Day Break

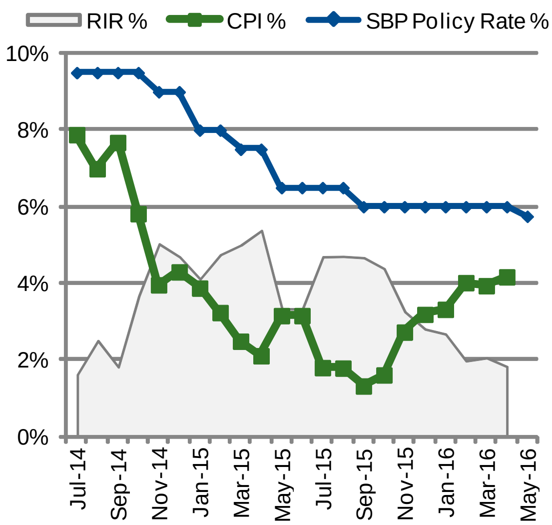
Monday, 23 May 2016

Economy

SBP Inflation/policy rate Monthly (%YoY)

Month	CPI %	Target Rate	Policy Rate
Oct-15	1.6%	6.0%	6.0%
Nov-15	2.7%	6.0%	6.0%
Dec-15	3.2%	6.0%	6.0%
Jan-16	3.3%	6.0%	6.0%
Feb-16	4.0%	6.0%	6.0%
Mar-16	3.9%	6.0%	6.0%
Apr-16	4.2%	6.0%	6.0%
May-16	n/a	6.0%	5.8%

Trend in Inflation and Policy rate response



Source: Bloomberg, KSE 100 & IGI Research

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Monetary Policy Statement

SBP Cuts Policy Rate; Despite Oil price Recovery

- State Bank of Pakistan announced monetary policy on 21st May-16 surprising market with a cut of 25bps to 5.75% citing lagged economic growth as an impetus to rate cut. Consequently, the Reverse repo rate and Overnight repo rate were adjusted to 6.25% and 4.25%, respectively.
- Owing to risk factors pointed out by SBP, which on materializing can potentially create significant inflationary pressure ahead in FY17. These include a) demand and supply imbalance, b) possible pass-on of rise in global oil prices and non-energy commodities prices, and finally c) probable increase in gas and electricity tariffs along with imposition of new tax measures in the upcoming budget.
- Our base case average inflation stands unchanged at 3.0% for FY16 and4.6% in FY17. We do not expect further rate easing in FY17.

The SBP surprises market by key policy rate cut by 25bps

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Exhibit: SBP Policy Rate

	Previous	Current
Reverse Repo Rate (Ceiling)	6.50%	6.25%
SBP Target Policy Rate	6.00%	5.75%
Overnight Repo Rate (Floor)	4.50%	4.25%
Minimum Saving Deposit Rate	4.00%	3.75%

Source: IGI Research, SBP

Policy rate decision – Inflation to Remain Below its FY16 Target

Headline CPI inflation rose to 4.2% in April-16 (3.9% in Mar-16)from a low of 1.3% in Sept-15, witnessing a continuous rise for seventh month during FY16TD. According to State Bank of Pakistan (SBP), CPI inflation is expected to remain below its FY16 target of ~6%. To note, average CPI inflation for the 10MFY16, is down to +2.8%YoY from

+4.8%YoY in same period last year.

Monetary Policy Statement:
"As expected, headline CPI inflation sustained its rising trend for the seventh consecutive month and on YoY basis rose to 4.2 percent in April 2016 from the low of 1.3 percent in September 2015… Similarly, core inflation measures have broadly followed a rising trend in this fiscal year indicating buildup of underlying inflationary tendencies."

Policy rate Guidance – Keeping an eye out on Inflation Trend

Owing to risk factors pointed out by SBP,which on materializing can potentially create significant inflationary pressure ahead in FY17. These include a) demand and supply imbalance, b) possible pass-on of rise in global oil prices and non-energy commoditiesprices,and finally c) probable increase in gas and electricity tariffs along with imposition of new tax measures in the upcoming budget.

In addition to above factors, we view surge in global food prices (as denoted by FAO food price index which is up by ~0.7%MoM in Apr-16) and bloatedcore inflation (non-food) for the country to +3.8%YoY in Apr-16 compared to +3.7%YoY in Apr-15, reaffirmsgradual up-tick in inflation. Our base case average inflation stands unchanged at 3.0% for FY16 and4.6% in FY17.

Outlook: Limited room for further cuts; the only direction now is northwards

We believe this rate cut will achieve little in terms of SBP monetary policy transmission objectives. Second to that, we think there is limited room for further cut in policy rates given a) recent recovery in oil prices leading to probable increase in domestic electricity and gas tariffs following rise in energy prices. Hence, in our view this to be the last stretch of monetary easing for FY16-17.

Equity Market: Further Pressure on Banking Sector

Lowering interest rates will certainly push down earnings yield for banks heavy on treasury bills and re-investment risk at lower yields, but this also means additional cost saving on deposits for banks heavy on savings. In short, we see limited stress of 25bps cut on banks' Net Interest Margins (NIMs). In addition, we view higher capital gains income for banks' which would somewhat dilute the impact of lower net interest income in CY17E.

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