Government of the Punjab

Punjab Pension Fund

Dated: 17 September 2010

MONTHLY REVIEW OF INVESTMENTS

August 2010

FUND SIZE

- A summary of changes in fund size during the current financial year is given in the following table:

Rs. millions (rounded to the nearest million)

	Jul-Aug 2010
Beginning fund size	12,097
Add: contribution during the period	-
Less: transfer to Reserve Pension Fund	-
Add: gain/(loss) during the period	253
Less: expenses during the period	3
Ending fund size	**12,347**

The numbers exclude unrealized capital gains/losses

FUND'S PORTFOLIO

- The Fund's exposures to different investment types are summarized as under:

Amounts: Rs. millions (rounded to the nearest million)

%: as percentage of Total Fund Size

	30 June 2010		**31 July 2010**		**31 August 2010**	
	Amount	**%**	**Amount**	**%**	**Amount**	**%**
PIBs	5,737	47.4	5,797	47.4	5,698	46.2
T-Bills	3,145	26.0	3,026	24.8	3,041	24.6
Short term bank deposits	3,015	24.9	3,031	24.8	3,062	24.8
Corporate bonds/TFCs	176	1.5	311	2.5	313	2.5
Cash at bank	21	0.2	56	0.5	233	1.9
Other assets*	3	0.0	1	0.0	0	0.0
Total Fund Size	**12,097**	**100.0**	**12,222**	**100.0**	**12,347**	**100.0**

*Other assets include prepaid expenses for management of PPF and book value of fixed assets (vehicles, computers etc.) of PPF

- Exposure to long-term PIBs was Rs. 5,698 m at the end of August which was slightly lower than the exposure of Rs. 5,797 m at the end of July. The difference is not because of any selling of PIBs – PPF has not sold any PIB until to date. The difference is attributable to accrued interest which is included as part of the overall exposure to

PIBs. Many of the PIBs paid coupons just before the end of August as a result of which the accrued interest was much lower as on 31 Aug. This translated into a slightly lower overall exposure to PIBs;

- PPF is gradually building its corporate bonds/TFCs portfolio whose yield is higher than government securities and bank deposits. At the end of the month, corporate bonds/TFCs constitute 2.5% of the Fund size.
- PPF has also been switching exposure between T-bills & short-term bank placements in pursuit of higher rates of return.

FUND'S PERFORMANCE

- Time Weighted Return (TWR) earned by PPF is summarized as under:

Period	Annualized Return for the period			Long-term Benchmark
	Gross Return	Net Return*	CPI Inflation	CPI Inflation + 3%
FY 2008-09	15.21%	15.00%	13.14%	16.14%
FY 2009-10	13.79%	13.61%	12.69%	15.69%
Aug 2010	12.96%	12.81%		

*Net Return means the return after deducting expenses incurred on management of PPF

- A significant portion (46.2%) of the Fund has been invested in long-term fixed-rate PIBs. The PIB portfolio is yielding a return close to 13% p.a. which provides stability to the overall return of the Fund.
- Current inflation rates are much higher than our long-term inflation expectations. As inflation declines, the strategy to invest in fixed rates will pay off and the Fund will be able to earn an attractive real rate of return in accordance with its long-term objective.
- The yield on corporate bonds/TFCs portfolio is higher than the PIB portfolio. However, its contribution to the overall return of the fund is not significant considering the small size of this portfolio relative to the Fund size.
- The portion of the Fund which is invested in short-term instruments including T-bills and TDRs can potentially add volatility to the return of the Fund depending upon the movements in short-term interest rates.

REVIEW OF IMPORTANT ECONOMIC & FINANCIAL VARIABLES

GDP GROWTH

- For FY 2010-11, the government had originally set a GDP growth target of 4.5%. After the devastation caused by floods, it is evident that the actual growth will be much lower. As per recent media reports, the projection for GDP growth has been revised to 2.6-2.7%.
- Three major segments of the GDP are agriculture, industry and services. Their shares in GDP, growth rates and contributions to the GDP during the last two financial years are summarized in the following table:

	FY 2008-09 (revised)			FY 2009-10		
	Share in GDP (%)	**Growth rate (%)**	**Contribution to GDP growth (%)**	**Share in GDP (%)**	**Growth rate (%)**	**Contribution to GDP growth (%)**
Commodity producing sectors	46.9	0.8	0.4	46.7	3.6	1.7
Agriculture	21.9	4.0	0.9	21.5	2.0	0.4
Industry	25.0	-1.9	-0.5	25.2	4.9	1.2
Services sector	53.1	1.6	0.8	53.3	4.6	2.4
Overall GDP	100	1.2	1.2	100	4.1	4.1

Source: Pakistan Economic Survey 2009-10 (published by Ministry of Finance)

Agriculture

- The share in GDP, growth rate and contribution to overall GDP growth of Agriculture sector along with its various subsectors in the last two financial years is shown in the following table:

	FY 2008-09			FY 2009-10		
	Share in GDP (%)	**Growth rate (%)**	**Contribution to GDP growth (%)**	**Share in GDP (%)**	**Growth rate (%)**	**Contribution to GDP growth (%)**
Agriculture	21.9	4.0	0.85	21.5	2.00	0.44
Major crops	7.4	7.3	0.50	7.0	-0.2	-0.01
Minor crops	2.5	-1.6	- 0.04	2.4	-1.2	-0.03
Livestock	11.4	3.5	0.39	11.4	4.1	0.47
Fishing	0.4	2.3	0.01	0.4	1.4	0.01
Forestry	0.3	-3.0	-0.01	0.3	2.2	0.01

Source: Pakistan Economic Survey 2009-10 (published by Ministry of Finance)

Industry

- The share in GDP, growth rate and contribution to overall GDP growth of Industry sector along with its various subsectors in the last two financial years is shown in the following table:

	FY 2008-09			FY 2009-10		
	Share in GDP (%)	**Growth rate (%)**	**Contribution to GDP growth (%)**	**Share in GDP (%)**	**Growth rate (%)**	**Contribution to GDP growth (%)**
Industry	25.0	-1.9	-0.49	25.2	4.9	1.24
Mining & Quarrying	2.5	-0.2	-0.01	2.4	-1.7	-0.04
Manufacturing	18.3	-3.7	-0.71	18.5	5.2	0.95
LSM	12.2	-8.2	-1.10	12.2	4.4	0.54
SSM	6.1	6.7	0.39	6.3	6.8	0.41
Construction	2.1	-11.2	-0.27	2.3	15.3	0.32
Elect. & gas dist.	2.1	30.8	0.49	2.0	0.4	0.01

Source: Pakistan Economic Survey 2009-10 (published by Ministry of Finance)

Services sector

- The share in GDP, growth rate and contribution to overall GDP growth of Services sector along with its various subsectors in the last two financial years is shown in the following table:

	FY 2008-09			FY 2009-10		
	Share in GDP (%)	**Growth rate (%)**	**Contribution to GDP growth (%)**	**Share in GDP (%)**	**Growth rate (%)**	**Contribution to GDP growth (%)**
Services	53.1	1.6	0.84	53.3	4.6	2.42
Transport, Storage & Comm.	10.2	2.7	0.27	10.2	4.5	0.46
Wholesale & Retail Trade	16.9	-1.4	-0.24	17.1	5.1	0.86
Finance & Insurance	5.8	-7.0	-0.44	5.4	-3.6	-0.21
Ownership of Dwellings	2.8	3.5	0.09	2.7	3.5	0.10
Public Admn. & Defense	6.1	3.6	0.22	6.3	7.5	0.46
Other Services	11.4	8.9	0.94	11.6	6.6	0.75

Source: Pakistan Economic Survey 2009-10 (published by Ministry of Finance)

FISCAL MANAGEMENT

- A summary of revenues and expenditures during FY 10 and their comparison with the same period of the previous financial year is shown in the following table:

	Jul - Jun						
	Amount (Rs. bn)		As % of total exp.		As % of GDP		Growth (%)
	FY 09	FY 10	FY 09	FY 10	FY 09	FY 10	FY 10
(1)Total revenue	**1,851**	**2,078**	**73**	**69**	**14.1**	**14.2**	**12.3**
(1a) Tax	1,205	1,473	48	49	9.2	10.0	22.3
Direct Tax	440	529	17	18	3.4	3.6	20.1
Indirect Tax	764	944	30	31	5.8	6.4	23.5
(1b) Non-tax	646	605	26	20	4.9	4.1	(6.3)
Dividend	59	53	2	2	0.4	0.4	(9.8)
SBP Profit	161	233	6	8	1.2	1.6	44.6
(2) Total expenditure	**2,531**	**3,007**	**100**	**100**	**19.3**	**20.5**	**18.8**
(2a) Current	2,042	2,386	81	79	15.6	16.3	16.9
Domestic Debt Service	559	578	22	19	4.3	3.9	3.5
Foreign Debt Service	79	64	3	2	0.6	0.4	(19.1)
Defence	330	375	13	13	2.5	2.6	13.7
(2b) Development	449	613	18	20	3.4	4.2	36.7
Budget surplus / (deficit)	**(680)**	**(929)**	**(27)**	**(31)**	**(5.2)**	**(6.3)**	**36.5**
Financing	680	929	27	31	5.2	6.3	36.5
External	150	189	6	6	1.1	1.3	26.2
Domestic	531	740	21	25	4.1	5.0	39.5
Non-bank	224	436	9	15	1.7	3.0	94.6
Bank	306	305	12	10	2.3	2.1	(0.3)
Privatization	1	0	0	0	0	0	-100
Full Year GDP	**13,095**	**14,668**					
Revenue balance (1-2a)	**(191)**	**(308)**	**(8)**	**(10)**	**(1.5)**	**(2.1)**	**61.3**

Source: Ministry of Finance

- Deficit in Revenue Balance was Rs. 308 bn or 2.1% of GDP in FY 10. This is the amount by which the total revenues of the government from all sources have fallen short of its current expenditures. In addition to this deficit, the entire development expenditure is financed by the government by resorting to borrowing.
- The high borrowing needs of the government are a major reason behind high interest rates in the market despite a weak economic situation.

- The key budgetary targets (as a percentage of GDP) as per the Medium Term Budgetary Framework developed by the government, along with a comparison with the actual performance in FY 10, are shown in the following table:

	As % of GDP	
	Actual FY 10	**Target for FY 11**
Total revenue	14.2	15.2
Tax revenue	10.0	10.9
Total expenditure	20.5	19.2
Current expenditure	16.3	14.8
Development expenditure	4.2	4.4
Fiscal deficit	(6.3)	(4.0)
Revenue balance	(2.1)	0.4

Source: Ministry of Finance

- The government plans to improve its fiscal position through a combination of higher revenues and lower expenses which seems a daunting task especially in the aftermath of the destruction caused by recent floods.
- The government has set a budget deficit target of 4% for FY 11. As per SBP's analysis, the target is too ambitious and is unlikely to be met. SBP projects the budget deficit for FY 11 to be in excess of 5% of GDP.

DEBT

Domestic Debt:

- The domestic debt profile of Pakistan is summarized in the following table:

Domestic Debt	**Amount (Rs. bn)**		**As % of Total Dom. Debt**		**As % of GDP**		**Growth (%)**
	Jul-09	**Jul-10**	**Jul-09**	**Jul-10**	**Jul-09**	**Jul-10**	**FY 10**
A) Permanent	681	790	17.1	16.8	5.2	5.4	16.0
PIBs	441	505	11.1	10.7	3.4	3.4	14.6
Prize Bonds	200	238	5.0	5.1	1.5	1.6	19.0
B) Floating	1,981	2,446	49.8	52.0	15.1	16.7	23.5
C) Unfunded	1,305	1,467	32.8	31.2	10.0	10.0	12.4
DSCs	236	225	5.9	4.8	1.8	1.5	(4.7)
SSCs	310	354	7.8	7.5	2.4	2.4	14.1
BSCs	315	372	7.9	7.9	2.4	2.5	18.1
D) FC Instruments	8	3	0.2	0.1	0.1	0.0	(62.7)
Total Domestic Debt	**3,975**	**4,705**	**100.0**	**100.0**	**30.4**	**32.1**	**18.4**
GDP	**13,095**	**14,668**					

Source: SBP

- Floating debt consists of T-bills which are short term debt instruments. It constitutes more than 50% of total domestic debt. The high proportion of short-term debt in the overall debt structure reflects vulnerability to adverse short-term interest rate movements.
- Interest payments on domestic debt have already become the single biggest head of current expenditure in the annual budget.

External Debt:

- The external debt profile of Pakistan is summarized in the following table:

External Debt	Amount (USD bn)		Amount (Rs. bn)		As % of GDP		Growth[1] (%)
	Jun-09	Jun-10	Jun-09	Jun-10	Jun-09	Jun-10	Jul-Jun FY 10
A) Public	42.4	44.0	3,470	3,773	26.5	25.7	8.7
Medium & long term	41.8	42.2	3,421	3,610	26.1	24.6	5.5
Short term	0.7	0.8	57	69	0.4	0.5	19.7
IMF (Fed. Govt.)	0	1.1	-	94	-	0.6	-
B) Publicly guaranteed	0.2	0.2	16	17	0.1	0.1	4.8
C) IMF (Central Bank)	5.1	8.1	417	695	3.2	4.7	66.4
D) Scheduled banks	0	0.2	-	17	-	0.1	-
E) Private (non-guaranteed)	3.2	3.0	262	257	2.0	1.8	(1.8)
Total External Debt	**51.1**	**54.5**	**4,183**	**4,674**	**31.9**	**31.8**	**11.7**
Exchange Rate (Rs./USD)	**81.85**	**85.76**					
GDP			**13,095**	**14,668**			

[1]Growth in rupee value
Source: SBP

- Interest payments on external debt are lower than those on domestic debt which is evident from the numbers of the budget. However, interest payments do not reflect the true cost of external debt. The rupee value of the principal amount of external debt keeps increasing as a result of devaluation of the rupee.
- During FY 10, the external debt increased by 6.7% when measured in US dollars, but increased by 11.7% when measured in Pak rupees. The difference is attributable to 4.8% nominal depreciation of Pak rupee against US dollar (which translates into a rupee amount of Rs. 200 bn).
- Repayment of external debt can put pressure on the exchange rate as Pakistan has traditionally suffered from weak balance-of-payments and foreign-exchange-reserves position.

EXTERNAL ACCOUNT

- Balance of payments during the current financial year has been compared with the balance of payment in the same period of last financial year in the following table:

Billion US $

	July 09	July 10
Current Account	(0.6)	(0.6)
Capital Account	0.0	0.0
Financial Account	0.3	0.0
Errors and Omissions	0.0	(0.2)
Overall Balance of Payments	**(0.3)**	**(0.8)**

Source: SBP

CURRENT ACCOUNT

- Composition of Current Account during the current financial year and its comparison with the same period of the last financial year is shown in the following table:

Billion US $

	Jul 09	Jul 10
Current Account (1+2+3)	**(0.6)**	**(0.6)**
(1) Balance of trade in Goods & Services	**(1.5)**	**(1.6)**
Goods: Exports f.o.b	1.6	1.6
Goods: Imports f.o.b	2.9	2.8
Balance of trade in goods	(1.3)	(1.3)
Services: Credit (exports)	0.3	0.2
Services: Debit (imports)	0.6	0.6
Balance of trade in services	(0.3)	(0.3)
(2) Balance of Income Transfers	**(0.2)**	**(0.2)**
Income: Credit (inflows)	0.1	0.0
Income: Debit (outflows)	0.3	0.3
Interest Payments	0.1	0.1
Profit & Dividend	0.1	0.1
(3) Balance of Current Transfers	**1.1**	**1.2**
Current Transfers: Credit (inflows)	1.1	1.2
Workers' Remittances	0.8	0.7
FCA Residents	0.0	0.1
Current Transfers :Debit (outflows)	0.0	0.0

Source: SBP

- Current Account Deficit stood at $ 3.5 bn or 2% of GDP in FY 10.
- According to SBP, real appreciation in the exchange rate during FY 10 and the resulting trend in the terms of trade suggest a potential widening of trade deficit in FY 11.

- SBP projects the Current Account Deficit to rise in FY 11 to $6.9 bn or 3.7% of GDP on the back of higher growth in imports (projected at 12%) compared with exports (projected at 7%).

FINANCIAL ACCOUNT

- Composition of the Financial Account during the current financial year and its comparison with the same period of last financial year is shown in the following table:

Billion US $

	July 09	July 10
Financial Account (1+2+3)	**0.3**	**(0.0)**
(1) Direct Investment	0.1	0.2
(2) Portfolio Investment	0.0	(0.0)
(2a) Equity	0.0	0.0
(2b) Debt	0.0	(0.0)
(3) Other Investment	0.1	(0.2)
Equity based flows (1+2a)	0.1	0.2
Debt based flows (2b+3)	0.1	(0.2)

Source: SBP

- The sustainability of Current Account Deficit depends on the country's ability to finance it by generating a Financial Account Surplus (preferably through equity rather than debt creating inflows).
- Given the projected rising path of external current account deficit for FY 11, improvement in financial inflows is critical to avoid a fall in country's foreign exchange reserves and pressure on exchange rate.

INFLATION

CONSUMER PRICES

- A summary of inflation rates is given in the following table:

	CPI Inflation								
Period	**CPI Overall (%)**			**CPI Food (%)**			**CPI Non-food (%)**		
	YOY	**MOM**	**12mma[1]**	**YOY**	**MOM**	**12mma**	**YOY**	**MOM**	**12mma**
May 2010	13.1	0.1	11.7	14.8	0.1	12.1	11.7	0.1	11.4
Jun 2010	12.7	0.6	11.7	14.5	0.7	12.5	11.2	0.6	11.1
July 2010	12.3	1.2	11.8	12.8	1.5	12.6	12.0	1.0	11.1
Aug 2010	13.2	2.5	12.0	15.6	5.1	13.1	11.2	0.3	11.2
12 month min.	8.9	-0.5	11.7	7.5	-1.7	11.9	10.0	0.1	11.1
12 month max.	13.7	2.5	17.1	15.6	5.1	16.1	12.2	2.8	16.4

[1]12 month moving average

Source: SBP

Period	Core Inflation					
	NFNE[1] (%)			Trimmed[2] (%)		
	YOY	MOM	12mma	YOY	MOM	12mma
May 2010	10.3	0.6	11.5	12.5	0.4	12.0
Jun 2010	10.4	0.7	11.0	11.7	0.7	11.6
Jul 2010	10.3	0.5	10.7	12.0	0.7	11.4
Aug 2010	9.8	0.4	10.5	12.5	0.7	11.2
12 month min.	9.8	0.4	10.5	10.4	0.4	11.2
12 month max.	11.9	1.7	16.6	12.7	1.3	17.6

[1]NFNE stands for non-food non-energy measure of core inflation

[2]Trimmed Mean measure of core inflation excludes 20% of the items in the CPI basket showing extreme changes in price

Source: SBP

- CPI Inflation rose during July and August 2010. The month-on-month inflation rate (which indicates the recent momentum) is particularly worrisome. Analysis of food and non-food segments of CPI shows that inflationary pressures are concentrated in the food segment. This is understandable since the country is faced with food shortages as a consequence of devastating floods. Easing inflationary pressures in the non-food segment are a better reflection of the dull economy.
- NFNE inflation declined during July and August which indicates that inflationary pressures are concentrated in food & energy items. Trimmed mean inflation rose in July and August which shows that within the food & energy categories, inflationary pressures are quite broad based.
- The recent upsurge in inflation does not seem to be caused by excessive demand. It is driven by food shortages due to floods and continuing adjustments in electricity prices as a result of phasing out of subsidies. Rest of the economy is suffering from weak demand as is evident from the declining trend in non-food and NFNE inflation.

WHOLESALE PRICES

- A summary of inflation rates based on WPI (Wholesale Price Index) is given below:

Period	WPI Inflation								
	WPI Overall (%)			WPI Food (%)			WPI Non-food (%)		
	YOY	MOM	12mma	YOY	MOM	12mma	YOY	MOM	12mma
May 2010	21.2	0.9	11.7	14.4	0.11	11.57	26.9	1.4	12.2
Jun 2010	17.6	-0.6	12.9	14.5	1.17	11.93	20.2	-1.9	13.9
Jul 2010	18.7	1.67	14.4	14.3	1.86	12.40	21.98	1.1	16.1
Aug 2010	19.2	2.62	16.0	16.38	4.18	13.07	21.29	1.5	18.4
12 month min.	0.3	-0.6	7.6	5.82	-0.7	11.37	-5.6	-1.9	3.87
12 month max.	22.0	4.2	14.4	16.27	2.68	19.7	27.7	5.5	16.14

- A breakdown of WPI inflation (YoY) into its various components is shown in the following table:

Index	Weightage in overall WPI	Aug 2010 - Inflation (%)		
		YOY	MOM	12mma
WPI	100	19.2	2.6	16.0
WPI food	42.1	16.4	4.2	13.1
WPI non-food	57.9	21.3	1.5	18.4
Raw materials	8.0	52.9	0.8	36.7
Fuel, lighting & lubricants	19.3	15.4	2.7	20.8
Manufactures	25.9	20.6	0.5	13.7
Building materials	4.7	8.0	-0.7	-1.5

Source: SBP

- Wholesale prices track international prices more closely than other measures of inflation.
- High year-on-year inflation reflects low base effect because international prices had crashed a year earlier.
- Month-on-month inflation is of more significance because it captures the recent trend in wholesale prices. This number has been quite volatile in recent months but the upsurge in July and August is worrisome.

INTERNATIONAL COMMODITY PRICES

- The following table shows inflation rates, based on the Indices of Fuel and Non-Fuel Commodities maintained by IMF:

	Inflation Rates as per the indices maintained by IMF								
Period	(Overall) Index of Fuel & Non-fuel Commodities (%)			Commodity Fuel (Energy) Index (%)			Index of Non-fuel Primary Commodities (%)		
	YOY	MOM	12mma	YOY	MOM	12mma	YOY	MOM	12mma
Apr 2010	48.3	5.7	3.6	60.0	6.0	5.2	31.3	5.1	4.1
May 2010	24.5	-7.5	9.4	29.0	-8.8	11.9	17.5	-5.1	7.8
Jun 2010	9.9	-1.8	13.6	9.6	-0.9	16.7	10.3	-3.2	10.8
Jul 2010	16.4	1.5	18.7	17.4	0.3	22.4	14.9	3.7	14.3
12 month high	48.3	7.1	18.7	60.0	8.9	16.7	31.3	5.1	14.3
12 month low	-33.5	-7.5	-36.2	-40.1	-8.8	-42.1	-18.0	-5.1	-24.3

Source: IMF

- A detailed breakdown of the Overall Index of Fuel & Non-Fuel Commodities into its various components is shown in the following table:

Index	Weightage (%) in overall Commodity Index	Jul 2010 Inflation (%)		
		YOY	MOM	12mma
Fuel & Non-fuel Commodities	**100**	**16.4**	**1.5**	**18.7**
Fuel Commodities (Energy)	**63.1**	**17.4**	**0.3**	**22.4**
Petroleum	53.6	15.5	-0.1	33.5
Natural Gas	6.9	24.7	7.5	17.8
Coal	2.6	30.7	-1.8	10.8
Non-Fuel Commodities	**36.9**	**14.9**	**3.7**	**14.3**
Industrial inputs	18.4	25.8	2.0	27.6
Agricultural Raw Mat.	7.7	23.2	0.7	21.5
Metals	10.7	27.2	2.8	31.4
Edibles	18.5	6.3	5.3	4.8
Food	16.7	5.0	5.6	3.3
Beverages	1.8	17.1	2.4	18.0

Source: IMF

- High year-on-year inflation numbers should be interpreted carefully because of the low base effect – international commodity prices crashed a year earlier and the recent YOY numbers partly reflect a catching up of prices.
- After remaining negative during May and June, month-on-month inflation turned positive during July due mainly to a sharp increase in food prices.

INTEREST RATES

- A summary of interest rates for the current financial year is given below:

Period	Yield on 1-yr T-bill (%p.a.)		Yield on 10-yr PIB (%p.a.)		6-month KIBOR (%p.a.)	
	Month end	12mma	Month end	12mma	Month end	12mma
May 2010	12.23	12.21	12.63	12.45	12.27	12.44
Jun 2010	12.38	12.23	12.84	12.52	12.37	12.41
Jul 2010	12.42	12.28	12.95	12.61	12.42	12.45
Aug 2010	12.75	12.32	13.19	12.68	12.87	12.47
12m high	12.75	12.83	13.19	13.51	12.87	13.71
12m low	11.95	12.21	12.40	12.42	12.23	12.41

Source: SBP, Reuters

- We do not believe that the economy is suffering from demand-pull inflation. Private sector spending is already weak which is reflected in low wage and job growth, low capacity utilization of industries, low growth in rents and lower asset prices (property, stocks etc.).
- We think that the current inflation is due to a combination of rising costs (energy) and supply shortages (food). The problem is that both of these segments (food & energy) lead to a higher cost of living in general and therefore have second round effects i.e. increase in prices across the board.
- SBP seems to be caught in a dilemma – raising interest rates risks slowing down the economy even further whereas doing nothing risks fuelling inflationary expectations.
- During the last Monetary Policy Statement, SBP raised interest rates and gave a signal that it would do everything within its power to control inflation.
- We think that SBP will maintain discount rate at its current level of 13% in the next Monetary Policy Statement due at the end of this month. Our expectation is based on the following reasons:
    - Although overall inflation has increased in July and August, a detailed analysis of the numbers shows that inflationary pressures are highly concentrated in the food sector and are driven primarily by supply shortages rather than excessive demand.
    - Having raised the discount rate in its previous Monetary Policy Statement in July, SBP will prefer to wait and carefully assess the macroeconomic situation before making the next move.

INVESTMENT STRATEGY

- A PIB Auction with an overall target of Rs. 25 bn was held during August 2010. The instruments (3, 5, 7, 10, 15, 20 and 30-yr PIBs) to be offered in the auction start trading in 'when issue' market two weeks before the auction as the primary dealers (banks/DFIs appointed by SBP) are allowed to short sell each instrument up to 5% of its auction target. PPF participated in the 'when issue' market by purchasing 10 & 15-yr PIBs and also participated in the auction by bidding for 10, 15, 20 & 30-yr PIBs. The government, however, scrapped the entire auction and PPF was unable to further build its PIB portfolio.
- Given the weaknesses in the economy and SBP's resolve to fight inflation, we do not expect inflationary pressures to persist for long.
- In our opinion, the higher interest rates currently prevailing in the market offer an opportunity to further build the long-term fixed-rate portfolio. We, therefore, intend to increase our exposure to long-term PIBs over the next few months. However,the

government is consistently showing reluctance to borrow long-term at high rates of interest. This is complicating the execution of PPF's strategy of investing in longer tenors.

- Considering the attractive yields on a few highly rated TFCs, the ISC may consider increasing the allocation to corporate bonds/TFCs which currently stands a maximum of 5% of Fund size.
- A major limitation of investments in floating-rate TFCs is that their yields are vulnerable to a decline in interest rates. In order to manage the interest rate risk underlying the floating-rate investments, the ISC will consider entering into fixed-for-floating Interest Rate Swaps so that PPF can convert its floating-rate investments into fixed-rate investments.
- The ISC is yet to make a decision on our recommendation to allocate 10% of Fund size to equity investments. This will also be discussed in the next ISC meeting.
- There has been no breakthrough in negotiations with commercial banks for long term placement of funds. The banks are generally reluctant to take fixed deposits for periods longer than one year. The matter will be discussed in the next ISC meeting. The ISC may consider revising the asset allocation and reallocating this portion to other avenues such as corporate bonds/TFCs, T-bills, Short-term TDRs or Stocks etc.

(Aquil Raza Khoja)
General Manager
Punjab Pension Fund