



First Capital
First Capital Research

First Capital Fixed Income Recommendation

16TH FEBRUARY 2018

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ANALYST CERTIFICATIONS AND REQUIRED DISCLOSURES BEGIN ON PAGE 17

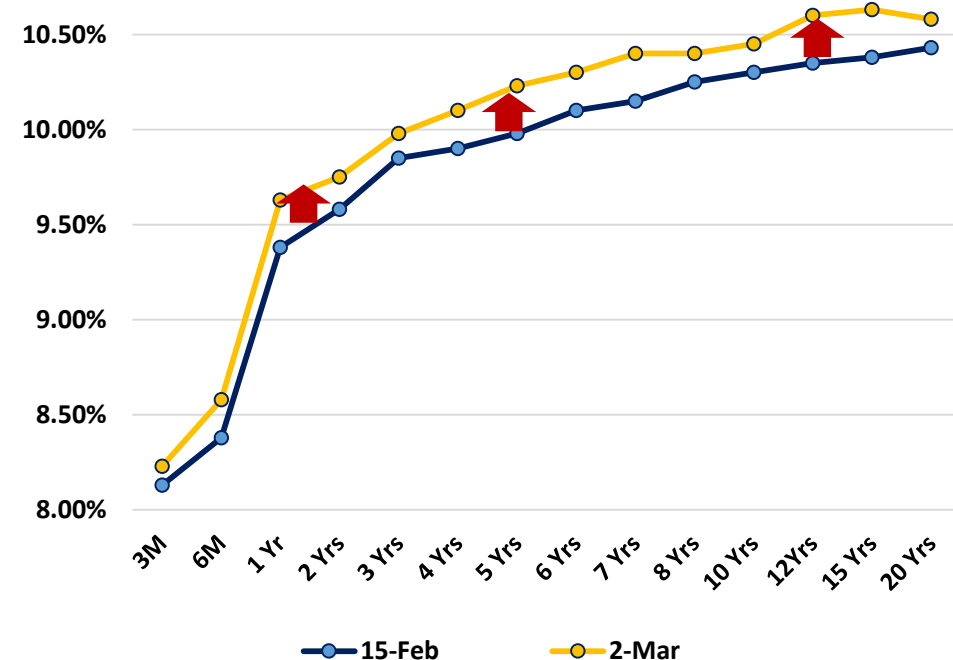
Previous Month 18th Jan Recommendations and Yield curve movement afterwards

Recommendation for 18th Jan 2018 (Last month)

- Previous plans of increasing carry portfolio to 50% failed as rates further fell sharply
- Portfolio exposure: **Cut carry portfolio to 30% from 40%**. Trading portfolio to be maintained at 0%
- Portfolio Recommendation: **SELL** primarily the shortest tenors of 3M and 6M and consider lending in the REPO market
- Yields of shortest tenors of 3M and 6M are considered to be too low with the recent fall in rates.

We continue expect the overall yield curve to move upwards amidst the pressure in rates towards the 2Q and 3Q of 2018.

Yield Movement [17th Jan – 15th Feb]



Rate Movement Review

Interest Rate Change (bps)			
Tenure	17-Jan	15-Feb	Change (bps)
3M	7.50%	8.13%	63
6M	8.00%	8.38%	38
1 Yr	8.85%	9.38%	53
2 Yrs	9.05%	9.58%	53
3 Yrs	9.20%	9.85%	65
4 Yrs	9.40%	9.90%	50
5 Yrs	9.55%	9.98%	43
6 Yrs	9.60%	10.10%	50
7 Yrs	9.65%	10.15%	50
8 Yrs	9.82%	10.25%	43
10 Yrs	9.87%	10.30%	43
12Yrs	9.95%	10.35%	40
15 Yrs	10.12%	10.38%	26
20 Yrs	10.12%	10.43%	31

- ❑ Following our previous report on 18th Jan 2018, yields registered a significant upward movement over the last 2-3 weeks with big spike especially after LG polls result
- ❑ Economic health showed signs of deterioration with some outflows and uncertainty on the political front. However, Monetary Board maintained policy rates.
- ❑ Foreign outflow of LKR 6.0Bn was observed last week with some profit taking amidst very low level of yields in most bonds.
- ❑ Overall yield curve shifted upwards and heavy selling pressure was observed in the mid tenors.

1.0 Economic Health Score

Feb 2018 Economic Health Score

Health score remains near to 70 despite a marginal dip while further downtrend anticipated towards mid 2Q;

Primary Criteria - 60 - 02+ 01 - 59 ↓

Secondary Criteria - 11 - 01 - 10 ↓

Economic Health Score (Feb 2018) - 69 ↓

- [As against 71 in Jan 2018 & 44 in Feb 2017 (1 Year ago)]

Changes to Health Score – Priority Criteria

Criteria	Update	Current Score	Add / Deduct Score	New Score
Foreign Reserves	Jan 2018 Reserves dipped by USD 250Mn to USD7.7Bn which is equivalent to 4.4 months of imports, in spite of CBSL purchasing USD 191Mn from the market.	14/15	-01	13/15
Liquidity	Liquidity level was moderate at LKR 24Bn following continuous volatility during last 2 weeks.	09/15		09/15
Inflation	CCPI at 5.8%, below the First Capital Research expectation being 6.7%; Significant decline in Core Inflation.	11/15	+01	12/15
Foreign Buying	Net outflow of LKR 6 Bn over the last week suggests slowdown in foreign interest	07/10	-01	06/10
Credit	Nov & Dec 2017 credit improved to LKR 60.0Bn	09/10		09/10
CBSL Holdings	CBSL Holdings drop to LKR 2.3Bn	10/10		10/10

Primary Criteria - 60 – 02 +01 = 59

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	Next Fed rate hike expectations advanced to Mar 2017 might increase outflows	02/05	-01	01/05
BoT & BoP	BoP was remained at USD +2.0Bn as at Nov2017. Trade Deficit for Nov 2017 YoY expanded which is a bad sign but need to check.	01/05		01/05
Political Risk	Uncertainty maintained after LG Polls	00/05		00/05
Investor Confidence	LMD-Nielson Business Confidence index climbed to 127, well above 12 month average of 118 but behind the all time mean of 130 – 23% state that economy will improve in the coming 12 months as against 20% 1 month ago and 11% 3 months ago	03/05		03/05

Secondary Criteria - 11 - 01 = 10

2.0 Recommendation

Expectations for (Mar-Jun 2018)

PRIORITY CRITERIA

Foreign Reserves	13/15	-01
Liquidity	09/15	
Inflation	12/15	-01
Foreign Buying	06/10	-01
Credit	09/10	
CBSL Holdings	10/10	

Total - 59/75 -03

SECONDARY CRITERIA

Rating Outlook	05/05	
External Environment	01/05	-01
BoT & BoP	01/05	
Political Risk	00/05	
Investor Confidence	03/05	

Total - 10/25 -01

Total 69 - 04 = 65

Reasons for Expected 1Q2018 Health Score

We expect Economic Health Score to start to slowly deteriorate towards 2Q2018 due to:

- High debt payments towards 2Q-3Q2018
- Possible rise in inflation and core inflation towards 2Q2018
- Lower levels of liquidity in the market

Recommendation

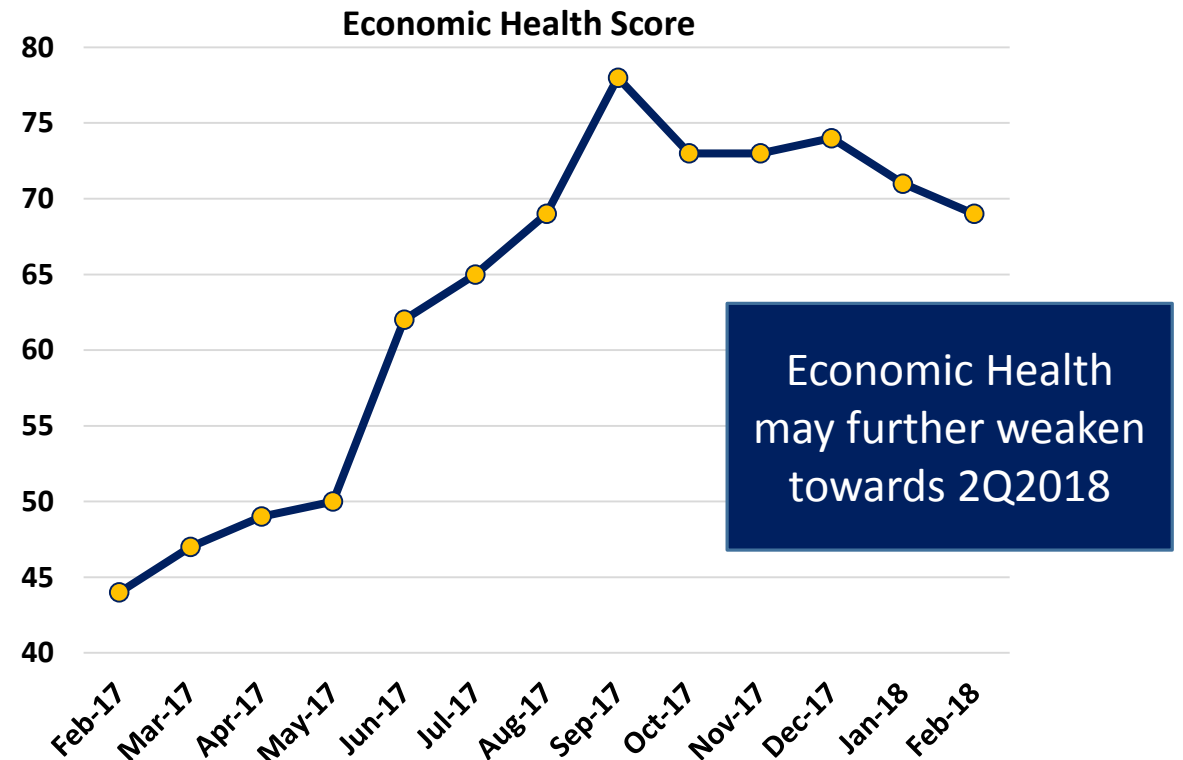
Fixed Income Portfolio Recommendation

— 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 40%.
 - **Increase Trading portfolio to 10% from 0%.**
 - Carry portfolio to be maintained to 30%.

– Yields of short tenors of 2Y, 3Y and 4Y have fallen into a buy range while 5Y and 6Y have also registered attractive price levels to initiate accumulation

We continue expect the overall yield curve to move upwards amidst the pressure in rates towards the 2Q and 3Q of 2018.



Sequence of Events

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%

17th Oct 2017 – Hold position as carry portfolio. Capacity Utilization maintained at 40%

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%.

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

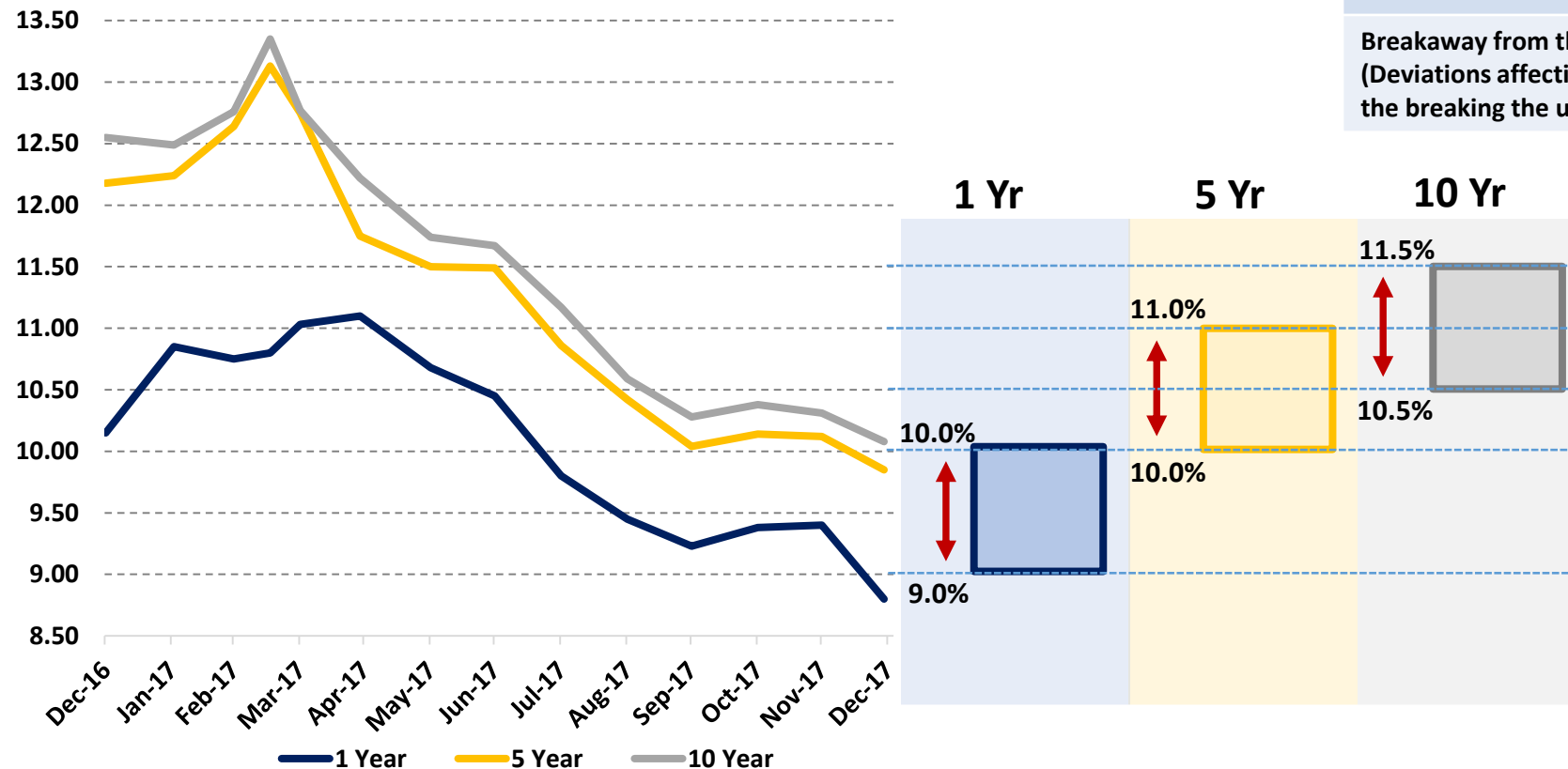


Current Period

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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