

August 02, 2010

Pakistan Market**MPS 1QFY11: SBP raises DR by 50bps****MORNING BRIEFING**

KSE100 Index: Closing 10519.02 ↑ (+80.36)

In its July 30th policy review, the SBP opted to raise the policy rate by 50bps to 13.0%. This surprising move by the SBP was brave, especially in the absence of three core members of the Monetary Policy Committee (MPC). For now we await the release of minutes of the Monetary Policy meeting (to be released in three months) in order to know how many members voted in favor of this decision. The reasons cited by the SBP for macro stability risk include 1) decline in investments 2) robust public sector demand 3) weak aggregate supply and 4) rising total debt. Moreover, the central bank highlighted an upward revision in the electricity tariff, increase in the GST rate by 1%, and increased government employees' salaries as upside risks to inflation; and expects inflation to be in the range of 11-12% in FY11. The question now emanates whether this is the beginning of further hikes or will the SBP pause here. We foresee the SBP will follow a wait and watch approach, as it stays extra cautious and highlighted the fiscal and external risk in the years to follow.

SBP maintains interest rate corridor at 300bps

Further, inline with a hike in the DR (reverse-repo), the central bank has raised its Overnight Repo rate to 10% from 9.5% previously. This will serve as a 'Floor' for the interest rate corridor.

The impact

Yields of long-term bonds are up in the vicinity of 25bps, while equity markets opened 2% down from its previous closing. Historically, we have seen the equity market reacting negatively to steep rate hikes of 150bps, but remaining positive to neutral incase of small hikes of 50bps (see table). Therefore, we expect market to normalize in the days to follow.

We flag highly leveraged sectors such as cement & textile together with Engro Corp. as major losers due to rise in financial charges on the back of expected up-tick in KIBOR.

Moreover, yield plays like IPPs would also lose relative attraction for investors. On the flip side, cash rich E&Ps are likely to be the preferred plays for investors in the coming months.

KSE-100 reaction to increase in discount rate next day

| MP Date | Δ in DR | New DR | Δ in KSE-100 (pts) | Δ in KSE-100 (%) |
|------------|---------|--------|--------------------|------------------|
| 11-Apr-05 | 150bps | 9.0% | (305.5) | -4.2% |
| 29-Jul-06 | 50bps | 9.5% | 144.1 | 1.4% |
| 1-Aug-07 | 50bps | 10.0% | 81.6 | 0.6% |
| 31-Jan-08 | 50bps | 10.5% | (42.6) | -0.3% |
| 23-May-08 | 150bps | 12.0% | (427.0) | -3.3% |
| 30-Jul-08 | 100bps | 13.0% | (269.4) | -2.5% |
| 12-Nov-08* | 200bps | 15.0% | 1.0 | 0.0% |

Source: SBP & KSE, *price floor period

Minutes of the March 27th MPC meeting

The SBP has started to post minutes of the MPC meetings in order to bring more transparency and to send signals to markets about its future intentions. The March 27th MPC meeting was attended by Mr. Yaseen Anwar, Mr. Tariq Saeed Saigol, Mr. Mirza Qamar Beg, Dr. Hafiz Ahmed Pasha, Mr. Riaz Riazuddin, Mr. Asad Qureshi, Dr. Hamza Ali Malik and Mr. Aftab Mustafa Khan. It discussed the importance of the persistent fiscal deficit, which determines the effectiveness of the monetary policy, and raised concerns about rising inflationary pressures, government borrowing, low revenue collections and high financing rates. Recovery in the LSM sector and external accounts were also discussed. After deliberation on macro issues, the Chairman invited members to vote for one of the following options 1) policy rate at 12.50% or 2) 50bps hike. Five members of the MPC voted in favor of no change while the remaining two voted in favor of a hike. Similarly, for the July 30th Policy review, only six members had attended the meeting out of the nine; and we await the release of minutes.

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Also in focus**PSO promised Rs24.7bn**

Pakistan State Oil (PSO) is likely to receive Rs24.7bn from the government to ease its financial woes, with Rs17bn expected this week. The remaining amount of Rs7.6bn is likely to be received the following week. PSO had threatened to halt fuel supply to HUBCO and KAPCO on credit basis from Aug 1, as its receivables have escalated to Rs142bn due to non-payments from the power sector. Despite the ongoing circular debt issue, we maintain our 'Buy' recommendations on PPL, POL, PSO, APL and HUBCO in the energy sector.

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