



First Capital  
A Janashakthi Group Company

# ***“Finding Silver Linings in Declining Yield Rates”***

## **19<sup>th</sup> Jun 2023**

**FIRST CAPITAL FIXED INCOME RECOMMENDATION**

**FIRST CAPITAL RESEARCH**

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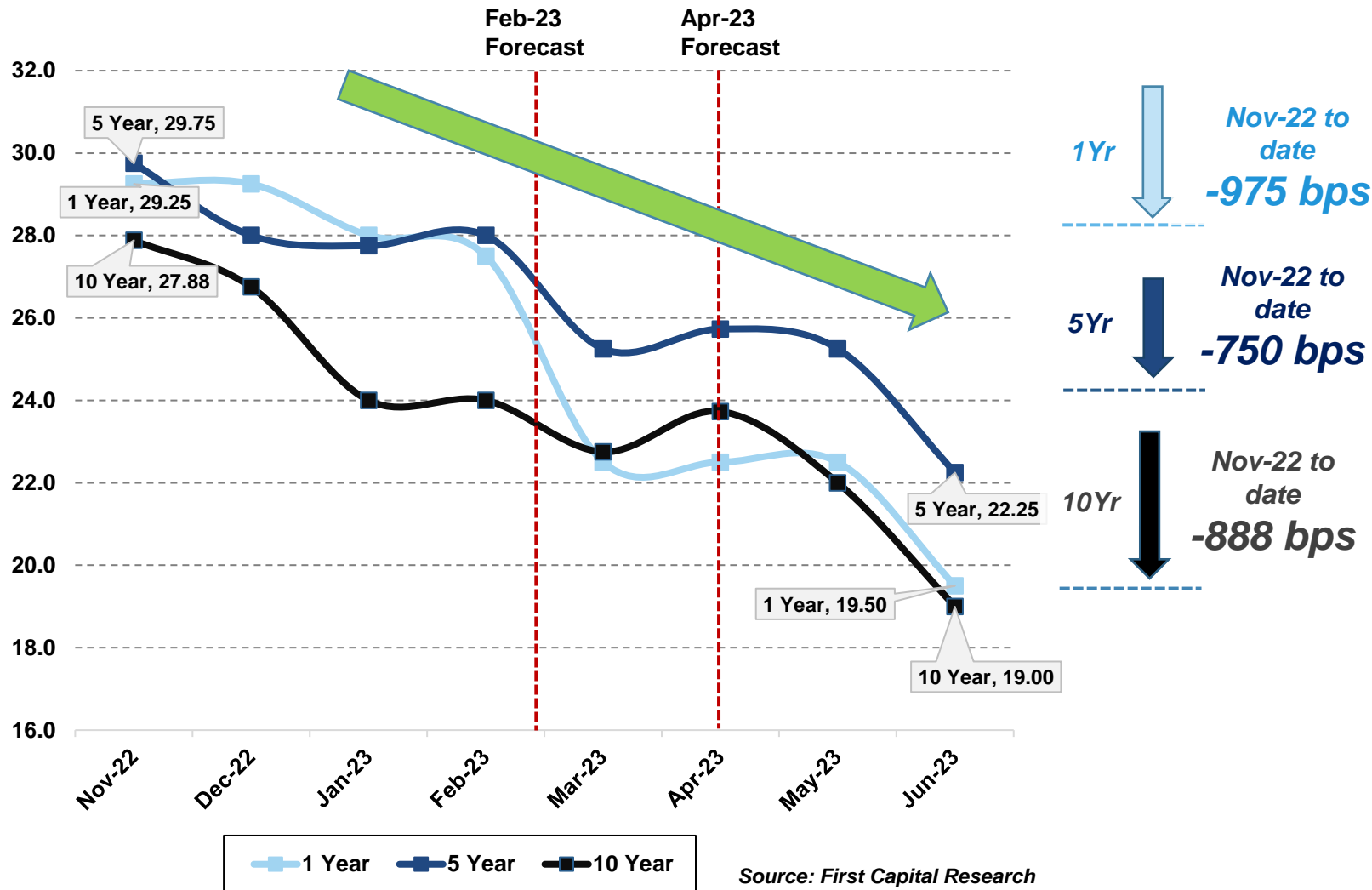
# 1.0 FCR - Previous Recommendation

*“Yields returning to normalcy after Sri Lanka secured the USD 3.0Bn IMF deal ”*



# 30<sup>th</sup> Nov-22 to 19<sup>th</sup> Jun-23 bond yields plunged by over 750bps

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## Previous Recommendations

### 28<sup>th</sup> Feb 2023

“Bond yields are likely to witness a continuous dip towards Mar 2023 on successful progression that is likely to be made on the board level agreement and receiving of the 1st tranche from the IMF”

- **Accurate**

### 04<sup>th</sup> Apr 2023

“Comparing the expectations by the end of the year of the completion of domestic debt restructuring, the yield curve is expected to normalize while also dipping to a range of 17%-19% ”

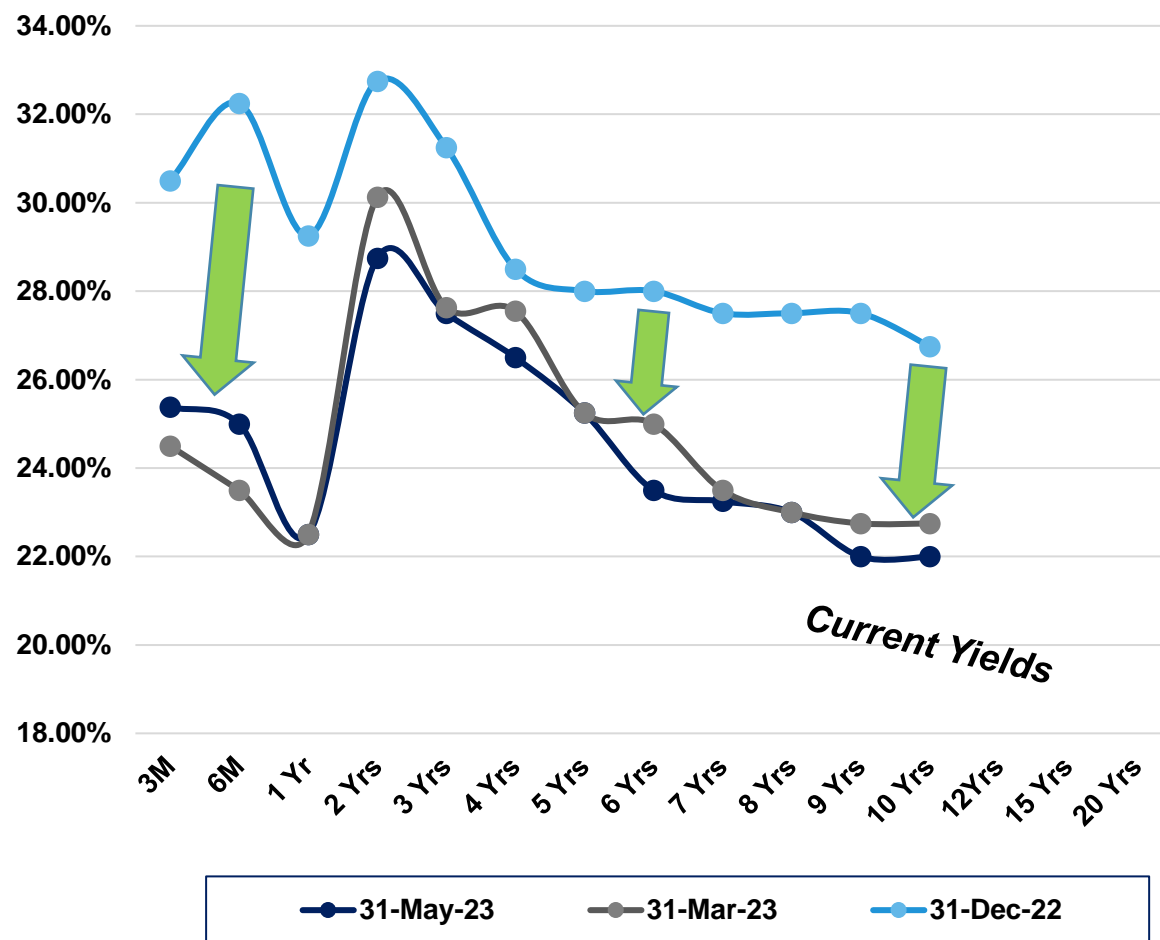
- **Accurate**



# Overall yield curve movement

4

## Yield curve quarter end comparison



## Interest Rate Change (bps)

Tenure	May-23	Mar-22	Change (bps)	Dec-22	Change (bps)
3M	25.38%	24.50%	+88	30.50%	-512
6M	25.00%	23.50%	+150	32.25%	-725
1 Yr	22.50%	22.50%	0	29.25%	-675
2 Yrs	28.75%	30.13%	-138	32.75%	-400
3 Yrs	27.50%	27.63%	-13	31.25%	-375
4 Yrs	26.50%	27.55%	-105	28.50%	-200
5 Yrs	25.25%	25.25%	0	28.00%	-275
6 Yrs	23.50%	25.00%	-150	28.00%	-450
7 Yrs	23.25%	23.50%	-25	27.50%	-425
8 Yrs	23.00%	23.00%	0	27.50%	-450
9 Yrs	22.00%	22.75%	-75	27.50%	-550
10 Yrs	22.00%	22.75%	-75	26.75%	-475
12 Yrs	N/A	N/A	N/A	N/A	N/A
15 Yrs	N/A	N/A	N/A	N/A	N/A
20 Yrs	N/A	N/A	N/A	N/A	N/A





## 3.0 Fixed Income Health Score

*“Fixed Income health score show signs of improvement in months to come”*



## FI Economic Health Score – May-23

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*Fixed Income Health Score records a significant improvement during the 2Q2023 supported by multiple factors in primary and secondary criteria inclining the health score to 57 points.*



Primary Criteria

$$- \quad 30 \quad + \quad 09 \quad = \quad 39$$

Secondary Criteria

$$- \quad 11 \quad + \quad 07 \quad = \quad 18$$

Economic Health Score  
[May 2023]

$$= \quad 57$$

Source: First Capital Research

Jun 2023

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[As against 41 in Mar 2023 &  
13 in May 2022 (1 Year ago)]



# Changes to Health Score

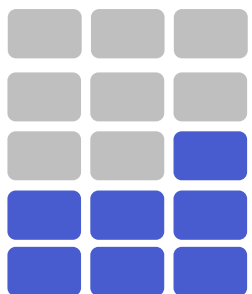
## Primary Criteria – Mar-May 2023

39/ 75



7

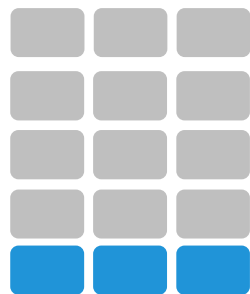
May 2023- Score



07/15

### Foreign Reserves

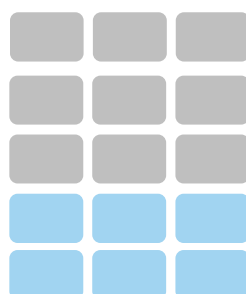
Foreign reserves surpassed LKR 3.0Bn and recorded at USD 3.5Bn in May 2023, highest in 21 months.



03/15

### Liquidity

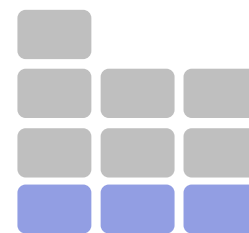
Liquidity level was highly volatile and closed the month of May 2023 negatively at LKR 84.5Bn compared to LKR - 146.7Bn recorded at the beginning of the month.



06/15

### Inflation

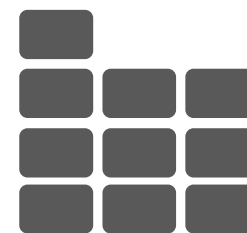
CCPI continued to decline for the 8<sup>th</sup> consecutive month and recorded at 25.2% in May 2023, indicating stabilization of inflation.



03/10

### Foreign Activity

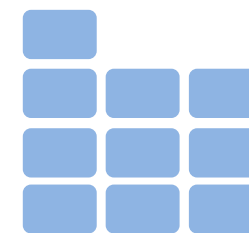
Foreign Investment in Govt. securities significantly inclined to LKR 161.2Bn amidst the high interest rates.



10/10

### Credit

Private sector credit continued to contract for the 11<sup>th</sup> consecutive month to LKR 7,109.6Bn in Apr 2023 compared to the sharp escalation in lending rates.



10/10

### CBSL Holdings

CBSL holdings remained steady above LKR 2,600.0Bn during the month of May 2023.

Mar 2023- Score



03/15

03/15



02/15



02/10

10/10

10/10

Jun 2023

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# Changes to Health Score

## Secondary Criteria – Mar-May 2023

18 / 25

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May 2023- Score



01/05

### Rating Outlook

S&P has downgraded Sri Lankan bonds to 'D', representing default. Meanwhile, Moody's downgraded Sri Lanka's debt rating to 'Ca' from 'Caa2' in Apr 2022. Fitch downgrades SL Long-Term Local-Currency Issuer Default Rating (IDR) to 'CC', from 'CCC'.

01/05



05/05

### External Environment

Foreign exchange market remains highly volatile, while USD/LKR has appreciated by 18.6% YTD and 8.1% during the month of May 2023.



03/05



05/05

### BOT & BOP

Trade deficit contracted and recorded at USD 583.0Mn in Apr 2023 while BOP turned into surplus and recorded at USD 883.0Mn amidst the rise in foreign inflow from tourism and worker remittances.



04/05



04/05

### Political Risk

Political stability is maintained. However, popularity of the govt. is deteriorating due to uncertainties.



02/05



03/05

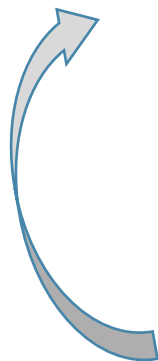
### Investor Confidence

The BCI registered only a marginal decline of one basis points to 34 in 1Q2023 cf. 35 in 4Q2022. However, we believe business confidence to improve gradually considering the economic rebound post IMF



01/05

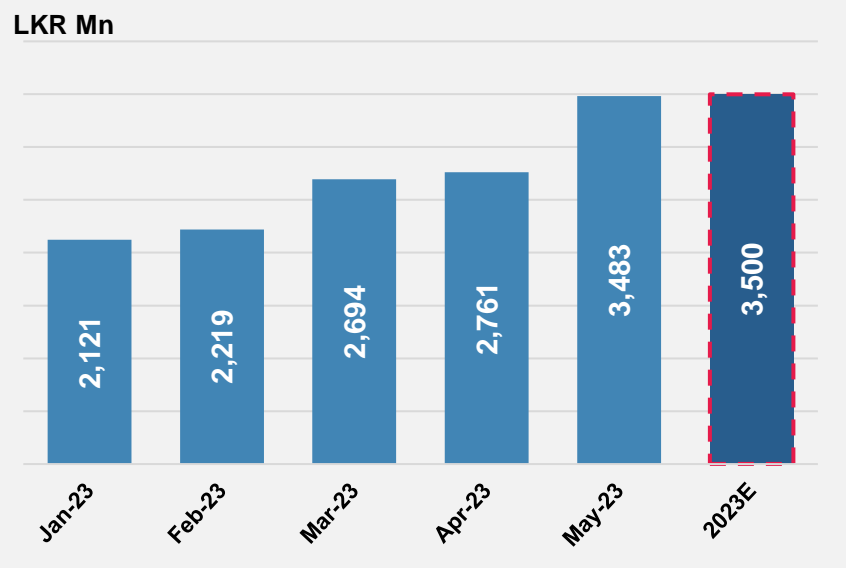
Mar 2023- Score



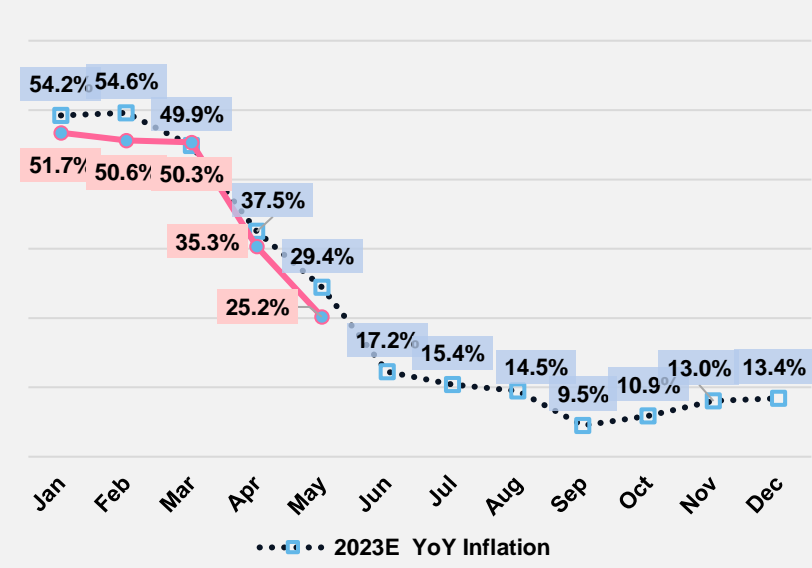


# Economic Indicators shows signs of recovery

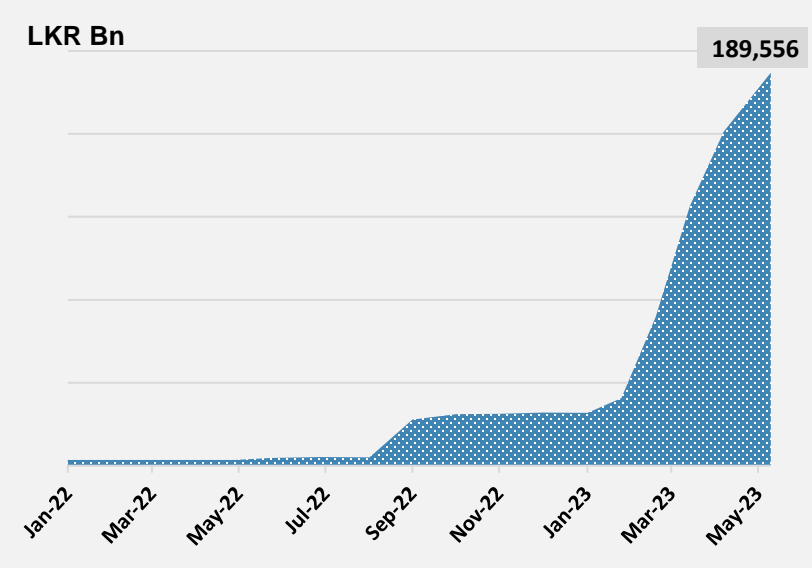
Foreign reserves reaches FCR’s 2023 target



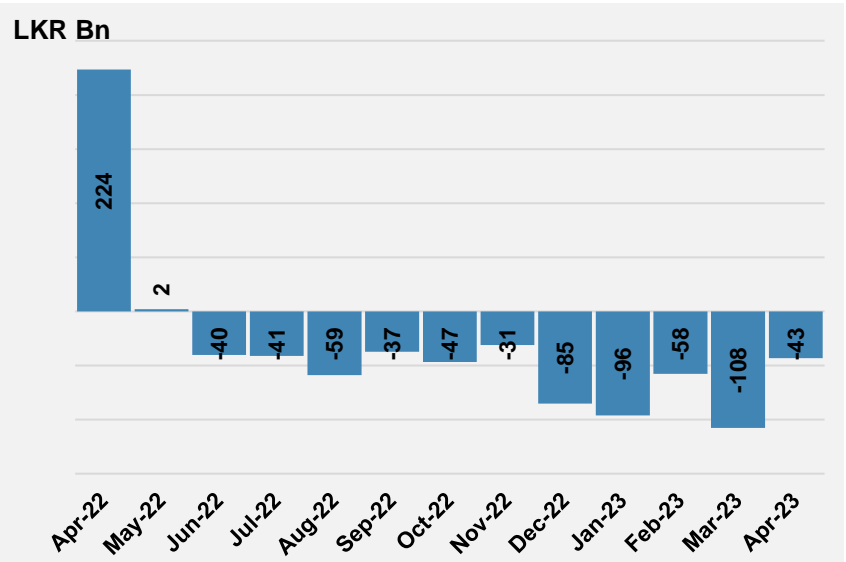
Inflation decelerates well above the target



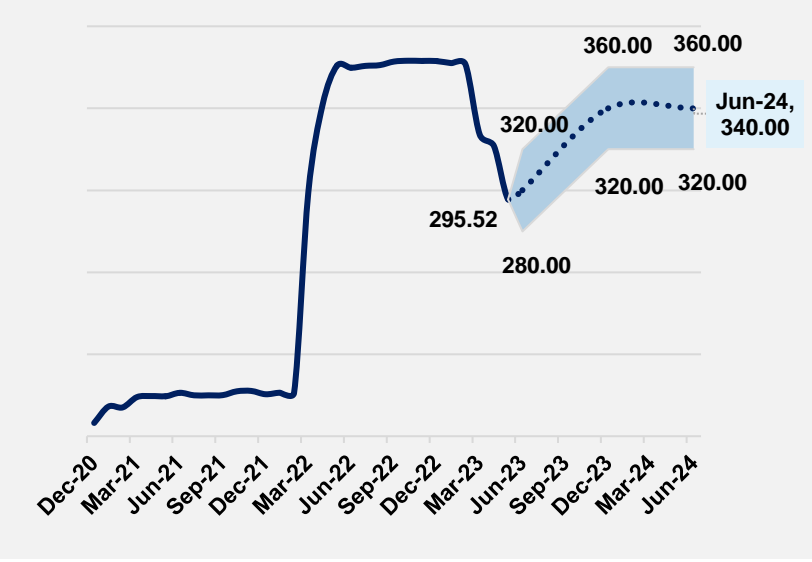
Foreign investment in Govt. securities rose >100%YTD



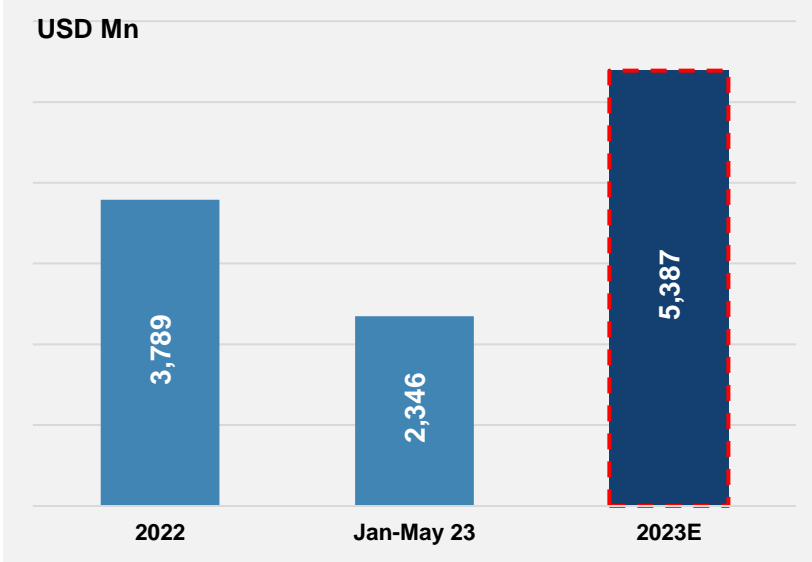
Private sector credit declines for the 11th month



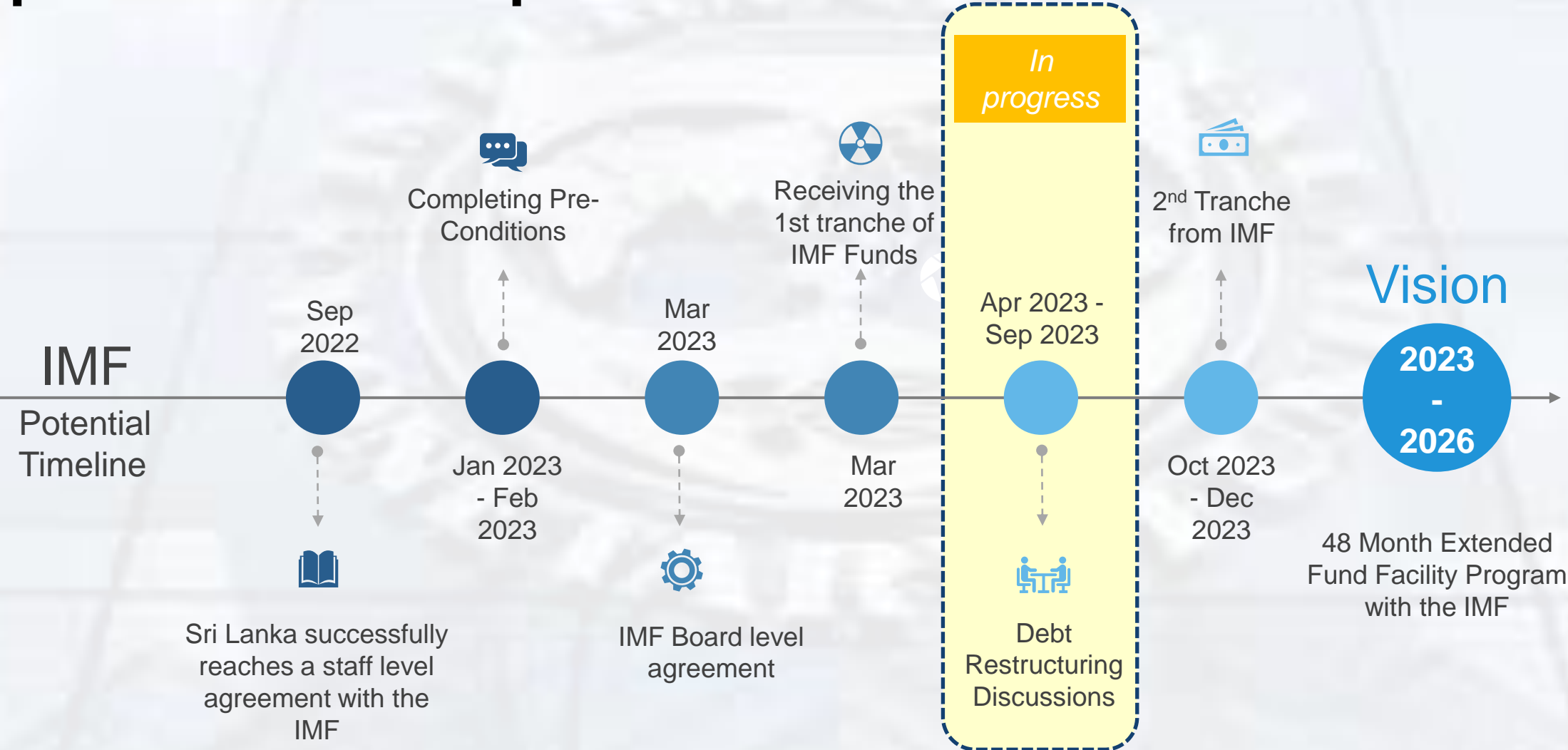
USD/LKR remains volatile, hence FCR revises target for 2023



Worker Remittances depicts positive YoY growth



# Sri Lanka signs IMF deal in Mar-23, in-line with First Capital Research expectations



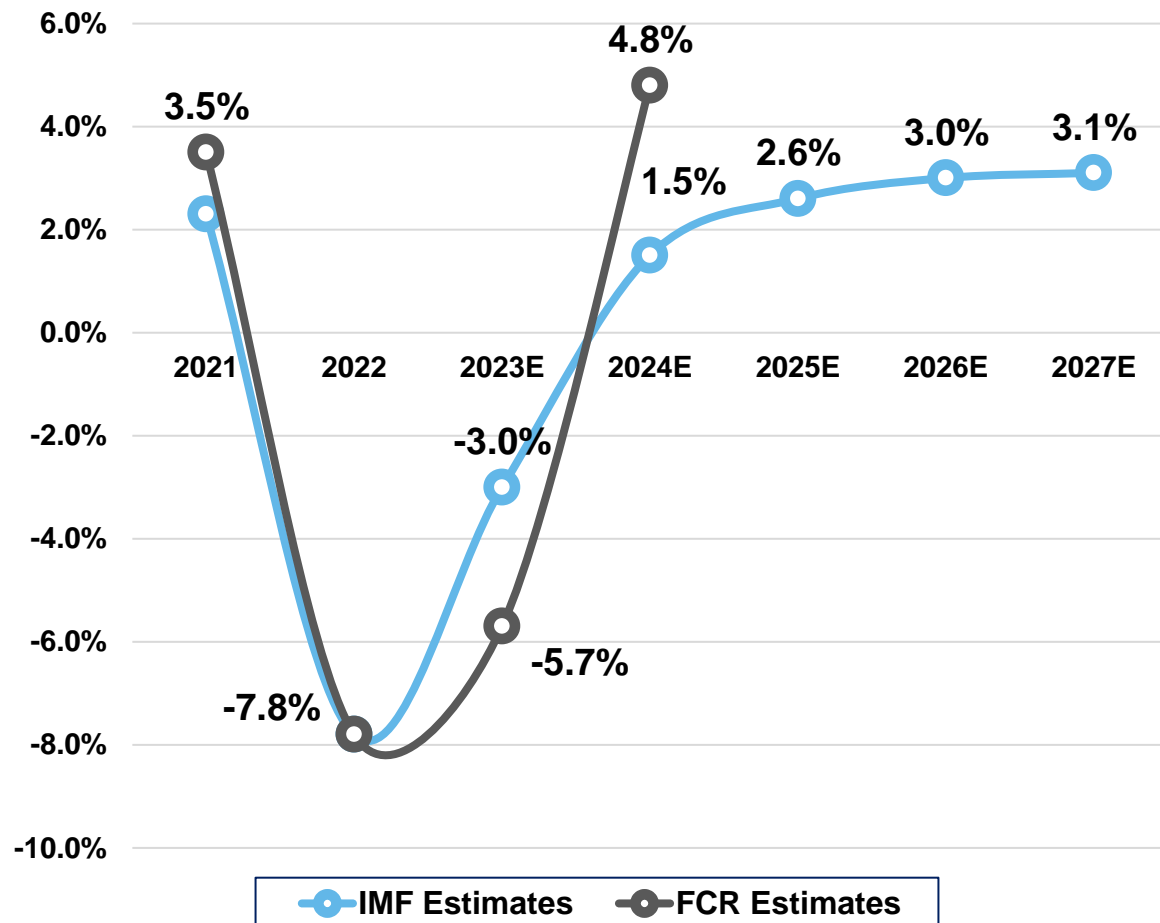
Source: First Capital Research



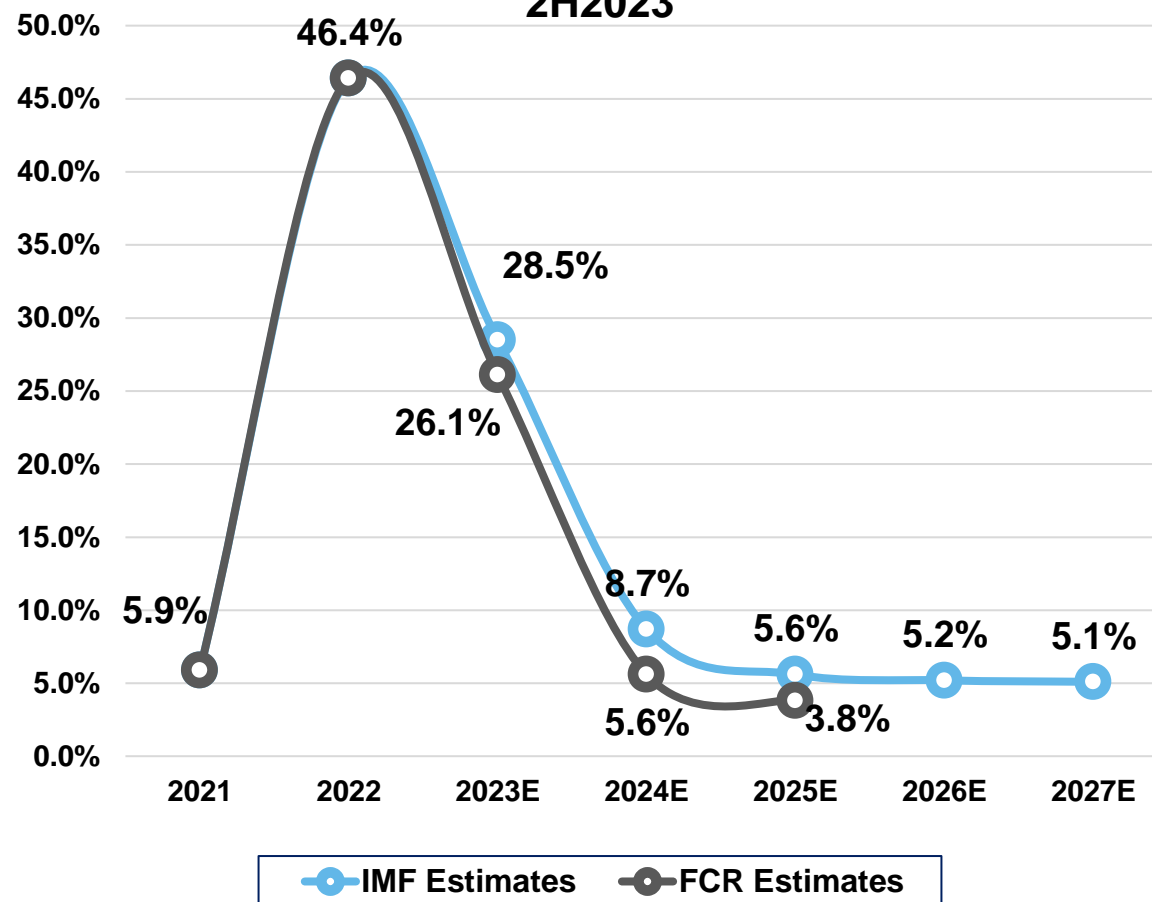
# Sri Lanka on the track to restore macroeconomic stability

11

## GDP to turn positive in 2024E



## Inflation expected to be stabilized from 2H2023

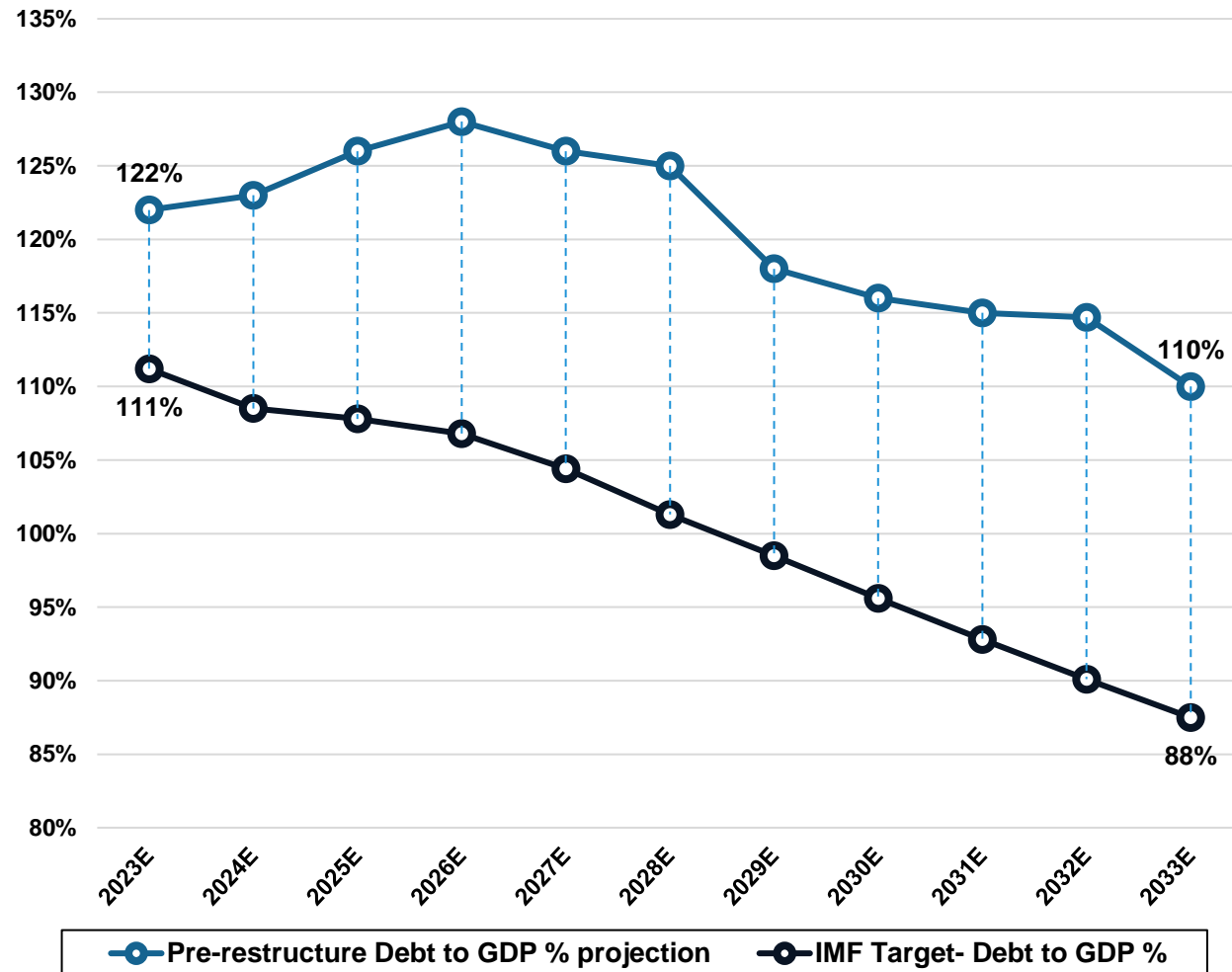




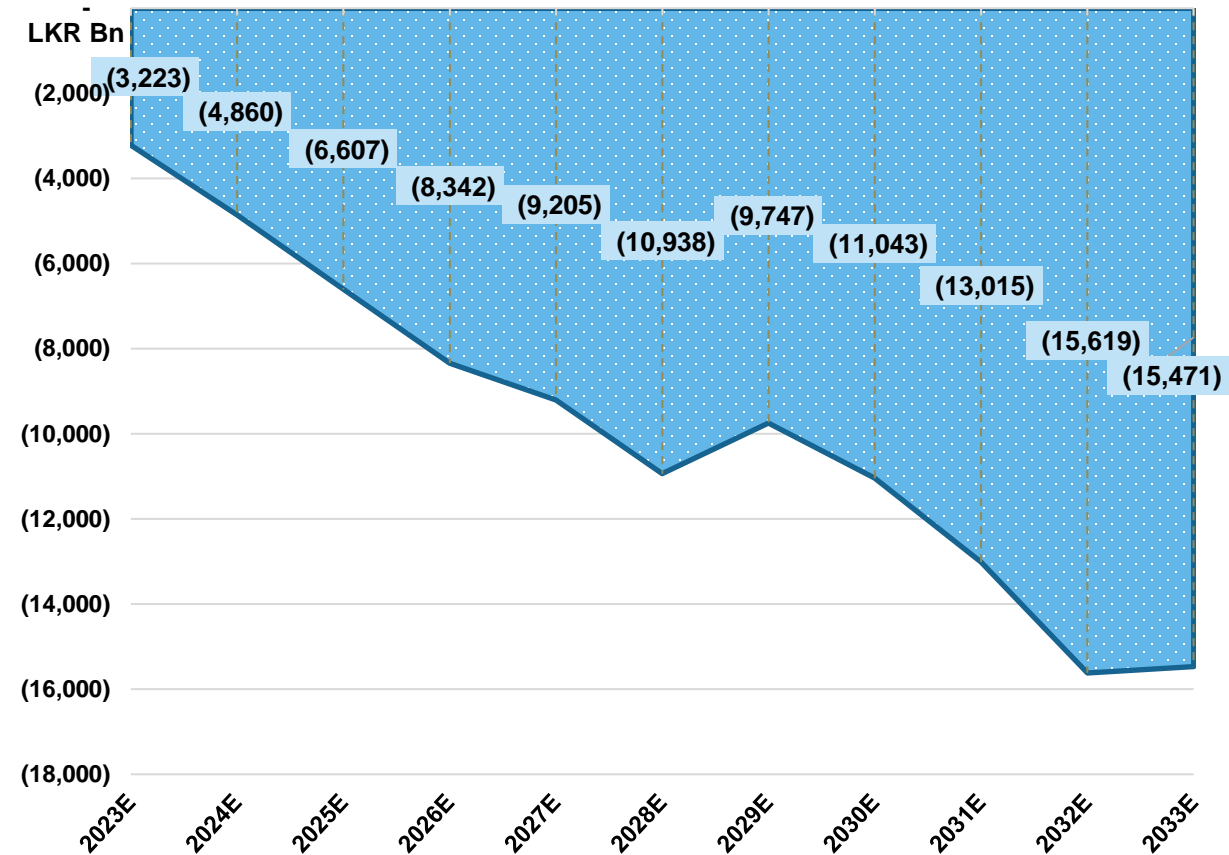
# The GoSL is undertaking a comprehensive restructuring of External and Domestic debt....

12

## Sri Lanka Debt to GDP % - Pre-restructuring Vs IMF Target



## Targeted debt to be reduced to meet the IMF target (LKR Bn)

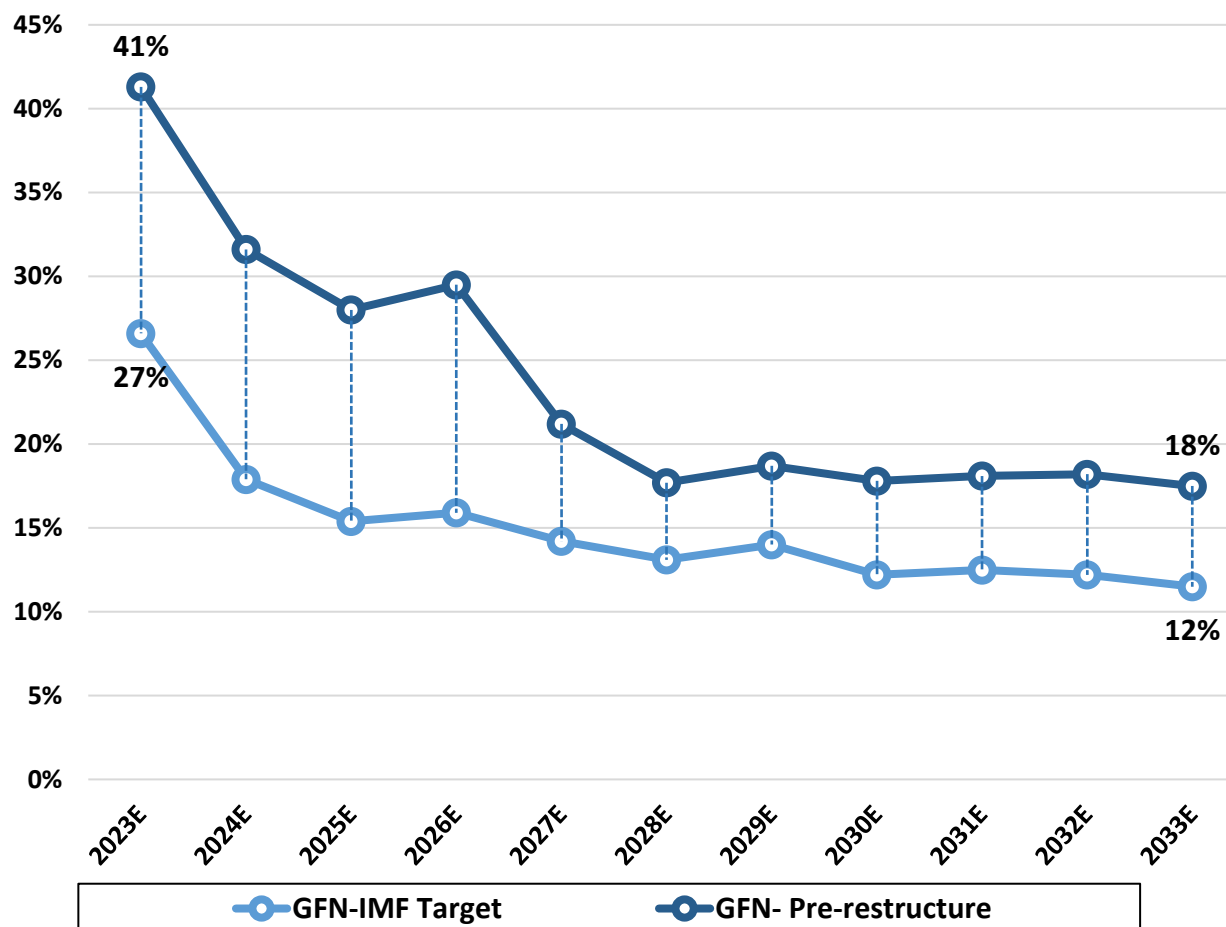




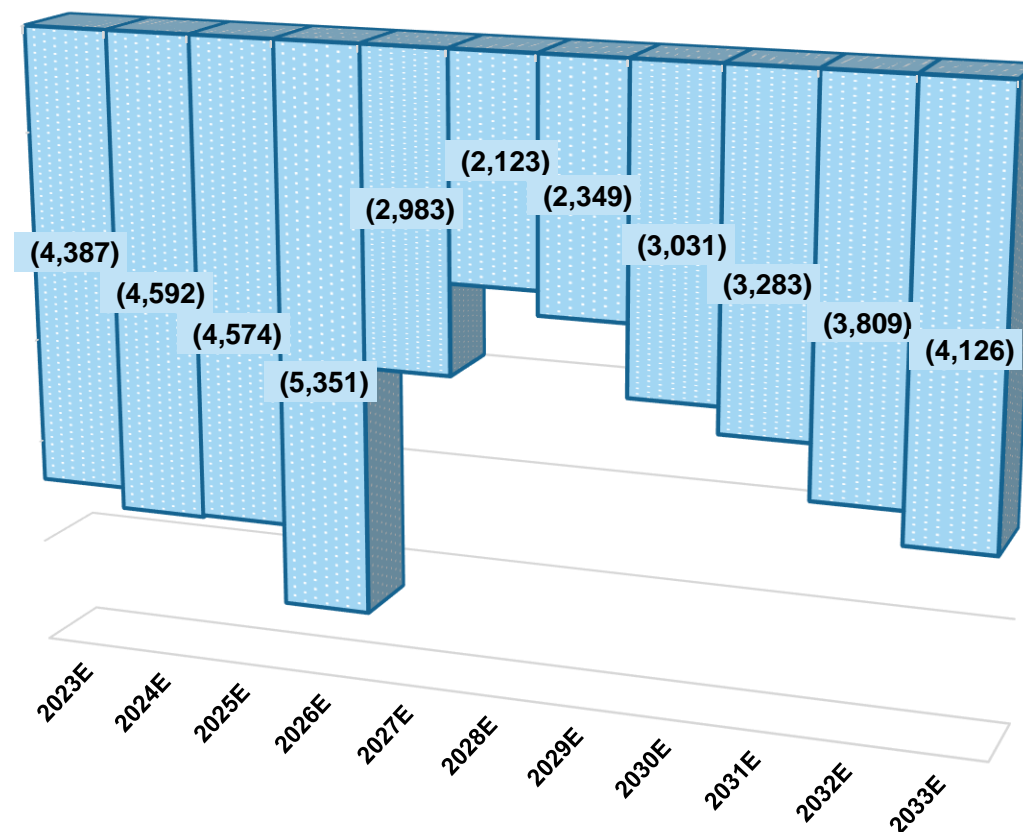
# ...to attain sustainable level of Gross Financing Needs (GFN)

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## Sri Lanka GFN Target % of GDP – Pre restructuring Vs IMF target



## Gross Financing Needs (Difference between pre-restructure vs IMF) LKR Bn





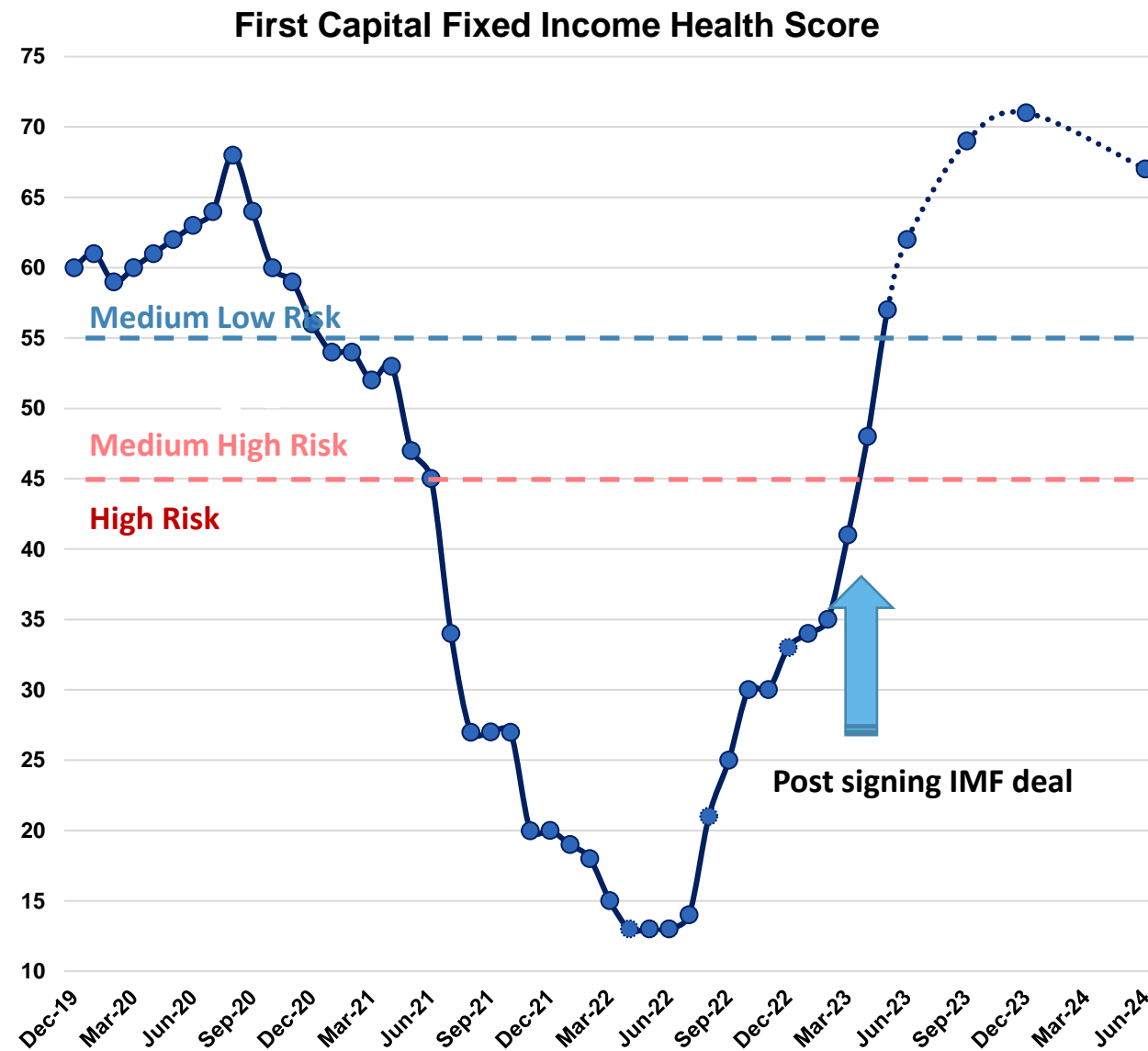


# 4.0 New Recommendation

*“Time to be cautious;  
Downgrade to Hold from Buy”*

Post signing the IMF deal in Mar-23, FI Health Score recorded a further accelerated improvement in 2Q2023 crossing over from the High Risk to Medium Low Risk in 2Q2023 supported by the development in key economic indicators.

*Further improvement is expected in 3Q2023, where the FI Health is expected to cross towards the Low-Risk territory leading the way for a further decline in interest rates.*





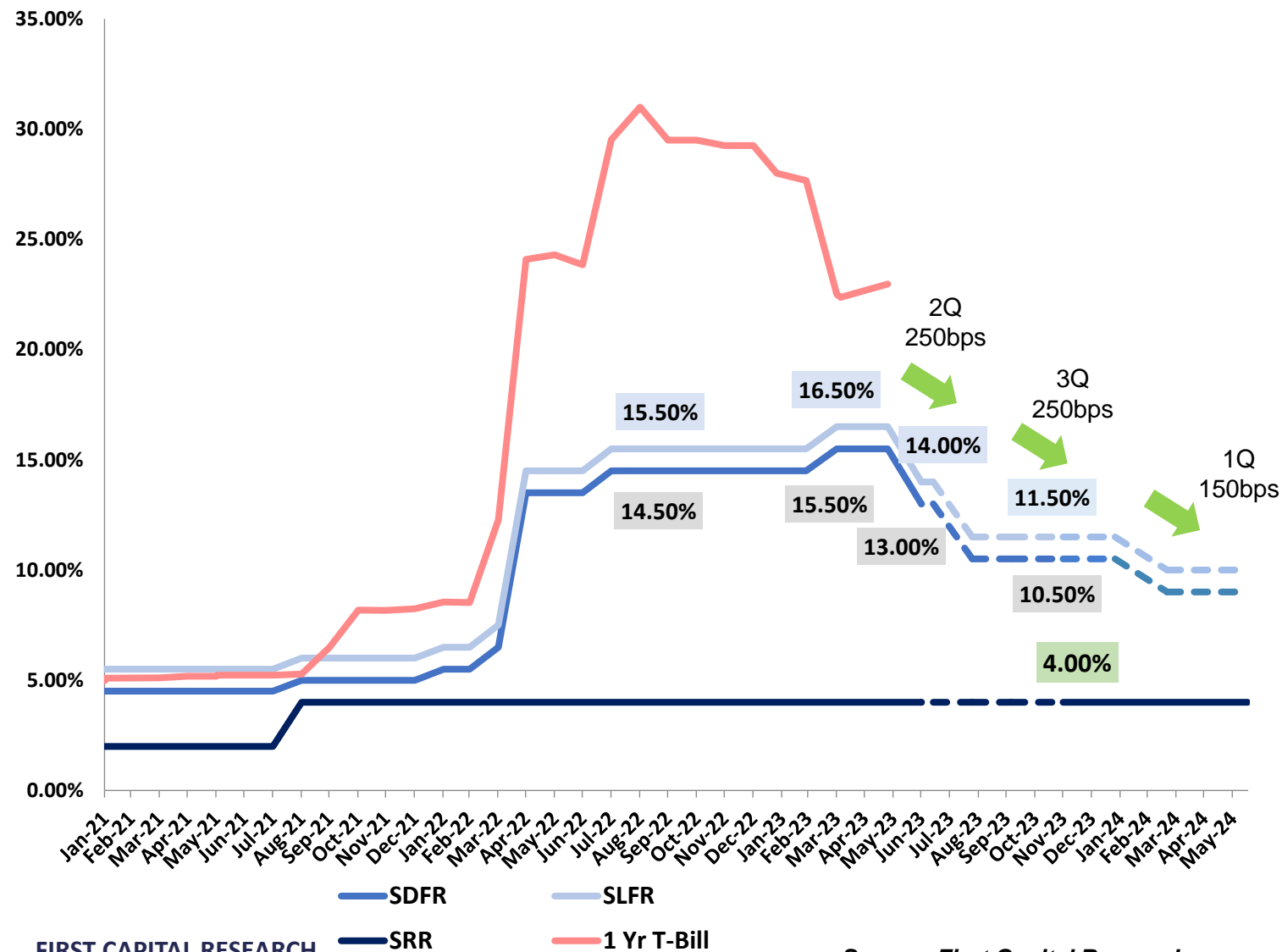
## Policy rates trend further down amidst stabilization

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Post IMF, following the stabilization of the economy and the accelerated improvement in the economic indicators, CBSL has adopted an aggressive path for reduction in interest rates by announcing a 250bps rate cut in May-23.

**A further Rate cut is a strong probability towards 3Q2023. We target about two rate cuts amounting to a cumulative dip of about 500bps of which 250bps has already been given in 2Q while a further 250bps is likely in the 3Q.**

**A further 150bps is likely in 1H2024 supported by the decline in inflation.**



Source: First Capital Research

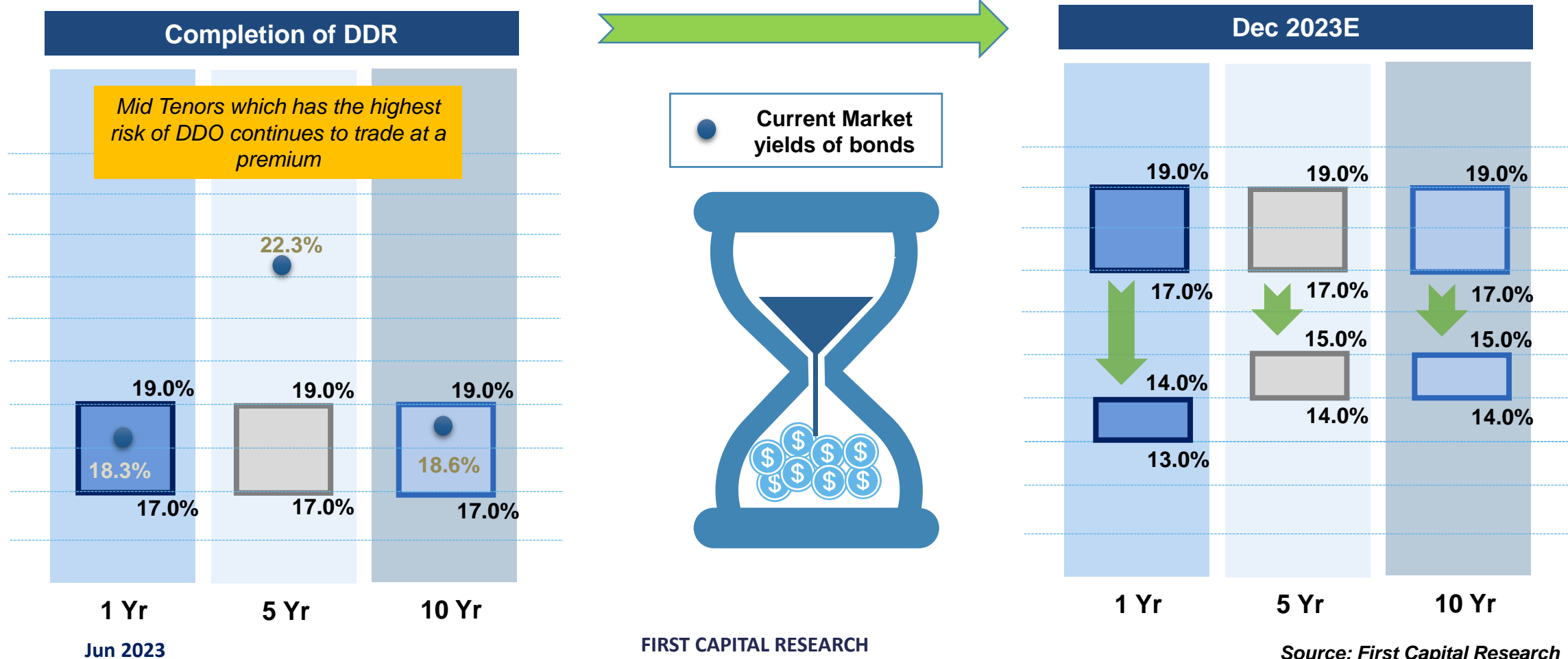
Jun 2023



# Bond Yield Expectations of 2023

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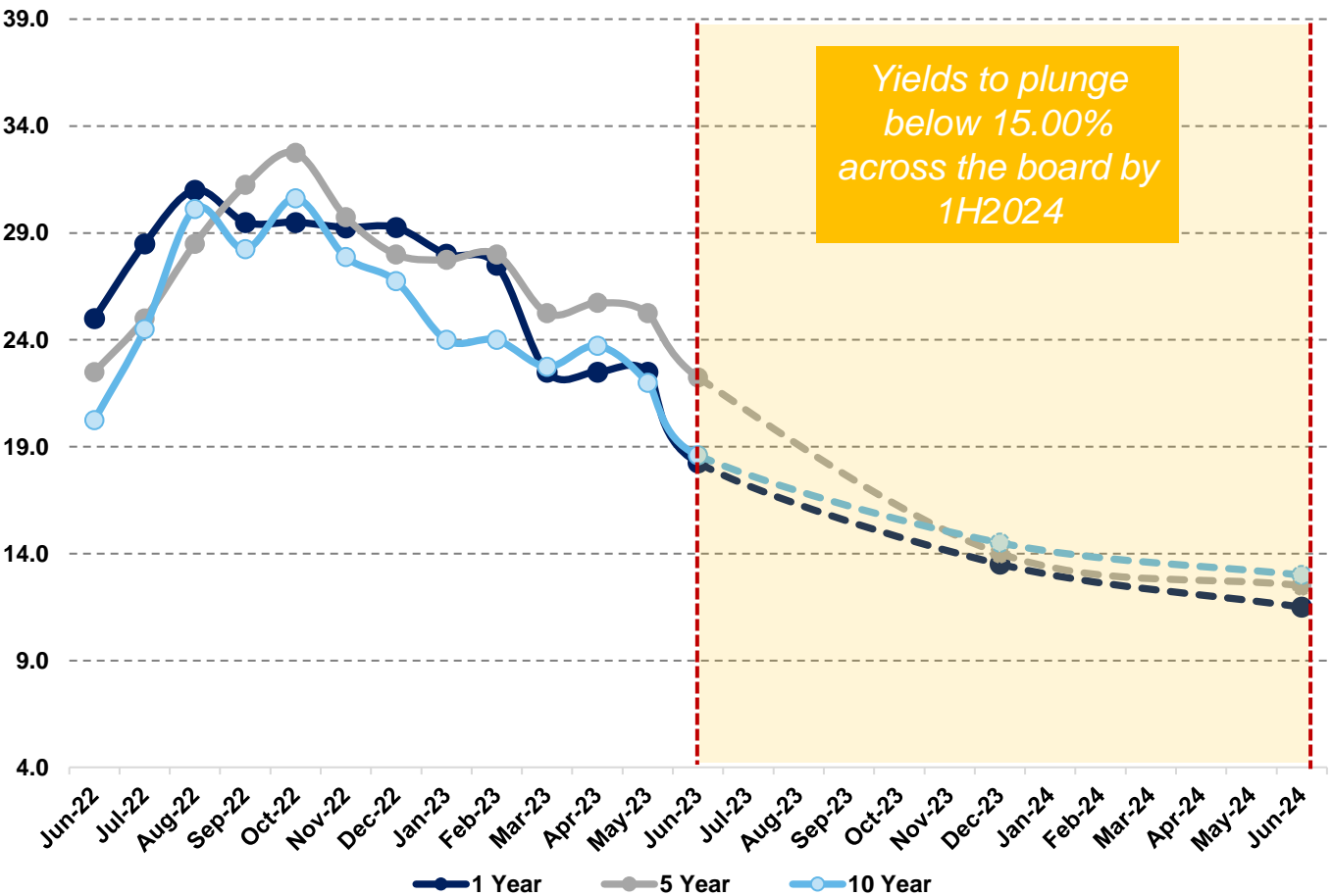
In line with the expectations following the IMF Board Level Agreement and the subsequent creditor meeting bond yields recorded a steep drop falling into the targeted ranges of First Capital Research. *With the completion of domestic debt restructuring or towards Dec-23 we believe the overall yield curve is likely to drop below 20%.*





# Bond Yield Expectations of 1H2024

Bond yields to normalize to pre-crisis level

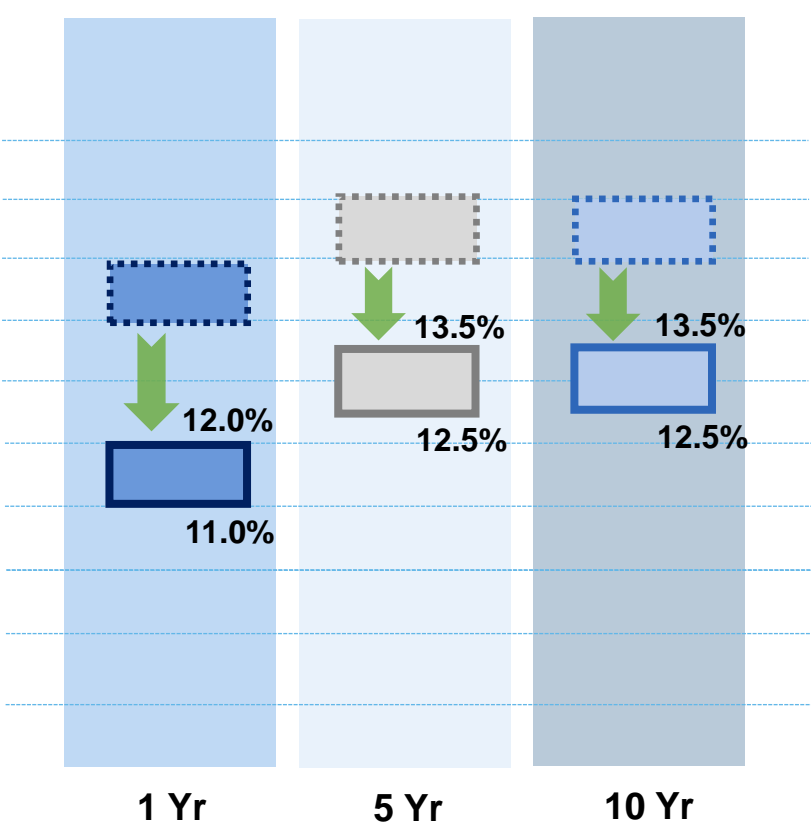


Source: First Capital Research

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Jun 2023

Jun 2024E



Source: First Capital Research





First Capital Research believes it's time to **partly book profits**

**Recommendation Change:**  
Downgrade to **Hold** from **Buy**

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## Time to be cautious



**DDO draws closer; Premiums decline:** With the massive decline in G-Sec yields, the significant premium that was previously available on yield curve is no longer available. The extreme short term (1Yr) and the long tenors (10Yr) has already reached our post DDO target while 5Yr only has about a 400bps spread to fall into the target range of 17%-19% of First Capital.



**Book profits reduce exposure:** There is a lot of uncertainties surrounding DDO and its application. As the premiums attached to the bonds have significantly reduced and in some cases completely eliminated, we would like to advice investors adopt a **wait and see approach** on their portfolios. We would like to further advice to book profits on part of the bondholding specifically on the long end of the portfolio.

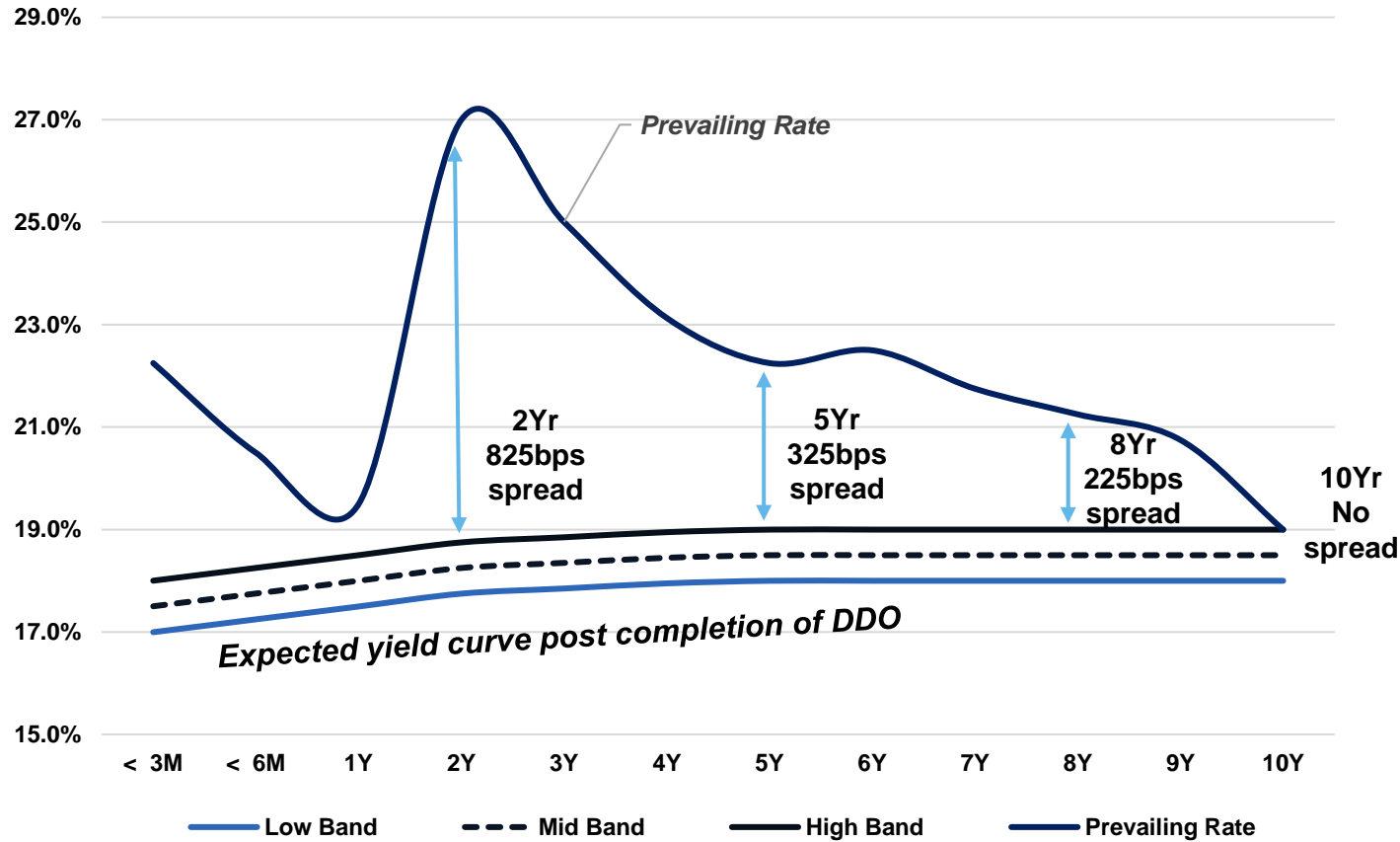


**Ability to BUY post DDO:** Multiple risks are associated with DDOs. It could be in the form of extension of maturity, coupon cut or principal haircut. It can be applicable for specific investors or even specific bonds. 2024 and 2025 bonds have the highest restructuring risk considering the IMF gross financing needs criteria. Post DDO Govt is likely to re-enter the market to raise debt via bond auctions. Considering the uncertainty, possible volatility in yields and new bond auctions post DDO, it is advisable for investors to create some buying capacity to take advantage of the volatility in rates post DDO.



## 2Yr and 3Yr have the largest spread while most other yields have trimmed down

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*“SUCCESSFUL INVESTMENTS IS  
ABOUT MANAGING RISKS”*

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