NAFA

NBP Fullerton
Asset Management Limited
(Formerly National Fullerton Asset Management Limited)

Present Economic Situation and Capital Markets

Dr. Amjad Waheed, CFA
Chief Executive Officer

In FY2007, private sector borrowing from the banking sector was Rs 366 billion, and Government borrowing was Rs 164 billion. In FY2010, private sector borrowing declined to Rs 113 billion, whereas the Government borrowed Rs 631 billion (see Chart 1). In the first quarter (as of September 17, 2010) of FY2011, the Government has already borrowed Rs 155 billion. And this is the mother of the economic problems facing Pakistan today. The private sector, which is the more efficient and productive sector, creates nine out of 10 jobs, pays taxes, and brings in foreign currency via exports, has almost come to a halt, crowded out by excessive Government borrowing. High inflation and cost of borrowing, and a slow economic growth has brought private sector growth to a snail's pace. The Government has been unable or unwilling to increase revenues and reduce its expenditures. The axe has again fallen on the development spending, which will not only slow down economic growth, but will also cause resentment among the lower sections of the society. International commodity prices like wheat and cotton are up by over 30% in the last few months, and floods in Pakistan, has further deteriorated the situation.

The Government is now contemplating taking some steps to increase its revenue base by imposing a special surcharge on income tax, customs duty, property and introduce a reformed general sales tax. Although this will be inflationary in the short-term, it is expected to mitigate the budget deficit situation in the long–term. The Government is also expected to receive around US$ 4 billion from international donor agencies, IMF and some friendly countries to rehabilitate the flood victims. A scenario where foreign inflows improve liquidity, and budget deficit can be contained within 5% of GDP in FY2011 can enable the State Bank of Pakistan to start reducing discount rates by June 2011. If such a scenario materializes it will be good news for the Pakistani capital markets. The stock market can sustain an upward trend in such a scenario. Historically, there has been a significant positive relationship between the stock market performance and Net Foreign Assets (NFA) – see Chart 2. Oil and other commodity prices rose in 2008, resulting in outflow of foreign currency and decline in foreign exchange reserves of Pakistan. The stock market also declined as a result. Since then our foreign exchange reserves have surpassed the previous level, and our current account deficit has declined from US$ 1.28 billion per month, on average, in 2008 to around US$ 272 million per month, on average, in 2010. Thus, there is little downside risk in equities at present, and higher upside potential resulting from large commitments of foreign assistance by international donor agencies and friendly countries.

For present, the high Treasury bills rates are encouraging investors to invest in money market funds where the return is presently in excess of 11% per annum. Despite attractive valuations and the possibility of a Margin Trading System in place in the next three months, investors are expected to remain in the sidelines of the stock market till they see macro-economic improvements, especially reduction in inflation and interest rates. We are presently primarily holding those shares in our stock and balanced funds, which are blue chip, liquid and offer high dividend yields. Investors should refrain from holding long-term fixed rate instruments as interest rates volatility may remain high in these uncertain times.

Chart 1

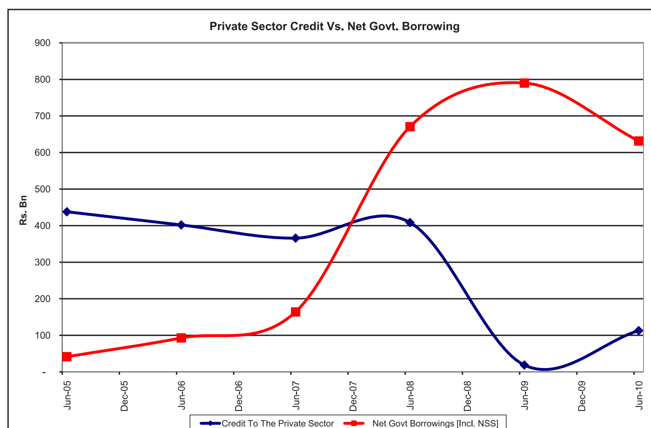
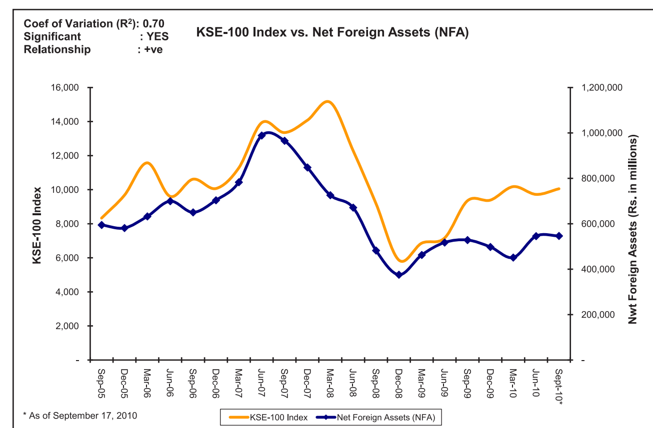


Chart 2



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