



Resurgence on track

Investment Strategy 2023 | Feb 2023 | SRI LANKA



First Capital
A Janashakthi Group Company

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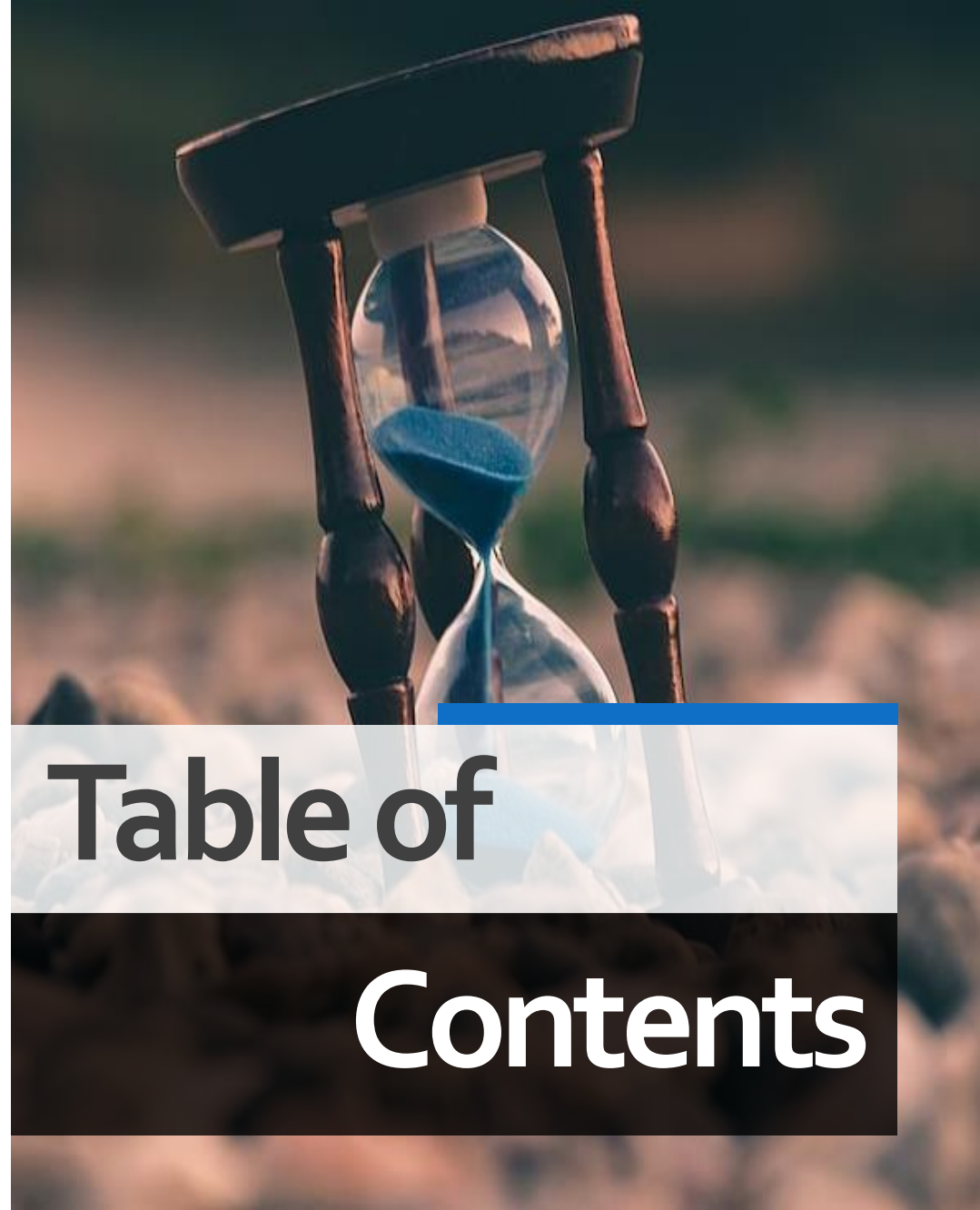


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EXECUTIVE SUMMARY



Bond yields to moderate during 1H2023E

- Bond yields are expected to moderate in 1Q2023E and gradually witness a decline as Govt. secures the IMF Board Level approval and inflation tames down. However, political stability and ability to enter an IMF support facility are key TRIGGER POINTS that will impact the market sentiment. Further during 2H2023 despite positive developments, there could be speculation on domestic debt restructuring that may push yields higher temporarily.

AWPR to reverse in 1H2023E

- We expect AWPR to follow the yield of 5Yr bond thus reverse towards 23.0%-25.0% by Jun-23 and further dip to 18.0%-20.0% by Dec-23.

Exchange Rate is likely to be stable throughout 2023E with possible marginal depreciation amidst trade relaxation

- With the potential inflows following IMF, CBSL is likely to use the opportunity to buy USD to build reserves while trade relaxation may result in the currency marginally weakening over 2H2023E. We narrowed our exchange rate target for Jun-23 to LKE 350.0-390.0 while targeting LKR 345-405.0 for Dec-23

ASPI to reach 12,000 by Dec-23E, raise equity exposure to 65%

- On expectation of a strong recovery in earnings and positive growth levels of GDP returning from 4Q2023 and beyond, it is likely create a strong bullish sentiment for equities. We expect market to re-rate allowing the index to showcase strong positive returns in 2H2023E with the index likely to reach 12,000.

A close-up photograph of a hand in a blue shirt moving a white chess king piece on a chessboard. The board has alternating light and dark squares, and several other pieces are visible in the background.

Track Record

[Jan 2022 & Sep 2022]

Section 1.0

First Capital Levels of Accuracy

- 81% - 100% accuracy - Accurate
- 61% - 80% accuracy - Mostly Accurate
- 41% - 60% accuracy - Partly Accurate
- 20% - 40% accuracy - Weak Accuracy
- 00% - 20% accuracy - Inaccurate

Previous Forecasts of Economic Indicators

Forecast: **Accurate**



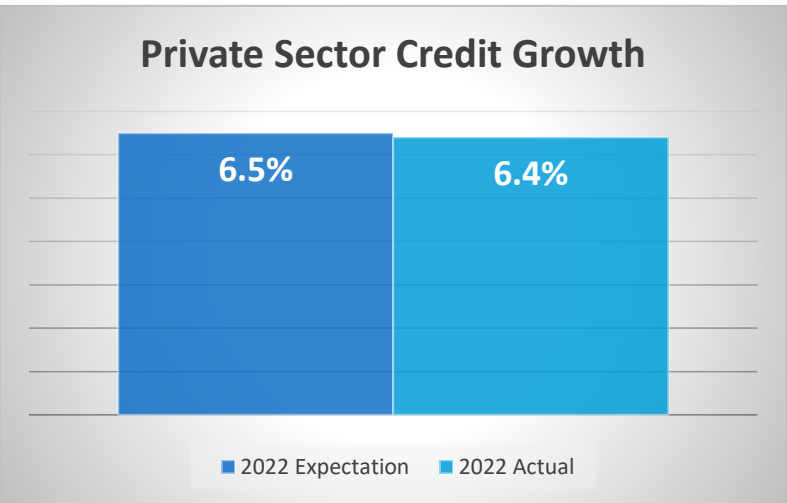
Forecast: **Accurate**



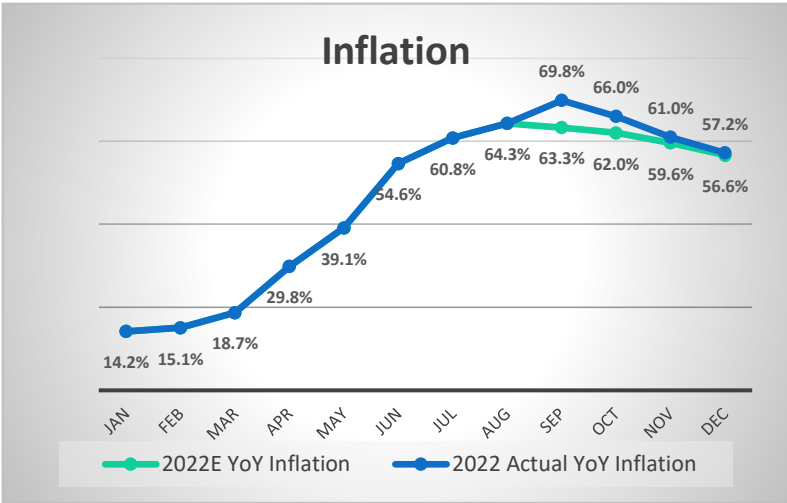
Forecast: **Accurate**



Forecast: **Accurate**



Forecast: **Accurate**



Forecast: **Accurate**



Previous Recommendations - Bonds

24th Jan 2022 [Investment Strategy 2022 Report]

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

Mostly Accurate

Yields rise beyond our worse case scenario amidst political turmoil

21st Sep 2022 [Mid-Year Outlook 2022 Report]

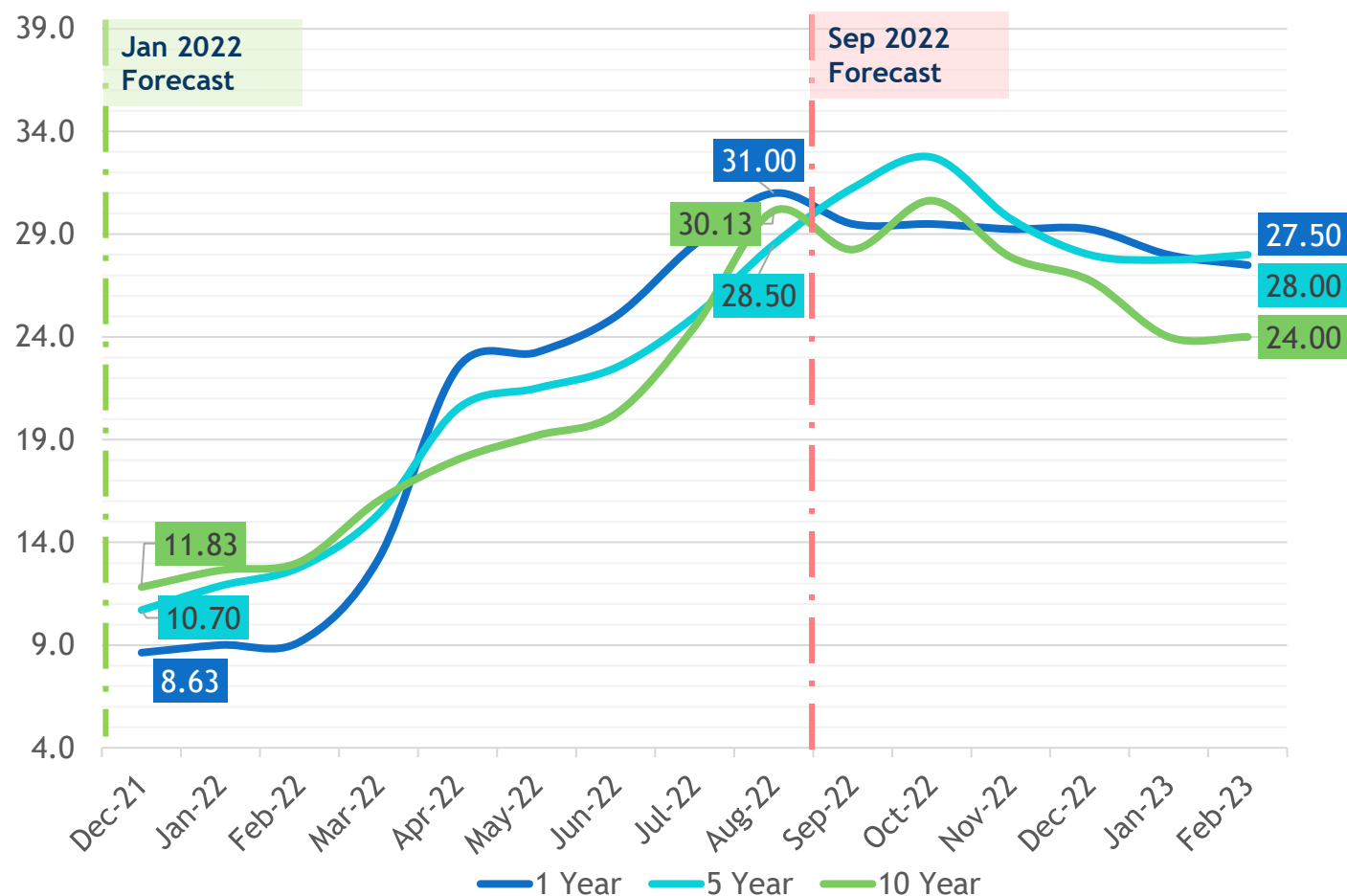
“Bond yields are expected to moderate in 4Q2022E and gradually witness a decline as political instability resolves and as Govt. secures an IMF Board Level agreement.”

Mostly Accurate

Delay in IMF stalls downward trend of Short-Mid tenor yields

Bonds – Jan-22 & Sep-22 Re cap: Mostly Accurate

Bond yields are expected to moderate in 4Q2022E and gradually witness a decline as political instability resolves and as Govt. secures an IMF Board Level agreement



Source: First Capital Research

10Y - YTD 1830 bps ↑
5Y - YTD 1780 bps ↑
1Y - YTD 2237 bps ↑

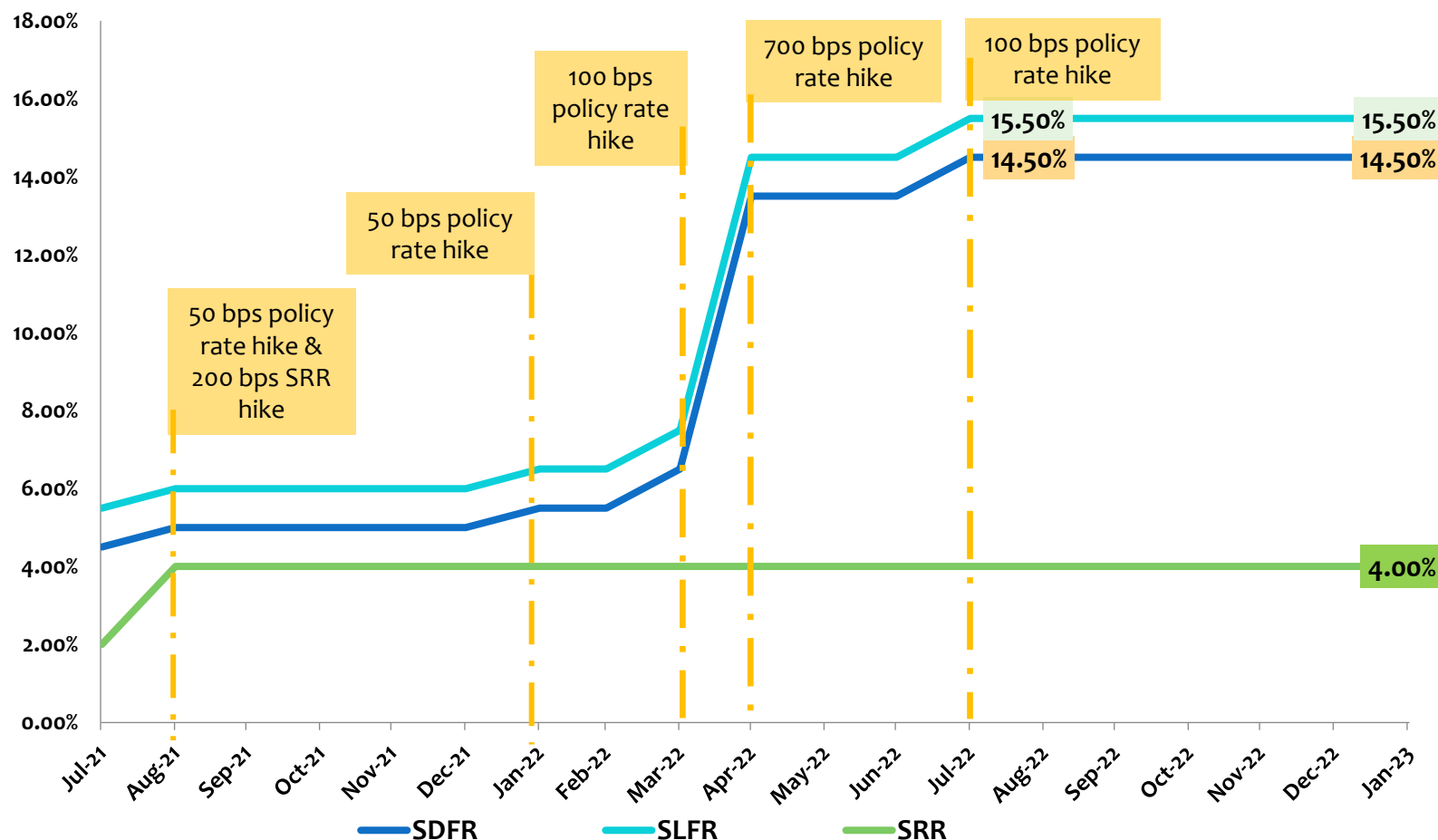
8 Months 2022
Jan - Aug

1Y - YTD 350 bps ↓
5Y - YTD 50 bps ↓
10Y - YTD 613 bps ↓

5 Months 2022
Sep - Jan

Policy Rates – Apr-22 & Sep-22 Re cap: Accurate

Policy rates to remain unchanged and trend downwards from 2Q2023 onwards

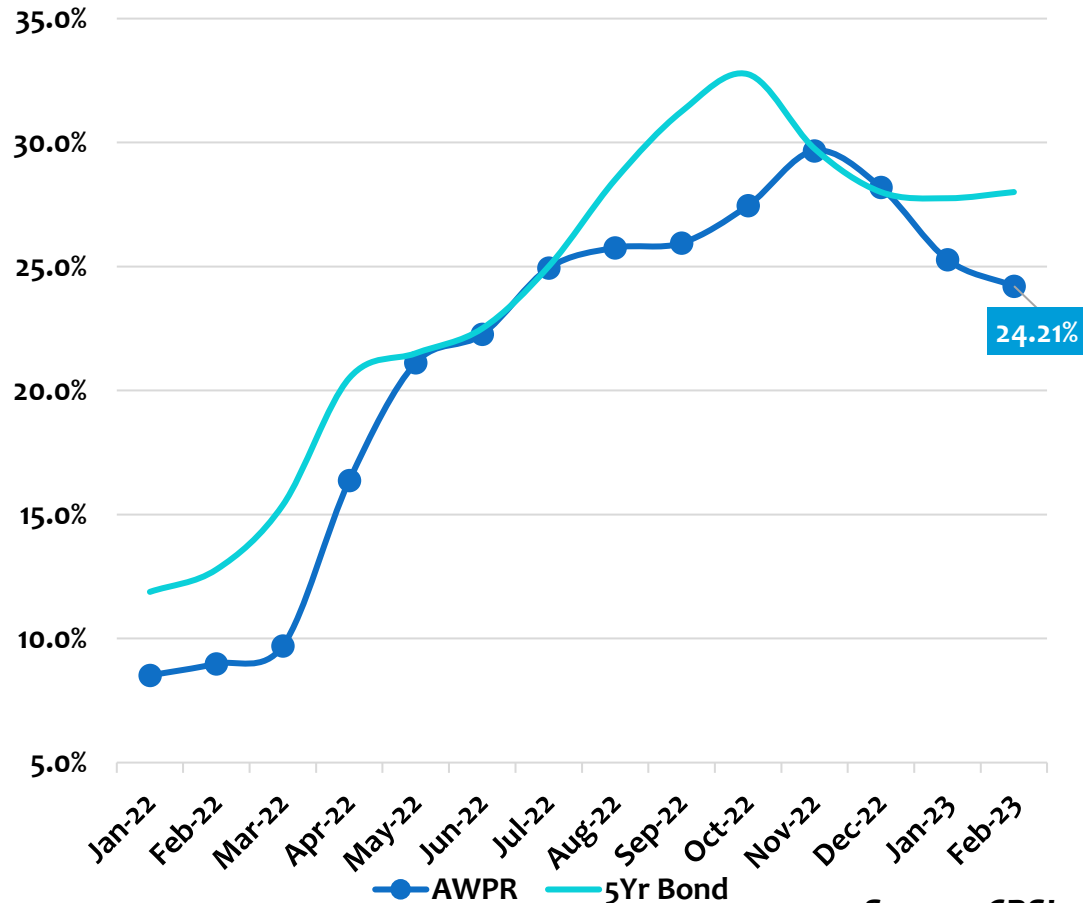


Policy Rates remain stable post Jul-22

Expectations were accurate with 2H2022 post Jul-22 rates been maintained stable. In Jan-22 as well most accurate in the number of hikes (5) in 2022, but the Jan-22 expectation was for around 450bps (100bps in 2021, 350bps 2022), as against the increase of 1,000bps which was witnessed. However, we renewed our forecast with the change of the Governor ahead of the individual policy meetings which have been proved to be accurate throughout the year.

Bank Rates – Jan-22 & Sep-22 Re cap: Accurate

AWPR to follow the yield of 5Yr bond thus hover in the range of 25.0%-30.0% by Dec-22 and reverse towards 21.0%-23.0% towards Jun-23



Source: CBSL

Jan 2022
Expectation

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

Mostly Accurate

AWPR moved exactly in line with 5-Yr Bond, but as bond yields overshot expectations AWPR also moved beyond expectations

Apr 2022
Expectation

We expect AWPR to follow a similar suit with an accelerated pace and to reach 16.0%-18.0% by Jun-22

Mostly Accurate

AWPR moved exactly in line with 5-Yr Bond, but as bond yields overshot expectations AWPR also moved beyond expectations

Sep 2022
Expectation

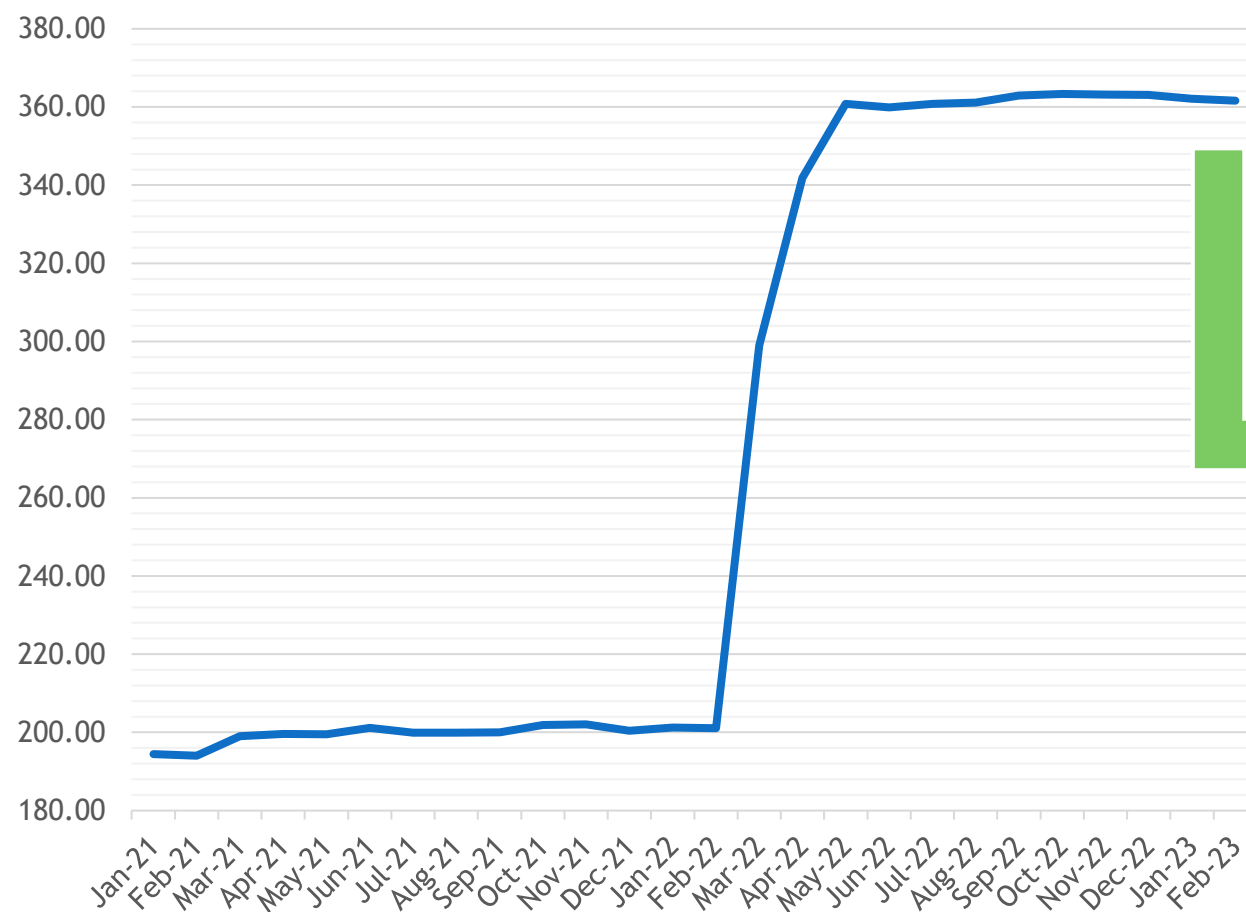
AWPR to follow the yield of 5Yr bond thus hover in the range of 25.0%-30.0% by Dec-22 and reverse towards 21.0%-23.0% towards Jun-23

Accurate

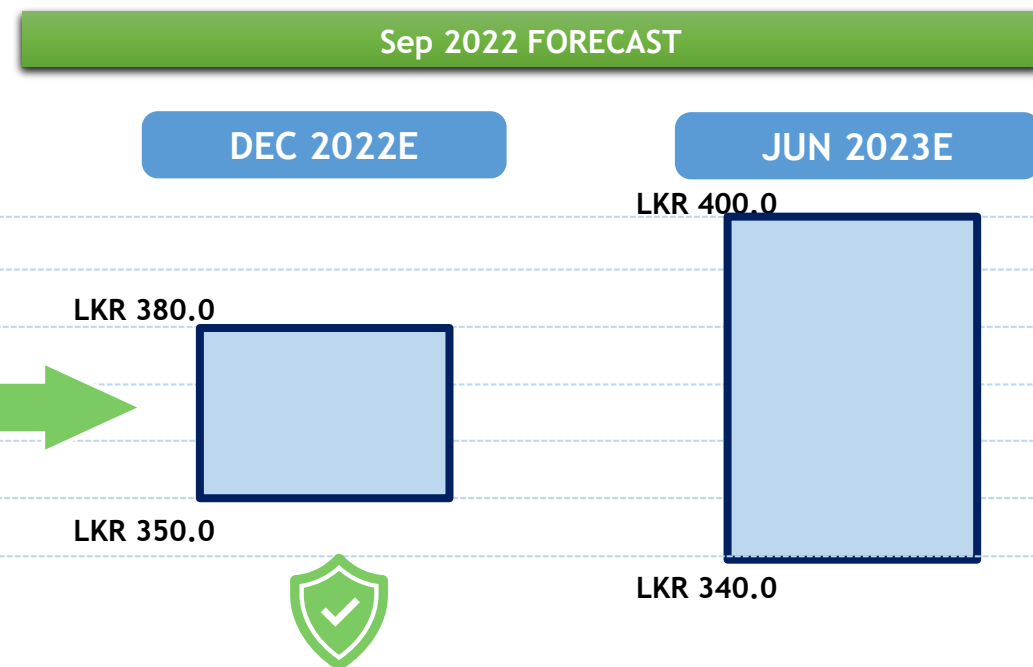
AWPR did not move as high as the bond yields started to dip early slightly ahead of the bond yields

Exchange Rate – Jan-22 & Sep-22 Re cap: Accurate

Exchange Rate is likely to be stable throughout 2022E & 2023E with possible marginal depreciation amidst trade relaxation



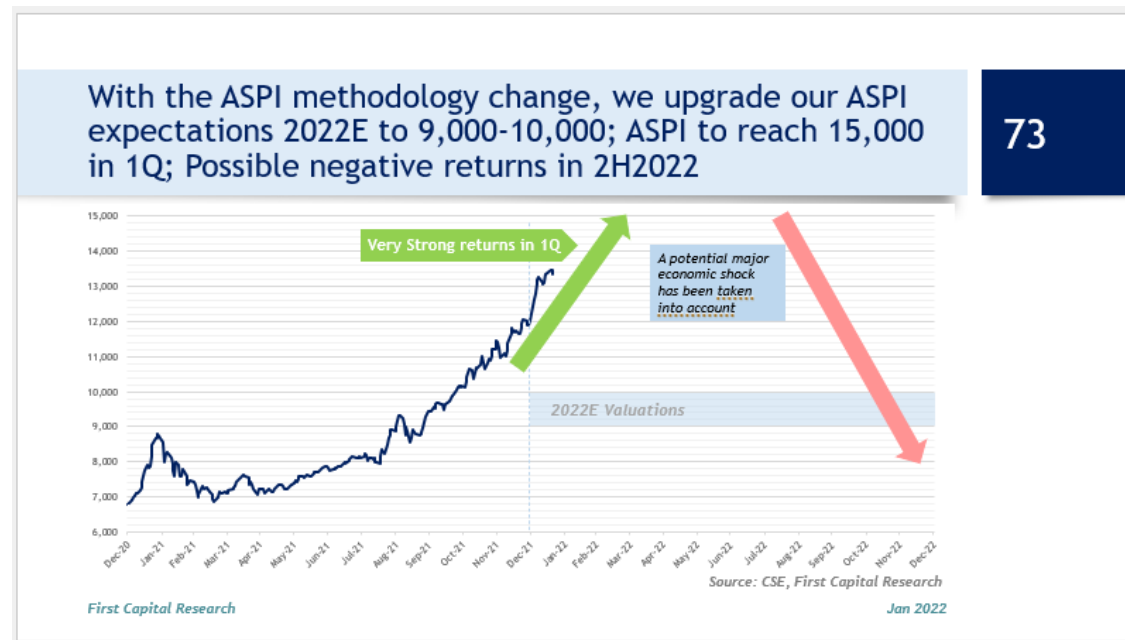
Previous Recommendations



Equity – Jan-22 & Sep-22 Re cap: Accurate

Reduce Equity Allocation by 75% (Jan-22), 90% (Mar-22) & increase to 50% in Apr-Sep 22; Volatile uptrend in the index

Jan 2022 Expectations



ASPI reverses to the red around 13,500; Negative returns were recorded 6 months ahead of expectations

Equity allocation accurately decreased to reach 10% by Mar-22, again gradually increased to Apr-22



Source: CSE, First Capital Research

A close-up photograph of a hand in a blue shirt moving a white chess king piece on a chessboard. The board has alternating light and dark squares, and several other chess pieces are visible in the background and foreground, some in focus and some blurred. The lighting is warm, with a soft glow on the hand and the piece being moved.

Key Elements of consideration *for Investment Strategy 2023*

Section 2.0

Potential IMF program draws closer...

Sri Lanka has gone through a turbulent 2022 and is stepping into 2023 on the verge of a potential IMF support program.

First Capital believes that attaining the required financial assurances and entering into an IMF program is key for Sri Lanka's revival while a well-planned reform program will ensure acceleration in the recovery trajectory.

At this juncture, Sri Lanka stands with high level of hope with Sri Lanka so far moving on track of a possible RESURGENCE in the economy! A Resurgence creates a wide range of opportunities for investors over the next 12 months period.

But many steps to be kept in the right direction...

Resurgence on track



Key Elements

External

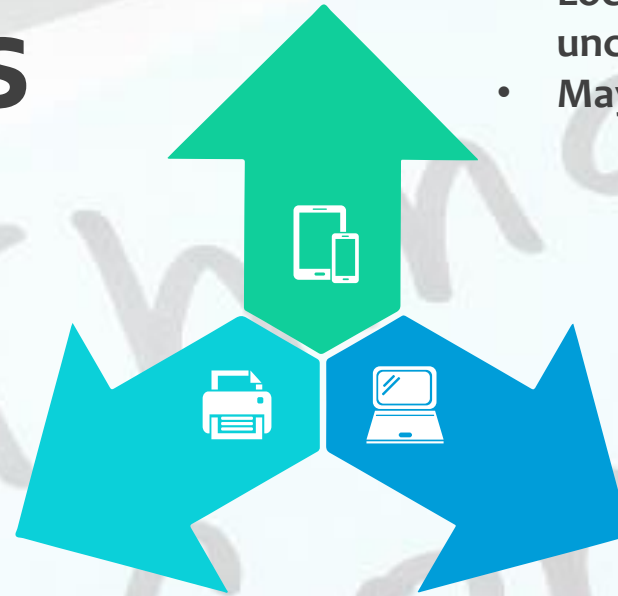
- Possible rating upgrade post debt restructuring
- Bridging Finance opportunities
- Stable Rupee
- Global Recession & Fund Flow

Political

- Local Government Elections to create uncertainty
- May ensure full term of Government & President

Economical

- GDP may turn positive in 4Q2023
- IMF Support Program
- Inflation to plunge
- The Debt Struggle
- Liquidity at lower positive territory
- Credit contracts, but may turn positive in 2H



A close-up photograph of a hand in a blue suit sleeve moving a white chess king piece on a chessboard. The board has alternating light and dark squares, and several other chess pieces are visible in the background and foreground, some in focus and some blurred. The lighting is warm and slightly dim.

Elections may disturb policy stability

*Maintain **Medium-High Risk***

Section 3.0

First Capital accurately predicts elections in 1H2023

In Jan 2022, First Capital accurately predicted that local government elections that was supposed to be held in Feb 2022 are likely to be postponed by 1 Year.


Also, since it was not legally possible to further postpone the election, we forecasted that elections are likely to be held in 1H2023.

The elections commissioner previously announced the date of the Local Government elections to be 9th Mar 2023, but currently has delayed the election due to lack of funds to print ballot papers.

However, we continue to maintain the stance that elections are likely to be held during 1H2023.

But elections are unavoidable in 1H2023E creating volatility

What Does 2023 hold?
Local Government Elections or General Elections



- First Capital in Jan 2022 (Investments Strategy) accurately predicted that local government elections supposed to be held in Feb 2022 are likely to be postponed by 1 Year.
- Legally the local Government elections cannot be postponed any further and is announced to be held before 20th Mar 2023. The Government and President may prefer General Elections over Local Government elections as any election may have perception bearing on the other.
- If General Elections are held first, it will create necessary trend for the local government elections as well.
- HOWEVER, IN THE CURRENT CLIMATE IT IS DOUBTFUL WHETHER ANY PARTY WOULD SECURE SUFFICIENT MAJORITY TO FORM A GOVERNMENT!!!

SJB ENDORSES G.L.'S DEMAND FOR A GENERAL ELECTION

- A general election should be held in March next year as soon as constitutional barriers for the President to call for an election ends
- SLPP Chairman G. L. Peiris himself has called for a general election whenever it is possible and also local government elections should be held immediately

YUNANI PERERA AND ANITH SENEVIRATNA
Endorsing the request made by MP Professor G.L. Peiris for an election, Samangi Jana Balawegaya (SJB) MP Dr. Harsha de Silva yesterday said a general election should be held in March next year as soon as constitutional barriers for the President to call for an election ends. Some of the proposals in the interim budget are ones which we also made in the past, but one wonders whether President Ranil Wickremesinghe is able to implement these proposals.

SEE BEST OF THE STORY ON p.12 >>>

Political Outlook: Downgraded to **Medium-High Risk**

First Capital Research

First Capital

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Elections may create policy uncertainty



- Though the Local Government elections has no bearing on the Parliament or the President, the results of the election may create policy uncertainty.
- There is a tendency that election results may be mixed with no party obtaining a clear majority. The ruling party obtaining a weaker voter base is sufficient to create uncertainty on the political front.
- However, there is a high probability that the Government and the President may desire to govern for their full term instead of going for elections which may create some amount of stability, provided the Government can retain the relevant no. of MPs intact.
- Presidential election is next in line in just over 18 months (in Nov 2024)

Political Outlook: Maintain *Medium-High Risk*

A close-up photograph of a hand in a blue suit sleeve moving a white chess king piece on a chessboard. The board has alternating light and dark squares, and several other chess pieces are visible in the background.

Economic recovery intact; But role of IMF critical

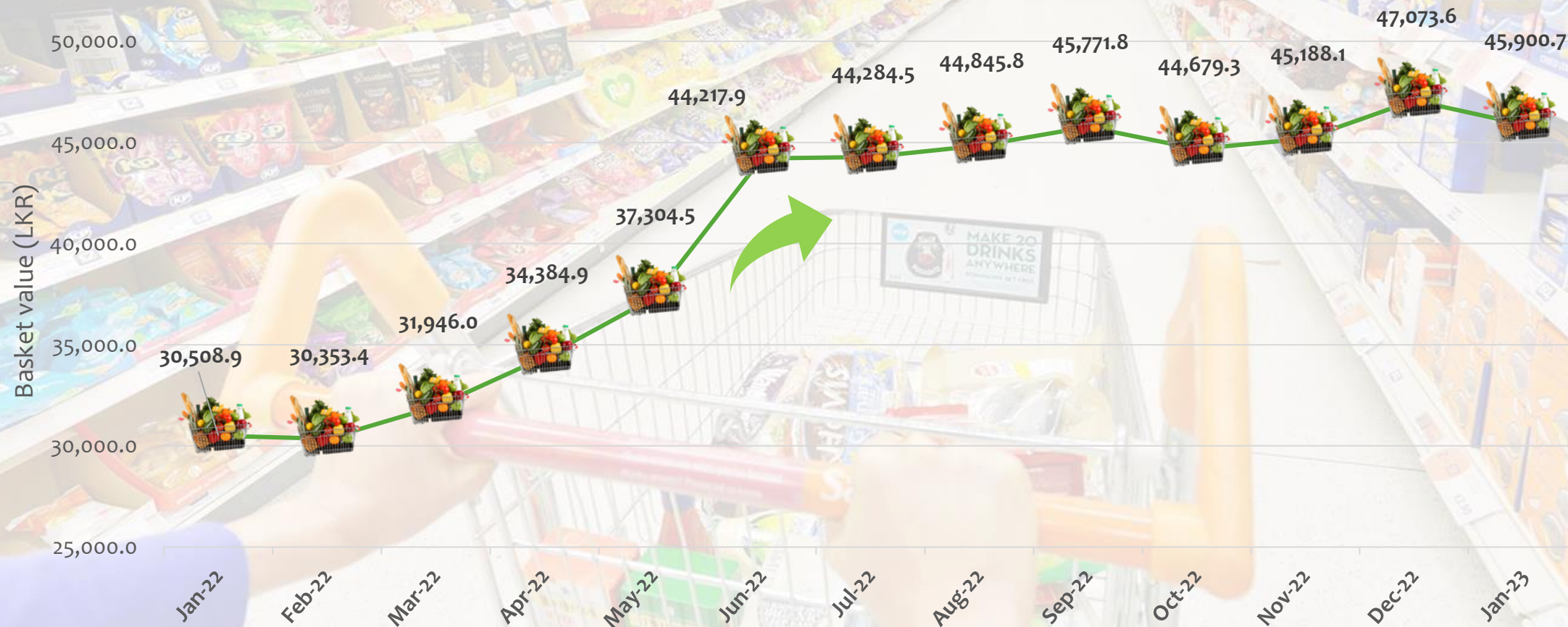
*Maintain **Medium-High Risk***

Section 4.0

Food Inflation stabilizes...

First Capital Food Basket indicated signs of stabilization in food inflation

First Capital Food Basket



Source: First Capital Research

...but as expected Govt implements another electricity hike potentially resulting in a higher impact on the non-food segment...



ELECTRICITY TARIFF REVISION (FIXED CHARGE)					
Units	Unit Per Price				
	Previous (Rs.)	New (Rs.)	% Increase	PUCSL Suggested Fixed Rate (Rs.)	% Increase
0- 30	120	400	233%	140	17%
31- 60	240	550	129%	280	17%
61- 90	360	650	81%	420	17%
91- 120	960	1,500	56%	1,000	4%
121- 180	960	1,500	56%	1,100	15%
Over 180	1,500	2,000	33%	1,800	20%

Sources: CEB, PUCSL

Daily GraphicsDesk

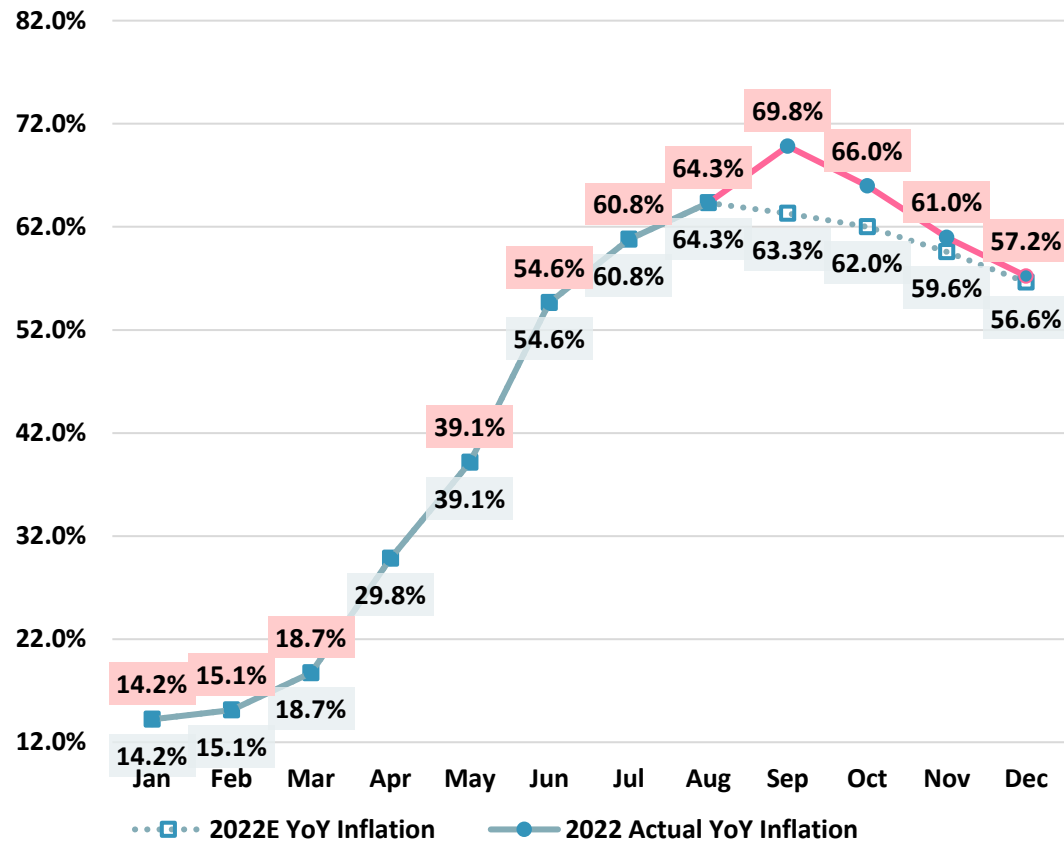


ADA
derana

...despite the shock inflation may continue to die down

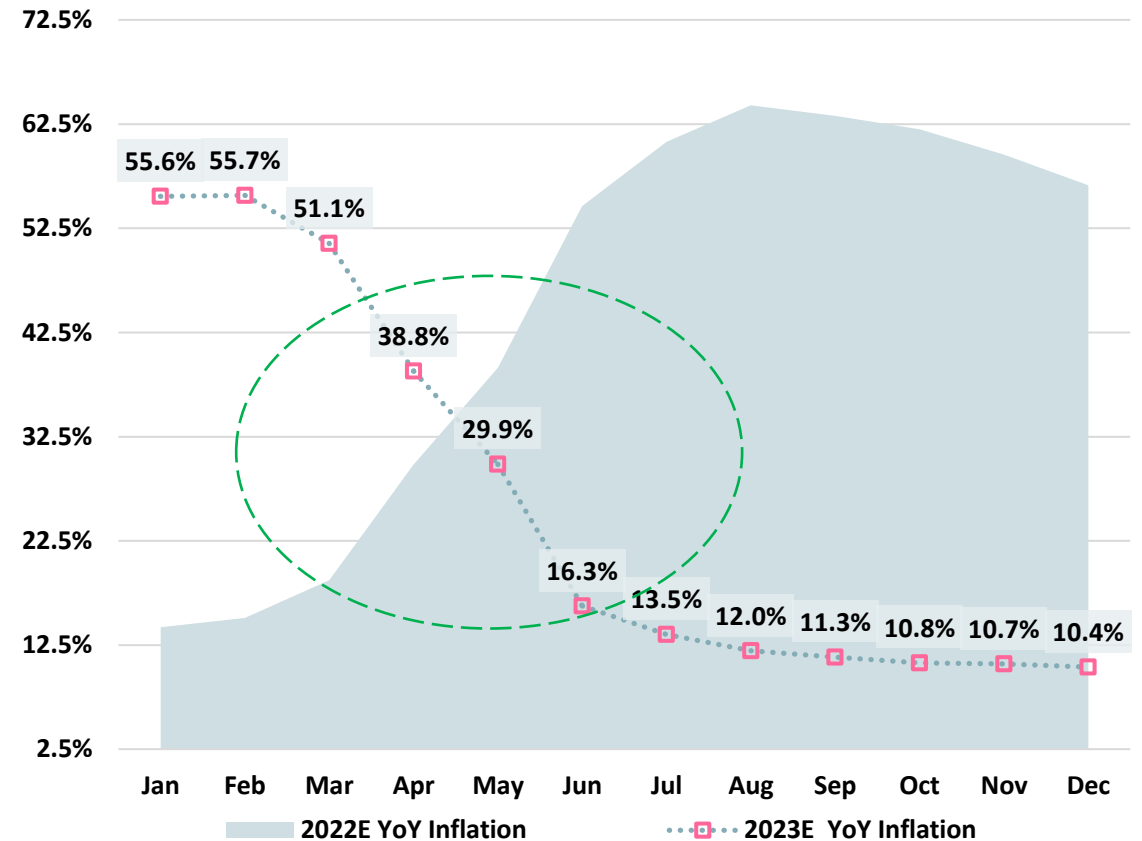
Steep dip in inflation is expected in 2Q2023 amidst the higher base effect on inflation

Inflation dips in line with FCR expectations



Source: Dept. Census and Statistics, First Capital Research

A steep dip in inflation is anticipated during 2Q2023



Source: Dept. Census and Statistics, First Capital Research



*“Inflation, taxation drags
down private sector
consumption”*

GDP growth to turn positive in 2024E

We maintain our GDP growth expectations from our Sep-22 Report (Mid-Year Outlook). Hyper inflation, monetary tightening with surge in interest rates and higher taxation has led to a plunge in private sector consumption which may not recover until the 2H2023. Despite a gradual recovery from 2H2023 onwards a positive GDP growth supported by private sector consumption is likely only by 4Q2023.

(-9.0%) - (-12.0%)



2022E

(-4.0%) - (-6.0%)



2023E

2024E



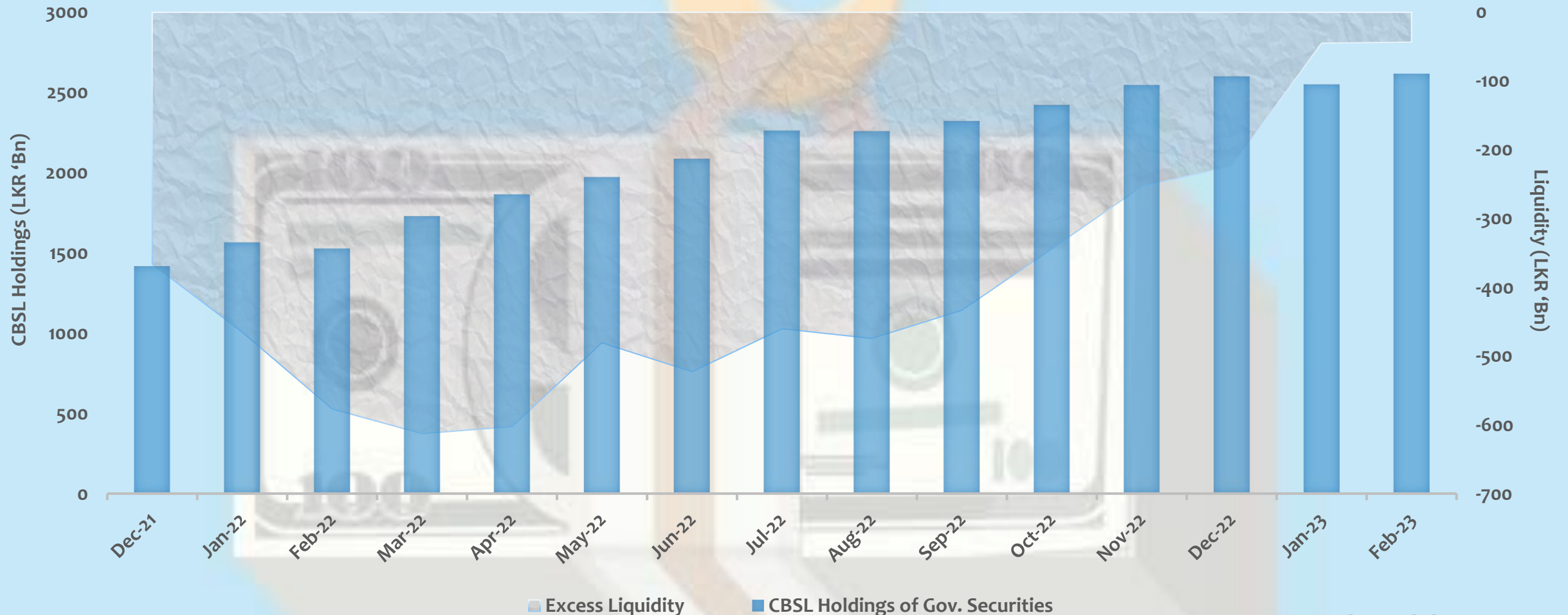
+4.0% - +5.0%



Source: First Capital Research

CBSL pumps liquidity into the system...

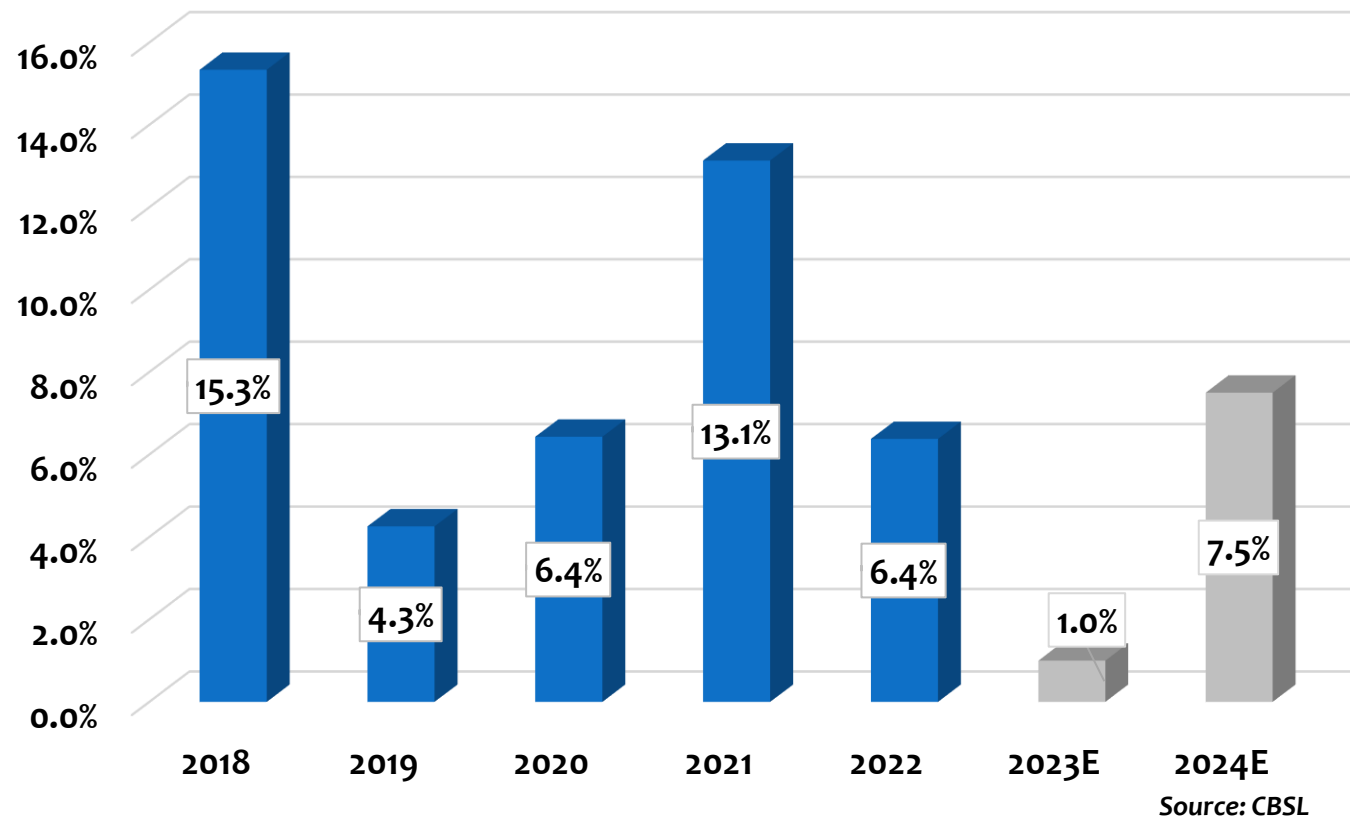
CBSL Holdings has currently stabilized to a level of just over LKR 2.5Tn highest value in its history



Source: CBSL

...But credit may contract in line with GDP, and recover towards 2H2023

Private sector credit may remain broadly flat (marginal 1% growth), but recover to 7.5% amidst the recovery in GDP in 2024E



Government incorporates massive tax increases across the board...

Unified Tax Rate

At **30%** from the standard rate of 24%

The **capital gain Tax rate** applicable on the realization of investment assets by the companies **increased to 30%**

Personal Tax base Broadening

Personal Relief (per annum)
From **LKR 3.0Mn to LKR 1.2Mn**

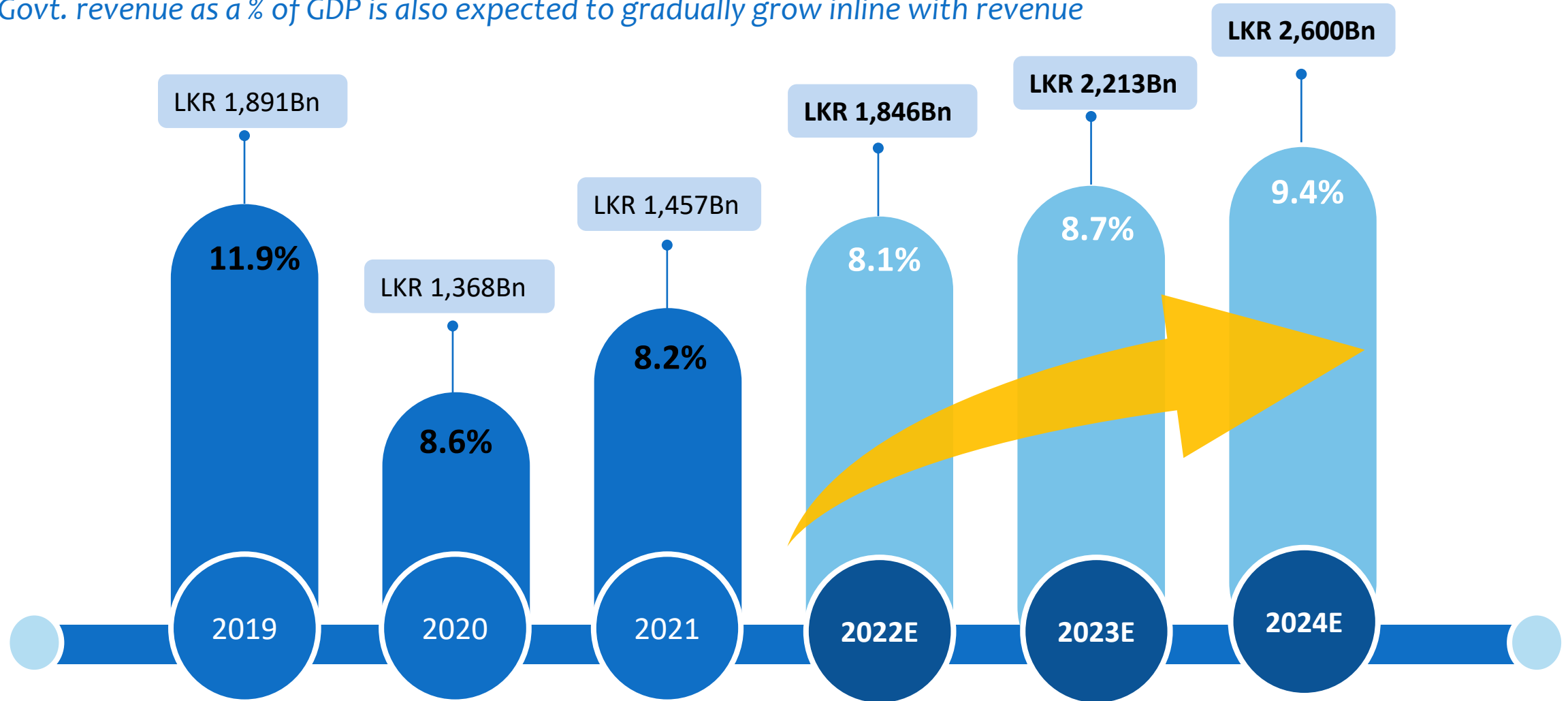
Source: Ministry of Finance



		2018-2019	2020-2022	Effective from 01.01.2023
Standard		28%	24%	30%
Concessionary	SMEs	14%	14%	30%
	Exports (Goods)	14%	14%	30%
	IT	14%	0	30%
	Agro-processing	28%	14%	30%
	Education	14%	14%	30%
	Tourism	14%	14%	30%
	Construction	28%	14%	30%
Health care		28%	14%	30%
Manufacturing		28%	18%	30%
High (Liquor, tobacco, betting and gaming)		40%	40%	40%

...potentially improving Govt. Revenue...

Govt. revenue as a % of GDP is also expected to gradually grow inline with revenue



* % - As a percentage of GDP

Source: CBSL, First Capital Research

...positively impacting Budget deficit

But budget deficit continues to remain high compared to peer economies!

OVERALL BUDGET DEFICIT IN SRI LANKA *(Net Domestic and Foreign Financing)*

2021 (Actual) LKR -2,058Bn (-11.6%)

2022E LKR -2,479Bn (-11.0%)






2023E LKR -2,027Bn (-8.0%)

2024E LKR -1,407Bn (-5.1%)

9M2021 LKR -1,328.2Bn (-7.9%)

9M2022 LKR -1,244.4Bn (-5.2%)

YoY
+6.3%

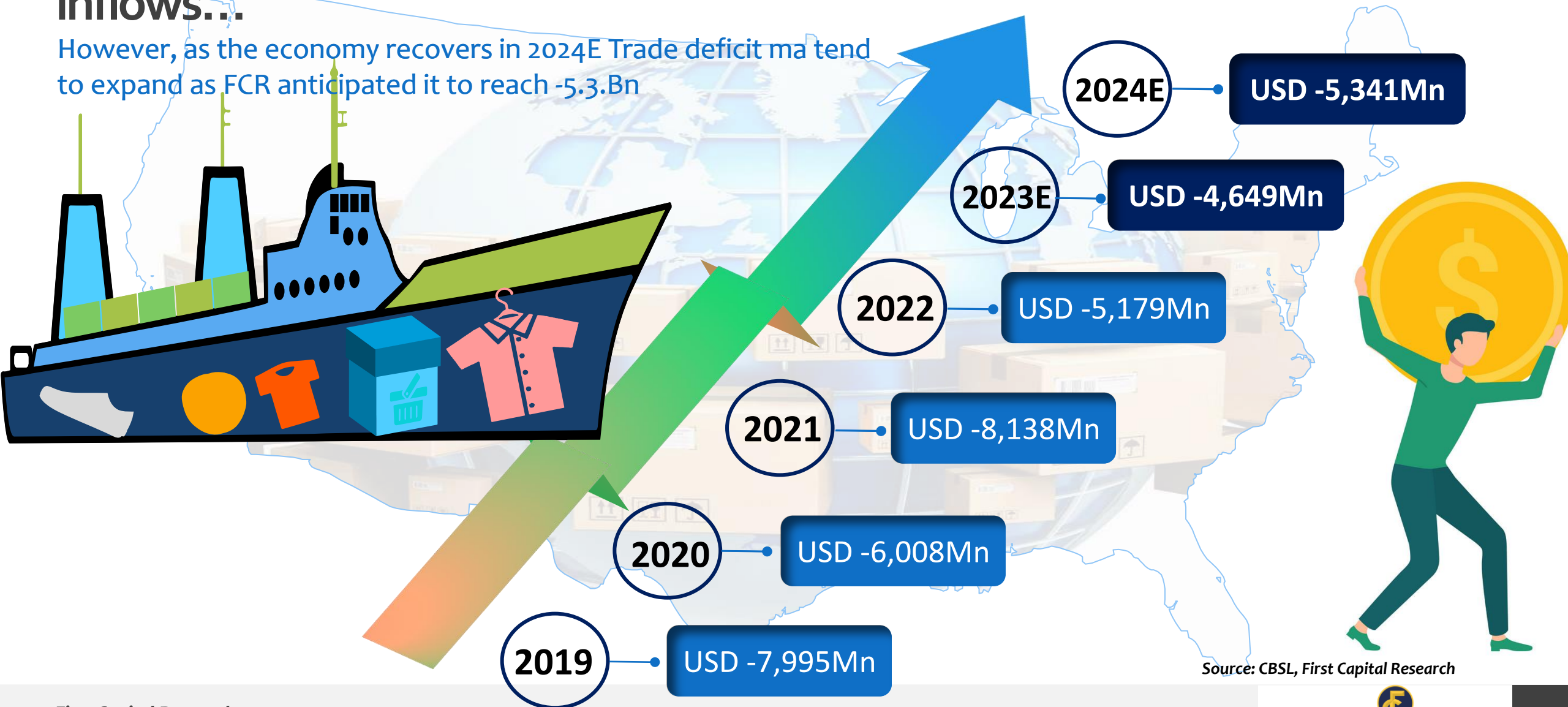
Country	2021 (Budget Balance)	USD (20.02.2023)	As a % of GDP
	LKR-2,058	-5.68Bn	-11.6%
	KIPS -3,954Bn	-0.23Bn	-2.7%
	THB-609Bn	-17.6Bn	-9.1%
	Rs. 5,259Bn	-20.08Bn	-7.9%
	INR -15,845Bn	-191.32Bn	-6.7%

* % - As a percentage of GDP

Source: CBSL, First Capital Research

Trade deficit contracts significantly with import restrictions & fuel quota system; But may be relaxed with the gradual improvement in foreign inflows...

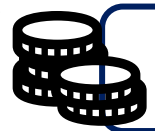
However, as the economy recovers in 2024E Trade deficit may tend to expand as FCR anticipated it to reach -5.3.Bn



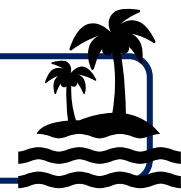
Source: CBSL, First Capital Research



...led by the surge in Tourist Arrivals and Tourism Earnings...



Earnings from Tourism

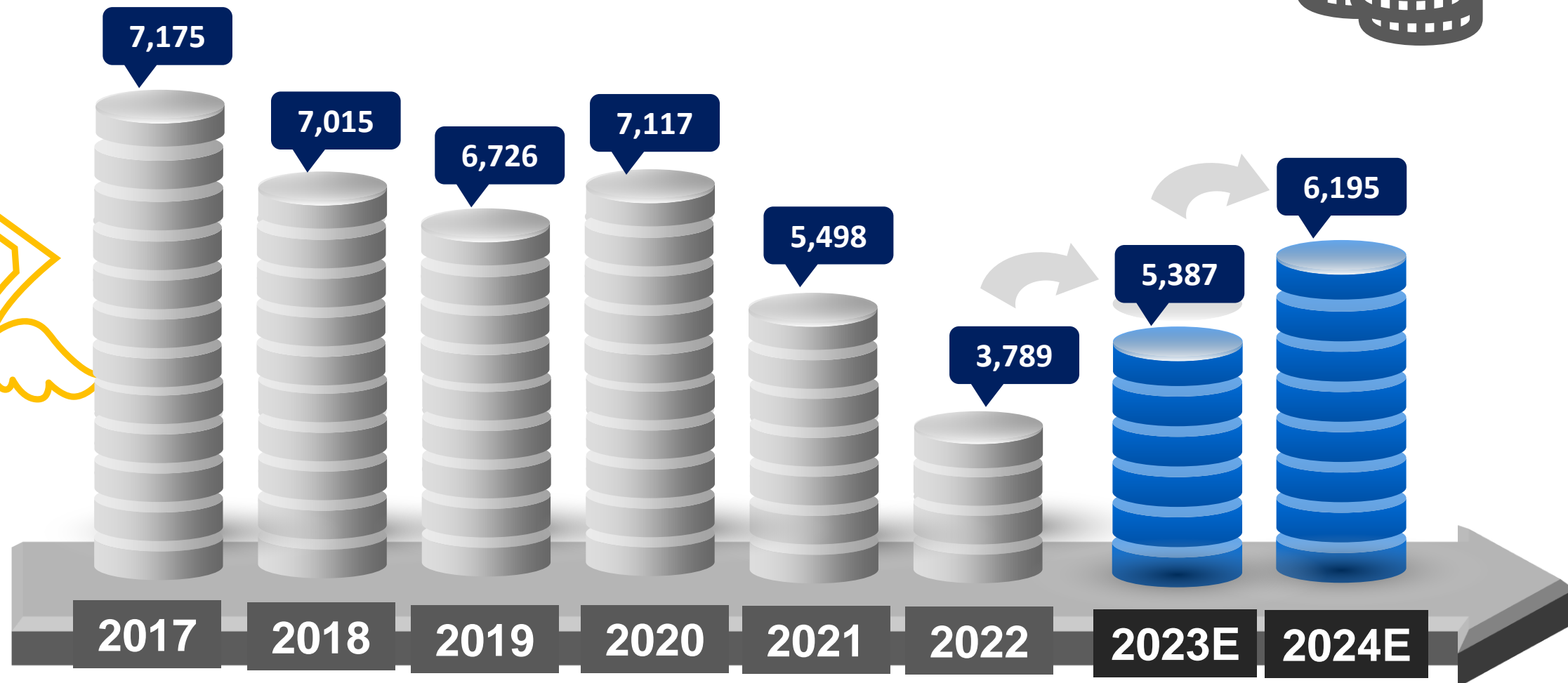
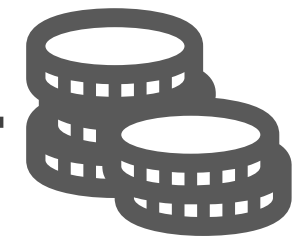


Tourist Arrivals



Source: SLTDA, First Capital Research

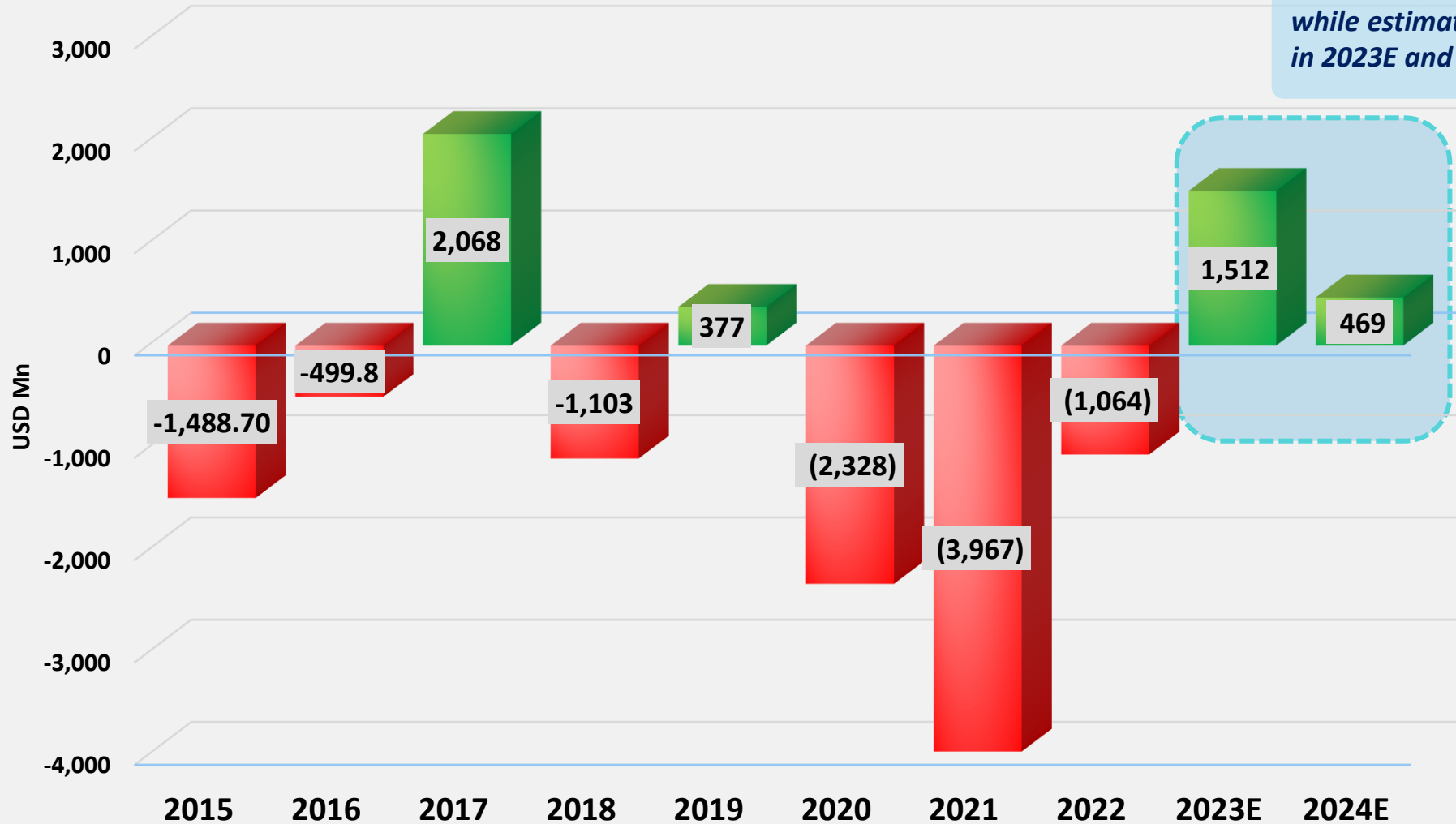
...while worker remittances recovers at an accelerated pace...



*All values are in USD Mn

Source: CBSL, First Capital Research

...coupled with the support of multilateral lenders Balance of Payments is expected to turn positive...



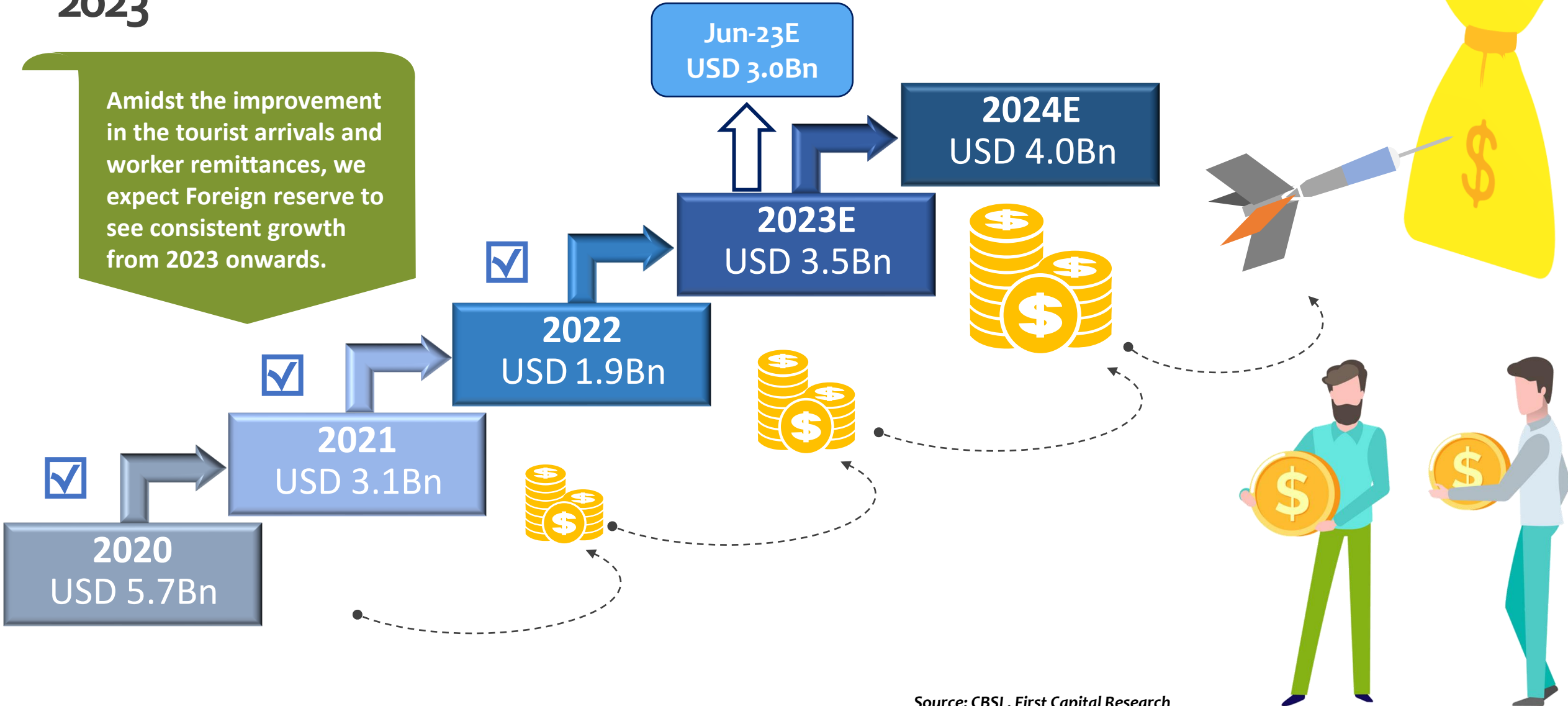
BOP is expected to improve from 2022E onwards while estimating to register a surplus of USD 1.5Bn in 2023E and surplus of USD 0.5Bn in 2024.



Source: CBSL, First Capital Research

...supporting to reach our Foreign Reserves target of USD 3.0Bn by Dec 2023

Amidst the improvement in the tourist arrivals and worker remittances, we expect Foreign reserve to see consistent growth from 2023 onwards.



With the Delays in obtaining IMF Board Level approval...

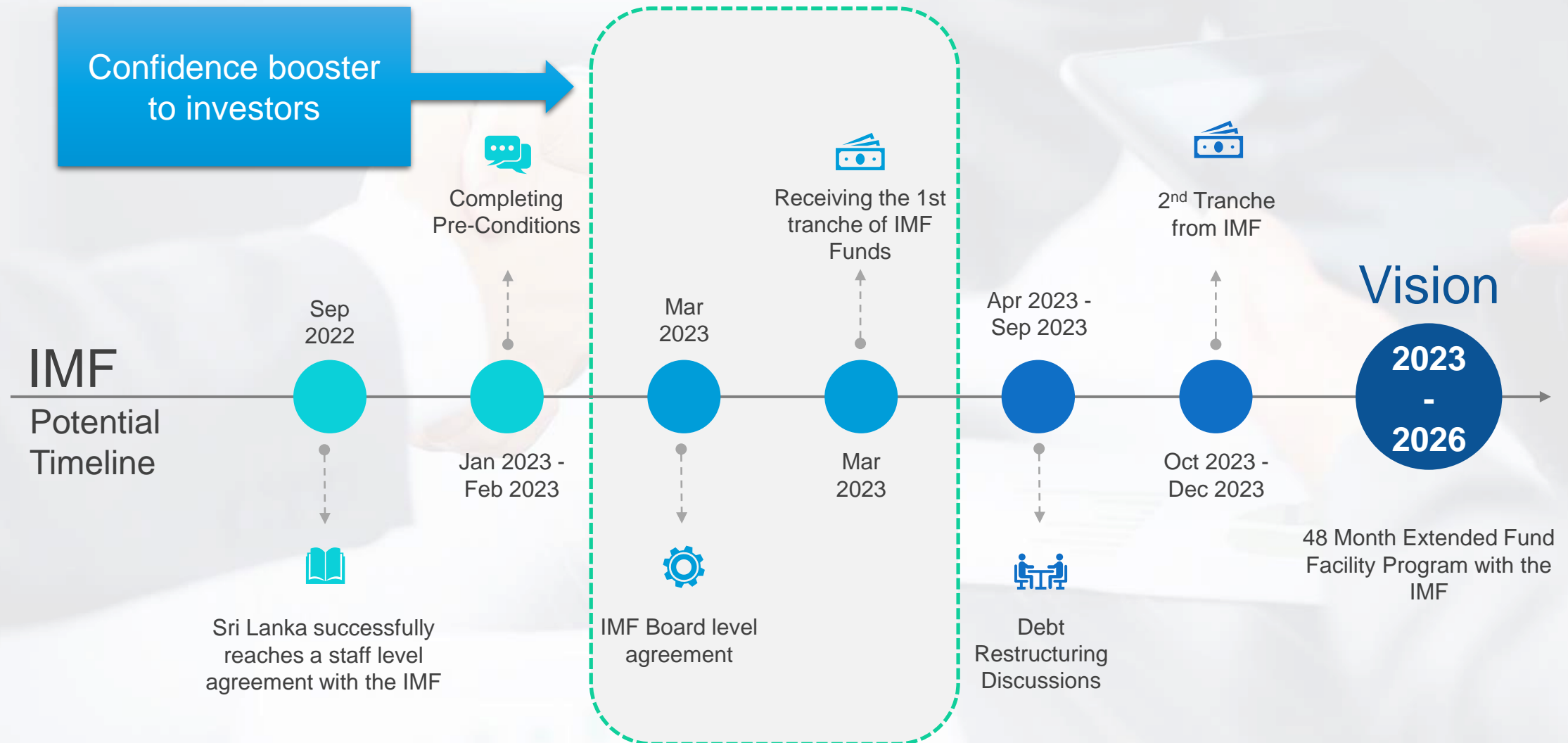
“We are trying our level best to get the approval by the first quarter of next year,” Minister Semasinghe told EconomyNext

“Bilateral creditors have not officially informed us anything on debt restructuring. The Paris Club has expressed their willingness to help us, but there is no official communication on that so far,” he said.



“When creditors tell the IMF that they are willing to help formally, we are almost done. We are almost there in my view. Once we get that assurance, the IMF needs a maximum of two to three weeks to prepare all the board papers, circulate with the board members, go to the board and get the programme approved.”

...FCR revises its expected timeline relating to potential financial assistance from IMF



Source: First Capital Research Estimates

Ascertaining creditor assurances, a priority for IMF...;
But SL struggles with China

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Asian Markets

3 minute read · February 7, 2023 10:00 PM GMT+5:30 · Last Updated 6 days ago

Paris Club creditors give assurances to back IMF bailout for Sri Lanka

By Jorgelina Do Rosario



IMF

Sri Lanka needs bilateral creditor assurances to unlock \$2.9bln bailout, IMF says

The country has been engaging with bilateral creditors

Uditha Jayasinghe and Swati Bhat, Reuters News

February 10, 2023

Sri Lanka's bailout package can be presented for approval as soon as the island nation meets remaining requirements

The island of 22 million people is seeking independence from British rule and the global lender IMF.

me the recent sta
g the assurance

NIKKEI Asia

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SRI LANKA CRISIS

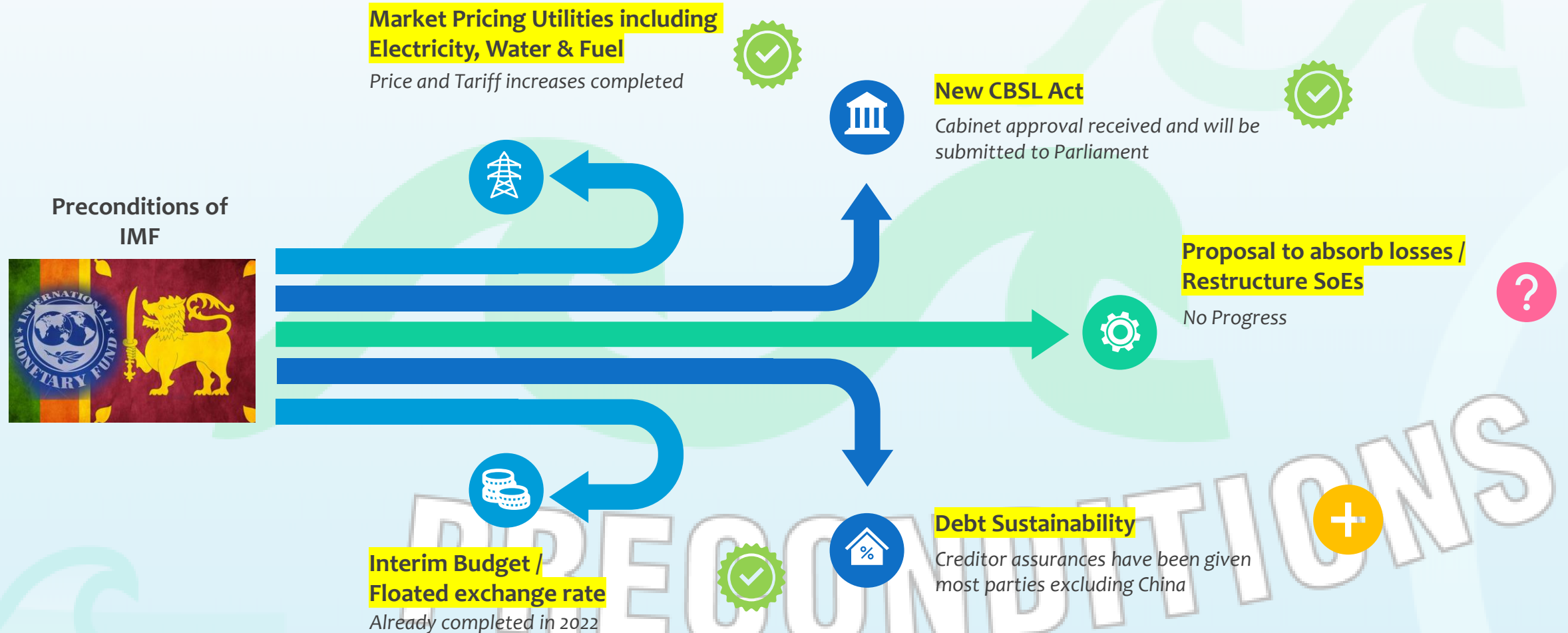
IMF confirms India assurances on Sri Lanka debt needed for bailout

Fund 'engaged' with other creditors for similar pledge as all eyes turn to China



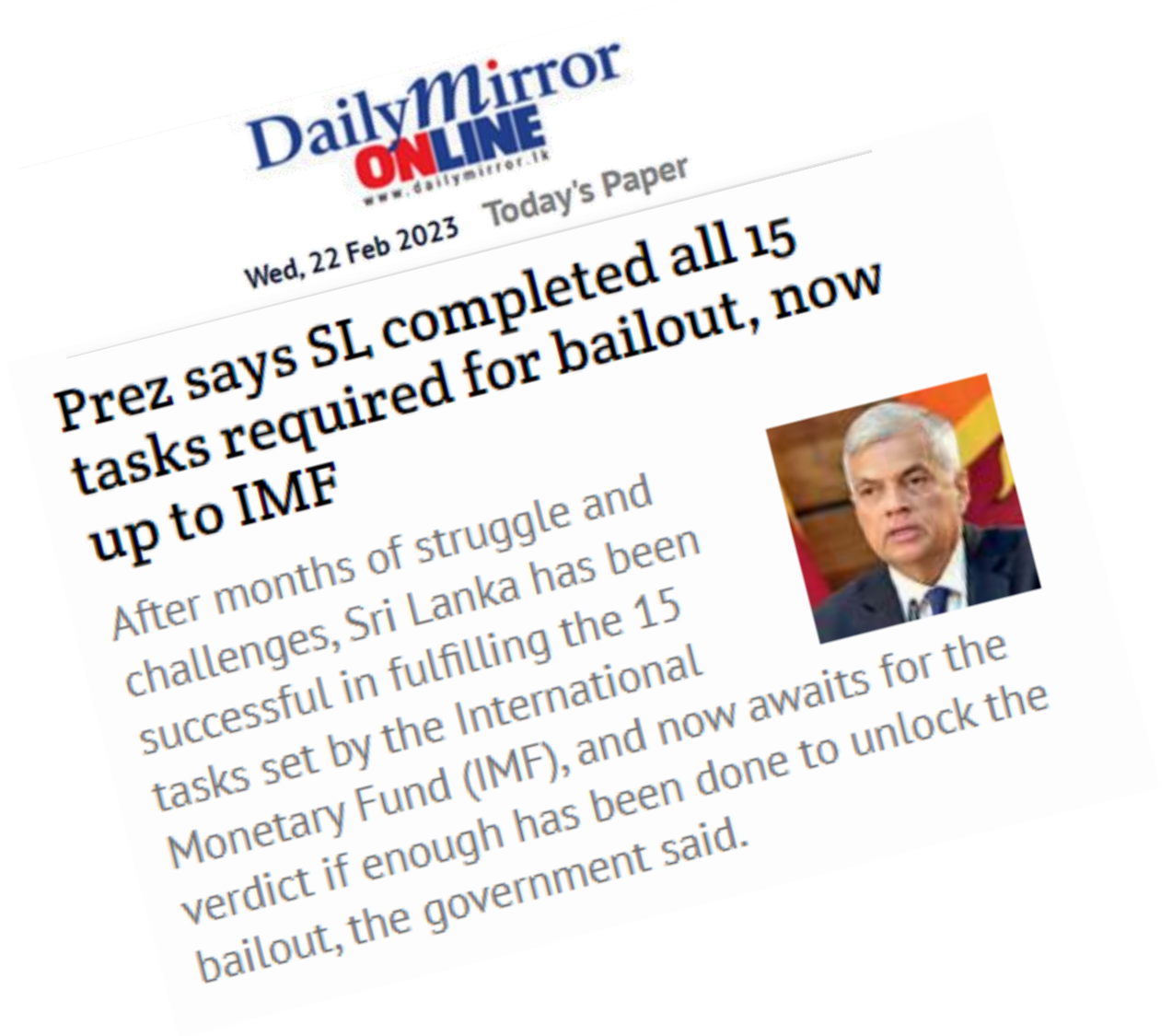
...other conditions also lie on the table...

However, most conditions are in the process of being implemented



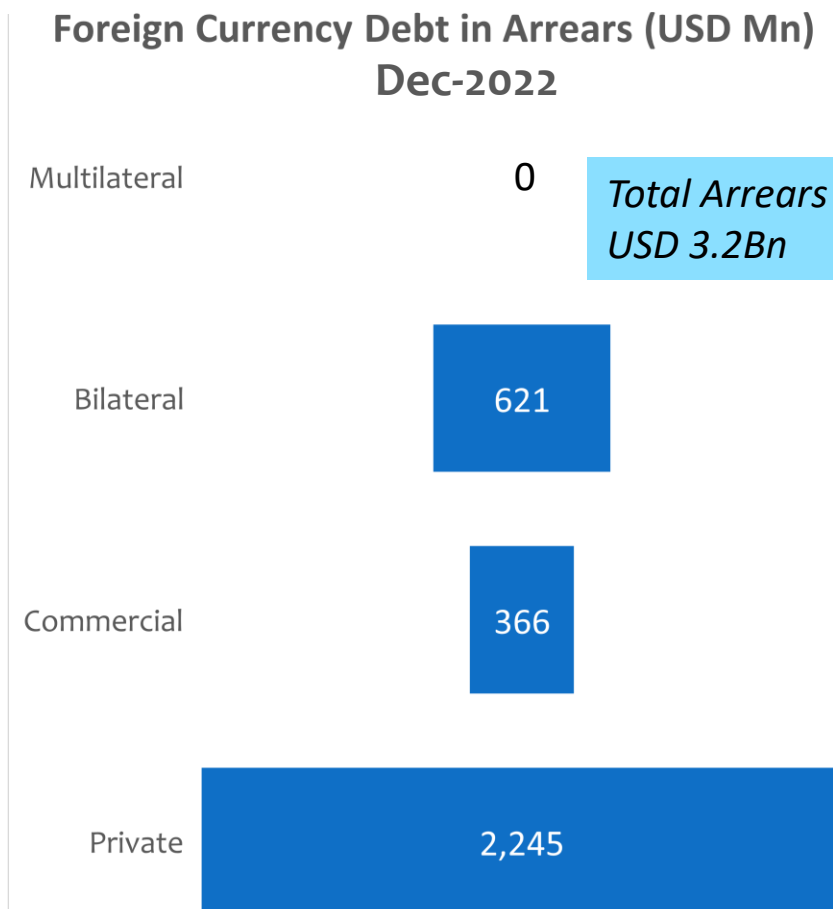
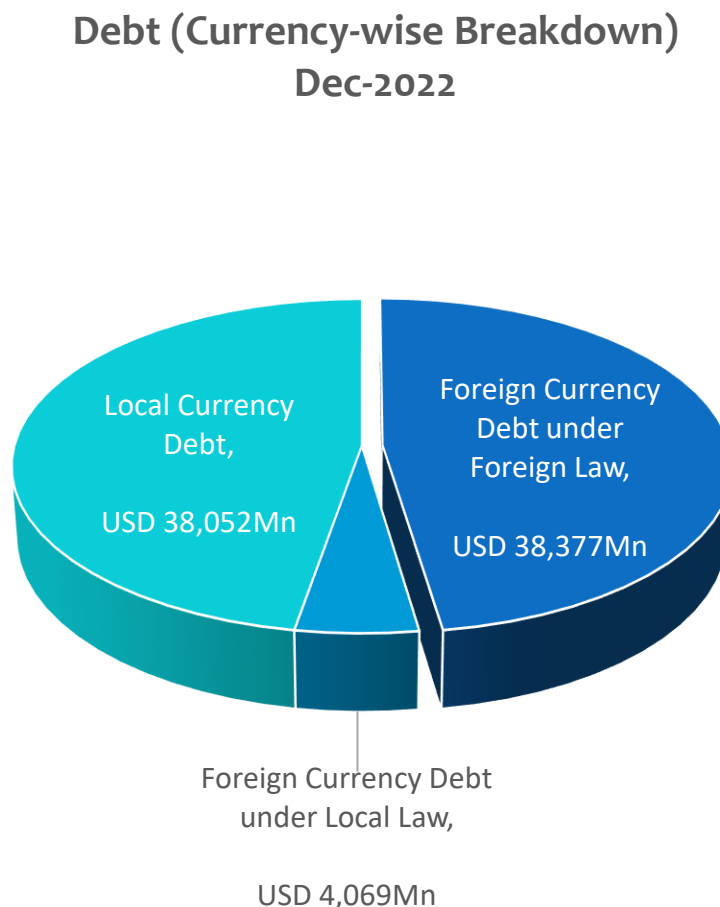
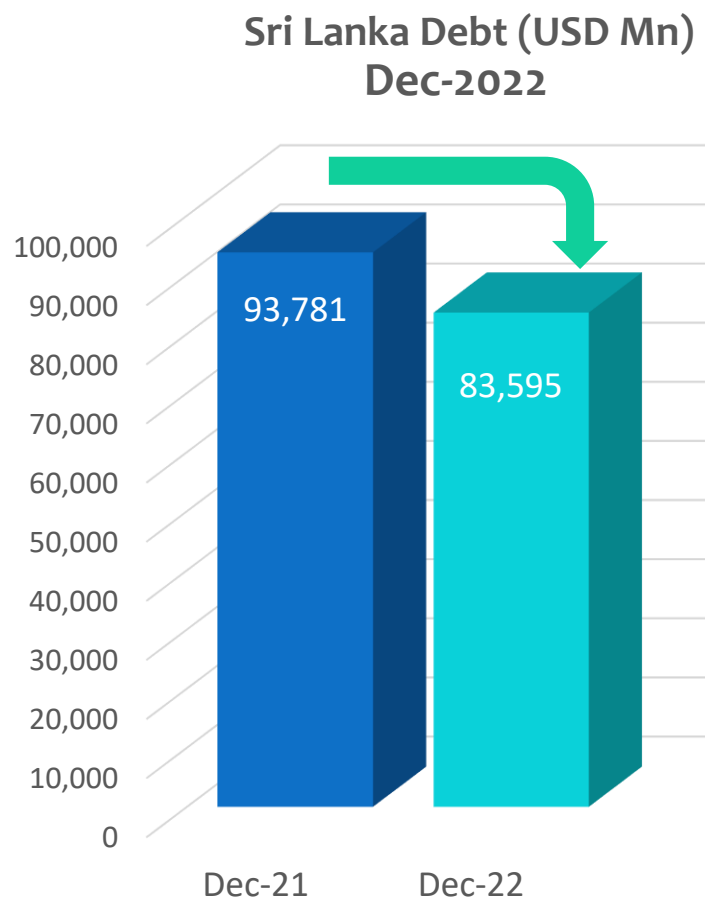
...However, Government claims all tasks have been completed

...providing a level confidence of the ability to achieve IMF Board level by Mar-2023



Sri Lanka Debt stock reduces dollar terms to USD 84Bn, but...

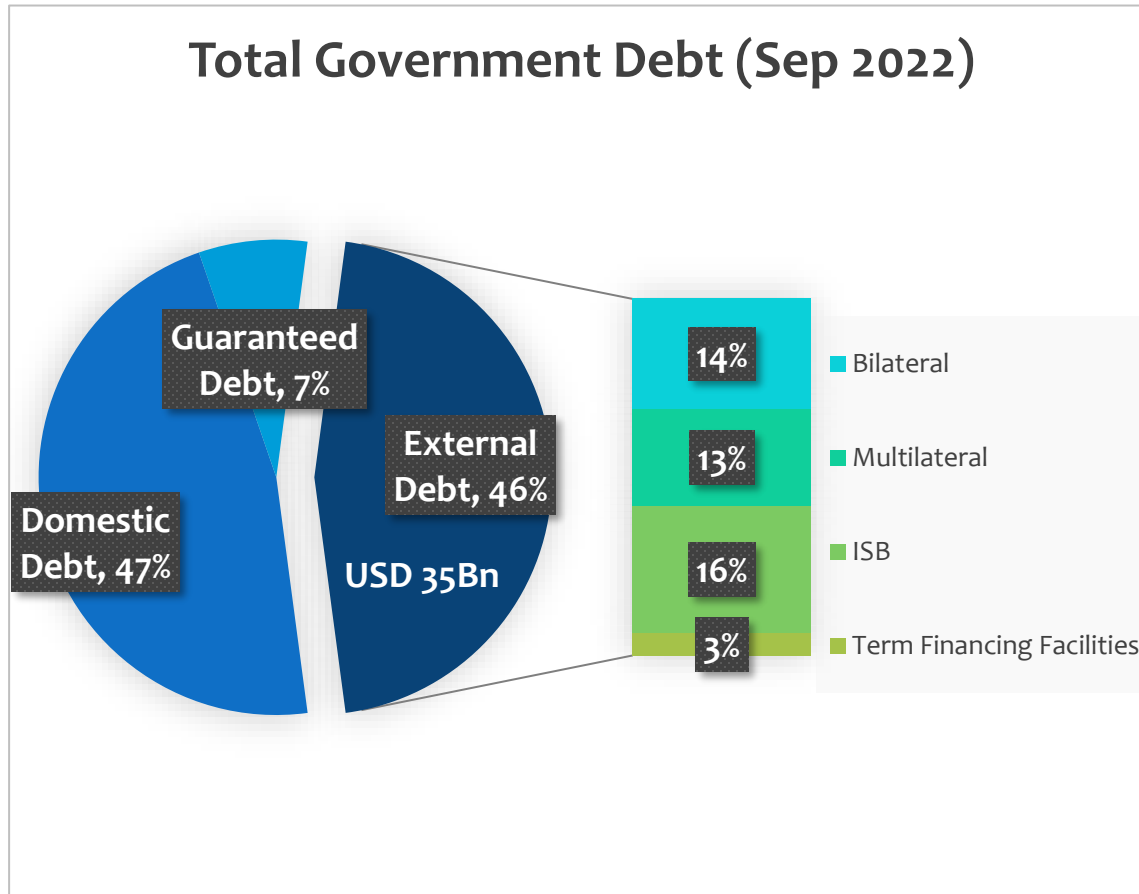
Currency depreciation, repayment of debt in 1Q2022 are key reasons for debt stock reduction; However, GDP contraction has worsened the debt to GDP ratio



Source: Dept of External Resources, First Capital Research

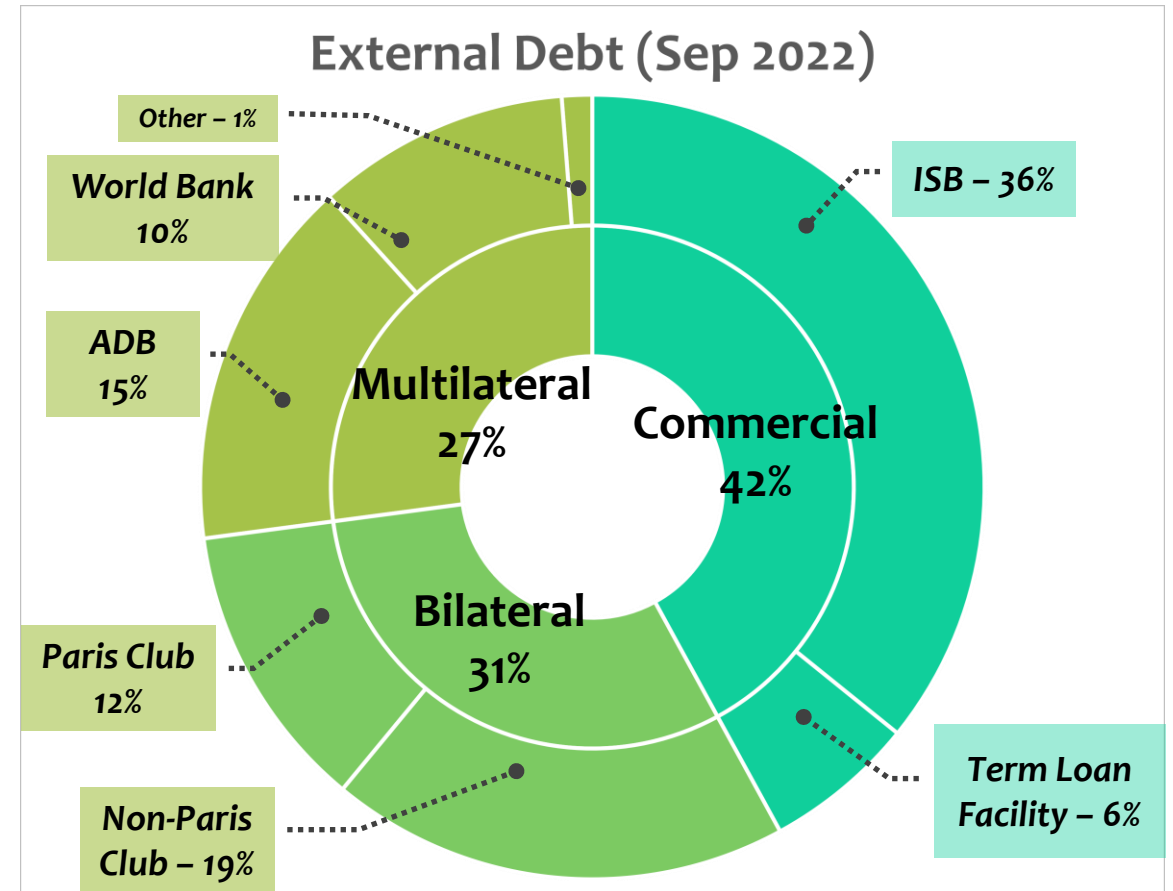
...the foreign currency debt repayment continues to be its biggest challenge at the moment...

External Debt stands at 46% of total debt



Source: Dept of External Resources, First Capital Research

Bilateral Debt amounts to 31% of external debt while Commercial debt stands 42%

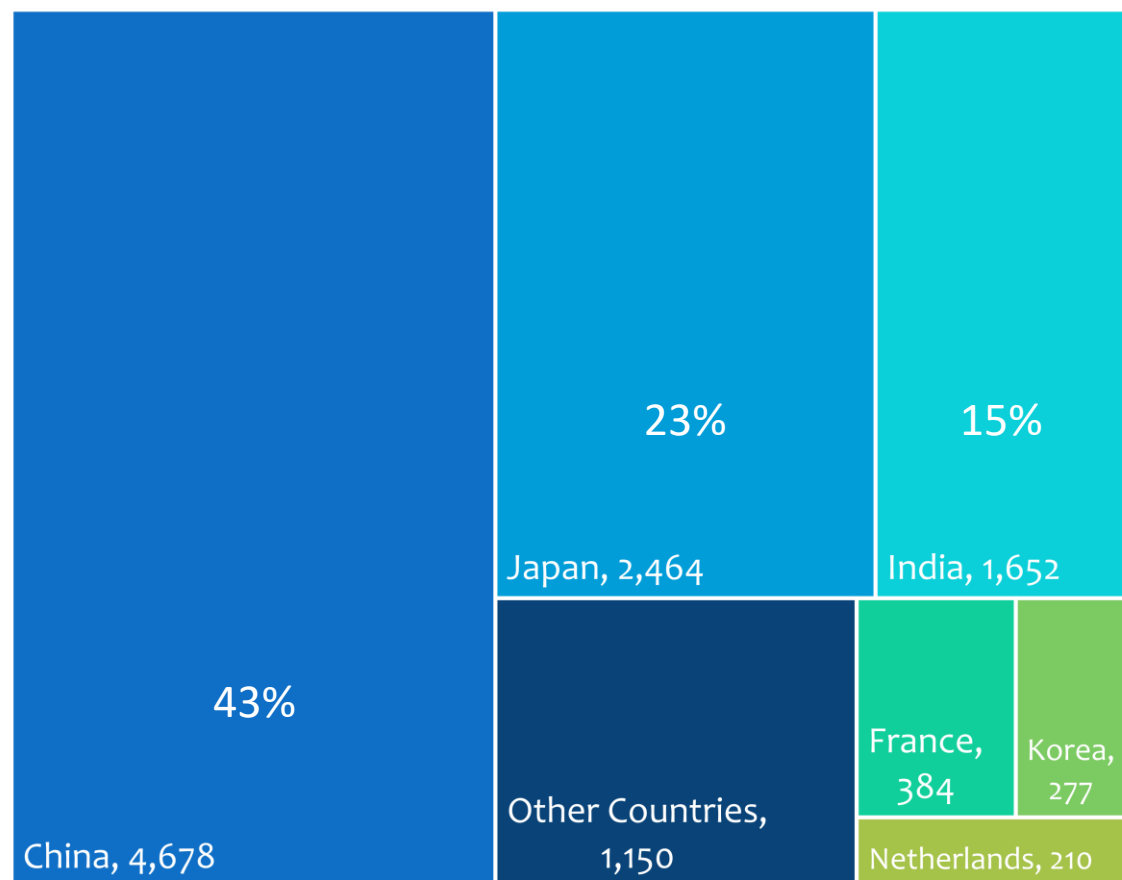


Source: Dept of External Resources, First Capital Research

...with China leading the Bilateral loans segment with 43% (USD 4.7Bn)...

With the large exposure to Bilateral loans from China, restructuring negotiations with China are going to be critical

Bilateral Loan Breakdown (Sep 2022)



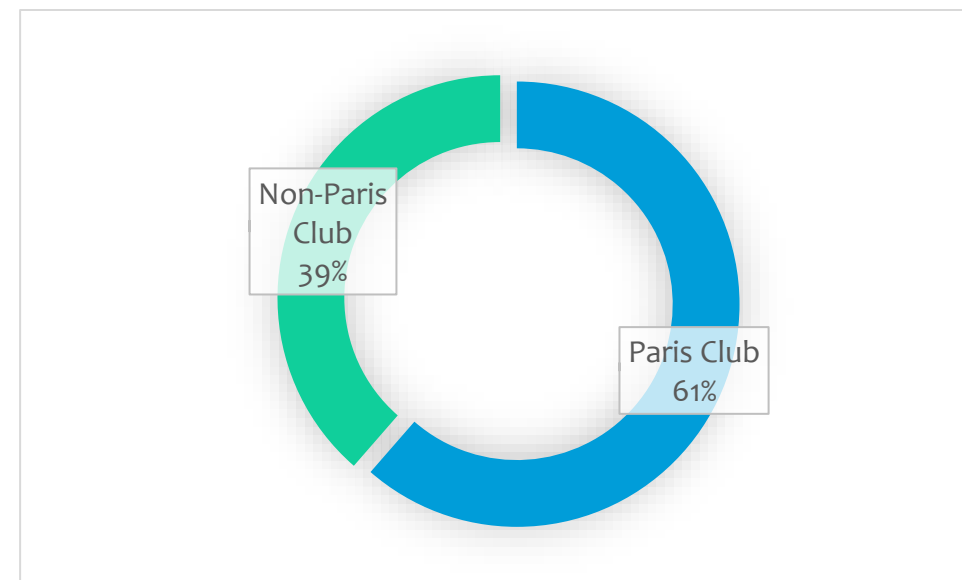
Source: Dept of External Resources, First Capital Research

- **Paris Club**

- ☐ Japan, France, Korea, Germany, USA, Spain, Russia, Sweden, Australia, Canada, Austria, UK, Belgium, Denmark, Netherlands

- **Non-Paris Club**

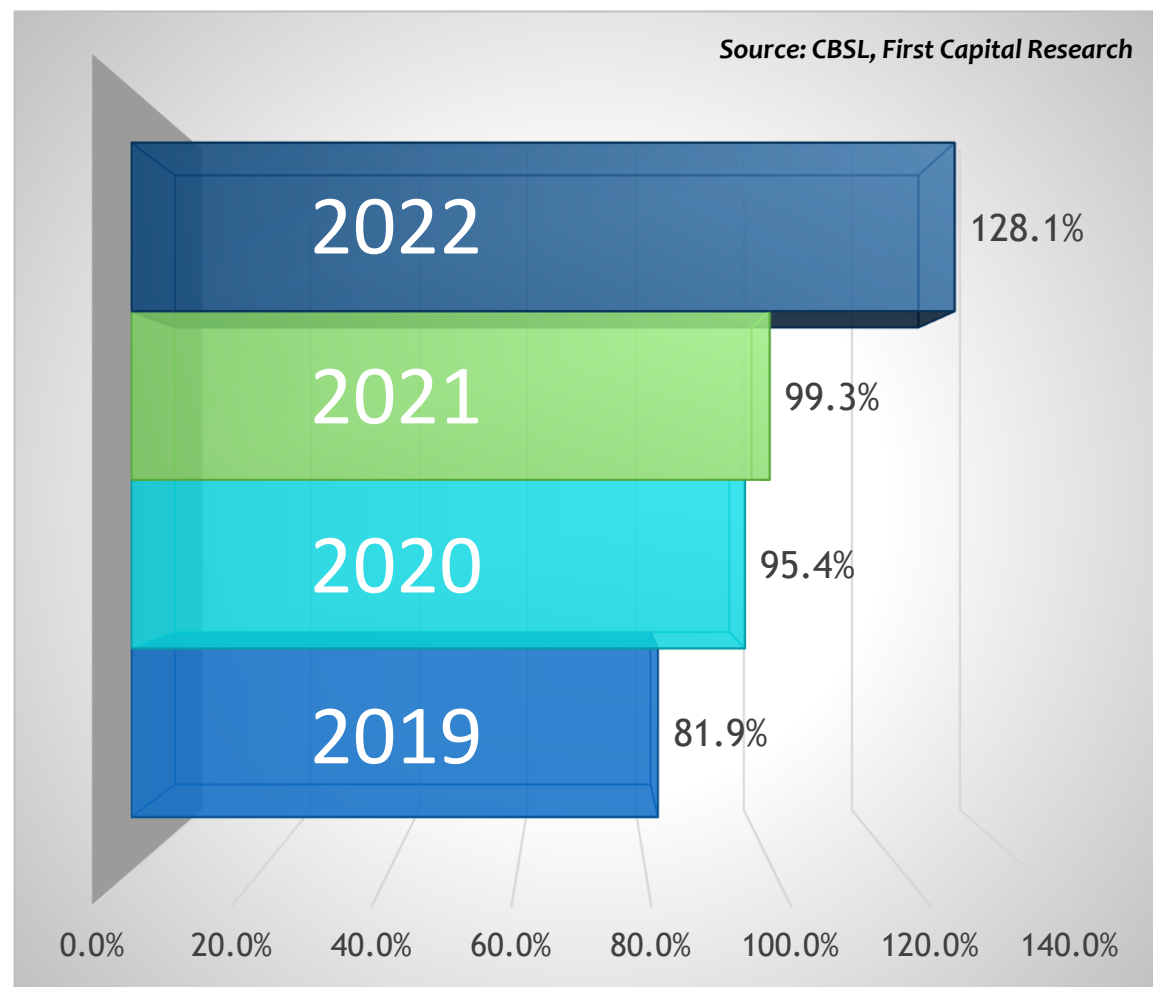
- ☐ China, India, Saudi Arabia, Kuwait, Hungary, Iran, Pakistan



Source: Dept of External Resources, First Capital Research

...while Debt to GDP has reached 128% (Dec-22)

Debt to GDP is slightly lower than our previous estimate of 133% primarily supported by the rebasing of GDP



We expect the debt restructuring process would provide adequate support to improve the ratio below the recommended 100%





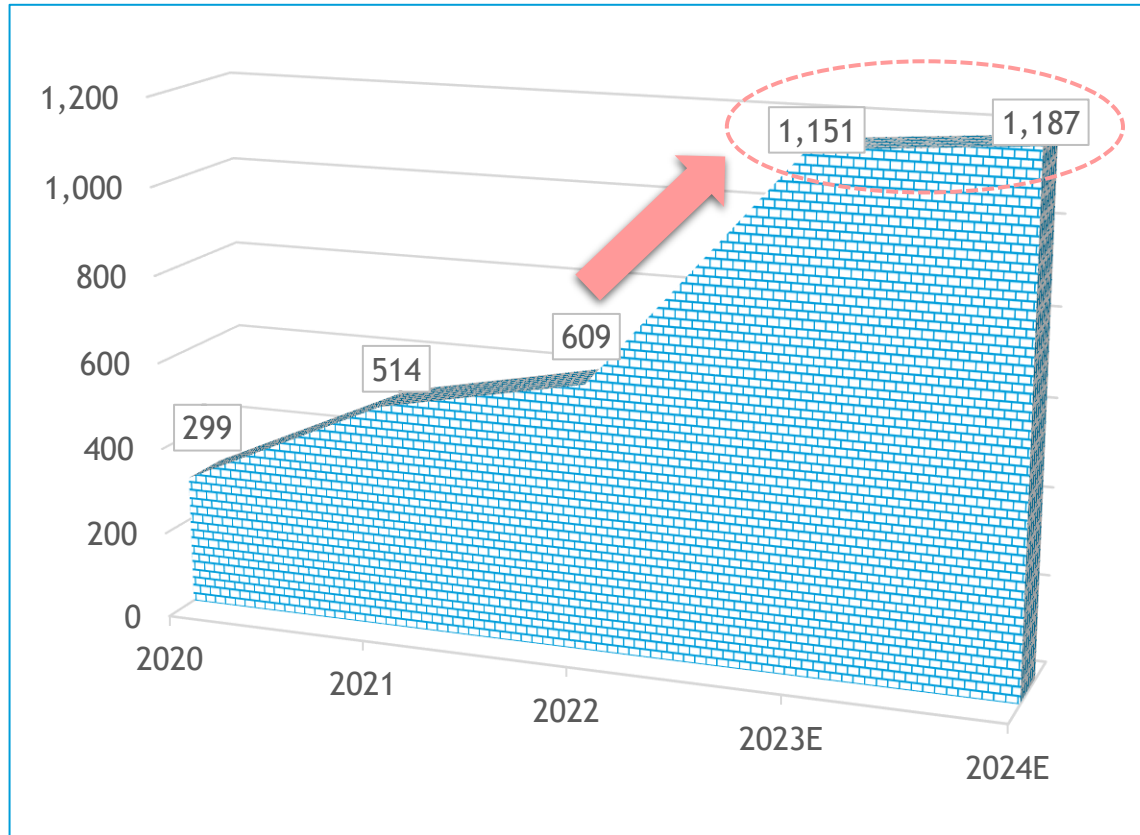
“

Sri Lanka has already suspended its foreign debt repayments amidst the unsustainability of the external debt, but domestic debt has also been bloating

”

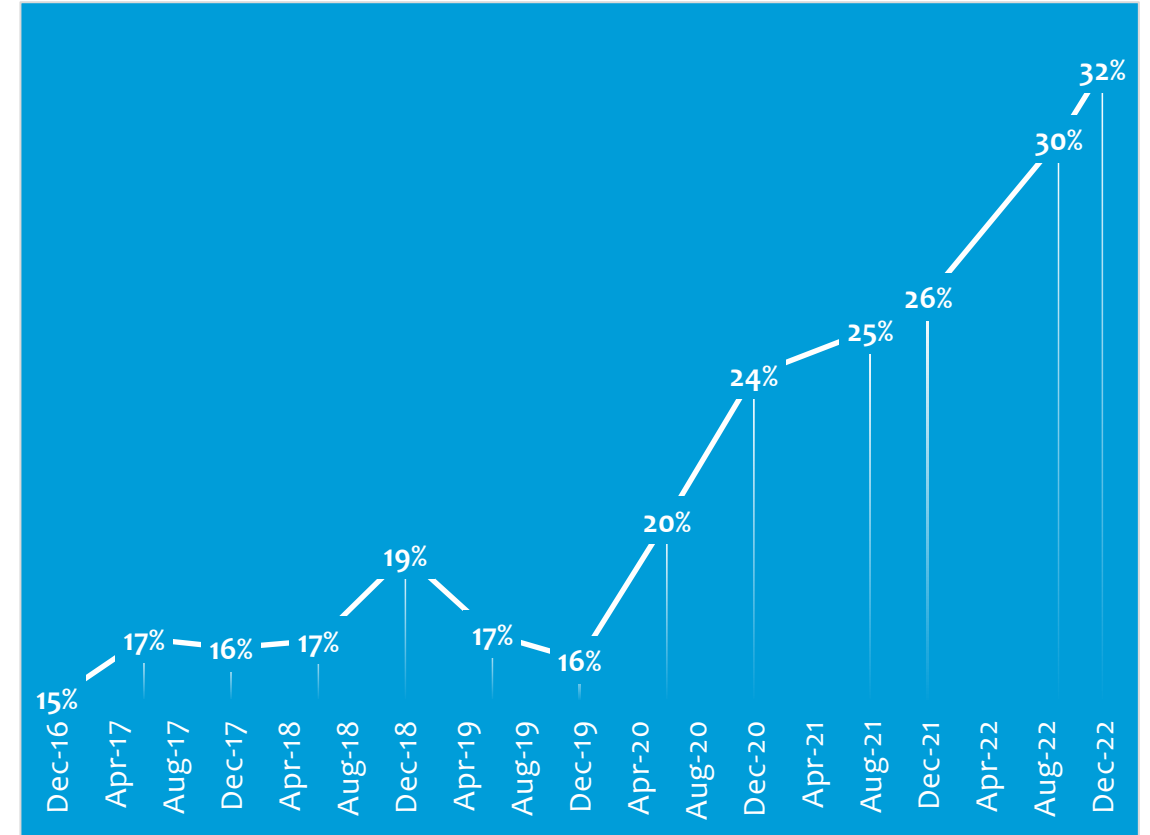
Domestic debt maturities in G-Sec surge illustrating continuous borrowing requirement in the short - mid term...

Treasury Bond maturities rises above 1Tn for 2023



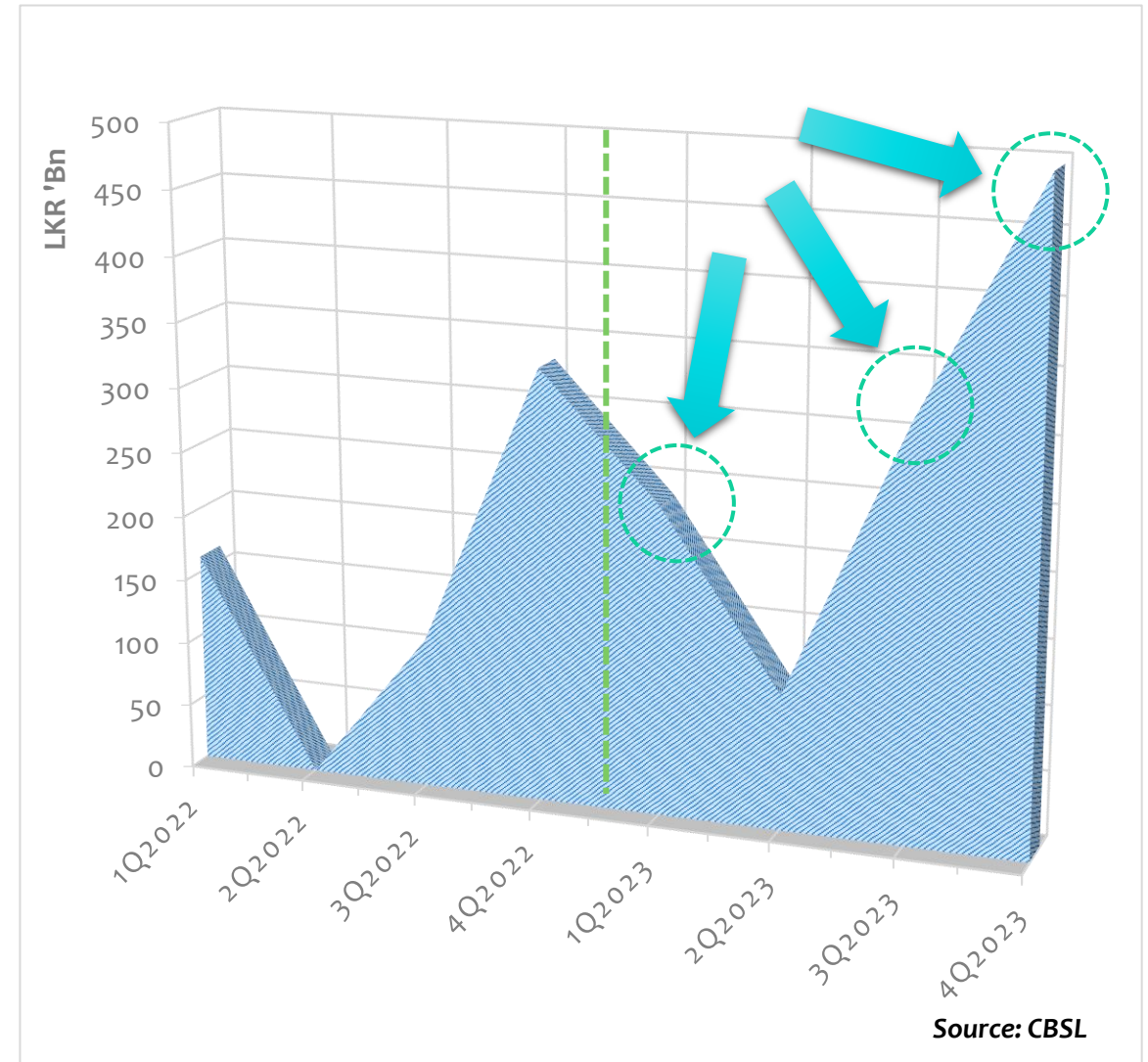
Source: CBSL, First Capital Research

Treasury Bill stock surpasses 32% of the G-Sec market



Source: CBSL, First Capital Research

...while most of 2023 (1Q, 3Q and 4Q) remains high in bond maturities



However, domestic debt restructuring probabilities stand low for SL...

Arguments for Local Debt Restructuring

- **Debt Sustainability and Gross Financing Needs:** SL's debt to GDP is above 120% and Gross financing need to be at 25% while IMF expects both indicators to be at 100% and 15% over the medium term. With China maintaining a tough stance there is a possibility that external debt restructuring may not be sufficient to achieve the expected target, which may lead to domestic debt restructuring.

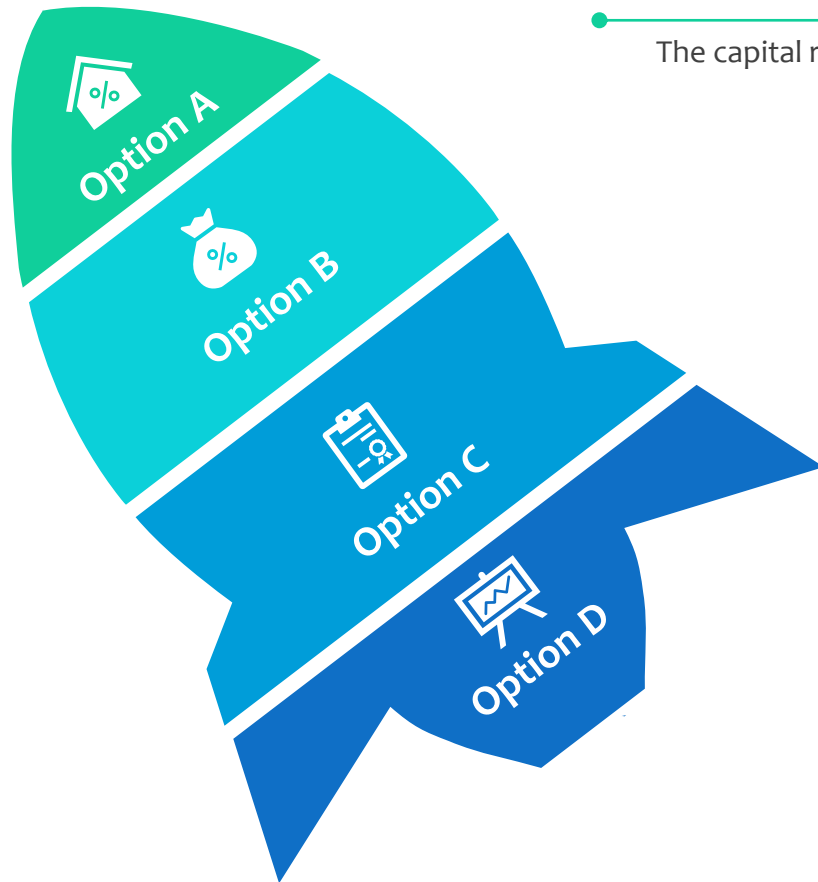
**First Capital Probability of DDR –
20% (Maintained)**



Arguments Against Local Debt Restructuring

- **Rupee investors equivalent to having suffered debt restructuring:** With the steep depreciation and high inflation faced by local investors, buying power of the local currency investors have almost halved resulting in a major set back. In such a situation it is unfair to again consider restructuring of local debt.
- **Requirement to recapitalize selected banks:** Restructuring of domestic debt may cause a detrimental impact to the financial institutions Banks, Finance Companies, Insurance companies and Pension Funds such as EPF which have invested a large portion of their assets in domestic debt and also are struggling amidst the ailing economic conditions. It is likely to cause a significant erosion in capital resulting in a Govt requirement to support to recapitalize some of the financial institutions which may again be a burden to the budget deficit.
- **Ghana struggles to finalize DDR:** 3 months after announcing domestic debt restructuring Ghana still struggles to implement DDR amidst the major impact to its financial system. The latest amendment to DDR illustrates insufficient impact total debt NPV but a severe impact to the financial system continues to be present.

...with varied Domestic Debt Restructuring options



Hair Cut on principle



The capital returned at the end of the period is reduced. The move is expected to reduce the overall debt stock.

Hair Cut on Coupon



Adjusting the interest rates to be paid or coupon rates commonly known as coupon adjustment.

Increase in the maturity period



Extending the repayment or maturity period

Hybrid of above options



A Mix of some or all of the above

Domestic Debt Restructuring Impact Assessment

Tenor	<2 Year	<4 Year	<5 Year	<10 Year
Maturity	15-Jan-25	15-Sep-27	15-Jan-28	01-Jul-32
Coupon	22.50%	20.00%	18.00%	18.00%
Current Yield	32.25%	29.40%	28.00%	25.50%
20% Haircut on Principle	22.23% Loss - (10.02%)	26.89% Loss - (2.51%)	25.61% Loss - (2.39%)	24.80% Loss - (0.70%)
20% Haircut on Coupon	26.91% Loss - (5.34%)	23.85% Loss - (5.55%)	23.38% Loss - (4.62%)	20.76% Loss - (4.74%)
5-Year Maturity Extension	26.74% Loss - (5.51%)	27.06% Loss - (2.34%)	25.53% Loss - (2.47%)	24.83% Loss - (0.67%)
10-Year Maturity Extension	26.10% Loss - (6.15%)	26.54% Loss - (2.86%)	24.94% Loss - (3.06%)	24.64% Loss - (0.86%)
20% Haircut on Principle & 10-Year Maturity Extension	25.75% Loss - (6.50%)	26.37% Loss - (3.03%)	24.76% Loss - (3.24%)	24.57% Loss - (0.93%)
20% Haircut on Coupon & 10-Year Maturity Extension	20.89% Loss - (11.36%)	20.95% Loss - (8.45%)	20.09% Loss - (7.91%)	19.71% Loss - (5.79%)

New Yield after Debt Restructuring

Source: First Capital Research

Summary of Overall Economic Outlook

Positives

- Economic Reforms
 - Cost reflective pricing of electricity, water & fuel
 - Measures to increase Tax Revenue
- Recovery in Tourism
- Negative Private Credit
- Inflation gradually easing off
- Stable LKR

Negatives

- Negative GDP growth
- High budget deficit may increase Govt borrowing requirement
- Negative liquidity
- High level of CBSL Holdings
- High Rupee and Dollar debt maturities
- Difficulty in raising foreign debt
- Delay in IMF Board Level approval
- Delay in External Debt Restructuring

Economic Outlook: Maintain Medium-High Risk



External Outlook gradually stabilizing

*Maintain **Medium-High Risk***

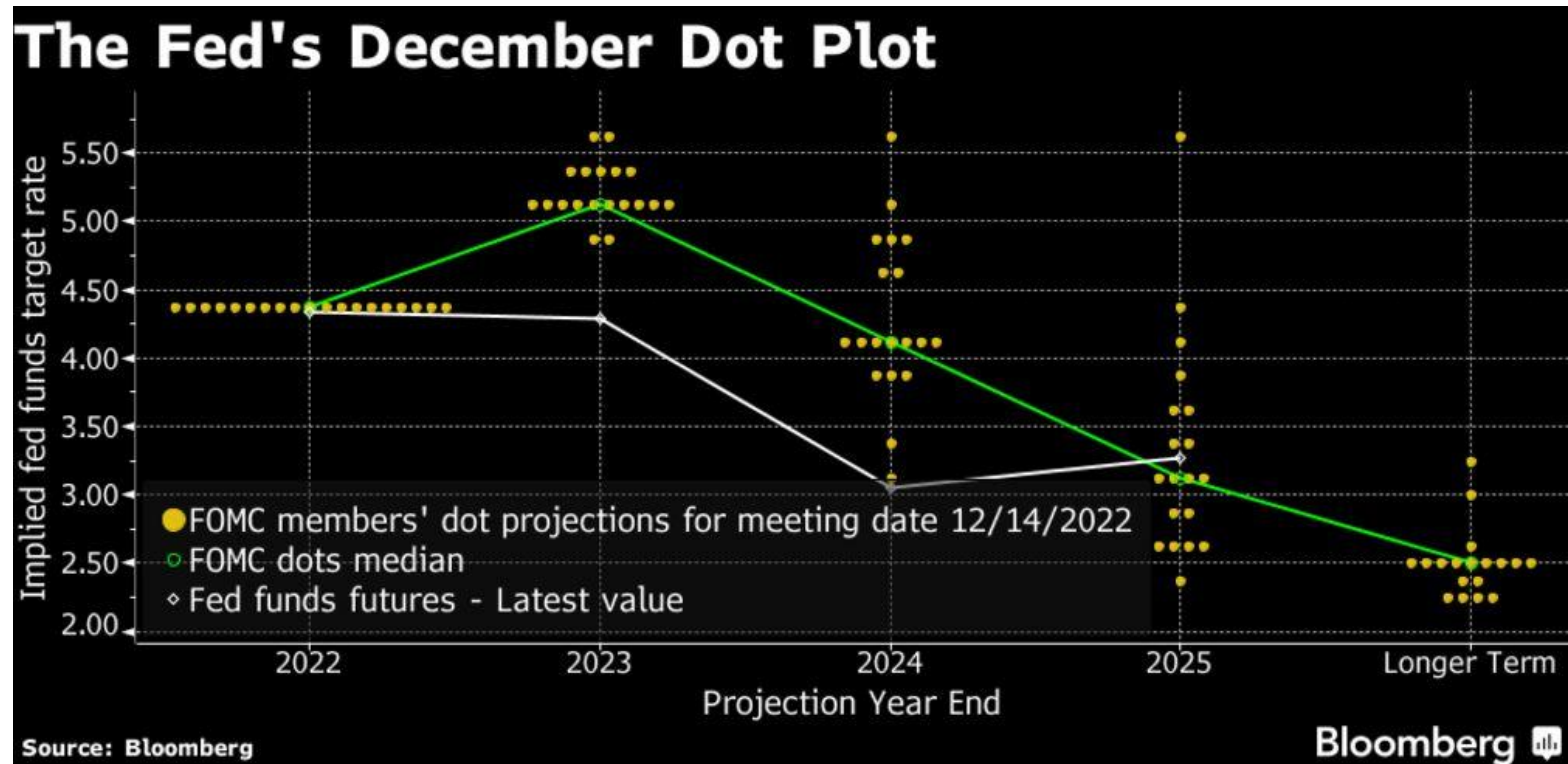
Section 5.0

Fed to continue hikes with US signaling further acceleration in economy

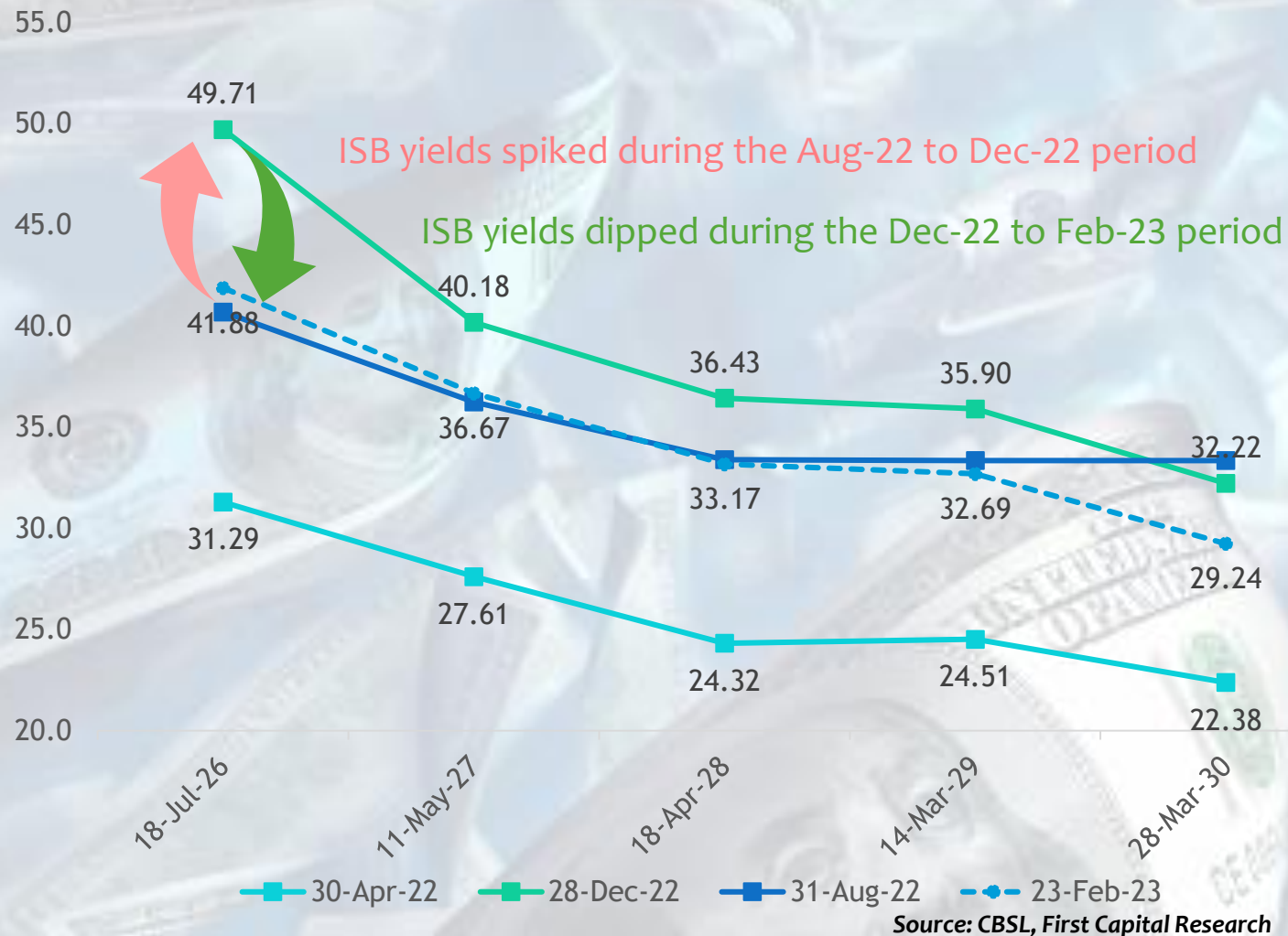
Following Jan 2023 US producer prices accelerating at the fastest pace in 7 months and labour market data unexpectedly indicating a fall in filing new claims for unemployment benefits, both Goldman Sachs and Bank of America has raised its expectations for US Federal Reserve to **raise rates 3 more times in 2023 targeting a range of 5.25-5.50%**.

The move is expected to further increase global interest rates during 2023 but may not impact SL with the current high level of interest rates prevailing in the country. The situation may **indirectly favour SL with commodity prices likely to hover at the current levels for a longer period of time.** Further, any signs of recession may even push down commodity prices lower.

Further hikes may support to maintain commodity prices under check favouring SL



ISBs slightly ease off on expectations of a IMF Board level agreement...

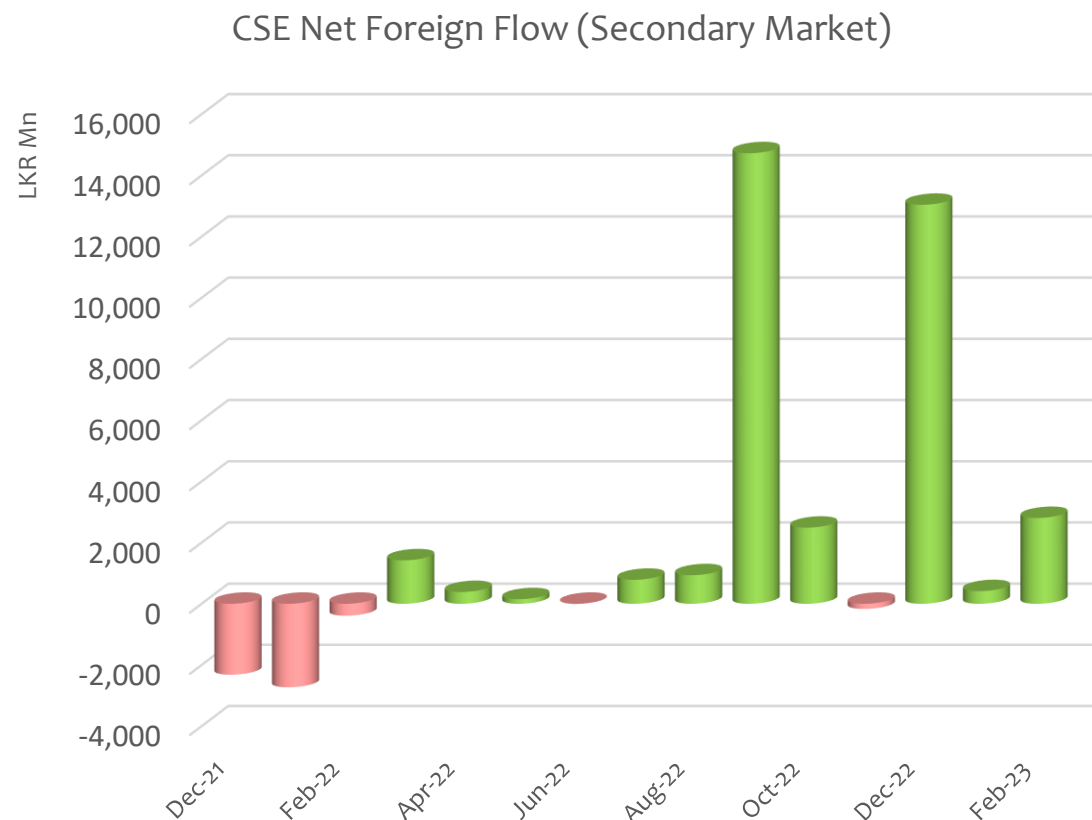


With the uncertainty created over the 2H2022, ISB yields saw a further spike mostly in the mid tenor maturities.

However, with IMF Board level approval drawing closer there is a confidence booster among foreign investors pushing yields lower by 300-800bps across the mid-long tenor yield curve.

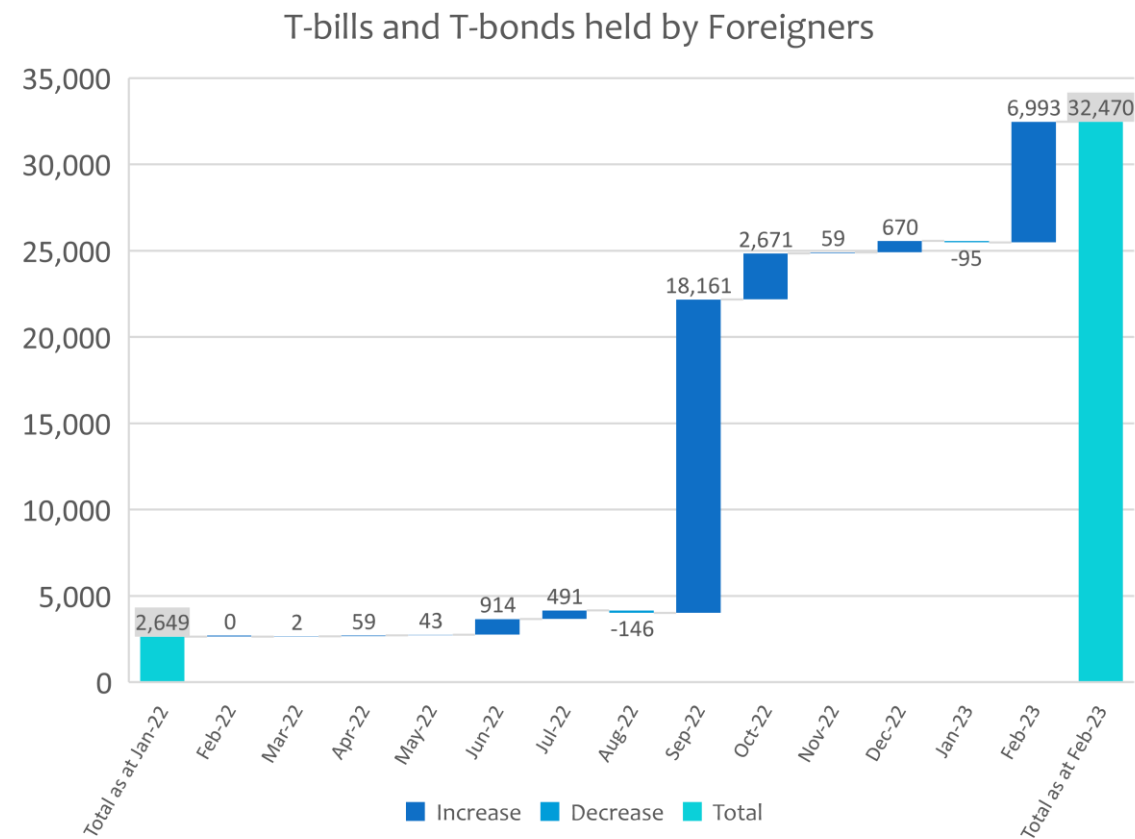
...while inflows continue to flow into the capital markets

CSE YTD2023 net inflow crosses LKR 3Bn



Source: CBSL, First Capital Research

G-Sec YTD net inflow is near LKR 7Bn



Source: CBSL, First Capital Research

Debt restructuring, once completed may provide opportunity for credit rating upgrade for SL

RATING ACTION COMMENTARY Fitch Upgrades Mozambique to 'CCC+'; Removes From UCO

Fri 26 Aug, 2022 - 5:01 PM ET

S&P, Fitch upgrade Ukraine's credit rating but warn there's still a chance of default

Edited By: Mochita Kaur Garg
Washington, United States • Updated: Aug 20, 2022, 05:30 AM(IST)



ECONOMY

Sri Lanka rupee debt rating downgraded to 'CC' by Fitch on debt restructure risks

Friday December 2, 2022 8:36 am

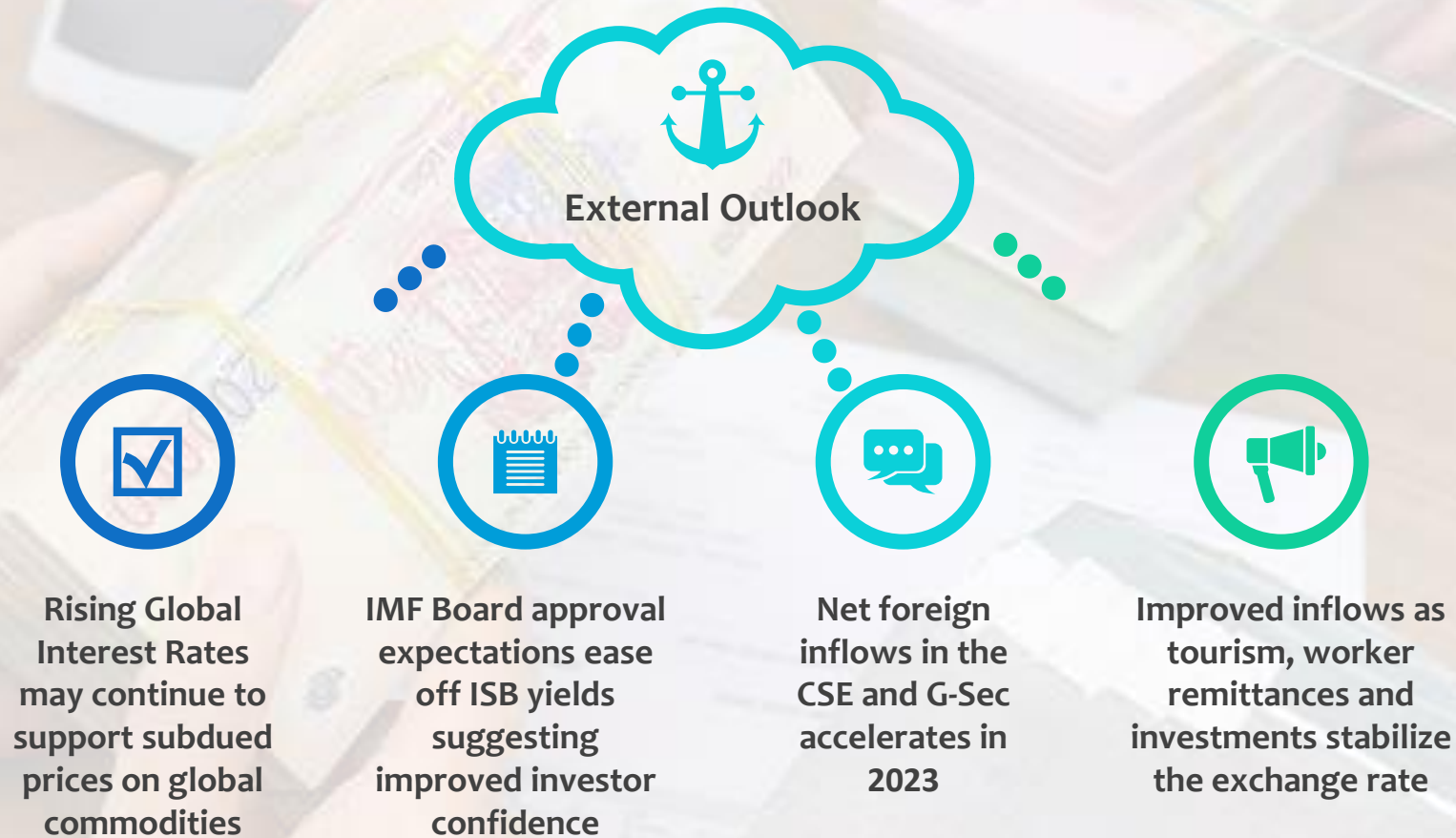
ECONOMYNEXT - Fitch Ratings has downgraded Sri Lanka's local currency rating to 'CC' from 'CCC' citing probable restructure of domestic debt.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- Completion of a commercial debt restructuring that Fitch judges to have normalised the relationship with private-sector creditors.
- The government puts local-currency debt service on a sustainable path, and avoids a default or debt restructuring.

Credit rating upgrades opens up the international capital market for SL

Summary of External Outlook



Economic Outlook: Maintain Medium-High Risk

Outlook Trend for Sri Lanka

Time Period	Political	Economical	External
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
Sep 2022	Medium-High Risk	Medium-High Risk	Medium-High Risk
Feb 2023	Medium-High Risk	Medium-High Risk	Medium-High Risk

Risk Levels (Low-High)



A close-up photograph of a hand in a blue suit sleeve moving a white chess king piece on a chessboard. The board has alternating light and dark squares, and several other pieces are visible in the background. The lighting is warm and focused on the hand and the piece being moved.

Recommendations

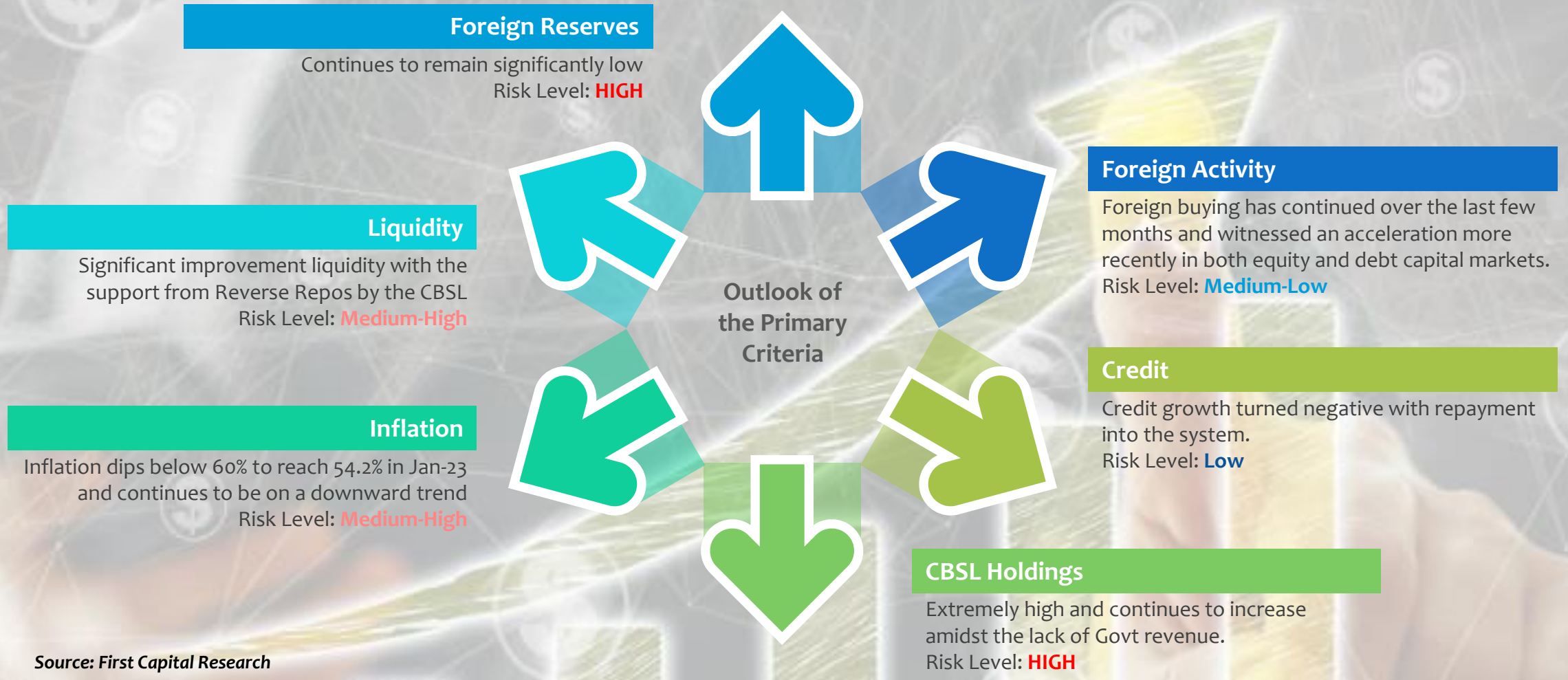
Section 6.0

First Capital Research View on Bond Market 2023

Section 6.1



Primary Criteria



Secondary Criteria

Rating Outlook

Despite being at default level, SL secured the IMF staff level agreement, and currently though delayed, are proceeding towards IMF Board Level approval.

Risk Level: **MEDIUM-HIGH**

External Environment

Currency has stabilized with strong support from tourism and worker remittances and investment inflows.

Risk Level: **MEDIUM-LOW**

BOT & BOP

BOT is negative with stronger inflows BoP turns positive over last few months supporting accumulation of reserves.

Risk Level: **MEDIUM-HIGH**

Political Risk

Some level of stability has been achieved, but potential elections may create some level of instability.

Risk Level: **MEDIUM-HIGH**

Investor Confidence

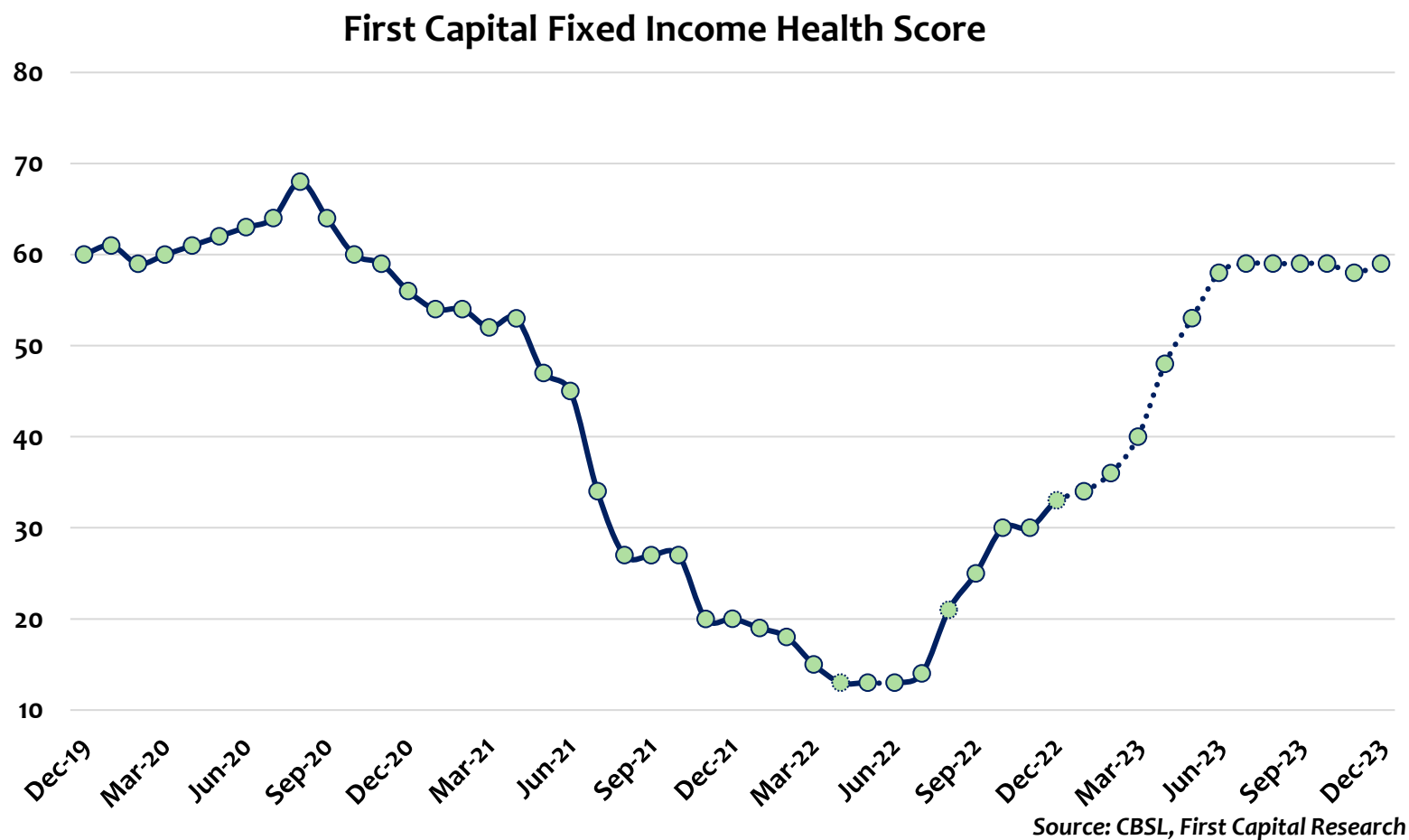
Business confidence continues to remain very low. New electricity hike further dampens confidence.

Risk Level: **HIGH**

Source: First Capital Research

Interest rate pressure to ease off

First Capital's Fixed Income Health Score is expected to surge amidst the improvement in high frequency indicators supported by the potential IMF support program



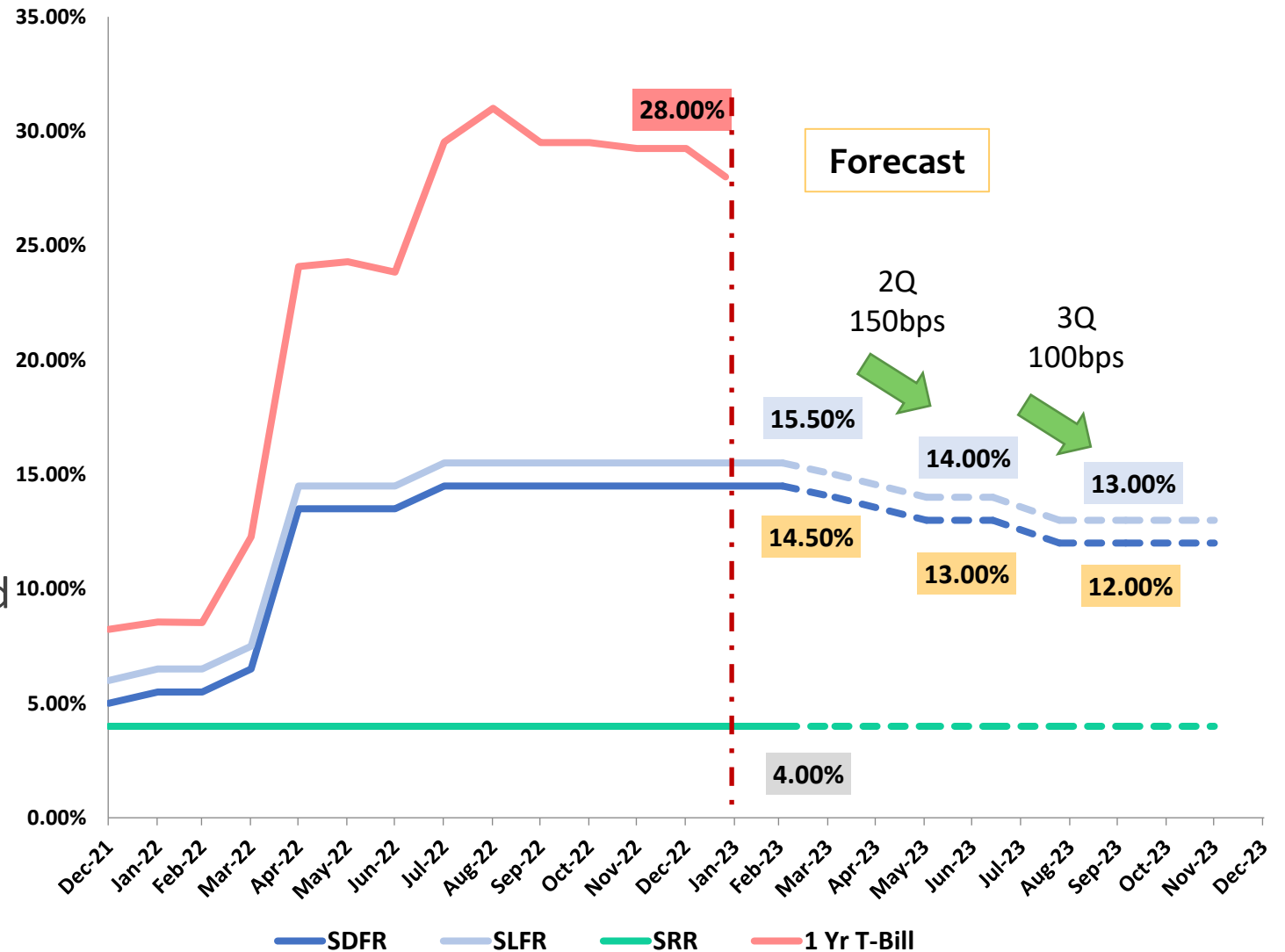
FI Health score nosedived in Jun-22 and in line with our expectations is now showing signs of improvements

However, a further accelerated recovery is anticipated in 1H2023

Policy rates trend downwards amidst stabilization

Considering the outlook over the next 06M-01Yr, we expect the complete normalization of the economy with the country being able to enter into an IMF EFF support program. Thereby with the complete stabilization of economic indicators, concentration would be shifted towards fast tracking the revival of the economy giving rise to a possibility of a rate cuts from 1Q2023 although at a lower probability of 40%-45%.

Rate cut is likely to be a strong probability towards 2Q-3Q2023 where we target about 3 rate cuts amounting to a cumulative dip of about 250bps.



Source: CBSL, First Capital Research



Attractive

BOND YIELDS

Attractive yields despite possible domestic debt restructuring



Attractive Yields: Bond yields have moved beyond 20% and at near 30% levels which is a rare occurrence in SL's past standards. Despite the local debt restructuring risk, it can be noted that after eliminating the potential loss in yields, the current market & auction yields could be identified as attractive. We recommend long term investors to BUY into the market to take advantage of the current attractive yields.



Debt Restructuring: We believe the probability of debt restructuring is low with tolerance level of banks falling to significantly low levels amidst the high level of NPLs and provisioning related to hits on potential external debt restructuring



Avoid Short tenors; Go Long: With impact to shorter tenors being significantly large in debt restructuring, we recommend investors to buy into 5Year or longer bonds.

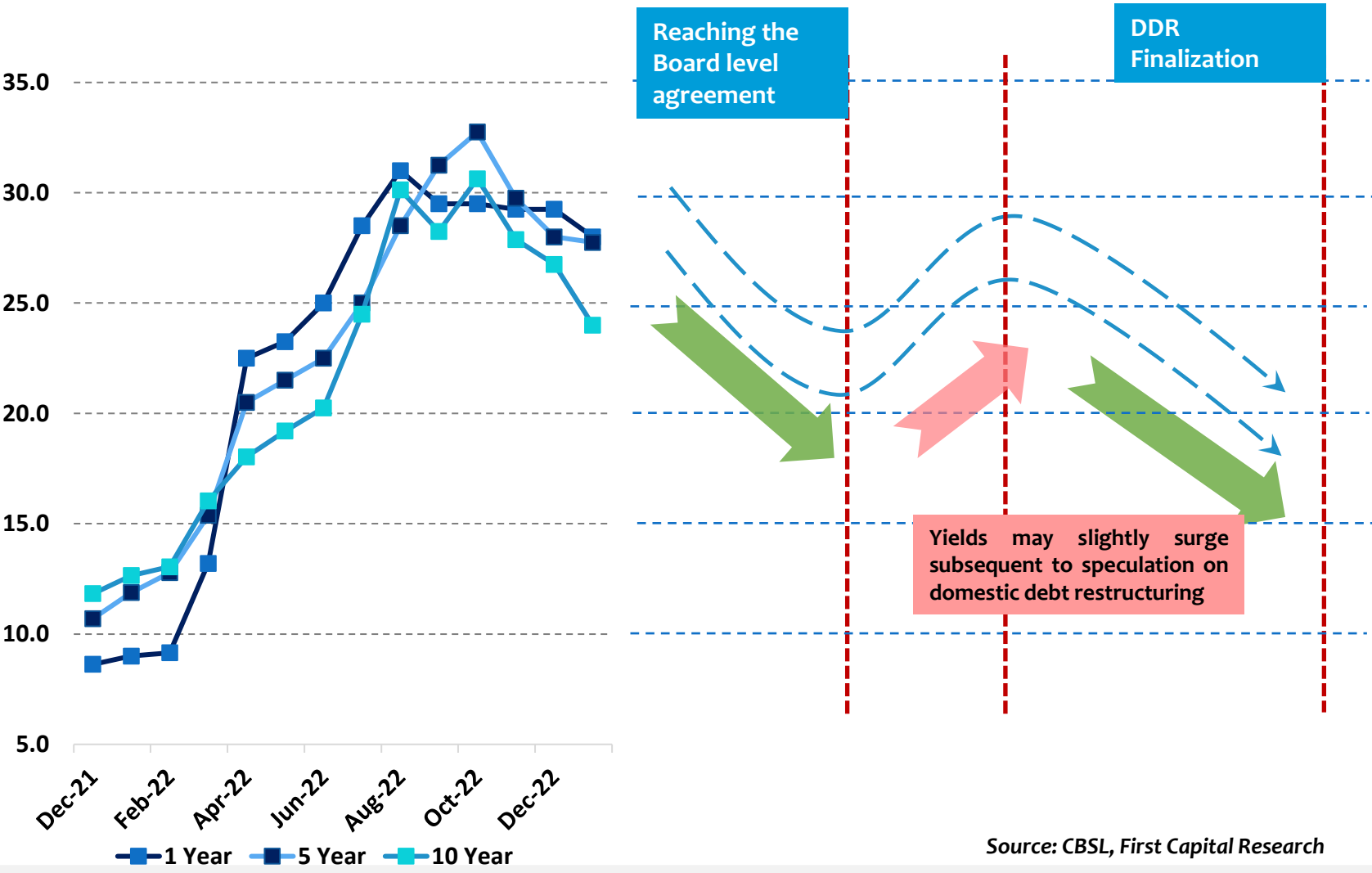
Broader View: First Capital Research is **Bullish** on Bonds



Bond yields to **moderate** during 1H2023E

- Bond yields are expected to moderate in 1Q2023E and gradually witness a decline as Govt. secures the IMF Board Level approval and inflation tames down.
- However, political stability and ability to enter an IMF support facility are key TRIGGER POINTS that will impact the market sentiment.
- First Capital remains highly **OPTIMISTIC with strong BULLISHNESS for Bonds!**
- Consequently, in light of gradual improvement in economic conditions, yields are expected to moderate depending on the timing of developments that reduce the uncertainty.
- *Further during 2H2023 despite positive developments, there could be speculation on domestic debt restructuring that may push yields higher temporarily.*

Bond yields to trend downwards with volatility, amidst speculation on debt restructuring which may continuously haunt investors



With some level stability achieved on the economic front supported by the gradual improvement in the key economic indicators led by; Inflation, exchange rate, credit growth Government Securities yield curve managed to drop below the 30% mark excluding the 2025 maturity short term bond.

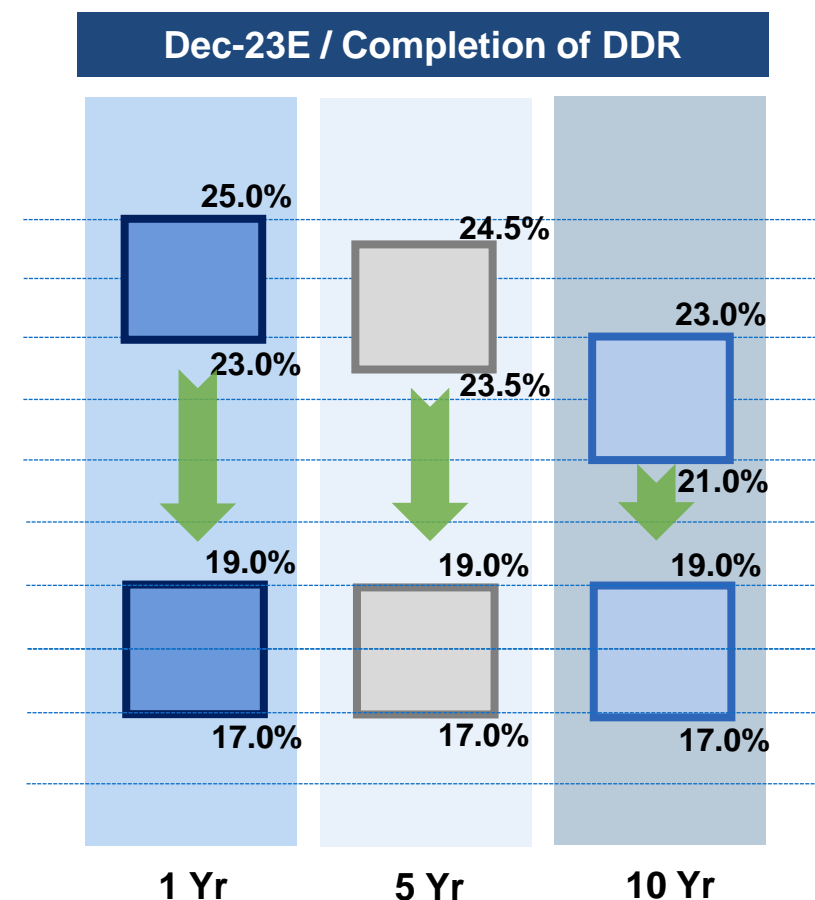
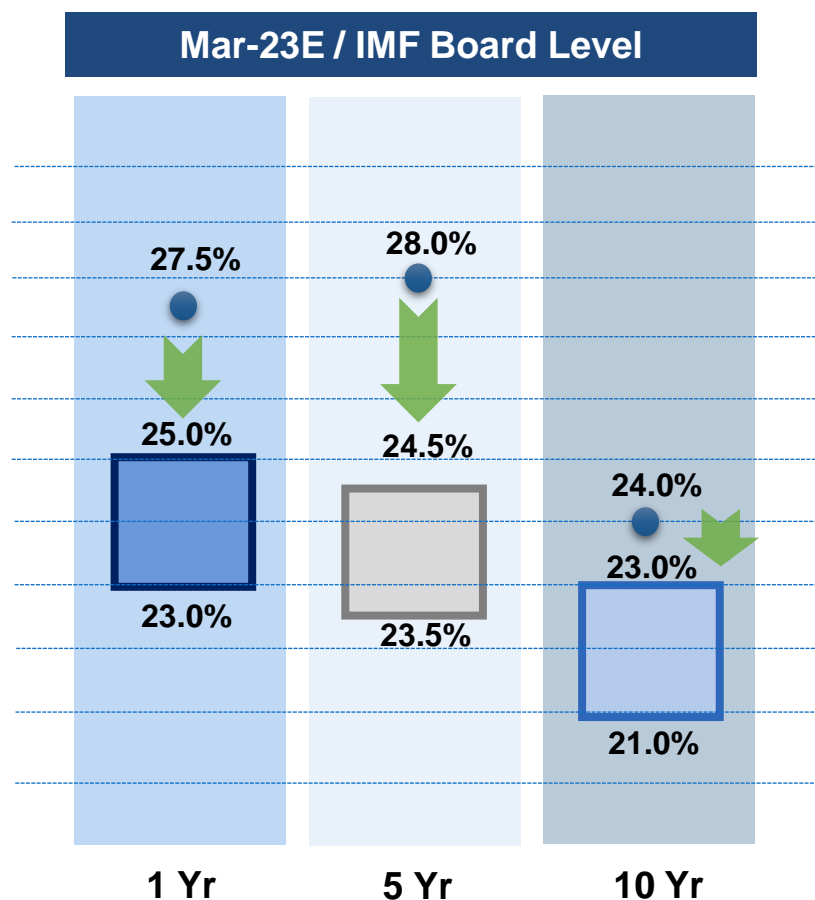
FCR is of the view that yields are likely to witness a continuous dip towards Mar-23 on successful progression that is likely to be made on the board level agreement and receiving of the 1st tranche from the IMF.

Ensuring debt sustainability is likely to improve the outlook for Sri Lanka resulting in a moderation in bond yields by Dec-22.

Source: CBSL, First Capital Research

First Capital Research view on lower yields maintained

FCR maintain the view of moderate yields by 1H2023 amidst political stability (post elections), and IMF Board Level Approval. Some level of volatility could be expected in 2H2023 on account of any speculation on DDR



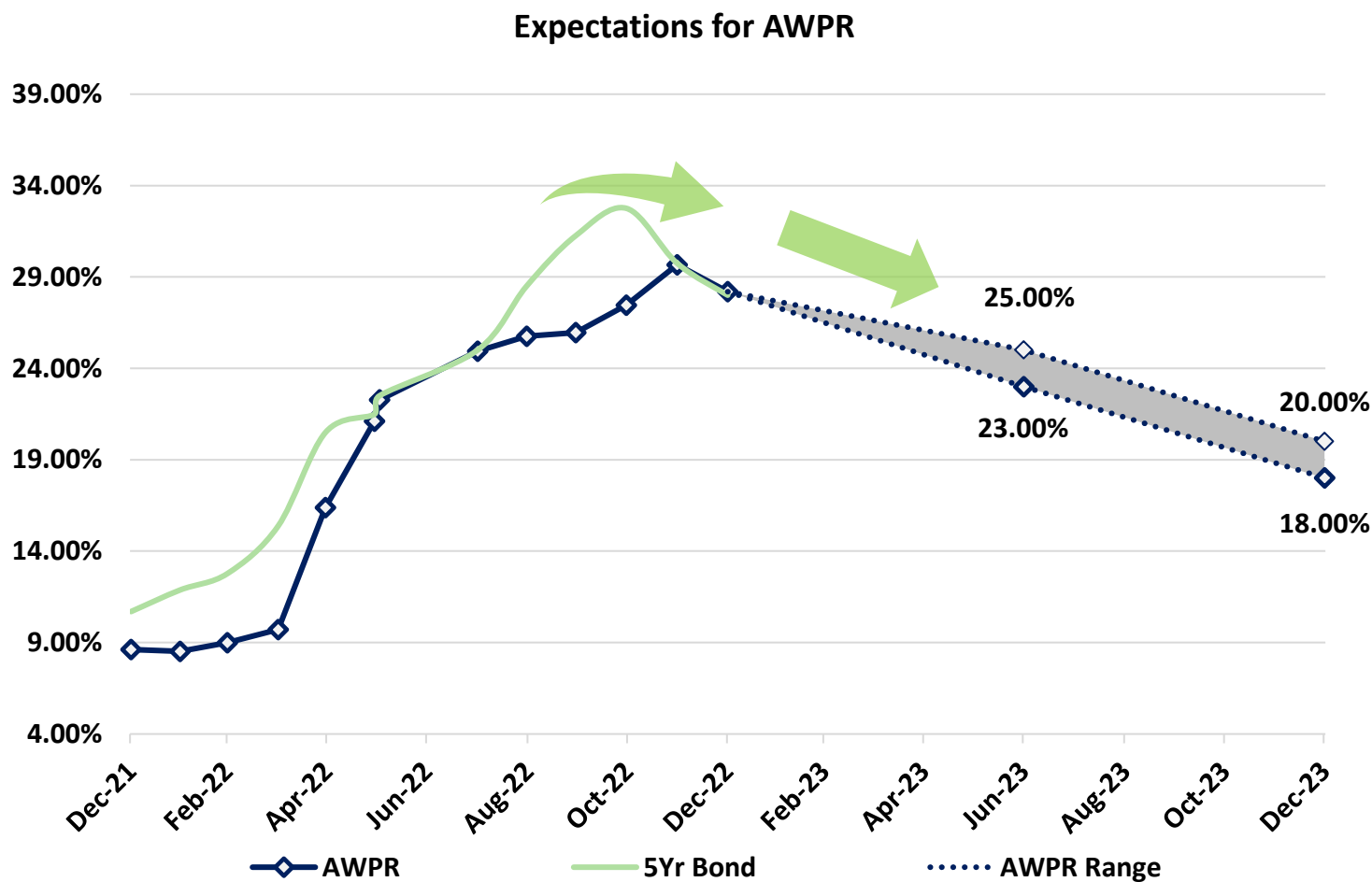
Source: First Capital Research

First Capital Research View on Banking Rates 2023

Section 6.2



AWPR to reverse in 1H2023E



Source: CBSL, First Capital Research

Following the sharp rise in policy rates in Bond yields, AWPR was expected to follow a similar suit with an accelerated pace.

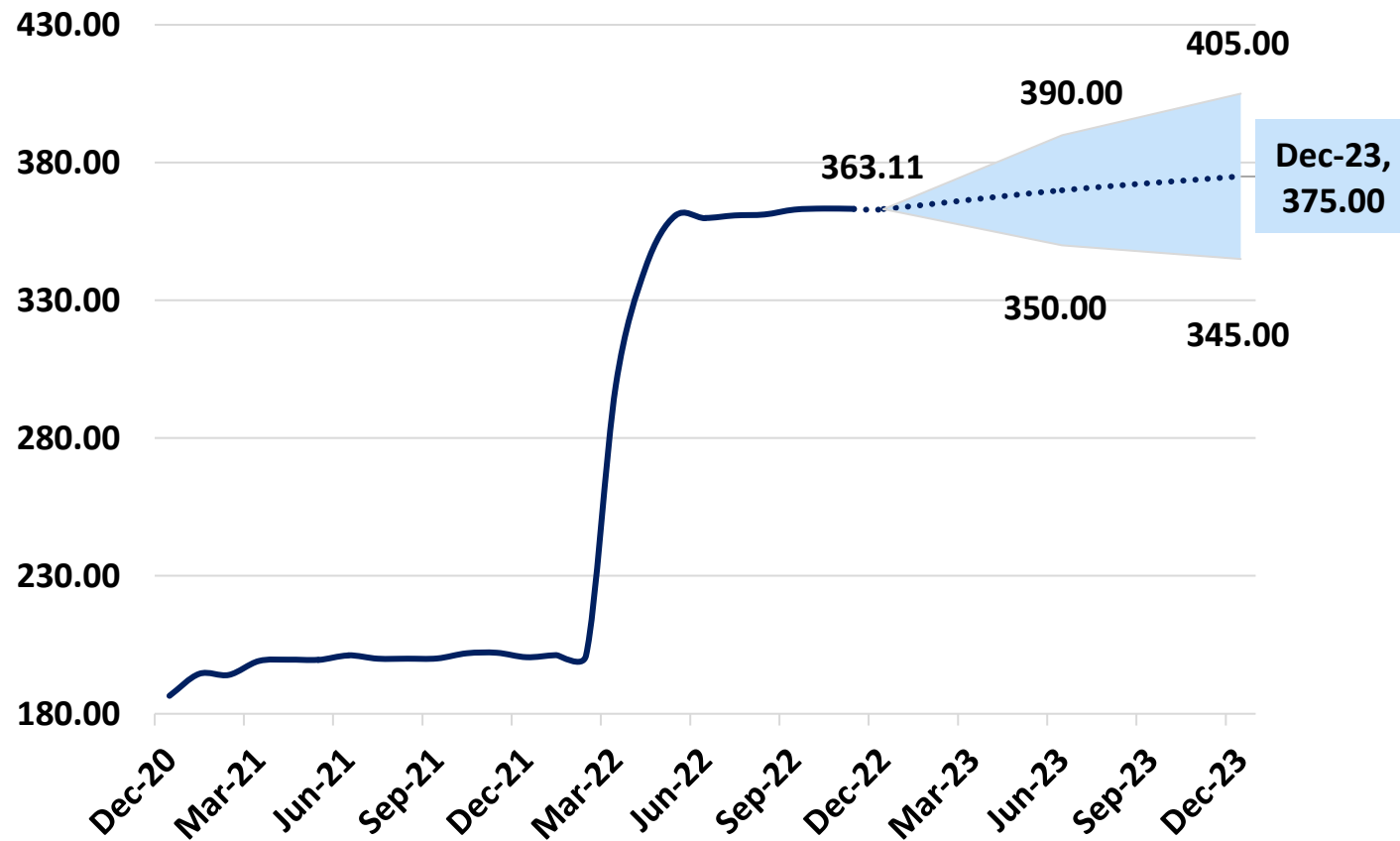
We expect AWPR to follow the yield of 5Yr bond thus reverse towards 23.0%-25.0% by Jun-23 and further dip to 18.0%-20.0% by Dec-23.

First Capital Research View on Exchange Rates 2023

Section 6.3



Exchange Rate is likely to be stable throughout 2023E with possible marginal depreciation amidst trade relaxation



Source: CBSL, First Capital Research

Following IMF Staff level agreement being signed and Board level agreement expected around Mar-23, we expect foreign inflows in terms of investments and potential loans into the country.

However, CBSL is likely to use the opportunity to buy USD in the market in order to build reserves which is a significant priority. Therefore, currency appreciation opportunities are likely to be limited in the market.

During 2023E with the IMF program, we may see trade relaxation, which may result in the currency marginally weakening over the period

First Capital Research View on Equity Market 2023

Section 6.4



Indicators turn positive for Equity



Government passes the budget with relative ease providing a level of comfort and certainty to investors



CBSL infuses liquidity into system significantly reducing the negative position in overnight liquidity



Despite the high level of taxation implemented, Equity Market continues to maintain the tax-free status



High Dividend Yields offer extra boost to gains



Interest rates reverse to a downtrend in line with inflation

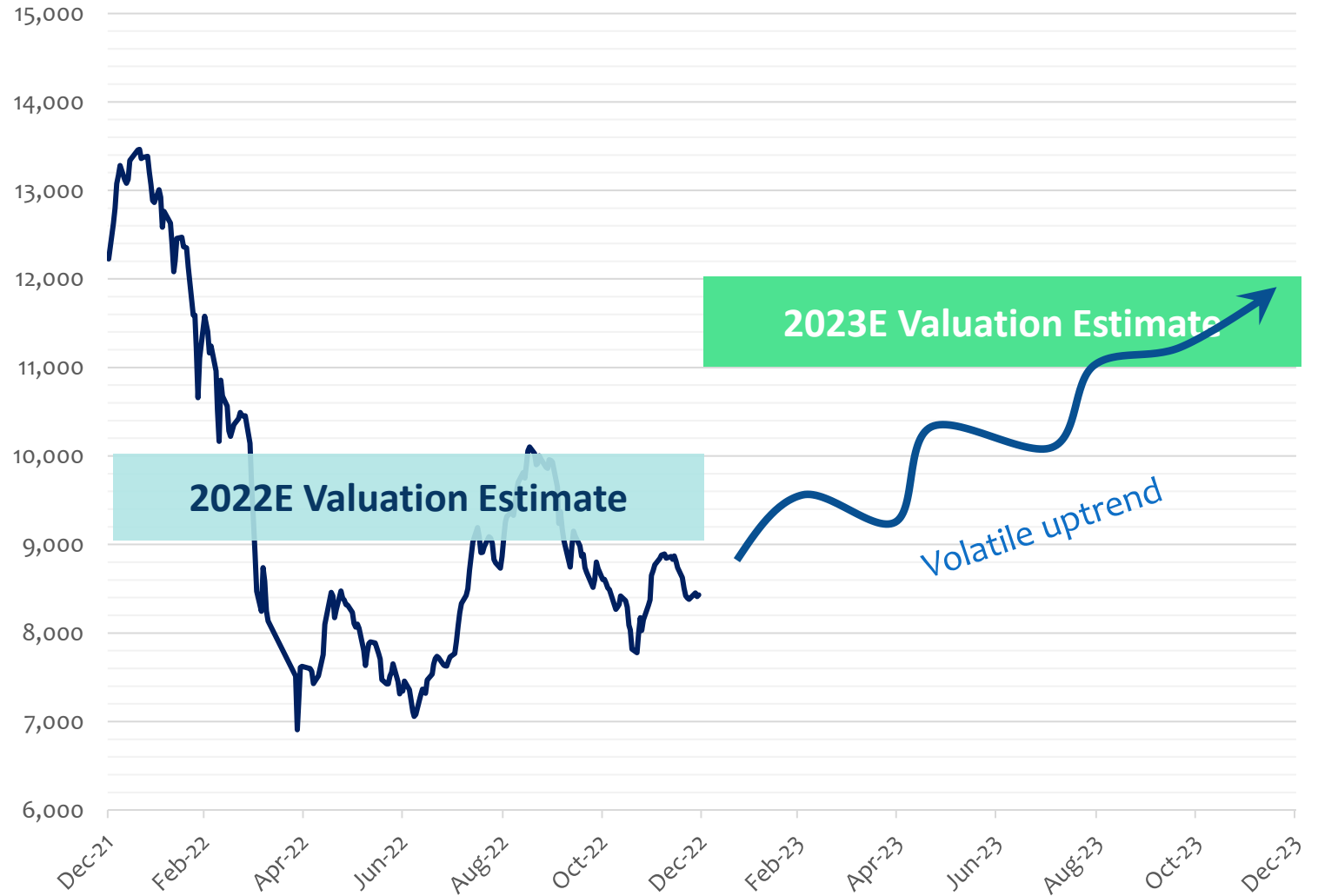
Potential IMF deal in 1Q2023 may boost equity investor confidence



ASPI to reach **12,000** by Dec-2023 on IMF positivity

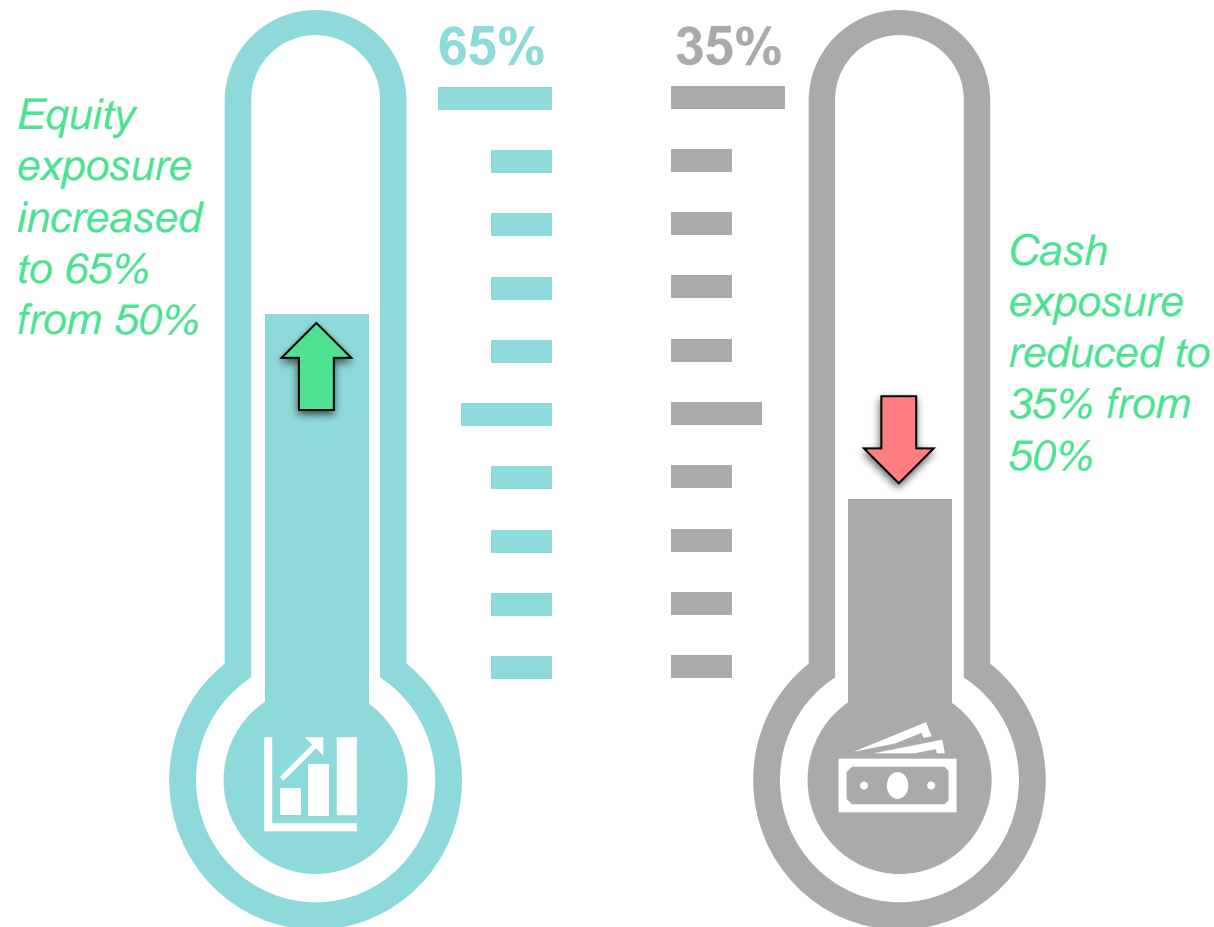
First Capital maintains ASPI 2023E fair value range of **11,000-12,000** on the positivity of the potential IMF support program and recovery in GDP towards 4Q2023

On expectation of a strong recovery in earnings and positive growth levels of GDP returning from 4Q2023 and beyond, it is likely create a strong bullish sentiment for equities. We expect market to re-rate allowing the index to showcase strong positive returns in 2H2023E with the index likely to reach 12,000.



Source: CSE, First Capital Research

Cautiously Bullish; Equity Exposure increase to 65%



> Invest more into equity

With the improving economic indicators and the potential developments listed below, Equity Market warrants a higher exposure to benefit from the potentially stronger returns towards the 2H2023.

- Government retains majority securing stability
- Strengthening liquidity position
- Retention of Tax-Free Environment for Equity
- Interest rates trend downwards
- Potential IMF Board Level Agreement

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Thank You

“Successful investments is about managing risks”