PAKISTAN INVESTMENT RESEARCH

In Focus

Pakistan Economy

Inflationary Concerns at the Forefront

Friday, August 18, 2023

Recent developments have sparked another wave of inflationary pressures, and is likely to decelerate CPI's downtrend seen during recent months. Since the dissolution of the National Assembly, the Pak Rupee lost around 2.5% of its value in the interbank market, reaching a low of PKR 295/USD.

Moreover, the rise in global crude and refined prices have pushed domestic petroleum prices to newer highs, further influencing the industry's inflation outlook. Onwards, the IMF-led structural adjustments, including a sharp rise in domestic gas prices, will further contribute towards the prevalent inflationary trend.

Speculations of another rate hike have emerged given recent developments, particularly the higher inflation projections and the Pak Rupee weakness. Real rates, however, continues to remain in positive territory on a forward-looking basis as the high-base will likely contain average CPI inflation to around 23% in FY23.

Another inflationary wave brewing

Recent trends have ignited another wave of inflation in the country, driven by the rising energy tariffs, Pak Rupee weakness and the commodity upcycle. July 2023 saw the hike in the base power tariff, which caused monthly inflation to register at 3.5% MoM. Moreover, the control of the gas-based circular debt has became a priority, likely entailing a sharp rise in the average gas tariff. Based on our estimates, plugging the leakages emanating from gas sales may **entail an average tariff hike of over 60% .**

Additionally, the past four weeks saw a sudden rise in the domestic petroleum prices, driven by an increase in global crude and refined products. We foresee the impact of said hike to trickle down into the broader economy and push general inflationary pressures. As such, next month's inflation reading may depict a 2.0% MoM rise.

Interbank rate playing catch up to its open market counterpart

As mentioned, the Pak Rupee lost considerable grounds since the dissolution of the National Assembly, eroding 2.5% of its value and reaching a **low of PKR 295/USD**. The interbank rate, in essence, is playing catch up with the open market rate, which has surged past the 300 mark and is **presently hovering around PkR 302-3/USD**. As the industry foresees limited intervention in the currency market during the interim setup, the Pak Rupee is likely set to test new lows in the coming weeks.

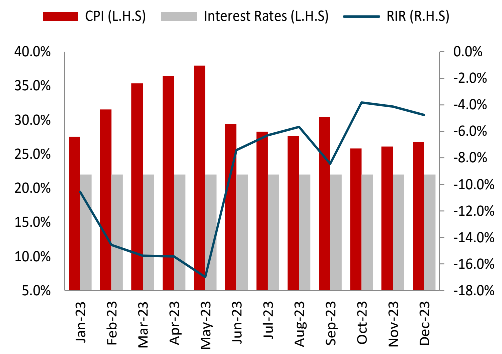
...additional pressure as trade normalizes and capital flow restrictions ease

Recall that recent restrictions on imports and capital flow controls have created a large backlog of uncleared LCs **(estimated at USD 6.0bn),** and delayed profit repatriations. As the IMF program entails limited trade and capital flow controls, we may witness large outflows of capital under these two heads. External imbalances emanating from normalizing imports, a high debt servicing burden, and maturing deposit rollovers may push the PkR/USD parity around the **325-330 mark during FY24.**

Commodity upcycle amidst a weakening Pak Rupee

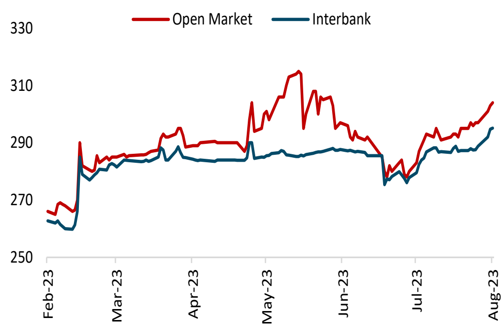
Recent months have witnessed a semblance of another global commodity upcycle, driven by the reopening of major economies, particularly China. Since the start of the fiscal year, refined fuel is up 25%, and global fertilizer prices increased by over 20%. Moreover, since India's ban on the export of rice, global rice prices are up by 25%. Coupled with the recent currency weakness, increased energy tariffs, and high domestic petroleum prices, these developments are expected to push Pakistan's food inflation (CPI weight: 34.6%) even higher.

Pakistan Projected Real Interest Rates



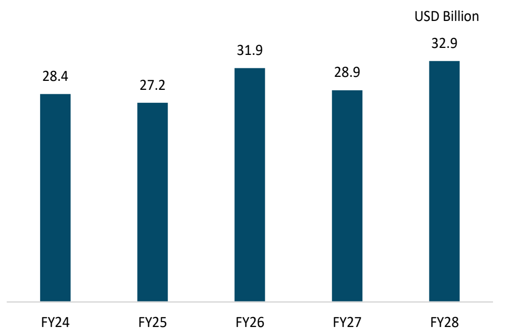
Source: SBP, BMA Research

PKR/USD Parity – Open Market Rate vs. Interbank



Source: SBP, BMA Research

External Debt Servicing Requirements



Source: SBP, BMA Research

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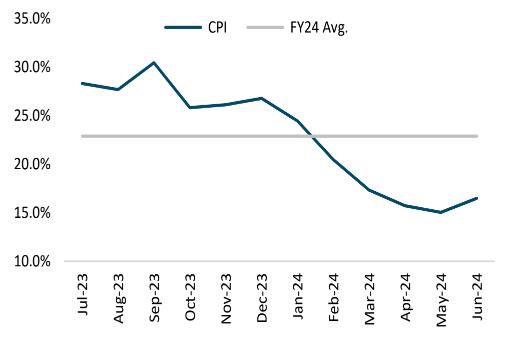
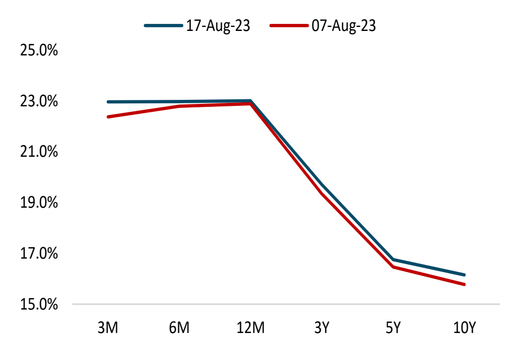
High inflation base to kick in from 2HFY24



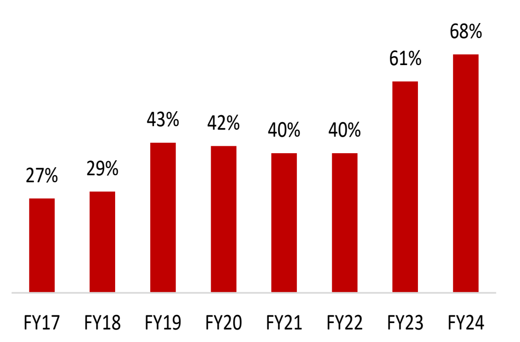
Source: PBS, BMA Research

Secondary Yields rise by 30bps



Source: IMF, BMA Research

Mark-up expense to Revenues Ratio on the rise



Source: IMF, BMA Research

Global refined fuel prices may, however, ease as supply catches up

Global refined fuel prices are hovering at 6-month high levels because of increased demand from Asian countries. Notably, the **cracking spreads are also hovering at six-month high levels** (HSD cracks: 3x FYTD; MS cracks: 2x FYTD) led by the demand-supply imbalance. We, however, **project the refined fuel prices to ease off** in the coming weeks as many refineries have scaled up production to meet the sudden increase in demand. While the Rupee weakness may offset the benefits of lower fuel prices, we think domestic petroleum prices will likely start to **ease as cracking spreads normalize** to past averages**.**

The high-base will also restrict monthly CPI prints

We think the previous year's high base will likely restrict the monthly CPI readings from 2HFY24. After incorporating the impact of structural adjustments, including energy tariff revisions, and the Rupee weakness, we estimate **FY24's CPI inflation to average at 22.8% in FY23.** Moreover, we project CPI to fall below the 20% by March 2024.

Speculations of another rate hike have emerged

Recent developments inciting inflationary concerns and trends in the currency market have fueled speculation of another policy rate hike. Since the dissolution of the National Assembly, secondary market yields have **risen by around 30bps points.**

Prior communications by the SBP, however, suggested peaked interest rates as the central bank had largely incorporated the structural adjustments and the commodity upcycle into its inflation projections. The recent currency weakness and the sudden rise in domestic petroleum prices, however, **may compel the SBP revise its inflation projections (FY24 CPI projections 20-22%).**

….these speculations gained momentum after the FM's appointment

Dr. Shamshad Akhtar's appointment as the Finance Minister (FM) caused these speculations to gain momentum. Her past as the SBP governor (Dec'06 - Jan'09) saw the central bank **raise interest rates by 550bps.** The hikes were in response to FY09's inflation spike, led by the sudden surge in global oil prices, and the Rupee depreciation. Moreover, her 3-month tenure as the interim Finance Minister saw the **policy rate increase by 100bps.** At the time, the country was battling a balance of payment crisis, which saw the Pak Rupee lose 6.5% of its value during her stint.

With the ongoing inflationary trend and the FM's history of adhering to economic fundamentals, a growing number of investors within the industry have started to contemplate the possibility of additional policy rate hikes, **with ranges hovering between 100 and 200bps.**

The fallout of additional tightening – cyclicals likely to come under pressure

Additional policy rate hikes will likely exert pressure on the profitability of cyclical industries, particularly the highly-leveraged cements, and steel. Moreover, the textile industry also remains vulnerable to policy rate hikes since the scaling-back of its subsidized financing.

Stocks with built-in currency hedges may fare well during recent developments. The energy chain, particularly E&P companies and IPPs benefit from USD-hedged revenues. While exporters, such as textiles, are likely to benefit from increased revenues in PKR terms, they remain exposed to higher energy tariffs.

On the economic front, the government's fiscal space may further shrink as its debt servicing burden will increase. Notably, we estimate that **nearly 70%** of the government's projected revenues will be utilized to finance its debt.

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Buy	>15% expected total return
Hold	10%-15% expected total return
Underperform	<10% expected total return
*Total stock return = capital gain + dividend yield	

Old rating system

Overweight	Total sector return > expected market return
Marketweight	Expected market return
Underweight	Total stock return < expected market return

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.)