Investment Outlook

National Fullerton
Asset Management Limited

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Capital Markets in FY 2010

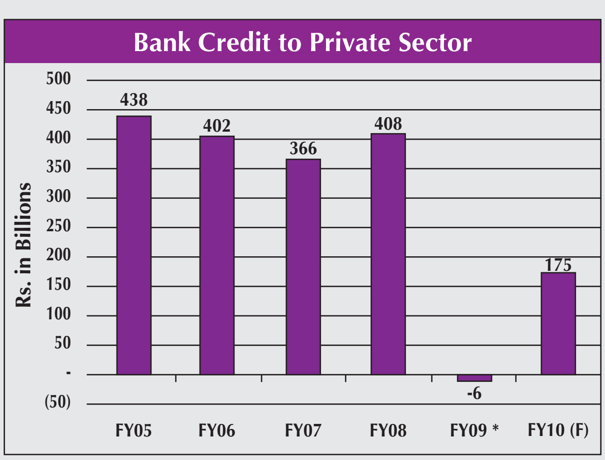
Fiscal Year (FY) 2009 (July 1, 2008 – June 30, 2009) was a very difficult year for the Pakistani capital markets. Interest rates remained very high, driven by high inflation and risk aversion, resulting in crowding out of the private sector. Private sector borrowing dropped drastically from Rs 408 billion in FY08 to a negative Rs 6 billion in FY09 (Chart 1). A sharp rise in interest rates and abnormal tightening of liquidity kept the bond / TFCs prices volatile and depressed. The Stock Market (KSE 100 Index) declined by 41.72% in FY09, which is one of the worst performances in the history of the Pakistani stock market.

The following three factors will have a major impact on capital markets in FY10: (i) extent of government domestic borrowing; (ii) amount of foreign funding; and (iii) law and order situation. The recently announced budget for FY10 seems expansionary in nature. The Government plans to increase development spending to over Rs 646 billion from Rs 419 billion last fiscal year, which is admirable. But this is not being done by reducing non-productive spending. In fact, development spending, non-development spending and debt servicing are all projected to rise significantly in FY10. Revenue collection is projected to remain at a dismal 9.3% of GDP. This means that there will again be extensive reliance on borrowing and foreign inflows. The Government has projected to borrow Rs 250 billion again next year mainly from national savings schemes. Actual borrowing may turn out to be much higher. This will most likely again crowd out the private sector, which is the more productive and efficient sector relative to the Government. This will also force businesses to borrow at high rates, as the Government will continue to offer attractive rates on national savings schemes.

Inflation (CPI) has dropped from 25.33% p.a. in August, 08 to an estimated 13% p.a. in June 2009. We had earlier projected the inflation and interest rates to decline to single digits by October 2009. However, after seeing an expansionary budget, and expected rise in power rates and petroleum prices, we expect interest rates (6-month KIBOR) to be around 12% and the inflation rate to be at 9.5% by October 2009, which will only gradually go down further provided sufficient foreign funding materializes. The government is expecting over US$ 6 billion from the international donor agencies, the US, and Friends of Pakistan. Of this, US$ 2 billion is expected till September, 2009. If this materializes, liquidity will improve substantially, resulting in lowering of interest rates. The current account balance is well under control, with a surprise current account surplus of US$ 406 million reported in May, 2009 (Chart 2). Following the success of the Swat Operation, terrorism is expected to be relatively better contained in FY10, although not completely eliminated.

Corporate earnings are expected to rise by 15%, on average, for FY10. We project the Stock Market (KSE 100 Index) to be around the 9,500 level by June 2010. Presently it is trading around 7162 level. This means that a 33% upside is expected in one year. This is based on an assumption of slow and steady recovery in economic growth rate. Good rated TFCs declined substantially in 2H, FY09. They have risen since then, but are still trading, on average, 8% below their par value. We expect that these will be trading at around par by end of FY10. Thus, both NAFA equity-related funds and cash / income funds are expected to do well in FY10.

(Chart 1)



** Till June 20, 2009*

(Chart 2)