Azimut Pakistan Equity Fund

May 2020 – Markets & Sectors Outlook

AZIMUT
DEFINING INVESTMENT DIRECTION

Economic Update

After a weak month of April due to the COVID-19 lockdown, the economy began to crawl back to life in May as easing restrictions in the lead up to Eid celebrations saw a pick-up in activity. Inflation continued to slow as the government passed on the impact of lower oil prices and interest rates dropped again in line with our expectations.

Our projections suggest further sharp dip in inflation in the second half of 2020, due to lower oil prices and lower overall demand. We expect YoY inflation to drop to around 6% mark by the last quarter of 2020 which should bring interest rates into the 7.0%-7.5% range i.e. an additional 100-150bps easing from here.

Current account deficit (CAD) for the month of Apr plunged to USD 572 mn compared to USD 1,165mn for Apr'19. The decline in CAD was driven by 26% YoY decline in total imports along with a 1% YoY rise in remittances during Apr. On a MoM basis remittance declined by 6% taking the 10MFY20 remittances to USD 18,782mn (up 6% YoY) compared to USD 17,801mn during 10MFY19. However, as expected exports also fell by 30% YoY during Apr due to global lockdowns. We expect May numbers to demonstrate a sharp rebound as world markets began to open up and exports orders re- established. We expect CAD levels to stay manageable at 1.5% - 2.0% of GDP for 2021 and committed support from IMF and other multilateral agencies will keep the devaluation of PKR against the USD to the tune of 5%-7% p.a., in line with our expectations.

On the policy front, in a scheduled MPS meeting on 15th May, 2020 State Bank of Pakistan decided to further cut the Policy Rate by 100 bps to 8%. This was the fourth cut in the policy rate since mid-March, taking cumulative easing to 525bps. The reasons cited by SBP for this decision were significant decrease in oil prices, improved inflation outlook, and the slowdown in overall demand due to outbreak of Coronavirus.

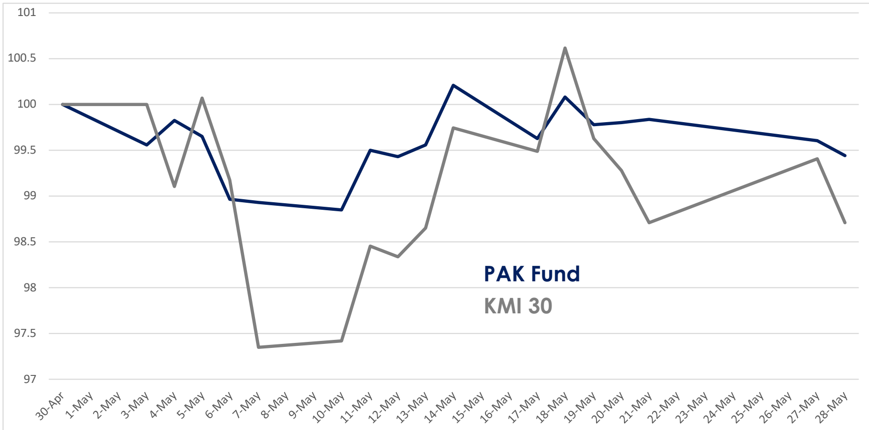
Market Performance

The KMI-30 was flat in May 2020 (down 0.5% MoM), taking CYTD decline to 15%. There were some positive triggers, including the lifting of lockdown conditions by the government and the cut in policy rate further by 100bps to 8% by the SBP. However, the market reacted earlier in April to these developments as it rebounded approx. 33% from its low in March. Much of May focused on earnings announcements keeping markets range-bound as it absorbed the future impact of COVID-19 on earnings attrition. Ramadan also kept trading activity somewhat lower and we expect better market performance post Eid break in early June.

Notable sectors which generated the largest monthly contribution to the KMI30 Index were E&P (+4.6% return), food & Personal care (+8.9% return) and pharmaceuticals (+7.7% return). Major laggards this month were Fertilizers (-2.6% return), Power Generation (-5.3% return), Cements (-3.1% return) and Textile composite (-3.1% ret

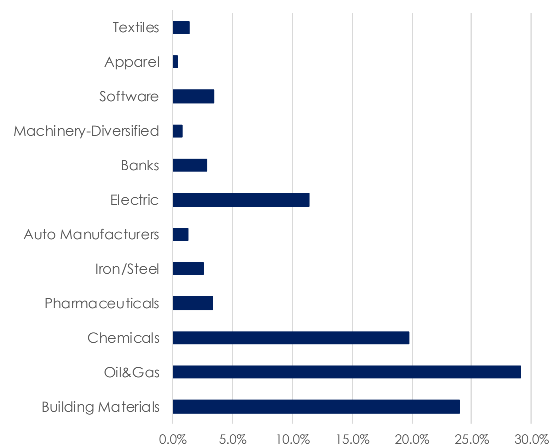
Our Performance, Exposures & Strategy

We continue to build positions in the market and we raised overall exposure to equities to approx. 40% from 20% in early April. As per our expectations we have witnessed slight recovery (prices up 1.5% - 2%) on the debt side as well during the month under review. The fund has returned +7.3% since hitting its bottom. We will continue to build towards 50% exposure in equities initially with a strict buy on dips strategy and then target 60-65% as confidence builds on the sustainability of the economic recovery.



Brief Overview of the favored sectors

As mentioned previously as well, the potential for recovery in underlying assets of the fund is high both on the equity and the fixed income side. Our allocation on the equity side is focused on quality stocks across various sectors, especially those which have more earnings visibility going forward, safer demand/supply dynamics in the current situation and will recover fast given any reversal in economic activity. Our portfolio has a forward Price-to-Earnings (P/E) multiple of approx. 6.5x against the 10- year market average of 8x. Cements, Oil and Gas Exploration, Fertilizers and Power Generation & distribution sectors constitutes approximately 75% of our equity portfolio. Our investment thesis for these sectors is listed below.



Cements

Domestic demand theme mainly due to

a) Population size of more than 200mn
b) Strong propensity to spend (household consumption = 83% of GDP)
c) Focus of the government on the construction sector

Steep monetary easing, soft coal prices and price recovery after a 3-year expansion cycle will only boost sector's profitability

Fiscal stimulus by the Government with kick start of mega projects like Dams construction and low budget housing scheme supports our view of having a positive stance on the sector

Oil & Gas Exploration

At a sustainable oil price of USD 30 and lower interest rate environment, selective stocks in the E&P space are very cheap on valuation basis. As economies have eased lockdowns we have seen oil prices jump from their lows seen in April. On the back of more demand with economies attaining normalcy we expect E&P companies to further perform in the short to medium term.

Fertilizers

We expect the fertilizer off take to remain intact in the current scenario as the Government focus would be to ensure food security.
The stocks we have in the Fertilizer space have sustainable earnings and offers double digit dividend yield in current scenario.

Power Generation & Distribution

Our preferred play in power sector is HUBC as we consider it one of the safest and lucrative growth company which offers significant earnings growth on the back of timely investments in key projects. The return on these projects offers a guaranteed ROE and are hedged to both inflation and USD, making it less prone to economic shocks.

Future Outlook

We believe that governments focus is now firmly on reviving economic growth thereby relegating Covid19 to a health issue rather than an economic issue. As lockdowns ease across the world over June-July, the markets should respond positively to a revival of this economic activity. Upcoming events include the government's fiscal budget announcement in mid-June 2020 which will set the tone for further stimulus measures. Fiscal space remains limited, however given the circumstances, we may be in for an expansionary budget via tax reliefs in certain segments. Revival in corporate operations post easing of lockdown and resultant increased demand along with government efforts to restore the economic activity will improve the investor sentiment and market performance.