

FC Fixed Income Recommendation

SEPTEMBER 2017

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



First Capital
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

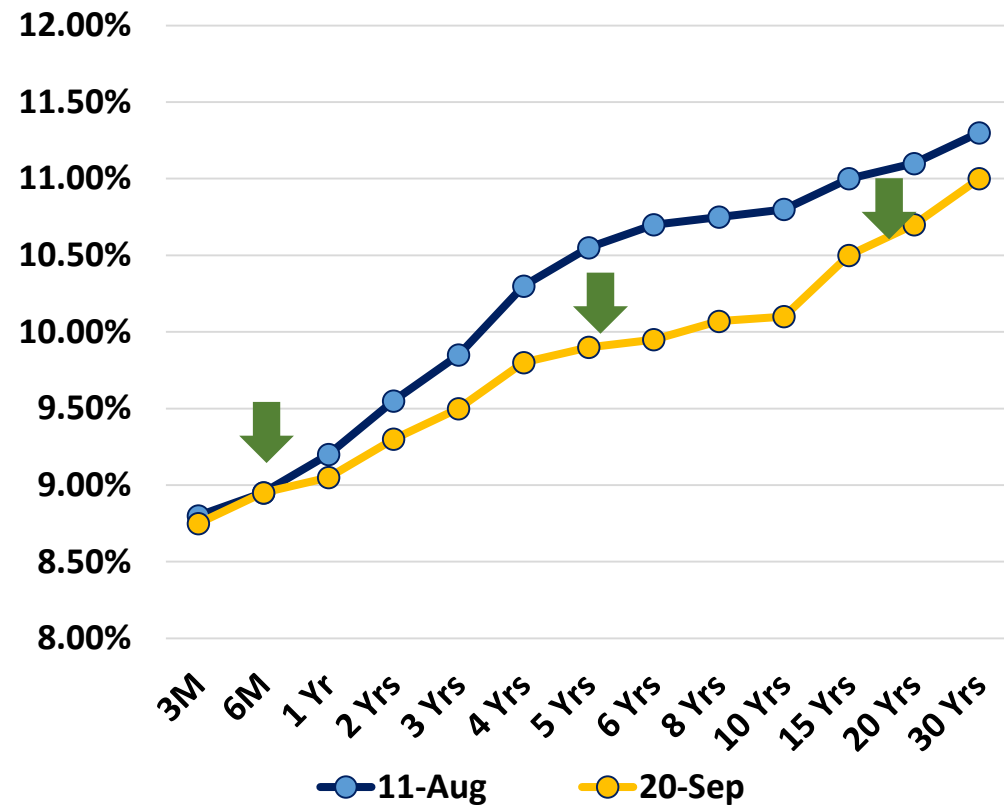
Re-cap [Aug 2017]: Time Period vs Health Score

	3 Months Outlook Jul-Sep 2017	3-6 Months Outlook Oct-Dec 2017	6-9 Months Outlook Jan-Mar 2018	9-12 Months Outlook Apr-Jun 2018
Health Score Estimate	75-100	60-75	60-65	50-60
Risk Level	Remote	Medium-Low	Medium	Medium-High

Previous Month 14th Aug Recommendations and Yield curve movement

Recommendation for 14th Aug 2017 (Last month)

- 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



Rate Movement Review (Last 30 days)

Interest Rate Change (bps)			
Tenure	11-Aug	20-Sep	Change (bps)
3M	8.80%	8.75%	-5
6M	8.95%	8.95%	0
1 Yr	9.20%	9.05%	-15
2 Yrs	9.55%	9.30%	-25
3 Yrs	9.85%	9.50%	-35
4 Yrs	10.30%	9.80%	-50
5 Yrs	10.55%	9.90%	-65
6 Yrs	10.70%	9.95%	-75
8 Yrs	10.75%	10.07%	-68
10 Yrs	10.80%	10.10%	-70
15 Yrs	11.00%	10.50%	-50
20 Yrs	11.10%	10.70%	-40
30 Yrs	11.30%	11.00%	-30

Following our previous report on 14th Aug 2017, market saw some profit taking with rates marginally improving across the yield curve

However, amidst the announcement of the surge in foreign reserves by USD 1Bn to USD 7.7Bn strong buying interest emerged pushing rates down across the yield curve

Net foreign buying continued was also witnessed over the last 2 weeks

1.0 Economic Health Score

Sep 2017 Economic Health Score

Strong improvement in the score;

Primary Criteria	-	57 + 05	-	62
Secondary Criteria	-	12 + 04	-	16

Economic Health Score (Sep 2017) - 78

- (As against 69 in Aug 2017 & 44 in Feb 2017)

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Changes to Health Score – Priority Criteria

Criteria	Update	Current Score	Add / Deduct Score	New Score
Foreign Reserves	Increase by USD 1Bn	13/15	+02	15/15
Liquidity	Remains positive and sustained LKR30-40 Bn over the last 15 days	09/15	+01	10/15
Inflation	CCPI at 6.0%; FC Research expectation was also 6.0%; Non-existence of VAT in previous period gives a higher value for inflation	15/15		15/15
Foreign Buying	Net inflow of LKR 16 Bn over the last 5 weeks; Foreign holdings reaches 5.6%.	04/10	+01	05/10
Credit	Jul 2017 credit figures are not out yet. Expected to be low	08/10		08/10
CBSL Holdings	CBSL Holdings decline by another LKR 50Bn to LKR 67 Bn	08/10	+01	09/10

Primary Criteria - 57 + 05 = 62

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	04/05	-01	03/05
BoT & BoP	Marginal increase in deficit of BoT in Jul 2017	01/05		01/05
Political Risk	Elections only in 1Q2018 (LG & PC polls)	02/05		02/05
Other (New Taxes)	Inland Revenue Act passed implementation only in 01.04.2018	00/05	+05	05/05

Secondary Criteria - 12 + 05 - 01 = 16

2.0 Recommendation

Expectations for October 2017

PRIORITY CRITERIA

Foreign Reserves	15/15	
Liquidity	10/15	
Inflation	15/15	
Foreign Buying	05/10	
Credit	08/10	
CBSL Holdings	09/10	

SECONDARY CRITERIA

Rating Outlook	05/05	
External Environment	03/05	-01
BoT & BoP	01/05	
Political Risk	02/05	
Other (New Taxes)	05/05	

Total - 62/75 +00

Total - 16/25 -01

Total	78	+	(0-1)	=	77
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Reasons for Expected October 2017 Health Score

We expect Economic Health Score to remain broadly stable but slowly reduce over 4Q2017 due to:

- Rising debt payment levels that exist in 2018
- Slowdown in foreign inflows as fed rate hike draws closer (Possibly in Dec 2017 according to US Economic Analyst surveys)

Recommendation

Fixed Income Portfolio Recommendation

- Portfolio exposure: REDUCE
- Capacity Utilization to be reduced to 40% from previous 50%
- Recommend to start further reducing position in shorter tenors. Continue **SELL** recommendation all mid & long tenors.

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

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%

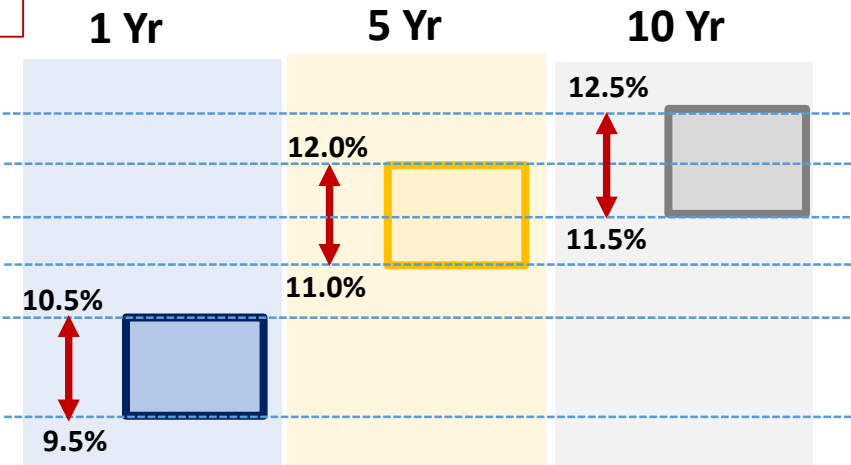
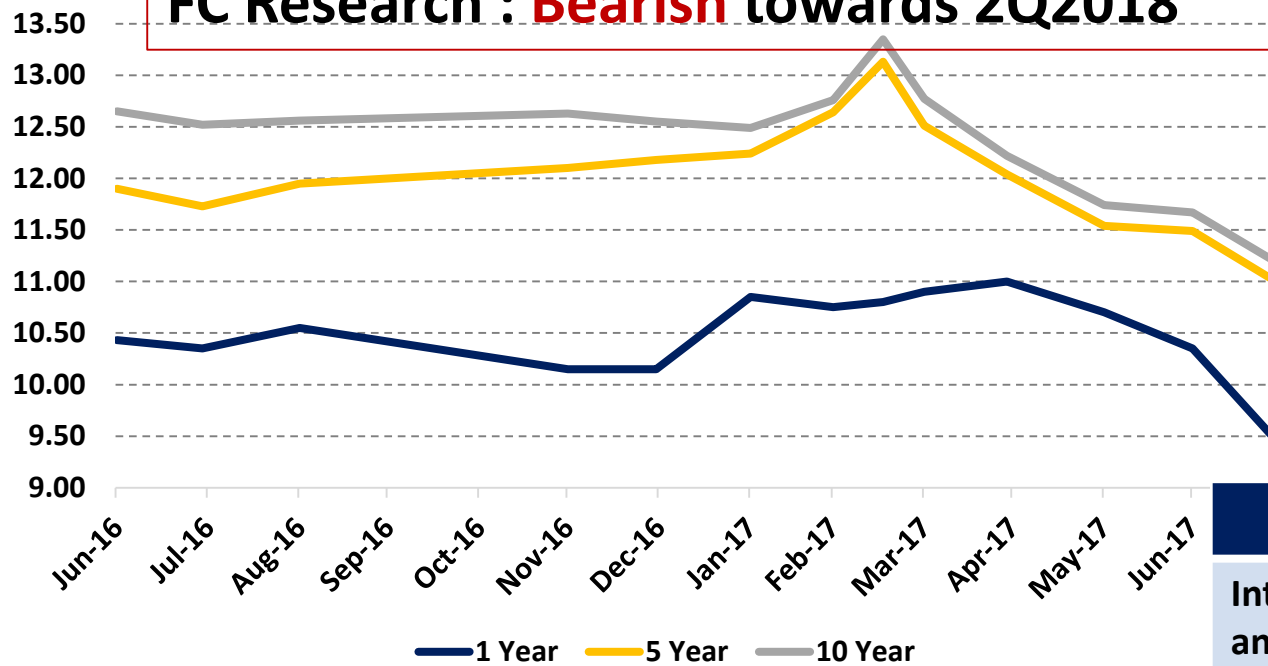
14th Aug 2017 – Start reducing position in shorter tenors. Capacity Utilization to be reduced to 50%

21st Sep 2017 – Further reduce position. Capacity Utilization to be reduced to 40%

3.0 Recap of Aug 2017 Economic Wrap

Interest Rates to be Bearish towards 2Q2018 despite stable 2H2017 (12 months)

FC Research : Bearish towards 2Q2018



Jul 2017 – Aug 2018		Probability
Interest Rates to be upward trending towards 2Q2018 and reaching upper bands		65%
Strong Foreign inflows stabilizing interest rates around the lower bands		35%

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