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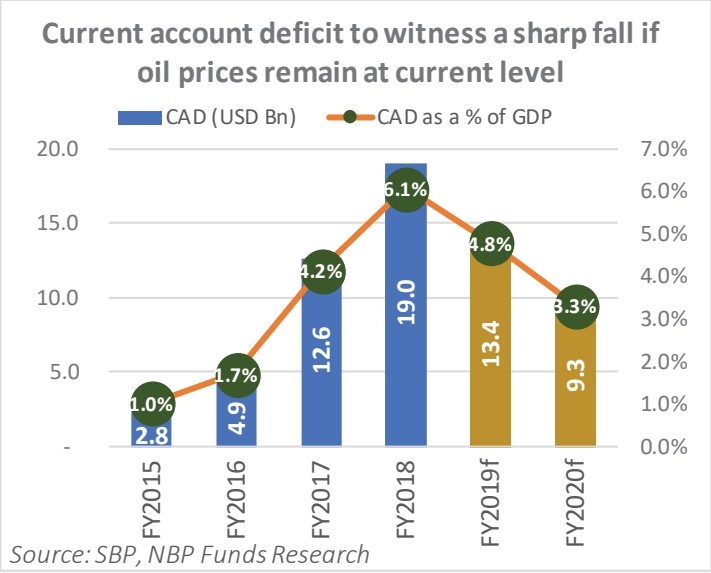
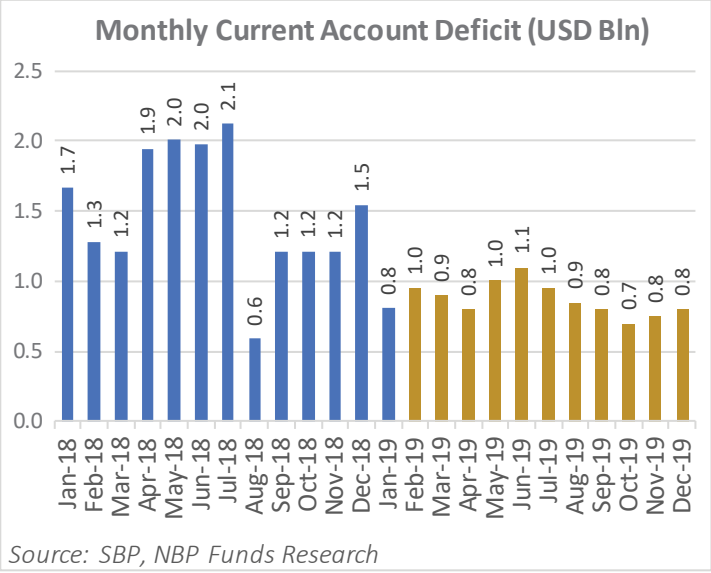
Robust corporate earnings growth to propel stock market in CY19 and CY20

Economic Outlook: Two months into 2019, the benchmark KSE-100 Index is up by around 5.4% after witnessing a decline of around 8% during CY18 that came on the heels of a 15% correction in CY17. Lackluster performance of the stock market in the previous two years is attributable mainly to a relatively week corporate earnings growth amid challenging economic conditions emanating from burgeoning Current Account Deficit (CAD) along with lumpy external debt repayments. It resulted in drop of SBP forex reserves from USD 18.1 billion at the start of FY2017 to a paltry USD 8.0 billion currently. The precarious situation prompted the incumbent government to pursue tightening policies including PKR devaluation, monetary policy tightening, and levying and expanding the import duties with the aim to contain domestic consumption. Because of these measures, we have seen a drop in key import heads; however no meaningful compression in overall import numbers in 7MFY19 was visible due to higher global oil prices. Encouragingly, from a peak of around USD 2.1 billion in July 2018, CAD has dropped to USD 0.8 billion in January 2019 and we expect this improvement to sustain in the coming months as well owing to aforementioned tightening measures and slightly lower oil prices. The government has also made great stride in arranging external financing from friendly countries to alleviate pressure on foreign reserves while reportedly negotiations with the IMF are also in its final stages. While the media reports of still stringent conditions by the IMF seem to be the stumbling block but the need for long-standing structural reforms cannot be overemphasized to put the economy on a sustainable growth path and regain macroeconomic stability.



Source: SBP, NBP Funds Research



Source: SBP, NBP Funds Research

GDP growth is expected to decelerate to around 3% in FY2019 due to dismal performance of manufacturing and agriculture sectors driven by significant monetary tightening, large cut in development spending, and rising cost of doing business as a result of a hefty PKR devaluation and upward adjustments in utility prices. While the Real Effective Exchange Rate (REER) as per the latest data point is now near its equilibrium value, significantly low level of Foreign Exchange Reserves in terms of import cover still necessitates additional PKR devaluation in our view, in order to further curb the trade deficit.

So far, average inflation for 8-month FY 2019 has risen to 6.5% as a result of a large 26% PKR devaluation during CY2018 and higher utility & transportation related costs. We foresee inflation to further rise as government still has to raise utility tariffs in order to reduce subsidy burden while Petroleum products prices may also be raised to generate additional revenues. Average inflation for FY20 is expected to rise to around 9.7% and monthly inflation is likely to peak near 11% in 1HFY20, before gradually tapering off in 2HFY20. After a hefty 4.5% rise in interest rates during the ongoing monetary tightening cycle, the Discount Rate has risen to 10.75%. We expect around 100bps increase in interest rates henceforth as real interest rates would remain in positive territory even after accounting for upward trajectory of inflation and also because of implication of high interest rates for the fiscal side. Expected fall in inflation in second half of FY20 makes a case for decline in interest rates in late FY20.

Stock Market Outlook: From the valuation perspective, the market is trading at an attractive Price-to-Earnings (P/E) multiple of 7.8 times. Led by the Index heavy weight Oil and Gas Exploration & Production, Banking, and Fertilizer sectors; we expect a healthy double-digit corporate earnings growth for 2019 and 2020. There is ample local liquidity sitting on the sidelines, awaiting clarity on the economic policy front. We believe that given attractive valuations, subsiding risks of sharp currency devaluation, and improving external account position; the market would regain its luster for foreign investors post entry into the IMF program. We advise our investors to hold their position in the stock market unfazed by the periodic volatility spikes, keeping their investment objective in mind as the market holds potential to deliver a healthy return in CY19 and CY20.

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