



National Fullerton
Asset Management Limited

Investment Outlook 2010

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The New Year is expected to be another difficult one for Pakistan. The economic, security and political challenges that the country faced in 2009 will take time to improve. There are structural problems that Pakistan is facing such as the lack of adequate spending on basic education, health care and infrastructure. Lack of sufficient education spending on the poor over the years created the gap, which has been filled by the 40,000 or so madrassahs. Successive governments have paid no attention to development of energy, especially alternate sources of energy such as coal, hydel, wind, nuclear, etc.. This has resulted in not only a severe shortfall of energy, but also production of very expensive energy versus our neighbors such as China and India, where more than 50% of the electricity is generated by indigenous use of coal. These problems have been building up for decades and it will take years to resolve them, even if we start now.

In the short term, the key steps that the government needs to take to improve the economic situation is to control its expenses, especially non-productive spending. The policy of just borrowing internally and externally and spending at this high rate will increase our debt and debt servicing to unsustainable levels in the next few years. We will continue to fall deep in the debt trap. Excessive government borrowing also results in interest rates remaining high, and crowds out the private sector. The government has already set up a Committee to be chaired by the Finance Minister to suggest austerity measures. Let's hope that the recommendations of the Committee are implemented at the earliest. The Government also needs to bring those sectors under the tax net which are presently not paying their due share of taxes including agriculture and services sectors, and those investors earning capital gains on sale of their assets such as real estate, stocks, etc.

The year-to-year inflation (CPI) is down to 10.51%. However, if we examine the monthly inflation average over the last two months (October – November), the annualized inflation for this period is 14.06%, which is a cause of concern. We do not expect that the State Bank of Pakistan will be able to make any significant reduction in the discount rate considering the monthly inflation rate, and the fact that this rate is expected to remain high in the coming months due to the recent rise in utility prices. KIBOR is also expected to decline only marginally and gradually considering the high inflation rate, excessive government borrowing, circular debt issues and tight liquidity situation in the market.

The economic growth rate is expected at around 3% per annum in 2010 due to the global economic slowdown, internal security situation, high interest rates, and a significant drop in foreign direct investment. The current account deficit has improved significantly over the last year. It averaged US\$ 721 million per month in 2008 and around US\$ 256 million per month in 2009. High foreign remittances and a drastic reduction in imports have primarily contributed to improvement in the current account deficit and this trend is expected to continue in 2010. This means that there will not be excessive pressure on the rupee versus other currencies, although a normal devaluation of rupee of 5%-6% against key currencies during the year is possible.

A significant improvement in the economic and liquidity situation can be seen if the promises of foreign assistance made by the US and other Western countries, and donor agencies materialize in 2010. This will help the government clear the circular debt and reduce domestic borrowing, which may help bring down interest rates.

The Pakistani stock market is presently trading at around 8 times forward earnings versus regional markets that are trading at around 14 times forward earnings. Thus, the market is trading at a 45% discount to regional markets, which we believe is justifiable based on the high political, security, and economic risks of Pakistan versus regional countries. The corporate earnings of listed companies in Pakistan are expected to rise by 18% in 2010. We expect the Pakistani stock market to rise in line with the trend in corporate earnings in 2010. The trigger points will be improving liquidity on receipt of foreign inflows, implementation of margin financing / leverage products, and expected improvement in the law and order situation. We expect Oil & Gas, Fertilizer, and power sectors to perform well.

The Fixed Income (TFC / Sukuk) market is also expected to perform well in 2010. In Q4, 2008, TFC prices declined sharply by around 15% as a result of severe economic and liquidity crises. In 2009, TFC prices have



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in general risen by around 9%. However, most TFCs are still trading at around 5%-10% below their par values. We expect TFC prices to rise further in 2010, resulting in narrowing of discounts relative to par values. One reason for this is that the period to maturity of TFCs will reduce further. Another reason is that the TFCs are offering a very attractive return of 18% per annum at present. Also, some TFCs that had defaulted over the last couple of years are now being restructured. Income / balanced funds in general have substantially provided for these TFCs, and will be in a position to gradually reverse back these provisions, thus providing attractive returns to their investors in the process.

Money Markets – primarily Government Treasury Bills - rates are expected to remain on the higher end in 2010, due to expected continued excessive reliance of Government on T-bills to meet its budget deficit. Thus, the return on Government Securities / money market mutual funds is expected to remain attractive for investors in 2010 in the range of 10% - 11% per annum.

Considering the security and economic risks in the country, investors' risk aversion is expected to continue to be on the higher side as was the case in 2009. This is evident from the fact that the fastest growing mutual fund category in 2009 was the money market / government securities funds. NAFA Government Securities Liquid Fund, rated AA+ by PACRA, was launched in mid-May 2009, and is among the fastest growing funds in the market. The Fund has provided an annualized return of 10.81% since inception, and the unit price has not declined on any day since its launch. Below is the list of key Fixed Income / Money Market funds in the market, along with their ratings. The highest rated funds are also the fastest growing funds. We expect that this trend of investors preferring the safe money market funds will continue in 2010 as well.

Key Fixed Income / Money Market Funds

S. No.	Fund Name	Stability Rating
1	NAFA Government Securities Liquid Fund	AA+(f)
2	UBL Liquidity Plus Fund	AA+(f)
3	JS Income Fund	AA-(f)
4	NAFA Cash Fund	A+(f)
5	Meezan Islamic Income Fund	A+(f)
6	ABL Income Fund	A+(f) *
7	United Growth & Income Fund	A(f)
8	Faysal Savings Growth Fund	A(f)
9	Askari Income Fund	- **
10	MCB Dynamic Cash Fund	- **

* As of December 31, 2009

**Rating (Recent) Not Available

- These are all funds in the market with fund size of over Rs. 3 billion as of November 30, 2009
- Stability Rating is compulsory under SECP rules
- Ratings are awarded by PACRA & JCR and are as of November 2009