

# FC Fixed Income Recommendation

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17<sup>TH</sup> OCTOBER 2017

**ANALYST CERTIFICATIONS AND REQUIRED  
DISCLOSURES BEGIN ON PAGE 17**



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# Re-cap [Aug 2017]: Time Period vs Health Score

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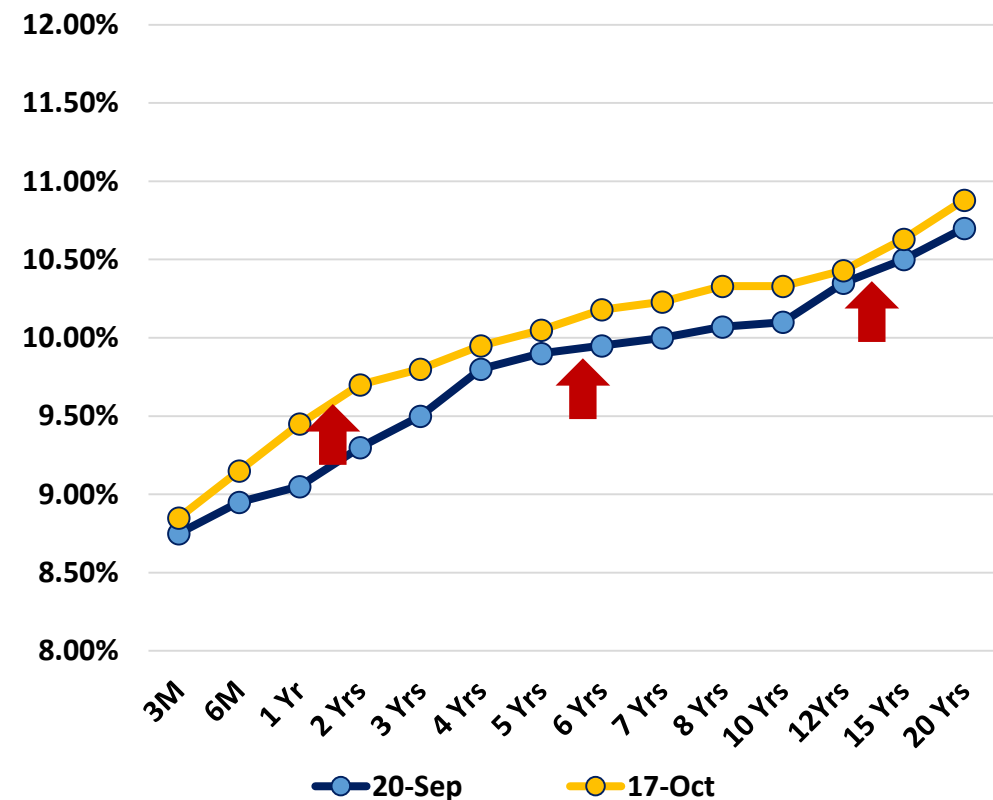
|                                  | <b>3 Months Outlook<br/>Jul-Sep 2017</b> | <b>3-6 Months Outlook<br/>Oct-Dec 2017</b> | <b>6-9 Months Outlook<br/>Jan-Mar 2018</b> | <b>9-12 Months Outlook<br/>Apr-Jun 2018</b> |
|----------------------------------|--|--|--|---|
| <b>Health Score<br/>Estimate</b> | <b>75-100</b>                            | <b>60-75</b>                               | <b>60-65</b>                               | <b>50-60</b>                                |
| <b>Risk Level</b>                | <b>Remote</b>                            | <b>Medium-Low</b>                          | <b>Medium</b>                              | <b>Medium-High</b>                          |

# Previous Month 21<sup>st</sup> Sep Recommendations and Yield curve movement afterwards

## Recommendation for 21<sup>st</sup> Sep 2017 (Last month)

- Fixed Income Portfolio Recommendation
- Portfolio exposure: REDUCE
- Capacity Utilization to be reduced to 40% from previous 50%
- Recommend to start further reducing position in shorter tenors. Continue **SELL** recommendation all mid & long tenors.

Yield Movement [20<sup>th</sup> Sep-17<sup>th</sup> Oct]



# Rate Movement Review

| Interest Rate Change (bps) |        |        |              |
|----------------------------|--------|--------|--------------|
| Tenure                     | 20-Sep | 17-Oct | Change (bps) |
| 3M                         | 8.75%  | 8.85%  | 10           |
| 6M                         | 8.95%  | 9.15%  | 20           |
| 1 Yr                       | 9.05%  | 9.45%  | 40           |
| 2 Yrs                      | 9.30%  | 9.70%  | 40           |
| 3 Yrs                      | 9.50%  | 9.80%  | 30           |
| 4 Yrs                      | 9.80%  | 9.95%  | 15           |
| 5 Yrs                      | 9.90%  | 10.05% | 15           |
| 6 Yrs                      | 9.95%  | 10.18% | 23           |
| 7 Yrs                      | 10.00% | 10.23% | 23           |
| 8 Yrs                      | 10.07% | 10.33% | 26           |
| 10 Yrs                     | 10.10% | 10.33% | 23           |
| 12Yrs                      | 10.35% | 10.43% | 8            |
| 15 Yrs                     | 10.50% | 10.63% | 13           |
| 20 Yrs                     | 10.70% | 10.88% | 18           |

Following our previous report on 21<sup>st</sup> Sep 2017, market saw uptrend after some profit taking with rates marginally improving across the yield curve

However, mid tenors saw buying interest beyond 3<sup>rd</sup> Oct which pushed yield down by 5-10bps.

Net foreign buying continued was also witnessed over the 4 weeks under review

# 1.0 Economic Health Score

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# Oct 2017 Economic Health Score

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*Health score starts dipping amidst rise in risk;*

|                    |   |         |   |    |
|--------------------|---|---------|---|----|
| Primary Criteria   | - | 62 - 03 | - | 59 |
| Secondary Criteria | - | 16 - 02 | - | 14 |

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Economic Health Score (Oct 2017) - 73

- [As against 78 in Sep 2017 & 47 in Mar 2017 (6 months ago)]
-

# Changes to Health Score – Priority Criteria

| Criteria         | Update  | Current Score | Add / Deduct Score | New Score |
|------------------|---|---------------|--------------------|-----------|
| Foreign Reserves | Decreased by USD 400Mn  | 15/15         | -01                | 14/15     |
| Liquidity        | Remains positive and sustained LKR10-20Bn over the last 14 days   | 10/15         | -01                | 09/15     |
| Inflation        | CCPI at 7.1%; FC Research expectation 6.3%; Steep jump above expectations led by food prices. Core inflation still manageable | 15/15         | -02                | 13/15     |
| Foreign Buying   | Net inflow of LKR 24 Bn over the last 4 weeks; Foreign holdings reaches 6.08%.  | 05/10         | +01                | 06/10     |
| Credit           | Aug 2017 credit increased to LKR 53Bn. So far credit growth remains under control   | 08/10         |                    | 08/10     |
| CBSL Holdings    | CBSL Holdings remained LKR 60Bn with some fluctuation.  | 09/10         |                    | 09/10     |

Primary Criteria - 62 - 04 + 01 = 59

# Changes to Health Score – Secondary Criteria

| Criteria             | Update  | Current Score | Add / Deduct Score | New Score |
|----------------------|---|---------------|--------------------|-----------|
| Rating Outlook       | Some risks highlighted with strengthening dollar              | 05/05         | -01                | 04/05     |
| External Environment | Possible Fed Rate hike affecting global fund flows towards US | 03/05         | -01                | 02/05     |
| BoT & BoP            | Trade deficit widened in Aug 2017                             | 01/05         |                    | 01/05     |
| Political Risk       | Elections only in 1Q2018 (LG & PC polls)                      | 02/05         |                    | 02/05     |
| Other (New Taxes)    | Inland Revenue Act passed implementation only in 01.04.2018   | 05/05         |                    | 05/05     |

Secondary Criteria - 16 - 02 = 14



# 2.0 Recommendation

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# Expectations for November 2017

## PRIORITY CRITERIA

|                  |       |     |
|------------------|-------|-----|
| Foreign Reserves | 14/15 | -01 |
| Liquidity        | 09/15 | -01 |
| Inflation        | 13/15 |     |
| Foreign Buying   | 06/10 |     |
| Credit           | 08/10 |     |
| CBSL Holdings    | 09/10 |     |

## SECONDARY CRITERIA

|                      |       |     |
|----------------------|-------|-----|
| Rating Outlook       | 04/05 |     |
| External Environment | 02/05 | -01 |
| BoT & BoP            | 01/05 |     |
| Political Risk       | 02/05 | -01 |
| Other (New Taxes)    | 05/05 |     |

**Total - 57/75 -02**

**Total - 14/25 -02**

|                             |
|-----------------------------|
| <b>Total 73 + (-4) = 69</b> |
|-----------------------------|

# Reasons for Expected November 2017 Health Score

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We expect Economic Health Score to slowly reduce over 4Q2017 due to:

- Rising debt payment levels that exist in 2018
- Slowdown in foreign inflows as fed rate hike draws closer (Possibly in Dec 2017 according to US Economic Analyst surveys)

# Recommendation

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## Fixed Income Portfolio Recommendation

- Portfolio exposure: **HOLD** [Already reached minimum level]
- Capacity Utilization to be maintained at 40% as carry portfolio
- All remaining positions to be held in short term securities.

***Short tenors have now reached the lower bands on FC Research expectations. Mid and long tenor maturities are slow to adjust upwards. We expect mid-long tenors to adjust upwards to reach FC Research lower bands over the next few months possibly supported by the expected US Fed Rate hike***

# Sequence of Events

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May 2017 – Successful Bond issue; Signs of Future Risk reducing; Increase from 50% to 60% but slow increase as mid term bond rates are too low

Jun 2017 – Concrete signs of future risk reducing; Increase capacity utilization to 70% from 60%; Possibility of overall yield curve touching bottom bands over next 2 months; But watch out for Inland Revenue Act

18<sup>th</sup> Jul 2017 – Sell all longer tenors (10y, 15y, 20y, 30y) and invest in the shorter tenors. Continue to HOLD mid tenor bonds. Continue to watch out for Inland Revenue Act

31<sup>st</sup> Jul 2017 – SELL all mid tenors (4y, 5y, 6y, 8y). Capacity Utilization to be reduced to 60%

14<sup>th</sup> Aug 2017 – Start reducing position in shorter tenors. Capacity Utilization to be reduced to 50%

21<sup>st</sup> Sep 2017 – Further reduce position. Capacity Utilization to be reduced to 40%

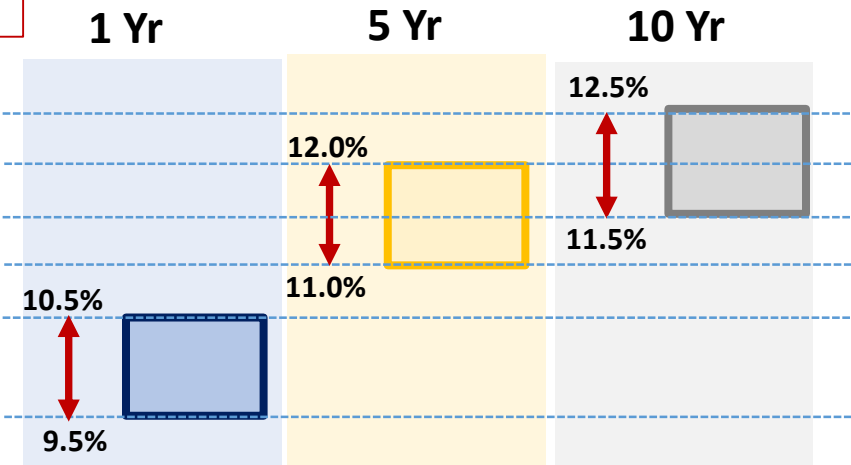
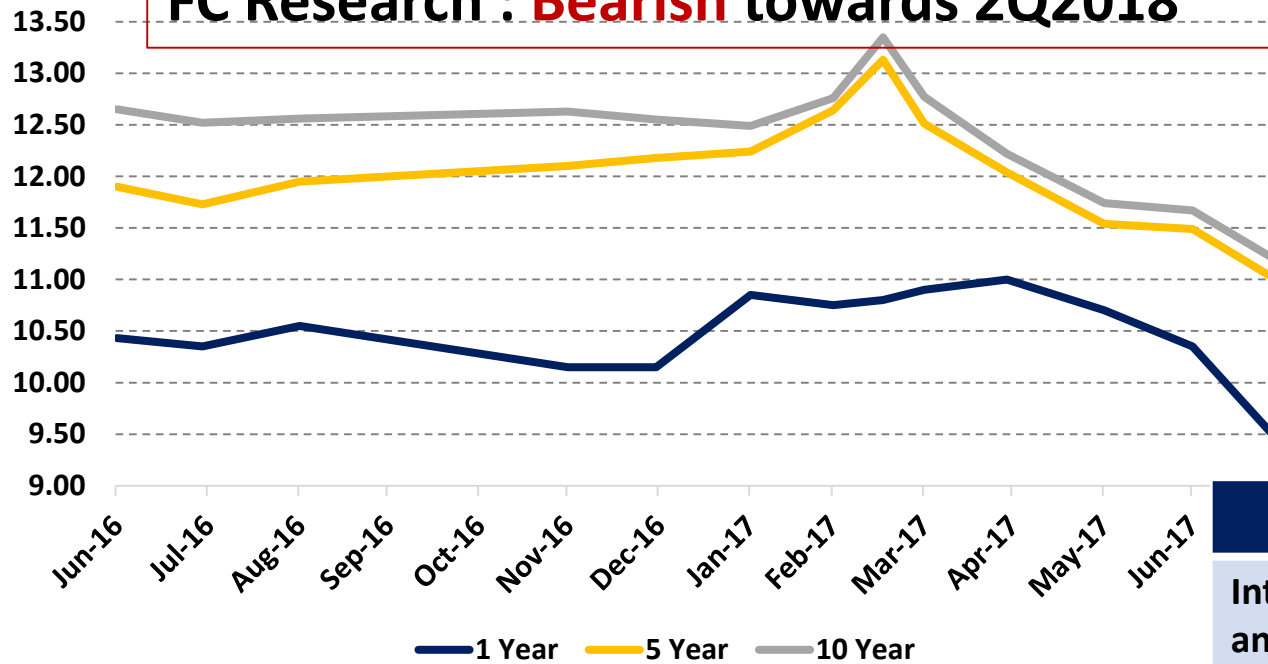
17<sup>th</sup> Oct 2017 – Hold position as carry portfolio. Capacity Utilization maintained at 40%

# 3.0 Recap of Aug 2017 Economic Wrap

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# Interest Rates to be Bearish towards 2Q2018 despite stable 2H2017 (12 months)

**FC Research : Bearish towards 2Q2018**



| Jul 2017 – Aug 2018  |  | Probability |
|--|--|-------------|
| Interest Rates to be upward trending towards 2Q2018 and reaching upper bands |  | 65%         |
| Strong Foreign inflows stabilizing interest rates around the lower bands     |  | 35%         |

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