



First Capital

First Capital Research

Continuation of Policy rates, amidst slow economic activities

PRE-POLICY ANALYSIS

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Policy rates to continue, amidst slow economic activities and to allow the impact of previous rate hike to materialise

- ❑ Previous Pre-Policy issue;
 - We believed that the risk posed by relatively lower reserve position prevailed during the period, foreign debt repayment fell due in 1Q2019 coupled with sovereign downgrade from three major rating agencies were addressed by the unexpected rate hike in Nov 2018 while allowing the impact of the rate hike to materialize during 1Q2019 by improving credit and GDP growth.
- ❑ Changes took place during the period;
 - Instability in political front continued as further delay in holding provincial council elections, major political parties not having nominated their prospective Presidential candidate while divergence between the President and the UNF continue to persist.
 - In early January secondary market yield curve experienced a parallel downward shift predominantly on the belly and long end of the curve followed by a brief uptrend with the overall curve dipping by 22-60bps. Equity market saw a continuous downward shift with low activities and foreign outflow of LKR 5.1Bn YTD. However, debt market saw inflow of LKR 20.5Bn since mid Jan 2019. On the back of foreign inflows and accelerated USD conversions by exporters, USD:LKR strengthened towards the early Feb 2019, to reach LKR 176.65 on 01 Feb from 2018 closing of 182.90 and stabilising around 178.00-179.00 levels.
 - CBSL holdings increased throughout the period to peak at LKR 177.2Bn and stabilized around LKR 176.3Bn while market liquidity shortage widened to LKR 139.3Bn towards mid-Jan 2019 and narrowed to fall below LKR 70.0Bn.
 - Fed indicated the adoption of a cautious approach signaling that the tightening phase might be coming to an end amid rising risks to economic growth.
 - First Capital Research believes that continuation of policy rate is appropriate. However, we have increased the biasness towards a rate cut where we allocate a 10% probability in Feb 2019.

Strategy Report Recap[Policy Rate Expectation]: On a base case First Capital Research expects 2 rate cuts of 25bps each during 2019 (2Q & 4Q) as overnight CBSL standing lending facility rate which stands at 9.0%, we believe is too high for accelerated economic activity.

Expected Monetary Policy Stance

Considering the below par GDP growth and overly sluggish credit growth, First Capital Research expects a continuation of the rates while permitting the effect of the recent rate hike to materialize. However, probability of a rate cut exists beyond 1Q2019 to boost the revival of economic activities.

Expected Monetary Policy Stance by CBSL	Probability
Raising Policy Rates by 50bps	0%
Raising Policy Rates by 25bps	0%
<i>Policy Rates to remain unchanged</i>	90%
Cutting Policy Rates by 25bps	10%
Cutting Policy Rates by 50bps	0%

Decreased from 100% allowing the impact of rate increase in Nov 2018 to materialize.

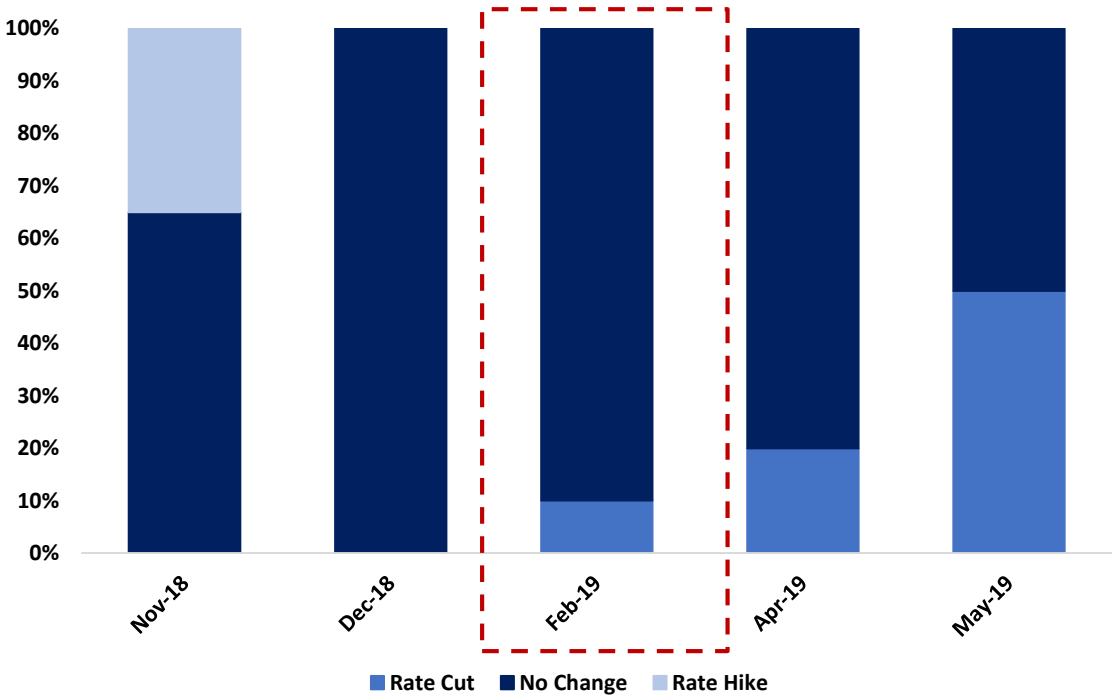
Increased by 10% amidst sluggish credit growth and below par GDP growth.

Current Policy Rates	
Standing Deposit Facility Rate (SDFR)	8.00%
Standing Lending Facility Rate (SLFR)	9.00%
Statutory Reserve Ratio (SRR)	6.00%

We expect the CBSL to keep Statutory Reserve Ratio (SRR) unchanged at 6.00%

Graph 1 : Policy Rate Expectations – First Capital Research

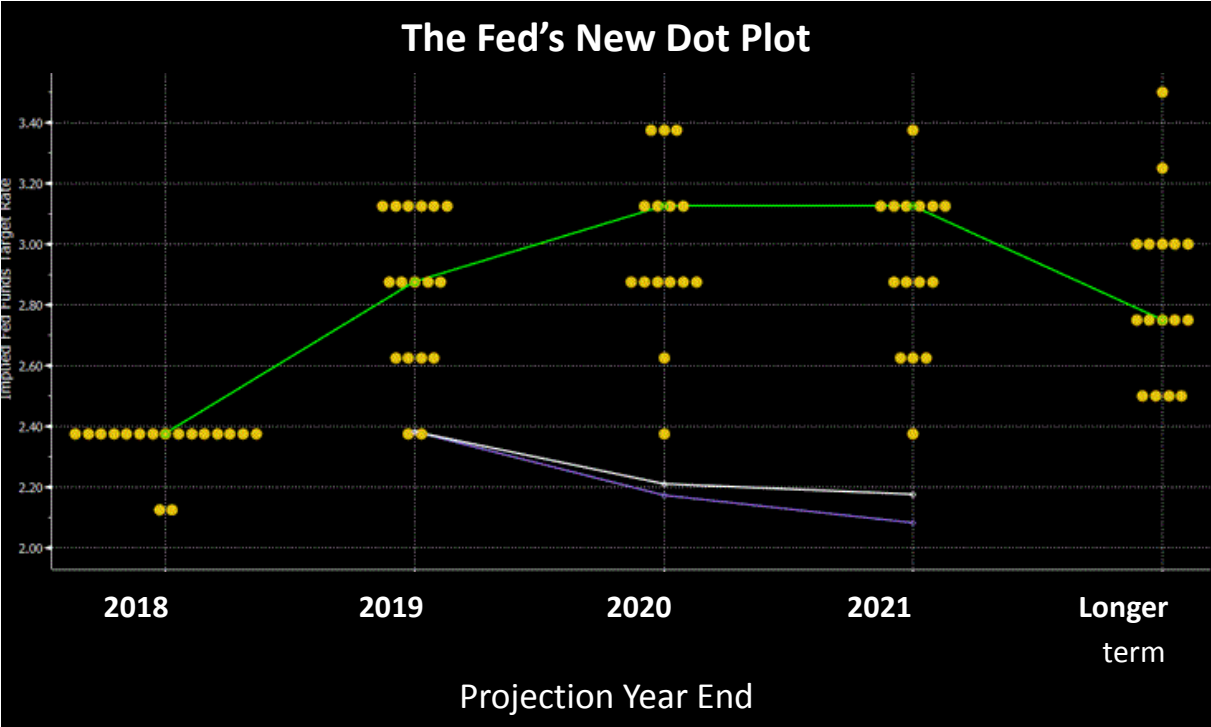
First Capital Research expects a continuation of policy rates at current levels. However, we recognize an increased probability of 10% for a rate cut considering the prevailing below par GDP growth and sluggish credit growth.



Source: First Capital Research Estimates

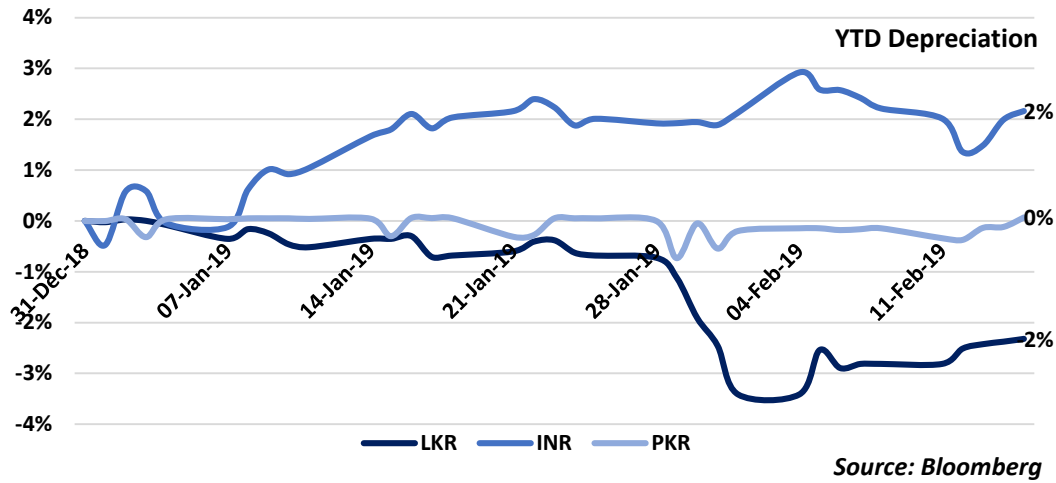
Graph 2 : Fed Rate Hike Expectations – up to 2021

Fed reserve officials decided to keep rates unchanged at the first meeting for 2019 as Policy makers is of the view that they have the capacity to wait and carefully take stock of the incoming data and other developments.

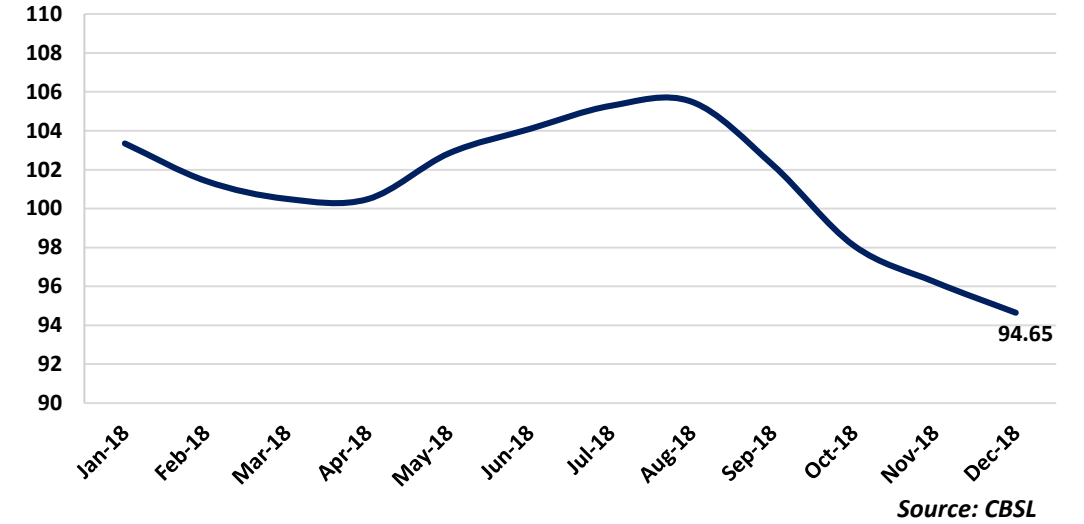


Source: Bloomberg

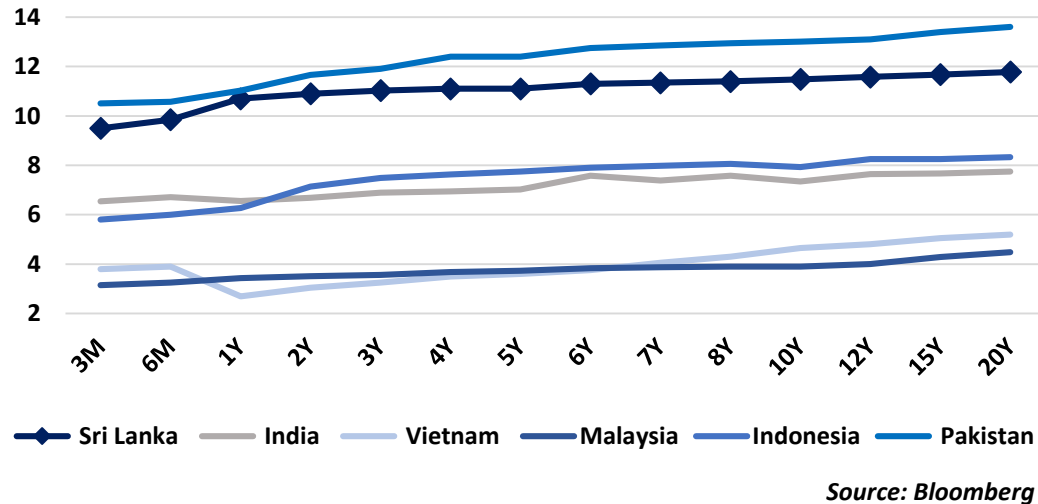
Graph 3 : LKR strengthened, PKR remained stable while INR weakened against the USD



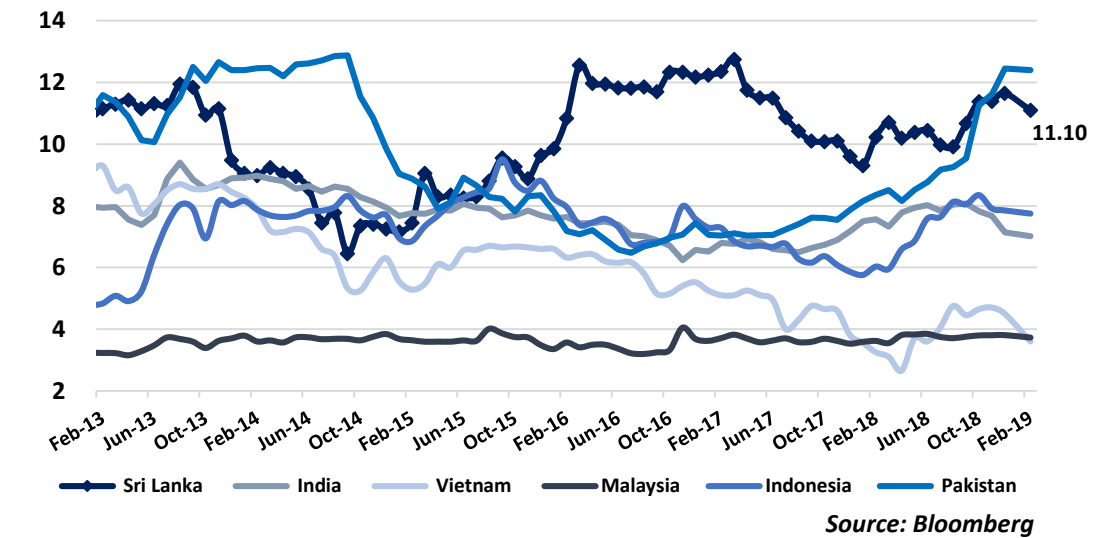
Graph 4 : Real Effective Exchange Rate reached 94.65 in Dec 2018



Graph 5 : Comparative Yield curve as at Feb 2019



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



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