



**ALL OR NOTHING TRADING OPPORTUNITY**

**FLASH NOTE**

**DEAL WITH IMF TO FURTHER PUSH DOWN YIELDS...**

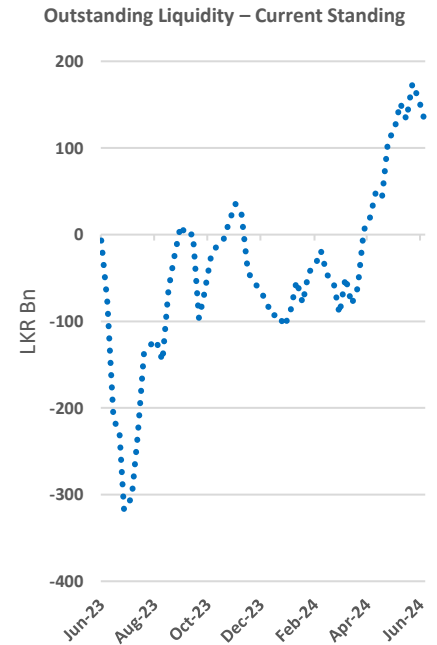
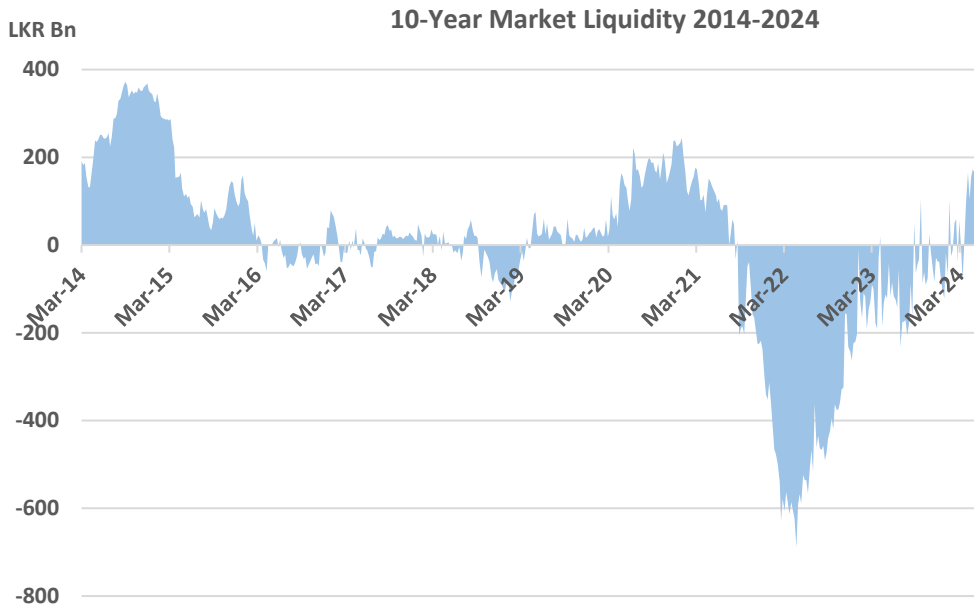
**June targets hit ahead of our expectations.** As mentioned in our previous FI update, the short tenors have fallen below our target whilst the mid tenor hovers between our Jun-24 target of 11.0%-12.0%. However, the long tenors are currently trading slightly above our target of 11.0%-12.0%.

**Large Auction an opportunity to accumulate:** With yield curve near bottoming out across all tenors, the upcoming bond auction for LKR 295.0Bn announced by CBSL, offers a strong opportunity to accumulate before re-rating of the yield curve. CBSL expects to raise LKR 60.0Bn from the 15.10.2027 maturity, whilst LKR 125.0Bn and LKR 110.0Bn are expected to be raised from 15.09.2029 and 01.12.2031 tenors, respectively.

**FIRST CAPITAL RESEARCH**

**Ranjan Ranatunga** +94 11 263 9863  
[ranjan@firstcapital.lk](mailto:ranjan@firstcapital.lk)

LKR Bn		
Bond	Coupon	Amount Raised
15-Oct-27	10.30%	60.0
15-Sep-29	11.00%	125.0
01-Dec-31	12.00%	110.0
<b>Total</b>		<b>295.0</b>



**Liquidity surge provides potential to bring down yields further.** Overnight liquidity in the banking sector improved significantly compared to 1Q2024 end yet remained volatile and recorded at LKR 145.6Bn as of 07<sup>th</sup> June 2024, after hitting the highest of LKR 200.7Bn on 30<sup>th</sup> May 2024 (highest since Jan-21). With private sector credit growth recording a decline of LKR 16.2Bn in Apr-24 largely due to holiday season, we expect private sector credit to remain weak in the current months, as spreads maintained by banks continue to remain slightly high compared to the AWPLR (AWPLR stood at 13.14% in Apr-24 cf. AWPLR of 10.13% in Apr-24 and 9.65% in May-24).

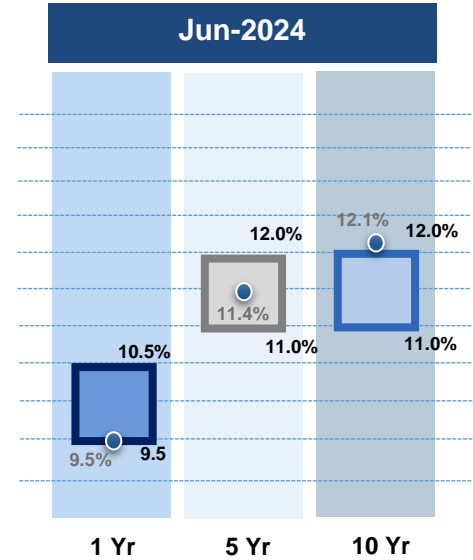
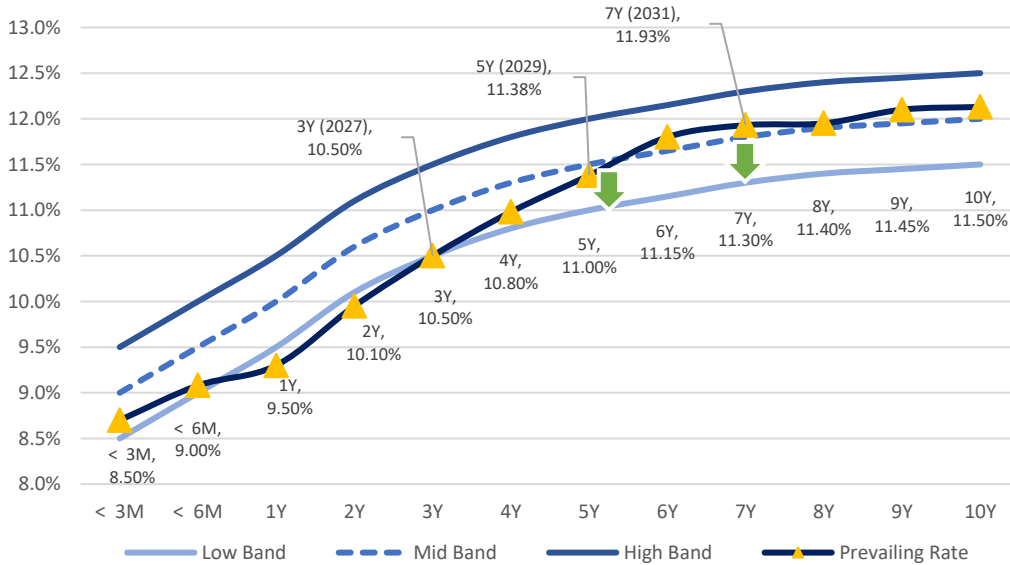
*“Liquidity hits LKR 200.7Bn in May-24, highest since Jan-21”*

**Recovery in economic indicators further supports the case for decline in yields.** Since our last update in May, economic indicators have remained stable with gross official reserves maintained at USD 5.4Bn and CBSL Holdings of G-Sec’s declining slightly to LKR 2,615.6Bn as of 07<sup>th</sup> Jun 2024 from LKR 2,635.6Bn recorded in May-24 end. Moreover, CCPI inflation for May-24 was recorded at 0.9%, below our estimate of 4.8%, as pressure from food inflation subsided. We expect inflation to remain timid and below the CBSL guidance of 5% in the next few months, largely benefitted by the downward revision of electricity and fuel prices, which is expected to bring down non-food inflation in the absence of demand pressure in the system.



**Opportunity to maximize gains with possible completion of trigger events.** With short term tenors trading below the lower band of the curve, whilst the mid to long tenors trading slightly above, we identify the upcoming bond auction, as possible trading opportunity for investors. We believe, the opportunity largely lies within the 5-Yr (2029) and the 7-Yr (2031) tenors, given that the improving liquidity, together with the completion of EDR and 2<sup>nd</sup> review are expected to lift the uncertainty adjusting the mid to long tenors down towards the lower band of the yield curve.

*“Mid to Longer tenors offer a trading opportunity with a possible downward shift in yield curve by 50-150bps compared to 1yr”*



**Spreads narrow in high liquidity periods:** Historically in period of LKR 150Bn+ levels of liquidity, significant decline in spreads have been noticed. According to our analysis in Annexure 2 & 3 during period 2012-16 and 2016-21, 1Yr-5Yr average spreads have been around 145bps and 135bps while in Annexure 1 within 2008-12 it has been 78bps. In terms of 5Yr-10Yr spreads, Annexure 2 & 3 illustrates periods 2012-16 and 2016-21 with spreads of 56bps and 50bps respectively while in 2008-12 it has been around 25bps.

**Bonds Spreads to normal post EDR:** Sri Lanka is currently in the final stages of debt restructuring to bring down 2032 debt to GDP ratio to 95% and achieve debt sustainability, in line with the IMF targets. Therefore, we believe the upcoming 2<sup>nd</sup> review of the IMF to be crucial, given it marks the completion of EDR. With the return of debt sustainability, coupled with a possible foreign currency credit rating upgrade, we believe there is a possibility for spreads to normalize, with 1Yr-5Yr spread re-rating to 100-150bps, whilst a spread of 25-50bps can be expected between 5Yr-10Yr and the long tenor. Furthermore, continuous improvement in liquidity in an environment of limited private sector growth, is also expected to aid towards the downward revision of the yield curve. In line with the above yield curve expectations, 5-Yr and above yields are expected dip towards the lower bands of the curve.

**Recap FI Recommendation Report – May 2024:**

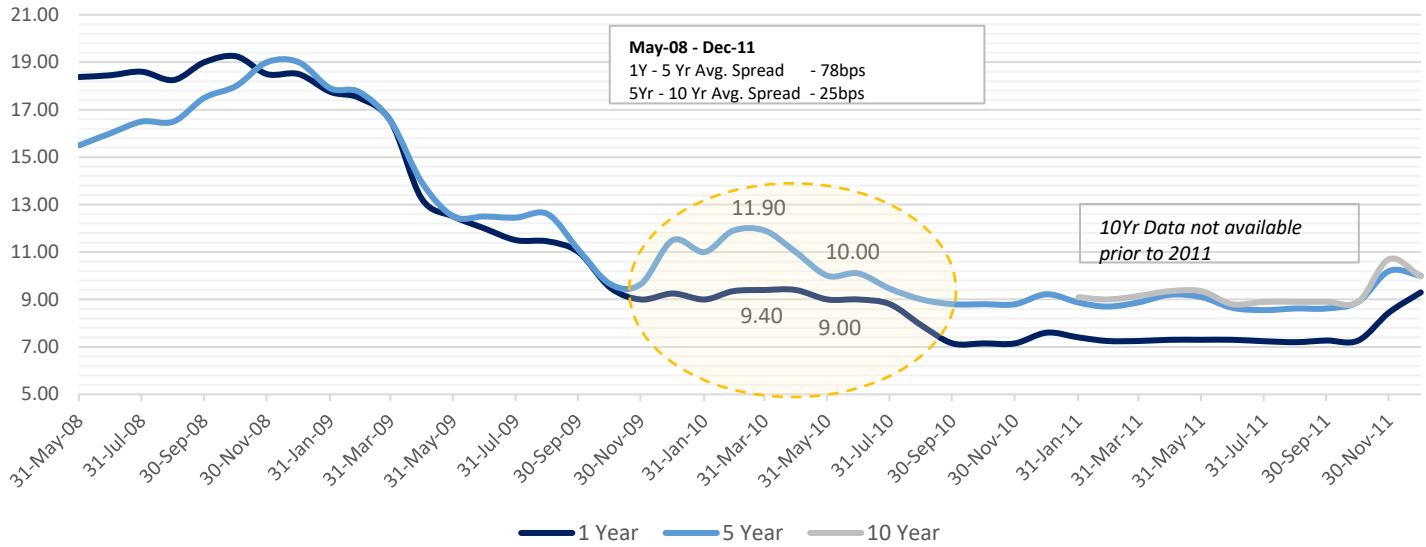
**Mid and long tenor yields to lower:** given the premature achievement of our Jun-24 targets, we believe that a timely completion of EDR, 3<sup>rd</sup> tranche of IMF and Rating Upgrade can further boost prospects for a downward adjustment of the yield curve. We expect further downward potential of 25-30bps on mid tenors while the long tenors have downward potential of 50-100bps. However, we recommend a **SELL** on the short tenors which fallen steeply below our expected guidance levels.



## Annexures: Yield Curve and Spread Comparison in periods 2008-12, 2012-16, 2016-22

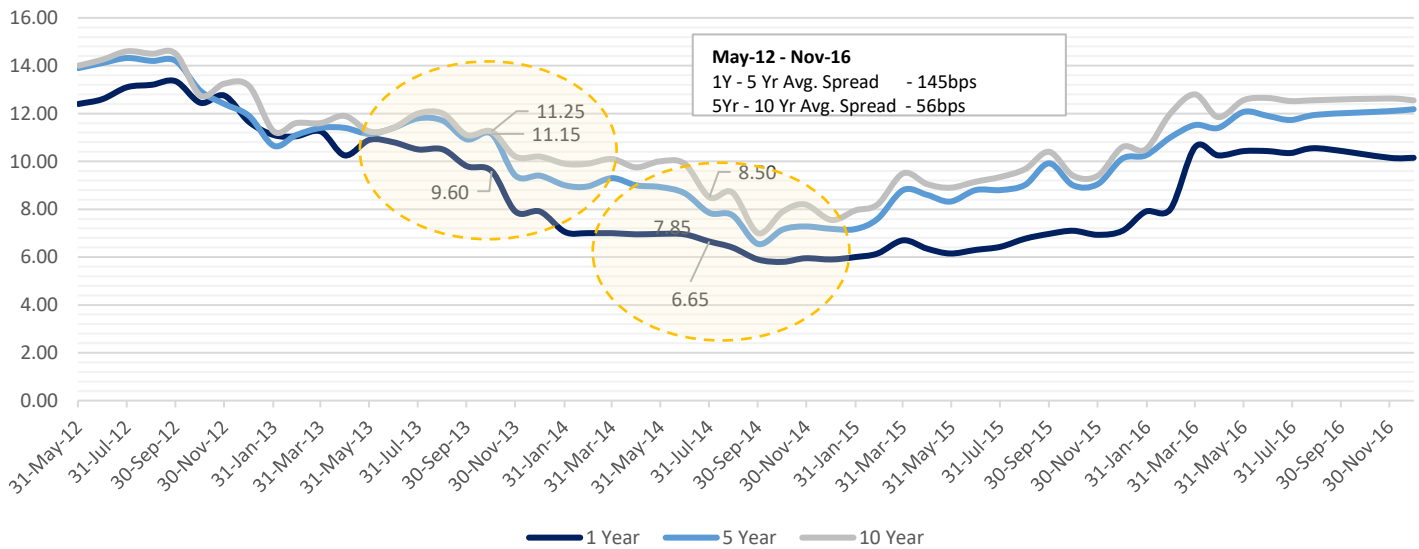
### Annexure 1

#### Yield Movement 2008-12



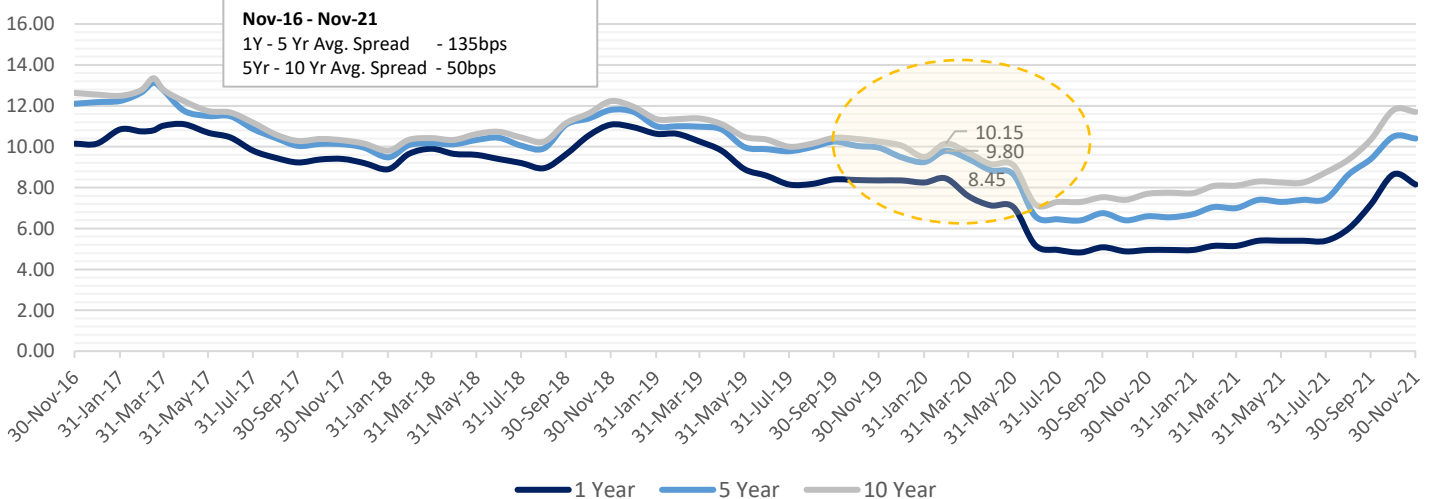
### Annexure 2

#### Yield Movement 2012-16



### Annexure 3

#### Yield Movement 2016-21





**First Capital**  
A Janashakthi Group Company

# First Capital Holdings PLC

No.2, Deal Place,  
Colombo 3

Tel: +94 11 2145 000  
Fax: +94 11 2145 050

## RESEARCH

Dimantha Mathew	+94 11 2639 853	Zaeema Jihan	+94 11 2639 866
Ranjan Ranatunga	+94 11 2639 863	Anjali Mathews	+94 11 2639 866
Vinodhini Rajapoopathy	+94 11 2639 866	Nethmi Fernando	+94 11 2639 866
Tharusha Ashokgar	+94 11 2639 866		

## GOVERNMENT SECURITIES SALES

Anjelo Simmons	+94 77 3031 636	Arun Kandasamy	+94 75 4861 506
Anushka Dissanayake	+94 77 2220 021		
Anushi Ranawaka	+94 77 3876 819		

## CORPORATE DEBT SALES

Tharusha Ekanayake	+ 94 77 7 809 154
--------------------	-------------------

## EQUITY SALES

<b>CEO</b>	Jaliya Wijeratne	+94 70 2910 042
------------	------------------	-----------------

### Colombo

Rasika Indra Kumara	+94 77 7072 698	Anjelo LaBrooy	+94 77 7546 645
Isuru Jayawardena	+94 76 7084 953	Dillon Lowe	+94 76 616 0647
Nishantha Mudalige	+94 70 2910 041	Evelyn John	+94 77 779 2452
Anushka Buddhika	+94 71 4310 600	Yudheshan Kannadasan	+94 77 415 5809
Thushara Pathiraja	+94 70 2910 037		

### Negombo

Priyanka Anuruddha	+94 70 2910 035	Priyantha Wijesiri	+94 70 2910 036
--------------------	-----------------	--------------------	-----------------

## UNIT TRUST SALES

Kavin Karunamoorthy	+94 77 0328 060	Imali Abeygunawardena	+94 77 1764 799
---------------------	-----------------	-----------------------	-----------------

## BRANCHES

<b>Kandy</b>	<b>Kurunegala</b>	<b>Matara</b>	<b>Negombo</b>
CSE Branch Office, No. 88, Dalada Veediya, Kandy 20000.	No.174/B2, Negombo Road, Kurunegala. Kurunegala 60000.	CSE Branch Office, 1 st Floor, E.H.Cooray Tower, No.24, Anagarika Dharmapala Mawatha, Matara 81000.	Colombo Stock Exchange Negombo Branch Office, No. 72 A, 2/1, Old Chilaw Road, Negombo 11500.
<b>Manager: Salinda Samarakoon</b>	<b>Manager:</b>	<b>Manager: Rohana Jayakody</b>	<b>Manager:</b>
Tel: +94 81 2236 010	Tel: +94 37 2222 930	Tel: +94 41 2222 988	Tel: +94 31 4937 072

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