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

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Is The Pakistani Stock Market Overvalued?

Since June 2015, the Pakistani stock market has posted around 13% return. On a longer horizon, the KSE 100 Index has posted around 600% return in six years from the trough level of 4,815 it touched in January 2009. With the KSE 100 Index hitting new highs, a key question in the mind of investors is whether the stock market is overvalued at current levels! Some are even making an analogy with the peak level hit in 2008 which was followed by a steep collapse of the stock market later in the year. We have been repeatedly hearing aforesaid concerns in the midst of significant volatility witnessed last month wherein the stock market depicted large swings between gains and losses.

Presently, the stock market Index is trading at 33,600 levels. However, merely looking at the absolute stock market levels in isolation can be misleading without taking into account the key stock market drivers. Stock market valuations, for example P/E and P/B multiples, are reasonable and corporate earnings growth is robust. Also, key macroeconomic indicators such as interest rates, inflation, external account position and GDP growth are improving. In addition, the law and order and political situation are stabilizing.

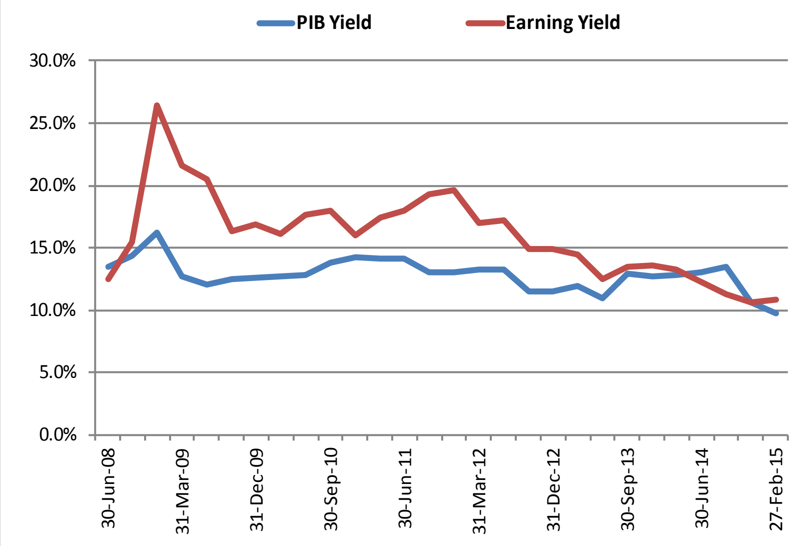
2015 versus 2008

	FY2008	FY2015F
Market PE*	14.9x	9.2x
Foreign Exchange Reserves (USD bn)	11.4	17.7
Import Cover (number of weeks)	8.6	19.1
Current Account Deficit as % of GDP	8.2%	0.9%
Fiscal Deficit as % of GDP	7.3%	5.5%
Inflation	12.0%	5.5%
SBP Discount rate	12.0%	8.0%

Source: SBP & NAFA estimate
*Forward

Stock market performance has been phenomenal over the last few years. However, as per our estimates, the forward price to earnings multiples of the stock market is still reasonable at 9.2 times due to strong corporate earnings growth. This is much lower than the peak PE multiple of around 15x touched in April 2008. Moreover, compared to 2008, key macroeconomic indicators depict a better picture of the economy, which should support further re-rating of the stock market in the coming months. For instance, inflation has declined to under 4.0%, fiscal deficit has narrowed to just 2.2% of GDP in 1HFY15 and foreign exchange reserves have increased to around USD16bn by February. Supported by lower commodity prices, especially crude oil, GDP growth is likely to hit a multi-year high of 4.5% in FY15 and external account is expected to post a sizable surplus driven by a narrow current account deficit and healthy inflows under financial account. Moreover, the yields on fixed income investment avenues have declined sharply with 10- year PIB yielding just 9.7%, thus making equities attractive on a relative basis.

We have used the Fed Model to analyze the valuation of Pakistani stock market, based on market's forward earnings yield and the 10-year PIB yield. The stock market is fairly valued when 1-year forward earnings yield on equities equals the 10-year bond yield. However, when earnings yield on stocks is more than that on bonds, investors generally switch from bonds to stocks. Likewise, when earnings yield on equities is below the long-term bond yield, investors generally sell stocks and buy bonds. As shown in the chart below, market's forward yield is still around 1.2% above than that of 10-year PIBs, which corroborates our view that the stock market at these levels has room to offer attractive returns going forward.



Source: SBP & NAFA estimate

That said, in the short-term we may see some profit taking after a strong rally in the stock market. We believe that this correction will be a short term phenomenon and an opportunity for the value investors to build position in the market considering the favorable investment backdrop for equities.