



First Capital

First Capital Research

Surprise Fed rate cut to push for **easing**

PRE-POLICY ANALYSIS

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Surprise Fed rate cut to push for **easing...**

Previous Pre-Policy report; CBSL maintains its policy rates

- In line with our expectation, CBSL, maintained its policy rates at current levels as they believed that private sector credit may pick gradually and also there is ample space for market lending rates to adjust downwards in response to the policy measures taken to address the subpar economic growth which was affected by Easter Sunday attacks.

Although in our previous report dated 07th Oct we mentioned that there will be no more policy changes for 2019 we are revising our stance considering the recent changes in the political and economical landscape of the country and external outlook for Sri Lanka.

Surprise Fed rate cut leads another round of global easing

- ❑ Fed in late Oct 2019 cut benchmark overnight lending rate a quarter point to a range of 1.50%-1.75%, the 3rd such move in 2019 while most of the committee members saw the moves as enough to support the outlook of moderate growth. Following US's Fed move, China, Thailand and Gulf countries also joined a round of monetary easing (see slide 04). The global move towards easing monetary policy, creates a supportive environment for SL to provide further easing in the domestic economy.

Easing Political uncertainty accelerates foreign inflows potentially improving liquidity

- ❑ Strengthening macro economic indicators and the current high yields has been slowly attracting foreign inflows which is likely to further accelerate post Presidential Election amidst easing political uncertainty to a certain extent. With the support of foreign inflows, currency has been strengthening over the past couple of weeks. We believe, a significantly undervalued rupee (as indicated by the REER) and lower credit growth, provides room for CBSL to buy dollars, strengthening the reserves and increasing liquidity in the system.

Surprise Fed rate cut to push for **easing...**

External position appears comfortable near-term while the Samurai bond will be an added cushion to reserves

- ❑ Sri Lanka's external position looks comfortable near-term, with foreign reserves at USD 7.8Bn as at Oct 2019 and the improved current account position. CBSL plans to raise a Samurai bond of USD 500.0Mn in Dec 2019, further adding cushion to the foreign reserves. We expect reserves to hover comfortably around USD 8.0Bn mark with sufficient foreign repayment cover during the rest of 2019. Accordingly, we expect the comfortable position in the external sector to exert lower pressure on reserves.

Overly sluggish economic growth, calls for more supportive economic policies

- ❑ Post Easter Sunday attacks, SL's GDP growth for 2Q2019 slowed down to 1.6%. We expect GDP growth to gradually improve with lower interest rates and the election season. Private sector credit growth continues to remain negligible with Jan-Sep 2019 growth at 2.13%. Despite CBSL cutting rates in Aug 2019 for the 2nd time, the decline in interest rates has been slow amidst the high level of NPLs in the system forcing CBSL to introduce lending caps to banks. Post completion of the Presidential Election business activity and credit growth has shown slow progress but continues to remain below expectations calling for further monetary easing.

Expectation

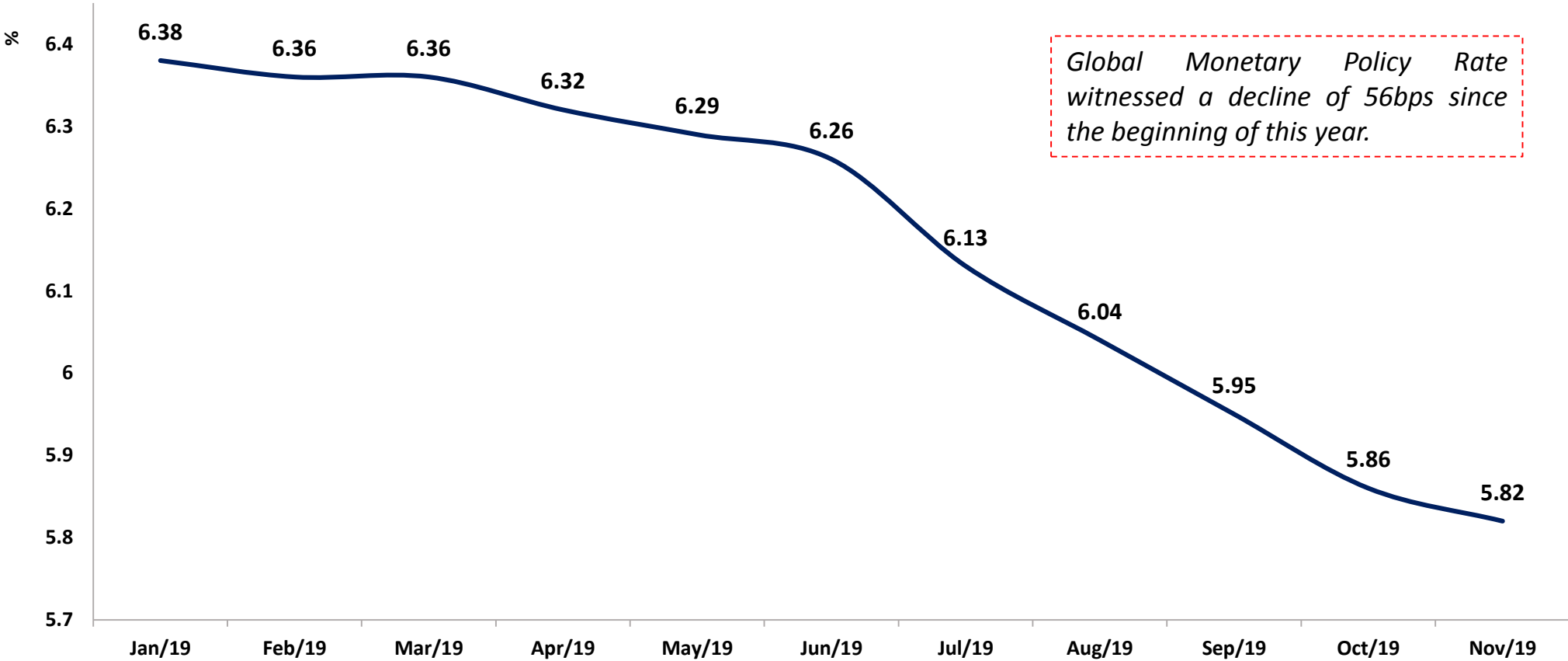
Despite the 50bps rate cuts each in May and Aug, First Capital Research believes that door is open for a **rate cut** considering the need to address the sluggishness in economic activity. The external outlook favouring SL, easing political uncertainty and positive macro environment provides opportunity for monetary easing despite the risk in lower liquidity position. Accordingly, we do not rule out a possibility of a rate cut though at a lower probability of 40%. We are more biased towards a rate cut in Dec 2019 considering the risk in lower liquidity position.

Central Banks around the globe delivered more rate cuts

	September 2019	October 2019	November 2019
Total Rate Rises	150 basis points	100 basis points	125 basis points
Total Rate cuts	1,050 basis points	950 basis points	280 basis points
Net Change	-900 basis points	-850 basis points	-155 basis points
Countries with rate cuts	Chile, Ukraine, Russia, Armenia, Turkey, ECB, Denmark, Azerbaijan, Vietnam, United States, Saudi Arabia, Brazil, Hong Kong, Macao, Qatar, UAE, Jordan, Indonesia, Costa Rica, China, Paraguay, Seychelles, Philippines, Egypt and Mexico	Australia, Iceland, India, Uganda, South Korea, Chile, Indonesia, Ukraine, Turkey, Russia, Azerbaijan, USA, Saudi Arabia, Brazil, Bahrain, Kuwait, UAE, Qatar, Jordan, Hong Kong and Macao.	Iceland, Thailand, Belarus, Serbia, Peru, Egypt, Mexico and China
Countries with rate rises	Georgia (2 times), Kazakhstan and Norway	Georgia	Zambia
Global Monetary Policy Rate	5.95%	5.86%	5.82%

Source: Centralbanknews.info

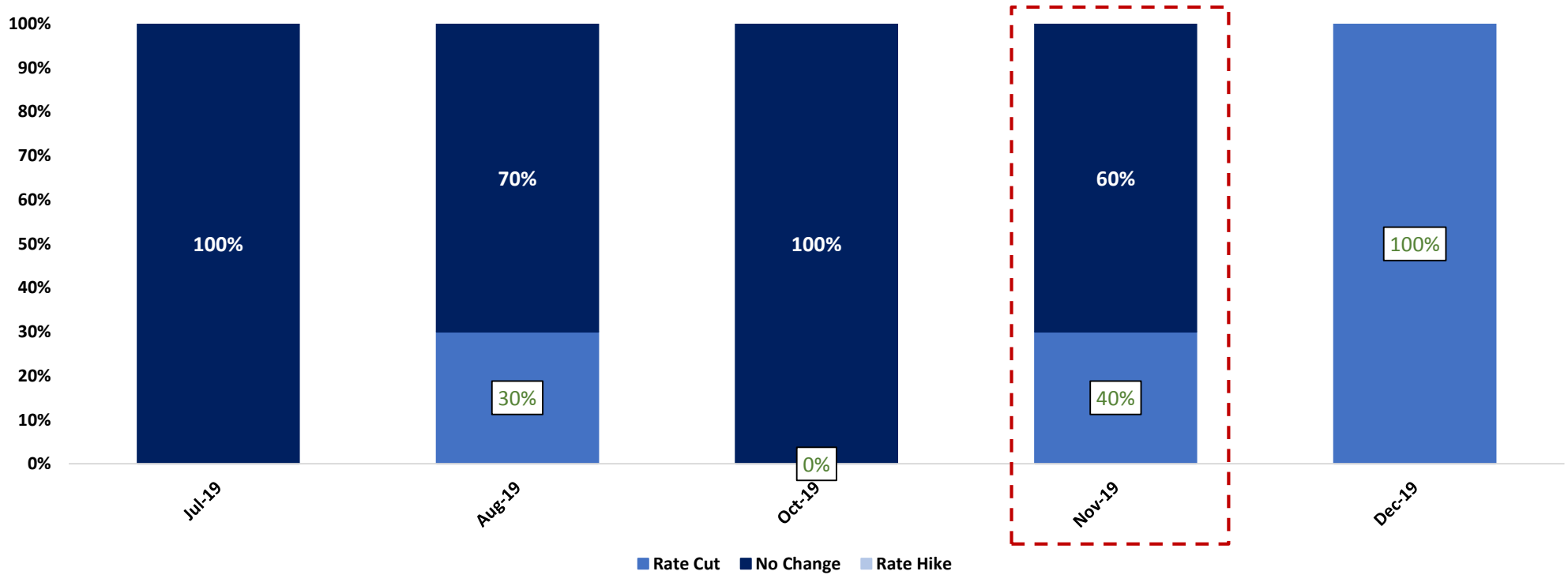
Global Monetary Policy Rate witnessed a decline amidst softening global growth



Source: Centralbanknews.info

FCR Policy Rate Forecast – Nov 2019 to Dec 2019

First Capital Research expects a 40% probability for a rate cut in Nov 2019 and 100% probability for a relaxation of policy rates in Dec 2019 to further accelerate the economic growth.



Source: First Capital Research Estimates

Expected Monetary Policy Stance

First Capital Research expects a 40% probability for a rate cut in Nov amidst the dovish monetary policies around the globe and increased probability of 100% in Dec 2019.

Expected Monetary Policy Stance	Probability
Raising Policy Rates by 50bps	0%
Raising Policy Rates by 25bps	0%
Policy Rates to remain unchanged	60%
Cutting Policy Rates by 25bps	20%
Cutting Policy Rates by 50bps	20%

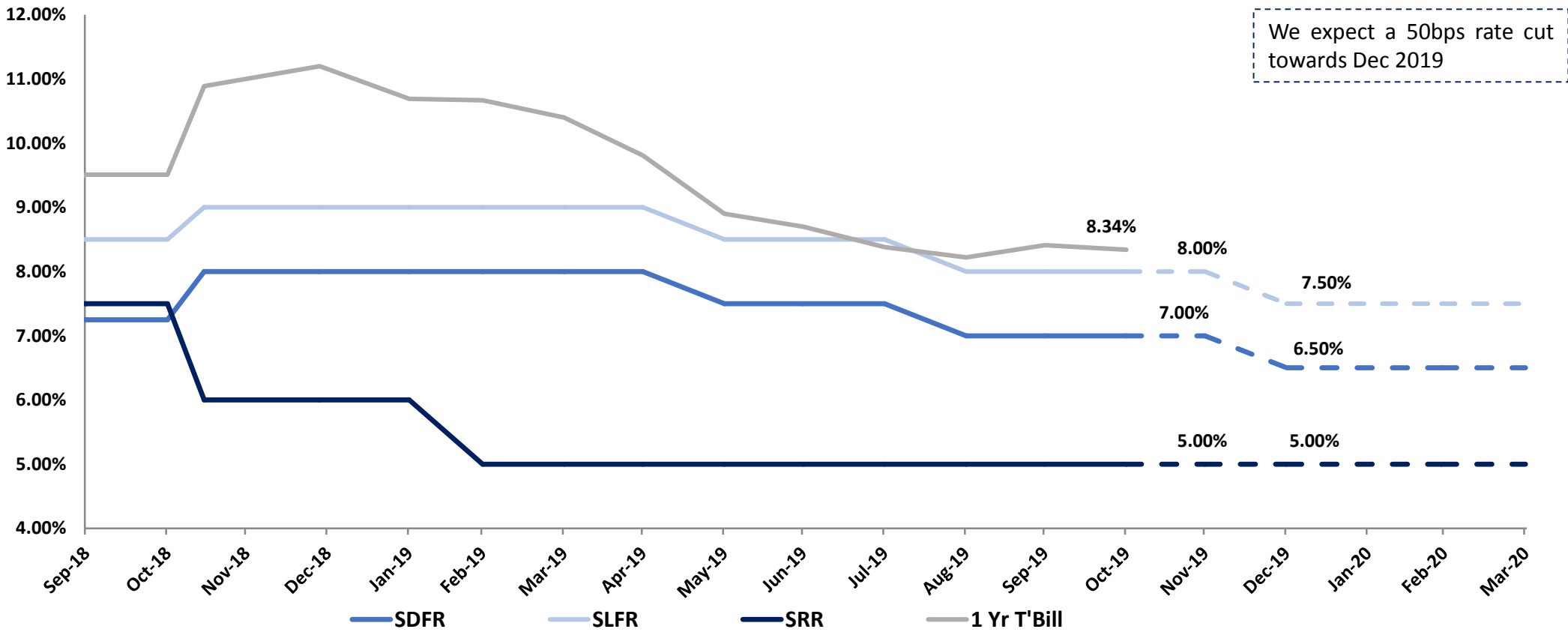
Expected Stance on SRR	Probability
Raising SRR by 100bps	0%
Raising SRR by 50bps	0%
SRR to remain unchanged	100%
Cutting SRR by 50bps	0%
Cutting SRR by 100bps	0%

40%

Probability for a 25bps and 50bps rate cut increased by 20% to address the sluggish economic growth

Maintained at 100% due to increased external vulnerability and continued slowness in the system.

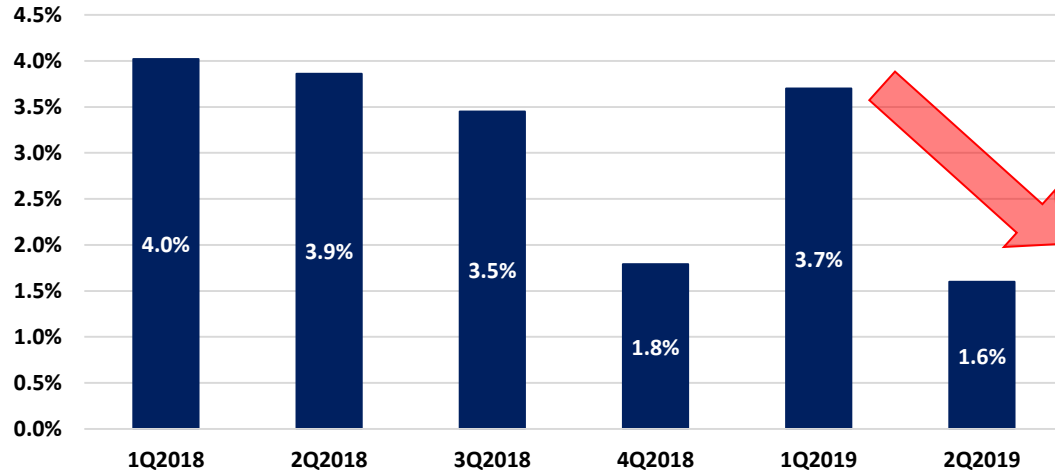
Monetary Policy Rates



We expect a 50bps rate cut towards Dec 2019

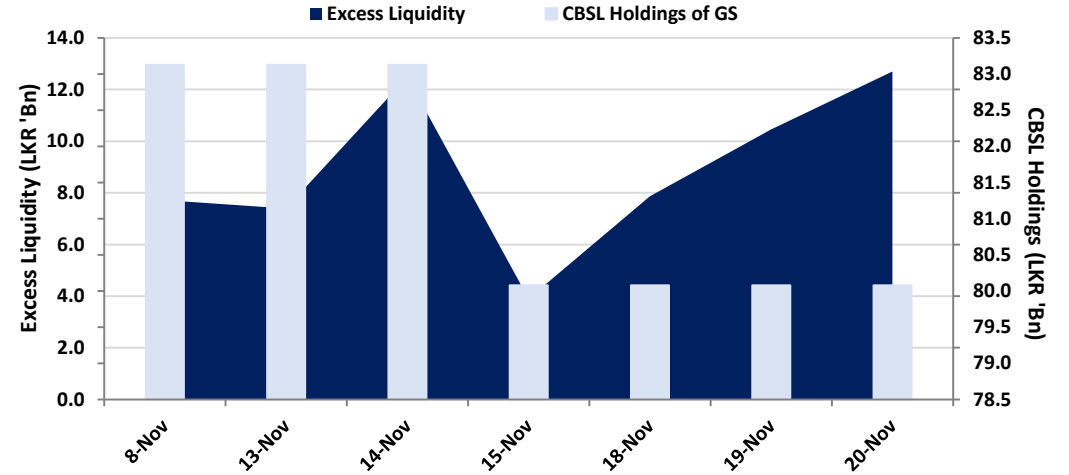
Source: CBSL, First Capital Research Estimates

Graph 1 : GDP growth declined in 2Q2019 to 1.6% as a result of the Easter Sunday attacks although it was higher than our expectation



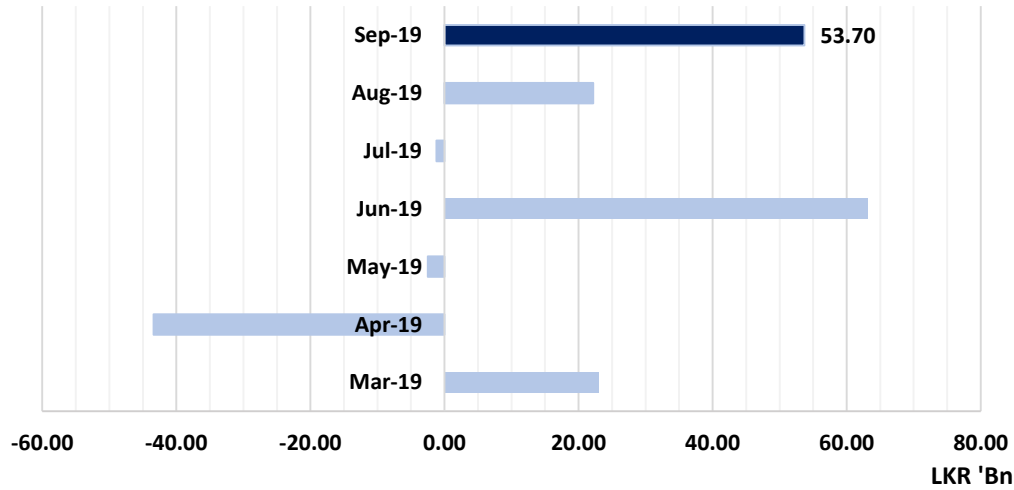
Source: Census & Statistics

Graph 2 : Excess Liquidity and CBSL Holdings of Gov. Securities



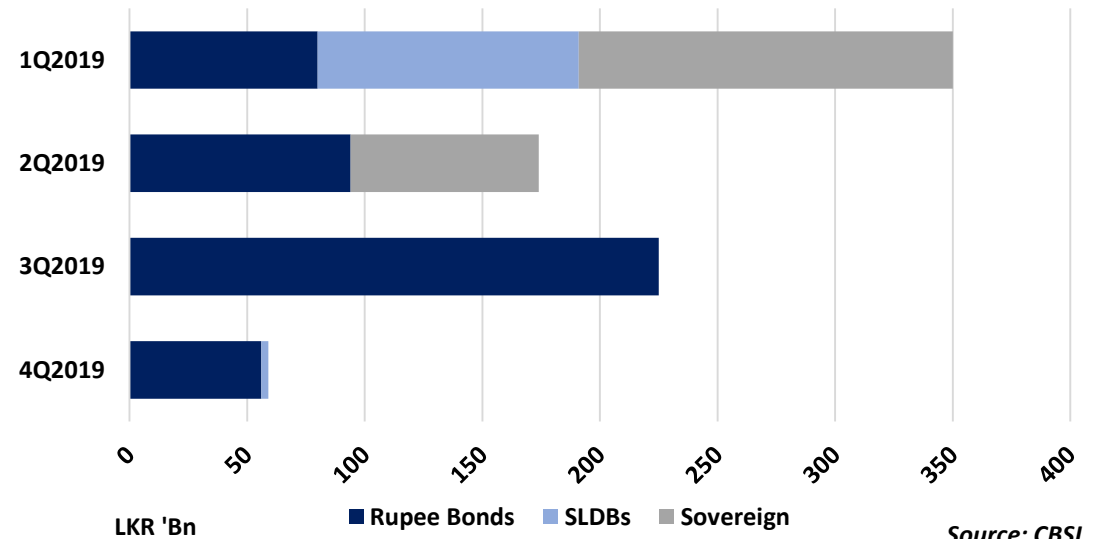
Source: CBSL

Graph 3 : Private Credit recorded a positive figure in Sep 19 for the second consecutive month



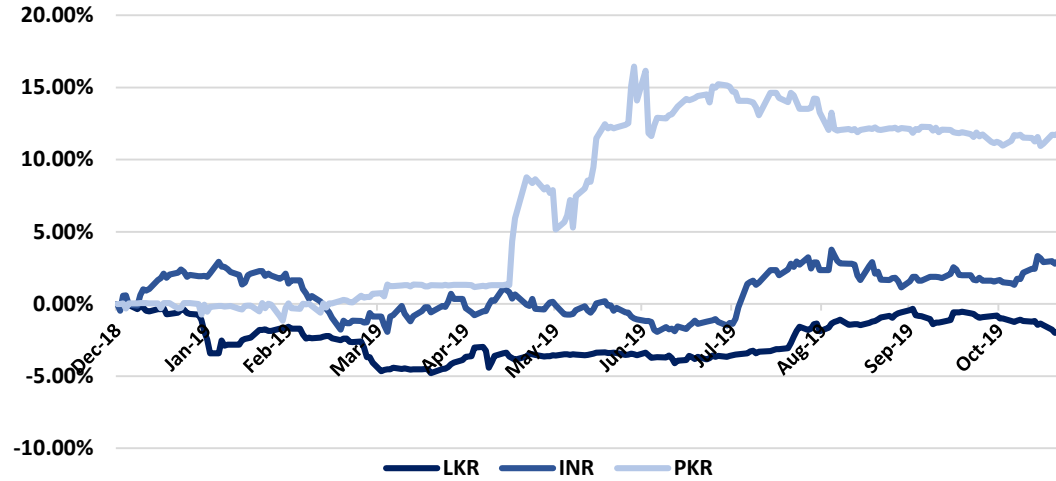
Source: CBSL

Graph 4 : Sri Lanka's Foreign debt repayments – 2019



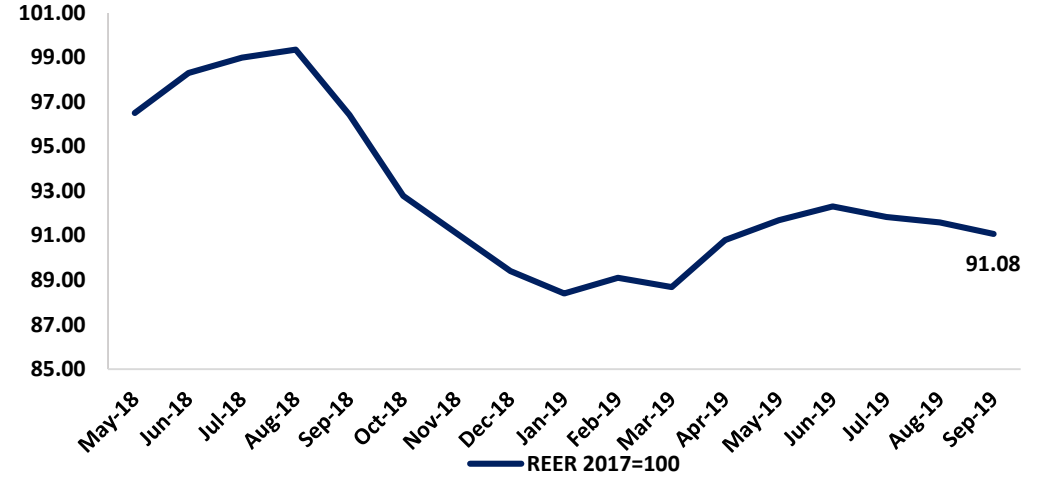
Source: CBSL

Graph 5 : LKR remained mostly stable compared to other currencies against USD while steep depreciation in PKR in YTD basis was witnessed



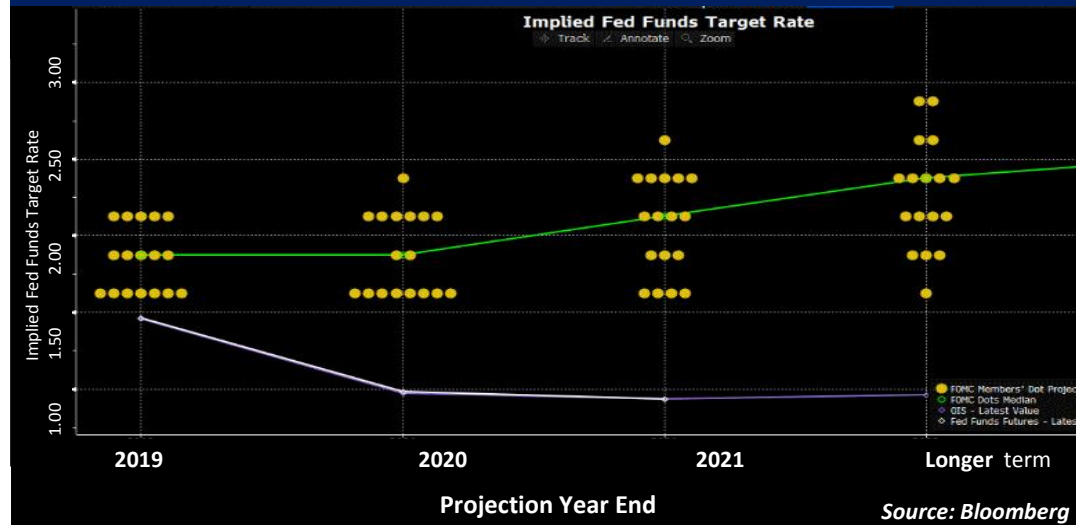
Source: Bloomberg

Graph 6 : Real Effective Exchange Rate continued to be undervalued at 91.08 in Sep 2019



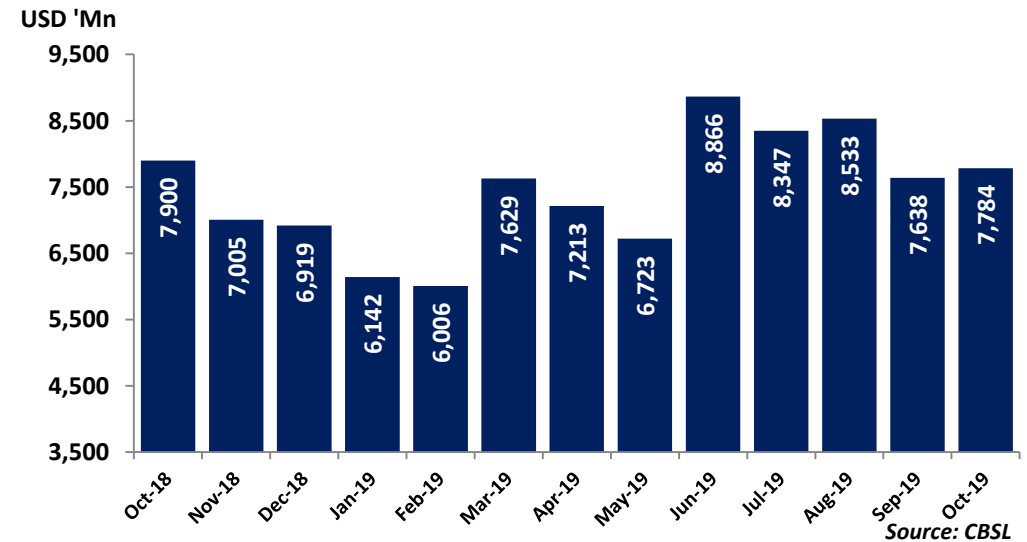
Source: CBSL

Graph 7 : Fed reserve officials cut rates at the meeting held in Sep 2019 by 25 basis points and further 25bps in October



Source: Bloomberg

Graph 8 : Foreign Reserves improved to USD 7.8Bn in Oct 2019 from USD 7.6Bn in Sep 2019.



Source: CBSL

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