



First Capital
A Janashakthi Group Company

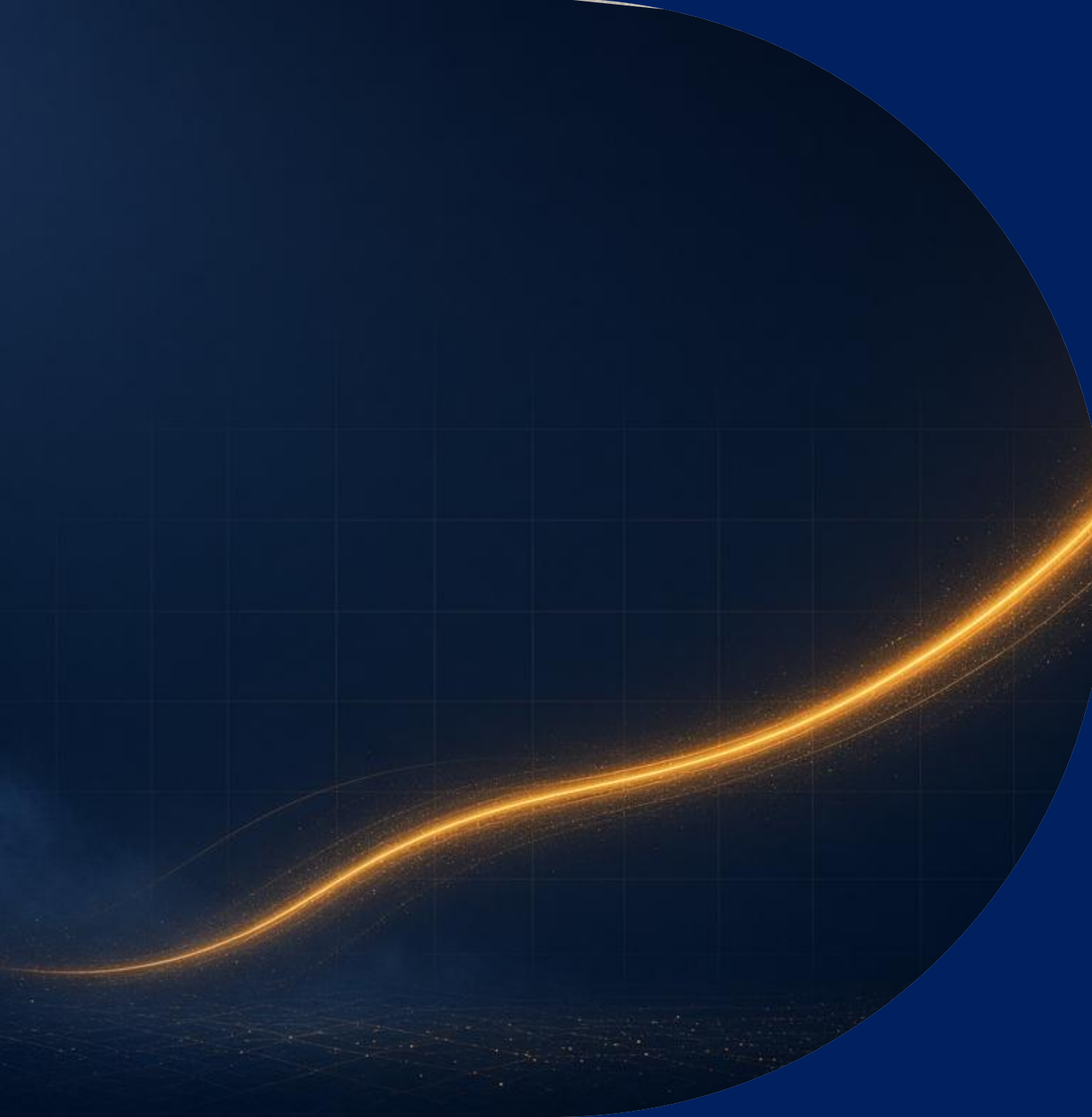
“Liquidity vs. Inflation: A Steeper Curve Emerges”

FIRST CAPITAL FIXED INCOME RECOMMENDATION | 18 Sep 2026

FIRST CAPITAL RESEARCH

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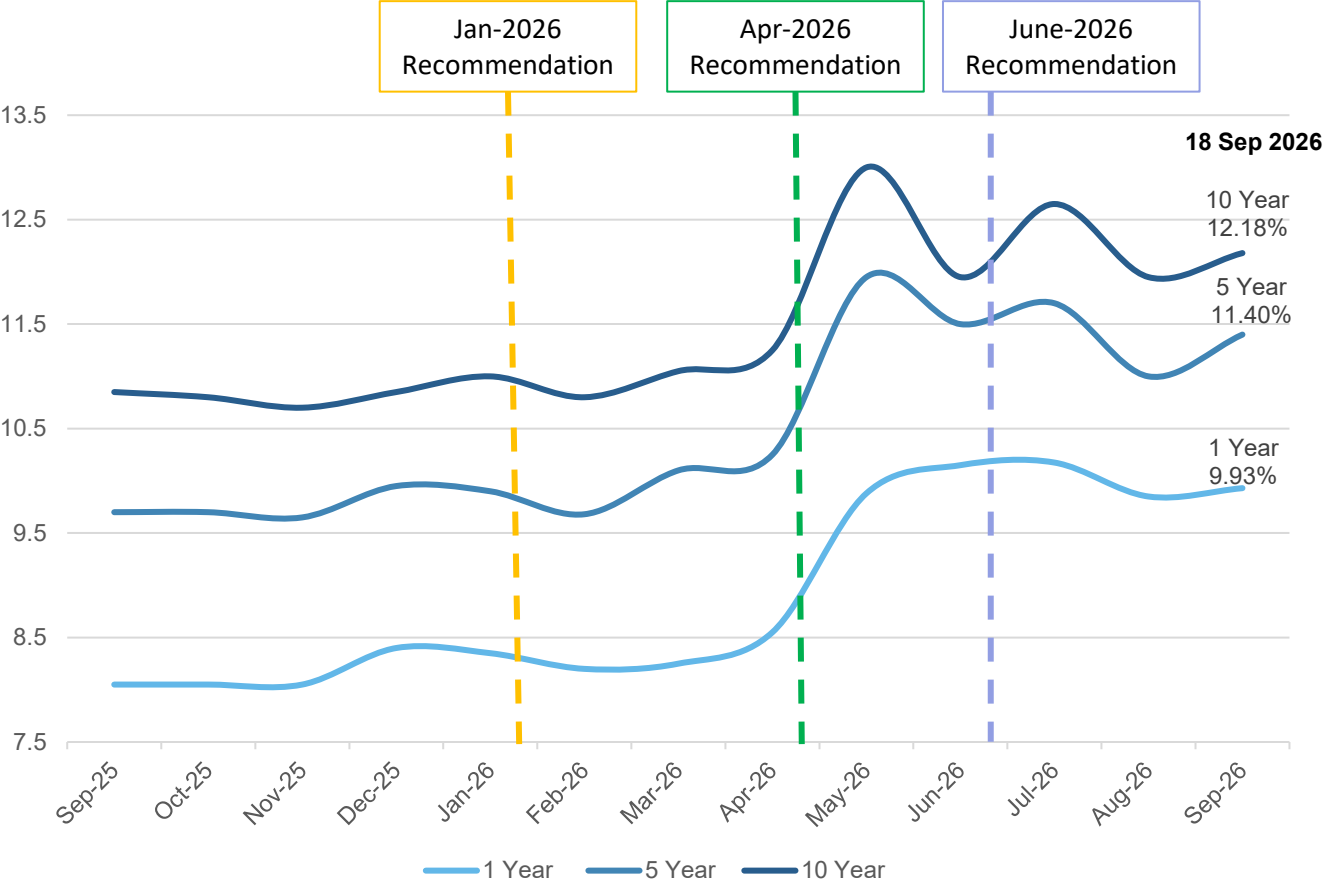


1. Previous Recommendation

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



Accuracy of previous recommendations:



22nd January 2026

"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



06th April 2026

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

-Accurate



30th June 2026

"...[we advise] investors to adapt a cautious stance and stay amongst short to mid tenors, whilst slight selling pressure is expected on the longer tenors..."

-Accurate



Review on market movement: Jul – Aug 2026

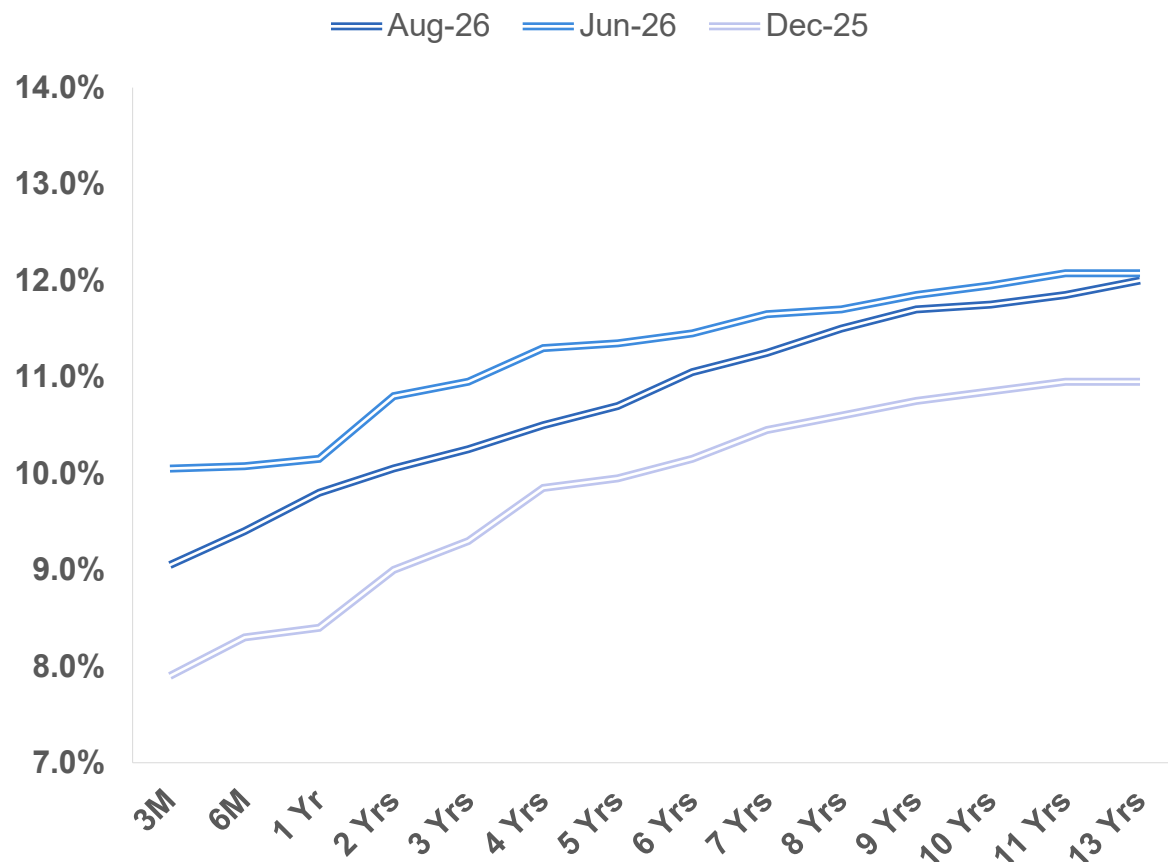
Consistent with FCR's expectations, bond yields moderated across the curve during Jul-Aug 2026, led primarily by a decline in short-tenor yields. Improved liquidity conditions, easing concerns over inflation, and expectations of softer economic activity supported investor demand for government securities. As a result, short-tenor yields moved closer to FCR's target bands, while mid and long tenor yields remained broadly stable, validating the recommendation to maintain a defensive short-duration portfolio.

- ✓ Short-term yields declined materially during Jul-Aug 2026, with the 1Y yield falling from around 10.15% at end-Jun to 9.80% by end-Aug. As of 18-Sep, yields have increased modestly to around 9.90%, remaining below end-Jul levels, reflecting continued investor demand for shorter-duration securities despite the recent upward adjustment.
- ✓ Mid- and long-tenor yields declined more moderately during Jul-Aug 2026, with the 5Y yield easing from 11.50% to 10.70% and the 10Y yield from 11.95% to 11.75% by end-Aug, broadly in line with FCR's expectation for a relatively stable longer end of the curve. However, yields have since reversed higher, with the 5Y yield rising to 11.40% and the 10Y yield to 12.18% as of 18-Sep.
- ✓ The yield curve bull-steepened during the period, with short-end yields declining more sharply than long-end yields, supporting FCR's view that greater value remained in shorter maturities.
- ✓ System liquidity increased steadily during July and August, exceeding LKR 175Bn in July and LKR 200Bn in August, driven by substantial foreign exchange purchases by the CBSL following its temporary pause during the Middle East conflict. To absorb excess liquidity, the CBSL conducted open market operations through overnight and term reverse repo auctions. Including liquidity absorbed through these operations, outstanding excess system liquidity exceeded LKR 300Bn by end-August, providing significant support to the decline in short-term yields and the bull-steepening of the yield curve.
- ✓ In addition, comments made by the CBSL Governor in early August, suggesting a lower likelihood of further policy rate hikes unless warranted by evolving economic conditions, further reinforced the downward movement in yields and supported investor demand for government securities.
- ✓ As a headwind, private sector credit growth remained strong at around 28% YoY during May-Jun 2026, with outstanding credit rising by LKR 483Bn to LKR 11.3Tn despite higher rates, partly reflecting the delayed transmission of the May-26 policy rate hike.



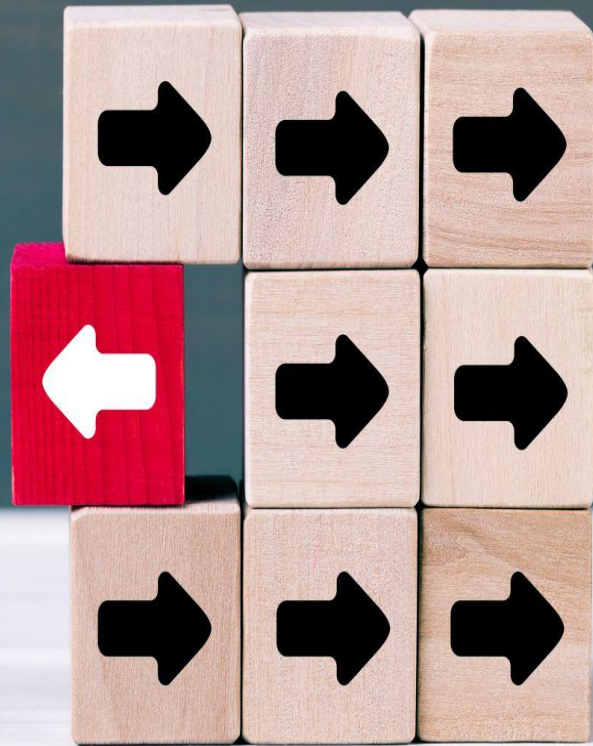
Overall yield curve movement

Yield curve Month-end comparison



Interest Rate Change (bps)

Tenor	Aug 2026	Jun 2026	Change (bps)	Dec 2025	Change (bps)
3M	9.05%	10.05%	-100	7.90%	+115
6M	9.40%	10.08%	-68	8.30%	+110
1 Yr	9.80%	10.15%	-35	8.40%	+140
2 Yrs	10.05%	10.80%	-75	9.00%	+105
3 Yrs	10.25%	10.95%	-70	9.30%	+95
4 Yrs	10.50%	11.30%	-80	9.85%	+65
5 Yrs	10.70%	11.35%	-65	9.95%	+75
6 Yrs	11.05%	11.45%	-40	10.15%	+90
7 Yrs	11.25%	11.65%	-40	10.45%	+80
8 Yrs	11.50%	11.70%	-20	10.60%	+90
9 Yrs	11.70%	11.85%	-15	10.75%	+95
10 Yrs	11.75%	11.95%	-20	10.85%	+90
11 Yrs	11.85%	12.08%	-23	10.95%	+90
13 Yrs	12.00%	12.08%	-8	10.95%	+105
15 Yrs	N/A	N/A	N/A	N/A	N/A
20 Yrs	N/A	N/A	N/A	N/A	N/A



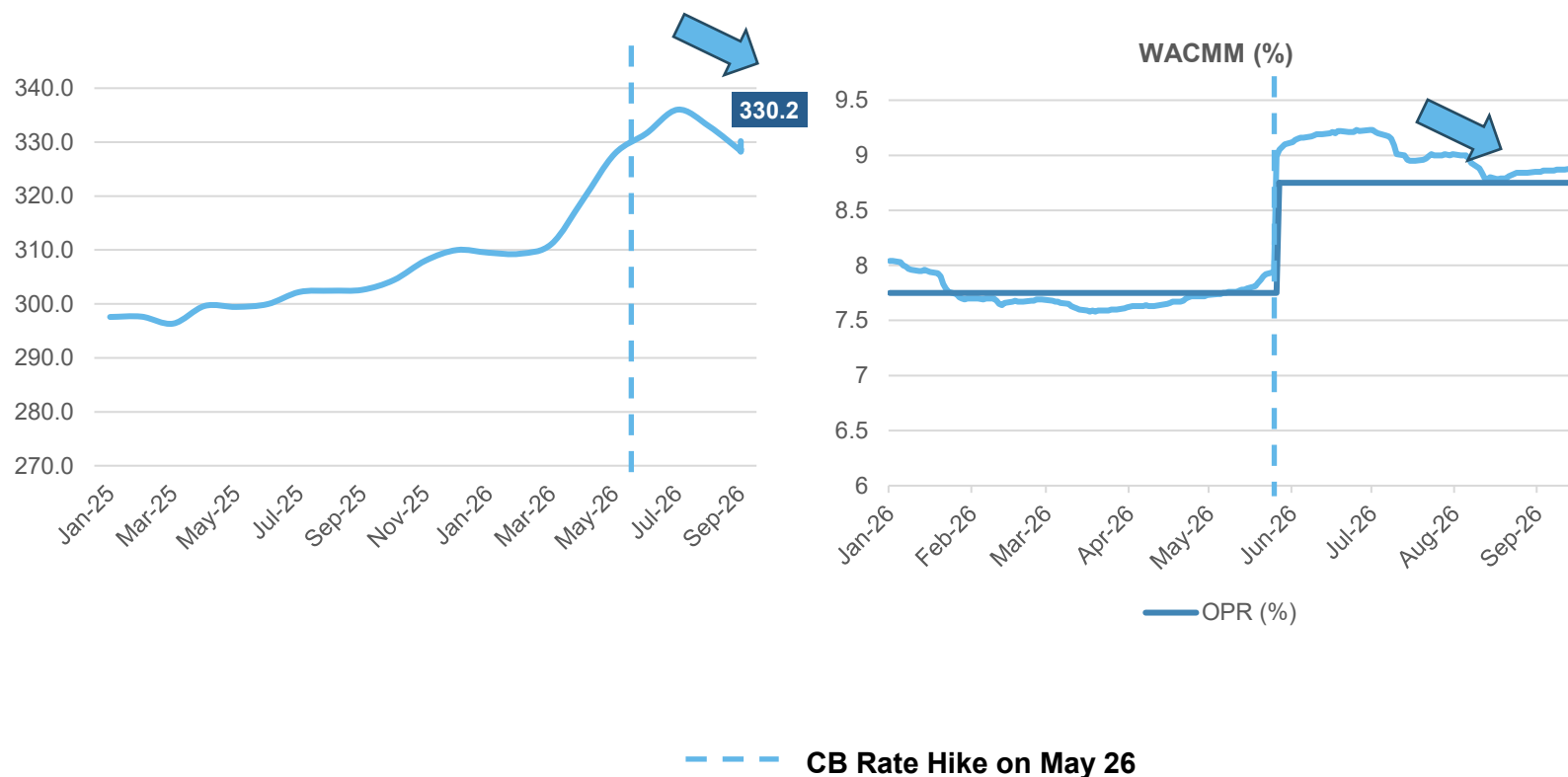
2. Outlook for Fixed Income Instruments

“Continued but Decelerating Short-end Easing, with the Belly And Long End Largely Range-bound”



Policy actions have helped restore market stability

CB Rate hike helped to stabilize the USDLKR rate while money market rates dropped from the initial peak

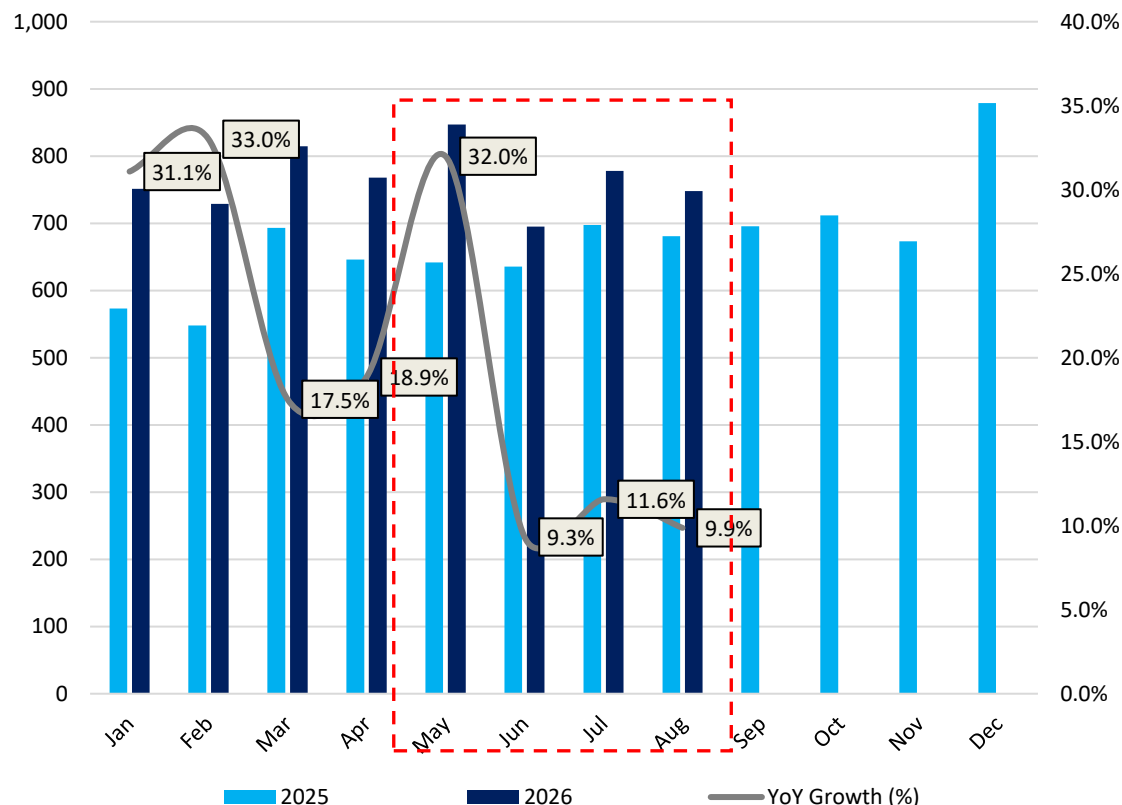


- ✓ Rupee depreciation pressures have largely subsided following the CBSL's 100 bps rate hike and tighter FX measures.
- ✓ These actions helped restore market confidence and improve exchange rate stability.
- ✓ The LKR's appreciation is in line with our June FCR forecast, which anticipated that the initial market overreaction would gradually unwind in the short term.
- ✓ At the same time, the Central Bank injected liquidity into the banking system, contributing to a gradual easing of short-term money market rates after the immediate post-hike adjustment.



Remittances continue to anchor external stability

Worker remittances record strong growth during Jan-Aug 2026



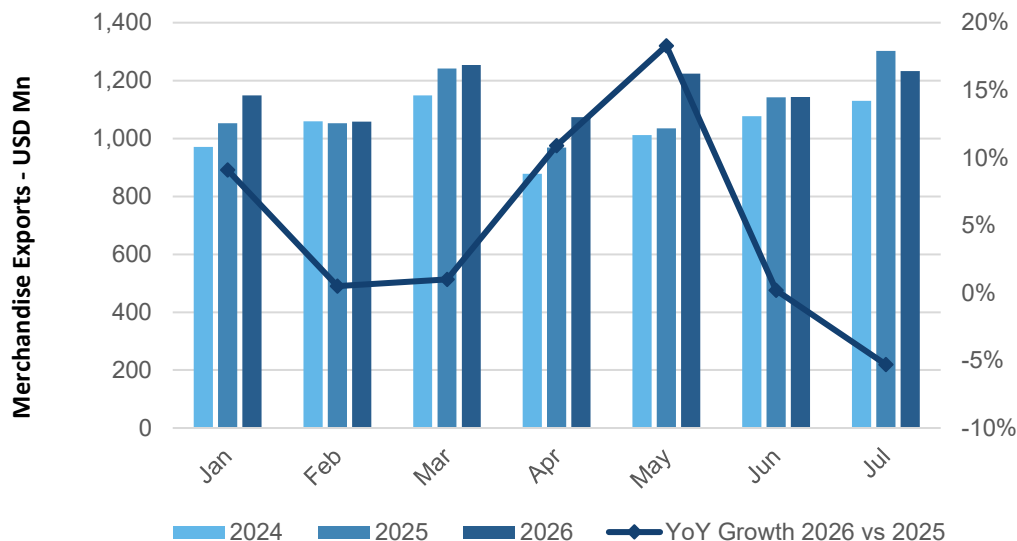
- ✓ Workers' remittances remained a key source of foreign exchange inflows, rising 20% YoY to USD 6.13 Bn during Jan-Aug 2026 and helping offset pressures from the wider trade deficit.
- ✓ Monthly remittances remained resilient at USD 749 Mn in Aug-26, supported by continued overseas employment and stronger formal remittance channels.
- ✓ The strength of remittance inflows has been a major factor supporting the recent improvement in external liquidity conditions, alongside the moderation in fuel-related import pressures.
- ✓ Given the softer outlook for tourism earnings and mixed performance across exports, remittances remain the most reliable source of non-debt creating foreign exchange inflows.
- ✓ Accordingly, sustained remittance growth remains critical to preserving external stability, supporting reserve accumulation, and maintaining favourable liquidity conditions in the domestic financial system.
- ✓ Worker remittances remain broadly on track to achieve FCR's 2026E forecast of USD 9.6Bn, continuing to provide a key buffer for the external sector.



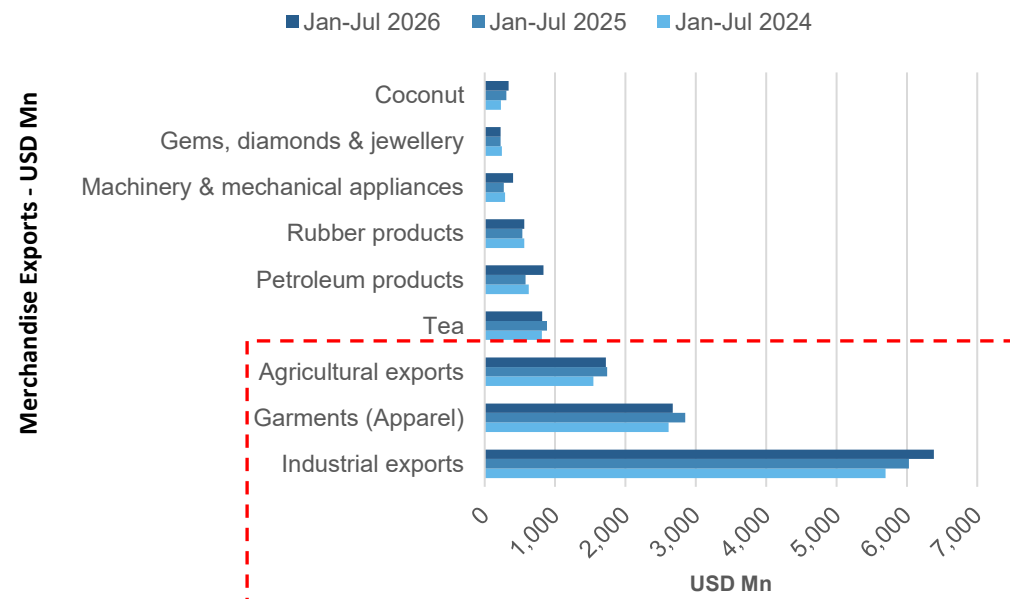
Exports remain resilient despite weak global demand

- ✓ Merchandise exports continued to expand during Jan-Jul 2026, broadly in line with FCR's expectation of modest export growth in 2026E, despite softer demand across several key export categories and markets.
- ✓ Export growth remains uneven across sectors, with apparel, tea and several key export categories facing softer demand from major markets.
- ✓ Weak growth in key trading partners is likely to constrain the pace of export earnings growth over the near term.
- ✓ While exports should continue to provide support to the external sector, they are unlikely to generate a material improvement in the balance of payments on their own.

Total exports remain robust during Jan-July 2026...



...while mixed results over key exports categories

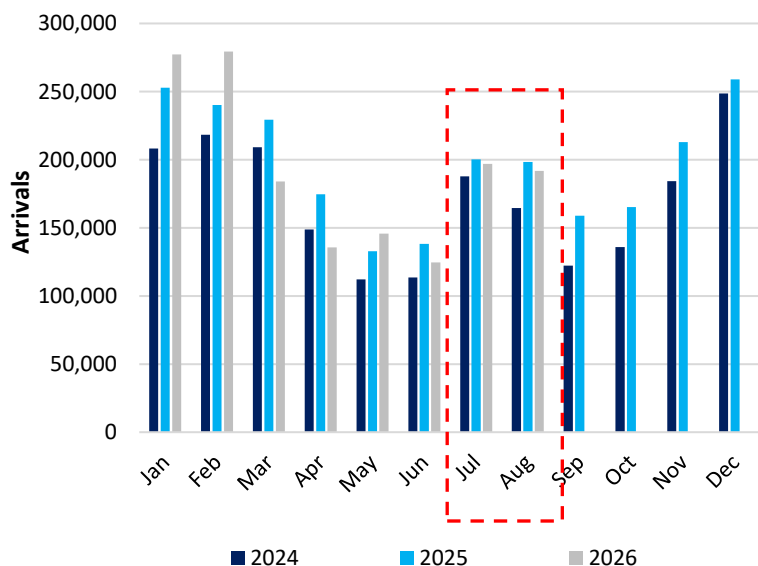




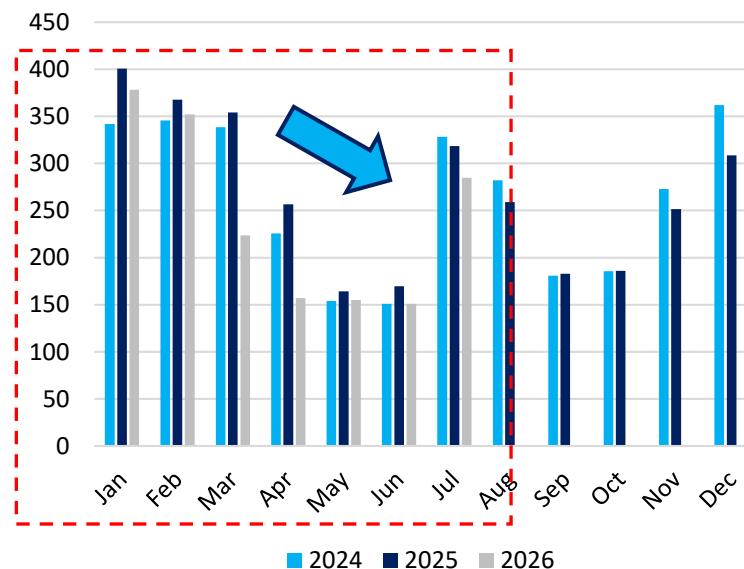
Tourism supports FX inflows, though earnings remain soft

- ✓ Tourist arrivals reached 1.57 Mn during Jan-Aug 2026, broadly maintaining the levels recorded in the corresponding period of 2025 despite earlier disruptions linked to Middle East tensions. Tourist arrivals, remaining broadly on track to achieve FCR's 2026E forecast of 2.5Mn arrivals, although tourism earnings continue to lag amid weaker spending per visitor.
- ✓ While tourist arrivals remained broadly stable, survey-based tourism earnings estimates declined by 11.5% YoY during Jan-Jul 2026 under SLTDA's revised methodology.
- ✓ Performance across major source markets remained mixed, with strong growth from China and India offset by softer arrivals from several European markets, resulting in a muted overall improvement in tourism-related inflows.
- ✓ As a result, while tourism continues to support foreign exchange inflows, the sector is unlikely to provide a significant boost to external sector balances in the near term.

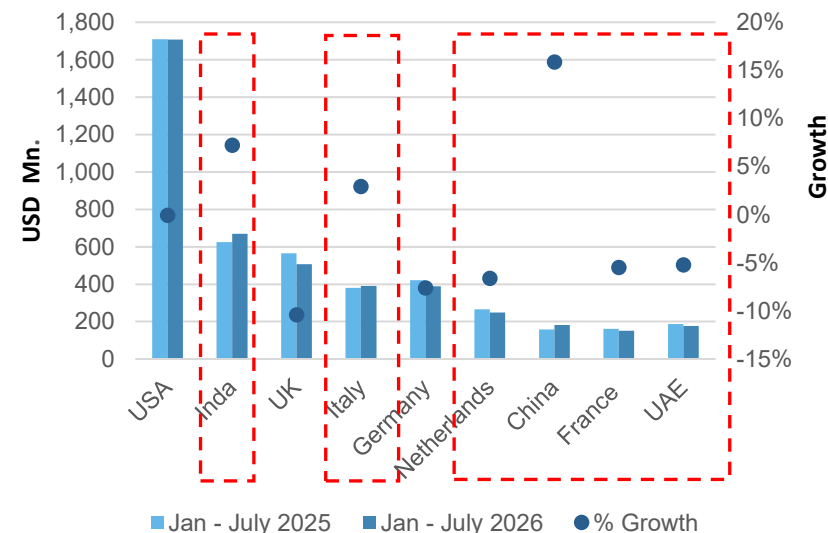
Arrivals remain resilient...



...but earnings continue to lag



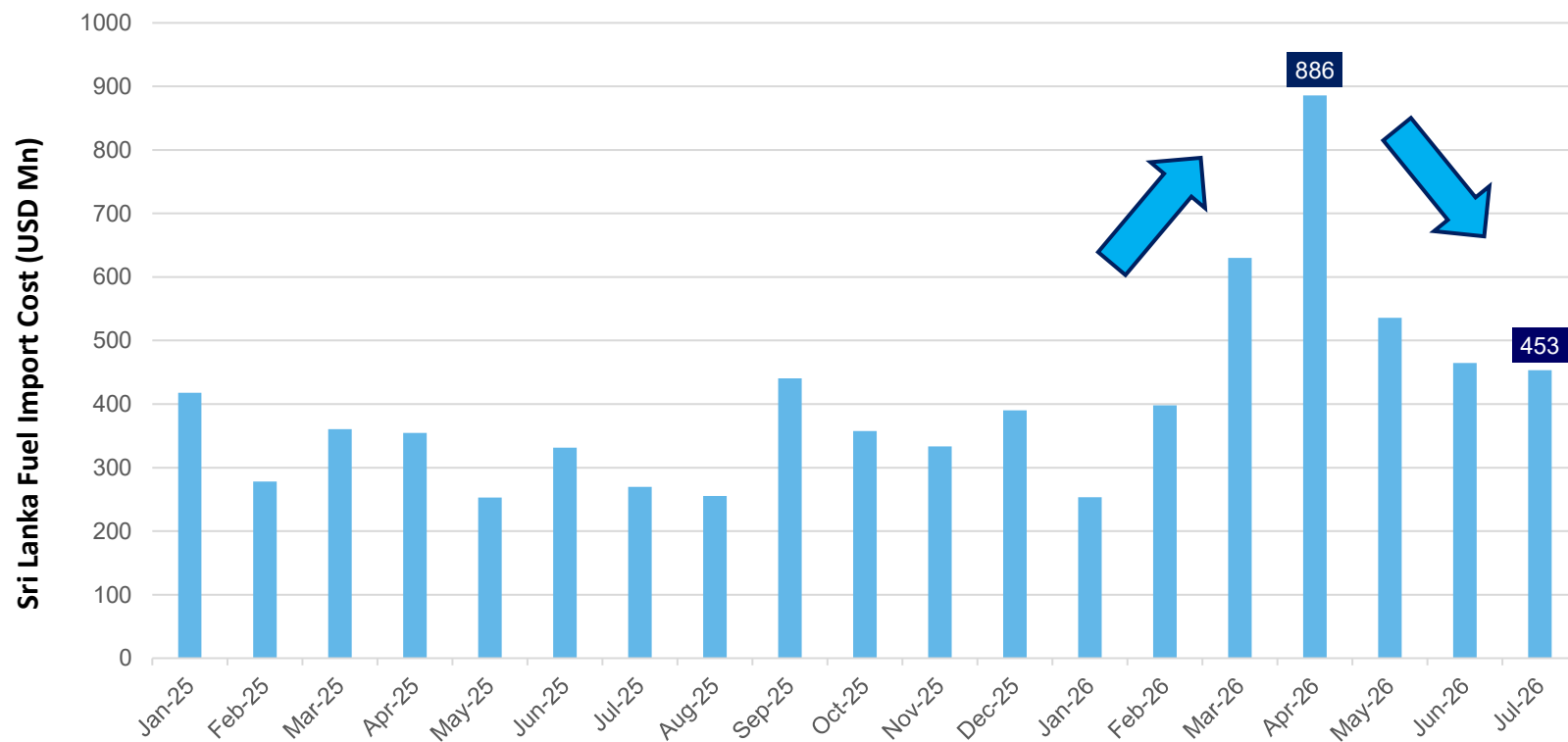
...amid mixed performance across key markets





Lower fuel import costs have reduced external pressures

Fuel import costs peaked at USD 886Mn in Apr-26 but eased to USD 453Mn by Jul-26, helping reduce external sector pressure and support domestic liquidity conditions

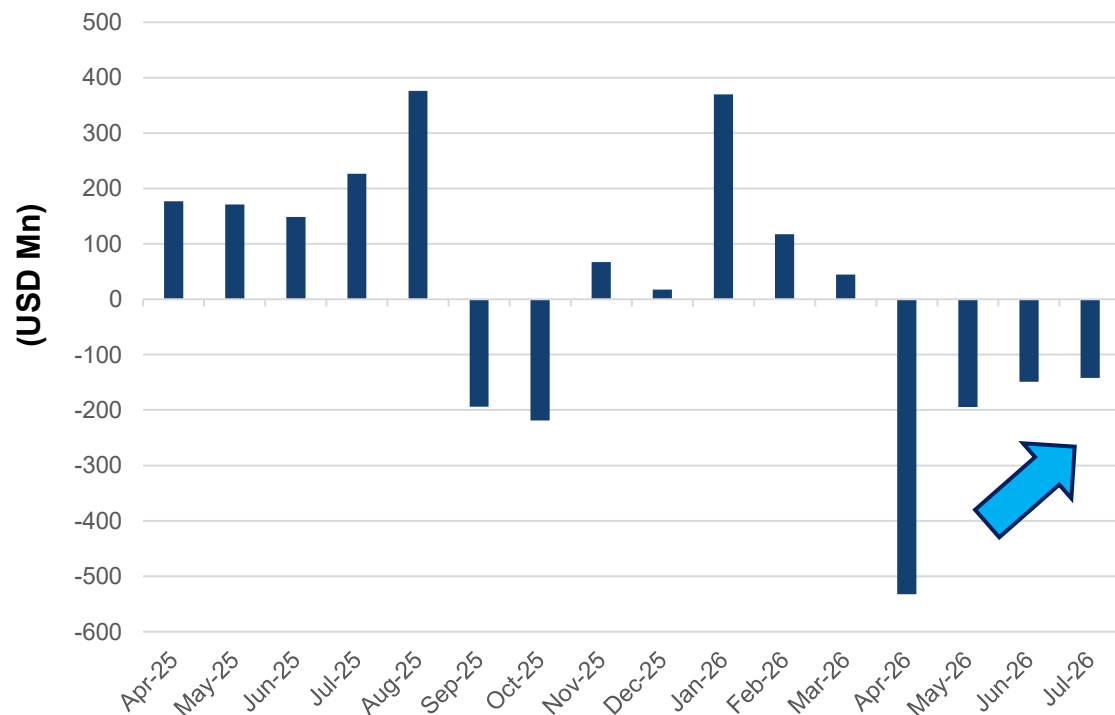


- ✓ Fuel import costs surged during the height of the Middle East tensions, peaking at USD 886Mn in Apr-26 amid higher oil prices and elevated risk premiums.
- ✓ The fuel bill subsequently eased to USD 453Mn by Jul-26 as oil prices moderated, premiums normalized, and domestic fuel demand softened.
- ✓ Lower fuel-related dollar outflows helped improve external liquidity, enabling CBSL to rebuild FX liquidity and support the easing bias in short-term interest rates.



Collectively, these developments have largely offset earlier current account pressures

The wider current account deficit recorded in Apr-26 narrowed by Jul-26

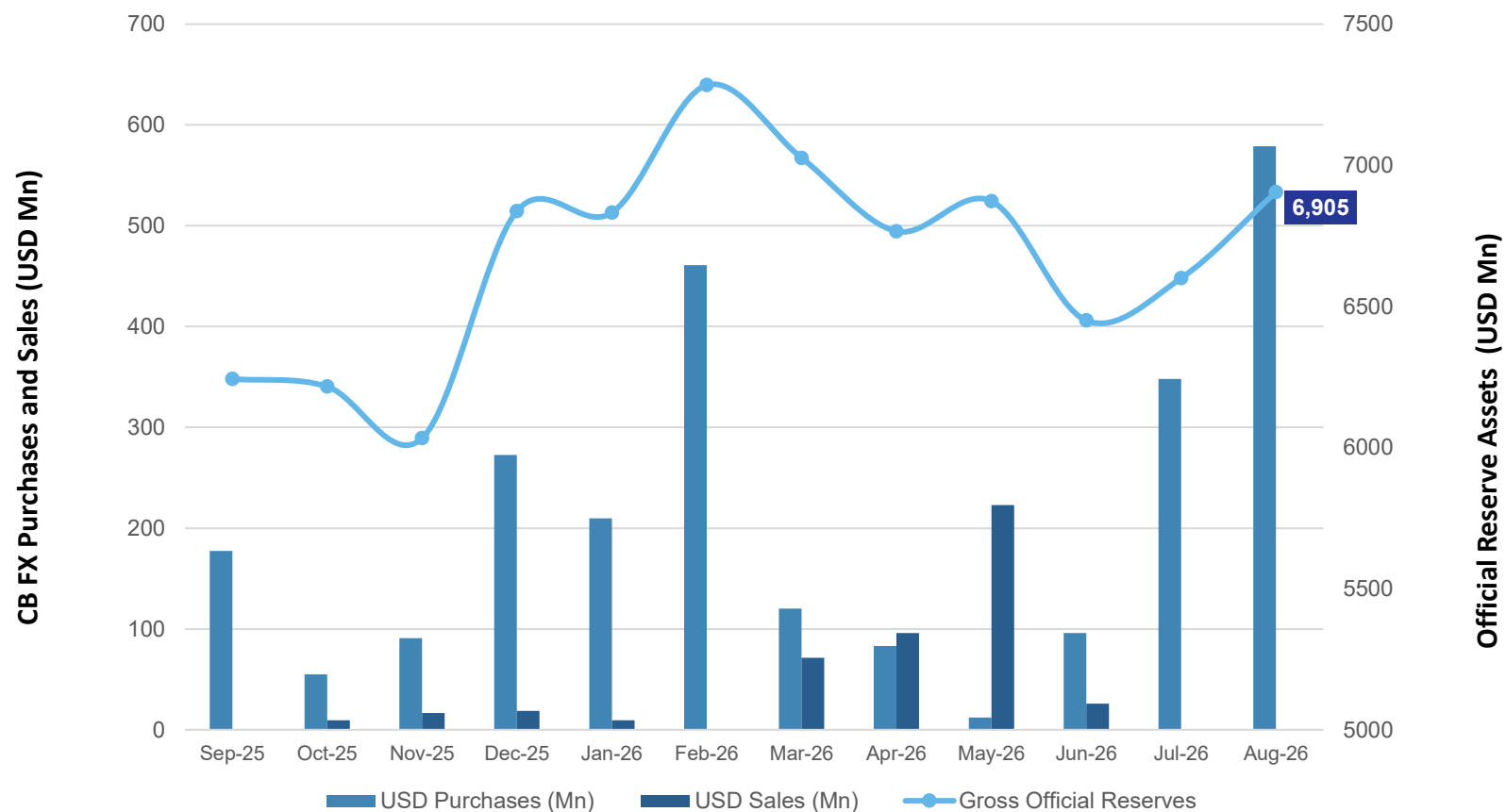


- ✓ The current account recorded its widest deficit in Apr-26 amid heightened Middle East tensions and elevated fuel import costs.
- ✓ Since then, improving remittance inflows and a sharp moderation in fuel import costs have helped ease external sector pressures.
- ✓ As a result, the monthly current account deficit narrowed to USD 142Mn in Jul-26 from the Apr-26 trough, indicating a gradual improvement in Sri Lanka's external position.
- ✓ The improving external backdrop has supported stronger FX liquidity, helping sustain excess liquidity in the banking system and reinforcing the easing bias at the short end of the yield curve.
- ✓ Cumulatively, the current account recorded a deficit of USD 387Mn during Jan-Jul 2026, whereas FCR expects the current account to remain broadly balanced in 2026E (USD 19.5Mn surplus), with stronger remittances largely offsetting pressures from trade and tourism.



Improved external conditions support FX reserve build-up

Improved FX liquidity supported substantial dollar purchases while reserves remained stable

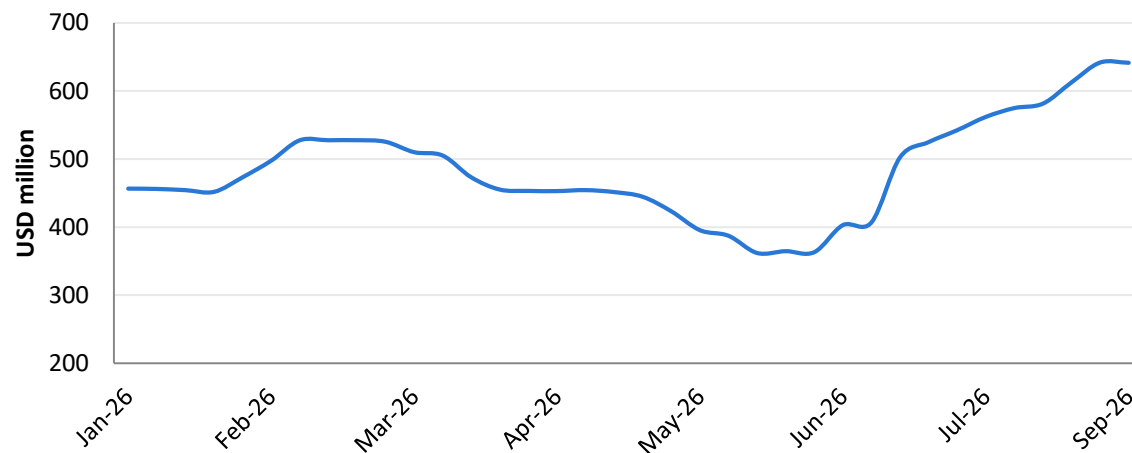


- ✓ CBSL accelerated net FX purchases to USD 579Mn in Aug-26 as market liquidity improved.
- ✓ Given sustained dollar purchases, gross official reserves increased to USD 6.9Bn through Aug-26.
- ✓ Reserve levels remain within our year-end target of USD 7.25 Bn.
- ✓ The combination of strong FX purchases and stable reserves suggests that improved foreign currency inflows were sufficient to support external sector stability while enabling reserve build-up.

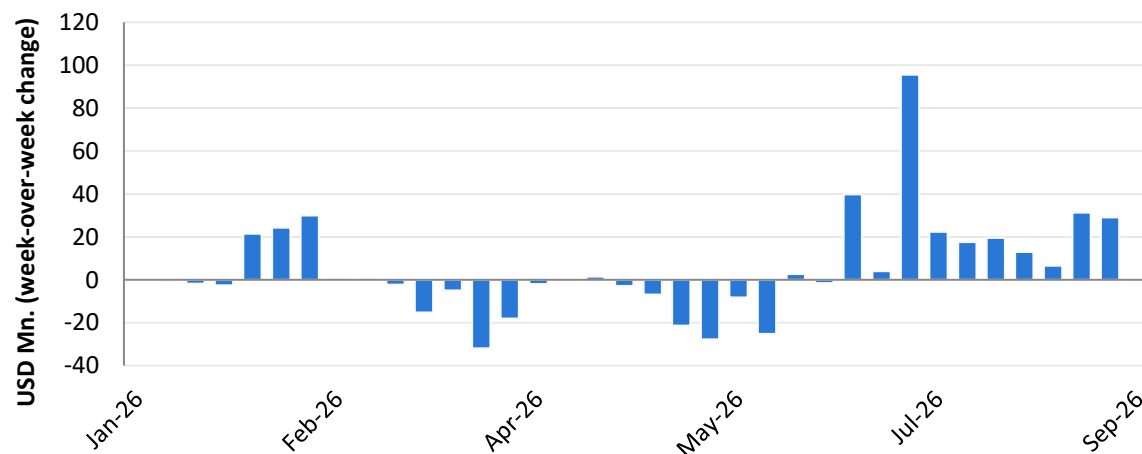


Improving fundamentals continue to attract foreign participation

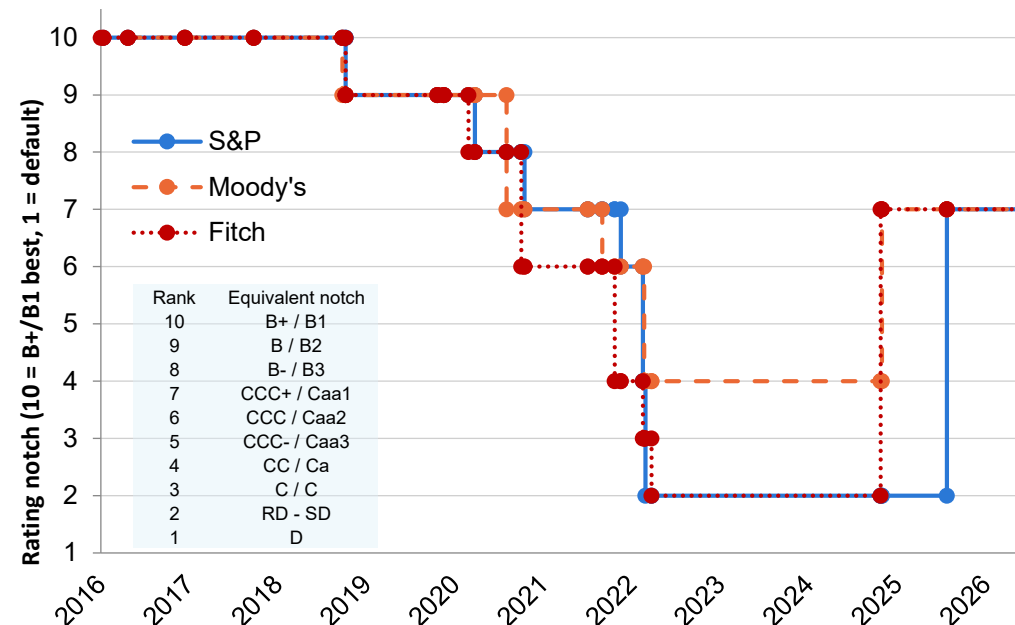
Foreign holdings of T-Bills & T-Bonds (USD mn)



Weekly net foreign flow to TBills & Bonds (USD mn)



Sri Lanka sovereign credit rating history (2016-2026)

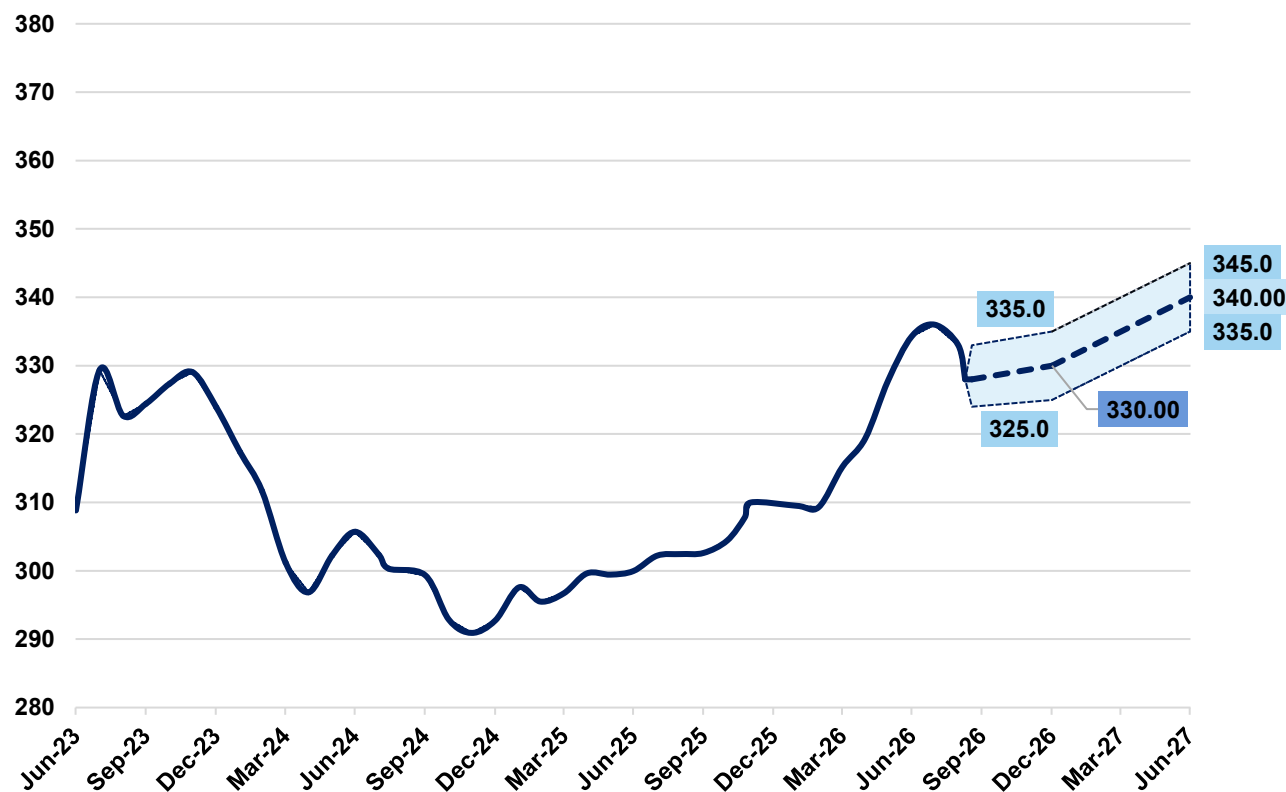


- ✓ Foreign inflows to government securities strengthened alongside improving external sector conditions.
- ✓ Moody's reaffirmed Sri Lanka's Caa1 foreign currency issuer rating, while noting residual external vulnerabilities.



A more stable external environment supports the LKR

FCR now expects the LKR to trade within a range of 325.0-335.0 in 4Q2026E and 335.0-345.0 in 1H2027E

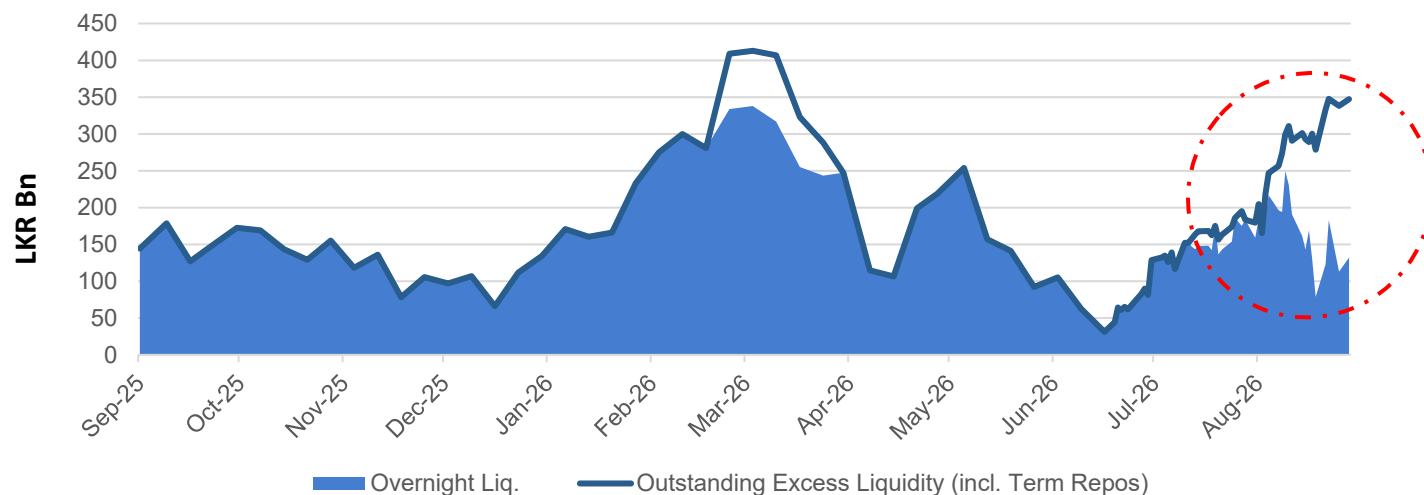


- ✓ The LKR depreciated by 5.5% YTD by end-Aug-26 amid a wider trade deficit and elevated fuel import costs.
- ✓ However, the LKR appreciated moderately in July and August, in line with the FCR forecast that the earlier excessive depreciation was likely to moderate.
- ✓ Nevertheless, the current account remains in deficit, while reserve accumulation continues to face challenges from import demand and external debt repayments.
- ✓ Accordingly, FCR expects the LKR to trade within 325.0-335.0 in 4Q2026E and 335.0-345.0 in 1H2027E.
- ✓ A more stable currency outlook reduces the likelihood of further policy tightening and supports gradual easing at the short end of the yield curve.

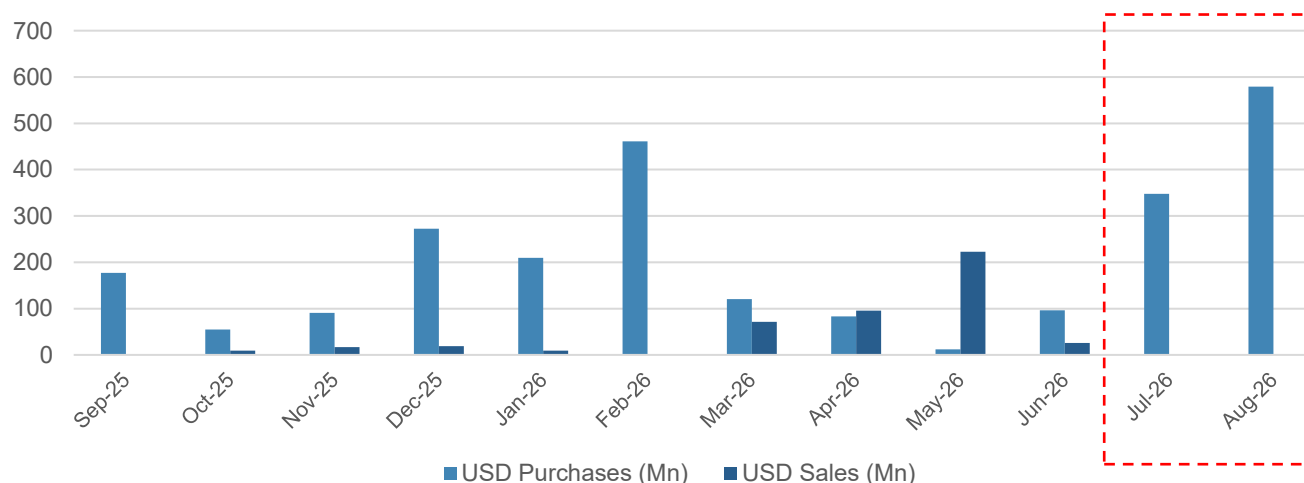


Improved FX liquidity is supporting domestic liquidity conditions

System liquidity has gradually retreated from the highs seen in recent months...



... amid the CBSL shifting from USD purchases to increased USD sales in recent months

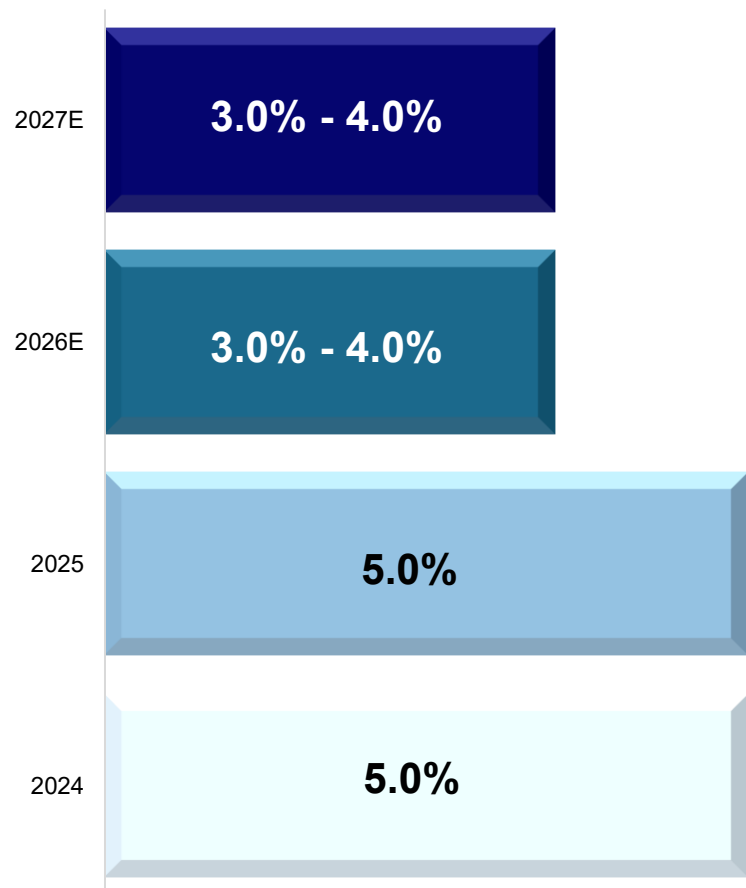


- ✓ Average system excess liquidity stood at approximately LKR 150Bn during July 2026. Including term repos, outstanding excess liquidity averaged around LKR 209Bn, remaining high similar to the Q1 2026 peak.
- ✓ Liquidity recovery remains consistent with the FCR mid-year forecast (LKR 100-200 Bn), though the outturn has exceeded expectations.
- ✓ A key driver of elevated liquidity was CBSL's net USD purchases, which turned sharply positive during July-Aug.
- ✓ Excess liquidity is likely to remain high but gradually ease, supported by tighter reserve requirements and CBSL liquidity absorption measures. A sustained surplus could raise the probability of a higher SRR.
- ✓ Therefore, we target LKR 150-250Bn outstanding liquidity for the remainder of the year.



Economic activity is expected to moderate

Gross Domestic Product Growth (%) to moderate to 3.0%-4.0% in 2026E

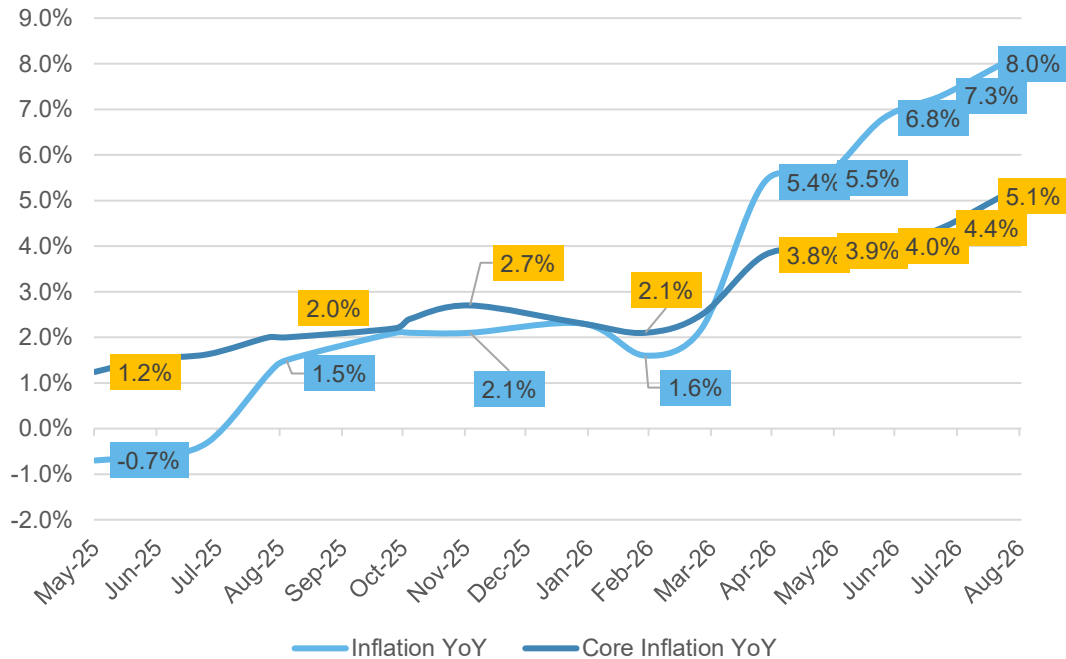


- ✓ GDP growth is expected to moderate to 3.0%-4.0% in 2026E-2027E as the lagged effects of the May-26 policy tightening continue to weigh on consumption and investment.
- ✓ The moderation in growth suggests that monetary policy is continuing to transmit through the broader economy.
- ✓ A softer growth outlook reduces the likelihood of further policy tightening, particularly amid signs that policy rates may have already peaked.
- ✓ Accordingly, slower economic growth provides an additional basis for a policy pause and supports lower short-term interest rates.

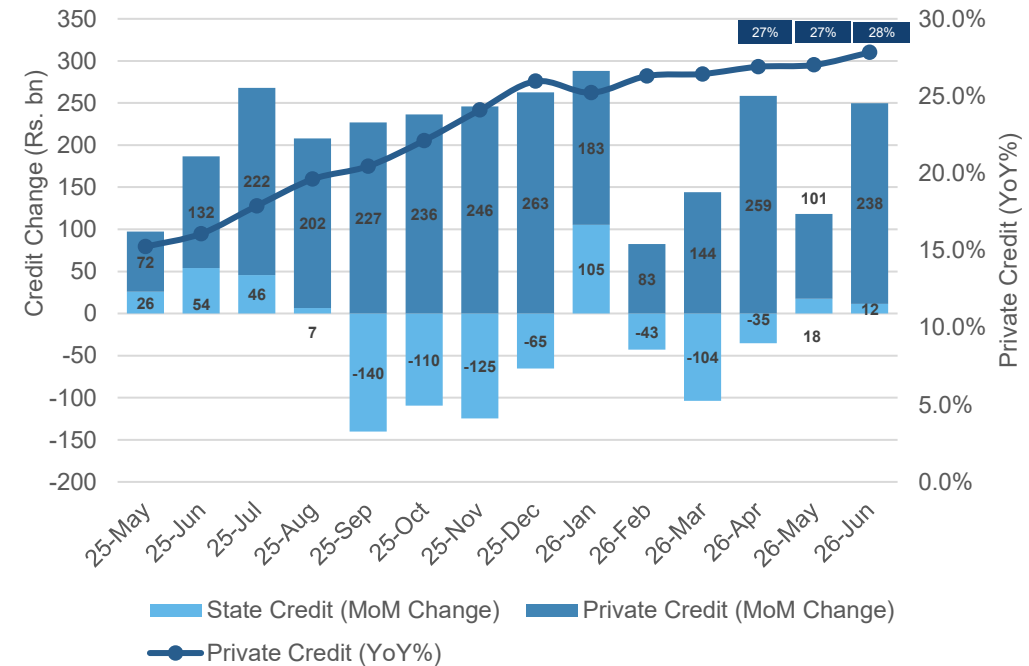


Inflation and credit growth remain key headwinds

Inflation rose above CB upper band 7% during July Aug



Private sector credit grows robustly 27.0%YoY in June-26

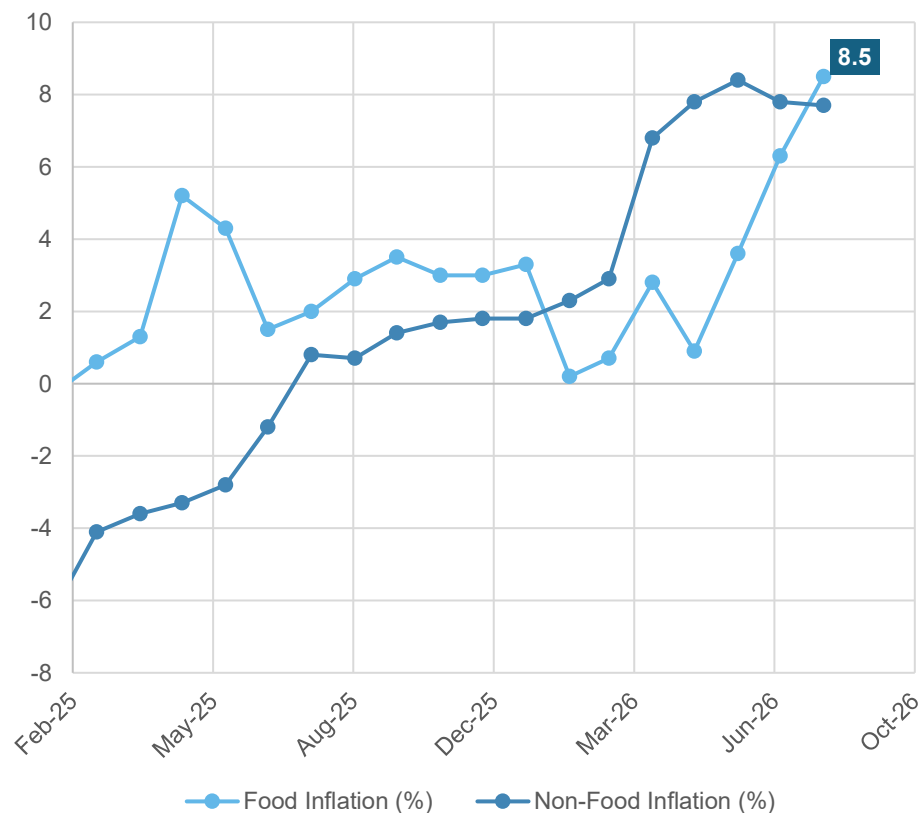


- ✓ Inflation moved above the CBSL's 7% threshold, while credit growth remained strong at 28% YoY.
- ✓ Both factors offset part of the liquidity benefit by absorbing excess liquidity and sustaining inflation expectations.
- ✓ As a result, while the short end may continue to ease, elevated inflation and resilient credit growth are likely to moderate the pace of further yield compression.



El Niño risks could add to inflationary pressures

Inflation projected stay above CBSL upper threshold for 2026E

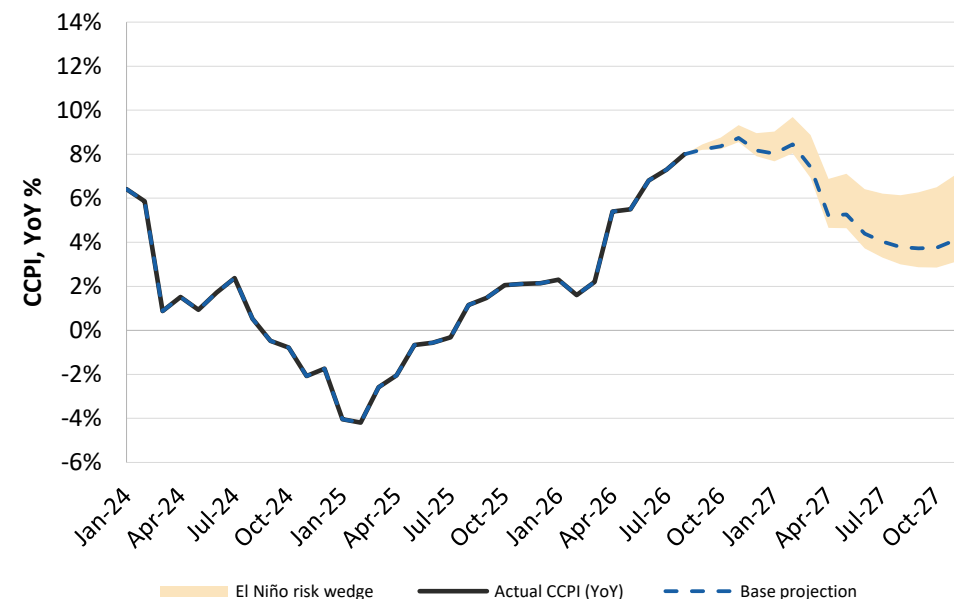
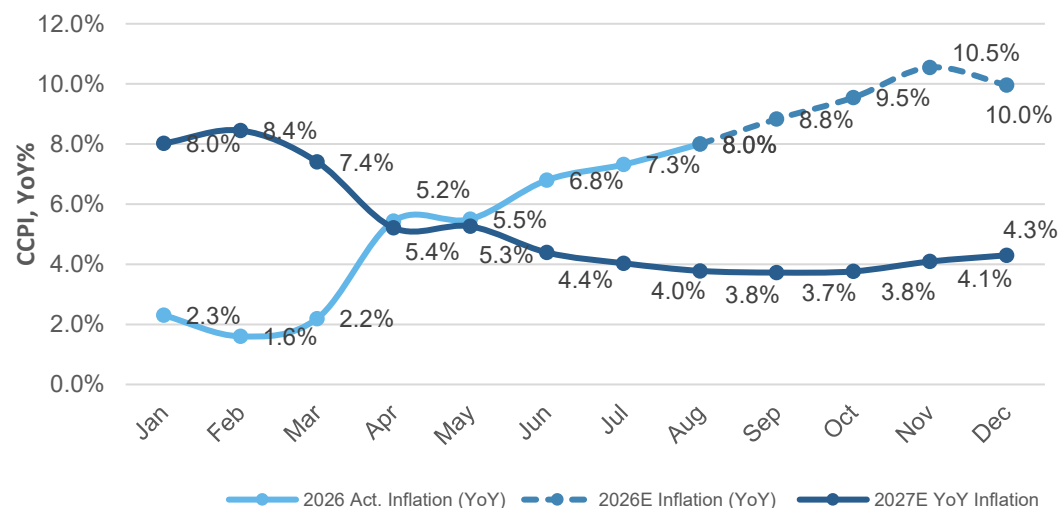


- ✓ *El Niño is a recurring climate phenomenon that disrupts rainfall patterns, often leading to excessive rainfall in some regions and drought conditions in others, adversely affecting agricultural output and food supply.*
- ✓ *The impact is already becoming visible in Sri Lanka, with nearly 80,000 hectares of agricultural land reportedly affected by adverse weather conditions.*
- ✓ *In response, the Government has allocated approximately LKR 3 billion for relief and remediation measures to support affected farmers and mitigate crop losses.*
- ✓ *The UN has also warned of a heightened risk of heavy rainfall events towards the end of 2026, raising the possibility of further disruptions to agricultural production and food distribution networks.*
- ✓ *With food inflation already accelerating to 8.5%, weather-related supply shocks could keep food prices elevated and sustain upward pressure on headline inflation through 2026E.*



Inflation risks likely to keep belly and long-end yields rangebound

Inflation projected stay above CBSL upper threshold for 2026E



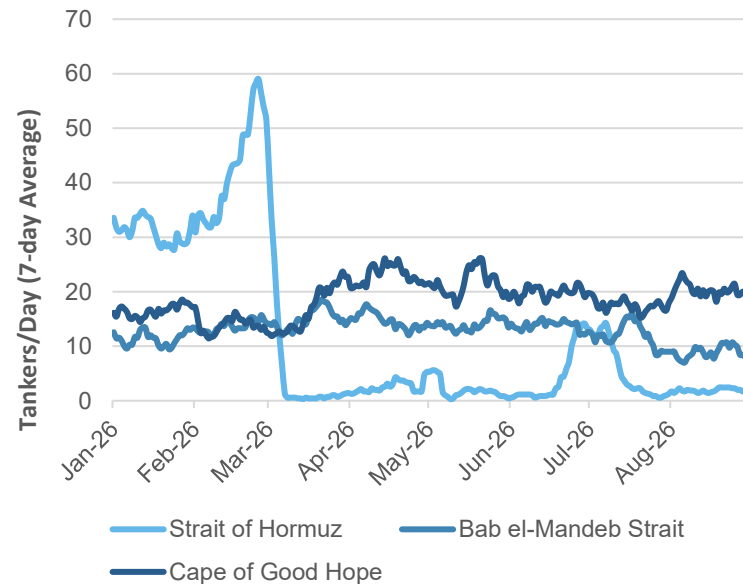
- ✓ *Headline inflation accelerated above the CBSL's upper tolerance band, reaching 8.0% YoY in Aug-26, driven by higher fuel prices, tariff adjustments, and rising food inflation.*
- ✓ *Realized inflation has broadly remained in line with FCR projections so far (7.3% for Jul-26 and 8.3% for Aug-26).*
- ✓ *Weather-related disruptions and supply-side pressures are expected to keep food inflation elevated in the coming months, posing upside risks to the inflation outlook.*
- ✓ *In addition, the severity of the El Niño event could further shift inflation away from the baseline projection.*
- ✓ *While supportive liquidity conditions may continue to weigh on short-end yields, elevated inflation remains a key constraint on a broader decline across the yield curve.*



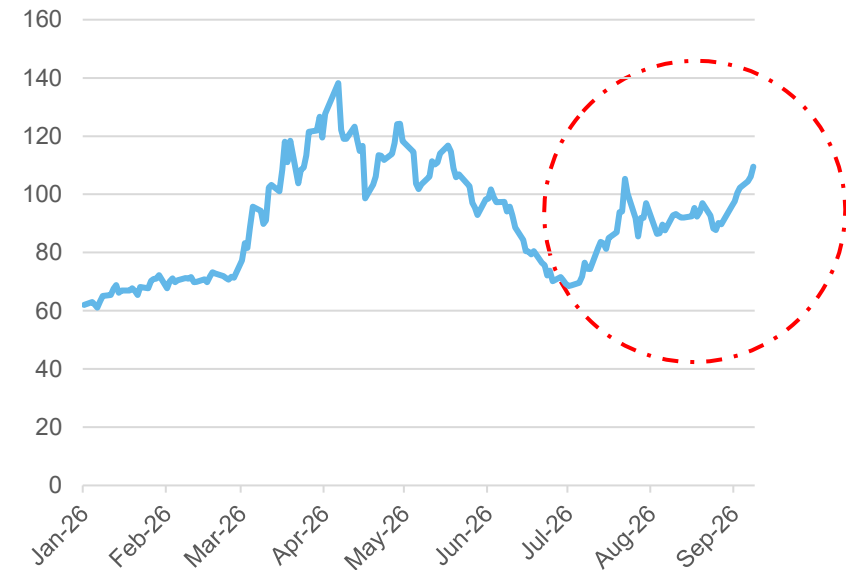
Risks: Elevated oil prices too continue to pose upside risks



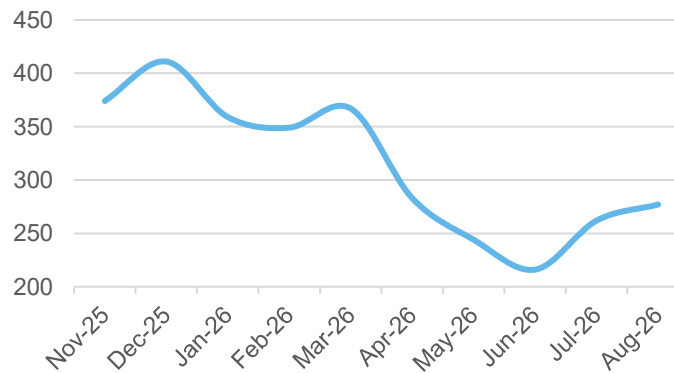
7-Day Avg. Oil Tanker Transits, Jan–Aug 2026



Brent crude oil futures (USD/BBL) remain elevated



Chinese Oil Imports (Mn/bbl)



- ✓ Supply risks remain elevated due to potential disruptions in both the Strait of Hormuz and Bab el-Mandeb, although alternative shipping routes provide some mitigation against Iran-linked regional tensions and intermittent Houthi attacks.
- ✓ Weak demand, particularly from China, continues to cap oil prices despite ongoing geopolitical tensions.
- ✓ Currently, oil prices are positioned near the upper boundary of FCR's "Renewed Flare-up" near-term outlook.

Route	Pre-War Avg (tankers/day)	Latest, Aug 2026 (tankers/day)	% Change
Strait of Hormuz	37.0	1.9	-94.9%
Bab el-Mandeb Strait	12.5	8.6	-31.4%
Cape of Good Hope	15.1	20.4	+34.5%

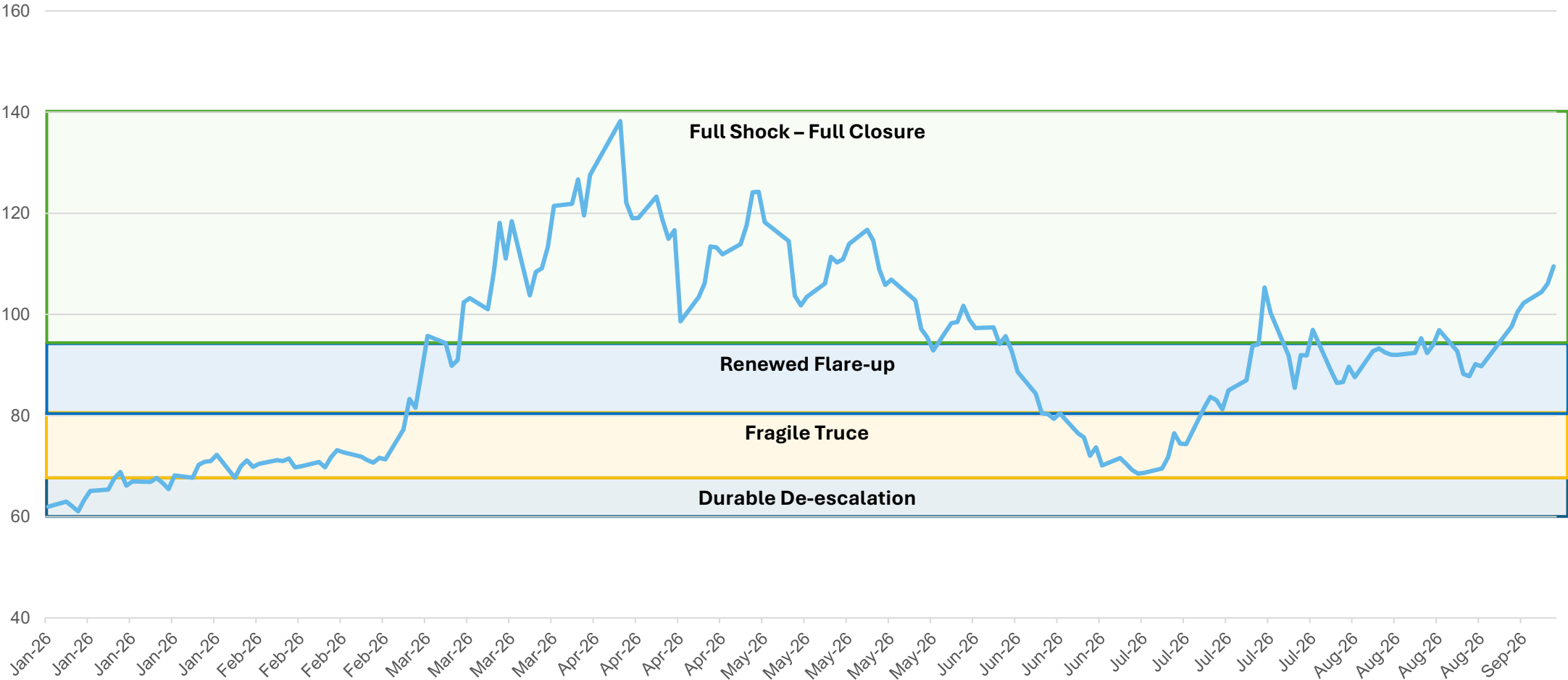


Geopolitical risks remain a key swing factor

 Scenario 1 20%	 Scenario 2 50%	 Scenario 3 20%	 Scenario 4 10%
Durable De-escalation	Fragile Truce	Renewed Flare-up	Full Shock Strait Closure
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% ASPI Target 28,000 – 32,000	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% ASPI Target 20,000 – 24,000	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% ASPI Target 17,000 – 19,000	BRENT USD 95 + CCPI 9.0–11.0% GOR <USD 4.5Bn OPR Repressed 1-10Yr 10.0% - 16%+ ASPI Target ↓15,000 → 24,000 – 26,000
POSITIVE	NEUTRAL	CAUTIOUS	RISK-OFF / REPRESSION



Oil price movement mapped to the scenarios





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 dropping 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 80 / 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 68–80 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%	USD 6.5–7.5bn	→ 8.75%	9.50 - 12.50%



Key assumptions for the scenarios cont...

S3 • Renewed Flare-up

~20% • Brent USD 80 – USD 95 / 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 80–95 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 hikes totalling to around 100bps 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 95+

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 above USD 95+ 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+%



3. Fixed Income Health Score

*“Health score to improve towards
4Q2026 and 1H2027 ”*



FI Economic Health Score: Jun – Aug 2026

The Fixed Income Health Score has improved by 7 points since its last update in June-26. While the rising inflation has somewhat deteriorated the score, the sharp rise in excess liquidity cushioned the impact and improved the score. The outstanding liquidity in the market has risen to LKR 347Bn



Primary Criteria

$$- \quad 40 \quad + \quad 07 \quad = \quad 47$$

Secondary Criteria

$$- \quad 16 \quad \pm \quad 0 \quad = \quad 16$$

Economic Health Score
[Jun 2026]

$$= \quad 63$$

[As against 56 in June-26 &
67 in Aug-25 (1 Year ago)]



Changes to Health Score

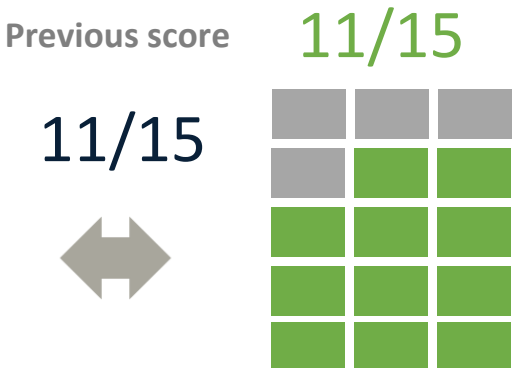
Primary Criteria: July – Aug 2026

47/75



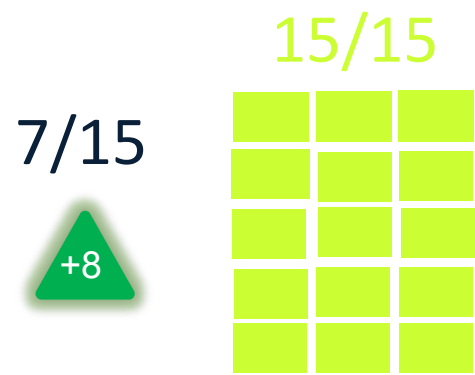
Foreign Reserves

Gross official reserves stood at USD 6.9Bn in Aug 2026, largely balanced by the foreign debt repayments and net USD purchases by the CBSL.



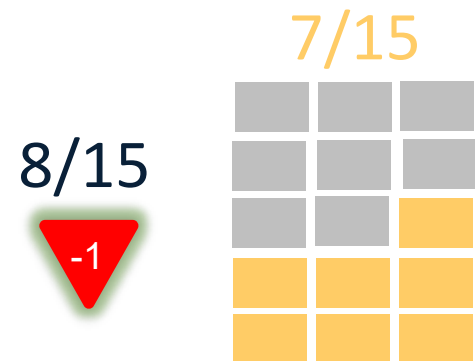
Liquidity

System excess liquidity improved sharply, although CBSL absorbed part of the surplus through term repos. By end-Aug-26, actual excess liquidity stood at LKR 132Bn, compared to LKR 347Bn including term repos.



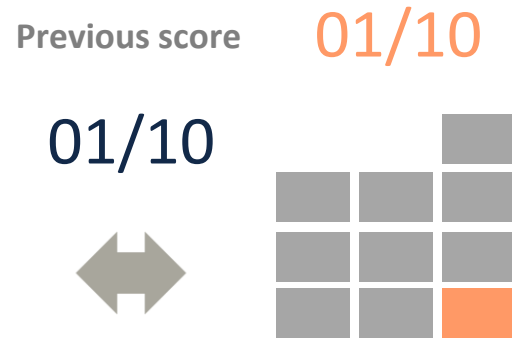
Inflation

Inflation rose sharply to 8.0%YoY in Aug-26, driven largely higher food prices that food related inflation recorded 8.5% (YoY) in the same month.



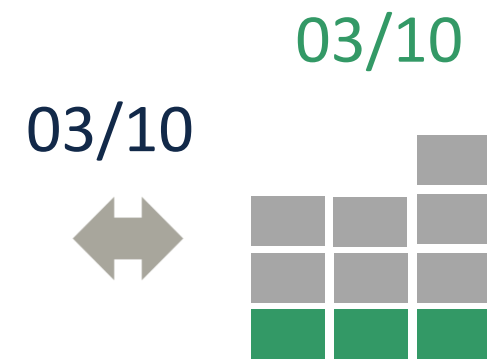
Foreign Activity

Foreign activity underwent little change since June-26 and continues to remain below the 5.0% threshold prescribed by the CBSL.



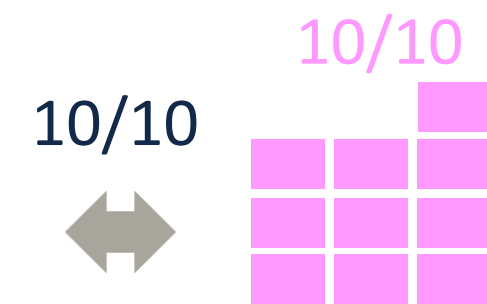
Credit

Private sector credit grew by 27.0% YoY in Jun-26, with outstanding credit increasing by approximately LKR 483Bn between Apr-26 and Jun-26 to reach LKR 11.3Tn.



CBSL Holdings

CBSL holdings remained broadly unchanged at LKR 2.5Tn.



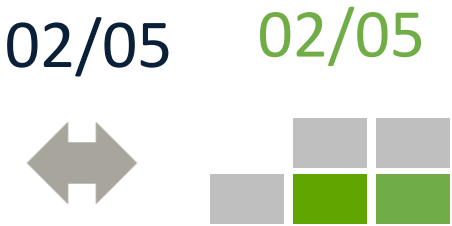


Changes to Health Score

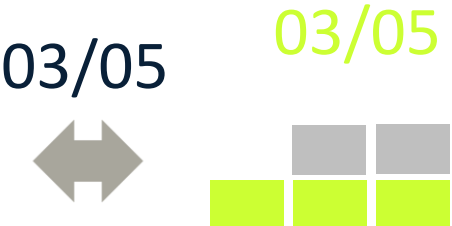
Secondary Criteria: July – Aug 2026

16/25

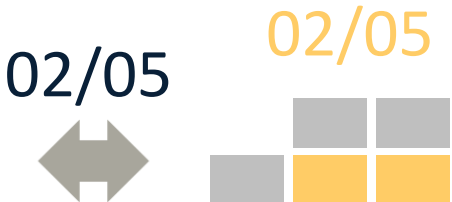
Previous score



Rating Outlook
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.

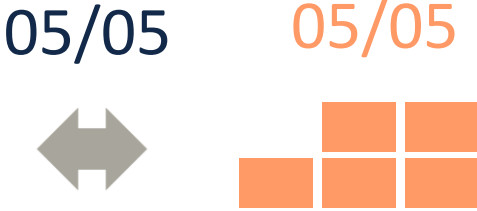


External Environment
The LKR has recovered from its earlier sharp depreciation but remains around 5.5% weaker on a year-to-date basis.



BOT & BOP
The current account still in a deficit in July-26. Escalating tensions in the Middle East led to a sharp increase in global fuel prices, placing additional pressure on the current account balance.

Previous score



Political Risk
The political stability Sri Lanka achieved in 2025 continues to hold firm in Aug-26. While Moody's maintained a stable outlook on Sri Lanka, the latest Verité Research survey indicated a moderation in government approval and economic confidence.



Investor Confidence
The LMD-PepperCube Business Confidence Index (BCI) edged up to 192 in Aug-26 from 190 in Jul-26, suggesting that business sentiment has stabilised following July's sharp decline



FI Health expected maintain its position in medium-low-risk territory with improvement anticipated towards 4Q2026 and 1H2027

FI Health Score in 2025:

"A modest weakness was evident"

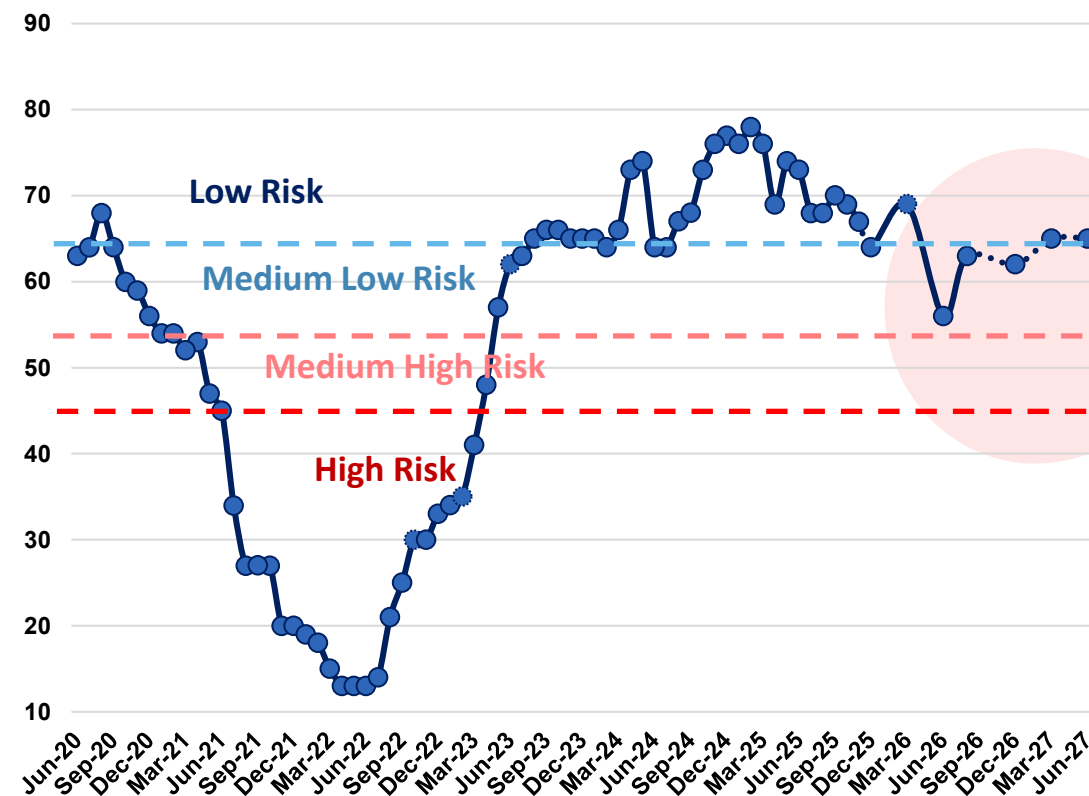
- ✓ Economic indicators underpinning the FI Health Score exhibited modest weakness in 2025, with the score edging lower, yet remaining above the medium-risk threshold.
- ✓ The decline reflected a contained build-up in official reserves, sustained expansion in private sector credit, rising inflation, and volatility in liquidity conditions.

FI Health Score in 2026E:

"Already inside the medium-low-risk band, with room to improve further"

- ✓ The Health Score rose to 63 in Aug-2026 from 56 in Jun-2026, though still below 67 a year earlier, strengthening its position in the medium-low-risk category.
- ✓ The improvement was driven primarily by the sharp increase in system liquidity (excess liquidity exceeding LKR 300Bn in August), more than offsetting the drag from elevated inflation.
- ✓ The score is expected to improve further or remain stable through 1H2027, supported by slower credit growth, easing inflation, ample liquidity, and recovering reserves.
- ✓ The improved Health Score supports further, albeit slower, easing in short-tenor yields, while mid and long-tenor yields are expected to remain broadly stable over the next 12 months.

First Capital Fixed Income Health Score





4. New Recommendation

"Stay Short, Add the Belly"



New Recommendation: Stay Short, Add the Belly

- ✓ *We favour immediate allocation to short tenors and selective accumulation of the 3–7 year belly at current levels. Short-tenor yields offer relatively defensive return potential, while the belly provides stronger capital-gain upside. Near-term volatility from Middle East tensions, oil prices, inflation and El Niño could push yields temporarily higher, creating opportunities to add exposure at more attractive levels.*
- ✓ *With potential yield compression of around 105bps in the 2-year, 70bps in the 3-year and 25bps in the 7-year tenor, we recommend maintaining short-tenor exposure while progressively accumulating the belly, using any yield spikes to increase allocations.*
- ✓ *We remain cautious on long tenors, where current valuations offer comparatively limited upside.*

SHORT TENOR < 2 YEARS

Current Yield Levels (18-Sep-26)

- 1Y Bill: 9.93%
- 2Y Bond: 10.70%

FCR Dec-2026 Target

- 2Y Bond: 9.65%

Expected Yield Compression

- 105 bp (2 Yr)

Recommendation

- Preferred entry point at current levels
- Attractive risk-adjusted return potential

MID TENORS: 3-7 YEARS

Current Yield Levels (18-Sep-26)

- 10.90%-11.85%

FCR Dec-2026 Target

- 10.20%-11.60%

Expected Yield Compression

- 70bps (3Yr)-25bps(7Yr)

Recommendation

- Attractive at current levels; selectively accumulate, with stronger buying on any 30–50bps yield backup

LONG TENORS: 8-10 YEARS

Current Yield Levels (18-Sep-26)

- 12.00%-12.18%

FCR Dec-2026 Target

- 11.80%-11.90%

Expected Yield Compression

- around 20-28 bps

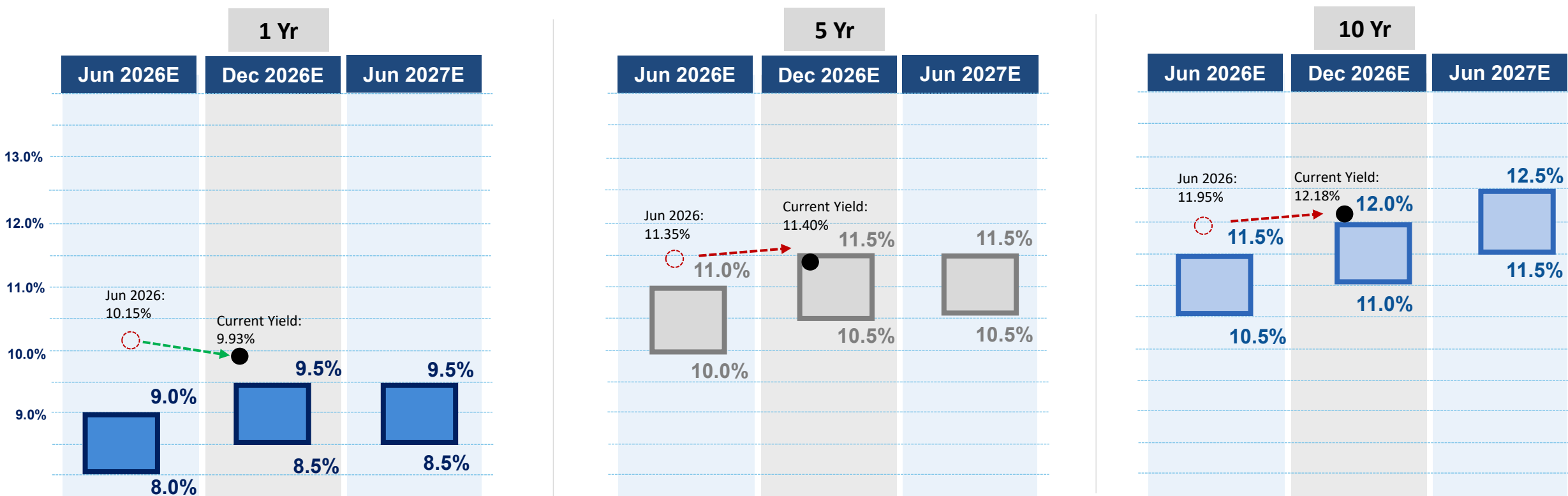
Recommendation

- Limited upside at current yield levels
- Not recommended unless yields back up 50-100bps from our upper band to justify risk-adjusted returns of new positions.



Renewed Yield Pressures Present Tactical Buying Opportunities

- ✓ The 1Y yield has already eased from 10.15% in Jun-2026 to 9.93% as of 18-Sep-2026, validating our short-end call. With mid and longer tenors already broadly within our bands, we see continued - though narrower - room for the short tenor to adjust lower toward 8.5%-9.5% through 4Q2026E and into 1H2027E.
- ✓ In Jul-26, belly and tail-end yields returned to our forecast bands as ceasefire talks pushed oil below USD 80/barrel. However, renewed Middle East tensions and oil prices exceeding USD 100/barrel have driven yields above our bands. We favour the short and belly of the curve, anticipating a return to our fragile truce scenario (oil at USD 68–80/barrel). Easing inflation, moderating credit growth, liquidity above LKR 200.0Bn and gradual reserve accumulation should support yield compression.
- ✓ Tail-end opportunities remain limited over the next 12 months amid moderate growth prospects and debt sustainability concerns.

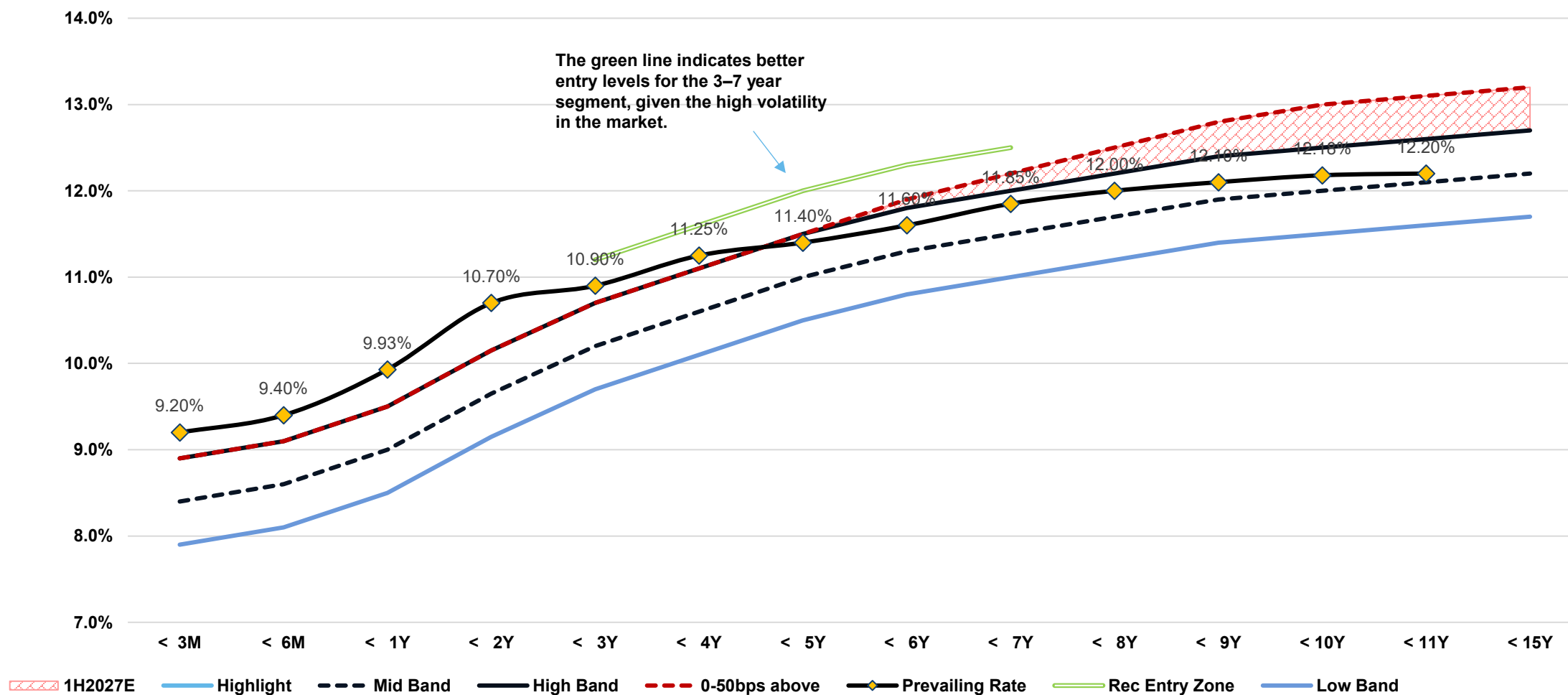


“The strongest opportunities remain at the short end and the belly”

- ✓ **External Sector Conditions Continue to Improve:** While the USD/LKR exchange rate has stabilised, remittance inflows remain strong and exports remain resilient. Meanwhile, the current account deficit has narrowed from its April peak, supported by moderating fuel import costs and robust remittance inflows.
- ✓ **A Policy Hold Remains the Most Likely Near-Term Outcome:** With growth expected to moderate and prior policy tightening still transmitting through the economy, CBSL is likely to maintain current policy settings while assessing incoming data.
- ✓ **Elevated System Liquidity Continues to Support Short Tenors:** Outstanding excess liquidity has exceeded LKR 350Bn, providing strong support for money market conditions and short-term government securities. While CBSL absorption operations may gradually reduce excess liquidity, liquidity conditions remain conducive to further, albeit slower, easing at the short end.
- ✓ **A Gradual Easing Cycle Remains Likely in 2027E:** GDP growth is expected to moderate to around 3.0%-4.0% in 2026E. As demand conditions soften and inflation pressures ease, a policy rate cut remains likely towards the beginning of 2027E.
- ✓ **Yet, Inflation and Credit Growth Remain Key Headwinds:** Despite the May-26 rate hike, headline inflation remains above CBSL's upper tolerance band, while private sector credit growth continues to be robust, limiting the scope for a broad-based decline in yields.
- ✓ **El Niño and Elevated Oil Prices Continue to Pose Upside Risks:** Weather-related disruptions and geopolitical tensions in the Middle East could sustain food and energy price pressures, creating upside risks to inflation.
- ✓ **The strongest opportunities remain at the short end and the belly:** Abundant liquidity and a likely policy pause support further downside in short-tenor yields, while the 3–7 year segment offers the strongest capital-gain potential under our target scenario. In contrast, inflation, geopolitical risks and rich long-end valuations limit further upside beyond 8 years.



Short-End Support Remains; Belly Emerges as the Key Capital-Gain Opportunity





Illustrative bond returns highlight strongest value in the Belly

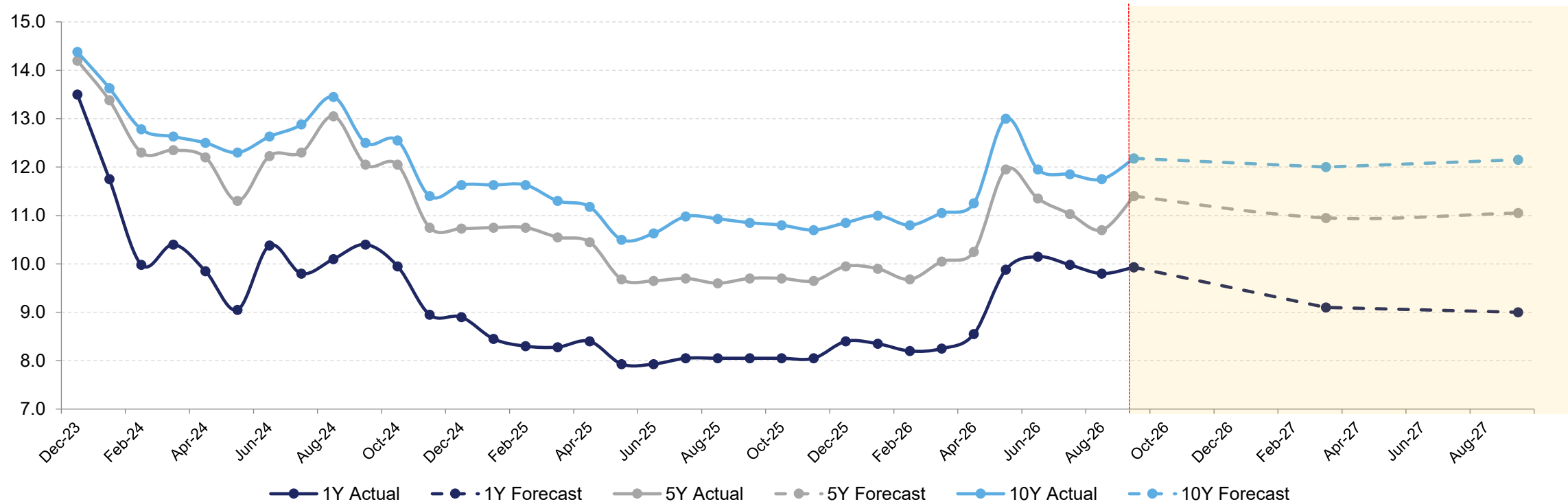
- ✓ The table presents hypothetical capital gains from current mid-yields as at 18-Sep-2026 to our Dec-2026 target mid-band yields.
- ✓ **We remain positive on both the short end and the belly of the curve:** Short-tenor securities, particularly up to 2 years, continue to offer an attractive defensive entry point, with the current 2-year yield of 10.70% providing scope for approximately 105bps of yield compression towards our December 2026 target of 9.65%.
- ✓ **The 3–7 year belly, however, offers the strongest capital-gain potential at current yields, with illustrative returns of up to 2.13% under our target-yield scenario:** Accordingly, we recommend selectively accumulating the belly at prevailing levels, while retaining capacity to add more aggressively if near-term geopolitical uncertainty, oil-price volatility or inflation concerns trigger a temporary yield backup. Such weakness would further enhance entry valuations and subsequent return potential.
- ✓ **Bonds beyond 8 years remain relatively less attractive,** offering limited incremental return relative to their materially higher duration risk; accordingly, we do not recommend fresh long-tenor exposure at current levels.”
- ✓ **Overall, we favour maintaining short-tenor exposure while increasing allocations to the 3–7 year belly, using any yield spikes as opportunities to accumulate further.**

Tenor	Maturity Date	Coupon Rate	Face Value	Purchased Yield	Purchase Price*	Sale Yield expected dip by Dec-26	Sale Price if yield dip by Dec-26	Capital Gain / Loss	Return
< 2Y	01-May-28	9.00%	100,000,000	10.70%	97.5	9.65%	99.2	1,670,058	1.71%
< 3Y	15-Jun-29	11.75%	100,000,000	10.90%	101.9	10.20%	103.3	1,353,394	1.33%
< 4Y	01-Aug-30	10.00%	100,000,000	11.25%	96.1	10.70%	97.9	1,802,929	1.88%
< 5Y	15-Mar-31	11.25%	100,000,000	11.40%	99.5	10.95%	101.0	1,472,041	1.48%
< 6Y	01-Oct-32	9.00%	100,000,000	11.60%	88.9	11.20%	90.8	1,897,086	2.13%
< 7Y	01-Jun-33	9.00%	100,000,000	11.85%	87.0	11.60%	88.4	1,402,660	1.61%
< 8Y	15-Jun-34	10.75%	100,000,000	12.00%	93.8	11.80%	94.9	1,103,716	1.18%
< 9Y	15-Jun-35	10.70%	100,000,000	12.10%	92.5	11.85%	93.9	1,414,933	1.53%
< 10Y	15-Aug-36	10.85%	100,000,000	12.18%	92.4	11.90%	94.0	1,606,592	1.74%



Short-mid tenors expected to adjust downwards in 4Q2026E

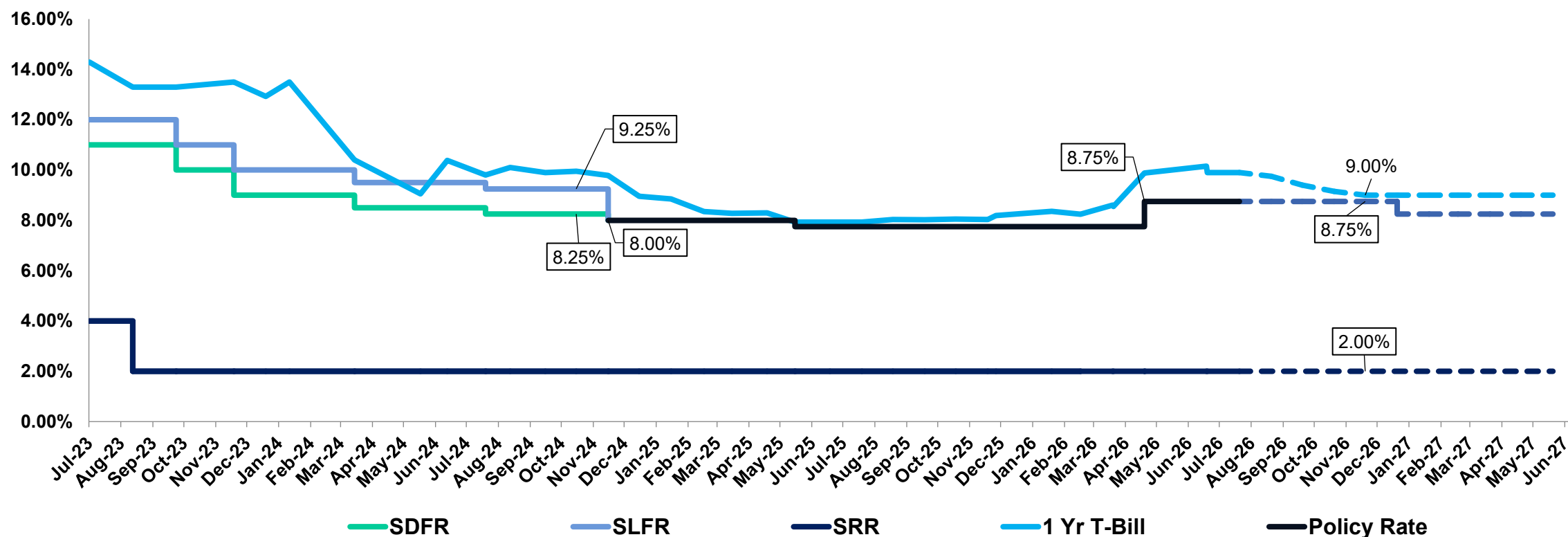
Short- and mid-tenor yields are expected to normalize within FCR's forecast range, while longer-tenor yields are likely to remain broadly stable over the medium term





With the support of potential easing in 2027E

- ✓ The 1Y T-bill yield has already declined to 9.93% from 10.15% in Jun-26, while recent CBSL guidance suggests rates are more likely to remain on hold than move lower in the near term.
- ✓ In addition, potential easing of demand pressures, slower GDP growth, and moderating inflation, particularly as oil-related price pressures ease, could create room for a policy rate cut in early 2027E.



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Thank you!

*“SUCCESSFUL INVESTMENTS IS ABOUT
MANAGING RISKS”*



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