7 April 2022

Monetary Policy

SBP acts as the adult

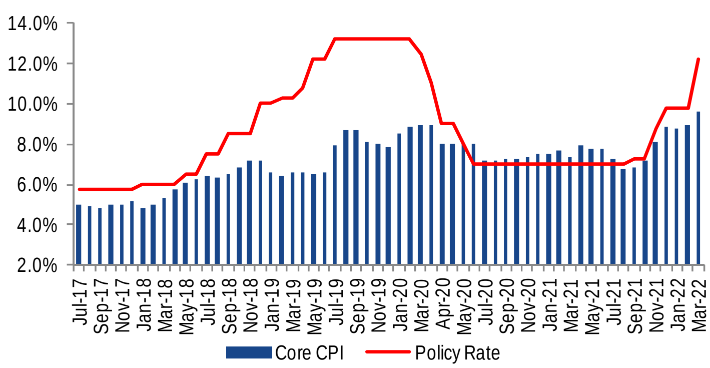
The SBP has increased the Policy Rate by 250bps to 12.25% in an emergency meeting held today, the first interest rate increase this calendar year. Given a deteriorating outlook for inflation and rapidly slipping PKR, in the backdrop of heightened domestic political uncertainty, the SBP had to act swiftly and decisively to shore up confidence. Today's move should help achieve this objective, but politics still retains paramount importance for macroeconomic stability, in our view. The central bank has also increased export refinancing rates by 2.5ppt to 5.5%, and increased cash margins on a wider set of imported items (mostly finished goods; raw materials not included).

The reasons for the interest rate increase are:

- Outlook for higher inflation, on the rise in core inflation (has entered double-digits on rural side) and sticky international commodity prices, especially oil
- Risks to external stability, captured by the recent 5% slip in the PKR and lower Fx reserves, even as the FY22 external funding needs are fully met
- Expectations for a quicker increase in US interest rates, and therefore globally

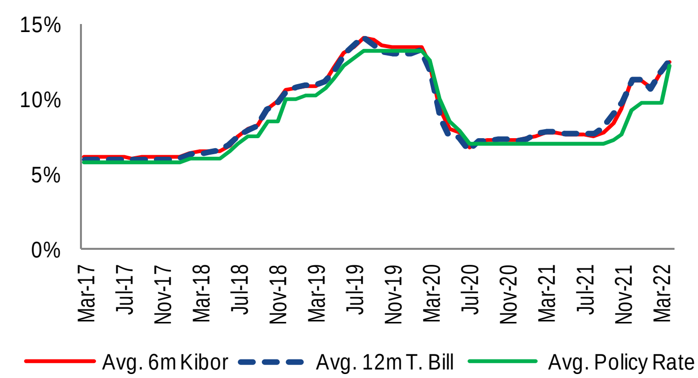
The SBP expects CPI to average 11% in FY22 before moderating in FY23. While we see upside risks to the inflation outturns, particularly if the PM's Relief Package is reversed, today's interest rate increase reinstates mildly positive interest rates from a forward-looking perspective. It also narrows the gap with secondary market yields where the cutoff on the 12m paper came in at 13.30% in yesterday's auction.

SBP raises Policy Rate by 250bps



Source: PBS, SBP, IMS Research

The gap versus secondary market yields has closed



Source: SBP, IMS Research

Impact on Equities

The 250bps rate hike comes in higher than consensus expectations, with the central bank feeling the need to act decisively. That said, with secondary market yields already having risen by c. 230bps since the start of March, the higher interest rate environment may already be greatly priced in by the equity market, especially as the central bank seemed to indicate that it is done with monetary tightening for now. Cuts to analyst estimates will likely come through (see table below), but valuations remain attractive – the discount to 10yr average Market Capitalization to GDP is already a wide c.30%.

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Sector-wise impact of the emergency monetary policy

Sector	Stance	Comments
Oil & Gas Exploration	Positive	▪ OGDC/PPL/POL are all sitting on cash. Hence, increase in policy rates will elevate other income and eventually net profits, in our view.
Banks	Positive	▪ Higher margins that should not be offset by any asset quality deterioration, with nearly 100% coverage providing comfort.
Cements	Negative	▪ The hike in interest rate is negative for IMS cement Universe except for LUCK which is relatively less leveraged. DGKC, PIOC and CHCC are more exposed to increase in interest rates.
Fertilizers	Neutral to Positive	▪ For the Fertilizer sector the increase in interest rates is neutral to positive for the sector, as most of the producers have net excess cash or have less interest-bearing debt.
Textiles	Negative	▪ The recent hike in the policy rate is estimated to have a negative impact However, the sector faces a double-whammy due to the rise in export refinance rates (c.5% isolated impact) ▪ From a demand perspective, sales are unlikely to be impacted materially due to the large share of exports. However, retail sales may decline, in our view, while the sector may need to borrow more for working capital needs.
Technology & Communication	Positive	▪ Higher interest rates is positive of Tech sector as majority of the companies have higher cash and short term investments than interest bearing debt.
Oil & Gas Marketing	Negative	▪ Finance costs for PSO and SHEL will rise post interest rate hike and hence negative for both companies. However, this will be positive for APL as it has higher cash and short term investments. ▪ At higher interest rates, we expect automobile sales to slowdown; which will slow the growth in petroleum consumption (that is already under pressure from record high retail prices)
Autos	Negative	▪ Due to the sector being nearly debt-free, earnings are likely to rise due to significant other income. However, auto-financing is likely to decline significantly, as seen in the past due to double-digit interest rates. Hence volumes and earnings are likely to dip, in our view.
Chemicals	Neutral	▪ Largely be will neutral for the sector, where other income will rise for LOTCHEM amid higher interest rates, while EPCL will have to bear higher finance costs, in our view.
Power	Negative	▪ As HUBCO is significantly leveraged, an increase in interest rates will erode company's future profits. Also if SBP sustains current momentum, this could erode liquidity and give rise to a new circular debt, in our view.
Steel	Negative	▪ Almost all of the steel companies are highly leveraged. Therefore, rise in interest rates will significantly erode the earnings of the sector. Also demand will shrink, as the increase in interest rates will restrict fresh borrowing for construction activities, in our view.
Tractors	Neutral	▪ Due to low debt levels, Tractor industry earnings are likely to increase slightly However, from a demand point of view, the agriculture sector receives special lending rates from the SBP, which for now have not changed. Hence the rise in interest rates is likely to be Neutral for the sector, in our view.

Source: IMS Research

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Ratings Guide*	Criteria
Buy	Total return expectation of ≥ 15% or expected to outperform the KSE-100 index
Neutral	Total return expectation of > -5% or expected to match the return of KSE-100 index
Sell	Expected downside of more than 5% or expected to underperform the KSE-100 index

*Based on 12 month horizon unless stated otherwise in the report.

Valuation Methodology: We use multiple valuation methodologies in arriving at a Target Price including, but not limited to, Discounted Cash Flow (DCF), Dividend Discount Model (DDM) and relative multiples based valuations.

Risks: (i) lingering political uncertainty feeding into poor economic policymaking, (ii) further increase in international commodity prices, (iii) sharper than expected tightening of global monetary settings

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