Positioning for the Rebound

Mid-Year Outlook | Jul 2026 | SRI LANKA

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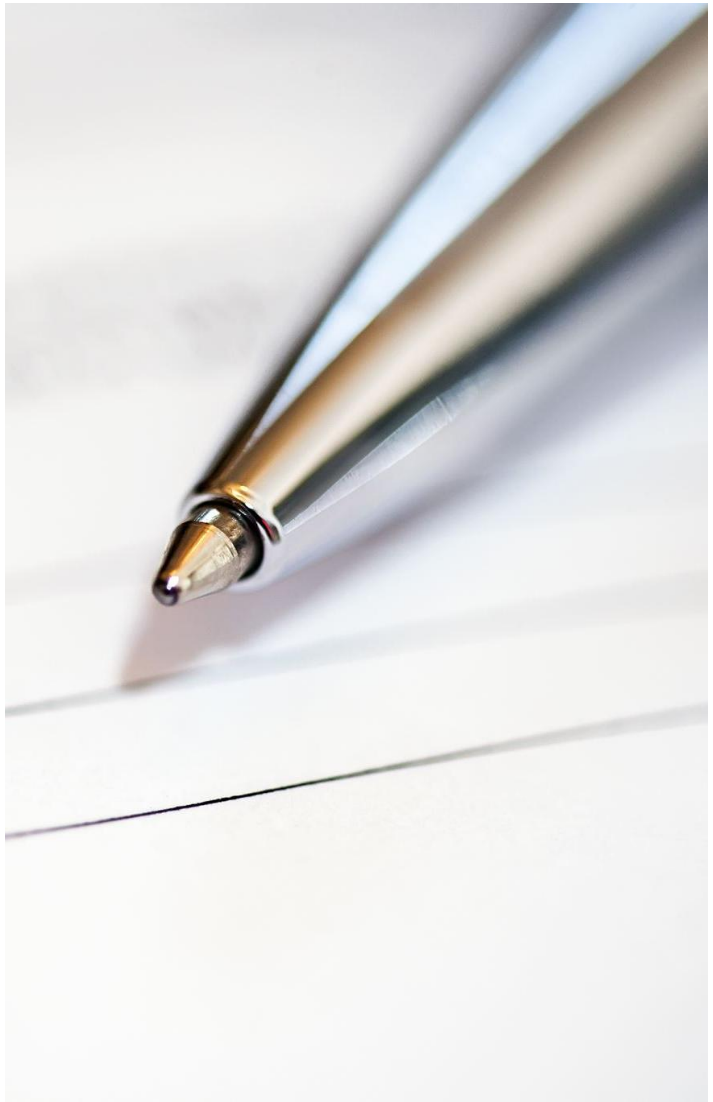
EXECUTIVE SUMMARY



Bond yields maintained for 2026E and introduce a 50bps premia to tail for 1H2027E on debt sustainability concerns, recommendation maintained to stay within short tenures

- CBSL overacted and pushed rates by 100bps with the aim to curtail a further rise in inflation, which FCR expects to average at 6% in 2026E. The excessive rate hike brings stability to inflation, yet costs through a moderation in economic growth, which is already showing signs of exhaustion. Moderation in economic growth, triggering a slowdown in credit disbursed to offer support to liquidity whilst creating space for a rate cut in 1H2027E. However, debt sustainability still expected to remain a question amidst limited progress in reforms, prompting FCR to add a 50bps premia to the tail end of the yield curve in 1H2027E.
- CBSL's May-26 tightening moderated yields, easing ME crisis-driven premia. 5Yr and 10Yr rates now sit within our bands, though short tenures remain elevated, anchored by auction outcomes. This creates a dual opportunity in short tenures over the next 12 months. We recommend staying short, running a carry strategy, preserving capital, and positioning for gains as short tenures converge toward our bands.

AWPR: 10.0%-11.0% Maintained for 2H2026E, Revised to 9.5%-10.5% for 1H2027E

- AWPR is tracking in line with expectations, currently around 10%, within our bands. Backed by the revised OPR and relatively tighter liquidity, we expect AWPR to hold between 10.0%-11.0% through 2H2026E. Looking ahead, a potential rate cut in 1H2027E, moderating GDP and credit growth, and liquidity stabilizing near LKR 100.0Bn should drive AWPR down by 50bps to 9.5%-10.0% in 1H2027E.

Exchange Rate outlook revised up to LKR 325.0 – LKR 335.0 for 2H2026E and LKR 335.0 – LKR 345.0 for 1H2027E

- A tighter OPR, which should constrain demand and imports, combined with relatively lower oil prices, is expected to bring the LKR back within our bands during 2H2026E. In 1H2027E, tighter credit should ease pressure on Sri Lanka's BOP, while CBSL USD purchases weigh on the Rupee, prompting a weakening to LKR 335.0-345.0 over the period.

ASPI Dec-26 base case fair value maintained at 20,500 for 2026E and introduces a 2027E FV of 24,500

- In line with expectations, the ME crisis pushed ASPI to our base case of 20,500 in 1H2026. Ceasefire uncertainty, elevated oil prices, moderating earnings, and a tighter OPR should keep ASPI sideways within 20,500-22,500 for the balance of 2026E.
- Momentum should turn bullish in 2027E on softer inflation, an earnings rebound, partial OPR relaxation, and improving liquidity and sentiment. FCR introduces a 2027E base case target of 24,500 and bull case of 26,500.
- Given near-term sideways momentum, we raise cash allocation to 50% from 35%, positioning to capitalize on entry points ahead of the 2027E rally.

Track Record [Aug 2025 & Jan 2026]

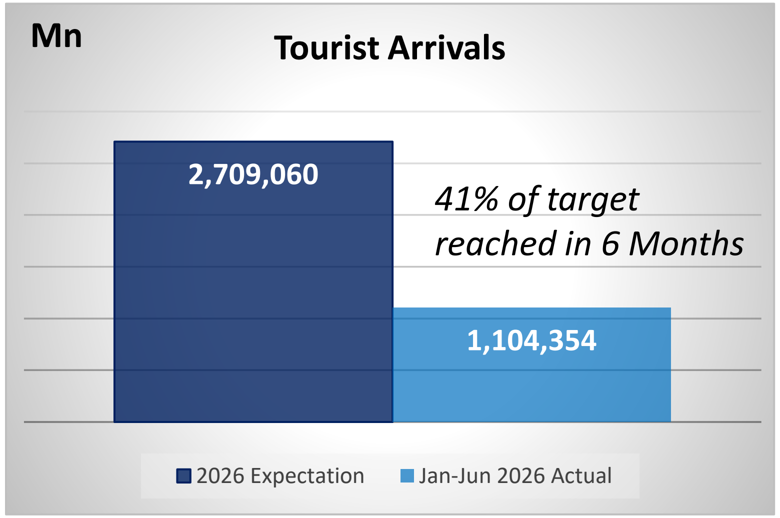
Section 1.0

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

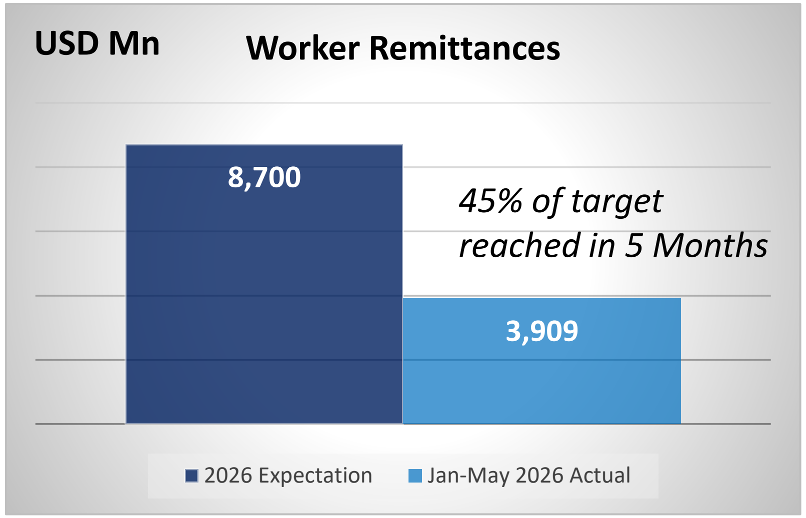
Previous Forecasts of Economic Indicators

Forecast: In line with expectations

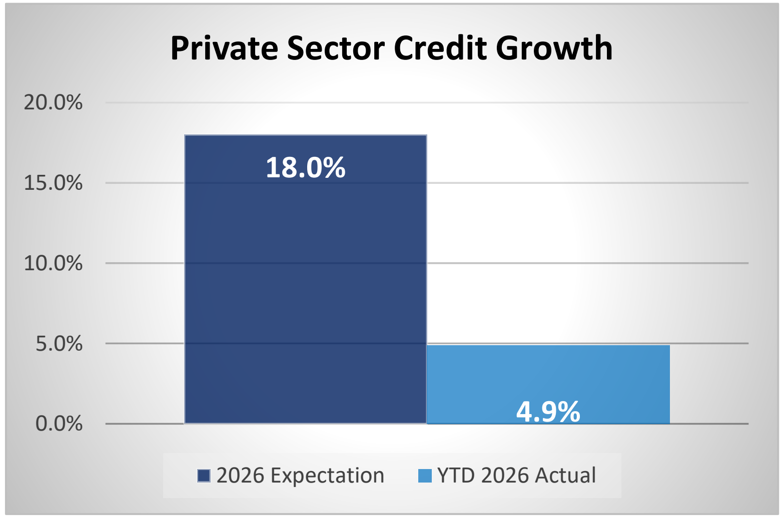


Forecast: Slow growth towards target

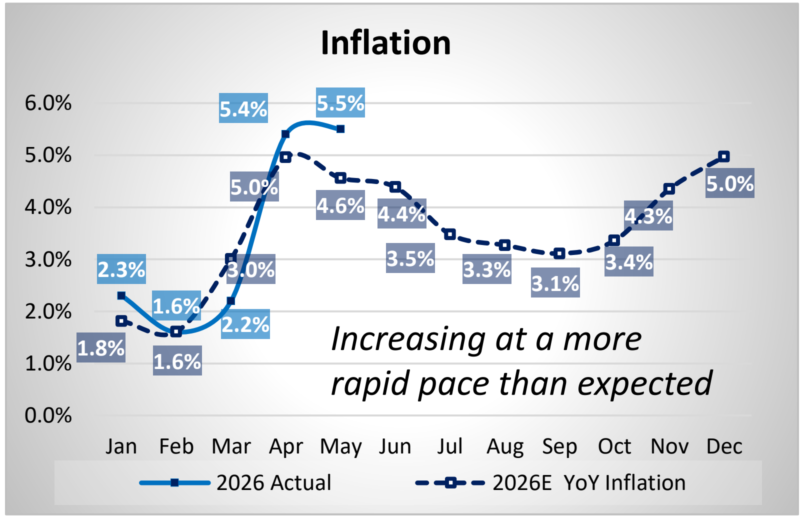
Forecast: Greater than expectations



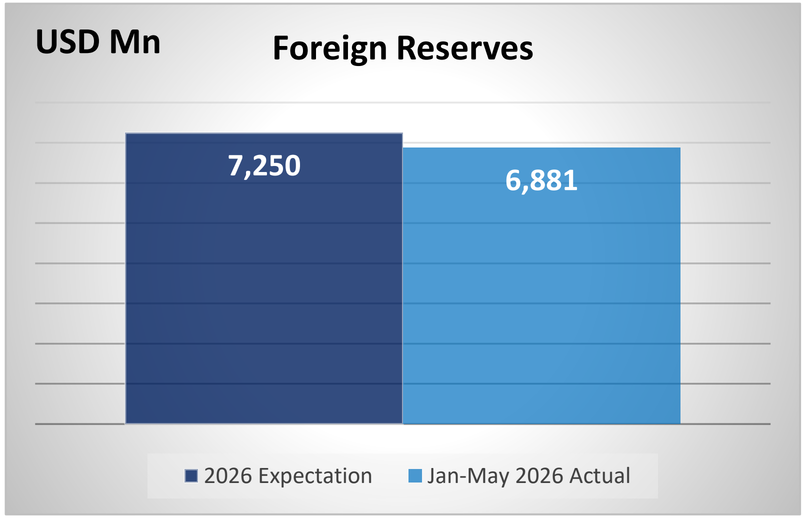
Forecast: Greater than expectations



Forecast: Greater than expectations



Forecast: In line with expectations



Source: CBSL, Dept. Census and Statistics, SLTDA, First Capital Research

Previous Recommendations - Bonds

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2025

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

The yield curve underwent a temporary decline on hopes of a rate cut, soon settled back to place as OPR was maintained at Jan & Mar policy meetings

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

1H2026

22nd Jan 2026 [Investment Strategy Report]

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

Accurate

Yields edged up, as ME crisis posed concerns on inflation and external buffers

06th April 2026 [FI Report]

"Yields may rise by 50-100bps during the next 12 months leading to Dec-26; Maintain a carry portfolio consisting of short tenors."

Partly Accurate

Yield curve shot up beyond our expectations, caused by greater than expected rate hike of 100 bps in May-26

Previous Recommendations - Bonds

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

22nd Jan 2026 [Investment Strategy Report]

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

Accurate

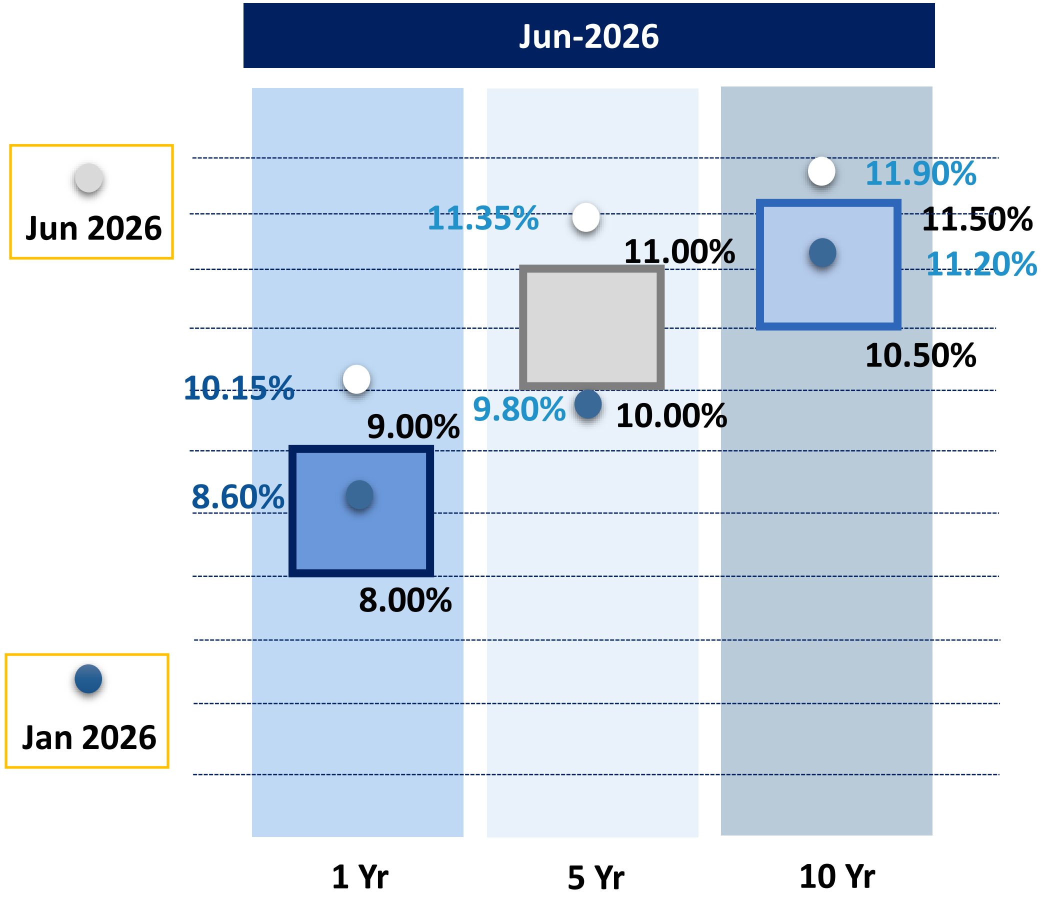
Yield curve edged up inline with our expectations

06th Apr 2026 [FI Report]

"Yields may rise by 50-100bps during the next 12 months leading to Dec-26; Maintain a carry portfolio consisting of short tenors"

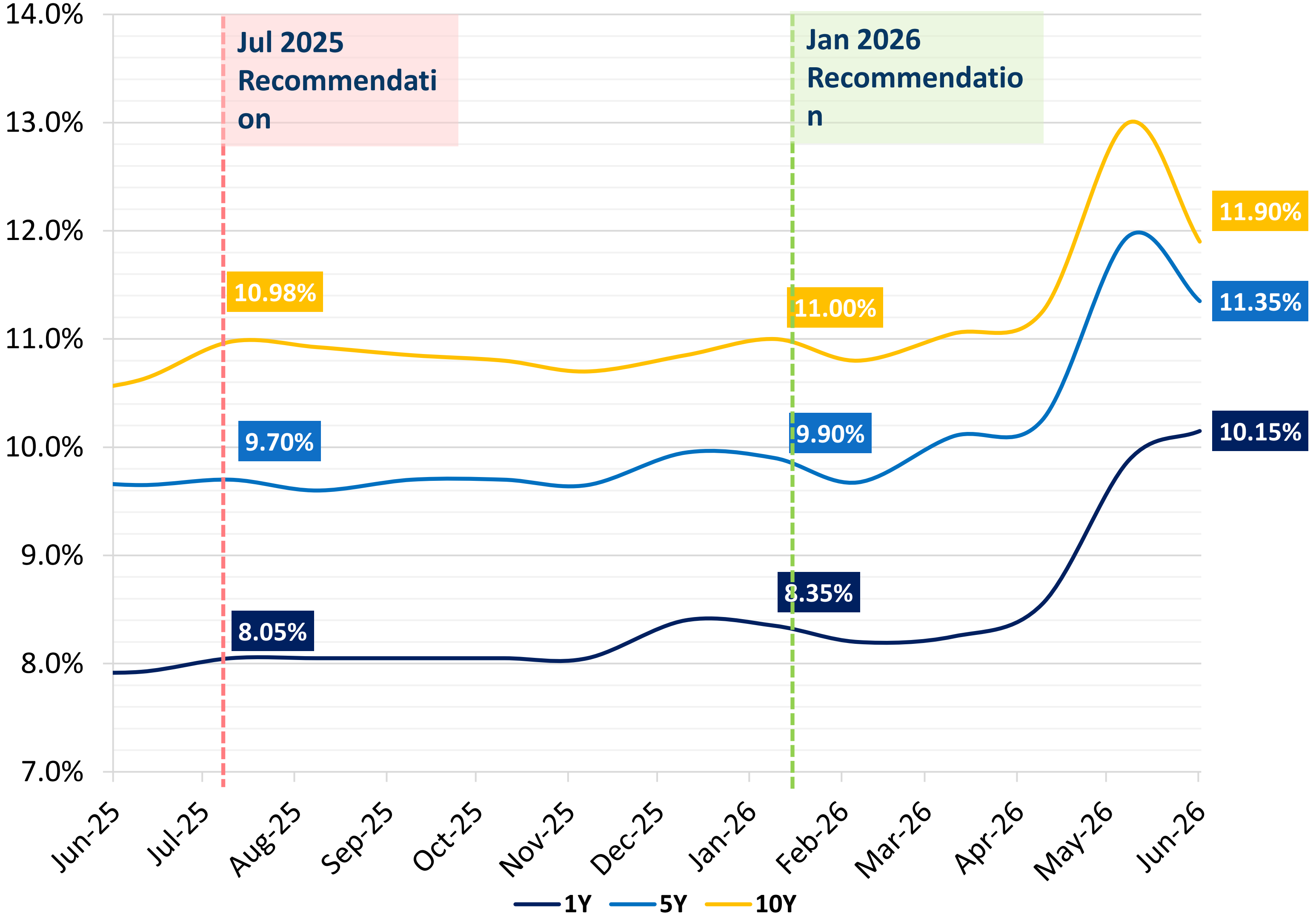
Mostly Accurate

100bps hike pushed yields above our bands



Bonds – Jul-25 & Jan-26 Recap: Mostly Accurate

Yields to rise 50-100bps over the next 12 months



1Y - YTD 30 bps

5Y - YTD 20 bps

10Y - YTD 2 bps

6 Months 2025

Jul – Jan-26

1Y - YTD 180 bps

5Y - YTD 145 bps

10Y - YTD 90 bps

6 Months 2026

Jan - Jun

Policy Rates – Jul-25 and Jan-26 Recap: Inaccurate

22nd Jan 2026 - No change in policy rates over the next 12 months

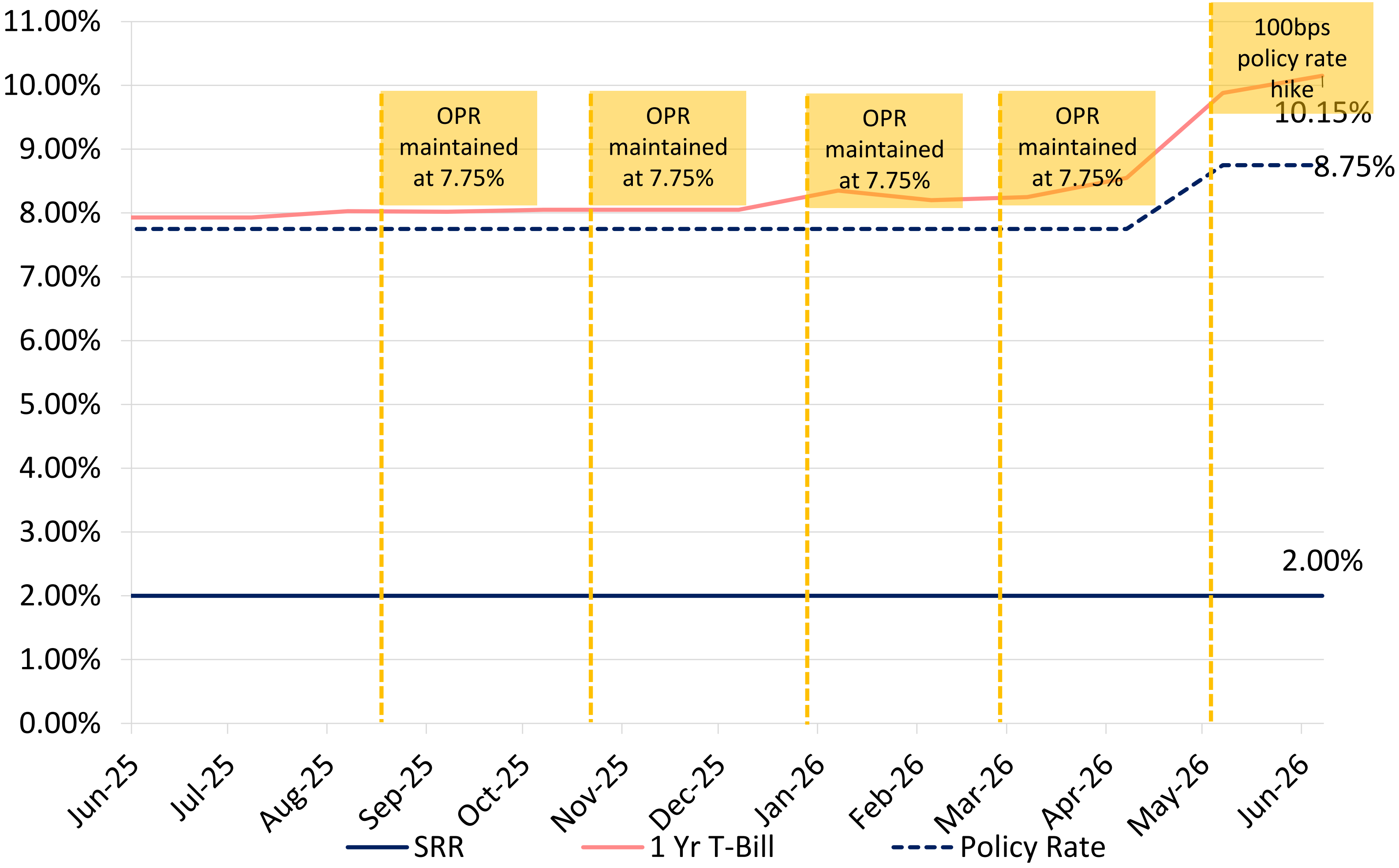
Review

Policy rates increased 100bps in 1H2026

The CBSL announced an increase of 100 bps in the Overnight Policy Rate (OPR) on 25-May-2026.

This decision was prompted by rising inflationary pressures, stronger underlying demand, and increasing external risks, with the objective of containing inflation expectations and preserving macroeconomic stability.

This subsequently resulted on yields edging upward across the board. Additionally, tighter liquidity conditions and ongoing geopolitical tensions in the Middle East reinforced the upward shift in the yield curve.

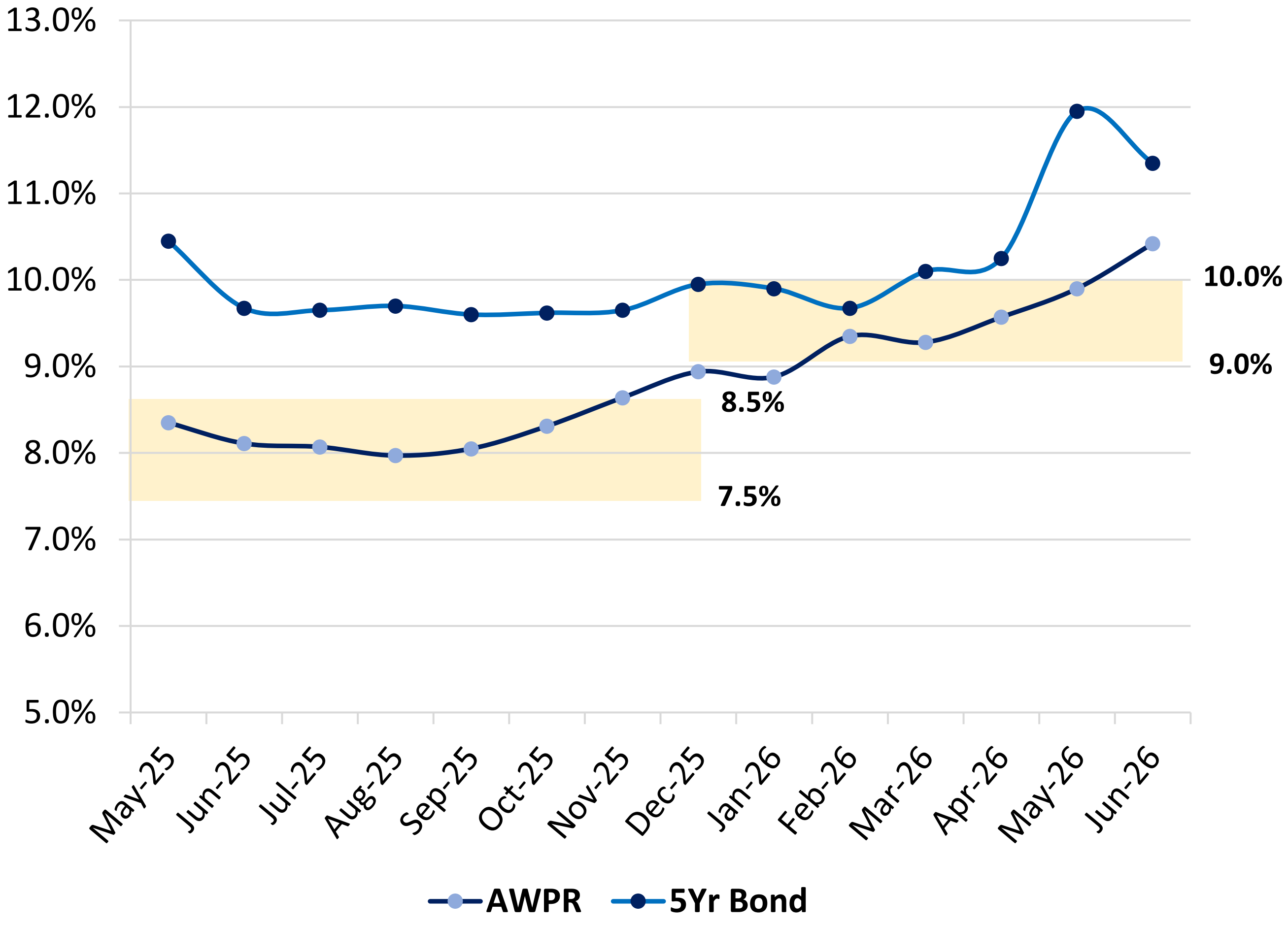


Source: CBSL, First Capital Research

Bank Rates – Jul-25 and Jan-26 Recap: Accurate

Jul-25 - AWPR to remain between 7.5%-8.5% for 2H2025

Jan-26 - AWPR to rise towards 10.0%-11.0% in 2026E



Review

AWPR broadly followed our expectation and hovered between 8.1% to 8.9% and gradually stabilized as private sector credit outperformed our expectations in 2025 driven by the expansion in the economy and demand for vehicle imports.

However, ongoing tensions in the Middle East and tighter liquidity conditions resulted in a gradual increase in the AWPR during 1H2026, moving towards our threshold of 10.0% during 1H2026.

Source: CBSL, First Capital Research

Exchange Rate – Jul-25 & Jan-26 Recap: Partly Accurate

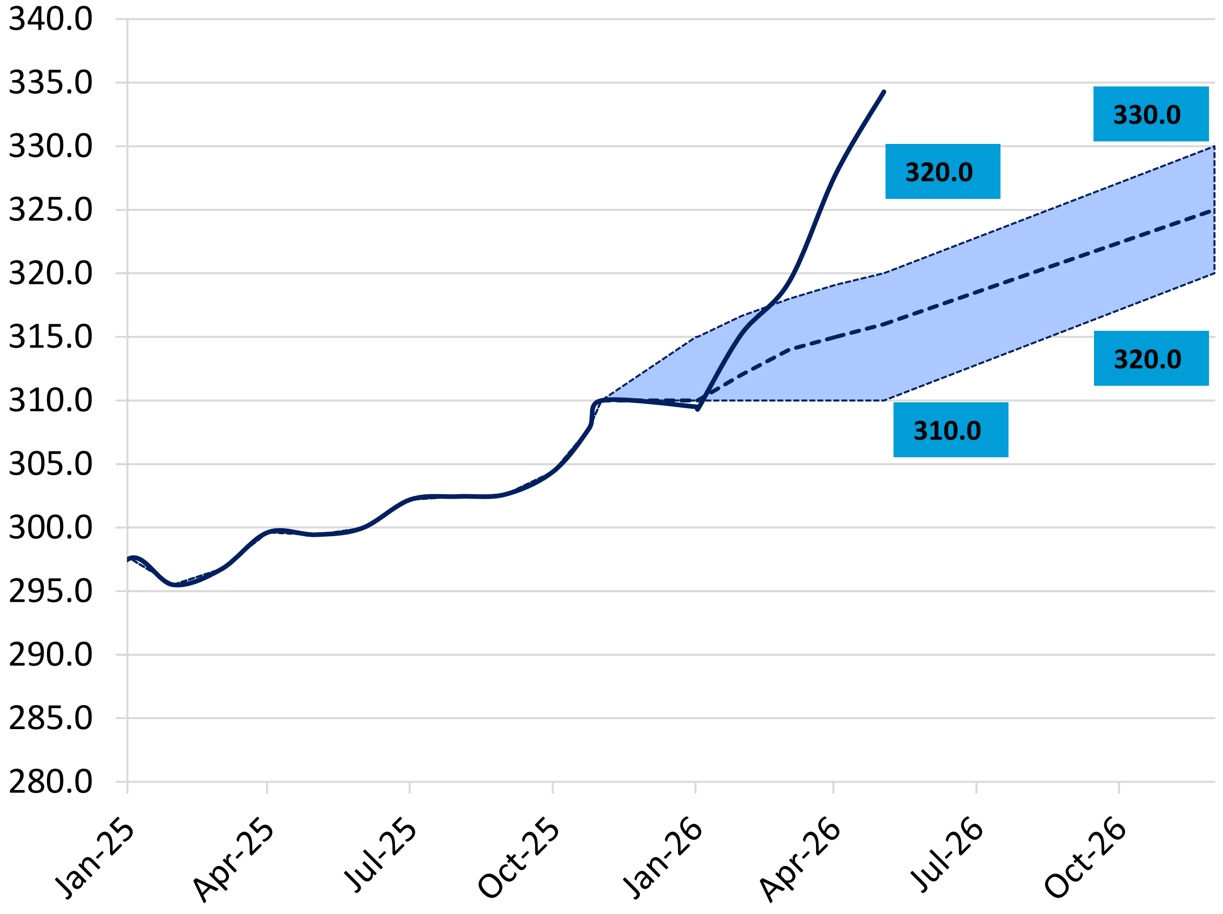
29th Jul-25- FCR extends its Jun 2025 target to Dec 2025 (300.0-310.0) while expecting some pressure to the LKR in 1H2026 with target of LKR 305.0-315.0

22nd Jan-26- Exchange Rate outlook upgraded to LKR 310.0-320.0 for 1H2026 and LKR 320.0-330.0 for 2H2026

Review

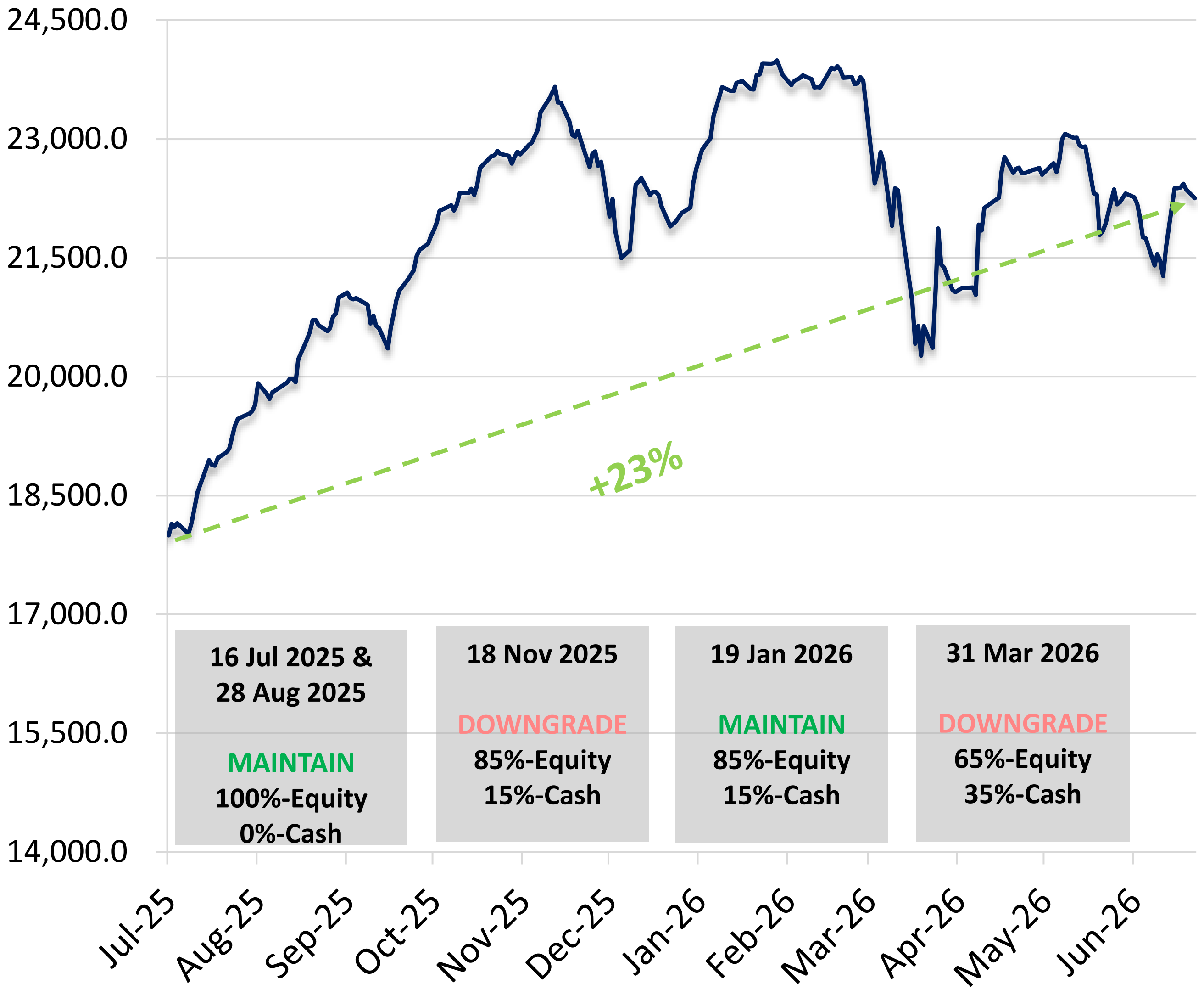
FCR expected LKR to depreciate to 305.0-310.0 during 2025. The LKR depreciated mainly due to higher demand for USD from rising imports and external debt repayments, alongside a flexible exchange rate regime, and closed at LKR 309.99 at end Dec-2025, exactly in-line with FCR's forecast.

During 1H2026, the LKR depreciated further, exceeding FCR's initial expectations, as higher global oil prices widened the import bill, increased demand for foreign exchange and exerted additional pressure on the balance of payments.



Equity – Jul-25 & Jan-26 Recap: Accurate

On 22nd Jan 2026 First Capital introduced its Dec 2026 ASPI fair value of 22,000.



Funds allocated Equity: Be 65% invested

Review

The ASPI was subjected to increased levels of volatility, with an overall increase of +23% during the period from Jul-25 to Jun-26.

Our cautious outlook for the broader market was reflected in the movement of the index as increased uncertainty due to the tensions in the Middle East, coupled with a slowdown economic growth resulted in reduced investor confidence.

Source: CSE, First Capital Research

Key elements of consideration

for Mid-Year Outlook 2026

Section 2.0

Positioning for the Rebound

Sri Lanka's recovery held firm in 1Q2026, with GDP growing 5.1%YoY on fiscal discipline and broad-based momentum. But the runway ahead is bumpier, we expect **growth to moderate to 3%-4% in 2026E-27E as elevated energy prices reopen Sri Lanka's old wound**: exposure to external shocks. CBSL's response, a sharper-than-expected 100bps hike in May-26, trades near-term growth for medium-term stability, as demand already shows signs of fatigue under higher taxes and tighter spending.

Reform momentum remains slow, with GoSL prioritizing fiscal buffers over structural change. That caution comes at a cost: with the ME crisis still weighing on our external accounts, the case for accelerating growth reforms has never been more urgent, especially with the 2027 debt repayment wall approaching.

Sri Lanka now stands at a crossroads. A harder 2H2026 will test resolve, but it sets the stage for a 2027E that rewards those who stay the course. The path ahead won't be smooth, and fixed income and equities won't move in lockstep, each will send its own signals, worth watching closely as the cycle turns. What matters most over the next 18 months isn't predicting the rebound, it's being positioned for it when it arrives. **2026 is for patience. 2027 is for conviction.**

Source: First Capital Research

Key Elements to consider for investments

POLITICAL

- Provincial elections to follow within the next 12 months
- Policy certainty
- Continuation of IMF program

ECONOMICAL

- GDP growth to soften further
- Primary surplus better than IMF expectations
- Liquidity to improve as money stuck in the systems slowly unlocks
- Private sector credit to further moderate
- Inflation to rise rapidly in 2026E, but to ease in 2027E

EXTERNAL

- Current account poses challenges in the near-term, conditions slowly ease in 2027E.
- Global uncertainties weigh down on external buffers.
- Currency to recover from rapid weakening in 1H2026

Source: First Capital Research

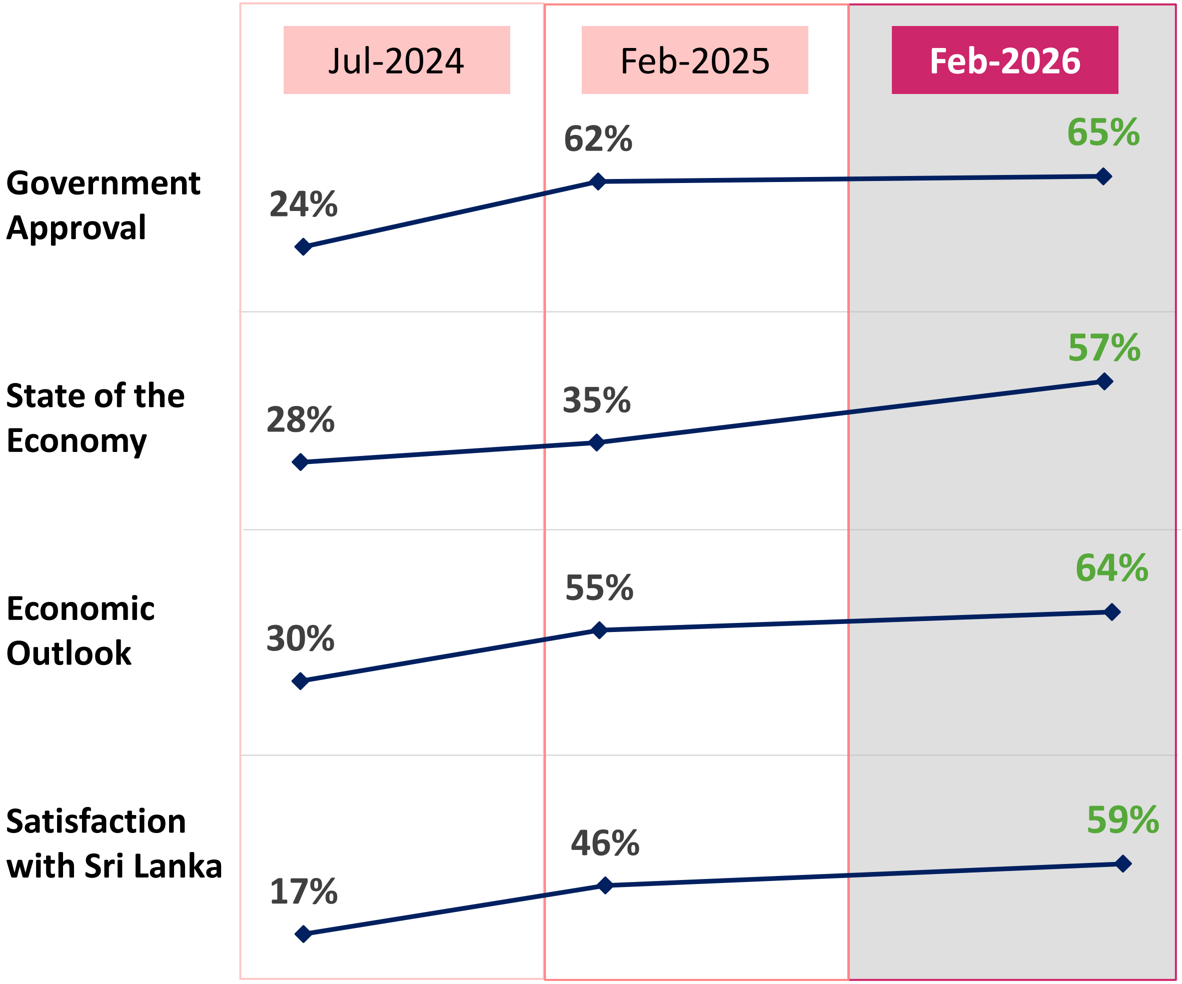
Popularity cools, majority-holding

*Maintain **Low Risk***

Section 3.0

Political stability maintained amidst external challenges...

Based on the *"Mood of the Nation" poll by Verité Research*, public confidence remains strong, with government approval at 65% and improving perceptions of the economy.



RECAP

Current Situation

- NPP continues to enjoy a strong political mandate following victories at the Presidential, Parliamentary and Local Government elections.
- Political stability has supported policy continuity and the implementation of key economic reforms.

Provincial Council Elections

- The Provincial Council election date is yet to be announced. Current opinion polls indicate that the NPP remains the preferred political party.
- The election will serve as the next key test of the government's public mandate.

Outlook:

While the Middle East conflict may have softened public sentiment at the margin, the NPP is still expected to retain majority support.

...difficult decisions ahead to transform stability to growth

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Political Landscape: Stability secured, execution remains the key challenge

- **Stability continues to persist two years into power.** Since coming into power in Aug-24, the current NPP led government continues to ensure stability, moving forward together with the IMF and continuing the stability-oriented reforms including the continued implementation of cost reflective pricing and providing independence to CBSL and initiation of debt office inline with the IMF mandate.
- **Debt related engagement continues, yet bilateral talks to grow the economy remains limited.** Government continues to make strides in finalizing debt restructuring agreements during 1H2026. However, limited progress is made in bilateral negotiations including free-trade agreements and FDIs, which we believe is necessary to unlock sustainable growth in the economy.
- **Growth related reforms continues to remain slow as 2028 debt repayments concerns lingers.** Despite the stability achieved, progress on growth-oriented reforms continues to be slow. Sri Lanka should focus on implementing reforms pertaining to trade, land, entrepreneur, SOE and investments soon as 2028 debt burden lingers in the horizon, which we believe poses a different challenge given the limited reserves buffer, which presently covers just 3 months of imports.
- **Low Risk maintained.** Given the popularity of the current government and the continuity of the IMF agreement, we continue to rate the political landscape at Low Risk.

Political Outlook: Maintained at *Low Risk*

Source: First Capital Research

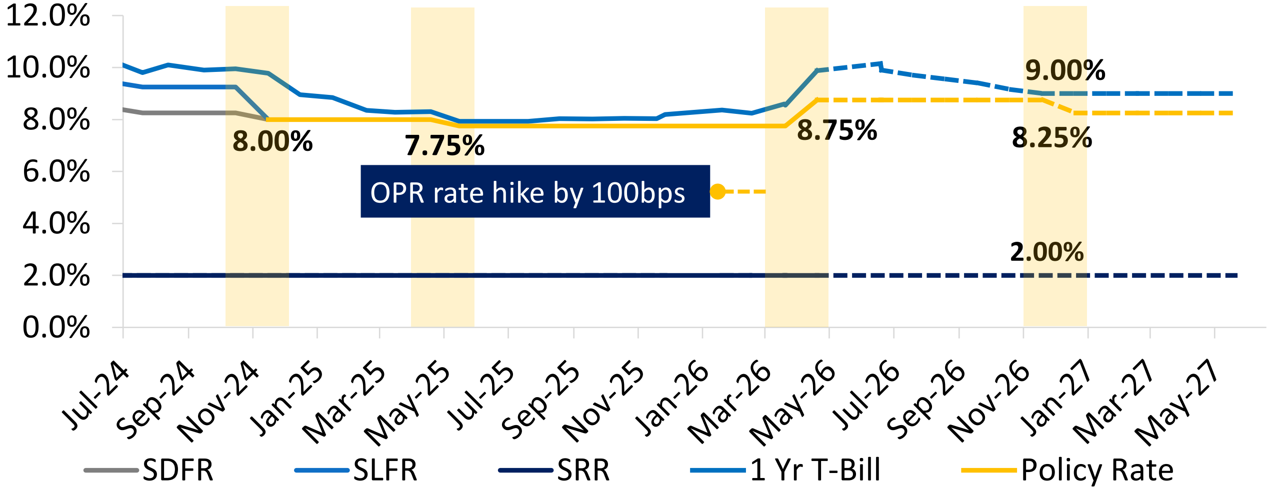
Slow growth amidst external shocks

Maintain Medium-Low Risk

Section 4.0

In a surprise move, CBSL moves to hike OPR beyond our expectations...

At the 3rd monetary policy meeting held on 25th May 2026, the CBSL decided to increase the OPR by 100bps to 8.75%...



...however, FCR expected a 60% probability that the Central Bank would maintain its current policy rates at the third monetary policy meeting.

Expected Monetary Policy Stance	Probability
Raising Policy Rates by 50bps	0%
Raising Policy Rates by 25bps	40%
Policy Rates to remain unchanged	**60%**
Cutting Policy Rates by 25bps	0%
Cutting Policy Rates by 50bps	0%

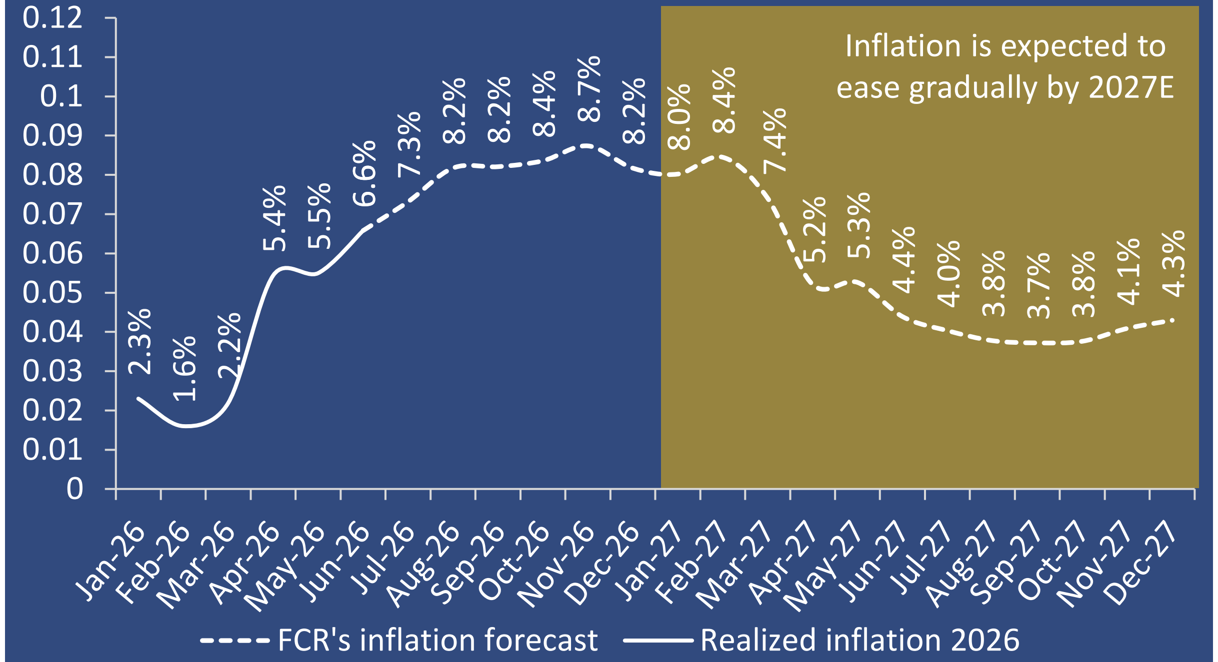
CBSL viewed that a tighter monetary policy stance was appropriate due to:

- Elevated inflation expectations.
- Potential second-round effects from energy price adjustments.
- Continued expansion in private sector credit amidst record liquidity, fueling import demand.
- Persistent pressures on the external sector.

Source: CBSL, First Capital Research

…acting proactively to tame down the raging inflation…

FCR expects average annual inflation to remain at 6.1% in 2026E

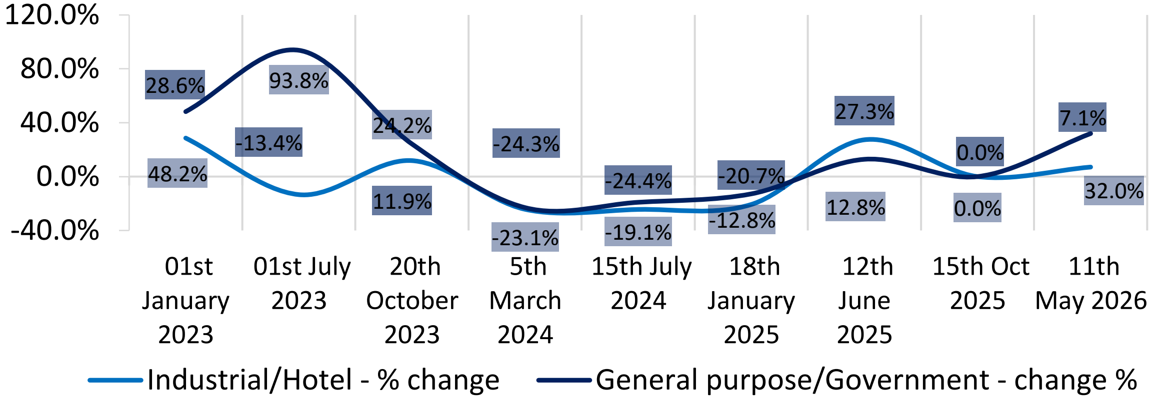


We expect headline inflation to peak at 8.7% in Nov-26E, with average inflation of around 6.0% in 2026E before easing further to 5.2% in 2027E.

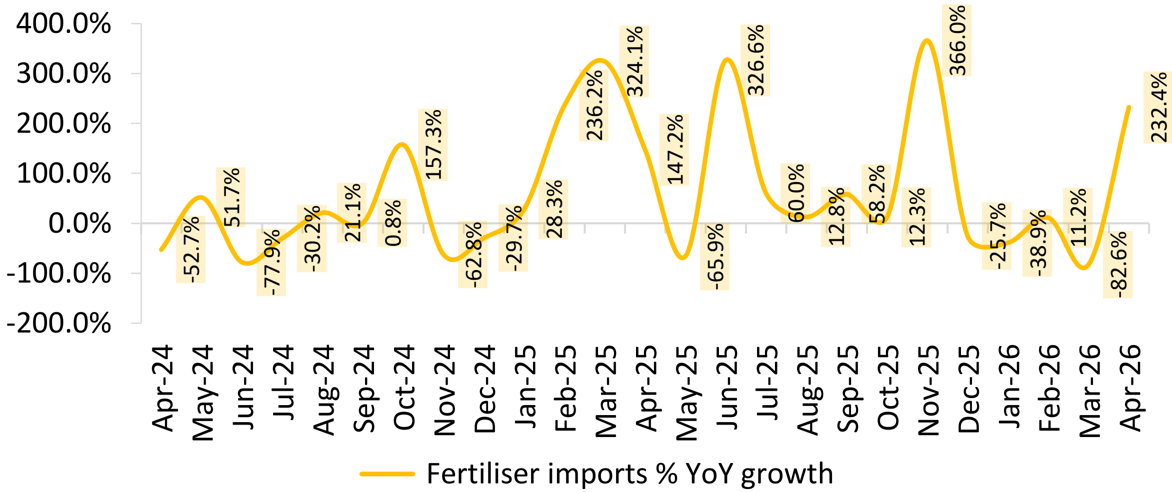
Inflation drivers for 2026E

- Elevated fuel prices
- Second-round LKR depreciation pass-through effects on input costs and higher fertilizer prices
- Anticipated cost reflective electricity tariff hike
- Potential supply-side disruptions associated with El Niño-related weather conditions

FCR's indicative tariffs example for 400/230V customers below 42 kVA show increases of c.32.0% for General Purpose/Government and c.7.1% for Industrial/Hotel after 11th May-26 revision, adding inflationary pressure.



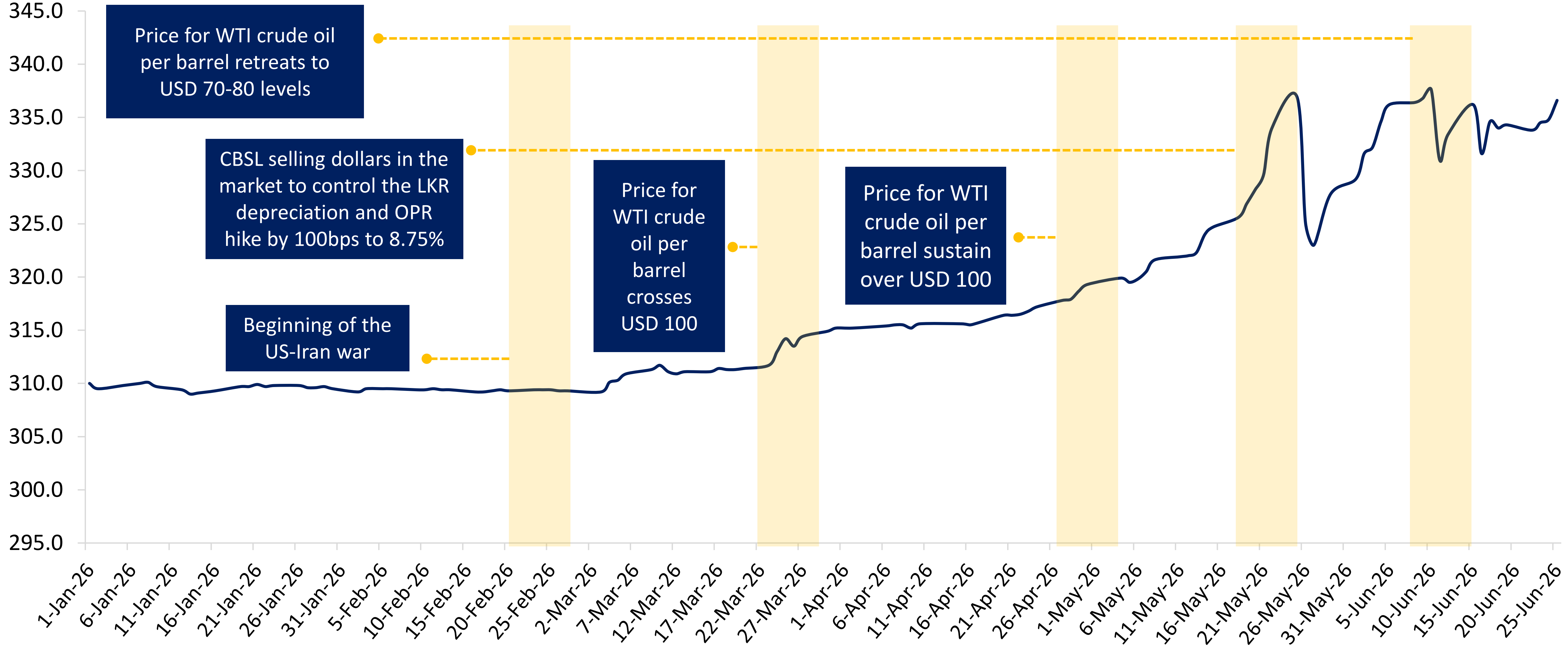
Higher global urea prices and LKR depreciation are raising fertilizer import costs, likely feeding into higher inflation.



Source: CBSL, PUSL, First Capital Research

...and slowdown the rapid depreciation of the Rupee

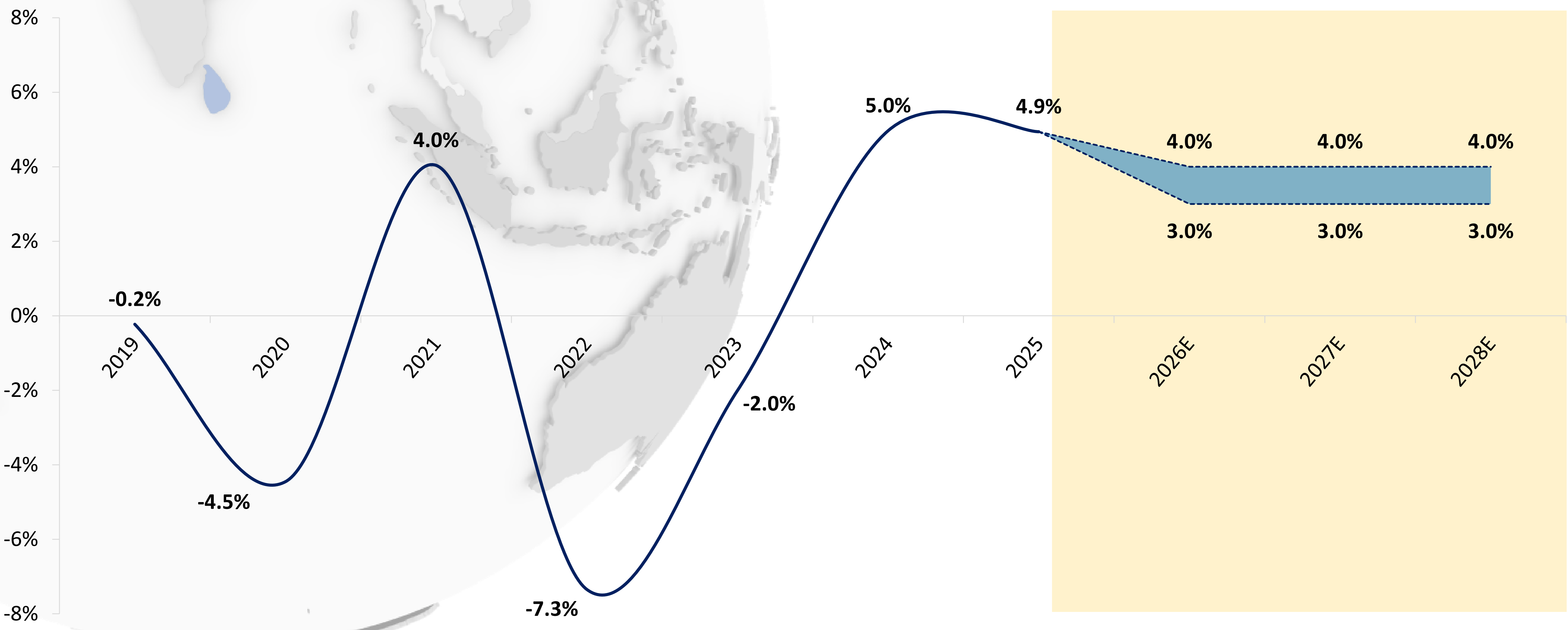
Following the war outbreak, the LKR depreciated by 8.9% against the USD up to 25th May 2026, before recovering 4.1% and stabilizing at LKR 330–336/USD, supported by CBSL's OPR hike, dollar sales, and tighter vehicle import financing by reducing LTV ratios and surcharges.



Source: CBSL, First Capital Research

However, the move is expected to further stall post Ditwah economic growth…

FCR expects GDP growth to remain within the 3.0%–4.0% range in both 2026E and 2027E, amid softer consumer spending, constrained government expenditure, and a weaker global environment marked persistent geopolitical tensions.



Source: CBSL, DCS, First Capital Research

...as consumption growth taking multiple blows

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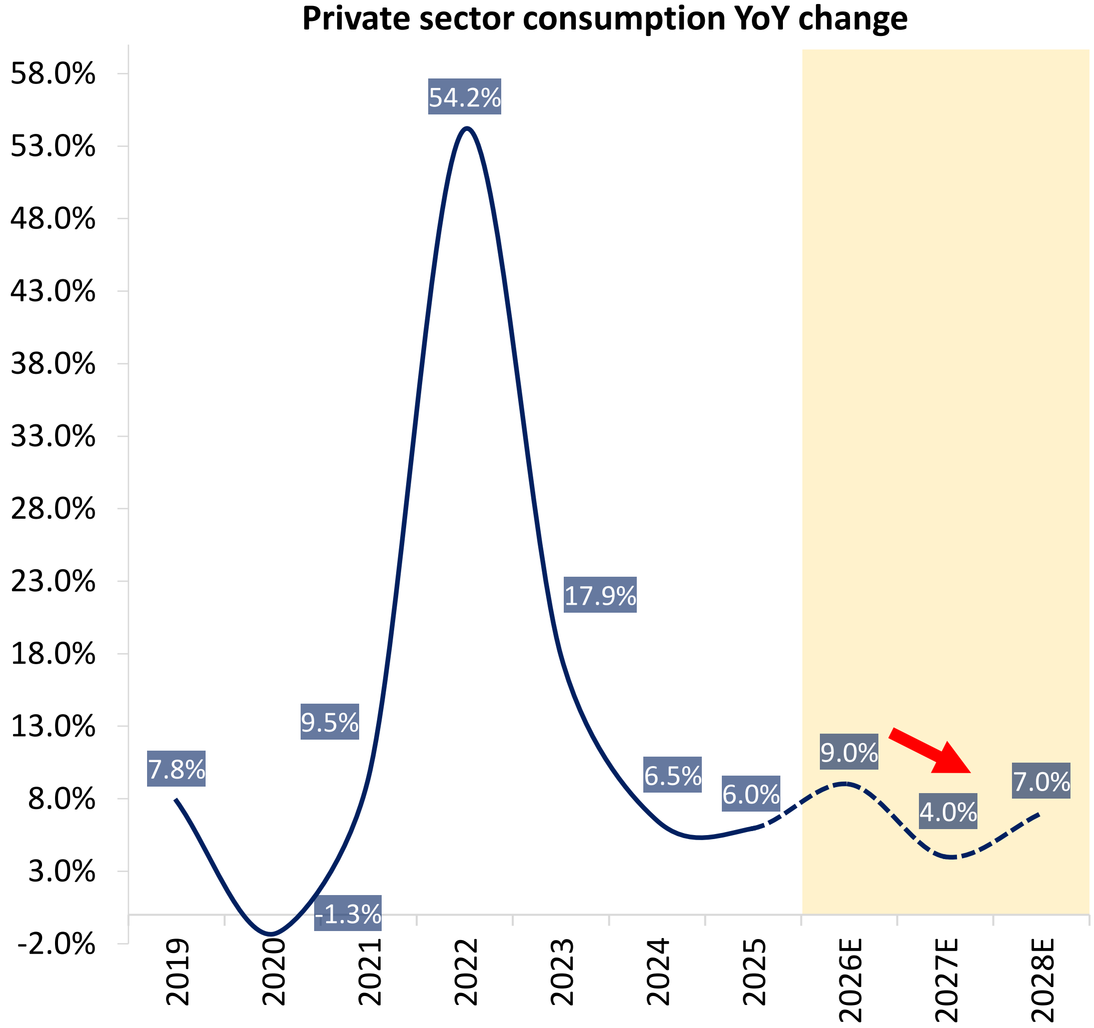


Consumer spending is expected to remain subdued amid rising inflation, elevated borrowing costs, weak real wage growth, and fiscal measures that continue to weigh on household disposable income.

Inflation re-acceleration: Higher electricity tariffs, fuel prices, and fading base effects are expected to push inflation higher in 2026, eroding household purchasing power.

Higher borrowing costs: Elevated interest rates and tighter bank lending standards are likely to keep consumer credit expensive and less accessible.

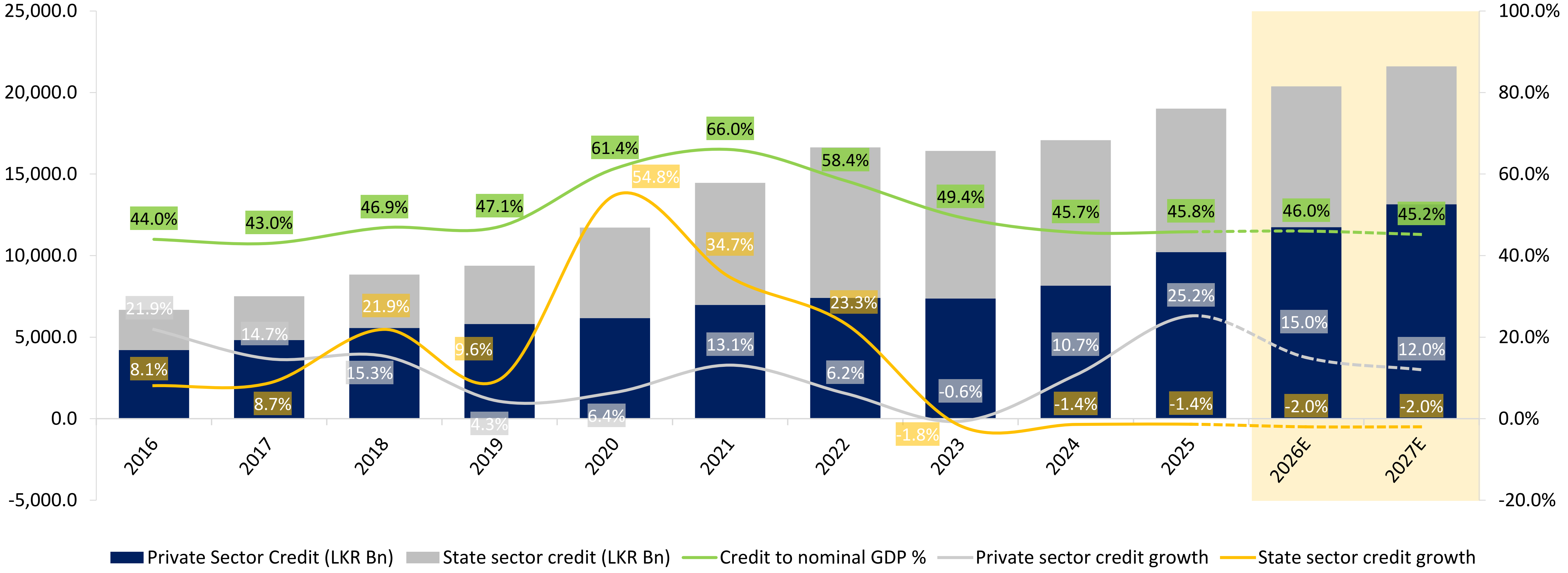
Weak real wage growth: Wage increases are expected to lag inflation, reflecting fiscal constraints and subdued private sector profitability.

Fiscal drag: Higher VAT and broader income tax measures are expected to reduce disposable income and weigh on household consumption.

Source: CBSL, DCS, First Capital Research

Total credit expected to slow further, prompting FCR to revise down 2026E forecast to 15%YoY…

Private sector credit growth is expected to moderate, weighed down by a combination of softening GDP momentum, the gradual unwinding of pent-up vehicle import demand, elevated borrowing costs from higher interest rates, and persistent inflation eroding real household purchasing power. These dynamics are likely to suppress credit appetite across both the corporate and retail segments. Reflecting this subdued outlook, we revise our private sector credit growth forecast down to 15.0% from 18.0% for 2026E, with total credit to GDP expected to remain anchored below the 50% threshold in the near-term.



Source: CBSL, First Capital Research

...with private sector credit demand moderating further, and state credit continuing to contract...

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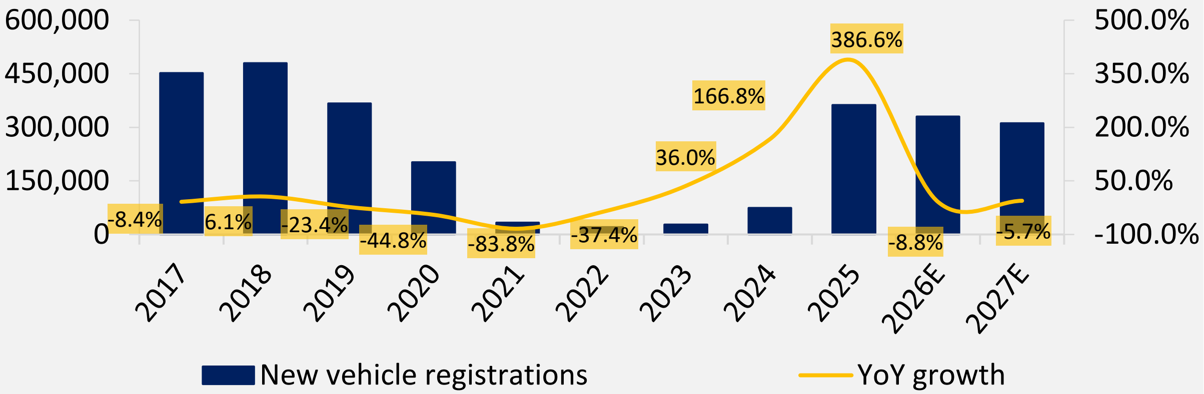
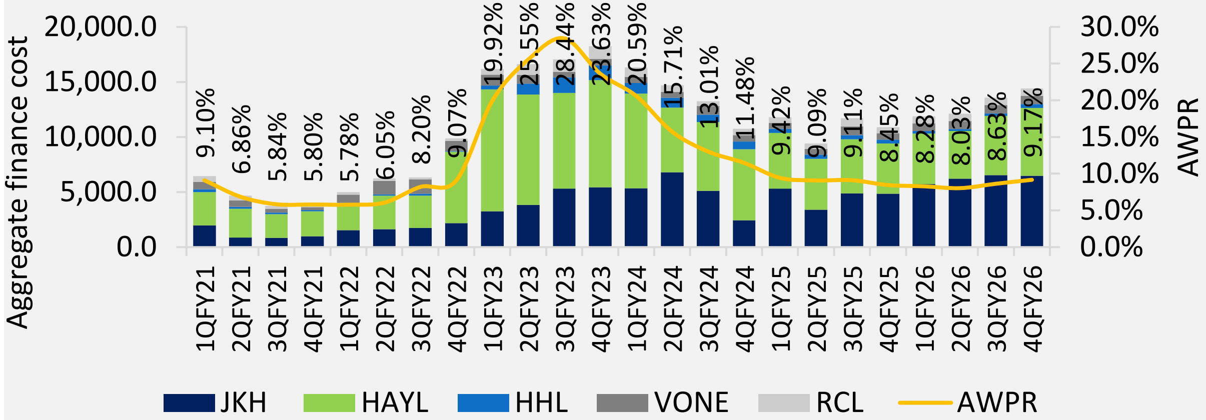
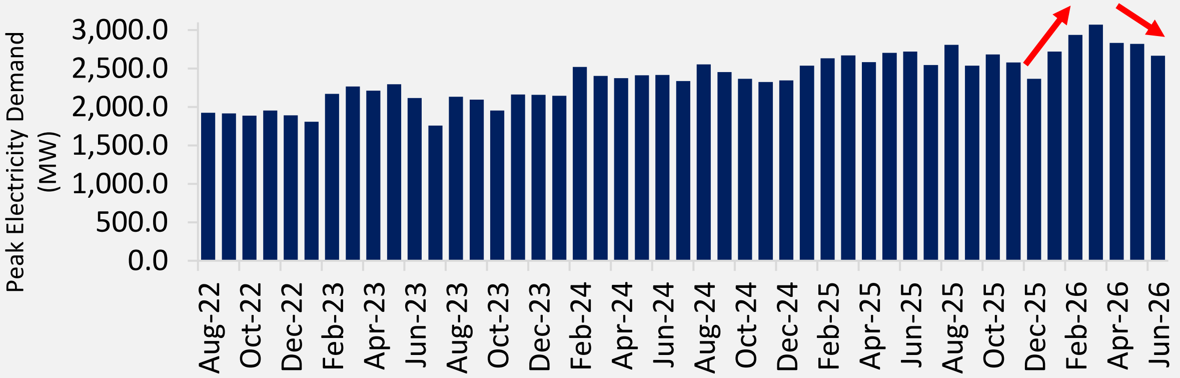
FCR forecasts an 8.8% decline in vehicle registrations, driven by expectations of slower credit demand due to lower LTVs, surcharges and LKR depreciation.



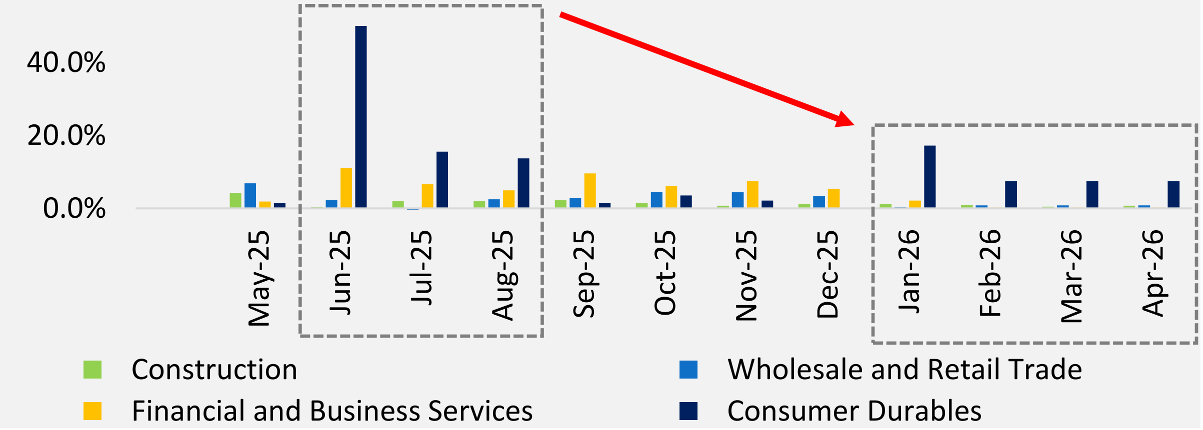
Borrowing activities of corporates may reduce as interest rates rises due to higher cost of funding.



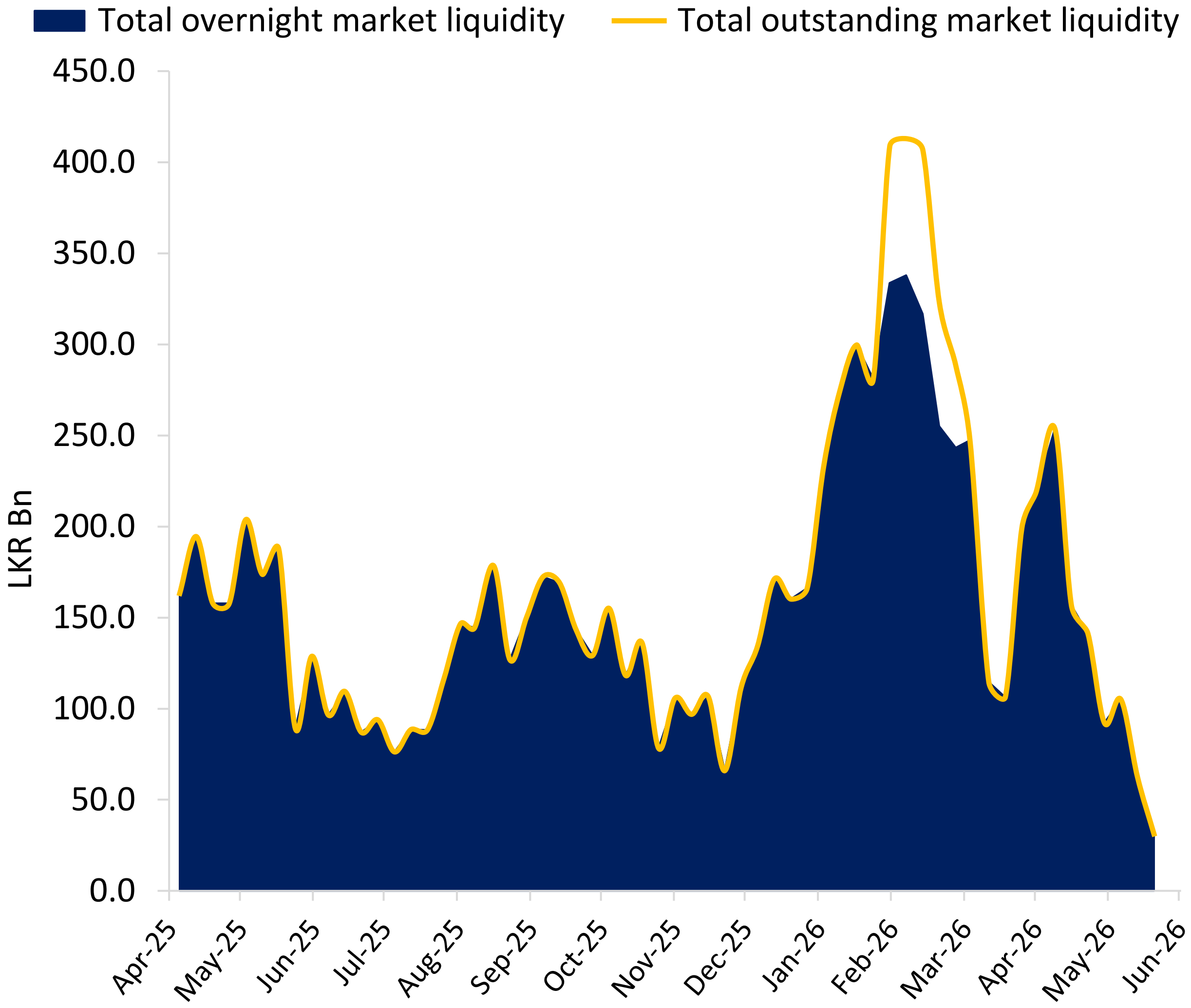
Electricity demand is a leading indicator of consumer activity, with weaker demand signaling slower loan growth.



MoM growth seen in specific key loan categories, have shown a decline in recent months indicating credit slow down has started.



…whilst liquidity expected to improve gradually back to above LKR 100Bn



System liquidity averaged approximately LKR 170.0Bn during Apr-May 2026, down from the excess liquidity of over LKR 300.0Bn recorded earlier in the year. Liquidity conditions have continued to tighten in recent weeks, with liquidity falling below LKR 50.0Bn. This decline was primarily driven by the CBSL's sustained USD sales to the market over the past three months, alongside continued expansion in private sector credit and inventory piling by importers ahead of the Rupee weakening.

Looking ahead, FCR expects liquidity conditions to gradually recover and remain above LKR 100.0Bn. The anticipated improvement is expected to be driven by slower credit growth amid rising borrowing costs, slow unwinding on piled up inventories unlocking stuck liquidity and moderating economic activity.

Source: CBSL, First Capital Research

Summary of Overall Economic Outlook

Positives

- Continuation of the IMF EFF Program
- Sizeable growth in Remittances
- Stability in Foreign Reserves
- Recovery in Tourism
- Proactive CBSL and inflation moderating towards target
- Primary Surplus

Negatives

- Lower capital spending limiting GDP growth
- High level of CBSL Holdings
- Relatively higher debt maturities
- Limited buffers with 3x import cover
- Difficulty in raising foreign debt
- Widening trade deficit
- Slow growth in reserves
- Relatively lower liquidity availability

Economic Outlook: Maintain *Medium-Low Risk*

Source: First Capital Research

Revenue strong, consolidation holds

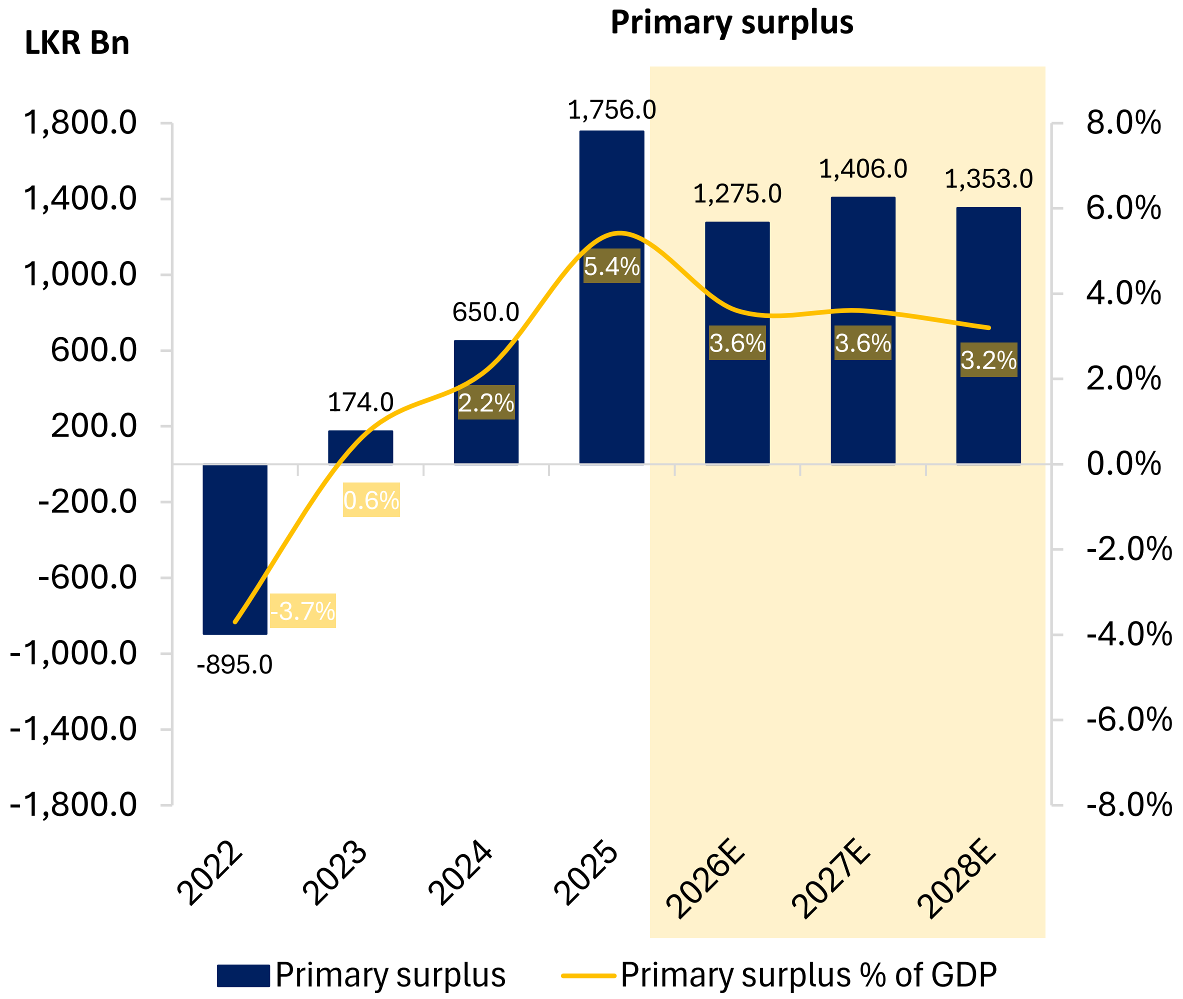
Maintain Medium-Low Risk

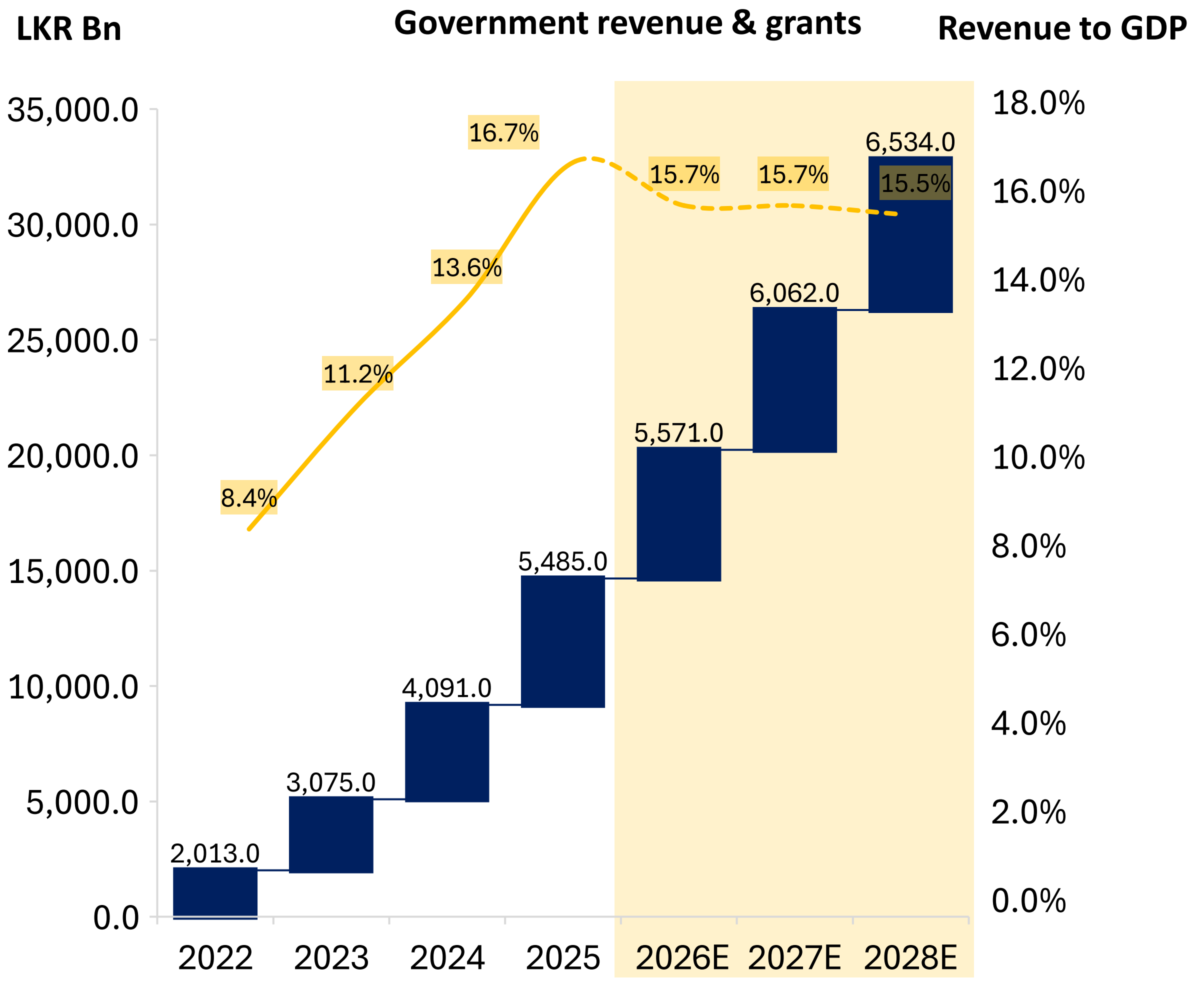
Section 5.0

Primary surplus continues benefited by stable revenues...

Primary surplus is expected to continue at a measured pace, supported by the increase in government revenues and lower capex.

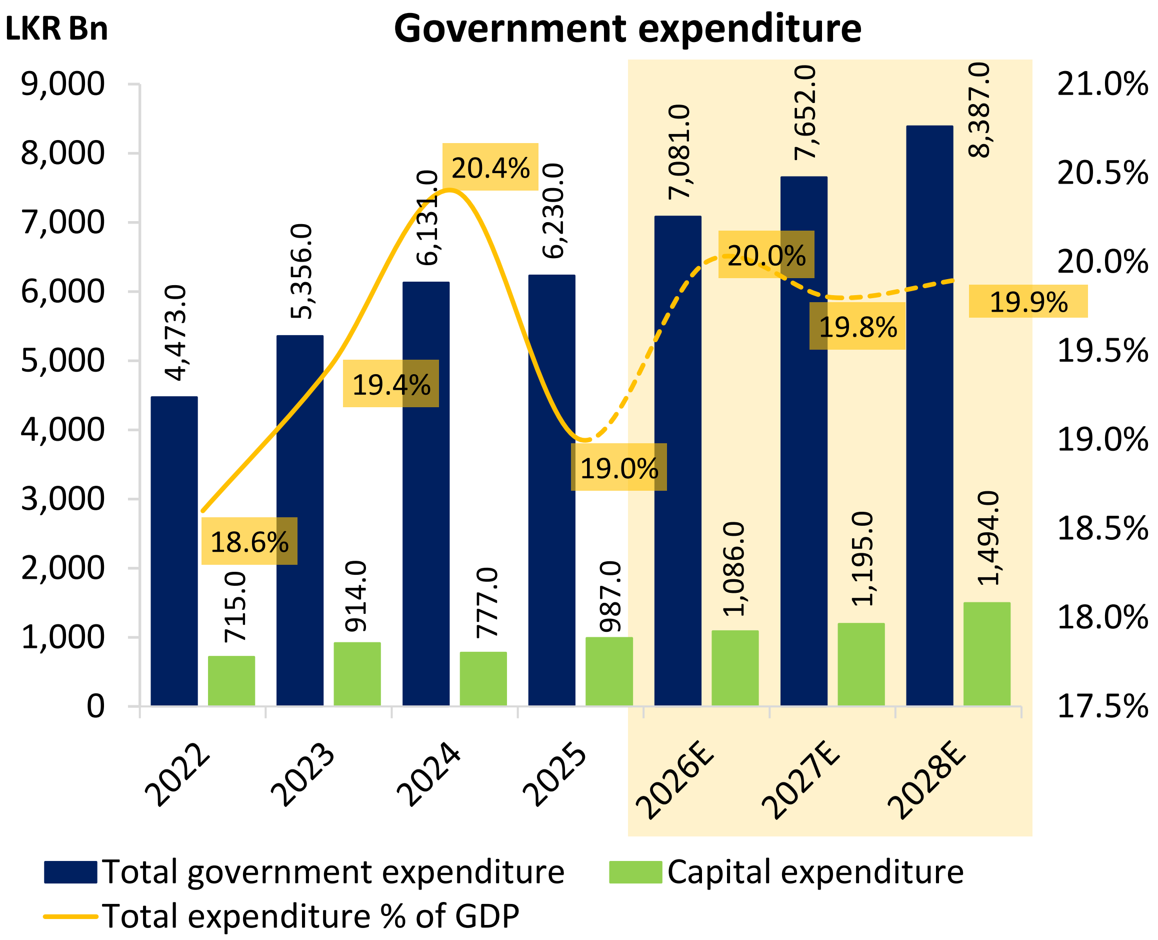
Fiscal revenue is projected to grow YoY, primarily owing to higher revenue from taxes.

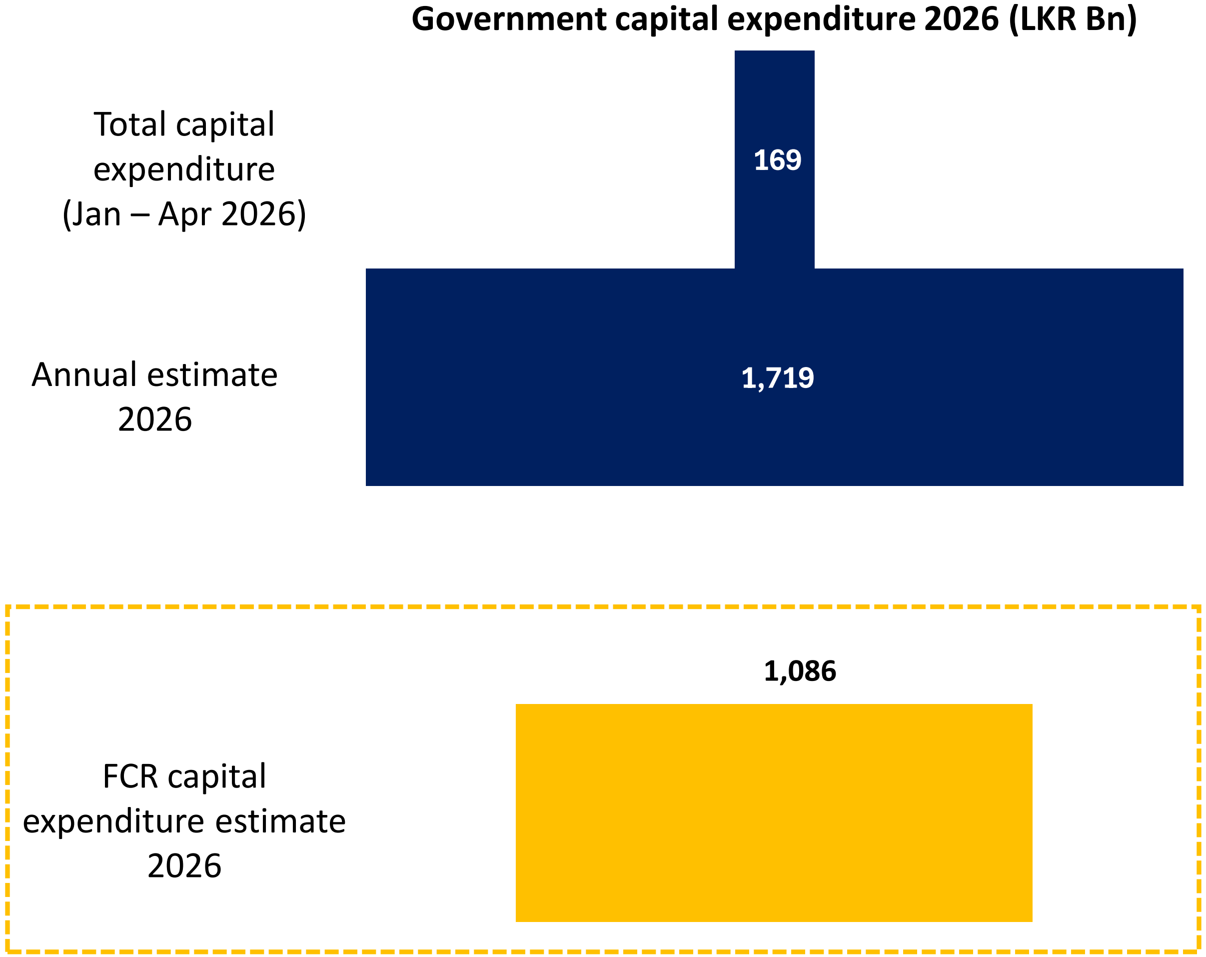




...and below the budget spending

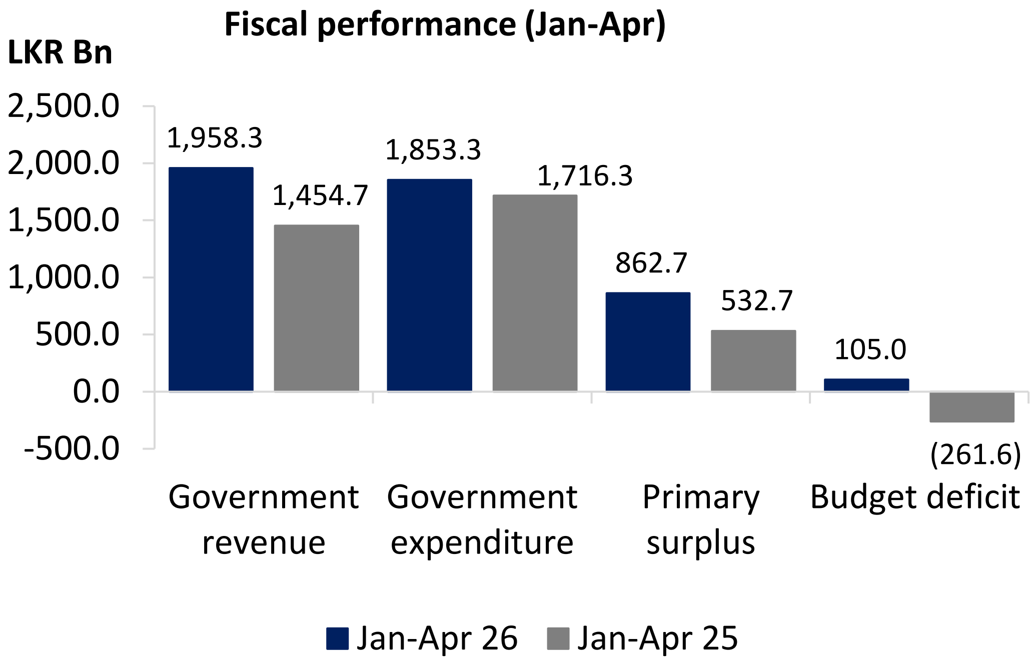
FCR expects the government expenditure to remain below the budget, due to subdued capital expenditure. As of Apr 2026, the government has spent LKR 168.6Bn out of the total capex budget of LKR 1,719Bn.

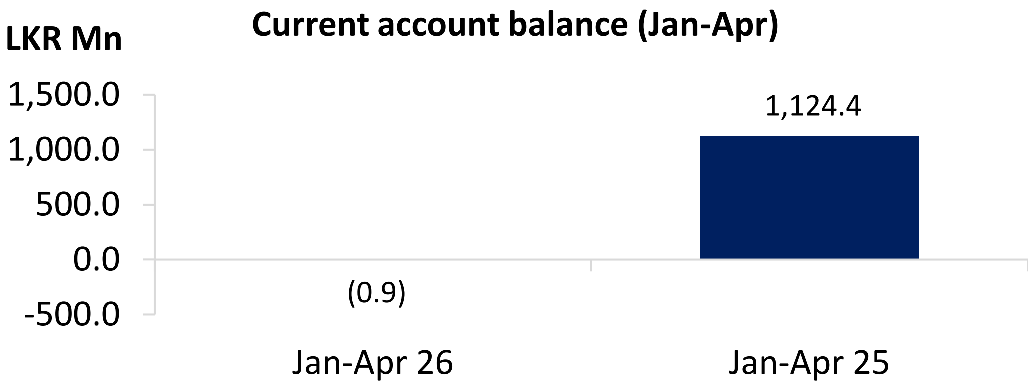




Source: Ministry of Finance, Planning and Economic Development, and First Capital Research

Key fiscal targets continues to outperform IMF expectations





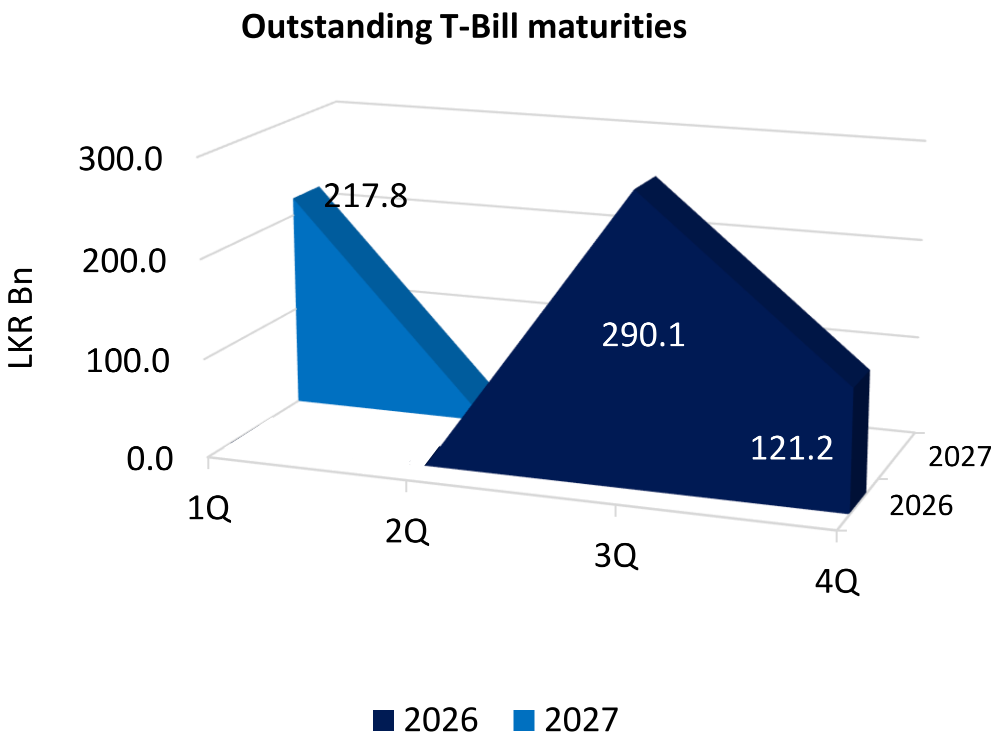
Key fiscal targets projections (% of GDP)

		Revenue	Expenditure	Primary balance	Budget deficit	Current A/C balance
2026E	IMF	15.2	20.3	1.4	-5.1	-0.5
	FCR	**15.7**	**20.0**	**3.6**	**-4.3**	**-1.3**
2027E	IMF	15.1	18.7	2.3	-3.7	-0.1
	FCR	**15.7**	**19.8**	**3.6**	**-4.1**	**-1.1**
2028E	IMF	15.0	18.8	2.3	-3.8	-0.3
	FCR	**15.5**	**19.9**	**3.2**	**-4.4**	**-0.9**

Source: Ministry of Finance, Planning and Economic Development, IMF and First Capital Research

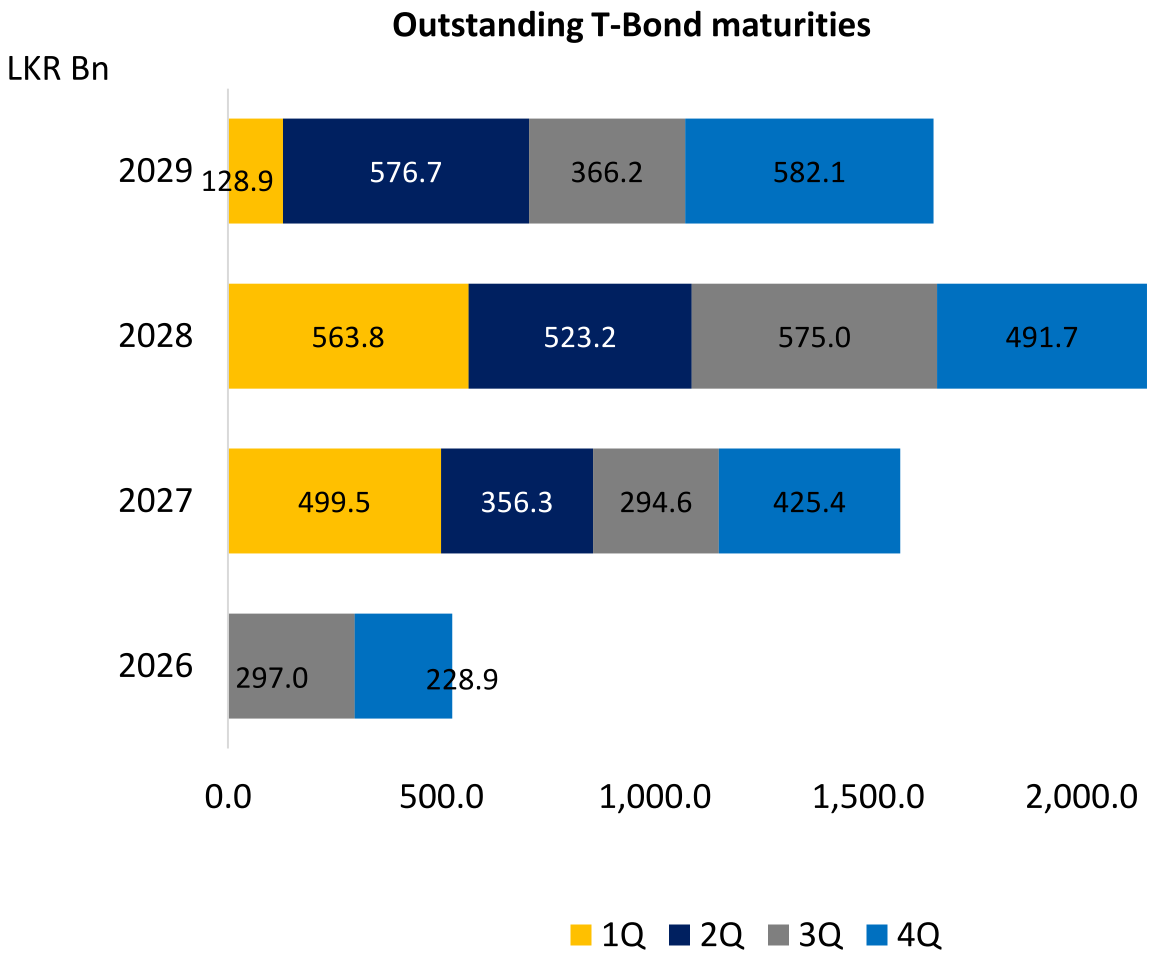
LKR maturities ease during 2H2026…

Outstanding T-Bill maturities in 2H2026 amounts to LKR 411.4Bn.



Outstanding T-Bill maturities in 1Q2027 totals LKR 217.8Bn.

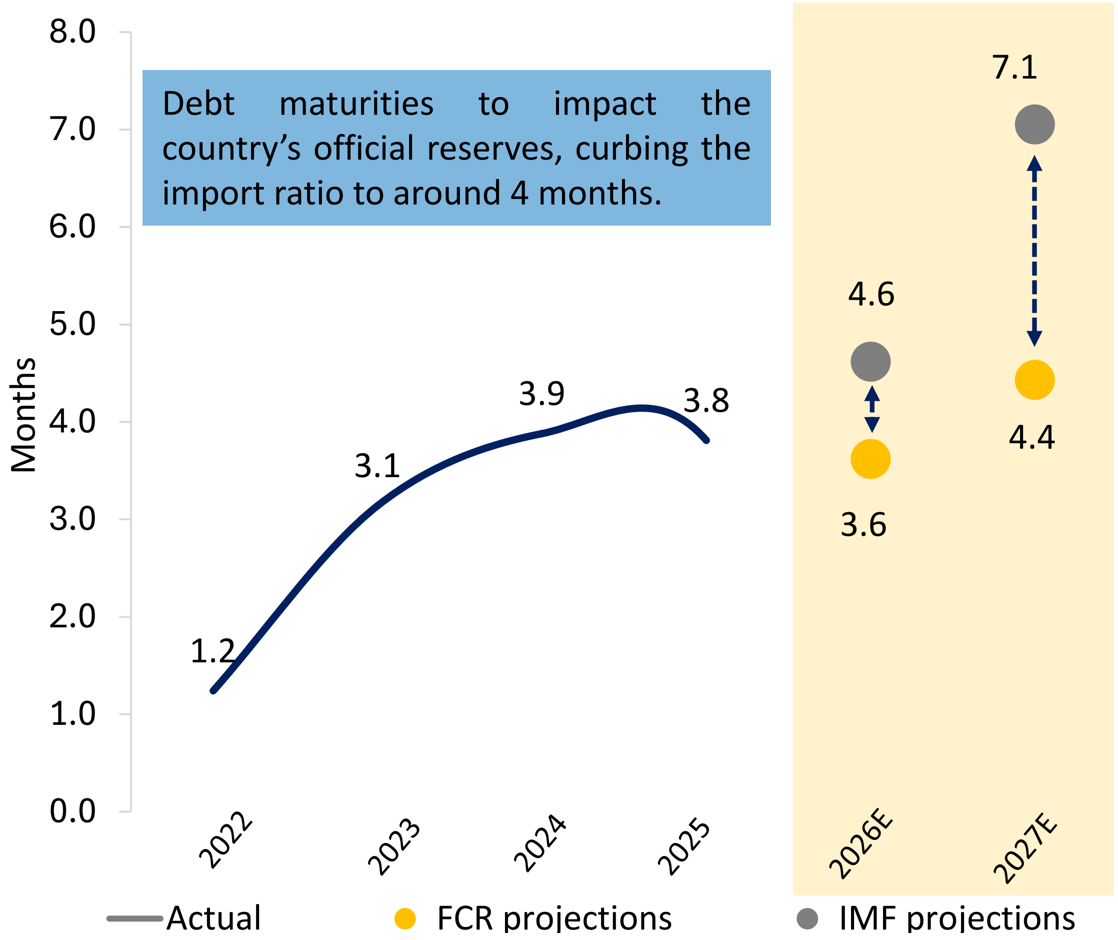
A total of LKR 526.0Bn worth of LKR Bonds to be matured in 2H2026.



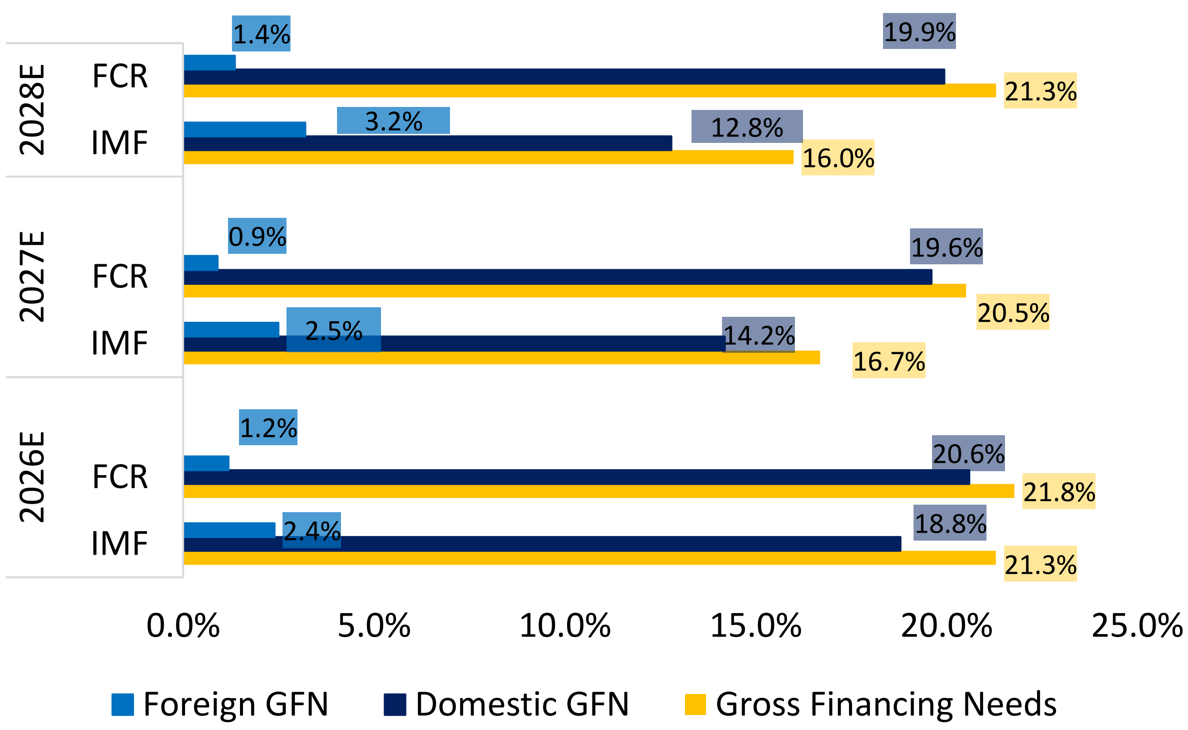
...whilst debt burden remains elevated adding caution towards debt sustainability

Import cover is projected to remain cautious around 4 months, below IMF projections. Additionally, FCR expects the government's gross financing needs to GDP to gradually reach <13.0%, in line with the debt sustainability targets.

Import cover



Gross financing needs projections



GFN = Budget deficit + Outstanding T-Bond maturities + Outstanding T-Bill maturities + Gross external financing amortization

External volatility, elevated risk

Downgraded Medium-High Risk

Section 5.0

ME unrest continues exposing SL weakness to external shocks

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Sri Lanka's economic performance during major crisis periods

	2008 global financial crisis	2011 European debt sovereign crisis	2021 Covid pandemic
GDP growth	Amidst the global financial crisis, real GDP growth was limited to 6.0%	Sri Lanka achieved real GDP growth of 8.3%, mainly driven by the expansion of infrastructure facilities and peace dividend	Real GDP growth significantly declined to 3.7%
Fuel imports	Fuel imports totaled USD 3.4Bn, with oil prices averaging to USD 94.2/barrel during 2008	Fuel imports totaled USD 3.0Bn, with oil prices averaging to USD 96/barrel during 2011	Fuel imports totaled USD 3.7Bn, with oil prices averaging to USD 65.7/barrel during 2021
Trade deficit	Trade deficit widened by 60.6%YoY to USD 5.9Bn (-14.4% of GDP)	Trade deficit widened by >100%YoY to USD 9.7Bn (-16.4% of GDP)	Trade deficit widened by 35.0%YoY to USD 8.1Bn (-9.6% of GDP)

2026 Middle East conflict

Jan-Apr 2026

- **Crude oil prices rose >USD 100/barrel**
- **Fuel imports totaled USD 2.2Bn, exerting downward pressure on LKR**
- **Trade deficit widened to USD 3.7Bn**
- **Current A/C decelerated to USD -0.9Mn compared to USD 1.1Bn in Jan-Apr 2025**

Real GDP growth projections

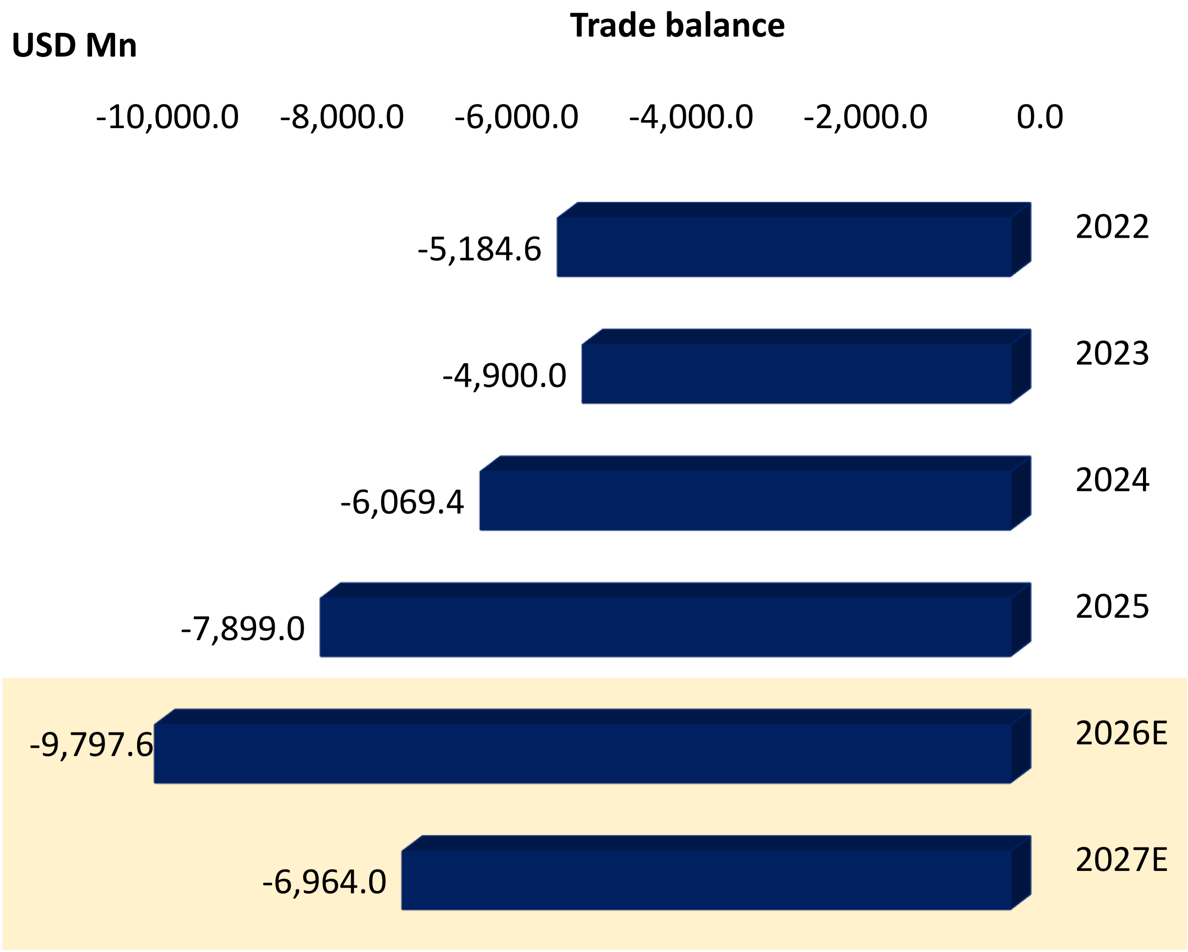
	2026	2027	2028
IMF	3.0%	3.2%	3.1%
FCR	3.0% - 4.0%	3.0% - 4.0%	3.0% - 4.0%

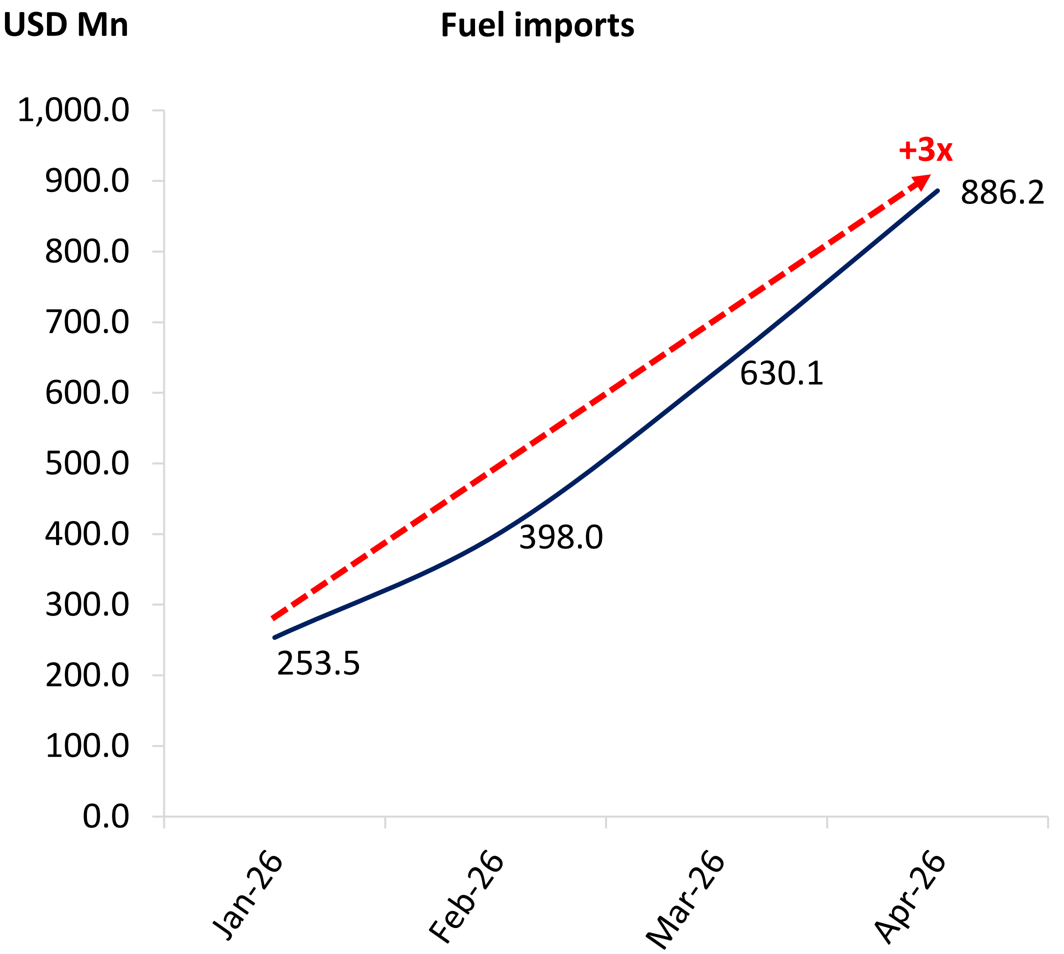
Source: US Energy Information Administration, CBSL and First Capital Research

Trade balance widens with fuel expenditure growing 3x…

As a net oil importer, Sri Lanka is exposed to higher oil prices caused by the Middle East war, inflating the import bill and widening the trade deficit.

Since Jan-26, fuel imports have grown by around 3x, due to the increase in fuel prices.

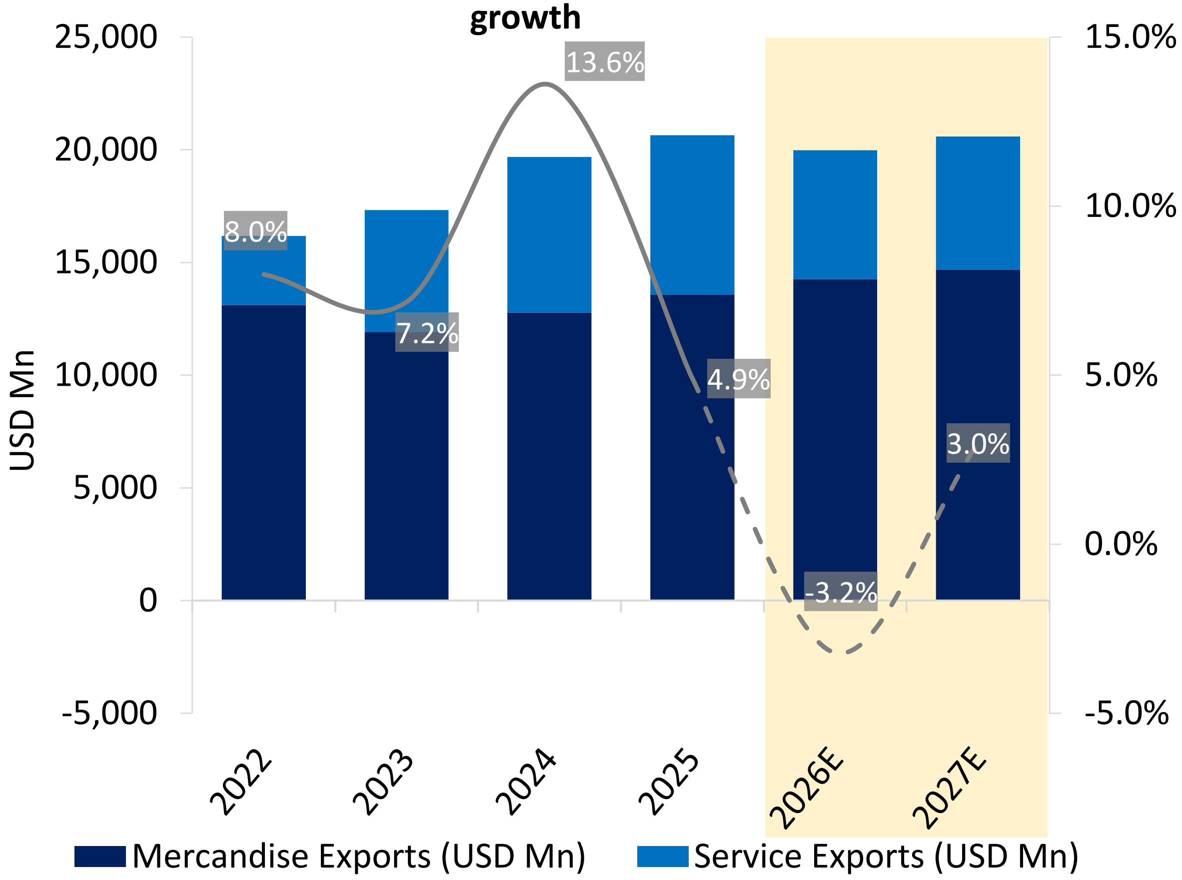




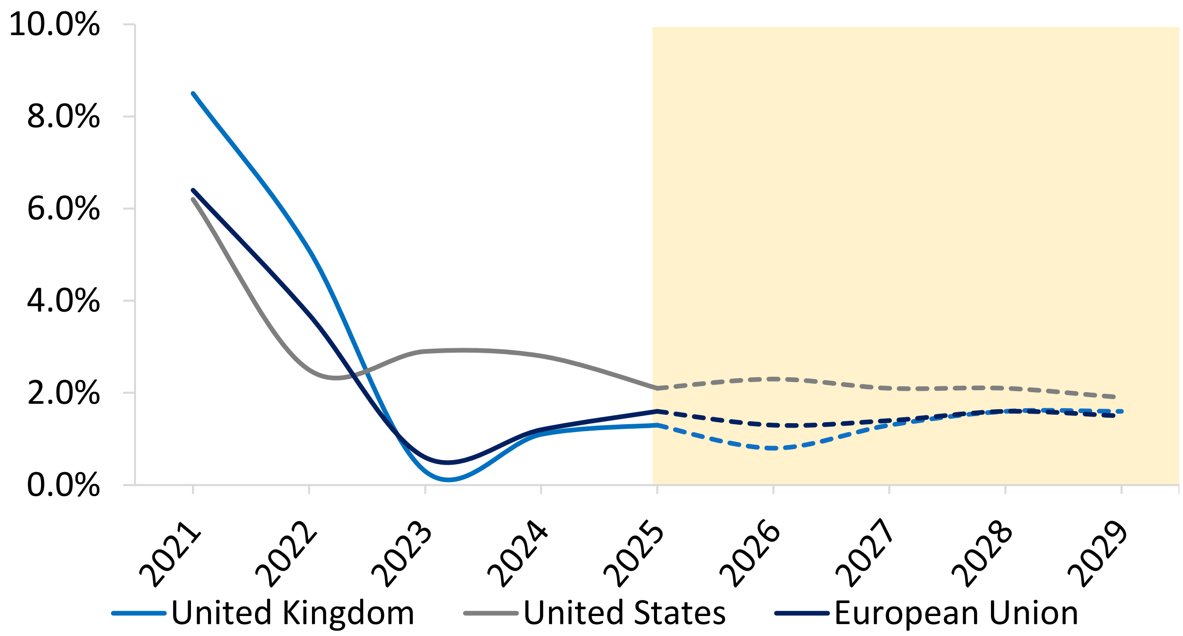
...whilst exports holding on despite external challenges

Total export earnings are expected to face near-term pressure in 2026, primarily due to expected 19% YoY contraction in service exports, mainly driven by lower tourism earnings amid travel disruptions resulting from the escalation of tensions in the Middle East. Nevertheless, merchandise exports are projected to record modest growth of around 5% in 2026 and 3% in 2027, providing support to overall export earnings despite prevailing external challenges.

Sri Lanka's goods and services exports and total export growth



Real GDP growth of Sri Lanka's main export partners



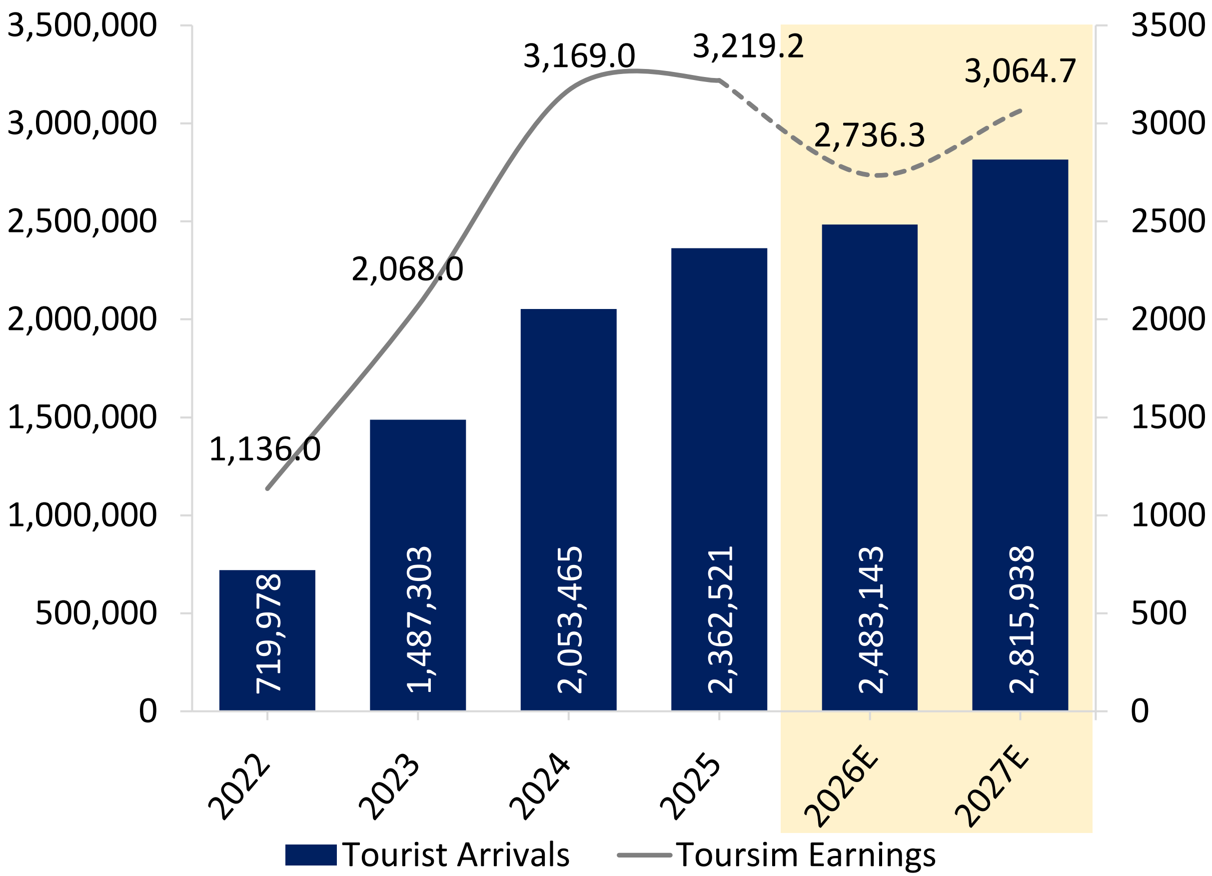
Growth in Sri Lanka's tea, petroleum product, rubber, and textile exports is likely to moderate, reflecting weaker economic growth prospects in key export destinations, which may constrain market expansion and dampen external demand.

Source: CBSL, International Monetary Fund, First Capital Research

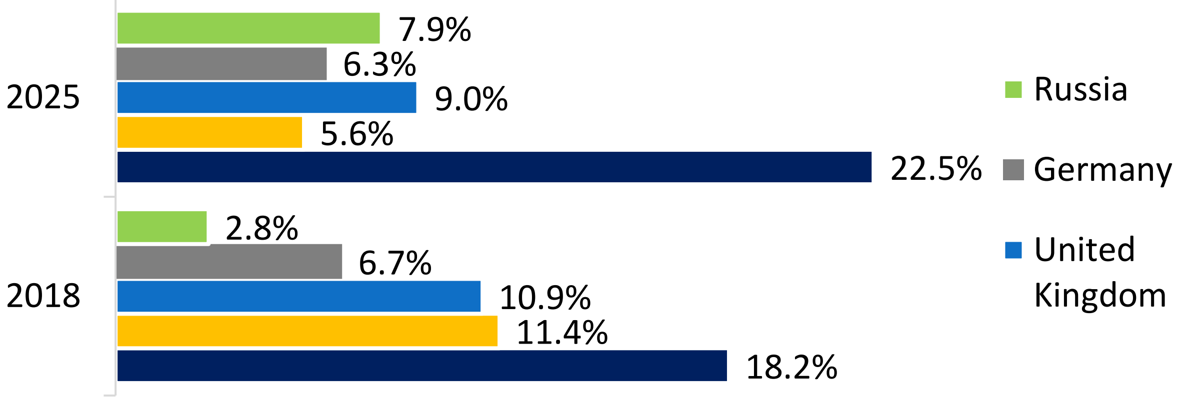
Tourism earnings remains challenged as travelling becomes costly…

Tourist arrivals were adversely affected by Middle East tensions during the first half of the year. However, arrivals are expected to recover gradually in 2H26, resulting in total arrivals of approximately 2.5Mn for the year 2026. Despite this recovery, tourism earnings are projected to decline to USD 2.7Bn in 2026 before improving to USD 3.0Bn in 2027, still very much below 2018 peak, as a result of the change in key source countries and shortened average stay.

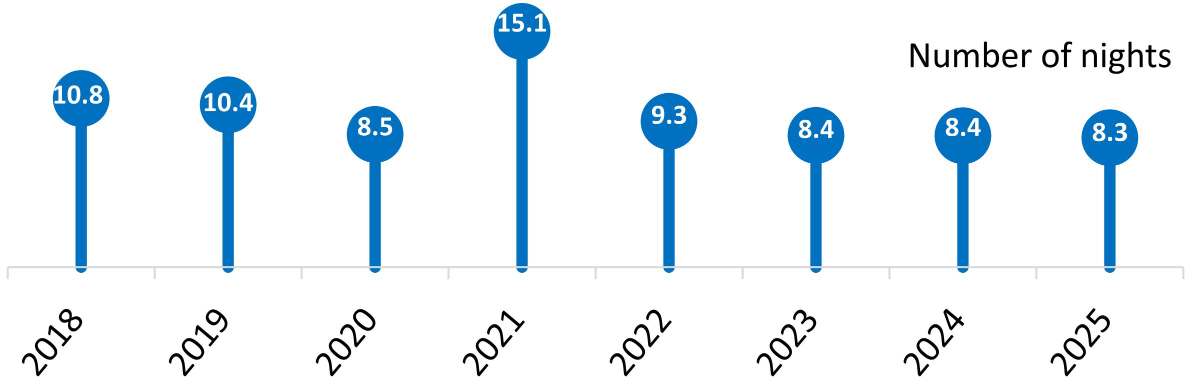
Tourist Arrivals and Earnings



Declining China, UK and German visitors tend to constrain tourism earnings

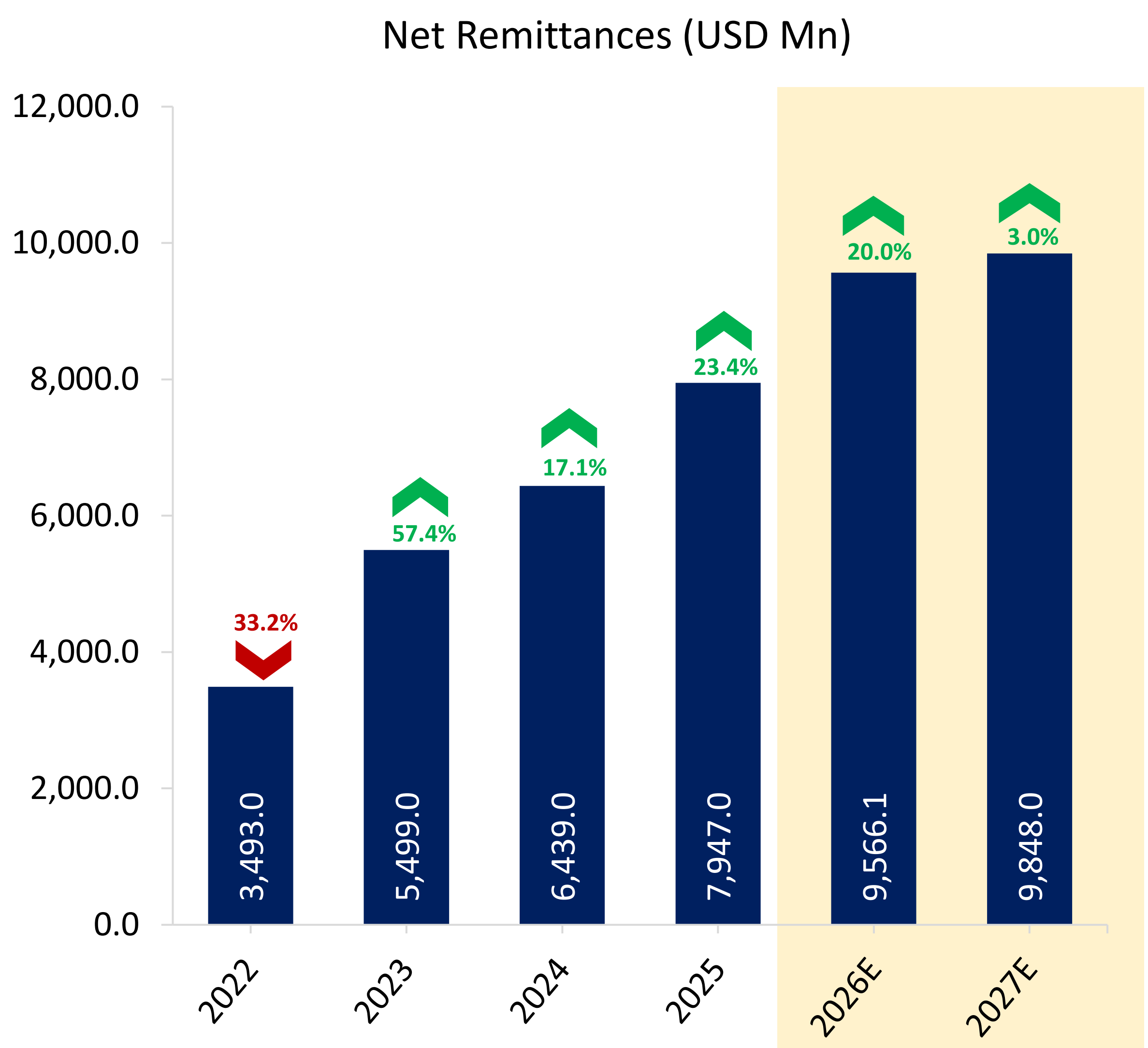


The average length of stay has declined in recent years, contributing to lower tourism earnings



Source: CBSL, SLTDA, First Capital Research

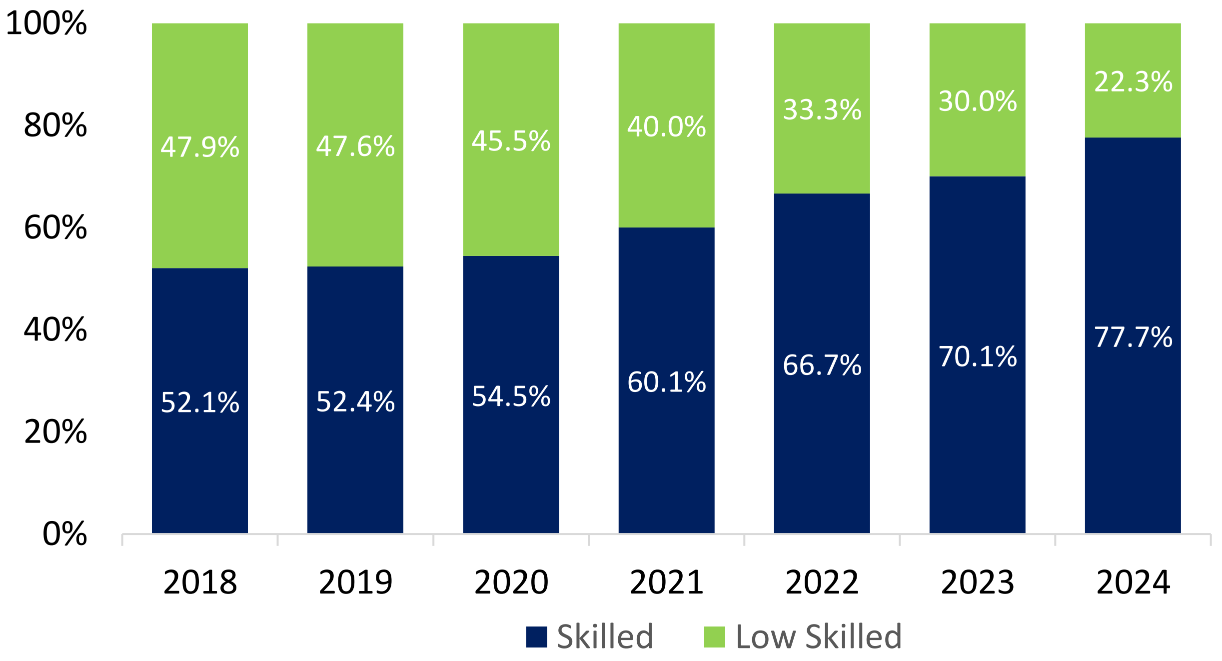
...whilst remittance flow continues uninterrupted...



FCR anticipates a 20% YoY growth in remittances earnings in 2026 followed by a moderate 3% YoY growth in 2027.

According to the Bureau of Foreign Employment, departures for foreign employment in the skilled labor category have increased in recent years, which may lead to higher remittance inflows compared to departures of low-skilled workers.

Registrations for foreign employment in the skilled labor category have increased in recent years

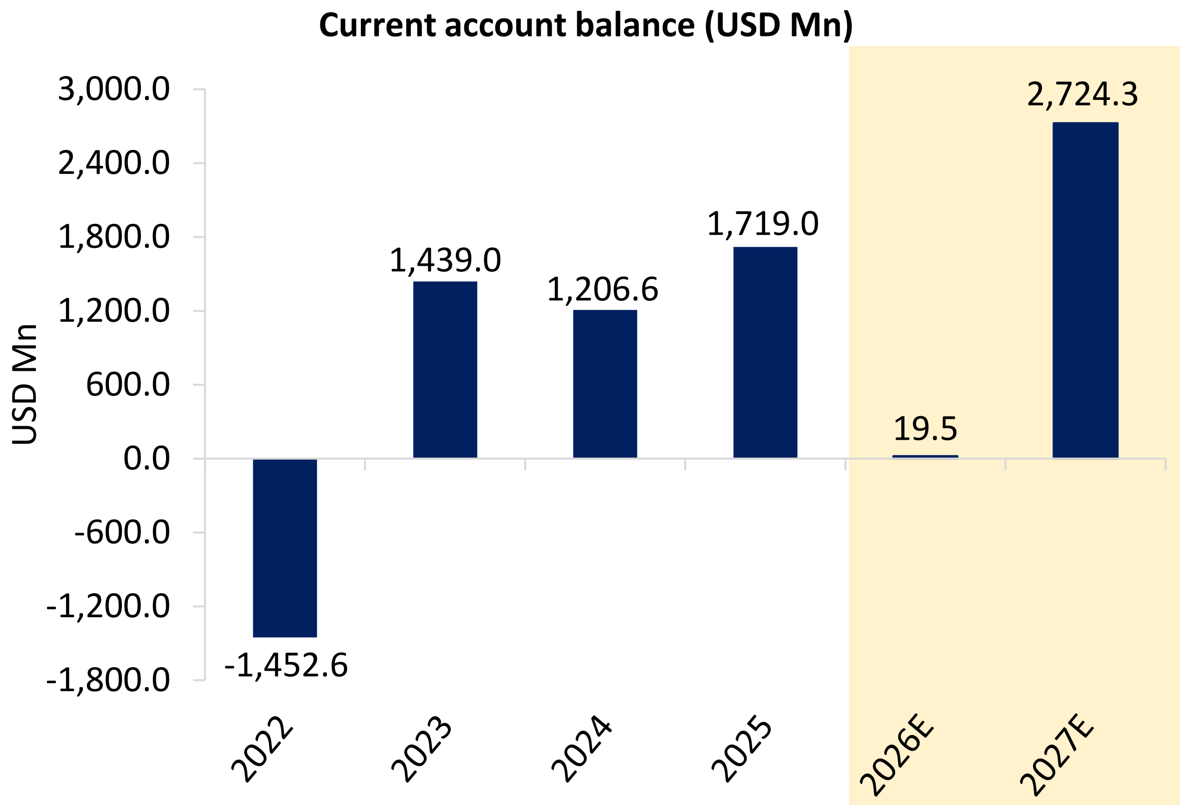


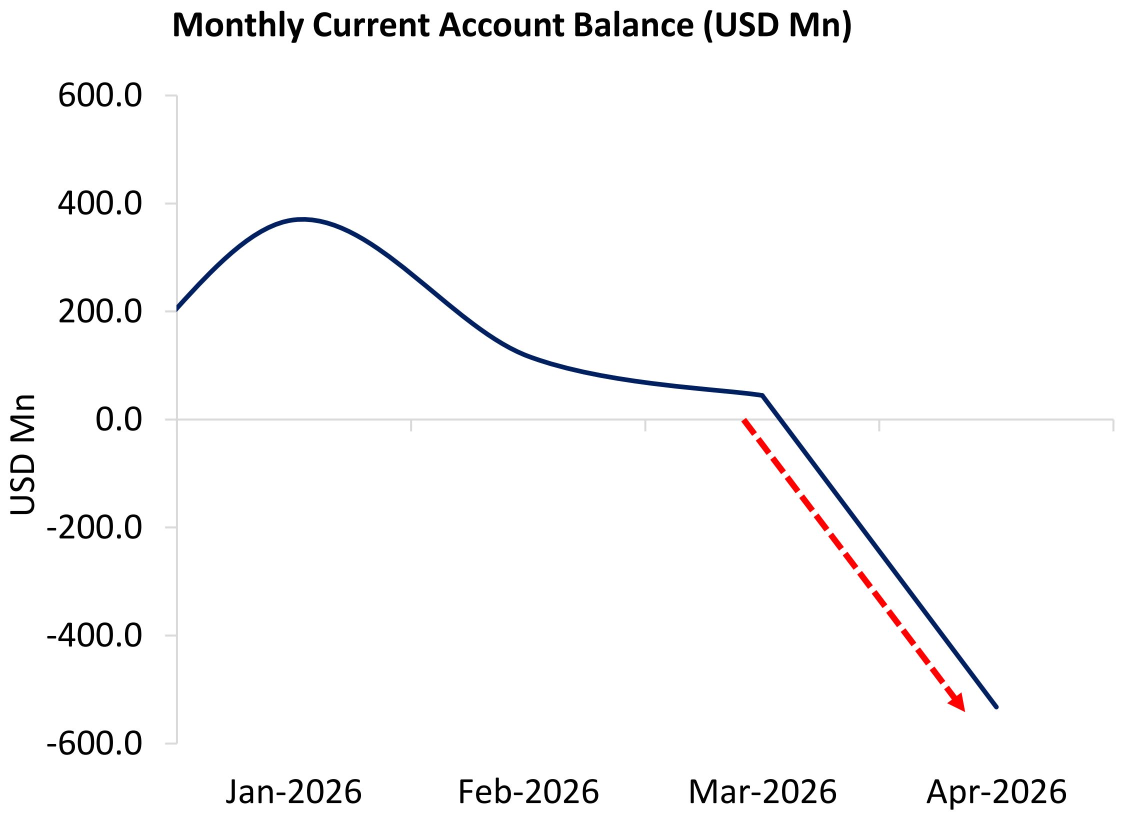
Source: CBSL, SLBFE, First Capital Research

...supporting the fragile current account balance

The current account balance is expected to narrow in 2026, primarily due to higher import costs driven by increased fuel import bill with the elevated crude oil prices.

Remittance inflows are anticipated to partially mitigate these adverse effects. They are unlikely to fully offset the impact of higher import costs and weaker tourism receipts.

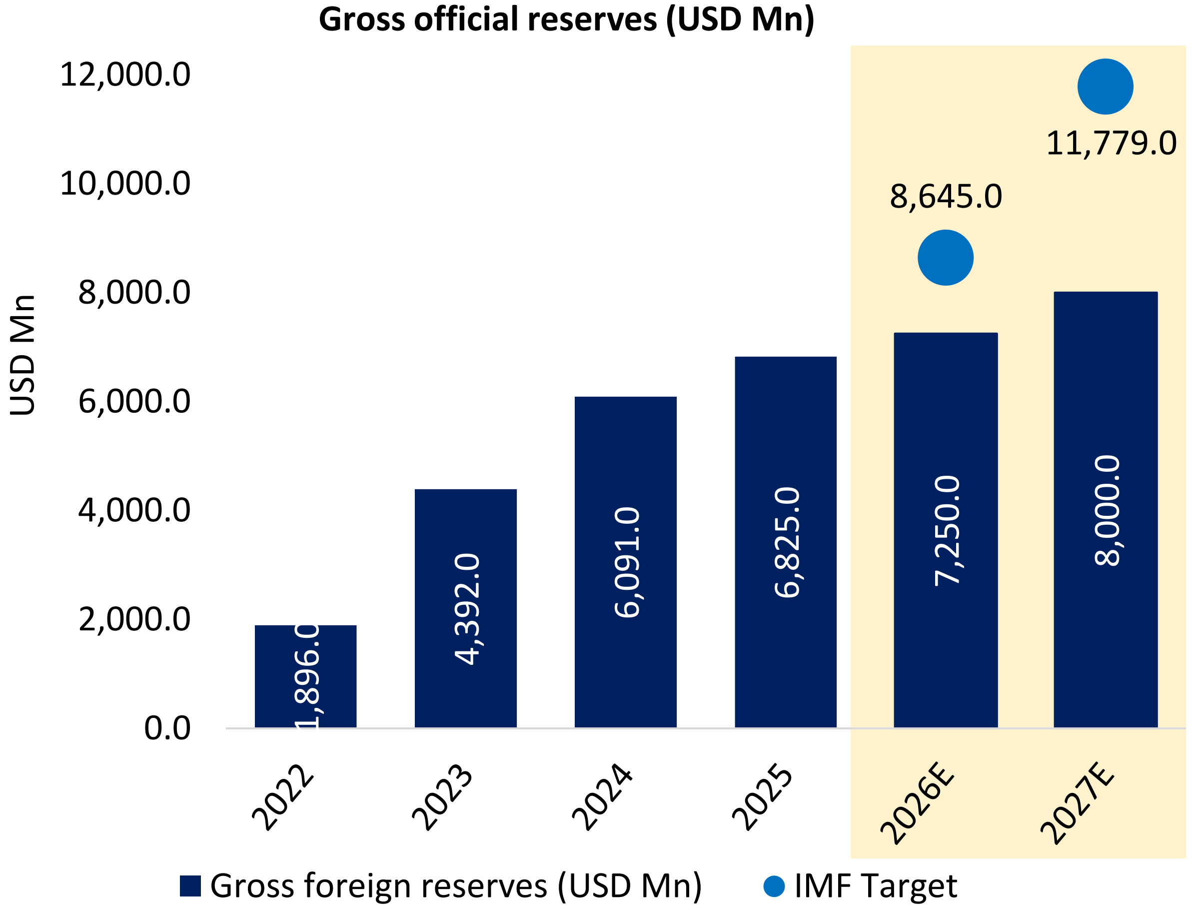




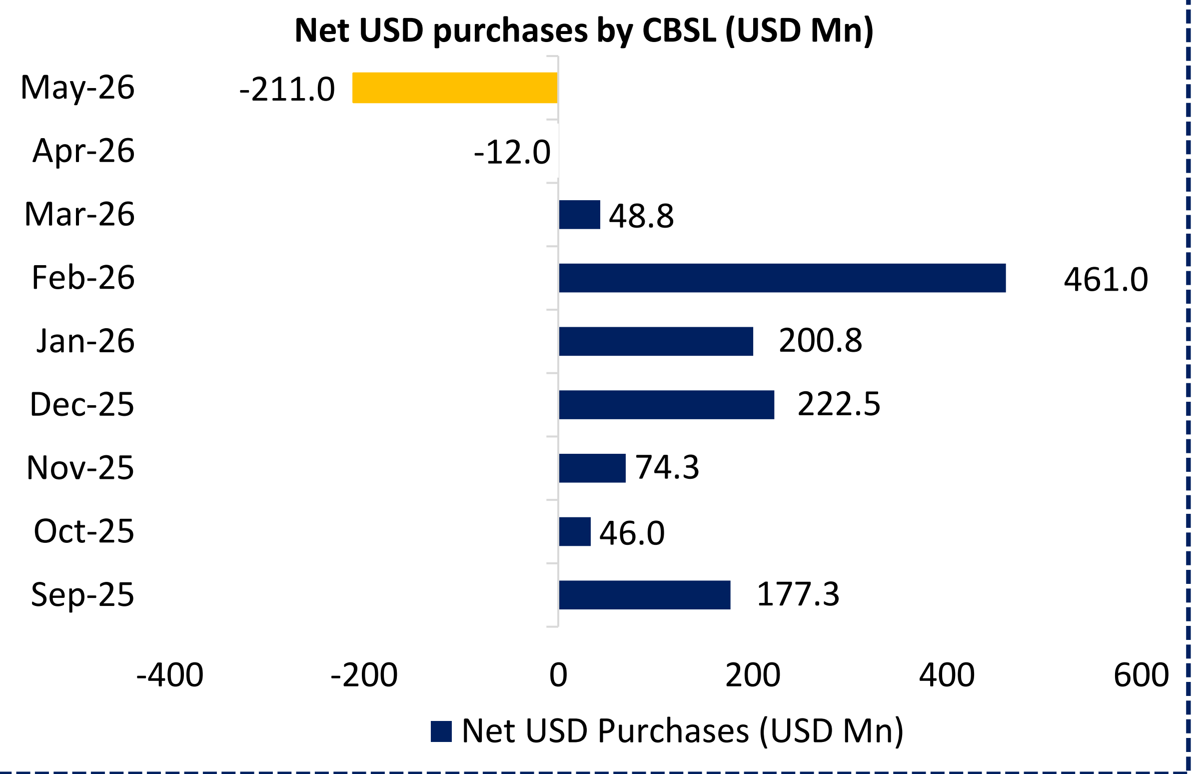
Source: CBSL, First Capital Research

Gross official reserves on track but below IMF expectations…

Gross foreign reserves are expected to grow steadily in 2026–2027 but may remain below IMF targets due to higher FX outflows from increased upcoming debt service obligations, CBSL interventions and imports, while inflows from key sources such as tourism, FDI, and merchandise exports are expected to grow modestly, which may not be sufficient to fully support stronger reserve accumulation.



CBSL's net USD purchases turned negative amid higher fuel import FX outflows, reflecting interventions to contain pressure on the LKR.

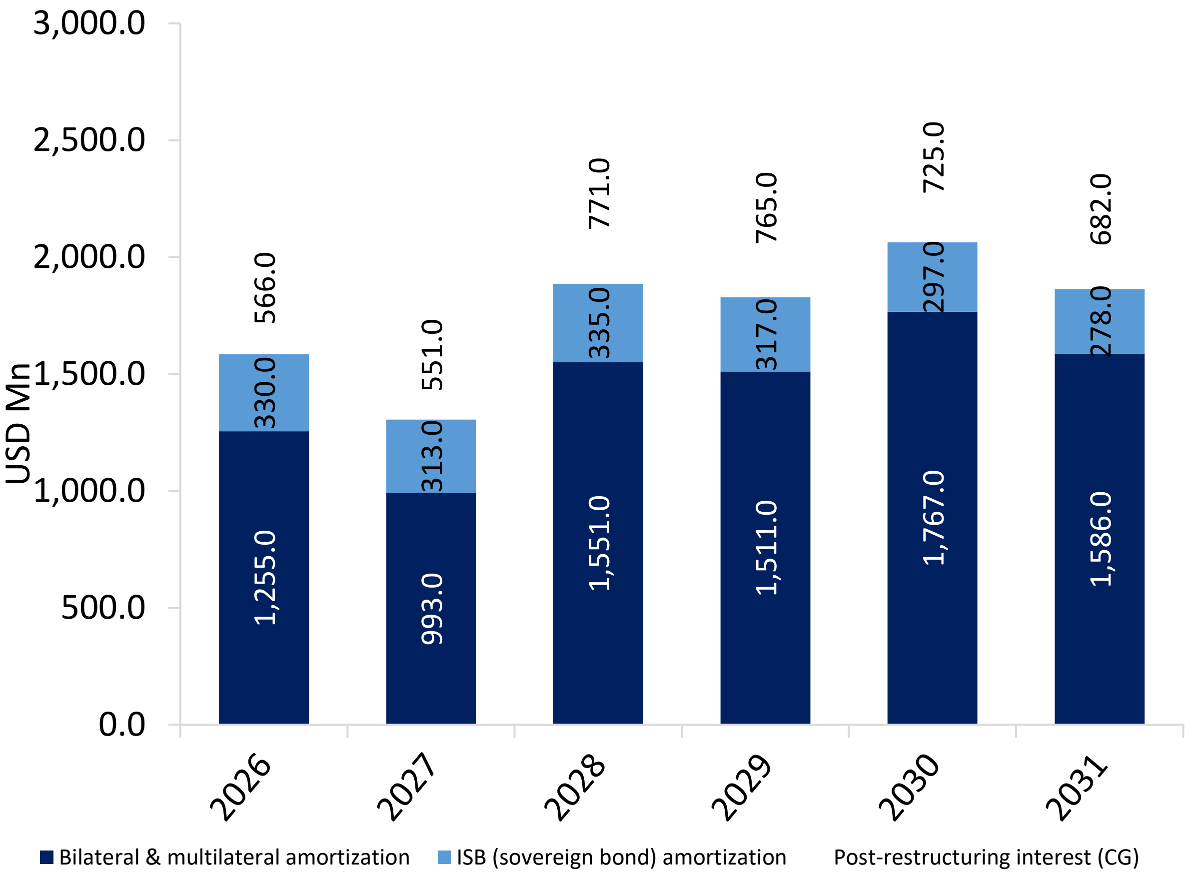


Source: CBSL, First Capital Research

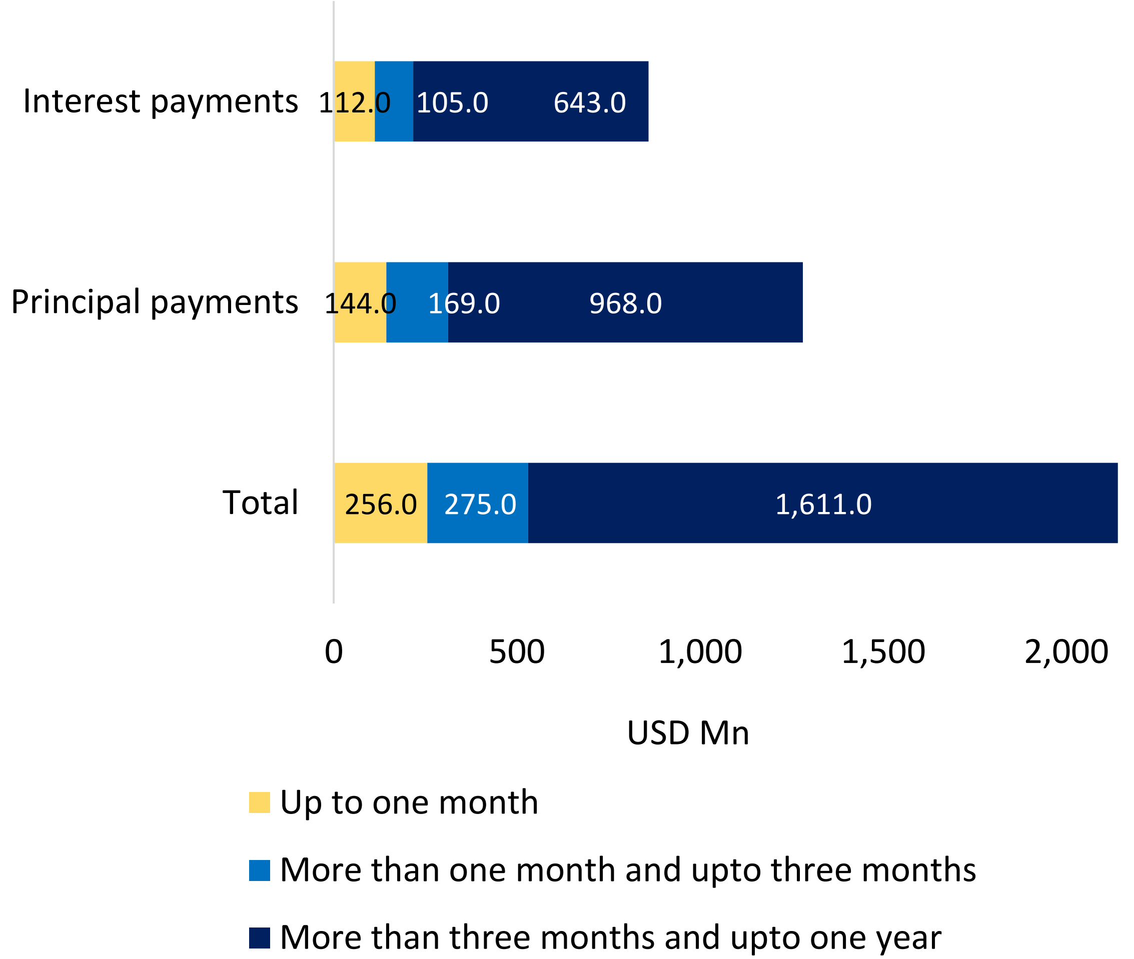
…whilst pressure slowly builds on pending USD repayments

Following the completion of the IMF EFF program in March 2027, Sri Lanka will face higher external debt-servicing obligations, including bilateral and multilateral debt repayments from 2028 onward.

Debt amortization and post-restructuring interest payments



Predetermined short term net drains of foreign currency assets (USD Mn) As of June 2026



Source: CBSL, IMF Country Report No. 26/111, First Capital Research

Scenarios

Section 6.0

Given the uncertain global political environment FC introduces four possible scenarios

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Scenario 1 20%
Durable De-escalation

BRENT
USD 60 – USD 68
CCPI
4.0–4.5%
GOR
USD 8.0 – USD 9.0Bn
OPR
↓ 7.75%
1-10Yr
8.00% - 11.50%

POSITIVE

Scenario 2 50%
Fragile Truce

BRENT
USD 68 – USD 80
CCPI
5.0–6.0%
GOR
USD 6.5 – USD 7.5 Bn
OPR
→ 8.75%
1-10Yr
9.50% - 12.50%

NEUTRAL

Scenario 3 20%
Renewed Flare-up

BRENT
USD 80 – USD 95
CCPI
7.0–8.0%
GOR
USD 5.0 – USD 5.5Bn
OPR
↑ 9.5–10.0%
1-10Yr
10.50% - 14.00%

CAUTIOUS

Scenario 4 10%
Full Shock Strait Closure

BRENT
USD 95 +
CCPI
9.0–11.0%
GOR
<USD 4.5Bn
OPR
Repressed
1-10Yr
10.0% - 16%+

RISK-OFF / REPRESSION

Source: First Capital Research

Key assumptions for the scenarios

S1 · Durable De-escalation

~20% · Brent USD 60 – USD 68 / bbl

ASSUMPTIONS

Geopolitical
A comprehensive US-Iran agreement takes hold. The Strait of Hormuz returns to full unimpeded transit within 60 days, and the stranded vessel backlog clears entirely, removing the risk premium baked into crude.

Oil market
OPEC+ increases its existing quota. Returning Iranian supply plus evaporating risk premium pushes Brent below the pre-war baseline, drifting toward USD 60–68. A structural supply surplus re-emerges.

Domestic fiscal
Lower energy import costs materially shrink Sri Lanka's current account deficit and ease the energy subsidy burden, giving the Government fiscal breathing room.

Monetary policy
With positive real rates at +3%+, CBSL has the cover to begin cutting 75–100bps by Q4 2026 or Q1 2027 once signs of average CCPI droping decisively below 5%, opening a full easing cycle.

CCPI	GOR	OPR	1Y/5Y/10Y
4.0–4.5%	USD 8.0–9.0bn	↓ 7.75%	8.00 - 11.50%

S2 · Fragile Truce

~50% (Base) · Brent USD 68 – USD 78 / bbl

ASSUMPTIONS

Geopolitical
No comprehensive deal is reached. An interim ceasefire holds but remains brittle — periodic flare-ups including tanker strikes and stalled diplomacy cause temporary oil price spikes that revert within days.

Oil market
Supply uncertainty keeps a floor under Brent above the pre-war baseline, while OPEC+ compliance and softening demand cap upside. The market trades a USD 68–78 band with headline-driven volatility.

Domestic fiscal
GOR stays broadly stable at USD 6.5–7.5bn. IMF program reviews track on schedule. Debt service is absorbed without acute reserve stress. Current account continues gradual correction.

Monetary policy
CBSL holds OPR at 8.75% through at least 2026 reviews, banking credibility from the May hike. The market signal is 'peak rate confirmed — pivot timing data-dependent into 2027'.

CCPI	GOR	OPR	1Y/5Y/10Y
5.0–6.0%	USD6.5–7.5bn	→ 8.75%	9.50 - 12.50%

Source: First Capital Research

Key assumptions for the scenarios cont...

S3 · Renewed Flare-up

~20% · Brent USD 80 – USD 90 / bbl

ASSUMPTIONS

Geopolitical
The ceasefire collapses. Intermittent attacks on tankers and shipping infrastructure resume, slowing (not closing) Hormuz transit. The geopolitical risk premium re-enters oil pricing, reversing the post-truce de-escalation.

Oil market
Supply disruption premium returns. OPEC+ uses the opportunity to defend price floors rather than increase output. Brent re-tests USD 80–90 and crack spreads widen, driving up Sri Lanka's refined product import cost.

Domestic fiscal
The higher fuel import bill widens the current account again. CBSL defends the LKR at the cost of accelerated reserve drawdown, taking GOR toward USD 5.0–5.5bn and tightening fiscal manoeuvre space.

Monetary policy
Rekindled non-food/energy inflation forces one to two further 100bps hikes through H2 2026 into Q1 2027. Real rates stay positive but fiscal space contracts, laying the groundwork for S4 dynamics to emerge.

CCPI	GOR	OPR	1Y/5Y/10Y
7.0–8.0%	USD 5.0–5.5bn	↑ 9.5–10.0%	10.50 -14.00%

S4 · Full Shock — Strait Closure Redux

~10% · Brent USD 100 – USD 120+/ bbl

ASSUMPTIONS

Geopolitical
Escalation reaches direct confrontation, triggering a genuine Hormuz closure replicating the March 2026 peak. An estimated 20–21% of global oil supply is disrupted for 30 or more days. Strategic reserve releases prove insufficient.

Oil market
Brent spikes to USD 100–120+ with no credible ceiling. Crack spreads widen sharply. Demand destruction is too slow to offset supply loss. Sri Lanka's refined fuel import bill rises to crisis levels within weeks.

Domestic fiscal / external sector
GOR falls toward and below USD 4.5bn. The 2028 MLB coupon cliff rollover risk rises materially. CBSL is caught simultaneously defending LKR, financing the fiscal gap, and containing a CCPI moving toward 9–11%.

Monetary policy — financial repression

CBSL suppresses OPR below CCPI to avoid a fiscal and banking-sector collapse — negative real rates by necessity, not choice.

CCPI	GOR	OPR	1Y/5Y/10Y
9.0–11.0%	< USD 4.5bn	Repressed	~10.0 - 16.0+%

Recommendations

Section 7.0

First Capital Research View on Bond Market Jul’26-Jun’27

Section 7.1

Primary Criteria

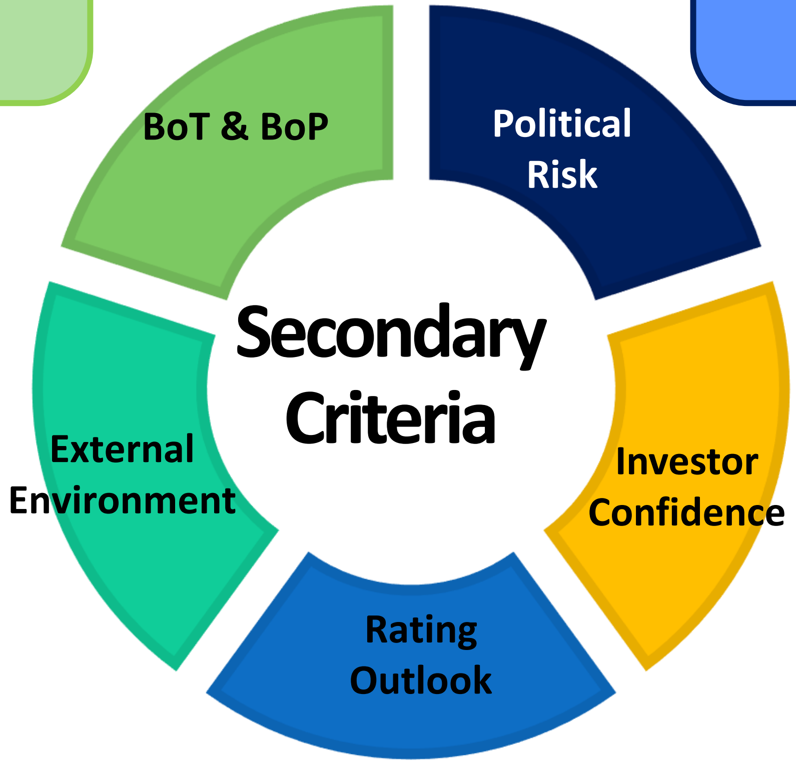
Criteria		Risk Level
Inflation	Inflation rose significantly to 6.8%YoY in Jun-26, driven by higher global oil prices, which led to increases in domestic fuel and electricity tariffs. Average inflation for 2026E forecasted at 6.0%.	Medium Low (downgraded)
Liquidity	System liquidity moderated to an average of LKR 170.0Bn during Apr-May 2026 and declined below LKR 50.0Bn in Jun-26, reflecting CBSL USD sales and strong private sector credit growth. Currently liquidity stands at LKR 100.0Bn+.	Medium Low (downgraded)
Foreign Reserves	Gross official reserves stood at USD 6.9Bn in May 2026, reflecting external debt repayments and net USD sales. The IMF also approved a USD 695.0Mn disbursement following the 5th and 6th EFF reviews.	Medium Low (maintained)
Foreign Activity	Foreign activity underwent little change since Mar-26 and continues to remain below the 5.0% threshold prescribed by the CBSL.	Medium Low (maintained)
Credit	Private sector credit grew by 27.0%YoY in Apr-26, as outstanding credit increased by LKR 100.6Bn MoM to LKR 10.8Tn. Growth was supported by festive-season demand and higher working capital requirements among importers amid currency pressures.	Low (Upgraded)
CBSL Holdings	CBSL holdings remained broadly unchanged at LKR 2.5Tn.	High (maintained)

The current account continued to remain a deficit in May-26, driven by a widening trade gap. Escalating tensions in the Middle East led to a sharp increase in global fuel prices, placing additional pressure on the current account balance.

Risk Level : Medium Low (Maintained)

The business confidence index fell by 16 points to 132 in June - from 148 in the month prior - marking a sharp decline, from the recovery observed during May-26. Deterioration in business sentiment caused by lingering economic uncertainty, weigh down on business confidence.

Risk level : Low (Maintained)



Amid ongoing geopolitical tensions, the LKR has depreciated sharply, declining by approximately 8.0% YTD and currently hovers around LKR 335.0 per USD.

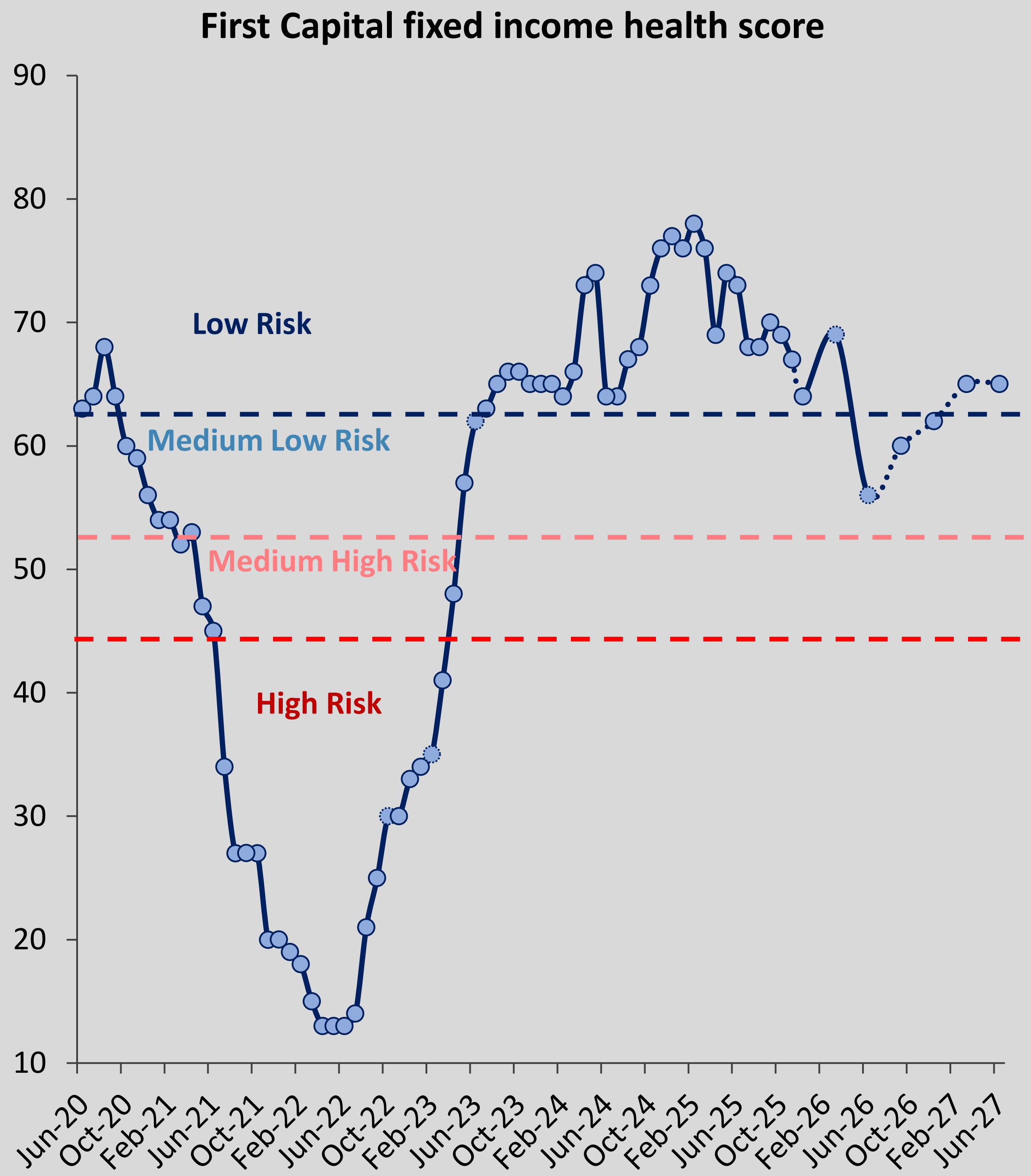
Risk Level : Medium Low (Downgraded)

The political stability Sri Lanka achieved in 2025 continues to hold firm in May-26.

Risk Level : Low (Maintained)

Backed by the stable outlook and recovery in economic indicators, S&P revised up their rating for Sri Lanka to CCC+ in Sep-25. With this all three agencies have revised up their rating for Sri Lanka from its previous SD rating

Risk Level : Medium Low (Maintained)



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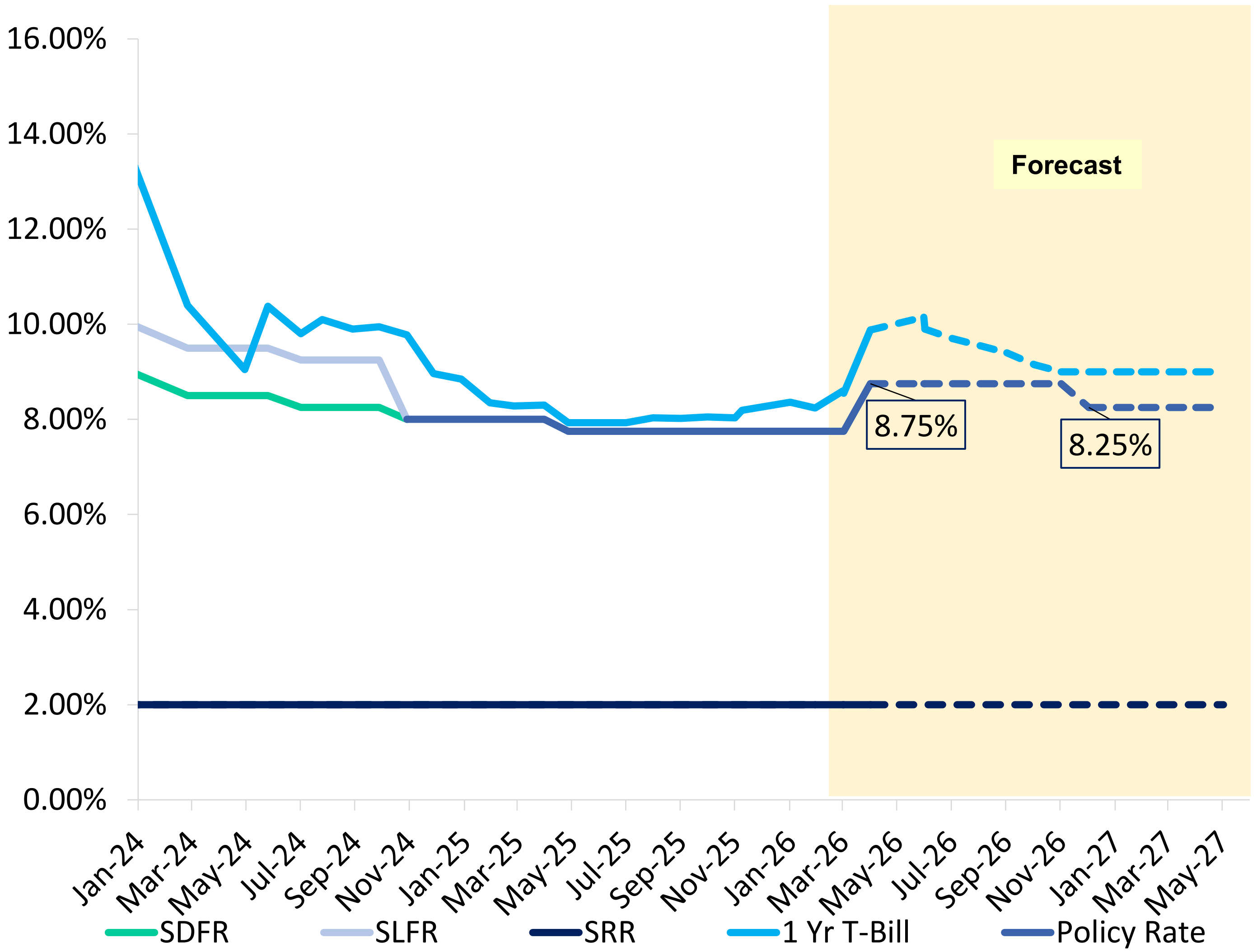
FI Health expected to dip in 2026E, and gradually recover towards Low risk in 2027E

- The Health Score is expected to enter the medium-low risk threshold by mid-2026.
- However, an improvement in health score is anticipated towards 2H2026 and 1H2027 aided by possible slowdown in credit, improvement in liquidity conditions, moderation in inflation in 1H2027 and gradual buildup in reserves.
- Considering the anticipated improvement in health score, which is already believed to be priced into the yield curve, stabilization in yields expected during the upcoming 12 months period.

Source: First Capital Research

OPR likely to be reduced towards the beginning of 2027E



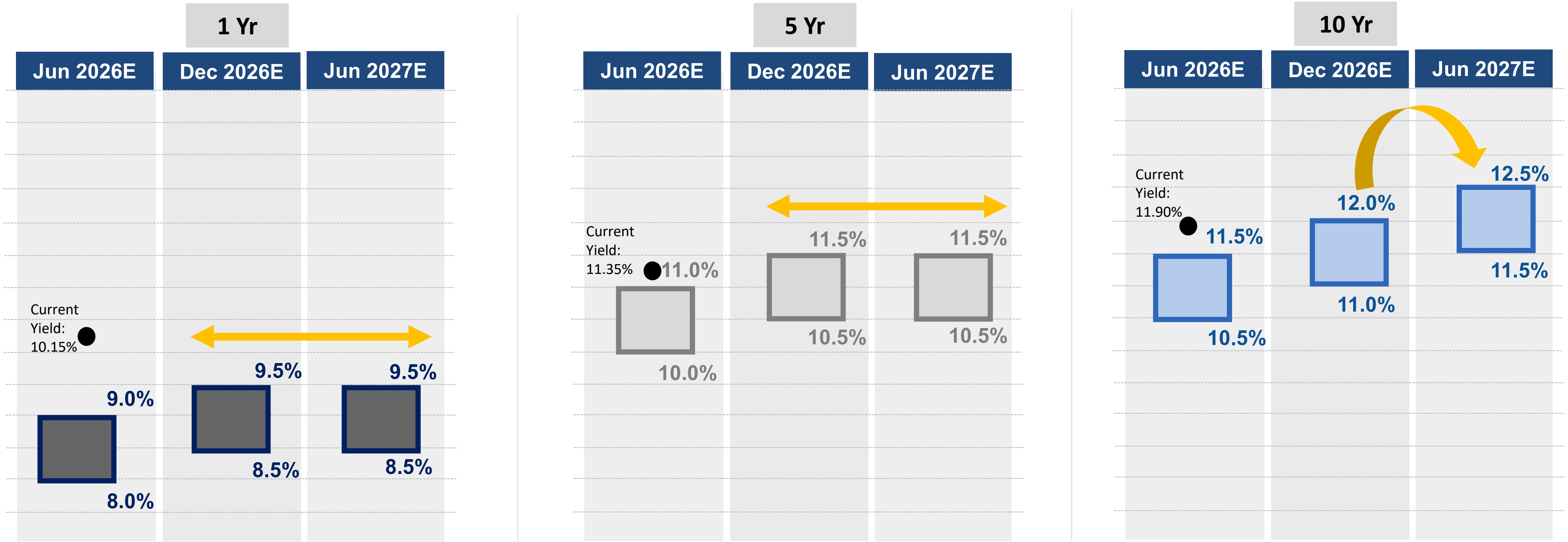
The health score is expected to improve through 2H2026 and into 1H2027 as macro conditions normalize following the CBSL's recent 100bp OPR hike. However, with this improvement already reflected in our health score, we expect bond yields to remain broadly stable, limiting the scope for further policy rate cuts this year.

However, taking the assumption that path ahead remains under the base case scenario of "Fragile Truce", we believe that CBSL may look to partially loosen the previous tightened policy, in an effort to re-ignite consumer spending and push up economic growth. Therefore, we see an opportunity for a 50bps rate cut in early 2027E.

Source: CBSL, First Capital Research

Mid to long tenors to remain stable, a dual opportunity lies in short tenors

The 100bps policy rate hike implemented by CBSL in May 2026 pushed the yield curve well above our guidance, reflecting what we viewed as an overreaction by investors. However, subsequent direction from the PDMO, through reduced acceptance of the WAYR and the rejection of longer-tenor bids at recent auctions, helped correct this overreaction, bringing yields back in line with our projected levels. Looking ahead, with medium- and long-term tenors already trading within our target bands, we believe there is further scope for short-term yields to decline and converge towards our projected ranges during 2H2026E, before remaining broadly stable throughout 1H2027E. Nevertheless, Sri Lanka's vulnerability to external shocks was once again highlighted by the Middle East conflict, particularly given the country's still-limited reserve buffer, which currently covers approximately 3.5 months of imports. As a result, we expect investors to maintain a cautious stance, favoring short- to medium-term tenors, while modest selling pressure is likely to persist at the longer end of the curve in anticipation of rising external debt repayments from 2028E onwards. Accordingly, we continue to incorporate a 50bps premium on longer-term tenors in our 1H2027E projections.



“Dual advantage in short tenors; continue short-end focus for defensive positioning”

Elevated inflation already factored in and countered by May-26 rate hike: Following the CBSL's 100bp rate hike in the May 2026 policy review to address inflation that exceeded its 7% upper boundary, we believe inflation has largely been brought under control. Assuming the impact of the upcoming El Niño on Sri Lanka's inflation remains moderate during 2H2026E, we see limited scope for further upward pressure on the yield curve from inflation.

Private sector credit growth is expected to remain subdued amid higher borrowing costs and moderate liquidity levels: Higher borrowing costs, weaker external demand, and tighter domestic policy measures, including import restrictions and stricter LTV limits are expected to weigh on credit growth by dampening investment appetite and slowing lending activity across key sectors.

Liquidity is expected to stabilize above LKR 100.0Bn: The expected improvement is likely to be driven by slower credit growth amid higher borrowing costs and moderating economic activity. We also expect liquidity conditions to improve as importers gradually release funds tied up in inventories accumulated during the May-Jun 2026 period of sharp rupee depreciation, while a stronger primary fiscal balance, supported by higher tax revenues, should provide additional support to market liquidity.

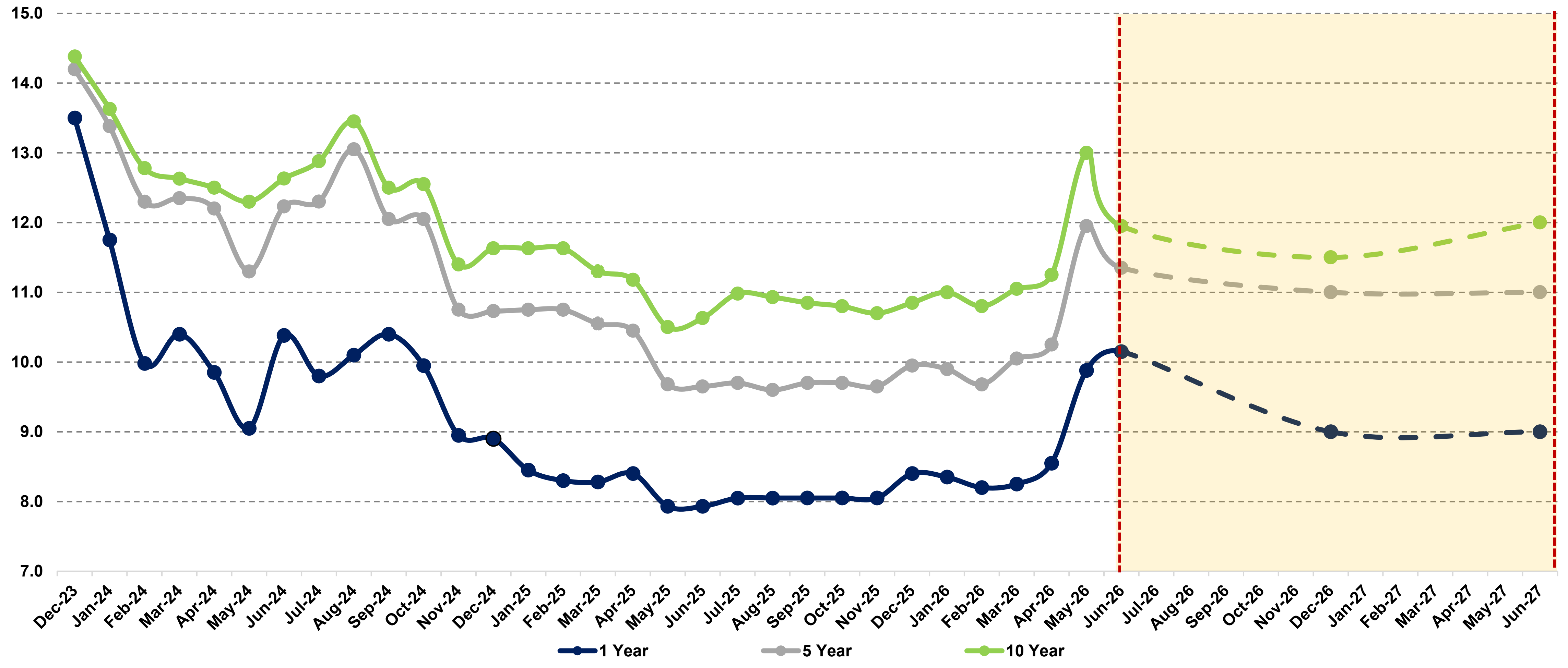
Pressure on BOP to remain low in 2H2026E: We expect pressure on the balance of payments from imports to remain contained in 2H2026E, supported by market-based fuel pricing from 3Q2026E and subdued global oil prices. However, weak export and tourism earnings are likely to limit any meaningful improvement in the current account balance.

Possibility of a rate cut with a possible slowdown in the economy: GDP growth is expected to moderate to 3.0%-4.0% in 2026E, weighed down by weaker household consumption amid higher VAT and borrowing costs, as well as lower government capital spending. This is likely to pave the way for a policy rate cut in early 2027 to support economic activity.

With mid to long-term yields already having adjusted lower, we see remaining value in the short end of the curve. Given the potential for capital gains alongside carry through to maturity, and the limited room for further declines in longer tenors, we continue to recommend maintaining exposure to shorter durations.

Short tenors expected to adjust downwards in 2H2026E:

Short-tenor yields are expected to normalize within FCR's range, while mid and longer-tenors are likely to remain stable



Source: CBSL, First Capital Research

First Capital Research View on Banking Rates Jul’26-Jun’27

Section 7.2

AWPR to remain between 10.0%-11.0% for 2H2026 and reach 9.5%-10.5% in 1H2027

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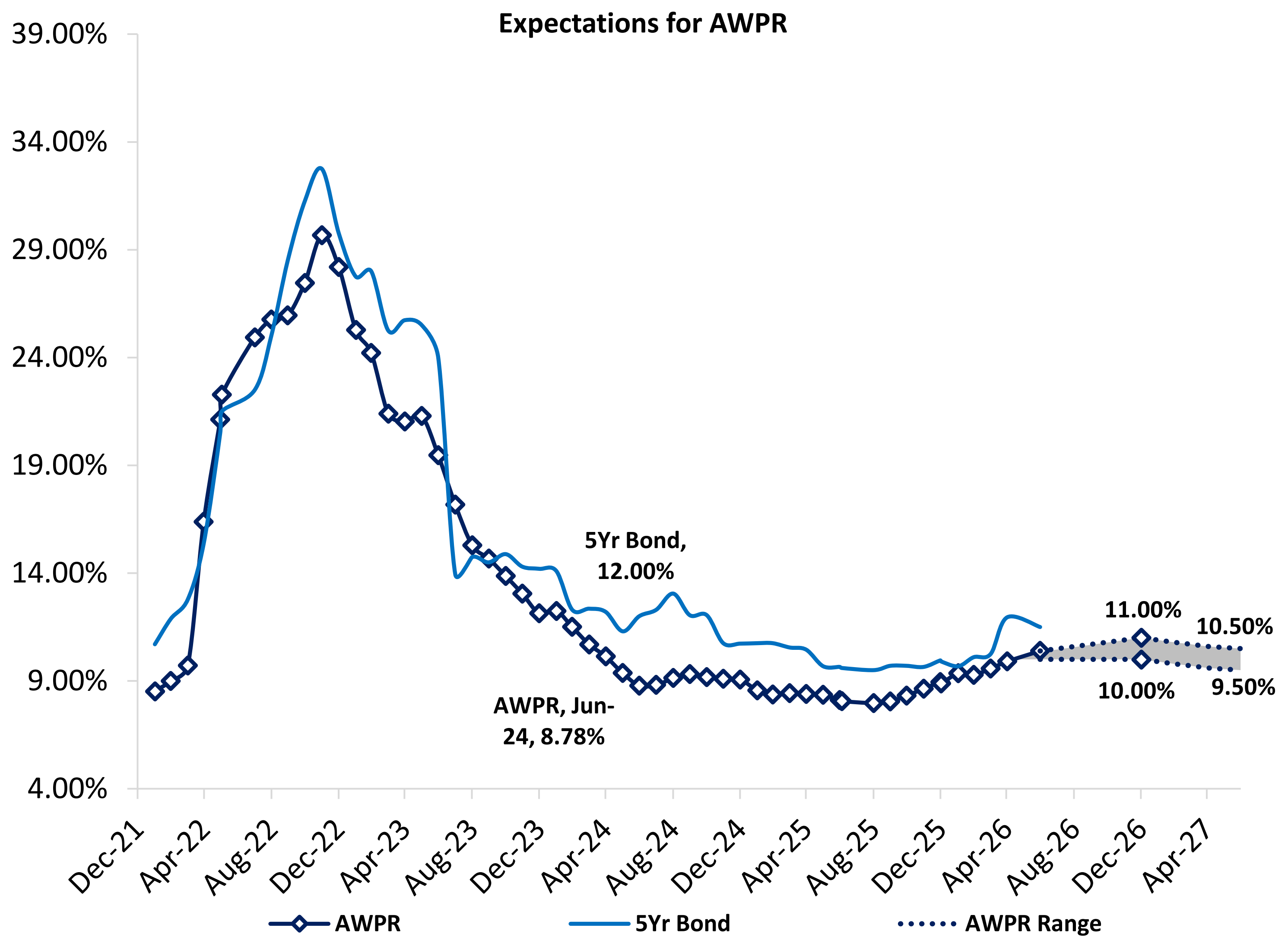


AWPR to ease in the near term

AWPR to fall further: *Stronger private sector credit growth together with higher USD sales has tightened liquidity conditions. This together with the 100bps recent policy rate hike has caused a rise in the AWPR, which is expected to remain elevated between 10.00%-11.00% during 2H2026E.*

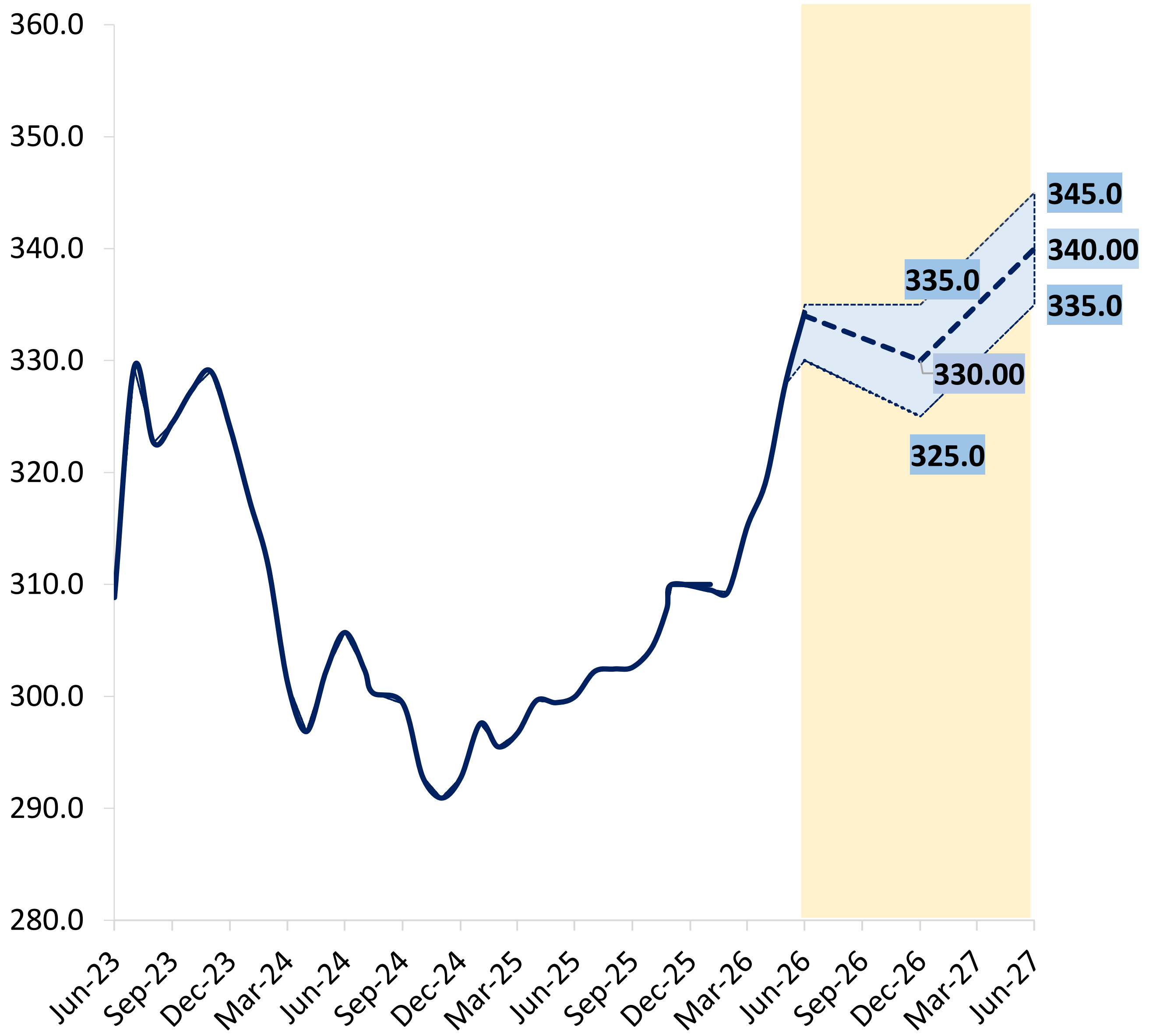
AWPR target maintained at 9.5%–10.5%: *Meanwhile, moderation in private sector credit growth, coupled with a slowdown in economic activity, is expected to prompt a policy rate cut in early 2027E to support growth amid easing demand and inflationary pressures. This is expected to bring the AWPR within our target range of 8.5%-9.5% during 1H2027E.*

Source: CBSL, First Capital Research

First Capital Research View on Exchange Rates Jul’26-Jun’27

Section 7.3

Exchange Rate for 1H2027E expected at LKR 335.0 – LKR 345.0



FCR initially projected a 5% depreciation of the LKR in 2026E, with the currency expected to trade in the range of LKR 310.0-320.0 in 1H2026E and LKR 320.0-330.0 in 2H2026E.

However, the LKR depreciated more sharply than initially expected during Apr-May 2026, largely driven by a surge in import demand amid the ongoing crisis.

However, considering the steeper than expected OPR adjustment, FCR expects imports to tone down faster in the coming months, further moderating the existing demand in the economy and reducing the pressure on the currency.

*FCR expects **<u>LKR at 325.0–335.0 in 2H2026E</u>** on a lighter fuel import bill. Thereafter, depreciation should revert to the 15-year average of 5% p.a. <u>(335.0–345.0 during 1H2027E)</u>, driven by reignited growth, import demand, policy easing, and CBSL USD purchases in 2027E.*

Source: CBSL, First Capital Research

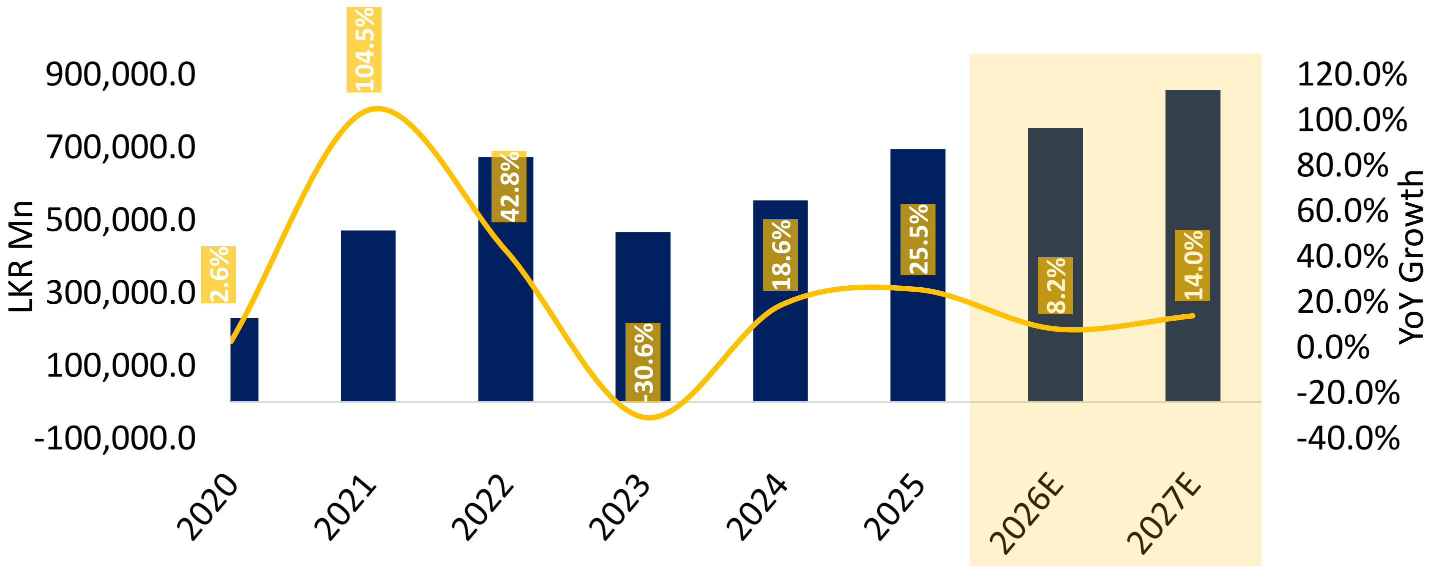
First Capital Research View on Equity Market Jul’26-Jun’27

Section 7.4

Slower 2H2026E and stronger 1H2027E for listed corporate earnings...

First Capital
A Janashakthi Group Company

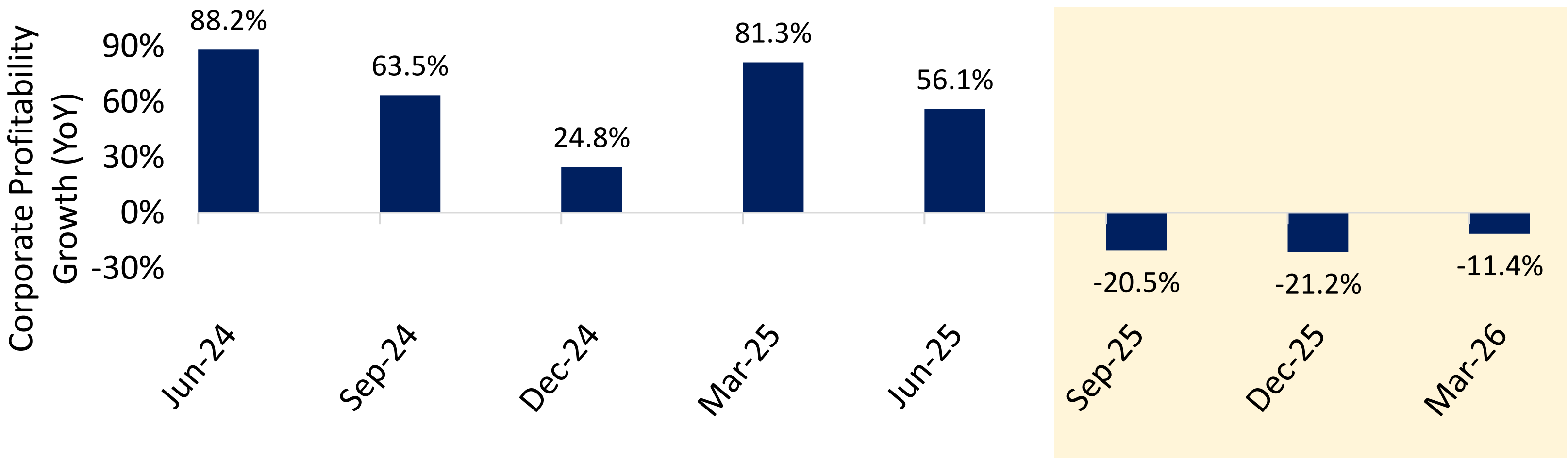
Corporate earnings growth set to moderate in 2026E & rebound in 2027E



Market earnings grew 25.5% YoY in 2025, in line with FCR's 25.0% forecast. Growth is expected to slow to 8.2% in 2026E due to geopolitical spillovers. A modest recovery is expected in 2027E, with earnings growth forecasted at 14.0% supported by relatively lower oil prices, awakened consumer spending and possible lower borrowing costs.

corporate earnings declined for the 3rd consecutive quarter in 1Q2026

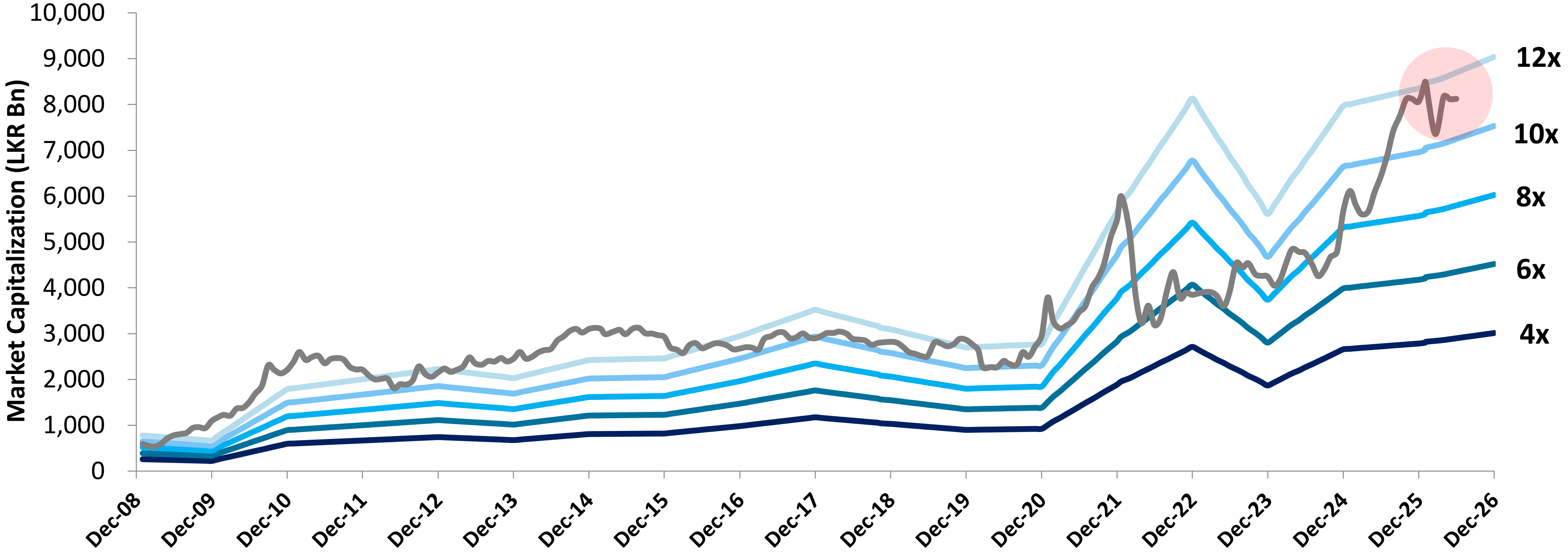
corporate earnings declined for the 3rd consecutive quarter, falling 11.4%YoY in 1Q2026, with the Food, Beverage & Tobacco sector emerging as the largest drag on aggregate profitability.



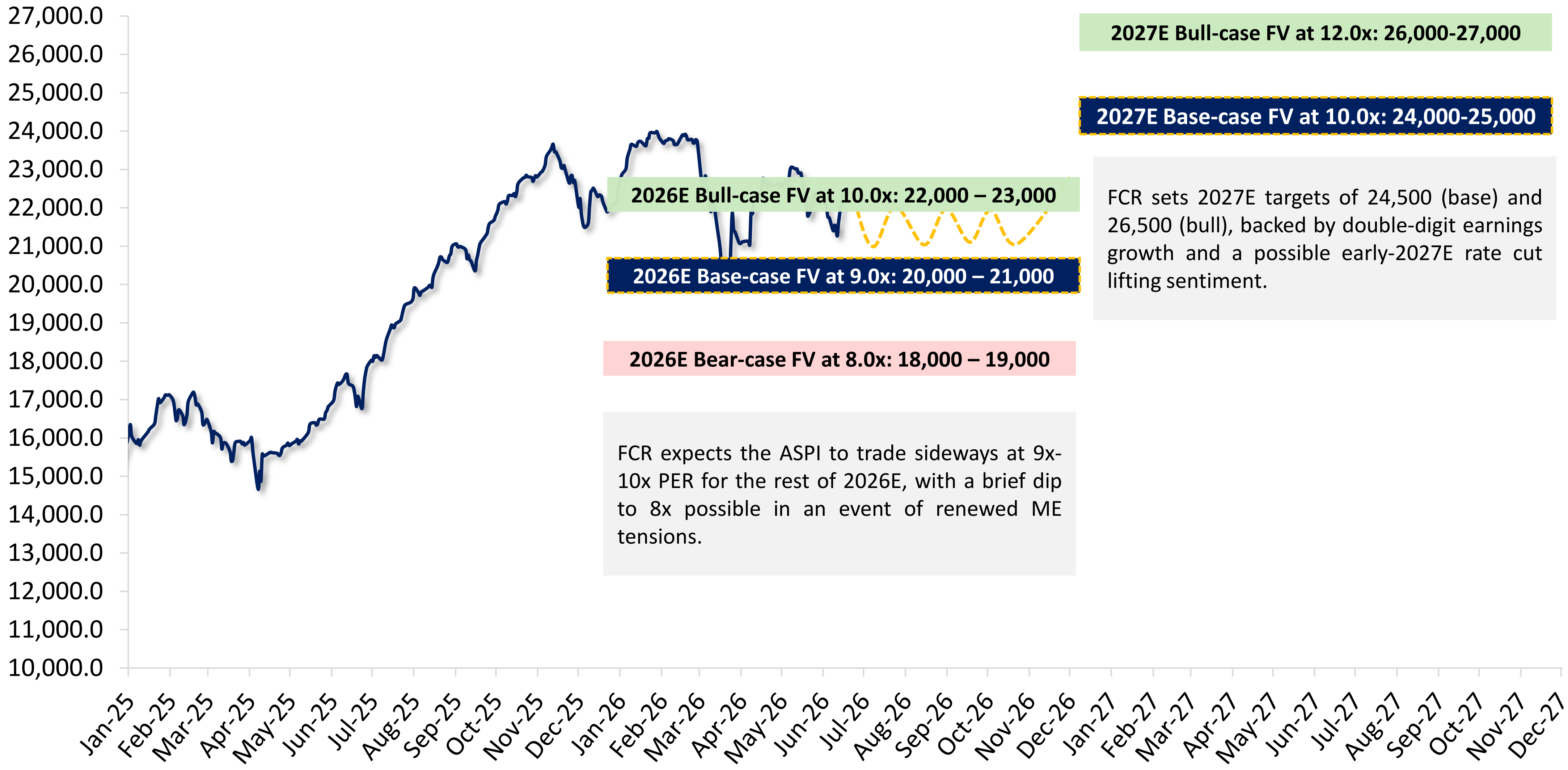
Source: CSE, First Capital Research

12x PE: A Recurring Resistance Level for ASPI

- ✓ Since the onset of geopolitical tensions in late Feb-2026 which took a palpable toll on the ASPI, the index has continued to trade below its 18-year average PER of 12.0x, where selling pressure has surfaced several times during the past few months.
- ✓ Amid the temporary easing of the tensions evident at present, the ASPI is projected to trade sideways between 9.0x and 10.0x PER through the remainder of 2026E. However, should geo-political tensions re-escalate, mirroring the unrest seen in March-April of 2026 the ASPI is likely to slip to the 7.0x-9.0x bands.
- ✓ Meanwhile, considering the earnings rebound during 2027E, coupled with a possible partial relaxation in policy rates, sentiment is expected to renewed as equities favored over fixed income investments. Considering this, we expect ASPI to trade between 10x – 12x again in 2027E.



FCR's 2027E outlook: 24,500 base, 26,500 bull



FCR sets 2027E targets of 24,500 (base) and 26,500 (bull), backed by double-digit earnings growth and a possible early-2027E rate cut lifting sentiment.

FCR expects the ASPI to trade sideways at 9x-10x PER for the rest of 2026E, with a brief dip to 8x possible in an event of renewed ME tensions.

ASPI Consolidates Ahead of the 2027E Re-Rate

Earnings Trajectory: Short-Term Drag, Medium-Term Recovery

- Corporate profits expanded 25.5% YoY in 2025 — tracking closely with our prior 25.0% projection. Going into 2026E, we've held our earnings growth estimate at 8.2%, factoring in margin compression driven by elevated energy costs.
- The mid-June 2026 US-Iran ceasefire has taken some heat off geopolitical risk, though we expect the knock-on economic effects from the earlier disruption to continue working through the local economy for some time yet.
- Growth momentum is likely to soften from the 5.1% GDP print in 1Q2026, with inflationary pressure, potential electricity tariff hikes, and the delayed impact of currency depreciation all weighing on corporate top lines and margins.
- We expect most of these pressures to fade over the course of 2026, supporting an unchanged 2027E earnings growth call of 14.0% — underpinned by softer oil prices, a pickup in government expenditure, and the possibility of monetary easing in the first half of the year.

Index Targets: Steady Through 2026E, Re-Rating Into 2027E

- Given flat earnings expectations for 2026E and competitive yields available in fixed income, we anticipate the index will trade in a narrow, low-volume band of 9.0x-10.0x PE through the year.
- A renewed flare-up in regional tensions could pull valuations down to roughly 7x PE (~19,000), though we'd view this as a temporary setback ahead of an anticipated climb to 24,000-25,000 in 2027E, powered by stronger earnings and rate-cut expectations.
- If the economic recovery surprises to the upside, there's room for a further re-rating toward the market's 18-year average of 12.0x PE — implying a fair value range of 26,000-27,000, above our central 2027E estimate of 26,500.

Source: CSE, First Capital Research

First Capital Downgrades Equity Exposure to 50% and Cash to 50%

First Capital
A Janashakthi Group Company

Recommendation for Funds allocated purely for Equity investments

Previous Recommendation: March 2026

Equity – 65%

Cash – 35%

Current Recommendation: June 2026

Equity – 50%

Cash – 50%

Given the shifting macro environment, FCR is calling for a more cautious portfolio tilt, trimming equity weight to 50% from 65% and lifting cash holdings to 50% from 35%. The shift is designed to protect capital during this period of elevated uncertainty, while still keeping enough market exposure to benefit if conditions turn more favorable. Just as importantly, holding a larger cash buffer gives investors the agility to move quickly and put capital to work as fresh opportunities surface heading into the next upturn.

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.

Source: CSE, First Capital Research

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Thank You

"Successful investment is about managing risks"

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