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Improving Stock Market Prospects

Economy:

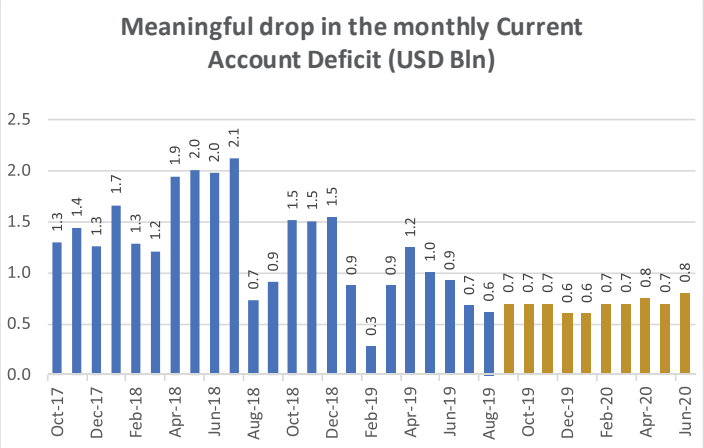
Faced with the challenging economic conditions, painful yet necessary stabilization policies undertaken by the incumbent government during the last one year have started yielding results. While controlling the fiscal side and reviving the manufacturing sector entail more efforts, there are several encouraging developments on the economic front:

- Demand compression policies including hike in the interest rates and massive currency devaluation narrowed Current Account Deficit (CAD) to USD 13.5 billion in FY2019 from USD 19.9 billion in FY2018. Further, CAD has dropped massively by 55% to USD 1.3 billion during 2MFY2020 versus USD 2.9 billion last year.

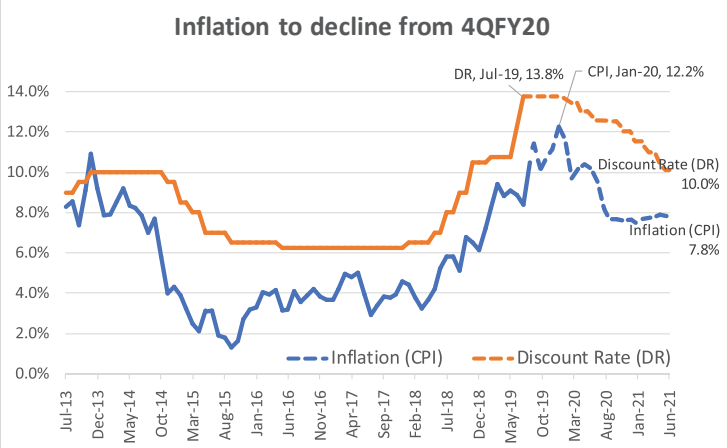
- To regain export competitiveness, the move to a market-based exchange rate system from a controlled exchange rate regime resulted in a massive devaluation of PKR versus the USD dollar. This has aligned the PKR to its true fundamental value as reflected by the Real Effective Exchange Rate, which is presently around 93 versus 120 in July 2017. This in turn has mitigated the risk of significant currency devaluation.

- After entry into the IMF program in FY2020, the focus has shifted to relatively cheaper sources of external financing i.e. multilateral agencies such as the World Bank, Asian Development Bank, and Islamic Development Bank. This will also facilitate access to international capital markets via Euro bonds and Foreign Portfolio Investment, which we expect to pick up pace from November post FATF decision.

- The trajectory of CPI has somewhat softened and we expect inflation to peak at around 12%. This is positive in terms of reversal of monetary tightening cycle, which we expect to commence from the second half FY2020. A steep drop in inflation in the next twelve months is likely to be followed by a meaningful drop in the Policy Rate.



Source: SBP, NBP Funds Research



Source: SBP, PBS, NBP Funds Research

- As a consequence of the ongoing tightening policies, GDP growth during FY2020 is anticipated to decelerate to 2.2% before picking up to 3.8% in FY2021. Economic activity has slowed down significantly as reflected by the 3.3% contraction in the Large Scale Manufacturing (LSM) in July 2019. The clampdown on wholesale & retail sector with the objective to bring it under the tax net is also likely to hold back economic growth.

- Though revenue collection remains impressive, it is still below the target set with the IMF. We project the fiscal deficit at 7.9% in FY2020, which is expected to drop to 6.6% in FY2021.

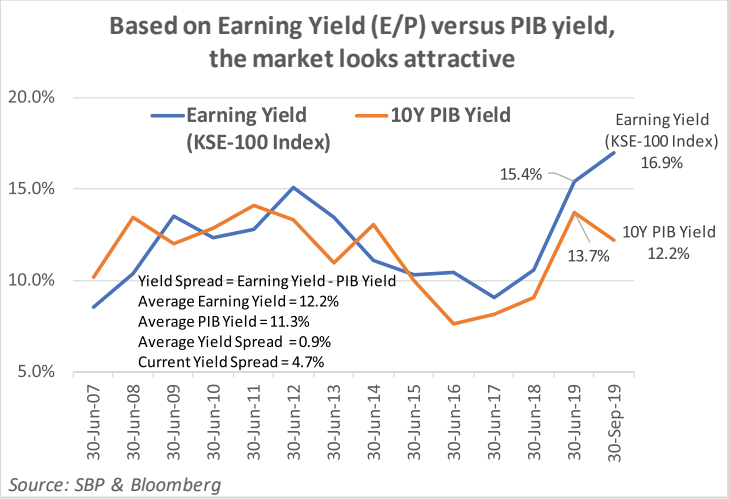
Stock Market:

After a significant decline of 12.5% during the July-Aug 2019 period, the stock market witnessed a sharp rebound of 8.1% in September. However, the market is still down by a hefty 39% from its peak witnessed in May-17. Looking ahead, we hold a positive view on the stock market due to the following reasons:

- If history is any guide, improving Current Account Deficit and expected drop in inflation & interest rates in the next six months would lead to re-rating of the stock market. With the waning risks of large devaluation, we have seen foreigners becoming net buyers in the market with inflow of USD 71 million during CY2019 and we expect the continuation of Foreign Portfolio inflows, followed by domestic investors returning to the stock market due to attractive price levels.

- Despite slowdown in GDP growth, overall corporate earnings remain resilient and are still poised to grow at double-digit rate for 2019 and 2020, helped by robust profitability of the Index heavy Banking, Fertilizer and Oil & Gas Exploration sectors.

- From the valuation standpoint, the stock market is currently trading at a compelling forward Price-to-Earnings multiple of 5.9 times (Earnings Yield of 16.9%), and offers an attractive dividend yield of 7%. The yield on 10-year PIB has declined to 12.2%. Resultantly, the yield spread between Earnings Yield of the KSE 100 Index and 10-year PIB yield stands at around 4.7% versus the 10-year average of 0.9%, indicating immense potential for the stock market re-rating.



Bottom Line: We hold on to the view that the stock market is well poised to deliver robust returns in FY2020, and beyond. The stock market has become very attractive due to a massive decline over the last couple of years, providing a good opportunity to investors to benefits from the expected upside in the next couple of years. With a strong bull case for equities, we advise investors to consider adding positions in the stock market gradually, keeping their long-term investment objectives in mind.