



First Capital
A Janashakthi Group Company

Investment Strategy 2022

SRI LANKA

JAN 2022

Time is Running Out!

First Capital Research

Dimantha Mathew

+94 11 2639 853 | dimantha@firstcapital.lk

Hiruni Perera

+94 11 2639 864 | hiruni@firstcapital.lk



Time is running out!

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Time is Running Out!

Executive Summary

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2022 to be Bearish on Bonds

- Resulting from the uncertainty over access to creditors, continued high budget deficit and negative liquidity, 1H2022 bond yields are likely to rise by 150bps-200bps and in 2H a further 100bps-150bps upside is expected; But with no IMF or inflows, yields could just skyrocket. Altogether Bond Yields are expected to rise sharply by 250-350bps within the period 1Q2022 - 4Q2022.
- In 1H2022, the extremely weak economic indicators may force the Monetary Board to further tighten monetary policy. Thereby, we expect 2 rate hikes in 1H2022 while 1 rate hike was already announced in Jan-22. In 2H2022 we expect 1 more rate hike to take place to balance the overall economic outlook. Cumulatively, we expect 3 rate hikes for 2022.

Banking Rates (AWPR) to accelerate uptrend rising by 150-250bps by Jun-22 and 350-450bps (12months) by Dec-22

- In Jan 2022 policy rates have been increased again while a significant negative liquidity portion continues. Demand for private sector credit is also continuing at a similar pace. With the expect rise in bond yields, we expect AWPR to follow a similar suit with a similar accelerated pace as witnessed in 2H2021 to reach 10.0%-11.0% by Jun-22 and 11.0%-12.5% by Dec-22.

Exchange Rate target for 1H2022 downgraded to LKR 230.0-245.0 with 2022 Year End target at LKR 240.0-270.0

- Taking the weak macro situation into consideration, we expect a strong depreciation of the currency over the forecasted period. We further downgrade our Jun-22 target from LKR 225.0-240.0 to LKR 230-245.0 while targeting LKR 240.0-270.0 for the Dec-22.

ASPI to reach 15,000 in 1Q; Possible negative returns in 2H2022

- With strong Dec-21 earnings and negative real interest rates, we expect ASPI returns to be strong in the shorter term resulting in the ASPI potentially rising to the 15,000 mark within the 1Q2022. We believe that Sri Lanka could be in for a major shock within the next 3-12 months, thereby, our long-term view is to reduce risk by aggressively shifting to defensive counters while we expect possible negative return in the broader market in 2H2022.



| Track Record [Jan 2021 & Sep 2021]

Section 1.0

First Capital Levels of Accuracy

6

- 100% accuracy - Accurate
- 75% accuracy - Mostly Accurate
- 50% accuracy - Partly Accurate
- 25% accuracy - Weak Accuracy
- 0% accuracy - Inaccurate

Previous Recommendations - Bonds

7

25th Jan 2021 [Strategy Report]

“Bond Yields to gradually trend up from 1Q2021 onwards. Yield Curve may rise by 150-200bps and reach our upper bands of the yield curve”

Accurate

08th Sep 2021 [Mid-Year Outlook Report]

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

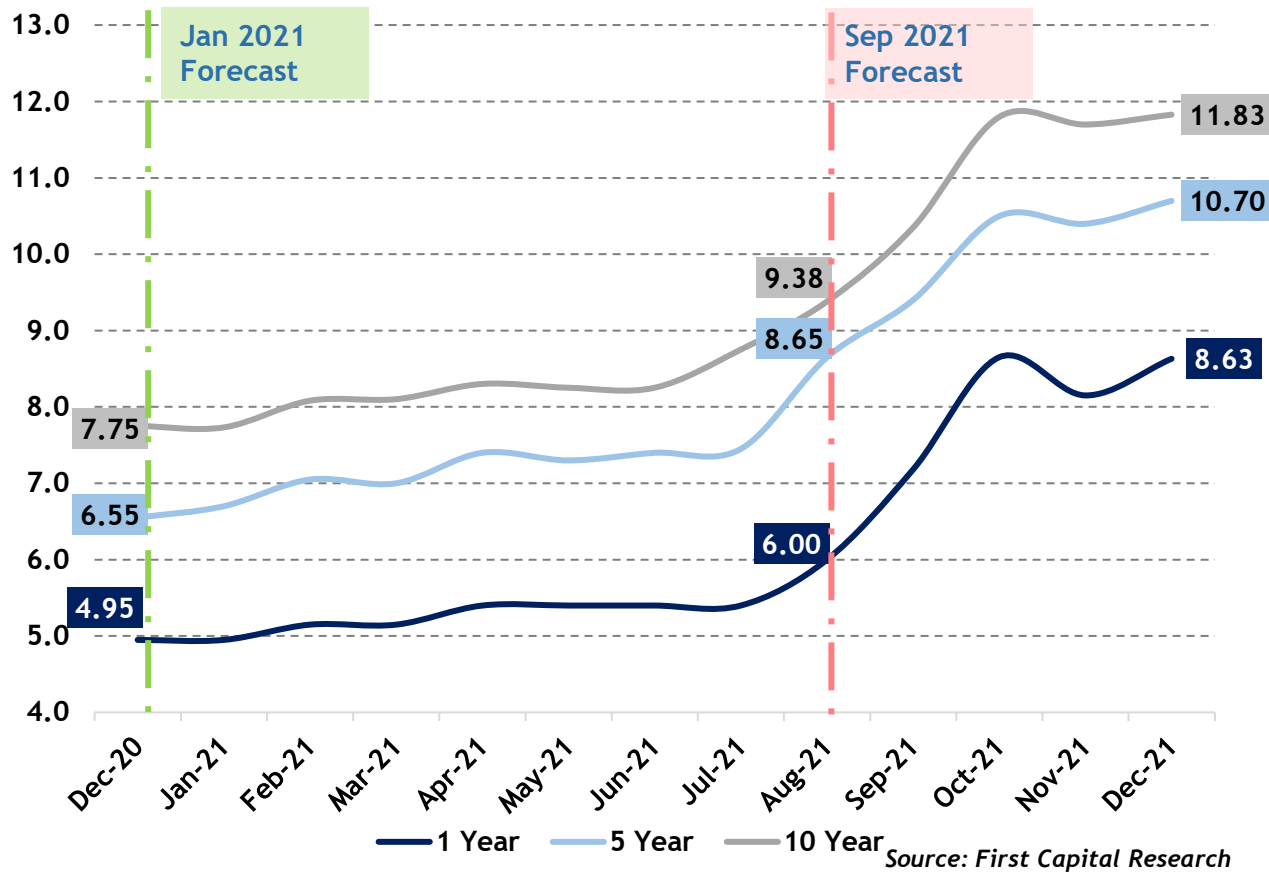
Mostly Accurate

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

Bonds - Jan-21 & Sep-21 Re cap: Mostly Accurate

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

8



YTD 208 bps ↑

YTD 220 bps ↑

YTD 105 bps ↑

8 Months 2021
Jan - Aug

YTD 245 bps ↑

YTD 205 bps ↑

YTD 245 bps ↑

4 Months 2021
Sep - Dec

Policy Rates - Jan & Sep 2021 Re cap: Mostly Accurate *“2 policy rate hikes in 2H2021”*

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

- Only 1 hike was given in 2H2021 - Monetary Board 18th Aug raised policy rates by 50bps and hiked SRR by 200bps

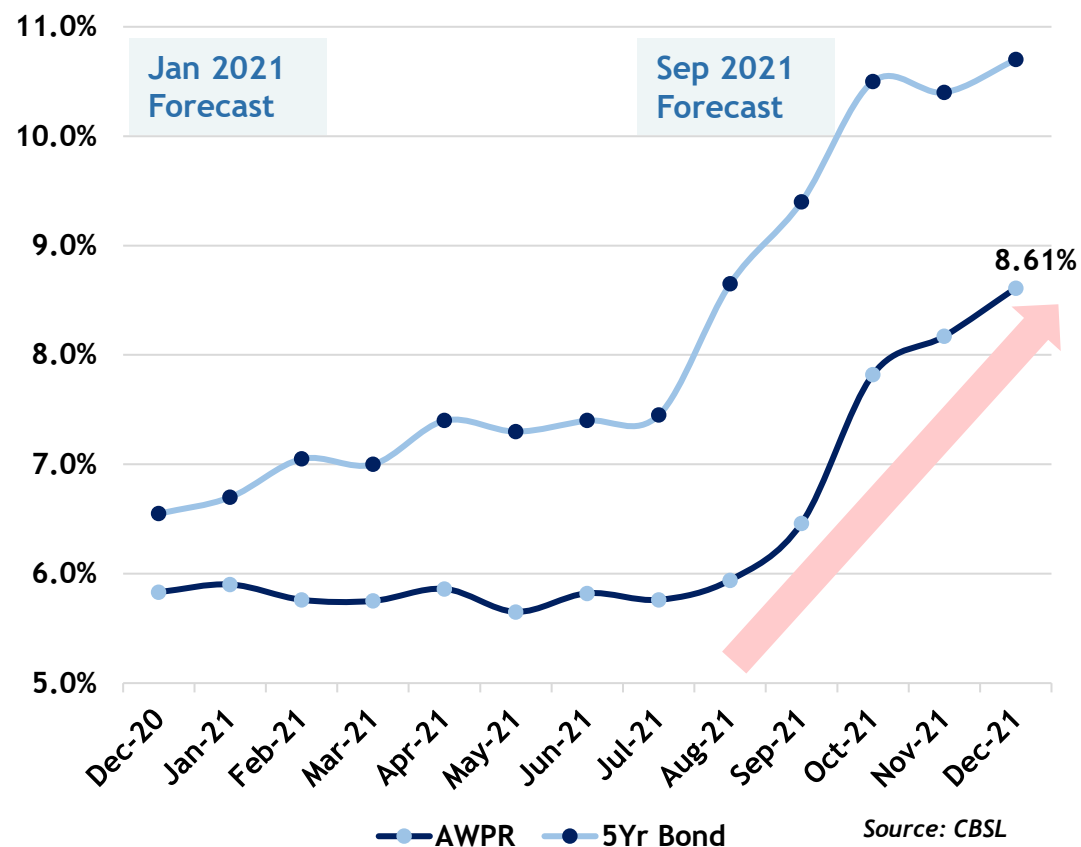
In 1H2022, the extremely weak economic indicators may force the Monetary Board to further tighten the monetary policy. Thereby, we expect a further 2 rate hikes in 1H2022 - Sep 2021

- 1 hike was already given in Jan 2022 - Monetary Board 19th Jan raised policy rates by 50bps

Jan, Apr Revision & Sep-20 AWPR Re cap: Mostly Accurate

Banking Rates (AWPR) to change course and shift upwards rising by at least 150bps (7.5%-9.0%) by Jun 2022

10



Previous Recommendations

Jan 2021 Expectation

AWPR to have bottom out around 6.5%-7.0% by Jun-21 and move towards 7.0%-8.0% by Dec-2021

Inaccurate

Sep 2021 Expectation

We expect AWPR to rise to a range of 6.0%-6.5% by Dec-2021 and further move towards 7.5%-9.0% by Jun-2022.

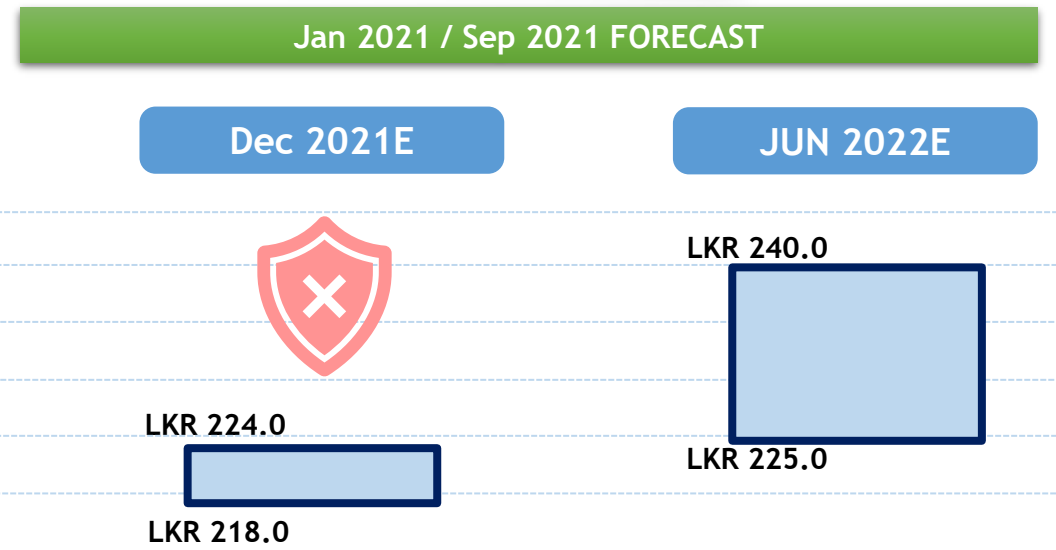
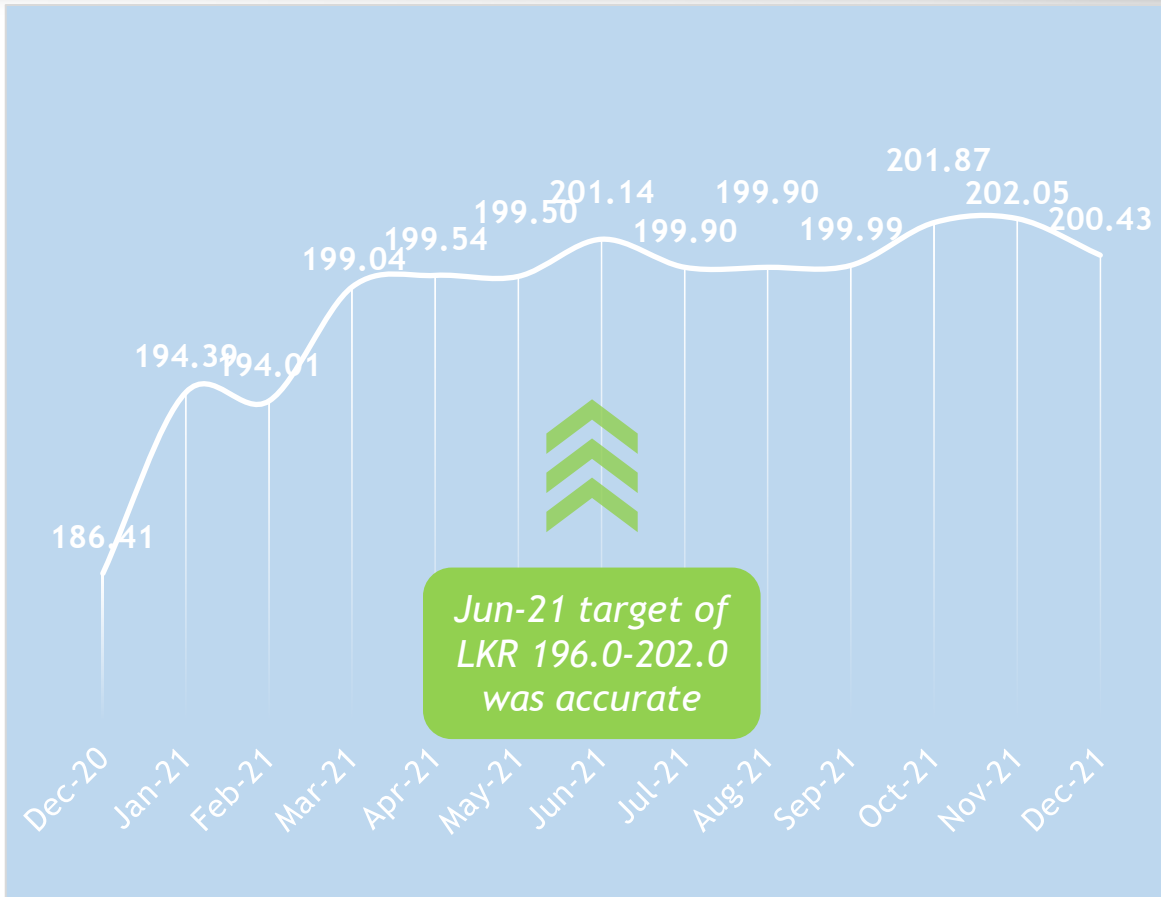
Mostly Accurate

Target Accurate but 6 months ahead with steep movement in bonds

Sep 2021 Ex-Rate Re cap: Inaccurate

Exchange rate target for Dec-2021 downgraded to LKR 218.0-224.0 and Jun-2022 target introduced at LKR 225.0-240.0

11

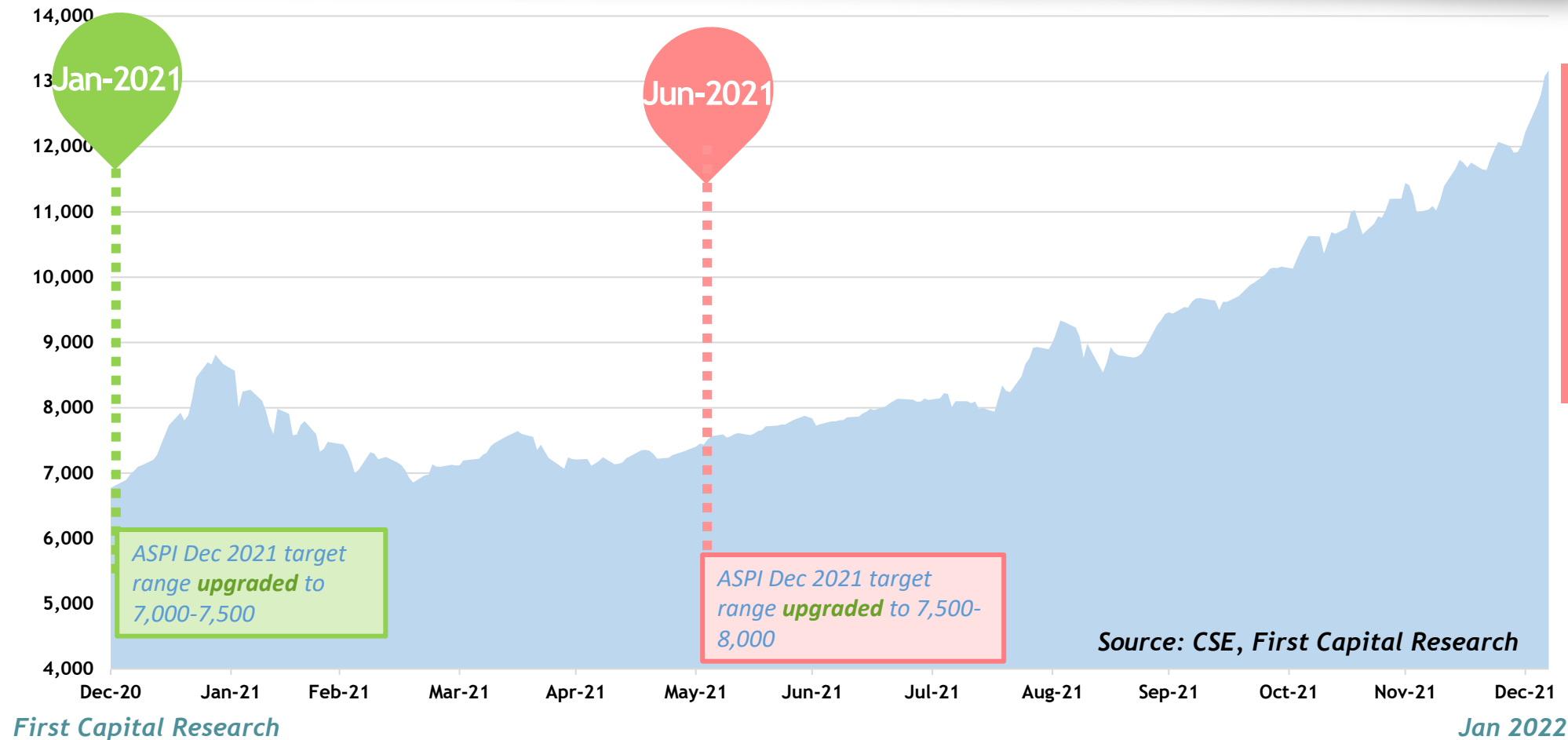


Sep 2021 - Dec 2021 CBSL controlled between LKR 197.0 - LKR 203.0 leading to a significant shortage of foreign currency for importers

Jan-21 & Sep-21 Equity Re cap: Weak Accuracy

ASPI initial (Jan) target for year was 7,000 - 7,500, upgraded in Jun-21 to 7,500-8,000

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Market moves significantly beyond our expectations continuing its bullrun reaching 13,000+ by Jan 2022



Factors to Consider for 2022 Outlook

Section 2.0

Time is running out!

Sri Lanka's foreign reserves are draining while debt has already piled up within short intervals. Even if the country manage to find funds to settle part of this year debt, more repayments are on the cards at an unbearable level.

Most probably this year 2022 we are likely to run out of time and reserves to repay. There is NO alternative to debt restructuring. We may need the support of IMF to get through this crisis.

Most important factor to REMEMBER is that for Sri Lanka now the **TIME IS RUNNING OUT!**



Factors to make decisions

Political Factors

- Deteriorating Political Stability

Economic Factors

- Low GDP Growth
- Low Foreign Reserves
- Liquidity Deficit
- Rising Inflation
- Debt Repayment

External Factors

- Ratings on Sri Lanka
- Ability to raise foreign borrowings
- Global fund flow for emerging markets



Policy Stability Deteriorates: **Medium-Low**

(Maintained)

Section 3.0

Economic woes to force in an election for 2022?

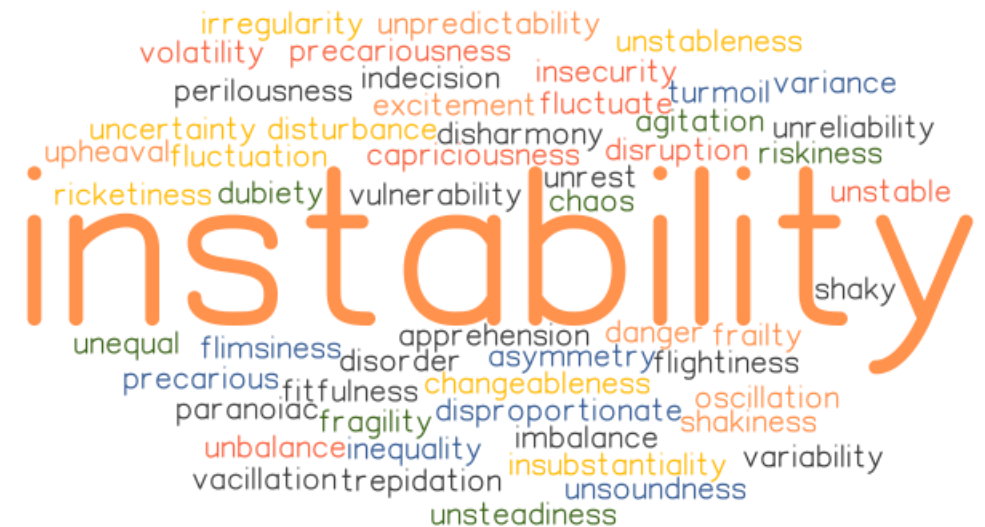
- ***Local Government Elections postponed to 2023 in line with report:*** As explain in our Mid-Year Outlook in Sep 2021 local govt elections which were to be held in Feb 2022 has been postponed to 19th Mar 2023 extending the local governments by 1 Year.
- ***Provincial Council Elections in 2022?*** With India taking an upper hand amid the economic struggle in Sri Lanka, India is currently supporting through credit lines and swaps. With it, India has managed to make progress in relation to the Trincomalee oil tanks, a deal stalled for over 30 years. Knowing India's preference, it is highly likely that India may push Provincial Council Elections in Sri Lanka. We expect SL may look at elections by 4Q2022.



Policy stability deteriorating

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- Appointment of a new Finance Minister or a Cabinet Reshuffle has not solved the popularity issue for the present Government.
- The decision-making process has significantly weakened within the Government with continuous issues arising.
- Critical issues that have created policy uncertainty during 1H2021 were the delay in importing vaccines, fertilizer ban, teacher salaries.
- More recent the gas explosions, fuel shortage, gas shortage, massive food inflation and looming power cuts have left the Government with no answers.
- The forex crisis would be the latest and the worst of the lot clearly illustrating the instability in the system.



Political Outlook: Maintained at
Medium Low Risk



Economy in a Major Struggle: ***High Risk***

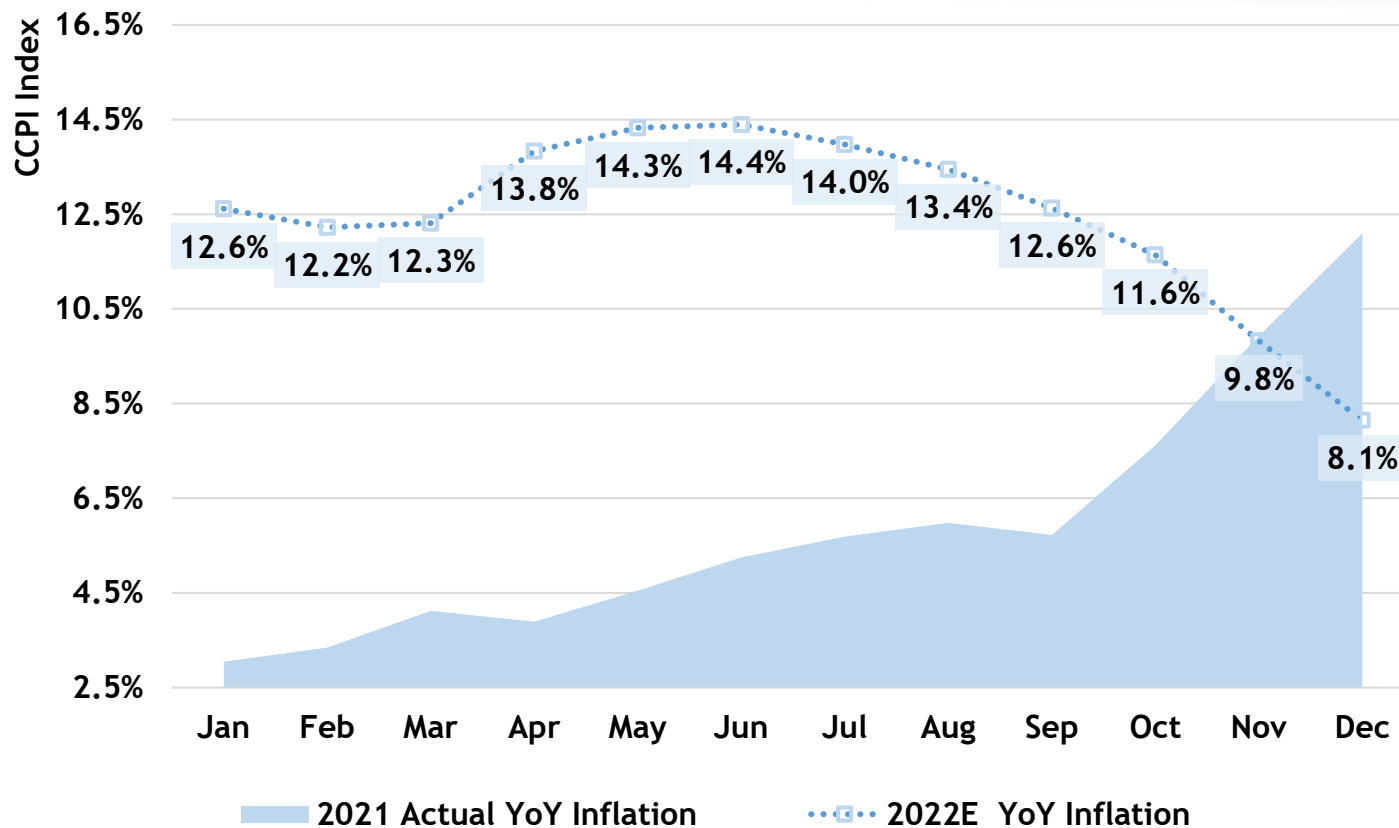
(Maintained)

Section 4.0

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

2022 inflation to peak at 14.4% and amid higher base effect

20



2021 Actual YoY Inflation

2022E YoY Inflation

Source: Dept. Census and Statistics

Cement

Cement prices with multiples hikes increased up to LKR 1,375 recently.

Gas

Price of Litro gas 12.5kg increased to LKR 2,675.

Wheat

Price of a 1Kg of wheat flour has gone up to LKR 132-140.

Milk Powder

1 kg packet of milk powder will be released to the market at LKR 1,345.

Jan 2022

...drastically slowing down GDP growth...

21

2021E

We expect 4Q2021 GDP growth to record a growth of 3.6% amidst the strong growth witnessed in the industrial segment led by manufacturing construction segments

4.0%

2022E

Inflation is likely to take a toll on GDP growth for 2022E with a continuous struggle throughout the year. A surge in interest rates and heavy depreciation are expected factors for 2022E

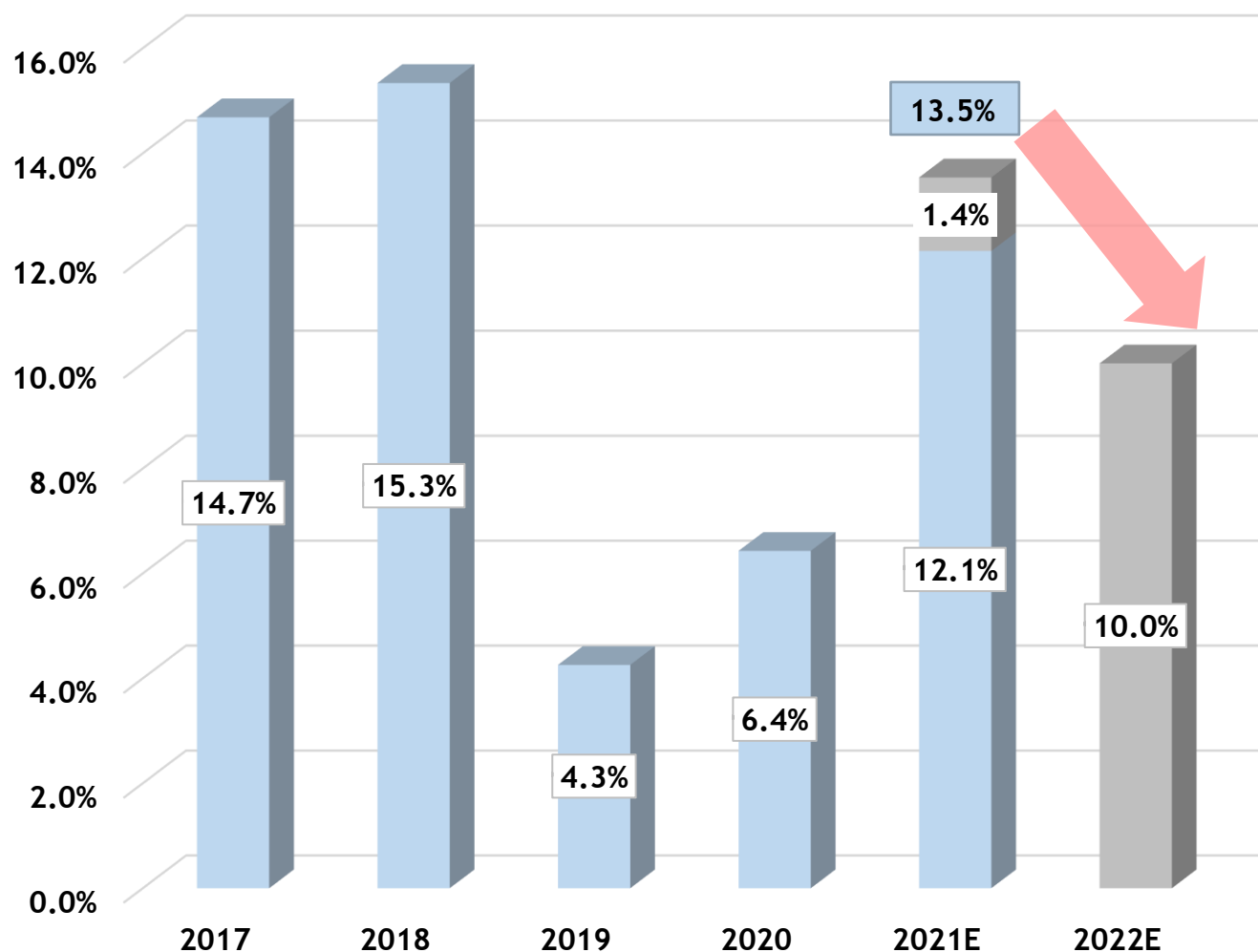
+0.5% - (-1.6%)

2023E

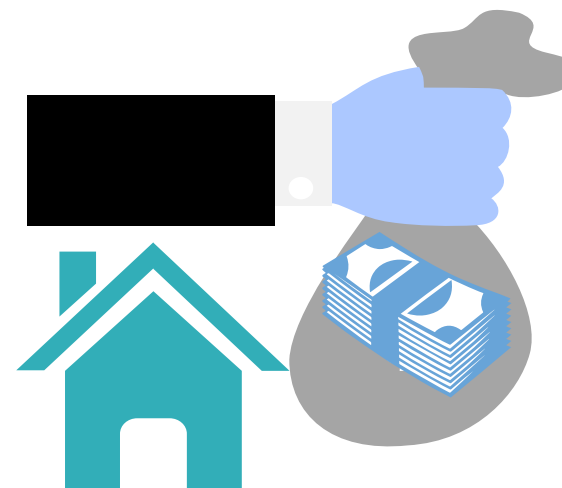
Sri Lanka is expected to start a very slow recovery process with the support of an IMF program or self-induced debt restructuring program

+2.0% - +2.5%

Private credit has recovered with historically low rates



Source: CBSL



...Credit also
may slowdown
slightly to 10%
for 2022E



Globally money printing halts...
...as inflation takes a steep upshift

23

“

But can Sri Lanka follow suit with no money printing?

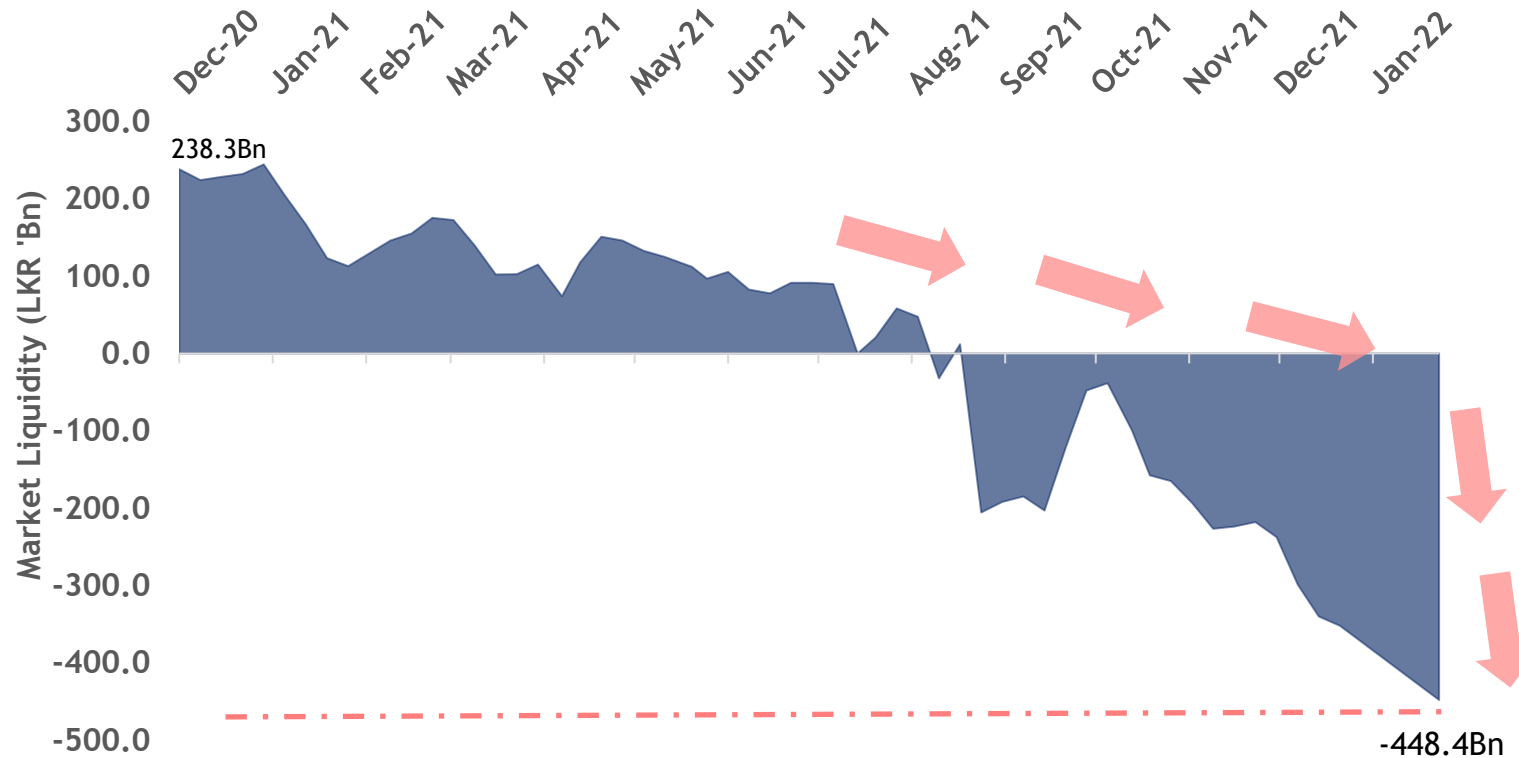
”

A daunting task!!!

24

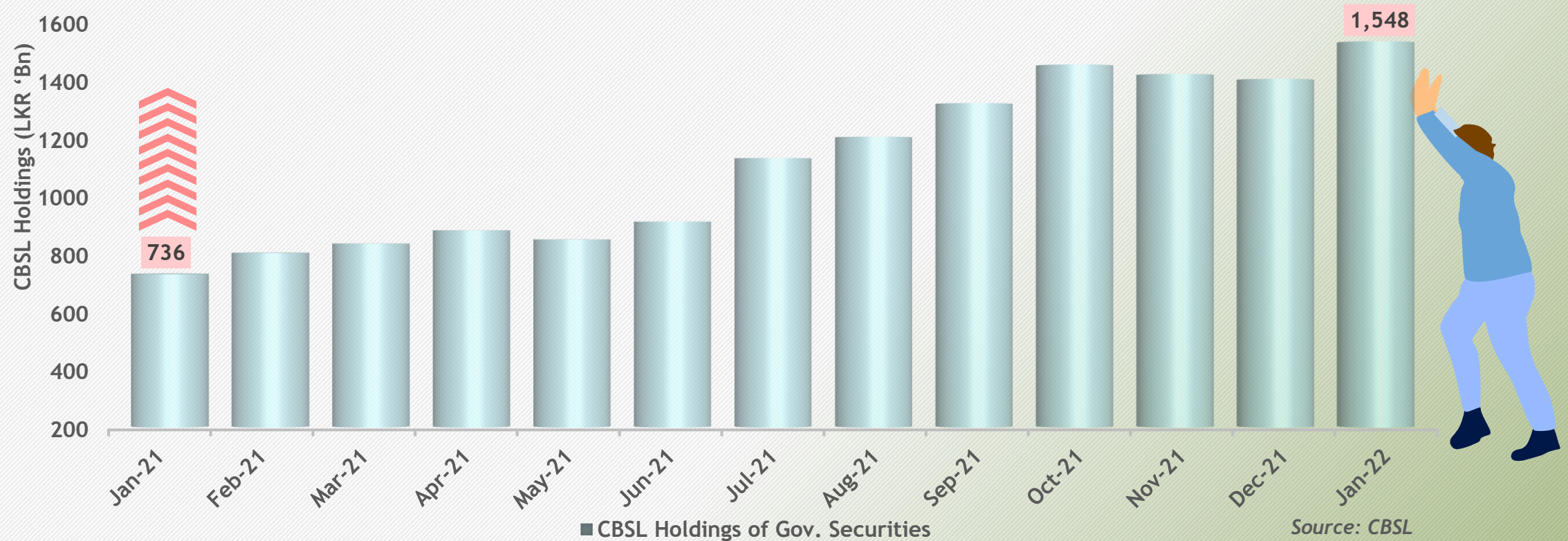
Sri Lanka's liquidity in the system has completely dried up...

25



Source: CBSL





...while CBSL Holdings of GS keep climbing as CBSL finds it difficult to borrow at current rates...

26

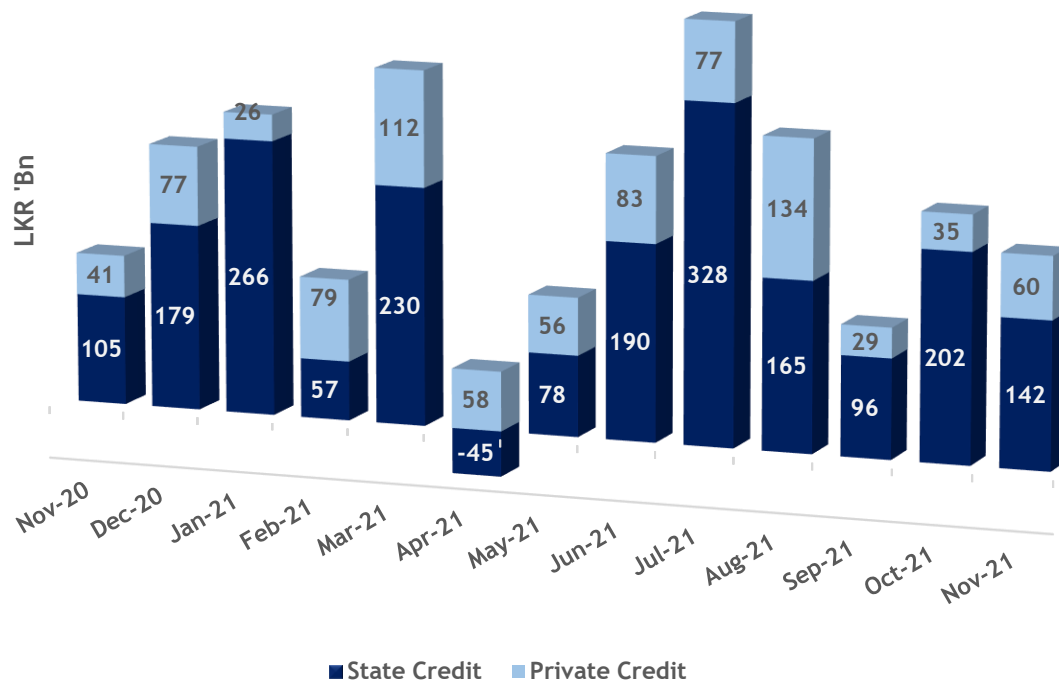
...But lower rates are attracting private sector credit growth in competition with Gov. Borrowings...



...AWPR takes a steep uptick

27

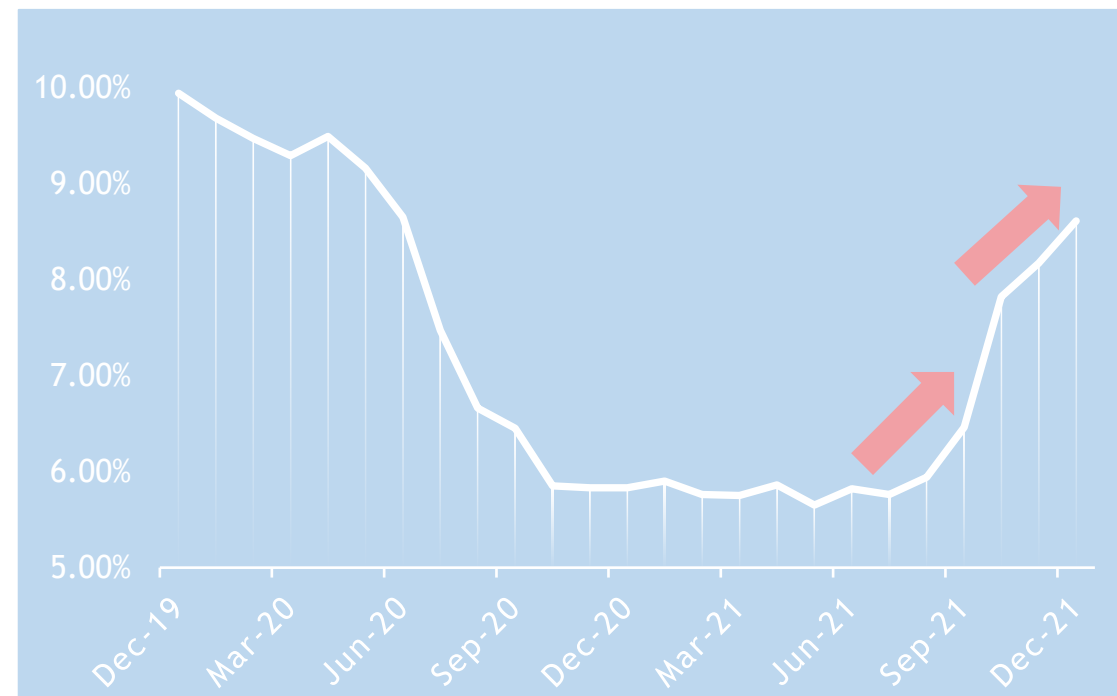
Private credit has recovered with historically low rates



Source: CBSL

First Capital Research

However AWPR has risen by nearly 80bps during 3Q2021 and 215bps in 4Q2021



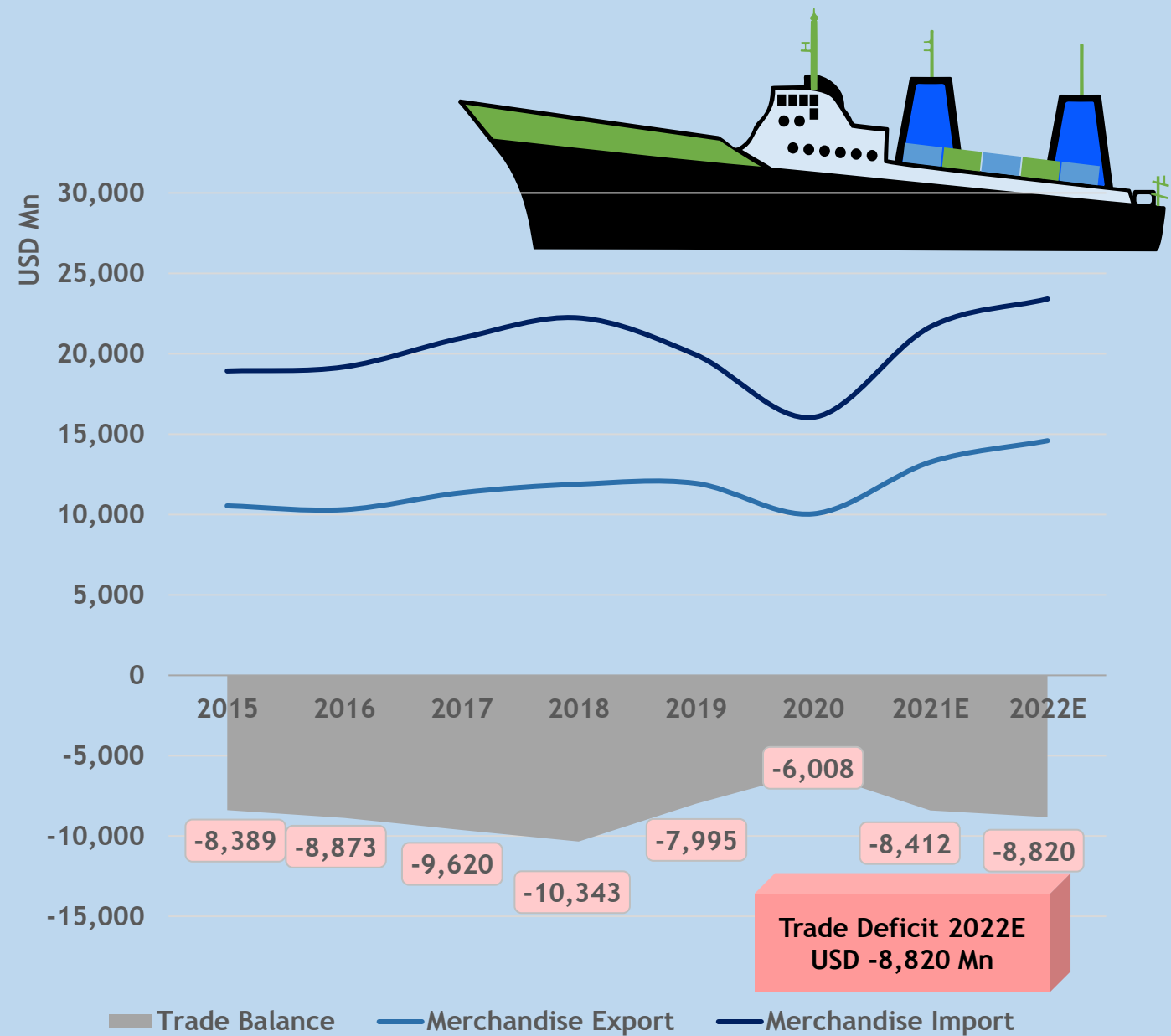
Source: CBSL

Jan 2022

Export-import activity
recovered strongly...

...we expect it to continue
during 2022E as well
provided CBSL supports with
a floated rupee...

Jan 2022



First Capital Research

Source: CBSL, First Capital Research Estimates

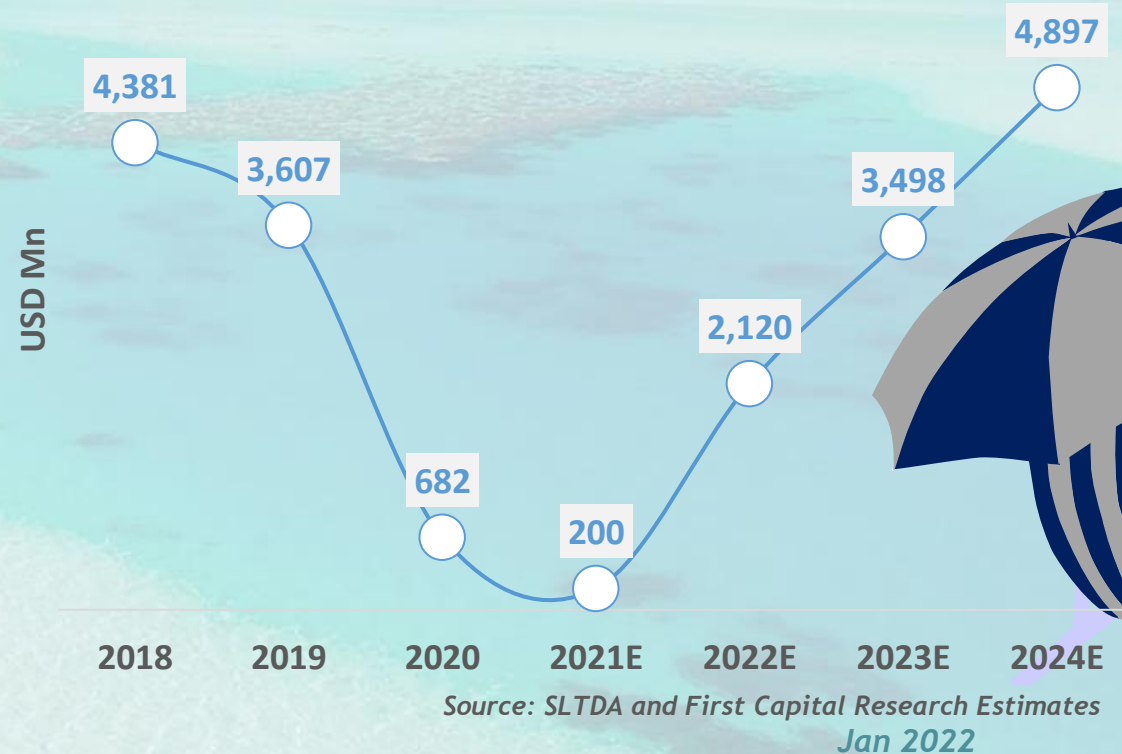
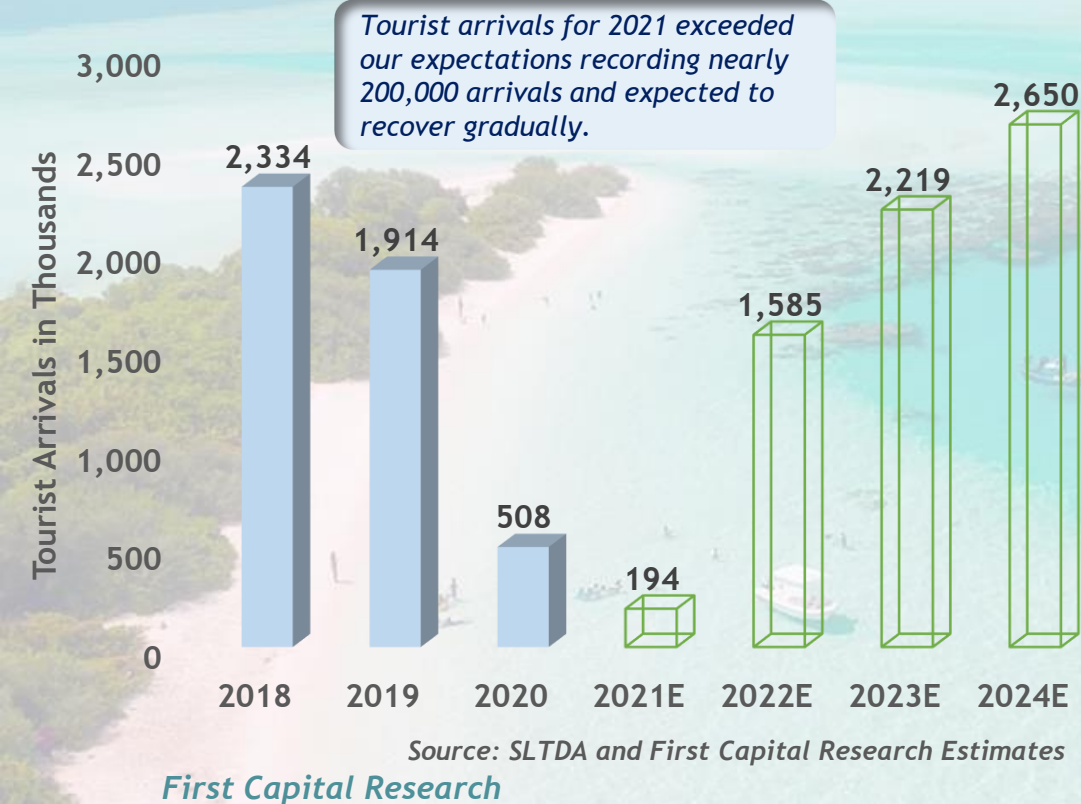


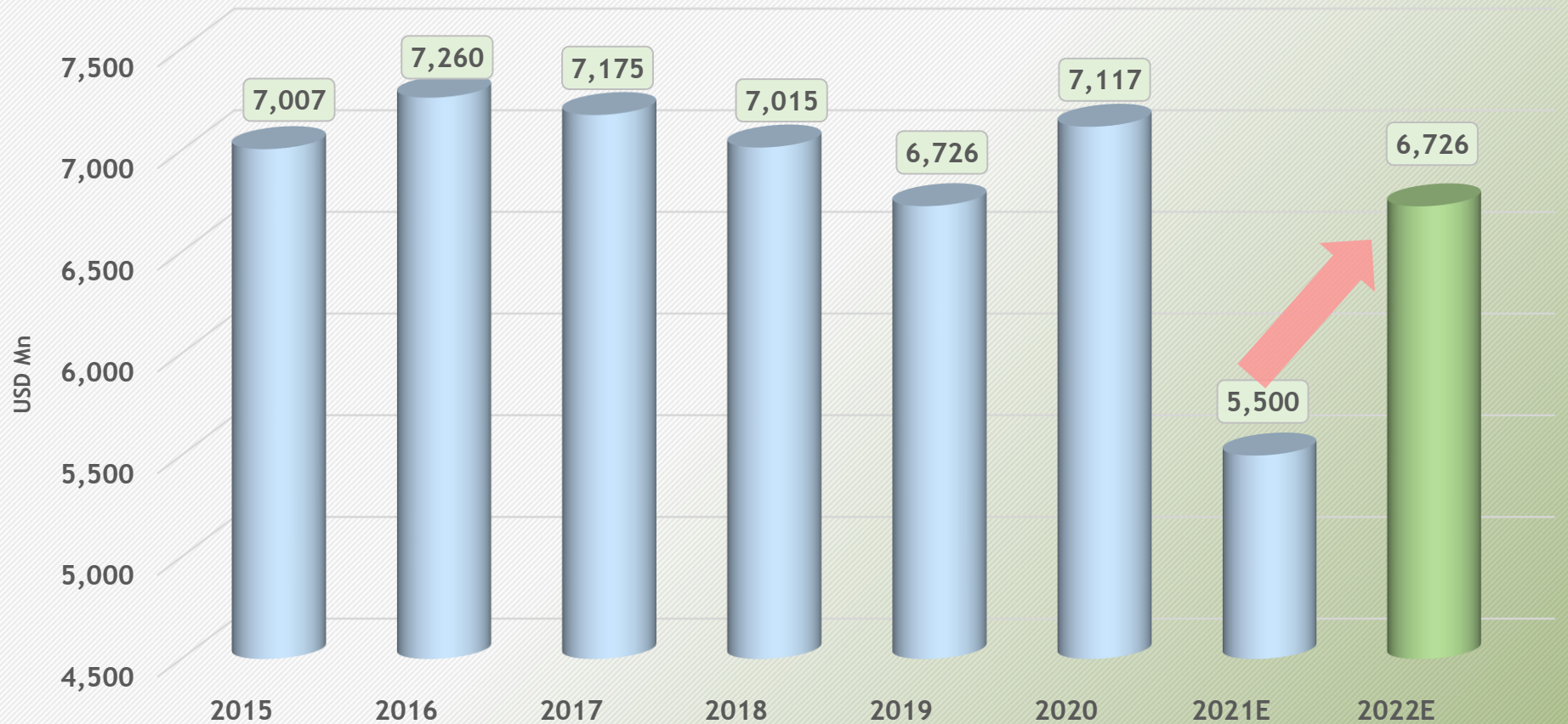
Tourism supports at a healthy scale...

29

Recovery of tourism is expected to be gradual...

...reaching nearly USD 5Bn by 2024E





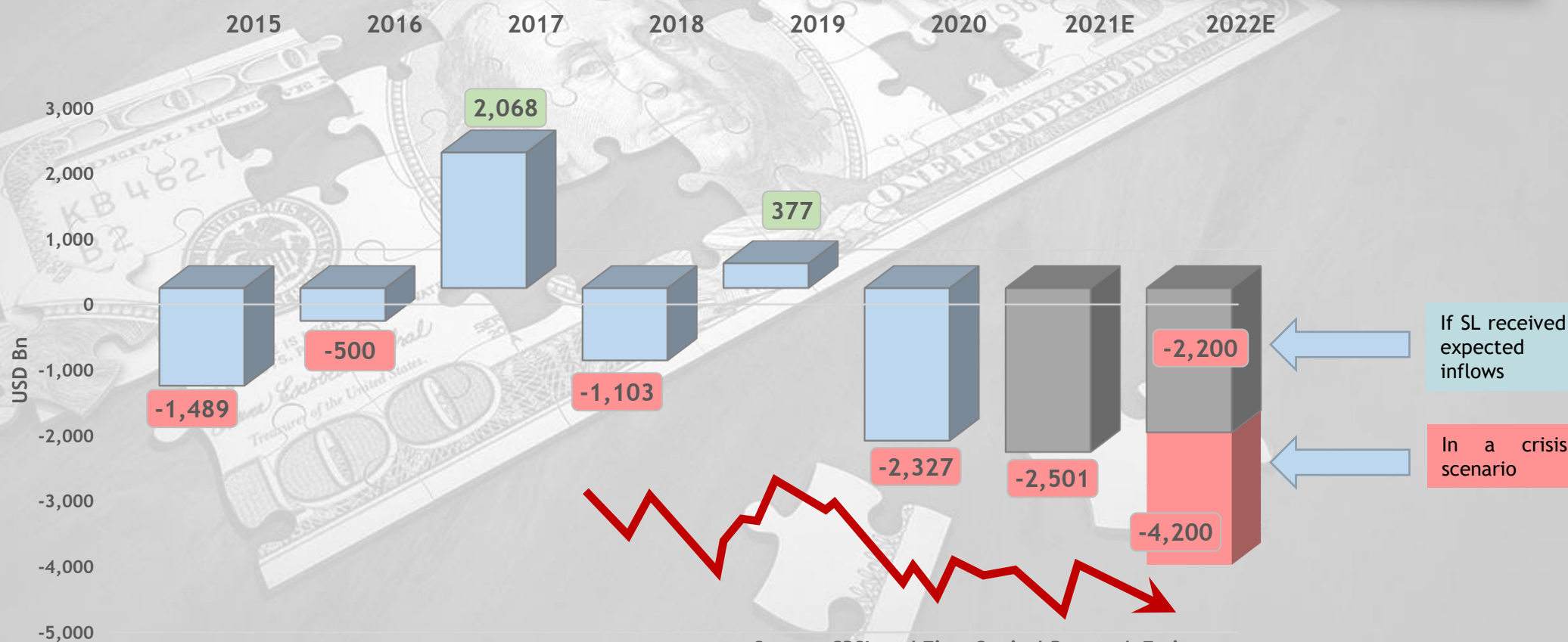
Source: SLTDA and First Capital Research Estimates

...while worker remittances are expected to recover from a 10-Yr low in 2021 amidst the expected currency float

30

However, BoP indicates continued deficits and expects to record USD -2.5Bn in 2021E and USD -4.2Bn in 2022E amidst significant debt repayments

31



“ Balance of Payments is only part of the problem. Even if we somewhat manage the BoP position temporarily, SL Govt’s Budget Deficit is again a serious concern at unsustainable levels resulting in high Govt Borrowings requirement ”

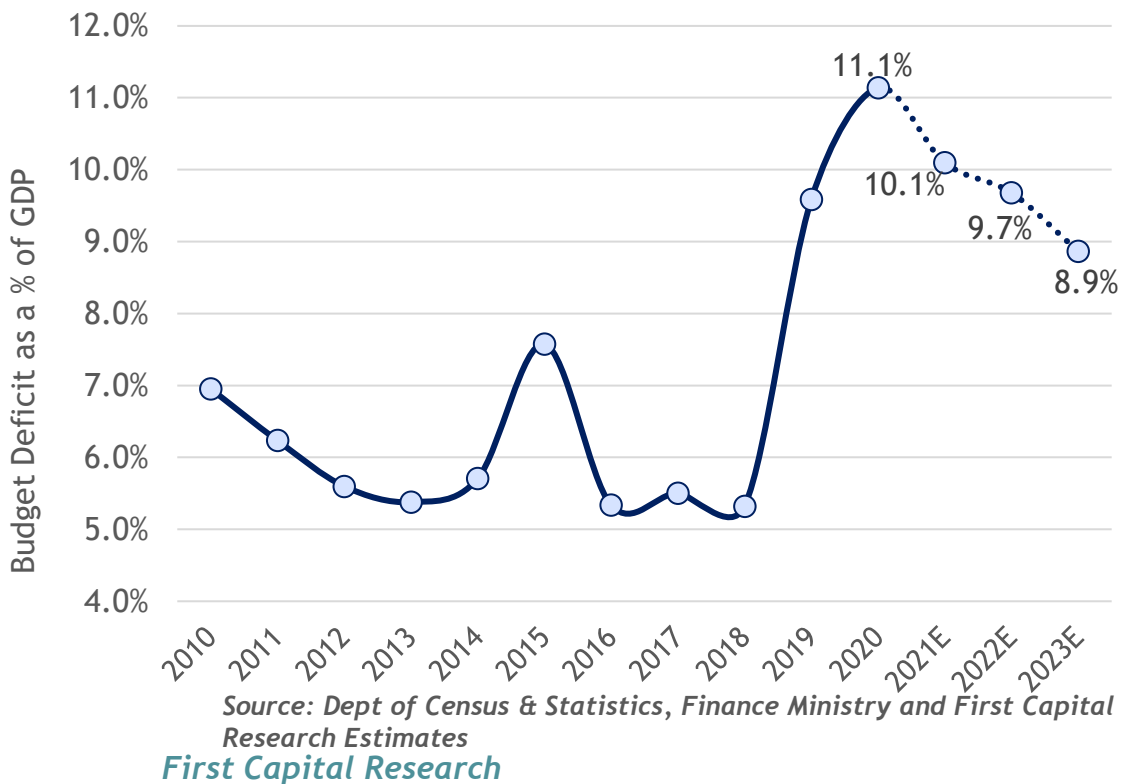
Budget is a much bigger issue

32

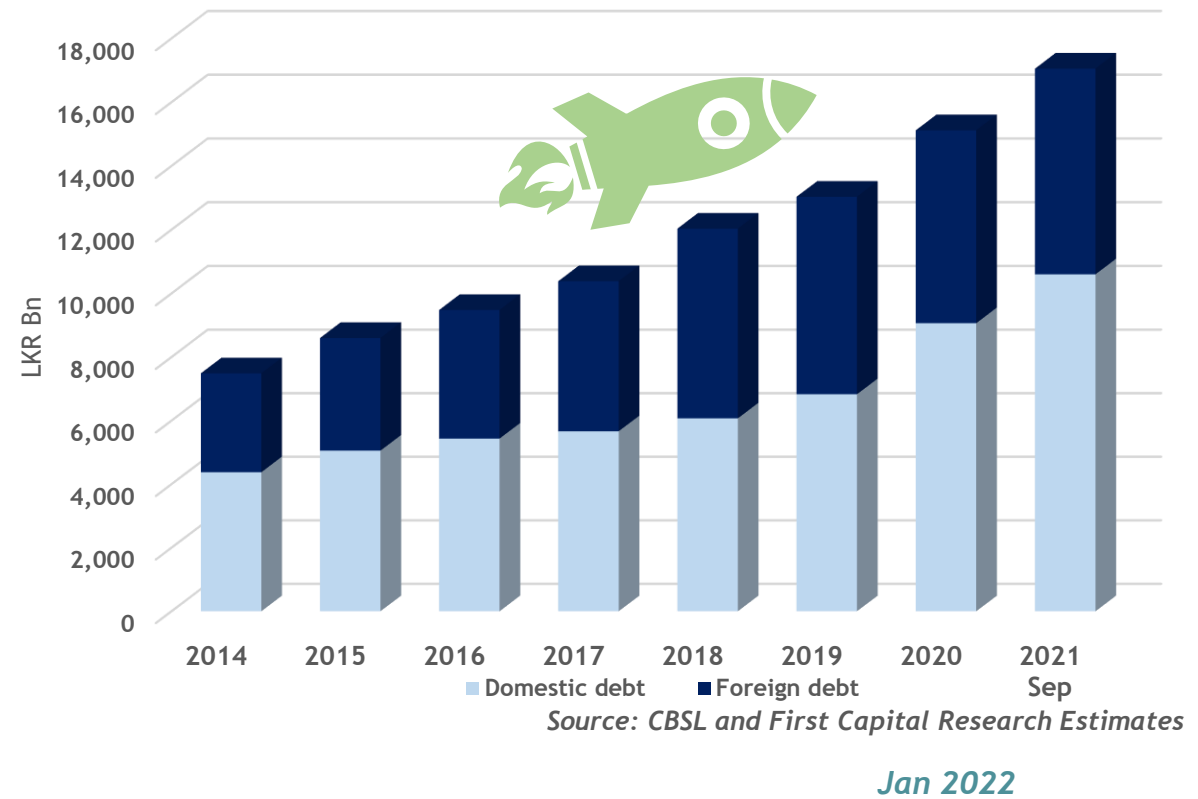
Budget Deficit rises high resulting in stronger borrowings

33

SL is expected to record another close to 10.0% budget deficit in 2022E



...resulting in borrowings reaching LKR 17.0Tn



However, transitory borrowing options provides a lifeline...

Swap facility by the Reserve Bank of India and deferred ACU settlement of USD 515.2Mn (by two months)

USD 900.0Mn

Swap facility from Qatar

USD 500.0Mn

Indian credit facility of USD 1.0Bn for importing food, essential items, and USD 500.0Mn for importing fuel from India.

USD 1,500.0Mn

Another possible loan from China

N/A

Relief package from Japan

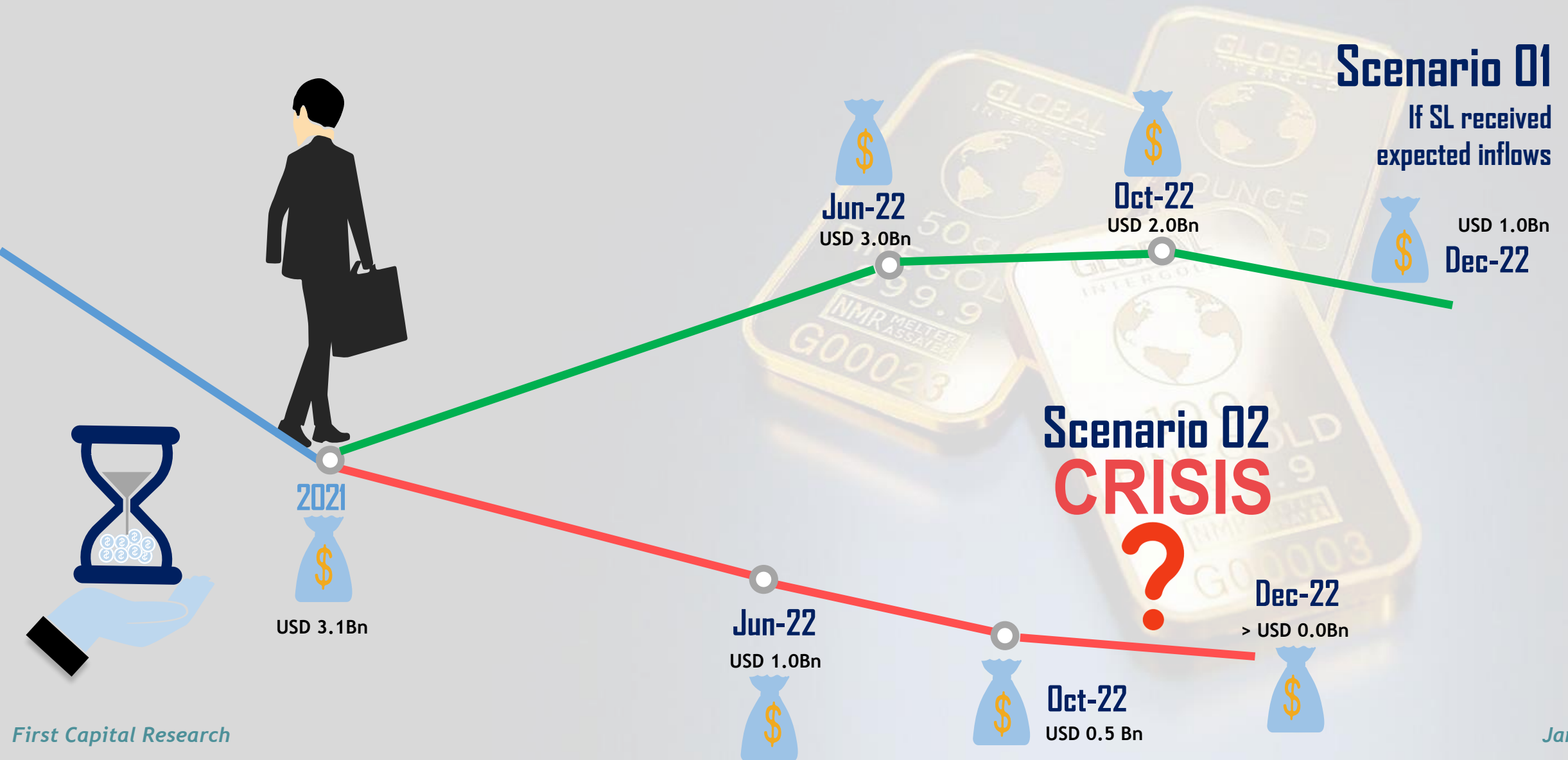
USD 2.0-3.5Bn

USD 6.4Bn



Source: CBSL and various media and newspaper articles

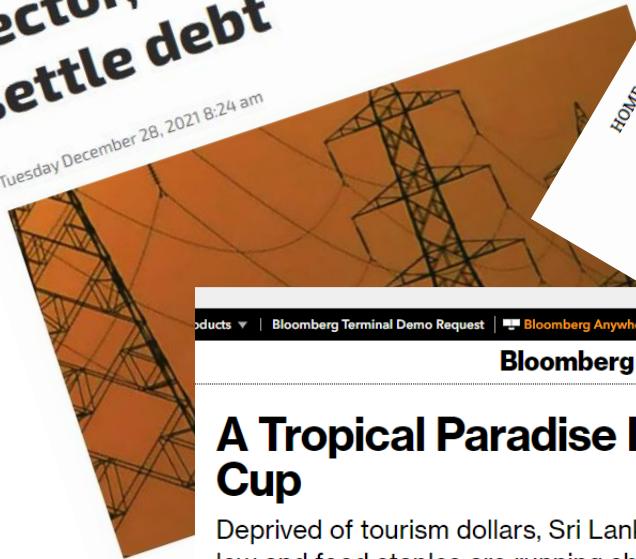
...to tackle Foreign Reserves which is going through a tight rope



Forex crisis

Sri Lanka forex shortages reaching electricity sector, CPC asks CEB to settle debt

Tuesday December 28, 2021 8:24 am



First Capital

A Tropical Paradise Is Brewing a Storm in a Teacup

Deprived of tourism dollars, Sri Lanka's foreign exchange reserves are dangerously low and food staples are running short. The question now is will it turn to China, India or the IMF for help?

Daily Mirror
THU, 13 JAN 2022
www.dailymirror.lk
TODAY'S PAPER

Forex crisis hits pharmaceutical imports

Sri Lanka declares food emergency as forex crisis worsens

President Gotabaya Rajapaksa invokes emergency regulations to secure supplies of essential food items as private banks say they are unable to finance imports.

Tourism Gets Hit In Sri Lanka As Hotels & Restaurants Shut Down Due To Shortage Of Cooking Gas

Business Standard

OPINION TECH SPECIALS PF PORTFOLIO THE MORNING
Economy Finance Current Affairs International Management Strategy

Sri Lanka to shut three foreign missions as dollar crisis worsens

economy was severely hit by the pandemic and the government imposed an import ban to shore up forex reserves

the SUNDAY TIMES

Dollar crisis threatens to ground airline operations from Lanka

say foreign carriers may cut down flights, unless dues are paid

“

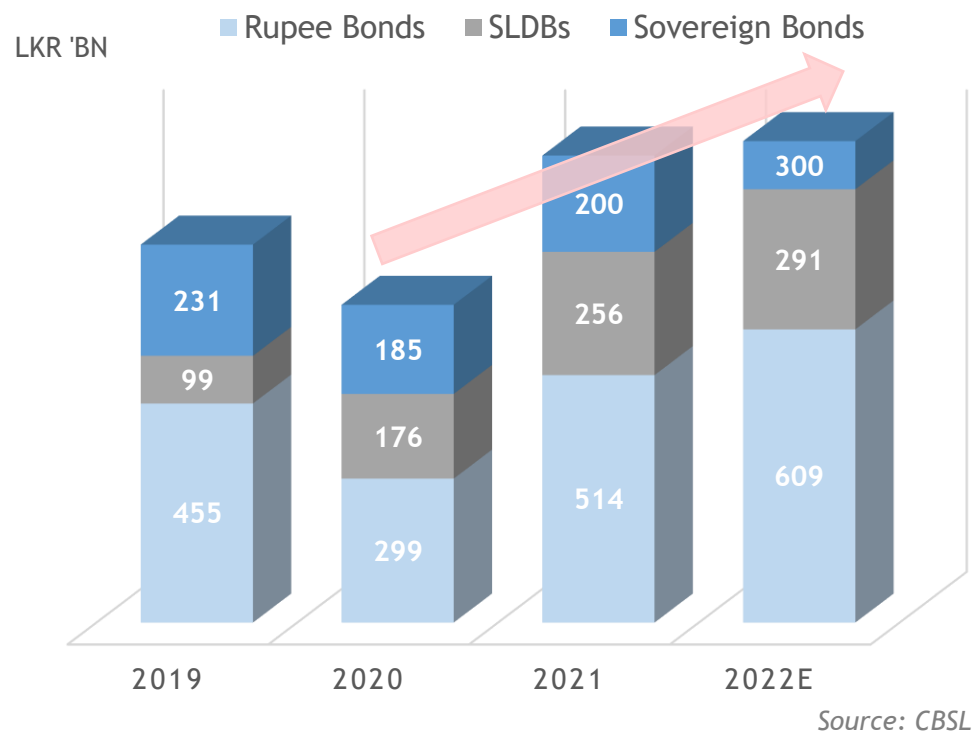
In addition to the BoP deficit and high Budget Deficit, SL faces a surge in Debt Maturities

”

Debt obligations continue its uptrend...

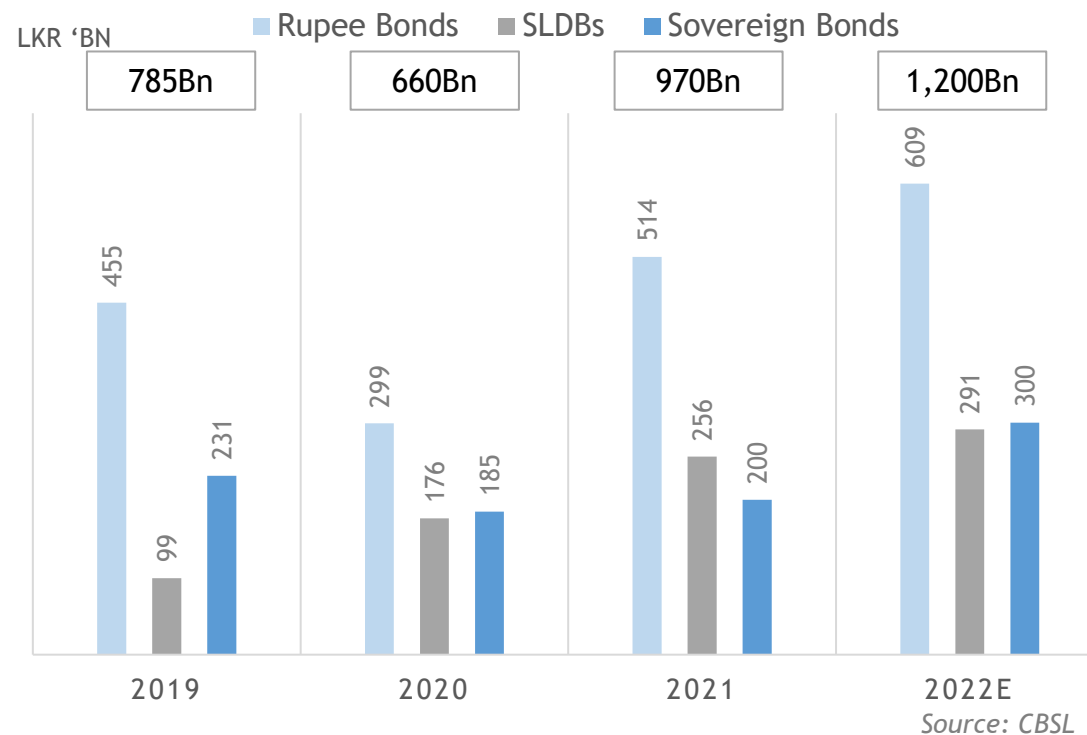
38

2022E Bond Obligations rises to LKR 1.2Tn



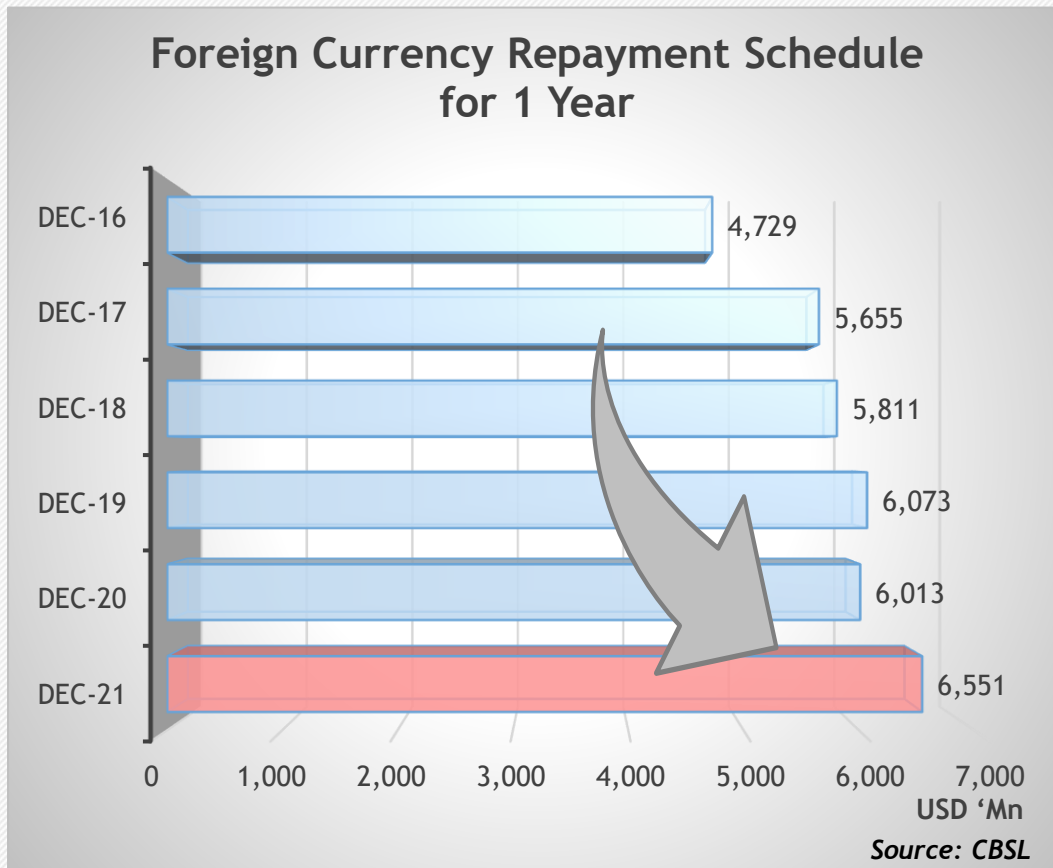
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2022E Bond repayments are 24% higher

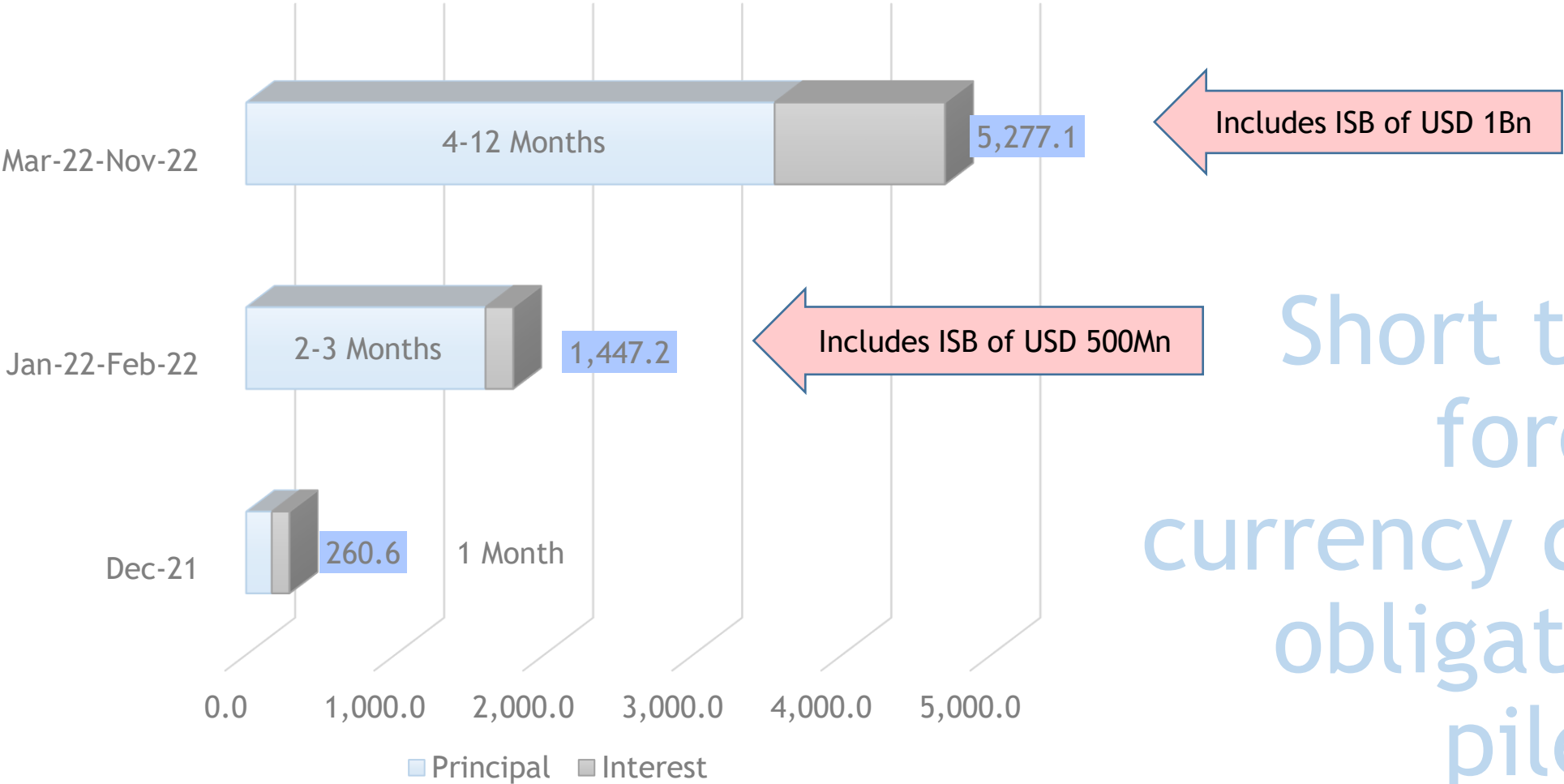


Jan 2022

...with foreign debt
continuing a similar trend



Foreign Currency Debt for next 12 months amounts to USD 6.6Bn



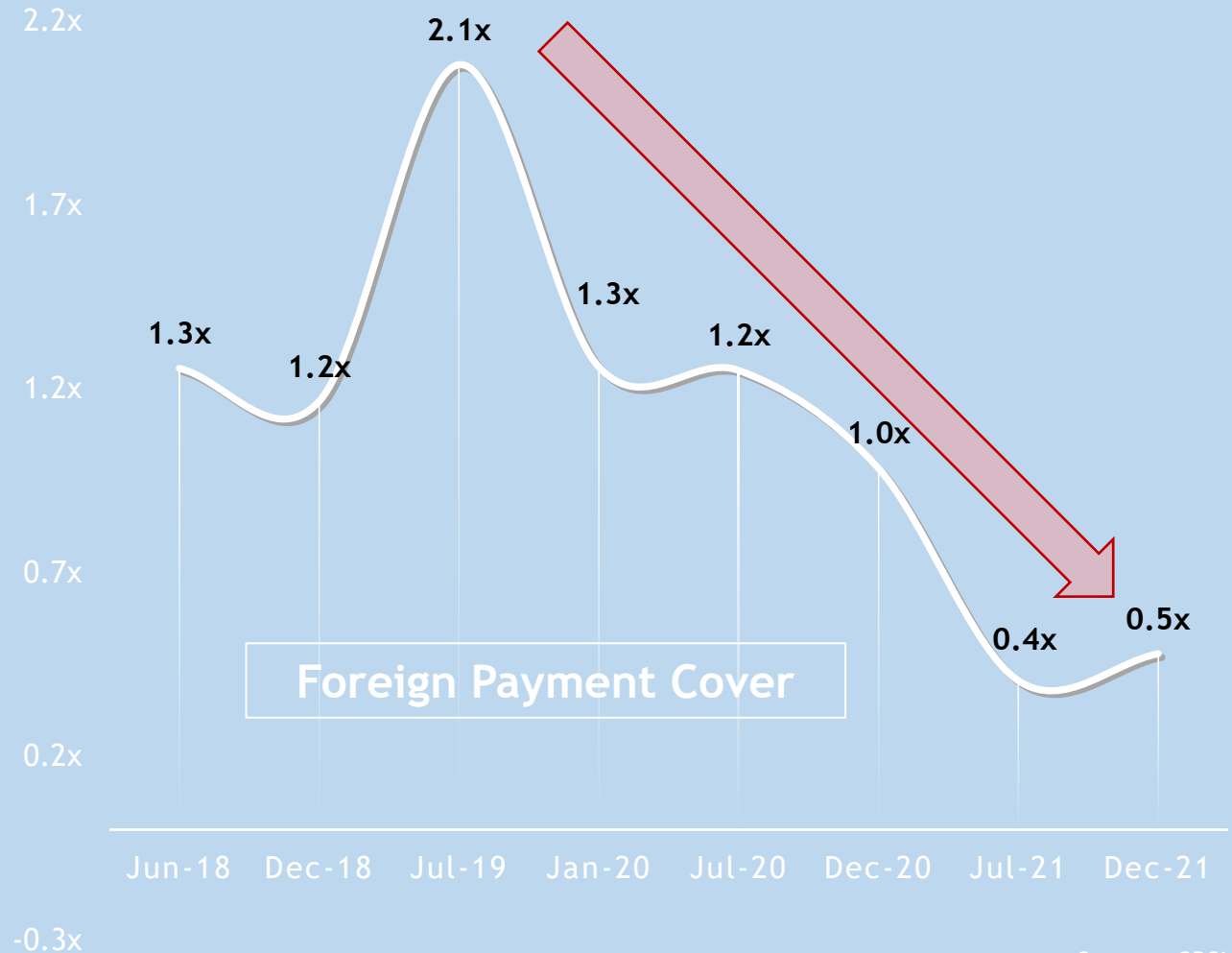
Short term foreign currency debt obligations pile up

Source: CBSL

With support of People's Bank of China, Foreign Reserves was at USD 3.1Bn as at Dec-21, but continue to remain low compared to the repayment requirement

Foreign Reserve cover stands at dangerously low levels...

[Remains same as Sep-21]



Source: CBSL

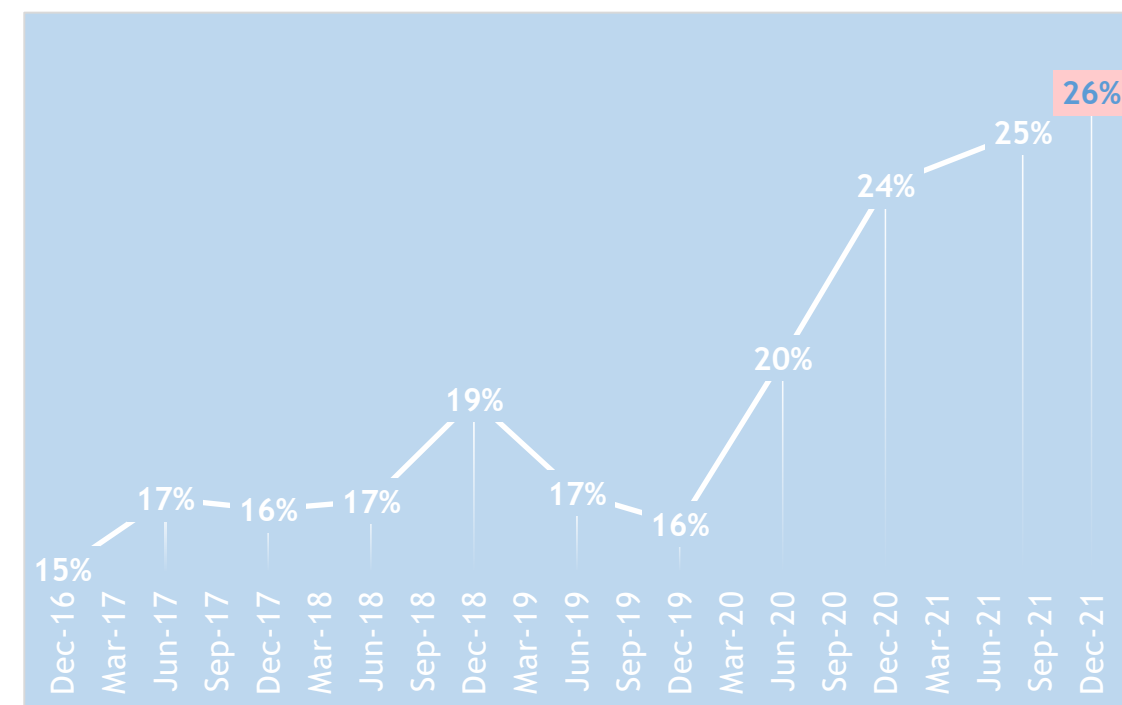
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Jan 2022

...amid the risk, demand for short term rises

42

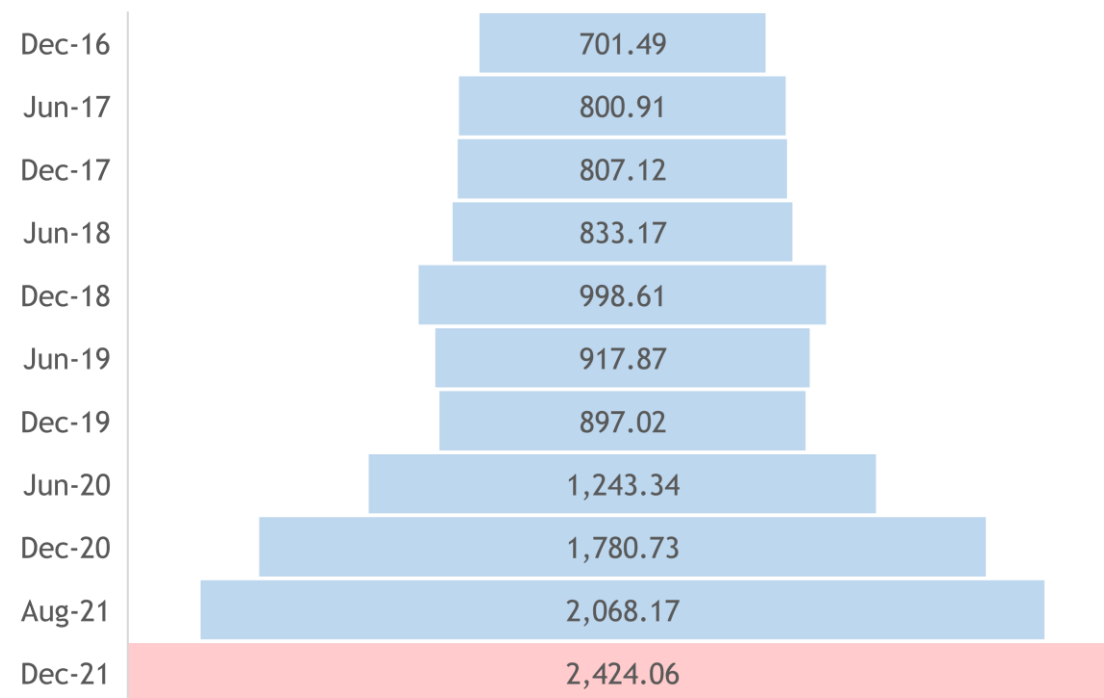
T-Bills as % of the Government Securities market touches a high of 26%



Source: CBSL

First Capital Research

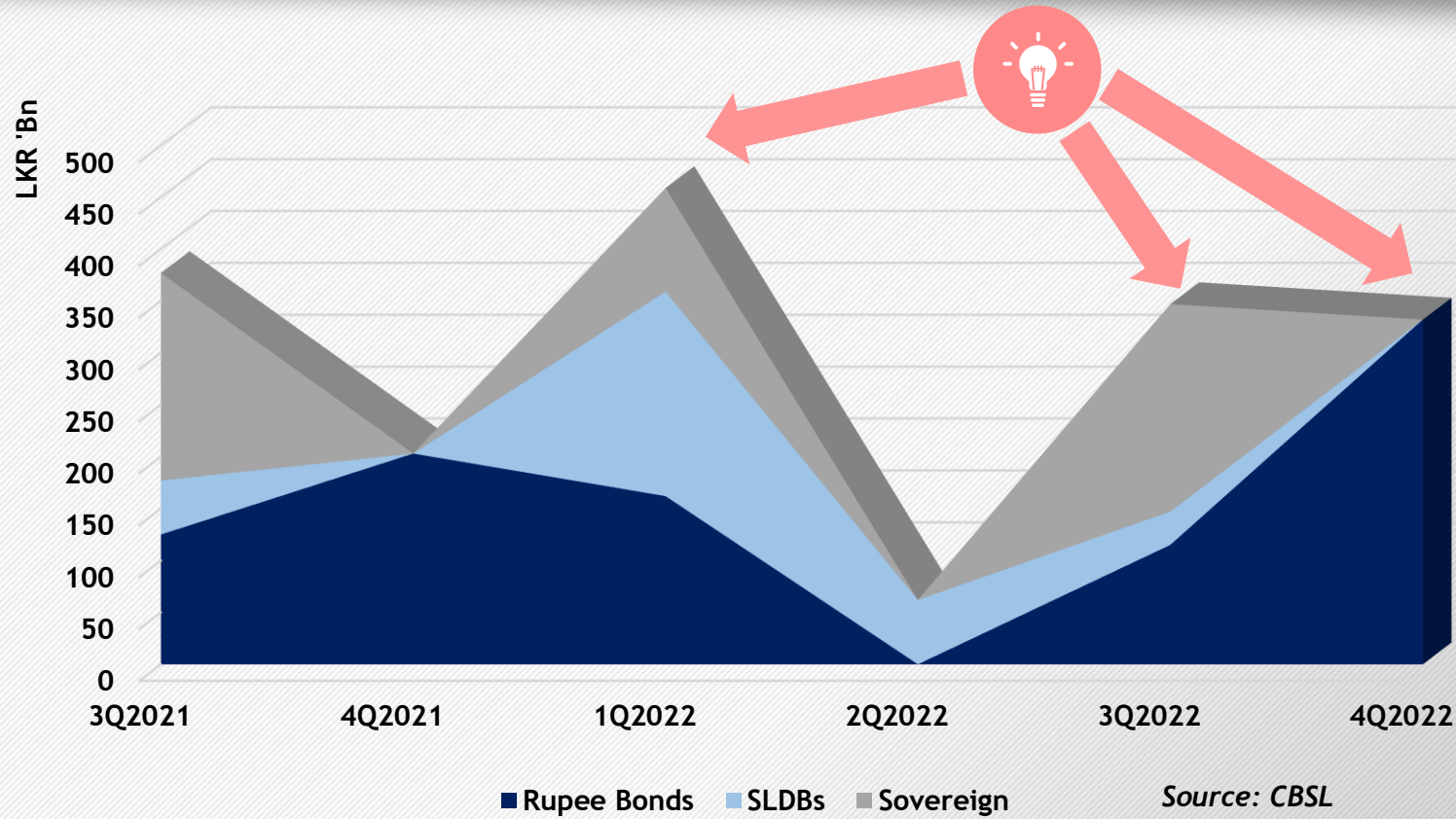
Outstanding T-Bill stock moves to LKR 2Tn range



Source: CBSL
Jan 2022

Repayment pressure to remain high in 3 out of 4 quarters in 2022

43



Summary of the Economic Indicators for next 12 months

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Positives

- Recovery in Tourism

Negatives

- GDP may decline sharply amidst rising inflation
- Sharp increase in inflation
- High budget deficit may increase Govt borrowing requirement
- Negative liquidity
- Rising Credit Growth
- Rising Lending Rates
- Potential further surge in CBSL Holdings
- Potential steep LKR depreciation
- High Rupee and Dollar debt maturities
- Difficulty in raising foreign debt

Economic Outlook: *High Risk*



External Outlook suffers hefty blow: **High Risk**

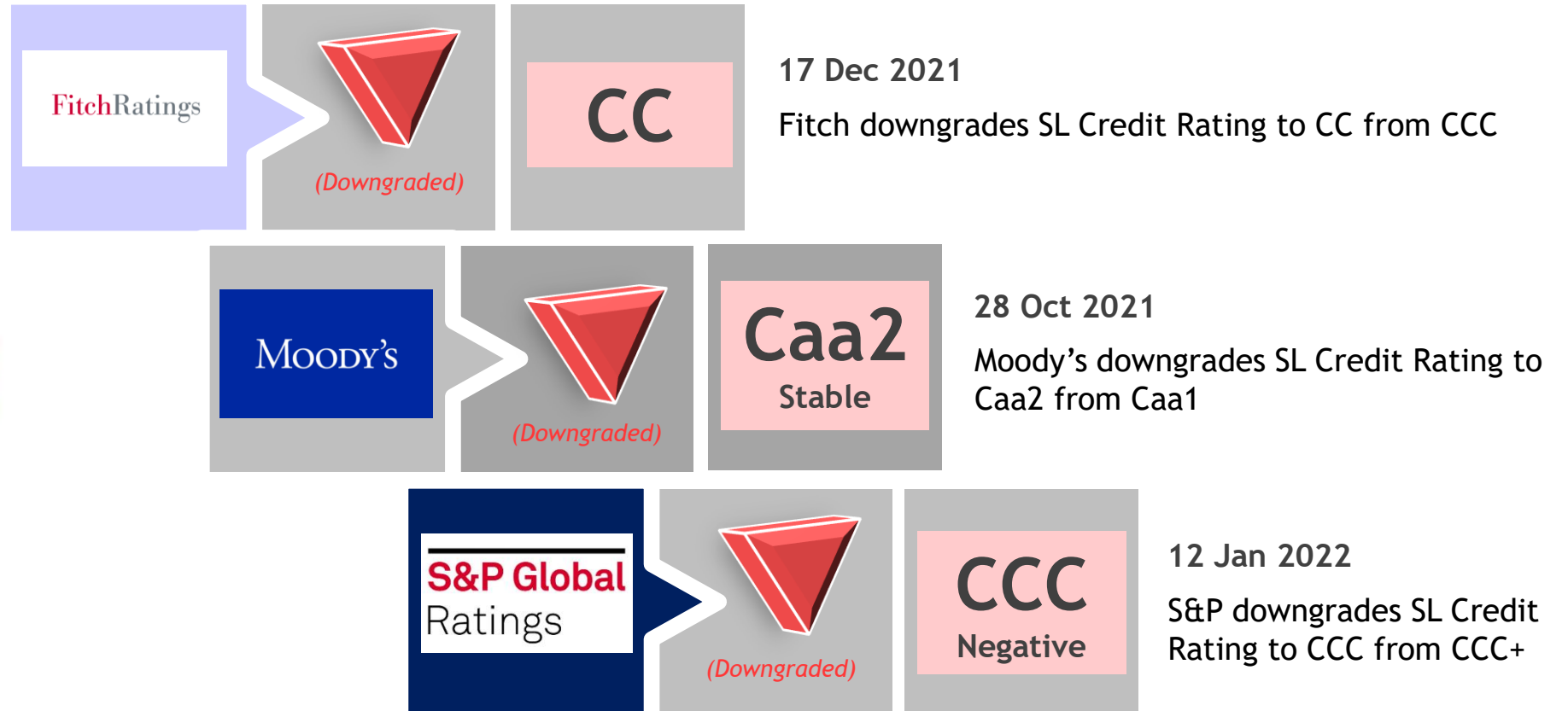
(Maintained)

Section 5.0

Another downgrade by all 3 rating agencies

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Downgrade

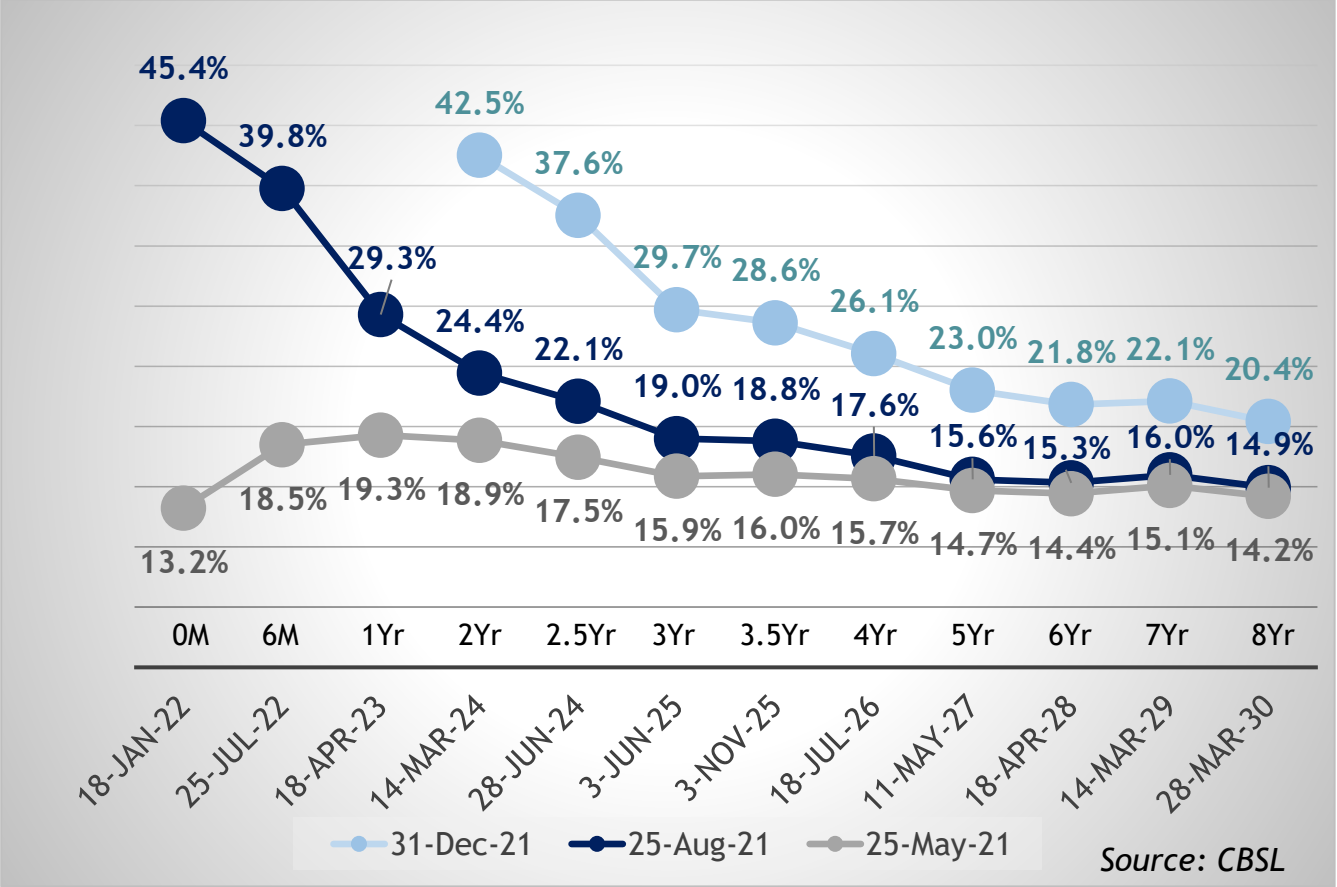


Global Central Banks move towards a hawkish path

	Aug 2021	Sep 2021	Oct 2021	Nov 2021	Dec 2021
Net Change	+55 bps	+630 bps	+2,715 bps	+1,005 bps	+1,365 bps
Total Rate Cuts	500bps	110bps	200bps	100bps	105bps
Total Rates Rises	555bps	740bps	2,915bps	1,105bps	1,470bps
Rate Cuts	Liberia	Turkey and Denmark	Turkey	Turkey	Turkey and China
Rate Rises	Armenia, Georgia, Brazil, Czech Republic, Uruguay, Mexico, Peru, Sri Lanka, Paraguay, Hungary, Iceland, South Korea and Chile	Moldova, Ukraine, Peru, Russia, Kazakhstan, Armenia, Azerbaijan, Pakistan, Hungary, Paraguay, Brazil, Norway, Czech Republic, Mexico, Jamaica and Colombia	Romania, Moldova, Uruguay, New Zealand, Iceland, Poland, Peru, Chile, Hungary and Paraguay, Russia, Tajikistan, Kazakhstan, Brazil, Zimbabwe, Azerbaijan and Colombia	Poland, Czech Republic, Romania, Mexico, Uruguay, Peru, Hungary, Jamaica, Iceland, South Africa, Pakistan, Ghana, Paraguay, Lesotho, New Zealand, Zambia, Dominican Republic, South Korea and Kyrgyzstan	Moldova, Georgia, Poland, Brazil, Ukraine, Peru, Pakistan, Armenia, Hungary, Chile, Costa Rica, Norway, United Kingdom, Mexico, Azerbaijan, Russia, Colombia, Jamaica, Paraguay, Czech Republic, Sierra Leone and Dominican Republic
Global Monetary Policy Rate	5.01%	5.02%	5.28%	5.38%	5.51%



All ISB rates move beyond 20%



First Capital Research



Jan 2022

External Outlook Summary



Credit Rating Agencies downgrade to extreme low levels



Fed move towards policy tightening and global central banks move towards a similar direction



Sri Lanka ISB rates increase sharply making it impossible to raise funds in the international market

External Outlook: *High Risk*

Outlook Trend for SL

50

Time Period	Political	Economical	External
Jan 2019	High Risk	Medium	Low Risk
Sep 2019	Low Risk	Medium	Medium
Jan 2020	Low Risk	Medium	Medium
Aug 2020	Low Risk	Medium	Medium
Jan 2021	Low Risk	Medium-High Risk	Medium-High Risk
Sep 2021	Medium-Low Risk	High Risk	High Risk
Jan 2022	Medium-Low Risk	High Risk	High Risk

Risk Levels (Low-High)


 Low Risk
 Medium-Low Risk
 Medium-High Risk
 High Risk



Assessing the macro economic criteria

Section 6.0

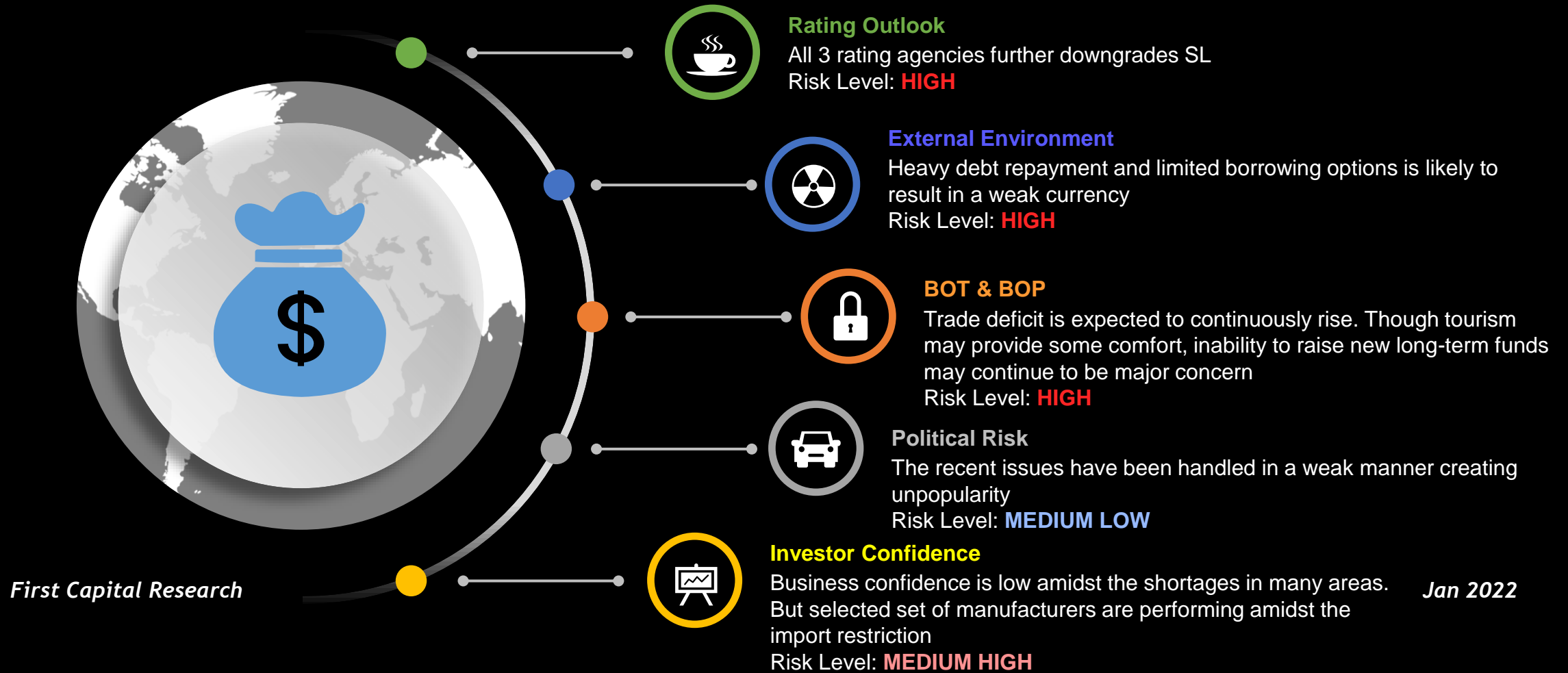
Priority Criteria

52



Secondary Criteria

53



IMF is an immediate necessity



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Cabinet has on couple of occasions considered to move into an IMF program, but has so far rejected the proposal.

We, at First Capital believe that moving into an IMF program early and start debt restructuring is of paramount importance.

Sri Lanka is already experiencing shortages on multiple grounds and even power cuts.

We believe the short-term measures so far that are been taken by the CBSL and the Govt is unlikely to solve the long-term debt issue in Sri Lanka

First Capital Research maintains its stance that there is an **85% probability the Sri Lanka may consider an IMF program as soon as possible.**

As predicted IMF program is now more likely than not



- In the line with the forecast of our Fixed Income Health score in Jan 2021, First Capital Research expected that Sri Lanka may negotiate an IMF program within 3Q2021. Though there are rumours of negotiations, so far such a program has not materialized, but the Govt has obtained the Rapid Funding Facility of USD 787Mn from the IMF.
- Considering current situation of the economy, the economic indicators seem to be slightly worse than our initial estimates (For Eg: Jun-2021 Foreign Reserves dipped to USD 4.0Bn 6months earlier than our expectations).
- Analyzing the economic indicators and the forecast, we believe there seems to be an **85% probability that Sri Lanka may consider to move into an IMF program as soon as possible.**

First Capital Research



Sep 2021



Recommendations

Section 7.0

First Capital Research View on Bond Market 2022

Section 7.1

56

View Maintained

Bond yields to extend the surge

57



01

Uncertainty over access to creditors

Sri Lanka's credit rating has significantly weakened making it extremely difficult to raise external funding.

This situation is likely to lead to lack of inflows resulting in deteriorating foreign reserves.

02

Continued high budget deficit

Following the tax cuts in 2019, tax revenue has been insufficient to meet the Govt expenses.

With Covid SL's expenses skyrocketed leading to double digit budget deficits. Even after budget 2022, there is a high possibility that SL's budget deficit still might be closer to double digit.

03

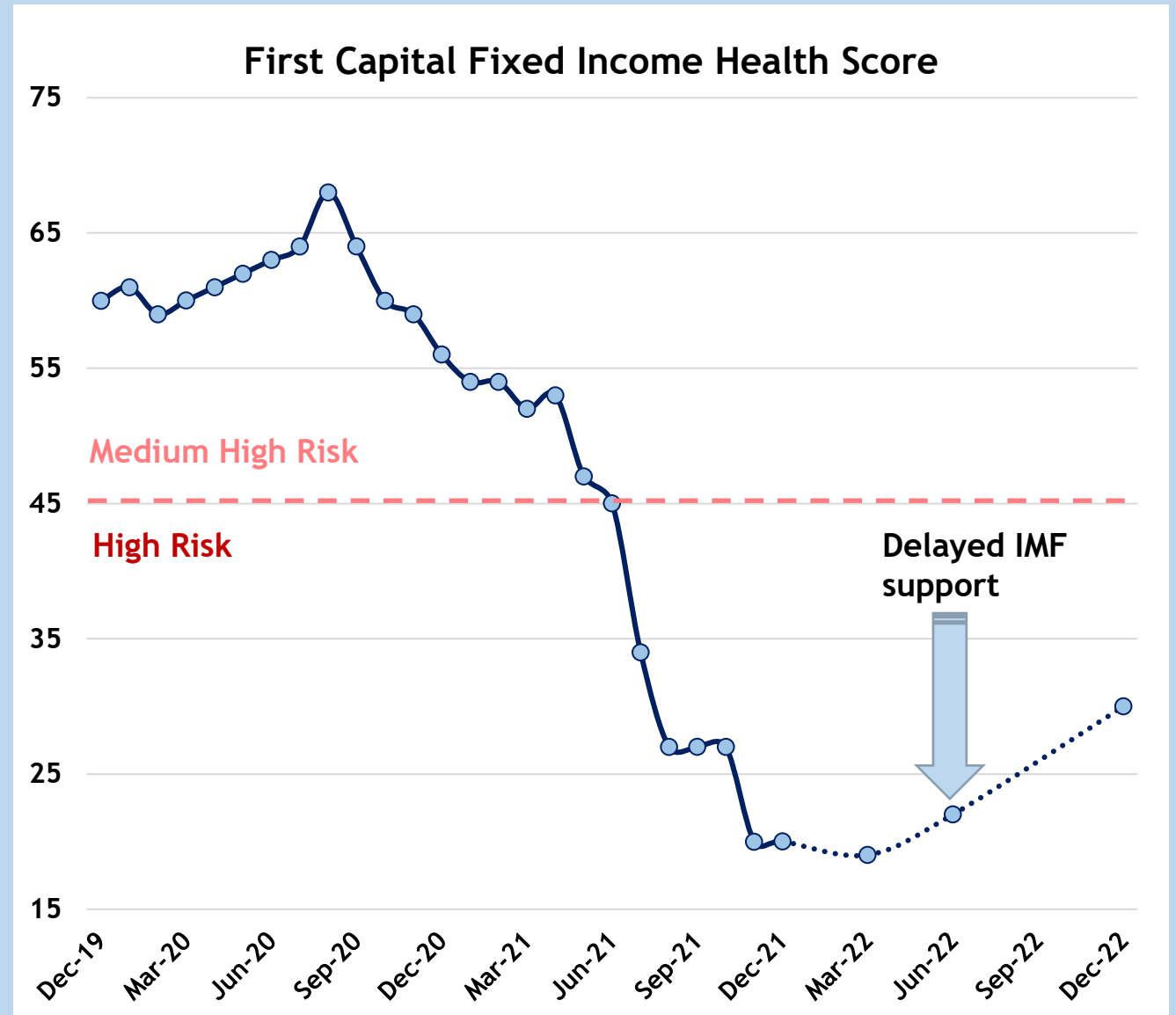
Negative Liquidity

With Govt borrowing requirement at high levels and private sector recovering the pressure for credit has been significant.

The SRR hike aggravated the negative liquidity situation. With the Govt slow increase rates, the situation may further aggravate before it gets better.

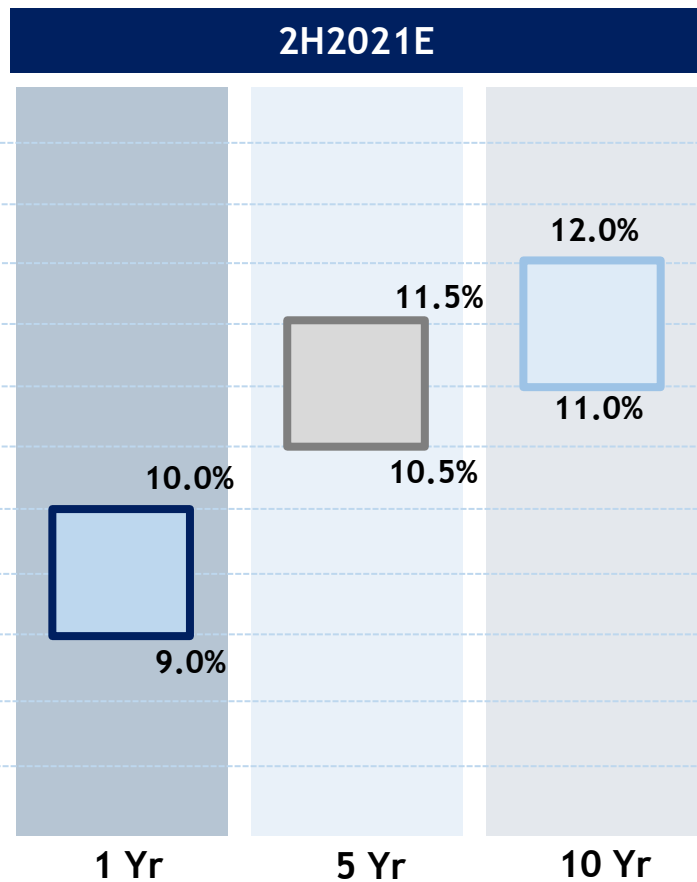
Fixed Income Health Expectations has already registered a steep decline suggesting a surge in yields...

...IMF support continues to get delayed

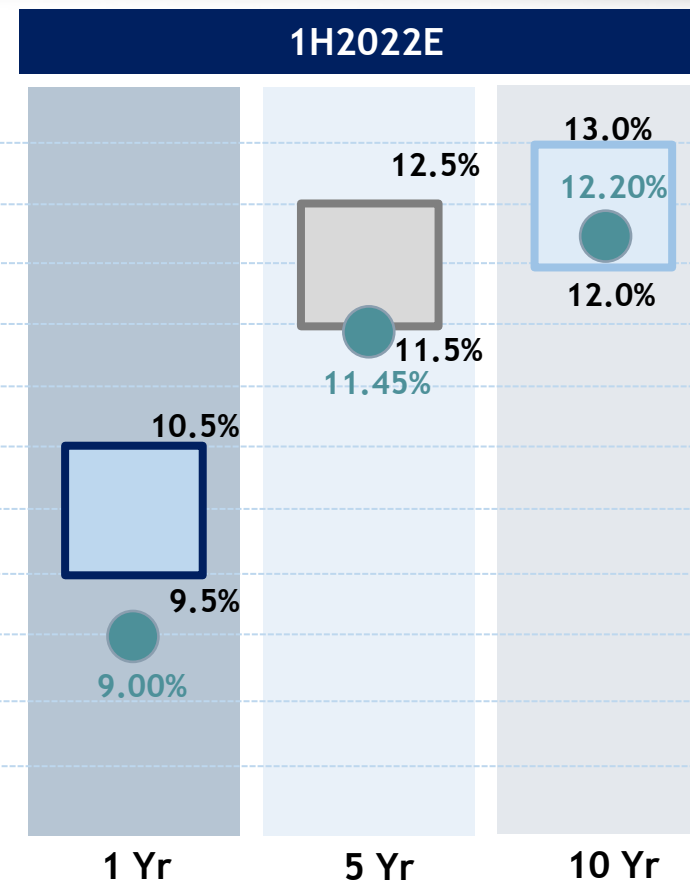


Yield Curve may rise by 150-200bps and reach our upper bands of the yield curve in 1H2022

59



Compared to 2H2021 1Yr - 5Yr and 1Yr - 10Yr spreads has been raised by 50bps



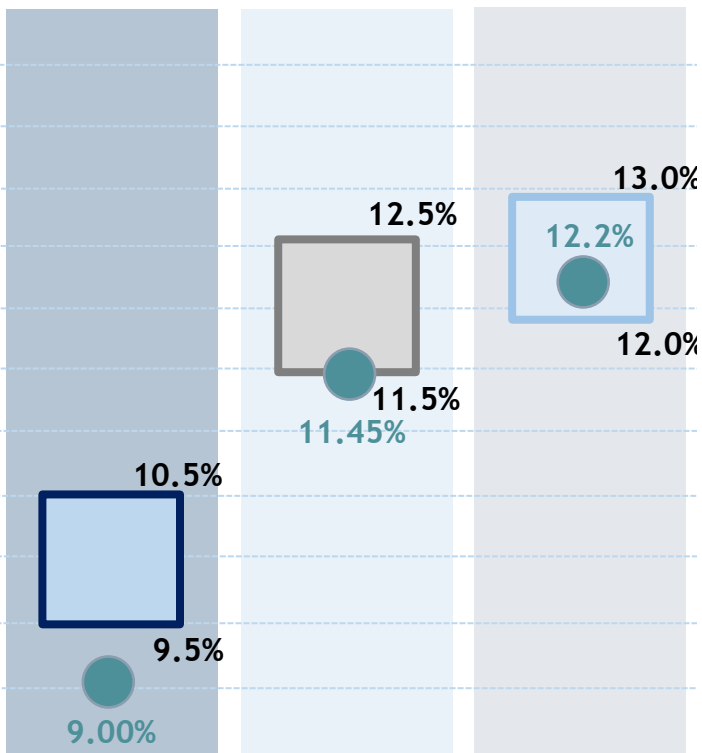
1H2022E If No IMF & No inflows	
1Yr	12.0% - 13.0%
5Yr	15.0% - 16.0%
10Yr	16.0% - 17.0%

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

60

1H2022E



1 Yr 5 Yr 10 Yr

First Capital Research

1H2022E If No IMF & No inflows

1Yr
12.0% - 13.0%

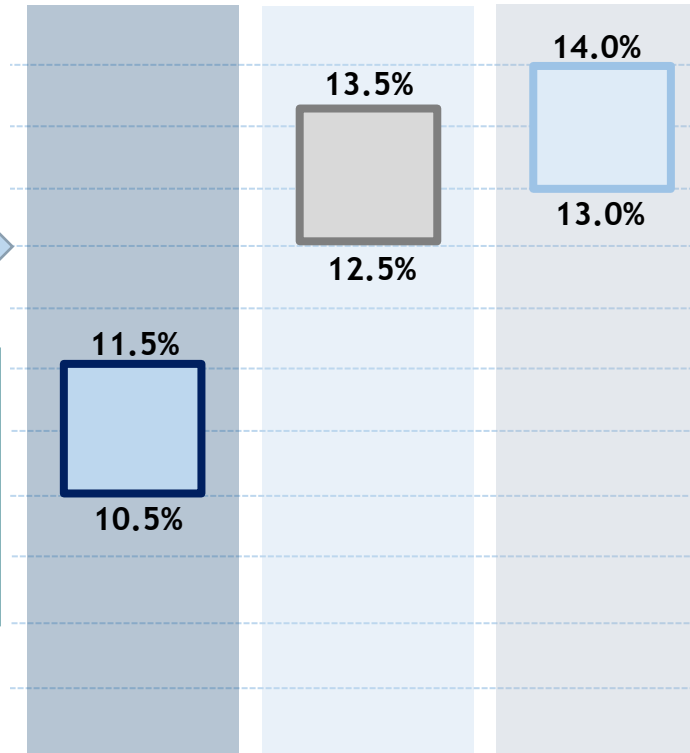
5Yr
15.0% - 16.0%

10Yr
16.0% - 17.0%

2H

Yield curve expectations have been raised by 50bps

2H2022E



1 Yr 5 Yr 10 Yr

Jan 2022

2H2022E If No IMF & No inflows

1Yr
14.0% - 15.0%

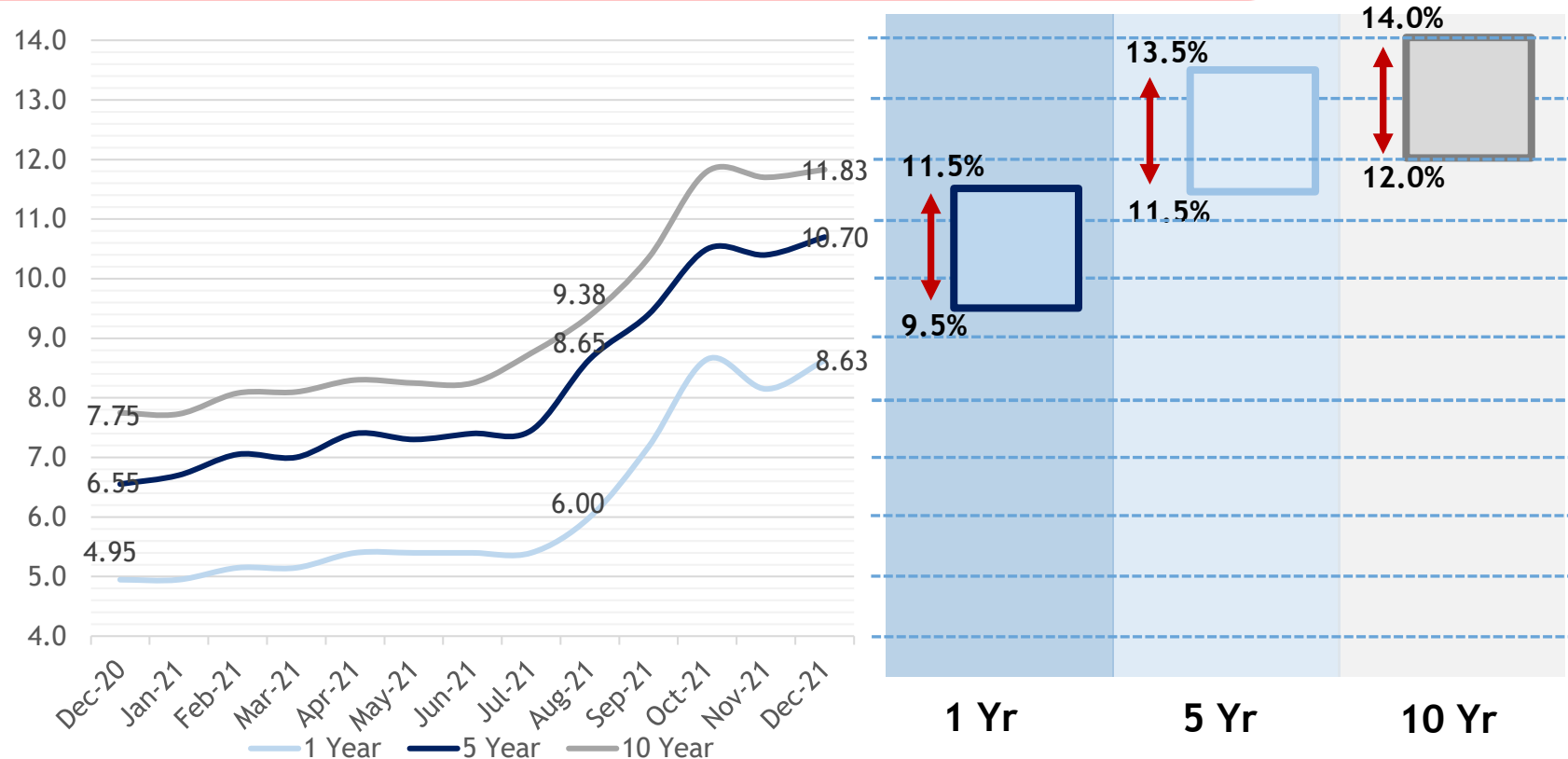
5Yr
17.0% - 18.0%

10Yr
18.0% - 19.0%

Bond Yields to rise sharply by 250-350bps within the period 1Q2022 - 4Q2022 (12 months)

61

Expectations: **Strong Bearishness** 1Q2022 - 4Q2022



Jan 2022 - Dec 2022	Probability	Impact
Govt considers to move without IMF; Bond yields to surge at a steep pace	20%	Extremely Bearish
Bond yields to spike sharply 1Q2022-4Q2022	70%	Very Bearish
Better than expected foreign inflows may allow bond rates to rise slower	10%	Less Bearish

Jan 2022

“ In 1H2022, the extremely weak economic indicators may force the Monetary Board to further tighten the monetary policy. Thereby, we expect 2 rate hikes in 1H2022. In Jan-22, Monetary Board has already announced 1 rate hike.

In 2H2022 we expect 1 more rate hike to place to balance the overall economic outlook ”

3 rate hikes in 2022

Policy rate Outlook - View Maintained

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First Capital Research View on Banking Rates 2022

Section 7.2

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Banking Rates (AWPR) to accelerate uptrend rising by 150-250bps by Jun-22 and 350-450bps (12months) by Dec-22

64

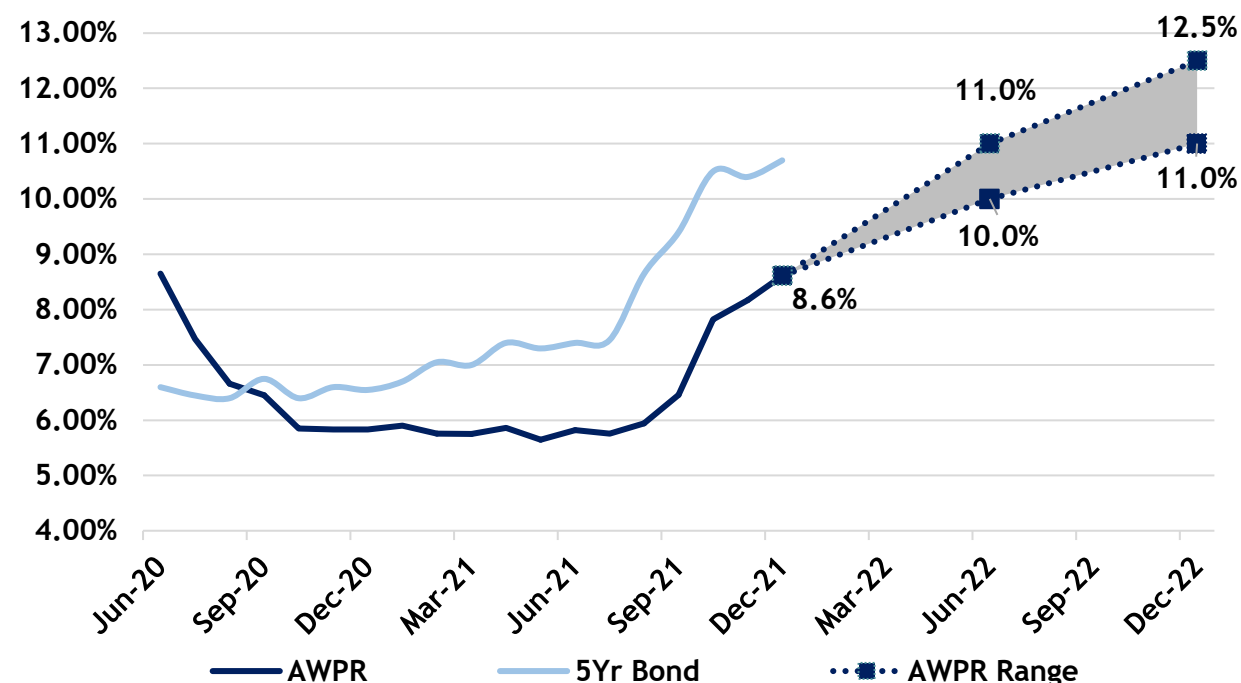
Jan 2022-Dec 2022 Outlook

During the 2H2021 we witnessed a steep rise AWPR amidst the monetary policy hike, negative liquidity and rising demand for private sector credit.

In Jan 2022 policy rates have been increased again while a significant negative liquidity portion continues. Demand for private sector credit is also continuing at a similar pace. With the expected rise in bond yields, we expect AWPR to follow a similar suit with a similar accelerated pace as witnessed in 2H2021 to reach 10.0%-11.0% by Jun-22 and 11.0%-12.5% by Dec-22.

Rising demand and negative liquidity to increase pressure on AWPR

Expectations for AWPR



Source: First Capital Research, CBSL

Jan 2022

First Capital Research View on Exchange Rate 2022

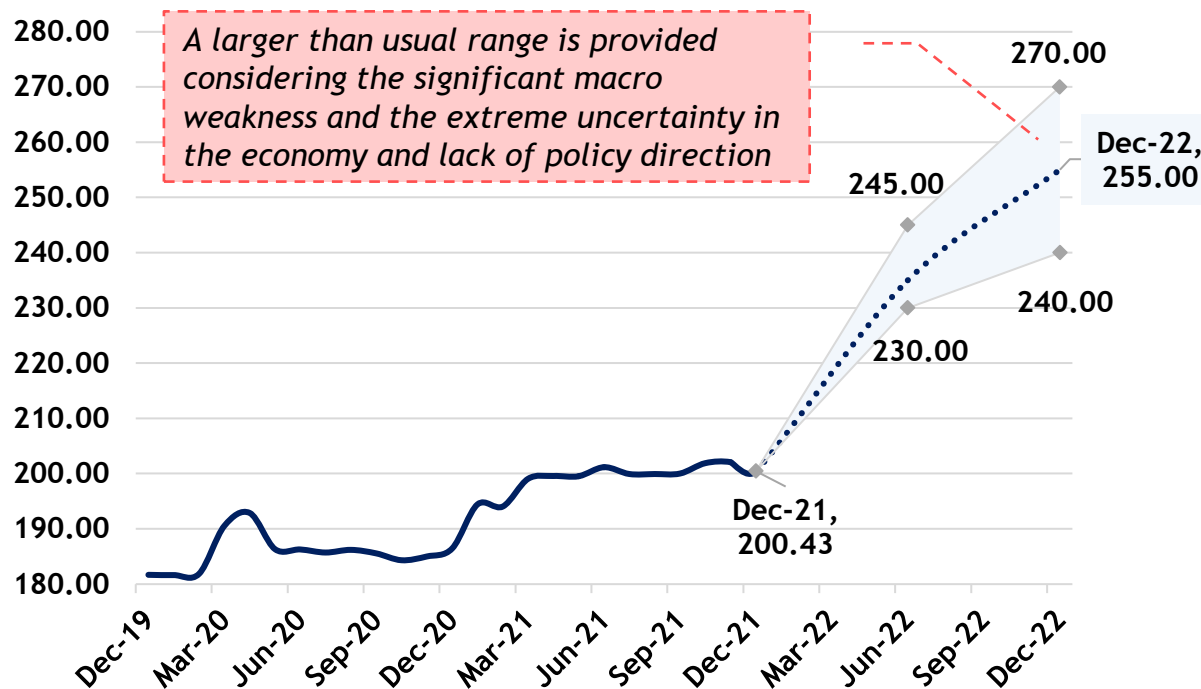
Section 7.3

65

Exchange Rate target for 1H2022 downgraded to LKR 230.0-245.0 with 2022 Year End target at LKR 240.0-270.0

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Considering the current forex may result in the currency experiencing heavy depreciation if floated



Source: CBSL, First Capital Research

Jan 2022-Dec 2022 Outlook

Sri Lanka's lower foreign reserve position and high foreign currency debt repayments are the primary concerns for the significant weakness in the currency. The rise in imports despite the ongoing import restrictions is an added concern.

Taking the situation into consideration, we expect a strong depreciation of the currency over the forecasted period. We further downgrade our Jun-22 target from LKR 225.0-240.0 to LKR 230-245.0 while targeting LKR 240.0-270.0 for the Dec-22.

First Capital Research View on Equity Market 2022

Section 7.4

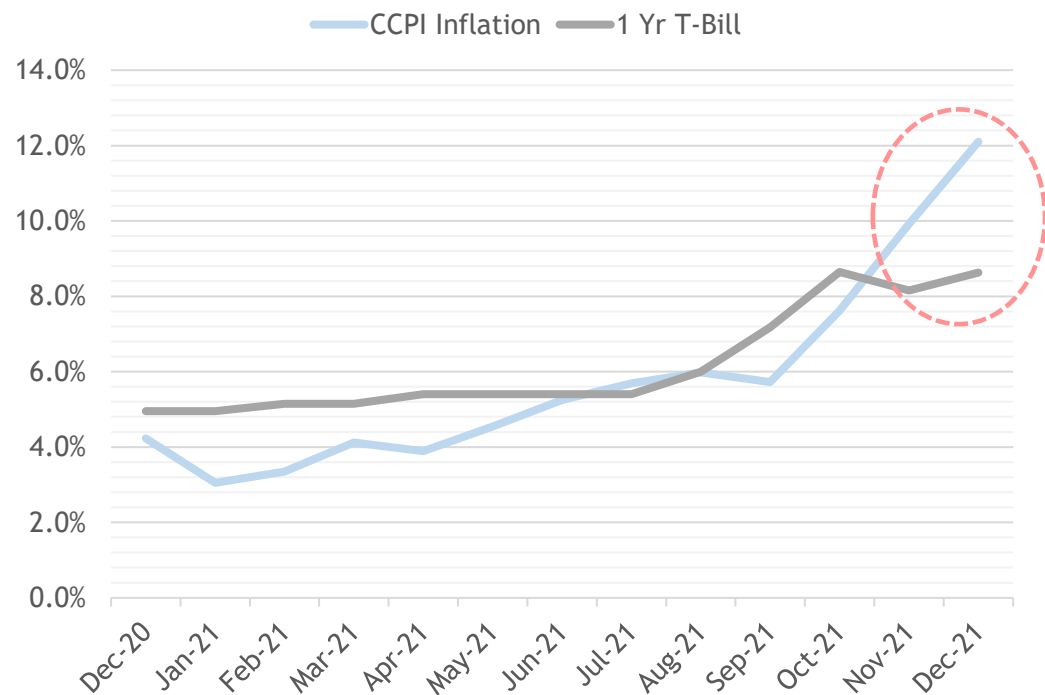
67

Real Interest Rates turn negative making Fixed Income unattractive...

...while FI rates including FD rates remains below 10%

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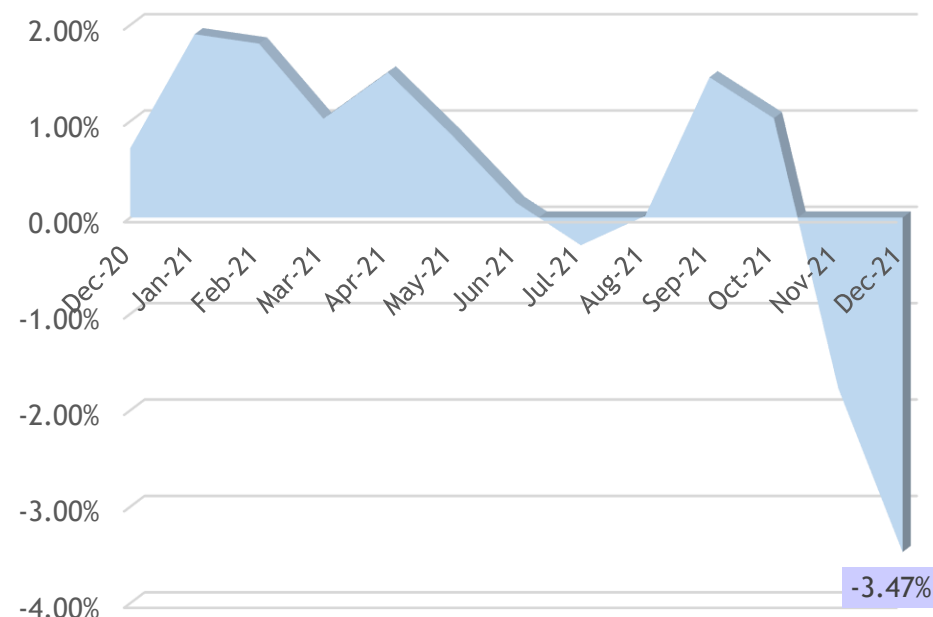
Inflation vs 1Yr T-Bill



Source: Department of Census and Statistics, CBSL, First Capital Research

First Capital Research

Real IR



Source: Department of Census and Statistics, CBSL, First Capital Research

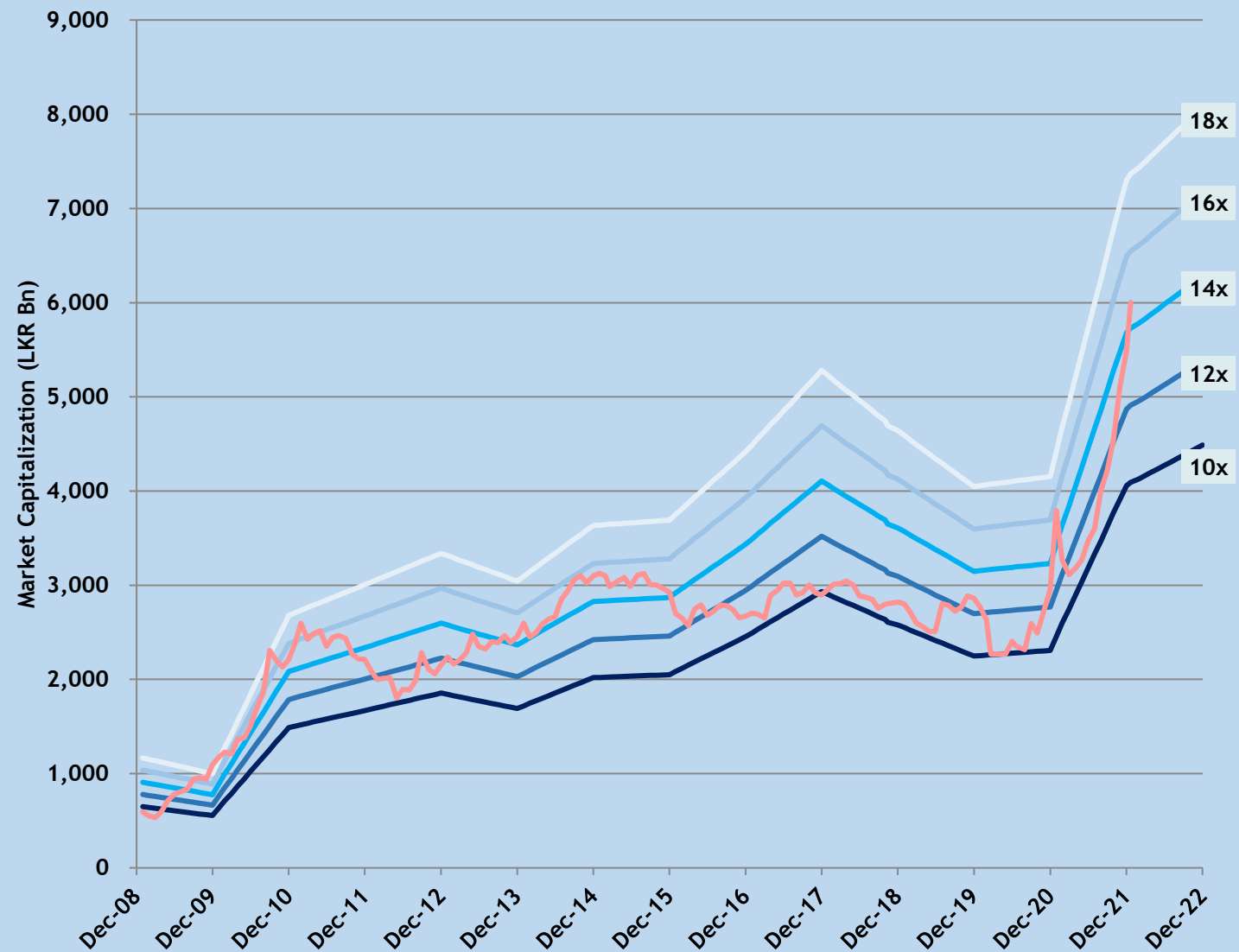
Jan 2022

How are interest rates affecting the equity market?

*Negative Real Interest rates to **favour** Equity Market*

- With the 1Yr T-Bill standing around the 9.0% mark and inflation spiking sharply to 12.1%, real interest rates have turned negative. This situation is unfavourable to towards fixed income instruments with value of money falling amidst higher inflation rates.
- The continuous quantitative easing strategy coupled with import restrictions and controlled currency are pushing inflation to higher levels while also keeping interest rates under check. This may lead to continued environment of **negative real interest rates in the short-mid term.**
- Though, the FD ceiling stands at 10.11% at present, marginally above 10%, most large to mid finance companies are offering well below maximum interest rates due to the lack of lending opportunity, thereby market **FD rates by most Finance companies may remain below 10% over the next 2-3 months.**
- Lower FD rates and negative interest rates are critical factors favouring the equity market as most investors search for alternative investments in such situations.

Strong earnings in
Diversified
Financials, Banks
and Capital Goods
sector improve
valuations



Source: First Capital Research Estimates

Short Term View: ASPI to reach 15,000 in 1Q2022



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Earnings & Negative Real interest rates to DRIVE ASPI

- Dec-2021 quarter earnings are likely to be extremely strong similar to Sep-2021 with Transportation Sector, Construction and Building Material Sector and Diversified Financials sector leading the way in terms of earnings.
- Continuous negative real interest rates and reluctance of the larger finance companies to raise FD rates beyond 10% is expected result in the fund flow remaining strong towards the Equity Market.
- **We expect ASPI returns to be strong in the shorter term resulting in the ASPI potentially rising to the 15,000 mark within the 1Q2022.**

Mid-Long Term View:

Possible Economic Shock; Aggressively shift to Defensive counters

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Possible Economic Shock

- Sri Lanka's foreign reserves were fallen to USD 1.6Bn in Nov 2021, the lowest level since 2009 and improved in Dec-21 to USD 3.1Bn. With USD 7.0Bn foreign currency debt to be repaid over the next 12 months, Sri Lanka seems to be at a very critical juncture. Amidst the controlled currency worker remittances have started to drop by about 50% creating a further slowdown of currency inflows. With the Governor continuously reiterating that they are NOT willing to obtain IMF support, it unclear as to the repayment plan of the Government. Therefore, we believe that Sri Lanka could be in for a major shock within the next 3-12 months creating a high-risk environment.

Reduce Risk by aggressively shifting to Defensive Counters; Possible Negative Return in the broader market in 2H2022

- The weak environment could lead to a major depreciation in the currency and a spike in interest rates. Though the import restrictions and rise in inflation are supporting growth in the earnings, it is likely to be temporary on the face of the crisis. It will be prudent for investors to move into defensive counters out of which **Dollar income companies** are at the priority list, though it's best to move into companies that have NOT surged in price. **Life Insurance Companies** and **Banks** are expected to benefit from the rise in interest rates. We would also recommend **high dividend yielding counters** (Refer First Capital's Dividend Hunter Report). Please refer top recommendations section in Equity Strategy Report (Slide 12).
- For risk averse conservative investors who are unwilling to take economic shock, we would recommend to further reduce equity exposure. From our previous cash allocation of 50%, it would be wise to increase to 75%.



With the ASPI methodology change, we upgrade our ASPI expectations 2022E to 9,000-10,000; ASPI to reach 15,000 in 1Q; Possible negative returns in 2H2022

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Source: CSE, First Capital Research



Possible events preventing our 85% probability

Section 8.0

Possible extraordinary events that could completely reverse our expectations for 2022

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If the below mentioned events materialise, it will prevent our majority probability from being achieved, while giving priority to the minority probability

- Re-emergence of another shock to the system similar to Covid-19 [Worsens our view]
- Significant net foreign inflows of USD 2-3Bn is achieved above our estimates during 2022 [Reverses our short-term view]
- External sector significantly improves with rating outlook upgrade and Global fund flows trend towards Sri Lanka [Reverses our view]

“Time is running out!”

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THANK YOU

“Successful Investment Is About Managing Risk...”

CONTACT US

First Capital Holdings PLC

No: 02, Deal Place, Colombo 00300, Sri Lanka.

E: research@firstcapital.lk

Dimantha Mathew

Head of Research

T: +94 11 2639 853

E: dimantha@firstcapital.lk

Hiruni Perera

Assistant Manager- Research

T: +94 11 2639 864

E: hiruni@firstcapital.lk

Vidushika Perera

Assistant Manager- Research

T: +94 11 2639 865

E: vidushika@firstcapital.lk

Tharusha Ashokgar

Junior Analyst-Research

T +94 11 2639 866

tharushaash@firstcapital.lk



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