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Pakistan's Economy & Stock Market - Key Challenges and Opportunities

Constructive investment backdrop for local equities characterized by robust economic growth, attractive stock market valuations, multi-year low inflation and interest rates is overshadowed by the elevated domestic political uncertainty, deteriorating Pak-US relations, and rising risks to the Balance of Payment (BoP) position. Massive investment activity by public sector under CPEC, capacity expansions and higher utilization by the private sector, and robust domestic consumption helped push the economic growth to 5.3% during FY17, which is expected at 5.5% for FY18. The consequent surge in aggregate demand led to robust growth in imported industrial raw material, machinery & equipment, automobile, food, and fuel products. This along with muted exports & remittance growth has ballooned Current Account Deficit, which is expected at USD15.9bn (5.0% of GDP) for FY2018. Another risk facing the country is the inclusion in list of nations which are not doing enough to combat terror financing, entailing severe economic implications. While Pakistan has taken some steps to address these issues, but more visible actions may need to be taken given the harder stance of current US administration towards alleged militant outfits. The heightened domestic political uncertainty initially linked to Panama Leaks case, and now the outcome of the verdict of the case is keeping the investors at bay.

To address the risks to the Balance of Payment (BoP), the government has taken some measures which include raising duties on non-essential import items, improvement in package for exporters, and limited PKR devaluation against our trading partners. To boost exports, we expect further PKR devaluation of around 5%-10% against the US Dollar, and reduction in GIDC and electricity tariffs for export-oriented sectors. This rupee devaluation and some changes in tariffs on non-essential imports will help gradually bring down the import bill. The index heavy Banking, Oil & Gas, as well as the export-oriented Textile Composite and Technology & Communication sectors will see a boost in their profitability from this currency devaluation. To fill the remaining gap, we also anticipate Pakistan to return to IMF program in the summer of 2018. This will also bring the much needed fiscal consolidation through broadening of tax base, rationalizing of government expenditures and privatization/restructuring of loss making Public Sector Enterprises. A foreign assets tax amnesty scheme is also under active consideration of the government and according to news reports Federal Board of Revenue (FBR) has prepared a draft titled the 'Foreign Assets Declaration Scheme' (FADS) and handed over to the Prime Minister, proposing tax rates of 2 to 10 percent for bringing back offshore assets into Pakistan on the pattern of the Indonesian model. According to some estimates, Pakistanis have parked about USD 120 billion worth of assets abroad, and the scheme is expected to fetch USD 3-5 billion. We feel that if amnesty scheme goes through, a decent chunk of this repatriated money will find its way in the real estate and the stock market.

Political concerns are likely to be addressed to a large extent with holding of both Senate and National Assembly elections that would give the new government a fresh mandate to restart the waning economic reforms program. We expect long-term economic growth of around 5% driven by strong domestic consumption, rising business investment activity, and continued public sector development. Precarious law & order situation and chronic power shortages are no more being cited as the key areas of concern by businesses, and are now overtaken by more manageable issues like high taxation and red tape in bureaucracy.

While political noise may remain elevated till election time, investors will take into account medium-term double digit corporate earnings growth. From a valuation standpoint, PSX is trading at a Price-to-Earning (P/E) multiples of 10 times, which is at a deep discount to other Emerging Markets. We feel that there is a high probability of substantial inflows in the stock market from foreign investors post devaluation, and from local investors post the expected tax amnesty scheme. We believe that over the next 12 months, the stock market is well-poised to deliver healthy double digit returns.