



First Capital

# *“MACRO WOES TO IMPEL BOND YIELD EXPECTATIONS HIGHER”*

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First Capital Fixed Income Recommendation – 15<sup>th</sup> Feb 2022

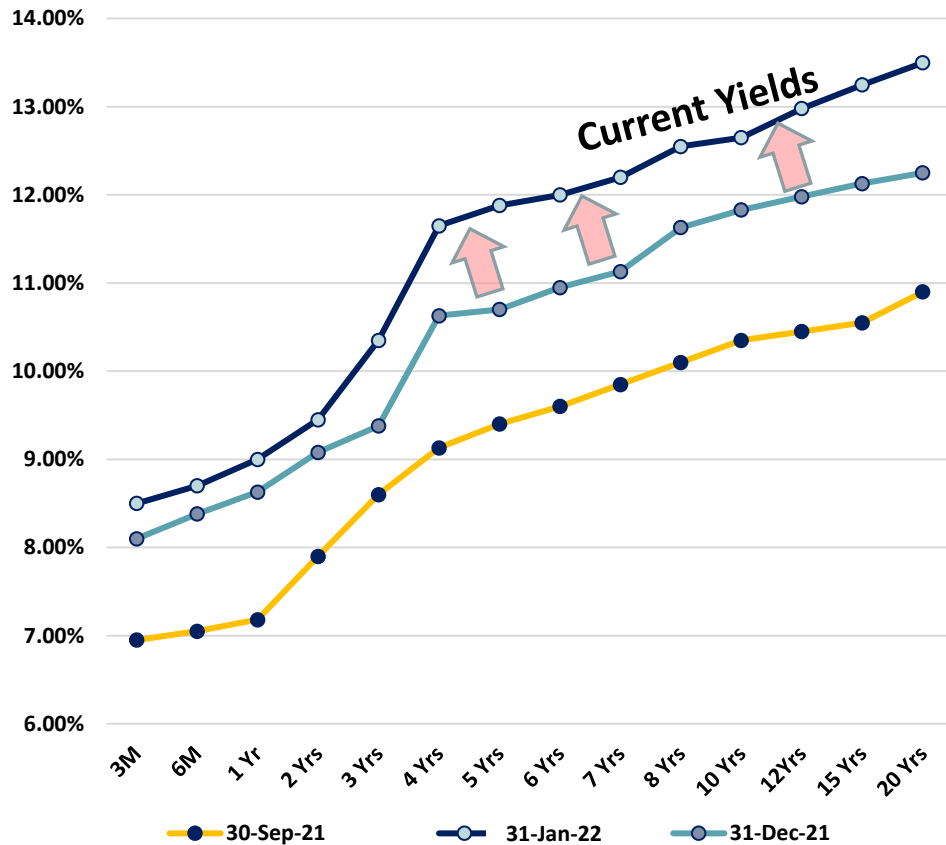
**FIRST CAPITAL RESEARCH**

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Dimantha Mathew**

# 1.0 Previous Recommendation

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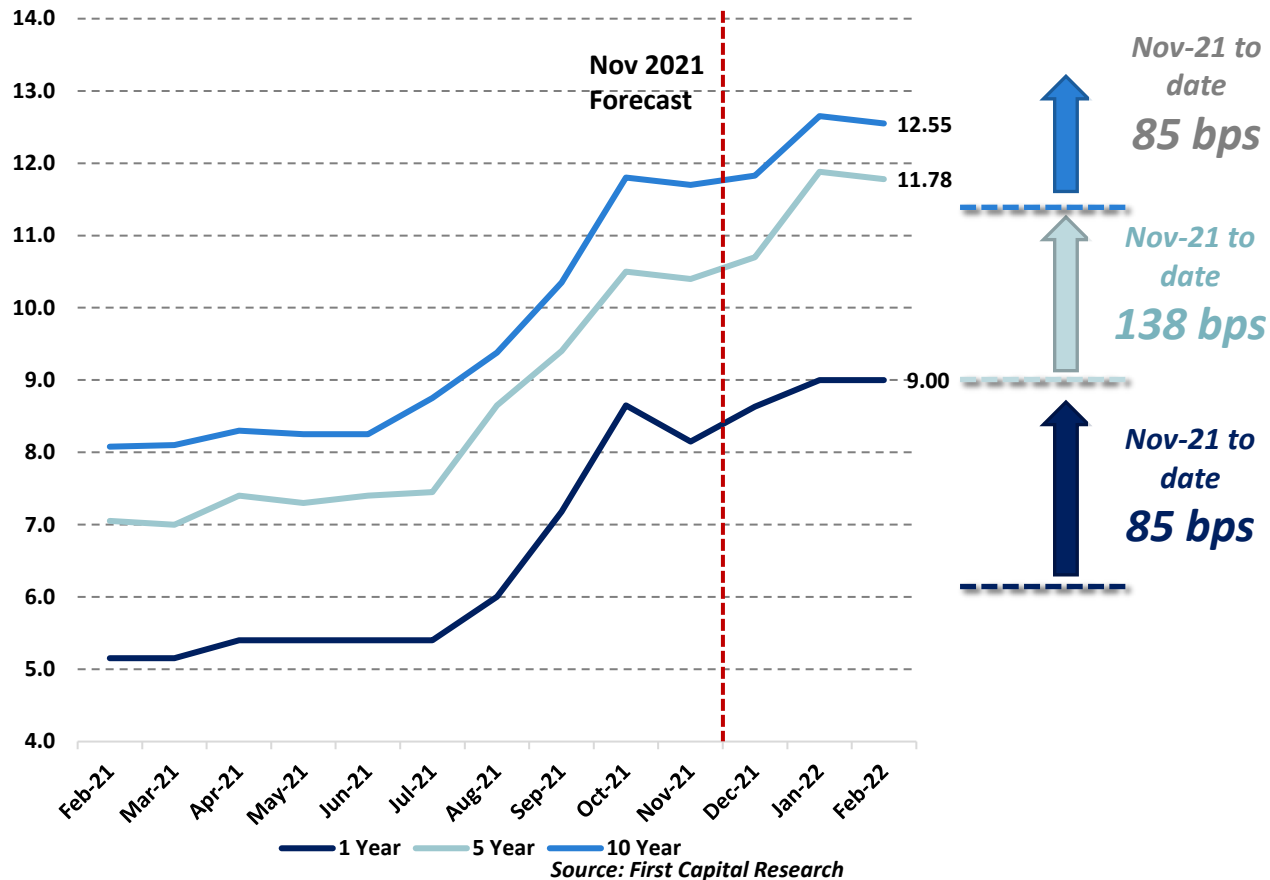
# Overall Yield Curve Movement



Interest Rate Change (bps)					
Tenure	Jan-22	Dec-21	Change (bps)	Sep-21	Change (bps)
3M	8.50%	8.10%	40	6.95%	155
6M	8.70%	8.38%	32	7.05%	165
1 Yr	9.00%	8.63%	37	7.18%	182
2 Yrs	9.45%	9.08%	37	7.90%	155
3 Yrs	10.35%	9.38%	97	8.60%	175
4 Yrs	11.65%	10.63%	102	9.13%	252
5 Yrs	11.88%	10.70%	118	9.40%	248
6 Yrs	12.00%	10.95%	105	9.60%	240
7 Yrs	12.20%	11.13%	107	9.85%	235
8 Yrs	12.55%	11.63%	92	10.10%	245
10 Yrs	12.65%	11.83%	82	10.35%	230
12 Yrs	12.98%	11.98%	100	10.45%	253
15 Yrs	13.25%	12.13%	112	10.55%	270
20 Yrs	13.50%	12.25%	125	10.90%	260

# 30<sup>th</sup> Nov 2021 – 15<sup>th</sup> Feb 2022 (1.5 months)

## Bond Market spikes 85-138bps



### Previous Recommendations

#### Jan 2022 [Strategy Report]

“Yield Curve may rise by 150-200bps and reach our upper bands of the yield curve in 1H2022” - **Currently ongoing**

#### 09<sup>th</sup> Nov 2021

“Yields upsurge as bonds gird for taper clues” - **Accurate**



# 2.0 Fixed Income Health Score

As at Jan-22

# FI Economic Health Score – Jan-22

*Primary indicators on a downtrend while secondary criteria holds steady.....*

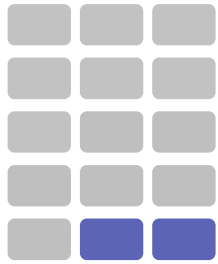


[As against 20 in Dec-21 & 54 in Jan- 21 (1 Year ago)]

Source: First Capital Research

# Changes to Health Score – Primary Criteria

New Score



03/15

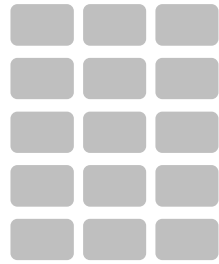
### Foreign Reserves

Foreign reserves deteriorated and recorded at USD 2.4Bn for Jan-22 which is equal to nearly 1.1 months of imports.

Current Score



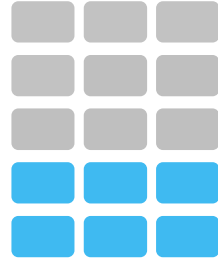
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### Liquidity

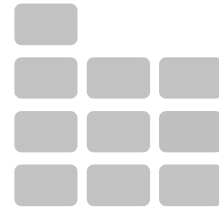
Liquidity level was highly volatile and recorded below LKR -500.0Bn towards the latter half of the month of Feb-22 and closed at LKR-539.1Bn.



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### Inflation

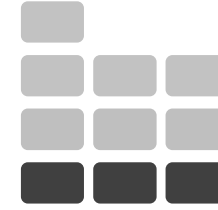
CCPI increased to 14.2% in Jan-22, exceeding the CBSL's and FC Research's targeted range of 4%-6% and 5%-7% respectively.



00/10

### Foreign Activity

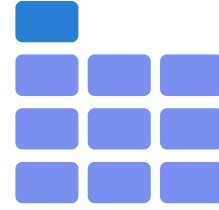
Foreign Investment in Govt. securities remains below LKR 5.0Bn.



02/10

### Credit

Private sector credit recorded an increase of LKR 60.5Bn for the month of Nov-21 and is expected to slow down amidst gradual rise in interest rates.



10/10

### CBSL Holdings

CBSL holdings remained above LKR 1500.0Bn.



# Changes to Health Score – Secondary Criteria



New Score

Current Score



00/05

### Rating Outlook

S&P has placed Sri Lanka at CCC from an earlier CCC+ while Moody's downgraded Sri Lanka's debt rating to 'Caa2' from 'Caa1' in Oct-21. Fitch downgrades SL Credit Rating to CC from CCC in Dec-21.

00/05



00/05

### External Environment

Foreign exchange market remains volatile, USD/LKR has depreciated by 7.5% in 2021 and 0.4% during the month of Jan-22.

00/05



00/05

### BOT & BOP

Trade deficit recorded at USD 1.1Bn in Dec-21 while YTD BOP deficit recorded at USD 4.0Bn with a significant expansion on a YoY basis.

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### Political Risk

Political stability is maintained. However, popularity of the govt. is deteriorating due to uncertainties.

03/05



02/05

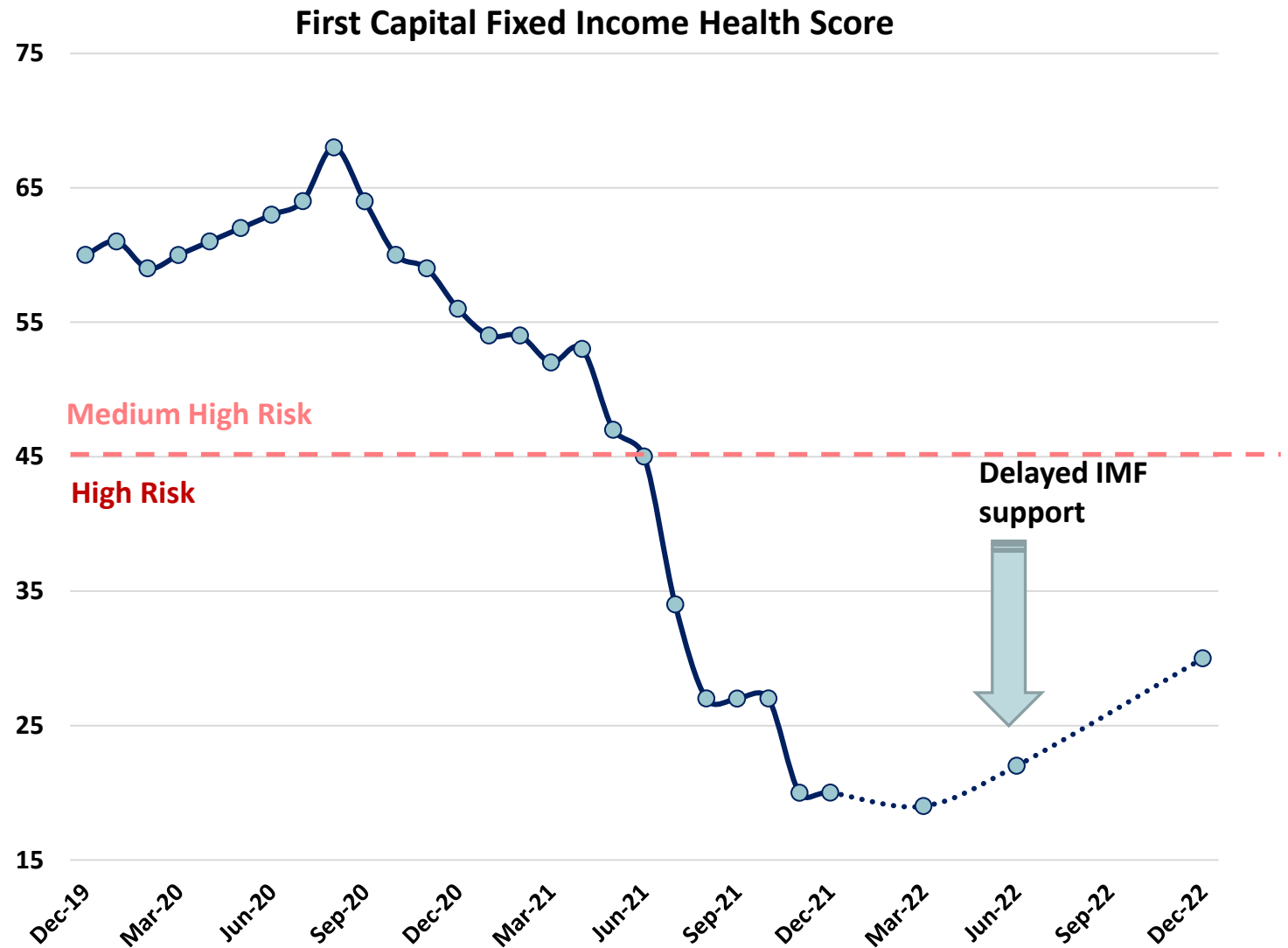
### Investor Confidence

The BCI registered only a slight increase of three basis points to 122 in Jan-22 compared to Dec-21, of 119.

02/05



FI Health score  
further  
deteriorates as  
IMF support is  
delayed



## 3.0 Weakening Outlook

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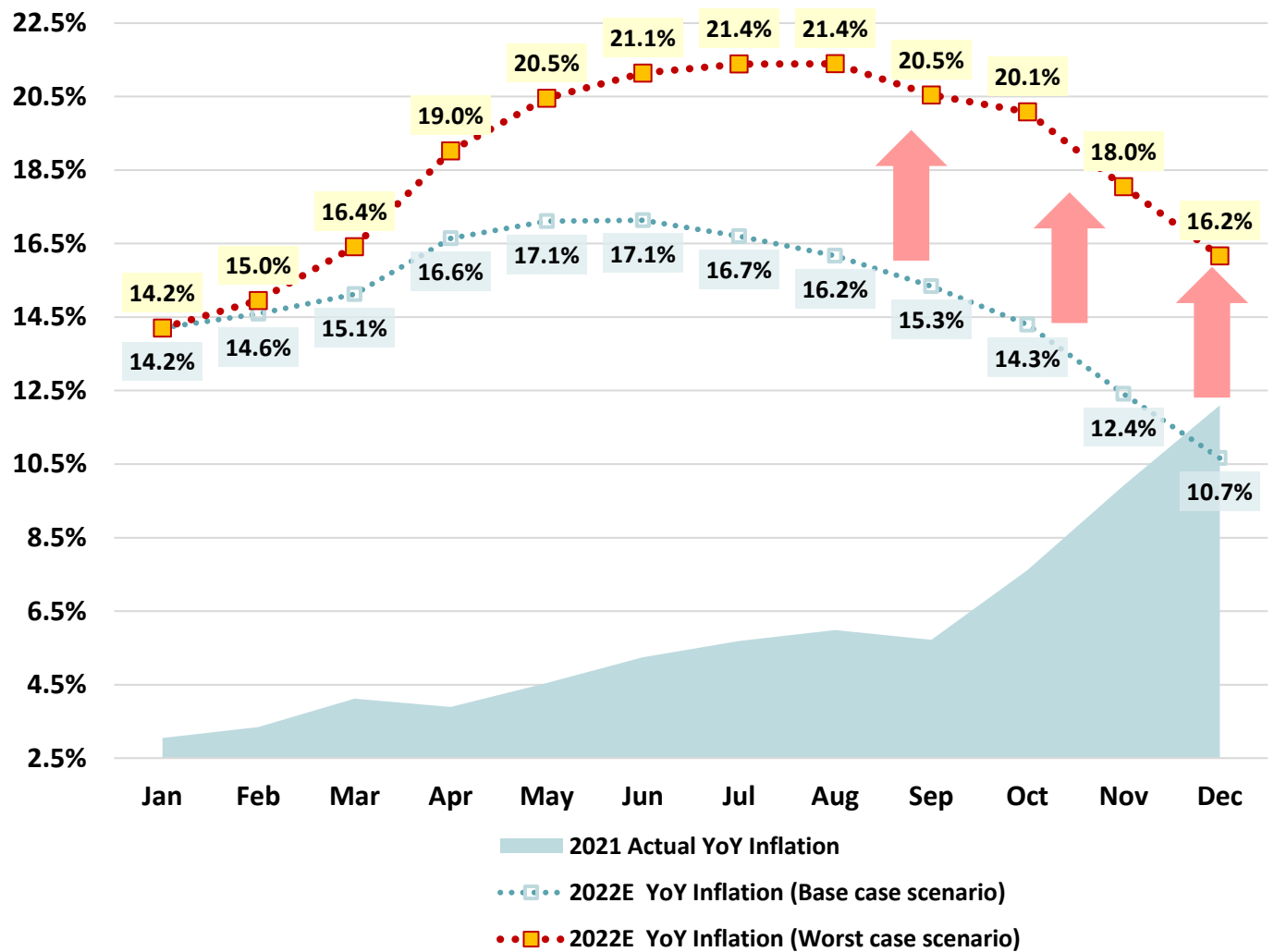
# Higher inflation to take a toll on yields

On the domestic front, rising inflationary pressure is expected to take a toll on yields. In Jan-22 inflation measured on CCPI accelerated to 14.2% from 12.1% in Dec-21 amidst rise in CBSL holdings, import restrictions and due to other supply shortages, such as fertilizer ban which hit on agri produce.

Inflation is likely to increase in the coming months and remain elevated throughout 2022 as a result of foreign currency shortage and continued import restrictions.

We expect that this may force CBSL to raise rates further in order to curb inflation pressure which is currently building up.



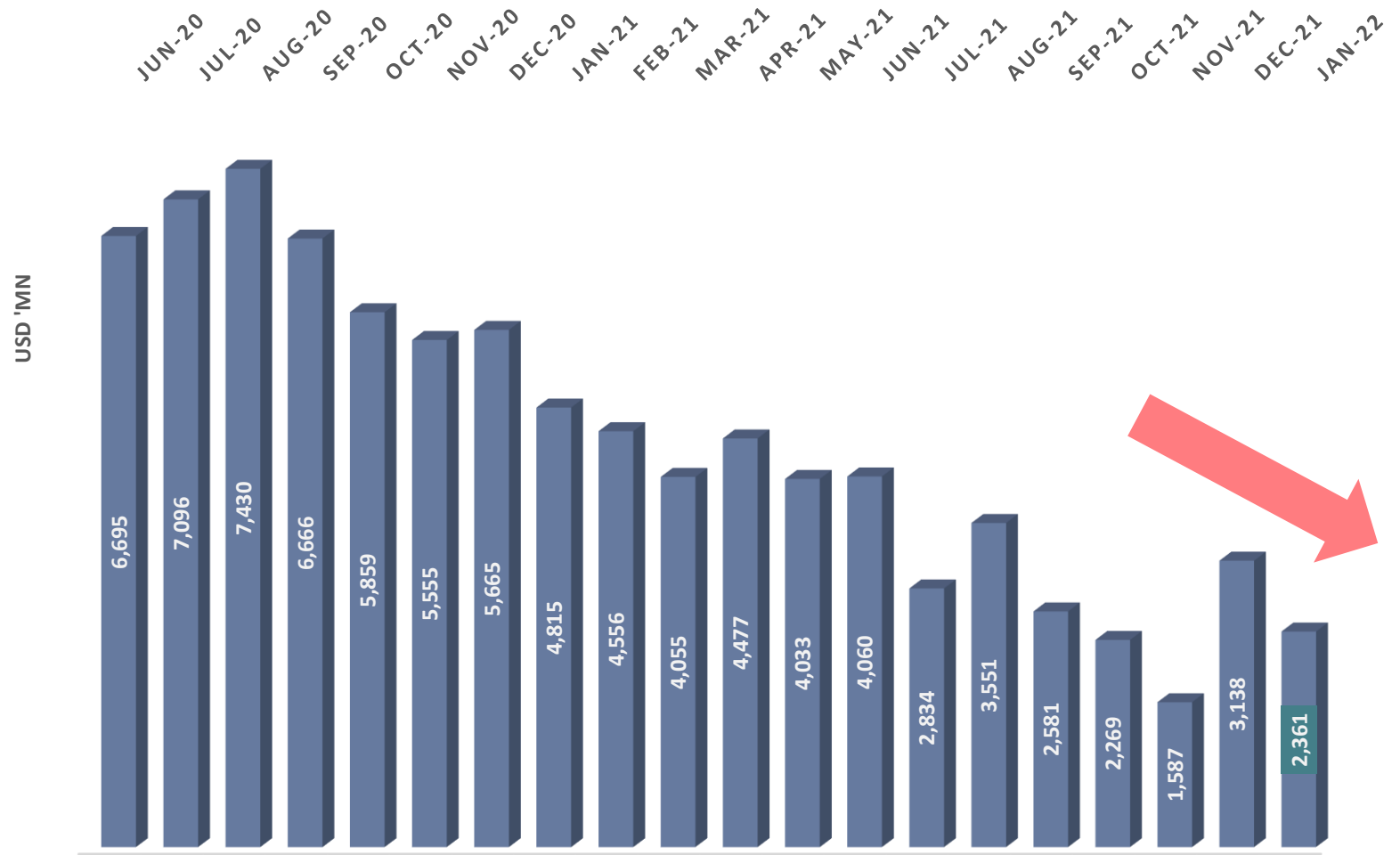


Source: Dept. Census and Statistics and First Capital Research Expectations

Inflation rises to a record 13-Year high...

*while 2022 inflation is expected to peak at 17.1% in a base case scenario and even increase up to 21.4% on a worsening economic conditions.*

Sri Lanka's gross official reserves amounted to USD 2.4Bn by end Jan-22 (including the swap facility with the People's Bank of China of RMB 10 Bn equivalent to USD 1.5 Bn and Indian swap amounting to USD 400.0Mn) with an import cover of 1.1 months, in terms of Dec-21 imports.



# First Capital Research has identified

*two scenarios for foreign reserves*

## Base Case Scenario

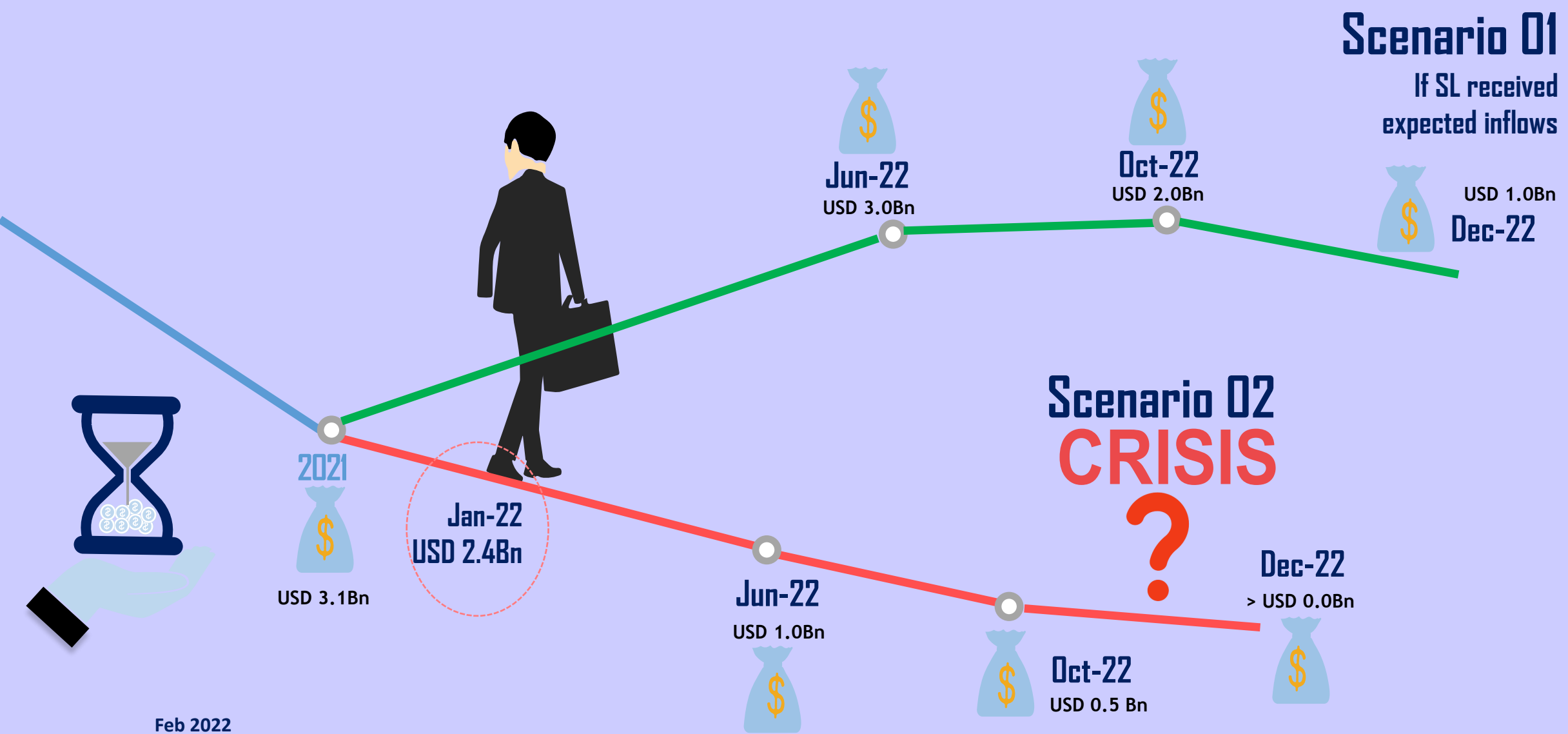
In the base case scenario, we have assumed that Sri Lanka will materialize the expected foreign inflows which is amounted to USD 6.4Bn. Accordingly, by end 2022, SL is expected to record a foreign reserves value amounting to USD 1.0Bn.

## Worst Case Scenario

In the worst-case scenario, we have assumed that expected inflows will not materialize and therefore will confront with a crisis situation by Oct-22 recording a foreign reserves value near zero.



Based on the current economic conditions, we believe that SL is heading towards the scenario 2 and will reach near zero foreign reserves by Oct-22



### Scenario 01

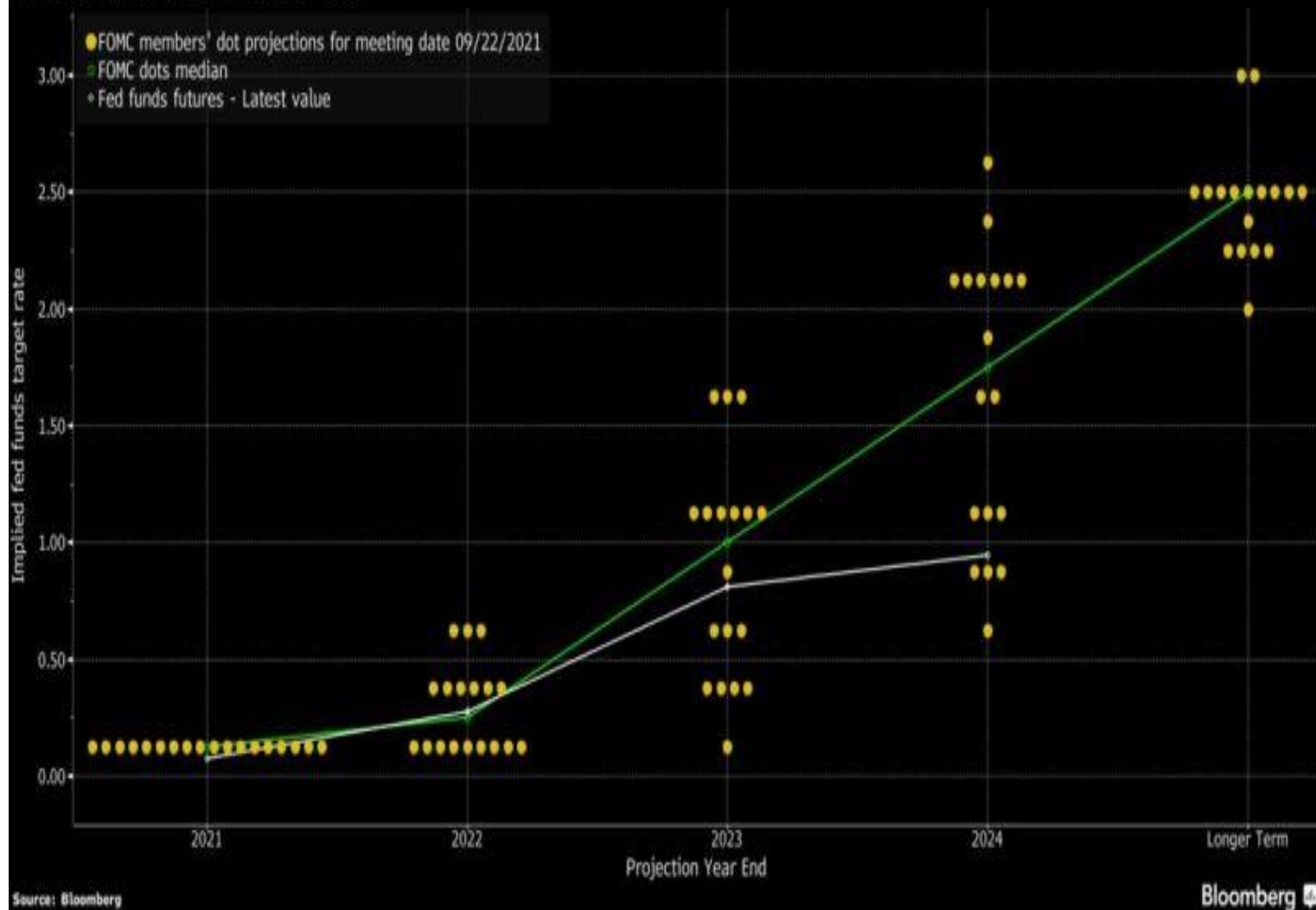
If SL received expected inflows

### Scenario 02 CRISIS



Feb 2022

## The Fed's New Dot Plot



...while Fed's hawkish turn places emerging economies including SL at a disadvantageous position

After its two-day January confab, the Federal Open Market Committee (FOMC) reiterated much of what they had said in Dec-21. The federal funds rate remains on hold at zero to 0.25% for now, bond purchases should end in Mar and then it's time to raise rates.

With inflation well above 2.0% and a strong labor market, the Committee expects it will soon be appropriate to raise the target range for the federal funds rate.

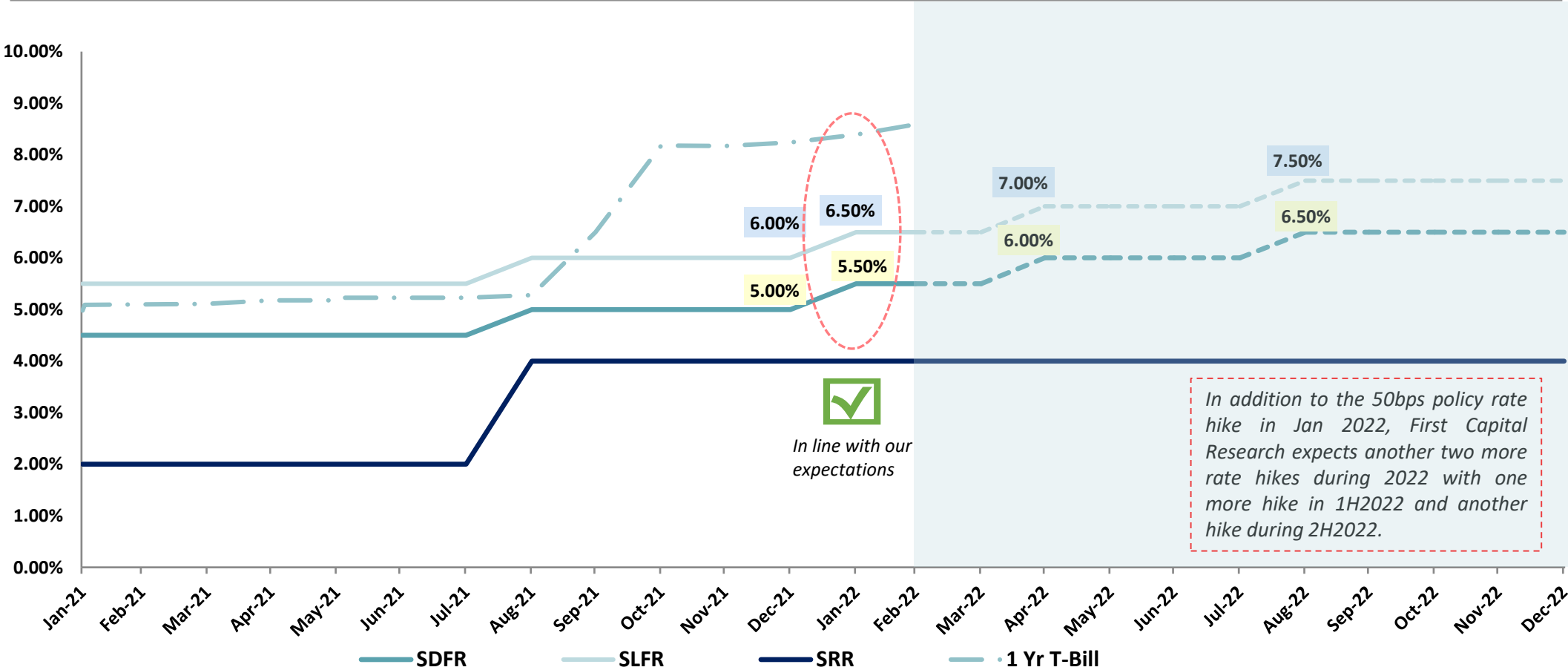
The post-meeting statement from the Federal Open Market Committee did not provide a specific time for when the increase will come, though indications are that it could happen as soon as the Mar meeting.

These changes have made the outlook for emerging markets including Sri Lanka more uncertain as they need to follow suit since rate hikes by Fed can result in a further a currency depreciation due to possible foreign outflows.



# CBSL raises policy rates in Jan-22...

*while we expect further 100bps hike for 2022*



Source: CBSL and First Capital Research Expectations

# 4.0 New Recommendation

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# Broader view: Bond yields to extend the surge amidst significant macro pressures

*Sri Lanka's foreign reserves recorded at USD 2.4Bn in Jan-22 and is expected to further deplete as a result of approximately USD 7.0Bn outstanding loan payments for the next 12 months.*

*Depleting foreign reserves, rising foreign currency debt repayment requirements, and restricted market funding sources are projected to put more pressure on yields in 2022E.*

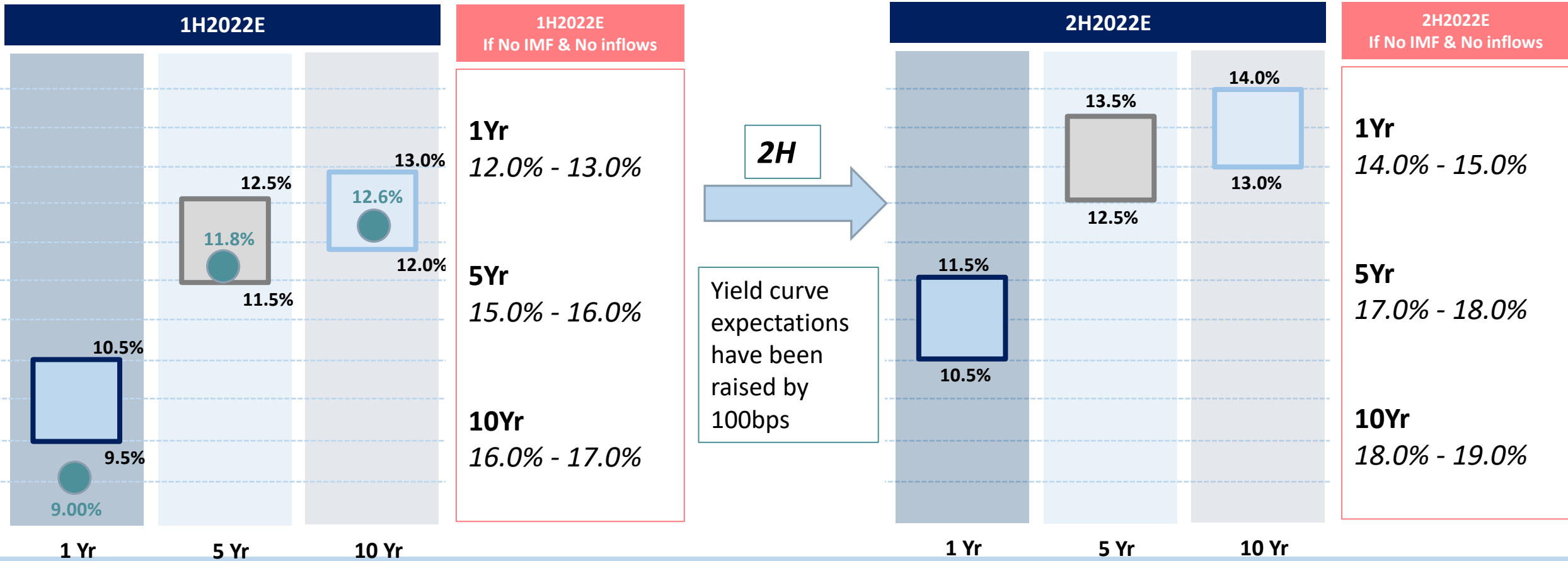
*In 1H2022, the extremely weak economic indicators may force the Monetary Board to further tighten the monetary policy. Thereby, we expect 2 rate hike in 1H2022. In Jan-22, Monetary Board has already announced 1 rate hike and we expect 1 more rate hike to take place in 1H2022 to balance the overall economic outlook.*

*In light of the weaker economic conditions, we believe bond yields are picking up at an accelerated pace and expect it to move further over upcoming months.*

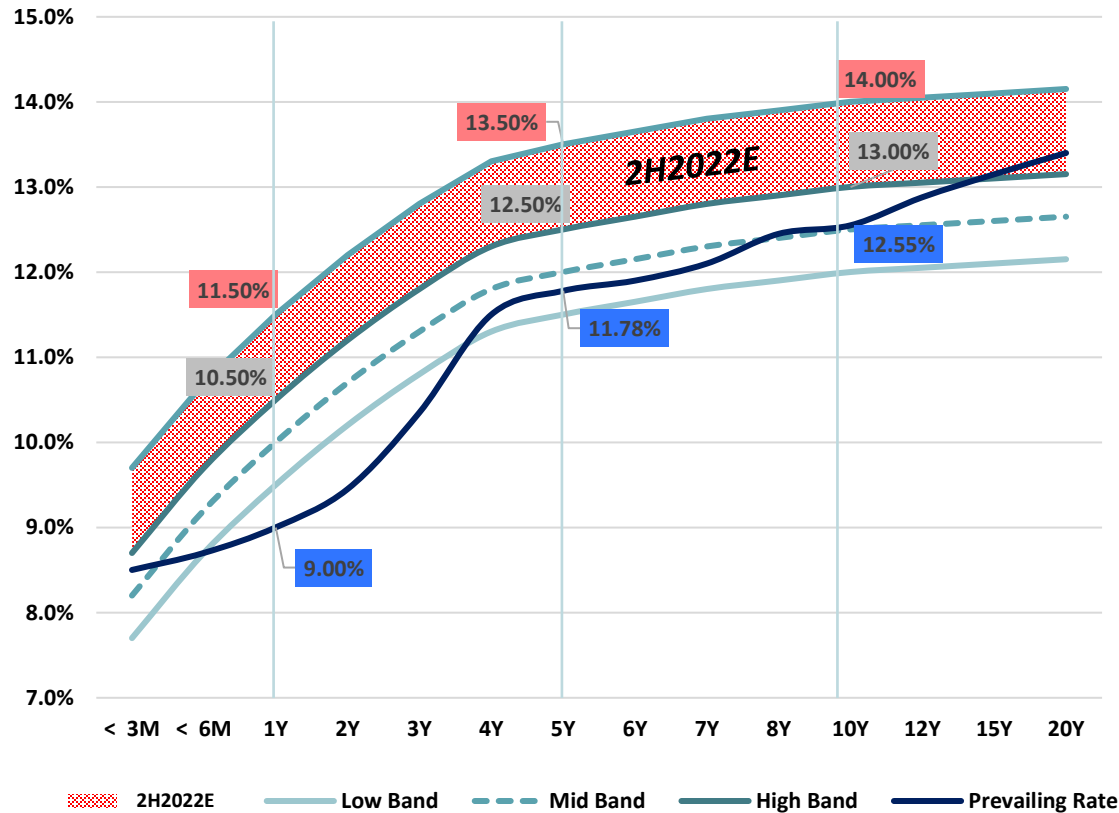


# 2022 to be Bearish on Bonds – View Maintained

1H yields to rise by 150bps-200bps and in 2H a further 100bps-150bps; But with no IMF or inflows yields could just skyrocket



# Yield Curve Recommendation



Tenure			Current Yield	Recommendation
< 91 Days	< 3M	Short	8.50%	<b>SELL</b>
< 182 Days	< 6M	Short	8.70%	<b>SELL</b>
< 364 Days	1Y	Short	9.00%	<b>SELL</b>
15-Mar-24	2Y	Short	9.45%	<b>SELL</b>
15-Mar-25	3Y	Short	10.35%	<b>SELL</b>
01-Feb-26	4Y	Mid	11.50%	<b>SELL</b>
15-Jan-27	5Y	Mid	11.78%	<b>SELL</b>
15-Mar-28	6Y	Mid	11.90%	<b>SELL</b>
01-Jan-29	7Y	Mid	12.10%	<b>SELL</b>
15-May-30	8Y	Mid	12.45%	<b>SELL</b>
01-Oct-32	10Y	Long	12.55%	<b>SELL</b>
01-Jan-34	12Y	Long	12.88%	<b>SELL</b>
15-Mar-35	15Y	Long	13.15%	<b>SELL</b>
01-Jan-41	20Y	Long	13.40%	<b>HOLD</b>

Source: First Capital Research

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“Successful Investment Is About Managing Risk...”

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