# Day Break

Monday, 29 January 2018

## Economy

Exhibit: Historical inflation and discount rate

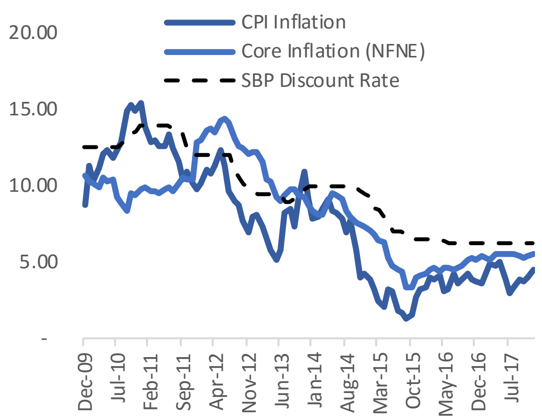
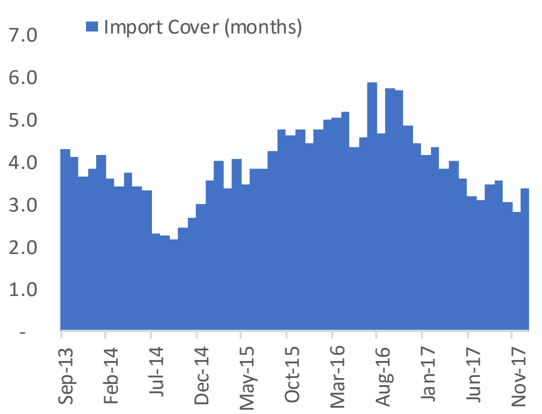



Exhibit: SBP interest rate corridor

| Date | SBP Reverse Repo Rate (%) | SBP Repo Rate (%) | SBP Policy (Target Rate) (%) |
|---|---|---|---|
| 18-Nov-13 | 10.00 | 7.50 | - |
| 17-Nov-14 | 9.50 | 7.00 | - |
| 26-Jan-15 | 8.50 | 6.00 | - |
| 24-Mar-15 | 8.00 | 5.50 | - |
| 25-May-15 | 7.00 | 5.00 | 6.50 |
| 14-Sep-15 | 6.50 | 4.50 | 6.00 |
| 23-May-16 | 6.25 | 4.25 | 5.75 |
| 26-Jan-18 | 6.50 | 4.50 | 6.00 |

Exhibit: Import cover remained below 5 in past 12 months




Source: SBP, PBS & IGI Research

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# Monetary Policy Statement

## Monetary cycle reversed; Target rate up by 25bps

- In its recently announced monetary policy statement (MPS), the State Bank of Pakistan (SBP) has increased policy rate by +25bps
- We expect the central bank to continue gradual monetary tightening with a further 75bps hike in the remainder of CY18
- We see Steel, followed by Fertilizer, as most effected on earning basis given high debt levels
- Positive implication holds for Banks, with mid-tier banks (BAHL, BAFL and FABL) preferred over large banks, due to their positive fund gap.

### Monetary Policy cycle reversed

In its recently announced monetary policy statement (MPS), the State Bank of Pakistan (SBP) has increased policy rate by +25bps (compared to market consensus of status quo), finally bringing a halt to ~3-year long monetary easing cycle. As per the statement, the rate increase decision came amid a) rising international oil prices, b) depreciating PKR and c) rising aggregate demand.

*"Four key factors of Pakistan's economy have witnessed important changes since November 2017 impinging upon the policy rate decision. Firstly, PKR has depreciated by around 5 percent. Secondly, oil prices are hovering near USD 70 per barrel. Thirdly, a number of central banks have started to adjust their policy rates upwards adversely affecting PKR interest-rate differentials vis-à- vis their currencies. Fourthly, multiple indicators show that the output gap has significantly narrowed indicating a buildup of demand pressures."*- SBP monetary Policy Statement, Jan 2018

### CPI outlook changed from benign to bullish

On inflation, SBP pointed out the rising trend in core inflation (non-food, non-energy), wherein, core inflation clocked in at 5.5% during 1HFY18, compared to 4.9% last year. Furthermore, increase in oil prices and recent PKR depreciation is expected to lead to uptick in headline inflation. However, it is still expected to remain within SBP estimate of 4.5-5.5% while the YoY figure is anticipated to reach 6.0% (SBP target) by the end of FY18.

### Growth momentum of real sector to continue

As per the MPS, production of major Kharif crops has exceeded last year's level while Large Scale Manufacturing (LSM) continues its robust upward trajectory, reaching 7.2% in 5MFY18. The regulator points out that although there could be a slowdown in LSM owing to some sector specific issues, yet the growth is expected to remain healthy. Simultaneously, estimating the impact of commodity sector dynamics on services sector, the regulator has decreased the forecasted GDP growth of FY18 from 6.0% to 5.8%.

### External sector stability depends upon timely official financial inflows

Outlining the external sector challenges, the regulator states that +10.8%YoY growth in exports and +2.5%YoY growth in remittances were outpaced by rise in imports which resulted in C/a deficit ballooning to USD 7.4bn during the first half of the year. Thus, despite healthy FDI and official financial inflows, the foreign exchange reserves declined by USD 2.6bn, since Jun-17, to USD 13.5bn until 19th Jan-18. Although recent policy measures and favorable external environment is expected to sustain C/a deficit, but rise in global oil prices is a major risk factor. Thus, further timely official financial inflows are key to managing balance of payments in the short run.

**Exhibit:**
Sharp PKR depreciation in Dec-17 after a long period of stability

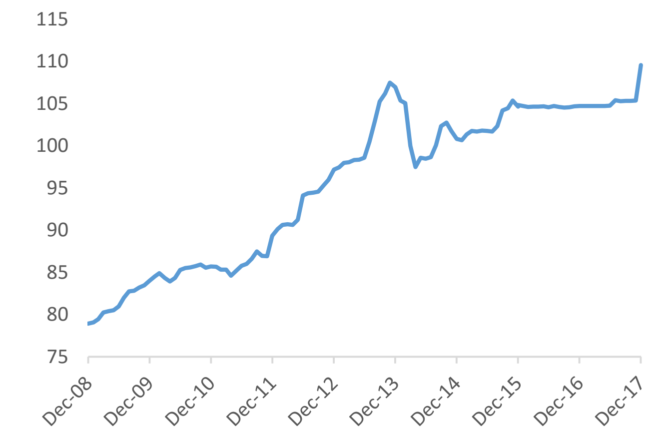
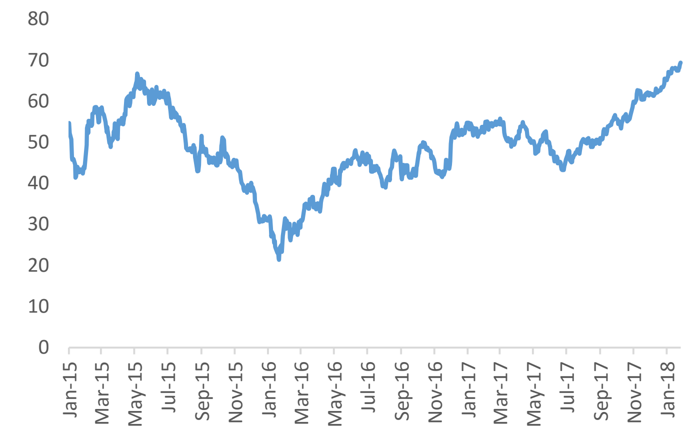



**Exhibit:**
Arab light (USD/bbl) trending upwards




*ource: IGI Research, SBP, PBS*

### Further +75bps hike expected in CY18

Given the macroeconomic environment, the impact on headline inflation of +25bps rate hike will be minimal, with real interest rates hovering around 1%. However, the move is prudent as it highlights a gradual rather than a sharp change in monetary policy. At the same time, although policy measures have been put in place recently to arrest aggregate demand with the change in target rate being one of them, yet we do not expect the growth momentum to slow down significantly. We expect the central bank to continue gradual monetary tightening with a further 75bps hike in the remainder of CY18.

### Capital market impact to be limited; Fertilizer and Steel most affected

In line with the rate change, interbank lending rate (KIBOR), treasury yields and cost of equity will be adjusted subsequently to reflect 25bps increase. From a market perspective, given low debt to equity ratio (IGI universe companies), we see minimal negative impact on earnings resulting from a policy rate hike. However, we see Steel followed by Fertilizer as most effected on earning basis given high debt levels. Positive implication holds for Banks, with mid-tier banks (BAHL, BAFL and FABL) preferred over large banks, due to their positive fund gap.

**Exhibit:**
Debt to equity of market (IGI universe) reduced substantially

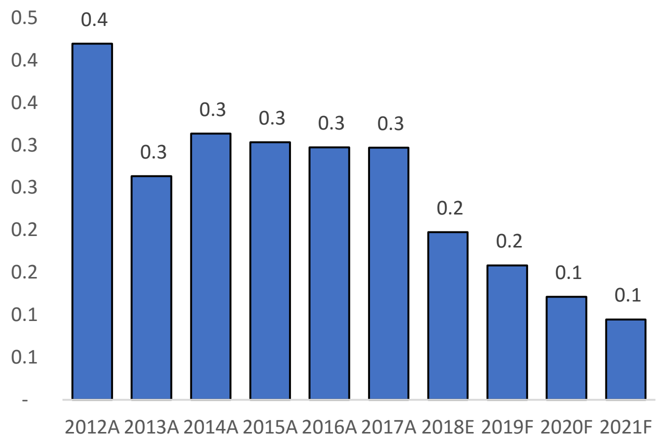
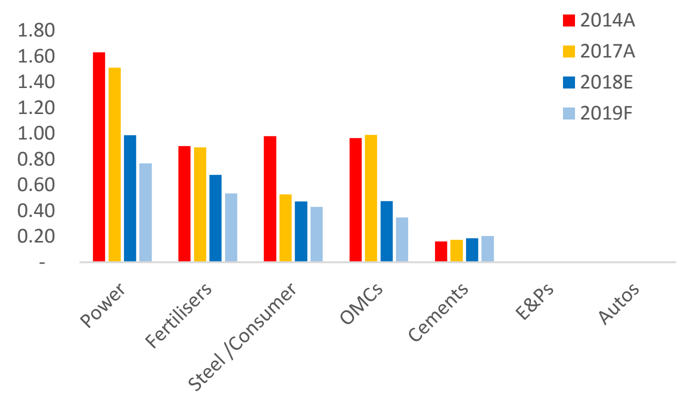



**Exhibit:**
Debt to equity of individual sectors (IGI universe); Fertilizer and Steel most affected




*Source: IGI Research, Company Financials*

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