



First Capital
A Janashakthi Group Company

“Time to take profits...”

29th Feb 2024

FIRST CAPITAL FIXED INCOME RECOMMENDATION

FIRST CAPITAL RESEARCH

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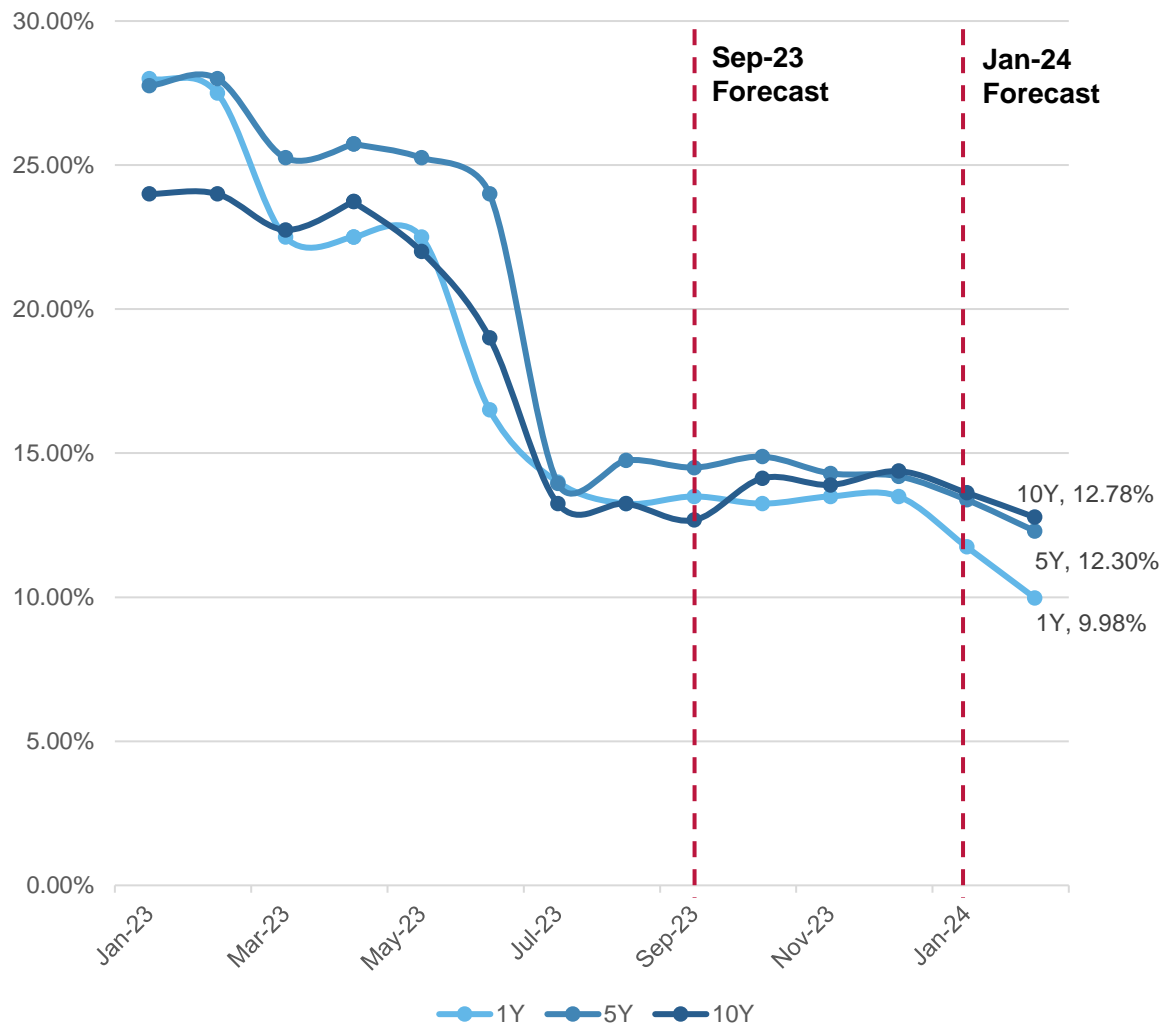
1.0

FCR - Previous Recommendation

“Taking profits in declining interest rates”



11th Dec-23 to 29th Feb-24 bond yields showed mixed change



Feb 2024

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Previous Recommendations

05th Jul 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% ”
- **Accurate**

27th Sep 2023

“ 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**

18th Jan 2024

“ Bond Yield to continue downtrend in 1H2024 to reach 10.0%-12.5%. ”
- **Accurate**

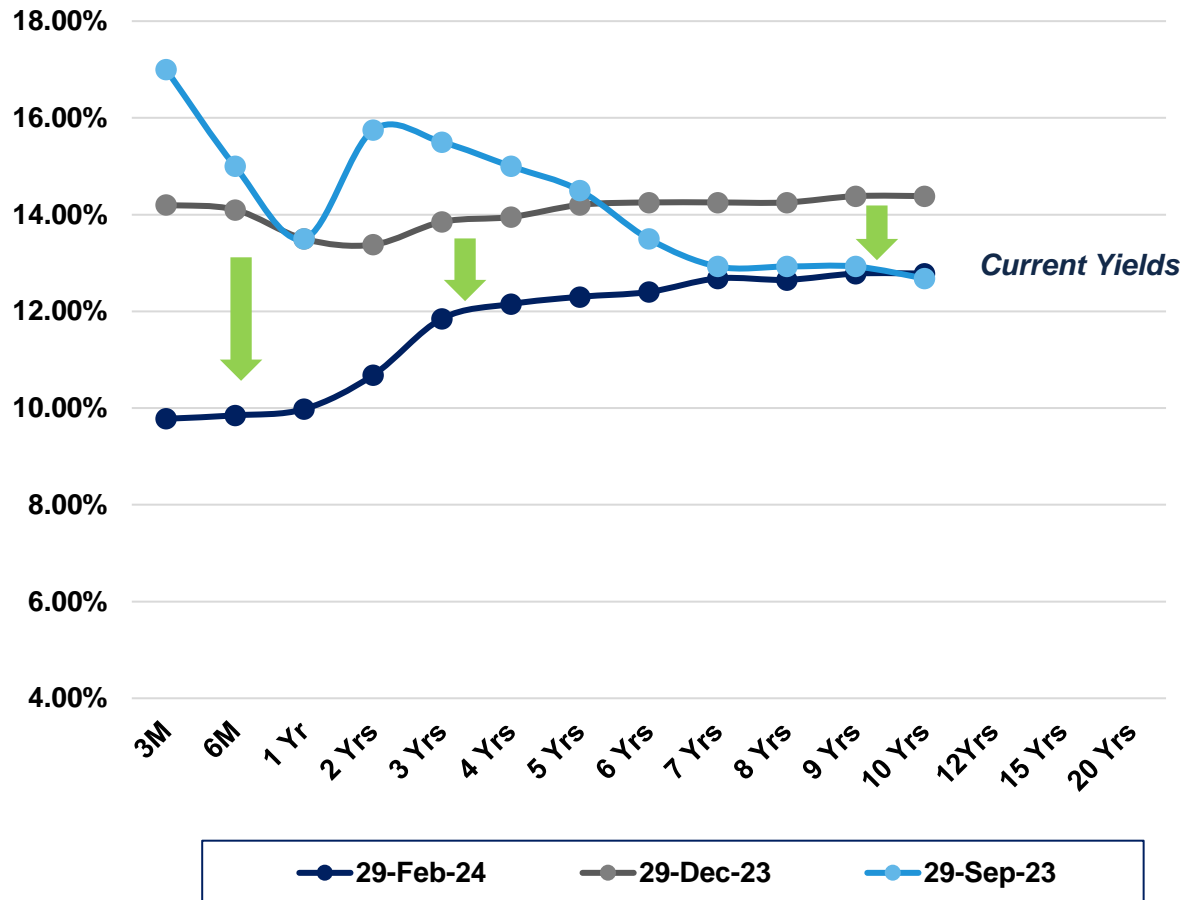
10Yr ↓ Jan-24 to date -160 bps
5Yr ↑ Jan-24 to date -190 bps
1Yr ↓ Jan-24 to date -352 bps



Overall yield curve movement

4

Yield curve quarter end comparison



Interest Rate Change (bps)

Tenure	Feb-24	Dec-23	Change (bps)	Sep-23	Change (bps)
3M	9.78%	14.20%	-442	17.00%	-722
6M	9.85%	14.10%	-425	15.00%	-515
1 Yr	9.98%	13.50%	-352	13.50%	-352
2 Yrs	10.68%	13.38%	-270	15.75%	-507
3 Yrs	11.85%	13.85%	-200	15.50%	-365
4 Yrs	12.15%	13.95%	-180	15.00%	-285
5 Yrs	12.30%	14.20%	-190	14.50%	-220
6 Yrs	12.40%	14.25%	-185	13.50%	-110
7 Yrs	12.68%	14.25%	-157	12.93%	-25
8 Yrs	12.65%	14.25%	-160	12.93%	-28
9 Yrs	12.78%	14.38%	-160	12.93%	-15
10 Yrs	12.78%	14.38%	-160	12.68%	10
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



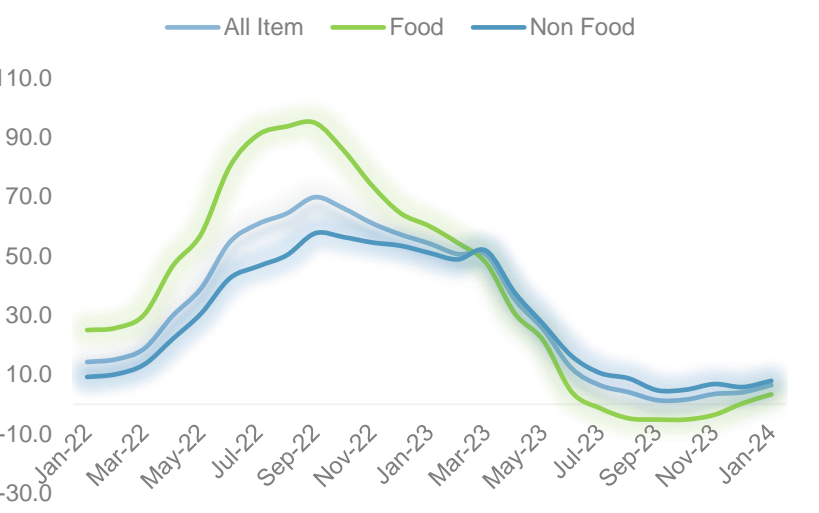
2.0

Outlook for Fixed Income Instruments

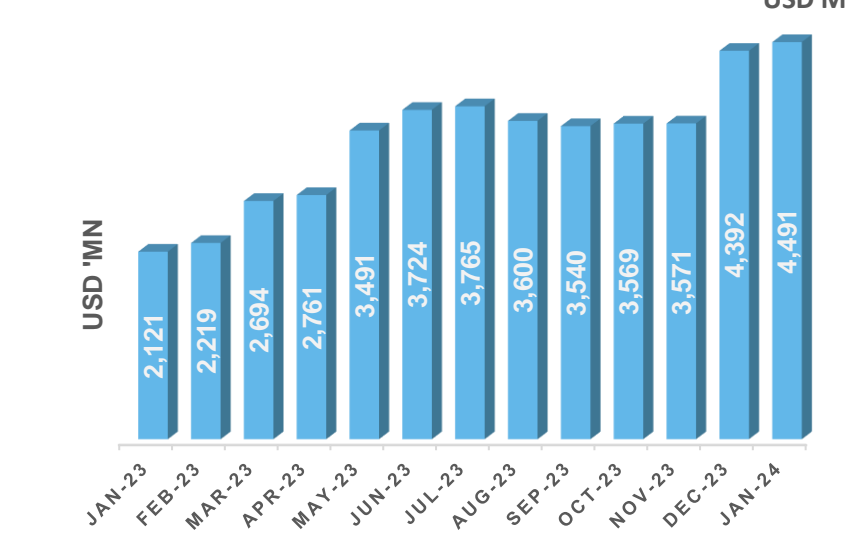
*“Economic Indicators shows steady
recovery”*

Economic Indicators shows steady recovery

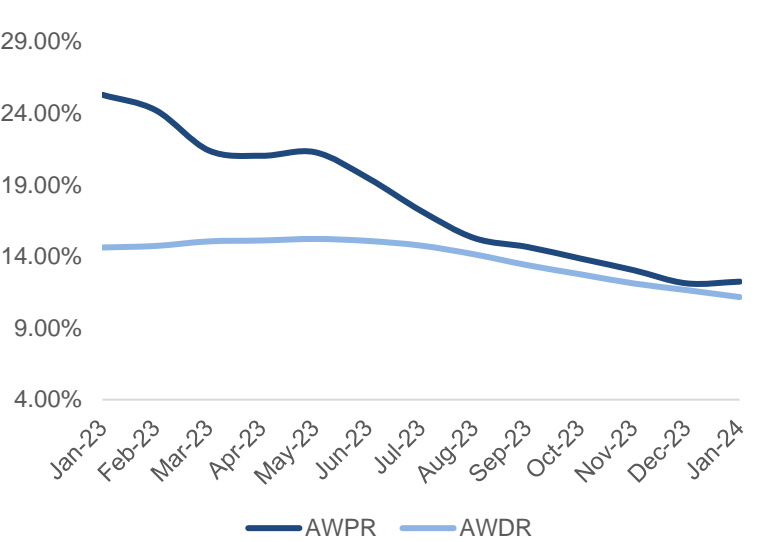
Jan-24 inflation records higher than our expectation driven by VAT increase



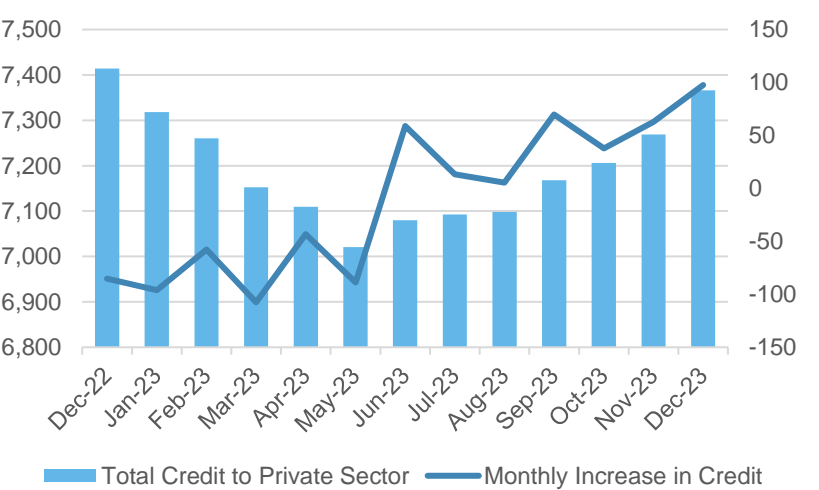
Foreign Reserves improved further to USD 4.5Bn in Jan-24



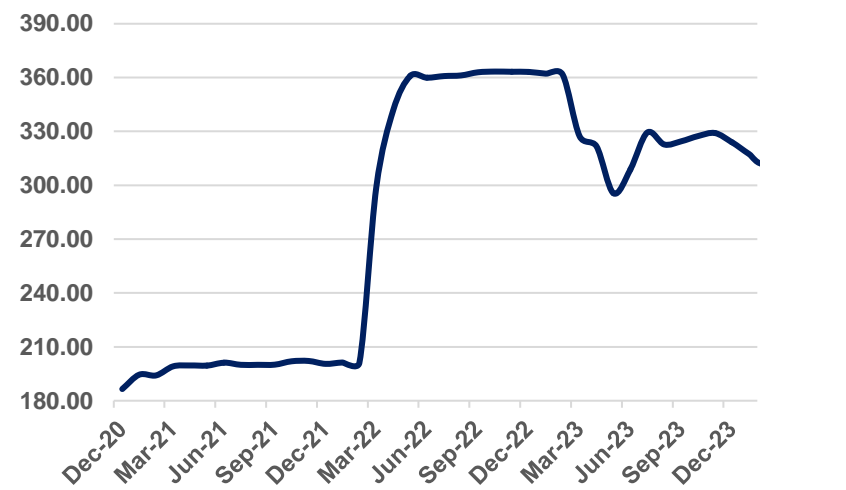
AWPR and AWDR shifts momentum in line with declining interest rates



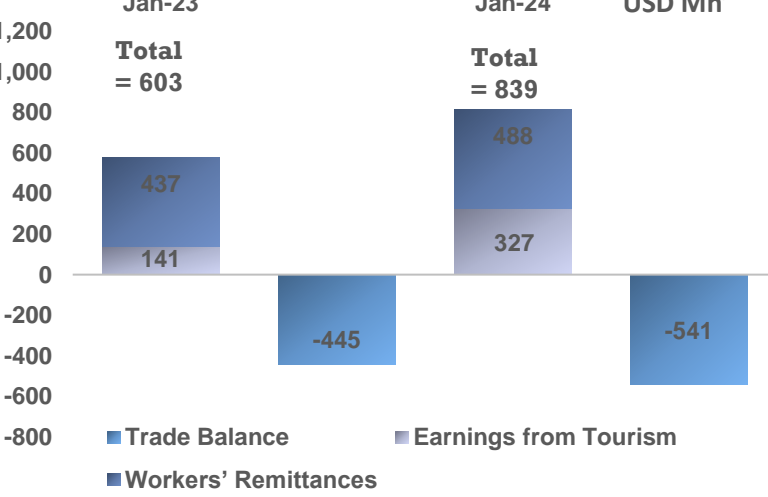
Private sector shows persistent improvement through the latter part of 2023



USD/LKR showcased a steady appreciation during the last 12 months



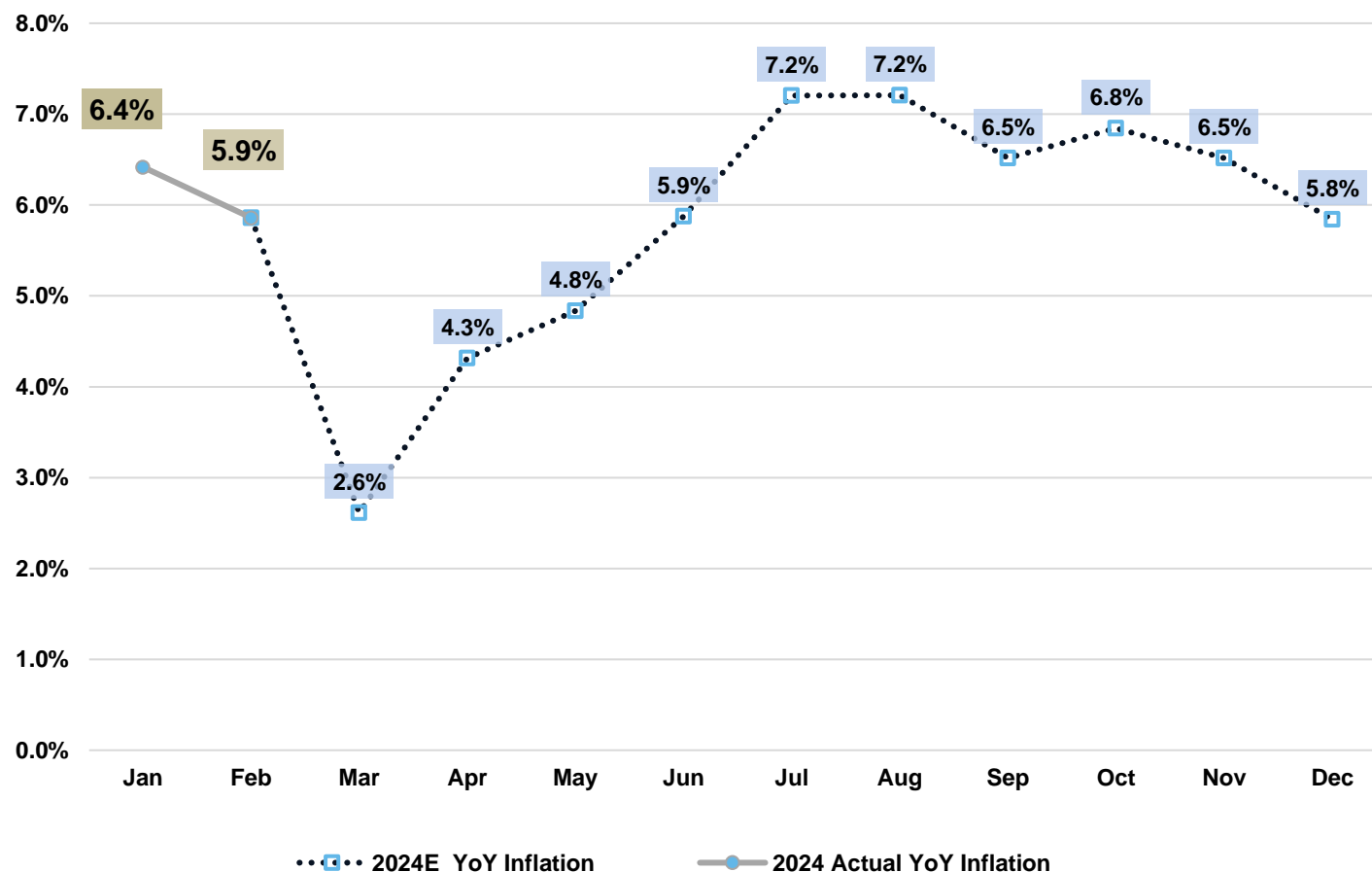
Remittance and tourism earnings scale high strengthening BoP





FCR revised its inflation forecast upwards amidst the higher than anticipated spike in Jan-24

7



CCPI inflation decreased to 5.9% in Feb-24 from 6.4% in Jan-24, caused by a decrease in non-food inflation, whilst food inflation was marginally up.

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.

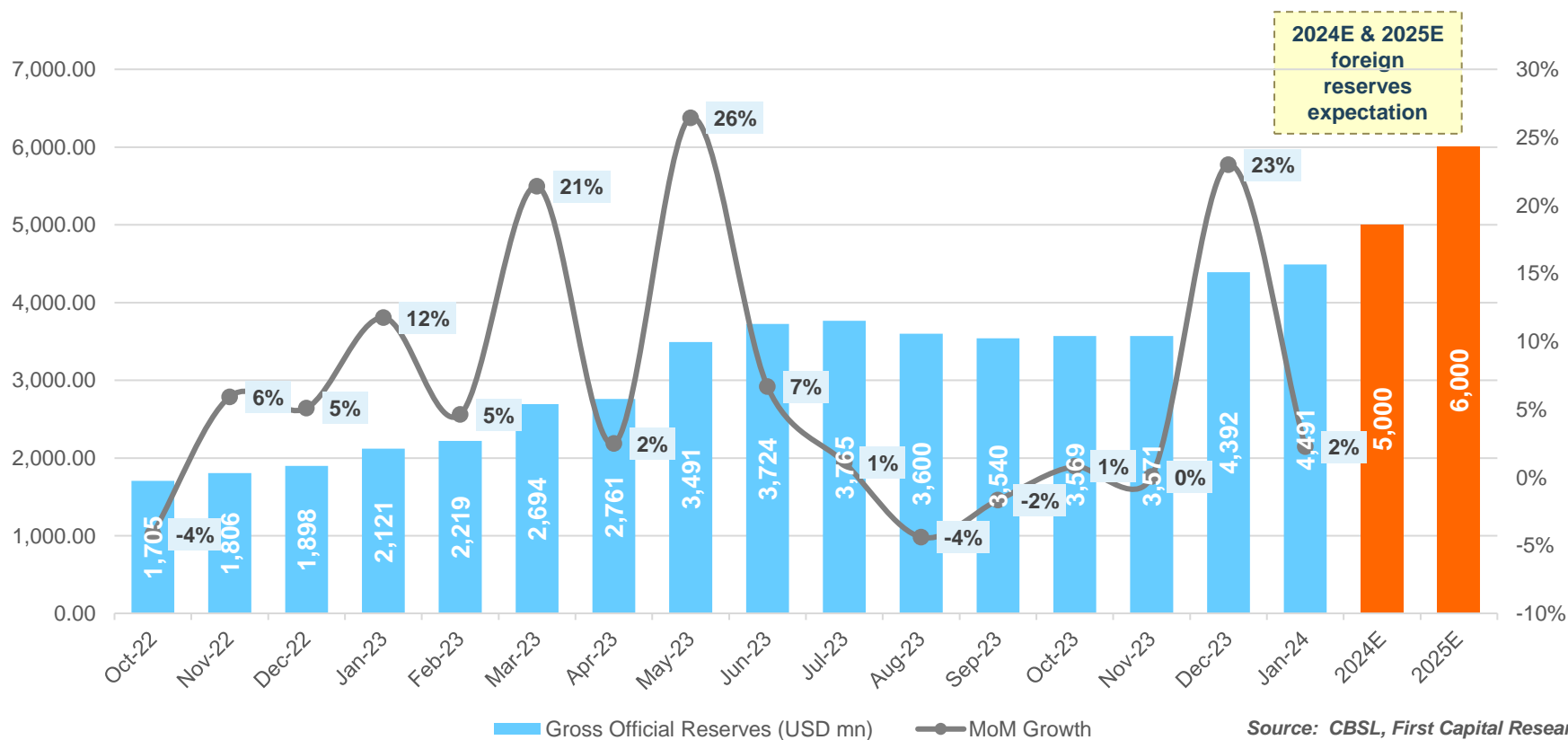
Source: Dept. Census and Statistics, First Capital Research



Foreign Reserve expectations for 2024E at USD 5.0Bn

Gross official Reserves strengthened further during the month of Jan-24 to USD 4.5Bn. Inflows from multilaterals totaling to +USD 700Mn during Dec-23 together with the FX purchases carried out by the CBSL positively contributed towards the growth in reserves during the period.

Going forward, we expect Sri Lanka to reach gross official reserves of USD 5.0Bn in 2024E and USD 6.0Bn in 2025E backed by the positive current account balance and inflows from multilateral agencies.



Feb 2024

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Expected Multilateral fundings in 2024E

USD 450.0Mn

ADB

ASIAN DEVELOPMENT BANK

USD 330.0Mn

THE WORLD BANK

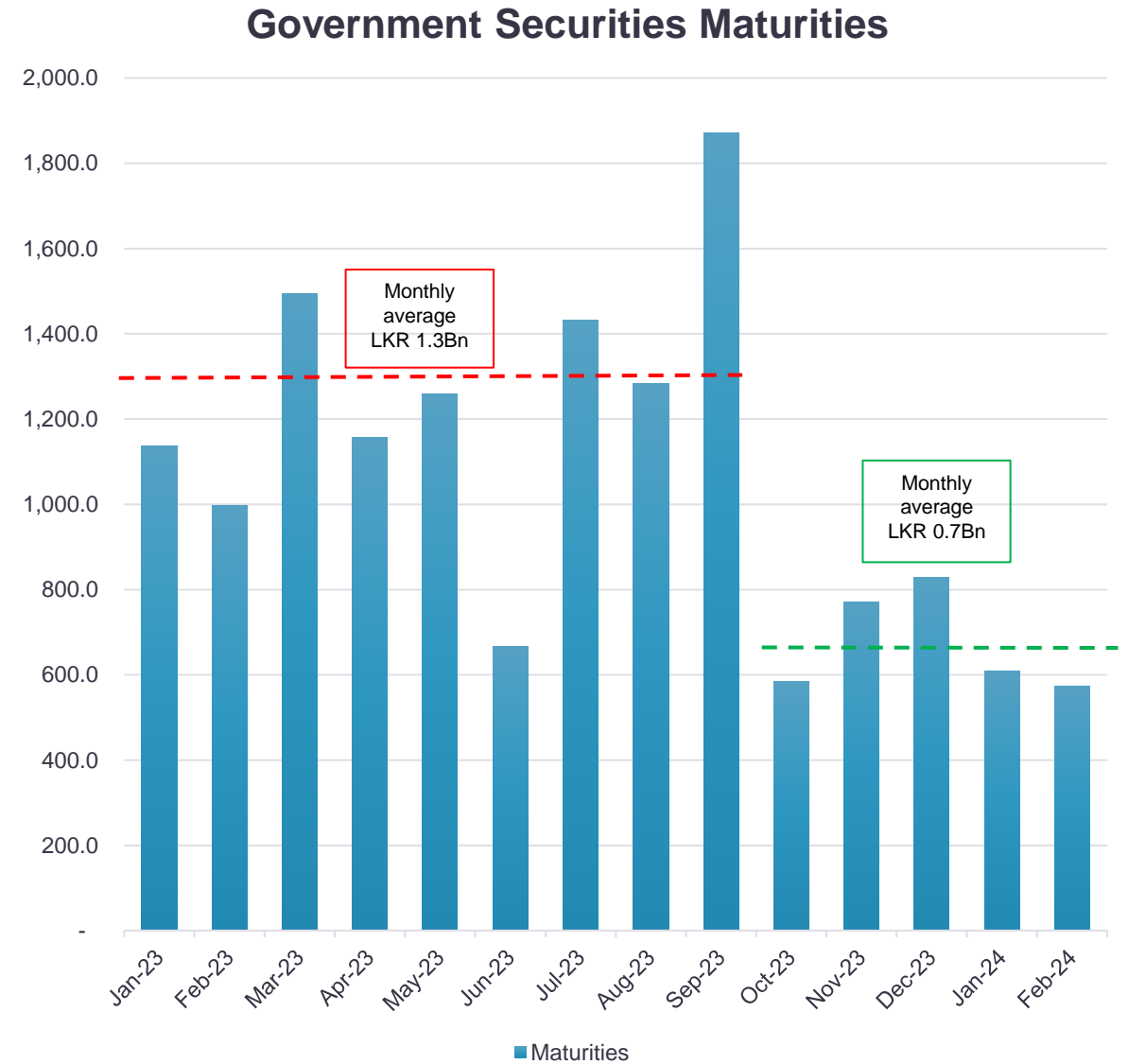
USD 682.0Mn

INTERNATIONAL MONETARY FUND

Progress so far on External Debt Restructuring (EDR)

- Sri Lanka rejected the first proposal submitted by the bondholders to exchange a 'downside' bond linked to gross domestic product which will have a 20% hair cut with additional haircuts if GDP growth is low as forecasted by the International Monetary Fund. However, GoSL rejected the proposal and submitted a counter proposal in Feb-24 to bring the outstanding debt to a desired level, in-line with the IMF targets.
- Upon completion of DDO, Sri Lanka successfully completed negotiations with the bilateral creditors including EXIM bank of China and Official Creditor Committee (OCC) which was co-chaired by India, Japan and France (as chair of the Paris Club), paving the way to receive the 2nd tranche of the IMF extended fund facility of USD 337.0Mn. According to official sources, Sri Lanka is expected to sign a MOU with Paris Club within weeks.
- Presently, Government of Sri Lanka is conducting discussions with the private creditors (ISB bond holders and China Development Bank) to restructure USD 16.5Bn of debt and aims to complete negotiations within 6-months.

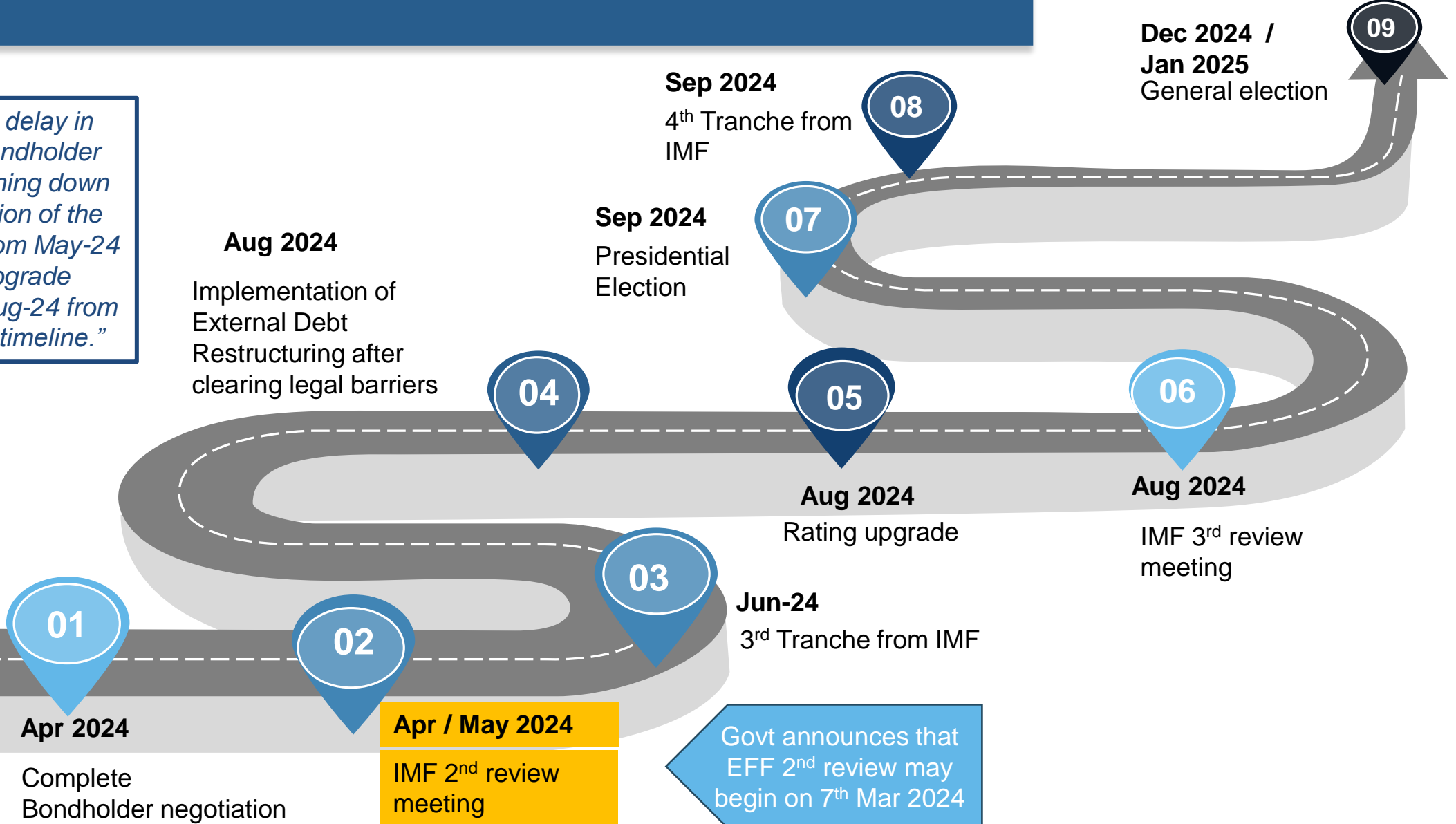
The successful completion of Domestic Debt Optimization during Sep-23, enabled GoSL to reduce its monthly maturities to LKR 0.7Bn (post Sep-23 period) cf. LKR 1.3Bn.





FCR Revises the Projected timeline for 2024

“FCR expects a delay in finalization of bondholder negotiations pushing down the Implementation of the EDR to Aug-24 from May-24 and Rating upgrade expectations to Aug-24 from previous Jun-24 timeline.”





4.0

Fixed Income Health Score

“Fixed Income health score dips marginally due to inflation pressure”



FI Economic Health Score – Jan-24

13

Fixed Income Health Score dipped marginally to 64 points during Jan-24, largely owing to the more than anticipated inflation in Jan-24 to 6.4%. However, steady improvement in other indicators enabled FI Health score to mitigate the dip during Jan-24 period.



Primary Criteria

$$- \quad 50 \quad - \quad 02 \quad = \quad 48$$

Secondary Criteria

$$- \quad 15 \quad + \quad 01 \quad = \quad 16$$

Economic Health Score
[Jan 2024]

$$= \quad 64$$

[As against 65 in Dec 2023 &
34 in Jan 2023 (1 Year ago)]

Source: First Capital Research

Feb 2024

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Changes to Health Score

Primary Criteria – Jan-24

48/75

Previous score

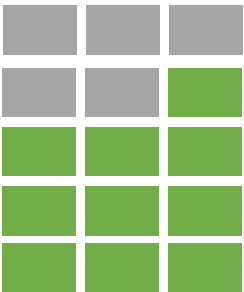
10/15



Foreign Reserves

Foreign reserves showed an uptick in the month of January reaching USD 4.5Bn aided by loans from multilateral lenders including IMF.

10/15



03/10



Previous score

03/10



Foreign Activity

Foreign Investment in Govt. securities continued the declining trajectory and recorded at LKR 103.6Bn as of 22nd Feb 24 compared to LKR 118.5Bn recorded by Dec-23.

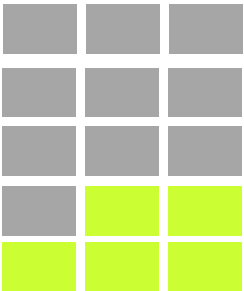
05/15



Liquidity

Liquidity continued to remain volatile, yet negative liquidity swings remained limited recording LKR 25.3Bn by the end of Jan-24.

05/15



09/10



09/10



Credit

Private sector credit continued to improve during the concerned period, recording a +1.3%MoM growth to LKR 7.4Bn in Dec-23.

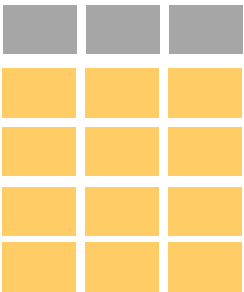
13/15



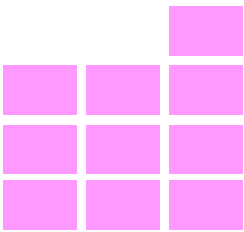
Inflation

CCPI inflation rose to 6.4% in Jan-24, amidst the increase in Food inflation which turned positive in Dec-23.

12/15



10/10



10/10



CBSL Holdings

CBSL holdings declined to LKR 2,735.6Bn in Feb-24 from LKR 2,743.6Bn towards the end of Dec-23.



Changes to Health Score

Secondary Criteria – Jan-24

16/25

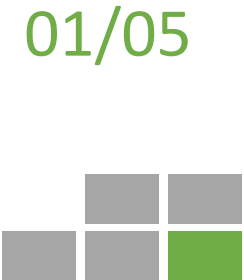
Previous score

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.

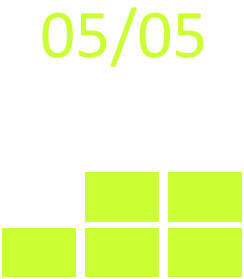


05/05



External Environment

FOREX market remained volatile throughout 2023, with USD/LKR appreciating by 3.8% YTD during the month of Feb-24.

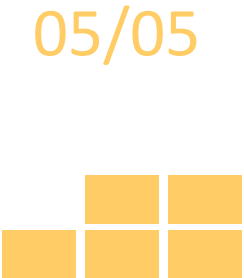


05/05

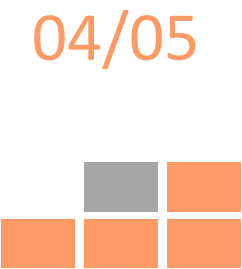


BOT & BOP

Trade deficit shrunk cf. Nov-23 and recorded at USD 487.0Mn in Dec-23 while BOP remained a surplus and recorded at USD 2.8Bn amidst the rise in foreign inflow from tourism and worker remittances.



Previous score

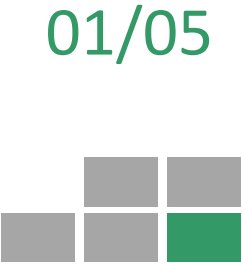


Political Risk

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

04/05





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.

01/05

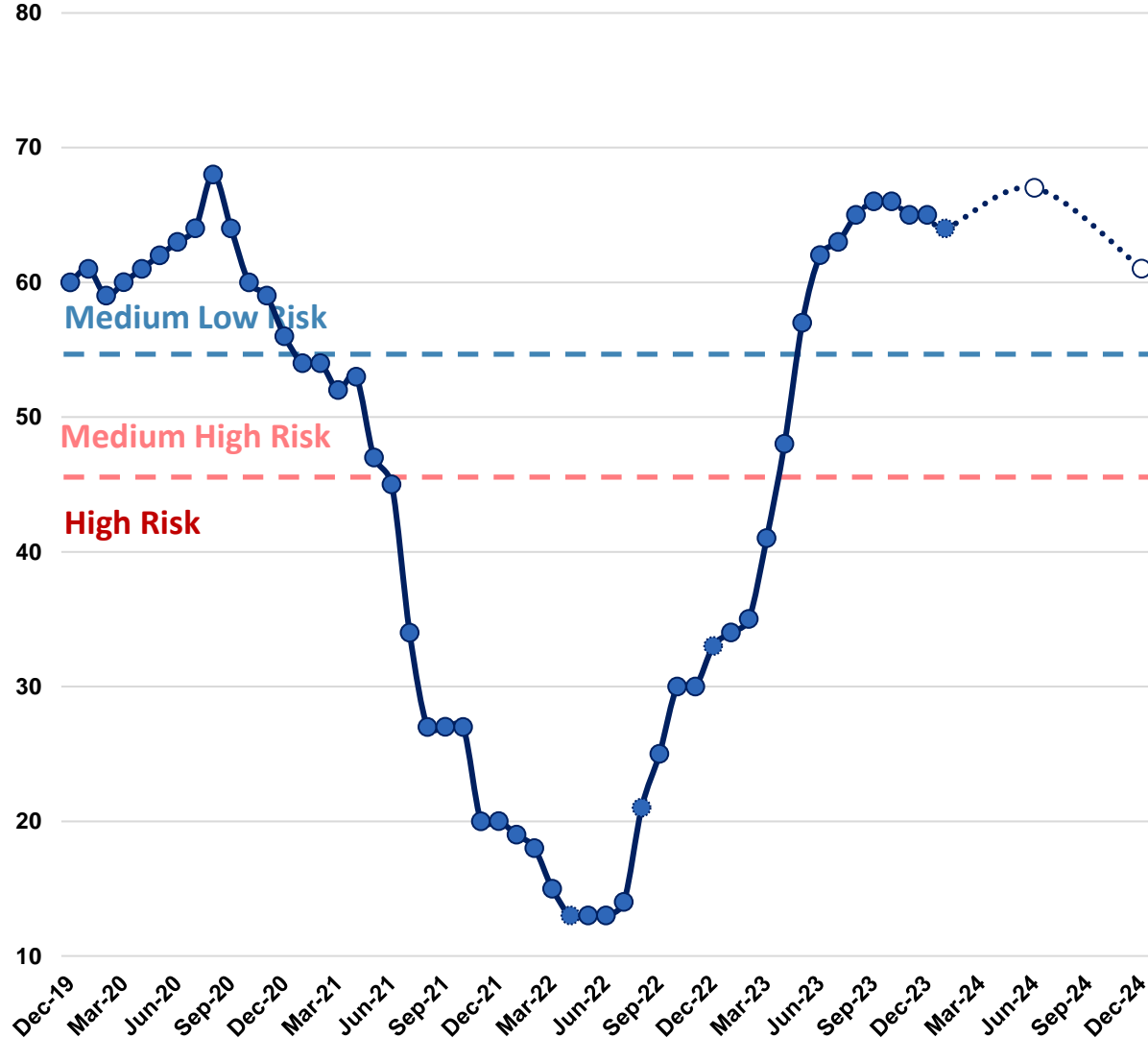




5.0 New Recommendation

“Taking profits in declining interest rates”

First Capital Fixed Income Health Score



First Capital FI Health Score remains strong in the low-risk territory

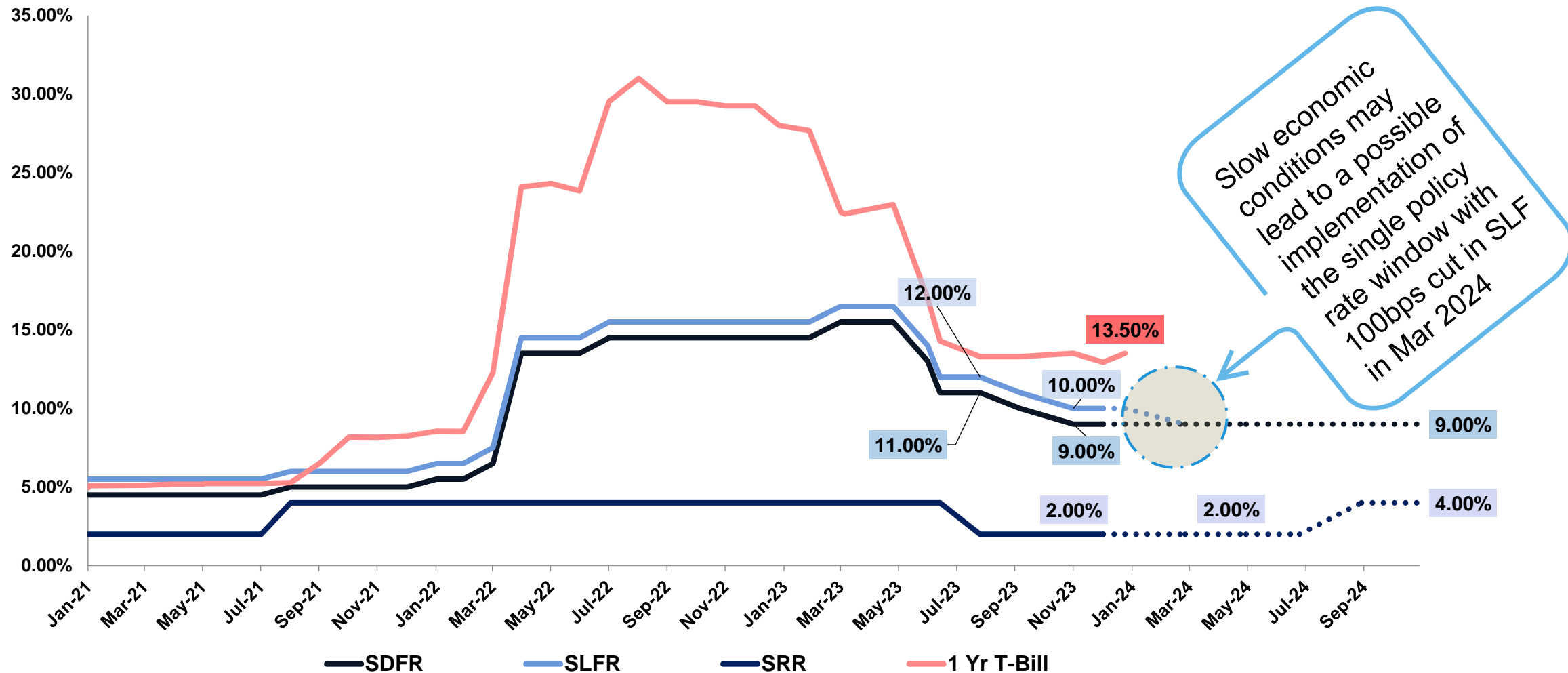
- Similar to the past 2-3 months throughout 1H2024 considering improvement in economic health, we expect Fixed Income Health Score to remain strong with minimum impact on creating pressure on interest rates maintaining the current low interest rate environment and potentially falling lower, aided by completion of the 2nd review of IMF, possible decline CBSL SLF rate, investor confidence amidst the completion of the External Debt Restructuring and the subsequent potential rating upgrade coupled with improvement in foreign activity.
- However, beyond Jun-24, FI health score is expected to dip gradually towards Medium-Low risk territory, on pent up credit pressure and election uncertainty.

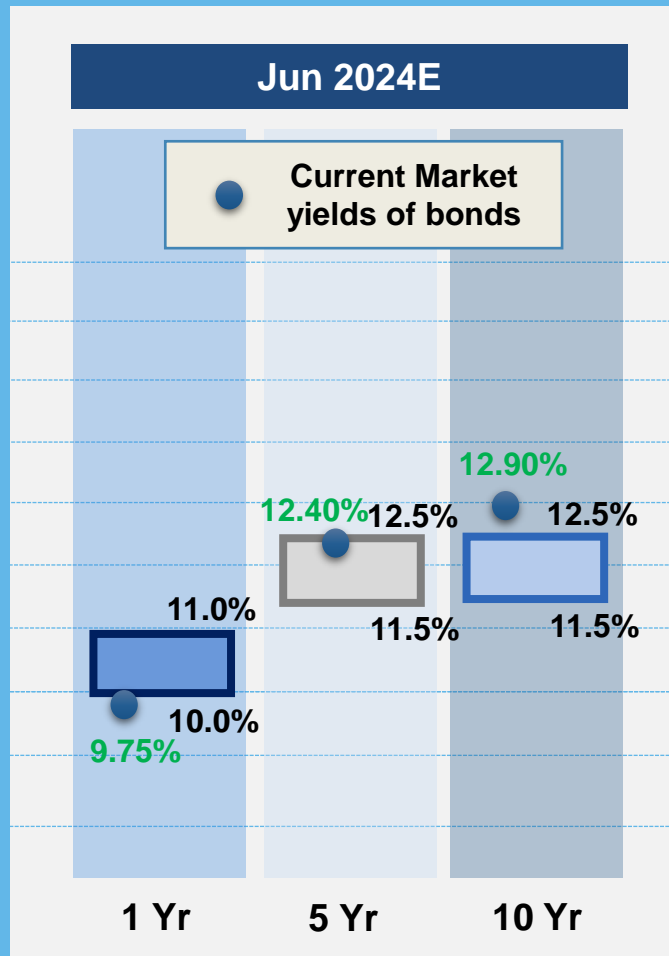


Policy rate cuts to take a pause;

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

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Source: First Capital Research

Expectation: Bond Yield to continue downtrend in 1H2024 to reach 10.0%-12.5%.

The overall yield curve witnessed a sharp downturn since our last report and currently hovers around our Jun-24 target of 10.0%-12.5%. The significant drop in yields were driven primarily by the lower borrowing requirement of the government, in the wake of higher revenue collection and suspended service costs, which enable GoSL to post a primary account surplus.

However, we believe that the present circumstances of the economy is correctly reflected in the current yield curve and key catalysts such as,

- *External Debt Restructuring,*
- *Successful completion of the IMF 2nd review and approval of the 3rd tranche, and*
- *possible reduction of a further 100bps on SLF to bring down to a single policy rate guidance window,*

needs to be completed to bring the yields down further to our Jun-24 lower guidance level.

Yield Curve nears bottoming out; But further downside possible

Recommendation: **Book Profits** as yields falls

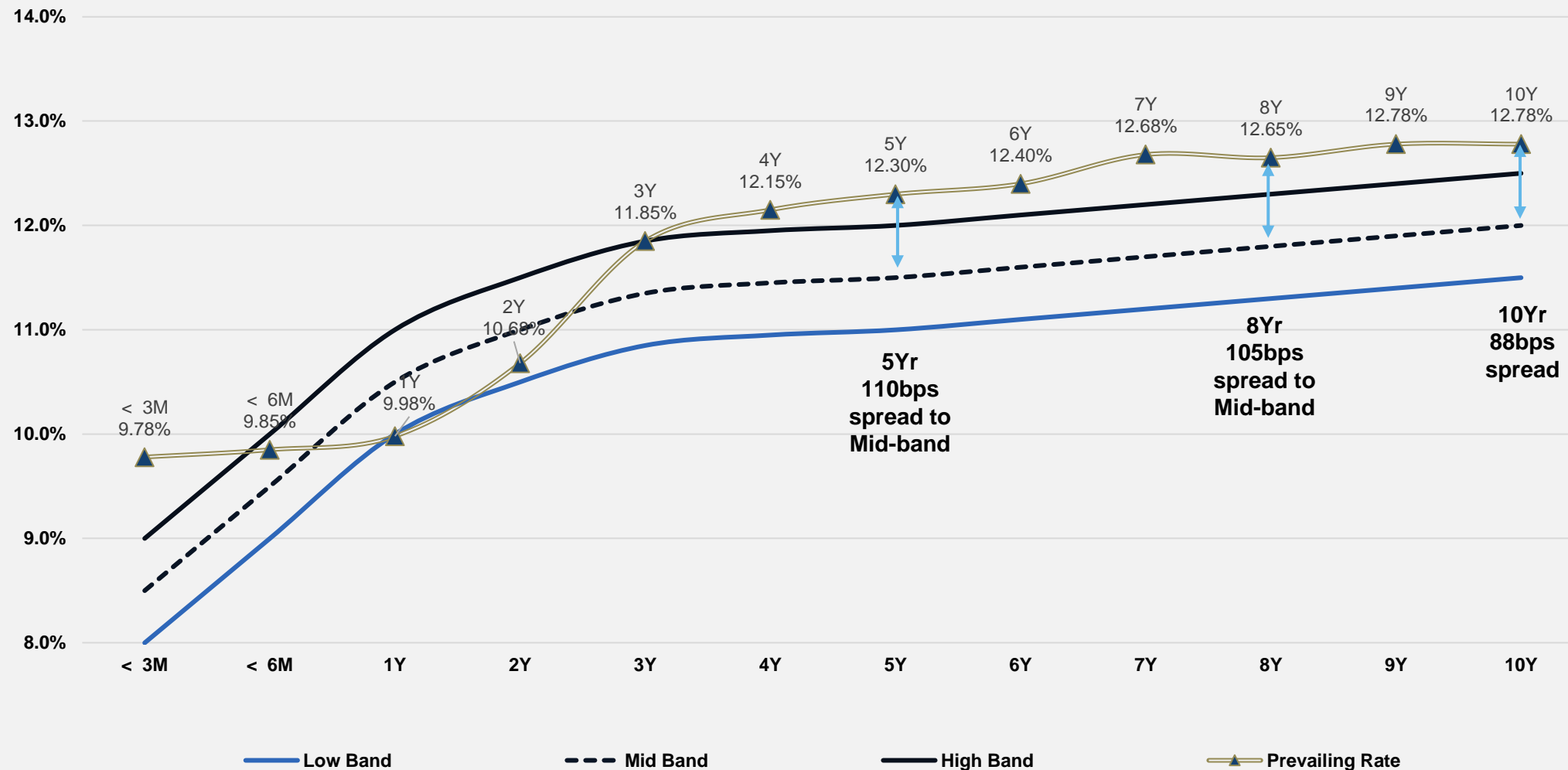
Jun-24 targets hit ahead of our timeline. In-line with our Jan-24 forecast, yields fell below the 13.00% mark, offering opportunities to gradually reduce portfolios and take profits. With the faster than anticipated reduction in yields, short and mid tenures currently trades between 9.75%-12.50%, below our Jun-24 lower guidance, whilst long-term tenures hovers around 12.90% levels, slightly above our guidance. Thus, we recommend investors to gradually reduce their portfolios and book profits as yields decline towards the 12.00% mark and below.

Further opportunities in the horizon. However, we believe there is a further possible downside across the yield curve upon completion of the following milestones.

- ❖ *Possible downward adjustment of SLF by 100bps at the Mar-24 policy review, to bring down the policy rates to a single guidance window.*
- ❖ *Finalization of External Debt Restructuring and approval of the IMF 3rd tranche.*
- ❖ *Possible upward revision of Sri Lanka's credit rating by rating agencies, in-line with the rating upgrade on local currency following the completion of domestic debt optimization in Sep-23. We believe this can also trigger foreign investments to government securities, which could further boost prospects for further downward movement of yields.*



Mid-Long tenors may have further room for yields to move down



Source: First Capital Research



Key Risks for consideration



Uncertainty of External Debt Restructuring:

The finalization of the External Debt Negotiations with private creditors have faced significant delays, given the wide number of stakeholders involved and complicated nature of the outstanding debt maturities. In an event where GoSL fails to arrive at a consensus with the private creditors, GoSL may have to negotiate with both the multilaterals and domestic investors, which may hinder the process and increase the risks of the outstanding debt. We believe this may also cause a delay in obtaining the 3rd tranche from the IMF, which may result in hampered investor and consumer confidence, which can prolong the economic recovery timelines.



Minute foreign investments to government securities:

Total foreign investments to government securities witnessed a steep decline of LKR 1.0Tn. The announcement of default of outstanding debt together with the downgrading of credit ratings from multiple agencies to Restricted Default (RD) caused the sell off in government securities. In an event where GoSL fails to restructure its debt, we believe that the expected rating upgrades will not take place, and further hamper investment towards fixed income securities.



Lower demand for government securities:

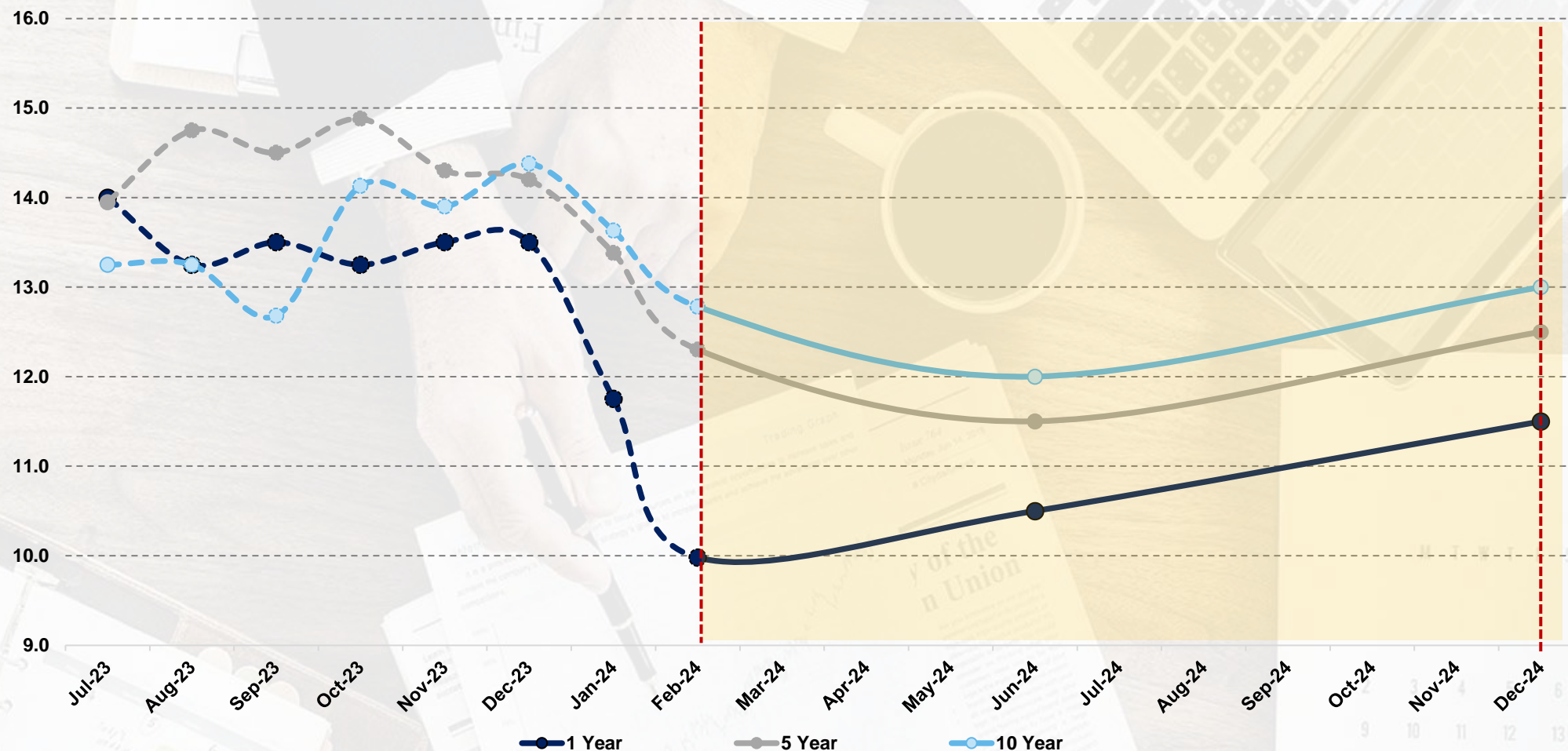
With rates hovering below 10% mark on short end and around 12% level towards the mid and belly end of the curve, we believe that there is limited upside on the curve in the coming months ahead. Together with limited returns, coupled with attractive opportunities for equity investments (with the added incentive of tax-free returns), we believe demand for government securities may be constraint in the coming months.



2H2024 is likely to witness upward pressure in the yield (rise of 100bps)

23

Bond yields may rise during 2H2024



Source: First Capital Research



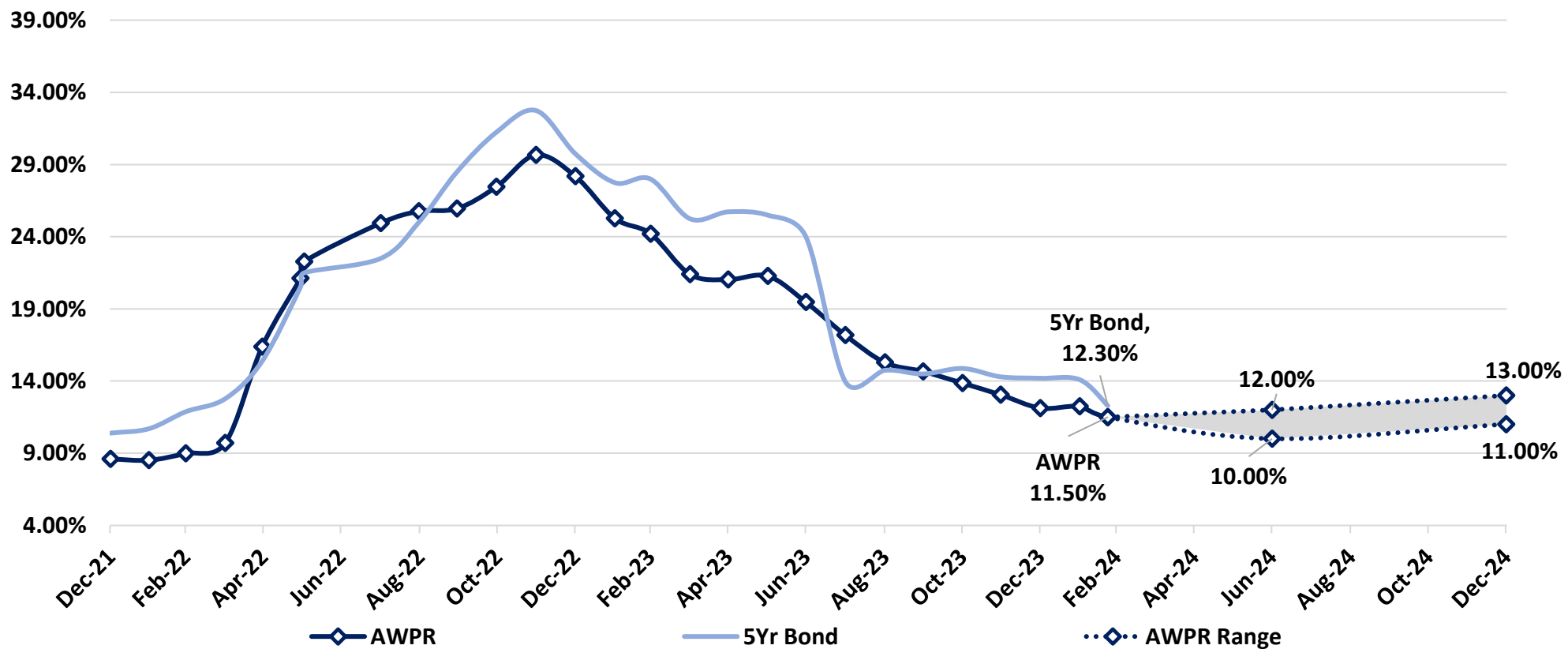
5.0 AWPR Recommendation

*“AWPR on track to our 10.0%-12.0%
target by Jun-24”*



AWPR expectations maintained at a range of 10.0%-12.0% by Jun-24

Expectations for AWPR



Source: First Capital Research



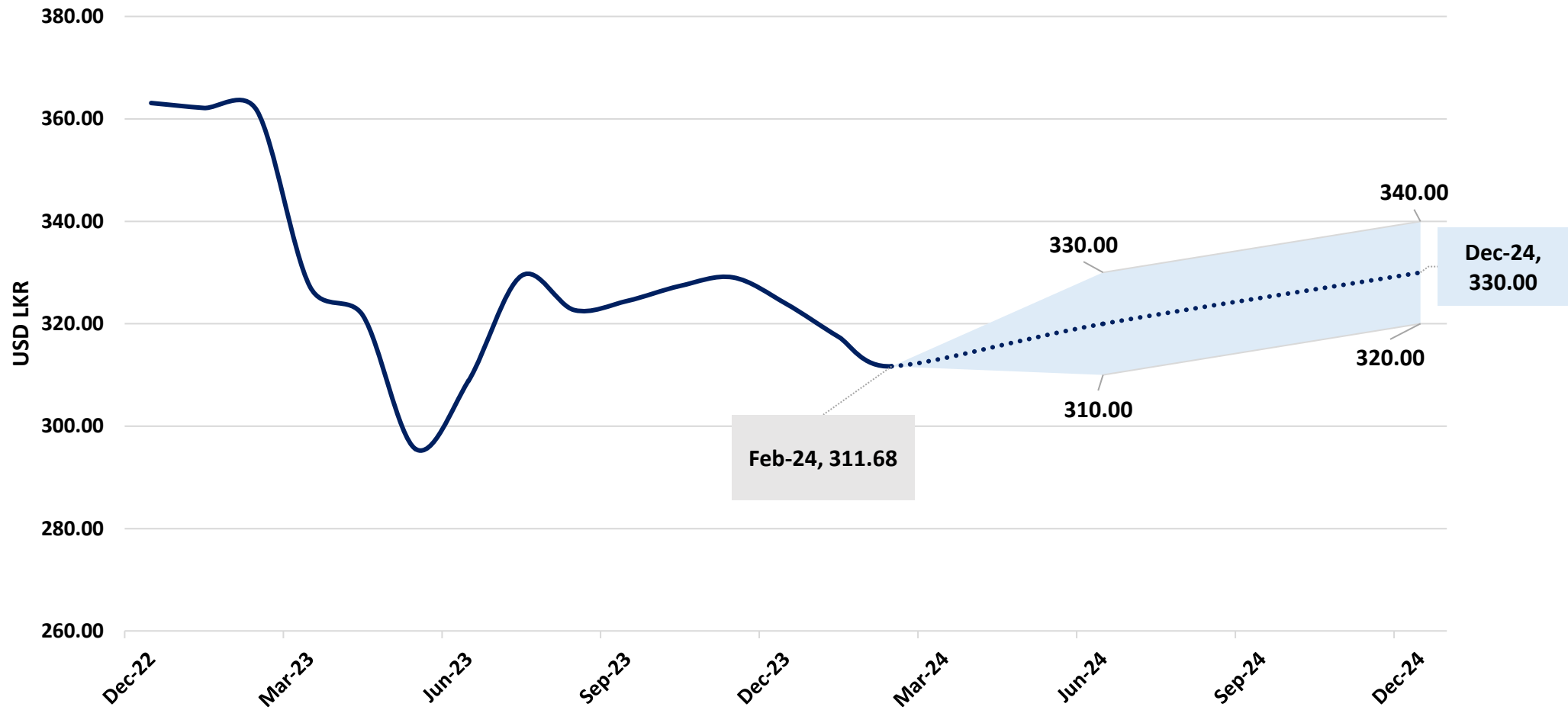
6.0

Exchange Rate Recommendation

“LKR expected to gradually depreciate as economy picks up”



Exchange Rate maintained with LKR 310.0-330.0 for 1H2024



Source: CBSL, First Capital Research



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*"SUCCESSFUL INVESTMENTS IS ABOUT
MANAGING RISKS"*

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