



First Capital
First Capital Research

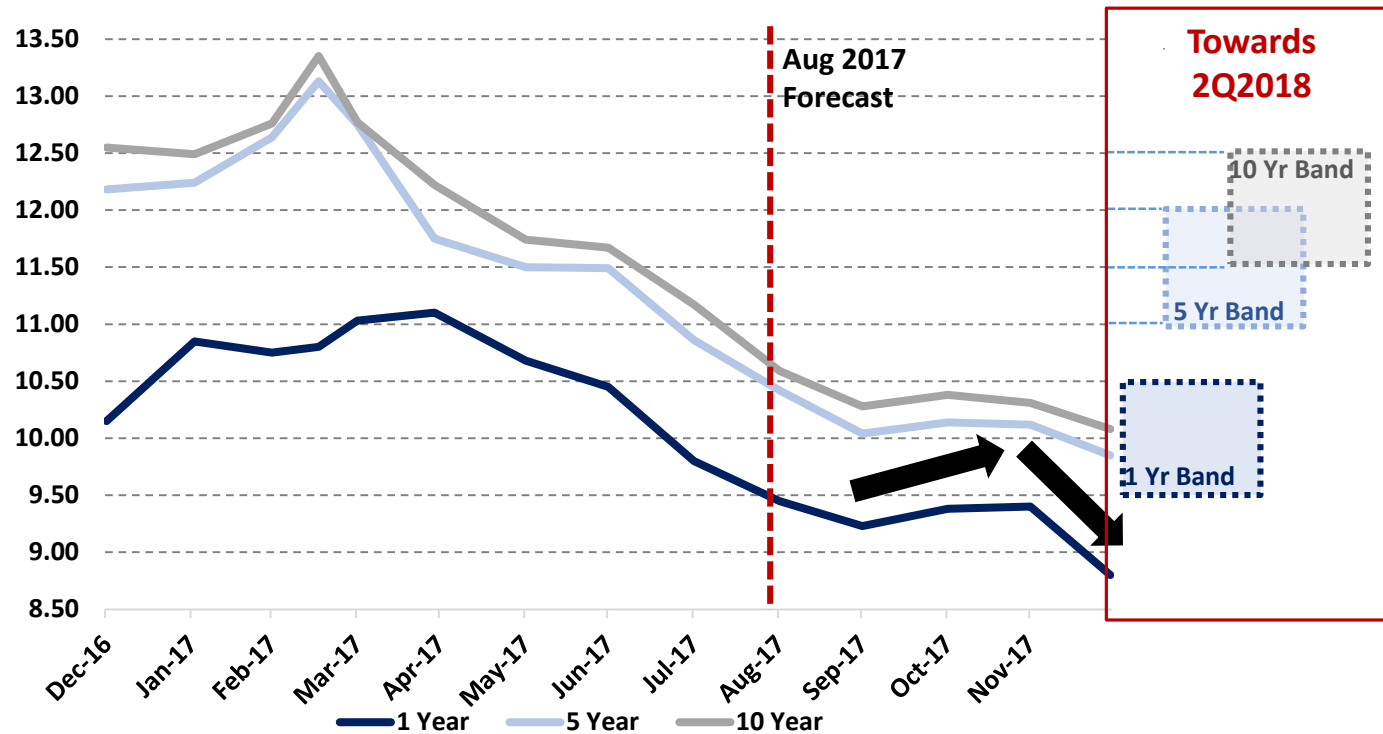
First Capital Fixed Income Recommendation

20TH JUNE 2018

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ANALYST CERTIFICATIONS AND REQUIRED DISCLOSURES BEGIN ON PAGE 17

Aug 2017 Re cap: *Glamorous 2H2017 with a cautious 1H2018*



AUG 2017 FORECAST FOR 12 MONTHS

First Capital Research : **BEARISH** towards 2Q2018

Jul 2017 – Jun 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%

Review on Recommendation Aug 2017

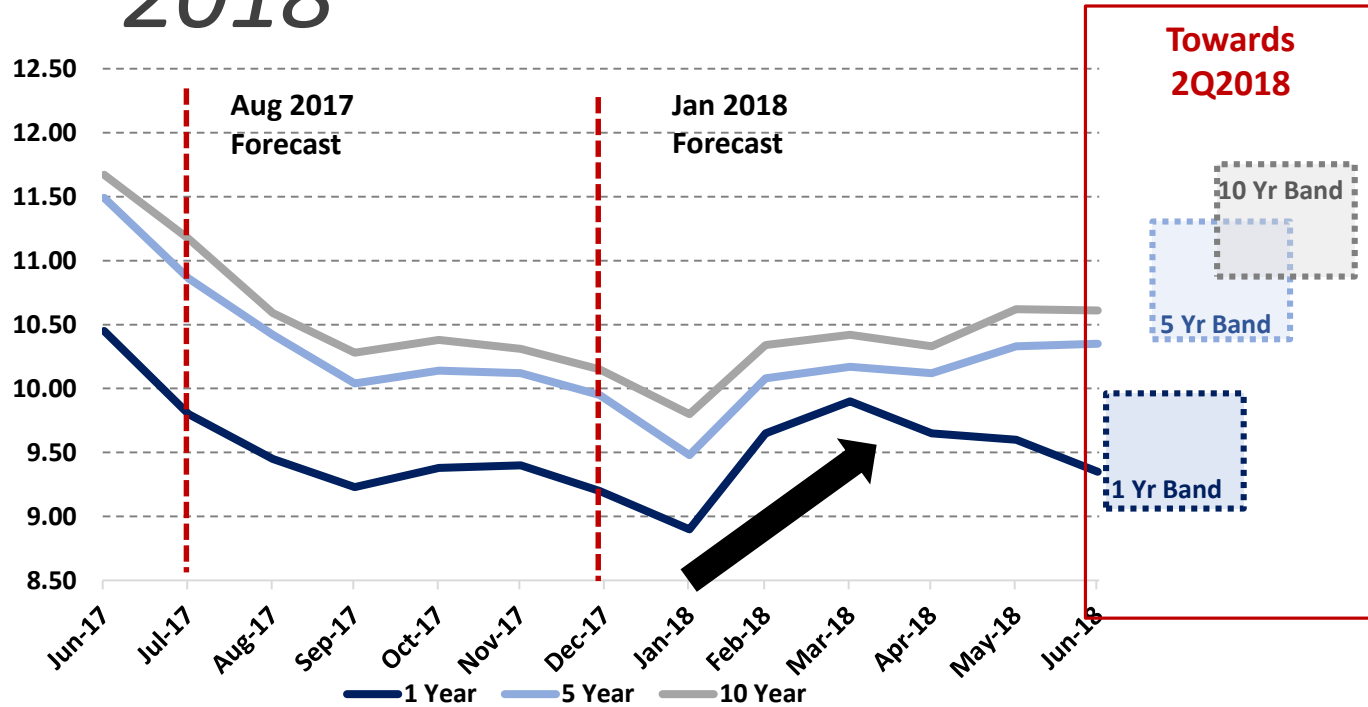
Glamorous 2H achieved; Signs of bearishness reversed in Nov-Dec 2017

Expectations of a glamorous 2H2017 was realized with a strong downtrend in yields with increased levels of Economic Health in 3Q2017.

Despite some signs of economic health deterioration was expected towards end of 4Q2017, heavy net inflows amounting to almost USD 0.8Bn (Hambantota Port Deal, IMF 4th tranche and heavy inflows into Govt. Securities) in Dec 2017 reversed all signs of economic weakness further improving health and pushing yields down even further.

	3 Months Jul-Sep 2017	3-6 Months Oct-Dec 2017	6-9 Months Jan-Mar 2018	9-12 Months Apr-Jun 2018
Health Score Estimate	75-100	60-75	60-65	50-60
Risk Level Estimate	Remote	Medium-Low	Medium	Medium-High
Actual Risk Outcome	Remote	Remote		

Jan 2018 Re cap: Tough Conditions, but Cautiously Optimistic 2018



JAN 2018 FORECAST

First Capital Research : **BEARISH** towards 2Q-3Q2018

Jan 2018 – Dec 2018	Probability
Interest Rates to be upward trending towards 2Q-3Q2018 and reaching upper bands	65%
Breakaway from the continuous reform program (Deviations affecting IMF program) may result in the breaking the upper bands	35%

Review on Recommendation Jan 2018

Unexpected early spike in yields

The unexpected local polls victory by the opposition resulted in an early surge in yields across the yield curve with low level of investor confidence.

Following the USD 2.5Bn sovereign bond some stability was seen during Apr 2018

However, business confidence dropped to a 70 month low in Apr 2018.

With investors expecting a further rise in yields, most switched to short tenors resulting in a continuous dip in yields

	3 Months Jan-Mar 2018	3-6 Months Apr-Jun 2018	6-9 Months Jul-Sep 2018	9-12 Months Oct-Dec 2018
Health Score Estimate	65-75	65-75	60-65	65-75
Risk Level – Jan 2018	Medium-Low	Medium-Low	Medium	Medium-Low
Previous Expectations – Aug 2017	Medium	Medium-High		

Previous Month 23rd May Recommendations and Yield curve movement afterwards

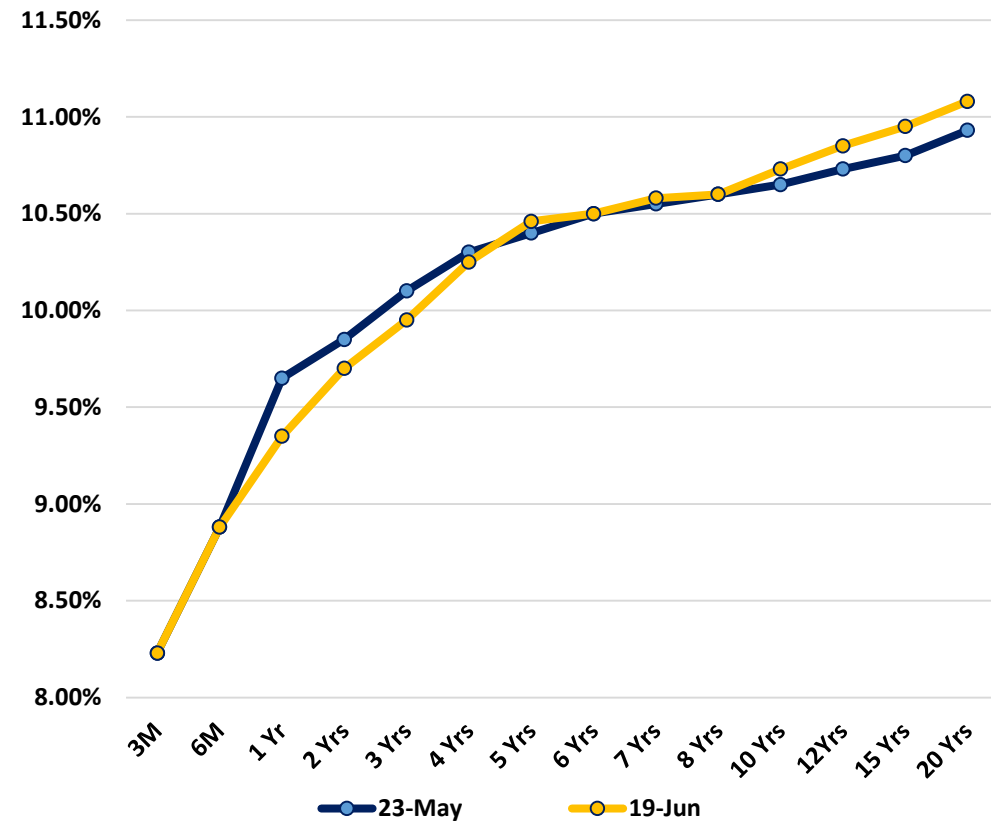
Fixed Income Portfolio Recommendation

Fixed Income Portfolio Recommendation

– Portfolio Recommendation: Maintained overall portfolio at 50%.

- Carry portfolio to be maintained at 40%.
- Trading portfolio to be maintained at 10%

We expect economic health score to improve further in June with expected inflows from IMF tranche, final payment of Hambantota port sale and proceeds of a syndicated loan. Subsequently, health score likely to slowly decline towards Jul and Aug due to high maturities in 3Q2018.



Rate Movement Review (Last 25 days)

Interest Rate Change (bps)			
Tenure	23-May	19-Jun	Change (bps)
3M	8.23%	8.23%	0
6M	8.88%	8.88%	0
1 Yr	9.65%	9.35%	-30
2 Yrs	9.85%	9.70%	-15
3 Yrs	10.10%	9.95%	-15
4 Yrs	10.30%	10.25%	-5
5 Yrs	10.40%	10.46%	6
6 Yrs	10.50%	10.50%	0
7 Yrs	10.55%	10.58%	3
8 Yrs	10.60%	10.60%	0
10 Yrs	10.65%	10.73%	8
12Yrs	10.73%	10.85%	12
15 Yrs	10.80%	10.95%	15
20 Yrs	10.93%	11.08%	15

- Following our previous report on 23rd May 2018, yields registered 15-30bps downward in 1Yr to 3Yr and 8-15bps upward in 10Yr to 20Yr.
- Yield curve shifted slightly downwards in the short tenors amidst foreign selling pressure.
- Further LKR 4.0Bn net foreign selling was also witnessed over last 3 weeks.

1.0 Economic Health Score

Jun 2018 Economic Health Score

Health score slipped from short bounce

Primary Criteria	-	57	- 3	-	54
Secondary Criteria	-	10	- 1	-	09

Economic Health Score (May 2018) - 63

- [As against 67 in May 2018 & 50 in May 2017 (1 Year ago)]

Changes to Health Score – Priority Criteria

Criteria	Update	Current Score	Add / Deduct Score	New Score
Foreign Reserves	May 2018 Reserves fell to USD 8.8Bn from 9.9Bn in April 2018. CBSL sold USD 220Mn to the forex market.	14/15	-02	12/15
Liquidity	Liquidity shortage witnessed during last 4 weeks.	07/15	-01	06/15
Inflation	CCPI at 4.0%, lower than First Capital Research expectation of 4.8%; Core inflation remains under control.	14/15		14/15
Foreign Buying	Net outflow LKR 7.0Bn over the last 3 weeks; Foreign holding reaches 7 month low to 6.0%.	05/10		05/10
Credit	Mar 2018 private sector credit growth accelerated to LKR 122Bn; Need to check whether it is one off.	09/10		09/10
CBSL Holdings	CBSL sold down LKR 15Bn in the CBSL Holdings which creates liquidity shortage.	08/10		08/10

Primary Criteria - 57 - 3 = 54

Changes to Health Score – Secondary Criteria

Criteria	Update	Current Score	Add / Deduct Score	New Score
Rating Outlook	No major changes	05/05		05/05
External Environment	Rupee continuously remain weak importer dollar demand surpassed selling by exporters and banks.	01/05	-01	00/05
BoT & BoP	Historic high level exports in Mar 2018 contributed to a lower trade deficit, While expenditure on imports continued to increase.	02/05		02/05
Political Risk	Uncertain environment slowly subsiding with coalition government.	02/05		02/05
Investor Confidence	On the back of extreme political uncertainty, business confidence has regained lost ground, moving up to 106 in May from 98 in Apr 2018.	00/05		00/05

Secondary Criteria - 10 - 1 = 09

2.0 Recommendation

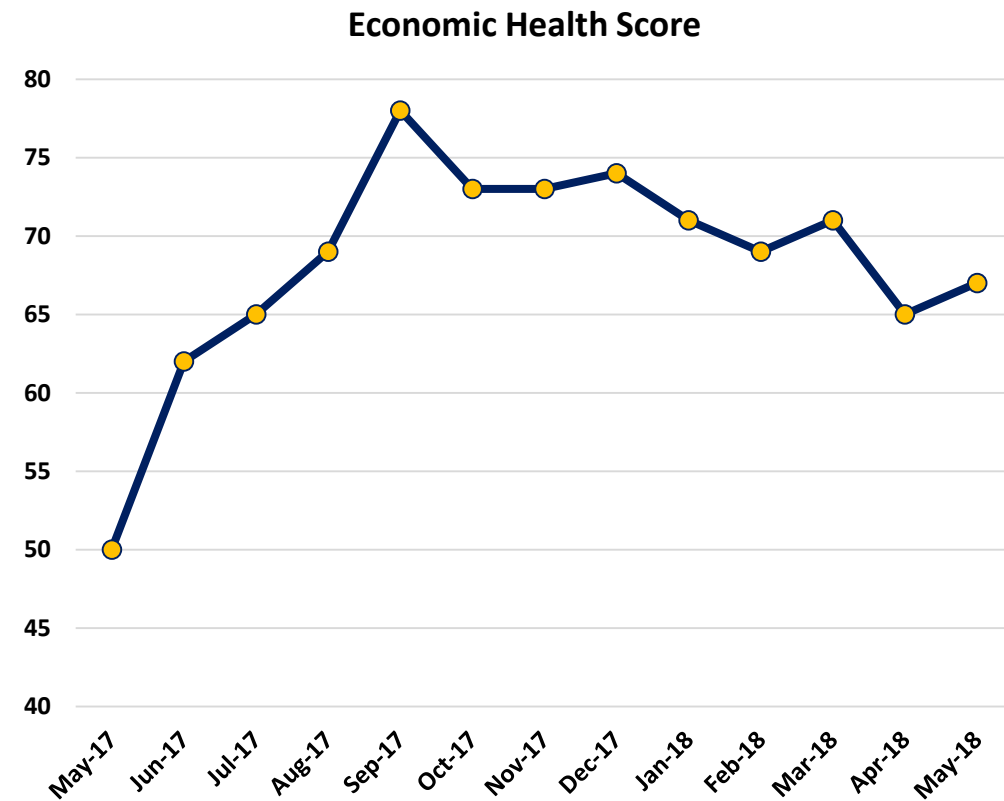
Recommendation

Fixed Income Portfolio Recommendation

– Portfolio Recommendation: Maintained overall portfolio at 50%.

- Carry portfolio to be maintained at 40%.
- Trading portfolio to be maintained at 10%

We expect economic health score likely to decline towards Jul and Aug due to high maturities (Rupee bond and SLDBs) in 3Q2018.



Sequence of Events

18th Jan 2018 – Previous plans of increasing carry portfolio to 50% failed as rates further fell sharply. Cut carry portfolio to 30% from 40%. Trading portfolio to be maintained at 0%. SELL primarily the shortest tenors of 3M and 6M and consider lending in the REPO market

16th Feb 2018 – **BUY** primarily into the short tenors (2Y, 3Y, 4Y) and mid tenors of 5Y, 6Y. Overall portfolio to be increased to 40%. Increase Trading portfolio to 10% from 0%. Carry portfolio to be maintained to 30%.

5th Mar 2018 - **BUY** primarily into the short tenors (2Y, 3Y, 4Y) and mid tenors of 5Y, 6Y. Overall portfolio to be increased to 50%. Increase carry portfolio to 40% from 30%. Trading portfolio to be maintained to 10%.

22nd Mar 2018 - **BUY** primarily into the long tenors (8Y, 10Y). Overall portfolio to be increased to 60%. Increase Trading portfolio to 20% from 10%. (Primarily into 8Y, 10Y on the back of sovereign bond). Carry portfolio to be maintained to 40%.

16th Apr 2018 - **Reduced** overall portfolio to 50% from previous 60% mainly on mid-long tenors (5Y to 10Y). Cut Trading portfolio to 10% from 20%. (Primarily into 5Y to 10Y). Carry portfolio to be maintained to 40%.

23rd May 2018 - Maintained overall portfolio to 50%. Carry portfolio to be maintained to 40%. Trading portfolio to be maintained to 10%

19th June 2018 - Maintained overall portfolio to 50%. Carry portfolio to be maintained to 40%. Trading portfolio to be maintained to 10%

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