



First Capital
First Capital Research

“FCR REDUCES BOND YIELD BANDS AMIDST HIGHER FOREIGN RESERVES”

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Increased foreign reserves change future expectation

In our last FC FI Recommendation Report on 16th May 2019 (last week), we recommended to significantly cut portfolio exposure to 40% from 70% amidst the fall in yields well below our yield curve bands. We expected Sri Lanka's foreign reserve to drop to USD 6.7Bn after repaying USD 500.0Mn sovereign bond maturity and USD 250.0Mn project loan payments in Apr 2019. Surprisingly foreign reserves had dropped only by USD 417.0Mn to USD 7.2Bn in April 2019 from USD 7.6Bn in March suggesting additional inflows into reserves. Further the net surplus liquidity in the system (including term repo) is likely to be sustainable with CBSL discontinuing reverse repo and also gradually reducing CBSL Holdings on Government Securities.

Recent Developments

CBSL has already secured 65% of the total USD commitment for this year through issuance of USD 2.4Bn sovereign and USD 344.0Mn SLDB. We expect balance commitments to be met via USD 1.0Bn Sovereign Bond backed by the World Bank (WB) Policy-Based Guarantee with a longer-term repayment of over 5 to 10 years and Samurai Bonds from the Japan Bank for International Cooperation, Panda Debt and term loan as indicated by the CBSL Governor. These potential facilities are expected to maintain reserves above USD 7.0Bn during June to Dec 2019. Sri Lanka's next large local SLDB repayment is due in Mar 2020 and international sovereign repayment in Oct 2020.

IMF Agreement

We expect recent extension of the IMF agreement until June 2020 to boost investor confidence, which was temporally halted amidst the political crisis that commenced on 26 Oct 2018.

Reduction in Yield curve Bands

Improved indicators in the First Capital Economic Health Score suggest a lower risk profile as Sri Lanka returns to the situation prior to Oct 2018 in terms of economic health, justifying a lower yield expectation in the bond market similar to the same period. Thereby, we reduce our yield curve band expectations across the yield curve by 50bps.

Justification for Revision of Bond Yield

- Previous Expectations for 2019 as at Mar 2019

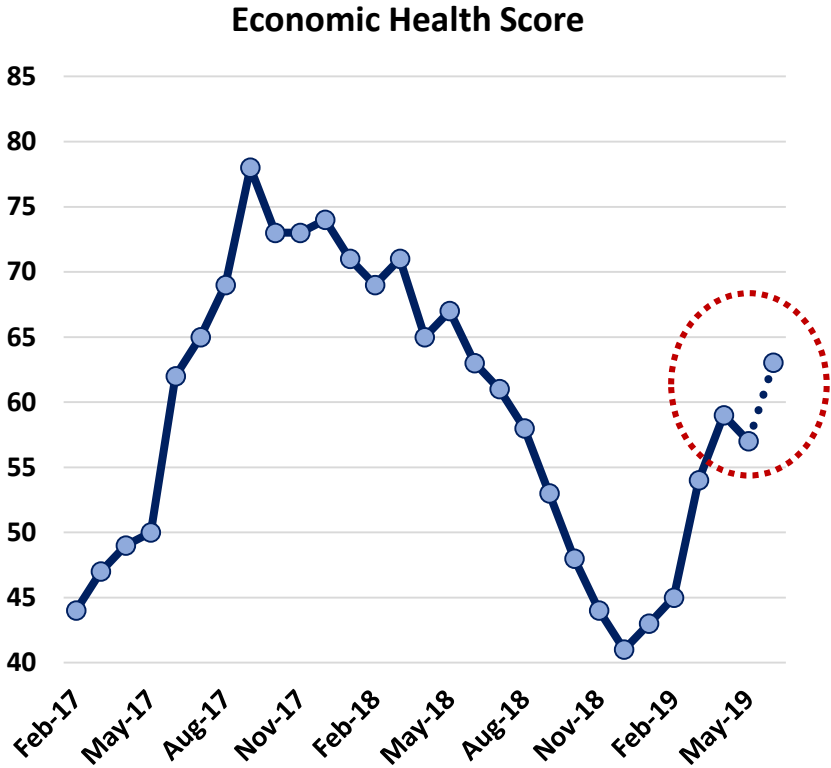
As at Mar 2019	1 Yr	5 Yr	10 Yr
Beyond 2Q2019	9.5%-10.5%	10.5%-11.5%	11.0%-12.0%

As at 23 May 2018, with reduction in the future risk resulting from expected rate cut in the upcoming monetary policy we revisited our band expectations as follows:

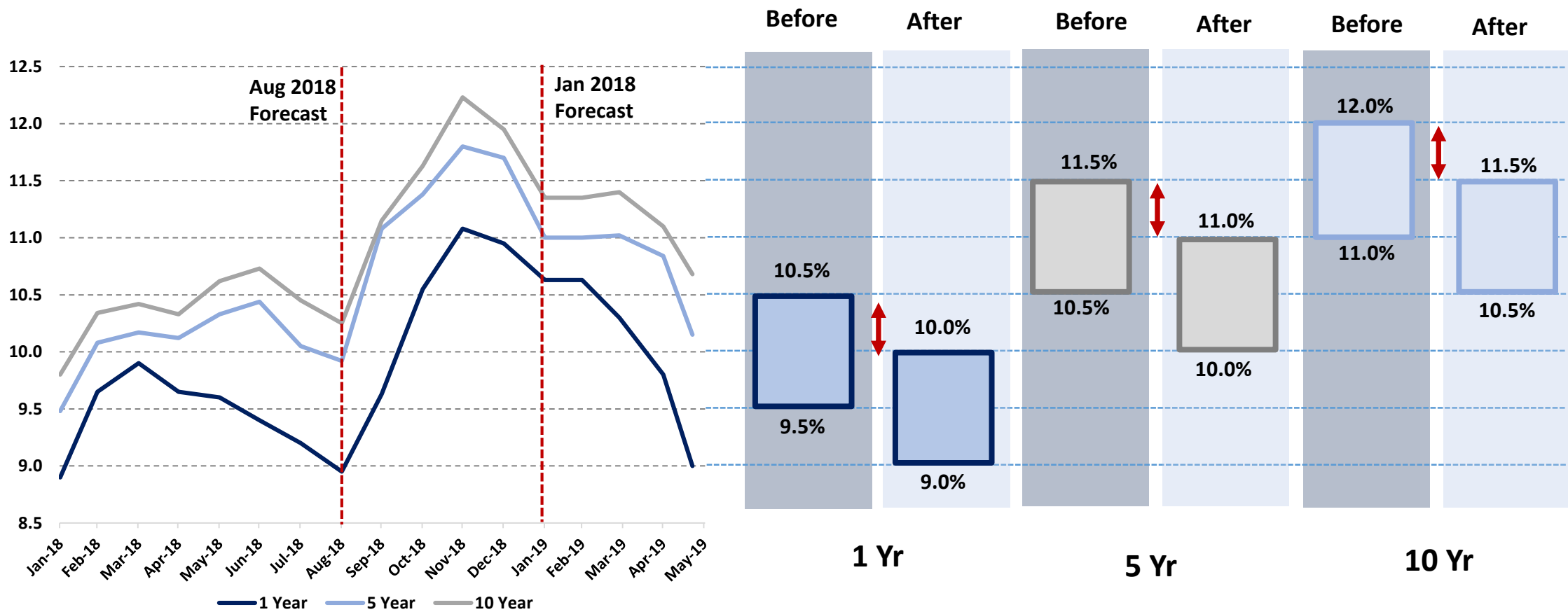
Yield expectation across the yield curve is brought down by 50bps

- New Expectations for 2019 as at May 2019

As at May 2019	1 Yr	5 Yr	10 Yr
Beyond 2Q2019	9.0%-10.0%	10.0%-11.0%	10.5%-11.5%



Revision of Bond Yield



1.0 Economic Health Score

Changes to Health Score – Priority Criteria

Criteria	Update	Current Score	Add / Deduct Score	New Score
Foreign Reserves	Forex reserves maintain above expected levels: dropped by USD 416.0Mn to USD 7.2Bn in Apr 2019, after sovereign payment of USD 500.0Mn.	10/15	+02	12/15
Liquidity	CBSL continuously conducting term repo auctions to absorb liquidity.	10/15	+02	12/15
Inflation	CCPI at 4.5% in Apr, lower than First Capital Research expectation of 5.2%.	11/15		11/15
Foreign Buying	Net outflow of LKR 27.0Bn in government securities over the last 7 weeks; Foreign holding reaches 2.6%.	06/10	-01	05/10
Credit	Private credit grew by LKR 26.3Bn in the first quarter of 2019 compared to LKR 200.2Bn in the first quarter of 2018.	07/10	-01	06/10
CBSL Holdings	CBSL Holding is maintained at LKR 158.5Bn amidst improved liquidity.	06/10		06/10

Primary Criteria - 50 + 04 - 02 = 52

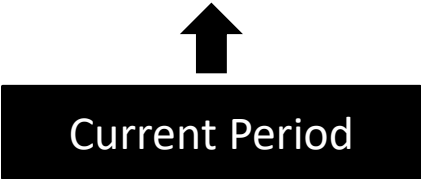
Changes to Health Score – Secondary Criteria

Criteria	Update	Current Score	Add / Deduct Score	New Score
Rating Outlook	No major changes.	02/05		02/05
External Environment	Rupee continued to strengthen to close at 176.45 on 23 May 2019 supported by foreign inflows	02/05		02/05
BoT & BoP	Deficit in the trade account slowed down with contraction in imports in Jan & Feb 2019.	02/05	+01	03/05
Political Risk	Political stability reinstated to some degree amidst the prospect Presidential elections in 2019	01/05	+02	03/05
Investor Confidence	BCI dropped to 77 in April to its lowest in over a decade	02/05	-01	01/05

Secondary Criteria - 09 + 03 - 01 = 11

Revisiting Health Expectations

	3 Months Outlook Jan-Mar 2019	3-6 Months Outlook Apr-Jun 2019	6-9 Months Outlook Jul-Sep 2019	9-12 Months Outlook Oct-Dec 2019
Health Score Estimate	40-50	50-60	60-65	65-70
Risk Level – May 2019	High	Medium	Medium	Medium-Low
<i>Previous Expectations – Jan 2019</i>	High	Medium-High	Medium	Medium



Risk Levels:- High: 40-50, Medium High: 50-55, Medium: 50-65, Medium Low: 65-75, Low: 75 above

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