



First Capital

# *“YIELDS UPSURGE AS BONDS GIRD FOR TAPER CLUES”*

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First Capital Fixed Income Recommendation – 09<sup>th</sup> Nov 2021

**FIRST CAPITAL RESEARCH**

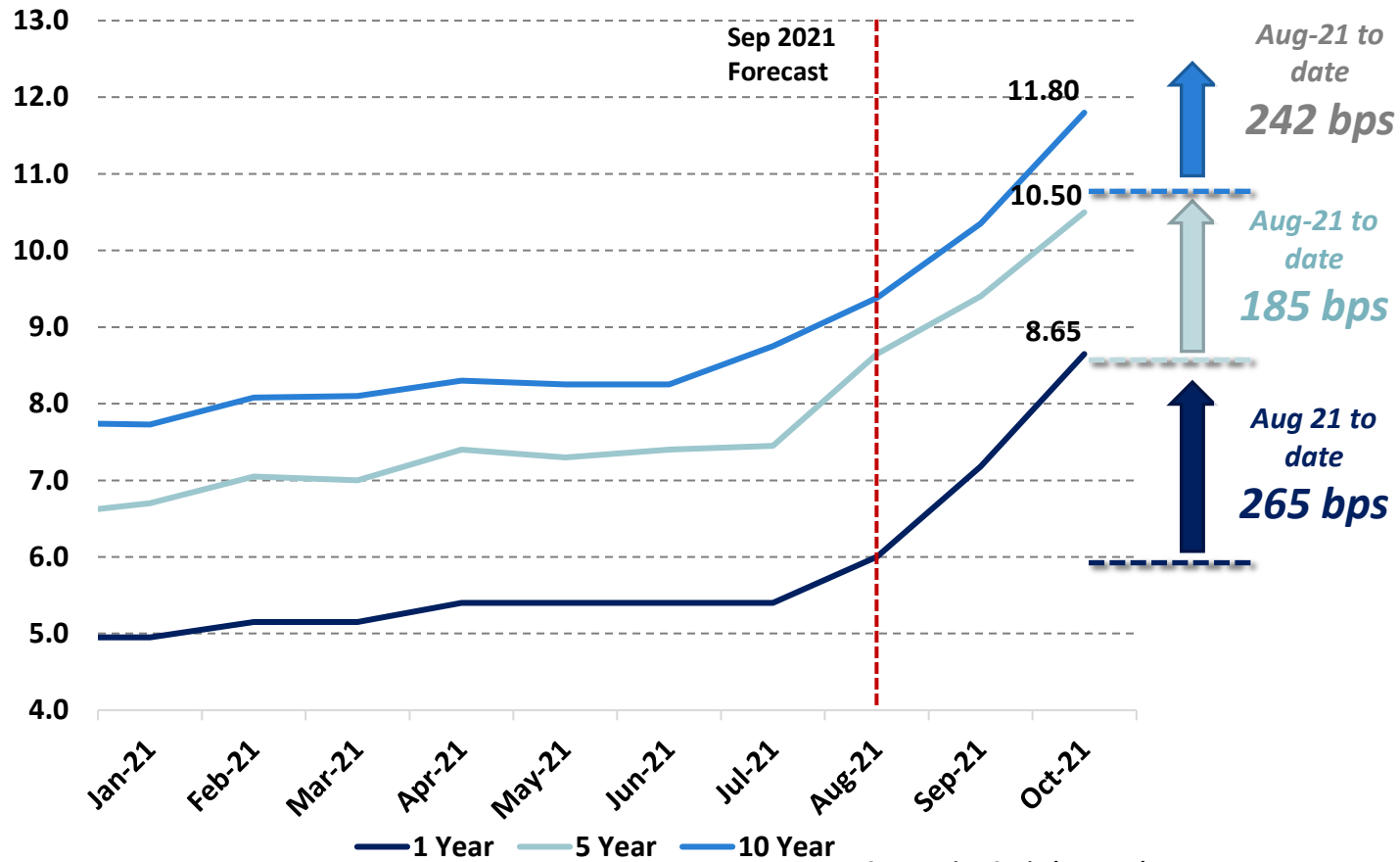
**Analysts: Hiruni Perera  
Dimantha Mathew**

# 1.0 Previous Recommendation

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# 31<sup>st</sup> Aug 2021 – 31<sup>st</sup> Oct 2021 (2 months)

## Bond Market spikes 200-250bps



Source: First Capital Research

### Previous Recommendations

**28<sup>th</sup> Jul 2021**

“Warning of upward lurch in yields”

**Accurate**

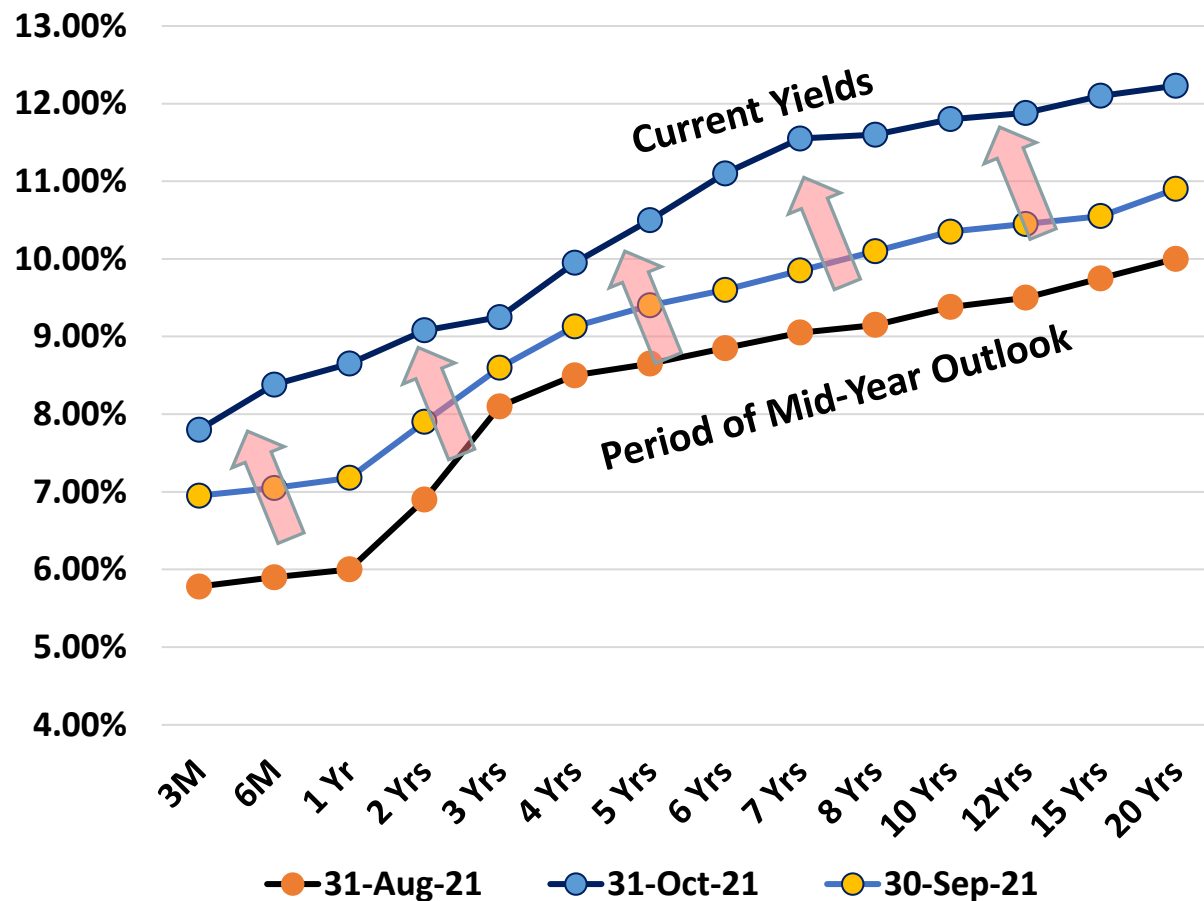
**08<sup>th</sup> Sep 2021 [Strategy Report]**

“Bond Yields to rise sharply by a further 150-200bps within the period 3Q2021 – 2Q2022”

**Partly Accurate**

Speed of rise in yields was **even sharper than our expectations**

# Overall Yield Curve Movement



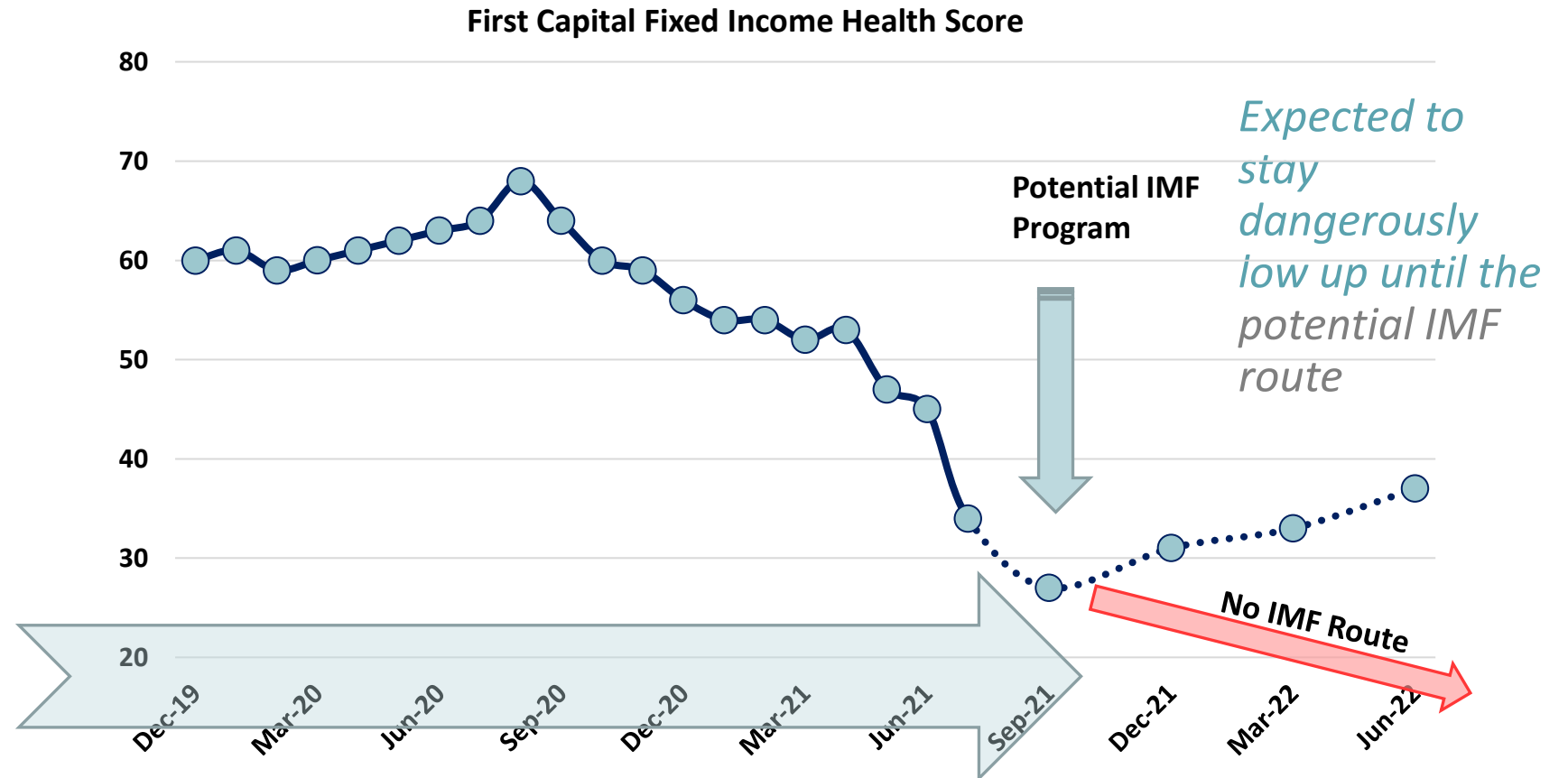
| Interest Rate Change (bps) |           |           |              |           |              |
|----------------------------|-----------|-----------|--------------|-----------|--------------|
| Tenure                     | 31-Oct-21 | 30-Sep-21 | Change (bps) | 31-Aug-21 | Change (bps) |
| 3M                         | 7.80%     | 6.95%     | 85           | 5.78%     | 202          |
| 6M                         | 8.38%     | 7.05%     | 133          | 5.90%     | 248          |
| 1 Yr                       | 8.65%     | 7.18%     | 147          | 6.00%     | 265          |
| 2 Yrs                      | 9.08%     | 7.90%     | 118          | 6.90%     | 218          |
| 3 Yrs                      | 9.25%     | 8.60%     | 65           | 8.10%     | 115          |
| 4 Yrs                      | 9.95%     | 9.13%     | 82           | 8.50%     | 145          |
| 5 Yrs                      | 10.50%    | 9.40%     | 110          | 8.65%     | 185          |
| 6 Yrs                      | 11.10%    | 9.60%     | 150          | 8.85%     | 225          |
| 7 Yrs                      | 11.55%    | 9.85%     | 170          | 9.05%     | 250          |
| 8 Yrs                      | 11.60%    | 10.10%    | 150          | 9.15%     | 245          |
| 10 Yrs                     | 11.80%    | 10.35%    | 145          | 9.38%     | 242          |
| 12Yrs                      | 11.88%    | 10.45%    | 143          | 9.50%     | 238          |
| 15 Yrs                     | 12.10%    | 10.55%    | 155          | 9.75%     | 235          |
| 20 Yrs                     | 12.23%    | 10.90%    | 133          | 10.00%    | 223          |

# Recap: Mid-Year Outlook – Sep 2021

## Fixed Income Health Expectations

### RISE IN BOND YIELDS JUSTIFIED

In line with the comments of the CBSL Governor it is clear that Sri Lanka is currently adopting the **NO IMF ROUTE** justifying the acceleration of the rise in bond yields



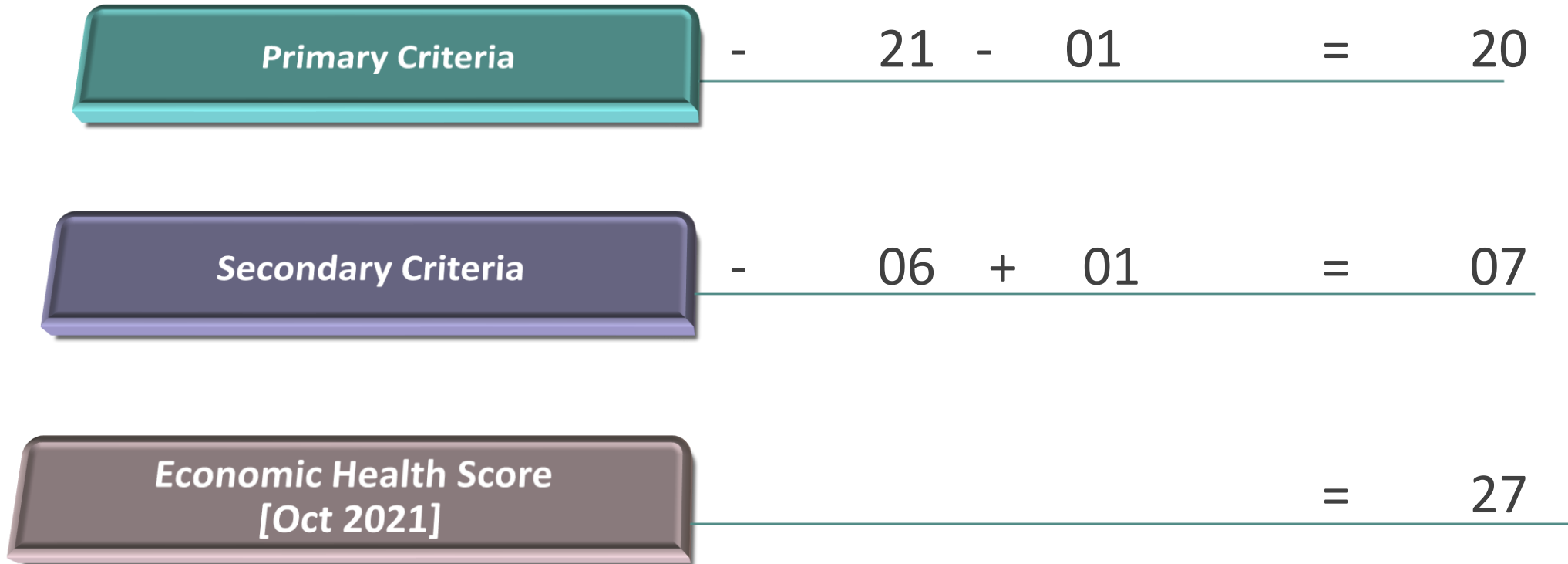


# 2.0 Fixed Income Health Score

As at Oct 2021

# FI Economic Health Score – Oct 2021

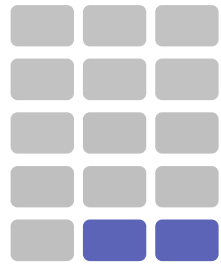
*Primary indicators on a downtrend while secondary criteria holds steady.....*



[As against 27 in Sep 2021 & 60 in Oct 2020 (1 Year ago)]

Source: First Capital Research

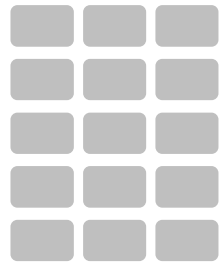
# Changes to Health Score – Primary Criteria



02/15

### Foreign Reserves

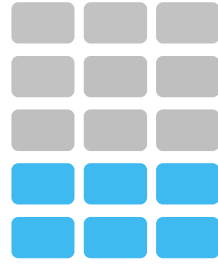
Foreign reserves recorded at USD 2.6Bn for Sep 2021 and further deteriorated to USD 2.3Bn in Oct 2021.



00/15

### Liquidity

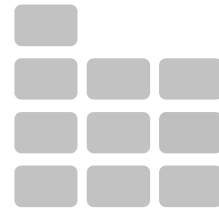
Liquidity level was highly volatile and recorded above LKR -100.0Bn towards the latter half of the month and closed at LKR -142.85Bn.



06/15

### Inflation

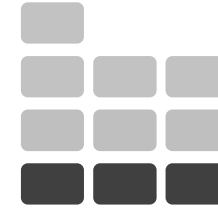
CCPI increased to 7.6% in Oct 2021, exceeding the CBSL's and FC Research's targeted range of 4%-6% and 5%-7% respectively.



00/10

### Foreign Activity

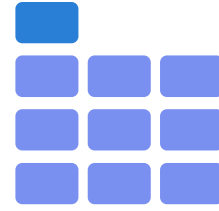
Foreign Investment in Govt. securities remains below LKR 5.0Bn.



03/10

### Credit

Private sector credit recorded a moderate increase of LKR 29.1Bn for the month of Sep 2021.



10/10

### CBSL Holdings

CBSL holdings remained above LKR 1400.0Bn.



02/15

00/15

04/15

00/10

04/10

10/10

-2

+1



# Changes to Health Score – Secondary Criteria



New Score

Current Score



00/05

### Rating Outlook

S&P has placed Sri Lanka as Negative outlook while Moody's downgraded Sri Lanka's debt rating to 'Caa2' from 'Caa1' in Oct 2021.

00/05



00/05

### External Environment

Foreign exchange market remains volatile, USD/LKR has depreciated by 8.9% till end of Oct 2021.

00/05

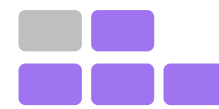


00/05

### BOT & BOP

Trade deficit recorded at USD 586.0Mn in Aug 2021 with deficit expanding significantly on a YoY basis.

00/05



04/05

### Political Risk

Political stability is maintained.

04/05



02/05

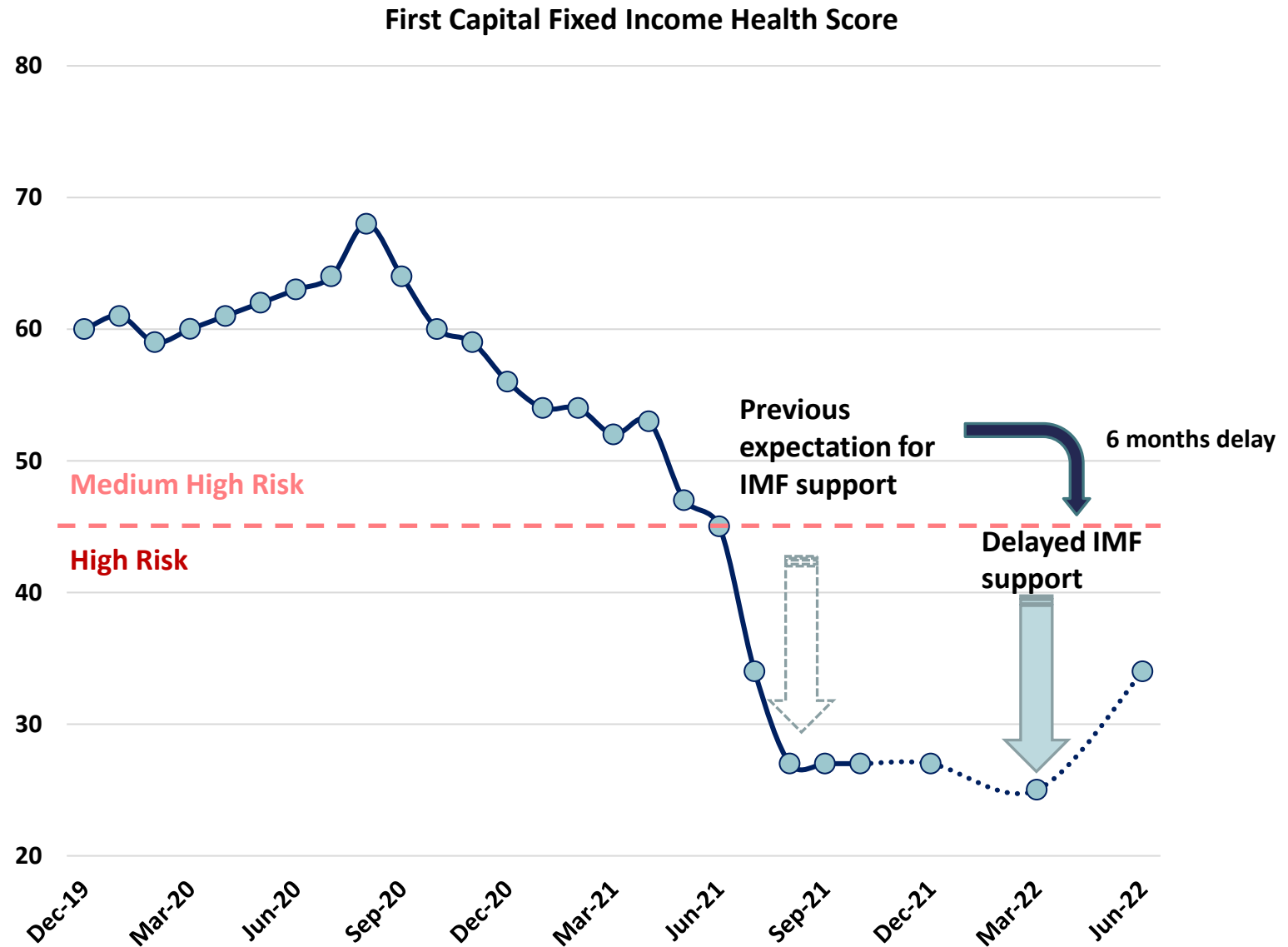
### Investor Confidence

The BCI recorded an increase of 07 points to 111 in Oct –6 points up than the 12M-average for the 1st time since Apr.



03/05

FI Health score further deteriorates as IMF support is delayed

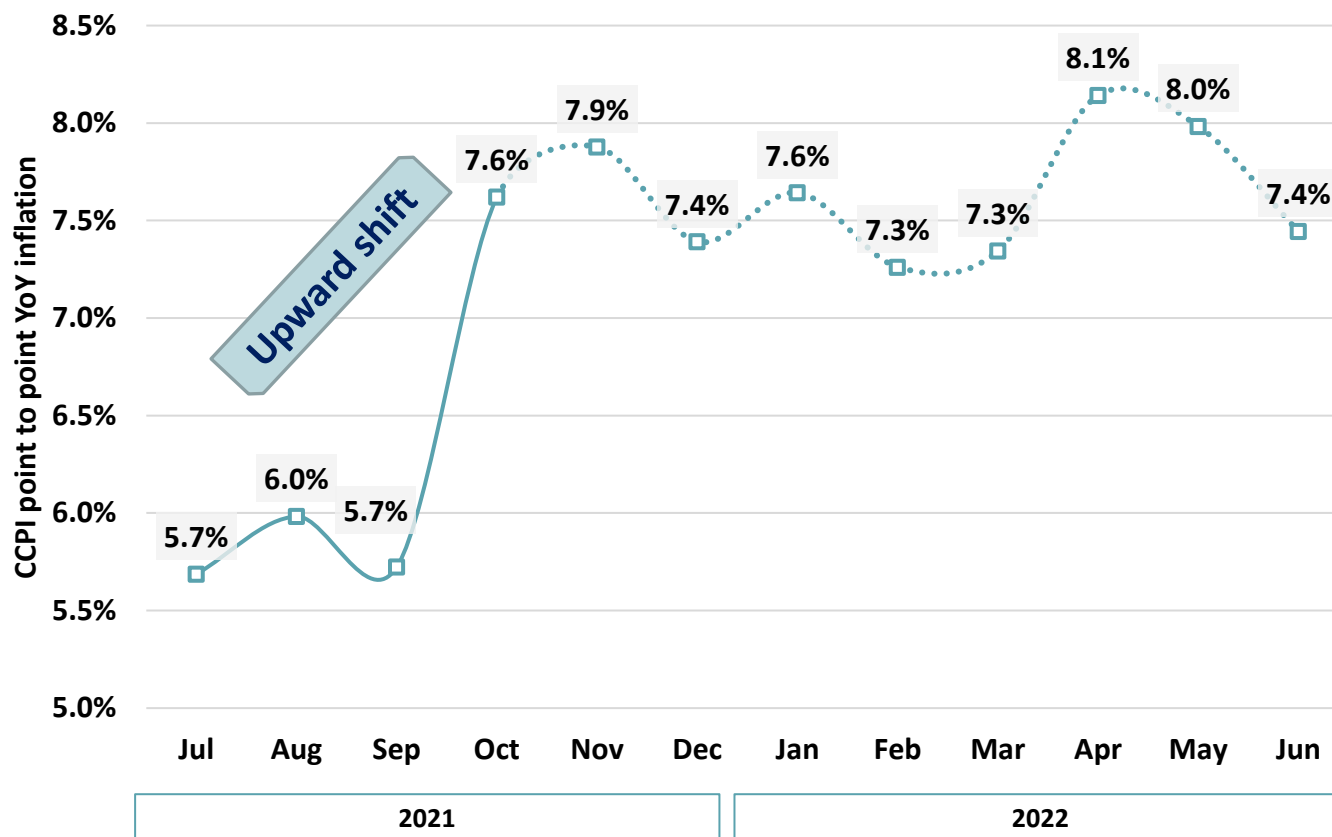


## 3.0 Weakening Outlook

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# Massive pressure on inflation

## *...but primarily led by Cost Push Inflation*



Source: First Capital Research, Dept. Census and Statistics

### Cement

Cement prices increased by LKR 93.0 initially and by LKR 177.0 to LKR 1,275 recently.

### Gas

Price of Litro gas 12.5kg increased by LKR 1,257 to LKR 2,750.



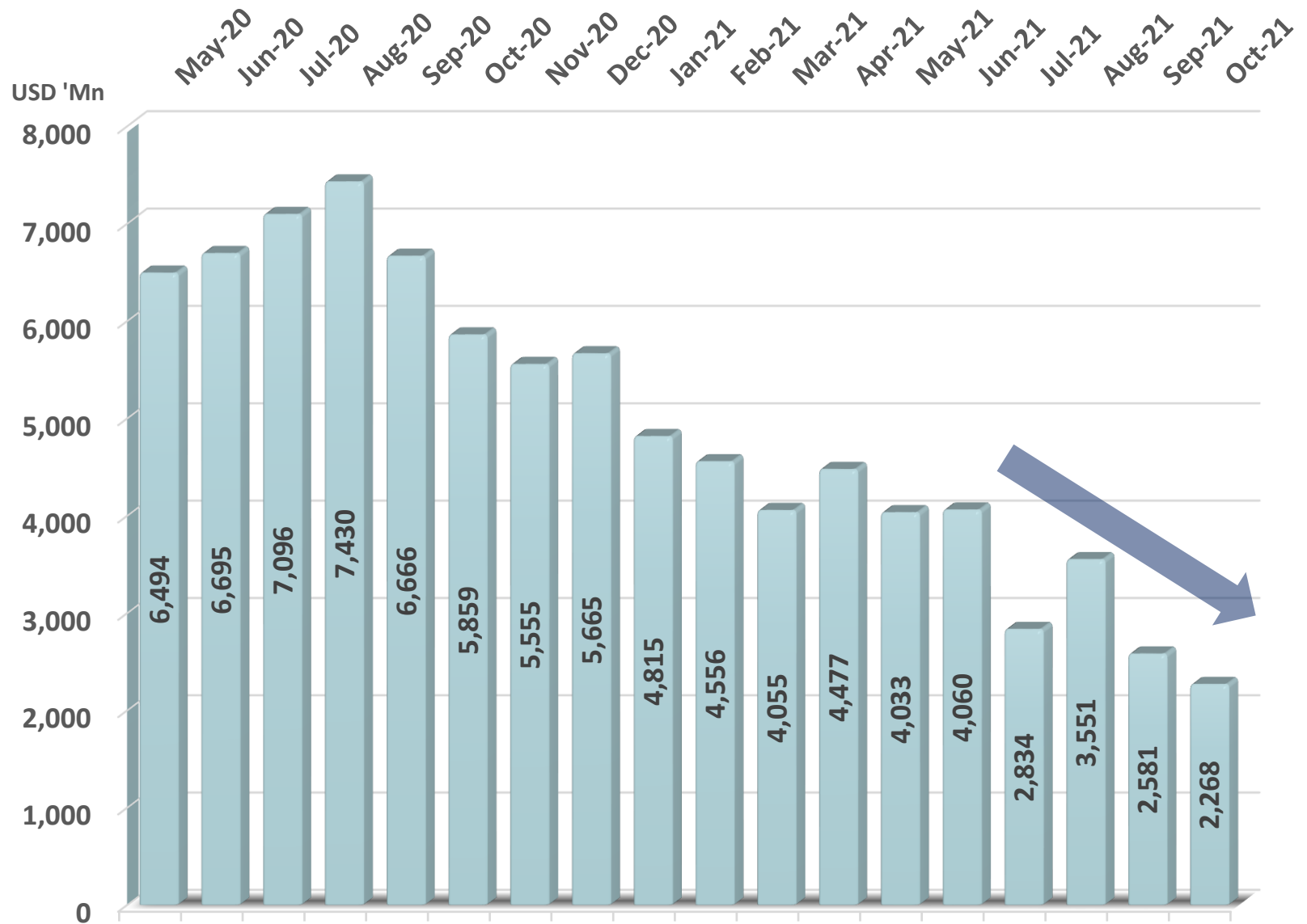
### Wheat

Price of a 1Kg of wheat flour has gone up to LKR 97 by LKR 10.0.

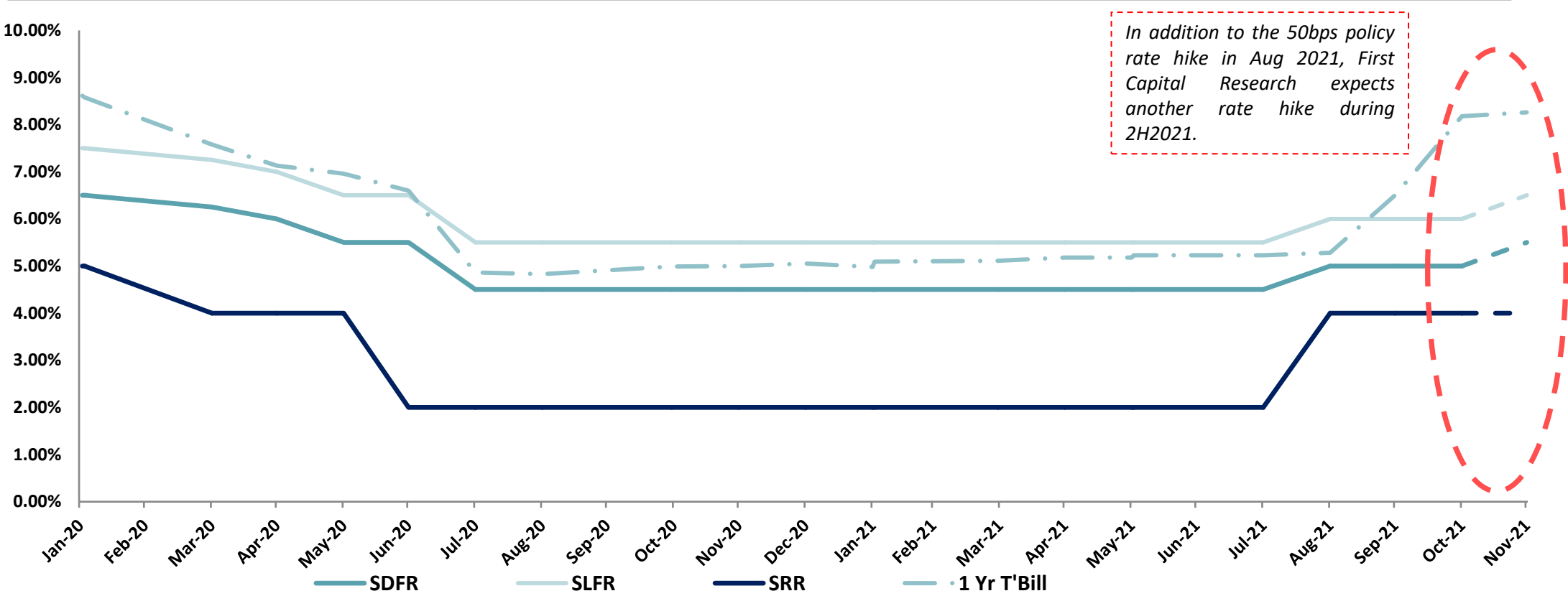
### Milk Powder

1 kg packet of milk powder will be released to the market at LKR 1,195.

Sri Lanka's gross official reserves amounted to USD 2.3Bn (excluding the swap facility signed with the People's Bank of China of RMB 10 Bn equivalent to US\$ 1.5 Bn) with an import cover of 1.4 months, in Oct 2021.

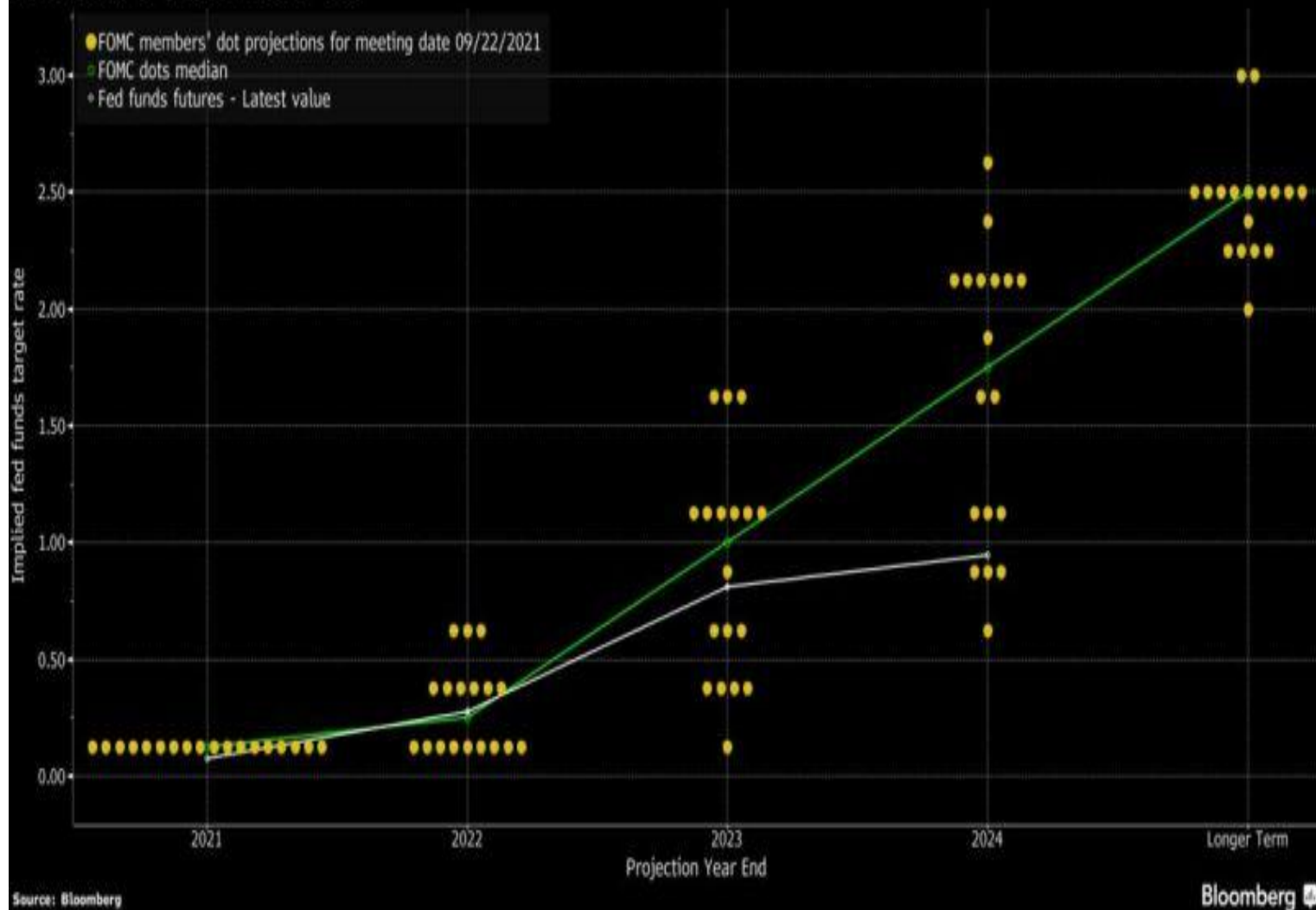


# CBSL raises policy rates in Aug-21 nearly after three years



Source: CBSL

## The Fed's New Dot Plot



## Fed holds rates steady but tapering of bond buying to expect soon

The Federal Reserve on 22<sup>nd</sup> Sep held benchmark interest rates near zero for the 12th straight session but indicated that rate hikes could be coming sooner than expected.

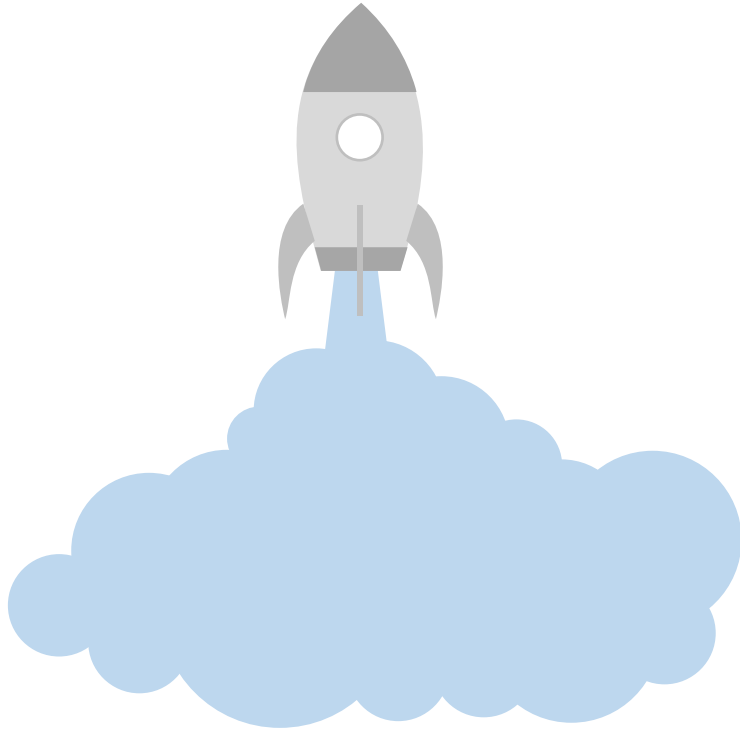
Along with those largely expected moves, officials on the policymaking Federal Open Market Committee indicated they will start pulling back on some of the stimulus the central bank has been providing during the financial crisis. There was no specific indication, though, as to when that might happen.

If progress continues broadly as expected, the Committee judges that moderation in the pace of asset purchases may soon be warranted.

# 4.0 New Recommendation

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# Broader view: Bond yields to extend the surge

*“Sri Lanka's foreign reserves recorded at USD 2.3Bn in Oct 2021 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 2H2021E. Accordingly, we maintain our forecast that 1 more rate hike is possible in 2H2021.*

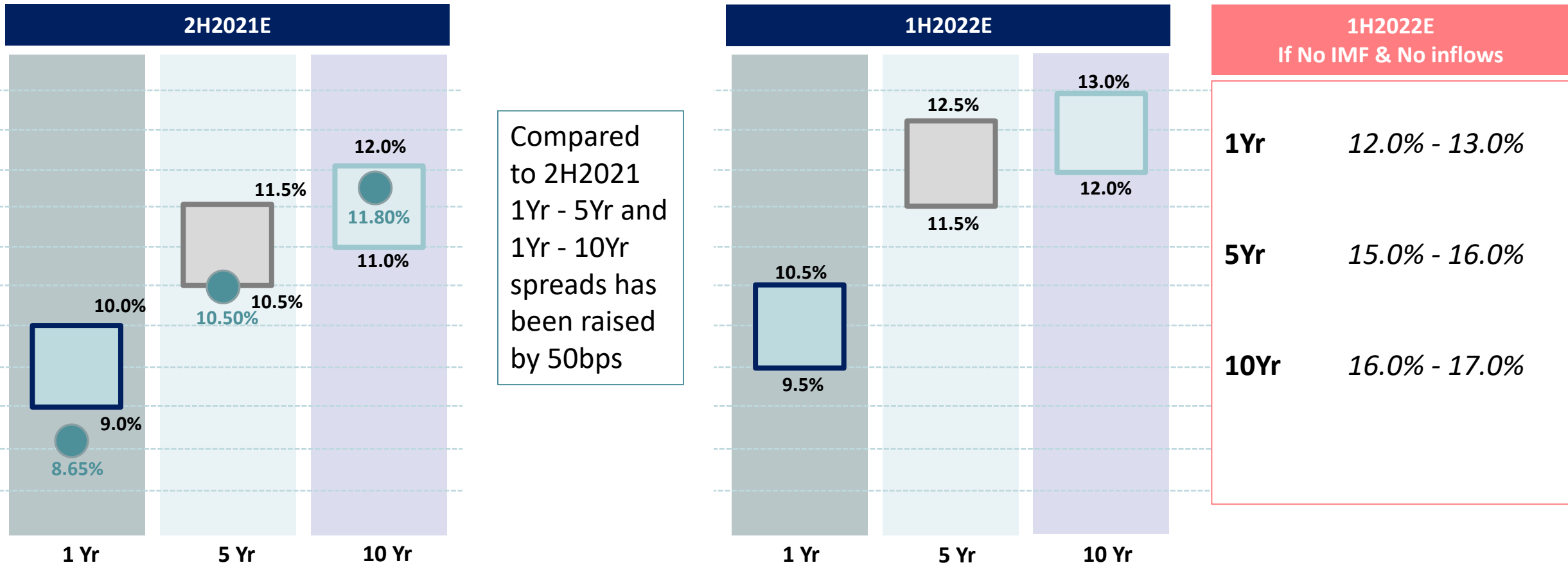
*The severely poor economic indicators in 1H2022 may push the Monetary Board to tighten monetary policy even more and as a result, we anticipate two further rate rises in 1H2022.*

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

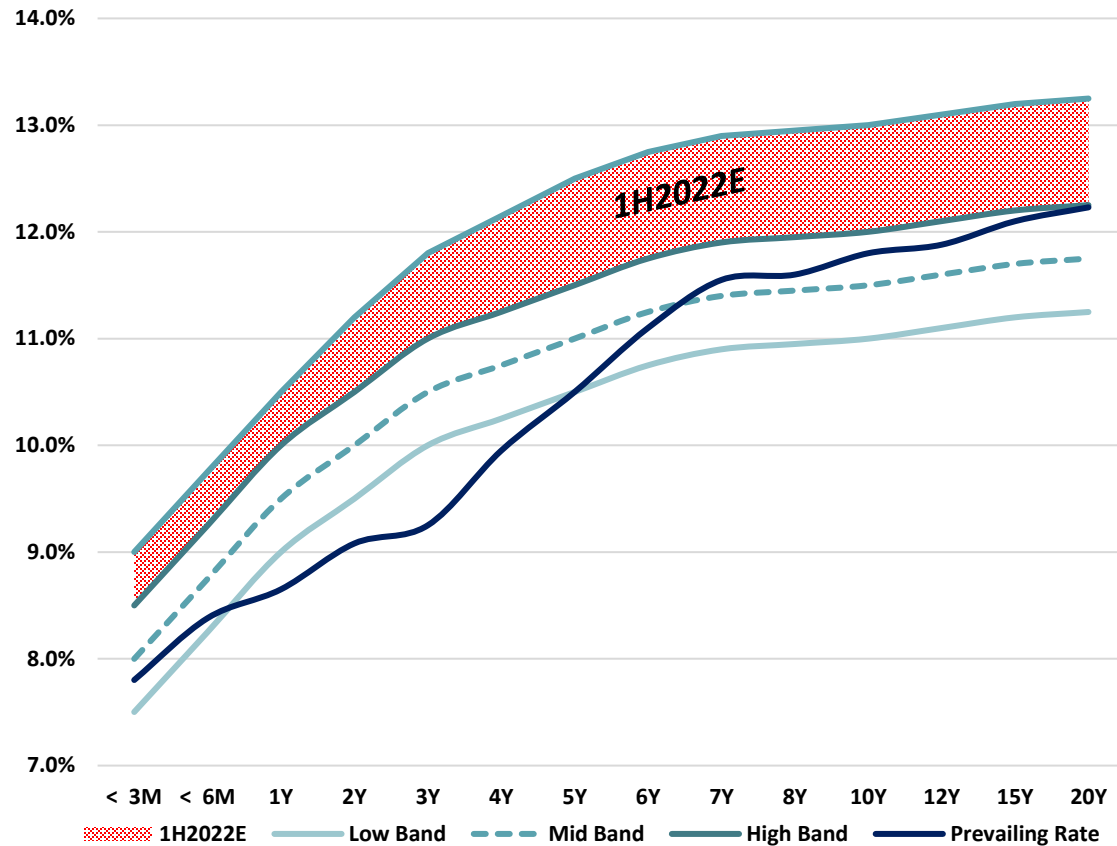
# Introducing Bond Yield Expectations

...with the assumption of some IMF support at least beyond 1Q2022

Bond Yield band expectations **advanced by 12 months** in the current no IMF environment...



# Yield Curve Recommendation



| Tenure     |      |       | Current Yield | Recommendation |
|------------|------|-------|---------------|----------------|
| < 91 Days  | < 3M | Short | 7.80%         | <b>SELL</b>    |
| < 182 Days | < 6M | Short | 8.38%         | <b>SELL</b>    |
| < 364 Days | 1Y   | Short | 8.65%         | <b>SELL</b>    |
| 15-Nov-23  | 2Y   | Short | 9.08%         | <b>SELL</b>    |
| 01-Dec-24  | 3Y   | Short | 9.25%         | <b>SELL</b>    |
| 15-Oct-25  | 4Y   | Mid   | 9.95%         | <b>SELL</b>    |
| 01-Aug-26  | 5Y   | Mid   | 10.50%        | <b>SELL</b>    |
| 15-Aug-27  | 6Y   | Mid   | 11.10%        | <b>SELL</b>    |
| 01-Sep-28  | 7Y   | Mid   | 11.55%        | <b>SELL</b>    |
| 01-May-29  | 8Y   | Mid   | 11.60%        | <b>SELL</b>    |
| 15-Mar-31  | 10Y  | Long  | 11.80%        | <b>SELL</b>    |
| 15-Jan-33  | 12Y  | Long  | 11.88%        | <b>SELL</b>    |
| 15-Mar-35  | 15Y  | Long  | 12.10%        | <b>SELL</b>    |
| 01-Jan-41  | 20Y  | Long  | 12.23%        | <b>SELL</b>    |

Source: First Capital Research

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# THANK YOU

“Successful Investment Is About Managing Risk...”

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