ALFALAH INVESTMENTS

Effect of COVID-19

On the Economy & Capital Markets, April 2020

ECONOMIC OUTLOOK

Global recession has already begun

As the world remains at a stand-still due to the spread of COVID-19 infections across all major continents, we affirm our conviction of a global recession driven particularly by: i) an expectedly weak industrial output pickup from China as it opens up again, ii) considerably damaged demand from Europe, the UK and the United States, and, iii) an extended lock down situation in much of the world including the Middle East, India and Pakistan. As we write, the global count for coronavirus cases place the US, Spain, Italy, France and Germany at the top based on confirmed cases. With the exception of China, the world's top economic blocs as represented by the US and Europe/UK remain firmly in demand suppression mode due to significant challenges in controlling the spread of Covid19. Limited ammunition in the form of lower interest rates have already been used and historically large asset buyback programs as initiated by the Federal Reserve will have limited impact in the immediate term as consumer focus stays firmly on health and quarantine matters.

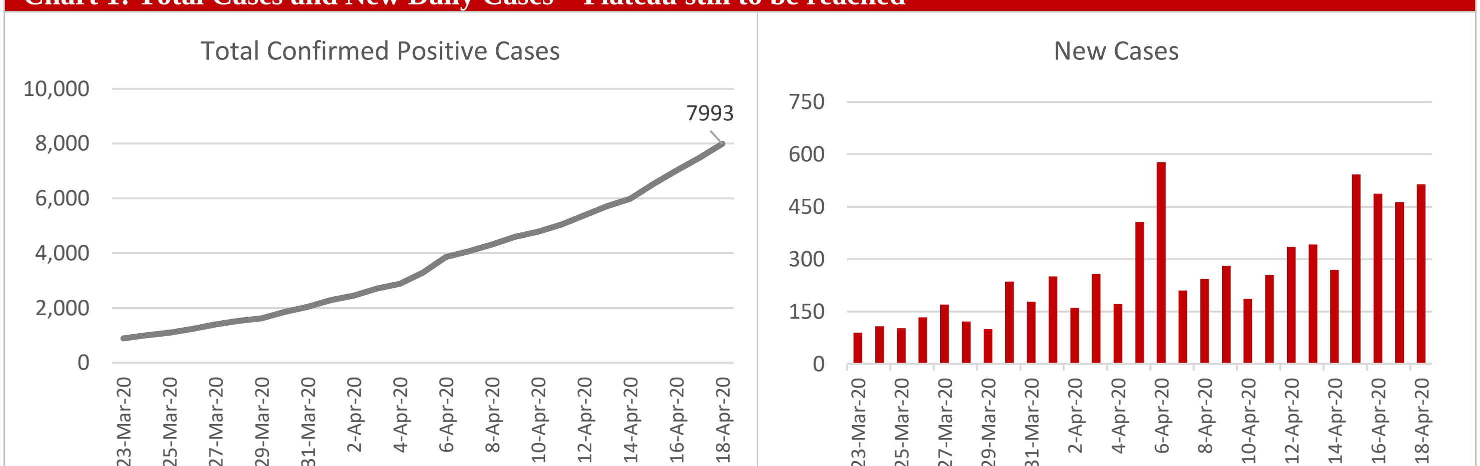
It is too early to assess how quickly economic growth will recover and it is largely dependent on how soon an effective treatment can be modelled. A vaccine is still at minimum 12-18 months away and it is hence quite likely that economic activity would suffer many starts and stops due to outbreak clusters forcing closure for a few weeks and then starting again. What is abundantly clear is that no world economy can afford to completely close their borders and businesses indefinitely and hence an interrupted and cautious return to business activity is more possible.

Pakistan – Vulnerabilities are high

As far as Pakistan is concerned, the total confirmed COVID-19 cases tally is currently approx. 8,000 with 156 deaths reported so far. In the global context, confirmed cases in Pakistan only comprise of 0.23% of the global infections along with a negligible 0.09% of the total global mortalities. This number is considerably lower given Pakistan's population size with a much lower mortality rate compared to the global averages. Early closure of schools, complete/partial lockdown in all provinces along with effective quarantine of returning Pakistani Citizens and daily tracking has helped keep the virus spread numbers low so far compared to global numbers.

However, as the disease has proved, complacency in control results in heavy casualties both in the form of an overstretched medical system as well as in the body count. So far, most developing countries (with exception of Iran) have not fared as poorly as the developed ones. However, the economic cost of the current semi-lockdown situation will have a deep impact on economic vulnerabilities.

Chart 1: Total Cases and New Daily Cases – Plateau still to be reached



Source: http://covid.gov.pk/ *Source: : http://covid.gov.pk/*

Disclaimers: All investments in mutual funds are subject to market risks. Past performance is not necessarily indicative of the future results. Please read the Offering Document to understand the investment policies and risks involved. While due care has been taken, we have relied on several data sources from external research and thus cannot guarantee accuracy of data and views expressed thereon. Given the unique nature of the pandemic and given we have limited information on the scenario. Investors are therefore advised to exercise due diligence; we do not recommend decisions solely on the basis of shared information

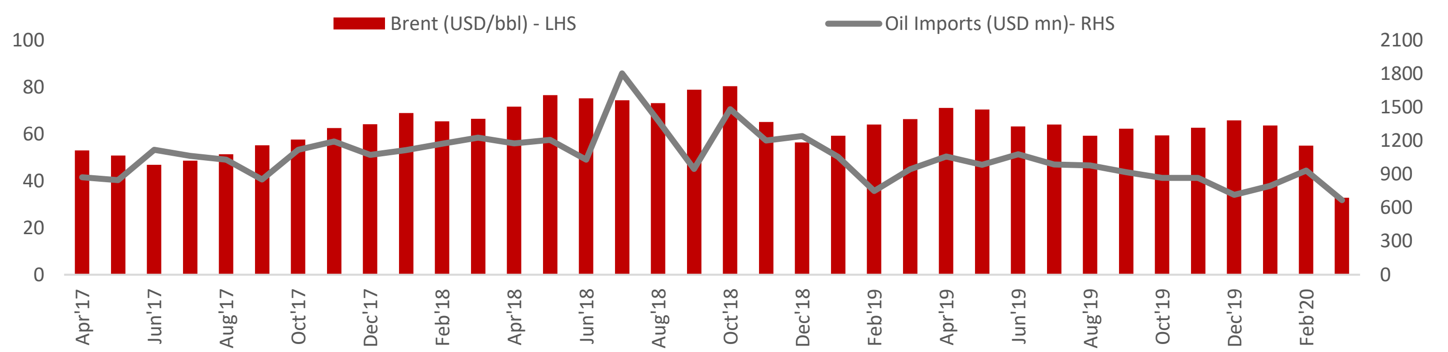
External Account – Trade deficit manageable however remittances at risk

As a representation of the unprecedented demand suppression globally, international oil prices have failed to sustain above US30/barrel despite a massive 9.7mn barrel a day cut by OPEC and implicitly supported by the G20. As it will take substantial time for global oil demand to recover post the COVID-19 lock-down we can expect oil to stay range-bound between US$20-30/barrel in the immediate future.

Export drop inevitable; oil bill decline will cushion that dip

Pakistan' trade deficit has fallen by 31% during 8MFY20 compared to same period last year. This is due to a decline in imports by 15%, rise in remittances and exports by 5% and 3% respectively, thus, supporting the country's CAD, which has reduced drastically by 71% YoY. The falling international oil prices (Brent Crude), down by 61% YoY from $71/ bbl, is a good omen for Pakistan's economy as about 25% of the country's total import bill consists of petroleum products. At an average Brent of US $30, oil imports will fall by ~ US $500mn per month from the current level of US $1bn per month resulting in potential annual savings of US $6bn.

Chart 2: Oil Prices versus Pakistan Oil Imports



Source: Bloomberg, SBP, Alfalah Investments

Economic Indicator	USD in millions			
	FY18A	FY19A	FY20E	FY21E
Exports	30,056	29,511	28,203	21,152
% change		*-2%*	*-4%*	*-25%*
Imports	67,948	62,295	51,720	43,484
% change		*-8%*	*-17%*	*-16%*
Trade Deficit	**-37,892**	**-32,784**	**-23,518**	**-22,332**
% change		*-13%*	*-28%*	*-5%*
Remittances	19,914	21,838	22,500	21,375
% change		*10%*	*3%*	*-5%*
Current account Deficit	**-19,897**	**-13,830**	**-4,601**	**-4,541**
% change		*-30%*	*-67%*	*-1.32%*

On the other hand, going forward exports are expected to decline as textile export orders from EU/ USA and China could be deferred or even cancelled due to the economic slowdown and other applicable travel restrictions. Moreover, this also applies to non-essential imports, which are also expected to take a dip due to depressed economic activity and demand on the back of the imposed lockdown in the country. If we assume that global trade drops by one-third than an approx. 20-30% dip in Pakistan exports is not unreasonable. This would reduce exports from a previously estimated US$28bn to

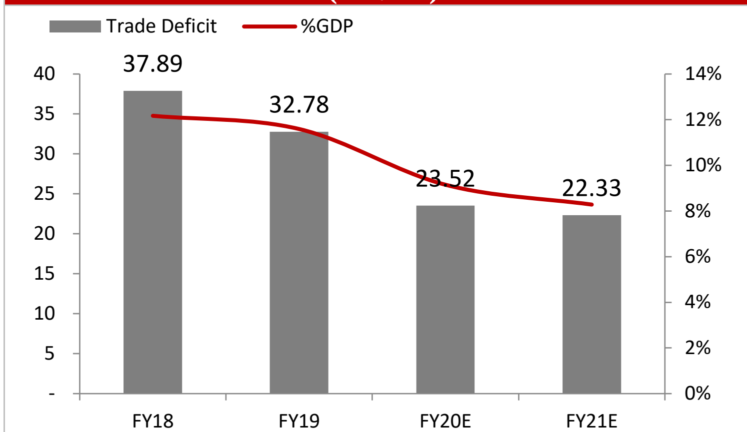
US$21bn; thereby negating any positive effect of lower oil imports. However, we do highlight that export orders could pick up in the 2H2020 as economies re-open and hence there is certainly upside in these projections.

Worker's Remittances have also been a major source in supporting country's Current account balance in the past. Remittances can also be negatively impacted in the short term, as a) world's major economies have locked down cities to limit the spread of the virus and b) oil price decline which can result in slowdown in GCC and Middle East and restrict remittances inflows (55% contribution in total remittances) and c) future expected layoffs globally due to a recession will also reduce remittance inflows. We project a 3% annual decline in remittance flows annually in 2021 but highlight that significant medium-term downside risk remains.

Current Account deficit to remain under 2% of GDP

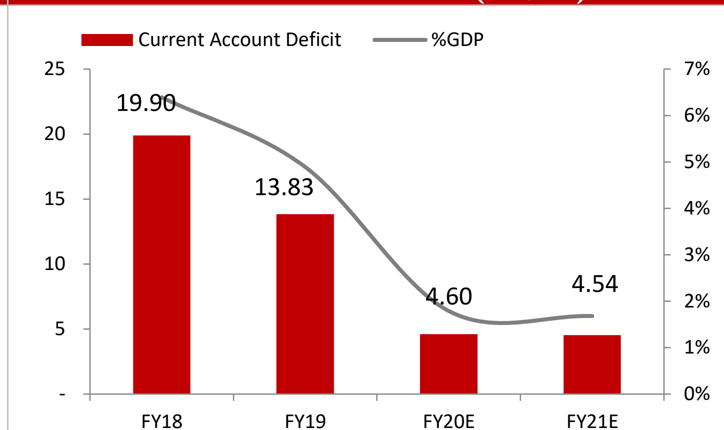
This scenario shows the current account deficit for FY20 to drop to $4.60bn or 1.79% of GDP while in 2021 we expect the current account to register at $4.54bn, down 1.32% from 2020 and 1.68% of GDP. These numbers do indicate relative insulation from CA account vulnerabilities which were much higher in 2018-2019, hence sharp currency movements should not be expected.

Chart 3: Trade Deficit – (US$ bn)



Source: Bloomberg, Alfalah Investments

Chart 4: Current Account Deficit – (US$ bn)



Source: Bloomberg, Alfalah Investments

PKR expected to range between PKR165-170/USD over next six month. Relief via external debt re-profiling and multilateral flows will be key to maintaining range stability.

The currency fluctuation can be minimized if capital account flows are restructured and deferred loan repayments are considered. The key constraint on the external balance then remains the sheer quantum of debt both in terms of interest and principle that Pakistan is due to pay over the next two years. Approx. $12.7bn of foreign debt is due in 2021 and $7.7bn in 2022 reflecting total payment of US$20.4bn over the next two-year period. Given the current nature of the economic burden that Pakistan is faced with we project that a significant portion of this debt will be rescheduled, written off or deferred forward – a request already formally made by the GOP. This is already under consideration by G20 nations and the IMF. If we assume approx. 30% of debt due in 2021 is deferred for the next two years this will allow a cushion of approx. US$4bn on the external account.

Further assistance from the IMF, WB and ADB estimated at US$4.0bn for budgetary support from the economic fallout from Covid19, of which US$1.4bn has already been confirmed by the IMF, is also expected to materialize over the next few months thereby lending important balance of payments support as well as fiscal support.

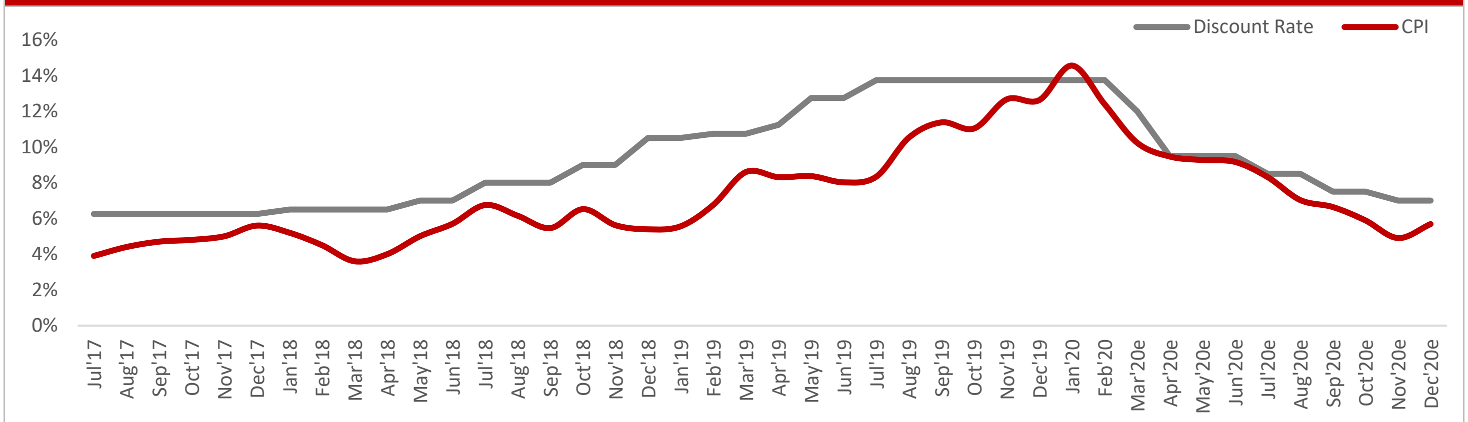
Assuming these numbers do come through, this gives Pakistan considerable cushion on the external account and breathing space over the next two years to re-establish economic normalcy

Steady Deflationary Pressure; CPI to stand at 6% by December 2020

The implications then for interest rates and inflation appear quite benign. Pakistan has historically been vulnerable to supply shocks in particular oil price spikes which have filtered into the broader commodity market and led to cost push inflation and subsequently policy action via higher interest rates has sought to suppress demand to reduce inflationary pressure. However, in the current environment, inflation spirals are unlikely unless there is a major food supply chain disruption. Hence our projected CPI numbers indicate a sharp dip in inflation for the rest of CY20 driven by a combination of demand suppression due to closed industries and businesses and lower international oil prices.

This should move the interest rate easily into single digit territory sooner rather than later. Already as we write the State Bank has dropped the interest rate by a further 2% to 9% citing global weakness in demand and unprecedented slowdown in the local economy due to Covid19. Risks to inflation now appear firmly on the downside. Our projections indicate 6% CPI by 4Q 2020 and interest rates down by an additional 200bps before year end to 7%.

Chart 5: Discount rate versus CPI



Source: SBP, Alfalah Investments

Fiscal Challenges – Current Relief Measures will Help Liquidity but Not Demand

Overall stability of the financial system via external account seems comfortable while with additional benefit of debt re-profiling and multilateral assistance flows, overall balance of payments should be comfortable over 2021. The focus on the fiscal side will be divided between immediate term relief to shuttered businesses, SME and traders and in the medium term to providing stimulus to ensure business activity recovers albeit in an interrupted manner.

Relief Measures will only stabilize liquidity and stop layoffs for now

Various relief measures for industry and businesses have already been announced along with significant social security disbursements via Ehsaas/BISP programs. The ECC meeting held on March 30, 2020 approved a fiscal stimulus package of PKR 1.2tn to mitigate the impact of the lockdown by focusing on social safety nets for low income groups as well as providing small businesses with various reliefs including easing of loan repayment terms.

Moreover, the release export tax refunds to the export sector has already commenced while the SBP has announced various provisions for deferment of interest and principal payments to the banks on all borrowers. To support the banking sector to supply additional loans to businesses and households, SBP has reduced the Capital Conservation Buffer (CCB) from its existing level of 2.50% to 1.50%. This will enable banks to lend an additional amount of around PKR 800bn, an amount equivalent to about 10% of their current outstanding loans. Further, cheap funding to cover salary costs and avoid layoffs has also been proposed by the SBP along with changes to reserve requirements on foreign currency.

Further, emphasizing the pivotal role of construction sector in the economy, the Prime Minister announced relief package for the sector embodying various benefits like waiver of withholding tax on most of the construction materials, fixed tax regime for developers with 90% exemption in tax if construction is carried under Naya Pakistan Housing scheme and rationalization of taxes on sale and purchase of property.

Start – Stop – Start Covid19 Economy

These measures should help stabilize business cash flows at a time when bulk of operations are at a standstill. However, medium term it will be necessary to impose a smarter version of lockdown by allowing industry, SME and services particularly small-scale traders etc. to operate as the fallout on daily wagers will still be substantial. Most likely some allowances will be made to lift the lockdown in less infective areas and keep enforced in areas where community spread continues to be an issue. However, this will still result in an outbreak of infections and hence we foresee a full resumption of business as unlikely until a clear treatment plan or vaccine is available which again could take some time. In effect, we need to adjust to the new reality of a Start – Stop – Start Covid19 economy where surges in infection are met with temporary lockdowns to control further spread.

In this scenario, ability of GOP to raise revenues via taxation will continue to be severely hampered. The bulk of tax revenues come from indirect taxes which are predominantly focused on WHT or GST taxes. With a drop-in business activity, these two heads will see significant attrition along with a natural attrition from lower income taxes. This points to strong vulnerabilities on the fiscal front hence making debt re-profiling and external financial support more crucial.

Tax collection will drop significantly while stimulus will be necessary
Deferment of external debt repayments (both principle and interest) by US$4bn and a natural drop in domestic debt servicing due to drop-in interest rate to 7% could create a room on the fiscal deficit financing front.

However, positive impact on fiscal deficit may be limited as most likely there will be a need to provide additional incentives once the lockdown lifts to encourage consumer spending. This would most likely be in the form of tax reliefs including a drop in withholding or income tax rates which would naturally keep fiscal deficit elevated to >14% of GDP particularly also if a partial impact of low oil prices is passed on. Additional stimulus in the form of PSDP spend may be needed however it is uncertain if that can be considered due to fiscal constraints in combatting the virus spread. Hence fiscal spend and deficits will continue to be elevated over the next two years.

Also, tremendous juggling on the part of the government will be needed in assessing outbreaks quickly and limited lockdowns to hotspot areas while allowing broader the business environment to sustain. For this, testing, tracking and close monitoring and coordination will be needed among all provincial and federal bodies – in a manner that does not allow politics to get in the way.

Fiscal Deficit	PKR in Billions		
	FY19	FY20	FY21
Total Revenue	4,901	6,101	4,271
Change %		25%	-30%
Tax revenue	4,473	4,792	3,355
Change %		7%	-30%
Non tax revenue	427	1,309	916
Change %		206%	-30%
Total Expenditure	8,346	10,046	11,005
Change %		20%	10%
Markup payments	2,091	2,724	2,219
Change %		30%	-19%
Other expenditures	6,255	7,322	8,786
Change %		17%	20%
Fiscal Deficit	- 3,445	-3,945	-6,734
Change %		15%	71%
As % of GDP	**-8.9%**	**-9.4%**	**-14.5%**

Focus will turn inwards: local demographics will be our strength … but consumption patterns will change

It seems that many of our weaknesses could well turn out to work in our favor. Limited export base compared to other larger economies will shield us from much of the demand destruction in the West. A young population (70% under the age of 30) indicates a population at fairly low risk from serious Covid19 infection even if infection rates run high. A burgeoning middle class that has binged on retail and consumption spend over the last 10 years appears impatient to return to that lifestyle indicating that it may not be a challenge to lift demand once lockdowns ease and we could well see a strong initial demand surge on lockdown lifting.

However, concepts of social distancing and workplace health and safety may well see demand shift from previous brick and mortar channels to alternative distribution modes. And consumption will most likely be more home-centric with a focus on online education, health, entertainment and so forth. A large chunk of the informal sector that caters to large public events, weddings, social gatherings, public entertainment, retail and even commercial real estate and so forth will have to adapt to a changed environment which would result in definite job losses in one segment and more employment in others as consumers change spending habits.

IT industry has a big opportunity

One of the biggest benefits to Pakistan will be the overnight plunge that most businesses have had to take into the digital space. This will throw our fledgling IT industry heavily into the limelight as work from home, social distancing and so forth become the new normal. We expect a strong demand for business process outsourcing, software development and connectivity over the next year as consumers and businesses alike seek more efficient ways to change business models. The SBP’s National Payments Strategy that seeks to generate inter-operability across all financial institutions could not have been launched at a more opportune time earlier this year; and this should be further sped up to come online earlier than the Dec 2020 projection. Exports, employment and innovation would also rise if this sector is given support.

Supply Chains to become more local

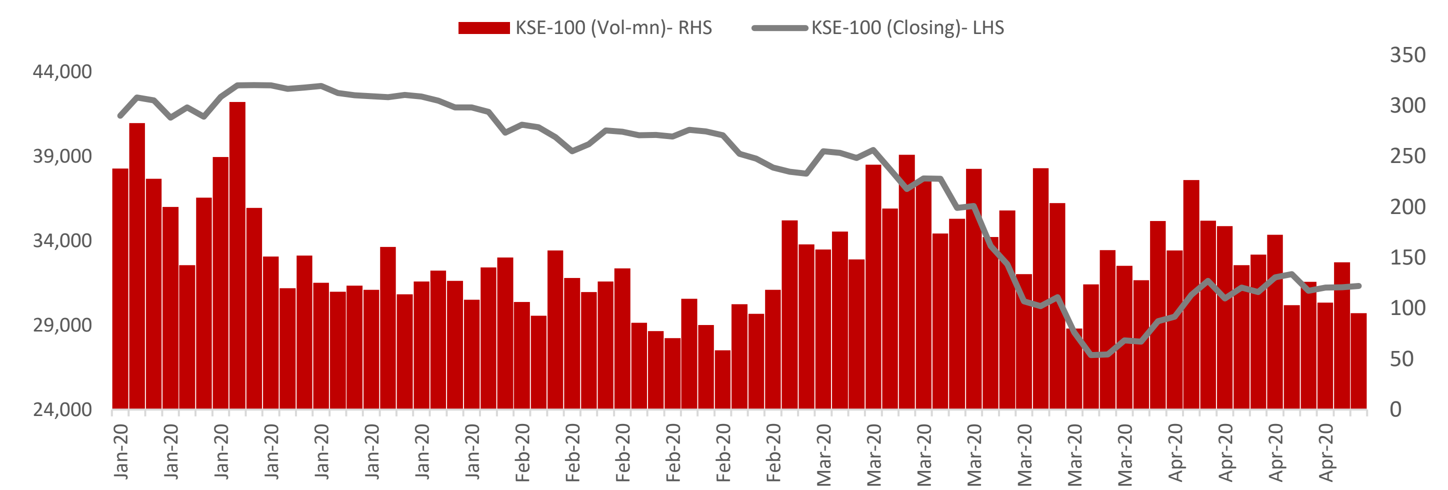
The agricultural economy and supply chains have so far been unaffected and it will be critical that they remain so as Pakistan can meet much of its need for dietary staples with some redirection of crop plantation patterns so that unnecessary imports are also contained. Industrial supply chains need to be reworked to allow for more local sourcing of parts that should help the SME sector flourish.

Nothing is off the table

Broadly, the structural weaknesses that have plagued our economy for decades and resulted in a cash transfer of wealth from the government to the elites now need can be firmly assessed to be more balanced – in particular the starting point should be the energy chain which has benefited dozens of business groups in guaranteed capacity payments and yet lead to tremendous buildup of circular debt. This will only be the beginning of multiple re-negotiations on contractual obligations on the part of businesses and government. Indeed, it seems like an ideal time for governments, businesses and individuals to throw out the old outdated rule book and move towards a more efficient eco system.

Equity Markets – Earnings Decline expected in certain sectors; others remain shielded

Chart 6: PSX has fallen by 24% since 13th Jan, 2020

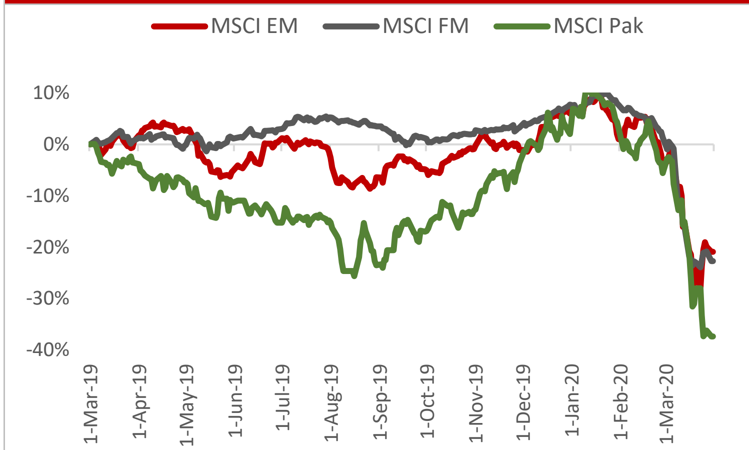


Source: Zakheera, Alfalah Investments

The stock market has dropped ~24% since the peak recorded in Jan 2020 and is up 7.2% since the lockdown announcement. The Chart 5 below, shows the comparison of Pakistan market versus other global indices. Given the severity of the disease appears higher elsewhere, we believe the market is reacting to the social and economic costs of a prolonged lockdown which is being used to contain the spread as well as uncertainty regarding demand resumption post lockdown.

Add to this the tremendous uncertainty of restarting and maintaining business strength in a changed environment. It is quite likely that certain sectoral earnings on the KSE100 will see a significant dip over the remainder of 2020. Stabilization may come through by 2021 but that is very dependent on Covid19 vaccine or treatment.

Chart 7: MSCI Pak Vs MSCI EM and FM Markets



Source: Bloomberg, Alfalah Investments

Chart 8: Forward PER at multi-year lows…

Source: Bloomberg, Alfalah Investments

In any case we should expect continued volatility as events unfold; however, for the time being we think that the bulk of the correction for Pakistan equity market may have taken place however we do highlight that room for further downside may exist. The upcoming two earnings season in June 2020 and September 2020 will provide a true gauge for the extent of business impact

Fixed income – rapid capital gains fast coming to an end;

On the fixed income side, we continue to expect a fairly rapid decline in interest rates towards 7.0% and continued policy action particularly on the export and industry front. This should lead to an across the board decline in secondary market yields on all treasury instruments. Thereafter we do expect steady single digit yields post 2020. Resumption of IMFs EFF and new conditions that may be attached to that would also dictate policy action going forward.