



First Capital
A Janashakthi Group Company

“Diligently reap gains in declining yields”

27th Sep 2023

FIRST CAPITAL FIXED INCOME RECOMMENDATION

FIRST CAPITAL RESEARCH

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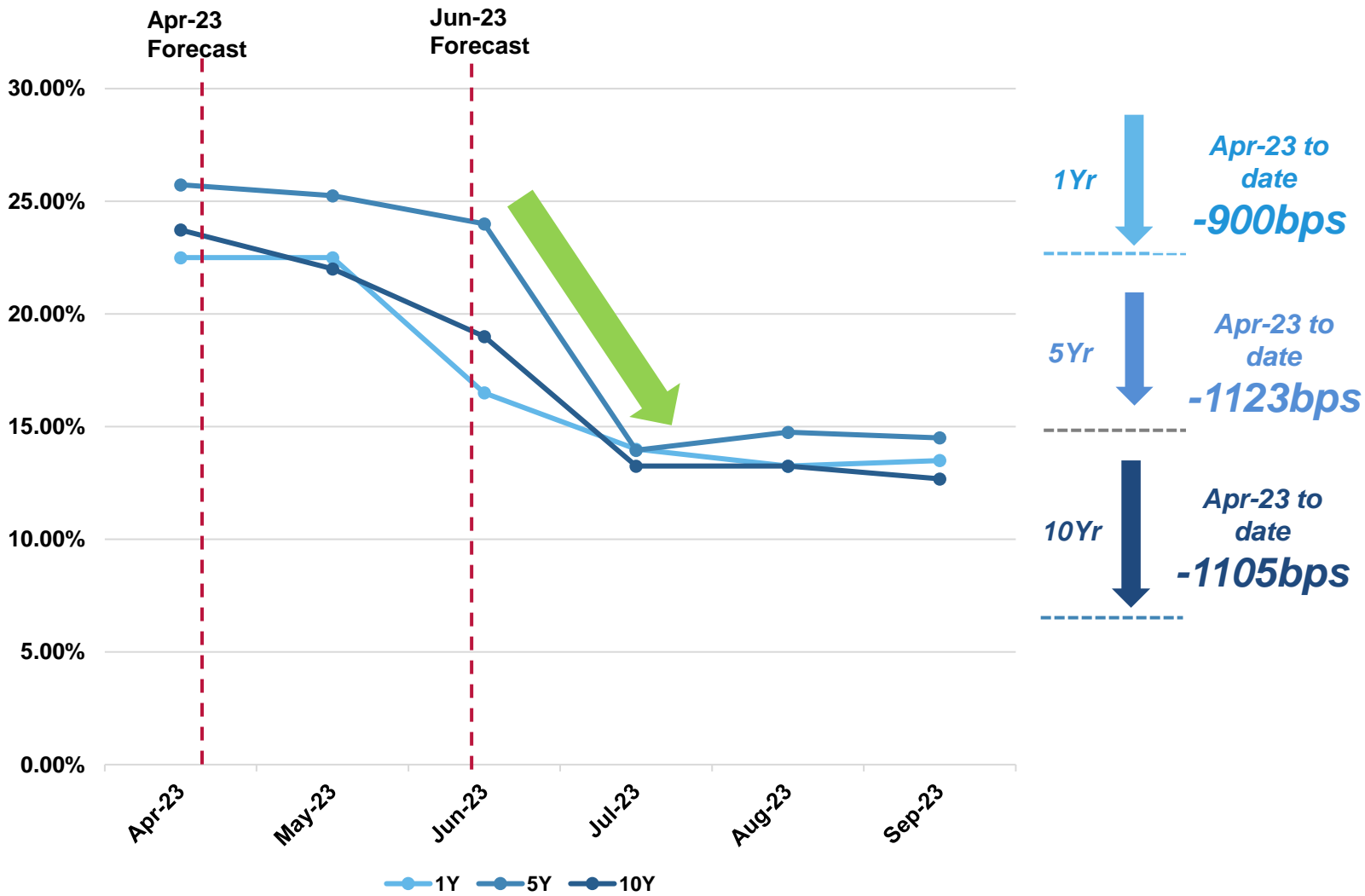


1.0 FCR - Previous Recommendation

*“Yields decline steeply post DDO
Proposal”*



28th Apr-23 to 26th Sep-23 bond yields plunged by over 900bps



1Y ↓ Apr-23 to date -900bps

5Y ↓ Apr-23 to date -1123bps

10Y ↓ Apr-23 to date -1105bps

Previous Recommendations

04th 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**

19th Jun 2023

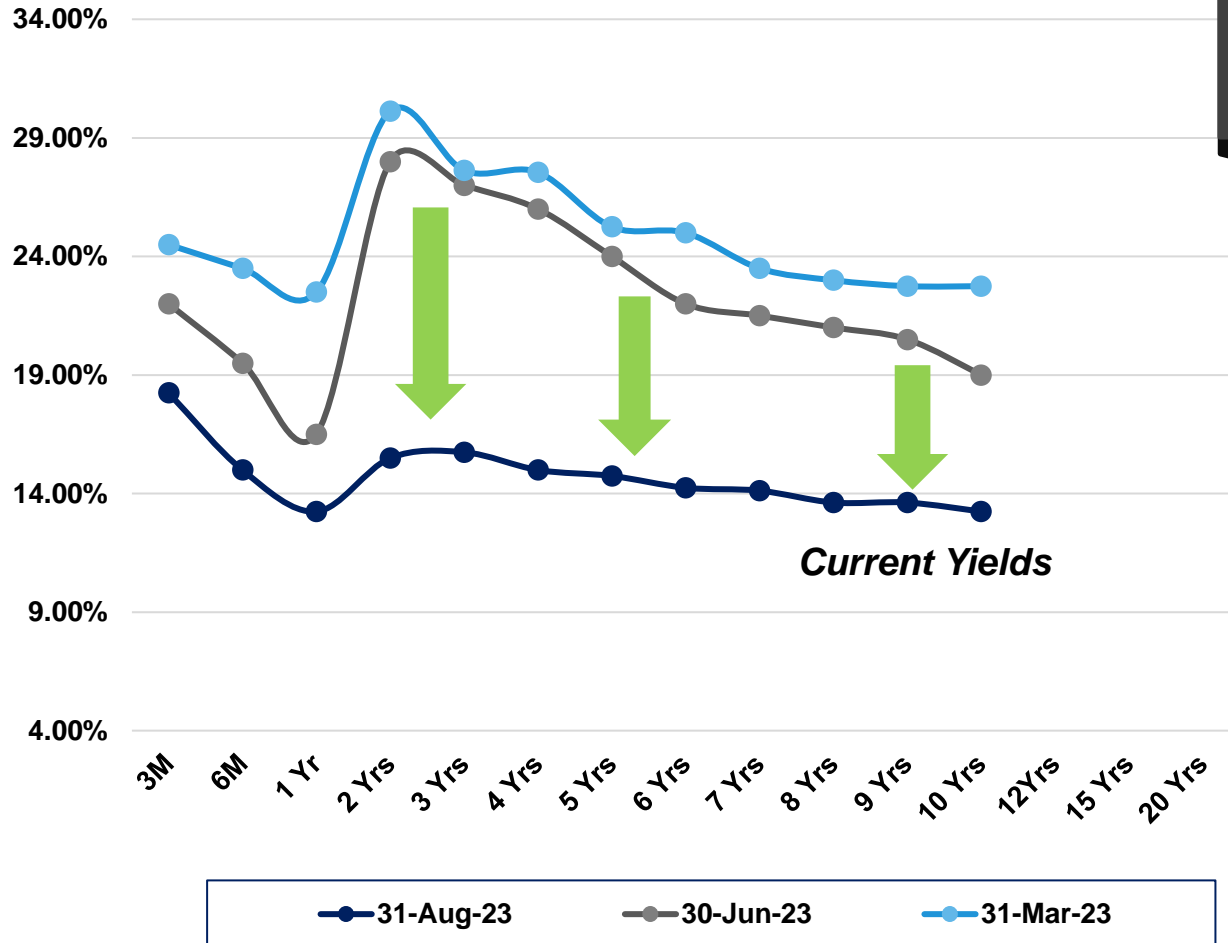
“With the completion of domestic debt restructuring or towards Dec-23 we believe the overall yield curve is likely to drop below 20% and reach a range of 13%-15%. Bond Yields in 1H2024 is expected further drop to a range 11%-13.5%.”

- **Accurate**



Overall yield curve movement

Yield curve quarter end comparison



Interest Rate Change (bps)

Tenure	Aug-23	Jun-23	Change (bps)	Mar-23	Change (bps)
3M	18.25%	22.00%	-375	24.50%	-625
6M	15.00%	19.50%	-450	23.50%	-850
1 Yr	13.25%	16.50%	-325	22.50%	-925
2 Yrs	15.50%	28.00%	-1250	30.13%	-1463
3 Yrs	15.75%	27.00%	-1125	27.63%	-1188
4 Yrs	15.00%	26.00%	-1100	27.55%	-1255
5 Yrs	14.75%	24.00%	-925	25.25%	-1050
6 Yrs	14.25%	22.00%	-775	25.00%	-1075
7 Yrs	14.13%	21.50%	-737	23.50%	-937
8 Yrs	13.63%	21.00%	-737	23.00%	-937
9 Yrs	13.63%	20.50%	-687	22.75%	-912
10 Yrs	13.25%	19.00%	-575	22.75%	-950
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



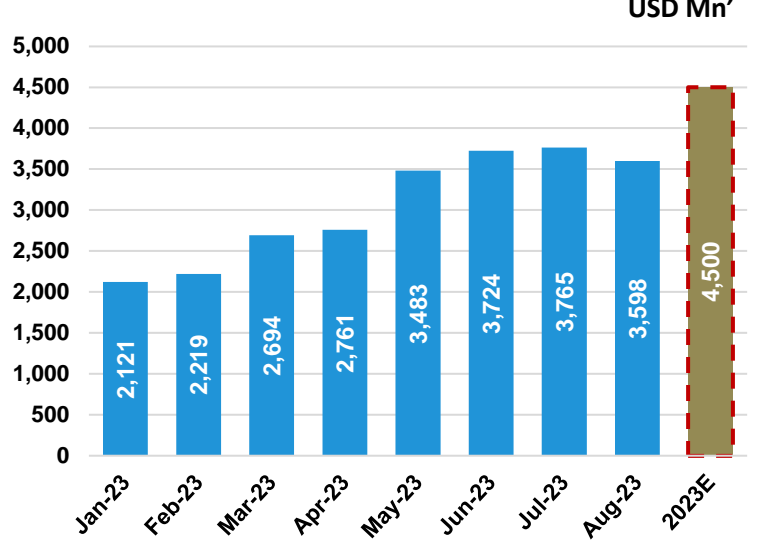
2.0

Outlook for Fixed Income Instruments

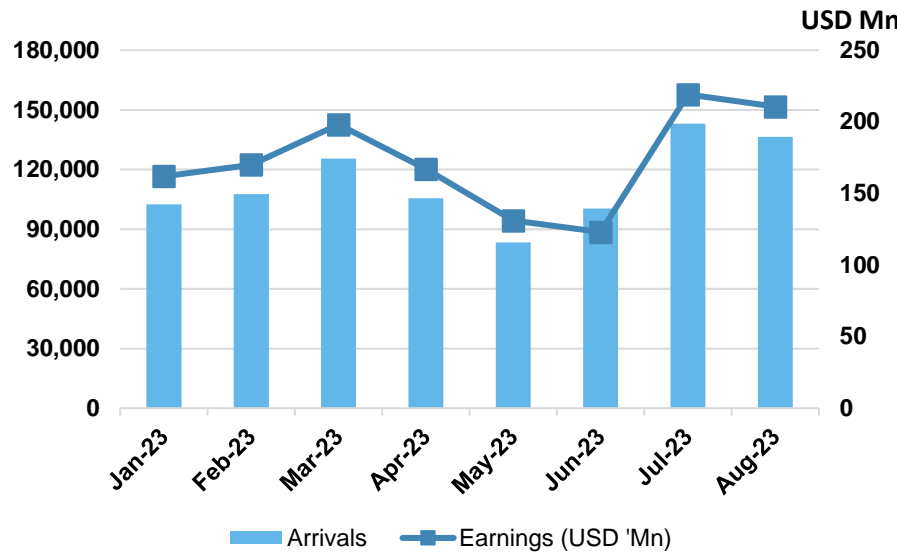
*“Economic Indicators are expected to
further improve”*

Economic Indicators shows signs of recovery

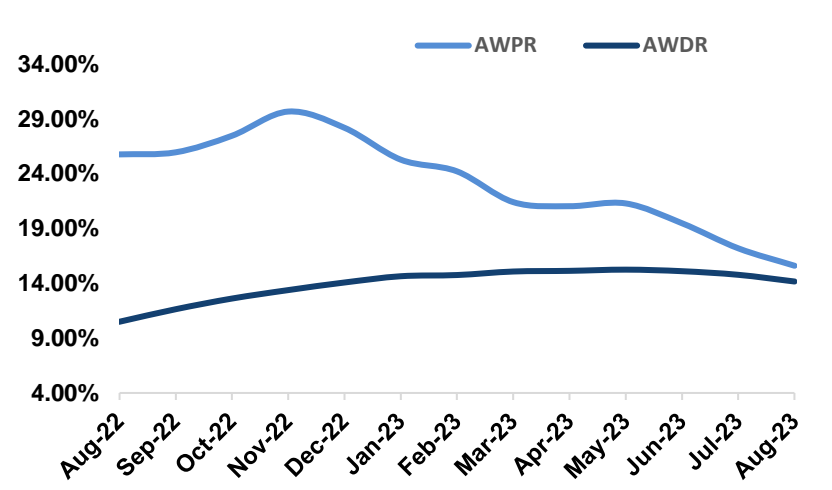
FCR targets reserves to reach USD 4.5Bn By 2023E



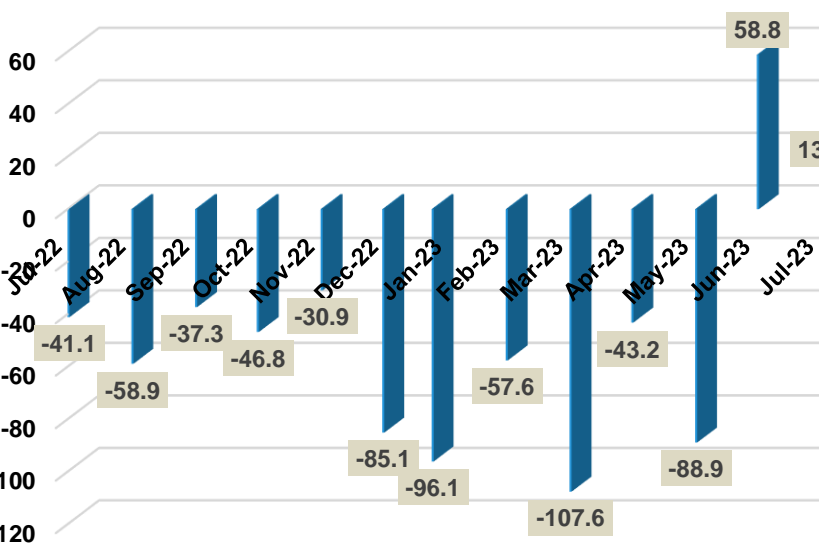
Tourism accelerates yielding higher earnings



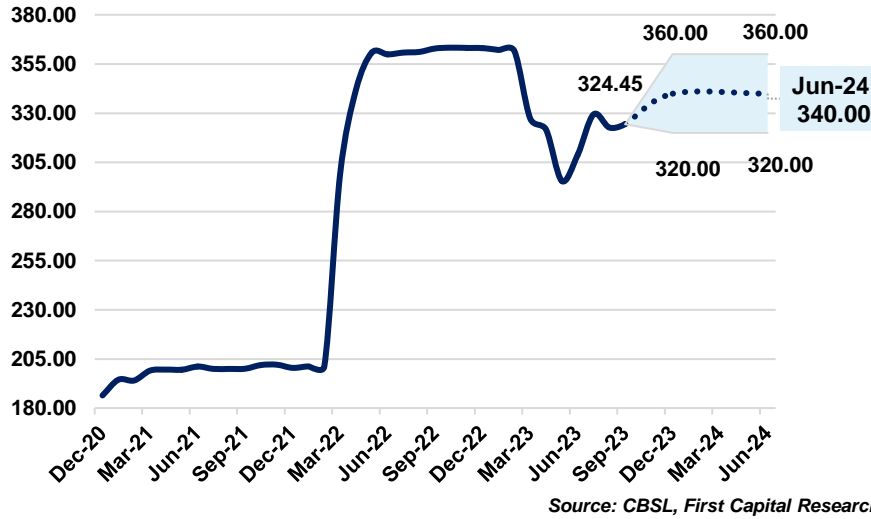
AWPR and AWDR shifts momentum in line with declining interest rates



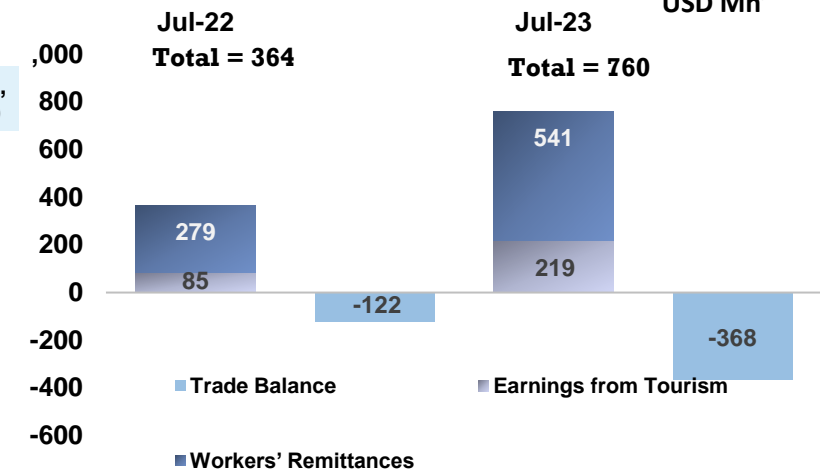
Private sector credit improves for the 1st time in 12 months in Jun-23



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

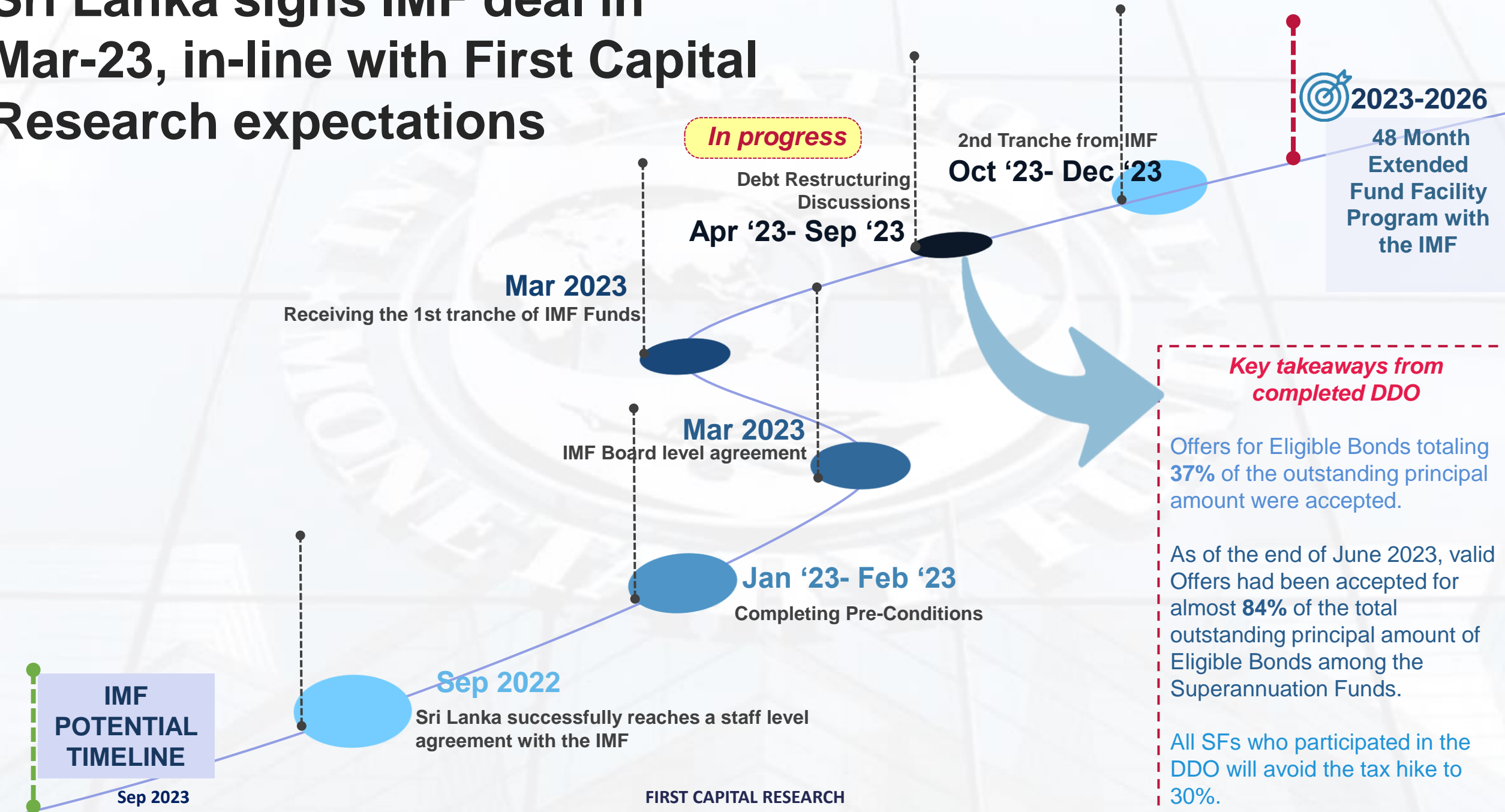


Remittance and tourism earnings scale high strengthening BoP

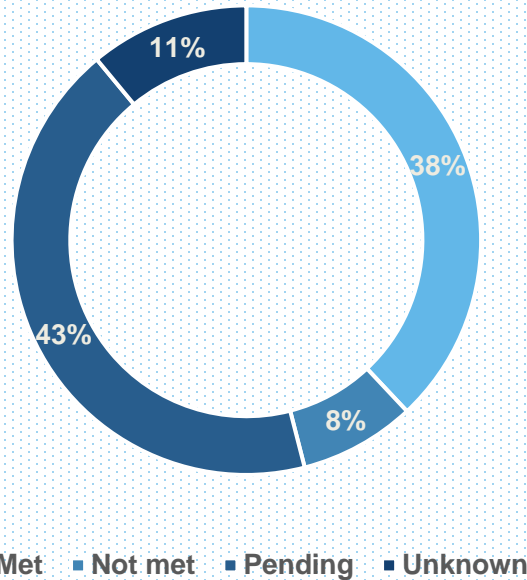


Source: CBSL, First Capital Research

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



Sri Lanka meets 38% of IMF commitments as first IMF review of the EFF kicks off



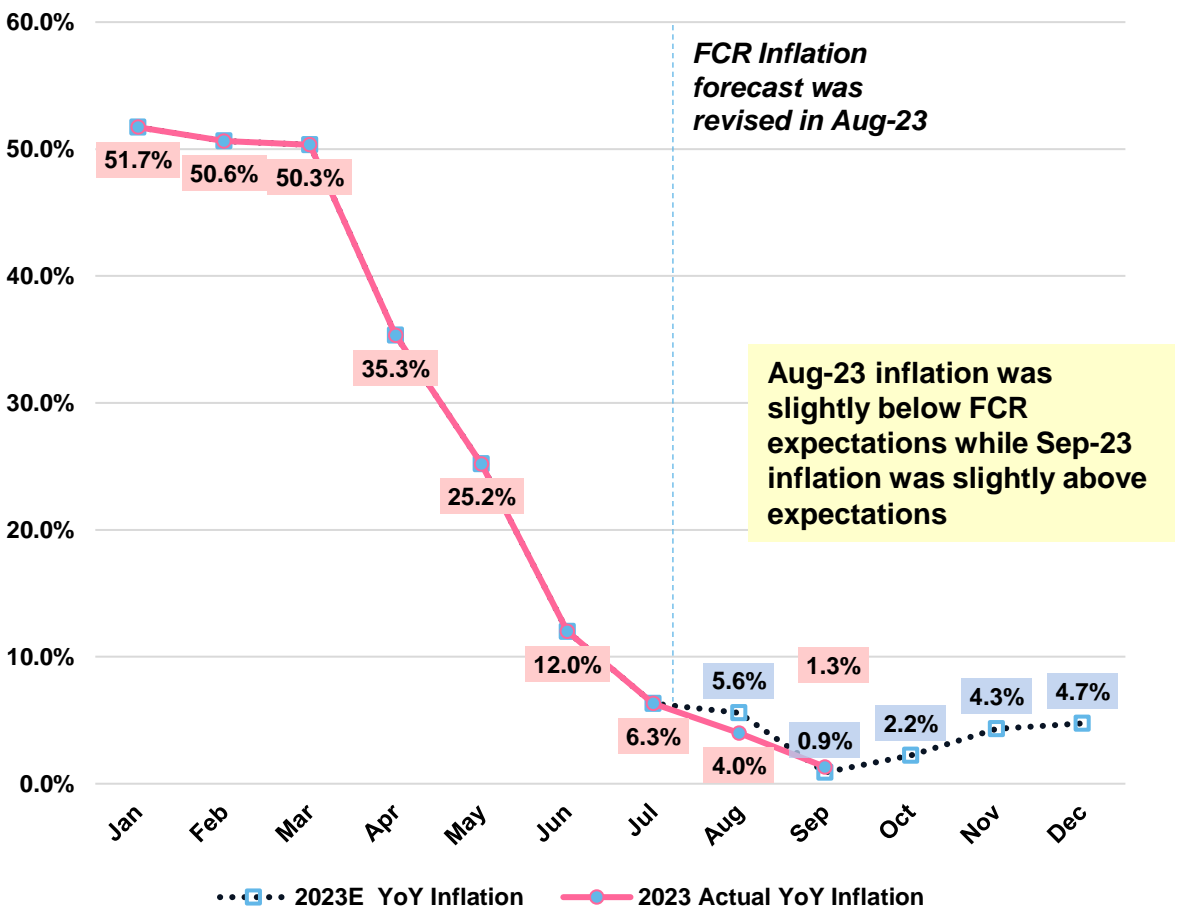
In a nutshell, the commitments that were fulfilled throughout the previous six months....

- ✓ Increase policy rates by 100 basis points
- ✓ Establish fuel prices that ensure at least full cost recovery
- ✓ Establish electricity prices that ensure at least full cost recovery
- ✓ Social spending to 0.1% of GDP by (LKR 35.0Bn) March 2023
- ✓ Parliamentary approval on new Central Bank Act
- ✓ Increase betting and gaming levies
- ✓ CCPI inflation between 34% and 28% by June 2023
- ✓ Primary deficit to 0.4% of GDP (-LKR 113 Bn) by June 2023
- ✓ Treasury guarantees to 5.6% of GDP (LKR 1,700 Bn) by June 2023

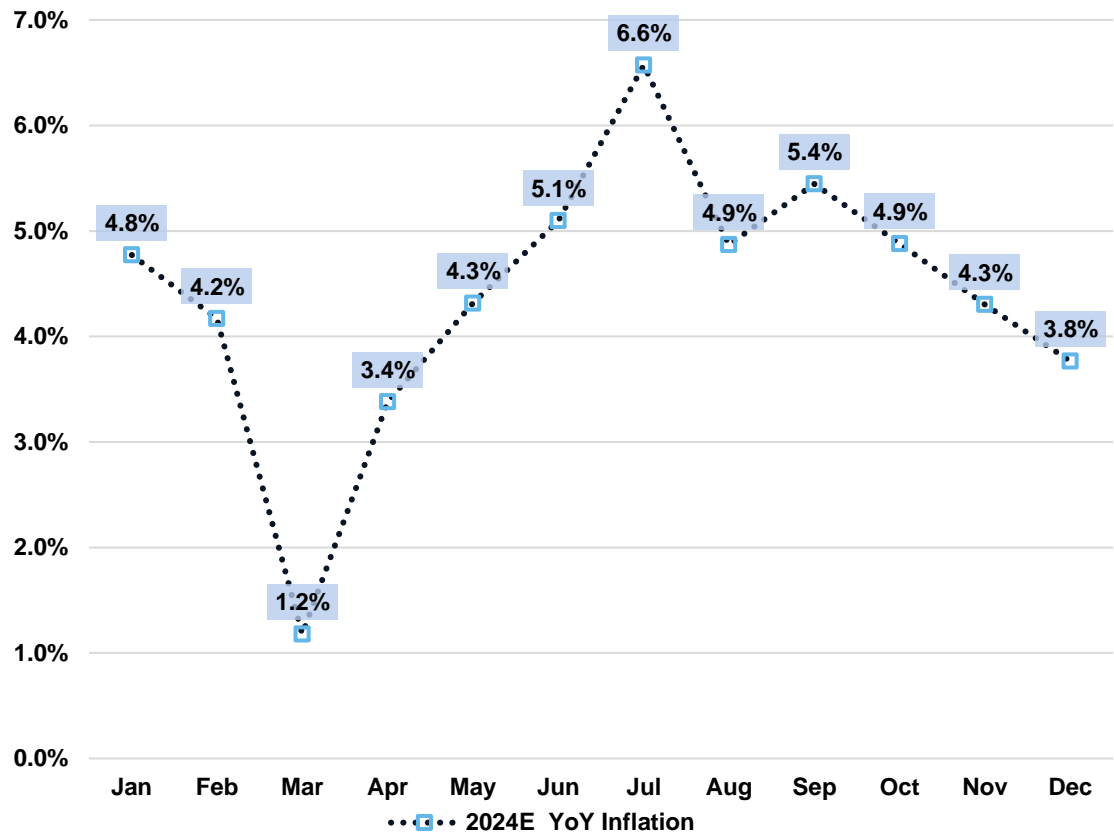


With inflation falling fast than our expectations First Capital revises its inflation forecast

Inflation on a robust recovery paving way for stability



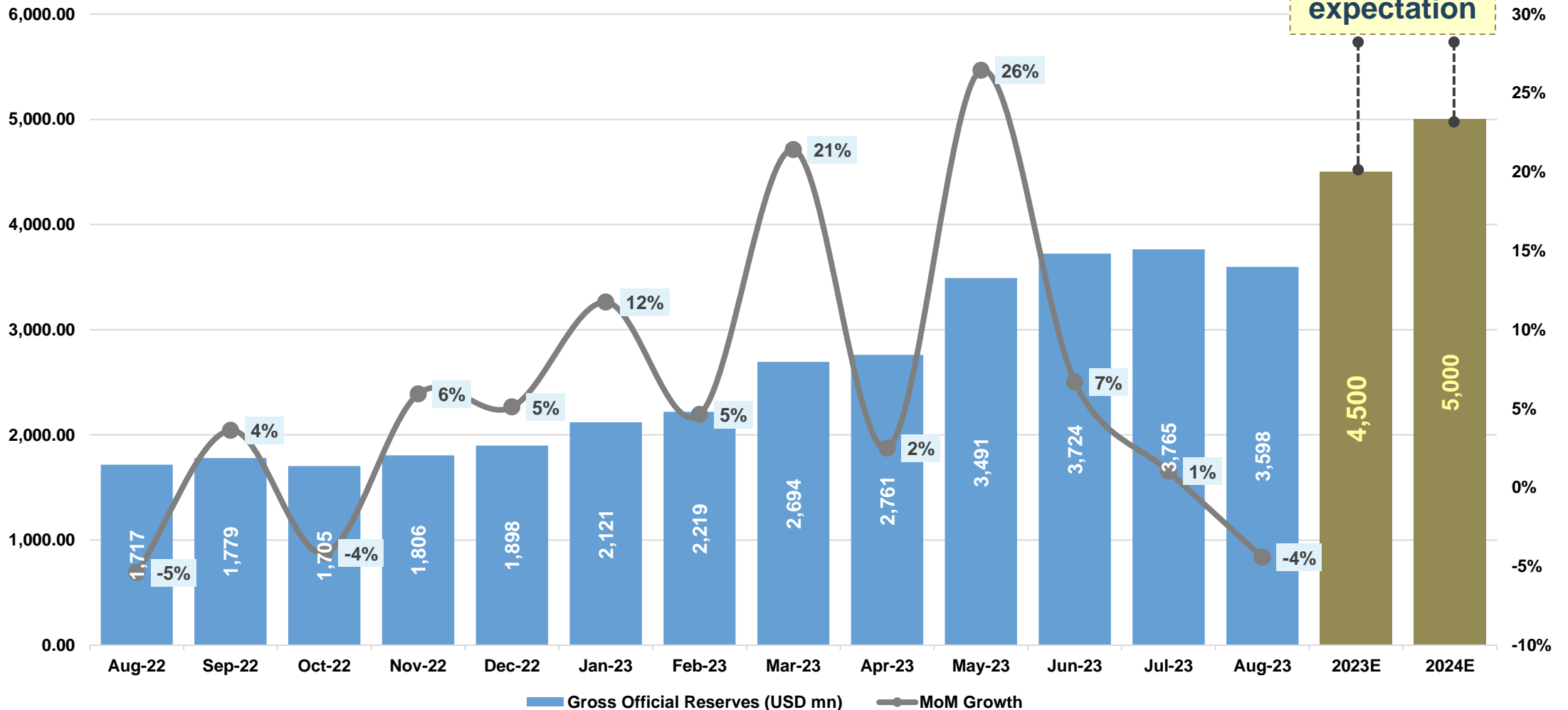
2024E inflation expectation to move on a single digit as stability restores





Foreign Reserves to strengthen surpassing USD 3.5Bn by end of 2023 reaching USD 4.5Bn

Thriving tourism and amplifying remittance levels are expected to support the enhancement of foreign reserves

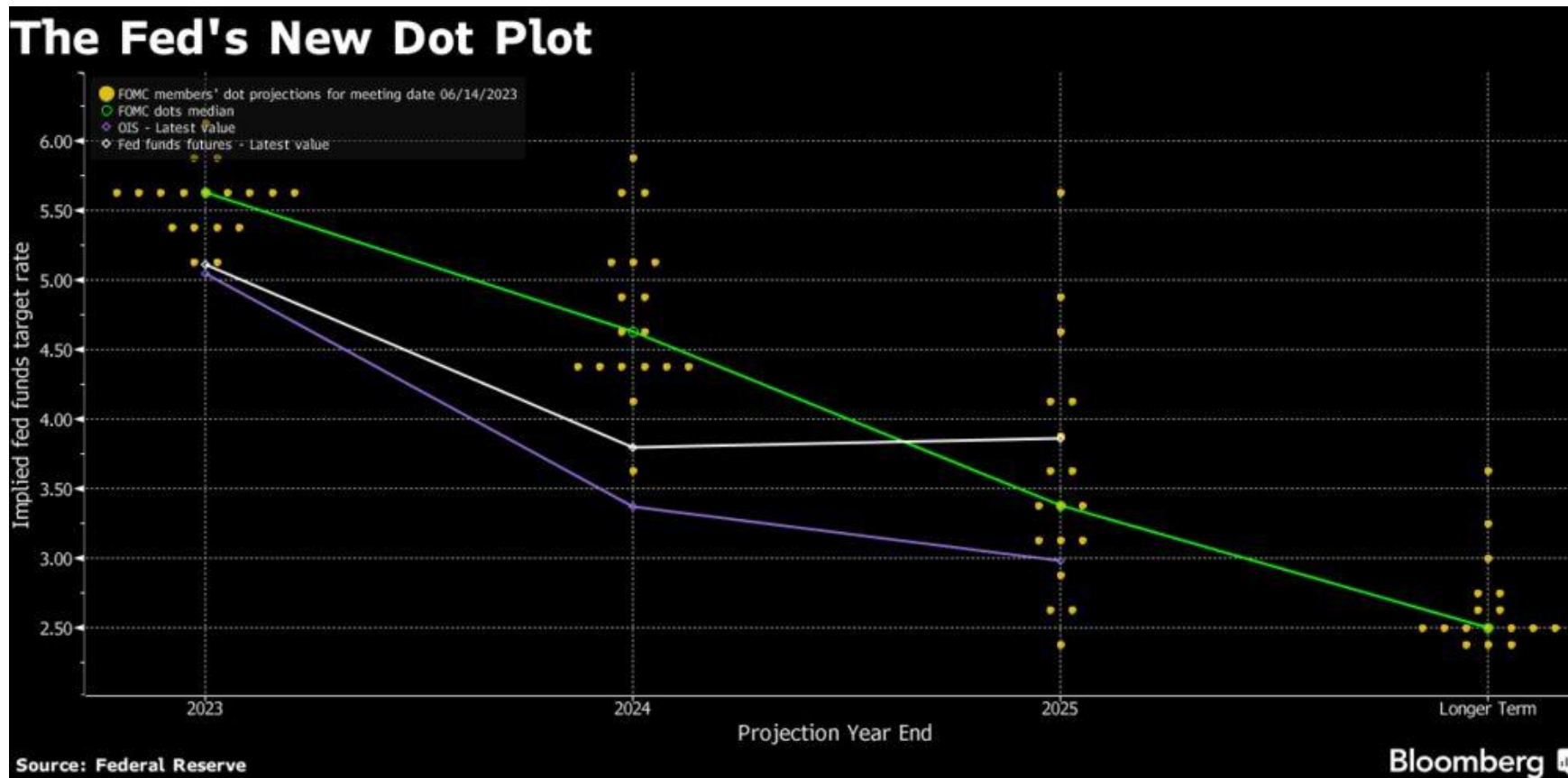


2023E and 2024E foreign reserves expectation



However, global outlook remains bleak as tightening stance of fed persists..

The June meeting's rate projection, conveyed through the dot-plot, indicated a median Fed projection of rates reaching 5.50%-5.75% by the end of 2023, suggesting the likelihood of an impending rate hike.



As policymakers carefully assess signs of declining inflation along with the robust performance of the economy and labor market, Federal Reserve stresses the potential necessity for the US Federal Reserve to implement additional interest rate hikes in order to contain inflationary pressures. However, the Fed could maintain rates at its upcoming meeting in September, according to Powell, as officials evaluate the data coming in and the shifting outlook and risks.



3.0

Fixed Income Health Score

*“Fixed Income health score improves in
at an accelerated pace”*



FI Economic Health Score – Aug-23

Fixed Income Health Score records a significant improvement during the 3Q2023 supported by multiple factors in primary and secondary criteria inclining the health score to 65 points by Aug-23.



Primary Criteria

$$- \quad 39 \quad + \quad 10 \quad = \quad 49$$

Secondary Criteria

$$- \quad 18 \quad + \quad 00 \quad - \quad 02 \quad = \quad 16$$

Economic Health Score
[Aug 2023]

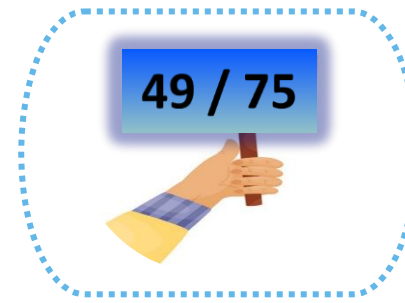
$$= \quad 65$$

[As against 57 in May 2023 & 21 in Aug 2022 (1 Year ago)]

Source: First Capital Research

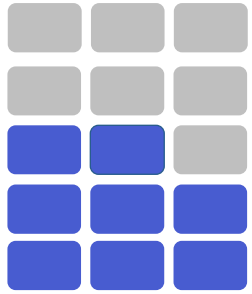


Changes to Health Score Primary Criteria – Aug 2023



Aug 2023- Score

May 2023- Score



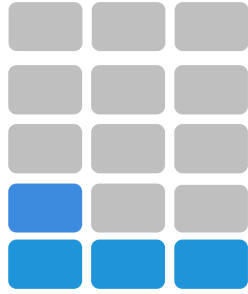
08/15

Foreign Reserves

Foreign reserves continued to remain above the 3.5Bn territory for 4 consecutive months and recorded at USD 3.6Bn in Aug 2023.



07/15



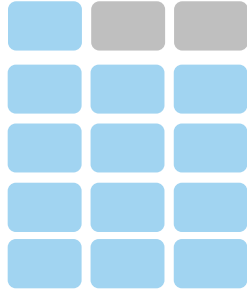
04/15

Liquidity

Liquidity displayed volatility during the month of Aug 2023 yet indicated recovery towards the end of the month as it closed at LKR - 101.1Bn compared to LKR - 206.1Bn recorded at the beginning of the month.



03/15



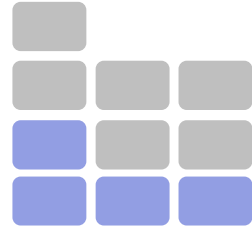
13/15

Inflation

CCPI continued to decline for the 11th consecutive month and recorded at 4.0% in Aug 2023, indicating the sharp easing of inflation.



06/15



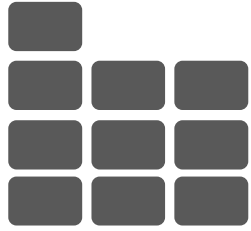
04/10

Foreign Activity

Foreign Investment in Govt. securities remained broadly stable as it closed at LKR 163.2Bn amidst the declining interest rate environment.



03/10

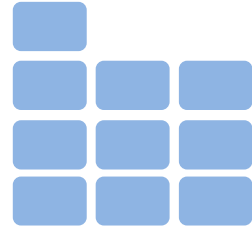


10/10

Credit

Private sector credit upturned and showed an incline for the first time in 12 months during Jun 2023 to LKR 7,079.5Bn while in Jul 2023 it further increased to LKR 7,092.8Bn amidst sharp dip in lending rates.

10/10



10/10

CBSL Holdings

CBSL holdings declined from LKR 2,714.9Bn recorded during the beginning of the month to LKR 2,571.9Bn towards the end of Aug-23.

10/10



Changes to Health Score Secondary Criteria – Aug 2023



Aug 2023- Score

May 2023- Score



01/05

Rating Outlook

S&P has upgraded Sri Lankan bonds to CCC+/C from 'SD' on 26th Sep-23, after the completion of a domestic debt restructuring. However, 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 'RD', from 'CC'.

01/05



05/05

External Environment

Foreign exchange market remains highly volatile, while USD/LKR has appreciated by 11.4% YTD and 2.0% during the month of Aug 2023.

05/05

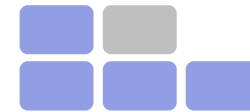


05/05

BOT & BOP

Trade deficit contracted and recorded at USD 367.0Mn in Jul 2023 while BOP remained a surplus and recorded at USD 2.1Bn amidst the rise in foreign inflow from tourism and worker remittances.

05/05



04/05

Political Risk

Political stability is maintained. However, uncertainty persists ahead of the upcoming election.

04/05



01/05

Investor Confidence

The BCI shed 20 points and recorded at 73 during the month of Aug-23. Volatilities in the Financial sector and uncertainties on DDO completion were major contributors to this decline.



03/05



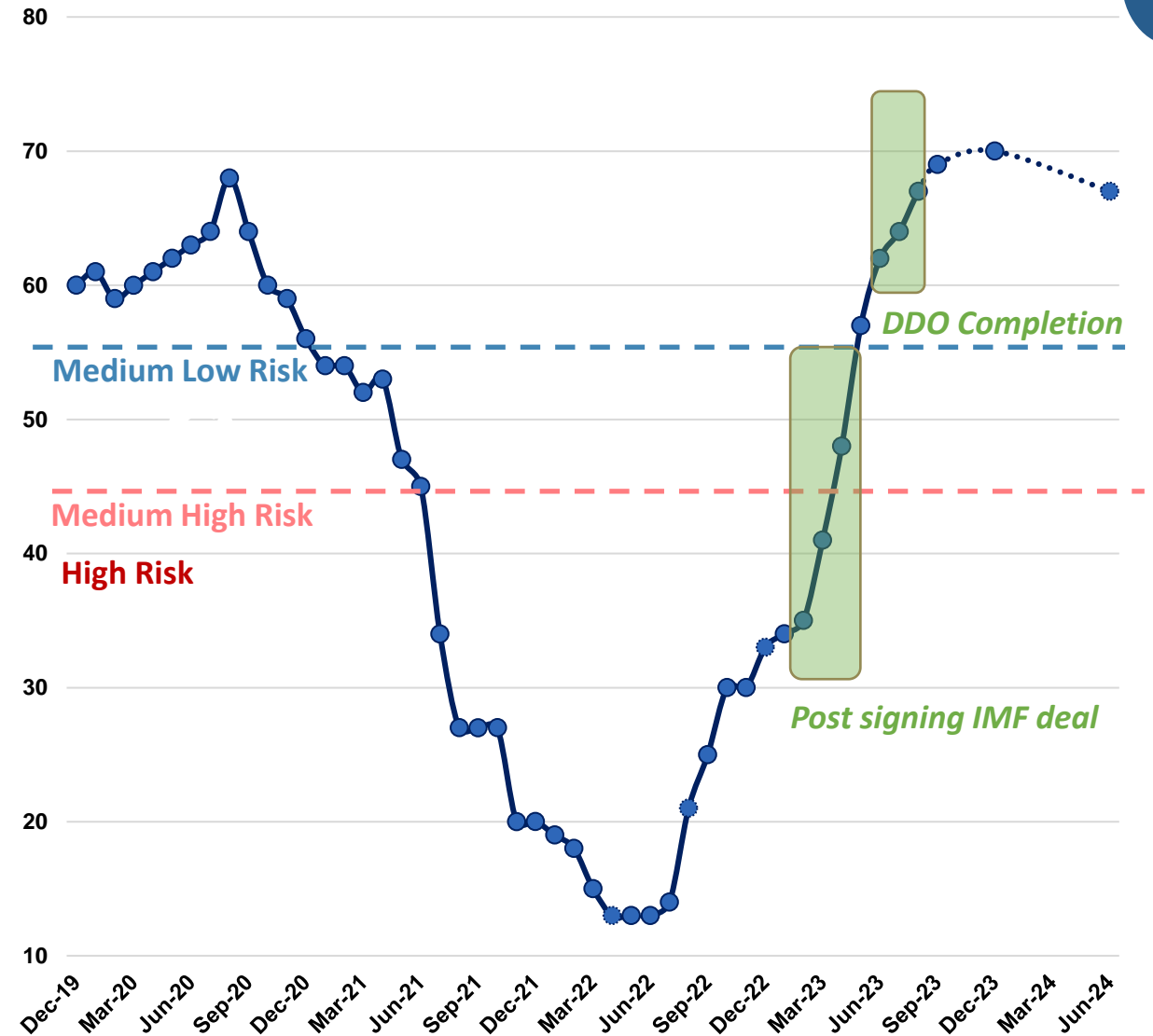
4.0 New Recommendation

“Hold Portfolio, look out for Buy opportunities above 15%”

Following the IMF deal in Mar-23 and DDO completion in Sep-23, FI health score recorded an accelerated improvement moving across the medium low risk territory into the low-risk territory with a healthy improvement witnessed during 3Q2023 led by decelerating inflation and other macro developments.

Further improvement is anticipated towards the end of 2023, where the FI Health Score is expected to remain in the Low-Risk territory on grounds of amplifying reserves, optimistic business confidence and upgraded credit rating by S&P to CCC+ may further support improvement.

First Capital Fixed Income Health Score



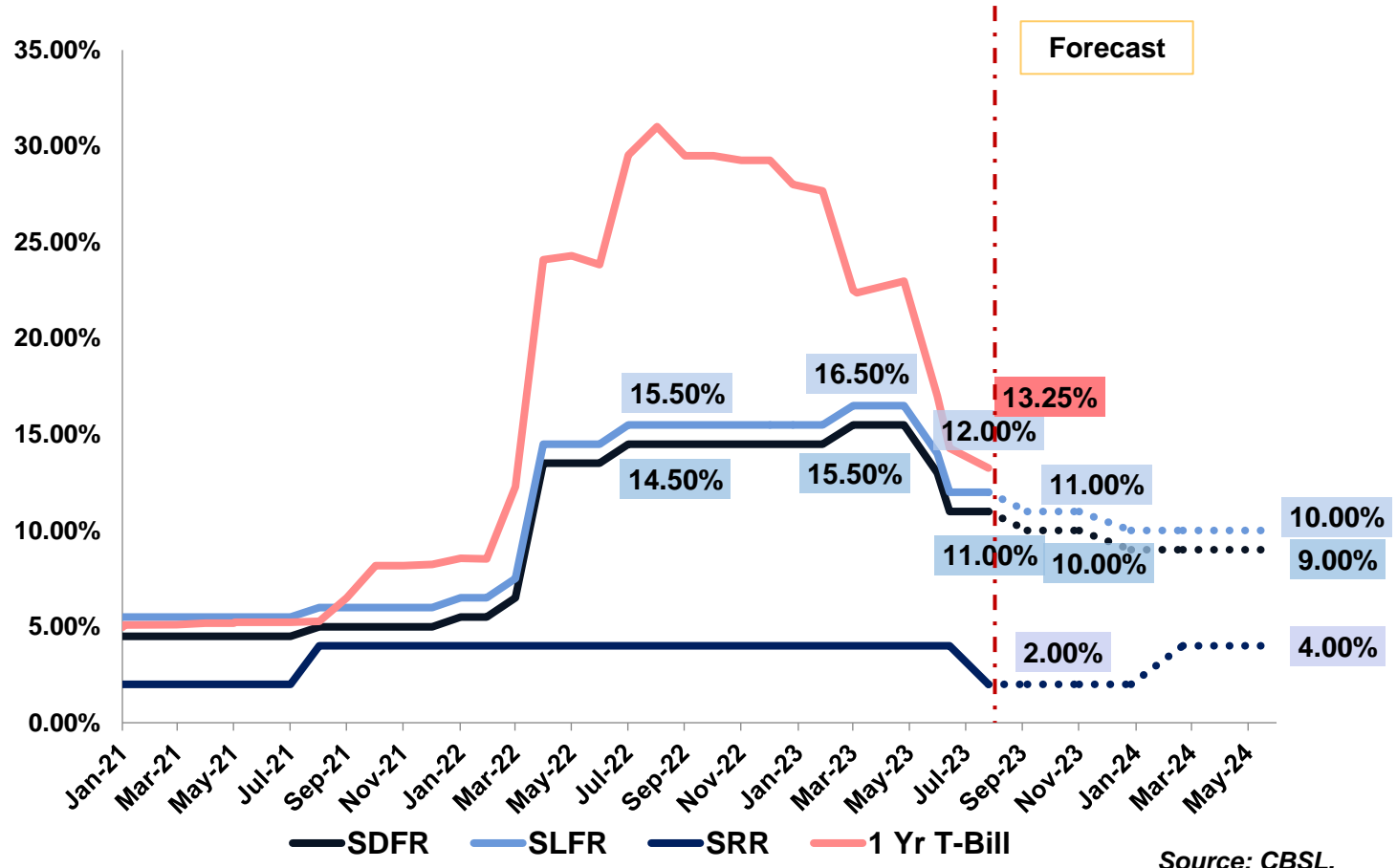


Policy rates trend further down amidst stabilization

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 in Jun-23 and a further 200bps rate cut in Jul-23.

We target about two rate cuts amounting to a cumulative dip of about 200bps resulting in the SDF and SLF to 9.0% and 10.0% respectively.

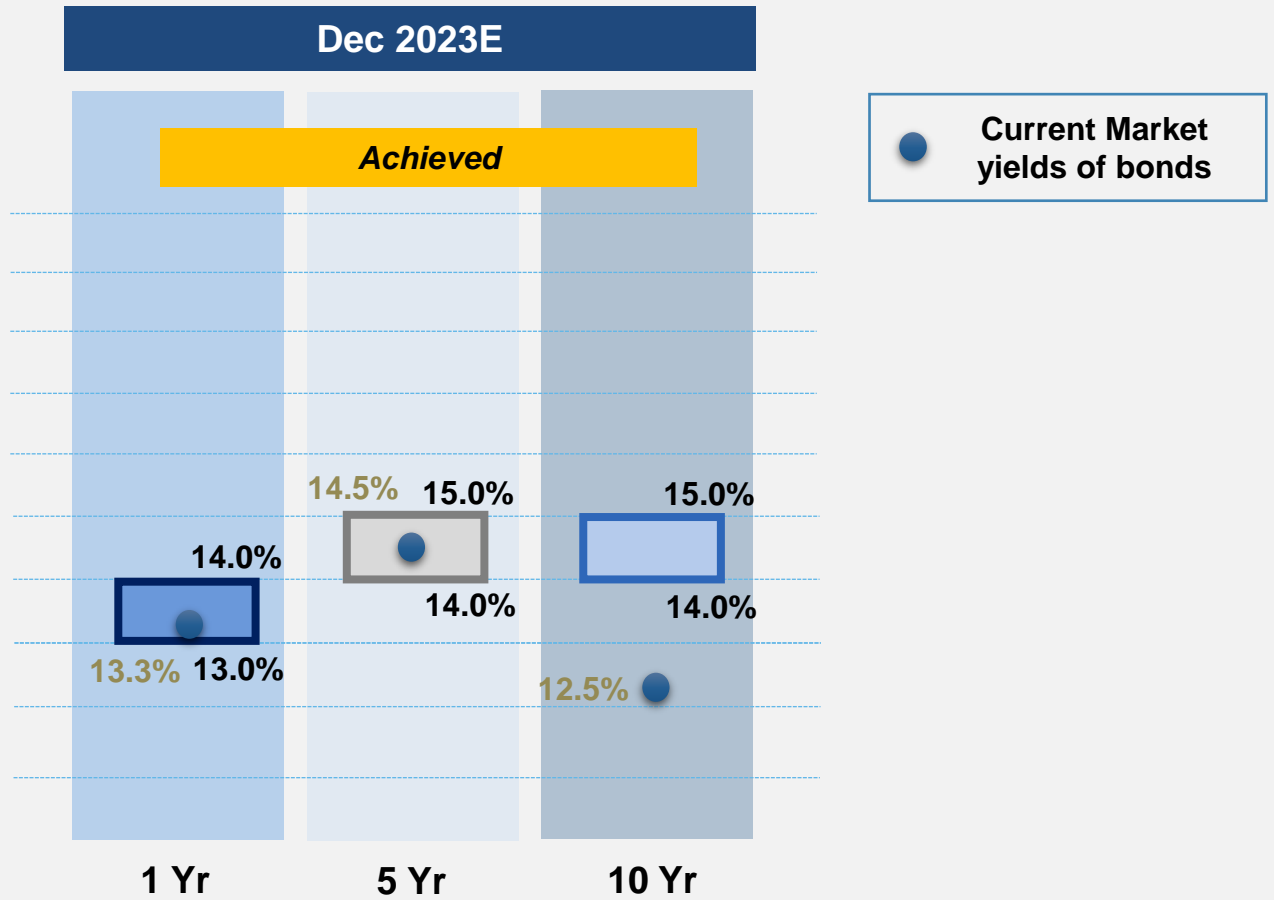
A portion of the cut possibly 100bps is likely in 1H2024 supported by the decline in inflation. CBSL may also consider pushing up the SRR back to 4.0% may be towards 1H2024.



Source: CBSL,



Bond Yield Expectations Dec-23 achieved in advance



Source: First Capital Research

Expectation: With the completion of domestic debt restructuring or towards Dec-23, we believe the overall yield curve is likely to drop below 20% and reach a range of 13%-15%.

Following the DDO proposal announcement in Jul-23 and subsequent implementation of the proposal in Aug and Sep-23, the bond market experienced a substantial decline in the yield curve with the yields of 1Yr and 5Yr falling to our targeted Dec-23 while the 10Yr falling below the range with strong buying interest.

The fall in the yields were supported by 2 rates cuts by the CBSL amounting 450bps and a SRR cut of 200bps.



First Capital Research believes there is
further downside potential

Cautiously Optimistic

Recommendation:
Maintain **Hold**

Buy on sudden spikes if yields
move above 15%

20



DDO completed; External debt restructuring in progress: Following completion of the Domestic Debt Optimization, yield curve recorded a steep decline significantly reducing the spread between the policy rates and the yield curve. However, the shorter tenors and the mid tenors continue to trade at a premium while the yield continues to remain inverted. First Capital Research estimates, external debt restructuring to get completed over next 2 months.



Potential policy rate cuts to push yields lower: With the completion of the IMF review for the 2nd tranche, we believe the CBSL may continue with its monetary easing stance with a view to push yields lower, stimulate the economy and accelerate economic growth. Thereby, we believe a further 200bps is on the cards. If rate cuts are given it is highly likely to influence the yield curve pushing yields lower.



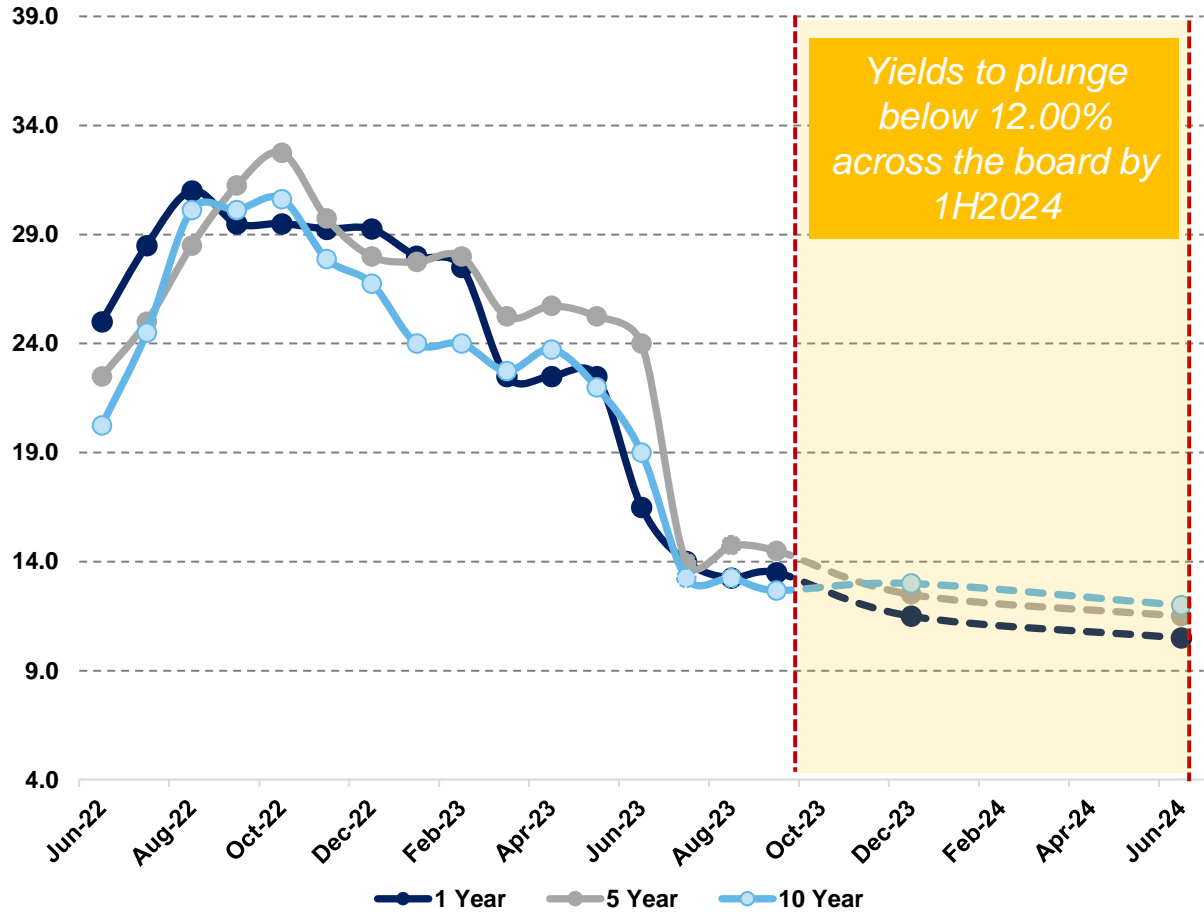
Hold Portfolio, look out for Buy opportunities above 15%: We highly recommend investors to hold your current portfolio to gain the benefit of a further decline in the yields. Further, amidst the current high volatility in the bond market, opportunities exist to collect or accumulate a bond portfolio yielding above 15%. Recent auctions have given such opportunities to most investors. Investors should be mindful to gradually reduce portfolios / book profits as yields decline towards the 12% mark.



Bond Yield Expectations of 1H2024 upgraded to Dec-23

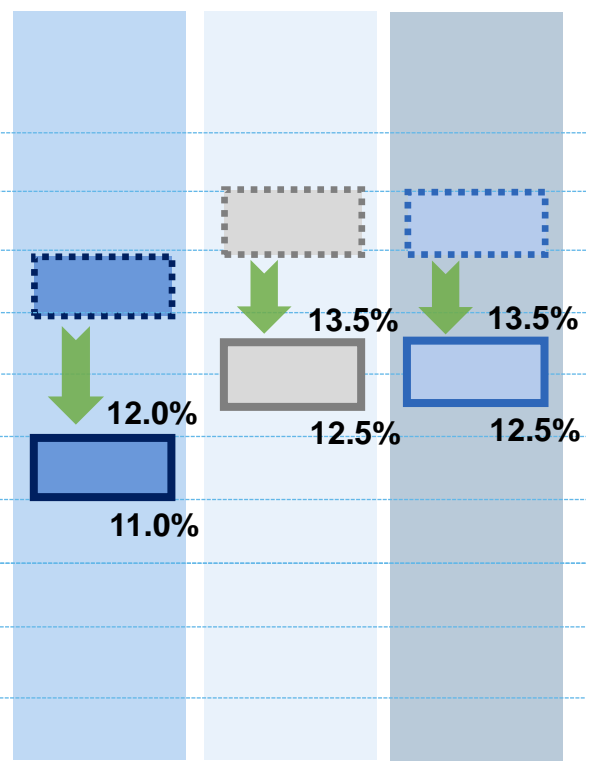
Yields declining timelines advanced

Bond yields to normalize to pre-crisis level

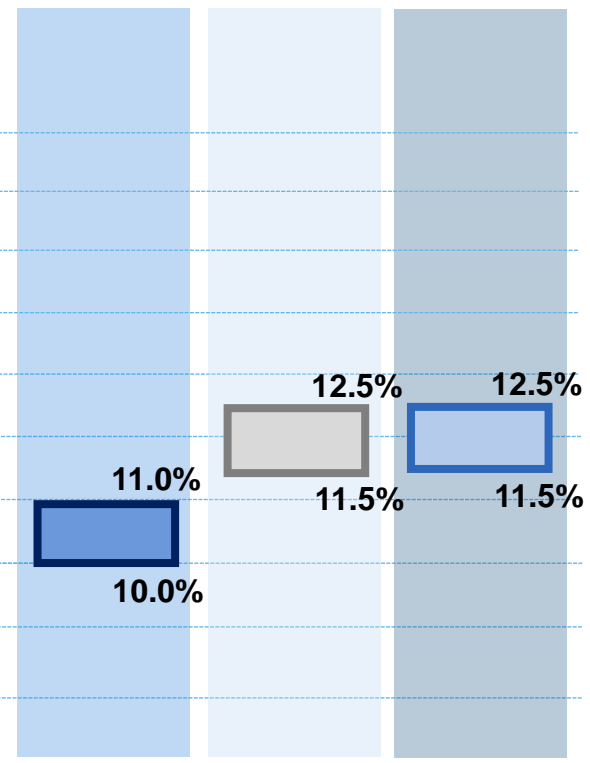


Source: First Capital Research

Dec 2023E



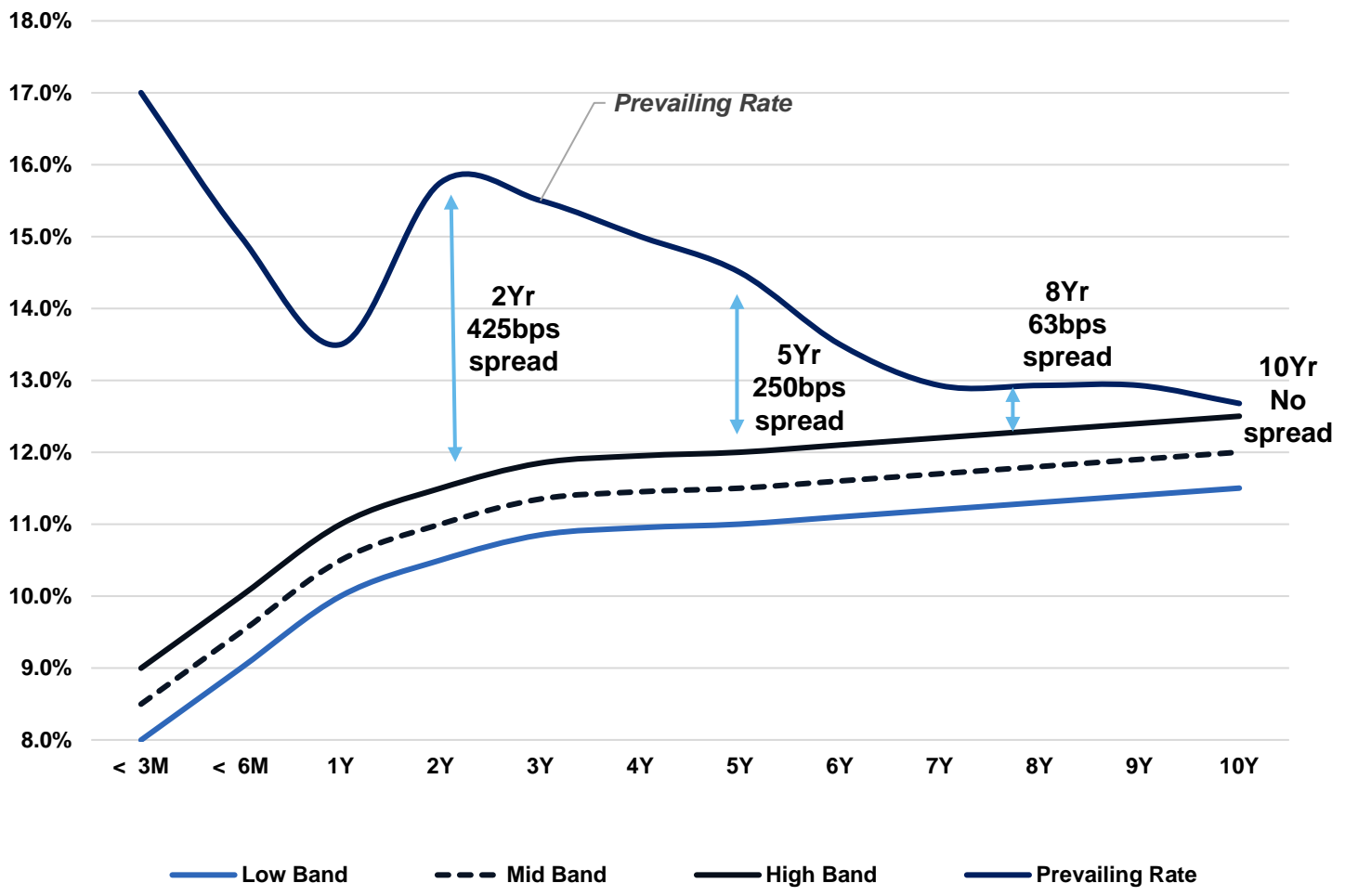
Jun 2024E



Source: First Capital Research



2Yr, 3Yr & 4Yr have the largest spread while longer tenors have bottomed out





5.0

AWPR

Recommendation

*“AWPR decline to 13.0%-15.0% by Dec-23
and 10.0%-12.0% by Jun-23”*

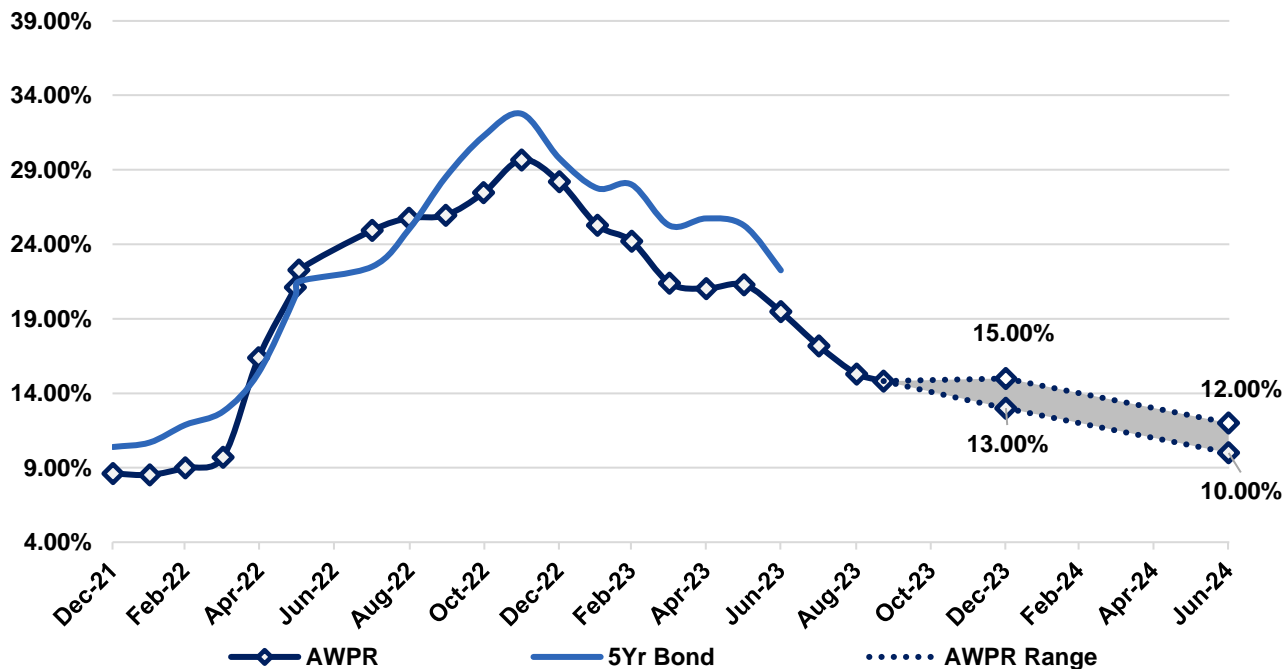


AWPR Jun-2024 expectations advanced to Dec-23

Previous Recommendation:
AWPR to dip to 10%-15% over the next 12 months **Achieved**

New Recommendation:
AWPR decline to 13.0%-15.0% by Dec-23 and 10.0%-12.0% by Jun-23

Expectations for AWPR





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Thank you!

*“SUCCESSFUL INVESTMENTS IS ABOUT
MANAGING RISKS”*

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