May 2009

Economics & Strategy

Bottoms Up

FY09 presented myriad challenges on all fronts; political, macro-economic, liquidity and regulatory. In response policymakers undertook substantial measures to stabilize the economy and appear to have lifted the capital markets, economy and political framework out of their misery. We expect a definitive but gradual turnaround in FY10, providing a good lead indicator for the direction of capital markets. In the current Bearish environment non-cyclical defensive plays are likely to satisfy investors, however hardy investors should maximize gains from cyclical sectors such as Cements, Autos and Banks in the longer term.

Capitalizing on improving vulnerability ratios

Key support lines are the twin deficits; the Current Account Deficit is expected to contract to USD 11bn in FY09 on account of strong remittances and a shrinking Trade Deficit estimated at USD 16bn. Headline CPI is also expected to stabilize in the region of 10% YoY by Jun09 providing a 12mo Average Inflation Rate of 21%. Nevertheless structural constraints from shrinking Export receipts, FDI and flattening Remittances, laggard GDP growth and debt dependence do remain and need to be effectively managed for sustained development of the economy.

Earnings dip to the bottom of the Bust

Early indications for Mar09 results season suggests recessionary pressure has receded substantially; net earnings on a standalone basis are improving by a sturdy 4% on a QoQ basis with the drag from Power and Transport sectors being evident Dec08 onwards. Given the current momentum we expect the index to continue to trade at a P/E multiple in the range of 10x-11x earnings which would stabilize the KSE 100 in the range of 6,600-8,000points. The KSE 100 index has already pulled its socks up by over 64% since it bottomed out to the 4,800points range before retreating again. This is in line with the recovery in global markets such as Shanghai Comp, BSE 30 and Hang Seng averaging 33% gains during CY09. Another positive trigger would be the inclusion of Pakistan in the MSCI Emerging Market Index up for review in Oct09. The KSE already qualifies for the Frontier Index which is expected to be formalized on May 13'09.

Band-aid gets bigger

Anticipating a large Balance of Payments gap in FY09 and FY10, the government of Pakistan is already in talks with the IMF to increase the stipulated amount of the SBA to USD 12.1bn from the current USD 7.9bn over the 23mo period ending Nov10. Given the current pressure on the global community to stabilize the political and macro-economic situation in Pakistan, a key player in the War on Terror, we feel the necessary external financing is likely to come through. Especially in view of the better than expected performance of monetary and fiscal policy makers, to stabilize vulnerability ratios.

We're still a bit Hawkish

Despite the apparent reversal in macro-economic trends, focus remains on the resource mobilization strength of the monetary system. Deposit and Time Liabilities (DTLs) reflect a PKR 52bn drawdown from stock of PKR 3,703bn in FY08 as of Apr 25'09, despite a successful rebound from an outflow of PKR 250bn earlier. Meanwhile Net Foreign Assets still reflect a net outflow of more than PKR 230bn in FY09 although this is also a significant improvement from levels in Oct08. The potential for another liquidity crunch cannot be ruled out and policymakers will have to make sure that any disincentives to desirable liquidity levels are weeded out effectively.

Confidence deficit could cause policy decouple

In view of the loosening grip on the confrontation with the Pakistani Taliban and recent internal rift between the PPP and PML-N, the political variable is the wildcard in our investment strategy. Key measures of foreign investor confidence in Pakistan are the Eurobond and CDS spreads which have rebounded substantially in May09 signaling easing pressure on Pakistan. The PKSTAN'16 has retracted by over 600bps from a low point of over 1900bps against the relevant UST, while the CDS spreads have rebounded by over 3000bps to the 1900bps level in May09. On the domestic front aggressive resource mobilization in the monetary system, a recently stable PKR and sustained Remittances have all contributed to strengthening confidence in the economy since Jan09. However if political variables were to broaden the confidence deficit, economic outcomes are likely to decouple from policymaking.

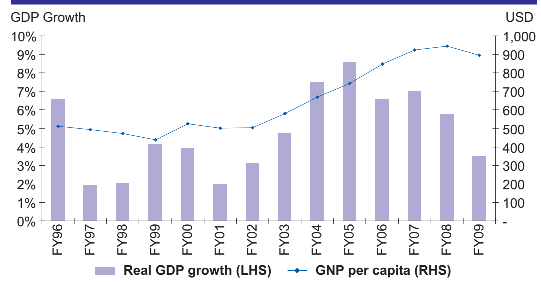
Zainab Jabbar

zainab.jabbar@igi.com.pk

111-234-234 Ext. 810

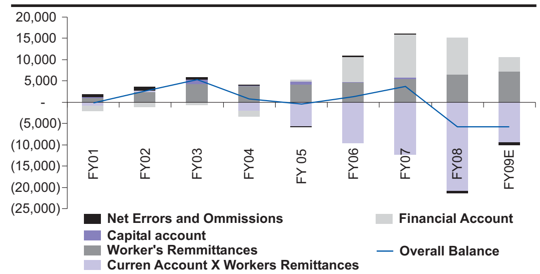
Data as of May 08, 2009

Chart 1: Growth and Income per capita



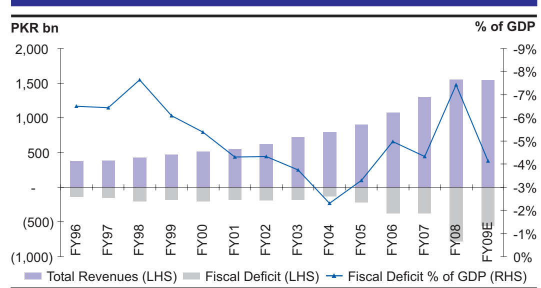
Source: SBP

Chart 2: Balance of Payments (USD mn)



Source: SBP

Chart 3: Fiscal Management



Source: Economic Survey

Chart 4: KSE 100

Source: KSE

Table of Contents

IGI Securities

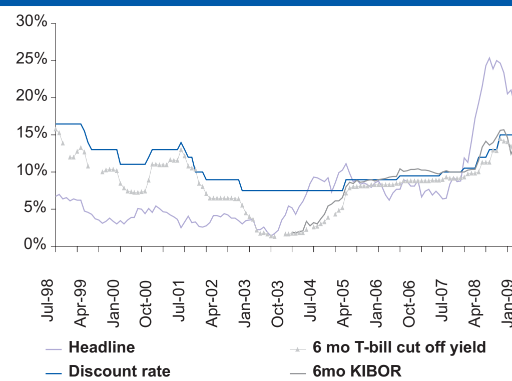
Silver lining

We expect FY09 to be a year of reckoning for Pakistan; a lot of problem resolution is underway and we think policy makers, particularly on the monetary front, are managing macroeconomic vulnerabilities effectively. Consequently we expect the growth cycle to trough out close to 2% in FY09 with improved prospects for key macro-variables likely to emerge in FY10. Given the economy provides a good lead indicator of capital market performance we suggest investors maintain a cautious but optimistic market outlook. Key risks to our outlook are a broader than expected U-turn in the economy on account of deterioration in liquidity or political drivers.

Inflation U-turn expected post Jun09

The SBP rate cut of 100bps to 14% in Apr09 reflects a positive outlook on Headline CPI inflation which should roll back to 10% YoY by Jun09 and an average 14% for 4Q FY09. Supply constraints should keep prices pressures on Fuel & Lighting and House Rents Indices up in the last quarter however Food and Transport & Communication Indices are showing brighter prospects for FY10. Although Core Inflation remains sticky in the 18% range, we expect it to wind down by 1Q FY10 on account of an adjustment lag with Headline CPI numbers. Real rates are also expected to rebound to positive territory from the current -6% post Jul09.

Chart 5: Inflation and Interest Rates



Source: SBP

Fiscal deficit narrows in line with IMF Agreement

The full year deficit is likely to hover around the PKR 562bn in line with IMF targets and 1H FY09 annualized estimates. During 1H FY09 fiscal policy makers have narrowed the Budget Deficit to under PKR 250bn. Key drivers of the decline are a 41% decrease in Development Spending & Net Lending, a 47% increase in Non-Tax Revenues and 28% increase in Tax Revenues. This translates into an annualized rate of 4.3% against a restricted GDP growth of 2.5% to PKR 12.8tn.

Table01: Fiscal Operations **(PKR mn)**

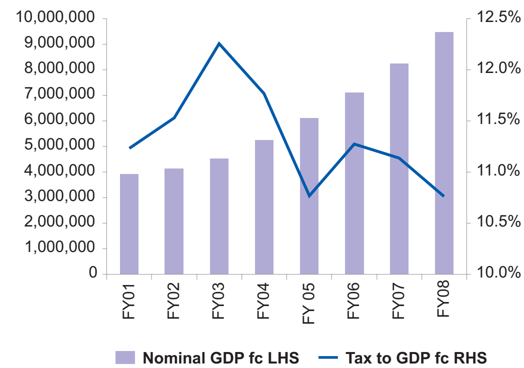
	1H FY08	1H FY09	%Change
Total Revenue	625,592	834,478	33%
Tax Revenue	450,709	577,993	28%
Non-Tax Revenue	174,883	256,485	47%
Total Expenditure (Booked)	1,000,823	1,049,729	5%
Current	775,055	916,750	18%
Development Expenditure & net lending	225,768	132,979	-41%
Unidentified Expenditure	(18,910)	35,317	NA
Fiscal Balance	356,321	250,568	-30%

Source: Ministry of Finance

Narrow Tax base presents a longer term constraint

Revenues from Taxation surprised on the upside with a 20% increase over 8mo FY08 to PKR 704bn however have a slim chance of meeting the Taxation target of PKR 1.36tn for FY09. According to 1H FY09 Fiscal Operations data it appears a shortfall may occur in the range of PKR 1.16tn which would translate into a 15% increase over FY08 levels of PKR 1.01tn. Sales Taxes are expected to serve as a key driver of revenue growth reflecting 28% growth to PKR 222.3bn in the 1H of the fiscal period. Direct Taxes also indicate a similar trajectory rising by 30% to PKR 211bn during the 1H FY09. We expect Non-Tax Revenues from SBP profits, PDLs and Defense proceeds to boost the fiscal coffers closer to the Consolidated Federal Gross Revenue Receipts target of PKR 1,679.2bn

Chart 6: Tax to GDP Ratio **(PKR mn)**



Source: Economic Survey

Current Expenditures growth slows to 18% from 34% last year

Growth in Current Expenditures has been largely restricted on account of an unfortunate decline in spending on Education, Social Protection, Health, Recreation, Religious & Cultural activities of between 14-59%. Defense spending meanwhile rose by 12% to PKR 148bn and is likely to remain up on account of security constraints. Servicing of both Domestic and Foreign Debt stood relatively stable at PKR 26.6bn and PKR 33.9 respectively for the 1H FY09. Moving forward however debt servicing is likely to rise due to the volumetric increase in the debt burden by 13%. EDLs rose above USD 50bn up 10% from Jun08, while Domestic debt is up 11% to PKR 3,749.3bn as of 8mo FY09 translating into an overall total public debt in the region of PKR 7,762.3bn. We could see Total Public Debt breaching the 60% of GDP cap in FY09, as stipulated in the Fiscal Responsibility Act 2005.

Regulators mitigate Valuation Risk feedback via relaxation of Interest Rates, IAS39 and FSV

In line with our expectations (IGI Securities, **Monetary Policy Review** *Anchoring Inflation* Feb09) the Regulator has played a greater role in ensuring a soft landing for both Corporates and Banks in CY09. Apr09 saw a 100bps Discount Rate Cut which aims to capitalize on improving macro-variables and prevent further valuation risk feedback to overall growth. Although we are more hawkish on the policy rate, we do agree that this policy decision will ease the leverage burden, reduce input costs and stabilize balance sheets.

Asset price deterioration strengthened the financial disruption of 2Q FY09 necessitating the intervention of the SECP and SBP. In Jan08 the SBP reversed its earlier decision to withdraw FSV against NPLs, allowing Banks and DFIs to apply 30% FSV value to NPLs. Following this SECP and SBP in conjunction granted 'relaxation' in accounting treatment for securities held by companies under the Available for Sale category.

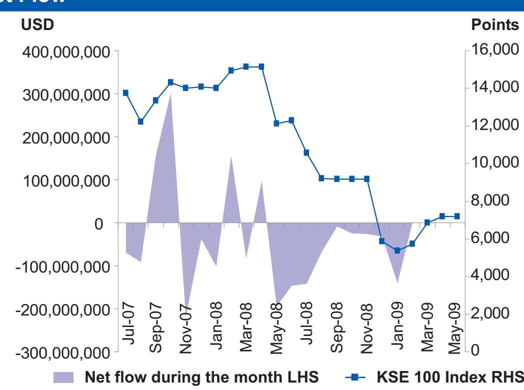
IAS-39 requires that any revaluation of surplus or deficit on Available for Sale investments must be routed through equity, unless it is deemed to be an impairment loss, in which case it will be routed through P&L. Although assessment of impairment is at the company's discretion, this can be challenged by Auditors, as in the case of NML. Financial accounts can be 'qualified' by Auditors or categorized as 'subject to correction'.

Via the relaxation companies can now recognize any revaluation deficit in their Equity instead of an impairment loss to P&L as of Dec 31'08. However moving forward, the revaluation deficit and any adjustment shall be routed through the P&L Account on a quarterly basis in CY09. Notably the revaluation deficit taken to Equity will remain a 'charge' to the Profit and Loss Account for the purposes of dividend distribution.

Global disinvestment from Pakistan eases up

Foreign holding of Market Capitalization declined to 5% from 7% peak a year earlier while SCRAs reflect an outflow just under USD 600mn during FY09. In absolute terms Foreign Holdings of KSE Market Capitalization dropped from PKR 331bn in Apr08 to just PKR 84bn in Jan09 a decline of 75% but have since rebounded to PKR 107bn at last count. This is also accounting for the slump in Index Value in Jan09 and its recent revival back up to the 7,900 level. SCRA numbers also show a decelerating pace of outflows MoM, with May09 figures indicating a small but positive inflow.

Chart 7: SCRA MoM Net Flow

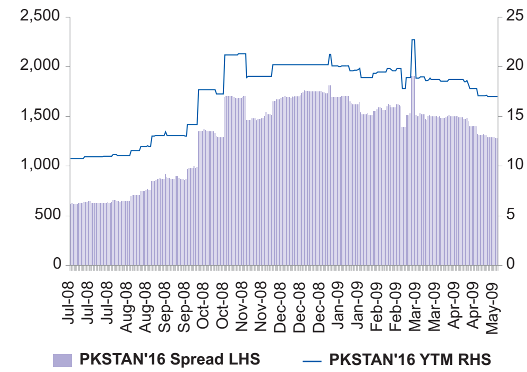


Source: SBP

Eurobond and CDS spread signal easing pressure on Pakistan

In recent weeks Yields on Pakistan's 2016 and 2036 bonds have eased considerably, reflecting improving investor confidence from the dismal days of Oct08. Yield to Maturity in the 2016 Eurobond had crossed 26% in Jan08, soaring from a range of 6% a year earlier, after the assassination of former PM Benazir Bhutto and failed to recover till very recently. Towards the latter end of Mar09 the PKSTAN'16 Yield to Maturity YTM dipped to the 20% range while the YTM of the PKSTAN'36 bond which followed a similar trajectory dipped to 18% indicating fresh investor interest. Spreads against the relevant US Treasury note have also shrunk from a high above 2400bps to less than 1300bps in CY09. Credit Default Swap rates on Pakistan's Sovereign debt meanwhile have also eased from highs above 5000bps in Oct08 to 1500points in Mar09 however it has rebounded to the 1900bp range in May09.

Chart 8: Eurobond 2016 (bps)



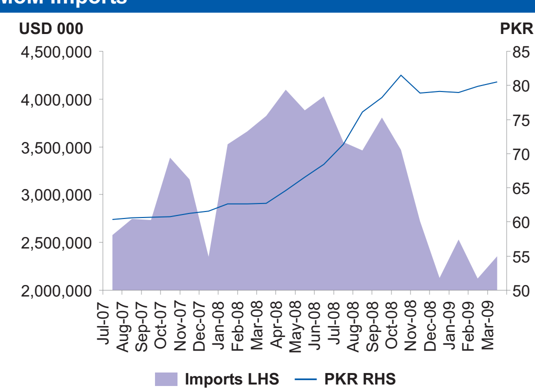
Source: Bloomberg

PKR depreciation reins in Aggregate Demand

The erosion of FX Reserves and the subsequent push against the PKR in 2Q FY09 led to a further 18% deterioration of the currency during the fiscal period. This adjustment allowed the PKR to function more appropriately as a 'transactional price' and suppress aggregate demand and inflation. The cooling effect on the economy is most visible in the shrinking Trade Deficit with 9mo FY09 figures already down 13% YoY to USD 12.7bn and Mar09 MoM Imports down 38% to USD 2.4bn.

Although much of the contraction in import value is attributed to the 30% slide in average oil prices per barrel, other segments of the import basket have also retreated including Machinery, Transport and Textiles. Recently however Brent, WTI and Arab Light prices have trekked above the USD 57/bbl mark, after several months close to the USD 45/bbl range. If a reversal in oil prices were to occur in 1Q FY10, the Trade Deficit is likely to suffer again, particularly in the face of weak export demand.

Chart 9: PKR against MoM Imports



Source: SBP & FBS

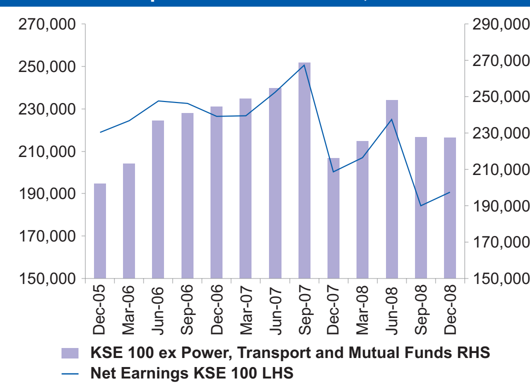
Uphill from here

Historically economic variables and earnings growth have presented a 1yr lead time to asset price adjustment. Given the turnaround in economic indicators and profitability in Dec08 from the troughs of Sep08 we expected the KSE Indices to stabilize by 2H FY10. Boosted by State intervention with NIT emergency funds the KSE indices rebounded sooner than we expected in Apr09 in line with global markets. Noticeably the drag from Power, Transport and Mutual Fund sectors on the KSE 100 Net profits has also bottomed out in Dec08, with KSE 100 ex Power, Transport and Mutual Funds reflecting positive earnings growth of 5%.

Accumulative stance: Net Earnings looking up

The benchmark index dipped to a recent low of 4,800points and bounced back nearly 65% to a high of 7,900 before retreating to the 7,000 mark. The index is trading in the region of 11x earnings from a low of 6x earnings earlier. Although we do not expect multiples to stretch to the higher double digits anytime soon, we advise investors to maintain a cautious but accumulative stance on specific liquid blue chips. We are particularly bullish on cyclical sectors which we feel have bottomed out in FY09 particularly Banks, Cements and Autos. Net earnings of companies in the IGI Universe declined sharply in Dec08 over the Last Twelve Months by 21%, 52% and 52% respectively and are likely to pick up in line with easing interest rates, input costs and currency stability.

Chart 10: KSE 100 against Market Cap IGI Universe Banks, Cements and Autos (PKR mn)



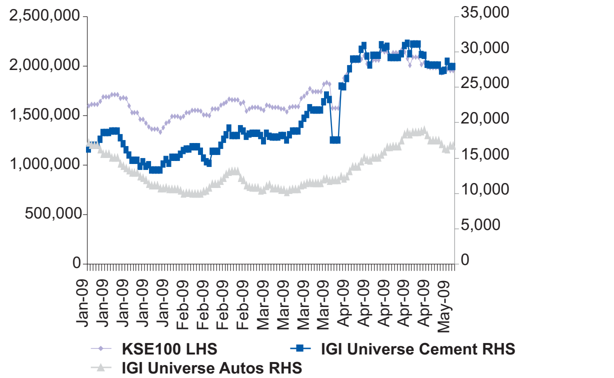
Source: Company Reports

Mar09 LTM early indications 7% improvement over the previous quarter

On a standalone basis net profits could slip by an estimated 6% in Mar09 compared to the same period last year. However on a QoQ basis profitability has been rising since Dec08. Given the current momentum we expect the index to continue to trade at a P/E multiple in the range of 10x-11x earnings which would stabilize the index in the range of 6,600-8,000 points. Potential political constraints could suppress volumes and index levels below 80mn shares a day and 6,000points respectively.

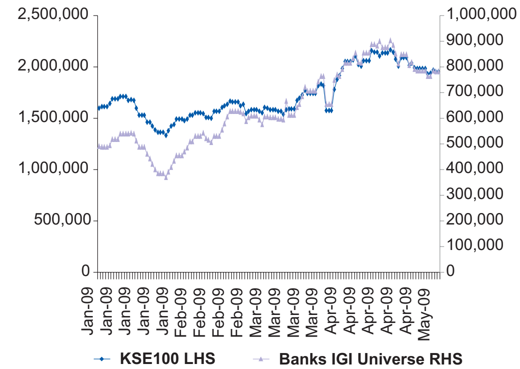
However we feel this will be a short term dip and may present opportunities for attractive future gains. The KSE 100 has already pulled its socks up by over 64% since it bottomed out to the 4,800points range in line with the recovery in global markets averaging 20% during CY09. Although with headwinds from the US and internal security situation catching up, it has retreated again. A positive trigger to look out for would be the inclusion of Pakistan in the MSCI Emerging Market Index, which is expected to be reviewed in Oct09.

Chart 11: KSE Autos and Cements Market Cap (PKR mn)



Source: Bloomberg, Company Reports & KSE

Chart 12: KSE and Banks Market Cap (PKR mn)



Source: Bloomberg, Company Reports & KSE

Pakistan Index to be included formally in the MSCI Frontier Index on May 13'09

On May 13'09 MSCI Barra (NYSE: MXB), a leading provider of investment decision support tools world wide, will formalize the standalone Pakistan Index's re-inclusion into the MSCI Frontier Index. In Oct09 at the Semi-Annual Index Review, there is a chance that KSE may qualify for inclusion in the MSCI Emerging Markets Index. That would be considered a very positive trigger for the indices and could lead to a revaluation of price multiples and a fresh high for the Index. Earlier the total share of Pakistani companies in the MSCI EM Index was 0.18% and included JSCL, PTCL, UBL, MCB, FFC, NBP, PSO and OGDC. In May08 the investment advisor had reduced the number of Pakistani companies in its index from 13 to 8.

During 2Q FY09 Pakistan faced a barrage of downgrades and votes of no confidence. The last nail in the coffin was the Dec 10'08 announcement by MSCI that it will remove the Pakistan from the MSCI Indices as of the close of Dec 31'08. The press release stated that the imposition of the market floor in Aug08, and the resultant paralysis of the KSE indices had compelled the institution to take the above action. The deterioration of investability, price discovery and the following ambiguity regarding the removal of the floors made the investment decision inevitable. A day later the SECP announced the KSE BoD would lift market floors; it was time to wake up and smell the coffee. Having ridden out the storm in Jan-Feb09 the KSE Indices have now bounced back on expectations of improved earnings and economic indicators; a scenario which could have been achieved much earlier had the indices not been frozen in Aug08.

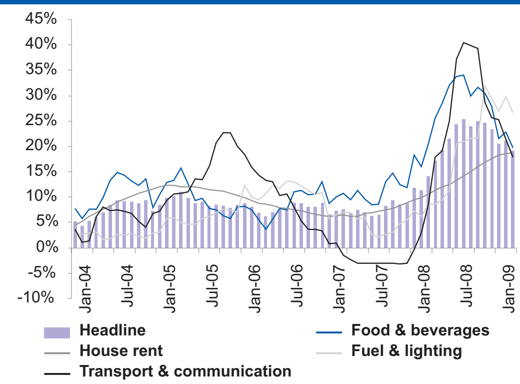
Money Matters

Apr09 CPI inflation likely to dip to the 16% range

CPI headline inflation saw an uptick in Mar09 with a MoM increase of 1.4% in prices compared to the deflationary trends seen since Nov08. Nevertheless Headline CPI inflation rolled back to the 19% level MoM during the month. Given the high base of Apr08 we expect CPI inflation to dip to 16% in Apr09.

The recent rate cut is also likely to soften price pressures, however upward momentum from House Rents and Fuel & Lighting should sustain through the remaining quarter. On the flip side we expect easing pressure from the Food and Transport & Communication index as we move towards Jun09.

Chart 13: Annual Inflation YoY and MoM



Source: SBP

SPI provides a good lead indicator

Early indications of the U-turn in prices was reflected in April WoW SPI trends which present a lead indicator of CPI movement. SPI was down 42bps by Apr 30'09 over the previous week while Combined SPI inflation was up only 13.3% in the last week of Apr09 over the corresponding week last year.

Key factors keeping upward pressure on prices are commodities including Cement, Urea, Diesel, Wheat, Sugar and Furnace Oil. Prices of these essential items are up between 20-40% over the corresponding week and are likely to sustain upward pressure on the CPI index. According to news reports OMCs have increased Furnace Oil prices by almost PKR 4000/MT over the last couple of months to just under PKR 30,000/MT on account of supply shortages. In line with these reports we expect Fuel & Lighting and House Rents to reflect the largest YoY increase in the range of 17-28% in Apr09.

Market rates reflecting risk rather than liquidity

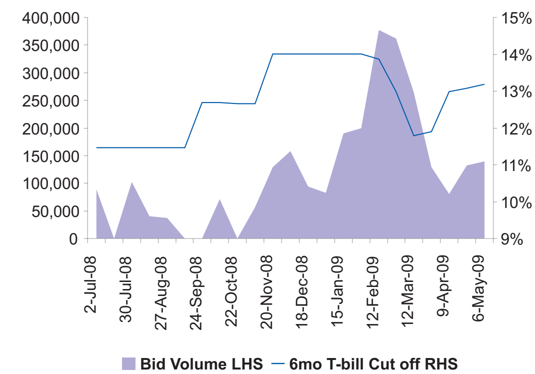
Admittedly market rates have dipped significantly since Jan09; 6mo KIBOR has shed over 250bps to sink to 12.54% while 1yr T-bill cut off yields nose-dived 243bps in tandem with soaring bid volumes which topped PKR 377bn from barely PKR 60bn in Aug08. We were cautious about the loosening of market rates (IGI Securities **Day Break**, March 05, 2009) and felt it reflected banks' risk aversion, rather than excess market liquidity.

Banks were likely to continue to recycle their excess funds through investment in government securities till they feel comfortable enough to expand their loan book. At present Private Sector credit rests at a meager PKR 48bn above Jun08 stock; down 7x over the same period last year. Loan growth from this segment has been subdued due to prevailing uncertainty and the consequent slim Working Capital and Fixed Investment demand.

Market rates U-turn on Money Demand

Turns out we were right with regards to market rates – T-bill cut offs inched back up another 140-150bps by May 6'09 while 6mo KIBOR also jumped 100bps from a low of 12.5% to 13.5%. Despite the aggressive CRR cut to 5% in Nov08 and the recent 100bp cut in the Discount rate in late Apr09, we remain cautious about the potential Money Demand Gap.

Chart 14: T-bill Auction Bid Volumes vs. Cut off Yields (PKR mn)



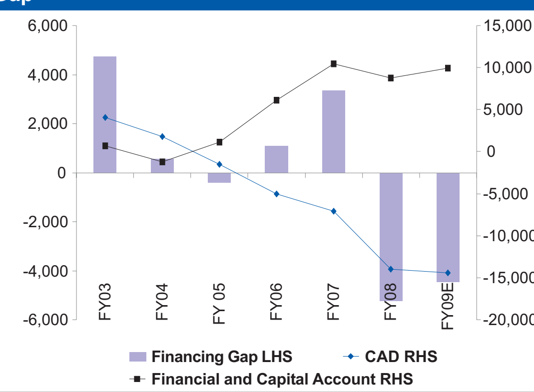
Source: SBP & IGI MM Desk

For now the government debt burden may have shifted to the Commercial Banking sector, but direct borrowing from the Central Bank remains high at over PKR 250bn as of Apr 25'09. The Fiscal Deficit has shrunk by 30% in 1H FY09 over the same period last year to PKR 250bn on account of aggressive development spending and subsidy cuts, however the External Account gap remains wide at USD 4.5bn. With Money Demand from Circular Debt, Commodity operations and a potential Balance of Payments deficit in the range of USD 4bn mounting we could see the liquidity gap widen again in late 4Q FY09. Pressure on market rates would be immediate however is unlikely to stretch to Oct08 levels.

External Account gap still could create further liquidity pressure

According to our estimates the External Account gap could extend to as much as USD 4.5bn at current levels unless further external financing is received before Jun09. We expect the Current Account to run up a deficit of USD 11bn while Financial Account Inflows are unlikely to exceed USD 6.5bn in FY09. The Ministry of Finance is expecting inflows amounting to USD 500mn from the Central Bank of China and another delayed pledge of USD 1bn from the US before the end of Jun09. Meanwhile talks are underway between the Advisor on Finance Shaukat Tarin and the IMF team regarding an expansion of the SBA loan agreement by another USD 4.5bn before Nov10. This could alleviate pressure on liquidity but nevertheless is evidence of persistent constraints that requirement longer term solutions.

Chart 15: Financing Gap (USD mn)



Source: SBP

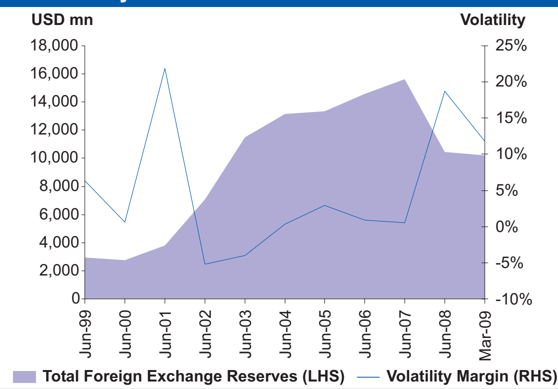
Bearish signals for the PKR on structural constraints

Barring a confidence deficit that may present a severe drag on the currency, we expect the PKR to consolidate in the range of PKR 81-86 against the USD in FY09. Supporting the currency is a vigilant and reserve rich State Bank that doesn't intend to loosen its grip on capital outflows as it did in Aug-Oct08. Confidence in the progressive stance of the IMF on Pakistan with regards to Monetary and Fiscal targets is also a key factor and likely to boost the PKR; particularly if the IMF SBA loan agreement expands to USD 12.1bn against the previously agreed USD 7.9bn.

However structural constraints will keep the PKR on thin ice moving forward; Export receipts, FDI and Remittances which form the backbone of PKR support are likely to face pressure in the medium term. Export receipts have remained at 11% of GDP for the last 10yrs whereas Import payments have doubled. FDI which was robust in recent years is likely to move inline with slowing global cross-border flows and slip to the USD 2.5bn range, while Remittances should also flatten in line with the global economic slowdown. This could push the Balance of Payments gap beyond our cautious estimate of USD 4bn and signal concerns for the currency.

Noticeably, a key factor which has eased pressure on SBP foreign currency liquidity is the removal of FO import payments from the SBP books; allowing the SBP to intervene more effectively, if not as frequently, in the market to stabilize the PKR. Moving forward plans to remove Diesel payments by Aug09 and Crude oil import payments by Feb10 from SBP books will also improve the central bank's flexibility.

Chart 16: Exchange Rate Volatility and NFA



Source: SBP

Safe and Sound

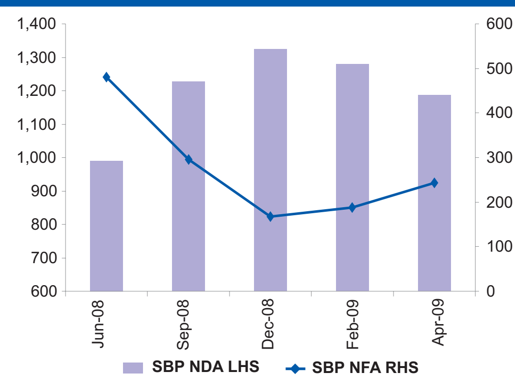
According to quantitative targets set by the IMF, SBP was committed to maintaining a floor on Net Foreign Assets of USD 671mn and a ceiling on Net Domestic Assets of USD 1,412mn. Both categories reflect the level of Foreign Reserves maintained by the central bank and the government borrowing absorbed by the State Bank. The SBP was pleased to announce that it has indeed met the IMF's targets for the quarter ending Mar09. According to the State Bank's Reserve details outstanding stock of Reserve Money including NDA and NFA of the SBP ending Apr 25'09 stood at just under PKR 1,500bn. The NFA stock outstanding was just above USD 2.9bn far above the USD 671mn required. Meanwhile NDA stood at PKR 1,189bn well below the target of PKR 1,412bn and down over PKR 100bn since Feb09.

SBP Reserve Money targets for Jun09 likely to be met

The IMF team has set a floor of USD 2.8bn in SBP NFA for Jun09 and an official reserve target of USD 8.6bn. As of Dec08 the SBP holdings of NFA, defined as the difference between its foreign assets and foreign liabilities, stands at roughly USD 1.5bn while NDA stock is well within limits as well.

The drag on NFA from import payments and portfolio outflows has also stemmed, stabilizing the Reserve Money position. At present FX Reserves are presently above USD 10bn and if expected inflows from the US and Friends of Pakistan materialize before Jun09, Reserves are likely to rise above USD 11bn, pushing the SBP NFA close to USD 3bn.

Chart 17: SBP NFA and NDA (PKR bn)

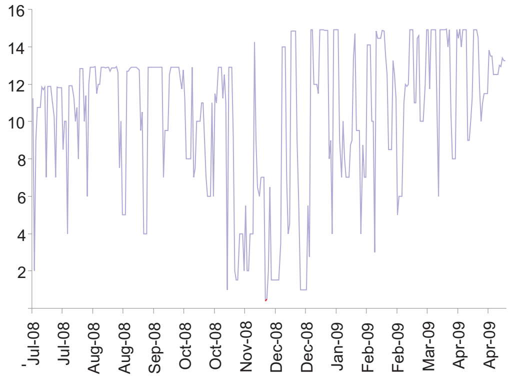


Source: SBP

Liquidity management a priority

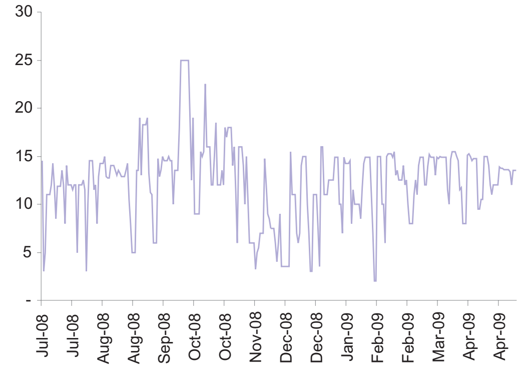
On the monetary policy front several positive developments have enhanced the SBP's cash management capacity. The announcement of a rate corridor to rationalize money market rates is one such positive. Rates using the SBP's reverse Repo rate as the ceiling and the standing Repo facility to absorb excess liquidity as the floor will stabilize market liquidity and send clear monetary policy signals. In CY09 O/N Repo rates have averaged above 11% whereas the DR has been at 15%. Call rates have remained similarly stable in the 13% range improving the SBP's visibility. Further improvements include clear treasury auction volume targets, advance notice of auctions and availability of T-bills from the Treasury to the SBP, as needed, to conduct its Open Market Operations.

Chart 18: O/N Repo Rates (%)



Source: Bloomberg

Chart 19: O/N Call Rates (%)



Source: Bloomberg, Company Reports & KSE

Greater Fiscal and Monetary policy coordination bodes well for the economy

In our opinion a major constraint preventing macroeconomic stabilization, without structural adjustment guidelines imposed by the IMF, is monetary and fiscal policy confrontation rather than coordination. According to the Fiscal Responsibility Act 2005 fiscal managers were bound to ensure that total public debt is reduced by not less than 2.5% of GDP for any given year amongst a number of other provisions. Needless to say these targets were not achieved and increasing pressure to finance government spending fell on the State Bank in FY08 leading to a hard landing 1H FY09.

After the IMF SBA was signed in Nov08 we were optimistic about improved monetary and fiscal policy coordination. Representatives from the MoF made an earnest attempt to reduce government borrowing from the SBP and spread the debt burden. The IMF LoI also noted the urgency for the formation of an interagency committee that will draft legislative changes to ensure operational independence of SBP. A step in the right direction has been the independent pricing of government securities by the Ministry of Finance instead of the SBP, effectively delinking policy rate signals from auction cut off yields.

Poli….ticking

More than a year after the PPP government swept the 2008 election, politics has again emerged as the key determinant of all things to come. Politics in Pakistan is now more than ever likely to determine whether policy makers succeed in reviving the economy and setting Pakistan on the route to stability.

The Long March has just begun

In line with our expectations of a short-lived and fragile coalition (IGI Securities, **Macro Review**, *Transitionomics* April 2008) former foes PML-N leader Nawaz Sharif and President Asif Ali Zardari came to blows in the country-wide Long March which culminated in the Restoration of the Judiciary and Shahbaz Sharif as CM Punjab. Negotiations between PM Gilani and the Sharif brothers continue regarding the role of the PPP in Punjab and there is anticipation that the PML-N could return to the Federal coalition. In the backdrop, the nuisance factor from the Pakistani Taliban has evolved into a very serious Law and Order problem with no let up in security slippages in recent weeks. The damage to the country's credibility has been expansive, evident in the scale down in foreign investment both in Capital Markets and other sectors.

PPP's internal fissures must heal

PM Yousuf Raza Gilani's announcement of the reinstatement of the country's deposed Chief Justice Iftikhar Chaudhry by Mar 21'09 ended the crackdown on the Opposition led by PML-N Chief Nawaz Sharif. However collateral damage to the PPP include resignations of Information Minister Sherry Rehman, alienation of key party member Barrister Aitezaz Ahsan and a public condemnation of the government's actions by former PPP Political Secretary of Benazir Bhutto, Naheed Khan. Following the reinstatement of the Judiciary and the PML N led Provincial Government in Punjab we feel the pressure has somewhat abated due to PM Gilani's conciliatory approach to governance. We feel this has been a step in the right direction and is necessary in order to effectively deal with the greater concerns at hand such as macro-economic vulnerability and Law and Order.

Pakistan stability crucial to US Regional Strategy

Reportedly intervention by US Secretary of State Hillary Clinton compelled the government to meet the terms of PML-N leader Nawaz Sharif and Lawyer's movement. We expect foreign intervention and the carrot dangling at the end of the stick: foreign aid, to remain a key determinant of Pakistan politics. External pressure to resolve pending issues will have a broadly positive impact, however we remain cautious as any consensus between PML-N chief Nawaz Sharif and President Asif Zardari could be derailed quickly due to marked political and personal differences. The recent ascent of the Pakistani Taliban, their sustained offensive stance in Swat and the acquiescence of the ANP led NWFP government to the imposition of Shariah in the Malakand Division has has prompted both the US and domestic pressure on the Pakistan's administration to stabilize and respond effectively to the situation.

Takeaways from the Zardari-Karzai-Obama meetings in Washington

Following the crucial juncture of the Pak-Afghan-US meetings in Washington in early May09, we find the administration has developed a defensive rather than conciliatory stance to the Pakistani Taliban on account of a severe trust defict. PM Gilani announced on May 8'09 that the federal government would undertake a full-scale military operation to wipe out the Taliban from the insurgency-hit areas. This is inspite of the Nizam e Adl peace agreement, as the stakeholders TNSM (Tehreek-e-Nifaz-e-Shariat-e-Muhammadi) had not kept their end of the bargain.

On May 7'09 TSNM leader Sufi Muhammad's son Maulana Kifayetullah was also killed in an aerial attack. The Army led by General Kiyani also reinforced its support to the government, vowing a decisive victory. Between May-July we expect Pakistan's Administration to be facing a Herculean task; domestic and global audiences are likely to be on tenterhooks as they watch events unfold. In the meanwhile key investment indicators such as the KSE Indices, Eurobonds and overall Portfolio Investment are likely to remain under price pressure.

Regional issue is a Law & Order problem

Earlier interpreted as a regional concern, the confrontation with militants on the Western front has evolved into a serious internal security threat. The nuisance factor from terrorists reached a fever pitch in FY09 as we expected (IGI Securities **Pakistan Strategy FY09** *Is the Party Over?* July 2008). From the strife in Swat and the subsequent adoption of Nizam e Adl to the busy streets of Lahore where the Sri Lankan cricket team was ambushed, the confrontation between the State and anti-State elements continues. While friction on Pakistan's eastern border with India has eased, the conspirators of the dramatic attack on Mumbai were unfortunately traced back to Muridkot in Punjab. Tension with India remains on the backburner, but nevertheless a growing concern.

Other than the military, what remains to control this cluster of anti-state elements is a fragmented, antiquated and ill-equipped Law & Order infrastructure. Internal political rifts are likely to be curtailed by US intervention, however cannot be ruled out as we move into the latter half of CY09. If that were to occur the response to terrorist activities will be delayed, as will the broader pace of reform which Pakistan can ill-afford. Given the low base of Law and Order infrastructure investment in Pakistan, we do not expect a major roll back in the accelerating militant activity both internally and regionally; unless the Army steps in and fights them to the teeth. Global and domestic investors, observers and audiences are likely to remain very cautious in the coming months, regarding the country's vulnerability to these elements given its nuclear status, geographic positioning and role in US and NATO regional strategy.

Research Team

Zainab Jabbar	Investment Strategy, Economy	Tel: (92-21) 111-234-234 Ext.:810	zainab.jabbar@igi.com.pk
Aisha Kirmani	Research Analyst	Tel: (92-21) 111-234-234 Ext.:808	aisha.kirmani@igi.com.pk
Abdul Sajid	Database	Tel: (92-21) 111-234-234 Ext.:813	abdul.sajid@igi.com.pk
Mansoor Ahmed	Design, Layout	Tel: (92-21) 111-234-234 Ext.:812	mansoor.ahmed@igi.com.pk

Equity Sales

Maheen Rahman (Karachi)	Tel: (92-21) 536-8823	maheen.rahman@igi.com.pk
Nazia Enam (Karachi)	Tel: (92-21) 530-1711	nazia.enam@igi.com.pk
Samira Omer (Karachi)	Tel: (92-21) 536-8845	samira.omer@igi.com.pk
Ovais Ahsan (Karachi)	Tel: (92-21) 536-8811	ovais.ahsan@igi.com.pk
Abrar Raza (LHR)	Tel: (92-42) 570-7415	abrar.raza@igi.com.pk
Shafqat Ali Shah (ISL)	Tel: (92-51) 280-2243	shafqat.ali@igi.com.pk
Chaudhry Usman Javed (SKT)	Tel: (92-52) 3242689	usman.javed@igi.com.pk
Muhammad Ejaz Rana (FSD)	Tel: (92-41) 254-0854	ejaz.rana@igi.com.pk
Riaz Naseeb Khan (Multan)	Tel: (92-61) 450-0183	riaz.naseeb@igi.com.pk
Asim Irfan (Peshawar)	Tel: (92-91) 525-3980	asim.irfan@igi.com.pk

IGI

Securities

Head Office

7th floor, The Forum, Suite 701-713, Khayaban-e-Jami, Clifton, Karachi
Phone: (92-21) 111-234-234 Fax: (92-21) 111-567-567, 5301729

Branch Offices

Karachi (Clifton)
F-5, Block 9, Clifton, Karachi.
Phone: (+92-21) 5309258-60 Fax: (+92-21) 5309168

Karachi - KSE
Room # 70, 1st Floor, KSE Bldg. Karachi Stock Exchange Road, Karachi
Phone: (92-21) 2429601-06 Fax: (92-21) 2429607

Lahore
5-F.C.C. Ground Floor, Syed Maratib Ali Road, Gulberg, Lahore
Phone: (92-42) 5756701, 5777861-70 Fax: (92-42) 5762790

Lahore - DHA
75-T, Phase 2, DHA (near Lalak chowk), Lahore
Phone: (92-42) 5707411-33 Fax: (92-42) 5748935

Islamabad
Mezzanine Floor, Razia Sharif Plaza, 90 – Blue Area, G-7, Islamabad
Phone: (92-51) 111-234-234, 2802241-43 Fax: (92-51) 2802244

Faisalabad
9th Floor, State Life Building, 2 – Liaqat Road, Faisalabad
Phone: (92-41) 2540843-45 Fax: (92-41) 2540815

Sialkot Office
Room No: 206, Sialkot Trading floor, Cantt Plaza, Sialkot Cantt.
Phone: 052 -4566032-36 Dir.: 052 – 4566034-36 Fax: 052- 4566035

Multan Office
C-2, 1st floor, Hassan Arcade, Multan Cantt.
Phone: (92-61) 4784401-02 Fax: (92-61) 4784403

Gujranwala Office
Nasir Plaza, Main GT Road, (Adjacent to New Railway Station), Gujranwala
Phone: (92-55) 3841346-48 Fax: (92-55) 3257453

Peshawar Office
Mall Tower, 2nd floor, 35. The Mall Peshawar
Phone: (92-91) 5253980-88 Fax: (92-91) 5253989

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