Day Break

Wednesday, 08 November 2017

IGI Securities
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Economy

Exhibit: Arab light oil price - Quarterly Average (USD/bbl)

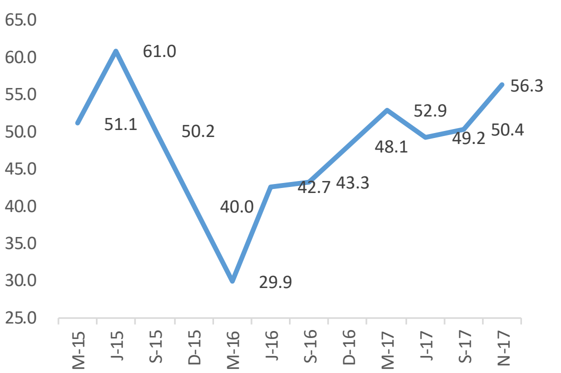
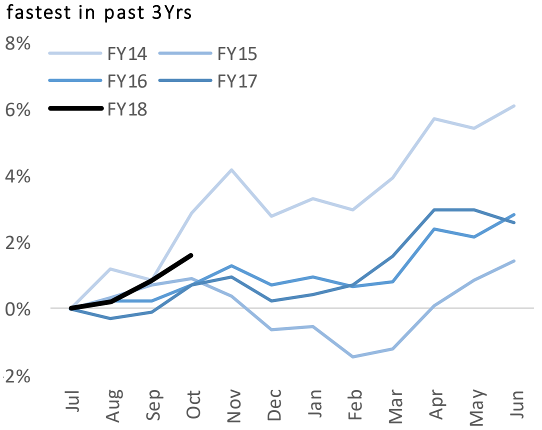


Exhibit: CPI index picked up pace, in 4M starting FY18, fastest in past 3Yrs



Source: PBS & IGI Research

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Monetary policy

Rising oil prices cast concerns over inflation

- Starting Jul-17, oil prices have gained momentum, trading above USD 50/bbl since Aug-17 to reach a high of USD 60/bbl at the beginning Nov-17. A multitude of factors have contributed to this upsurge
- The rise in international oil prices has significant implications for domestic price level and subsequently, on monetary policy
- Based on our findings, every USD 5/bbl increase in oil prices leads 20-35bps accretion in headline index alone.
- Impact of 20-35bps on inflation is based only on the narrow energy components (with motor fuel and electricity being the largest); we have not explicitly accounted for second-round effects.
- Initially, we estimated rate hike to begin no earlier than 2QCY18, starting with a 50bps rise. However, under aforementioned scenarios, we suspect monetary policy cycle is likely to reverse sooner than projected, in our view.

Rising oil prices could bring monetary policy stance reversal sooner than projected, in our view

The relatively favourable inflation figure (headline 3.5%YoY, 4MFY18) has led to high hopes of policy rate stability in remainder of FY18. As such, recent State Bank of Pakistan (SBP) reports have rushed to foresee inflation target of 4.5-5%, indicating positive real interest rate to likely persist in FY18 as was the case in FY17 and to a large extent in FY16. However, recent runaway international oil prices do exhort pressure on domestic inflation, indicating that real interest environment could be short lived. In short, rising oil prices could bring monetary policy stance reversal sooner than projected, in our view.

Oil price averaging above USD 50/bbl in FY18 to date…

Starting Jul-17, oil prices have gained momentum, trading above USD 50/bbl since Aug-17 to reach a high of USD 60/bbl beginning Nov-17. To put things in perspective, FY18 to date oil prices now average USD 53.3/bbl, compared to average of USD 48.7/bbl and USD 39.6/bbl recorded in FY17 and FY16, respectively.

…and its seems that prices are likely to stay above for the reminder of FY18

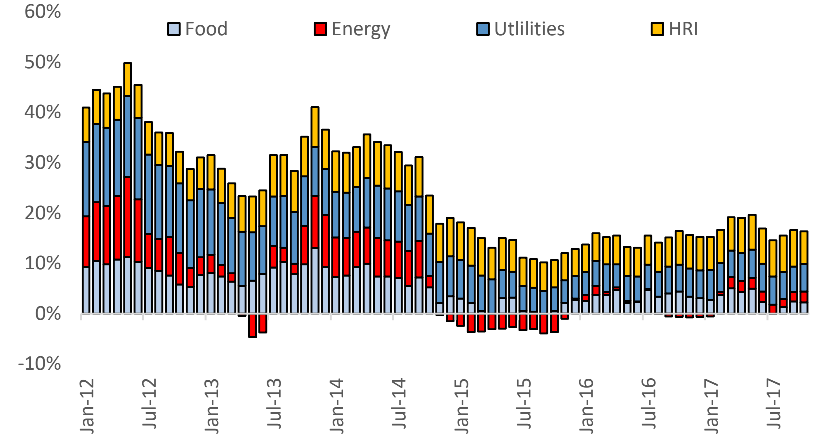
A multitude of factors have contributed to this upsurge, mostly pertaining to tighter global supply of oil. To start with, US inventory and oil rig count have been showing a consistent decline while demand from China is on a rising trend. To top it up, upcoming meeting of OPEC (scheduled for 30th Nov-17) is anticipated to extend production cuts beyond Mar-18 by both OPEC and Non-OPEC members. Additionally, ongoing geopolitical tensions in Middle East also adds geopolitical risk premium to the supply side. To summarize, supply constraints and rising demand are likely to keep oil prices buoyant in near to medium term.

Inflation implication

The rise in international oil prices has significant implications for domestic price level and subsequently, on monetary policy. Based on our findings, every USD

5/bbl increase in oil prices leads 20-35bps accretion in headline index alone. This would put retail prices of Motor Sprit (MS) close to PKR 80/ltr as per our estimates from PKR 71.3/ltr recorded in Jul-17, up by +11%. To recall, responding to rise in international prices, the government increased local POL prices by an average of ~3% starting Sep-17. Moreover, the government also revised electricity base tariff prices in addition to monthly fuel adjustments.

Exhibit:
Inflation Break-up; Non-food (utilities & HRI pulling up inflation)



Source: IGI Research, SBP, PBS

Second round effect likely to be more profound

Impact of 20-35bps on inflation is based only on the narrow energy components (with motor fuel and electricity being the largest); we have not explicitly accounted for second-round effects. Also, we leave out administered energy, POL prices and other components of the CPI basket where energy is a significant input cost. Therefore, by construction, our estimates may be somewhat downwardly biased.

Exhibit:
Core inflation staying downward sticky

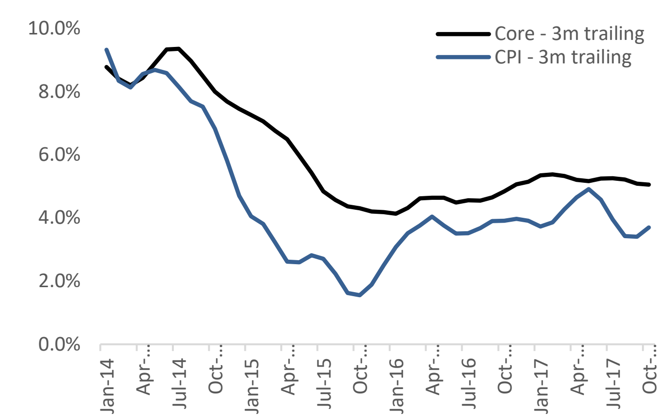
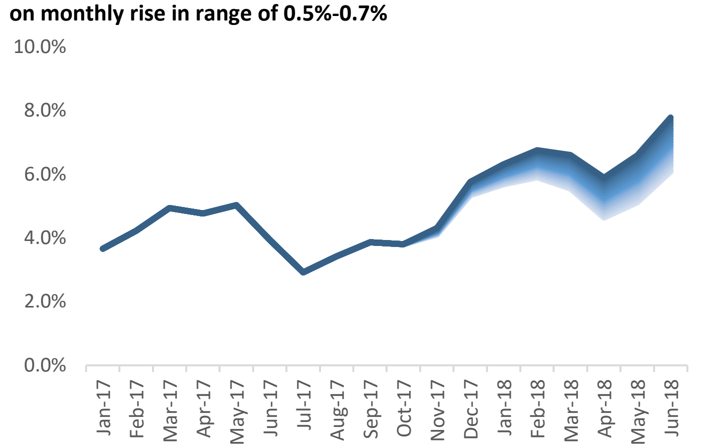


Exhibit:
Yearly inflation projected to stay well above 6.5% by Jun-17; based on monthly rise in range of 0.5%-0.7%



Source: IGI Research, Company Financials, Bloomberg

Reflecting on inflation drivers

To reflect back, headline inflation on a monthly basis is showing no signs of slowing down. During 4MFY17 inflation has registered on average ~0.5% growth (Oct-17 showing a monthly increase of +0.74%) favoured by better supply leading to relatively stable food prices. Energy and utilities the two main components; have had a major impact on non-food inflation. Core inflation as measured by NFNE (non-food, non-energy) has shown rigidness in recent times, averaging +5.5% in 4MFY18 compared to +4.8% last year same period. As core prices continue an upward trajectory, chances of this price pressure feeding into headline inflation cannot be ruled out as yet.

Outlook: Monetary policy cycle is likely to reverse sooner than projected, in our view

A mix of exchange rate movements and the relative uncertainty of inflation, in our view, will keep policy makers on toes. In our view, the inflationary risks are certainly tilted towards the upside given the rising oil prices. Combined with a sharp upswing in exchange rate this will eventually amplify the inflation problem. Initially, we estimated rate hike to begin no earlier than 2QCY18, starting with a 50bps rise. However, under aforementioned scenarios, we suspect monetary policy cycle is likely to reverse sooner than projected, in our view.

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