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LEADING INDEPENDENT ANALYSIS OF IRAN'S ECONOMY

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Stockmarket Tips

Market overview:
The stock market is likely to continue to rise, fuelled by negative real interest rates, causing savings to leave the banking sector for the stock market. However, the fundamentals are looking increasingly shaky – it is hard to envisage earnings growth in the stock market when our GDP forecast for 2011 is -1%. Furthermore, the current cash crisis is paralysing 70% – 80% of the manufacturing sector, which cannot access working capital for its business, or foreign currency for raw material imports. Our economists believe that Tehran Stock Exchange earnings will have to be revised down sharply. Investors with a strong stomach may still make money in the forthcoming months but the risks of a sharp correction are growing.

We advise investors to move into defensive stocks with good cash flow, such as exporters who are benefiting from the recent devaluation of the Rial. Investors should also increase holdings in cash (USD and EUR) and gold. We suggest investors move out of banking stocks as negative real interest rates are causing a flight from bank deposits, damaging loan-to-deposit ratios. Investors need to take care in choosing defensive stocks – if energy cards are introduced in lieu of cash subsidy payments, some of the burden of subsidy payments could shift to the utility companies.

Stock recommendations: As predicted in our last newsletter, in late June US Treasury sanctioned Tidewater (TAYD1). Other companies associated with the Islamic Revolutionary Guard Corps (IRGC) may also be sanctioned, including Iran Telecom Company (MKBT1) and Mapna (MAPN1). **SELL.**

Fundamentals remain strong for the copper industry, including Bahonar Copper (BAHN). **BUY.**

Insights – Collapsing Rial and Risk of Hyperinflation.

Central Bank of Iran (CBI) officials are worried about whether they can prevent an economic collapse. Iran is experiencing negative real interest rates (inflation 40%; interest rates 15%). In order to hedge against inflation Iranians are moving their savings out of the banking system and into other assets: the Iranian housing market has recently experienced a mini boom and a large bubble is developing in the stock market. Of even greater concern to economists is the capital flight into precious metals and foreign currencies, most notably USD and EUR. The rush to buy USD, which is in increasingly short supply, continues to put pressure on the Rial. For months, the CBI has been using up precious reserves of USD and EUR to defend the Rial and is depleting reserves by filling orders at the official rate rather than the unofficial rate. The marked difference between the official and unofficial rates – at times over 10% – will inevitably tempt corrupt officials to exploit it.

The CBI needs more than USD 1 billion per month to keep the exchange rate stable. The CBI currently has only approximately USD 200m cash and circa 6 tonnes of gold available in Iran. The prospects of replenishing these reserves are slim. Financial sanctions have ensured that Iran cannot access its foreign currency reserves and cannot replenish its cash reserves. Some of the National Iranian Oil Company's largest clients, such as India and China, have stopped paying cash for oil, and the Iranian government has been forced to resort to barter trade to secure valuable imports of essential commodities. The shortage of cash reserves is likely to have a severe knock-on effect on the whole business sector, which needs access to hundreds of millions of USD per day in cash from the CBI to function.

The CBI cannot fulfil its promise to flood the market with cash. As we said in our last newsletter, it is very likely that the CBI will be forced to devalue the Rial again in the coming months which will further fuel inflation and accelerate the cash outflow from the banks. The CBI estimates that the Rial could fall to IRR 20,000:USD 1 before the end of the year, which may leave Iran exposed to the possibility of hyperinflation.

The end of cash subsidy payments?
The government can no longer afford the cash subsidy payments to families as they are fuelling inflation and the flight to USD. Internal government estimates indicate that inflation could reach 70% post-subsidy reform: prices of key commodities and services are rising, the CBI is printing Rials to fund the cash subsidy payments, the cash subsidy payments are fuelling money supply, and the Iranian public is taking its cash payments and converting them into USD, causing a run on the currency. Senior banking officials have warned the government that the current situation is untenable. The debate over energy cards is part of the plan to curtail the cash payments.

Statistics

GDP growth
-1% (2011 best case estimate)
vs. IMF estimate 1%
vs. CBI estimate 3.5-4.5% 1388

Inflation
1Q 1390 20% vs 4Q 1389
1390 (F) 70%

Liquidity growth
24% (2010 estimate)

Unemployment
Over 35% in much of the country

Forex Reserves

> USD 80 billion

Foreign Exchange Reserve Account
(Oil Stabilisation Fund)
< USD 3 billion

Government and private sector debt to banks
USD 29 billion in Dec 2010