First Capital
First Capital Research
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Strategy Report 2019

Jan 2019

SRI LANKA

Crisis weakens Fundamentals; 2H2019 to regain stability

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Crisis weakens Fundamentals; 2H2019 to regain stability

Executive Summary

Bond Rates to peak in 1Q2019 and gradually ease

- With the heavy debt payments and liquidity shortage, we expect bond yields to touch the upper bands of the yields curve during 1Q. The heavy risk associated with lower reserve position by end Jan 2019 following payment of the USD 1Bn Sovereign Bond and other debt payments would be the primary cause for the yields to move towards the upper bands. Though the fund flow towards Emerging Markets (EM) is positive now, there is a cap of 5% for foreign holdings in Sri Lanka. With foreign inflows & debt inflows towards 2Q, rise in economic activity amidst upcoming elections, and low debt payments after 7th April, liquidity is likely to improve and ease yields beyond 1Q2019 towards the lower bands.

Real Interest rates to dip by 300bps to 5% by 4Q2019 with higher inflation and lower yields

- We expect real interest rates to dip to 5% towards end of 2019 with lower yields and rising inflation, though in 2 different time periods. We expect heavy debt inflows to result in lower yields during the 2Q2019 while we expect a gradual rise in inflation as producers pass on cost increases amidst possible rise in demand during 3Q-4Q period.

Banking Rates (AWPR) to be volatile within a 100bps band but dip to *c.*11% towards 4Q

- 5 Year Bond is likely to peak in the 1Q around the 12% mark. The AWPR has already risen marginally above 12%. We expect banking rates to remain high during 1H2019 with AWPR at *c.*12% while illustrating a declining trend towards 2H, dipping to *c.*11%. In a more broader sense during the next 12 months, we expect AWPR to stay within the band of 11.0% - 12.0%.

Exchange Rate 2019 target of LKR 194.0 (6% dep.) marginally above the 15yr avg of 4%

- We expect rate hikes in the US to significantly slowdown in 2019 positively impacting emerging market currencies. The rupee may remain volatile in the 1Q with weak macro conditions, but is likely to stabilize in 2Q & 3Q amidst the debt driven foreign inflows.

Equity Market, Positive but cautious; Increase equity exposure to 60% from 50%

- We believe the events that have unfolded may benefit Sri Lanka and the equity market over the next few months positively impacting earnings and possibly leading to net foreign inflows. Thereby, we upgrade our equity exposure to 60% and upgrade ASPI volatility expectations to 6,000-6,500 (from our previous 5,800 – 6,200), assuming Market PER to be 8.5x – 9.5x.

Track Record [Jan & Jul 2018 (Revised Nov 2018)]

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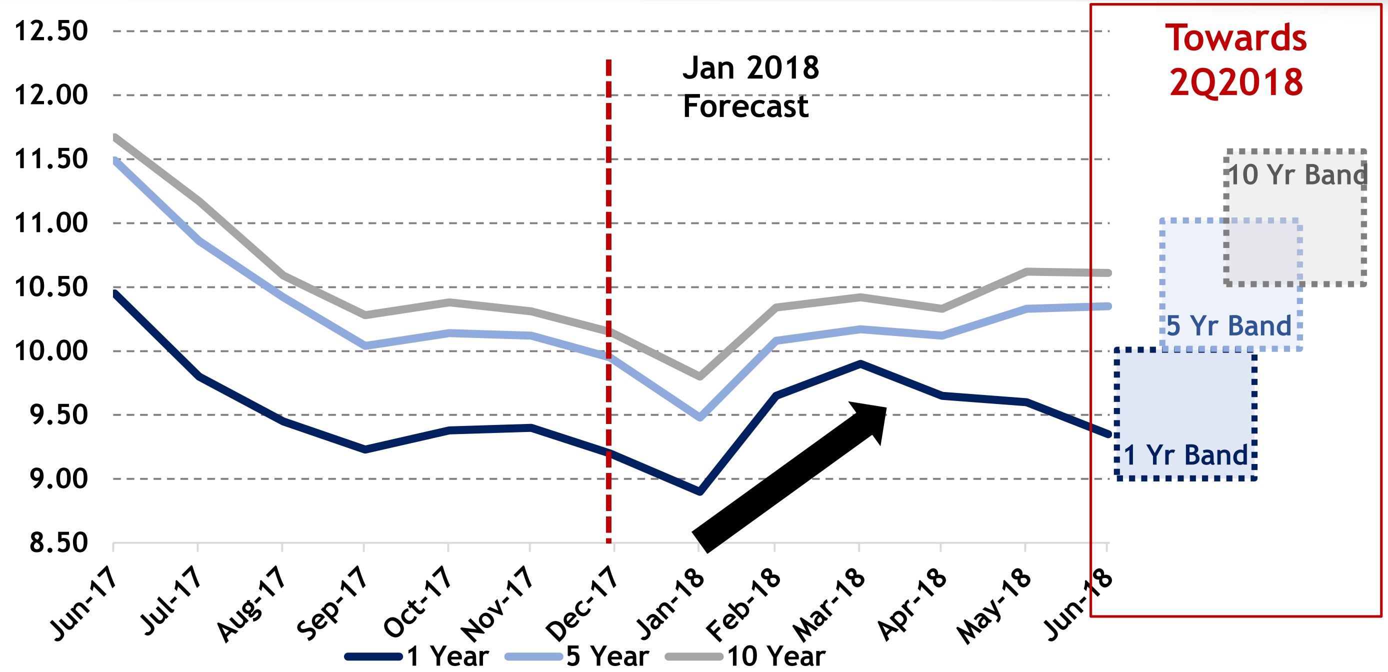
Section 1.0

Jan 2018 Re cap: Accuracy Maintained

Tough Conditions, but Cautiously Optimistic 2018

First Capital Research BEARISH towards 2Q-3Q2018



	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*		

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

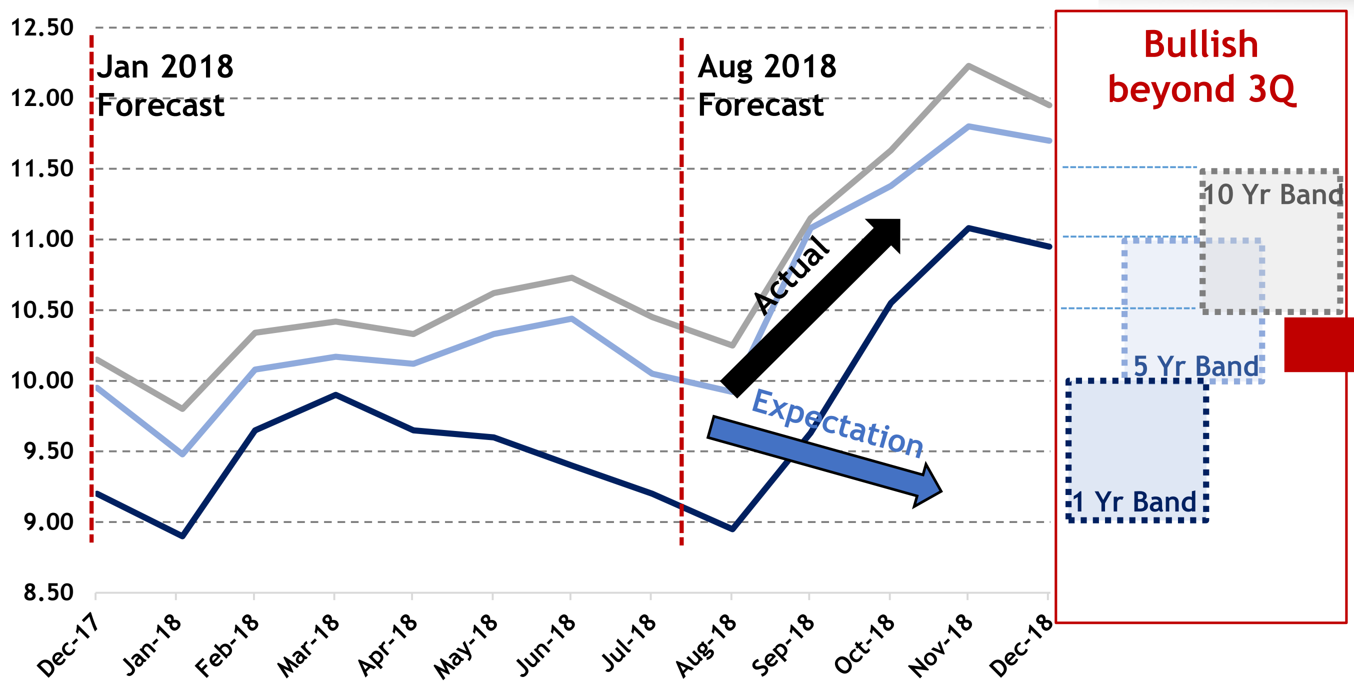
Unexpected early spike in yields

- 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

Jul 2018 Re cap: Recommendation turned inaccurate

Fundamentals strengthening, Growth remains key

Bond Rates to peak in 3Q2018 and gradually ease



	3 Months Jul-Sep 2018	3-6 Months Oct-Dec 2018	6-9 Months Jan-Mar 2019	9-12 Months Apr-Jun 2019
Health Score Estimate	60-65	65-75	60-65	65-75
Risk Level - Jun 2018	Medium	Medium-Low	Medium	Medium-Low
Previous Expectations - Jan 2018	*Medium*	*Medium-Low*		

JUL 2018 FORECAST FOR 12 MONTHS

- Moderately Bullish beyond 3Q2018

Jul 2018 - Jun 2019	Probability	Impact
Bond Rates to peak in 3Q2018 and gradually ease	65%	Moderately Bullish / Stable
Breakaway from reform program (Deviations affecting IMF program) or political deadlock may result in the breaking the upper bands	35%	Bearish

Review on Recommendation Aug 2018

Recommendation turned inaccurate as Delay in debt inflows & Political Crisis hit the economy spiking yields

- The expected loans from China Development Bank of USD 1Bn was delayed and received only in Oct 2018 resulting foreign reserves falling below USD 8Bn for the 1st time in 5 months.
- After receiving the above loan all subsequent fund raising plans had to be delayed as Sri Lanka went through a political crisis on Oct 26th for a period of 2 months resulting in reserves dipping below USD 7Bn by Dec 2018

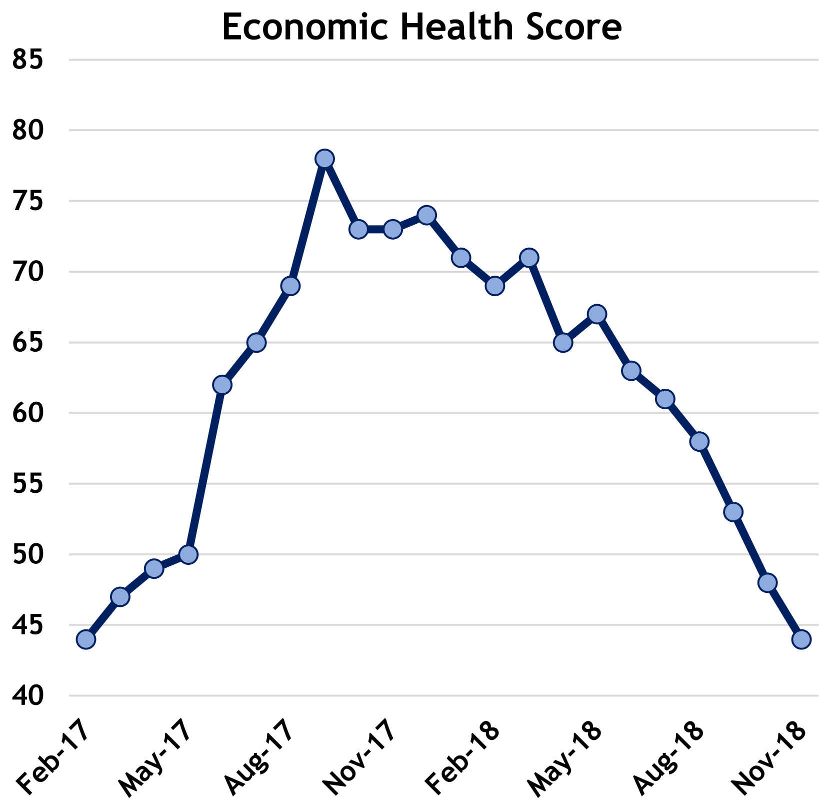
Recap Nov 2018:
Immediate Revision of Bond Yield Expectations following Political Crisis

- Previous Expectations for 2018 as at July 2018

As at July 2018	1 Yr	5 Yr	10 Yr
Beyond 3Q2018	9.0%-10.0%	10.0%-11.0%	10.5%-11.5%

- With political uncertainty created through the sudden change in Government and the subsequent dissolution of parliament increased future short term risk for bond investors with some critical sovereign debt maturities falling during the next 3-6 months which may have a major impact on country's foreign reserve position.
- We believe that Sri Lanka is unable to raise funds in the international market until it settles the political uncertainty. Therefore we shift our overall yield curve expectations upwards by 100bps.
- New Expectations for 2018 as at Nov 2018

As at Nov 2018	1 Yr	5 Yr	10 Yr
Beyond 3Q2018	10.0%-11.0%	11.0%-12.0%	11.5%-12.5%



Source: First Capital Research

Jul 2018 Recap:
Key Shocks to look out for in 2018-19

- Further defeats in PC Elections or Coalition Government falls off
  - Further increase in political uncertainty

Materialized

- Surge in oil prices or falling off of IMF agreement
  - Economic Uncertainty increases

Materialized

- Heavy increase in US treasury rates may push fund flows towards US or weak SL policies leading to foreign outflows
  - May lead to foreign outflows

Materialized Sep-Nov

Factors to Consider for 2019 Outlook

Section 2.0

Factors to make decisions

- Political Factors
  - Budget for 2019
  - PC Elections
  - Presidential Election
- Economic Factors
  - GDP Growth
  - Foreign Reserves
  - Liquidity Shortage
  - Debt Repayment
  - IMF Agreement
- External Factors
  - Global Growth
  - Trade War
  - Global fund flow for emerging markets

Political Outlook to continue to haunt with uncertainty: *Negative*

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Section 3.0

Political Uncertainty to continue affecting investor confidence: Negative Outlook

- Budget for 2019?
- Provincial Council Elections (6 Councils)
  - Elections Commissioner has not yet called for nominations
  - Sabaragamuwa, North Central, Eastern Central, North Western and Northern PCs expired in 2017 & 2018
  - Southern, Western and Uva PCs terms will expire on Apr.10, 21 and Oct.8 in 2019
  - Cabinet has approved a proposal put forward by President to hold Provincial Council elections before Jun 2019
- Presidential Election
  - Presidential Election is to be called on or before 8th Nov 2019
  - No obvious candidate for any of the parties!!!

We believe divergent views between the UNF Government and President is likely to continue throughout 2019.

The first test for the UNF Government would be, the passing of the budget on 4th April 2019 as it would be a reality check on whether the Government has majority support of the parliament.

With nominations for Presidency, likely to be called before Nov 2019, uncertainty within the Government and the President is likely to further escalate.

By 8th Oct 2019, the term of all provincial councils would stand expired. There is a possibility that all provincial council elections may be called together with the Presidential election provided all parties agree. In the alternative 8 out of 9 provincial councils stand expired by after April, providing the possibility of those provincial council (or all PCs by dissolving Uva) elections being held between April and Oct 2019. In the meantime cabinet approval has been received to hold PC polls before Jun 2019 though it is not clear whether it refers to all PCs as Governor has power to dissolve non-expired PC councils.

We believe with multiple alternatives, Government is unlikely to have the will and the ability to take key policy decisions during 2019. Further with the upcoming elections coupled with the pressure from the President, Government may be leaned towards upholding populist measures which may give rise to deficit concerns.

Elections may revive economic activity: Neutral

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Section 4.0

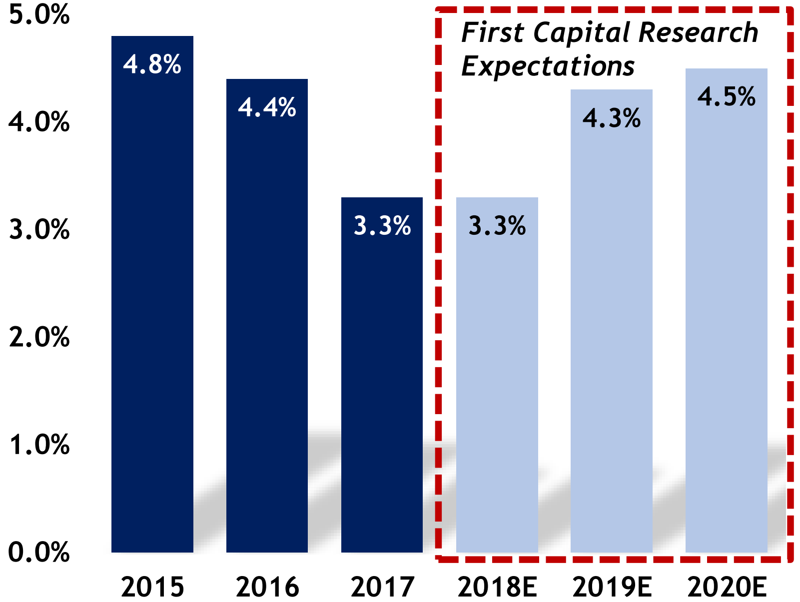
Economic Forecasts

- GDP to remain slow in 1H and pick with economic activity led by elections in 2H
- Delay in foreign loans adversely affects reserves…but may recover in 2Q
- Overall debt payments ease off despite high foreign debt component
- Liquidity shortage may continue in 1Q, possibly easing 3Q-4Q
- Private Sector Credit to further moderate to 14%
- Inflation to be upward trending, but remain between 4-6% most part of 2019

GDP to remain slow in 1H and pick with economic activity led by elections in 2H

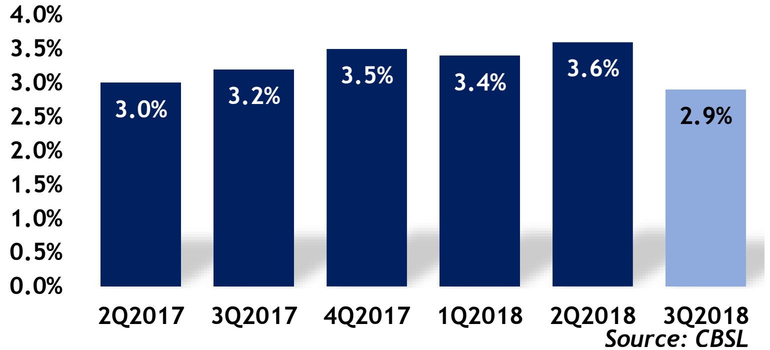
Long term nature of high private investment in previous years may push GDP growth in years ahead (Eg: Port City)

SL GDP Growth Forecasts	2017	2018E	2019E	2020E
CBSL	3.3%	4.0%	4.0%	4.5%
World Bank		3.7%	4.0%	4.1%
IMF		3.7%	4.5%	4.7%
ADB		3.7%	4.5%	4.5%
City Group		3.8%	4.0%	4.4%
Standard Chartered		3.7%	4.2%	4.5%
Average		3.8%	4.2%	4.5%



Source: First Capital Research, CBSL

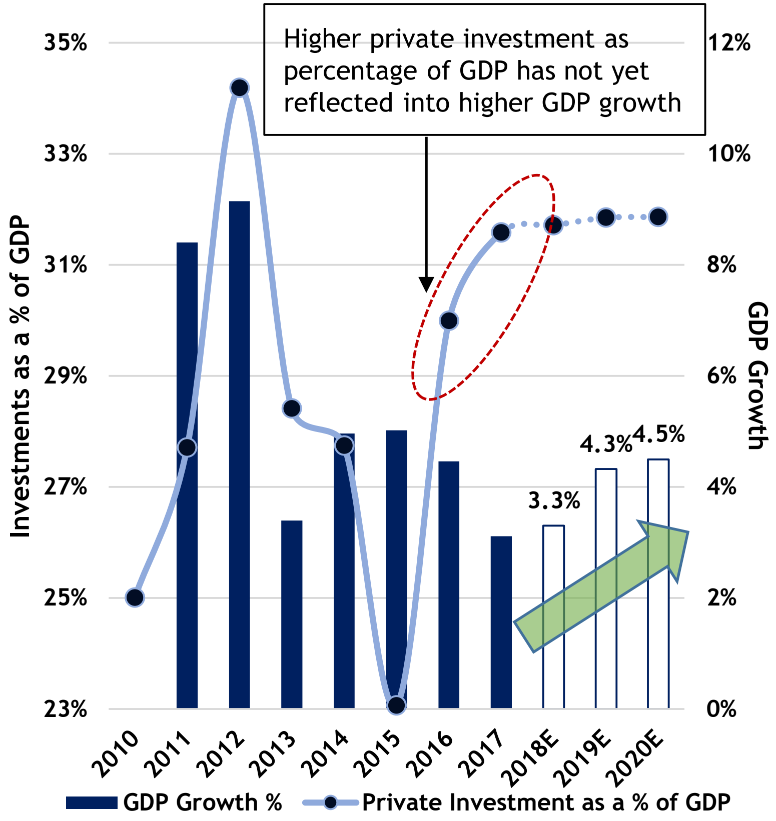
Quarterly GDP Growth



Source: CBSL

- *GDP growth 2019 rise to 4.3% due to elections:* We expect the upcoming budget to be consumer friendly, given the due elections in 2H2019. Further up coming elections are likely to create economic activity with increased spending by relevant parties creating a sudden rise in money circulation. The above factors are likely to improve private consumption towards the 2H2019 boosting GDP.
- *Strong rise in Private investments as percentage of GDP to 32%:* Private investment in the last few years has been high and is usually followed by strengthening GDP growth but is not reflective in SL. We believe that long term nature of the private investments such as Port City has resulted in the expected failure in the GDP growth picking up. Thereby, with the private investment starting to generate returns we expect GDP growth to improve in the years ahead.

Long term nature of higher private investments may push GDP growth in years ahead



Source: First Capital Research, CBSL

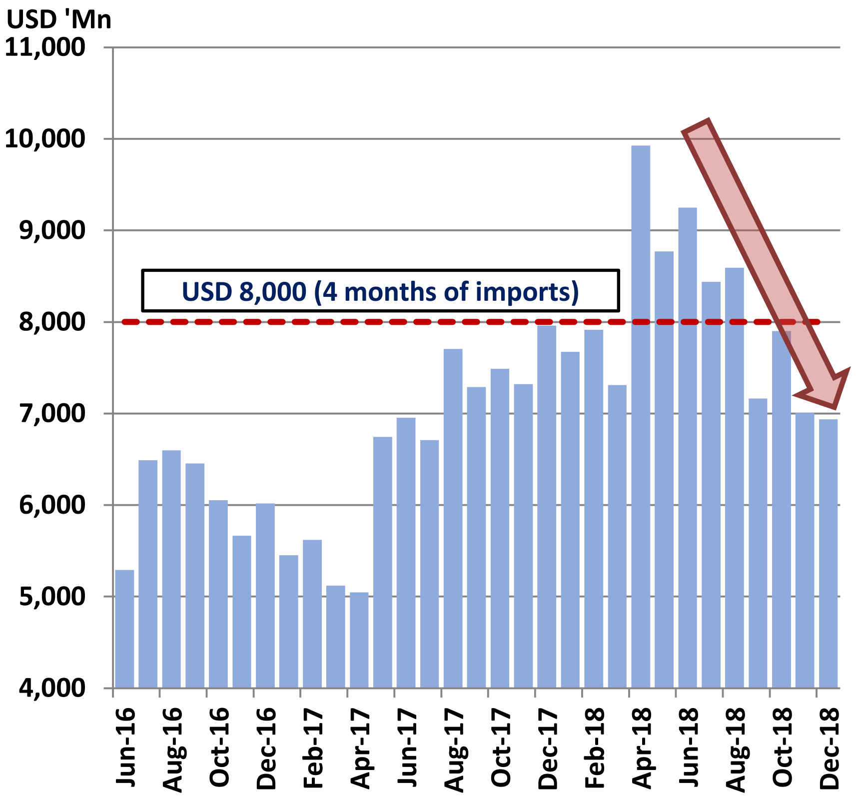
Delay in foreign loans adversely affect reserves…….

Newly targeted Sovereign Bond and bilateral loans may lift reserves above USD 7Bn by 2Q

- *Dip in reserves in the 2H2018 started off with delay in the China Development Bank loan of USD 1Bn in Aug 2018. Subsequently, political crisis triggered in Oct 2018 delayed the ability to raise funds in the international market pushing down foreign reserves below USD 7Bn by Dec 2018. With next 12 months foreign currency repayments amounting to USD 6Bn, foreign repayment cover has fallen to a 2 yr low of 1.2x.*
- Central Bank has also announced the raising of USD 2Bn as a Sovereign Bond while also planning on upgrading existing facilities from India and China. Further currency swaps are also on the cards which are likely to boost reserves by the 2Q.

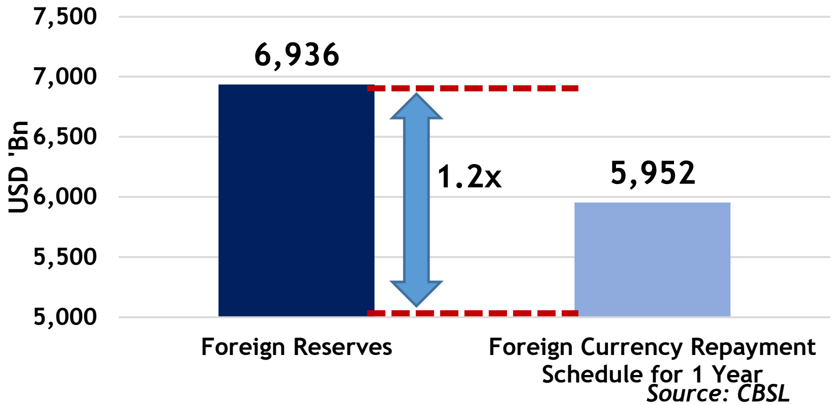
We expect reserves to further dip in 1Q2019 and subsequently rise above USD 7Bn by 2Q2019. On the back of raising a significant quantum of foreign currency debt coupled with lower foreign currency payments beyond 7th Apr, we expect foreign repayments cover to improve by mid 2019 (as the next sovereign payment is due in Sep 2020).

Foreign Reserves



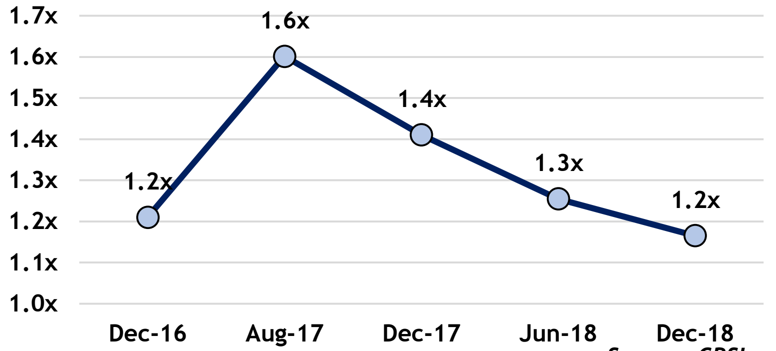
Source: CBSL

Foreign Reserves vs Foreign Repayments



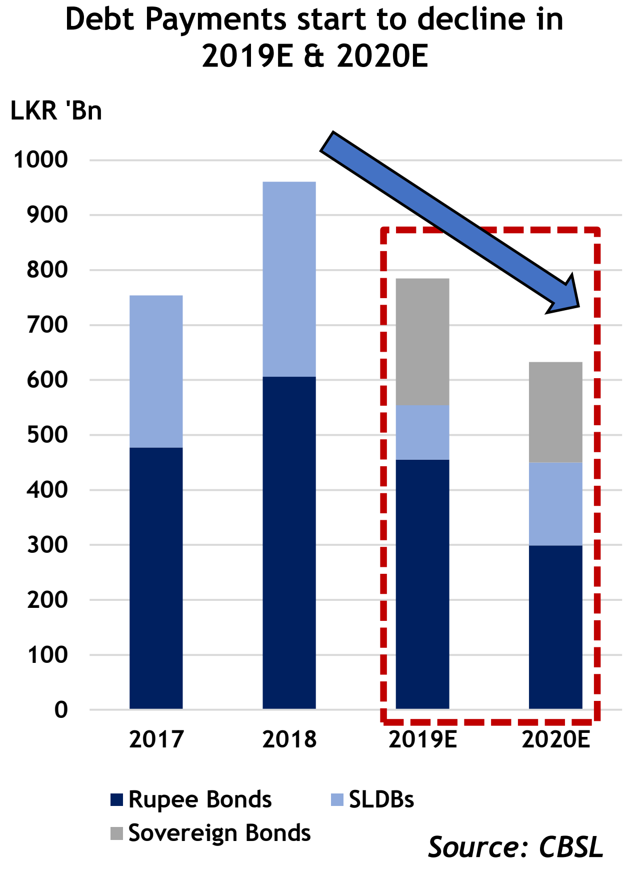
Source: CBSL

Foreign Repayments Cover



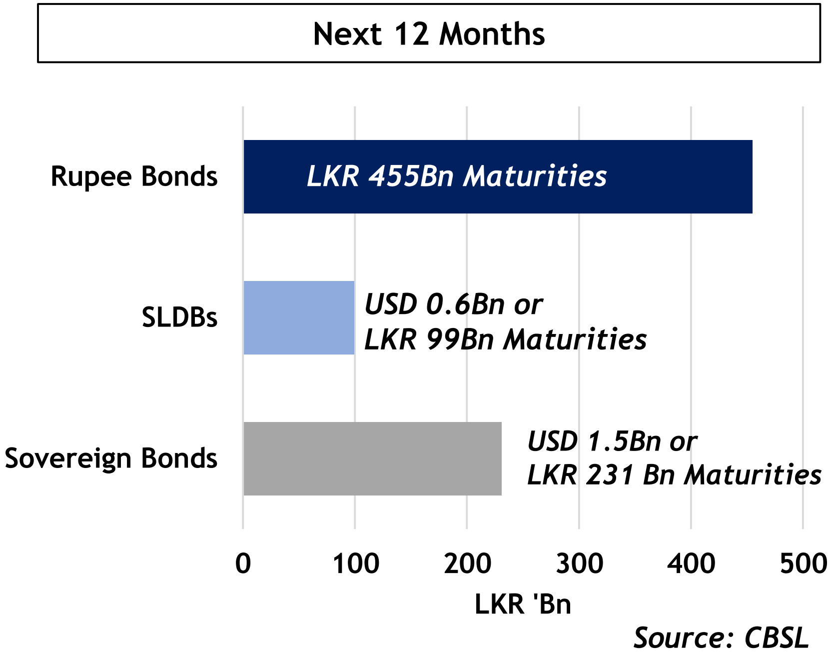
Source: CBSL

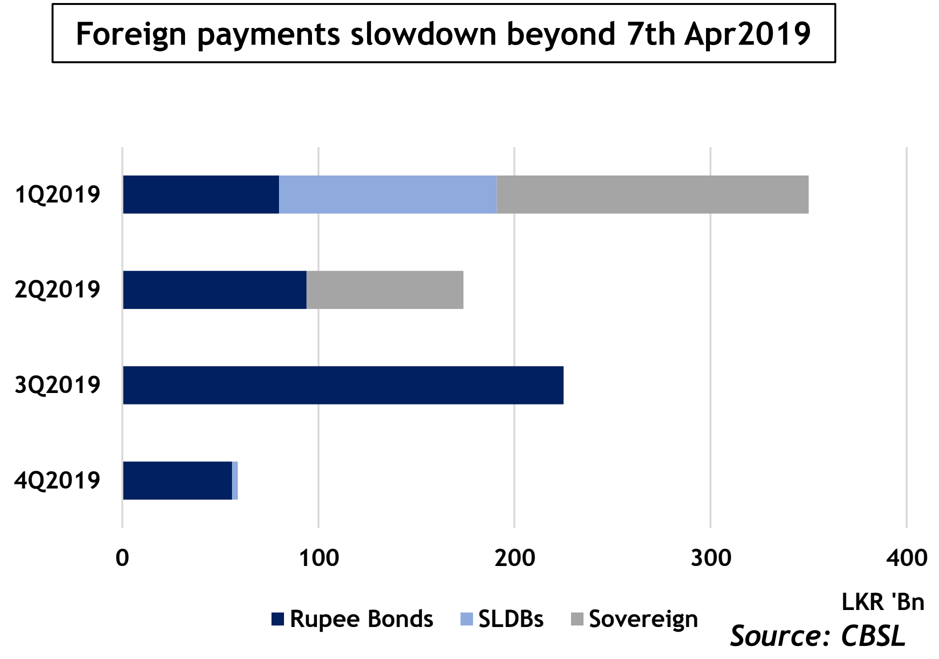
Overall debt payments ease off despite high foreign debt component



2019 Outlook (Next 12 Months)

As the below graphs illustrate the dollar bond payments dry off beyond 7th Apr 2019 for the year 2019. However, we expect foreign payments in the range of USD 300-400Mn to exist on a monthly basis in the form of project loan repayments.





Liquidity shortage may continue in 1Q, possibly easing towards 3Q-4Q

Private Sector Credit to further moderate to 14% on the back of liquidity shortage and capital constraints (BASEL III & IFRS 9)

Liquidity shortage aggravates; May improve in 3Q-4Q....

We expect the liquidity shortage to prevail during 1Q2019 improving only towards 3Q-4Q as we expect upcoming elections to result in a rise in economic activity leading to stronger money circulation and thereby improving liquidity.

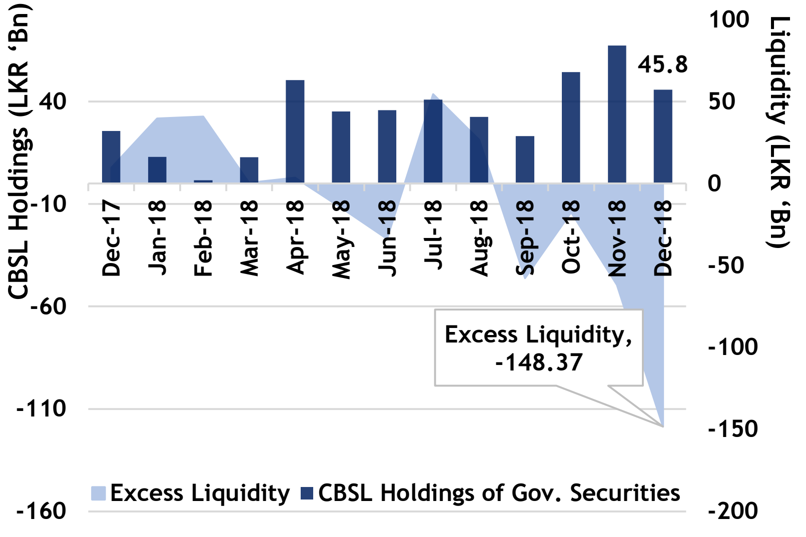
....as the new rule limits foreign holdings

Beyond the 1Q, we expect net foreign inflows also to benefit Sri Lanka, however, with the foreign holding limit for Treasury Bills and Bond downgraded to 5% by CBSL, only a maximum of LKR 100Bn worth of net inflows could materialize into the Bond market.

2019 Outlook: Credit to Moderate to 14%

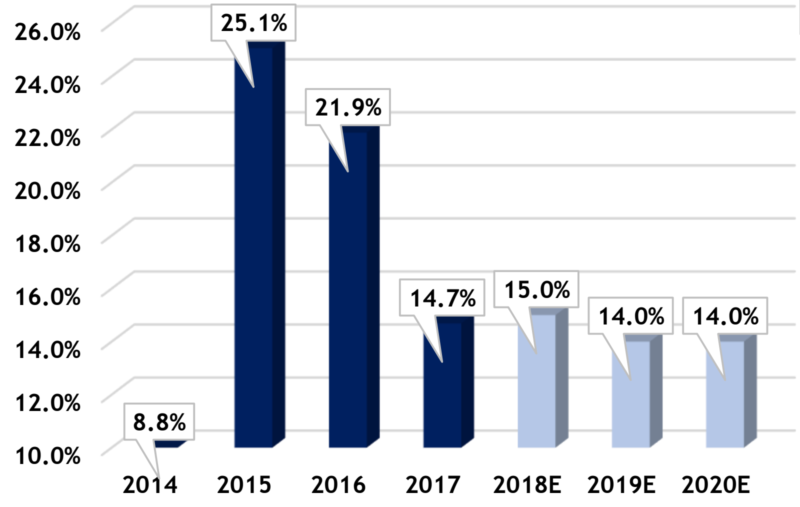
Liquidity shortage and heavy capital adequacy requirements and capital erosion through IFRS 9 implementation, are likely to limit credit growth during 2019 and 2020 to 14%.

Liquidity remains negative for over 5 months



Source: CBSL

Private Sector Credit Growth to remain moderate



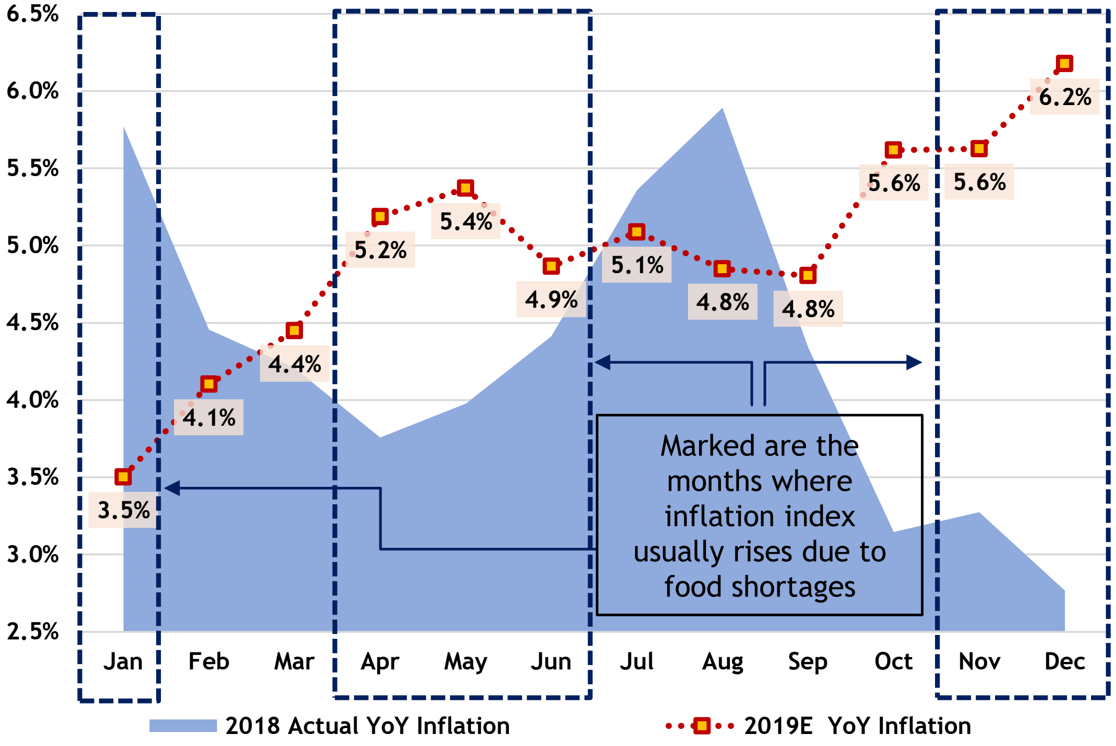
Source: CBSL

Credit surge in 4Q2018; May Outperform our 2018 target

- With the economic conditions that materialized in the 4Q2018 liquidity shortage escalated despite CBSL cutting banking sector SRR by 150bps and increasing CBSL holdings above LKR 40Bn. Heavy rupee depreciation leading to accelerated imports resulted in a jump in private sector credit in 4Q worsening the liquidity situation.
- The new developments in 4Q saw a surge in credit leading to a boost in the overall credit growth for 2018 to c.16% marginally above our expectation of 15% for 2018 (last year).

Inflation is likely to be upward trending as pricing adjusts for higher raw material costs and higher demand triggered by elections

- *We expect inflation to be on a rising trend throughout the year as the real impact of the currency depreciation impacts prices. However, we expect inflation to be within the CBSL's inflation target of 4%-6% for most part of the year.*
- *4Q2019 is likely to experience higher inflation with possible food shortages, higher demand with elections and full impact of the currency depreciation.*
- *With the prevailing tight monetary conditions, producers are reluctant to pass on the full or part of the currency depreciation impact to the consumers while some producers with larger stock holding periods would have higher prices as older stocks deplete in 1Q or 2Q.*



Source: Dept. Census and Statistics

External Environment to benefit SL: Positive

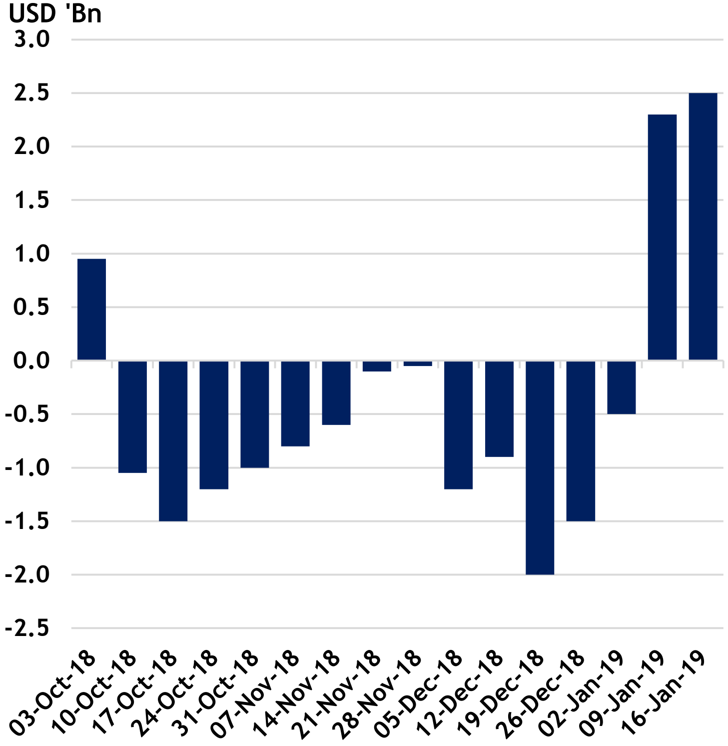
Section 5.0

Possible fund flow reversal towards emerging markets and weaker oil prices to benefit SL

- World Bank expects Global Growth to lose pace to 2.9% led by deceleration in the US and further softening in China. It is likely to slowdown the pace of rate hikes by providing stability to most emerging market currencies - Positive
- Supported by, possible peaking of US treasury rates and attractive emerging market yields, global fund flows have shown signs of shifting towards emerging Asia - Positive
- Sri Lanka is also likely to re-enter the IMF agreement towards end of the 1Q which is major confidence booster for investors – Positive
- Commodity Prices are expected to stay depressed through 2019 amidst the trimmed growth rates in most Developed Countries which provides a short term benefit for SL with stronger BoT position – Positive

External Outlook: Positive

EM Bond funds weekly flow show signs of strong inflows

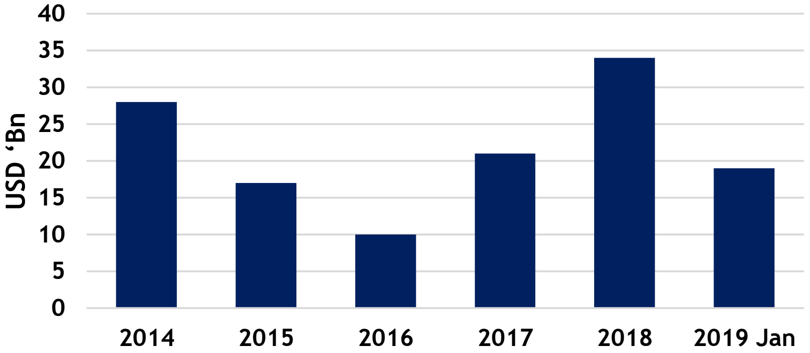


Source: EPFR Global

Investors' new-found appetite for risk is prompting an unexpected rush into emerging-market bonds. EM Bond sales have started the year heavy with close to USD 20 raised in the 1st 22 days of 2019. Most Fund managers believe that Emerging Markets have started 2019 much stronger than envisaged.

Morgan Stanley upgraded its EM Sovereign debt stating cheap valuations offer "bullish return" forecast for 2019. NN Investment Partners indicate that return could be of 5-10% and even higher in the case of frontier debt.

EM Sovereign issues of last 6 years (1st - 22nd Jan)



Source: Bloomberg

What does the indicators say for investments?

- Political Outlook : Negative
  - ❑ Political Uncertainty to continue
- Economic Outlook : Neutral
  - ❑ Negative for 1Q but improvements are expected beyond the 1Q2019 while possible elections may revive economic activity
- External Outlook: Positive
  - ❑ Reversal of global fund flows towards EM and lower commodity prices to benefit SL.

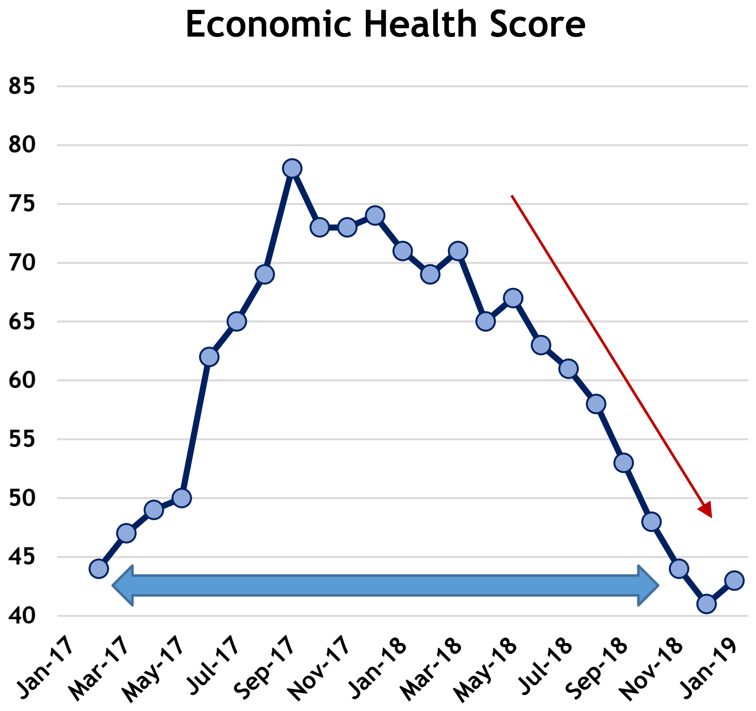
Overall Outlook : Neutral

Political outlook offsets Economic and External improvements

Time Period	Political	Economical	External
Dec 2016	Negative	Negative	Neutral
Aug 2017	Negative	Neutral	Neutral
Jan 2018	Negative	Neutral	Neutral
Jun 2018	Negative	Neutral	Negative
Jan 2019	Negative	Neutral	Positive

Economic 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	60-65
Risk Level - Jun 2018	High	Medium-High	Medium	Medium
Previous Expectations - Jun 2018	Medium	Medium-Low		



Source: First Capital Research

Recommendations

Section 6.0

First Capital Research View on Bond Market 2019

Section 6.1

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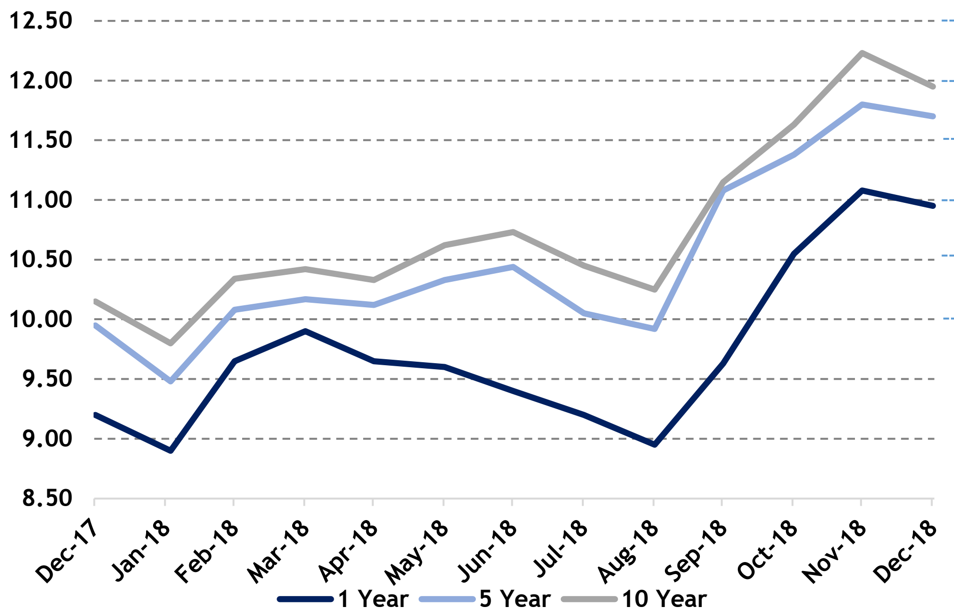
Bond Rates to peak in 1Q2019 and gradually ease (12 months)

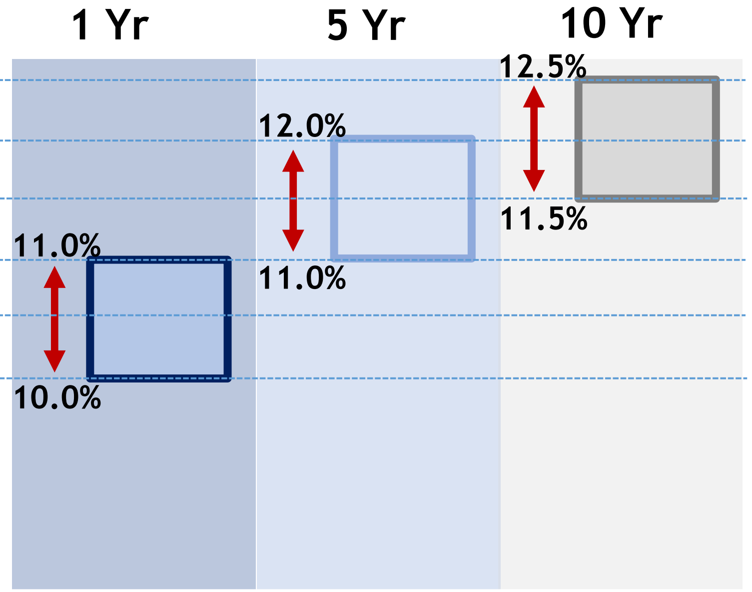
Expectations: Moderately Bullish beyond 1Q2019

Policy Rate Expectation

On a base case First Capital Research expects 2 rate cuts of 25bps each during 2019 as overnight CBSL standing lending facility rate which stands at 9.0%, we believe is too high for accelerated economic activity.

Jan 2019 - Dec 2019	Probability	Impact
Bond Rates to peak in 1Q2019 and gradually ease to the bottom bands	75%	Moderately Bullish / Stable
Political deadlock or Economic turmoil (adverse impact to foreign income or foreign debt) may result in the breaking the upper bands	25%	Bearish





Source: CBSL, First Capital Research

2019 Outlook - Base Case (75% Probability)

With the heavy debt payments and liquidity shortage, we expect bond yields to touch the upper bands of the yields curve during 1Q. The heavy risk associated with lower reserve position by end Jan 2019 following payment of the USD 1Bn Sovereign Bond and other debt payments would be the primary cause for the yields to move towards the upper bands. Though the fund flow towards EM is positive now, there is a cap of 5% for foreign holdings in Sri Lanka.

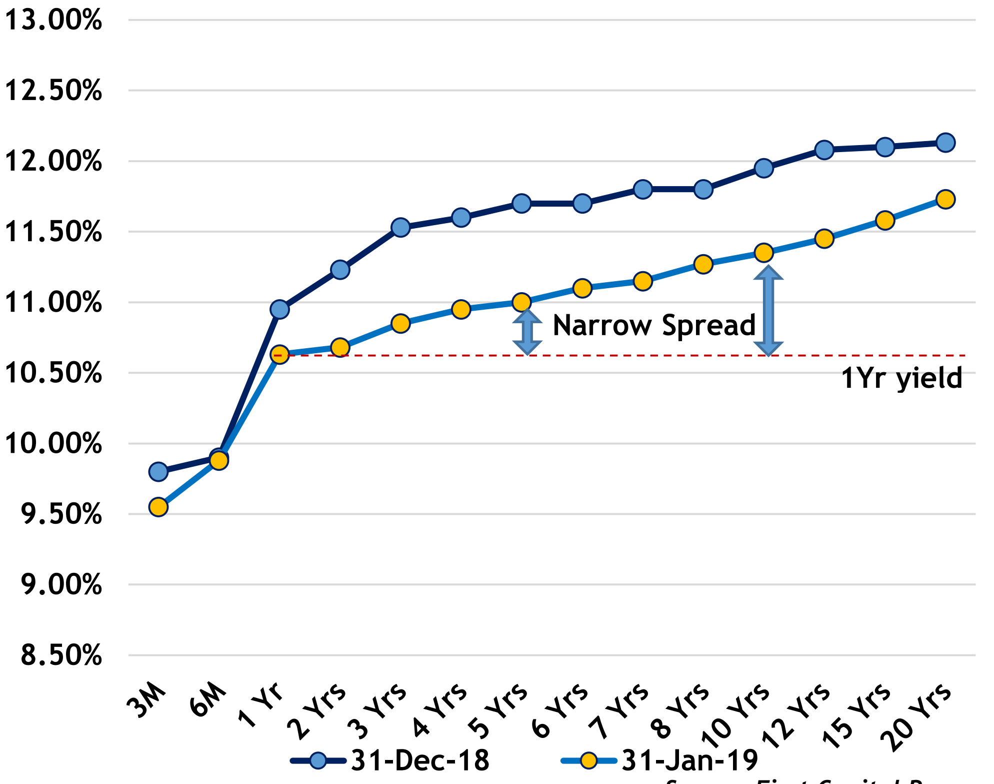
With foreign inflows & debt inflows towards 2Q, rise in economic activity amidst upcoming elections and low debt payments after 7th April, liquidity is likely to improve and ease yields beyond 1Q2019 towards the lower bands.

Bond Market Outlook in 1Q2019 (Short Term View)

1Yr-5Yr spread to increase to 100bps, 1Yr-10Yr spread to increase to 150bps

- The yield curve saw a slight improvement towards end Dec 2018, on the back of the resolved political crisis. Following the payment of the Sovereign Bond maturity on 14th Jan 2019, and subsequent statements by CBSL Governor, Prime Minister and Finance Minister to the effect regarding planned debt inflows and possible reinstatement of the IMF agreement boosted investor confidence in the overall market.
- Confidence of market participants further improved with CBSL initiating the process for raising USD 2Bn as an international Sovereign Bond. In addition the market also witnessed some net foreign buying after a long lapse though in smaller scale.
- During the month of Jan 2019 the yield curve saw a sizable downward shift as 2yr-20yr bonds dipped by 50-70bps while the 1yr dipped 30bps.
- The dip in bonds has resulted in the yield curve flattening with only 50bps or lower spread between 1yr - 5yr and 70bps or lower spread between 1Yr - 10Yr. We continue to believe that macro economic conditions are weak and such a heavy downward shift in yields is unwarranted.
- We believe this movement was sentiment driven and despite the different announcements made, the macro economic condition in the 1Q is likely to remain weak, and likely to only improve beyond 1Q.
- For Feb and Mar 2019, we expect investors to identify the above risk and shift bond exposure to extreme shorter tenors which continue to remain attractive and more closer to the upper bands identified in Slide 26. With the shift we expect an upward shift in the mid to long tenor maturities during the rest of the 1Q increasing 1Yr - 5Yr spread back to 100 bps and 1Yr - 10Yr Spread to 150bps.

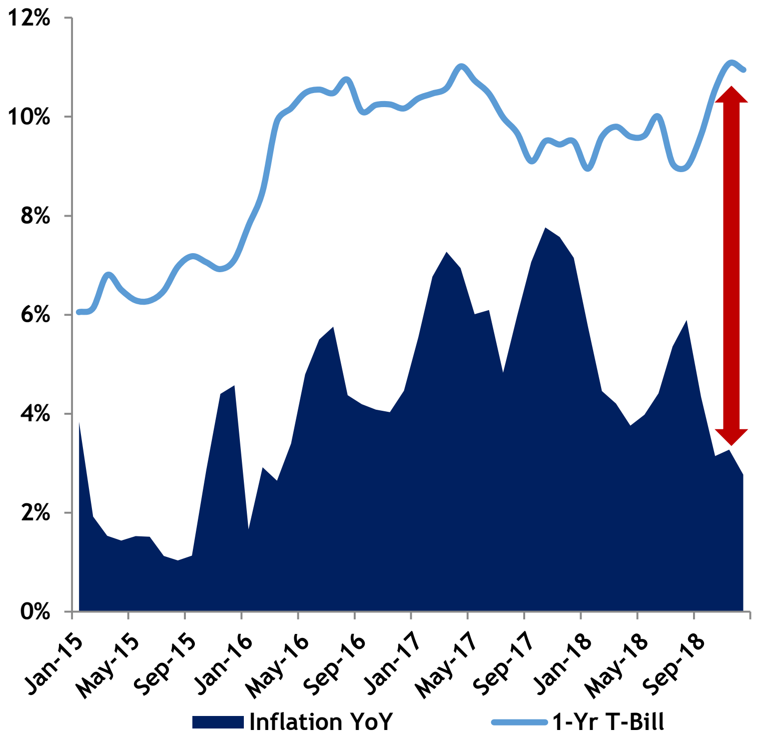
Yield Curve records a steep downward shift in Jan 2019



Source: First Capital Research

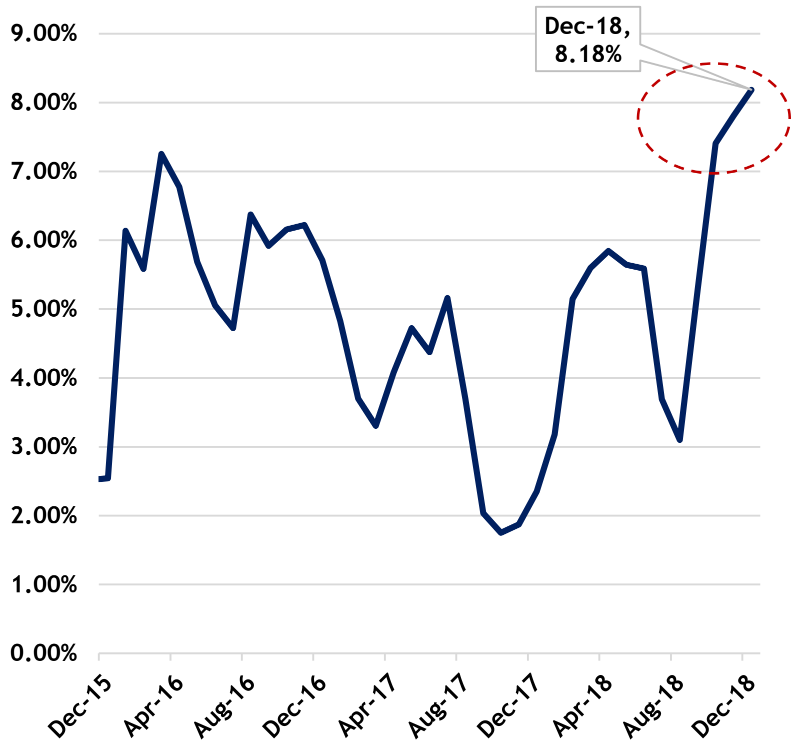
Real Interest rates to dip by 300bps to 5% by 4Q2019 with higher inflation and lower yields

1 Yr T-Bill vs Inflation



Source: CBSL, Dept. Census and Statistics

Real Interest Rate reaches historical highs



Source: CBSL

2019 Outlook

We expect real interest rates to dip to 5% towards end of 2019 with lower yields and rising inflation, though in 2 different time periods.

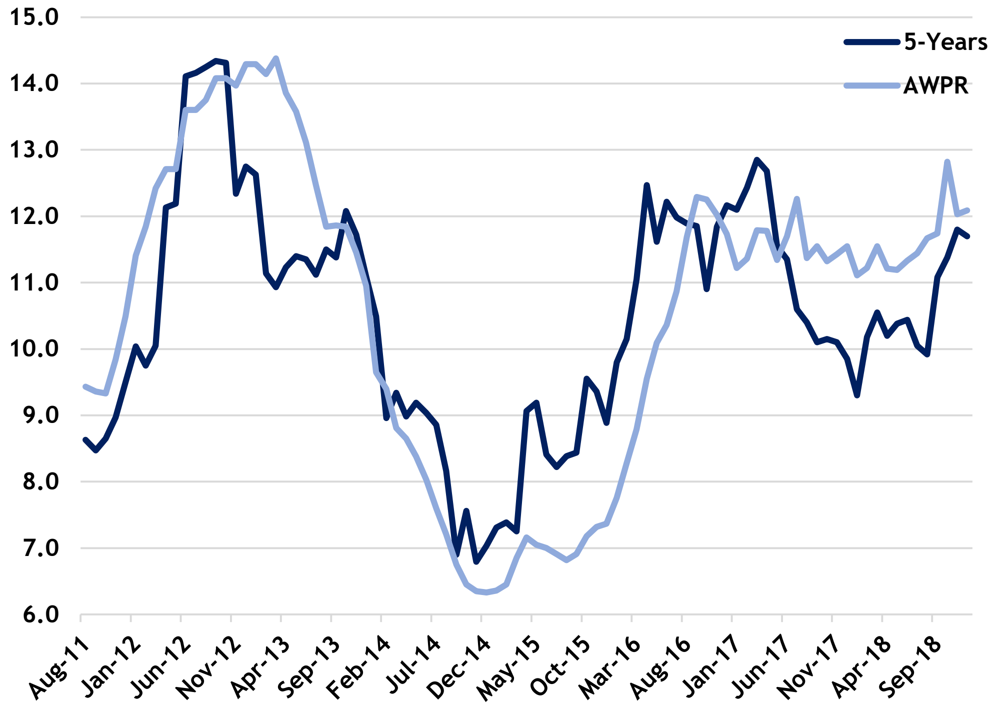
We expect heavy debt inflows to result in lower yields during the 2Q2019 while we expect a gradual rise in inflation as producers pass on cost increases amidst possible rise in demand during 3Q-4Q period.

First Capital Research View on Banking Rates 2019

Section 6.2

Banking Rates (AWPR) to be volatile within a 100bps band but dip to c.11% towards 4Q

AWPR vs 5 year Bond



Source: CBSL

Lag effect reduces

- Banking Rates are usually reflective of the bond rates with a 6 month lag. AWPLR has usually had a 6 month lag effect for the 5 year bond. However, in more recent as it illustrates in the graph the banking rates are more responsive to market interest rates while also having an impact due to the increased capital adequacy issues arising out of BASEL III requirements.

2019 Outlook:

- 5 Year Bond is likely to peak in the 1Q around the 12% mark. The AWPR has already risen marginally above 12%. We expect banking rates to remain high during 1H2019 with AWPR at *c.*12% while illustrating a declining trend towards 2H, dipping to *c.*11%.
- In a more broader sense during the next 12 months, we expect AWPR to stay within the band of 11.0% - 12.0%.

First Capital Research View on Exchange Rate 2019

Section 6.3

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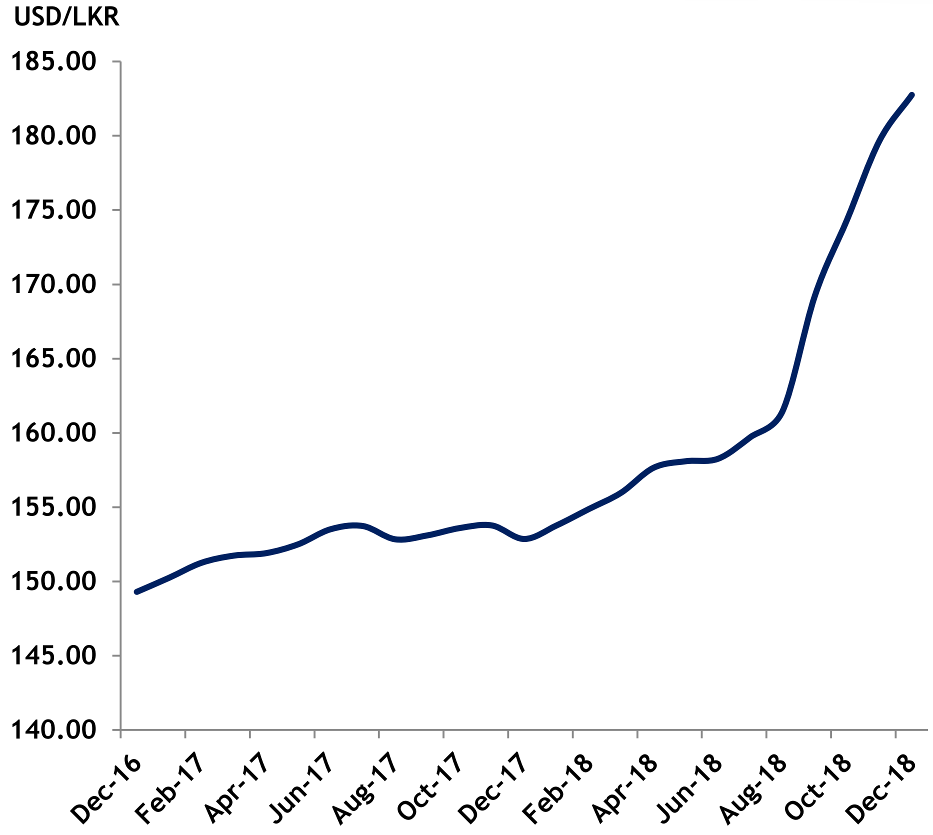
Exchange Rate 2019 target of LKR 194.0 (6% dep.) marginally above the 15yr avg of 4%



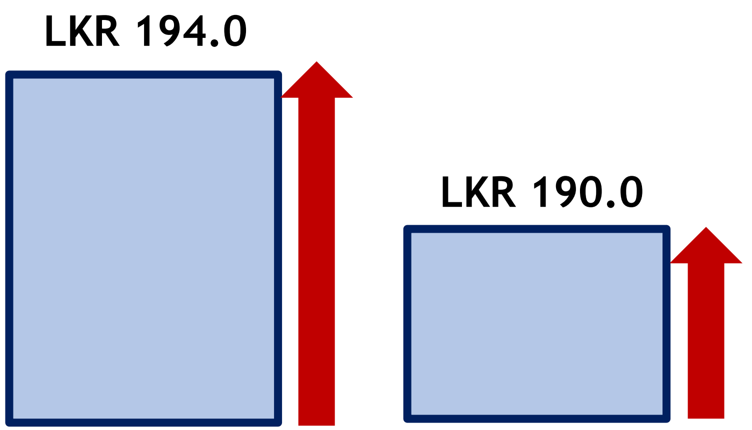
Source: CBSL

2019 Outlook - 75% Probability

We expect rate hikes in the US to significantly slowdown in 2019 positively impacting emerging market currencies. The rupee may remain volatile in the 1Q with weak macro conditions, but is likely to stabilize in 2Q & 3Q amidst the debt driven foreign inflows.

2018 Review:

Continuous rate hikes in US and sudden deterioration in macro economic fundamentals followed by a political crisis, led to a collapse in the LKR depreciating 7% & 8% in 3Q & 4Q of 2018 with 20% depreciation against the greenback in the full year of 2018.



Bearish Case	Bullish Case
75% Probability	25% Probability

First Capital Research View on Equity Market 2019

Section 6.4

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POSITIVE but Cautious; INCREASE EQUITY EXPOSURE to 60% from 50%

- ***Political uncertainty settles; But battle for policy certainty may continue***

Following the re-appointment of “pre-October 26th Government” and passing of the Vote of Account in Parliament, the political uncertainty that prevailed over the last 8 weeks eased off, providing financial capability for the Government & its institutions to function beyond 31st Dec 2018. However, stability created, is likely to be temporary, as suggested by the differences that were prevalent in the process of appointing the new cabinet. We expect the divergent views between the President and UNF Government to continue to affect key policy decisions within the cabinet throughout 2019, up until the Presidential elections due in Jan 2020.

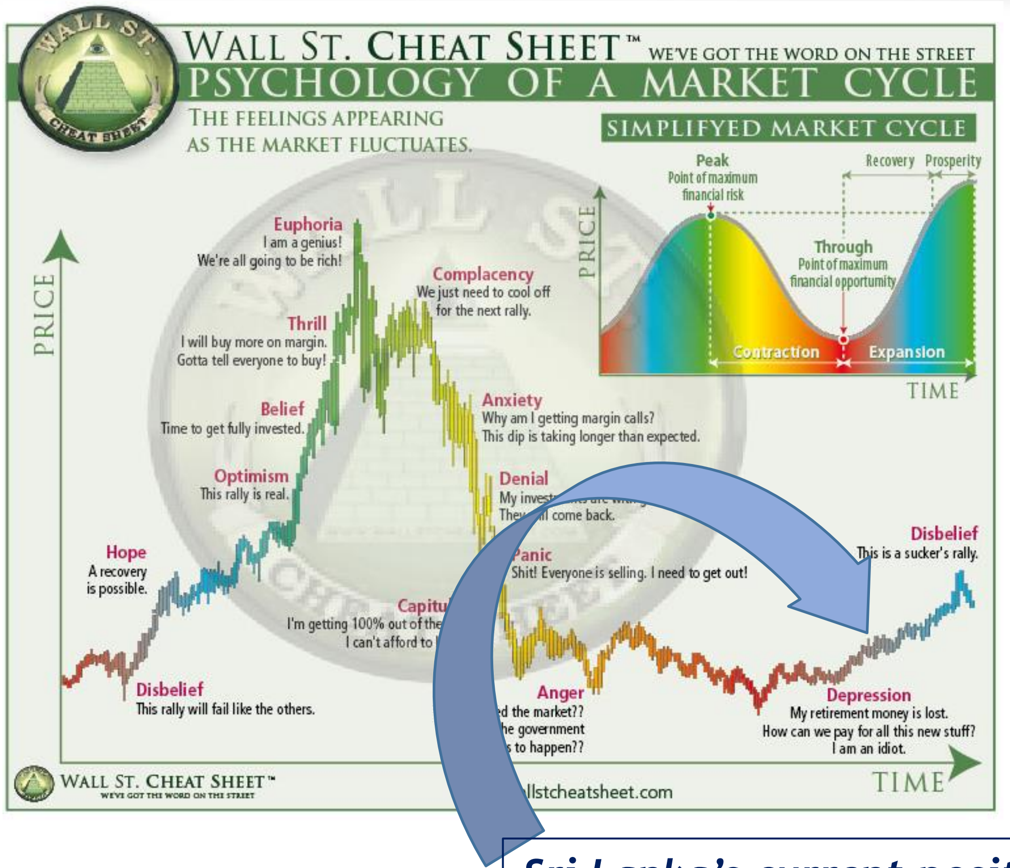
- ***External sector turns positive favouring Emerging ASIA***

Global growth is expected to slow down during 2019 primarily led by the possible impacts arising out of the trade war between the US and China coupled with the downgrade in growth expected in the US economy. The slowdown in the US economy is also likely to result in decelerating the Federal Reserve’s interest rate normalization process which may provide some breathing space for most weaker Asian economies. Global fund flow has already started to reverse towards Asia and emerging markets providing reasonable level of stability to Asian & other Emerging Markets.

- ***Exposure increased to 60%; We are cautiously Bullish***

Over the 3 months (25-Sep to 24-Dec) we’ve maintained exposure at 50% considering earnings hit via depreciation and political unrest affecting sentiment of the market. However, during the period market gained by about 100-120 index points. As we step into 2019, we are witnessing the global fund flow reversing towards Emerging Asia and depressed commodity prices led by dip in oil prices benefiting the BoP position of Sri Lanka while positively affecting Cost of Living. We believe the events that have unfolded may benefit Sri Lanka and the equity market during 2019 positively impacting earnings and possibly leading to net foreign inflows. However, weak macro economic conditions in the 1Q may weaken market returns. Considering the mid-term positive impact, we upgrade our equity exposure to 60% and upgrade ASPI volatility expectations to 6,000-6,500 (from our previous 5,800 – 6,200), assuming Market PER to be 8.5x – 9.5x beyond 1Q2019.

Stock Market Cycle and Sri Lanka's Position



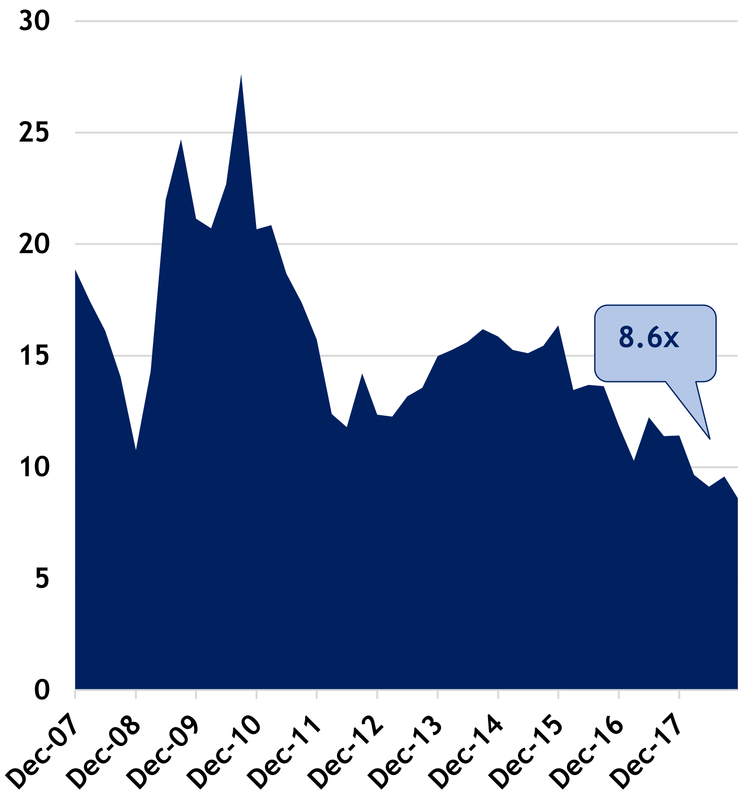
- Stock markets usually passes through many phases as indicated in the chart. It very rarely reaches fair value, as a result, markets <u>either overshoot or over-correct</u>.
- The ASPI, we believe has over-corrected and is currently passing through a <u>depression phase and potentially on its way to a disbelief state</u>.
- Valuations suggest to be attractive relative to its peer countries strongly suggesting a healthy range of undervalued stocks. Most banks which account for 40% of the equity market is trading below its book value.
- When the market enters such a phase it would be a matter of time before an unforeseen event or best known as a black swan event may lead to the market cycle to get converted to phase of "Hope" which begins a strong bull run.

Sri Lanka's current position is likely to be passing through the Depression stage

Equity Recommendations - Dec 2018

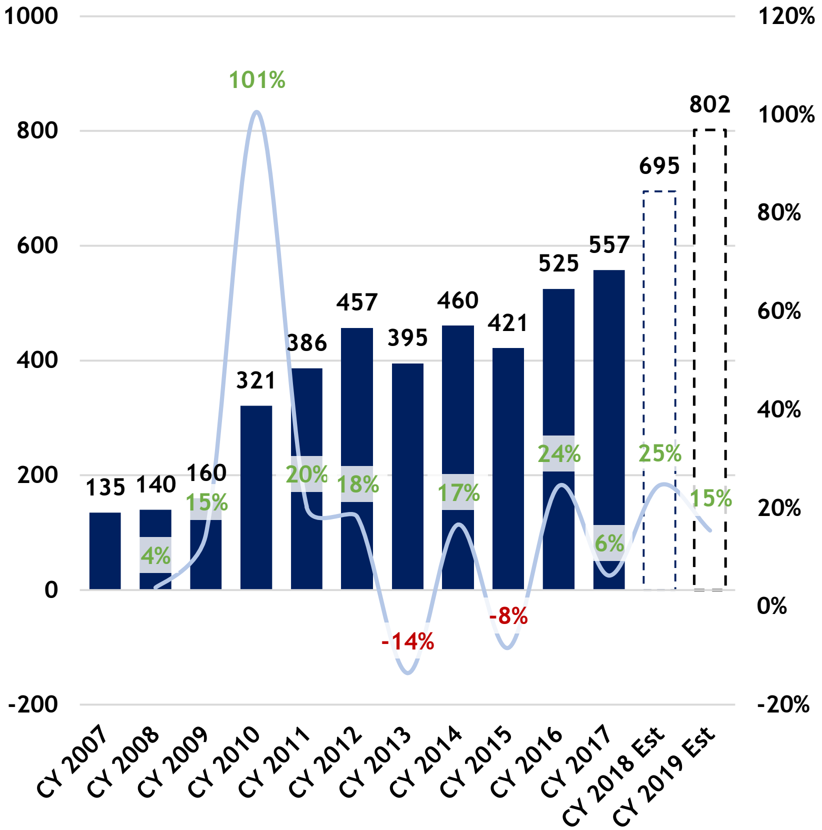
Increase Equity Exposure to 60% from 50%;
ASPI to be volatile between 6,000 - 6,500; If debt driven inflows delay can fall to 5,800

Market PER



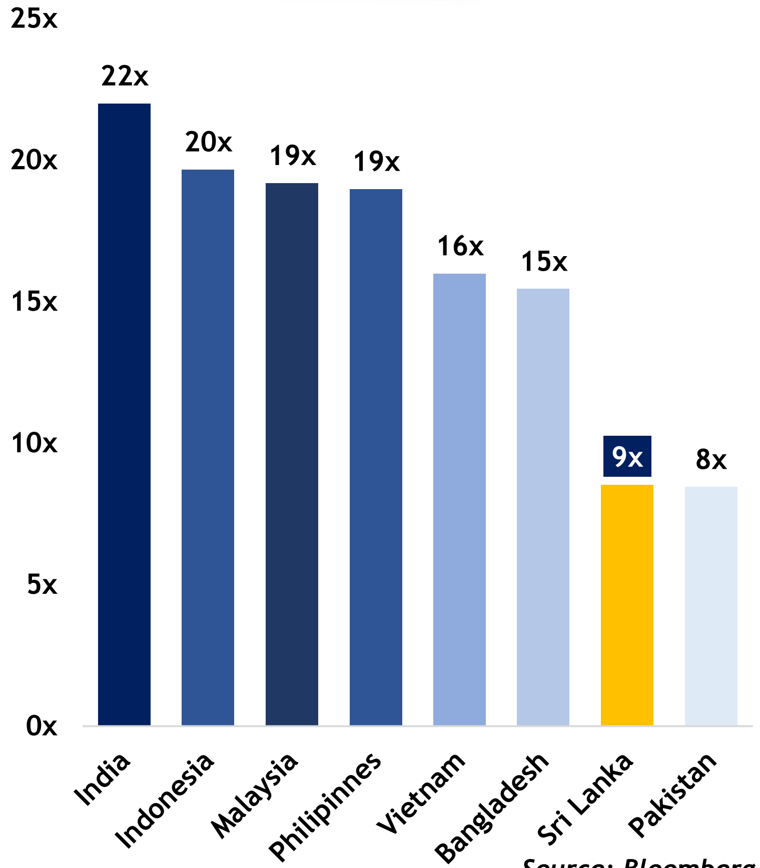
Source: Bloomberg

Indexed Earnings & Growth



Source: Bloomberg

Comparative Market PER



Source: Bloomberg

TOP PICKS for 2019

Top Tier

		Fair value 2019E / FY20E	
JKH	-	LKR	270.0
COMB	-	LKR	152.0
HNB	-	LKR	270.0
DIAL	-	LKR	15.1
PLC	-	LKR	20.0
TJL	-	LKR	43.0
LION	-	LKR	720.0
NEST	-	LKR	2,050.0
CARG	-	LKR	240.0

2nd Tier (lower liquidity)

KFP	-	LKR	180.0
CDB	-	LKR	150.0
ALUM	-	LKR	15.0
LOFC	-	LKR	7.0

Valuations have been rolled over to 2019E & FY20E respectively depending on the Financial Year

Possible shocks preventing our 75% probability

Section 7.0

Possible Shocks that could materialize in 2019

If any of the below mentioned shocks materialize, it will prevent our majority probability from being achieved while giving priority to the minority probability

- Government loses majority before general election
- Surge in oil prices or black swan event causing a tourism hit with heavy travel advisories
- Failure of rolling over key large foreign loans or failure to secure funding through sovereign bonds

Crisis weakens Fundamentals; 2H2019 to regain stability

THANK YOU

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