NBP Fullerton Asset Management Ltd.
A Subsidiary of National Bank of Pakistan

Investment Outlook CY 2013

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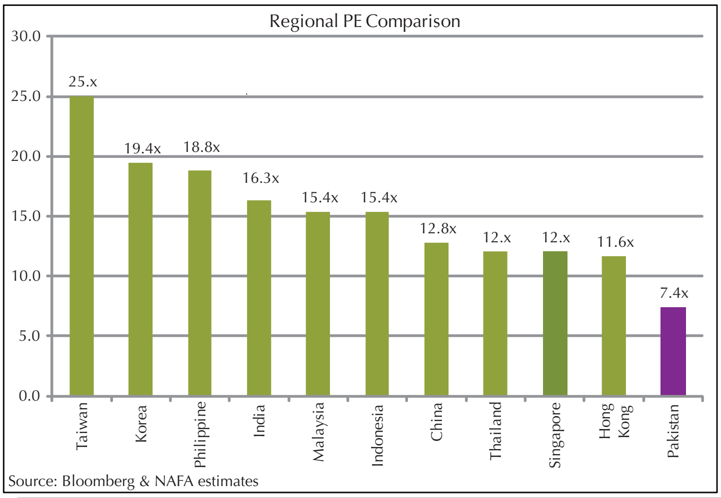
The stock market depicted a very healthy performance during CY12, posting around 50% returns with the Index reaching all time high levels. Key drivers for this upbeat performance of the stock market were (i) attractive valuations; (ii) relaxation of Capital Gains Tax regime; (iii) monetary easing with 250 bps reduction in policy rate by the SBP based on the easing in inflationary pressures; and (iv) materialization of much needed inflows on account of Coalition Support Fund. Overall, economic performance remained dismal due to structural issues facing the economy emanating from power shortages, crowding out of the private sector credit by the excessive government borrowing, muted foreign inflows, large foreign loans payments and deteriorating law and order situation in the country.

IMF has projected economic growth of 3.3% for FY2012-13 against 3.7% for the previous year. Large scheduled foreign loan payments and rising trade deficits are depleting foreign exchange reserves, which are exerting pressures on the exchange rates. This trend is expected to continue in CY 2013 as well. Slippages on the already rising fiscal deficit are highly likely in the election year, which is predominantly being financed from the domestic sources due to paucity of foreign flows. Highly inflationary government borrowing from the banking system; supply side bottlenecks due to subdued private sector investment in the wake of power shortages; and imported inflation due to currency depreciation are stocking up inflation expectations.

With general elections around the corner, we expect that the new administration will enact policies aimed at improving the fiscal discipline by rationalizing government expenditures and taxing the non-taxed and under-taxed sectors of the economy. The other key policy priority will be to bring structural reforms for resolving the chronic power sector issues facing the economy. Measures are expected to be introduced to attract foreign flows in the backdrop of unprecedented global monetary easing. New administration will have no option but to enter into a new financing package with IMF under the tougher conditions to buy some time to bring the reeling economy back on its feet. Restructuring and / or privatization of the debt laden and poorly run public sector enterprises will be all the more important to save large government outlays. Blanket subsidies in the agriculture and power sectors need to be reconsidered, while providing the safety net where necessary. Improvement of the law and order situation will also be of paramount importance for the economic uplift. Declining trends in the saving and investment rates will need to be reversed by enacting investment friendly policy measures, which are important to make a real dent in alarmingly high unemployment rate.

Pakistani stock market is currently valued at around 7 times forward earnings, on average, and is offering 7.5% dividend yield. At these levels the market is at a higher discount compared with the regional markets based on the historical comparison (see chart 1). In over view, corporate earnings are expected to grow by around 17% in the next four quarters. As chart 2 reflects, corporate earnings continued to grow at a healthy rate of around 20% per annum versus the nominal GDP growth of 17% per annum during the last 10 years. As we see it, stock market is fairly valued at these levels and may post returns in line with corporate earnings growth rate during the next year. However, investors may witness downside in the short run with the expected rise in inflation and interest rates in the coming months. We like shares of companies with strong balance sheets, healthy dividend payouts and lower business risks. Our preferred investments in the fixed income category are floating rate TFCs belonging to the AA & above rated companies in the banking and corporate sectors; and short maturity T-Bills. We continue to avoid investing in fixed rate PIBs, to protect investors from pricing risk due to latent upside risks to the interest rates and associated liquidity squeeze.

Chart 1



Source: Bloomberg & NAFA estimates

Chart 2