



Debt Concerns Re-Emerge as Growth Outlook Moderates

Investment Strategy | Jan 2026 | SRI LANKA



First Capital
A Janashakthi Group Company

Analysts:
Dimantha Mathew
dimantha@firstcapital.lk

Ranjan Ranatunga
ranjan@firstcapital.lk

01	Executive Summary	3
02	Track Record [Jan 2025 & Aug 2025]	4
03	Key Elements of consideration for 2026 Outlook	13
04	Uncertainty clear; Policy certainty returns: Low Risk	16
05	Macro-economic stability elevates: Medium-Low Risk	19
	Economic growth to soften	21
	Reserve accumulation remain challenged	31
	Fiscal discipline continues to remain on focus	35
06	Global Outlook remains stable: Medium-Low Risk	41
07	Scenarios for Emerging Systemic Risk	50
08	Recommendations	56
	First Capital Research View on Bond Market 2026	55
	First Capital Research View on Banking Rates 2026	65
	First Capital Research View on Exchange Rate 2026	67
	First Capital Research View on Equity Market 2026	69



EXECUTIVE SUMMARY



Yields may gradually revert up by 50-100bps during next 12 months up to Dec-26

- With private sector credit expected to remain elevated in 2026E growing 18%YoY, liquidity levels in the banking sector are expected to remain low, whilst gradual acceleration in inflation coupled with slow accumulation of foreign reserves amidst increased debt repayment obligations are expected to add pressure towards rates in 2026E.
- With G-Sec yields likely to be on a rising trend during most part of 2026, we advise investors to shift to short tenors with a willingness to run a carry portfolio, which is where investors are expected to hold the investments upto maturity to avoid any capital losses.

AWPR may rise to 9.0%-10.0% during 1H2026 and 10.0%-11.0% in 2H2026

- We expect AWPR to continue to hover between 9.0%-10.0% during the 1H2026 whilst introducing a new target of 10.0%-11.0% for 2H2026. Growth in private sector credit and a run down in banking sector liquidity, coupled with increasing rates on government securities, pushing up costs of banks are expected drive AWPR during 1H2026E.

Exchange Rate outlook upgraded to LKR 310.0-320.0 for 1H2026 and LKR 320.0-330.0 for 2H2026

- Sri Lanka Rupee performed inline with our expectations in 2025, recording a depreciation of 5.4%YoY to close the year at LKR 310.0/USD. Looking ahead, we expect the currency to depreciate by 5% during 2026E and gives targets of LKR 310.0-LKR 320.0 for 1H2026E and LKR 320.0-330.0 for 2H2026E.

ASPI Dec-26 fair value maintained between 21,000 – 22,000

- With corporate earnings coming in line with our expectations in 9M2025, we expect listed corporate earnings to moderate in 2026E, recording a growth of 17%YoY in 2026E. Considering the moderation of earnings coupled with ASPI trading at an 18Yr average PE multiple of 12.0x, we maintained our ASPI fair value for 2026E at 21,000-22,000. Moreover, given that ASPI have surpassed our fair value estimate, we advice to revise down our equity allocations to 85% from previous allocation of 100%.



Track Record [Jan 2025 & Aug 2025]

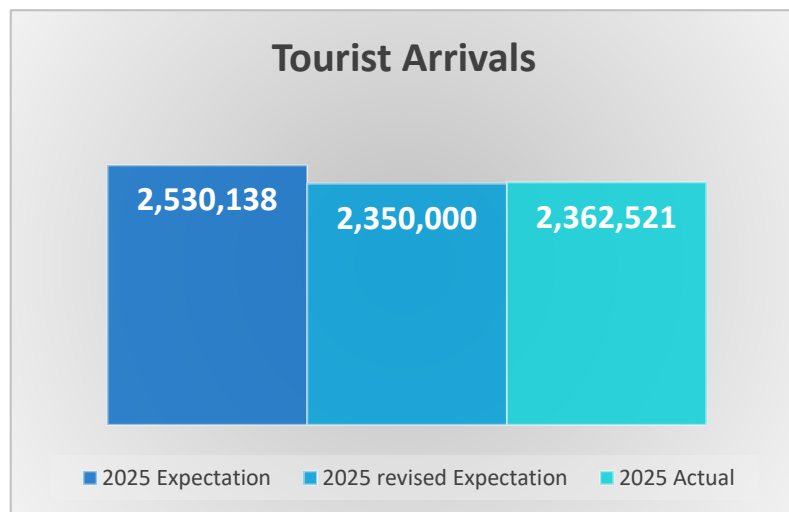
Section 1.0

First Capital Levels of Accuracy

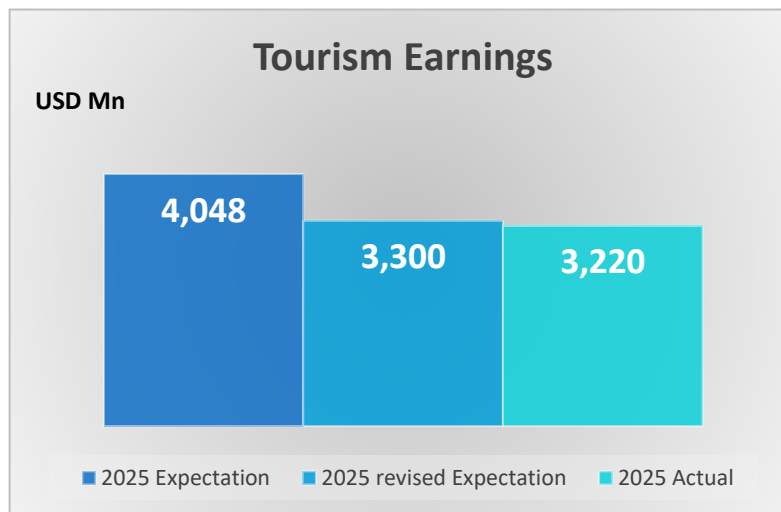
- 81% - 100% accuracy - **Accurate**
- 61% - 80% accuracy - **Mostly Accurate**
- 41% - 60% accuracy - **Partly Accurate**
- 20% - 40% accuracy - **Weak Accuracy**
- 00% - 20% accuracy - **Inaccurate**

Previous Forecasts of Economic Indicators

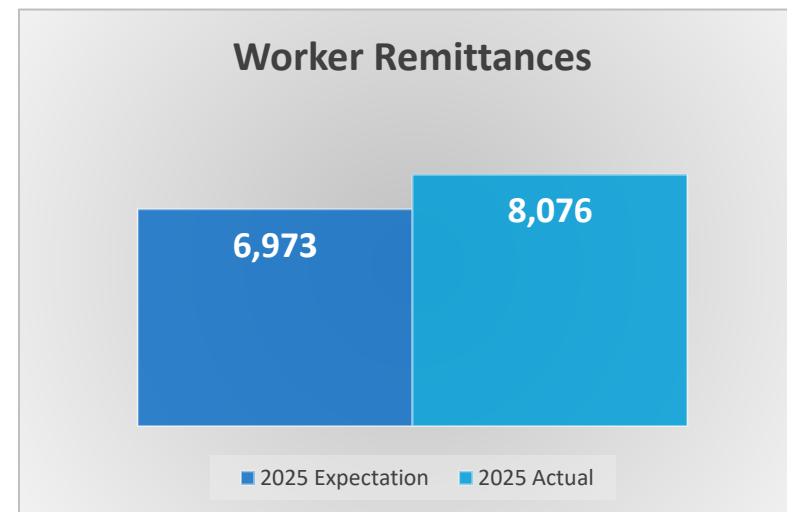
Forecast: **Accurate**



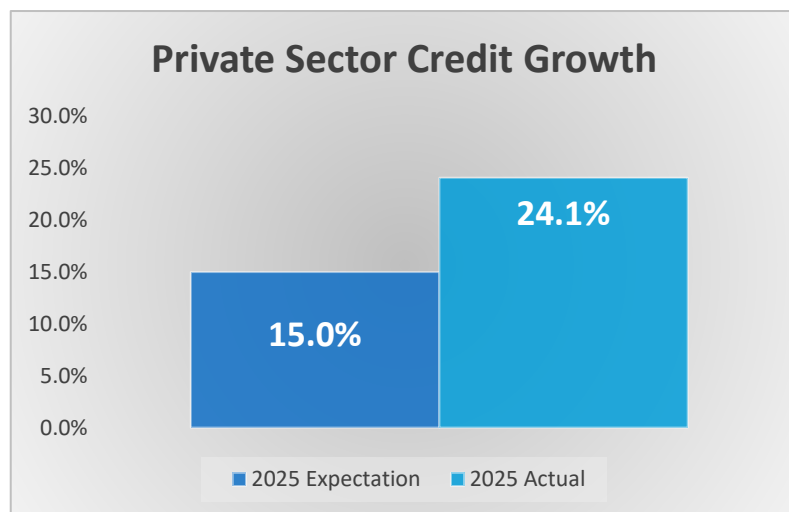
Forecast: **Partly Accurate**



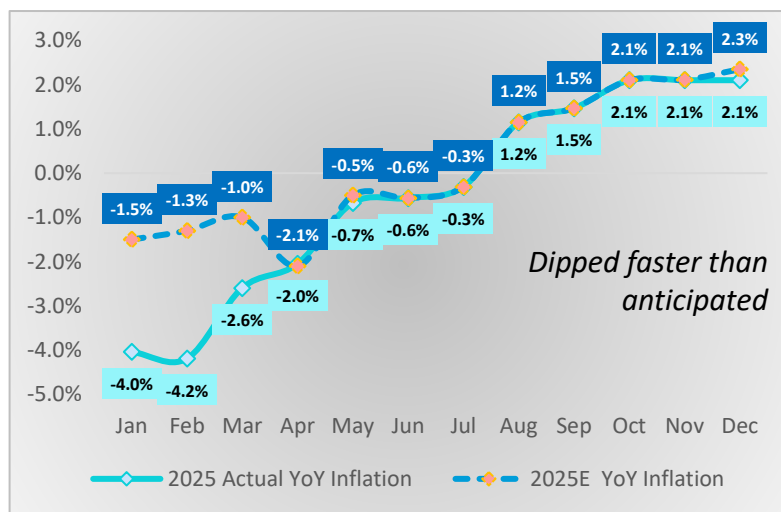
Forecast: **Mostly Accurate**



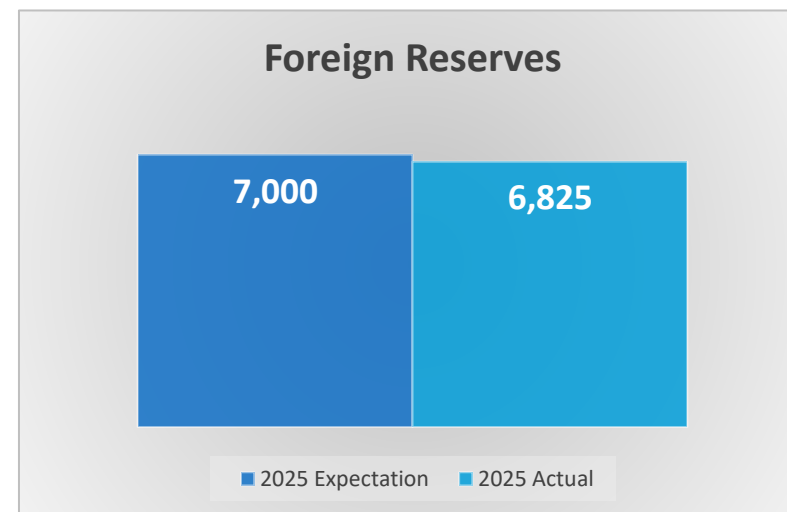
Forecast: **Mostly Accurate**



Forecast: **Mostly Accurate**



Forecast: **Accurate**



Previous Recommendations - Bonds

16th Jan 2025 [Investment Strategy 2025 Report]

2Q2025 onwards G-Sec yields are likely to witness upward pressure of c.100-150bps as the economy accelerates.

Inaccurate

Yield curve remained flat against our expectation

28th Mar 2025 [FI Report]

The expectation of the upward adjustment of the yield curve is delayed to 4Q2025E.

Accurate

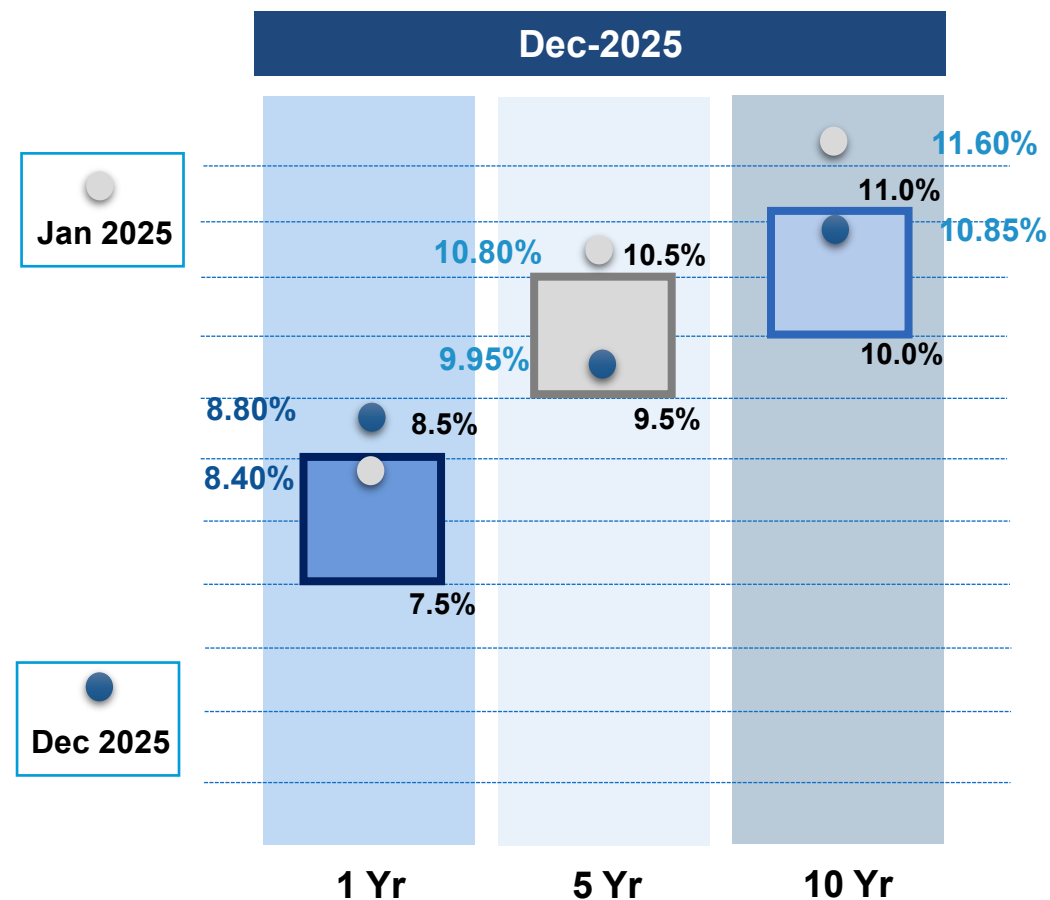
Yield curve declined slightly and moved within our bands

14th Jul 2025 [Mid-year report]

Yields to remain stable within the next 6-12 months, Shift to short tenures with a willingness to run a carry portfolio.

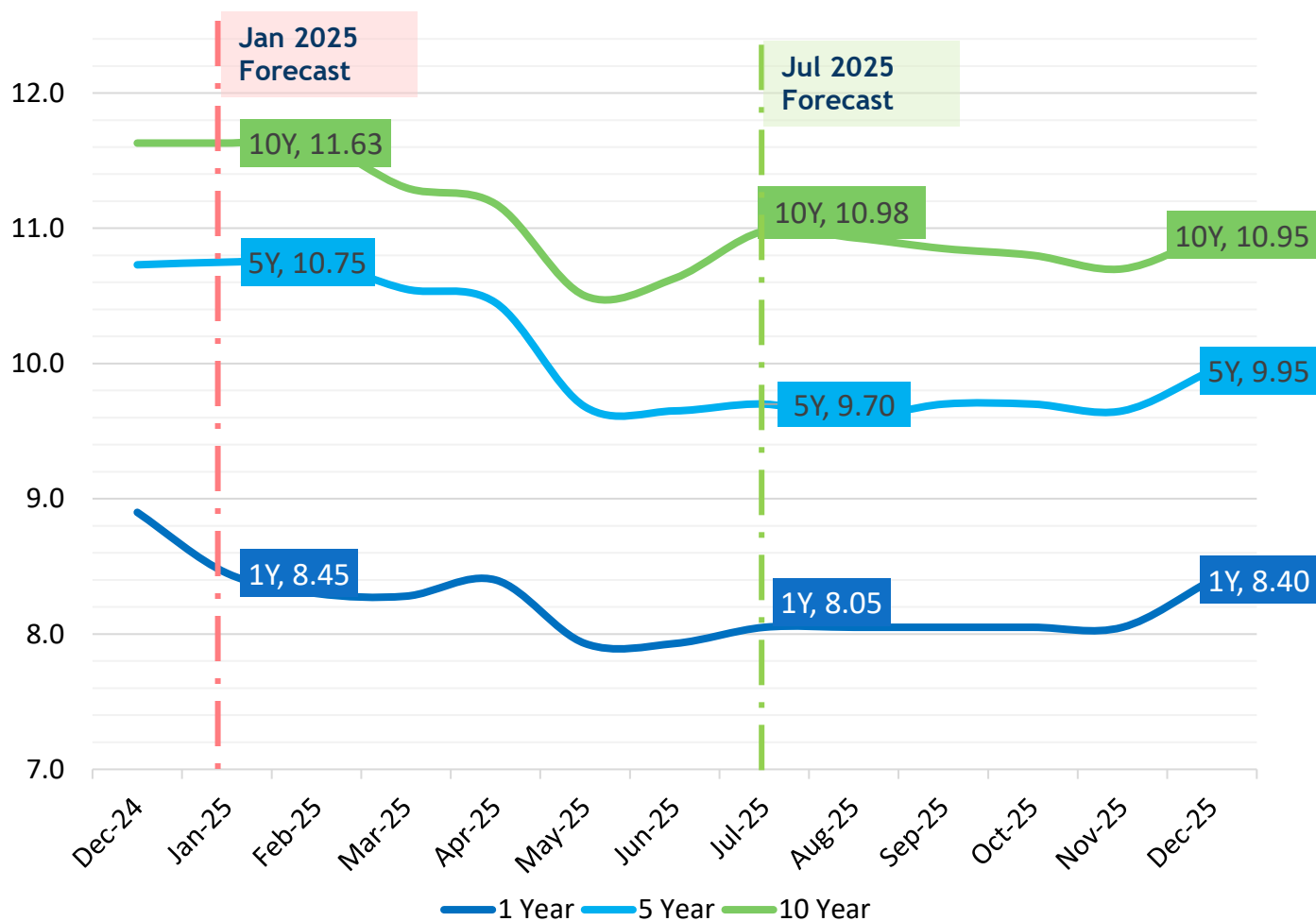
Partly Accurate

Yield curve declined marginally to remain within our bands



Bonds – Jan-25 & Jul-25 Recap: Partly Accurate

Yields to rise 100-150bps over the next 12 months



Source: First Capital Research

10Y - YTD 85 bps ↓

5Y - YTD 103 bps ↓

1Y - YTD 65 bps ↓

6 Months 2025
Jan - Jun-25

10Y - YTD 50 bps ↓

5Y - YTD 78 bps ↓

1Y - YTD 78 bps ↓

6 Months 2025
Jun - Dec

Policy Rates – Jan-25 & Jul-25 Recap: Accurate

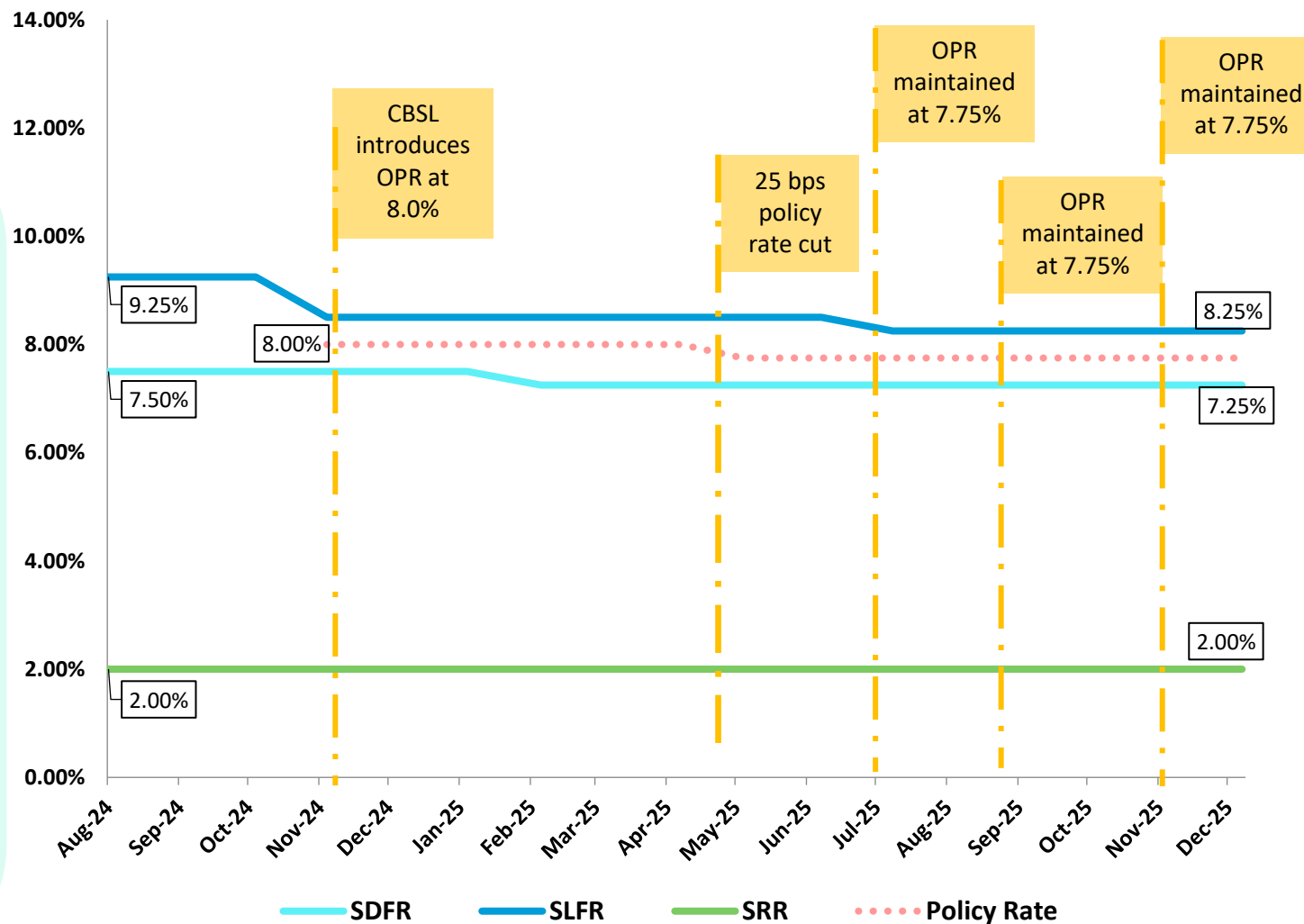
17th Jan 2025 - No change in policy rates over the next 12 months

Policy rates decline by mere 25bps in 2025

After heavy declines in 2024, we expected rates to remain broadly stable throughout 2025 with an option to reduce rates by merely 25bps.

The CBSL reduced single policy rate in the May-25 policy meeting and adjusted rates by 25bps to bring overnight policy rate (OPR) to 7.75%, which brought yields further down.

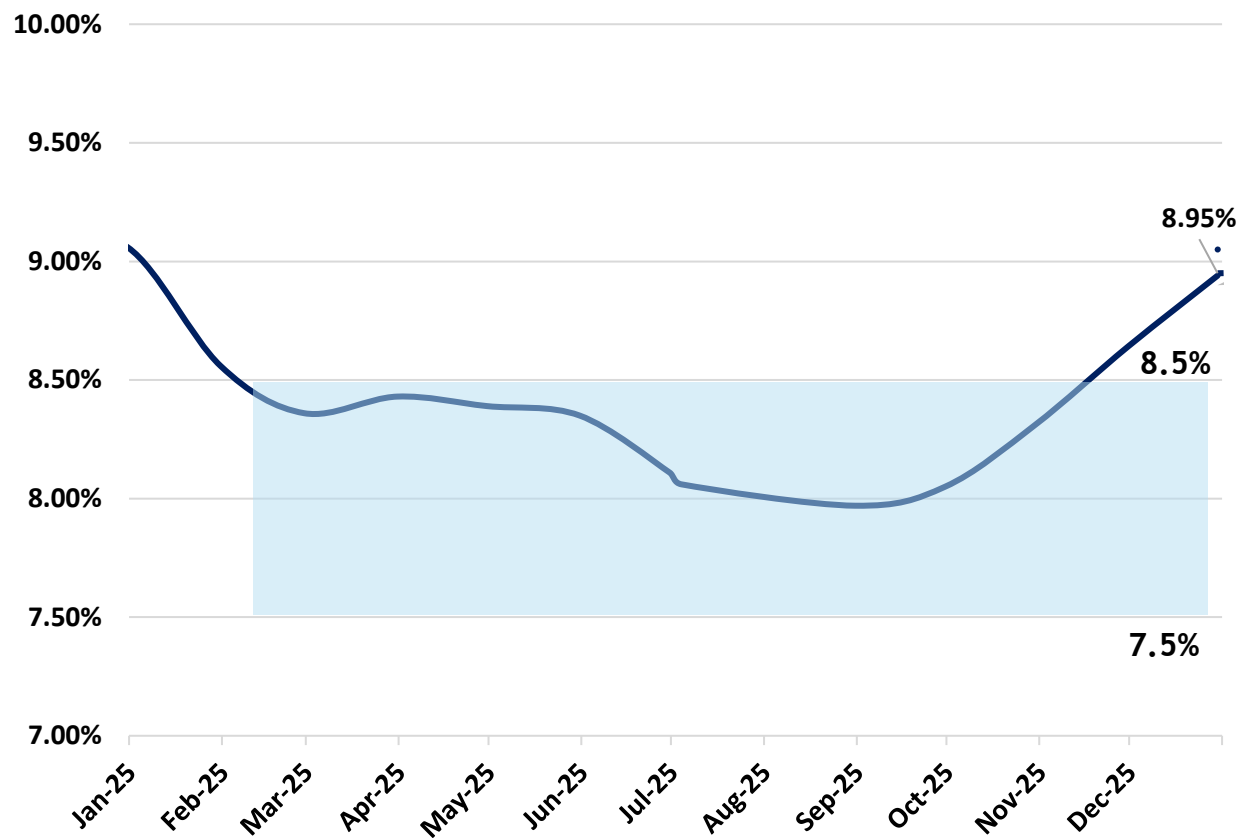
Additionally, with the surge in liquidity during 1H2025, rates further adjusted bringing yields below our targeted levels.



Bank Rates – Jan-25 & Aug-25 Recap: Partly Accurate

17th Jan 2025 - AWPR may rise to 10.0%-12.0% during 1H2025 and 10.5%-12.5% in 2H2025

29th Jul 2025 - AWPR to remain between 7.5%-8.5% for 2H2025 and reach 8.0%-9.0% in 1H2026



Review

AWPR consistently performed lower than our expectations in 1H2025 despite accelerating demand for credit and stable GDP growth, amidst inflation remaining within the expected threshold.

In light of slower than anticipated demand for credit, FCR revised the year end AWPR target to 7.5%-8.5%, which was broadly in line with 2H2025 figures, despite a spike towards year-end due to concerns regarding Ditwah related increased expenditure.

Exchange Rate – Jan-25 & Revised Jun-25 Recap: Accurate

17th Jan-25- Exchange Rate outlook upgraded to LKR 300.0-310.0 for 1H2025 and LKR 305.0-315.0 for 2H2025

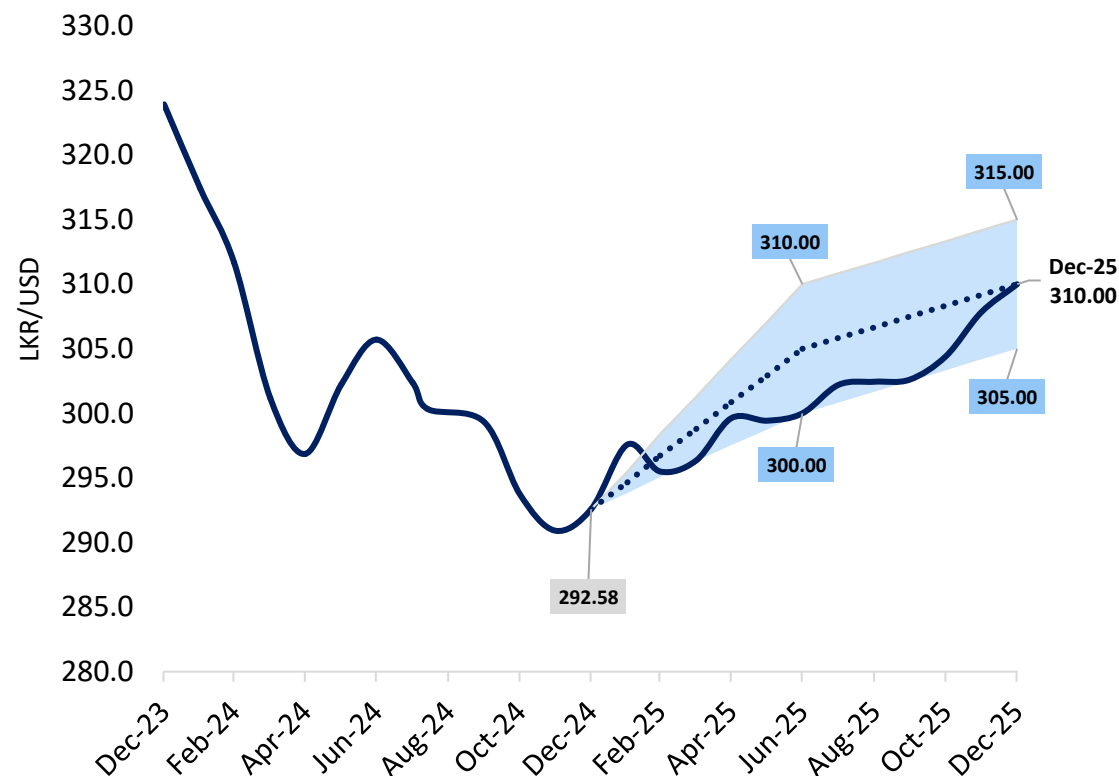
29th Jul-25- FCR extends its Jun 2025 target to Dec 2025 (300.0-310.0) while expecting some pressure to the LKR in 1H2026 with target of LKR 305.0-315.0



Review

FCR expected LKR to depreciate to 305.0-310.0 during 2025.

The LKR depreciated mainly due to higher demand for USD from rising imports and external debt repayments, alongside a flexible exchange rate regime. This pressure was accelerated by higher central bank intervention, where a net of USD 1.8Bn was purchased from the domestic markets.



Equity – Jan-25 & Jul-25 Recap: Partly Accurate

17th Jan 2025 - First Capital upgrades its ASPI Dec-25 fair value to 18,500 while introducing a Dec-26 fairvalue of 22,000.

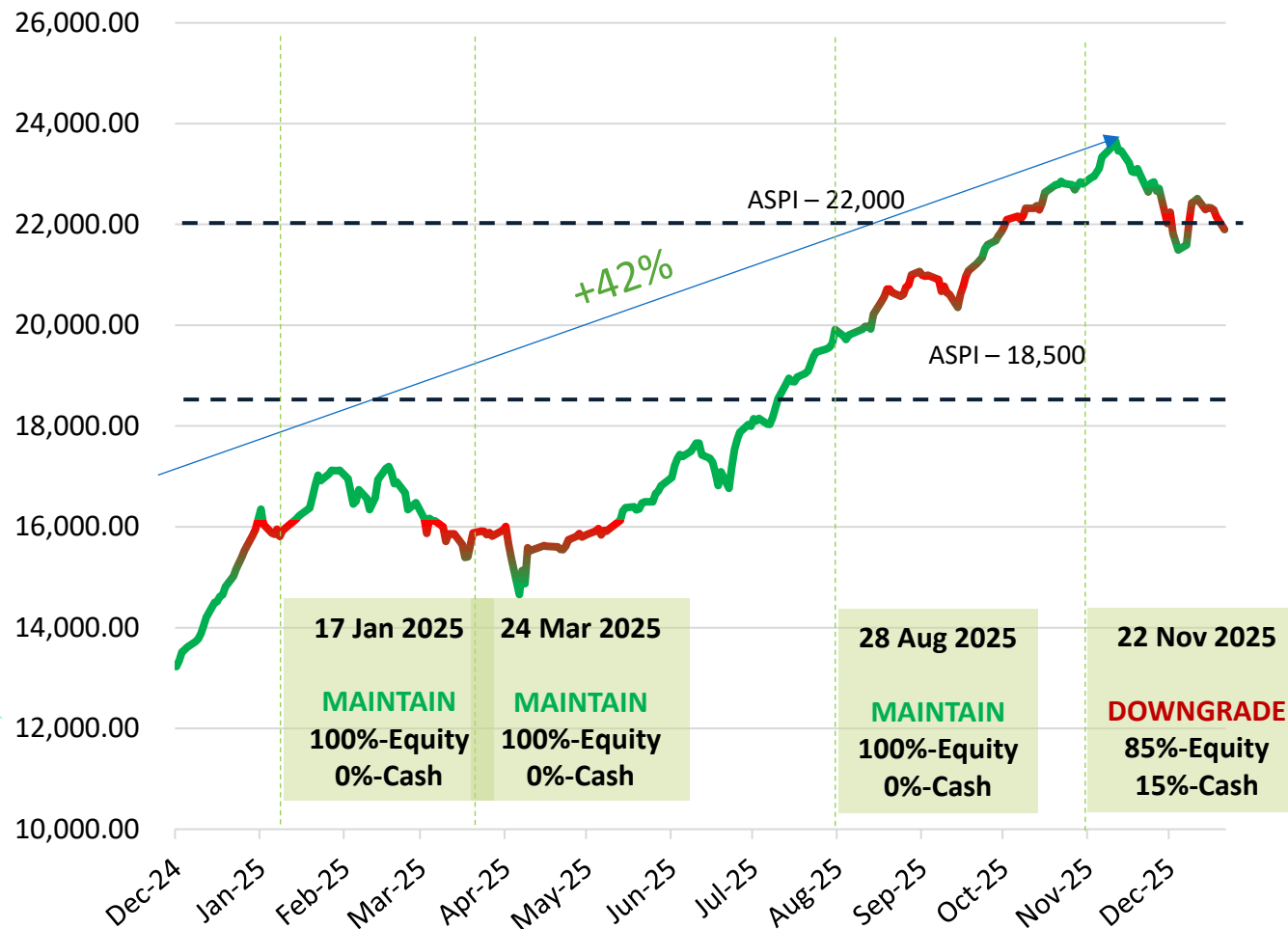
The ASPI's rise in 2025 is driven by strong earnings growth, supported by low inflation, lower interest rates, and improved corporate margins. Macroeconomic stability, IMF program continuity, and a shift from fixed income to equities have further strengthened investor confidence.

Funds allocated to Equity: Be 85% invested

Review

ASPI adopted a steady uptrend with Dec-24 to Dec-25 rising +42% during the period.

Our bullish outlook for the ASPI proved accurate during the concerned period, as clearing out of uncertainties and steady growth in corporate profitability resulted with ASPI reaching all time highs and continuously refreshing the peak.





Key Elements of consideration *for Mid-Year Outlook 2025*

Section 2.0

Debt Concerns Re-Emerge as Growth Outlook Moderates

Sri Lanka progressed on its recovery journey attaining strong GDP growth, in-line with our expectations. However, the growth came off to a low base as the economy contracted in the early years. The financial health of the economy improved with most IMF indicative target being achieved. Growth was also supported by the unsustainable consumer demand amidst the surge in vehicle demand.

Looking ahead, we expect a slight moderation in GDP growth for 2026E affected by the damage caused by Ditwah, limited progress on reforms and relatively lower growth in consumer spending. The slow conditions may trickle down to slower credit growth despite the rebuilding effort providing some support in respite.

[Continuity of the Government's reform progress holds the key to change Sri Lanka's trajectory to strengthen growth and the hold the IMF program together. Catering to popular demands and implementing reforms is the key balance that Government needs to maintain.](#)

The key challenge is to take forward the positive strides and short-term stability attained over past couple years achieved through healthy financial discipline. Moderating growth levels and widening budget deficits may pose multiple blows to the economy as debt concern re-emerge.



Key elements to consider for investments

Political

Political Landscape

Provincial Council elections

Policy certainty

IMF program & SOE restructuring

Economic

Economic Landscape

Consumer demand & credit growth

Rising inflation

Debt payments & BoP position

Govt revenue and budget deficit

Global

Global Landscape

Delayed FDI flows

Rupee depreciation

Stable commodity prices

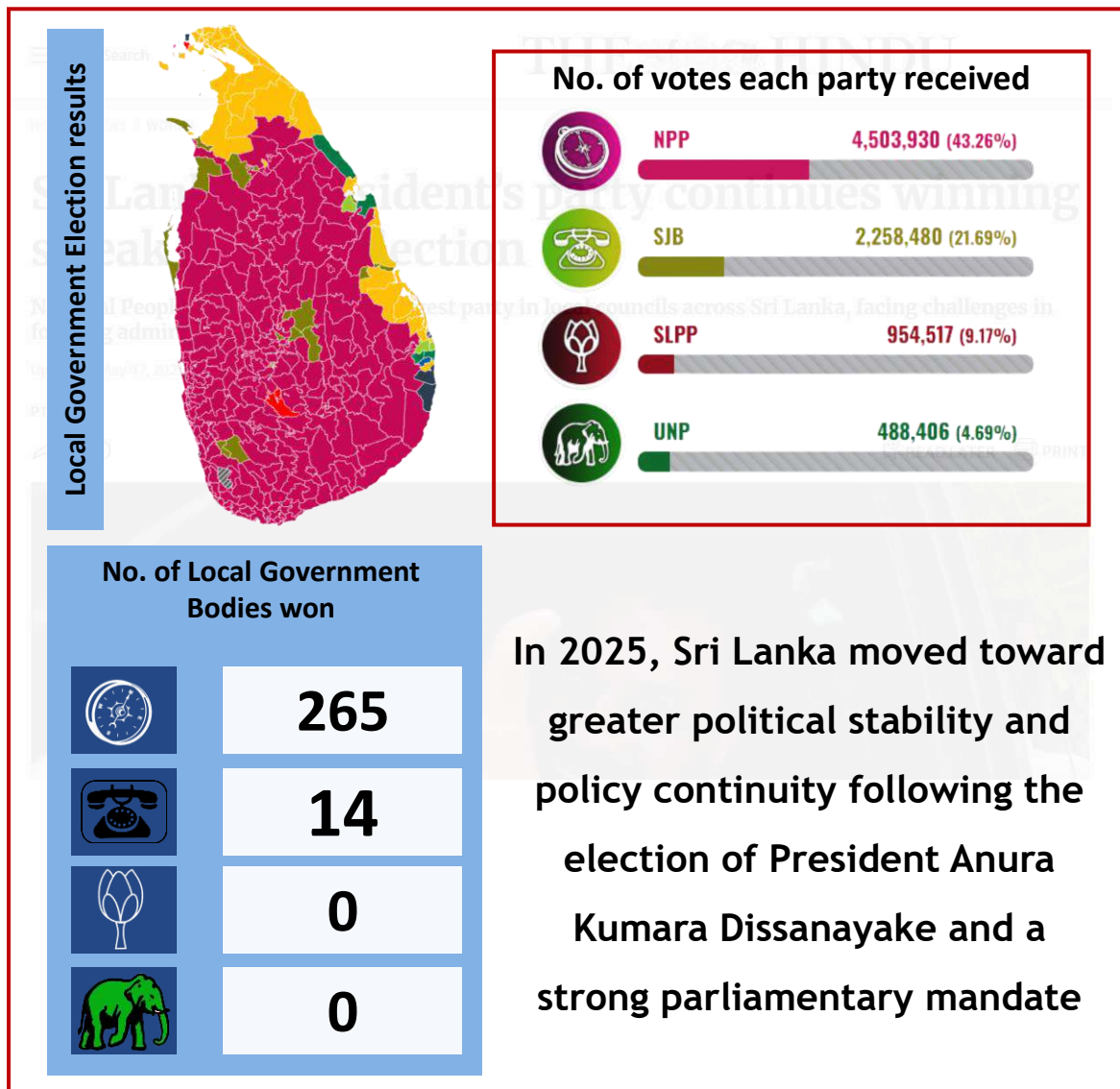


Uncertainty clear; Policy certainty returns

Upgrade to **Low Risk** (from **Medium-High Risk**)

Section 3.0

Political stability reinforced under new leadership...



In 2025, the National People’s Power (NPP) sustained strong popular momentum, consolidating its dominance in local government elections and more than doubling the seat count of the SJB (the main opposition) in key regions. This reinforced the NPP’s position as Sri Lanka’s most popular political force, particularly in urban and semi-urban areas.

A date for the Provincial council elections is yet to be announced, and we expect elections to be held within the next 12 months. Although popularity remain subdued compared to the previous elections, we believe that the governing party is likely to win the majority.

...ensuring confidence in policy direction

- **Clear policy direction and consistency drive investor confidence:** A strong governing mandate has enabled the government to maintain policy consistency, pushing up investor confidence.
- **International engagement reinforcing credibility:** Continued commitment to the IMF programme, alongside active engagement with multilateral lenders and global development partners, has strengthened external credibility.
- **However, progress on reforms front remain slow:** In line with our expectations, the reform progress continues to remain slow with government slow to implement crucial reforms. In the absence of crucial reforms, growth is expected to slow with ability to attract FDI limited.
- **Low risk maintained:** Given the strong mandate for the ruling party following the win in all three major elections and continuity of the IMF agreement, we continue to rate the political landscape as low risk.



Political Outlook: Maintained at *Low Risk*



Macro-economic stability maintained

*Maintain **Medium-Low Risk***

Section 4.0

ECONOMICAL CONSIDERATIONS
FOR INVESTMENT DECISIONS

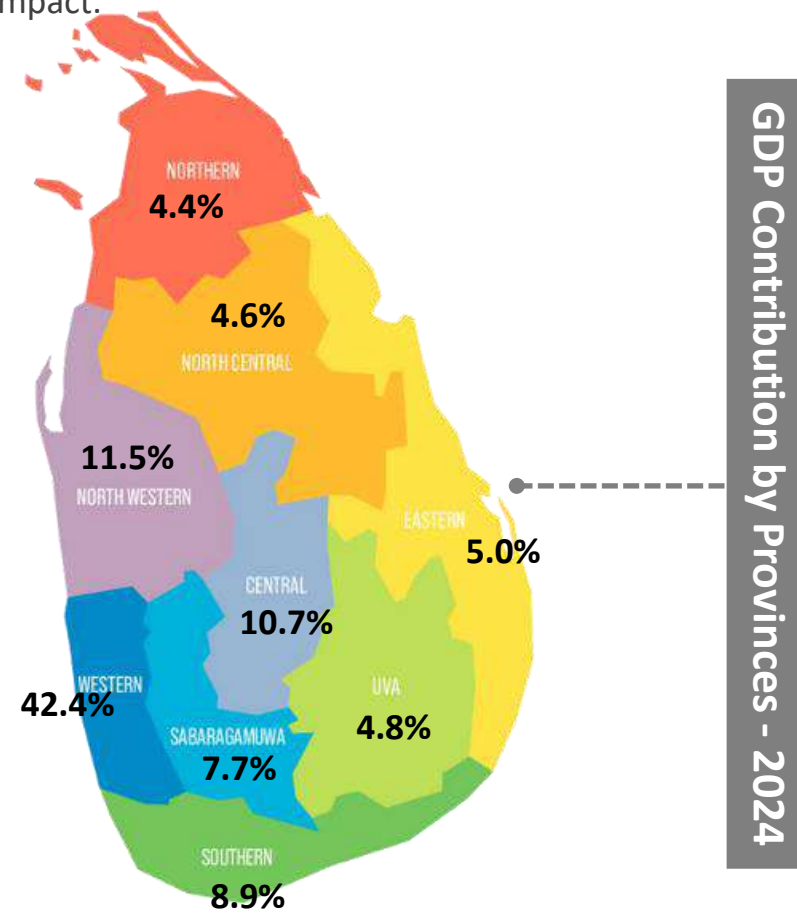
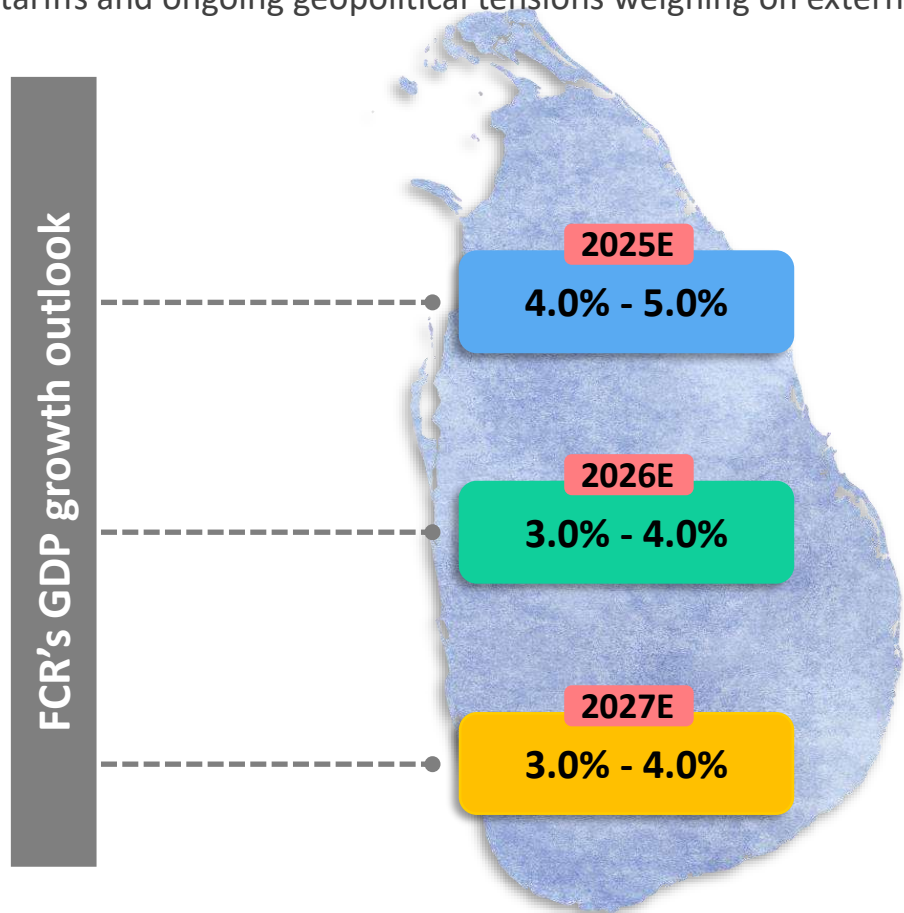


4.1 Economic growth to soften

GDP growth forecast to remain lower between 3%-4% in 2026E-2027E affected by the cyclone Ditwah...

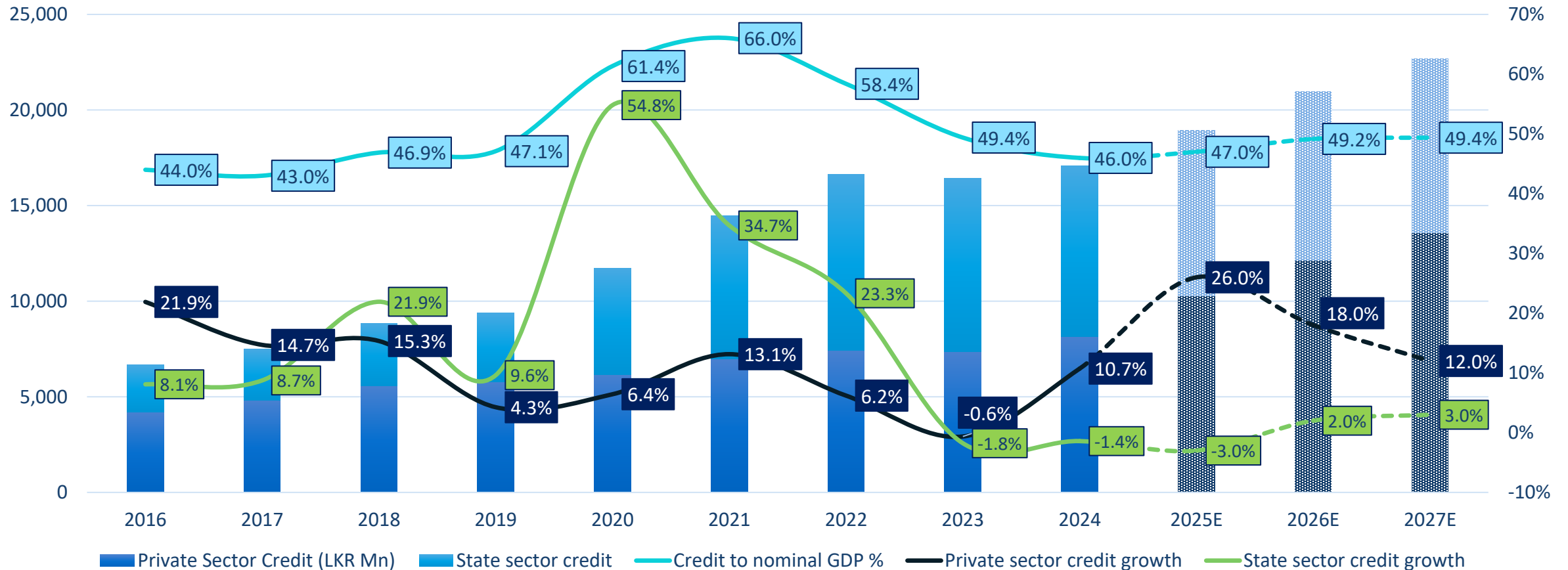
FCR projects Sri Lanka's real GDP growth at 4.0%–5.0% in 2025E, moderating to 3.0%–4.0% in 2026E, with growth expected to remain subdued in 2027E. The deceleration reflects softer consumer spending, constrained government expenditure, and a challenging global backdrop, characterized by higher tariffs and ongoing geopolitical tensions weighing on external demand.

Moreover, damaged caused by cyclone Ditwah is also expected to weigh down on GDP growth with consumption been affected and trade balance widening caused by ballooned imports. However, rebuilding efforts post Ditwah and increased spending by govt. is expected to partially offset the impact.



...and relatively slower disbursements to the private sector compared to 2025...

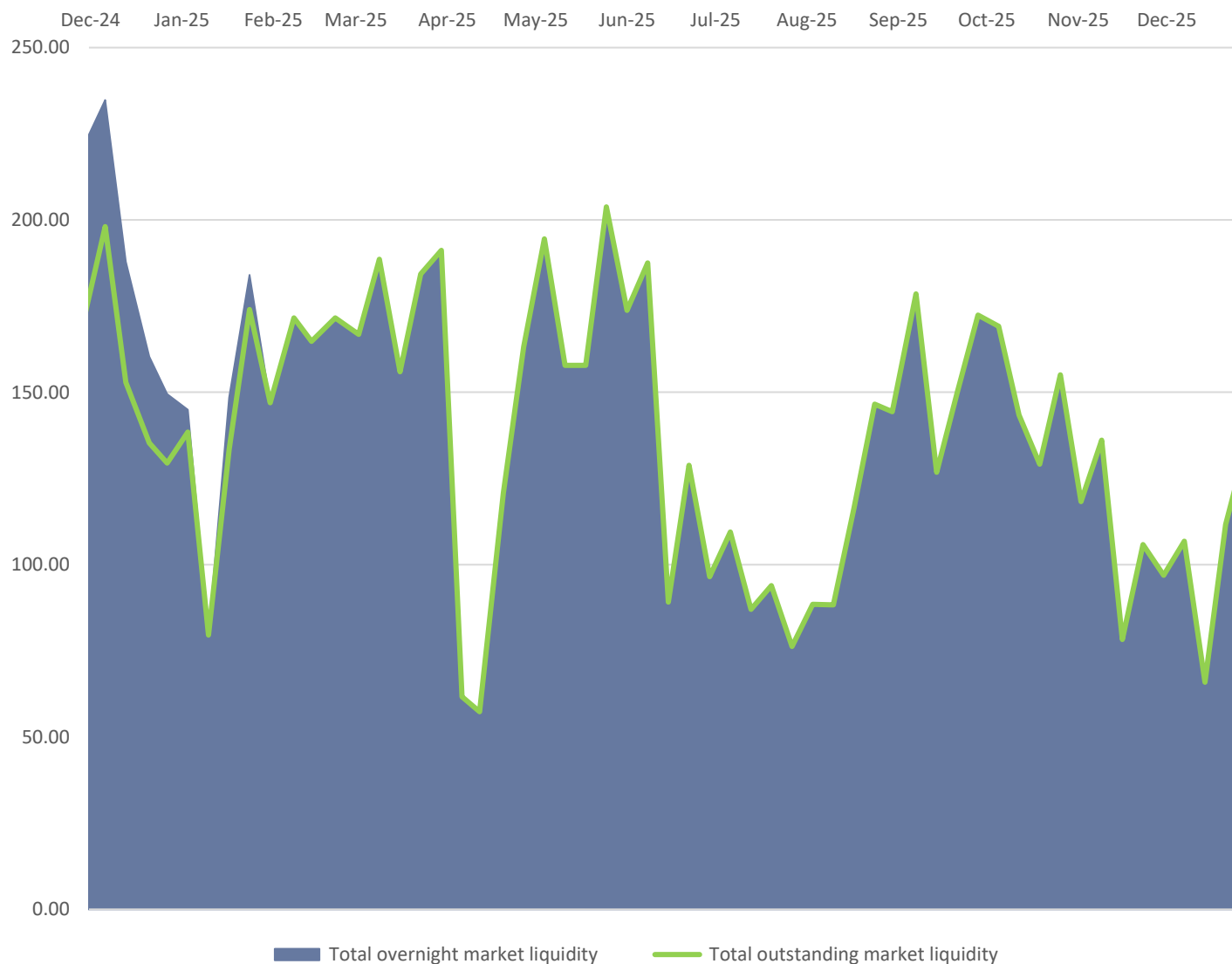
On the back of lower interest rates, private sector credit saw a sharp upturn surpassing the estimate FCR placed for 2025E. However, looking ahead we expect private sector credit growth to slowdown, partially due to the slow growth anticipated in the GDP and lower demand for vehicle import credit, as pent-up demand for vehicles slowly ease. Considering the expected slowdown, we expect total credit to GDP to hover below the 50% levels.



...alongside constrained liquidity within the market...

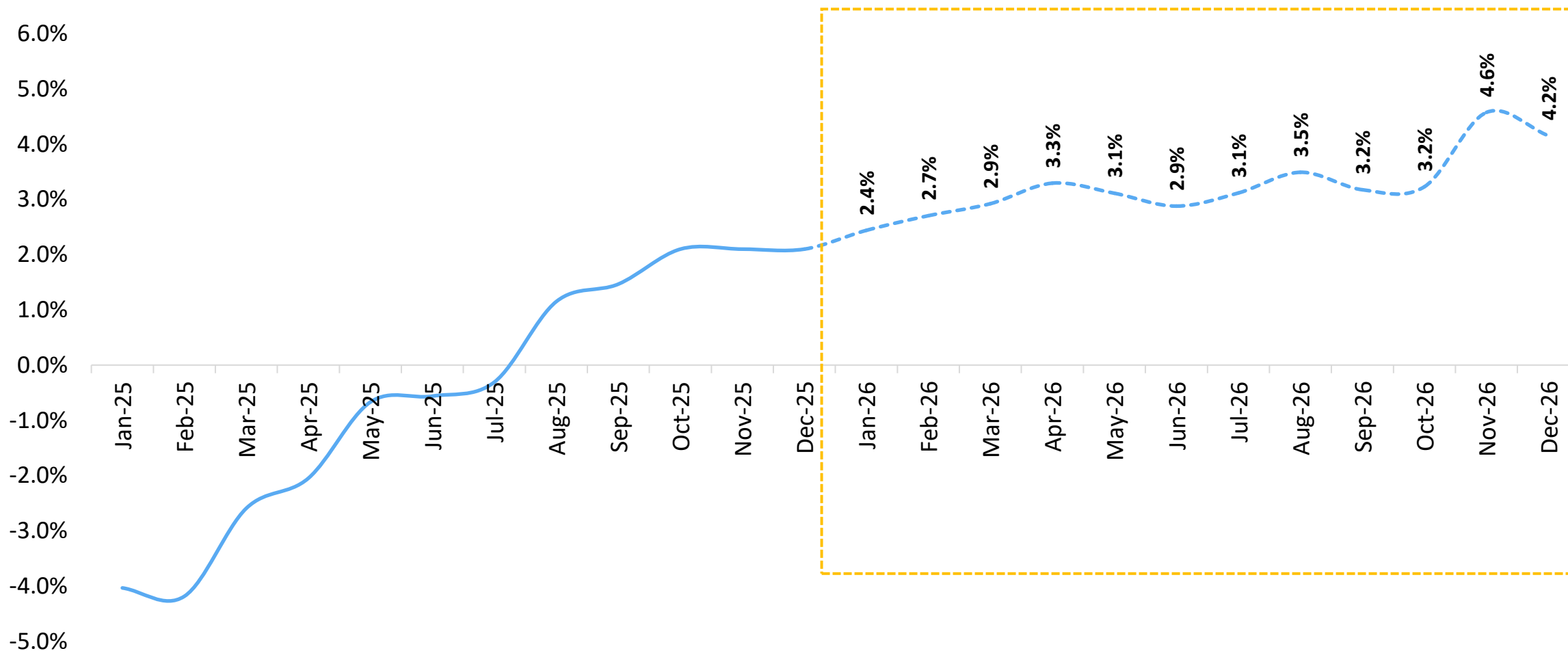
Despite a brief dip to about LKR 57.3Bn in mid April, overnight liquidity largely stayed within the LKR 75.0–150.0Bn range through 2025, supported mainly by the CBSL’s sustained USD purchases. Treasury cash buffers held with state banks and subsequently channeled to private banks further eased liquidity asymmetries, maintaining comfortable system liquidity despite strong private credit growth in 2025.

Looking ahead, FCR expects liquidity to face some pressure, with material expansions viewed as highly unlikely. Private credit growth of 18.0% in 2026E, alongside limited LKR injections through USD absorption and a reduced capacity of state banks to address market-wide liquidity asymmetries amid a lower primary surplus, are likely to weigh on liquidity conditions.



...whilst gradual rise in inflation...

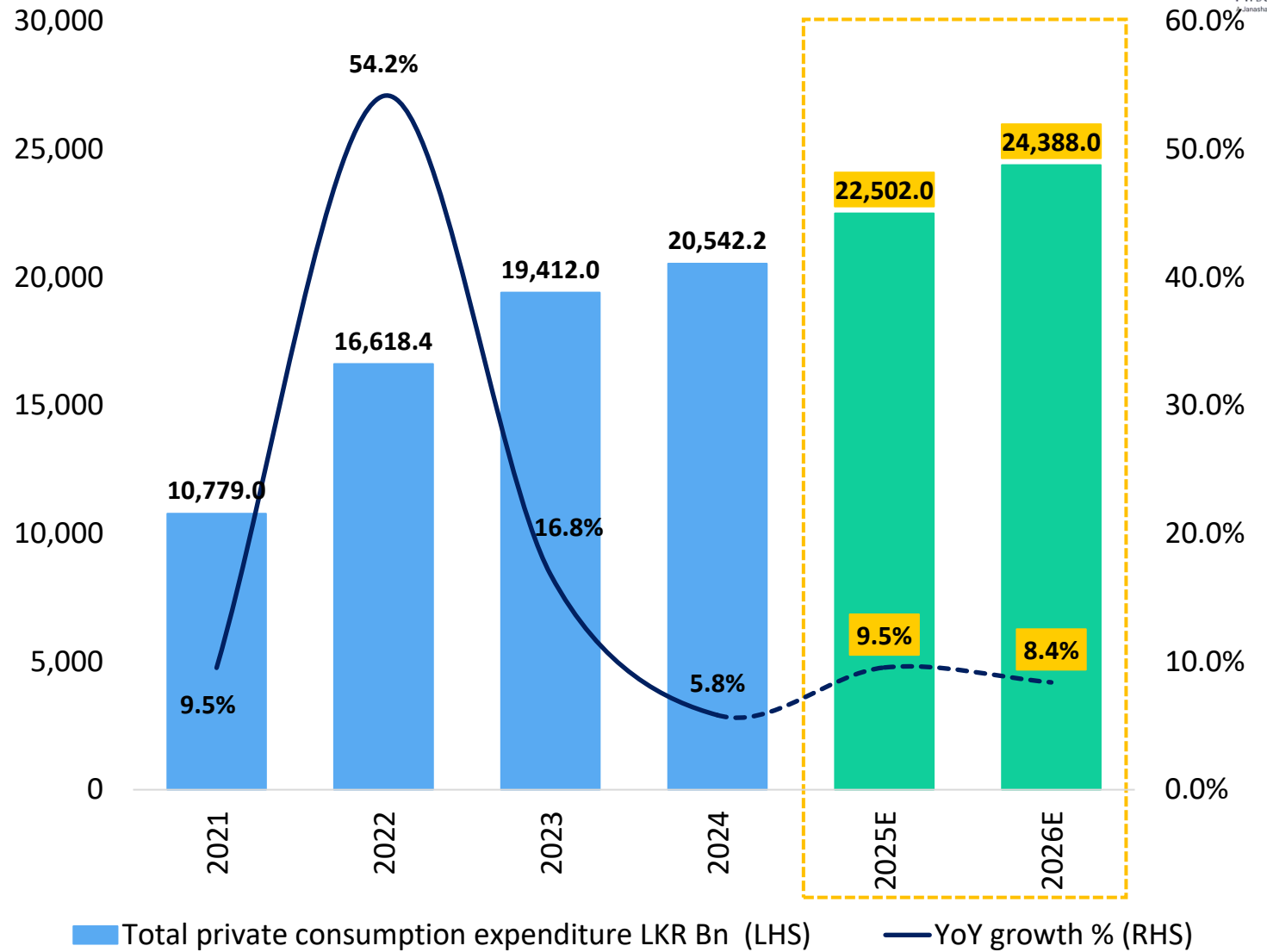
Inflation under performed FCR estimates throughout 2025, broadly due to the slower than anticipated recovery in the demand of the economy. Looking ahead, FCR expects inflation to trend gradually higher, driven by the proposed electricity tariff increases and rising food prices, the latter exacerbated by LKR depreciation amid higher import demand to support construction activity. However, average inflation for 2026E is expected to remain below the CBSL guided threshold of 5%.



...and prevailing high taxes to limit growth in consumption

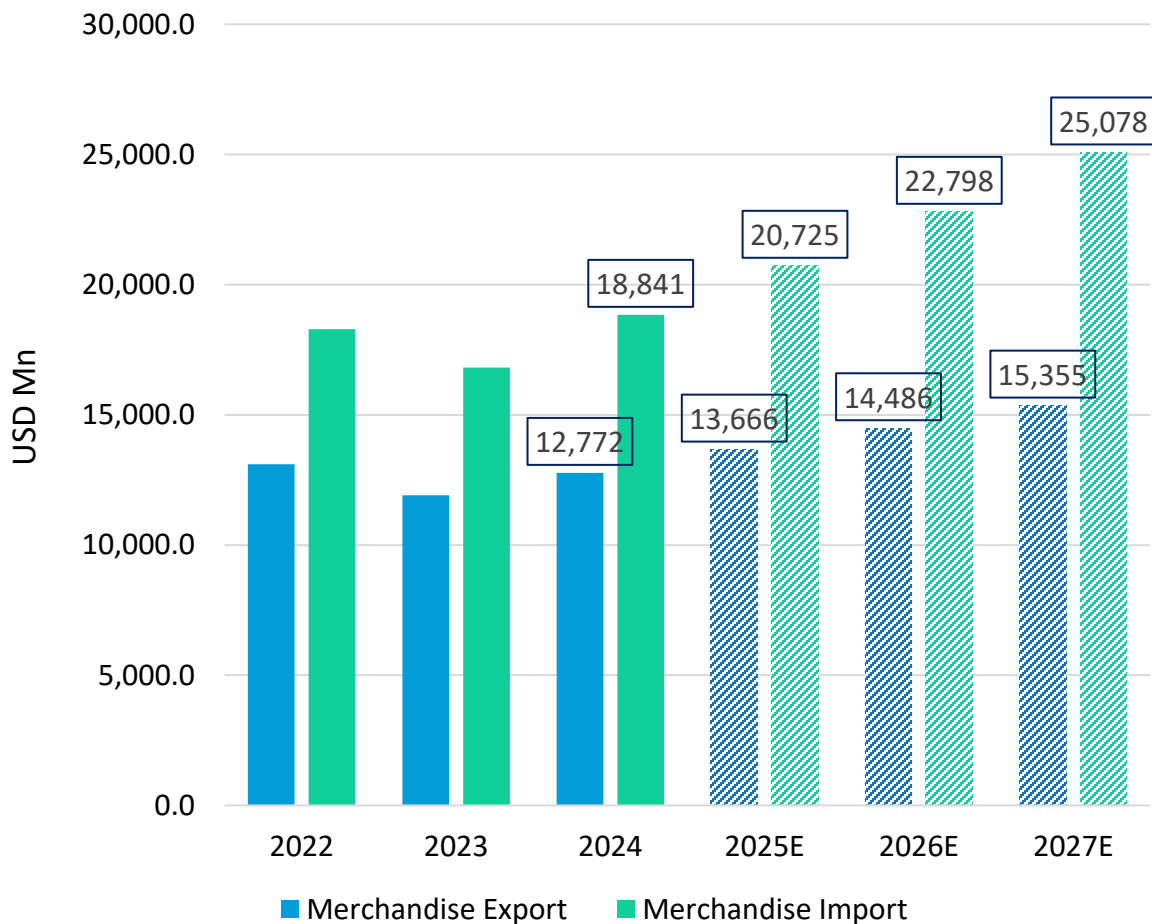
Currently Sri Lanka has one of the highest tax structures in the region with variety of taxes affecting disposable incomes and consumption.

- Value added tax at 18%
- Standard corporate taxes at 30% and taxes on liquor and gaming set between 40%-45%
- Personal income taxes with ceiling rate set at 36%
- Other taxes including Excise taxes, Withholding taxes, custom duties etc.




Imports expected to gather pace in the near term, whilst exports continue to observe slow growth...


Imports to rise at a limited growth, while export growth is projected to increase gradually in 2026E




Due to Post-cyclone reconstruction, higher import demand is expected, particularly for construction materials. Concurrently, exports are expected to decline in the short-term, however gradually pick up to 4.0%-5.0%YoY growth in 2026E.



As the cyclone has created reconstruction needs, import demand for food, medicine, oil and construction materials is expected to rise significantly.



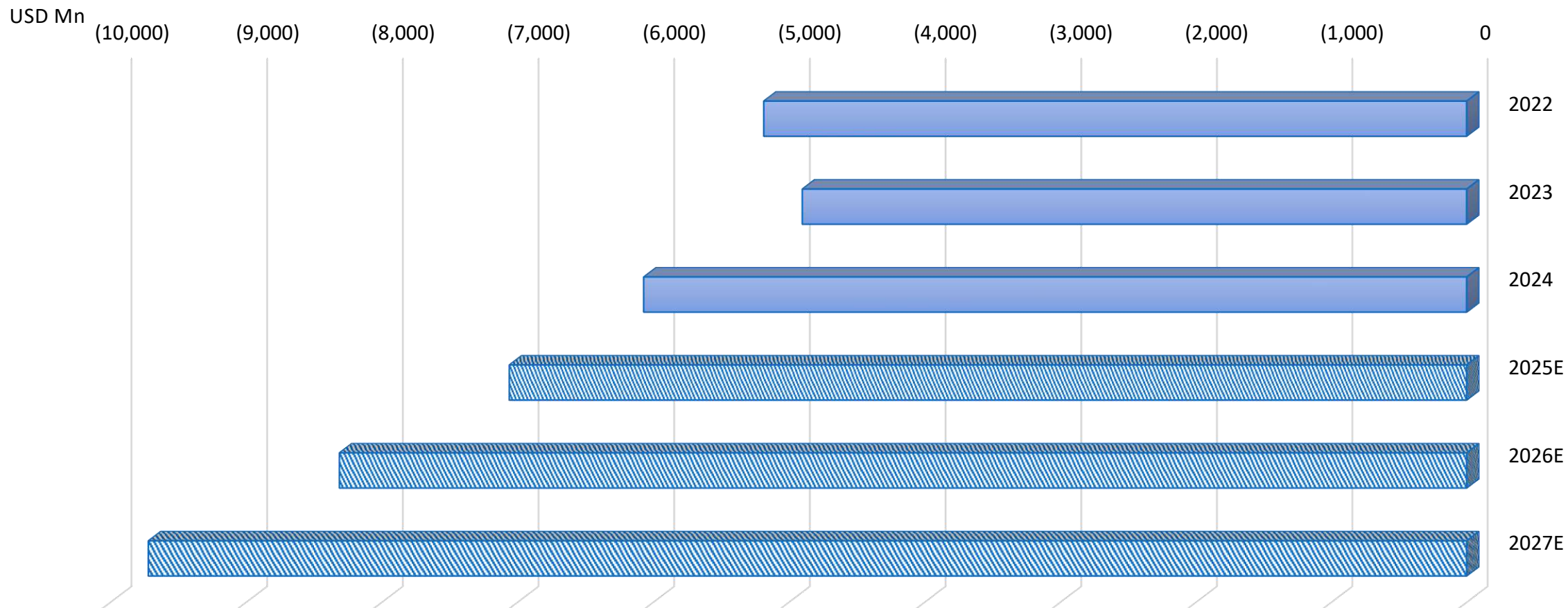
However, the decelerating vehicle imports will ease the import growth compared to 2025.



Resulting from Ditwah, agricultural exports will soften in the near-term and will pick-up with the recovering economy.

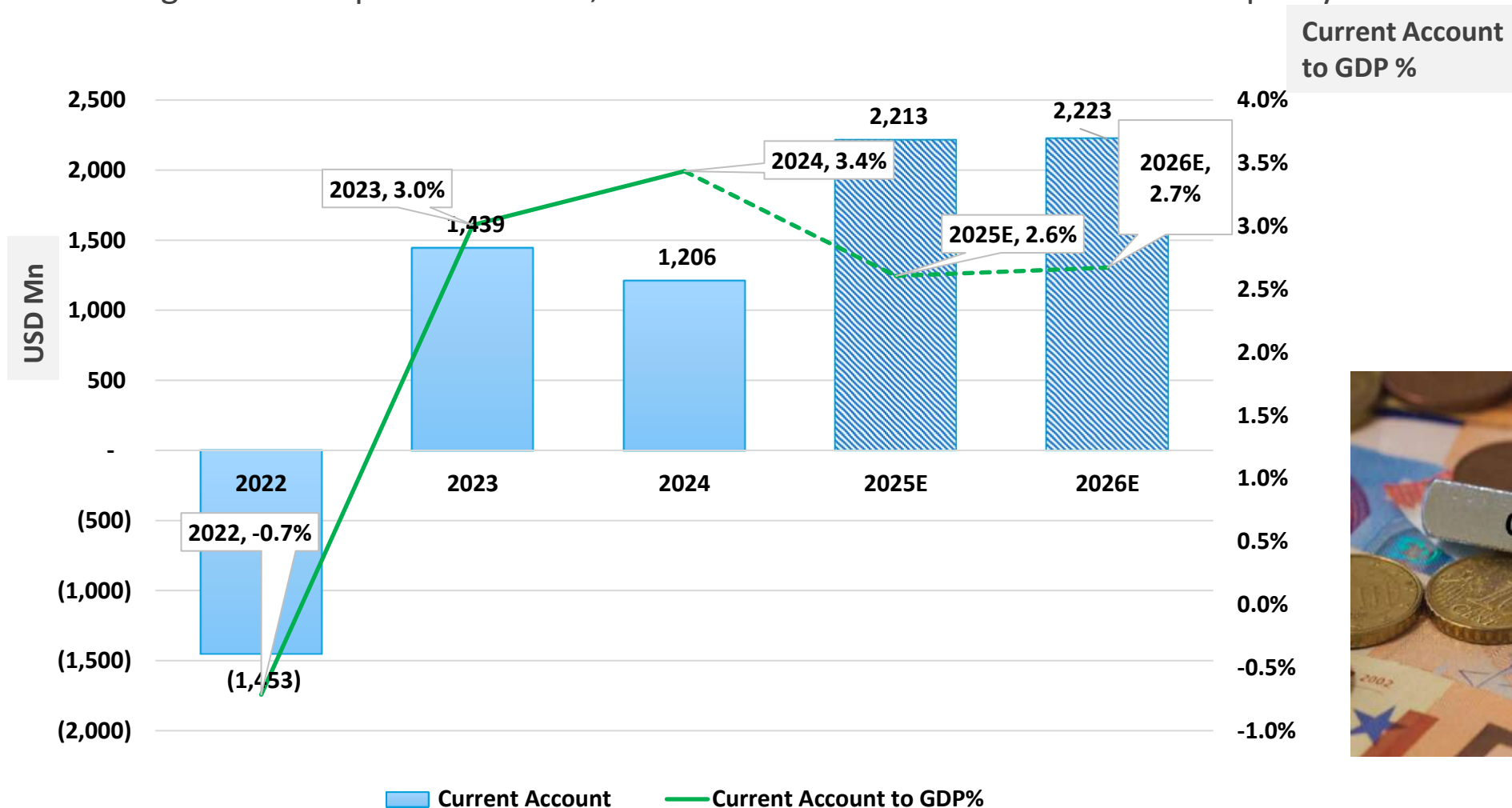
...pushing up trade deficit widening in the near term

Increase in imports will challenge the trade balance in 2026, as the cyclone has given rise to reconstruction needs. As the import demand for reconstruction material, food and oil rises, Sri Lanka requires higher export and foreign exchange earnings to reduce the broadening trade deficit.



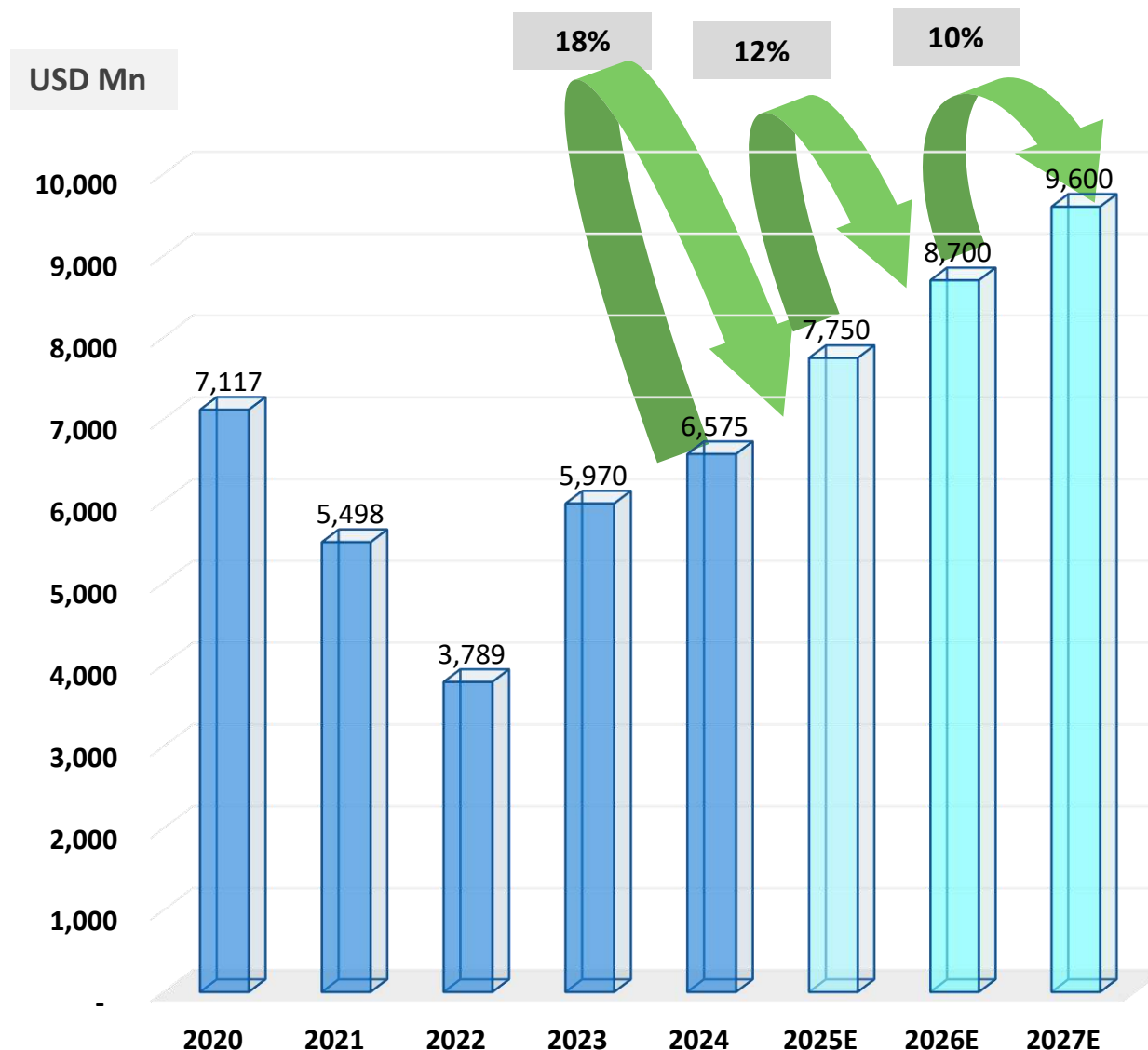
However, current account expected to stay positive...

However, we project the current account surplus to narrow down in 2026, caused by increase imports and relatively slower growth in exports. However, inflows from tourism and remittances to partly offset the impact.



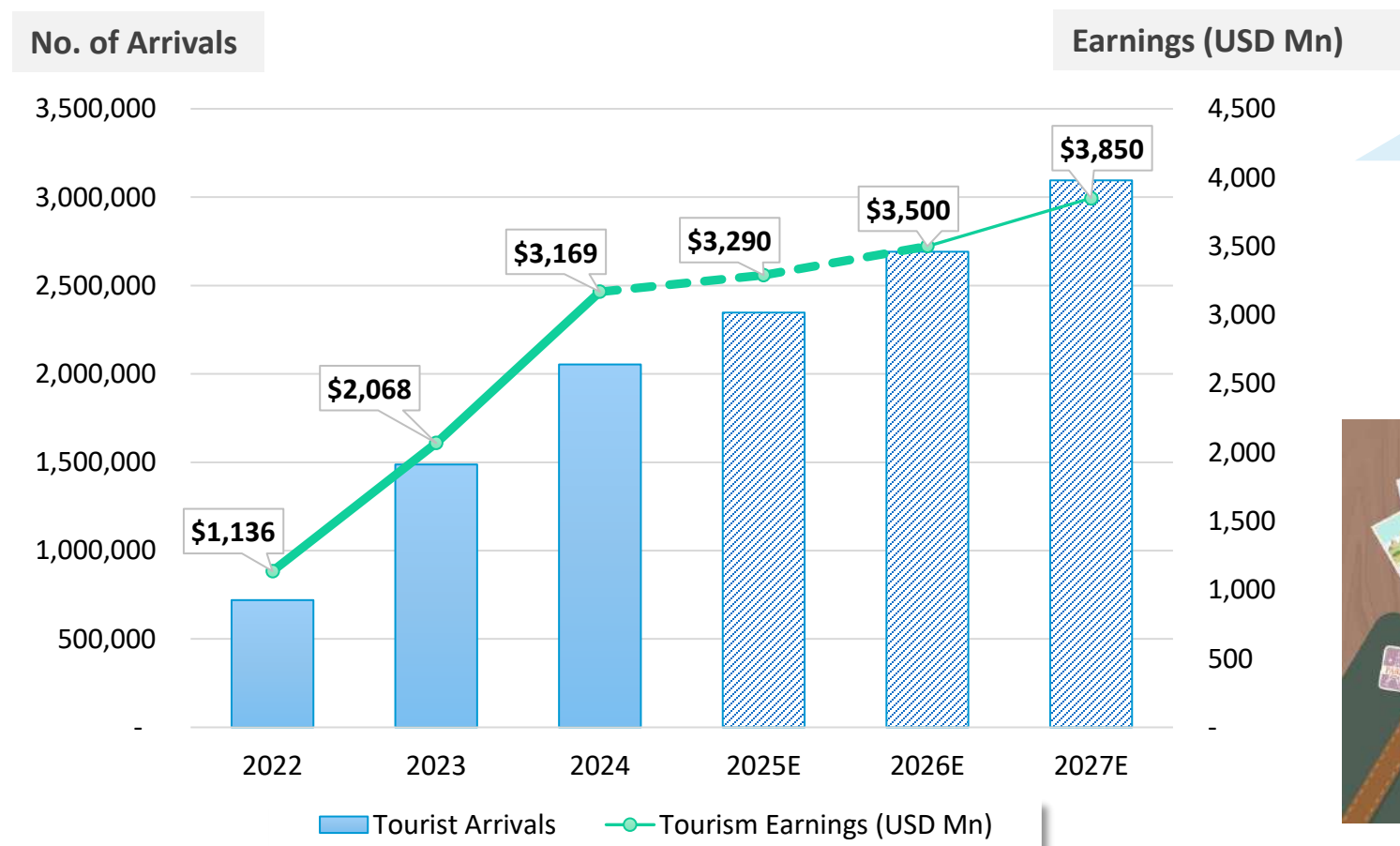
...contributed by improved remittances...

- ❑ In the short-term, worker remittances will increase to 10.0%-15.0%, as expatriates provide financial support to the reconstruction of Sri Lanka.
- ❑ FCR expects net remittances to stabilize towards 2H2026 and improve at its underlying trajectory.



...and receipts from tourism

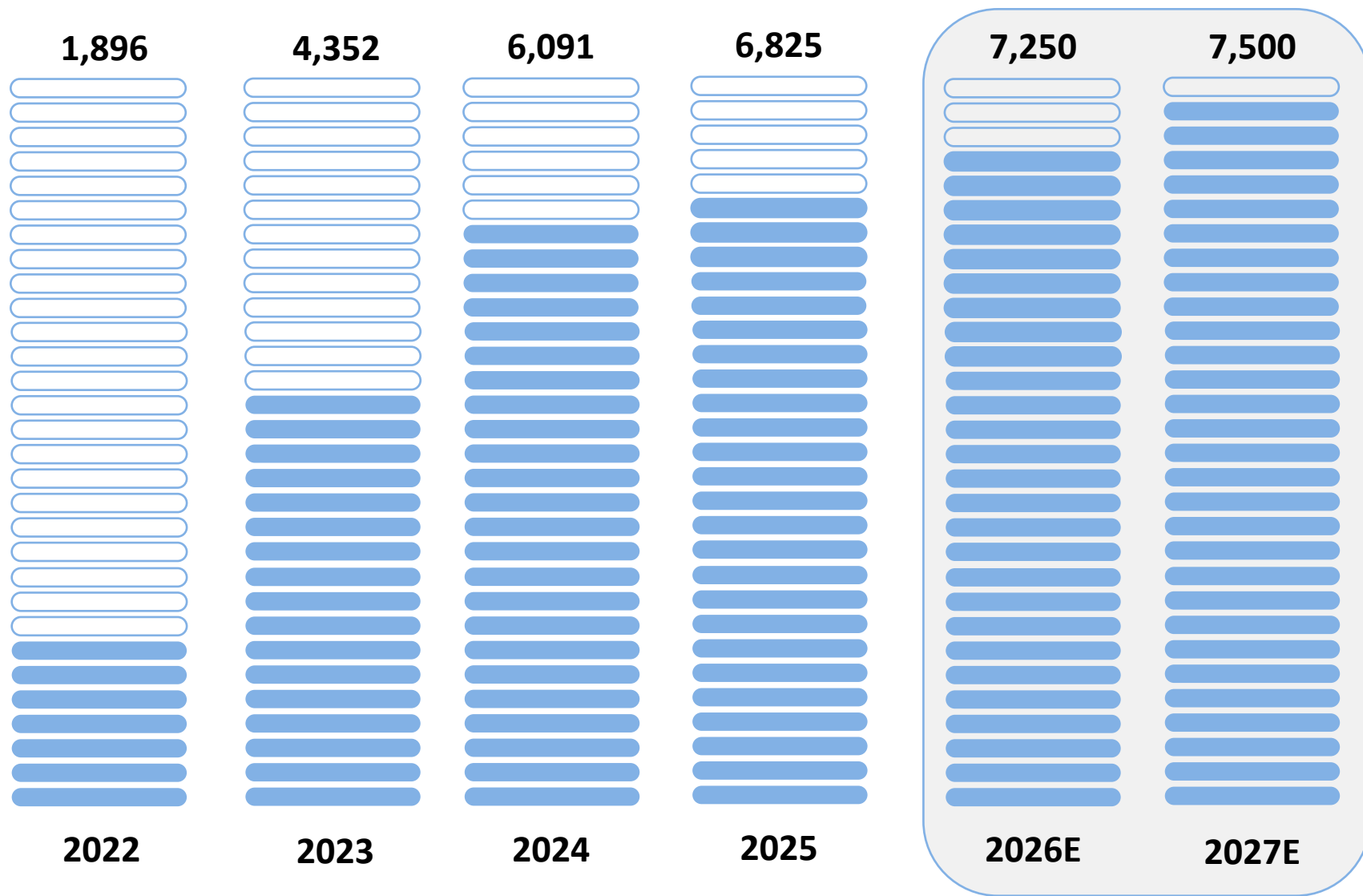
In 2025, Sri Lanka recorded the historic highest no. of tourist arrivals, surpassing 2.3Mn. As the industry was hit by the cyclone, FCR expects a dip in tourist arrivals and earnings during the near-term. However, it is expected to gradually pick up during the latter half of 2026, with projected total tourist arrivals at 2.7Mn and earnings at USD 3.5Bn by the end-2026.



The expected rebound in tourism sector towards latter 2026 will attract more FX earnings and narrow the balance of payments.



Despite the positive surplus, reserve accumulation continues to remain slow...

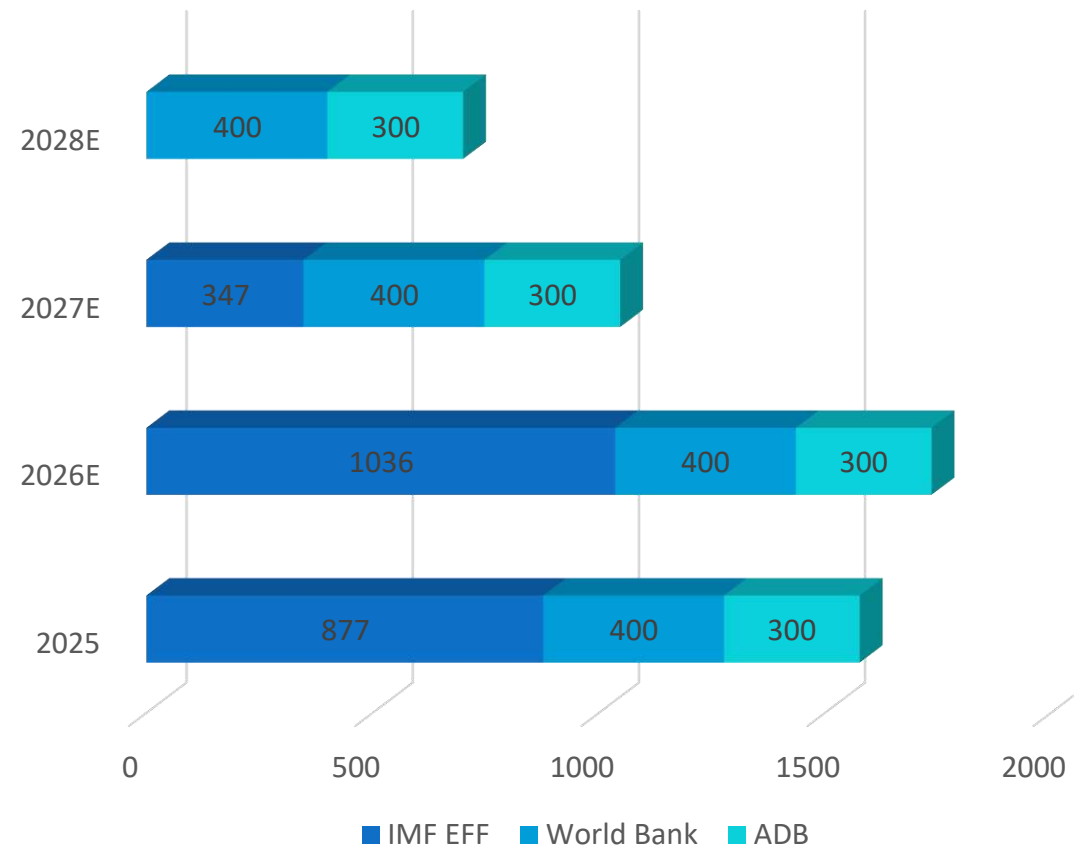
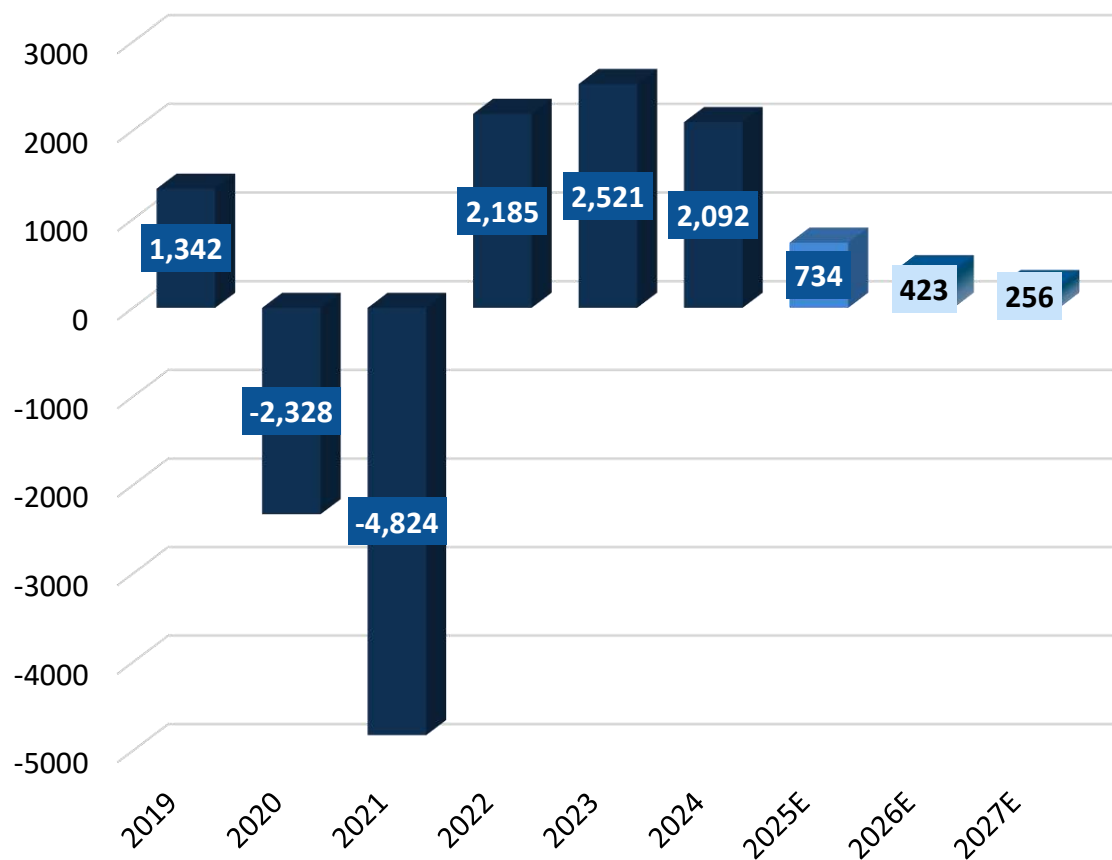


Sri Lanka's foreign currency reserves have declined as FX outflows, including multilateral debt servicing, imports, and Central Bank intervention, continue to exceed inflows, while tourism, remittances, and FDI remain insufficient for sustained reserve accumulation.



...on the back of weaker BOP performance...

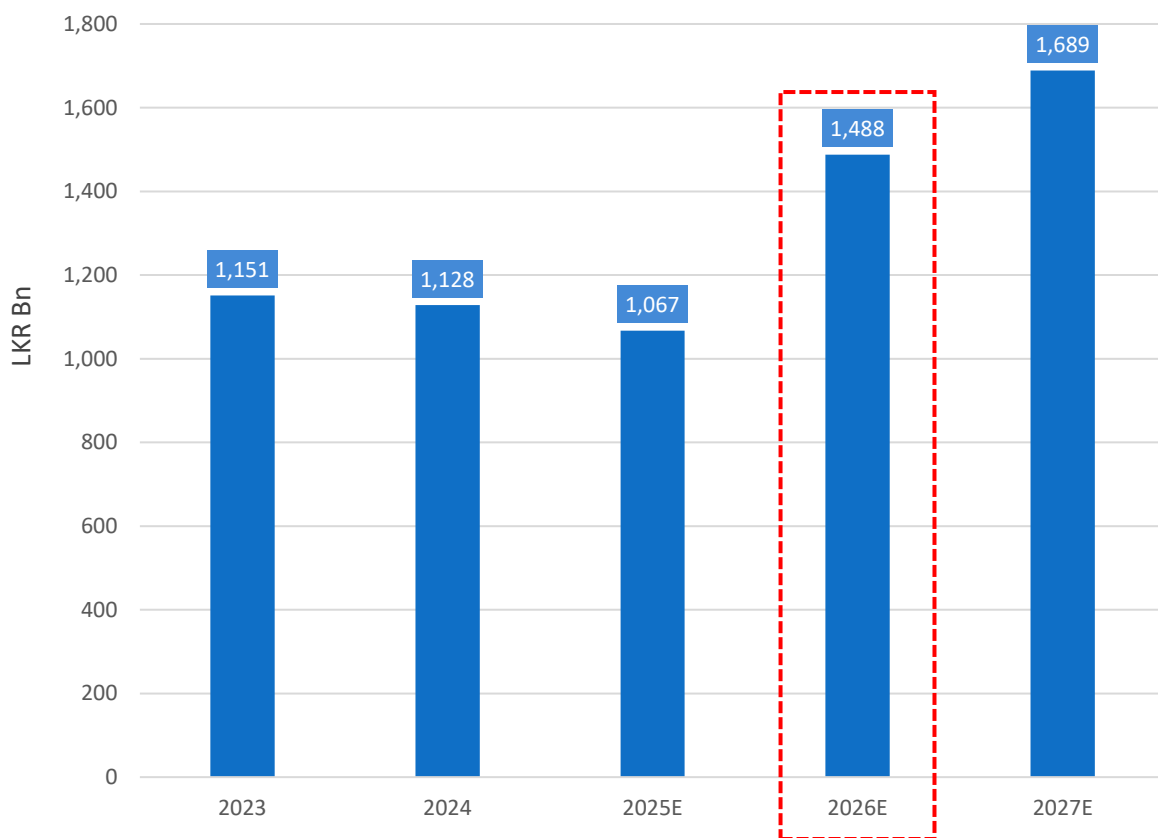
Sri Lanka's BOP surplus is expected to remain moderate throughout 2026E and 2027E, owing to the expansion in imports, driven by improving domestic activity and easing restrictions. Despite the slowness, a positive BOP is anticipated for the next 2 years, contributed by continued IMF programme support and stable multilateral inflows, recovery in tourism earnings and record worker remittances.



...as local maturities picks up in the near term

During 2026 local debt maturities of Sri Lanka is expected to be at LKR 4.1Tn of which total T-bill maturities is expected to be around LKR 2.7Tn and remainder which is the outstanding T-bond maturities is expected to be around the LKR 1.4Tn. Out of the maturities in 2026, 1Q2026 seems the largest with T-bill maturities of LKR 1.5Tn and a T-bond maturities of LKR 478.0Bn.

Total Debt Maturities

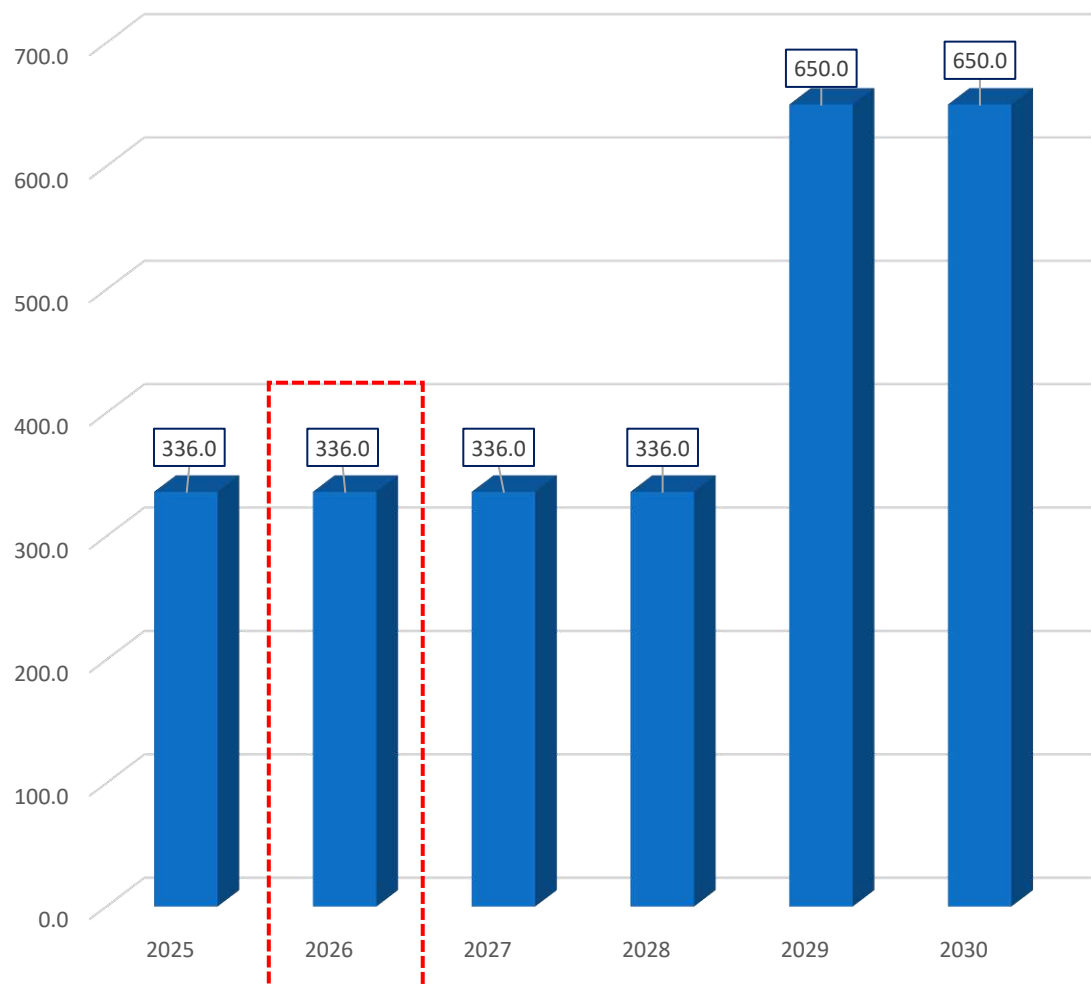


Quarterly outstanding LKR bond maturities



...and foreign maturities remains stable in the medium term

Repayment schedule post ISB restructure



Predetermined Short-Term Net Drains on Foreign Currency Assets ^(e) (USD mn)				
Item	Total	Maturity breakdown (residual maturity)		
		Up to 1 month	More than 1 and up to 3 months	More than 3 months and up to 1 year
1. Foreign currency loans, securities, and deposits^(d)	(2,094)	(181)	(258)	(1,656)
outflows (-) Principal	(1,215)	(106)	(98)	(1,011)
outflows (-) Interest	(880)	(75)	(160)	(644)
inflows (+) Principal				
inflows (+) Interest				
2. Aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the domestic currency (including the forward leg of currency swaps)	(3,794)	(1,846)	(880)	(1,069)
Short positions (-) ^(e)	(3,794)	(1,846)	(880)	(1,069)
Long positions (+)				
3. Other	(1)	(1)		
inflows related to reverse repos (+)				
outflows related to repos (-)				
other accounts payable (-)	(1)	(1)		



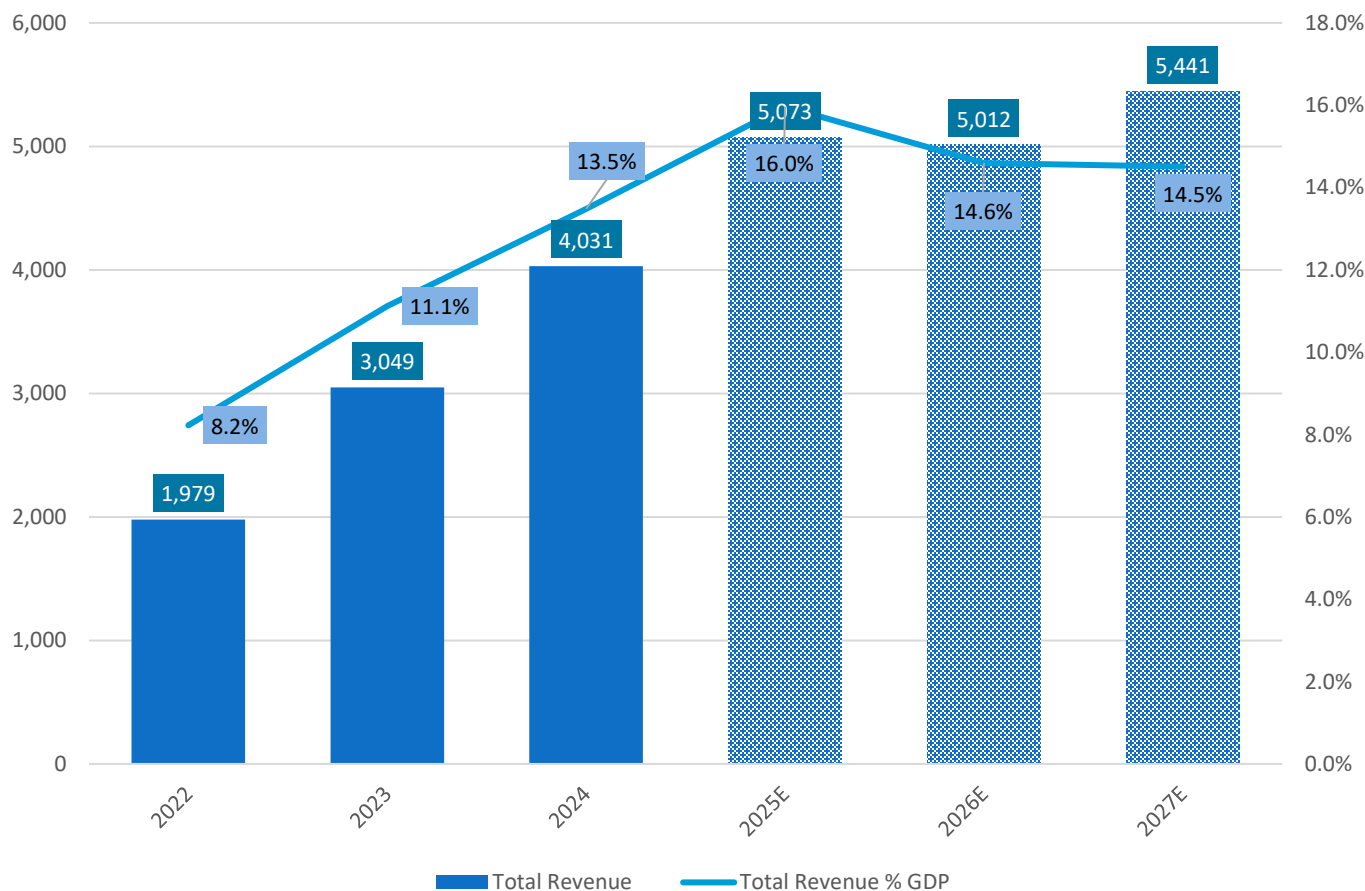
ECONOMICAL CONSIDERATIONS
FOR INVESTMENT DECISIONS



4.3 Fiscal discipline continues to remain on focus

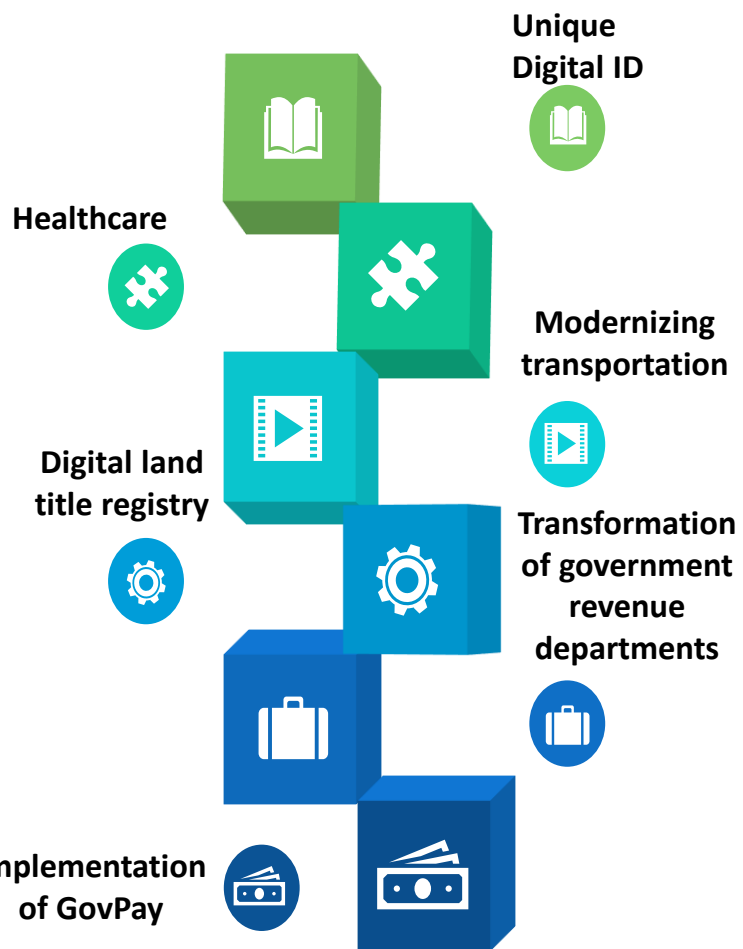
Government revenue growth to remain moderate...

FCR anticipates government revenue growth to stabilize in 2026, as one-off windfalls, particularly elevated vehicle import taxes fade and external trade tax collections soften, even though income and goods-and-services taxes are likely to grow at a more moderate pace.



...with all eyes on digitalization

Digitization of government institution priority areas



❑ SLUDI (National Digital ID)

Sri Lanka's SLUDI provides a secure, interoperable digital identity to enable paperless, people-less access to public and private services.

❑ Digital Motor Insurance Card

Vehicle insurance verification is now digital, allowing policyholders and authorities to access and validate insurance electronically.

❑ Ministry of Digital Economy

The Ministry drives national digital transformation, setting policy, overseeing ICT infrastructure, and promoting digital inclusion.

❑ GovPay

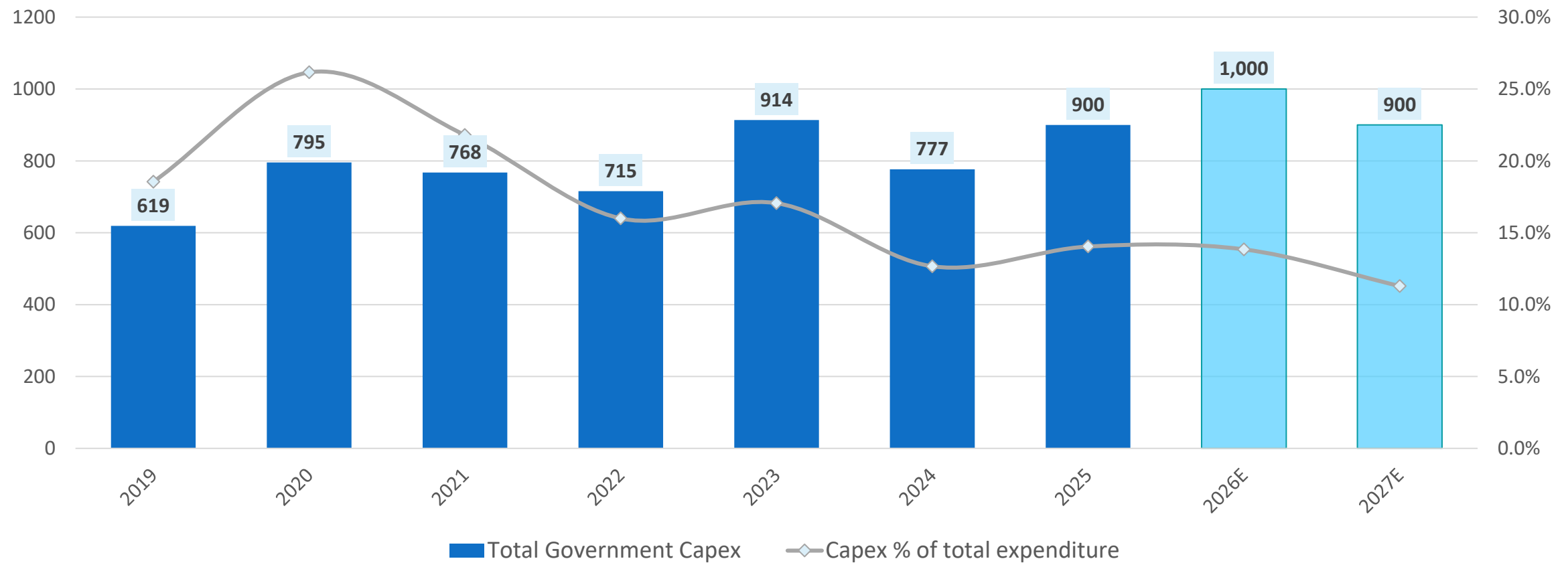
GovPay is a centralized platform enabling citizens and businesses to make secure online payments for government services.

❑ Other e-Government Services

Sri Lanka offers online access to birth, marriage, and death certificates, social program applications, and other digital government services.

Expenditure expected to gradually pick up, caused by the ramp up in government capex...

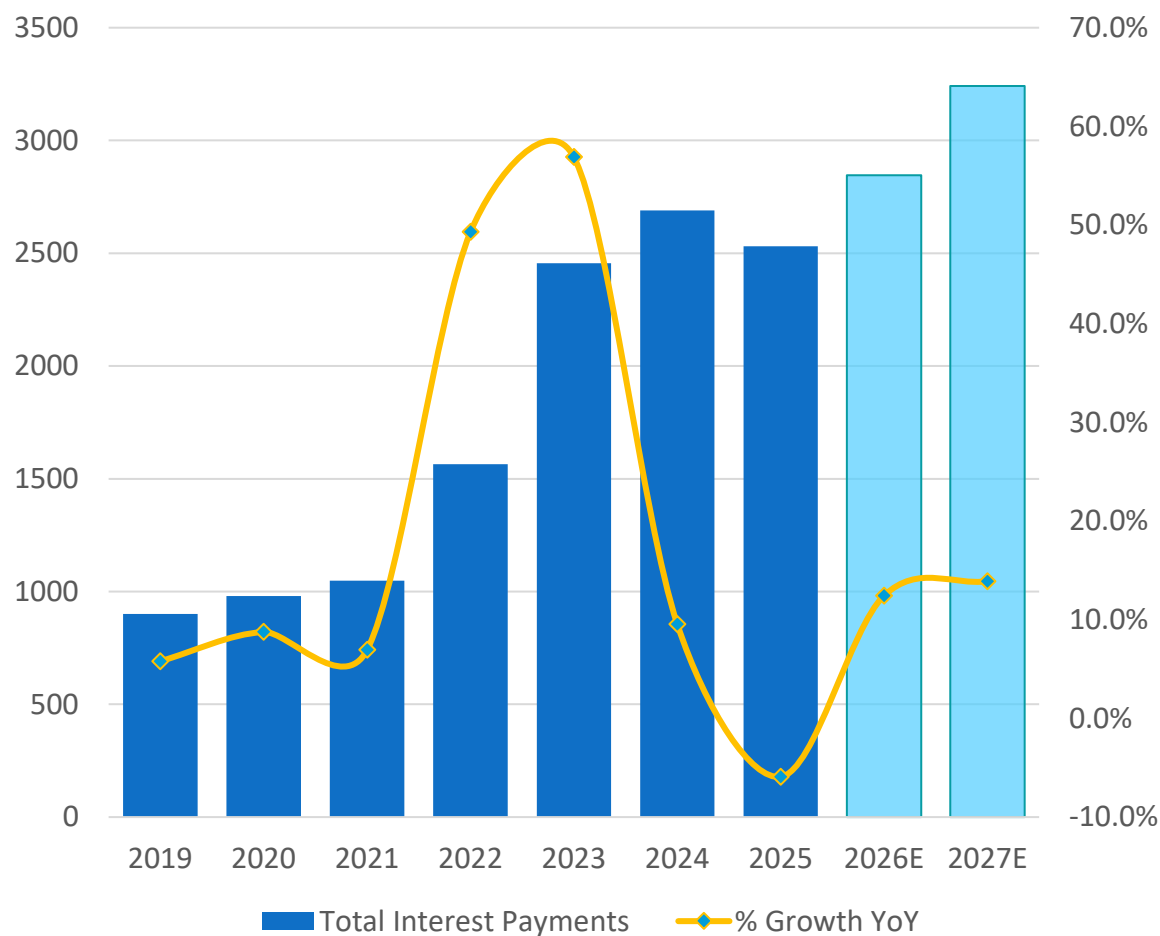
Sri Lanka’s government plans to ramp up capital expenditure in 2026 to drive economic growth and infrastructure development, with allocations expected to reach around LKR 1.3Tn for projects including roads, energy, and public facilities. However, with primary surplus in focus, we expect government to underspend again on capex, with concentration on rebuilding infrastructure damaged by Ditwah leading to a slowdown in new project capex.



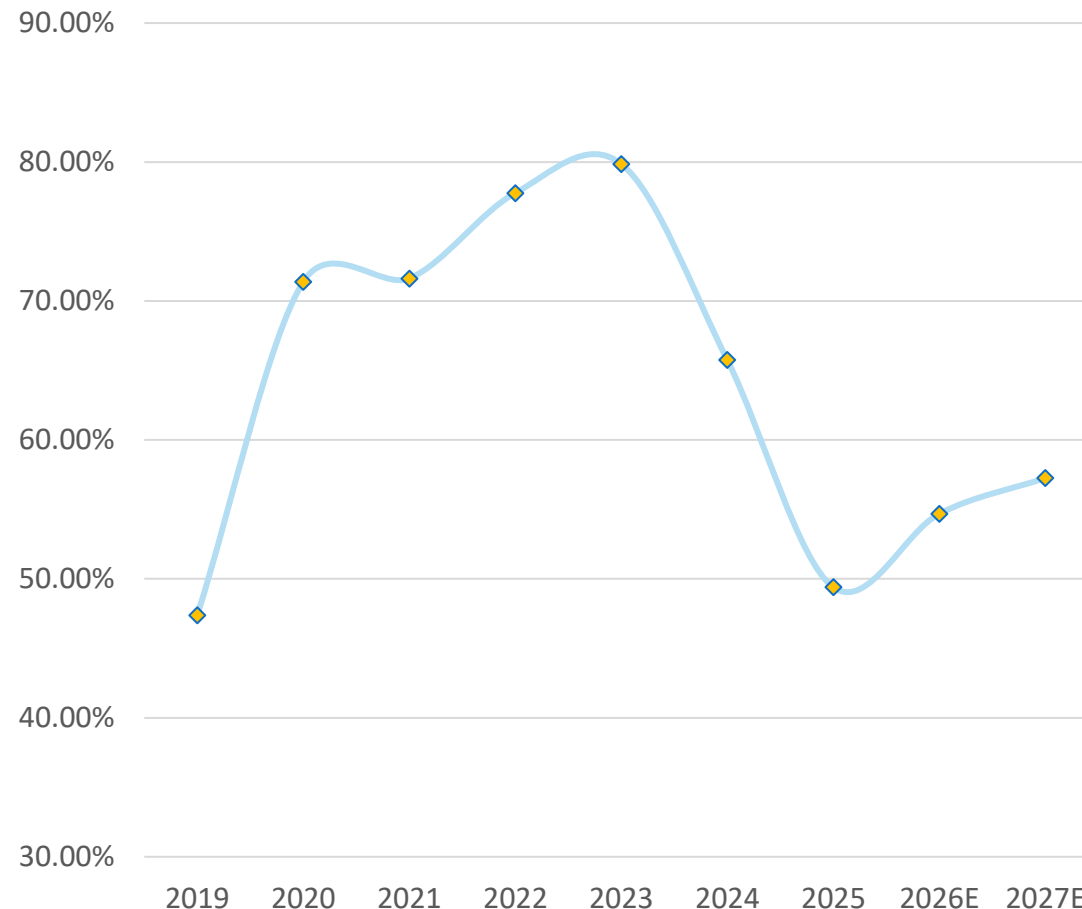
...and increased debt service payments

Sri Lanka's government debt service payments have risen sharply, with total interest and principal repayments reaching about 16% of GDP in 2025, placing significant pressure on fiscal resources despite ongoing restructuring efforts.

Total Interest Payments



Total Interest Payments as a % of Revenue and Grants

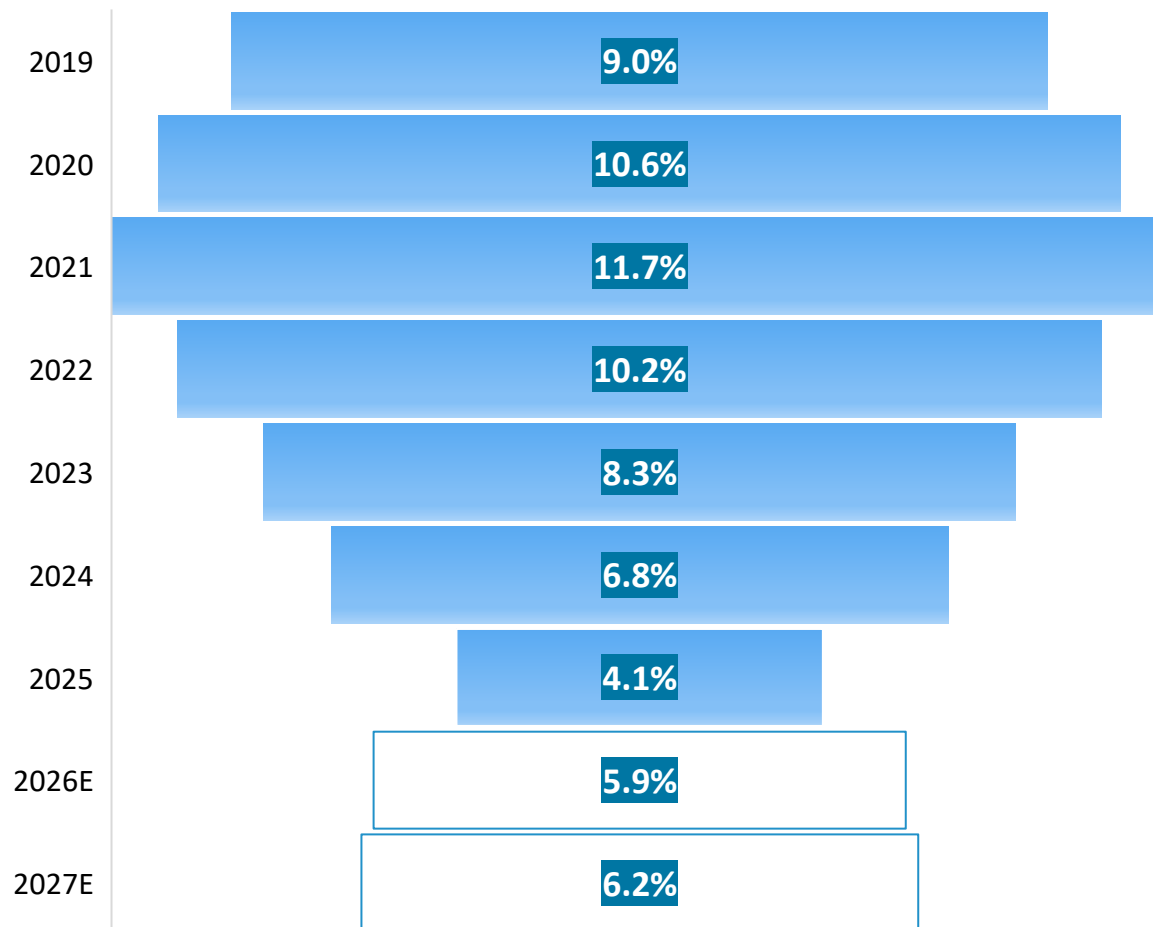



...pushing up budget deficit slowly

- Primary surplus is expected to stage a gradual narrowing...



- ...Resulting in budget deficit to widen as a proportion of GDP





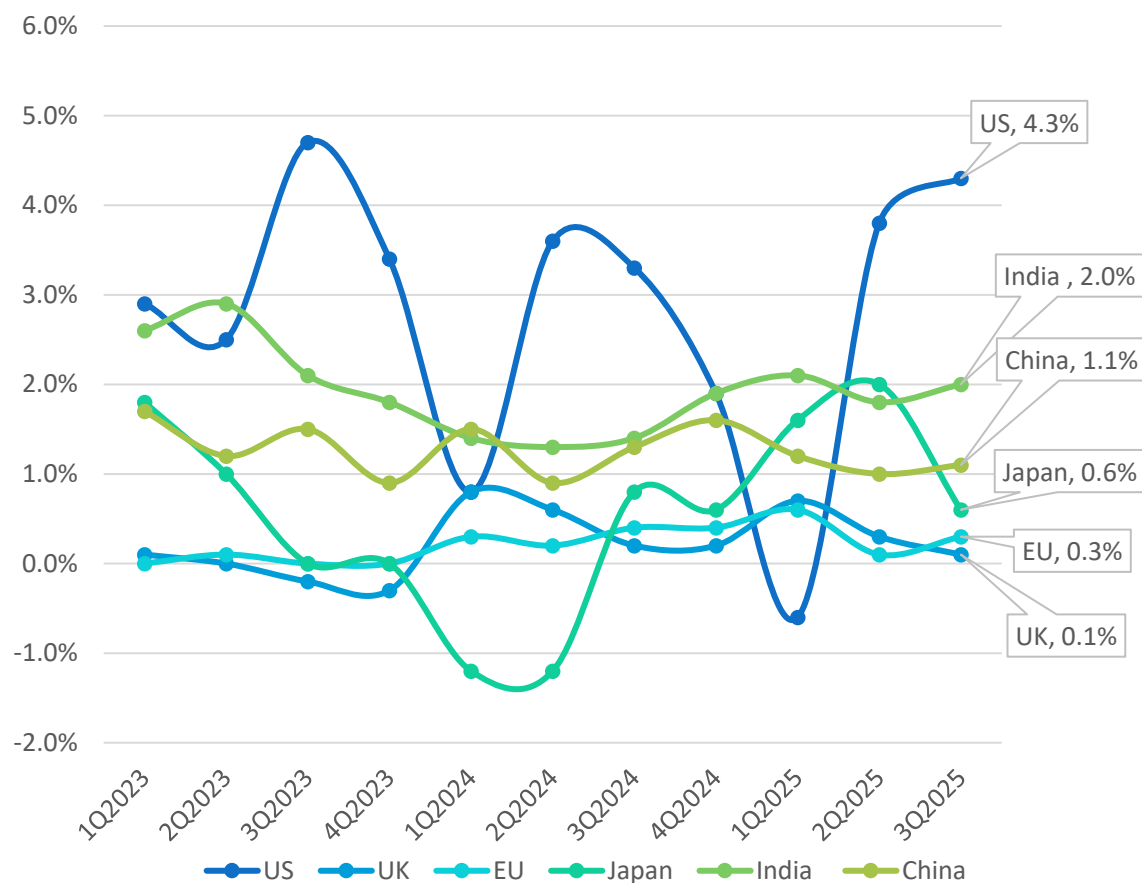
Global Outlook remains stable

Maintain **Medium-Low Risk**

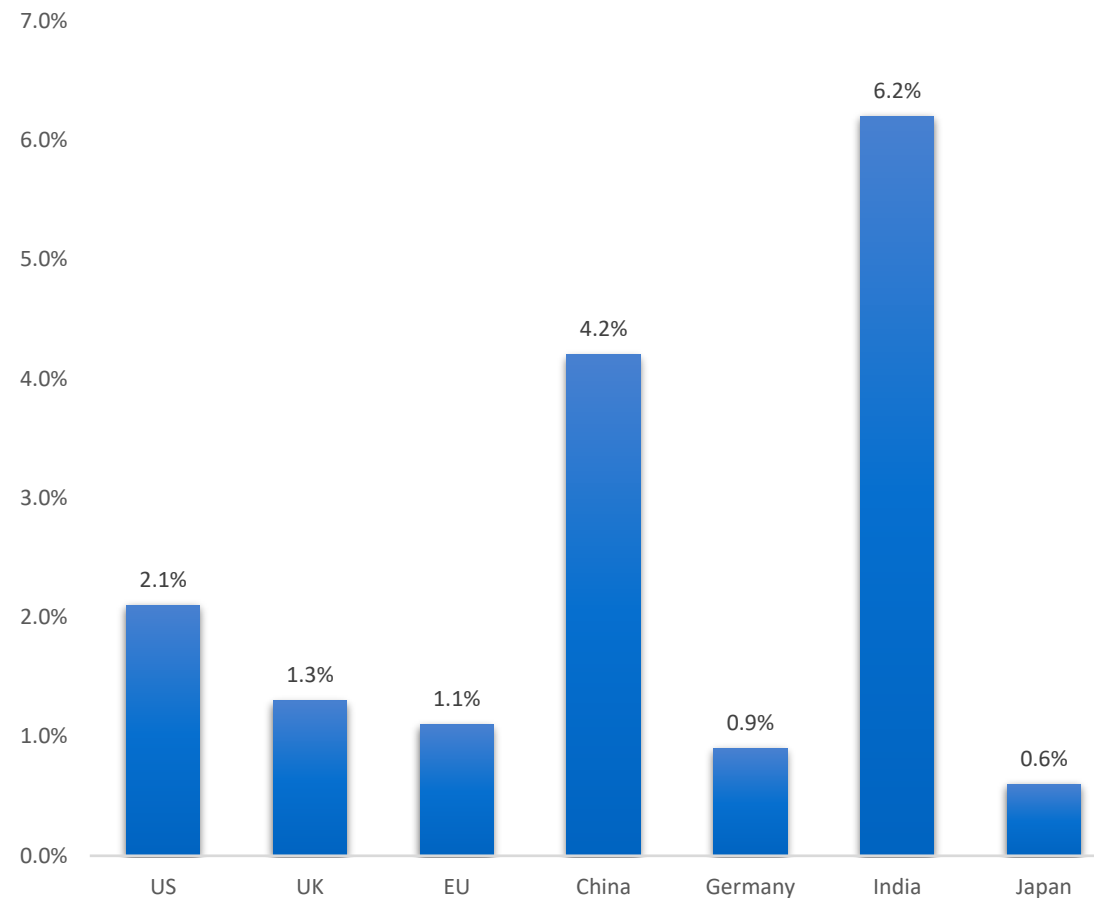
Section 5.0

Amidst slow growth in global GDP...

Global GDP growth - Quarterly

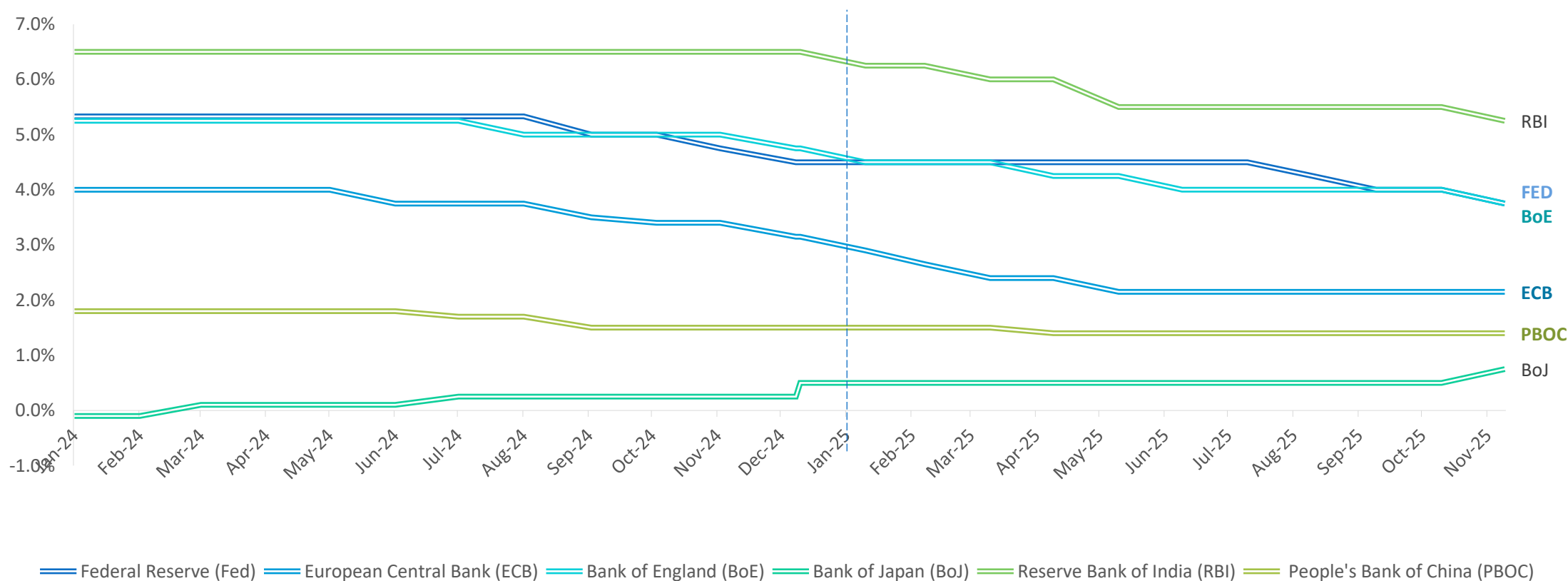


2026E GDP growth forecasts (IMF) - key economies



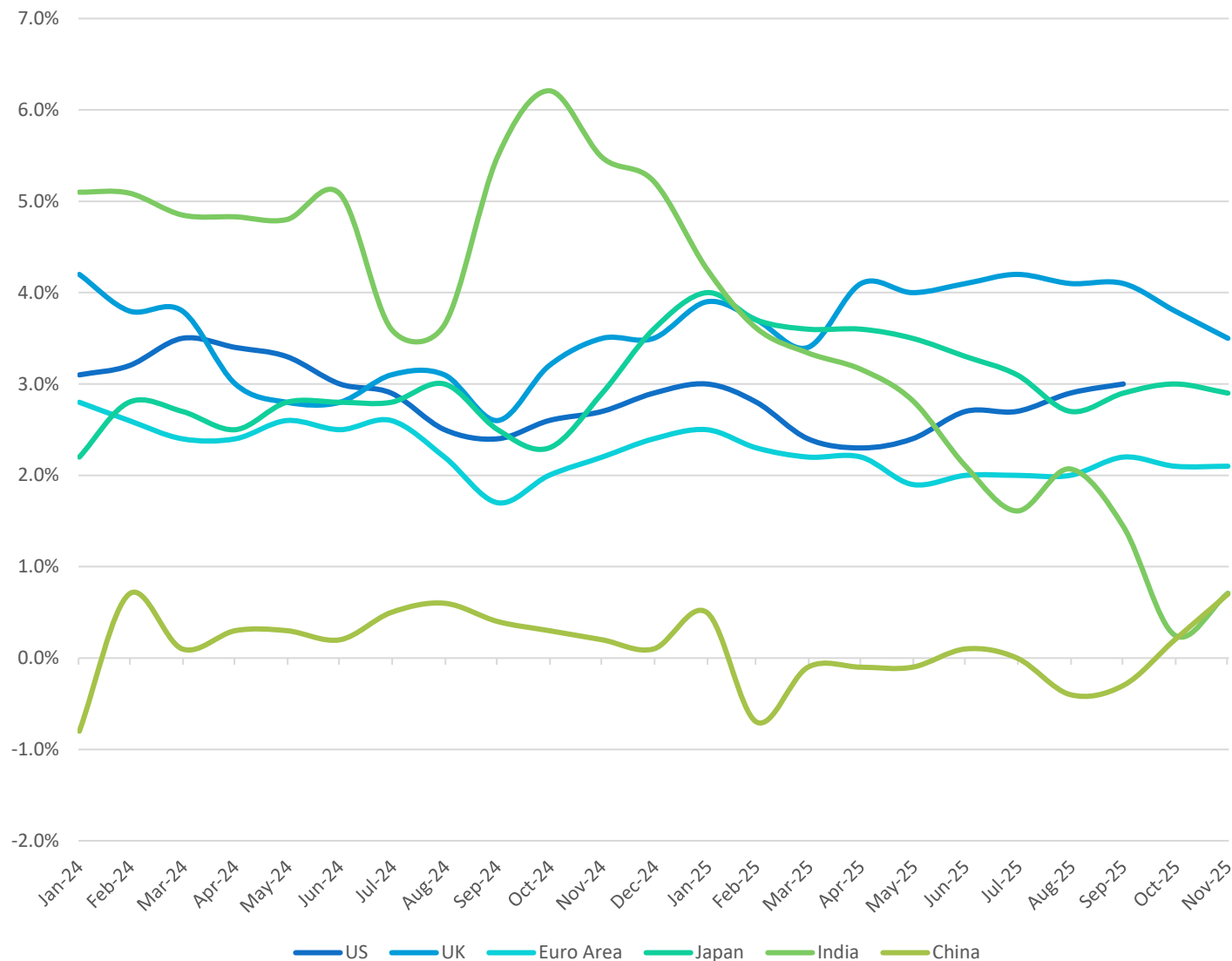
...Central banks around the world are looking for lower interest rates

The Federal Reserve began reducing interest rates in September 2025, cutting a total of 25 basis points to 4.25% from the 4.50% rate that had been maintained throughout the year. The move aimed to ease inflationary pressures and support the U.S. labor market. The Fed continued lowering rates over the next two policy meetings, ending with a December cut that brought the benchmark rate to 3.75%. The Federal Open Market Committee's (FOMC) dot plot indicates expectations of one additional rate reduction for 2026.



Which may push inflation up in the coming years

- ❑ **Inflation to remain between 2.5%-4.2%** : Global inflation is expected to remain elevated and hover between 3.5% to 4.2% during next 2 years. Headline inflation has risen across major economies, contributing to higher global inflation.
- ❑ **Inflation shows mixed signals** : Global inflation is easing from the peaks recorded in 2022-2023 supported by tighter monetary policies. Following the US tariff announcements in April 2025, tariff affected economies experienced supply disruptions, while the US economy faced a demand slowdown. During the final quarter of 2025, inflation trends moderated across the US, UK, and EU, while Japan, India, and China experienced an upward movement.



However, global political tension is on the rise adding pressure towards global GDP...

Trump eye on Greenland
Trump is considering acquiring Greenland for strategic and national security motives. Denmark has rejected the idea, warning that any forceful takeover would undermine NATO. In response, several European countries have deployed small, symbolic military forces to Greenland, while Danish diplomats continue talks with Washington to ease tensions.

Russia-Ukraine war
Ukraine declares an energy emergency after Russian attacks on its electricity and heat infrastructures. Meanwhile, Ukraine continues drone strikes along the Black Sea coast. The ongoing war, rooted in long-standing geopolitical tensions, has now passed over 1,400 days since Russia's initial invasion in 2022.

China & Taiwan semiconductor dilemma
China carries out multi-domain drills around Taiwan territory following its claims on Taiwan territory, while US backing Taiwan's self-defense with USD 11Bn arms supply last month. Meanwhile Taiwan has entered into a trade deal with US on semiconductor powerhouse's exports, in exchange for lower tariffs.

US strike on Venezuela
Following the strikes on maritime vessels, US captured the Venezuelan President on 3rd of Jan 2026 drawing global criticism. US has completed the first sales (USD 500Mn) of Venezuelan oil that are part of a USD 2Bn deal reached earlier this month between Caracas and Washington

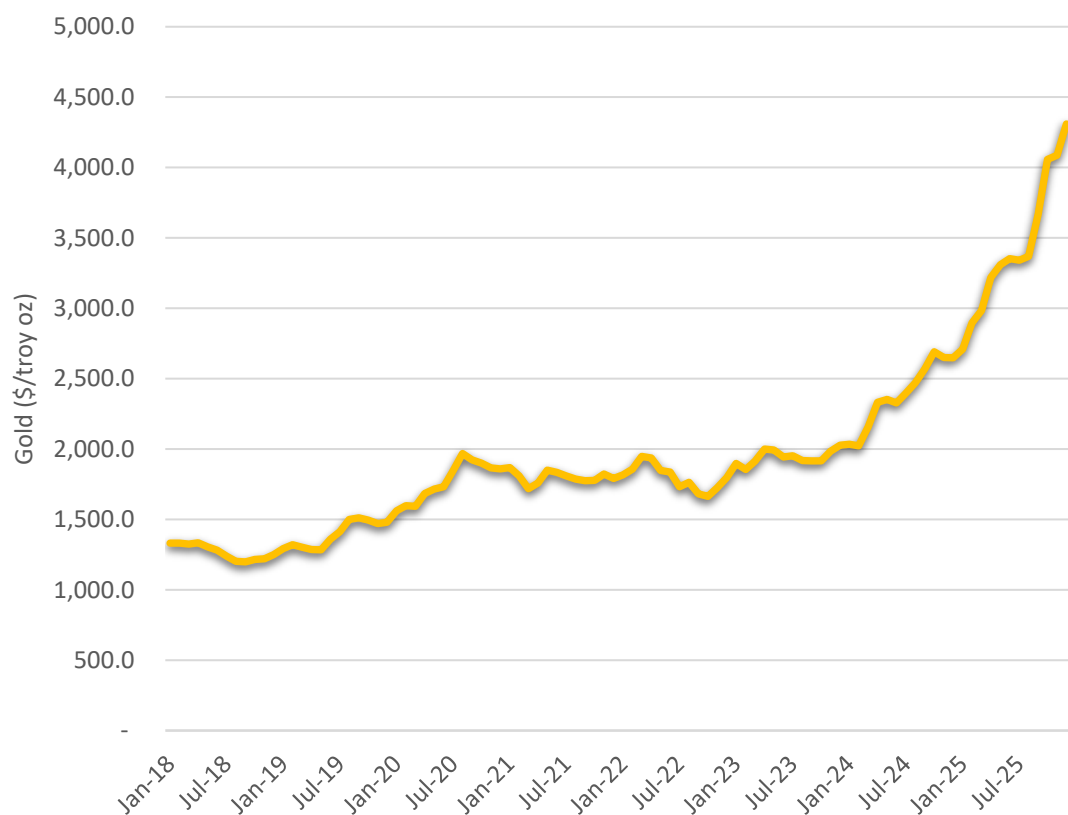
Middle East Flashpoints
While Israel agents are operating on the grounds on Iran backing antigovernment protests, it is also carrying out wars with Syria, Yemen, Lebanon and Gaza.

Iran's crackdown
Antigovernment protests across Tehran have been sparked following severe economic distress in the country. The demonstrations have resulted in many deaths, and the U.S. has imposed sanctions on Iran over its crackdown on protesters.

Cambodia-Thailand border conflict
After a long-standing border dispute, periodically erupting into violence the two countries entered to a cease fire on 24th Dec 2025 to stop hostilities, freeze troops, and monitor peace.

... whilst pushing up the demand for safe haven assets

Gold prices surged in the recent months as a global hedging asset against uncertainty. Rising trade tensions among major economies, a weakening US dollar, increased demand from central bank purchases and exchange traded funds have collectively driven the recent surge in global gold prices.



Silver prices have risen in recent months, driven primarily by strong industrial demand, with growth outpacing that of gold. Despite supply-side pressures, demand for silver continues to increase, supported by its expanding use in solar photovoltaics, electronics, and automotive manufacturing.



Summary of External Outlook

Easing Global Rates

Sri Lanka benefits from global monetary easing through reduced borrowing costs and increased investment

Increased global political tension

Global political environment remains volatile bringing uncertainty to global GDP growth



Inflation picking up across major regions

With major economies looking to cut rates to boost economies, inflation is on track to edge higher across major regions

Fund flows to frontier markets expected to remain slow

With political uncertainty picking up across major regions, investors seek investments in safe havens, limiting investments towards frontier markets

External Outlook: Maintain *Medium-Low Risk*

Summary of Overall Economic Outlook

Positives

- Completion of EDR
- Continuity of IMF Program
- Primary surplus
- Controlled inflation
- Credit rating upgrade
- Foreign reserves improvement
- Strong performance in worker remittances
- Improved liquidity levels
- Continuous recovery in total credit

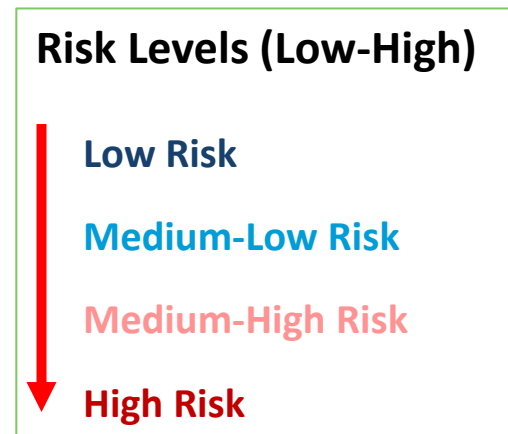
Negatives

- Rising credit growth
- High CBSL Holdings
- Difficulty in raising foreign debt
- LKR Depreciation
- Weak tourism earnings
- Increasing trade deficit

Economic Outlook: Maintain *Medium-Low Risk*

Outlook Trend for Sri Lanka

Time Period	Political	Economical	External
Feb 2023	Medium-High Risk	Medium-High Risk	Medium-High Risk
Jun 2023	Medium-Low Risk	Medium-Low Risk	Medium-Low Risk
Jan 2024	Medium-High Risk	Medium-Low Risk	Medium-Low Risk
Aug 2024	Medium-High Risk	Medium-Low Risk	Medium-Low Risk
Jan 2025	Low Risk	Medium-Low Risk	Medium-Low Risk
Aug 2025	Low Risk	Medium-Low Risk	Medium-Low Risk
Jan 2026	Low Risk	Medium-Low Risk	Medium-Low Risk

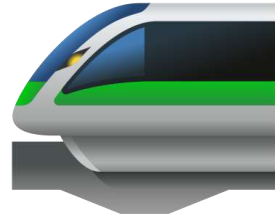
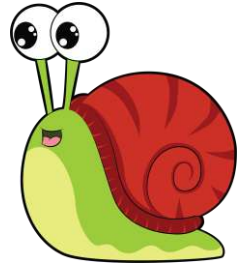


ECONOMICAL CONSIDERATIONS
FOR INVESTMENT DECISIONS



6.0 Scenarios for Emerging Systemic Risk

First Capital Research identified four likely scenarios post elections in Nov 2024



Base Case Low Scenario Snail Pace Stroll

Highlight

- Hung Parliament / Unwillingness for drastic change
- IMF program barely on course
- Governance related reforms completed to keep IMF on course
- Slow economic growth
- Potential new tax hike if tax not broad based

Base Case High Scenario Monorail Dream

Highlight

- Strong Parliament
- IMF program on accelerated course with fiscal positive reforms
- FDI Flows
- Digital ID and Govt move into digitalization
- Increase in financial literacy

Super Case Scenario Super Grade Highway

Highlight

- Capitalistic President & Parliament
- IMF program on accelerated course with privatizations
- Reverse brain drain
- Lower Taxes
- Move towards digital economy

Worse Case Scenario The Lankan Pothole

Highlight

- Weak President / Hung Parliament
- IMF program falls apart
- Rise in inflation
- Currency Depreciation
- Brain Drain
- Tax Hike
- Demand for Non-liquid assets

...out of which two scenarios emerge highly likely ahead of 2026 capital repayments

Scenario 1

Snail Pace Stroll Scenario

Possible outcomes

- Hung Parliament / Unwillingness for drastic change
- IMF program barely on course
- Governance related reforms completed to keep IMF on course
- Slow economic growth
- Potential new tax hike if tax not broad based

FCR scenario outcomes

- GDP growth between 3%-4%
- Interest rates to rise between 100bps-250bps
- Debt to GDP remain elevated compared to IMF targets
- GFN to under perform IMF target



Scenario 2

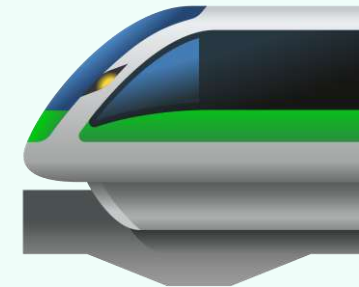
Monorail dream scenario

Possible outcomes

- Strong Parliament
- IMF program on accelerated course with fiscal positive reforms
- FDI Flows
- Digital ID and Govt move into digitalization
- Increase in financial literacy

FCR scenario outcomes

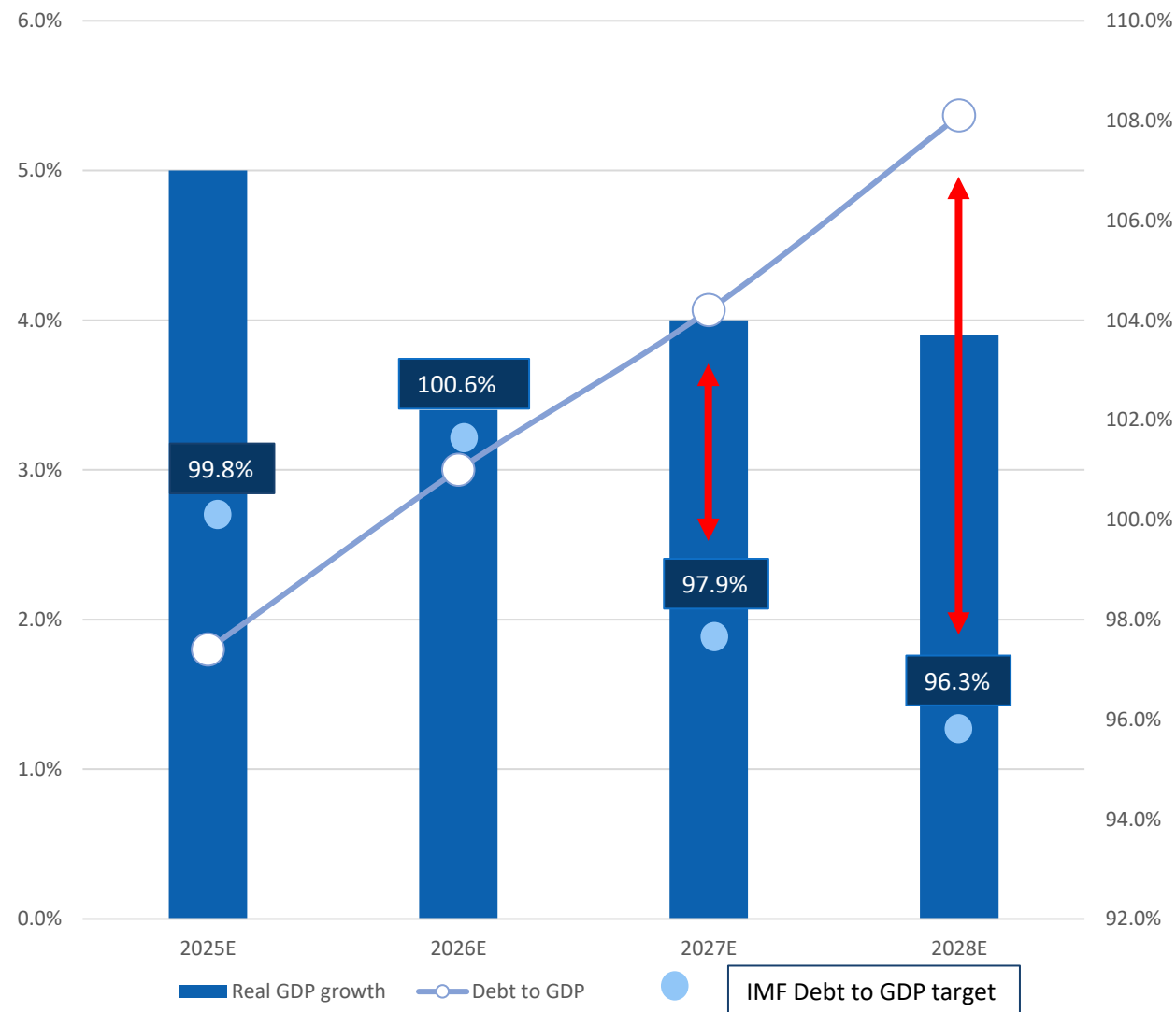
- GDP growth above 5%
- Interest rates to remain stable
- SL to outperform debt to GDP targets
- SL to outperform GFN targets



With snail pace stroll (base case) raising questions on debt sustainability...

Salient factors

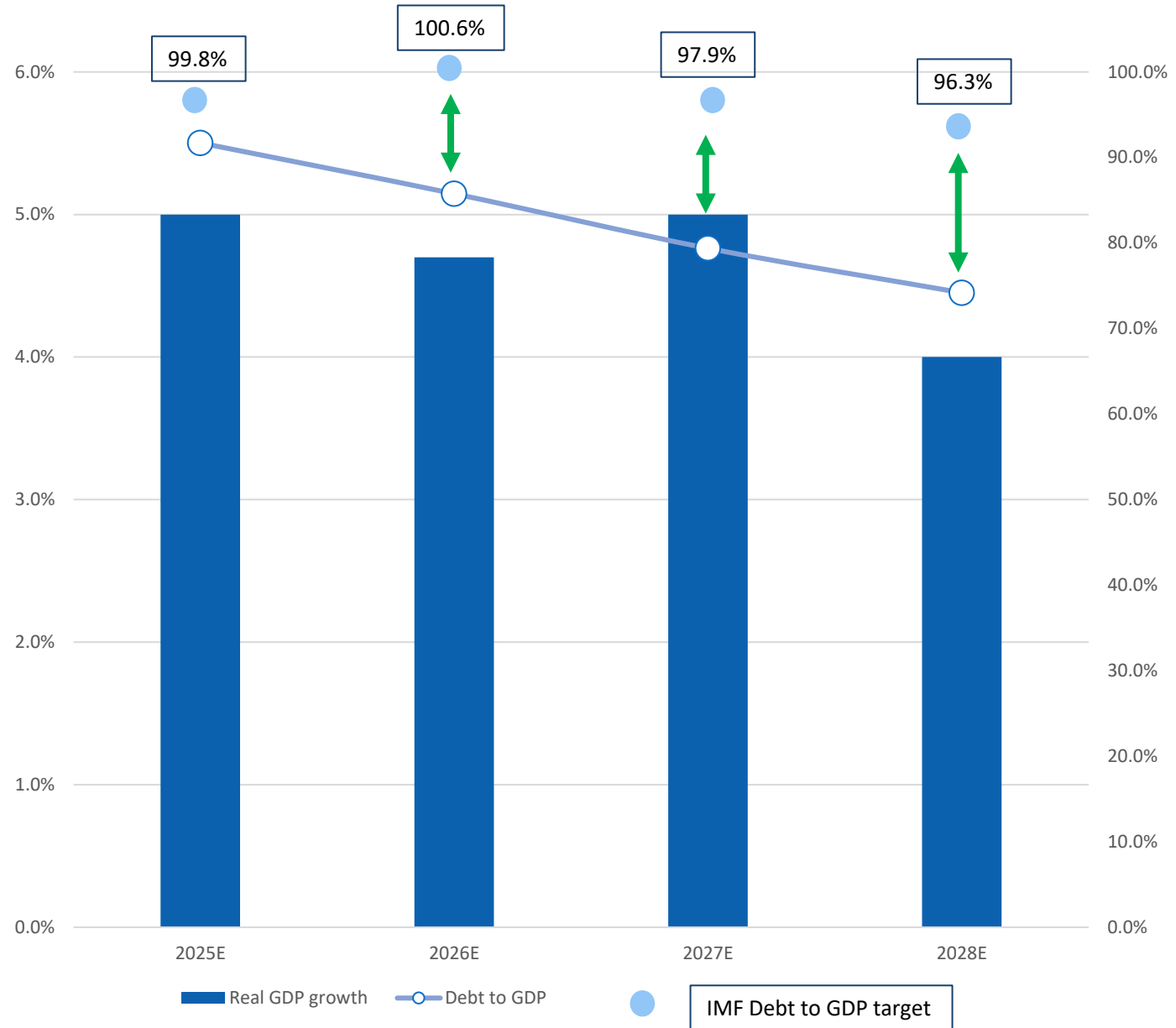
- GDP growth expected to remain between 3%-4% for the period of 2026E-2028E amidst slow progress on reforms.
- Policy rates are likely to remain on the same levels, with somewhat pressure as capital repayment comes closer.
- Debt to GDP levels decline below 95% in 2025E, yet slower GDP growth making it difficult for debt to GDP levels come below 100% in the medium term
- GFN likely to remain elevated with pressure coming in as interest rates slowly climbs.



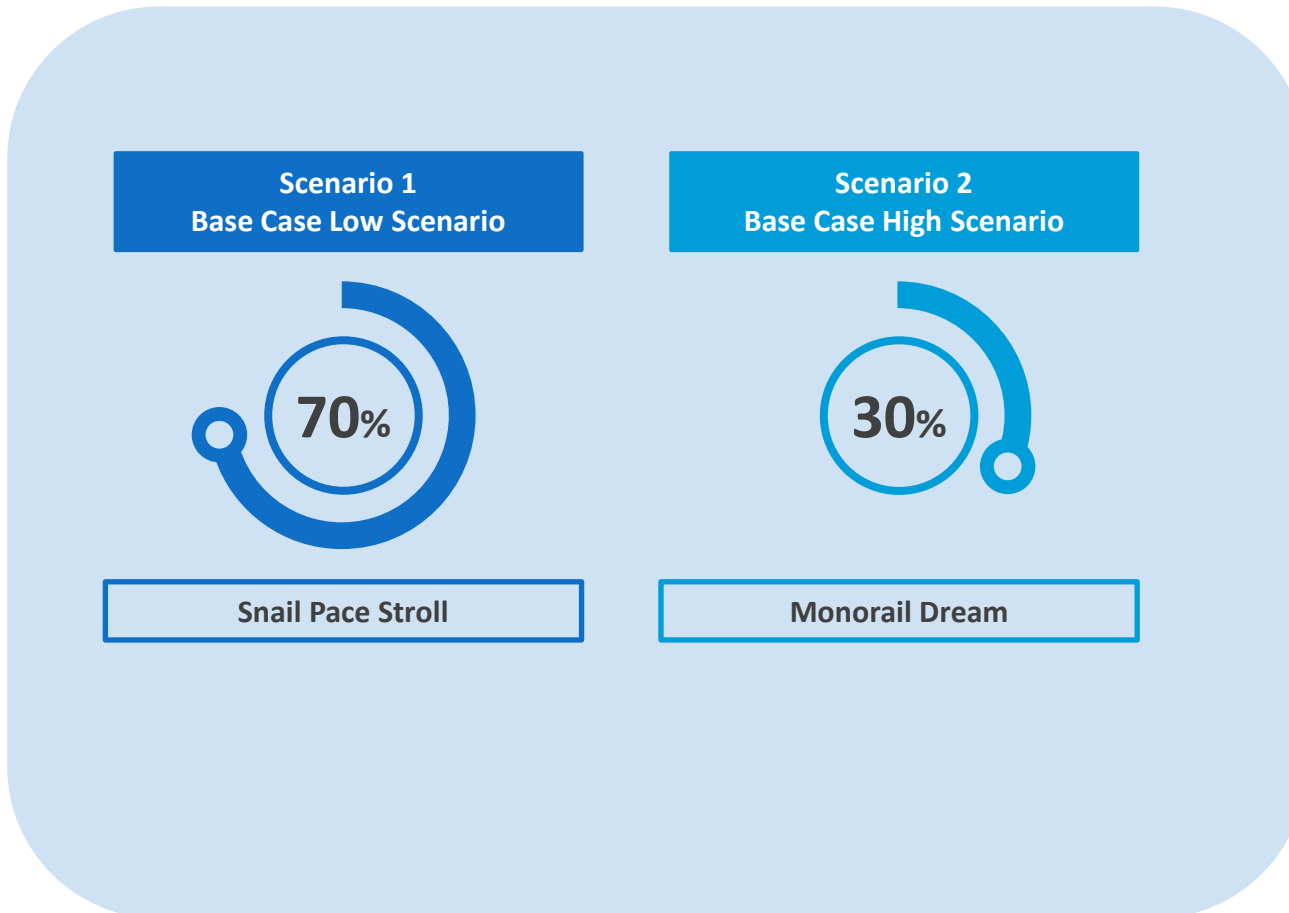
... whilst optimism backed Monorail Dream scenario with faster growth on track towards debt sustainability

Salient factors

- GDP growth likely to remain above 5% in the medium term with successful reform implementation.
- Fiscal discipline offers more room for further reduction of rates.
- Sri Lanka slowly inches towards debt sustainability with debt to GDP consistently on the decline.
- Gross financing need to remain steady with slow decline.

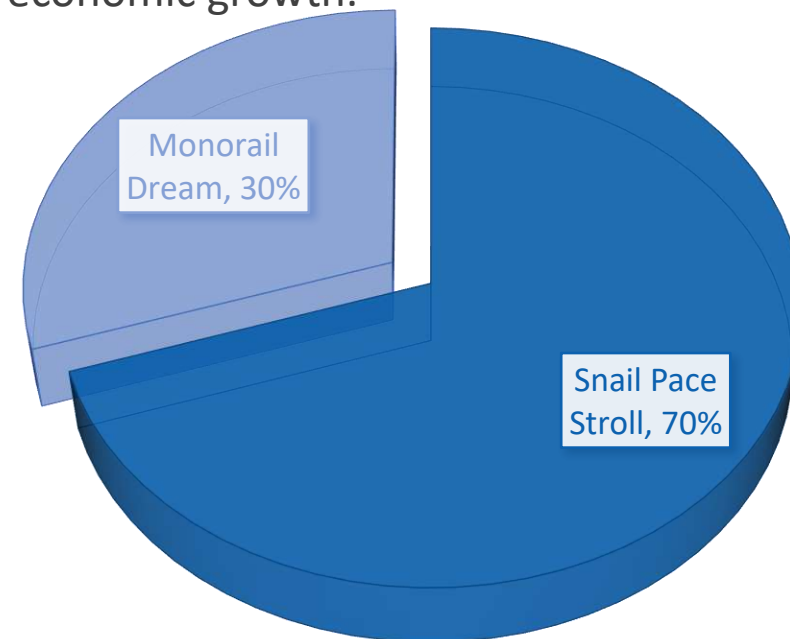


Potential scenario possibilities



Possible outcomes

- ❑ Considering the current trajectory of the economy, case for a Snail Pace Scenario (base case low) is highly likely and we give a 70% probability as the outlook for Sri Lanka.
- ❑ We assign a lower probability of 30% for Monorail Dram scenario (Base case high), given the slow progress in reforms and expected slow trajectory of the economic growth.





Recommendations

Section 7.0

First Capital Research View on Bond Market 2026

Section 6.1



Primary Criteria

CBSL Holdings

CBSL holdings marginally reduced to LKR 2.5Tn but continues to remain at elevated levels.

Risk Level: High
(Maintained)

Credit

Private sector credit for the first eleven months increased by 26%YoY to LKR 10.0Tn whilst state sector credit declined 2.5%YoY to LKR 8.7Tn.

Risk Level: Medium-Low
(Maintained)

Foreign Activity

Foreign Investment in G-Sec slightly improved in 2025 and remains stable at the current level. Currently value is immaterial to make impact.

Risk Level: Medium-Low
(Maintained)

Foreign Reserves

Foreign reserves reached USD 6.8Bn in Dec 2025, marginally below our target of USD 7.0Bn.

Risk Level: Medium-Low
(Maintained)

Liquidity

Liquidity level displayed significant volatility during 2025 with outstanding liquidity in the banking sector hovering between LKR 100.0Bn – LKR 150.0Bn.

Risk Level: Low
(Upgraded **Medium-Low**)

Inflation

CCPI for Dec-25 came in at 2.1% and continues to remain below CBSL directed threshold of 5%

Risk Level: Low
(Maintained)



Secondary Criteria

Rating Outlook

Backed by the stable outlook and recovery in economic indicators, S&P revised up their rating for Sri Lanka to CCC+. With this all three agencies have revised up their rating for Sri Lanka from its previous SD rating.

Risk Level: Medium-Low
(Upgraded **Medium-High**)



External Environment

LKR depreciated by 5.1%YoY to LKR 310.0 per USD in 2025. Elevated imports coupled with continuous USD purchases by the CBSL prompted LKR to depreciate against the USD

Risk Level: Low
(Maintained)



BOT & BOP

Trade deficit for the 1st 11 months expanded by 31.7%YoY to USD 6.9Bn whilst current account surplus for the 1st 11 months recorded a slight decline to USD 1.68Bn cf. USD 1.7Bn in 2024

Risk Level: Medium-Low
(Maintained)



Political Risk

With the governing party securing the majority in all three major elections, political stability continued to be maintained. Moreover, we expect the ruling party to secure the majority in the upcoming provincial council elections, which is expected to take place in the next 12 months.

Risk Level: Low
(Upgraded **Medium-High**)



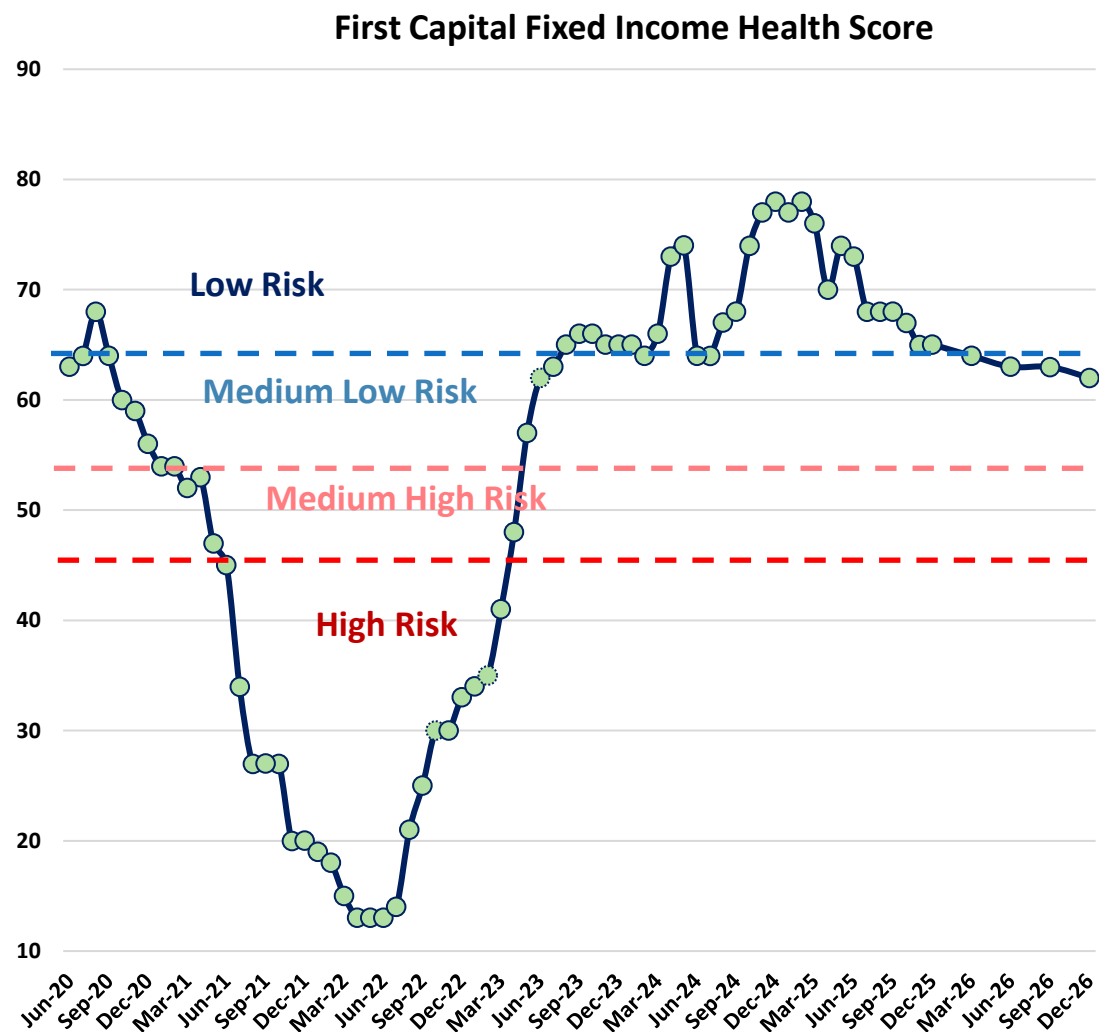
Investor Confidence

The business confidence index hit an all time high of 210 in Jun-25. However, since then, with the recent developments in the global context, BCI index has been gradually moderating.

Risk Level: Low
(Upgraded **Medium-High**)

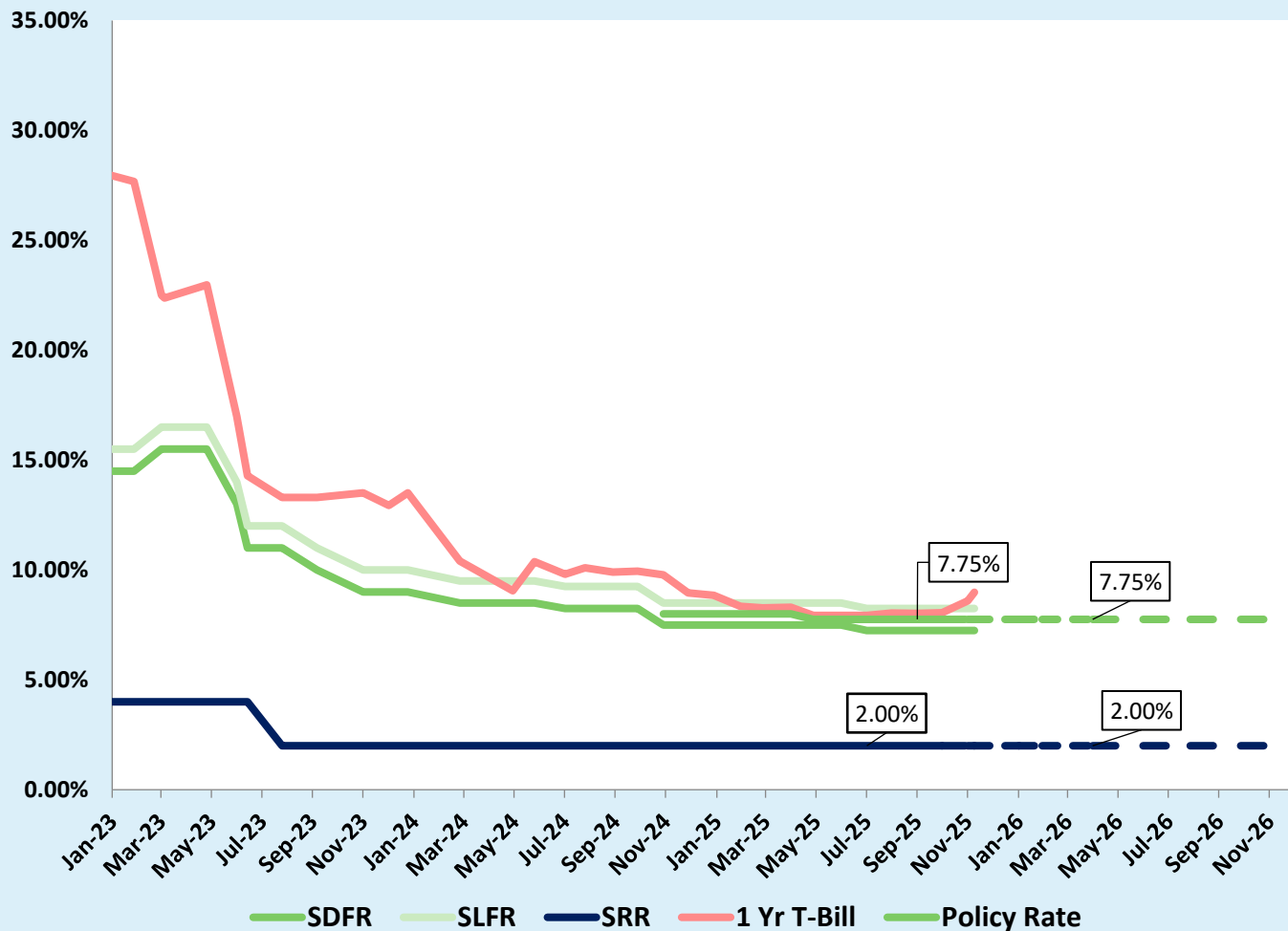


Fixed Income Health Score risk level declines medium low risk territory



- ❑ The economic indicators related to the FI Health Score demonstrated a slight weakness in 2025, with the health score slightly declining, yet hovering above the medium risk territory. Slow build up in official reserves, continuous expansion in private sector credit, pick up in inflation and volatility in liquidity were causes towards the wakened health score.
- ❑ Looking ahead, we expect health score to slightly decline below the medium low risk territory affected by gradual movement in inflation towards the 5% mark, growth in private sector credit and a possible decline in business confidence as the economic growth is expected to remain slow.
- ❑ *Given the slight decline in health score below the medium risk territory, we expect some pressure on interest rates in 2026E.*

Policy rates may stay anchored for 2026



No change in Rates for next 12 months

- All economic indicators showcased a steady recovery in 2025 whilst activity levels in the economy improved simultaneously with purchasing managers index showcasing a steady expansion and business confidence recording all time high levels.
- With economic recovery showing signs of slowing down affected by slow growth in consumption. Moreover, economic activity in the coming months is expected to slow caused by cyclone Ditwah. Considering the factors mentioned another rate cut cannot be entirely ruled out, the likelihood remains low. Current expectations suggest that rates will be held steady for at least a year to ensure sustained economic stability and broad-based recovery.

“Bond yields to rise by 50-100bps:
Recommendation maintained to stay in short
tenures and run a carry portfolio”



Recommendation: Yields may gradually **revert up by 50-100bps** during next 12 months up to Dec-26

Possible drying up of market liquidity as credit expected to remain elevated

Although private sector credit is expected to moderate in 2026E compared to 2025, credit disbursed is expected to remain high with monthly demand expected to remain between LKR 150Bn – LKR 170Bn. This is expected to dry down liquidity in the banking sector and add adverse pressure on market interest rates.



Debt maturities edge up in 2026, adding burden on foreign reserve accumulation

Despite 2025 being on of the lowest years in terms of debt maturities, reserve accumulation remained a challenge for the CBSL. Coming into 2026, debt maturities are expected to pick up whilst lower current account surpluses triggered by higher trade deficits is expected to limit CBSL ability to purchase USD from the market.



Inflation to rise towards CBSL directed threshold of 5%

Inflation broadly remained under target in 2025. Looking ahead, we expect inflation to gradually revert towards the CBSL target of 5% driven by supply side constraints including pick up in food inflation and relatively higher electricity prices in 2026 compared to 2025. With inflation gradually moving towards 5% target, investors are expected to demand higher yields pushing up bond yields in 2026E.



Rates may rise 50-100bps. Recommendation maintained to run a carry portfolio with short tenures

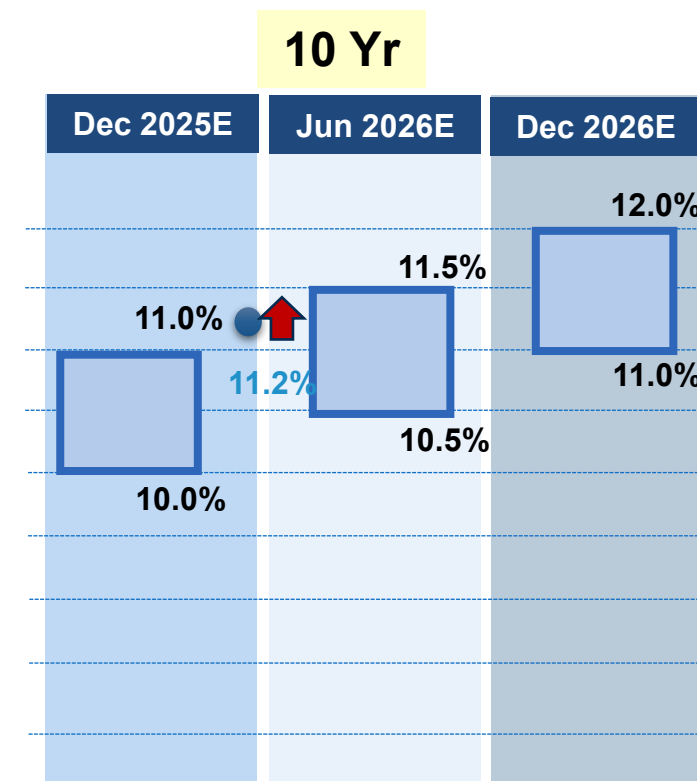
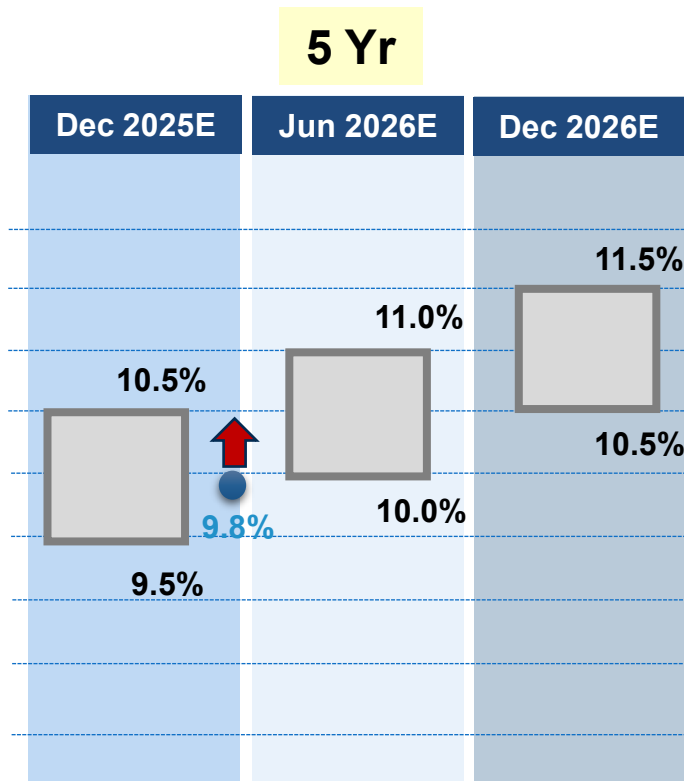
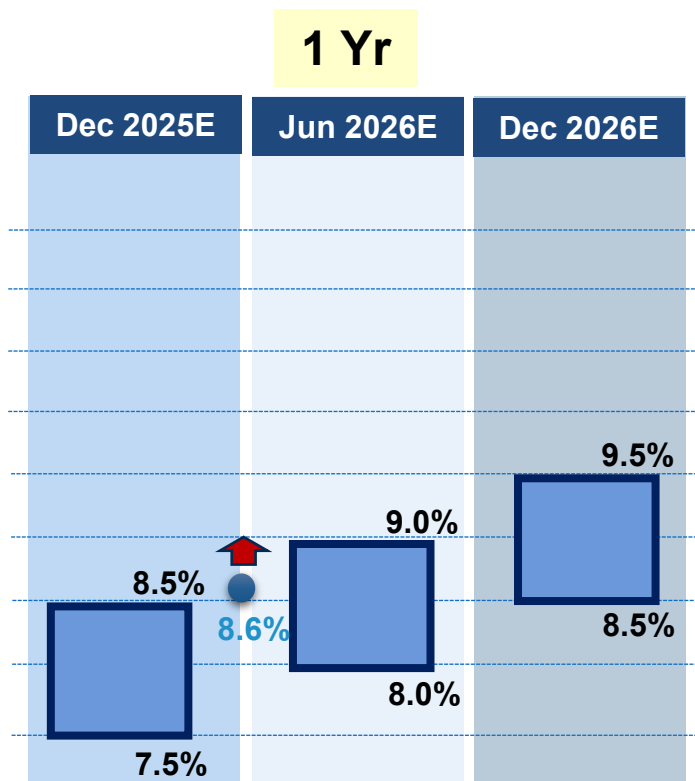
Considering the above factors, we expect bond rates to rise by 50-100bps in the next 12 months. Therefore, with yields expected to rise, to reduce potential capital losses on bonds, we maintain our advice for investors to shift to shorter tenures with willingness to run a carry portfolio till maturity.



Bond Yield Expectations for Jun-26 & Dec-26:

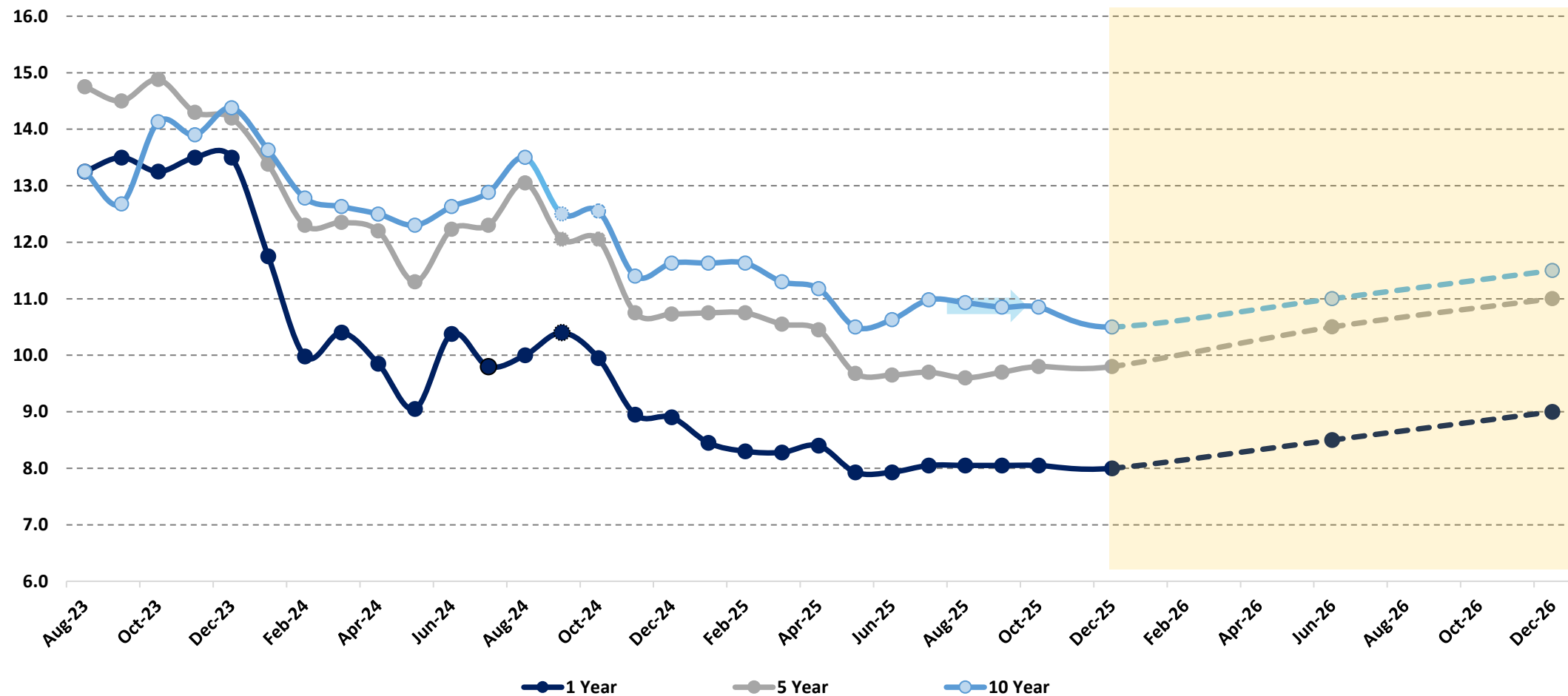
Yields to rise 50-100bps over next 12 months

We expect a slight buildup of pressure on interest rates in the next 12 months caused by a possible slowdown in GDP growth caused by multiple factors including slowing consumer demand, weak government capex spending and dwindling factors of production affected by cyclone Ditwah. Moreover, escalation in overall inflation, declining business confidence and growing credit demand are also expected to insert pressure on interest rates in the coming 12 months. Therefore, we expect interest rates to rise between 50-100bps during the next 12 months.



The pressure observed on government securities at the beginning of 2026 to prevail during the remainder of 2026

Bond yields to increase between 50bps-100bps during 2026E



First Capital Research View on Banking Rates 2026

Section 6.2

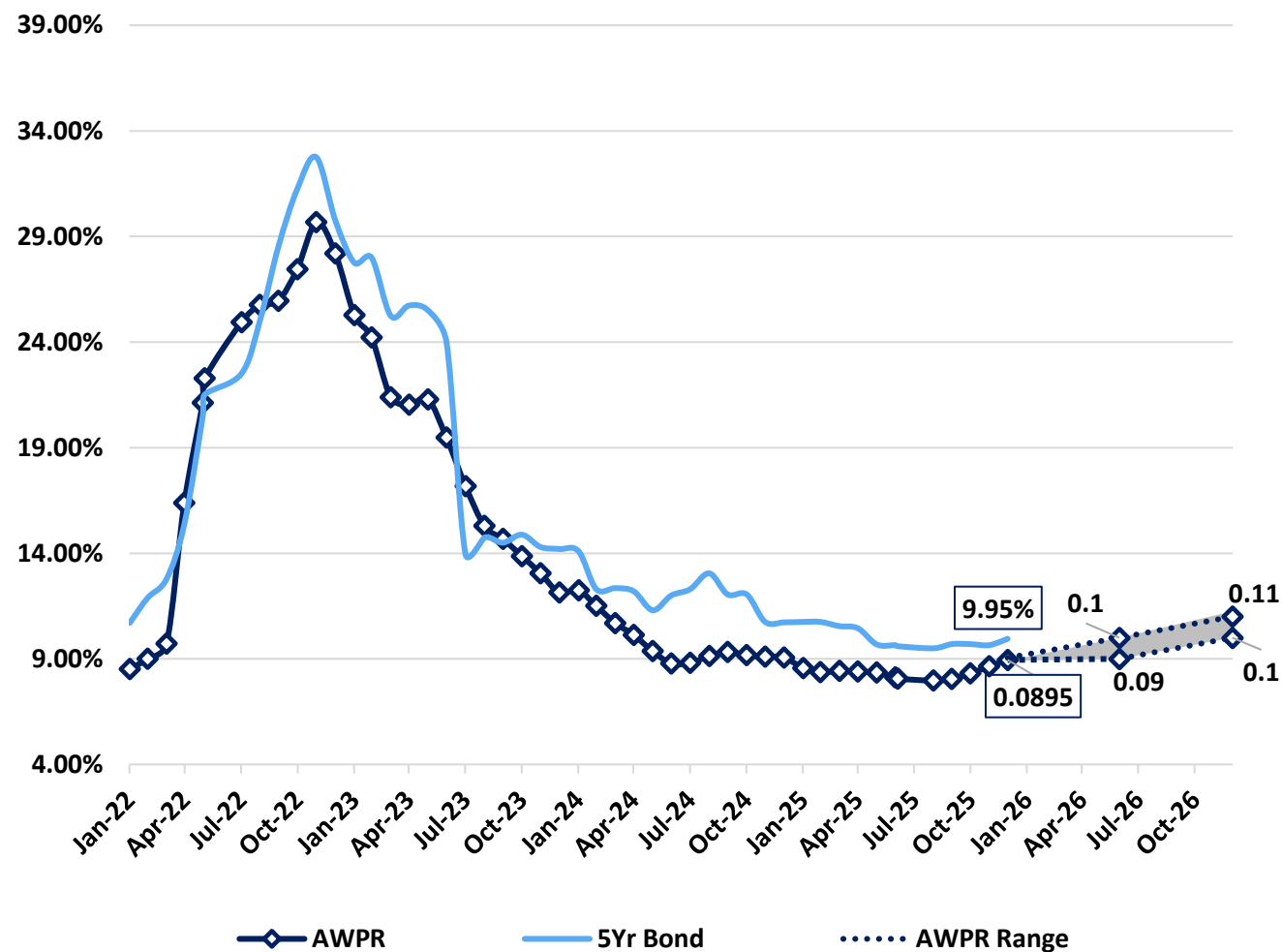


AWPR to rise towards 9.0%-11.0% in 2026E

AWPR to trend upwards

- ▣ **Private Credit picks up:** Private sector credit outperformed our expectations in 2025 driven by the expansion in the economy and demand for vehicle imports. With credit demand picking up AWPR closed 2025 within our forecasted band of 8%-9%.
- ▣ **AWPR to rise with liquidity tightening up:** AWPR is expected to gradually increase towards 9.0%-11.0% in 2026E with expectations of continued demand for credit from the private sector, tightening the availability of liquidity in the banking system.

Expectations for AWPR

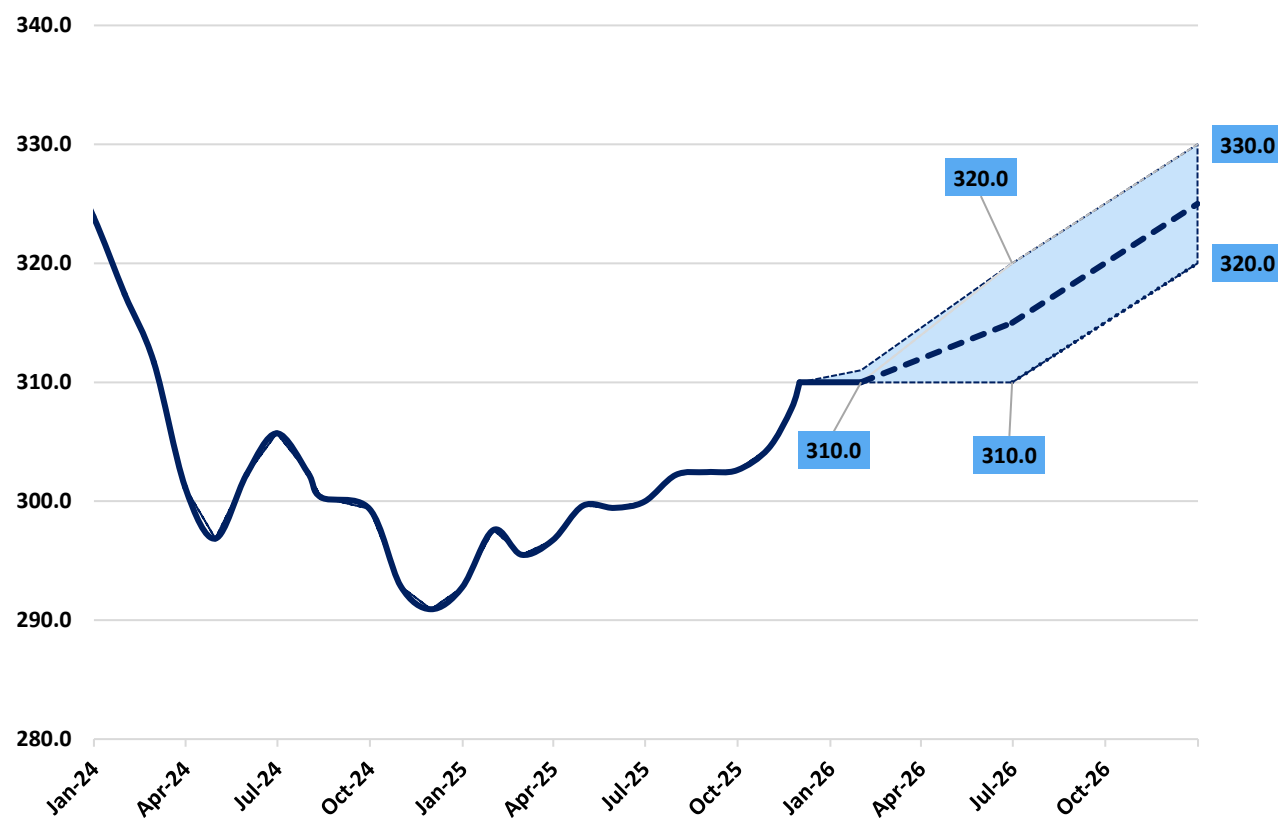


First Capital Research View on Exchange Rates 2026

Section 6.3



Exchange Rate outlook upgraded to LKR 310.0-320.0 for 1H2026 and LKR 320.0-330.0 for 2H2026



LKR may weaken as imports picks up

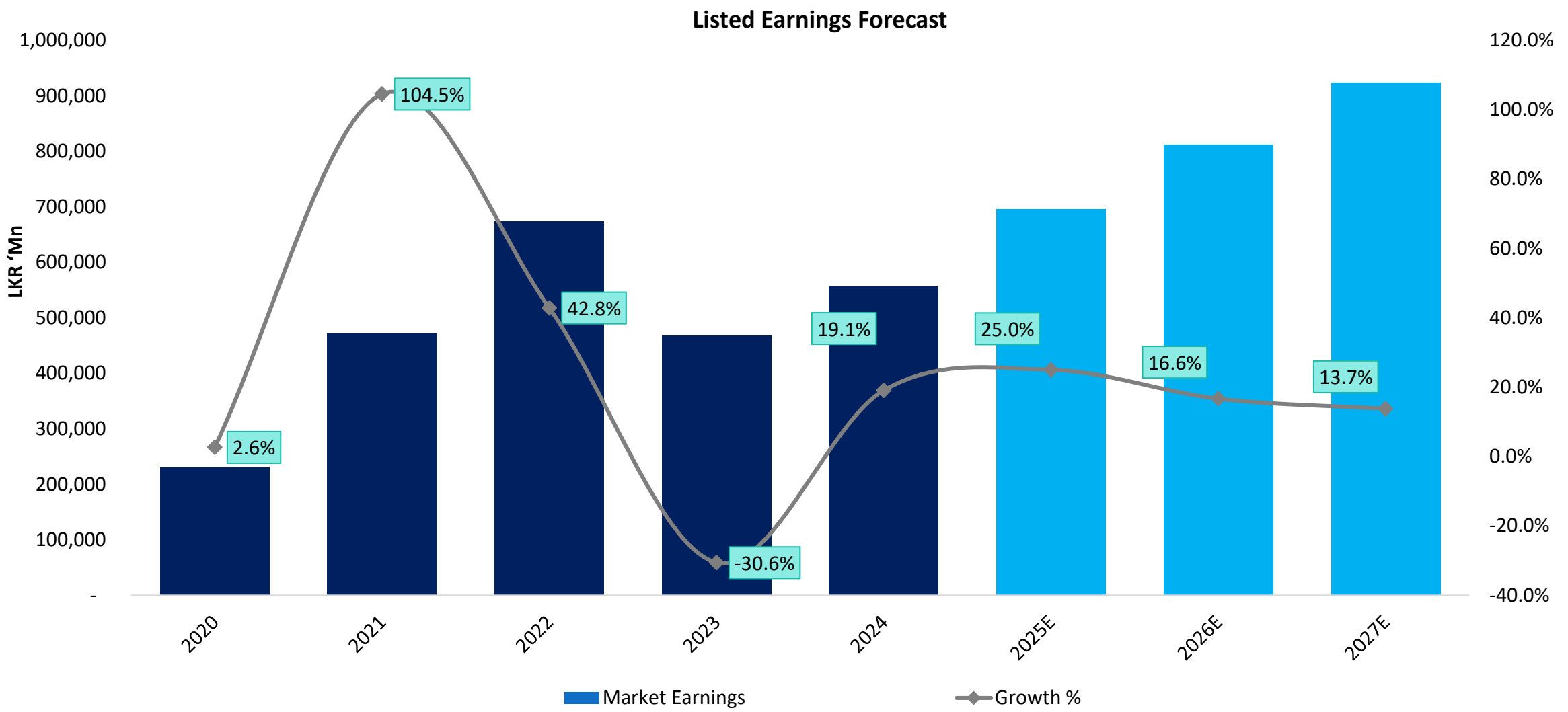
- ❑ **Import demand to spike:** Post Ditwah rebuilding efforts is expected to push up imports in the next 12 months. Moreover, slow growth in export earnings is also a concern, adding pressure to the currency.
- ❑ **LKR to reach 320-330 by Dec-26:** FCR upgrades expectations for Dec 2026. LKR is expected to depreciate by 5% during 2026, amidst widened trade deficit whilst USD purchases by the CBSL to build reserves is also expected to adversely affect the currency during the concerned period.

First Capital Research View on Equity Market 2026

Section 6.4

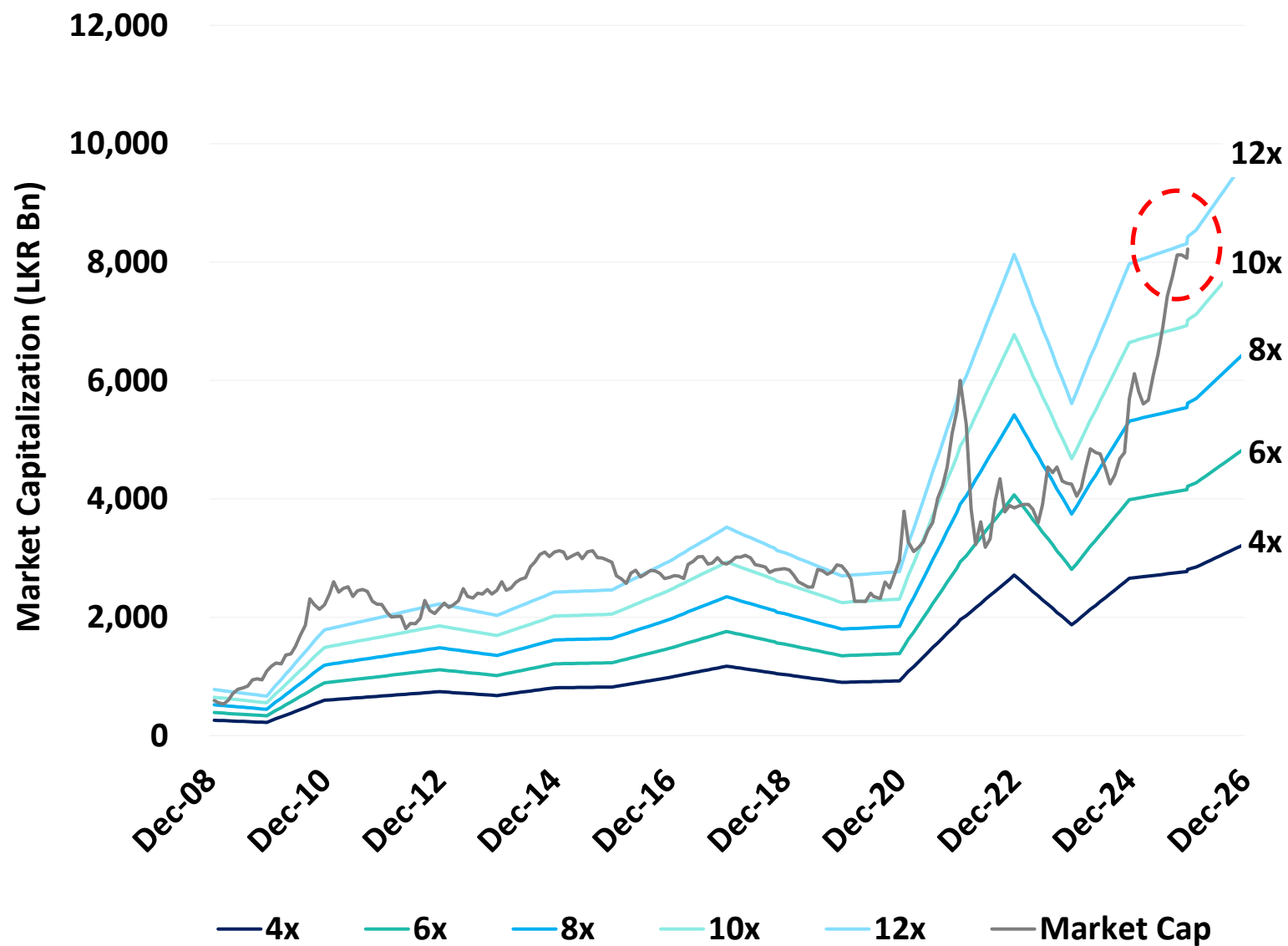


Corporate earnings growth for 2026E is maintained at 17% YoY, moderating from the stronger 25% YoY growth recorded in 2025E



Market continues to trade at a premium...

With the ASPI rising over 40.0% in 2025, the ASPI trades at a significant premium, in close proximity to its 18-year average PER of 12.0x...



...as FCR maintains the ASPI Dec-26 fair value range of 21,000-22,000

Market optimism remains ahead of underlying economic conditions

We maintain our fair value target range for the ASPI at 21,000–22,000, underpinned by a modest earnings growth outlook of 17% for FY2026E. Following volatility during Nov-Dec 2025, the index has rebounded to around 23,000 and is now trading above FCR's 2026E target range.

Given this valuation backdrop, we continue to recommend a more defensive stance, with equity exposure capped at 85% and cash holdings maintained at 15%. As the market transitions into a phase of moderated growth in early 2026E, gradual profit-taking is advised.

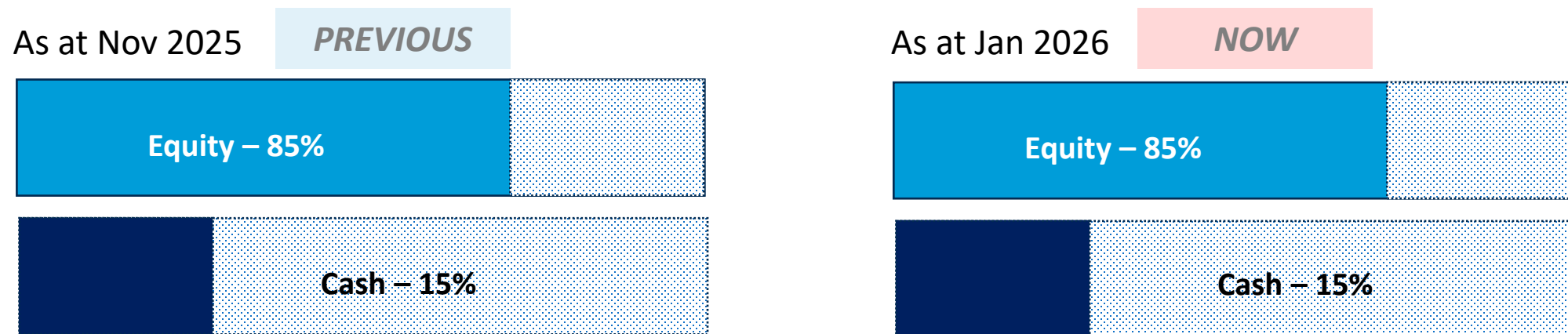
ASPI fair value range maintained at 21,000-22,000



Equity Portfolio Recommendation:

First Capital maintains Equity Exposure at 85% and cash at 15%

Recommendation for Funds allocated purely for Equity investments



19 Jan 26 – Approach to Equity Investments during 2026E:

Following the fluctuations observed during Nov-Dec 25, the ASPI has now recovered to the 23,000 level, and continues to trade above FCR’s 2026E target range of 21,000-22,000. In light of this, we maintain our recommendation to adopt a more defensive positioning, with equity exposure capped at 85% and cash allocations maintained at 15%. Gradual profit-taking is advised as the market moves into a period of moderated growth in early 2026E. However, it's crucial to note that all investments carry inherent risks, and we encourage regular reviews of portfolio in light of evolving market conditions and individual circumstances.

Disclaimer

This Review is prepared and issued by First Capital Holdings PLC based on information in the public domain, internally developed and other sources, believed to be correct. Although all reasonable care has been taken to ensure the contents of the review are accurate, First Capital Holdings PLC and/or its Directors, employees, are not responsible for the accuracy, usefulness, reliability of same. First Capital Holdings PLC may act as a Broker in the investments which are the subject of this document or related investments and may have acted on or used the information contained in this document, or the research or analysis on which it is based, before its publication. First Capital Holdings PLC and/or its principal, their respective Directors, or Employees may also have a position or be otherwise interested in the investments referred to in this document. This is not an offer to sell or buy the investments referred to in this document. This Review may contain data which are inaccurate and unreliable. You hereby waive irrevocably any rights or remedies in law or equity you have or may have against First Capital Holdings PLC with respect to the Review and agree to indemnify and hold First Capital Holdings PLC and/or its principal, their respective directors and employees harmless to the fullest extent allowed by law regarding all matters related to your use of this Review. No part of this document may be reproduced, distributed or published in whole or in part by any means to any other person for any purpose without prior permission.



 First Capital Holdings PLC
 No. 2, Deal Place, Colombo 3
 research@firstcapital.lk
 +94 112 651 651

Thank You

“Successful investments is about managing risks”

Dimantha Mathew
Chief Research & Strategy Officer
T: +94 11 2639 853
E: dimantha@firstcapital.lk

Charith Gamage
Vice President – Research
T: +94 11 2639 863
E: charith@firstcapital.lk

Ranjan Ranatunga
Assistant Vice President – Research
T: +94 11 2639 863
E: ranjan@firstcapital.lk

Shahana Kanagaratnam
Senior Assistant Manager – Research
T: +94 11 2639 866
E: shahana@firstcapital.lk

Akna Tennakoon
Senior Research Analyst
T: +94 11 2639 866
E: akna@firstcapital.lk

Dilhari Dias
Research Analyst
T: +94 11 2639 866
E: dilhari@firstcapital.lk

Imashi Sellapperuma
Research Analyst
T: +94 11 2639 866
E: imashi@firstcapital.lk

Manusha Kandanaarachchi
Research Associate
T: +94 11 2639 866
E: manusha@firstcapital.lk

Salaama Sanoon
Research Associate
T: +94 11 2639 866
E: salaama@firstcapital.lk