

# FC Fixed Income Recommendation

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JUNE 2017

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



First Capital  
FC Research  
Dimantha Mathew  
Head of Research

# Re-cap [Dec 2016]: Time Period vs Risk Score

	3 Months Outlook Feb-Apr	3-6 Months Outlook Apr-Jul	6-9 Months Outlook Jul-Oct	9-12 Months Outlook Oct-Dec
Risk Score Estimate	<b>&lt;50</b>	<b>50-75</b>	<b>75-100</b>	<b>50-75</b>
Rise in Rates by +1%	<b>High</b>	<b>Medium</b>	<b>Remote</b>	<b>Medium</b>
Utilization Recommendation	<b>Reduce</b>	<b>Slow Increase</b>	<b>Significantly Increase</b>	<b>Slow Decrease</b>
Utilization of Capacity	<b>Limited to 40% or less</b>	<b>Limited to 60% or less</b>	<b>Limited to 80% or less</b>	<b>Limited to 60% or less</b>

# 1.0 Economic Health Score

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# Jun 2017 Economic Health Score

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Primary Criteria	-	36 +12	-	48
Secondary Criteria	-	14 +00	-	14

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Economic Health Score (Jun 2017) - 62

- (As against 50 in May 2017 & 44 in Feb 2017)



# Changes to Health Score – Priority Criteria

Criteria	Update	Current Score	Add / Deduct Score	New Score
Foreign Reserves	Surge by USD 1.8Bn	04/15	+08	12/15
Liquidity	No significant change; Constant change towards small short/excess	07/15		07/15
Inflation	Dipped to 6.0%; FC Research expectation was 6.3%	11/15	+02	13/15
Foreign Buying	Increased by LKR16.7 Bn over the last 4 weeks; Foreign holdings reach 4.6%	02/10		02/10
Credit	March 2017 credit remains high; But we believe it may be one off	08/10		08/10
CBSL Holdings	CBSL Holdings decline by LKR 60Bn to LKR 208 Bn	04/10	+02	06/10

Primary Criteria - 36 + 12 = 48

# Changes to Health Score – Secondary Criteria

Criteria	Update	Current Score	Add / Deduct Score	New Score
Rating Outlook	No Change	05/05		05/05
External Environment	No Change	04/05		04/05
BoT & BoP	Negative Balance of Payments position continues to be an issue	01/05		01/05
Political Risk	No Change	03/05		03/05
Other (New Taxes)	New IRA has not been gazetted as yet	01/05		01/05

Secondary Criteria - 14 + 0 = 14

# 2.0 Recommendation

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# Expectations for July 2017

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## PRIORITY CRITERIA

Foreign Reserves	- 12/15	
Liquidity	- 07/15	
Inflation	- 13/15	
Foreign Buying	- 02/10	+02
Credit	- 08/10	
CBSL Holdings	- 06/10	+01

**Total** - 48/75 +03

## SECONDARY CRITERIA

Rating Outlook	- 05/05	
External Environment	- 04/05	
BoT & BoP	- 01/05	
Political Risk	- 03/05	+01
Other (New Taxes)	- 01/05	+04

**Total** - 14/25 +05



<b>Total</b> 62 + (3+5) = 70
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# Change in Probabilities

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AS AT DEC 2016

Jan - Jul 2017	Probability	May 2017	Jun 2017
Interest Rates to be volatile within 150-200bps strip until uncertainty ends	65%	 70%	 85%
Macro Economic Conditions further worsens, upper band targets of the bonds will break	35%	30%	15%

# Reasons for Expected July 2017 Health Score

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Further improvement in the Economic Health Score is possible due to:

- Acceleration in foreign buying
- Completion of passing of the New Inland Revenue Act
- Further reduction in CBSL Holdings via Funds received from Dollar buying by CBSL and possible net inflows into Debt or equity capital markets

# Recommendation

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## Fixed Income Portfolio Recommendation

- Further increase portfolio exposure: BUY
- Increase capacity Utilization to 70% from 60%
- Possibility of Bonds touching the bottom bands of FC Research across the yield curve
- Need to watch out for the passing of the Inland Revenue Act
- Need to heavily target the possible July Bond Auction & Bill Auctions over the next few weeks

# Sequence of Events

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Feb 2017 – Risk was high had a utilization of less than 40%.

Mar 2017 – Risk reduced signs of positivity. BUY; Portfolio increased to 50%

Apr 2017 – Signs of further outflows but risk score increases so HOLD or SELL a portion to represent future risk

Early May 2017 – Comments on delay in Sovereign Bond; Hold portfolio and switch to Bills or shorter term securities.

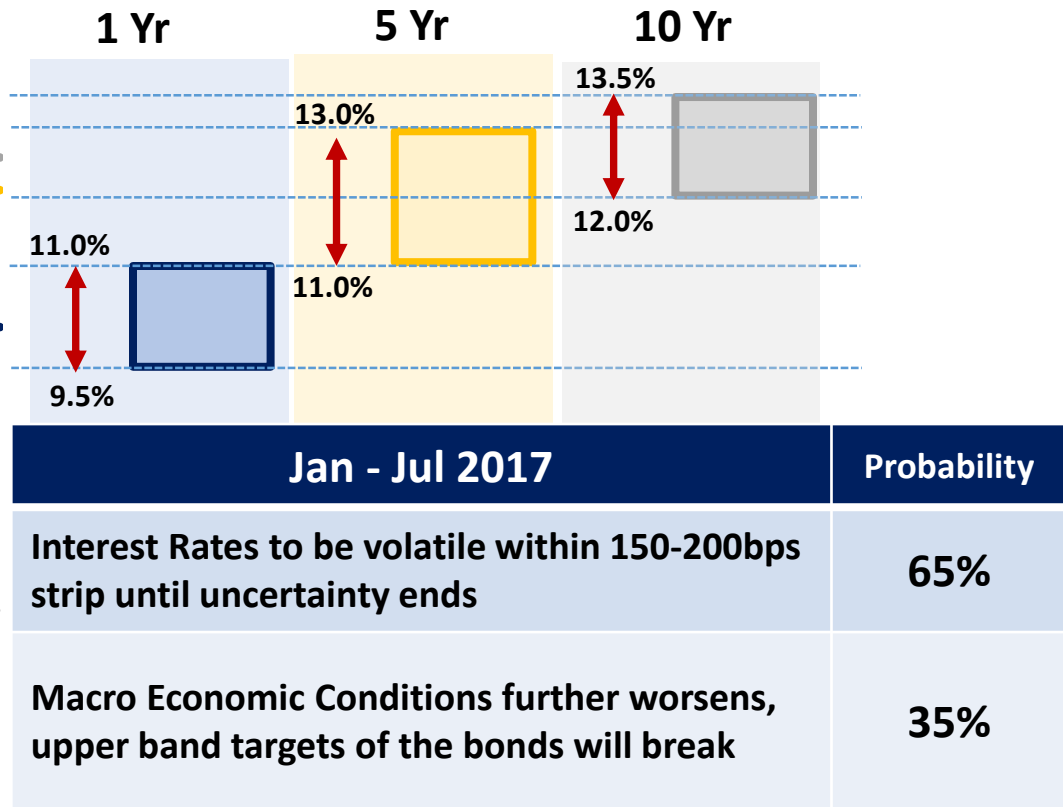
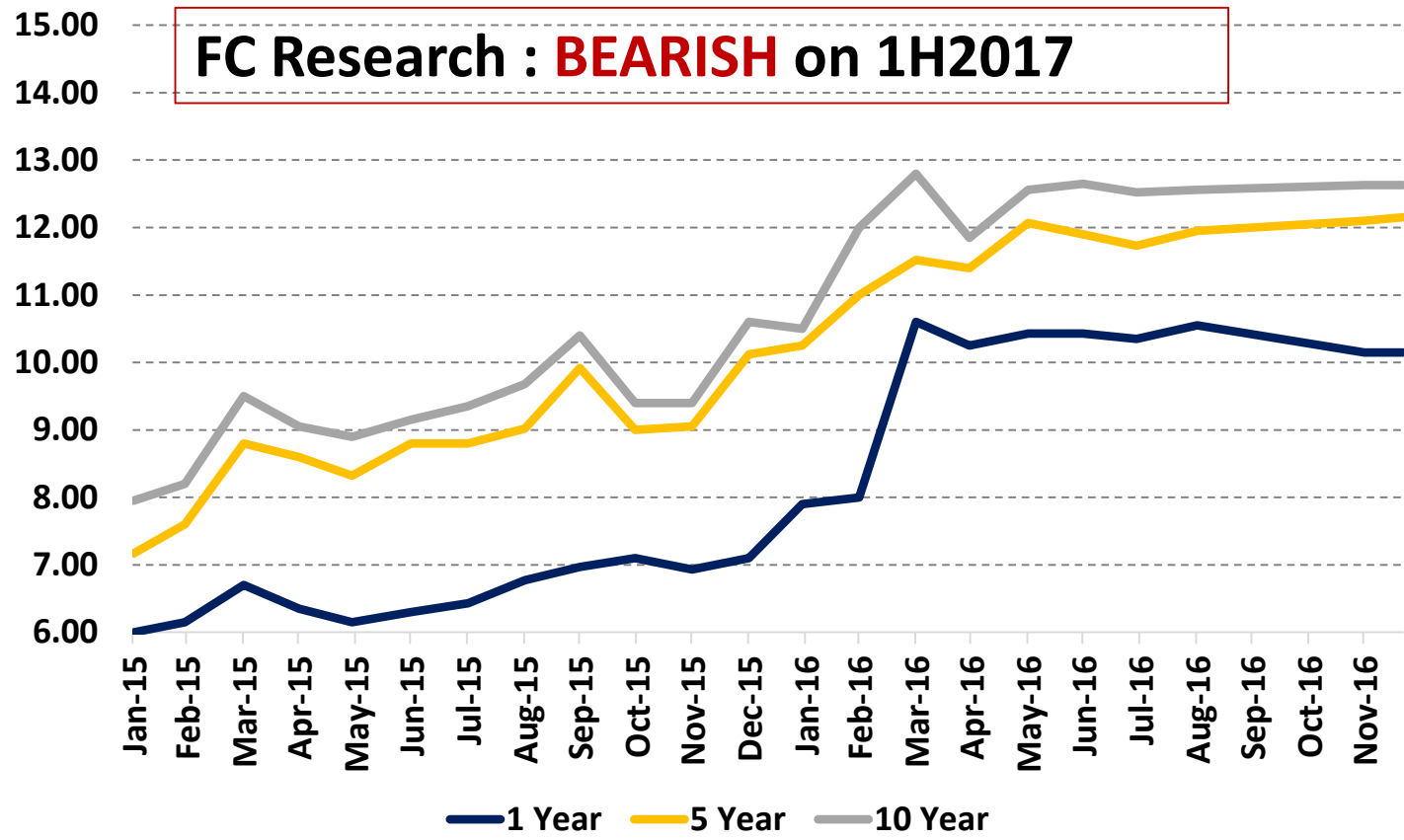
May 2017 – Successful Bond issue; Signs of Future Risk reducing; Increase from 50% to 60% but slow increase as mid term bond rates are too low

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 watchout for Inland Revenue Act

# 3.0 Recap of Dec 2016 Economic Wrap

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# Interest Rates to be volatile within 150-200bps strip until uncertainty ends (Target: 7 months)



# Pressure on interest rates to ease off over the 2H2017 (Target: 12 months)

No Bond Maturities beyond Jul 2017

No SLDB Maturities beyond 1<sup>st</sup> Aug 2017

No elections unless 1H2017 elections and referendums are delayed

Low Government Borrowing Requirement and low Private Sector Credit Growth may improve money supply and liquidity in the system

**FC Research : BULLISH on 2H2017**

BY END 2017	Probability
Interest Rates to decline and hit the lower bands (1 Yr – 9.5%, 5 Yr – 11.0%, 10 Yr – 12.0%)	65%
Macro Economic Conditions further worsens in 1H2017, end 2017 rates will remain same as current rates (1 Yr – 10.0%, 5 Yr – 12.0%, 10 Yr – 12.6%)	35%

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# CONTACT US

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First Capital

Dimantha Mathew +94 11 2639 853

Amanda Lokugamage +94 11 2639 868

Atchuthan Srirangan +94 11 2639 863

Michelle Weerasinghe +94 11 2639 866

Hansinee Beddage +94 11 2639 864