Day Break

Wednesday, 21 March 2018

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Economy

Exhibit: SBP Interest rate corridor

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

Source: SBP, IGI Research

Exhibit: Trend in household interest rate expectation

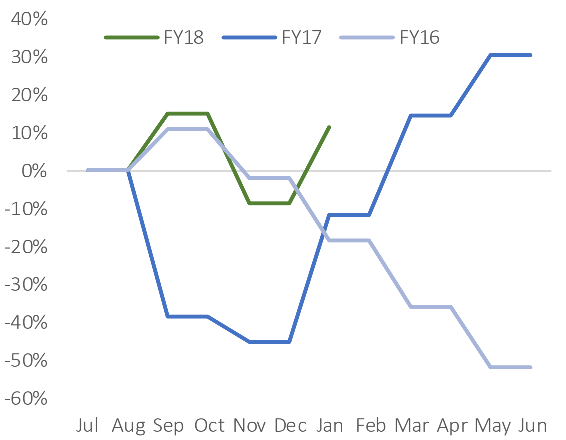
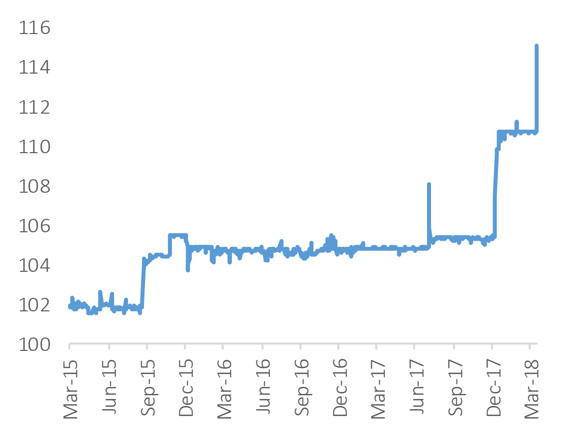


Exhibit: Daily PKR parity against USD



Source: SBP, PBS & IGI Research

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Monetary Policy

PKR depreciates; Monetary tightening to continue

- Monetary policy review is due this month, wherein, we expect the State Bank of Pakistan (SBP) to raise target rate by a minimum 25bps to 6.25%
- Yesterday (20th Mar-18), PKR slipped approximately ~4% to ~115 against USD, experiencing one of the sharpest single day depreciation in past 5 years
- Apart from PKR depreciation, other major drivers of inflation include higher oil and other commodity prices
- We see higher public sector cash requirement in 2HFY18 to result in higher growth in board base monetary aggregate (M2)
- Market has been quick to respond to PKR depreciation, with benchmark KSE 100 rising by ~800 points, led by a rally in Banks, E&P and Power sector stocks
- To protect the already meagre FX reserves as well as to proactively manage inflation, the central bank is expected to increase interest rates faster than previously estimated

PKR depreciation; more reasons for rate hike

Monetary policy review is due this month, wherein, we expect the State Bank of Pakistan (SBP) to raise target rate by a minimum 25bps to 6.25%, subsequently raising discount rate to 6.75% and bringing cumulative rate hike to 50bps during CY18. Moreover, yesterday (20th Mar-18), PKR slipped approximately ~4% to ~115 against USD, experiencing one of the sharpest single day depreciation in past 5 years. Although PKR depreciation was widely anticipated, albeit in phase-in manner, but the sudden move took the market by surprise, cementing the monetary cycle reversal.

In a press release issued late evening yesterday, SBP reiterated that widening trade deficit (USD 19.7bn in 8MFY18 versus USD 16.2bn last year) led to a demand supply imbalance, which combined with low foreign exchange reserve – by month end Mar-18 fx reserve stood at USD 12.2bn leaving import cover just under ~3moonths – leaves less buffer to ward-off abrupt movement in PKR. Henceforth SBP left the market forces to determine the exchange rate.

"[…] SBP believes that the exchange rate movements will continue to reflect the demand-supply conditions in the foreign exchange market. SBP will continue to closely monitor the foreign exchange markets; and stands ready to intervene to curb the emergence of speculative pressures."
– (SBP press release 20th March, 2018)

A look back at monetary policy statement of Jan-18, whereby SBP delivered a 25bps rise in the key policy rate to 6.25% (earlier than ours/consensus estimate) highlighted exchange rate depreciation as a key factor. To recall, monetary policy statement highlighted,

"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 January 2018)

Sources of higher inflation

Apart from PKR depreciation, other major drivers of inflation include higher oil and other commodity prices. International oil prices have come down by USD 8/bbl from a high of USD ~70/bbl (in Jan-18) to average USD 62/bbl since Jan-18. However, non-energy domestic prices are rather downward sticky in nature, meaning despite a drop in international oil prices, domestic non-energy prices failed to depict the impact. On the contrary, local POL prices inched up by nearly ~+4.5% on a monthly basis for Jan, Feb and Mar. As a reflection, growth in transport index (contributing ~7.2% to CPI) averaged +5.2%YoY in the past 3months (Dec.-Feb.), compared to +3.5%YoY in 6months (Jun.-Dec.). Simultaneously, core inflation (NFNE) is up by +5.2%YoY, growing at monthly rate of ~+0.4% on average.

Exhibit:
Trend in Core inflation (%)

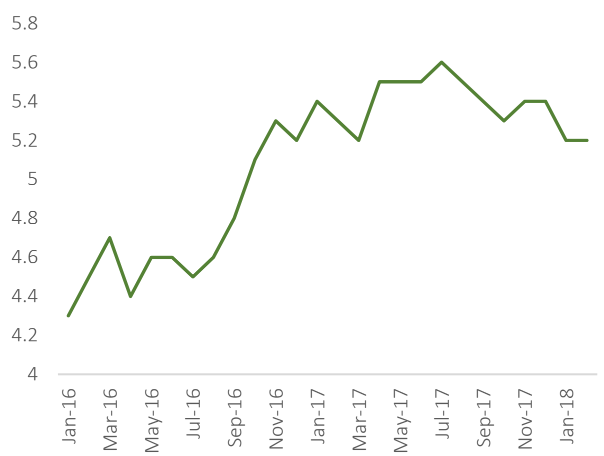
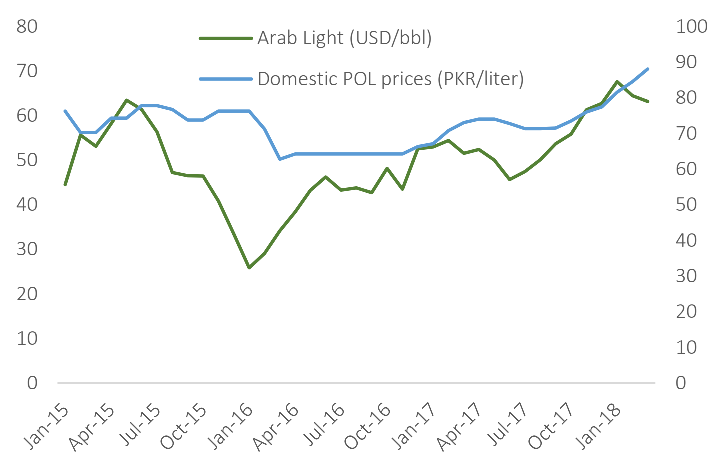


Exhibit:
Domestic POL prices (RHS) vs international oil prices (LHS)



Source: IGI Research, Bloomberg

Budgetary requirements could lead to fiscal slippages

Recent IMF projection stated country's fiscal deficit could jump to 6% of GDP compared to government's target of 4.1%, requiring roughly about ~600bn (or USD ~5.8bn) of additional funding. More so, government's intention to clear off power sector deficit along with continuance of support to textile and agri. sector in form of subsidy could further dent fiscal estimates. Although broad money growth has been relatively shallow during Jan-18 (11.8%) compared to

14.7% in the same period last year, we see higher public sector cash requirement in 2HFY18 to result in higher growth in board base monetary aggregate (M2).

Investors have reacted positively to PKR depreciation

Market has been quick to respond, with benchmark KSE 100 rising by ~800 points, led by a rally in Banks, E&P and Power sector stocks. We highlight a short list of potential beneficiaries and disadvantaged sectors;

Exhibit:

Sector-wise impacts

Sector	Impact	Comment
E&Ps	Positive	USD based revenues
Autos	Neutral to Negative	Increase cost of input and exchange losses; high pass-over capacity
Chemicals	Neutral to Negative	Increase cost of input and exchange losses; high pass-over capacity
Foods	Neutral to Negative	high input cost and potential benefit from export; selective stocks
OMCs	Neutral to Negative	Potential one-time exchange losses
Refineries	Neutral to Negative	Potential one-time exchange losses
Steel	Neutral to Negative	Higher cost of imported raw material; high pass-over capacity
Fertilizer	Neutral	Increase cost of input for DAP; high pass-over capacity. No change for Urea
Cement	Negative	Higher input cost and capex cost, declining exports
Banks	Neutral to Positive	Expecting a rate hike
Sugar	Neutral to Positive	Potential benefit from export; selective stocks
Textile	Neutral to Positive	Potential benefit from export; selective stocks

Source: IGI Research

Outlook: Strong case for faster than anticipated rate hikes

Latest round of PKR depreciation may finally quicken the pace of sluggish growth in prices. Combined with external sector woes as well as the expected government spending in next few months, there is a strong case for faster, than previously estimated, monetary tightening cycle.

Moreover, a number of countries have adopted a hawkish stance in their recent monetary policies, including the US, which may result in weakening of currency from interest rate differentials. Hence, to protect the already meagre FX reserves as well as to proactively manage inflation, the central bank is expected to increase interest rates faster. Given the current scenario, we project a minimum of +25bps rise in upcoming monetary policy announcement and remain positive about our CY18 estimate of policy rate at 6.75%.

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