First Capital
A Janashakthi Group Company

"Further downside on the cards…"

18th Jan 2024

FIRST CAPITAL FIXED INCOME RECOMMENDATION

FIRST CAPITAL RESEARCH

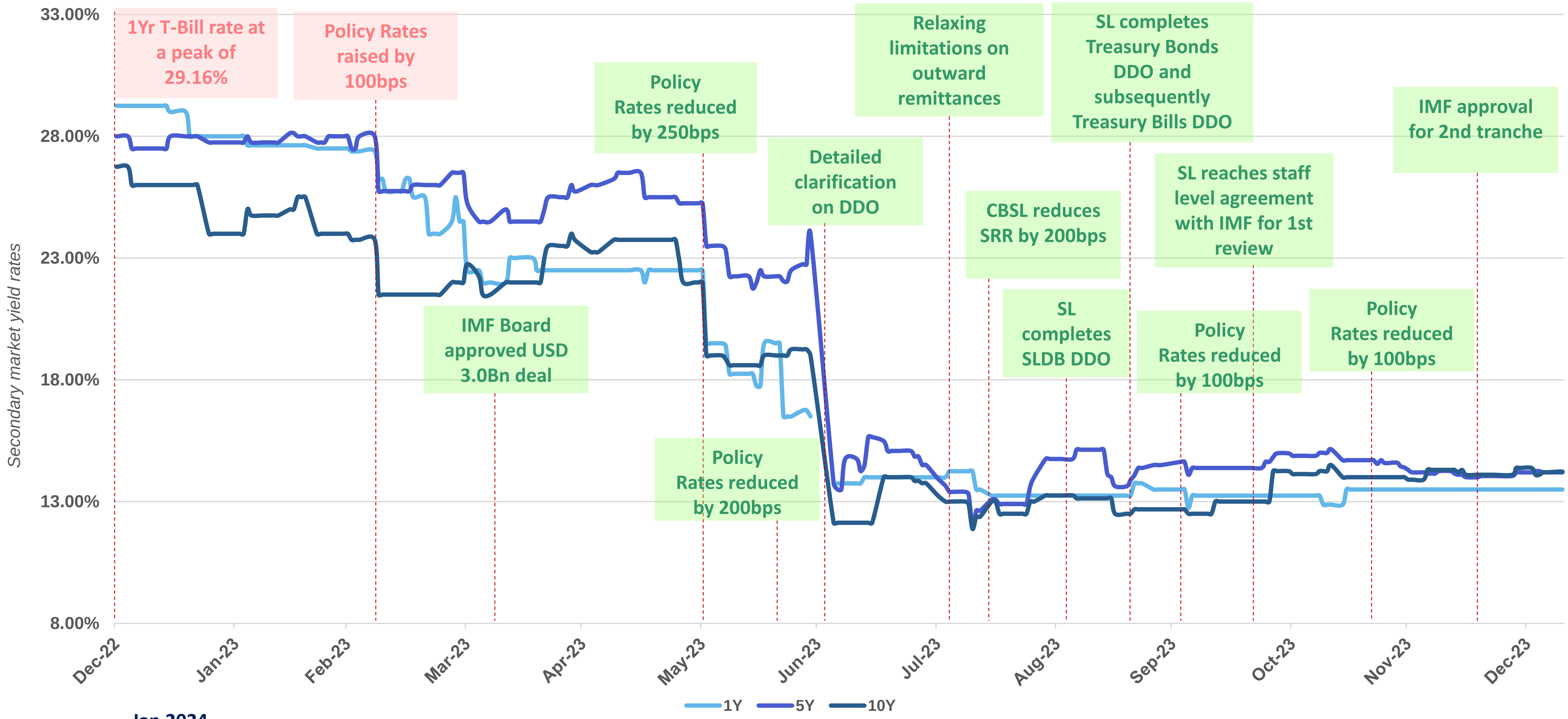
Analysts: Dimantha Mathew
dimantha@firstcapital.lk

Zaeema Jihan
zaheema@firstcapital.lk

1.0
FCR - Previous Recommendation

"Taking profits in declining interest rates"

2023 Yield Movement and Key Highlights



2023 Economic Snapshot

Inflation (CCPI)
2023: 4.0%
2022: 57.2%

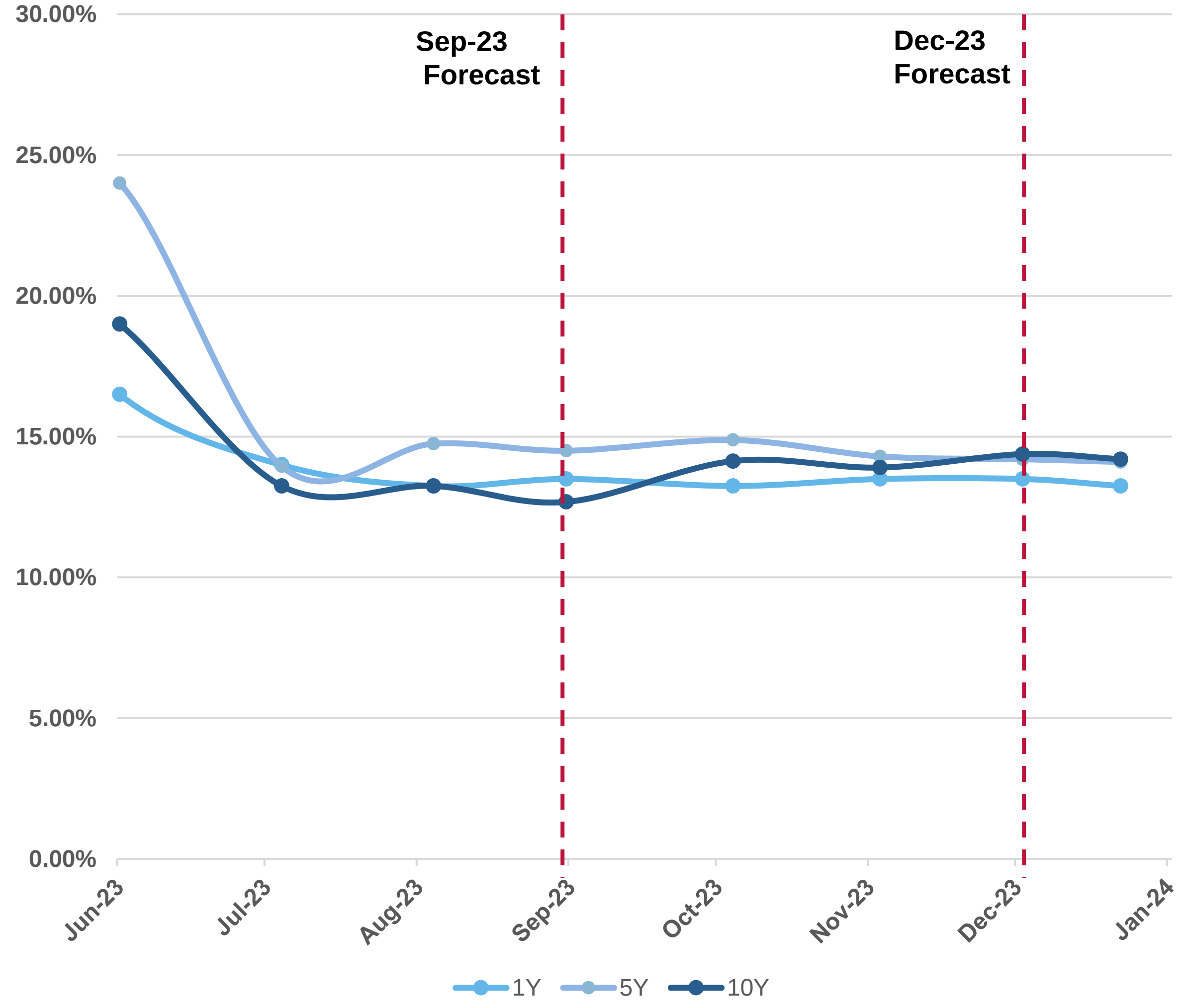
AWPLR
2023: 12.1%
2022: 27.2%

Gross Official Reserves
2023: USD 4,400.0Mn
2022: USD 1,898.0Mn

Exchange Rate (USD/LKR)
2023: LKR 323.9
2022: LKR 363.1

Balance of Payment
Jan-Nov 2023: USD 1,908.0Mn
Jan-Nov 2022: USD -2,888.0Mn

30th Nov-23 to 18th Dec-24 bond yields showed mixed change



10Yr — Nov-23 to date **+30 bps**

5Yr — Nov-23 to date **-20 bps**

1Yr — Nov-23 to date **-25 bps**

Previous Recommendations

27th Sep 2023

Supported by 2 rate cuts totaling to 450bps and SRR cut of 200bps, the overall yield curve is expected to hover between 13.0%-15.0% towards Dec-23.

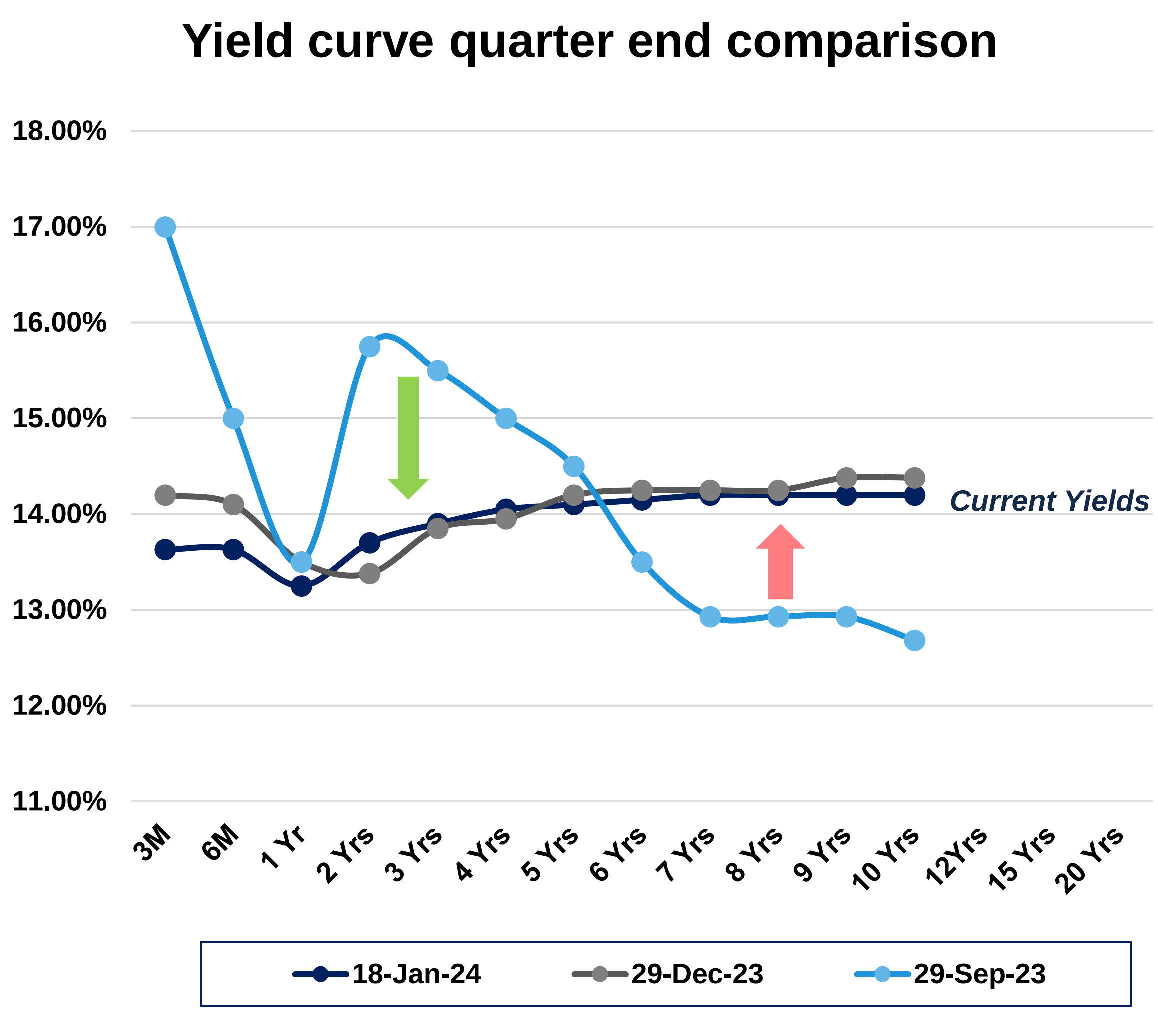
\- **Accurate**

11th Dec 2023

With the completion of external debt restructuring towards Dec-23, we believe the overall yield curve is likely to drop below 15.0% and reach a range of 11.0%-13.5%.

\- **Mostly Accurate**

Overall yield curve movement



Interest Rate Change (bps)

Tenure	Jan-24	Dec-23	Change (bps)	Sep-23	Change (bps)
3M	13.63%	14.20%	-57	17.00%	-337
6M	13.63%	14.10%	-47	15.00%	-137
1 Yr	13.25%	13.50%	-25	13.50%	-25
2 Yrs	13.70%	13.38%	32	15.75%	-205
3 Yrs	13.90%	13.85%	5	15.50%	-160
4 Yrs	14.05%	13.95%	10	15.00%	-95
5 Yrs	14.10%	14.20%	-10	14.50%	-40
6 Yrs	14.15%	14.25%	-10	13.50%	65
7 Yrs	14.20%	14.25%	-5	12.93%	127
8 Yrs	14.20%	14.25%	-5	12.93%	127
9 Yrs	14.20%	14.38%	-18	12.93%	127
10 Yrs	14.20%	14.38%	-18	12.68%	152
12 Yrs		N/A	N/A	N/A	N/A
15 Yrs		N/A	N/A	N/A	N/A
20 Yrs		N/A	N/A	N/A	N/A

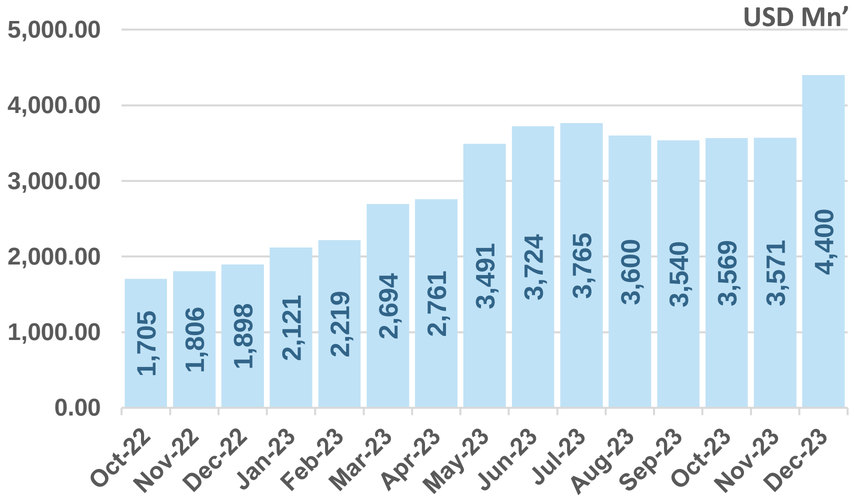
Source: First Capital Research

2.0
Outlook for Fixed Income Instruments

"Economic Indicators shows steady recovery"

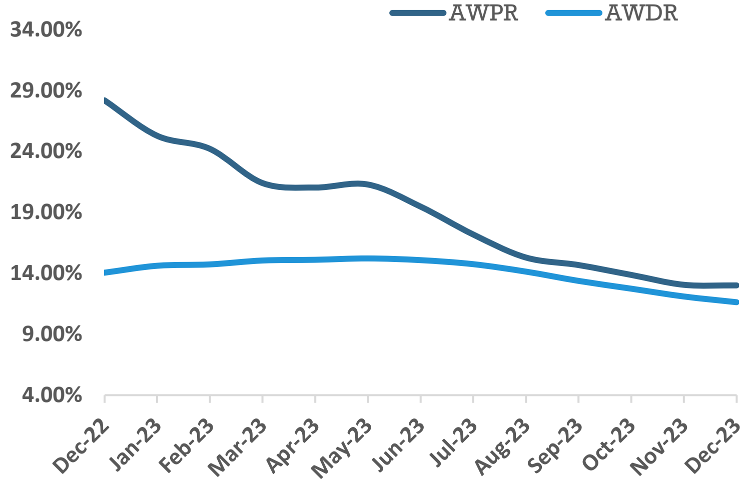
Economic Indicators shows steady recovery

Foreign Reserves for Dec-23 end at USD 4.4Bn almost reaching FCR target of USD 4.5Bn

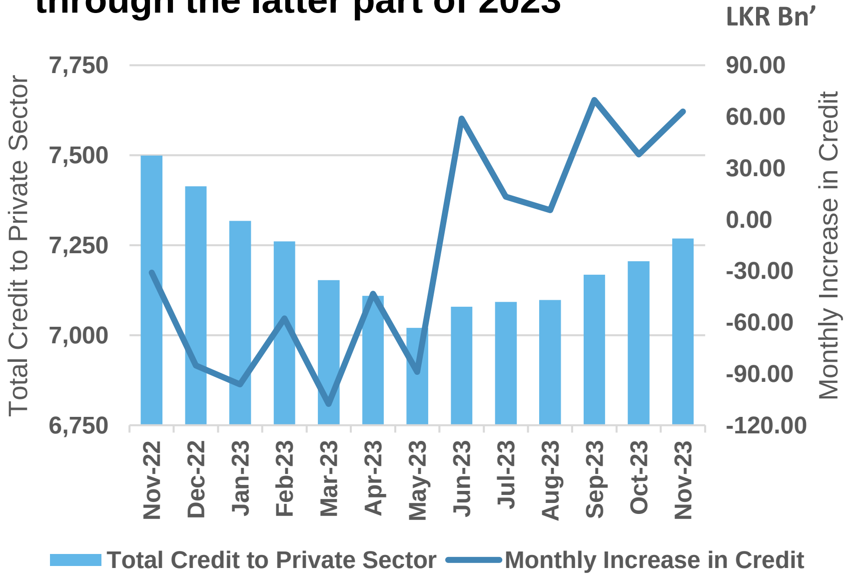


Tourism accelerates yielding highest arrivals for 2023

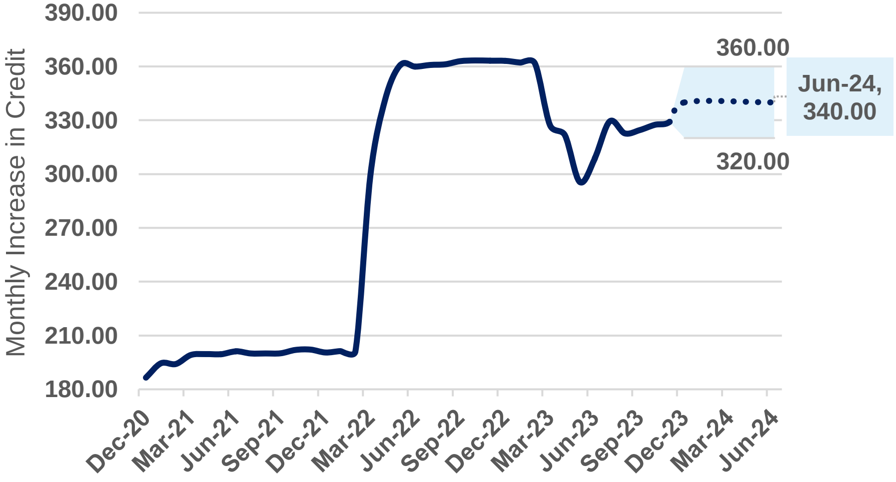
AWPR and AWDR shifts momentum in line with declining interest rates



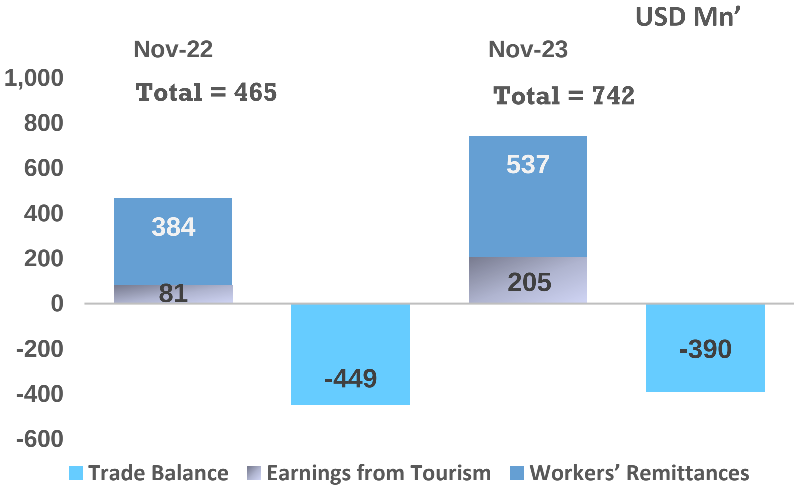
Private sector shows persistent improvement through the latter part of 2023



USD/LKR remains stable over the last 3-4 months



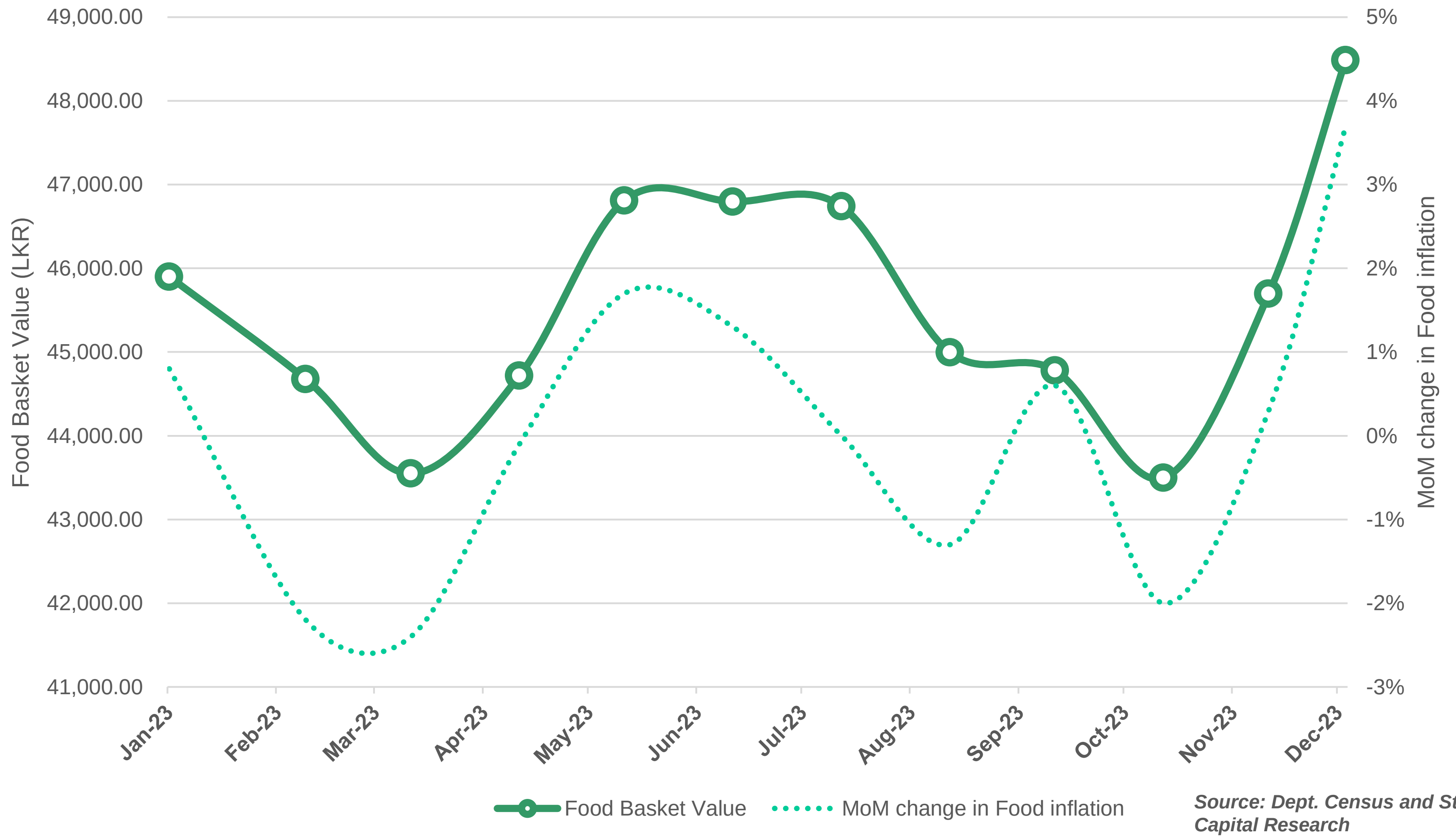
Remittance and tourism earnings scale high strengthening BoP



Source: CBSL, First Capital Research

Food inflation sees steep spike since Nov-23

FCR Food basket value indicated a steep rise from Oct-23 onwards in line with the MoM change in CCPI Food Inflation amidst adverse weather conditions and reduced yield of vegetables mainly.



Source: Dept. Census and Statistics, First Capital Research

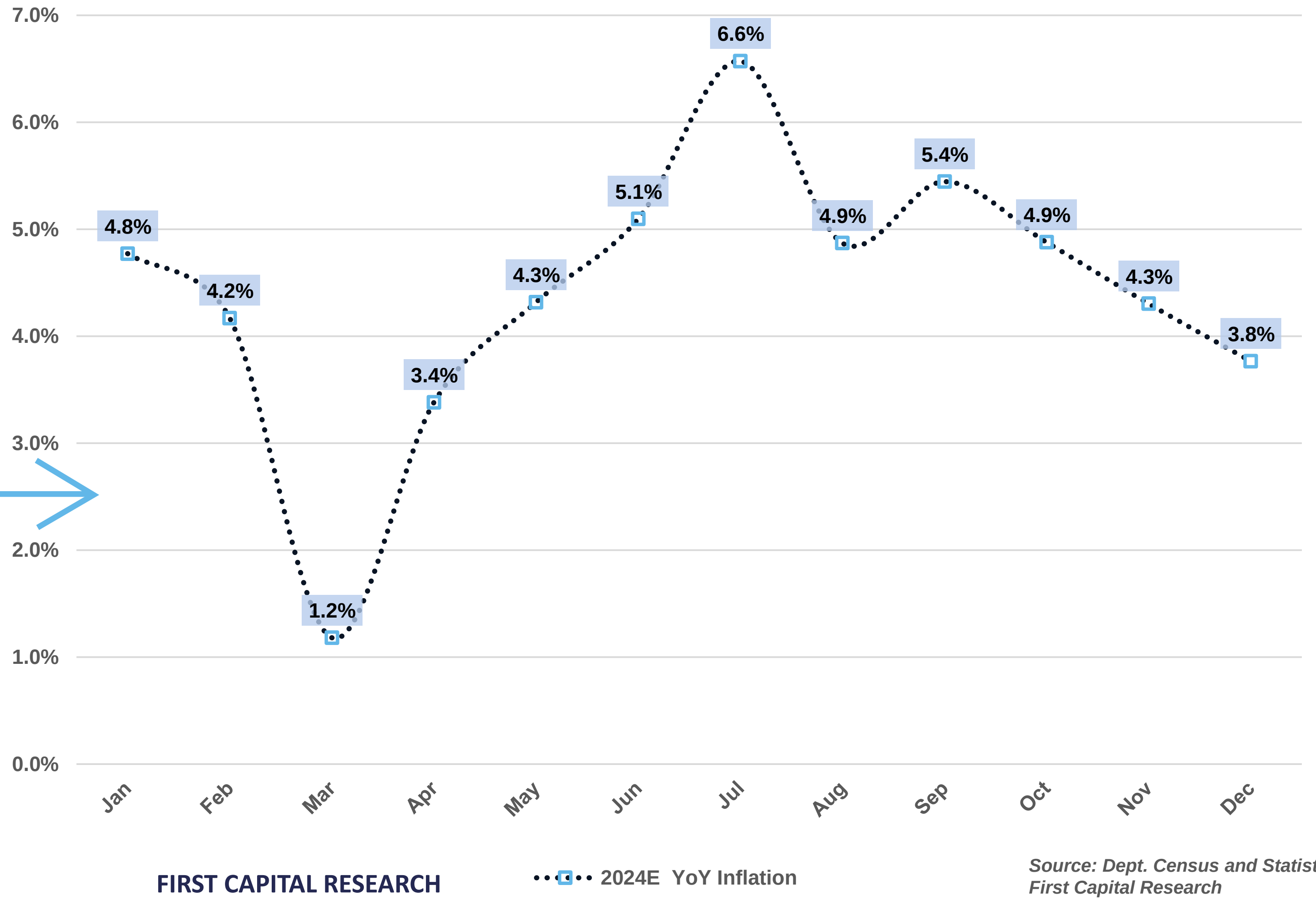
Major price changes observed in Nov-23 & Dec-23

	Price change Oct-Nov (LKR)	Price change Nov-Dec (LKR)
	164.88 ↑	57.82 ↑
	161.68 ↑	299.68 ↑
	578.82 ↑	703.10 ↑
	120.70 ↑	-322.05 ↓
	95.80 ↑	66.21 ↑
	-799.68 ↓	492.73 ↑
	-144.84 ↓	-67.94 ↓

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

CCPI for the beginning of 2024 is likely to remain on the high side as food inflation may further surge amidst skyrocketing prices of vegetables and the potential impact of VAT hike to 18%.

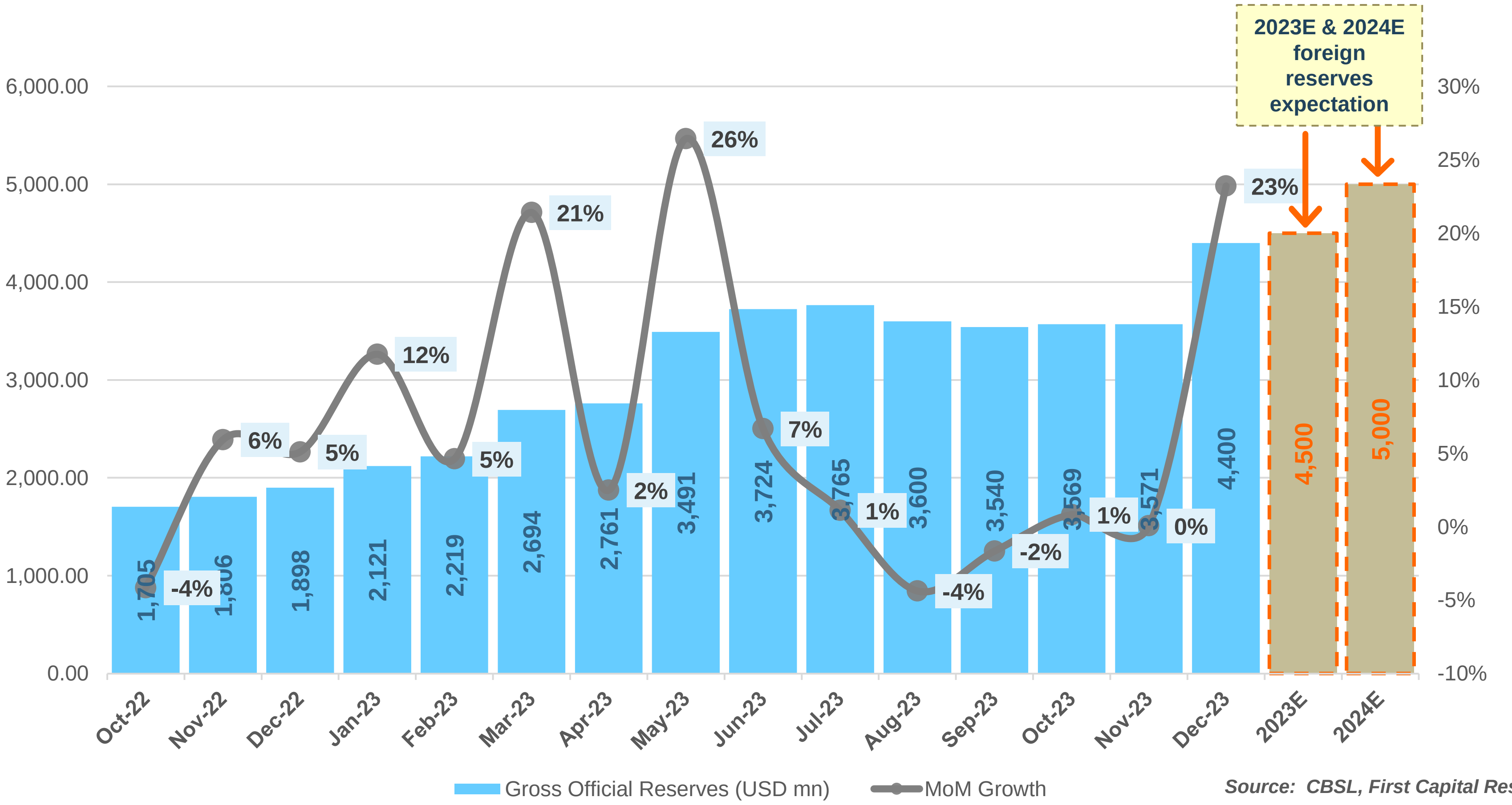
However, our CCPI expectations for 2024E is anticipated to remain in the single digit territory and the expected band with no significant threat perceptible on price levels in the period ahead.



Source: Dept. Census and Statistics, First Capital Research

Foreign Reserves expectations for 2024E at USD 5.0Bn

Gross official Reserves for 2023 closed at USD 4.4Bn aligning with our expectation of USD 4.5Bn largely aided by the multilateral fundings which came through in Dec-23. Reserves has surged by USD 829.0Mn during Dec-23 marking the largest MoM absolute increase since Dec-21.
We expect reserves to hit USD 5.0Bn in 2024E fueled by further fundings and improving dollar inflows.



Source: CBSL, First Capital Research

Multilateral fundings received in Dec-23

USD 200.0Mn — ADB ASIAN DEVELOPMENT BANK

USD 250.0Mn — THE WORLD BANK

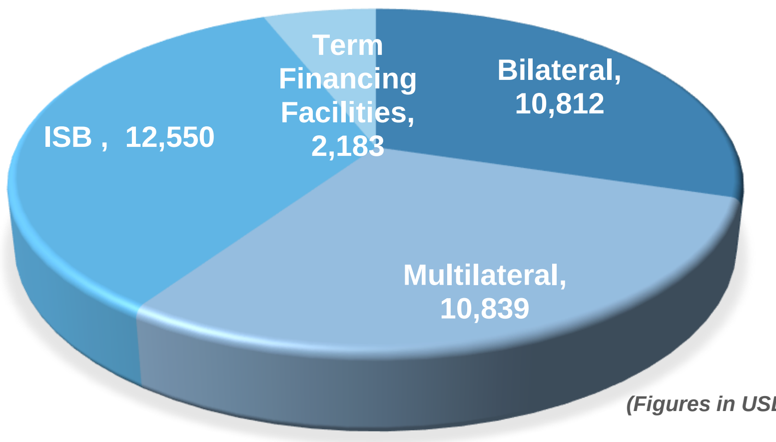
USD 337.0Mn — INTERNATIONAL MONETARY FUND

Sri Lanka's progress so far on the External Debt Restructuring

Sri Lanka successfully completed the Domestic Debt Optimization in Sep-23, after the finalization of restructuring plans in Jul-23. Consequently, the country progressed to make negotiations with the external lenders while securing an agreement with the EXIM bank of China and Official Creditor Committee (OCC) which was co-chaired by India, Japan and France (as chair of the Paris Club). However, debt treatment conditions are yet to be finalized on the EDR as negotiations are underway with private creditors.

- ✔ Sri Lanka has announced that the Exim Bank of China has agreed to "key principles and indicative terms" for the restructuring of USD 4.2Bn in bilateral debt. - Oct 2023 -
- ✔ Official Creditor Committee (OCC), jointly led by India, Japan, and France, concluded an agreement with Sri Lanka outlining the principal aspects of debt treatment. - Nov 2023 -
- ✔ The IMF cleared the second tranche of USD 337.0Mn of the Extended Fund Facility (EFF) to Sri Lanka, based on the debt treatment plan drawn up by the country and its bilateral creditors. - Dec 2023 -
- ? Wrapping up negotiations with external commercial creditors, including the bondholder group overseeing a portion of the country's USD 12.0Bn outstanding bonds, and to implement agreements with official creditors. -Pending-

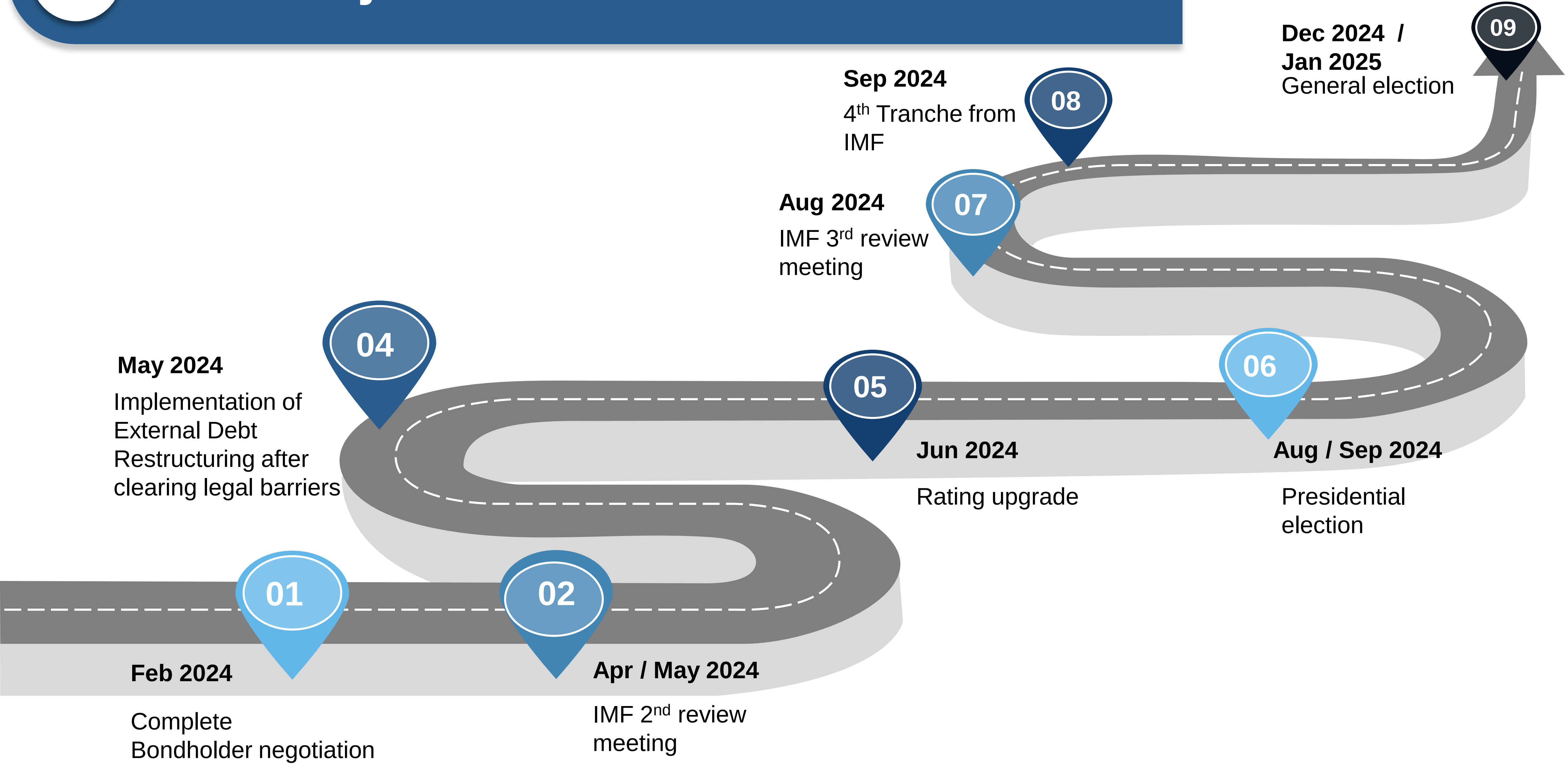
OUTSTANDING EXTERNAL DEBT AS AT SEP-23



(Figures in USD Mn)

Source: Ministry of Finance; Quarterly Debt bulletin

FCR Projected timeline for 2024



3.0 CBSL Annual Policy Statement 2024

"Monetary and Financial sector policies for 2024 and beyond"

CBSL presented its Annual Policy statement on the 10th Jan-24, envisioning on Monetary and Financial sector policies for 2024

Monetary Policy Strategy and Policies 1

Key Takeaways

- Monetary policy measures will be directed towards **sustaining the CCPI** based headline inflation **at the 5.0% level.**
- Following the **most recent decrease in policy interest rates** in November 2023, any additional easing has been **temporarily halted** in the near future.
- The discontinuation of monetary financing through the CBA (Central Bank Act), the **stabilization of inflation** expectations, and the **lowering of risk premia** on government securities are anticipated to **positively influence the medium-term transmission of Central Bank** monetary policy actions.
- Significantly, the Central Bank is **considering a shift to a singular policy interest** rate mechanism, replacing the current dual policy interest rates, with the aim of enhancing the transmission and signaling effectiveness of the monetary policy stance.
- A **user-friendly Open Market Operations (OMOs)** system will be implemented, smoothly transitioning to a new auction system by 2025. Additionally, **2024 OMO auction schedule is expected to be introduced** which will provide certainty in liquidity management for market participants.

Source: CBSL Annual Policy Statement 2024

- CBSL aims to **gradually remove limitations** on the utilization of **Standing Facilities by LCBs within OMOs** without disrupting market momentum and exploring alternative mechanisms to lessen the reliance of Standalone Primary Dealers on the Central Bank.

- The commitment of the Central Bank persists in upholding a **market-determined and flexible exchange rate** as a safeguard against external shocks.

- Starting in 2024, the **number of monetary policy reviews has been decreased to six annually,** aligning with the CBA's mandate for the Monetary Policy Board to convene at least once every two months. The Advance Monetary Policy Release Calendar for 2024 is as follows;

No.	Monetary Policy Board Meeting	Monetary Policy Announcement
01	22nd Jan - 24	23rd Jan – 24 *(Monetary Policy Report – 15th Feb 24)*
02	25th Mar - 24	26th Mar - 24
03	28th May - 24	29th May - 24
04	23rd Jul - 24	24th Jul – 24 *(Monetary Policy Report – 15th Aug 24)*
05	26th Sep - 24	27th Sep - 24
06	26th Nov - 24	27th Nov - 24

Source: CBSL Annual Policy Statement 2024

Financial Sector Policies 2

Key Takeaways

- The Central Bank has devised a roadmap for the **restructuring and recapitalization of nine major banks**, aiming to tackle capital and foreign exchange liquidity deficiencies identified through diagnostic assessments.
- The regulatory **inspections of licensed banks will be intensified,** aligning with a risk-based consolidated supervision framework.
- Enhancing the **evaluation of the suitability of directors**, chief executive officers, and key management personnel of licensed banks involves reinforcing approval processes for individuals possessing pertinent qualifications and experience, thereby **enhancing the composition and competencies** of the Board of Directors.
- Historically, the Government and **State-Owned Enterprises heavily relied on systemically important state-owned banks for funding**, posing challenges to financial stability. The Central Bank **is formulating guidelines to limit large exposures**, prompting potential balance sheet restructuring and diversification of funding for SOBEs and major corporations.
- The stability of the non-bank sector are anticipated through the **initiation of Phase II of the Masterplan for Consolidation of Non-Bank Financial Institutions,** starting in 2024, aimed at fostering robust and secure Non-Bank Financial Institutions (NBFIs).

Source: CBSL Annual Policy Statement 2024

Policies to Strengthen the Broader Economy 3

Key Takeaways

- Continuing to engage with pertinent stakeholders to **facilitate the external debt restructuring process** remains crucial for restoring debt sustainability. A timely resolution with external private creditors on comparable terms would additionally **help alleviate market uncertainties,** leading to a reduction in risk premia linked to government securities and achieving the targeted downward shift of the yield curve.

- The Central Bank will aid the Ministry of Finance in **establishing the Public Debt Management Agency (PDMA),** anticipated to function as the exclusive authority for managing the public debt within the country.

- Given the enhanced liquidity in the domestic foreign exchange market, the Central Bank will prioritize **reviewing current restrictions on specific capital foreign exchange outflows,** aiming to progressively ease and **eventually remove** these restrictions.

- The **Export Proceeds Monitoring System (EPMS)** introduced in 2022 will undergo **further optimization** to enhance the efficiency and effectiveness of monitoring the repatriation of export proceeds.

- The Central Bank has **ceased its own funded initiatives** for regional development, as the CBA lacks provisions for such initiatives. Going forward, the **Ministry of Finance will be responsible** for implementing such schemes, with the Central Bank assisting the Ministry in enhancing its capacity for program implementation.

Source: CBSL Annual Policy Statement 2024

4.0
Fixed Income Health Score

"Fixed Income health score remains broadly unchanged"

FI Economic Health Score – Dec-23

Fixed Income Health Score kept steady compared to our Nov-23 update. Improvements in official reserves level supported by multilateral fundings aided positively to the health score during the period whilst rising inflation caused tailwinds to the FI health score up to Dec-23 period.

Primary Criteria	-	50	-	00	=	50
Secondary Criteria	-	15	+	01	=	16
Economic Health Score [Dec 2023]					=	66

[As against 65 in Nov 2023 & 33 in Dec 2022 (1 Year ago)]

Source: First Capital Research

Changes to Health Score
Primary Criteria – Dec 2023

50/75

Previous score

10/15

08/15 (+2)

Foreign Reserves

Foreign reserves showed a sharp uptick in the month of December reaching USD 4.4Bn aided by loans from multilateral lenders including IMF.

05/15

05/15

Liquidity

Liquidity continued to remain volatile, yet negative liquidity swings remained limited recording LKR 88.0Bn by the end of Dec-23.

13/15

15/15 (-2)

Inflation

CCPI inflation rose to 4.0% in Dec-23, amidst the increase in Food inflation which turned positive in December from the -3.6% recorded in Nov-23.

03/10

Foreign Activity

Foreign Investment in Govt. securities continued the declining trajectory and recorded at LKR 118.5Bn as at end Dec-23 compared to LKR 130.6Bn recorded by Nov-23.

03/10

09/10

Credit

Private sector credit continued to improve during the concerned period, recording a +0.5%MoM growth to LKR 7.2Bn in Oct-23.

09/10

10/10

CBSL Holdings

CBSL holdings declined from LKR 2,759.4Bn recorded during the beginning of the month to LKR 2,743.6Bn towards the end of Dec-23.

10/10

Previous score

Changes to Health Score
Secondary Criteria – Dec 2023

16/25

Previous 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.

01/05

05/05

External Environment

FOREX market remained volatile throughout 2023, with USD/LKR appreciating by 10.8% YTD while it appreciated by 1.1% during the month of Dec-23.

05/05

05/05

BOT & BOP

Trade deficit shrunk cf. Oct-23 and recorded at USD 390.0Mn in Nov-23 while BOP remained a surplus and recorded at USD 1.9Bn 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 spiked by 27 points in Dec-23 and closed at 85. The main cause for the improvement in confidence is securing the IMF 2nd tranche while gaining ground on EDR efforts.

00/05

+1

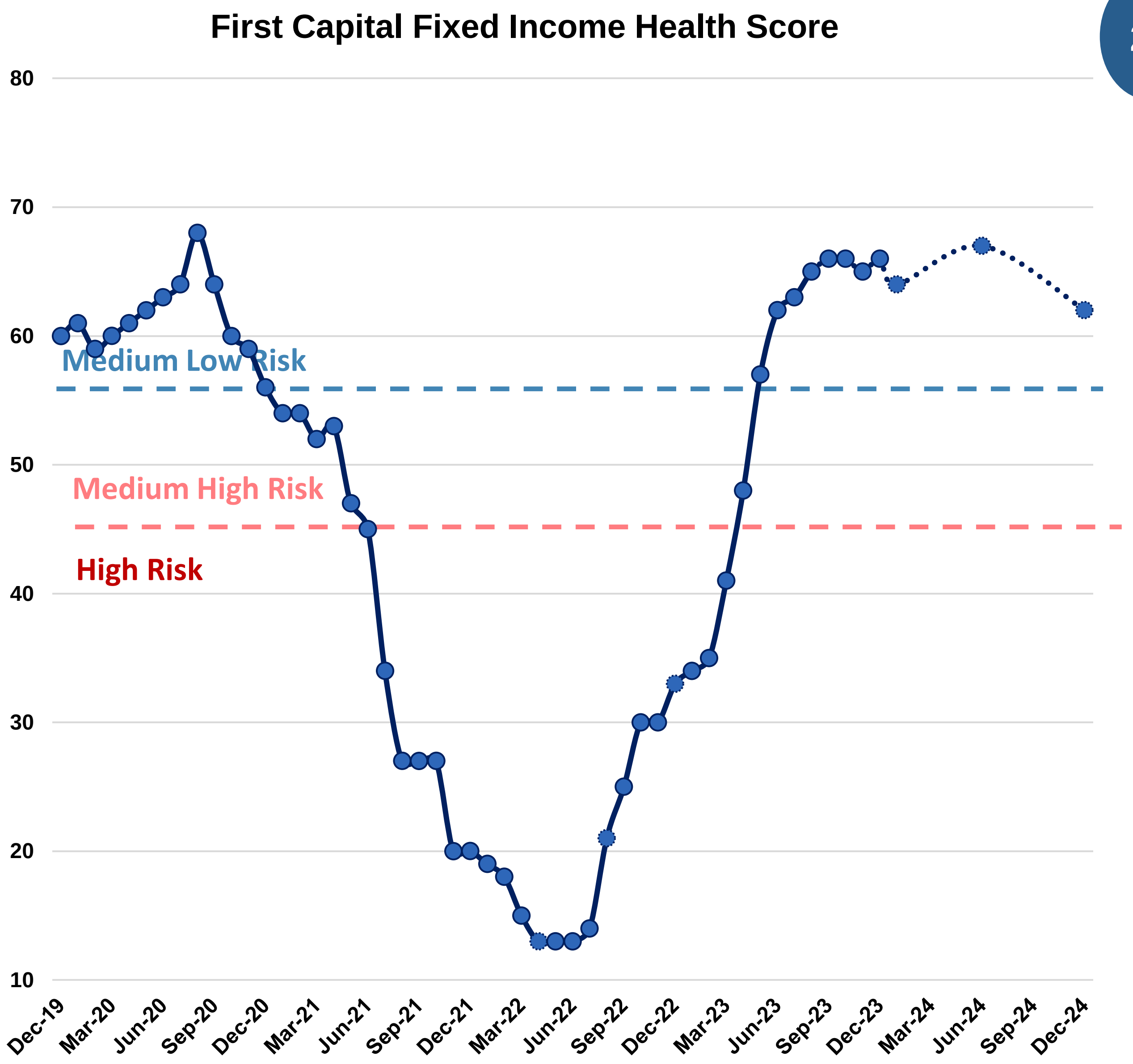
Previous score

5.0 New Recommendation

"Taking profits in declining interest rates"

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.

Going forward, we expect FI Health Score to marginally incline towards Mar-24, aided by improvement in foreign activity and investor confidence amidst the completion of the External Debt Restructuring and the subsequent potential rating upgrade. However, FI health score is expected to dip towards Jun-24, and remain stable through 2H2024 on pent up credit pressure and election uncertainty which may loom from Jun-24 onwards.



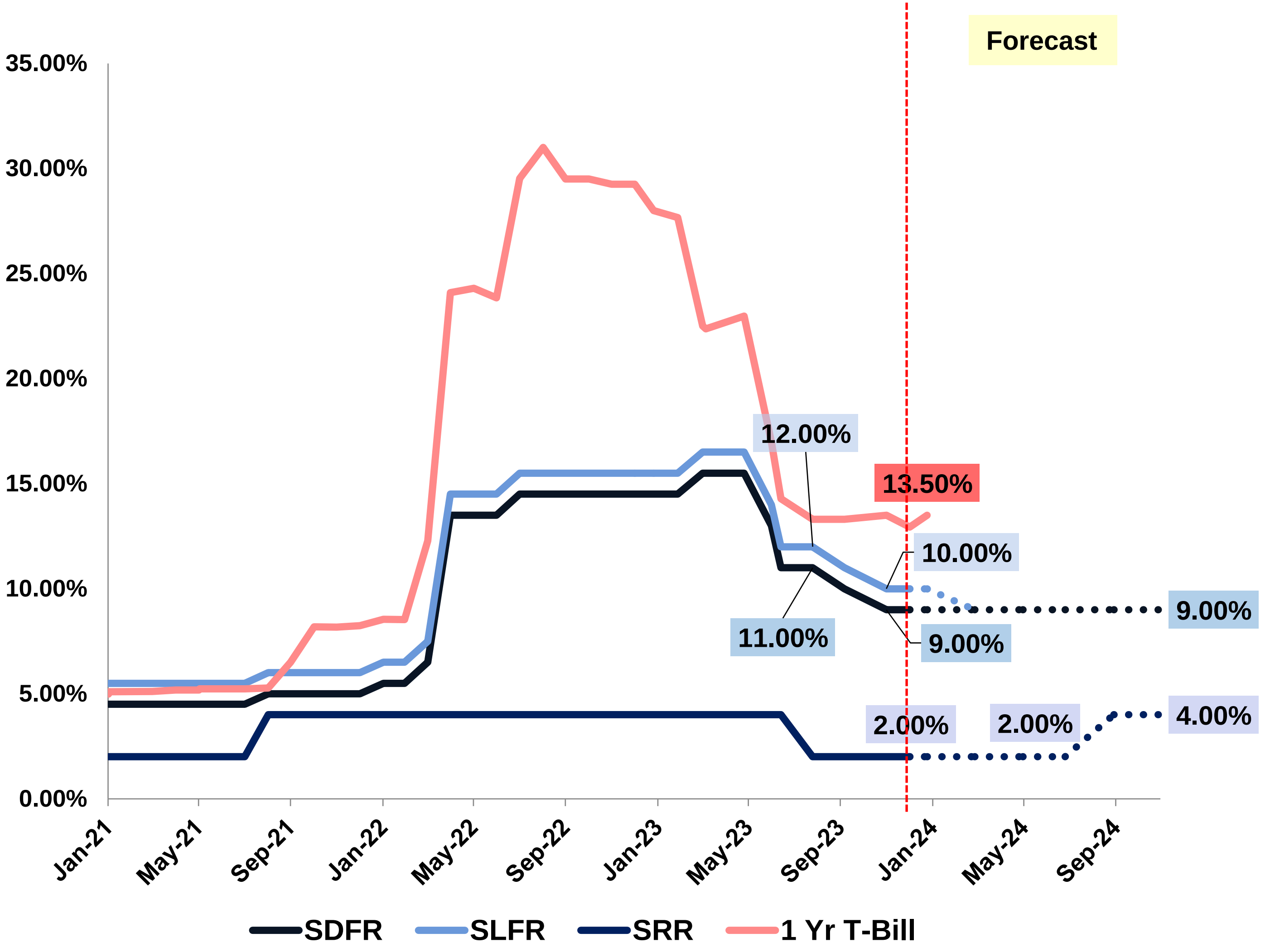
Policy rate cuts to take a pause;

But implementation of single policy rate window may cause a 100bps rate cut for SLF

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. Thus, CBSL has reduced policy rates on four occasions, totaling to 550bps, with the latest 100bps reduction announced in Nov-23.

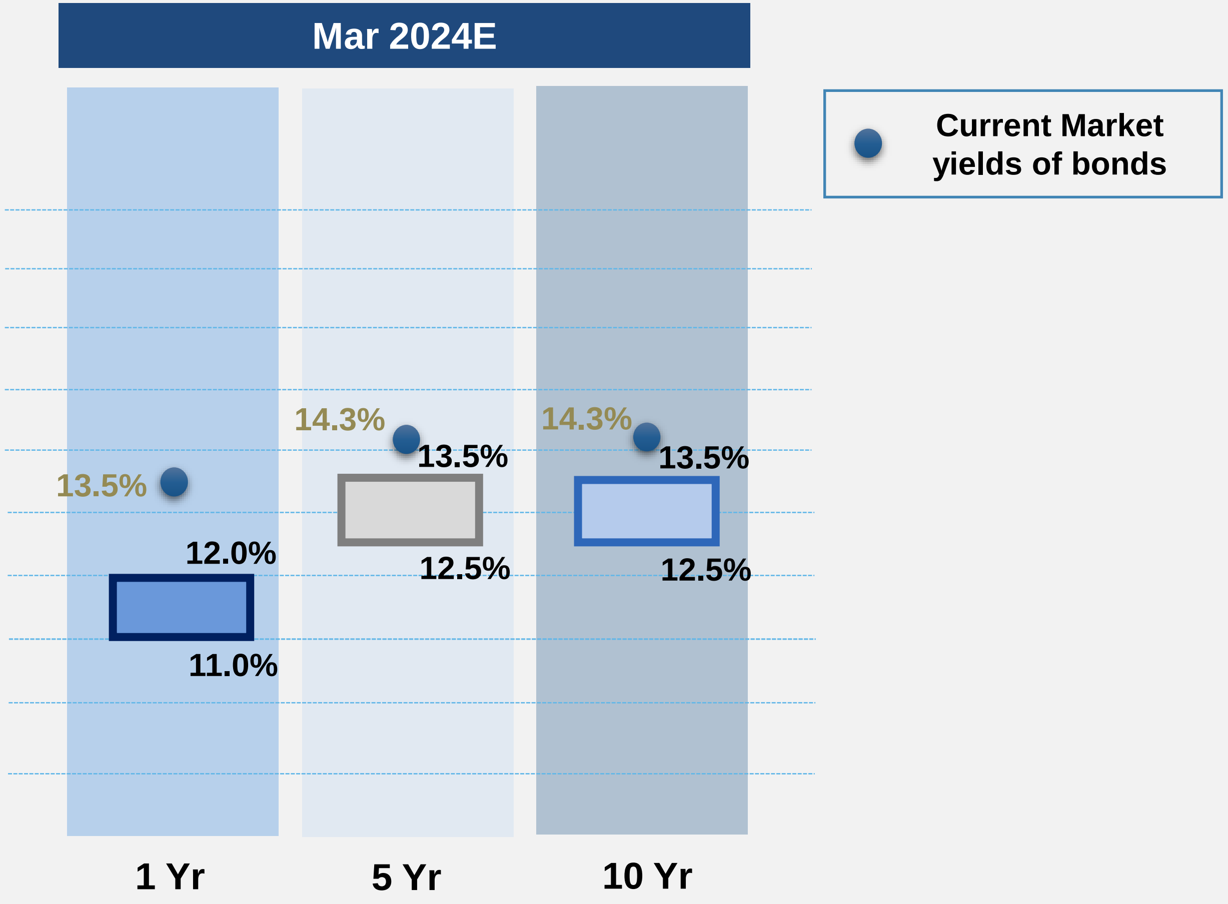
Having announced the latest rate cut ahead of our next year mid-expectation, we expect CBSL to take a pause and maintain rates in the near future, paving way for market rates to adjust downward in-line with the decline in risk premia attached to government yields, with positive strides made on external debt restructuring while going in line with IMF guidelines in order to secure the subsequent tranches.

However, CBSL plans on implementing a single policy rate window. **We believe it may be implemented in the Mar-24 policy meeting via a rate cut for SLF reducing it to 9.0% to be in line with the SDF.**



Source: CBSL, First Capital Research

Bond Yield Expectations of Dec-23 extended to Mar-24



Source: First Capital Research

Expectation: With the completion of external debt restructuring during 1Q2024, we believe the overall yield curve is likely to drop below 13.5% and reach a range of 11.0%-13.5%.

The uncertainty and delay in the external debt restructuring has caused the yields to hover in the range of 13.0%-15.0%. However, we expect the external debt restructuring to be completed during 1Q2024. The Government with the support of the official creditor committee has mostly completed the negotiations with the larger Bi-lateral partners while negotiations with the Bondholder group has not concluded as yet. This component consists of USD 12.6Bn as of Sep-23 International Sovereign Bonds and is critical for the successful conclusion of the external debt restructuring.

Moreover, the 100bps policy rate cut is also expected for the SLF from the Mar-24 policy meeting in order for the CBSL to implement a single policy window which may also support a further dip in rates.

First Capital Research believes there is further downside potential

Recommendation:
Maintain **Hold**

Book Profits if yields fall closer towards the 13.0% mark

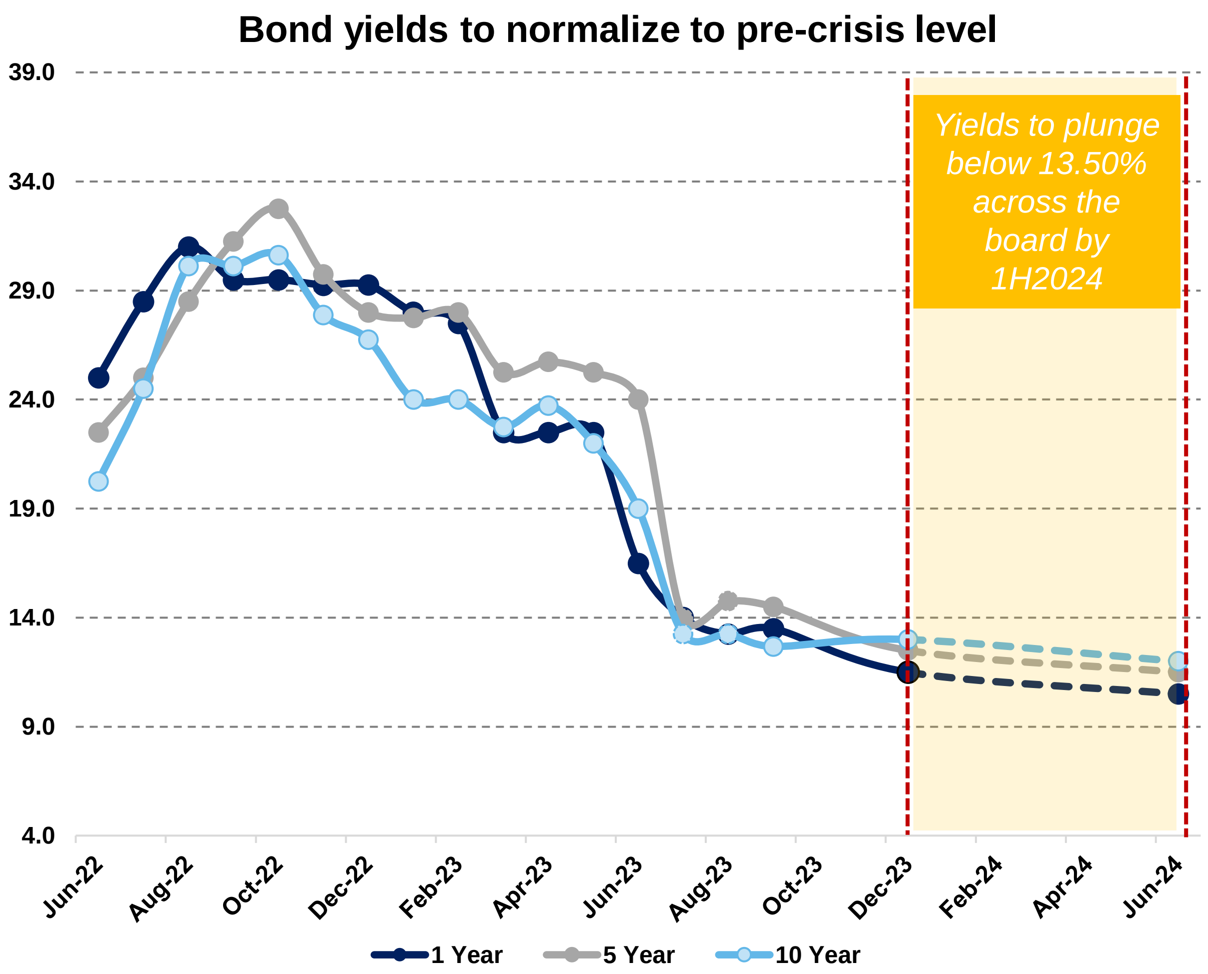
Optimistic on a downward shift

External debt restructuring in progress: External debt restructuring discussions has significant progress with SL reaching an agreement in principle with its Official Creditor Committee (OCC) on the financial terms of a debt treatment covering USD 5.9Bn in outstanding public debt. However, negotiations of International Sovereign Bonds is still ongoing with the Bondholder Group and is expected to conclude soon paving the way for the external debt restructuring.

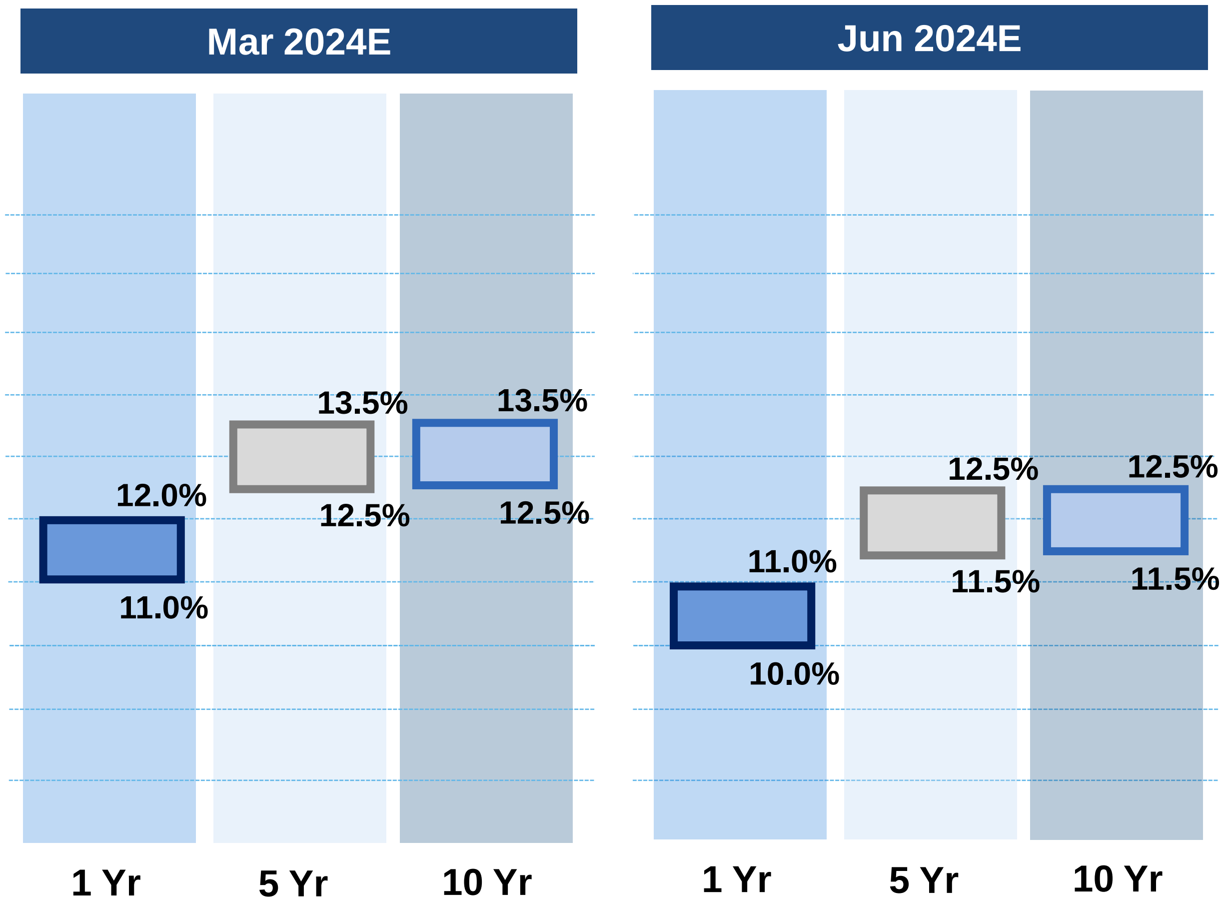
CBSL to look for a pause in rate cuts: Having announced the final rate cut of 100bps for 2023, CBSL has indicated that it will take a pause in monetary policy easing for the near term in line with the FCR expectation. However, a 100bps cut in the SLF is expected to reach 9.0% to the same level of SDF in order to implement a single policy rate window.

Hold Portfolio, look out for Sell opportunities near 13.0%: We highly recommend investors to hold your current portfolio to gain the benefit of a further decline in the yields. Mid tenors have already fallen off its peak in mid-Nov 23, but opportunity exists for further gains. Following the opportunities received in accumulating near the 15.0% mark across the yield curve, we would like to advise investors to be mindful to gradually reduce portfolios / book profits as yields decline towards the 13.0% mark and below.

Bond Yield Expectations of 1H2024 extended to Mar-24

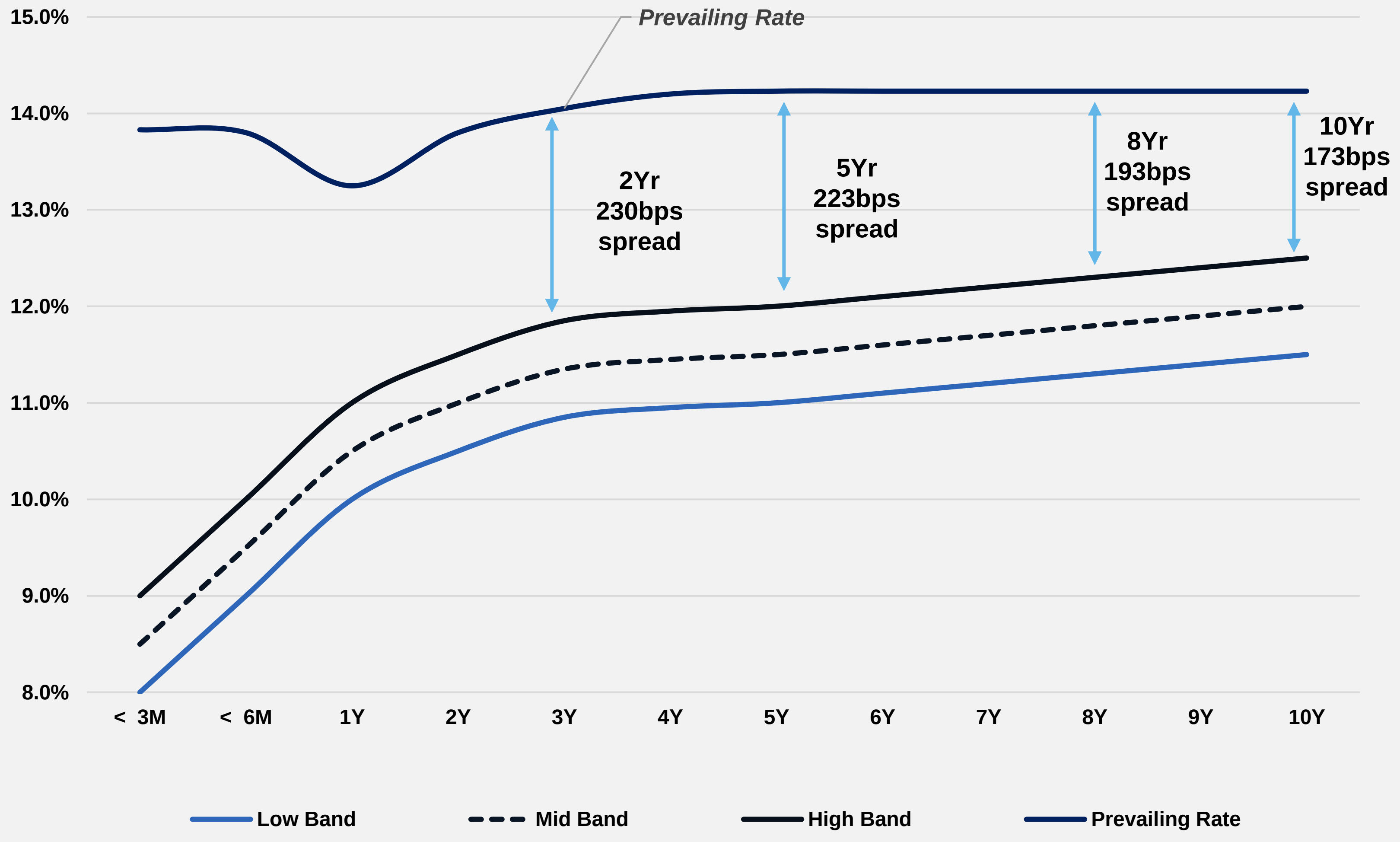


Source: First Capital Research



Source: First Capital Research

Mid-Long tenors may have a parallel shift across the yield curve

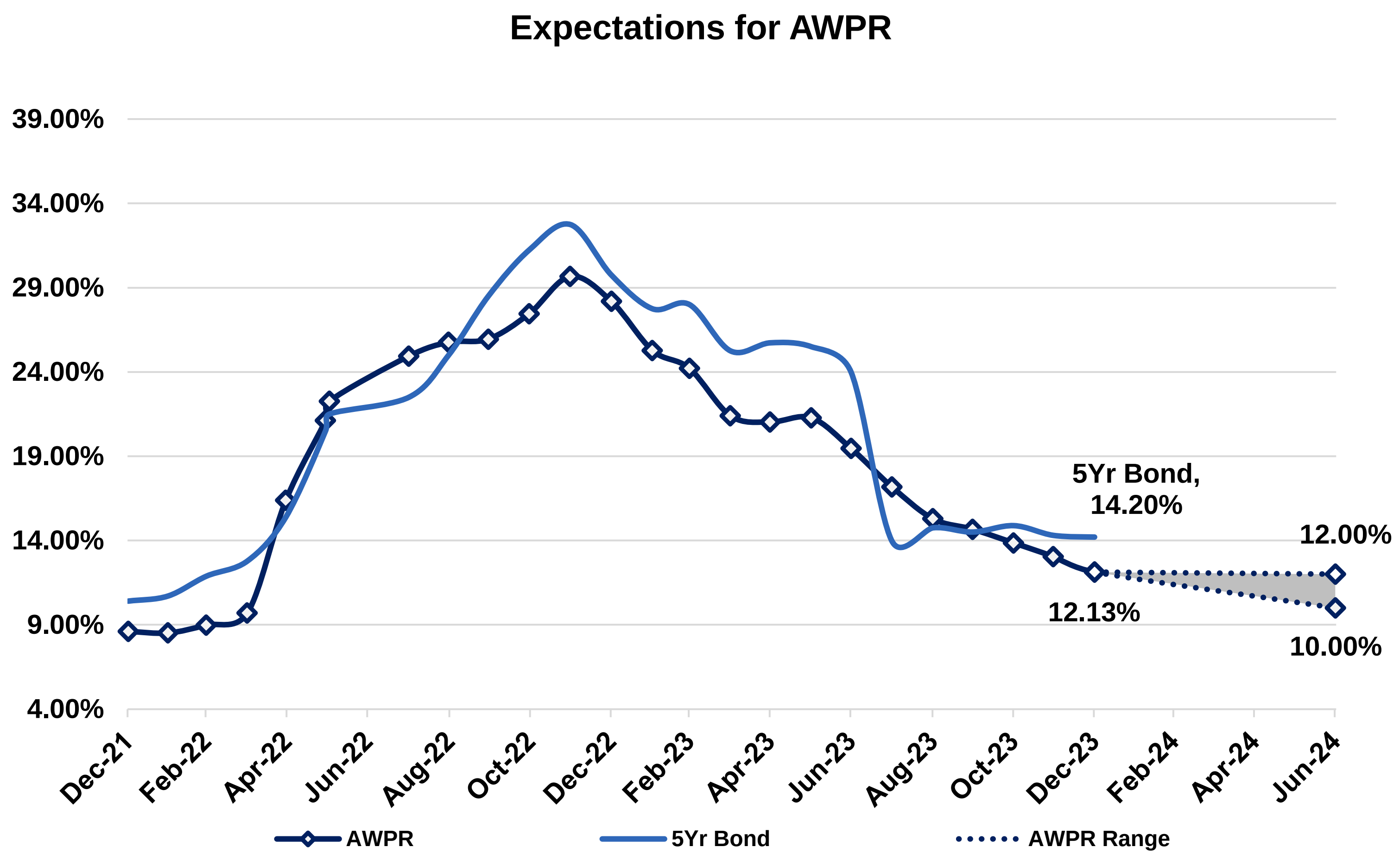


Source: First Capital Research

5.0
AWPR Recommendation

"AWPR on track near 13.0% by Dec-23 and 10.0%-12.0% target by Jun-24, maintained"

AWPR decline to 10.0%-12.0% by Jun-24



Source: First Capital Research

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Contact Us

First Capital Holdings PLC
No: 02, Deal Place,
Colombo 00300,
Sri Lanka.
E: research@firstcapital.lk

Dimantha Mathew
Chief Research & Strategy Officer
T: +94 11 2639 853
E: dimantha@firstcapital.lk

Ranjan Ranatunga
Assistant Vice President – Research
T: +94 11 2639 863
E: ranjan@firstcapital.lk

Vinodhini Rajapoopathy
Assistant Manager - Research
T: +94 11 2639 866
E: vinodhini@firstcapital.lk

Tharusha Ashokgar
Senior Research Associate
T: +94 11 2639 866
E: tharushaash@firstcapital.lk

Zaeema Jihan
Senior Research Associate
T: +94 11 2639 866
E: zaheema@firstcapital.lk

Nethmi Fernando
Associate
T: +94 11 2639 866
E: nethmi@firstcapital.lk