First Capital

First Capital Research

Despite constitutional standoff, policy remains unchanged

PRE-POLICY ANALYSIS

12TH NOV 2018

Lead Analyst: Amanda Lokugamage
Secondary Analyst: Dimantha Mathew

Uncertainty with constitutional standoff, but policy remains unchanged

- Constitutional Standoff impact overall economy
  - President's appointment of a new Prime Minister, subsequent dissolution of Parliament and calling for elections, led to a controversy relating to the constitution which created political turmoil impacting both the debt and equity markets.
  - With the Fed raising rates by 25bps to 2.25% in Sep 2018, foreign outflow of LKR 48.4Bn was witnessed from the debt market since our last Pre-Policy report (published on 28 Sep 2018) while equity market saw an outflow of LKR 10.4Bn during the same period creating pressure on the LKR. Despite the inflow of USD 1.0Bn commercial loan from China Development Bank, foreign reserve position stood at USD 7.9Bn as of end of Oct 2018.
  - Currency depreciation was further aggravated by the turmoil prevailed in the political front which led to LKR:USD reaching an all-time low of 175.60 on 31 Oct while currency depreciated by 14% YTD to close at 175.25 on 09 Nov amidst continuous foreign outflows from both equity and debt markets outweighing the effect of USD 1.0Bn foreign inflow.
  - Yield curve continued its uptrend across all maturities predominantly on the short tenure maturities which experienced a steep increase of 110-135bps.
  - Continuous outflows and a possible Fed rate hike in Dec 2018 may intensify pressure on the currency as USD 1.5Bn worth of Sovereign Bonds fall mature in the next 3-6 months period.
- Weakening LKR and continuous foreign outflows may warrant a rate hike, but is unlikely to reverse the fund flow into foreign inflows. Further, below par GDP growth level and lower credit growth provide less scope for the monetary board to increase rates as the possibility of a rate cut would further aggravate the foreign outflows provoking a further weakening of USD:LKR.
  - Considering the prevailing political and economic conditions of the country, First Capital Research believes that **policy rate change is not required**. However, we are of the view that a 35% probability exists for a rate hike, depending on the ability to raise foreign borrowings to service the maturing debt in early 2019.

Expected Monetary Policy Stance

First Capital Research expects the Monetary Board to hold rates, as a rate cut would aggravate the foreign outflows increasing the pressure on LKR while a hike would hinder the growth. However, we recognize a 35% probability of a 25bps rate hike considering the USD:LKR depreciation, lower foreign reserve position and higher foreign debt repayments in Jan – Apr 2019. We believe political situation has hampered the ability to raise foreign debt over the next 6 months, thus affecting reserves.

Expected Monetary Policy Stance by CBSL	Probability
Raising Policy Rates by 50bps	0%
Raising Policy Rates by 25bps	35%
Policy Rates to remain unchanged	***65%***
Cutting Policy Rates by 25bps	0%
Cutting Policy Rates by 50bps	0%

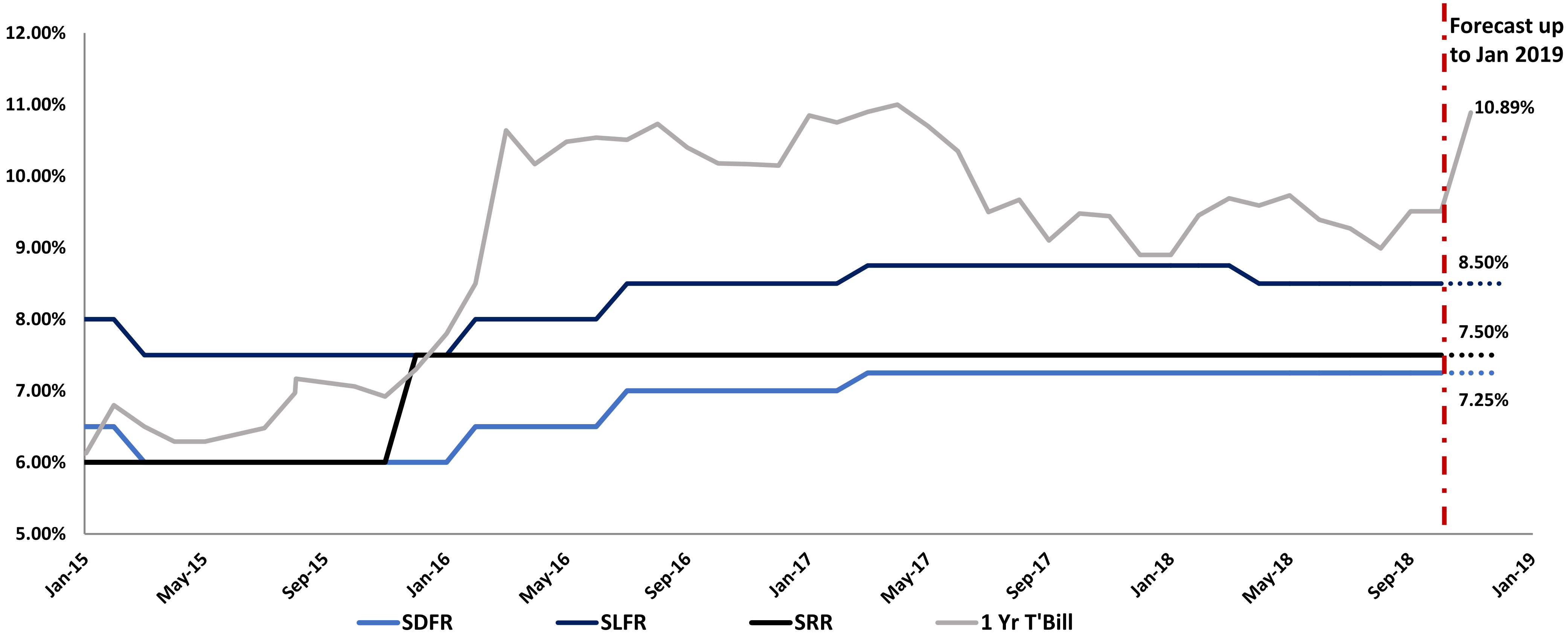
Increase from 20% amidst continued USD LKR depreciation, lower reserve position and high debt repayments.

Decrease from 80% amidst increased risk profile due to political uncertainty.

Current Policy Rates	
Standing Deposit Facility Rate (SDFR)	7.25%
Standing Lending Facility Rate (SLFR)	8.50%
Statutory Reserve Ratio (SRR)	7.50%

We expect the CBSL to keep Statutory Reserve Ratio (SRR) unchanged at 7.50%

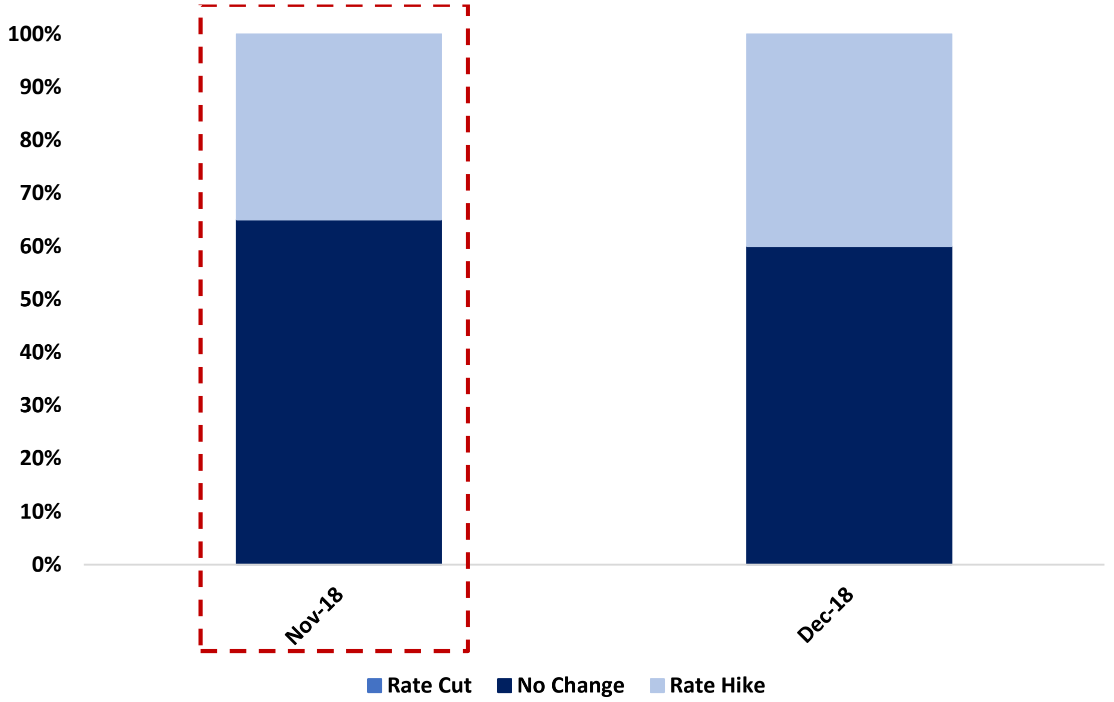
Policy Rates vs 1-Yr T'Bill rate (2015 to date)



Source : CBSL and First Capital Research Estimates

Graph 1 : Policy Rate Expectations – First Capital Research

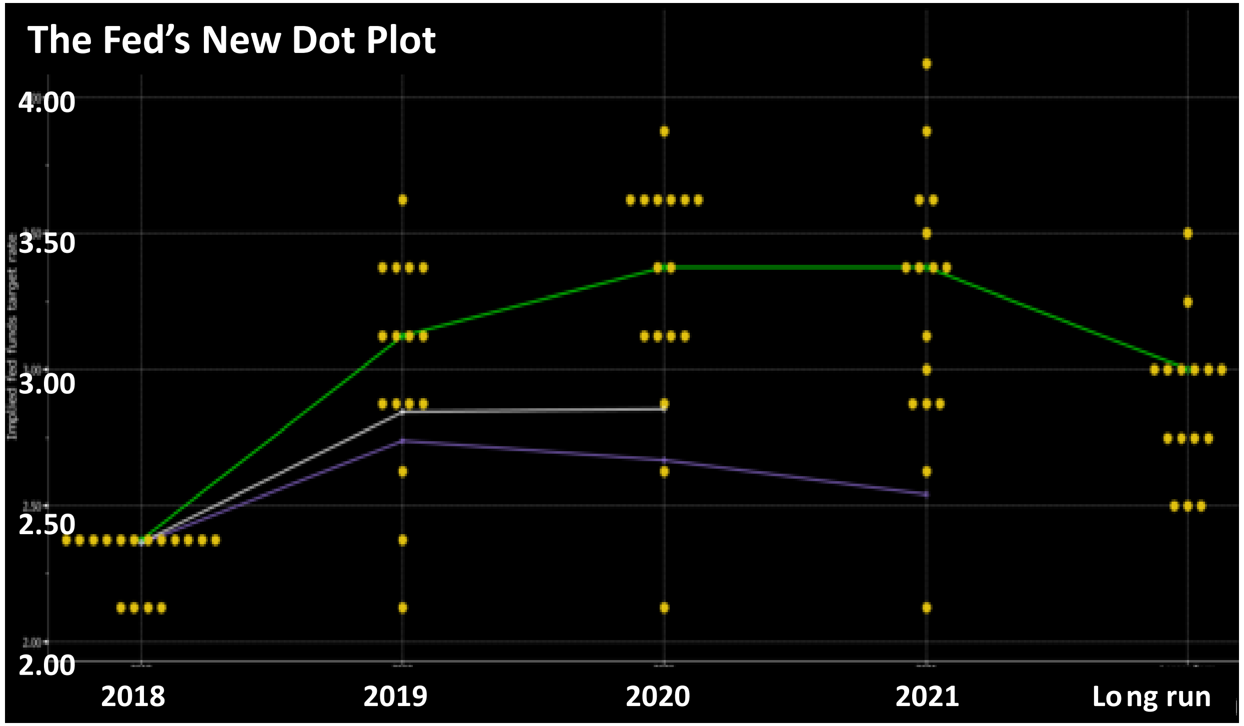
First Capital Research is of the view that a continuation of policy rates is appropriate. However, we recognize an increased probability of 35% for a rate hike, amidst increased risk profile owing to prevailing political uncertainty and continued foreign outflows in spite of considerably low GDP growth and sluggish credit growth.



Source: First Capital Research Estimates

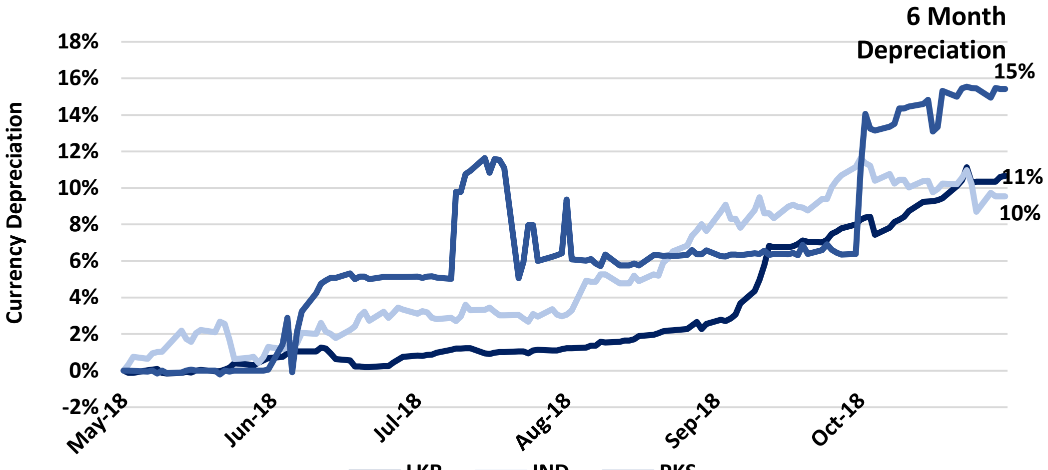
Graph 2 : Fed Rate Hike Expectations – up to end 2019

Fed reserve officials raised interest rates by 25bps boosting the benchmark federal funds rate to a spread of 2.00%-2.25% in Sep 2018. On the back of strong economy and moderate financial vulnerabilities, Fed officials estimates 3 rate hikes in 2019 from previously expected 2 hikes for 2019.



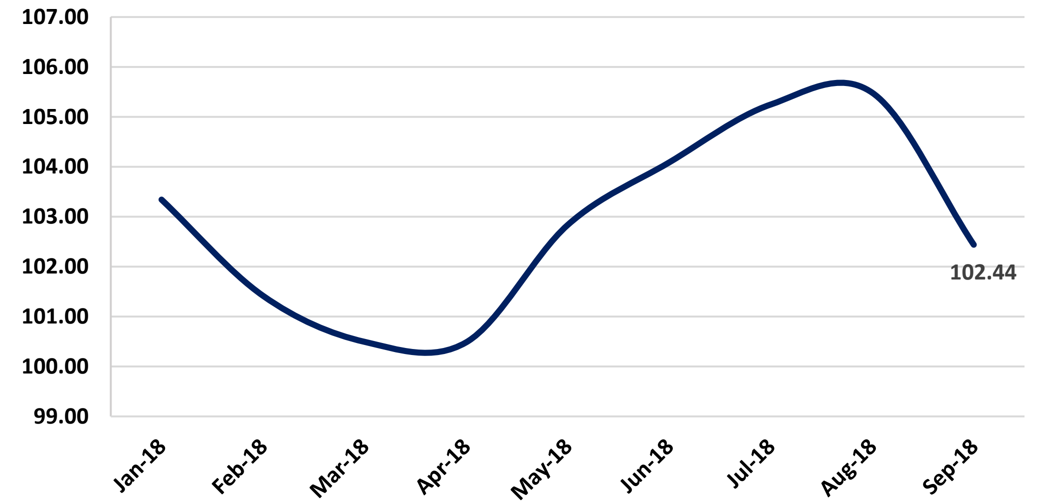
Source: Bloomberg

Graph 3 : LKR, INR and PKR weakened on the back of strengthening of USD



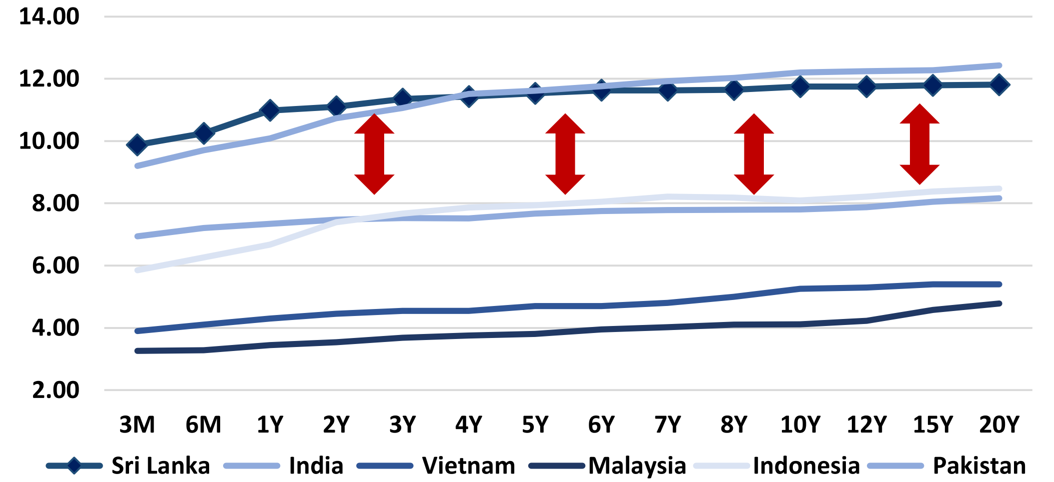
Source: Bloomberg

Graph 4 : Real Effective Exchange Rate reaches 102.44 in Sep 2018



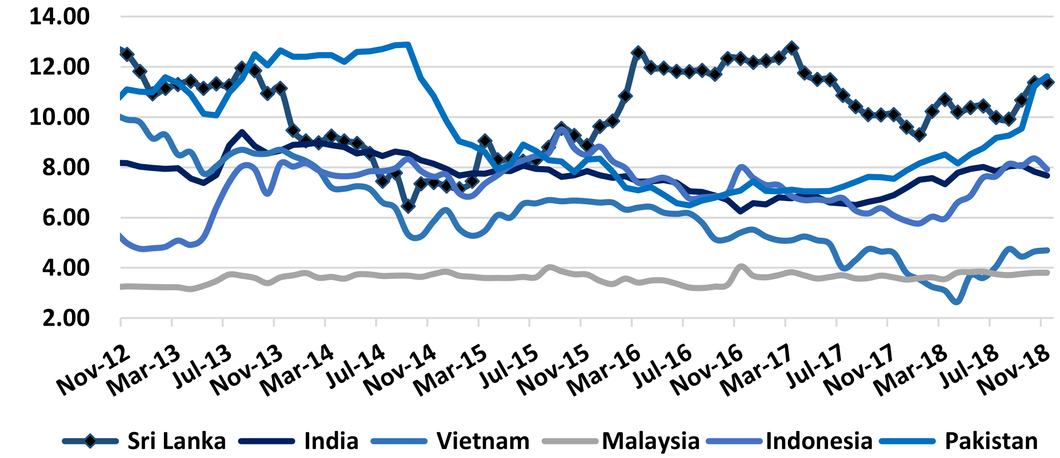
Source: CBSL

Graph 5 : Comparative Yield curve as at Nov 2018



Source: Bloomberg

Graph 6 : Sri Lanka's 5-Yr Bond Yield Premium readjusting



Source: Bloomberg

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 correctness, 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.

CONTACT US

Dimantha Mathew	+94 11 2639 853
Atchuthan Srirangan	+94 11 2639 863
Amanda Lokugamage	+94 11 2639 868
Hiruni Perera	+94 11 2639 864
Nisansala Kuruppumudali	+94 11 2639 866