



First Capital
First Capital Research

“INCREASE EXPOSURE; BID FOR AUCTION”

First Capital Fixed Income Recommendation – 28th Mar 19

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1.0 New Recommendation

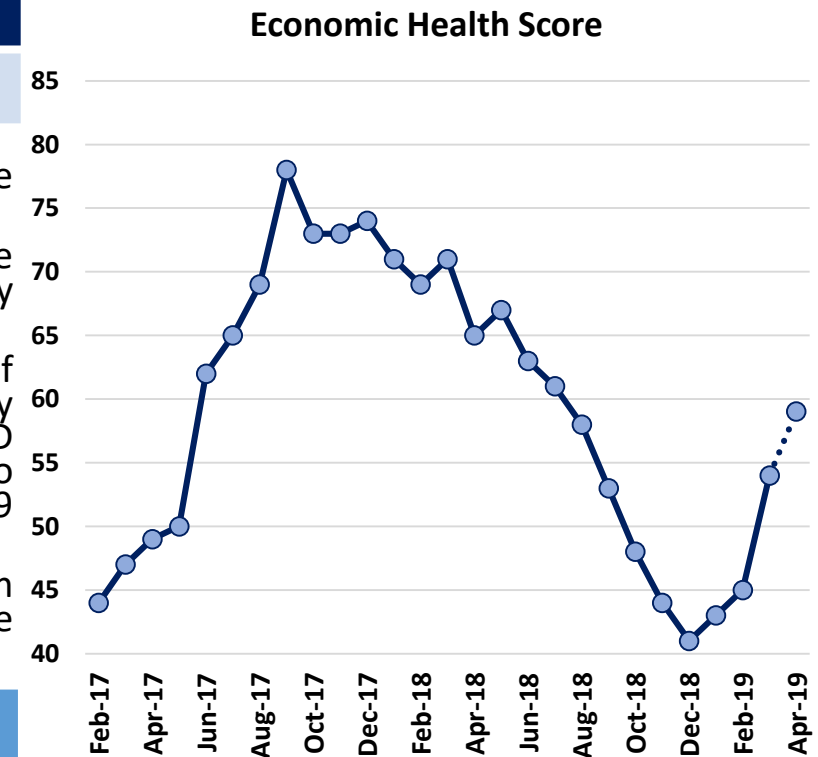
Justification for Revision of Bond Yield Expectation

- Previous Expectations for 2019 as at Nov 2018

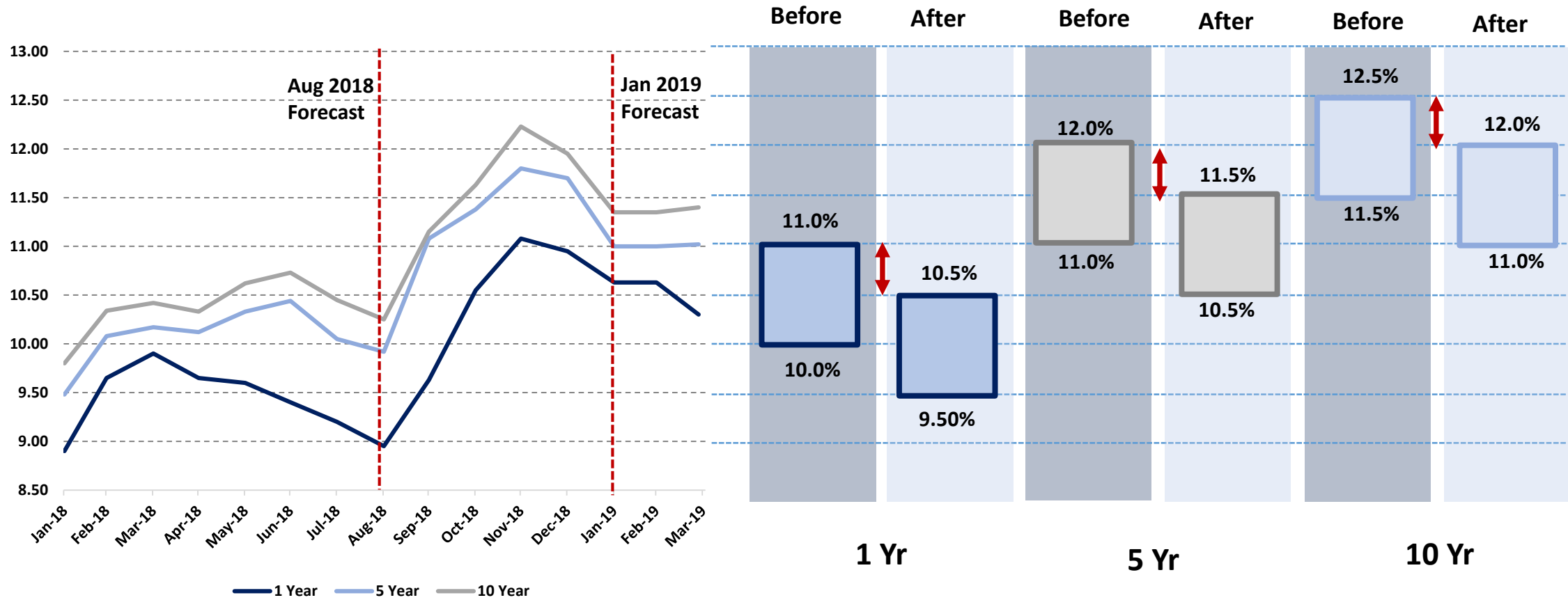
As at Nov 2018	1 Yr	5 Yr	10 Yr
Beyond 3Q2018	10.0%-11.0%	11.0%-12.0%	11.5%-12.5%

- Political uncertainty eased off to a certain extent with TNA supporting the Government on the passing of the budget.
- We expect successful issuance of USD 2.4Bn sovereign bonds to improve foreign reserves to reach above USD 7.5Bn in Mar 2019. CBSL has already secured 50% of the total USD commitment for this year.
- We expect the balance commitments to be met via USD 1.0Bn from Bank of China, USD 500Mn Top-up loan from Chinese Development bank and Currency Swap from Reserve Bank of India and People’s Bank of China amounting to USD 700Mn and USD 1.5Bn respectively. These potential loans are expected to provide the ability to maintain reserves above USD 7.0Bn during Apr-Sep 2019 despite the USD 500Mn payment (maturing ISB) due on 7th Apr.
- The recent positive developments resulted in a surge in the Economic Health Score while reducing the probability of potential future risks. Accordingly, we shift our overall yield curve expectations downward by 50bps

As at Mar 2019	1 Yr	5 Yr	10 Yr
Beyond 2Q2019	9.5%-10.5%	10.5%-11.5%	11.0%-12.0%



Revision of Bond Yield



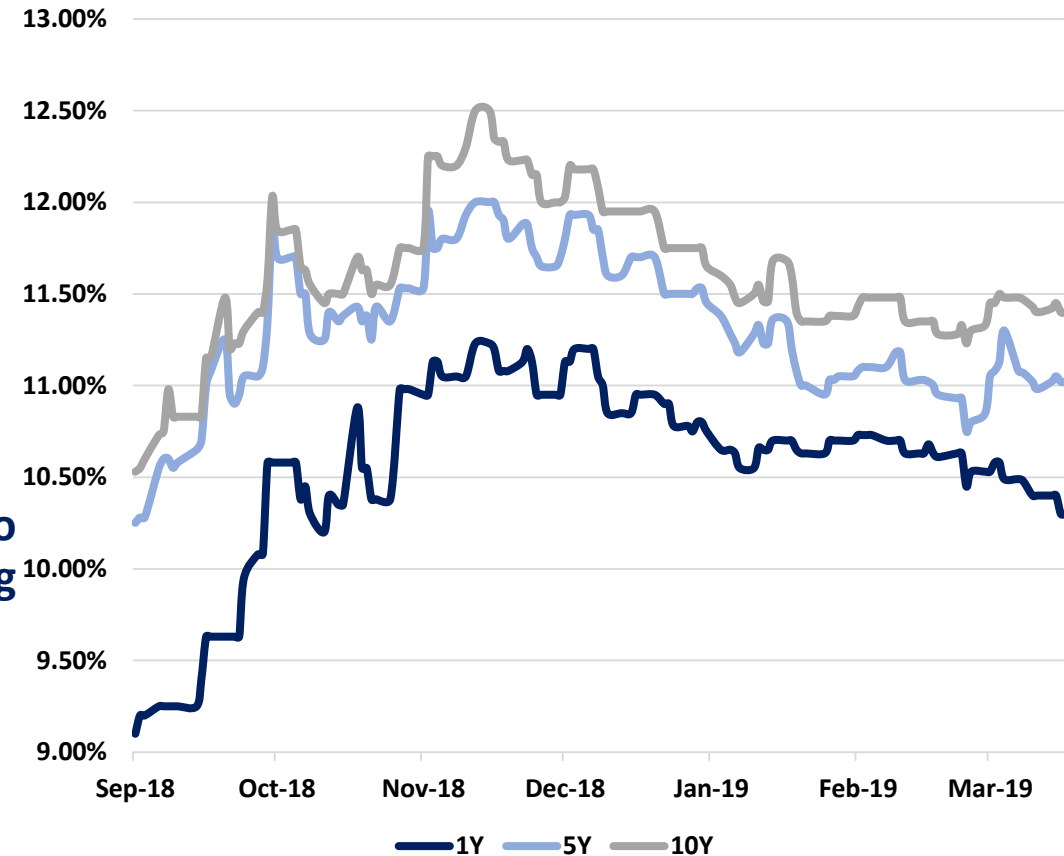
Portfolio Recommendation

Fixed Income Portfolio Recommendation

– Portfolio Recommendation: **Increase overall portfolio to 70% from 55%.**

- Increase Carrying Portfolio to 50% from 45%.
- Increase Trading Portfolio to 20% from 10%.

We recommend to add 2021, 2022 maturities to the carrying portfolio while further increasing trading portfolio by adding 2024, 2026.



Sequence of Events

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%.

19th Dec 2018 - **Increase portfolio to 50% from 40%**. Increase Trading Portfolio to 15% from 5%. Carrying Portfolio to be maintained at 35%.

11th Mar 2019 - **Increase overall portfolio to 55% from 50%**. Increase Carrying Portfolio to 45% from 35%. Reduce Trading Portfolio to 10% from 15%.

28th Mar 2019 - **Increase overall portfolio to 70% from 55%**. Increase Carrying Portfolio to 50% from 45%. Increase Trading Portfolio to 20% from 10%.

1.0 Economic Health Score

Changes to Health Score – Priority Criteria

Criteria	Update	Current Score	Add / Deduct Score	New Score
Foreign Reserves	Issuance of USD 2.4Bn Sovereign Bond boost reserve above USD 7.5Bn end of March.	10/15		10/15
Liquidity	CBSL continuously conducting reverse repo auctions during last 2 weeks to maintain liquidity.	08/15	+02	10/15
Inflation	CCPI in Mar at 4.3%, lower than First Capital Research expectation of 4.4%.	10/15	+01	11/15
Foreign Buying	Net inflow of LKR 5.2Bn over the last 3 weeks; Foreign holding reaches 3.11%.	05/10	+01	06/10
Credit	Credit growth remains under control.	07/10		07/10
CBSL Holdings	CBSL Holdings incessantly increased during last couple of weeks.	06/10		06/10

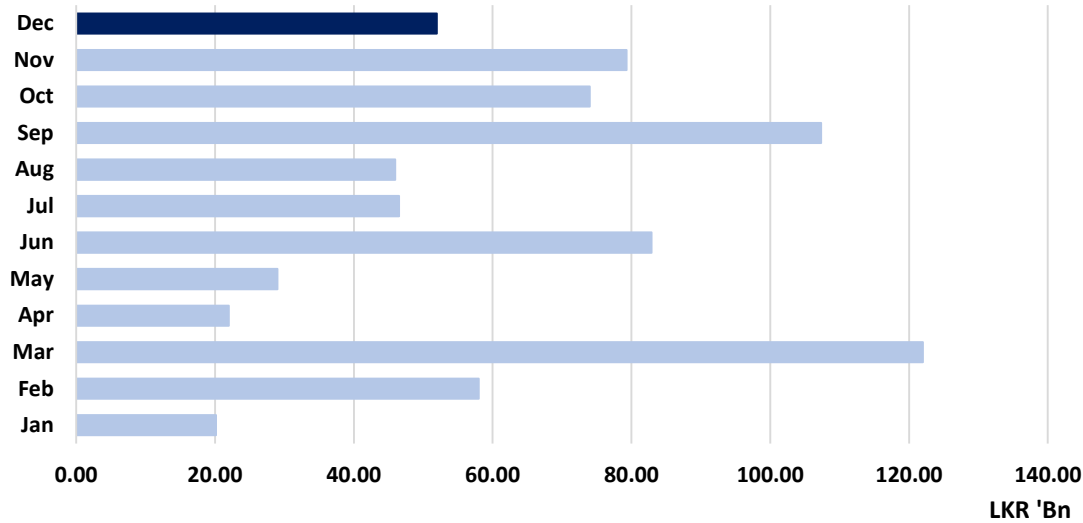
Primary Criteria - 46 + 04 = 50

Changes to Health Score – Secondary Criteria

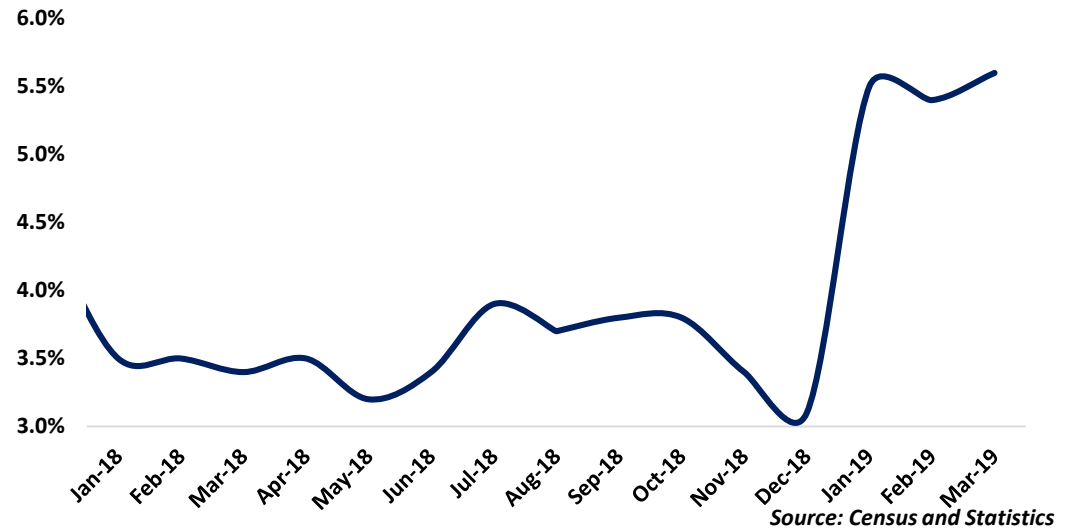
Criteria	Update	Current Score	Add / Deduct Score	New Score
Rating Outlook	No major changes.	02/05		02/05
External Environment	Rupee continued to strengthen to close at 176.17 on 28 Mar 2019 supported by foreign remittance conversions and foreign inflows	01/05	+01	02/05
BoT & BoP	Deficit in the trade account slowed down with reduction in imports in Dec 2018.	02/05		02/05
Political Risk	Political stability reinstated to some degree and amid the prospect one or more election in 2019	01/05		01/05
Investor Confidence	BCI recorded a notable increase of 14 points to reach 115 in Feb – compared to 101 in Jan	02/05		02/05

Secondary Criteria - 08 + 01 = 09

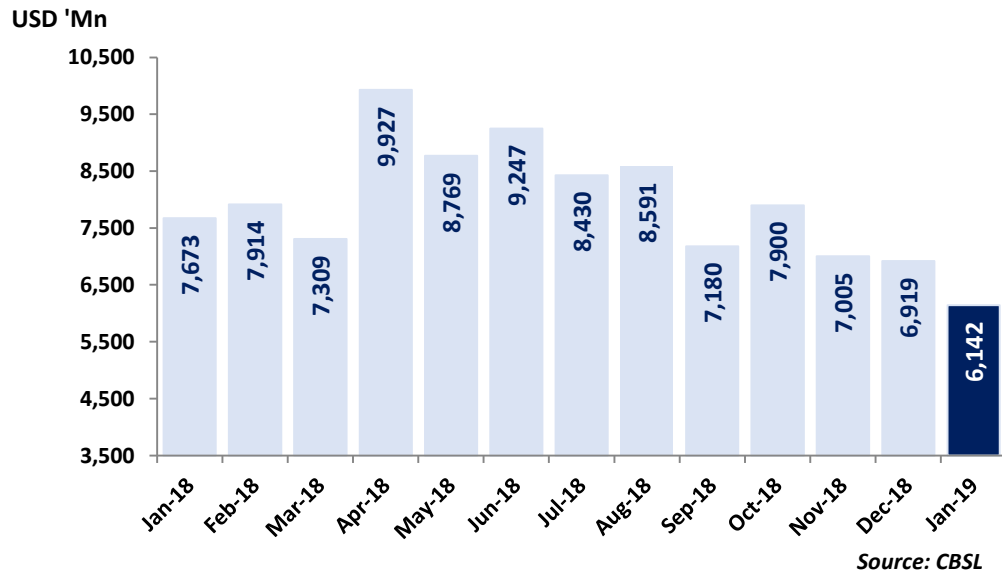
Graph 1 : Private Sector Credit - 2018



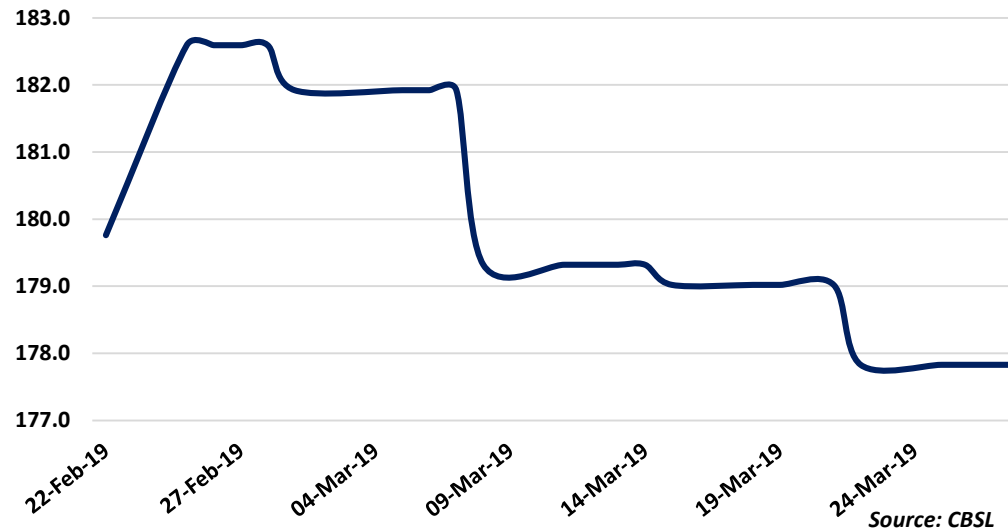
Graph 2 : Core Inflation spikes but remains below at 6% in Mar 2019



Graph 3 : Official Reserves decreased to USD 6.1Bn in Jan 2019



Graph 4 : CBSL holding in Gov Sec above LKR 170Bn



Graph 5 : USD: LKR appreciated by 3%YTD to 176.2

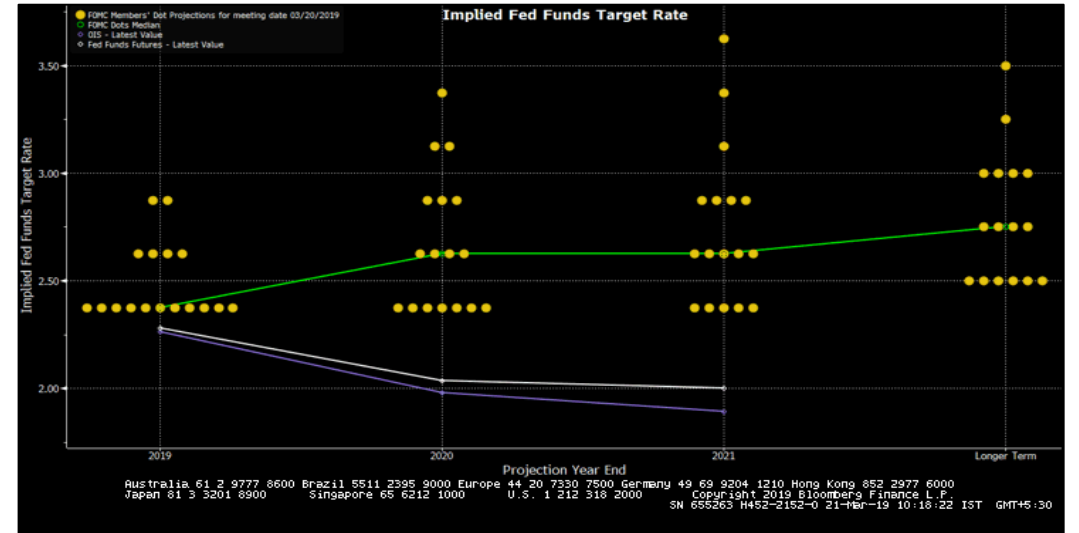


Table 1 : Comparison of 5Yr Bond rates in Frontier Economics

Country	31-Dec-18	28-Mar-19	Change in bps
Sri Lanka	11.65	10.90	-75
Philippines	7.01	5.87	-114
Malaysia	3.81	3.56	-25
Vietnam	4.50	3.90	-60
India	7.14	6.92	-22
Pakistan	12.45	12.65	20
Indonesia	7.05	7.05	0
China	3.01	2.93	-8
Brazil	8.52	8.09	-43

Source: Bloomberg

Graph 6 : Fed Rate Expectations



Source: Bloomberg

Table 2 : Bond Maturities – 2019

ISIN	Series	Issue Date	Maturity Date	Outstanding (LKR) Mn
LKB01019E016	08 50 2019 A	5-Jan-2009	1-May-2019	93,975
LKB00619G019	10 60 2019 A	7-Jan-2013	1-Jul-2019	109,578
LKB00619I155	10 60 2019 B	15-Sep-2013	15-Sep-2019	115,585
LKB00819K017	08 00 2019 A	1-Nov-2011	1-Nov-2019	55,851

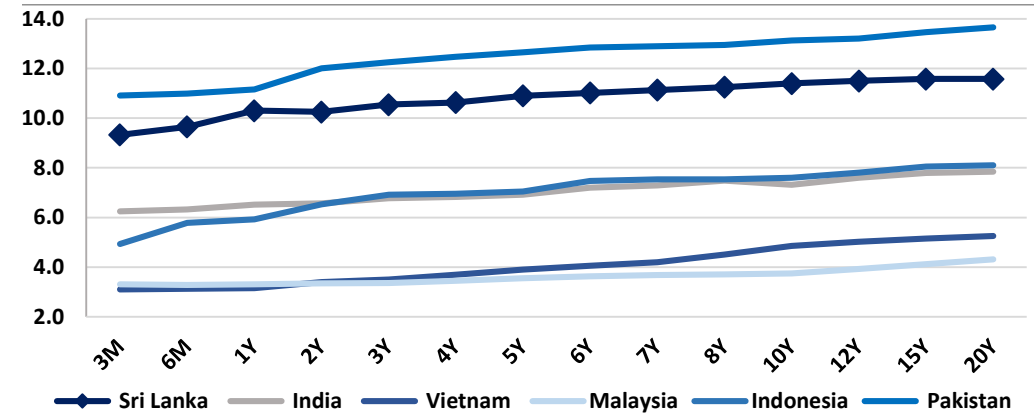
Source CBSL

Sri Lankan Bonds trade at an attractive premium

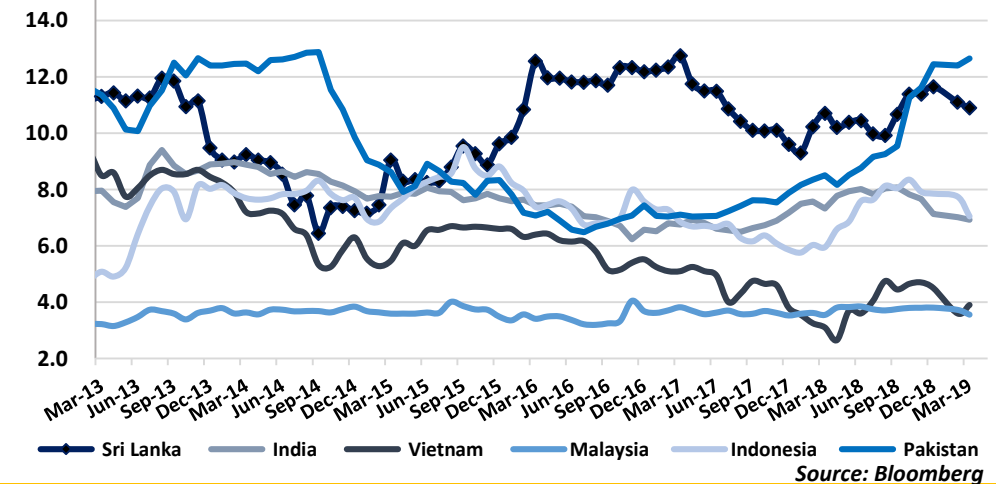
YIELD TO MATURITY FOR 15 YEARS

	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
2018	10.95	11.23	11.53	11.70	11.95
Mar-19	10.30	10.45	10.60	11.20	11.40

COMPARATIVE YIELD CURVE AS AT MAR 2018



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



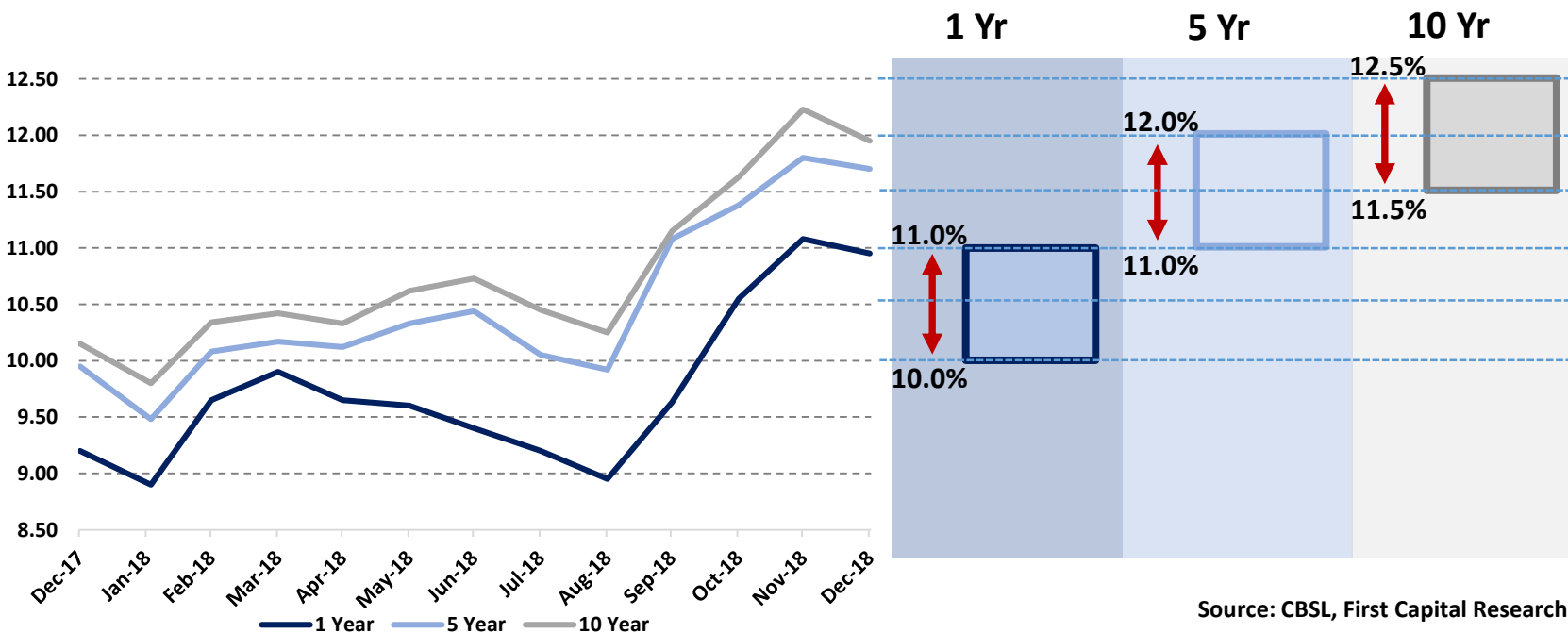
Bond Rates to peak in 1Q2019 and gradually ease (12 months)

Expectations: Moderately Bullish beyond 1Q2019

Policy Rate Expectation

On a base case First Capital Research expects 2 rate cuts of 25bps each during 2019 as overnight CBSL standing lending facility rate which stands at 9.0%, we believe is too high for accelerated economic activity.

Jan 2019 – Dec 2019	Probability	Impact
Bond Rates to peak in 1Q2019 and gradually ease to the bottom bands	75%	Moderately Bullish / Stable
Political deadlock or Economic turmoil (adverse impact to foreign income or foreign debt) may result in the breaking the upper bands	25%	Bearish



Source: CBSL, First Capital Research

2019 Outlook - Base Case (75% Probability)

With the heavy debt payments and liquidity shortage, we expect bond yields to touch the upper bands of the yields curve during 1Q. The heavy risk associated with lower reserve position by end Jan 2019 following payment of the USD 1Bn Sovereign Bond and other debt payments would be the primary cause for the yields to move towards the upper bands. Though the fund flow towards EM is positive now, there is a cap of 5% for foreign holdings in Sri Lanka.

With foreign inflows & debt inflows towards 2Q, rise in economic activity amidst upcoming elections and low debt payments after 7th April, liquidity is likely to improve and ease yields beyond 1Q2019 towards the lower bands.

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