September 10, 2018

PAKISTAN ECONOMY

REP-019

MARKET VISTA

Emerging Contagion - More smoke less fire

Haris Imtiaz
Haris.imtiaz@akdsecurities.net
111-253-111 Ext:685

- **Recent crisis in Argentina and Turkey has fuelled speculation of a contagion in Emerging Markets. Economies most vulnerable in this regard are the ones with high current account deficit and greater reliance on foreign lending.**
- **Dollar adjusted return for the KSE-100 is directionally in line with regional markets (-11%CYTD vs. EM at -20%CYTD) where primary reason for increased correlations with regional emerging markets (REMs) appears to be currency deval. (11.04%CYTD).**
- **That said, with PSX's correlation against REMs at 0.57x still below peak reading at 0.78x (crisis of 2008), we believe the correlation number only partially explains the market's dismal performance. In this regard, we believe indigenous factors contributed more towards weaker returns rather than contagion risks.**
- **Currency volatility in EMS could possibly keep PkR under pressure where we maintain our FY19 end estimate at PkR133/US$.**
- **We recommend thematic exposure to sectors (Banks, E&Ps, Power and IT) that benefit from a policy shift.**

MSCI EM Index returns from its peak on Jan 26'18

Source: Bloomberg & AKD Research

Contagion – a mere perception?: Recent bouts of currency volatility in emerging countries and ongoing economic turbulence in Argentina, Turkey & South Africa harken back to the blight of 'Financial Contagion' escalating foreign portfolio risk profile and expectations. Incidents like emerging market mining mania (1820s), the great depression (1920s) Japanese crisis (1980s), Asian Tigers crisis (1997) and mortgage crisis (2008) fulfill the merits of a contagion. Although crisis in Argentina and Turkey seem to be self-inflected and isolated so far,

Economic Indicators of regional economies:

	CAD % of GDP			External Debt % of GDP			CPI Inflation %YoY		
Country	2008	2013	2018	2008	2013	2018	2008	2013	Current*
Pakistan	(8.2)	(1.8)	(5.8)	27.1	27.0	33.6	-	9.2	5.8
China	9.2	1.5	0.5	28.8	31.0	-	1.2	2.5	2.1
India	(5.1)	(2.6)	(1.9)	19.4	23.0	20.4	-	9.5	4.2
Korea	0.7	6.2	4.5	31.5	32.4	28.8	4.1	1.1	1.4
Indonesia	(0.0)	(3.3)	(2.4)	30.4	29.2	35.0	11.1	8.1	3.2
Malaysia	17.1	3.9	3.3	-	65.7	73.9	4.4	3.2	0.9
Philippines	0.1	4.2	(0.6)	37.4	28.9	23.3	7.8	3.8	6.4
Taiwan	6.5	10.1	14.3	91.6	127.5	129.8	1.3	0.3	1.5
Thailand	0.3	(1.0)	9.8	26.1	33.8	33.6	0.4	1.7	1.6
Egypt	(0.8)	(1.2)	-	19.9	15.9	34.3		11.7	13.5
Greece	(14.4)	(0.6)	(1.1)	142.4	239.9	245.2	2.0	(1.7)	0.9
Hungary	(8.4)	2.6	3.5	109.6	122.3	91.8	3.5	0.4	3.4
Qatar	23.1	30.0	-	2.9	12.0	17.7	-	-	0.2
Russia	6.2	1.4	3.0	28.9	31.7	33.0	13.3	6.5	3.1
South Africa	(5.5)	(5.8)	(3.2)	26.1	37.4	46.7	9.6	5.4	5.1
Turkey	(5.1)	(6.7)	(6.3)	36.7	41.3	54.8	10.1	7.4	17.1
UAE	7.1	19.0	4.7	-	-	-	-	1.4	3.8
Brazil	(1.7)	(3.1)	(0.7)	17.1	25.1	33.1	5.9	5.9	4.2
Chile	(3.8)	(4.2)	(1.2)	36.2	49.0	65.1	7.1	2.9	2.6
Mexico	(1.6)	(2.5)	(1.5)	11.2	20.4	29.9	6.5	4.0	4.9
Sri Lanka	(9.5)	(3.4)	(2.6)	-	53.7	57.6	-	-	5.9
Peru	(4.3)	(4.6)	(1.3)	29.0	30.1	35.7	6.7	2.9	1.1
Argentina	1.6	(2.1)	(5.2)	42.6	28.2	39.8	-	-	31.2

External debt as % of GDP is calculated as stock of total external debt divided by most recently reported GDP. Historical CPI inflation is YoY reading reported in the last month of the year.

Source: Bloomberg & AKD Research

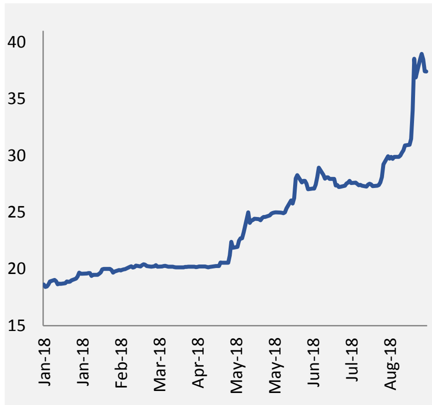
AKD Securities Limited

debt sustainability (common to both) in the backdrop of stronger US$ raise concerns of a possible credit bubble. A similar case during Asian Tigers crisis of 1997 brought Thailand in the limelight, where lack of reserves along with collapse of Baht (losing 50.7% in 2HCY97) in wake of uprising US interest rates, sparked speculative attack on regional currencies. Subsequently it engulfed even the stronger economies like Singapore and Malaysia with eventual economic slowdown across the region. Although it is premature to set merit for a contagion, mere perception of it could keep volatility in emerging market high in the backdrop of rising yields, stronger US$ and escalating trade tensions between US & China.

Argentina is in trouble of its own making: The fourth largest Latin-American country has remained engulfed in a prolonged economic crisis that started in 2015, when gov't removed fix peg against US$ in the backdrop of economic recession (GDP growth -1.8%YoY in 2016 vs. +2.7%YoY in 2015). This eventually led to peso losing ~26.5% in a single day. Despite recovery in 2017, populist policies such as prolonged fiscal expansion (avg. fiscal deficit at 4.4% of GDP during 2015-17) led to widening of external imbalance (CAD at 4.8% of GDP in 2017), pushing inflation higher. Subsequently authorities raised their benchmark interest rate to a historic high of 45.5% (18.20pts hike in CY18TD). However, despite the country's inclusion into IMF financing facility of US$50bn (amongst the biggest in the IMF's lending history) in Jun'18, Peso further spiraled down, depreciating 33.2% since entry into IMF program (cumulative 50.2% in CY18TD. Additionally, composition of borrowing (gross stock of debt stands at US$345.41bn - ~59.3% of GDP) remains vulnerable to a rising US$ (as 73% of debt is in foreign currency) while ~35% is financed through securities (primarily through bond issuance in international market) - not to mention Argentina's history of debt defaults (eight times since independence, including in 2001 & 2014).

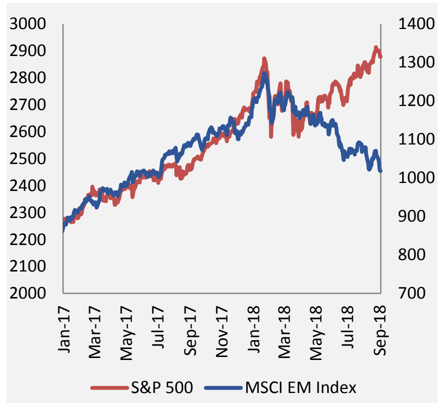
EM market has been choppy in 2018: EM market performance has been dismal so far where MSCI EM Index is down 20.0% from its peak in Jan 26th. Amongst the majors, index heavy weight Chinese equities slipped away 24.1% on account of ongoing financial deleveraging drive, slowing indicators of growth and rising trade tensions with the US. In tandem, US$143.8bn outflow in foreign portfolio investment was witness during 1HCY18 (vs. US portfolio investment inflow of US$138.7bn in the same period) signifying a flight to safety. Additionally, uptick in Indian equities (+6.5%) were offset by weak performers, South Korea (-11.4%), and Brazil (-10.7%), which kept the MSCI EM index returns negative. Additionally, in the FX market the Lira (down 38.6% in CY18TD), Brazilian peso (-18.5%), Russian Ruble (-17.3%) and India Rupee (-11.2%) weakened against the Greenback.

Fallout of Peso against US$



Source: Bloomberg & AKD Research

Widening Differential between US equities and EM



Source: Bloomberg & AKD Research

Emerging market performance over the years

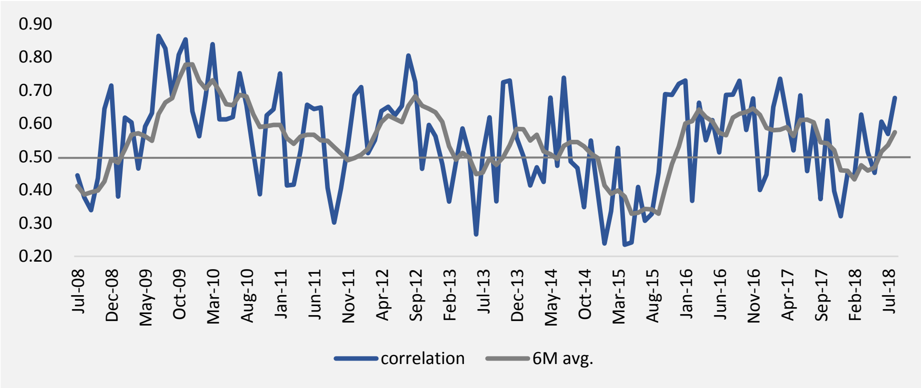
	Pakistan	China	india	indonesia	korea	Malaysia	Philippines	Taiwan	Thailand	Bangladesh	Sri Lanka	Vietnam
$ adjusted Index returns												
CY16	45%	-18%	-1%	18%	0%	-7%	-7%	13%	20%	10%	-14%	14%
CY17	-21%	14%	34%	19%	35%	20%	25%	23%	24%	18%	0%	48%
CYTD18	-11%	-23%	2%	-16%	-12%	-2%	-18%	-1%	-4%	-13%	-9%	-4%
Currency Performance												
CY16	0%	-6%	-3%	2%	-3%	-4%	-5%	2%	1%	0%	-4%	-1%
CY17	-5%	7%	7%	-1%	13%	11%	0%	8%	10%	-4%	-2%	0%
CYTD18	-11%	-5%	-11%	-8%	-5%	-2%	-7%	-3%	-1%	-2%	-5%	-3%

	Singapore	Brazil	Russia	Qatar	Dubai	Kuwait	Oman	Saudi Arabia	Egypt	Nigeria	S&P	MSCI EM
$ adjusted Index returns												
CY16	-3%	56%	47%	0%	12%	3%	6%	-52%	2%	-8%	10%	9%
CY17	27%	28%	-1%	-18%	-3%	11%	-11%	1%	66%	47%	19%	34%
CYTD18	-11%	-19%	-4%	15%	-17%	3%	-13%	6%	-2%	-11%	8%	-12%
Currency Performance												
CY16	-3%	21%	20%	0%	0%	-1%	0%	0%	-57%	-37%	4%	n.a
CY17	9%	-1%	6%	0%	0%	1%	0%	0%	2%	-12%	-10%	n.a
CYTD18	-3%	-18%	-17%	0%	0%	0%	0%	0%	-1%	-1%	3%	n.a

Source: Bloomberg & AKD Research

Correlation between KSE-100 & REM: Among the leading indicators to gauge a potential contagion is spike in correlation in asset class returns across the region. Updating estimates for Pakistan's correlation with regional emerging markets determined through GARCH (1,1) variances of dollar adjusted returns, we find 6M moving average has moved up to 0.57x in Aug'18, marginally higher than 0.46x in Dec'17. However, it still remains lower than 0.78x high during the crisis of 2008 (we highlight sensitivity of the estimation method to selection of sample markets and period). Historically, KSE-100 index has remained largely immune to global factors, where correlation between domestic and international equities remains below 0.5x barring one off events (2008 crisis and Post Taper tantrum). The recent increase in correlation is primarily due to currency depreciation (11.04%CY18TD), where dollar adjusted return for the Index is in-line with regional markets (down ~11% vs. EM: 20.0%). That said, we believe the KSE-100's relative cushion to EM markets remained largely hedged to wider regional dampeners (global trade tensions slowing leading indicators of growth) where Index recent decline remained largely due to domestic developments rather than contagion risks.

Pakistan Index performance correlation with regional markets



Source: Bloomberg & AKD Research

Bond yields to stay elevated: Emergence of concerns over debt sustainability in the backdrop of rising global interest rate profile have propped up yields on Pakistan's Eurodollar issuance to 9.01% (vs. 7.46% in Dec'17 during last issuance). Apart from rising global yields (US 10-year treasury yield up 57bps during the same period), rising risk profiles have pushed the CDS spread to 479.75bps (up from 310.41 in Dec'17) where sharp drawdown of FX reserves by US$6.36bn in FY18 along with a rising external financing gap (estimated at US$22.44 in FY19F) remained major propellants. That said, it remains significantly lower than average of 824.50bps in CY13. Going forward, yields are expected to stay elevated due to ongoing monetary tightening in developed countries. However, CDS spread should see some retraction post inclusion into an IMF financing facility and subsequent build-up of FX reserves (upward risk emanates from crisis in emerging markets).

Currency weakness remains on the cards: Intervention by the central bank has remained a swing factor in currency parity to deter pressures from volatility in regional market's currencies. That said, given weakness on the BoP front (CAD standing at 5.8% of GDP) along with sharp drawdown in FX reserves, authorities have adjusted the parity by cumulative ~15.04% since Dec'17. Despite adjustment, current account deficit has remained elevated (average month CAD at US$1.89bn in past six months) while in the absence of inadequate financial inflows reserves fell to US$9.89bn (implying import cover of ~2.15 months). Going forward, we stick to our estimates of another round of ~6.5% depreciation with the parity ending at PkR133/US$, likely near an IMF bailout program by the end of current year. Additionally, REER still seems overvalued while trading at 108.4x in Jul'18 - above it historic average of 104x where recent depreciation of regional currencies against dollar is likely to pull it downward.

Investment perspective: Heightened external imbalance along with volatility in regional market currencies should keep foreign selling unabated (foreign holdings under SCRAs stand at ~8% of total market cap vs. ~9% in Jun'17). Factors including i) lack of clarity on the policy direction ii) macro headwinds along with structural changes (currency weakness & upward interest rate profile) and iii) potential fiscal austerity by GoP could keep the market under pressure in the near term. While wary on market direction, we recommend thematic exposure to the sectors (i.e. banks, E&Ps, Power and IT) benefitting from policy shift (i.e. monetary tightening and PkR weakness).

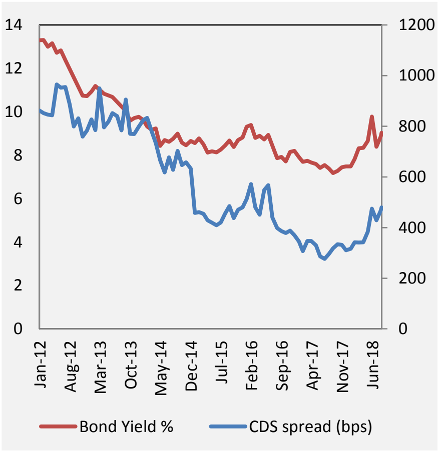
Bond Yields vs. CDS Spreads

	BondYTM(%)	CDSspread(bps)
Pakistan	9.01	480
china	4.46	58
india	n.a	94
indonesia	4.99	142
korea	3.84	40
Malaysia	4.18	102
Philippines	4.16	87
Thailand	n.a	41
SriLanka	7.59	n.a
Vietnam	5.03	167
Singapore	n.a	80
Brazil	6.76	278
Russia	5.71	177
Qatar	4.91	82
Kuwait	3.66	62
Oman	7.29	269
KSA	4.91	80
Egypt	8.69	350
Nigeria	8.52	377
Turkey	8.12	531
Argentina	9.79	709
SouthAfrica	6.87	242

Source: Bloomberg & AKD Research

Bond yields are of on the run GoP international bonds with maturity of at least 10 yrs

Pakistan 5-year CDS spreads & Eurodollar Yields



Source: Bloomberg & AKD Research

Disclosure Section

Neither the information nor any opinion expressed herein constitutes an offer or a solicitation of an offer to transact in any securities or other financial instrument and is for the personal information of the recipient containing general information only. AKD Securities Limited (hereinafter referred as AKDS) is not soliciting any action based upon it. This report is not intended to provide personal investment advice nor does it provide individually tailored investment advice. This report does not take into account the specific investment objectives, financial situation/financial circumstances and the particular needs of any specific person. Investors should seek financial advice regarding the appropriateness of investing in financial instruments and implementing investment strategies discussed or recommended in this report and should understand that statements regarding future prospects may not be realized. AKDS recommends that investors independently evaluate particular investments and strategies and it encourages investors to seek the advice of a financial advisor.

The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives. The securities or strategies discussed in this report may not be suitable for all investors, and certain investors may not be eligible to purchase or participate in some or all of them.

Reports prepared by AKDS research personnel are based on public information. AKDS makes every effort to use reliable, comprehensive information, but we make no representation that it is accurate or complete. Facts and views presented in this report have not been reviewed by and may not reflect information known to professionals in other business areas of AKDS including investment banking personnel. AKDS has established information barriers between certain business groups maintaining complete independence of this research report.

This report has been prepared independently of any issuer of securities mentioned herein and not in connection with any proposed offering of securities or as agent of any issuer of any securities. Neither AKDS, nor any of its affiliates or their research analysts have any authority whatsoever to make any representation or warranty on behalf of the issuer(s). AKDS Research Policy prohibits research personnel from disclosing a recommendation, investment rating, or investment thesis for review by an issuer prior to the publication of a research report containing such rating, recommendation or investment thesis.

We have taken all reasonable care to ensure that the information contained herein is accurate, up to date, and complies with all prevailing Pakistani legislations. However, no liability can be accepted for any errors or omissions, or for any loss resulting from the use of the information provided as any data and research material provided ahead of an investment decision are for information purposes only. We shall not be liable for any errors in the provision of this information, or for any actions taken in reliance thereon. We reserve the right to amend, alter, or withdraw any of the information contained in these pages at any time and without notice. No liability is accepted for such changes.

Stock Ratings

Investors should carefully read the definitions of all ratings used in each research report. In addition, research reports contain information carrying the analyst's view and investors should carefully read the entire research report and not infer its contents from the rating ascribed by the analyst. In any case, ratings or research should not be used or relied upon as investment advice. An investor's decision to buy, sell or hold a stock should depend on individual circumstances and other considerations. AKDS uses a three tier rating system: i) Buy, ii) Neutral and iii) Sell (new rating system effective Sep 10'18) with total returns (capital upside + dividend yield) benchmarked against the floating (variable) risk free rate (10yr PIB) plus risk premium.

New Rating Definitions

Buy	> 16% expected total return (Rf: 10% + Rp: 6%)
Neutral	> 10% to < 16% expected total return
Sell	< 10% expected total return (Rf: 10%)

Old Rating Definitions (Discontinued)

Buy	> 20% upside potential
Accumulate	> 5% to < 20% upside potential
Neutral	< 5% to > -5% potential
Reduce	< -5% to > -20% downside potential
Sell	< -20% downside potential
Not Rated	No investment opinion or recommendation

Valuation Methodology

To arrive at our period end target prices, AKDS uses different valuation techniques including:

- Discounted Cash Flow (DCF, DDM)
- Relative Valuation (P/E, P/B, P/S etc.)
- Equity & Asset return based methodologies (EVA, Residual Income etc.)

Analyst Certification of Independence

The analysts hereby certify that their views about the companies and their securities discussed in this report are accurately expressed and that they have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report.

The research analysts, strategists or research associates principally having received compensation responsible for the preparation of this AKDS research report based upon various factors including quality of research, investor client feedback, stock picking, competitive factors and firm revenues.

Disclosure of Interest Area

AKDS and the authoring analyst do not have any interest in any companies recommended in this research report irrespective of the fact that AKD Securities Limited may have, within the last three years, served as manager or co-manager of a public offering of securities for, or currently may make a primary market in issues of, any or all of the entities mentioned in this report or may be providing, or have provided within the previous 12 months, significant advice or investment services in relation to the investment concerned or a related investment.

Regional Disclosures (Outside Pakistan)

The information provided in this report and the report itself is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use would be contrary to law or regulation or which would subject AKDS or its affiliates to any registration or licensing requirements within such jurisdiction or country.

For the United States

Compliance Notice.

This research report prepared by AKD Securities Limited is distributed in the United States to Major US Institutional Investors (as defined in Rule 15a-6 under the Securities Exchange Act of 1934, as amended) only by Decker & Co, LLC, a broker-dealer registered in the US (registered under Section 15 of Securities Exchange Act of 1934, as amended). All responsibility for the distribution of this report by Decker & Co, LLC in the US shall be borne by Decker & Co, LLC. All resulting transactions by a US person or entity should be effected through a registered broker-dealer in the US. This report is not directed at you if AKD Securities Limited or Decker & Co, LLC is prohibited or restricted by any legislation or regulation in any jurisdiction from making it available to you. You should satisfy yourself before reading it that Decker & Co, LLC and AKD Securities Limited are permitted to provide research material concerning investment to you under relevant applicable legislations and regulations.