First Capital

"TRANSITIONING FROM HAWKISH TO DOVISH"

PRE-POLICY ANALYSIS

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First Capital Research

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Previous Pre-policy report: Recap

CBSL maintained its policy interest rates at the current levels

In-line with our expectations, at the previous policy announcement held on 18th Aug-22, CBSL decided to maintain the SDFR and the SLFR at the current levels of 14.50% and 15.50%, respectively. This decision has been made considering the larger than expected contraction in activity and a faster than expected easing of price pressures, compared to the previous monetary policy review. The Board was of the view that despite headline inflation being projected to remain elevated in the near term, the policy measures taken by the Central Bank and the Government thus far would help contain any aggregate demand pressures, thereby anchoring inflation expectations, along with the anticipated decline in global commodity prices and its pass-through to domestic prices in the period ahead.

Key Arguments considered by CBSL for its policy stance on 18th Aug-22

- ✓ Global economic growth is expected to slow at a faster pace.
- ✓ Domestic economic activity is expected to record a notable downturn.
- ✓ Despite heightened challenges, positive developments are observed in the external sector.
- ✓ Market interest rates have increased further in response to tight monetary and liquidity conditions.
- ✓ The pace of acceleration of inflation has moderated faster than expected.

“TRANSITIONING FROM HAWKISH TO DOVISH”

Economic activities in Sri Lanka have severely contracted during 2Q2022 to a GDP growth of -8.4%. Larger than expected slump in the economy is alarming for prompt remedial actions before it cascades to irrecoverable levels.

On the other hand, key economic variables such as forex rate, external sector activities, foreign activity as well as inflation that were dangerously heated during the heart of economic crisis have almost cooled off at a much more rapid rate than we expected and are positioned for a monetary stimulus to gear up the economy.

Accordingly, the gradual transformation of the monetary policy stance that FCR projected to effect over the next 3-6 months is now accelerated and, we transition our perspective from hawkish to dovish. Thus, we completely eliminate the possibility of a further monetary policy tightening while gradually increasing the probability of a monetary relaxation in the next 3-6 months.

Analysis of upcoming policy decision on 06th Oct

Arguments for a Monetary Relaxation

25%

The below-mentioned factors argue for a relaxation in policy rates at the upcoming policy meeting

- Continuous slump in domestic economic activities alarms a recession
- Higher foreign investor attraction towards local rupee debt
- Limited fluctuation in forex rates and external sector improvements
- Back-to-back dive in bill auction yields
- Moderation in MoM inflation, a possible negative growth in Oct-22

Arguments against Monetary Relaxation

75%

- Relentless tightening in global monetary policy
- Foreign reserves remained critically low
- A rate cut to amplify the negative real rate of return
- Persisting negative liquidity

The above-mentioned factors argue against a relaxation in policy rates

Arguments for relaxation in monetary policy

Continuous slump in domestic economic activities alarms a recession

SL economy further contracted by 8.4% in 2Q2022 recording negative growth across all major economic activities of Agriculture (-8.4%), Industrial (-10.0%) and Services (-2.2%). Two consecutive quarters of negative economic growth is considered as recession along with the other economic indicators such as private sector credit growth, which also reported a continuous month-on-month negative growth of LKR -40.3Bn in Jun-22, LKR -41.1Bn in Jul-22 and LKR -58.9 in Aug-22. Persistent contraction in credit to private sector risks the continuity of businesses leading to many possible bankruptcy events while also causing higher level of unemployment in the near term. Moreover, Business Confidence Index (BCI), an important corporate barometer, slipped by 5bps to 76 points in Sep-22 following a sharp upturn of 32bps to 81 points in Aug-22. Meanwhile, Asian Development Bank (ADB) has revised Sri Lanka’s economic growth outlook for 2022 to -8.8% from its previous growth of 2.4% estimated in Apr-22. Additionally, ADB revised its forecast for 2023 to -3.3% from its previous growth forecast of 2.5%. Therefore, immediate remedial actions in terms of monetary stimulus have become the need of the hour to prevent any further downfall in the economy.

Higher foreign investor attraction towards local rupee debt

The value of Treasury Bills and Bonds held by foreigners that was under LKR 5.0Bn for a prolonged period since Jun-21 has now witnessed regained interest after the Sri Lankan authorities reached an IMF staff-level agreement to support economic policies with a 48-month arrangement under the extended fund facility worth of USD 2.9Bn. Currently the government is in the process of initiating debt restructuring discussions with the bilateral creditors. Following the positive news, the value of Treasury Bills and Bonds held by foreigners increased by LKR 18.2Bn to LKR 22.2Bn during Sep-22 from LKR 4.0Bn recorded as at the end of Aug-22, showing signs of prospect in attracting foreign funds. Furthermore, equity market also attracted net foreign inflow of c. LKR 14.7Bn during the month of Sep-22. Developing macroeconomic stability coupled with eased off political and social unrest hinting the needlessness for further monetary tightness.

Arguments for relaxation in monetary policy

Limited fluctuation in forex rates and external sector improvements

Following the steep depreciation of LKR against USD during the 1H2022, the LKR/USD foreign exchange rate remained broadly stable since Jun-22 depreciating by only 0.6%. On the other hand, external sector performance for the first 7-months of the year displayed a notable improvement with gradual shrinking of the merchandise trade deficit. Cumulative earnings from exports displayed a notable growth of 12.9% during Jan-Jul 22 compared to the same period last year. Moreover, the impact of policy measures to curtail non-urgent imports aided in reducing the import bill continuously throughout the period. As a result, trade deficit declined to USD 3.6Bn during Jan-Jul 22 from USD 4.9Bn recorded in Jan-Jun 21. Continuous sourcing of financial assistance and improved forex liquidity retained the gross official reserves at USD 1.7Bn in Aug-22 compared to USD 1.8Bn in Jul-22, draining only USD 100.0Mn. Thus, given the developed stability in the external sector, CBSL may opt for a relaxation of the monetary policy in order to induce economic growth.

Back-to-back dive in bill auction yields

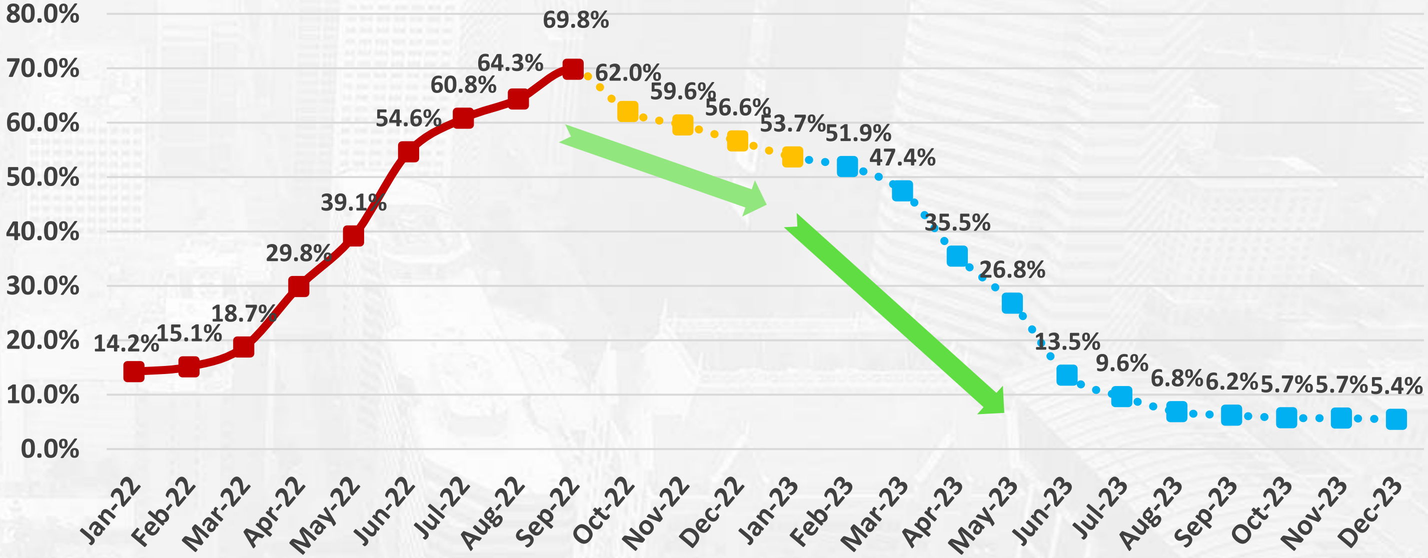
A gradual drop in weighted average yields was witnessed in all four Treasury Bill auctions held during the month of Sep-22 while secondary market yields followed suite. Accordingly, weighted average auction yields for 91 Days, 182 Days and 364 Days maturities dipped by 95bps, 69bps and 65bps, respectively. Similarly, short end of the secondary market yield curve nudged down by 150bps-300bps since the last monetary policy review announcement. Moreover, greater investor participation was also witnessed in the phase II of Treasury Bill auctions affirming the aligned market expectation with the downward momentum in yields while recording full or more than 95.0% acceptance in the last three auctions held in Sep-22 (14^{th}, 21^{st} and 28^{th} Sep) after four consecutive auctions in Aug-22 with partial acceptance. Therefore, anticipations of the market participants are leaning towards a monetary relaxation in response to the overreacted yields during the tighter monetary policy environment.

Arguments for relaxation in monetary policy

Moderation in MoM inflation, a possible negative growth in Oct-22

The ceaseless acceleration in inflation observed during 1H2022 came to a slower pace since Jul-22 reducing the percentage change in MoM inflation measured by the CCPI. Index value for both food and non-food inflation increased at a lower magnitude with a possibility of a decline in inflation for the month of Oct-22. Moreover, as the demand pushed inflation is restrained via tighter monetary and fiscal policies, cost push inflation is also expected to moderate in the near term owing to the looming global recessionary outlook with the expected normalization of global food and non-food commodity prices, thereby vanquishing the supply shortages while reducing cost. Accordingly, as the demand pushed inflation is at its minimum, monetary stimulus via a relaxation of the policy is not projected to distort the inflation outlook of the country.

FCR forecast a marginal dip in inflation in 2022E while illustrating a sharp dip towards 2Q2023E

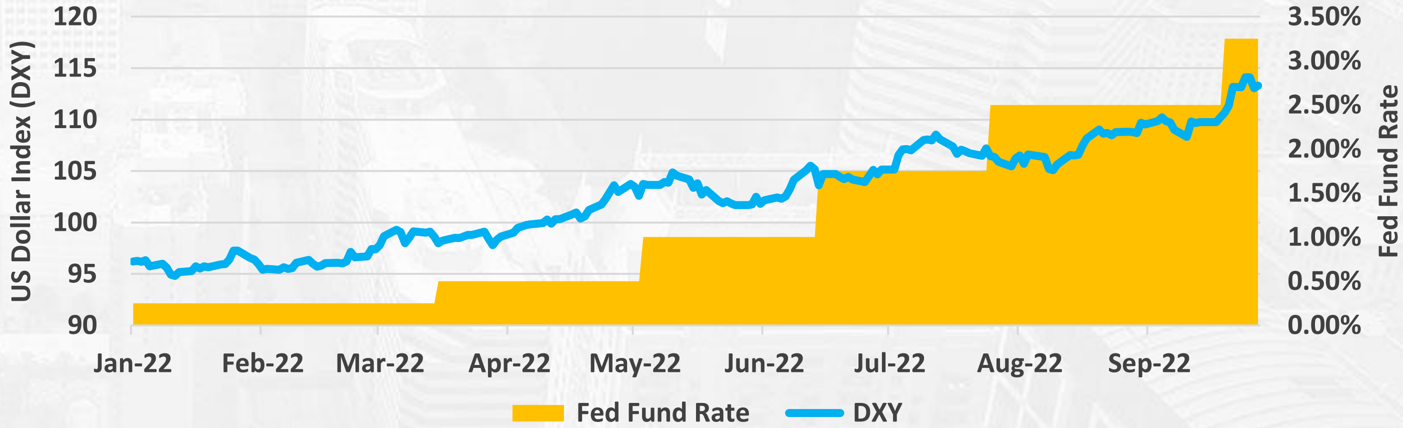


Source: Department of Census and Statistics, FCR Estimates

Arguments *against relaxation* in monetary policy

Relentless tightening in global monetary policy

Despite myriads of recessionary hints, central banks around the world speed up the monetary policy tightening actions to dampen the buoyant demand in order to curtail the soaring inflation. Accordingly, Federal Reserve hiked the fed fund rate by 0.75% in Sep-22 for the fifth consecutive time since its first rate hike for the year in Mar-22 when the benchmark fed fund rate was hovering around 0.0%-0.25%. Since then, the Fed raised rates by 300bps to a range of 3.00%-3.25% as a measure of combating the stubbornly high level of inflation in US. Federal Reserve Chair Jerome Powell signals further hawkish stance as they expect to keep up the battle to beat down the inflation to its desired levels. Moreover, Bank of England also raised its base rate by 50bps to 2.25% in Sep-22 and it is widely expected that further rate hikes are likely in the near future. Other nations such as, Philippines, Indonesia and Taiwan also hiked their policy rates during Sep-22. Accordingly, a monetary relaxation by CBSL may showcase as an outlier that move against the flow. Furthermore, despite weakening of other major currencies, USD strengthened by c. 18.0% in 2022 owing to the continuous monetary policy tightening which resulted in 'flight to safety' and 'home bias' by most of the global investors. Therefore, decline in interest rates via a monetary relaxation might lose SL's attractiveness as a high yield investment destination, resulting low inflow of foreign funds.



Source: investing.com, FOMC Meeting Minutes

Arguments against relaxation in monetary policy

Foreign reserves remained critically low

Despite lightened MoM drain, Official Reserve Assets are still at a critical juncture as out of the reported value of USD 1.7Bn, the usable reserves are limited to a negligeable number while approx. USD 1.5Bn is representing the swap line from the People's Bank of China, which cannot be used to finance imports. Given the delayed IMF staff level agreement and the major difficulties that are yet to encounter in bringing all the creditors into the discussion tables on debt restructuring, may further delay the IMF board level approval and securing of the stated financial assistance. Therefore, monetary relaxation by CBSL at this stage may have a detrimental effect on the already diminished foreign reserves.

A rate cut to amplify the negative real rate of return

In the midst of high inflationary environment, a policy rate cut may result in a reduction in real interest rates, thereby reducing the real rate of return on investment which is already in the negative territory for a prolonged period of time. At current levels, investment in 1Yr Treasury Bill yields 29.85% (weighted average auction yield) while the inflation measured by CCPI hovers around 69.80% leading to a real return of -39.95% which is deeply in loss compared to the nominal rate of return. Investors may get discouraged in the short term due to insufficient compensation for the risk they undertake, thereby further depressing savings and investment in the short term until inflation falls to desirable levels.

Persisting negative liquidity

Market liquidity remained deeply negative and continued to deteriorate since Oct-21 despite a marginal improvement since Feb-22 yet residing below LKR -400.0Bn levels. Therefore, in an environment with persistent negative domestic liquidity and perpetual rising of CBSL holdings of Government Securities, it may not be conducive for a monetary relaxation given its negative impact on the market liquidity. The returning of significant flow of funds to the banking system that was witnessed as a consequence of high deposit interest rates may get drained due to change of investor sentiment in a declining interest rate environment.

Factors of concern at the policy review

Inflation
CCPI 69.8% for Sep-22

Foreign Reserves
USD 1.7Bn by Aug-22

GDP Growth
-8.4% in 2Q2022

03M T-Bill rate
31.94% as of 28.09.22

Private Credit
LKR -58.9Bn for Aug-22

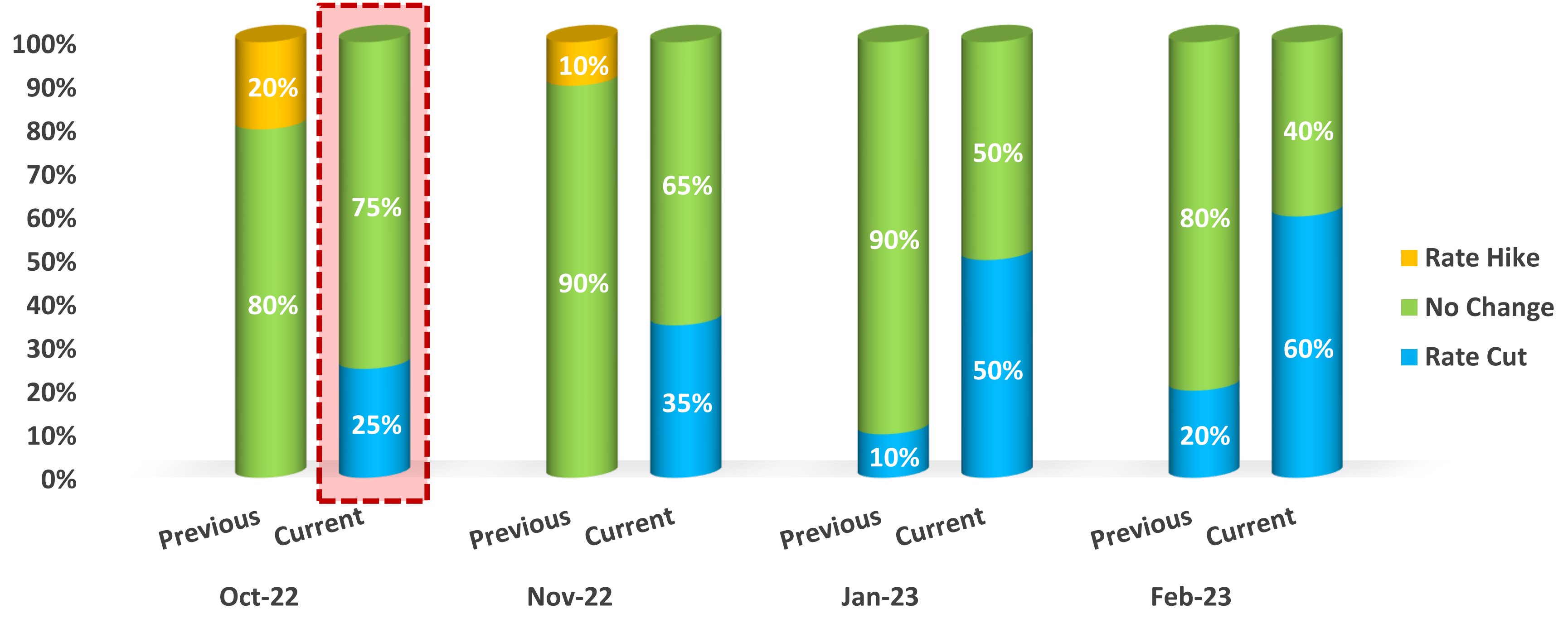
Liquidity and CBSL Holdings
LKR -433.5Bn and LKR 2.3Tn

BOT and BOP
USD -3.6Bn and USD -3.0Bn
for Jan-Jul 22

FCR Policy Rate Forecast (Oct-22 to Feb-23)

We believe that CBSL may consider maintaining the monetary policy rates at its current levels in the upcoming policy review meeting allowing a soft landing from its hawkish to dovish stance. However, given the necessity to provide monetary stimulus to prevent further weakening of the economy and the notable improvement in majority of the key economic indicators, we have assigned a lower probability for a relaxation in the monetary policy to alleviate the overreacted interest rates in the tighter monetary environment. Thereby we have assigned a probability of 75% for rates to remain unchanged at the upcoming policy review while also assigning a 25% probability for a relaxation in policy rates.

However, considering the positive outlook over the next 6-12 months, we expect a complete normalization of the economy with the country being able to secure necessary financing from IMF and other multilateral creditors while regaining its access to the global capital market. Thus, the complete stabilization of economic indicators may give rise to a possibility of sizeable rate cuts towards 1Q2023 with a significant probability to fast track the revival of the economy



We expect 75% probability for rates to remain unchanged with a 25% probability for a relaxation in policy rates.

Expected Monetary Policy Stance

As per our view, at the upcoming policy meeting, **there is a high possibility for CBSL to maintain the rates at its current levels** allowing further strengthening of key economic indicators, along with **a lower probability for a dovish stance to relax its policy rates** in order to prevent a major economic downturn as well as to signal the market participants a clear direction on the way ahead. As a result, we assigned a major probability of 75% to maintain the rates while also assigning a lower probability of 25% towards a monetary relaxation. Moreover, considering the persistent negative liquidity in the banking system, we assigned a lower probability of 15% for a 50bps cut in the SRR while placing majority bets on the SRR to remain unchanged.

Expected Monetary Policy Stance	Probability
Raising Policy Rates by 100bps	0%
Raising Policy Rates by 50bps	0%
Policy Rates to remain unchanged	**75%**
Cutting Policy Rates by 25bps	**20%**
Cutting Policy Rates by 50bps	**5%**

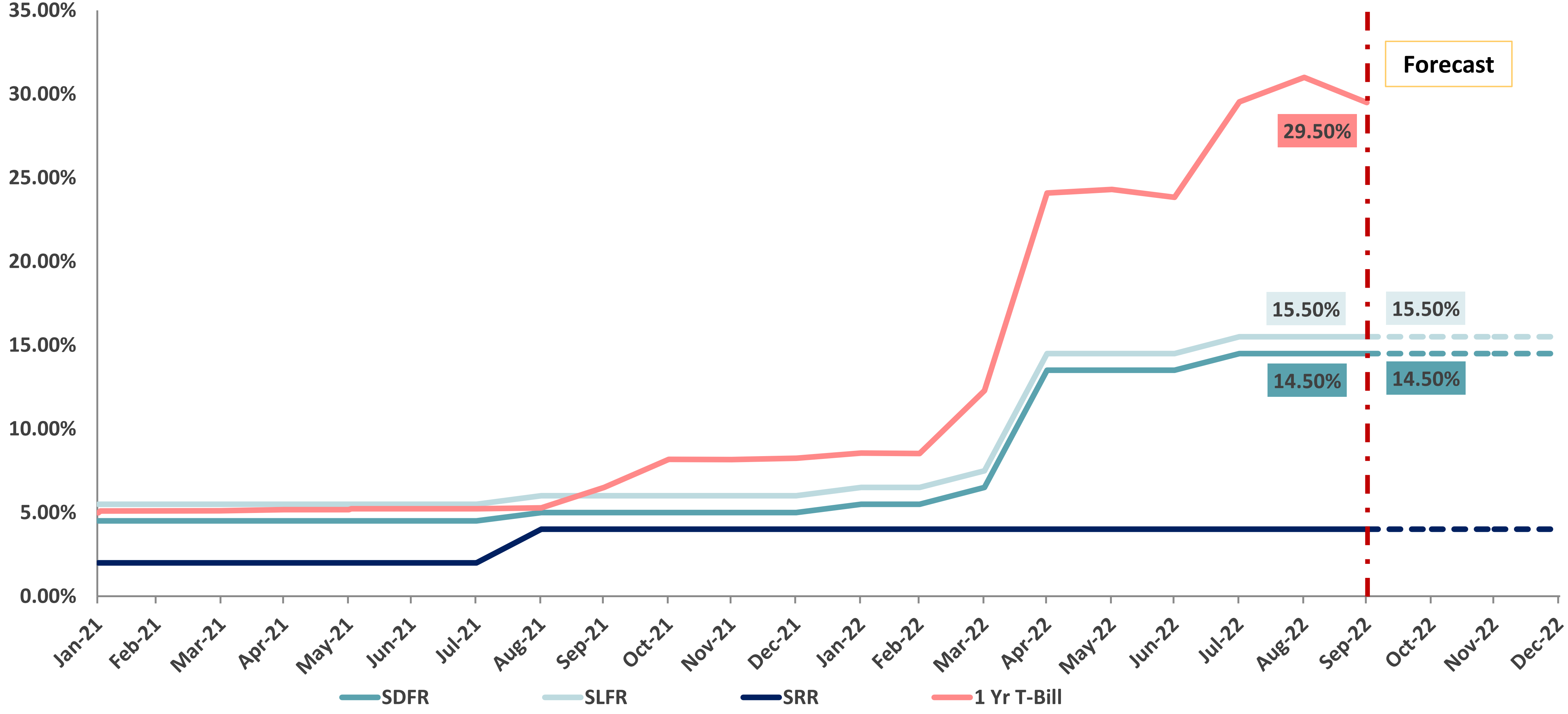
25%

We believe that there is 75% probability to maintain the rates at its current levels to further promote the stability of the key economic indicators.

Expected Stance on SRR	Probability
Raising SRR by 100bps	0%
Raising SRR by 50bps	0%
SRR to remain unchanged	**85%**
Cutting SRR by 50bps	**15%**
Cutting SRR by 100bps	0%

Considering the increase of SRR by 200bps to 4% in 19th Aug 2021 we expect SRR to remain unchanged at same levels despite a lower probability of a SRR cut.

Monetary Policy Rates



Source: CBSL, First Capital Research Estimates

Disclaimer

Thank you!

"SUCCESSFUL INVESTMENTS IS ABOUT MANAGING RISKS"

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