



First Capital
First Capital Research

*“**CUT** EXPOSURE; BID FOR AUCTION”*

First Capital Fixed Income Recommendation – 09th NOV 18

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1.0 New Recommendation

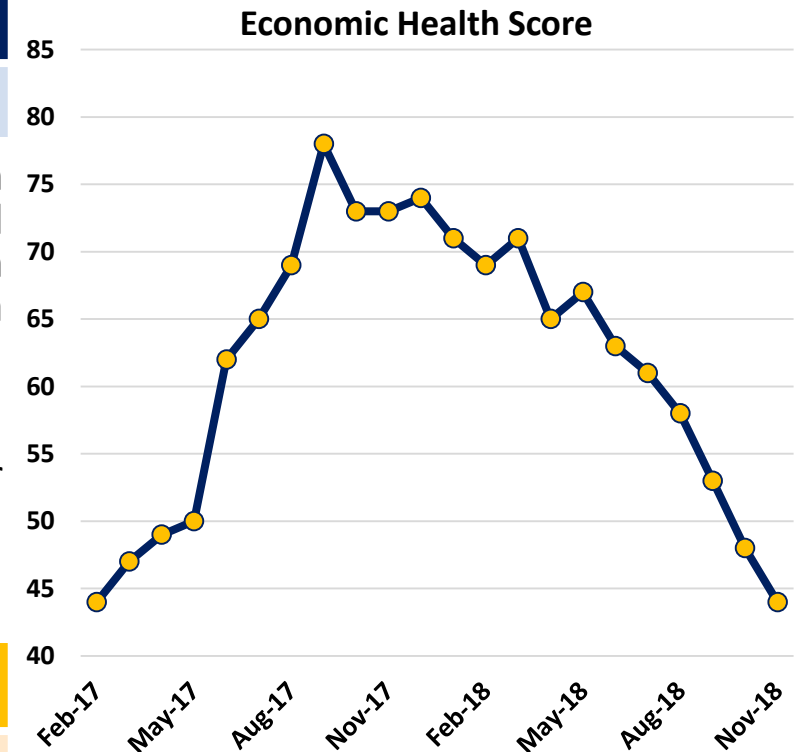
Justification for Revision of Bond Yield Expectations

- Previous Expectations for 2018 as at July 2018

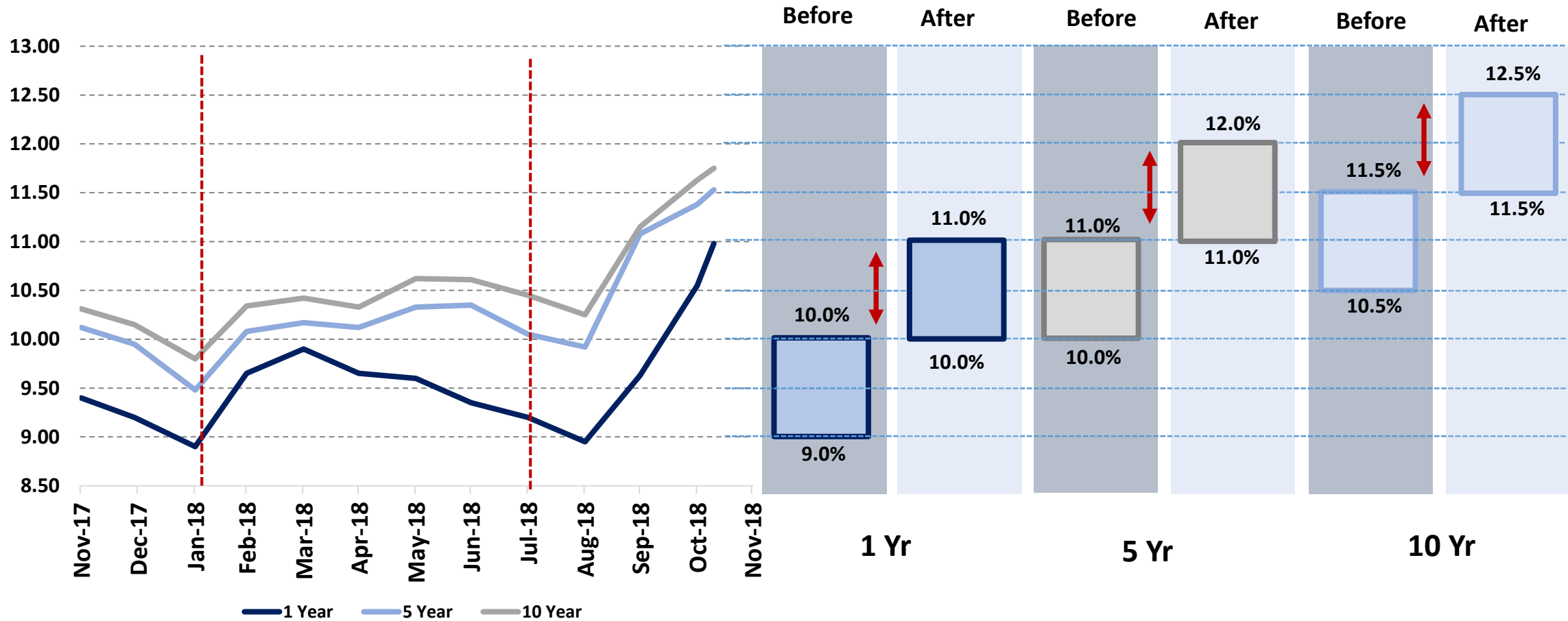
As at July 2018	1 Yr	5 Yr	10 Yr
Beyond 3Q2018	9.0%-10.0%	10.0%-11.0%	10.5%-11.5%

- With political uncertainty created through the sudden change in Government and the subsequent dissolution of parliament increased future short term risk for bond investors with some critical sovereign debt maturities falling during the next 3-6 months which may have a major impact on country's foreign reserve position.
- We believe that Sri Lanka is unable to raise funds in the international market until it settles the political uncertainty. Therefore we shift our overall yield curve expectations upwards by 100bps
- New Expectations for 2018 as at Nov 2018

As at Nov 2018	1 Yr	5 Yr	10 Yr
Beyond 3Q2018	10.0%-11.0%	11.0%-12.0%	11.5%-12.5%



Revision of Bond Yield



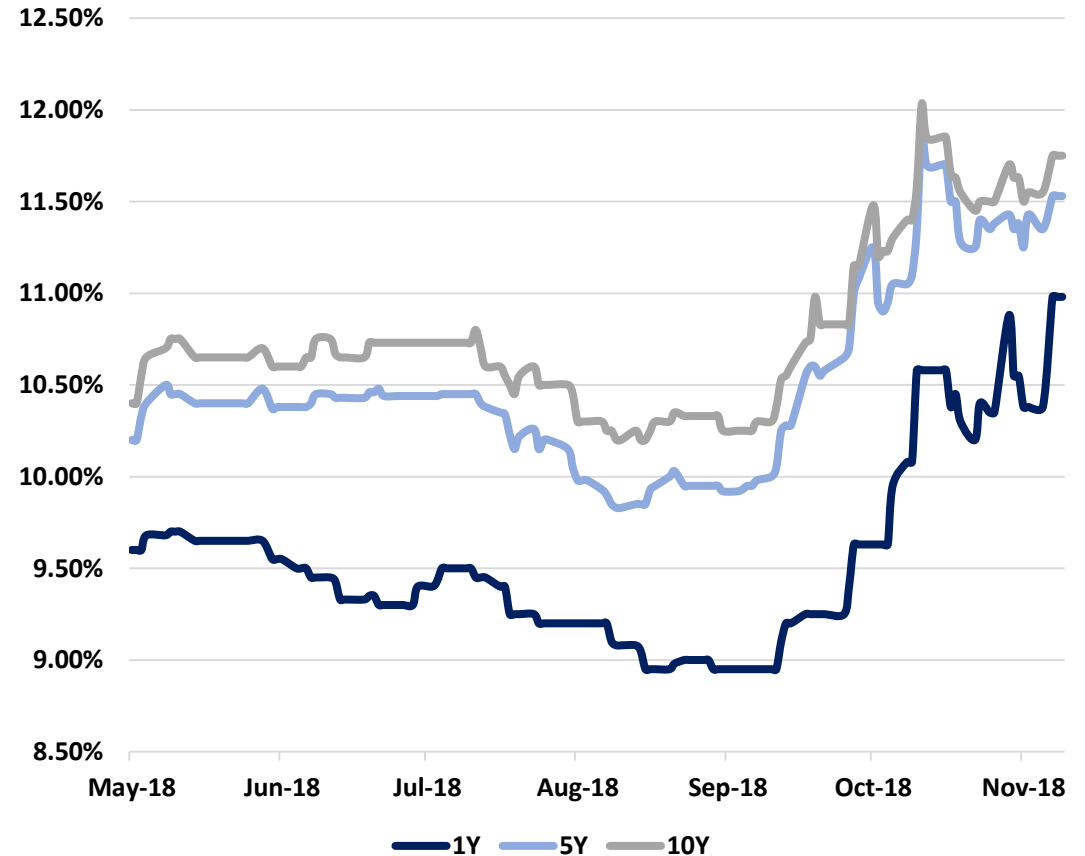
Portfolio Recommendation

Fixed Income Portfolio Recommendation

– Portfolio Recommendation: **Reduce** overall portfolio to 40% from previous 60%.

- Cut Trading portfolio to 5% from 25%.
- Carrying portfolio to be maintained at 35%.

Yields of mid to long tenors 4Y, 5Y, 6Y and 7Y attractive price level to accumulate. Avoid accumulation in the secondary market in order to bid for the auctions.



Sequence of Events

23rd May 2018 – Maintain overall portfolio to 50%. Carry portfolio to be maintain to 40%. Trading portfolio to be maintained to 10%.

19th June 2018 - Maintain overall portfolio to 50%. Carry portfolio to be maintain to 40%. Trading portfolio to be maintained to 10%.

26th Jul 2018 - **Reduce** overall portfolio to 40% from previous 50%. Cut Trading portfolio to 0% from 10%. Carry portfolio to be maintained at 40%.

23rd Aug 2018 - **Reduce** overall portfolio to 30% from previous 40%. Cut Carrying portfolio to 30% from 40%. Trading portfolio to be maintained at 0%.

19th Sep 2018 - **Increase portfolio to 50% from 30%**. Increase Trading Portfolio to 20% from 0%. Carrying Portfolio to be maintained at 30%.

12th Oct 2018 - **Increase portfolio to 60% from 50%**. Increase Carrying Portfolio to 35% from 30% and Trading Portfolio to 25% from 20%.

9th Nov 2018 - **Reduce** overall portfolio to 40% from previous 60%. Cut Trading portfolio to 5% from 25%. Carrying portfolio to be maintained at 35%.

1.0 Economic Health Score

Nov 2018 Economic Health Score

Health score slipped again

Primary Criteria	-	42	- 03	+ 01	-	40
Secondary Criteria	-	06	- 02		-	04

Economic Health Score (Nov 2018) - 44

- [As against 48 in Sep 2018 & 73 in Nov 2017 (1 Year ago)]

Changes to Health Score – Priority Criteria

Criteria	Update	Current Score	Add / Deduct Score	New Score
Foreign Reserves	Oct 2018 reserves rise to USD 7.9Bn from USD 7.2Bn in Sep 2018, assisted by loan from China. CBSL sold net USD 297Mn in the forex market.	08/15	-01	07/15
Liquidity	CBSL continuously conducting reverse repo auctions during last 2 weeks to maintain liquidity.	06/15	-01	05/15
Inflation	CCPI in Oct at 3.1%, lower than First Capital Research expectation of 4.1%; Core inflation remains under 4.0%.	09/15	+01	10/15
Foreign Buying	Net outflow LKR 26.5Bn over the last 4 weeks; Foreign holding reaches 4.39%.	05/10		05/10
Credit	Credit growth remains under control.	07/10		07/10
CBSL Holdings	CBSL Holdings incessantly increased during last couple of weeks.	07/10	-01	06/10

Primary Criteria - 42 - 03 + 01 = 40

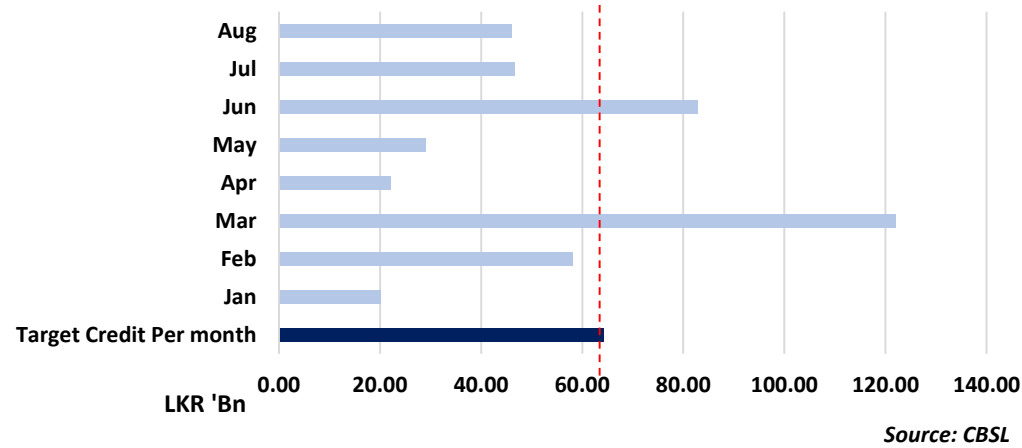
Changes to Health Score – Secondary Criteria

Criteria	Update	Current Score	Add / Deduct Score	New Score
Rating Outlook	Most of the rating agencies stating the political crisis was credit negative.	04/05	-02	02/05
External Environment	Rupee remains weak.	00/05		00/05
BoT & BoP	Deficit in the trade account continued to expand in Jun 2018 with slowdown in exports.	02/05		02/05
Political Risk	Political instability threatens growth	00/05		00/05
Investor Confidence	Depreciation of the rupee and fear of rising inflation are worrying both business and customer. BCI index slides to 114 month low of 85 in Oct compared to 87 in Sep.	00/05		00/05

Secondary Criteria - 06 - 02 = 04

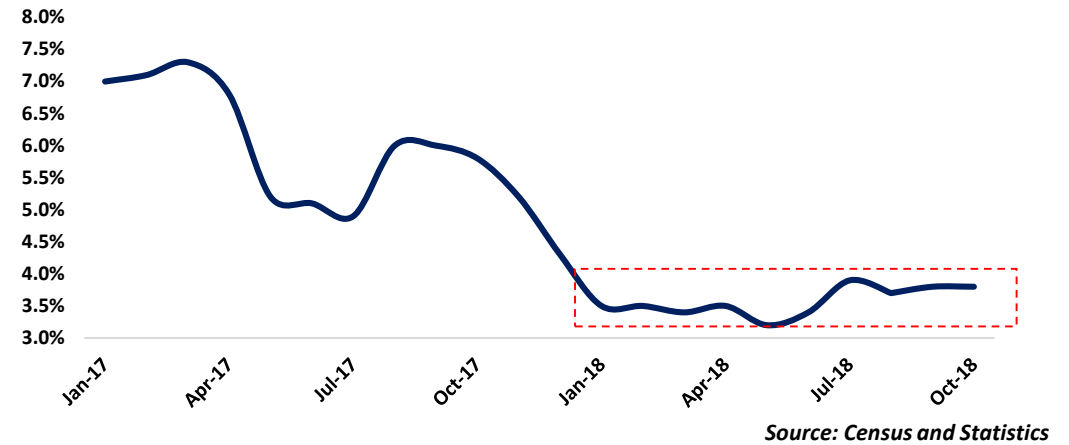
Graph 1 : Credit Growth remains slow at 9%YTD

Credit growth remains sluggish at 9%YTD, below First Capital Research target of 16%.



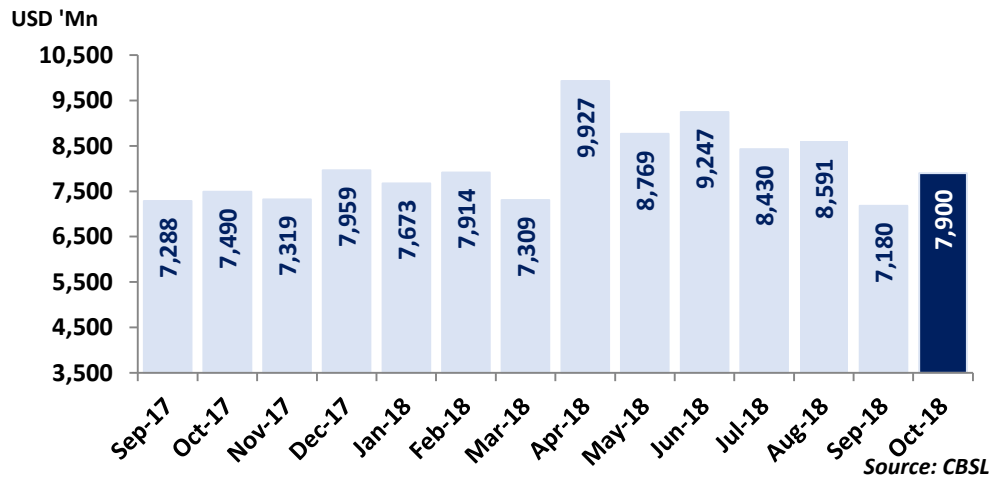
Graph 2 : Core Inflation spikes but remains below at 3.8% in Oct 2018

Core inflation is expected to increase with the implementation of pricing formula



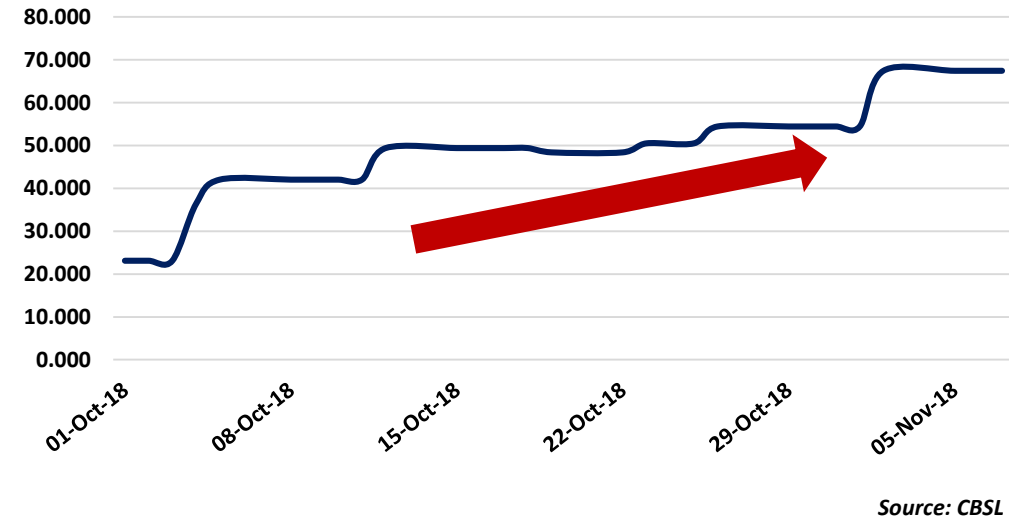
Graph 3 : Official Reserves increase to USD 7.9Bn in Oct 2018

Oct 2018 reserves rise to USD 7.9Bn from USD 7.2Bn in Sep 2018, assisted by loan from China. CBSL sold net USD 297Mn in the forex market.



Graph 4 : CBSL holding in Gov Sec above LKR 60Bn

CBSL holding in Government Securities increased to LKR 67.0Bn on 07 Nov 2018.



Graph 5 : LKR weakens against strengthened USD

LKR was seen at a new low around LKR/USD 175.60 levels on 30th Oct.

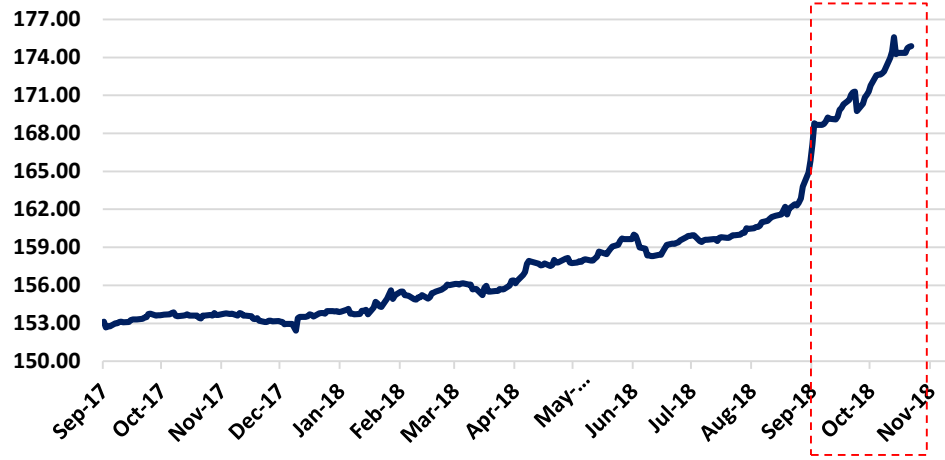


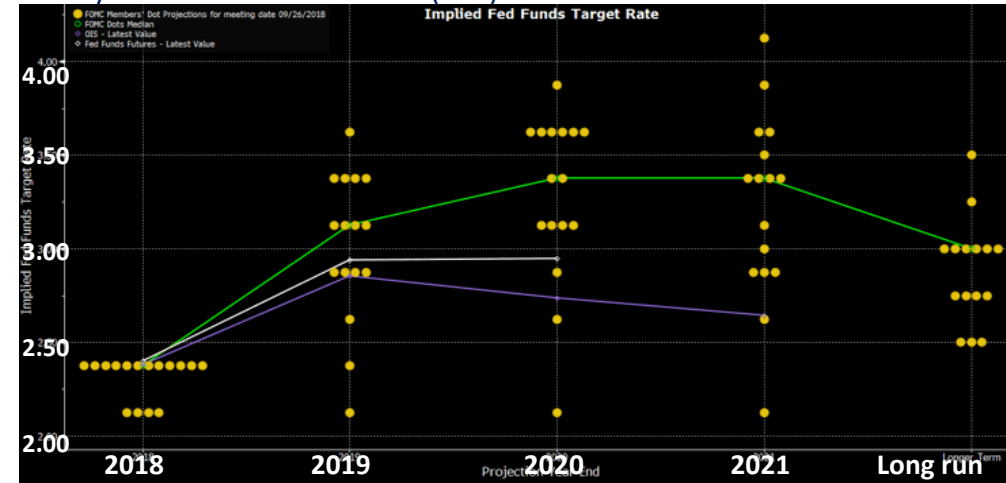
Table 1 : Comparison of 5Yr Bond rates in Frontier Economics

Country	19-Sep-18	8-Nov-18	Change bps
Sri Lanka	10.60	11.39	79
Philippines	7.10	8.16	106
Malaysia	3.78	3.81	2
Vietnam	5.10	4.70	-40
India	8.14	7.67	-47
Pakistan	9.55	11.58	203
Indonesia	8.22	7.92	-30
China	3.49	3.31	-19
Brazil	11.27	9.45	-182

Source: Bloomberg

Graph 6 : Fed Rate Hike Expectations - 2018

Surveys indicated one rate hike (Dec) in 2018 and three rates hike in 2019.



Source: Bloomberg

Table 2 : Bond Maturities – Next 6 Month

ISIN	Series	Issue Date	Maturity Date	Outstanding (LKR) Mn
LKB00718K151	08 00 2018 A	15-Nov-2011	15-Nov-2018	102,691
LKB00819A158	05 65 2019A	15-Jan-2011	15-Jan-2019	32,244
LKB00219A151	10 75 2019A	15-Jan-2017	15-Jan-2019	48,479
LKB01019E016	08 50 2019 A	5-Jan-2009	1-May-2019	93,975
LKB00619G019	10 60 2019A	7-Jan-2013	1-Jul-2019	109,578

Series	ISIN	Maturity Date	Outstanding (USD)
SLDB2019B	LKG00419A301	1/30/2019	196
SLDB2019C	LKG00219C178	3/17/2019	403
SLDB2019C	LKH00219C177	3/17/2019	7

Source CBSL

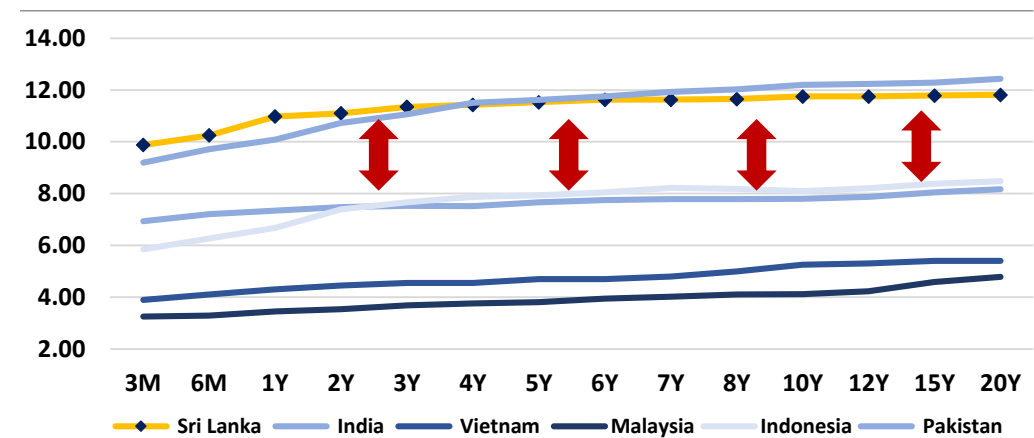
Sri Lankan Bonds trade at an attractive premium

YIELD TO MATURITY FOR 15 YEARS

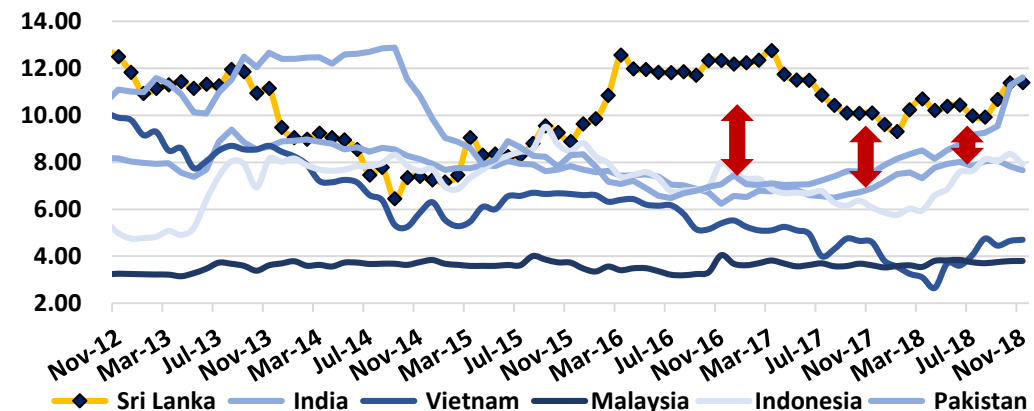
Yields in 2018 spike similar to 2012 & 2016 amidst the current political climate.

	Yield to Maturity (%) (At the end of the Year)				
	1 Yr	2 Yr	3 Yr	5 Yr	10 Yr
2003	7.59	8.90	9.17	9.52	9.47
2004	7.65	9.75	9.75	8.99	9.60
2005	10.37	11.10	11.38	12.00	10.88
2006	12.98	13.16	13.37	13.69	14.00
2007	19.96	17.47	17.00	16.15	16.84
2008	18.50	20.15	19.38	19.07	17.65
2009	9.25	10.51	10.91	11.52	12.10
2010	7.60	8.01	8.23	9.39	9.60
2011	9.30	9.57	9.88	9.99	10.06
2012	11.65	11.65	11.74	11.94	12.32
2013	7.90	8.86	9.05	10.29	10.90
2014	5.90	6.22	6.94	7.26	7.99
2015	7.10	7.65	8.96	9.63	10.41
2016	10.15	11.38	11.80	12.18	12.55
2017	9.85	9.20	9.45	9.85	10.15
Nov-18	10.98	11.10	11.35	11.53	11.75

COMPARATIVE YIELD CURVE AS AT NOV 2018

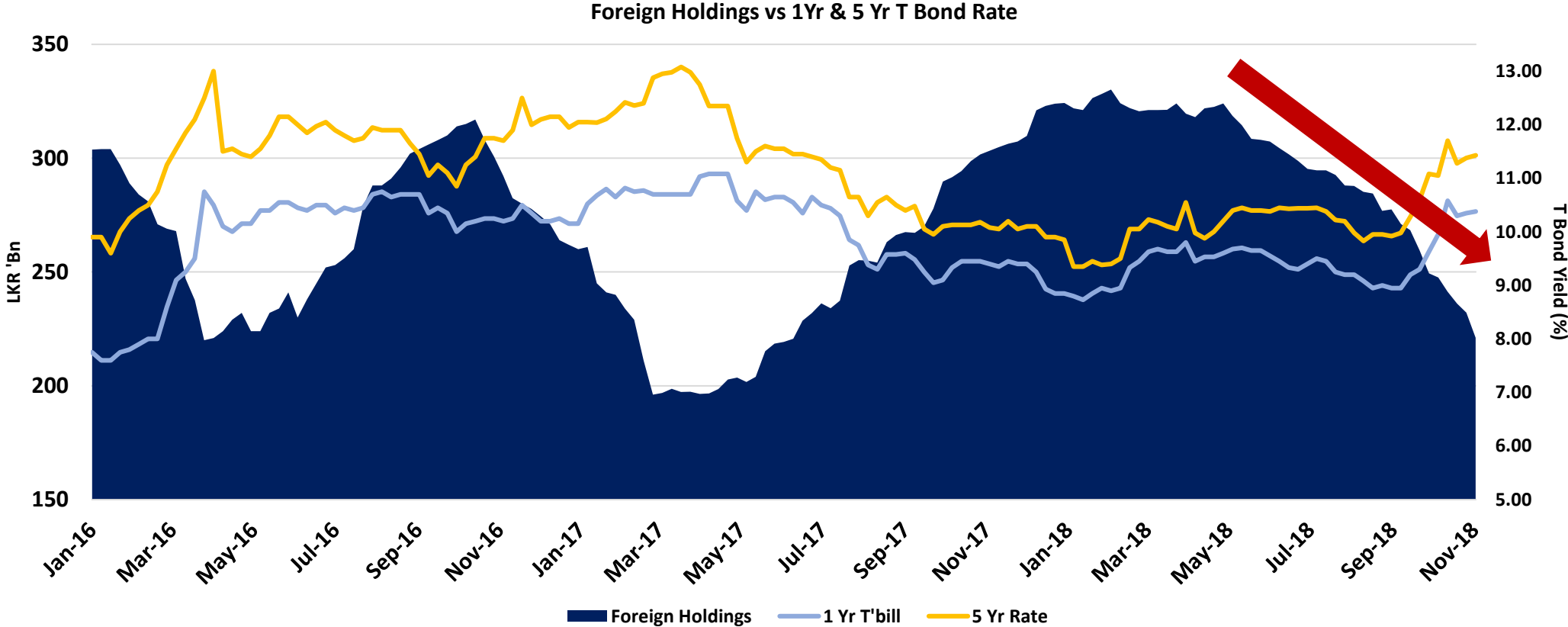


SRI LANKA'S 5 YR BOND YIELD PREMIUM IS RE-ADJUSTING



Foreign Interest in Sri Lanka's Bonds has shown a decrease over last 7 months

Foreign holding in Government securities has decreased to 4.2% over last 7 months on the back of foreign outflow resulting from the strengthening dollar.

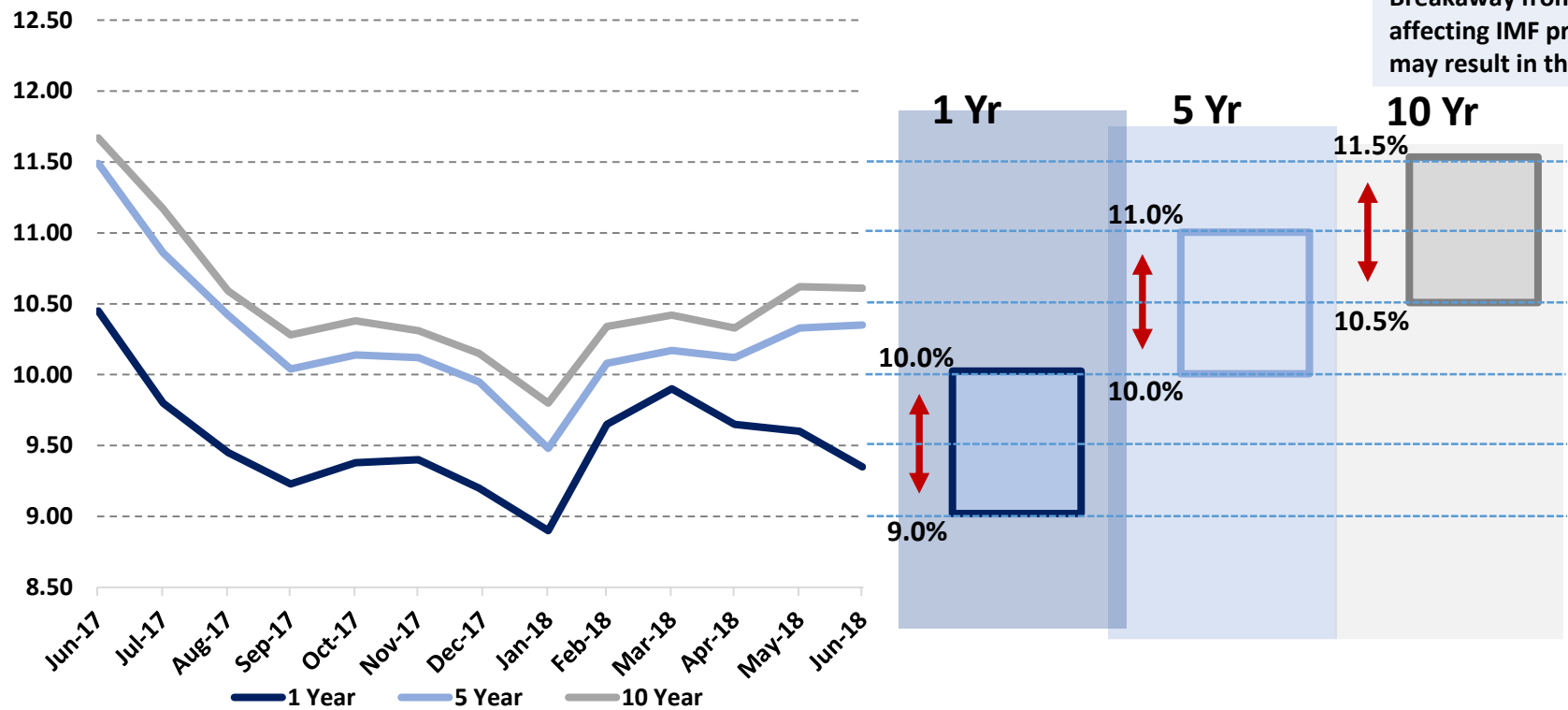


Source: CBSL & First Capital Research

Jul 2018 Re cap: Bond Rates to peak in 3Q2018 and gradually ease (12 months)

Expectations: **Moderately Bullish** beyond 3Q2018

Jul 2018 – Jun 2019	Probability	Impact
Bond Rates to peak in 3Q2018 and gradually ease	65%	Moderately Bullish / Stable
Breakaway from reform program (Deviations affecting IMF program) or political deadlock may result in the breaking the upper bands	35%	Bearish



Base Case (65% Probability) – Explanation

With higher borrowing requirement resulting in tight monetary conditions and increase in inflation could push the yield curve towards the upper bands. It could result in an increase in CBSL Holdings as well to manage interest rates.

Pressure could ease somewhat in 4Q2018, but will be short lived as debt payments continue to be high in 1Q & 2Q in 2019 with the maturity of the Sovereign Bonds

Policy Rate Expectations

On a base case First Capital Research expects a policy rates to remain stable throughout 2018. However, if GDP growth fails to pickup we expect policy rates to be cut by 25 basis points towards end of 3Q2018

2.0 Previous Recommendation

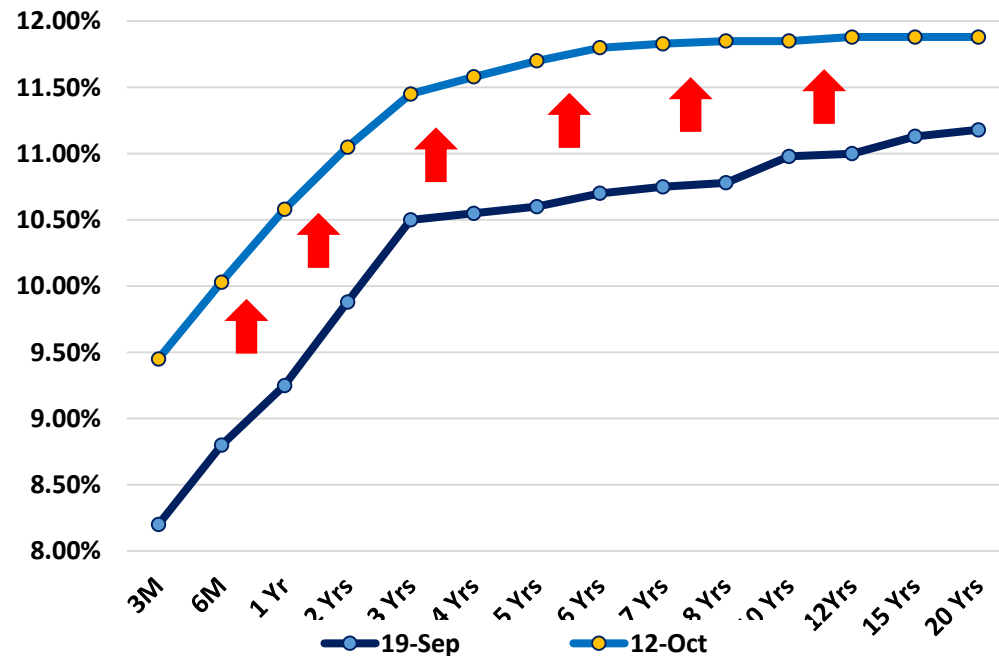
20th Sep Recommendations and Yield curve movement afterwards

Fixed Income Portfolio Recommendation

– Portfolio Recommendation: **Increase portfolio to 50% from 30%**

- Increase Trading Portfolio to 20% from 0%.
- Carrying Portfolio to be maintained at 30%.

Yields of short-mid tenors 3Y, 4Y and 5Y have fallen into a buy range while 7Y and 8Y have also registered attractive price levels to initiate accumulation.



12th Oct Recommendations and Yield curve movement afterwards

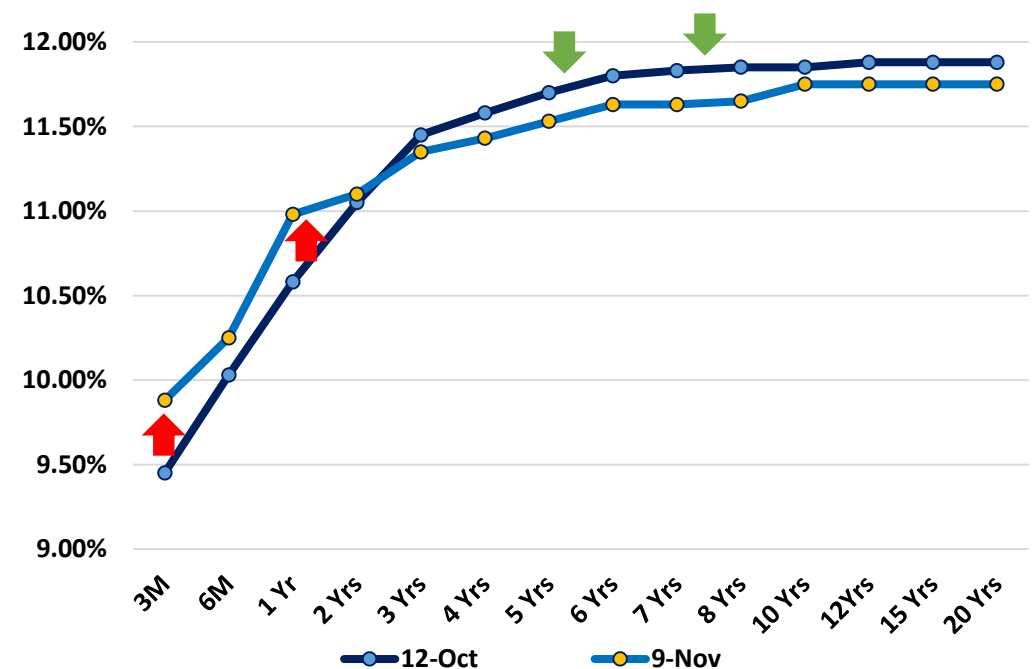
Fixed Income Portfolio Recommendation

Fixed Income Portfolio Recommendation

– Portfolio Recommendation: **Increase portfolio to 60% from 50%**

- Increase Carrying Portfolio to 35% from 30% and Trading Portfolio to 25% from 20%.

Yields of mid to long tenors 4Y, 5Y, 6Y and 7Y attractive price level to accumulate.



Rate Movement Review (Last 28 days)

Interest Rate Change (bps)			
Tenure	12-Oct	7-Nov	Change (bps)
3M	9.45%	9.88%	43
6M	10.03%	10.25%	22
1 Yr	10.58%	10.98%	40
2 Yrs	11.05%	11.10%	5
3 Yrs	11.45%	11.35%	-10
4 Yrs	11.58%	11.43%	-15
5 Yrs	11.70%	11.53%	-17
6 Yrs	11.80%	11.63%	-17
7 Yrs	11.83%	11.63%	-20
8 Yrs	11.85%	11.65%	-20
10 Yrs	11.85%	11.75%	-10
12Yrs	11.88%	11.75%	-13
15 Yrs	11.88%	11.75%	-13
20 Yrs	11.88%	11.75%	-13

- Following our previous report on 12th Oct 2018, yields registered 10-20bps downward movement in 3Yr to 20Yr.
- Heavy foreign outflow of LKR 36.4Bn was observed over the last 4 weeks.

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