Government of the Punjab

Punjab Pension Fund

Dated: 8 October 2010

MONTHLY REVIEW OF INVESTMENTS

September 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	377
Less: expenses during the period	4
Ending fund size	**12,470**

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 Mar 2010		30 June 2010		30 Sep 2010	
	Amount	%	Amount	%	Amount	%
PIBs	4,975	39.7	5,737	47.4	5,570	44.7
T-Bills	3,363	26.9	3,145	26.0	4,503	36.1
Short term bank deposits	2,558	20.4	3,015	24.9	-	-
Corporate bonds/TFCs	-	-	176	1.5	300	2.4
Cash at bank	1,619	12.9	21	0.2	2,092	16.8
Other assets*	8	0.1	3	0.0	5	0.0
Total Fund Size	**12,523**	**100.0**	**12,097**	**100.0**	**12,470**	**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 is Rs. 5,570 m at the end of September which is slightly lower than the exposure of Rs. 5,737 m at the end of June. The difference is not because of any sale 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. Most of the PIBs pay coupons at the end of August & in the beginning of September as a result of which the accrued interest is much lower as on 30 September. This has 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 2.4% of the Fund size.
- PPF has also been switching exposure between T-bills & short-term bank placements in pursuit of higher rates of return.
- Cash-at-bank was Rs. 2,092 m as on 30 September. This balance was kept at bank so that it could be invested at a higher rate in case SBP increased the discount rate in the monetary policy decision due at the end of September.

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-Sep 2010	12.97%	12.82%		
Sep 2010	13.00%	12.84%		

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

- A significant portion (44.7%) 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. A complete assessment of the damage caused by floods has not been made as yet. According to SBP, the provisional estimates suggest that GDP growth for FY 2010-11 could come down to 2.5%.
- 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

- 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

- Revenue Balance is computed by subtracting the current expenditure from total revenue. It shows
  - o the capacity of the government to meet its current expenditure out of its current sources; and
  - o whether any surplus is available to finance the development expenditure which is important for the long-term productivity of the economy.
- In FY 10, the deficit in Revenue Balance was Rs. 308 bn or 2.1% of GDP in FY 10. This was the amount by which the total revenue of the government fell short of its current

expenditure. In addition to this deficit, the entire development expenditure was 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 has set a budget deficit target of 4% for FY 11. As per SBP's analysis, the budget deficit target has shot up to 5.2% of GDP after the announcement of provincial budgets and even that will be difficult to meet considering the enormity of prevailing fiscal imbalances.

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 $

	Jul-Aug FY 10	Jul-Aug FY 11
Current Account	(0.6)	(0.9)
Capital Account	0.0	0.0
Financial Account	2.0	0.1
Errors and Omissions	(0.2)	0.0
Overall Balance of Payments	**1.2**	**(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-Aug FY 10	Jul-Aug FY 11
Current Account (1+2+3)	**(0.6)**	**(0.9)**
(1) Balance of trade in Goods & Services	**(2.4)**	**(2.8)**
Goods: Exports f.o.b	3.0	3.5
Goods: Imports f.o.b	5.0	5.7
Balance of trade in goods	(2.0)	(2.3)
Services: Credit (exports)	0.6	0.6
Services: Debit (imports)	1.0	1.2
Balance of trade in services	(0.5)	(0.6)
(2) Balance of Income Transfers	**(0.5)**	**(0.4)**
Income: Credit (inflows)	0.1	0.1
Income: Debit (outflows)	0.6	0.5
Interest Payments	0.2	0.2
Profit & Dividend	0.1	0.1
(3) Balance of Current Transfers	**2.3**	**2.3**
Current Transfers: Credit (inflows)	2.3	2.3
Workers' Remittances	1.5	1.7
FCA Residents	0.1	0.0
Current Transfers :Debit (outflows)	0.0	0.0

Source: SBP

- 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%).
- Actual figures show that that Current Account Deficit has increased during Jul-Aug FY 11 compared with last year. Positive growth shown by exports and foreign remittances has been more than offset by the growth in imports.

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-Aug FY 10	Jul-Aug FY 11
Financial Account (1+2+3)	**2.0**	**0.1**
(1) Direct Investment	0.3	0.2
(2) Portfolio Investment	0.1	0.1
(2a) Equity	0.1	0.1
(2b) Debt	(0.0)	0.0
(3) Other Investment	1.6	(0.1)
Equity based flows (1+2a)	0.4	0.3
Debt based flows (2b+3)	1.6	(0.1)

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.
- During the first two months of the current financial year, the Financial Account is showing a surplus of $ 0.1 bn against $ 2 bn during the same period of last financial year. This clearly points towards the difficult times ahead.

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

	Core Inflation					
Period	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.
  - Surge in CPI food inflation came primarily from a sharp jump in prices of perishable food commodities in the wake of production losses & supply shortages caused by heavy floods. Non-perishable food commodities showed lower inflation compared with preceding months.
  - Analysis of non-food group indicates that out of nine sub-groups, six recorded decline in inflation during August 2010.

- 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.

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
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
Jul 2010	18.7	1.7	14.4	14.3	1.9	12.4	22.0	1.1	16.1
Aug 2010	19.2	2.6	16.0	16.4	4.2	13.1	21.3	1.5	18.4
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	14.4	16.3	2.7	19.7	27.7	5.5	16.1

Source: SBP

- 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

- Month-on-month inflation 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
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
Aug 2010	12.3	3.3	22.5	8.7	0.9	26.5	18.3	7.4	17.3
12 month high	48.3	5.7	22.5	60.0	8.0	26.5	31.3	7.4	17.3
12 month low	-28.5	-7.5	-36.2	-40.1	-8.8	-42.1	-14.6	-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	Aug 2010 Inflation (%)		
		YOY	MOM	12mma
Fuel & Non-fuel Commodities	**100**	**12.3**	**3.3**	**22.5**
Fuel Commodities (Energy)	**63.1**	**8.7**	**0.9**	**26.5**
Petroleum	53.6	6.1	1.8	37.1
Natural Gas	6.9	9.4	-7.6	21.8
Coal	2.6	23.6	-7.1	17.3
Non-Fuel Commodities	**36.9**	**18.3**	**7.4**	**17.3**
Industrial inputs	18.4	25.2	10.1	31.3
Agricultural Raw Mat.	7.7	23.9	7.9	24.8
Metals	10.7	25.9	11.3	35.4
Edibles	18.5	12.3	4.9	7.2
Food	16.7	12.0	5.3	5.8
Beverages	1.8	14.9	1.6	19.6

Source: IMF

- Year-on-year inflation eased during August 2010 compared with July 2010. Mainly because of low YoY inflation exhibited by fuel/energy commodities.
- Non-fuel commodities show high YoY as well as MoM inflation. 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 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
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
Sep 2010	12.97	12.36	13.75	12.79	13.27	12.52
12m high	12.97	12.81	13.75	13.34	13.27	13.52
12m low	11.95	12.21	12.40	12.42	12.23	12.41

Source: SBP, Reuters

- In its monetary policy decision dated 29 Sep 2010, SBP raised the discount rate by 0.5% from 13% to 13.5%.
- We were expecting that SBP would maintain the discount rate at 13% because the inflation numbers were skewed (supply-driven food inflation on one hand and easing of non-food inflation on the other hand) and a number of other indicators (asset prices, employment, capacity utilization of industry etc.) were pointing towards a dull economy.
- The key points of SBP's monetary policy statement are summarized as under:
  - The recent spike in food prices is temporary and is largely due to floods. It may take two to three months for food inflation to return to normal levels.
  - Inflation is expected to increase. Average CPI inflation for FY 11 may fall between 13.5 & 14.5%.
  - Slowdown in private demand later in the year will at best have a moderating effect on CPI inflation as it is likely to be neutralized by an expected increase in government spending in general and on reconstruction in flood affected areas in particular.
  - Likely increases in electricity prices, imposition of reformed GST and continued reliance of government on borrowings from SBP add to the uncertainties surrounding inflation expectations.
  - The government borrowed Rs. 220 bn from SBP during 1 Jul – 24 Sep 2010 compared with Rs. 126 bn during the same period of last year. This is against the spirit of macroeconomic stabilization.
  - Heavy government borrowing through short-term T-bills is creating rollover risk.

- o The rising ratio of Net Domestic Assets (NDA) to Net Foreign Assets (NFA) of the banking system does not bode well for inflation which has shown a high correlation with this ratio.
  - o Trade balance is expected to worsen with import growth expected to outpace export growth. If the damage caused by the floods to the cotton crop turns out to be extensive, even the existing projections of export growth may not materialize.
  - o The failure of the government to contain the fiscal deficit & inflationary borrowings from SBP & the banking system has resulted in the private sector bearing the full brunt of the adjustment as a result of monetary tightening.
- We think that higher interest rates are achieving very little in terms of restoration of economic stability. There has been no growth in private sector borrowing over the last two to three years which means that the private sector has already made most of the adjustment that it could make. Further reduction in private sector demand can come mainly from higher unemployment which is certainly not desirable.
- SBP alone cannot ensure macroeconomic stability until the government shoulders its own responsibilities. The government needs to
  - o tackle food shortages urgently in order to bring down inflation; and
  - o finance more of its expenditures from taxes and lower its reliance on borrowings.

  This will set the stage for lower inflation and interest rates, revival of private sector borrowing and investment, job creation and income growth.

INVESTMENT STRATEGY

- During the 18 year period from June 1992 to June 2010, inflation has averaged a little less than 9% p.a. Three (important but conceptually different) measures of average inflation over this 18 year period are as under:

Measure	Rate p.a.	Interpretation
CAGR	8.8%	An asset or liability growing at inflation rate would have grown at a compound rate of 8.8% p.a.
Mean	8.9%	Simple average of annual inflation rates over this period comes to 8.9% p.a.
Median	8.6%	Half of the time over this period, annual inflation remained at or below 8.6% p.a.

- Our long-term inflation expectation 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 our investments is consistent with our long-term return objective of 'inflation + 3%'.
- Currently, inflation stands at more than 13% p.a. 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, our strategy is to continue to invest at fixed rates of return.
- We are, however, finding it increasingly difficult to invest at fixed rates of return for longer periods. The government is consistently showing reluctance to borrow long-term at high rates of interest. The government scrapped all the bids for 15-yr, 20-yr and 30-yr PIBs during the last four PIB auctions. In fact the last two of these four auctions were entirely scrapped i.e. no bid was accepted for any tenor.
- Another PIB auction is taking place on 13 October 2010. We intend to participate in this auction with the hope, if not the expectation, that it will not be scrapped.
- 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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