

January 2011

Stock Market Review

During the month of January 2011, the stock market continued its upward trend. Key factors for this performance were better than expected corporate results, election of the new Board of Directors of KSE, positive developments on the leverage product and healthy external accounts position. Moreover, both local and foreign investors brushed aside tensions in the local politics. The month started with the KSE-30 Index at around 11588 levels and increased by 7.7% to touch a high of 12476 levels as on January 17, 2011. During the latter half of the month the market took a breather due to slowdown in foreign investors' activity and expectations of the Policy Rate hike by SBP in its recently announced Monetary Policy Statement. Overall, the market increased by 3.64% during the month.

SBP kept the discount rate intact in its Monetary Policy announcement on January 29, 2011 due to shift of Govt. borrowing to non - SBP sources and improvement in external accounts. Inflation as measured by CPI was recorded at 14.6% for H1FY2011. Net Foreign Portfolio Investment (FPI) activity slightly decreased during the month. Net FPI during the month of January was recorded at around US \$ 63.1million, as against US \$ 72.95 million during December 2010. Trading activity improved significantly and Average Daily Traded Volume during January 2011 was recorded at 170.14 million shares, compared to 139.60 million shares in December 2010.

Fertilizer and Refineries sub-sectors out-performed the market. Banking sector and Oil and Gas Exploration, Oil Marketing Companies, Cement, and General Industries sub- sectors lagged the market during January 2011. Better than expected corporate results of key companies and improvements in the fundamentals contributed to the outperformance of the Fertilizer sub-sector. Cement sub-sector lagged the market due to rising coal prices. Lack of any trigger for Banking sector contributed to its underperformance versus the market. Refineries sub-sector performed better than the market due to strong earnings posted by the key companies. Escalating circular debt continues to haunt the performance of Oil Marketing Companies sub-sector. Key companies of Oil and Gas Exploration sub-sector took a breather during the month due to strong rally witnessed during the last few months.

Going forward, we believe that the following key factors will drive the stock market: (i) Foreign Portfolio Investment (FPI) activity; (ii) launch of the Leverage Product; (iii) law and order situation; (iv) inflation; and (v) SBP monetary stance.

Fixed Income Review

The State Bank of Pakistan (SBP) kept the Discount Rate unchanged at 14% in its bi-monthly Monetary Policy announcement on January 29, 2011. We expect that upward pressure on interest rates, witnessed throughout the ongoing fiscal year, to persist in the remaining five months. Three months T-Bill was quoted at 13.62% on January 31, 2011 while the 6-Months KIBOR was at 13.83%. These rates are respectively 45 and 21 basis points higher as compared to a month ago at end-December 2010. Recent T-Bill auctions have shown almost all the participation in three month T-Bills while there was negligible participation in 6 months and 12 months papers. Hence, the money market is anticipating rate hikes in next two Monetary Policy Statements (MPS) due at end-March and end-May.

Inflation, the key parameter addressed in each MPS, is also showing upward direction. The Table aside highlights the same trend witnessed so far in this Fiscal Year as against the previous year. The 1.5% rise in discount rate so far in current FY does not seem adequate. The SBP estimate for the average CPI for FY 2011, as mentioned in its latest MPS, is 15-16%. Considering supply side factors after the 2010 floods, gradual removal of subsidies in energy sector, inevitable reforms in indirect taxes, inadequate energy resources contributing to less than available productivity, fiscal deficit, all point that inflationary trends, and hence market interest rates may remain high.

Simultaneously, a few positive developments have been encouraging. Firstly the current account balance for 1H FY 2011 was positive by USD 26 mln, as against a deficit of USD 2,570 mln for the same period a year back.

This is attributable mainly to healthy exports (growth of 19%), higher workers' remittances (a 16.8% rise) and receipt of funds in the head of Coalition Support Fund. Secondly, there was a down tick in Government's inflationary borrowing from the SBP at end-December 2010 and a resolve to keep this in check going forward.

The above theme testifies the market's positive response in short-maturity funds of NAFA namely NAFA Government Securities Liquid Fund (NGSLF), NAFA Savings Plus Fund (NSPF) and NAFA Riba Free Savings Fund (NRFSSF), all ending the December month with competitive double digit returns. These funds are expected to benefit further due to their short-term maturities in the current interest rate environment. NGSLF, an ultra low credit-risk fund rated 'AAA(f)' has exceeded Rs 10 bln in fund size. This is a reflection of market focus on safety of investments. For longer-term investors, our Income / Aggressive Income funds offer very attractive yields with investment horizon of three or more years.

| INFLATION - ALL FOUR MEASURES | | | | |
|-------------------------------|------------------|--------|----------------------|---------|
| Inflation Measure | Year on Year (%) | | Average % July - Dec | |
| | Dec-10 | Dec-09 | FY 2011 | FY 2010 |
| Consumer Price Index | 15.5 | 10.5 | 14.6 | 11.7 |
| Wholesale Price Index | 25.7 | 15 | 22.3 | 12.6 |
| Sensitive Price Indicator | 21.5 | 11.9 | 19.2 | 13.2 |
| Core Inflation - Trimmed | 13.6 | 10.4 | 12.5 | 11.6 |