

# First Capital Fixed Income Recommendation

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18<sup>TH</sup> JANUARY 2018

ANALYST CERTIFICATIONS AND REQUIRED DISCLOSURES BEGIN ON PAGE 17



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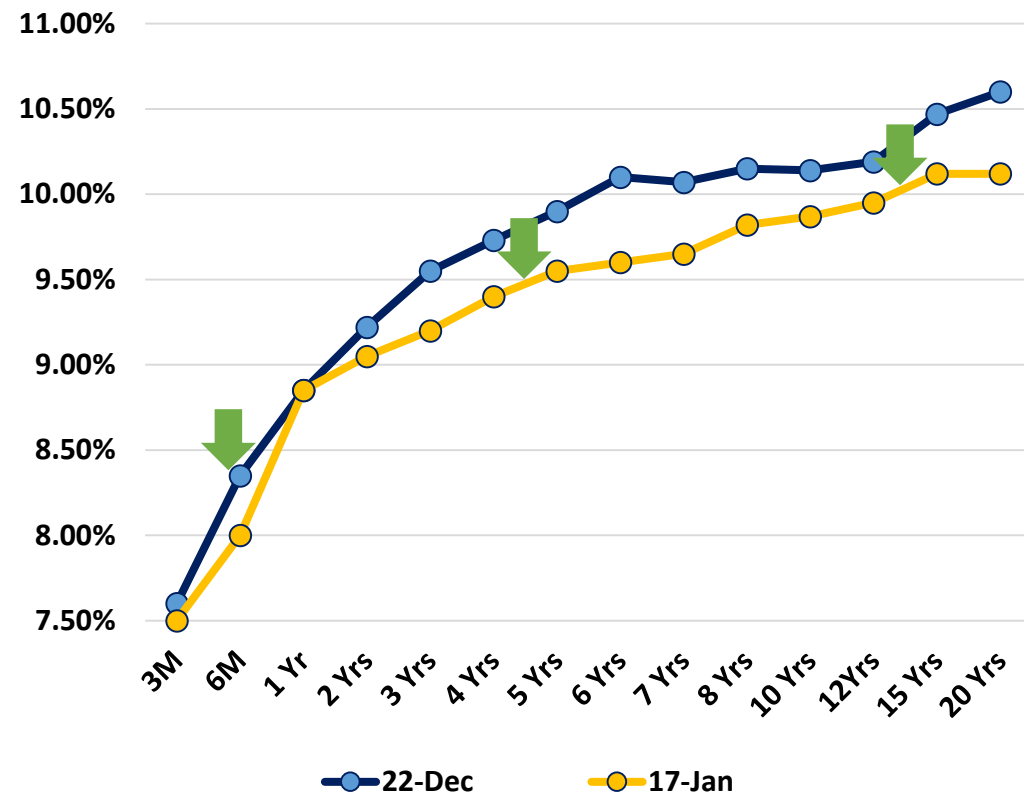
# Previous Month 22<sup>nd</sup> Dec Recommendations and Yield curve movement afterwards

## Recommendation for 22<sup>nd</sup> Dec 2017 (Last month)

- Portfolio exposure: Increase carry portfolio to 50% from 40% [to represent the lower future risk with health score being maintained] Trading portfolio to be maintained at 0%
- Portfolio Recommendation: **Cautiously BUY** primarily into the short tenors of 2Y, 3Y and 4Y at or above 9.5%, 9.75% and 10.0% levels
- Yields of shortest tenors of 3M, 6M and 1Y 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 [22<sup>nd</sup> Dec – 17<sup>th</sup> Jan]



# Rate Movement Review

Interest Rate Change (bps)			
Tenure	22-Dec	17-Jan	Change (bps)
3M	7.60%	7.50%	-10
6M	8.35%	8.00%	-35
1 Yr	8.85%	8.85%	0
2 Yrs	9.22%	9.05%	-17
3 Yrs	9.55%	9.20%	-35
4 Yrs	9.73%	9.40%	-33
5 Yrs	9.90%	9.55%	-35
6 Yrs	10.10%	9.60%	-50
7 Yrs	10.07%	9.65%	-42
8 Yrs	10.15%	9.82%	-33
10 Yrs	10.14%	9.87%	-27
12Yrs	10.19%	9.95%	-24
15 Yrs	10.47%	10.12%	-35
20 Yrs	10.60%	10.12%	-48

- ❑ Following our previous report on 22<sup>nd</sup> Dec 2017, the downtrend in yields which was prevalent over the last 6-7 weeks, continued with heavy local investor interest.
- ❑ Economic health did not show any signs of falling back and the Monetary Board maintained policy rates which informing the jump in foreign reserves to USD 8.0Bn.
- ❑ Some foreign outflow was observed over the last 2 weeks with some profit taking amidst the heavy price appreciation.
- ❑ Overall yield curve shifted down and heavy buying was observed in the extreme shorter tenors (less than 1Yr).
- ❑ In addition for the first time an upward movement was experienced which is illustrated with 1Yr remaining flat over the 4 weeks.

# 1.0 Economic Health Score

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# Dec 2017 Economic Health Score

*Health score remains **strong (above 70)** despite a marginal dip while further downtrend anticipated towards mid 2Q;*

Primary Criteria	-	62 - 02	-	60	↓
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Secondary Criteria	-	12 - 01	-	11	↓
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Economic Health Score (Jan 2018)	-	71	↓
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- [As against 74 in Dec 2017 & 44 in Feb 2017 (11 months ago)]

# Changes to Health Score – Priority Criteria

Criteria	Update	Current Score	Add / Deduct Score	New Score
Foreign Reserves	Dec 2017 Reserves hit USD8.0Bn (Rise in imports to USD 1.7Bn per month have resulted in USD7Bn now being required for minimum 4 months of imports)	14/15		14/15
Liquidity	Liquidity level was low at LKR 6Bn following continuous decline	10/15	-01	09/15
Inflation	CCPI at 7.1%, broadly in line with FC Research expectations being at 7.2%; Core inflation remains under control.	11/15		11/15
Foreign Buying	Net outflow of LKR 2 Bn over the last 4 weeks suggests slowdown in foreign interest	08/10	-01	07/10
Credit	Oct & Nov 2017 credit marginally improved but Government was net a settler	09/10		09/10
CBSL Holdings	CBSL Holdings slightly increased to LKR 13Bn	10/10		10/10

Primary Criteria - 61 - 02 = 60

# 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	03/05	-01	02/05
BoT & BoP	BoP was remained at USD +2.0Bn as at Oct 2017. Trade Deficit for Oct 2017 YoY dipped which is a good sign but need to check sustainability	01/05		01/05
Political Risk	Uncertainty to prevail until LG election finishes	00/05		00/05
Investor Confidence	LMD-Nielson Business Confidence index climbed marginally, edging above the 12 month average of 118 but behind the all time mean of 130 – 20% state that economy will improve in the coming 12 months as against 18% 1 month ago and 21% 2 months ago	03/05		03/05

Secondary Criteria - 12 - 01 = 11

# 2.0 Recommendation

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# Expectations for 1Q2018 (Jan-Mar)

## PRIORITY CRITERIA

Foreign Reserves	14/15	-02
Liquidity	09/15	-01
Inflation	11/15	
Foreign Buying	07/10	-01
Credit	09/10	-01
CBSL Holdings	10/10	-01

**Total** - 60/75 -06

## SECONDARY CRITERIA

Rating Outlook	05/05	
External Environment	02/05	
BoT & BoP	01/05	
Political Risk	00/05	+03
Investor Confidence	03/05	

**Total** - 11/25 +03

<b>Total</b> 71 + (-6) +3 = 68
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# Reasons for Expected 1Q2018 Health Score

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

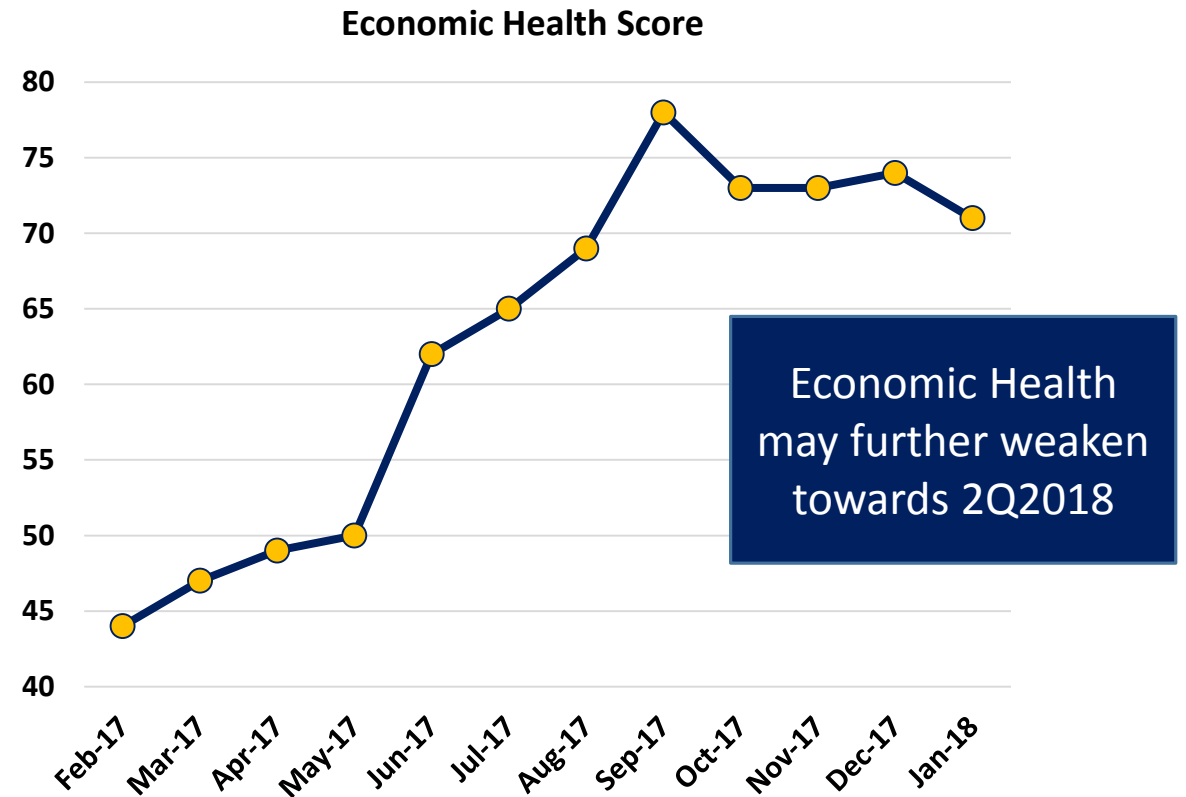
- High debt payments towards 2Q2018
- Possible rise in inflation and core inflation towards 2Q2018
- Lower levels of liquidity in the market

# Recommendation

## Fixed Income Portfolio Recommendation

- 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.*



# Sequence of Events

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31<sup>st</sup> Jul 2017 – SELL all mid tenors (4y, 5y, 6y, 8y). Capacity Utilization to be reduced to 60%

14<sup>th</sup> Aug 2017 – Start reducing position in shorter tenors. Capacity Utilization to be reduced to 50%

21<sup>st</sup> Sep 2017 – Further reduce position. Capacity Utilization to be reduced to 40%

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

24<sup>th</sup> 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

22<sup>nd</sup> 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%.

18<sup>th</sup> 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

# 3.0 Recap of Aug 2017 Economic Wrap

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# Re-cap [Aug 2017]: Time Period vs Health Score

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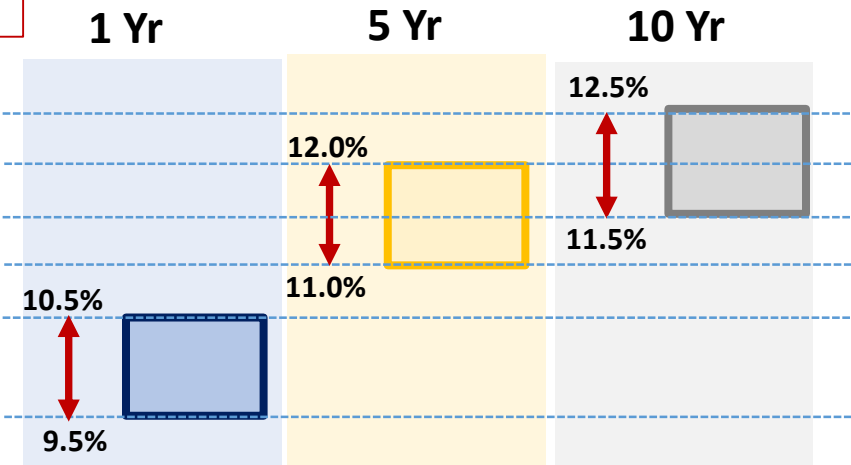
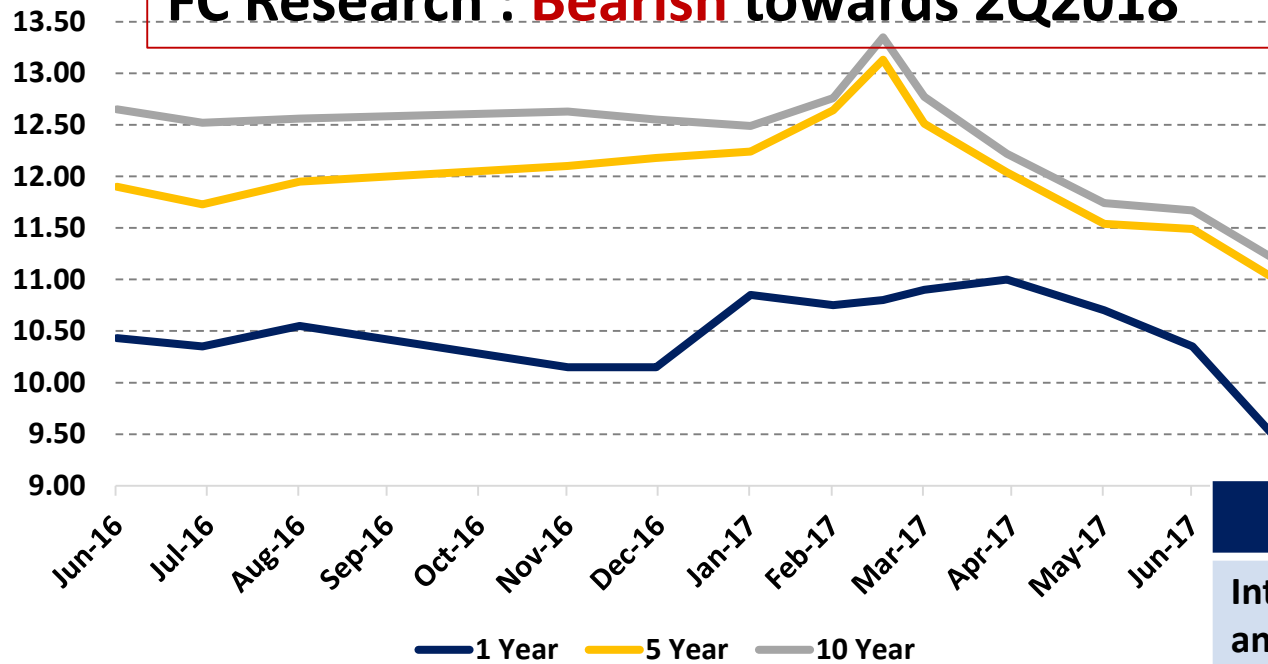
	3 Months Outlook Jul-Sep 2017	3-6 Months Outlook Oct-Dec 2017	6-9 Months Outlook Jan-Mar 2018	9-12 Months Outlook Apr-Jun 2018
Health Score Estimate	75-100	65-75	60-65	50-60
Risk Level	Remote	Medium-Low	Medium	Medium-High



Current Period

# Interest Rates to be Bearish towards 2Q2018 despite stable 2H2017 (12 months)

**FC Research : Bearish towards 2Q2018**



Jul 2017 – Aug 2018		Probability
Interest Rates to be upward trending towards 2Q2018 and reaching upper bands		65%
Strong Foreign inflows stabilizing interest rates around the lower bands		35%

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