

FC Fixed Income Recommendation

AUGUST 2017

**ANALYST CERTIFICATIONS AND REQUIRED
DISCLOSURES BEGIN ON PAGE 17**



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FC Research
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Re-cap [Dec 2016]: Time Period vs Risk Score

	3 Months Outlook Feb-Apr	3-6 Months Outlook Apr-Jul	6-9 Months Outlook Jul-Oct	9-12 Months Outlook Oct-Dec
Risk Score Estimate	<50	50-75	75-100	50-75
Rise in Rates by +1%	High	Medium	Remote	Medium
Utilization Recommendation	Reduce	Slow Increase	Significantly Increase	Slow Decrease
Utilization of Capacity	Limited to 40% or less	Limited to 60% or less	Limited to 80% or less	Limited to 60% or less

Previous Month 18th Jul & 31st July Recommendations and Yield curve movement

Recommendation for 18th Jul 2017 (Last month)

- Portfolio exposure: HOLD
- Capacity Utilization to be maintained at 70%
- Recommend to **SELL** all longer tenors (10y, 15y, 20y, 30y) and invest in the shorter tenors. Continue to HOLD mid tenor bonds
- Need to watch out for the passing of the Inland Revenue Act

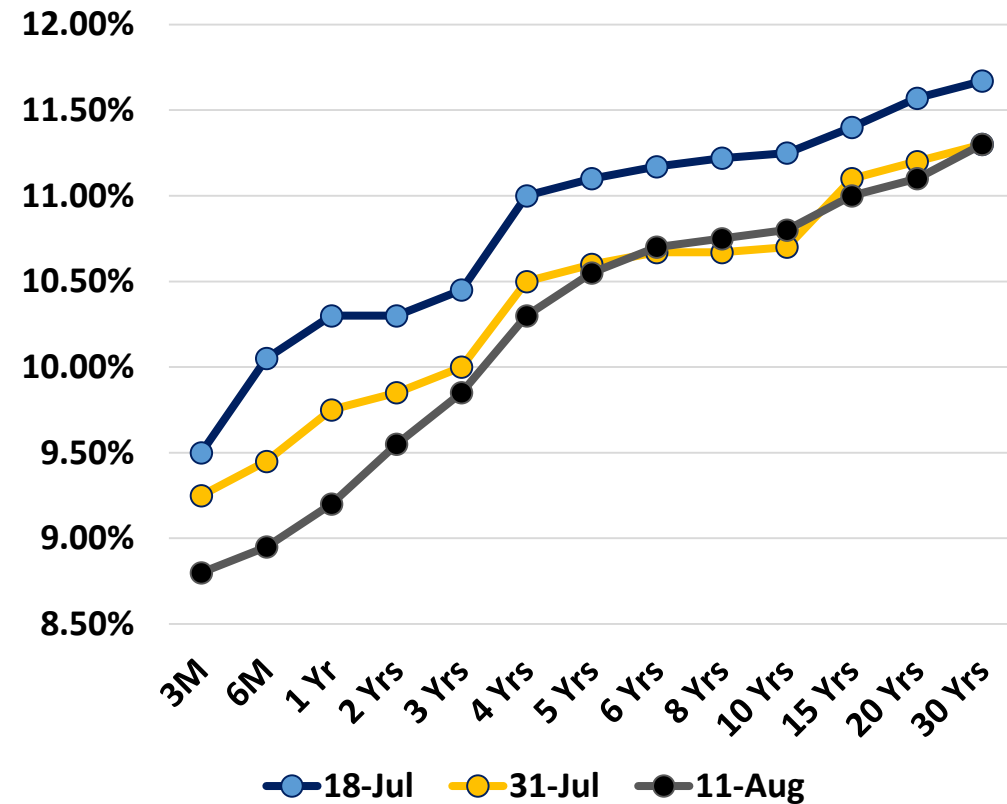
Recommendation for 31st Jul 2017 (Last month)

Recommend to **SELL** all mid tenors (4y, 5y, 6y, 8y) as the securities fall sharply below our lower band of 11%.

We already remain on a **SELL** on all longer tenors (10y, 15y, 20y, 30y) securities as at 18th Jul 2017.

Portfolio exposure: REDUCE

Capacity Utilization to be reduced to 60%



Rate Movement Review (Last 30 days)

Interest Rate Change (bps)					
Tenure	18-Jul	31-Jul	Change (bps)	11-Aug	Change (bps)
3M	9.50%	9.25%	-25	8.80%	-45
6M	10.05%	9.45%	-60	8.95%	-50
1 Yr	10.30%	9.75%	-55	9.20%	-55
2 Yrs	10.30%	9.85%	-45	9.55%	-30
3 Yrs	10.45%	10.00%	-45	9.85%	-15
4 Yrs	11.00%	10.50%	-50	10.30%	-20
5 Yrs	11.10%	10.60%	-50	10.55%	-5
6 Yrs	11.17%	10.67%	-50	10.70%	3
8 Yrs	11.22%	10.67%	-55	10.75%	8
10 Yrs	11.25%	10.70%	-55	10.80%	10
15 Yrs	11.40%	11.10%	-30	11.00%	-10
20 Yrs	11.57%	11.20%	-37	11.10%	-10
30 Yrs	11.67%	11.30%	-37	11.30%	0

Rates saw steep fall well below the FC Research targets forcing sell recommendations on mid and long tenors

In line with expectations mid and longer tenor interest rates saw upward pressure over the last couple of weeks

Further small amount of net foreign selling was also witnessed over the last 2 weeks

1.0 Economic Health Score

Aug 2017 Economic Health Score

Further improvement in the score; Secondary criteria continues its dip amidst future concerns

Primary Criteria	-	52 +05	-	57
Secondary Criteria	-	13 - 01	-	12

Economic Health Score (Aug 2017) - 69

- (As against 65 in Jul 2017 & 44 in Feb 2017)



Changes to Health Score – Priority Criteria

Criteria	Update	Current Score	Add / Deduct Score	New Score
Foreign Reserves	Decrease by USD 200Mn	13/15		13/15
Liquidity	Remains positive and sustained LKR25-30 Bn over the last 30 days	08/15	+01	09/15
Inflation	CCPI at 4.8%; FC Research expectation was 5.8%; Exceptional fall in food prices	13/15	+02	15/15
Foreign Buying	Net inflow of LKR 17 Bn over the last 4 weeks; Foreign holdings reaches 5.2%. But some outflow over last 2 weeks	03/10	+01	04/10
Credit	Jun 2017 private sector credit surged to LKR 80Bn; Need to check whether it is one off	08/10		08/10
CBSL Holdings	CBSL Holdings decline by LKR 35Bn to LKR 117 Bn excluding SDF	07/10	+01	08/10
Primary Criteria		-	52 + 05	= 57

Changes to Health Score – Secondary Criteria

Criteria	Update	Current Score	Add / Deduct Score	New Score
Rating Outlook	No Change	05/05		05/05
External Environment	Possible Fed Rate hike affecting global fund flows towards US	05/05	-01	04/05
BoT & BoP	Strong improvement in exports and hefty decline in imports significantly improving BoT in Jun 2017; Need to see if trend continues	00/05	+01	01/05
Political Risk	Signs of elections towards end of 2017	03/05	-01	02/05
Other (New Taxes)	Possible passing of Inland Revenue Act	00/05		00/05

Secondary Criteria - 13 + 01 - 02 = 12

2.0 Recommendation

Expectations for September 2017

PRIORITY CRITERIA

Foreign Reserves	13/15	
Liquidity	09/15	+01
Inflation	15/15	
Foreign Buying	04/10	+01
Credit	08/10	
CBSL Holdings	08/10	

SECONDARY CRITERIA

Rating Outlook	05/05	
External Environment	04/05	-02
BoT & BoP	01/05	
Political Risk	02/05	-01
Other (New Taxes)	00/05	

Total - 57/75 +02

Total - 12/25 -03

Total 69 + (2-3) = 68

Reasons for Expected September 2017 Health Score

Further improvement in the Economic Health Score is possible due to:

- Retained foreign buying although at a much slower pace
- Further reduction in CBSL Holdings / liquidity improvement via Funds received from Dollar buying by CBSL and possible net inflows into Debt or equity capital markets

Recommendation

Fixed Income Portfolio Recommendation

- Portfolio exposure: REDUCE
- Capacity Utilization to be reduced to 50% from previous 60%
- Recommend to start reducing position in shorter tenors. Continue **SELL** recommendation all mid & long tenors.
- Need to watch out for the passing of the Inland Revenue Act

Market is trading well below FC Research lower bands in short, mid and long tenor maturities. As a result we believe that the market is currently trading below the fundamental levels

Sequence of Events

Apr 2017 – Signs of further outflows but risk score increases so HOLD or SELL a portion to represent future risk

Early May 2017 – Comments on delay in Sovereign Bond; Hold portfolio and switch to Bills or shorter term securities.

May 2017 – Successful Bond issue; Signs of Future Risk reducing; Increase from 50% to 60% but slow increase as mid term bond rates are too low

Jun 2017 – Concrete signs of future risk reducing; Increase capacity utilization to 70% from 60%; Possibility of overall yield curve touching bottom bands over next 2 months; But watch out for Inland Revenue Act

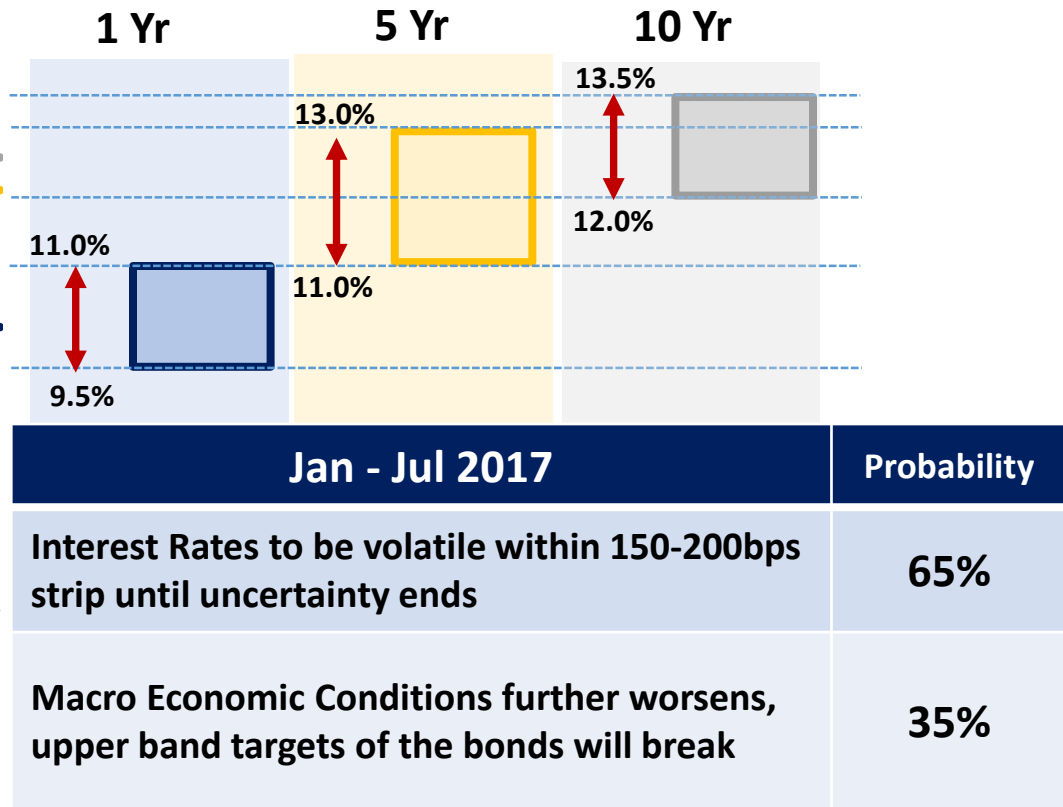
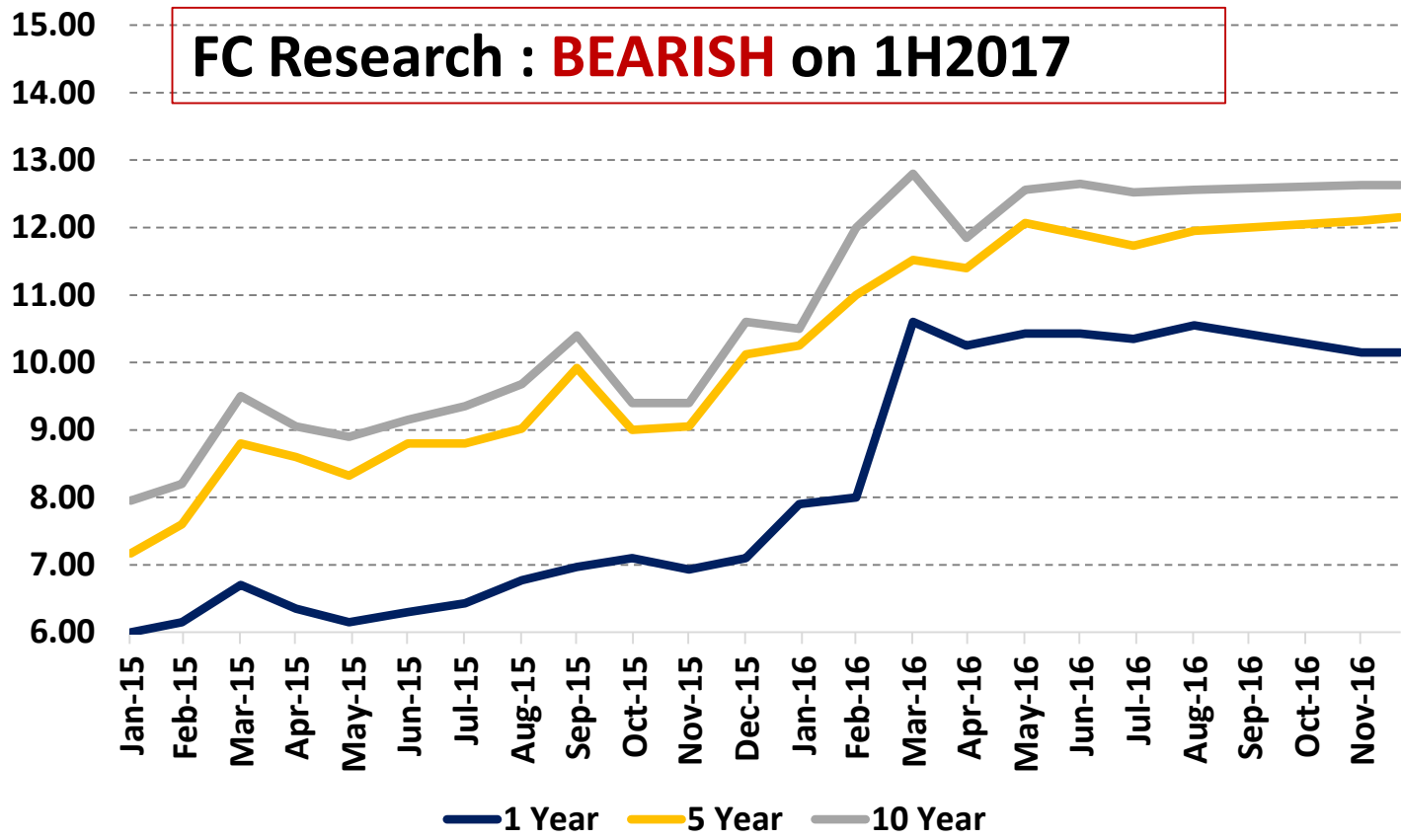
18th Jul 2017 – Sell all longer tenors (10y, 15y, 20y, 30y) and invest in the shorter tenors. Continue to HOLD mid tenor bonds. Continue to watch out for Inland Revenue Act

31st Jul 2017 – SELL all mid tenors (4y, 5y, 6y, 8y). Capacity Utilization to be reduced to 60%

14th Aug 2017 – Start reducing position in shorter tenors. Capacity Utilization to be reduced to 50%

3.0 Recap of Dec 2016 Economic Wrap

Interest Rates to be volatile within 150-200bps strip until uncertainty ends (Target: 7 months)



Pressure on interest rates to ease off over the 2H2017 (Target: 12 months)

No Bond Maturities beyond Jul 2017

No SLDB Maturities beyond 1st Aug 2017

No elections unless 1H2017 elections and referendums are delayed

Low Government Borrowing Requirement and low Private Sector Credit Growth may improve money supply and liquidity in the system

FC Research : BULLISH on 2H2017

BY END 2017	Probability
Interest Rates to decline and hit the lower bands (1 Yr – 9.5%, 5 Yr – 11.0%, 10 Yr – 12.0%)	65%
Macro Economic Conditions further worsens in 1H2017, end 2017 rates will remain same as current rates (1 Yr – 10.0%, 5 Yr – 12.0%, 10 Yr – 12.6%)	35%

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