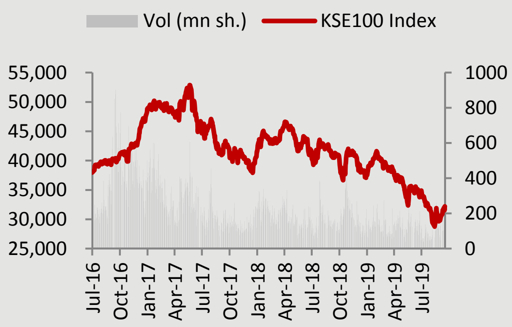
Pakistan Economy

Peak inflation in September; a rate cut in November?

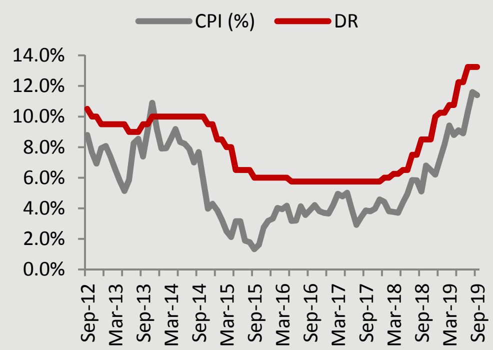
Thursday, October 03, 2019

KSE-100 index vs volumes



Source: SBP, BMA Research

CPI vs. DR



Source: SBP, BMA Research

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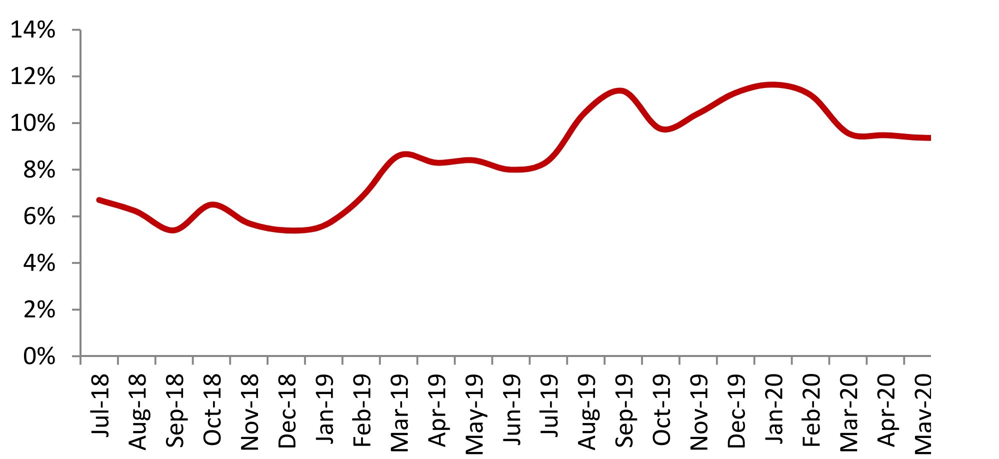
- **As per our estimates, inflation has peaked in Sep'19. Consumer Price Index (CPI) inflation for Sep'19 was reported at 11.37%/12.54% on new/old base respectively.**
- **We expect average inflation on new base to be in the range of 10%-10.25% for FY20. This takes real interest rates to 3% from average of 2% during the last 3 years given current State Bank of Pakistan (SBP) Policy Rate of 13.25%.**
- **SBP is scheduled to announce its Monetary Policy in mid-November. Based on above inflationary expectations, we are of the view that a rate cut of 50 basis points is likely and shall set the tone for further rate cuts in future.**
- **We see low likelihood of any significant cuts in the SBP Policy Rate that may still remain elevated because of ongoing International Monetary Fund (IMF) program and the need to maintain and build FX reserves.**
- **Recent phenomena of carry trades, which have brought in US$328mn in portfolio investments (short term T-Bills) from Jul 1-Sep 27 will also be negatively affected if interest rates decline significantly in next few years.**

Inflation has likely peaked in Sep'19. The Consumer Price Index (CPI) inflation for Sep'19 was reported at 11.37%/12.54% on new/old base respectively. As per our estimates, this is peak inflation level for the current fiscal year FY20. Going forward, inflation on new base is now expected to remain in double digits till Feb'20 after which we expect inflation to fall in single digits.

Inflation trajectory on new base

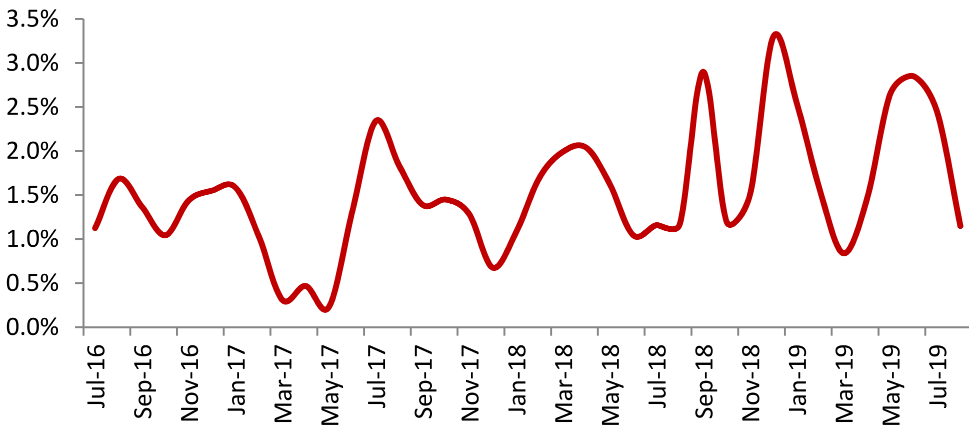


Source: BMA Research

Real rates average around 3%. We expect average inflation on the new base to be in the range of 10%-10.25% for FY20. This is significantly lower than our previous expectations of 11.50% on the old base. This takes real interest rates to around 3% given current SBP policy rate of 13.25%.

It is interesting to note that real interest rates for last 3-years have averaged around ~2%. Further, in one of the recent analyst sessions at State Bank of Pakistan (SBP), the Central Bank Governor echoed that he felt comfortable at current real interest rate spread (of 2%) based on policy rate of 13.25% and average inflation expectation of SBP of 11%-12% for FY20. Also, in a recent seminar at a local educational institute, the Central Bank Governor has stated that interest rate changes in future will primarily depend on inflation trajectory, which is now showing strong signs of peaking and is expected to eventually come down in next few quarters.

Real interest rate during last three years



Source: BMA Research

Rate cut in November? The SBP is scheduled to announce its Monetary Policy in mid-November. Based on above inflation expectations and current real interest rate, we are of the view that a rate cut of 50 basis points is likely and will set the tone of further cuts in coming quarters. However, even though inflation is expected to come down to single digits by 3QFY20, we see low likelihood of any significant cuts in the SBP Policy Rate that may still remain elevated at around 12% (current 13.25%) during the next calendar year 2020. This is because of ongoing International Monetary Fund (IMF) program and the need to maintain and build adequate foreign exchange reserves.

Carry trades to curtail reduction in interest rates. The recent phenomena of carry trades, which have brought in US$328mn in portfolio investments (short term T-Bills) from July 1-September 27 may also restrict any substantial reduction in interest rates as this would result in lower returns to foreign investors in local government paper.

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Buy	>20% expected total return
Neutral	10%-20% expected total return
Underperform	<10% expected total return

*Total stock return = capital gain + dividend yield

Old rating system

Overweight	Total stock return > expected market return + 2%
Marketweight	Expected market return ± 2%
Underweight	Total stock return < expected market return - 2%

Valuation Methodology

To arrive at our period end target prices, BMA Capital uses different valuation methodologies including

- Discounted cash flow (DCF, DDM)
- Relative Valuation (P/E, P/B, P/S etc.)
- Equity & Asset return based methodologies (EVA, Residual Income etc.)