

# FC Fixed Income Recommendation

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JULY 2017

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



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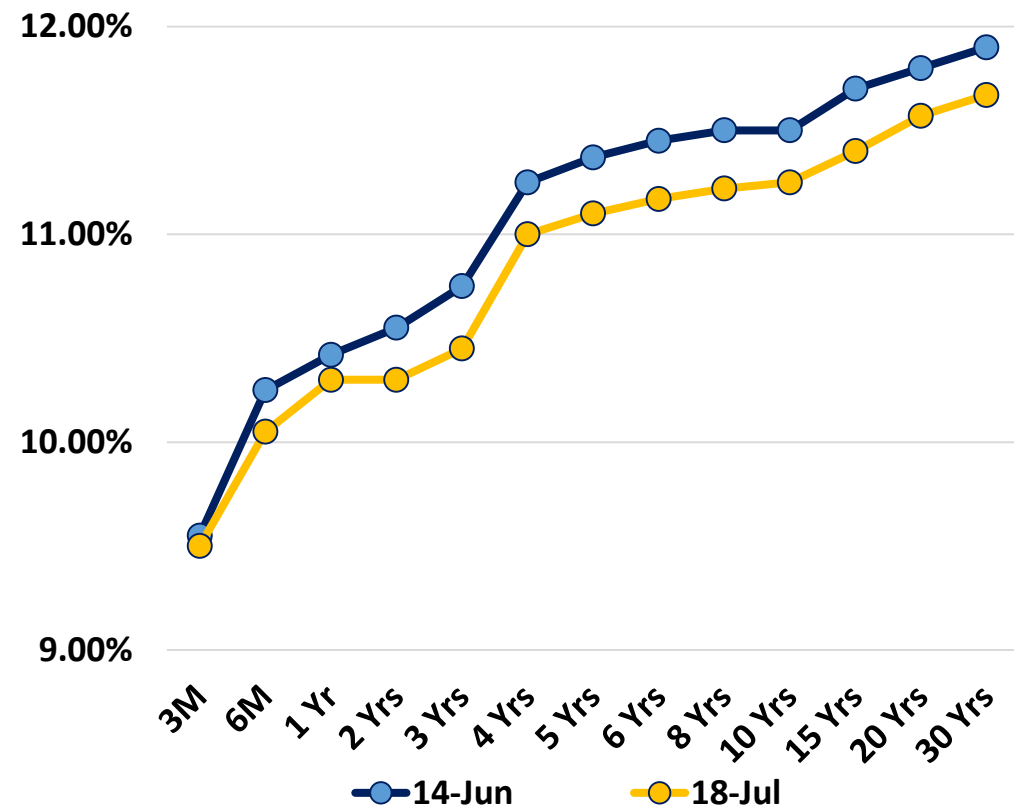
# Re-cap [Dec 2016]: Time Period vs Risk Score

	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	<b>&lt;50</b>	<b>50-75</b>	<b>75-100</b>	<b>50-75</b>
Rise in Rates by +1%	<b>High</b>	<b>Medium</b>	<b>Remote</b>	<b>Medium</b>
Utilization Recommendation	<b>Reduce</b>	<b>Slow Increase</b>	<b>Significantly Increase</b>	<b>Slow Decrease</b>
Utilization of Capacity	<b>Limited to 40% or less</b>	<b>Limited to 60% or less</b>	<b>Limited to 80% or less</b>	<b>Limited to 60% or less</b>

# Previous Month Jun 2016 Recommendation and Yield curve movement

Recommendation for Jun 2017 (Last month)

- 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



# 1.0 Economic Health Score

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# Jul 2017 Economic Health Score

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*Further improvement in the score; It is important to note some concerns arisen in the secondary criteria*

Primary Criteria	-	48 +04	-	52
Secondary Criteria	-	14 - 01	-	13

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Economic Health Score (Jul 2017) - 65

- (As against 62 in Jun 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 200Mn	12/15	+01	13/15
Liquidity	Turned positive and has maintain as excess over the last 2 days	07/15	+01	08/15
Inflation	CCPI at 6.1%; FC Research expectation was 6.0%	13/15		13/15
Foreign Buying	Net inflow of LKR 8.9Bn over the last 4 weeks; Foreign holdings reaches 4.9%	02/10	+01	03/10
Credit	April 2017 private sector credit slumped to LKR 18Bn; So far credit remains under control	08/10		08/10
CBSL Holdings	CBSL Holdings decline by LKR 55Bn to LKR 151 Bn	06/10	+01	07/10

Primary Criteria - 48 + 04 = 52

# 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	IMF approves 2 <sup>nd</sup> tranche to Sri Lanka	04/05	+01	05/05
BoT & BoP	Negative Balance of Payments position and slowdown in tourism earnings and decline in worker remittances	01/05	-01	00/05
Political Risk	Signs of elections towards end of 2017	03/05		03/05
Other (New Taxes)	Risk increases with publishing the gazette of the Inland Revenue Act	01/05	-01	00/05

Secondary Criteria - 14 + 01 - 02 = 13

# 2.0 Recommendation

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# Expectations for August 2017

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## PRIORITY CRITERIA

Foreign Reserves - 13/15		
Liquidity - 08/15	+01	
Inflation - 13/15		
Foreign Buying - 03/10	+01	
Credit - 08/10	+01	
CBSL Holdings - 07/10	+01	

**Total - 52/75 +04**

## SECONDARY CRITERIA



Rating Outlook - 05/05		
External Environment - 05/05		
BoT & BoP - 00/05		
Political Risk - 03/05		- 01
Other (New Taxes) - 00/05		

**Total - 13/25 -01**

<b>Total 65 + (4-1) = 68</b>
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# Probabilities for 2H2017

NOTE: PROBABILITIES FOR 2H2017 WAS DIFFERENT FROM 1H2017. AS AT DEC 2016 2H2017 FC RESEARCH WAS BULLISH FOR INTEREST RATES TO REMAIN LOW WHILE THERE IS A TENDENCY FOR RATES TO MOVE UP TOWARDS 4Q2017

As at Dec 2016	Probability	Jun 2017	Jul 2017
Interest Rates to decline and hit the lower bands (1 Yr – 9.5%, 5 Yr – 11.0%, 10 Yr – 12.0%)	65%	 85%	 90%
Probability of Systemic Risk increasing and thereby Rates moving up	35%	15%	10%

# Reasons for Expected August 2017 Health Score

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

- Acceleration in foreign buying
- Further reduction in CBSL Holdings via Funds received from Dollar buying by CBSL and possible net inflows into Debt or equity capital markets
- Continued slowdown in private sector credit growth and government borrowing requirement to improve liquidity

# Recommendation

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## Fixed Income Portfolio Recommendation

- 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

# Sequence of Events

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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

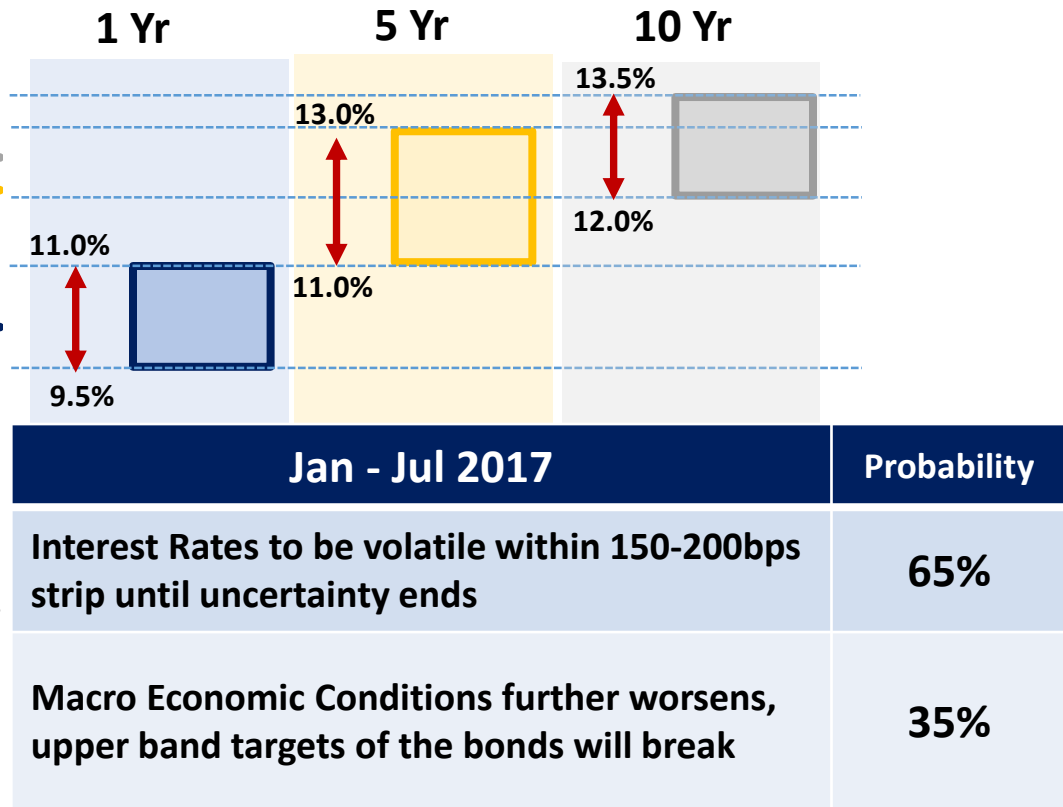
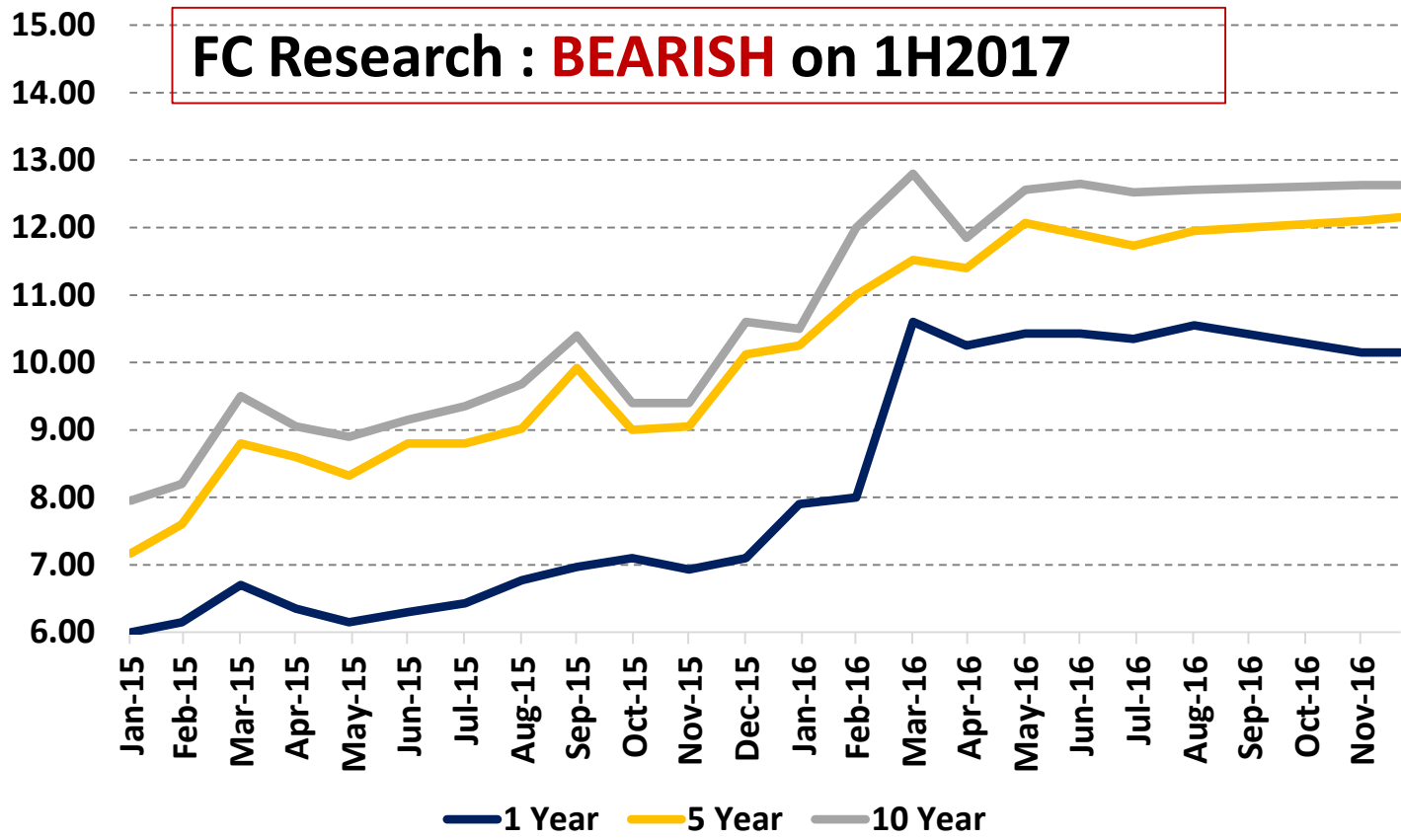
Jun 2017 – Concrete signs of future risk reducing; Increase capacity utilization to 70% from 60%; Possibility of overall yield curve touching bottom bands over next 2 months; But watchout for Inland Revenue Act

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

# 3.0 Recap of Dec 2016 Economic Wrap

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# 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 1<sup>st</sup> 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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