



First Capital
First Capital Research

First Capital Fixed Income Recommendation

16TH MARCH 2018

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ANALYST CERTIFICATIONS AND REQUIRED DISCLOSURES BEGIN ON PAGE 17

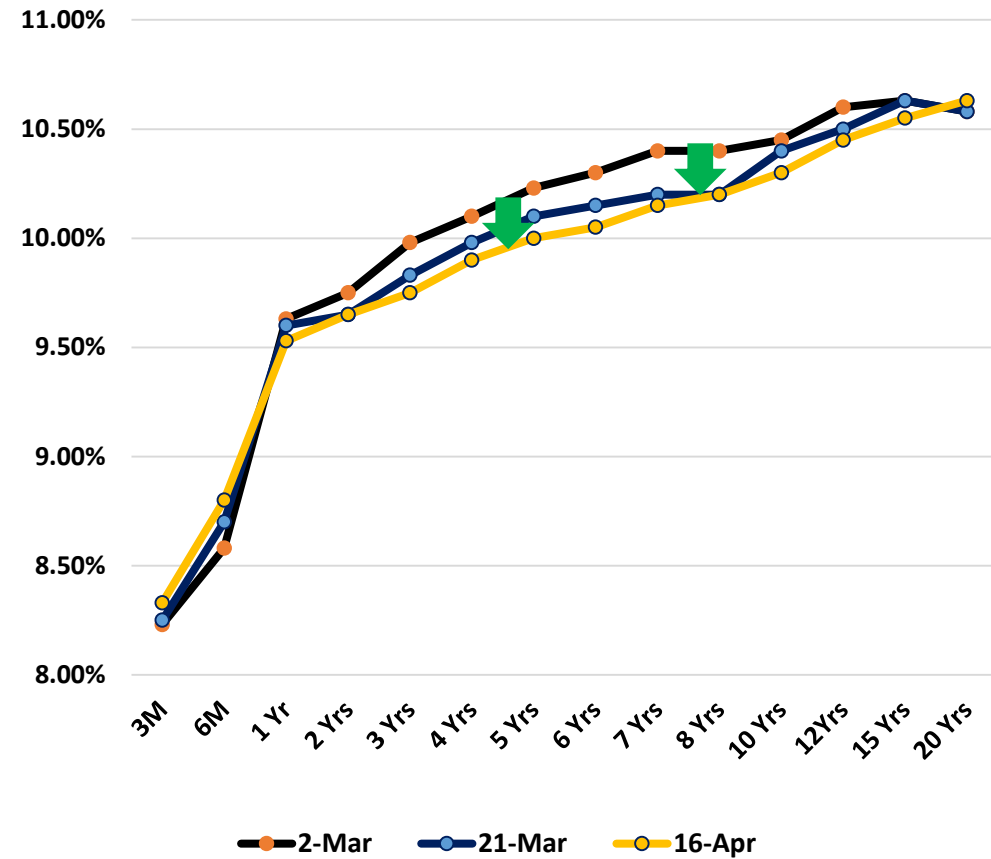
5th Mar & 22nd Mar Recommendations and Yield curve movement

Recommendation for 05th Mar 2018

- Portfolio Recommendation: **BUY** primarily into the short tenors (2Y, 3Y, 4Y) and mid tenors of 5Y, 6Y
- Portfolio exposure: Overall portfolio to be **increased to 50%**.
 - **Increase carry portfolio to 40% from 30%.**
 - Trading portfolio to be maintained to 10%.

Recommendation for 22nd Mar 2018

- Portfolio Recommendation: BUY primarily into the long tenors (8Y, 10Y)
 - Portfolio exposure: Overall portfolio to be **increased to 60%**.
 - **Increase Trading portfolio to 20% from 10%.** (Primarily into 8Y,10Y on the back of sovereign bond)
- Carry portfolio to be maintained to 40%.



Rate Movement Review (Last 45 Days)

Interest Rate Change (bps)					
Tenure	21-Mar	16-Apr	Change (bps)	2-Mar	Change (bps)
3M	8.25%	8.33%	8	8.23%	10
6M	8.70%	8.80%	10	8.58%	22
1 Yr	9.60%	9.53%	-7	9.63%	-10
2 Yrs	9.65%	9.65%	0	9.75%	-10
3 Yrs	9.83%	9.75%	-8	9.98%	-23
4 Yrs	9.98%	9.90%	-8	10.10%	-20
5 Yrs	10.10%	10.00%	-10	10.23%	-23
6 Yrs	10.15%	10.05%	-10	10.30%	-25
7 Yrs	10.20%	10.15%	-5	10.40%	-25
8 Yrs	10.20%	10.20%	0	10.40%	-20
10 Yrs	10.40%	10.30%	-10	10.45%	-15
12Yrs	10.50%	10.45%	-5	10.60%	-15
15 Yrs	10.63%	10.55%	-8	10.63%	-8
20 Yrs	10.58%	10.63%	5	10.58%	5

- Overall yield curve shifted upwards amidst some selling pressure was observed in the mid tenors last few days
- Following our previous report on 26th Mar 2018, yields registered 35-70bps upward movement in 5Yr to 20Yr after bond auction held on 28th March 2018. 5Yr bond peak at 10.7% and 10Yr peak at 11.15%.
- During 1st and 2nd week of April registering a strong down trend with 50-70bps dip immediately after CBSL rate cut and assumption of Sovereign bond issue.
- The attractive 5Yr and 10Yr had the biggest drop of 70-90bps from peak with some profit taking .

1.0 Economic Health Score

Apr 2018 Economic Health Score

Health score dip below 70 again

Primary Criteria	-	60	-	5	-	55		
Secondary Criteria	-	11	+	1	-	2	-	10

Economic Health Score (Apr 2018) - 65

- [As against 71 in Mar 2018 & 47 in Mar 2017 (1 Year ago)]

Changes to Health Score – Priority Criteria

Criteria	Update	Current Score	Add / Deduct Score	New Score
Foreign Reserves	Mar 2018 Reserves dropped USD 613Mn to USD7.3Bn which is equivalent to 3.8 months of imports, in spite of CBSL purchasing USD 98.5Mn from the market.	13/15	-02	11/15
Liquidity	Liquidity level saw heavy volatility with CBSL conducting few reverse repo auction during last 2 weeks to maintain liquidity	09/15	-01	08/15
Inflation	CCPI at 4.2%, lower than First Capital Research expectation of 4.5%; Core Inflation remained 3.5%.	13/15		13/15
Foreign Buying	Foreign inflow mixed with both buying and selling netting with LKR 0.67Bn	06/10		06/10
Credit	Feb credit picked up to LKR 58Bn still fell below desire level of LKR 60Bn to achieve 15% growth	09/10		09/10
CBSL Holdings	CBSL Holdings saw drastic increase last week to LKR 72Bn.	10/10	-02	08/10

Primary Criteria - 60 - 5 = 55

Changes to Health Score – Secondary Criteria

Criteria	Update	Current Score	Add / Deduct Score	New Score
Rating Outlook	No major changes	05/05		05/05
External Environment	Fed rate increased by 25bps. Currency continuously remain weak.	01/05		01/05
BoT & BoP	BOP remain strong with inflows in spite widening of the trade deficit.	01/05		01/05
Political Risk	Uncertain environment slowly subsiding with coalition government.	01/05	+01	02/05
Investor Confidence	LMD-Nielson Business Confidence index shed to 117, below 12 month average of 119 and 17 notches shy of the median 134	03/05	-02	01/05

Secondary Criteria - 11 + 1 - 2 = 10

2.0 Recommendation

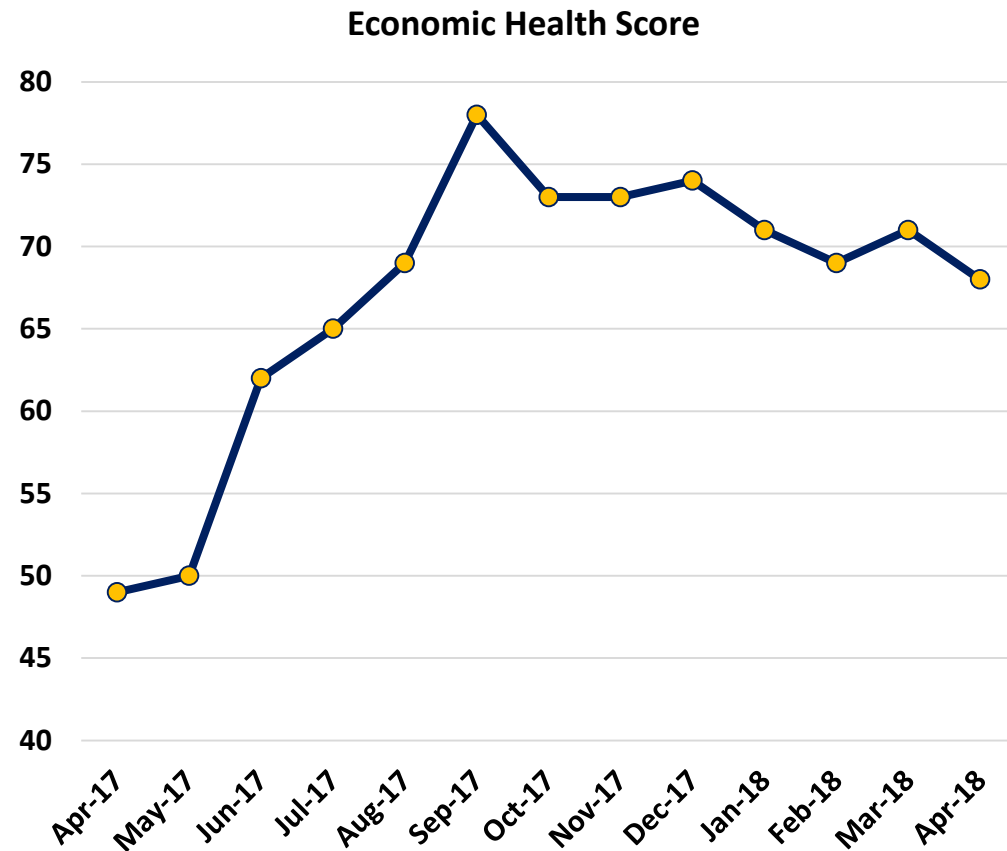
Recommendation

Fixed Income Portfolio Recommendation

– Portfolio Recommendation: **Slowly Reduce** overall portfolio **to 50%** from previous 60% mainly on mid-long tenors (5Y to 10Y).

- **Reduce Trading portfolio to 10% from 20%.** (Primarily into 5Y to 10Y).
- Carry portfolio to be maintained to 40%.

We expect economic health score to improve in May and June with successful issuance of USD 2.5Bn sovereign bond. Afterwards, health score to slowly deteriorate towards Jul and Aug due to high maturities in 3Q2018.



Sequence of Events

24th Nov 2017 – Hold position as carry portfolio. Capacity Utilization maintained at 40%. Watch out for the effects of the Fed rate hike on the market

22nd Dec 2017 – Cautiously BUY primarily into the short tenors of 2Y, 3Y and 4Y at or above 9.5%, 9.75% and 10.0% levels. Increase carry portfolio to 50% from 40%.

18th Jan 2018 – Previous plans of increasing carry portfolio to 50% failed as rates further fell sharply. Cut carry portfolio to 30% from 40%. Trading portfolio to be maintained at 0%. SELL primarily the shortest tenors of 3M and 6M and consider lending in the REPO market

16th Feb 2018 – **BUY** primarily into the short tenors (2Y, 3Y, 4Y) and mid tenors of 5Y, 6Y. Overall portfolio to be increased to 40%. Increase Trading portfolio to 10% from 0%. Carry portfolio to be maintained to 30%.

5th Mar 2018 - **BUY** primarily into the short tenors (2Y, 3Y, 4Y) and mid tenors of 5Y, 6Y. Overall portfolio to be increased to 50%. Increase carry portfolio to 40% from 30%. Trading portfolio to be maintained to 10%.

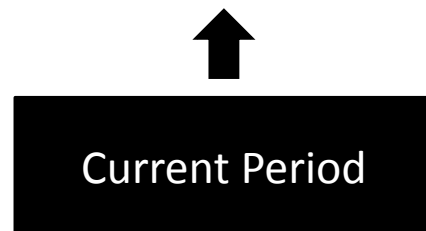
22nd Mar 2018 - **BUY** primarily into the long tenors (8Y, 10Y). Overall portfolio to be increased to 60%. Increase Trading portfolio to 20% from 10%. (Primarily into 8Y, 10Y on the back of sovereign bond). Carry portfolio to be maintained to 40%.

16th Mar 2018 - **Reduced** overall portfolio to 50% from previous 60% mainly on mid-long tenors (5Y to 10Y). Cut Trading portfolio to 10% from 20%. (Primarily into 5Y to 10Y). Carry portfolio to be maintained to 40%.

3.0 Recap of Jan2018 Economic Wrap

Re-cap [Jan 2018]: Time Period vs Health Score

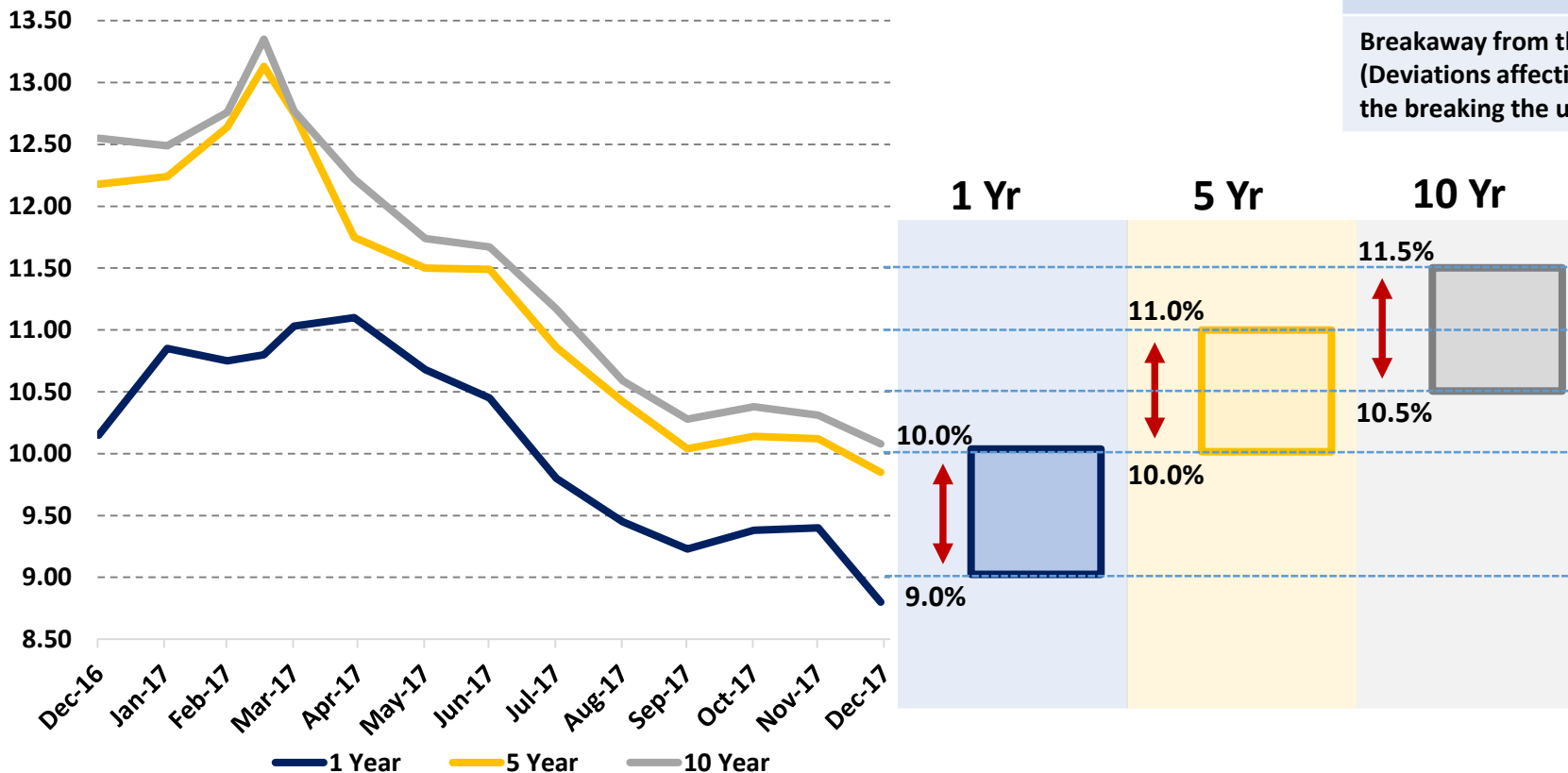
	3 Months Outlook Jan-Mar 2018	3-6 Months Outlook Apr-Jun 2018	6-9 Months Outlook Jul-Sep 2018	9-12 Months Outlook Oct-Dec 2018
Health Score Estimate	65-75	65-75	60-65	65-75
Risk Level – Jan 2018	Medium-Low	Medium-Low	Medium	Medium-Low



Interest Rates to be Bearish towards 2Q-3Q2018 (12 months)

Expectations: **Bearish** towards 2Q-3Q2018

Jan 2018 – Dec 2018	Probability	Impact
Interest Rates to be upward trending towards 2Q-3Q2018 and reaching upper bands	65%	Moderately Bearish / Stable
Breakaway from the continuous reform program (Deviations affecting IMF program) may result in the breaking the upper bands	35%	Very Bearish



Base Case (65% Probability) – Explanation

With higher borrowing requirement resulting in tight monetary conditions and increase in inflation could push the yield curve towards the upper bands. It could result in an increase in CBSL Holdings as well to manage interest rates.

Pressure could ease somewhat in 4Q2018, but will be short lived as debt payments continue to be high in 1Q & 2Q in 2019 with the maturity of the Sovereign Bonds

Policy Rate Expectations

On a base case First Capital Research expects a policy rates to remain stable throughout 2018. However, if GDP growth fails to pickup we expect policy rates to be cut by 25 basis points towards end of 3Q2018

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