



Reforms to stay course with Bets on Elections

Investment Strategy | Jan 2024 | SRI LANKA



First Capital
A Janashakthi Group Company

Analyst:
Dimantha Mathew
dimantha@firstcapital.lk

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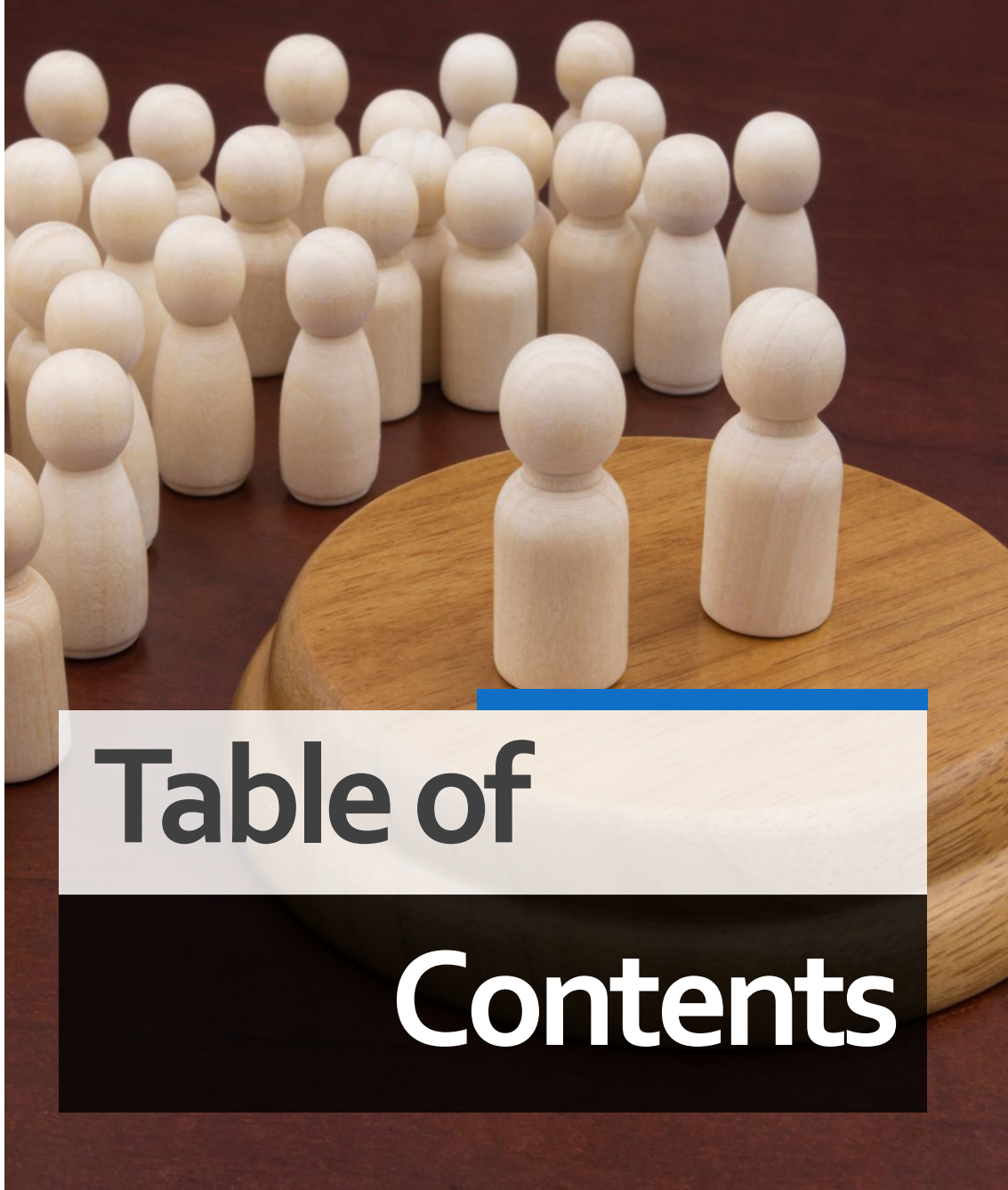
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EXECUTIVE SUMMARY



Bond Yields to continue downtrend; Book Profits if yields fall closer towards the 13.0% mark

- Having announced the latest rate cut in Nov-23, we expect CBSL to take a pause and maintain rates in the near future, paving way for market rates to adjust downward. However, CBSL plans on implementing a single policy rate window, we believe CBSL may be implement it in the 1Q2024 via a rate cut to the SLF reducing it to 9.0% to be in line with the SDF.
- With the completion of external debt restructuring during 1H2024, we believe the overall yield curve is likely to drop below 13.5% and reach a range of 11.0%-13.5% in the short term and towards end of 1H2024 to reach 10.0%-12.5%

AWPR may decline to 10.0%-12.0% by Jun-24 and rise again to 11.0%-13.0% by Dec-24

- We expect the downtrend in AWPR to continue and reach a low of 10.0% - 12.0% during 1H2024, but with the stronger demand for credit and the pick in the economy with the gradual rise in SME segment and inflation, we expect slight pressure on interest rates pushing AWPR to 11.0-13.0% during 2H2024.

Exchange Rate outlook upgraded to LKR 310.0-330.0 for 1H and LKR 320.0-340.0 for 2H2024

- FCR outlook for 1H2024 for the LKR has been upgraded with potential appreciation pressure as the newly implemented higher taxes are likely to significantly slowdown the rising consumer demand in the short term supported by the rise in cost of living resulting in LKR appreciating to a range of 310.0-330.0. LKR may register depreciation pressure amidst the growth in the economy as we target a range of LKR 320.0-340.0 for the 2H.

ASPI Dec-24 target at 13,500; Out of equity allocated funds invest 100%

- The substantial decline in interest rates stands as a key catalyst, poised to prompt a market re-rating. This shift is anticipated to drive a notable liquidity transition from fixed income to equity, potentially resulting in a market range of 13,000-14,000 for 2024E.



Track Record

[Jan 2023 & Jul 2023]

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

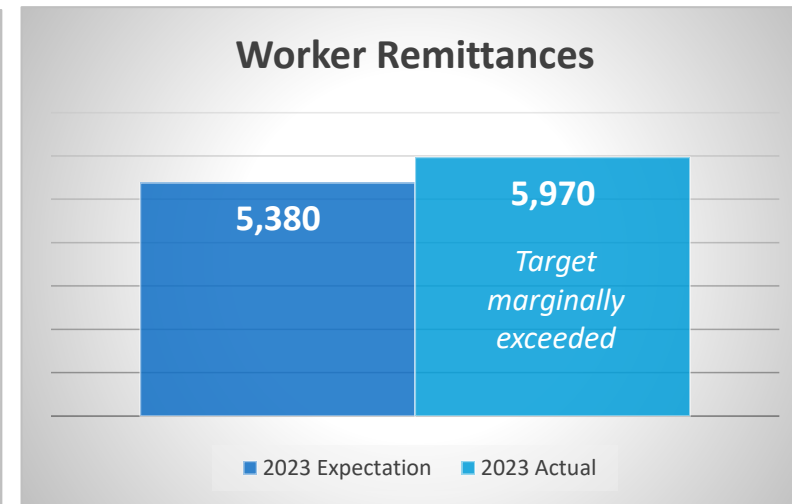
Forecast: **Accurate**



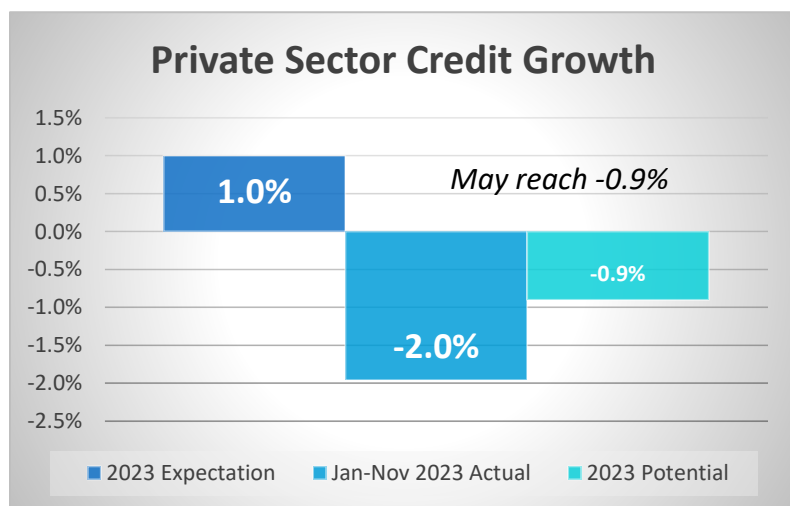
Forecast: **Accurate**



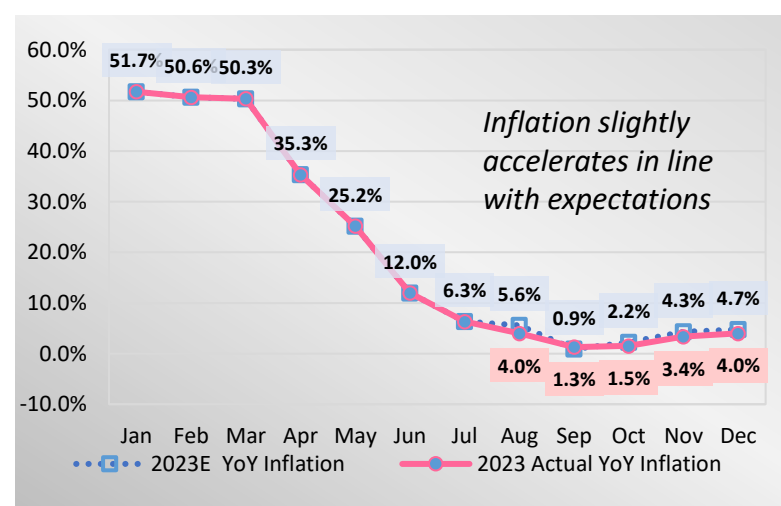
Forecast: **Accurate**



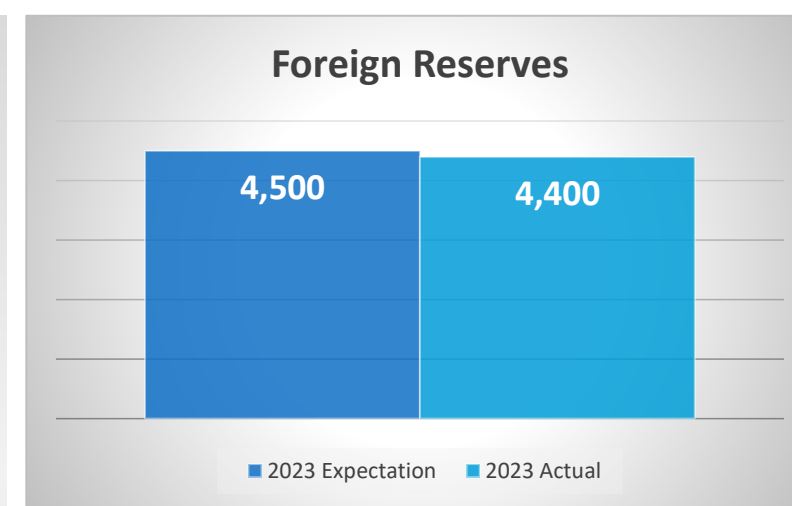
Forecast: **Mostly Accurate, slower growth**



Forecast: **Accurate**



Forecast: **Accurate**



Previous Recommendations - Bonds

28th Feb 2023 [Investment Strategy 2023 Report]

“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. With the completion of DDR or towards Dec-23 we believe the overall yield curve is likely to drop below 20%.”

Accurate

Yield curve recorded an accelerated downward shift in line with expectations

05th Jul 2023 [Mid-Year Outlook 2023 Report]

“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%.”

Accurate

Yield curve recorded an accelerated downward shift in line with expectations

New Recommendation on 27th Sep 2023 [FI Report] “With the completion of external debt restructuring towards Dec-23, we believe the overall yield curve is likely to drop below 15% and reach a range of 11%-13.5%.”

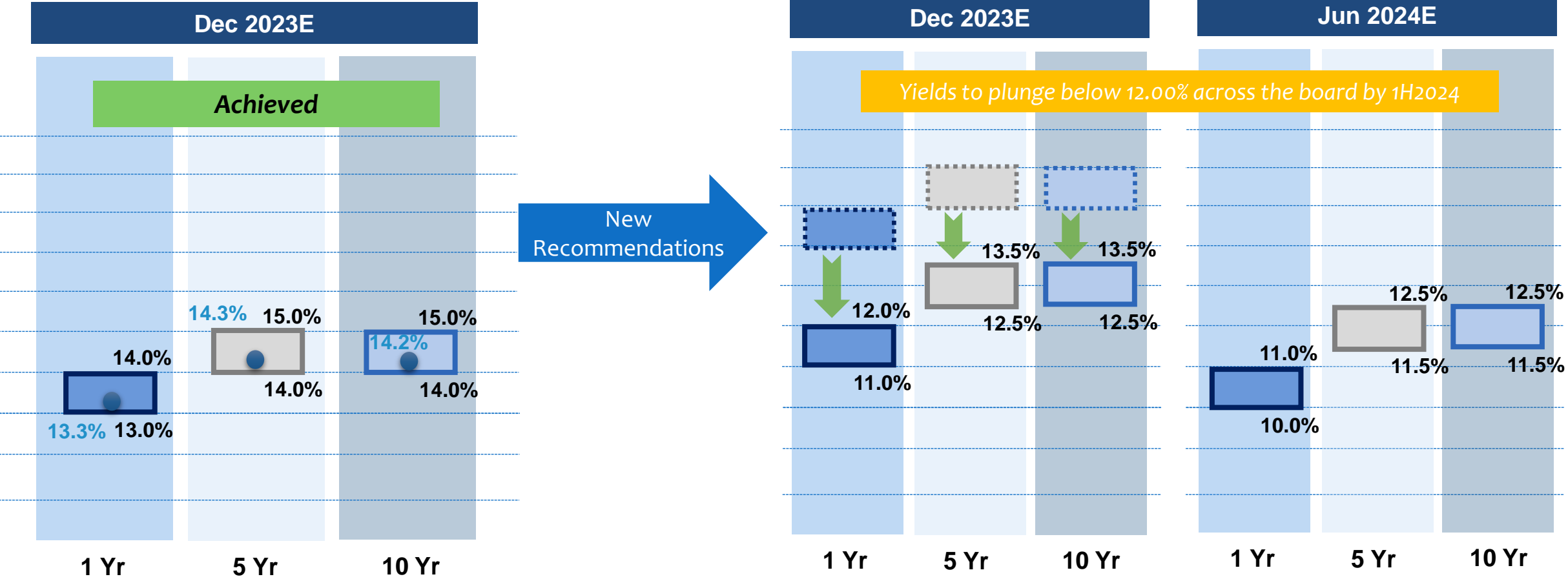
Partly Accurate

Delay in External Debt Restructuring conclusion halts downward shift in yields

Previous Recommendations – Bonds - Mostly Accurate

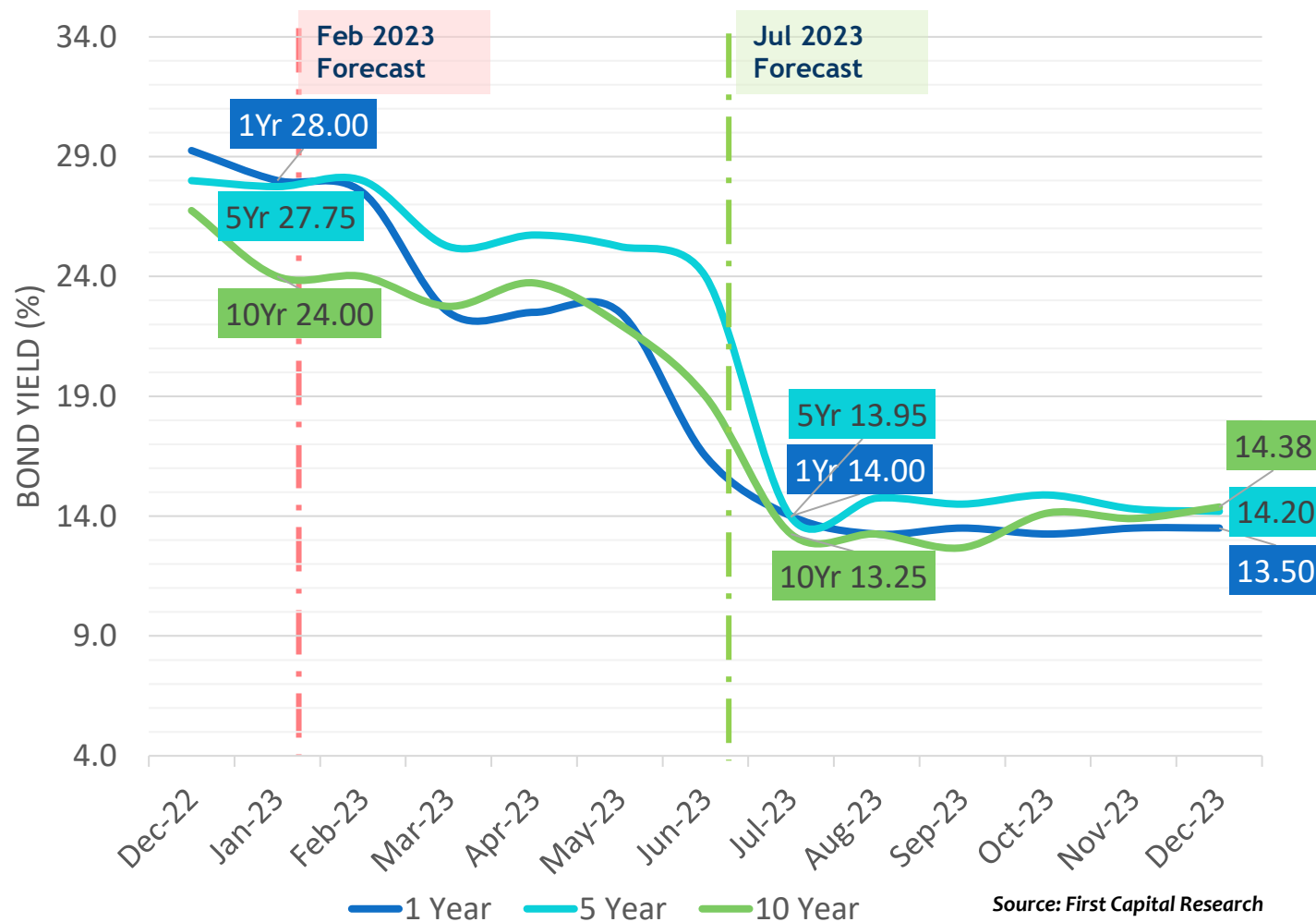
“With the completion of domestic debt restructuring or towards Dec-23 we believe the overall yield curve is likely to drop below 20% and reach a range of 13%-15%.”

“With the completion of external debt restructuring towards Dec-23, we believe the overall yield curve is likely to drop below 15% and reach a range of 11%-13.5%.”



Bonds – Feb-23 & Jul-23 Re cap: Mostly Accurate

“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%. With the completion of external debt restructuring towards Dec-23, we believe the overall yield curve is likely to drop below 15% and reach a range of 11%-13.5%.”



1Y - YTD 1400 bps ↓
5Y - YTD 1380 bps ↓
10Y - YTD 1075 bps ↓

5 Months 2023
Feb - Jul

1Y - YTD 50 bps ↓
5Y - YTD 25 bps ↑
10Y - YTD 113 bps ↑

6 Months 2023
Jul - Dec

Policy Rates – Feb-23 & Jul-23 Re cap: Accurate

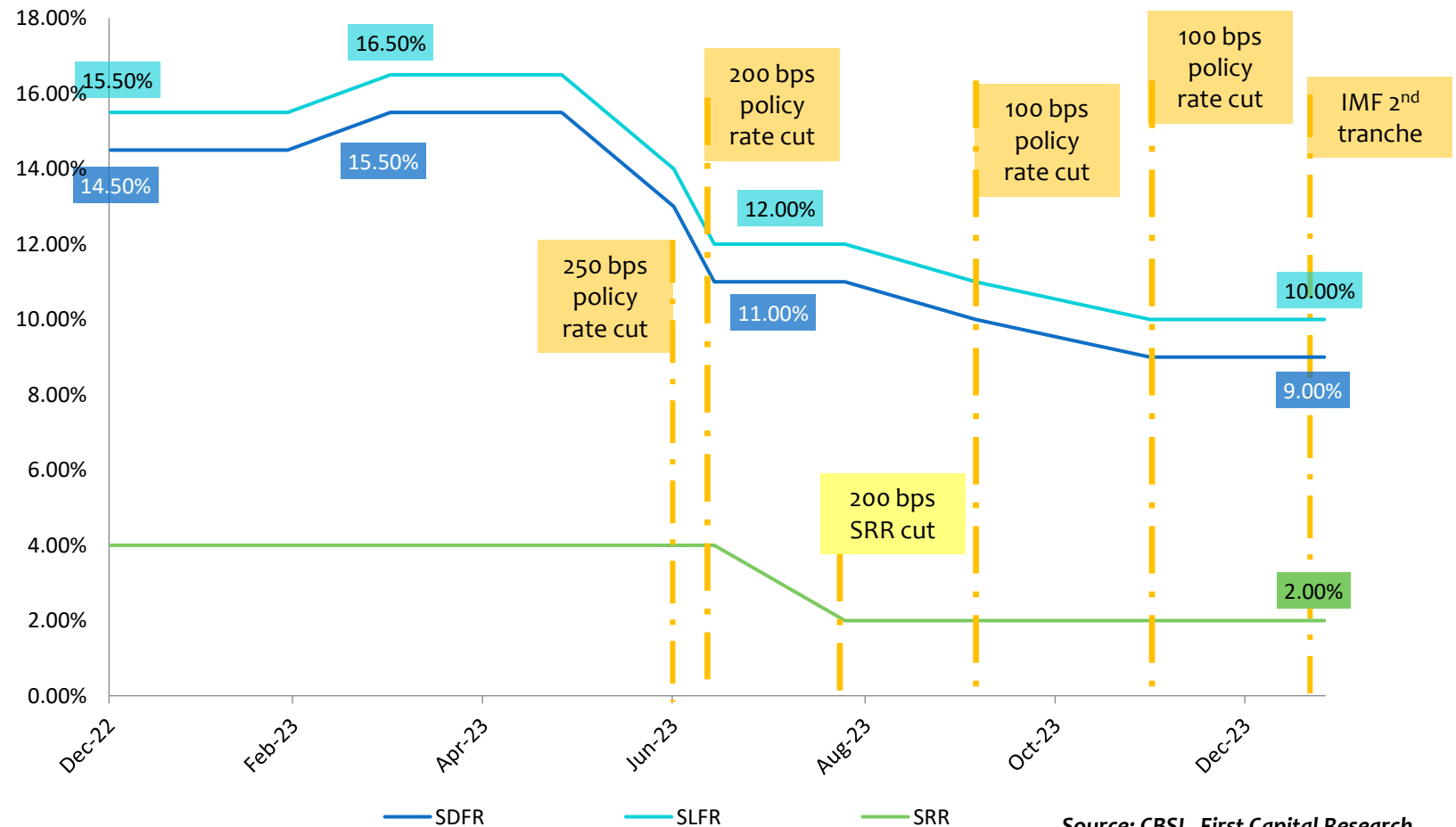
400bps rate cut over the next 12months to reach SDF / SLF of 9.0% to 10.0%

Surprise hike and 650bps cuts in policy rates in 2023

Following negotiations with the IMF, CBSL decided to hike rates by 100bps, immediately ahead of the IMF Board approval in Mar-23.

However, with the accelerated decline in inflation, CBSL cut policy rates by 650bps while also cutting SRR by 200bps to accelerate the decline in market rates.

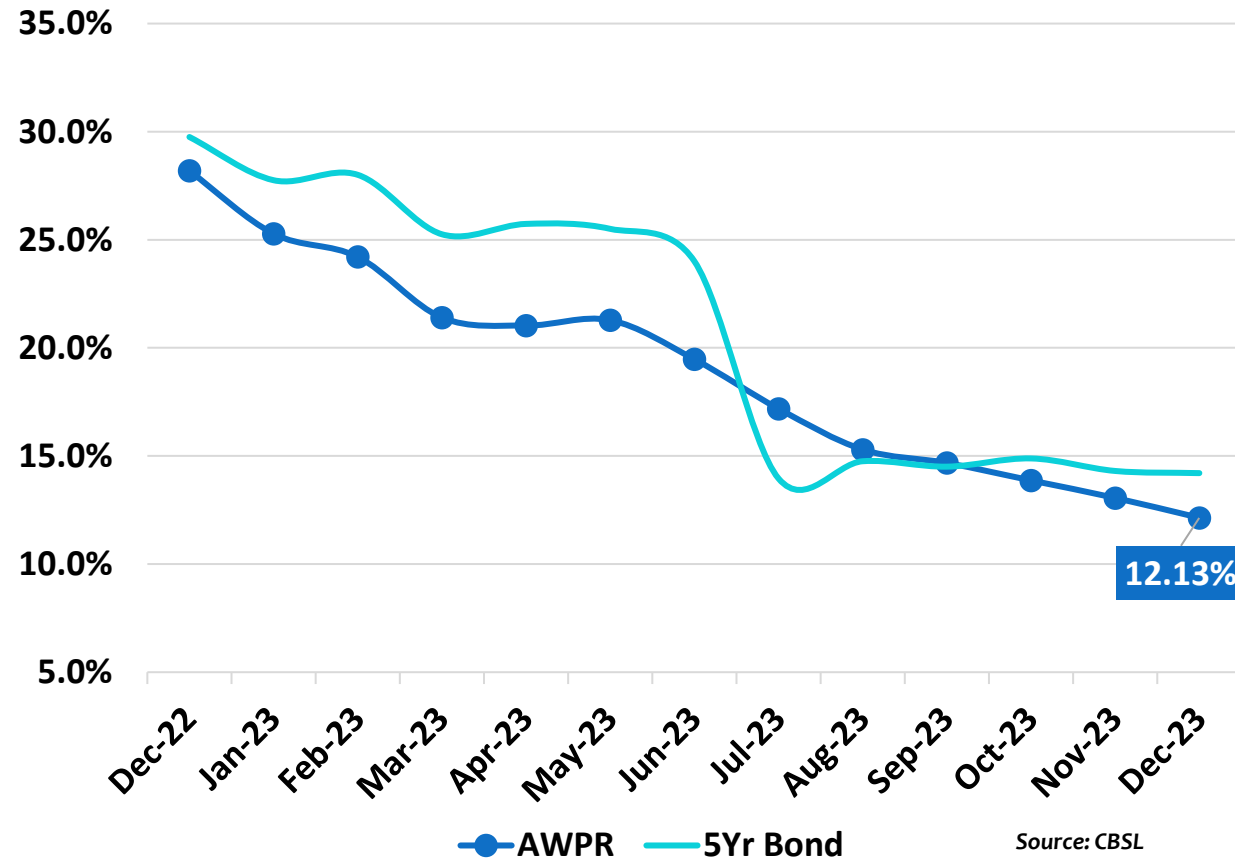
FC Research (Jul 2023): FCR expected policy rates to bottom out at 9.0% and 10.0% for SDF & SLF. In line with the expectations CBSL announced a halt in monetary easing.



Source: CBSL, First Capital Research

Bank Rates – Feb-23 & Jul-23 Re cap: Accurate

AWPR to dip to 10%-15% over the next 12 months; AWPR decline to 13.0%-15.0% by Dec-23 and 10.0%-12.0% by Jun-24



Review

In line with expectations AWPR recorded a steep drop while unexpectedly falling faster than the 5-Yr Bond amidst the lack of demand for credit in the system.

Exchange Rate – Jul-23 Re cap: Accurate

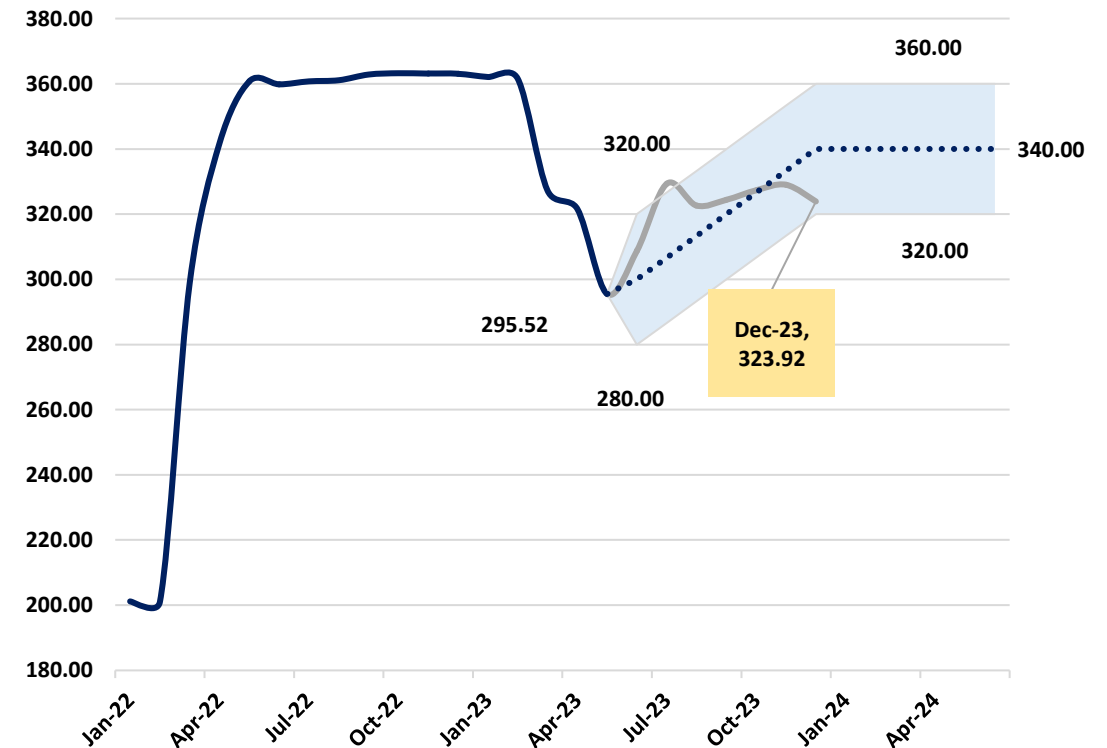
USD/LKR is expected to gradually depreciate in 2H2023 & 1H2024 amidst trade relaxation, hovering within a range of LKR 320.0-360.0 over the next 12 months (upto Jun-24)

Review

In line with our Jul-23 expectations, CBSL continued to allow the rupee to trade freely without influencing the direction of the rupee. CBSL continued to purchase dollars throughout the year in order to achieve the Reserve targets for the year.

However, towards the latter part of the year CBSL announced that it will refrain from transactions in the market allowing the rupee to move based on the demand and supply of currency.

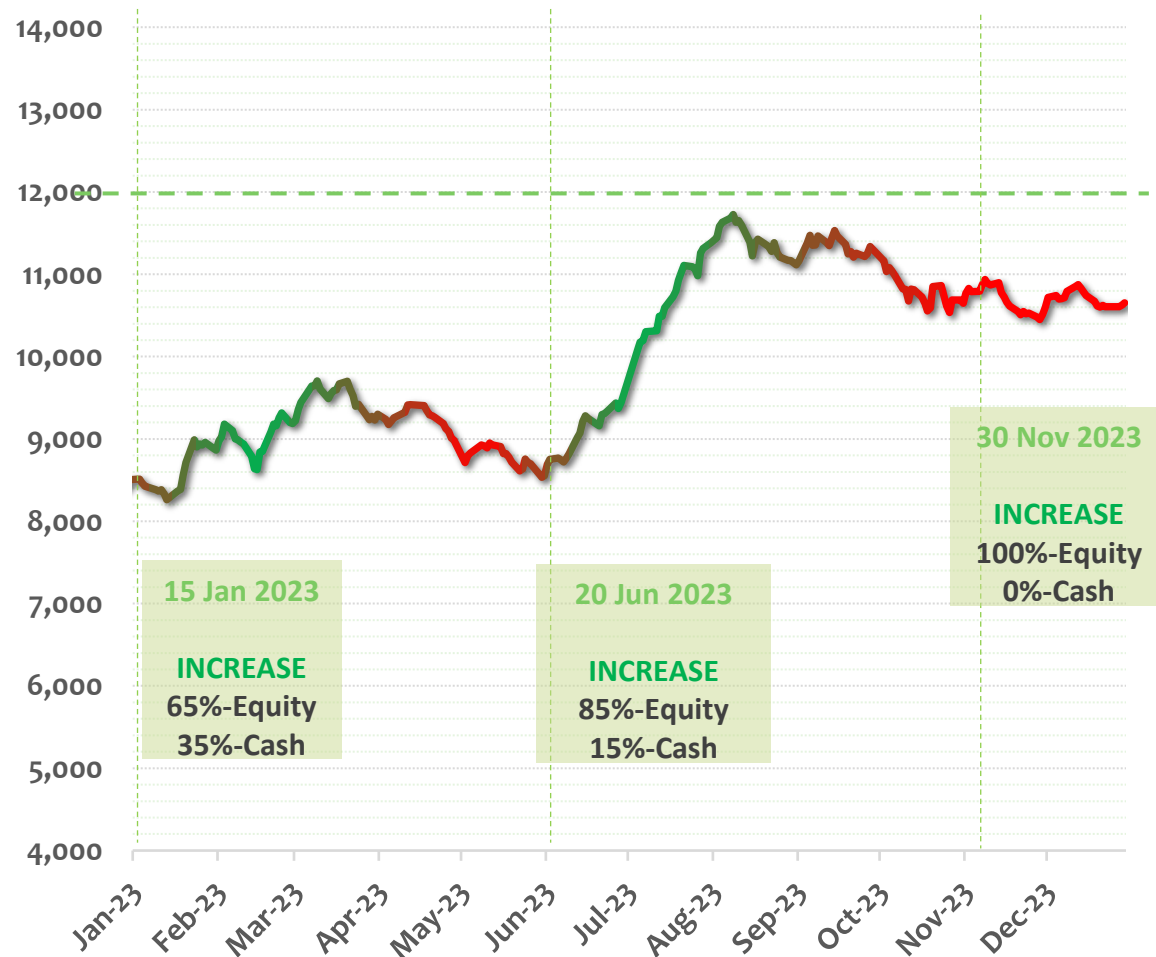
Currency witnessed an initial depreciation pressure, but subsequently registered appreciation pressure. However, the rupee continued to hover within the targeted band of LKR 320.0-360.0 during the period under review.



Source: CBSL, First Capital Research

Equity – Jan-23 & Jul-23 Re cap: Partly Accurate

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

Investment of Equity allocated funds:
65% by Jan-23 increased to 100% by Nov-23

Review

ASPI gains

+26% Jan-Dec 2023
(12 Months)

Despite a market upswing and reaching over 11,700 close to the 2023 target of 12,000, setbacks ensued due to delays in finalizing the IMF 2nd tranche. Selling pressure prompted investors to adopt a cautious stance, keeping the market stagnant between 10,000 to 10,500 during 4Q2023.

A close-up photograph of a wooden chessboard with alternating light and dark squares. Several wooden chess pieces are visible, including a king, queen, and pawns. Some pieces are standing upright, while others are knocked over. The background is a rustic wooden wall.

Key Elements of consideration *for Outlook 2024*

Section 2.0

Debt restructuring & Reforms ahead of elections...

The Year 2023 has been tough with multiple tax reforms being implemented coupled with market pricing of most of the SOE related services significantly impacting purchasing power of consumers.

Sri Lanka has been broadly in line with IMF conditions achieving or exceeding most of the conditions except achieving debt sustainability that has been significantly delayed due to the delay in external debt restructuring.

Following the completion of the domestic debt restructuring, now external debt restructuring stands as a key requirement for Sri Lanka to achieve debt sustainability. Significant progress was made by achieving credit assurances from the Bi-lateral partners while negotiations with the Bondholder group is still pending and is vital for the completion of the external debt restructuring.

SOE reforms has been a key element that the IMF has been focusing on and SL has made major progress in some of the privatization initiatives.

With 2024 being a year of elections, it is important see the progress of the reforms despite the elections as the crisis in SL pushing any Government into continuous reforms...

Reforms to stay course with Bets on Elections



Key Elements to consider for investments

Political Climate

Elections
Policy uncertainty

Economic Recovery Process

Recovery of the economy
Stable inflation
External Debt Restructuring
Reforms & Privatization
Stronger demand for credit

External Environment

Stable rupee
Rating Upgrade
Potential easing in global interest rates
Funds flow towards frontier markets



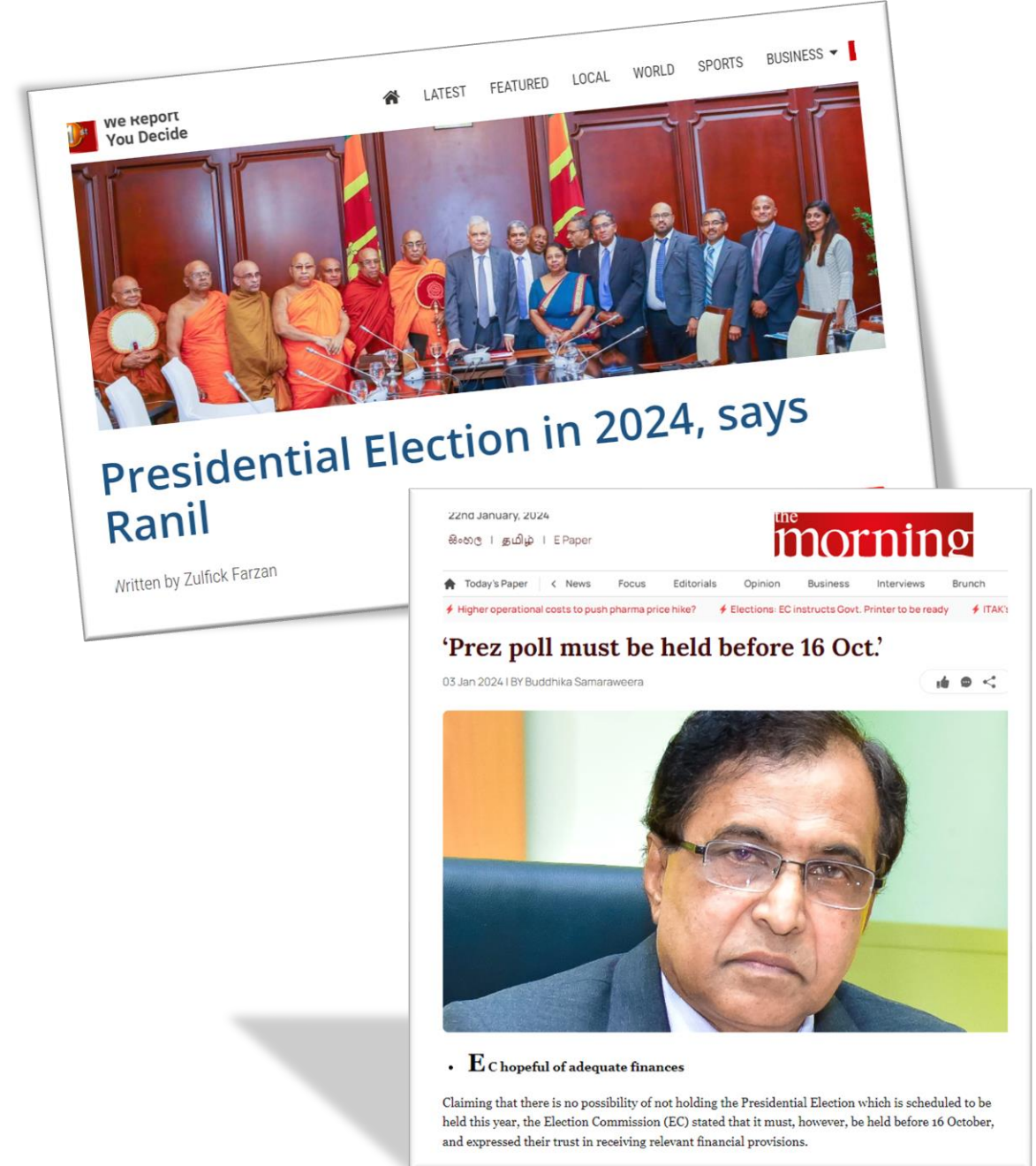
Election Year; Uncertainty to rise in 2H

*Downgrade to **Medium-High Risk** (from Medium-Low Risk)*

Section 3.0

Multiple elections between Jun-24 to Jun-25

- ❑ Year 2024 is expected to be an election year with Presidential Term ending in 4Q2024. According to the Elections Commissioner **Presidential Elections must be held latest before the 16th Oct 2024.**
- ❑ First Capital Research expects **Presidential Elections** to be held or initiated during **Aug / Sep 2024.**
- ❑ As soon as the Presidential Election concludes the newly elected President is most likely to dissolve Parliament and hold **General Elections** in line with the past trend. Thereby, subject to constitutional provisions it is likely that Elections may be initiated or held in **Dec-24-Feb-25** period followed by Local Government polls.





Elections as usual creates an uncertainty for investments

- ❑ Following the economic crisis, SL will be going into elections in 2024, with Presidential election likely to be the first to come.
- ❑ This election is important as SL comes out of a crisis and continues on an IMF program, but unofficial surveys suggest no clear winner. With elections itself creating uncertainty, absence of a leader for the Presidential Election race adds on to the uncertainty.
- ❑ Uncertainty on the election front may deter most investors to invest long term while they gain preference or biasness towards the short-term which is the resultant of the uncertainty in the system.

Political Outlook: Downgraded to *Medium-High Risk* (from *Medium-Low Risk*)

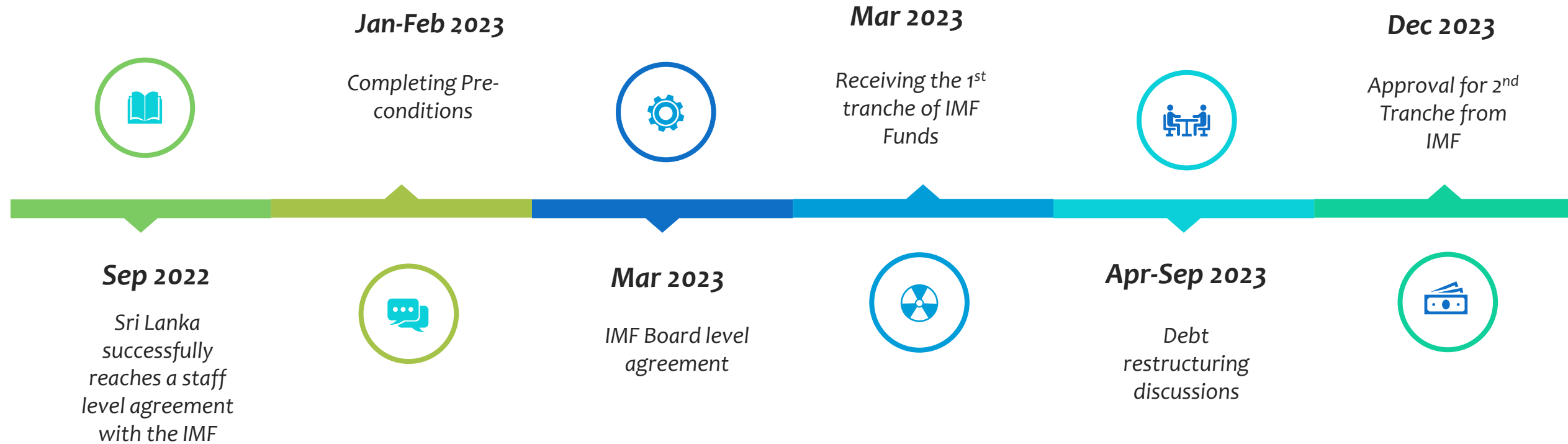
An hourglass with orange sand is shown on the left, with sand falling from the top bulb to the bottom bulb. To the right of the hourglass are several stacks of silver coins of varying heights. The background is a dark blue gradient.

Economy to recover on a slower note; Reforms Key *Maintain **Medium-Low Risk***

Section 4.0

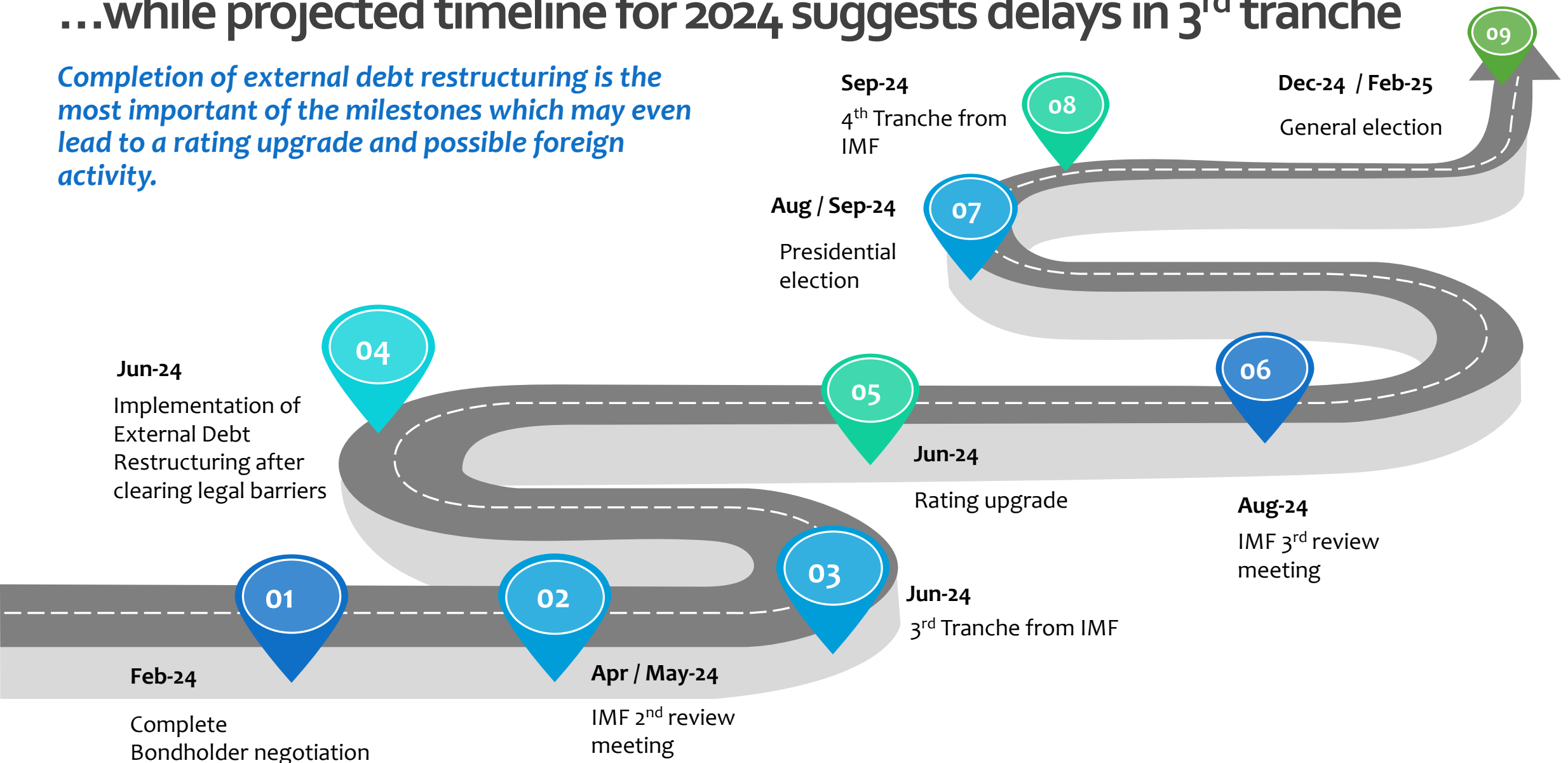
IMF successfully concludes the 1st review and releases the 2nd tranche broadly aligning to First Capital Research timeline for 2023...

In line with the projections First Capital Research expected, the approval for the 2nd tranche by early Dec 2023



...while projected timeline for 2024 suggests delays in 3rd tranche

Completion of external debt restructuring is the most important of the milestones which may even lead to a rating upgrade and possible foreign activity.



External debt restructuring concentrates on bondholder negotiations



Sri Lanka successfully completed the Domestic Debt Optimization in Sep-23, after the finalization of restructuring plans in Jul-23.



SL secured an agreement with the EXIM bank of China and Official Creditor Committee [co-chaired by India, Japan and France (as chair of the Paris Club)]. However, debt treatment conditions are yet to be finalized.



Negotiations with the Bondholder group has had significant delays in conclusion with the complexity attached to it and with multiple proposals being exchanged.



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.

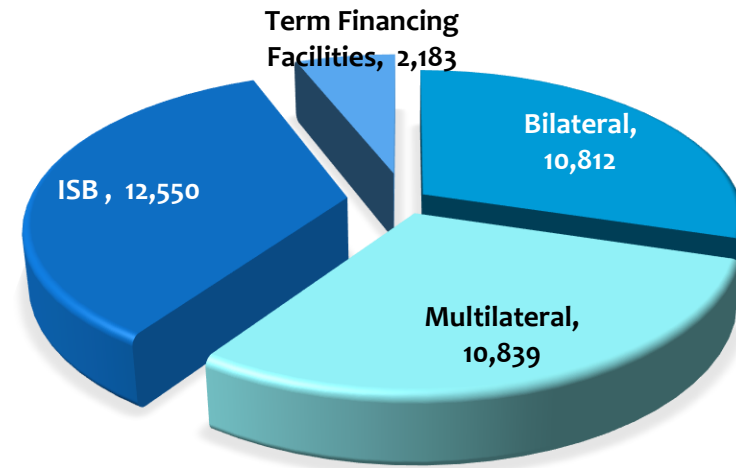
- Dec 2023 -



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










Source: Ministry of Finance

Food prices rise on continuous basis...

Source: CBSL, 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 ↓

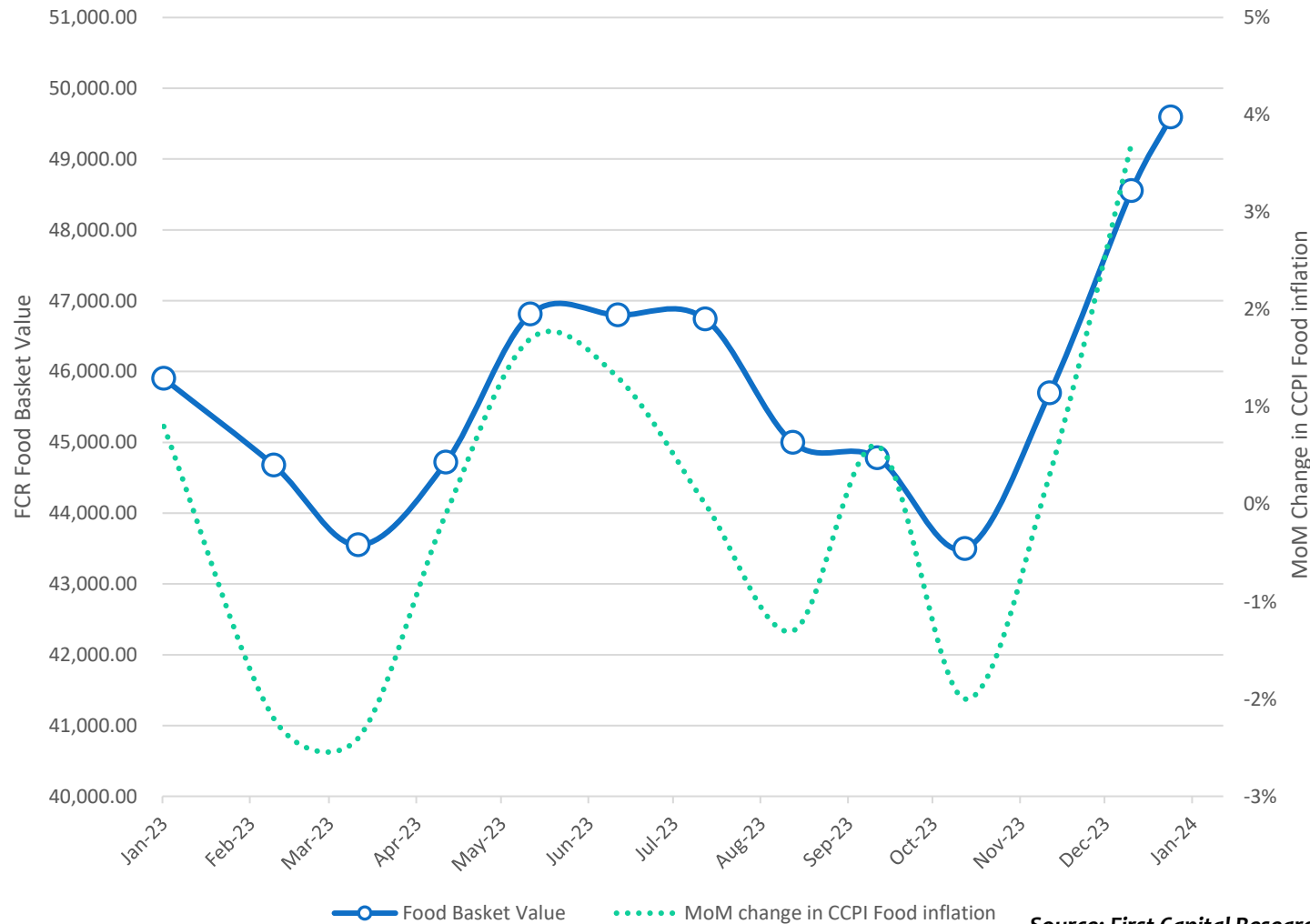
Food item prices as at 19th Jan-24 and 19th Dec-23 (Price per Kg)

	Price as at 19 th Jan-24	Price as at 19 th Dec-23		Price as at 19 th Jan-24	Price as at 19 th Dec-23
Beans 	LKR 850.0	LKR 450.0	Samba 	LKR 250.0	LKR 250.0
Carrot 	LKR 1,900.0	LKR 370.0	Red Onion 	LKR 500.0	LKR 550.0
Cabbage 	LKR 700.0	LKR 370.0	Potato 	LKR 400.0	LKR 400.0
Tomato 	LKR 350.0	LKR 575.0	Coconut (LKR/nut) 	LKR 120.0	LKR 130.0
Brinjal 	LKR 550.0	LKR 400.0	Red Dhal 	LKR 315.0	LKR 315.0
Green Chilies 	LKR 1,000.0	LKR 1,100.0	White Sugar 	LKR 300.0	LKR 300.0
Lime 	LKR 200.0	LKR 500.0	Egg (LKR/each) 	LKR 50.5	LKR 59.50

...driving cost of household food basket...



Food prices exhibited **significant volatility** since Oct-23, owing to the **adverse weather conditions** coupled with demand and supply fluctuations. By mid-Jan 24, **FCR food basket value peaked** to near LKR 50,000 fueled by price increases observed largely across vegetables and rice.



Source: First Capital Research

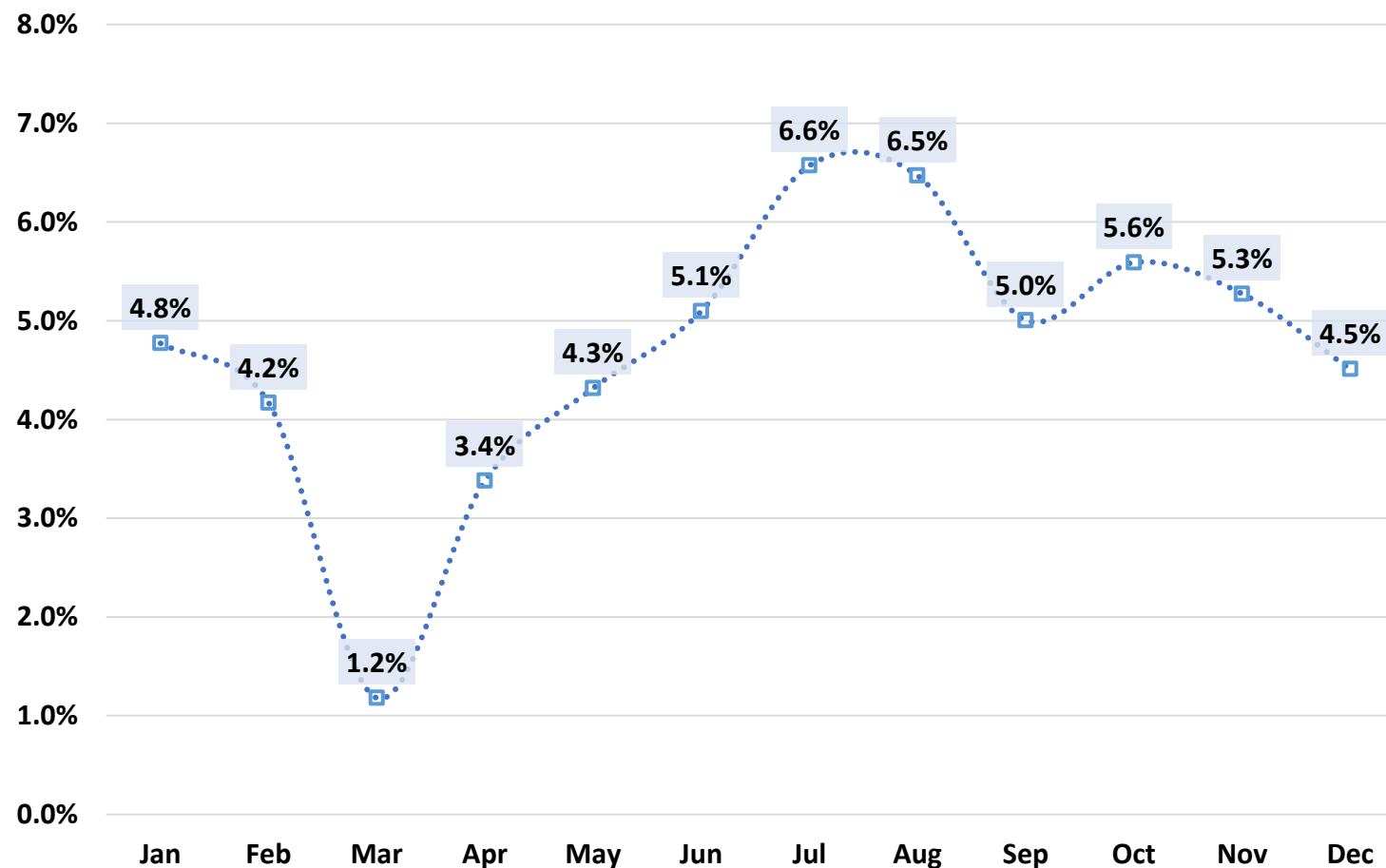
...resulting in cost push inflation...

Mid-Year inflation may jump closer to 7.0% before easing off

CCPI

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%.

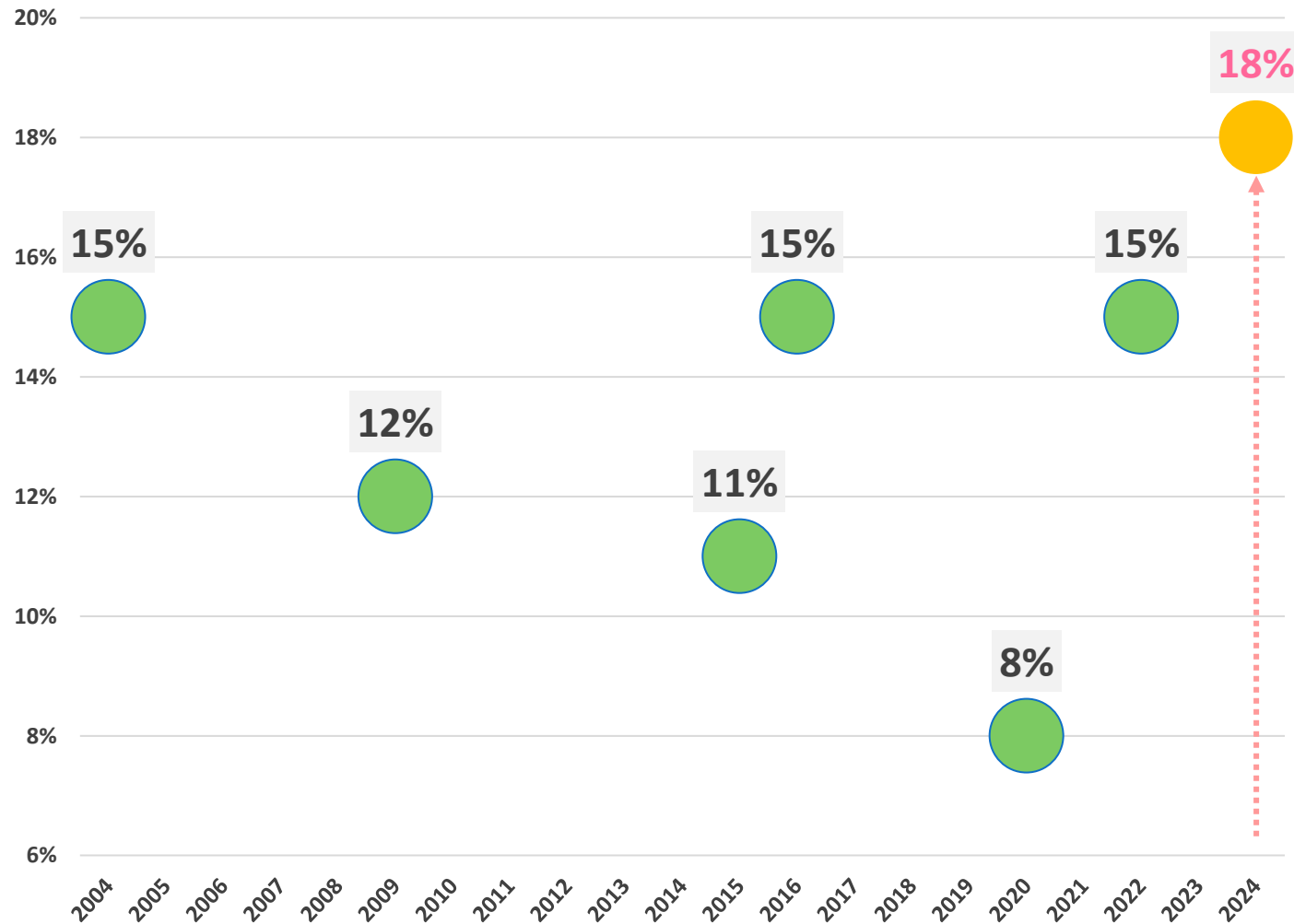
However, our CCPI expectations for 2024E is anticipated to remain in the single digit territory and the expected band with no significant threat perceptible on price levels in the period ahead.



Source: Dept. Census and Statistics, First Capital Research

...together with the new tax hit, may adversely impact private consumption...

Standard VAT rate reaches 20Yr high of 18% in Sri Lanka



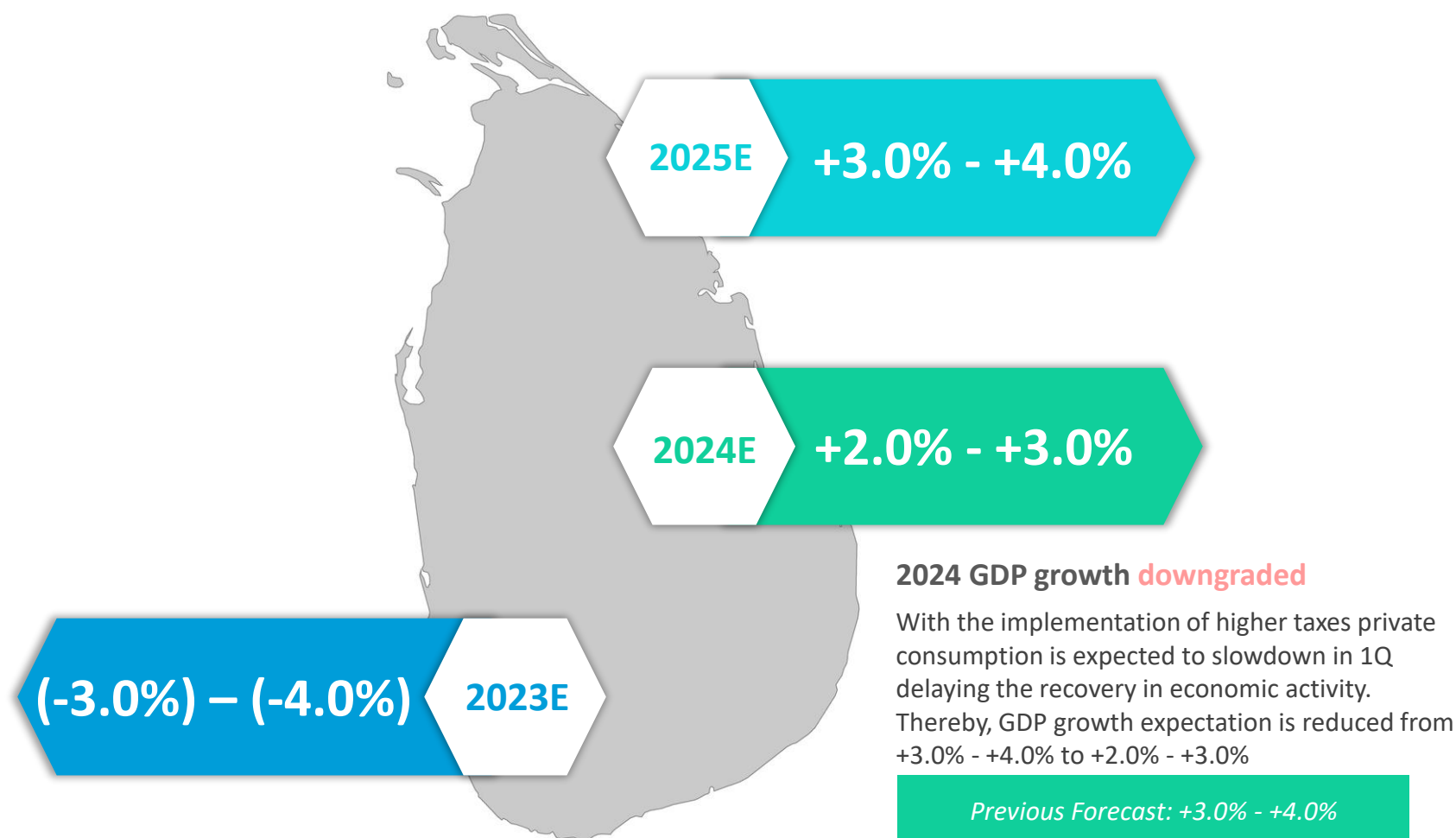
To **meet the 2024 IMF tax revenue target of LKR 4.2 trillion**, the government enacted significant tax reforms effective January 1, 2024. Notably, the VAT rate was **raised from 15% to 18%**, marking its highest level in two decades. Further reducing VAT threshold may also indirectly impact to increase cost.

The resulting price adjustments for essential items, such as electricity, fuel, gas, and food, have raised concerns about potential social unrest due to the **projected decline in disposable income**.

This complex situation poses a challenge, as any **positive impact from a wage hike may be offset by the additional tax burden**, potentially influencing overall consumer spending behavior.

...unfavorably impacting GDP growth...

First Capital **downgrades** its GDP growth estimates for 2024 to **2.0%-3.0%** down by 100bps



Other Projections

2024E
+1.8%



2024E
+1.3%

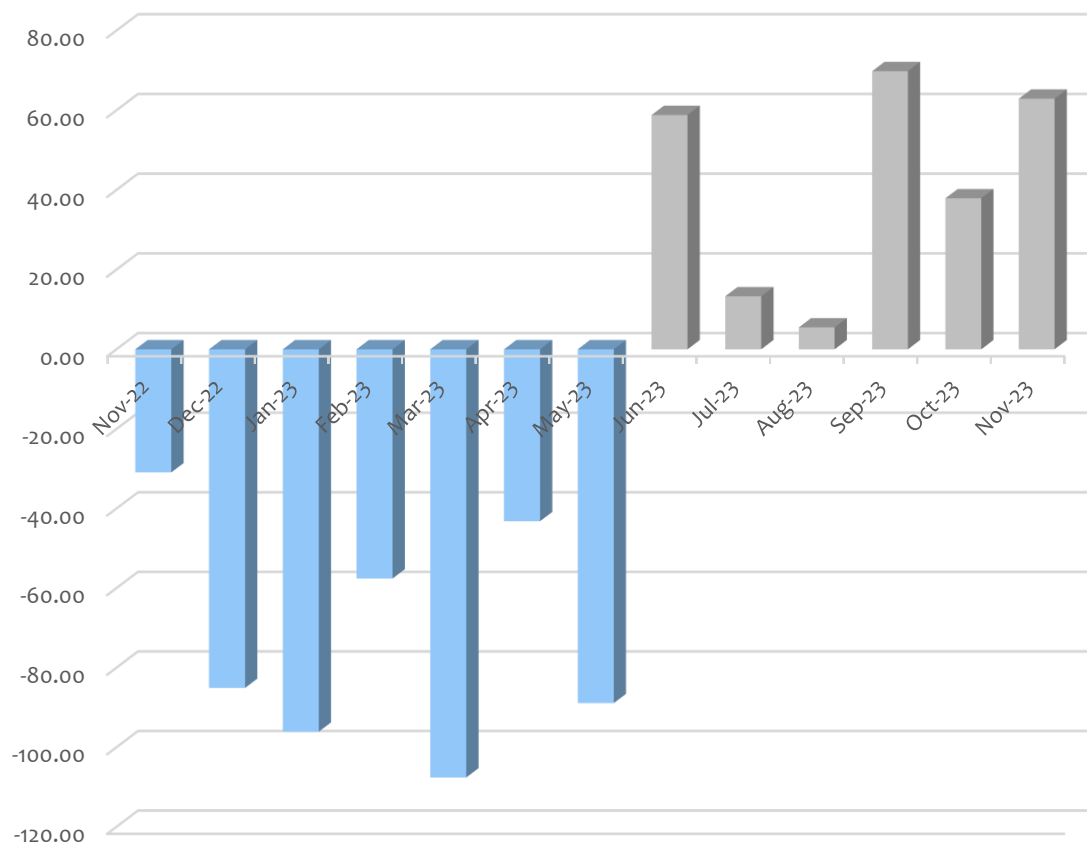


2024E
+1.7%

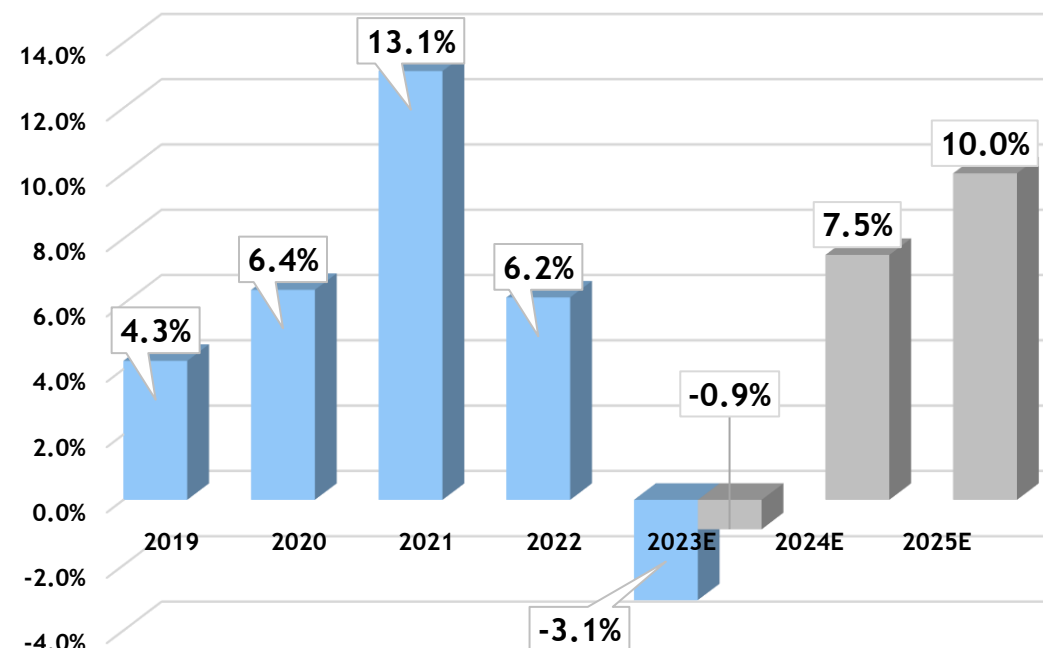


...But despite a slower 1Q, credit may improve and reach 7.5% for 2024E...

Private sector credit expands for 6 consecutive months



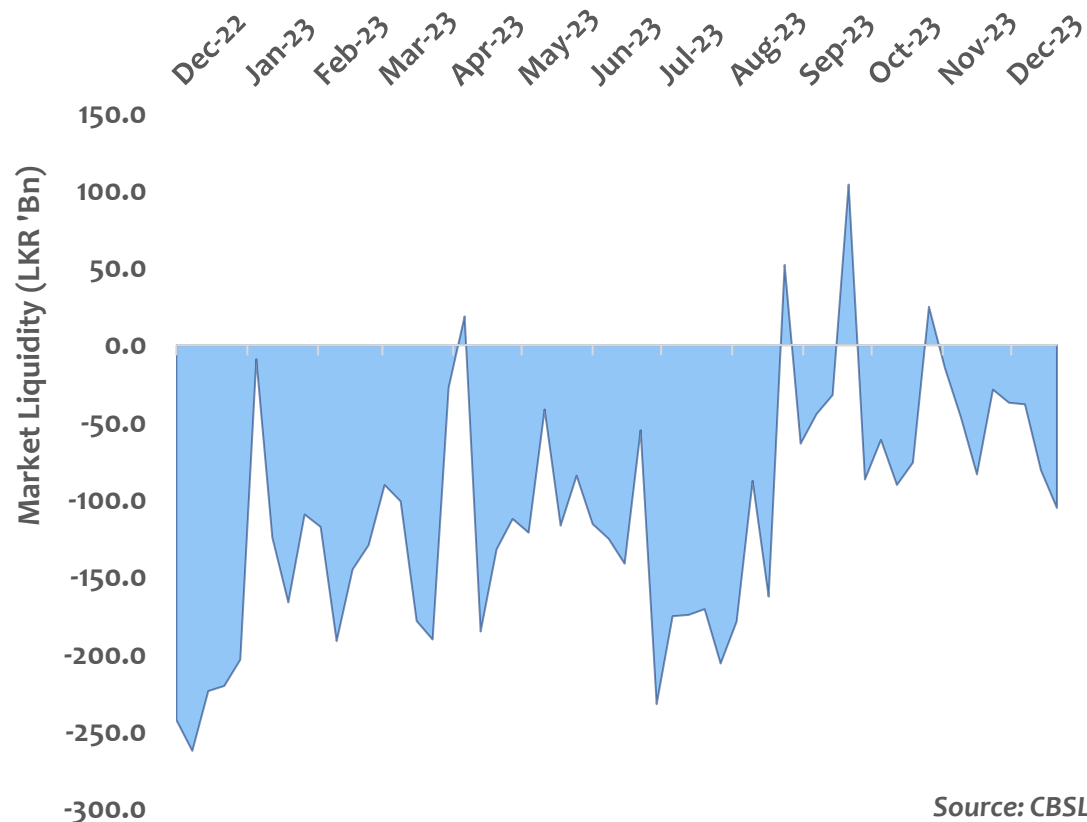
Despite possible slowness in higher taxes, we maintain growth at 7.5% for 2024E



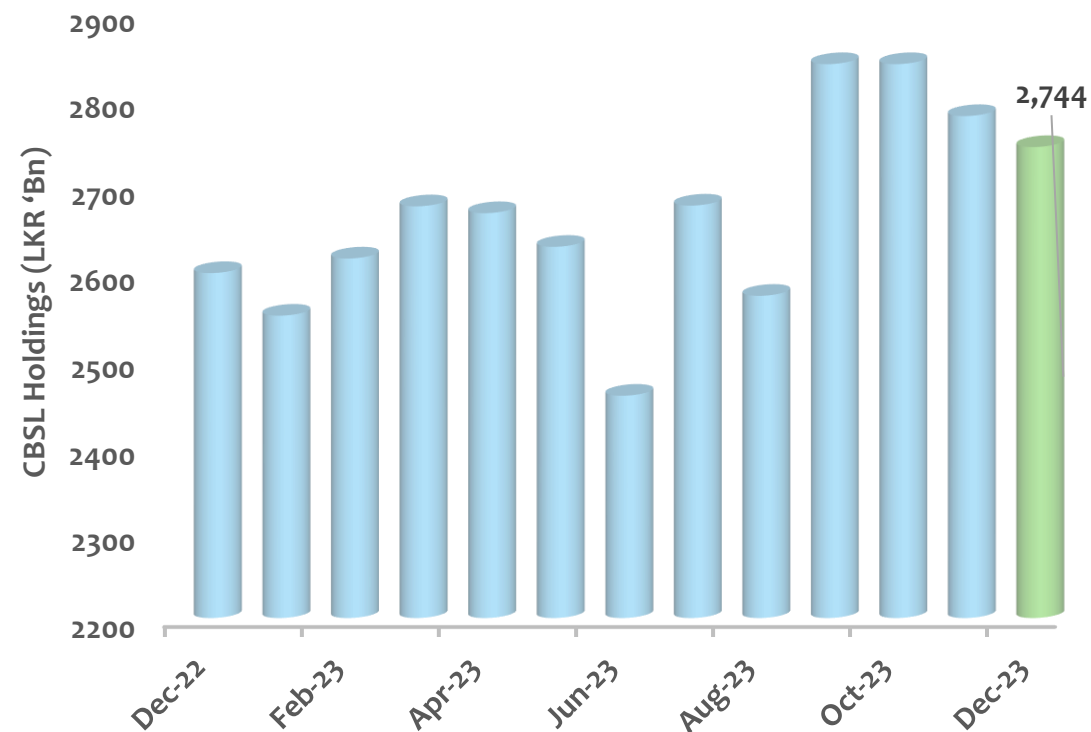
Source: CBSL

...despite a volatile liquidity position!

Liquidity has been mostly negative and volatile, but some improvement were witnessed in 2H2023



CBSL Holdings has gradually dipped from Oct-23 onwards possibly impacting liquidity adversely



Government successfully hits its revenue targets for 2023...

LKR 'Bn	2023 Revised Budget	2023 Actual	Achievement
Total Revenue & Grants	2,851	3,115	✓
Tax Revenue	2,596	2,752	✓
Non-Tax Revenue	243	363	✓
Total Expenditure	5,253	5,252	✓

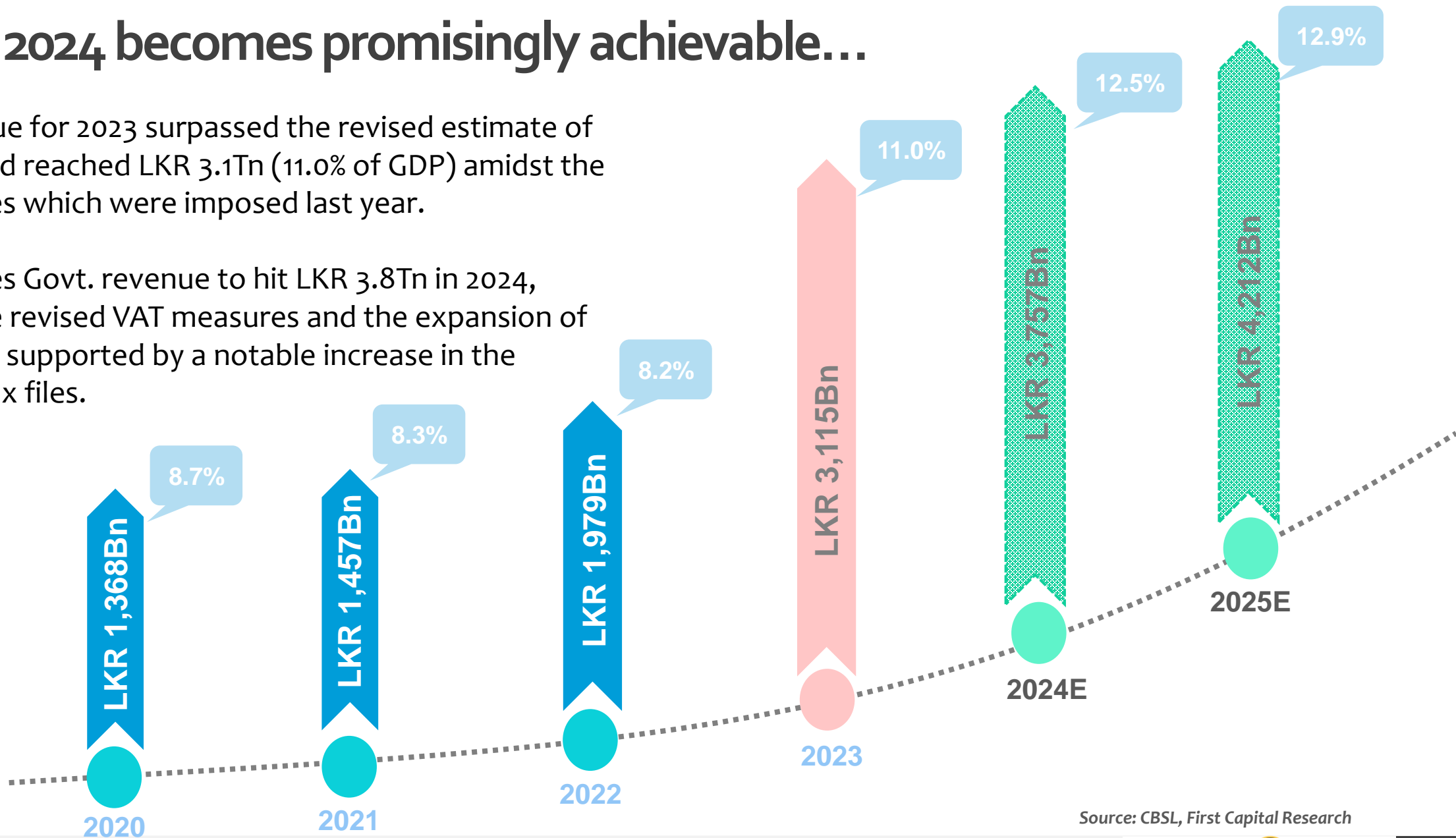
Source: Daily FT



...while 2024 becomes promisingly achievable...

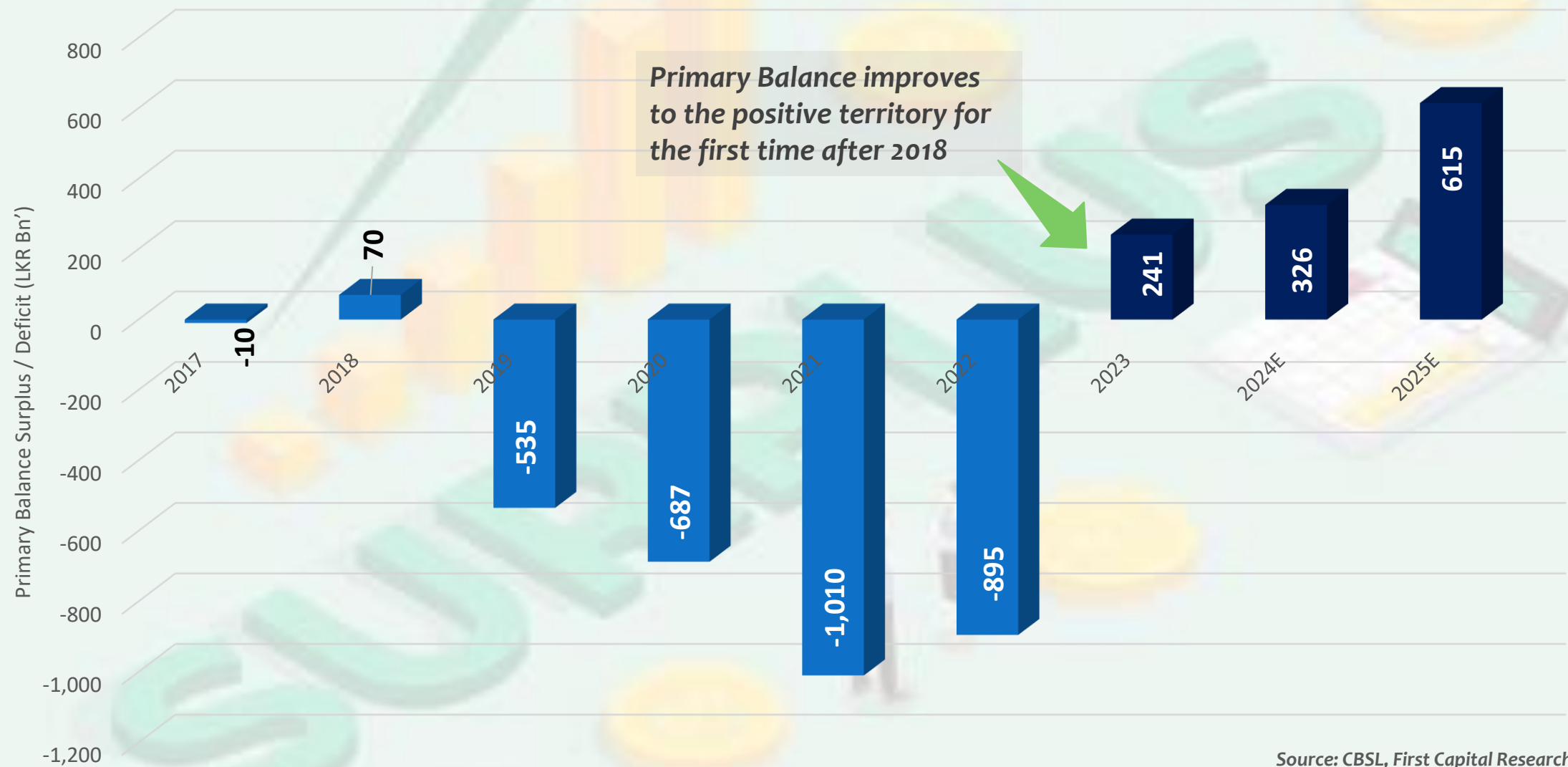
Govt. Revenue for 2023 surpassed the revised estimate of LKR 2.9Tn and reached LKR 3.1Tn (11.0% of GDP) amidst the multiple taxes which were imposed last year.

FCR estimates Govt. revenue to hit LKR 3.8Tn in 2024, fueled by the revised VAT measures and the expansion of the tax base, supported by a notable increase in the number of tax files.



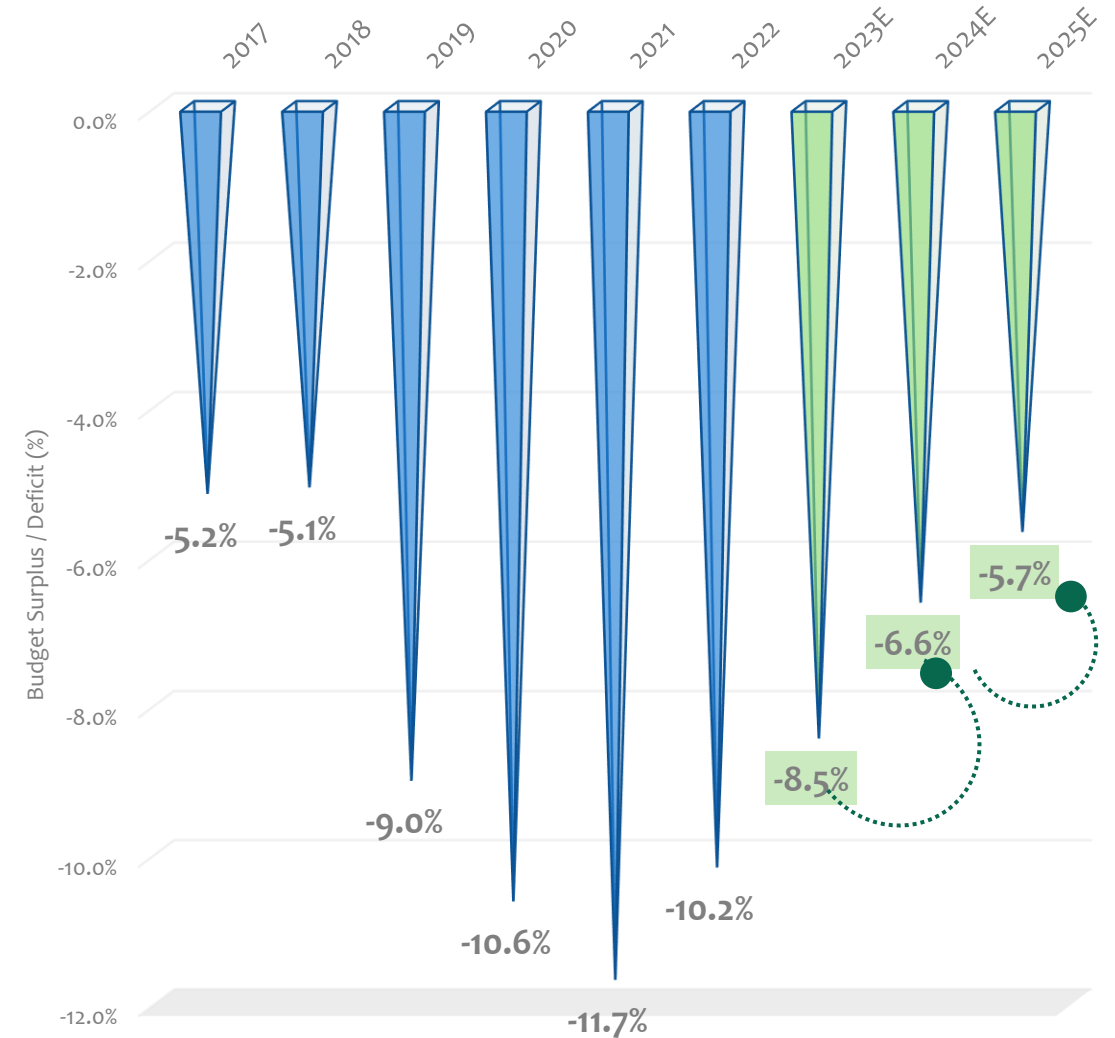
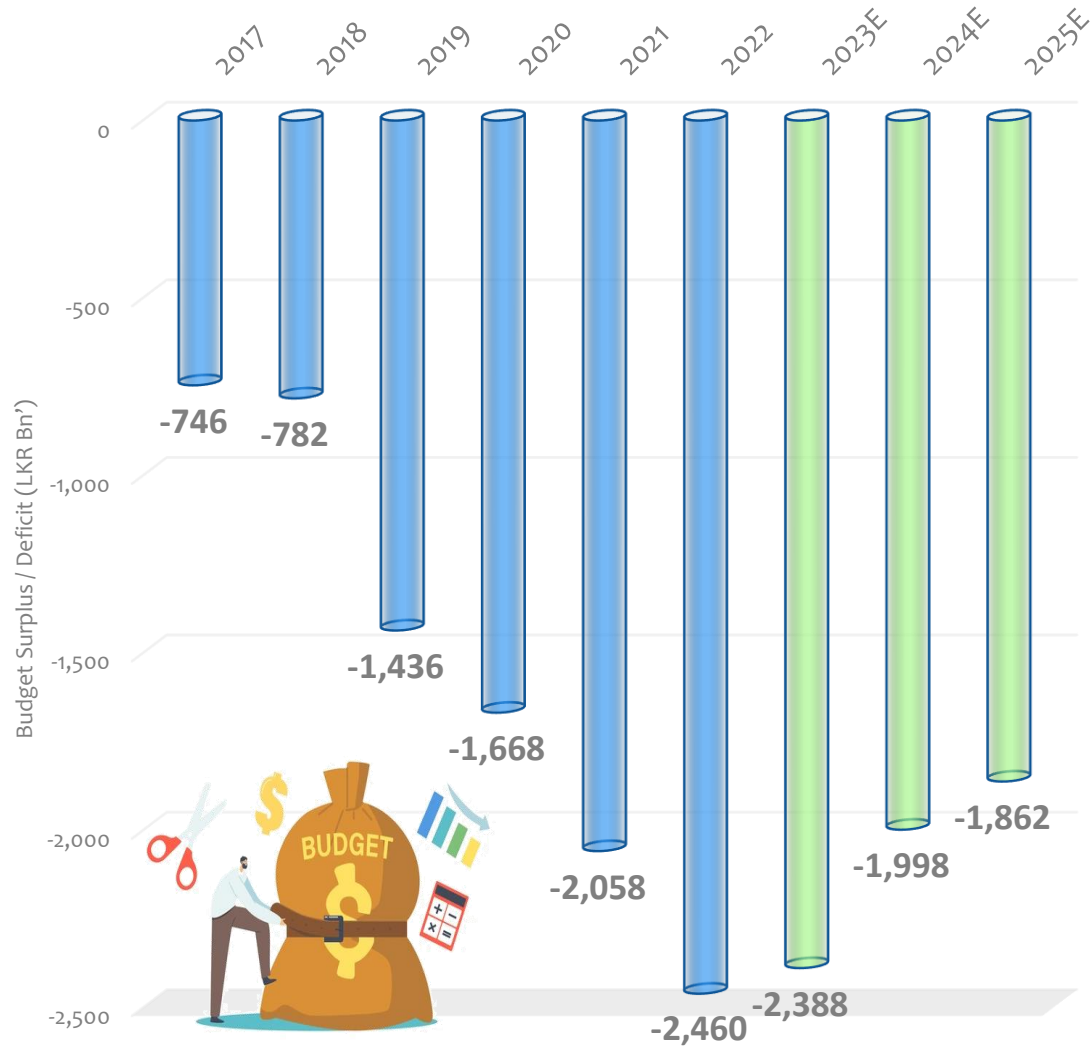
Source: CBSL, First Capital Research

...improving the primary surplus...



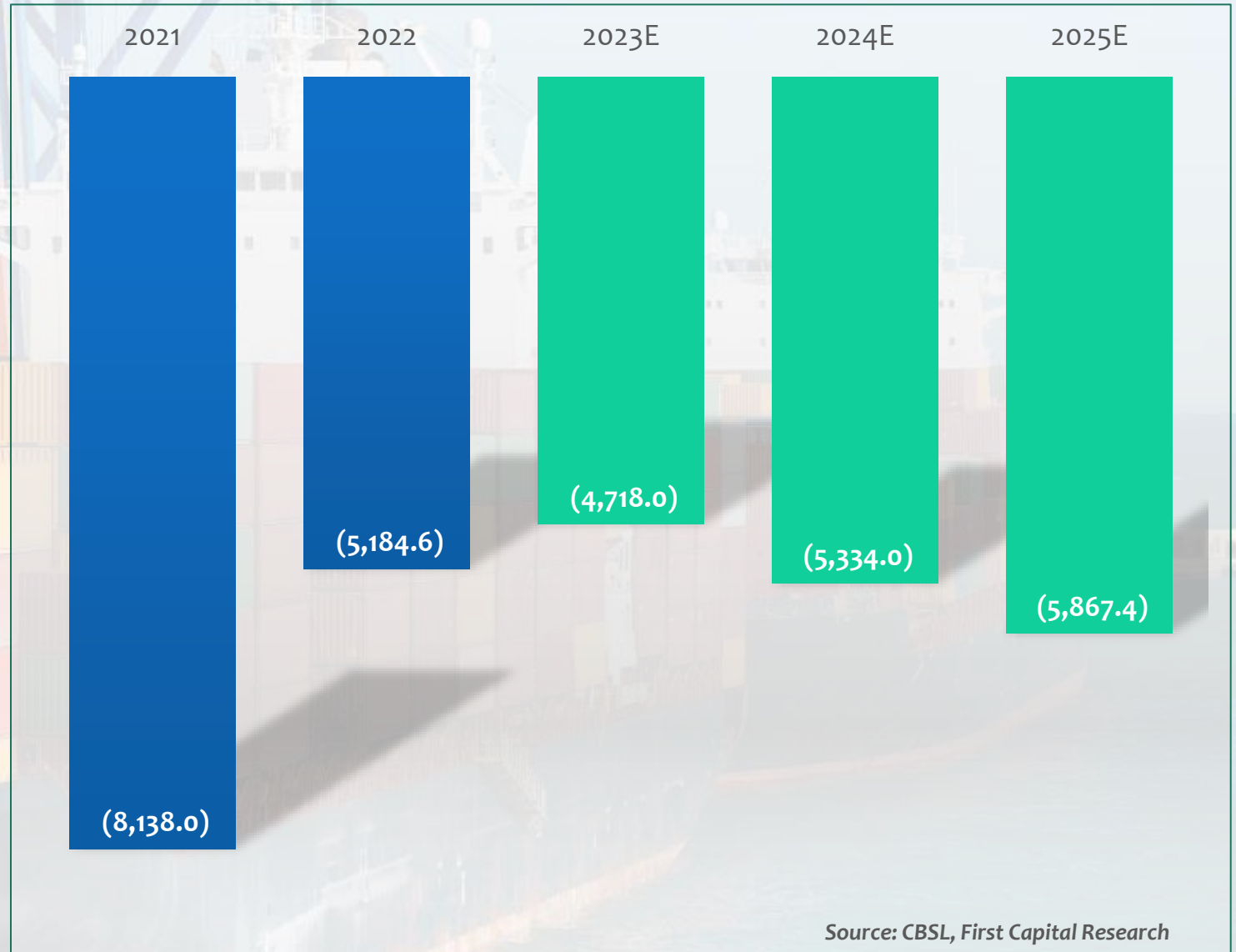
Source: CBSL, First Capital Research

...and pushing down budget deficit



As the economy expands, trade deficit increases...

Trade deficit of Sri Lanka is expected gradually widen, as Sri Lankan economy picks up. However, exports to strengthen and offer comfort whilst the recovery in global economy is expected to boost demand for merchandise exports.



...but the surge in tourism earnings...

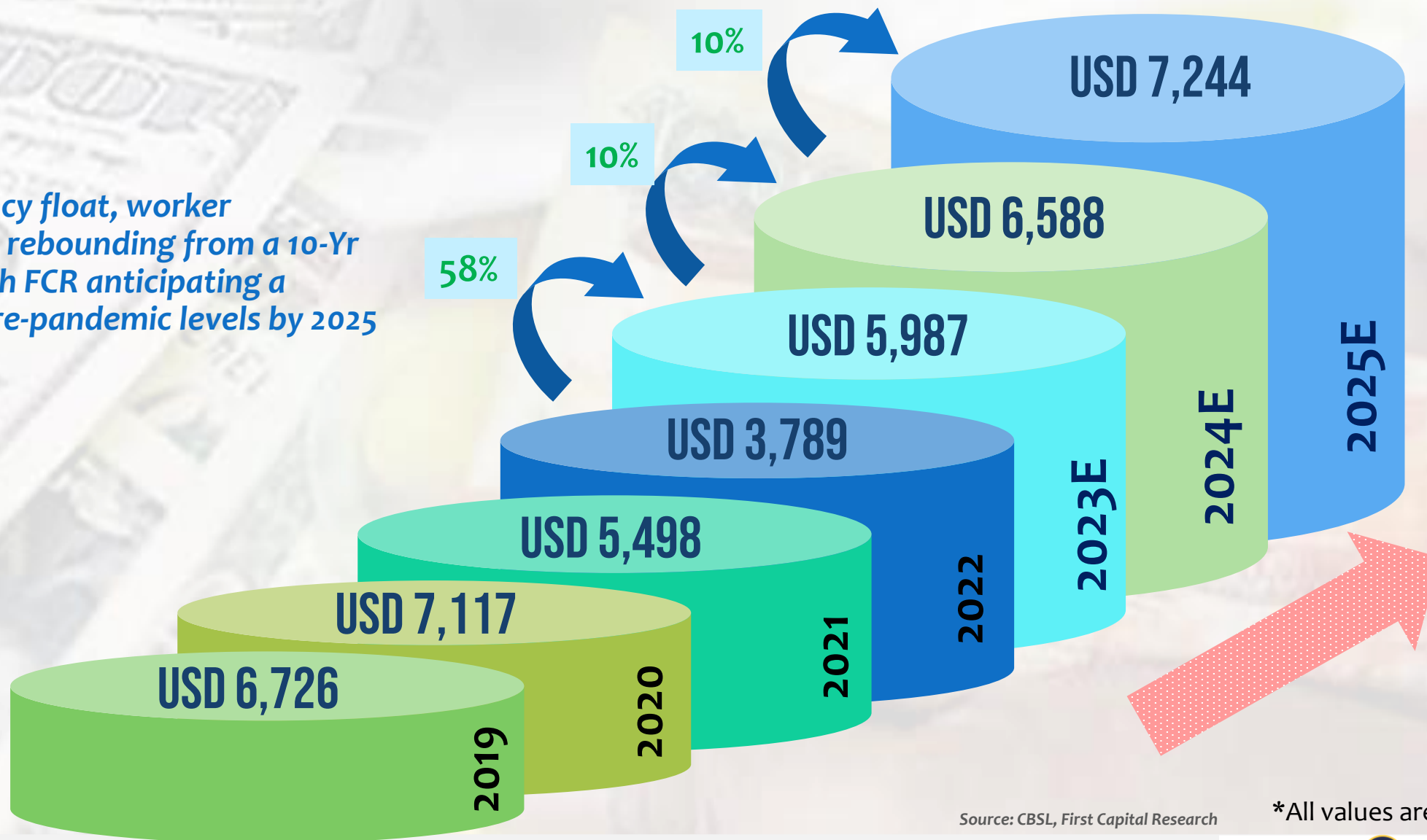


In 2025, tourist arrivals are projected to surpass pre-pandemic levels, reaching an estimated 2.5Mn arrivals. This surge is anticipated to generate a substantial USD 4.0Bn in earnings, reflecting a robust 5-year CAGR of 42.7%.

Source: SLTDA, First Capital Research

...and worker remittances supports the expansion...

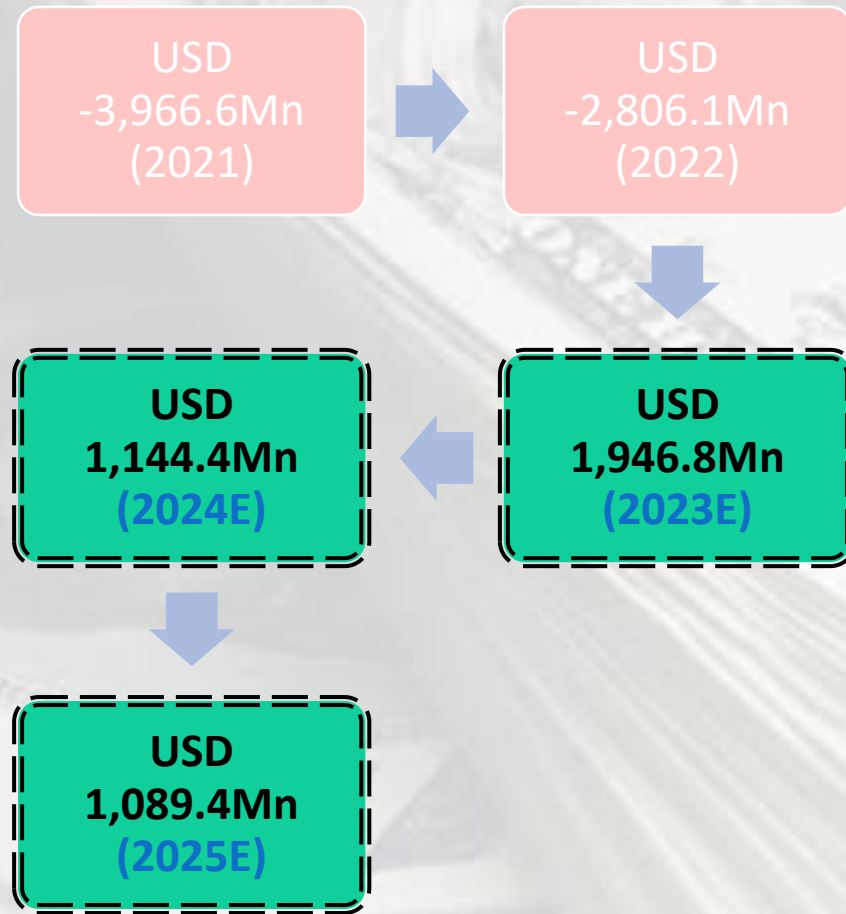
Amidst a currency float, worker remittances are rebounding from a 10-Yr low in 2022, with FCR anticipating a surpassing of pre-pandemic levels by 2025



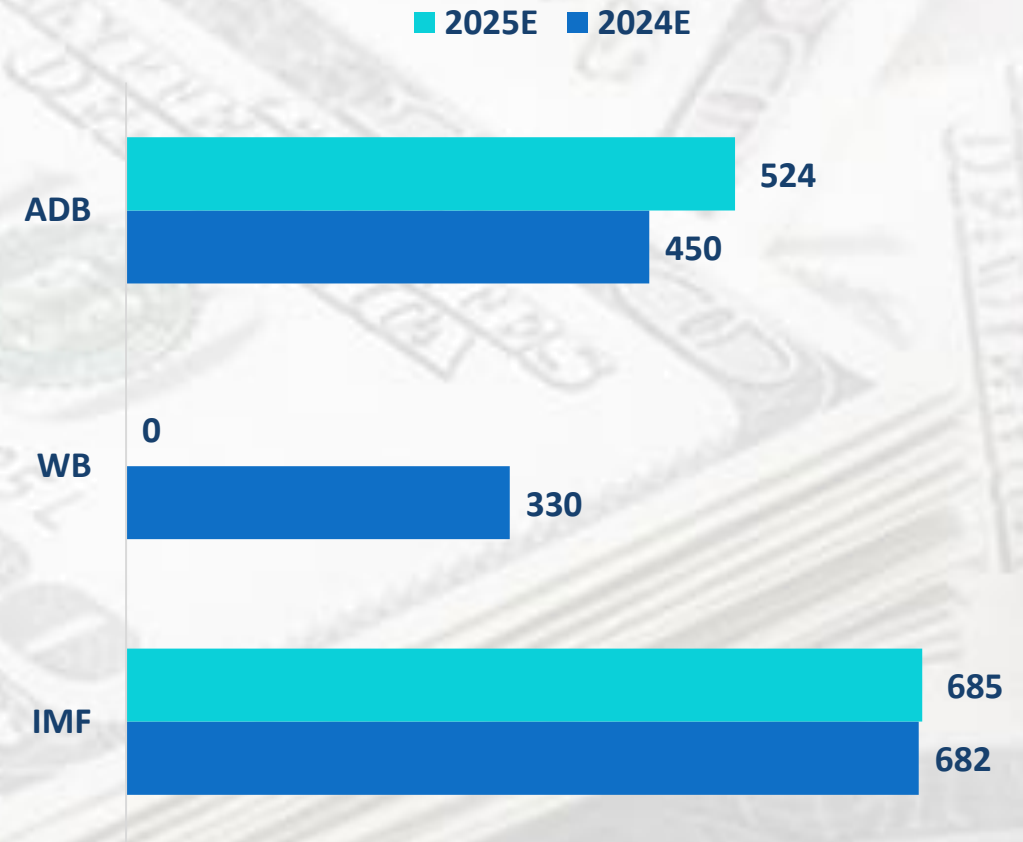
Source: CBSL, First Capital Research

*All values are in Mn

...additionally supported by multilateral funding, balance of payments is expected to remain positive...

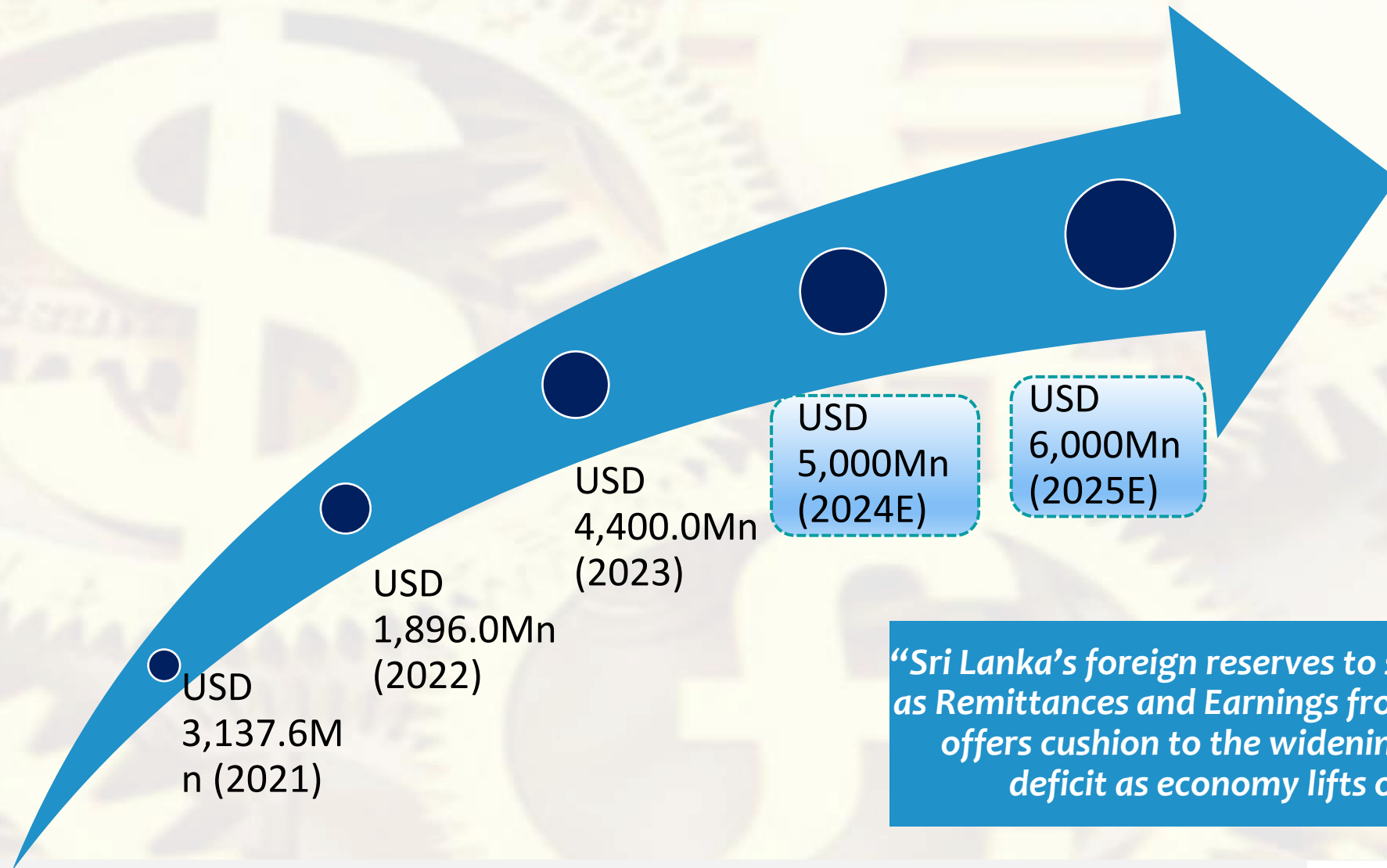


Scheduled receipts from multilateral (USD Mn)



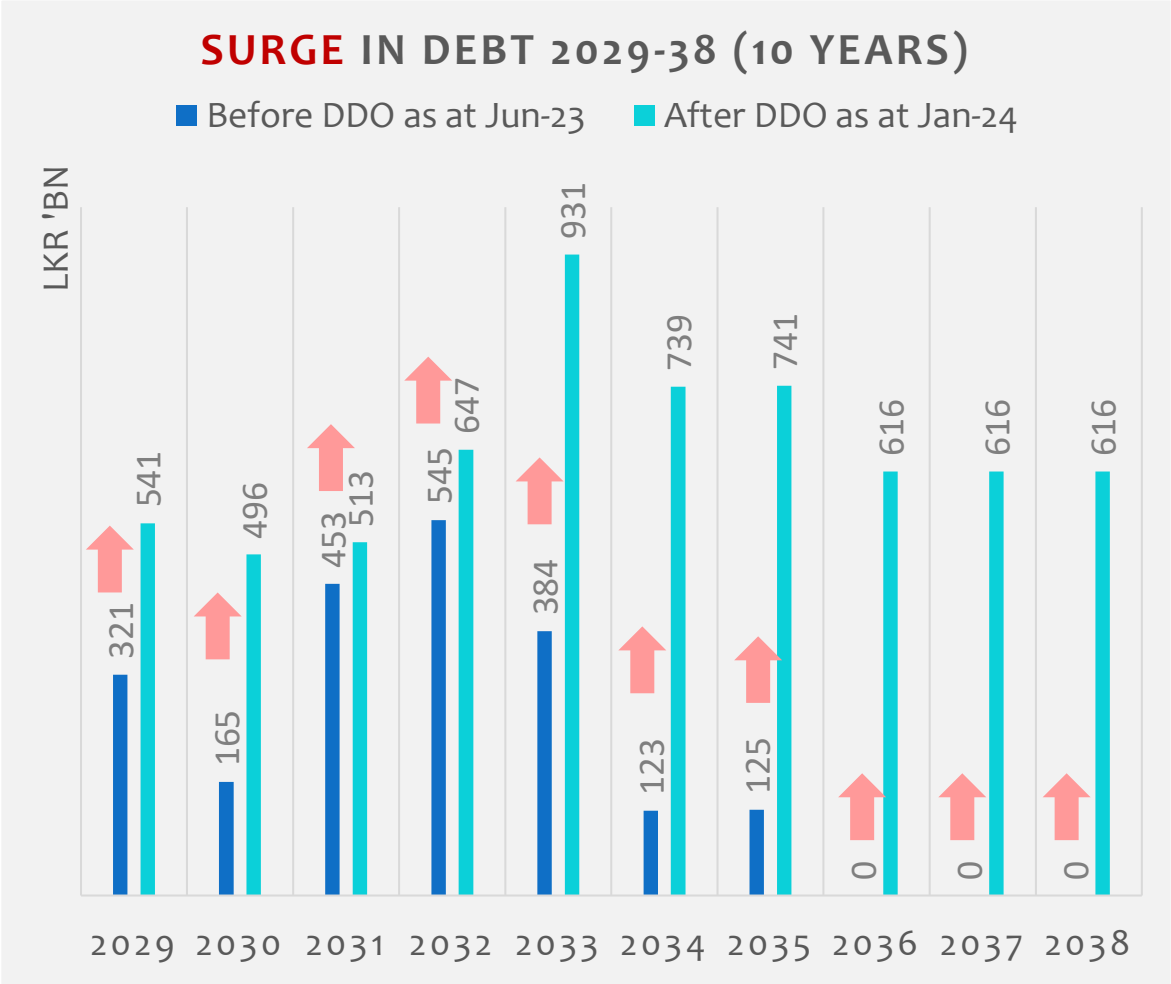
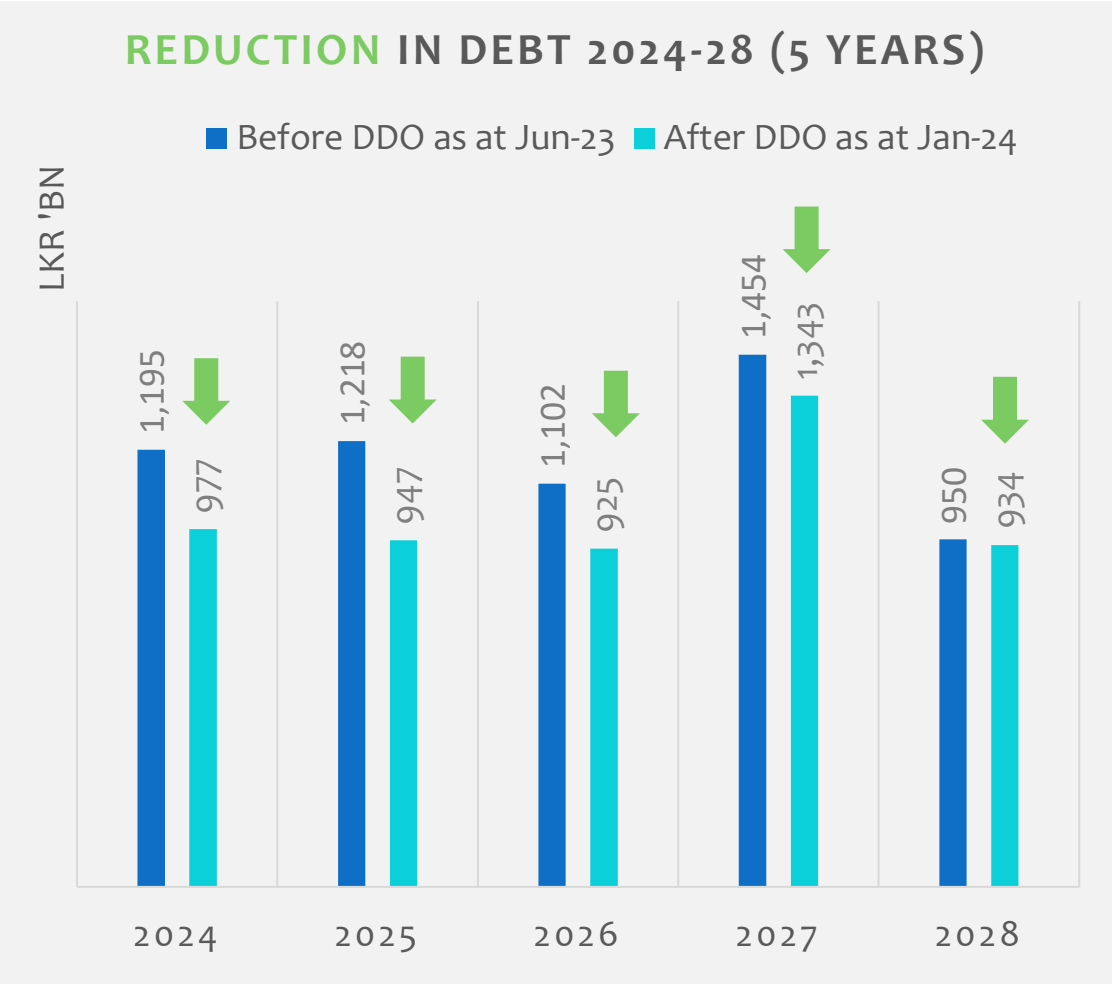
Source: IMF, First Capital Research

...thereby, First Capital Research maintain the targets for Foreign Reserves at USD 5.0Bn for 2024E and reaching USD 6.0Bn for 2025E



Following the domestic debt restructuring, debt maturities (T-Bonds) have slowed down in the near term

Post domestic debt restructuring with the maturity extensions part of 2024-28 debt has been extended to 2029-38 period



Summary of Overall Economic Outlook

Positives

- Positive GDP growth
- IMF EFF Program
- Surge in Foreign Reserves
- Sharp increase in taxes reducing budget deficit
- Economic Reforms (Cost reflective pricing of electricity, water & fuel, Measures to increase Tax Revenue)
- Accelerated recovery in Tourism
- Recovery in Worker Remittances
- Inflation under control
- Stable LKR
- Primary Surplus

Negatives

- Acceleration in private credit
- Negative liquidity
- High level of CBSL Holdings
- Delay in external debt restructuring
- Difficulty in raising foreign debt
- Possible delay in IMF 3rd tranche

Economic Outlook: Maintain *Medium-Low Risk*



External pressure continues to ease

*Maintain **Medium-Low Risk***

Section 5.0

Global Central Banks to move towards **Dovish** path

As of the 3Q2023, policy interest rates in the US, eurozone, and the UK have remained stable, likely reaching their peaks for the current tightening cycle.

Considering the recent dovish statements from Fed Chairman Jay Powell, it is anticipated that the next actions from the Federal Reserve (Fed), European Central Bank (ECB), and Bank of England (BOE) will involve rate cuts, although at a pace slower and less pronounced than currently anticipated by financial markets.

Fitch Ratings further projects a 75bps reduction in policy rates by the end of 2024 across these three economies. **This would result in the Fed Funds rate (upper band) settling at 4.75%, the ECB Main Refinancing Rate at 3.75%, and the BOE Bank Rate at 4.50%.**

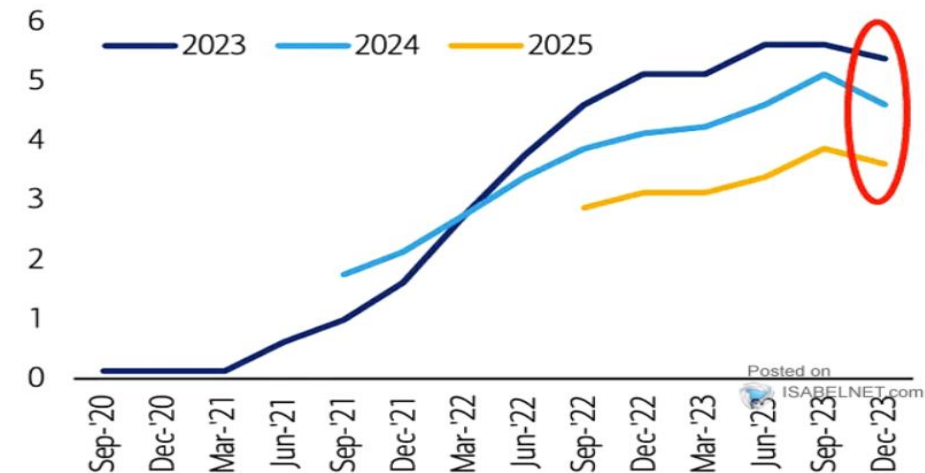
This shift in monetary policy is deemed **beneficial for frontier economies like Sri Lanka**, potentially alleviating pressure arising from a strengthening USD due to rising rates.

Markets Expect Rate Cuts Soon. Central Banks Say Not So Fast.

Officials will probably loosen monetary policy in 2024, but they have reasons to move more slowly than investors are betting

Exhibit 2: Median policy rate projections in the Fed's Summary of Economic Projections (%)

In a significant pivot, the Fed cut its policy rate projections for 2023, 2024, and 2025 at its December meeting; this is the first cut in any of these forecasts from the first time they were reported



Source: BOA, Federal Reserve Board

Potential rating upgrade on foreign currency post EDR completion

Post completion of the Domestic Debt Restructuring in Sep 2023, SL's local currency received rating upgrades

FitchRatings



CCC-

28 Sep 2023

Fitch upgrades SL's Long-Term Local-Currency to CCC- from IDR

S&P Global Ratings



CCC+

26 Sep 2023

S&P upgrades SL local currency sovereign credit ratings to CCC+ from SD

RATING ACTION COMMENTARY

Fitch Upgrades Pakistan to 'CCC'

Mon 10 Jul, 2023 - 7:21 AM ET

Fitch Ratings - Hong Kong - 10 Jul 2023: Fitch Ratings has upgraded Pakistan's Long-Term Foreign-Currency Issuer Default Rating (IDR) to 'CCC' from 'CCC-'. Fitch typically does not assign Outlooks to sovereigns with a rating of 'CCC+' or below.

RATING ACTION COMMENTARY

Fitch Upgrades Argentina's FC IDR to 'CC'; Affirms LC IDR at 'CCC-'

Tue 13 Jun, 2023 - 2:02 PM ET

ECONOMY

IMF expects Sri Lanka to reach private creditor deal by next review

Saturday January 20, 2024 8:11 am

Examining Sri Lanka's net general government debt, which currently exceeds 100% of GDP and is projected to persist until at least 2028, there are challenges ahead. Addressing concerns about long-term sustainability, potential positive shifts can be driven by factors such as nominal GDP growth, successful fiscal consolidation, increased revenue generation, current interest rates, and the positive impacts of future restructuring efforts. By navigating these aspects effectively, Sri Lanka has the potential to enhance its fiscal outlook and achieve more favourable outcomes in the coming years.

Source: Fitch ratings, S&P Global ratings

Fund flow may shift towards emerging and frontier markets

The upward interest rate trajectory by the FED is believed to have peaked with investor expectations of a dip in rates in the short term. This trend may support to pause the rise in global interest rates as well.

The peak in the US interest rates may reverse the strength in the USD as well.

Historically Emerging Markets have outperformed 12 months after the final FED rate hike while the dollar index also has weakened.

It indicates that in a downward trajectory Emerging and Frontier Market may benefit with the global fund potentially switching to these economies benefiting countries such as Sri Lanka.

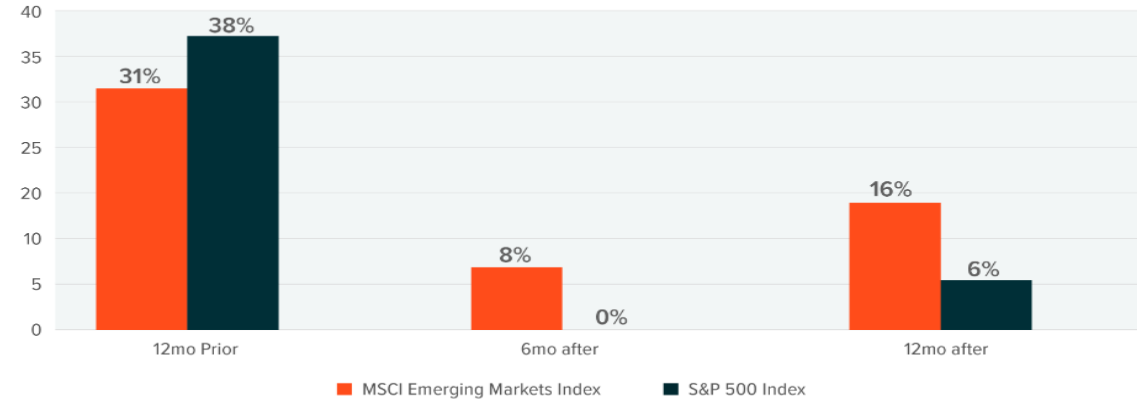
EM HAS HISTORICALLY OUTPERFORMED 12 MONTHS AFTER THE LAST FED RATE HIKE

Source: Global X ETFs with information derived from: Bloomberg LP. Data as of March 31, 2022. EM=MSCI EM Index, DM=S&P 500 Index.

12mo Prior (6/30/98-6/30/99; 6/30/03-6/30/04; 12/16/14-12/16/15; 3/16/21-3/16/22).

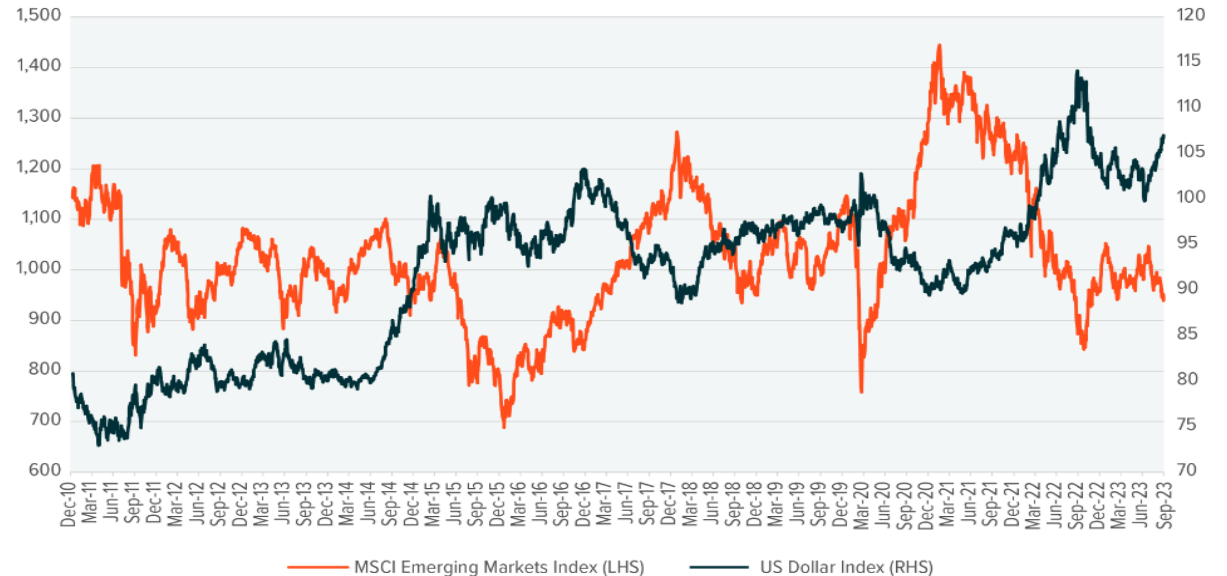
6mo After (6/30/99-12/30/99; 6/30/04-12/30/04; 12/16/15-6/16/16; 3/16/22-9/16/22).

12mo After (6/30/99-6/30/00; 6/30/04-6/30/05; 12/16/15-12/16/16)



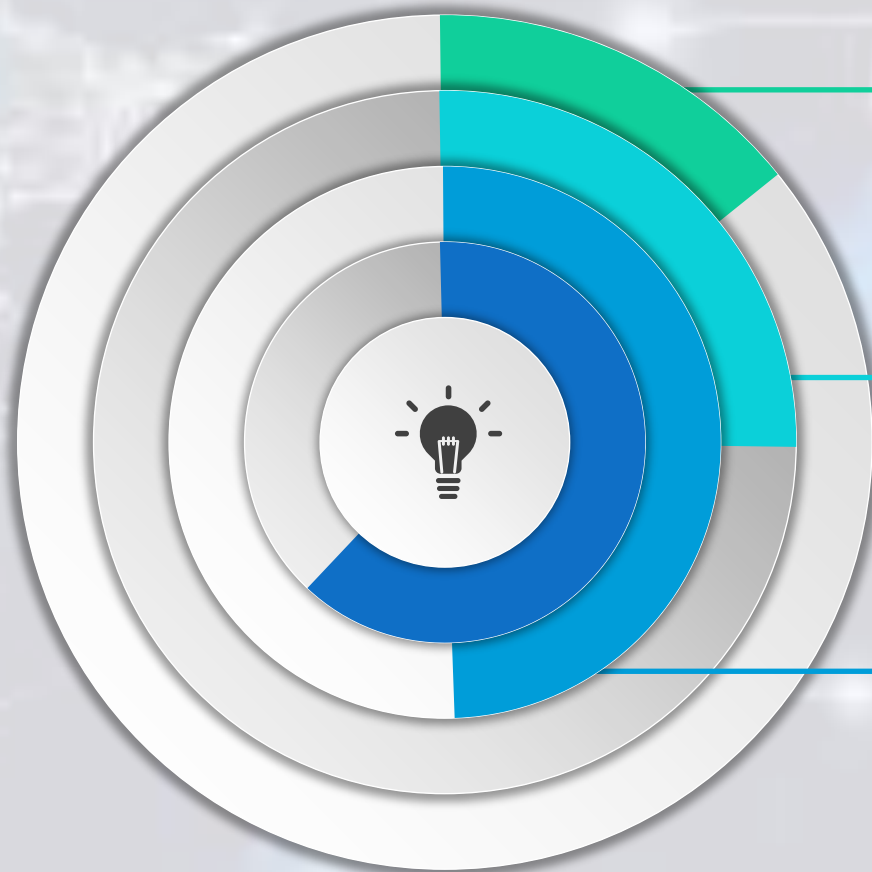
A REVERSAL OF THE US DOLLAR SHOULD SUPPORT EM EQUITIES

Source: Global X ETFs with information derived from: Bloomberg LP. Data through September 30, 2023.



Summary of External Outlook

External factors are favouring Sri Lanka at the moment improving the overall outlook



Global central banks move towards policy easing, reduces currency pressure



Credit Rating Agencies upgrades SL local currency and potential to upgrade foreign currency post EDR



Peaking of US interest rates may switch the global fund flow towards Emerging and Frontier markets while also weakens the currency

External Outlook: Maintain *Medium-Low Risk*

Outlook Trend for Sri Lanka

Time Period	Political	Economical	External
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
Jun 2023	Medium-Low Risk	Medium-Low Risk	Medium-Low Risk
Jan 2024	Medium-High Risk	Medium-Low Risk	Medium-Low Risk

Risk Levels (Low-High)



A background image of a wooden chessboard with several chess pieces. Some pieces are standing upright, while others are lying on their sides. A semi-transparent white rectangular box is overlaid on the middle of the image, containing the word 'Recommendations'.

Recommendations

Section 6.0

First Capital Research View on Bond Market 2024

Section 6.1

Primary Criteria

Foreign Reserves

Foreign reserves reached at USD 4.4Bn in Dec 2023, marginally below our target of USD 4.5Bn.

Risk Level: Medium-Low
(Upgraded from **Medium-High**)



Liquidity

Liquidity level remained volatile and continued to range between LKR -120Bn and LKR 120Bn.

Risk Level: Medium-High
(Maintained)



Inflation

CCPI inflation rose to 4.0% in Dec-23, amidst the increase in Food inflation which turned positive in Dec.

Risk Level: Low
(Upgraded from **Medium-Low**)



Foreign Activity

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

Risk Level: Medium-Low
(Maintained)



Credit

Private credit continued to improve during the 2H2023, recording LKR 248.2Bn credit from Jun - Dec-23 compared to the contraction in 1H.

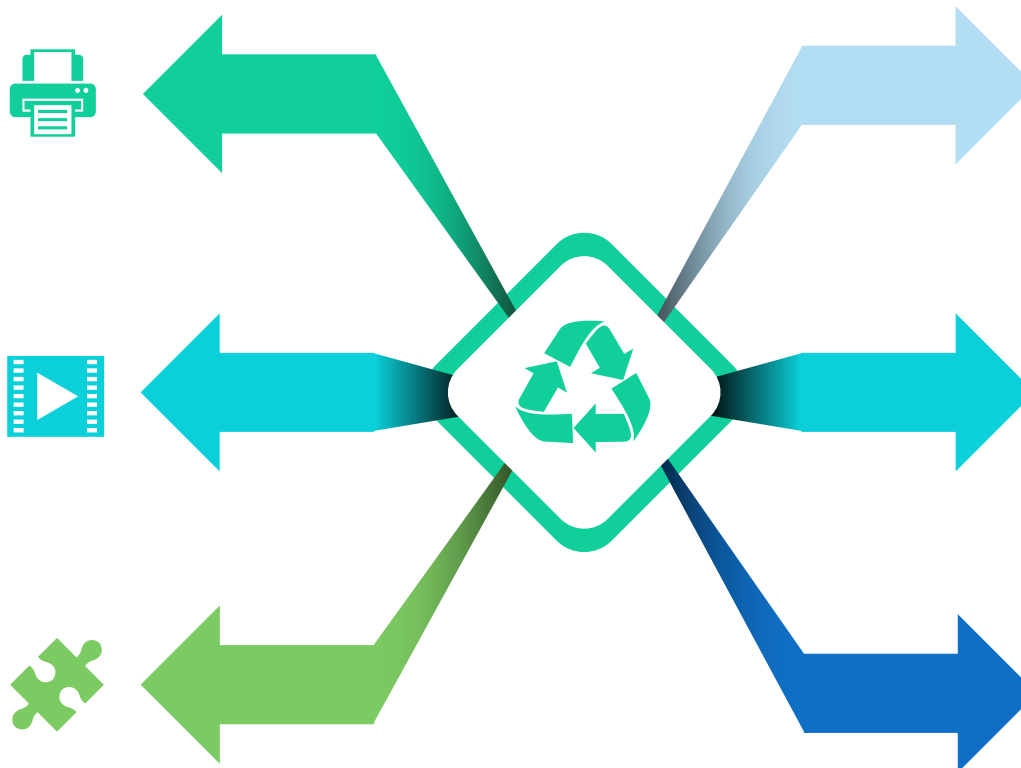
Risk Level: Medium-Low
(Downgraded from **Low**)



CBSL Holdings

CBSL holdings remained steady above LKR 2,700.0Bn during the 2H2023.

Risk Level: High
(Maintained)



Secondary Criteria

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. Despite the improvement the BCI remain volatile with sizable ups and downs.

Risk Level: Medium-High
(Maintained)

Political Risk

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

Risk Level: Medium-High
(Downgraded from Medium-Low)

Rating Outlook

With the completion of the domestic debt restructuring Fitch and S&P upgraded SL's local currency rating. However, foreign currency rating still stands in the default status amidst the delay in external debt restructuring.

Risk Level: Medium-High
(Maintained)

External Environment

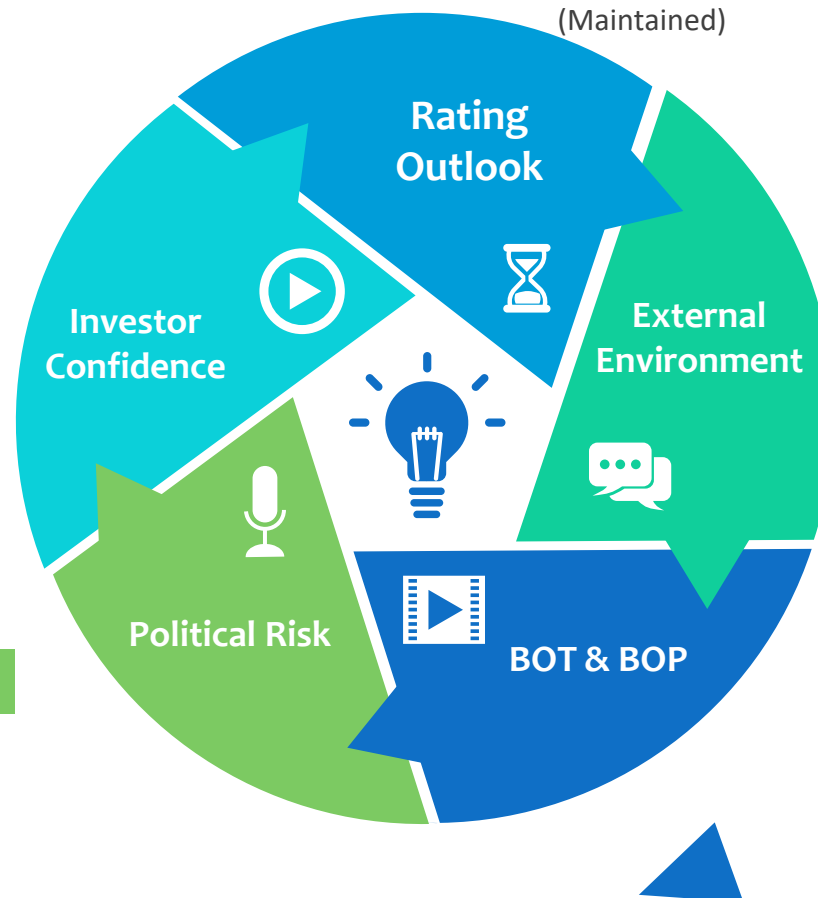
Forex market remained volatile throughout 2023, with USD/LKR appreciating by 10.8% YTD while it appreciated by 1.1% during the month of Dec-23.

Risk Level: Low
(Upgraded from Medium-Low)

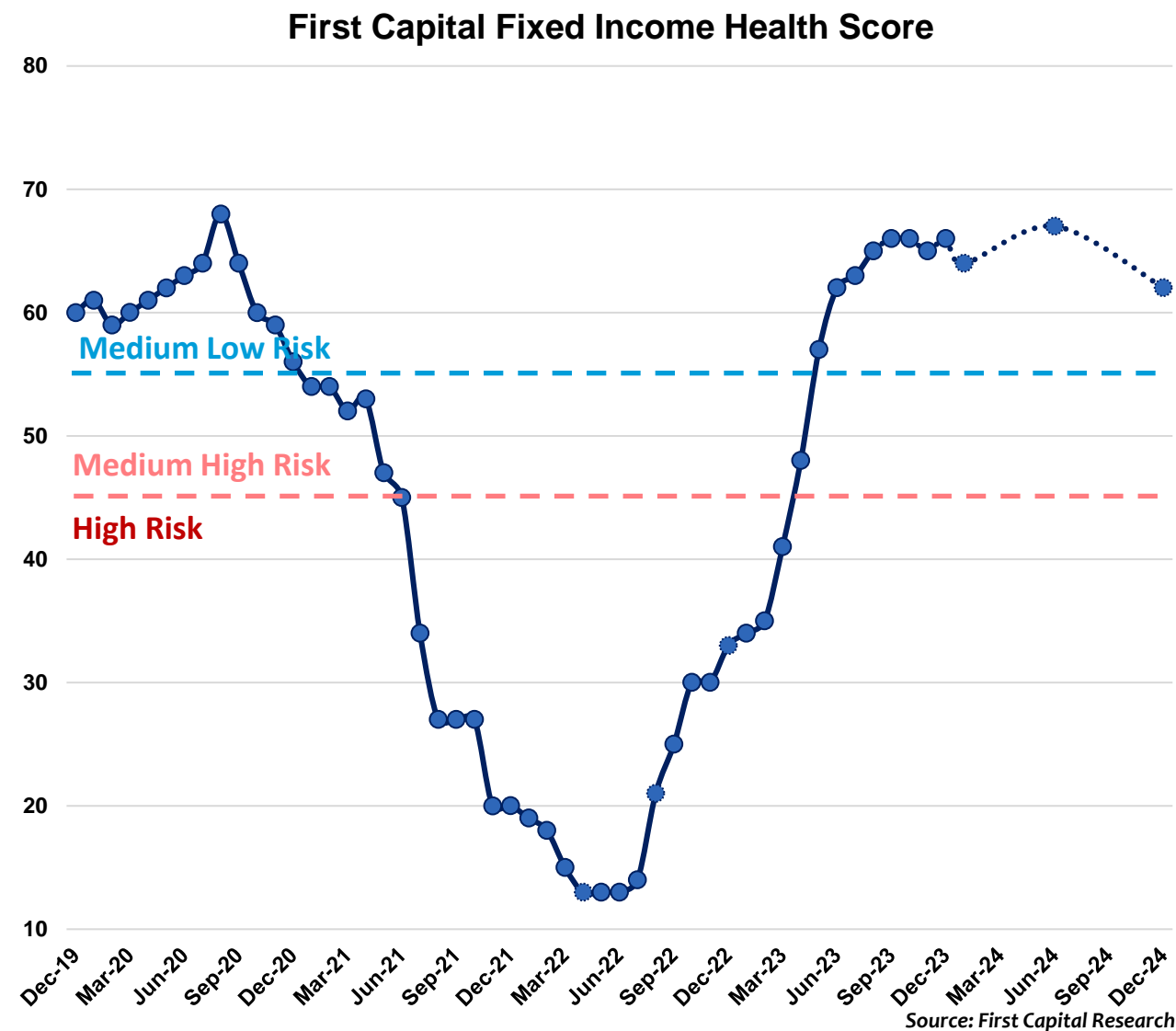
BOT & BOP

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.

Risk Level: Medium-Low
(Maintained)



FI Health Score to remain at Low Risk Level



- 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 *marginally dip towards Jun-24 and remain stable through 2H2024 on pent up credit pressure and election uncertainty which may loom from Jun-24 onwards.*

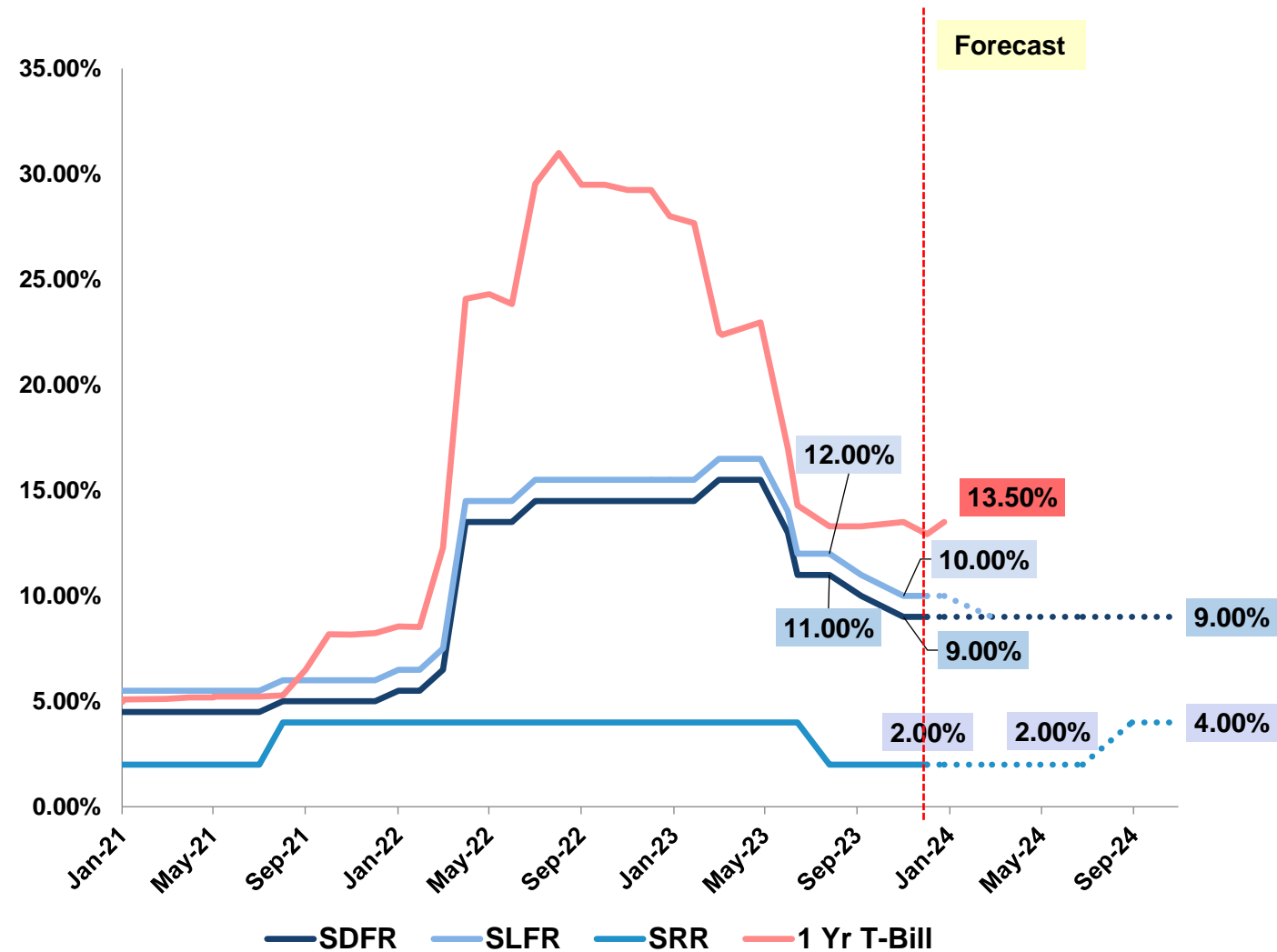
Policy rate cuts to take a pause;

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.

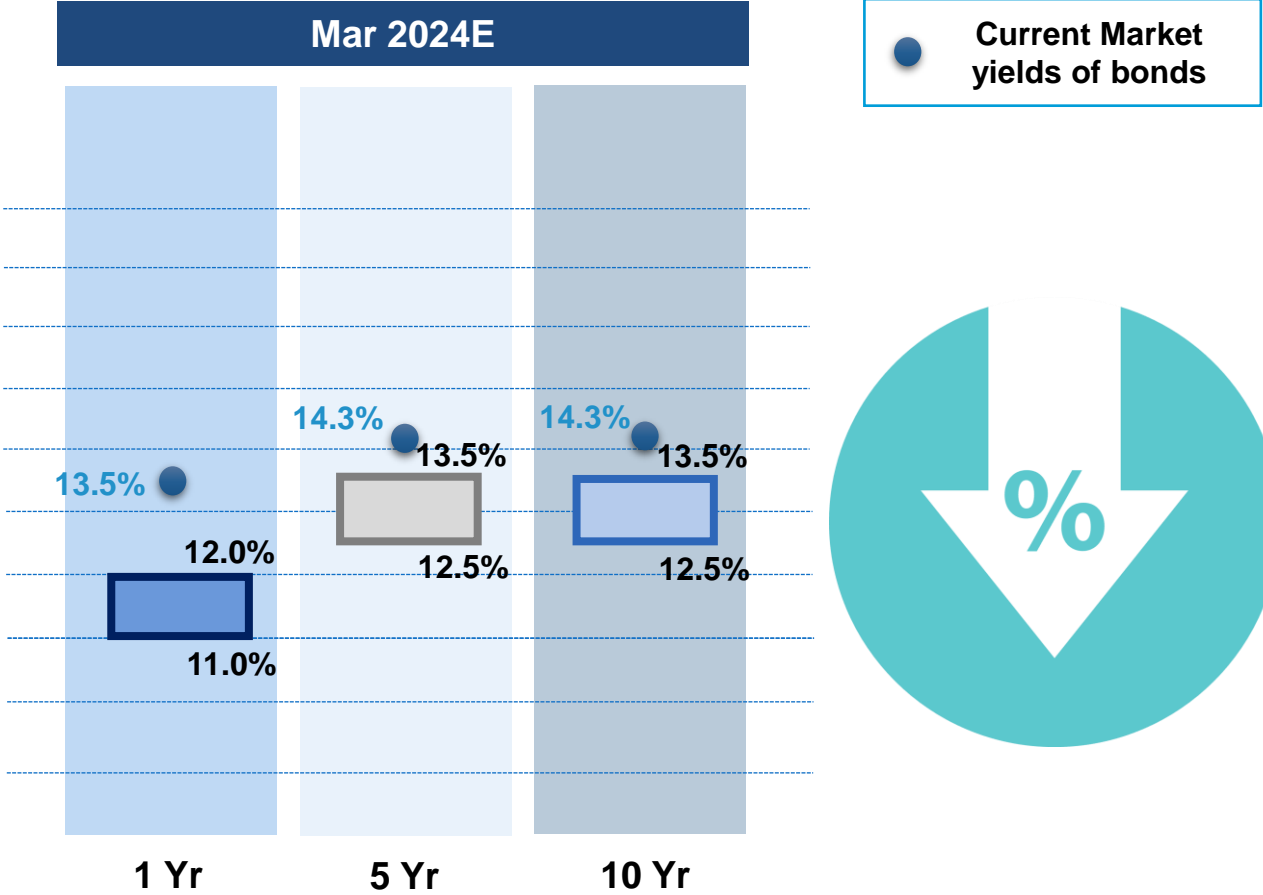
Having announced the latest rate cut in Nov-23, we expect CBSL to take a pause and maintain rates in the near future, paving way for market rates to adjust downward in-line with the decline in risk premia attached to government yields, with positive strides made on external debt restructuring while going in line with IMF guidelines in order to secure the subsequent tranches.

However, CBSL plans on implementing a single policy rate window, we believe CBSL may be implement it in the 1Q2024 via a rate cut to the 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

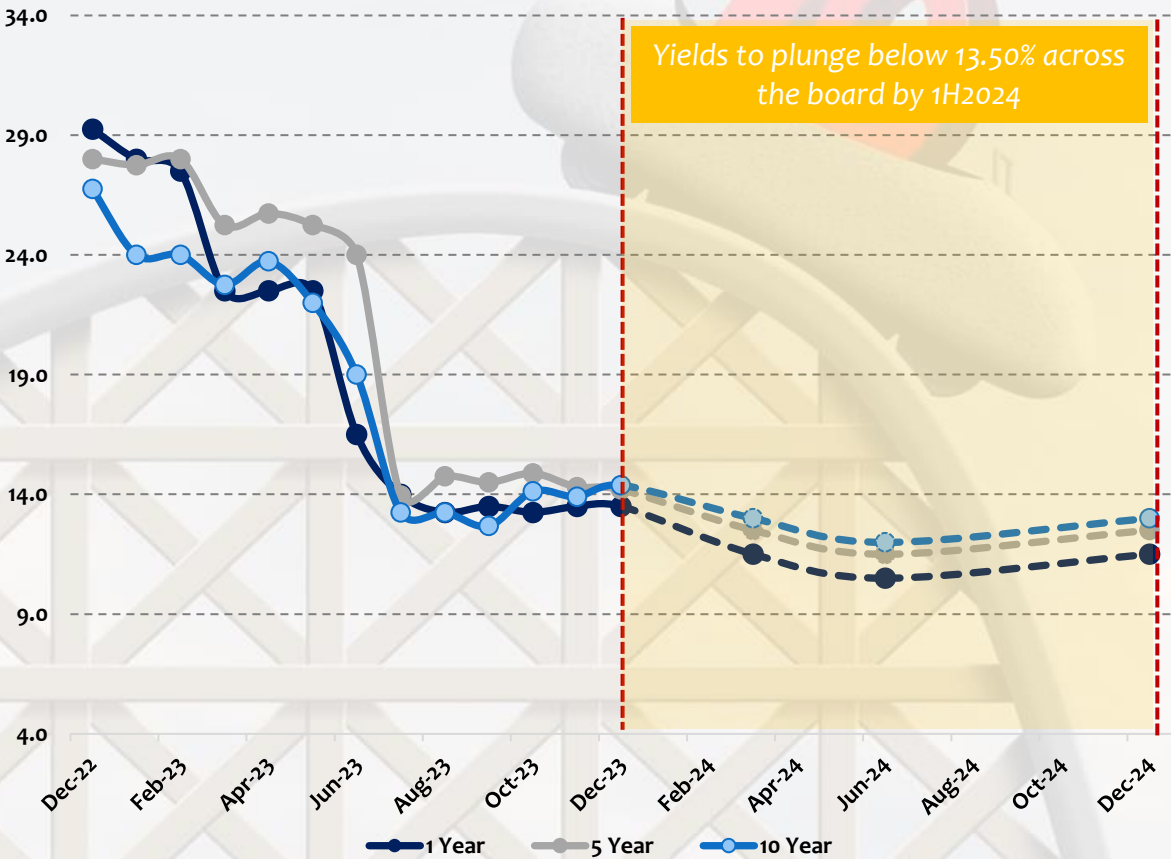
Expectation: With the completion of external debt restructuring during 1H2024, we believe the overall yield curve is likely to drop below 13.5% and reach a range of 11.0%-13.5% in the short term.

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.

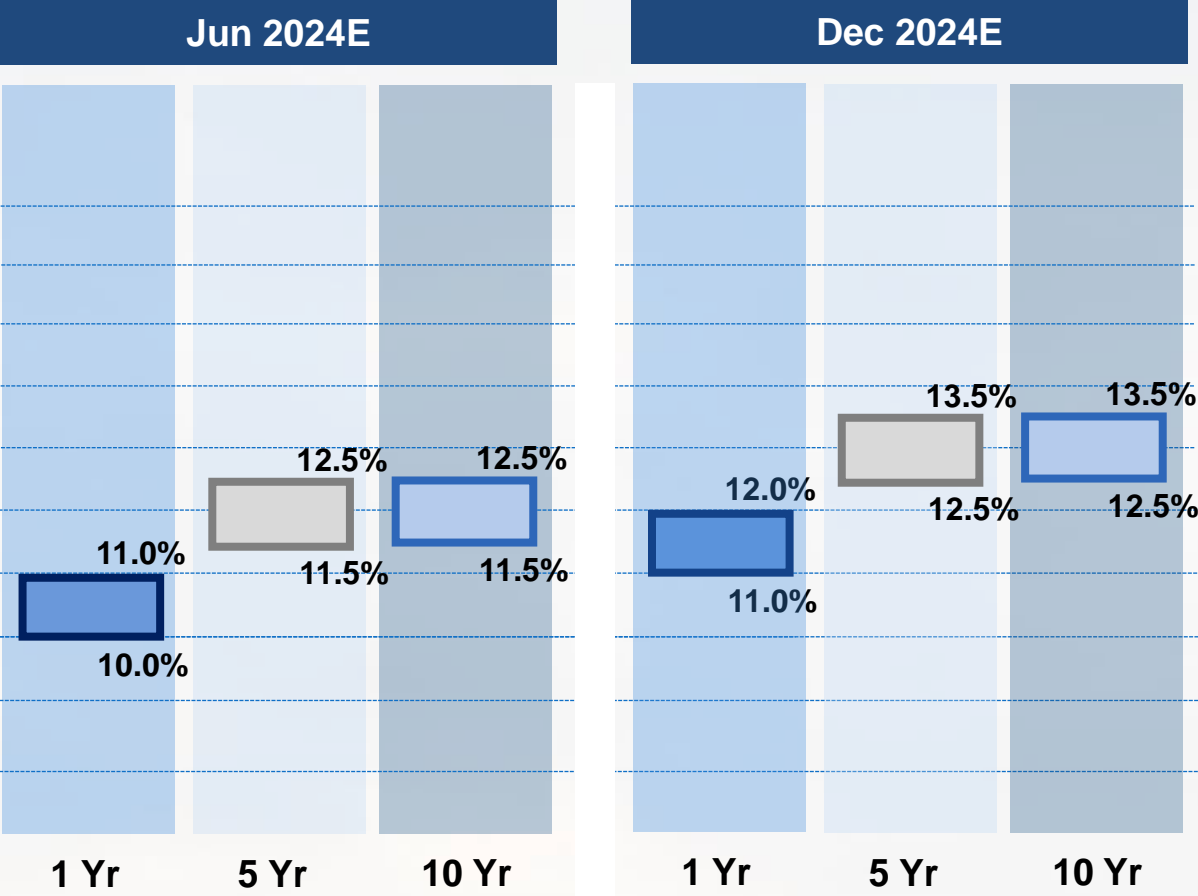
Moreover, the 100bps policy rate cut is also expected for the SLF from the Mar-24 policy meeting in order for the CBSL to implement a single policy window which may also support a further dip in rates.

Bond Yield to continue downtrend in 1H2024 to reach 10.0%-12.5%; Recovery in economy & pressure on inflation may push yields 100bps to 11.0%-13.5%

Bond yields to normalize to pre-crisis level



Source: First Capital Research



First Capital Research believes there is **further downside potential**



Recommendation:
Maintain **Hold**

Book Profits if yields fall closer towards the 13.0% mark



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%:

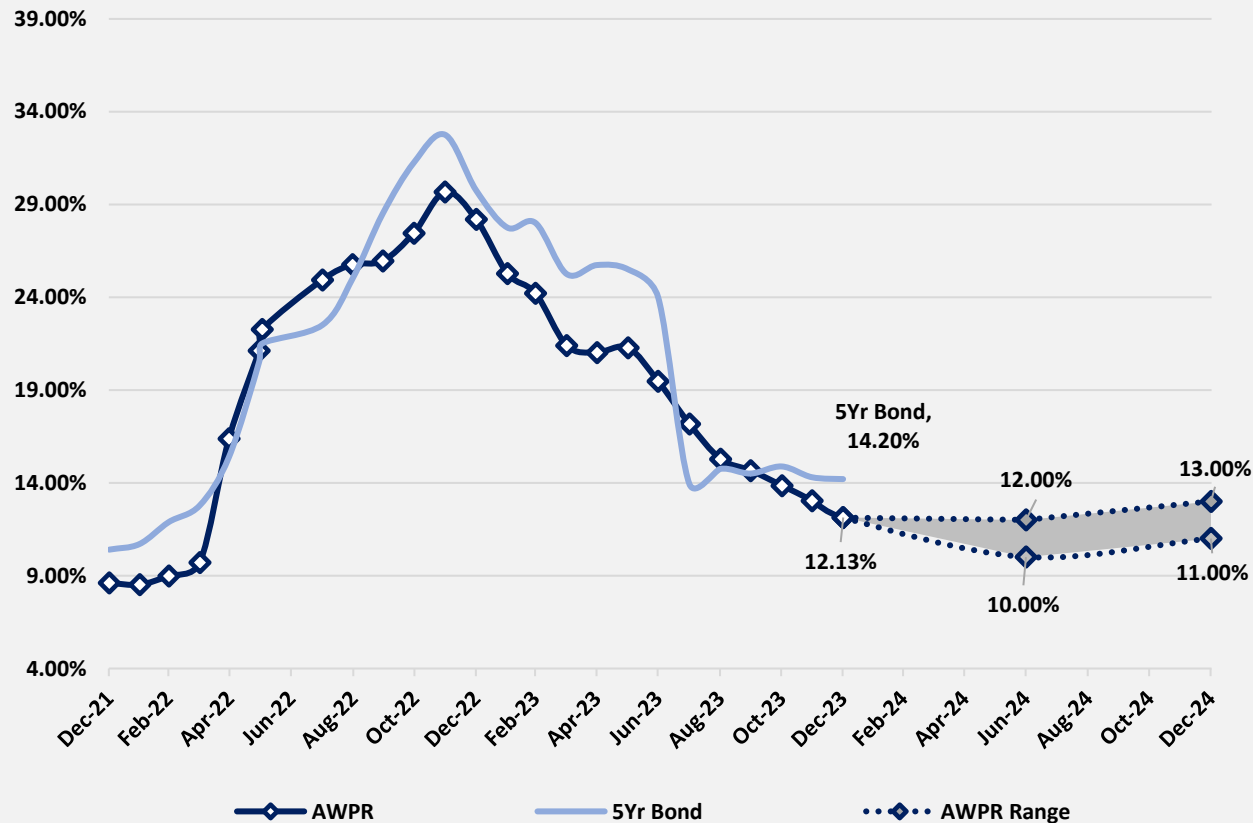
We highly recommend investors to hold your current portfolio to gain the benefit of a further decline in the yields. Mid tenors have already fallen off its peak in mid-Nov 23, but opportunity exists for further gains. Following the opportunities received in accumulating near the 15.0% mark across the 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.

First Capital Research View on Banking Rates 2024

Section 6.2

AWPR may decline to 10.0%-12.0% by Jun-24 and rise again to 11.0%-13.0% by Dec-24

Expectations for AWPR



Source: First Capital Research

AWPR continue its downtrend 1H; But reverse stabilize higher in 2H

AWPR falls faster: The steep fall in the AWPR has been beyond our expectations and ahead of the dip in bond yields primarily due to the lack of credit in the system.

Credit may slow in 1H: Credit has started to pick during 4Q2023 but may slowdown with the economy amidst the higher taxes and cost of living.

Credit fall in 1H and rise in 2H2024: Thereby, we expect the downtrend in AWPR to continue and reach a low of 10.0% - 12.0% during 1H2024, but with the stronger demand for credit and the pick in the economy with the gradual rise in SME segment and inflation, we expect slight pressure on interest rates pushing AWPR to 11.0-13.0% during 2H2024.

First Capital Research View on Exchange Rate 2024

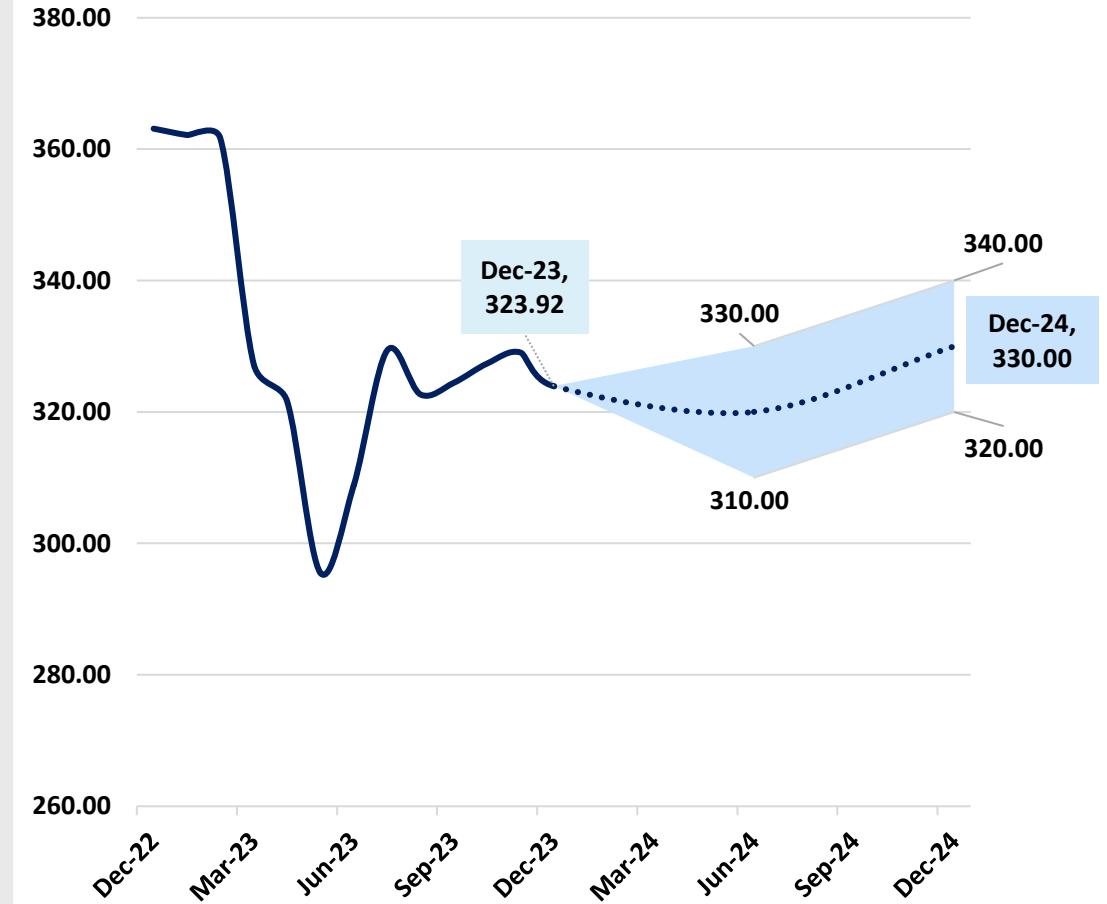
Section 6.3

Exchange Rate outlook upgraded to LKR 310.0-330.0 for 1H and LKR 320.0-340.0 for 2H2024

Slower economy may appreciate LKR in 1H; But depreciation pressure in 2H

Slower economy to appreciate LKR: FCR outlook for 1H2024 for the LKR has been upgraded with potential appreciation pressure as the newly implemented higher taxes are likely to significantly slowdown the rising consumer demand in the short term amidst the rise in cost of living resulting in LKR appreciating to a range of 310.0-330.0. Slower consumer demand may reduce imports while the peak season for tourism may result in a stronger LKR specially during the 1Q2024. Afterwards some stabilization may be observed as consumer demand improves and tourism income slows down.

Depreciation Pressure in 2H: With Govt. projects restarting and Govt accelerating development while private consumption gradually reinstates and upward trending path. LKR may register depreciation pressure amidst the growth in the economy as we target a range of LKR 320.0-340.0 for the 2H.

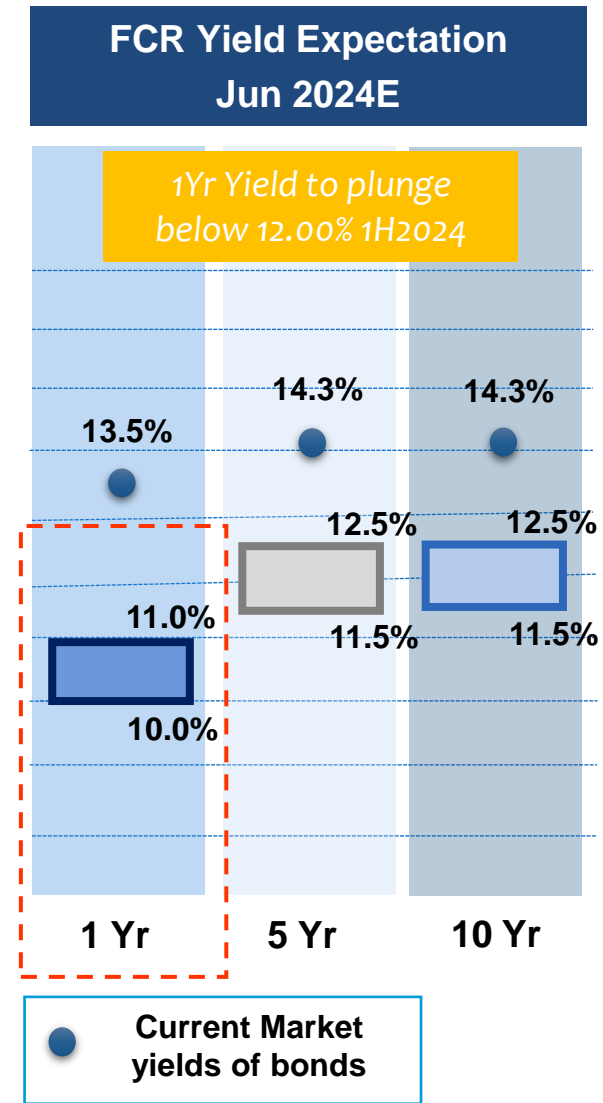
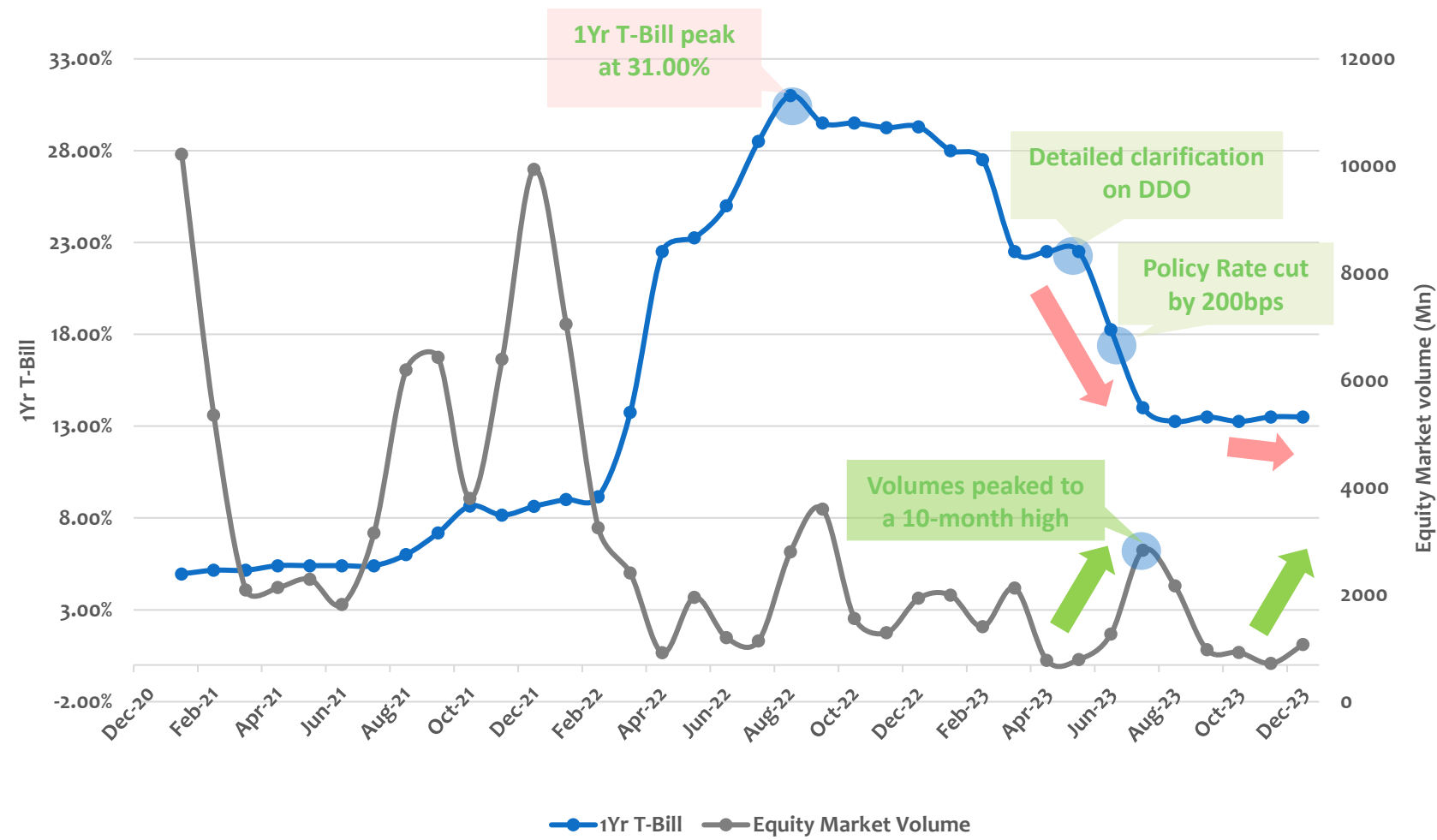


Source: CBSL, First Capital Research

First Capital Research View on Equity Market 2024

Section 6.4

The expected decline in 1Yr interest rates below 12% is poised to drive a liquidity shift from Fixed income to Equity



**Equity Market
continues to
maintain tax
free status!!**

**CAPITAL GAIN
TAX**

“

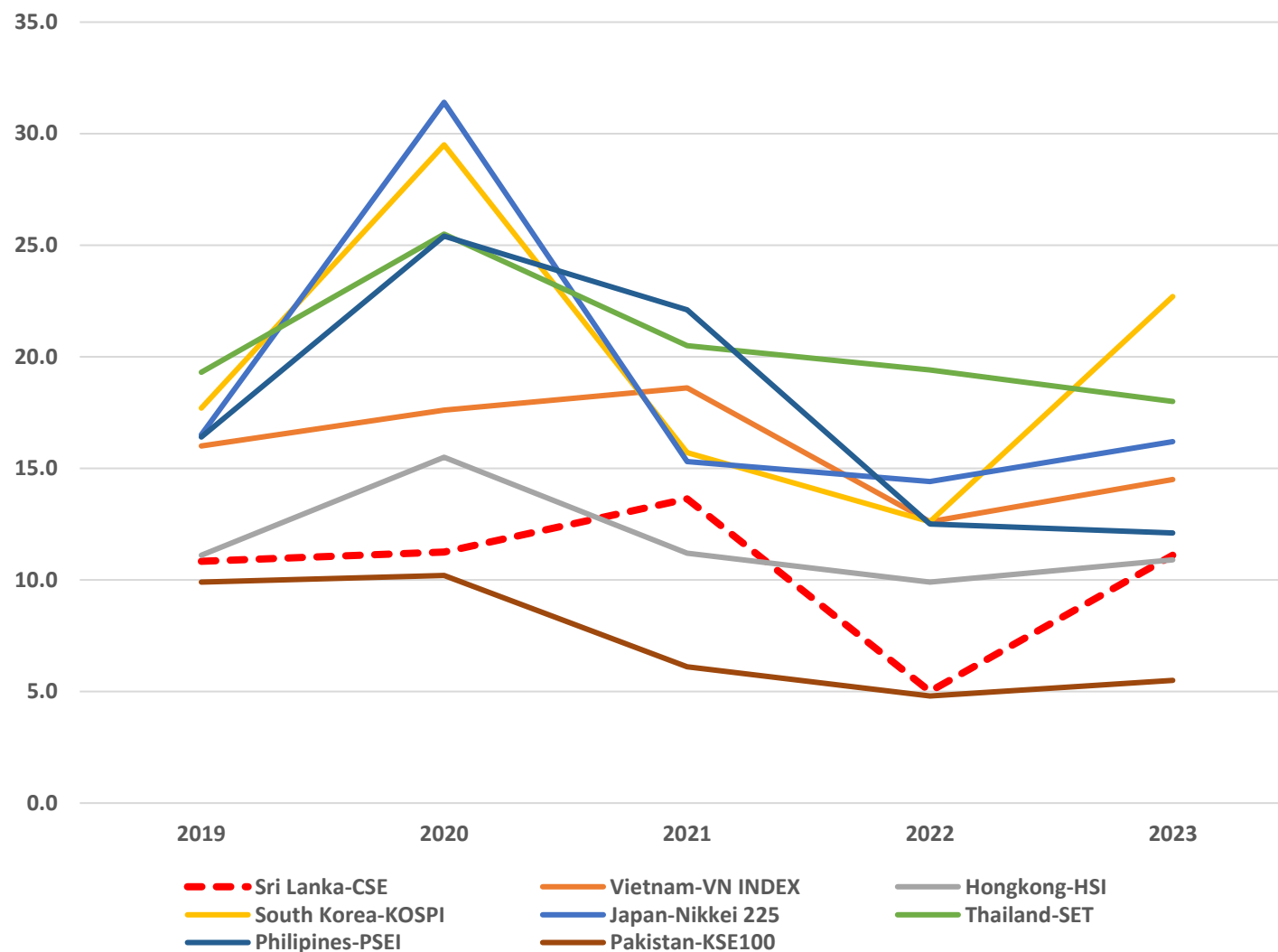
Meanwhile, the budget 2024 also offered investors a comfort with much anticipated capital gains tax on banks and primary dealers, been left out. This is expected to offer an additional boost to the investor sentiment, amid the improvement in earnings, which is also expected to further aid the investor sentiment in the coming period.

”

CSE trades at a steep discount compared to the regional peers, unleashing upside potential

The Colombo Stock Exchange (CSE) is currently trading at 11.1x P/E, notably below its regional peers. Looking ahead, there is an anticipation of market earnings recovering amid improved economic conditions and heightened business confidence. This optimism is viewed as a potential catalyst for a P/E re-rating, particularly considering the projected 2024E earnings growth of +37.0%YoY.

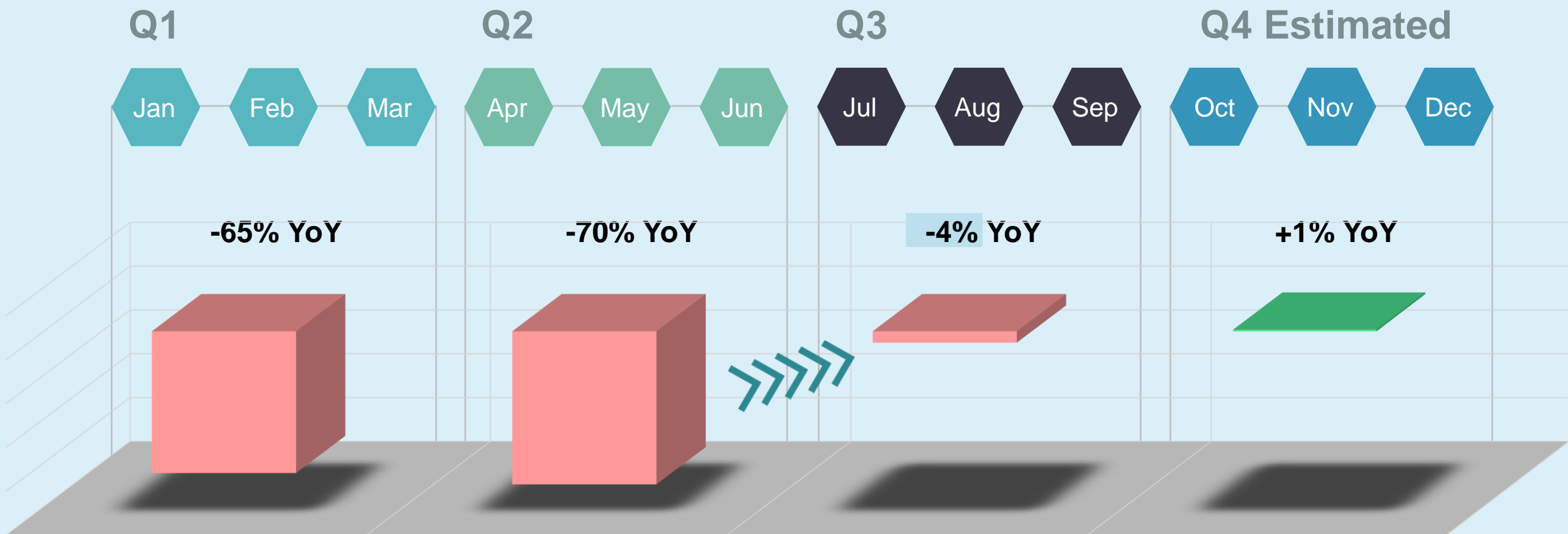
Regional Market P/E (X) Valuations Comparison



Source: CSE, Bloomberg

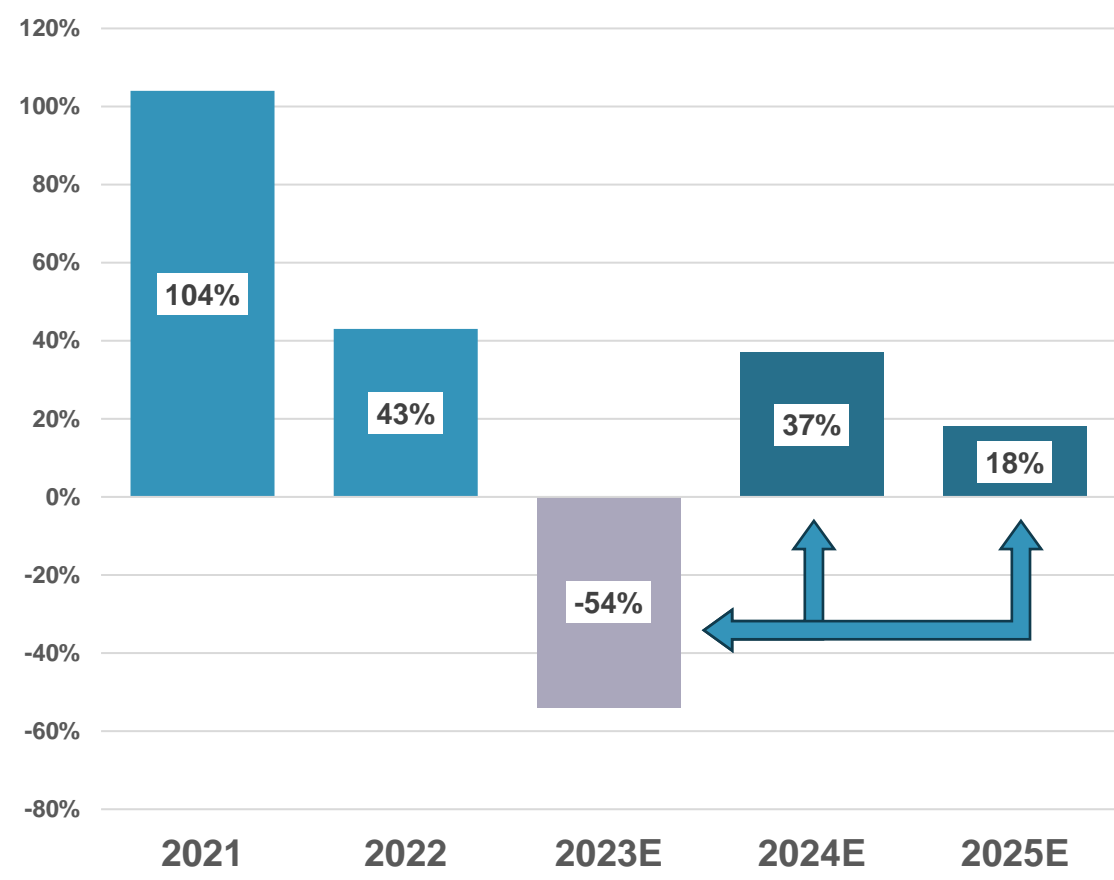
Market earnings to recover from 4Q2023 onwards...

Earnings dip in 1Q & 2Q 2023 was far worse than expectations

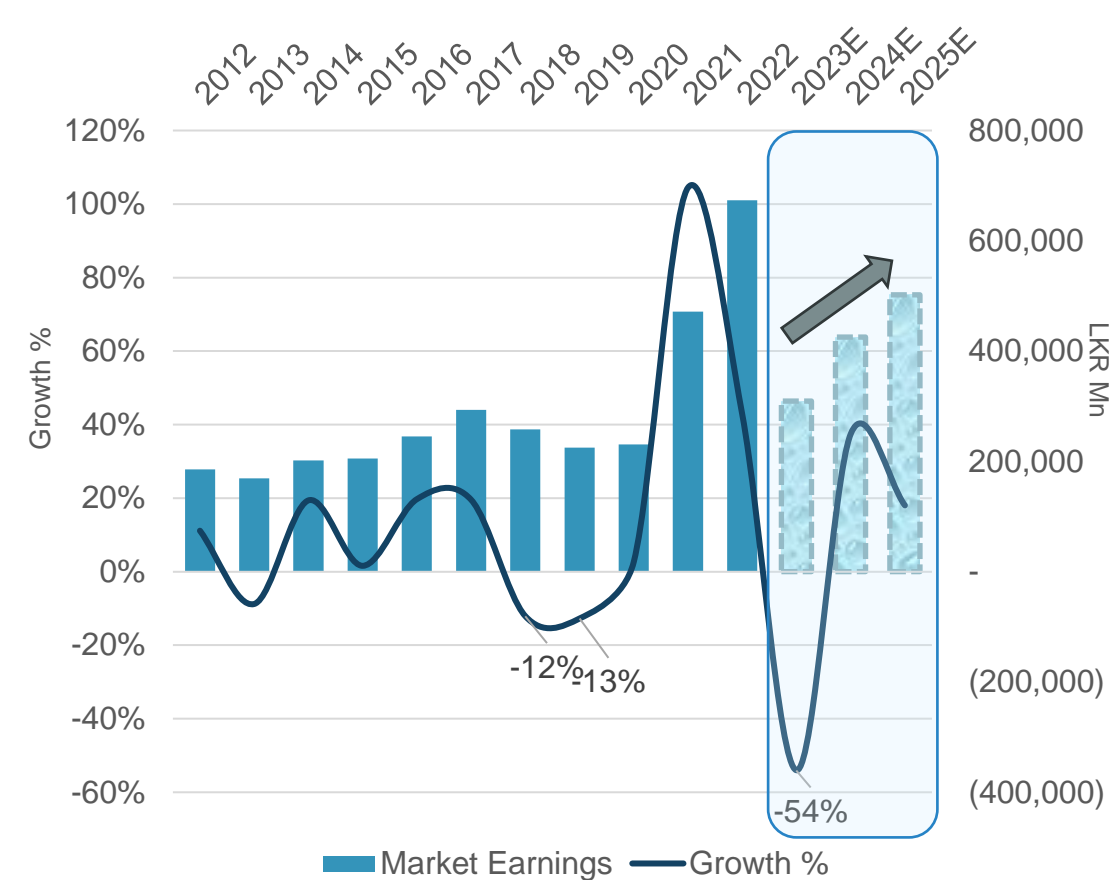


...however, market earnings for 2024E in absolute terms was tamed down amidst the steep drop in 2023 earnings

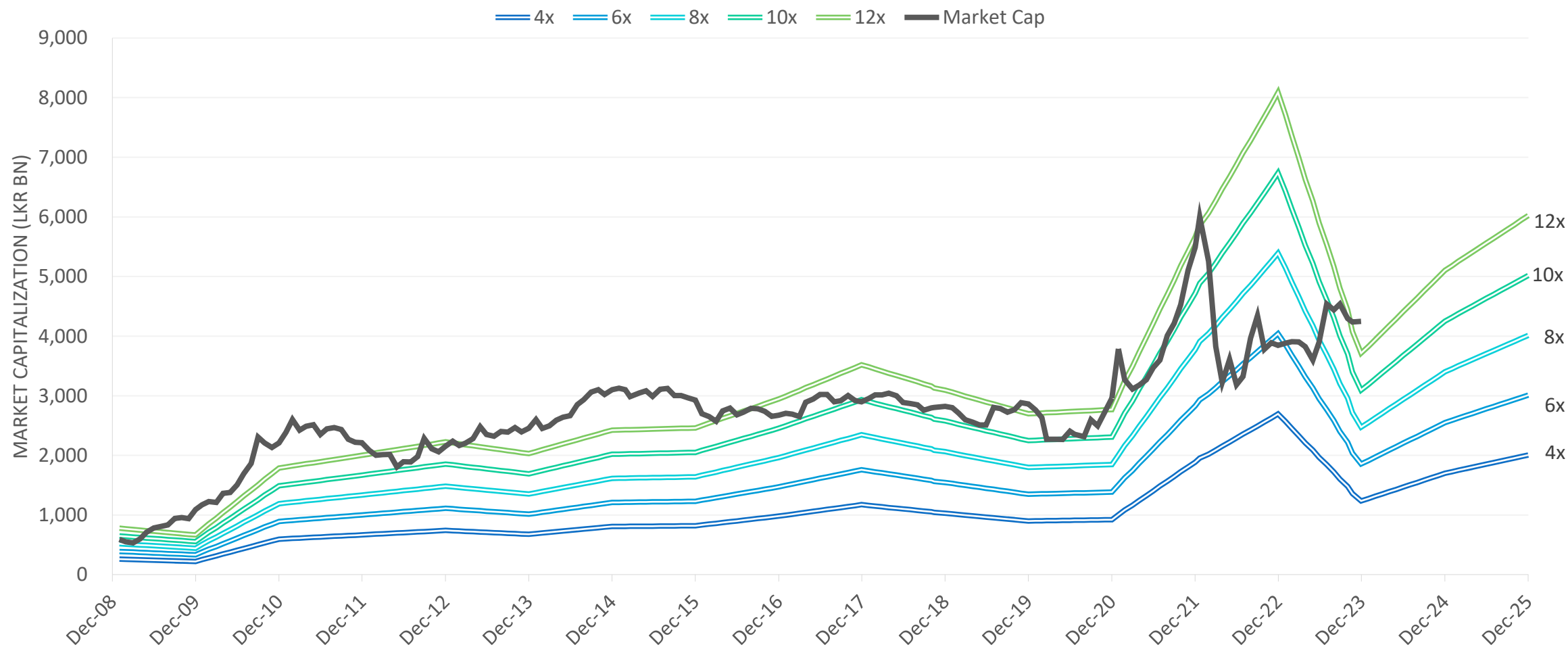
Market Earnings falls sharply beyond expectations in 2023



Market Earnings bottom out in 2023 and to recover afterwards



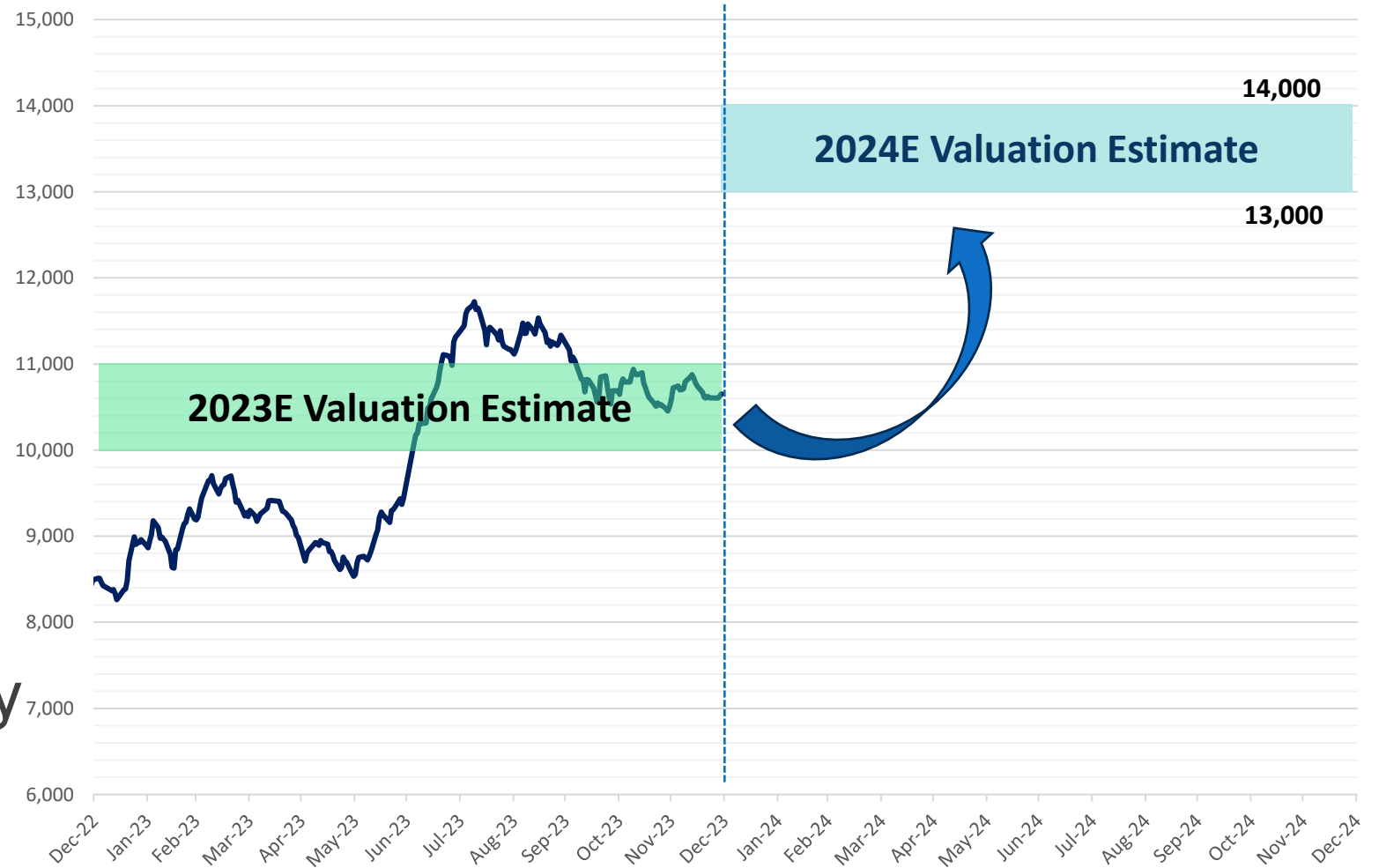
...pushing the PER to 12x on 2023E earnings



Source: First Capital Research Estimates

ASPI Dec-24 target at 13,500

First Capital maintains ASPI 2024E fair value range of **13,000-14,000** owing to the anticipated moderate recovery in earnings on the back of the recovery in the economy.



Market to re-rate with the completion of External Debt Restructuring

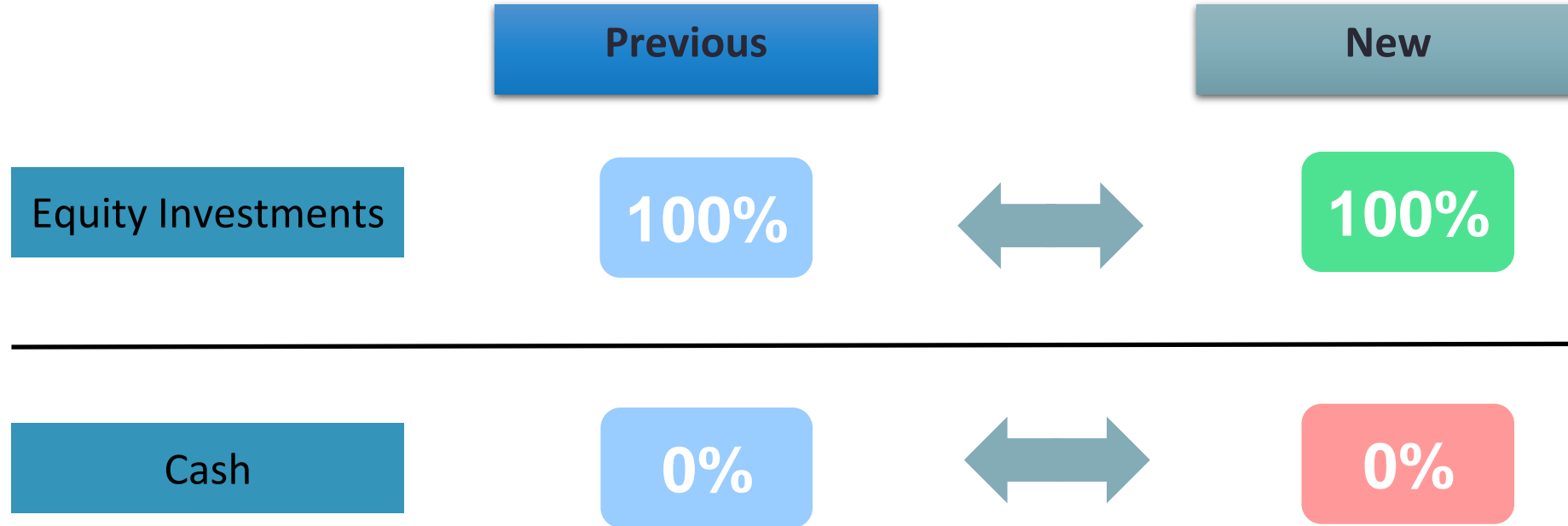
Dive into Equity; Seize Opportunities

- **External Debt Restructuring may potentially complete in Feb-24:** Following SL reaching a deal with the official creditor committee, negotiations with the bondholder group stands to be completed for the ISBs. By reaching an agreement of external debt restructuring (EDR) SL may have a rating upgrade which may improve foreign activity in the SL market.
- **Interest Rate Dynamics:** Achieving EDR may push yields lower, supporting stronger recovery in economic activity and credit growth, which may improve demand for equity amidst the expectation of stronger market earnings.
- **Market Outlook:** The substantial decline in interest rates stands as a key catalyst, poised to prompt a market re-rating. This shift is anticipated to drive a notable liquidity transition from fixed income to equity, potentially resulting in a market range of 13,000-14,000 for 2024E.



First Capital **Maintains** Equity Exposure to 100% retaining cash to 0%

*First Capital Research assumes that investors have **separately allocated funds for equities**, and our recommendation is to fully utilize 100% of the allocated funds for equity investments.*



- With the completion of the external debt restructuring process and progress in the SoE reforms, Sri Lanka's debt is likely to be classified as sustainable improving confidence and pushing yields down. Thereby, in relation to the equity allocated funds, we recommend to be fully invested.
- Amid the improving economic indicators and the potential developments, Equity Market warrants a higher exposure to benefit from the potentially gradual growth in returns in 2024E.
- Out of the funds **purely allocated for equity** we have been advising on investing in the equity market, emphasizing the potential for substantial upside. However, it's crucial to note that all investments carry inherent risks, and we encourage regular reviews of portfolio in light of evolving market conditions and individual circumstances.

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First Capital Holdings PLC



No. 2, Deal Place, Colombo 3



research@firstcapital.lk



+94 112 651 651



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

Research Associate

T: +94 11 2639 866

E: nethmi@firstcapital.lk

Thank You

“Successful investments is about managing risks”