Chapter 5 Financial Markets

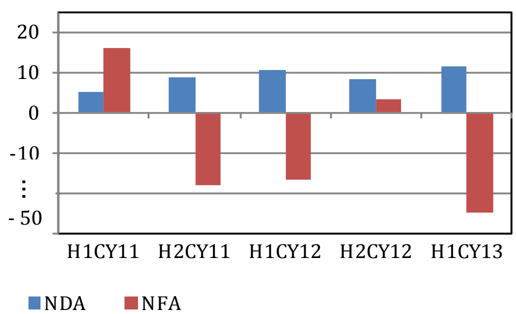
Twin deficits and sluggish macroeconomic performance (except for declining inflation) continued to test the financial markets during H1-CY13. The money market largely relied on substantial OMO injections by the central bank to maintain sufficient market liquidity, which remained under stress due to unpredictability of high Government financing needs. Similarly, the Foreign Exchange market also remained volatile and the market sentiment remained passive as current account turned negative and the FX reserves held with the central bank continued to decrease. Meanwhile, the bullish sentiments in the equity market further gained momentum and the index surged by 24.2 percent during the period on account of favorable corporate earnings, dividend expectations and smooth transition of the political process.

Money Market liquidity and depleting reserves tested financial markets

Financial markets remained largely resilient against economic challenges primarily emanating from persistent twin deficits and non-conducive business conditions (private sector crowding-out, energy shortages, law and order concerns etc). The markets were testing during H1-CY13 due to heavy fiscal borrowings, exchange rate volatility and negative market sentiments in response to depleting foreign exchange reserves. Despite these adverse developments, the financial markets exhibited reasonable performance and continued to provide intermediation to various economic segments during H1-CY13.

Figure 5.1

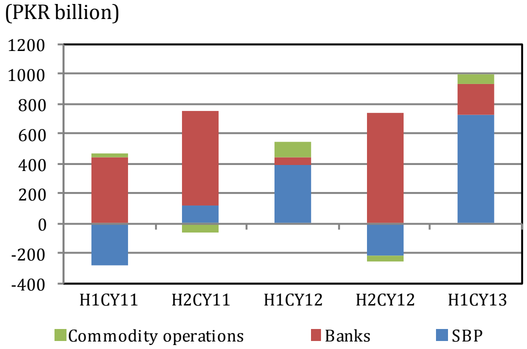
Half-yearly trends in M2 (percent change)



The money market witnessed stress in liquidity due to surge in the Government funding needs to bridge revenue-expenditure gap. Similarly, the FX market also remained under pressure as the current account deficit exacerbated and reserves depleted. However, the exchange rate (PKR/USD) depreciated by only 2.5 percent during the period. The equity market remained bullish and the benchmark KSE-100 index further increased to 21,005 points, showing a growth of 24.2 percent during H1-CY13 largely due to increased corporate profitability in line with the market expectations and dividend payouts.

Figure 5.2

Pattern of Government Borrowings - Half-Yealy Flows (PKR billion)



The rising Government borrowings further increased the Net Domestic Assets (NDA) of the banking system by 11.5 percent (**Figure 5.1**). A consistent decline in FX reserves owing to repayment of IMF loans dampened the Net Foreign Assets (NFA) by 50.9 percent during the period. This further enhanced the Government financing requirements, most of which were met through central bank borrowings as the banks' appetite relatively subdued on account of unattractive return on investments and to some extent, due to liquidity strain in the money market (**Figure 5.2**).

Figure 5.3

Trend of overnight Repo Rates (percent)

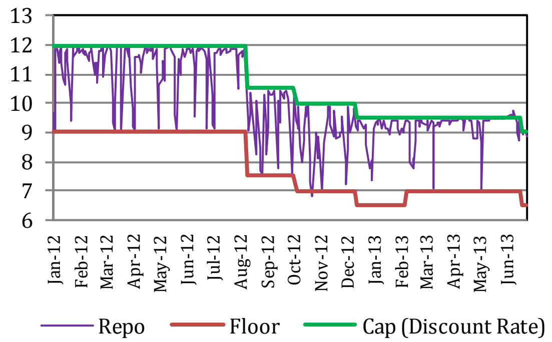


Figure 5.4

Outstanding Open Market Operations (PKR billion)

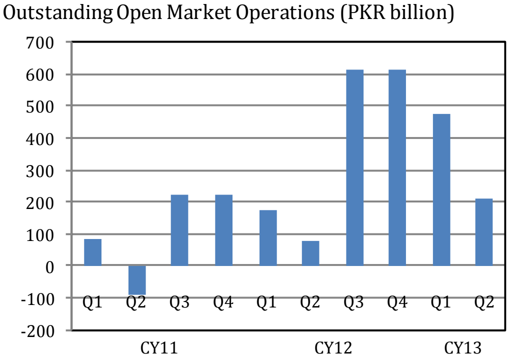
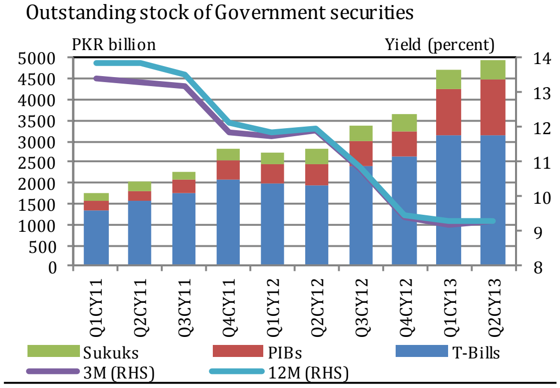


Figure 5.5

Outstanding stock of Government securities



Money Market

The money market remained relatively under stress despite various measures taken by SBP including narrowing down of interest rate corridor by 50 bps[43] with the objective of managing exchange rate stability and controlling excess money supply (**Figure 5.3**). The latter objective remained unfulfilled due to increased reliance of the Government on SBP for managing its fiscal needs. In the meantime, gradual decline in OMOs, led banks to recourse to interbank window for meeting short term liquidity needs particularly in the second quarter of the year[44] (**Figure 5.4**). As a result, the overnight rate – a measure of market liquidity remained close to the ceiling of the interest rate corridor during most of the half year.

During H1-CY13, the Government increased borrowings from the banking system particularly the Central bank as it was not able to raise required funds from the market participants. The Federal Government borrowed PKR 665 billion mostly to roll over the maturing T-bills and increased expenses in the last quarter of the fiscal year including retirement of circular debt[45]. Meanwhile, the banks remained wary of investing in shorter-term securities in expectation of decline in discount rate. The stock of T-Bills witnessed deceleration during H1CY13 compared to increasing trend in last few years, while investment in PIBs grew substantially particularly in the Apr-Jun quarter due to settlement of inter-corporate circular debt (**Figure 5.5**).

Auction profile of Government debt instruments posed mix picture

The auction of T-bills in general remained dismal until the announcement of election results in mid of May CY13. The offer to target ratio which started at 1.88 for first two T-bill auctions in month of January, 2013 reduced to as low as 0.57 during February auctions. During the first quarter, the aggregate offer to target ratio remained 1.38. However, post-election, the bidding patterns improved and the average offer to target ratio reached 1.5. Overall, the ratio deteriorated from 1.73 in H2-CY12 to 1.25 in H1-CY13 (**Figure 5.6**). This change in behavior of the market resulted from unattractive yields on short-term instrument and unpredictable behavior of government borrowings.

[43] The Monetary Policy Statement announced in Feb 2014 narrowed the interest rate corridor (Discount rate – Repo rate) from 300bps to 250bps.
[44] The banks accessed the discount window 102 times during the second quarter of CY13 as against 57 times in the first quarter.
[45] The reduction in circular debt was arranged through a dynamic funding mechanism that included settlement through cash, issuance of PIBs and adjustment for receivable dividends by the incumbent Government.

Figure 5.6

Profile of T-bill Auctions (PKR billion)

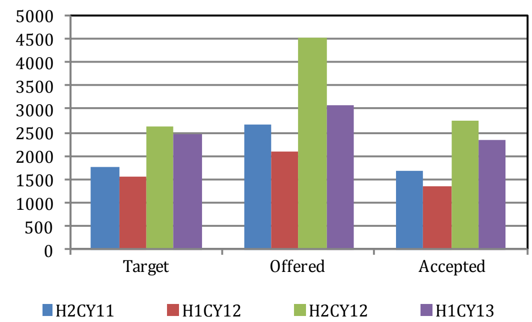


Figure 5.7

T-Bill Tenure offered (percent share)

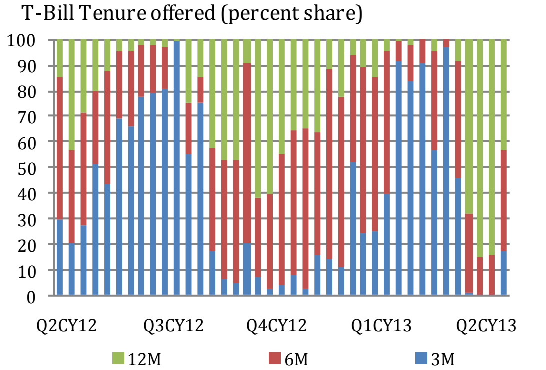


Figure 5.8

Fluctuating share of Non-Competitive Bids

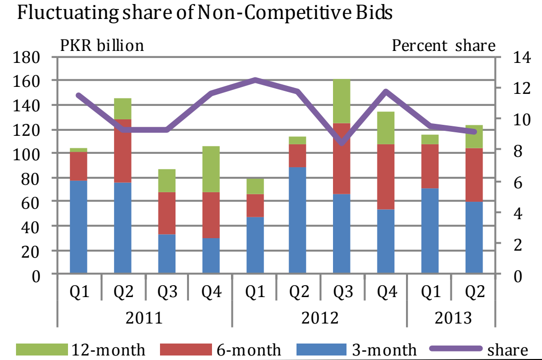
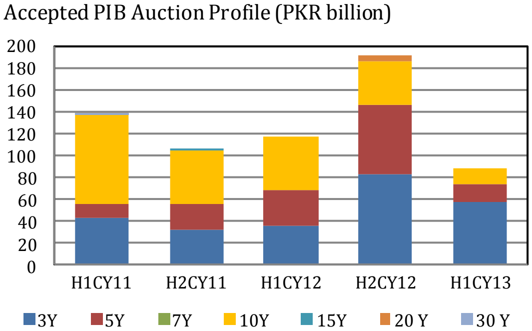


Figure 5.9

Accepted PIB Auction Profile (PKR billion)



The discount rate remained at 9.5 percent throughout the half year, before 50 bps cut in the last week of the June, 2013. The market perceived the rate to remain unchanged and subsequently, banks offered more in 6-month T-bills during Jan-Feb CY13. However, as the banks expected an increase in the discount rate, the 3-month bids offered rose sharply. Later on, as the inflation rate subsided to 5.1 percent in May CY13 (YoY basis) and with positive sentiments following the 11th May, 2013 election, the banks perceived the discount rate to decline, which increased the offers for 12-month T-bills to average 66 percent in May-Jun CY13 period (**Figure 5.7**).

Besides, the participation of financial institutions in T-bill auctions, the Government also provided investment opportunities to general public and businesses through Non-Competitive Bids (NCBs). However, following the trend in T-bill auctions, the NCB acceptance also remained dull during the first quarter of CY13 and the acceptance ratio declined from 11.7 percent in Dec CY12 to 9.5 percent in Mar CY13 quarter. Though, the volume of NCBs increased in the second quarter, the higher acceptance of T-bills further reduced the ratio to 9.3 percent in Jun CY13 (**Figure 5.8**). A decline in NCBs can be explained in terms of higher yields available elsewhere to investors such as the equity market.

The PIB auctions also witnessed a mix picture during the first half CY13 as the Government rejected all the offered bids of PKR 70 billion against the target of PKR 75 billion during Q1-CY13 on account of higher offer rates by the bidders (banks and financial institutions). Meanwhile, the three auctions that took place in Q2-CY13 saw very high offerings (offerings of PKR 189 billion against the target amount of PKR 75 billion and the acceptance of PKR 87.3 billion). In line with the trend, most of the PIB subscriptions were predominately of 3-year tenure (**Figure 5.9**). The investors remained cautious of investing in longer tenure of 15-30 years on account of maturity mismatches (non-availability of long-term funding) and also due to high degree of macroeconomic and geo-political uncertainty involved in long term placements.

In addition to conventional modes of raising debt, the Government also borrowed by issuing Ijarah Sukuks. However, like the conventional debt instruments, PIBs and T-bills, the auction of Ijarah has also been relatively dull during H1-CY13 (**Figure 5.10**). A single issue of PKR 43 billion was targeted which was well received by the dealers with an offer to target ratio of 2.0. Despite enormous demand for Ijarah Sukuks by Shariah compliant and conventional financial institutions alike,

Figure 5.10

Auction Profile of Ijara Sukuk (PKR billion)

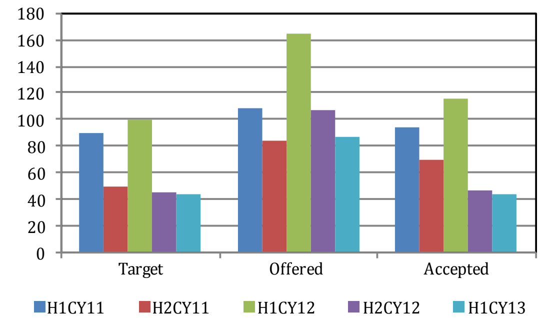


Figure 5.11

Yield Curve (percent)

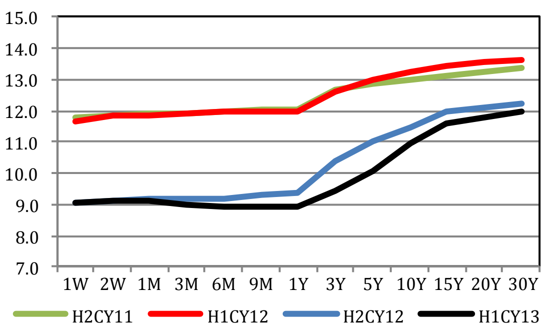
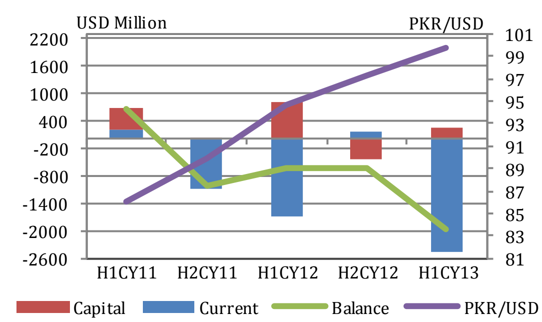


Figure 5.12

Developments in External Account



the size of Ijarah is strictly limited as it is backed by physical assets thereby imposes a limit on Government's ability to generate debt from Sukuks.

The yield curve after the announcement of 50bps reduction in the discount rate period (Jun CY13) revealed the limited effectiveness of the central bank decision on market as the short-term rates (1 week to 3 months) remained almost unchanged. This is also indicative of excess demand for market liquidity. Similarly, the PKRV rates[46] for medium term (3 months to 1 year) show a moderate downslide in response to 50bps reduction in the policy discount rate. However, the impact of monetary easing has been highest on 3 to 10 years maturities which saw an average of 82 bps reduction in the rates (**Figure 5.11**).

Foreign Exchange Market

Drying up of international flows kept the FX market under stress

The FX market witnessed stress on account of volatility in the exchange rates as the current account turned negative in addition to continuous decline in international reserves. The start of H1-CY13 was optimistic as current account registered a surplus in last half of CY12[47]. But this trend could not be continued as current account deficit swelled to USD 2.5 billion in H1-CY13 along with weak foreign exchange reserve position, which created a self-enforcing sentiment of further decline in PKR/USD parity. Particularly, dried net financial flows and continued hefty payments of IMF loans, the country's foreign exchange reserves depleted to US $ 6.01 billion[48] (**Figure 5.12**). As a result, the PKR/USD rate remained volatile both in the interbank and the kerb markets. However, with prudent interventions by the central bank[49], the PKR/USD exchange rate depreciated marginally by 2.5 percent at the end of the first half CY13 (5.1 percent for FY13) thus keeping the FX market relatively stable.

[46] The Pakistan Revaluation Rates (PKRV) are calculated by money market dealers on daily basis and are used for revaluation of Government securities.

[47] Most of this improvement is due to the receipt of US $1.8 billion under the Coalition Support Fund (CSF).

[48] Liquid FX reserves held with banks = banks' FX deposits – FX financing. The total liquid FX reserves stood at USD 11 billion including USD 6.01 billion held with SBP while USD 5.01 billion held with the commercial banks as deposits.

[49] In terms of MPS of Sep-2013, the SBP not only intervened in the FX market but also through monetary management kept the rates on rupee dominated bonds higher than on assets denominated in foreign currencies. Further, due to liquidity strain in the money market, the banks in order to avoid higher cost of OMO maintained rupee liquidity by rolling over their forward foreign exchange transactions with the central bank thus helping in stabilizing the exchange rate.

Figure 5.13

KERB Exchange Rate and Premium

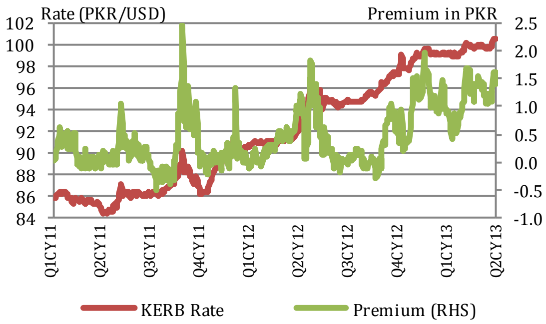


Figure 5.14

Foreign Exchange Reserves and Import Coverage

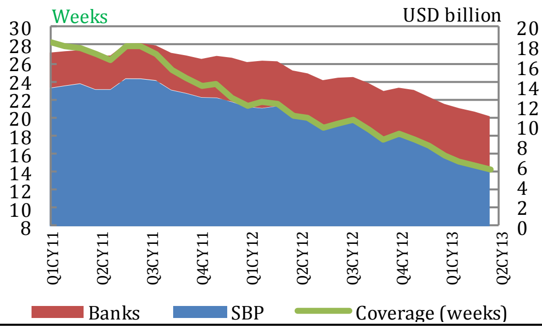


Figure 5.15

KSE-100 Index and Trading Volumes

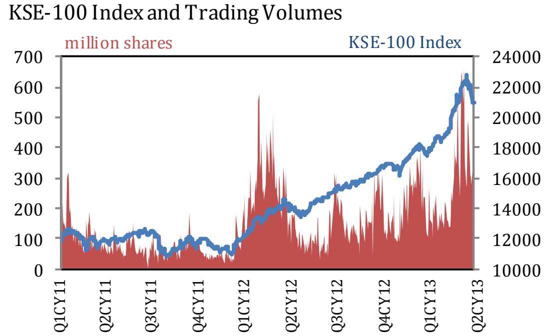
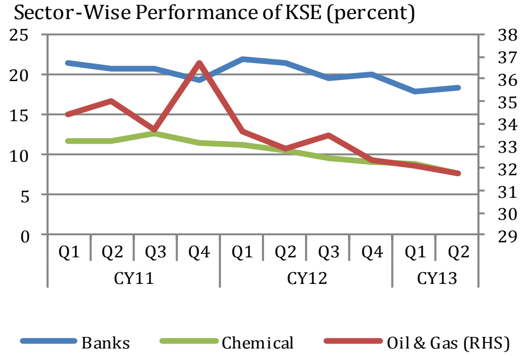


Figure 5.16

Sector-Wise Performance of KSE (percent)



The kerb market exhibited even more volatility on account of sluggish economy, tapering off of worker's remittances[50], and uncertain political environment during pre-election period. Moreover, the gradual decline in FX reserves resulted in market's perception about central bank's limited ability to intervene in the market. As a result, the kerb market besides witnessing fluctuations in the exchange rate also saw kerb premium increased from PKR 0.25 during H2-CY12 upto PKR 1.96 during H1-CY13 (**Figure 5.13**). Additonal, the import coverage slashed from 18 weeks during Dec CY12 to 14.3 weeks at the end of H1-CY13 (**Figure 5.14**).

Capital Markets

Equity Market kept on making new records

The bullish sentiment gained further momentum in the leading equity market of the country, leading to sharp rise in equity prices during H1-CY13. The Karachi Stock Exchange (KSE) benchmark KSE-100 index surged by 24.2 percent during H1-CY13 and 52.2 percent for the year 2012-13 (**Figure 5.15**). The index kept on reaching historical highs throughout the half year, with some correction in post federal budget announcement.

The surge in index was despite the adverse developments in macroeconomic environment mainly in the external sector and constant depreciation of the domestic currency. However, strong corporate sector profitability, expectations of higher dividend payouts and smooth political transition after the general elections enhanced the local and foreign interests in the market. Likewise, the turnover – a measure of investors' interest, also improved drastically to 251 million shares as against 147 million shares in previous half.

In terms of international comparison, the KSE outperformed other regional and world stock exchanges. In fact, many of the leading emerging and BRICS countries posted negative growth in its equity market indices. This is also reflected in the MSCI emerging market index that witnessed a decline of 10.9 percent during H1-CY13 (**Table 5.1**).

Corporate Sector performance drive market momentum

Though, the growth in the benchmark KSE-100 index was robust, it varied across the sectors listed in the equity market. The

[50] Workers remittance declined in Jan 2013 stimulating KERB premium reaching highest level of 1.96, while it came down and touched its lowest in H1-CY13 (0.39 per dollar) in March 2013 as the flow of workers' remittances increased in the month of March and April 2013.

Table 5.1: World Equity Market Indices

	29 Jun 12	31 Dec 12	28 Jun 13	%Δ-H1CY13
USA (DJIA)	12880.1	13104.1	14909.6	13.8
USA(NAScomp)	2935.1	3019.5	3403.2	12.7
China (SSEA)	2225.4	2269.1	1979.2	-12.8
Japan (Nikkei)	9006.7	10395.1	13677.3	31.6
Britian (FTSE)	5571.1	5897.8	6215.4	5.4
France (CAC)	3195.6	3641.0	3738.9	2.7
Russia (RTI)	1350.5	1526.9	1275.0	-16.5
Germany (DAX)	6416.2	7612.3	7959.2	4.6
Turkey (ISE)	62543.4	78208.4	76294.5	-2.4
India (BSE)	17429.9	19426.7	19395.8	-0.2
Indonesia (JSE)	3955.5	4316.6	4818.8	11.6
Malaysia (KLSE)	1599.1	1688.9	1773.5	5.0
Pakistan (KSE)	13801.4	16905.3	21005.6	24.3
Singapore (STI)	2878.4	3167.0	3150.4	-0.5
Thailand (SET)	1172.1	1391.9	1451.9	4.3
Argentina (MERV	2346.6	2854.2	2976.2	4.3
Brazil (BVSP)	35354.6	60952.0	47457.1	-22.1
MSCI Developed	1235.7	1338.5	1433.5	7.1
MSCI Emerging	937.3	1055.2	940.3	-10.9

Source: Bloomberg

concentration in market capitalization and turnover also augmented during the period. Specifically, the turnover in the banking sector scrip boosted during last two months of H1CY13. While in terms of market performance, the share of oil and gas sector continued to dominate the market capitalization on account of improved profitability thus attracting investors' interests (**Figure 5.16**).

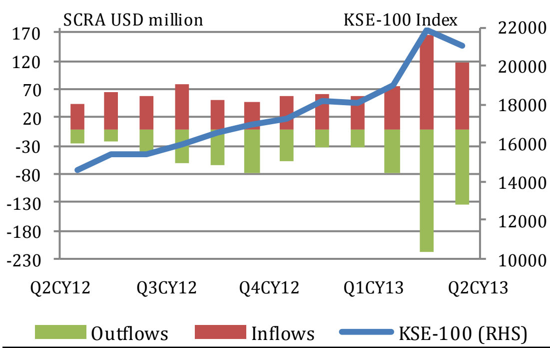
The corporate results played an integral part in the bullish behavior of the KSE. Nearly all the major listed sectors witnessed improved profitability (**Table 5.2**)[51]. As discussed earlier, banks' profitability declined on account of declining yields on government securities while the profits of oil and gas boosted on realization of receivables and increased revenues. Furthermore, owing to improvements in the equity markets and favorable yields on long-term securities, the profitability of the Modaraba Companies and Mutual funds (Mod/MF) also boosted during H1-CY13.

SCRA flows are source of concern

The improved corporate profitability and booming stock indices, attracted foreign interest and liquidity, which augmented the overall market momentum[52]. The gross SCRA inflows improved to USD 538.5 million during H1-CY13 showing an improvement of 56.9 percent over the preceding half year. However, the SCRA investments remained short-lived and heavy outflows were witnessed in the last two months in expectations of market correction on account of federal budget. Accordingly, the net SCRA flow for H1-CY13 remained negative USD 16.2 million as against positive USD 246.6 million during H2-CY12 (**Figure 5.17**). These heavy outflows pose a significant risk as it reduces stock prices and aggravates volatility. The effect of foreign outflows trickled-down on local investors leading to further correction in the index in the latter part of the H1-CY13.

Figure 5.17

KSE-100 Index and SCRA flows



[51] The Table 5.1 presents the half-yearly results announced by the listed companies until 30th August 2013.
[52] One such measure of attracting foreign investors is P/E (Price to Earnings ratio). The KSE traded at a price-equity ratio of 7.5x (multiple) meanwhile, the regional markets traded at 11.5x during H1-CY13 implying the KSE traded at discount.

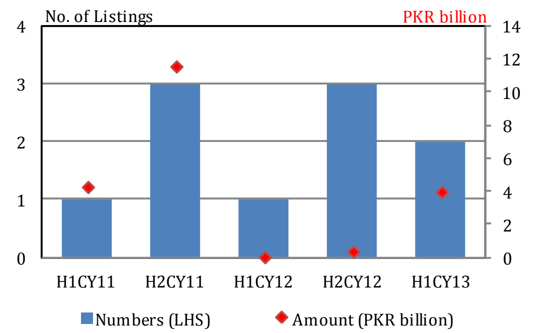
Table 5.2

Improved Corporate Profitability (PKR billion)

	CY10	CY11	CY12	H1-CY13
Oil and Gas	162.11	196.11	240.5	250.49
Banks	107.84	158.82	172.2	84.31
Chemical	44.26	70.37	54.45	10.67
Cement	-5.63	4.2	24.58	8.14
Food	18.47	24.56	28.83	16.82
Power	-0.917	5.43	23.23	33.03
Textiles	30.54	35.43	16.51	3.62
Auto	7.47	7.65	11.19	6.28
Telecom	11.12	4.88	10.23	-3.69
Insurance	4.65	5.51	9.6	8.01
Pharma	5.21	6.44	7.71	3.73
Engineering	11.52	9.03	5.87	13.94
Mod/ MF	2.82	4.95	3.73	13.84
Transport	2.66	3.02	1.92	1.72
NBFC	-10.52	-2.33	1.64	0.82

Figure 5.18

Equity Listings in KSE



Profile of Equity and Debt markets continued to strengthen.

In addition to a record equity market performance, the listings in the equity and debt markets also carried on from the trend of previous half-year. The two new listings increased the listed capital by PKR 4 billion which is far more than the capital listed during CY12. Moreover, as the power sector remained dominant in getting bank credit recently, the equity market also witnessed a number of listings in the power sector (**Figure 5.18**).

The listing of debt instruments also observed some improvement as Term Finance Certificates (TFCs) worth of PKR 7 billion were listed during the half year as against PKR 5.2 billion in the previous half year. Banks listed of six new TFCs for meeting for the regulatory capital requirements and for meeting long-term financing needs. In addition, two TFCs of oil and gas sector were also listed during the period. With some improvement in economic and business environment, it is expected that the listing trend will further boost in future.