



First Capital
A Janashakthi Group Company

“From Anchored to Adjusting: Yield Curve Set to Move Higher”

FIRST CAPITAL FIXED INCOME RECOMMENDATION | Jan 2026

FIRST CAPITAL RESEARCH

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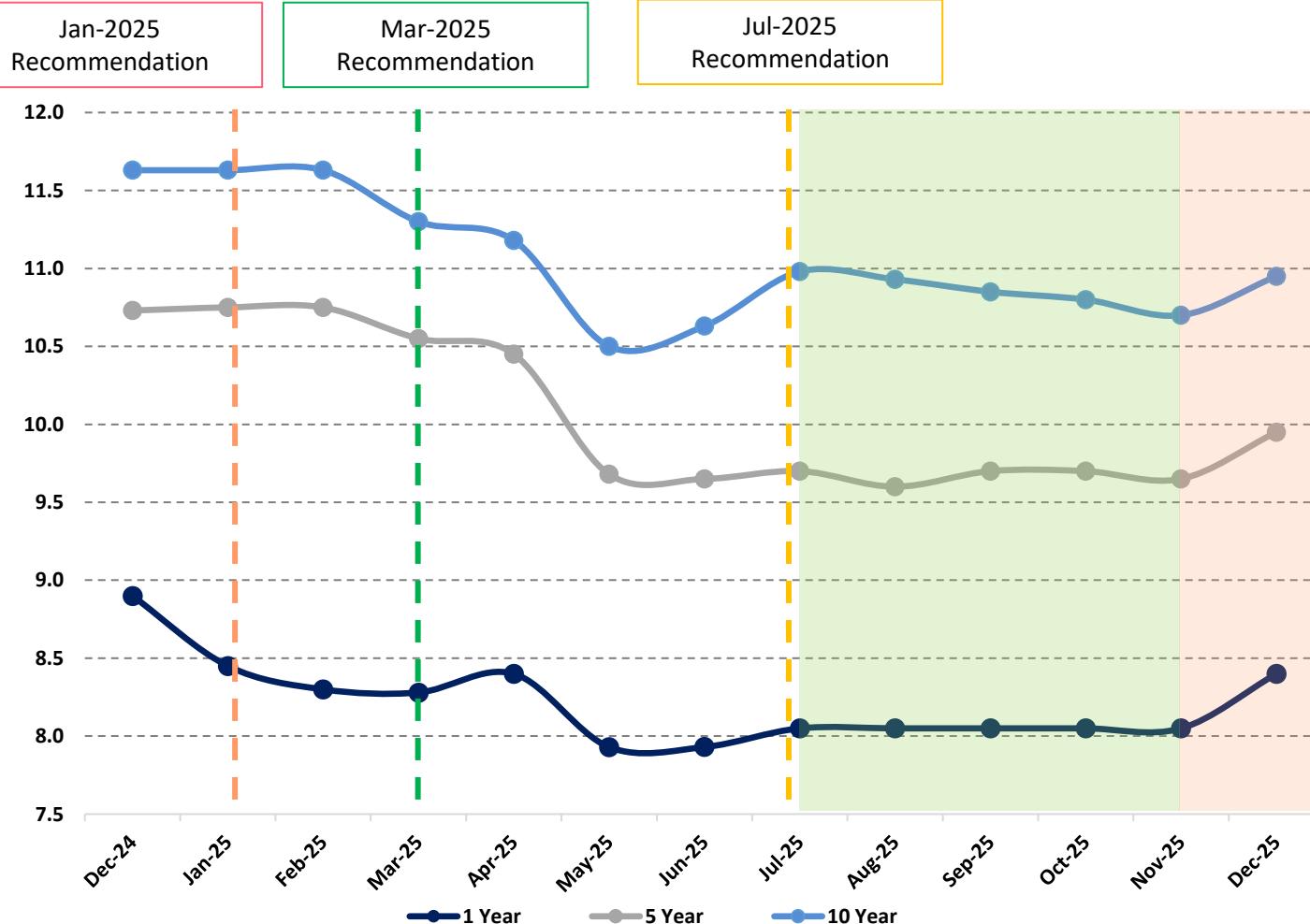


1. Previous Recommendation

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



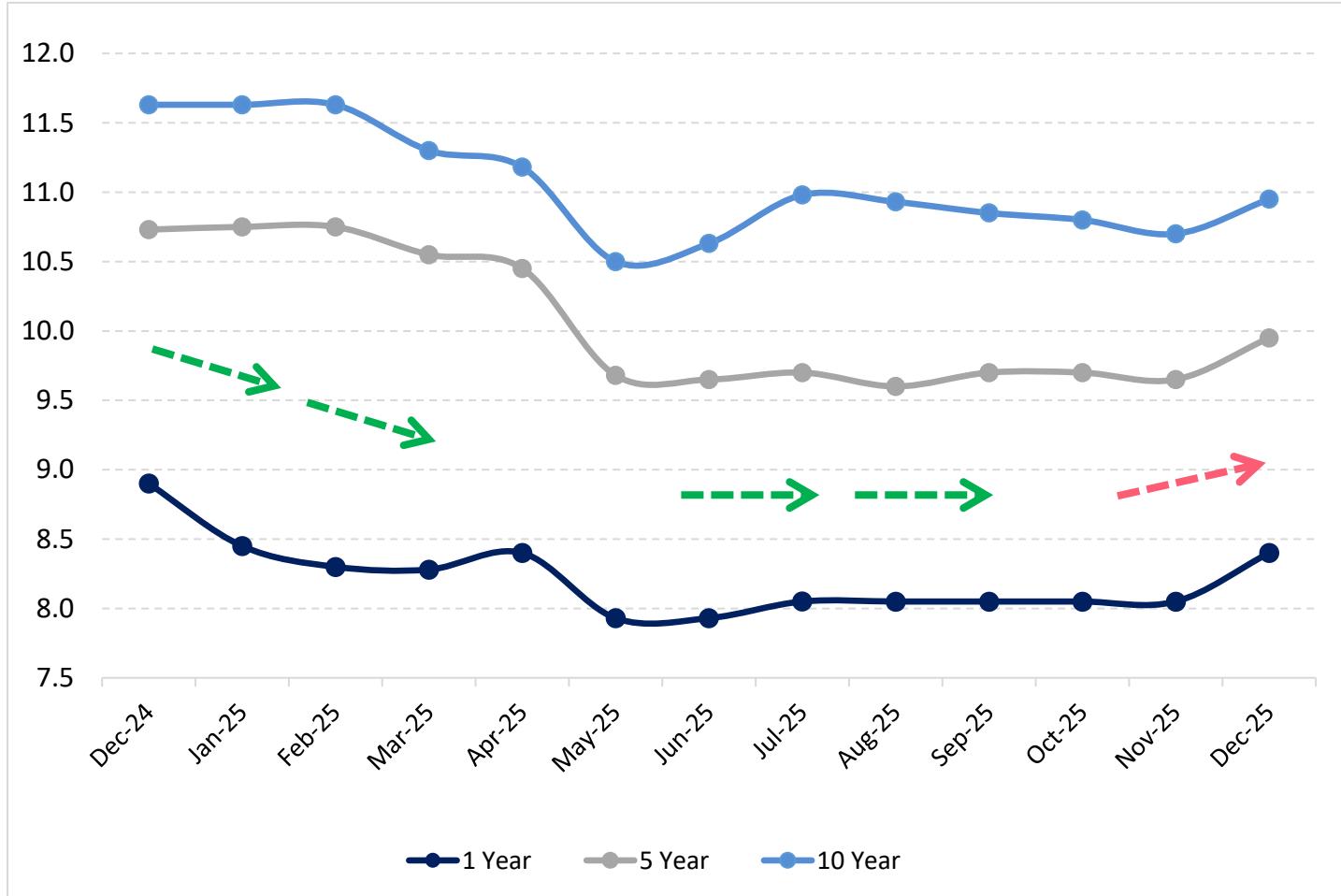
Accuracy of previous recommendations:



- 16th January 2025**
"2Q2025 onwards G-Sec yields are likely to witness upward pressure of c.100-150bps as the economy accelerates"
-Inaccurate
- 28th March 2025**
"The expectation of the upward adjustment of the yield curve is delayed to 4Q2025E"
-Accurate
- 14th July 2025**
"Yields to remain stable within the next 6-12 months, Shift to short tenures with a willingness to run a carry portfolio"
-Partly Accurate



The yield curve inched up in Dec-25, deviating from our previous recommendation:



Last 12 months:	<u>Dec-24 to Dec-25</u>
1 Year	- 68bps
5 Year	- 78bps
10 Year	- 50bps
Last 6 months:	<u>Jun-25 to Dec-25</u>
1 Year	+ 48bps
5 Year	+ 30bps
10 Year	+ 23bps
Last 1 month:	<u>Nov-25 to Dec-25</u>
1 Year	+ 35bps
5 Year	+ 30bps
10 Year	+ 15bps



Review on market movement: Jul – Dec 2025

"The yield curve remained within the range stated in our Jul-25 recommendation between July to November"

- ✓ *The yield curve remained well within the band forecasted by FCR in its last Fixed Income recommendation (Jul-25), up to November 2025.*

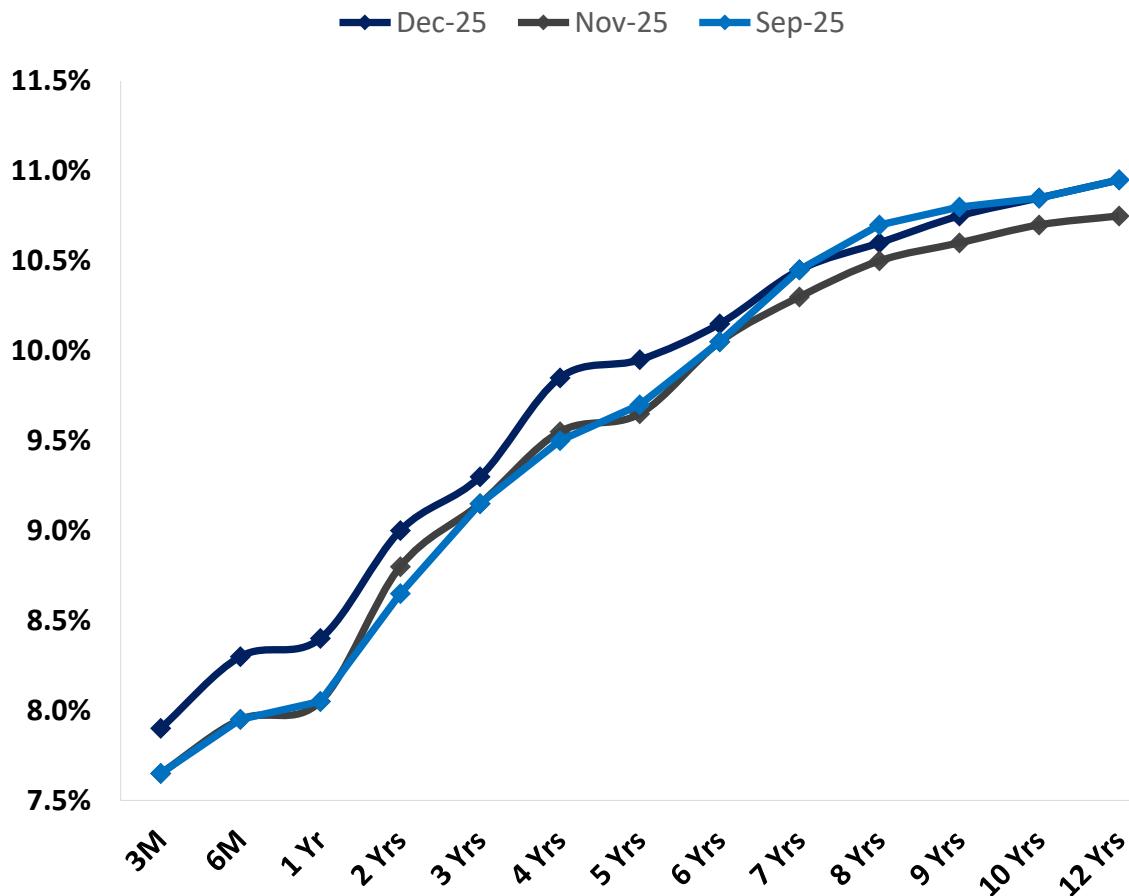
"The yield curve inched up in Dec-25 contrary to FCR's Jul-25 forecast, warranting a revision of FCR's outlook"

- ✓ *The yield curve deviated from FCR's previously stated range in December of 2025, denoted by a 35bps, 30bps and 15bps uptick in yields for 1Y, 5Y and 10Y maturities respectively, between end-Nov to end-Dec alone.*
- ✓ *This trend that emerged towards the very latter part of the year was not in line with FCR's previous forecast for the 6-month period starting from Dec-25.*
- ✓ *What propelled this trend was the continuation of private sector credit growth by over LKR 200.0Bn, each month during 2H2025, which FCR had not anticipated.*
- ✓ *In fact, this persistence intensified during Oct-Nov, as monthly growth averaged to around LKR 250.0Bn.*
- ✓ *Given this backdrop and ongoing liquidity asymmetries within the private banking apparatus, lending rates came under pressure, which is reflected in a nearly 30-bps upward shift in the AWPR from end-Nov to end-Dec.*
- ✓ *Thus, an unexpected intensification in private credit growth during the latter part of the year together with asymmetries that persisted among private banks exerted upward pressure on the yield curve in Dec-25, calling for a revision of our outlook for the period leading to Jun-26.*



Overall yield curve movement

Yield curve Month-end comparison



Interest Rate Change (bps)

Tenure	Dec 2025	Nov 2025	Change (bps)	Sep 2025	Change (bps)
3M	7.90%	7.65%	+25	7.65%	+25
6M	8.30%	7.95%	+35	7.95%	+35
1 Yr	8.40%	8.05%	+35	8.05%	+35
2 Yrs	9.00%	8.80%	+20	8.65%	+35
3 Yrs	9.30%	9.15%	+15	9.15%	+15
4 Yrs	9.85%	9.55%	+30	9.50%	+35
5 Yrs	9.95%	9.65%	+30	9.70%	+25
6 Yrs	10.15%	10.05%	+10	10.05%	+10
7 Yrs	10.45%	10.30%	+15	10.45%	0
8 Yrs	10.60%	10.50%	+10	10.70%	-10
9 Yrs	10.75%	10.60%	+15	10.80%	-5
10 Yrs	10.85%	10.70%	+15	10.85%	0
12 Yrs	10.95%	10.75%	+20	10.95%	0
15 Yrs	N/A	N/A	N/A	N/A	N/A
20 Yrs	N/A	N/A	N/A	N/A	N/A

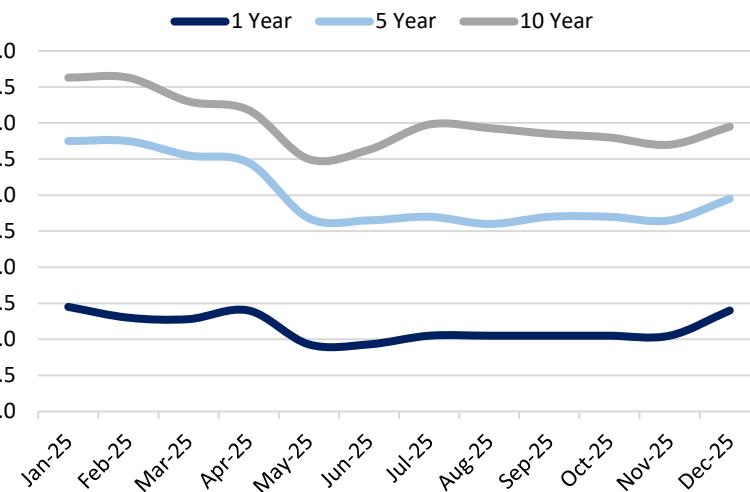


2. Outlook for Fixed Income Instruments

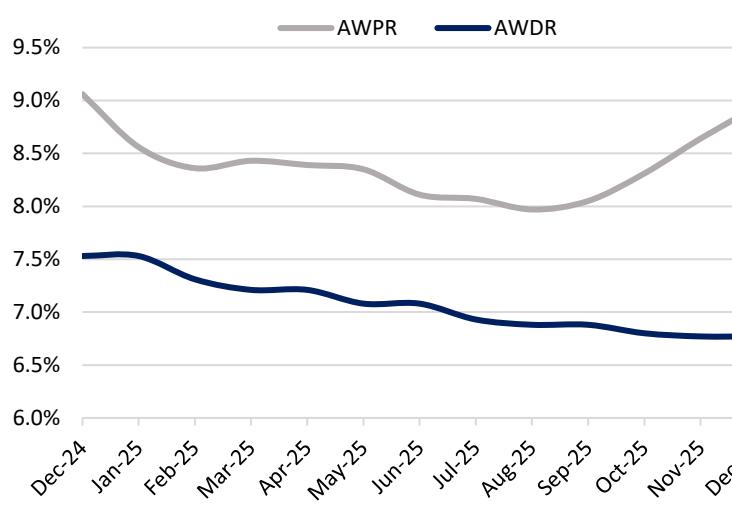
“Headwinds emerge; economic indicators may soften”

Stability in economic indicators maintained in 2025...

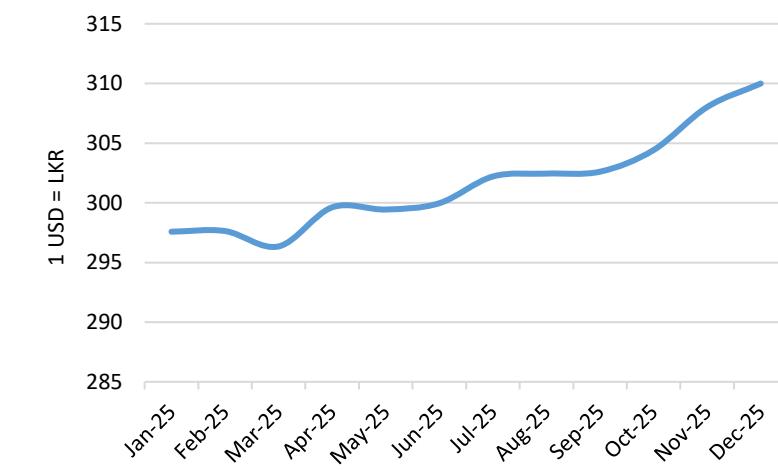
Gov. security yields hold largely steady



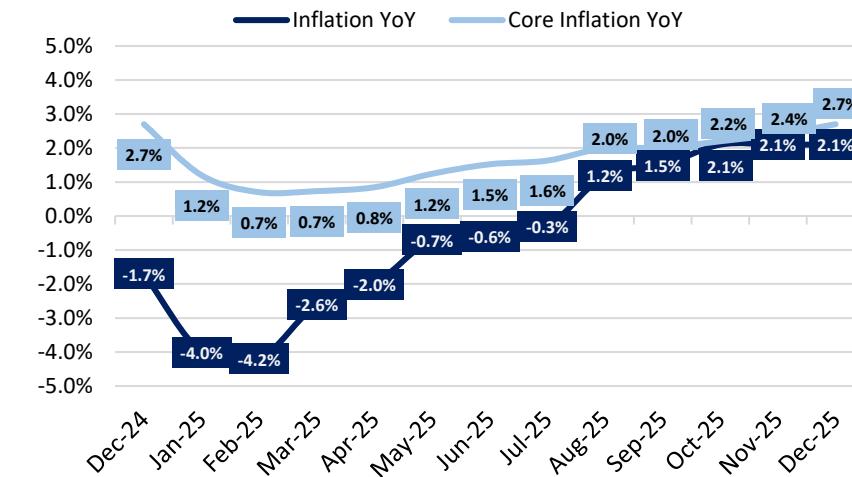
Lending rates trended up towards end-25



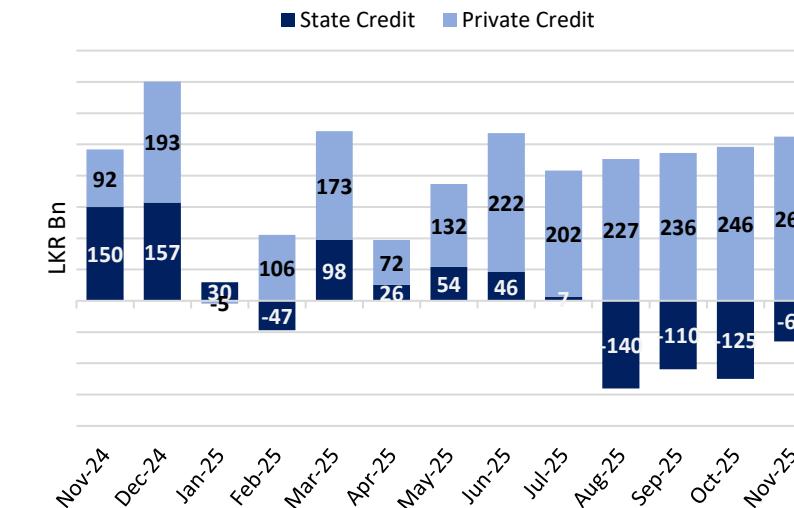
LKR depreciates by 4.2%YTD against the USD



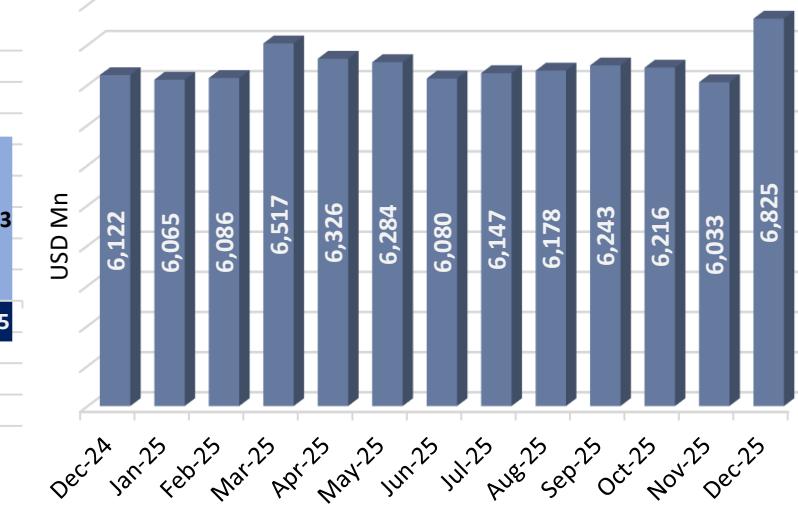
Inflation remained 2.1% for the third consecutive month



Private sector credit accelerates by 26.0%YoY

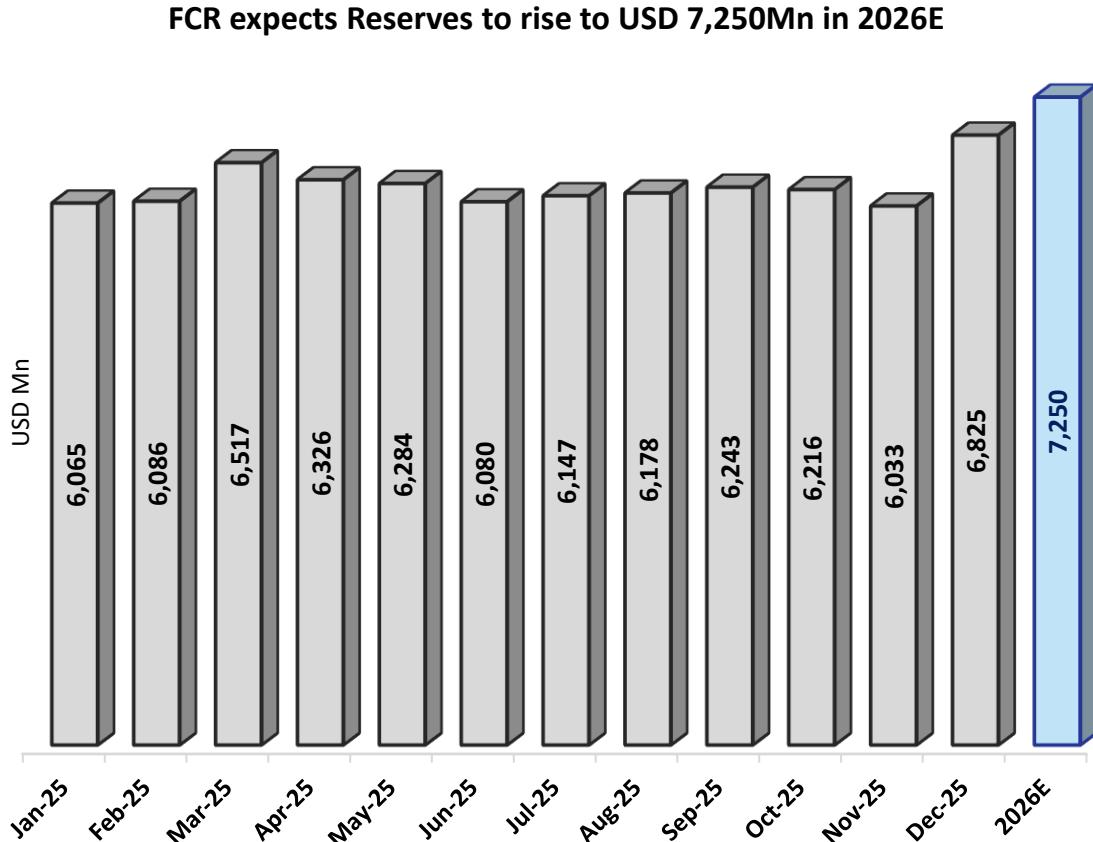


Reserves expanded to USD 6.8Bn in Dec-25





Gross Official Reserves hover close to end-2025 FCR forecast...



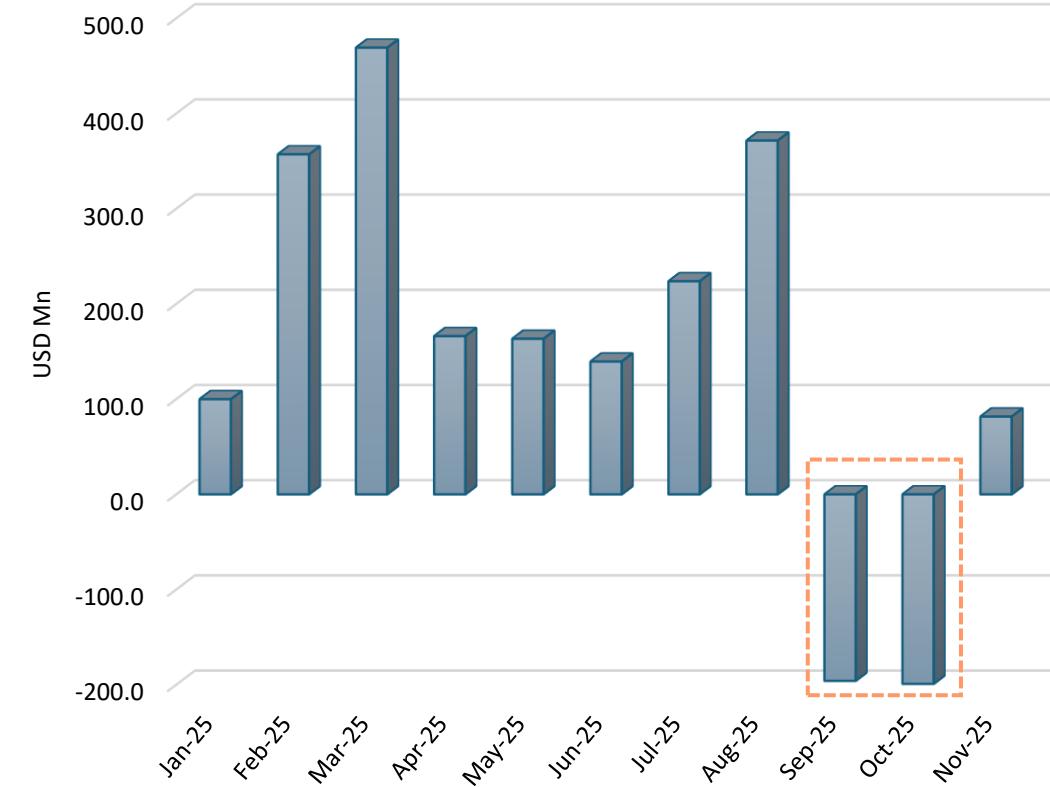
- ✓ Gross official reserves rose to USD 6.8Bn (FCR's forecast for 2025E: USD 7.0Bn), overcoming the stagnation that was evident between Jun-Nov of 2025.
- ✓ CBSL's persistent purchases of USD from the market together with heightened inflows from multilaterals, particularly following cyclone Ditwah enabled this development.
- ✓ While the IMF's 6th tranche which amounted nearly to USD 350.0Mn didn't come through, USD 206.0Mn was received through a Rapid Financing Instrument (RFI).
- ✓ Additionally, funding was also received from other multilateral and bilateral partners which enabled Sri Lanka to enhance its reserves by 13.1% MoM denoting an uptick of nearly USD 800.0Mn.
- ✓ FCR expects gross official reserves to increase to USD 7,250Mn, reflecting a relatively measured build-up amid constrained current account surpluses and an active policy approach toward external debt settlement, which is expected to partially offset reserve accumulation.



...despite the current account deficits seen in Sep-Oct...

- ✓ Sri Lanka's current account surplus demonstrated remarkable strength during Jan-Aug of 2025, driven largely by:
 - Persistently high inflows from remittances
 - Ongoing inflows from tourism
 - Relatively limited imports
- ✓ However, this trend registered a reversal in Sep-Oct of 2025 as outflows triggered by pent up demand for imported private vehicles took its toll.
- ✓ Moving forward, large outflows as a result of vehicle importation could be limited as pent-up demand has now been largely addressed.
- ✓ Yet higher imports associated with post-Ditwah rebuilding efforts and contained agricultural exports (due to the adverse impact of Ditwah) could continue to widen the trade deficit in 2026E.
- ✓ FCR believes that ongoing resilience and an anticipated further expansion of remittances could still uphold Current Account resilience moving into 2026E, despite the widening of the trade deficit.
- ✓ **Consequently, moving forward, the current account is still likely to remain in modest surpluses, though large positive balances (USD 200.0-400.0Mn) seem unlikely.**

Current Account deficits in Sep-Oct constrained reserve accumulation

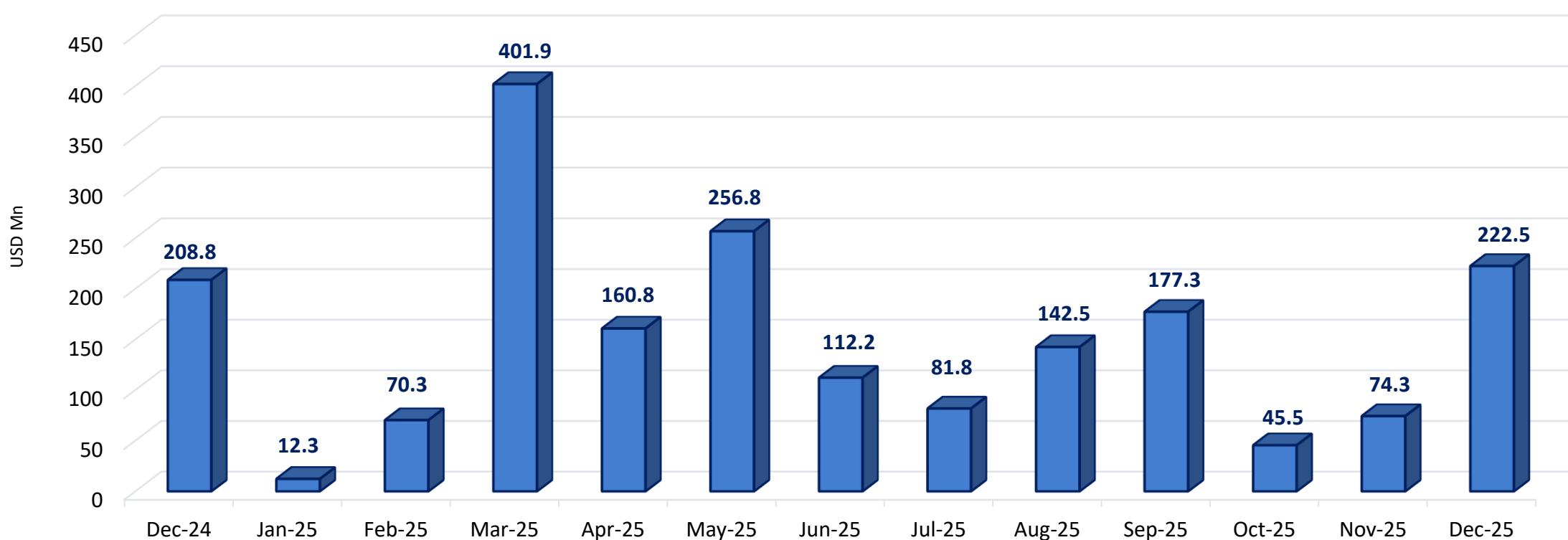




...CBSL continues its reserve accumulation, remaining a net buyer of USD...

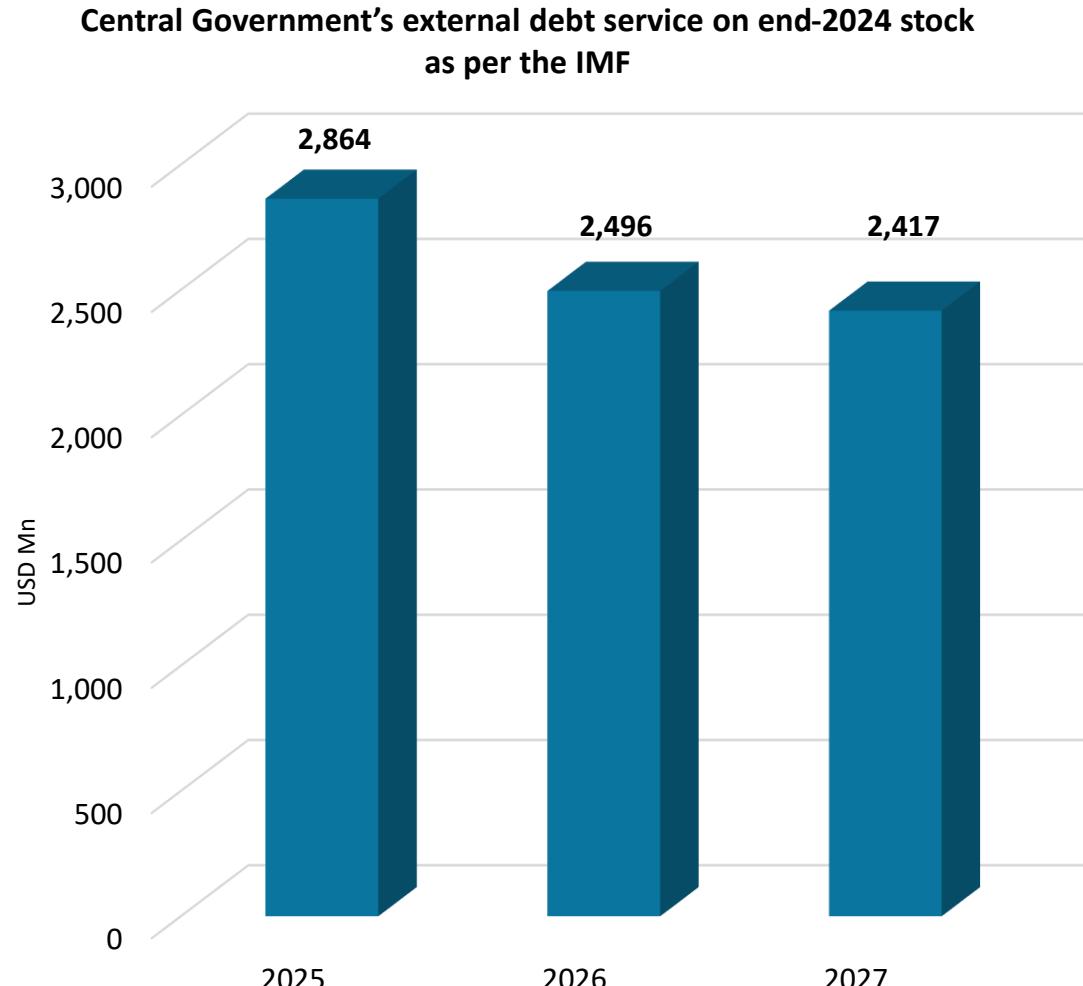
The Central Bank of Sri Lanka has persistently emerged as a net buyer of USD from the market. In 2025 alone the CBSL has purchased a net amount of **USD 1.8Bn from the market**, fueling Sri Lanka's Gross Official Reserve Position. Looking ahead, the CBSL's scope to aggressively absorb USD from the market is likely to be limited, as sizable current account surpluses are expected to be infrequent in 2026E.

CBSL has remained a net buyer of USD through 2025





...Reserve accumulation remains a crucial, particularly given the impending debt obligations



*The charts that follow set out Sri Lanka's external debt service profile over 2025–27, constructed on the basis of the central government's outstanding external debt stock as at end-2024. Against this backdrop, IMF projections suggest that central government external debt service in 2026 will be approximately USD 2.5Bn. Allowing for minor timing shifts and valuation effects, we assess that aggregate **central government external repayments in 2026E are likely to remain within a USD 2.0–2.6Bn range.***

However, external debt service in 2025 proved materially higher than initially anticipated, reaching close to USD 3.8Bn. This overshoot was driven largely by repayments on external liabilities carried by the Central Bank of Sri Lanka (CBSL), rather than by slippage in the central government's own obligations.

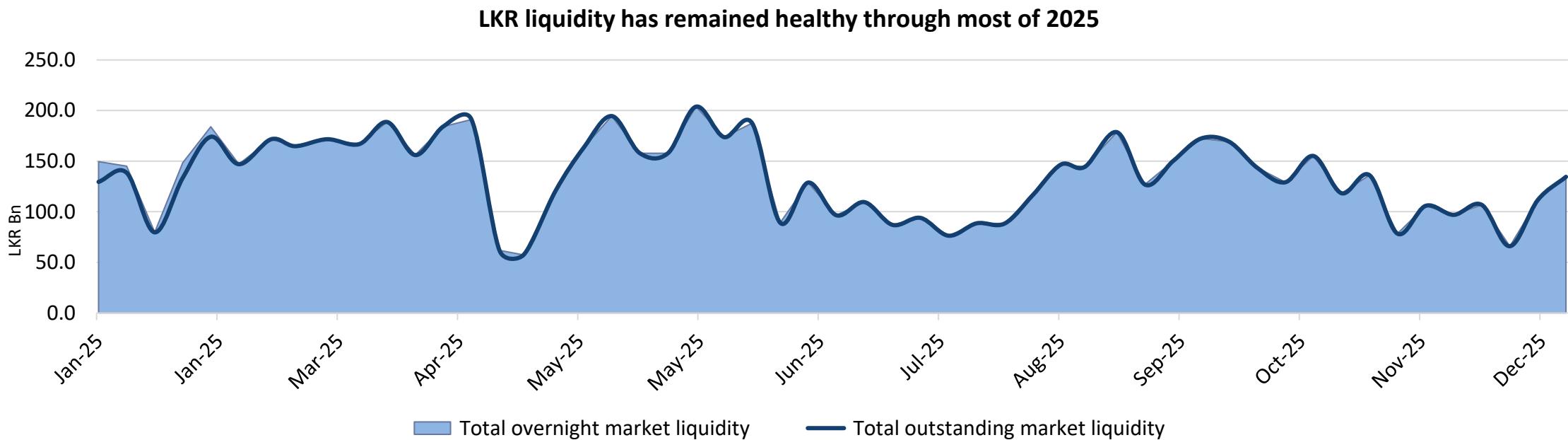
Accordingly, while the Central Government's external debt service obligations are expected to moderate in 2026E, a proactive shift towards liability management, as indicated by the Public Debt Management Office (PDMO), suggests that actual repayments could exceed the initially anticipated USD 2.0–2.6Bn range.



CBSL's purchases of USD has prompted elevated levels of LKR liquidity in the market...

Despite a temporary dip to around LKR 57.3Bn in mid-April, overnight liquidity largely remained within the LKR 75.0–150.0Bn range through 2025, driven primarily by the CBSL's sustained USD purchases from the market. In addition, Treasury cash buffers largely parked with state banks and subsequently channeled to private banks, helped ease liquidity asymmetries, supporting comfortable system liquidity even amid strong private sector credit growth.

Looking ahead, FCR expects liquidity conditions to come under some pressure, ruling out material expansions as highly unlikely. Continued expansion in private credit, albeit at a relatively modest 18.0% (for 2026E) stands out as a key contributor to this trend. Limited USD absorption from the market (and the subsequent injection of LKR) due to constrained current account surpluses, alongside reduced capacity of state banks to address liquidity asymmetries within the broader market (given a lower primary surplus expected for 2026E) also emerge as factors likely to exert pressure on market liquidity.

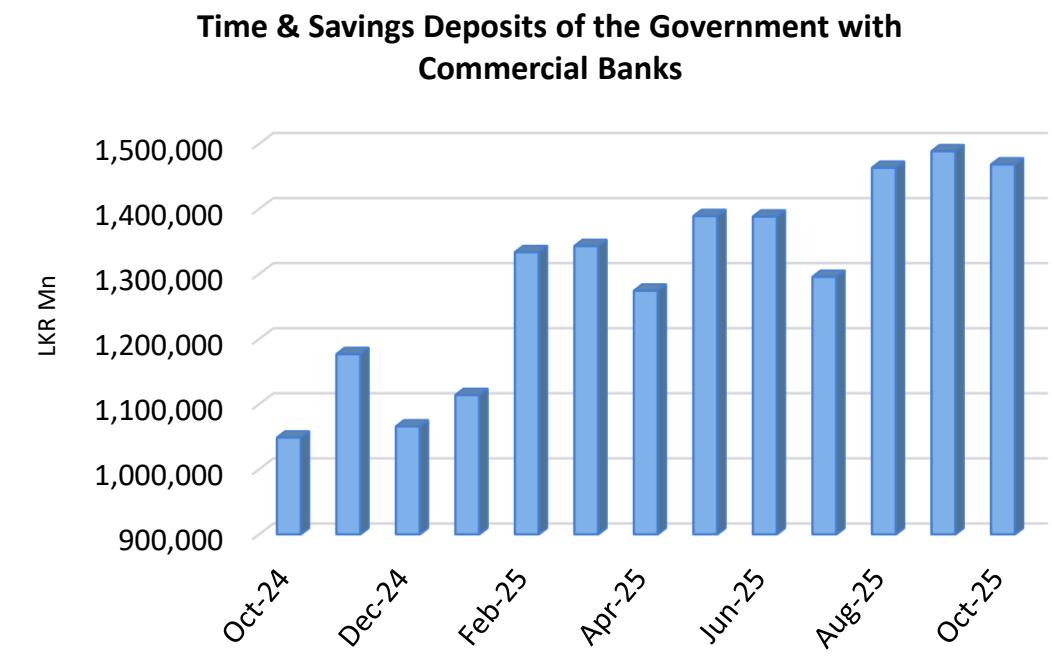
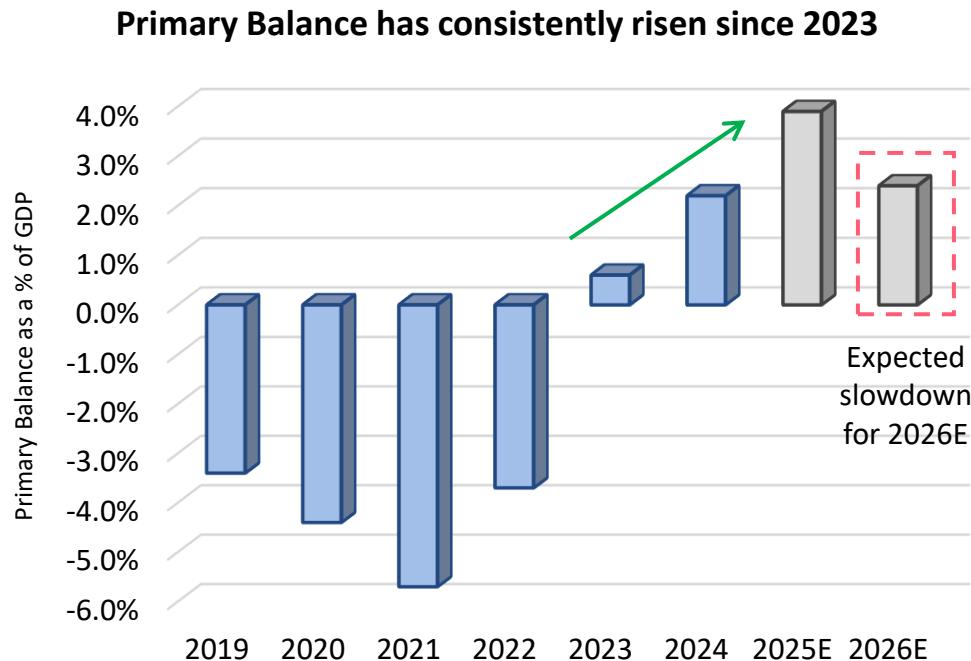




...Treasury's cash surplus addressed liquidity asymmetries within privatee banks...

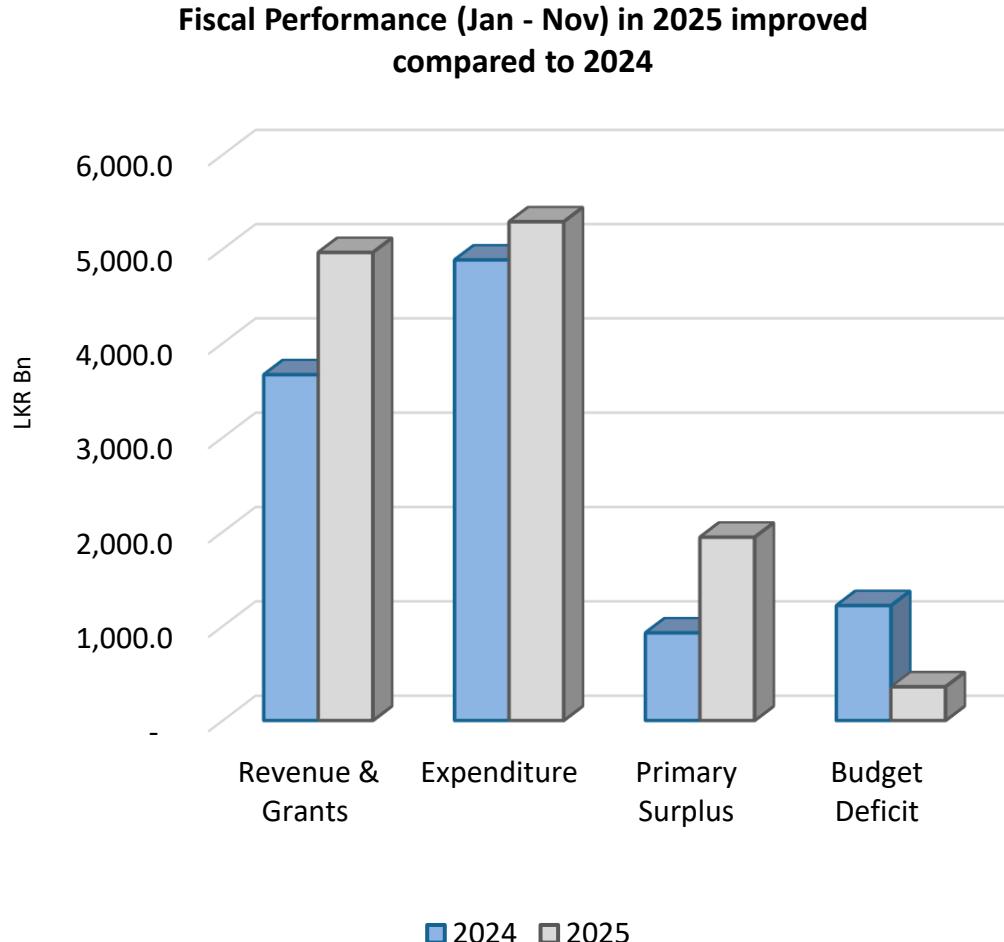
The treasury has been accumulating surplus since Sep-2023, plausibly for the first time in the last few decades. These surpluses, achieved largely through stringent fiscal discipline, have been parked at State Banks. According to data published by CBSL, through 2025, state banks have been lending to private banks, particularly in the repo market. Thus, the Treasury's cash surpluses also stand out as a factor that has smoothed overall liquidity through addressing disproportionate LKR liquidity within private banks.

FCR anticipates a relative slowdown in Sri Lanka's primary balance owing to a plausible uptick in capital expenditure in 2026E, as post-Ditwah rebuilding efforts kick in, hindering its ability to address liquidity asymmetries within private banks. This would also put market liquidity under pressure, particularly given an ongoing expansion of private credit.





...fiscal discipline facilitated the accumulation of cash buffers within the treasury...

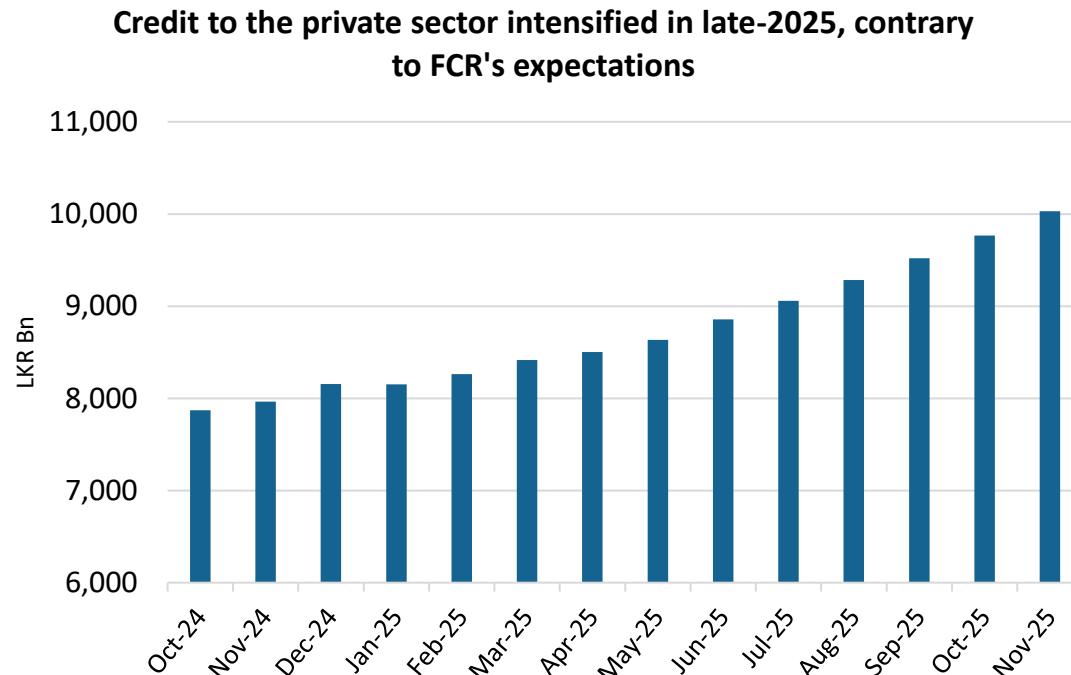


- ✓ Following the commencement of the EFF programme with the IMF and the enactment of the new Central Banking act in 2023, the government has been compelled to remain on a path of revenue based fiscal consolidation.
- ✓ As a result, Sri Lanka has been able to secure total revenues of LKR 3.1Tn and LKR 4.1Tn in 2023 and 2024 respectively, closing in on a near LKR 5.0Tn figure for 2025.
- ✓ Sri Lanka's fiscal discipline has also been shaped by constrained spending by the government, particularly that of capital expenditure.
- ✓ Consequently, heightened revenue and limited spending together have produced persistent primary surpluses since late 2023.
- ✓ These primary surpluses together with other factors like limited external debt repayments has enabled the government to accumulate cash buffers, which have largely been parked at state banks.
- ✓ Moving forward, FCR expects the primary surplus to slowdown, predominantly owing to enhanced capital expenditure.
- ✓ **Despite this anticipated slowdown in the primary surplus, which in turn would lead to a more constrained accumulation of cash buffers, fiscal discipline is expected to remain firmly intact.**

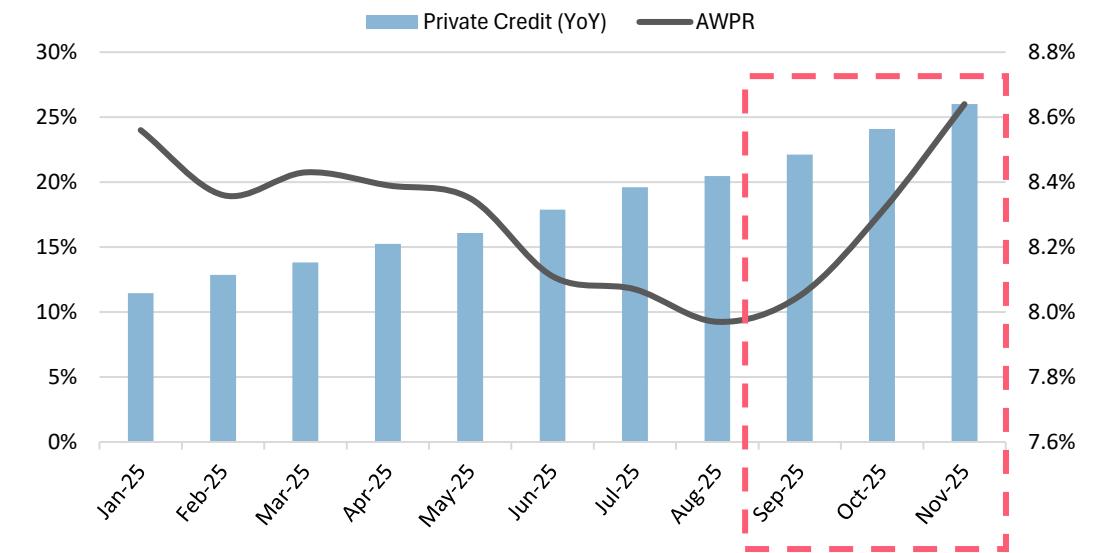


..equipped with adequate liquidity and enhanced capacity to lend, private credit continued to grow...

Private credit extended by licensed commercial banks grew substantially through 2025. While adequate liquidity and improved credit worthiness propelled capacity and willingness to lend, the easing rate environment and elevated activity within the real economy fueled demand for credit. The pent-up demand for imported private vehicles emerged as a primary driver of private credit particularly towards the latter part of 2025. Banks were making explicit lease finance facilities and also lending to the finance companies, implicitly facilitating the financing of private vehicles. **An intensification in private credit growth that kicked in particularly towards the latter part of 2025, contrary to FCR's initial expectation, exerted upward pressure on lending rates.**



An intensification in private credit growth towards end-25, exerted pressure on lending rates



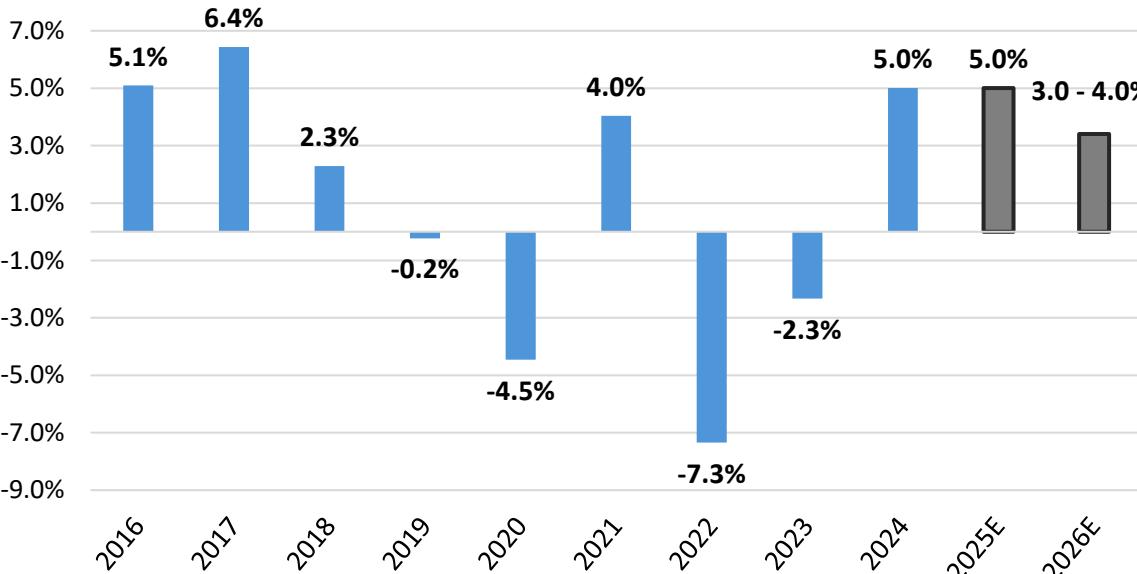


..albeit an anticipated slowdown in GDP, credit to the private sector is still expected to enhance...

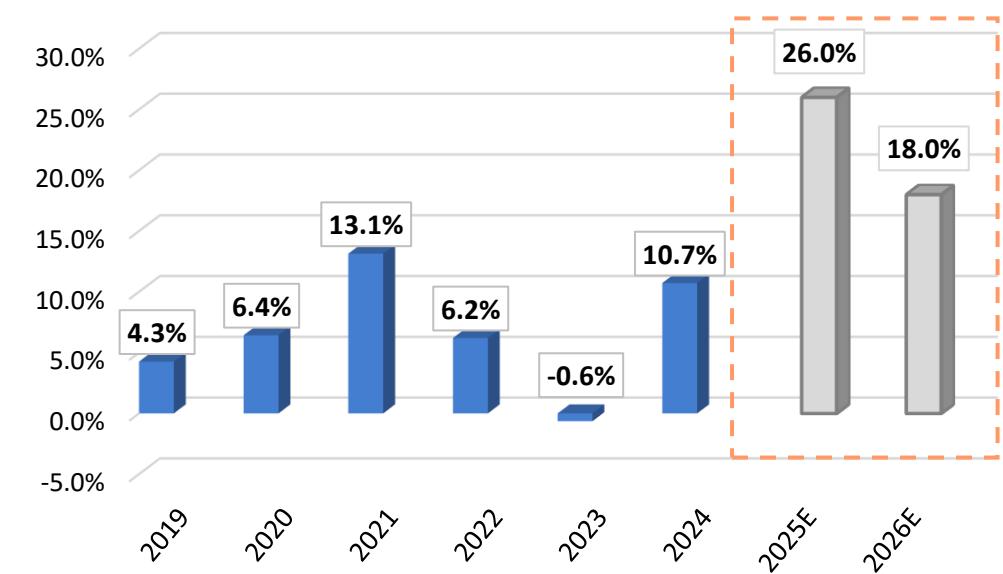
Sri Lanka's GDP grew at 4.8%, 4.9% and 5.5% in 1Q, 2Q and 3Q of 2025 respectively. We expect this growth momentum to have continued through the final quarter of 2025 as well. However, FCR anticipates a gradual slowdown in 2026, predominantly owing implications of Ditwah taking its toll. The primary repercussion of the cyclone is likely to be a slowdown in consumption, particularly across areas other than the Western Province. While heightened capital infusions, as a part of post-Ditwah rebuilding efforts would somewhat offset the impact from constrained consumption, GDP growth for 2026E is likely to hover between 3.0-4.0%.

Despite this anticipated slowdown in GDP, we expect the expansion in private credit to continue, although at a relatively modest 18.0% in 2026E. While consumption is expected to slow down, FCR holds the view that targeted lending, particularly towards infrastructure rebuilding efforts and enhanced trade finance initiatives would facilitate on going demand for private credit.

FCR expects GDP growth to moderate in 2026



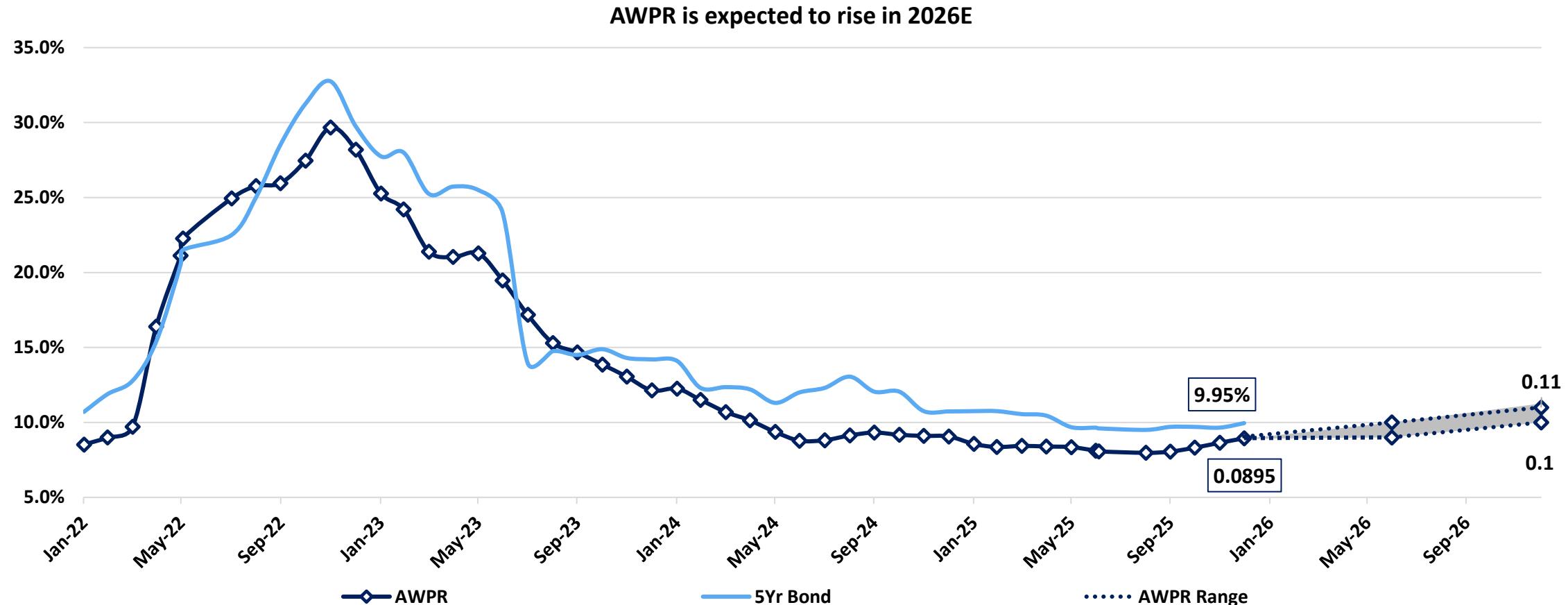
Growth in private credit is expected continue in 2026E





...pressure on liquidity and persistence in private credit growth would exert pressure on lending rates...

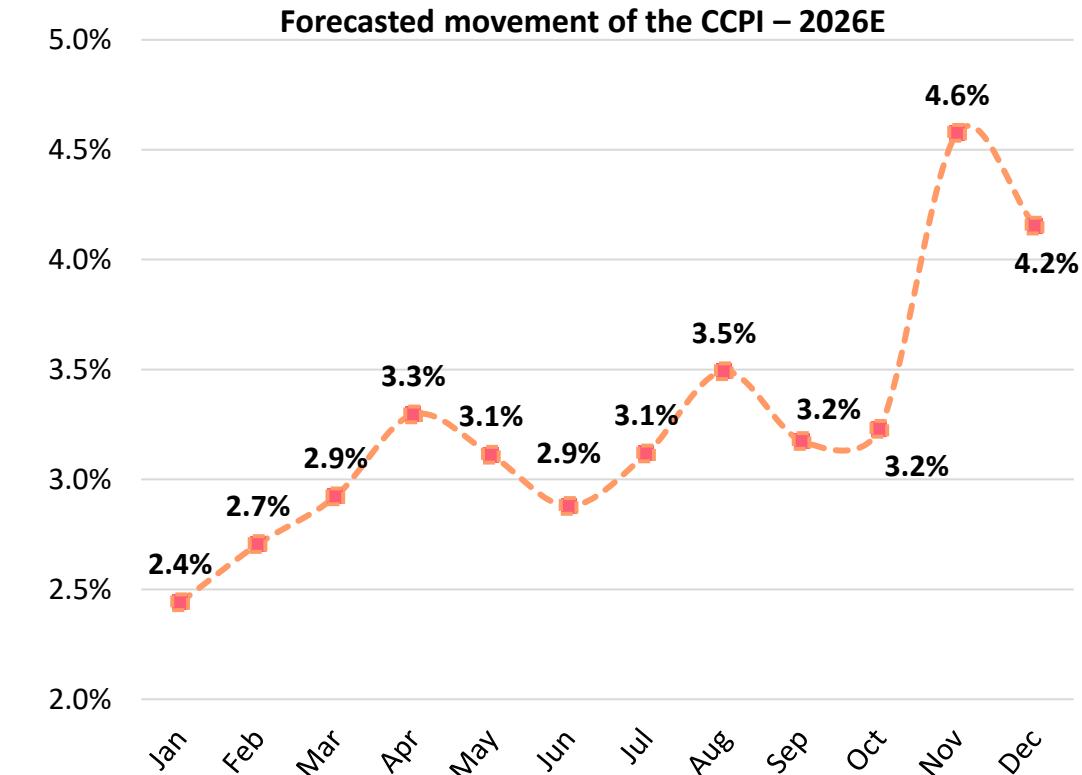
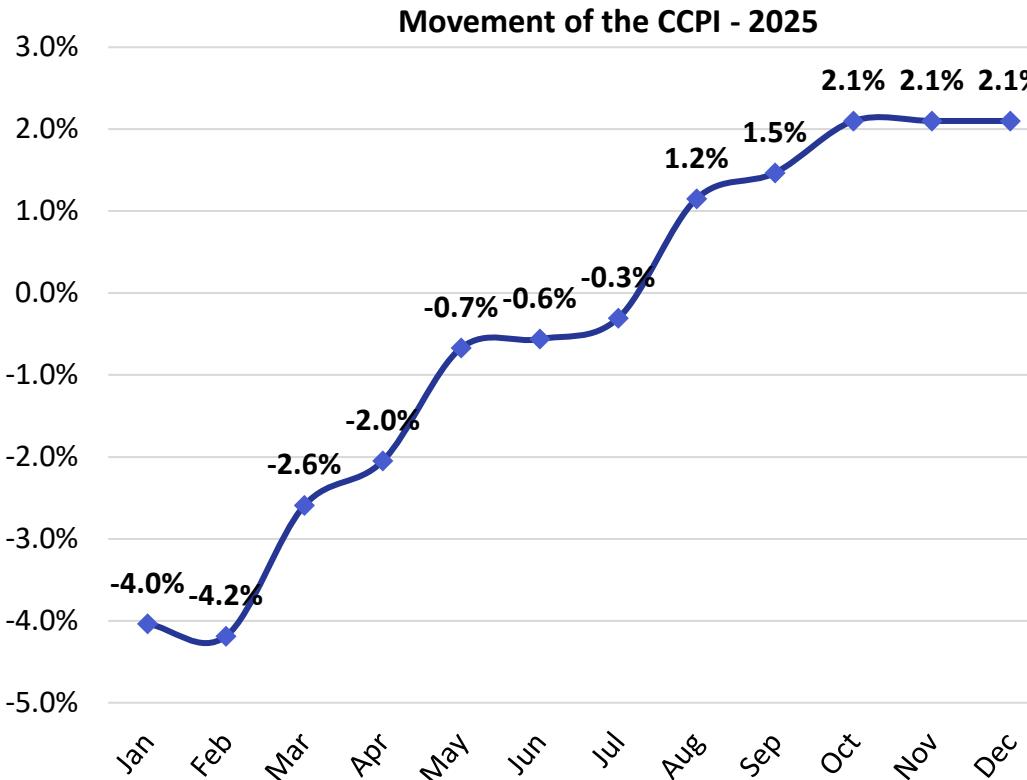
Liquidity constraints, exacerbated by liquidity asymmetries within private banks alongside continued growth in private credit would exert upward pressure on lending rates. Consequently, FCR expects the AWPR to inch higher in 2026E, reaching the 9.0-11.0% threshold.

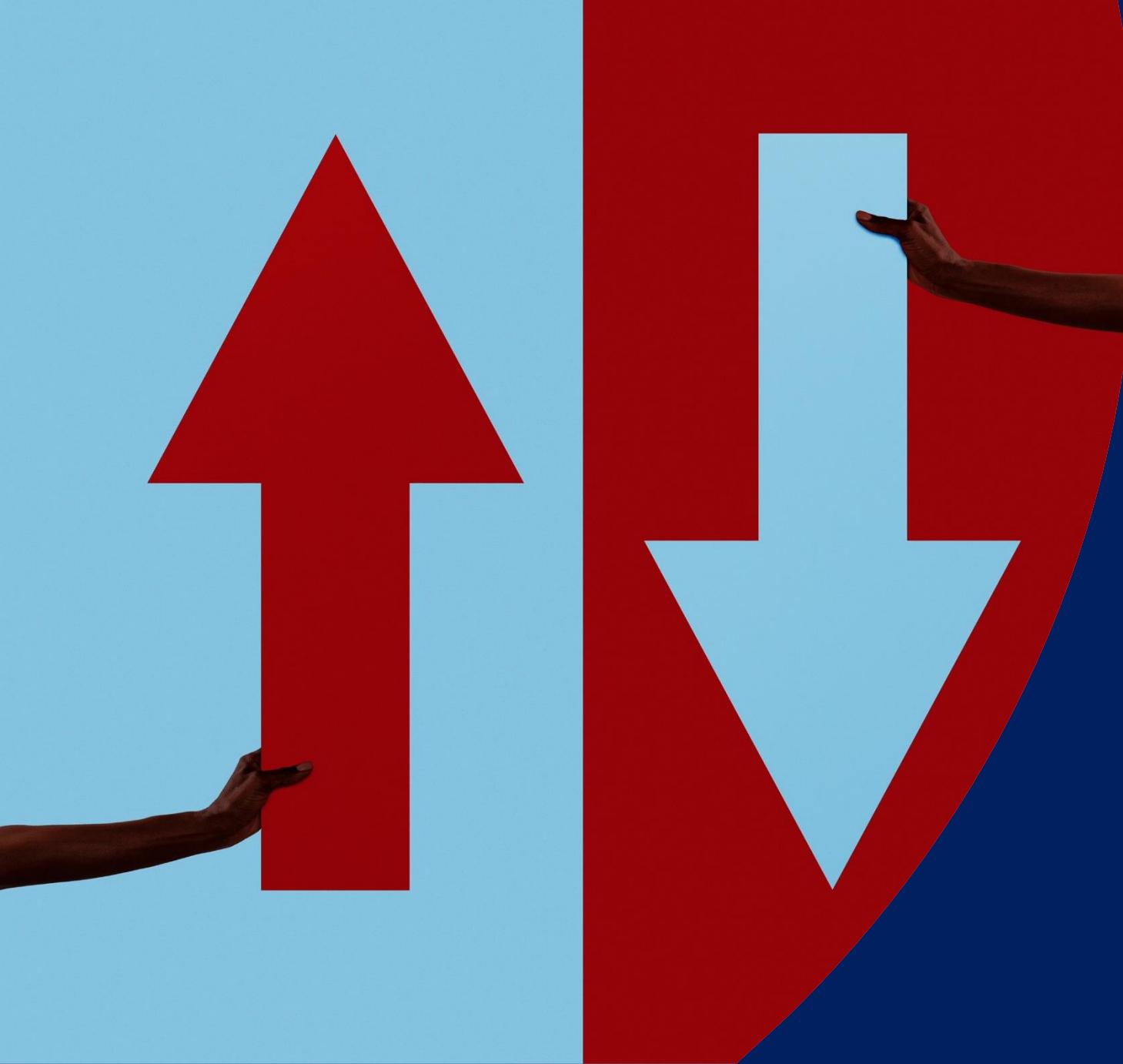




...despite inflation remaining below the 5.0% target...

FCR expects inflation (CCPI, YoY) to remain positive throughout 2026E. While supply-side shocks from Cyclone Ditrwah could trigger temporary upward pressure on prices, the CCPI is expected to remain below 5.0% through 2026E. The cancellation of the electricity tariff hike scheduled for January–February further moderates price pressures, keeping inflation largely in the 2.0–3.0% range for most of the year. Seasonal factors may produce short-term deviations from this range, but on an annual basis, FCR forecasts average inflation to settle around 3.3% in 2026E.





3. Fixed Income Health Score

“Health score set to dip further”



FI Economic Health Score: Oct-25 – Jan-26

Since our last update of the Fixed Income Health Score which was done in Oct-25, it has registered a decline of 3 points. This dip primarily reflects anticipated pressures on market liquidity, alongside a gradual pick up in inflation.



Primary Criteria

$$- \quad \quad 49 \quad - \quad 03 \quad = \quad 46$$

Secondary Criteria

$$- \quad \quad 18 \quad + \quad 00 \quad = \quad 18$$

**Economic Health Score
[Jan 2026]**

$$= \quad \quad \quad 64$$

[As against 67 in Oct-25 &
77 in Jan-25 (1 Year ago)]



Changes to Health Score

Primary Criteria: Oct-25 - Jan-26

46/75



A Janashakthi Group Company





Changes to Health Score

Secondary Criteria: Oct-25 – Jan-26

18/25

Previous score

02/05



02/05



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.

External Environment

The external environment remains broadly consistent with the conditions observed in Oct-25.

03/05



03/05



BOT & BOP

The current account went into deficit in Sep-Oct as pent-up demand for private vehicle imports took its toll. However, owing to a subsequent normalization in vehicle imports, Nov-25 saw a contained surplus of USD 81.7Mn.

04/05



04/05



Political Risk

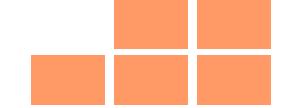
The political stability Sri Lanka achieved in 2025 continues to hold firm in Jan-26.

Previous score

05/05



05/05



Investor Confidence

The business confidence index hit an all time high of 210 in Jun-25. However, since then, the index continued to moderate. Yet, no material developments were observed since Oct-25.

05/05



05/05





4. New Recommendation

*“Yields may rise by 50-100bps;
Maintain a carry portfolio
consisting of short tenures”*



FI Health expected to dip further in 2026E, entering the medium-low-risk territory...

FI Health Score in 2025:

"A modest weakness was evident"

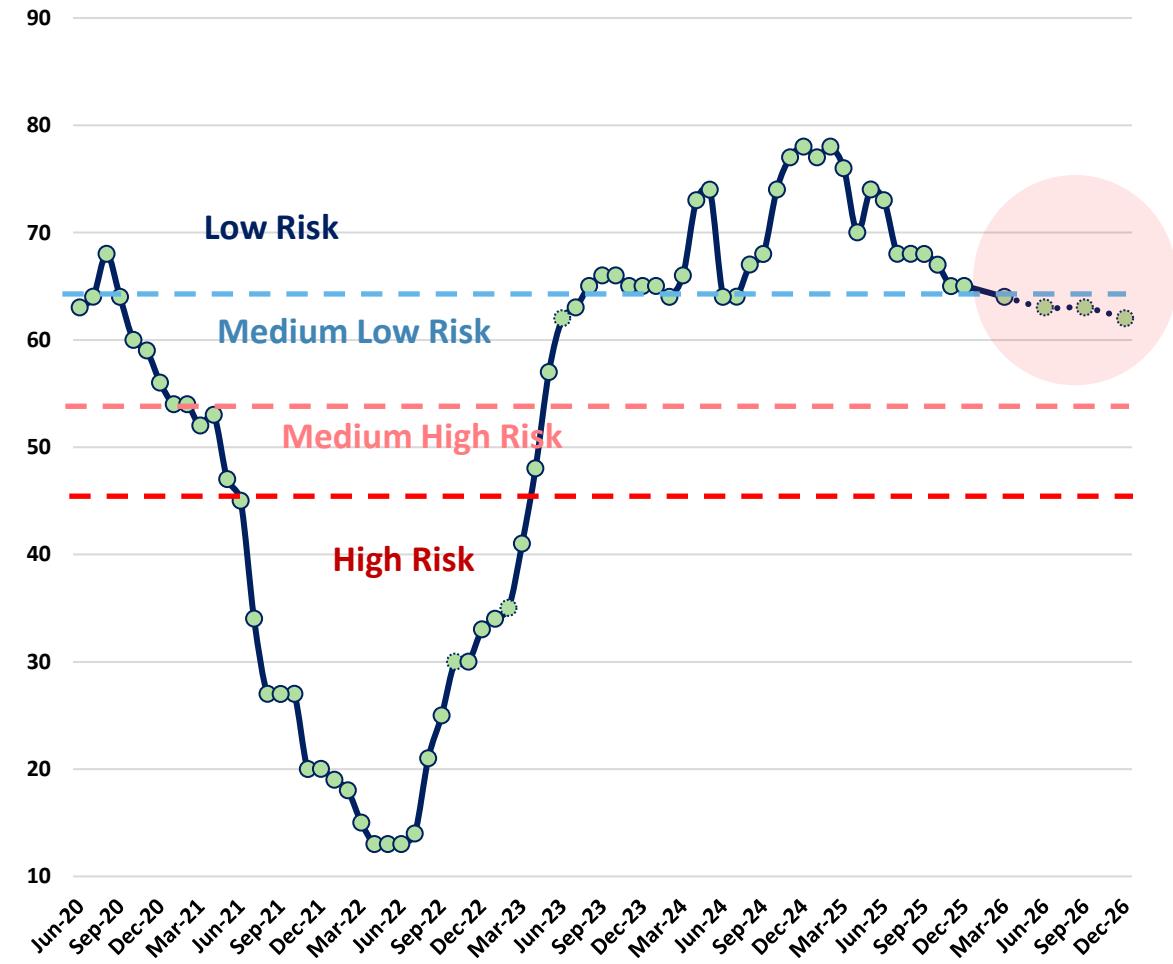
- ✓ Economic indicators underpinning the FI Health Score exhibited modest weakness in 2025, with the score edging lower, yet remaining above the medium-risk threshold.
- ✓ The decline reflected a contained build-up in official reserves, sustained expansion in private sector credit, rising inflation, and volatility in liquidity conditions.

FI Health Score in 2026E:

"Set to enter medium-low-risk territory"

- ✓ The Health Score is expected to edge further down, entering the medium-low risk threshold by mid-2026.
- ✓ Liquidity pressures alongside a plausible persistence in liquidity asymmetries within private banks triggered by continued private sector credit growth albeit at a modest 18.0% and elevated external debt repayments are key facilitators of this downward adjustment.
- ✓ **Given the decline in the Health Score and its expected entry below the medium-low-risk threshold, some upward pressure on interest rates is anticipated in 2026E.**

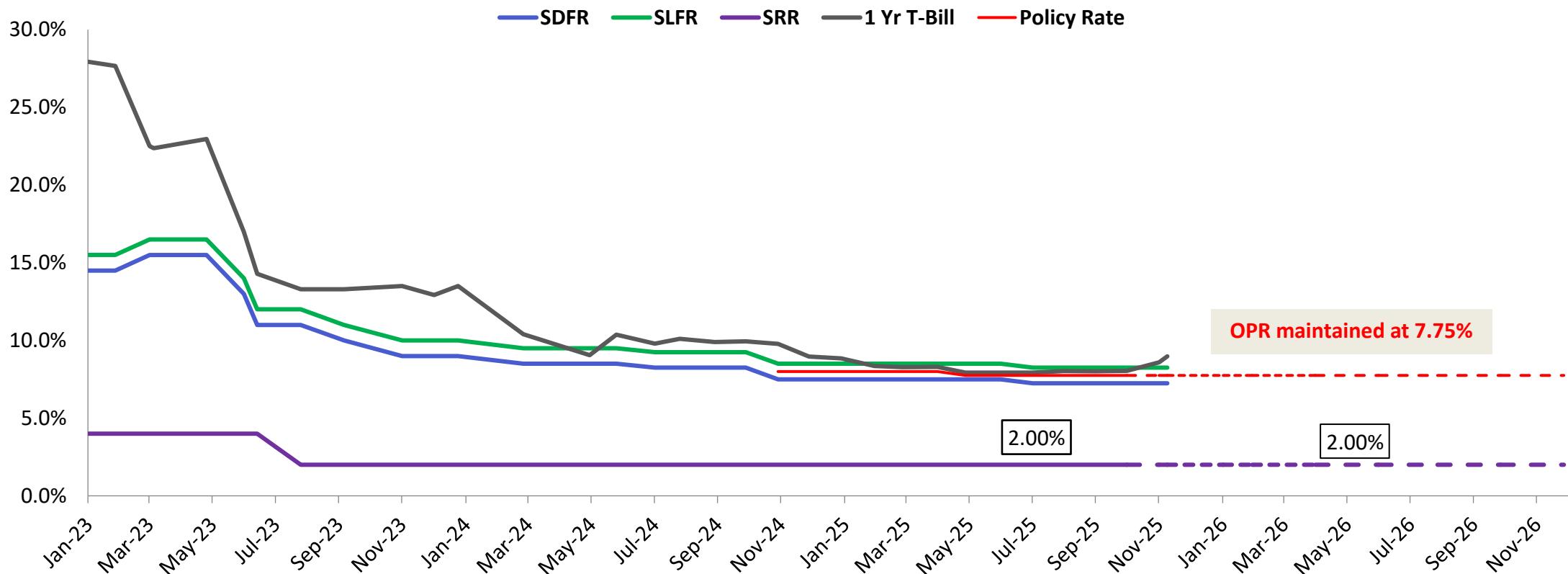
First Capital Fixed Income Health Score





OPR would remain unchanged through 2026E...

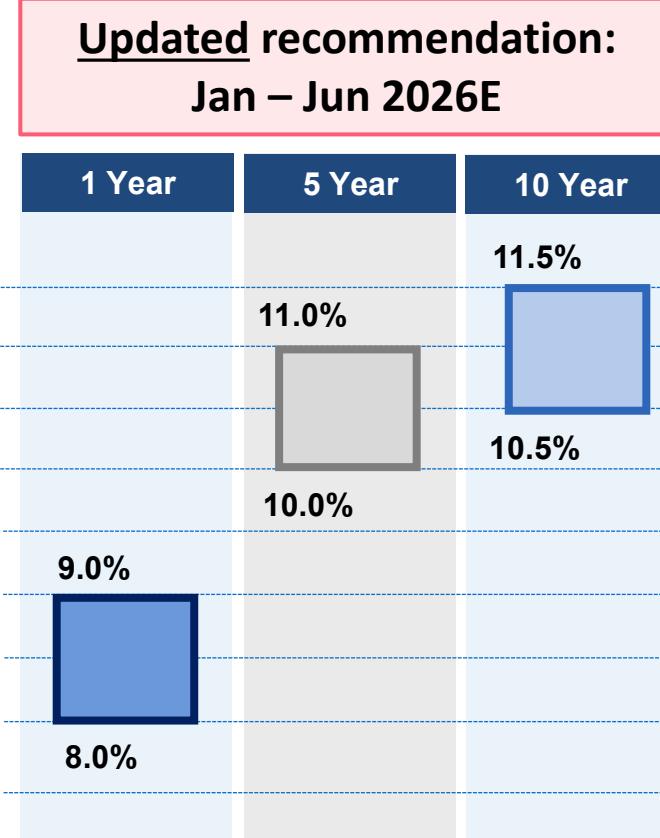
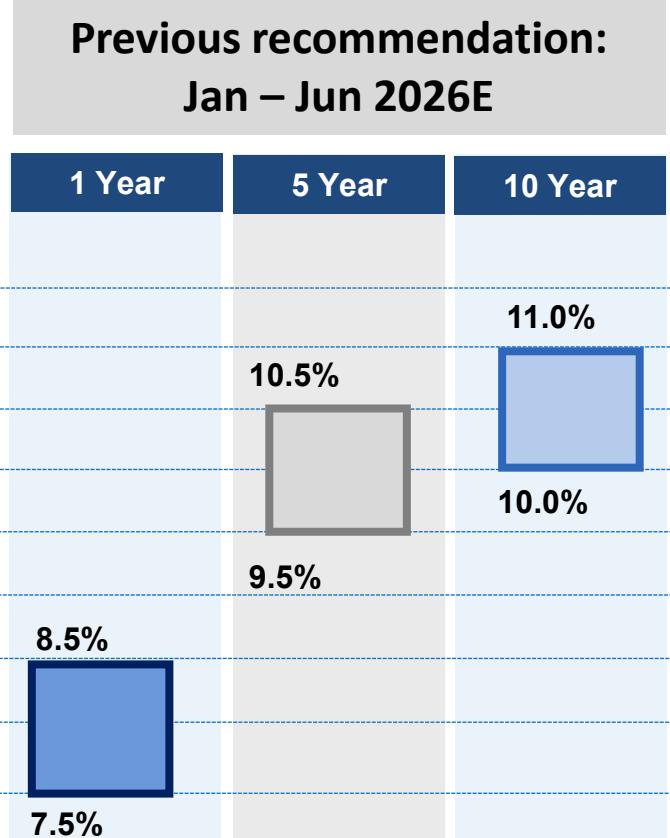
- ✓ With the FI Health Score trending down, implying upward pressure on interest rates, FCR is of the view that a further easing of the OPR is unlikely in 2026E.
- ✓ Consistent improvement in private sector credit, despite a plausible moderation, persistently positive inflation and recent enhancement and positive outlook associated with both manufacturing and services PMI all point towards the possibility of the OPR remaining unchanged in the coming 12 months.





FCR updates its Jan-Jun 2026E outlook for yields in line with anticipated economic dynamics

FCR anticipates a parallel upward shift of 50bps for Jan-Jun 2026E, from its last forecast for the same period.

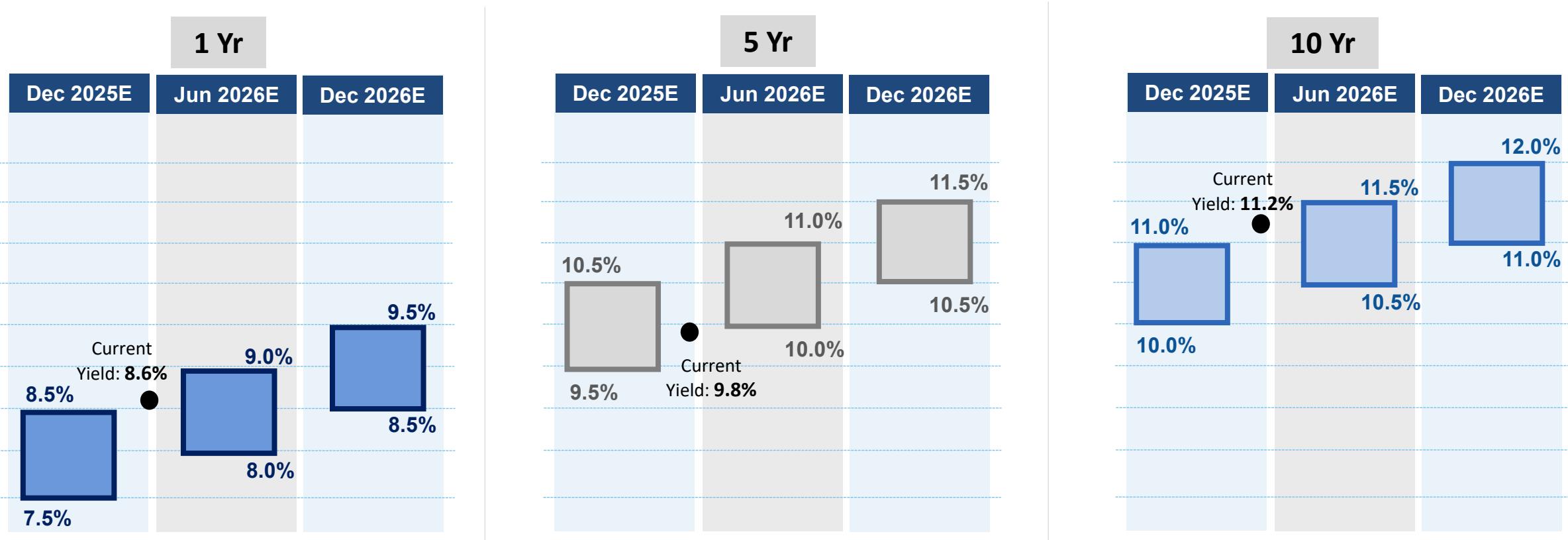


Taking into account the deviation of government yields from the trajectory projected in our last report that was evident from Dec-2025, concerns over liquidity constraints as well as asymmetries, and an expectation for higher than anticipated external debt repayments, FCR has updated its yield outlook for the January to June period of 2026E.



Bond yield expectation for Jun-26 and Dec-26:

Liquidity constraints are likely to keep interest rates under pressure. FCR expects liquidity to remain tight, with limited USD absorption (subsequent LKR injections). Lower 2026E primary surpluses will weaken state banks' ability to smooth private-bank liquidity asymmetries. These trends would exert upward pressure on lending rates in 2026E. This backdrop alongside a proactive liability management stance by the PDMO which in turn could lift external debt repayments above expectations would exert pressure on yields. Consequently, yields may gradually rise by 50-10bps in 2026E.

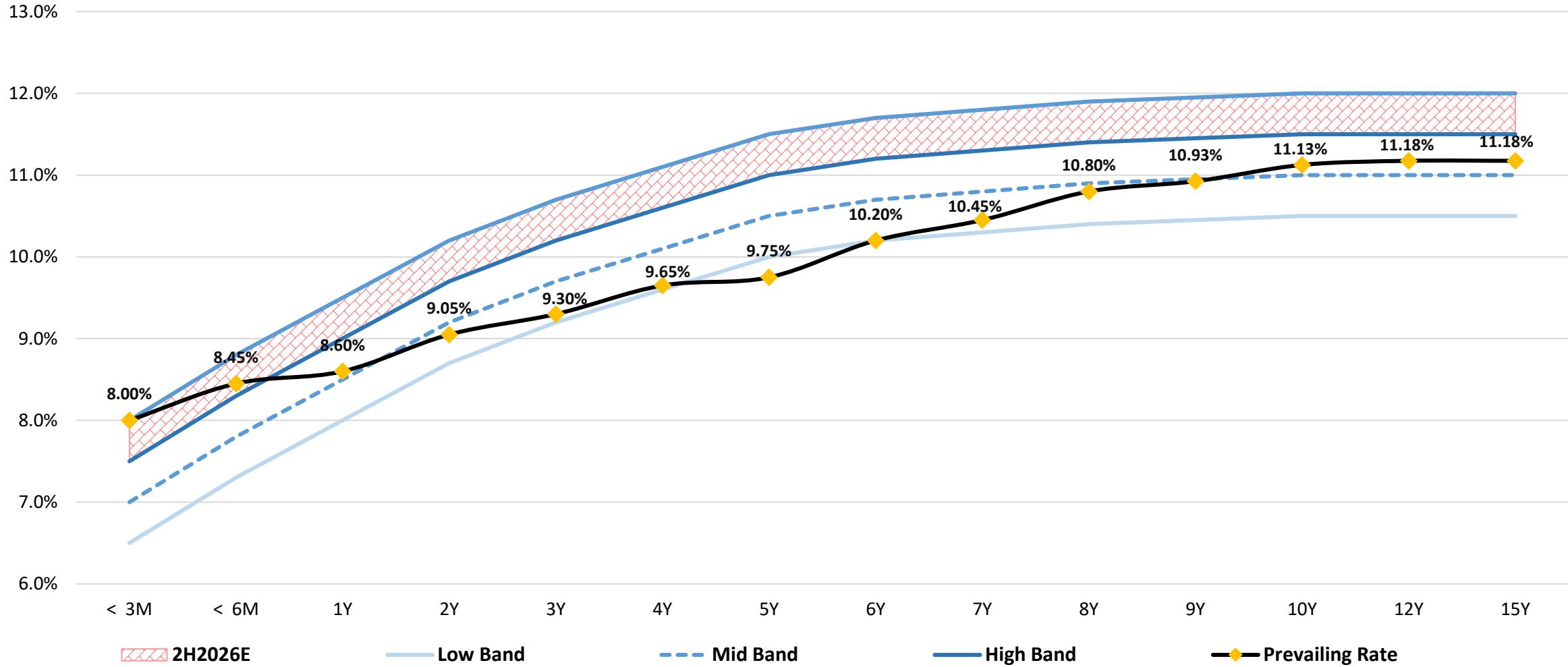


“Yields may gradually revert up by 50-100bps during the next 12 months leading to Dec-26”

- ✓ **Liquidity constraints could translate into pressure on interest rates:** Material expansions in liquidity are considered unlikely, with private credit growth of 18.0% in 2026E shaping overall market conditions. Moreover, limited liquidity injections through USD purchases from the market also suggest a broadly contained liquidity environment.
- ✓ **Limited capacity of state banks to address liquidity asymmetries within private banks would further exacerbate liquidity pressures:** Lower primary surpluses expected in 2026E would also reduce the capacity of state banks to address liquidity asymmetries within private banks (through the repo market), further subjecting market liquidity to potential pressure.
- ✓ **External liability management efforts by the PDMO could also exert interest rate pressure:** While external debt repayments are expected to moderate in 2026E, a proactive shift towards liability management, as indicated by the Public Debt Management Office (PDMO), suggests that actual repayments could exceed the initially anticipated USD 2.0–2.6Bn range.
- ✓ Considering the above factors, bond yields are expected to rise by 50–100bps over the next 12 months, denoting a structural shift in the impending interest rate landscape. **Consequently, Maintain a carry portfolio consisting of short tenures is recommended.**



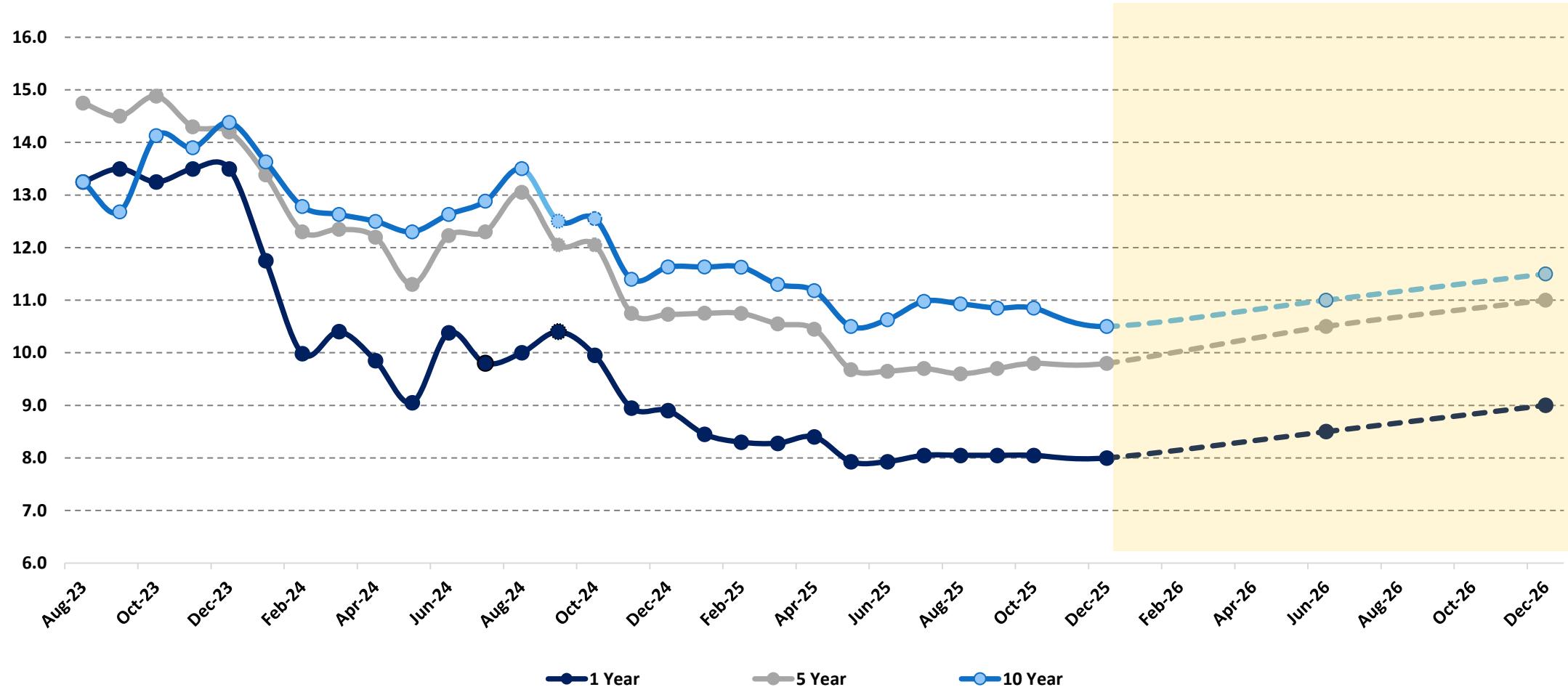
Lower tenures and long tenures currently at the forecasted mid-band while mid tenures hover close to the low band





Pressure expected on government yields is likely to prevail throughout 2026E

Bond yields to increase between 50bps-100bps during 2026E





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Thank you!

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MANAGING RISKS”***



First Capital
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