. Global recession as well as domestic factors such as power shortages, circular debt, law & order situation, lack of investor confidence stemming from a significant fall in foreign exchange reserves and downgrading of country's rating, played a role in this contraction. However, it seems that the economy has bottomed out, and there are signs of a recovery. The Index of Large Scale Manufacturing (LSM) bottomed out in October, 2008 at 187.8, and has since then gradually risen to 202.7 (see Chart below). Our investors in the textile, steel, auto and construction businesses have all been pointing to a recovery at the ground level. However, the recovery is expected to be slow and steady.

The key risks to this economic recovery are as follows: (i) high inflation, due to rise in global commodity prices, especially crude oil, as a result of global economic recovery; (ii) high current account deficit due to the huge oil import bill stemming from increased domestic power production; (iii) high interest rates due to excessive Government borrowing; and (iv) continued private sector's reluctance to invest. The most important step the Government can take to manage these risks is to keep its own spending and borrowing within manageable limits.

Liquidity is presently tight in the system, as is evident by the nearly 2% shrinkage in money supply (M2) during July-August 15, 2009. Despite this tight liquidity, the Stock Market has risen substantially during the month. This is driven by a record investment of US\$95 million by foreign investors during the month. Encouraged by attractive valuations and foreign support, local investors have also jumped in. However, the main beneficiaries of this rally are a few companies which have large enough free float and liquidity for foreign investors to enter. There are several smaller companies with very attractive valuations, which have underperformed despite strong fundamentals as foreign investors generally do not take positions in these companies due to their relatively lower liquidity.

The Pakistani Stock Market is now trading at a price-to-earnings ratio of around 8x on FY10 forecast earnings. Thus, the market seems fairly priced relative to historical averages and regional comparisons. Several blue chip companies are now trading close to their fair values, and the interest is expected to gradually shift to "value" rather than "size". In the long term, it will be the economic fundamentals, especially the direction of interest rates, inflation, budget and current account deficits that will determine the direction of the Stock Market rather than foreign buying.

### *Index of Large Scale Manufacturing (LSM)*



Source: Federal Bureau of Statistics