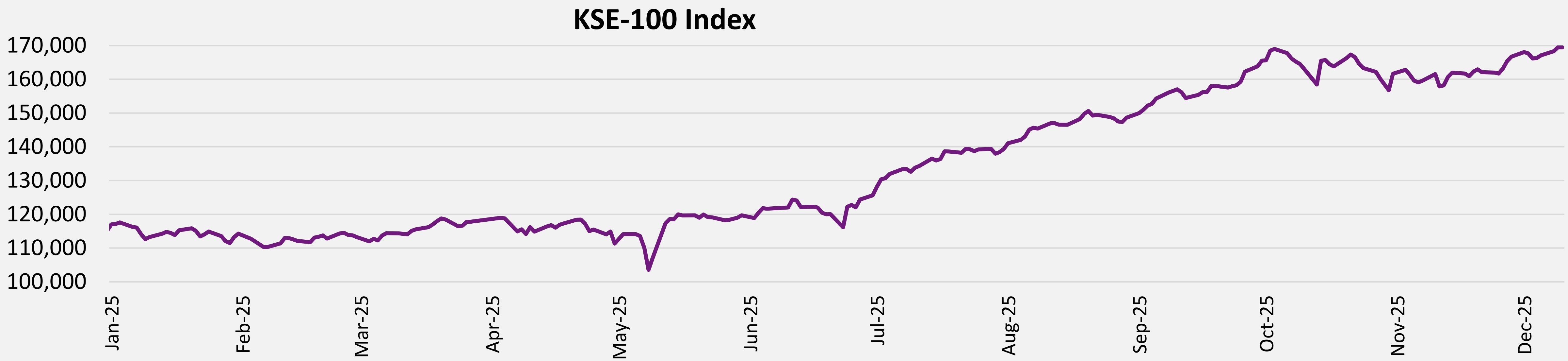
KSE100 Index touches a new high

Next triggers?

With market multiples rebounding from a low of 3x to now near its historical average of 8x in a span of 2-3 years, and KSE100 Index touching its all-time high levels at 170,000, **investors now look forward to the next triggers.**



We analyze various macro economic indicators, identifying the **two highly correlated macro indicators** that heavily **influence investor confidence, reflected in the market's P/E ratio:**

1. **External stability** – a key pivot of the macroeconomic landscape
2. **How normalized is inflation** – for a predictable purchasing power and cost of capital

Reserves, FCY stability and inflation

Interconnected factors

WHY THESE FACTORS?

The flow charts below explain how **both factors are interconnected.**

When FX reserves are sufficient:	**When FX reserves are low:**
Comfort on currency	Demand of US$ increases
Stable PKR/US$ or gradual and low single-digit devaluation	Pressure on PKR/US$ - currency devaluation shocks
~50% of inflation basket directly/indirectly impacted by PKR/US$	~50% of inflation basket directly/indirectly impacted by PKR/US$
Stable inflation and interest rates	Increase in inflation and interest rates
Investors maintain confidence on all asset classes	**Investors shift to lower risk asset classes**

How correlated are these with KSE100 Index valuation? We present ahead.

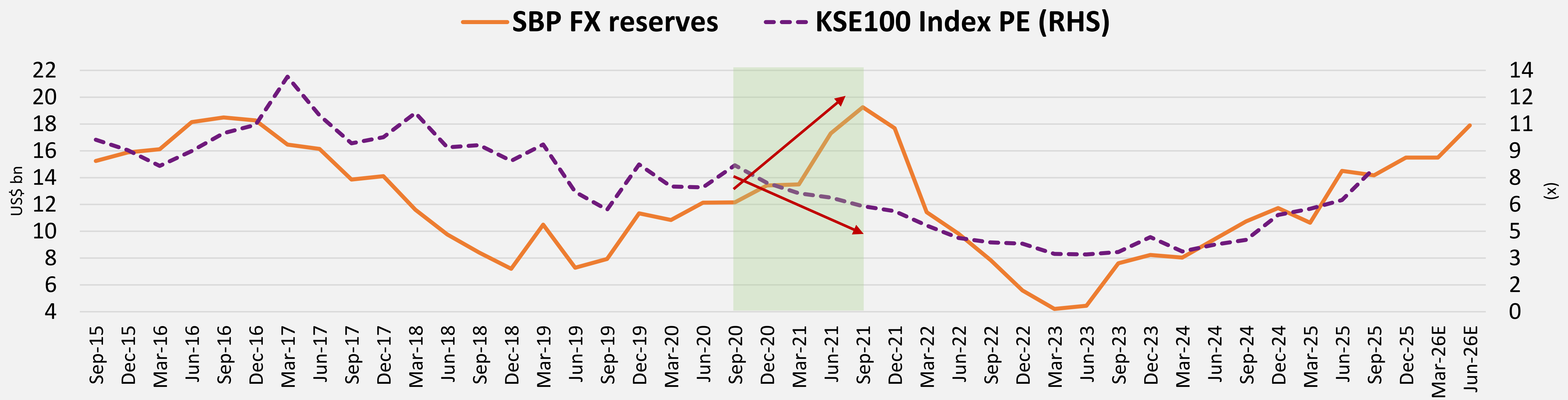
Securing external stability

To ensure lesser PKR/US$ shocks

1 **Historical data suggests the notion that the KSE-100 Price-to-Earnings (P/E) ratio — market's key valuation metric — mirrors Pakistan's external account health.**

Charting the P/E ratio vs foreign reserves depicts the correlation to a certain extent but does not capture the complete picture.

This was evident from late-2020 to 2021 (*the shaded part*) when reserves rose, but P/E de-rated as this excludes a vital element which we discuss in the next slide**.**

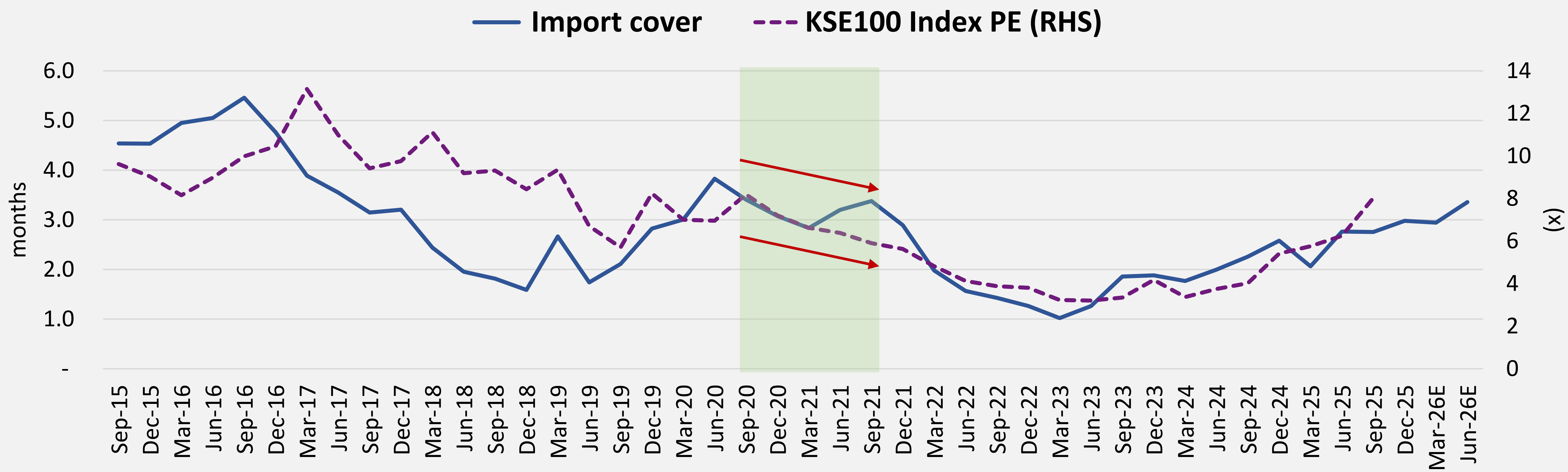


Securing external stability

To ensure lesser PKR/US$ shocks

The P/E ratio tracks Import Cover more closely than absolute FX Reserves levels because this compares the adequacy of the foreign reserves in relation to the import needs of the country – a key distinction that is missed out when looking at FX reserves only.

Revisiting the late-2020 to 2021 (*the shaded part*) reflects this as rising reserves were not sufficient to cover the import needs and **hence investors kept assigning a lower P/E ratio to the market as import cover slipped.**



Healthier import cover, driven by foreign flows, should help P/E ratio sustain / re-rate, providing impetus to the market.

Avoiding CPI shocks

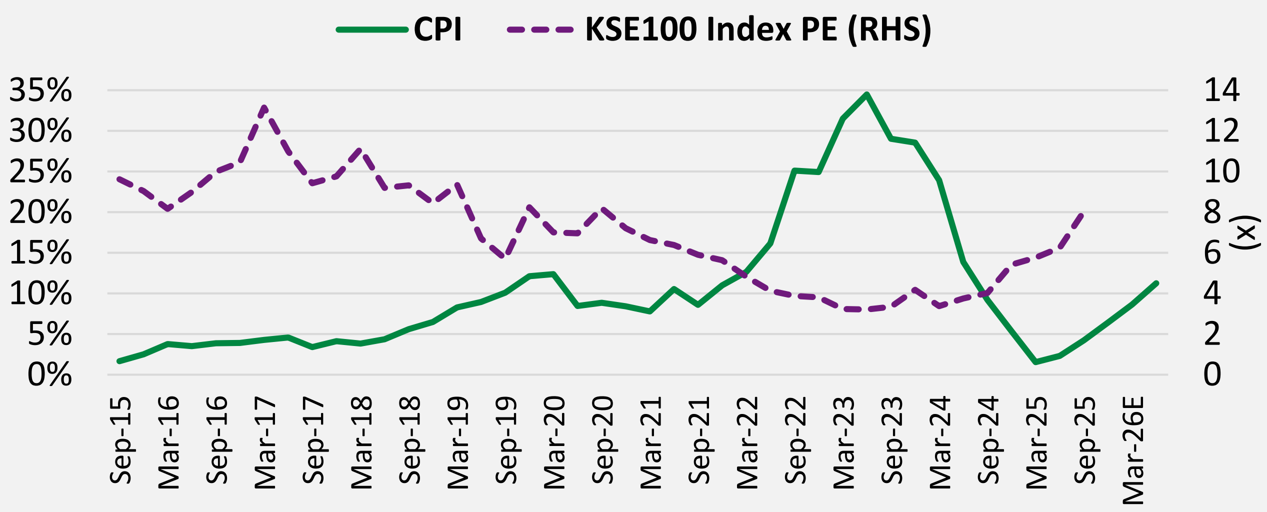
The inverse link with P/E

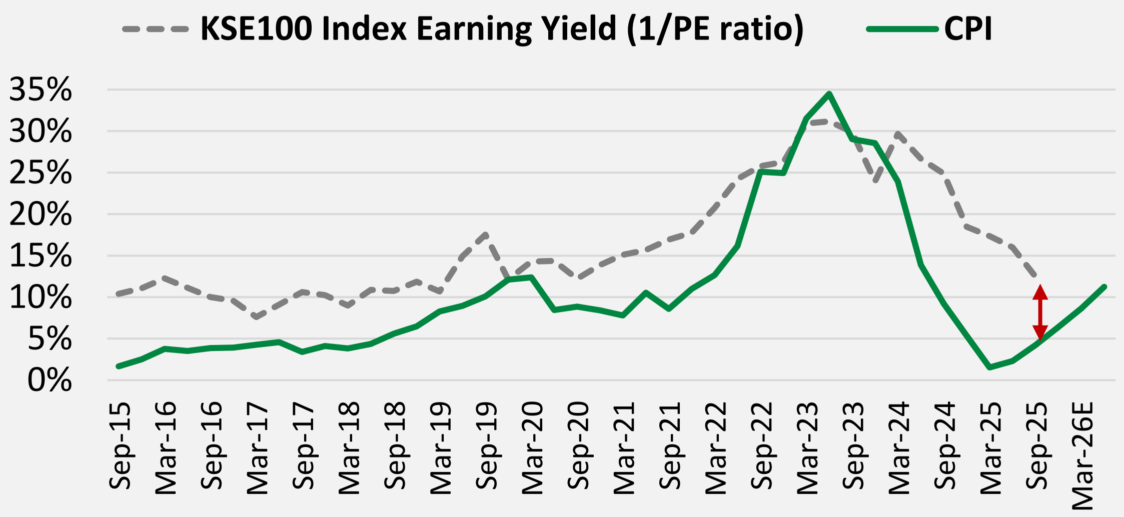
2

As external stability minimizes PKR/US$ volatility, it assures investors absence of inflationary shocks, and hence relatively normalized CPI.

In the left chart below, when inflation goes up, the market P/E goes down as investors are willing to pay less for stocks because their future money is worth less. Earnings Yield is just the P/E ratio flipped upside down (Earnings/Price), hence, the **chart on the right side below** depicts Earnings Yield moving in the same direction as inflation.

To note, market has continued to factor ***forward long-term CPI****, ignoring recent 2%-6% CPI anomaly.*





Stable inflation trend should support investor confidence on corporate profitability growth – propelling organic market momentum; which will be compounded further by re-rating as confidence on import cover outlook increases.

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