Sovereign Risk and the Pakistani Stock Market

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Presently, Pakistan has been assigned "B-" sovereign rating by Standard and Poor's (S&P). The rating pertains to a country's ability and willingness to service its commercial debt on time and in full. There are five key factors that form the basis of sovereign rating of S&P. These are: (i) institutional effectiveness and political risks; (ii) economic structure and growth prospects; (iii) external liquidity and international investment position; (iv) fiscal performance and debt burden; and (v) monetary flexibility.

S&P assigns ratings to 126 sovereign governments, and Hellenic Republic (Greece) is the only country among these governments that has been assigned a rating below than that of Pakistan. The other four countries that have been assigned the same B- rating as that of Pakistan are Belize, Ecuador, Grenada and Jamaica. Pakistan is ranked at the bottom of the list while India and Bangladesh are ranked 65th and 86th respectively. Several African countries like Uganda, Burkina Faso, Cameroon and Ghana are ranked higher than Pakistan.

Pakistan's ranking should be a cause of concern for all stakeholders. The present economic situation raises the likelihood of a worsening economic, social, and security situation. Such a scenario will substantially increase the miseries of the people and the businesses, and it could take over a decade to recover from it. The solutions to avert it are already well documented: (i) taxing all sources of income, and imposition of heavy penalties and imprisonment for those not paying their due share; (ii) reduction of non-productive spending: (iii) privatization of state-owned enterprises; (iv) improvement of social net for the poor such as expansion of Benazir Income Support Program, and basic facilities such as education, health care, clean drinking water, etc. ; (v) providing an enabling environment to the private sector to grow by reducing government budget deficits and interest rates, improving law & order situation, and resolving the energy crises.

An important question for investors in the Pakistani stock market is whether the country risk is already reflected in the share prices. To answer this question we have analyzed the stock markets valuations and economic growth rates of 40 countries in relation to their risk rating. Table 1 summarizes the results. For all categories of rating above "B", the earnings yields of the stock markets are in the range of 7.8% to 10%, with an average yield of about 9%. The earnings yield of the Pakistan stock market is around 16%. Purely based on earnings yield, and ignoring the economic growth prospects and risks, Pakistan's stock market seems very attractive versus other countries. When compared with the stock markets of countries in the same rating category (B), the Pakistan's market has a higher earnings yield. The higher earnings yield versus other countries is a reflection of the higher inflation and credit risk. Investors demand a higher return while investing in Pakistan to be compensated for the higher risks versus other countries.

Based on the 16% earnings yield, we believe that the economic risks and growth prospects are adequately reflected in the Pakistan's stock market valuations. Some foreign and local investors will be bold enough to continue to invest despite high economic risks in pursuit of higher returns. Investing in the stock market means investing in businesses. Businesses generally increase the price of their products and services in line with the inflationary trends. Thus, investing in the stock market for the long-term can be a good hedge against inflation.

Table 1 – Sovereign Risk and Stock Market Valuations

Rating Category	No. of Countries	Earnings Yield 2011F	GDP Growth 2011F
AAA	12	9.6%	2.8%
AA	7	7.8%	3.1%
A	6	9.1%	3.8%
BBB	9	8.7%	4.4%
BB	3	9.8%	4.4%
B	3	14.0%	4.3%
Average	**-**	**9.1%**	**3.6%**
Pakistan (B-)		**16.2%**	**2.4%**