Government of the Punjab

Punjab Pension Fund

Dated: 19 February 2011

MONTHLY REVIEW OF INVESTMENTS

January 2011

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-Jan 2011
Beginning fund size	12,097
Add: contribution during the period	-
Less: transfer to Reserve Pension Fund	-
Add: gain/(loss) during the period	919
Less: expenses during the period	(10)
Ending fund size	**13,006**

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 Dec 2010		31 Jan 2011	
	Amount	%	Amount	%	Amount	%
PIBs	5,737	47.4	5,789	45.0	5,849	45.0
T-Bills	3,145	26.0	595	4.7	598	4.6
Short term bank deposits	3,015	24.9	6,000	46.6	6,036	46.4
Corporate bonds/TFCs	176	1.5	349	2.7	354	2.7
Cash at bank	21	0.2	130	1.0	160	1.2
Other assets*	3	0.0	1	0.0	9	0.1
Total Fund Size	**12,097**	**100.0**	**12,864**	**100.0**	**13,006**	**100.0**

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

- Long-term investments consist of PIBs and TFCs whereas short-term investments consist of T-bills and bank deposits.
- PPF has 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%
Jul-Jan 2011	13.24%	13.09%		
Jan 2011	13.90%	13.76%		

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

- Inflation rates over the last 2-3 years have been much higher than our long-term inflation expectations of 9%-10% p.a. Current interest rates are also higher than our long-term expectations. We consider this an opportunity to invest in long-term fixed rate instruments. As inflation and interest rates decline and revert to their long-term averages, the strategy to invest at 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.

REVIEW OF IMPORTANT ECONOMIC & FINANCIAL VARIABLES

GDP GROWTH

- SBP expects real GDP growth for FY 11 to be in the range of 2-3%.
- Reasons for the slowdown of the economy include:
  - Damage to crops, livestock, infrastructure, industry and economic activity in general, caused by floods;
  - Intensification of inflationary pressures due to
    - food shortages caused by floods
    - rising prices of petroleum products
    - rise in electricity tariffs
  - Slowdown in borrowing and investment by the private sector due to a combination of slow economy, rising costs and high interest rates.
- A few bright spots in the economy which are expected to support real GDP growth include:
  - Better than expected performance of services sector due to healthy growth in

- social, community and personal services (led by massive relief and rehabilitation efforts undertaken in flood-affected areas),
- finance & insurance and
- transport, storage & communication subsectors.

o Significant growth in nominal income of farmers, due to rise in prices of agricultural commodities, will support the demand for other goods and services being produced in the economy.

FISCAL MANAGEMENT

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

	Jul - Sep						
	Amount (Rs. bn)		**As % of total exp.**		**As % of GDP**		**Growth (%)**
	FY 10	**FY 11**	**FY 10**	**FY 11**	**FY 10**	**FY 11**	**FY 11**
(1)Total revenue	**427.3**	**400.1**	**66**	**59**	**2.9**	**2.3**	**(6.3)**
(1a) Tax	298.8	317.3	46	47	2.0	1.9	6.2
Direct Tax	84.1	94.4	13	14	0.6	0.6	12.3
Indirect Tax	214.7	222.9	33	33	1.4	1.3	3.8
(1b) Non-tax	128.5	82.9	20	12	0.9	0.5	(35.5)
Dividend	18.9	0.5	3	0.1	0.1	0.0	(97.6)
SBP Profit	70.0	40.0	11	6	0.5	0.2	(42.9)
(2) Total expenditure	**650.9**	**676.3**	**100**	**100**	**4.4**	**4.0**	**3.9**
(2a) Current	521	566.7	80	84	3.5	3.3	8.8
Domestic Debt Service	129.3	146.6	20	22	0.9	0.9	13.4
Foreign Debt Service	12.2	14.9	2	2	0.1	0.1	22.5
Defence	86.2	93.1	13	14	0.6	0.5	8.1
(2b) Development	109.0	59.4	17	9	0.7	0.3	(45.5)
Budget surplus / (deficit)	**(224)**	**(276)**	**(34)**	**(41)**	**(1.5)**	**(1.6)**	**23.5**
Financing	224	276	34	41	1.5	1.6	23.5
External	77.1	56.9	12	8	0.5	0.3	(26.2)
Domestic	146.6	219.3	23	32	1.0	1.3	49.6
Non-bank	107.6	98.4	17	15	0.7	0.6	(8.6)
Bank	39	121	6	18	0.3	0.7	210.0
Privatization	0	0	0	0	0	0	-
Full Year GDP	**14,838**	**17,106**					
	(93.7)	**(166.6)**			**(0.6)**	**(1.0)**	**77.8**

[1]Revenue surplus/(deficit) = Total revenue – Current expenditure

Source: Ministry of Finance

- Fiscal situation has been very difficult during the first quarter of the current fiscal year. As a percentage of GDP
    - Tax as well as non-tax revenues fell;
    - Expenses also fell but the brunt was borne by development expenditures which has adverse consequences for long-term growth potential of the economy;
    - Overall budget deficit increased;
    - Revenue deficit increased significantly.
- Due to delays in introduction of tax reforms and a weak economy, the fiscal situation in expected to remain quite challenging in the near future.
- The Government continues to borrow heavily which is contributing to high inflation, high interest rates and crowding out of the private sector.

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 (%)
	Jun-10	**Dec-10**	**Jun-10**	**Dec-10**	**Jun-10**	**Dec-10**	**FY 11**
I) Permanent	794	910	17.1	17.2	5.4	5.3	14.5
PIBs	505	522	10.9	9.9	3.4	3.1	3.3
Prize Bonds	236	252	5.1	4.8	1.6	1.5	6.8
II) Floating	2,399	2,859	51.6	54.0	16.4	16.7	19.2
III) Unfunded	1,456	1,524	31.3	28.8	9.9	8.9	4.7
Saving Schemes	1,350	1,416	29.0	26.7	9.2	8.3	4.9
IV) FC Instruments	3	2	0.1	0.0	0.0	0.0	(48.4)
Total Domestic Debt	**4,653**	**5,295**	**100.0**	**100.0**	**31.7**	**31.0**	**13.8**
GDP	**14,668**	**17,106**					

Source: SBP

- The government's dependence on short-term borrowing is quite high and has increased further during the current financial year. Floating debt, which consists of T-bills having maturities of 3, 6 and 12 months, constituted 54% of the total domestic debt at the end of Dec 2010.

- Currently, the market is lending bigger amounts to the Government only in the shortest tenor (i.e. 3-month T-bill) because of the apprehension that continued high borrowing by the Government may lead to even higher inflation & interest rates in future. The result is that the Government has to roll over its debt after very short intervals. This, combined with the fresh borrowing needs of the Government, is putting further upward pressure on interest rates.

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] (%)
	June-10	Sep-10	June-10	Sep-10	June-10	Sep-10	Jul-Sep10
1) Public Debt	52.1	54.8	4,458	4,733	30.4	27.7	6.2
a) Govt Debt	42.9	44.8	3,671	3,869	25.0	22.6	5.4
i) Medium & long term	42.1	43.9	3,603	3,793	24.6	22.2	5.3
ii) Short term	0.8	0.9	68	76	0.5	0.4	12.0
b) From IMF	8.1	8.9	691	769	4.7	4.5	11.3
c) Foreign Ex Liabilities	1.1	1.1	96	95	0.7	0.6	(1.0)
2) PSE Guaranteed Debt	0.2	0.2	14	13	0.1	0.1	(4.1)
3) PSE Non-Guaranteed Debt	0.8	0.8	69	68	0.5	0.4	(2.1)
4) Schedule Bank Borrowings	0.2	0.2	17	21	0.1	0.1	28.7
5) Pvt. Guaranteed Debt	0.0	0.0	0	0	0	0	-
6) Pvt. Non-Guaranteed Debt	2.2	2.3	191	200	1.3	1.2	4.5
7) Pvt. Non-Guaranteed Bonds	0.1	0.1	11	11	0.1	0.1	1.0
Total External Debt	**55.6**	**58.4**	**4,759**	**5,046**	**32.4**	**29.5**	**6.0**
Exchange Rate (Rs./USD)			**85.56**	**86.38**			
GDP			**14,668**	**17,106**			

[1]Growth in rupee value
Source: SBP, MOF, Reuters

- Relationship between external debt and exchange rate is quite tricky.
    - Depreciation of exchange rate leads to higher debt servicing cost (in terms of domestic currency) on external debt.
    - Repayment of external debt, especially in the backdrop of a weak external account position, can cause depreciation of the exchange rate.

EXTERNAL ACCOUNT

- Balance of payments is summarized in the following table:

Billion US $

	Jul-Dec		
	FY 10	**FY 11**	**Growth* %**
Current Account	(2.6)	0.0	101
Capital Account	0.1	0.1	(46)
Financial Account	2.9	0.8	(72)
Errors and Omissions	0.6	0.1	(89)
Overall Balance of Payments	**1.1**	**1.0**	(10)

Source: SBP

*Growth is positive where an account has shown improvement e.g. deficit has decreased or surplus has increased. Growth is negative where an account has worsened e.g. deficit has increased or surplus has decreased.

CURRENT ACCOUNT

- Detailed position of Current Account is given in the following table:

Billion US $

	Jul-Dec		
	FY 10	**FY 11**	**Growth %**
Current Account (1+2+3)	**(2.6)**	**0.0**	**101**
(1) Balance of trade in Goods & Services	**(7.4)**	**(6.1)**	**18**
Goods: Exports f.o.b	9.3	11.1	19
Goods: Imports f.o.b	15.2	16.7	10
Balance of trade in goods	(5.9)	(5.6)	5
Services: Credit (exports)	2.0	3.1	60
Services: Debit (imports)	3.5	3.6	4
Balance of trade in services	(1.5)	(0.5)	68
(2) Balance of Income Transfers	**(1.6)**	**(1.5)**	**7**
Income: Credit (inflows)	0.2	0.4	50
Income: Debit (outflows)	1.8	1.8	1
Interest Payments	0.7	0.8	8
Profit & Dividend	0.3	0.3	(12)
(3) Balance of Current Transfers	**6.4**	**7.6**	**18**
Current Transfers: Credit (inflows)	6.5	7.6	18
Workers' Remittances	4.5	5.3	17
FCA Residents	0.4	0.3	(16)
Current Transfers :Debit (outflows)	0.1	0.0	(43)

Source: SBP

- The Current Account has shown remarkable improvement compared with the same period of last year.
    - Deficit on trade in goods & services is lower than the same period of last year. Exports of goods as well as services have grown faster than imports.
    - Workers' remittances have also shown a healthy growth over the same period of last year.
- Although Current Account has shown a surplus during H1-FY11, SBP expects the Current Account balance to deteriorate during second half of FY11 and to record a deficit of 1.5% of GDP for the entire FY11.
    - The increase in exports during H1-FY11 is attributable more to higher prices and less to higher volumes. Export growth for the entire FY11 is projected by SBP at 15%;
    - Imports are expected to grow faster during H2-FY11 compared with H1 because of rising international commodity prices, especially oil. Import growth for the entire FY11 is projected by SBP at 12%.

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 $

	Jul-Dec		
	FY 10	**FY 11**	**Growth %**
Financial Account (1+2+3)	**2.9**	**0.8**	**(72)**
(1) Direct Investment	0.9	0.8	(12)
(2) Portfolio Investment	0.3	0.2	(15)
(2a) Equity	0.3	0.2	(22)
(2b) Debt	(0.0)	(0.0)	71
(3) Other Investment	1.8	(0.2)	(111)
Equity based flows (1+2a)	1.2	1.0	(15)
Debt based flows (2b+3)	1.7	(0.2)	(112)

Source: SBP

- Financial Account shows a significantly weak position compared with the same period of last year. Equity as well as Debt flows have been weaker than the same period of last year. This clearly indicates a weak capacity to finance the Current Account Deficit.

INFLATION

CONSUMER PRICES

- A summary of consumer price 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
Oct-2010	15.3	0.6	13.1	20.1	0.1	15.1	11.3	1.1	11.3
Nov-2010	15.5	1.5	13.5	20.5	2.2	15.9	11.1	0.9	11.4
Dec-2010	15.5	-0.5	13.9	20.4	-1.9	16.7	11.4	0.8	11.5
12 month min.	12.3	-0.5	11.7	12.8	-1.9	11.9	11.1	0.1	11.1
12 month max.	15.7	2.7	13.9	21.2	5.3	16.7	12.2	2.8	13.3

[1]12 month moving average

Source: SBP

- On a year-on-year basis, CPI inflation is quite high and is attributable mainly to food inflation. However, CPI inflation fell in Dec 2010 on month-on-month basis as food prices showed some downward adjustment after many months of price increases.
- The breakdown of CPI inflation into its various components is shown in the following table:

Index	Weightage % in CPI	Dec 2010 - CPI Inflation (%)		
		YOY	MOM	12mma
CPI	100	15.5	-0.5	13.9
CPI food	40.34	20.4	-1.9	16.6
Non-perishable food items	35.20	17.1	0.3	15.0
Perishable food items	5.14	43.5	-12.9	27.3
CPI non-food	59.66	11.4	0.8	11.5
Apparel, textile & footwear	6.10	11.9	1.0	8.9
House rent	23.43	6.7	0.7	9.6
Fuel & lighting	7.29	22.5	1.8	19.3
Household, furniture & equipment etc.	3.29	10.0	0.8	7.5
Transport & communication	7.32	16.2	0.2	15.5
Recreation & entertainment	0.83	13.8	0.1	11.6
Education	3.45	5.2	0.0	8.7
Cleaning, laundry & personal appearance	5.88	11.4	0.9	10.2
Medicare	2.07	17.8	1.4	10.5

Source: SBP

CORE INFLATION

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

	Core Inflation					
Period	**NFNE[1] (%)**			**Trimmed[2] (%)**		
	YOY	**MOM**	**12mma**	**YOY**	**MOM**	**12mma**
Oct 2010	9.3	0.7	10.1	12.8	1.0	11.9
Nov 2010	9.5	1.0	10.1	13.4	1.2	12.1
Dec 2010	9.5	0.7	10.0	13.6	0.7	12.2
12 month min.	9.3	0.4	10.0	11.7	0.4	11.2
12 month max.	10.6	1.7	13.9	13.6	1.3	14.4

[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

- Year-on-year NFNE inflation has remained in single digits over the last few months indicating that inflationary pressures are concentrated in food & energy items.
- Trimmed mean inflation has strengthened over the past few months which shows that within the food & energy categories, inflationary pressures are quite broad based.
- Since the trimmed mean excludes the more volatile items, it is a relatively more stable measure of inflation. Rise of trimmed mean inflation above 13% is not a good sign and suggests that it will take some time to tame the inflationary pressures.

WHOLESALE PRICES

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

	WPI Inflation								
Period	**WPI Overall (%)**			**WPI Food (%)**			**WPI Non-food (%)**		
	YOY	**MOM**	**12mma**	**YOY**	**MOM**	**12mma**	**YOY**	**MOM**	**12mma**
Oct 2010	23.8	3.1	19.4	22.2	1.8	15.6	25.1	4.2	22.6
Nov 2010	24.7	3.5	20.4	22.7	2.3	16.8	26.2	4.4	23.5
Dec 2010	25.7	1.1	21.3	21.7	-1.5	17.6	29.0	3.1	24.4
12 month min.	17.6	-0.6	7.7	14.3	-1.5	11.4	20.1	-2.0	3.4
12 month max.	25.7	4.2	21.3	22.7	4.5	17.6	29.0	5.5	24.4

Source: SBP

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

Index	**Weightage (%) in WPI**	**Dec 2010 - WPI Inflation (%)**		
		YOY	**MOM**	**12mma**
WPI	100	25.7	1.1	21.3
WPI food	42.1	21.7	-1.5	17.6
WPI non-food	57.9	29.0	3.1	24.4
Raw materials	8.0	70.8	8.5	52.9
Fuel, lighting & lubricants	19.3	15.5	0.1	21.3
Manufactures	25.9	30.8	3.4	21.0
Building materials	4.7	20.0	0.6	8.4

Source: SBP

- YOY inflation is very high in both food and non-food segments of wholesale prices.
- As per the wholesale price index, non-food inflation is actually higher than food inflation.
  - Since the WPI tracks international price trends more closely, this reflects the rising trend in prices of non-food items.
  - This is also a warning sign for the future of CPI inflation as high wholesale prices eventually feed into consumer prices.

INTERNATIONAL COMMODITY PRICES

- The following table summarizes international commodity price inflation rates:

Period	Inflation Rates as per the indices maintained by IMF								
	(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
Oct 2010	17.7	5.6	28.2	12.3	6.3	32.3	27.5	4.6	22.6
Nov 2010	16.5	3.1	27.9	11.3	3.6	31.3	25.8	2.3	23.5
Dec 2010	23.6	5.9	26.5	21.1	6.4	28.9	27.9	4.9	23.6
12 month high	48.3	5.9	28.2	60.0	6.4	32.3	31.3	7.4	23.6
12 month low	9.9	-7.5	-19.1	8.7	-8.8	-21.8	10.3	-5.1	-11.8

Source: IMF

- A breakdown of the Commodity index into its various components is given below:

Index	Weightage (%) in Commodity Index	Dec 2010 Inflation (%)		
		YOY	MOM	12mma
Fuel & Non-fuel Commodities	**100**	**23.6**	**5.9**	**26.5**
Fuel Commodities (Energy)	**63.1**	**21.1**	**6.4**	**28.9**
Petroleum	53.6	20.6	6.5	33.6
Natural Gas	6.9	3.9	7.6	27.0
Coal	2.6	38.4	11.9	37.6
Non-Fuel Commodities	**36.9**	**27.9**	**4.9**	**23.6**
Industrial inputs	18.4	31.3	3.5	39.1
Agricultural Raw Mat.	7.7	34.5	2.7	35.2
Metals	10.7	29.6	4.0	41.5
Edibles	18.5	24.6	6.3	12.0
Food	16.7	26.8	6.6	11.9
Beverages	1.8	9.0	4.0	14.2

Source: IMF

- International commodity prices exhibited high YOY as well as MOM inflation during Dec 2010. Both the major categories i.e. fuel and non-fuel commodities have experienced large price increases over the past few months. The major reason for this trend is high demand from emerging markets whose economic performance has been better than expectations.

MONEY SUPPLY & INTEREST RATES

- A summary of the total stock of money supply (M2) and the changes in it during the current financial year is given in the following table:

Rs. billions

			Change (1 Jul – 04 Feb 2011)	
		End Jun 2010	Absolute	%
	Broad Money (M 2)	5,777	497	8.6
	LIABILITY SIDE (A+B)			
A	Currency in circulation	1,295	258	20.0
B	Demand & Time deposits	4,482	234	5.2
	ASSET SIDE (C+D)			
C	Net Foreign Assets (NFA) of banking system	545	125	22.9
D	Net Domestic Assets (NDA) of banking system (a+b+c)	5,232	371	7.1
a	Net Govt. Sector borrowings	2,441	341	14.0
b	Credit to Non Govt. Sectors	3,389	179	5.3
c	Other items (net)	(598)	(148)	

Source: SBP

- A summary of the total stock of Reserve Money (RM) and the changes in it during the current financial year is given in the following table:

Rs. billions

			Change (1 Jul – 04 Feb 2011)	
		End Jun 2010	Absolute	%
	Reserve Money (RM)	1,679	274	16.3
	LIABILITY SIDE (A+B)			
A	Currency in circulation	1,295	258	19.9
B	Others (Cash in tills & Deposits)	384	16	4.2
	ASSET SIDE (C+D)			
C	Net Foreign Assets (NFA)	379	121	31.9
D	Net Domestic Assets (NDA) (a+b+c)	1,301	154	11.8
a	Govt. Sector	1,225	186	15.2
b	Non Govt. Sector	330	21	6.4
c	Others	(254)	(54)	

Source: SBP

- It is evident that, during the current financial year, the Monetary Base (Reserve Money RM) has grown much faster than the Monetary Aggregate (Broad Money M2). The major causes of high growth in Reserve Money include
  - growth in NFA; and
  - government borrowing from SBP
- Since the Monetary Base is ultimately converted to Monetary Aggregate through the multiplier effect (repeated cycles of deposits and loans), the risk of high growth in M2 in future has increased. And high growth in M2 accompanied by slow growth in Real GDP will lead to higher inflation. This scenario clearly points towards persistence of inflationary pressures in the near future.
- A summary of interest rates for the last few months 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
Nov 2010	13.38	12.52	13.88	13.01	13.60	12.66
Dec 2010	13.68	12.65	14.25	13.14	13.62	12.75
Jan 2010	13.84	12.81	14.22	13.29	13.83	12.89
12m high	13.84	12.81	14.25	13.29	13.83	12.89
12m low	12.23	12.21	12.56	12.42	12.27	12.41

Source: SBP, Reuters

- In its monetary policy statement (MPS) announced in Jan 2011, SBP decided to keep the discount rate unchanged at 14%. The key points of the MPS are summarized below:
  - The pickup in private sector credit during Q2-FY11 was mainly due to working capital needs (as input prices increased) and is expected to slow down in future;
  - Progress on fiscal reforms including implementation of GST, reduction in subsidies and amendments in SBP Act to restrict government borrowings from SBP has not been promising;
  - Government had initially set a fiscal deficit target of Rs. 685 bn (4% of GDP) for FY11 and later revised it to Rs. 812 bn (4.7% of GDP). Provisional data suggests that fiscal deficit has been close to Rs. 500 bn during H1-FY11. Growth in tax revenue has been lower than expected so far. A substantial shortfall in external financing for the budget is expected. Government's decision of not passing on the impact of rising international oil prices to domestic consumers may cause

additional loss of Rs. 25-35 bn the end of the fiscal year. It seems unlikely that government will meet even the revised fiscal deficit target;

- Government borrowing from the banking system is expected to increase in H2-FY11. Incremental borrowings by government through short-term instruments especially T-bills are consistently increasing future roll over requirements as well as the interest expense of the government. A debt management strategy geared towards long-term borrowings is needed;
- Due to high government spending, the aggregate demand is expected to remain high relative to current productive capacity of the economy. Aggregate money supply M2 is now expected to grow by 15% in FY11;
- Due to a large gap in aggregate demand and aggregate supply, average CPI inflation for FY11 is expected to remain high and is now projected to fall in the range of 15-16%;
- To bring inflation under control, critical measures include reduction in fiscal deficit (through a combination of tax reform, broadening of tax base and rationalization of expenditures) and government borrowings from SBP;
- Positive developments include
  - reduction in government borrowing from SBP during Jan 2011 and an understanding from the government to restrict such borrowings to below the end-September 2010 stock of Rs. 1,290 bn;
  - external current Account surplus during H1-FY11 which is a big improvement over earlier projections and indicates that fiscal problems have not extended into external account;
- In order to balance risks to inflation and economic growth, SBP has decided to keep the discount rate unchanged at 14%. The future course of policy action depends on the expected progress in key area of concern.

INVESTMENT STRATEGY

- Our long-term inflation expectation for the future is in the range of 9-10% p.a. We think that a fixed rate of return of 12.5% p.a. or above on the investments is consistent with PPF's long-term return objective of 'inflation + 3%'.
- We think that the current inflation rate is too high and will gradually revert to its long-term average. Since above-average inflation has led to above-average interest rates also, this is an opportunity to invest at fixed rates of return for longer periods.
- 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, PIBs, Saving Schemes or Stocks etc.

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