

# FC Fixed Income Recommendation

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22<sup>ND</sup> DECEMBER 2017

**ANALYST CERTIFICATIONS AND REQUIRED DISCLOSURES  
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# Previous Month 24<sup>th</sup> Nov Recommendations and Yield curve movement afterwards

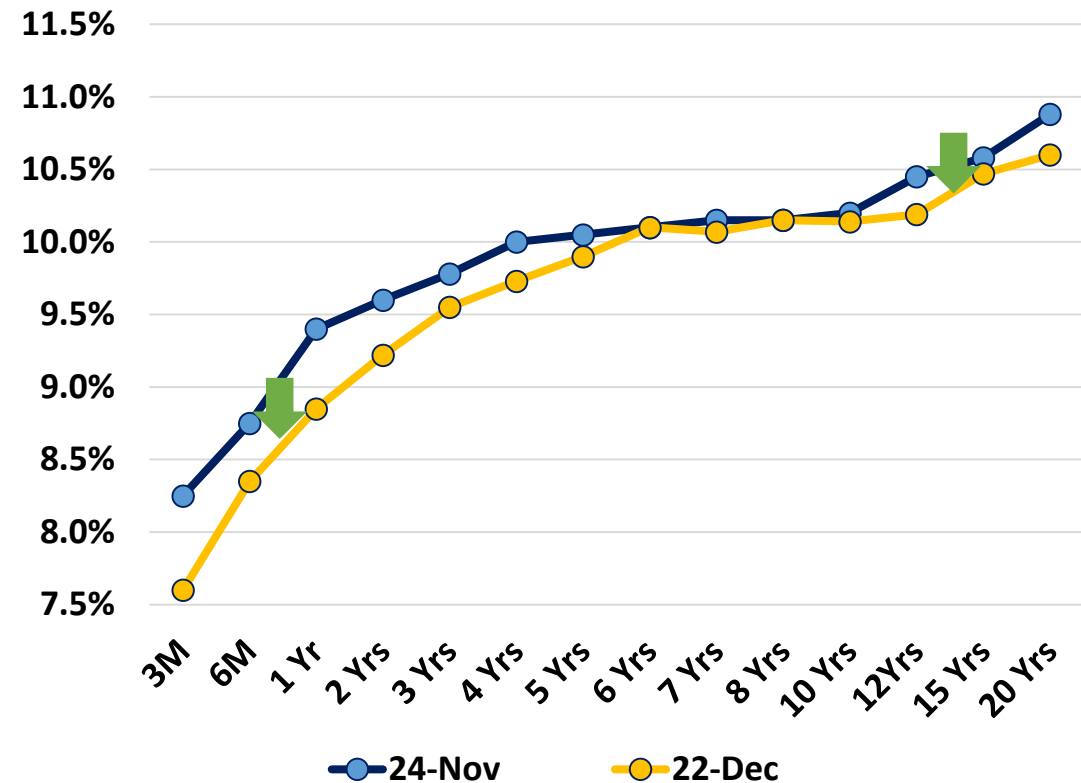
## Recommendation for 24<sup>th</sup> Nov 2017 (Last month)

- Portfolio exposure: HOLD [Already reached minimum level]
- Capacity Utilization to be maintained at 40% as carry portfolio
- All remaining positions to be held in short term securities.

***Short tenors have now reached the lower bands on FC Research expectations. We expect mid-long tenors to adjust upwards to reach FC Research lower bands over the next few months possibly supported by the expected US Fed Rate hike***

***Despite stability returning to the market and possible chances to increase carry portfolio remains we would prefer to see the Fed rate hike and its effects on the market before increasing exposure to the carry portfolio***

Yield Movement [24<sup>th</sup> Nov – 22<sup>nd</sup> Dec]



# Rate Movement Review

Interest Rate Change (bps)			
Tenure	24-Nov	22-Dec	Change (bps)
3M	8.25%	7.60%	-65
6M	8.75%	8.35%	-40
1 Yr	9.40%	8.85%	-55
2 Yrs	9.60%	9.22%	-38
3 Yrs	9.78%	9.55%	-23
4 Yrs	10.00%	9.73%	-27
5 Yrs	10.05%	9.90%	-15
6 Yrs	10.10%	10.10%	0
7 Yrs	10.15%	10.07%	-8
8 Yrs	10.15%	10.15%	0
10 Yrs	10.20%	10.14%	-6
12Yrs	10.45%	10.19%	-26
15 Yrs	10.58%	10.47%	-11
20 Yrs	10.88%	10.60%	-28

- ❑ Following our previous report on 24<sup>th</sup> Nov 2017, the downtrend in yields which was prevalent from before the last report, continued after the report as well following the strong economic health indicators in the economy.
- ❑ Economic health did not show any signs of falling back resulting in sharp price appreciation primarily in the shorter tenor maturities.
- ❑ Shorter tenors upto the 5 Year saw sharp dip in yields with heavy biasness towards the extreme short tenors 3M, 6M & 1Y. Some buying interest was also observed in the longer tenors.
- ❑ Heavy foreign interest was observed supporting the downtrend in yields.

# 1.0 Economic Health Score

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# Dec 2017 Economic Health Score

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Health score remain healthy as *Economic Health stands Strong (above 70)* despite anticipated downturn;

Primary Criteria	-	61	+ 03	- 02	-	62	↑
Secondary Criteria	-	12	+ 01	- 01	-	12	↔

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Economic Health Score (Dec 2017) - 74 ↑

- [As against 73 in Nov 2017 & 49 in Apr 2017 (9 months ago)]

# Changes to Health Score – Priority Criteria

Criteria	Update	Current Score	Add / Deduct Score	New Score
Foreign Reserves	Nov 2017 Reserves dip marginally by USD 200Mn to USD7.3Bn	14/15		14/15
Liquidity	Liquidity was above LKR 20Bn for most part of the month	09/15	+01	10/15
Inflation	CCPI at 7.6%, higher than FC Research expected target was 7.0%; Inflation remains higher than expected for the 3 <sup>rd</sup> consecutive month. Core inflation remains under control.	13/15	-02	11/15
Foreign Buying	Net inflow again accelerated to LKR 16 Bn over the last 4 weeks with foreign holdings reaching 6.7%	06/10	+02	08/10
Credit	Sep 2017 credit increased by LKR 50Bn with no signs of acceleration	09/10		09/10
CBSL Holdings	CBSL Holdings further dipped to LKR 0Bn from LKR 19Bn	10/10		10/10

Primary Criteria - 61 + 03 - 02 = 62

# Changes to Health Score – Secondary Criteria

Criteria	Update	Current Score	Add / Deduct Score	New Score
Rating Outlook	Moody's maintain negative outlook signals signs of improvement	05/05		05/05
External Environment	Fed rate hike has not signaled signs of outflow	02/05	+01	03/05
BoT & BoP	BoP was strong at USD +2.0Bn as at Sep 2017. Trade Deficit for Sep 2017 YoY remains flat	01/05		01/05
Political Risk	As LG election comes closer, policy implementation have started to get difficult	01/05	-01	00/05
Investor Confidence	LMD-Neilson Business Confidence index climbed marginally ahead of the 12 month average of 117 but behind the all time mean of 130 – 18% state that economy will improve in the coming 12 months as against 1 in 5 (21%) respondents which said the same 2 months ago and 10% 1 month ago	03/05		03/05

Secondary Criteria - 12 + 01 - 01 = 12

# 2.0 Recommendation

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# Expectations for 1Q2018 (Jan-Mar)

## PRIORITY CRITERIA

Foreign Reserves	14/15	-02
Liquidity	10/15	-01
Inflation	11/15	
Foreign Buying	08/10	-01
Credit	09/10	-01
CBSL Holdings	10/10	-01

**Total - 62/75 -06**

## SECONDARY CRITERIA

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

**Total - 12/25 +02**

$$\text{Total } 74 + (-4) + 2 = 70$$

# 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

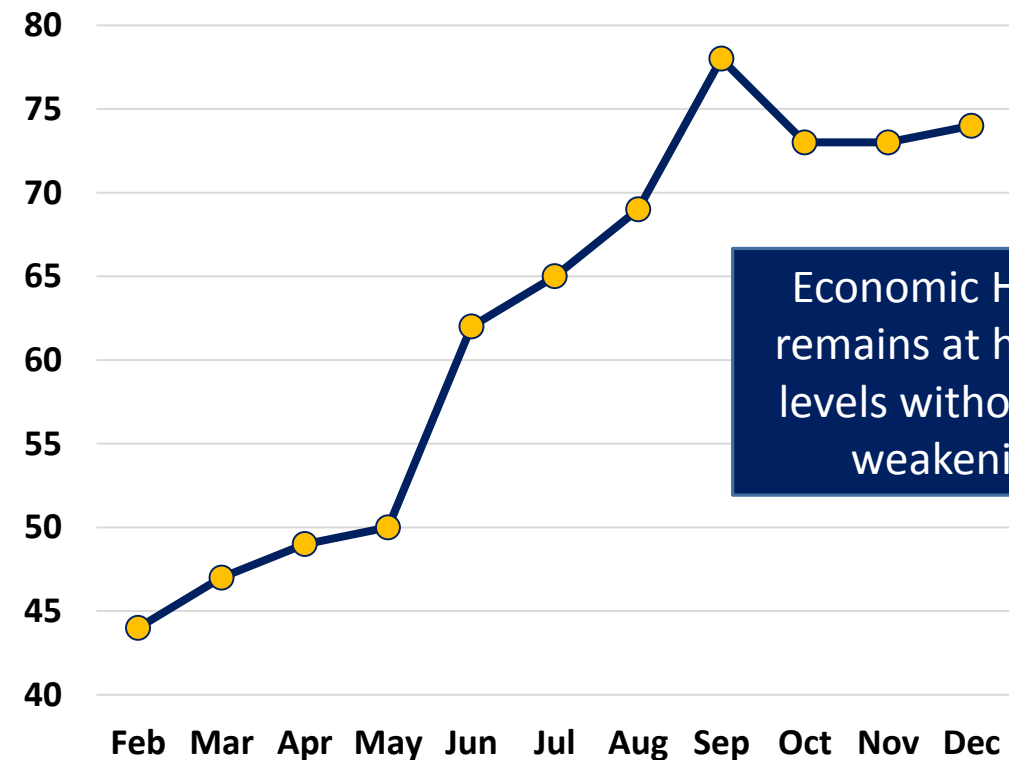
# Recommendation

## Fixed Income Portfolio Recommendation

- 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.***

### Economic Health Score



Economic Health remains at healthy levels without any weakening

Source: FC Research

# Sequence of Events

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18<sup>th</sup> Jul 2017 – Sell all longer tenors (10y, 15y, 20y, 30y) and invest in the shorter tenors. Continue to HOLD mid tenor bonds. Continue to watch out for Inland Revenue Act

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%.

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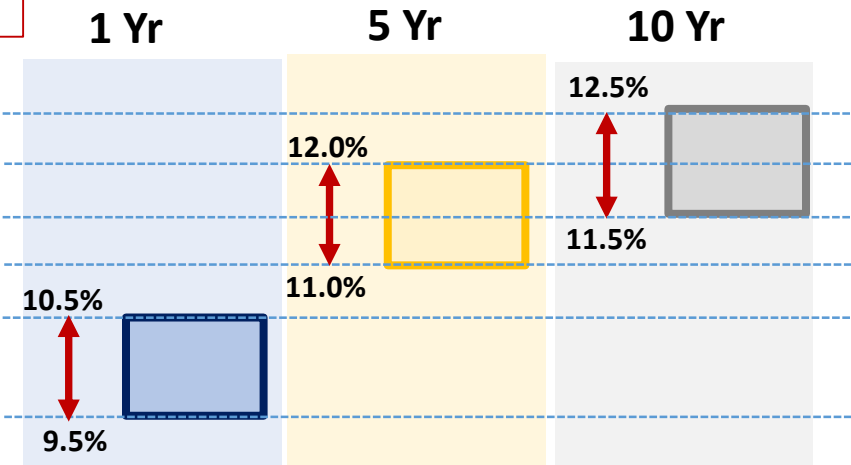
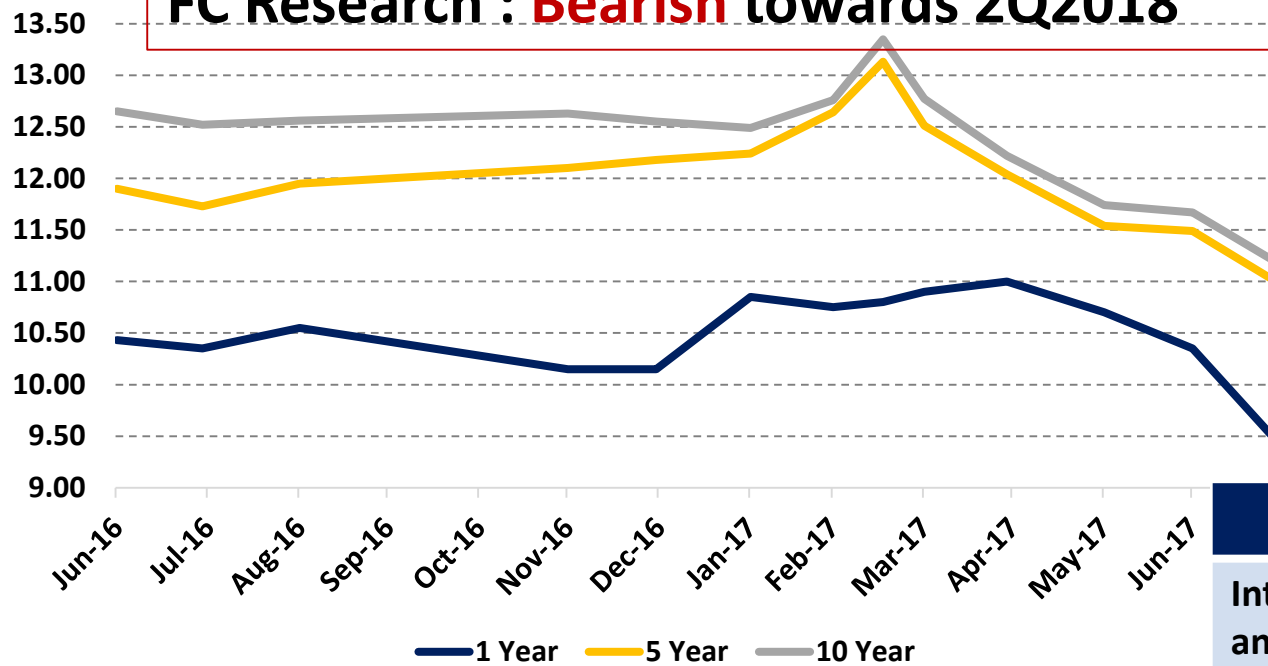
	3 Months Outlook Jul-Sep 2017	3-6 Months Outlook Oct-Dec 2017	6-9 Months Outlook Jan-Mar 2018	9-12 Months Outlook Apr-Jun 2018
Health Score Estimate	75-100	65-75	60-65	50-60
Risk Level	Remote	Medium-Low	Medium	Medium-High



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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