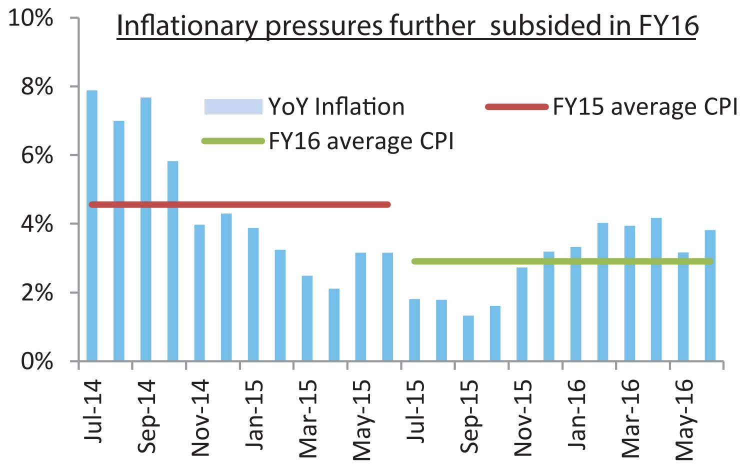
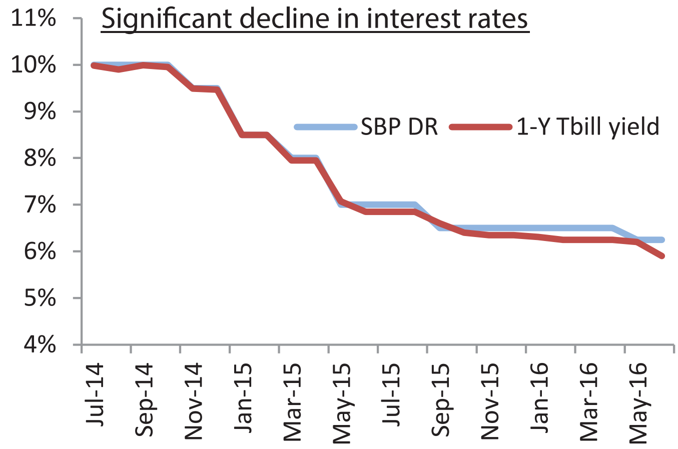
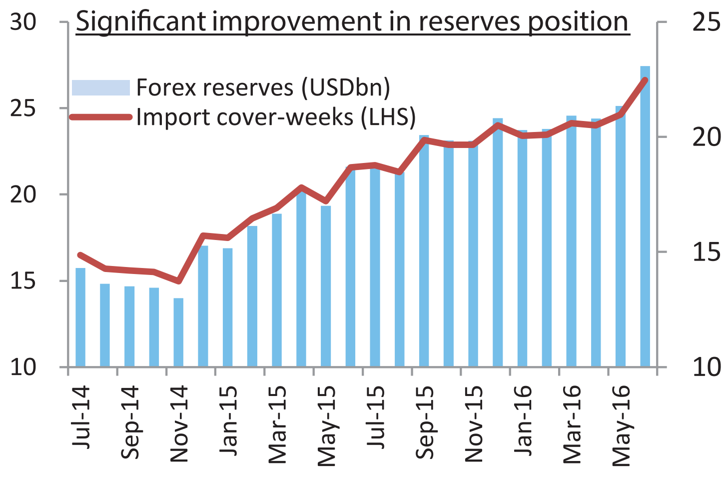
Dr. Amjad Waheed, CFA
Chief Executive Officer

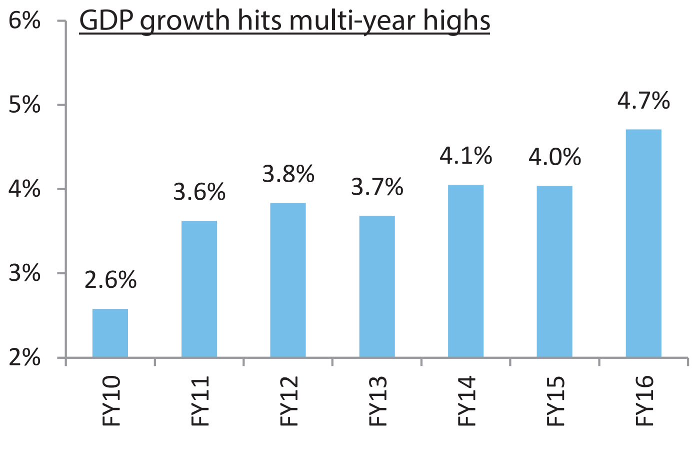
Fiscal Year 2017 Economic and Investment Outlook

Pakistan's economy finished fiscal year 2016 on a promising note though mainly helped by the global developments, notably a sharp decline in global commodity prices including crude oil. This is reflected in the following indicators: (i) low Inflationary pressures as captured by 2.9% average CPI inflation in FY16; (ii) strengthening balance of payments position as manifested in record foreign exchange reserves (USD23.1bn that translate to 27 weeks of import cover) ; (iii) stable exchange rate as reflected in just 3.0% PKR depreciation against US Dollar during the fiscal year; (iv) budget deficit shrunk to under 4.5% of GDP due to lower subsidy burden and healthy tax revenue growth; (v) interest rates falling to mid-single digits; and (vi) economic growth accelerating to an 8 year high of 4.7%.









We expect further pickup in domestic economy in FY17, driven by improving power supply situation, continuation of benign oil prices, a positive macroeconomic policy direction, and tangible progress on CPEC related projects. In fact, Pakistani economy, being mainly domestic demand driven with limited global financial and trade linkages, is among the few economies projected to do better in the current uncertain global political and macroeconomic environment.

We expect GDP growth to hit 5% mark in FY17, on the back of robust consumption and rising investment demand, along with a reasonable degree of macroeconomic stability. For instance, though we foresee some increase in headline inflation numbers during FY17 albeit from low levels, owing to reversal of base effect, gradual increase in commodity prices from their trough, levy of new taxes and measured PKR depreciation, we expect headline inflation to still stay subdued at 5.5%. On the external side, we anticipate overall balance of payments position to remain comfortable on higher financial inflows even though the current account deficit is likely to increase to 1.5% of GDP (US4.8bn) due to higher increase in imports, especially those related to energy and infrastructure projects, and a slowdown in remittances growth. On the fiscal front, while we find official fiscal deficit target (3.8% of GDP) ambitious due to higher expected expenditure growth (pre-election spending and higher subsidies), we still think FY17 budget deficit would remain manageable at 4.5% of GDP.

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Foreign Exchange Market: In the foreign exchange market, Pak Rupee saw a modest 3.0% depreciation against the US Dollar during FY16 compared to a larger decline in the emerging and regional currencies. Resultantly, an overvalued PKR has negatively impacted our export competitiveness as reflected in around 10% decline in exports during 11MFY16. Going forward, notwithstanding a comfortable balance of payments position, we expect around 4% depreciation of PKR against the US Dollar during FY17 to partially restore export competitiveness.

Fixed Income Market: During FY16, yield on fixed income avenues declined sharply driven by falling inflation and massive liquidity injections by SBP. For instance, yield on 1 year T-bill decreased by around 107bp from 6.98% to 5.91% during the fiscal year. We think interest rates have bottomed out now and expect around 50bp rise in SBP policy rate in 2HFY17. Accordingly, we expect money market yields to move up by 50bps in 2HFY17 driven by rising inflation and healthy credit demand from both public and private sector. In this backdrop, we prefer shorter-term fixed income avenues considering low term premium and lopsided upside risks to inflation and interest rates.

Stock market: Despite improving macroeconomic fundamentals, the local stock market performance remained lackluster in FY16 amid heightened volatility, with the benchmark KSE 100 Index rising by around 10%. We attribute this subdued performance to significant foreign selling and short-term corporate earnings slowdown led by energy, fertilizer and bank stocks. However, in an extremely positive development, Pakistani stock market has been recently upgraded to MSCI Emerging Market Index effective May 2017. It is widely estimated that around USD1.5trillion of emerging market funds follow MSCI EM Index. Though Pakistan would have a small 0.19% weight in the Index, it still equates to a staggering USD3billion. We expect sizable inflows to materialize in due course of time.

Local stock market valuations, as captured in forward PE of 8.6 times and dividend yield of around 5%, are quite attractive vis-à-vis regional peers (average forward PE 12.4x) and a paltry 5-6% yield offered by the fixed income avenues. Post Pakistan's re-entry in MSCI EM Index, we expect Pakistan's market to rerate on improving macroeconomic fundamentals, attractive stock market valuations, and increasing foreign investor interest. Further, following a temporary hiccup in 2016, we expect corporate earnings growth to pick up momentum in 2017. Thus, we see local equity market to deliver healthy double-digit returns over the next 12 months as Emerging Market funds gradually build position in Pakistani stocks.

However, the stock market may exhibit higher volatility in the coming months on unfolding global political and policy developments (e.g. Brexit, US elections, monetary and exchange rate policies of major central banks etc.). We recommend investors to focus on improving local fundamentals, and ignore bouts of volatility, keeping a long-term perspective in mind.