

FC Fixed Income Recommendation

JUNE 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
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

1.0 Economic Health Score

Jun 2017 Economic Health Score

Primary Criteria	-	36	+12	-	48
Secondary Criteria	-	14	+00	-	14

Economic Risk Score (Jun 2017) - 62

- (As against 50 in May 2017 & 44 in Feb 2017)
-

Changes to Health Score – Priority Criteria

Criteria	Update	Current Score	Add / Deduct Score	New Score
Foreign Reserves	Surge by USD 1.8Bn	04/15	+08	12/15
Liquidity	No significant change; Constant change towards small short/excess	07/15		07/15
Inflation	Dipped to 6.0%; FC Research expectation was 6.3%	11/15	+02	13/15
Foreign Buying	Increased by LKR16.7 Bn over the last 4 weeks; Foreign holdings reach 4.6%	02/10		02/10
Credit	March 2017 credit remains high; But we believe it may be one off	08/10		08/10
CBSL Holdings	CBSL Holdings decline by LKR 60Bn to LKR 208 Bn	04/10	+02	06/10

Primary Criteria - 36 + 12 = 48

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	No Change	04/05		04/05
BoT & BoP	Negative Balance of Payments position continues to be an issue	01/05		01/05
Political Risk	No Change	03/05		03/05
Other (New Taxes)	New IRA has not been gazetted as yet	01/05		01/05

Secondary Criteria - 14 + 0 = 14

2.0 Recommendation

Expectations for July 2017

PRIORITY CRITERIA

Foreign Reserves - 12/15		
Liquidity - 07/15		
Inflation - 13/15		
Foreign Buying - 02/10	+02	
Credit - 08/10		
CBSL Holdings - 06/10	+01	

Total - 48/75 +03

SECONDARY CRITERIA



Rating Outlook	- 05/05	
External Environment	- 04/05	
BoT & BoP	- 01/05	
Political Risk	- 03/05	+01
Other (New Taxes)	- 01/05	+04

Total - 14/25 +05

Total 62 + (3+5) = 70

Change in Probabilities

AS AT DEC 2016

Jan - Jul 2017	Probability	May 2017	Jun 2017
Interest Rates to be volatile within 150-200bps strip until uncertainty ends	65%	 70%	 85%
Macro Economic Conditions further worsens, upper band targets of the bonds will break	35%	30%	15%

Reasons for Expected July 2017 Health Score

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

- Acceleration in foreign buying
- Completion of passing of the New Inland Revenue Act
- Further reduction in CBSL Holdings via Funds received from Dollar buying by CBSL and possible net inflows into Debt or equity capital markets

Recommendation

Fixed Income Portfolio Recommendation

- Further increase portfolio exposure: BUY
- Increase capacity Utilization to 70% from 60%
- Possibility of Bonds touching the bottom bands of FC Research across the yield curve
- Need to watch out for the passing of the Inland Revenue Act
- Need to heavily target the possible July Bond Auction & Bill Auctions over the next few weeks

Sequence of Events

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

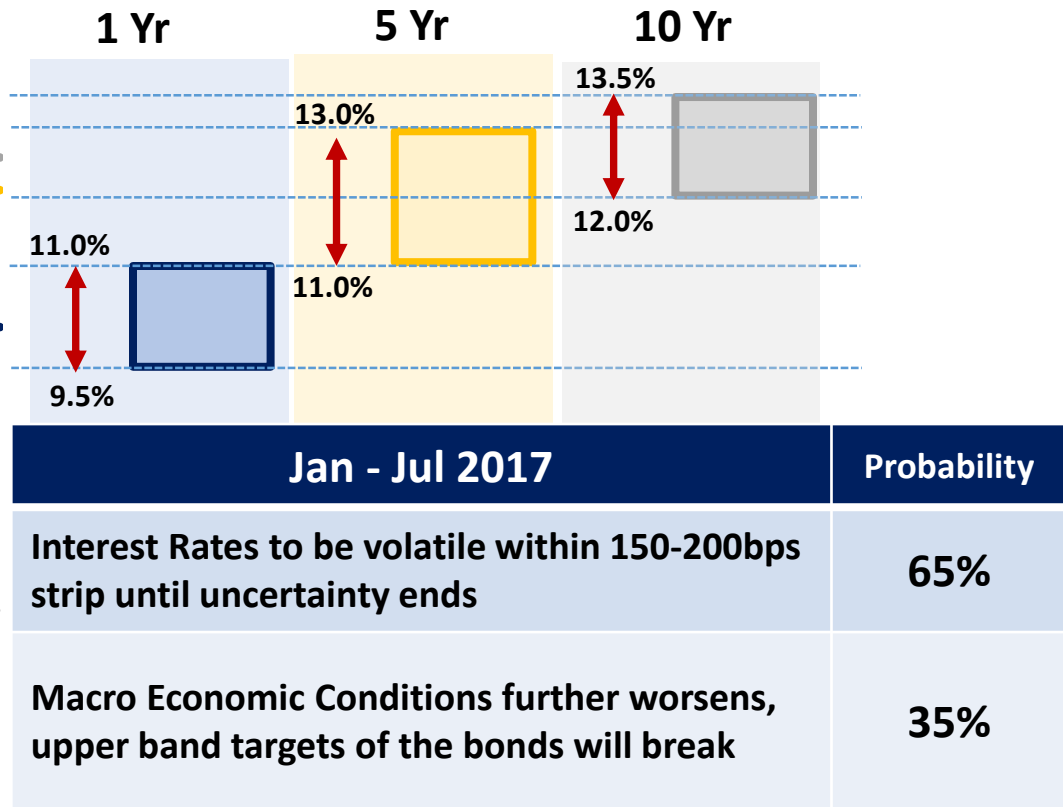
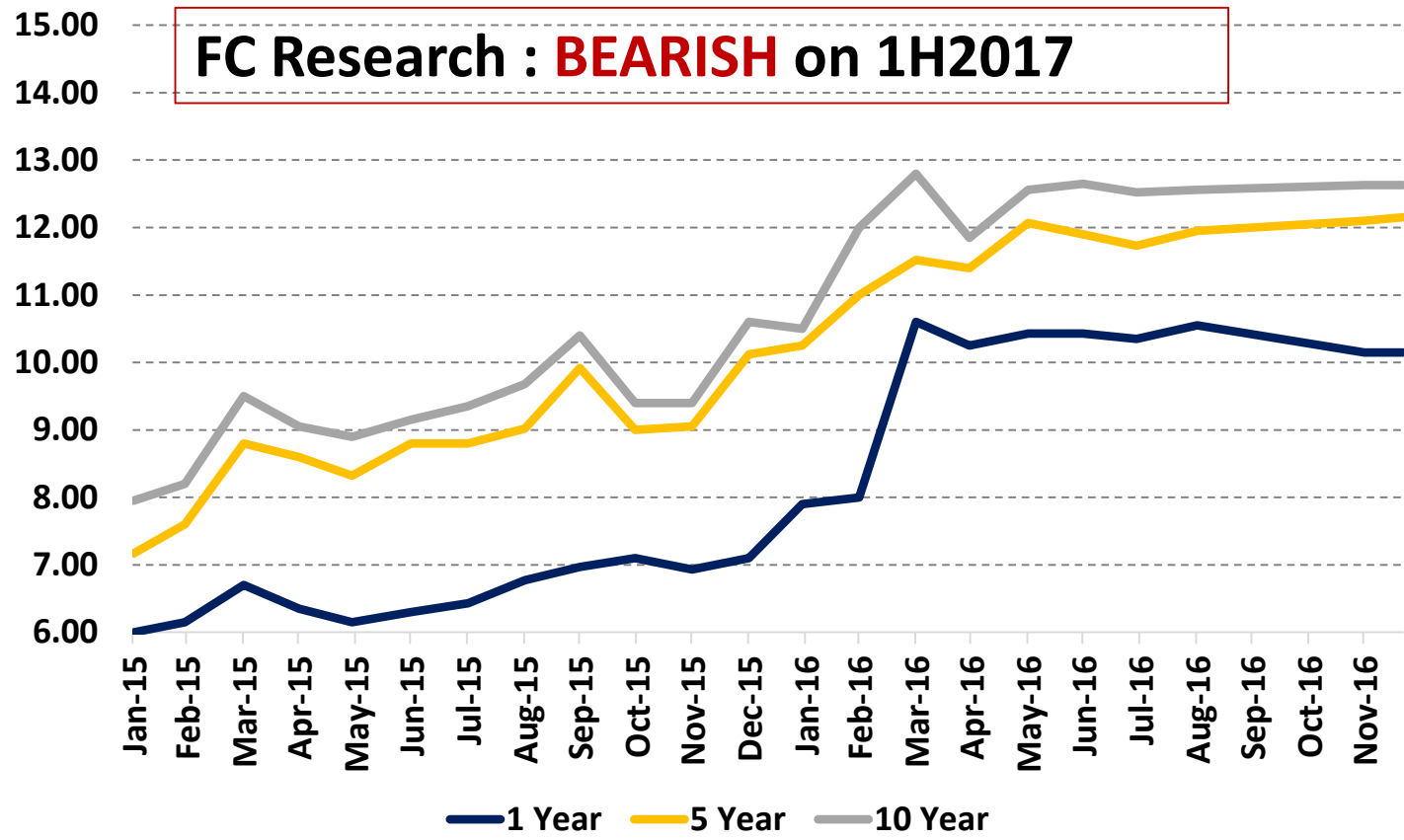
Early May 2017 – Comments on delay in Sovereign Bond; Hold portfolio and switch to Bills or shorter term securities.

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

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 watchout for Inland Revenue Act

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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