Capital Markets Outlook 2012

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Calendar year 2012 is expected to be another challenging year for Pakistan's economy and investment climate. The economic growth will continue to be constrained by government's excessive budgetary financing from domestic sources resulting in the crowding out of private sector. The law and order situation is not expected to improve substantially, especially due to slowdown in job creation in an environment of prevailing high unemployment rate in the country. It will be difficult for the Government to introduce new taxation measures as elections are around the corner. In the absence of any significant foreign investment, the balance of payment situation is expected to be worrisome due to the growing trade deficit and large payments becoming due to the multilateral donor agencies. This in turn is expected to put further pressure on the rupee, which is expected to weaken by about 10% in 2012.

Inflation has eased recently, 13.3% in June 2011 to 10.2% in Nov 2011, largely driven by easing of food prices and change in CPI calculation methodology. Concomitantly, the State Bank of Pakistan reduced the discount rate by 200 basis points in the last 6 months. However, there is a fear that excessive government borrowing averaging about Rs 3 billion per day will make it very difficult to contain inflation. Moreover, the utility prices will also have to be increased to better manage the circular debt and energy shortages. In such a scenario, inflation may start rising again and the discount rate may have to be increased again by the mid of 2012. Thus investors are advised to shorten the maturities of their investments in Treasury bills, Pakistan Investment Bonds, and bank deposits. This will help them to benefit from high interest rates if such a scenario materializes. In this environment, investors should avoid investments in fixed rate long-term instruments such as Pakistan Investment Bonds and Defence Savings Certificates and instead focus on Treasury Bills and term deposits of below one-year maturity.

The Pakistani stock market has depicted lukewarm performance in the second half of CY 2011, declining by around 10%. The stock market is trading at a forward price-to-earnings multiple of 6.6x offering dividend yield of 8.9%. We believe that the economic and political situation of the country is already reflected in the stock market valuations. Despite weaker economic growth; and uncertain political and security situation, corporate earnings are expected to grow by 18% in 2012. As can be seen from Chart 1 below, although the economy has depicted slower growth during the last few years, corporate earnings have remained robust, growing on average by 19% over the last four years. This trend is expected to continue in the future as well. As Chart 2 below shows, presently the earnings yield of the stock market is better than the 10-year PIB yield, which is another indicator that the stock market is attractively priced. Further, we believe that the political climate will also improve in 2012. Thus on a one-year or longer investment horizon, stock market investment is expected to reward new investors as well as those who are already invested. A possible qualification to our assessment is a substantial deterioration of external accounts that could unnerve foreign and local equity investors. Thus, investors are advised to keep a close watch on the current account situation.

Chart 1

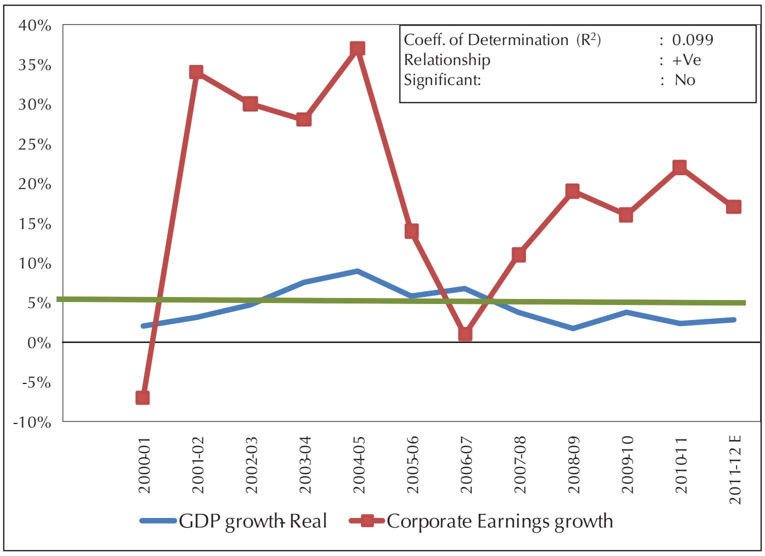

Chart 2