“Economic Steadiness Anchors Bond Yield Curve Stability”

FIRST CAPITAL FIXED INCOME RECOMMENDATION | 28 Oct 2025

FIRST CAPITAL RESEARCH

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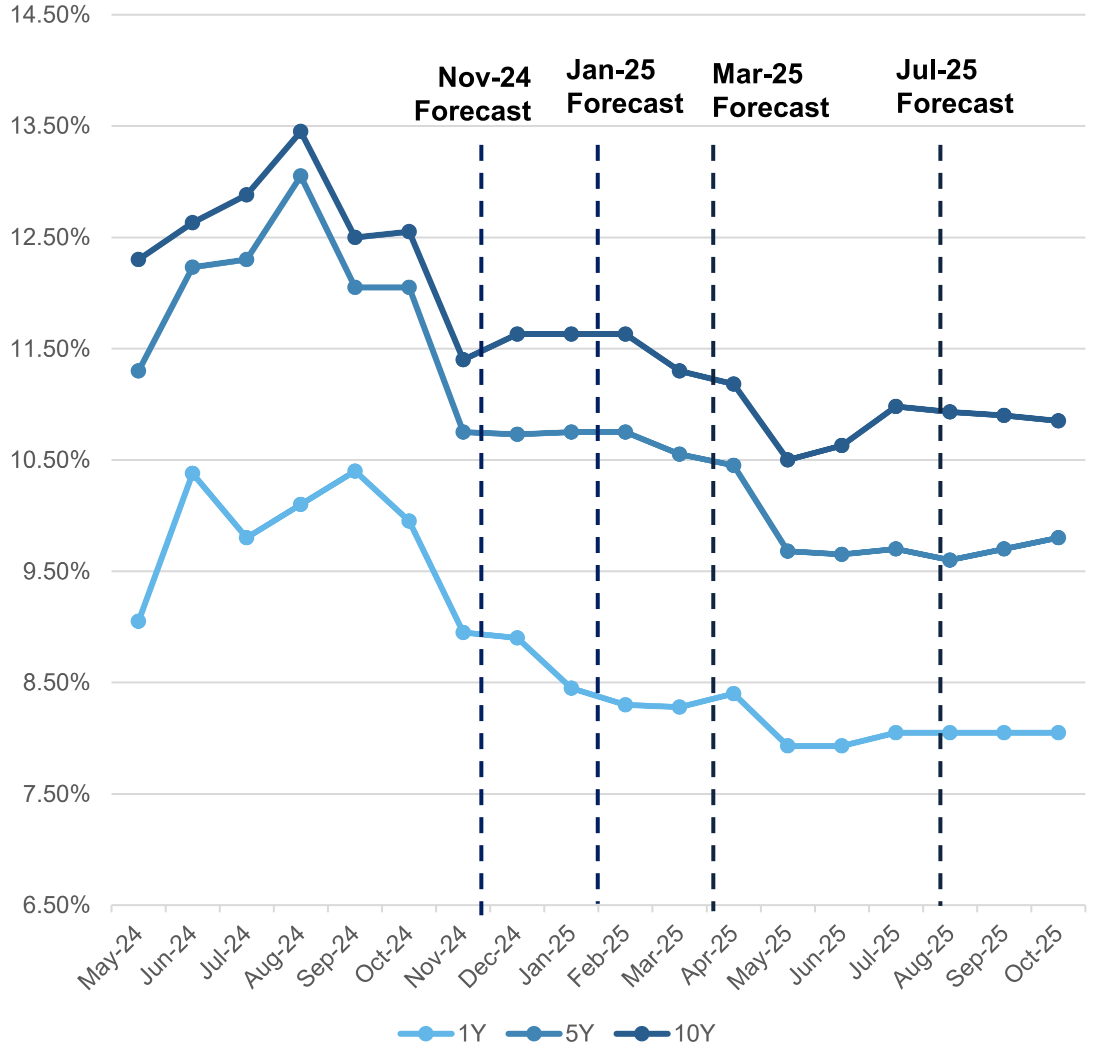
1.0
FCR - Previous Recommendation

"Yields to remain stable within the next 6-12 months"

Yields to remain stable within the next 6-12 months



10Yr — Dec-24 to date **-78 bps**

5Yr — Dec-24 to date **-93 bps**

1Yr — Dec-24 to date **-85 bps**

Previous Recommendations

16th Jan 2025

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

- Inaccurate

28th Mar 2025

The expectation of the upward adjustment of the yield curve is delayed to 4Q2025E.

- Accurate

14th Jul 2025

Yields to remain stable within the next 6-12 months, Shift to short tenures with a willingness to run a carry portfolio.

- Accurate

Review on Market Movement – 9M2025

Recap 9M2025:

"Shift to short tenures with a willingness to run a carry portfolio"

The yield curve witnessed a dynamic shift during 1H2025 with yields declining across the board by nearly 100bps. The decline observed on the yield curve was supported largely by the increase in excess liquidity in the banking sector (reached LKR 203.8Bn on 30th May 2025) and a further relaxation of the policy rates by 25bps at the May-25 policy meeting.

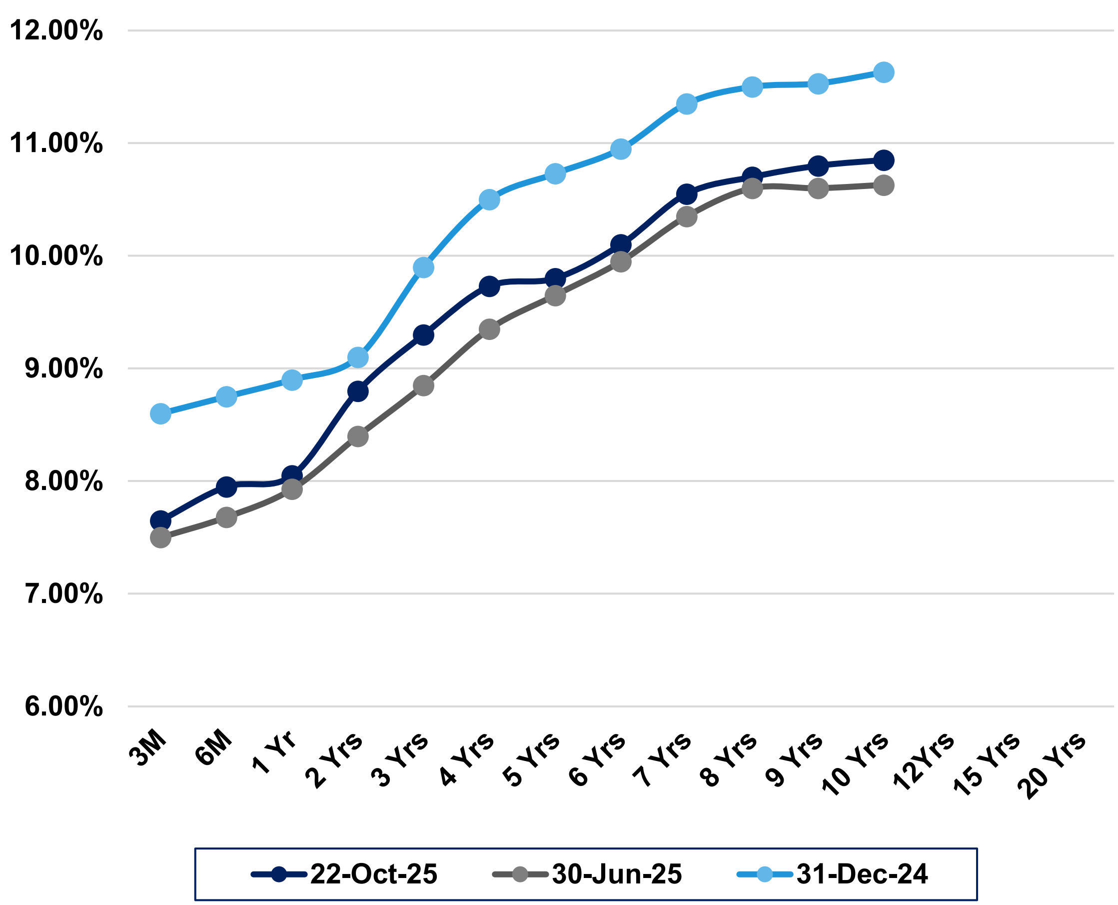
However, declining trend on the yield curve reversed during 3Q2025 with yields rising by 12bps, 5bps and by 27bps for 1Yr, 5Yr and 10Yr maturities, respectively. The slow growth in official reserves position, reversal of inflation to positive territory, significant pick-up in private sector credit are identified as causes towards the slight reversal on yields.

The outlook presented at the mid year outlook proved accurate with yields holding stable and remaining within our guided bands.

Source: CBSL, First Capital Research

Overall yield curve movement

Yield curve Month-end comparison



Interest Rate Change (bps)

Tenure	Sep-25	Jun-25	Change (bps)	Dec-24	Change (bps)
3M	7.65%	7.50%	+15	8.60%	-95
6M	7.95%	7.68%	+27	8.75%	-80
1 Yr	8.05%	7.93%	+12	8.90%	-85
2 Yrs	8.80%	8.40%	+40	9.10%	-30
3 Yrs	9.30%	8.85%	+45	9.90%	-60
4 Yrs	9.73%	9.35%	+38	10.50%	-77
5 Yrs	9.80%	9.65%	+15	10.73%	-93
6 Yrs	10.10%	9.95%	+15	10.95%	-85
7 Yrs	10.55%	10.35%	+20	11.35%	-80
8 Yrs	10.70%	10.60%	+10	11.50%	-80
9 Yrs	10.80%	10.60%	+20	11.53%	-73
10 Yrs	10.85%	10.63%	+22	11.63%	-78
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

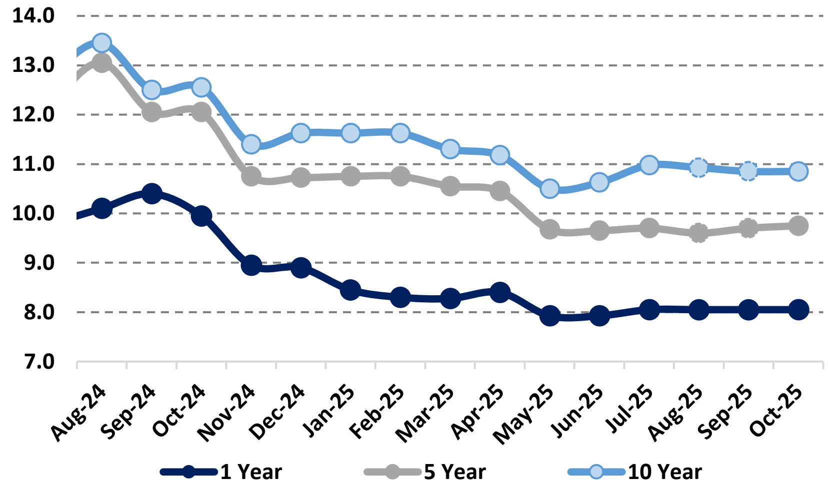
Source: CBSL, First Capital Research

2.0
Outlook for Fixed Income Instruments

"Economic Indicators show steady recovery"

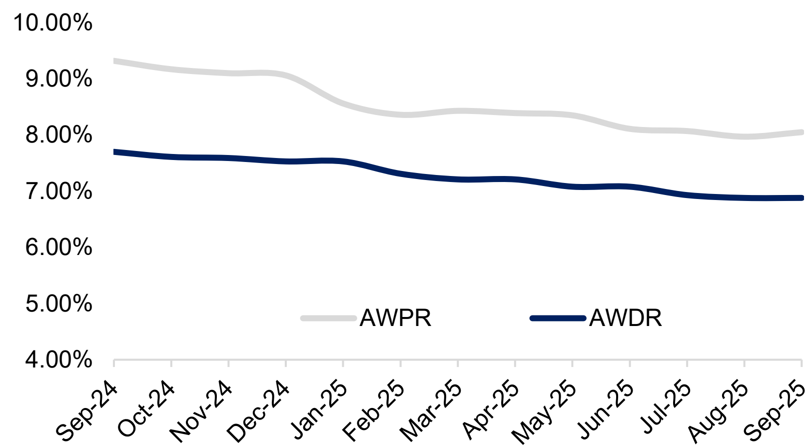
Stability in economic indicators maintained

Gov. securities holds steady

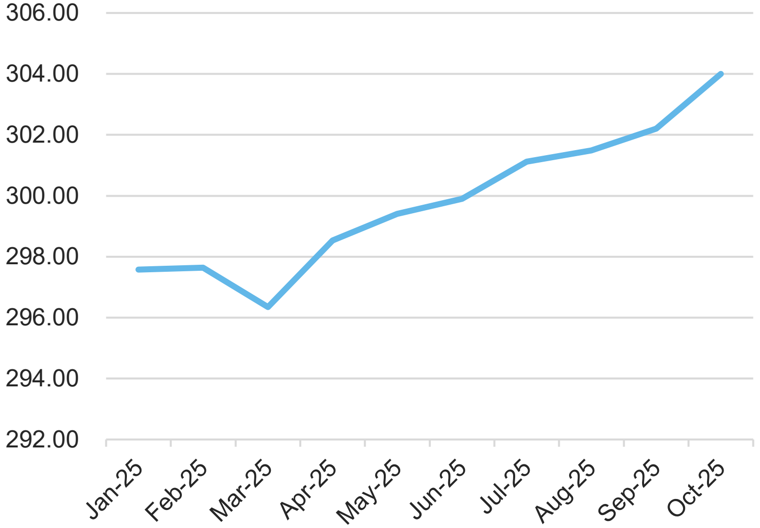


Interest rates remains steady

USD Mn'

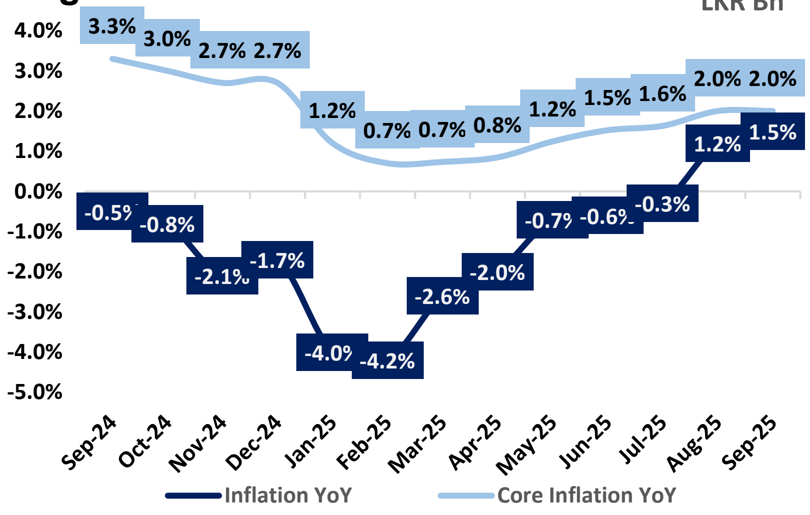


LKR depreciates by 3.4%YTD against the USD

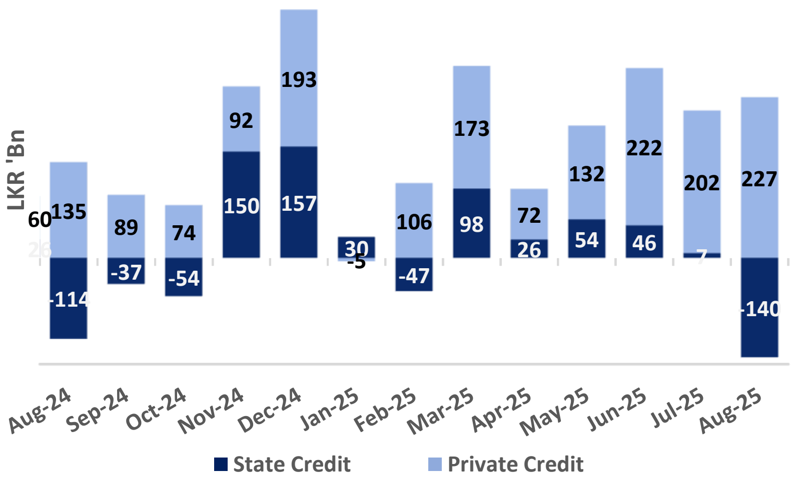


Inflation turns positive after 11 months in Aug-25

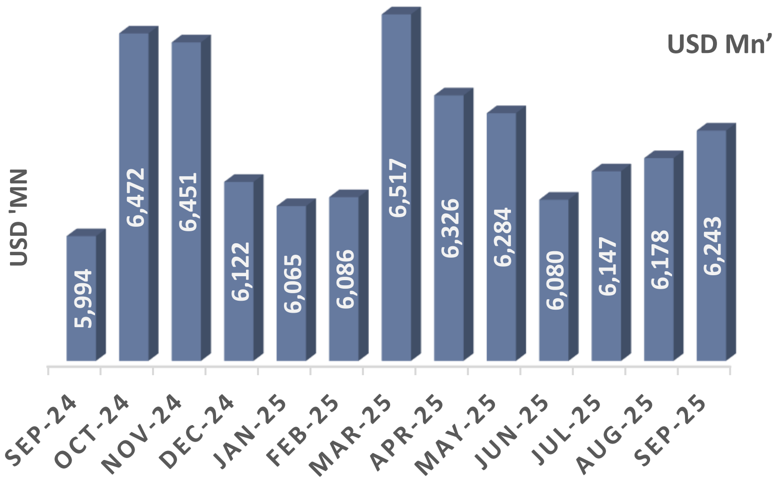
LKR Bn'



Private sector credit accelerates by 13.8%YTD



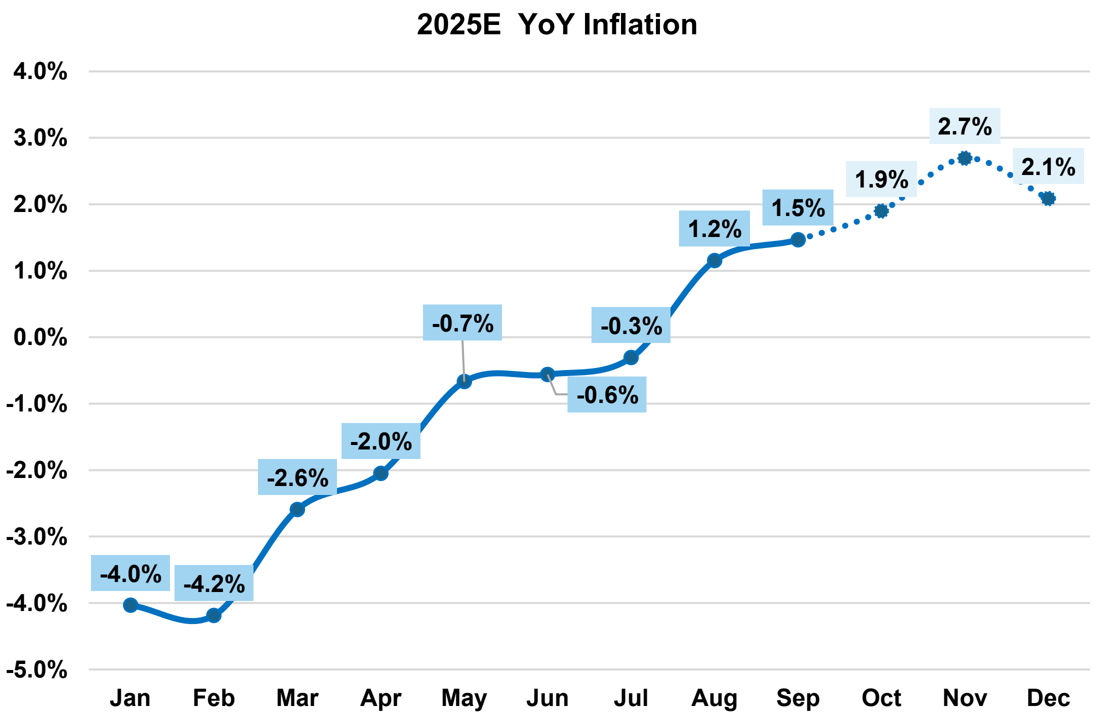
Reserves remains steady at USD 6.2Bn



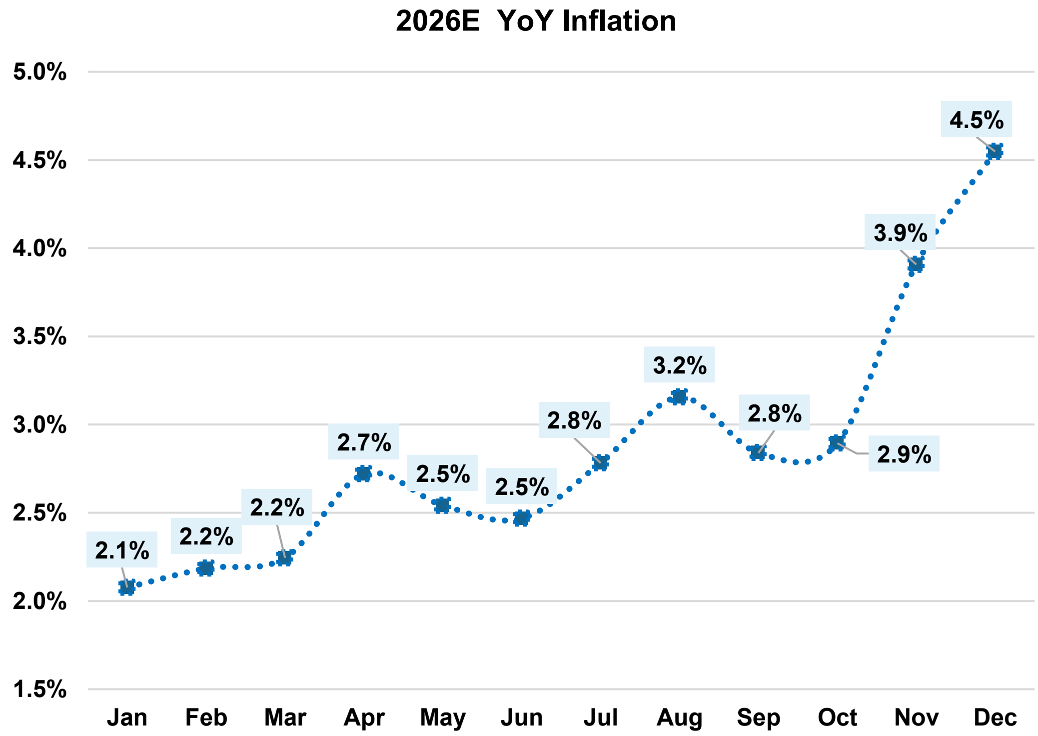
Source: CBSL, First Capital Research

Inflation continues to hover below CBSL target…

CCPI inflation turned positive after 11 consecutive months in Aug-25 recording 1.2%YoY largely driven by the base effect in 2024. Inflation continued to edge up in Sep-25 recording 1.5%YoY as food prices escalated slightly to 2.9% in Sep-25 cf. 2.0% in Aug-25 whilst non-food inflation decelerated marginally to 0.7% in Sep-25 from 0.8% in Aug-25. Looking ahead, inflation is projected to remain below CBSL desired threshold in both remainder of 2025E and 2026E, amidst the slowness in the economy.



Source: Dept. Census and Statistics, First Capital Research

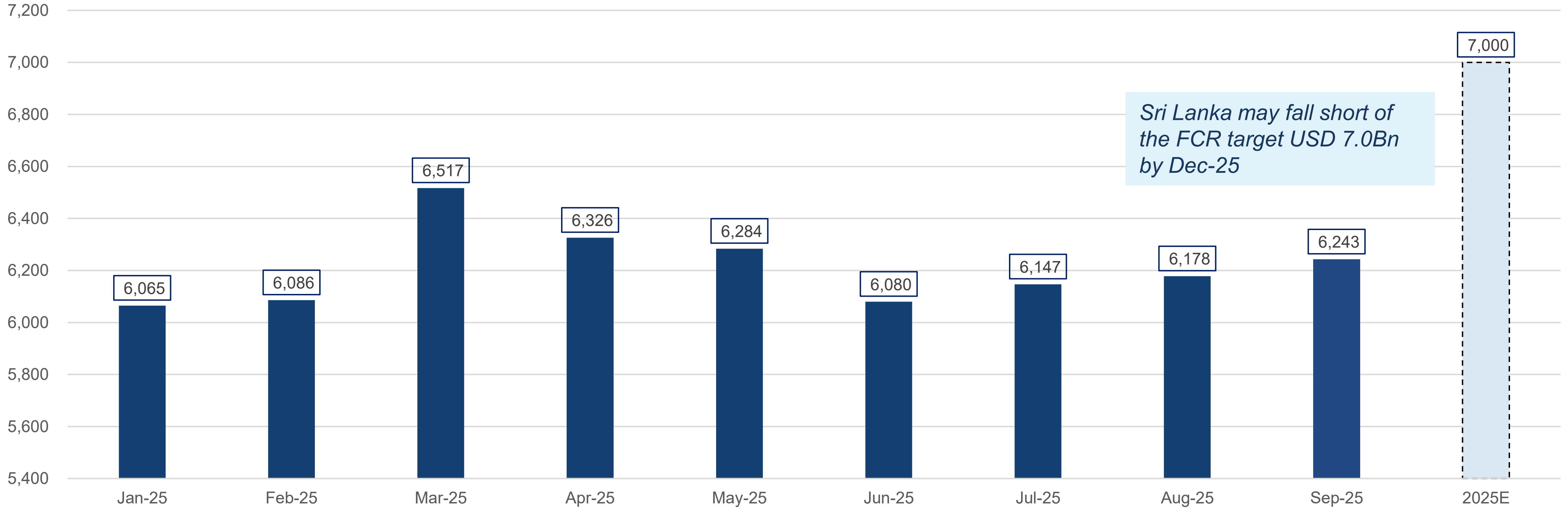


Source: Dept. Census and Statistics, First Capital Research

Source: Dept of Census & Statistics, First Capital Research

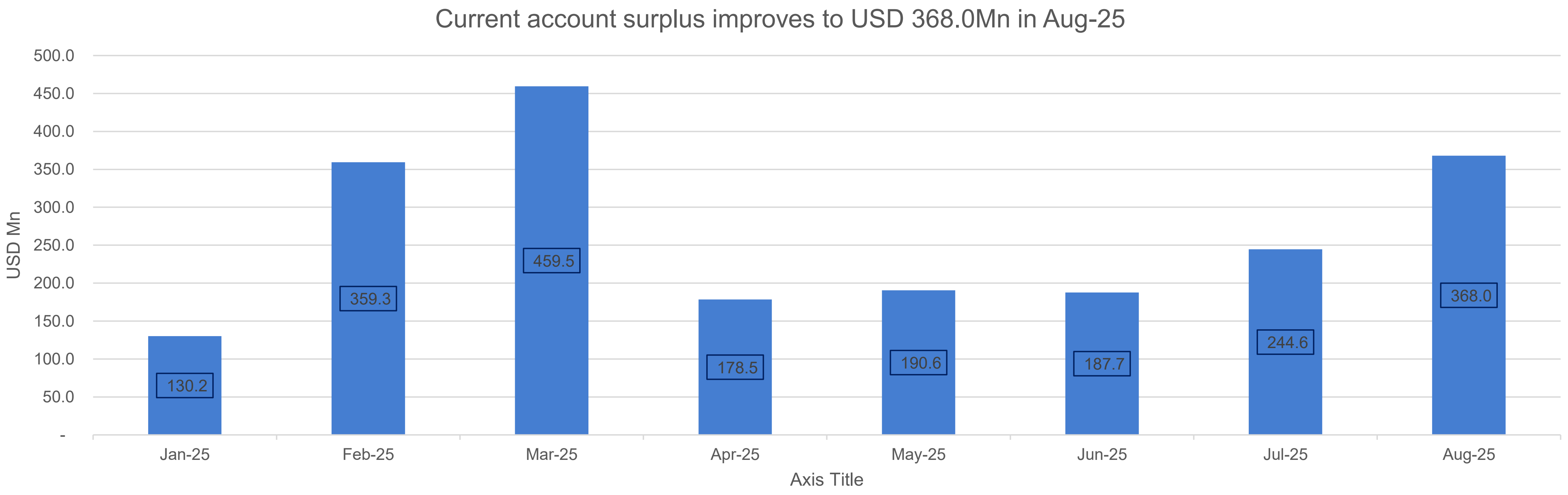
… whilst reserves accumulation continues to remain slow…

Sri Lanka's gross official reserves recorded USD 6.5Bn in Mar-25, highest since Sep-20 of USD 6.6Bn. However, reserve buildup thus far has been slow largely due to the settlements to the Reserve Bank of India and the IMF, which stood at USD 900.0Mn and USD 209.0Mn, respectively up to Mar-25. We believe the settlement of the said loans together with the USD outflows for vehicle imports (stood at USD 1.5Bn as of Aug end) were the primary obstacles towards the reserve's buildup since Mar-25. With FCR forecast set at USD 7.0Bn for 2025E and IMF forecast set at USD 7.2Bn for 2025E, we believe Sri Lanka will fall short of the targets mentioned, given the limited time ahead and possible inflows expected to bump up reserves.



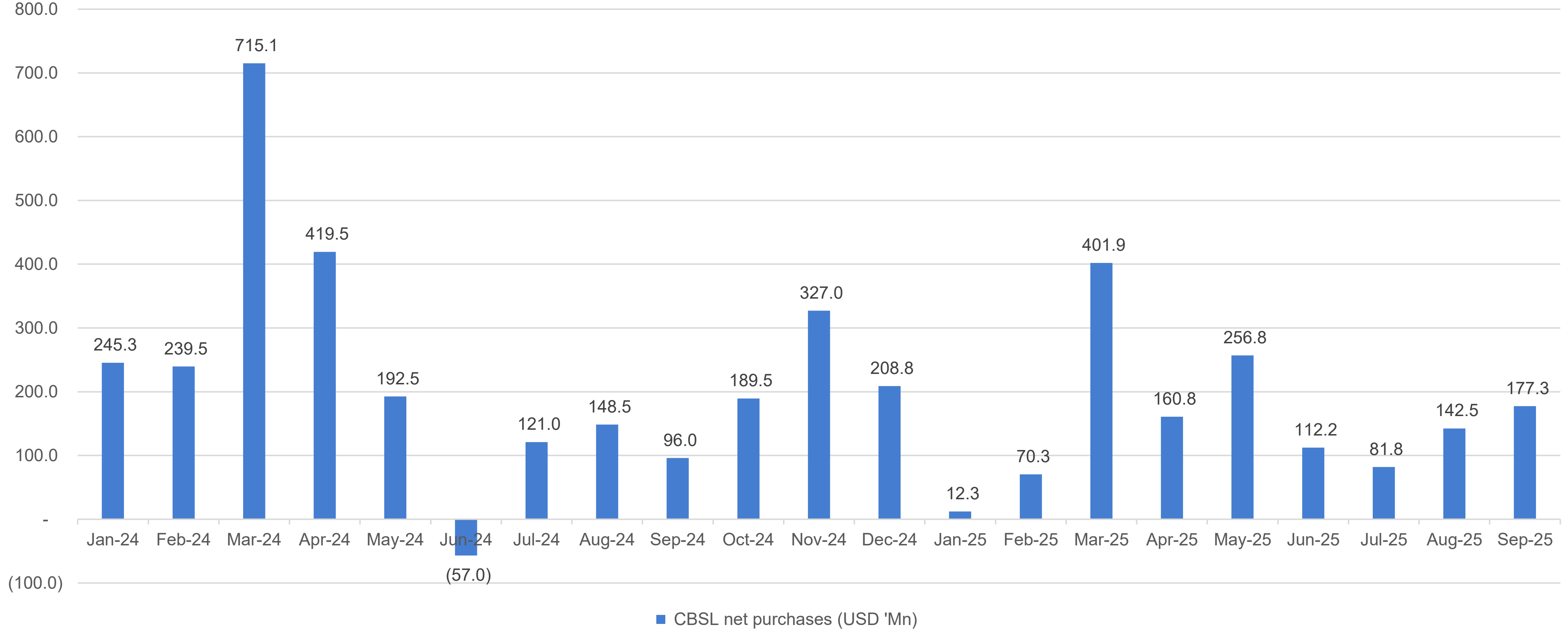
… despite elevated current account surplus for the 1st eight months

Sri Lanka's external position continues to improve post economic crisis despite import bans being lifted. The widened trade deficit was largely offset by the improving receipts from tourism and remittances, whilst inflows from multilaterals has also aided the cause. Current account position of Sri Lanka is expected to improve further in 2025 and 2026 as pent-up demand in vehicle imports eases whilst growing remittances and tourism continues to benefit.



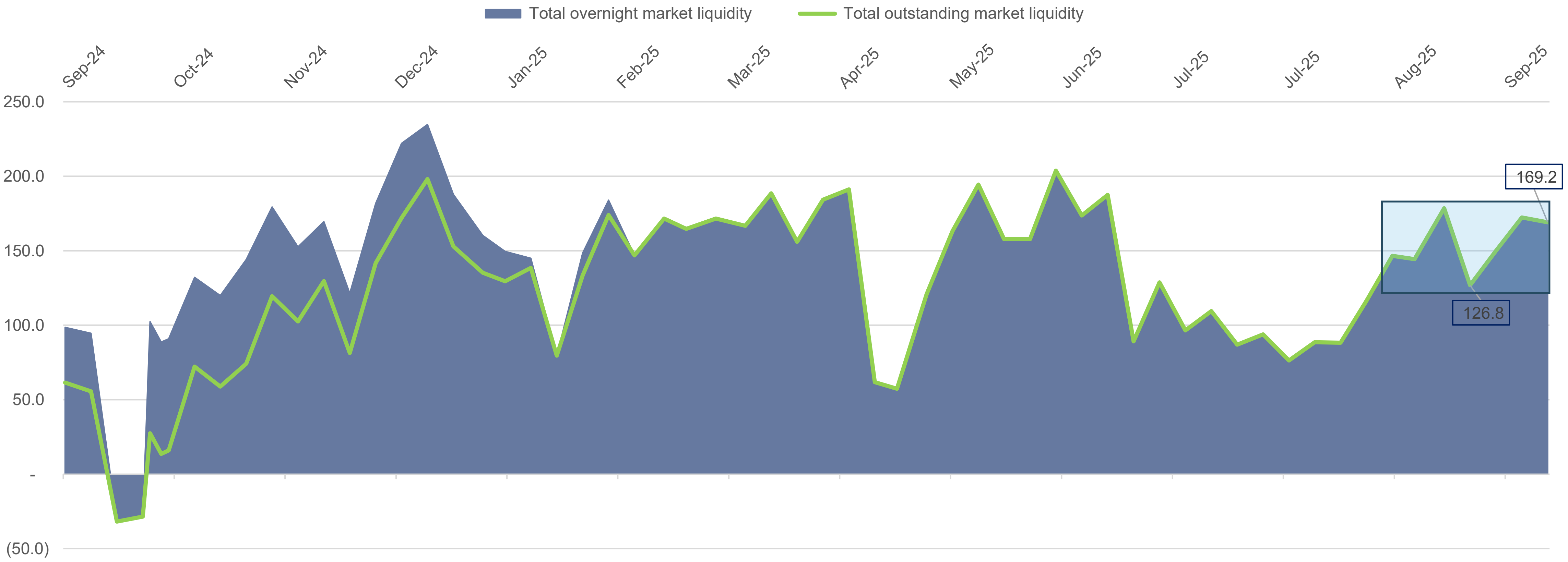
However, CBSL continues to buy USD from the market to collect USD reserves…

Central bank of Sri Lanka continued to be net buyer of USD from the domestic market as it continued purchase USD for the 14th consecutive month in excess of the amount sold in the market. Thus far till Sep-25 CBSL has bought net of USD 1.4Bn from the domestic market. We expect USD purchases to continue forward as Sri Lanka continues to record current account surpluses in the external account.



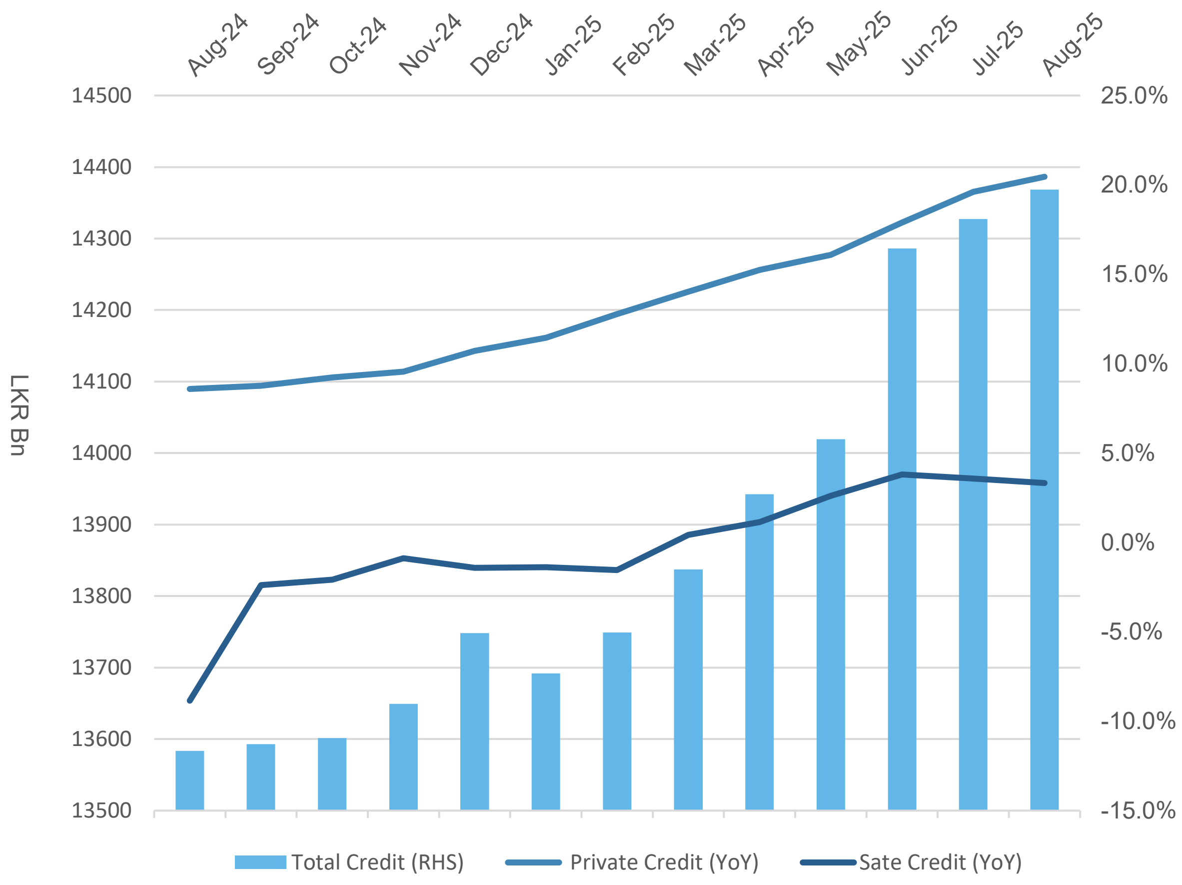
… aiding liquidity to return to previous highs…

In-line with our expectations, outstanding liquidity in the banking system has improved back near previous high from its dangerous low in Aug-25. Continuous USD purchases by the CBSL, temporary suspension of the unwinding in CBSL holdings and increased tax collection by the government agencies aided the recovery in liquidity position whilst, increase in credit demand from vehicle imports, partially slowed down the recovery.

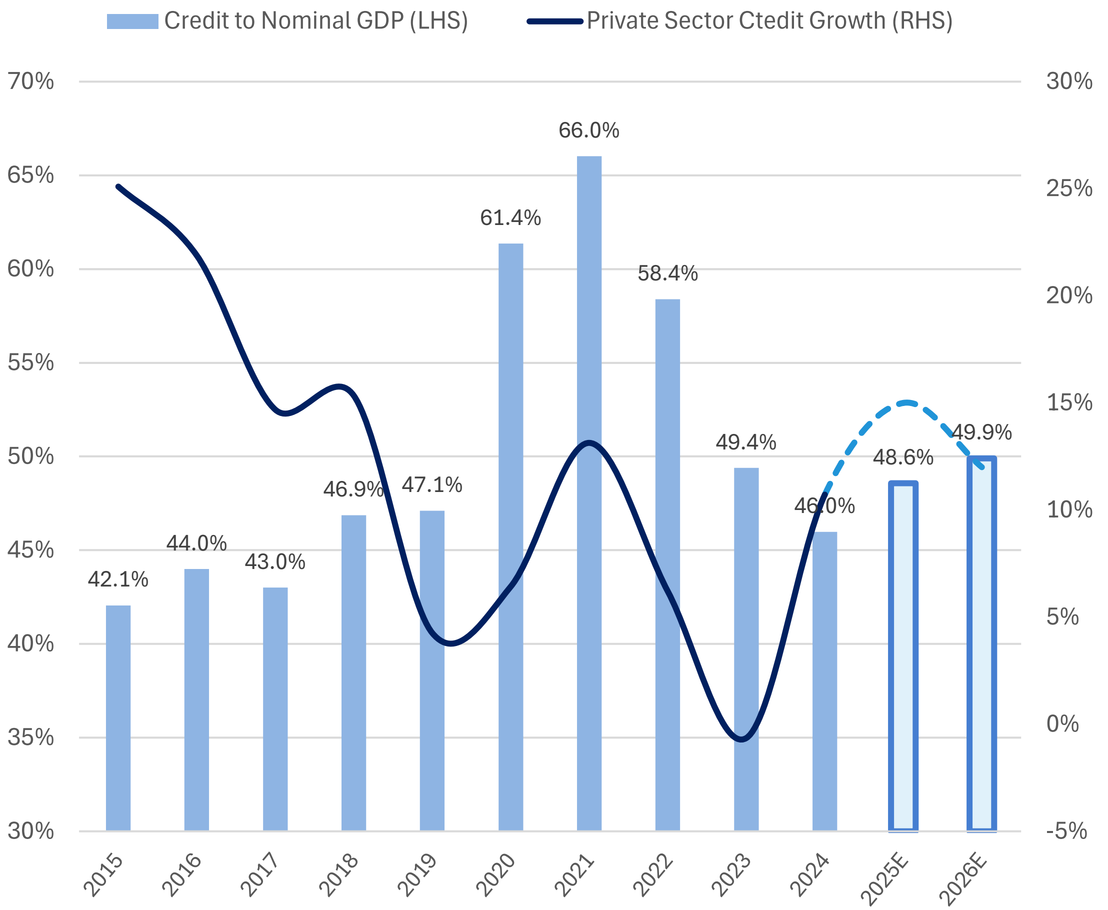


Despite the increased demand for credit…

Total credit grew fueled by heightened private credit growth while credit to the state lagged behind

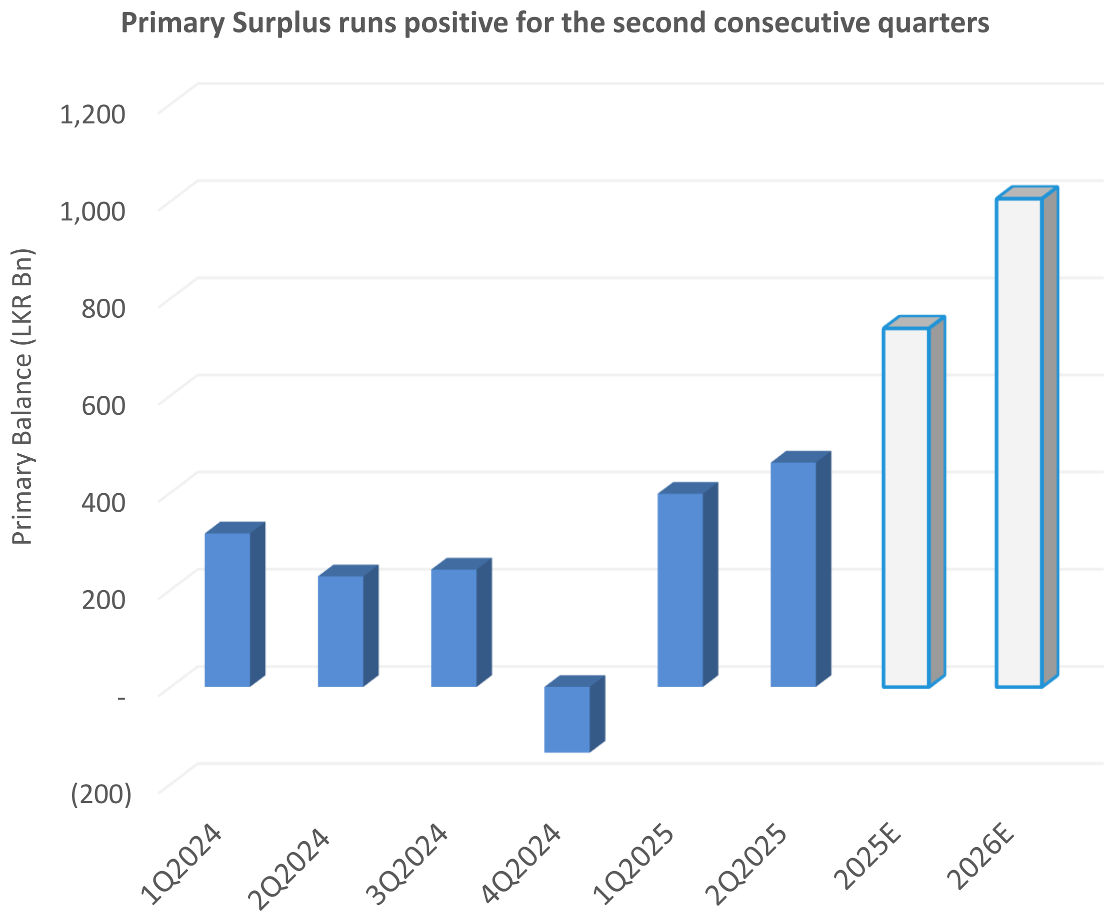


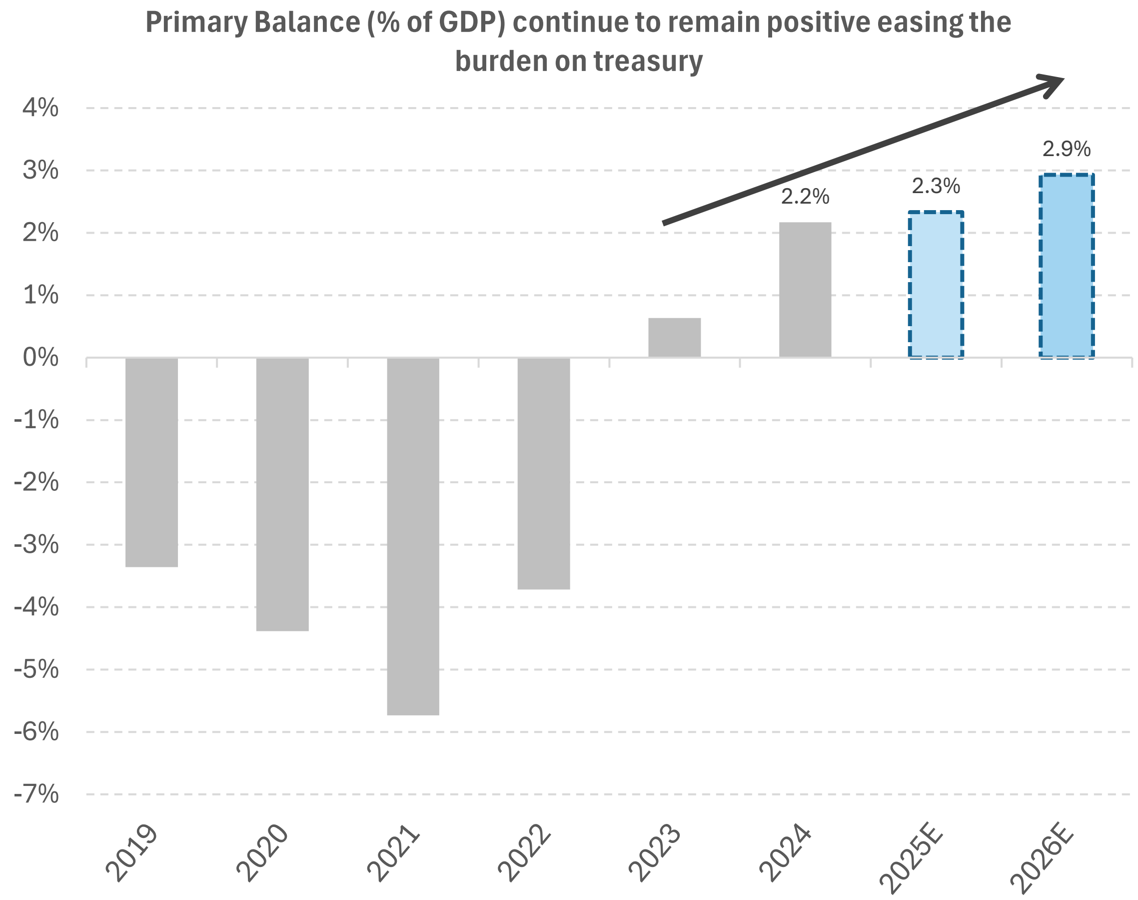
FCR expects this trend to persist with credit to GDP hovering around 50% and private sector credit growth nearing 15% in 2025E



… government continues to run a tight ship…

The government has been largely consistent in maintaining primary surpluses through 2023, remaining on par with IMF conditionality. FCR expects this trend to be upheld in 2025E as well as 2026E, with the primary surplus reaching 2.3% (of GDP) in 2025E from 2.2% in 2024.

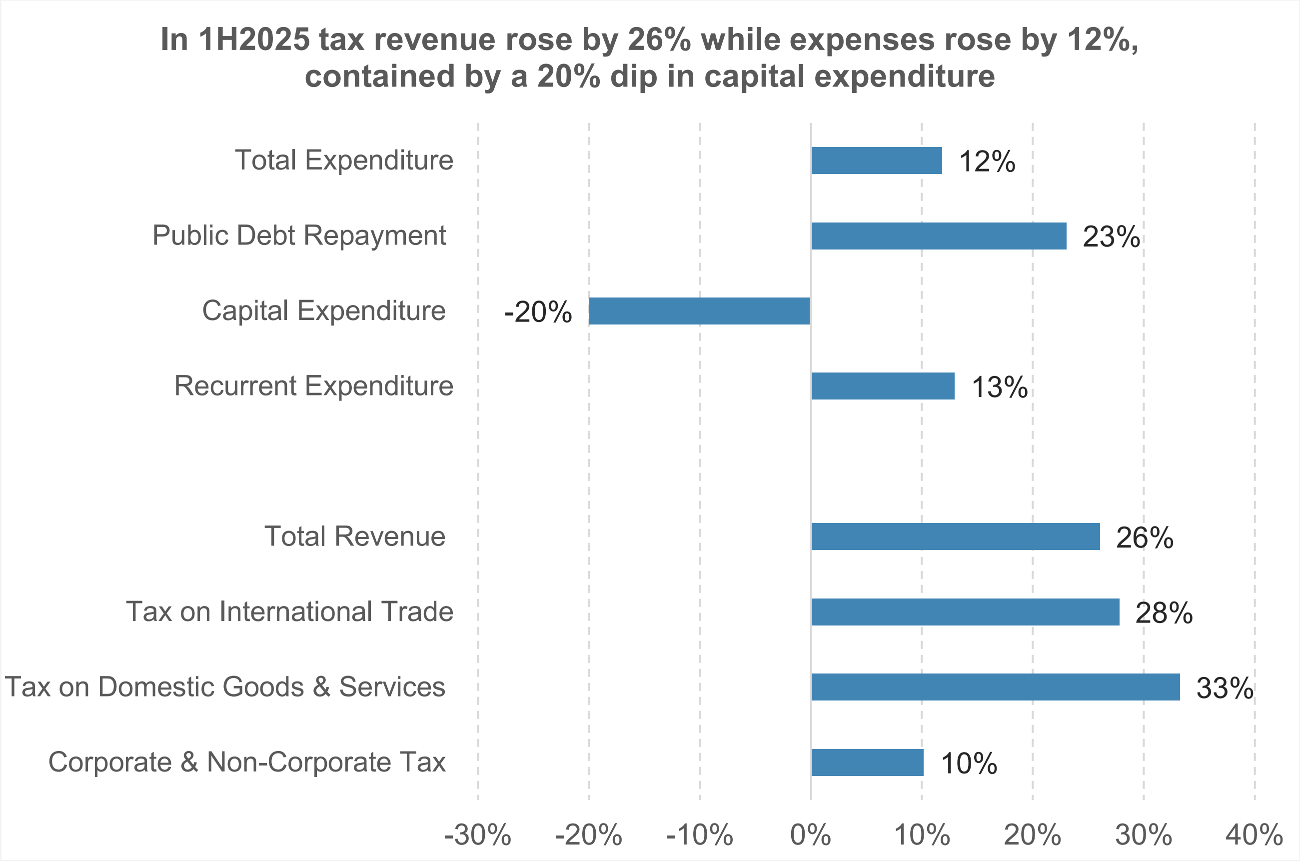


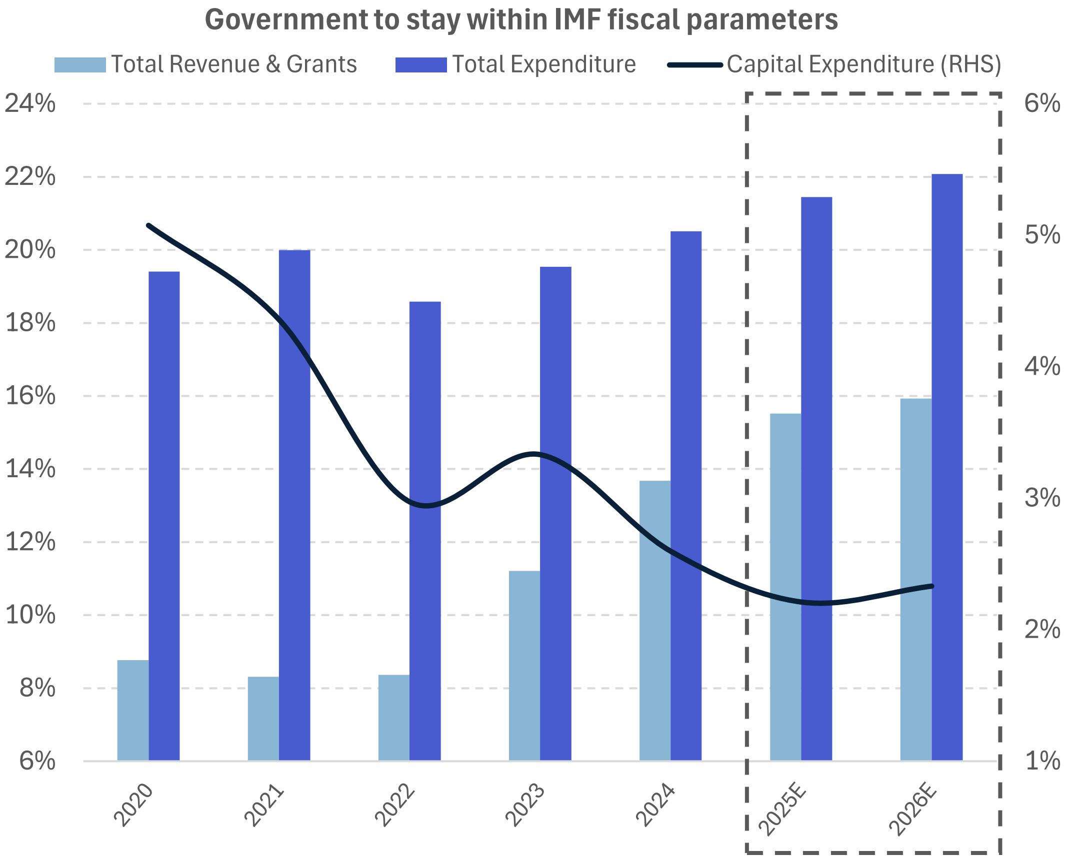


Source: CBSL, First Capital Research

… supported by increased revenues and limited spending…

Sri Lanka has maintained stringent fiscal discipline through 2023 to date, particularly since entering the EFF program with the IMF in Mar-23. Revenue has consistently expanded on the back of tax-reforms while containment of expenditure has largely stemmed from lower deployment of capital expenditure. FCR expects revenue and expenditure to reach 15.5% and 21.4% of GDP in 2025E, largely on par with IMF conditionality.



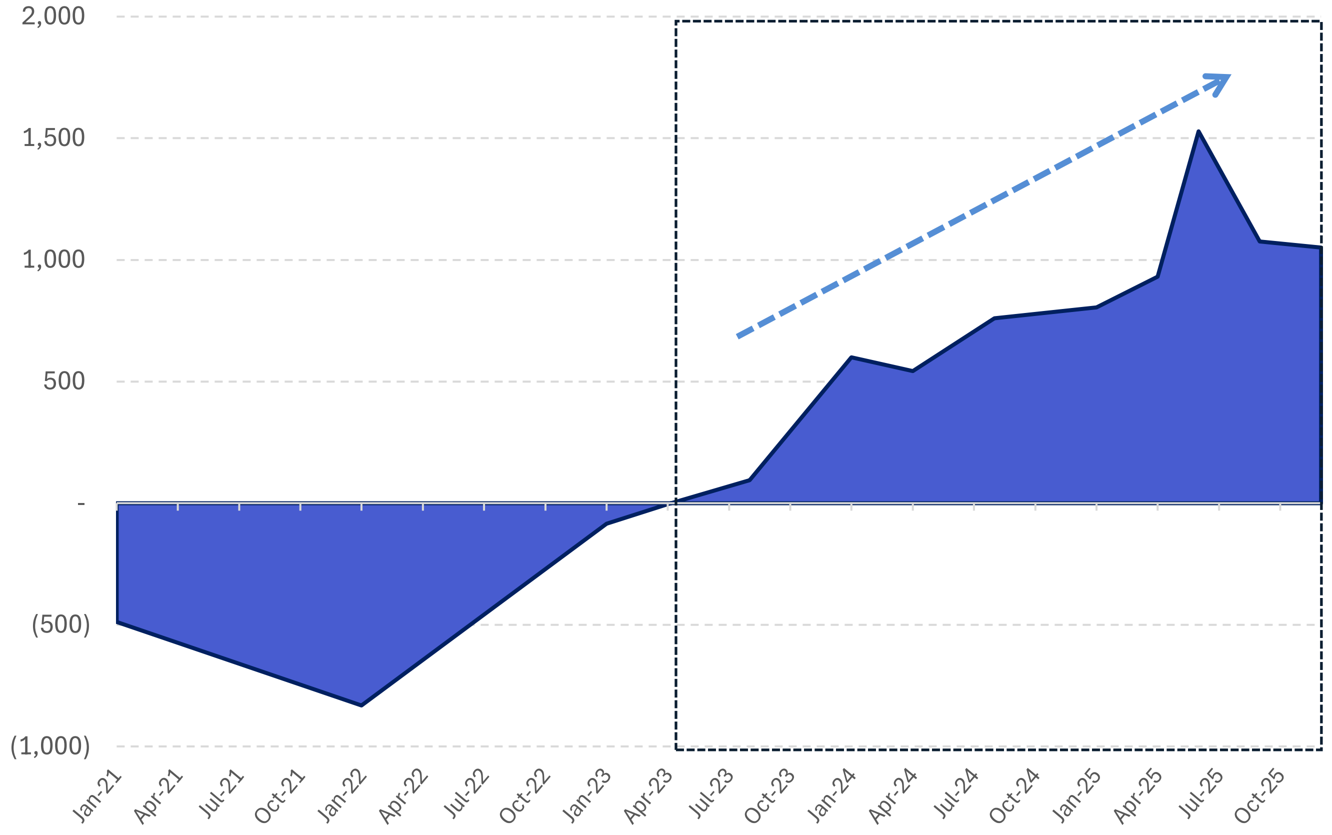


Source: CBSL, MoF, First Capital Research

Enabling the govt. to maintain a positive treasury surplus…

Primary surpluses that the Sri Lankan government has been consistently maintaining remains a key factor behind the treasury's cash surplus the country has witnessed since late 2023 up to now.

Forecasted cash surplus to remain around LKR 1.0Tn



Note: Figures from Apr-25 are forecasts of FCR.

Treasury's Cash Surplus

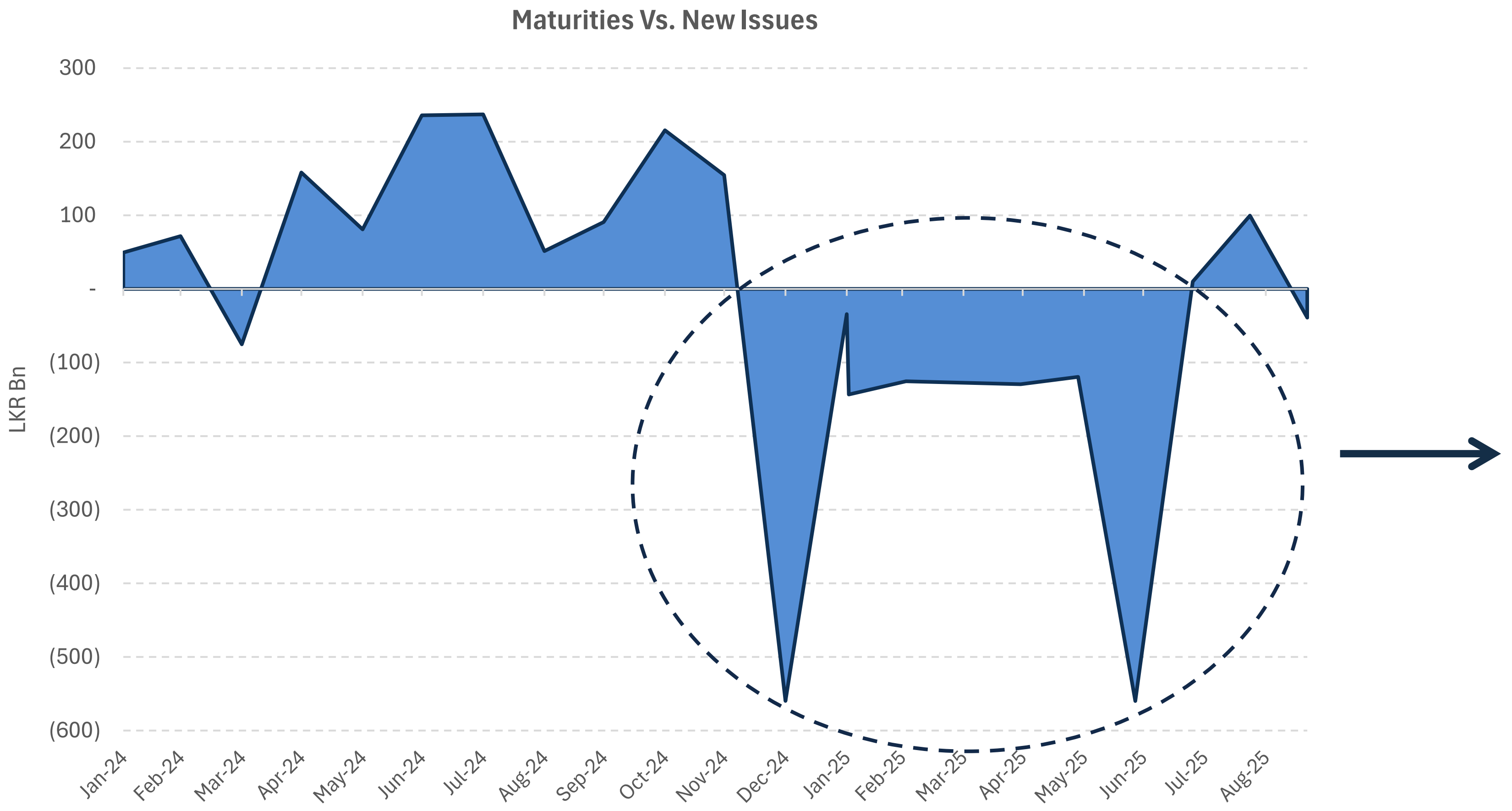
Dominant Drivers:

- Primary surplus of the government…
- Multilateral inflows…

Source: CBSL, MoF, First Capital Research

… lowering pressure on CBSL to accept auctions despite looming maturities.

The treasury's cash surplus has enabled monetary authorities to reject certain bids at T-Bill and Bond auctions, in turn exerting more proactive control over interest rates.



Instances where maturities exceed new issues is often a result of bids being rejected during T-Bill and Bond auctions. It is the treasury's cash surplus that has enabled monetary authorities to do this.

Source: CBSL, First Capital Research

3.0 Fixed Income Health Score

"Health score showing signs of slowing down"

FI Economic Health Score: Jul-25 - Sep-25

Since our last update in Jun-25, the Health Score has largely been volatile and hovered in between 69-72 points. The volatility surrounding the health score is primarily due to the return in inflation to positive territory and volatility of the available liquidity position of the banking sector.

Primary Criteria	-	54	-	02	=	52
Secondary Criteria	-	19	+	00	=	19
Economic Health Score [Mar 2025]					=	71

[As against 72 in Jun-25 & 68 in Sep-24 (1 Year ago)]

Source: First Capital Research

Changes to Health Score Primary Criteria – Jun-25 - Sep-25

52/75

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A Janashakthi Group Company

	Previous score	Current score
Foreign Reserves Foreign reserves grew marginally during Sep-25 to USD 6.2Bn from USD 6.1Bn in Aug-25. However, reserves continue to remain below the peak of USD 6.5Bn recorded in Mar-25	11/15	11/15
Liquidity Since falling near LKR 50.0Bn in Jul-25, liquidity in the banking system bounced back up in-line with our expectations and currently hovers around LKR 169.1Bn in Oct-25.	12/15	12/15
Inflation After 11 months of deflation, inflation bounced back to positive 1.2% in Aug-25 and grew further to 1.5% in Sep-25, as both food and non-food prices picked up.	15/15 (-2)	13/15
Foreign Activity Foreign investments in government securities continued to improve slowly and recorded at LKR 130.3Bn. However, this continues to remain below the CBSL threshold of 5%.	01/10	01/10
Credit Credit to the private sector continued to expand in Aug-25 recording LKR 226.8Bn in Aug-25 and a YTD growth of 13.8%.	05/10	05/10
CBSL Holdings CBSL holdings remained unchanged since Jun-25 at LKR 2.5Tn. .	10/10	10/10

Source: First Capital Research

Changes to Health Score
Secondary Criteria – Jun-25 – Sep-25

19/25

Criteria	Previous score	Current score
Rating Outlook Backed by the stable outlook and recovery in economic indicators, S&P revised up their rating for Sri Lanka to CCC+. With this all three agencies have revised up their rating for Sri Lanka from its previous SD rating.	02/05	02/05
External Environment Despite the positive current account surplus, LKR depreciated +3.4%YTD against the USD to close at LKR 304.0/USD in Oct-25	03/05	03/05
BOT & BOP With the relaxation of import bans, trade deficit for the 1st 8 months increased by 19.6%YoY to USD 4.3Bn. However, aided by tourism and remittances, current account continued to strengthen and record USD 2.0Bn for Jan-Aug 2025.	04/05	04/05
Political Risk Political stability improved further in 2025 with the governing party securing the majority in the local govt. election conducted in May-25.	05/05	05/05
Investor Confidence The business confidence index hit an all time high of 210 in Jun-25. However since then, with the recent developments in the global context, BCI index fell slightly in Aug-25 to 192 points.	05/05	05/05

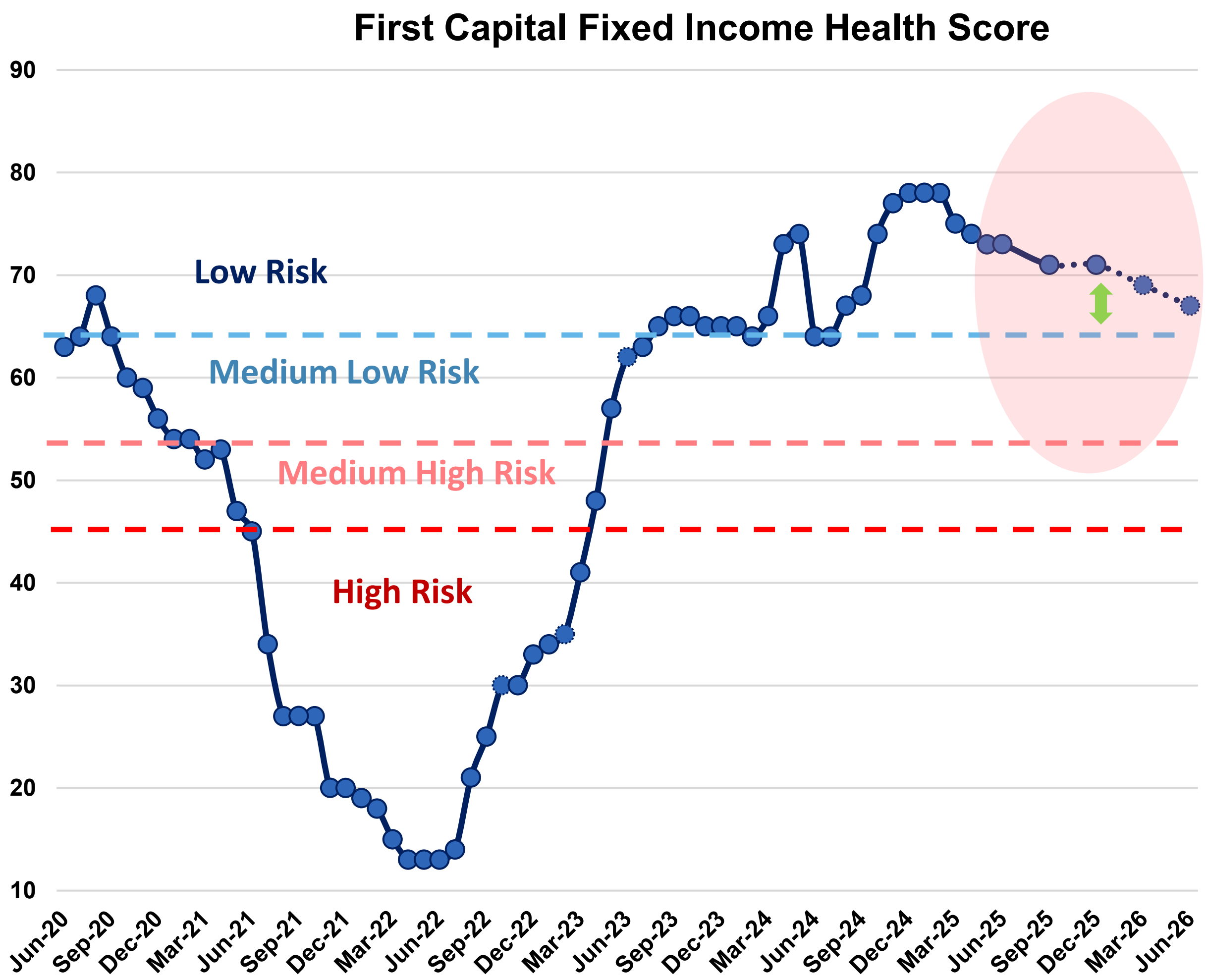
Source: First Capital Research

FI Health expected to dip slightly towards mid 2026E

- Since hitting a peak of 78 points in Dec-24, economic indicators leading to health score has deteriorated slowly, largely contributed by the growing demand for credit, decline in reserves and expanding trade deficit.

- Going forward, we expect FI Health Score to decline further, caused by increased demand for credit by private sector, pushing down liquidity in the system, which is expected to *lead to a slight decline in the Health Score while adding some pressure on interest rates.*

- *However, FI Health Score is expected to continuously remain in low-risk territory with only limited impact to interest rate pressure.*

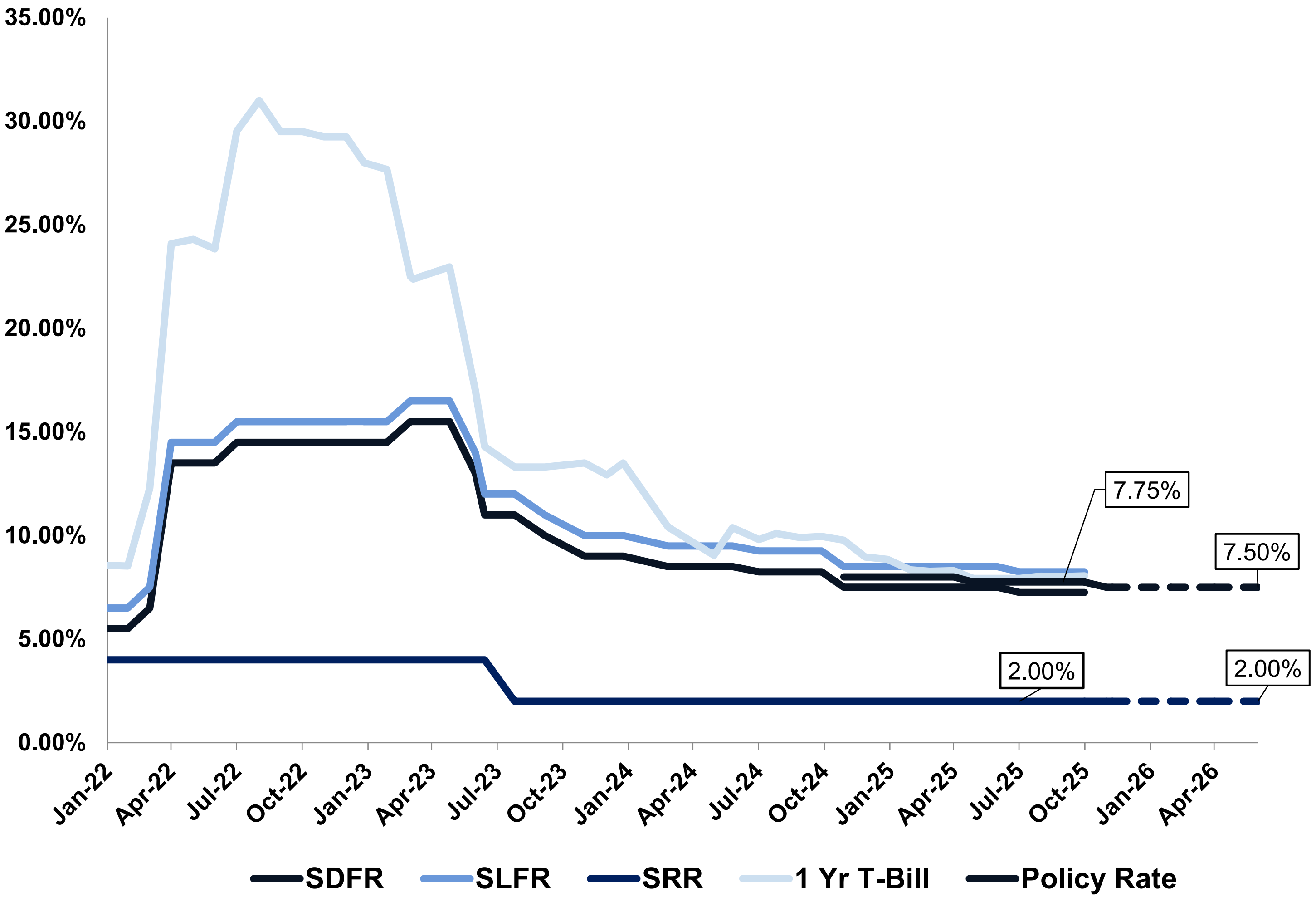


Source: First Capital Research

4.0 Recommendation Maintained

"Maintain a carry portfolio"

OPR to remain stable, a 25bps cut maybe on cards to accelerate the economy



The Central Bank of Sri Lanka **decided to maintain the Overnight Policy Rate (OPR) at 7.75%** at the 5th monetary policy review held on 23rd September 2025, **in line with First Capital Research expectations.**

Considering the high prevailing taxes which is limiting consumer spending coupled with limited capital expenditure by the GoSL, we believe that the economic growth may ease towards 2H2025. Moreover, the easing of growth is also visible from the slow expansion in the M2b money multiplier, which currently hovers around 9.01x in Jul-25. Further, the slowness is expected to be carried forward towards 2026E as well, with US imposing significant tariffs across many countries, which is expected to reduce spending and limit growth in 2026E.

Therefore, considering the above, **we believe that the CBSL may look to relax OPR further by 25bps at the Nov-25 policy review.** However, lowered rates are expected to continue during the next 12 months period, with limited pressure coming towards rising rates.

Recommendation Maintained

Maintain a carry position

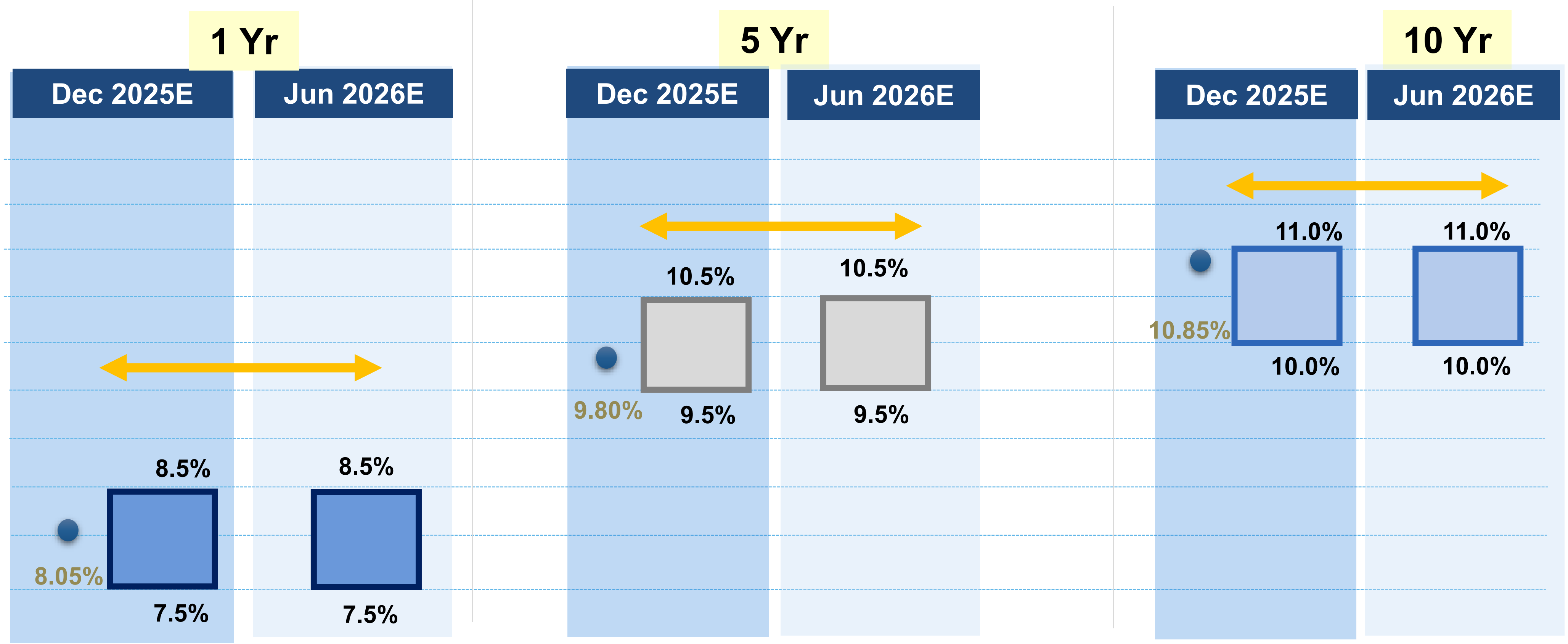
Recommendation:

"Yields to remain stable within the next 6-12 months"

- **Yields currently hovers with our bands and in-line with our expectations.** The yield curve currently is hovering within our bands, showing slight upwards movement amidst sell down of g-sec instruments by local banks to buff-up respective liquidity positions. Amidst these developments, the yield curve currently hovers within our bands with 1Yr trading at 8.05% whilst 5Yr and the 10Yr trading at 9.80% and 10.80%, respectively.
- **Another 25bps rate cut on cards for Nov-25 review:** Despite the positive 4.9%YoY growth in GDP, economic growth projected for the next 12M period is expected to remain slow affected by reduced global growth which is caused by slowdown in exports caused by tariffs, coupled with below average spending by government on capital expenditure and consumer growth burdened with higher taxes. Hence, we believe that there is space for another 25bps rate cut at the Nov-25 policy review to bring down OPR to 7.50% from prevailing 7.75%.
- **Liquidity expected to remain elevated lowering pressure on interest rates. With the expected easing of pent-up demand from vehicle imports** and slight slowness in credit thereafter, liquidity in the banking system is expected to hover between LKR 150-200Bn in the next 12 months. Moreover, increased tax collection and lower spending, which is expected to lead to primary surplus is also expected to release the pressure on liquidity in the near term.
- **Maintain positions in short term: recommendation maintained:** With expectations that the yield curve, be stable and within our bands in the next 12 months, we continue to maintain our recommendation for investors to stay within the shorter tenures and to maintain a carry position to reduce possible capital loss and earn an interest income through holding till maturity.

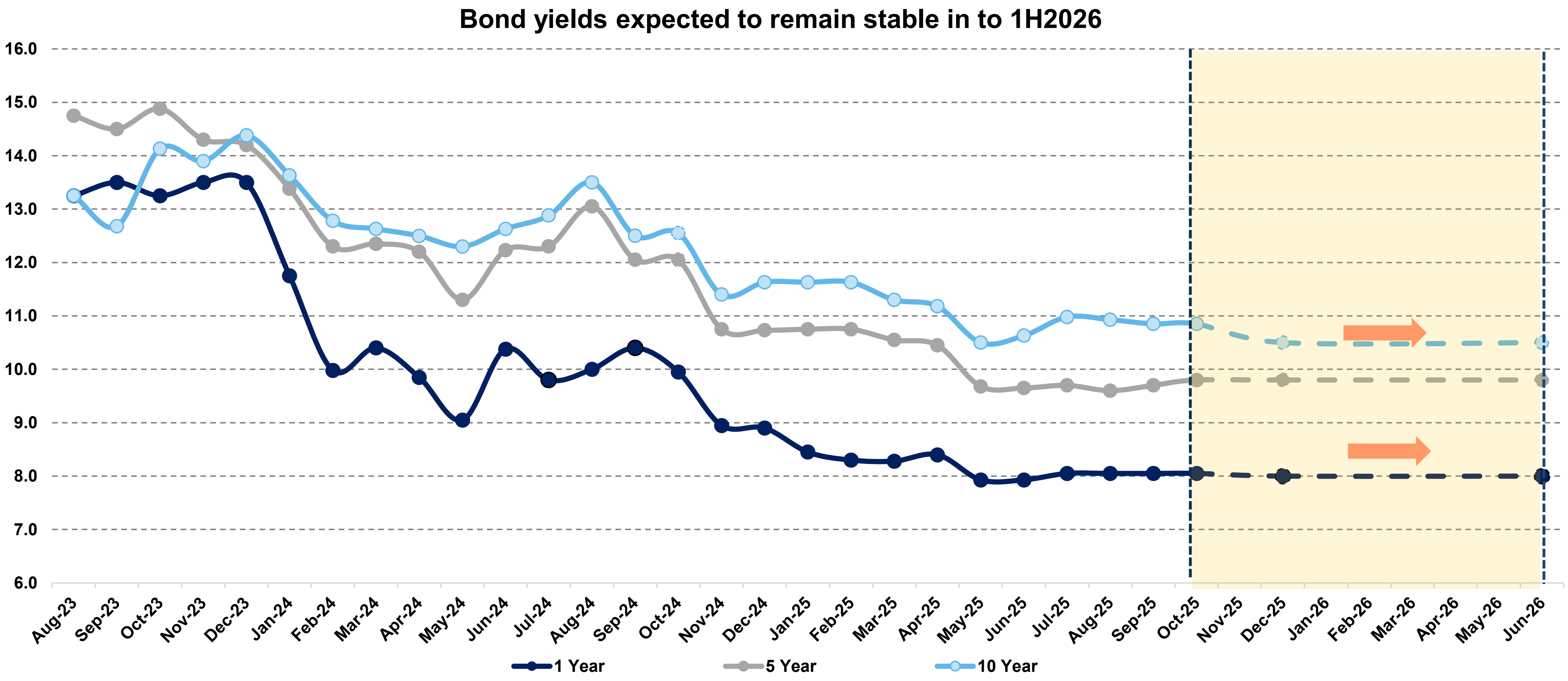
Bond Yield Expectations for Dec-25 and Jun-26:
Yields remain stable as pressure slowly builds up

Despite the FCR projection of a 25bps rate cut in Nov-25 policy meeting to bump up the possible slowness in GDP, yield curve is expected to remain stable during Dec-25 and Jun-26 period. Continuous demand for credit amidst the slow recovery in GDP is expected to dry down liquidity in the market coupled with slower than expected recovery in key economic indicators and increased debt maturities in 2026E and 2027E are expected to limit a further downside in the yield curve and is expected to remain stable between Dec-25 and Jun-26 period.



Source: First Capital Research

Rates to remain stable in the next 12 months



Source: First Capital Research

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