BMA Capital Management Limited

Monthly Economic Update

The Resurgence of Economic Concerns

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Report by:
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Monthly Review - The resurgence of economic concerns

Recent weeks have witnessed the resurgence of macroeconomic concerns, characterized by an escalation of inflationary pressures, a notable uptick in external account imbalances, and the depreciation of the Pak Rupee to historic lows. These concerns were further exacerbated by an uncertain political landscape as talks of **possible delays in the general elections** gained prominence. Investors remain concerned over the possibility of an extended interim setup and its potential to disrupt the long-term policy-making process.

IMF conditions influencing macroeconomic trajectory: The IMF's Standby Arrangement (SBA) entailed structural adjustments for ensuring Pakistan's sustainable long-term economic growth. The program's revival hinged on significant measures aimed at reducing the accumulation of circular debt, enforcing fiscal discipline, adopting a flexible exchange rate regime, and limiting restrictions on trade and capital controls. These stipulations have considerably influenced the recent trajectory of Pakistan's macroeconomic landscape, as evident by recent economic data points.

Talks of another monetary tightening cycle making rounds: A deteriorating macroeconomic landscape has driven talks of additional monetary tightening for containing inflationary pressures, arresting the Pak Rupees freefall, and controlling the projected external account imbalances. Moreover, the past month saw consumer and business confidence take a considerable hit, given a lack of a long-term policy direction and uncertainty over the election timeline. Industry expectations hover between **a 150 and 300bps hike in the policy rate** as the SBP tackles the unexpected surge in inflationary pressure and the continuous weakening of the Pak Rupee.

Tough reforms amidst country-wide protests: The new cabinet came on record **with its plan to ensure strict fiscal discipline and adherence to the IMF program** during its tenure. Pakistan's energy chain, in turn, outperformed the broader market, driven by investors anticipating the implementation of energy sector reforms during the interim setup. The recent country-wide protests over elevated electricity bills, however, raised concerns about potential delays in the planned energy reform process because of its impact on the general inflation outlook. We think any delays on this front could affect the IMF's SBA program, which is due for its first review in Oct-Nov23.

Catalyzing FDI taking precedence: The prior government took steps to catalyze foreign direct investments (FDI) into Pakistan, primarily targeting investments from GCC economies. The most prominent investment on the radar has been a **USD 10-12bn deep-conversion refinery complex** with key stakeholders belonging to Saudi Arabia (via Aramco), China, and the Pakistan. Moreover, the Pakistan government was also contemplating offering Saudi Arabia an equity stake in the Reqo Diq mining project. Most notably, the government recently agreed to lease out a portion of the Karachi Port in a 50-year concessions agreement with the UAE government with expected investment inflows of over USD 200mn.

A selective stock-picking strategy amidst falling confidence: We highlight stocks offering natural US Dollar hedges, particularly energy chain companies, **with MARI, OGDC,** and **HUBC** as our top picks. The sector is also slated to benefit from any progress on the planned energy reforms. Moreover, we also prefer the consumer industry because of its inherent ability to mitigate inflation. As imported goods become increasingly uncompetitive because of a weakened Rupee, we think the industry may benefit from a potential switch in consumer preferences towards locally-produced goods.

Source: PBS, BMA Research

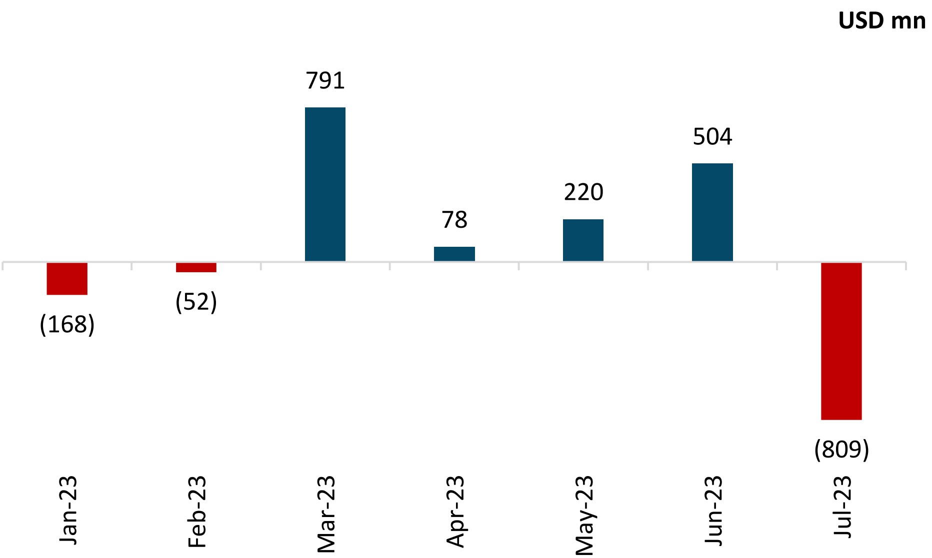
External Accounts - The post-IMF imbalance

Current Account Deficit back on the table as import restrictions ease: Since the onset of the IMF's SBA and the implementation of its stipulation to eliminate trade and capital flow constraints, Pakistan's external accounts have witnessed considerable pressure. July 2023's import figure surged by 33% MoM to USD 4.2bn as the import bill of notable heads grew significantly. Most prominently, automobile imports surged by 3x MoM and machine imports rose by 69% MoM. Consequently, after four consecutive months of CA surplus, July 2023's **CA balance registered a deficit of USD 809mn.**

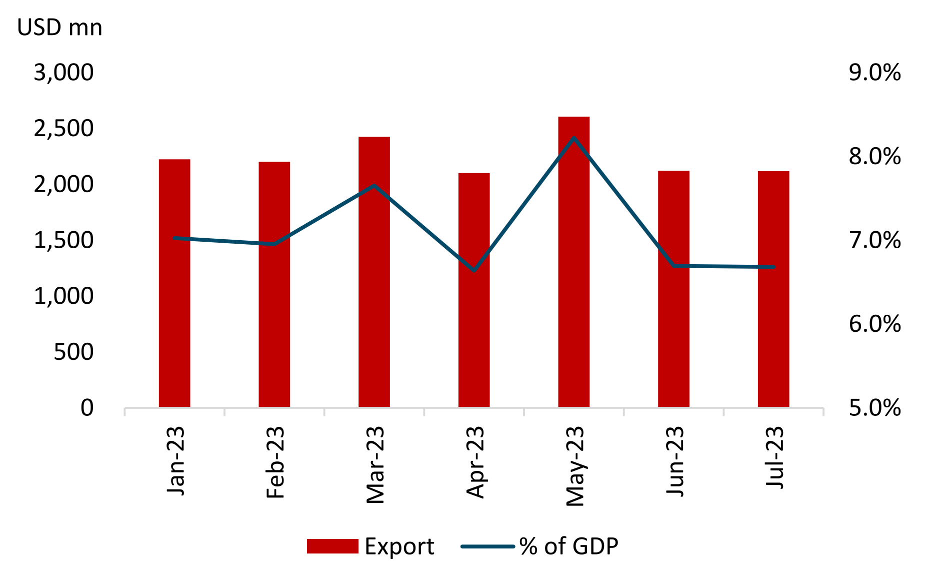
Falling remittances also contribute towards the imbalance: Apart from the aforementioned increase in imports, the monthly CAD can be credited to declining remittance inflows, which fell by 7% MoM to USD 2.0bn in July 2023. Notably, remittances have remained under pressure since October 2022 with the emergence of a parallel currency market, which offers conversion rates markedly higher than the official interbank rate. At the time of writing, the open market rate for the **US dollar exceeds the interbank rate by 6**%. This difference has effectively nullified the impact of monetary incentive programs aimed at promoting the use of official banking channels for remittances.

Exports under pressure as well: Despite currency weakness, Pakistan's exports have exhibited a declining trend, falling below **the 7% of GDP mark**. July 2023's figure of USD 2.1bn stood nearly **10% below FY23's monthly average** and 22% below FY22's figure. While the decrease can be partially attributed to a slowdown in key export markets, we assess that the primary driver of the decline is a fall in global competitiveness. The discontinuation of subsidized energy tariffs and the reduction of financing schemes have additionally impacted the export sector's potential.

Monthly Current Account Deficit (CAD)



Pakistan Monthly Export to GDP (%)



Source: SBP, BMA Research

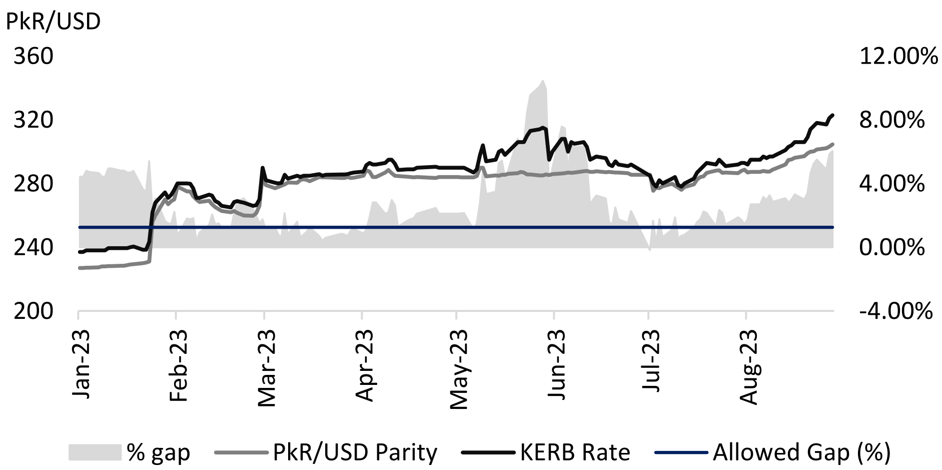
Pak Rupee – Testing new lows as outflows a concern

The Pak Rupee's post-IMF recovery was short-lived as the currency continues to test new lows, losing over 10% of its value since recent highs. The reasons for the recent decline are manifold, primarily driven by high US dollar outflows, limited inflows, and rampant inflation. As mentioned, the clearance of the import backlog **(~USD 6.0bn),** falling remittances, and declining exports resulted in a monthly external deficit. Moreover, a high debt servicing burden continues to exert pressure on SBP's Forex balance.

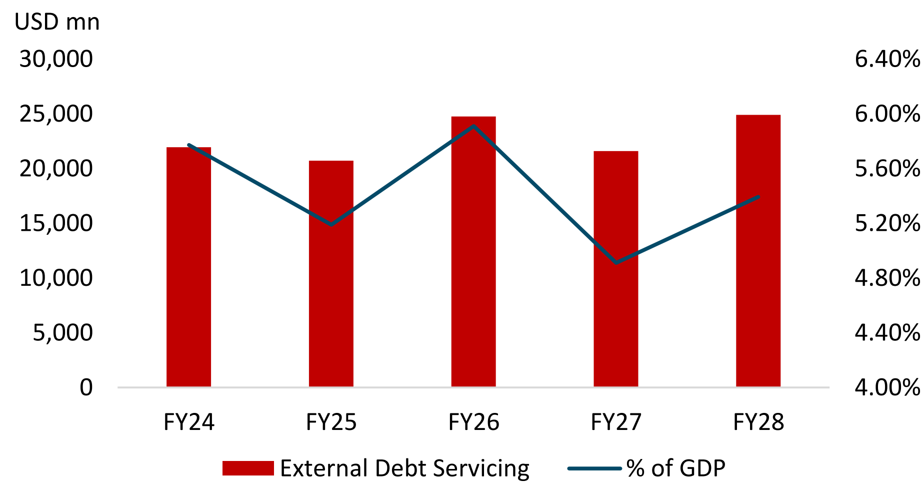
Debt servicing burden a concern amidst low reserves: Pakistan's debt servicing requirement for FY24 was projected at USD 25.0bn, of which USD 3.3bn would comprise interest payments. The SBP estimated that around USD 11.3bn of the debt liability would be refinanced, suggesting that the government would need to secure an additional **USD 8.5bn during the fiscal year** to sustain its reserves balance. Apart from IMF's tranches, potential avenues for funding could include multilateral institutions (The World Bank, IDB, etc.) and commercial loans **(budgeted estimate: USD 4.5bn)**. While the government had also budgeted **floating additional Euro Bond/Sukuks for raising USD 1.5bn,** we do not see it as a viable financing avenue given that yields for Pakistan's International Bonds still hover north of 20%.

Widening gap with the parallel currency market: Despite the adoption of the flexible exchange rate regime, the open market's conversion rate exceeds the interbank market rate by 6% because of the limited availability of US dollars. In view of the high inflation environment, the demand for the US dollar has increased with an intent to preserve wealth. Given the IMF condition of maintaining a maximum 1.25% parity between the two currency markets, we foresee the interbank rate catching up to the open market rate in the coming days. We think the materialization of external inflows and stringent policy measures would be imperative to arrest the Pak Rupee's decline.

Interbank vs KERB Rate



Projected Debt-Servicing Burden



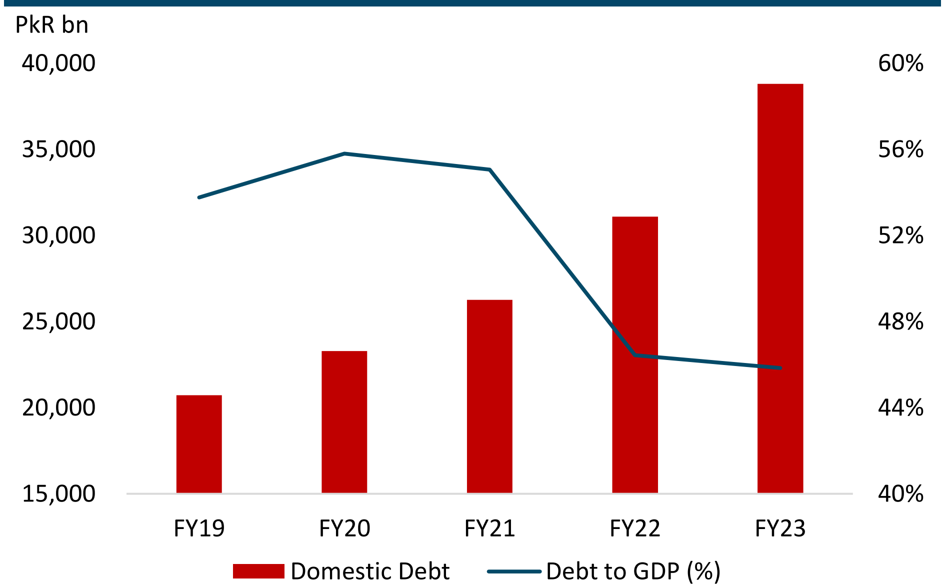
Fiscal Accounts – Shrinking space led by high debt servicing

Pakistan's fiscal accounts are expected to remain under pressure during FY24, driven by a high debt servicing burden, elevated inflation, and the general economic slowdown. Notably, FY23's **fiscal deficit (7.7% of GDP)** overshot budgeted estimates because of a sharp surge in markup servicing and an inflation-driven increase in expenditures.

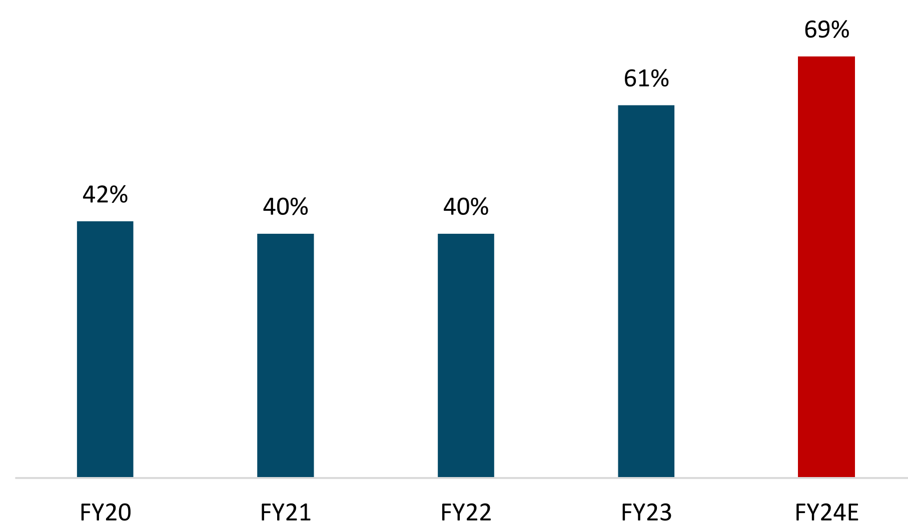
Markup expenditures may hover around 70% of revenues: Prior budgetary deficits (5yr avg: 8.0% of GDP) and an increasing reliance on domestic borrowings have pushed Pakistan's domestic debt balance to PkR 38.8tn as of June 2023, **depicting a 5yr CAGR of 19%.** Given that the bulk of the government's debt balance constitutes floating rate liabilities (~70%) amidst a high-interest rate environment, we project a large increase in the fiscal debt servicing burden. We estimate that FY24's markup figure would hover around PkR 8.5tn, 69% of the country's projected revenues. **Moreover, a 1pps hike in the policy rate may cause this figure to rise by PkR 250-275bn.**

Downside risks to public development spending: We anticipate downside risks to the government's fiscal spending, particularly the development expenditure, given the tight fiscal space. The present cabinet has come on record to ensure fiscal discipline, insinuating reduced reliance on subsidies and controlled spending. We foresee a potential downside risk to the budgeted development spending (PkR 1.14tn for FY24) if fiscal accounts remain tight.

Pakistan Domestic Debt



Mark-up to Revenues Ratio



Source: SBP, MoF, BMA Research

Inflation – 2nd wave brewing

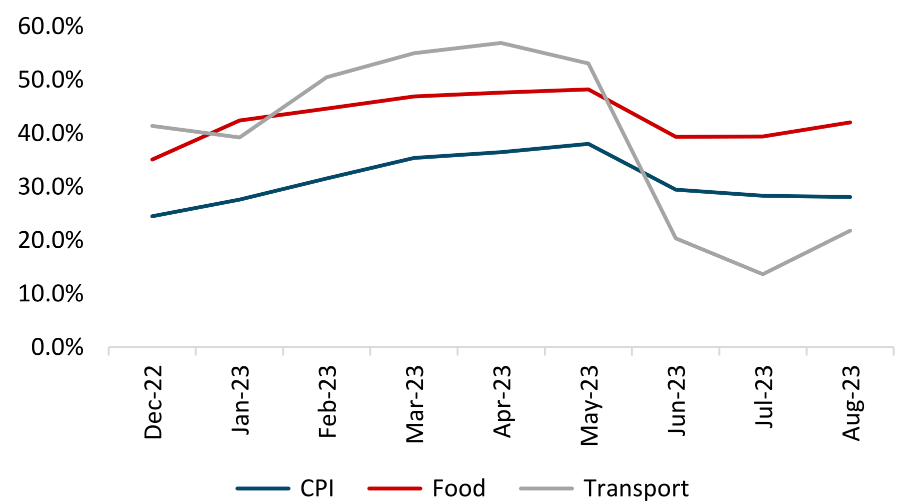
While the monthly inflationary print appears to have largely peaked during May23 (CPI: 38.0% YoY), we foresee another inflationary wave brewing given recent developments, including sharp Pak Rupee weakness, higher fuel prices, and energy tariff adjustments. Most notably, entrenched expectations of high inflation and partial dollarization of the economy will likely limit a potential reversal in the prevalent inflationary trends.

Continuous escalation of domestic petroleum prices: The Pak Rupee weakness and elevated refined fuel prices will continue to drive domestic petroleum prices to record levels. Notably, MS and HSD prices crossed the **PkR 300/liter mark during today's fortnightly repricing**. While the weight of domestic fuel prices in the CPI basket remains low at under 3.0%, its impact on broader inflation categories, particularly the food index (CPI weight: 35%), will further drive the prevalent inflation outlook.

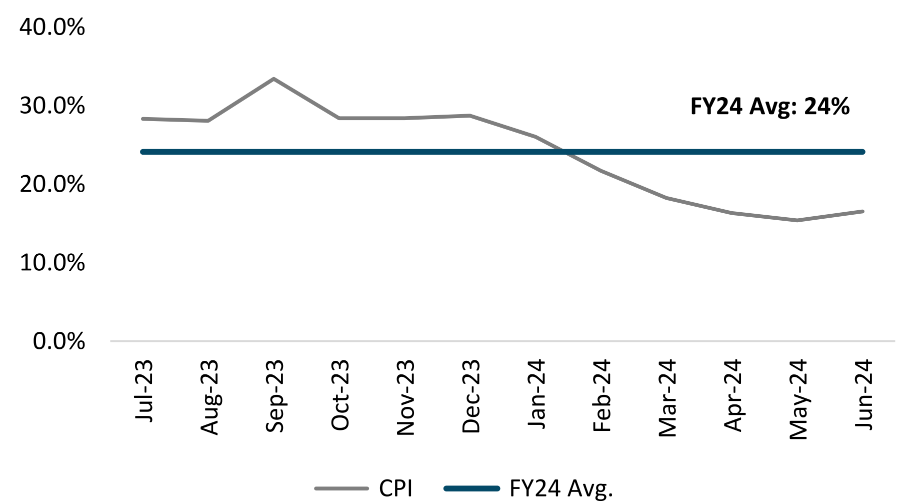
Further revisions in the energy tariff: Pak Rupee weakness and higher interest rates have compelled the revision of the electricity tariffs through the quarterly tariff adjustments. This increase would be applicable to Sep'23's electricity bill, likely pushing the inflation trajectory for the coming months. In tandem with higher petroleum prices, we foresee **September 2023's inflation reading to hover around 33% YoY**. Moreover, FY24's average inflation would likely cross SBP's targeted range of 22-23%, with our **estimates projected at 24%.**

Moreover, the base gas tariff is also slated to increase in an effort to plug the circular debt emanating from discounted gas sales. We estimate that the recent round of currency weakness **necessitates a 60% increase in tariff** to bridge the shortfall, up from the 50% estimate at the start of the calendar year.

Monthly Inflation by Segment (YoY %)



Monthly Inflation Projections



Source: PBS, BMA Research

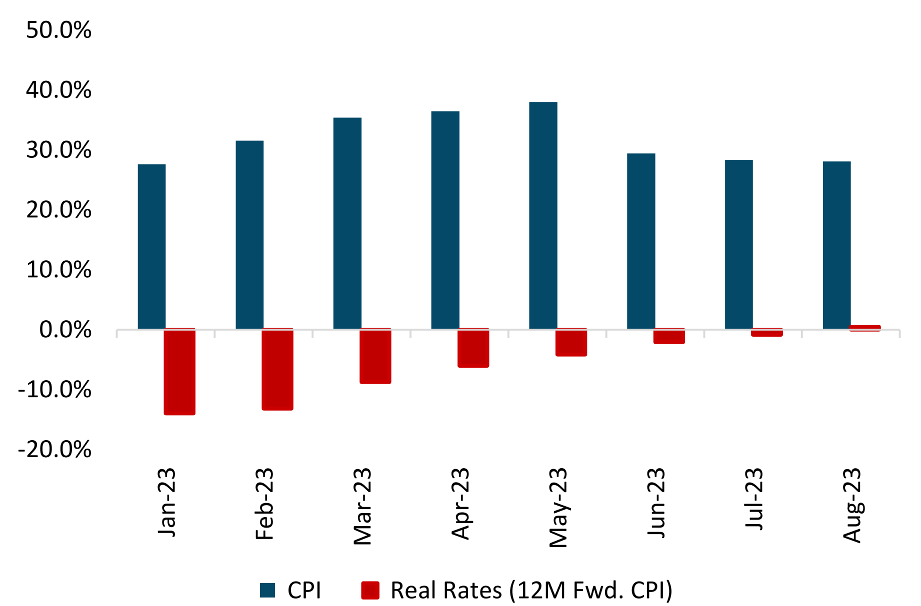
Interest Rates – Hike anticipated amidst a deteriorating backdrop

As mentioned, talks of an additional hike in the policy rate have gained prominence in recent weeks, driven by a deteriorating macroeconomic backdrop. Despite prior communications by the SBP hinting at peaked interest rates, the general market consensus suggests that a **200bps hike** in the policy rate is likely on the cards to alleviate inflationary concerns, arrest the Pak Rupee's decline, and ease the external account imbalance.

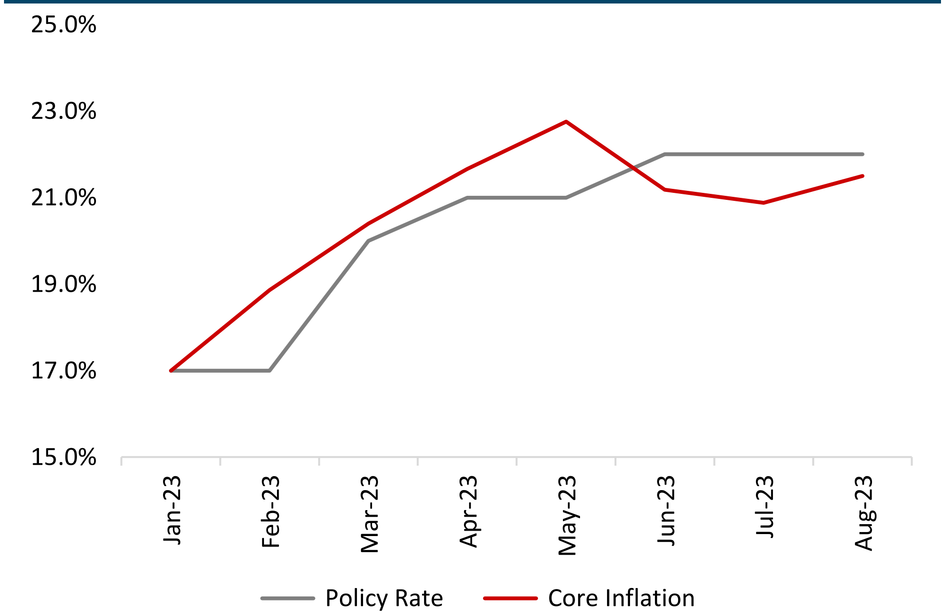
Real rates likely turning negative on a forward basis: Real interest rates (RIR) remain deep into negative territory, estimated at around -5% based on 1HFY24's inflation projections. Moreover, recent developments driving inflationary concerns, including the Pak Rupee weakness, higher energy tariffs, and rising petroleum prices **may have turned Pakistan's RIR negative** on a 12M forward-looking basis as well.

Pressure on core inflation may also materialize: Recent policy actions have closely tracked the trend witnessed in core inflation, which stood at **20.9% in Jul23's inflation reading**. Notably, core inflation has consistently remained below N-CPI as over a two-year horizon, the general CPI index rose by 60%, while the food index and energy indices surged by 79.3% and 84.3%, respectively. Recent developments, particularly the currency weakness and anchored inflationary expectations, may drive core inflation to higher levels. This development further strengthens our case for additional policy tightening.

Monthly Real Interest Rates



Core Inflation vs. Policy Rate



Source: SBP, PBS, BMA Research

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Old rating system

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.)

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Stock Exchange Road, Karachi.
Tel: (021) 32410617

Bahadurabad Branch:
Office # 3, Mezzanine Floor,
Akber Manzil, Main Bahadurabad
Roundabout, Karachi
Tel: (021) 3486 0393-98
Fax: (021) 3493 1396

Gulshan-e-Iqbal Branch:
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Road, Gulshan-e-Iqbal Karachi.
Tel: (021) 34825023

North Nazimabad Branch:
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MCB Building, Near 5 Star Round About,
North Nazimabad Karachi.
Tel: (021) 36672301-00.

Awami Markaz Branch:
G13, Ground floor, Awami Markaz,
Shahrah-e-Faisal Karachi.
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Tel: (042) 3667 6614-20
Fax: (042) 3661 9912

Lahore Gulberg Branch:
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Mega Tower 63-B, Main Boulevard,
Gulberg II, Lahore.
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Fazel e Haq, Blue Area, Islamabad
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Centre, Paris Road, Sialkot, Adjacent to
Sialkot Chamber of Commerce.
Tel: (052) 4260091-94

Multan Branch:
Office No. 607/A, 6th Floor,
The United Mall, Plot No. 74
Abdali Road, Multan
Tel: (061) 457 6611-15
Fax: (061) 457 6615

Sargodha Branch:
Ground floor, Shan Plaza, Block No 16,
Main Khushab Road, Near Allied Bank
Limited, Sargodha.
Tel: (048) 3767 817-18

Faisalabad Branch:
Mezzanine Floor, State Life Building #2,
Plot No. 833 Liaquat Road, Faisalabad.
Tel: (041) 2612261-5.

Gujranwala Branch:
51-H block Near Standard Chartered Bank
Trust Plaza GT road Gujranwala.
Tel: (055) 3848501-05

Chakwal Branch:
Office No. 12, 1st Floor, Ejaz Plaza,
Talagang Road Chakwal.
Tel: (0543) 553850, 0543-543720,0543-543721.

Jhelum:
2nd Floor, Khalid Plaza, Plot#7/89, Kazim
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