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Update on Pakistan's Economy

July 18th, 2008

Subject: Stock Exchange Review during June 2007 to July 2008

Introduction:

Capital markets are key elements of a modern, market-based economic system as they serve as the channel for flow of long term financial resources from the savers of capital to the borrowers of capital. Efficient capital markets are hence essential for economic growth and prosperity. With growing globalization of economies, the international capital markets are also becoming increasingly integrated. While such integration is positive for global economic growth, the downside risk is the contagion effect of financial crisis, especially if its origin lies in the bigger markets.

Fiscal year 2007-08 has been an exigent year when perceived in the context of critical developments on global and domestic forefronts that continue to pour in throughout the year. Equity markets all over the world are having a rough time and Pakistan is no exception. The US subprime debacle and the resulting ease in the monetary policy continuously pursued by FED in order to combat with the prevailing liquidity crunch has had its dire repercussions on emerging markets in the form of international capital flight aiming to abridge the persistent liquidity gap. Relief in the form of fiscal stimulus package to save the banking sector from collapse due to huge write-offs is in the process and many big names have been amalgamated into bigger ones, the prime example being JP Morgan deal to buy Bear Stearns shares at throughaway price on March 17, 2008.

A multifaceted crisis of such a huge magnitude, affecting housing, credit and equity markets at the same time, has never been experienced before in the US at least, eventually resulting in lower performance of global stock markets when compared to their growth trajectories in the recent past. Part of the game was played by sky-rocketing global oil & commodity prices and intensifying inflationary pressures in most countries of the world.

Review of Global Stock Markets:

During the fiscal year 2007-08, the leading stock markets of the world observed negative growth ranging from a meager positive 0.8 percent (Hong Kong) to a negative 31.9 percent (Philippines). The global liquidity crunch coupled with rising commodity prices can be seen as the prime reasons for this bearish performance. The Karachi stock market showed lackluster performance as its index decreased by 25.7 percent in terms of local currency owing to deterioration in domestic macroeconomic conditions and political upheaval and slumped to 36.5 percent in terms of USD compared to 23.5 percent rise in the same period last year. Chief stock indices including US S&P 500, UK FTSE 100 and Japanese Nikkei 224 also recorded declines of 16.1 percent, 18.9 percent and 18.4 percent respectively during FY08. *Table 6.1* provides a quick snapshot of the returns in terms of both domestic currency and USD for these markets.

Sr. #	Country	Stock Name	Index (Local Currency)		Currency			Market Return	
			30 Jun'07	18 Jul'08	Exchange Rate	30 Jun'07	18 Jul'08	Local Currency	USD
1	Pakistan	KSE 100	13,772.46	10,234.78	PKR/USD	60.46	70.70	-25.7%	-36.5%
2	India	Sensex 30	14,650.51	13,635.40	INR/USD	40.59	42.67	-6.9%	-11.5%
3	Indonesia	Jakarta Composite	2,139.28	2,141.14	IDR/USD	9,011.90	9,139.10	0.1%	-1.3%
4	Taiwan	Taiwan Weighted	8,883.21	6,815.32	TWD/USD	32.74	30.35	-23.3%	-17.2%
5	South Korea	Seoul Composite	1,743.60	1,509.99	KRW/USD	923.89	1,013.40	-13.4%	-21.0%
6	Hong Kong	Hang Seng	21,772.73	21,874.19	HKD/USD	7.82	7.80	0.5%	0.8%
7	Malaysia	KLSE Composite	1,354.38	1,105.04	MYR/USD	3.45	3.25	-18.4%	-13.2%
8	Japan	Nikkei 224	18,138.36	12,803.70	JPY/USD	123.39	106.75	-29.4%	-18.4%
9	Singapore	STRAIT TIMES	3,548.20	2,847.73	SGD/USD	1.53	1.35	-19.7%	-9.1%
10	Sri Lanka	All Shares	2,572.20	2,412.38	LKR/USD	111.35	107.55	-6.2%	-2.9%
11	China	Shanghai Composite	3,820.70	2,778.37	CNY/USD	7.61	6.82	-27.3%	-18.8%
12	Philippines	PSE Composite	3,665.23	2,389.52	PHP/USD	46.24	44.25	-34.8%	-31.9%
13	Australia	All Ordinaries	6,310.60	4,915.30	AUD/USD	1.18	1.03	-22.1%	-10.8%
14	US	S & P 500	1,502.97	1,260.68	PKR/USD	1.00	1.00	-16.1%	-16.1%
15	UK	FTSE 100	6,607.90	5,376.40	GBP/USD	0.50	0.50	-18.6%	-18.9%
16	New Zealand	NZSE 50	4,234.29	3,120.91	NZD/USD	1.29	1.31	-26.3%	-27.3%

Table 6.1: Global Stock Indices during June 30, 2007 to July 18, 2008

Source: Invisor Securities

Review of Karachi Stock Exchange:

Like equity market performance in emerging markets, the dismal performance of the premier stock market of Pakistan can partially be attributed to the unfavorable global developments discussed above in addition to a variety of internal tribulations. Fiscal year 2007-08 proved to be a tough year for the domestic stock exchange. Many factors played key role in eroding the investors' confidence. These factors include: (i) political instability, (ii) adverse law and order situation, (iii) deteriorating security environment in tribal areas, (iv) downgrading of Pakistan's rating by S&P and Moody's, (v) suspension of Pakistan from the Commonwealth, and (vi) continued tightening of monetary policy to stabilize inflation and curb aggregate demand.

Until recently, the Pakistan's benchmarked stock market-the Karachi Stock Exchange- was screening a boom and the KSE-100 index has increased from 1,521 points on June 30, 2000 to 13,772.5 points on June 30, 2007 – a rise of over 12,251.5 points or an increase of 805.5 percent. In the same spell, Aggregate Market Capitalization (AMC) has increased from Rs 392 billion ($ 7.6 billion) on June 30, 2000 to Rs 4,019 billion ($ 66.4 billion) on June 30, 2007, showing a rise of over Rs 3,627 billion ($ 58.8

billion) or an increase of 925.3 percent. This resilience in the local bourses is accredited to the continuity of the macroeconomic policies of the government and capital market reforms implemented by the apex regulator, the Securities and Exchange Commission of Pakistan (SECP).

It was, however, during the year 2007-08 that the stock market has shown a negative growth trail after an era of unabated success by finishing the fiscal year ended June 2008 down 10.8 percent and has lost almost 25.7 percent (as against June 30, 2007 position) to close at 10,234.8 points on July 18, 2008. Subsequently, the AMC was down by 6% in terms of Rupee and 16.9% in terms of USD in the wake of escalating rupee/dollar parity. The same figures stood at Rs 3,196.3 billion and $ 45 billion as of July 18, 2008, declining by 20.5 percent and 32.2 percent respectively since June 30, 2007.

Table 6.2: Leading Stock Market Indicators on KSE ***(KSE-100 Index: November 1991=1000)***

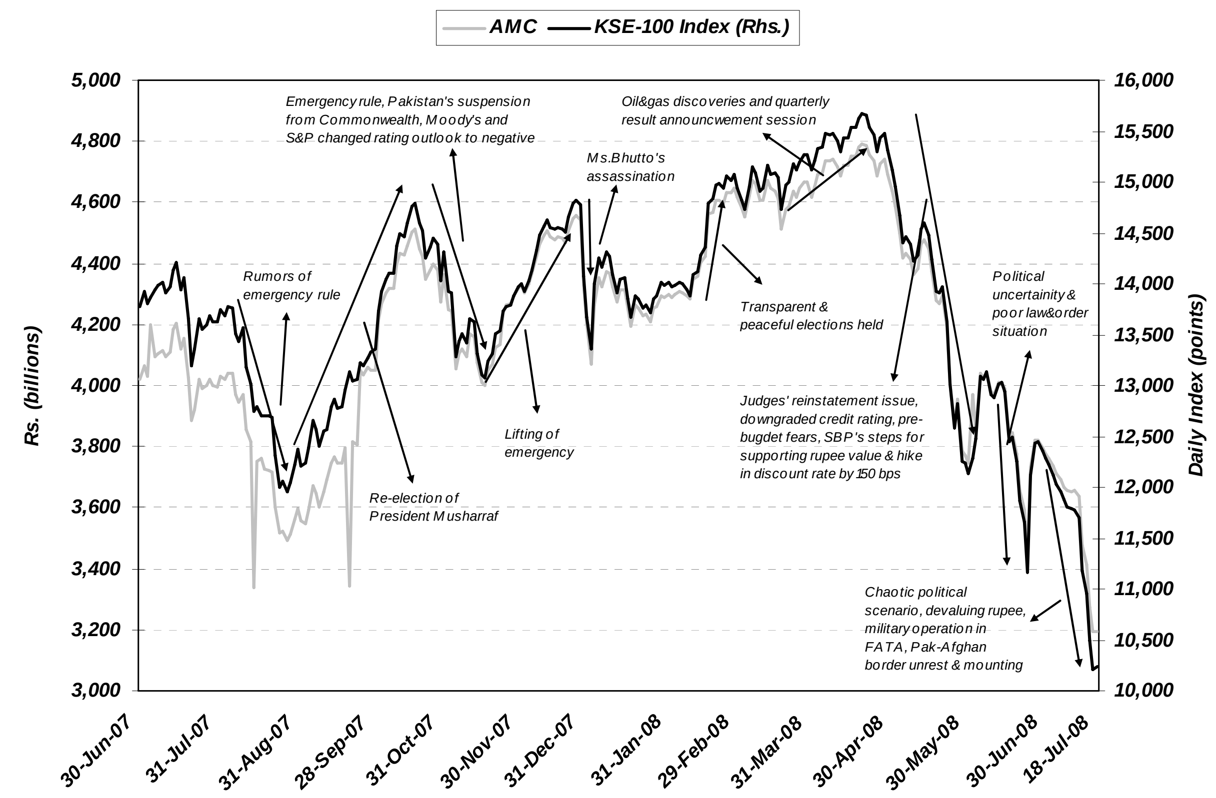
Months	2006-07			2007-08		
	KSE Index (end month)	Market Capitalization (Rs billion) (end month)	Turnover of Shares (billion)	KSE Index (end month)	Market Capitalization (Rs billion) (end month)	Turnover of Shares (billion)
July	10,497.6	2,905.1	4.4	13,738.9	4,028.1	7.7
August	10,064.1	2,786.9	4.0	12,214.3	3,555.2	4.5
September	10,512.5	2,874.7	3.0	13,351.8	4,050.0	4.2
October	11,327.7	3,074.3	3.2	14,319.4	4,364.3	6.6
November	10,618.8	2,919.7	3.8	13,998.5	4,328.9	5.2
December	10,040.5	2,738.4	2.6	14,075.8	4,329.9	4.7
January	11,272.3	3,043.3	3.3	14,017.0	4,297.5	5.6
February	11,180.0	3,052.0	5.6	14,934.3	4,618.9	5.1
March	11,271.6	3,065.8	3.6	15,125.3	4,622.9	5.0
April	12,369.7	3,603.0	6.0	15,122.5	4,634.8	6.4
May	12,961.3	3,781.2	6.5	12,130.5	3,746.2	4.9
June	13,772.5	4,019.4	8.1	12,289.0	3,777.7	
July 18'08				10,234.8	3,196.3	

Source: KSE

Contrary to the negative behavior, buoyancy in the market was caused by a dearth of reasons including the announcement of healthy corporate results, issuance of positive report by foreign brokerage houses on Pakistan capital markets, oil and gas discoveries and re-admission of Pakistan by the Commonwealth as its member. Moreover, SBP intervention to make rupee stable in the inter-bank and of open markets also conferred hope of alleviating local economy. Finally, the clouds of lingering fears were dispersed and the index re-energized on the back of announcement of two-year further recommencement in Capital Gain Tax exemption. Federal budget created an overall 'neutral-to-positive' impact (especially for fertilizer, oil and auto sectors) on the stock market.

The sheer plunge in the market during June forced SECP to adjust the upper and lower circuit breakers of trading band, to 10% and 1%, respectively, from previous 5% on both sides and rule out short sale in the futures market. This amendment gave the market a brief breather and the index made a sudden resurgence of 960 points on June 24. These market stabilization measures left little option for selling and transformed the stock market into a buying market. However, this regulation was unable to improve the market sentiments as it reduced the width of exit way to 1/5 of what it was earlier. As a result, investors did not find the band wide enough to quit the market amid non-availability of buyers.

Figure 1 **KSE Snapshot**
Jun 30'07-Jul 18'08



Recent Developments:

The month of ***July***-the first month of the current fiscal year 2008-09-took off with a bearish behavior of the stock exchange on account of foreign divestment and reduced banking sector margins. Furthermore, concern over possible discount rate hike and falling international capital markets lend the investors' approach to cautious despite the announcement of June based result session soon. At the center of the investors' angst was the perception that the new government is still directionless on political and economic fronts. Statement by the US officials regarding their intentions on striking in Pakistan without prior intimation to the government has further heightened the sense of insecurity in the local ground. Constant depreciation of local currency viz. US dollar added to the nervousness at the local bourses. Military operations in FATA, bomb blast in Islamabad and series of bomb explosions in Karachi were some gloomy events that emerged one after another, dampening investors' outlook. The SBP made a move to arrest the declining value of rupee and it was successful as the rupee recovered almost 3%. Adding to the drastic weakness of the market was the awaited outcome of the SECP meeting with the Stock Exchange Board to influx liquidity into the stock market. The formation of Rs 50 billion Equity Market Opportunity Fund (EMOF) in pipeline to be injected in the market on melancholy days, news of economic assistance offered by Saudi Arabia in the shape of oil supply with deferred payment arrangement, rise in cement prices and government's stance on privatization were the plus points attracting investors towards the ring. Finally, circuit breakers were reverted to the previous levels but the market continued to melt in the wake of deteriorating law and order situation at Pak-Afghan border. The fall was massive this time due to the extended capacity and the index shed 518.5 points on the very first day of the regulatory change. The stock market fell below the psychological barrier of 11,000 points due to profit taking. After making an 18-month low of 10,213 points on July 17, special market session was held the same evening in order to provide exit to leveraged buyers. Hence, the next day on July 18, the market managed to break the prolonged string of bear rule by registering a modest gain of 22 points on the back of emergency measures taken by the KSE management and large investors, ultimately raising investor’s confidence.

Future Outlook:

Investors are eyeing on the level of support that can be provided to the market by the Equity Market Opportunity Fund. With the expectations of further increase by another 50 to 100 basis points in the half year Monetary Policy (MP) to be announced by the central bank shortly, the issue of liquidity crisis would become more compound. Fundamentals have turned weaker and sentiments too, but an influx of positive news such as announcement of June corporate results in line with market expectations could save the market from the worst.

Review of Lahore & Islamabad Stock Exchanges:

The LSE-25 index closed at 3,123.1 points, a decrease of 1126 points or 26.5 percent in comparison to end June’07 index position of 4,249.3 points. The ISE-10 index closed at 2,330.3 points, a decline of 238.5 points or about 9.3 percent in comparison to June 30, 2007 index position of 2,568.8 points. However, both the indices were highly volatile during the period under review and followed the trend setting KSE-100 index *(See Figure 2).*

Figure 2 **Lahore & Islamabad Stock Exchanges Snapshots**
Jun 30'07-Jul 18'08