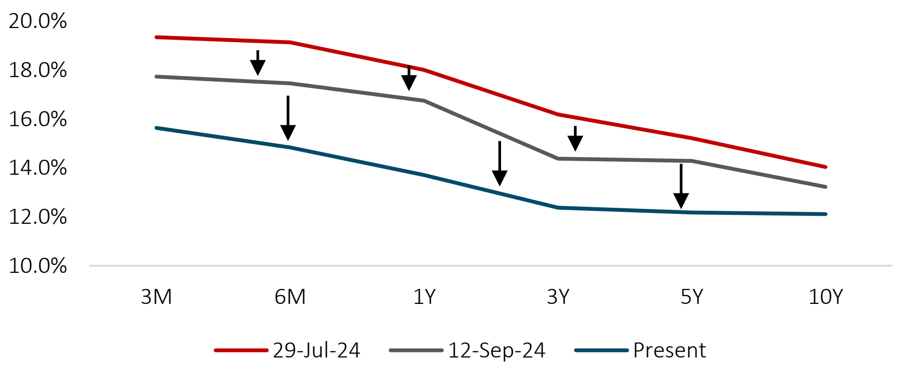
Pakistan Economy

Yields fall as fiscal and external pressures ease

Monday, September 30, 2024

Over the past few weeks, Pakistan's domestic bond yields have corrected sharply. Since July 2024's monetary policy, short-term yields have declined by over 400bps, and long-term yields have eased off by nearly 300bps. Pakistan's international bond yields are also declining as yields for some maturities have fallen below the 10% mark.

Pakistan Secondary Market Yields



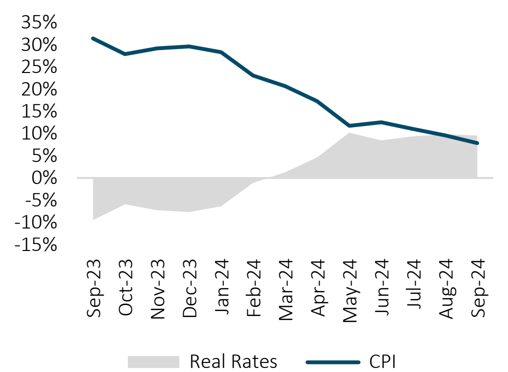
Source: PBS, BMA Research

Easing inflation influencing yields: As we highlighted in our earlier report titled *"The SBP cuts policy rate by an additional 200bps"*, a high inflation base, a stable Pak Rupee, and falling commodity prices will bring monthly CPI readings to **around 7% between Nov24 and Apr25**. Notably, monthly inflation **has averaged 0.2%** over the past six months. Despite a cumulative 450bps cut in the policy rate, the RIR hovers **above the 10% mark**. Record-high real interest rates (RIR) have reinforced **expectations of an expedited easing cycle**.

Easing fiscal pressure also impacting yields: Recent developments have alleviated Pakistan's budgetary imbalances. This trend was apparent in the previous MTB auction in which the SBP rejected all bids. Improving fiscal position stems from the anticipated inflows of SBP profits, **likely crossing the budgeted PkR 2.5tn** mark, given the **central bank's PkR 3.4tn (+2x YoY) profit in FY24**. Moreover, the government's plan to eliminate 150k posts and six ministries further lends credence to improving fiscal discipline.

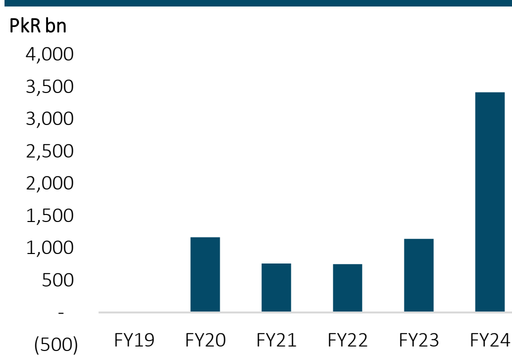
Improving liquidity provided the government an opportunity to reprofile its debt via a PkR 500bn bond buyback program. While we remain uncertain of the participation size, given the significant reinvestment risks faced by banks, signs of **improving liquidity had an immediate impact on domestic yields**.

Pakistan Real Interest Rates



Source: PBS, BMA Research

SBP Profits Trend



Source: SBP, BMA Research

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Lending rates to fall even further: Since the last monetary policy, Pakistan's lending rates are **down 225bps to 15.43% (6M KIBOR**). We anticipate lending rates to further decline as indicated by the falling secondary market yields. Historically, the gap between lending rates and secondary yields **has averaged 15bps.** Presently, the lending rates' gap with **6M PKRV stands at 60bps,** and the gap with **12M PKRV stands at 172bps.** The anticipated convergence between the two rates during the fiscal year will likely benefit leveraged balance sheets (cements, steel, and textiles).

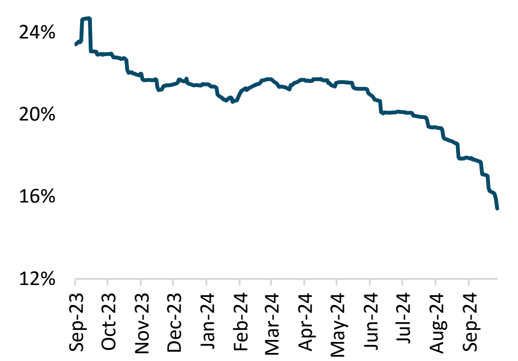
Falling long-term yields to support equities valuation: Long-term yields have also corrected considerably over the past few weeks. Since August 2024, the 10Y PKRV rate has declined by 200bps to around 12%. Falling yields of longer tenor securities generally benefit equities valuation, creating an **impetus for an equity market rerating**. Notably, the gap between earnings yield and the long-term bond yields has **widened by over 200bps to 13.7pps** during September 2024. During FY13-18's economic bull cycle, **this gap averaged 1.5pps**.

High-yield stocks to garner investors' attention: Since SBP's monetary easing cycle, investors have continued building positions in high-yielding stocks. Historically, **these stocks have repriced faster once yields fell** as investors felt compelled to lock in dividend yields. Moreover, FY25's budgetary measures also limited investment avenues by imposing high taxes on real estate. We may potentially see further **re-rating of high-yielding stocks as long-term yields fall further.**

International bond yields also converge to historical levels: The prices of Pakistan's International Bonds have surged considerably over the past 15 months. From pricing in a default back in June 2023, many of these bonds are hovering close to their par value. Notably, the yields of certain securities have **fallen below the 10% mark.** Price resurgence stemmed from an improving external position, aided by the country's entry into the IMF program. Given plans for a controlled trade balance, falling global commodity prices, and support from bilateral allies, we foresee limited risks to Pakistan's reserve position.

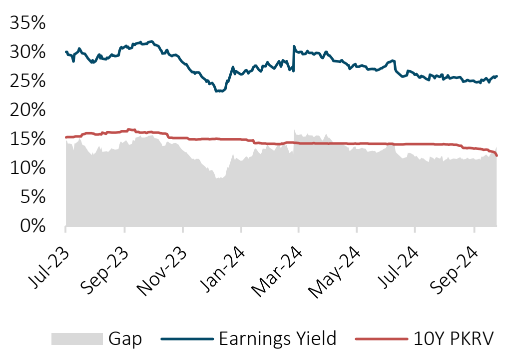
As rating agencies incorporate the country's improving external position, **Pakistan can potentially re-enter the global securities market** to raise financing at competitive rates.

6M KIBOR Rates



Source: SBP, BMA Research

Earnings Yield vs 10YR PKRV



Source: MUFAP, BMA Research

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Old rating system

Valuation Methodology

To arrive at our period end target prices, BMA Capital uses different valuation methodologies including

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