

FC Fixed Income Recommendation

MAY 2017



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Sovereign Bond Risk Premium reduces

Date	10-Yr SL Sovereign bond	10-Yr US Treasury Yield	Risk Premium
12-Jul-2016	6.875%	1.530%	5.345%
04-May-2017	6.200%	2.330%	3.870%
Change	0.675%	(0.800%)	(1.475%)

Economic Risk Score

MAY 2017

Changes to Risk Score – Priority Criteria

Criteria	Update
Foreign Reserves	Dip further to USD 5.0Bn
Liquidity	Improvement in liquidity in the money market
Inflation	April inflation dips to 6.9%
Foreign Buying	Continuing to remain positive but slow volumes
Credit	Private sector credit is high in Feb and Mar
CBSL Holdings	CBSL Holdings reduces back LKR 260-270Bn

Primary Criteria - 36 + 01 - 01 = 36

Changes to Risk Score – Secondary Criteria

Criteria	Update
Rating Outlook	Positive Outlook
External Environment	Successful Sovereign Bond issue
BoT & BoP	Negative Balance of Payments position continues to be an issue
Political Risk	No Change
Other (New Taxes)	New gazette confirms existing laws will apply until act comes in

Secondary Criteria - 13 + 1 = 14

May 2017 Economic Risk Score

Primary Criteria - 36

Secondary Criteria - 14

Economic Risk Score (May 2017) - 50

- (As against 49 in Apr 2017 & 44 in Feb 2017)



Recommendation

Fixed Income Portfolio Recommendation

- Increase portfolio exposure: BUY
- Utilize 60% capacity (Increase utilization from 50% to 60%)
- But Bond prices seems too low; May want to look at market mismatches or wait rate increases with auctions

Re-cap: 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
Leverage	Reduce to 9.0x-12.0x	Slow Increase 12.0x-15.0x	Significantly Increase 15.0x or More	Slow Decrease 12.0x-15.0x
Utilization of Leverage	Limited to 40% or less	Limited to 60% or less	Limited to 80% or less	Limited to 60% or less

Sequence of Events

Assume a capital of LKR 2 Bn

Feb 2017 – Risk was high had a utilization of less than 40%.

Mar 2017 – Risk reduced signs of positivity. BUY; Portfolio increased to 50%

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

Change in Probabilities

AS AT DEC 2016

Jan - Jul 2017	Probability	Apr 2017	May 2017
Interest Rates to be volatile within 150-200bps strip until uncertainty ends	65%	↓ 50%	↑ 70%
Macro Economic Conditions further worsens, upper band targets of the bonds will break	35%	50%	30%

Expectations for June 2017

PRIORITY CRITERIA

Foreign Reserves	+03
Liquidity	+02
Inflation	
Foreign Buying	+02
Credit	
CBSL Holdings	+01

Total - 36/75 +08

SECONDARY CRITERIA

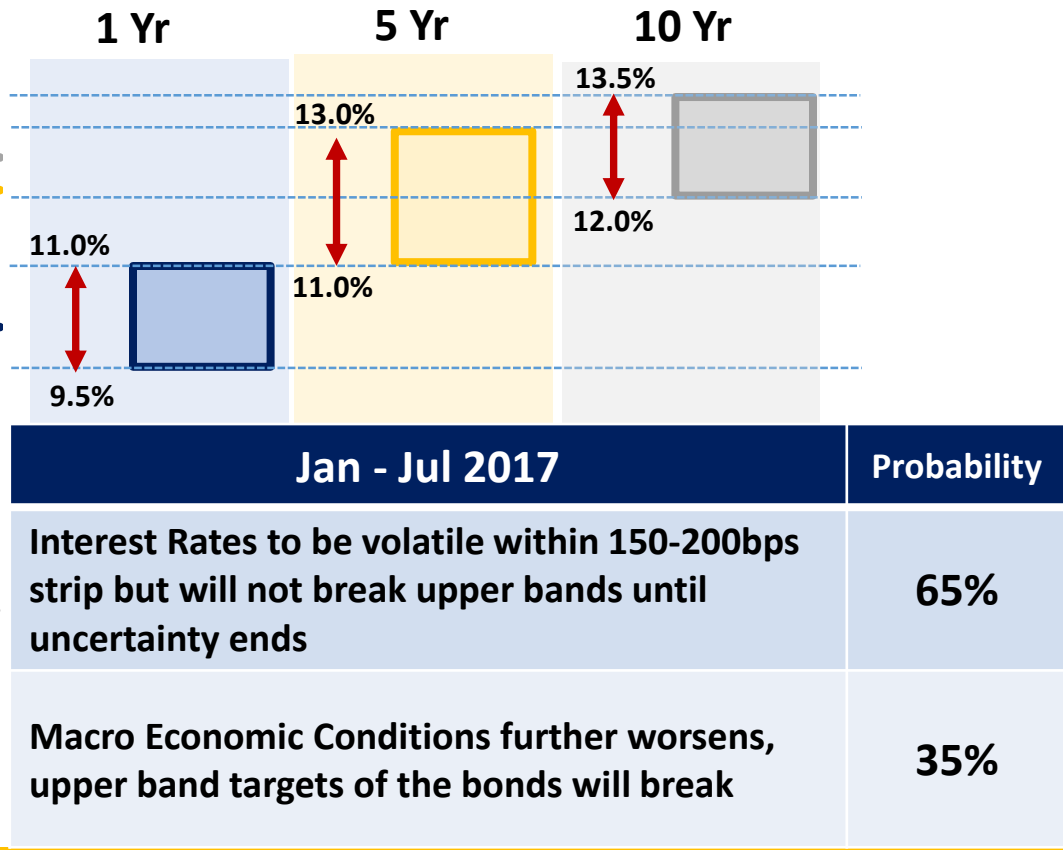
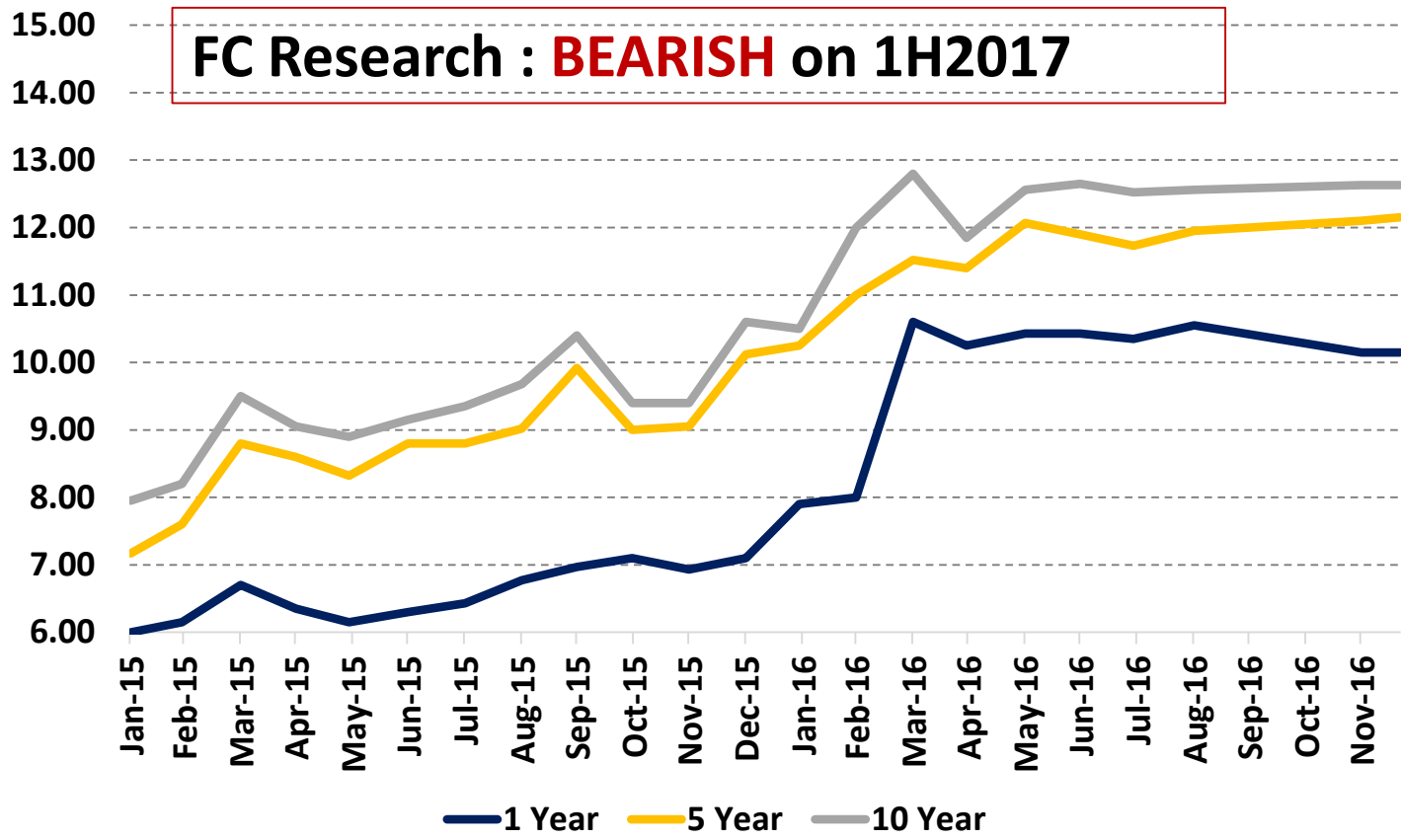
Rating Outlook	
External Environment	
BoT & BoP	
Political Risk	+01
Other (New Taxes)	-01

Total - 14/25 +00

Total	50 + (8+0) =	58
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Recap of Dec 2016 Expectations

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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