Faysal Asset Management

Research Note

October 05, 2012

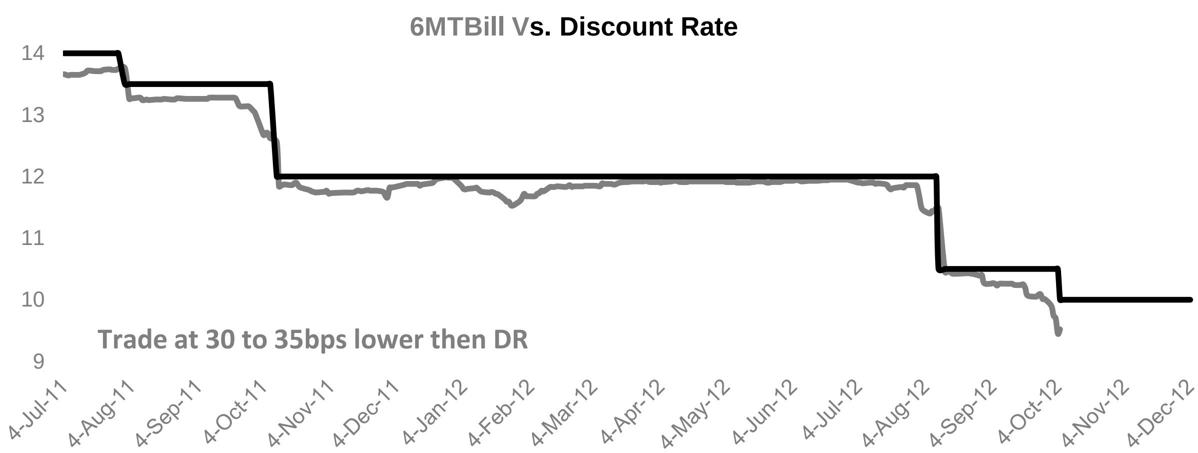
Key Policy Rate Reduced by 50bps…

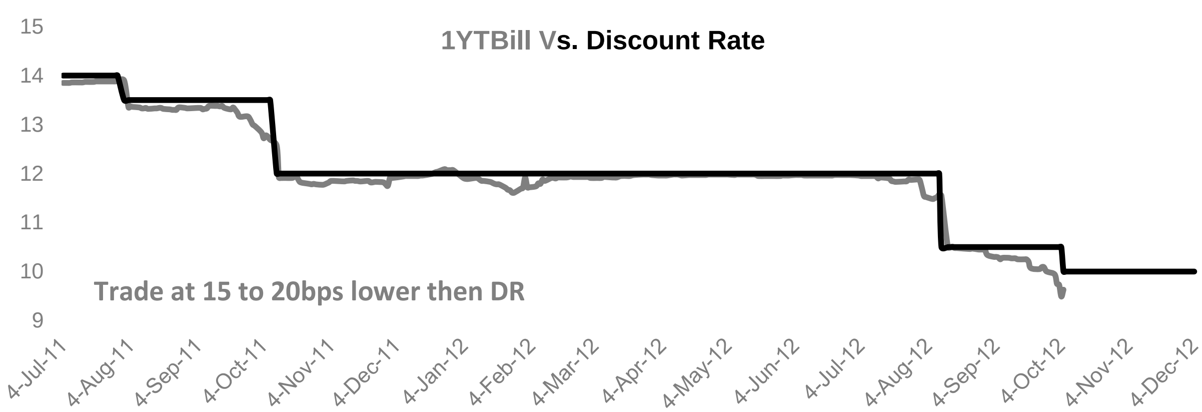
The State Bank of Pakistan announced a cut of 50bps in the key policy rate today, disappointing many punters and economic gurus who were anticipating a cut of 100bps. With the recent expansionary measure, the discount rate now stands at 10% - still short of the much coveted single digit figure.

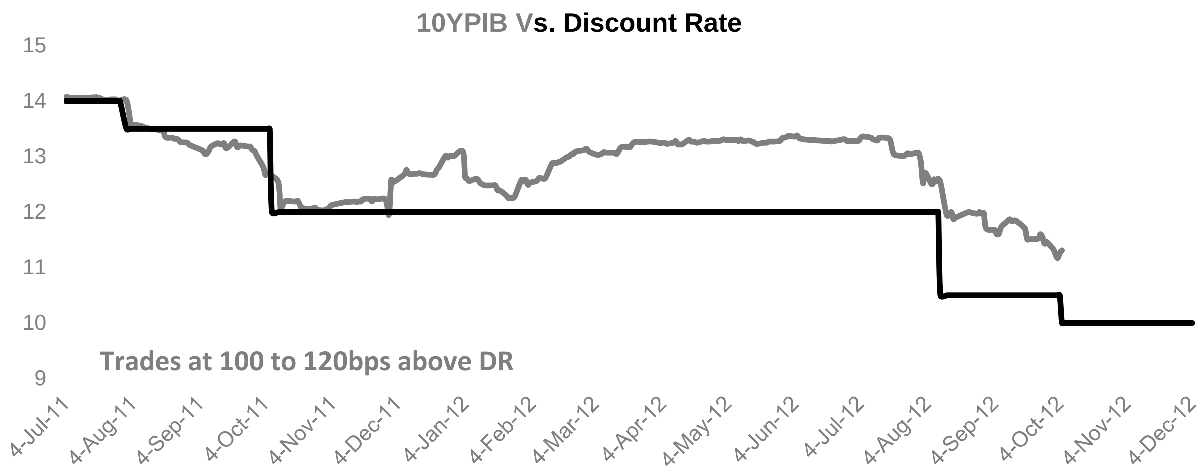
On theoretical grounds, we believe this rate cut is justified and that the central bank executed a rational maneuver to spur economic growth, without risking monetary fueling. Practically speaking, however, the measure was met with negativity – strikingly conspicuous from the manner in which money market and fixed income market yields reacted during the 30 minutes following the policy statement.

In this regard, 12-month Treasury Bills skyrocketed from 9.50%, just minutes before the policy statement, to 10.10%. 10-year Pakistan Investment Bonds, meanwhile, soared from 11.32% to 11.58%. Historically, T-bills trade 20-30bps below the discount rate, while PIBs trade 108-123bps above the discount rate. With a discount rate of 10% (50bps incorporated), this ought to translate into 12m T-bill yield of 9.80% and 10-yr PIB yield of 11.20% - clearly hinting at the panic that ensued post policy announcement.

That said, we believe the fixed income market will correct this exuberance and settle down near aforementioned yields (i.e. 11.20% for PIBs and 9.80% for T-Bills). Thus, opportunity to capitalize on this exuberance exists in the very short-term, which is expected to be capitalized upon by investment managers across the industry.







With reference to the monetary policy minutes released by the State Bank of Pakistan, it is interesting to note that in previous policy minutes (August '12), central bank governor Yaseen Anwar emphasized on attaining inflation target of 10.5% for FY13. This emphasis was crucial as the discount rate had been reduced by 150bps to 10.5%. Even a single basis point increase in inflation beyond 10.5% would have turned real returns negative. Now, with the new policy statement, Mr. Anwar seems extremely confident about the pace of monetary fueling and believes that the economy will not only stay below 10.5%, but possibly achieve the revised single digit inflation target of 9.5%! This undoubtedly bodes well for industrial managers, consumers and investment managers as the former will be able to avail cheaper financing (spurring private credit off-take) and the latter will be able to capitalize on the possibility of further monetary easing in December.

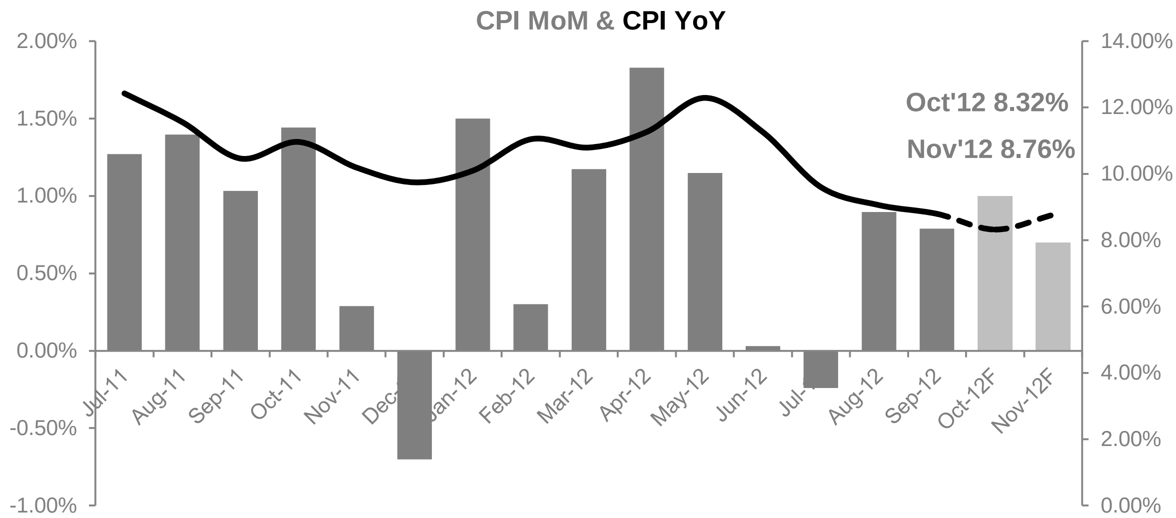
August Policy Extract:

"In any case, it would be too early to call it an emerging trend as there are still deep-rooted factors driving inflation. Stickiness in both the core inflation measures points towards the persistence of inflation in low double digits. SBP projects average CPI inflation for FY13 to remain in the range of 10 to 11 percent, which is higher than the announced target of 9.5 percent for FY13…Inflation outlook, has improved with a projection of 10.5 percent for FY13 and loans to private sector businesses have sharply decreased. This has led to an increase in real interest rates. In taking the monetary policy decision, the Central Board of Directors of SBP has decided to give a relatively higher weight to the state of private sector credit and investment in the economy, knowing that the projected inflation for FY13 could remain slightly higher than the target."

October Policy Extract:

"A consistent deceleration in inflation since May 2012, to 8.8 percent in September 2012, is more than earlier estimates. Thus, despite an expected uptick in H2-FY13 the overall inflation outlook has improved. In fact, the likelihood of meeting the 9.5 percent inflation target for FY13 has increased."

In accordance with our inflation projections over remaining FY13, we anticipate the statistic to remain subdued even with a growth of 1.0% to 0.7% in October and November, respectively. There exists strong premise for curtailed monetary fueling as international oil prices and high base effect will likely play a key role in keeping inflationary pressure under control. As proclaimed by the State Bank Governor, Inflation for FY13 will consolidate within the target set at the commencement of the fiscal year.



FY13 Inflation 9% - 9.5%

Our inflation projections suggest economic managers still have room for further monetary easing (up to 50bps cut in DR) till December 2012. However, the decision may be influenced considerably by upcoming IMF payment to the tune of USD 540mn in November 2012.

On the Equity front, the 50 bps cut in the discount rate to 10% is expected to bode well for companies as lower finance cost will improve their bottom line and equity valuations. It is pertinent to mention that highly leveraged companies will benefit the most while companies with high cash balances will record reduced investment incomes. We have highlighted companies that are likely to benefit the most based on Debt-to-Price ratio.

S.No	Name	Debt/Price (PKR)
1	Nishat (Chunian) Limited	9.78
2	Nishat Power Ltd.	2.85
3	Nishat (Chunian) Power Limited	2.69
4	Engro Chemical Pakistan Ltd.	1.59
5	Fauji Cement Co., Ltd.	1.54
6	Nishat Mills Ltd.	1.40
7	Sui Southern Gas Co., Ltd.	1.16
8	Byco Pakistan Ltd.	1.11
9	Shell Pakistan Ltd.	1.07
10	Hub Power Co. Ltd.	1.01
11	Pakistan State Oil Company Ltd.	1.01
12	Packages Ltd.	0.95
13	Fatima Fertilizer Ltd.	0.76
14	Sui Northern Gas Pipelines Ltd.	0.75
15	Tri-Pack Films	0.61

The above table shows the list of companies that have the highest proportion of debt compared to their closing prices as of 5th October, 2012. The following table, on the other hand, highlights companies that are expected to witness a decline in other income on account of reduced yields on fixed income investments.

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Conclusion

With a 50bps rationalization, the central bank has indeed left the fate of the next monetary policy in question. While lower anticipated inflation may provide further expansionary impetus, upcoming IMF payments and resultant pressure on Pak Rupee and general price level serves as a looming downside risk to the monetary authority's expansionary ambitions.

On the investment front, we expect equities to remain buoyed on higher cash flow valuations and lower leveraging costs. Fixed Income market, however, is expected to witness immediate volatility, followed by consolidation towards average mean spreads (from DR).