Economy

November 23, 2020

Nov'20 MPC: Monetary Policy Review

Think Investments. Think BMA

BMA Research is available on Bloomberg and Reuters

Faizan Ahmed
Faizan.ahmed@bmacapital.com
UAN: 111-262-111 (Ext:2057)

REP-005

Best Brokerage House 2017
Best Brokerage House 2016 (Runner-up)
Best Analyst & Trader 2013 (Runner-up)

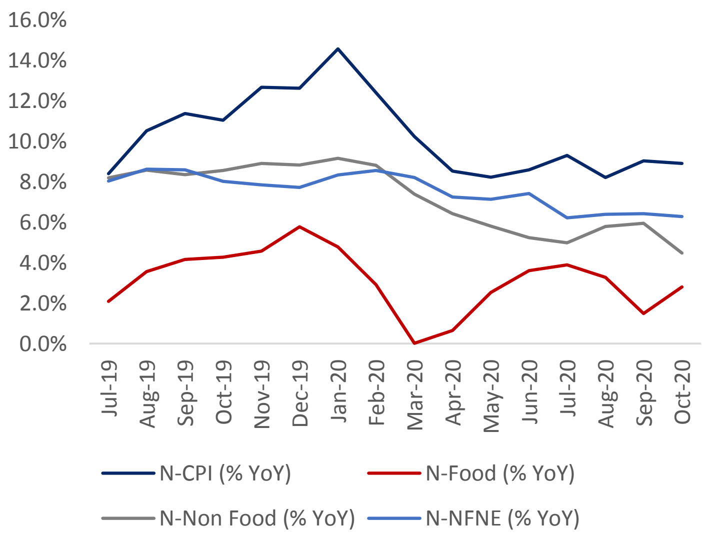
Best Local Brokerage 2015 (Runner-up)

Financial Markets Association of Pakistan
Best Broker Money Market 2017
Best Broker F. Exch. 2014 (Runner-up)

Top IPO/ SPO Book Runner Award 2016-17-18

- **Policy Rate to remain unchanged for next two months:** The State Bank of Pakistan (SBP) in its Nov'20 bi-monthly meeting decided to keep the Policy Rate (PR) unchanged at 7.00% level, in-line with broad consensus. Recent concerns related to increases in inflation were comprehensively addressed in the latest MPC communication where the SBP, while keeping its 7.0-9.0% YoY inflation projection for FY21 intact, emphasized that inflation expectations remain 'well-anchored'. Improvements in the *level* of inflation are expected going forward with indications visible in recent SPI data. SBP will continue to tolerate periods of higher *headline* inflation as increases in *core inflation* continue to remain benign.
- **Domestic output is recovering but idle capacities will keep price levels in-check:** The output seems to be recovering as indicated by recent high-frequency indicators such as the auto (↑ 8.1% YoY in 4MFY21), cement (↑ 21.9% YoY in 4MFY21), FMCG and petroleum sales (↑ 7.4% YoY during 4MFY21) etc. Surveys conducted by SBP in Oct'20 also show notable improvement in Business Confidence as compared to Aug'20. Despite these improvements, output gap remains negative and idle capacities are likely to keep core inflation levels in-check. It made sense to keep the rates unchanged given benign NFNE readings.
- **There are positives and there are negatives:** Whilst SBP's growth and inflation targets have remained unchanged, risks to the outlook have emerged in the form of increases in COVID-19 cases. Concerns related to extended lock-downs, both globally and locally, have resurfaced once again. Lockdowns in the international market are important from a local perspective given that it could lead to higher 'risk-aversion' in the international capital markets. Govt's strategy worked in the first wave but it will be important to manage the second-wave effectively as well.
- **Increases in FX reserves is 'high quality':** From USD 7.3Bn as of 30 June 2019, SBP's gross FX reserves have improved to USD 12.2Bn as of 29 October 2020. The net improvement in reserves was mainly driven by organic reserves building instead of official borrowings. The governor in his post-MPC communication has highlighted that improvement in reserves is 'high-quality' and we concur with the statement looking at these numbers. Recent movement of PKR against the Dollar also seems to be fundamentals driven rather than speculative in nature.
- **Current Account surplus might not sustain but better performance in 4MFY21 led to revision in targets:** A structural improvement in C/A is visible, backed mainly by improved average monthly remittances and better trade balance. Whilst the present surplus in the C/A is unlikely to sustain given higher machinery and food imports in 2HFY21; overall improvements led to cut-down in SBP's deficit projections for FY21 from previously 2.0% of GDP to 1.6%. SBP now sees deficit to stay lower despite heavier TERF-induced machinery and food imports in 2HFY21.
- **Negotiations with the IMF are ongoing – gaps narrowing:** The governor highlighted that technical discussions with the IMF are ongoing and major progress has been made on key sticking points such as electricity tariffs, taxation etc. The authorities remain committed to continuing with the IMF program and the gap seems to be closing. The focal point of discussion is on the timing of implementation and material progress is expected soon.
- **Policy rate likely to stay unchanged at least until May'20; possibly beyond that as well:** SBP has consistently highlighted that it stands ready to take action looking at the data available at its disposal. Barring a material change in domestic demand indicators and inflation forecasts, we believe that upcoming data releases will continue to support continuation of current PR at least until May'20. Expect rates to remain *lower for longer!*

Inflation History & Trajectory (% YoY)



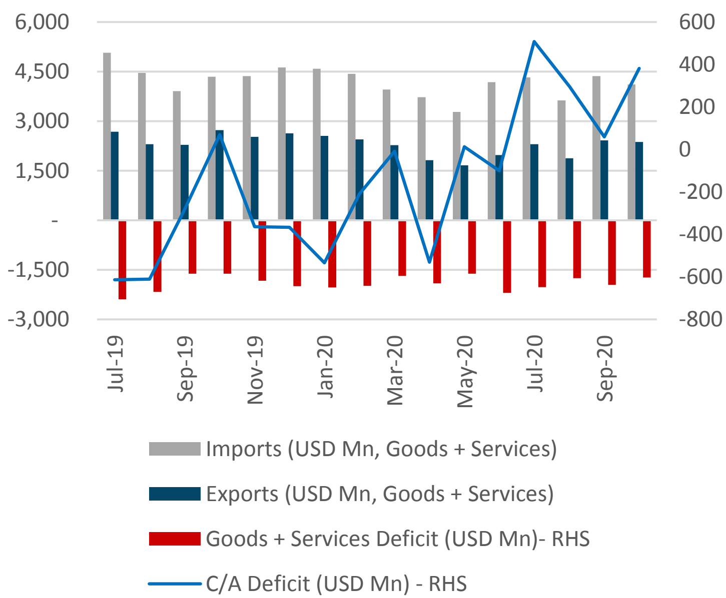
Source: PBS, BMA Research

Inflation estimates maintained at 7.0%-9.0%: SBP acknowledges that recent increases in inflation are mainly driven by supply-side factors. Encouraging signs were seen in recent SPI data where a prices of few key commodities such as Wheat and Rice have shown some reversal. SBP assesses that there is no need to change its inflation forecast as YoY readings going forward will consistently be lower. This seems true looking at our projections as base-effect, coupled with better price administration will likely keep the numbers lower.

Core inflation is important, but a holistic view is required: Current SBP regime puts more emphasis on the *headline inflation from a communications perspective,* but also looks at *core inflation* to make its decisions. Focusing on just core can be problematic due to: A) *wage-price spiral;* and B) lower representation of core inflation in terms of weight in the overall inflation basket.

Idle capacities to keep prices in-check: Large-Scale Manufacturing (LSM) and its sub-sectors have improved during 1QFY21 period. 9 out of the 15 key sectors of the LSM have shown considerable improvement. SBP's business confidence surveys also show improvement in overall business sentiments during this period. Despite these improvements, the negative output gap persists as estimated by SBP. Given the idle capacities available, SBP expects demand-side pressure on inflation to remain limited.

Monthly C/A deficit (USD Mn)



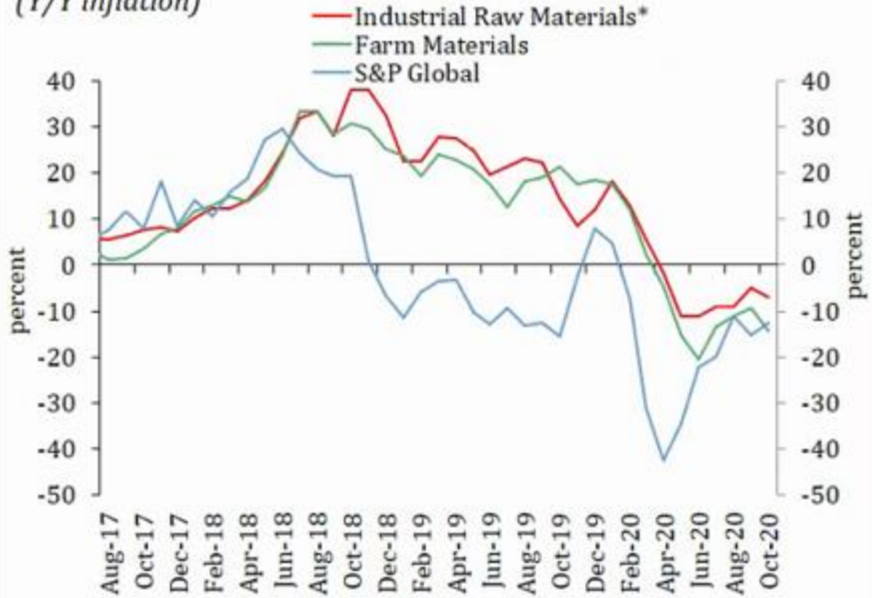
Source: SBP, BMA Research

External sector has strengthened since the last MPC: C/A shows a surplus of USD 1.16Bn dollars in 4MFY21 as compared to a deficit of USD 1.42Bn in the corresponding period last year. Outsized monthly remittances have remained one of the key reasons behind this large surplus and remained one of the key reasons behind revision in SBP's forecast. Key takeaway from the discussion is that the counterintuitive improvement in remittances is a trend seen in South Asian countries where: A) diversion of flows to official channels; B) reduced air travel; and C) greater support from expats in difficult times have remained the major reason behind this improvement.

SBP now forecasts C/A deficit of 1.6% of GDP vis-à-vis 2.0% previously: Persistently better numbers have led to a downward revision in SBP's forecasts. The central bank now expects better exports and remittances to counteract the effects of greater food and machinery imports in 2HFY21. One key point related to goods trade balance is that weak oil prices seem to be offsetting the impact of greater import volumes, keeping import bill in-check. In contrast, on the exports front, it is the price effect which is causing improvements. On the point of machinery imports, SBP has highlighted that utilization of Temporary Economic Relief Fund (TERF) is picking up and more businesses are availing long term financing at cheap rates. This greater utilization does implies greater machinery imports but will improve productive capacity of the economy in the long run.

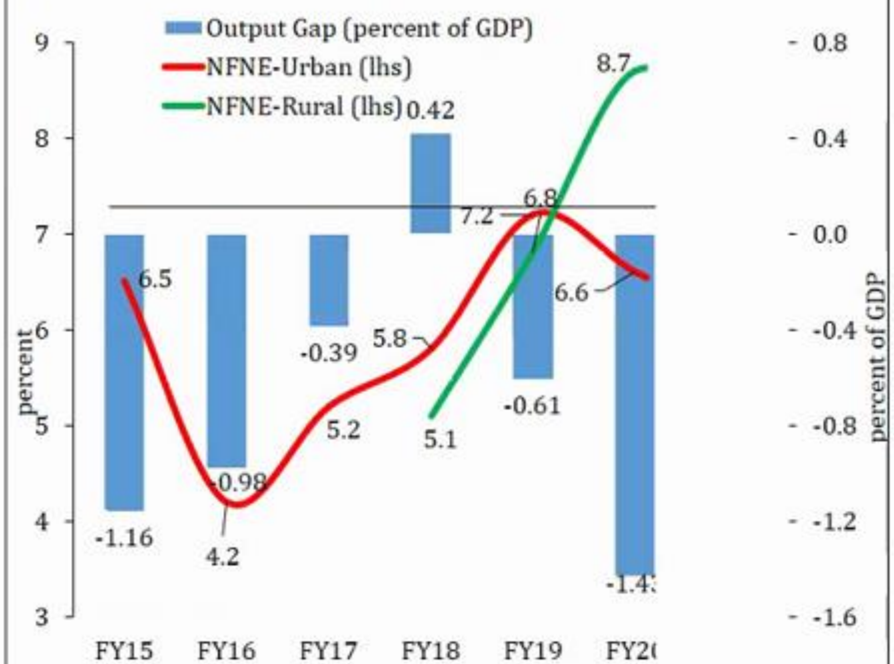
Relations with the IMF: The governor has highlighted that discussions with the IMF are ongoing and gaps are closing. However, the timing of implementation of the measures proposed is causing delays. Technical discussions are continuing are there are two schools of thought: one is to not go forward with tough measures such as increase in energy tariffs, increased taxation etc. as it could derail an already fragile macroeconomic recovery; and the other is to swallow the bitter pill now in hopes of a better future. The latter is clearly infeasible for the incumbent PTI as it could incite severe backlash from the public and the opposition parties. That said, both sides will need to establish some middle ground in order to get things done. SBP expects good news to come on this front soon as the gap between discussions is narrowing.

Figure 1: Farm and Non Farm Input Costs
(Y/Y inflation)



-**Farm Material** includes farm inputs like Fertilizers, pesticides, insecticides, tractors, cultivators and electrical energy.
-**Industrial/Non Farm** includes energy inputs (coal, diesel oil, natural gas, Kerosene and furnace oil), hard board, printing paper, cotton corn, other lubricants and dying materials.

Figure 2: Output Gap and Core Inflation

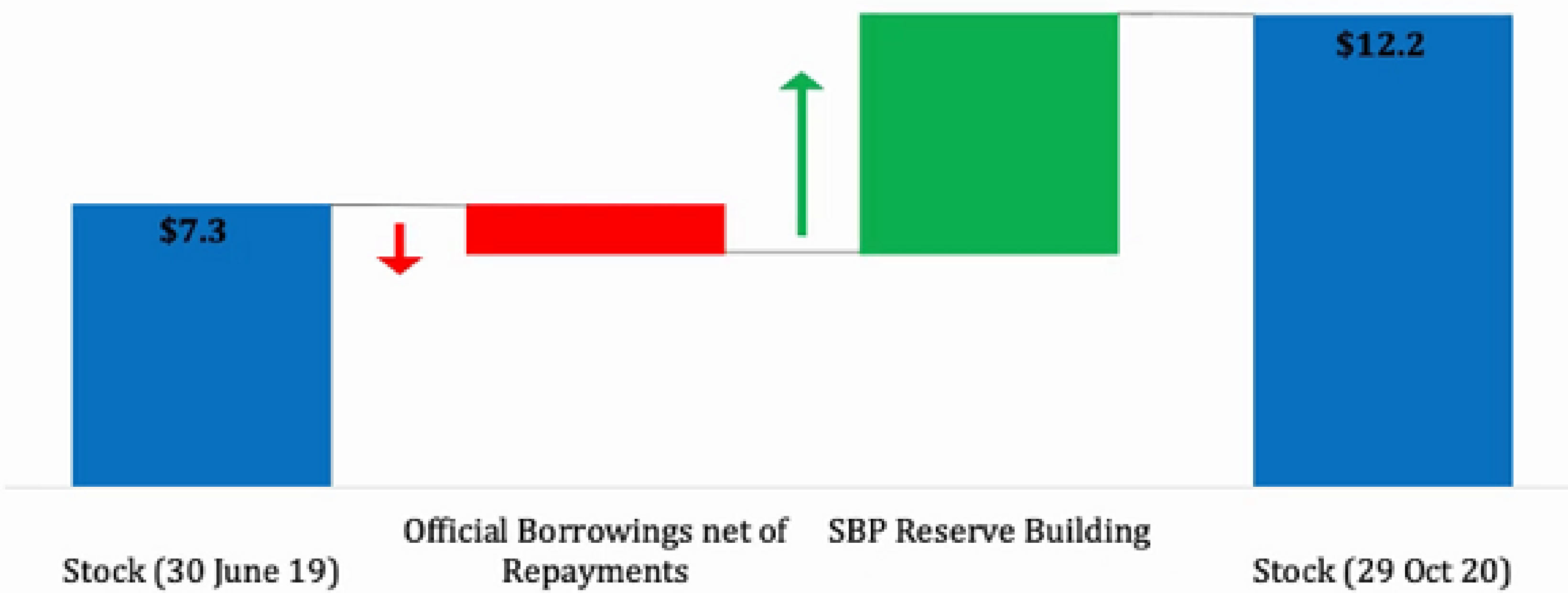


Source: Pakistan Bureau of Statistics and SBP staff estimates

SBP's foreign exchange reserves rose 67 percent since 30th June 2019; despite net retirement in official borrowings

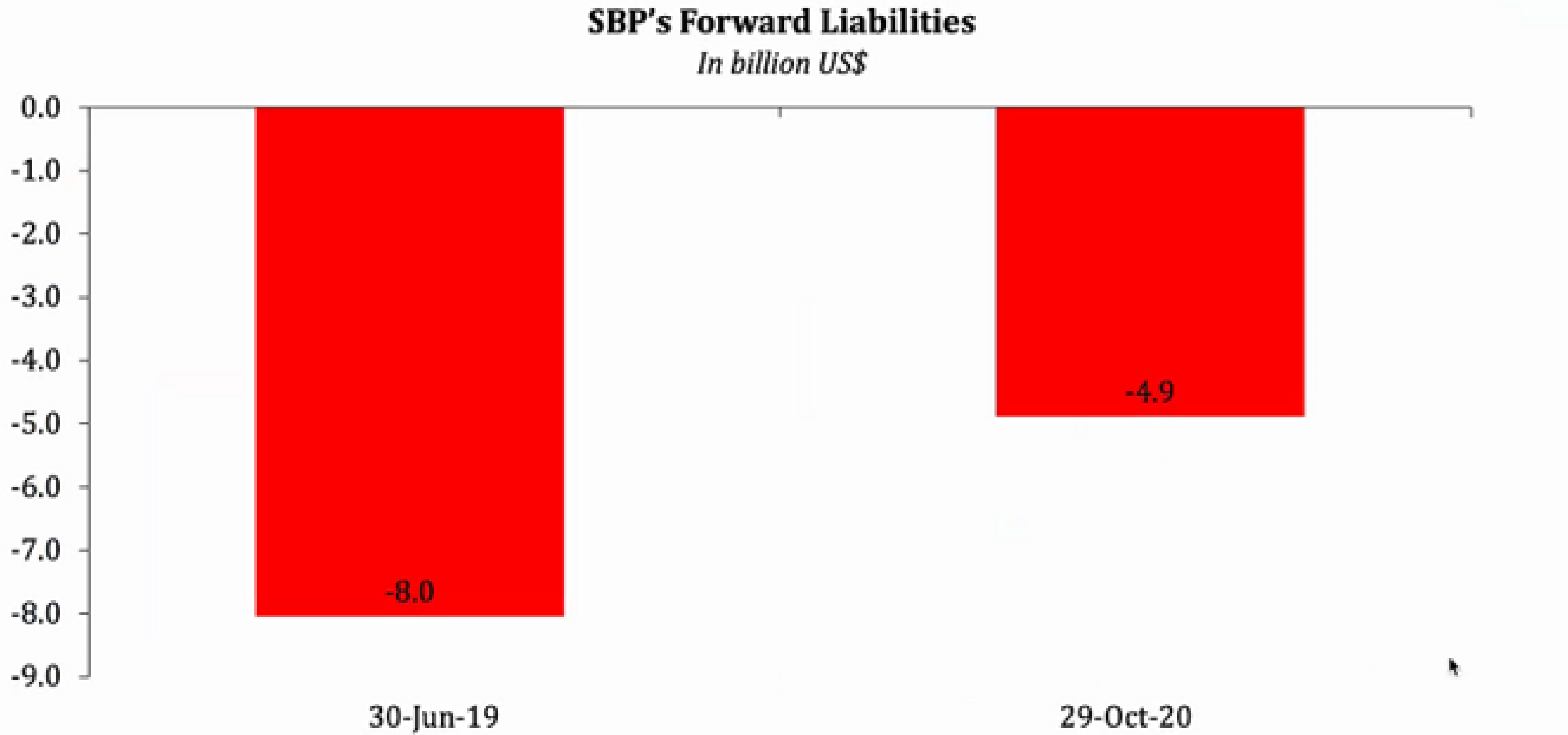
SBP's Gross FX Reserves

In billion US$



Source: SBP

SBP's forward liabilities fell 39 percent ($3.1 billion) since 30th June 2019; Net FX buffers (gross reserves less forward liabilities) rose $ 8 billion



Source: SBP

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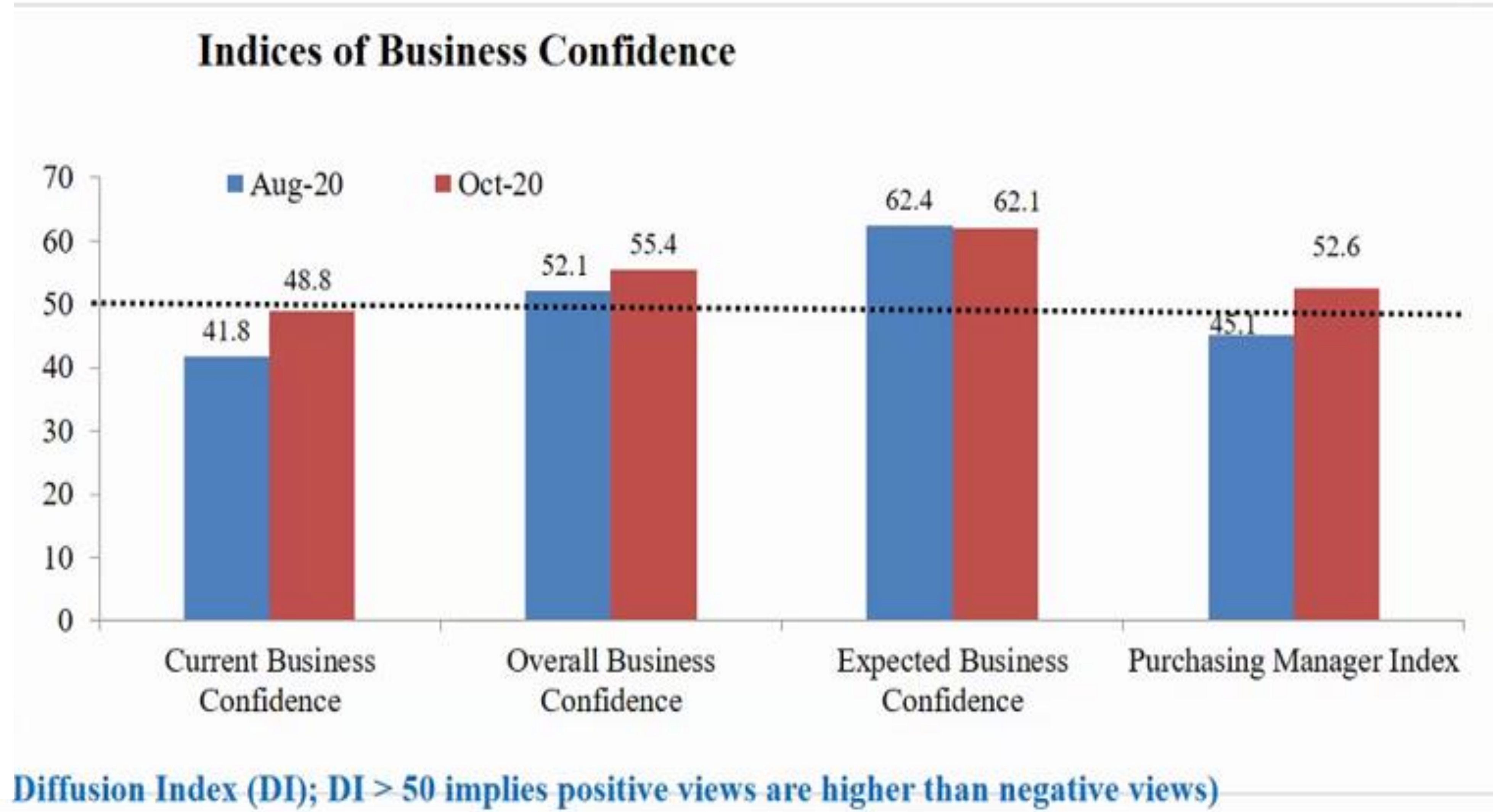
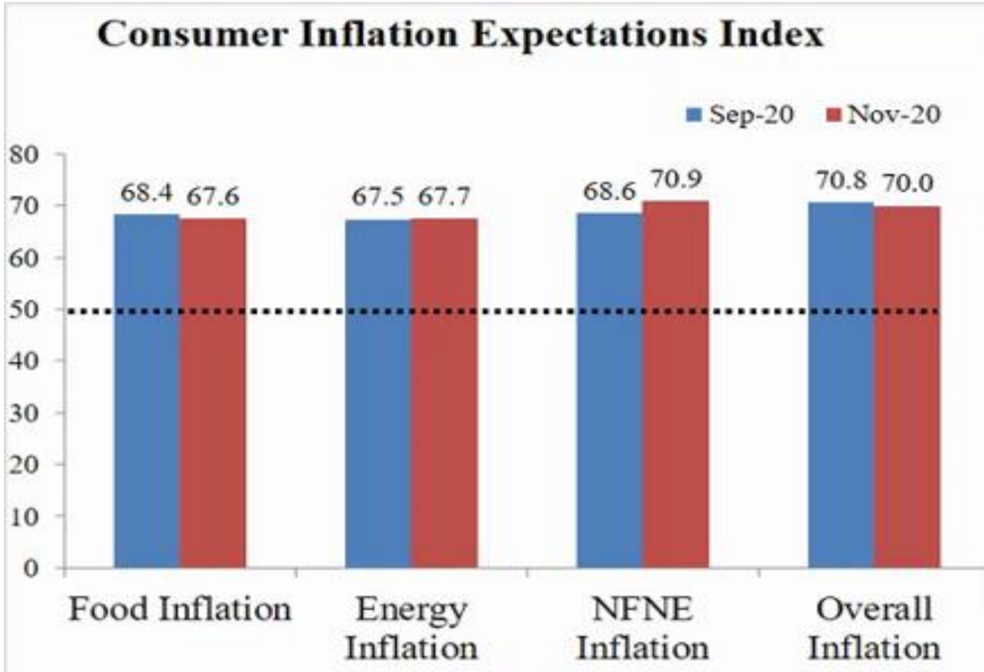
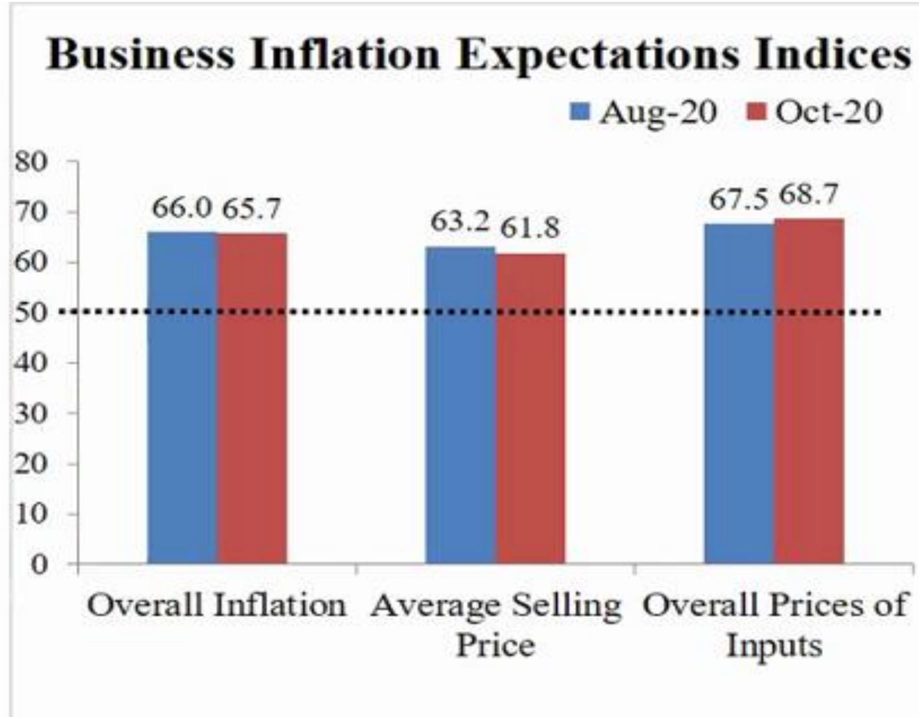
Countering Covid-19: Measures by State Bank of Pakistan

Progress as on 17 November 2020	Rs. In Billion			No. of Businesses (change since last MPS)
	Last MPS (18 Sep 2020)	Latest (17 Nov 2020)	Change since last MPS	
Policy rate cut (625 basis points)	470	470	0	
Loans Deferment and Restructuring	835	861	26	
of which				
(i) Loans deferred	*651*	*655*	*5*	
(ii) Loans restructured	*184*	*206*	*21*	
Refinance Scheme for Wages to Prevent Layoffs	213	238	25	2,955 (322)
Refinance Scheme for Hospitals	6.3	7.8	1.4	39(5)
Refinance Scheme for Setting-up New Projects or Expansion/BMR	78	186	108	240(122)
Total	**1,602**	**1,762**	**160**	**3,234 (449)**

Updated: as of Nov 20, 2020
Source: SBP


Indices of Business Confidence
Aug-20
Oct-20
70
60
50
40
30
20
10
0
41.8
48.8
52.1
55.4
62.4
62.1
45.1
52.6
Current Business Confidence
Overall Business Confidence
Expected Business Confidence
Purchasing Manager Index
Diffusion Index (DI); DI > 50 implies positive views are higher than negative views)





Diffusion Index (DI); DI > 50 implies positive views are higher than negative views)

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

*Total stock return = capital gain + dividend yield

Disclaimer

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.)

Pakistan Stock Exchange Branch
Room 141, Pakistan Stock Exchange,
Stock Exchange Road,
Karachi - 74000
Pakistan

Faisalabad Branch:
Mezzanine Floor, State Life Building #2,
Plot No. 833 Liaquat Road,
Faisalabad.

Gujranwala Branch:
Office No. 51, "H" Block,
Ground Floor, Trust Plaza,
Gujranwala.

Lahore LSE Branch:
1st Floor Room 110-111, LSE Building, 19, Khayaban-e-Awan Iqbal, Lahore

Islamabad Branch:
104, 1st Floor, 82-East,
Muhammad Gulistan Khan House,Fazel e Haq, Blue Area,
Islamabad

Lahore Cavalry Branch:
2nd Floor, 74-Commercial Area, Main Cavalry Ground,
Lahore.

Gulshan-e-Iqbal Branch:
Commercial Office premises bearing, B-29 Mezzanine Floor 13/A, Main University Road,
Gulshan-e-Iqbal Karachi.

Sialkot Branch:
Plot 16-S-71/A/1, First Floor,
Opposite Christian Memorial Hospital Paris Road, Sialkot.

Bahadurabad Branch:
Office # 3, Mezzanine Floor,
Akber Manzil, Main Bahadurabad Roundabout, Karachi

Multan Branch:
Office No. 607/A, 6th Floor,
The United Mall, Plot No. 74 Abdali Road, Multan

Lahore Gulberg Branch:
Commercial Office No. 402, 7th Floor, Mega Tower 63-B, Main Boulevard,
Gulberg II, Lahore.

Peshawar Branch:
Shop No. F1 & F2, 1st Floor
Mall Tower 35, The Mall
Peshawar Cantt,
Peshawar

Chakwal Branch:
Office No. 12, 1st Floor,
Ejaz Plaza, Talalgang Roadi
Chakwal

Sargodha Branch:
Ground Floor, Shan Plaza Block No. 16,
Main Khushab Road
Near ABL, Sargodha

Karachi – North Nazimabad
D-14, Office No.2, 2nd Floor,
Block H, MCB Building, Near 5 Star Round About, North Nazimabad, Karachi

Karachi Head Office:
Unitower, Level 8, I.I. Chundrigar Road, Karachi – 74000 Pakistan
UAN: +92 21 111 262 111
Email: info@bmacapital.com