Dr. Amjad Waheed, CFA
Chief Executive Officer

Economic and Investment Outlook 2015

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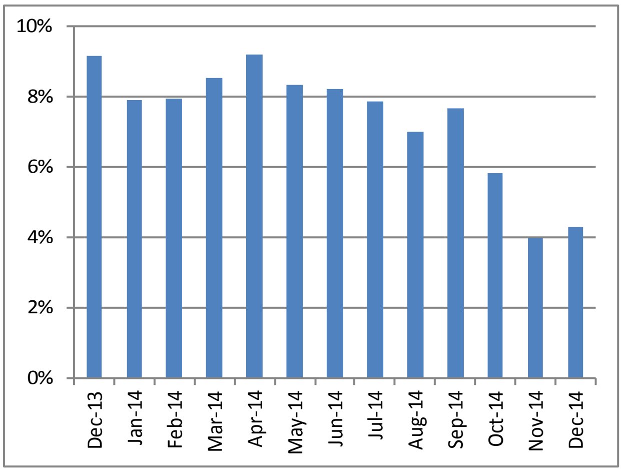
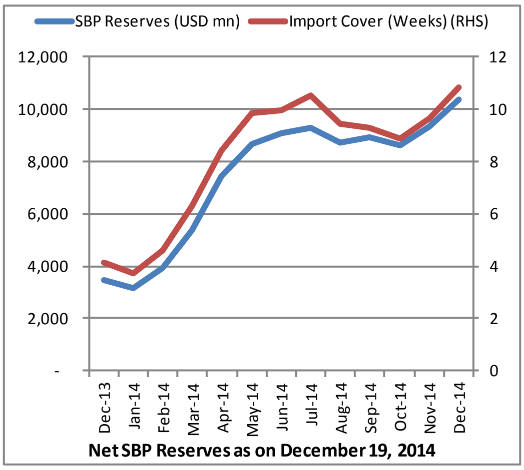
The year 2014 has ended on an optimistic note for the domestic economy. Key positives include: i) significant abatement in inflationary pressures as captured in subdued headline inflation numbers, particularly in 4QCY14; ii) strengthening of external account position as reflected in rising forex reserves and stabilization of Pak rupee; iii) considerable fall in money market yields following a reduction in policy rate in November; iv) contained budget deficit demonstrating government's commitment to fiscal discipline ; and v) decline in political tensions after prolonged sit-ins and demonstrations by some opposition parties.

Significant Decline in Headline Inflation



Healthy Increase in Forex Reserves



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With 2014 coming to an end, key question on the mind of investors is what lies ahead in 2015 for the local financial markets. Subject to continuation of structural reforms and a stable political and security situation, we hold a positive economic and investment outlook for 2015.

Being a big net commodity importer, Pakistan stands to benefit immensely from the latest decline in global commodity prices, especially 50% drop in crude oil prices. First, oil makes up about 40% of Pakistan's imports. Based on FY14 trade figures, every USD10/bbl drop in oil price saves Pakistan an annual USD1.4 billion in imports. The recent decline, if sustained, could lower country's import bill by USD5-6 billion over a 12 month period. The above would significantly strengthen Pakistan's external account position. Second, lower oil prices would enhance GDP growth rate due to its positive impact on household income and lower cost of production for the industry. Third, lower oil prices would keep inflationary pressures at bay. Lastly, cheaper oil narrows Pakistan's budget deficit by reducing energy subsidies, which are huge.

We expect macroeconomic indicators to depict a healthy trend in the new calendar year.

We expect that higher household expenditures, lower input costs and an expected improvement in energy supply is likely to bolster GDP growth to 5%. Inflation is expected to remain benign at 6%-7% due to continued soft commodity prices and restricted money supply growth. Budget deficit for the current fiscal year is expected to be around 5.5% of GDP on account of lower subsidies and development expenditures. In view of further expected improvement in foreign exchange reserves and external account, exchange rate is likely to remain stable in 2015.

In our view, an unforeseen and significant deterioration in political situation is the chief risk to macroeconomic stability and budding economic recovery.

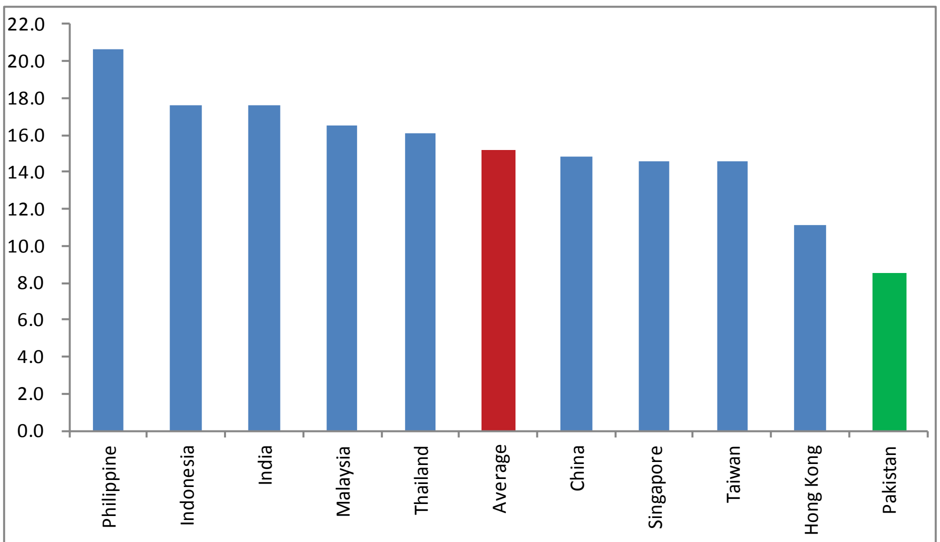
Our view is premised on continuation of structural reforms agenda which requires consensus among major political parties. As mentioned in the latest IMF staff report, Pakistan would need to continue with fiscal, financial and energy reforms and undertake some strategic privatizations of power distribution companies in CY15 and beyond. Some of the measures agreed with IMF, including hike in gas and electricity tariffs, additional taxation measures to plug revenue shortages, restructuring of Public Sector Enterprises (PSEs) and strategic privatizations, being publicly unpopular would require broad agreement between political parties. In our view, an unforeseen and significant deterioration in political situation is the chief risk to the macroeconomic stability and budding economic recovery.

Debt markets have already started responding to falling inflation expectations and improving macroeconomic outlook as yields on long-term bonds (3-10 years) have declined by around 300bp in the last quarter of the CY14. We see strong likelihood of another 50-100bp cut in discount rate in the next monetary policy review meeting. We expect the yield on the debt instruments to remain subdued in CY15 due to benign inflation outlook, restricted budget deficit and higher government borrowing from external sources.

Stock market remained buoyant with the benchmark KSE-100 Index rising by 27% during 2014.

Notwithstanding some hiccups witnessed at the height of the political crisis during Aug-Nov, Pakistani stock market remained buoyant with the benchmark KSE-100 Index rising by 27% during CY14 despite lackluster performance of index heavy Oil & Gas sector amid collapsing global oil prices. It merits mention that our NAFA Stock Fund has generated 39% return during CY14, out-performing the stock market by 12%. This out-performance is net of management fee and all other expenses.

Pakistan Stock Market Trading at a Significant PE Discount to Regional Peers



Source: Bloomberg, NAFA research

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

Despite lower earnings growth, we expect the stock market to deliver double-digit returns in 2015 on earnings multiple rerating.

The stock market is now trading at reasonable forward earnings multiple of 8.5, which is attractive in comparison with regional peers and historical levels. Corporate earnings growth is expected to decelerate to 10% in 2015 due to the drag from oil stocks. However, we see strong possibility of multiple rerating due to improving macroeconomic fundamentals going forward and easy monetary environment. We expect that in view of falling inflation and lower oil prices, companies with high dividend yield, gearing and/or energy-intensive manufacturing are likely to outperform. Despite relatively lower corporate earnings growth, we expect the stock market to deliver healthy returns in 2015 on earnings multiple rerating.