

## JS take on inflation and interest rates

KSE100 Index: Closing 7075.93 ↑ (+202.97)

Yesterday's T-bill auction outcome (100bp cut) can be interpreted either as SBP's monetary stance getting softer or as SBP's tough signal to markets regarding its sticky interest rate outlook. We believe monetary outlook is forward looking and always incorporates inflationary expectation and demand outlook. While the former is increasing on the back of rising international oil prices, however, latter is weak due to contraction in domestic demand outlook.

JS Research has a different view point on inflation irrespective of today's higher oil prices compared to trough prices hit in March 2009. We expect inflation to be in the range 8-10% in FY10 even with 10% increase in oil prices and electricity tariff revision due to 1) base effect, 2) stable staple food prices and 3) positive output gap. As a result, we expect SBP to cut policy rate by 300bps in remaining part of 2009. The rate cut is expected to be gradual. On the back of declining interest rates, Pakistani bond market has provided an exceptional return of 46% compared to equity market return of 21%YTD.

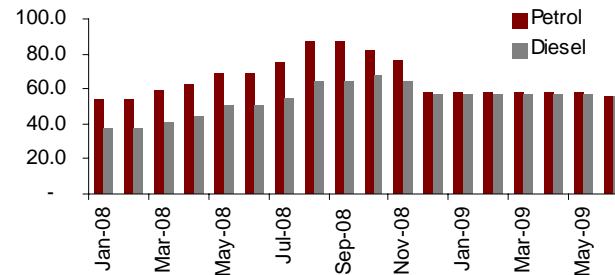
### The inflation outlook

**Theory:** Investor's termed FY10 budget as inflationary, due to imposition of carbon tax and possible electricity tariff adjustments. However, we believe the measures are neutral in the medium term, as higher carbon and electricity tariff avoids huge deficit, which in turn reduces government borrowing and pressure from interest rates. On the same token, higher charges rationalizes consumption, hence taking pressure away from imports and balance of payment.

**Empirical:** On the other hand, even with the 10% increase in oil prices from July 1<sup>st</sup> the year-on-year oil inflation is negative, with today's oil prices of Rs53.7/litre compared to Rs75.7/litre last July. We also got the chance to interact with Pakistan's leading finance experts (from public and private sector) during budget FY10 at Islamabad, however, noted that their food inflationary expectation are higher due to higher

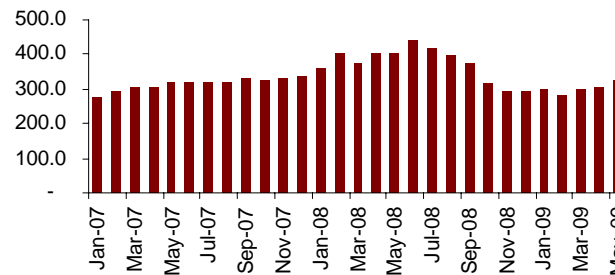
wheat support prices (+50%YoY). Our view is slightly different on two accounts 1) today's flour prices compared to year ago is flat even with the 50% wheat support price increase, 2) risk of smuggling is lower due to lower international wheat prices (see food indices CRB graph), 3) surplus wheat available in local market. We expect MoM inflation in the 0.6-0.8% band over the next 12 months.

**Graph: Domestic petroleum products price trend (Rs)**



Source: OGRA

**Graph: CRB Food indices**



Source: CRB

### The interest rate outlook

JS outlook for interest rate is intact with expectation of another 300bps cut in the remaining part of 2009. Since January the bond market has provided the 46% return on annualized basis, compared to 21% return from stock market. Our outlook on debt market is still bullish, however, we

believe its time to switch to equity market, as its performance has been laggard. Currently, KSE-100 index is trading at 2010F PE of 6.3x vs regional markets PE of 13.7x, while also offering 9.6% dividend yield. As per our sensitivity analysis, every 100bp reduction in risk free rate has 6-7% positive impact on valuation. Currently, JS is using 13% risk free rate. We prefer quality cyclical and leverage companies (Lucky, DG, Engro, ANL, and NML) in the current environment. The impact of every 100bps cut on earnings of the companies mentioned above is as follows.

**Table: Impact of 100bps reduction in interest rate**

(Rs mn)	After-tax interest savings	Per share impact
Lucky Cement	77	0.24
DG Khan Cement	91	0.31
Nishat Mills Limited	80	0.33
Azgard Nine Limited	70	0.21
Engro Chemicals	160	0.54

Source: JS Research

muzzammil.aslam@js.com  
92 (21) 111-574-111 (ext. 3035)

### JS Global Capital Limited

6th Floor, Faysal House, Main Shahrah-e-Faisal, Karachi

**Research:**

Tel: +92 (21) 2799005  
Fax: +92 (21) 2800163  
js.research@js.com

**Fixed Income Sales:**

Tel: +92 (21) 2799541-44  
Fax: +92 (21) 2800165  
tariq.usman@js.com

**Equity Sales:**

Tel: +92 (21) 2799513  
Fax: +92 (21) 2800166  
junaid.iqbal@js.com

**Corporate Finance:**

Tel: +92 (21) 2799005  
Fax: +92 (21) 2800165  
Ilyas.ahmed@js.com

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