



First Capital

“WARNING OF UPWARD LURCH IN YIELDS”

First Capital Fixed Income Recommendation – 28th Jul 2021

FIRST CAPITAL RESEARCH

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Track Record:- Strategy Report 2021

Recap: Investment Strategy Report 2021

Bond Yields to gradually trend up from 1Q2021

Accuracy Maintained

Jan 2021 – Dec 2021	Probability	Impact
Bond yields are expected to be bearish from 1Q2021 onwards	85%	Bearish
Better than expected foreign inflows may allow bond rates to fall below our bands	15%	Stable / Bullish

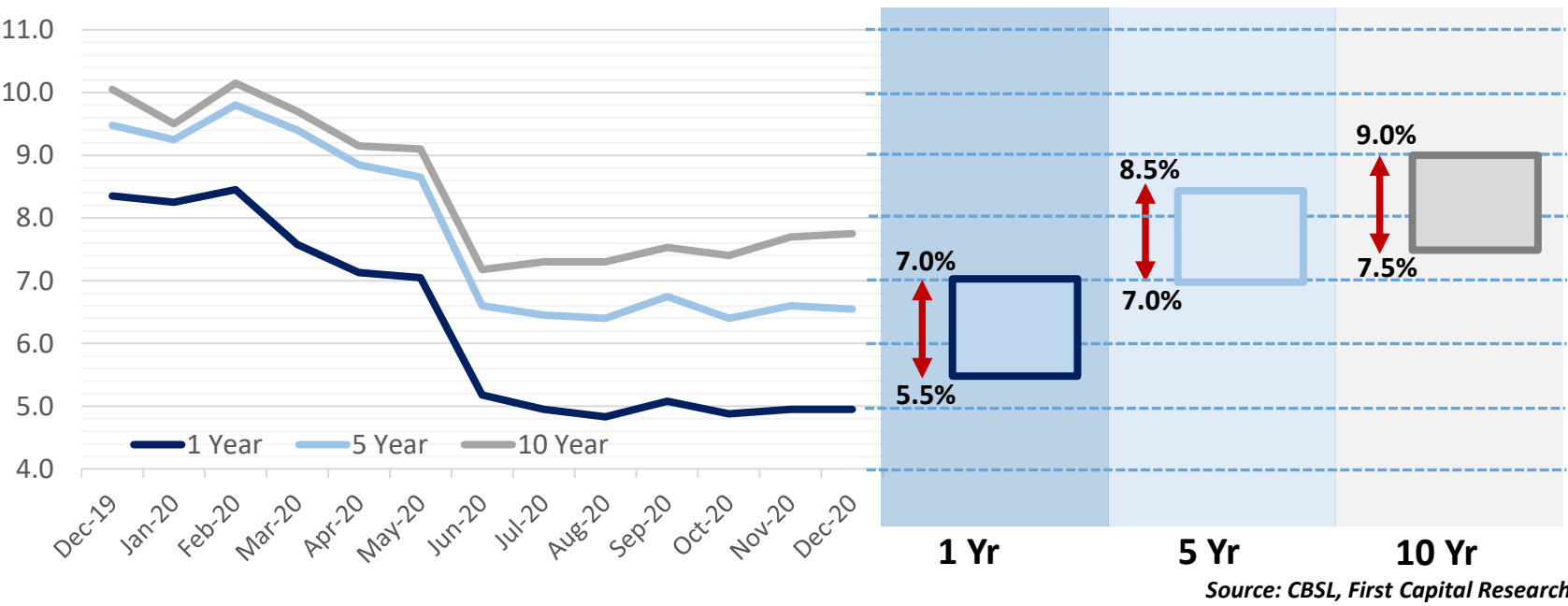
Expectations: Bearish 1Q2021 onwards

Policy Rate Expectations

On a base case First Capital Research expects a stable policy environment upto Jun 2021 followed by policy rates reverting upwards with potential 2 policy hikes in 3Q/4Q.

2021 Outlook - Base Case (85% Probability)

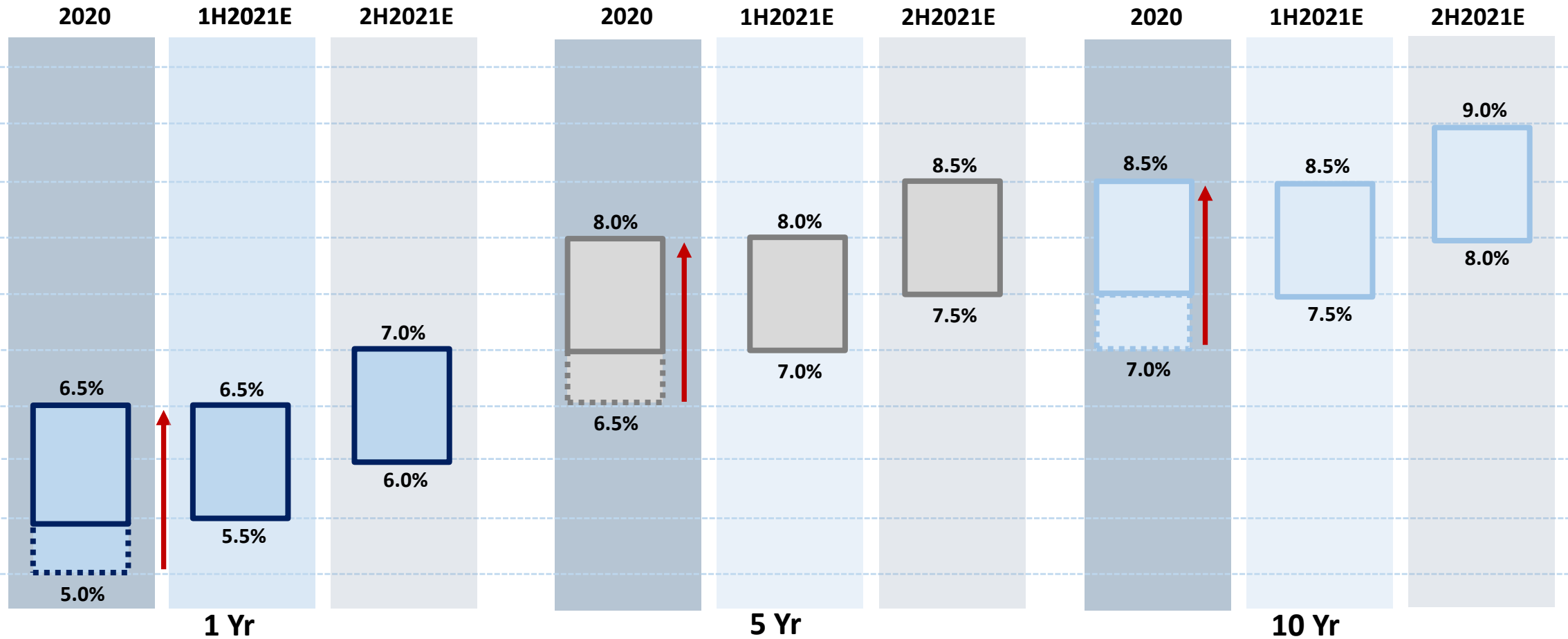
With the rise in Govt borrowing requirement, rising consumer demand and private credit, we expect a gradual increase in pressure on bond yields during 1Q2021 and afterwards to gradually move up further during 2021



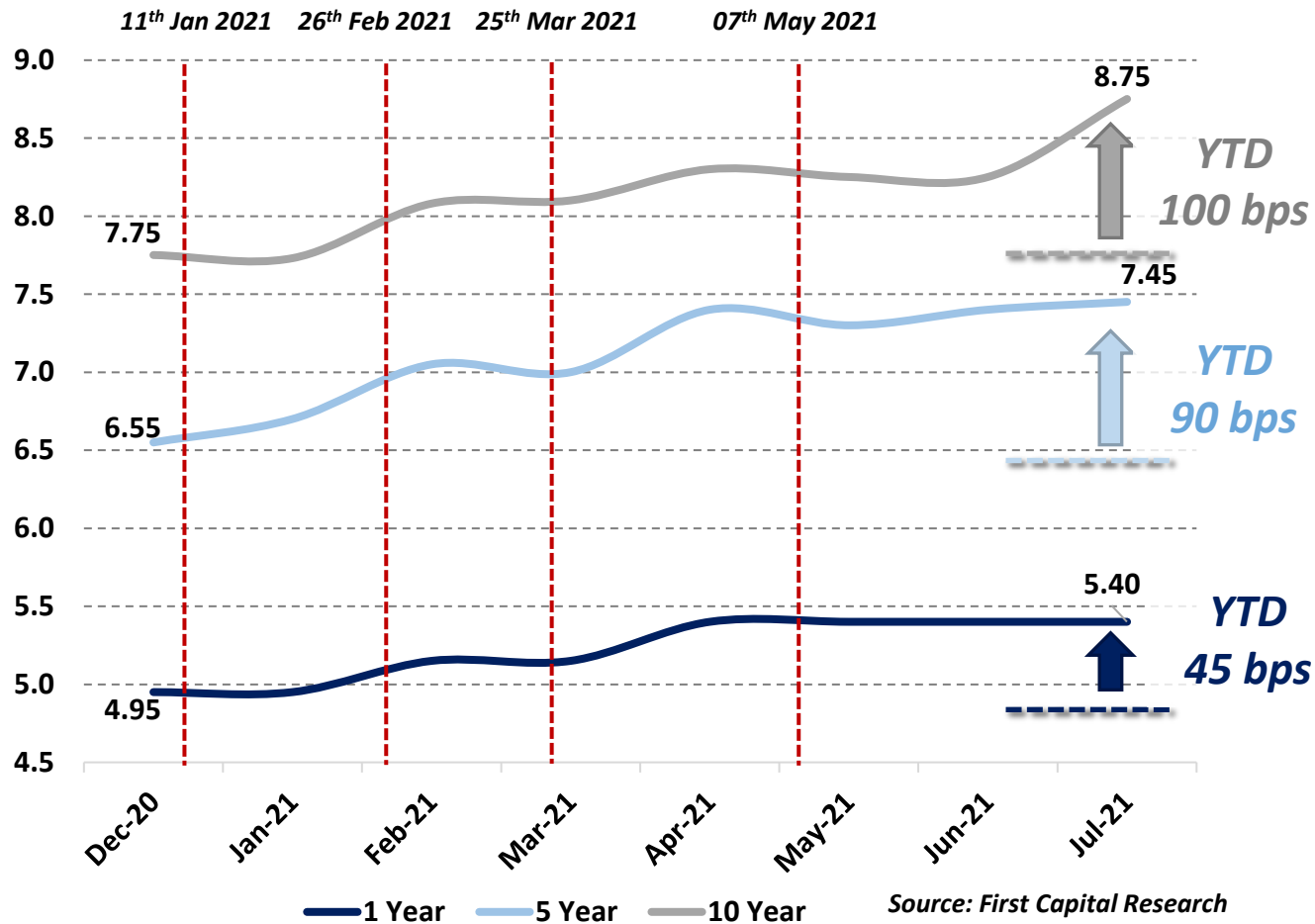
Source: CBSL, First Capital Research

Recap: Investment Strategy Report 2021

Yield Curve may rise by 150-200bps and reach our upper bands of the yield curve



In-line with First Capital Research expectation Bond Yields gradually trend up in 1H2021



2021 FI Recommendations

- 11th Jan 2021 - BOND BULLS GO BUST!!!
- 26th Feb 2021 - UNCERTAINTY BRINGS BACK THE BEARS; BOND MARKET ALARMED!!!
- 25th Mar 2021 - ALARM SNOOZED WITH SWAP!!!
- 07th May 2021 - ENHANCED LIQUIDITY TO KEEP BOND YIELDS IN CHECK

First Capital Research View 2H2021

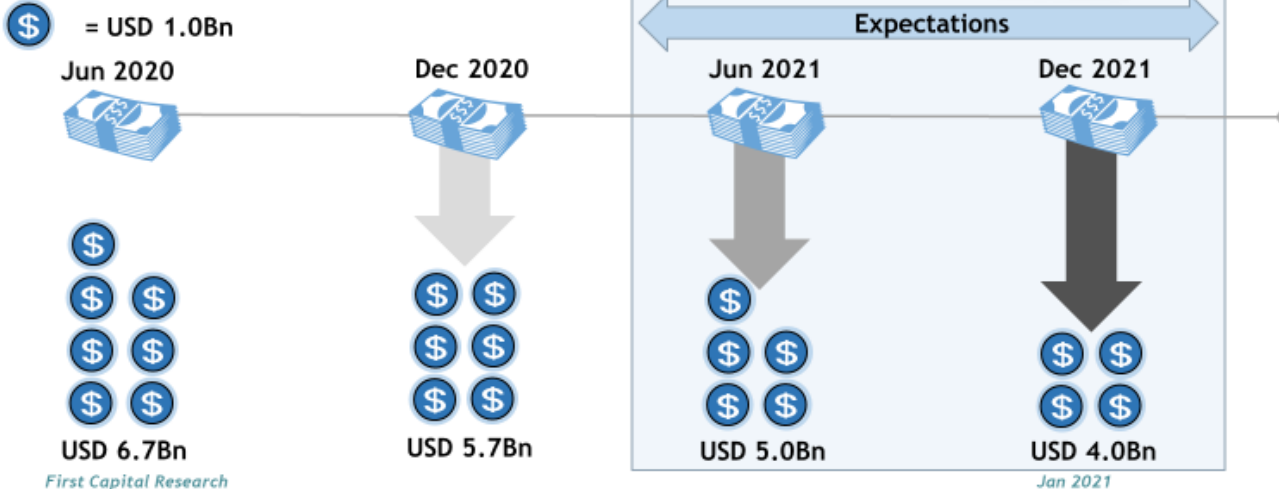
Foreign reserves falls below First Capital Research expected levels

Recap :- Strategy Report 2021

...risking foreign reserves to fall below comfortable levels

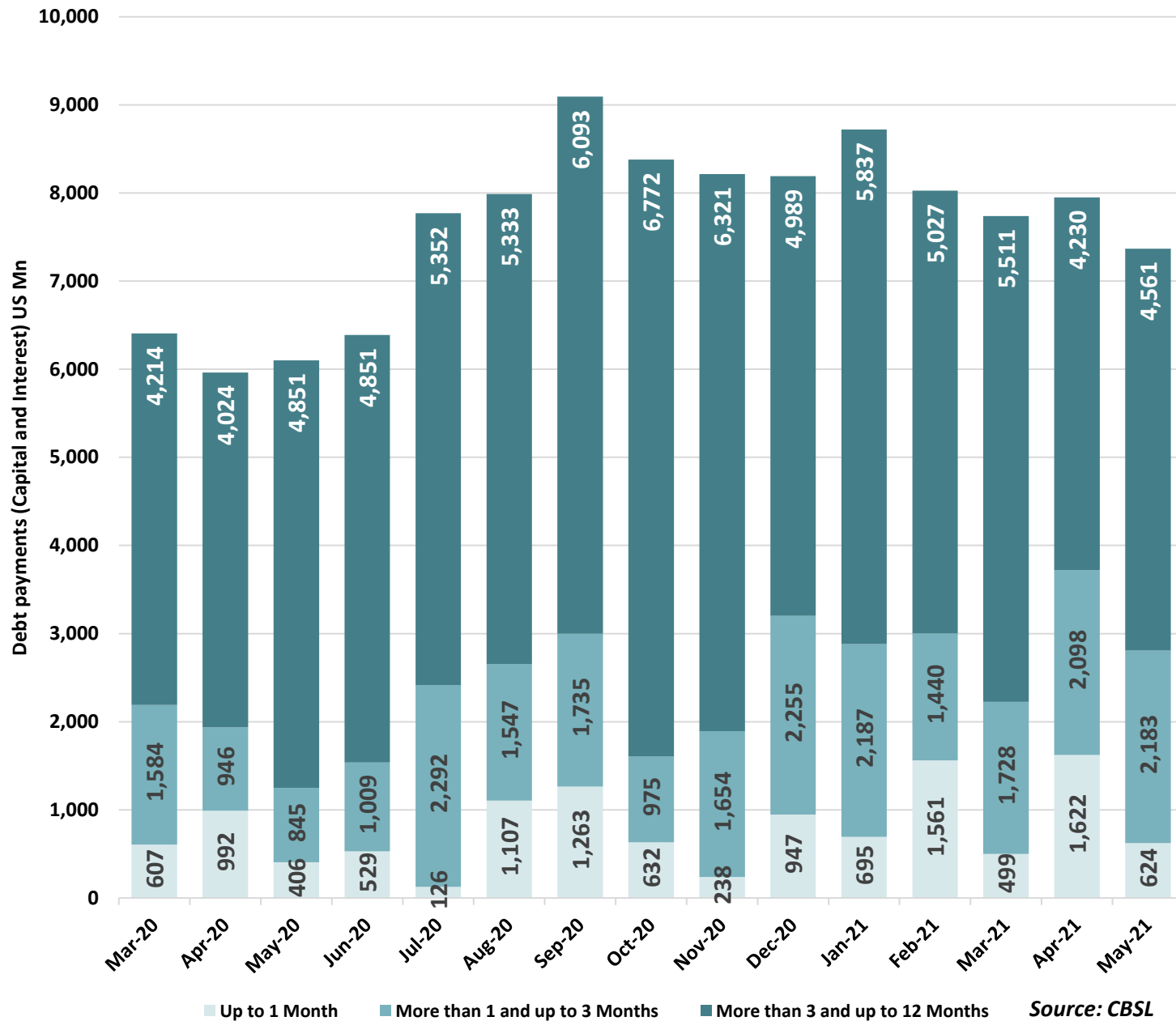
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Source: CBSL, First Capital Research



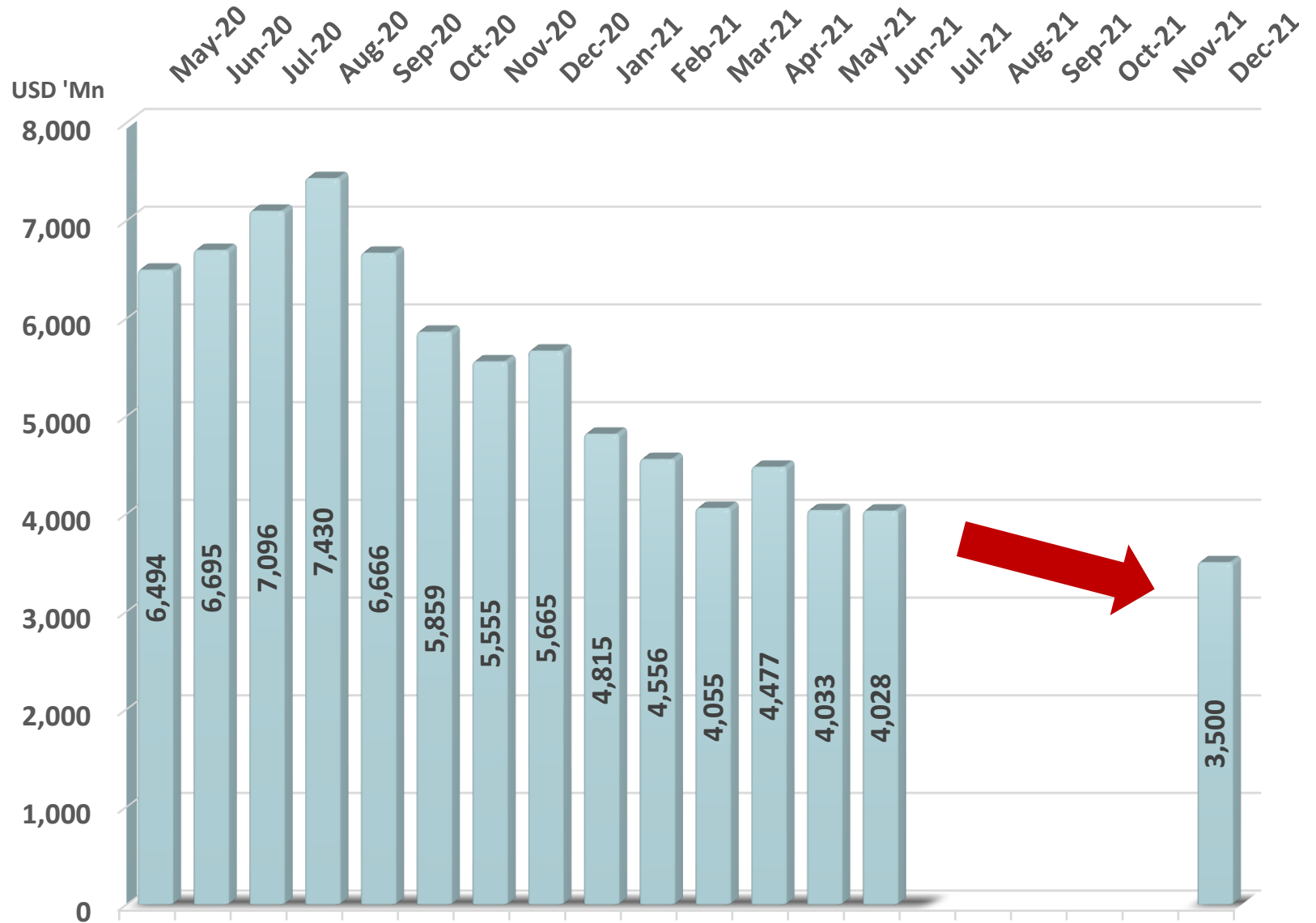
Reserves down to USD 4.0Bn: Sri Lanka's foreign reserves trimmed down to USD 4.0Bn in Jun 2021 amidst high debt repayment and inadequate inflow of foreign currency. Foreign reserves was well below First Capital Research expectation, which was estimated at USD 5.0Bn by Jun 2021 while it was only expected to reach USD 4.0 by Dec 2021.

Dec 2021 target downgraded USD 3.5Bn: A USD 1Bn Sovereign Bond matured on 27th Jul while a further 0.2Bn SLDBs are expected to mature in 3Q2021. Further, number of project loans payments also fall due within the period. However, SL is expecting inflows from IMF of USD 780Mn and potentially a couple of more SWAPs over the next few months to support the reserves. Considering all the factors, we still believe the foreign currency reserves may dip to around USD 3.5Bn by Dec 2021.



Sri Lanka's next 12-month FX liabilities exceeds Value of Foreign Official Reserve of USD 4.0Bn as of Jun 2021

Sri Lanka's gross official reserves USD 4.0Bn(excluding the swap facility with the PBOC), with an import cover of 2.4 months, in Jun 2021.



Market liquidity wipes out to a 17-month low in the midst of Sovereign payment

- ❑ Liquidity dropped gradually in Jul 2021 amidst interventions in forex markets as well as settling of dollar loans. Excess liquidity dropped to LKR 0.03Bn from LKR 53.6Bn on 22nd Jul 2021 amidst the maturity of a Sri Lanka USD Sovereign Bond.
- ❑ In the week of Sovereign payment, CBSL Holdings rose to LKR 1,135Bn from LKR 911Bn. In the past months, whenever excess liquidity dropped from loan payments, new money has been printed to bring it above the comfortable levels.
- ❑ Private sector credit increased by LKR 56Bn in May 2021 sustaining the growth momentum for 10th consecutive month, while state credit picked up after slowing down in Apr 2021.
- ❑ Sri Lanka's balance of payment deficit hit USD1.0Bn YTD to May 2021 amidst money printing while the trade deficit has exceeded the 2019 level despite import controls.
- ❑ Rise in private sector credit growth and the Government's high borrowing requirement may result in lower liquidity in the system. Govt may adopt further quantitative easing measures to manage the situation which may improve the liquidity position. However, with economy starting to pickup, liquidity is likely to continue to remain low.



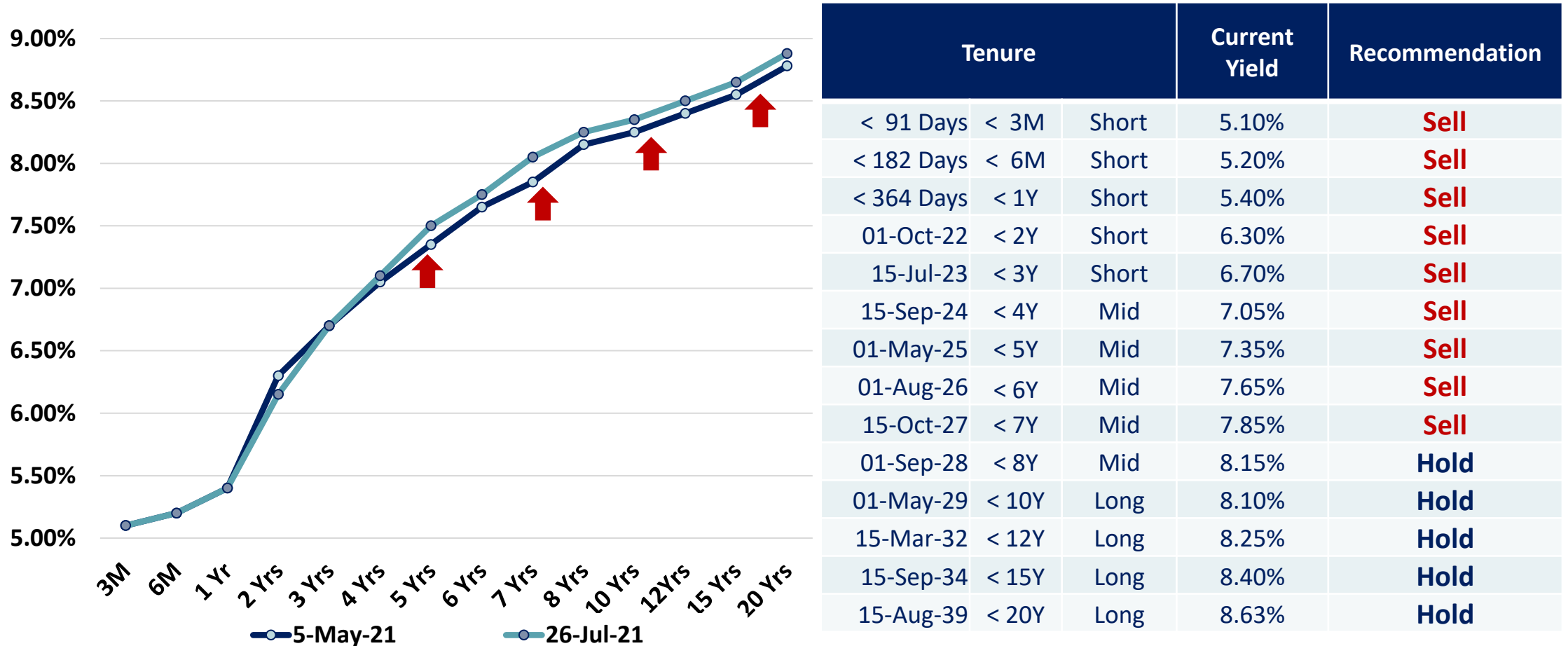
Hefty deficit increases pressure

- ❑ Sri Lanka's overall budget deficit of LKR 520.5Bn for the first four months of 2021 has overtaken revenues of LKR 481.7Bn, following tax cuts in Dec 2019 compounded by a Coronavirus pandemic.
- ❑ Over the near term, inflation and potential monetary policy normalization will play a more important role in shaping the interest rate trajectory.
- ❑ With gradual progress in vaccination and inflation picking up, talks of policy normalization may intensify. We believe bond yields have already started to pick up and expect it to move higher over upcoming months.

1.0 Previous Recommendation

07th May 2021 Re Cap:

Recommendations and Yield curve movement



Fixed Income Health Expectations

First Capital Fixed Income Health Score

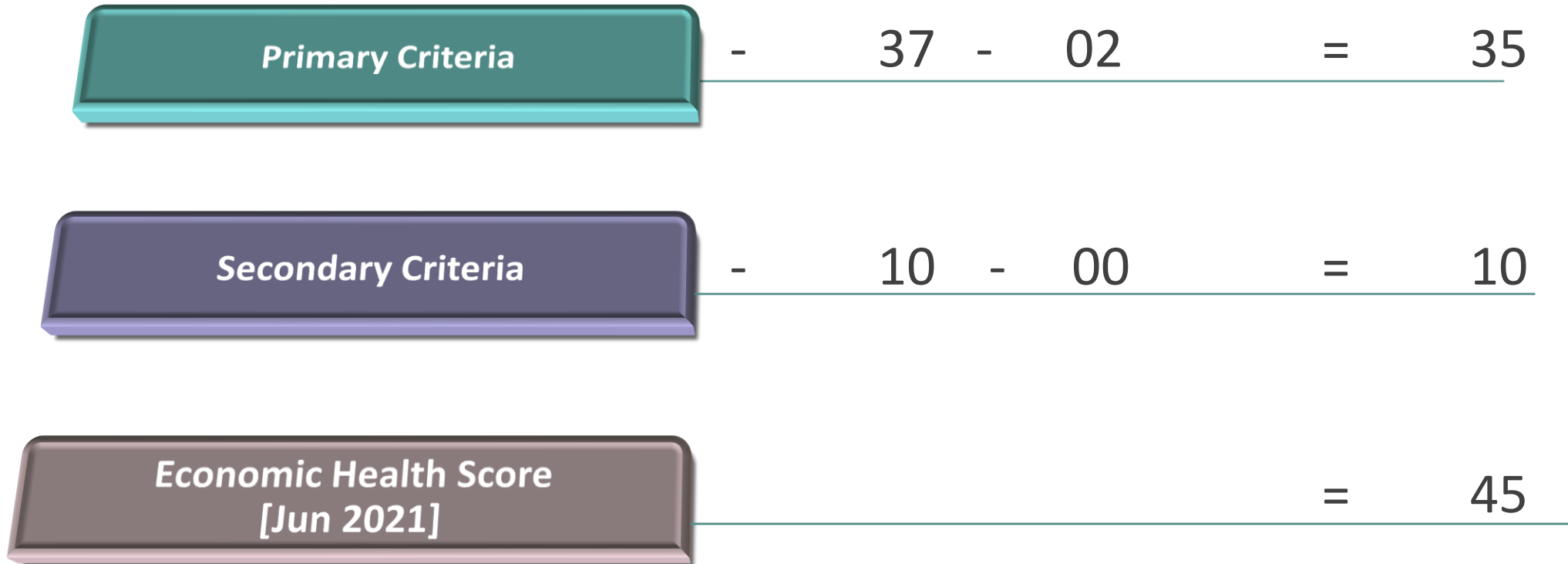




Fixed Income Health Score

FI Economic Health Score – Jun 2021

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



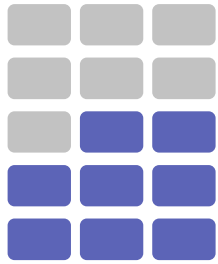
[As against 47 in May 2021 & 63 in Jun 2020 (1 Year ago)]

Source: First Capital Research

Changes to Health Score – Primary Criteria



New Score



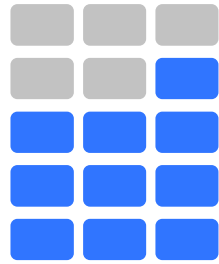
04/15

Foreign Reserves

Foreign reserves were stable at USD 4.0Bn in Jun 2021. However, it was below FCR expectation.



05/15

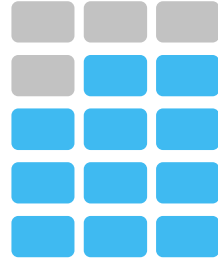


08/15

Liquidity

Liquidity level was highly volatile and declined to LKR 79.80 during mid Jun which recovered to LKR 91.25Bn towards the end.

08/15



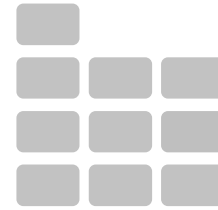
08/15

Inflation

CCPI increased to 5.2% in Jun 2021, driven by increase of prices in the Food and Non-Food category.



09/15

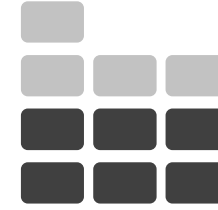


0/10

Foreign Activity

Foreign Investment in Govt. securities below LKR 5.0Bn

0/10

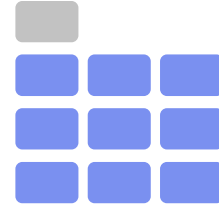


06/10

Credit

Private credit expanded by LKR 55.6Bn May 2021 amidst the travel restrictions.

06/10

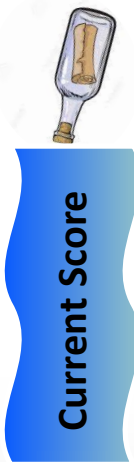


09/10

CBSL Holdings

CBSL holdings remained above LKR 850.0Bn along with improved liquidity.

09/10



Current Score

Changes to Health Score – Secondary Criteria



01/05

Rating Outlook

Affirmation of ratings by Fitch and S&P has resulted in further downgrade in ratings unlikely. However, delay in IMF and uncertain future debt plans may affect the rating.

01/05



0/05

External Environment

Foreign exchange market remains volatile, YTD USD/LKR has depreciated by 7.3%

0/05



02/05

BOT & BOP

Trade deficit decreased to USD 716.0Mn in May 2021.

02/05



05/05

Political Risk

Political stability is maintained.

05/05

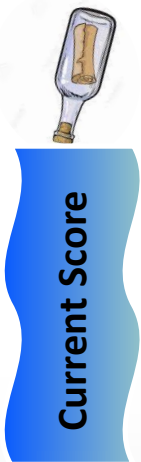


02/05

Investor Confidence

Following its free fall in the previous month, the BCI remained largely the same in June, recording a slight drop of two basis points to 87.

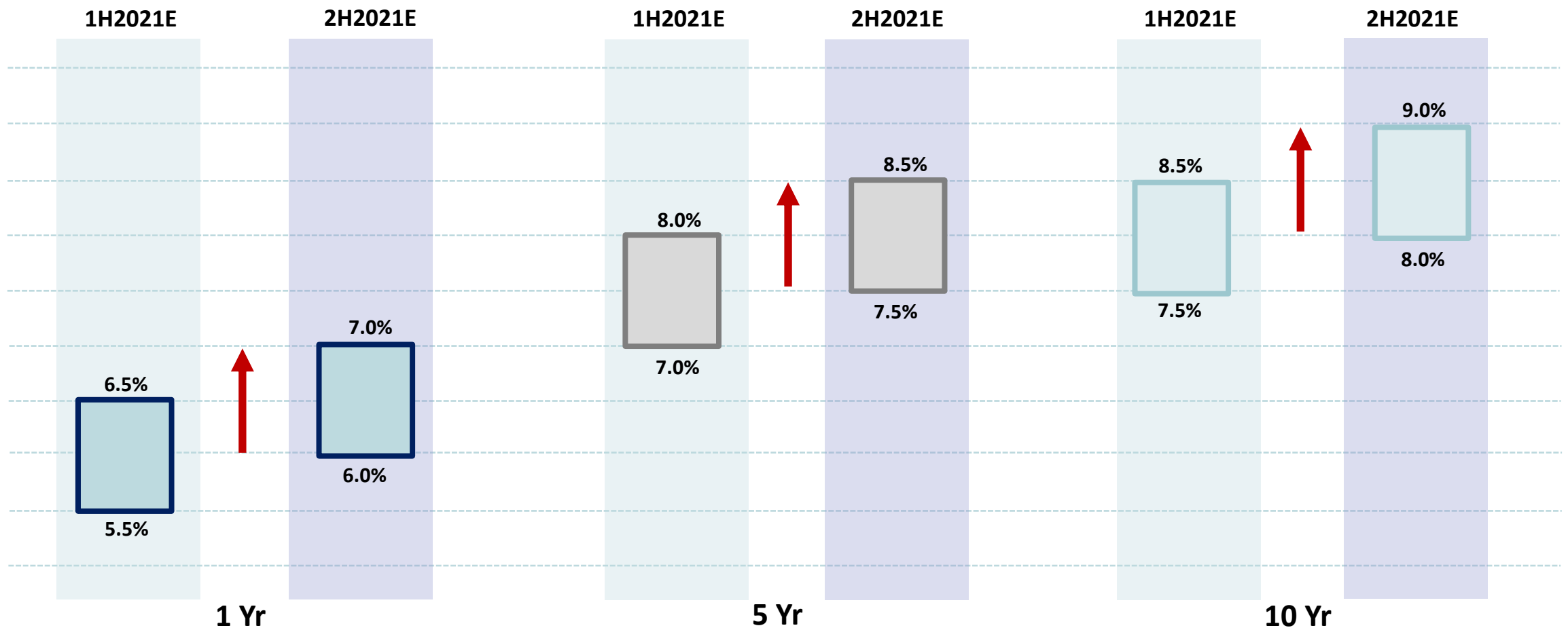
02/05



2.0 New Recommendation

Bond Yield Expectations

In line with Investment Strategy 2021, we are increasing our targeted bond yield bands by 50bps for the 2H2021E (Refer Slide 4)

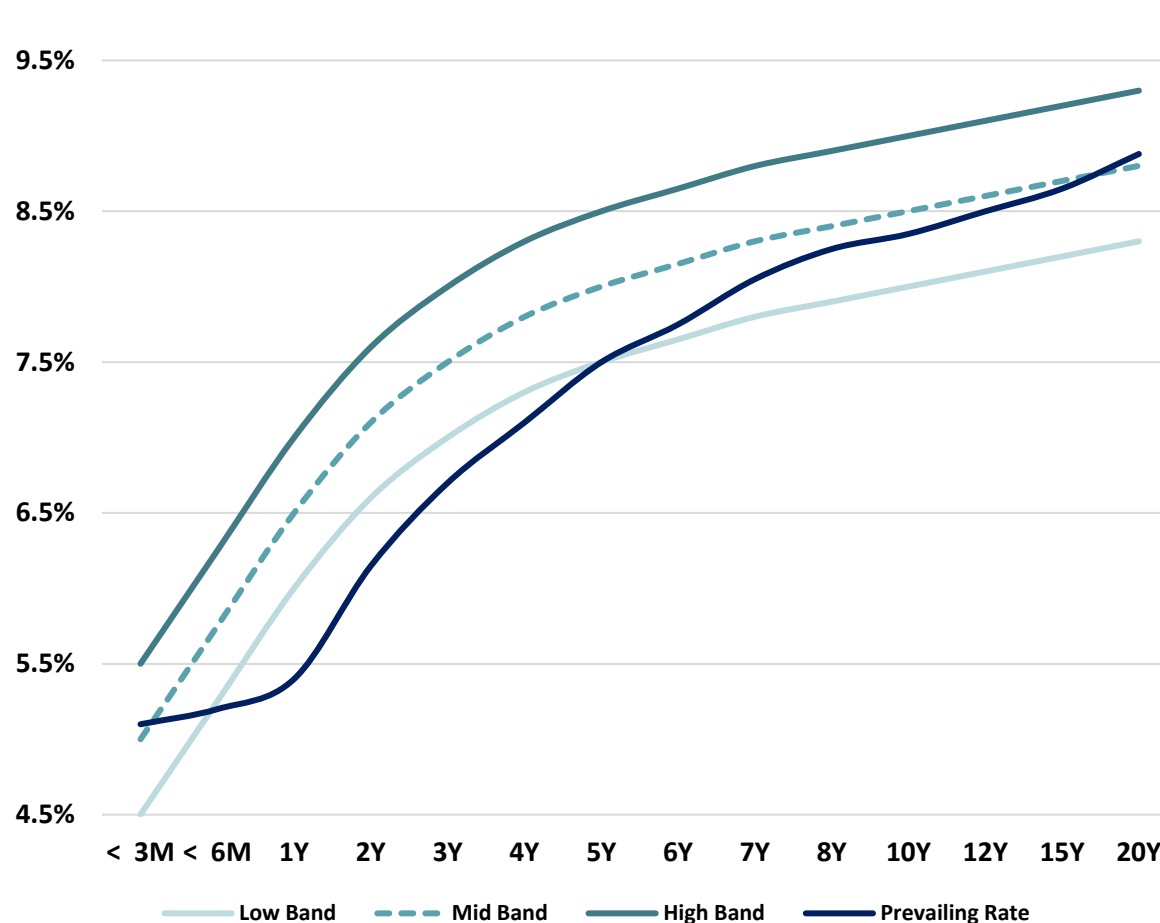


Broader view: Brace for bond tantrums

- ❑ **Higher Borrowing requirement:** Government's dissaving nature increased as a result of the Covid-19 pandemic, worsening the pre-existing weaknesses in government finances. Amidst the continued high infrastructure spending we expect the fiscal deficit to surge above 10% for 2021 similar to 2020. Covid-19 has exacerbated existing weaknesses in government finances, with general government's borrowing requirement skyrocketing during 2021.
- ❑ **Uncertainty over access to creditors:** We expect Sri Lanka's foreign reserve to drop USD 3.0Bn in Jul 2021 after repaying USD 1.0Bn sovereign bond but recover somewhat following IMF funding and SWAPs to USD 3.5Bn by Dec 2021. Weaker external profile due to a high share of dollar-denominated debt exposures has continued to increase the uncertainty over access to official creditors resulting in inadequate foreign currency inflows. The situation has forced the government to shift its risk sentiment into more short-term higher risk SWAP deals.
- ❑ **Weaker conditions may lead to downgrade:** Funding from multilateral/bilateral partners may not be sufficient to cover external financing needs over the next 12 months. As of May 2021, foreign reserves not enough to cover maturities over the next 12 months, it would bring down to a dangerously low-level impairing debt servicing ability. Monitoring the environment, Moody's on 19th Jul placed Sri Lanka's "Caa1" foreign currency long-term issuer and senior unsecured debt ratings under review for downgrade.

Increased budget deficit and uncertainty in all other indicators (Foreign Reserves, Inflation and exchange rate) may significantly deteriorate macro economic conditions and increase pressure on interest rates. We expect Gov. Sec. yield curve to move towards our upper bands towards the end of the year. The uptrend would be gradual considering the continued quantitative easing strategy.

Yield Curve Recommendation



Tenure			Current Yield	Recommendation
< 91 Days	< 3M	Short	5.10%	Sell
< 182 Days	< 6M	Short	5.20%	Sell
< 364 Days	< 1Y	Short	5.40%	Sell
15-Jul-23	< 2Y	Short	6.15%	Sell
15-Sep-24	< 3Y	Short	6.70%	Sell
01-May-25	< 4Y	Mid	7.10%	Sell
15-Feb-26	< 5Y	Mid	7.50%	Sell
15-Aug-27	< 6Y	Mid	7.75%	Sell
01-Jul-28	< 7Y	Mid	8.05%	Sell
01-May-29	< 8Y	Mid	8.25%	Hold
15-Mar-31	< 10Y	Long	8.35%	Hold
15-Jan-33	< 12Y	Long	8.50%	Hold
15-Mar-35	< 15Y	Long	8.65%	Hold
01-Jan-41	< 20Y	Long	8.88%	Hold

Source: First Capital Research

Disclaimer

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Thank You

"Successful Investment Is About Managing Risk..."