

## Pakistan Strategy Update

After Nawaz, focus shifts back to twin balances; politics still a background risk; stick with yield and large caps

Macro Strategy Report

www

### Nawaz steps aside, Kahqan-Shahbaz offer continuity

Nawaz Sharif's decision not to contest his disqualification should be taken positively by local investors this week. Mutual funds are sitting on cash (7.4% from our sample) and dividend yields have become attractive. The PML-N has promised continuity by deciding on Shahid Kahqan Abbasi (formerly the petroleum minister) as interim PM, and Shahbaz Sharif, the brother of Nawaz, as the PM who will take the party into next year's elections. We think that economic policy will be largely unchanged in the run-up to those elections. Markets may be reassured that Finance Minister Ishaq Dar and Planning Minister Ihsan Iqbal will remain in their posts for now.

### FX & budget deficit back in focus; foreign bid will be weak

With political noise taking a back seat for now, we think that foreign investor focus will return to economic fundamentals, namely pressure on PKR and the risk of a higher-than-expected budget deficit. While a good share of the CA deficit is still funded by FDI and loans, we note that SBP foreign reserve coverage has fallen from a recent peak of 5.6 months of imports (October 2016) to 4.2 months (May 2017). The recent [devaluation-that-never-was](#) has not helped foreign investor perceptions, and we expect foreigners will hold back until we see a larger FX move. Meanwhile, we think that a weakened PML-N will go for growth in the run-up to next year's elections. The [FY2018 deficit target](#) looks ambitious – an overshoot now seems more likely.

### Rates could rise, good for banks; buy yield in the meantime

A higher fiscal deficit and FX pressure increase the chances of interest rate rises over the next year. In the meantime, yield is likely to be an important driver of stock selection for local funds - from our coverage, [we highlight INDU for high yield and consistent cash generation](#). Banks also offer good yields, and we repeat our broad preference for large caps over small caps over the next 12 months. Aside from yield, we think that credit growth and the potential for rising interest rates will be supportive for banks. However, foreign investors should stay Underweight Pakistan.

### Political risk is not dead, just sleeping; stay cautious

Sharif's departure has weakened the PML-N as it prepares for 2018's elections, and a hung parliament – and thus a shift towards populism - looks increasingly likely. Politics is unlikely to be quiet in the meantime. Panama-related cases have gone to the NAB for investigation, which could lead to more charges - PTI leader Imran Khan is pressing his advantage. We stick with our view that the market will be volatile post-MSCI year, and USD returns – MXPk is down 12% YTD – are likely to be negative from here.

Simon Kitchen

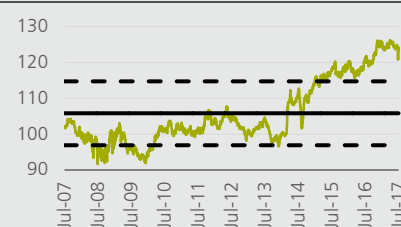
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#### REER beyond 10-yr average

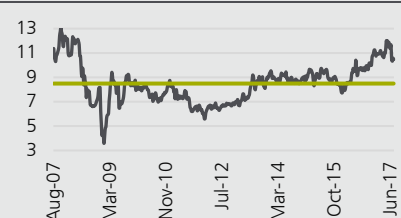
Real effective exchange rate with LT average +/- 1 St. Dev.



Source: Bloomberg, EFG Hermes calculations

#### Not cheap enough for foreign bid

MXPk consensus forward P/E (with average)



Source: Bloomberg, EFG Hermes estimates

#### FM & GEM funds reduced positions

Active weighted allocation by fund type  
Pakistan weight was 13bps in EM at end June 2017

	Jun-15	Jun-16	Jun-17
GEM	0.20%	0.16%	0.09%
FM	11.67%	13.14%	6.88%

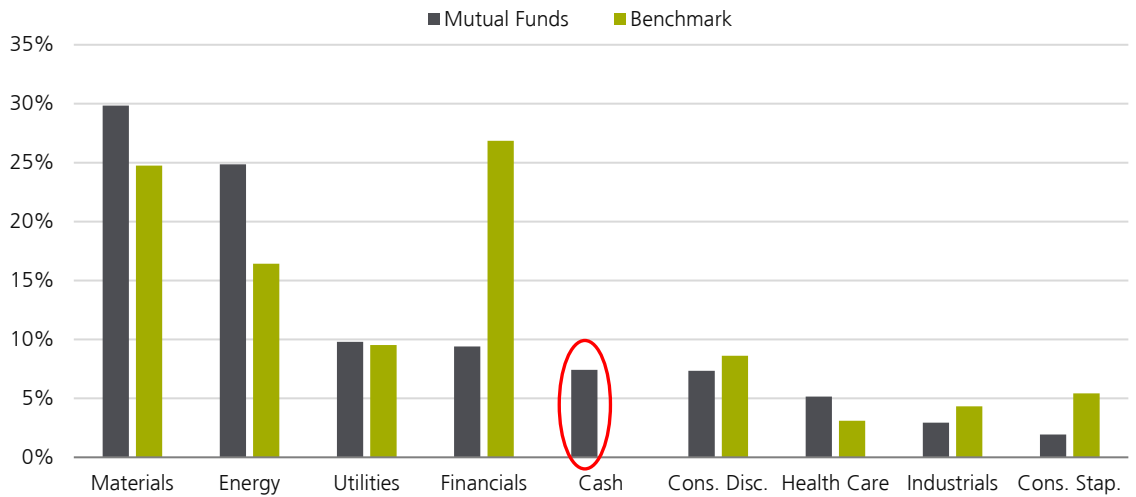
Source: EPFR Global, EFG Hermes

## Mutual funds could drive a short rally, but FX blocks foreign bid

- ▢ Conditions are right for a locally-driven rally driven by mutual funds
- ▢ But FX risks are still building, and valuations are unlikely to have bottomed out
- ▢ Foreign investors will sit on the side until FX question is resolved, in our view

**Figure 1: Mutual funds are sitting on cash, likely to look for yield as market recovers**

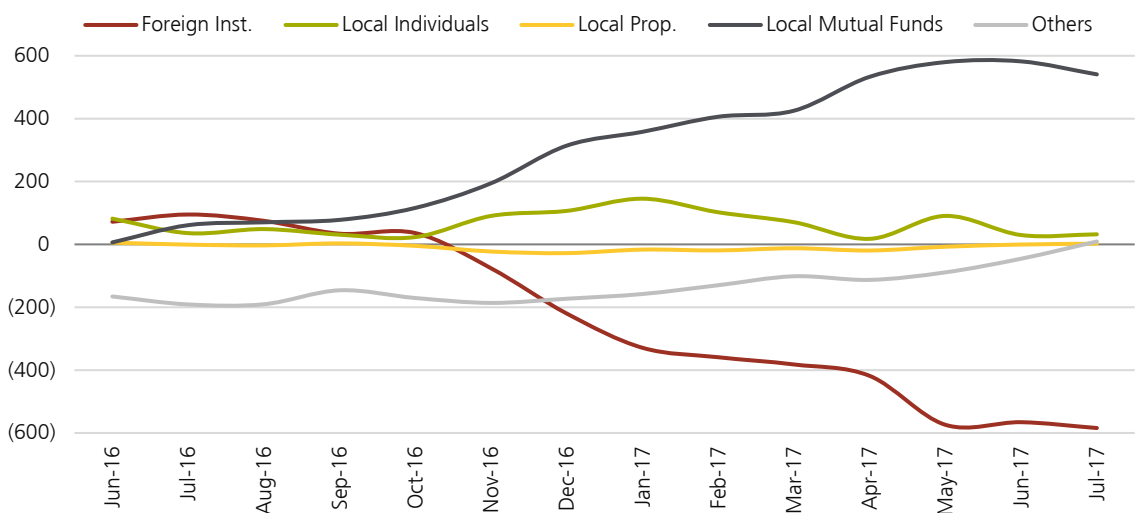
Aggregate positioning for 8 mutual funds with AUM of USD900mn



Source: KSE, EFG Hermes calculations

**Figure 2: Mutual funds have matched foreign offer since MSCI upgrade announcement**

Cumulative monthly net buying since June 2016



Source: KSA, EFG Hermes calculations

**Figure 3: Market is cheaper, but macro risks mean that multiples are unlikely to have bottomed out...**

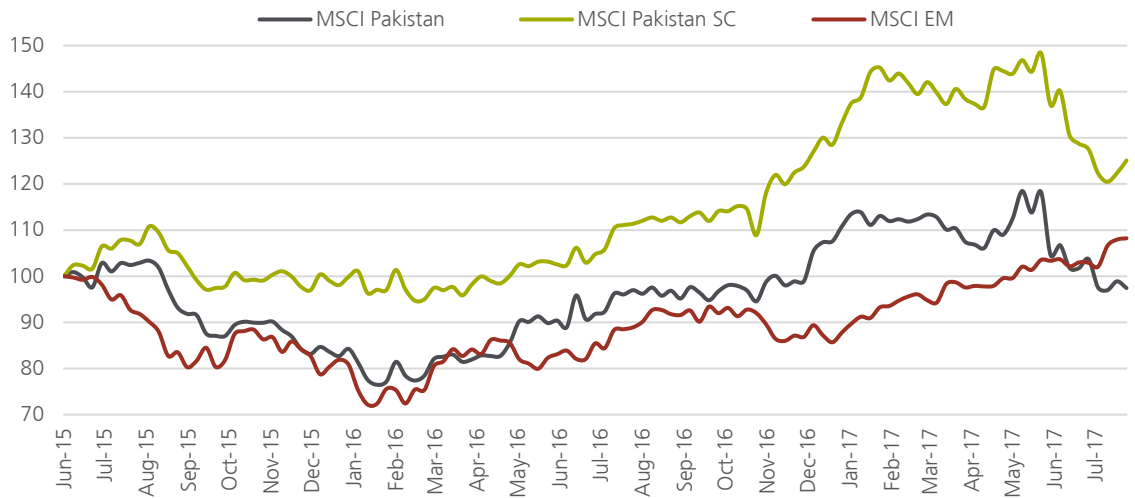
MSCI Pakistan Index - consensus estimated P/E multiple with 10-year average



Source: Bloomberg

**Figure 4: ...meaning that recent underperformance relative to EM will continue**

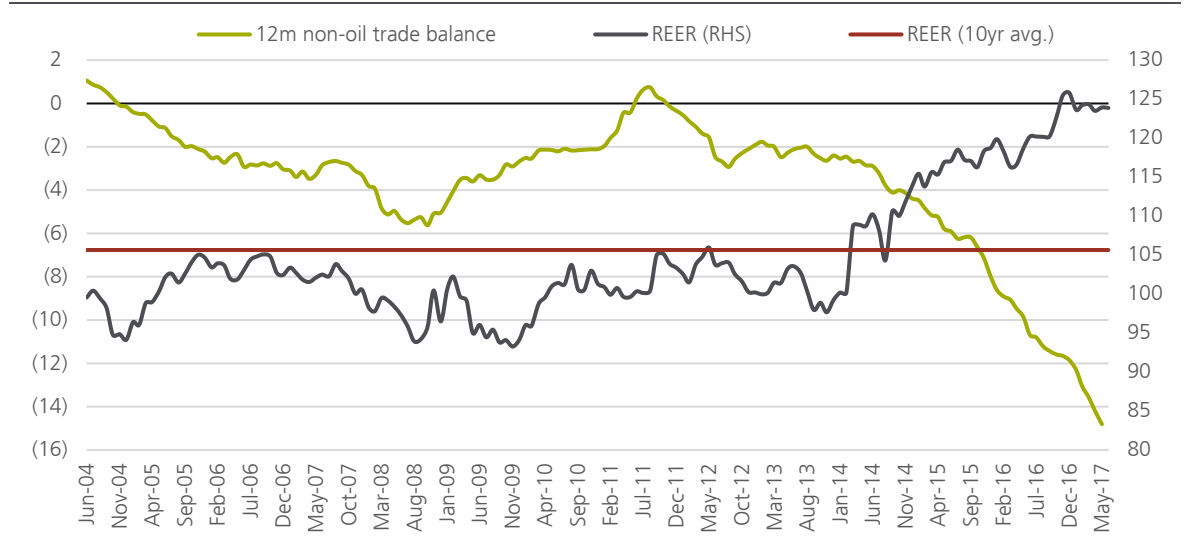
MSCI Pakistan, MSCI PK Small Cap and MSCI EM Indices (rebased 100 = June 2015)



Source: Bloomberg

**Figure 5: Current account remains under pressure, and PKR looks overvalued**

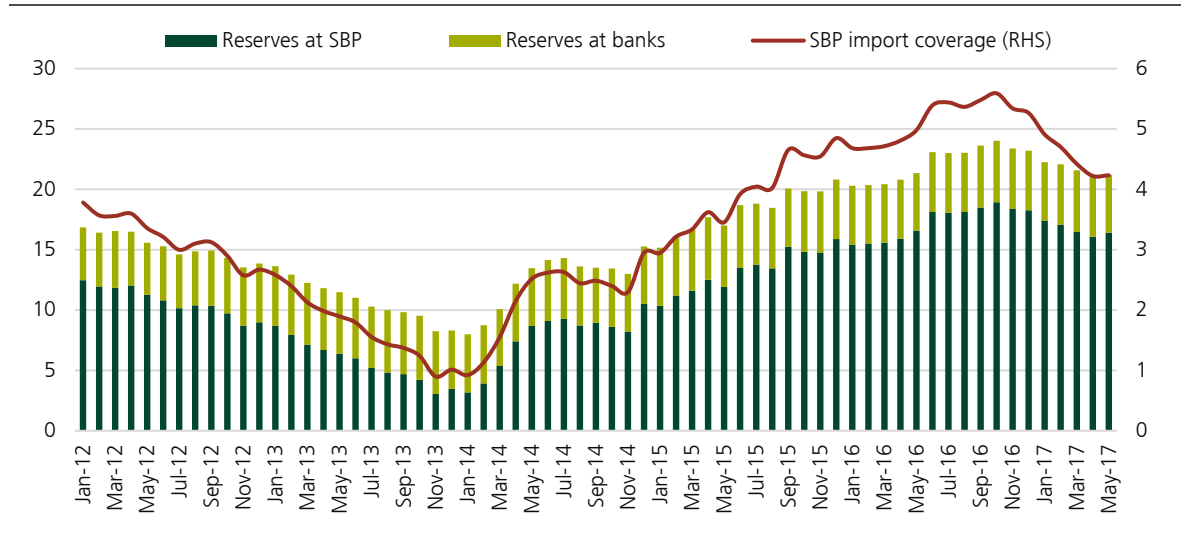
12m trailing non-oil trade balance in USDbn, Real Effective Exchange Rate plus average (RHS)



Source: SBP, Bloomberg, EFG Hermes calculations

**Figure 6: FDI still covers around 25% of CA deficit, but reserve coverage has recently slipped**

Foreign reserves at State Bank of Pakistan (SBP) and banks (USDbn), SBP reserves in months of imports (RHS)



Source: SBP, EFG Hermes calculations

**Figure 7: Yield will be in focus for local investors – our coverage pick is INDU**

Members of MSCI Pakistan Investible Market Index, sorted by market cap (EFG Hermes coverage in bold, all other estimates from Bloomberg consensus)

	Mcap (USDbn)	3MADVT (USDmn)	P/E (x)			P/B (x)	DY (%)
			2016	2017e	2018	TTM	TTM
Oil & Gas Development Co	6.3	5.6	10.9	9.7	8.2	1.3	3.4%
Habib Bank	3.5	5.7	10.6	10.8	9.1	1.9	5.7%
United Bank Pakistan	2.4	5.7	9.2	9.2	8.2	1.6	6.2%
MCB Bank	2.2	3.5	10.4	10.2	9.2	1.6	7.8%
Lucky Cement	2.2	5.4	15.3	15.9	13.1	3.0	1.4%
Engro Corp	1.6	7.5	2.4	14.0	12.2	1.2	7.6%
<b>Indus Motor Co</b>	<b>1.3</b>	<b>0.8</b>	<b>12.4</b>	<b>9.8</b>	<b>9.7</b>	<b>4.1</b>	<b>5.6%</b>
Hub Power	1.3	1.8	11.7	12.1	10.3	4.5	9.1%
NBP	1.2	0.8	6.3	7.5	6.7	0.8	12.6%
Pakistan Oilfields	1.1	1.4	11.2	13.4	11.9	3.4	7.3%
Fauji Fertilizer Co	1.0	1.4	8.9	8.8	8.2	2.2	9.5%
Pakistan State Oil Co	1.0	3.4	10.2	6.1	6.1	1.0	2.3%
SUI Northern Gas Pipeline	0.9	6.5	N.A	13.1	9.6	26.2	0.0%
<b>Honda Atlas Cars Pakistan</b>	<b>0.9</b>	<b>0.4</b>	<b>26.6</b>	<b>16.3</b>	<b>12.5</b>	<b>7.3</b>	<b>1.0%</b>
DG Khan Cement Co	0.8	3.8	9.6	9.4	8.2	1.1	3.2%
Engro Fertilizers	0.7	1.9	8.1	7.5	6.8	1.9	12.3%
Searle Co	0.7	1.8	36.5	23.6	19.2	8.8	0.8%
Kot Addu Power Co	0.6	0.3	7.2	7.1	6.5	2.2	6.4%
Bank Alfalah	0.6	1.3	8.1	7.9	6.9	1.0	0.0%
Packages	0.6	0.5	12.0	11.7	10.3	1.1	3.6%
Shell Pakistan	0.6	0.1	8.9	13.7	11.7	4.8	6.0%
Millat Tractors	0.6	1.0	32.2	14.4	12.0	11.6	3.7%
Maple Leaf Cement	0.6	1.9	12.2	10.6	8.9	2.8	3.6%
National Refinery	0.6	1.9	7.6	-	-	1.4	2.7%
International Steels	0.5	6.5	48.2	19.8	12.2	6.7	0.0%
Nishat Mills	0.5	3.1	9.3	10.3	8.3	0.6	3.1%
Fauji Cement Co	0.5	1.5	10.0	19.0	8.9	2.9	9.5%
Pak Elektron	0.5	4.6	13.5	10.2	9.1	1.9	3.0%
<b>PAK Suzuki Motor Co</b>	<b>0.5</b>	<b>0.6</b>	<b>18.8</b>	<b>12.8</b>	<b>12.0</b>	<b>2.0</b>	<b>0.9%</b>
Thal	0.5	0.3	18.6	8.7	9.9	2.7	1.3%
IGI Insurance	0.4	0.1	20.5	21.7	18.2	2.9	1.8%
Fauji Fertilizer Bin Qasim	0.3	0.7	36.7	13.3	10.1	2.7	1.4%
Ferozsons Laboratories	0.1	0.1	5.0	-	-	2.0	3.3%

Source: Bloomberg, EFG Hermes estimates

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