January 2010

Monetary Policy Review

Call It Like It Is

As expected the SBP kept the discount rate firm at 12.5% in Jan10, however, monetary policy makers are likely to shave a further 50bps off the policy rate in Mar10. Closely tied to the Monetary Policy announcements are the IMF 4th Review due on Feb 28'10 and 5th Review expected on May 31'10. This is likely to alert the market to any upsets regarding policy trajectory as they arise.

In our assessment, the key drivers of the cautious but definitive downward trend in the policy rate are;

i. Falling YoY inflation expectations toward a 12% 12mo average for CPI, bottoming out Core Inflation 10.6% in Nov09

ii. Keeping Liquidity stable without providing a stimulus which could derail the 'disinflationary' monetary policy

We maintain our monetary easing stance with an expectation of a further 50bps cut before the end of 2H FY10. Two more policy announcements are scheduled for Mar10 and May10 during the current fiscal period.

On the Defensive

We expected the SBP to remain on the defensive in FY10 as the economy treads towards recovery. Key vulnerabilities that have sustained the cautious stance are systemic risks arising from:

i) The low Savings Base at 14% of GDP

ii) Federal Tax Revenues which stand at a meager 9% of GDP

iii) Laggard Fiscal consolidation which could trigger price instability

iv) Potential fiscal deficit overshooting by 100bps in the range of 5.5% of GDP by Jun10

v) Unaccounted for expenses which include Circular Debt overhang of an estimated gross PKR 400bn across the energy chain remain to be resolved.

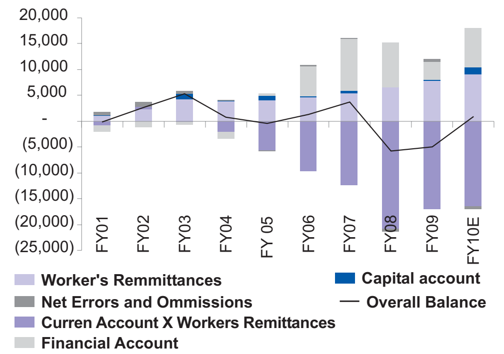
vi) Excess government borrowing pressure on the domestic resource base from commodity financing and general budgetary financing via SBP, commercial banks and national savings, particularly if external financing shortfalls occur.

vii) External Debt overhang will rise at a 3yr CAGR of 10% or more to USD 70bn by FY13 and related capital outflows will weaken the PKR

viii) Security related expenditures on the War on Terror and against the insurgency in North

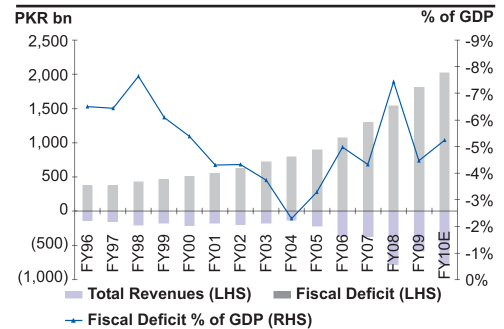
ix) Weaker FDI flows and Export receipts in the region of USD 2.6bn and USD 18bn for FY10 respectively

Balance of Payments (USD mn)



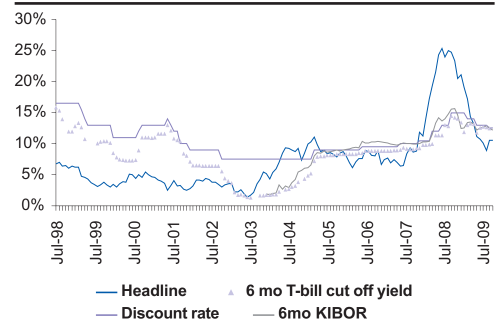
Source: SBP

Fiscal Management



Source: SBP, FBS

Inflation and Interest Rates



Source: SBP

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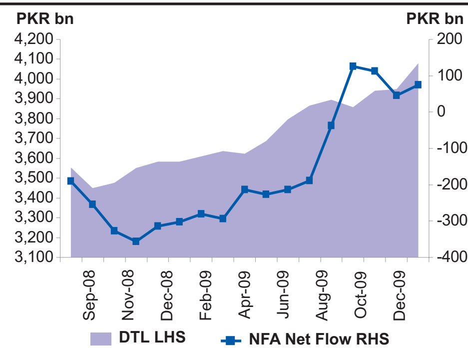
Vulnerability ratios in check for the short term

Although macro-variables seem to have stabilized for the near term, macro-stability remains on thin ice limiting the extent to which monetary policy makers can slash rates and reflate the economy. A 20% expected rise in Remittances to the tune of USD 9bn and a shrinking Current Account Deficit to the range of USD 6bn or 4% of GDP during FY10E have been the fruits of the joint IMF-Pakistan Structural Adjustment effort. The shoring up of Foreign Reserves to USD 14bn with access to IMF funding of USD 11.2bn (or SDR 7.2bn) till Nov10 and expected inflows from Tokyo-related funds to the tune of USD 1.2bn by Jun10 may also come into play to limit capital outflows and keep vulnerability ratios in check in the short term. But the challenges associated with the economy's limited real resource base and its apparent liabilities will leave monetary policy makers inclined towards caution in the medium term.

SBP remains PKR defensive

Sensing currency vulnerability to potential external financing shortfalls, the Central Bank remains on the defensive with regards to the currency. The DTL base has stabilized but NFA buildup remains unpredictable moving forward. YoY the currency has already depreciated by nearly 5% and may loosen further if external financing shortfalls occur. Broadly fluid foreign inflows expected in 2H FY10 from FoDP, Kerry-Lugar Bill disbursements and the IMF for Budgetary Financing should keep the currency buoyed in the current range in FY10. Given all things remain the same, we expect the PKR will depreciate by 6% YoY in FY10 and could sustain a similar pace in FY11.

DTLs and NFA Flow



Source: SBP, FBS

Government borrowing target should be met by commercial Banks

The 3Q FY10 Government T-bill Auction target has been announced at a rather high PKR 430bn against maturities of under PKR 400bn during the quarter. This is not a large gap which we feel the SBP will be able to fill with regular injections into the money market via OMOs. With demand for government paper remaining stable in line with attractive rates, borrowing targets are also likely to be met with Commercial Banks' participation in Government Security Auctions.

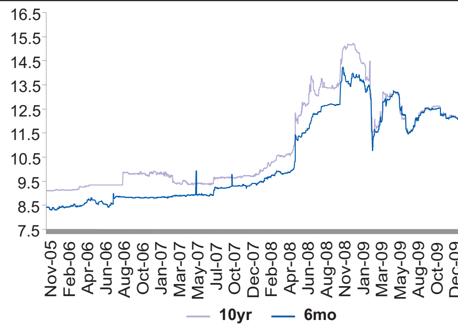
Banks' asset base to remain tilted towards investments

As of Sep09 we feel banks' comfort level over Statutory Liquidity Requirement (SLR) remain sufficiently above 19%, infact the excess liquidity is estimated in the range of 15% over and above the SLR requirement. The low Cash Reserve Requirement (CRR) at 5% also indicates banking liquidity is fairly fluid for now. Nevertheless, lending risk aversion remains due to i) default risk ii) strained earnings growth and iii) attractive alternative investments which feature positive real rates of return. Consequently we feel banks' asset books will continue to see accumulation of Investments in Government Securities versus increasing Advances and Loans.

A flatter yield curve depicts lower vulnerabilities

Although the downward shift in the yield curve has been definitive, it has been gradual rather than rapid. In previous years, the yield curve also remained relatively steep as inflation was on the uptick and inflows into NSS instruments were waning. However, recently the yield curve has flattened considerably with the spread between secondary market yields on T-bills and PIBs narrowing to under 10bps. This is largely because cut offs on PIBs have been given some relief from i) an exponential increase in NSS investment during FY10 YoY and ii) CPI inflation has been on the definitive decline towards 12% during the same period from 21% in FY09.

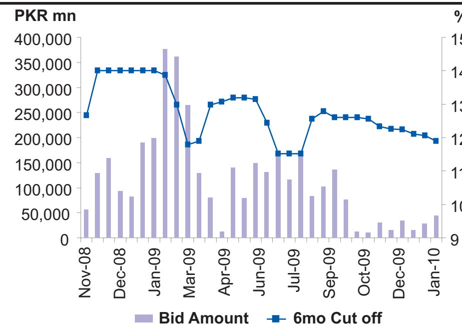
PIB T-bill Spread (%)



Source: SBP, FBS

The long end of the yield curve has shed a considerable amount of weight in CY09 by nearly 300bps while the short end has come off by 200bps. Moving forward into 3Q FY10 we feel if things remain the same, the short end will shave off another 20-40bps in line with the movement in cut off yields in the recent auction.

T-bill Auction Yield and Bids



Source: SBP, FBS

A major constraint to this movement, however, could be a shortfall in external financing particularly from the FoDP, Kerry Lugar Bill which amounts to more than USD 2bn. If so, the government borrowing pressure could increase on the Commercial Banking sector, leading to volatile cut off yields.

Fixed Income Investments to Shine

In the shorter term we expect Fixed Income investments to see a rollover including investment in government securities, corporate bonds and cash base instruments such as longer term savings accounts. This bodes well for security of the DTLs base and ultimately stability if not shrinkage of the Investment Savings Gap. We are particularly bullish on TFCs from under leveraged companies with cushioned balance sheets as most TFCs in the market are Floating Rate Notes (FRNs) linked to KIBOR. Consequently they present minimal interest rate risk due to the variable coupon rate. Some sectors will still face credit risk associated with compressed earnings and the lagged impact of high borrowing and input costs. However, the downturn in domestic borrowing costs and unwinding of global inflation has stemmed pressures associated with these two variables. Large scale credit risk, which caused a jam in the TFC market during the liquidity crisis of 4Q CY08, appears minimal during CY10 as Net Earnings and NPLs have bottomed out in CY09.

TFC gains still draw investors.

The average return on TFC, including fixed and variable coupons, sits at roughly 2.50% above benchmark 6mo KIBOR. We are expecting a marginal decline in KIBOR rates by 40-60 bps to the 11.80% range in 3Q FY10, however in 4Q FY10 rates may bounce up again leaving the benchmark rate in the 12% range. At present TFCs present an attractive Held to Maturity and Available for Trading Investment as prices are likely to rise when interest rates come off. With the steady decline in the policy rate, price objectives will materialize slowly though still presenting attractive gains over a potentially lackluster equity index performance.

Macro Lag will sober Earnings revival

The impact of monetary easing on the market has been broadly played out in CY09 which motivated frequent macro-optimism related rallies in Mar09, Jul09 and Sep09. The market turned a YTD return of 64% in CY09 with a rebound from trough presenting a 104% gain to investors. During CY10 we feel monetary policy changes will have a muted impact on market performance, however the anticipated trek towards the 11,000 point level will be Earnings led with a Macro lag. Net Earnings across the IGI Universe remain flat with an expected 2010E P/E of 8.5x against a 2009 P/E of 9.3x. However, a stock-selective, sector specific approach presents much more attractive gains to hardy investors. Our basket of Top Picks include NBP,BAFL, PPL, POL, PSO, HUBC, LUCK, FFC and ENGRO for FY10 presenting significant upside to current levels as the market continues its rebounding streak. However, macro-vulnerabilities have emerged again in 2Q FY10 which could dampen price objectives in CY10.

Monetary Statistics

	Date	Year ago	Latest	Change bps
Monetary Indicators %				
Discount Rate	Jan-10	15.0	12.5	-250
6mo T-bill average cut off yield	Jan-10	14.1	11.9	-220
5yr PIB market average yield	Jan-10	14.0	12.03	-200
6mo KIBOR Offer	Jan-10	15.5	12.3	-318
Headline Inflation	Jul-09	20.5	10.5	-1000
WA Lending Spread ex-zero markup	Jun-09	7.6	7.8	25
Monetary Aggregates (PKR mn)				**%**
Credit to govt sector	Jan 17'10	270,080	142,499	-47%
Credit to private sector	Jan 17'10	172,487	101,358	-41%
Other Items	Jan 17'10	(141,043)	(179,328)	27%
Net Domestic Assets	Jan 17'10	360,480	147,511	-59%
Net Foreign Assets	Jan 17'10	(303,763)	129,245	-143%
M2 growth	Jan 17'10	1.20%	5.40%	

Source: SBP

Banks' margins will hold up for now

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In our view, the recent status quo on the policy rate front would have neutral impact on the banking sector. In our valuations we have assumed average KIBOR at 12% in CY10 based on our expectation of 50bps cut in DR in FY10. The key driver for banking scrips is the spread & asset quality outlook. In the current scenario, Interest rate spreads remain sticky given funding costs declining faster than asset yields, as low credit appetite gives banks room to adjust funding mix towards low cost CASA deposits and shedding term deposits. During CY09, banking system's average spread increased by 19bps YoY to 7.48% as compared to 7.29% in the corresponding period last year. In the long run, although we maintain the view that spreads are bound to fall; however, the pace of the decline is expected to be slow.

Secondly, on the asset quality front, stress seems to be easing off as SBP data reveals sequential easing in fresh NPL accumulation as growth receded to 4-5% QoQ in 3Q CY09. Moreover, additional FSV benefit and NPL restructuring provisions will further cushion credit costs in the coming quarters. On the balance sheet side, robust quarterly growth was witnessed in deposits and private sector credit (PSC) during Oct-Dec08 period. After contraction of around PKR 70bn each in 3Q CY09, deposits and PSC grew by PKR 265bn and PKR 199bn respectively in 4Q CY09. In terms of valuations, the quarterly trends support positive outlook for CY10; however, we believe most re-rating potential is priced in the current valuations. At current levels, our coverage banks trade at forward PE and

PB of 8.5x and 1.3x and we maintain a neutral stance on the sector. Our top picks in the sector are NBP, MCB, and BAFL offering total return of 19%, 13% and 15% respectively.

E&Ps face exogenous not endogenous interest rate risk

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The exploration sector is completely unleveraged at the moment and thus the financial charges for the E&P companies are non-existent. Going forward, however, the liquidity constraints in the energy chain seem to be making borrowing inevitable. OGDCL and PPL are the two likely candidates who could seek external financing to meet their operational and capex requirements. This in turn can reflect in financial charges and potentially trim our earning estimates for FY11 and beyond for OGDCL and PPL. POL, nonetheless, is comfortable placed, firstly because it is part of an integrated group Attock Oil Company and secondly due to its lower production base. The E&Ps tend to benefit from higher interest rates since all the companies hold sizable investments in fixed income instruments. However, the impact on other income and consequently the bottom-line is concerned remains marginal for the sector.

PSO looking forward to welcome relief

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The oil marketing companies are relatively de-leveraged of long term debt and financial charges had historically only consisted of markup on short term bank borrowing for the companies' capital working requirements. However, for PSO, the ongoing inter-corporate debt issue has taken a toll on its financial charges on two accounts. i) constrained liquidity has forced the company to resort to higher short term borrowing to retire its LC's on oil imports and ii) continuous accumulation of payables to local refineries has triggered an interest expense on delayed payments. At the prevailing interest rates, we expect PSO to post financial charges of PKR 4.5bn and an EPS of PKR 45.6 in FY10. We reiterate our view that fresh accumulations will retard on the implementation of the 24% power tariff hike in Apr10 and possible policy rate cut in Mar10 will provide welcome relief to PSO's bottomline as financial charges ease.

Short Term borrowing costs will strain Power Sector liquidity

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The policy rate does not effect the payments for long-term debt for the sector as the financial charges for long-term loans are already accounted for in the Power Purchase Agreement (PPA) with WAPDA. However, the sector remains greatly dependent on short-term borrowing for working capital requirement amid the issue of inter-corporate debt. Therefore, a cut in policy rate would have provided some respite to the financial charges for the companies in 2H FY10. Furthermore, a declining interest rate scenario would have made the sector's dividend play even more attractive. At current levels, our FY10E dividend yield of 13.8% offers a 130bps spread over discount rate.

ENGRO's cash flow must catch up with interest payments

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After a year of healthy fertilizer offtake in 2009, Engro Corp's financial charges dropped by 16%, mainly on account of easing interest rates and lower working capital requirements. We expect borrowings to remain low on the operating front, and thus SBP's decision to maintain the discount rate will have minimal impact on this front. However, the new fertilizer plant, Engro Foods and Engro Polymer are highly leveraged and the interest payments on loans this quarter is expected to remain high. However, Engro Energy is slated to start commercial operation in early February. This could boost cash flows, although not significantly given the impending circular debt issue. Going forward, if discount rates are eased and once the urea expansion project comes online, financial charges are likely to see a drop as borrowings on the operating front further decline as the company witnesses higher positive cash flows.

LUCK wins in the rate game

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We foresee a mixed impact on companies under our coverage in the cement sector. In the case of Lucky Cement (LUCK) with export constituting approximately 58% of its cement dispatches in 1H FY10, the company has been able to transfer its debt obligations to a cheaper cost export refinance loans. The company's long term liabilities have declined by PKR 4.6bn to PKR 2bn. Thus, in our opinion the stable outlook on the policy rates in the Jan30'10 policy will not impact the company. DGKC, on the other hand, remains substantially leveraged with short-term running finance amounting to approximately PKR 7bn and long-term debt in the region of 4.3bn.

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