Faysal Asset Management

Crude Oil

October 2, 2012

CPI surprises month after month

Over the month of August, Consumer Price Index as reported by Pakistan Bureau of Statistics (PBS) clocked in at 9.05% YoY as a result of 0.89% spike on monthly basis. True to historical trend, the Ramadan effect trickled down to food prices during the month, causing the most heavy-weight category to surge by 0.97%. Moreover, hike in prices of petroleum products was also partially incorporated in the CPI statistic for August. All that said, the single digit figure of 9.05% YoY remains a highly supportive statistic for the economy as it can undoubtedly contribute towards a possible monetary easing attempt by the SBP in October. If this indeed transpires, equity and fixed income market are very likely to witness another bullish spell.

The downward trajectory followed by inflation since June 2012 is expected to continue till Dec 2012 on account of high base effect and tactically timed price reduction in petroleum products. Additionally, a well-timed reduction in gas tariff in July also played a crucial role in setting up the inflationary trajectory.

Using the premise of receding inflationary pressure and importance of economic growth, policy makers opted for drastic monetary easing in August. In this regard, SBP Governor Yaseen Anwar had hinted at a 150bps cut in the discount rate in a speech delivered at SAARC FINANCE SEMINAR ON "MONETARY POLICY FRAMEWORK IN THE SAARC REGION" on 14-16 JUNE 2012.

"The universal aim of monetary policy is achieving price stability; a secondary aim of monetary policy may be growth. The preamble to The State Bank Act states that the bank is supposed to "regulate the monetary and credit system of Pakistan… with a view to securing monetary stability and fuller utilization of the country's productive resources". Therefore, SBP is concerned with not just inflation and price stability, but also with economic growth. Inflation targeting regime requires that the central bank's policies remain independent of the fiscal authority, have market credibility and are time-consistent. Given that conditions in developing countries may not allow for such freedoms, inflation targeting may prove to be ineffective in such economies."

While rationalizing the aggressive expansionary move by State Bank on 10th August 2012, Yaseen Anwer said the following:

"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."

Following the 150bps rate cut by Yaseen Anwer on August 10, the yield curve adjusted downward immediately and investors shifted exposure from short term to long term government securities to increase fund duration and gain from a declining interest rate scenario.

What's to follow…Further Easing??

Inflation sensitivity and projections suggest that CPI in coming months will most likely remain subdued and hence form the basis for further monetary easing. Even amidst high oil pressure prevalent in the international market, we foresee CPI to remain lower than August CPI as the government has adopted a prudent tactical approach to adjusting domestic oil prices. Under this approach, oil price is increased over second half of each month and is thus not completely incorporated in CPI calculation.

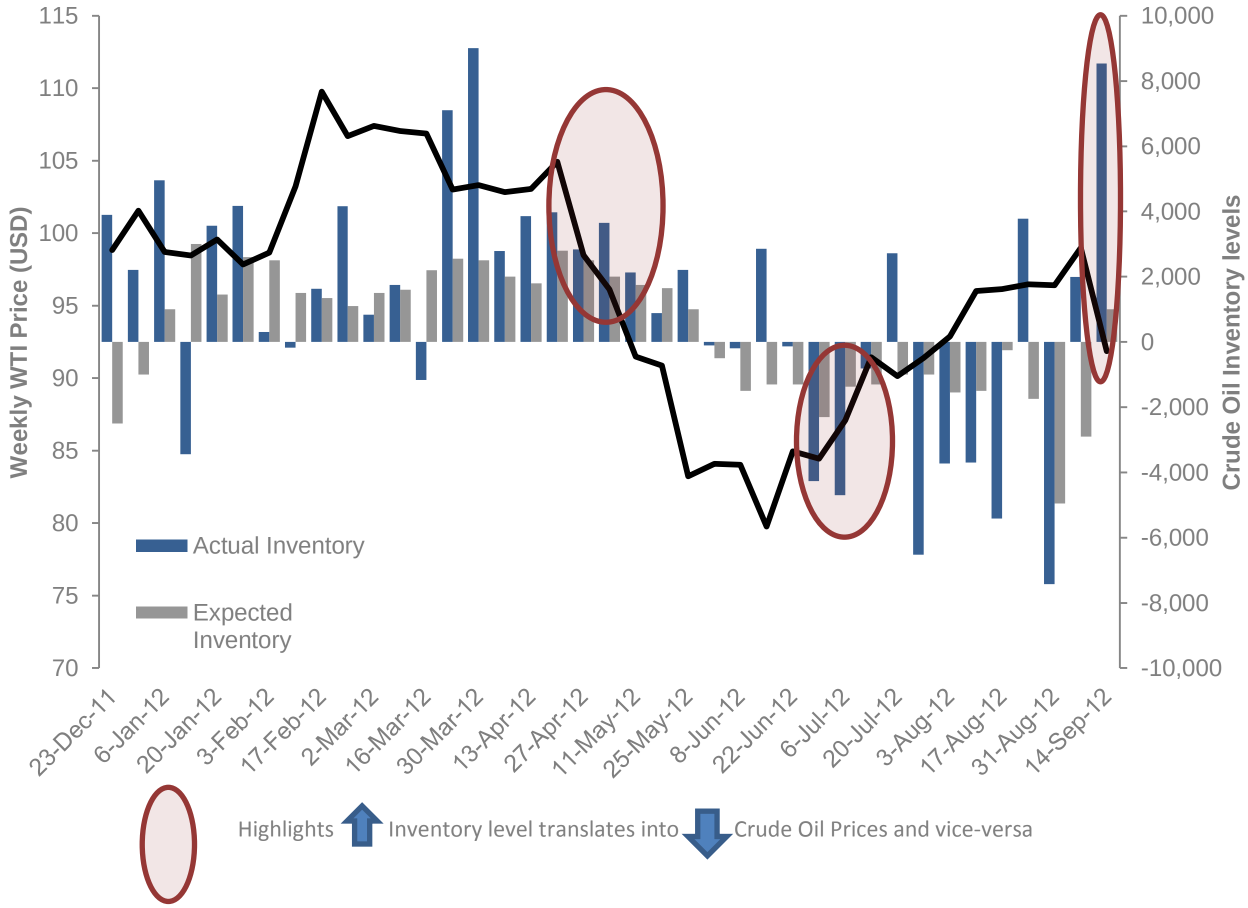
Forecasting International Oil Price after QE3

The U.S. Energy Information Administration (EIA) releases Petroleum status report on a weekly basis - announcing weekly changes in U.S. commercial crude inventories. The crude oil market religiously tracks this Petroleum Report, deeming it a key influencing factor for crude oil futures.

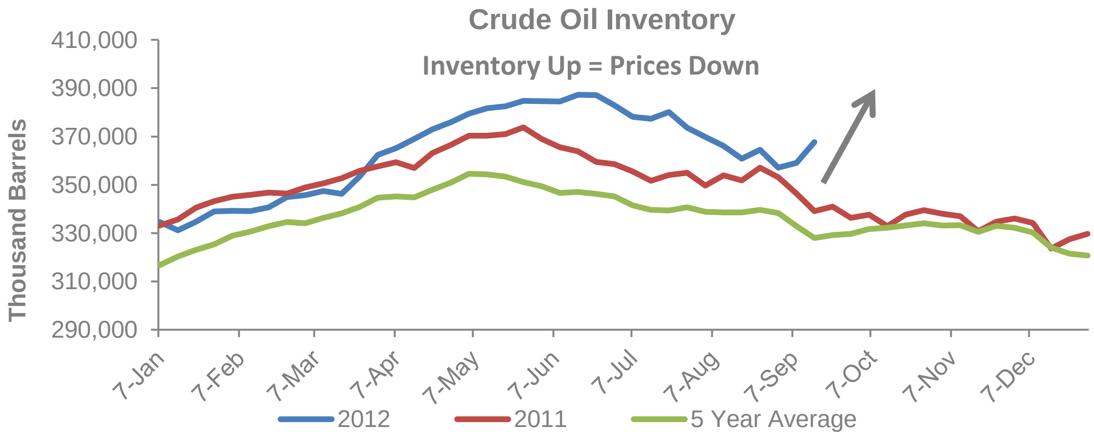
International oil prices are exposed to a set of diverse factors ranging from natural disasters, to disturbances in financial markets, to monetary injections by central Banks. Amidst all these, the petroleum status report on inventory levels is the most prompt in influencing oil prices. The cause and effect relationship between price and inventory levels is explained hereunder:

"Declining inventory levels lead to hike in prices while rising inventory levels translates into declining crude oil prices"

Oil analysts and gurus post their expectations of inventory levels before the release of the status report each week. The correction in crude oil price post-release is almost proportional to the magnitude of difference between the actual crude inventory level and analyst projections of the same.



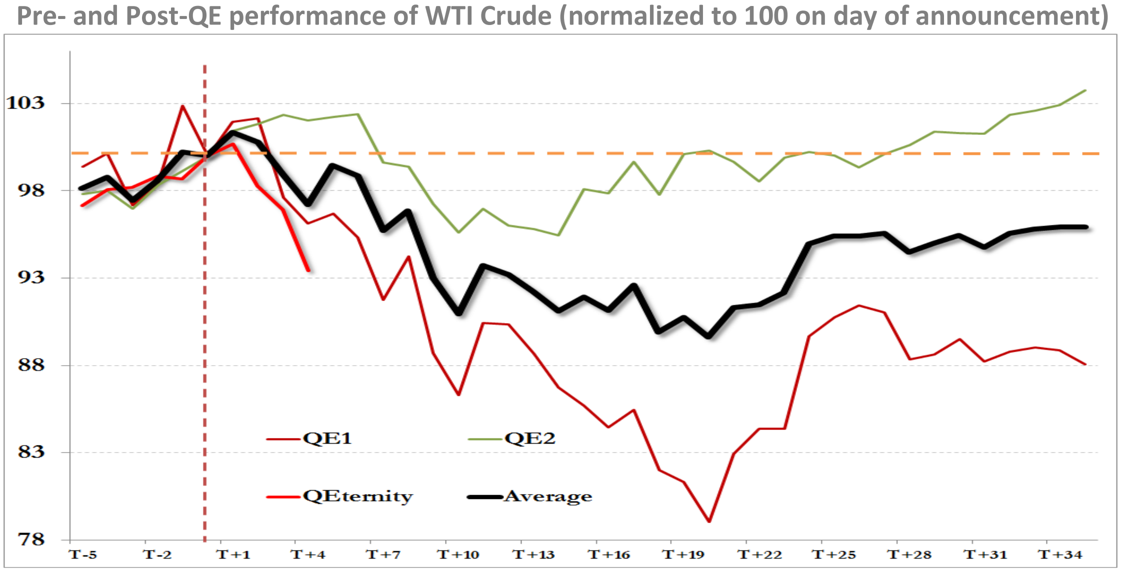
As per the weekly summary of Petroleum Data released on September 14, 2012, U.S. commercial crude oil inventories rose by 8.5 million barrels last week, bringing the total U.S. commercial crude inventory to 367.6 million barrels. This level is higher than the previous five year high inventory recorded for this time of the year. Consequently, crude futures reacted to the report and crude oil prices plunged, disregarding effects of the recent launch of QE-3. This decline was continuation of a sell-off that began earlier in the week on the hopes of disclosure of Strategic Petroleum Reserve. Additionally, oil analysts claim that Saudi Arabia, the world's largest exporter of crude, is producing at the highest level in more than three decades.



Interestingly, crude oil prices are known to embark on a short-term downward trajectory after every Quantitative Easing introduced by the U.S Federal Reserve. To depict this, price trends pertaining to previous QEs have been plotted below. As experienced in QE 1 & 2, oil prices have a tendency to rise prior to easing announcement and slide down once the announcement is made. This downward move takes place over ensuing 20 to 22 trading sessions post-announcement.

Keeping in view the behavior of oil prices to QE and bearish fundamentals we anticipate international crude oil prices to dip from the current levels.

Pre- and Post-QE performance of WTI Crude (normalized to 100 on day of announcement)



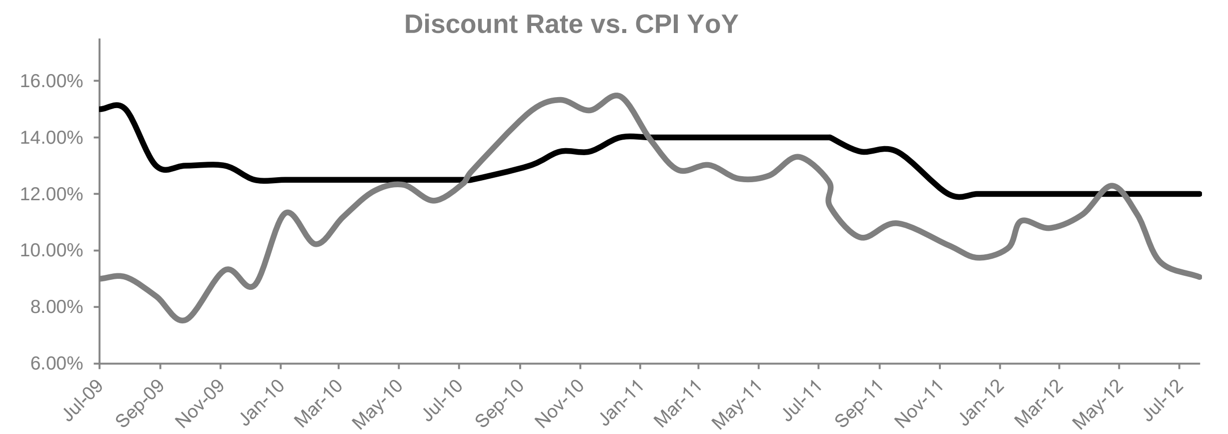
Impact of International Crude Oil Prices on Domestic Markets

Having a correlation of 94%, Arab light prices follow international crude oil prices with a lag of not more than a day. Hence, declining international oil prices will consequently be a bearer of good news to the skyrocketing domestic petroleum prices.

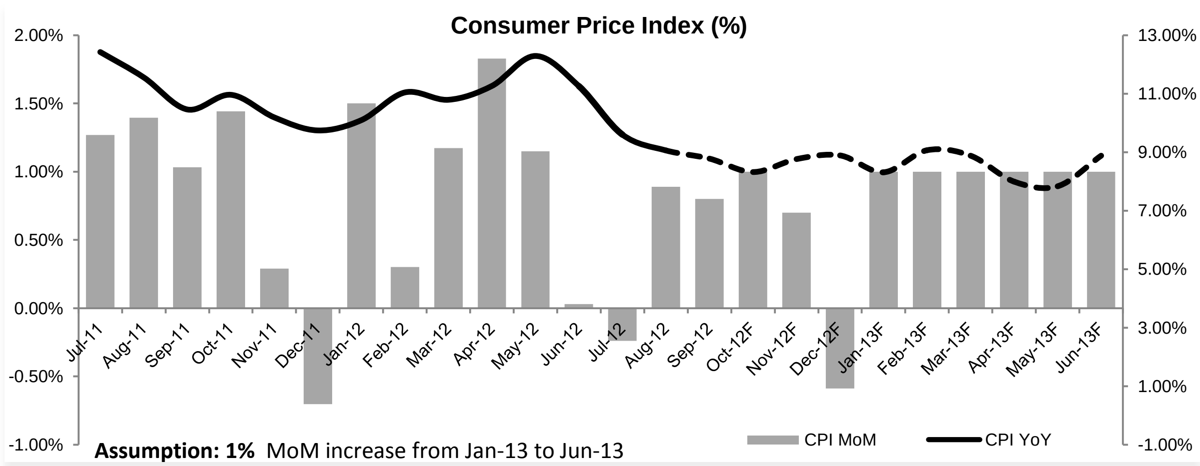
Inflation Projections for FY13

With high base effect to sustain the downturn in inflation, we expect the Consumer Price Index (CPI) to remain in single digit at least till November 2012. Additionally, our in-house analysis on international oil and commodity prices suggests that the government will be able to meet the inflation projection of 9.5% for FY13.

Keeping in mind the targeted inflation of 9.5%, policy makers have ensured that the real rate of return remains positive. For now, it seems that the central bank's primary concern is to spur economic growth via private credit off-take and maintain positive real interest rates for general consumers. Going forward, we believe that this outlook of SBP will remain steadfast till June 2013 leading to vigilant and encouraging macroeconomic management.



With an assumed 0.8% MoM inflationary growth, CPI is expected to comfortably consolidate and hover around 8% to 8.5% in June 2013. Following is the graphical representation of inflation forecast for FY13:



Conclusion

With 8.78% CPI in September 2012, we foresee considerable room for another 50 to 100 bps cut in the Discount rate in the monetary policy announcement scheduled for October 05, 2012. In light of this, we foresee the yield curve to adjust downward after the monetary policy announcement, with institutional investors expected to increase their inclination further towards longer tenor government securities.