Steady, but Slow

Mid-Year Outlook | Jul 2025 | SRI LANKA

Analyst:
Ranjan Ranatunga
ranjan@firstcapital.lk

First Capital
A Janashakthi Group Company

Executive Summary 3

01 Track Record [Aug 2024 & Jan 2025] 4

02 Key Elements of consideration for Mid-2025 Outlook 14

03 Political stability reinforced: Low Risk 17

04 Recovery on course; Growth remains slow: Medium-Low Risk 20

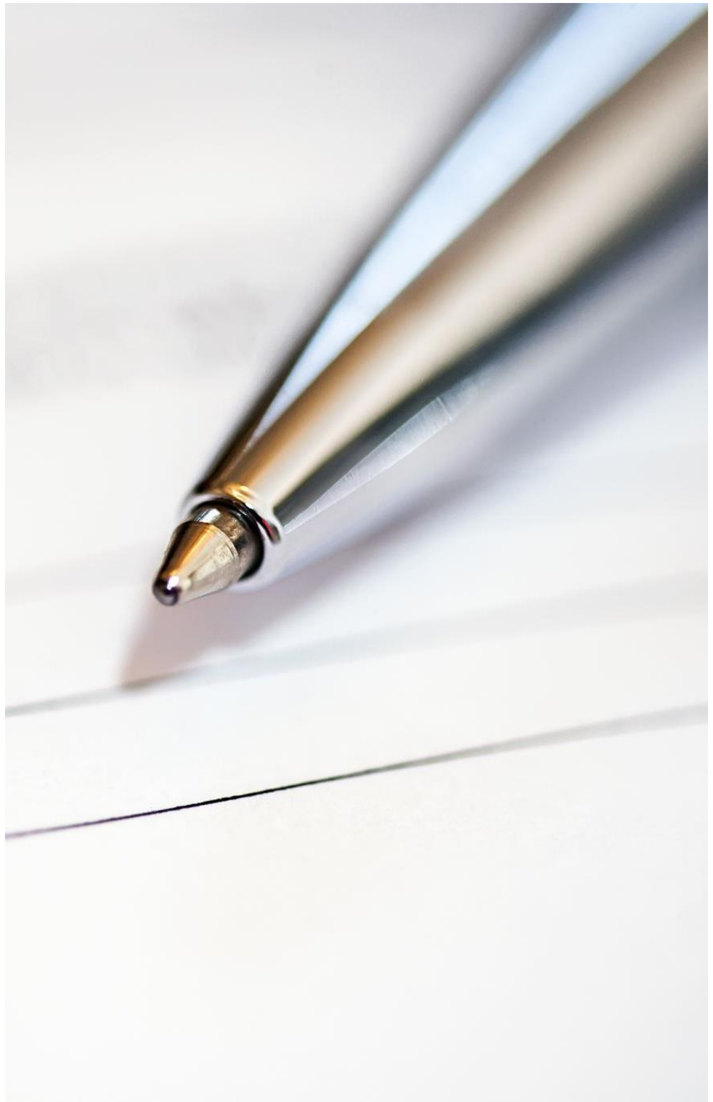
05 External Outlook volatility persists: Medium-Low Risk 40

06 Investment Risks 45

07 Recommendations 48

- First Capital Research View on Bond Market Jul’25-Jun’26 49
- First Capital Research View on Banking Rates Jul’25-Jun’26 58
- First Capital Research View on Exchange Rates Jul’25-Jun’26 60
- First Capital Research View on Equity Market Jul’25-Jun’26 62

EXECUTIVE SUMMARY



Bond yields to remain stable, recommendation maintained to shift to short tenures with a willingness to run a carry portfolio

- FCR anticipates another 25bps rate cut during 3Q2025E to counter the slow growth in the economy whilst ensuring that inflation returns to CBSL envisaged target of 5%. Moreover, return of market liquidity back to LKR 150.0Bn mark coupled with expectations of reserves strengthening to FCR forecasted USD 7.0Bn (2025E) aided by inflows from multilateral funders are expected to enable the proposed rate cut of 25bps during 3Q2025E.
- Yield curve bands upgraded with 1Yr tenure adjusted down by 100bps whilst 5Yr and 10Yr adjusted down by 50bps respectively. With rates already hovering near our lower bands of the revised target, we expect near to low further downside on the yield curve. Therefore, we continue to maintain our recommendation to shift to short tenures with a willingness to run a carry portfolio.

AWPR to hover between 7.5%-8.5% for 2H2025 and reach 8.0%-9. 0% in 1H2026

- Possibility for another 25bps rate cut, gives potential for a further downward shift in our outlook for AWPR to between 7.5% - 8.5% for 2H2025E whilst pick up in both private and state sector credit is expected to reduce liquidity in 1H2026E, pushing AWPR to our upgraded target of 8.0%- 9.0%.

Exchange Rate outlook extended for 2H2026E at LKR 305.0 – LKR 315.0

- Driven by aggressive USD purchases by the CBSL aided by the positive current account balance, exchange rate hovers around the LKR 300.0 mark. Looking ahead, Sri Lanka's currency is expected depreciate slightly caused by widening trade deficit and slowdown in exports.

ASPI Dec-25 fair value upgraded to 18,000-19,000 and introduced a new fair value of 21,000-22,000 for 2026E

- With listed corporate earnings expected undergo a sizeable jump of 25.0%YoY in 2025E coupled with 2 consecutive years of double digit growth, predominantly led by John Keells Holdings with the commissioning of its mega projects, improved profits from F&B and banks, coupled with expectations of prolonged low-interest rate period, benefiting through improved participation and further shift in volumes from alternative asset classes to equities, are key catalyst towards the expected re-rating of the index to 10.0x from current 8.6x PE. On the back of this, FCR continues to remain bullish on equities, upgrading our set fair value for 2025E to 18,000-19,000 whilst introducing a new fair value of 21,000-22,000 for ASPI for 2026E.

Track Record [Aug 2024 & Jan 2025]

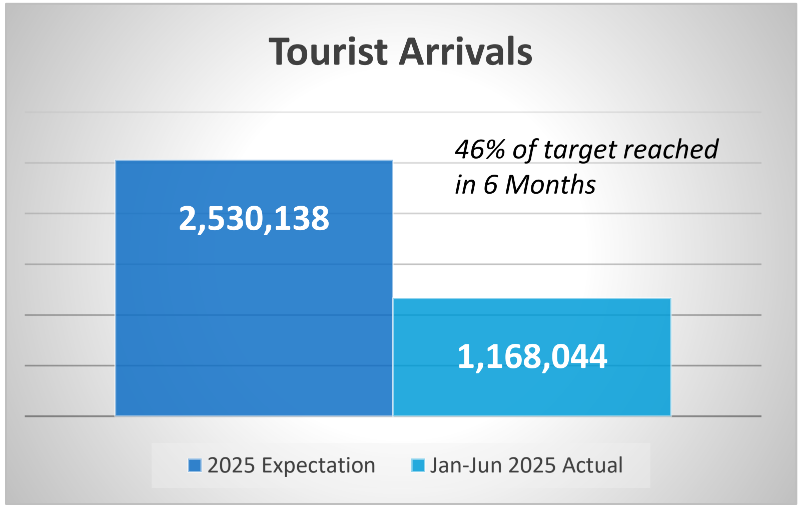
Section 1.0

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

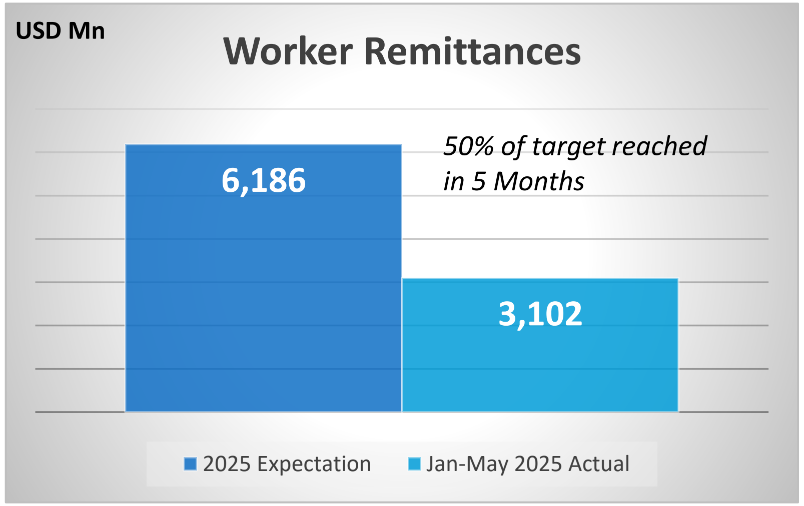
Previous Forecasts of Economic Indicators

Forecast: In line with expectations

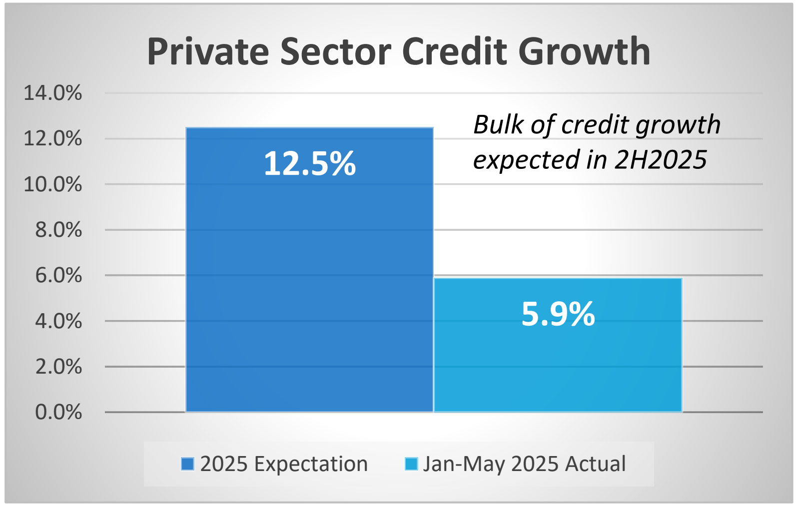


Forecast: In line with expectations

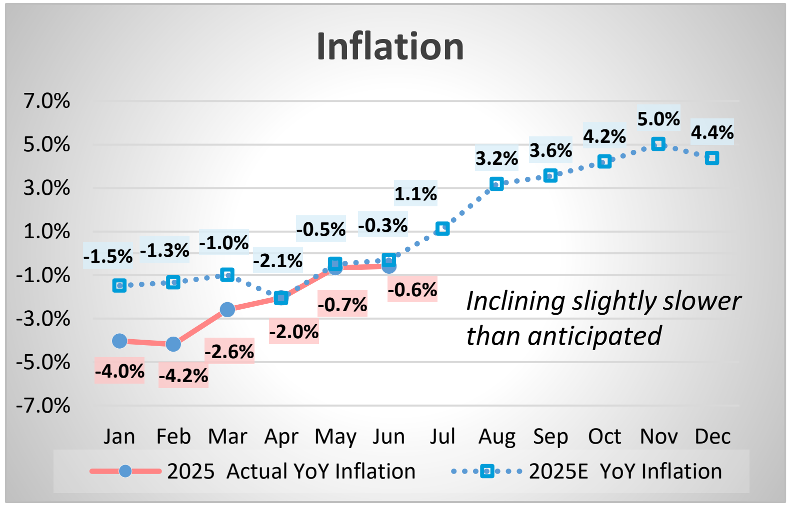
Forecast: In line with expectations



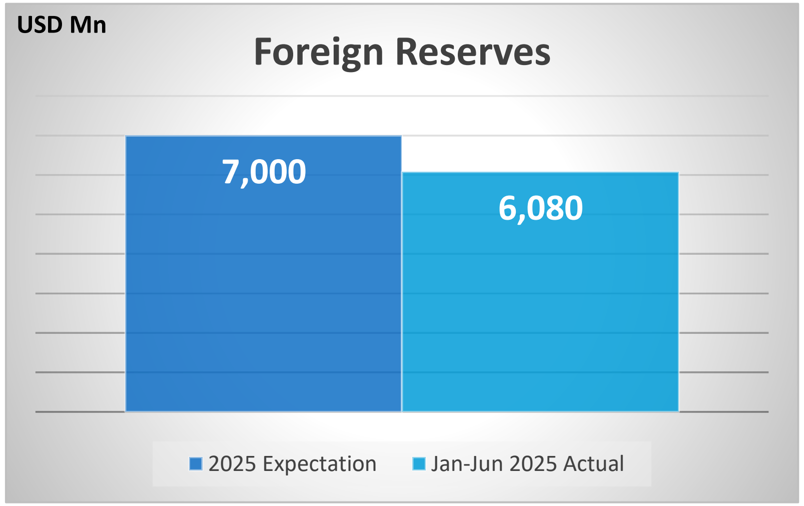
Forecast: In line with expectations



Forecast: Well below expectations



Forecast: Slow growth towards target



Source: CBSL, Dept. Census and Statistics, SLTDA, First Capital Research

Previous Recommendations - Bonds

First Capital
A Janashakthi Group Company

2H2024

21st Aug 2024 [Mid-Year Outlook 2024 Report]

"Mid to long tenors are likely to adjust downward by 100bps to 150bps to reach the mid band during 3Q2024."

Accurate

Yield curve recorded an accelerated downward shift in line with expectations

New Recommendation on 3rd Dec 2024 [FI Report]

"Mid to long tenors are likely to adjust downward by 50bps to 75bps to reach the low band till Dec-24 - Jan-25."

Accurate

50bps policy rate cut pushed the yields downward further

2025

16th Jan 2025 [Investment Strategy 2025 Report]

"2Q2025 onwards G-Sec yields are likely to witness upward pressure of c.100-150bps as the economy accelerates."

Inaccurate

The yield curve underwent a temporary decline on hopes of a rate cut, soon settled back to place as OPR was maintained at Jan & Mar policy meetings

New Recommendation on 28th Mar 2025 [FI Report]

"As previously anticipated (2H2025E), the expectation of the upward adjustment of the yield curve is delayed to 4Q2025E, given the surplus liquidity in the system and the delay in passing down of benefits of economic growth to major part of the economy."

Accurate

Excess liquidity pushed down rates as anticipated whilst 25bps policy rate cut pushed the yields down further

Source: CBSL, First Capital Research

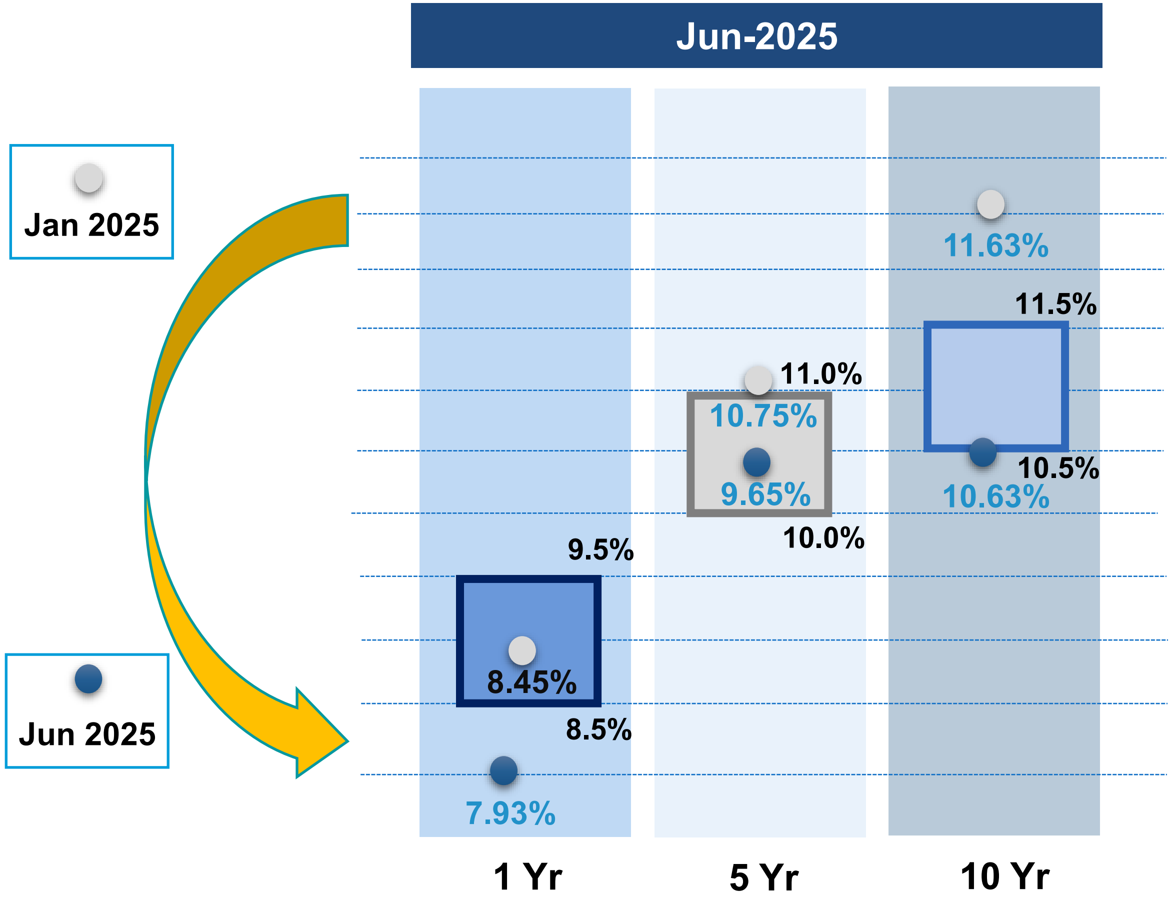
Previous Recommendations - Bonds

28th Mar 2025 [FI Report]

"As previously anticipated (2H2025E), the expectation of the upward adjustment of the yield curve is delayed to 4Q2025E, given the surplus liquidity in the system and the delay in passing down of benefits of economic growth to major part of the economy."

Accurate

Yield curve recorded an accelerated downward shift in line with expectations driven by surplus liquidity in the system amidst aggressive USD purchases by the CBSL whilst the policy rate cut in May, further pushed down yields

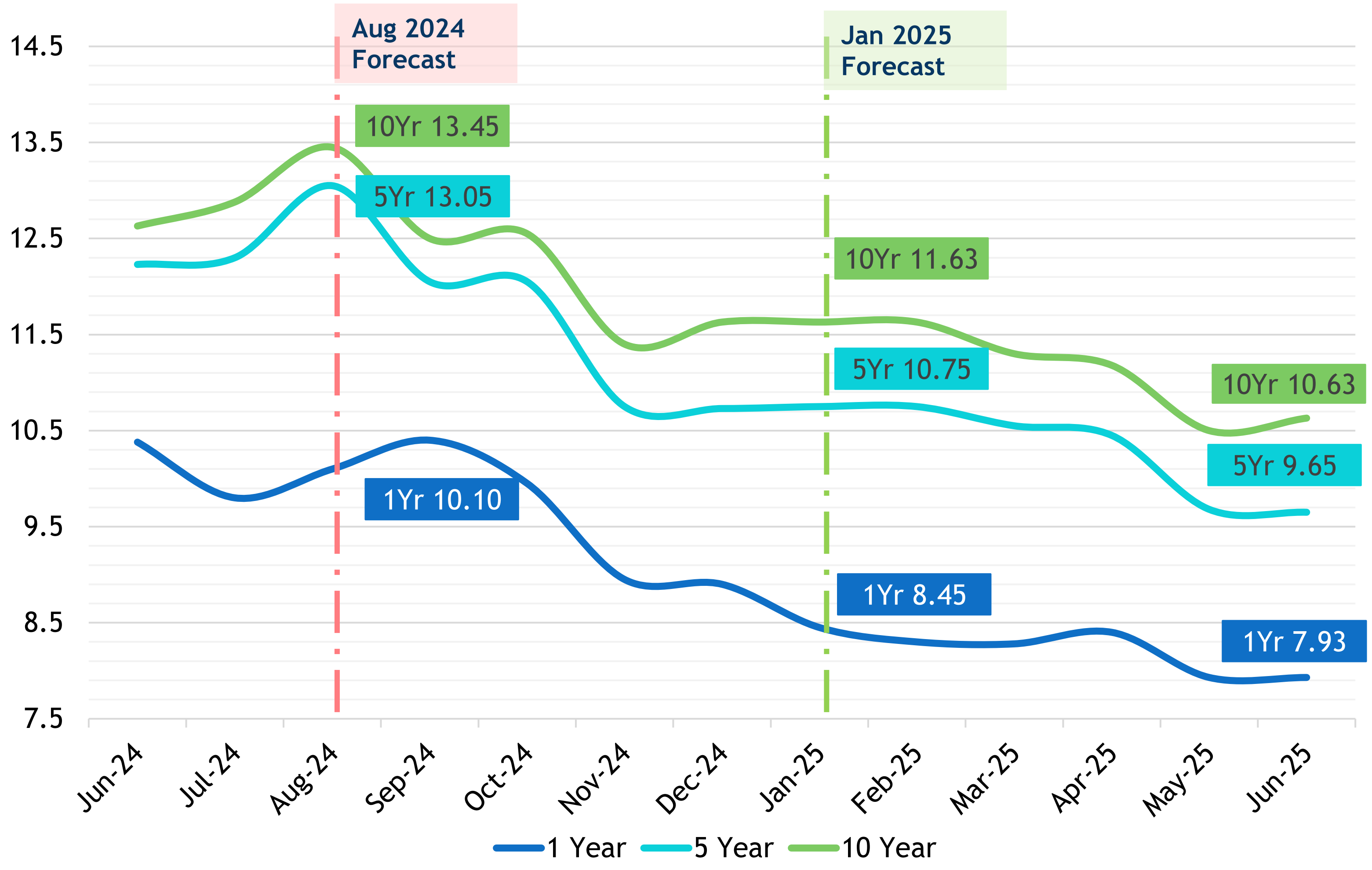


Source: First Capital Research

Bonds – Aug-24 & Jan-25 Re cap: Partly Accurate

Aug-24 - Mid to long tenors are likely to adjust downward by 100bps to 150bps to reach the mid band during 3Q2024

Jan-25 - Yields to rise 100-150bps over next 12 months



1Y - YTD 165 bps

5Y - YTD 230 bps

10Y - YTD 182 bps

6 Months 2024

Jul - Jan-25

1Y - YTD 52 bps

5Y - YTD 110 bps

10Y - YTD 100 bps

6 Months 2025

Jan - Jun

Policy Rates – Aug-24 & Jan-25 Re cap: Mostly Accurate

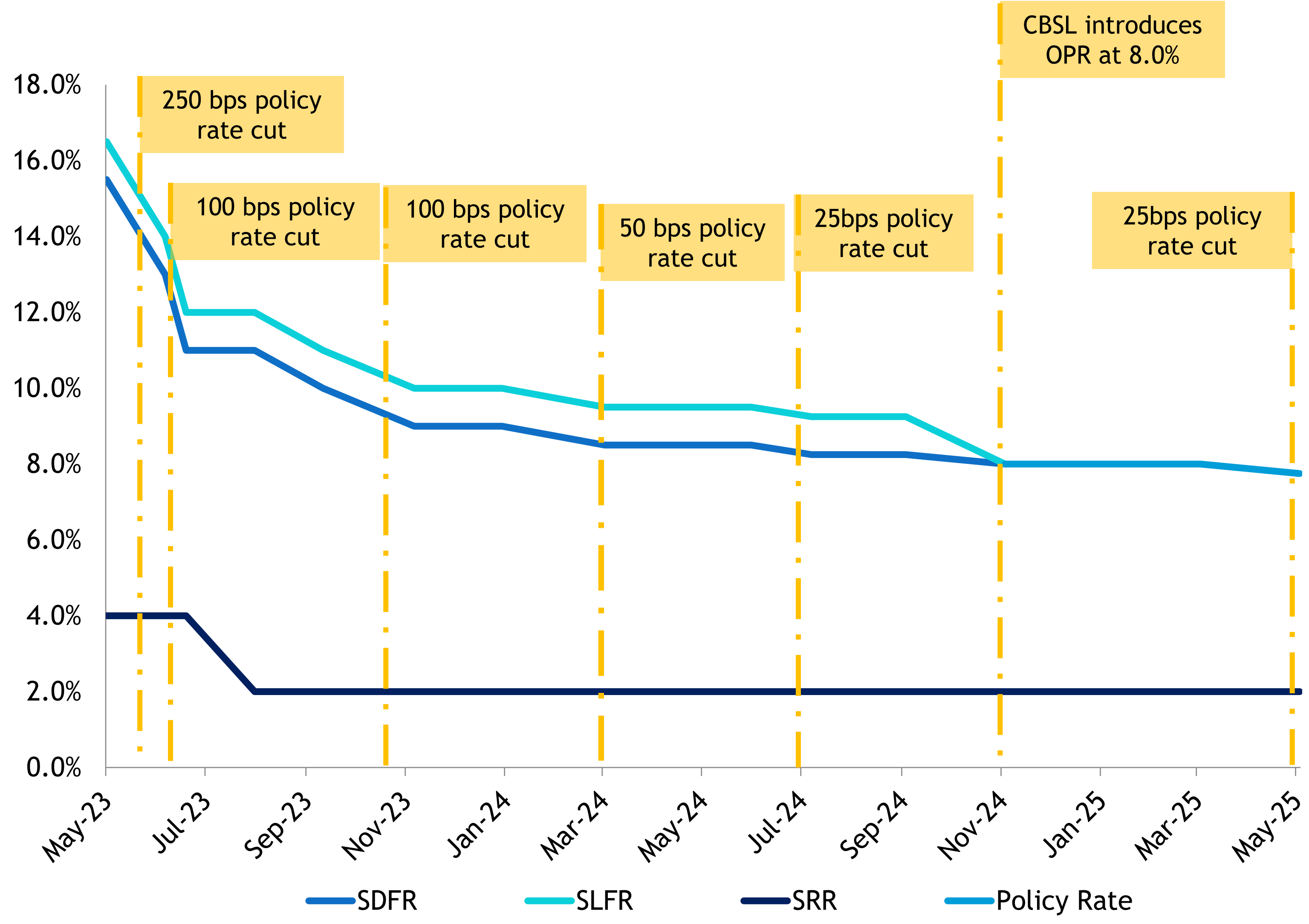
16th Jan 2025 - No change in policy rates over the next 12 months

Policy rates decline below expectations

After heavy declines in 1H & 2H of 2024, we expected rates to remain stable throughout 2025.

In line with expectations, the CBSL implemented single policy rate in the Nov-24 policy meeting and adjusted rates by 75bps to bring overnight policy rate (OPR) to 8.0%, which brought yields further down in-line with our expectations.

However, with the surge in liquidity during 1H2025, rates further adjusted bringing yields below our targeted levels.

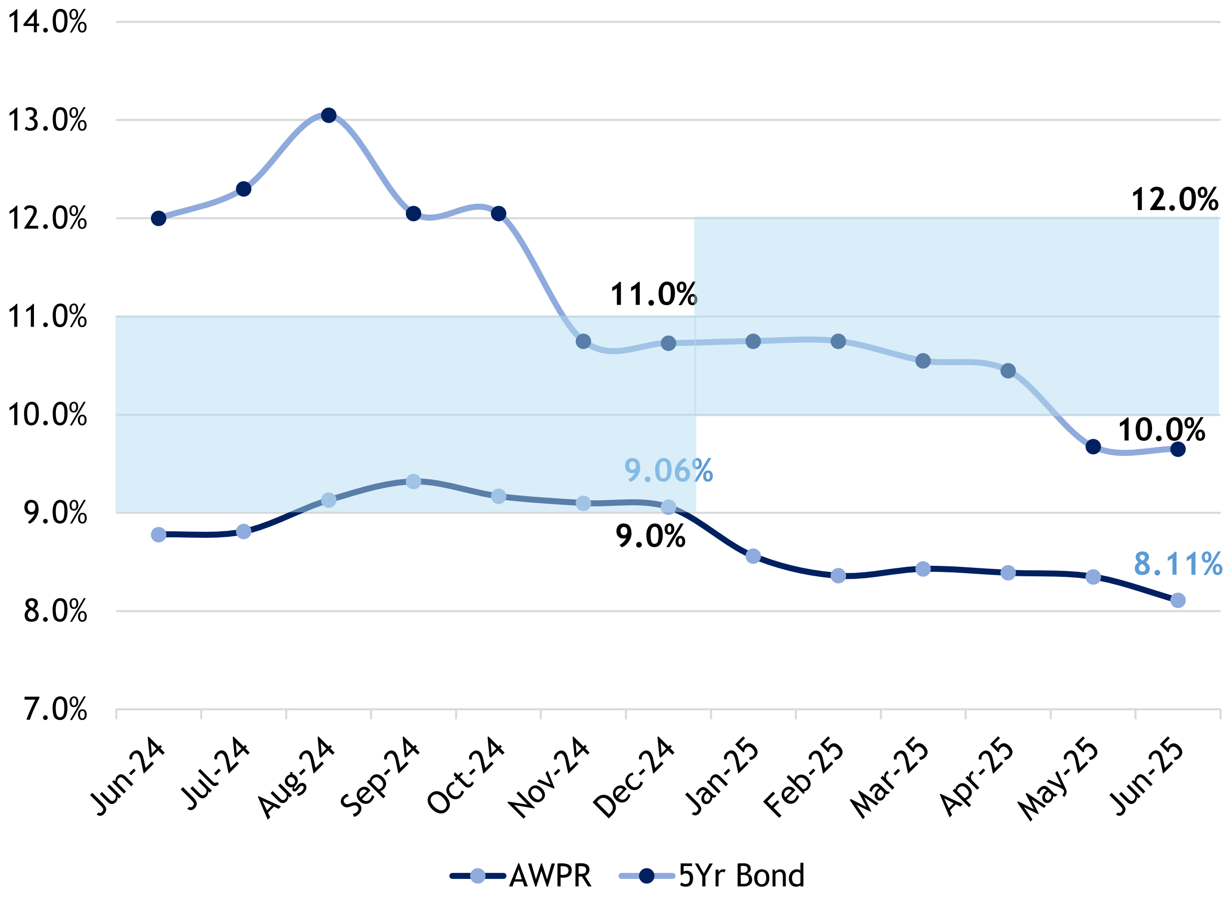


Source: CBSL, First Capital Research

Bank Rates – Aug-24 & Jan-25 Re cap: Partly Accurate

Aug-24 - AWPR to remain at 9.0%-11.0% for 2H2024 and reach 10.0%-12.0% in 1H2025

Jan-25 - AWPR may rise to 10.0%-12.0% during 1H2025 and 10.5%-12.5% in 2H2025



Review

AWPR broadly followed our expectation and hovered between 8.5% to 9.6% and gradually stabilized towards the lower end of the band during 2H2024 as demand for credit gradually accelerated.

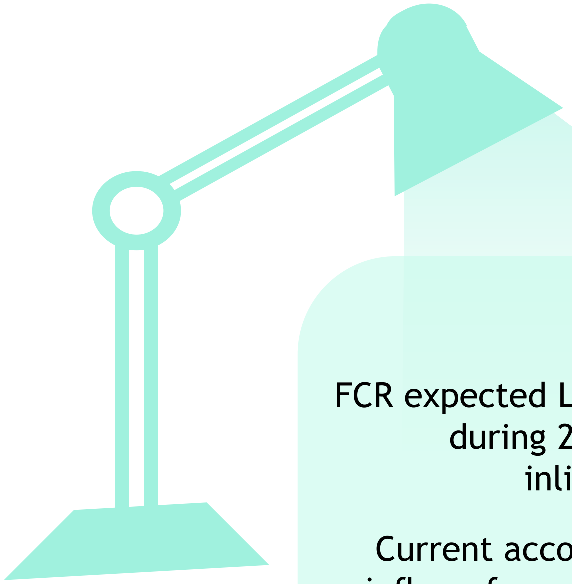
However, stable liquidity conditions prevailed during 1H2025, coupled with lower state credit and lower willingness to lend from banks, moved AWPR against our upwards AWPR projection.

Source: CBSL, First Capital Research

Exchange Rate – Aug-24 & Revised Jan-25 Re cap: Accurate

Aug-24 - Economic recovery and consumer demand may influence some depreciation towards 1H2025 allowing the currency to trade within a range of LKR 305.0-315.0 over the next 12 months (Jun-25)

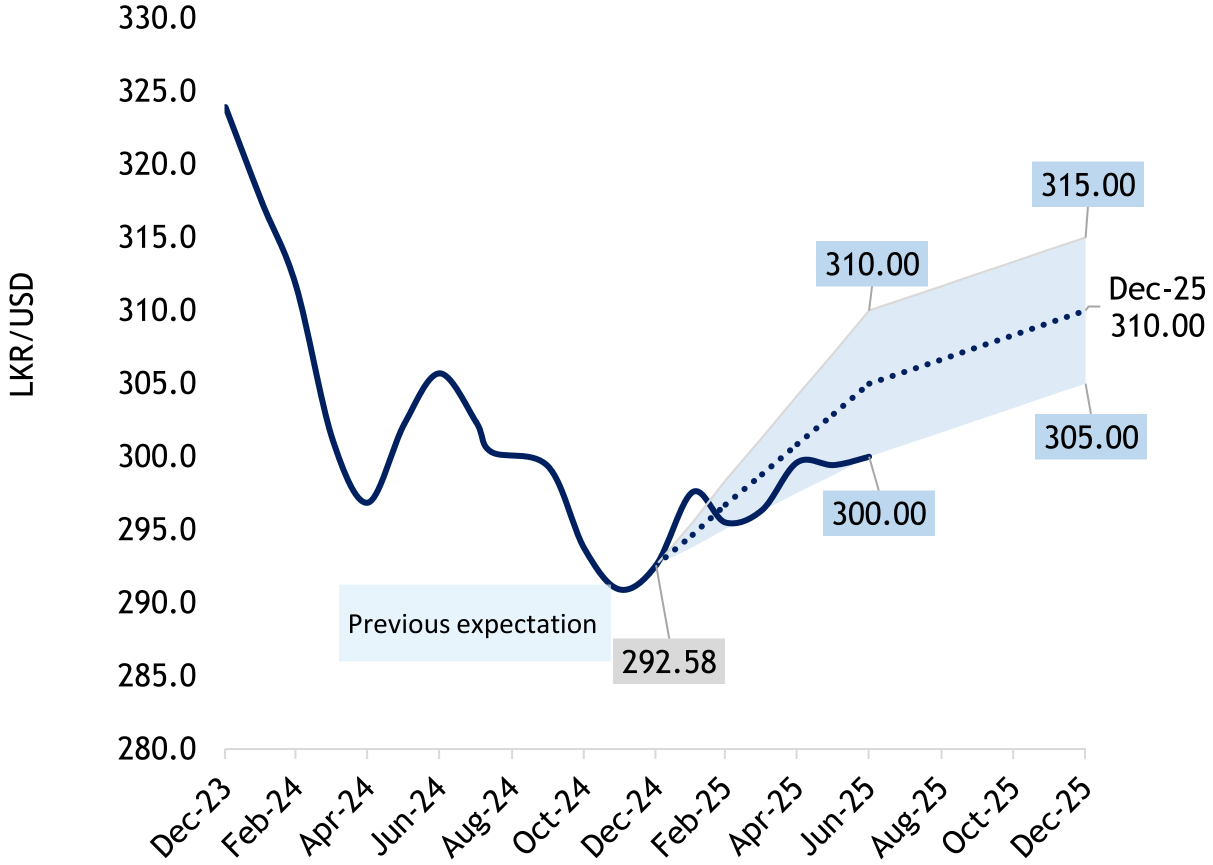
Jan-25 (Revised) - Exchange Rate outlook upgraded to LKR 300.0-310.0 for 1H2025 and LKR 305.0-315.0 for 2H2025



Review

FCR expected LKR to depreciate to 295.0-305.0 during 2H2024. That was broadly inline with our targets.

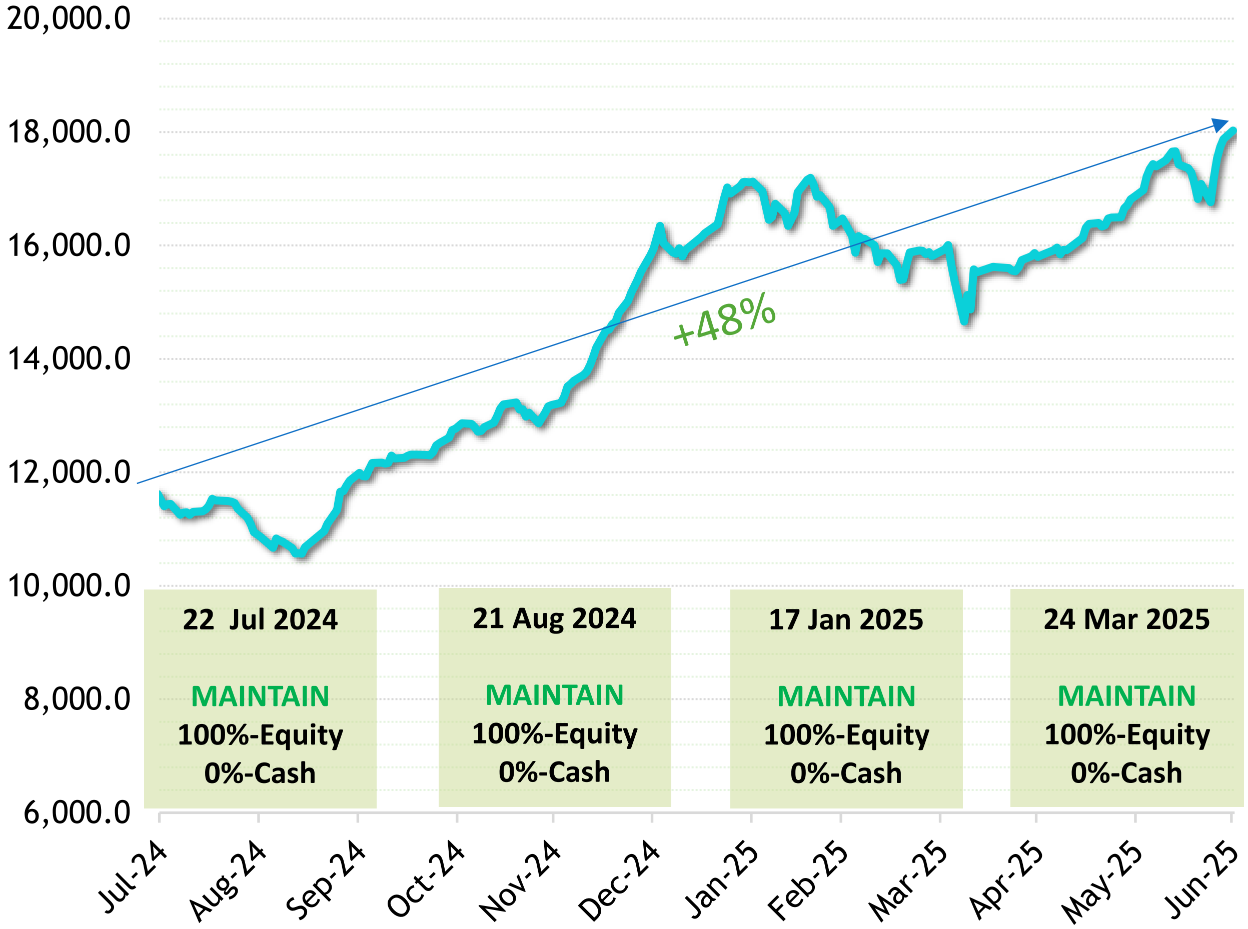
Current account surplus enabled by strong inflows from tourism and remittances aided CBSL to aggressively buy USD from the market during 1H2025, causing LKR to hover in the lower end of our target.



Source: CBSL, First Capital Research

Equity – Aug-24 & Mar-25 Re cap: Accurate

On 21st Aug 2024 First Capital maintained its 2024E ASPI target at 14,000, whilst on 15th Mar 2025, First Capital introduced a new target range for ASPI at 17,000 – 18,000 for 2025E.



Funds allocated Equity: Be 100% invested

Review

ASPI adopted a steady uptrend with Jul-24 to Jul-25 rising +48% during the period.

Our bullish outlook for ASPI proved accurate during the concerned period, as clearing out of uncertainties and steady growth in corporate profitability resulted with ASPI reaching all time highs and continuously refreshing the peak.

Source: CSE, First Capital Research

Key elements of consideration

for Mid-Year Outlook 2025

Section 2.0

Steady, but Slow

Sri Lanka continued its recovery trajectory during the past 12 months, with continuous recovery in key economic indicators and completion of IMF 3rd and 4th review amidst challenges and delays. **GDP growth is expected to hover between 4%-5%,** with the 1st quarter GDP already recorded closer to the high end of our estimate. Debt restructuring was marked complete with the completion of external debt restructuring in Dec-24 and confirmation of the deals from major bilateral creditors.

Political stability was further reinforced with the ruling party garnering most seats at the recently concluded local government elections.

With stability achieved, **attaining growth remains key for Sri Lanka during the upcoming years** with increased repayments hovering from 2027 and later. Balancing its fiscal position and attaining growth looks challenging, with consumer drive burdened with high taxes whilst government maintaining minimal capex spending trying to meet IMF primary surplus targets.

Despite **growth coming in at steady during 1Q2025, outlook for growth remains slow** adding concerns to meeting growing debt obligations in 2027E. Therefore, we believe that fiscal stimulus is on cards driven by increased capital expenditure to revive the slow growth in the economy.

Key Elements to consider for investments

POLITICAL

- Provincial elections to follow within the next 12 months
- Policy certainty
- Continuation of IMF program

ECONOMICAL

- Total credit demand to reach 20% in 2025E
- GDP growth to remain slow
- Liquidity to dry down driven by expansion in credit
- Budget deficit to increase driven by fiscal stimulus

EXTERNAL

- Current account surplus maintained.
- Global uncertainties curtail growth.
- Currency to depreciate marginally

Source: First Capital Research

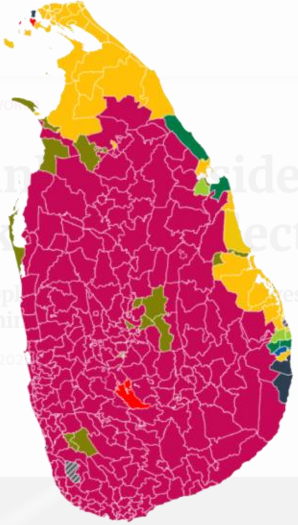
Political stability reinforced

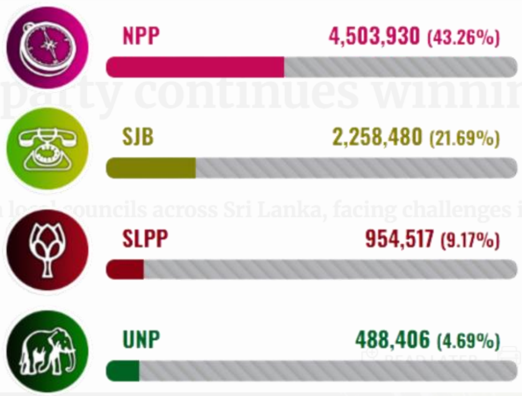
*Maintain **Low Risk***

Section 3.0

Victory for governing party at local government polls...

Local Government Election results





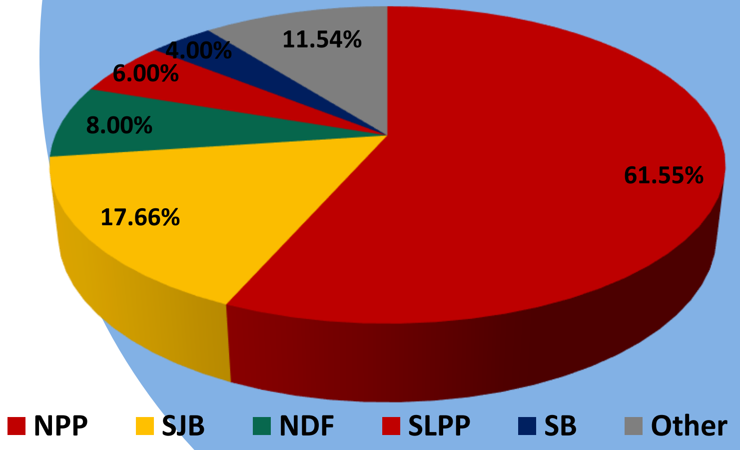
No. of Local Government Bodies won

NPP	265
SJB	14
SLPP	0
UNP	0

"The NPP secured a majority in the local government elections held on 7th May 2025, winning control of 265 local government bodies across the island. The party secured 3,926 local government seats and received 43.26% of the total votes cast."

2024 ELECTIONS

During 2024 Presidential Election, which was on 9th September 2024, Sri Lanka elected Mr. Anura Kumara Dissanayake as the 9th Executive President of the Democratic Socialist Republic of Sri Lanka, with him receiving a majority of 42.31% of the total votes cast.



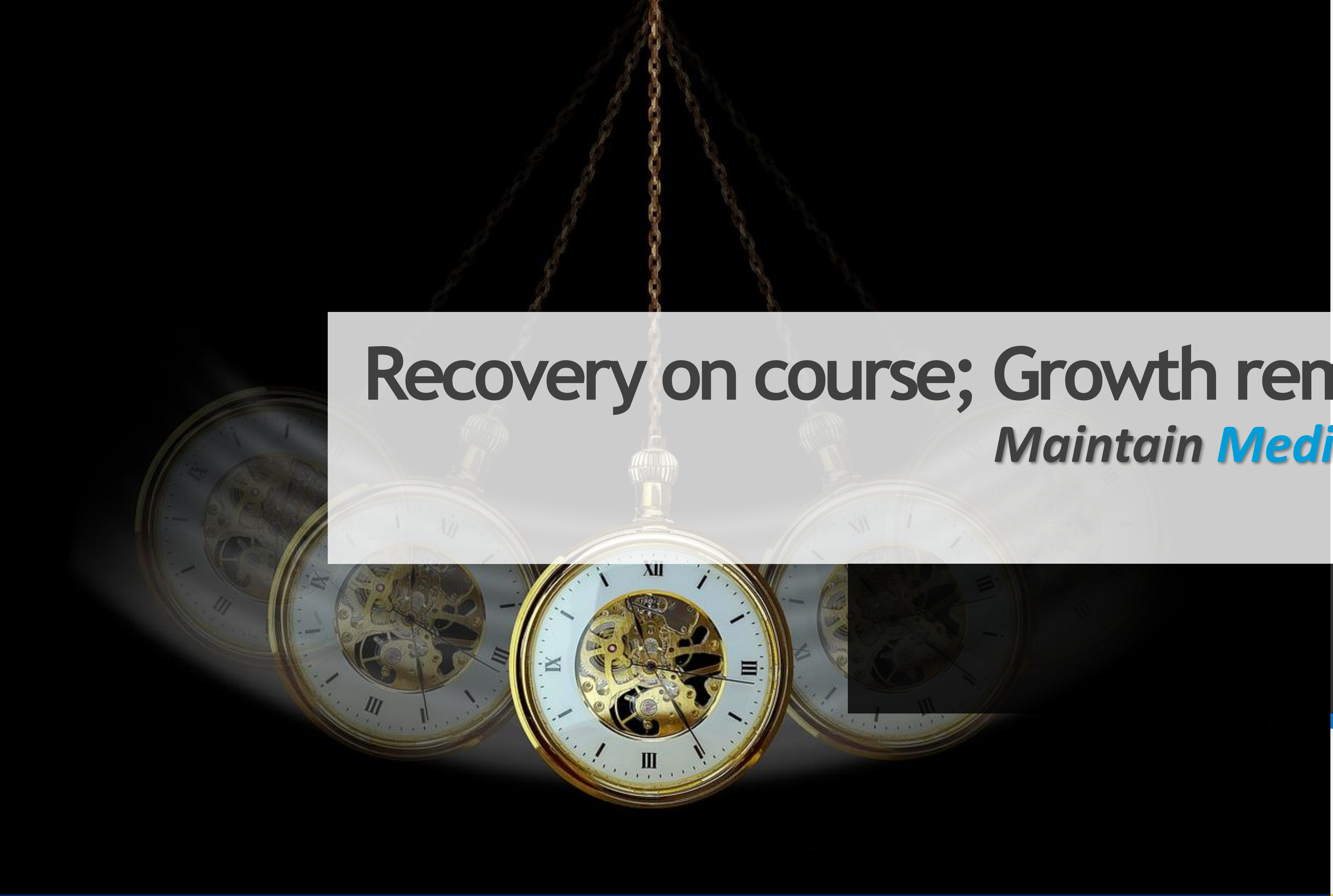
The General Election which was held on 14th December 2024 resulted in a decisive victory for the President's party, the NPP, which secured over **2/3 majority**, enabling it to form a government.

...reinforces policy stability

- Along with securing two-thirds majority in Parliament and victory at the recent local government elections, is seen as a positive sign by the investors, as it allows a single party to govern decisively and implement policies more effectively with political stability.
- However, voter turnout in the Local Government Elections appeared low, with the NPP securing only 43.26% of the total votes. Unlike in the Parliamentary Elections, the NPP has not enjoyed the same level of popularity.
- Looking ahead, the Government is yet to announce Provincial Elections, which we expect to take place within the next 12 months. While the NPP is likely to secure a majority, its popularity may remain subdued.
- With the government's continued efforts to promote good governance, and its recent victory in the Local Government Elections, supported by the continuity of the IMF programs and gradual fulfilment of its conditions, we expect consistent policy implementation supported by political stability. Furthermore, with the NPP's likely win in the Provincial Elections, political risk remains low. Considering the favourable forward-looking political environment provides confidence for long-term investments.

Political Outlook: Maintain *Low Risk*

Source: Election Commission of Sri Lanka, First Capital Research



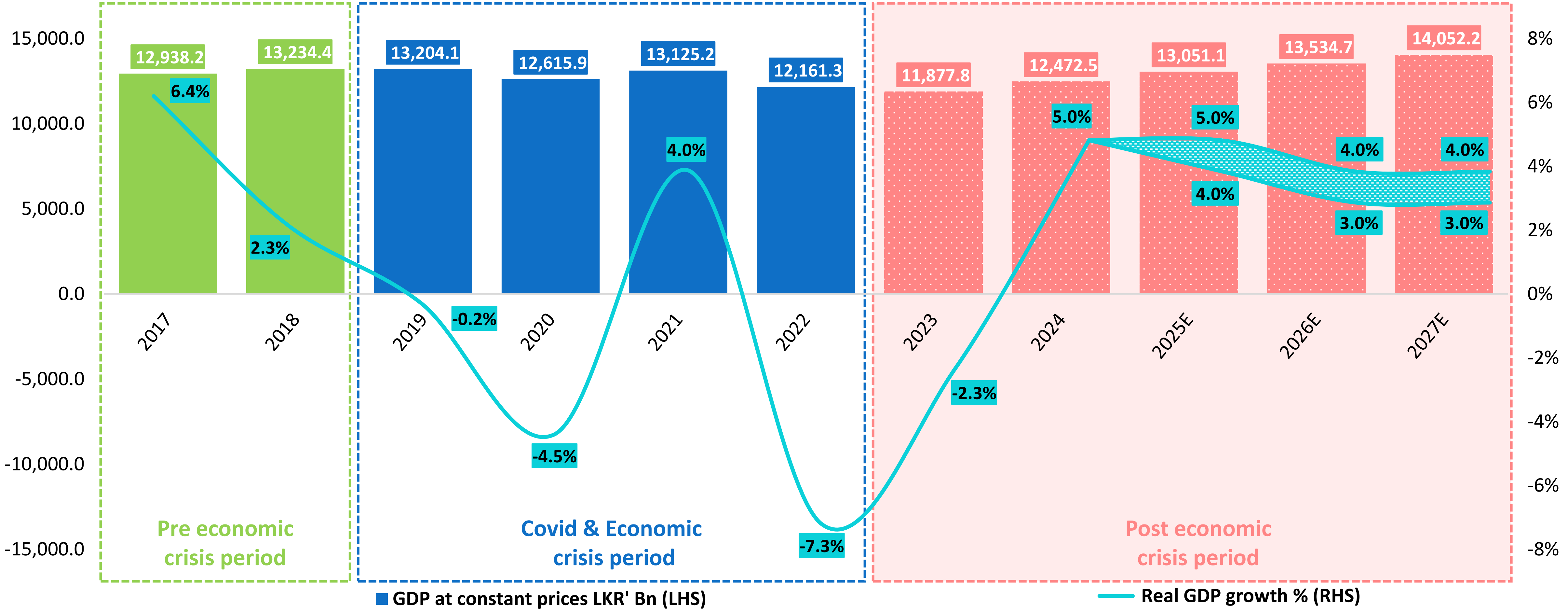
Recovery on course; Growth remains slow

*Maintain **Medium-Low Risk***

Section 4.0

Economic stability maintained…

FCR projects real GDP growth to hover between 4.0%–5.0%YoY in 2025E, with the 1Q2025 already recording a 4.8%YoY growth according to recently released data by Census and Statistics Department of Sri Lanka. For 2026E and 2027E, growth is estimated to hover between 3.0%–4.0%YoY. The growth outlook for 2026E and 2027E tamed down amidst weak spending by the government, as external growth stemming from global economy looks gloomy with tariffs and wars clouding the outlook.

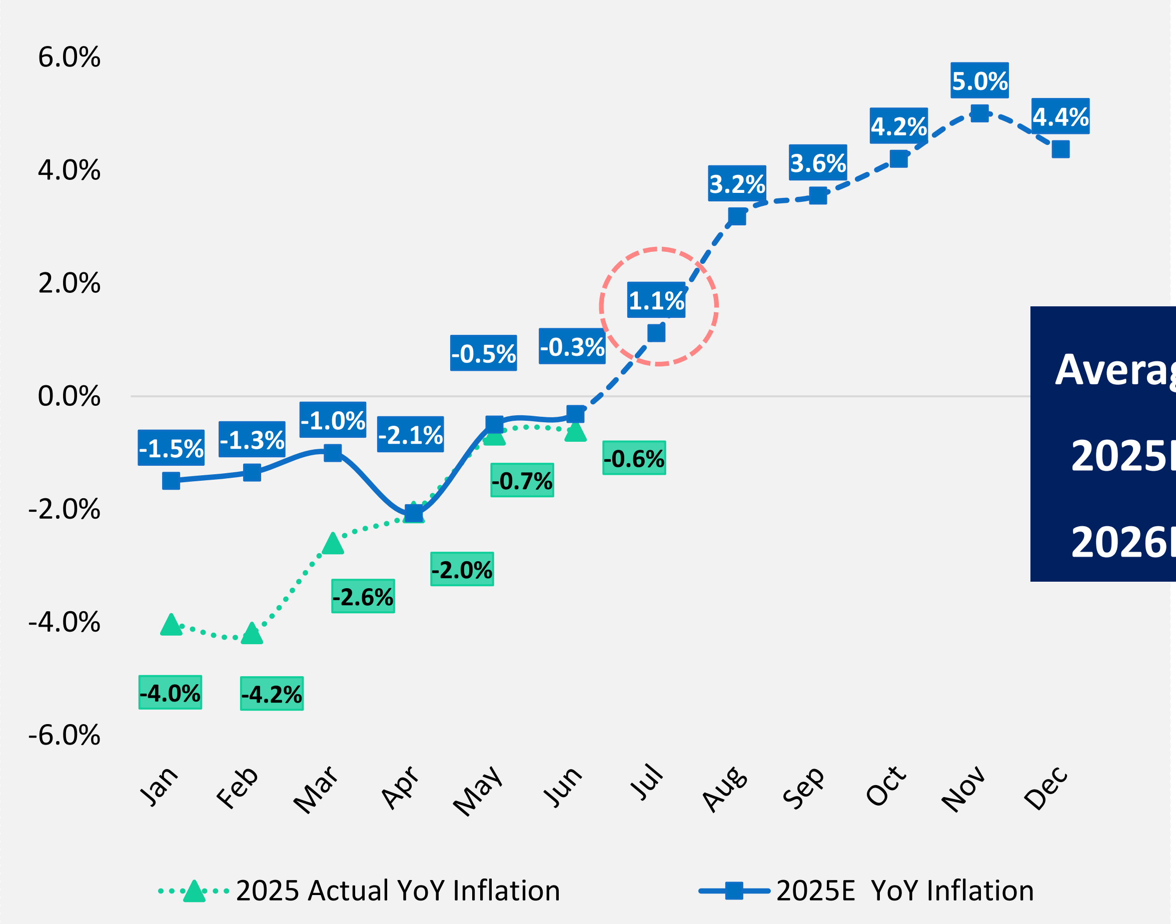


Source: CBSL, Dept. Census and Statistics, First Capital Research

...aided by lower-than-expected inflation...

First Capital
A Janashakthi Group Company

FCR expects inflation to turn positive in Jul-25, propelled by the reversal of the electricity tariff. As the year progresses, inflation is expected to gradually pick up, fueled also by the base effect from Sep-25.

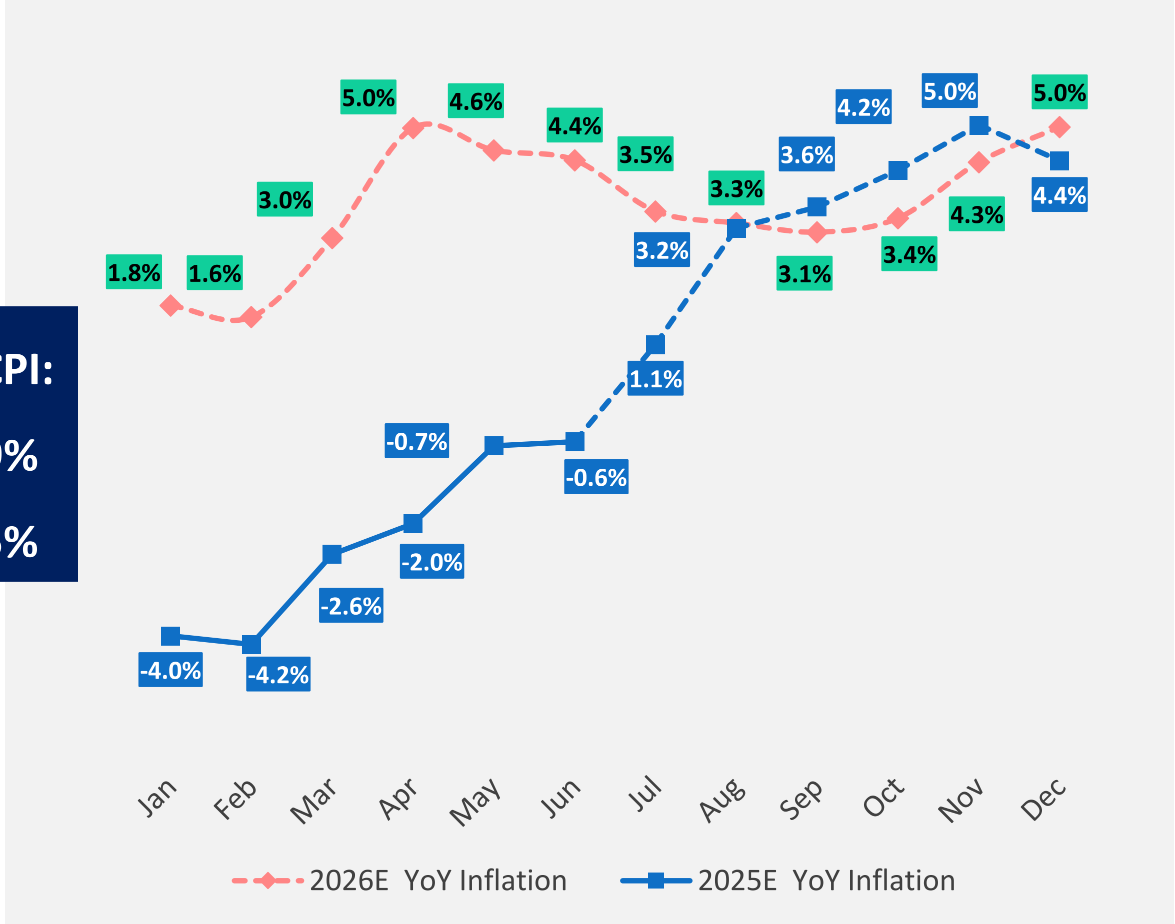


Average CCPI:

2025E: 1.9%

2026E: 4.5%

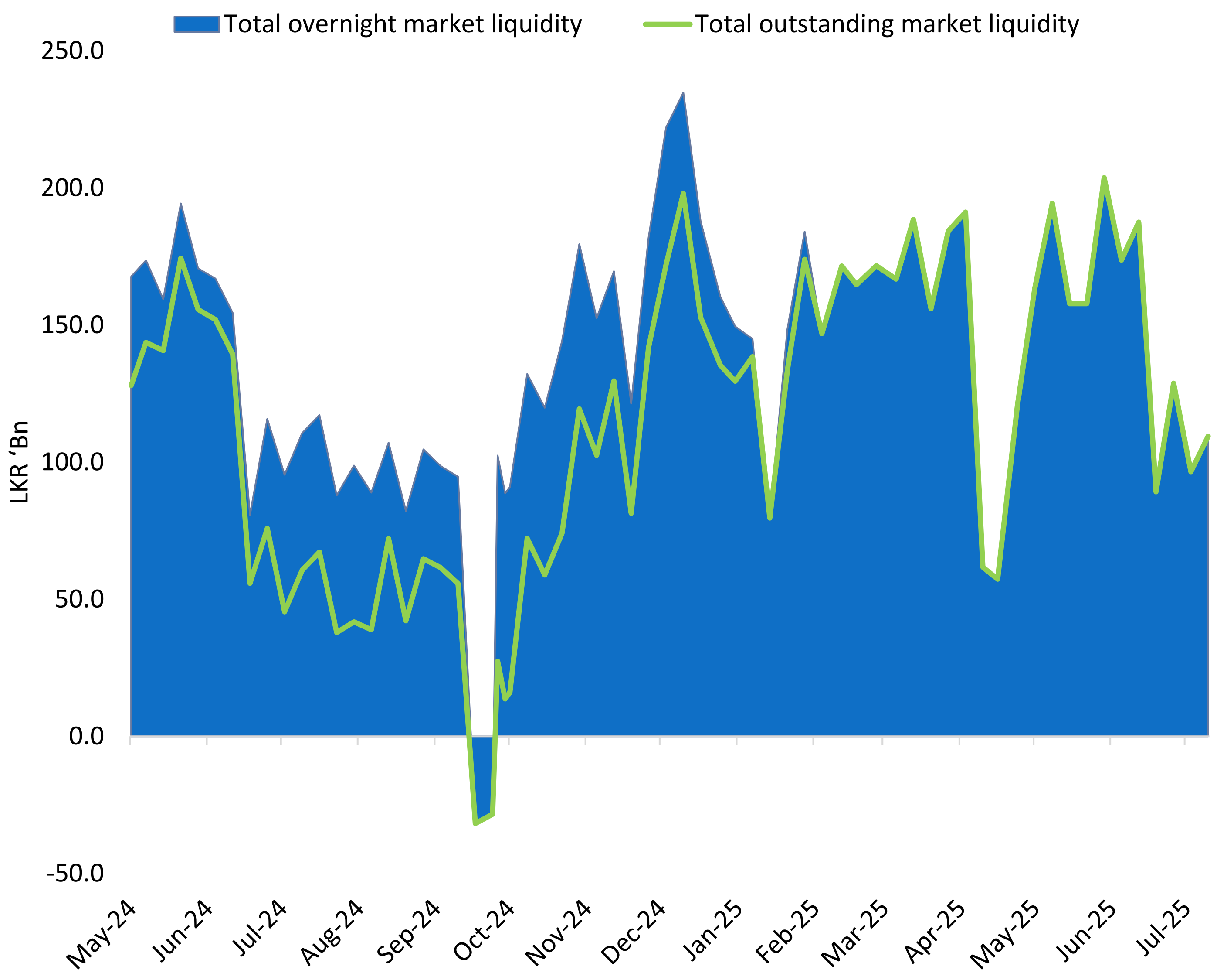
In 2026E FCR expects inflation to remain positive and largely inline with CBSL's target of 5.0%.



Source: CBSL, Dept. Census and Statistics, First Capital Research

... and stable liquidity positions...

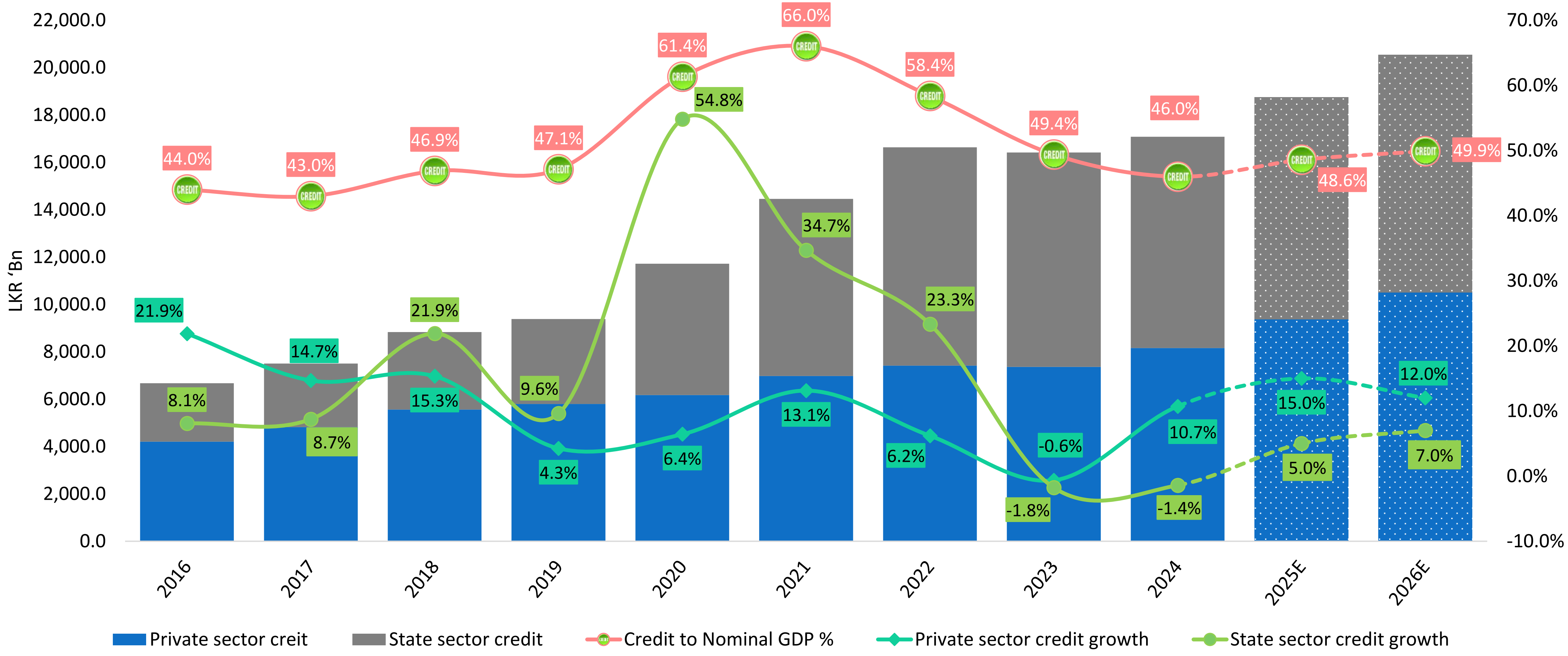
Limited growth in credit, particularly from the state sector coupled with aggressive USD purchases by the CBSL and limited sell down in government securities led to stable liquidity positions in the banking sector. Looking ahead, liquidity during 2H2025E is expected to remain stable, whilst market liquidity in 2026E is expected to become weaker on the back of increased credit demand from both private and state sector.



Source: CBSL, First Capital Research

...supporting credit demand...

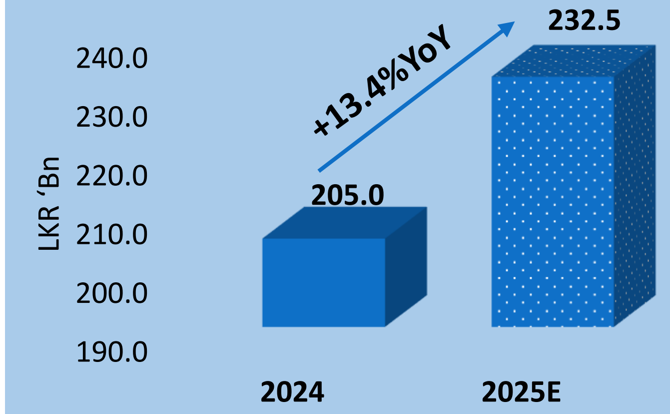
FCR believes that boosting GDP growth may require the government to increase capital expenditure, which could, in turn, improve state credit. Meanwhile, credit growth in the private sector is likely to be driven by rising consumption and increased private investments.



...with budget driven upside...

GDP growth is maintained, driven by a projected 5.5% increase in private-sector consumption. The rise in consumption is attributed to relatively higher disposable income levels, resulting from increased allocations under the "Aswesuma" program, as well as recent salary hikes in both the public and private sectors. The growth may further be supported by the increase in upper-bound tax brackets implemented in Dec-24, ahead of the budget.

1 "Aswesuma" programme



The monthly benefit allowances for the poor and extremely poor were raised from LKR 8,500 to LKR 10,000 and LKR 15,000 to LKR 17,500, effective January 2025. Enumeration for eligible but unenrolled "Aswesuma" beneficiaries was expected to conclude in May 2025, allowing them to join the program. An additional increase of LKR 500.0Mn was also proposed under the "Aswesuma" empowerment programme, which may increase the disposable income levels.

2 Public sector salary increment

Monthly net salary increase	From Apr-25	From Jan-26	From Jan-27
Rs. 8, 250	5, 975	7, 113	8, 250
Rs. 10, 000	6, 500	8, 250	10, 000
Rs. 15, 000	8, 000	11, 500	15, 000
Rs. 25, 000	11, 000	18, 000	25, 000
Rs. 40, 000	15, 500	27, 750	40, 000
Rs. 50, 000	18, 500	34, 250	50, 000

In addition to a minimum monthly basic salary increase of LKR 15,750, it has been proposed to raise the value of the annual salary increment by 80.0%. An allocation of LKR 110.0Bn has been set aside for the salary increase in 2025E.

Pensions: *It was proposed that, in the 1st phase, pensions for all retirees prior to 1st January 2018 be adjusted according to the third-stage 2018 salary scales, effective from July 2025. The government has proposed allocating LKR 10,000.0Mn for this initiative in the 2025 Budget.*

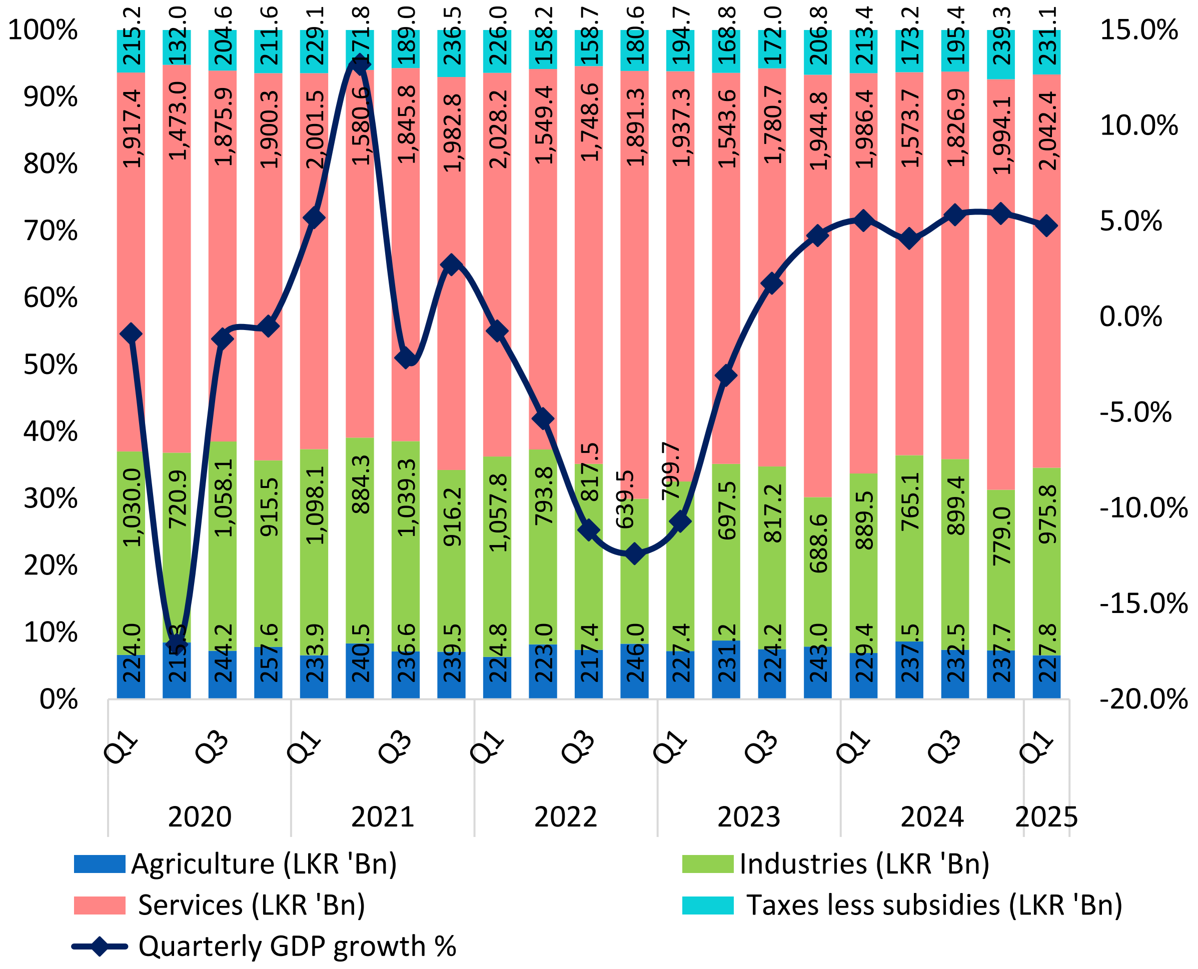
3 Private sector salary increment

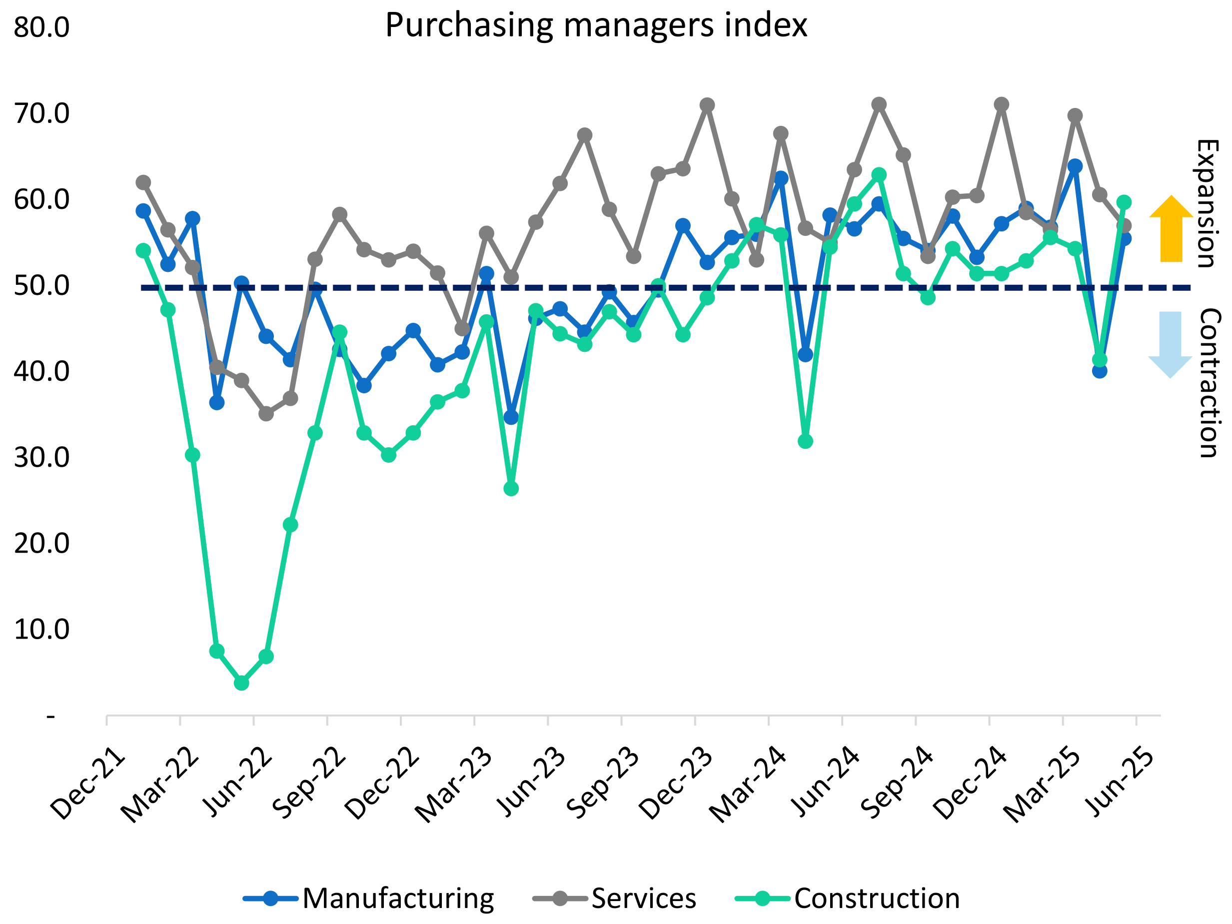
Monthly minimum wage to the private sector workers was increased from Apr-25;

Source: Ministry of Finance, First Capital Research

...and slow real sector gains

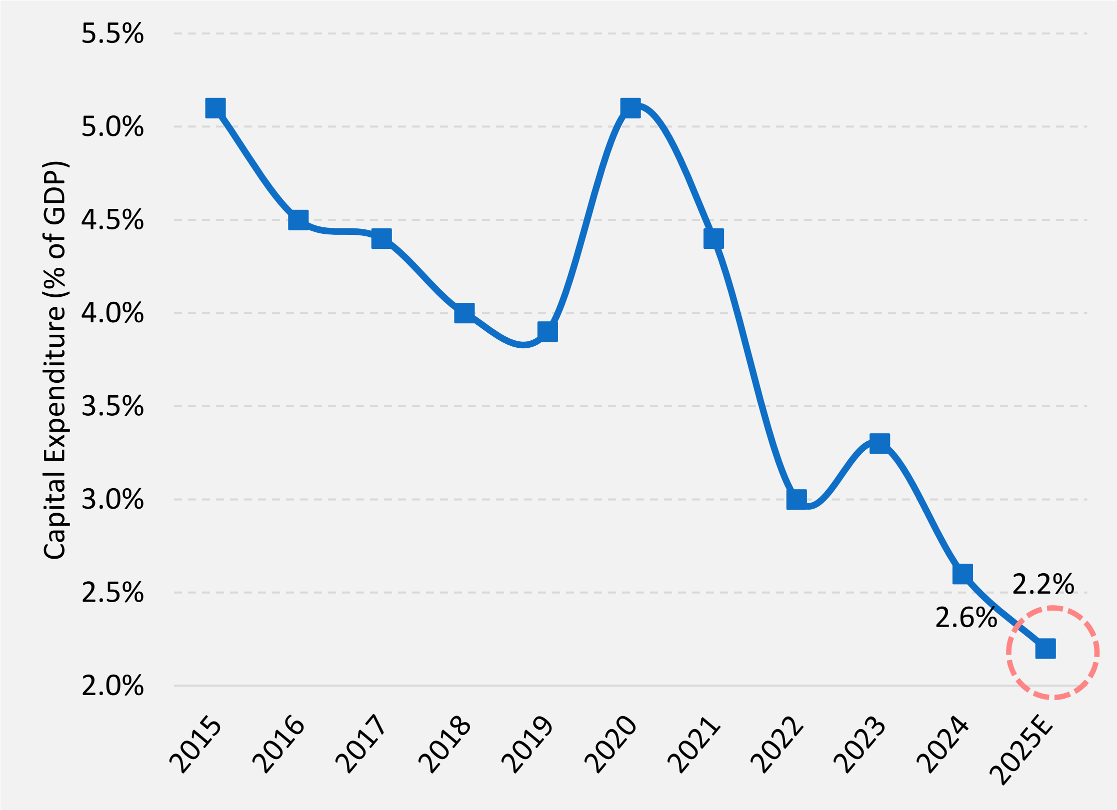
Even though the PMI's showing expansions in all three subsegments, FCR anticipates GDP growth to slowdown affected largely by lower-than-expected expansion in consumption which is burdened with higher taxes whilst limited government spending on CapEx is also expected to hinder GDP growth in the coming quarters.

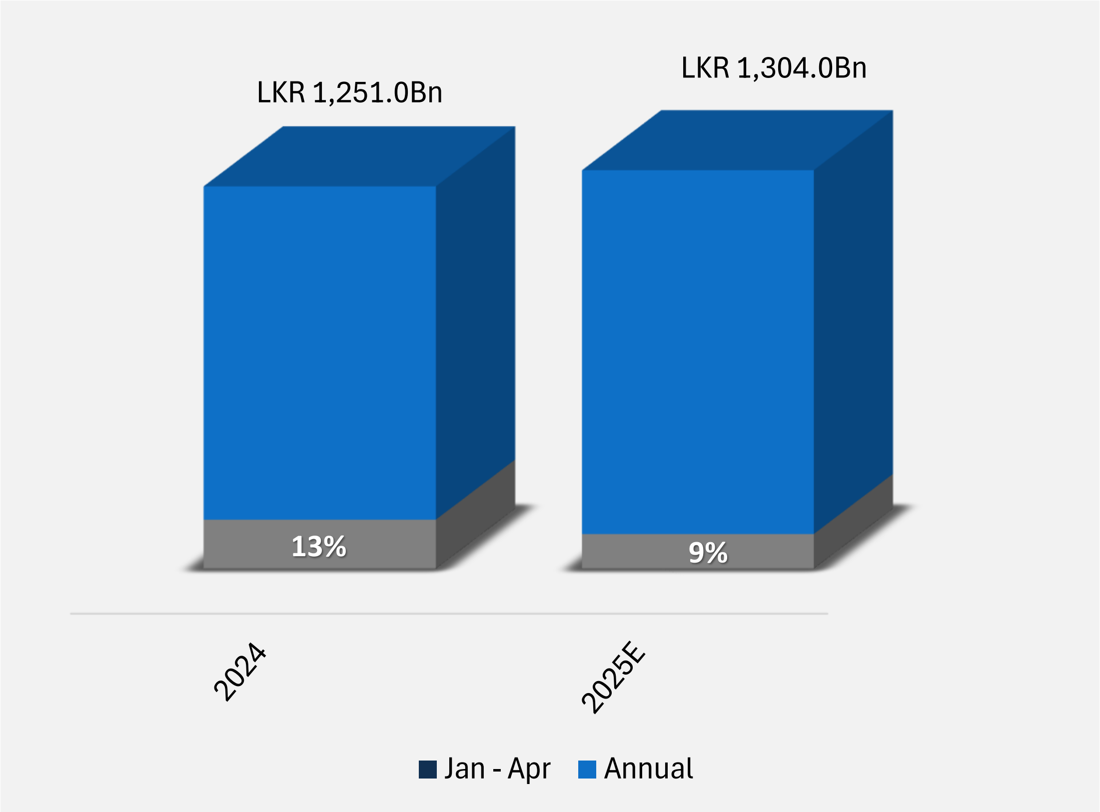




Lower than expected capital spending...

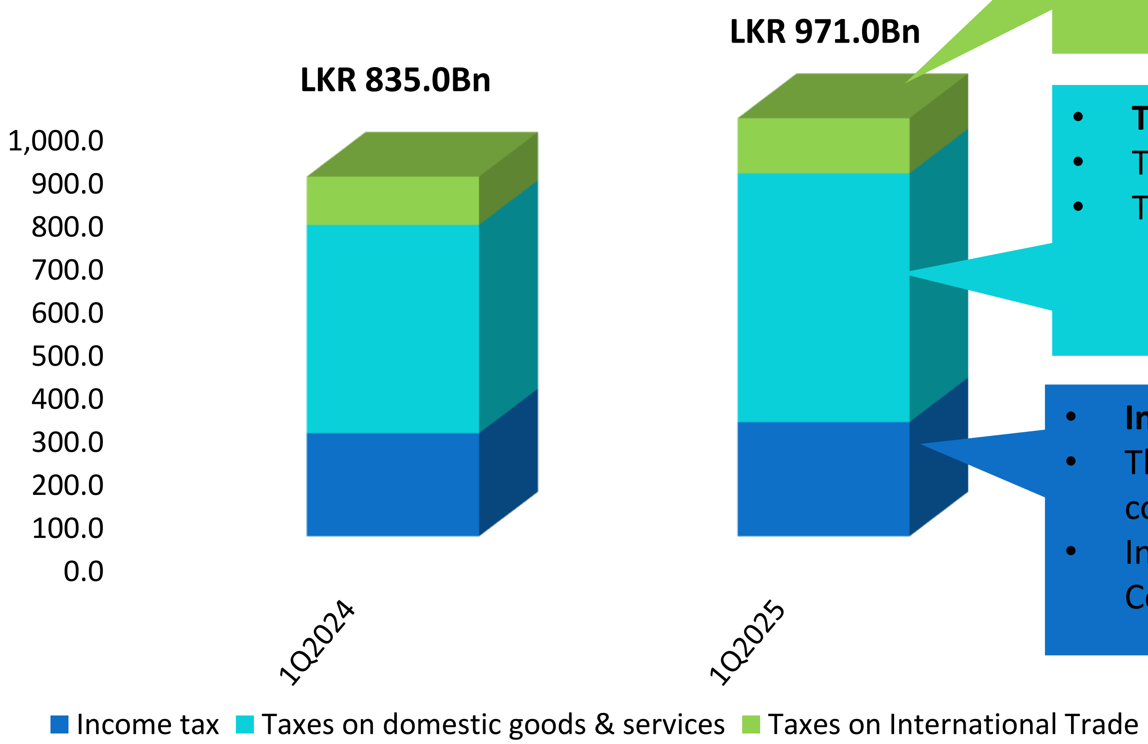
- LKR 1,304.0Bn has been earmarked as Capital Expenditure as per the budgetary documents relevant for 2025E.
- This translates roughly to 3.2% of GDP according to the government.
- Up to Apr-25 LKR 113.0Bn (9% of target) has been spent, compared to LKR 160Bn spent during the same period last year.





...and improved revenue collection...

Sri Lanka's tax revenue registered a 16%YoY increase in 1Q2025.



- **Tax on international trade** rose by **14.3%** YoY in 1Q25.
- This component made up 13% of tax revenue during the period.
- The YoY rise was fueled by:
  - **33%** YoY rise in **import duties**
  - **84%** YoY rise in **special commodity levy**

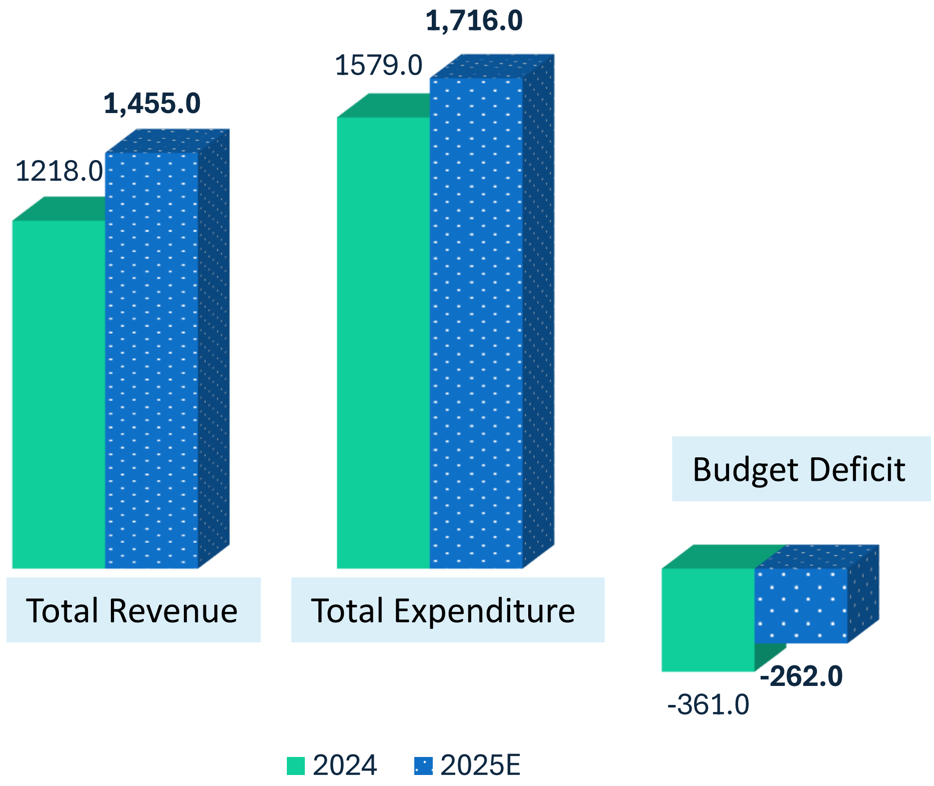
- **Tax on domestic goods & services** rose by **19.9%** YoY in 1Q25.
- This component made up 59% of tax revenue during the period.
- The YoY rise was fueled by:
  - **25%** YoY rise in **VAT**
  - **7%** YoY rise in **excise duty**

- **Income tax** rose by **10.9%** YoY in 1Q25.
- This was predominantly driven by a YoY uptick in Non-Corporate tax components.
- Income Tax made up 27% of total tax revenue and its key components include: Corporate Income Tax, Withholding Tax, PAYE

Source: CBSL, Ministry of Finance, First Capital Research

… led to better-than-expected fiscal performance in 2025E, but potentially leading slower than anticipated growth for 2026E

Fiscal Performance: Jan – Apr (LKR 'Bn)



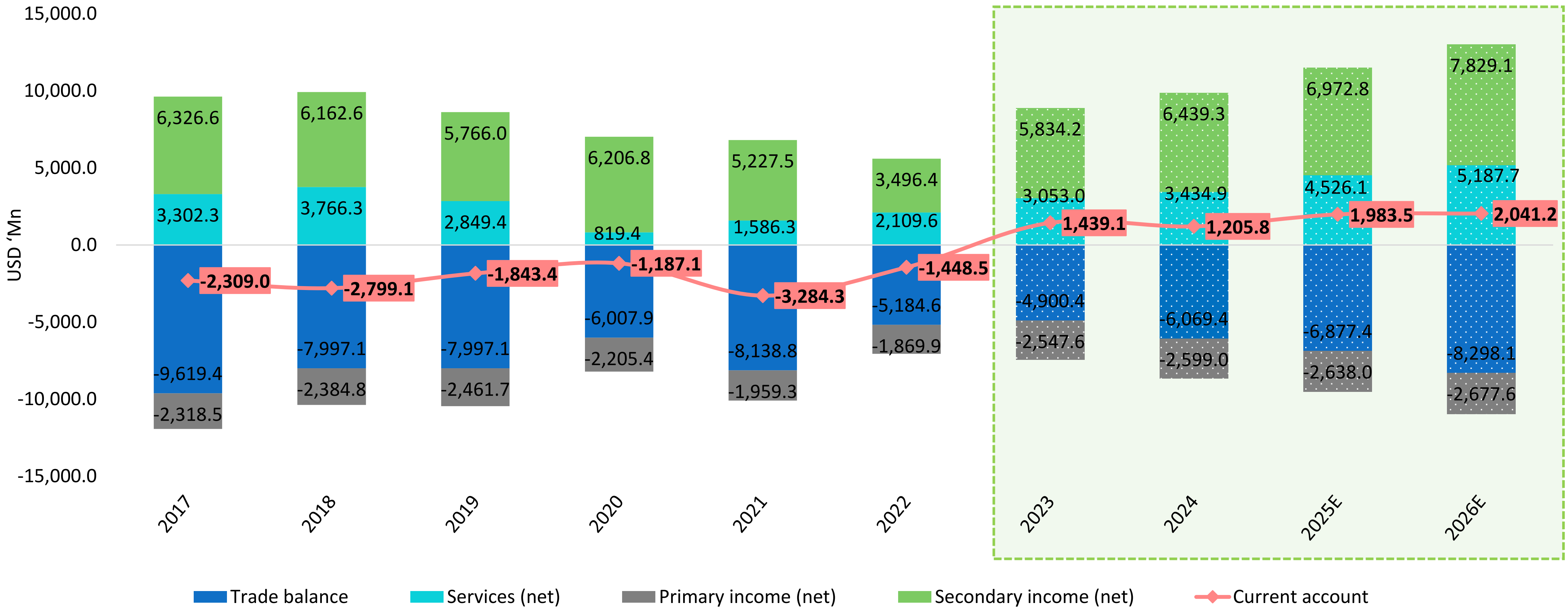
Fiscal Targets: 2025 – 2030 (% of GDP)

	2023	2024	2025E	2026E	2027E
Revenue	11.2%	13.7%	15.5%	15.9%	16.4%
Expenditure	19.5%	20.5%	21.4%	22.1%	23.0%
Current A/C deficit	-6.0%	-4.4%	-3.9%	-4.0%	-4.2%
Primary A/C surplus	0.6%	2.2%	2.3%	2.9%	3.7%
Budget deficit	-8.3%	-6.8%	-5.9%	-6.1%	-6.8%

Source: CBSL, Ministry of Finance, First Capital Research

Current account expected to stay positive for the 3rd consecutive year…

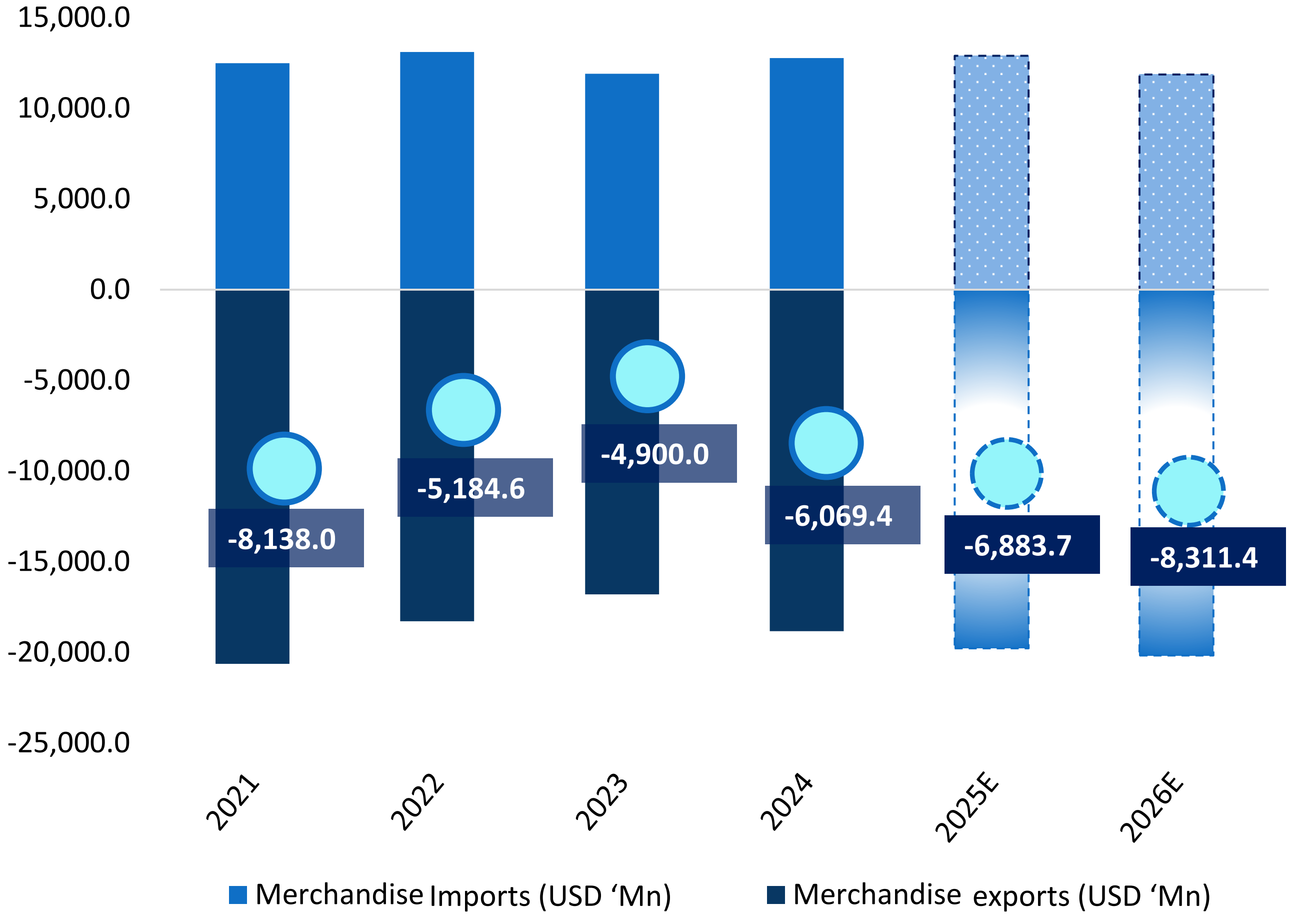
FCR forecasts the current account to remain in surplus for a third straight year in 2025E, primarily supported by stronger worker remittances and an upswing in services exports.

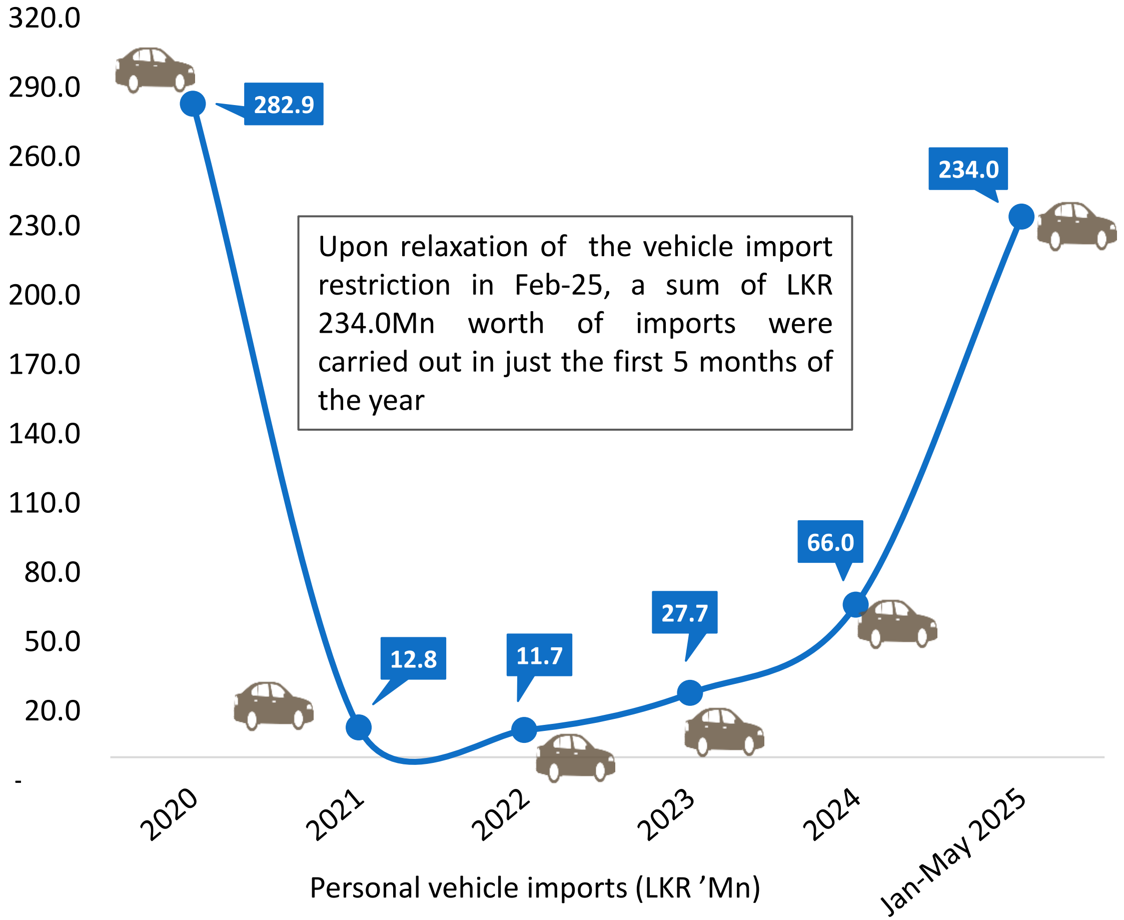


Source: CBSL, Dept. Census and Statistics, First Capital Research

...despite widening trade deficit, partly driven due to relaxed import controls...

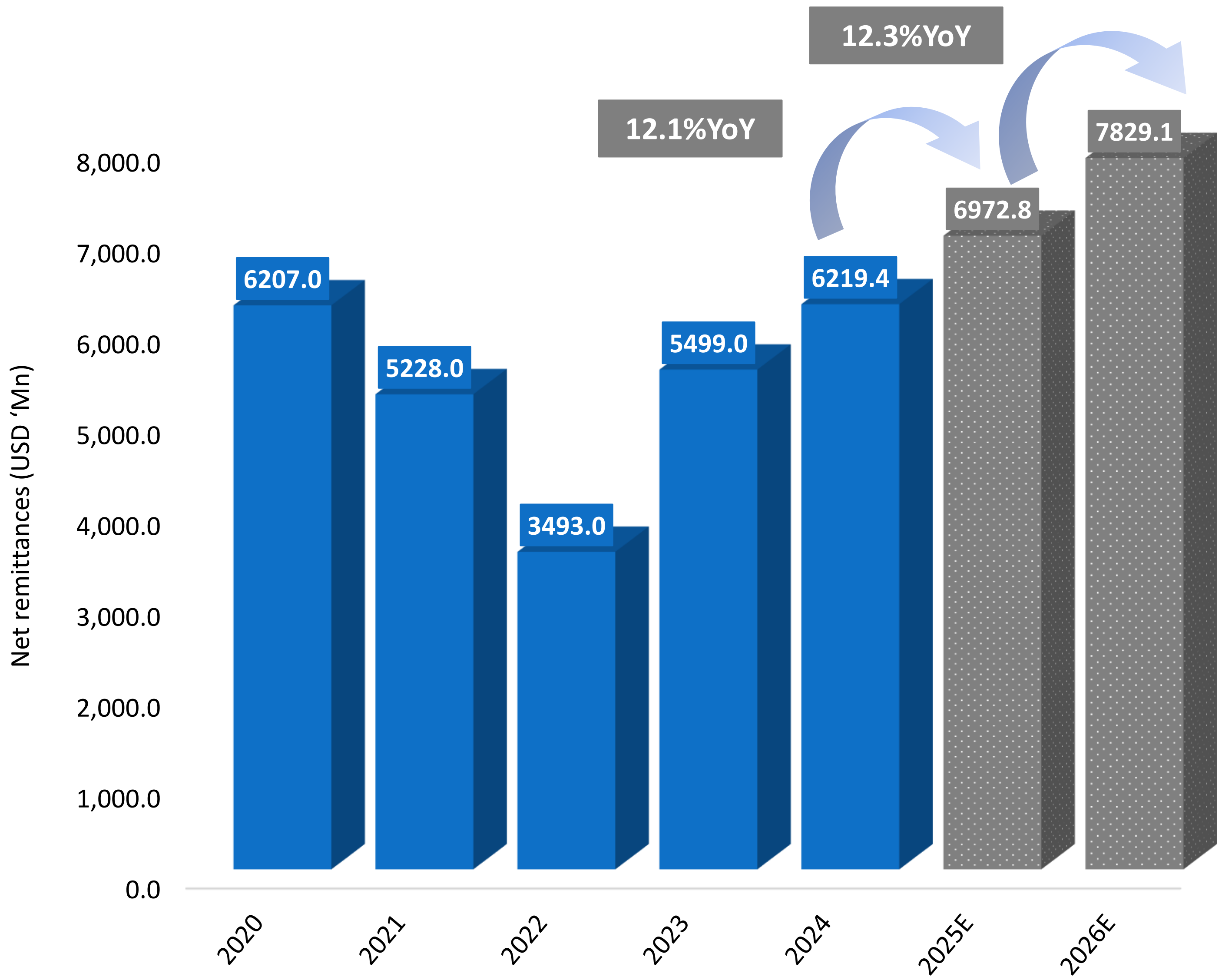
Sri Lanka's trade deficit is expected to continue its widening stance driven largely by growing imports as country relaxed import restrictions placed on all items. Moreover, import reliance on key industries such as F&B and tourism, and recovery in these sectors are also expected to increase imports during upcoming months. Meanwhile, 30% tariffs placed by US on SL exports is expected to cause major distress to SL exports with volumes expected to decrease during coming years largely due to SL's high operating costs compared to peer countries leading to possible loss of market share in global markets.





Source: CBSL, Dept. Census and Statistics, First Capital Research

...whilst record high remittances...



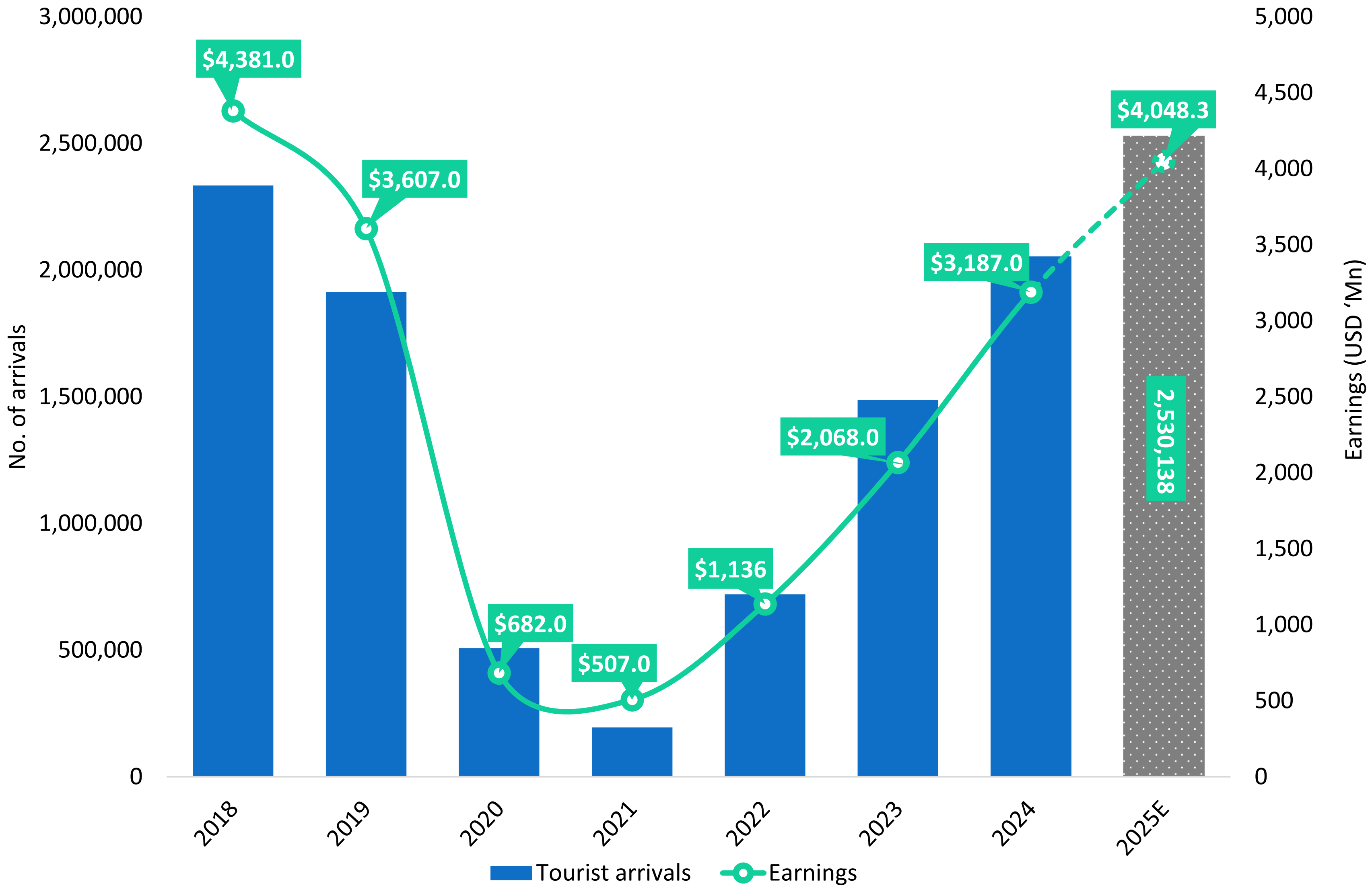
Net worker's remittances have revived from the previous 10 year low in 2022 and have reached a record high USD 6.2Bn in 2024.

This trajectory is expected to carry forward in 2025E and 2026E supported by improving global economic conditions and labor demand in key host countries, particularly in the Middle East.

Remittances will continue to play a critical role in bolstering foreign exchange reserves and offsetting the current account deficit, especially amid persistent trade imbalances.

Source: CBSL, Dept. Census and Statistics, First Capital Research

...and strong tourism inflows contribute towards the surplus

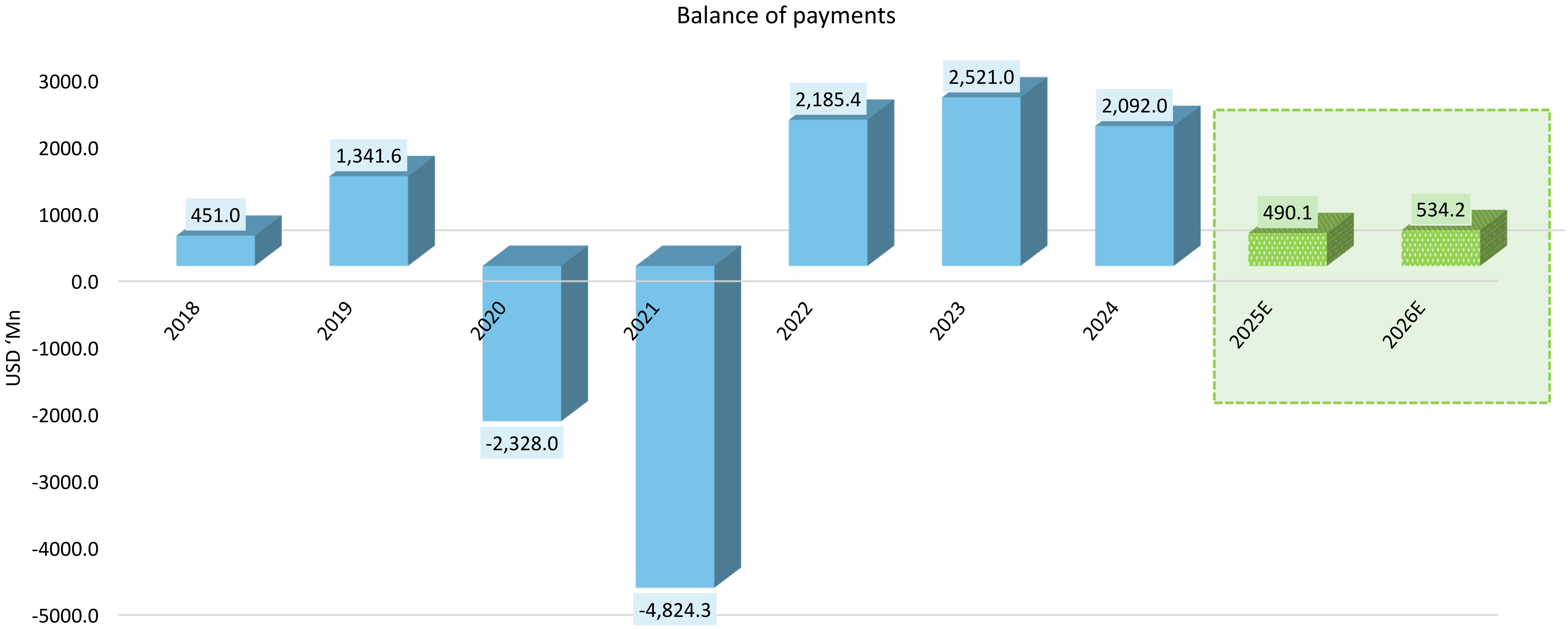


In 2025, tourist arrivals are projected to surpass 2018 levels, reaching an estimated 2.5Mn arrivals. This surge is anticipated to generate a substantial USD 4.0Bn in earnings, reflecting a robust 5-year CAGR of 42.7%.

Source: CBSL, SLTDA, First Capital Research

Balance of payment is expected to stay positive…

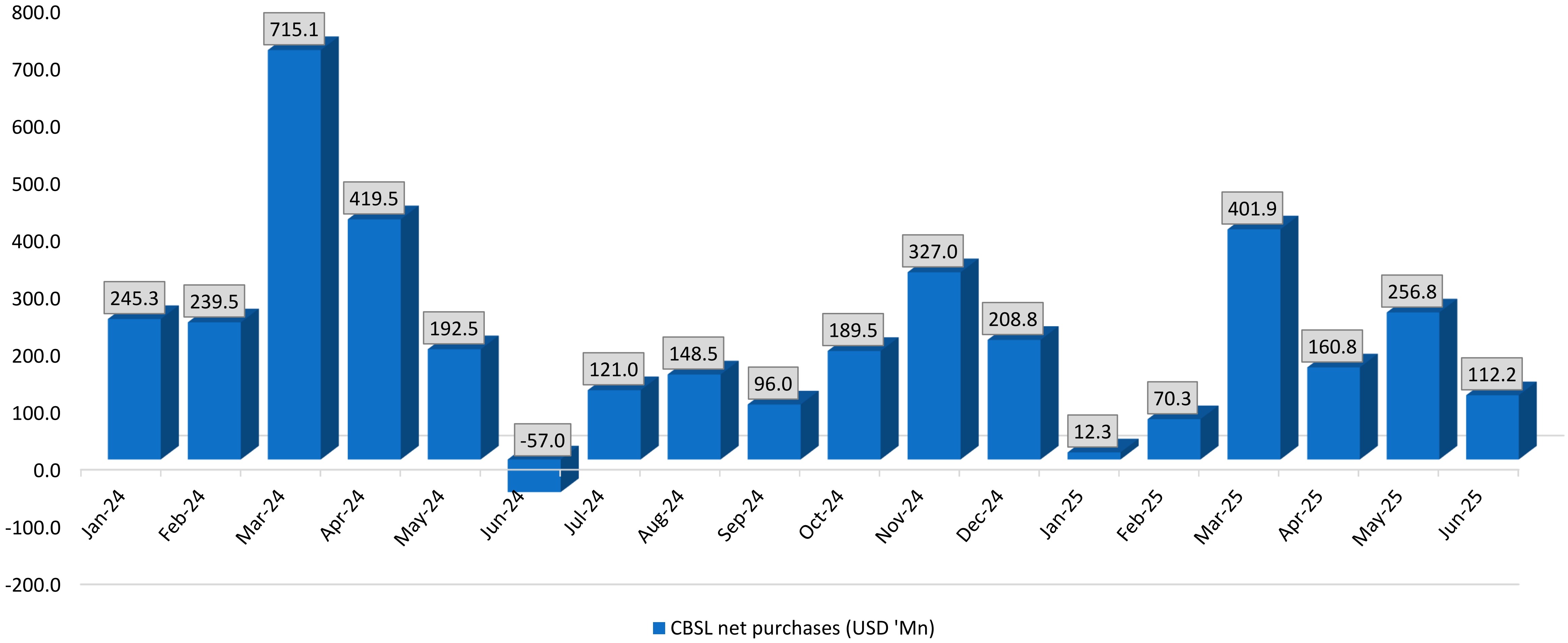
Sri Lanka's BOP surplus is expected to continue through 2025E and 2026E, supported by strong tourism earnings and rising worker remittances which are expected to offset higher import costs following the easing of restrictions. Additionally, Central Bank interventions and IMF support are helping build foreign reserves, further stabilizing the external sector.



Source: CBSL, Dept. Census and Statistics, First Capital Research

...enabling proactive FX purchases...

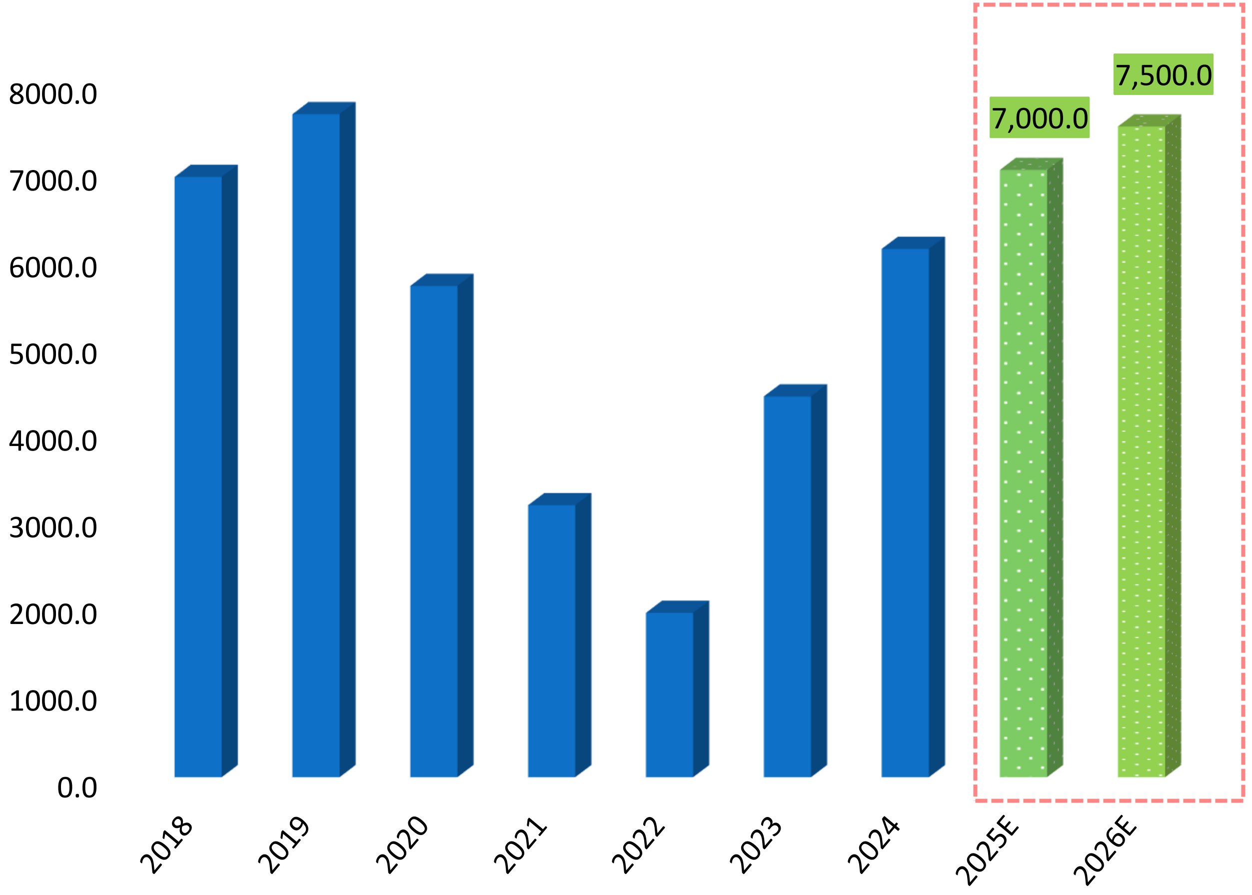
The CBSL has been actively purchasing U.S. dollars to rebuild reserves, with YTD net purchases reaching around USD 1,014.3Mn by June 2025. These interventions aim to stabilize the rupee and meet IMF reserve targets, though they also require careful liquidity management to avoid inflationary pressure.



Source: CBSL, Dept. Census and Statistics, First Capital Research

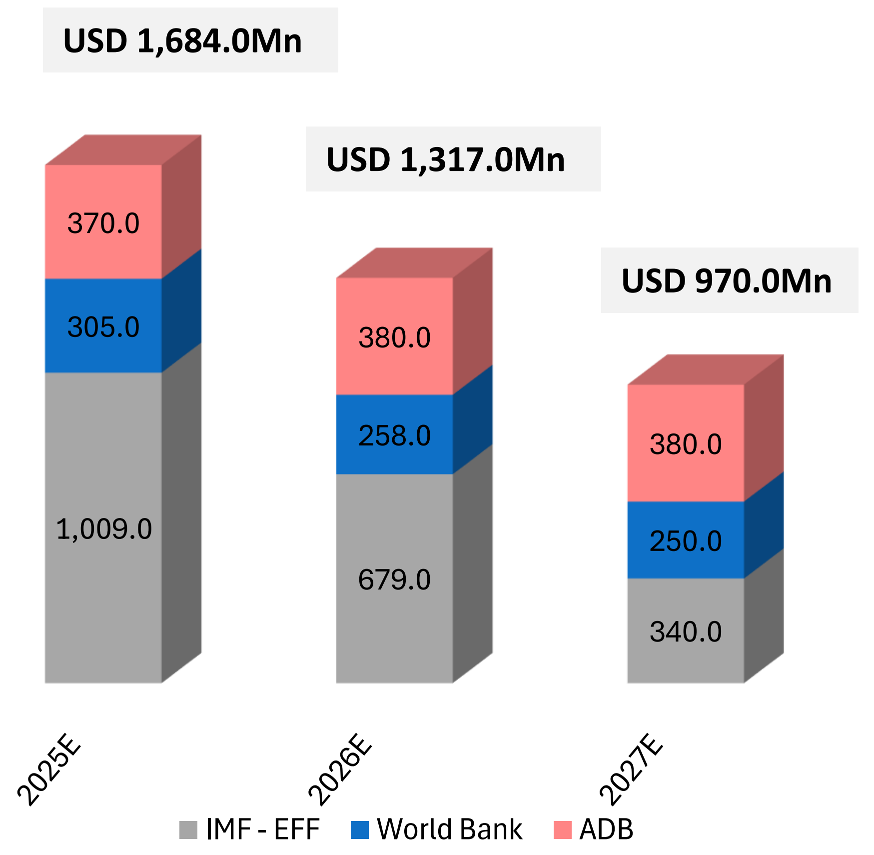
...driving gross official reserves to meet our set targets

FCR expects Foreign Reserves to reach USD 7,000Mn in 2025E and USD 7,500Mn in 2026E.



Foreign reserves (USD 'Mn)

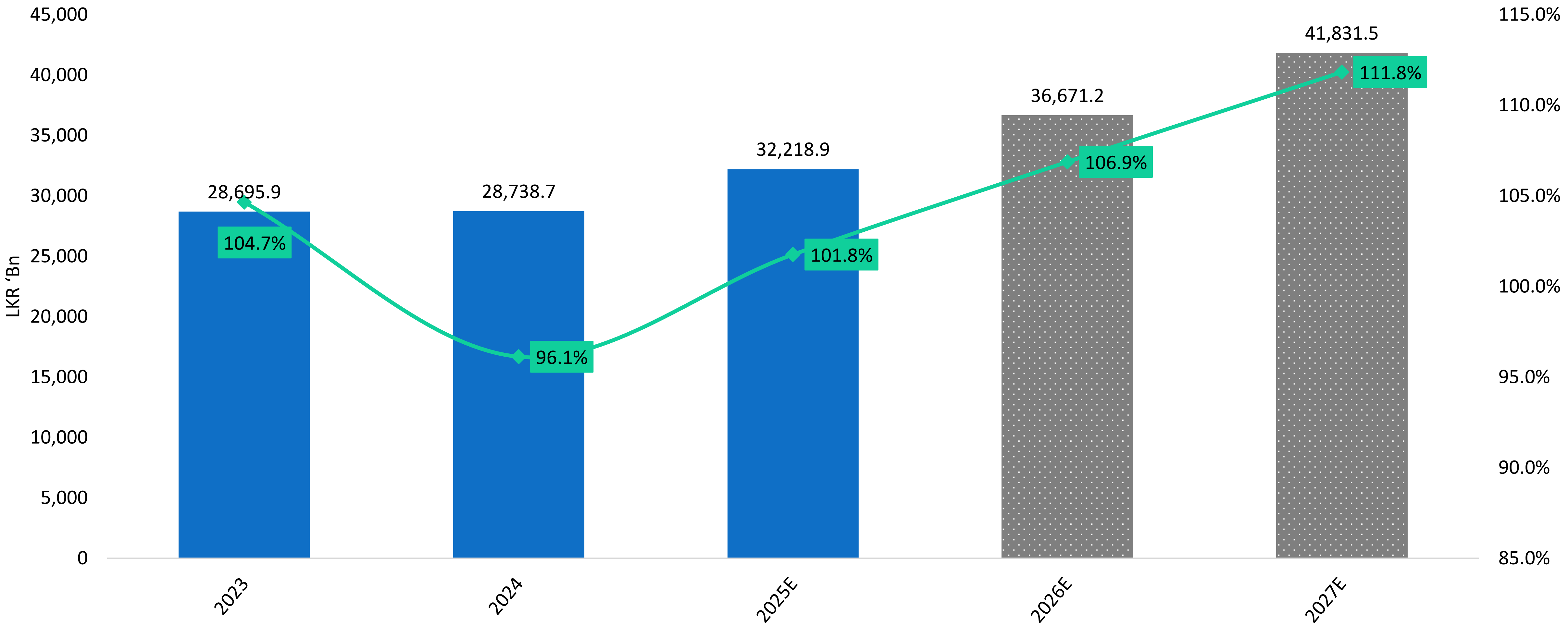
Inflows from the IMF and other International Financial Institutions (IFI) expected to aid Sri Lanka's reserve accumulation.



Support from the IMF and other IFI (USD 'Mn)

Debt to GDP to see an uptick...

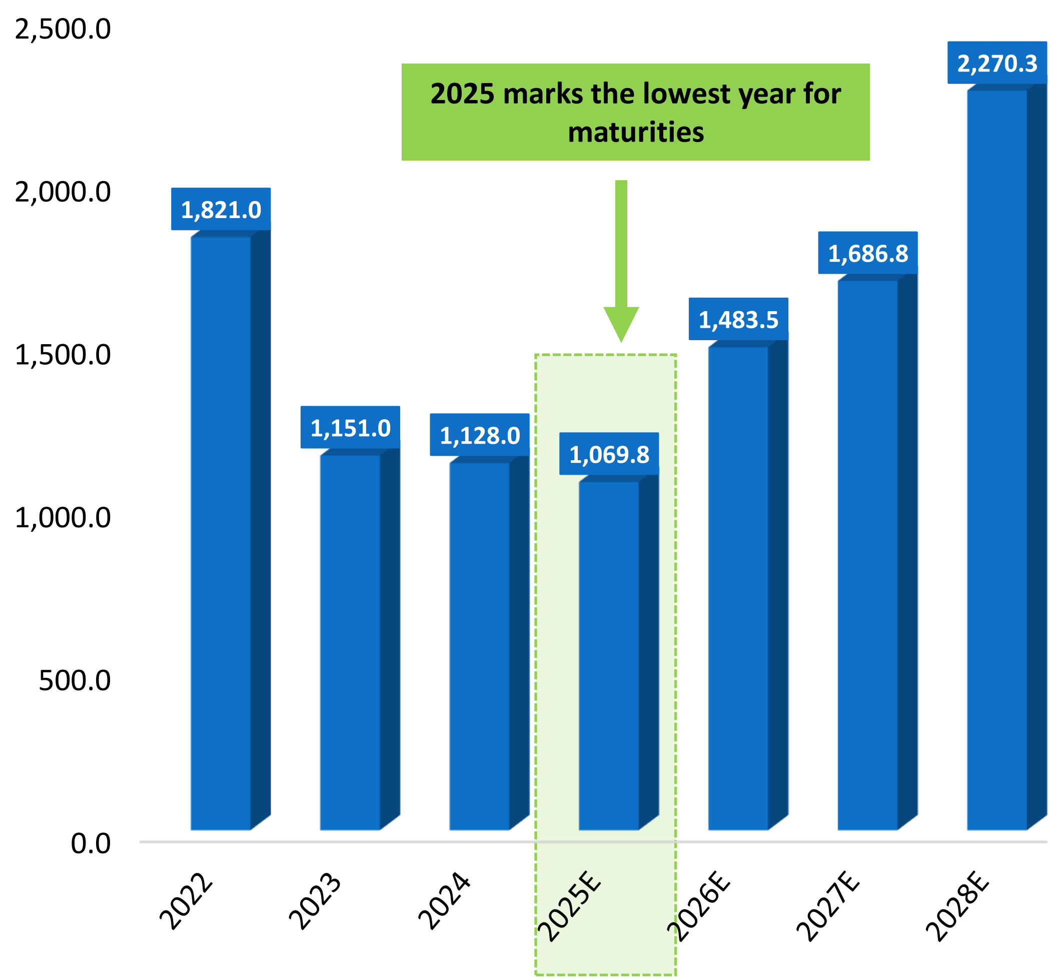
Sri Lanka's debt to GDP is expected to gradually pick up following the decline observed in 2024, as economic growth continues to slow. Boosting GDP growth amidst increased capital expenditure and relatively higher debt maturities in 2026E are considered challenges for GoSL during the upcoming years.



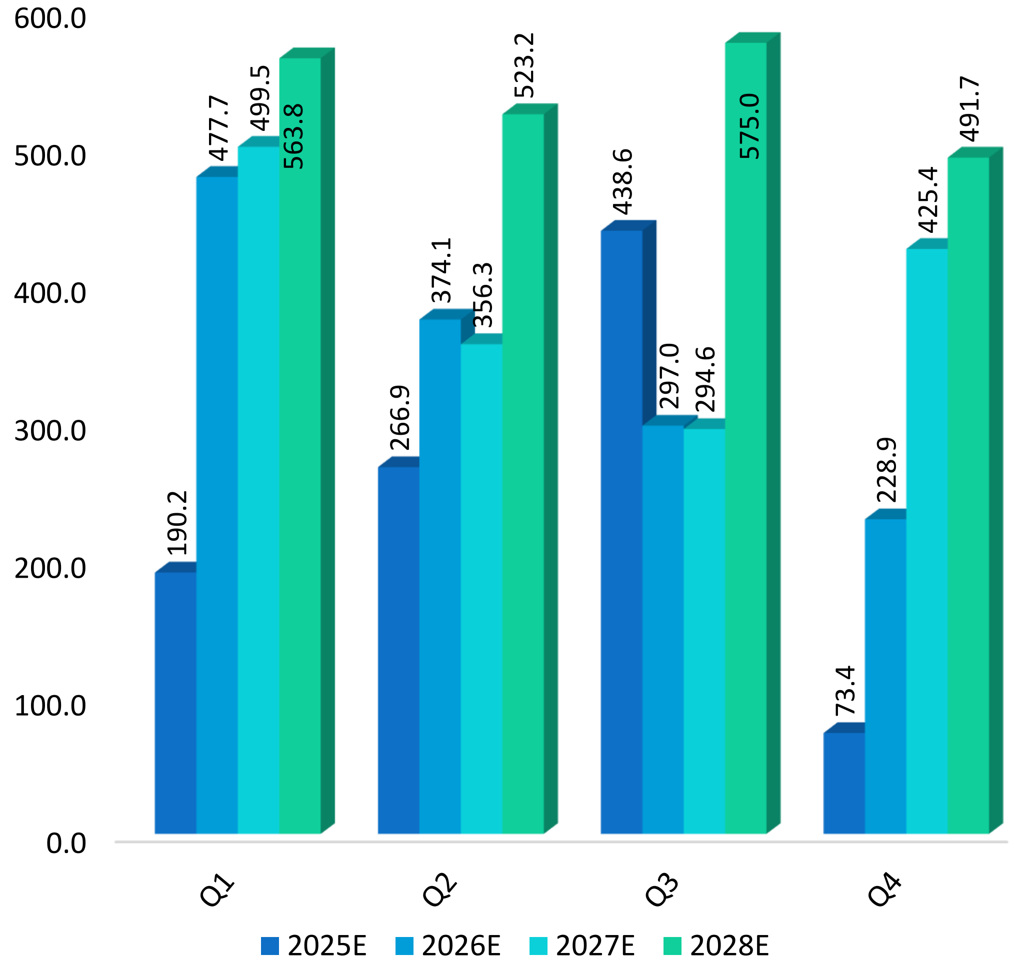
Source: CBSL, First Capital Research

...whilst maturities gradually climbs up from 2026E

Total maturities (LKR 'Bn)



Quarterly debt maturities (LKR 'Bn)



Summary of Overall Economic Outlook

Positives

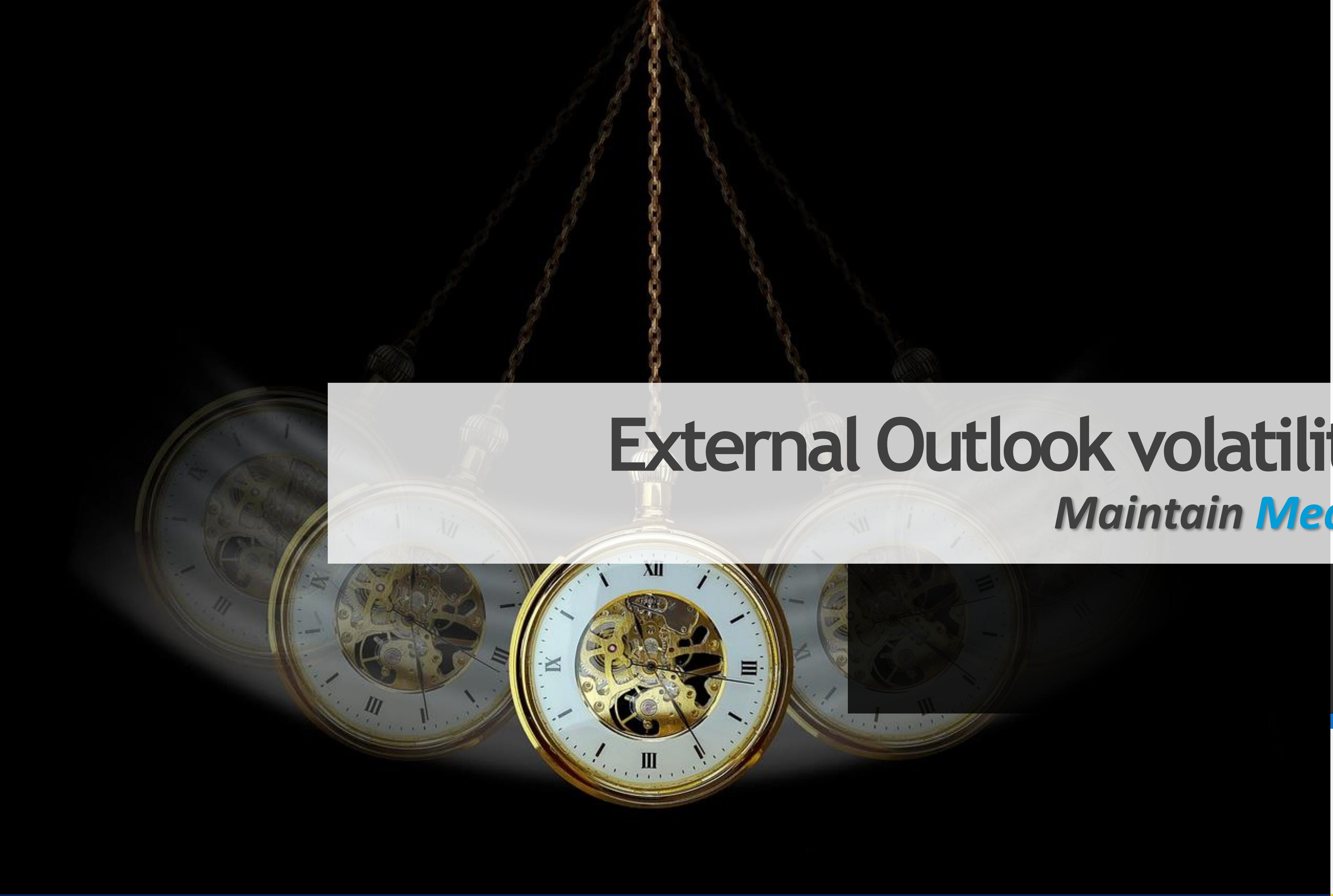
- Continuation of the IMF EFF Program
- Stable GDP growth
- Stability in Foreign Reserves
- Recovery in Tourism
- Record inflows from worker remittances
- Stable liquidity positions
- Inflation gradually rising towards CBSL guidance
- Stable LKR
- Primary Surplus

Negatives

- Rise in credit growth may exert pressure
- Lower capital spending limiting GDP growth
- High level of CBSL Holdings
- Relatively higher debt maturities
- Increase in debt to GDP ratio
- Difficulty in raising foreign debt
- US tariffs challenging trade deficit leading to possible slowdown in reserve buildup

Economic Outlook: Maintain *Medium-Low Risk*

Source: First Capital Research



External Outlook volatility persists

Maintain Medium-Low Risk

Section 5.0

Heightened geopolitical tensions across several regions...

Ukraine vs Russia

- Lower tourist arrivals
- Higher energy costs
- Lower import of wheat and other food products
- Lower tea exports

Israel vs Iran

- Higher energy costs
- Lower worker remittances
- Lower tea exports
- Lower tourist arrivals

India vs Pakistan

- Lower tourist arrivals
- Maritime trade disruption
- Lower FDIs and capital flows

With major agencies revising global growth forecasts downward…

Reuters

World Business Markets Sustainability Legal Commentary More

IMF cuts growth forecasts for most countries in wake of century-high US tariffs

By Andrea Shalal

April 23, 2025 1:17 AM GMT+5:30 · Updated April 23, 2025

Summary

- IMF sees global growth of 2.8% in 2025, down from 3.3% in January forecast
- IMF chief economist says new era ushered in by trade reset
- Escalating trade tensions could further dampen growth
- Click here for a table of the IMF's economic projections for 2025 and 2026 with comparisons to prior WEO forecasts

ALJAZEERA

News Middle East Explained Opinion Sport Video M

ald Trump > Live updates When will Trump's bill take effect? How world leaders massage Trump's ego

Economy | World Bank

World Bank slashes global economic outlook as trade tensions continue

The bank warned that without a swift course correction, the harm to living standards could be 'deep'.

The World Bank has slashed its 2025 global growth forecast, citing trade tensions and policy uncertainty as the United States imposed wide-ranging tariffs that weigh on global economic forecasts.

On Tuesday, the bank lowered its projection for global gross domestic product (GDP) growth to 2.3 percent in its latest economic prospects report, down from the 2.7 percent that it expected in January. This is the most recent in a series of downgrades by international organisations.

US tariffs, China slowdown cloud developing Asia's growth outlook, says ADB

By Reuters

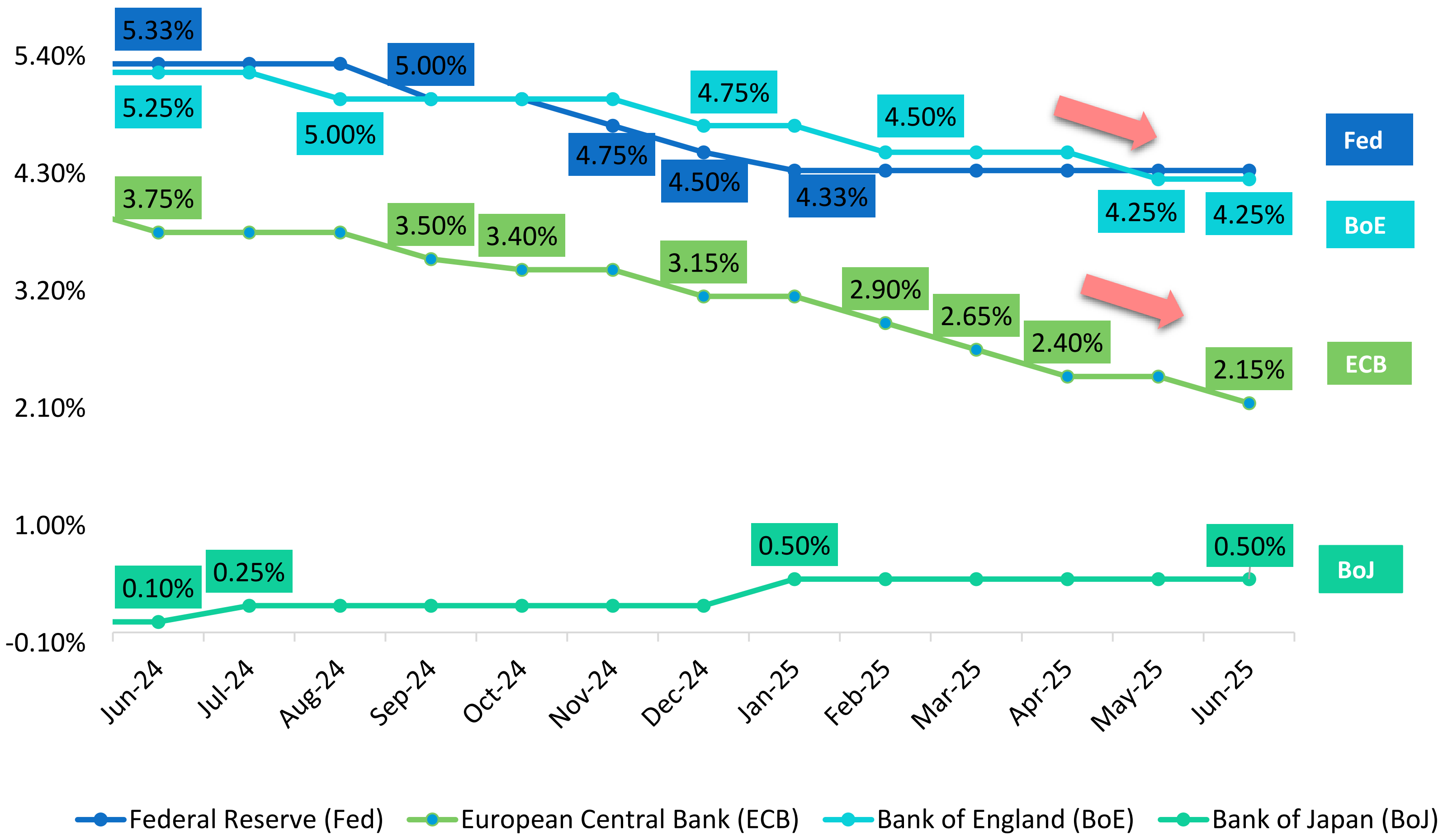
April 9, 2025 5:37 AM GMT+5:30 · Updated April 9, 2025

MANILA, April 9 (Reuters) - The full implementation of U.S. tariffs could cut developing Asia's growth by about a third of a percentage point this year and nearly a full percentage point in 2026, the Asian Development Bank said on Wednesday.

In its Asian Development Outlook report, the ADB projected that growth in developing Asia will ease slightly to 4.9% in 2025 — the slowest pace since 2022 — and slow further to 4.7% in 2026, from 5.0% in 2024.

Source: *Reuters, Al-Jazeera, Bloomberg, First Capital Research*

Central banks are expected to pivot towards a more accommodative policy stance



The Federal Reserve - The Fed's most recent dot plot projections indicate two additional interest rate cuts in 2025.
Next Policy Announcement Date: 30 Jul 2025

The Bank of England - In Jun 2025, the BoE held interest rates at 4.25%. The Bank signaled a rate cut later this year, and markets expect reductions in Aug and again by year-end.
Next Policy Announcement Date : 07 Aug 2025

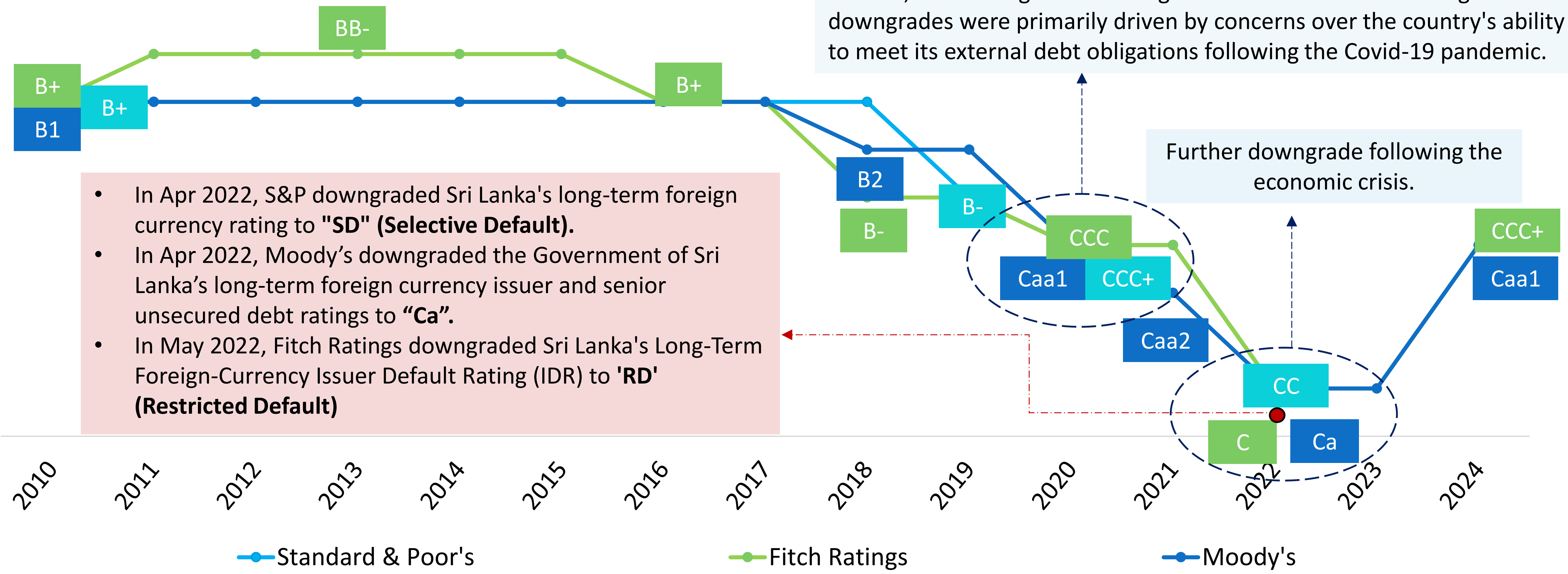
The European Central Bank - The ECB cut rates in Jun 2025, marking its eighth reduction since last Jun. The ECB has now signaled confidence in the current path, suggesting no further easing in the near term.
Next Policy Announcement Date : 24 Jul 2025

The Bank of Japan - In Jun 2025, the BoJ kept rates at 0.5%, signaling a cautious policy shift. Analysts now expect a rate hike only in early 2026 amid inflation concerns and growing risks from U.S. tariffs.
Next Policy Announcement Date : 31 Jul 2025

Source: FRB, BOJ, ECB, BOE, First Capital Research

Sri Lanka's credit rating expected to be maintained in the near term

First Capital
A Janashakthi Group Company



In 2020, all three agencies downgraded Sri Lanka's credit rating. The downgrades were primarily driven by concerns over the country's ability to meet its external debt obligations following the Covid-19 pandemic.

Further downgrade following the economic crisis.

- In Apr 2022, S&P downgraded Sri Lanka's long-term foreign currency rating to **"SD" (Selective Default).**
- In Apr 2022, Moody's downgraded the Government of Sri Lanka's long-term foreign currency issuer and senior unsecured debt ratings to **"Ca".**
- In May 2022, Fitch Ratings downgraded Sri Lanka's Long-Term Foreign-Currency Issuer Default Rating (IDR) to **'RD' (Restricted Default)**

"Upon completion of external debt restructuring in December 2024, Sri Lankan foreign currency rating was upgraded by Moody's and Fitch Ratings. However, Standard & Poor's continue to maintain its RD rating on SL, awaiting restructuring of the Sri Lankan Airlines USD 175.0Mn bond."

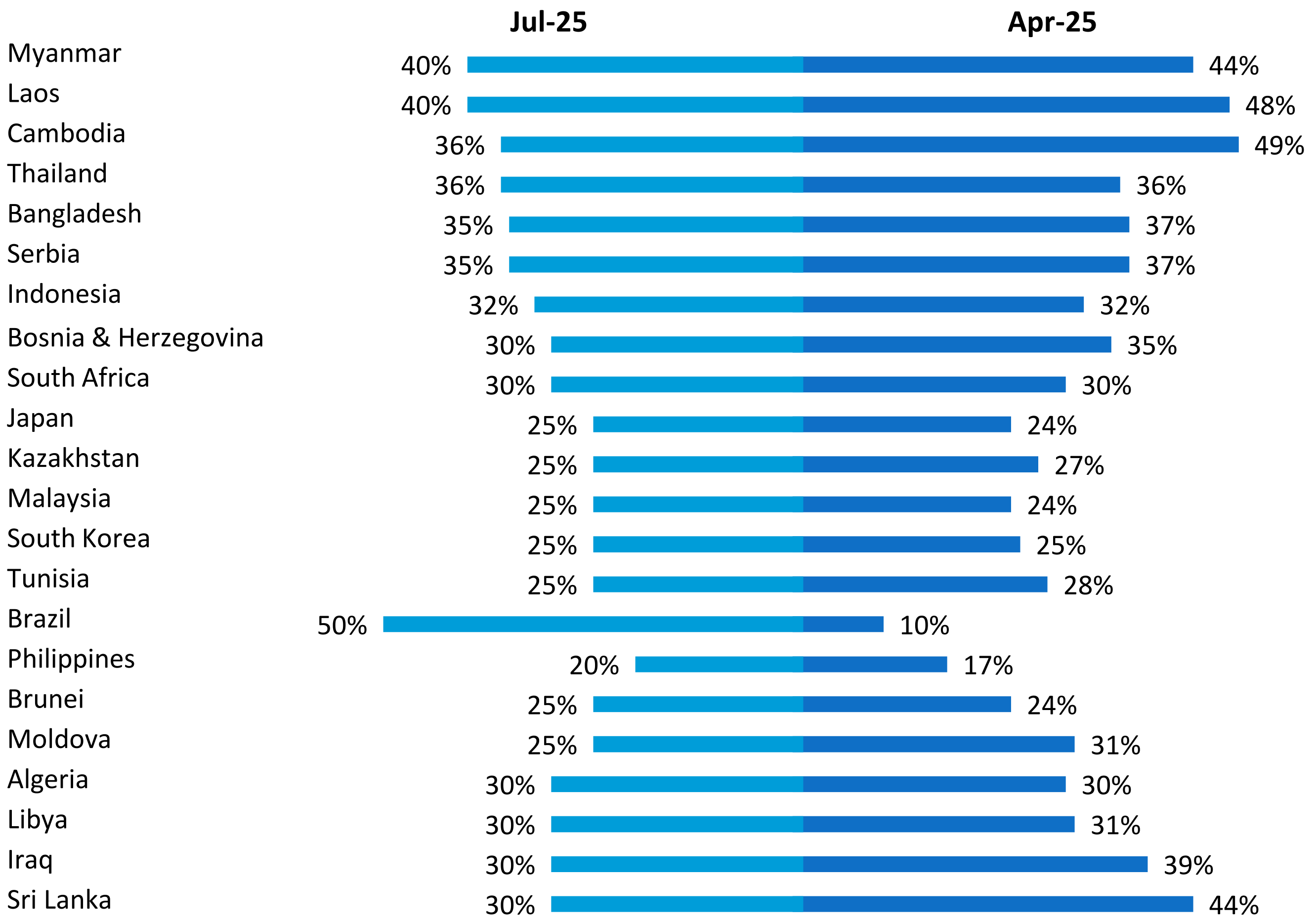
Source: Moody's, Fitch Ratings, S&P Global, First Capital Research

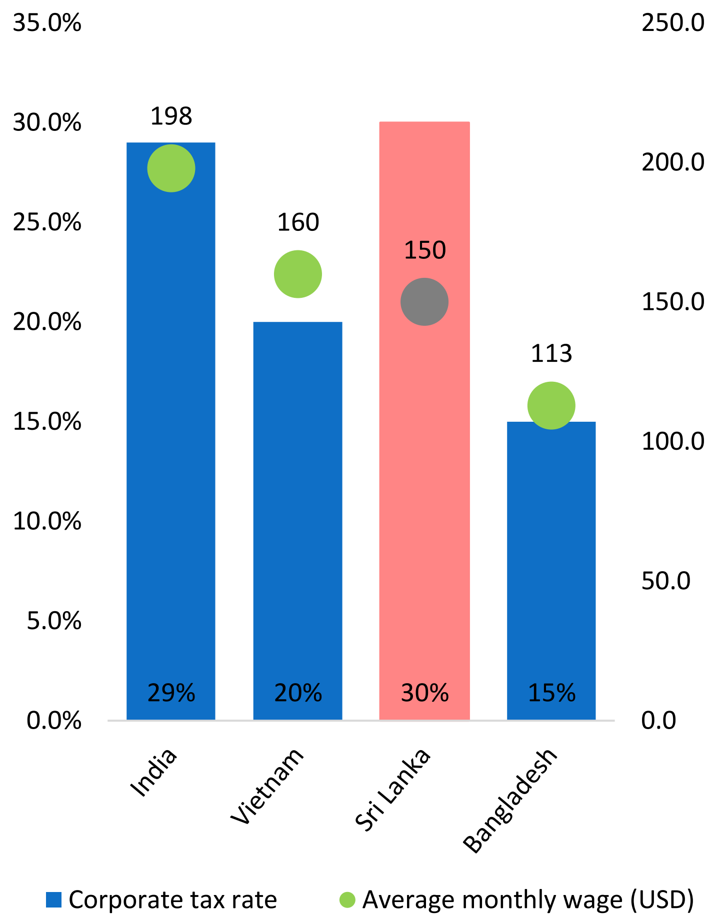
Investment Risks

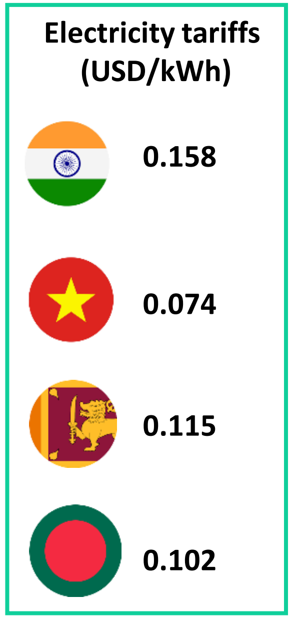
Section 6.0

President Trump Liberation day brings gloom to SL economy…

Sri Lanka stood as countries with the highest reduction of tariffs compared to its peers with US imposed tariff falling to 30% from previous imposed 44%. In terms of taxes, Sri Lanka continues to benefit more compared to its peers, with just Vietnam (tariff at 20%) below SL tax rate. However, despite the benefit from relatively lower taxes, Sri Lanka currently has one of the highest operating costs in the region, whilst increased taxes from existing 14%-15% to 44%-45% (including the new tax of 30%) makes Sri Lanka less competitive compared to its peers.







Source: BBC, White House, EY, S&P Global, First Capital Research

...whilst fragile peace treaties holds world peace by thread

- If Israel-Iran tensions escalate to the point of blocking the Strait of Hormuz, it could severely disrupt global oil flows, as around 20% of the world's oil and LNG pass through this critical chokepoint.
- Analysts predicted that Brent crude could spike to USD 100-120+ if the strait is fully closed.
- **For Sri Lanka, a net oil importer, this poses a serious economic concern, as each $1 rise in oil adds ~$50.0-70.0Mn to the annual import bill.**

- Sri Lanka relies heavily on remittances from overseas workers, a key source of foreign exchange, often exceeding USD 6.0Bn annually.
- **The Middle East, particularly Saudi Arabia, UAE, Qatar, and Israel, accounts for over 50.0% of these remittances.**
- If tensions expand to Gulf nations, a significant decline in inflows could emerge, tightening Sri Lanka's external financing position and weakening the rupee further.

- **The Middle East, especially countries like UAE, Iran, Iraq and Saudi Arabia are major buyers of Ceylon Tea, accounting for ~15.0–20.0% of total export volume and earnings.** Rising tensions may dampen export earnings.

- **Sri Lanka's tourism sector earnings could also take a negative turnaround** amid higher fuel costs resulting in higher airfares and lower tourist aarivals from the West, as they might be hesitant to transit through major hub airports located in the region.

Source: Reuters, Al-Jazeera, Bloomberg, First Capital Research

Recommendations

Section 7.0

First Capital Research View on Bond Market Jul’25-Jun’26

Section 7.1

Primary Criteria

First Capital
A Janashakthi Group Company

01

Foreign reserves

Risk Level : Medium Low (maintained)

Foreign reserves remains declined to USD 6.0Bn in June 2025, covering 4.0 months of imports.

02

Liquidity

Risk Level : Low (maintained)

Overnight liquidity continues to remain volatile yet consistently near and around the LKR 100.0Bn levels.

03

Inflation

Risk Level : Low (maintained)

CCPI continues its deflationary trend as inflation for June 2025 recorded at -0.6%YoY.

04

Foreign activity

Risk levels : Medium Low (maintained)

Foreign participation in government securities continue to remain weak with foreign participation below 5% from total debt.

05

Credit

Risk Level : Medium Low (maintained)

Total Credit grew by LKR 187.2Bn in May-25 with YTD credit growing by +2.0%.

06

CBSL holdings

Risk Level : High (maintained)

CBSL holdings marginally reduced to LKR 2.5Tn but continues to remain at elevated levels.

Secondary Criteria

Rating outlook

Completion of debt restructuring resulted with both Moody's and Fitch revising up their rating on Sri Lanka. However, S&P continues to maintain it default status on SL, due awaiting restructure of Sri Lankan Airlines debt

Risk Level : Medium Low

External environment

Risk Level : Low (Maintained)

LKR depreciated by 2.3%YTD cf. the USD on the back of widening trade deficit whilst aggressive USD purchases by the CBSL partially offset the decline

BOT & BOP

Trade deficit continued to expand and recorded at USD 1.3Bn with GoSL opened imports whilst positive current account surplus trickled down to the current year, aided by remittances and earnings from tourism

Risk Level : Medium Low (Maintained)

Political risk

Risk Level : Low (Maintained)

The ruling party won the local government elections after winning both presidential and parliament elections last year. Therefore, we maintain risk as low.

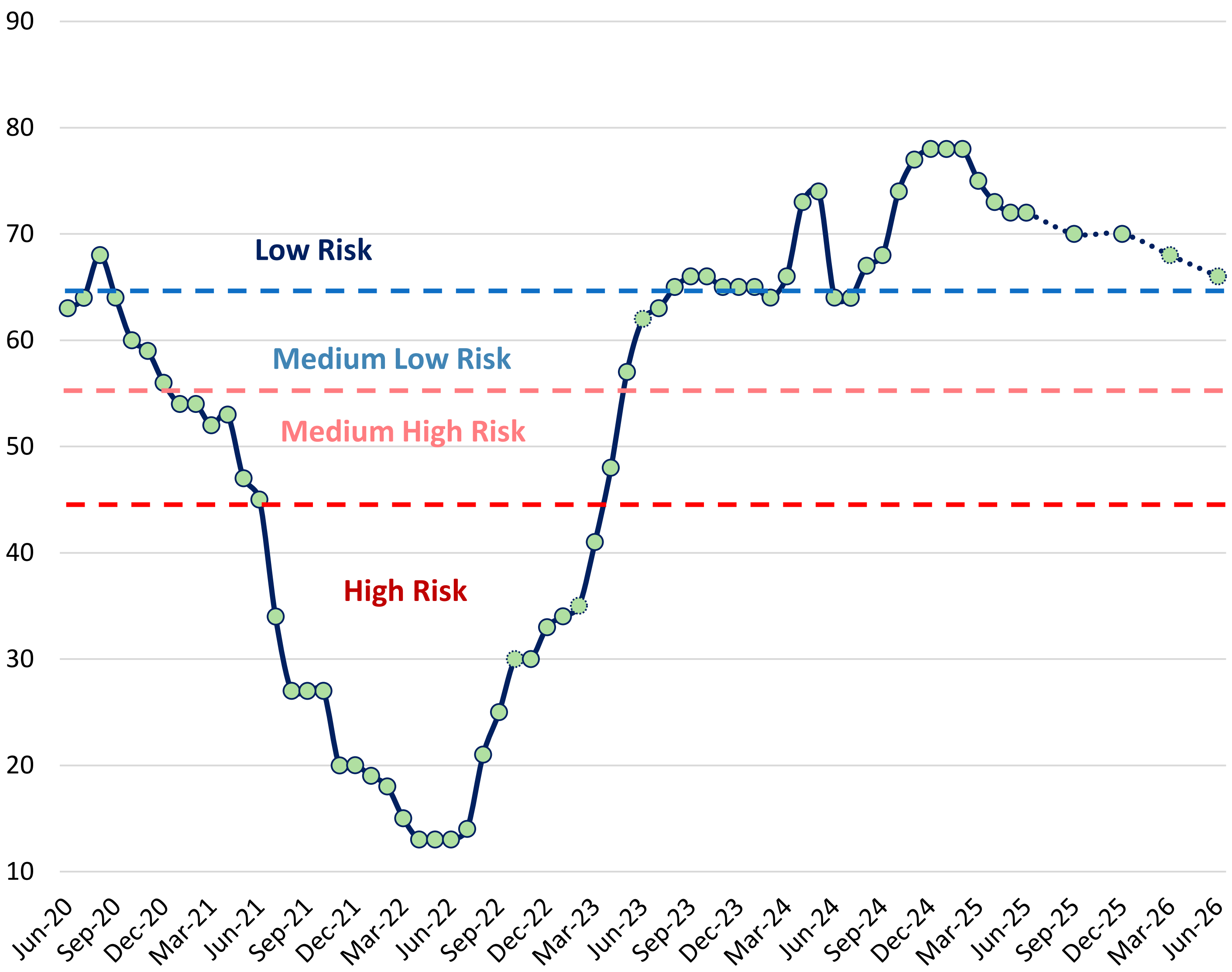
Investor confidence

Business confidence index hit an all time high of 210 in June 2025. Improvement in overall economy coupled with positive outcome of the local government elections.

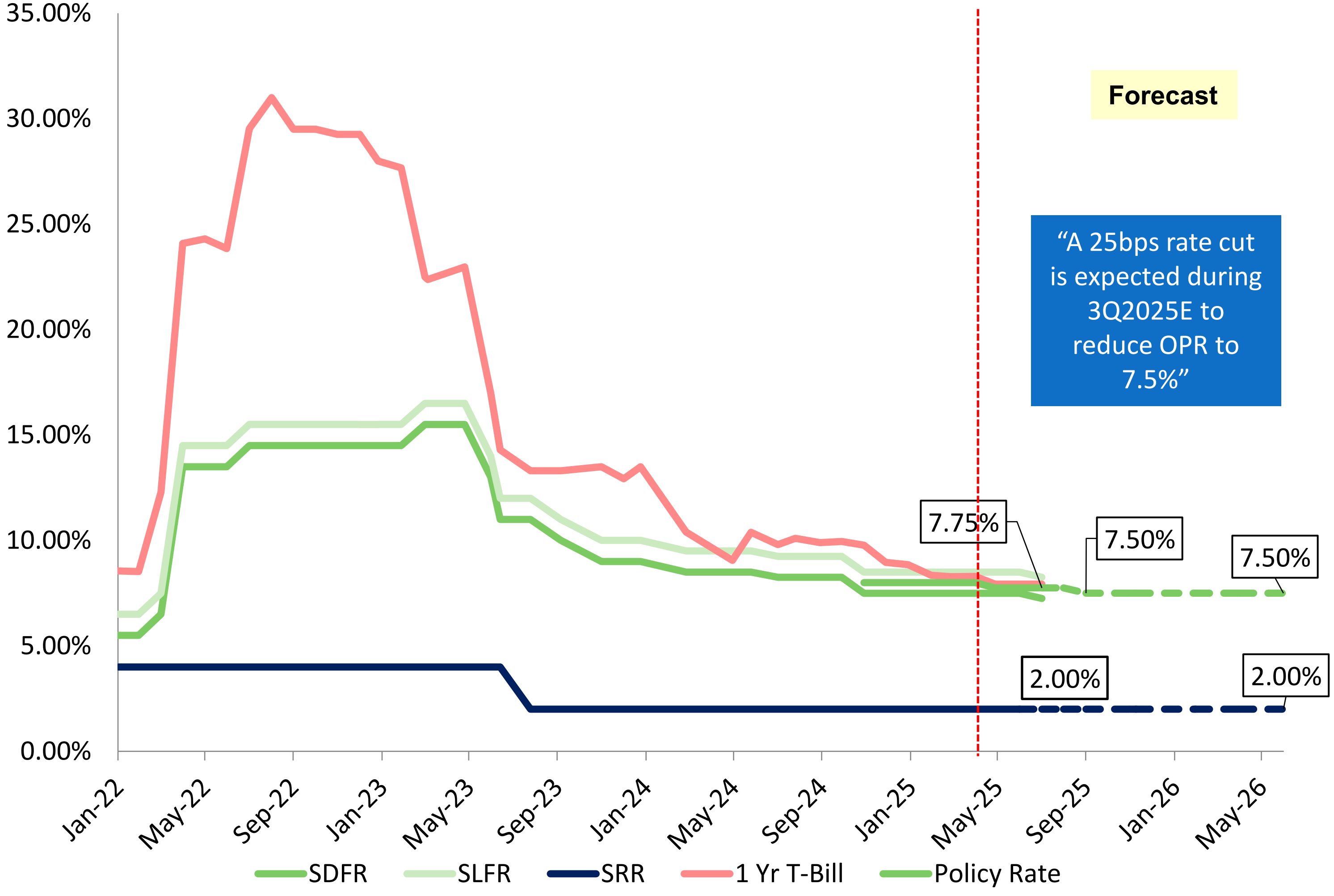
Risk level : Low (Maintained)

FI Health Score to remain stable

- The indicators relating to health score shows a prolonged stability as health score continues to hover above the low-risk category in the short term largely due to limited credit demand from state sector, which is positively affecting the liquidity position in the overall banking sector
- *However, with the continued economic recovery, coupled with increased credit demand driven by state sector expenditure, is expected to add pressure and move the health score towards the medium-low risk category. However, health score is expected to continue hover in the low-risk threshold during the next 12-month period.*



FCR expects policy rates to broadly remain stable, while a 25bps cut maybe considered offering comfort to economic growth



CBSL provided an OPR cut in its May-25 policy meeting, against our expectations.

Served with dual blows from US tariffs and possible global economic slowdown, we expect CBSL to support accelerated growth with another rate cut of 25bps to boost economic growth, which we believe is slowing down owing to limited government spending and weak consumer growth burdened with prevailing high taxes.

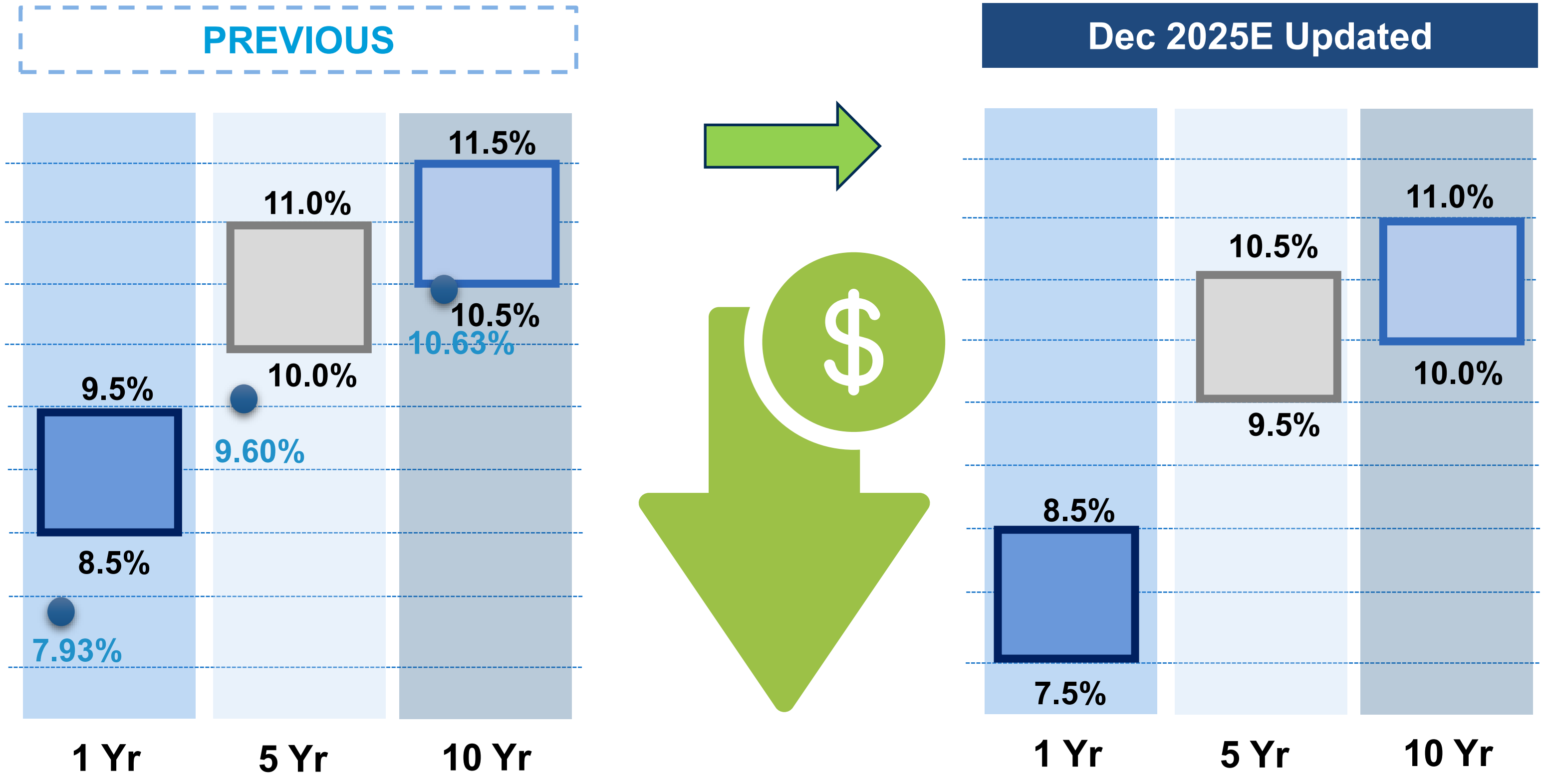
Considering CBSL aggressive attitude to cut policy rates in May-25, we expect further 25bps cut in OPR to 7.50% towards 3Q2025E followed by a broadly stable policy outlook over next 12-months

Source: CBSL, First Capital Research

Shorter tenure adjusted down by 100bps while mid to longer tenures adjusted by 50bps

Considering the unprecedented 25bps rate cut in May-25 and CBSL's boldness to potentially provide further 25bps easing amidst the slow economic environment, FCR target for Dec-2025 needs to be adjusted down by 50bps for the mid (5Yr) and long (10Yr) tenor maturities.

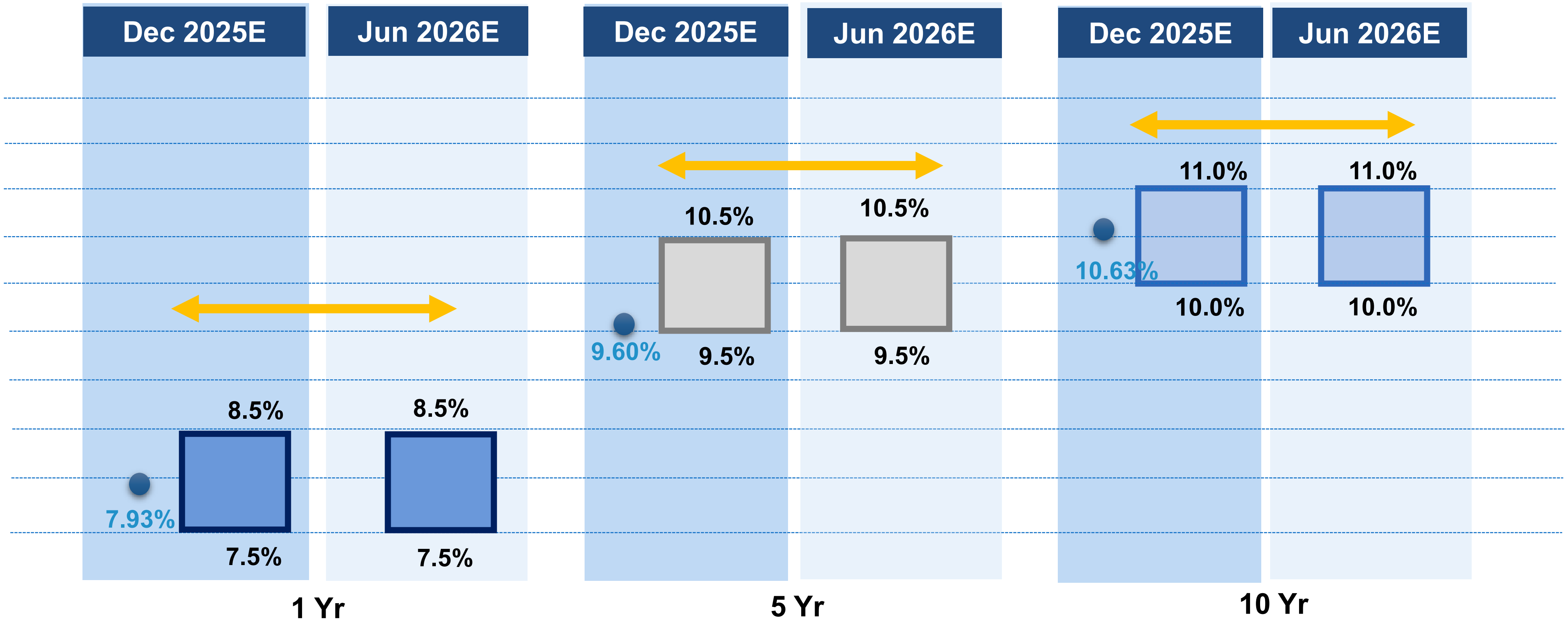
However, the spike in debt repayments beyond 2027 creates an additional attractiveness and bias towards short tenors resulting in an enhanced spread from short to mid tenors. Thereby, FCR is adjusting target for 1-Yr maturities down by 100bps.



Bond Yield Expectations for 1H2026E

Yields remain stable as pressure slowly builds up

Looking ahead, we expect yield curve to remain broadly stable following the potential rate cut of 25bps during 3Q2025E. Continuous gradual recovery in private and state credit, coupled with the anticipated slow growth in the economy, and increasing debt maturities in 2026E and 2027E are main concerns which we believe will limit a further downside on yields and enabled it to be maintained during next 12 months.



Source: First Capital Research

Recommendation

“Yields to remain stable within the next 6-12 months”

Recommendation maintained: Shift to short tenures with a willingness to run a carry portfolio

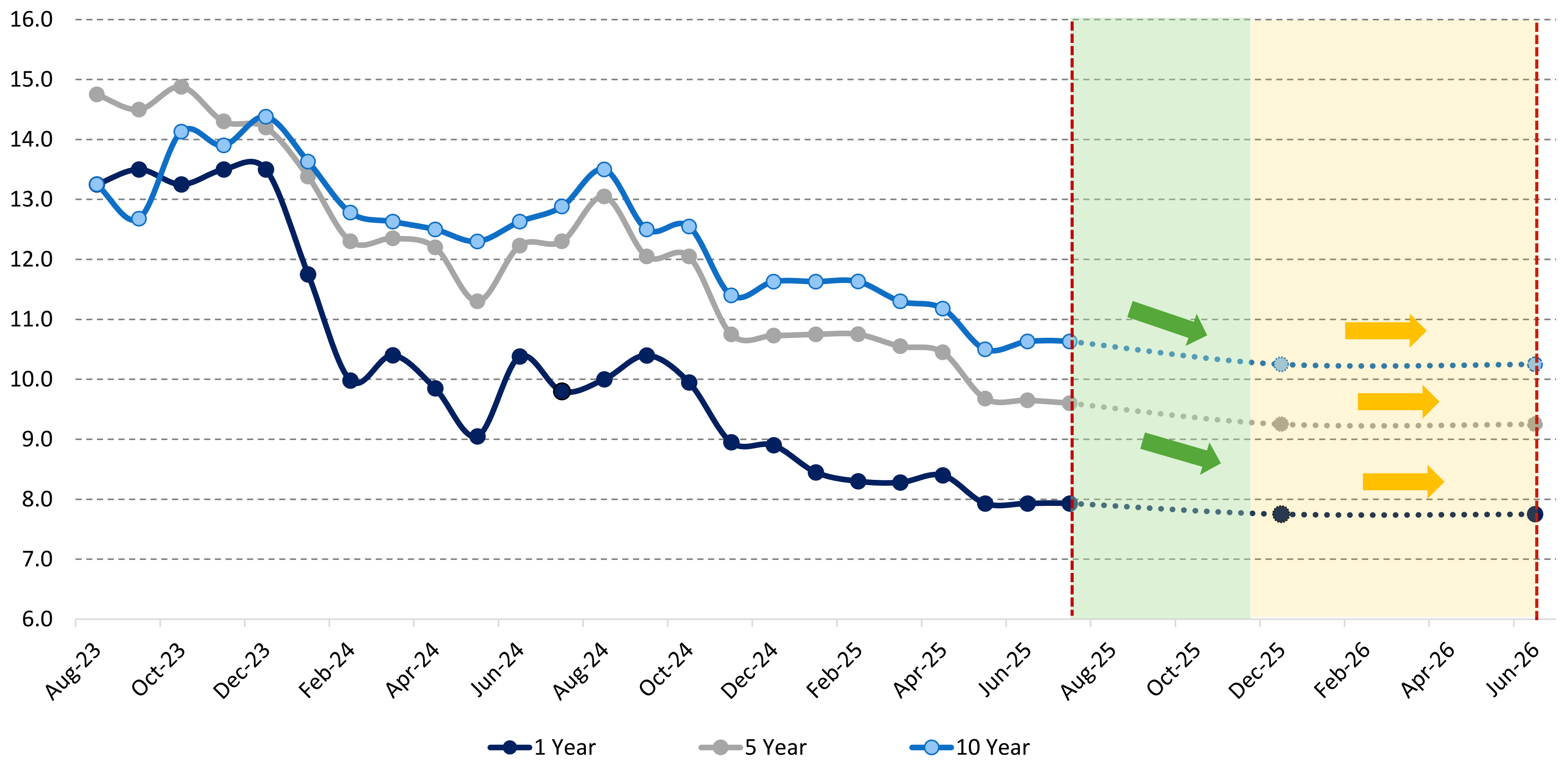
A 25bps rate cut on cards: Considering the expected slow growth in GDP in 2026E and 2027E together with the expectations of normalized liquidity levels in the banking sector and slow movement of inflation to CBSL desired thresholds backed by weaker than expected consumer demand, which is curtailed by relatively higher taxes are key considerations, providing space for another 25bps rate cut to bring the overnight policy rate (OPR) to 7.50% from current 7.75% levels.

Rate cut to offer limited downside: Since all three maturities are already trading within and near our lower bands of the recommendation, we see little downside potential for the yield curve. Moreover, with investor interest widely hovering around the 3Yr-4Yr tenures, the yield curve has further steepened between 1Y to 5Yr tenures whilst 5Yr to 10Yr spreads has remained stable with little to none fluctuations.

Rates to remain stable during next 12 months period. Despite the expectations of a possible 25bps rate cut during 3Q2025E, we believe yield curve to remain within our targeted bands within the next 12-month period. Possible increase in government capital spending to counter the slowness of the economy, coupled with increased private and state sector credit demand drying down liquidity in the market, and increasing trend of bond maturities in 2026E and 2027E are considered key factors limiting further downward shift on yields and to remain within our stipulated targets. Moreover, looming uncertainties with regards to debt repayments in 2027, are also adding caution to investor sentiment limiting further downside on the yield curve.

Shift to short tenures: With rates expected to remain stable and with limited downside potential, we advice investors to shorten the durations and maintain their positions on short tenures. Therefore, we maintain our recommendation to **run a carry portfolio positioning on the short tenures of the yield curve.**

Yields are expected to gradually increase with short to mid term tenures rising faster than the longer tenures

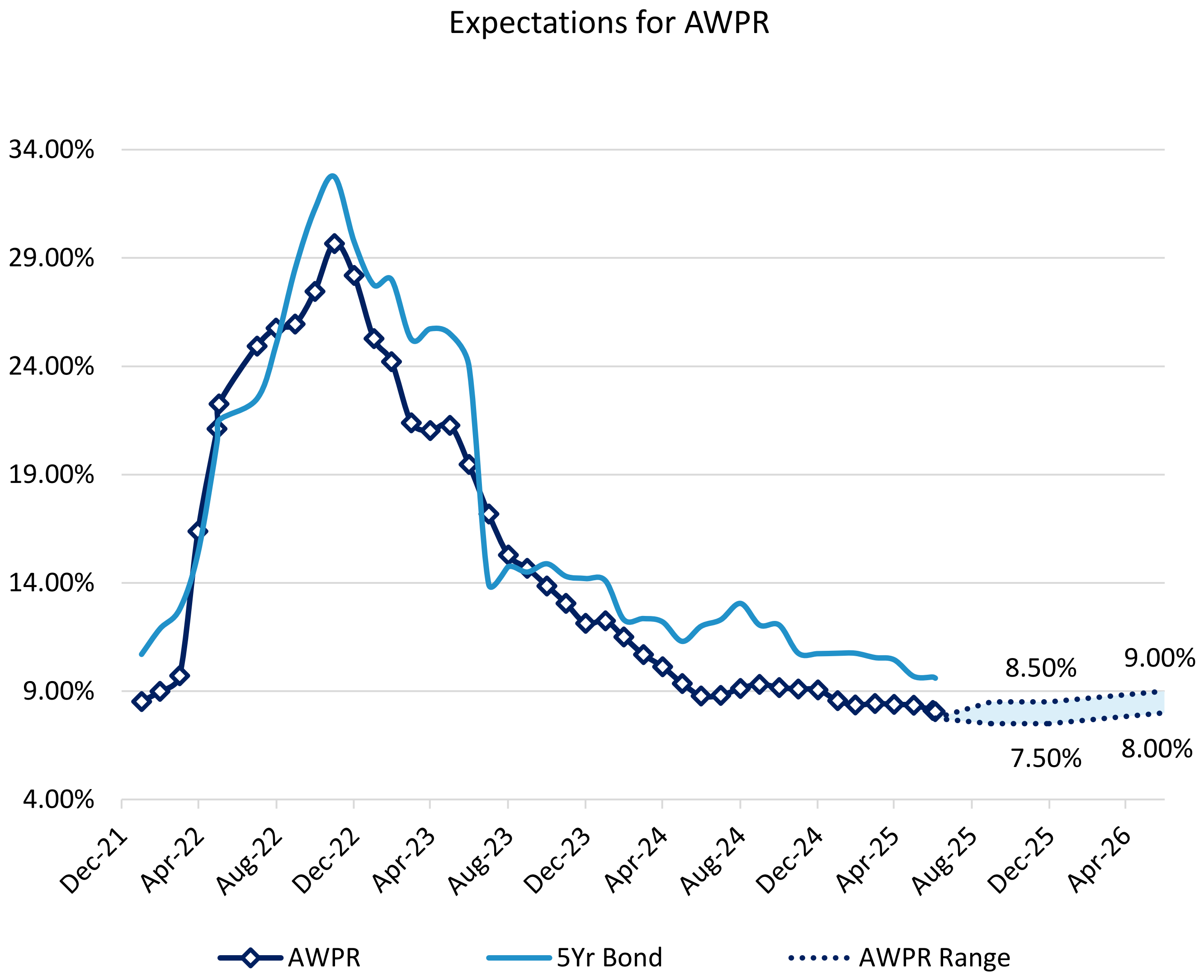


Source: CBSL, First Capital Research

First Capital Research View on Banking Rates Jul’25-Jun’26

Section 7.2

AWPR to remain between 7.5%-8.5% for 2H2025 and reach 8.0%-9.0% in 1H2026



AWPR to reduce further

AWPR to fall further: Weaker than expected consumer demand coupled with increased demand for credit from corporates and lower risk appetite of banks, pushed down AWPR beyond our expectations and towards the risk-free rate in 1H2025. However, on the back of an expectation of another 25bps rate cut by the monetary board of CBSL is expected to further reduce AWPR to between 7.5% - 8.5% by 2H2025E.

AWPR target upgraded to 8.0%-9.0% : *With state credit slowly on the rise, together with the existing demand from private sector are expected to drive AWPR to our targeted range in 1H2026E.*

Source: CBSL, First Capital Research

First Capital Research View on Exchange Rates Jul’25-Jun’26

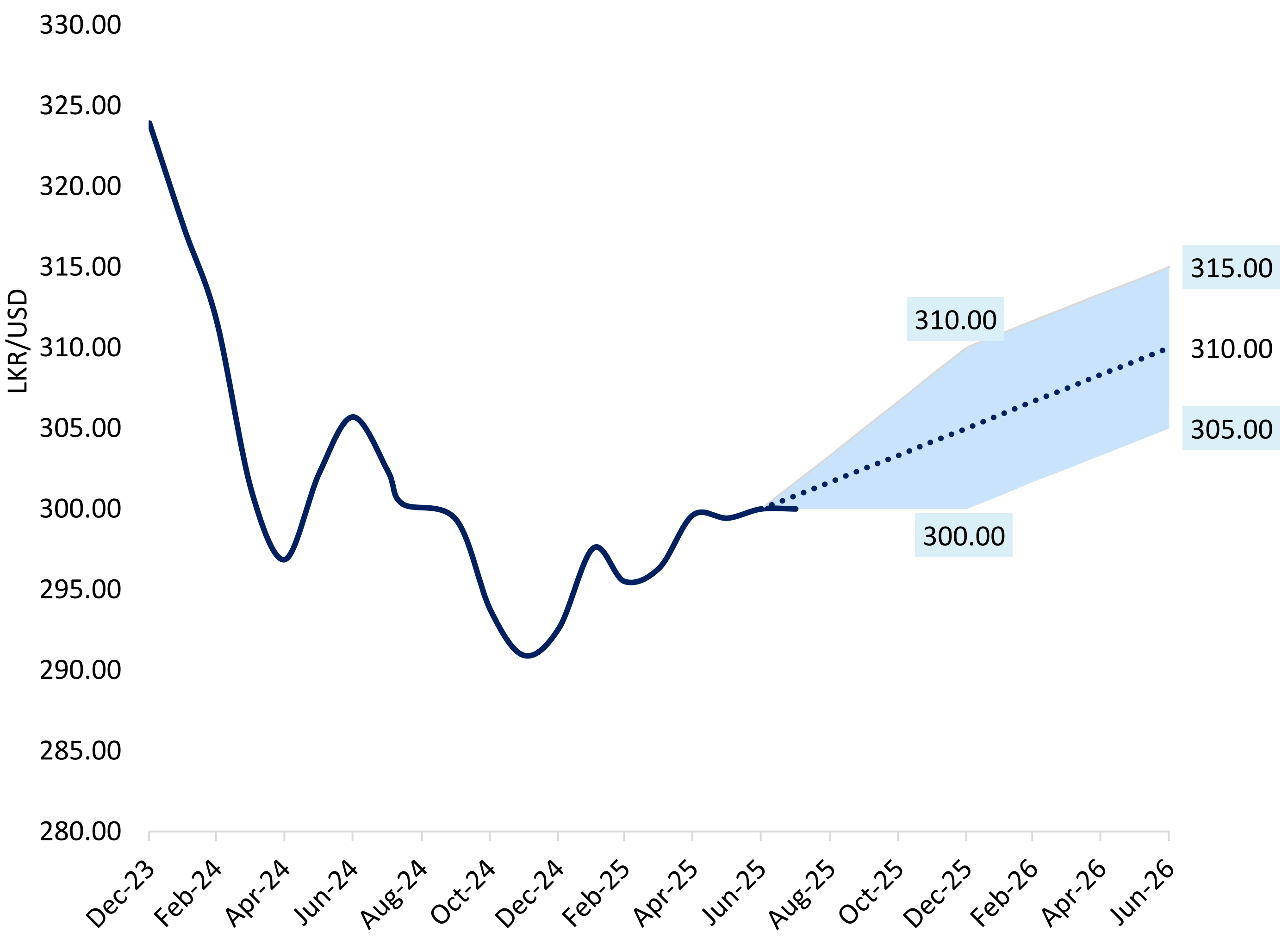
Section 7.3

Exchange Rate outlook extended for 1H2026E at LKR 305.0 – LKR 315.0

Aggressive FX purchases lower depreciation outlook

LKR depreciation remains limited in 2025E: Despite the recovery of consumer demand, the currency held its ground during 1H2025E showing a modest depreciation of 2.3%YTD, aided largely due to aggressive USD purchases by the CBSL.

FCR currency target extended: FCR extends its Jun 2025 target to Dec 2025 (300.0-310.0) while expecting some pressure to the LKR in 1H2026 with target of LKR 305.0-315.0



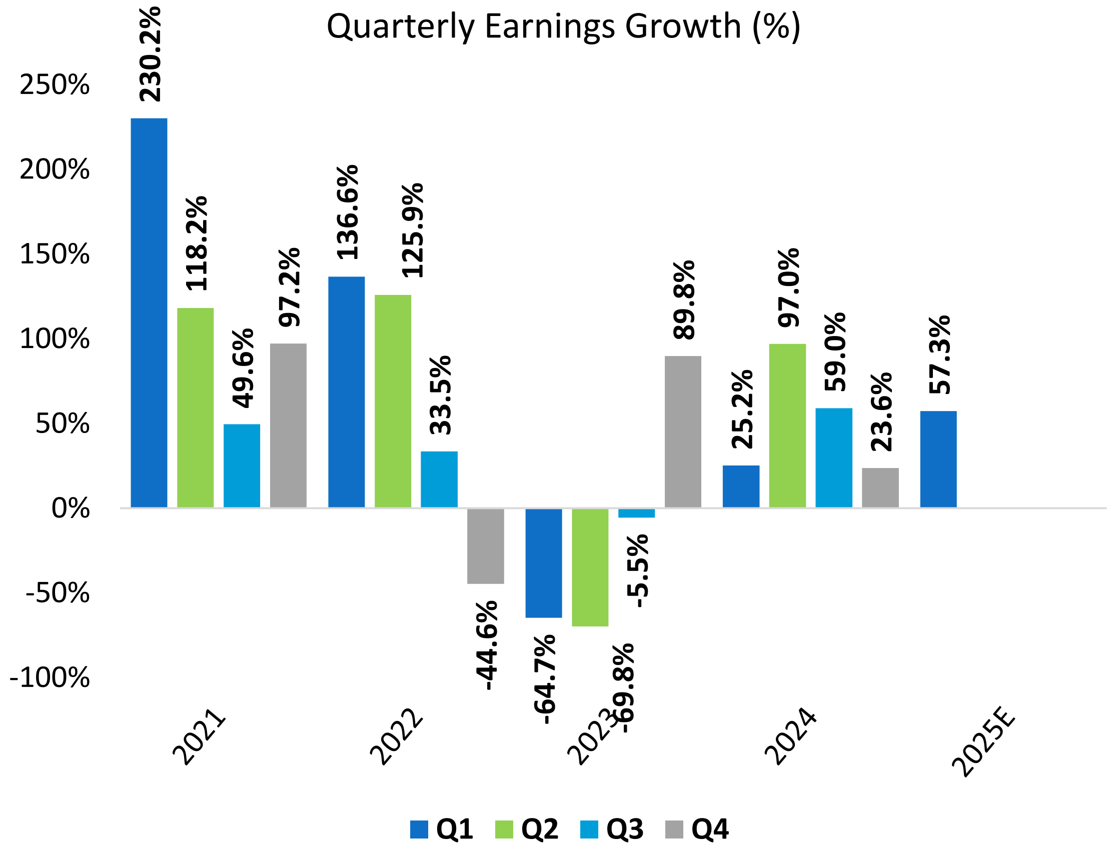
First Capital Research View on Equity Market Jul’25-Jun’26

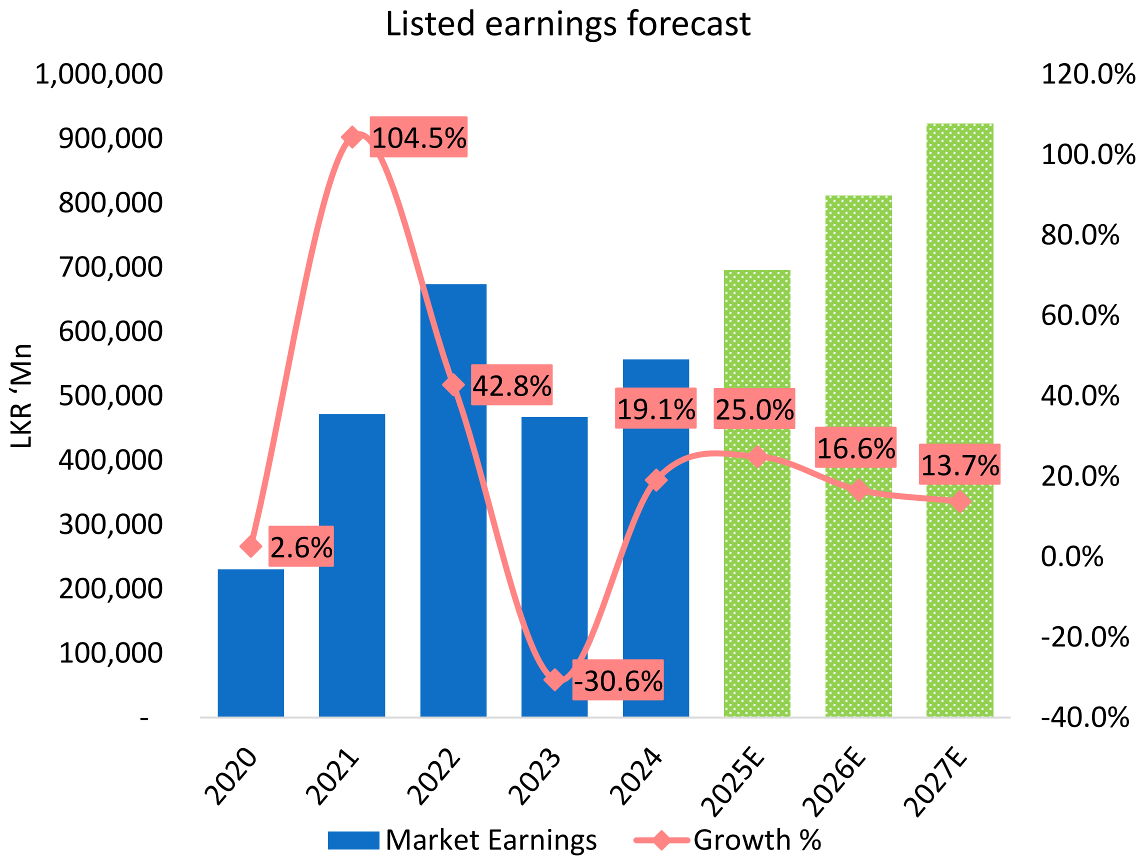
Section 7.4

Steep upsurge in Corporate earnings growth reaching 25% in 2025E and 17% in 2026E...

Profitability rises for the fifth consecutive quarter driven predominantly by banks and Food, beverage and Tobacco sector

Listed corporates recurrent profits, taking off the one-off impacts from ISB reversals and gain of LKR 110.0Bn from LOLC, expected to jump by 25.0%YoY in 2025E and 16.6%YoY in 2026E.

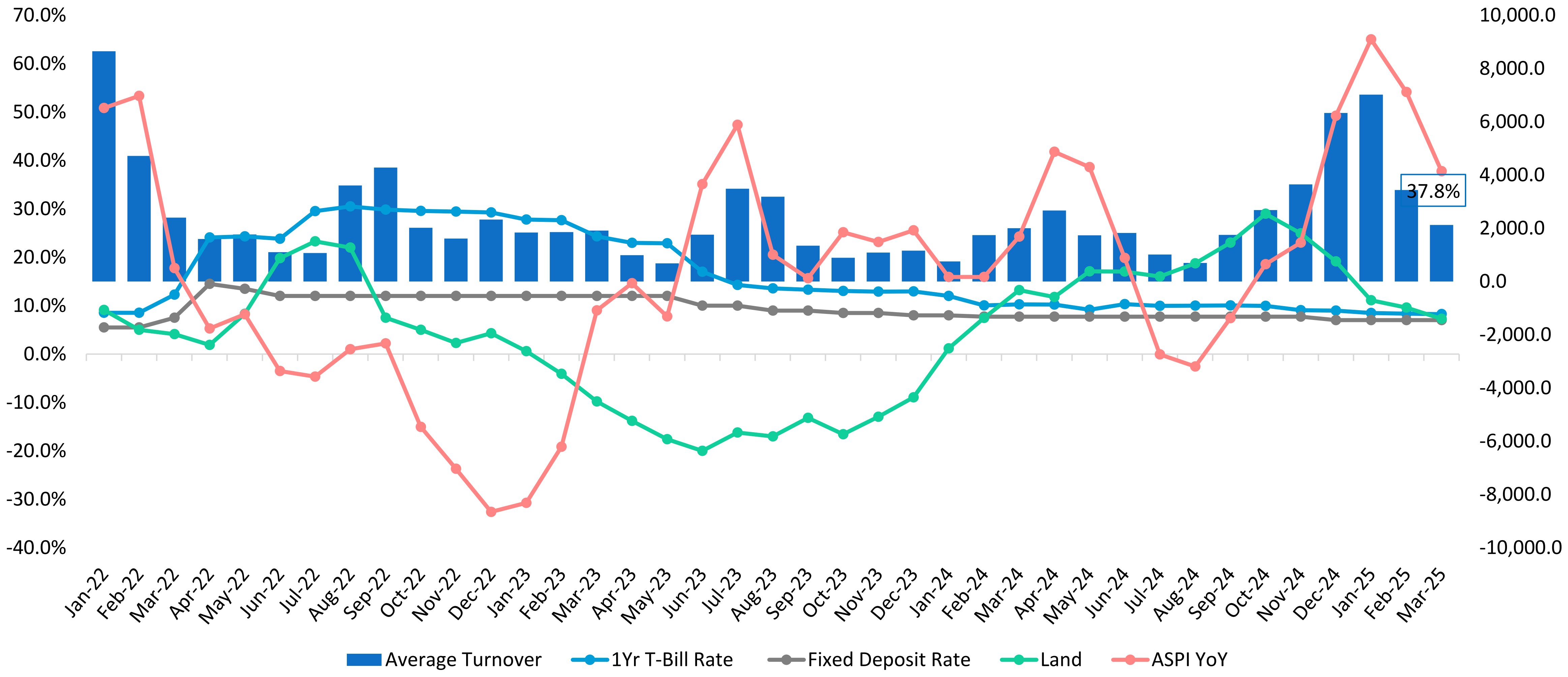




Source: CSE, First Capital Research

...coupled with a low-interest rate environment, channel investor flows into equities...

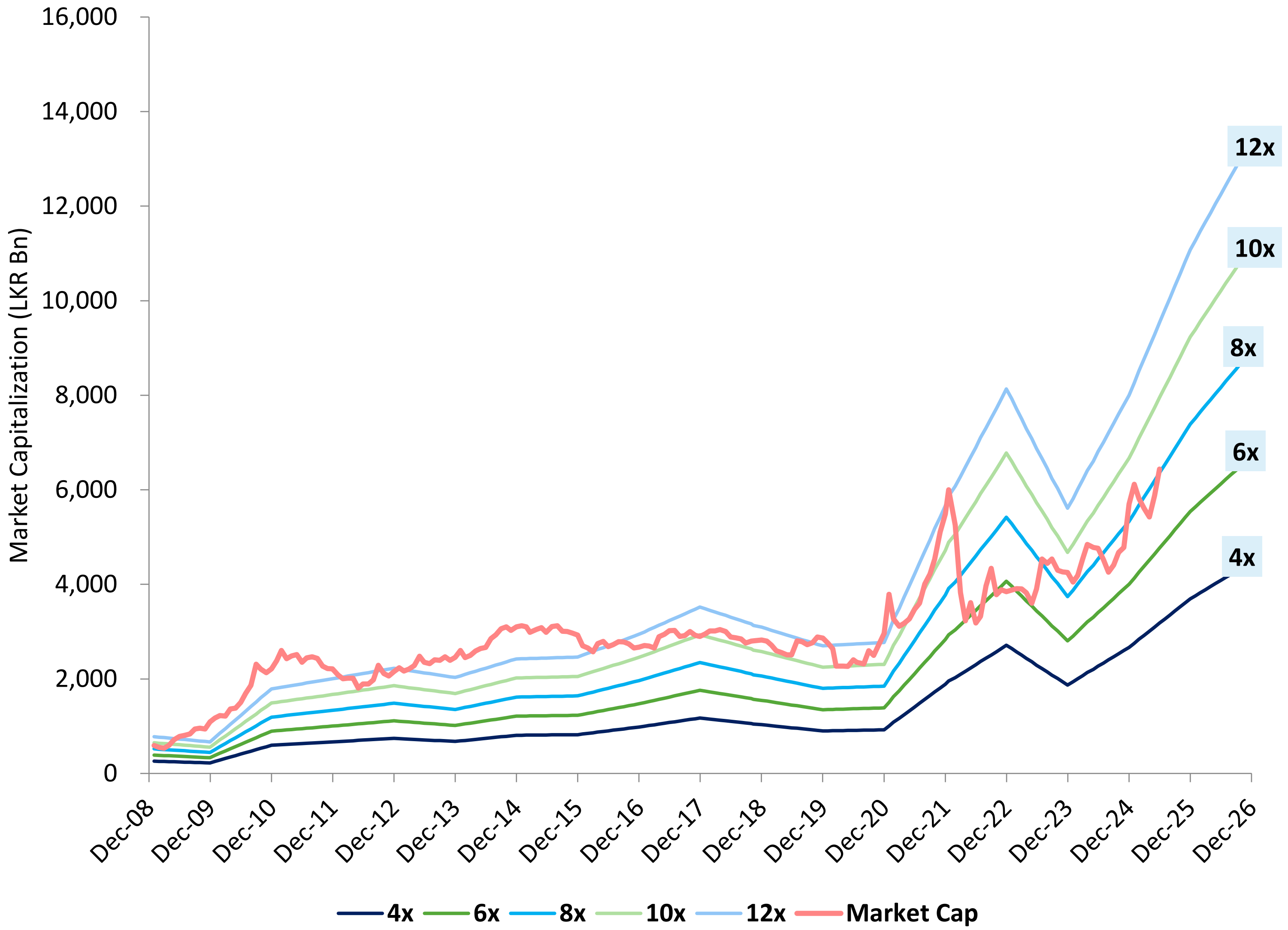
Improvement in average turnover at CSE indicates a possible shift in asset classes as interest rates and government security yields remains moderate.



Source: CBSL, CSE, Lanka Property Web, First Capital Research

CSE still trades at a steep discount to its historical average of 12.0x PER

CSE PER has averaged at 12.0x considering the past 10-year history. With the ASPI currently trading at 8.6x PER, we believe the index at a considerable discount to its historical average. Moreover, current low interest rates and expectations of 38.5%YoY and 21.0%YoY growth in earnings are expected to further boost the prospects for the ASPI.



Source: CSE, First Capital Research

…reinforcing our positive outlook for ASPI as we introduce our 2026E fair value at 21,000 – 22,000 (while upgrading our 2025E fair value at 18,000-19,000)

First Capital
A Janashakthi Group Company

Source: CSE, First Capital Research

Prolonged low interest rates and jump in profits to re-rate ASPI for 2026E

First Capital Research maintains stance on BUYING

- **Low interest rates to prevail:** With interest rates expected to remain stable, largely aided by lower spending by government, high taxes offsetting consumer spending and stable liquidity in the banking sector. Low interest rates trickling down to lower returns on alternative assets are considered key catalysts for improved participation at CSE, leading to re-rating of the index.

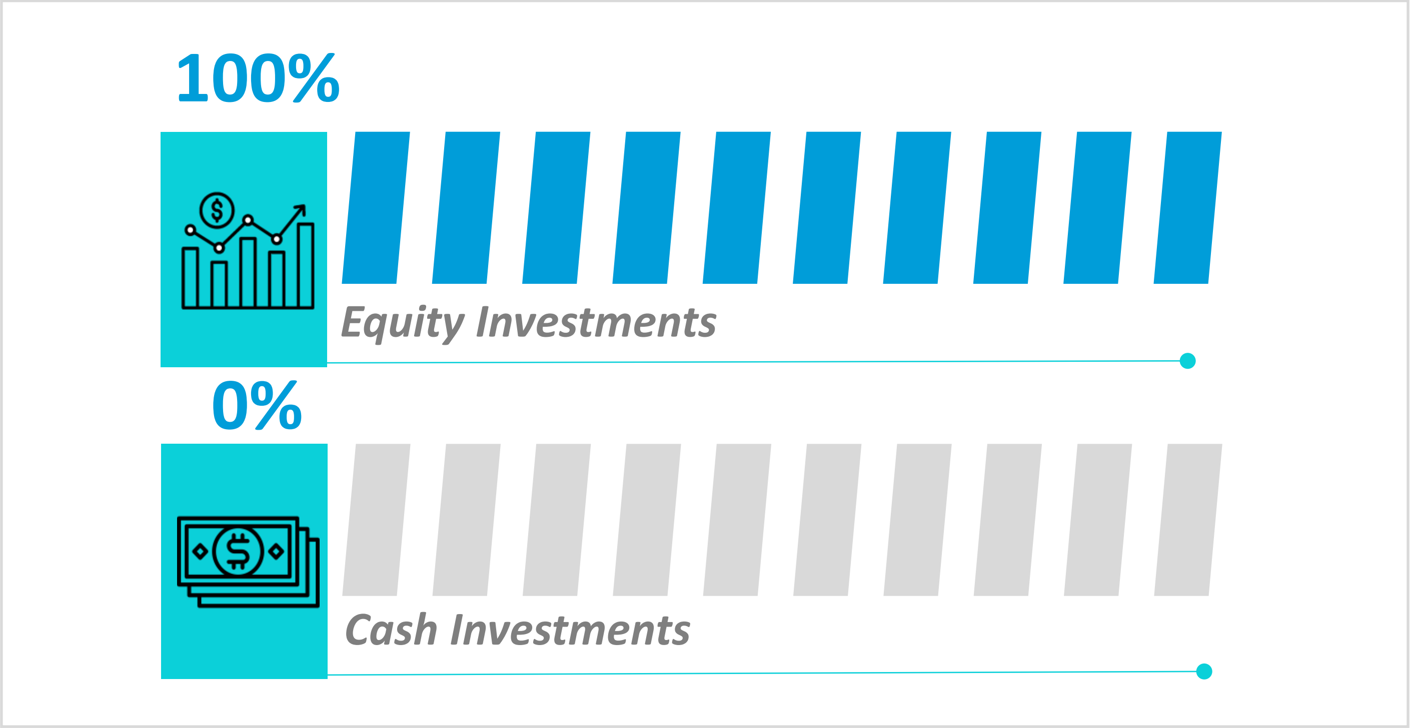
- **Earnings momentum to continue:** Listed corporate earnings are expected to see 3 years of double-digit growth in profits driven by increased profits of banks and F&B shares whilst Capital Goods sector earnings will be driven predominantly by JKH through the commissioning its mega projects such as City of Dreams Sri Lanka and West Container Terminal. Meanwhile, remaining companies in the bourse are also expected to see earnings growth contributed by the pickup in business activities on the back of improved demand and factory utilization, coupled with cost savings from finance cost reductions and stable inflation and recovery in disposable incomes.

- **CSE trades at a considerable discount to its historical average:** CSE is currently trading at a PER of 8.6x and a PBV of 1.2x, which is steeply below its 10Yr average PER of 12.0x. We expect CSE trading PER to re-rate to 10.0x, driven largely by price increases in blue chip companies. Stable growth in earnings of listed banks coupled with commissioning of JKH's mega projects are expected to offer the boost to earnings enabling the re-rating of the index.

- **Market to re-rate and reach a target of 21,000 - 22,000 for 2026E:** significant jump in recurrent profits in 2025E by 25.0%YoY coupled with two consecutive double digit returns in profitability from listed corporates led by blue chips together with a backdrop of prolonged low interest rates, which we believe improve fund inflows to CSE seeking higher returns compared to alternative assets classes are expected to be main contributors towards the re-rating of the CSE PER to 10.0x by 2026E. Considering the re-rating together with the potential for earnings growth, we are maintaining our bullish stance on equities and allocate a target range of 21,000 – 22,000 for the index.

Source: CSE, First Capital Research

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.

- Given the better-than-expected performance of the listed corporates together with the expectations of a prolonged low interest regime, are expected to contribute towards the re-rating of the ASPI to the stipulated 2026E targets.

- 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.

Disclaimer

This Review is prepared and issued by First Capital Holdings PLC based on information in the public domain, internally developed and other sources, believed to be correct. Although all reasonable care has been taken to ensure the contents of the review are accurate, First Capital Holdings PLC and/or its Directors, employees, are not responsible for the accuracy, usefulness, reliability of same. First Capital Holdings PLC may act as a Broker in the investments which are the subject of this document or related investments and may have acted on or used the information contained in this document, or the research or analysis on which it is based, before its publication. First Capital Holdings PLC and/or its principal, their respective Directors, or Employees may also have a position or be otherwise interested in the investments referred to in this document. This is not an offer to sell or buy the investments referred to in this document. This Review may contain data which are inaccurate and unreliable. You hereby waive irrevocably any rights or remedies in law or equity you have or may have against First Capital Holdings PLC with respect to the Review and agree to indemnify and hold First Capital Holdings PLC and/or its principal, their respective directors and employees harmless to the fullest extent allowed by law regarding all matters related to your use of this Review. No part of this document may be reproduced, distributed or published in whole or in part by any means to any other person for any purpose without prior permission.

Thank You

"Successful investments is about managing risks"

First Captial 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

Shahana Kanagaratnam
Senior Assistant Manager – Research
T: +94 11 2639 866
E: shahana@firstcapital.lk

Akna Tennakoon
Senior Research Analyst
T: +94 11 2639 866
E: akna@firstcapital.lk

Manusha Kandanaarachchi
Research Associate
T: +94 11 2639 866
E: manusha@firstcapital.lk

Salaama Sanoon
Research Associate
T: +94 11 2639 866
E: salaama@firstcapital.lk