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PAKISTAN RESEARCH

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ECONOMIC & MARKET PERSPECTIVE

- ***Due to the weakening economic situation, the government has been forced to rely excessively on tightening monetary policy. Therefore, the government should focus more on fiscal measures in order to resolve the economic crisis more effectively.***

- ***Domestic issues pertaining to export oriented sectors will have to be addressed, vis-à-vis high cost of doing business in order to make them more competitive and eventually ease the burgeoning trade deficit which soared by 51% to USD18.7bn in 11M/FY08.***

- ***Inflation during the first eleven months of FY08 stood at a record double digit 11.1% with food inflation at 16.2%. In coming months though, it is expected to be much lower as against current levels of close to 20% due to a relatively lower rate of increase required in petroleum prices.***

- ***Forex reserves during the year fell to an almost five year low of around USD11bn from a peak of USD16.5bn. At the same time, the exchange rate has depreciated by almost 10% during 2H/FY08 alone.***

- ***Downgrading by global rating agencies was the main trigger of deteriorating foreign investment and dampening prospects of GDRs and privatization process. Excluding foreign public investment, total foreign investment from foreigners during the first eleven months of FY08 plunged by 30% to USD3.9bn. At the same time remittances have grown from USD1.1bn in FY01 to an estimate of USD6.5bn in FY08.***

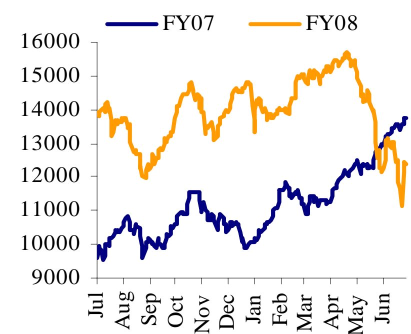
- ***After KSE-100 Index lost more than 4500 points, various measures were taken to cool the market down. While there was respite initially, the pitfall of these measures has been a significant decline in volumes. As far as sectoral measures of the Budget were concerned, the Fertilizer sector is anticipated to gain the most while Banks stand at the greatest disadvantage.***

- ***In view of the fundamentals looming, we recommend investors to begin accumulation in the E&P and Fertilizer sectors at current levels. Even from a global perspective, the discount of KSE's 2009 prospective price to earnings multiple vis-à-vis regional markets stands at 23%.***

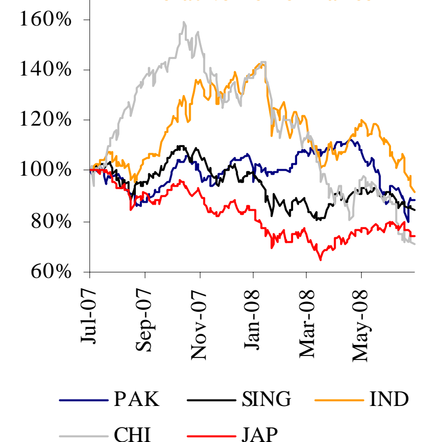
Economic Highlights

Financial Year	2007A	2008E
- GDP Growth (%)	7.0%	5.8%
- Total GDP (USDbn)	86.4	92-93
- GDP/Capita (USD)	546.4	574-580
- T. Deficit (USDbn)	13.5	20-21
- Remit. (USDbn)	5.5	6.0-6.5
- FDI (USDbn)	5.1	4-4.5
- FPI (USDbn)	3.3	0.1
- Forex (USDbn)	15.6	11.3
- Fed. Tax (PKR)	846	1000
- Inflation (%)	7.8%	11.8%
- Avg. 6m T-Bills (%)	8.8%	9.5%
- Ex. Rt. (Avg-PKR/USD)	60.6	62.7

KSE-100 Index



Relative Performance



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Introduction

The economic situation of the country has thus far maintained a more-or-less downward trajectory particularly from the start of this calendar year. While political and law and order crises observed various degrees of severities well prior to 2008, the culmination of economic deterioration and more importantly its realization was a more recent phenomenon. Rapid erosion of foreign investment as a result of an insecure environment followed by Moody's and S&P's downward ratings owing to a perceived lack of sustainability created the major dent. For the same reasons, the government has been unable to issue Global Depositary Receipts during such depressing times. This coupled with mounting trade deficit owing to spiraling commodity prices led to the vicious cycle of the government eating into reserves and jacking up the exchange rate to curtail the trade deficit.

The two ingredients combined – seeming lack of accord within the newly elected coalition and mounting economic distress was the major factor that sparked warning signals to the global community

With fiscal measures fast depleting, the government ultimately had to pass on the burden of increasing global oil prices onto the domestic consumers and thereby causing a wave of inflation like never before. Consequently the SBP was brought into play to raise interest rates and put brakes on inflation. However, the much criticized 150bps hike made recently in the discount rate turns out to be an effort in vein as inflation continues to spiral owing to the increase in international oil prices and at the same time burdening industries carrying heavy amounts of debt.

Due to the weakening economic situation, the government has been forced to rely excessively on tightening monetary policy, which in isolation can be self defeating

Therefore, brave fiscal measures will have to be adopted by the government to overcome this drastic situation. The main aim should be to aggressively raise revenue collection from all sources possible. Various measures to enhance revenue through indirect taxation were made in the budget 2008-09. Nevertheless, it is strongly felt that, these petty measures will barely create fiscal space in the wake of growing demand, expenditure and subsidy requirements. A more effective measure would to enhance direct taxation by way of increasing the tax net. This will boost overall collections as it is the single highest contributor of revenue collection. It will only be with enhanced fiscal space that the government will be in a position to more effectively resolve the inflation and twin deficit issue and be able to create a healthier environment for capital markets.

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The Political and Law & Order Picture

Law & order crisis amidst an uncertain political setup has reigned more than ever across the country since March 2007

Starting from a few months prior to fiscal year 2008 was perhaps the most troubled period for the country since the turn of the century. Turbulence was abundant left right and center, from political disorder to law and order upheaval, from the deposition of the Chief Justice to the imposition of a state of emergency, from militant drama in the capital city over the Red Mosque crusade to civil war ripe in Karachi due to a desperate attempt to block the entry of the overthrown Chief Justice into the city. Nonetheless, all the aforementioned brutalities were scaled to being virtually non-repercussive after the assassination of the Former Prime Minister, Benazir Bhutto and the following three-day countrywide strike.

The constant delay in establishing a formal government brought the coalition to the brink of collapse

It was initially envisaged that a perceived peaceful and transparent election in February 2008 which gave birth to a coalition of parties – the Pakistan People's Party, Pakistan Muslim League (Nawaz) and the Awami National League would gradually rid the country from all evils. Support and regards were received from global economies too. However, the constant delay in establishing a formal government brought the coalition to the brink of collapse. Over a month later, the PPP named Mr. Yousuf Raza Gilani as nominee for Prime Minister who was then elected and took oath on March 25th. Several months have passed and important matters within the political circles still remain unresolved. Furthermore, the country continues to suffer from the threat of militant attacks, particularly in the tribal areas. Topping that is frequent street crime emanating from public frustration and agitation over frequent and long hours of power outages, soaring energy prices and scarcity of essential food items. All aforementioned factors combined have forced the government not to pay due attention on economic stability.

Economic Signals

Mounting Trade Deficit

Amidst the political tumult, lack of focus has been shed on the economic front leading to its current state. Trade deficit and inflation have gone unchecked far too long. While not much could have been done about soaring imports due to a drastic surge in global commodity prices, exports have been neglected. Despite having observed a growth of 11% during the eleven months period July – May, it is certainly short of the annual target of 13%. The lackluster performance emanates from a negative growth in the country's key commodity – textiles, which is attributable to growing competitive pressures and partly to slowdown in textile imports in the key EU and US markets. Therefore, though textile exports may pick up as the recessionary situation in the US eases out, the government will have to address the domestic issues pertaining to the sector vis-à-vis high cost of doing business in order to make it more competitive and eventually ease the burgeoning trade deficit which during the July 2007 – May 2008 stood at USD18.7bn. It would be a relief to note that exports during the month of May 2008 alone stood at a historic peak of USD1.95bn, however, imports continued to race ahead at close to twice the size of exports.

The government will have to address the domestic issues pertaining to the textile sector vis-à-vis high cost of doing business in order to make it more competitive and eventually ease the burgeoning trade deficit

Inflation Escalation

With the government no longer being able to bare the brunt of international-local differential in oil prices, domestic oil prices were raised in the recent past like never before. Even then, the race of global oil price continues to burden the government. Inflation during the first eleven months of FY08 stood at a record double digit 11.1% with food inflation at a staggering 16.2%.

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Prior to the last petroleum products' price increase on June 29th, the price differential claim on diesel exceeded PKR35/litre, which in a nutshell according to the World Bank's and IMF's recommendation of abolishing all subsidy on oil would mean that the domestic retail price of HSD in the country should be raised to more than PKR85/litre in six months time from PKR50/litr. However, viewing the issue from another perspective, assuming the current global and domestic price trends persist, the cumulative subsidy (owed to OMCs) the government will have to bear during FY09 on diesel alone translates into around PKR400bn (approx. PKR100bn accumulated over last year and approx. PKR300bn additional). At the same time, if the government maintains its budgeted subsidy level of PKR140bn, the remainder will have to be passed on. This incremental level in price of diesel comes out to approximately PKR28/litre, or a 55% increase from its current price.

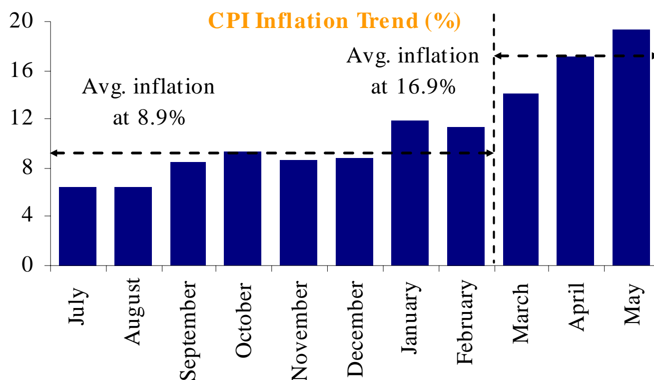
Subtracting the subsidized amount on diesel prices, the remainder burden of passing on of prices to the consumers translates into PKR28/litre

During the first eight months of the year, inflation averaged 8.9%. Over the next three months it averaged 17%. This was mainly due to an over 30% increase in weighted average prices of regulated oil products (Gasoline, Diesel, Kerosene and Light Diesel Oil) which was made between March and the first fortnight of May. This yields a monthly average increase of 12%. Going forward though, if the weighted average prices of oil products are to be raised by 55%[1] over the fiscal year 2009, or 4.5% every month, its incremental impact on overall inflation would be much lower over the coming months than what it has been so during the past two.

Inflation is expected to be much lower in coming months as against current levels

Having said that, petroleum product prices were raised just before the end of FY08 by approximately 10% in one go and at the same time the government paid PKR70bn to PSO and Shell to retire their respective debt obligations. Even still, in view of the soaring global oil prices, PDC on HSD stands at PKR35/litre. By raising prices so significantly at the onset, the government will be much less pressurized to raise them by such an extent in the latter months. Nevertheless, vigilance will have to be maintained in case inflation on account of another head gets out of control or global prices begin to crawl further up as this scenario seems to be turning out currently.

Following the approximately 10% increase in prices, PDC on HSD still stands at PKR35/litre



Source: SBP

Desperation in Monetary Policy

As economic theory goes – to spur consumption, demand or effectively growth in a depressed economy, the government through the central bank can reduce interest rates to deter consumers from saving and therefore encourage spending. After 9/11, with the inflow of billions of dollars worth of remittances and observing a pretty much stagnant economic situation, in order to channel this large sum of money into the economy, the SBP began an expansionary drive by way of reducing interest rates. In pursuit of

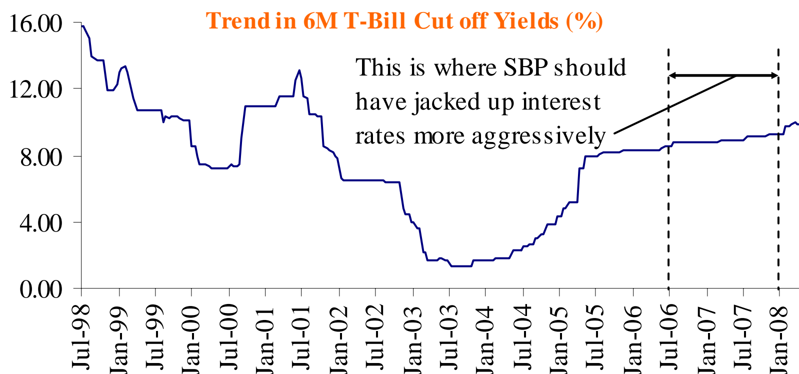
In pursuit of immediate growth and not foreseeing the long term impact, the discount rate was lowered by 650bps to 7.5% in just a year and a half

[1] It has been assumed that the price increase of Diesel will equate to the weighted average increase in oil products because it accounts for more than 75% of the total weight amongst the regulated petroleum products.

immediate growth and not foreseeing the long term impact, the discount rate was lowered by 650bps to 7.5% in just a year and a half while T-bill cut-off yields were chopped to less than 2% from over 10% during more-or-less the same period.

However, as a result of excess demand and shortage in capacities, inflation began setting in. From a near low of 3.1% in FY03 up to 9.3% in FY05 it is now estimated at 11.5% for FY08. Consequently interest rates were gradually raised too. The rate of increase was nevertheless too slow due to the fear of slowing down the excellent pace the overall GDP was growing at (average of 7.2% over FY04-07). Therefore, combined with an unprecedented increase in prices internationally and its partial passing onto domestic prices coupled with fiscal expansion undertaken by the government led to the SBP drastically bump up the discount rate by 350bps over a period of ten months during FY08. Moreover, in order to dissuade consumption (to curtail demand pull inflation) the SBP imposed a minimum return requirement of 5% on all savings deposits as announced in its interim monetary policy statement. Later, in the Budget 2008-09 the government enhanced national saving scheme rates by 200bps in order to further broaden the plethora of saving opportunities.

Combined with an unprecedented increase in oil prices coupled with fiscal expansion led the SBP to drastically bump up the discount rate by 350bps over a period of ten months



Source: SBP

Depleting Reserves & Pressurized Exchange Rate

As a result of the combined effects of a soaring current account deficit and inability to collect funds, the government was ultimately forced to reach into the reserve pocket in order to finance its requirements. As a result, forex reserves of the country fell to an almost five year low of below USD11bn in June 2008 from a peak of USD16.5bn reached just seven months earlier in October 2007 and closing the year at USD11.3bn. At the same time, while the dollar witnessed depreciation against international currencies, the rupee depicted a sharp deterioration versus the dollar. After observing a close to 2% depreciation over an 18 month period from July 2006 to December 2007, the rupee lost almost 10% over a period of six months since then, now hovering around PKR68-70/USD.

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Foreign Rating Downgrades and Consequences

Downgrading by global agencies was the main trigger of deteriorating foreign investment

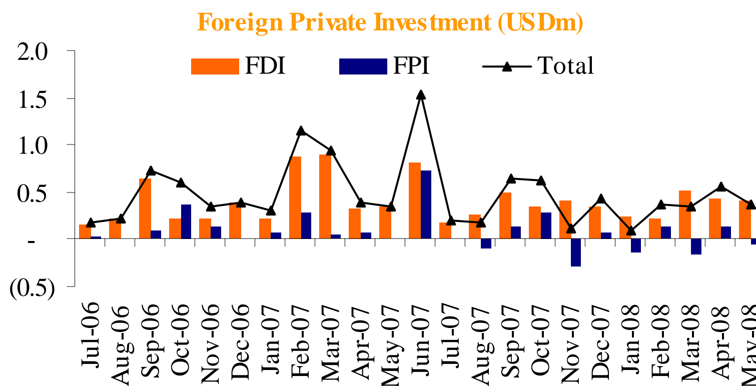
Following the aggravating situation of the country, both foreign renowned rating agencies – Standard & Poor's and Moody's Investors Service cited the threat of increasing pressure from expanding fiscal and external imbalances amidst a volatile political setting for lowering their ratings on Pakistan. While S&P cut its long-term foreign currency debt rating to B from B+ and its long-term local currency rating to BB- from BB and placed a negative outlook, Moody's lowered the Pakistan Government's Bond Ratings to B2 from B1 and downgraded the Foreign Currency Bank Deposit Ceiling to B3. At the same time the latter also changed the outlook on the Foreign Currency Country Ceiling of Ba3 to negative from stable.

Two-way negative factors dampening prospects of GDRs and privatization process

On the one hand, ever since the eruption of political crisis more-or-less from March 2007, the government has had a hard time to focus much on capital market reforms and developments. This led to a slow down in the progress of activities particularly in the form of attracting foreign investment by way of foreign listings and an almost complete ignorance on the privatization front. This is evident from the fact that the government had to revise its budgetary revenue target through privatization proceeds from PKR75bn to PKR1.65bn for FY08 and has budgeted and amount equivalent to PKR25bn for FY09. On the other hand, the aforementioned downgrade would further have a negative impact on launching of GDRs and bonds in the international markets and could at the same time dampen the privatization process.

Excluding foreign public investment, total foreign investment during the first eleven months of FY08 plunged by 30% to USD3.9bn

While the domestic stock market to a large extent ignored the effects of political and law and order hiccups, particularly during the first three quarters, these factors had a serious toll on foreign investment. Excluding foreign public investment, total foreign investment during the first eleven months of FY08 plunged by 30% to USD3.9bn. Out of this foreign direct investment dropped by 14% while portfolio investment fell by a colossal 96% to a negligible USD45m compared to USD1.1bn recorded previously.



Source: SBP

Support from Remittances

All is certainly not a lost cause. Significant support comes to the economy by way of a robust inflow of remittances. This is one major factor which supports the case for trust in the eventual recovery in the economic situation of the country. Showing strength year on year for at least the past seven years, annual remittances have grown from a miniscule USD1.1bn in FY01 to an estimated level of USD6.5bn in FY08.

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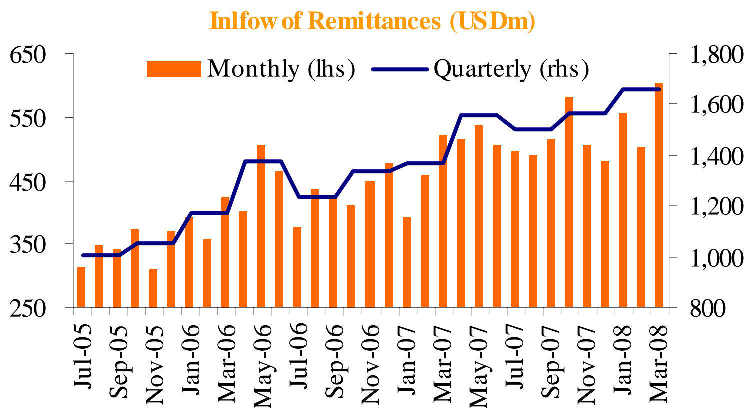

Source: SBP

The Story of KSE

After six consecutive years of a bull run at the Karachi Stock Exchange, the benchmark KSE-100 index closed the year FY08 at 12289 which is 11% lower than last year's closing of 13772. Record after record was made during the year. In spite of the host of uncertainties dominating the market in terms of political u-turns, the market kept its upward momentum and made a peak of 15676 on April 18th. Thereafter, with the economy losing steam and international rating agencies such as Moody's and S&P's having stamped the country with a downward rating, the index at one point in time lost more than 4500 points towards the end of the fiscal year, making a low of 11163. By this point in time, market capitalization in rupee terms lost close to 12% during the year, whereas in dollar terms it plunged by more than 20% due to an almost 10% depreciation in the rupee. Thereafter, the SECP and the Board of KSE came up with certain relief measures (discussed later) which saved the market to some extent.

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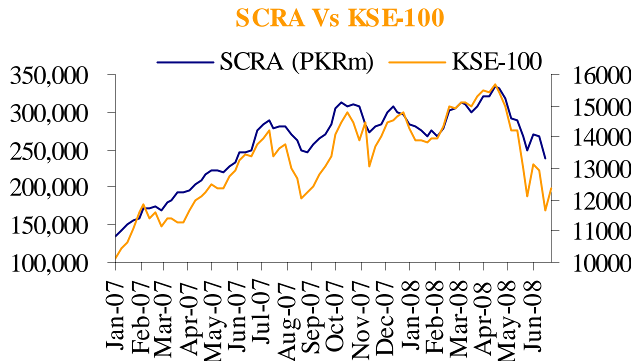
On the whole, as a consequent to weak sentiments, average daily trading values during the year stood just 14% higher at around 242m shares compared to 212m shares recorded during FY07. However, it would be worth highlighting that these levels are nonetheless much less than the previous three year FY04-FY06 average of 350m shares.

Correlation with Foreign Investment

Foreign investment remained unmoved following the ousting of the Chief Justice in March 2007. It was moderately affected in July during the crisis in the capital city and again staged robust recoveries after dipping in November after the imposition of the state of Emergency by the President Musharraf and in January after the Assassination of Benazir Bhutto. It even remained robust and peaked during the brief rift between the coalition leaders after the general election in February up till the formation of the PPP led government. The event that actually triggered the meltdown of foreign investment was when the economic situation was left orphaned and exposed to actually standing at a very delicate position. Soon after, downward ratings were made by global agencies, foreign investment began to get ploughed out leaving the domestic investors stranded. This factor is substantiated from the sharp dip in the special convertible rupee account as the KSE-100 index began its descent from April 18th onwards.

The event that actually triggered the meltdown of foreign investment was when the economic situation was left orphaned and exposed to actually standing at a very delicate position

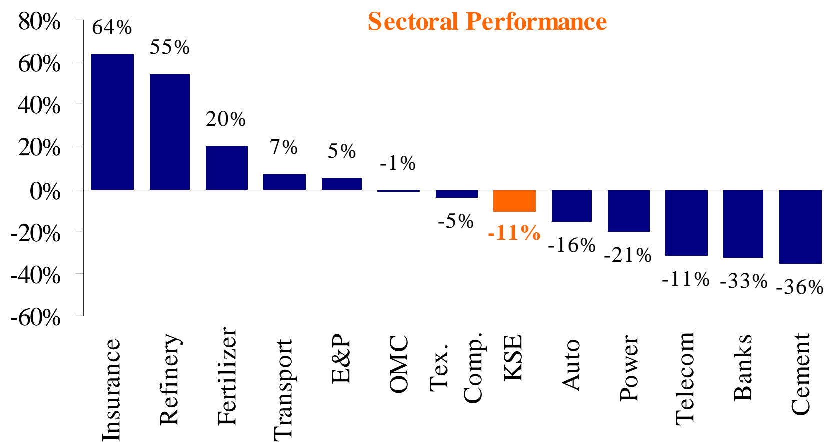


Source: SBP and KSE

Sectoral Performances

Insurance and cement sectors were the best and worst performers respectively during FY08

During the first half of the year and more during the third quarter in particular, appreciation in stock values was observed across the board. Thereafter, during the third quarter, when bears took charge, virtually no scrip in any sector remained unscathed. Many blue chip and second tier stocks at one point in time stood at a value even lower than that at which they started the fiscal year. On the whole, by the end of the year, the sectors which outperformed the market were Insurance (64%), Refinery (55%), Fertilizer (20%) and E&P (5%). On the other hand, those which significantly underperformed were Cement (-36%), Banks (-33%), Telecom (-32%) and Power (-21%).



Source: KSE and Live Database

Desperate Measures Implemented

Unexpectedly benign measures were taken to support the weakening market condition

Following a more than 4500 points decline in less than two and a half months (1336 points in last four days of the crash), the Board of KSE and apex regulator – SECP, came up with market stabilization measures just five days before the end of the fiscal year. These were as follows:

- Scrip-wise circuit breakers in Ready, Deliverable Future Contracts and Cash Settled Future Contracts markets were revised as: Lower Circuit Breakers were applicable at price fluctuation of 1% from the closing price of the previous day and Upper Circuit Breakers were applicable at price fluctuation of 10% from the closing price of the previous day. These will be reviewed again on July 15, 2008:

- Short Selling was completely prohibited in Deliverable Future Contract Market as currently allowed under regulations. Furthermore, Short Sale in Ready Market with pre-existing interest against purchase on another exchange will also be prohibited. These prohibitions shall be for a period of one month, effective June 24, 2008. The said prohibitions will be reviewed again one week prior to the start of August Deliverable Futures Contract.

- Bank Guarantees from "A" and above rated banks were allowed as margin eligible security for Margin Deposit in the Ready, Futures and CFS Market.

- A Market Stabilization Fund of PKR30bn will be launched in line with international practice. The utilization of the said fund will be automatically triggered if and when volatile circumstances are witnessed in the market.

Market participants welcomed such relief measures and as a result the index made a single intra-day record climb of 960 points or an 8.6% increase. Positive in all respects, the KSE-100 index has virtually been transformed into a profit making machine for all. With the respective circuit breakers in place, assuming a 50/50 chance of the index climbing or falling, the expected return an investor can obtain on any given day equates to 4.5% compared to 0% earlier. This off-course is up until the point in time the revised upper and lower circuit breakers of 10% and 1% respectively remain in place. Furthermore, prohibiting short-selling completely will reduce element of speculative downturns whereas bank guarantees could to a large extent resolve the problem of lack of liquidity. In addition, the establishment of a PKR30bn fund would further mitigate the market from the inherent risks of any crash-like situation. While a similar fund was proposed to be in place during this meltdown to support the market, the fact that the funds were to be originated from different government institutions with no guarantee of any other support, deterred them from investing. However, the fund under the current supportive measures is expected to be more effective and utilized in a timelier manner given that it is being formally designed to embrace the market in volatile times.

With these measures in place, the expected return an investor can obtain on any given day equates to 4.5% compared to 0% earlier

Though the positive factors of the aforementioned measures were abundant, they were at the same time prone of criticism. One measure in particular, was the lower circuit at 1%. The negative aspect of this measure is that in times of a down-turn, volumes can dry out completely, as was the case in the last session of the fiscal year (June 30, 2008), when turnover stood at an all time low of 11.5m shares ever since January 1999.

The pitfall of these measures has been a significant decline in volumes

Budgetary Impact

Investors anxiously waited for the Budget 2008-09 hoping for some kind of a relief. As far as the KSE was directly concerned, the Budget only confirmed the exemption of capital gains tax until the end of FY10, while no other levy was imposed nor enhanced. However, this hardly had any impact on the bourse as the announcement regarding another two year extension in the CGT exemption was already made a few weeks prior to the budget.

The budget hardly impacted the index as the announcement regarding a two year extension in CGT exemption was made a few weeks earlier

Looking at the major sectoral effects that the budget had on them, were as follows:

- **Auto**
  - FED at the rate of 5% imposed on import of cars with engine capacity greater than 850CC
  - Duty on import of cars with engine capacity greater than 1800CC raised from 90% to 100%

  Overall Impact: Negative

- **Banks**
  - Provisions on loans will no longer be exempted from being taxed
  - Rates on National Saving Schemes to be raised by 200bps

  Overall Impact: Negative

- **Cement**
  - PKR150/ton (PKR7.5/bag) increase in FED
  - Allocation of PKR225bn on infrastructural development

  Overall Impact: Neutral

- **Fertilizer**
  - Subsidy on DAP raised by PKR530/bag to PKR1000/bag
  - General Sales Tax eliminated on sales of all fertilizers

  Overall Impact: Positive

- **E&P**
  - No measure announced (all major factors affecting E&P sector are made in Petroleum Policies, the last of which was made applicable in July 2007)

  Overall Impact: *Neutral*

- **OMC & Refinery**
  - 5% customs duty removed on import of JP-4 and JP-8
  - Budgeted amount of subsidy much less than estimated annual claim that will be created, thus indicating an increase in domestic petroleum prices

  Overall Impact: *Positive for OMCs*
  Negative for Refineries

- **Telecom**
  - FED on all telecommunication services raised from 15% to 21%
  - Imposition of PKR500 tax on import of mobile phone sets

  Overall Impact: *Neutral*

- **Textiles**
  - Duty on Polyester Staple Fiber reduced from 6.5% to 4.5%
  - Zero rating of Acetic acid and its raw materials

  Overall Impact: *Positive*

Regional Comparison

The discount of KSE's 2009 prospective price to earnings multiple vis-à-vis other markets (ex-Japan) stands at 23%

The KSE-100 index rebounded from being the best performing index in the region during the first nine months of the fiscal year to one of the worst performers in the last quarter alone. It depicted an increase of 9.8% in 9M/FY08 compared to a regional average of negative 7.1%, whereas during the last quarter, it lost 18.8% as against the regional average decline of 7.4%. Apart from the benchmark Chinese stock exchange that fell by 21.2%, the plunge at the KSE was by far the greatest amongst peer markets. The major reason for this disparate trend was that while internal strife led to the bear domination at the KSE, regional indices recovered from the low base effect after suffering from the sub-prime crisis that emerged in the US earlier during the year. The Pakistani market virtually went unscathed during this incident mainly because of a relatively lack of exposure in global financial markets. As a whole therefore, the KSE witnessed a year to date decline of 10.8%, identical to that of the regional decline.

Comparizon with regional Markets

Country	Jun-07	Mar-08	Current	Q-T-D	FY-T-D
Indon.	2139	2447	2349	-4.0%	9.8%
HK.	21773	22849	22102	-3.3%	1.5%
S. Korea	1744	1704	1675	-1.7%	-3.9%
India	14651	15644	13462	-14.0%	-8.1%
Pak.	**13772**	**15126**	**12289**	**-18.8%**	**-10.8%**
Malay.	1354	1248	1187	-4.9%	-12.4%
Sing.	3476	3007	2948	-2.0%	-15.2%
Taiwan	8883	8573	7524	-12.2%	-15.3%
Japan	18138	12526	13481	7.6%	-25.7%
China	3821	3473	2736	-21.2%	-28.4%
Avg:				**-7.4%**	**-10.8%**

Source: Yahoo Finance

Following the trends all markets have taken, Pakistan's prospective earnings multiple was the second lowest in the region. That of Thailand's apart, all other benchmark indices of major South and South East Asian countries fair less attractive than the KSE. On an average, the discount of KSE's 2009 prospective price to earnings multiple vis-à-vis other markets now (ex-Japan) stands at 23%.

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Regional Price to Earning Ratios

Country	2008	2009	2010
Thai.	8.72	7.04	5.88
Pak.	**10.04**	**8.28**	**7.30**
S. Kor.	11.61	9.97	8.94
Indon.	13.09	10.91	9.48
Malay.	12.40	11.09	10.30
India	13.54	11.02	10.10
Sing.	13.66	11.85	10.58
Taiwan	13.20	11.72	11.09
H. Kong	15.19	12.99	11.57
China	15.61	12.78	10.96
Reg. Avg.	**12.71**	**10.77**	**9.62**
Disc.	**-21.0%**	**-23.1%**	**-24.1%**

Source: Thomson ONE

Conclusion

If all issues are tackled willfully and in a planned manner, the country can land on much smoother pasture and a lot sooner too

Numerous challenges have fallen on the present government's shoulders. That said, apart from the seeming downturn we are currently heading, in absolute terms, the economic platform of the country was far worse when the economic boom took place during the years FY02-FY07. Therefore, if tackled willfully and in a planned manner, the country can land on much smoother pasture and a lot sooner too.

Monetary policy as a tool to control inflation has become very much redundant, which leaves the authorities to improve fiscal space to finance petroleum subsidies in order to curtail inflation

We are of the opinion that monetary policy as a tool to control inflation has become very much redundant, which leaves the authorities to improve fiscal space to finance petroleum subsidies in order to curtail inflation. More aggressive reforms will have to be made on the capital markets in order to further attract foreigners by way of portfolio investment and getting large public sector entities listed abroad through GDRs to raise greater finance. At the same time, as fiscal space broadens, the government should highlight and support those industries which can contribute significantly to exports, mainly textile, in order to bring the current account deficit to more controllable levels and hence prevent forex reserves from depleting.

Economic and political pressures apart, assessing individual sectors shows immense upside at current levels and therefore recommend investors to begin accumulation in the E&P and Fertilizer sectors at current levels on fundamental grounds

Despite all hurdles in the way, individual corporate entities have lost more value than they deserve at the stock exchange mainly fueled by the pull out of foreign investment and panic selling and more so from the intermittent cropping up of rumors. After a major bullish spree up until mid/end April, the KSE stands very much neglected as compared to regional markets. Economic and political pressures apart, assessing individual sectors shows immense upside at current levels and therefore recommend investors to begin accumulation at current levels on fundamental grounds. In view of the domestic and global economic situation and budgetary measures implemented, we position the E&P and Fertilizer stocks at the top of the investment priority. A reversion of investor interest (local and foreign) towards the KSE is very much inevitable in order to exploit the extremely cheap valuations it is currently trading at, particularly when compared to the region. The nation as a whole has treaded across rough waters and resurfaced successfully before as well. There seems no plausible reason why this can't be done again.

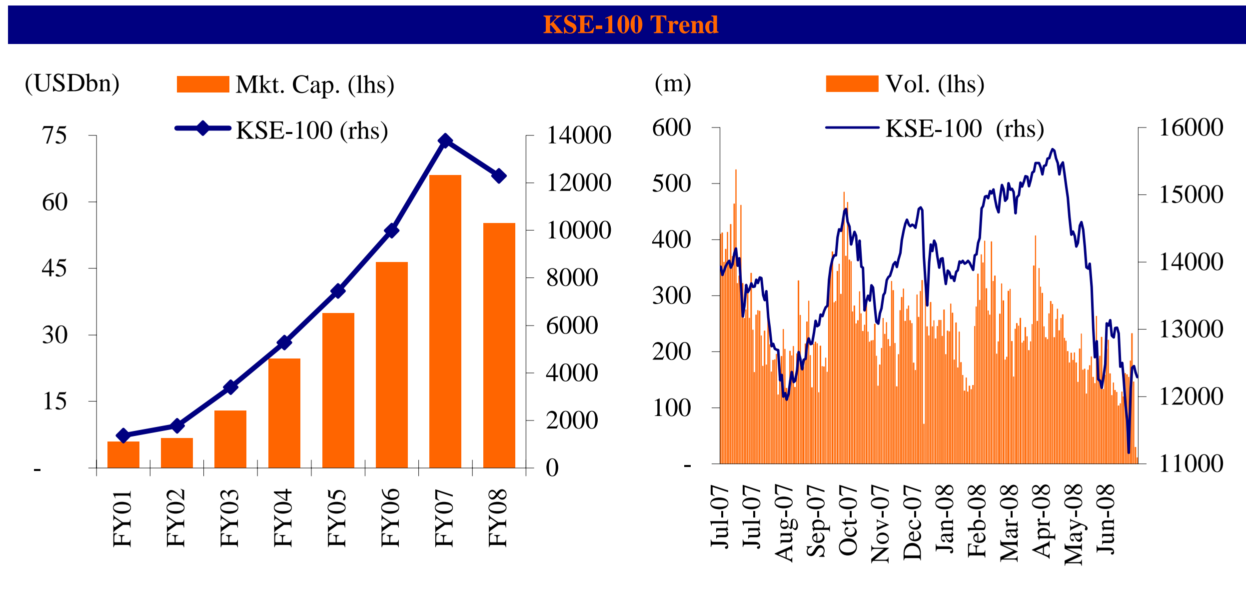
Economic & Market Statistics

Economic Highlights						
Fiscal Year	**2004A**	**2005A**	**2006A**	**2007A**	**2008E**	**2009F**
- GDP Growth	***7.5%***	***9.0%***	***6.6%***	***7.0%***	***5.8%***	***5.5-6%***
Agriculture	2.4%	6.5%	2.5%	5.0%	1.5%	2-2.5%
Manufacturing	14.0%	15.5%	10.0%	8.4%	5.4%	5-5.5%
Services	5.8%	8.5%	9.6%	8.0%	7.6%	7-7.5%
*- Total GDP (USDbn)**	*73.2*	*77.4*	*81.8*	*86.4*	*92-93*	*98-100*
*- GDP/Capita (USD)**	*489.0*	*507.3*	*526.5*	*546.4*	*574-580*	*600-610*
Population	149.7	152.5	155.4	158.2	160.5	163.0
- Trade deficit (USDbn)	***3.3***	***6.2***	***12.1***	***13.5***	***19.5-20.5***	***18-19***
(Deficit exc. oil imp.)	*0.1*	*2.4*	*5.5*	*6.3*	*7.5-8.5*	*4.5-5.5*
Exports (USDbn)	12.3	14.4	16.5	17.0	19.5-20	21.5-22
Imports (USDbn)	15.6	20.6	28.6	30.5	39.5-40	40-40.5
- Remittances (USDbn)	3.9	4.2	4.6	5.5	6.0-6.5	6.5-7.0
- Foreign Direct Inv. (USDbn)	1.0	1.5	3.5	5.1	4-4.5	4.5-5
- Foreign Portfolio Inv. (USDbn)	N/A	0.2	0.4	3.3	0.1	0.5-1
- Forex Reserves (USDbn)	12.3	12.6	13.1	15.6	11.2	12-12.5
- Fed. Tax Collection (PKR)	521	591	710	846	1000	1200-1300
- Inflation	4.6%	9.3%	7.9%	7.8%	11.5-12%	12-13%
- Int. Rate (Avg. 6m T-Bills)	1.7%	5.1%	8.2%	8.8%	9.5%	12-12.5%
- Exch. Rate (Avg - PKR/USD)	57.6	59.4	59.9	60.6	62.7	67-68

**Constant factor cost*

Source: SBP Report, Economic Survey, Budget Reports & Live Research

KSE-100 Trend



EQUITY VALUATIONS

Sector/ Symbol	Price* (PKR)	Y-o-Y Change	EPS (PKR)			P/E (X)**			Yield (%)		
			FY07A	FY08F	FY09F	FY07A	FY08F	FY09F	FY07A	FY08F	FY09F
AUTO											
INDU	**200.1**	-34.5%	34.9	29.5	32.2	5.7	6.8	6.2	6.5%	5.0%	6.0%
PSMC	**119.8**	-69.4%	33.7	14.7	16.9	3.6	8.2	7.1	4.2%	2.1%	2.5%
BANKS											
ABL	**85.3**	-26.3%	6.3	8.3	8.7	13.5	10.2	9.8	3.5%	4.7%	5.3%
BAFL	**41.1**	-22.4%	3.9	5.6	5.9	10.5	7.3	6.9	3.7%	6.1%	7.3%
BOP	**31.1**	-63.3%	8.4	-2.7	7.3	3.7	N/M	4.3	0.0%	0.0%	0.0%
MCB	**326.4**	-10.6%	24.3	26.7	28.9	13.4	12.2	11.3	3.8%	3.8%	3.8%
NBP	**147.5**	-38.1%	21.2	24.2	26.5	7.0	6.1	5.6	5.1%	5.4%	5.8%
UBL	**85.1**	-51.6%	9.1	11.3	13.0	9.3	7.5	6.5	3.5%	4.7%	5.9%
CEMENT											
DGKC	**67.1**	-42.4%	6.4	3.2	1.6	10.5	21.2	N/M	2.2%	0.0%	0.0%
LUCK	**97.9**	-28.9%	9.7	7.7	9.1	10.1	12.7	10.7	1.3%	1.5%	1.3%
E&P											
OGDC	**124.4**	3.8%	10.6	12.3	15.4	11.7	10.1	8.1	7.2%	9.6%	12.1%
POL	**364.8**	15.1%	32.0	38.9	43.9	11.4	9.4	8.3	4.1%	4.8%	5.5%
PPL	**246.0**	3.1%	22.2	27.5	33.2	11.1	9.0	7.4	4.5%	8.1%	10.2%
FERTILIZER											
ENGRO	**280.8**	16.2%	16.3	17.5	17.1	17.2	16.0	16.4	2.5%	2.8%	2.8%
FFBL	**36.0**	-7.8%	2.7	3.1	3.6	13.2	11.6	10.0	7.0%	8.3%	9.7%
FFC	**132.3**	9.1%	10.9	12.1	13.6	12.2	11.0	9.8	8.3%	9.1%	9.8%
OMC											
APL	**432.3**	3.5%	36.0	46.4	48.7	12.0	9.3	8.9	3.2%	4.0%	4.6%
PSO	**417.2**	6.6%	27.3	59.2	44.7	15.3	7.1	9.3	5.0%	9.6%	8.4%
SHEL	**417.0**	1.7%	12.9	60.2	55.6	N/M	6.9	7.5	3.8%	7.2%	6.0%
POWER											
HUBC	**28.6**	-22.1%	2.3	2.4	2.6	12.5	12.0	11.2	10.0%	8.7%	8.7%
KAPCO	**47.0**	-21.9%	5.7	5.5	5.7	8.3	8.6	8.2	12.8%	12.8%	12.8%
REFINERY											
ATRL	**249.9**	168.0%	10.5	31.3	24.5	23.7	8.0	10.2	1.6%	2.0%	2.0%
NRL	**297.5**	4.7%	52.6	52.1	46.2	5.7	5.7	6.4	6.7%	6.7%	5.9%
PRL	**151.4**	-20.4%	7.1	49.8	23.0	21.2	3.0	6.6	2.2%	0.0%	0.0%
TELECOM											
PTC	**38.6**	-32.2%	3.1	0.0	4.6	12.6	N/M	8.4	5.2%	0.0%	6.5%
TEXTILE											
NML	**86.0**	-34.1%	10.2	10.5	12.4	8.4	8.2	7.0	2.9%	2.9%	3.5%
					Aggregate Market:	**11.7**	**9.9**	**8.6**	**5.5%**	**7.1%**	**8.0%**

** Market Prices as of June 30, 2008*

*** P/E ratios exclude negative values and those greater than 30*

Notes:

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