First Capital

First Capital Research

Pre-Policy Analysis

03RD APRIL 2018

Lead Analyst: Amanda Lokugamage
Secondary Analysts: Dimantha Mathew
Atchuthan Srirangan

ANALYST CERTIFICATIONS AND REQUIRED DISCLOSURES BEGIN ON PAGE 12

Policy Expectation

Sri Lanka's forex reserve assets increased to USD 7.9Bn in Feb 2018, above the 4 months import bill value of USD 7.4Bn.

Changes took place during the period;

CBSL offer and acceptance of SLDBs 50% lower than its maturity, delay in issuance of much anticipated USD 2.0Bn Sovereign Bond and extending the closing date of Foreign Currency Term Financing Facility coupled with heavy net foreign outflow from capital markets; both equity and debt amounting to over USD 100Mn and continuous widening of trade deficit

The above factors are likely to result in a considerable dip of approximately USD 300-400Mn in forex reserves, bringing the reserves very close to the minimum level, which is 4 months of imports (which is USD 7.4Bn), thus significantly aggravating the economic risk profile of the country.

However, private sector credit growth continues to be sluggish with no signs of acceleration and inflation (even if a fuel price hike is incorporated) is expected to be within the bands of 4%-6% while REER is believed to have moved further towards the fair value in Mar 2018 from 105.57 in Dec 2017 with depreciating LKR and a weaker USD.

GDP growth for 4Q2017 released in Mar 2018 saw growth continuing to be below par at 3.2% even slower growth than the previous consecutive quarter (3Q) of 3.7%. With it 2017 registered the slowest GDP growth (3.1%) for 16 Years.

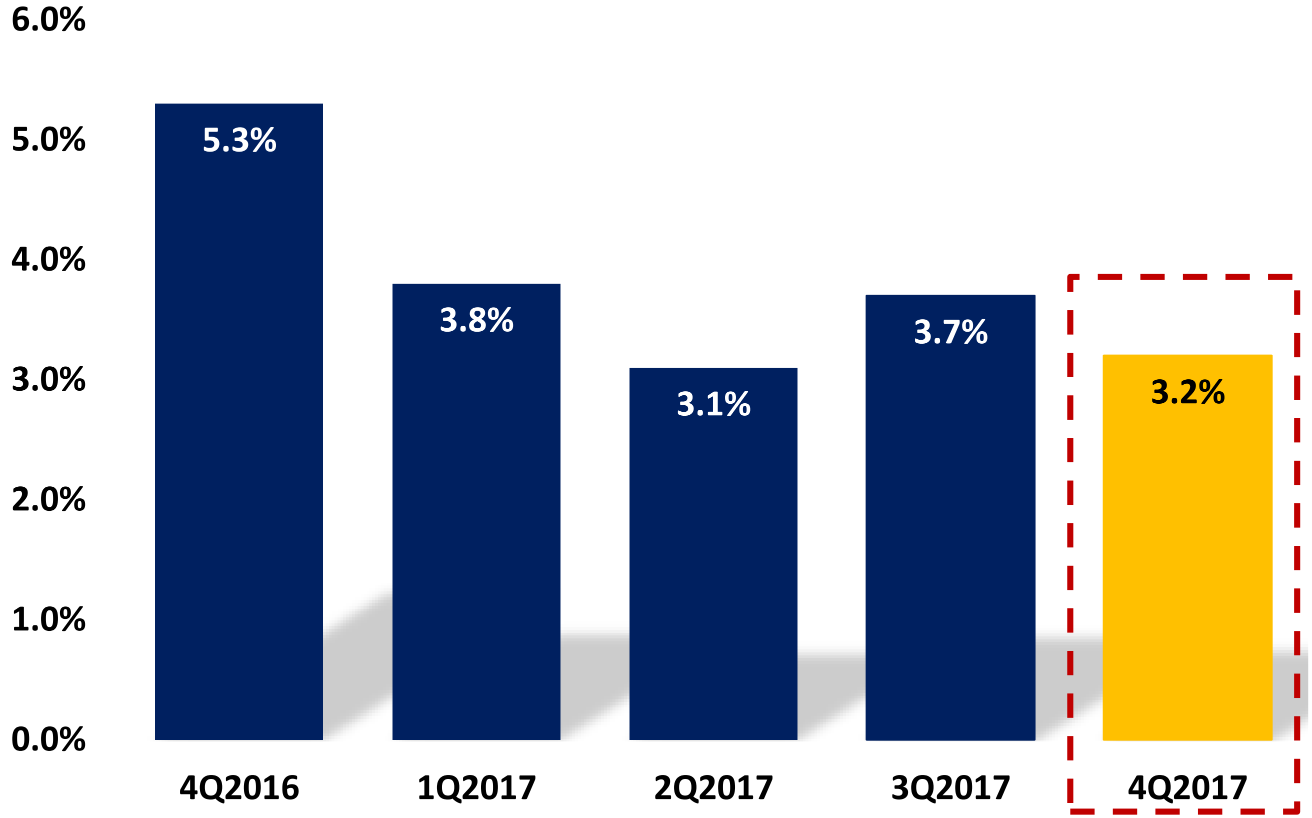
On previous pre-policy issues First Capital Research have highlighted a slow but increasing probability of a rate cut where probability of a rate cut was raised to 15% in Feb 2018 which was in line with the increasing stability of the economy. However, the sudden risk created with the possibility of a lower reserves completely wipes out the possibility of a rate cut which was required to boost the economy. Though low foreign reserves may warrant a rate hike to increase rates further and attract inflows, the considerably slow GDP growth level that is prevailing in the country is expected to significantly reduce probability of a rate hike. Further the expectation of foreign funds through sovereign bond and fund facilities over next 2 months also dilute the rate hike possibility.

Therefore despite the recent developments considering the slow economic conditions First Capital Research believe **current monetary policy is appropriate and no change is required.**

GDP Growth below expectations

GDP growth for 4Q2017 continued to remain below 4% to record at 3.2%YoY. Agriculture activities posted a +7.1%YoY growth, Industrial grew by a moderate 3.9%YoY while the highest contributor; Services grew by a positive 3.2%YoY.

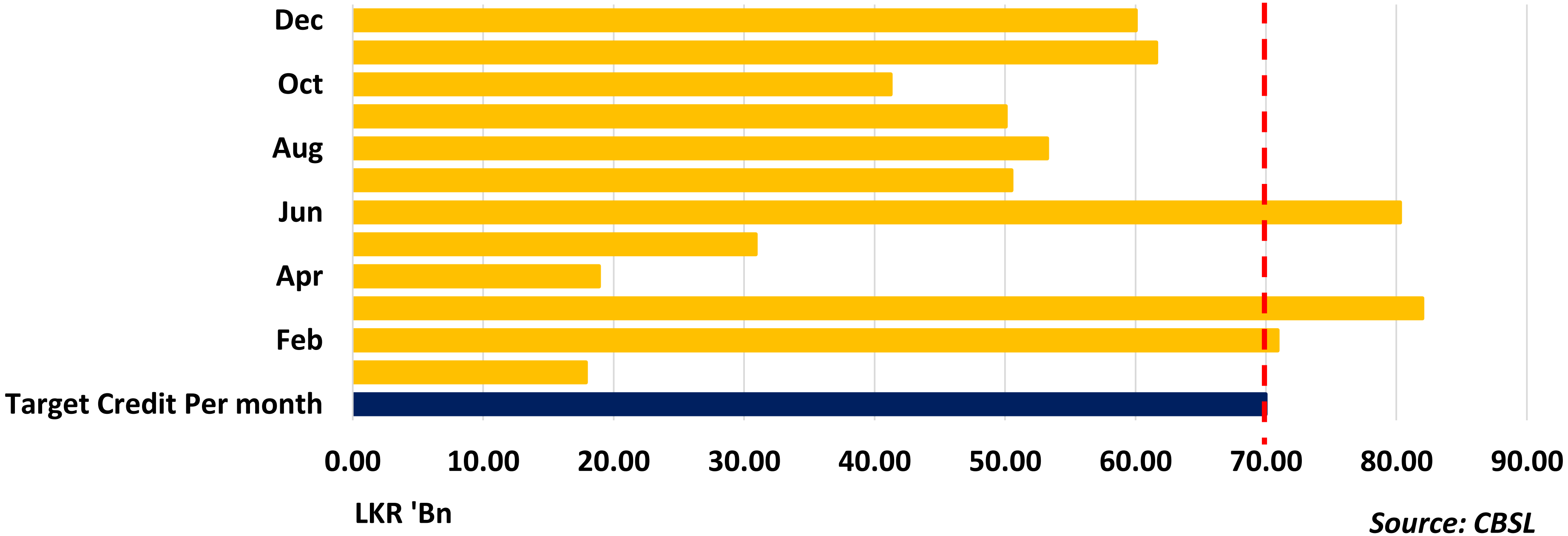
During the 2017, GDP was recorded at 3.1%YoY, registering the lowest growth in 16 years. First Capital Research expect GDP to grow by 5.1% in 2018E supported by higher FDIs, improved private investments and recovery in consumption towards 2H2018.



Source: CBSL

Credit Growth remain slow

Private sector credit growth for 2017 was registered at 14.7%, falling slightly below the First Capital Research target of 16% primarily owing to lower disbursements during April-May and in October. First Capital Research expects the private sector credit growth to remain slow during 1H2018 while picking up in 2H2018 to record at 15% for 2018E.



Source: CBSL

Inflation dips with lower food prices

CCPI based headline inflation, decelerated on a YoY basis to 4.5% in Feb 2018 (below the First Capital Research estimate of 5.1%) and to 4.2% in Mar 2018 (below the First Capital Research estimate of 4.5%). NCPI based inflation decelerated on a YoY basis to 7.2% Feb 2018 from 7.6% Jan 2018.

However, Core inflation remained under check to remain steady at 3.5% and 3.4% in Feb 2018 and Mar 2018.

<u>First Capital Research View</u>

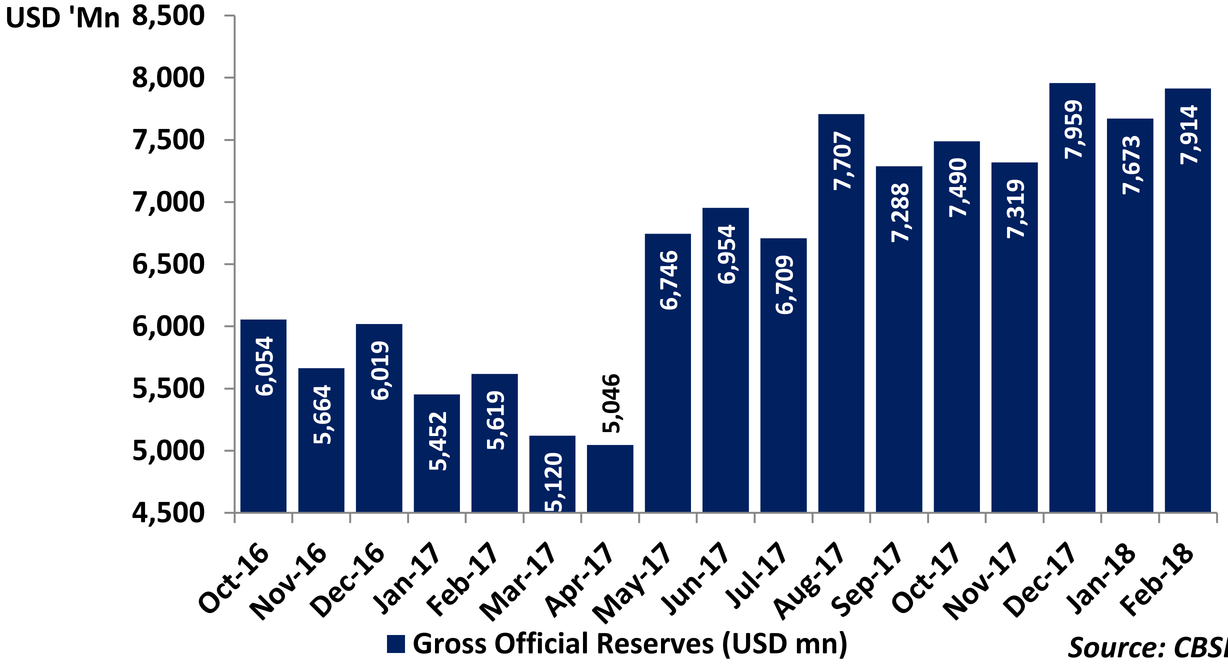
First Capital Research forecast Apr 2018 CCPI headline inflation to rise to 5.0% on the back of possible implementation of fuel pricing formula. However, if a rise in fuel prices fails to take place we expect inflation to be at 4.3% in Apr 2018.

We believe inflation will be under control over the next 1-2 months while there could be some upward pressure towards end of 2Q2018.

Official Reserves may dip amidst delay in Sovereign Bond

Sri Lanka's forex reserves increased by USD 242Mn to USD 7.91Bn in Feb 2018.

First Capital Research View: The delay in Sovereign Bond and the lower acceptance of SLDB's is likely have an adverse impact on the Reserves with a possible outflows of USD 300-400Mn. We expect reserves to dip to USD 7.5-7.6Bn slightly above the threshold of 4 months of imports which is now close to USD 7.4Bn.



Source: CBSL

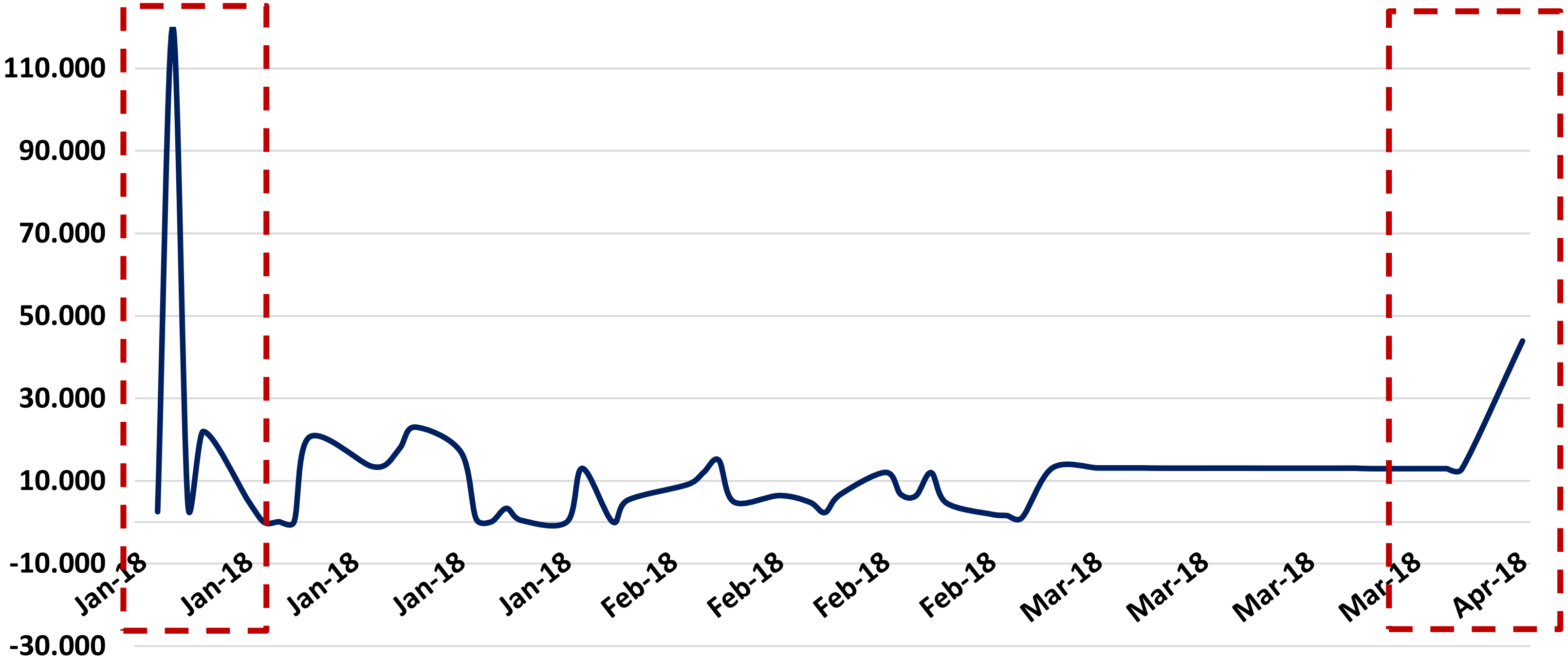
Central Bank Purchases and Sales (USD Mn)

	Purchase	Sales
Apr-17	257.92	-
May-17	183.47	35.00
Jun-17	136.00	-
Jul-17	344.75	-
Aug-17	200.00	-
Sep-17	186.50	-
Oct-17	97.00	-
Nov-17	206.00	-
Dec-17	200.50	-
Jan-18	191.00	-
Feb-18	93.00	-

Source: CBSL

CBSL Holdings increases

CBSL holding in Government Securities were seen maintaining around LKR 13Bn levels through most of Mar 2018 prior to increasing to LKR 43.9Bn on 02nd Apr 2018.

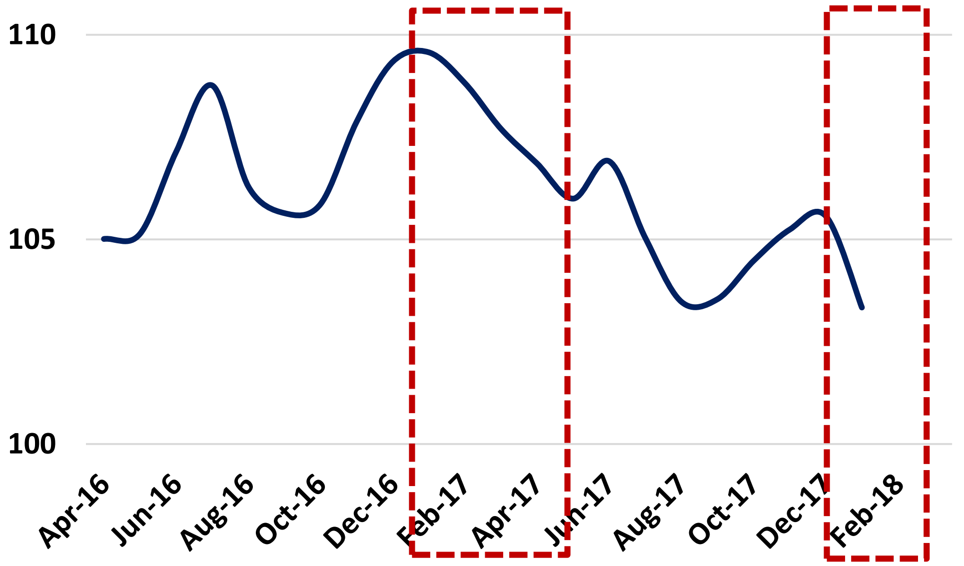


Source: CBSL

Real Effective Exchange Rate

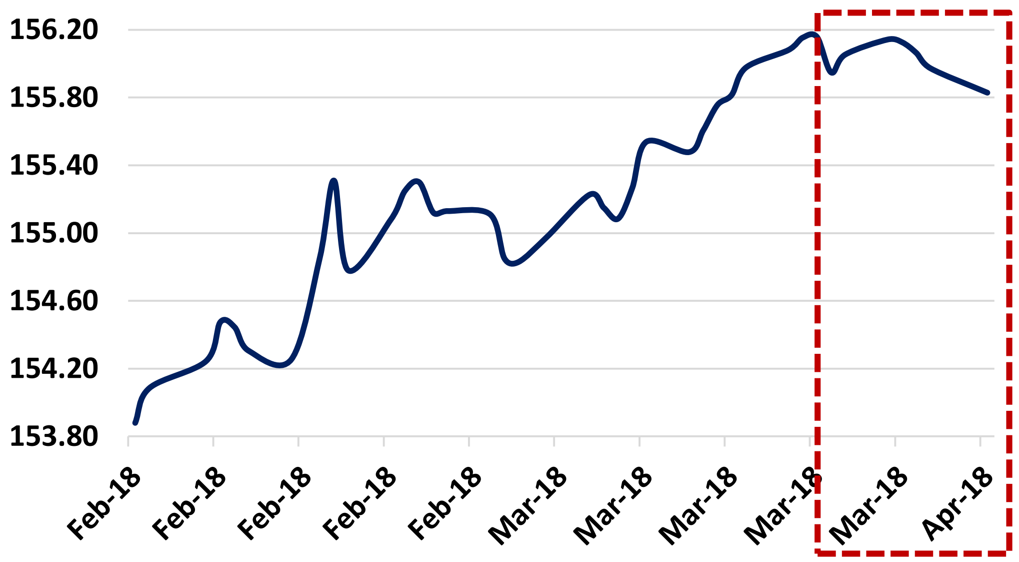
REER has improved from a peak on 108.82 a year ago and a recent peak of 105.57 in Dec 2017. First Capital Research believe REER to have further improved towards 100 on the back of currency depreciation witnessed in Feb and Mar 2018 coupled with prevailing weaker USD (graph 2).

Graph 1 : Real Effective Exchange Rate (REER)



Source: CBSL

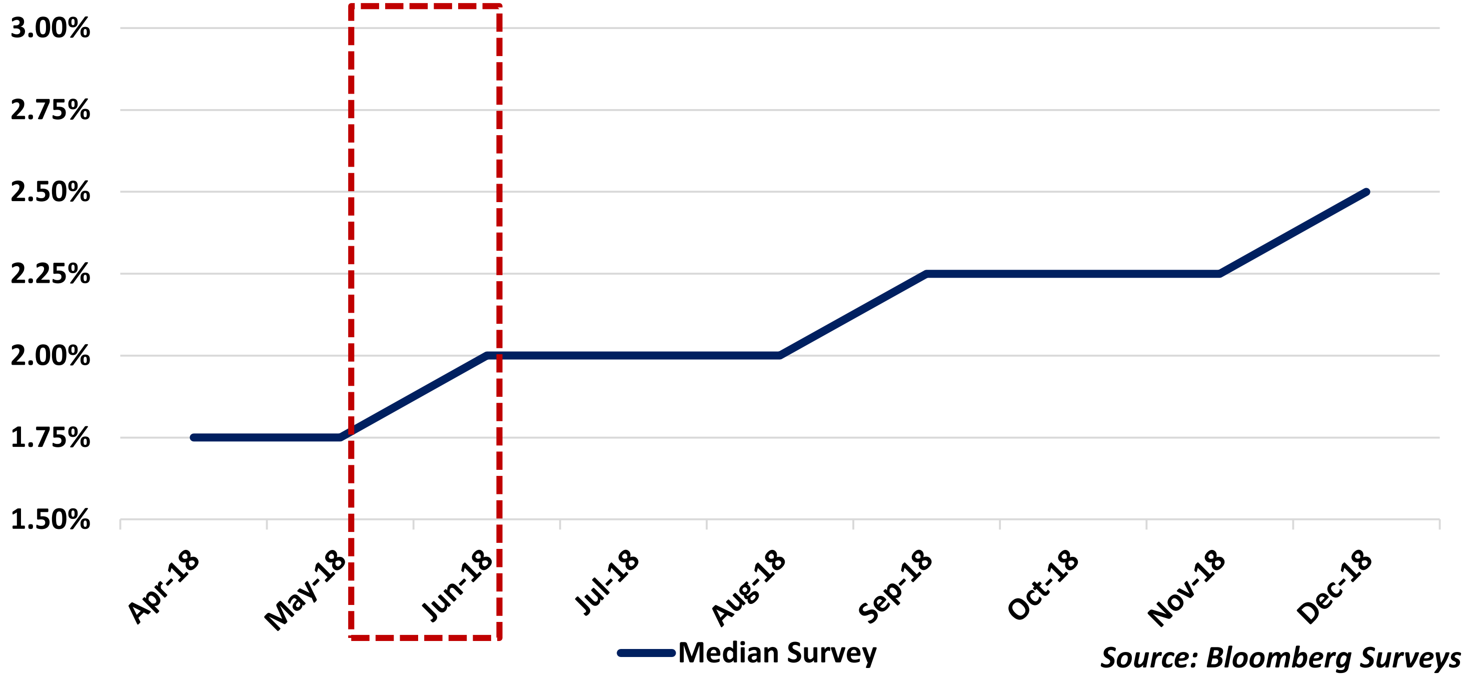
Graph 2 : USD:LKR Movement



Source: CBSL

Fed Rate Hike Expectations

Surveys conducted in Dec 2017 and in Feb 2018 indicated three rate hikes for 2018. However, as per survey conducted from 12-14 Feb 2018, Economists believe that the Fed will still pencil in three hikes for rest of 2018 (Jun 2018, Sep 2018 and Dec 2018) but moved forward one of those projected moves to March 2018 from June 2018.



Source: Bloomberg Surveys

Expected Monetary Policy Stance

Delay in Sovereign bond and three fed rate hikes penciled for the year have created a sizable risk on reserve position. However, considering the fact of overly slow GDP growth and appropriate levels of other economic indicators (inflation, REER, credit growth, CBSL holding) we believe **current monetary policy is appropriate and no change is required.**

Expected Monetary Policy Stance by CBSL	Probability
Raising Policy Rates by 50bps	0%
Raising Policy Rates by 25bps	10%
Policy Rates to remain unchanged	**90%**
Cutting Policy Rates by 25bps	0%
Cutting Policy Rates by 50bps	0%

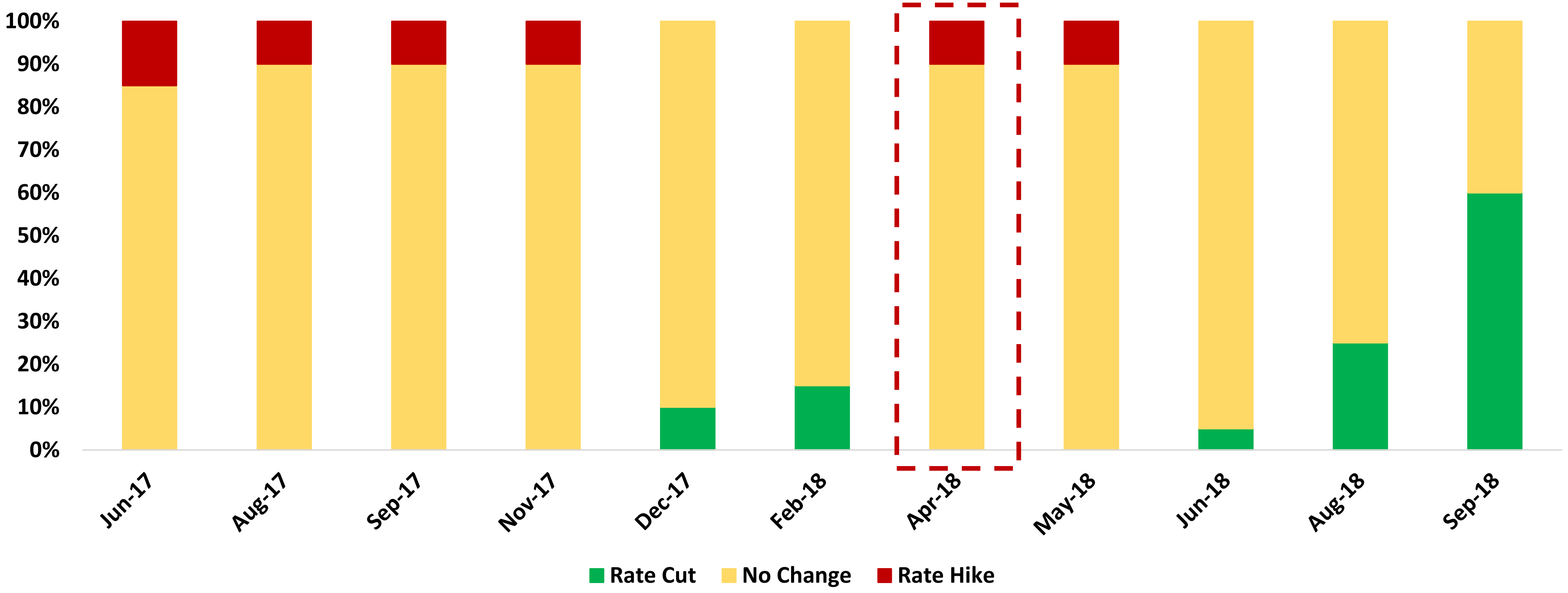
Probability increased to 10% from 0% in Feb 2018

Probability decreased to 0% from 15% in Feb 2018

Current Policy Rates	
Standing Deposit Facility Rate (SDFR)	7.25%
Standing Lending Facility Rate (SLFR)	8.75%
Statutory Reserve Ratio (SRR)	7.50%

We expect the CBSL to keep Statutory Reserve Ratio (SRR) unchanged at 7.50%

First Capital Expectations



Source: First Capital Research

Disclaimer

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

Research Disclosure
NOTICE TO US INVESTORS

This report was prepared, approved, published and distributed by First Capital Equities (Pvt) Ltd, company located outside of the United States (a "non-US Group Company"). This report is distributed in the U.S. by LXM LLP USA, a U.S. registered broker dealer, on behalf of First Capital Equities (Pvt) Ltd only to major U.S. institutional investors (as defined in Rule 15a-6 under the U.S. Securities Exchange Act of 1934 (the "Exchange Act")) pursuant to the exemption in Rule 15a-6 and any transaction effected by a U.S. customer in the securities described in this report must be effected through LXM LLP USA.

Neither the report nor any analyst who prepared or approved the report is subject to U.S. legal requirements or the Financial Industry Regulatory Authority, Inc. ("FINRA") or other regulatory requirements pertaining to research reports or research analysts. No non-US Group Company is registered as a broker-dealer under the Exchange Act or is a member of the Financial Industry Regulatory Authority, Inc. or any other U.S. self-regulatory organization.

Analyst Certification. Each of the analysts identified in this report certifies, with respect to the companies or securities that the individual analyses, that (1) the views expressed in this report reflect his or her personal views about all of the subject companies and securities and (2) no part of his or her compensation was, is or will be directly or indirectly dependent on the specific recommendations or views expressed in this report. Please bear in mind that (i) First Capital Equities (Pvt) Ltd is the employer of the research analyst(s) responsible for the content of this report and (ii) research analysts preparing this report are resident outside the United States and are not associated persons of any US regulated broker-dealer and that therefore the analyst(s) is/are not subject to supervision by a US broker-dealer, and are not required to satisfy the regulatory licensing requirements of FINRA or required to otherwise comply with US rules or regulations regarding, among other things, communications with a subject company, public appearances and trading securities held by a research analyst account.

Important US Regulatory Disclosures on Subject Companies. This material was produced by Analysis First Capital Equities (Pvt) Ltd solely for information purposes and for the use of the recipient. It is not to be reproduced under any circumstances and is not to be copied or made available to any person other than the recipient. It is distributed in the United States of America by LXM LLP USA and elsewhere in the world by First Capital Equities (Pvt) Ltd or an authorized affiliate of First Capital Equities (Pvt) Ltd. This document does not constitute an offer of, or an invitation by or on behalf of First Capital Equities (Pvt) Ltd or its affiliates or any other company to any person, to buy or sell any security. The information contained herein has been obtained from published information and other sources, which First Capital Equities (Pvt) Ltd or its Affiliates consider to be reliable. None of First Capital Equities (Pvt) Ltd accepts any liability or responsibility whatsoever for the accuracy or completeness of any such information.

All estimates, expressions of opinion and other subjective judgments contained herein are made as of the date of this document. Emerging securities markets may be subject to risks significantly higher than more established markets. In particular, the political and economic environment, company practices and market prices and volumes may be subject to significant variations. The ability to assess such risks may also be limited due to significantly lower information quantity and quality. By accepting this document, you agree to be bound by all the foregoing provisions.

LXM LLP USA assumes responsibility for the research reports content in regards to research distributed in the U.S. LXM LLP USA or its affiliates has not managed or co-managed a public offering of securities for the subject company in the past 12 months, has not received compensation for investment banking services from the subject company in the past 12 months, does not expect to receive and does not intend to seek compensation for investment banking services from the subject company in the next 3 months. LXM LLP USA has never owned any class of equity securities of the subject company. There are not any other actual, material conflicts of interest of LXM LLP USA at the time of the publication of this research report. As of the publication of this report LXM LLP USA, does not make a market in the subject securities.

CONTACT US

First Capital

Dimantha Mathew	+94 11 2639 853	Amanda Lokugamage	+94 11 2639 868
Atchuthan Srirangan	+94 11 2639 863	Nisansala Kuruppumudali	+94 11 2639 866