Government of the Punjab
Punjab Pension Fund

Dated: 10 August 2010

MONTHLY REVIEW OF INVESTMENTS

July 2010

FUND SIZE

- A summary of changes in fund size during July 2010 is given in the following table:

Rs. millions (rounded to the nearest million)

	Jul 2010
Beginning fund size	12,097
Add: contribution during the period	0
Less: transfer to Reserve Pension Fund	0
Add: gain/(loss) during the period	126
Less: expenses during the period	1
Ending fund size	**12,222**

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

	31 Dec 2009		**30 Jun 2010**		**31 Jul 2010**	
	Amount	**%**	**Amount**	**%**	**Amount**	**%**
PIBs	4,287	35.3	5,737	47.4	5,797	47.4
T-Bills	0	-	3,145	26.0	3,026	24.8
Short term bank deposits	7,844	64.5	3,015	24.9	3,031	24.8
Corporate bonds/TFCs	0	-	176	1.5	311	2.5
Cash at bank	22	0.2	21	0.2	56	0.5
Other assets*	2	0.0	3	0.0	1	0.0
Total Fund Size	**12,155**	**100.0**	**12,097**	**100.0**	**12,222**	**100.0**

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

- PPF has been increasing its exposure to long-term fixed-rate investments which are more suitable for the Fund considering the long-term nature of pension liabilities. At the end of the month, long term PIBs constitute 47.4% of the Fund size;
    - A PIB Auction with an overall target of Rs. 20 bn was held during July 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 upto 5% of its auction target. PPF was an active participant in the 'when issue' market. We purchased 10, 15 & 20-yr PIBs from the 'when issue' market and also participated in the auction by bidding for 10, 15, 20 & 30-yr PIBs. The government, however, scrapped the entire auction and in the end we were unable to build our PIB portfolio.

  - There is another PIB auction in August 2010 with an overall target of Rs. 25 bn. PPF should be able to expand its PIB portfolio in this auction.

- 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%
Jul 2010	12.96%	12.81%		

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

- A significant portion (47.4%) of the Fund has been invested in long-term fixed-rate PIBs. The PIB portfolio is yielding a return close to 13% p.a. This will provide stability to overall return of the Fund, going forward.
- Current inflation rates are quite high. 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 has set a GDP growth target of 4.5%.
- 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

- Full year's figures of the actual budgetary situation in FY 10 have not been released yet. A summary of revenues and expenditures during the first three quarters of FY 10 and their comparison with the same period of the previous financial year is shown in the following table:

	Jul - Mar						
	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	**1,301**	**1,402**	**76**	**69**	**9.7**	**9.3**	**7.7**
(1a) Tax	849	1,015	50	50	6.3	6.7	19.5
Direct Tax	308	342	18	17	2.3	2.3	11.3
Indirect Tax	542	672	32	33	4.0	4.5	24.1
(1b) Non-tax	452	387	27	19	3.4	2.6	(14.4)
Dividend	40	43	2	2	0.3	0.3	7.2
SBP Profit	135	183	8	9	1.0	1.2	35.3
(2) Total expenditure	**1,707**	**2,028**	**100**	**100**	**12.8**	**13.5**	**18.8**
(2a) Current	1,416	1,660	83	82	10.6	11.0	17.3
Domestic Debt Service	395	429	23	21	3.0	2.8	8.5
Foreign Debt Service	48	45	3	2	0.4	0.3	(5.7)
Defence	224	270	13	13	1.7	1.8	20.4
(2b) Development	246	364	14	17	1.8	2.3	42.9
Budget surplus / (deficit)	**(405)**	**(626)**	**(24)**	**(31)**	**(3.0)**	**(4.2)**	**54.5**
Financing	405	626	24	31	3.0	4.2	54.5
External	84	93	5	5	0.6	0.6	10.3
Domestic	321	533	19	26	2.4	3.5	66.0
Non-bank	144	322	8	16	1.1	2.1	124.4
Bank	176	211	10	10	1.3	1.4	19.6
Privatization	1	0	0	0	0	0	-100.0
Full Year GDP	**13,384**	**15,039**					
Revenue balance (1-2a)	**(114)**	**(258)**	**(7)**	**(13)**	**(0.9)**	**(1.7)**	

Source: Ministry of Finance

- Deficit in Revenue Balance reached Rs. 258 bn or 1.7% of GDP in first nine months of FY 10. This is the amount by which the total revenues of the government from all sources have fallen short of its current expenditures. This implies that the government needs to borrow this amount in order to pay for its normal day-to-day expenses and all of the long-term development expenditure has to be financed from borrowing. This state of affairs is quite alarming and clearly unsustainable.

- The weak fiscal situation is one of the major reasons behind high interest rates in the market despite a weak economic situation.
- Although the details for the full financial year have not been released, reports suggest that the annual budget deficit exceeded Rs. 900 bn which is equivalent to more than 6% of GDP. This is much higher than the revised target of 5.1% communicated to IMF and shows that the fiscal situation is far from under control.
- As per the Medium Term Budgetary Framework developed by the government, the key budgetary targets as a percentage of GDP are as under:

	Target for FY 11 (as % of GDP)
Total revenue	15.2
Tax revenue	10.9
Total expenditure	19.2
Current expenditure	14.8
Development expenditure	4.4
Fiscal deficit	-4.0
Revenue balance	0.4

Source: Ministry of Finance

- 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 (%)**
	Jun-09	**Jun-10**	**Jun-09**	**Jun-10**	**Jun-09**	**Jun-10**	**FY 10**
A) Permanent	678	794	17.6	17.1	5.1	5.3	17.2
PIBs	441	505	11.4	10.9	3.3	3.4	14.6
Prize Bonds	197	236	5.1	5.1	1.5	1.6	19.6
B) Floating	1,904	2,399	49.3	51.6	14.2	16.0	26.0
C) Unfunded	1,271	1,456	32.9	31.3	9.5	9.7	14.6
DSCs	257	225	6.7	4.8	1.9	1.5	(12.6)
SSCs	289	351	7.5	7.5	2.2	2.3	21.5
BSCs	308	367	8.0	7.9	2.3	2.4	19.3
D) FC Instruments	8	3	0.2	0.1	0.1	0.0	(61.7)
Total Domestic Debt	**3,861**	**4,653**	**100.0**	**100.0**	**28.8**	**30.9**	**20.5**
GDP	**13,384**	**15,039**					

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:

Debt	**Amount (USD bn)**		**Amount (Rs. bn)**		**As % of GDP**		**Growth[1] (%)**
	Jun-09	**Mar-10**	**Jun-09**	**Mar-10**	**Jun-09**	**Mar-10**	**Jul-Mar FY 10**
A) Public	42.5	43.3	3,479	3,648	26.0	24.3	4.9
Medium & long term	41.5	41.4	3,397	3,488	25.4	23.2	2.7
Short term	1.0	0.8	82	67	0.6	0.4	(17.7)
IMF (Fed. Govt.)	0	1.1	-	93	-	0.6	-
B) Publicly guaranteed	0.2	0.2	16	17	0.1	0.1	2.9
C) IMF (Central Bank)	5.1	6.1	417	514	3.1	3.4	23.1
D) Scheduled banks	0	0.3	-	25	-	0.2	-
E) Private (non-guaranteed)	3.3	3.2	270	270	2.0	1.8	(0.2)
Total External Debt	**51.1**	**53.0**	**4,183**	**4,465**	**31.3**	**29.7**	**6.8**
Exchange Rate (Rs./USD)	**81.85**	**84.25**					
GDP			**13,384**	**15,039**			

[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, the rupee value of the principal amount of external debt keeps increasing as a result of devaluation of the rupee. During Jul-Mar FY 10, the increase in external debt (measured in rupees) has been driven partly by net borrowing and partly by devaluation of rupee during the year.
- 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 $

	FY 09	FY 10
Current Account	(9.3)	(3.5)
Capital Account	0.5	0.2
Financial Account	5.6	4.9
Errors and Omissions	0.12	(0.4)
Overall Balance of Payments	**(3.1)**	**1.3**

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 $

	FY 09	FY 10
Current Account (1+2+3)	**(9.3)**	**(3.5)**
(1) Balance of trade in Goods & Services	**(16.0)**	**(13.0)**
Goods: Exports f.o.b	19.1	19.6
Goods: Imports f.o.b	31.7	31.0
Balance of trade in goods	(12.6)	(11.4)
Services: Credit (exports)	4.1	5.1
Services: Debit (imports)	7.5	6.8
Balance of trade in services	(3.4)	(1.7)
(2) Balance of Income Transfers	**(4.4)**	**(3.3)**
Income: Credit (inflows)	0.9	0.6
Income: Debit (outflows)	5.3	3.8
Interest Payments	1.9	1.5
Profit & Dividend	0.8	0.7
(3) Balance of Current Transfers	**11.2**	**12.8**
Current Transfers: Credit (inflows)	11.3	12.9
Workers' Remittances	7.8	8.9
FCA Residents	(0.3)	0.6
Current Transfers :Debit (outflows)	0.1	0.1

Source: SBP

- Current Account Deficit (CAD) has lowered significantly during FY 10 compared with last year.

- Current Account may be divided into three major segments i.e. trade in goods & services, income-related flows and current (unilateral) transfers.

1. Trade in goods & services:
    - Deficit on trade in goods has lowered by 9.5% compared with last year. This resulted from a combination of lower imports (growth of -2.3% over last year) and a small rise in exports (growth of 2.7% over last year).
    - Deficit on trade in services has lowered by 50% compared with last year. This resulted from a combination of lower imports (growth of -9% over last year) and a rise in exports (growth of 24% over last year).

2. Income–related flows:
    - Deficit on Income-related flows has also lowered by 25% compared with last year. Lower inflows during the year were more than offset by lower outflows (attributable to lower repatriation of profits by foreign investors and lower interest payments on foreign loans).

3. Current (unilateral) transfers:
    - Surplus on account of current transfers increased mainly because of higher worker-remittances.

- Current Account Deficit stands at 2% of GDP for FY 10 which is better than earlier expectations.
- 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 the last financial year is shown in the following table:

Billion US $

	FY 09	FY 10
Financial Account (1+2+3)	**5.6**	**4.9**
(1) Direct Investment	3.7	2.2
(2) Portfolio Investment	(1.1)	(0.1)
(2a) Equity	(0.6)	0.6
(2b) Debt	(0.5)	(0.7)
(3) Other Investment	3.0	2.8
Equity based flows (1+2a)	3.1	2.8
Debt based flows (2b+3)	2.5	2.1

Source: SBP

- Surplus on Financial Account has decreased by $ 0.7 bn during FY 10 compared with last year. But the real worry is the substantial decline of $ 1.5 bn in Foreign Direct Investment. This has implications for future productivity and sustainable growth of the economy.
- The sustainability of Current Account Deficit (CAD) depends on the country's ability to finance it (preferably through non-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**
Mar 2010	12.9	1.3	12.2	14.5	1.8	12.1	11.6	0.8	12.6
Apr 2010	13.3	1.7	11.9	14.6	2.0	11.9	12.2	1.5	12.1
May 2010	13.1	0.1	11.7	14.8	0.1	12.1	11.7	0.1	11.9
Jun 2010	12.7	0.6	11.7	14.5	0.7	12.5	11.2	0.6	11.5
12 month min.	8.9	-0.5	11.7	7.5	-1.8	11.9	10.0	0.3	11.5
12 month max.	13.7	2.4	19.9	15.5	3.0	22.4	12.2	2.8	17.3

[1]12 month moving average

Source: SBP

	Core Inflation					
Period	**NFNE[1] (%)**			**Trimmed[2] (%)**		
	YOY	**MOM**	**12mma**	**YOY**	**MOM**	**12mma**
Mar 2010	9.9	0.8	12.6	12.7	0.8	13.2
Apr 2010	10.6	1.7	12.0	12.7	1.1	12.8
May 2010	10.3	0.6	11.5	12.5	0.4	12.4
Jun 2010	10.4	0.7	11.0	11.7	0.7	12.1
12 month min.	9.9	0.6	11.0	10.4	0.4	12.1
12 month max.	14.0	1.7	17.5	13.9	1.3	19.2

[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

- Inflationary pressures eased during June 2010. Both food and non-food segments of CPI showed lower inflation. The non-food segment showed a greater decline because of downward adjustment in administered prices of fuels and moderation in House Rent Index.
- Major factors causing food inflation, which has been the major contributor to overall inflation, include:
  - Increased transportation costs;
  - Strong external demand for meat and vegetables; and

  - o Supply shortages in domestic markets.
- The long-run trend of CPI inflation indicated by 12mma reached its lowest level (11.7%) in 25 months in June 2010.
- NFNE (non-food non-energy) inflation rose slightly whereas trimmed mean inflation declined during June 2010 compared with May 2010. This indicates that most of the decline during the month is attributable to lower fuel prices.

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
Mar 2010	21.8	2.5	9.2	16.3	1.7	11.5	26.5	3.2	7.7
Apr 2010	22.0	1.8	10.4	15.2	0.8	11.4	27.7	2.7	9.9
May 2010	21.2	0.9	11.7	14.4	0.1	11.6	26.9	1.4	12.2
Jun 2010	17.6	-0.6	12.9	14.5	1.2	11.9	20.2	-1.9	13.9
12 month min.	0.3	-0.6	7.6	5.8	-0.7	11.4	-5.6	-1.9	3.9
12 month max.	22.0	4.2	16.2	16.3	2.7	21.8	27.7	5.5	13.9

Source: SBP

- On a MOM basis WPI showed a deflation of 0.6%. YOY inflation is still high at 17.6% but has declined compared with last month when it stood at 21.2%.
- Wholesale prices track international prices more closely than other measures of inflation. High YOY inflation reflects low base effect because international prices had crashed a year earlier. Low MOM numbers shows that the recent trend in wholesale prices is of lower inflation.
- 12mma of WPI inflation continued to rise and stood at 12.9% in June 2010.
- A breakdown of WPI inflation (YoY) into its various components is shown in the following table:

Index	Weightage in overall WPI	Jun 2010 - Inflation (%)		
		YOY	MOM	12mma
WPI	100	17.6	-0.6	12.9
WPI food	42.1	14.5	1.2	11.9
WPI non-food	57.9	20.0	-1.9	13.9
Raw materials	8.0	50.5	0.3	28.7
Fuel, lighting & lubricants	19.3	12.6	-4.4	16.3
Manufactures	25.9	19.5	-0.8	10.2
Building materials	4.7	13.2	-0.4	-4.9

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
Mar 2010	45.9	4.0	-4.2	55.9	4.9	-4.2	31.3	2.4	-1.1
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
12 month high	48.3	7.1	13.6	60.0	8.9	16.7	31.3	5.1	10.8
12 month low	-44.6	-7.5	-36.2	-51.9	-8.8	-42.1	-26.3	-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	Jun 2010 Inflation (%)		
		YOY	MOM	12mma
Fuel & Non-fuel Commodities	**100**	**9.9**	**-1.8**	**13.6**
Fuel Commodities (Energy)	**63.1**	**9.6**	**-0.9**	**16.7**
Petroleum	53.6	8.1	-1.4	28.0
Natural Gas	6.9	34.0	1.9	12.2
Coal	2.6	37.6	-1.9	3.3
Non-Fuel Commodities	**36.9**	**10.3**	**-3.2**	**10.8**
Industrial inputs	18.4	27.9	-5.0	22.8
Agricultural Raw Mat.	7.7	28.5	-5.1	17.6
Metals	10.7	27.6	-5.0	26.2
Edibles	18.5	-2.6	-1.4	2.4
Food	16.7	-4.8	-2.2	0.9
Beverages	1.8	17.5	4.8	15.8

Source: IMF

- Negative MOM inflation numbers shows that prices of most commodities have fallen during June 2010. On a YOY basis, a sharp slowdown in inflation rates is quite evident.
- The decline in international commodity prices may be attributed to
  - concerns regarding Euro zone debt crisis;
  - concerns regarding US recovery; and
  - fiscal and monetary tightening in China.
- YOY inflation is still very high in some cases. However, this number 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.
- The 12-month moving average of YOY inflation rates captures a longer term trend of price changes. The 12mma does not show alarming increases in commodity 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
Apr 2010	12.25	12.29	12.56	12.43	12.33	12.57
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	12.41	12.28	12.97	12.61	12.42	12.45
12m high	12.56	12.87	12.97	13.67	12.85	13.86
12m low	11.95	12.21	12.36	12.42	12.23	12.41

Source: SBP, Reuters

- In the Monetary Policy Statement announced on 30 July 2010, SBP increased the discount rate by 0.5% to 13%. SBP has given the following reasons for its decision:
  - There are risks of persistence in inflationary pressures because of
    - Further upward adjustments in electricity prices;
    - Increase in General Sales Tax (GST);
    - Increase in government employees' salaries;
    - Rising domestic demand relative to weak productive capacity; and
    - Increase in Net Domestic Assets (NDA) to Net Foreign Assets (NFA) ratio and its strong association with CPI inflation.

- Fiscal weaknesses have intensified and have contributed towards expectations of rising inflation
  - Revised fiscal deficit target of 5.1% of GDP for FY 10 has been missed and the actual fiscal deficit is likely to be higher than 6% of GDP;
  - Target of government borrowings from SBP has been breached as of 30 June 2010 (actual borrowing of Rs. 1171 bn against the target of Rs. 1130 bn);
  - Government has set the fiscal deficit target for FY 11 at 4% of GDP. Considering the levels of revenues and expenses envisaged in the budget, the target is unlikely to be met. The actual budget deficit for FY 11 is likely to exceed 5% of GDP;
  - Expansionary fiscal position is leading to aggregate demand pressures.
- Current Account Deficit is expected to increase to 3.7% of GDP in FY 11 compared with 2% of GDP in FY 10. This is expected to put pressure on the overall external account, foreign exchange reserves and the exchange rate.

- We did not expect that SBP would raise interest rates. We believed that the existing rates were high enough to crowd out the private sector and inflationary pressures would not last long in the face of a weak domestic as well as global economy. SBP, however, preferred to send a strong signal that it would not allow a resurgence of inflationary expectations being fuelled by the expansionary fiscal policy of the government.

INVESTMENT STRATEGY

- Given the weaknesses in the economy and SBP's resolve to fight inflation, we do not expect inflationary pressures to persist for long.
- The future course of long-term interest rates is relatively more difficult to predict. We think that high targets set by the government for PIB auctions in the first half of FY 11 and the SBP's monetary policy decision are the major drivers behind the rising secondary market yields on the 10-yr PIB. However, the scrapping of the PIB auction in July, 2010 suggests that the government is reluctant to borrow long-term at higher rates. The next auction planned for 18 August 2010 will be a test of the government's willingness to borrow at current yields.
- 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.

- Our TFC portfolio continues to grow. 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.
- 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