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

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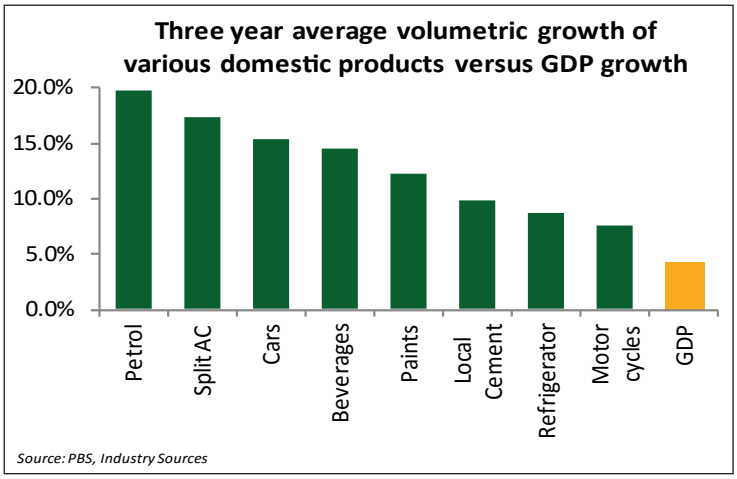
Pakistan Economy and Stock Market: 5-Year Outlook

After moribund growth during FY08-13 the economy expanded at 4.5% in FY16 and 5.3% in FY17 on the back of ameliorating security situation, massive ongoing investment of US $ 60 billion in infrastructure and power sector under China Pak Economic Corridor (CPEC), pick-up in private sector investment, and better availability of gas to industrial sector through imported RLNG. IMF projects Pakistan's GDP growth at 5.5%, 6.0%, and 5.7% for FY18, FY19, and FY20, while rating agency S&P has also affirmed Pakistan's 'B' long-term and short-term sovereign credit rating. The outlook for the long-term ratings remains stable. We expect that continuing acceleration in public & private sector investment activity, rising power generation, expected pick-up in exports growth, and sustained robust domestic consumption to underpin average economic growth rate of 6% p.a. over the next five years.

Pakistan-economic indicators and forecasts	2007-08	2016-17	2017-18F
Nominal GDP (US$bn)	170	304	330
Real GDP growth rate	5.0%	5.3%	5.6%
Inflation (CPI-average)	12.0%	4.2%	4.7%
SBP discount rate	12.0%	6.25%	6.75%
Consolidated fiscal deficit as % GDP	7.3%	5.8%	6.0%
Current account balance as % GDP	-8.2%	-4.0%	-4.7%

Source: SBP, NAFA Research



Source: PBS, Industry Sources

There are a large number of economic activities that fall outside the official reporting system and thus GDP figures under-report the real purchasing power of the consumers. Rise in private consumerism is evident from double digit volumetric growth in Refrigerator, Deep freezer, Beverage, Paints, Cement, Motorcycle, Automobile, and Petrol sales during the last three years versus an average 4.6% real GDP growth rate. By some estimates the real size of Pakistan's economy (GDP) is US$500bn and not the official estimate of US$300bn, if we include the parallel non-documented economy.

Sharp fall in global oil and other commodity prices along with better supply situation, and stable PKR helped bring inflation to a multi-decade low that currently stands at 3.5% thus far in FY18. Accordingly, the SBP pursued accommodative monetary policy and slashed discount rate by a cumulative 375 bps over the last 3 years to the current level of 6.25%. We expect a gradual rise in inflation and discount of 200 bps over the next couple of years driven by (i) partial recovery in global oil and other commodity prices; (ii) measured PKR devaluation; and (iii) pick-up in private and public sectors borrowing. We see inflation to gradually rise to 6%-7% over the long-term, but remain anchored due to global deflationary forces.

Concerns have been mounting on the sustainability of Balance of Payment (BoP) position due to the ballooning current account deficit that could reach around US$16billion during FY18. We contend that this is partly a result of sharp rise in import of power and other machinery and industrial raw material, while overvalued PKR has also encouraged food, fuel, and other non-essential imports. This, together with stagnant exports and tapering off of remittances growth, has worsened the current account deficit position. We expect that recently enacted exports incentive package, expected PKR devaluation of about 10%, reduction in input costs (abolishment of GIDC on gas, etc.) and hike in regulatory duties on imports will help bring the current account deficit down to a manageable level by FY18-end. This manageable current account deficit will be financed by external borrowing. At the expected real GDP growth of 5.6% for FY18 the size of Pakistan's economy will grow by US$26billion. Given the prevailing external debt level at 26% of GDP, the expansion in size of the economy will create further room for borrowing of US$6.8billion without increasing the external debt ratios. With resolution of power shortages, improving security situation, and push on structural reforms after the general election in 2018, we expect pick-up in FDI flows to the tune of US$ 3-5 billion per annum.

Despite high economic, political, and investment uncertainties, corporate profitability growth remained resilient at 11% per annum on average over the last 10 years. We expect corporate earnings to continue to grow in line with average annual nominal GDP growth of 12% (6% Real GDP growth plus 6% long-term Inflation) over the next five years. We believe that after a sharp correction of 25% from the recent peak, the stock market valuations have become attractive as captured in the forward Price to Earnings (PE) ratio of 9 times. The stock market is expected to rise in line with corporate earnings and nominal GDP growth of 12% per annum over the next five years. If we add the 5% dividend yield to it, the total expected return from the stock market is 17% per annum over the next five years. At this growth rate, an investment of Rs. 1 million today in the stock market will rise in value to Rs. 2.2 million (1 million *(1.17)^5) in five years. Well managed stock funds are expected to perform better than the stock market in the coming years. We advise investors with medium-to-long term investment horizon to invest in stock funds at these attractive levels.