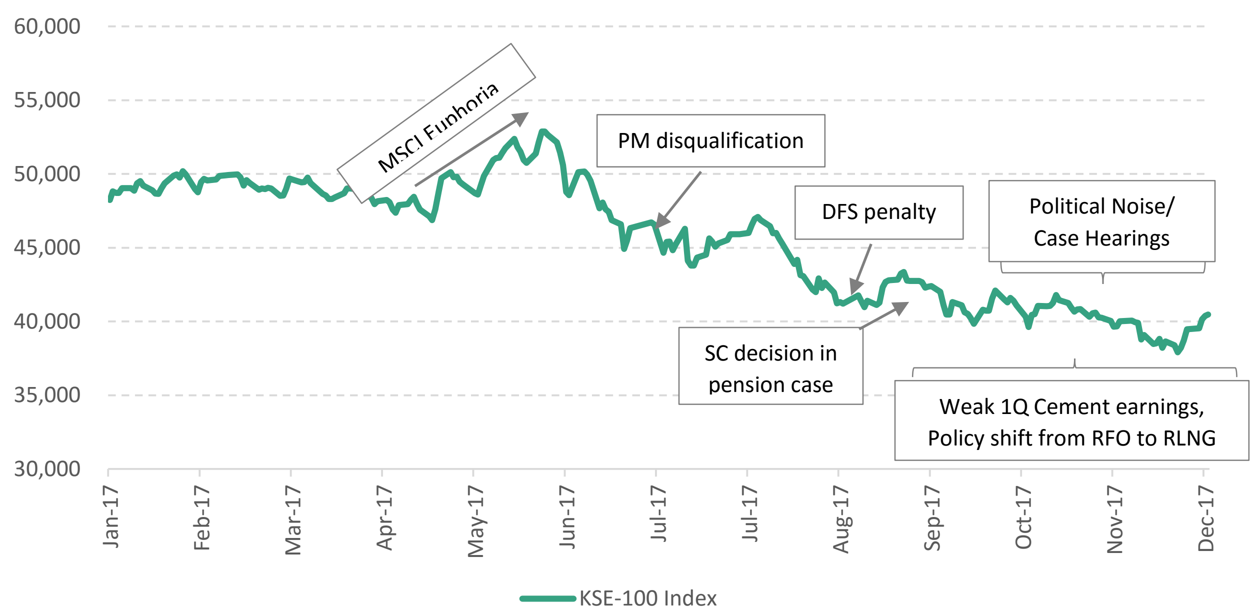
January 8, 2018

## Special Note – Pakistan Equities

## The Parting Gift of 2017

2017 was a year which gave us memorable lessons in "avoiding crowd behavior" and "value investing". After posting robust returns in 2016, Pakistan's stock market witnessed see-saw ride during 2017 with robust gains during 1H followed by a steep drop in 2H. KSE-100 index initially increased by 11% and touched its all-time high of 52,876 points on expectations of foreign inflows post up gradation of Pakistan market to MSCI Emerging market classification after 9 years. MSCI euphoria stretched forward Price to Earnings multiple from 10.8x in Jan-17 to 12.0x at peak. Pakistan's discount to Emerging index (EM) narrowed to 6% while PSX was trading at premium of 5% to Frontier index (FM). As investors disregarded valuations and rushed to out maneuver each other, foreign flows underperformed expectations significantly with just May-17 net outflow of USD141mn. And then the rut began!

**PSX's Rocky Ride in 2017**




The bad news kept pouring in second half – the disqualification of sitting Prime Minister, political noise of NAB/ Supreme Court case hearings, international oil price increase and current account deficit raising concerns over economic growth sustainability. Sector and stock specific news flow was also negative with HBL taking a hit on its US operations, declining cement companies' margins, Government's policy of replacement of RFO with RLNG in country's energy mix and OGRA's consideration of revision in gas pricing formula for gas distribution companies. These negative sentiments drove significant weakness in Pakistan equities as benchmark index dropped by 23% from its peak and closed the year with negative 15% return - the lowest amongst global stock markets.

## Outlook & Strategy for 2018

For simple folks, the silver lining at PSX comes from the fact that in the last twenty years, every negative return year has been followed by a positive return year. On that account alone, investors have a good reason to stock up on Pakistan's equities.

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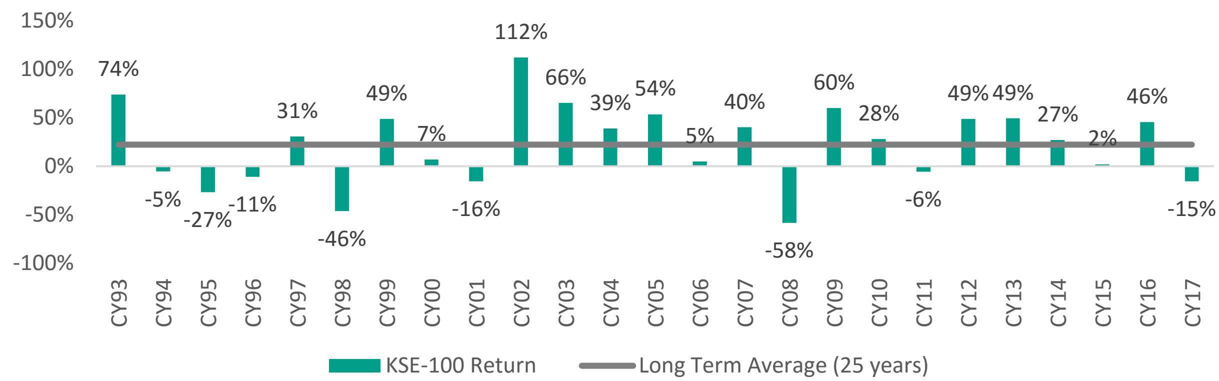
**History of PSX's Yearly Returns – Rebound in 2018?**




On more fundamental grounds, we believe that 2018 will be a better year for Pakistan equities with gradual phase out of political uncertainty, easing of economic challenges and better investor interest due to attractive valuations. The sharp rebound in the last trading days of 2017 shows that value hunters will not hesitate to grab bargains considering the quantum of liquidity sloshing in the system.

Political landscape has already witnessed betterment with passing of delimitation bill and nomination of Shahbaz Sharif as PML-N's next candidate for Prime Minister. Recent developments and reduction in political noise has increased possibility of smooth transition of power after elections. However, we cannot rule out risks of political noise as all the political parties gear up for elections. On the international front, recent exchange of statements by Pakistan-US representatives related to 'war on terror' might increase geopolitical risks but probability of materialization seems low with support from China (and other political allies) and its increased stake in Pakistan.

Higher oil prices (19% higher than 2017 average) and consistent growth in imports has worsened Pakistan's current account deficit (CAD) with initial five months of FY18 deficit at 4.5% of GDP. Rising CAD and slow pace of exports' pickup is a major concern for economic stability. However, economic growth during FY18 would likely be strong (GDP growth expected above 5%) and there is a high possibility of better foreign direct investment (FDI). Media reports suggest that there is a potential amnesty scheme in plan for overseas Pakistanis which can also be new avenue of foreign exchange inflows. Moreover, Government has also reiterated its policy of support for international trade in Chinese currency. Pakistan's trade deficit with China for trailing twelve months is US $ 10bn and if this trade is shifted to Yuan, it may open new avenue for funding country's foreign currency requirement.

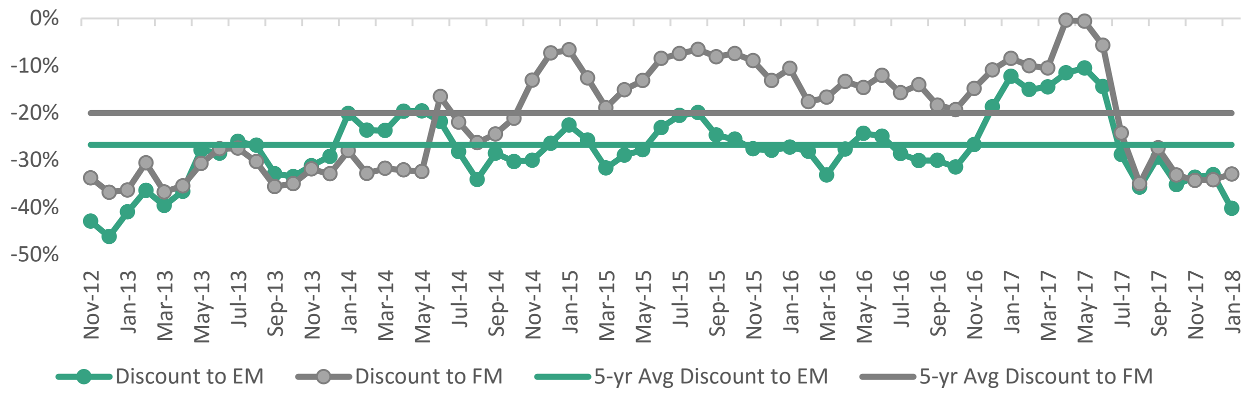
There is also the grim reality of low returns on other asset classes like fixed income, commodities and real estate. With low interest rates likely to persist through 2018 (we do expect a 50bps jump in 2Q18 but that would hardly make a dent), investors face some difficult choices. Attractive dividend yield of 6% plus in blue chip stocks will pull back a lot of investors who are waiting on the sidelines.

We believe that Pakistan equities can see a potential improvement in Price to Earnings multiple increase in 2018 as Rupee depreciation against US dollars might bring back foreign investor interest. Foreign investor interest is also evident in first week of the year with net foreign buying of USD23mn. If we implement Fed model* on Pakistan equities, forward earnings yield is currently 4.1% higher than 3-year bond yield, which is three times higher than last 12-year average of 1.4%. Pakistan market's discount to emerging as well as frontier indices has increased to 40% and 33% against 5-year averages of 27% and 20% respectively.



*** FED model:** This model suggests that returns on 10-year Treasury notes should be similar to S&P 500 earnings yield. Differences in these returns identify an overpriced or underpriced securities market.

**Pakistan Equities Discount to EM & FM**




For 2018, our strategy will be to align our portfolio with sectors and respective stocks where fundamentals will improve or at least sustain economic changes like PKR depreciation and higher interest rates. We will continue our identifying investment opportunities to make returns better than benchmark through active portfolio management. In the end, we would like to restate the fact that KSE-100 index average return for the past 25 years have been +20% which reaffirms Warren Buffet's quote:

**"The stock market is a device for transferring money from the impatient to the patient"**

**HBL Asset Management is currently managing following equity and asset allocation funds:**

- HBL Stock Fund
- HBL Equity Fund
- HBL Islamic Stock Fund
- HBL Islamic Equity Fund
- HBL Energy Fund
- HBL Multi Asset Fund
- HBL Islamic Asset Allocation Fund
- HBL Pension Fund – Equity
- HBL Islamic Pension Fund – Equity

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