



First Capital

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Possible rate cut, amidst overly sluggish economic activities

PRE-POLICY ANALYSIS

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Lead Analyst: Amanda Lokugamage

Secondary Analyst: Dimantha Mathew

Possible rate cut, amidst overly sluggish economic activities

Previous Pre-Policy issue; CBSL continues to support liquidity

- Contrary to our expectation of unchanged policy stance, CBSL reduced the SRR by 100bps to 5% as they believed policy intervention was required to address the large and persistent liquidity deficit which prevailed in the domestic money market.

Changes took place during the period;

- ❑ Sluggish sentiment in Sri Lanka's economy has been a major concern with latest GDP growth for 4Q2018 recording an alarmingly low 1.8%. Growth protracted in 2018 with annual GDP growth trimming to 3.2% compared to 3.4% in 2017.
- ❑ Supported by the SRR cut in Feb 2019, liquidity position saw a significant improvement. More recently minor level of foreign inflows and the subsequent foreign remittance conversions are having a impact on liquidity curtailing the deficit while we expect the situation to further improve over the next few weeks.
- ❑ Political uncertainty has worn off to a certain extent with the TNA supporting the UNF Government on the passing of the budget.

External sector strongly favouring Sri Lanka

- ❑ Fed signaled pausing of rate hikes in 2019 while certain analysts expect possible reversal in stance to a single rate cut in late 2019. Global fund flow which is already shifting towards emerging markets is likely to further strengthen and continue with the US yields easing off.
- ❑ USD:LKR continued to strengthen to close at 176.17 on 28 Mar 2019 supported by foreign remittance conversions and foreign inflows. We expect the REER to have reached 97-98 range with the rupee appreciation together with the strengthening of the dollar index in Feb and Mar 2019. REER for Jan 2019 recorded at 94.18 indicating the undervaluation of the currency.
- ❑ Resultant to the continuous foreign inflow witnessed in the secondary market since Mar 2019, short to belly end of the yield curve plunged by 5-23bps shifting downwards while equity market witnessed a net foreign outflow.
- ❑ First Capital Research allocates a **50% probability for a policy rate cut** in Apr 2019 as we are of the view that policy intervention is appropriate to address the overly sluggish economic growth. Keeping in line with the possible introduction of a single policy rate, we believe a rate cut, if at all, will be applicable only to SLFR. However, considering the negative liquidity position we allocate a further 50% probability for no change in rates as CBSL may consider to delay the rate cut upto the next policy meeting in May 2019.

Expected Monetary Policy Stance

Considering the protracted overly sluggish GDP growth and declining bond yields globally signaling a economic slowdown is on the way, First Capital Research expects a continuation of the rates while permitting the effect of the recent rate cut to materialize. However, we are of the view that policy intervention is required to address the protracted sluggishness in the economic activities thus we increase the probability of a SLFR cut by 25bps to 50% from 10% in Feb 2019.

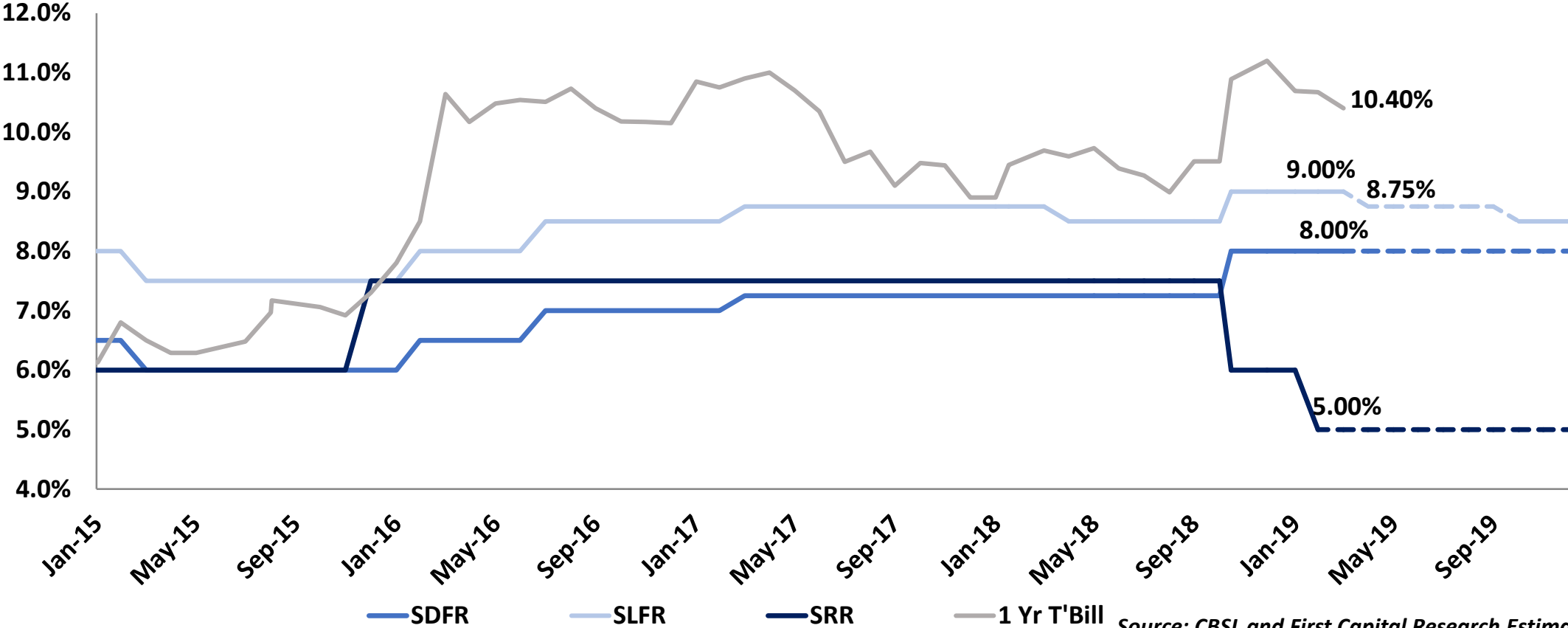
Expected Monetary Policy Stance	Probability
Raising Policy Rates by 50bps	0%
Raising Policy Rates by 25bps	0%
Policy Rates to remain unchanged	50%
Cutting Policy Rates by 25bps	50%
Cutting Policy Rates by 50bps	0%

Increased by 40% amidst below par GDP growth.

Expected Stance on SRR	Probability
Raising SRR by 100bps	0%
Raising SRR by 50bps	0%
SRR to remain unchanged	100%
Cutting SRR by 50bps	0%
Cutting SRR by 100bps	0%

Remain unchanged to allow the impact of 100bps SRR cut to materialize.

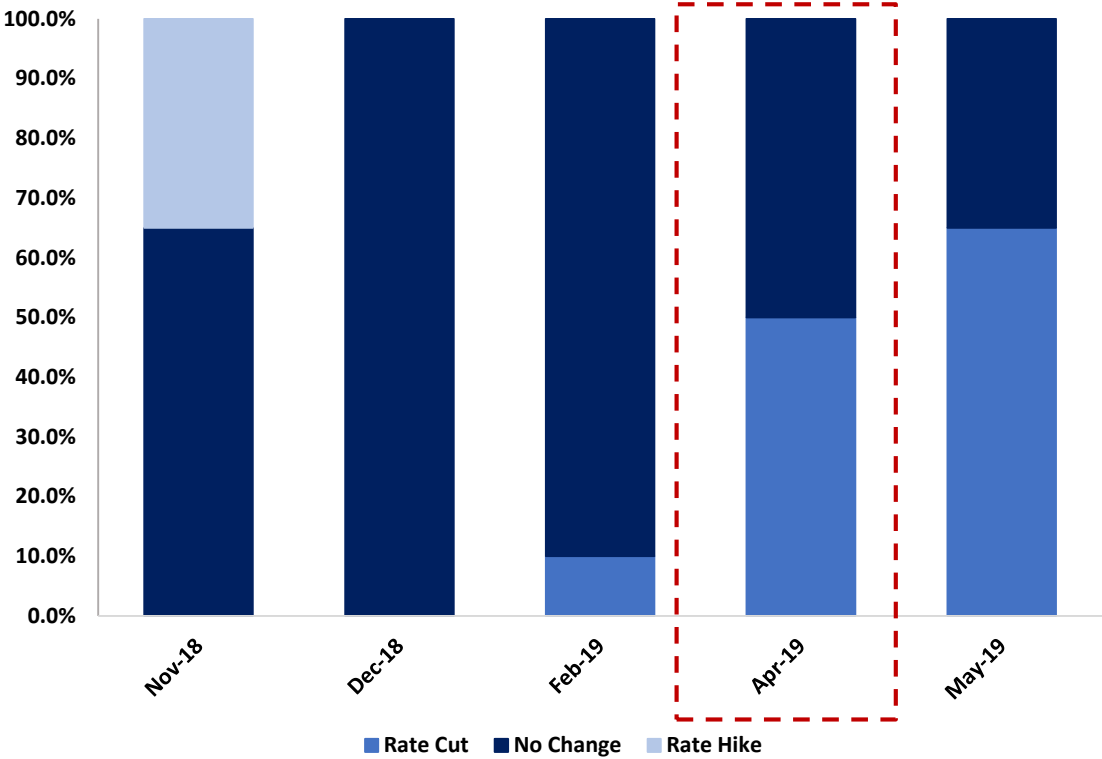
Monetary Policy Rates



Source: CBSL and First Capital Research Estimates

Graph 1 : Policy Rate Expectations – First Capital Research

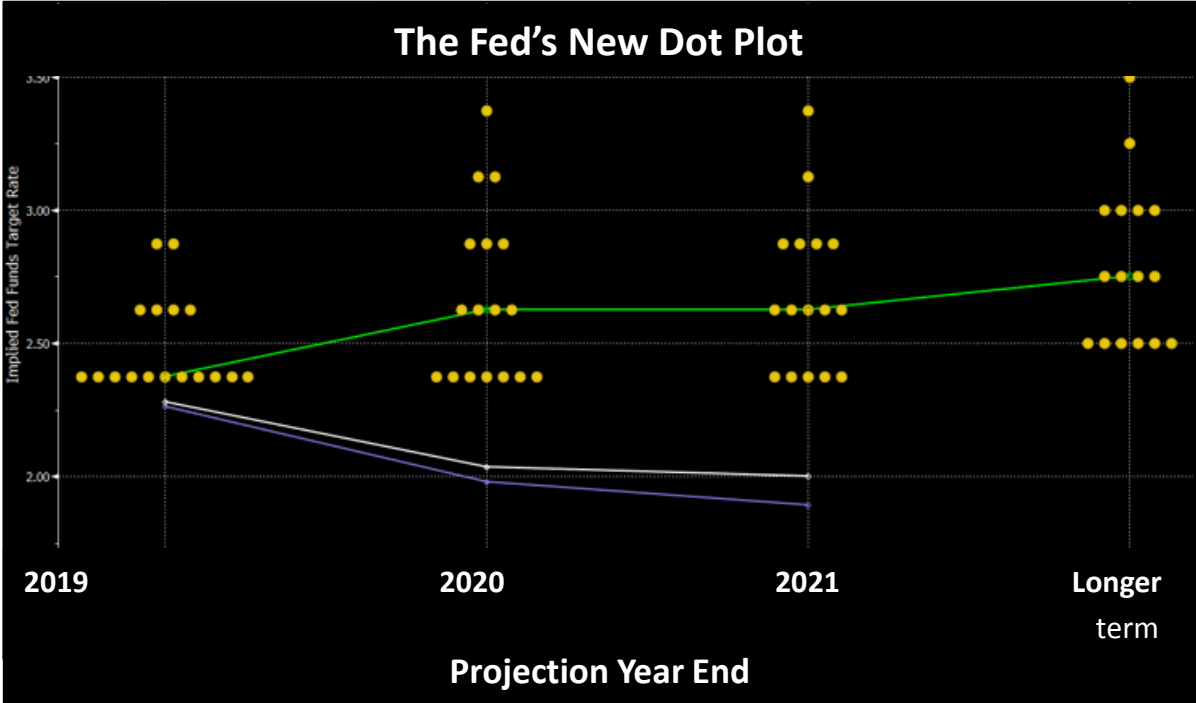
First Capital Research expects a continuation of policy rates at current levels. However, we recognize an increased probability of 50% for a rate cut to address the prolonged below par growth in economic activities.



Source: First Capital Research Estimates

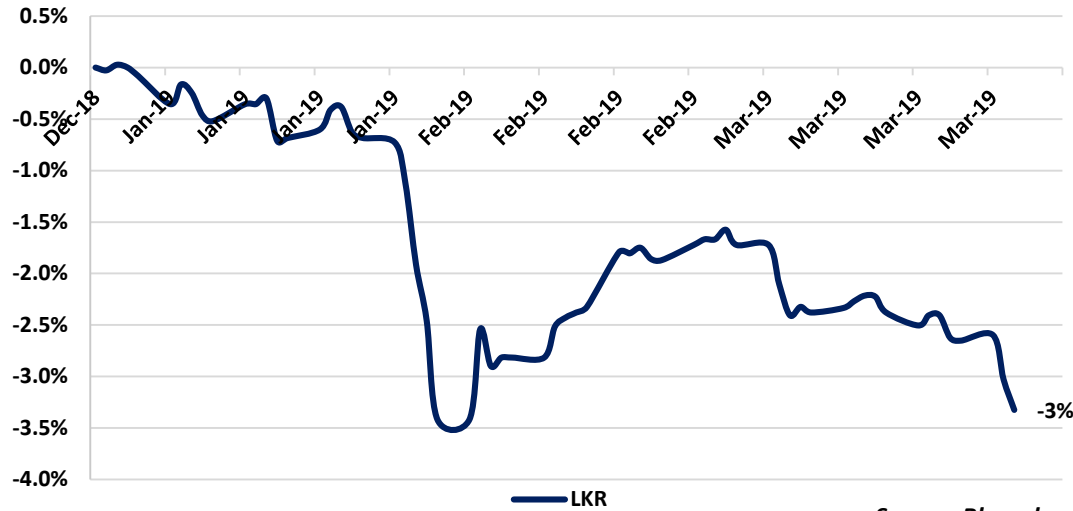
Graph 2 : Fed Rate Hike Expectations

Fed reserve officials decided to keep rates unchanged at the meeting held in Mar 2019 indicated it would remain "patient" before adopting any further increases while signaling that rates will be kept unchanged in 2019. The move came along with reduced expectations in GDP growth, inflation and a higher unemployment rate outlook.



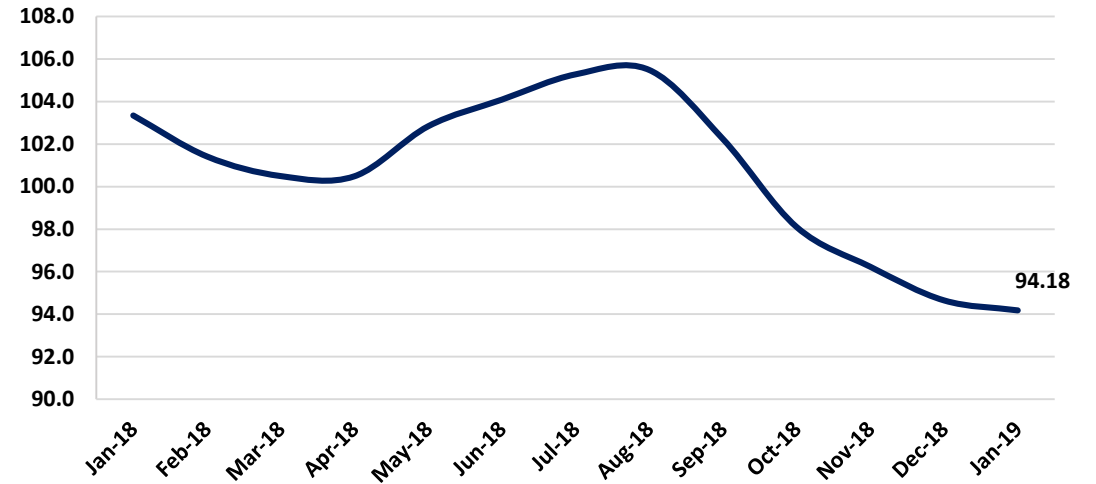
Source: Bloomberg

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



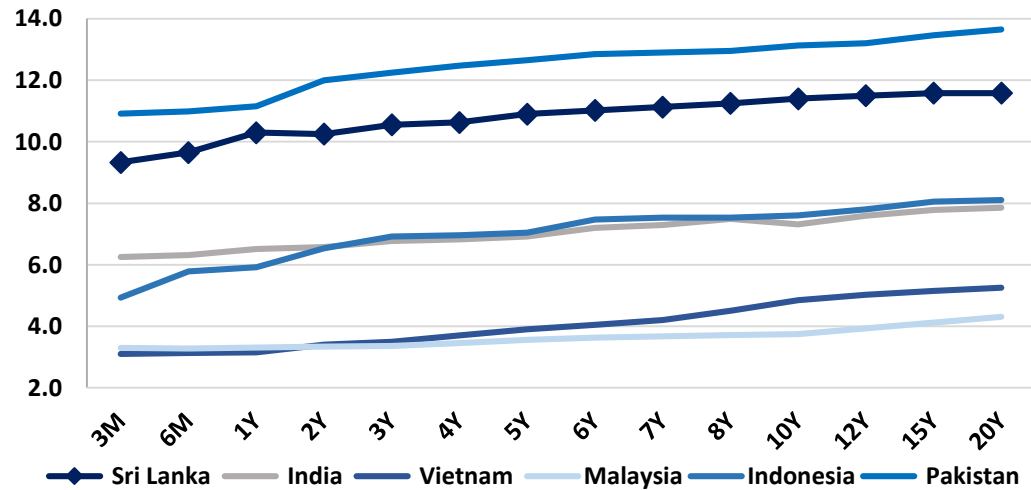
Source: Bloomberg

Graph 4 : Real Effective Exchange Rate continued to be undervalued at 94.18 in Jan 2019



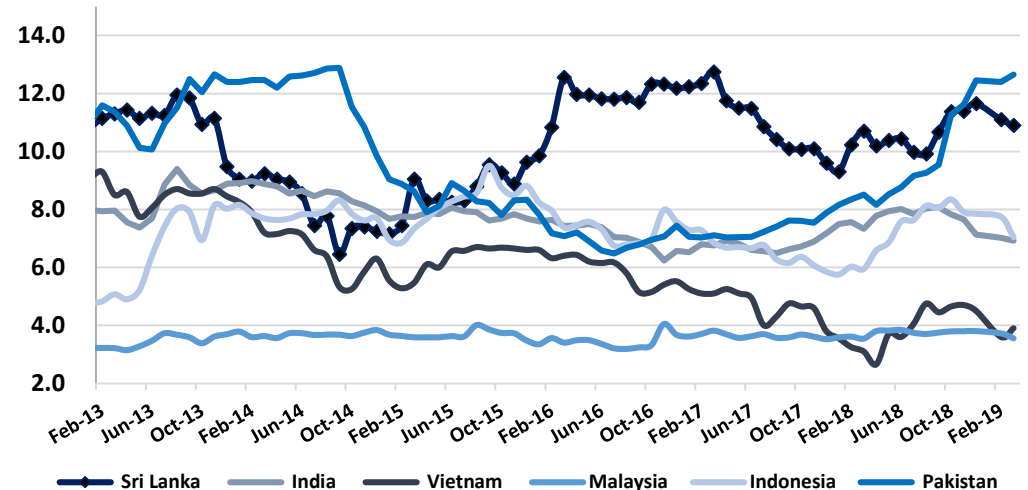
Source: CBSL

Graph 5 : Comparative Yield curve as at Mar 2019



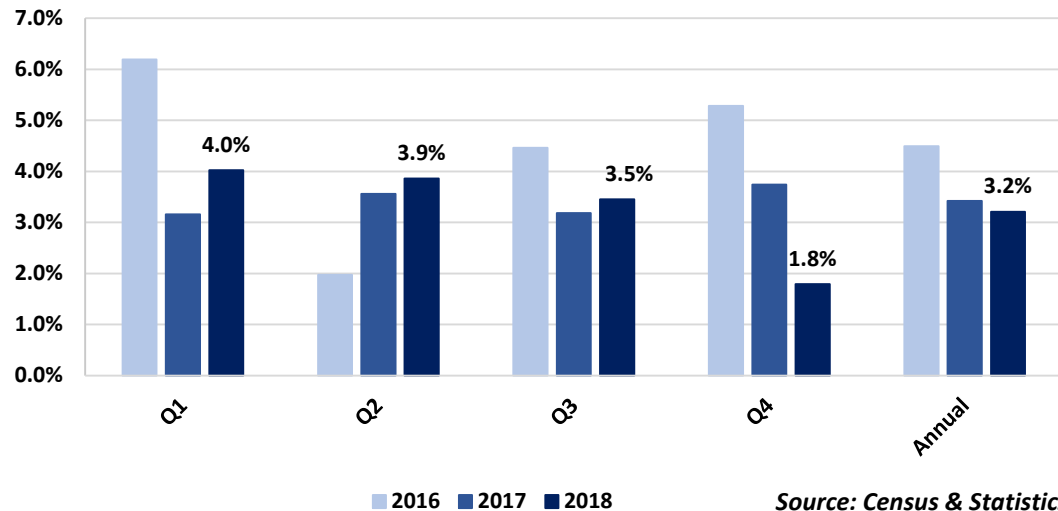
Source: Bloomberg

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

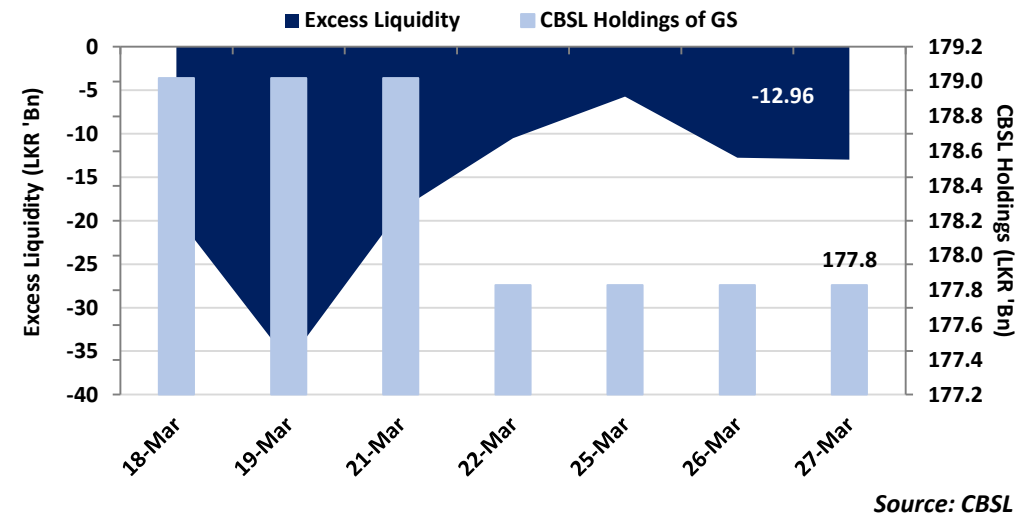


Source: Bloomberg

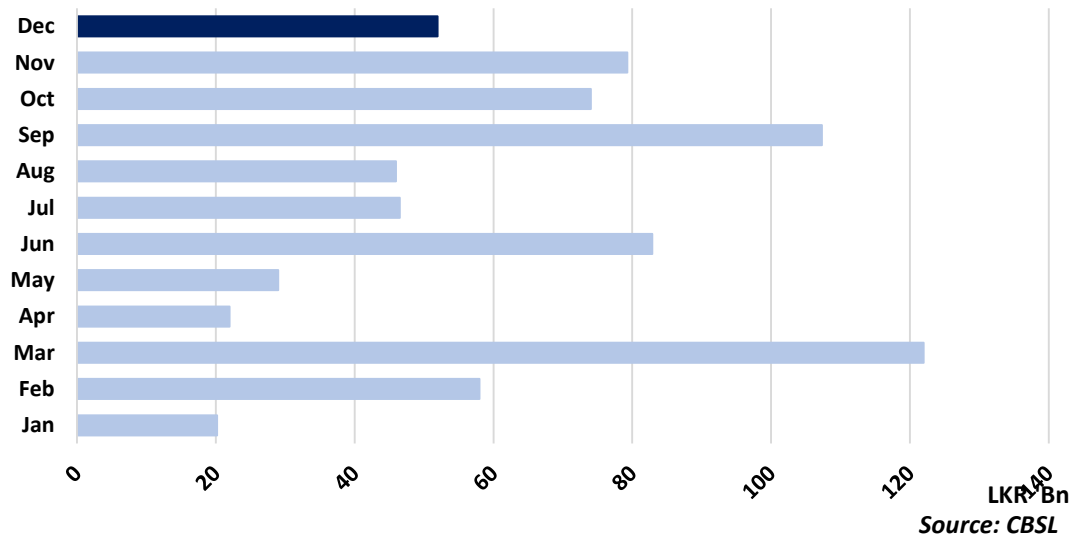
Graph 7 : GDP growth (2016-18)



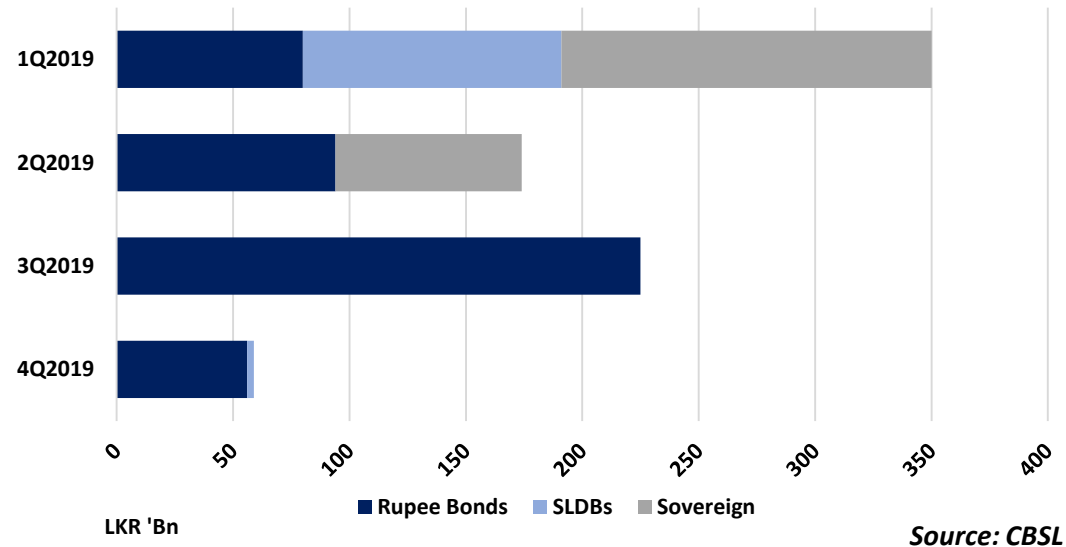
Graph 8 : Excess Liquidity and CBSL Holdings of Gov. Securities



Graph 9 : Private Sector Credit - 2018



Graph 10 : Sri Lanka's Foreign debt repayments - 2019



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CONTACT US



First Capital

Dimantha Mathew +94 11 2639 853

Hiruni Perera +94 11 2639 864

Atchuthan Srirangan +94 11 2639 863

Nisansala Kuruppumudali +94 11 2639 866

Amanda Lokugamage +94 11 2639 868